Policy Brief

January 2022

COVID-19 AND THE DILEMMA OF THE DEVELOPING COUNTRIES

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PB - 03/22

COVID-19 has caused serious damage throughout the entire world. As of mid-2021, the global fiscal cost of COVID-19—excluding the most important consequences, such as human lives, mental health effects, restrictions of human freedom, and other non-pecuniary components, have amounted to at least $16.5 trillion, about 18% of world GDP (Dinh 2021). Financial support has varied across countries depending on income level, political willingness, and the extent of the pandemic in each economy. As a result, fiscal deficits in both developed and developing countries have risen. For the former, the increase in the fiscal deficit comes from both rising expenditures and declining revenues. For the latter, the fiscal deficit increase heavily reflects the collapse in fiscal revenue.

However, the saga does not end here. In the coming 12–18 months, developing countries will continue to deal with the pandemic. They will be required to find resources to control the disease. In addition, governments are expected to continue to provide social protection—especially in terms of cash transfers for vulnerable populations—in order to protect the labor supply. These needs will pose massive challenges for countries under tight financial constraints, especially those at risk of debt distress. Thus, we will explore the implications of this necessary spending on the macrostability of selected developing countries.

THINK • STIMULATE • BRIDGE

DEBT SUSTAINABILITY

The basic macroeconomic framework used for this analysis employs the classic, standard model of external and internal balance. The directions for policy changes in this model are the same as those shown by the modern debt sustainability analysis used by the Bretton Woods institutions. In this analysis, the change in the debt to GDP ratio of a country depends on a number of variables, including the interest rate and GDP growth rate (also called the automatic debt dynamics), the inflation rate, and the primary deficit (budget deficit net of interest payments). A debt-to-GDP ratio of 65%[1] or above is considered a warning sign for debt problems. Two key components affecting this public debt ratio are the primary budget deficit and the automatic debt dynamics.

We review three cases concerning the possible path of the key macroeconomic variables. In the base case, we keep the same basic assumptions for key variables such as GDP growth, inflation, and effective interest rates as the international institutions.[2] In Scenario 1, we raise the budget deficit by the needed fiscal amount to fight COVID-19 and focus on two major components affecting the public sector debt ratio—namely, the primary deficit (budget deficit net of interest payments) and the automatic debt dynamics. The primary deficit will be directly affected by COVID spending. The debt dynamics will be affected by the interest rate and GDP growth rate effects. In scenario 2, we consider the case in which global conditions worsen as a result of a slowing down in economic growth amidst a tightened monetary environment, leading to higher interest rates in the developed economies and throughout the world.

Figure 1 shows the evolution of the debt ratios of the three scenarios for the ten developing countries reviewed. In the case of Zambia, in all three scenarios, the debt ratio would continue to reach over 120% by 2025—a clearly unsustainable situation. Egypt's external debt remains vulnerable due to the high share of short-term debt in local currency and its cost, which requires significant refinancing and interest rate risks. The country starts from a very high debt-to-GDP ratio so that, even with significant fiscal adjustment, the needed fiscal spending will bring the debt ratio to over 90% before coming down to 81% in 2025. Morocco's initial fiscal position before COVID-19 was better than Egypt's, but the crisis has brought on significant debt in 2020 and beyond. The gross public debt-to-GDP ratio is also expected to reach 85% in 2025. However, Morocco's debt stock is helped by its relatively long maturity, the relatively low share denominated in foreign currencies, and the investment base—made up mostly of local investors, many of whom are long-term investors. Thanks to such features, as well as its solid track record and favorable ratings, Morocco's government has maintained steady access to international capital markets at favorable terms over the last decade and, more recently, after the COVID-19 crisis. Further fiscal adjustment and continued implementation of structural reforms should help the debt-to-GDP ratio return to a downward trajectory over the medium term.

Tunisia's debt-to-GDP ratio would reach 95% in 2025 with the necessary COVID-19 spending, despite a valiant effort to reduce the primary fiscal deficit from over 7% of GDP in 2020 to virtually zero by 2025. Tunisia remains vulnerable to shocks coming from the debt dynamic, as well as from additional fiscal spending required for COVID-19 vaccines and treatment.

