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*Assessment*

# *The World Development Report 2022: Finance for an Equitable Recovery* in the Context of the International Debt Crisis

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## INTRODUCTION

> 'Progress in science is cumulative …. But progress in finance is cyclical; in money and banking, especially, we seem to keep making the same mistakes'.
> James Grant (2012)

As if the climate crisis was not enough, the world's economic system is now in a full-blown development crisis, with debt distress at its core. It threatens another 'lost decade', with economic insecurity, political instability and further erosion of democratic institutions for much of the world's population. The International Monetary Fund (IMF) projects the weakest global medium-term growth prospects in more than 30 years. Developing countries have amassed enormous debts dealing with the COVID-19 pandemic, and face high food and energy costs, exacerbated by a high US dollar. A slowing global economy, rising interest rates and depreciating currencies have come together to tip at least 60 countries into debt distress or close to it — more than twice as many as there were in 2015. The Institute of International Finance (IIF) estimates that total developing world debt rose to a record of US$ 98 trillion at the end of 2022.

Global debt relative to global output was already at unusually high levels before the pandemic. Moreover, global growth had slowed down in 2011–21, compared to the previous decade. In the later period, 80 per cent of developed countries experienced slower growth than in 2000–10, as did 75 per cent of developing countries. Then came the exogenous event of the global COVID-19 shock which began in early 2020. As the

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World Bank's *World Development Report 2022: Finance for an Equitable Recovery* states, 'The COVID-19 pandemic is possibly the largest shock to the global economy in over a century' (p. 20). In 2020, the first year of the pandemic, the global economy shrank by 3 per cent; economic activity contracted in about 90 per cent of countries. This is a higher percentage of countries experiencing negative growth in per capita GDP than in any year since 1901, when the data started — a higher proportion even than during two World Wars, the Great Depression of the 1930s, the emerging markets debt crisis of the 1980s, and the 2007–10 North Atlantic financial crisis.

Major economies administered the largest double dose of fiscal and monetary expansion in history, and major firms exploited the uncertainty of the pandemic to mark up their prices far above the cost of labour and non-labour inputs, making a combined demand- and sellers-inflation at the highest rate in decades. Central banks are now frantically trying to rein it in. Governments and private entities were forced to borrow even more than before in order to stay afloat as business activity ground to a halt; and they deferred payments on existing debt while borrowing more.

In 2020, the average total debt burden (both public and private) of low- and middle-income countries leapt by 9 percentage points, compared with an annual increase of 1.9 per cent in the previous decade. In the same year, 51 countries, including 44 emerging economies, experienced a downgrade in their sovereign debt rating, making borrowing more expensive. Then came exogenous shock number two in the form of Russia's war on Ukraine which began in early 2022 and continues at the time of writing (mid-2023), creating upheaval in global markets for food, fuel and fertilizer. The dramatic shrinkage of supply of these essentials has caused high prices, hurting many developing countries dependent on imports of these basics even more deeply than they had already been hurt by the COVID-19 pandemic. The two shocks together compounded inflation and multiplied public and private debt. The IIF reported that government debt in 30 large low- and middle-income countries hit almost 65 per cent of GDP by the end of 2022 — an increase of 10 percentage points over pre-pandemic levels and the highest ever year-end total. From the start of 2020 to the end of 2022, the debt of more than 100 developing countries ballooned by almost US$ 2 trillion (excluding China), as social spending soared while incomes froze.

These trends caused shock number three (this one endogenous), which, like shock two, also started in early 2022, as the US Federal Reserve and other central banks raised interest rates rapidly and synchronously to curb high inflation after decades of low inflation and low interest rates; monetary tightening in the past two years has been the fastest in the past four decades. Thanks to the deep integration of both developed and developing countries' into Western financial markets (with free capital mobility and flexible exchange rates strongly promoted by the IMF and World Bank), the rising interest rates in safe-haven US and other Western markets caused investors to pull capital from developing countries and the latters' currencies to

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depreciate. Currency depreciation produced higher import prices, higher inflation and higher borrowing costs (Grynspan, 2023; Wheatley, 2023). Both changes — the rise in interest rates and the rise of the dollar — had a knock-on impact on the cost of meeting existing debt obligations and current borrowing because most international debt obligations are contracted in US dollars and at variable, rather than fixed, interest rates.

The surge in debt service costs drains resources from public goods like food subsidies, health, education, social assistance and physical infrastructure, at the same time that costs of food and other basic necessities soar. Consumers are hit by inflation especially in products of inelastic demand (including healthcare, housing, pharmaceuticals) and by the erosion of public services. It is a fair guess that the global 'hardship index' (number of hours it takes an unskilled male labourer to earn the equivalent of 100 kg of the basic food grain) is now higher than it has been for several decades.

Private creditors — those who lent to developing countries to get high returns justified by high risk — are faced with very low visibility in terms of the location of losses. At the same time, they are faced with demands for large-scale debt renegotiation. They have responded by rushing to their governments and to the IMF to say 'make them pay', as though they should get the high returns *without* bearing the cost of risk. This is a blatant version of the long-established game of private finance in dealing with public financiers: 'heads I win, tails you lose'; or in other words, 'you (public creditors) have to take the hit so we can be made whole'.

