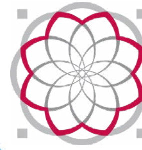

Another Debt Crisis in the Making?

Zeina Abla

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Another Debt Crisis in the Making?

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Debt crises have become more frequent across the world, especially in developing countries. More than 95 countries underwent some 600 debt restructurings during 1950-2010 with 280 restructurings taking place in 1980s and 1990s. The 1980s in Latin America were marked as a “lost decade”. The 1990s were not much better with many countries in unresolved debt crisis. The conditions improved over the last decade, as a result of a combination of internal and external factors like more favorable interest rates, growth of developing economies, changes in commodity prices, amongst others. Global changing conditions facilitated domestic and foreign borrowing. However, the increased borrowing was not driving economic and social development; it had limited impact on the real economy and became again more and more risky.

The COVID pandemic amplified economic and financial fragility, more so in developing countries that accumulated elevated debt levels. Arab middle-income countries are precisely facing a dire situation. The magnitude of the pandemic and economic disruptions jeopardized their ability to pay for much needed imports a well as high external debt service in foreign currencies and at the same time protecting people from health and economic repercussions. In the absence of a strong global response to ensure a steady recovery of the level of the crises, large debt overhangs could drive towards another “lost decade” in Arab middle-income countries.

This report aims to inform a general non-technical audience about current debt vulnerabilities of developing countries and Arab middle-income countries particularly, using secondary data from international organizations databases and documents. After introducing the debt sustainability issue (section 1), section 2 highlights trends governing developing countries’ debt over the last decade, and focuses on the impact of COVID. It does the same reading for Arab middle-income countries in section 3, with a focus on Egypt, Jordan, Iraq, Lebanon, Morocco, and Tunisia. The report ends with suggestions targeting particularly civil society to engage in mechanisms of fair and effective debt resolution (section 4).

Dealing with debt

The world economy has become increasingly reliant on borrowing over the last two decades. But it is developing countries that are more compelled to borrow, given their history and under prevailing global financial and trade systems of asymmetrical power relations.

Public debt financing is not necessarily bad

Public debt can finance large infrastructural projects and productive investments if they generate sufficient returns for repayment. Borrowing could be used to pass from an economic crisis to recovery, because it is relatively quicker and could be substantial in volume. This mainly holds when considering concessional debt and becomes a weaker argument when talking about the more costly market debt. Public debt can be used as a development financing instrument, when other financial resources are insufficient or take time.

To benefit, policymaking should channel it to

most effective use, considering its costs, and ensure its positive impact on fulfilling basic human rights (economic and social) and leading to a fair distribution of wealth. Public debt is thus about making policy choices and trade-offs (economic, political and social) at present and across time to boost the real economy that delivers to society. It is also about international political and economic conditions that impose power relations between creditors and debtors and could become a major obstacle to development, and sometimes locks developing countries in a state of underdevelopment.

But the perils of a debt crisis should not be underestimated

History shows that debt crises continue to occur and place heavy burden on societies especially that external debt financing has been moving in response to speculative investments rather than meeting real economy and productive sectors' needs . Over the past decades and even before COVID, the risks were quite high. In 2018, UNCTAD report warned: "…unsustainable international debt burdens haunt the developing world and are fast becoming a core obstacle to the international community delivering on its repeated promises to enable sustainable development finance."

Debt distress leads to economic contraction in the short-term and long-term, due to a reduction in consumption and investment on the demand side and higher financing costs and access to international capital markets and lower productivity on the supply side. More importantly, debt distress has social implications as it diverts public resources from social spending. It can become a mechanism to increase inequalities and exploitations within and between countries.

Debt management becomes more difficult because international financial institutions that set borrowing terms globally require fiscal consolidation and adjustment strategies for financial sustainability, to correct macroeconomic imbalances yet do not address the root causes of these imbalances. These measures often delay and accentuate the problem, leading to what is referred to as a debt trap; a situation where borrowing continues for the purpose of repaying previous debt.

Debt management is made more difficult in the absence of a global sovereign debt resolution system with fair and clear rules to support countries in crisis. Whereas corporates facing debt problems are subject to corporate insolvency laws that provide debtors with some minimum rights, no such regulations exist for countries in debt and consequently debt relief is avoided. Existing regulations only manage and bind some creditors. This leads to a prolongation of debt crises resolution. In addition, governments generally shy away from admitting and managing a debt restructuring, though risking debt sustainability. They defer as much as possible for political reasons, preferring to avoid igniting the economic crisis and making tough policy choices.

What is debt sustainability?

Debt is considered sustainable when a borrowing country can still meet its obligations to creditors without default or seeking special

financial assistance. It can rollover its debt or find new creditors to provide additional lending, notwithstanding whether the creditors are responding to sound economic fundamentals or political reasons.

The predominant approach to public debt sustainability considers debt from a financial and accounting perspective and focus on ability to repay creditors. It is the approach set by the International Monetary Fund (IMF), World Bank and adopted by the G20 and Paris Club . The IMF-World Bank Debt Sustainability Analysis (DSA) evaluates "the vulnerability of the country to a payments' crisis" and considers "debt sustainability as a situation in which a borrower is expected to be able to continue servicing its debts without an unrealistically large future correction to the balance of income and expenditure". In order for a certain level to be sustainable, the debt-to-GDP ratio should stand around a certain threshold (usually it is 70% for low income countries) while no new debt is issued to service existing debt and the fiscal balance is in surplus to settle debt service.

In 2021, the IMF adjusted its debt sustainability framework to broaden its assessment scope and take into consideration time and a wider set of country features and their interaction, and assess sovereign risk at large . The DSA calculates macroeconomic indicators along with the public debt indicators' present value (i.e. how much should be available at present to be able to pay interest and principal as scheduled to be settled) and compares to thresholds and peers, while attuning to countries with similar features and that historically faced distress. It uses a baseline macroeconomic situation, public finances, the debt stock and financing needs, in order to come up with projections and scenarios. It assigns countries different debt risk levels for classification. Despite its recent update, the framework remains concerned with financial objectives and did not equate longer term development goals and social sustainability to repayment risks. It is still geared towards meeting creditors interest primarily. The sovereign risk assessment does not consider the private sector debt that could ultimately become a burden on governments. It is also blind to the redistribution that the debt dynamics create in a country. DSA informs the IMF, World Bank and other creditors' lending decisions, yet without fully revealing the sustainability thresholds for middle income countries, allowing for some political leeway to drive the lending decision

In contrast, other organizations such as the Jubilee Debt Campaign assess debt crisis vulnerability beyond just the ability of repayment. They consider a country in crisis when debt constrains economies and governments' ability to provide basic social and economic rights to its people, i.e. by limiting government expenditures to meet development goals. So instead of thinking how much a country needs in financial adjustment to ensure creditors are repaid, the question becomes: how much a country needs to satisfy its citizens rights and pay creditors. Hence the thresholds adopted by the Jubilee Debt Campaign are more conservative than those of the IMF

In general, the most commonly used metric to assess a country's level of indebtedness is comparing the size of total public debt to the size of the whole economy or the gross domestic product (GDP). Other indicators reflect that the debt is owned to external parties (External debt/GDP), along with the currency of debt and type of creditors

(resident or non-resident). Goods and services exports are typically measured in relation to external debt and external debt service (the loan capital plus interest) to check if a country has sufficient foreign currencies to meet external obligations. Public debt service is also measured relative to public expenditures. These indicators complement macroeconomic indicators to reflect government's ability to mobilize domestic and external resources and thus the focus is also on fiscal and current accounts. The current account balance reflects the country's position in terms of transactions with the rest of the world and its ability to bring in foreign currencies while the fiscal balance measures government's revenues and spending balance.

Public debt sustainability assesses also the dynamics that drive the changes over time, especially in the debt-to-GDP ratio. Basically, three determinants drive debt dynamics: interest rate on public debt, economic growth and the changes in the fiscal balance. If interest is higher than growth, it means debt will grow by more than the economy and the other way around. In addition, when the fiscal deficit is growing, it adds to a country's financing needs and debt growth, while, when the fiscal balance is a surplus, it does the opposite. Governments often have limited influence on two of these determinants, especially external interest rates. Economic growth is also not fully under government control. International institutions and sometime governments find it easiest to control the fiscal balance.

The focus on public debt to GDP and its determinants is clearly insufficient and is more of a technical approach, whereas debt and macroeconomic conditions are variable and influenced by numerous external factors, as well as refinancing terms (issuing new debt), leading to more complex dynamics.

