



THOUGHT LEADERSHIP BRIEF

How Can a World Recovery Fund Relieve Developing Countries from Debt Having Piled Up in the COVID Aftermath?

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KEY POINTS

- ▶ After a pandemic with major social and economic consequences, emerging and developing countries need to swiftly address a two-pronged policy objective: sovereign debt sustainability and being able to fund investment, especially investment with high economic and social returns.
- ▶ So far, the international community – through the G20 in particular – has alleviated the liquidity strain facing developing countries with the DSSI and a quick mobilization of financial resources by the Bretton Woods institutions. However, the DSSI has now come to an end while the FED is tapering and about to hike interest rates. A handful of low-income countries face liquidity constraints or even solvency challenges already and such circumstances could also quickly extend to middle-income countries.
- ▶ With both new financing and legacy debt issues in mind, we make the proposal of setting up a World Recovery Fund (WRF), aimed at addressing some of the key problems with the design of the DSSI and more generally the existing international financial architecture for dealing with debt problems in the developing world. We first describe the main challenges in the international financial architecture for post-pandemic sovereign financing, and then detail our proposal for the WRF.



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ISSUE

Against the backdrop of tightening global financing conditions in 2022, emerging and developing countries need to swiftly address a two-pronged policy objective: sovereign debt sustainability and being able to fund investment, especially investment with high economic and social returns. With the G20 Debt Service Suspension Initiative (DSSI) ended in 2021 and the skepticism about the readiness of the Common Framework for Debt Treatment, additional and holistic solutions need to be developed. Otherwise, not only



will a handful of low-income countries face liquidity constraints or even solvency challenges, but such circumstances could also quickly extend to middle-income countries. This is even more likely if the cost of funding were to shoot up amid looming concerns about a taper tantrum 2.0. Besides problems with new financing, solidarity and continuous efforts are needed from different creditors – multilateral institutions, public sector and private sector creditors – to deal with the legacy of the high stock of debt accumulated.

However, a number of problems remain in the existing Global Financial Safety Net. First, the urgency of crisis management, especially when the shock is systemic and large, could blur the distinction between solvency and liquidity issues. Second, coordination among creditors has become increasingly challenging, given the increasingly diverse nature of creditor groups. A third issue is the lack of formal mechanisms to facilitate interlinkage between sovereign debt restructuring and financing, for instance through a central broker. Finally, on the financing side, we should also be aware of the limitation on the overall size of resources available for official sector financing and the allocation to individual debtor countries.

RECOMMENDATION

With both new financing and legacy debt issues in mind, a proposal is developed, namely setting up a World Recovery Fund (WRF), aimed at addressing some of the key problems with the design of the DSSI and more generally the existing international financial architecture for dealing with debt problems in the developing world. In a nutshell, setting up a WRF should enable emerging countries to swap existing debt for new debt and/or to issue new debt under improved market conditions, with an underlying project as collateral.

Aims of the Fund and Accessibility

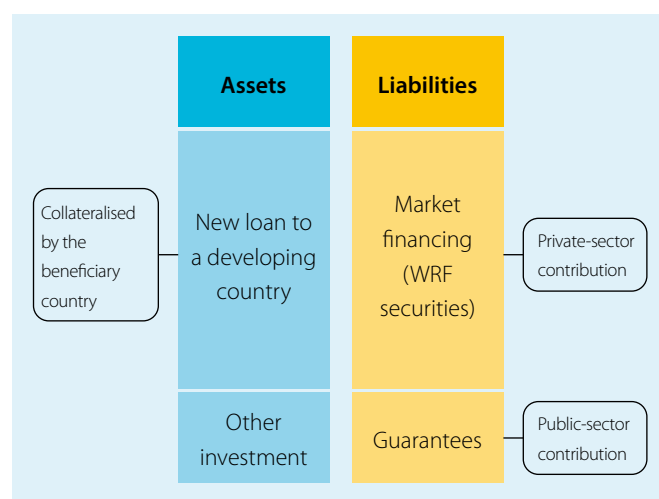
The WRF is a debt redemption fund in nature, designed to help debtor countries exchange highly costly and/or short-term debt for less costly and longer-term debt. It can buy back sovereign debt securities of a given country and swap them with a WRF loan financed by the WRF's own securities issued in international financial markets. With its financial structure based on guarantees from highly rated countries and/or large official creditors to developing countries (as will be explained in further detail later), the WRF is expected to have a better credit rating than the beneficiary developing countries, thus allowing a swap of higher-risk and costly