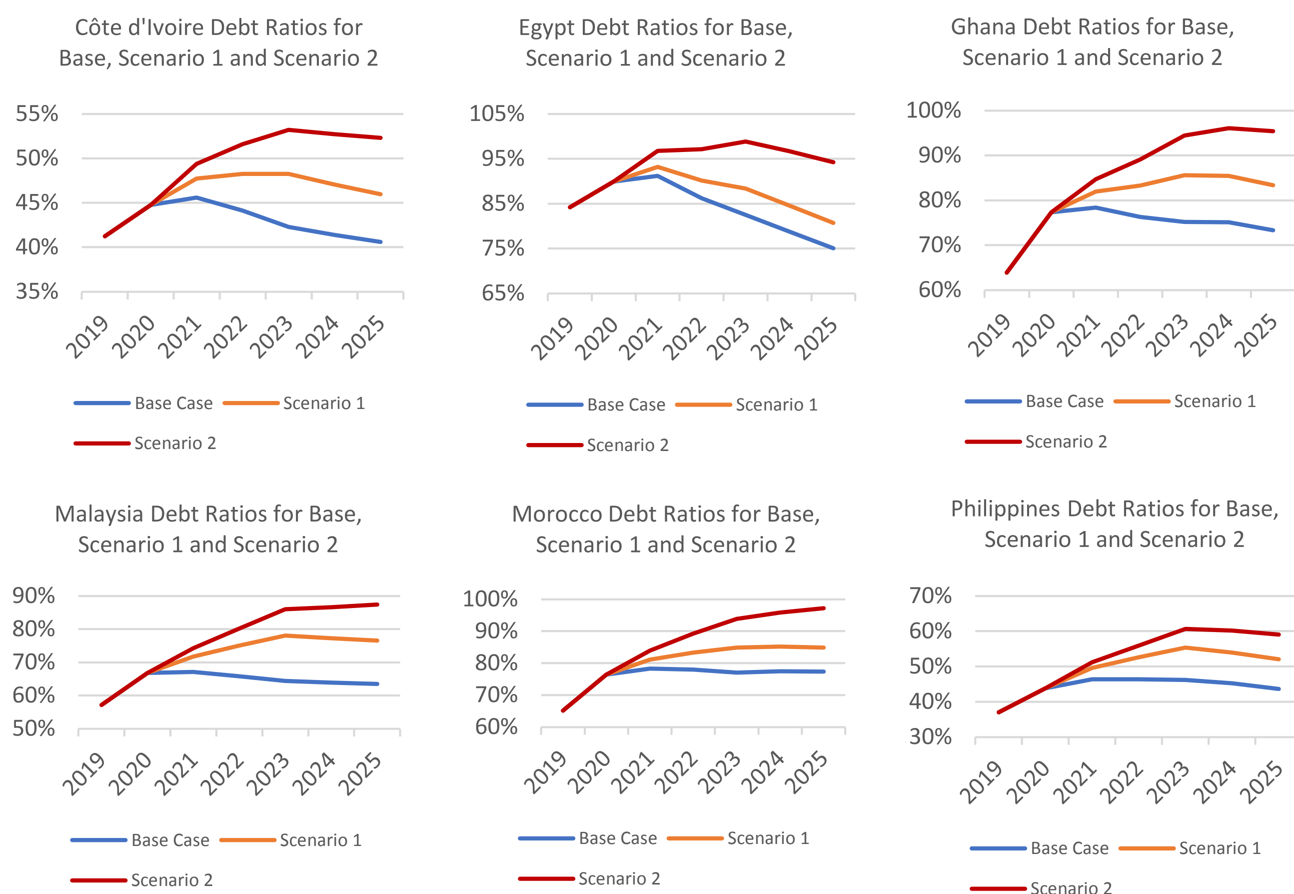
1. Countries whose debt burden was considered unsustainable and therefore eligible for the Highly Indebted Poor Countries (HIPC) Initiative on the average had debt-to-GDP ratios of 63%. An implicit HIPC's objective was to bring down this ratio to 37.5%. See also UNCTAD: https://vi.unctad.org/debt/debt/m1/HIPC.html.

