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BACKGROUND PAPER

Re-thinking
Emerging Market
Debt and
Development
Finance

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Re-thinking Emerging Market Debt and Development Finance¹

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Abstract

Post-pandemic debt levels have increased for emerging market economies (EMEs). Section 1 examines how the current international monetary system may be too debt-driven with structural imbalances that are unsustainable. The world is in a low-productivity liquidity trap, because reserve currency countries (“global banker”) can use quantitative easing (QE) to generate excess liquidity but EMEs have insufficient funding to invest for long-term sustainability. The world’s banker, with the reserve currency exorbitant privilege, has become a growing consumer of global credit. EMEs’ share of global funding is declining as they cannot use QE and their liquid assets placed with advanced markets earn 4 per cent less than their borrowing from the system. The global financial system is no longer serving the world’s savers and EMEs. Section 2 considers reform options including debt relief, SDR allocation, MDB capital increase and domestic capital market reforms. Post-pandemic is the time to consider major IMS reforms that would avoid future financial crises.

Introduction

The pandemic has devastated the global economy, but EMEs are now facing not only major health, but also wealth, job and debt crises.

Because of the pandemic shock, the EME shock has been severe, with large 2020 GDP losses for India (-8%), Latin America (-7%), South Africa (-7%), Mexico (-8.2%), although Sub-Saharan Africa (-1.9%), Middle East and Central Asia (-2.9%) were not hit as badly (IMF April 2021 WEO estimates).

The latest OECD Economic Outlook, March 2021, suggested that there will be K-shaped divergences in recovery, as the US and China will have better recovery due to larger stimulus and vaccinations, whereas the others may take more time. Europe and Japanese growth may be sluggish, whereas many EMEs are devastated by disruptions because of delays in vaccination, lack of recovery in global trade, capital outflows, and continual lack of funding for long-term investments. The impact on the lower half of society has been much larger than measured as informal markets were disrupted by the pandemics through loss of jobs, income and health.

¹ The author is grateful to Jillian Ng for research assistance and Eng San Chok for secretarial help in preparation for this paper. The views expressed are totally personal to the author.

1. Global Liquidity and Productivity Trap

Post-pandemic, the world faces a **global liquidity trap**, where at the short-end, financial markets (especially stock markets) are at record high, wealth inequality is worsening, and there is significant lack of investments in long-term infrastructure. The [United Nations](#)² argue that the shortfalls in funding for SDG goals are around \$2.5 trillion, with annual investments around \$1 trillion. Yet central banks increased their balance sheet by \$9 trillion in 2020 alone, mostly invested in government bonds, so at the short-end, financial markets are flooded with liquidity with stock, bond and real estate prices at historical peaks because of low interest rates.

Yet, given large and long-term uncertainties worsened by geopolitical tensions and technological/pandemic disruptions, investors are not willing to put more money in EMEs, as national security, civil strife and health risks escalate. In short, the world is direly short of long-term investments, yet flooded by short-term central bank-created liquidity.

The irony is that the world desperately needs investments to revive growth to deal with jobs, inequality or man-made calamities and climate-induced disasters, at a time when there is no shortage of monetary funds at record low interest rates. Furthermore, fiscal capacity is limited as budget deficits and debt levels balloon. Climate scientists and specialists agree that we can *technically* solve many of our problems, but *politically*, at country and global levels, there are collective action traps that stall or delay any collective and cooperative action forward. There is now awareness that despite geopolitical differences in ideology, without revived growth and narrowing inequalities at national, regional and global levels, the world will regress into stagflation and depression, perhaps even slide to war.

Global Trends to 2035/2040

The most recent [US](#)³ and [EU long-term](#)⁴ assessments broadly agree on the following major trends:

1. Major demographic shifts, as world ages and migration stresses societies.
2. Growing inequalities in education, income, wealth, infrastructure access and job opportunities at national and global levels.
3. Climate warming will worsen, with more pandemics, natural disasters and under-preparedness for adaptation and mitigation.
4. Technology is tool for change, but also disruptive through job disruption.
5. Financialization provides temporary liquidity, but has long term financial stability, social inequality and debt sustainability issues.

² UNCTAD. 2014. World Investment Report 2014: Investing in the SDGs: An Action Plan. Retrieved from https://unctad.org/system/files/official-document/wir2014_en.pdf

³ Office of the Director of National Intelligence. 2021. Global Trends 2040: A More Contested World. Retrieved from <https://www.dni.gov/index.php/gt2040-introduction>

⁴ European Parliament. 2018. Global Trends to 2035: Economy and Society. Retrieved from [https://www.europarl.europa.eu/RegData/etudes/STUD/2018/627126/EPRS_STU\(2018\)627126_EN.pdf](https://www.europarl.europa.eu/RegData/etudes/STUD/2018/627126/EPRS_STU(2018)627126_EN.pdf)

6. Moving from unipolar to multipolar situation created geopolitical rivalry that complicates cooperative solutions to collective action traps, as trade, jobs and rules are challenged and contested.
7. Existing global governance in security, technology, fiscal, monetary and structural issues are fraying, as emerging powers demand greater representation.

The pandemic lesson that none is safe till all are safe applies to the conditions facing EMEs. If the system does not address their problems, their crises will infect and also slow rich country search for peace, prosperity and health.

US Has Become Banker that Consumes Global Credit

As currently constituted, the Bretton Woods-era multilateral institutions cannot cope with the current challenges, as they are under-resourced with profoundly changed operating context. In the immediate post-war period, when most countries were devastated by war, the US-led efforts enabled the creation of the IMF and World Bank to provide post-war reconstruction and liquidity funding. This successfully led to the post-War recovery and growth in EMEs and advanced countries. The prevalent development finance paradigm was that the rich industrial countries had trade surpluses and higher savings that could fund the trade deficits and development needs of the poorer countries.