sovereign debt securities issued by a developing country with a less costly supranational loan provided by the WRF. Figure 1 illustrates the basic structure of the WRF. For readers who are familiar with the set-up of euro area crisis resolution mechanisms, the WRF is inspired by the European Financial Stability Facility (EFSF), created in 2010 to provide exactly the same type of debt transformation for the euro area countries facing sovereign debt crisis.

A very important issue in the design of the WRF is accessibility criteria. Our proposal is to combine a top-down and bottom-up approach to designing accessibility. The top-down assessment could be based on the longterm debt sustainability of the country soliciting the WRF debt treatment, taking into account the maturity transformation that the WRF could offer, as we will detail below. The most natural broker would be the IMF, as it has been performing this role to assess whether a country can have access to IMF funding.

This top-down approach, however, has proven to be difficult, given the considerable pandemic- related uncertainty surrounding key variables determining debt sustainability, and thus needs to be supplemented. This is why we propose to include a bottom-up approach based on the nature of the project a country wants to finance with the assistance of the WRF and/or the collateral that the country can provide to the WRF for the debt swap. This bottom-up approach could be effectively developed on the basis of the existing project financing models that multilateral banks are using. As for the collateral, it could take various forms, from the most liquid financial assets (e.g. assets in convertible currencies) to the least liquid tangible assets or projects, such as infrastructure developments.

Figure 1. World Recovery Fund's Balance Sheet

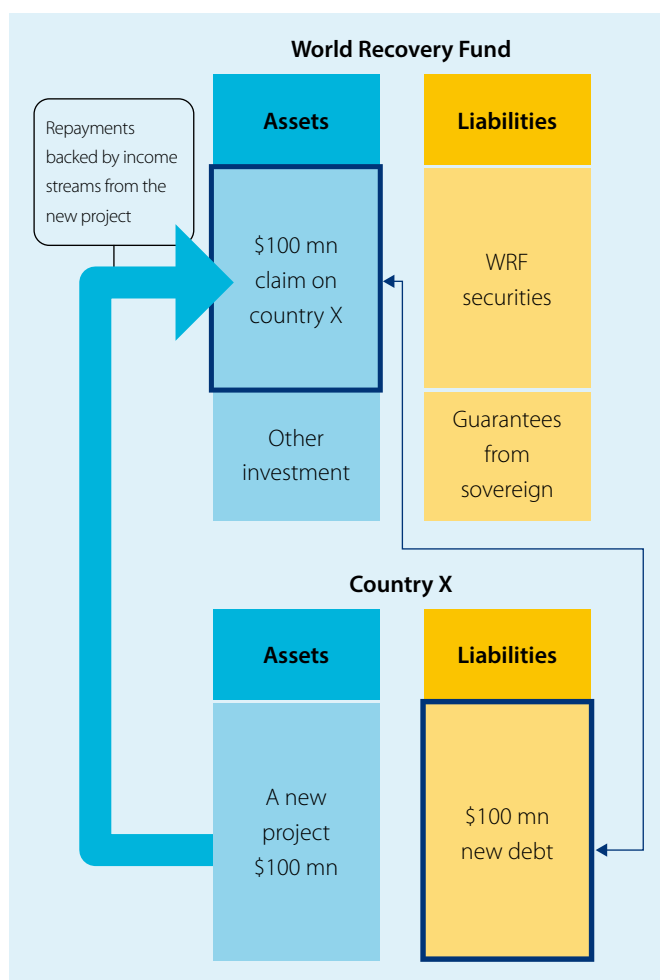


Basic Mechanism for the World Recovery Fund to Help a Developing Country

In our framework, there are two ways for the WRF to assist a developing country: new debt issuance and treatment of old debt.

In the first and most straightforward scenario, a country X could use the WRF to issue new debt. Given the high creditworthiness of the WRF (as discussed below), using the WRF as a financial intermediary could be cheaper for country X than issuing debt directly on its own in international financial markets. As Figure 2 shows, the WRF will raise funds from markets and provide a loan to country X. Country X can use this loan to finance a defined project and use the future income streams from the project as collateral to ensure the repayment of the WRF in the future.

