Avoiding 'Too Little Too Late'

Developing economy debt problems and the international response

ESCAP EGM on Public Debt and Sustainable Financing in Asia and the Pacific.

Session 3: Policies to prevent and resolve public debt crisis

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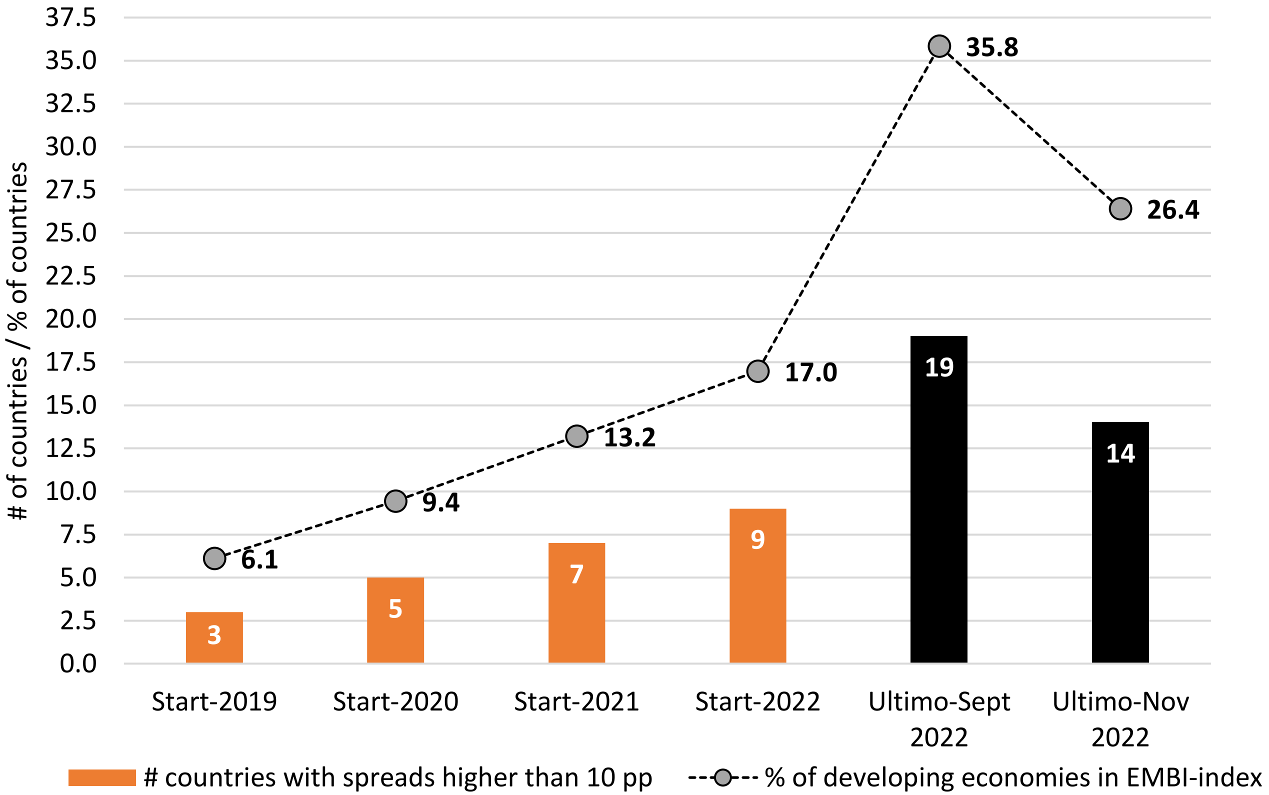
Debt problems have intensified sharply this year on top of a worsening trend

- ❑ 14 developing economies (DEs)* now have bond spreads higher than 10 pp, up from 9 countries at the beginning of this year, or 5 countries at the beginning of 2020.

- ❑ 26 DEs are now rated at either 'substantial risk, extremely speculative or default'** - close to one-third of all DEs rated - and up from 10 countries at the beginning of 2020.

- ❑ 40 of 69 (58%) IDA-eligible (LIC-DSA/poorest) countries are now rated either 'in debt distress' or at 'high risk' of debt distress according to their latest WB-IMF Debt Sustainability Analysis (DSA).

