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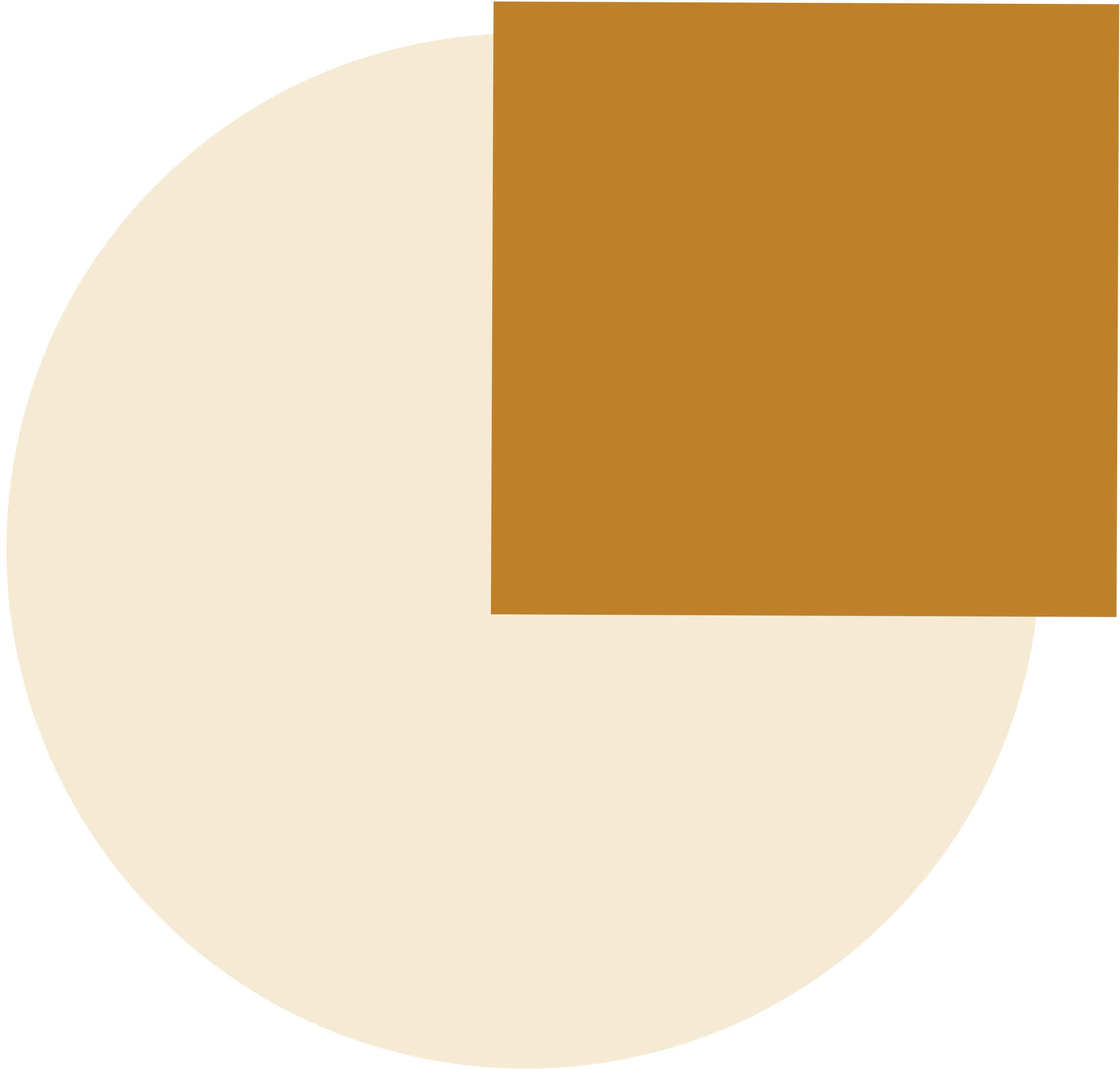
Public debt and COVID-19. Paying for the crisis in Latin America and the Caribbean



