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Ashmore

The well-meaning misguided G20 proposal

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The recently launched G20 initiative to provide debt relief for poorer Emerging Markets (EM) countries may be well-meaning, but it is also seriously misguided. In particular, the proposal fails on two counts.

First, it does not recognise a crucial difference between sovereign bonds and bi/multilateral loans.

Second, the proposal does not address the underlying cause of the problems facing poorer EM countries, namely so-called sudden stops. In its current form, the G20 proposal therefore risks setting back the financial development of poorer EM countries by years, hurting rather than helping them.

There is a better way.

For poorer Emerging Market (EM) countries, some of the most important structural advances over the past twenty years have been to gain access to sizeable foreign direct investment from China and to be able to place bonds in global capital markets. These two developments jointly enabled this group of countries to escape 50 years of *de facto* dependence on financing from conventional bilateral donors and multilateral agencies. But now one of these advances – access to global capital markets – could be reversed after the G20 group of countries called for debt moratoria in so-called IDA countries.

The ability to access capital from multiple and diverse sources is a big positive from a risk-mitigation perspective. However, access to global bond markets is additionally an essential part of any country's economic development because the influence of bond markets extends far beyond the mere supply of finance. In sharp contrast to bi- and multilateral loans, sovereign bonds are publicly traded instruments, whose yields provide real time information about a country's short-term and long-term cost of capital. This makes yield curves a fundamental piece of economic infrastructure central to the economic development process itself. Private sector companies need sovereign yield curves to price bonds without which they cannot obtain the capital required for investment and therefore growth.

Sadly, the special importance of bond markets appears to have been lost on the G20, which, in a recent communique, called on "private creditors, working through the Institute of International Finance" to participate in suspension of debt service payments from the world's poorest nations. Remarkably, even the World Bank, whose very mission it is to advance economic development, also appeared oblivious to the distinction between bond financing and official sector loans.[1]

There are other good reasons why the G20 should not insist on bond holder participation in its proposed moratoria on debt for IDA countries. Firstly, good policy solutions always start with the correct identification of the underlying fundamental problem and access to bond markets is clearly not the problem facing poor EM countries right now. Rather, the problem is that poorer EM countries face a capital stop, which has temporarily deprived a number of them of access to global finance. Most do not have sufficiently well-developed domestic markets to meet their financing needs at home. Given that the problem is a loss of finance, calling upon them to default, which only deprives them further of capital, can never be part of the solution. In fact, the best protection right now would be to help them maintain access to global capital, not to cut them off.

It is crucial to recognise that capital stops are the mirror image of bubbles, that is, they are massive market failures. Like bubbles, they require intervention to minimise their occurrence and limit their economic fallout. Capital stops occur during major global risk aversion events, when investors for many complex reasons 'dumb down' the world into a simple binary construct comprising 'risky EM countries' – from which capital is withdrawn – and 'safe developed countries' – to which the capital flows. Clearly, simplistic market bifurcation of this kind is irrational, since the 200-odd countries in the world sit on a very broad continuum of riskiness.

[1] See: https://www.worldbank.org/en/news/speech/2020/03/23/remarks-by-world-bank-group-president-david-malpass-on-g20-finance-ministers-conference-call-on-covid-19

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More importantly, it is economically inefficient and often gives rise to serious humanitarian issues, when markets act this way, because the countries that tend to get cut off from financing are the poorest and most finance-constrained in the world.

In fact, market failures of this kind would never be tolerated within individual countries. It is precisely to fight such market failures that most countries today have an arsenal of macro-prudential measures in place. The Fed bought mortgages in 2008/2009 because if markets had had full sway they would have pushed the US economy into depression. The Fed is buying high yield bonds today for the same reason. Yet, when it comes to global markets in which market failures are equally if not even more pronounced, there is no formal recognition that market failures even exist, no institutions have been assigned responsibility to address them, and no policy instruments have been designed to ameliorate their often serious deleterious effects.

Rather than addressing the obvious market failures that have cut EM countries off from scarce financing, the G20 has put forward a proposal that may make things even worse, and not just in the short term. The 25-odd low income EM countries that gained access to global capital markets over the past couple of decades worked very hard to reach this point, often fighting severe resistance from bi- and multilateral lenders. Yet, they forged ahead because they understand that market access is a giant step forward in their economic development. Hence, to now have to default in order to qualify for a temporary suspension of bi- or multilateral debt service would amount to a massive economic setback. Besides, debt restructurings are never forgotten by investors; they permanently raise the cost of capital. In a worst case scenario, the G20 risks pushing countries back decades into complete dependence on non-market finance with all its inherent interference in domestic affairs. So, although possibly well-meaning the G20 call for private participation in moratoria on debt in IDA countries is clearly completely misguided.

So what is a better way forward? Above all, now would be a good time for G20 to recognise that global financial markets regularly fail. With this recognition should come the realisation that maintaining access to global markets is not the problem, rather it is part of the solution, assuming, of course, that policies are good and debt is sustainable, which is the case in the vast majority of poorer EM countries.

Next, the G20 should assign responsibility to specific institutions to identify global market failures and to design programmes to soften their impact. These programmes should be seen as a complement to existing lending facilities that target economic business cycles and structural adjustment, but with the crucial difference that they specifically address financial market failures that lead directly to loss of market access during risk aversion events.

In practice, this can be done in various ways. One way would be to create credit lines that enable EM countries with good policy records to buy back their own debt in periods of extreme market mispricing. Alternatively, the bond purchases could be undertaken by the international financial institutions themselves. The programmes would likely repay quickly. The idea is just to grant low income EM countries the means to maintain their fragile footholds in financial markets during the duration of capital stops, which, thankfully, usually end quite quickly.

Beyond short-term market interventions, the World Bank in particular should re-focus on promoting the rapid development of domestic pension funds and the establishment of local bond markets. After all, the only failsafe way to escape the vulnerability arising from depending on unpredictable foreign capital flows is to have one’s own sources of finance, right at home.

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