Low- and middle-income countries with bond spreads > 10 percentage points

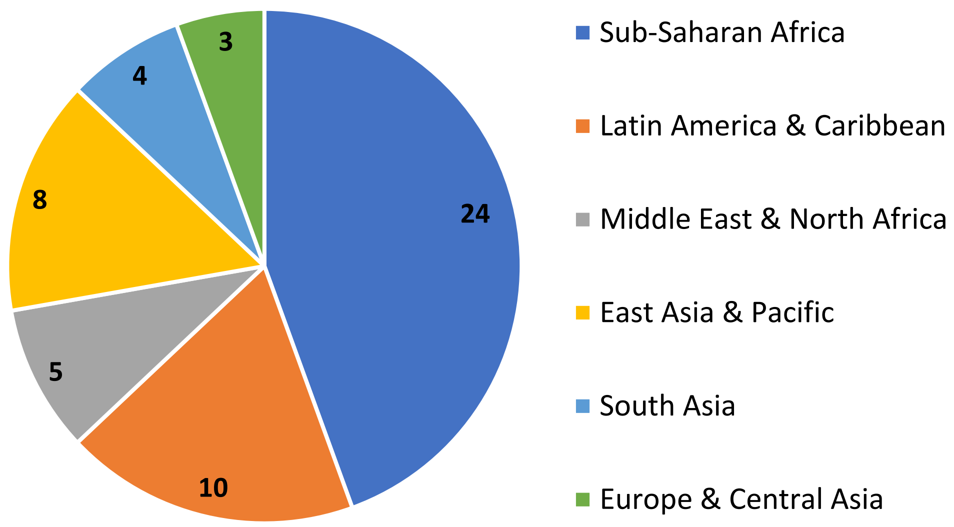


Source: Author based on data from Haver Analytics / JPMorgan's Global Emerging Market Bond index (EMBI Global).
Note: The index measures the spread of US$ denominated debt to similar maturity US Treasury bonds. 'Start' refers to first day of reporting in January. In 2019, spreads were reported for 49 DEs, and 53 from and including start 2020.

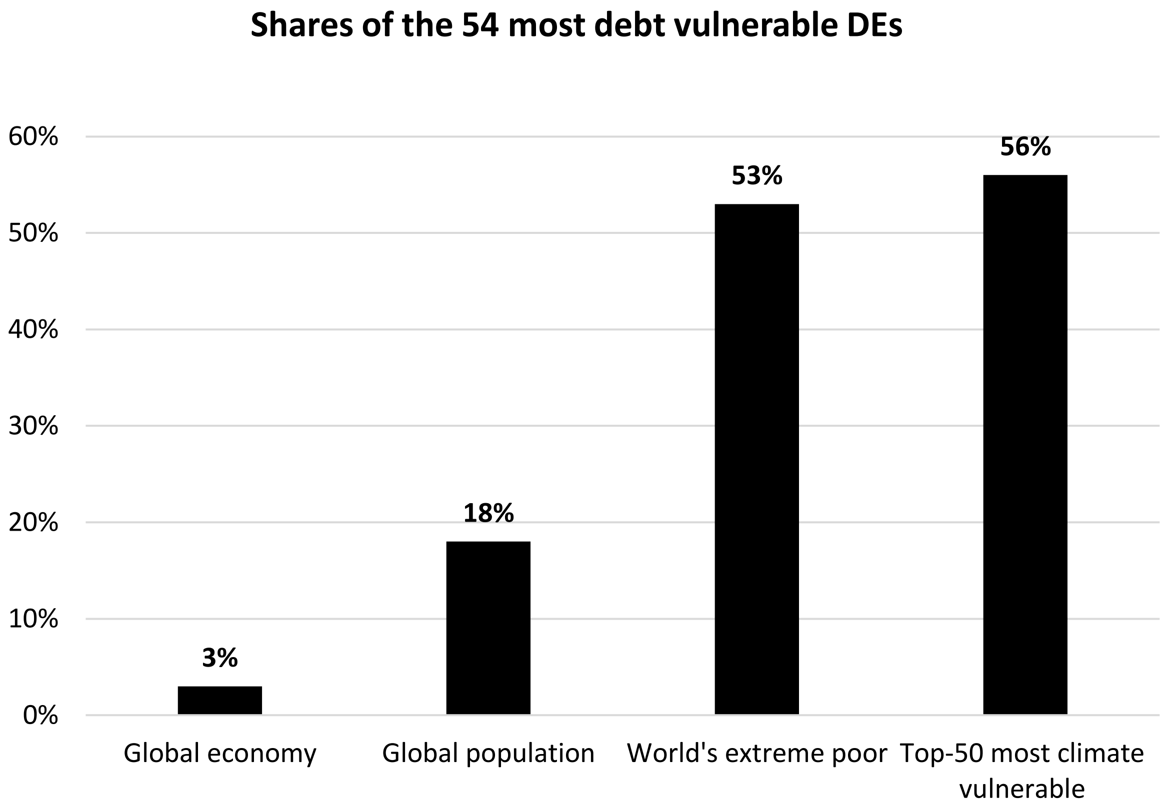
** Developing economies here refers to all low- and middle-income countries as per World Bank income group classification.*
*** Countries with an average rating below B3 (Moody's) or B- (Fitch and S&P).*

We identify 50+ developing economies with severe debt problems

- Based on credit-ratings, DSA-ratings and bond spreads we identified (ultimo-Sept) **54 DEs with severe* debt problems**.



