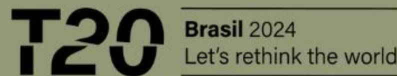
T20 Policy Brief



Task Force 03

REFORMING THE INTERNATIONAL FINANCIAL ARCHITECTURE

Public Debt and Sustainable Development in the Post-pandemic Era: A Global South View

Ramiro Albrieu, Principal Researcher, Centro de Estudios de Estado y Sociedad (CEDES) (Argentina)

Mma Amara Ekeruche, Senior Research Fellow, Center for the Study of the Economies of Africa (CSEA) (Nigeria)

Paul Lakuma, Senior Research Fellow, Economic Policy Research Centre (EPRC) (Uganda)

Alemayehu Geda, Professor of Macroeconomics and International Economics, Addis Ababa University (AAU) (Ethiopia)

Luis Miguel Galindo, Professor of Economics, Universidad Nacional Autónoma de México (UNAM) (México)

Fernando Lorenzo, Director, Centro de Investigaciones Económicas (CINVE), South American Network on Applied Economics (Red Sur) (Uruguay)

Arjan de Haan, Senior Program Specialist, Climate Adaptation and Resilience, International Development Research Centre (IDRC) (Canada)

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Abstract

The global economy has experienced unprecedented challenges posed by the pandemic. Central to these enduring repercussions is the escalation of public debt, casting a shadow over the fiscal space of governments and their ability to make progress in achieving the Sustainable Development Goals (SDGs) and address the growing impacts of climate change. It is thus urgent to reconsider debt restructuring strategies, the conditionalities associated with International Financial Institutions' loans, and emerging fiscal frameworks for the developing world. In this policy brief, we develop four concrete proposals involving international financial institutions, which can function as avenues to tackle the challenges mentioned above: (a) alternative ways to define "sustainability" in international financial institutions' debt analysis; (b) to promote debt-for-climate swaps; (c) support the implementation of green tax reforms; and (d) support government implementing non-regressive tax reforms.

Diagnosis

Public debt after the pandemic

The dramatic combination of higher public expenditures and lower tax revenues related to the pandemic led to a remarkable increase in public debt levels in Global South countries, presenting an unprecedented shock to public finances that has reshaped economic and fiscal landscapes. This was particularly true in middle-income countries - in low-income countries the fiscal situation was constrained even in 2020 (see Chuku et al. 2023).

Figure 1 provides a stark visual representation of this upheaval. During the pandemic, countries in the Global North had more room to implement mitigation policies, so that the debt/GDP ratio grew by almost 20%. In the Global South, with the heterogeneities mentioned above, the increase in public debt was significantly lower. However, in the aftermath of the 2020 peak, the Global North induced a partial reversal of pandemic-induced debt increases, with debt levels hovering around 100% of GDP. In stark contrast, in the Global South, their debt ratios over GDP remained at 2020 levels in the latest available data, signaling a sustained and elevated burden for governments. To summarize, the pandemic showed the asymmetries that exist in debt markets: countries in the Global North are better able to smooth the impact of adverse shocks, and have mechanisms to reduce the debt burden after such shocks; in the Global South, financing during shocks such as the pandemic is smaller, and the burden of such financing is long-lasting.