The upshot is that many developing countries and their governments today face an acute dilemma. On the one hand, they have to meet the continuing high costs of handling the pandemic and its aftermath, plus the high and rising 'cost of living' (amplified by Russia's invasion of Ukraine), plus the rising interest rates. On the other hand, they face the high costs of the debt they have already borrowed and the debt they now want to borrow to meet those high recurrent expenditures. Their creditors, public and private, press the governments to implement drastic rises in taxes and cuts in public spending, which implies severe cuts to investment and future growth, leading to more 'income divergence big time' between developing and developed countries.

## SUMMARY OF THE REPORT

The World Bank's World Development Report 2022 (hereafter WDR 2022, or the Report) provides valuable information about the economic aspects of the pandemic and economic recovery from it. It also lays out a broad-gauge set of policy priorities for governments of developing countries to pursue. What follows is a summary of these policy priorities.

The WDR 2022 identifies five broad policy priorities for governments to set their countries on a path to a more equitable and sustained economic

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recovery after the pandemic (see Ch. 6: 'Policy Priorities for the Recovery'). First, the many governments with dangerously high levels of sovereign debt have to give top priority to improved debt management. Second, many governments face elevated levels of financial sector risks and must focus on resolving these risks to ensure the continued supply of credit. Third, governments have to scale back support for the more resilient households and firms first, leaving relatively more for the poor in order to counter the strongly regressive impacts of the pandemic. Fourth, governments must set national policy in the context of heightened global economic risks, especially interest rate and currency risks caused by advanced economies scaling back stimulus policies and raising interest rates to fight inflation. Fifth, recovery policies should particularly target support at green sectors and business models.

The Report elaborates by saying governments should recognize that different sectors of the economy are interconnected, such that risks can spill over from one sector to another. Therefore, it is necessary to prioritize recovery resources where the risks to the economy are greatest and where policy action is likely to be most effective at reducing economic fragilities. Well-designed fiscal, monetary and financial policies can take advantage of sector interconnectedness and generate positive outcomes in support of economic recovery (p. 250).

Governments should rapidly scale back financial support (such as debt moratoria and credit guarantee schemes) to firms and industries that have access to private finance and avoid giving support based on pre-crisis size, because that could easily cause resources to be trapped — inefficiently — in firms and sectors that are less viable due to the crisis. Likewise, they should rapidly scale back support (such as cash transfers) for financially viable households, and concentrate the remaining support on vulnerable populations that have been hardest hit by the pandemic recession.

In middle-income countries with fairly well-developed financial sectors, households and small businesses typically take on debt. Income losses due to the pandemic (as well as the later shocks) have raised the risks of a sharp rise in loan defaults once government support measures are withdrawn. That in turn means governments must establish frameworks for quick and comprehensive recognition of financial sector fragility and default, and scale back support in a targeted and predictable way in line with economic recovery, to avoid a wave of insolvencies and defaults. In the longer term, an important tool for resolving high levels of private debt is a legal insolvency framework. The Report notes, 'Even in countries where institutional capacity is limited, small improvements in the bankruptcy code can make a difference' (p. 254).

According to the Report, governments should mobilize new sources of revenue to pay off debts incurred for crisis recovery. Most emerging economies rely on consumption taxes and lack the institutions for raising income taxes. Consumption taxes burden the poor disproportionately, which sets a limit on their revenue potential. For example, Mexico, which relies on

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consumption taxes, raised only 18 per cent of its GDP in taxes in 2020, as compared with 41 per cent on average for countries of the European Union, which rely on income taxes (p. 254). The pandemic response should include building up institutions for raising income taxes as a long-term project.

Governments also have to grapple with risks from the economy's interdependencies with other economies via credit markets, international trade and foreign aid that may threaten the robust, equitable recovery in their own economies. In particular, they must shape domestic policy in the light of high and rising global interest rates as the central banks of 'advanced economies' act to slow inflation. Those high external interest rates raise the cost of servicing domestic public and private debt — and higher debt service costs make debt defaults more likely, potentially cumulating into a national debt crisis. Moreover, high interest rates go with additional external risks in the form of exchange rate risks. High advanced-country interest rates tend to cause currency appreciation in those countries, as investors sell other currencies and buy those of the advanced countries — depreciating the currencies of many emerging economies, raising the cost of their imports and the cost of debt service. The WDR 2022 is careful not to identify the leading role of institutions such as the US Federal Reserve in raising US domestic interest rates without regard for impacts on the rest of the world; indeed, the Fed's mandate from Congress is to focus on only two objectives: full employment and price stability.

Finally, the Report emphasizes throughout that the COVID-19 crisis should be seized as an opportunity for national governments to accelerate the transition to a sustainable world economy, above all, with fast-falling carbon emissions. Governments should introduce carbon taxes, and revise the tax code to incentivize green investment, while central banks should mandate higher risk provisioning for loans for activities that are anti-green, notably activities that use fossil fuels.

