Towards A Solution to the Current Sovereign Debt Crises and to Restore Growth: Five Key Complexities

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Based on Diwan-Guzman-Kessler-Songwe-Stiglitz, FDL-IPD paper
"An Updated Bridge Proposal: Towards A Solution to the Current Sovereign Debt Crises and to Restore Growth"

A summary of the situation

- Flows changed in 2022:
  - Massive negative net transfer from LLMICs to the private sector, negative net transfers to China, large positive net transfers from IFIs
  - Implicitly, a **bailout** to **creditors** financed by global taxpayers
  - And indebted countries get strapped with more debt to IFIs that cannot be restructured
- Massive increase in debt payments as share of tax revenues and GDP
  - Meaning that countries are cutting budget to essential public services for economic and social development, such as education, knowledge, health, and critical public infrastructure
  - And aren’t able to make investments needed for green transition—hurting themselves and the world
- Different debt stock situations across countries, from low to high
  - But high coupon rates, an increasing debt service burden, and no access to credit markets are common features for distressed countries
  - “Access” like that of Kenya at exorbitant interest rates only “kicks the can down the road,” worsening eventual resolution
- Even if countries manage to forestall debt defaults, there is a development and environmental crisis going on

A proposal for solution

- Debt operations for restoring or ensuring debt sustainability
  - If d (debt to GDP) is such that for R (average financing rate) close to a weighted average of WB and concessional lending rates, a pair s (debt-stabilizing primary fiscal surplus to GDP) and g (growth rate of output) consistent with social and environmental goals can be achieved, **reprofilings with normalization of interest rates to the WB rate would suffice, *but only if there is a reduction in the interest rates charged commensurate with the low risk associated with sustainability***
    - In these circumstances, IMF money/guarantees might help with reprofiling/liquidity
    - But only if the money doesn’t go to bail-out private creditors and only if private creditors lower interest rates commensurate with risk

  - Otherwise, there is need for restructuring, with principal haircuts
  - In any sustainable restructuring, coupon should reflect *sustainability*, i.e. be low
    - Demand for high R *implies* belief that restructuring is not sustainable
    - Further implication: DSAs should use low interest rate

  - MDBs guarantees would transfer risk from private sector to the official sector and further justify the normalization of coupons to sustainable rates
    - But the characteristics of the proposed debt operations should hold nevertheless to restore or ensure debt sustainability

  - IMF DSA practice and policies should support inveigh against situation of “too little and too late” debt payments relief
    - Would affect bargaining outcomes
    - Accordingly, they will be resisted by private sector

1. No net negative transfers to <u>any</u> creditor category (no IFIs bailout to creditors condition)

- There should be not negative net transfers financed by IFIs neither to bilateral official creditors nor private creditors

- For private creditors, this requires either maturity extensions with a resetting of interest rates or debt restructurings that include principal haircuts

    - The new interest rate on the reprofiled/restructured bonds should be close to the World Bank's interest rate

    - It is not just the interest rate that applies to maturity extensions that matters, but also the interest rate on bonds that are not coming due
        - Otherwise, the reprofiling may not be sustainable

2. The structure of incentives for participation in debt operations will be key

- The IMF should define its policies in a way that encourages *meaningful* creditors' participation in debt operations
  - Conditionalities:
    - No payments to private creditors with IMF's money (at least in the absence of a sufficiently large positive shock that reverses the current state of distress)
    - No policies intended to contract imports to create revenues for foreign-exchange debt payments (austerity impedes growth, poverty reduction, and climate action)
    - On the contrary, counter-cyclical and pro-growth programs

- Importance of NY legislation for sovereign debt
  - Recovery cap on private creditors to ensure comparable treatment with official creditors
  - Pre-judgment compensatory rate should not incentivize delays to begin or finalize debt operations

3. Choice of discount factors in debt operations

- Frequent references to debt operations that are NPV neutral in current discussions
- But NPV depends on discount factor
- A sustainable debt deal should be associated with a “low”, sustainable discount factor
- The discount factor should be close to the WB’s lending rate
  - This is more obvious if there are MBDs guarantees in the new bonds

4. Extension of maturities: the choice of length of maturity extension

- The necessary length of the extension of maturities depends on the expectation about how long it will take to low and low-middle income countries (LLMICs) to recover access to international private credit markets *at sustainable interest rates*

- Given the procyclical nature of global capital markets for developing economies, it will probably take long until LLMICs recover market access
  - Suggesting that maturity extensions should be long (10-20 years)

5. Climate in Debt Sustainability Analysis (DSA)

- Trade policies / carbon taxes act as a terms of trade shock to distressed countries

- These matters should have been anticipated by the time creditors provided financing to the currently distressed LLMICs (post-2008, when the matter was already a well-known forthcoming issue)

- DSAs should account for the realization of those shocks, with consequences for the necessary debt relief that restores debt sustainability