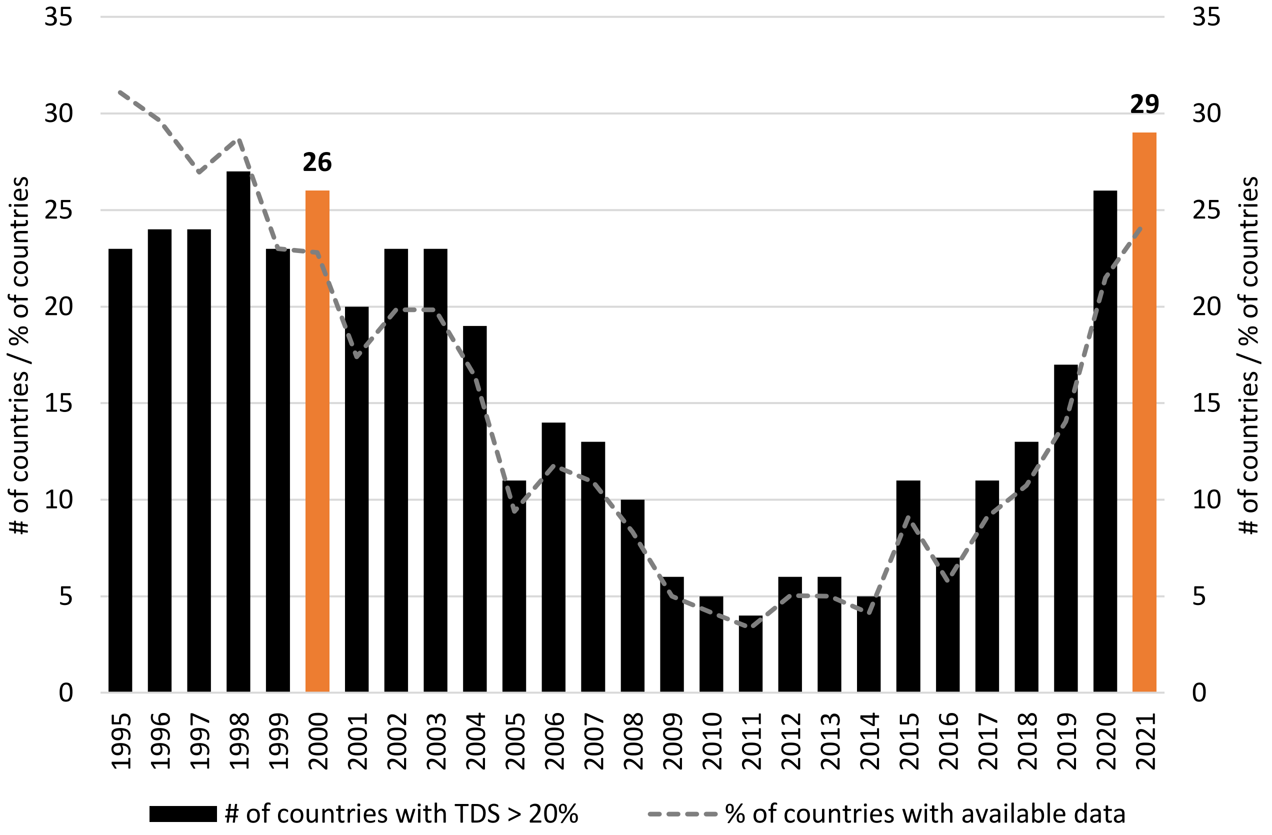
** Countries with an (average) rating below B3 (Moody's) or B- (Fitch and S&P) + Countries with an EMBI sovereign spread above 10 percentage points + Countries rated either in or at high risk of debt distress according to their latest DSA.*



Source: Author based on data from the IMF, World Bank WDI, the World Poverty Clock and the University of Notre Dame climate vulnerability index.