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Public debt and COVID-19: Paying for the crisis in Latin America and the Caribbean9

Author
Sebastián Nieto-Parra, René Orozco

Foreword
Mario Pezzini

45, Rue d'Ulm 75005 Paris
legrandcontinent.eu
geg@ens.fr

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Mario Pezzini • Director of the OECD Development Center

Foreword

The Covid-19 pandemic is having unprecedented socio-economic consequences everywhere. In the case of Latin America and the Caribbean (LAC) it is emphasizing complex scenarios that were deteriorating even before the Covid crisis. Despite some years of economic growth, in average +2,6% of GDP between 2000 and 2018, the continent continues to face significant structural development traps [Figure 1]. These persisting "development traps" fuel vicious circles of self-reinforcing dynamics that limit the capacity to transition towards greater development. For example, the institutional trap is particularly pressing today. Some efforts have been made, nevertheless, public institutions are failing to fully respond to citizens' increasing demands for services and investments, and in turn, distrust and low satisfaction are deepening.

Figure 1. Development traps in Latin America

Source: OECD et al. (2019a), Latin American Economic Outlook 2019: Development in Transition, OECD Publishing, Paris. In particular, Sebastián Nieto-Parra, Mario Pezzini and Juan Vázquez: Social discontent in Latin America through the lens of development traps in Development Matters,

From 2006 to 2018, the share of population in Latin America satisfied with quality of healthcare services felt from 57% to 42%, well below the OECD average of around 70%. In this context, citizens see less value in fulfilling their social obligations, such as paying taxes: 53% of the population justified not paying taxes in 2016, compared to 46% in 2011. This, in turn, makes it difficult to raise tax revenues, and it completes a vicious circle: ultimately limiting the capacity to finance better public services and respond to rising social demands. Despite heterogeneity across countries, tax revenues in Latin America and the Caribbean – 23.1% of GDP – remain well below the OECD figure of 34.3% of GDP (OECD et al., 2019b).

Similar traps have to deal with the circle of social vulnerability or of low productivity. 40% of the population is in vulnerable conditions. These individuals generally have informal jobs, with low and unstable income, no social protection and almost no-capacity to invest in their human capital or in a dynamic entrepreneurial activity. As a result, they remain trapped in low-productivity, with access to only low-quality jobs. These conditions put them at risk of slipping back into poverty if faced with a negative economic shock, health issues, and even a family event like a divorce. In fact, 27 million people have fallen into poverty from 2014 to 2019 (ECLAC, 2019). The structure of the economy does not help improving the situation and actually is likely to be the mayor cause of the problem. Exports in many LAC countries are biased towards primary sectors with low levels of sophistication and low-quality job creation. This is often to the detriment of the manufacturing sector, which tends to get squeezed. Dependence on the extractive industries tends to further attract resources (both financial and technical) away from more job-intensive manufacturing, again with direct implications on diversification, quality of jobs, and wide informality. No doubt that strong policies are required.

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In short, the region entered the Covid-19 crisis with the majority of countries

presenting low potential growth and social discontent. At present, the picture is worsen and all countries are being severely hit by the health crisis: on average, GDP growth will contract by more than 9.0% in 2020, putting Latin America and Caribbean in the lowest economic projection across emerging and developing regions. But the impact of this crisis goes far beyond income. It will reproduce and aggravate the already unsustainable inequalities in the continent. In fact, the crisis is affecting in particular the most vulnerable households, firms and workers, and in 2020, poverty rates may increase by 4.4 percentage points. The crisis will further accentuare the low productivity trap: more than 2.5 million companies will close, which would entail the loss of 8.5 million jobs, without reasonable hope for those jobs to be substituted by competitive formal jobs. Last but not least, the crisis will further depress the citizens' prospects of well-being, adding new drivers of social discontent, that will boil over in massive protests, at least in some countries, as it has appeared over the past weeks.

