

SAILING ON A STORMING SEA: POLICY CHALLENGES FOR DEVELOPING COUNTRIES 2022-2025

By Hinh T. Dinh

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The current bleak outlook for the world economy, with a likely recession in major economies, high inflation, rising interest rates, and slow productivity growth, will adversely emerging market and developing countries (EMDE) over the next few years. Unfortunately, these countries emerged from COVID-19 with less fiscal space and rising debt service payments. Policies to insulate the domestic economy from these external shocks will present policymakers with difficult choices among exchange rate stability, capital mobility, and monetary independence: the so-called monetary trilemma. The impact of these external shocks on the domestic economy could be reduced if there were greater flexibility in exchange rate management and/or management of capital flows. This would keep the ability to influence domestic interest rates with the national authorities to foster economic growth. In addition, EMDEs need to design and implement policies to protect the labor force, and to restore productivity growth. Greater coordination between developed and developing economies and international organizations is also critical for satisfactory debt resolution for both low- and middle-income countries. Failure to make the right economic policy choices could lead to financial crises and could cause the debt distress to spread from low-income to middle-income countries, a situation similar to Latin America's 'lost decade' beginning in 1982.

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POLICY PAPER

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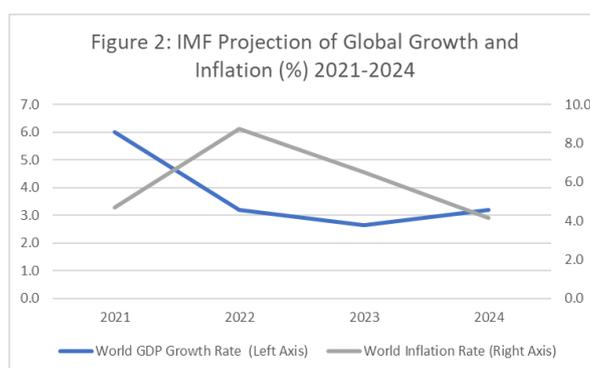
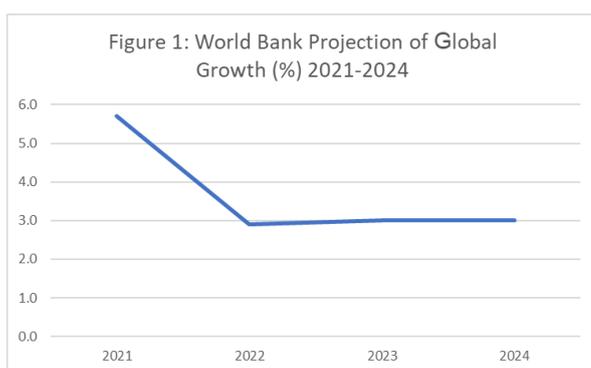


THINK • STIMULATE • BRIDGE

Two years after COVID-19 caused the deepest global recession since the Second World War, the world economy is now facing major new challenges. Inflation and interest rates are surging, the dollar exchange rate against major currencies has reached levels not seen in decades, and the Ukraine war is causing high food and energy prices worldwide. These events are taking place in the context of a long-term, secular decline in productivity growth. What are the implications of these adverse trends for emerging market and developing countries (EMDE) in the next three years, and what policy options are available to mitigate the effects? This policy note discusses these issues and some trade-offs among potential solutions.

GLOBAL ECONOMIC OUTLOOK

The global economic outlook has turned significantly worse in the last few months. In June 2022, the World Bank cut its global GDP growth forecast for 2022 by almost a third, from 4.1% to 2.9%. Global growth is expected to average 3% in 2023-2024 (Figure 1). In October 2022, the International Monetary Fund also lowered its previous forecast of global economic growth, stating “*More than a third of the global economy will contract this year or next, while the three largest economies—the United States, the European Union, and China—will continue to stall. In short, the worst is yet to come, and for many people, 2023 will feel like a recession*” (IMF 2022). The IMF now expects global growth to slow to 3.2% in 2022 and 2.7% in 2023, among the weakest growth profiles since 2001. Global inflation is forecast to rise from 4.7% in 2021 to 8.8% in 2022, then decline to 4.1% by 2024 (Figure 2). To address this rampant inflation, in the first 11 months of 2022 alone, the U.S. Federal Reserve raised interest rates by 3.75 percentage points, something it had not done since the 1980s.



Source: World Bank Global Economic Prospects, June 2022. Source: IMF WEO, October 2022.