The full 267-page document is as bland as the foregoing summary of policy priorities suggests, though it is lifted by some useful statistics. It is a depoliticized technical analysis that steers clear of power and inequality, and especially steers clear of how the geo-economic structure of the world-system — and its dominance by a small set of high-income countries led by the US, which have long coordinated amongst themselves to sustain their continued dominance — affects pandemics, financial crises and financial resolutions (Wade, 2019, 2020). The remainder of this Assessment focuses on these political economy issues. The next main section puts the COVID-19 economic crisis in the context of earlier economic crises; outlines the economic effects of the pandemic; and suggests how China's bilateral rather than multilateral approach to rescheduling debts of its Belt and Road borrowers is complicating the larger project of rescheduling the debts of developing countries. The following section then focuses on directions for progressive reforms at global and national levels, especially to reduce debt distress in developing countries now and in the future. The conclusion adds

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the COVID-19 crisis to the other elements of the more than run-of-the-mill weirdness of today's world system.

## THE COVID-19 ECONOMIC CRISIS IN WIDER CONTEXT

### Earlier Waves of Financial Crises

The COVID-19 economic crisis differs from almost all others because it did not originate as an economic crisis or debt crisis in the public or private sector. Let us put it in the context of the earlier parade of financial crises in order to see how, before the pandemic, we reached a global condition of already high financial fragility. Keep in mind the dictum of James Grant: 'Progress is cumulative in science …. But in finance [it] is cyclical' (Grant, 2012).

The dynamics are an updated version of John A. Hobson's (1902/2011) explanation in *Imperialism: A Study*, written at the start of the 20th century. Hobson argued that oversaving and underconsumption in the core meant that the owners and managers of capital found more lucrative investment opportunities abroad, in the periphery, and pushed their states to forge imperialist projects to conquer or otherwise control large parts of the periphery — imperial control by their own states giving them higher and more secure returns on their investments. Today's creditors have been actively enticing borrowers in the global South to borrow, and the latter have done so with abandon. Periodically, high levels of financial fragility have tipped into financial instability.

The prototype economic crisis occurs when a long expansion is followed by a recession; people and businesses who borrowed in the good times and slimmed their cushions of safety thinking the good times would roll on indefinitely can no longer afford to repay their debts (a 'Minsky crisis'). Looking back, we see that during the period of the Bretton Woods international financial architecture — from soon after World War II to the early 1970s, with fixed exchange rates and limited international capital mobility — there were no significant bouts of international financial instability. Subsequently, there have been three great waves of transnational financial instability, leading into today's fourth. The post-1970s episodes were all driven by low borrowing costs generating a large debt build-up — debt being dangerous because it has to be repaid regardless of ability to repay, or else the borrower faces default, insolvency and bankruptcy. In the case of sovereign debt, the ability to repay is commonly measured by GDP or exports or foreign exchange reserves. Here is a thumb-nail sketch.

The first wave began in the 1970s as Latin American economies boomed on the back of the commodity supercycle and heavy state borrowing from US banks (flush with oil states' deposits after the hikes in oil prices during the 1970s), and as the US faced high inflation. Incoming US Federal

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Reserve chair, Paul Volker, immediately hiked up central bank interest rates to curb the inflation. This in turn hiked up debt service obligations of Latin American borrowers, which tipped them into the debt crisis of the 1980s and into Latin America's one and a half 'lost development decades', with hyperinflation, riots and political instability in several countries including Argentina, Brazil and Peru. The debt crisis spread to other developing countries, to the point that for much of the 1980s and early 1990s there were 25 or more developing countries in default on sovereign debt.

The second wave began in the 1990s as Southeast and Northeast Asian economies boomed ('the East Asian miracle') and borrowed from Western banks at very low interest rates — until Wall Street switched its attention from their high growth rates to their very high debt rates and shouted 'fire in the theatre'. Lenders and investors stampeded for the exits, crashing the currencies, raising import costs and causing a deep recession. This caused a 'gestalt shift' in Wall Street and the City of London, such that 'developing countries' as a category were seen as dangerous, to be withdrawn from. This in turn spread the crisis to several more big developing countries, including Argentina, Brazil and Russia. The crisis mushroomed in August 1998 when Russia defaulted on its debt, spreading panic in financial markets all over the world. The giant US hedge fund, Long Term Capital Management, which had leveraged its extreme bets with loans from many big global banks but with no trading transparency, crashed as investors pulled out their capital. It had to be rescued from bankruptcy and default with a giant Federal Reserve bailout package in order to protect dozens of banks and investment houses on Wall Street and abroad (Wade, 1998a, 1998b).

The third wave grew in the aftermath of the East Asian crisis of the late 1990s. Western central banks, led by the US Federal Reserve and its chairperson, Alan Greenspan, continued to keep interest rates very low, and borrowing very cheap, to ensure that the East Asian crisis did not ricochet into the Western world. They kept rates very low for long after it was clear the crisis would not ricochet. These years of the 2000s came to be called 'the Great Moderation' and even 'the End of History', with low inflation and relatively fast growth in many economies, including those in the West. Low interest rates drove booming valuations in assets ranging from stocks to bonds to real estate, and the booms became both the cause and effect of massive credit misallocation. The misallocation included millions of subprime mortgages packed into vertiginous piles of financial securities resting on tiny slivers of capital and sold to unsuspecting buyers all over the world. Debt relative to GDP skyrocketed, especially mortgage debt (Micklethwait and Wooldridge, 2023; Wade, 2009a, 2009b, Wade and Sigurgeirsdottir, 2012).

