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Middle-income countries' debt trap

Public debt has skyrocketed in middle-income countries like Tunisia. Yet, the IMF and G20 are pushing for austerity measures, not debt relief

After almost two years of the pandemic, its global economic consequences still cannot be fully understood. One thing, however, is clear: the economic and financial policy options for counteracting the negative consequences of the pandemic are extremely unevenly distributed worldwide. While the G20 countries were already able to mobilise a gigantic 24 per cent of their gross domestic products to support their economies in 2020, most countries in the Global South do not have anywhere near such financial opportunities. For many lower- and middle-income countries in particular, there is hardly any way out of the crisis that these states alone could manage.

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In 2020, Tunisia, a typical middle-income country that has implemented the reforms advocated for by the World Bank and the International Monetary Fund (IMF) over many years, experienced the biggest economic slump since its independence. In just one year, public debt rose by 18 percentage points to almost 90 per cent of economic output. While economic recovery is now starting in other countries, the outlook for Tunisia is unclear. This also has to do with the political crisis and its national debt. In June 2021, the Tunisian President Kais Said suspended the parliament and took over its powers. The fundamental rights of Tunisians are largely being respected, but four months after assuming power, it is still uncertain how things will proceed over the long term.

Is austerity the answer?

Even before the political situation deteriorated, the IMF considered it

likely that Tunisia's indebtedness would continue to rise unsustainably in the medium term. In order to reduce it to a sustainable level, it recommended austerity measures as early as February 2021, including cutting spending on salaries in the public sector, doing away with energy subsidies, and only targeting social spending at the poorest segments of the population. But these measures would put an additional burden on the already shrinking middle class. A rapid departure from loose fiscal policy would also jeopardise the post-pandemic economic recovery.

Alternatively, once it has reached its peak, the high debt ratio could also be reduced by adjusting the debt level or debt servicing. This would mean involving the creditors in restoring Tunisia's debt sustainability by forcing them to waive their claims. In fact, debt relief as an instrument to combat the consequences of the pandemic was high on the political agenda in 2020: the IMF offered debt service relief to 29 low-income countries. In April 2020, the G20 agreed to suspend debt servicing in the short term for 73 of these countries, and a few months later they created a debt restructuring framework – the G20 Common Framework.

But these opportunities did not exist for middle-income countries. Access to these initiatives was not regulated according to the actual need for relief, but according to the countries' per capita income. Only those countries classified as poor according to the World Bank's categories had access. As a country with medium per capita income, Tunisia did not qualify – despite its debt problem. Debt restructuring and partial write-offs are therefore not part of the IMF's recommendations for reducing the Tunisian debt burden. On the contrary: the austerity measures recommended by the IMF are intended to maintain the full level of debt servicing between 2021 and 2025.

A 'good debtor'

Tunisia is not an isolated case. Middle-income countries threatened by a debt crisis are faced with the dilemma of either taking on more debt and thus deepening their debt crisis, or opting for fiscal austerity and thereby jeopardising their economic development. Given their already critical debt situation, many of these countries have little room for further borrowing anyway. Already in 2021, 85 countries in the Global South have had to cut spending. By 2023, this number is expected to increase to 115 countries. Yet in many countries, public health and social spending were already at dangerously low levels before the Covid-19 pandemic.

Countries excluded from the G20 and IMF debt relief initiatives can seek debt relief from their creditors outside the G20 framework. However, in the context of the pandemic, private creditors and their institutions

successfully used the argument that debt relief is not in the interest of the debtor countries. Bankers and fund managers were repeatedly quoted as saying that debt relief could make future borrowing more expensive. On the other hand, according to the bankers, by maintaining debt servicing according to schedule, stable financial relationships with private lenders could be maintained even during the crisis.

The threat worked. In April 2021, Tunisia's central bank governor publicly dispelled the rumour that Tunisia might seek negotiations on debt rescheduling. Shortly after, the country serviced its USD 1bn bond debt on time, with the result that its foreign exchange reserves sank to dangerously low levels. And thus, the argument that the use of debt relief leads to exclusion from the capital market is empirically untenable. Either way, this good obedience did not bring the promised support to lower middle-income countries. In fact, this group of countries repaid more interest and principal payments to private creditors abroad than they received in new loans from them over the same period.

Particularly during such a momentous global crisis, it would behove us to distribute the burden of adjustment evenly between debtors and creditors.

To date, the initiatives created by the IMF and the G20 have not been extended to all countries in need of relief. On the contrary, despite the IMF's rhetoric about the serious risk of a 'major divide' between richer countries and most developing countries, the international community is simply abandoning middle-income countries that are at risk of over-indebtedness. These countries have little scope to invest in an upswing, and therefore cannot expect a rapid economic recovery.

From the point of view of creditors, Tunisia has so far been a 'good debtor' who has always repaid its debts on time. In the current crisis, however, this is only possible if the rights of creditors are given priority over the economic and social rights of Tunisian citizens. Even before the crisis, health care was no longer guaranteed in some regions of Tunisia.

Restructuring unsustainable debt can be an effective way of stabilising the debt ratio and creating fiscal space without placing excessive burdens on the debtor's population. Particularly during such a momentous global crisis, it would be crucial to distribute the burden of adjustment evenly between debtors and creditors. In this situation, the greatest risk of a debt crisis is not that payments to the creditors will be missed, but that countries will be stifled in their development by the costs of debt servicing and, for example, that important investments to combat poverty and climate change will fail to materialise.

Ending the debt crisis

The overriding priority must therefore be to stabilise the health, economic, and social situation in the affected countries as quickly and comprehensively as possible and to enable sustainable investments in climate protection measures and the achievement of the United Nations Sustainable Development Goals (SDGs). In contrast, securing the short-term revenue expectations of individual creditors is of secondary importance. In view of the course that needs to be set to achieve the climate and sustainability goals, anything else would constitute a considerable loss – not only for the countries themselves, but for the entire world.

Given the lack of initiative on the part of the G20, the governments of critically indebted developing and emerging countries are forced to defend their own interests more strongly. Individual countries such as Pakistan and Jamaica, and entire groups of countries such as the Alliance of Small Island States (AOSIS), have made proposals as to which reforms are needed to get out of the debt crisis. It is important to make these initiatives visible and audible so that debtor countries are not excluded from finding solutions in the future.

The new German government plays a crucial role here. Tunisia, which has been the 'most important target country of the transformation partnership between the German government and the Arab world' since the upheaval of 2011, should receive stronger political and diplomatic support from Germany. Important aspects of the traffic-light coalition's foreign policy, from green hydrogen to migration and a value-based foreign policy, have their fulcrum in North Africa.

In addition, the future federal government has created the political basis for implementing sustainable solutions to the debt crisis, and not only in poor countries. The coalition agreement presented on 24 November includes an agreement to create a sovereign insolvency framework.

However, the coalition agreements of 2002 (red/green) and 2009 (black/yellow) already contained similar formulations without the agreements ever being implemented. This time, the new government must translate the good words in the coalition agreement into action. The German G7 presidency in 2022 would be a good starting point. The world simply cannot afford a decade of debt crisis.



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