

A debt pandemic

Dynamics and implications of the debt crisis of 2020

Briefing Paper • March 2021

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Executive Summary

This briefing provides an overview of the dynamics and implications of the 2020 sovereign debt crisis. The apparent financial resilience of developing countries in the aftermath of the Covid-19 shock is misleading. It is the result of a combination of cyclical factors in the form of sectoral adjustments and monetary policy responses triggered by the pandemic. Promoting a prompt return of countries to international financial markets without addressing the debt vulnerabilities exacerbated by the crisis will increase the external financial fragility of developing countries. In turn, it will require a growing transfer of resources from public borrowers to their external creditors over the coming decade. Until now, countries across the world have done so at great human and social costs to their populations. Continuing down this path will sound the death knell for the commitments under the 2030 Agenda, the Paris Climate Agreement and the Beijing Declaration.

To avoid this outcome, Eurodad calls for a shift in the nature of the multilateral response to the crisis. We must start by acknowledging that the current model of development finance – built on market-based mechanisms – is fundamentally broken. To begin to fix it requires, first of all, the implementation of urgent and systemic measures aimed at the provision of immediate debt relief and the establishment of a multilateral debt workout mechanism under the auspices of the UN.

The main findings of this briefing are:

- A debt pandemic: Public debt of developing countries has increased from an average of 40.2 to 62.3 per cent of GDP between 2010 and 2020. More than one third of the increase, equivalent to 8.3 percentage points, took place in 2020. Public debt increased in 108 out of 116 developing countries in 2020. Countries that entered the crisis with the highest levels of public debt tended to experience the largest increases in 2020.
- Calm in the eye of the hurricane: The apparent financial resilience of developing countries in the aftermath of the Covid-19 shock is misleading. This is the result of a combination of cyclical factors in the form of sectoral adjustments and monetary policy responses triggered by the pandemic. A response based on renewed borrowing to address the impact of the pandemic is the equivalent of dousing a raging fire with gas. It increases the external financial fragility of developing countries. They are becoming increasingly vulnerable to sudden stops in capital flows. Furthermore, it aggravates the net transfer of resources from public borrowers to external creditors.
- A unique adjustment under lockdown measures: Lockdown measures designed to contain the spread of Covid-19 caused an improvement of trade balances of developing countries, equivalent to the difference between exports and imports, by an average of 3.1 per cent of GDP in 2020. Out of 112 countries for which data is available for the first nine months of 2020, 77 improved their trade balances. Trade dynamics helped to strengthen the reserve position of developing countries. Of 88 countries for which data is available for the first nine months of 2020, 67 increased their foreign reserves by an average of 9.2 per cent with respect to pre-crisis levels. As a result, while countries struggled to finance their response to the pandemic, external debt repayment capacity actually improved.
- Searching for yield: The search by investors for positive returns on their portfolios stabilised sovereign bond markets across the board. Sovereign bond yields across regions surged in March 2020, but proceeded to return to close or below pre-crisis levels over the following months. For at least 35 out of 57 countries with outstanding sovereign bonds, borrowing costs have fallen below pre-crisis levels. A comparison of the pattern of sovereign bond issuance throughout 2020, and the trend observed in previous years, makes it impossible to discern any signs of clear stress commensurate with the magnitude of the crisis. For sovereign bond markets, the pandemic seems to be taking place on a different planet.

- **Staggering amounts continue to be transferred to creditors:** The crisis led to a net negative transfer on external public debt of developing countries of US\$ 194 billion in 2020. The public sector transferred resources to their creditors on a net basis in at least 58 countries. This figure is a damning indictment of the inadequacy of the ongoing multilateral response to the crisis. It is unconscionable that the public sector of developing countries has been forced to transfer such a staggering amount of resources to its external creditors in the middle of a global pandemic. Piling on more debt in response to the pandemic will only increase the required transfers to external creditors in the future.
- **Debt, austerity and long-term scars:** With more debt and no relief in sight, developing countries will be forced to implement austerity measures on an unprecedented scale. Primary expenditures are projected to contract below pre-crisis levels in at least 70 countries by 2025. The widespread decline in expenditures runs counter to the investments required to meet the commitments under the 2030 Agenda, the Paris Climate Agreement and the Beijing Declaration.
- **An unsustainable burden:** In a post-crisis context marked by debt and austerity, developing countries will be left with even less resources to invest in public services to protect the lives and livelihoods of local populations. A large number of countries in the developing world are already allocating more resources to debt service than to either public health care or education. External public debt service was larger than health care expenditure in at least 62 countries in 2020. Furthermore, external public debt service was larger than education expenditure in at least 36 countries in 2020.

A distinct crisis calls for a different approach: The prioritisation of creditor rights over the livelihoods of the population of developing countries is a well-known dead-end. Instead, the international community must recognise that the health and wellbeing of millions of people in developing countries is a precondition for debt sustainability. It will be impossible to achieve one without the other. An effective response to the crisis must start by acknowledging that the current model of development finance built on market-based mechanisms is fundamentally broken. To begin to fix it requires, among others, the implementation of urgent and systemic measures aimed at the provision of immediate debt relief and the establishment of a multilateral debt workout mechanism under the auspices of the UN.

A debt pandemic: Dynamics and implications of the debt crisis of 2020

Covid-19 had a devastating impact on developing countries in 2020. The combination of economic, health and social consequences of the pandemic created an extreme degree of uncertainty in the global economy. The International Monetary Fund (IMF), World Bank and the United Nations Conference on Trade and Development (UNCTAD) delivered warnings regarding a wave of sovereign debt defaults in developing countries.² Yet, despite all the visible human and social impacts of the pandemic, ranging from strained health care systems, hundreds of millions of young people out of schools and an alarming increase in global poverty, the feared wave of defaults has thus far failed to materialise.³

Countries across the world have met their debt service requirements at great human and social costs to their populations. This is a result of the unique nature of the crisis. The pronounced deterioration in the economic situation of developing countries has had a muted effect on the availability and cost of external finance. The combination of the impact of lockdowns in developing countries and monetary policies in Advanced Economies (AEs) seems to have upended observed patterns of sovereign debt distress registered in previous crises.⁴ The drastic adjustment of consumption caused by the lockdowns pre-empted the painful process of adjustment that usually occurs in the aftermath of a debt crisis.

From an historical perspective, this is both remarkable and unsustainable. Even in the absence of further shocks, the increase in debt burdens caused by the crisis limits the capacity of developing countries to protect the lives and human rights of their populations. Avoiding a missed payment to international creditors pales in significance compared to the mass default on the basic obligations of States to their citizens across the world.

Against this background, it is key to understand the dynamics and implications of the 2020 sovereign debt crisis. A misdiagnosis of the nature of the dilemmas faced by developing countries risks aggravating the underlying problem. Reliance on debt-creating capital flows to address the impact of the pandemic is the equivalent of dousing a raging fire with gas. It simultaneously increases external financial fragility of developing countries and aggravates the net transfer of resources from public borrowers to external creditors. This will systematically detract from the efforts of developing countries to recover from the pandemic and achieve the goals set under the 2030 Agenda, the Paris Climate Agreement and the Beijing declaration.

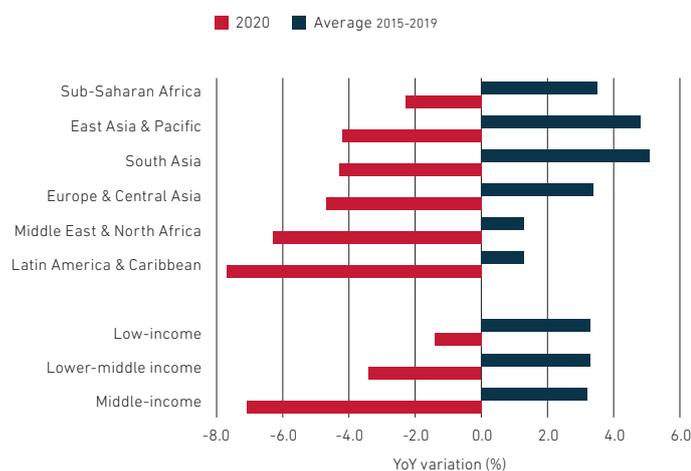
Instead, an effective response to the crisis must start by acknowledging that the current model of development finance built on market-based mechanisms is fundamentally broken. To begin to fix it requires, first of all, the implementation of urgent and systemic measures aimed at the provision of immediate debt relief and the establishment of a multilateral debt workout mechanism under the auspices of the UN.⁵

The briefing is structured as follows. The first section provides an overview of the impact of the pandemic on developing countries. A second section analyses the dynamics of adjustment in the context of the crisis of 2020. The third section discusses the implications of key debt trends for developing countries in the near future. Section four concludes with policy recommendations.