International organizations put a framework of dealing with debt sustainability by reframing the questions and consequently the approach since before the COVID pandemics. The UN General Assembly adopted in 2015 a resolution on Basic Principles on Sovereign Debt Restructuring Processes calling for transparency, impartiality, equitable treatment, sovereign immunity, legitimacy and sustainability and focused on "management and resolution of financial crises that take into account the obligation of sovereign debtors and their creditors to act in good faith and with cooperative spirit to reach a consensual rearrangement of the debt of sovereign States". In *Sovereign Debt Workouts: Going Forward - Road Map and Guide,* UNCTAD further provides a guide for debt workouts of 17 steps, whereby the debtor country is in charge and called for the formation of a debt workout institution that should be called upon if the debtor country finds itself in an unsustainable situation to launch a restructuring process . Other initiatives are being also discussed across international, national and regional organizations calling for debt relief and sustainability in the post-COVID phase, especially since developing countries have been struggling with debt since before the pandemic spread.

DEVELOPING COUNTRIES RECENT DEBT TRENDS

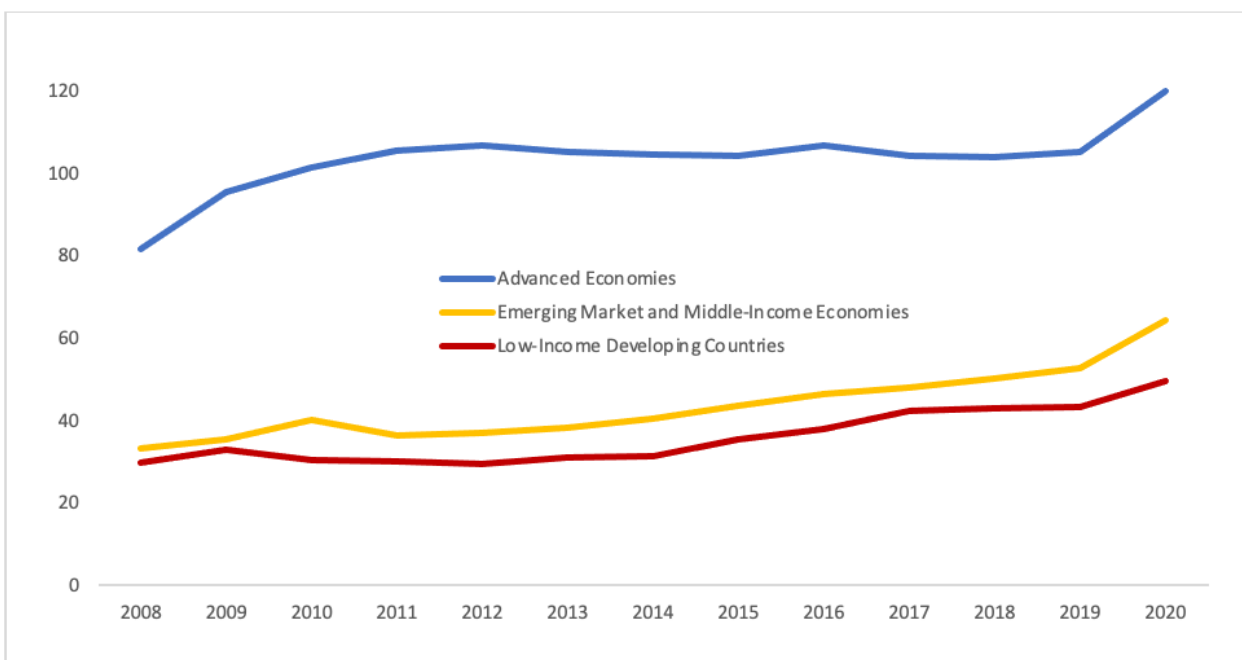
Just before COVID spread, global debt stock (private and public) had reached 322% of global GDP, up 40% from its level at the beginning of the 2008 crisis Both public and private debt had been crawling up, and raising countries' financial vulnerabilities. Nineteen countries were in default in 2019 . Beyond the growth in stocks, other indicators pointed towards increasing vulnerabilities and debt distress, especially amongst developing countries.

Developing countries public debt to GDP shooting up

Developing countries' public debt to GDP grew from 40% to 62% between 2011 and 2020

Half of low-income countries were already at risk or facing debt distress pre COVID and the majority of middle-income countries' saw their debt stock climbing to higher levels than in 2010. By 2020, the ratio was close to 50% of GDP for low-income countries and 70% for middle income countries. The outlook is not favorable and stabilization is not foreseen as the post COVID recovery is not yet clearly on track. Low growth rates projections and possible increasing interest rates - after hitting bottoms over the previous decades - can aggravate dynamics. Furthermore, debt has not been channeled to productive sectors to influence unemployment and boost growth

Figure 1 Central government debt to GDP (%) 2008-2020



Source: IMF Fiscal monitor data

The drivers behind the developing countries public debt growth pre pandemic are diverse. Most countries have been stuck in a series of debt crisis management, because of historical unsuccessful sovereign debt restructuring processes and fiscal consolidation measures that had contractionary effects, and led to growing social discontent amidst increasing poverty and inequality . International commodity prices that developing countries' exports revenues rely on have been declining . Official development aid decreased. And the repercussions of the 2008 crisis and monetary response pushing down interest rates in developed countries have been lingering and driving capital to seek higher returns in the developing countries. The increasing financialization (financial deregulation and heavily private leveraging, and financial intermediation) over more than three decades also facilitated debt financing's inflow to developing countries and the rapid integration into global markets . In addition, domestic political economy conditions facilitated increased borrowing of developing countries.

External public debt growth has been worrying

The developing countries external debt stock increased by an average of 8% per year over 2007-2018 to exceed 25% of GDP, while their economic growth rate has been volatile and following a declining trajectory

Developing countries spent 15% of their export revenues to meet external debt obligations in 2019, almost double the ratio a decade earlier[1]. Their external public and publicly guaranteed debt service to government revenues' ratio also doubled between 2012 and 2019 with some developing countries reporting a quarter of government revenues going to debt servicing[2]. By 2020, 32 developing countries were paying a fifth of their government revenues to service public debt, diverting away resources from their countries to pay off external creditors. Furthermore, shares of short-term external debt of total external debt have been also rising reaching around 30% of total external debt, when in 2000 they were a little above 10%.[3]

Developing countries' dependency on external capital flows put them at risk if flows are reversed, especially under an international financial architecture that does not regulate or manage cross-border capital flows. Developing countries often accumulate foreign reserves to ward off sudden foreign capital outflow and protect their currencies, while on the downside holding back resources' development financing. In addition, the fact that there are no clear set mechanisms to exit such crises and no sovereign insolvency regime and law for highly indebted countries make them resort to borrowing more to pay previous debt but at higher rates as the stock builds up and the risk increases.

External and domestic debt

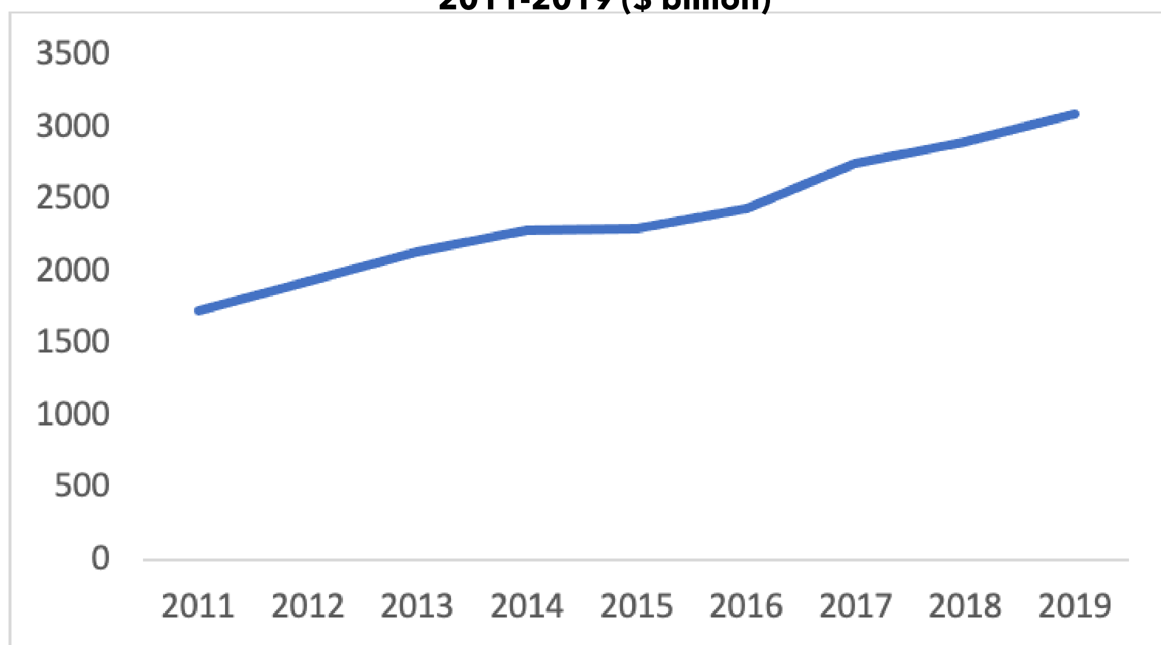
External debt is owed to a party/creditor outside the country concerned while domestic debt is owed to a party within the country. External debt is generally denominated in foreign currency, but does not have to be so just like domestic debt is not necessarily in local currency.