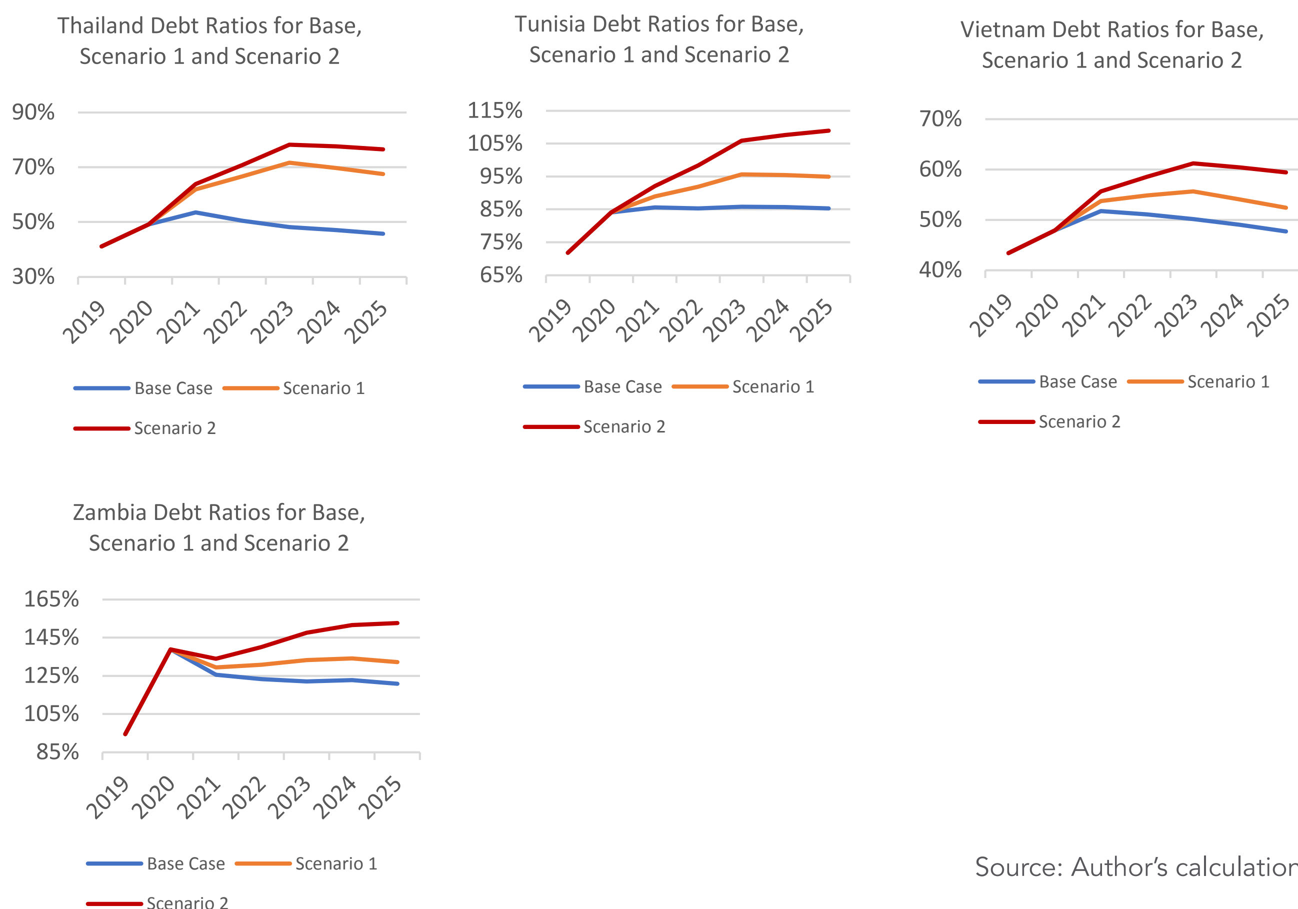
2. As shown in the country's latest IMF Article IV Consultations or IMF 2021 World Economic Outlook, April 2021, whichever is available.