As the global supply chain shifted since the 1980s to Northern Europe and East Asia, the middle income countries led by China emerged as the world's factory and also major savers. The Northern Europe supply chain centred around Germany also contributed to growing surpluses, but these are partly used to fund the deficits of southern Europe. As the US became the largest global consumer market financed by growing debt, the global financial structure changed.

As the IMF [External Sector Report 2020](#)⁵ and [April 2021 WEO](#)⁶ report (Fig.1) suggest, although current account deficits have widened to peak in 2006 and narrowed since then, the balance sheet effect of growing deficits have ballooned. The major reserve currency country (USA) has steadily increased its net liability to the rest of the world from 3.9 per cent of world GDP in 2005 to 16.7 per cent by 2020 (data per IMF WEO website). In other words, between 2005-2020, the US increased its net liability to the rest of the world by 12.4 per cent of world GDP, largely funded by Europe (creditors minus debtors) of 5.6 per cent, Japan (+1%), China (+2.2%), Advanced Asia (+3.3%) and Oil Exporters (+1.5%). Indeed, the net debtors from other advanced countries (Australia etc) hardly increased their net debt during this period (+0.3%), whereas EMEs (exc. China and Advanced Asia) comprising Latin America, Emerging Asia, Central and Eastern Europe, and Africa and Middle East, increased their net liability by 1.0 per cent to total 4.3 per cent of world GDP at the end of 2020.

⁵ IMF. 2020. 2020 External Sector Report: Global Imbalances and the COVID-19 Crisis. Retrieved from <https://www.imf.org/en/Publications/ESR/Issues/2020/07/28/2020-external-sector-report>

⁶ IMF. 2021. World Economic Outlook, April 2021: Managing Divergent Recoveries. Retrieved from <https://www.imf.org/en/Publications/WEO/Issues/2021/03/23/world-economic-outlook-april-2021>

The global debtor/creditor balance sheet was relatively balanced in 2005, with distribution and share of total world debtor net liability being US (33.3%), European debtors (24%), other Advanced debtors (13.8%) and EMEs (28.8%). By end-2020, the position had become US (64.8%), European debtors (11.2%), Other Advanced (7.3%), and EME (16.7%).

In short, **the world's banker has become the largest world net debtor**. There is a fundamental asymmetry emerging whereby the EMEs' access to global savings is being crowded out by the US as she absorbs more and more resources funded by debt. The US has superior credit ratings, and can afford to run larger and larger net debt denominated in USD because of the exorbitant privilege from her [dominant reserve currency status](#)⁷. The EMEs are vulnerable to capital flows and have to maintain large reserves, whilst they cannot engage in QE and cannot raise funds for long-term investment needs due to higher credit costs and bank-dominated short-term biased financial structures. They do not dare to run too large current account deficits and net debt.

This asymmetry between debtor/creditors is reflected in the stock-flow balance between current account deficits and net debt. The US expansion in net debt between 2005-2020 was less explained by her *cumulative* current account deficits (\$1.8 trillion or 15% of net increase in net deficit position), whereas net capital *inflows* and/or valuation effects accounted for \$10 trillion or 85 per cent (Table 1). In contrast, the major surplus economies, such as European creditors, China, Japan and Advanced Asia all ran large current account surpluses, but their net creditor position did not fully reflect such cumulative surpluses because of capital *outflows* and valuation effects. For example, Japan accumulated consistent current account surpluses (cumulative 3.52% of world GDP) between 2005-2020, but the net increase in her net creditor (stock) was only 0.96 per cent, suggesting that there was significantly capital outflow plus valuation differences. This pattern is true also for European creditors, China, Advanced Asia and Oil Exporters.

It could be argued that continued inflows into USD assets implied the superiority of return on investments, store of value, unit of account and means of payment benefits. However, increasing sanctions and geopolitical risks, plus inflation and slower US growth mitigate against such benefits. The EMEs which have younger demographics, faster growth prospects are starved of investments to maintain growth and inclusivity, where their savings are increasingly used to finance the largest too-big-to-fail borrower with slowing growth.

To sum up, the Triffin Dilemma has allowed the US to import global savings to consume and run continuous current account deficits, but neglected domestic inequalities and infrastructure that resulted in slowing productivity. This situation is not sustainable.

The April 2021 WEO projected narrowing of global international investment positions for 2021-2026 actually assumes that the US will narrow its current account deficits over the next

⁷“The US dollar.. is the foremost funding currency, with about half of all cross-border loans and international debt securities denominated in US dollars. Around 85% of all foreign exchange transactions occur against the US dollar. It is the world's primary reserve currency, accounting for 61% of official foreign exchange reserves. Around half of international trade is invoiced in US dollars, and around 40% of international payments are made in US dollars” (BIS CGFS, June 2020).

five years. Given that the Biden Administration has already committed to \$5.1 trillion of stimulus (Trump \$0.9+\$1.9+2.3 trillion infrastructure), equivalent to 22.9 per cent of 2020 GDP means that both future fiscal and current account deficits will worsen more than projected.

If so, the crowding out of funding for EMEs and long-term SDG infrastructure investments will continue, unless the risk spreads are widened substantially.