External debt creates a balance of payments risk because resources are transferred outside the country. Debt owed in a foreign currency creates an exchange rate risk because it is affected by local currency exchange rate changes. A devaluation, for example, will grow the foreign currency debt. External foreign currency debt carries both risks.

This does not mean that debt in national currency is risk-free (though it remains more manageable than debt in foreign currency). Issues such as difference in interest (cost) on each type of debt, the maturity and currency mismatch, impact on financial sector's stability, inflationary effect, and even national political economy factors come into play in determining the differences and risks between local currency and foreign currency debt.

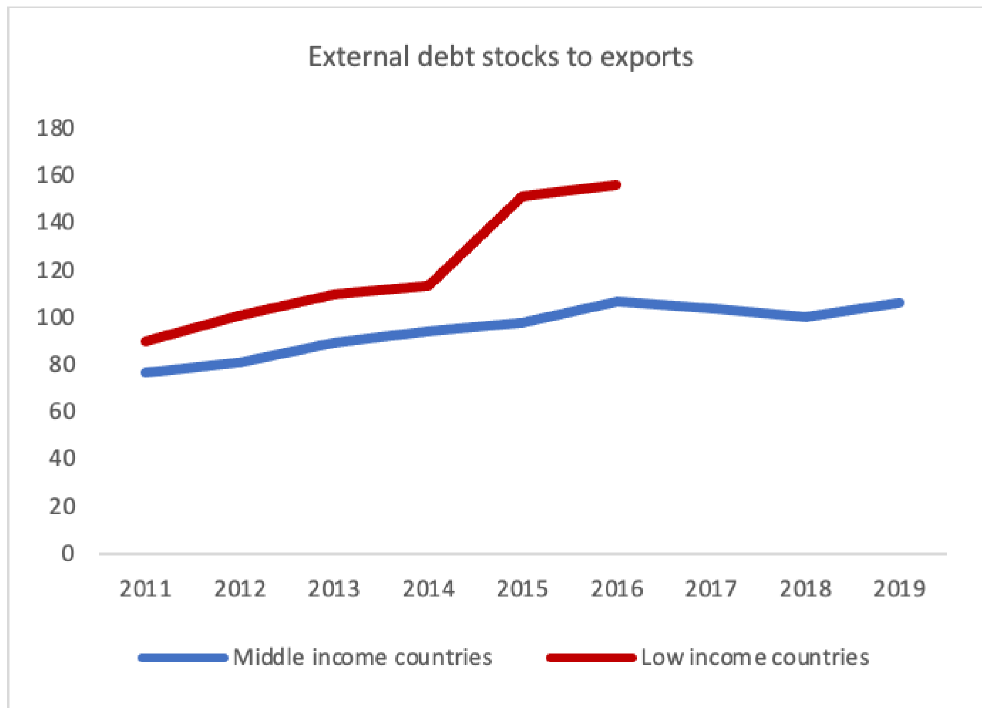
Source: Guide to understanding and accessing debt information

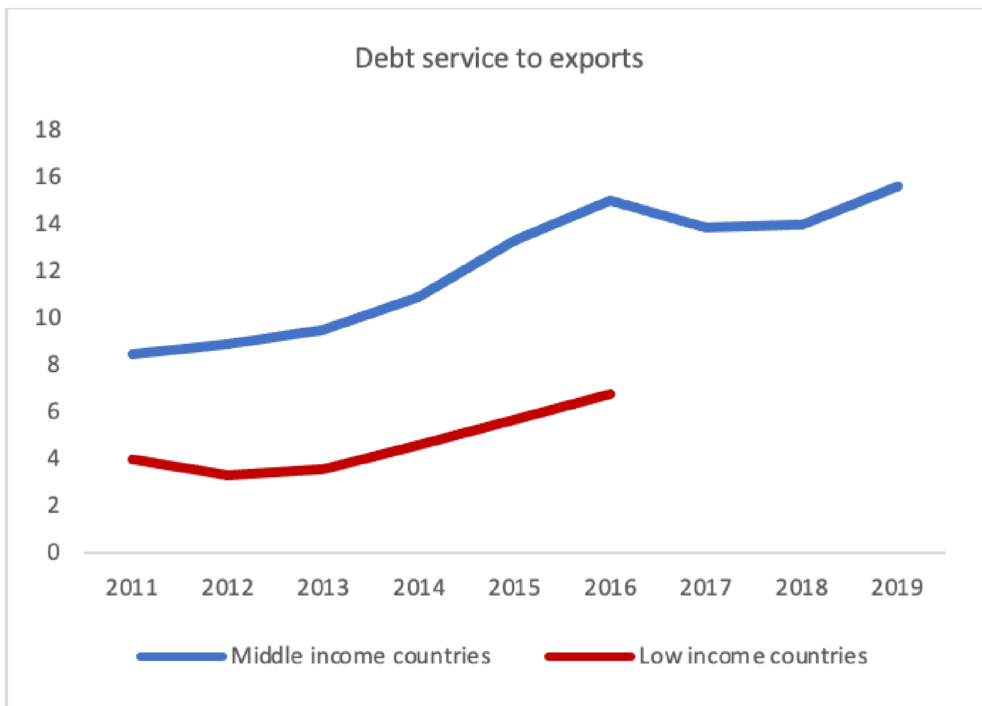
Figure 2: Developing countries' public and publicly guaranteed external debt 2011-2019 ($ billion)



Source: World Bank International Debt Statistics 2021

Figure 3: Developing countries external debt to exports and debt service payments to exports 2011-2019 (%)





Source: World Bank International Debt Statistics 2021 (data not available for aggregated low-income countries after 2015)

Changing composition of debt makes debt workout more difficult

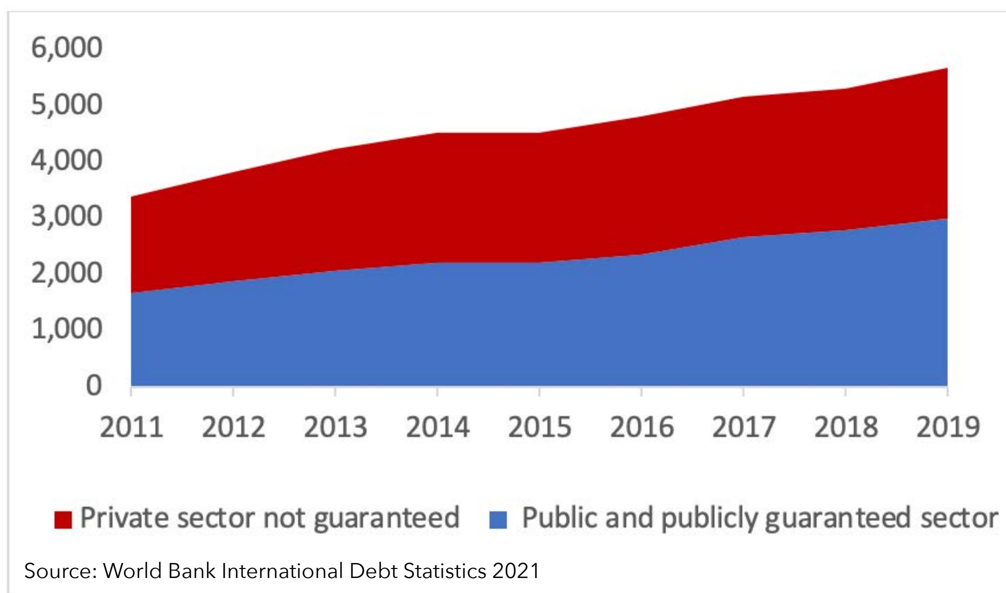
Sovereigns are borrowing more and more from the private sector. The share of developing countries' external public debt from the private sector went up from 51% in 2011 to 64% in 2019[4]. The share of non-residents holding developing countries debt has been rising to reach 43% of government debt in 2018[5]. The increase raises questions about the effectiveness of this form of financing and its productivity given its high cost (high interest rates) and makes it more difficult to service it. Borrowing from markets would make debt crisis and its workout much more complex and detrimental to the borrowing country. In line with the growing external debt, the share of debt denominated in US dollars has been also growing, as more and more developing countries resort to non-residents and the private sector for non-concessional borrowing in international markets and at commercial rates[6]. This makes debtor countries vulnerable to any change in US policy.