Following the 2007–10 North Atlantic financial crisis the US Federal Reserve and other central banks continued to keep interest rates very low. All through the 2010s, Western central banks, governments, private banks and corporations assumed that interest rates, inflation, and even economic

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growth would continue to hover around 2 per cent for the indefinite future, continuing the era of 'low-everything'. Surprisingly, even as late as 2022 the Federal Reserve's stress tests on banks did not include interest rate risks, because interest rate rises had not caused problems since 1994. People and businesses tried to take on more risk to earn money on their cash and borrowings, which meant that they tied up their money for longer (e.g. in longer-term bonds) or in more risky ventures. Western stock markets boomed and their economies became intensively financialized. In 1987, the US stock market was half the size of the US economy; in 2020, it was twice as large.

Western creditors, and latterly Chinese creditors, desperately searching for yield in more risky ventures, went all out to entice borrowers in developing countries to take on more debt, giving assurances that the borrowers could invest the funds, raise exports and tax revenues, and repay the debt comfortably. They sought returns substantially higher than on loans to developed country clients, saying that they had to be compensated for taking the extra risk of lending to developing countries.

Meanwhile, developing country commodity exporters benefited from high demand and high prices, thanks especially to China. In these boom years they borrowed heavily in the form of selling bonds bought by dispersed creditors across the West, as distinct from taking out loans from relatively concentrated banks as in the first two waves. However, after 2015, commodity prices tended to fall, bringing the supercycle to an end. Developing countries continued to borrow, much of it now to meet debt service obligations on existing debt which could no longer be met out of current export earnings. Financial fragility rose. From around 2010 to 2019, the combined government, household, corporate and financial sector debts of developing countries rose to their highest levels for three decades.

In short, after the 2007–10 North Atlantic financial crisis, central banks continued to keep interest rates exceptionally low. This encouraged soaring financialization of Western economies and high levels of borrowing by developing countries, opening up a debt trap. Then the COVID-19 pandemic, followed by skyrocketing energy and food costs (caused by Russia's invasion of Ukraine), plus soaring central bank interest rates to counter inflation, a strong US dollar, a sharp global economic slowdown and increasingly opaque loan transactions all combined to close the debt trap on countries that were already vulnerable (Wolf, 2023).

## The COVID-19 Crisis

The COVID-19 pandemic stands out from all previous pandemics for the breakneck speed at which vaccines and antibodies were brought into use. However, according to the website Our World in Data, for most of 2021 (after COVID vaccines had become available in December 2020), they were

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available largely to populations in the West.[1] This point was captured in a *Financial Times* cartoon in 2021, showing a syringe held in a hand ready to pump; the content at the head of the syringe was labelled 'The West', the content at the tail, 'The Rest'. Despite the fast arrival of medical countermeasures, the pandemic overwhelmed the health systems of many countries, and caused some 200 million cases of infection and between 5 and 20 million deaths of people 'with' (not necessarily 'of') severe acute respiratory syndrome coronavirus 2 (SARS-CoV-2) virus.

Public health outcomes, public health systems and public 'elder care' systems had been widely deteriorating since the start of the 21st century, which made the impacts much worse than they would otherwise have been. Private profit-seeking firms selling healthcare and health insurance exerted constant pressure to run down public health services to widen the opportunity for private profit making. In the UK, the National Health Service saw hospital waiting lists almost double between 2010 and 2022. Workers in the health service became almost as sick as those they treated (Haldane, 2022). More and more people took out private health insurance, boosting profits of private providers.

## Economic Efects of the Pandemic

As the pandemic began, developing countries faced a perfect storm with several reinforcing elements. First, their debt service payments multiplied as the US Federal Reserve raised interest rates at the fastest pace for decades and other central banks followed (recall that most of the debt is in US dollars and much of it is at variable interest rates). Second, the US dollar appreciated as investors pulled money from emerging economies and put it into US assets to take advantage of the rise in interest rates. By late 2022, the inflows had pushed the dollar up 40 per cent since its 2011 low against the currencies of a broad set of trading partners (according to a Federal Reserve exchange rate index that adjusts for differences in national inflation rates). Third, developing countries' currencies depreciated substantially, which raised both import costs and debt burdens in domestic currency. Fourth, their foreign exchange reserves shrank and they resorted to more foreign borrowing.

The number of people recorded as living in extreme poverty (using the international extreme poverty line of US$ 2.15 per person per day) increased for the first time in a generation — the first time since the

1. See: https://ourworldindata.org/explorers/coronavirus-data-explorer?zoomToSelection=true&time=2020-12-18..2023-033&facet=none&pickerSort=desc&pickerMetric=population&hideControls=true&Metric=People+fully+vaccinated&Interval=Cumulative&Relative+to+Population

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East Asian financial crisis in the late 1990s. The United Nations Sustainable Development Goal to reduce the percentage of the world population living at below the international extreme poverty line to 3 per cent by 2030 is probably out of reach. The COVID-19 crisis magnified gender inequalities: women as business owners or as employees took a harder hit than men, because they were more likely to be in sectors badly affected by lockdowns and social distancing, such as services, hospitality and retail. In addition, the burden of home schooling, with schools closed, fell disproportionately on women. For both women and men, income losses were proportionately greater and longer lasting among the initially less well-off and among smaller businesses. Income and wealth inequality — and income insecurity in the bottom half of the distribution — ratcheted upwards yet again.

