COVID-19 AND POOR COUNTRIES: THE RIGHT RESPONSE

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HELPING POOR COUNTRIES FINANCE COVID-19 PROBLEMS: A MARKET-BASED RESPONSE

Last week saw several financing measures by multilateral agencies (IFIs) and the G20 to assist poor countries with the COVID-19 crisis, sponsoring calls for assistance from the finance industry. We argue that any solution must be driven by the principle of "crowding in" market-based finance through market confidence-building measures. Leveraging the IFIs' credit rating is likely the optimal solution to augmenting flows to poor governments, and measures detracting from this strategy may prove negative for the affected sovereigns.

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A call for multilateral assistance

On 9 April 2020, the Institute of International Finance (IIF) wrote to the heads of several key multilateral agencies (IFIs) on behalf of its 450 finance industry members, setting out thoughts on how the finance industry might help assist the poorest governments struggling with the COVID-19 crisis. For short-term crisis management, the IIF framework has roles for multilateral, bilateral and market-based financial flows.

As the Bretton Woods Agreement international monetary management institutions were established in 1944 to deal with the post-WWII economic crisis, it would seem only right that they take a lead in providing financial assistance for the COVID-19 crisis.

We agree with the IIF argument that multilateral sources of financing should be augmented and easier to access. It appears the International Monetary Fund (IMF) is on the same page and has temporarily increased the amounts available from its Rapid Financing Instrument to 100% of quota from 50% of quota, and to 150% from 100% of quota on a cumulative basis net of scheduled repurchases. The six-month window can be extended past the 5 October 2020 deadline by the IMF Executive Board.

We argue that crisis liquidity is best delivered to the poorest countries via multilateral sources and encourage the IFIs to do everything possible to use their rating to augment their balance sheet at this great time of need.

Bilateral assistance and debt moratoriums

As an alternative, OECD governments can assist poor countries directly. On 15 April 2020, the G20 announced a plan to provide short-term financial liquidity assistance directly via a debt moratorium to begin 1 May 2020 and continue to the end of the year.

It is unclear if the plan covers all International Development Association (IDA) countries or only those requesting assistance, but the plan calls for postponing payments on USD 12-14 billion in interest and principle. It is also not clear if any interest rate will be applied to the postponed cash flows, or if there will be additional bilateral project or program financing available to augment the liquidity drive.

The IIF appears to be recommending that its market-based creditor members voluntarily agree to a similar debt moratorium. The idea is under discussion but it is not clear how such market-based assistance might work in the longer-term crisis-resolution phase.

Rules of engagement and "crowding in"

The IIF outlines some rules of engagement that market-based creditors should adopt when discussing financial assistance. These rules point toward voluntary negotiations between appropriate creditor committees (helped by collective action clauses) held in good faith, under the principle of fair and comparable creditor treatment.

However, we are not convinced that comparable treatment across creditors is always desirable as it may not benefit the sovereigns involved and/or may well undermine the fundamental logic for the existence of bilateral or multilateral lending.

Official or non-market-based lending is designed to overcome market shortcomings and "crowd in" private sector flows that are not constrained by OECD aid-budget tax flows. If short-term humanitarian actions such as debt reprofiling, however well meaning, work against market-based financial flows to poor governments, then they probably do not make sense on a cost-benefit analysis for the sovereign.

Unfortunately, the crowding-in mandate appears too often to be forgotten by non-market-based lenders who have a somewhat schizophrenic relationship with market-based lending. On the one hand, the IFIs espouse orthodox market-based economic policy, but then undermine the development of financial markets via their subsidized policy lending and often a somewhat patronizing view that many sovereigns are not ready to develop their financial markets by opening them up to foreign participation.

If the IFIs really want to speed up development, reduce poverty, raise living standards and reduce vulnerability to shocks such as COVID-19, no rock should be left unturned in encouraging market-based lending to sovereigns either in hard or local currency. It is exactly at times like this that IFI money should be used to crowd in market-based flows.

No call for debt freeze for local currency

Interestingly, there are no demands from the IFIs, G20 or debt lobby groups for local currency bond holders to participate in a debt freeze, despite the IIF noting that, of the estimated USD 140 billion IDA countries will pay in debt service this year, USD 130 billion is in local currency. So much for the principle of comparability of treatment among creditors.

No debt relief is being sought from the dominant local currency source of debt service because sovereigns understand they would push up the price and potentially destroy their market access just at the time the government most needs liquidity. Moreover, local currency debt relief would hit the savings of consumers who are already under extreme financial stress and potentially undermine the domestic banking systems.

The value of building confidence

Although the call from the G20 for market-based debt relief is probably designed to help poor countries at a time of need, the policy is highly detrimental. In fact, by raising concerns of potential economic losses on market-based bonds, their calls have raised the cost of financing and in many instances closed markets to already struggling sovereigns.

There also appears to be a misunderstanding within the media, G20 and even IFIs as to who bears the cost of any economic losses from debt relief. The major holders of IDA market-based hard currency eurobonds are OECD pension funds. It is not clear the G20 and IFIs would want to target OECD pension savings rather than the average OECD taxpayer. In fact, once again it totally goes against the mandate to crowd in market-based savings in order to augment the development finance curve. Clearly, those now calling for debt relief would think very differently if they had their savings in bonds being used to build essential schools, hospitals, roads and power stations, etc., in IDA economies.

Thus, any form of market-based financial assistance to IDA sovereigns that the G20 or IFIs are seeking must meet the criteria of crowding in market-based liquidity by increasing market confidence (just as the OECD governments and central banks are attempting to do in their own economies).

Second, IDA sovereigns should be able to choose whether the costs of potentially losing market access/higher yields on eurobonds are worth the cost of seeking reprofiling free from financial cohesion from bilateral or multilateral creditors. Indeed, we suspect that because eurobond issuance across IDA countries is limited, very few sovereigns will look for additional liquidity provisions, especially after the actions of the multilateral and bilateral donors (including China).

One potential solution is for the IFIs to use their credit rating to augment market-based lending into IDA countries that need it. Perhaps providing some form of guarantee for bond holders willing to postpone debt servicing would reduce the negative market impact. Alternatively, perhaps the IFIs should issue bonds in the local currency of the IDA sovereign in order to crowd in much needed USD at this special time.

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