Another form of public debt from the private sector not accounted for comes as a result of contingent liabilities that governments carry by dealing with the private sector. Most notable are public private partnership (PPP) arrangements. PPPs that are now widely promoted as a form of infrastructure development financing. They are contingent liabilities on governments because, by nature, they can allocate a large part of the economic risk on the borrower (government). If the contingency materializes, it creates an obligation for the sovereign to pay.

Private debt is as important

Private sector borrowing includes financial and non-financial corporates and households' debt. This type of debt is increasing globally and in developing countries, especially middle-income countries to make an important share of countries' external borrowing. Private sector's debt increased by more than 50% between 2011 and 2019 in developing countries[7]. Households' debt increased by 70% between 2007 and 2016[8].

Figure 4: Middle income countries external public and private debt stocks 2011-2019 ($ billion)



Source: World Bank International Debt Statistics 2021

This rising trend is in line with growing financialization and dwindling alternative financing instruments accessible to corporates, including lower wages for households (wages growth has been very low over the last decade[9]). It is as risky as public debt not only because of its growing size but because its build-up can trigger a sovereign crisis, especially when governments engage to support ailing sectors. Private debt's accumulation weighs also on economic agents' ability to spend and consequently constrains growth.

The pandemic raised the debt but international response came weak

The pandemic put under the spotlight worldwide financial fragility and exposed deteriorating debt trends. Countries that carried most debt saw their borrowing increase most. By 2020, 108 developing countries registered rising public debt, their debt service grew and consequently shifted away public resources and limited fiscal and policy space. The Jubilee Debt Campaign considered 52 countries in a debt crisis in 2020, 32 countries at risk of a private sector debt crisis, 7 countries at risk of a public sector debt crisis, and 24 at risk from both a private and public debt crisis[10]. This assessment was based on evaluating the changes in debt and macroeconomic indicators relative to benchmarks. There are 95 countries that resorted for IMF assistance, 30 of which are in distress as per IMF debt sustainability analysis. There is a general consensus by experts and echoed in international media considering the post pandemic economic crisis as worse that the great depression. And as previously shown, this did not happen overnight because of COVID, but had been boiling since long before, despite warnings.

The international response in terms of debt management revolved around two initiatives: the G20 Debt Service Suspension Initiative (DSSI) and IMF debt relief for low-income countries and other IMF financial lending programs to middle income countries such as additional funding under stand-by-agreements. The DSSI is a suspension of principal and interest payments on debt due between 1 May and end 2021 for the poorest developing countries to bilateral government lenders. The emergency financing has been insufficient, contracting more loans rather than relieving countries from their outstanding debt burden[11]. The aim has been to ensure primarily financial sustainability and to buy time even though for some countries it could be beyond a temporary liquidity and rather a solvency issue[12].

The DSSI allows for suspension of debt repayment till end 2021 yet does not include necessarily private creditors. The standstill for the period from May 2020 to June 2021 was estimated at $12 billion, when the debt service of the DDSSI eligible countries was almost seven times this break[13]. In addition, these countries will have to pay back more than $100 billion between 2022 and 2024[14]. The DSSI has no mechanism to make private sector creditors abide. By April 2021, the number of countries applying for the G20 Debt Service Suspension Initiative (DSSI) exceeded 40 out of the 73 eligible[15].

The IMF provided 29 of the low-income countries debt relief and 85 countries financial assistance through lending arrangements many of which qualified without policy conditionality. Indeed, the IMF's recent rhetoric has been less adamant on fiscal consolidation, even though its individual country assessment

such as its post pandemic article IV mission reports still recommend the same approach[16]. Indeed, across the past decade and since the international financial crisis, the majority of countries were following this direction[17]. Now fiscal austerity will become broader and harsher, further squeezing policy space, constraining social services, and consequently raising poverty and inequality, as well as weakening government's economic and political sovereignty; thus making recovery much more difficult. Ortiz and Cummins studied the IMF fiscal projections and concluded that budget cuts are expected in 154 countries in 2021, and as many as 159 countries in 2022 with expectations that the same trend would extend at least until 2025. As a result, some 6.6 billion people or 85% of the global population will be living under austerity conditions. The 2021 expenditures will be slashed by more than 3% of GDP almost the double of the measures post 2008 crisis and most developing countries will have much smaller budget than pre-crisis levels notwithstanding people's social needs[18].

On the other hand, the initiatives leave out a large number of indebted middle-income countries that have limited financial and fiscal ability pushing them to the boundary of a debt crisis. They are countries that do not qualify to facilities offered to low-income countries but that also do not have access to the financing of developed countries. According to UNDP's "Sovereign Debt Vulnerabilities in Developing Economies", 72 of the 120 low- and middle-income countries studied are vulnerable to debt challenges, with more than $598 billion in debt payments between 2021 and 2025. Middle income countries account for almost 95% of this amount[19].

Even the recent new IMF Special Drawing Rights (SDRs)[20] issuance came short of the required size to make a difference, despite a recent increase. The size of the new issue of $650 billion provides developing countries only a small fraction of their external debt service[21].

In light of these responses, developing countries net transfers towards external creditors turned negative in 2020, a dynamic that confirms they are in trouble, i.e. they paid annually on external debt (principal and interest payment) more than they received. Eurodad estimated that 58 countries had a negative net transfer. The transfer size was around $ 194 billion in 2020[22]. Countries are receiving new debt disbursements, but these are less than what they have been paying on previous debt. More borrowing coupled with fiscal consolidation, without debt restructurings and in some cases debt relief. It will only make the situation further unsustainable and divert all these countries from meeting their sustainable development goals. As a result, more than a hundred countries will have higher debt stocks and/or debt service in 2023. More debt will become the new normal, leading to a cyclical situation, and in many cases a debt trap, as economic growth is constrained through austerity and protracted pandemic impact.

The post-pandemic fiscal conditions are thus foreseen to be deeper and more difficult than after the 2008 financial crisis a decade ago. And still, the international financial institutions failed to find alternative responses beyond limited debt breaks, still shying away from debt cancelation.

Certain debt workout lessons learned

The world lacks an international debt workout mechanism to respond efficiently and adequately along clear principles and rules that ensure fairness between creditors and debtors, in light of the unbalanced political and economic global power structures. Every case of debt resolution varies according to the nature type of creditors and type of economy.

The current crisis and historical trends call for a more radical debt workout mechanism. Until the international financial system is corrected, previous cases can suggest ideas to support debtors' countries in pursuing their debt restructuring, notwithstanding that every country and every time has their own specificities. Some of these suggestions:

• Identifying odious debt – the case of Ecuador

Public debt audit before restructuring is necessary to identify odious debt, assess the losses, restructure and adjust accordingly. Odious debt is defined a debt incurred not in the interests of the people or the state and whereby the creditor could have had foreknowledge, that the funds concerned would not benefit the population . The decision to repudiate debt is facilitated once odious debt is recognized. This principle was applied several times in history. In 2008, Ecuador decided unilaterally to suspend debt repayment sold on international financial markets and maturing in 2012 and 2030 and investigated with the support of a UN commission for two years, and ultimately identified and defaulted on illegitimate debt while restructuring the rest. This freed its resources for social sending .

• Ensuring that debt workouts are timely and substantial – the case of Argentina

The long history of Argentina with debt defaults and restructuring lead to two conclusions: 1) Austerity and debt roll-overs are harmful and work against the necessary recovery needed for debt sustainability; 2) time is crucial and very relevant. Any debt restructuring plan should be sufficiently large to ensure the economy can kickstart rather than kick down the can.

The recent 2020 $ 65 billion public debt restructuring deal of Argentina after rounds of negotiations shows that any deal under current circumstances should allow economies to absorb the direct repercussions of COVID as well as dealing with macroeconomic adjustment. Argentina resisted IMF program conditionality and rather focused on long term development goals as well as debt sustainability by working against future exogenous shocks to ensure sustainability of the deal.

Argentina's case also highlights the importance of government's capacity to ensure a level playing field for negotiations and secure widespread

popular support to its decisions to support legal measures it used when facing a creditors substantial power within an unbalanced international financial architecture.

• Spreading equitably the debt burden across actors – the case of Iceland

Iceland is the only country that did not bailout its banking system as a result of the international financial crisis, but let it reach bankruptcy. Bank lenders had to bear a cost and write off debt. The government took measures to protect local depositors, moving them into new banks and implemented capital controls. By allowing the losses to fully materialise, the economy was hit hard, yet this also facilitated a more solid and faster recovery, compared to other southern European countries that bailed out the banking sector .

• Using the UN as platform for debt workout – the case of Iraq

The current international financial system and the shift to commercial market borrowing have limited scope in compelling all creditors to abide when debt restructuring is undertaken. In some cases, vulture funds (small creditors that typically following countries in debt distress buy their debt and refuse government's restructuring, resorting to litigation) can complicate a debt workout. In 2004 when Iraq was negotiating a debt workout, UN Security Council resolution 1483 was approved and served to shield the debtor country from vulture funds and the like. While such a resolution is politically driven, it does set a precedent of using the UN as the platform to support countries when undertaking a debt restructuring without the threat of litigation.