We are back at the 90s on many debt burden indicators (1/2)

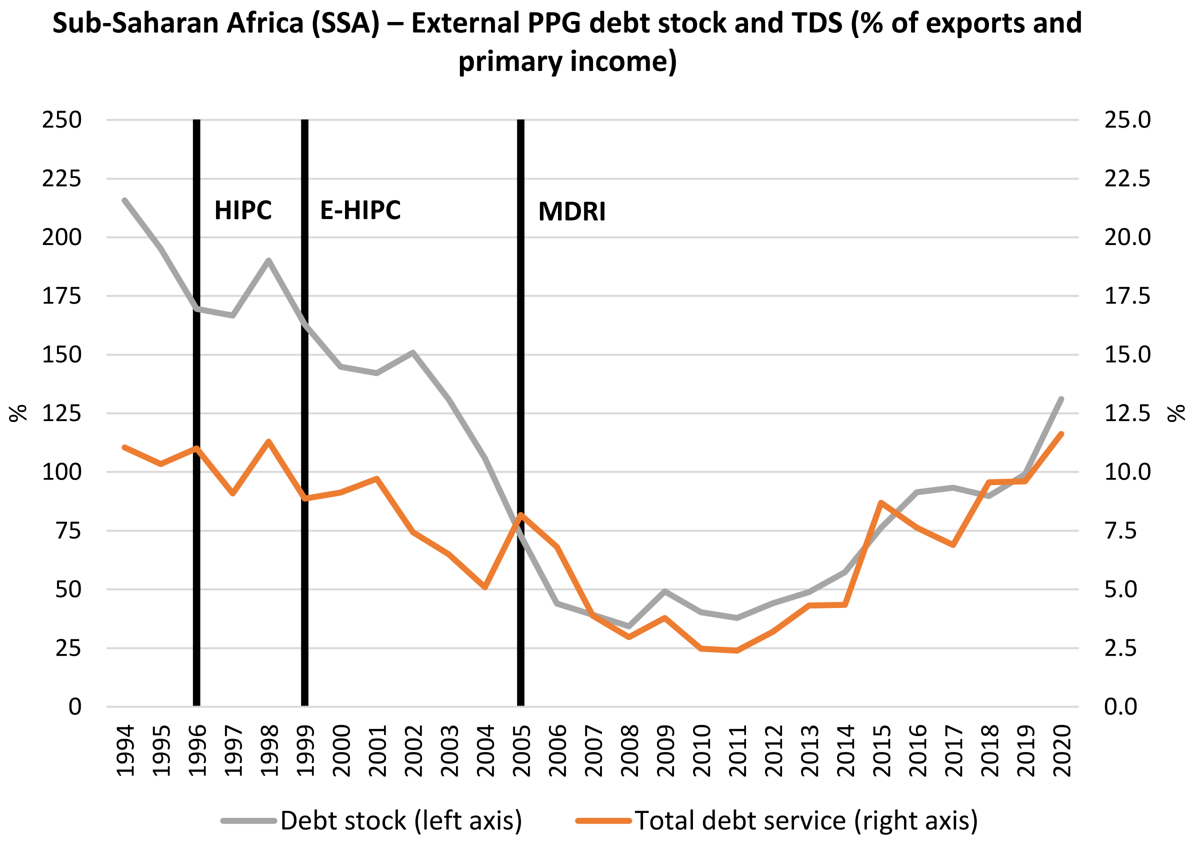
Number of DEs (in the WB IDS database) paying more than 20% of government revenue in total debt service (TDS) on external PPG