Tunisia's public debt is further complicated by state-owned-enterprises (SOEs) contingent liabilities and guarantees, financing risks, and the need for an exchange rate adjustment. Vietnam's external debt has been relatively low compared to other countries, below 50% of GDP, because it has relied on the domestic bond market to finance most of its deficits since at least 2012. The interest rates on this outstanding debt stock have been low, as Vietnam has relied on domestic financial repression to finance its budget deficits. With the necessary spending for COVID-19 vaccination and treatment, the external debt ratio would reach 56% of GDP in 2023, a high ratio by its standard. Moreover, if this scenario 1 is combined with slower economic growth and interest rate increases, perhaps, as a result the new variants of COVID-19 ravaging the labor supply and/or the US Federal Reserve tapering off the large-scale asset purchases, the debt to GDP ratio would approach 61% in 2023, a near debt distress level.

Figure 1

Debt-to-GDP Ratios of the Base Case, Scenario 1, and Scenario 2 for the 10 countries





Source: Author's calculation.

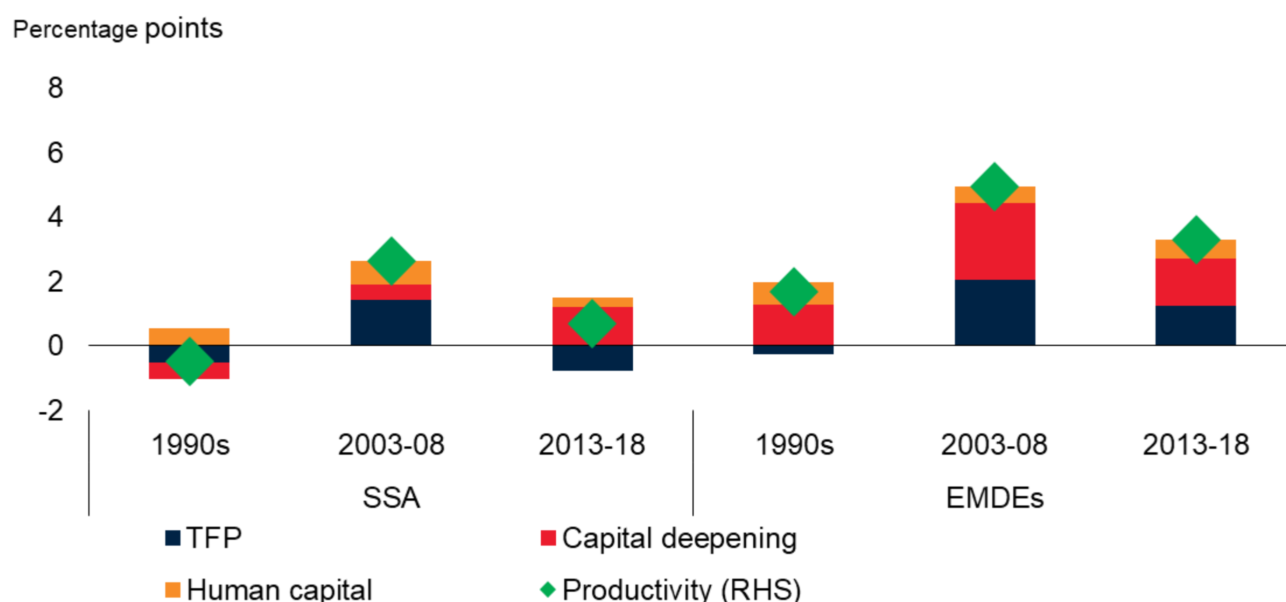
LONG-TERM PRODUCTIVITY GROWTH

COVID-19 could not have come at a worse time. In addition to the debt problem, the developing world has to cope with a slowdown in productivity growth, the source of long-lasting growth in all economies. For the emerging market and developing economies (EMDEs), this productivity slowdown is considered the steepest, longest, and most synchronized multiyear slowdown in recent decades (Dieppe 2021). This slowdown is related to the declining reallocation gains in labor going to the services sectors, where productivity tends to be lower than in the industrial sector. In particular, Sub-Saharan African (SSA) countries experienced the steepest and longest productivity slowdown in recent decades. Labor productivity growth in SSA dropped from 2.9% during 2003–2008 to 0.8% during 2013–2018 (Figure 2). Oil- and metal-exporting countries experienced the steepest slowdowns after the commodity price slump of 2014–2016.