Even though similar debt crises do not lead to similar results, the above examples/elements shed light on ways that could improve economic and social conditions when sovereign debt workouts are undertaken.

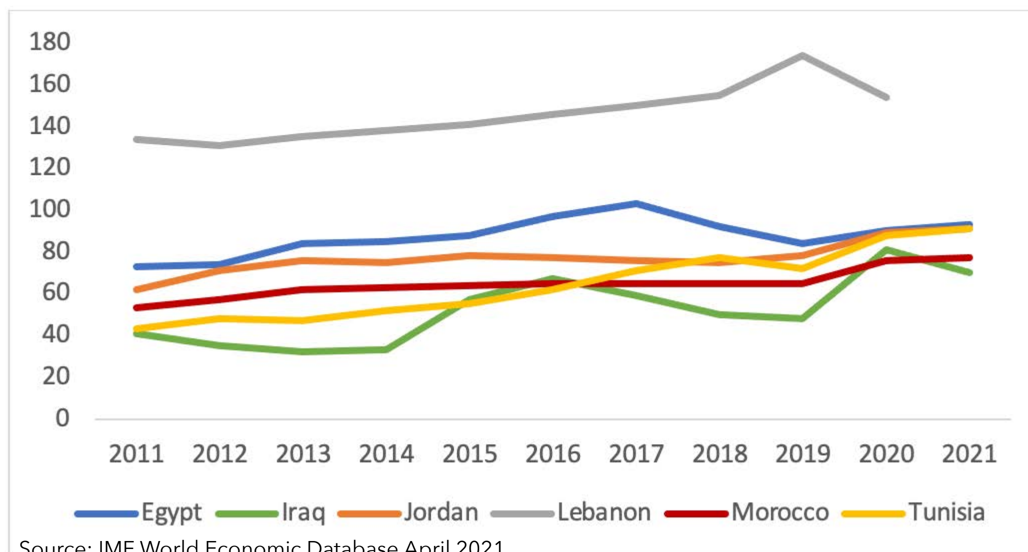
ARAB COUNTRIES RECENT DEBT TRENDS

"Arab countries are on a borrowing binge" before COVID wrote the Economist[23]. Even high-income oil-exporting Gulf countries are borrowing increasingly, amidst lower oil prices, yet their public debt is still contained. In contrast, low-income Arab countries have been struggling but are the first to get support of international financial institutions, like a series of debt relief programs since the 1980s and more recently the IMF Debt Service Relief from the Catastrophe Containment and Relief Trust program. Amongst Arab countries, Comoros, Djibouti and Yemen benefitted from this last relief program. In between, middle-income Arab countries are stuck with a debt overhang that became clearer in terms of deteriorating dynamics long before COVID hit[24]. This section will focus on the latter, namely on Egypt, Jordan, Iraq, Lebanon, Morocco, and Tunisia.

Following risky trajectories

The Arab region is following the same pattern as other countries in the world: increasing indebtedness aggravated by COVID. Public debt to GDP in Arab countries reached 48% in 2018[25], up from 26% in 2008, and is estimated to exceed 54% in 2020.[26] Arab middle-income countries register the highest gross debt to GDP in the region, exceeding 70% of GDP and reaching above 150% in Lebanon, with increasing financing needs consisting from wider fiscal deficit and a growing debt service. The negative growth rates along with larger fiscal deficits led to increased borrowing and higher debt ratios. If recommended fiscal consolidation reforms are implemented, the IMF assessment still considers these countries' debt stock and dynamics as sustainable. In contrast, the Jubilee Debt Campaign considers them already in crisis because of their large imbalance with the rest of the world and substantial government payments on external debt that jeopardize their ability to fulfill people's basic rights[27].

Figure 5: Central government debt to GDP in Arab middle-income countries 2011-2021 (%)



Source: IMF World Economic Database April 2021

The share of external debt out of total public debt remains moderate in most of the Arab middle-income countries (a little more than a third), except Tunisia and Iraq. The latter's external debt in arrears is under negotiation for restructuring with the Paris Club. Still, external borrowing has been increasing rapidly. Most of Tunisia's public debt is external (around 71% of total public debt), with the bulk (46%) being from official donors including the IMF that generally have softer terms than market debt. Banks' exposure to the sovereign is limited insulating them from sovereign risks. Tunisia is expected to report a notable increase in external debt to GDP to hover around 100% in the next couple of years[28]. Overall, most of the external debt in the region is from official creditors. These used to account for more than two thirds of external debt but now consist of around half of it[29].

However, in most countries, soft borrowing has been declining. In Egypt, for instance the share of concessional loans out of total external debt fell from 19% in 2011 to 5% in 2019[30]. In Morocco, the ratio fell from 7% to 3% over the same period[31]. As concessional borrowing and official development assistance are less available, the Arab middle-income countries are moving to borrowing from the private sector. The volume of public external debt from private creditors in the Arab region (excluding high income countries) has almost tripled over the last decade and as a share of external public debt it grew from 30% in 2011 to 42% in 2019. The ratio grew from 5% in 2009 to more than 50% in 2019 in Jordan and from 9% to more than 36% in Egypt, over the same period.

The majority of the external public debt private creditors consist of bondholders[32], which makes any debt workout, if needed, more complicated, not to mention the high cost of this type of borrowing versus official creditors. The growing external debt was accompanied with slow exports growth, driving higher the ratio of external debt to exports. This reflects economic development flaws in these countries and increased riskiness of the ability of economy to produce and generate foreign currency revenues to meet debt obligations for certain interest rate. The value of private and public partnerships (PPP) - a popular development financing arrangement in the region – amplifies the risks. In Egypt, some 53 PPP projects are active, worth more than ten billion US dollars and in Jordan 43 are active for a similar value[33].

The external private sector's debt (i.e. debt held by the private sector) remains moderate relative to the size of the economies in the region. Jordan's private external debt for example accounts for 30-35% of GDP with the bulk being the banking sector's[34]. This is naturally the result of the weak development of a formal business sector and its limited role in economic development. Lebanon stands out in that respect with the private sector non-guaranteed debt reaching nearly 50% of the country's external debt[35]. Lebanon's recent banking crisis reflects how the private sector and more critically the financial sector leverage can grow out of hand to trigger an economy-wide crisis. The Lebanese case is peculiar because the monetary authority that is supposed to be regulating the banking sector built up an unsustainable situation. The Central Bank incentivized commercial banks to place their dollar resources with the monetary authority. Banks reduced their dollar liquidity to risky levels to profit excessively. This process continued for years with no consideration for

its repercussions, amidst a growing balance of payments deficit (i.e. less and less foreign money flowing in) and the maintenance of a quasi-fixed exchange rates, despite banks and authorities' knowledge of the macroeconomic imbalances. Commercial banks dollar liquidity ultimately almost dried up, while they made exorbitant profits[36]. Their shareholders and largest depositors benefitted from this operation and many were able to exit, as soon as this process stopped at the onset of the first shock leading to a banking sector crisis[37]. Political authorities facilitated the exit by refusing to impose a capital control law[38].

Domestic debt is generally held by domestic creditors. In most cases, it is the banking sector that is increasing its public debt holdings. Central Banks also carry government debt in a few countries. In comparison to other developing countries, the exposure of these countries' banking sector to sovereign debt is generally high[39]. In Iraq, the Central Bank holds around one third of domestic debt, mostly short-term debt[40]. Commercial public banks affiliated with political parties[41] carry most of the rest. Such a situation is a double edge sword: banks provide a budget financing support but are diverted from delivering their intermediary role in financing the economy, hence the importance of managing well the trade-off. Lebanese banks have also high exposure to the sovereign, yet their situation became riskier since they have been placing

Figure 6: External debt service to exports 2011-2019 (%)