Surveying the impact of the pandemic in developing countries: Growth, fiscal balances and debt

Developing countries experienced a major economic shock as a result of the pandemic. The IMF projects an average decline in Gross Domestic Product (GDP) of 4.5 per cent for developing countries in 2020.⁶ The most affected regions were Latin America and the Caribbean (LAC) and the Middle East and North Africa (MENA). These experienced declines of 7.7 and 6.3 per cent of GDP respectively (Figure 1). In the case of the former, the large GDP contraction can be attributed to the impact of lockdowns and the unchecked spread of Covid-19 in the region.⁷ As a result, at least 45 million people are expected to fall into poverty.⁸ For the latter, a sharp decline in oil exports played a central role in explaining the economic contraction in 2020.⁹ The number of poor in the region is projected to increase by six million people.¹⁰

Figure 1: GDP growth in developing countries – Country average variation per region and income group (2015-2020)

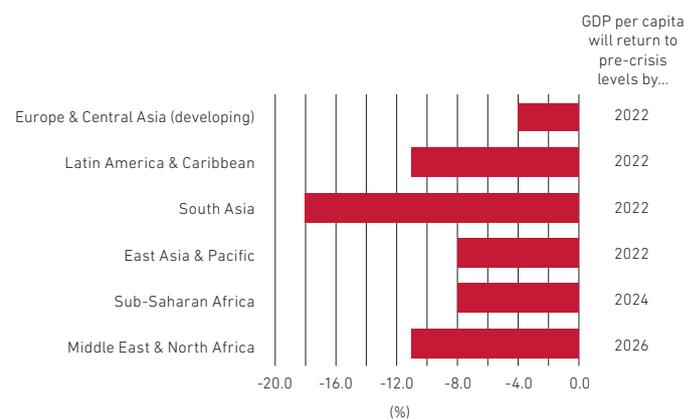


Source: Eurodad calculations based on IMF World Economic Outlook (WEO) October 2020

On an income basis, middle-income countries experienced the largest drop in GDP, equivalent to 7.1 per cent. The large decline in this group is explained by the large number of middle-income countries present in the LAC and MENA regions. It is interesting to note that low-income countries are projected to register the smallest decline amongst developing countries. This can also be partly attributed to the overlap between this classification and the sub-Saharan Africa country grouping. Lower infection levels, compared to other developing regions, and the quick recovery of metal exports from sub-Saharan Africa help to explain this outcome.¹¹ The decline in GDP is expected to push 51 million people in the region into poverty.¹²

The magnitude of the setback can be illustrated by comparing the projected decline of GDP in 2020 with growth rates observed in the years previous to the crisis. For most regions, the decline in GDP was equivalent to several years of economic growth. For example, for the LAC and MENA regions, the decline of 2020 is equivalent to six and five years of growth respectively. Making up the lost ground will be extremely difficult. In the scenario of a strong recovery, under the assumption of availability of a vaccine, the IMF projects that GDP levels of developing countries will be at least 4.6 per cent below pre-crisis projections by 2022.¹³ Even assuming a strong recovery, GDP per capita levels will take anywhere from two to five years to return to pre-crisis levels (Figure 2).

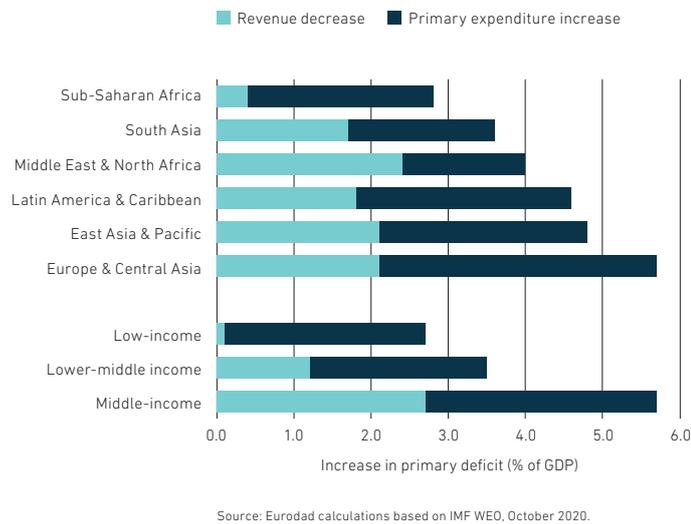
Figure 2: GDP per capita declines (2019-2020)



Source: Eurodad calculations based on Refinitiv data.

The economic contraction had a substantial knock-on effect on fiscal balances. The primary deficit, equivalent to government revenues minus expenditures excluding net interest payments, increased on average by 4 per cent of GDP in 2020. The sharpest deterioration in the government balance took place in Europe and Central Asia and East Asia and the Pacific. The primary deficit of governments in these regions increased by 5.7 and 4.8 per cent of GDP respectively (Figure 3). Re-organising countries on an income basis shows that middle-income countries experienced the biggest increase in their primary deficit (5.2 per cent of GDP).

Figure 3: Change in primary fiscal deficit of developing countries as % of GDP. Country average variation per region and income group (2019-2020)



The variation in fiscal responses across regions and income levels can be disaggregated on the basis of the evolution of government revenues and expenditures. Government revenues of developing countries are projected to decline by an astonishing US\$ 766 billion in 2020. Middle-income countries are expected to experience a sharp contraction of revenues, equivalent on average to 2.1 per cent of GDP. The sizable decline in government revenues for this group, relative to low-income countries, can be attributed to the use of discretionary policy measures.¹⁴ These include policies such as tax reductions and amnesties for individuals and corporations designed to protect income and employment.¹⁵ In addition, middle-income countries increased expenditures by three per cent of GDP. Most of the increase was related to measures designed to contain the economic and health impacts of the pandemic.¹⁶ Meanwhile, low-income countries concentrated in sub-Saharan Africa did not have the flexibility to implement a fiscal response on a similar scale to protect their population.

The combination of GDP contractions and higher government deficits caused a surge in public debt levels of developing countries. Public debt rose from an average of 40.2 to 62.3 per cent of GDP between 2010 and 2020. More than a third of the increase, equivalent to 8.3 percentage points, took place in 2020. The impact of the pandemic on debt levels varied across regions and income levels (Figure 4). Public debt increased the most as a result of the pandemic in South Asia and LAC regions. A more granular analysis shows that the impact of the crisis on debt levels was ubiquitous and exacerbated existing debt vulnerabilities. Public debt increased in 108 out of 116 developing countries in 2020. Countries that entered the crisis with the highest levels of public debt tended to experience the largest increases in 2020 (Figure 5).