This downgrade to the global outlook has its roots in rising food and energy prices, supply chain problems, trade restrictions, and interest-rate adjustments in developed economies. In addition, EMDEs also suffer from external debt solvency and sustainability issues, and a host of other problems caused by the fiscal policies implemented in 2020 and 2021 in the context of dealing with COVID-19 (Dinh, 2022).

IMPLICATIONS FOR EMDES

Inflation. The Federal Reserve's recent projection of 2% inflation in the U.S. in 2023 may appear optimistic to some economists¹, and this view is reflected in the IMF inflation projection indicated above. From a policy perspective, whether inflation remains elevated depends on inflation expectations. If these expectations are well anchored on central banks' credibility and resolute policy actions, pressures on aggregate demand will be reduced. In that case, if governments tighten monetary policy and unwind pandemic-related fiscal stimulus, prices will begin to stabilize, and a soft landing will be possible. However, this scenario may not be tenable, and there is a high risk that inflation will remain high because of further supply shocks that could de-anchor inflation expectations. Vicious circles of inflationary feedback could happen (Canuto, 2022). Central banks could also fail to reach their inflation targets, causing a loss of confidence from the public. This could lead to a wage-price spiral that could become institutionalized through cost-of-living adjustments. In short, with inflation now running high in many countries and supply expected to grow slowly, there is a real risk that inflation will remain higher for a longer period than currently anticipated.

Interest rates, exchange rates, and external debt. Even before these new external shocks emerged, EMDEs faced debt accumulation and debt servicing difficulties (World Bank, 2021). The surge in interest rates will now cause the external debt service payments of developing countries to rise even further. In the last ten years, there has been a rising trend in the share of EMDE's external debt held by private creditors. This share reached about 34% in 2020 (World Bank, 2022a), and much of this debt involves short maturity and variable interest rates that could cause debt service payments to spike suddenly. In addition, since most of this debt is denominated in U.S. dollars, the rise in the dollar exchange rate against major currencies to record levels will further reduce the debt servicing capacity of these countries. Not only does the private sector have to pay more in interest payments, the public sector, through government budgets, has to spend more on debt servicing, taking from money which could otherwise be spent on social services including health, education, and other necessities. As both interest rates and the dollar exchange rate increase, spending will also increase. Debt distress, which was previously confined to low-income countries, can quickly spread to middle-income countries.

Growth. High global inflation accompanied by tepid economic growth poses a significant risk to near-term growth and is reminiscent of the stagflation of the 1970s. A recession in the U.S. and the EU will dampen their demand for exports from the developing world, triggering a widespread downturn in the latter's economies. History has shown this clearly: in the late 1970s and early 1980s, policy tightening in the U.S. and other developed countries triggered a significant growth downturn in many indebted developing countries, and subsequently a global recession. The global recession was followed by financial crises in EMDEs in the 1980s and 1990s, especially in Latin America. Since then, progress in communication and globalization has made the world even more integrated. This means both the speed and magnitude of transmission of global shocks are greater today, raising the risk of financial stress in EMDEs.

Long-term Decline in Productivity. The source of long-lasting growth in all economies is productivity growth. Global productivity growth broadly declined in the decade before the arrival of COVID-19 (Dieppe, 2021). Specifically, global labor productivity growth slowed from its peak of 2.8% in 2007, just before the 2008–2009 global financial crisis (GFC), to a post-crisis trough of 1.4% in 2016, and remained below 2% per year in 2017–18. This slowdown affected about 70% of developed countries and EMDEs. For EMDEs, the slowdown was from 6.6% in 2007 to 3.1% in 2015—the steepest, longest, and most synchronized multiyear slowdown in recent decades. The

1. In the words of Lawrence H. Summers, "The Fed projection is simply not plausible as a forecast". See L.H. Summers, "Curbing Inflation Comes First, But We Can't Stop There", *The Washington Post*, October 31, 2022.

slowdown in productivity growth has to do with the declining reallocation gains in labor going to the services sectors, where productivity tends to be lower than in the industrial sector.

Sub-Saharan African countries experienced the steepest and longest productivity slowdowns in recent decades. Labor productivity growth in sub-Saharan Africa dropped from 2.9% during 2003–2008 to 0.8% during 2013–2018. Oil- and metal-exporting countries experienced the steepest slowdowns after the commodity price slump of 2014–2016. The decline in productivity in sub-Saharan African countries therefore was due to the region’s overdependence on commodity production and export.