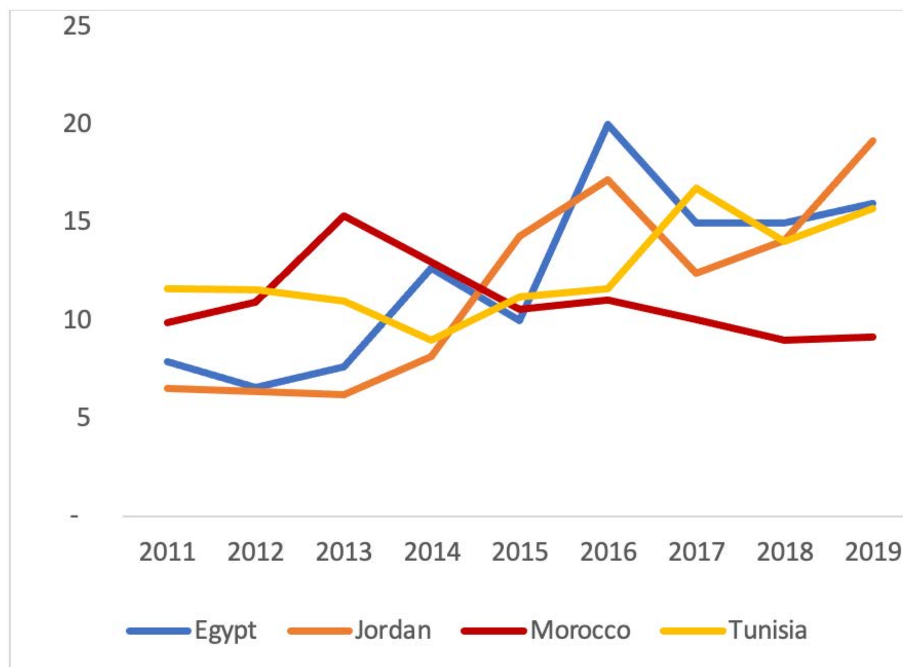
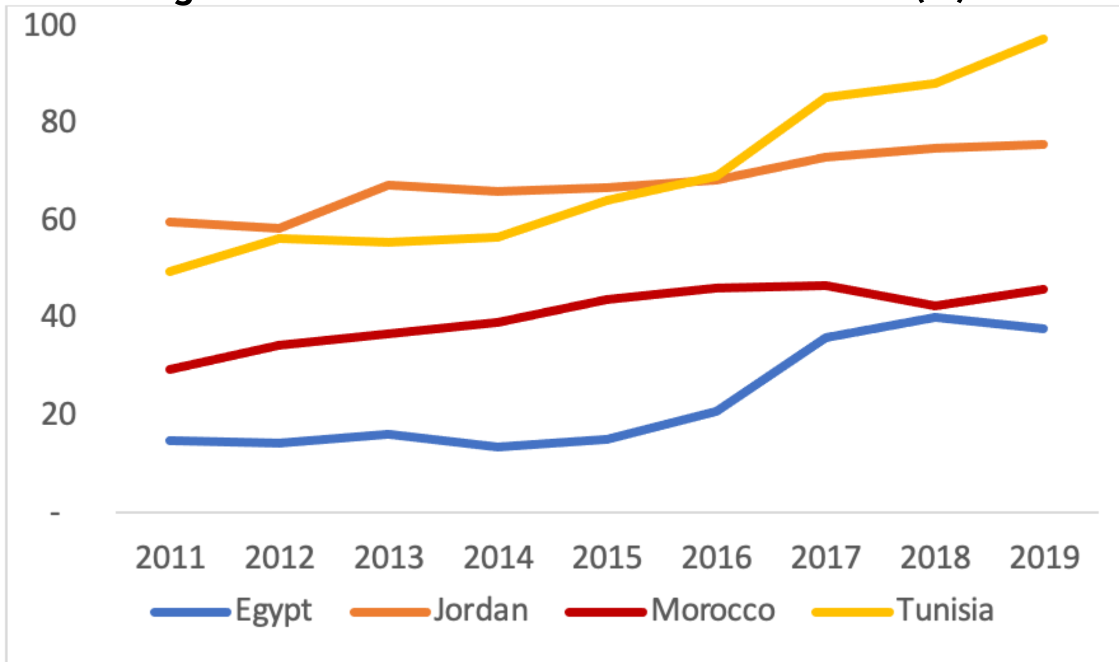
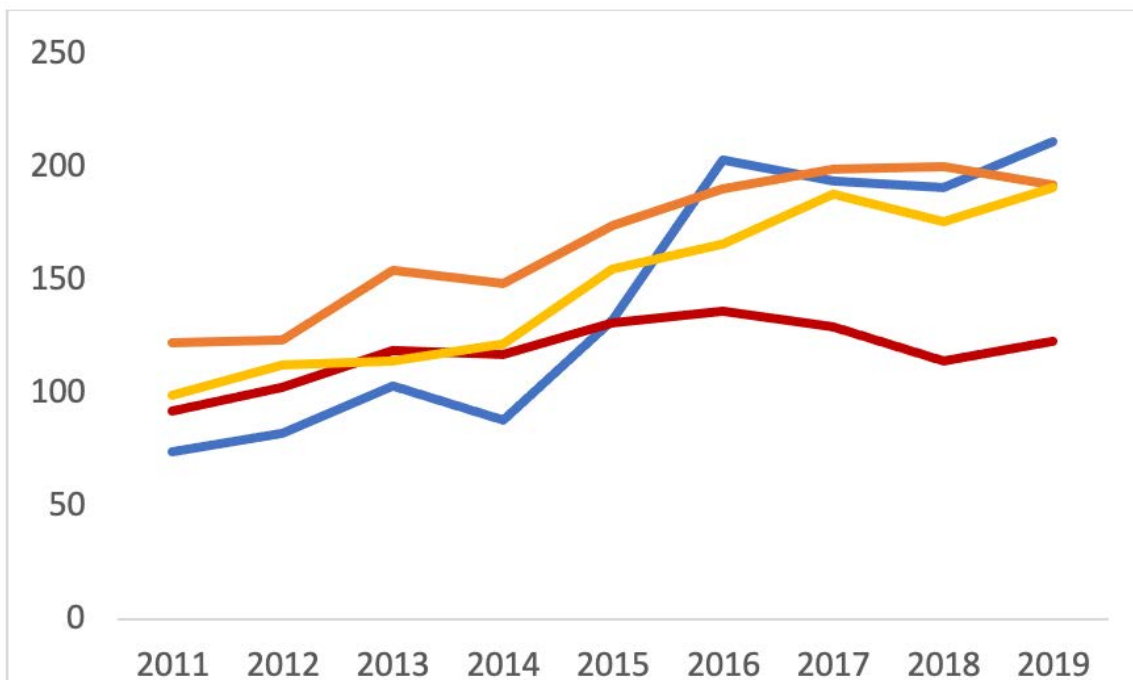


Figure 7: Public external debt to GDP 2011-2019 (%)



Source: World Bank International Debt Statistics 2021

Figure 8: Public external debt to exports 2011-2019 (%)



Source: World Bank International Debt Statistics 2021

large amounts of foreign currencies with the central bank for years, amidst growing balance of payments deficits ultimately leading to the collapse of the system and to a deep economic crisis.

Borrowing policy implications pre COVID

The dynamics driving debt ratios in the region depend on each country's interest and growth rate differentials that are affected by numerous other economic variables. Interest rates vary according to the debt stock composition itself, and in response to exchange rate and capital movements amongst other factors. In Egypt the differential helped in slowing public debt ratio spirals temporarily, but economic growth failed to make the economic transformation that can grow the country out of debt or at least stabilize it. In Lebanon and Jordan, the differential increased debt ratios[42]. In addition, Arab middle-income countries carried substantial gross public financing needs, specifically because of rising public debt service[43].

Debt does not serve a development process

Egypt, Iraq, Jordan, Morocco and Tunisia have been considered IMF's model reformers. They all engaged in IMF programs since decades and deregulated markets, liberalized external accounts and embarked on privatization, without achieving the desired long term economic development and stability. These policies did not build economies; they created a debt dependency.

The most notable 4-5% growth rates reported pre-COVID in Egypt that IMF commended was the result of external drivers, including the gas sector, currency depreciation and debt accumulation (external debt stock more than tripled over last decade)[44]. Spurts of economic growth failed to structurally correct historical twin deficits and finance a structural change in economy to resolve the real economic and social problems primarily, productivity and employment. Instead, it boosted volatile non-tradable sectors and non-gas exports. Egypt continuously needed to borrow to keep up its foreign reserves and became debt trapped. It regularly rolled over public debt, while continuing to accumulate it[45].