Unsurprisingly, the economic effects of the pandemic have been a lot more severe in low- and middle-income economies than in advanced countries. For example, 40 per cent of advanced countries exceeded their 2019 GDP by 2021, compared to only 27 per cent of emerging market countries and 21 per cent of low-income countries. Around two thirds of low-income countries are officially in 'debt distress', which should earn them serious multilateral debt restructuring. But they have a problem: they are not regarded as 'systemically important' in terms of effects on international capital markets, so the creditor states and privates tend to let their crises fester for years without resolution. However, note that only around five developing countries are in actual debt default, all of them small nations like Belarus, Sri Lanka and Zambia, in contrast to the 1980s and early 1990s when 25 or more developing countries were in default, including big ones such as Brazil and Turkey.

Inequality between countries — measured as the dispersion in per capita GDP with countries weighted by their populations — has increased since 2019, probably substantially. But bear in mind that the inter-country estimates of inequality trends are highly sensitive to India and especially China. Recent research suggests that China's true GDP may be around half its officially reported size (Chen, 2022; Martinez, 2022).

## China's Bailouts on Belt and Road Loans

In the 1990s, China was primarily an international borrower, and today it is the world's biggest international lender. In 2013 it launched the Belt and Road Initiative (BRI), by far the biggest transnational investment programme in world history. The BRI had two main aims. One was financial, to recycle its huge dollar export surpluses away from low-yielding US Treasuries, mortgage bonds and other US assets and into higher-yielding investments across Africa, Asia and Europe. The other was political, to gain influence independent of the US through 'infrastructure alliances' (as distinct from the US's military alliances). Around 150 countries signed up

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to the BRI between 2013 and 2020, for the construction of roads, railways, ports, airports and other infrastructures.

The scheme made China the world's biggest bilateral creditor, by far. But the slowdown in global growth, rising interest rates and record debt levels mean that many of its debtor countries are struggling to repay their loans, and the scheme has become a financial millstone for Beijing and its big banks. They have been ramping up bailout lending to some of those countries, particularly ones with geopolitical importance or natural resources and which owe a lot of money to the state-controlled banks. Hence, BRI lending has pivoted from infrastructure project lending to liquidity support operations in the past few years, making it the world's biggest national 'lender of last resort' (Kynge, 2023).

China uses a strictly bilateral approach and declines to participate in multilateral debt resolution programmes in the same countries, though it is a member of the IMF. While its BRI loans have been mostly in US dollars, more than 90 per cent of its emergency loans in 2021 were in renmimbi, furthering Beijing's ambition to limit reliance on the US dollar and tethering countries closer to China, since the renmimbi is hard to spend except on Chinese goods and services (Bradsher, 2023).

Analysis of a new dataset reveals that China granted US$ 104 billion worth of rescue loans to developing countries between 2019 and the end of 2021, almost as much as it had given in rescue loans over the previous two decades. Many of these operations were 'rollovers', in which the same short-term loans are extended again and again to refinance maturing debts, as distinct from 'write-downs' of the principal. It has suspended more debt service payments than any other G20 member (Horn et al., 2023).

China's loans and rescue operations are far more secretive than those from Western counterparts and come at significantly higher interest rates; the average rate of a Chinese rescue loan is 5 per cent, whereas a typical rescue loan from the IMF comes at 2 per cent. They contribute to the wider trend of the world's financial system becoming more multipolar, less institutionalized and less transparent (ibid.).

## DIRECTIONS FOR PROGRESSIVE REFORM

### Making the Banks Safer

Every financial crisis is triggered by hidden losses whether on loan books, derivative books or bond books. The WDR 2022 states several times that we do not yet know (as of its cut-off in mid-2022) the extent to which government and private debtors now face hidden risks, which could 'blow up' and block economic recovery. As of March 2023, the fast run-up of interest rates plus the lightning speed with which depositors can withdraw from a bank they think might be in trouble have exposed financial fragility in Western

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financial sectors. So far, three US banks have collapsed and Credit Suisse was transferred to UBS in an emergency takeover.[2]

The core cause of recurrent financial crises is 'moral hazard' in the context of fractional banking — an incentive structure such that bankers calculate they can privatize profits and 'force' the state to socialize losses, if they are 'systemic' enough. Now, with digital banking and domino effects, the state has to worry even when small banks collapse, which it did not before. This is a recipe for recurrent financial fragility, which may tip into financial instability. It is a centuries-old 'doom loop', now with speeded-up digital characteristics. Bankers know that however tough the state talks, it will bail them out if they are 'systemic', fearing the collateral consequences of not doing so, which induces them to take more and more risks. The standard prescription for making banks more stable would be tougher regulation of liquidity (a higher proportion of bank investments that can readily be converted into cash) and of capital (more excess of assets over liabilities). More effective, if it were implemented, would be to make bank managers directly subject to losses of shareholdings and income. They should be subject to 'multiple liability', although 'unlimited liability' would not be feasible. Then senior managers would face a serious loss when their bank failed, and would not be able to put the losses onto taxpayers. This would lighten the burden to be placed on regulation (Goodhart, 2023).