COVID-19 has actually created an anomaly in productivity growth in some developing countries: instead of labor going from low to higher productivity sectors, as normally occurs in the economic development process, e.g., from agriculture to manufacturing, the reverse has happened. In some countries, factory workers have gone back to rural areas after experiencing COVID-19 lockdowns in urban areas. Even after the urban situation stabilizes, some of these workers may not move back to their former jobs. This has been the experience of some East Asian countries such as Vietnam, and will have an adverse effect on long-term productivity growth in those countries.

It is likely that productivity growth has continued its slowdown since COVID-19. Moreover, history has shown that labor productivity tends to experience large and protracted declines following major economic disruptions (Dieppe, 2021). In a way, COVID-19 could not have come at a worse time, when the entire world was experiencing this adverse trend in productivity.

POLICY ISSUES

EMDEs face a number of issues in the short to medium term (2022-2025). First, export demand from their most important partners—the U.S., EU, China, and Japan—is likely to slow. This is happening at a time when many EMDE countries are projected to have negative output gaps—actual output fell below potential output—in the aftermath of COVID-19, therefore increasing the risk of a recession. Second, EMDEs face inflation pressures coming from import prices, particularly energy and food. Third, these countries face higher international interest rates coming from the global financial market as a result of tightened monetary policies in the developed world. Fourth, they face depreciation pressures as the dollar exchange rate against major currencies reached its highest levels in decades. Canuto (2022) pointed out that the appreciation of the U.S. dollar may lead to inflationary shocks in other countries and to even tighter monetary policies. These problems are happening in the context of limited fiscal space in the aftermath of COVID-19 because of widening budget deficits and rising debt and debt service payments. At the same time, the need for increased and sustainable economic growth has never been greater to address poverty and reduce inequality. Together, these issues will tax governments’ capabilities to their limit.

Is it possible for the developing world to avoid these adverse external shocks? Given the integrated global trade and investment setting, it is virtually impossible for any country to completely avoid these impacts. Yet through a combination of skillful management of economic policies and an understanding of the advantages and disadvantages of these policies, policymakers can reduce the impact on their domestic economies. To deal with rising inflation, some countries will be tempted to use direct control methods, such as price controls or quantitative restrictions. However, history has shown that these measures only create more distortions, and damage the economy in the long run. Another approach is to use the exchange rate as a nominal anchor, i.e., keep the exchange rate fixed (or pegged) in order to control domestic prices. This could risk speculative attacks on the exchange rate, leading to financial crises. Moreover, in an economy with capital mobility, this would lead to monetary policy losing its independence.

The Monetary Trilemma. To cope with external shocks, countries turn to the familiar fiscal, exchange rate, and monetary policies. We discuss fiscal policy in the next section. Exchange rate stability, independent monetary policy, and capital mobility form a nexus called the monetary trilemma, or impossible trinity, in international economics (Mundell, 1961, 1962, 1963; Fleming, 1962). In its simplest form, this trilemma states that a country could simultaneously achieve two of the following two goals, but not all three: exchange rate stability, monetary independence, and capital mobility² (Figure 3).

Figure 3

The Monetary Trilemma

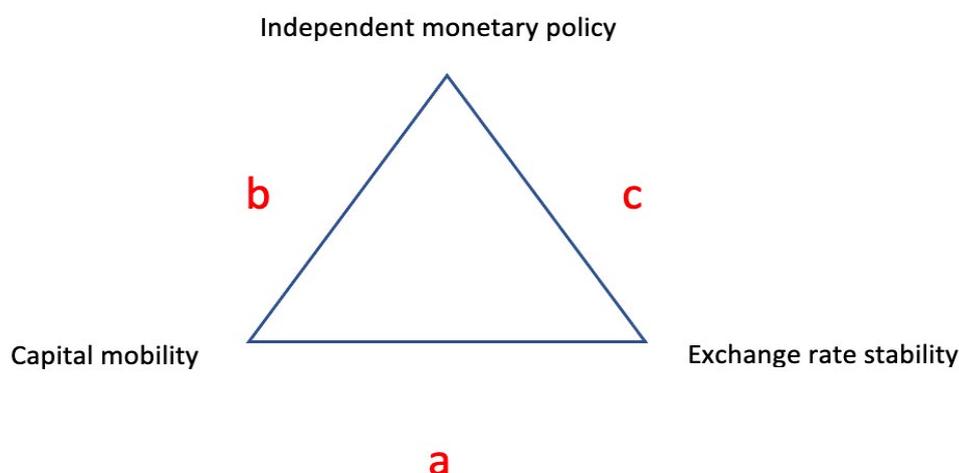


Figure 3 shows that a country can choose from one of three policy 'pairs'³:

a = Exchange rate stability (or exchange rate management) + capital mobility

b = Capital mobility + Independent monetary policy

c = Exchange rate stability + Independent monetary policy

Option a: The country will lose its independent monetary policy, i.e., the ability to change domestic interest rates as part of economic management. So, if the Federal Reserve raises U.S. interest rates, the country in question will also raise its domestic interest rates. Note that exchange rate management means allowing the exchange rate to rise or fall within a band. When the exchange rate passes outside the band, the central bank intervenes by selling or buying foreign currency.