Table 1: US Current Account Balance & Net Investment Position 2005-2019 (USD billion)

Year	CA Balance (USD bn)	NIP (USD bn)
2005	-209.6	-2,238.4
2006	-193.7	-1,807.8
2007	-167.1	-1,278.8
2008	-156.2	-3,994.6
2009	-101.9	-2,626.9
2010	-100.6	-2,511.1
2011	-109.8	-4,454.6
2012	-95.4	-4,517.1
2013	-73.4	-5,367.6
2014	-102.4	-6,944.2
2015	-99.4	-7,460.2
2016	-93.7	-8,129.3
2017	-92.8	-7,622.2
2018	-132.5	-9,674.4
2019	-104.3	-11,050.5
2020	-188.5	-14,092.1
Total CA (2006-2020) USD bn	NIP 2020 less 2005 (USD bn)	Change in NIP (USD bn)
-1,811.6	-11,853.7	-10,042.1

Source: BEA.^{8,9}

⁸ BEA. 2021. International Investment Positions. Retrieved from [https://www.bea.gov/data/intl-trade-investment/international-investment-position#:~:text=The%20U.S.%20net%20international%20investment,of%20Economic%20Analysis%20\(BEA\).](https://www.bea.gov/data/intl-trade-investment/international-investment-position#:~:text=The%20U.S.%20net%20international%20investment,of%20Economic%20Analysis%20(BEA).)

⁹ BEA. 2021. International Transactions. Retrieved from <https://www.bea.gov/data/intl-trade-investment/international-transactions>

In other words, the benign situation projected by the IMF will depend critically on the US reducing its current account deficit and fiscal deficits. Since such deficits can only be funded by more QE, and the growing debt can only be eroded by higher inflation, it is likely that the deficits and US debt situation will continue to worsen in the medium term.

The [CBO's projections in March 2021](#)¹⁰, before taking into consideration the \$2.3 trillion infrastructure package, estimated that annual deficits would average \$1.2 trillion a year from 2022 to 2031, exceeding their 50-year average of 3.3 per cent of GDP. The deficit would reach 5.7 per cent of GDP in 2031. By 2031, debt would equal 107 per cent of GDP, the highest in the nation's history.

Put bluntly, the US is able to run such unprecedented debt because reserve currency countries can use QE with little short term fear of inflation. In 2020, the four reserve currency central banks (Fed, ECB, Bank of Japan, and PBOC) increased their [balance sheet](#)¹¹ by an astounding \$9 trillion to \$29 trillion by end March 2021. It was only \$5 trillion at the end of 2006. Central bank balance sheets (including EMEs) now exceed \$40 trillion and are equivalent to the size of global pension funds and insurance companies. [FSB](#)¹² data showed that central bank assets, which was only 8.9 per cent of total G20 bank assets in 2002, had more than doubled to 19.6 per cent by 2019. It is the power of reserve currency central banks to use QE that has changed the structure and incentives within the global financial system balance sheet and financial sector behaviour.

In effect, the world has a banking system in which the leading banker and currency issuer has become the too-big-to-fail borrower and is increasingly absorbing more and more of global credit resources. The banker will not fail if he maintains prudent monetary and fiscal policies that constrains his debt to sustainable levels.

Global Debt Situation

According to the Institute of International Finance, global debt increased by \$19.5 trillion in 2020, of which US debt outstanding increased by \$6.8 trillion, bringing US outstanding debt to \$61.2 trillion or 284.7 per cent of GDP at end-2020. The Federal government debt alone increased by \$4.6 trillion, an increase of 21 per cent over 2019. As Triffin predicted, the US current account deficits, roughly 2-3 per cent of GDP annually, has resulted in cumulative net US debt to the rest of the world rising to \$14.1 trillion or 65 per cent of GDP, equivalent to 16 per cent of world GDP.

Global debt levels continue to increase, and leverage (debt/equity) are still increasing, since IPOs for equity are only for tech and growth companies. According to the IMF, the 2019 global public debt surpassed its 2007 level by 23 percentage points of GDP. This is primarily driven by

¹⁰ Congressional Budget Office. 2021. Additional Information About the Budget Outlook: 2021 to 2031. Retrieved from <https://www.cbo.gov/publication/57043>

¹¹ Yardeni, E. & Quintana, M. 2021. Central Banks: Monthly Balance Sheets. Retrieved from <http://www.yardeni.com/pub/peacockfedecbassets.pdf>

¹² FSB. 2020. Global Monitoring Report on Non-Bank Financial Intermediation 2020. Retrieved from <https://www.fsb.org/2020/12/global-monitoring-report-on-non-bank-financial-intermediation-2020/>

the higher levels among advanced economies, where public debt rose from 72 to 105 per cent of GDP, and to a lesser degree by EMEs (from 35 to 54 per cent of GDP) and low-income countries (an increase of 14 percentage points to 44 per cent of GDP). However, several low income countries are now in debt distress.

There is a moral hazard arising from the current financial structure. Savers are being “taxed” to fund borrowers, especially if the major borrowers use their power over global monetary policy to lower interest rates to make debt more affordable. Debt escalation is also aided by tax subsidies on interest paid, whereas dividends on equity are taxable at source. Moreover, fund raising is cheaper and faster through debt than equity, due to high IPO listing costs. Finally, existing shareholders prefer to increase profits by increasing leverage, since increasing equity would tend to dilute their control.

All these factors drive EMEs towards debt to follow the advanced borrowers. But because of higher credit risks (lower credit ratings), they are unable to access long-term credit for development and investments. According to [BIS data](#)¹³, the amount of outstanding international debt securities and cross-border loans that are denominated in US dollars was \$22.6 trillion as of Q4 2019, or 26 per cent as a share of world GDP, corresponding to about 50 per cent of all outstanding international debt securities and cross-border loans (CGFS June 2020). By mid-2020, [US dollar credit](#)¹⁴ to non-banks outside the US exceeded \$12 trillion, more than 14 per cent of world GDP – up from less than 10 per cent of world GDP in 2007 (Forni and Turner Jan 2021).