So, if the Covid crisis will exacerbate the existing problems in Latin America and the Caribbean, what to do? How to repair a broken citizens' sense of belonging, if any, to the national and regional communities? How can governments move forward to regain their citizens' trust and try to respond to their demands and aspirations? Is it just matter of marginal efficiency improvements in the different sectoral policy areas? The Covid-19 crisis seems to further highlight that responding to citizens' demands and aspirations' requires much more than a simple 'back to business as usual" or even to a "back better". Policy responses are oftentimes sectoral, technical, and appear disconnected, in the eyes of the population, from a broader vision about their well-being. What can be done to empower the population and create a shared understanding of development? In a moment of deep crisis, it seems key to give voice to the people by strengthening mechanisms for dialogue among all stakeholders and agree on strong narratives and visions towards a more inclusive development. National development plans have proliferated across Latin American countries. If revised in their objectives, methodology and procedures, they could constitute a first step, an initial platform to build participatory processes and design the medium-long term strategies for recovery. The aftermath of this crisis must be turned into an opportunity to redefine the social contract (or the social pact), putting well-being at the centre, with stronger social protection systems, better healthcare.

In this context, fiscal reforms are both a condition and a result of mid/long term development strategies. First, stronger social protection systems, better healthcare, courageous productive transformation strategies, formalization campaigns for a new social contract need to be financed by more robust and inclusive public finances. Second, a less unequal continent requires a more progressive system of taxation, less based on indirect taxes that are presently far prominent in the tax mix or other measures that do not help redistribution. At the same time, fiscal reforms can be sustainable only if governments improve the quality of public services and in general of public expenditure. Changing the mind-set of citizens, increasing tax paying and avoiding the 'institutional trap' is only possible if taxation is accompanied

by effective expenditure. These expenditures must be visible and produce productive investments, an equitable system of transfers, effective and quality public services, and they should be coherent with sound and agreed national development strategies. Moreover, fiscal reforms are credible to the eyes of middle-class citizens, if tax evasion, complexity and avoidance by multinational large firms and high-net-worth individuals are dealt with. On the contrary, the inability to contain profit shifting pushes countries to lower their tax rates for the sake of competitive advantage in what has come to be termed as a race to the bottom. Revenues lost to tax evasion of corporate income tax and personal income tax amounted to 4.3% of GDP and evasion of VAT amounted to 2.4% of GDP (ECLAC, 2016).

No doubt that governments have to navigate uncharted waters where effective and coherent expenditures are key for building trust between citizens and public institutions, while in turn trust is key to generate higher revenues and finance effective and coherent expenditure. While governments have to address such an over complicated conundrum, they have recently seen the Covid crisis adding an unprecedented challenge: an exogenous shock of significantly higher levels of debt. In fact, to contain the spread of Covid-19, many LAC countries have reacted swiftly by adopting social distancing measures. As these measures have a mayor socio-economic impact, several countries in the region (as well as in other regions) adopted fiscal and monetary policies to protect the most vulnerable and to preserve human, productive and financial capacities so to reduce the negative impact of the crisis. The question is: should countries now address as quickly as possible their increased Covid-debt and further post-pone the indispensable reforms demanded by the critical situation already present before the crisis? Or should they figure out exceptional resources and measures?

The countries in the regions have adopted measure on the spending and tax sides, but these measures do not seem sufficient. However, advocating additional and stronger austerity measures for an immediate reduction of the debt could reproduce both the depressive consequences experimented by many countries after 2008 and their negative long term spill-over effects on the global economy. I am rather thinking that interventions in the public debt market should be also explored. Some considerations and actions are presented in the article of Sebastian Nieto and Rene Orozco, where moreover they take into account the significant heterogeneity of the region in terms of public debt. A fact is clear: heavier debt services on a reduced GDP will seriously and further compromise the policy action of governments. This will aggravate the considerable socio-economic damages faced by a region where social discontent remains palpable and will project on a wider time horizont the social instability. To obtain the needed resources to fight Covid, public debt management is indispensable and it needs to be done in close coordination with international actors. More than ever, strong cooperation and coordination with creditors, international organisations, capital markets' actors and nations is fundamental.