Option b: If international capital flows (such as foreign direct investment) are allowed in and out, and monetary policy is independent (for example, the central bank can raise interest rates to control inflation or reduce interest rates to promote growth), the country has to allow for a flexible exchange rate (widening the exchange rate intervention band).

2. This can be seen intuitively if one focuses on the extreme policy choice in a small economy: a fixed exchange rate or a pure float regime; a complete independent monetary policy or no monetary policy control; and perfect capital mobility or financial autarky. If a country has a fixed exchange rate regime and free capital mobility, then it must give up its independent monetary policy. When a country faces an external shock such as interest rate increases from the base country (the U.S.), the interest rate differential will cause holders of domestic bonds to sell them in search of foreign bonds. This will increase the demand for foreign currency and, due to the fixed exchange rate regime, will require the central bank to intervene and reduce the money supply. Hence the country gives up its independent monetary policy.

3. I would like to thank Prof. Nguyen Tien Hung for making this point.

Option c: If the country wants to keep exchange rate stability and independent monetary policy, it would need to impose restrictions on capital flows.

This trilemma is not new. Since the gold standard more than a century ago, policymakers have had to deal with this trilemma with varying degree of success. Note that this trilemma does not imply that one policy choice is the best, nor that any one choice can resolve all economic problems. Each policy choice carries its own advantages and disadvantages, the magnitude of which could vary depending on specific conditions and over time. Recent research has shown that the trilemma remains valid today. Obstfeld and Taylor (2017) confirmed that the policy challenges of the trilemma remain true today and the monetary trilemma has made it impossible for most countries to maintain firm currency pegs, given the need to pursue independent monetary policy for domestic economic goals. Aizenman (2019) noted that new research has validated a modern version of the trilemma and "... countries face a continuous trilemma trade-off in which a higher trilemma policy goal is 'traded off' with a drop in the weighted average of the other two trilemma policy goals."

Today, countries can select a variety of exchange rate regimes between the two extreme forms of fixed and floating exchange rates: managed floating, target zone, basket peg, crawling peg, etc. In the 1980s and 1990s, EMDEs increased financial integration, which led to large capital inflows and economic booms, before suffering financial crises caused by "sudden reverse" of these flows and the flight of "hot money" (Aizenman, 2019). These crises eventually encouraged these economies to converge to "in-between regimes", with managed exchange rate flexibility, controlled financial integration, and limited monetary authority. Aizenman noted that the concern for financial stability added to the trilemma and effectively transformed it into a quadrilemma. He suggested that adequate reserves would be the fourth policy instrument in order to tackle this fourth goal. Obstfeld and Taylor (2017) noted that "floating still does facilitate some measure of domestic insulation, and policymakers can provide additional shock absorbers by deploying effective financial and macroprudential policies, by adopting sound fiscal and structural policies, and even by using measures to limit capital flow in some circumstances."

Aizenman et al (2008) proposed a set of trilemma indexes to measure a country's achievement against the three dimensions over time. As of August 2021, they have updated these indexes for over 172 countries through 2020⁴. The monetary independence index is measured using the annual correlation between the monthly interest rates of the home country and the base country⁵. This index varies between 0 and 1; the higher the index, the more monetary policy independence. The exchange rate stability index uses the annual standard deviations of the monthly exchange rate between the home country and the base country, and is normalized between 0 and 1. Here, higher index values indicate a more stable movement of the exchange rate against the currency of the base country⁶. The financial openness index uses the index of capital account openness based on information regarding restrictions in the IMF's *Annual Report on Exchange Arrangements and Exchange Restrictions*, and is normalized between 0 and 1. Higher values of this index indicate that a country is more open to cross-border capital transactions. Figure 4 below shows the values of these indexes for a set of African and Asian countries.