As EMEs also begin to draw on international funding by issuing local currency debt, the result is that they become highly vulnerable to capital outflows, against which they have to maintain higher and higher foreign exchange reserves. Out of [global foreign exchange reserves](#)¹⁵ of \$11.8 trillion at the end of 2019, roughly \$10 trillion are attributed to countries other than US and EU. EMEs increased their FX reserves from 5 per cent of GDP in 1990 to almost 30 per cent of GDP in 2018 (Arslan and Cantu).

There is a substantial cost to the EMEs to maintain such high liquidity premia relative to their borrowing costs. UNCTAD estimated “Between 1995–2018, developing countries earned, on average, about 2 percentage points less on their gross external assets and paid about 2 percentage points more on their gross external liabilities compared with developed countries, implying a [total return differential of about -4 percentage points](#)¹⁶ between developing and developed countries. In 16 developing countries, the resultant resource transfer to developed

¹³ BIS. 2020. US Dollar Funding: An International Perspective. Retrieved from <https://www.bis.org/publ/cgfs65.htm>

¹⁴ Forni, L. & Turner, P. 2021. Global Liquidity and Dollar Debts Of Emerging Market Corporates. Voxeu. Retrieved from <https://voxeu.org/article/global-liquidity-and-dollar-debts-emerging-market-corporates>

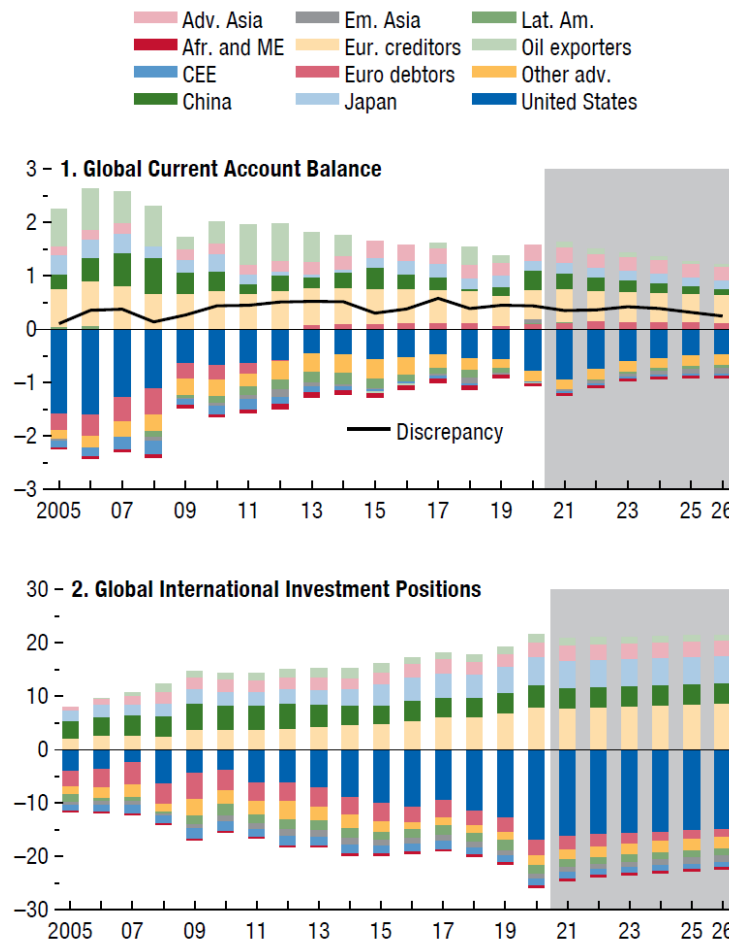
¹⁵ Arslan, Y. & Cantu, C. 2019. The Size of Foreign Exchange Reserves. BIS Papers No. 104. Retrieved from https://www.bis.org/publ/bppdf/bispap104a_rh.pdf

¹⁶ UNCTAD. 2020. Addressing Systemic Issues: Strengthening the Coherence and Consistency of Multilateral Financial, Investment, Trade and Development Policy. Retrieved from https://unctad.org/system/files/official-document/tdb_efd4d2_en.pdf

countries amounted to around \$440 billion per year, or 2.2 per cent of their combined GDP in 2000–2018

In other words, the EMEs have to maintain high FX liquidity in order to access foreign funding, and pay a high premium on their own savings. They cannot access IMF funding without strict conditionality, yet the IMF finds it easier to discipline poor country borrowers than rich country shareholders.

Figure 1. Current Account and International Investment Positions (per cent of world GDP)¹⁷



Source: [IMF World Economic Outlook, April 2021](#).

Can We Deleverage the Global Financial System?

How leveraged is the global financial system? A crude leverage ratio can be arrived at by dividing total bank assets (as proxy for bank debt) plus bond market capitalization by the total

¹⁷ IMF. 2021. World Economic Outlook: Managing Divergent Recoveries, April 2021. Retrieved from <https://www.imf.org/en/Publications/WEO/Issues/2021/03/23/world-economic-outlook-april-2021>

value of global stock market capitalization. Table 2 suggests that this ratio declined from 2010 from 365 per cent to 277 per cent by 2019. The broad explanation is that in the last decade, stock market capitalization has grown faster than debt growth. A closer examination of the data showed that this deleveraging may be illusory.

First, the stock market capitalization alone does not represent the total equity base of the corporate sector, as valuations have been inflated by rapid growth of the tech sector and the decline in interest rates and equity premia. Second, the stock market has also become more and more concentrated, with the number of listed companies declining to 41,000 and market capitalization concentrated in very large companies. For example, in China there are 6, 300 listed companies (including those in Hong Kong), but there are 18 million registered enterprises, plus hundreds of millions of unincorporated small and medium-sized enterprises who do not have access to fund raising through listings. The Chinese are addressing this issue through reforms towards a multi-tiered capital market, creating Third and Fourth New Markets to cater for the needs of smaller companies. These are still work in progress.