Otherwise, without progress in this direction, we have to face a much more radical move: recognize that the banking sector is a critical form of public infrastructure that we pretend is private, but which does not and cannot operate by private market rules; and bring systemically important banks into largely public ownership. But that has to be balanced against the need for some 'creative destruction' in banking (as in other sectors), so the major players do not act as though they are permanent incumbents, but know they can be displaced by new winners.[3]

2. The mid-sized US bank, Silicon Valley Bank, was the first to collapse, due to a technology-enabled bank run set off by a falling share price. The depositors came to realize that the bank had been making an elementary error, buying long-term fixed rate government bonds when it had short-term floating rate liabilities. The fast rise of US interest rates collapsed the price of its bonds, and it could not meet its depositors' demand to take out deposits. The resulting crisis was about liquidity, not about the quality of assets (this in contrast to the 2007–10 crisis). Silicon Valley Bank's collapse triggered panicky withdrawals from several other non-mega banks and an inflood into 'too-big-to-fail' banks. The 2007–10 banking crisis and the current banking crisis have in common the failure of bank boards to exercise prudential responsibility: in the former the boards did not challenge the rush into the subprime mortgage market; in the latter, the boards did not challenge unhealthy concentration of assets and liabilities.
3. Wade (2007) describes the US-led international project to make the financial system more stable in the wake of the 1997–98 East Asian financial crisis. The project entailed a raft of new or reinvigorated public and private international bodies tasked with formulating standards of good practice in corporate governance, coupled with surveillance of compliance with these standards and publication of the compliance results. The assumption was

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**Reducing the Risk of a Lost Development Decade**

Regarding developing countries, we know that in addition to those in or close to default, many more countries face increased complexity and opacity in public and private debt markets which make it difficult to assess the full risks on the balance sheets of banks, firms and households and, in particular, whether they face a crisis of liquidity or (much more seriously) insolvency. We also know that, at a general level, disruption in one sector of a national economy can quickly spill over to other sectors and to the entire economy. To the extent that this spillover happens, the financial sector may face a higher risk of loan defaults by firms and households and be less willing to provide credit to support economic recovery. Also, governments may find that the combination of higher sovereign debt repayment obligations and lower tax revenue (because of recession) means that they are less able to support economic recovery and less able to provide even basic public goods and services, let alone public investment.

The prospect of a lost development decade is a human catastrophe in low- and middle-income countries. It is also a huge problem for Europeans and North Americans, being so close to some of the worst hit countries from which large numbers of migrants are streaming. Immigration has become one of the most toxic issues in Western politics. Voters tend to believe that immigrants account for two to three times the proportion of the national population than they do in fact. As of March 2023, the British government is accommodating some 51,000 'asylum seekers' (a term used to include illegal economic migrants) in 395 hotels, mostly in England, at a cost of almost £ 7 million per day. (In March 2020, 2,600 migrants were being accommodated in this way.) As thousands more arrive each month by trucks or small boats, the inflamed sections of the British media and electorate push the Conservative government to arrange for those who arrive illegally to be flown to Rwanda to await the processing of asylum claims there, hoping that this will be a deterrent — although as of mid-2023 not a single migrant has been deported there. In June 2023, the UK Court of Appeal ruled that the Rwanda plan was unlawful.

The alarm bells ringing around immigration, mainly on the political right, make it difficult for public policy to act on immigration's positives. Increasing immigration and pulling more women into the labour force are the only quick ways to increase the labour force. Migrants start a much higher proportion of new businesses than their share of the population.

that private creditors and investors would weigh the degree of compliance in the price they charged, giving governments and privates on the receiving end an incentive to achieve a high degree of compliance. Its sponsors hoped that this would make banks safer without an increase in international authority to impose constraints. The project largely failed. Wade (2008) then examines the build-up of debt in the approach to the great crash of September 2008.

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Thereby, migrants make a net contribution to economic growth, understood as a function of population plus productivity.

When debt becomes unaffordable, its repayment period must be lengthened, the interest rate lowered or the principal reduced (restructured). This proved difficult enough after the Latin American debt crisis of the 1980s and the East Asian crisis of the late 1990s, when the main creditors were a small number of large, mostly American banks and Western governments and Western-dominated international financial organizations, notably the World Bank and IMF. It was relatively easy to coordinate them to restructure the debt. Yet Latin America still lost one and a half decades of development and, after 1997–98, Indonesia lost the best part of a decade.

Today, debt relief is much more difficult again because of the proliferation of creditors in number and diversity, making cooperation next to impossible. As Martin Wolf (2023) reports, between 2000 and 2021 the share of public and publicly guaranteed external debt of low and lower-middle income countries (other than that held by the international financial organizations) owed to bondholders jumped from 10 per cent to 50 per cent, while the share owed to China rose from 1 per cent to 15 per cent. The share held by the relatively easy-to-coordinate 22 predominantly Western members of the Paris Club of official creditors fell from 55 per cent to 18 per cent.