A quick review of these country indexes shows three features. First, of the three policy indexes, the financial openness index seems the most stable and remains low for most countries. The restrictions of capital flows thus follow the trend noted by Obstfeld and Taylor (2017): "in recent years, more countries have chosen to limit capital flows, notably after the 2008 global crisis. Volatility in exchange

4. For details, see https://web.pdx.edu/~ito/trilemma_indexes.htm.

5. The base country is the country to which a home country's monetary policy is most closely linked (Shambaugh, 2004). The base countries are Australia, Belgium, France, Germany, India, Malaysia, South Africa, the United Kingdom, and the United States.

6. If the rate of monthly change in the exchange rate stayed within +/-0.33 percent bands, they consider the exchange rate 'fixed' and assign it a value of 1 for this index. Single year pegs are also dropped.

rates, in international capital flows, or in both can bring risks of financial and economic instability, as economic history has shown.” Second, with regard to monetary independence, countries seem to lean towards less monetary independence (i.e., toward 0) over time. This trend appears to be more pronounced in Asia than in Africa. Third, with regard to exchange rate stability, there does not seem to be any discernible trend over this period for the African and Asian countries in the sample.

The tendency to raise domestic interest rates following a hike in the U.S. interest rates, however, could result in slower economic growth. This is because, coming out of the COVID pandemic, many SMEs and even large enterprises in these countries are in a vulnerable position. They need working capital and new investment to resume and expand production. Any attempt by the central bank to raise domestic interest rates in response to higher international interest rates will likely push these enterprises into bankruptcy and adversely impact economic growth.

Figure 4

Evolution of Trilemma Indexes for Selected African and Asian Countries 2012-2020



Source: Aizenman et al (2010). "The Emerging Global Financial Architecture: Tracing and Evaluating the New Patterns of the Trilemma's Configurations", Journal of International Money and Finance, Vol. 29, No. 4, p. 615-641. Updated to 2020 data at https://web.pdx.edu/~ito/trilemma_indexes.htm, accessed November 6, 2022.

Some economists have noted that a flexible exchange rate could avoid the reverse capital flows of the East Asian crisis in 1997-1998. This approach helps insulate the domestic economy from external shocks such as a rise in U.S. interest rates. Home countries that have currency pegs with open capital accounts tend to move their interest rates more closely with 'base' countries like the U.S., than countries that have floating exchange rates or pegs with closed capital accounts.

More importantly, this insulation effect carries over to output, too. Di Giovanni and Shambaugh (2008) found evidence that when the home economy has an open capital account and a peg, it tends to experience a real GDP growth slowdown when the base country (e.g., the U.S.) tightens monetary policy. This effect does not exist for countries that have a floating exchange rate, or a peg with a closed capital account.

Why do countries peg their currencies then? These countries believe that this choice protects their economy from macro-financial shocks caused by large exchange rate fluctuations. Obsfeld and Taylor (2017) found that the share of countries pegging their exchange rates fell from 90% in 1970 to about 40% in the 1980s, but since then this share has crept back up to more than 50%.

Note that a country faces the monetary trilemma even if there are no exogenous shocks from outside. With the exogenous shocks, the trilemma will get worse. Higher international interest rates will make it more difficult to peg an exchange rate because of pressures to devalue. It also makes it more difficult to keep an independent monetary policy because of the interest parity condition. And it makes it more difficult to keep the current policy on capital flows intact.

To reduce the impact of external shocks on the domestic economy, policymakers may want to limit capital flows and/or make the exchange rate more flexible in order to retain the ability to influence interest rates. The need for an independent monetary policy, i.e., the ability to manage domestic interest rates, is important today. As mentioned previously, coming out of the COVID-19 pandemic, many SMEs and even large enterprises are in vulnerable positions and need working capital and new investment to resume and expand production. Any attempt by the central bank to raise domestic interest rates in response to higher international interest rates could push these enterprises into bankruptcy and adversely impact economic growth.

Fiscal policy. Under normal circumstances, countries could turn to fiscal policy to absorb the external shocks. But the fiscal space for developing countries is now very limited. In a previous publication (Dinh, 2022), we discussed the fiscal space of EMDE after facing COVID-19, and analyzed the fiscal sustainability of selected low- and lower-middle-income countries. We found that the necessary containment measures implemented to slow the pandemic's spread led to a significant erosion of fiscal space. As a result, most EMDEs will be under debt stress, with the ratio of debt to GDP exceeding the critical 65% level. Some of these countries will experience liquidity problems, and most will face solvency problems that require their debt stock burdens to be addressed. Developing countries therefore face a stark choice between more spending to mitigate the cost of a recession following two difficult years of COVID-19, and risking further debt distress.