Executive Summary

Varying fiscal positions and access to international markets before COVID-19 is determining Latin American and Caribbean countries' ability to respond to and recover from this unprecedented crisis. With narrow fiscal space to take big, exceptional measures and global coordination of public debt management will be vital in mitigating the already devastating socio-economic consequences of the crisis in the region.

Most countries in the region entered to the COVID-19 crisis with limited fiscal space. Current circumstances entail a decrease in fiscal revenues and the impossibility to raise taxes to finance the spending needed to respond to the crisis.

Public debt management is an option but requires international action. There is no unique solution to managing public debt due to discrepancies across countries in terms of initial fiscal conditions, type of foreign creditors, and finally financial capacity to tap into capital markets. Addressing these issues calls for policy action:

- There needs to be coordinated action among bond-holders and capital markets' actors in restructuring debt issued by countries that were already facing financial difficulties before the crisis.
- To respond to the crisis, official support should go beyond the level of income and focus on economies that have little or no access to markets.
- Other countries, that already enjoyed ample fiscal sustainability before the crisis, must retain access to capital markets where risk premium remains low and through which they can raise the funds to respond to the crisis.
- Finally, another group of countries might have access to capital markets but face high debt cost due to a deterioration in the perception of debt sustainability by markets' participants. There are several policy options, including debt standstill/moratorium, debt relief, the creation of a special-purpose vehicle to finance the crisis or pay the debt, or further use of SDRs - Special Drawing Rights. Their common denominator is that they require international co-operation, involving multilateral banks, developed countries and/or private creditors.`

The COVID-19 crisis has been an exceptional, unexpected and exogenous shock to countries across the region. Meanwhile, abundant liquidity remains in international capital markets, making this crisis different to past global crises. International coordinated action must contribute to solve debt sustainability problems and respond to the impact of the crisis.

Sebastián Nieto-Parra • Head of Latin America and the Caribbean Unit, OECD Development Centre

René Orozco • Economist, Latin America and the Caribbean Unit, OECD Development Centre.

Public debt and Covid-19: Paying for the crisis in Latin America and the Caribbean

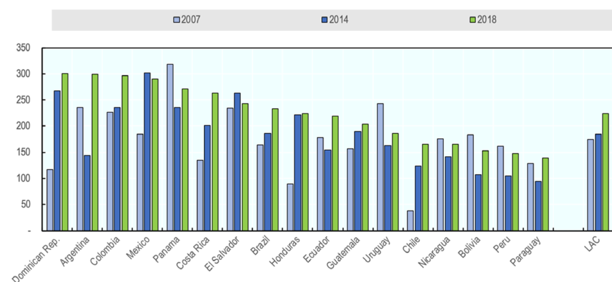
The COVID-19 pandemic is having dire socio-economic consequences in Latin America and the Caribbean, exacerbating an already complex scenario across the region (OECD et al., 2019). COVID-19 has struck the region at a time when most countries were already suffering from low economic growth and increasing social discontent. Between 2014 and 2019 the region experienced the weakest period of growth since the 1950s, consistently recording lower growth rates than the OECD average. In 2019, growth was practically zero, and mass protests erupted in certain countries, confirming that despite past progress in reducing income poverty, vulnerability remains a major challenge in a region where citizens' aspirations for better public services and jobs are growing.

Although uncertainty surrounding the socio-economic consequences of this crisis is high, Latin American and the Caribbean is already facing an unprecedented crisis. The level of economic contraction will vary considerably across countries and will depend on several aspects (OECD, 2020a). These include the scope and length of lockdowns, what policy measures countries adopt to contain the socio-economic crisis and the global economic path after the crisis. Another factor is how exposed countries are to external shocks, mainly in terms of the level of integration in the Global Value Chains, commodity markets, remittances, tourism, and global financial markets (ECLAC, 2020). Combined, these factors will result in a sharp contraction in incomes, and rising poverty and inequality across the region.