A common yardstick for productivity is total factor productivity (TFP), which measures the efficiency of labor and capital inputs used in the production process. Figure 2, derived from Dieppe (2021), shows the contribution of TFP and of labor and capital for Sub-Saharan African (SSA) countries over the three periods: the 1990s, 2003–2008 (before the global financial crisis in 2008), and post-2008.

Figure 2

Factor contributions to productivity growth



Source : Figure 5.31 in Dieppe (2021) based on Barro and Lee (2015); International Monetary Fund; Penn World Table; United Nations (Human Development Reports); Wittgenstein Centre for Demography and Global Human Capital; World Bank.

Note : EMDE = emerging market and developing economies. Productivity is defined as real GDP per worker (at 2010 market prices and exchange rates). Country group aggregates for a given year are calculated using constant 2010 U.S. dollar GDP weights. Data for multiyear spans shows simple averages of the annual data. Productivity growth is computed as log changes. Sample includes 30 SSA economies and 93 EMDEs.

The TFP for SSA countries rose from -0.5% in the 1990s to 1.4% from 2003–2008. Since then, it has declined to about -0.8%. The increase in 2003–2008 was attributed to, among other things, stronger investment, infrastructure development, and a better macroeconomic framework. The commodity price boom during that period represents another factor. The slowdown in TFP in SSA countries in the post-2008 period followed the collapse in commodity prices and the subsequent collapse in investment and FDI inflows.

COVID-19 has actually created a reverse structural transformation in some countries. Instead of labor going from lower to higher productivity sectors (i.e., from agriculture to manufacturing), which normally occurs in the economic development process, the reverse has happened. Some workers have gone back to rural areas after experiencing COVID-19 lockdowns in an urban setting. Some of these workers may not move back to their former jobs. This has been the experience of some East Asian countries, especially Vietnam, and will have an adverse effect on productivity growth.

POLICY IMPLICATIONS

Thus, COVID-19 has worsened the macroeconomic imbalances of the developing countries at a time when these countries experience rising debt due to their past borrowing and a slowdown in productivity growth which adversely affected their long term growth potential. Until now, with the exception of some countries that have access to debt relief in the context of the Debt Service Suspension Initiative (DSSI), most developing countries are coping with COVID-19's effects and managing their debt burdens the best they can. But, to bring the pandemic under control, the developing countries would need to spend more fiscal resources on vaccination and treatment of COVID-19 until at least 2023. Under this situation, many countries will likely face debt solvency and liquidity issues, especially among low-income countries in Africa. This is the policy dilemma facing these countries.

Without a concerted effort from lenders, borrowers, and the international community to help overcome this situation, ad hoc policy actions by individual countries can only lead to higher debt distress, further tightening of financial assistance, more defaults, and worsened poverty.

A comprehensive and coordinated approach to deliver this policy agenda includes three types of policy reforms:

- Short-term policies that respond to the pandemic's immediate health impact as it persists through 2021, and possibly into 2023, and provide financial stimulus to fuel economic recovery in subsequent years.
- Medium-term policy priorities to further stimulate post-pandemic economic recovery and lay the foundation for longer-term structural transformation. A pivotal aspect of the medium-term agenda is establishing an efficient fiscal-monetary and debt management system that facilitates fiscal expenditures while maintaining a sustainable debt level. A Medium-term Expenditure Framework would be needed to achieve this objective.
- Long-term investments and policy reforms should foster economic and market diversification, technological innovation, and large-scale job creation to reduce poverty and put developing countries on a clear path of inclusive, green, and sustainable growth.

Some of the most salient policy actions are presented below.