As discussed previously (Dinh, 2022), low-income countries⁷ have faced a particularly difficult fiscal situation during and after COVID-19. The contractions in output and exports caused revenues to drop, while expenditures had to increase to cope with COVID-19-related spending and rising debt service burdens. Many countries could not afford the needed fiscal support, resulting in higher poverty and malnutrition. Many resorted to cutting capital spending, which has made it harder to grow after the pandemic.

7. In this paper, we define income groups using the World Bank classification. Low-income countries are those with a GNI per capita at or below \$1045 in 2020, and middle-income countries are those with a GNI per capita between \$1046 and \$12695.

Debt issues. Today's global environment bears a resemblance to that of 1982-1989, when the monetary authorities in the U.S. and other developed countries increased interest rates sharply in order to bring down the entrenched inflation. This triggered a series of debt crises in developing countries. In Latin America, this period is referred to as the 'lost decade', or the Less Developed Countries (LDC) crisis. Prior to 1982, many Latin American countries coped with the two oil price shocks of the 1970s by borrowing from U.S. money-centered banks⁸. These banks had expanded their balance sheets through the deposits of the oil-exporting countries' current account surpluses (FDIC, 1997).

At the end of 1970, total outstanding debt from all sources to U.S. commercial banks and other creditors totaled only \$29 billion. But by 1982, the debt level had reached \$327 billion (FDIC, 1997). It was estimated that approximately two-thirds of this debt was tied to the floating London Inter-Bank Offered Rate (LIBOR)⁹. These loans were especially vulnerable to repricing risk driven by changes in the macroeconomic conditions of the creditor nations (FDIC, 1997). When the Federal Reserve tightened monetary policy to curb inflation, banks began to hike interest rates for loans. As a result, many Latin American countries were unable to service their debts. In August 1982, Mexico informed U.S. authorities that it was unable to make debt service payments on the \$80 billion owed to the banks, triggering a series of defaults, debt rescheduling, and debt workouts in some 27 developing countries, 16 of which were in Latin America. This crisis lasted for more than a decade and only ended after U.S. Secretary of Treasury Brady proposed a plan in 1989 to permanently reduce principal and interest payments on loans, resulting eventually in \$61 billion, or a third of outstanding debt at that time, being forgiven in exchange for domestic economic reforms in indebted nations.

Similarly, prior to COVID-19, developing economies experienced large current account deficits leading to higher borrowing. External debt ratios have deteriorated over the last decade, and this trend was exacerbated by the pandemic across all income groups, as shown by the DOD/GNI indicator (Table 1). Some countries borrowed domestically, but others borrowed from external commercial sources, particularly from Euro bond markets, leading to shortened debt maturities, higher interest payments, and a higher risk of a foreign currency crisis. The international debt structure has also changed, with creditors shifting from official (especially bilateral) to private institutions. The presence of private creditors has implications for the incentives and ability to provide debt relief. Among private creditors, bondholders are diverse and difficult to organize, in case debt restructuring is needed.

Higher borrowing from the non-Paris Club countries and commercial creditors has meant shorter maturities and higher refinancing risks. Since 2013-14, a surge in issuances of 10-year Eurobonds by many African countries, as well as non-Paris Club loans (which have shorter maturities than typical multilateral concessional long-term loans), has caused bunching and created sovereign debt liabilities coming due in 2024-25. This bunching in maturities increases the risks of debt distress, which could spread quickly from low-income to middle-income countries.

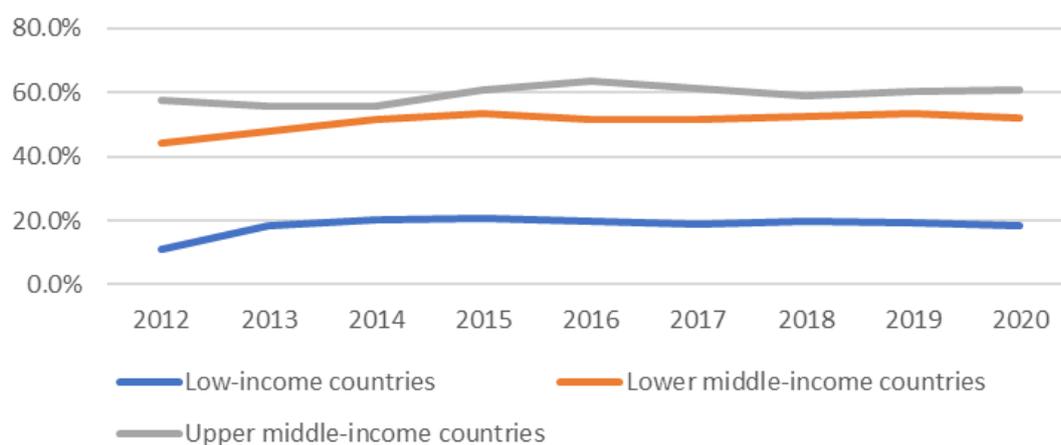
The World Bank compiled debt information by creditor for the first time in November 2020. Based on this information, Figure 5 and Table 1 show the debt owed by different income groups (guaranteed and non-guaranteed) to private creditors. These private creditors consist mostly of bondholders and commercial banks. Figure 5 shows that the share of private creditors in total debt has risen for both low-income and lower-middle income countries. Table 1 shows the structure and vulnerabilities of external debt grouped by income groups.