SMEs are the biggest victims of the pandemic, with huge declines in cash flow and business. They do not have access to IPOs in stock markets and extending debt through bank regulatory forbearance is not a long-term solution. Global NPLs will rise sharply in the wake of the pandemic shock.

Table 2: World Financial Assets (2010-2019)

Year	World GDP A	Stock Mkt Cap B	Bond Mkt Cap C	Bank Assets D	Total B+C+D	Crude Leverage (C+D)/B
		\$ trillion				
2010	75.5	58.0	82.2	129.8	270.0	365.5%
2019	86.6	94.0	105.9	155.3	355.2	277.9%
		% of World GDP				
2010	100.0	76.8	108.9	171.9	357.6	
2019	100.0	108.5	122.3	179.3	410.1	

Sources: Statista.com, SIFMA.

The fundamental mismatches in duration (borrow short-term funding for long-term investments), foreign exchange (sudden capital outflow risks), leverage (growing debt relative to equity) and paradigm (business model reset) are now daunting for EMEs. Corporate failure will inevitably lead to financial fragility. EME financial structure is skewed towards the banking

system, and many have been slow to develop their long-term funding institutional base through creating deep pension and insurance funds. Without higher domestic savings and equity cushion, many EMEs will not be able to sustain internal or external shocks without falling into either debt trap or financial distress. Conventional banking systems are not geared towards debt-equity swaps and corporate restructuring, and further reliance on fiscal bailouts of banking systems or failed corporations is constrained by the lack of fiscal space. Furthermore, EMEs do not have the monetary policy space in terms of QE.

In sum, even for the advanced markets, the policy bias towards solving debt problems with further debt creation is neither viable nor sustainable. **Mainstream policy has tended to ignore this structural flaw in the domestic and global financial system.** The world is therefore in a classic domestic and global liquidity trap, in which funding is ample at the short-end, but long-term funding and equity for a higher-risk environment is lacking.

The irony is that Amazon Inc is growing in market capitalization and valuation and yet the real Amazon as a major source of environmental diversity is being depleted and sorely need funding for re-forestation, natural carbon capture and protection of invaluable biodiversity. This is truly financialization that has destroyed our natural environment because excess consumption (and carbon emission) is essentially funded by excess debt creation.

If we look at the current global financial structure, shadow banks (non-bank financial institutions) have grown to comprise half of global financial assets (FSB NBF1 Report 2020), but the growth was mainly in short-term mutual funds, and less in development banks and long-term pension and insurance funds.

The reasons for this state of affairs have to do with a policy paradigm that focuses on the short-term at the expense of the long-term. Even central banks today focus on their own narrow silo remit and on short-term issues, whilst the market pushes for speculation and reliance on central banks to bail them out of liquidity trouble. Fiscal policies are driven by short-term political imperatives, rather than focused on structural reforms. Rich countries feel that their fiscal capacity is limited and are less generous in terms of aid or willingness to increase the capital of the multilateral development banks and agencies. For example, the total asset size of the World Bank and multilateral banks is \$1.7 trillion, a mere 1 per cent of the size of global banking system (\$155 trillion as at end-2019). As a result, the leading IFIs and regional development banks are depleted of capital, and the institutional capacity to design, plan, manage and operate sustainable development goal projects are today lacking at the national and multilateral financial institutions level. We should be aware that the damage to EME institutional capacity after the pandemic to cope with major structural reforms cannot be underestimated.

The advanced countries are fully aware that without greater inclusivity and representation, reforms to the international financial architecture will not gain support from the EMEs. They are also wary that diluting their majority shares may also change the nature of such institutions (Table 3, from EU Global Trends 2035 report).

The EME Financing Conundrum

The mindset problem is that after the 2007 GFC and 2020 pandemic, the EMEs have to re-think what new business model/supply chain and growth model will be possible in a context of growing supply chain decoupling, geopolitical tensions and technology disruption, on top of worsening climate change, natural disasters, social inequality and civil strife. Furthermore, what long-term funding and savings are available to fund such structural reforms?

Business as usual is no longer an option. Leaving totally to free markets is also not an option, when national security, sanctions and decoupling mean that private sector will shun EME risks. Indeed, we have an irony that after 2007, global asset management is now more and more concentrated in a few large asset management firms based in the rich countries. Since these are risk-adverse, the irony is that EME middle class and pension savings may go to these firms which may not recycle them back to EMEs!

Table 3: Share of Country's GDP in the World in 2035, Versus Current Vote Share at IMF.
Positive numbers indicate the country will be overrepresented at IMF based on its economy¹⁸

Country	GDP share (%)	Voting share (%)	Difference (%)
Australia	1.35	1.34	-0.92
Brazil	2.87	2.22	-22.66
Canada	1.62	2.22	36.99
China	24.31	6.09	-74.95
France	2.50	4.04	61.29
Germany	2.85	5.32	86.89
India	11.33	2.64	-76.70
Indonesia	2.69	0.95	-64.69
Italy	1.85	3.02	63.12
Japan	4.06	6.16	51.84
Mexico	2.43	1.80	-26.00
Russia	3.48	2.59	-25.54
South Africa	1.06	0.64	-39.71
South Korea	2.22	1.74	-21.63
Turkey	2.01	0.96	-52.31
United Kingdom	2.94	4.04	37.62
United States	19.52	16.53	-15.32

Source: IMF, OECD.

