Mounting Prospects for an Unprecedented Emerging Market Debt Crisis

William R. Rhodes

As the world continues to grapple with the COVID-19 pandemic and its impact on the global economy, it seems that this unfolding health and social crisis will be with us until we have both an effective treatment and a vaccine. As governments battle the consequences of this disease, Winston Churchill's words from 1942 echo, "This is not the end, it is not the beginning of the end. It is perhaps the end of the beginning." Search for a vaccine is engaging many of the smartest scientists from Oxford to Harvard to laboratories worldwide. Teams are rushing to test possible solutions; perhaps we will have a breakthrough, but it will take time. The next 12 months are critical in the race to find both an effective vaccine and treatment. As the coronavirus continues to mutate, scientists will be challenged by its changing nature. Advances in current scientific research give hope that a targeted therapeutic intervention may be in sight. Unfortunately, this pandemic and its economic fallout will cause the greatest emerging market financial crisis in memory.

The negative impact of the COVID-19 pandemic's health and economic fallout are already being felt in many emerging market countries worldwide, such as

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Argentina, Ecuador, Lebanon, Zambia, Tanzania, Caribbean countries, and many other countries to come. This will spark hugely damaging debt defaults in both the sovereign and private sectors, thereby delaying recovery and rebuilding. Most emerging market countries borrowed heavily both from international private sector lenders and from official governmental institutions, mostly in foreign currencies such as the dollar and the euro. Now they are facing a stronger dollar and a stronger euro and rising debt service costs at a time of increased economic difficulties and capital flight. The question here is what needs to be done to mitigate the fallout from this crisis which could become both a health and an economic disaster.

We must start preparing for this right away. How can we best deal with this emerging markets debt crisis? The International Monetary Fund requires additional resources, as it now faces not only immediate requests for fast-disbursing loans from 100 countries—the most in its history—but also a large number of follow-on loan requests from these countries in the coming months. The United States has resisted an increase in IMF Special Drawing Rights, which is needed to augment the capital available for lending. Without the support of the United States, the IMF risks being unable to respond financially on the scale that will be required. The United States needs to recognize that the IMF performs an essential emergency response role at an extremely low cost to U.S. taxpayers.

What is the plan for debt management after the current G20 moratorium on debt payments from the hardest pressed developing countries runs out at the end of the year? To date the G20 and the IMF have not clearly outlined a strategy going forward. Yet according to the IMF, fully 40% of low-income countries are trying to deal with high levels of distressed debt and high debt levels. We urgently need a plan, and a coordinated collective response involving governments, the international financial institutions like the IMF and World Bank, regional development banks and the private sector.

We have seen major sovereign debt crises on a regional scale before, such as in Latin America in the 1980s and East Asia in the 1990s—but never have we seen one with such a global reach.

Historically the U.S. Treasury, Federal Reserve and other developed countries' central banks would take leading roles, alongside private lenders working with the Paris Club. We worry that this time could be different. Will the G20 and U.S. administration take the necessary steps here? Solving debt crises is not a zero-sum game. It is not "I win you lose." All sides must give ground to succeed. That method worked in prior debt crises in Latin America and East Asia. In 2020 we can advance toward a solution if the United States plays its full part and if we secure China's active participation and leadership.

China is the largest official creditor in the developing world. Across Africa, Asia, and Latin America, roads and infrastructure have been repaired and constructed with the support from China via its Belt and Road Initiative, estimated by the Kiel Institute to amount to at least $520 billion in outstanding loans. As a result of this major investment surge, resolving the financial and debt crisis in the developing world demands China's full cooperation and support.

The possible approaches China might take were not clearly outlined in the statements coming out of the recently concluded National People's Congress meeting, and therefore, it is not clear how China will address this massive extension of international credit.

The G20 must work with China to bring it in as a full member of the Paris Club rather than limited to the observer status it now has. Part of that process will mean the Chinese will certainly have to be more transparent about their loans and conditions in the Belt and Road lending program. And China will have to agree to undertake substantial debt forgiveness and debt restructuring to the countries involved. China's stance in this regard will be key to a workable emerging market debt solution. During the last Great Recession in 2008, China was not a major creditor as it is today and was able to pump in some $800 billion to its infrastructure and other projects which helped avert a great worldwide depression, rather than the recession that we experienced. At that point China's debt to GDP level was very low and their economy was growing at double digit figures, rather than where it is today in the area of 1 to 2% growth.

Time is of the essence here. Failure to move quickly would undermine confidence in the international financial system and hinder the prospects for a rapid global economic recovery. It is in our national and collective strategic interest to see all G20 members working closely together alongside a strongly capitalized IMF and World Bank. Not to do so would do great damage to confidence in the international financial system, which would in turn harm the prospects for global economic recovery.