8. Money-centered banks are banks that borrow from and lend to governments, large corporations, and other banks in national and international financial markets.

9. LIBOR is an interest-rate average calculated from estimates submitted by the leading banks in London. It is a key benchmark for setting the interest rates charged on adjustable-rate loans, mortgages, and corporate debt.

Figure 5

Total External Debt from Private Creditors 2012-2020 (% of Total Debt)



Source: Author compiled from World Bank International Debt Statistics 2022.

Just like during Latin America's 'lost decade', rising interest rates in the next few years will hit middle-income countries hard. The most vulnerable group is the lower middle-income countries, where 46% of the debt stock is subject to variable interest rates, compared to 20% for low income, and 44% for upper-middle income countries (Table 1). The rise in the dollar exchange rate will also adversely

	2012	2018	2019	2020
Low-income countries				
Total External Debt from Private Creditors (US\$Billions)	9.7	28.1	29.3	30.5
Total private debt/total debt	10.9%	19.8%	19.4%	18.3%
o.w. PPG private creditor/total Debt	8.8%	11.1%	10.4%	9.6%
o.w. Non-PPG private debt/total debt	2.1%	8.7%	9.0%	8.7%
DOD/GNI	23.4%	30.7%	30.9%	33.2%
DOD/total exports GS	100.4%	N/A	N/A	N/A
ST to Total debt stock	9.8%	10.0%	10.2%	8.6%
Variable rate debt/DOD	12.9%	22%	21%	20%
Debt in US \$/total debt	57.9%	66%	65%	64%
Total debt service/EGS&prim. inc.)	3.0%	N/A	N/A	N/A
Lower middle-income countries				
Total External Debt from Private Creditors (US\$Billions)	623.5	1091.0	1195.8	1240.0
Total private debt/total debt	44.3%	52.6%	53.4%	51.9%
o.w. PPG private creditor/total Debt	14.8%	22.6%	23.3%	22.7%
o.w. Non-PPG private debt/total debt	29.5%	30.0%	30.1%	29.2%
DOD/GNI	23.1%	28.7%	29.4%	33.1%
DOD/total exports GS	81.0%	108.1%	116.2%	144.1%
ST to Total debt stock	18.6%	14.2%	14.0%	13.2%
Variable rate debt/DOD	42.4%	46.7%	46.7%	45.6%
Debt in US \$/total debt	60.8%	73.8%	74.0%	73.3%
Total debt service/EGS&prim. inc.)	8.5%	12.8%	14.5%	16.8%
Upper middle-income countries				
Total External Debt from Private Creditors (US\$Billions)	2383.3	3302.2	3526.2	3731.0
Total private debt/total debt	57.3%	58.9%	60.2%	60.8%
o.w. PPG private creditor/total Debt	19.8%	24.3%	25.2%	26.4%
o.w. Non-PPG private debt/total debt	37.5%	34.5%	35.0%	34.4%
DOD/GNI	23.0%	25.0%	25.6%	27.7%
DOD/total exports GS	82.5%	97.6%	102.3%	115.0%
ST to Total debt stock	32.2%	32.8%	31.5%	30.4%
Variable rate debt/DOD	48.7%	44.7%	45.0%	44.2%
Debt in US \$/total debt	83.7%	84.4%	84.4%	84.5%
Total debt service/EGS&prim. inc.)	9.1%	14.8%	16.3%	16.8%
Source: Author compiled from World Bank International Debt Statistics 2022				

Abbreviation: DOD is debt outstanding and disbursed; GNI: Gross National Income; GS: goods and services; ST: short-term; EGS: exports of goods and services; prim. Inc.: primary income.

impact the middle-income group, particularly the upper middle-income group, where 85% of the debt stock is denominated in dollars. Another concerning trend is the maturity of the debt stock. About 65% of debt in the lower middle-income group (over 91% for upper middle-income group) consists of private and short-term debt, which carries short-term maturity.