Figure 4: Public debt of developing countries as % of GDP. Country average level and variation per region and income group (2019-2020)

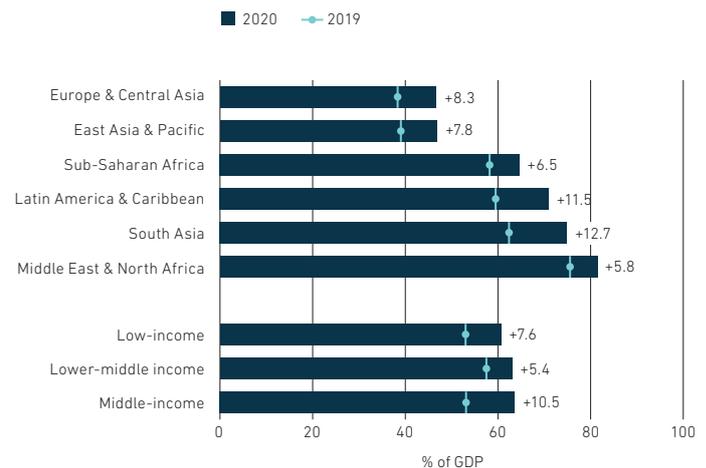
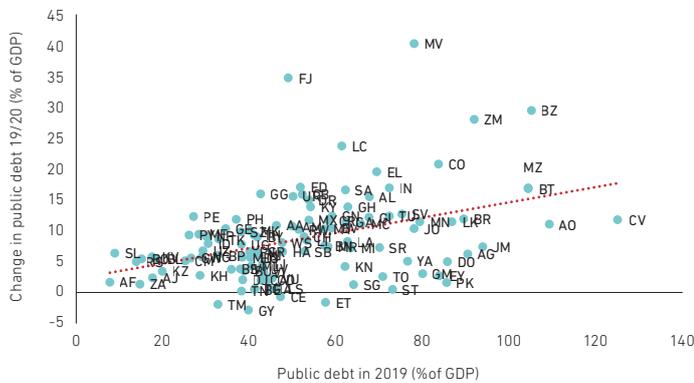


Figure 5: Public debt variation per country as % of GDP (2019-2020)



Source: Eurodad calculations based on IMF WEO, October 2020.

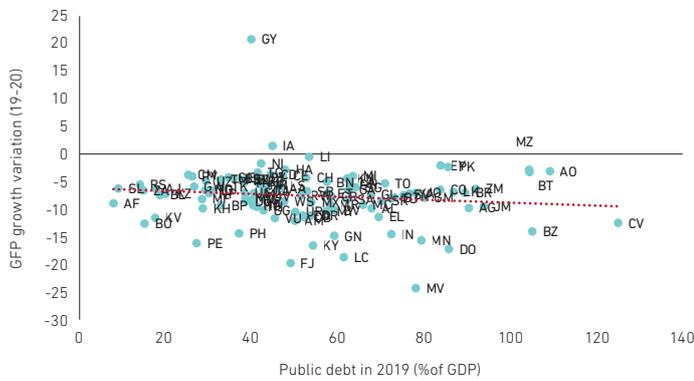
This dynamic is important for at least three reasons. First, the global character of the shock highlights the shortcomings of the ongoing multilateral response to the crisis. The G20 Debt Service Suspension Initiative (DSSI) and Common Framework for Debt Treatments beyond the DSSI only provide support to International Development Aid (IDA) countries and least developed countries. While the G20 DSSI provided a minimum degree of support to participant countries, the selection criteria leaves out most low-middle and middle income countries.¹⁷ It is precisely these groups of countries which have experienced the highest increase in debt levels (Figure 4). According to the World Bank, more than four-fifths of the total new poor from the pandemic will arise in these countries¹⁸.

Second, heavier debt burdens will limit the capacity of governments to support a sustainable recovery going forward. Without multilateral support to address debt vulnerabilities, developing countries will be forced to rely on self-defeating fiscal adjustments. The prioritisation of fiscal adjustment over recovery and development spending is ubiquitous amongst countries that have received IMF loans in the context of the pandemic.¹⁹ A premature and synchronised fiscal adjustment across developing countries will derail any prospect of a swift recovery and place the achievement of the 2030 Agenda hopelessly out of reach (see section 3).

Third, it is noticeable that the crisis did not cause a wave of defaults as was feared early on.²⁰ As of January 2021, only Belize, Suriname and Zambia have defaulted on their external public debts. These countries were already in a situation of debt distress before the pandemic.²¹ The resilience of other developing countries is an unexpected development. Global financial shocks have wreaked havoc in the past through different channels. High levels of public debt have been found to amplify the transmission of shocks to borrowing costs.²² As these increase, countries are likely to suffer deeper economic downturns.²³ Loss of market access and rising interest rates weaken the capacity of governments to play a stabilising role in the aftermath of a shock. Countries with high levels of debt often find themselves constrained to pursue counter-cyclical policies during a crisis.²⁴ This can trigger a doom loop cycle of rising borrowing costs, fiscal adjustment and unsustainable debt.

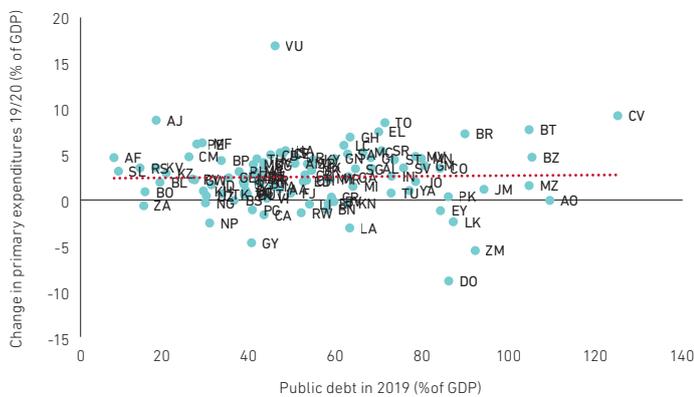
However, there is no evidence that these patterns of financial distress were at play in 2020. Public debt levels did not appear to have an immediate impact on the magnitude of either the economic shock or policy response in developing countries. Economies with high levels of debt did not contract more than those with lower levels of debt (Figure 6). Furthermore, the emergency response to the pandemic, measured by the change in primary public expenditures, did not seem to be constrained by existing levels of public debt (Figure 7). These patterns highlight the unique nature of the crisis. Thus, established assumptions of the dynamics of financial distress in developing countries need to be revisited in the context of the pandemic. A possible explanation is that the combination of adjustment patterns related to lockdown measures and financial and monetary policies put in place in AEs eased short-term financing constraints for most developing countries. The analysis now turns onto these issues.

Figure 6: GDP growth and public debt as % of GDP (2019-2020)



Source: Eurodad calculations based on IMF WEO, October 2020

Figure 7: Primary public expenditure and public debt per country as % of GDP (2019-2020)



Source: Eurodad calculations based on IMF WEO, October 2020

Then and now: adjustment and debt distress in the context of the pandemic

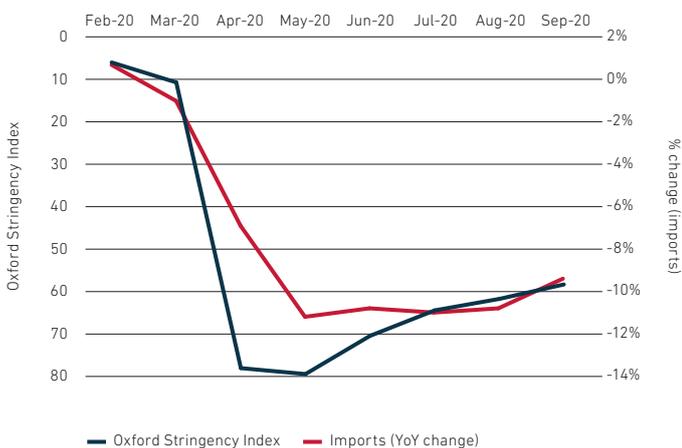
The anatomy of a “typical” debt crisis in developing countries has shown recognisable patterns in the past.²⁵ Debt crises have followed a boom-bust cycle tied to financial conditions in AEs. Increases in liquidity in AEs, caused by factors such as financial innovation, institutional developments or changes in monetary policy, can set off a wave of capital flows to developing countries.²⁶ Surges in capital flows then lead to bubbles in the prices of financial assets. Trade balances experience a substantial deterioration as consumption and imports boom.²⁷ A deterioration in the liquidity conditions in AEs sets the process in reverse, often in a dramatic fashion. Reduced availability of financing and capital outflows trigger increases in real interest rates and financial distress. Borrowers unable to meet their debt obligations are forced into defaults and restructuring. Countries then undergo a process of adjustment designed to compress domestic absorption of resources and improve their trade balance to meet outstanding claims.²⁸ The shock is swift while the process of adjustment is often long and difficult.²⁹

The crisis in 2020 didn’t follow this pattern on two accounts. First, the process of external adjustment took place swiftly during the shock, instead of after. Lockdown measures implemented to contain the spread of Covid-19 caused a sharp reduction of consumption and imports. As a result, most developing countries experienced an improvement of their trade balances and levels of foreign reserves through 2020. Second, monetary policies in AE stabilised the global financial system shortly after the initial shock caused by the pandemic.³⁰ After a record capital outflow from developing countries in March 2020, capital inflows resumed in April, gathering pace throughout the year.³¹ These trends maintained government liquidity and repayment capacity to external creditors during the crisis. In a context marked by extreme uncertainty and the threat of credit rating downgrades, the prioritisation of debt repayments came at the expense of stronger policy measures to protect the lives and human rights of local populations. This dynamic had a substantial impact in low-income countries (see Figure 3). The discussion will now turn to the analysis of these two processes.