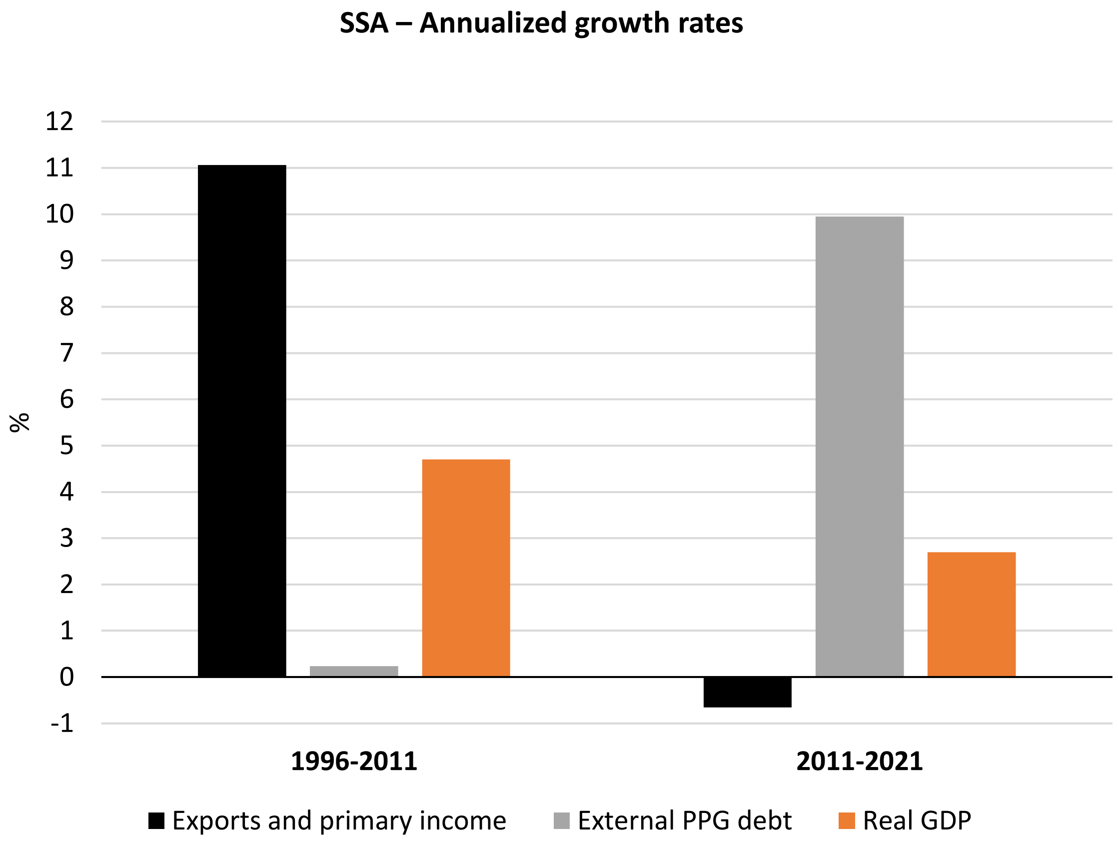


Income group	**2000**	**2021**
Low	1	5
Lower-middle	11	15
Upper-middle	12	9
High	2	0
Total	**26**	**29**
Geographical group	**2000**	**2021**
Sub-Saharan Africa	8	13
Latin America & Caribbean	8	2
Middle East & North Africa	5	4
East Asia & Pacific	3	2
South Asia	1	4
Europe & Central Asia	1	4
Total	**26**	**29**
Median country	**2000**	**2021**
TDS in % of revenue	**28.3%**	**27.7%**

Source: Author based on revenue data from IMF WEO (October 2022) and external debt data from World Bank IDS 2022 database. Note: 114 countries with data in 2000, 119 countries with data for 2021.

We are back at the 90s on many debt burden indicators (2/2)