Currently, unlike for low-income countries, there is no debt workout framework for middle-income countries. Such a framework would require efforts from all sides. For creditors, this means continuing to help countries overcome the crisis through debt relief, linked to investments where relevant. Debtors should focus on the need to develop and implement a medium-term debt framework to ensure continuing sustainability of both domestic and external debt. To do this, they must put mechanisms and institutions in place that enable them to strike the proper balance between the benefits and costs of additional debt. These include sound debt management, high debt transparency, proper use of non-concessional resources, and thorough monitoring of contingent liabilities. EMDE governments should also develop the necessary skills to be more proactively involved with lead issuance advisers in managing the bond negotiations for lower interest rates.

The solvency and sustainability conditions for the existing external debt stock (Cohen, 1991) call for EMDEs to reduce their non-interest current account deficits, and for a favorable path of the automatic debt dynamic term—the difference between the real international interest rate and real output growth. EMDEs cannot influence the international interest rates, but they can foster higher economic growth by retaining the ability to control domestic interest rates and microeconomic and structural policies.

Microeconomic and structural policies. EMDEs should undertake microeconomic and structural policies aimed at protecting the labor force during a time of global crisis, and enhancing labor productivity to restore pre-COVID-19 economic growth.

Foster long term growth. To restore their long-term growth potential, countries need to: i) complete ongoing infrastructure investment, especially in roads, ports, etc.; ii) accelerate reform of the education and training system in order to supplement traditional teaching methods with online resources; iii) undertake digital transformation of the economy to foster innovation; iv) reduce/eliminate administrative and red-tape requirements in the economic decision-making mechanism; and v) place the annual budget within a medium-term framework so that extraordinary spending can be made in any period without jeopardizing macroeconomic stability.

Boosting productivity. In some countries, there is a need to help the labor market recover after the pandemic, and to restore the global supply chains that existed prior to COVID-19, including by bringing back workers who left factories during the pandemic. To boost productivity growth at the firm level, EMDEs need to implement policies to reduce state ownership, revamp rigid labor regulations, improve access to finance, and leverage technology. In addition, education and training policies to help equip workers with skills required for new production techniques are needed.

CONCLUSION

The worsened global environment, and the debt problems of EMDEs, call for better management and coordination of economic policies over the next several years. Coordination between fiscal, monetary, and exchange rate policies needs to be strengthened to closely monitor the direction, speed, and magnitude of capital flows and their effects on the economy. To reduce the impact of external shocks on the domestic economy, policymakers may want to make the exchange rate more flexible, and/or to limit capital flows, in order to retain the ability to influence interest rates. Coming out of the COVID-19 pandemic, many SMEs and even large enterprises are in a vulnerable position and need working capital and new investment to resume and expand production. Any attempt by central banks to raise domestic interest rates in response to higher international interest rates could push these enterprises into bankruptcy and adversely impact economic growth.

No single policy choice is the best as the optimal solution depends on individual circumstances. Structural and microeconomic reforms are also needed to protect the labor force during a time of crisis, and to enhance labor productivity. The complexities and urgency of these macro and micro economic policies will tax EMDE governments' capacities to their limit.

The international community also needs to recognize fully the desperate situation of the indebted countries, and to take prompt and decisive actions to help restore growth. A change in the financial architecture is also needed, so that a longer-term resolution of the debt problem can be found. This would provide more certainty to the macroeconomic and investment policy framework to restore economic growth. Such a resolution would need to provide a differentiated response to the developing countries' varied needs, creating a distinction between the provision of liquidity, versus a permanent reduction in the debt overhead, between countries willing and able to undertake deep adjustment reforms, and between the creditors who are accountable to different owners of capital.

The possible rapid spread of debt distress from low to middle-income countries indicates the need for a debt workout framework for middle-income countries, which currently does not exist. Creditors need to continue to help EMDEs overcome the external shocks. Debtors need to develop and implement a medium-term debt framework to ensure continued sustainability of both domestic and external debt. To do this, they must put mechanisms and institutions in place that enable them to strike the proper balance between the benefits and costs of additional debt. These include sound debt management, high debt transparency, proper use of non-concessional resources, and thorough monitoring of contingent liabilities.

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