Lockdowns and external adjustment in developing countries

The spread of the pandemic led to the imposition of lockdown measures across developing countries. Measures designed to reduce people’s mobility and contain the spread of the disease were rapidly scaled up throughout the world in the second quarter of 2020. The side effects of these measures included a drastic reduction in consumption and imports. By May 2020, imports by developing countries fell by more than 10 percent with respect to the amounts observed in 2019.³² While lockdown measures have been eased since, imports have remained at depressed levels (Figure 8).

Figure 8: Lockdown measures* and imports of developing countries (2020)**



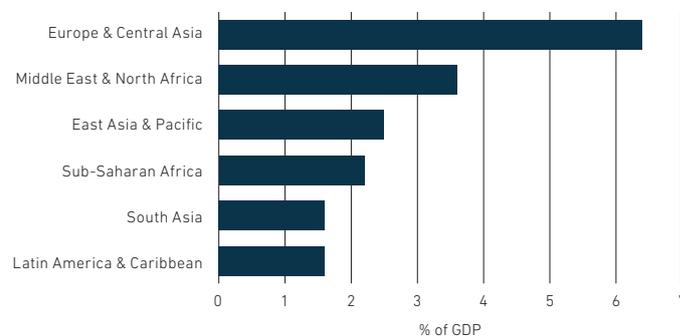
*As measured by the Oxford stringency index. The index records the strictness of 'lockdown style' policies that primarily restrict people's behaviour, including measures such as workplace and school closures. The index ranges from 0 to 100. A higher number indicates stricter restrictions. Figure represents the index monthly average for 106 developing countries for which data was available through Q3 2020.³³

**Cumulative year-on-year change in value of imports measured in US Dollars for 112 developing countries for which data was available through Q3 2020.

Source: Eurodad calculations based on Refinitiv data.

The adjustment caused by the lockdowns improved trade balances of developing countries by an average of 3.1 per cent of GDP in 2020. Out of 112 countries for which data is available for the first nine months of 2020, 77 improved their trade balances (Figure 9). This can be linked to both the impact of the lockdowns on imports as well as resilience of exports to China.³⁴ Trade dynamics helped to strengthen the reserve position of developing countries. This stands in stark contrast to the experience of the 2008 crisis, where most developing countries across regions registered substantial declines (Figure 10). Of 88 countries for which data is available for the first nine months of 2020, 67 increased their foreign reserves by an average of 9.2 per cent with respect to pre-crisis levels. Most of the countries that registered increases were low-middle (30) and middle-income (29) countries. This would indicate that in addition to trade balances, capital inflows to frontier and emerging markets played a role in the process of accumulation of reserves after the initial shock (see next subsection).

Figure 9: Change in trade balances of developing countries as % of GDP. Country average variation per region (Q1-Q3 2019-2020)



Source: Eurodad calculations based on Refinitiv data.

Figure 10: Change in foreign reserves of developing countries – Country average variation per region (2008-2009 / 2019-2020)



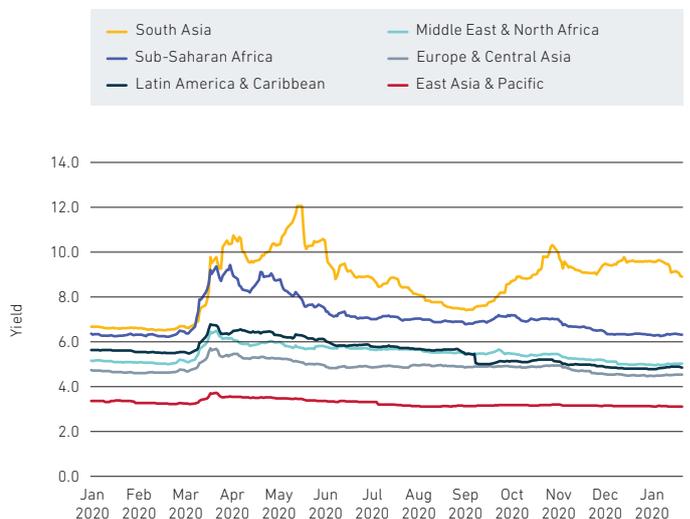
The implications of this pattern of adjustment for government debt and financing are substantial (see Box 1). A significant share of excess savings of the private sector, intermediated by domestic financial institutions, ended up financing the increase in government spending (see Figure 3). The depth and degree of sophistication of the domestic financial sector helped to ease financial constraints faced by governments in the aftermath of the pandemic. Countries with deeper financial systems are in a better position to intermediate a process of rebalancing across sectors.³⁵ In addition, central banks of developing countries played a supportive role with across the board interest rate cuts.³⁶ Furthermore, this process was accompanied by central bank bond purchases as a mechanism to ease the strain on domestic financial markets.³⁷ Low-income countries were likely not able to take advantage of this mechanism to the same extent. However, anecdotal evidence from countries such as Ghana and Kenya shows domestic financial systems helped to meet the increase in government financing needs observed in 2020.³⁸ Taken together, both sectoral balances adjustments, and financial depth, offset the risk of widespread debt distress in developing countries. They also received a helping hand from monetary authorities in AEs.

Monetary easing and external financial conditions

The extreme uncertainty caused by the pandemic led to a sudden stop in financial markets in March 2020. Developing countries experienced sharp exchange rate depreciation and were all but shunned from the global financial system.³⁹ Emerging markets experienced record capital outflows of nearly US\$ 100 billion.⁴⁰ Central banks in AEs reacted swiftly to stabilise the system. This included measures such as interest rate cuts, emergency liquidity provision and foreign currency swaps.⁴¹ The response alleviated the pressure on the system shortly afterwards.

One of the side effects of the response was an increase in negative-yielding debt which climbed to an all-time high of US\$17.5 trillion.⁴² This pushed investors into riskier markets as they searched for yield. After the sudden stop observed in March 2020, capital inflows to emerging markets resumed in April gathering pace throughout the rest of the year.⁴³ This dynamic stands in stark contrast to historical episodes of financial distress where capital inflows took years to resume.⁴⁴

Figure 11: Sovereign bond yields* – Bond average per region (2020-2021)



*Average yields for bonds maturing after 01/01/20.
Source: Eurodad calculations based on Refinitiv data.

Box 1: Covid-19 lockdowns and sectoral patterns of adjustment⁴⁵

External adjustment reflected an equally important process of domestic rebalancing. This can be explained through the national accounting definition of income and expenditure. National income is determined by the aggregate of private and government expenditure and net exports. The balance of the private sector is equal to the trade balance minus the government balance. Thus, for an open economy macroeconomic equilibrium in the level of income requires:

$$0 = (S-I) + (T-G) - (X-M)$$

Where *S* represents the savings of the private sector, *I* is investment expenditure, *T* is taxation of income, *G* is government expenditure, *X* is exports and *M* is imports.