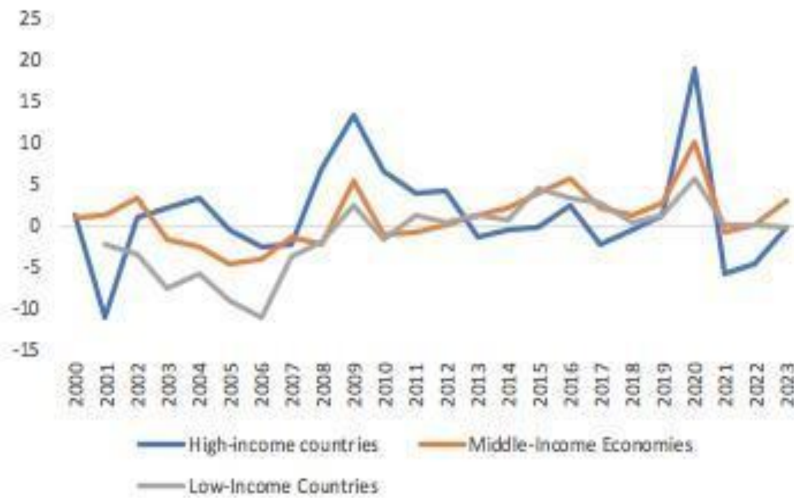

FIGURE 1. Change in gross public debt-to-GDP ratio

Source: IMF

However, the true complexity of the situation unfolds when adopting a prospective lens. The trajectory of the debt-to-GDP ratio in the Global South hinges on the interplay of two crucial sets of variables. Firstly, the flux of revenues and expenditures. Secondly, the intricate relationship between GDP growth and interest rates. According to the World Bank`s estimates for long term growth, Emerging Market and Developing Economies (EMDEs) will experience a further growth slowdown in the years to come (see Kose and Ohnsorge 2023). Moreover, the landscape of interest rates is expected to be shaped by the continued restrictive stance of monetary policies in developed countries. The IMF, in its latest Global Financial Stability Report, labeled the medium run as the “high-interest-rate era” (see IMF, 2023 and Adrian, 2023).

Figure 2 underscores the challenging path ahead for Global South countries, projecting a prolonged period of elevated public debt levels. The intertwining of sluggish GDP growth and high interest rates forms a nexus of enduring challenges, indicating a scenario where the burden imposed by the pandemic on fiscal space persists far into the

future. In navigating these uncharted waters, policymakers in the Global South are confronted with the immediate imperative of managing debt in the short term, and with a pressing need for fiscal consolidation.

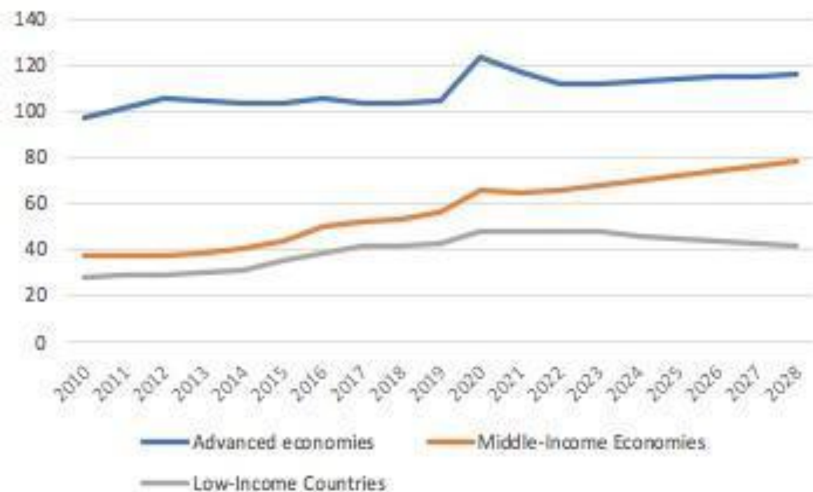

FIGURE 2. Gross public debt-to-GDP levels

Source: IMF

Painful Trade-offs to come

In the realm of high debt scenarios, interest payments on accumulated debt emerge as contenders for government resources, triggering challenging trade-offs. This is vividly illustrated in the aftermath of the pandemic, where the intersection of debt interest payments and overall public education expenditures saw a stark increase, as can be seen in Figure 3. This trend is more evident in Africa, with the ratio of interest payments to education expenditure escalating from 54% to 77% (see UNCTAD 2023). In stark contrast, the Global North witnessed an opposing trend during the same period.