Fiscal policy is playing an essential role in mitigating the negative socio-economic effects of the pandemic, and should play an essential role in the recovery. First, fiscal policy should aim to stop the spread of the virus and avoid a second wave of contagion, as well as support business continuity and protect jobs. Most economies in the region are already implementing these measures. They should, however, be designed as temporary measures, to avoid disrupting fiscal stability in the future (Izquierdo and Ardanaz, 2020). Looking forward, there also need to be measures to recover the economy, promote entrepreneurship and support the most vulnerable populations.

Before the COVID-19 crisis, fiscal space in most countries in the region was already limited. In fact, most countries' fiscal position worsened compared to just before the 2008 global financial crisis. In 2007, Latin America and the Caribbean had an average fiscal deficit of 1.1% of GDP and a public debt level of 46% of GDP (or 175% of tax revenues). In contrast, by 2018 fiscal deficits deteriorated to 4.8% of GDP and public debt increased to 68% of GDP (or 224% of tax revenues, close to 50 percentage points more than a decade ago) (Figure 1). In addition, despite some heterogeneity, tax revenues remain scarce in most countries with an average of 23.1% of GDP in 2018 - more than 10 percentage points lower than the 34.3% OECD average. Furthermore, revenues from commodities, a key source of financing for most South American countries, and others like Mexico and Trinidad and Tobago, have considerably decreased in the past years and should continue to decline in 2020 (OECD et al., 2020). Finally, fiscal policy has not been effective enough in reducing inequalities and promoting entrepreneurship (OECD et al., 2019).

Figure 1. Public debt as a percentage of tax revenues (%)[1]



Tax revenues are the compulsory, unrequited payments to general government. Taxes are "unrequited" in the sense that benefits provided by government to taxpayers are not normally in proportion to their payments. Compulsory social security contributions (SSCs) paid to general government are included.

In a regional context of limited fiscal space to respond to the effects of the pandemic, there are few fiscal options available to mitigate the socio-economic impact of the crisis and to start the recovery. The majority of Latin American and Caribbean countries have taken a number of measures to protect households, workers and firms. These include tax deferrals, loan postponements, and

1. Source: OECD Development Centre calculations based on IMF World Economic Outlook database, October 2019 and OECD et al. (2020), Revenue Statistics in Latin America and the Caribbean 2020, OECD Publishing, Paris.

monetary and non-monetary transfers to the most vulnerable populations (OECD, 2020a). Other options include credit guarantees from the government to promote entrepreneurship where the commissions to be paid can constitute a reserve fund to finance the potential contingencies of non-payments (Suescun, 2020).

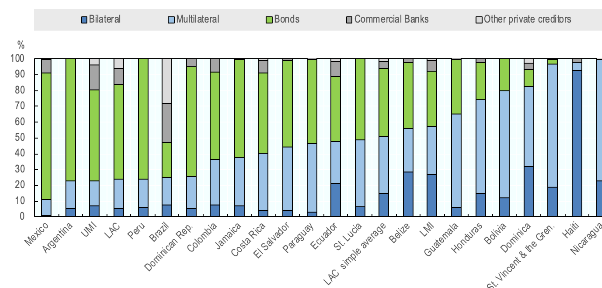
However, domestic resources remain scarce and therefore the effect of the aforementioned policies remain limited. To finance them, temporary options include "financial repression" actions, which involve various policies that allow governments to "capture" domestic savers; these include forced lending to governments by pension funds and other domestic financial institutions, interest-rate caps, and capital controls (Reinhart and Kirkegaard, 2012; McKinnon, 1973). While these options can contribute to finance unexpected public expenditures in the region, their effect is temporary and limited.