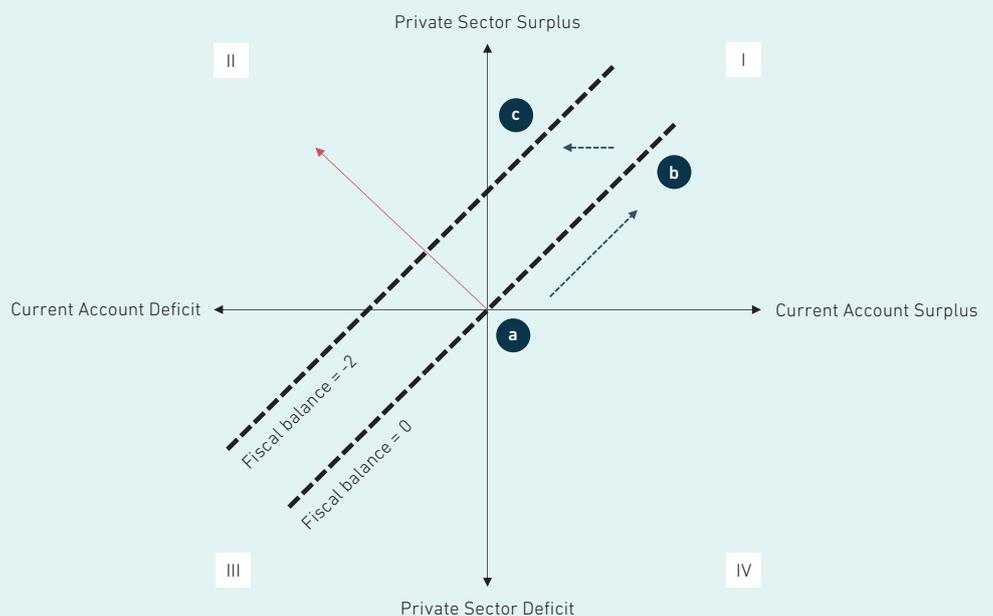
The private and public sectors can achieve a surplus (where $S > I$ and $T > G$) if – and only if – there is a current account surplus ($X > M$) sufficiently large to compensate it. A key insight from this model is that financial stability can only be secured when both the government and the private sector secure surpluses consistent with an external surplus. Other combinations yield rising domestic and/or external financial fragility as they lead to the accumulation of domestic and/or external debt by the private and/or public sector.

These relationships can be presented graphically following Robert Parenteau sectoral balances diagram (below). The graph represents three balances in two dimensions. The graph is normalised on the basis of balance in one of the three sectors to show the compatible positions of the other two. The vertical axis shows the financial position of the combined private sector, with a saving surplus represented by a positive sign (above the horizontal line) and a deficit position of increasing debt a negative sign (below the horizontal line). The horizontal axis shows a current account surplus as a positive sign (to the right of the vertical line) and a deficit as a negative sign (to the left of the vertical line). The 45 degree line through the origin which shows the combination of private sector and external sector positions compatible with government fiscal balance ($T-G=0$).

This framework allows a visualisation of the patterns of sectoral adjustment triggered by the pandemic. Lockdowns precipitated a collapse of consumption which increased the surplus of the private sector (point b in the figure). The involuntary increase in savings of the private sector forced by the pandemic must have been channelled as either capital outflows to the rest of the world, understood as the mirror image of a trade surplus, or financing for a government deficit (point c in the figure). This dynamic eased the financing constraints faced by governments in developing countries as they tackled the impact of the pandemic in 2020.

Covid-19 initial adjustment

- a. Initial equilibrium
- b. Lockdowns reduce consumption. Private surplus increases.
- c. Health emergency increases government deficit (shift to left).



The search for yield stabilised sovereign bond markets across the board. Sovereign bond yields across regions surged in March 2020, but proceeded to return to close or below pre-crisis levels over the following months (Figure 11).⁴⁶ For at least 35 out of 57 countries with outstanding sovereign bonds, borrowing costs have fallen below pre-crisis levels.⁴⁷ However, while borrowing costs have declined, issuance of new bonds has remained restricted to countries with high credit ratings.⁴⁸ These took full advantage of the search for yield. Issuance of sovereign bonds by 29 developing countries reached US\$ 173 billion in 2020. Excluding the issuance of bonds under the debt restructurings that took place in Argentina and Ecuador, the figure declines to US\$ 88 billion.⁴⁹ This is still above the levels observed in previous years (Figure 12). A comparison of the pattern of sovereign bond issuance throughout 2020, and the trend observed in previous years, makes it impossible to discern any signs of clear stress commensurate with the magnitude of the crisis (Figure 13). For sovereign bond markets, and financial markets in general, the pandemic seems to be taking place on a different planet.

The extreme degree of disconnection between the economic dislocation brought about by the pandemic and the evolution of global financial conditions helps to contextualise the positions of multilateral organisations such as the IMF and the United Nations Economic Commission for Africa (UNECA). The former has grown increasingly confident in the capacity of policy measures put in place to contain the risk of a widespread sovereign debt crisis. Distress is expected to remain concentrated in a few high-risk countries.⁵⁰ The latter has framed the crisis as a liquidity problem.⁵¹ On this basis, UNECA is advocating against the provision of debt relief involving private creditors for fears of damaging market access.⁵² The problem with an approach that focuses on financial conditions is that it misses the forest for the trees. Piling more debt onto developing countries will only cause them more harm. To understand why that is the case it is necessary to turn our attention to the architecture of global development finance and its often misunderstood role in the provision of resources for developing countries.

Figure 12: Sovereign bond issuance by developing countries (exc. China) – US\$ Billions (2016-2020)

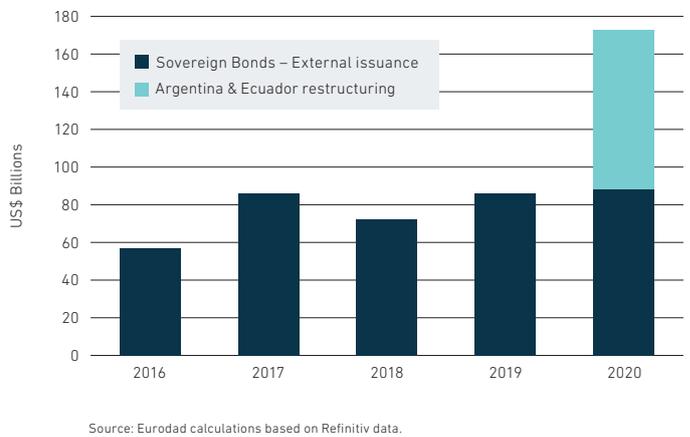
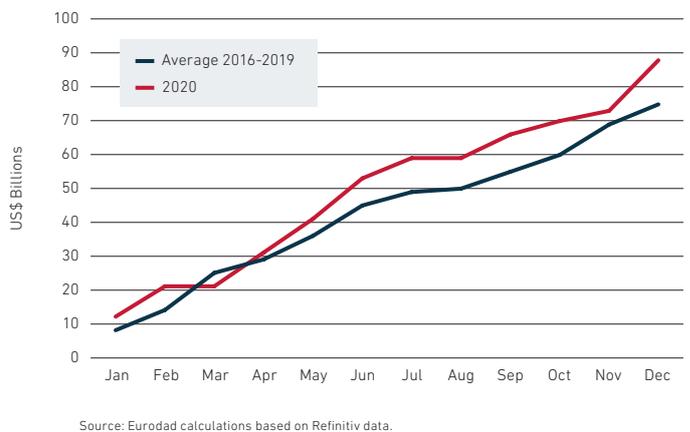


Figure 13: Sovereign bond issuance per month by developing countries (exc. China) – US\$ Billions (2016-2020)



