BERKELEY/CHICAGO – Without a comprehensive debt moratorium, the COVID-19 pandemic will lead to a wave of uncontrolled sovereign defaults, especially among emerging and developing economies. Should that happen, global efforts to contain the public-health crisis will fail, and the current economic collapse may well turn into a permanent decline.

Rich and poor countries alike are facing an unprecedented economic crisis as businesses close and workers lose their income. A downturn of this magnitude can cause tremendous long-term damage, as critical economic linkages vanish. Scores of firms will close permanently unless urgent action is taken. To this end, the United States Congress recently passed a $2 trillion rescue package, while the Danish and Canadian governments, for example, are subsidizing 75% of the payroll of their countries’ small and medium-size enterprises (SMEs). China, meanwhile, has expanded credit and eliminated payroll taxes, and just announced a rescue package worth almost $1 trillion.

But COVID-19 poses even greater problems for emerging economies such as India and Mexico. There, the economic costs of social distancing are even higher than in the US and Europe, and vulnerable SMEs, with low cash reserves, account for a much larger share of the economy. Such countries also have far more precarious health-care systems. The funds required to support vulnerable workers and businesses, as well as to treat COVID-19 patients, could be as much as 10% of their GDP.

Where will that money come from? Some advanced economies, such as the US, can borrow much more at little extra cost. But some of that funding comes from foreign investors seeking financial safety, and some from US private investors liquidating their foreign holdings. In other words, the financing that America and other advanced economies need comes in part from countries like Mexico.

What’s more, unlike during the 2008 global financial crisis, every emerging and developing economy now needs to borrow at exactly the same time. So, even if Mexico were able to issue bonds, it would be competing with many other countries in the same situation. It is an unfortunate fact, but countries have no one else to borrow from but other countries.
Left to their own devices, financial markets will pick winners and losers. The winners will be those countries with enough capacity to issue safe bonds. They will be able to borrow huge amounts at rock-bottom interest rates. The losers will be the world's Mexicos. In fact, such countries will be doubly damned: not only will they be unable to raise funds to deal with the crisis, but capital will also move away, as it has already started to, precisely because of borrowing by the US, China, and European countries. It is little wonder, then, that more than 90 countries have already approached the International Monetary Fund for financial assistance.

A cascade of disorderly sovereign defaults now, when developing-country governments need to spend huge sums to keep their citizens healthy and their economies on life support, would have enormous human and economic costs, and sharply diminish our chances of containing the pandemic. After all, to contain the virus anywhere requires containing it everywhere.

To avoid a catastrophic outcome, the world urgently needs strong collective action. The IMF estimates that emerging economies’ funding needs total $2.5 trillion, but this figure seems low. In any case, the resources of the World Bank and IMF are currently far too limited. Efforts to boost the Fund’s firepower – currently only $1 trillion – must be aggressively pursued.

In the meantime, the IMF should act to head off the coming wave of sovereign defaults by coordinating a broad debt moratorium. The moratorium would suspend all sovereign-debt repayments to private and public creditors by emerging and developing economies that requested such a freeze, and would remain in place until the health crisis passed.

Our estimates suggest that a one-year debt moratorium could free upwards of $1 trillion, or 3.3% of low- and middle-income countries’ combined income – vastly more than the estimated $14 billion that would be freed by the proposed moratorium on debt repayments to public creditors by poorer countries only. That would go a long way toward helping countries like Mexico and India tackle the current crisis.

Although some might object that a debt moratorium will stop most private lending to these countries, such capital flows have already stopped or reversed. And although a moratorium could lock such countries out of international capital markets for a long time, the stigma on this occasion should be much less, because the moratorium would be imposed as a result of a worldwide pandemic rather than fiscal profligacy. The IMF’s imprimatur should also help.

Private creditors will be more likely to agree to a moratorium once they understand that the alternative is a slew of uncontrolled defaults, which will not help their bottom line. A debt moratorium preserves the option of avoiding a formal debt restructuring if economic conditions improve after the pandemic.
A substantial share of this sovereign debt is now issued under local law, which can be modified. Debt issued under foreign law and without collective-action clauses is more problematic. In that case, sovereign-immunity laws in the US and the United Kingdom could temporarily be changed to permit judges to end lawsuits from holdouts against countries that the IMF certifies as unable to service their current debt owing to the pandemic. Such a solution would be in the social and economic interest of rich countries, too.

During Latin America’s debt crisis in the 1980s, it took almost ten years for creditors to enter into earnest discussions under the so-called Brady Plan. This time must be different. We need to coordinate a broad debt moratorium immediately to avoid another lost decade (or two) for the Mexicos of this world.

PIERRE-OLIVIER GOURINCHAS

Pierre-Olivier Gourinchas is Professor of Economics at the University of California, Berkeley and a visiting professor at Princeton University.

CHANG-TAI HSIEH

Chang-Tai Hsieh is Professor of Economics at the University of Chicago Booth School of Business.

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