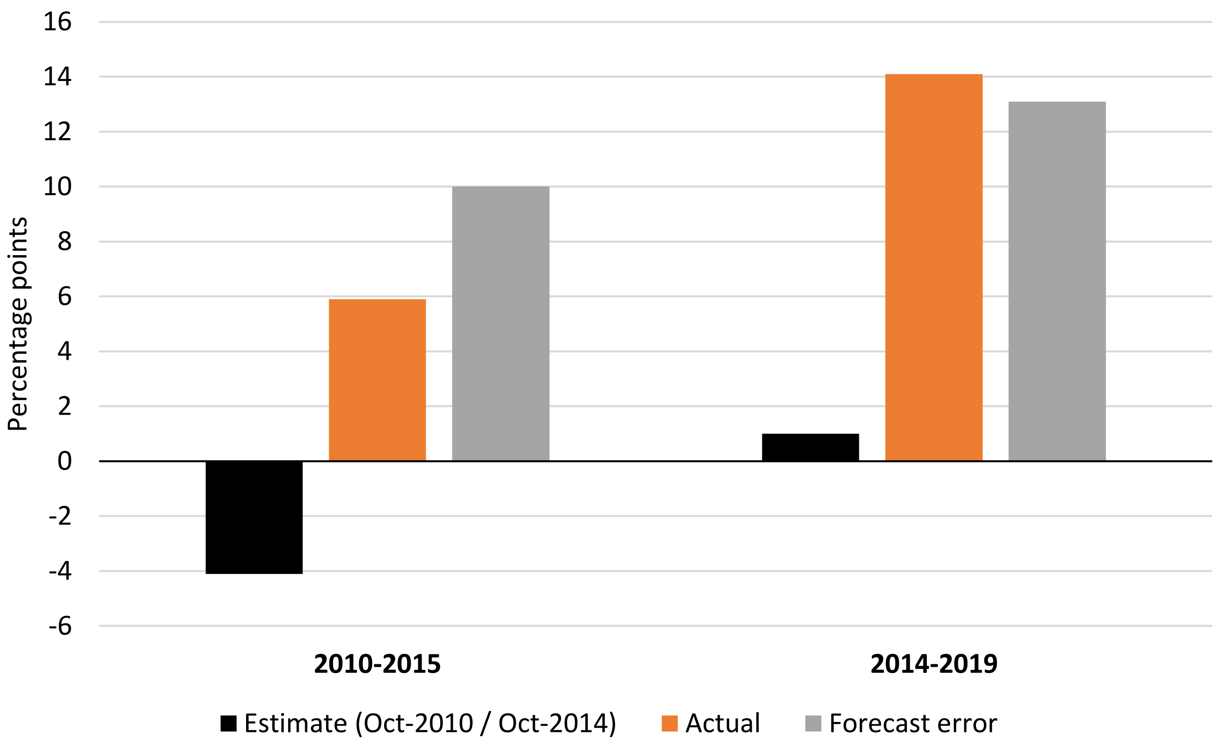


Source: Author based on data from IMF WEO (April 2022) and external debt data from World Bank IDS 2022 database. Note: RHS figure shows the nominal growth in exports and debt, and real growth in GDP. 2021 figures are calculated using IMF's (WEO April 2022) growth rates for exports and external debt for SSA.

The build-up in DE debt has been underestimated

- The DE debt-build up over the past decade was unexpected → no post-financial crisis / pre-COVID debt stabilization.
- In October 2014 it was expected that by end of 2019, 59 of today's low- and middle-income countries would have a higher debt ratio by 5.2 pp for the median country. Instead, debt rose in 99 countries, and by 13 pp for the median.
- Primary balance deficits has been the main contributor: deficits accounted for 11.9 pp of the 14.1 pp increase in the debt ratio from 2014-2019 → overestimating ability to cut spending and raise revenue.

EMDE change in gross public debt (percentage of GDP) – estimate vs. actual

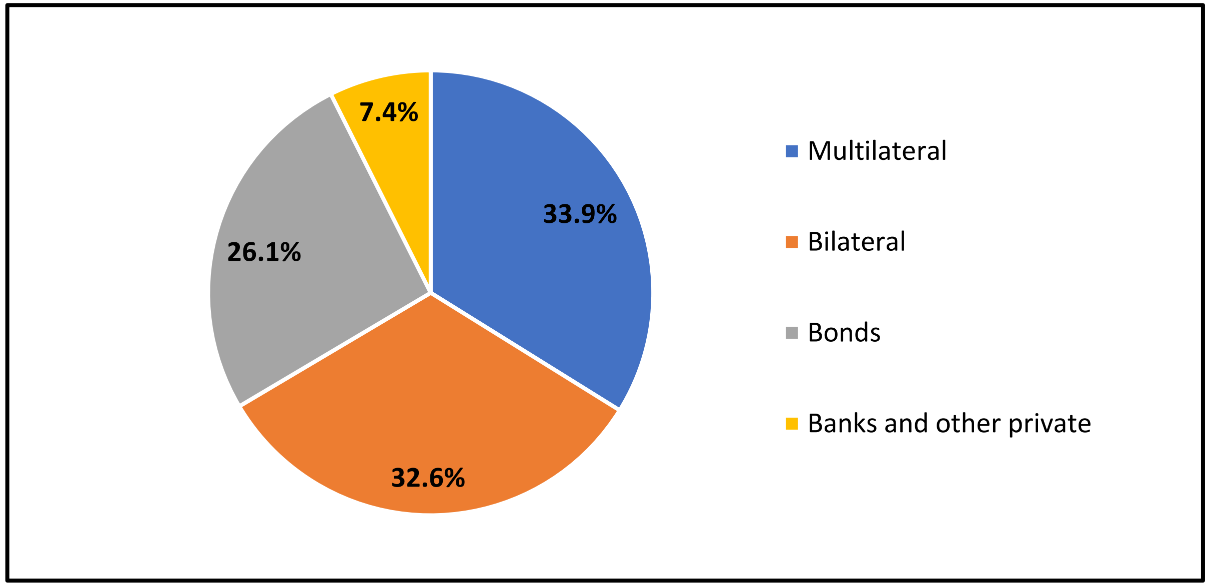


Source: Author based on IMF WEO vintages and WEO April 2022.