The structural implications of the 2020 crisis

The issue of net transfers on external public debt

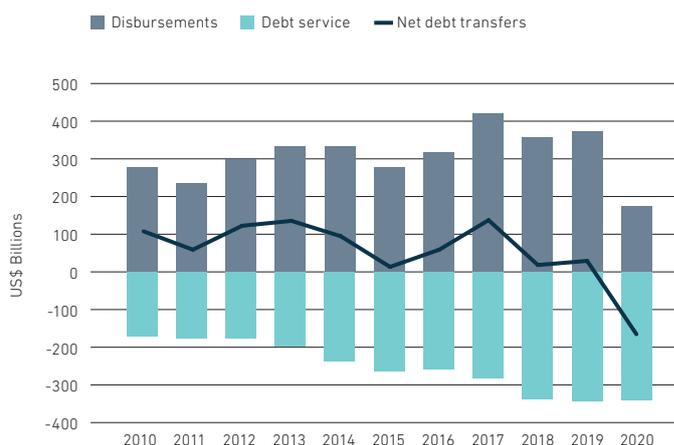
The current framework of development finance is premised on the need for external financing flows to support the process of economic development.⁵³ However, the shift from public development finance on concessional terms to private finance on market terms that took place starting in the 1970s turned this framework into a double-edged sword for developing countries.⁵⁴ While in specific situations external capital flows can play a supportive role in fostering growth and development, they also promote the structural transfer of resources from developing to developed countries. This dynamic is known in the literature as a net negative resource transfer. These transfers have been persistent over the last two decades, reaching as much as US\$ 977 billion in 2012.⁵⁵ Thus, the current system of development finance does not add, but rather subtracts from, available domestic resources of developing countries to support their own development.

To appreciate the structural implications of the 2020 crisis it is necessary to understand the role of net transfers on external debt of the public sector within this broader dynamic. These are defined as total disbursements minus external debt service of the public sector. A negative transfer shows net transfers made by a public borrower to its external creditors.⁵⁶ Historically, net transfers on external public debt have shown a pro-cyclical nature.⁵⁷ Periods of growth are correlated with high amounts of disbursements and net positive transfers. Once a financial shock takes place, the process is set in reverse motion. Disbursements dry down while the accumulation of debts over previous years leads to rising debt service needs and net negative transfers. Thus, at a time of crisis, the public sector in developing countries ends up transferring resources to creditors when they can afford it the least.

In this context, a debt crisis can then be understood as persistent net negative resource transfers from the public sector in the aftermath of a shock. In cases where countries can avoid a default, the costs of debt distress accumulate over time as adjustment frees up domestic resources to transfer to external creditors. In other cases where a debtor is unable to meet external debt service, this leads to default and front-loaded adjustment. The most severe debt crises involve a combination of both scenarios, with countries struggling for years and eventually defaulting on their external debt.

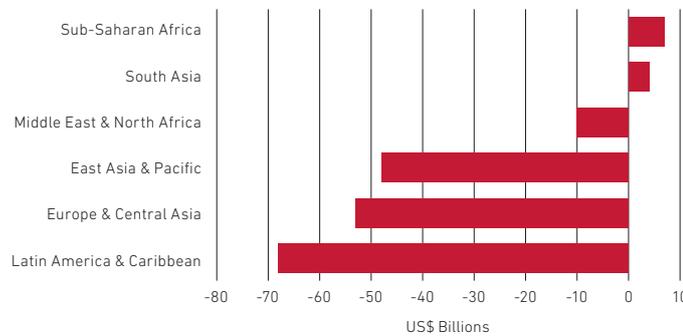
There are two ways to address the problem of net negative transfers. On the one hand, debts can be restructured upfront in line with post-crisis repayment capacity. This option frees up resources for investment and imports required to support a recovery which benefits both the domestic and global economy.⁵⁸ On the other hand, a country can gamble for redemption, by returning to international markets for new rounds of borrowing. In this scenario, debt repayments are prioritised, leaving scant resources available for investment in a recovery. Historically, creditors have favoured the second approach as it allows them to delay the recognition of losses and shift them onto debtor countries.⁵⁹ Meanwhile, developing countries are left in an endless loop of debt, external financial fragility and adjustment.

Figure 14: Public sector net external debt transfers by developing countries (exc. China) – US\$ Billions (2016-2020)



Source: Eurodad calculations based on World Bank International Debt Statistics (IDS) 2020

Figure 15: Public sector net external debt transfers by region (exc. China) – US\$ Billions (2020)



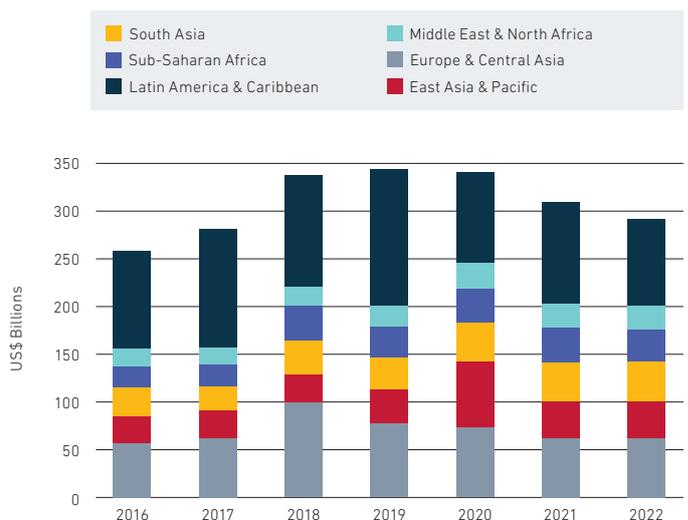
Source: Eurodad calculations based on World Bank International Debt Statistics (IDS) 2020

The evolution of net transfers on external debt over the last decade is a clear warning sign that this pattern of crisis and adjustment is about to repeat itself. 2020 was just the first phase of the process of net negative transfers from the public sector of developing countries (Figure 14). Over the last decade, net resource transfers on external public debt have steadily declined as a result of growing external debt burdens. Public debt service doubled from US\$ 171 billion to 341 billion between 2010 and 2020.⁶⁰ The precarious pre-crisis balance was thrown into disarray as disbursements declined sharply in the context of the pandemic. Notwithstanding the resilience of sovereign bond markets discussed in the previous section, the World Bank projects that the contraction in disbursements will lead to a net negative transfer on public debt of US\$ 167 billion.ⁱ The public sector in at least 58 countries transferred resources to their creditors on a net basis in 2020. Most of the negative transfers were concentrated in lower-middle and middle-income countries in Asia and LAC (Figure 15). This figure is a damning indictment of both the international financial architecture and the inadequacy of the ongoing multilateral response to the crisis.⁶¹ It is unconscionable that the public sector of developing countries has been forced to transfer such a staggering amount of resources to its external creditors in the middle of a global pandemic.

How the crisis will evolve will depend on the way the net transfer of resources from public debtors to creditors is addressed. The multilateral response, embodied in the G20 DSSI and Common Framework, has explicitly excluded measures to reduce the debt burdens of developing countries or substantially increase official non-debt creating capital flows. This leaves the option of adjustment and encouragement of debt-creating capital flows. However, a sharp increase in disbursements would further increase public debt of developing countries at a time when it is already at a historical high.⁶² This would increase external debt service requirements in the coming years, especially if disbursements take the form of commercial lending at market rates. In addition, it will further expose developing countries to the impact of sudden stops in capital flows.

An overview of debt service requirements in the coming years already shows a concerning picture. Debt service is projected to average US\$ 300 billion over the next two years (Figure 16). Debt repayments on sovereign bonds are projected to increase by 62 per cent over the next five years, reaching US\$ 83.7 billion in 2025 (Figure 17). Thus, just in order to avoid persistent net negative transfers on public debt, debt disbursements would have to at least return to pre-crisis levels. This will probably lead to a divergence amongst developing countries in terms of their ability to attract capital flows.