All creditors are primed to resist a 'haircut' on their repayments if that might benefit another creditor, but not the indebted country. Beijing has agreed in principle (as of April 2023) to accept a write-down on its borrowers' debts, but in practice it resists out of suspicion that what it offers by way of write-downs will go towards paying private and public creditors. It is critical of the World Bank's and IMF's claim to have priority for repayments ahead of all other creditors — a claim which means that if China agrees to take losses on its loans to country X, the latter may use the 'savings' to repay those Western creditors. Furthermore, China's banking system faces heavy losses on loans to real estate developers, making it even more reluctant to accept losses on loans to developing countries. According to the credit rating agency, Fitch Ratings (2023), it now takes three times as long to resolve a sovereign default as it did on average in the two decades before 2020.

In 2020, the G20 states presented the Debt Service Suspension Initiative as a response to soaring debt service. It provided modest relief on debt interest payments for most of the world's low-income countries — modest, because the private sector did not participate and it became clear that the pandemic would produce a long, not a short, recession which meant that debt restructuring, not just debt service suspension, was essential.

Next, in early 2021 the G20 presented the Common Framework for Debt Treatments (of low-income countries) as a framework for bringing the very diverse creditors together to coordinate a response to the severe debt distress of many developing countries. However, in 2023, the framework still

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does not have traction, as the IMF itself admits. First, it is not designed for lower-middle-income countries that are among the most worrisome. Second, the whole process of debt restructuring is broken, because it is designed for an era when creditors were mostly Western governments and banks. Creditors are now much more varied, including bondholders and other private financial organizations, multilateral development banks and sovereign lenders including the US and China, whose interests are often at odds but who must agree on how to restructure the loans of a specific country. International bondholders have a fiduciary duty to play hardball. Developed countries in the Paris Club have tried to take the lead, while other creditors including China are disengaged. The US has accused China of predatory lending and blocking multilateral negotiations. Chinese Foreign Minister Wang Yi replied, 'These are not "debt traps" but monuments of cooperation' (Bradsher, 2022). At the G20 summit in November 2022, the leaders expressed their concern about the 'deteriorating debt situation', but offered little more than hand waving.[4]

The whole approach assumes it is possible to get voluntary participation by private creditors. Yet abundant experience since as long ago as the 1700s shows that creditors want to be repaid, period, and will not accept a reduction in the amount they are owed. Today, the last thing any of the parties want to face is losses, or write-downs. They have to be legally compelled. This points towards an international bankruptcy court, as proposed in Anne Krueger's (2002) Sovereign Debt Restructuring Mechanism' when she was the American number two at the IMF. But private finance pushed back strongly against this idea, knowing that it would be less dominant in creditor–debtor negotiations in such a court. Yet private finance totally accepts bankruptcy courts in domestic business.

What is shocking is that this lack of a sovereign debt restructuring mechanism and international bankruptcy court defines the situation after not one, not two, not three, but four waves of multi-country financial crises in the past 40 years. The 'international community', whatever that means, has conspicuously failed the populations of poorer countries. This failure of the G7 and the G20 in the debt context gives China the opportunity to say to heavily indebted countries, 'we will negotiate debt forgiveness', and Russia to say, 'we will sell you cheap oil'. This might signal a clear downward ratchet of US and Western hegemony. Developing countries, faced with a G7 refusal to restructure impossible debts, are desperately looking for alternatives.

On the other hand, this situation might induce the US and other G7 countries to do more to win the 'hearts and minds' of developing countries than they have done in the nonchalant 'unipolar' era since the late 1980s, the late

4. See 'G20 Bali Leaders' Declaration'; www.whitehouse.gov/briefing-room/statements-releases/2022/11/16/g20-bali-leaders-declaration/

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years of the (first) Cold War, when they did not have to compete for those hearts and minds. One way to show more empathy with developing countries than they have been accustomed to show is to support a better debt framework. But this requires a more enlightened self-interest on the part of the G7 than they are accustomed to showing.

### Innovations at the Level of Bond Contracts

Perhaps more progress could be made by focusing less on innovations at the 'architectural' level (such as an international bankruptcy court analogous to domestic bankruptcy courts) and more on innovations at the level of bond contracts. The following adjustments to bond contracts are advised.

- *Make it normal for bond contracts to be part-equity contracts*. In this way, repayment is linked to a country's export earnings or to its GDP, or in the case of countries heavily dependent on one commodity, as Zambia is on copper exports, linked to the price of that commodity.
- *Include anti-vulture fund clauses in bond contracts*. Vulture funds buy bonds when they are trading at steep discounts to par and then refuse to vote in restructurings (claiming they must be paid out at par). Currently it is within their right to do so, and their recovery values can be huge as a result — and invite more vulture fund action, which is even more damaging for poor countries facing restructurings. Two changes should be made. First, require bonds to include an anti-vulture fund clause — or 'collective action clause' — allowing a majority of creditors (rather than 100 per cent of creditors) to approve a restructuring. Then it is irrelevant whether the vulture funds employ a holdout strategy while the others approve, because the vulture funds will just take the same haircuts as everyone else. Second, the clause should make it illegal to purchase a bond for the purpose of getting standing in a case to sue the debtor government for a higher payout.
- *Construct a bond to be received by creditors who agree to reduce the amount they are owed, which is backed by a guaranteed fund* such as the World Bank that commits to payment on the remaining amount. Then the creditors know they are guaranteed to receive that amount rather than nothing.
- *Require the international financial organizations that backstop debt restructurings to insert clauses that make it difficult for a country that secures a lot of debt relief to bulk up on non-concessional debt again* (Wigglesworth, 2023).
- *Include* force majeur *clauses*. In this way, debt repayments could be suspended in the event of a major national disaster.