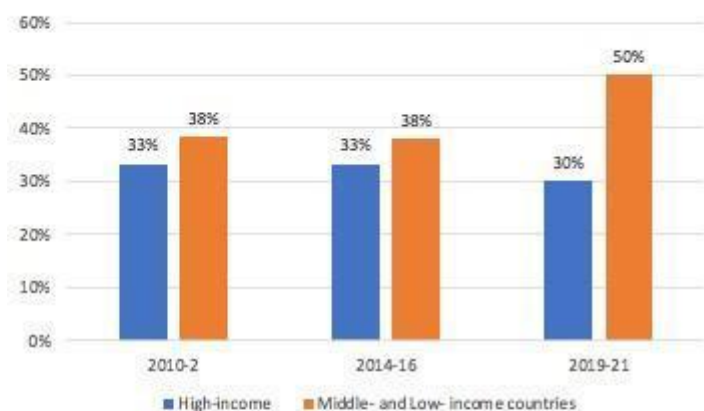

FIGURE 3. Ratio of interest payments to education expenditures

Source: UNCTAD

This intricate landscape casts a looming shadow over other development milestones, such as those associated with the green transition. For Global South countries, where the cost of transitioning towards a sustainable, zero-emission carbon scenario by 2050 stands at 5%/7% of GDP -see Galindo and Lorenzo (2023a)- the burden imposed by interest payments further jeopardizes these aspirations. The challenges are particularly acute in Africa and Latin America, as illustrated in Figure 4, where the ratio between interest payments and the investments needed for a zero-emission scenario doubled in Africa and increased by a third in Latin America over the last decade. In navigating this rugged terrain, the imperative for Global South nations lies in addressing immediate debt challenges and devising resilient strategies that safeguard vital development expenditures amid the pervasive spectrum of high public debt.

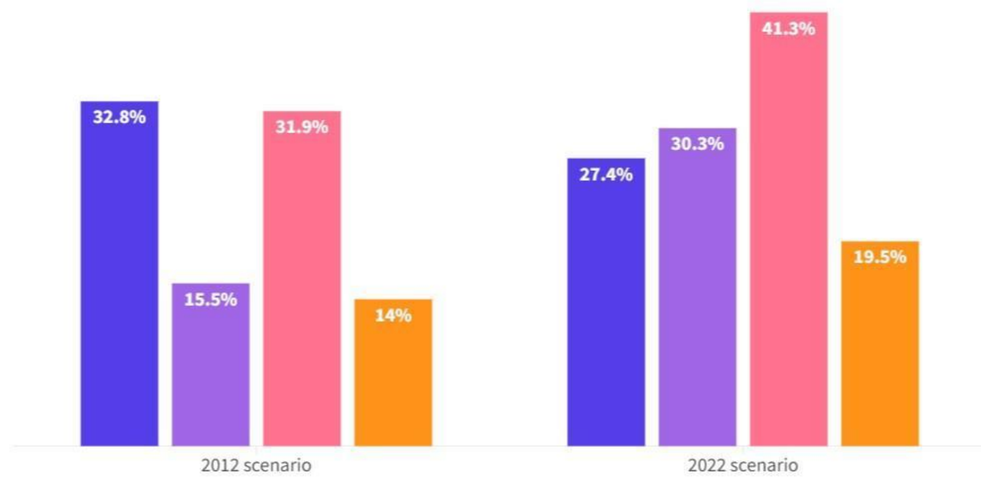

FIGURE 4. Ratio of interest payments to spending for a net zero scenario

Source: United Nations

Recommendations

In his closing speech at the G20 Summit in New Delhi on September 10, 2023 -when India formally handed over the presidency of the bloc to Brazil- President Luiz Inácio Lula da Silva said, "The Brazilian presidency of the G20 will have three priorities: (i) social inclusion and the fight against hunger; (ii) energy transition and sustainable development in its three aspects (social, economic and environmental), and; (iii) the reform of global governance institutions".