Figure 2. WRF as a Financial Intermediary to Provide New Financing



In a second scenario, countries can use the WRF to deal with legacy debt issues. When facing debt problems, whether liquidity- or solvency-related, the country in question could redeem part of its existing debt stock, which will finance this debt buy-back using the funds raised in international financial markets via its own securities. A natural question that stems from this design is which legacy debt is eligible for buy-back by the WRF, i.e. bilateral official debt or private debt. Theoretically speaking, all old debt could be eligible, but we propose to proceed stepwise. At the inception stage, only bilateral official debt will be eligible, so as to avoid the criticism that public money (in this case financing from the WRF) is used to redeem debt owed to private investors (whether bonds or loans from commercial banks). In addition, sovereign creditors are invited to serve as the WRF's guarantors, as we will explain in the next sub-section. Should this first step be successful, we could extend the WRF to allow buy-back of private debt from institutional investors. Compared with the first scenario, the second mechanism described above will lower the beneficiary country's gross financing needs only. Given that country X remains responsible for the principal payment, the WRF could require some forms of collateral to support this debt swap transaction. Country X's old creditors should also have incentives to resell their holding of country's X debt (of US\$100 million in the example), as their credit risks are lowered.

Contributions from Private and Official Creditors

In the current design, private and official creditors contribute in different ways to the new financing of developing or emerging economies, as well as the swapping of existing debt. Private-sector creditors contribute indirectly, as they would invest in the securities issued by the WRF in international financial markets. For the WRF to be able to raise funds cheaply, it needs to have a minimum solid capital structure, based on guarantees (like the EFSF) or paid-in and callable capital (like the European Stability Mechanism, ESM, or other MDBs). And this is where direct contributions from official creditors come in, under our proposal, as they will need to provide financial resources to fund the WRF.

For now, we propose that a set of creditor countries provide only guarantees to set up this WRF, according to a pre-set contribution scheme. The contribution scheme could, above all, reflect the current landscapes of the exposure of different creditors to developing countries. Namely, countries having lent more to

developing countries could contribute a larger share of guarantees to the WRF. However, such pre-set contributions alone cannot guarantee a good credit rating for the WRF, as a very large creditor nowadays is China and a few other emerging market economies. A good credit rating is essential to ensure low financing costs for WRF. This means that highly rated creditor countries (e.g. countries with a sovereign rating above AA+) need to be brought in. Therefore, over-collateralization should be considered, so as to raise the overall ratings of the WRF, following the example.

The remaining question is how to engage different sovereign investors in the WRF. There are a few ways, depending on the circumstances of the creditor. As regards existing creditor countries of developing/emerging economies, pooling together guarantees within the WRF for it to serve as a financial intermediary could lower the financial burden of each single guarantor, given that a group of creditors act in a coordinated manner to provide new financing or to treat legacy debt issues. Beyond the benefits of pooling resources, heavily exposed countries, such as China, can also benefit from the multilateral set-up of the WRF. In fact, a multilateral framework provides stronger legitimacy than bilateral official lending to less developed countries, thus subject to less strong criticism from public opinion. All in all, this framework could also enhance creditor coordination to minimise the consequences of a single creditor restructuring on other creditors (including potential free-riding or first-mover advantage). As regards potential WRF members that are not yet exposed to a specific credit name, but hold a good credit rating, a number of incentives can be set up to attract them. The first is to enhance transparency on lending practices and on the stock of debt of the developing world. Setting data pre-requisites for countries accessing WRF financing on their debt structure could entice high-rating countries to participate. In the same vein, earmarking the WRF's new funding to projects with a high socio-economic return should also help.

Other Operational Issues

In any event, to operationalise our proposal, we still face a number of technical challenges. First, depending on the size of the World Recovery fund, a balance needs to be struck between the WRF and the development of a primary market for sovereign financing at the national level. Secondly, there might be national legal constraints on our proposal. Finally, the current design of the WRF detailed above is based on the guarantees provided by official lenders. In a second stage, we can also consider the possibility of extending the group of guarantors to private investors.



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