Chatham House and TCX webinar
The Role of Debt Management in Achieving Debt Sustainability in Frontier and Emerging Economies

Issues Note

Overview

Frontier and emerging economies were always going to need large inflows of foreign capital to meet the **Sustainable Development Goals**. Accelerating climate change and the fallout from the pandemic have increased these requirements further. According to the UN's SDG 2020 report, achieving the Sustainable Development Goals, will require targeted investment across all sectors of $5-7 trillion per annum[i]. But current financing levels are far below this level.

The pandemic has also **seriously weakened the financial position** of frontier and emerging economies, increasing the challenge they face of stepping up financing to meet these requirements. The Managing Director of the IMF recently noted that public debt in sub-Saharan Africa jumped by more than **6 percentage** points to **58 percent** of GDP in 2020, the highest level in almost two decades. Interest payments last year reached **20 percent** of tax revenue for the region as a whole and exceeded **one-third** of revenue in some countries.[ii]

This webinar has been jointly organised by Chatham House and TCX to explore the key role of **debt management capabilities and policies (particularly as they relate to foreign exchange risk)** in enabling frontier and emerging economies to achieve the twin goal of a high level of access to external finance and sustainable debt over the long-term.

Background

The rise in public debt caused by the pandemic threatens to increase vulnerability, raise financing costs, and may in some cases halt market access. The continuing uncertainty about how and when economic recovery from the pandemic will occur adds further to the financing challenge. The foreign exchange risk on outstanding foreign currency debt, in the face of heightened local currency volatility, is a particular cause for concern for a number of borrowers.

Many low-income countries are taking advantage of the G20 Debt Service Suspension Initiative (DSSI) to gain breathing space, and a few countries, facing acute debt distress, are working with creditors under the G20 Common Framework to restructure their debt.

But it remains to be seen **how effective these efforts will be**. It is still unclear how the Common Framework will be implemented. And even if successfully implemented, the Common Framework does not provide solutions for a much larger group of frontier and emerging economies which are capable of servicing their debt now but may not be able to do so in the future in the face of further economic shocks.

Debt management capabilities and policies are one of several factors determining access to external finance and debt sustainability. Others include: the global macroeconomic situation, the economic policies adopted by the frontier and emerging economies themselves, the scope and depth of private financial markets, and the approaches of donors and external lenders.

Debt management is particularly important in controlling and managing **foreign exchange risk**. Foreign currency denominated debt of borrowers in all developing and emerging economies now stands at $6 trillion, of which low and lower-middle income countries account for about $2 trillion.

Countries vary considerably in the extent to which they rely on domestic vs external debt sales, and the extent to which either form of debt is denominated in foreign or local currency. Thus **Kenya's public debt** is split roughly equally between foreign and local currency. All local currency debt is sold to domestic investors and all foreign currency debt is sold externally. By contrast, all **Mexico's**

foreign currency debt is sold domestically, while it local currency debt is roughly equally split between domestic and external holders.

Such outcomes may sometimes reflect deliberate choices from a range of options. But they may also reflect a forced outcome in which countries have effectively had to make the best of very limited choices.

Issues for discussion

Through the presentation of academic research, practitioner perspectives, and a panel discussion, the following three core issues will be addressed in the webinar:

What contribution can effective debt management make to an individual country's ability to access external finance and its long-term debt sustainability?

Given the wide range of factors influencing the financing conditions a country faces, including the domestic economic policy framework and global economic environment, what is the specific contribution effective debt management can make to achieving a high level of access to external finance while maintaining debt sustainability?

What are the key challenges that frontier and emerging economies face in delivering effective debt management, particularly with respect to managing foreign exchange risk?

What is the role played by insufficient technical capabilities and experience, and where is the shortfall most acute?

How important are political and institutional governance structures for the decisions made on debt management and particularly those with respect to foreign exchange risk? What happens when these are not appropriately designed or implemented?

To what extent is a lack of deep and liquid private markets for hedging instruments (particularly long-term local currency foreign exchange forwards), or various kinds of contingent debt (such as GDP-linked bonds), a problem? What is the cause of these market gaps?

What steps can individual borrowing countries, the private sector, international financial institutions, or advanced country governments, take to enhance the contribution made by debt management to access to external finance and debt sustainability?

Can individual countries do more to enhance their **capabilities and experience**? Do they have access to the right kinds of training support from the IFIs?

Is there a role for **simple debt rules** that establish sustainable targets on the composition (or risk exposure) of the public debt portfolio? Should changes be made to the way external debt sustainability is assessed by the international financial institutions or the private sector? [iii]

Do advanced countries and/or international financial institutions need to **lead the way in developing new markets** which will also be of benefit to frontier and emerging economies? (Previous examples of this kind of behaviour include the introduction of collective action clauses in advanced country debt and the role of the IFIs in developing markets for natural disaster risk.)

How appropriate is the assumption of **"caveat emptor"** in the arrangement of development financing? Do MDBs, DFIs and other major providers of development finance need to change their approach, including greater use of local-currency lending, use of hedging instruments, and support to insurable-risk markets?

Is there a need for a **new international institutions** to substitute for gaps in the markets and over time help them develop. Recent proposals include establishing an *International Currency Fund*[iv] and a *Liquidity and Sustainability Facility*[v].

Should the **Common Framework** be developed further to ensure more definitively that debt restructuring negotiations lead to long-term debt sustainability? What are the lessons of Highly Indebted Poor Countries' (HIPC) Initiative and the Multilateral Debt Relief Initiative (MDRI) in this respect?

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[i] The Sustainable Development Agenda – United Nations Sustainable Development

[ii] IMF's Georgieva: The Road Ahead For Africa, Fighting The Pandemic And Dealing With Debt – Speech – Eurasia Review

[iii] See, for example, Emerging-market debt in the COVID-19 pandemic | Chatham House – International Affairs Think Tank and Managing global liquidity through COVID-19 and beyond | Chatham House – InternationalAffairs Think Tank

[iv] "A multilateral solution to hedging currency risk in developing country finance" *by Sony Kapoor, Harald Hirschhofer, Dimpal Kapoor and Nanno Klieterp*

[v] ECA launches LSF, a vehicle for debt management and fiscal sustainability | United Nations Economic Commission for Africa (uneca.org)