International debt relief efforts have been inadequate

- **Debt Service Suspension Initiative (DSSI):** Fear of rating downgrades; suspension profile did not necessarily match liquidity needs; no private creditor participation; suspension not reduction.
- **US$650 billion SDR allocation:** Not targeted at countries most in need, and re-channeling of SDRs has been slow.
- **Common Framework for Debt Treatments (CF):** Fear of rating downgrades; uncertain process and outcome; potentially politically and economically costly; the three CF cases to date have not instilled confidence in the process.
- **Complicated creditor landscape and lack of debt transparency:** Greatly complicates restructuring; CF is supposed to coordinate between Paris Club and China; private creditors now hold a much larger share of debt.

Creditor shares of public external debt – group of most debt vulnerable DEs



PPGE debt excl. Argentina, Ukraine and Venezuela					
		Official		Private	
	Total	Multilateral	Bilateral	Bonds	Banks and other
US$ billion	569	193	186	149	42
% of total		*33.9*	*32.6*	*26.1*	*7.4*

Source: Author based on World Bank IDS 2022 database. Note: Latest figures are from 2020 and the table includes figures for 46 countries with available data out of the 54 identified in the paper.

The common framework – where do we stand?

The CF was set up to help countries deal with protracted liquidity crisis and/or solvency problems with support focused on creditor coordination, - especially coordination between the Paris Club and China. Only three countries have signed on and only one country has (recently) reached an agreement after almost 2 years.

Chad is the only country of three to have reached an agreement with all creditors after almost two years

- ❑ Details still unknown, but it will be a debt rescheduling not a reduction.
- ❑ Chad faces an immense spending need: One of the poorest countries in the world with 40% of the population living in extreme poverty; fourth most climate vulnerable country in the world; deteriorating security situation; drought and food insecurity, etc.

Zambia

- ❑ The bilateral creditor committee has agreed to provide financial assurances and an agreement is expected early 2023.

Ethiopia

- ❑ Progress has been delayed because of the war.

A way forward for the common framework? (1/3)

<u>**Five considerations for an improved common framework**</u>

1. **Expand eligibility / suspend payments while undergoing treatment / maintain IMF lending into arrears policy**
   - ➢ Reduce debtor hesitancy (encourage pre-emptive restructuring), increase creditor participation while incentivizing a reasonable timeline.
2. **DSAs provide the estimate underpinning the negotiations → ensure DSAs are grounded in realistic assumptions about debt dynamics**
   - ➢ Country-specific spending needs and revenue mobilization capacity; vulnerability to external shocks, etc.
   - ➢ Shift focus of restructuring to face-value reductions for highly vulnerable economies to avoid subsequent rounds of restructuring and prolonged crisis. As an example: The IMF's Independent Evaluation Office (IEO) has concluded that <u>debt operations with principal haircuts and upfront fiscal adjustments have been more effective in restoring debt sustainability and in providing the basis for renewed markets access and a return to growth over operations with just debt reprofiling and lower coupons.</u>
3. **Provide financial incentives for private creditor participation**
   - ➢ Buy-back funds; credit-enhancements; value-recovery instruments, etc.
   - ➢ This will, however, cost money and will move debt and/or credit risk (at least temporarily) to the official sector.

A way forward for the common framework? (2/3)

Five considerations for an improved Common Framework

4. Resilience - expand the use of CACs and State-Contingent Debt Instruments (SCDIs)

- Cover all debt with CACs (not just bonds) and make use of SCDIs in countries with high exposure and vulnerability to external shocks.