Other potentially more ambitious measures, like public debt management, require global coordination and international action. Issuer or creditor inaction can even lead to debt defaults, and therefore debt crises, adding to the already complicated scenario. There is no unique solution to managing public debt in the region due to discrepancies across countries in terms of initial fiscal conditions, type of foreign creditors, and finally financial capacity to tap into capital markets. These three inter-related dimensions have to be taken into account to address public debt in the current crisis.

First, idiosyncratic shocks are forcing countries like Argentina or Ecuador to restructure their public debt. These countries were already facing fiscal constraints and pressure to honour their debts before the crisis, and capital markets' actors had already put a price on the cost of restructuring. For instance, Standard and Poor's had already downgraded Argentina and Ecuador's long term debt rating to selective default. The situation in these countries differs to those where debt sustainability was not already under threat before the COVID-19 crisis.

Second, the way in which countries raise resources differs across the region. Some Central American, as Nicaragua, Guatemala or Honduras, Caribbean economies, such as Haiti, Saint Vincent and the Grenadines and Dominica, and a few South American ones, such as Bolivia and Ecuador, have traditionally issued debt through bilateral creditors or multilateral banks (Figure 2). On the other hand, economies that have traditionally had access to markets still do. Economies like Brazil, Chile, Colombia, Mexico, Paraguay, Peru and Uruguay recently issued public debt in external markets. The majority of debt payments in the region in the next 12 months are owed to private creditors, by Argentina, Brazil, Colombia and Mexico.

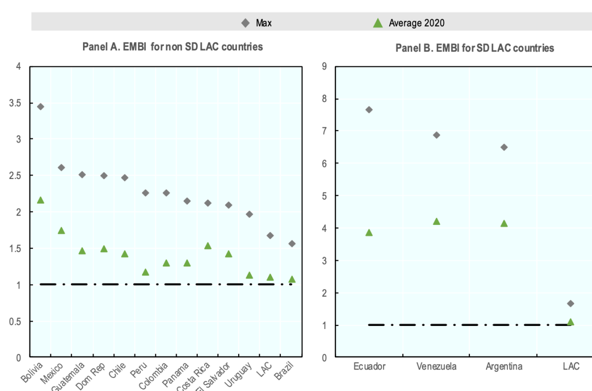
Figure 2. Total External Debt Stock by creditor (public and private)[2]



"LAC simple average" gives the same weight to all countries on their distribution of credit holders while "LAC" takes into consideration the amount issued by each LAC country. "LMI" and "UMI" are all lower middle income (LMI) and upper middle income (UMI) countries in the world.

Third, financial conditions to tap into capital markets differ from one country to another. Despite the market being open to many Latin American and Caribbean countries, pricing varies according to a country's debt sustainability. Furthermore, rating agencies have downgraded economies with already weak fiscal positions pre-crisis. Between March and May 2020, the three main agencies downgraded Latin American and Caribbean countries 25 times - the most downgraded emerging region so far (JP Morgan, 2020). Similarly, while global liquidity and the appetite for emerging markets have increased thanks to the Fed's expansive monetary policy, differentiation across countries remains, even among investment grade countries (Figure 3). Additionally, concerning exchange rate markets, currencies have depreciated differently among countries, even within investment grade countries. For instance, in comparison with averages in 2015-19, in 2020, the average exchange rate in Peru depreciated by 4%, in Chile, Colombia and Mexico by around 20% and in Brazil by almost 40%.

Figure 3. Sovereign bond spread in Latin America in the time of COVID-19 - Emerging Markets Bond Index (EMBI) spread as a percentage of the EMBI spread average of 2015-19[3]



2. Source: OECD Development Centre calculations based on World Bank's International Debt Statistics, accessed on May 2020.
3. Source: OECD Development Centre calculations based on Thomson Reuters Datastream, accessed on June 2020.

SD refers to selective default credit rating. The EMBI is a benchmark index for measuring the total return performance of international bonds issued by emerging market economies. The EMBI measures the average spread that is defined as the differentials between the performance of sovereign bonds denominated in US dollars and US Treasury bonds, as calculated by JP Morgan Chase. The period covered for the "Max" (maximum) and "Average 2020" goes from January 2020 to end-June 2020.