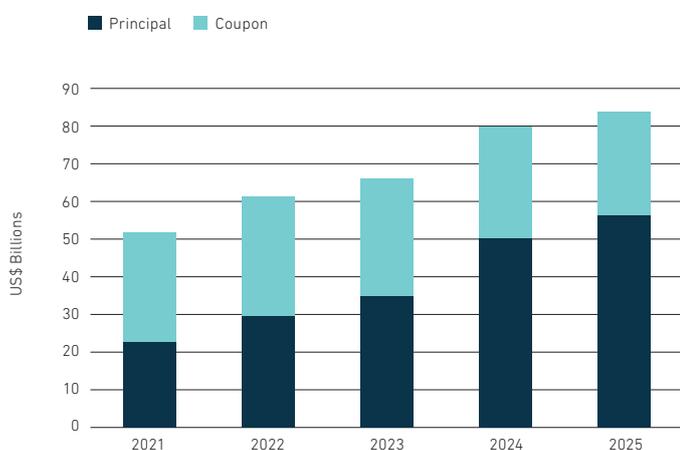
Figure 16: External public debt repayments per region (exc. China) – US\$ Billions (2016-2022)



Source: Eurodad calculations based on World Bank IDS 2020.

ⁱ This figure excludes net transfers on public debt for China. For all developing countries, the figure on net negative transfers on public debt reached US\$ 194 billion in 2020.

Figure 17: Repayment schedule of sovereign bonds of developing countries (exc. China) – US\$ Billions (2021-2025)



Source: Eurodad calculations based on Refinitiv data.

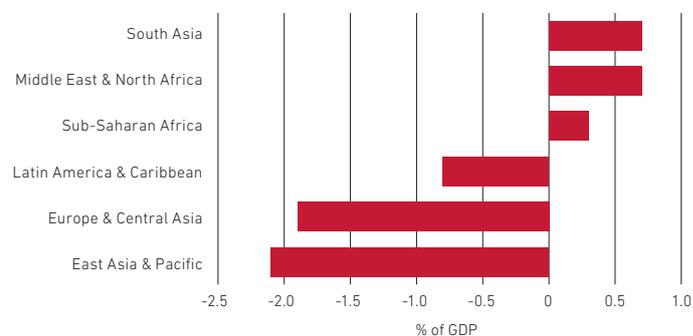
Developing countries that can manage to entice the return of investors will have to deal with an increase of their external financial fragility as most of their borrowing will be used to rollover existing liabilities. A profile of financing in which borrowing takes place solely to cover debt repayments represents the most extreme case of financial fragility. In this scenario, the main objective of debtors is not to convince the creditors of the viability of the projects being financed, but simply that they will be able to continue to borrow in the future to meet debt service. As soon as a debtor is unable to convince their creditors of their ability to continue borrowing, the pyramid scheme crashes down.⁶³ This dynamic is known as “Ponzi” financing.⁶⁴ By touting access to international financial markets as the long-term solution to the crisis, institutions such as the IMF and UNECA are herding a number of developing countries towards this financial cliff.

Meanwhile, vulnerable countries facing declining disbursements and persistent net negative transfers on debt will have to go through a painful process of adjustment. Regardless of whether the adjustment allows countries to avoid a default, they will be forced to provide for a steady transfer of domestic resources to their external creditors over the coming years. As a result, resources will be shifted away from the investments required to meet their commitments under the 2030 Agenda, the Paris Climate Agreement and the Beijing Declaration. This makes it clear that debt relief should not be seen as an act of charity. It must be understood as a prerequisite to preserve domestic resources and prioritise their mobilisation towards the accomplishment of the most important goals of the multilateral agenda.

Austerity measures and repayment capacity post Covid-19

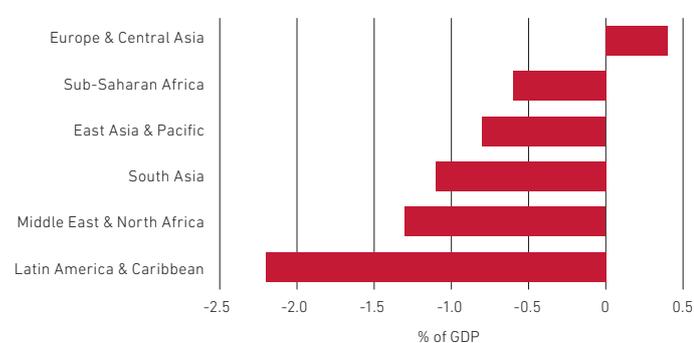
The risk of debt distress faced by developing countries in the aftermath of the pandemic is compounded by complex fiscal and sectoral dynamics. IMF projections show that developing countries are confronted by a Sisyphean adjustment (see Box 2). The crisis is projected to leave long-term scars on the capacity of governments to mobilise domestic revenues. Government revenues are expected to remain below pre-crisis levels over the medium term in at least 58 countries. The regions most affected by these dynamics are East Asia & Pacific and Europe & Central Asia (Figure 18). Difficulties to raise revenues will cause in turn a long-term reduction in expenditures. Primary expenditures are projected to contract below pre-crisis levels in at least 60 countries. Countries in LAC and MENA regions are expected to be the worst hit by the austerity wave (Figure 19). This widespread decline in expenditures runs counter to the required investments to meet the commitments under the 2030 Agenda, the Paris Climate Agreement and the Beijing Declaration.

Figure 18: Variation in government revenues as % of GDP – Country average per region (2019-2025)



Source: Eurodad calculations based on IMF WEO, October 2020

Figure 19: Variation in government primary expenditure as % of GDP – Country average per region (2019-2025)



Source: Eurodad calculations based on IMF WEO, October 2020.

Coupled with the deterioration of debt service ratios as a result of the pandemic, these dynamics paint a concerning picture for developing countries. The prioritisation of debt repayments in an attempt to either secure or retain access to international financial markets will be a developmental catastrophe. Over the last five years, the share of public external debt service in government revenues in developing countries nearly doubled across the board (Table 1). In at least 32 countries, governments allocate more than 20 per cent of revenues for external debt service.

This troubling pattern is likely to persist going forward as debts continue to increase and revenues struggle to recover. In a post-crisis context marked by across the board reductions in primary expenditures, this will leave even less resources available to invest in basic public services to protect the lives and livelihoods of local populations. A large number of countries in the developing world are already allocating more resources to debt service than to either public health care or education (Table 1). In the case of the former, external public debt service was larger than health care expenditure in at least 62 countries in 2020. 25 of these countries are located in Sub-Saharan Africa.⁶⁵ In the case of the latter, external public debt service was larger than education expenditure in at least 36 countries in 2020.⁶⁶ These figures are set to deteriorate in coming years as debt service increases the pressure on fragile public budgets.

Thus, a narrow focus on the number of countries in default as a metric of success of the multilateral response to the crisis is profoundly misleading. This approach ignores the long-term costs linked to financial distress from an economic and developmental perspective. The increase in debt burdens has increased the risk of debt distress. This will inevitably lead to systemic underinvestment as higher borrowing costs and limited access to new financing reduce potentially profitable investments over time.⁶⁷ Investment in SDGs where the public sector is expected to play a leading role, such as poverty reduction, food security, health, education and gender equality are likely to be disproportionately affected by this dynamic.⁶⁸

Table 1: External public debt service ratios* – Country average per region (2016-2020)

	# of countries	Debt service as a share of government revenues		Ratio of debt service to			
		2016	2020	Healthcare		Education	
		2016	2020	2016	2020	2016	2020
Europe & Central Asia	20	7.6	14.1	0.8	1.4	0.6	1.0
Latin America & Caribbean	23	10.9	14.2	0.8	1.0	0.6	0.7
Sub-Saharan Africa	41	8.1	14.6	1.1	2.1	0.4	0.8
East Asia & Pacific	16	5.6	14.7	0.8	1.5	0.5	0.9
South Asia	8	7.7	27.1	1.0	2.6	0.4	1.2
Middle East & North Africa	10	13.1	42.3	1.0	1.5	1.2	1.6

*Using the latest country level data available on public health care and education expenditure