Short-Term/Quick Wins: Defensive Actions for Damage Management

- Acquiring and deploying COVID-19 vaccines for at least 70% of the population. Also, obtaining adequate treatment medications and diagnostics.
- Continuing social distancing and other practices (face mask wearing, hand washing, restricted large public gatherings). Avoiding policies, such as premature reopening or stop-start containment.
- Extending safety nets and social protection programs through cash transfers, food aid, unemployment assistance, and free treatment to workers in the informal sector.
- Developing the capacity to do debt sustainability analyses, which allow the issuance of debt reports at fixed intervals.
- Strengthening the coordination among fiscal, monetary, and exchange rate policies to closely monitor the direction, speed, and magnitude of capital flows and their effects on the economy.

- Establishing a medium-term expenditure framework so as to manage responsibly fiscal and budgetary policies in a multi-year setting.

Medium-Term Actions: Dynamic Measures to Foster Strong, Sustainable, and Inclusive Growth

- Middle-income countries could initiate critical investments and policy reforms for small-and-medium enterprises and workers (formalization, education, skills development, digitalization, etc.) that have a longer gestation lag.
- Establishing mechanisms and institutions to strike a proper balance between additional external debt's benefits and costs. These include sound debt management, high debt transparency, proper use of non-concessional resources, and thorough monitoring of contingent liabilities. External financing should favor concessional terms and long maturities on reasonable borrowing terms.
- New investments in functional and efficient health systems to cope with future pandemics and lessen the burden on the government.
- Provide fiscal support and undertake policy reforms to enable the formalization of the informal sector through training for workers and businesses to close the skill mismatch.
- Investment in network infrastructure that facilitates digital transformation by expanding internet connectivity economy-wide to ensure that everyone (children, adults, workers, and businesses) can benefit from online learning.
- Support to small and medium enterprises (SMEs). Access to finance remains a critical impediment for SMEs' development, especially in African countries.
- Restructuring public enterprises, as well as monitoring and mitigation of their contingent liabilities, are integral for sound public debt management. Governments and debt managers need to carefully review state-owned enterprises' financial liabilities, subnational debt, guarantees, and other contingent debt.

Long-Term Actions

- Promoting economic and export diversification through trade policy reforms and fiscal investments in public goods and industrial clusters for non-extractive goods and services sectors.
- Improving economic resilience to exogenous, especially climate-related, shocks and future challenges (food security, water security, climate change).
- Investing in public goods necessary to reduce regional disparities and foster inclusive growth.
- Deepening regional integration in the context of the African Continental Free Trade Area (AfCFTA).

CONSIDERATIONS FOR THE INTERNATIONAL COMMUNITY

Both principal debt reduction and maturity extensions (re-profiling) are needed to bring developing countries' debt to sustainable levels. Re-profiling may be less effective when a country faces a large debt overhang—when the burden of debt is so large that a country certainly cannot pay it back. In these situations, it may simply imply that debt restructuring operations, such as the DSSI, which continue to deliver debt relief may be too little and too late. For countries that are currently insolvent, there is no way out except for creditors to take a substantial reduction in the principal. Given the recent trends in external debt structure, it is not clear that innovative debt workouts, such as auctions to buy debt at below-face-value prices or debt/nature swaps, would work for private creditors like bondholders and/or commercial banks. The wide distribution of bondholders and investors makes it difficult to come to any timely decisions—unlike the case with official creditors.

Until now, private creditors have not participated in the DSSI and are reluctant to accept reduced payments/haircuts from debtors. More importantly, no satisfactory solution to the debt problem in Africa could come without addressing the issue of China's debt. Currently, at least ten African countries have a debt problem with China. Most of these countries are currently facing very serious debt issues. As a result, the only feasible way to deal with the overall debt problem of Africa is to have a concerted effort by all lenders, bilateral and commercial, Chinese and non-Chinese, to resolve this issue.

At the moment, the Debt and Debt Service Suspension Initiative (DSSI) is no more than a temporary fix for the debt problems for low-income countries. No debt workout framework exists for middle-income countries. Such a framework would require effort from all sides, as well as bringing in private and emerging market creditors.

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The views expressed in this publication are those of the author.

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