Addressing the above-mentioned issues calls for policy action:

- There needs to be coordinated action among bond-holders and capital markets' actors in restructuring debt issued by countries that were already facing financial difficulties before the crisis. This is crucial to minimise reputational risk (i.e., access to capital markets in the future) and provide countries with some fiscal space to respond to the crisis. Collective Action Clauses (CACs) can help facilitate the renegotiation process with bond-holders. Going forward international coordination should also look to develop an international sovereign debt architecture capable of helping economies restructure their debts (UN/DESA, 2020).

- To respond to the crisis, official support should go beyond the level of income and focus on economies that have little or no access to markets (Figure 2). While some measures have been taken to support low-income countries at the G20 (OECD, 2020b), they should be expanded to other countries, without being conditional to level of income. In parallel, these countries will also need international support to access capital markets in the future, currently characterised by relatively low issuance in emerging markets. "New country" creditors, like China, should be involved in this process. China has become a key trade and financial partner for some economies of the region including Bolivia, Ecuador or Venezuela.

- Other countries, that already enjoyed ample fiscal sustainability before the crisis, must retain access to capital markets where risk premium remains low and through which they can raise the funds they need to respond to the COVID-19 crisis, thanks to abundant financial liquidity.

- Finally, another group of countries might have access to capital markets but face high debt cost due to a deterioration in the perception of debt sustainability by markets' participants, including rating agencies. No issuance means fewer resources to respond to the COVID-19 crisis. However, more debt issuance could deteriorate fiscal sustainability as GDP growth is negative and therefore could increase the risk of default in the medium term. Indeed, debt service would grow (and therefore debt repayment requirements would increase), fiscal revenues would be lower (as a consequence of the Covid-19 crisis) and sovereign bond spreads would jump in, generating a vicious circle. This second option makes economic recovery even more complicated as it could expose countries to a debt crisis.

The COVID-19 crisis has been an exceptional, unexpected and exogenous shock to countries across the region. Meanwhile, abundant liquidity remains in international capital markets, making this crisis different to past global crises. Therefore, international action must contribute to solving debt sustainability problems and responding to the socio-economic impact of the crisis.

There are several policy options in that respect, including debt standstill/moratorium, debt relief, further use of SDRs - Special Drawing Rights, and the creation of a special-purpose vehicle to finance the crisis or pay the debt. Their common denominator is that they require international co-operation, involving multilateral banks, developed countries and/or private creditors (Bolton et al., 2020; Ocampo, 2020; Cárdenas 2020; UNCTAD, 2020; IMF, 2020).

Any coordinated measure should mitigate reputational risk for emerging and developing economies. In fact, these countries cannot be suspected of moral hazard and actions that are agreed today should not affect access to capital markets in the future, nor should they condition the development of domestic capital markets. The present circumstances require exceptional action, not permanent norms. Furthermore, measures taken at the international level on debt management should be monitored to make sure they are targeted at mitigating the negative socio-economic effects of the crisis. Agreed conditionality where all countries have a voice should enable additional fiscal space to respond effectively to the COVID-19 crisis.

Looking back, a historical perspective can help us draw lessons to face today's public finance challenges. An example is the outcome of the long 1980-debt crisis resolution process in Latin American countries. Policy support and co-operation across countries in early 1990s were vital in reducing further socio-economic costs, and involving private creditors helped lower the uncertainty surrounding access to capital markets. Rapid policy response is essential to avoid high socio-economic costs (Flores, 2020).

Moving forward, the COVID-19 crisis highlights the need for a fiscal pact in the medium term, by improving the levels and structures of expenditures and fiscal revenues, thus guaranteeing debt sustainability and stronger state capacity to respond to potential future external

shocks, and more importantly to the development agenda of Latin American and Caribbean countries.

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