To sum up, the critical issues relating to [development finance](#)¹⁹ comprise, inter alia, the following:

1. EMEs are still subject to volatile commodity trade shocks, with volatile capital flows. 95 developing countries earn half or more of their foreign exchange revenue from

¹⁸ European Parliament. 2017. Global Trends to 2035: Geo-politics and International Power. Retrieved from <https://www.oxan.com/media/1969/global-trends-to-2035-geopolitics-and-power.pdf>

¹⁹ UNCTAD. 2020. Addressing Systemic Issues: Strengthening the Coherence and Consistency of Multilateral Financial, Investment, Trade and Development Policy. Retrieved from https://unctad.org/system/files/official-document/tdb_efd4d2_en.pdf

commodities highly exposed to excessive price volatility. Global FDI exhibited a broadly downward trend since the global financial crisis, declining from \$2 trillion in 2015 to \$1.5 trillion in 2018 and 2019. Non-resident capital flight from developing countries in response to the pandemic has been unprecedented compared with earlier crisis episodes, reaching a cumulative \$104.8 billion in the first three months of the pandemic, compared with \$33 billion in the same period following the global financial crisis.

2. IMF External Sector Report 2020 showed that in 2019, the bulk of global deficits and surpluses in current account was between advanced economies and select East Asian countries such as China, Japan, Korea etc (see Appendix Table A1). Excluding these large surplus and deficit countries, the EMEs have maintained very small net current account imbalances.
3. EMEs account for bulk of [foreign exchange reserves](#), which grew from 5 per cent of their GDP in 1990 to over 30 per cent of GDP by 2017²⁰. Gross foreign exchange reserves currently amount to \$12 trillion, or 15 per cent of world GDP
4. As UNCTAD estimated, between 1995–2018, developing countries paid a -4 percentage points between earnings on their investments in foreign exchange reserves and their cost of borrowing. If EMEs were to earn the interest differential of 4 per cent per annum on roughly \$10 trillion of their debt and FX reserves, the return would more than cover their net annual current account deficits.
5. If emerging markets account for 25 per cent of global debt outstanding, and US dollar debt amounted to \$11 trillion alone, having the bulk of their liquidity tied up in foreign currency reserves which earn low interest and cannot be used to invest in long-term assets does not make sense. They do not dare to draw down their reserves because the rating agencies would immediately downgrade and they would be subject to large capital flight risks.
6. Developing countries face a hurdle of debt service repayments throughout the 2020s, with repayments in 2020 and 2021 on their public external debt alone amounting to \$2 trillion to \$2.3 trillion for high-income countries and an estimated \$700 billion to \$1.1 trillion for low-income countries and middle-income countries.
7. The Bretton Wood institutions and multilateral development banks (MDBs) are under-resourced relative to the growing debt and structural reform needs. The IMF has existing quota of SDR 204.2 billion (equivalent to about US\$293 billion), which is small relative to EME crises needs. There is also tough conditionality to such credit. Even increasing the quota by [\\$650 billion](#)²¹, as proposed by G20, would bring IMF quota to \$943 billion. The increase of \$500 billion would only add \$14 billion FX liquidity to low income countries and \$60 billion to emerging markets²². SDRs are still EME debt when drawn down. They can only be used by advanced countries who can decide to donate these or invest them as capital in multilateral development banks.

²⁰ Arslan, Y. & Cantu, C. 2019. The Size of Foreign Exchange Reserves. BIS Papers No. 104. Retrieved from https://www.bis.org/publ/bppdf/bispap104a_rh.pdf

²¹ IMF. 2021. IMF Executive Directors Discuss a New SDR Allocation of US\$650 billion to Boost Reserves, Help Global Recovery from COVID-19. Pres Release No. 21/77. Retrieved from <https://www.imf.org/en/News/Articles/2021/03/23/pr2177-imf-execdir-discuss-new-sdr-allocation-us-650b-boost-reserves-help-global-recovery-covid19>

²² Jones, M. 2021. Which countries would benefit most from an IMF SDR increase. Reuters. Retrieved from <https://www.reuters.com/article/us-imf-sdr-idINKBN2AC1JX>

8. MDBs' balance sheets are currently \$1.6 trillion (Table A1) and have been starved of new equity due to unwillingness of major shareholders' to increase their equity. The China Development Bank balance sheet with assets over \$2 trillion alone is larger than these MDBs.

The bottom line is that as long as the global financial system is skewed with savings of EMEs sent to advanced financial markets in form of FX reserves and assets under management (increasingly concentrated), and the EMEs cannot get sufficient long-term funding and direct investments in return, then EME growth will be stunted and the poorer economies decline into debt traps.

This global liquidity trap and investment shortage for EMEs will in turn feedback to slow advanced country growth. Unless the world is able to retire or reduce its debt without default or hyper-inflation, the risk of global financial crises is rising.

Some Policy Considerations

The cure for over-leveraged companies often lies in the creditors allowing some debt-equity swaps to reduce the leverage, or some debt forgiveness and restructuring of the maturity of debt or the interest rate levels. In the late 1980s, sovereign debt restructuring was made possible by issuance of Brady Bonds²³, which basically enabled banks to sell their distressed debt in developing countries in exchange for 30 year zero coupon US Treasuries, bought by the debtor country using IMF, World Bank loans and/or drawing down foreign exchange reserves. The debtor negotiates with the creditors on the exit terms, either guaranteeing the principal, or a negotiated discounted principal with re-negotiated interest rates. The Brady Bond scheme was workable because most of the lending banks were US banks and their loans were to Latin American debtors deemed strategic to US interests.