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**Raising the Lending Resources of Multilateral Lenders**

Increasing the lending resources of the World Bank and other multilateral lenders is another direction of progressive reform. Raising the capital base of the World Bank is always difficult, not least because of chronic rejection by the US Congress, but it may be possible to raise the World Bank's lending capacity via special drawing rights (SDRs).

SDRs are a form of limited-purpose money that the IMF's board of governors can create by crediting the accounts of IMF member states (at an exchange rate set by a basket of major currencies). When the scheme was created at the end of the 1960s, SDRs were intended to provide an international money not tied to the currency of a particular country, such as the US dollar. They were allocated to IMF member countries proportional to their quotas (or voting rights) — so mostly to the rich countries. In the 1960s, they constituted a hot topic of debate among the cognoscenti. Their champions saw them as a way to adapt the prevailing international monetary system to avoid an impending world crisis. Their opponents included those who thought that the US-based dollar-standard world order established in 1945 could continue to work well without any such reforms, as well as others like President de Gaulle who wanted a radical return to the gold standard (Wade, 2002). In practice, they remained marginal until 2021 when the IMF shareholder governments approved a record-breaking issuance of US$ 650 billion in SDRs, meant to help countries cope with the pandemic-induced global downturn. But most of them remained unused in the central banks and treasuries of the world's richest nations.

Stephen Paduano and Brad Setser (2023) have recently proposed a scheme whereby the World Bank issues a set of bonds denominated not in US dollars or other currencies, but in SDRs. The central banks or treasuries of rich countries use their big stocks of SDRs to buy these World Bank bonds and add the bonds to their foreign exchange reserves. After some arcane financial wizardry with the IMF, the World Bank ends up with currencies it can lend to developing countries, potentially making a big jump — maybe a doubling — in its total lending resources. The good news is that the US Treasury, which controls the biggest bloc of SDRs, the US being the World Bank's largest shareholder, would not require explicit US congressional approval, which would be very hard to obtain in these polarized times. For all the complexities, according to Paduano and Setser, 'If senior officials at the World Bank and the large SDR holders would like an SDR bond, they can make it a reality much sooner than mid-2024' (quoted in Gold, 2023; see also Paduano and Setser, 2023). However, the mood is pessimistic. A *Financial Times* analysis concludes, 'There are few solutions being floated around. The IMF in February announced a new Global Sovereign Debt Roundtable to bring together the full gamut of creditors and debtors …. It is an initiative that few experts harbour much hope for' (Wigglesworth and Yu, 2023).

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## CONCLUSION: DIPLOMATIC LONG COVID

We know that the global debt problem is a lot more acute than it was a decade ago. It bears repeating that as of early 2023, the average debt to GDP ratio across developing countries was around 65 per cent. Five years ago, it was 50 per cent. Looking five years ahead, to 2028, it is likely to be 75–80 per cent and in several large countries, as much as 100 per cent. So, over the course of only a decade, the ratio is likely to rise by 25–30 per cent of GDP. This magnifies financial fragility in economies which do not issue hard currencies but have to repay in hard currencies and face exchange rate depreciation, and which have shifted their production structure from smallholder agriculture and industry towards (low-skill) services and commodities.

Despite the far-reaching disruptions in the more than three years since the pandemic hit, the world has made dismayingly little progress on preparing for the next pandemic. China's refusal to cooperate with investigations into the origins of COVID-19 is a sign of a wider breakdown in inter-state co-operation to build pandemic warning systems, and deepens fears that China will again be late in alerting the world to the next virus outbreak. But the pandemic risk and the debt risk are only two ingredients of the new epoch of polycrisis facing the global community. They join risks including climate change, an ageing labour force, the wild card of artificial intelligence, dramatic slowdown in China, and geopolitical-economic tensions particularly between China and the US, with other states under pressure to take sides and separate blocs emerging. Edward Luce of the *Financial Times* argues, 'The cost of Covid can also be measured in damage to global psychology, including a form of diplomatic long Covid. The world's superpower and its rising great power are now working from home and nourishing paranoia about each other. When we look back on Covid that may be its biggest cost' (Luce, 2023).

In March 2023, the World Bank (2023) issued a report called *Falling Long-term Growth Prospects*. Its message can be summarized in the context of this essay by saying that not only the developing world but the whole world faces the real prospect of a 'lost decade'. Yet in the months following the publication of that report, evidence has come to light which suggests that the 25 largest developing countries are beating growth forecasts. Their growth is less tightly linked to China's and their median inflation rate is no higher than in developed countries, which has not happened in four decades (Sharma, 2023). These are certainly 'interesting' times.

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