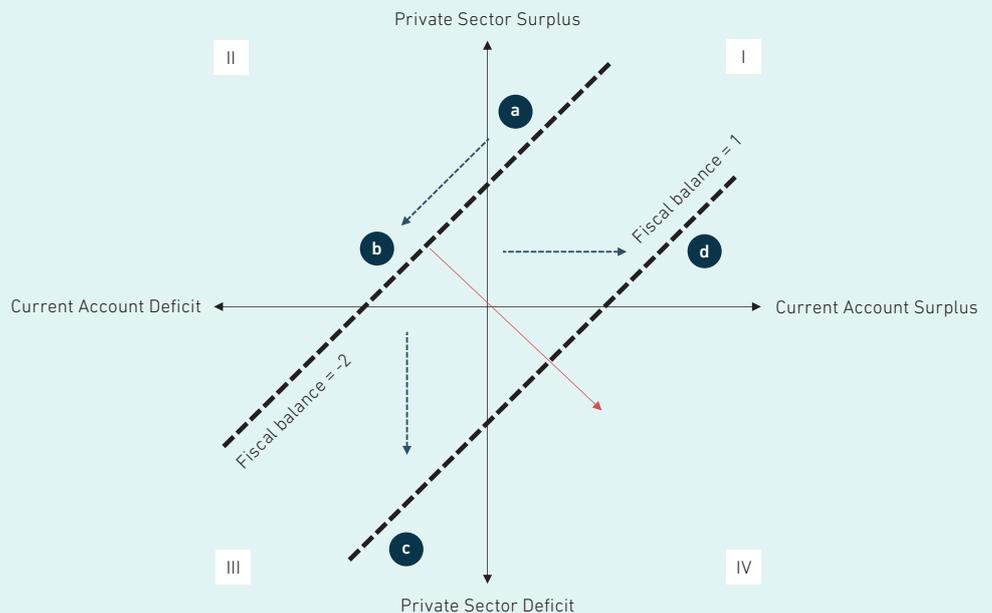
Source: Eurodad calculations based on Refinitiv.

Box 2: Patterns of sectoral adjustment in developing countries post Covid-19

Sectoral balances will play a central role in shaping the evolution of developing countries' economies in the aftermath of the pandemic. The framework explained in Box 1 is a useful tool to visualise the different paths of adjustment. As a starting point, it is almost certain that the temporary increase in the surplus of the private sector forced by the pandemic will give way to a steady deterioration of household and businesses financial balances. Private savings will be brought down by a combination of higher unemployment and business failures. In the most severe cases, the balance of the private sector will go into negative territory. Maintaining prevailing levels of expenditure would require either rising levels of debt or sales of assets by the private sector. As a result, the deterioration in the balance of the private sector must be matched by an increase in the trade deficit. This deficit is the counterpart of the external financing consistent with the deterioration in the balance of private and government sectors.

Against this background, maintaining a supportive fiscal stance will become a difficult endeavour. As the surplus of the private sector goes down, a given government deficit will require an increase in external financing. Countries with access to international financial markets would potentially be able to maintain fiscal support measures for a longer period of time. However, this would come at the expense of a higher degree of external financial vulnerability (point b in the figure). Countries which engage in premature fiscal consolidation will face an equally difficult challenge. Assuming a binding external constraint, fiscal consolidation can only be achieved through a further deterioration of the private sector balance. This would lead to either increased domestic financial fragility or falling levels of expenditure (point c in the figure). Only a scenario where the trade balance improves substantially via increased external demand would be consistent with the stabilisation of both private and government balances (point d in the figure). The narrow path of sustainable adjustment available to developing countries points to a fundamental blind spot on the ongoing multilateral discussions to address the crisis: the urgent need for substantial fiscal and trade coordination required to create a global context supportive of the recovery of developing countries. In this context, both the US and the EU are called to play a central role in creating the conditions for an improvement in the external balance of developing countries.

- Post Covid-19 adjustment**
- a. Post Covid-19 initial balance
 - b. Private surplus decreases (unemployment & bankruptcies). Fiscal support maintained via external financing
 - c. Fiscal consolidation leads to large private sector deficit. Domestic & external financial fragility.
 - d. Supportive external demand allows private and government balances.



The distinct nature of the present crisis calls for a different approach to address it. The current response, based on Debt Sustainability Assessments (DSAs) designed to ignore the developmental impact of debt, is bound to fail.⁶⁹ The prioritisation of creditor rights over the livelihood of the population of developing countries is a well-known dead-end. Instead, the best way to ensure long-term debt sustainability is to implement a framework that prioritises development financing needs. The international community must recognise that the health and wellbeing of millions of people in the developing world is a precondition for debt sustainability. It will be impossible to achieve one without the other. This requires the establishment of an ambitious debt relief program structured around the expenditure requirements consistent with the immediate response to the pandemic and the achievement of the 2030 Agenda, the Paris Climate Agreement and the Beijing Declaration.⁷⁰

Policy recommendations

This briefing provided an overview of the dynamics and implications of the 2020 sovereign debt crisis. The financial resilience of developing countries to the Covid-19 shock is misleading. This is the result of a combination of cyclical factors in the form of sectoral adjustments and monetary policy responses triggered by the pandemic. To promote a prompt return of countries to international financial markets without addressing the debt vulnerabilities exacerbated by the crisis will only increase the external financial fragility of developing countries. In addition, this will require a growing transfer of resources from public borrowers to their external creditors over the coming decade. This will sound the death knell of the commitments under the 2030 Agenda, the Paris Climate Agreement and the Beijing Declaration.

The current model of development finance built on market-based mechanisms is fundamentally broken. A complete overhaul is required. Measures required to place developing countries in the right path to meet the most pressing goals of the multilateral agenda ought to include:

- Global democratic governance: Eurodad is a strong advocate for the democratisation of global economic governance. This process ought to recognise the right of every country to be at the decision-making table. Eurodad, in collaboration with hundreds of CSOs across the world, has supported the call for an International Economic Reconstruction and Systemic Reform Summit under the auspices of the UN.⁷¹ This summit is the right place to begin the move towards a new global economic architecture that works for the people and planet.
- A systemic approach to address the broken global economic architecture: Prioritisation of debt repayments will lead developing countries to a harmful process of negative resource transfers to their external creditors. The required fiscal consolidation consistent with this process is known to undermine the provision of basic public services, increase income and gender inequality and hamper growth prospects.⁷² Urgent measures are required to avoid this outcome. These include, among others, a new allocation of Special Drawing Rights (SDR)⁷³, increases in Official Development Assistance (ODA)⁷⁴, and the establishment of effective global governance to tackle tax avoidance, evasion and illicit financial flows⁷⁵.
- Reform of the sovereign debt architecture: Multilateral discussions need to make progress towards the establishment of a permanent multilateral framework under UN auspices to support systematic, timely and fair restructuring of sovereign debt, in a process convening all creditors.⁷⁶
- Develop a post-Covid-19 debt relief and sustainability initiative: Additional borrowing simply postpones the inevitable acknowledgement of the unsustainable nature of debts in many countries across the world. Debt sustainability consistent with the SDGs and human rights can be achieved through an ambitious process of debt relief, including extensive debt cancellation. Relief must be granted to all countries in need and assessed with respect to their development financing requirements.
- Complete overhaul of Debt Sustainability Assessments (DSAs): Post Covid-19 debt relief needs cannot be assessed under a methodology that, in order to evaluate the risk and costs of debt distress, explicitly excludes investments required for the active pursuit of the commitments under the 2030 Agenda, the Paris Agreement on Climate Change and the Beijing declaration. A review of the methodology is needed. DSA's assessments of the risk and cost of debt distress must explicitly incorporate countries' long-term financing needs to pursue the SDGs, climate goals, human rights and gender equality commitments.⁷⁷

Endnotes

- 1 Prepared by Daniel Munevar. E-mail: dmunevar@eurodad.org. The author would like to thank Jean Saldanha, Iolanda Fresnillo, Jan Kregel and James K. Galbraith for their comments and Julia Ravenscroft for copyediting. All errors and omissions are the author's responsibility
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This publication has been produced with co-funding from the European Union and Brot für die Welt. It also has been supported in part by a grant from the Open Society Foundations. Its contents are the sole responsibility of Eurodad and do not necessarily reflect the views of the European Union, Brot für die Welt or the Open Society Foundations.



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