The Spring Meetings of the IMF have agreed in principle to issue SDR500 billion or \$650 billion. If these are only used to increase foreign exchange reserves, there is only a liquidity effect, with little impact on actual FX mismatch, leverage or structural mismatches.

We assume that low income and middle income EMEs will use \$75 billion for their own liquidity needs. The balance of \$575 billion can then be allocated for structural reforms for the global financial system. IMF shareholders which have SDRs surplus to their own liquidity needs can invest such assets without compromising their financial position, since the SDRs would earn the same returns (paid by borrowers who draw down on SDRs). The issue is whether the \$575 billion could be creatively used to solve the maturity mismatch in global funding and addressed the SDG long-term investment gap?

We suggest that the surplus countries should consider allocating \$100 billion in a special Trade Finance Facility, which can be drawn down by any participating bank or regional arrangement that helps directly to provide short-term trade finance for SMEs. The ICC is working on the design of such a platform and facility.

²³ See Brady Bonds, Wikipedia. https://en.wikipedia.org/wiki/Brady_Bonds

The balance of \$475 billion can be invested in MDB equity, enabling them to leverage and therefore lend more long-term debt to help member countries. Each SDR surplus member can decide how to allocate investments in which MDB. Using the maximum MDB leverage ratio of World Bank of 9:1, \$475 billion capital injection would increase both short-term and long-term development finance by \$4.275 trillion, which would help in major climate change, social infrastructure and job creation investments.

Such investment in MDB capital is long overdue, but one must be realistic that one of the principal constraints in long-term SDG investments is the capacity of EMEs to design, implement and operate such large-scale projects. MDBs have over-time also lost crucial expertise in project-engineers who can assist their clients in designing and managing large scale infrastructure projects or programmes.

Another idea for using SDR new allocation by [Avinash Persaud](#)²⁴ is for the issuance to be used to use in disaster relief by debt forgiveness, by creating an “IMF-administered Covid Asset Purchase Trust.. funded by rich countries voluntarily and permanently depositing part of their new and unused SDRs into the Trust's operation in return for a perpetual instrument that yields the SDR money market interest rates. The Trust would then "use" these SDRs to repay Covid-related debt in countries that do not have the capacity for asset purchases in return for a special credit instrument issued by the middle-income country that met the Trust's funding costs.”

Avinash correctly diagnose the fundamental flaw in current financing infrastructure as balance sheet problems. However, over two decades after the Asian financial crisis, after Richard Koo diagnosed debt deflation as a national balance sheet problem, very few nations have produced national balance sheets so that analytically we are still unable to examine how individual country and global balance sheet flaws reveal both structural flaws and possible solutions for consideration. This may be an opportune time whether the role of the IMF should be expanded to take care of disaster risks or other risks that impact on financial stability.

Over the medium-term, EMEs should think how to develop multi-tiered capital markets to help de-leverage the corporate sector, especially in providing capital for SMEs. Different EMEs, including China, have major pilot schemes to provide crowd-financing and digital platforms and credit/equity clearing systems that should be explored in depth.

Summary

The time has come for the Emerging Markets Forum to seriously re-think for the emerging markets how to deal with the debt after-effects of the pandemic and inadequacies of the existing financing structure in which structural mismatches of maturity, foreign exchange and leverage have been solved so far by essentially central bank expansion of their balance sheets.

There is probably no one-size-fit-all solution, since the growing debt problem afflicts the advanced economies as well as the EMEs. Specifically, what mechanisms and institutions that we might need to enable this deleveraging? However, unless there is some serious re-thinking

²⁴ Avinash Persaud, Briefing Note, per Appendix 1.

of different options for resolution of these growing imbalances, the risks of global financial crises are rising.

It is timely that the EMF should convene discussions on this urgent and important issue.

George Town, Penang, Malaysia,
16 April 2021.

Appendix Table A1: Multilateral Development Banks Total Assets (USD billion)

#	Development Bank	Assets (USD bn)
1	European Investment Bank	606.5
2	International Bank for Reconstruction and Development, World Bank Group	283.0
3	Asian Development Bank	191.9
4	International Development Association, World Bank Group	188.5
5	Inter-American Development Bank	129.5
6	European Bank for Reconstruction and Development	67.7
7	African Development Bank	48.3
8	Asian Infrastructure Investment Bank	19.6
9	Islamic Development Bank	18.5
10	Central American Bank for Economic Integration	10.9
11	New Development Bank	10.4
	Total	\$1,574.8

Source: Investopedia, 2018 year-end data, except for IBRD.²⁵

Appendix 2

²⁵ Kenton, W. 2020. Multilateral Development Bank (MDB). Investopedia. Retrieved from https://www.investopedia.com/terms/m/multilateral_development_bank.asp

Debt, Natural Disaster and SDRs, a Modest Proposal, version 2.0. (paper quoted with permission from author)

by Avinash Persaud

Middle-income Debt Crisis

We welcome the temporary suspension of debt payments for the poorest countries and consideration of its extension, but *this will do nothing to avert an impending global debt crisis centred around middle-income countries*. According to the IMF, public and private debt increased by over \$19trn in 2020, the most significant increase on record. Most of this debt build-up was understandably in advanced and middle-income economies. In the advanced economies, policymakers have tools such as large asset purchases, near-zero policy interest rates, and massive fiscal stimulus - *middle-income countries do not*. Globally rising bond yields, a stronger dollar, and resulting credit rating downgrades in emerging markets with US dollar debt will locate the coming crisis in middle-income countries, remove their policy space further and deepen the crisis. *We have a systemic balance sheet problem*. More but cheaper debt will not mitigate against it²⁶.