The urgency of addressing the issues of public debt and sustainable development is evident in the discussions mentioned in this policy brief. The global economy is characterized by an international financial architecture where financial institutions evaluate debtors primarily on short-term economic solvency, a high social discount rate that makes long-term problems -such as energy transition and environmental issues- invisible, and existing power structures that make the burden of adjustment fall on those with fewer resources and less vocal voices. It is high time we address these issues to ensure a sustainable future for all.

What should public policy - both national and at the G20 level- do to ensure that the post-pandemic period of high debt levels does not undermine sustainable development objectives? In a recent multi-regional project on public debt and the different dimensions of sustainability, called "Promoting a pandemic recovery: evidence to support managing the growing debt crisis," we try to answer this question with a Global South perspective. We produced 20 documents with the aim of improving the understanding of national contexts of debt and the connections between debt burden and fiscal space, listing the instruments for sustainable debt management and the promotion of a green transition, and

detecting opportunities to promote and advance gender equality as well as climate resilience and low-carbon transitions, among others.

In what follows, we list three concrete proposals studied in this project. These proposals are at the center of the connections between the three priorities for the G20 under the Brazilian presidency, as they can function as avenues to circumvent the painful trade-offs mentioned above, i.e., between debt sustainability, on the one hand, and social and environmental sustainability.

1. ***G20 countries should push for the adoption of a broader approach to sustainability for all Debt Sustainability Analysis (DSA) exercises***

In the Global South, the sustainable development agenda has many pending issues. In this context, the concept of "fiscal sustainability" cannot be determined exclusively by the need for short-term fiscal consolidation. If this is the case, fiscal policy frameworks (tax and expenditure) and debt management will seek only to generate short-term liquidity to service the debt. All other fiscal policy objectives -related to growth, poverty, equity, or the environment- take second place to this one. The debt-sustainability approach of multilateral lending institutions falls into this category, which means that more often than not, the majority of countries under debt stress implement macroeconomic policy frameworks that allocate a higher share of the burden of the needed fiscal consolidation on those with less voice in the society, such as women and the youth, or future generations. Consequently, expenditures related to development -such as public investment or education spending- are often prime candidates for initiating fiscal consolidation paths in these situations.

There are several initiatives within multilateral institutions to change this outlook. The IMF, for example, is actively engaged in supporting social expenditures in the aftermath of financial crises (IMF 2019). However, proper methodological frameworks that can assess these tradeoffs are still missing. We propose to modify Debt Sustainability Analysis (DSA) frameworks broadening the definition of sustainability to go beyond short-term government finance. This version of "sustainability" incorporates concepts associated with intra-generational equity (e.g. poverty and distribution) and inter-generational equity (e.g. climate and the environment), and explore bi-directionalities (e.g. how climate shocks affect the sustainability of public finances, and how fiscal consolidation cut funding on climate-change policies); if, as proposed in this policy brief, a broader definition of sustainability is taken, then it is possible to find common grounds between the goals of development finance and sustainability finance, and also uncover the necessary trade-offs (for more details on the framework and its analytics, see Galindo and Lorenzo 2023b). This policy brief takes into consideration that the low-income country Debt Sustainability Framework (LIC-DSF) is currently being reviewed. We recommend that the review process should be extended to the DSA for Market Access Countries.

2. ***The G20 should engage with developing countries, particularly those in Africa, to explore debt-for-climate swaps***

According to Chamon et al. (2022), debt-for-climate swaps are arrangements where debt is reduced in exchange for spending or policy commitments on the side of a debtor country at a fiscal cost no higher than the debt reduction. Ekeruche et al. (2023) explored the need for, viability of, and impacts of debt swaps in Global South contexts, particularly in Nigeria. It focused on two sources of debt that are most likely to be involved in a debt

swap: Paris Club ODA debt -most of which is owed to G20 countries- and underperforming private sector debt. These two sources together comprise a sizable part of total debt in several developing countries and whose exchange could free up resources to fund development priorities for facilitators of the debt swap. Beyond funding development projects, remaining funds could decrease the debt burden, provided they do not spawn additional borrowing. The authors reviewed five countries that have participated in debt-for-nature swaps. They found that debt-for-nature swaps marginally increased funding for the environment by providing funds for specific environmental projects in three out of the five countries. Therefore, debt swaps are a viable way to achieve two objectives: 1) Fund needed projects in areas neglected during times of economic downturn, and 2) Expand budgetary resources to alleviate debt burdens or make budgetary expenditures vital to economic recovery. Thus, developing countries should be encouraged to adopt debt swaps in cases where debt risks are elevated.