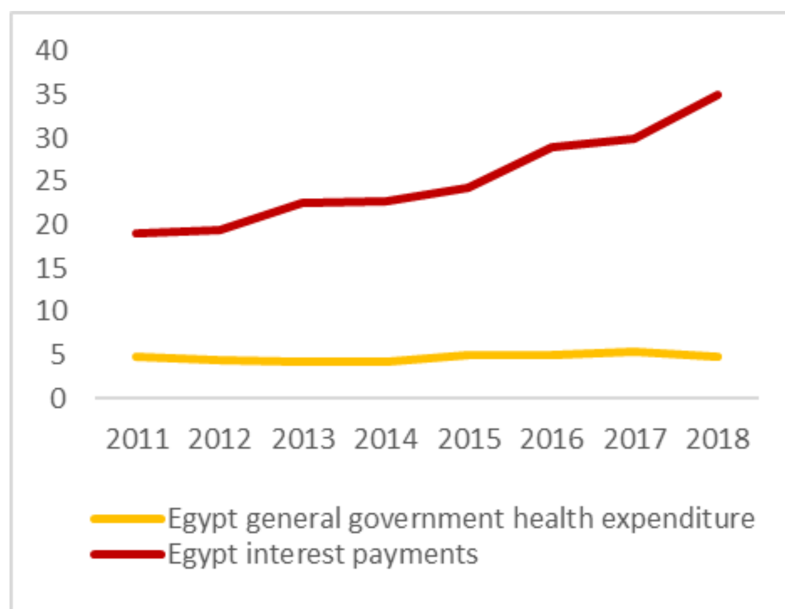
In Lebanon, public borrowing reinforced a rentier economy that further concentrated wealth in a cyclical manner. Governments in Lebanon continuously rolled back their debt paying higher interest to banks. Accumulated public debt financed current public expenditures, swelled a clientelist public administration, and upheld a political system based on apportionment that prioritized private interest economic development. The system ultimately collapsed when the local currency went into a freefall[46]. The Moroccan government policies also facilitated borrowing that reinforced a crony capitalist system and benefitted the economic elite politically connected to the monarchy[47]. In most of these countries, governments applied policies and targeted investments that do not necessarily respond to public needs, but rather served the elite, while populations continued to be squeezed to pay back the debts.

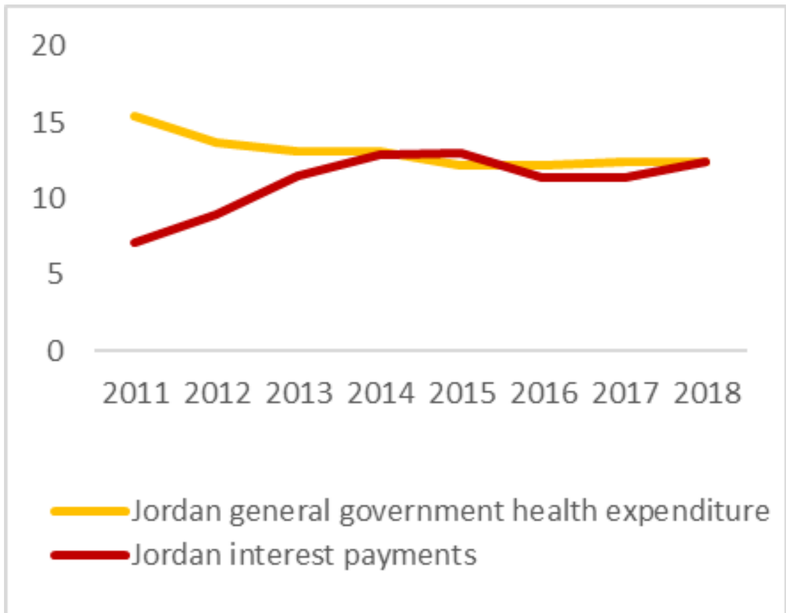
Debt service takes priority over social spending

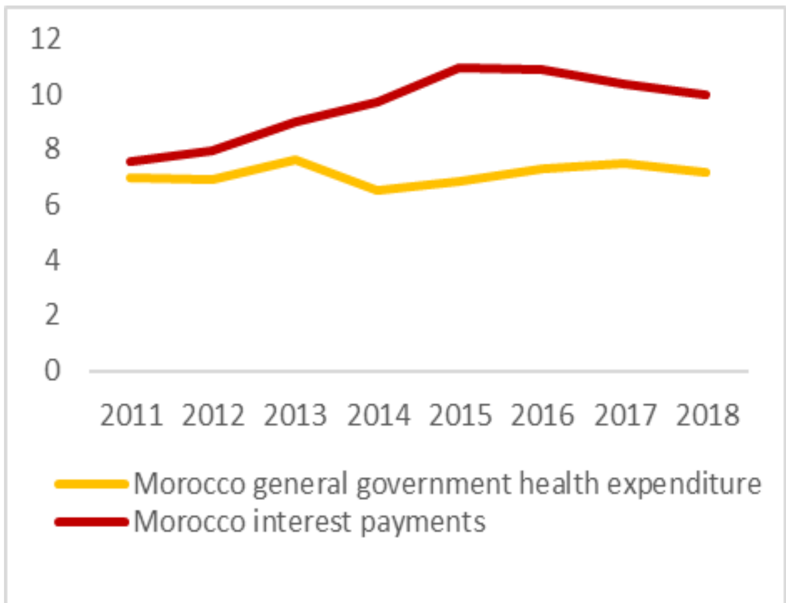
Debt service obligations reduced heavily public spending in health, education, and public investment.[48] Considering public spending composition, Lebanon, Morocco and Egypt reported debt service payments regularly above health expenditures before COVID.

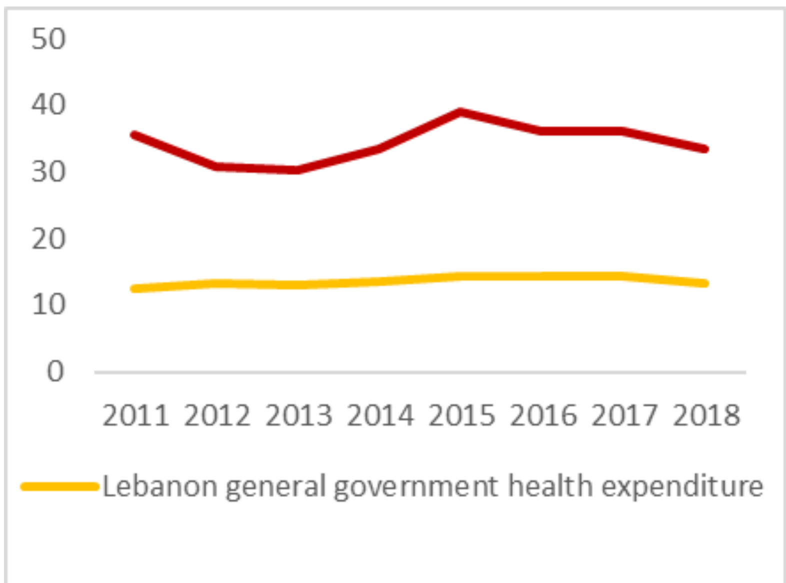
The IMF policy conditionality prioritizing creditors' claims made society pay a hefty price. In Tunisia for example, public spending on education and health relative to GDP has been constantly decreasing since 2011 and debt service grew to reach four times the health budget just before COVID hit[49]. In Egypt, debt service reached almost 40% of public expenditures and 57% of public revenues in 2019, when Egypt's poverty rates have been stubbornly high hovering around 33%. The World Bank stated[50]: "pre-pandemic growth was not poverty reducing." Reduced public spending, increased indirect taxes and lower currency value, raised dramatically costs of living. The policy prescription of the IMF was particularly associated with increasing income inequality, notwithstanding its recent rhetoric focus on the importance of tackling inequality[51]. Public debt served as a mechanism for redistribution of wealth from the poor to the rich. The former has the money to lend the government and get back higher returns while the financing created has not been necessarily benefitting the poor, especially since fiscal policy is not sufficiently progressive. The region indeed has been marked as having the highest income and wealth inequality[52].

Figure 9: Health & debt service expenditures as a share of total public expenditures 2011-2018 (% of total public expenditures)









Source: World Bank International Debt Statistics 2021

Decade-long borrowing always with austerity

Decades of austerity mark Egypt, Iraq, Jordan, Morocco, and Tunisia under IMF conditionality program after program, and notwithstanding a little occasional resistance to certain measures such as in Tunisia. The Arab region was considered to have the highest proportion of countries implementing austerity measures over the last decade[53]. Tunisia and Egypt show how fiscal consolidation operated through subsidies' removals, freezing and cutting wages, devaluing the currency, amongst others measures to contain a spiralling public debt, with no social protection. In Iraq, the same applied and pre 2003 Paris club debt relief was conditional upon following IMF policy recommendation of macroeconomic stabilisation, including massive layoffs, privatisation and especially food prices' liberalisation that impoverished people and further undermined an already-weakened state.