We need to add a systemic middle-income debt reduction scheme to our crisis response. Irresponsible domestic policy choices did not cause the increase in Covid-related debt in 2020, and policy could do little to avert it, especially in trade-dependent countries. If we can strictly ring-fence this debt, *to only debt stemming from exceptional health costs, cash transfers to vulnerable people and support to avoid unemployment, and only for those countries which suffered disproportionately as a result of COVID*, and with some cap to the support set at a small fixed multiple of quota, then the right way to address this systemic and externally-caused problem is an instrument or facility. One solution will be the establishment of an IMF-administered Covid Asset Purchase Trust. It would be funded by rich countries voluntarily and permanently depositing part of their new and unused SDRs into the Trust's operation in return for a perpetual instrument that yields the SDR money market interest rates. The Trust would then "use" these SDRs to repay Covid-related debt in countries that do not have the capacity for asset purchases in return for a special credit instrument issued by the middle-income country that met the Trust's funding costs.

This mechanism can free-up the balance sheet of Covid deb by taking advantage of the interest rate differential between SDR money market rates and the rate that

²⁶ Though offers of cheaper debt are not to be dismissed. The IMF's surcharges for borrowing in excess of 185% of quota should be suspended where this debt has arisen as a result of Covid-related expenses.

middle-income countries pay and particularly were paying before Covid. This spread reflects liquidity and credit risk that can be reduced in the following three ways: (1) the IMF Board must declare its operations to justify Preferred Creditor Status, (2) the instruments it pays interest on and those it receives interest from must be perpetual instruments with floating rates, and (3) after its operations it should still earn a small spread to create loss-absorbing capital. Then it will have a perpetual fixed spread with limited liquidity and credit risk to capitalise, at its cost of funding, and to use to buy and cancel the identified debt.

2. Natural Disaster Clauses in IFI, MDB and RDB Lending

The debate around the potential extension of the DSSI and the ad-hoc considerations at play tells us that we need to systematize and instrumentalize such initiatives. One way would be for the IFIs to adopt natural disaster clauses in their lending. In the Barbados clauses, when there has been independent measurement and verification that a natural disaster has occurred, debt service is automatically suspended for two years. Those payments are then returned through an automatic 2-year extension of the lending arrangement. All IFI and MDB lending instruments should have these clauses built in, helping to make these clauses conventions for all debt - public and private.

3. Supporting Private Sector Investment Towards Building Resilience

Natural disaster clauses in IFI financial instruments provide critical liquidity at the time of the disaster. Still, the countries vulnerable to disasters *need critical investment to build resilience*, especially private sector investment given the public sector's lack of fiscal space. Private sector investment in resilience may require public sector funded incentives, blended finance and deeper capital markets that need the support of the international community and regional development banks as well as local regulatory changes. But the eligibility for such international support today is the level of GDP. In contrast, countries susceptible to such devastating loss and damage from natural disasters are only loosely related to past GDP per capita and more strongly related to environmental vulnerabilities. **Poverty is vulnerability; vulnerability is poverty.** In the case of climate change, these vulnerabilities are largely determined by geography. All the States between the tropics of Cancer and Capricorn will experience the first intensification of temperatures, sea levels, flooding, fire, and drought, like Dominica's loss of 226 per cent of GDP in 2017, and serious loss and damage from climate events in Haiti, Kenya, Philippines and Sri Lanka in 2018 and 2019. We need instruments that help build resilience from the IFIs like the Fund's PRGT, the MDBs, and RDBs, to have eligibility criteria that are better targeted to those at risk of severe loss and damage. Failure to do so reduces the effectiveness of our actions. It is estimated that because eligibility was determined by a GDP-convention only, just 15 per cent of rich country

aid for climate adaptation and mitigation went to those deemed highly vulnerable to climate change by UNEP.

4. Clearing House for Vaccines

There have been 8.5 billion confirmed purchases of vaccines, with another 6.4 billion doses under negotiation as of March 12th, 2021. The market for vaccines is not one of perfect competition, but highly imperfect. High-income countries have purchased the vast majority of vaccines (see figures 1-4 in the appendix) and many times what they require. The 20 per cent coverage limit of COVAX - the scheme to support poorer countries obtain vaccines - may have contributed to the problem with poorer countries struggling to procure the rest of the vaccines they need because of rich country demands crowd out their relatively small order amounts. Poor countries are paying middle-men excessive amounts, sometimes more than ten times the amount paid by rich countries and still not getting sufficient access.

The Covax facility should be reimagined as a clearinghouse for all purchases and sales of COVID-19 vaccines, and critically for the re-sale of excess vaccines held by rich countries. WHO could define the vaccination threshold for population herd immunity and once rich countries hit this herd-immunity targets, they could then provide a *proportion of the excess* vaccines they have to the COVAX facility at the price they paid for them. COVAX could then match this supply with orders from poorer countries and middle-income countries, thereby ensuring that all developing countries have access to vaccine supplies at reasonable and bulk prices negotiated by rich countries. The clearinghouse would ensure equitable access to vaccines, remove the current price-gouging prevalent in the marketplace, certify supplier authenticity and bring better balance between buyers and sellers.

Appendix Table A2: Net Investment Position, Major Surplus and Deficit Countries, June 2020

Surplus Country	NIIP Surplus (\$ bn)	Deficit Country	Deficit (\$bn)
Japan	3,603	USA	-13,405
China	2,200	Ireland	-698
Hong Kong SAR	1,735	France	-655
Taiwan	1,343	United Kingdom	-613
Germany	2,662	Australia	-598
Norway	925	Spain	-1,000
Netherlands	903	Mexico	-522
Singapore	883	Russia	-480
Switzerland	809		
Saudi Arabia	671		
Total	15,734		-17,971

Source: IMF External Sector Report and national NIP data.