3. G20 countries should assist governments design green tax reforms in a way that they improve income distribution

Addressing the challenge of climate change requires implementing a new fiscal and financing strategy that is consistent with deep decarbonization. Green tax reforms initially sought to use the new tax revenues to reduce other levies, such as those on social security, to promote employment. Currently, green tax reforms are broader, without defining the specific use of resources, but considering possible fiscal recycling processes. The magnitude of the structural transformations associated with green tax reform requires consideration of their viability and the political economy they imply. Therefore, the implementation of these fiscal reforms must be based on a broad social consensus that

makes them viable and where the positive consequences for the population as a whole must be evident. In this sense, they must incorporate a contribution to improve income distribution. Incorporating these structural transformations into the current style of development requires a financing strategy. The structural transformations needed to build a carbon-neutral economy between 2050 and 2070 imply several transition risks that significantly impact the financial system. Evidence shows that the financial system does not properly incorporate the risks of the climate transition. For example, it does not incorporate the risks implied by stranded assets that will transfer into abrupt changes in the value of bank assets and affect their balance sheets. This will result in a carbon bubble. However, in recent years, there has been a substantial increase in thematic financing associated, for example, with green, sustainable, climate or gender bonds. These types of financing represent a fundamental lever for transformation. However, it should be noted that the fulfillment of certain climate, social or gender targets increasingly accompany these financing mechanisms. Therefore, non-compliance may result in higher payments. This can become an additional obstacle to development. Thus, a new fiscal and financing policy consistent with a profound decarbonization of the economy is essential to implement the structural transformations required for the current style of development. These fiscal and financing strategies should not only consider the preservation of current fiscal balances but also build a new fiscal and public debt management paradigm.

Scenario of outcomes

Regarding approaches to measuring fiscal sustainability in DSA exercises, the advantages for debtor countries under stress are substantial. On the one hand, a better understanding of the impact of shocks not associated with macro-financial variables on public debt profiles would be achieved. On the other hand, the new sustainability assessments would act as a new signaling device to the financial system, preserving expenditure items associated with sustainable development in the face of financial stress. The immediate adverse effects are related to a known methodology being replaced by another requiring a testing period.

Swapping debt service payments for nature spending is another way to preserve natural assets in situations of financial stress. With the medium-term outlook discussed in this policy brief, including high interest rates, and tight financial markets, these swaps will be extremely useful for the Global South in the near future. However, such instruments should not be expected to solve fiscal solvency problems; as the G77 (2024) pointed out, they should not be considered substitutes for deeper debt restructuring strategies. Similarly, they should not be seen as substitutes for a more general green financing strategy that many Global South governments must follow (Chamon et al., 2022).

Regarding the green tax reform, the available evidence of the consequences of environmental fiscal policy is complex but shows that environmental taxes contribute to reducing negative externalities. However, though it is common that they are insufficient to control the negative externality completely, they are important revenue-raising instruments. This is because the demands for the goods that cause the negative externality normally have high-income elasticities and low-price elasticities in absolute terms.

Likewise, evidence on tax incidence indicates that fuel and car taxes have, in general, progressive effects on income distribution, considering the percentage of expenditure on these goods in total expenditure by income quintile. Electricity taxes, in contrast, have mixed effects on income distribution. In this sense, it is important to consider fiscal recycling processes to ensure that green tax reforms have positive effects on income distribution. In this context, the potential relevance of a carbon tax stands out.

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