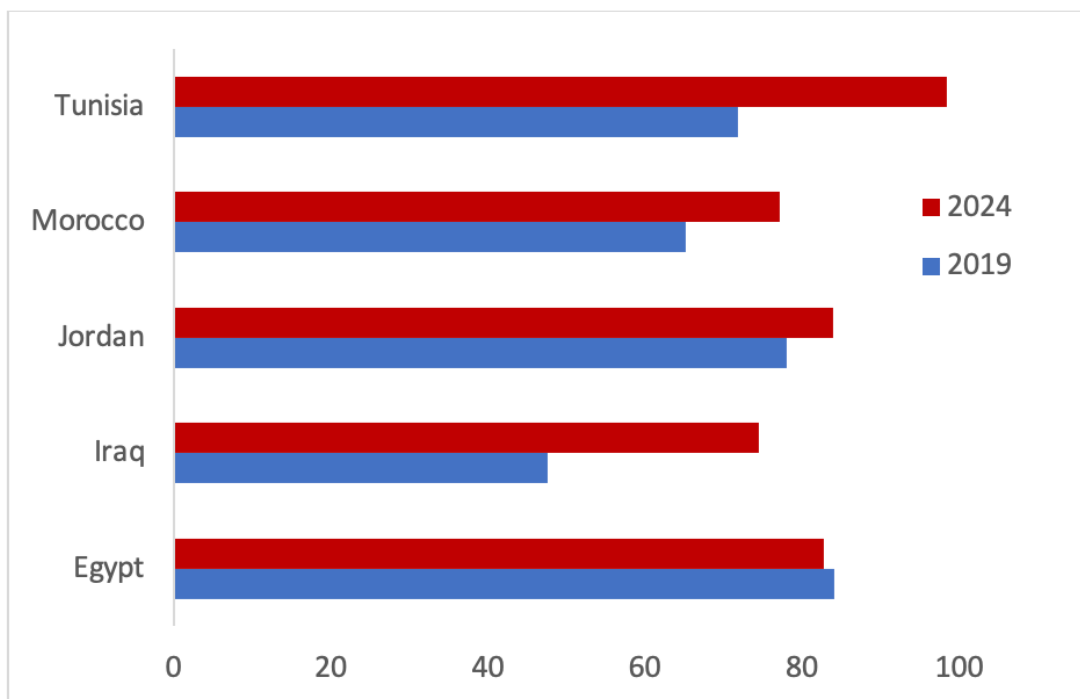
The contractionary policies' aim is to balance deficits (fiscal and external) in order to reach public debt sustainability and preserve the international reserves of the central bank. However, such policies weakened countries' shock buffers, suppressed economic growth and development, except where it got occasional boost from external factors. As COVID hit, countries faced an unprecedented shock with weak policy autonomy, no fiscal space, limited public resources, and tied with debt and years of austerity policies. In the absence of a global response of the size of the crisis and its repercussions, middle income Arab countries resorted once again to IMF borrowing.

Post COVID business as usual: more debt and austerity

Egypt, Iraq, Jordan, Tunisia, and Morocco have all resorted to IMF for additional borrowing post COVID. IMF loans boosted governments reserves and showed a better ability to pay back debt ratios. Nevertheless, they also committed to the IMF that debt service will be prioritized compressing their already limited resources for social spending and recovery. The increase in debt ratios will raise further debt service, reinforce the same pattern that led to their piling up: it is a cycle of borrowing more, then getting into debt distress, applying fiscal consolidation, yet failing to reduce the debt so they borrow again.

Public debt will be higher in 2024 relative to pre pandemic levels and gross public financial needs that will keep countries stuck in a negative debt dynamic. Only Egypt will see, according to the IMF, in 2024 its debt going back to its 2019 level, despite the exceptional $ 5.2 billion 12-month standby arrangement it received from the IMF in 2020 justified by having a "strong track record of successfully completing a home-grown economic reform program supported by the IMF's Extended Fund Facility in 2016-2019.[54]" Egypt that will see the maturity of a large part of its debt in the next couple of years relies on an agreement with other bilateral creditors to rollover this debt.

Figure 10: Gross public debt as a proportion of GDP 2019 versus 2024 (%)



Source: World Economic Outlook Databases April 2021

When people needed to see more social spending, post COVID response came with further austerity starting in 2021 as a third of Arab middle- and low-income countries populations would still be poor. Eurodad estimated that most developing countries austerity measures during the next three years will exceed the 2020 Covid-19 response packages implemented. In 2020, the Middle East and North African countries' COVID response package as a percent of GDP were below 1%, compared to more than 2% in other developing countries[55]. Tunisia figured amongst developing countries with the largest primary public expenditure cuts to offset Covid-19 response packages in the middle of the pandemic. The IMF considered Tunisia's public debt levels manageable post pandemic, if budget deficit remains contained over 2021–25 and consequently limiting gross financing needs and if loose fiscal and monetary policies, contingent liabilities are avoided, while local currency preserves its value[56]. In Jordan while the COVID-19 fiscal response was less than 1% of GDP, fiscal consolidation is also expected to start in 2021 at slightly less than 1% of GDP and then should exceed 1% of GDP annually between 2022-2024. This, along with the increased borrowing in response to the crisis raising debt service payments, further reducing the resources available for social protection and public services, in line with the pre-COVID situation

Countries' financial vulnerability increases, making any shortage of capital inflows problematic, and consequently weakens states abilities to face protracted impacts or future shocks, exactly what happened pre-COVID, only this time more harmful with bigger risks and losses.

PRIORITIES FOR A FAIR AND HUMAN DEBT FINANCING ADVOCACY

This report showed that Arab middle-income countries could be heading towards a debt crisis. The crisis is not happening when default materializes but, more generally, as debtors are pursuing debt payment and rollovers and creditors and international finance institutions pressing them to pursue this process reduce further public resources to the point of compromising the basic rights of their populations. Civil society organizations need to join forces globally, regionally and locally and connect with other like-minded actors to renegotiate for a fair and human debt financing conditions.

Any solution to the debt crisis should abide by the main principle of putting people's rights before debt repayment. Debt sustainability should incorporate primarily human rights, social, developmental and environmental implications to shield populations from debt crisis. Debt sustainability analysis should account for the financing of social spending for development goals. Going a step further, debt management policies, such as those the IMF requests could be evaluated along their impact on human rights and assessment of debt sustainability and this needs to be conducted by other parties than the lending institution.

The current situation requires all efforts to be immediately geared towards three immediate actions: i) pushing for a debt standstill as a result of the extreme and exceptional conditions resulting from the pandemic for legitimate reasons based on international law; ii) restructuring debt of countries in distress, including providing debt relief and even cancellations, not only to manage liquidity shortages but more structural issues that affect longer term debt sustainability and; iii) removing policy conditionality that is detrimental to human rights.

These steps require enacting some mechanisms that protect debtors during temporary standstills and while negotiating on restructuring, since some creditors take this opportunity to use litigations and force repayments. The increased reliance on market debt that is characterized by creditors' heterogeneity makes it difficult to ensure all debtors are abiding by a standstill or the negotiating process. Experience has shown limitations of previous contractual and market-based measures introduced to address the issue[57]; thus, the need for a new mechanism to ensure a binding temporary standstill even for cases already in litigation. In that respect, Eurodad is proposing resorting to IMF articles for a legal leeway that could facilitate the process[58].

At the same time, the elevated level of indebtedness and increasing complexity of debt portfolios call now more than ever for a new global economic governance system with a multilateral independent sovereign debt workout mechanism. While this issue has been repeatedly demanded since decades, the magnitude of the current pandemic and its economic spillovers provide an opportunity to advance this requirement.

The governance system should provide an early warning system of debt distress based on the burden that people carry and not just the

ability of repayment. It should level the playing field between all countries allowing them same rights and power between creditors and borrowers. The workout mechanism should provide systematic effective and a just debt resolution.

International actors pushing towards these changes have already provided preliminarily tools to reframe the assessment of debt financing. They include the UN Financing and Development summits recommendations and more broadly SDGs-related targets on establishing a framework of fair and developmental sovereign debt resolutions, as well the Principles on Promoting Responsible Sovereign Lending and Borrowing, and UNCTAD's framework presented earlier in this report. These remain however voluntary and need to be part of international instruments that ensure they are applied.

While this report focused on external debt because of its growing relevance and risk as a financing source, it will close with a word of caution on the importance of addressing local political economy dynamics that drive sovereign borrowing in general. A political economy analysis of borrowing patterns and public debt within each country can reveal areas where international conditions align with local forces leading to increased indebtedness to the benefit of a local elite at the expense of the majority.

Greater debt transparency from the borrowing decision to situations of restructuring negotiations can expose political economy dynamics locally and with international creditors. It allows for citizen debt audits to ensure just debt financing would serve to expose these connections and raise accountability behind borrowing. Citizen audits can identify illegitimate, odious, and illegal debts. Citizen debt audits can ensure independence of assessments, include contingent liabilities are taken into account, ensure debt financing productive investments and fulfilling development goals.

Local efforts to support these objectives also include making fiscal policy more progressive, starting with taxation, like setting a wealth tax, curbing illicit financial flows and tax evasions, reassessing public spending for increased effectiveness and social impact, among others can correct imbalances driving borrowing and limit growing financing needs. A more progressive and efficient fiscal policy might not however resolve shortages in foreign currency that drive the demand for external debt.

In the end, to put all such actions to practice requires catching the right political moment when change can happen. The pandemic and its repercussions might present an opportunity to act, as the global financial architecture deficiencies are exposed and national economic pressures are widespread while the recovery outlook remains changing. It could be a time when everyone is listening and sovereign debt crises and traps can be avoided.

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