A simple GDP- indexing example covering interest payments on external PPG debt

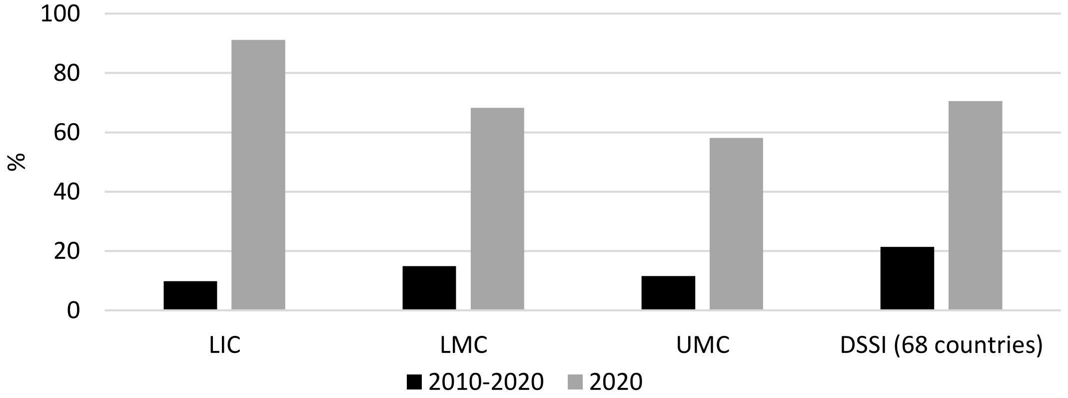
Assumptions

Covering all official and 50% of private creditor debt. A premium is added to the estimated implicit interest rate. Premium equals to the difference between the given year's real GDP growth rate and average growth over the four previous years, but with a cap limiting the premium during times of high growth to a maximum of 0.5 times the average rate. A zero lower bound is imposed on the indexed rate, which during sharp slowdowns in growth could otherwise turn negative. Finally, the indexing ensures that following a period of negative growth, interest payments are only resumed when real GDP has recovered to the level prior to the downswing.

Results

Total interest payments lower by US$114 billion (a 12 percent reduction in interest payments). In comparison this is more than half of what DEs received from the US$650 billion SDR allocation in 2021. In 2020 alone (when COVID hit), interest payments would have been lower by US$69 billion. The DSSI had the potential to free up US$12.2 billion for the DSSI-eligible (poorest) countries in 2020 but was only used to the tune of about US$3.2 billion. Under this indexing, interest payments in 2020 would have been lower by US$10.7 billion for the 68 DSSI-eligible countries with data, or US$8.3 billion lower if only official creditor debt had been covered by the indexed contract.

Percentage reduction in interest payments under indexing



US$ billions	2010-2020			2020		
	Official	Private	*Total*	Official	Private	*Total*
LIC	1.3	0.1	***1.4***	1.9	0.2	***2.1***
LMC	23.1	14.9	***38***	13.1	11.4	***24.4***
UMC	24.5	50.2	***74.7***	11.9	30.8	***42.7***
Total	**48.9**	**65.2**	***114.1***	**26.9**	**42.4**	***69.3***
DSSI (68) eligible	*15.4*	*3.4*	***18.8***	*8.3*	*2.4*	***10.7***

A way forward for the common framework? (3/3)

Five considerations for an improved Common Framework

5. **Policy conditionalities**

- Fiscal consolidation:
  - Often implemented disproportionately on the spending side which can lead to social unrest and political instability broadening the crisis, - for instance when abruptly phasing out broad-based (non-targeted/inefficient) subsidy programs (energy and food) with little or no compensation to poor and vulnerable households.
- Debt-for-development (DfD) deals/proposals/swaps:
  - There are many DfD proposals, but DfDs have historically not been focused on fixing debt problems → the nature of the debt problem matters for the effectiveness of a DfDs with respect to both the debt objective and development objective.
  - Typical DfDs are more appropriate for countries with no need for, or high cost of, a comprehensive restructuring, when grants are unavailable and/or where there is a strong link between the development objective and credit-risk (e.g., climate adaptation).
  - HIPC/MDRI was a "large scale DfD" with both a debt and development (poverty reduction) objective. A similar initiative focused on climate would make a lot of sense today due to the urgency of the climate transition and high correlation between debt and climate vulnerability.
  - In all cases, DfDs tend to move debt and/or credit-risk to the official sector, at least temporarily, why progress on this front will depend on the willingness of major official sector creditors and donors.

Conclusion

- Overall, larger EMs generally look resilient (likelihood of systemic crisis low). But a large group of relatively smaller DEs and frontier economies are already in or at high risk of a debt crisis.
- The combination of little or no fiscal space, high debt levels, a worsening of automatic debt dynamics (r-g) and a massive development spending/investment need, which new investors are reluctant to fund (at affordable rates), threatens solvency.
- To avoid a spillover from a debt to a development crisis, countries must be offered a viable pathway to effective debt relief.
- Additional liquidity injections (and rescheduling) are needed, - preferably targeted at vulnerable countries.
- But history has also shown us that during past debt crises, problems were initially often wrongly classified as ‘liquidity only’ which led to deepening crises, only finally resolved when focus shifted to comprehensive debt restructurings.
- The G20 Common Framework should be reformed to facilitate this process (avoid ‘too little too late’).

Thank you for listening

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Link to publication presented:

https://www.undp.org/publications/dfs-avoiding-too-little-too-late-international-debt-relief