Final reflections

- Resolving macroeconomic inconsistencies / unsustainability entails a distribution of losses (Guzman-Stiglitz, OXREP 2020)
  - Such a process is generally associated with conflict
- The process for resolving conflict differs if it is among countries (like with HIPC initiative for debt relief) or between a country and the private sector
- Under the current deficient international financial architecture (with no “bankruptcy court”) the best course may be a default
  - Defaults are costly
  - But not defaulting may be costlier
  - Private sector uses fear of default as a bludgeon to get outcomes that are better for itself but often unsustainable
  - A word of caution: **contingent bonds** must be designed to improve sustainability, not to maximize the payments to bondholders in upside scenarios unprotecting the debtor from the risk of reversal of positive shocks, as the recent asymmetric contingent bonds (Suriname and Sri Lanka) do
- The IMF’s stance (debt policies) affect the bargaining, a main determinant of debt outcomes
  - Our proposal is more likely to achieve more sustainable and more equitable outcomes than those obtained in past

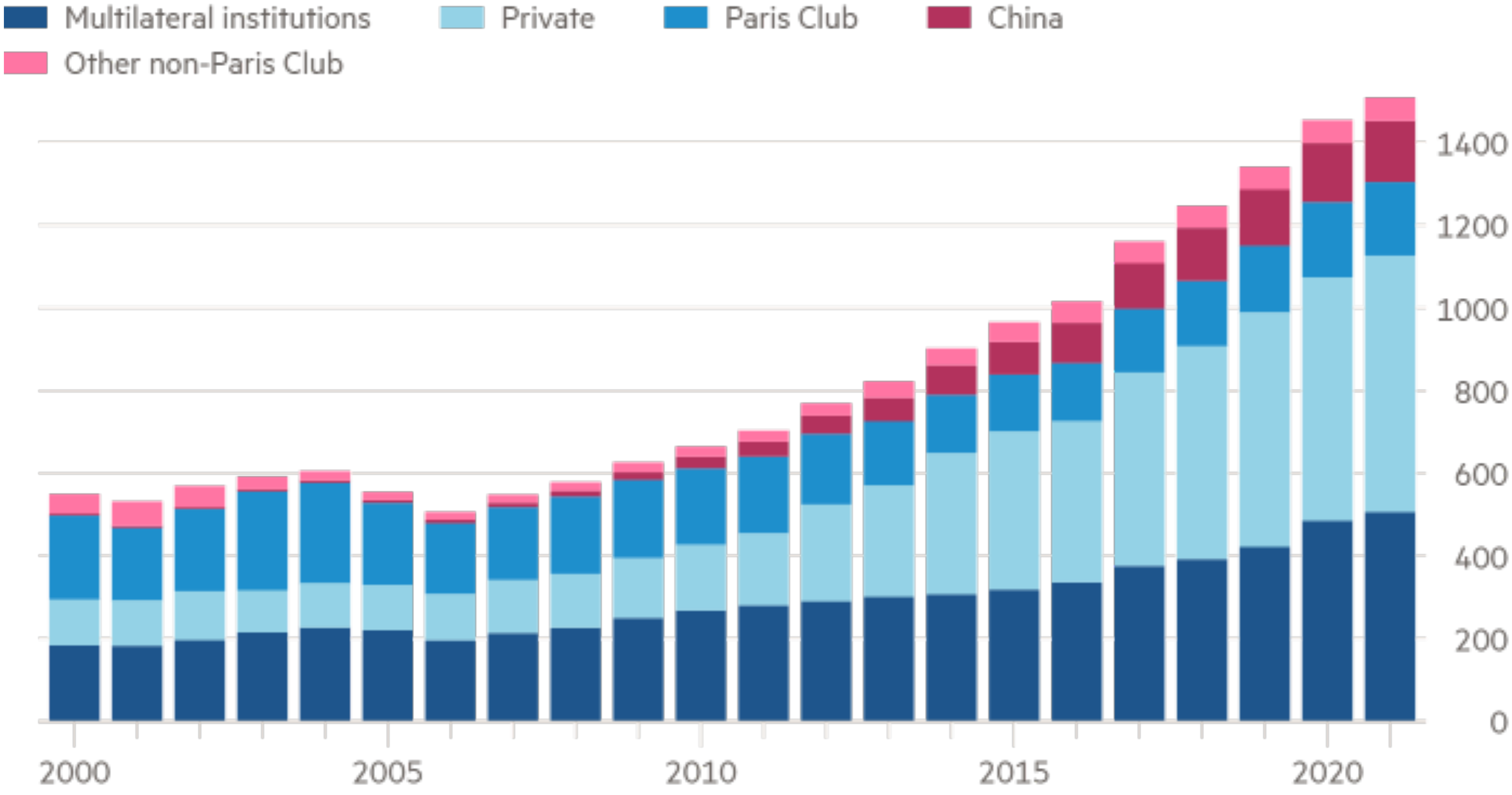
Data Annex

Net Transfers on Long Term External Debt

	Total NT LT debt	IFIs	Bilaterals creditors	China loans	Private lenders
2019	84.45	28.96	1.77	4.65	54.39
2020	55.20	68.35	8.69	0.95	3.08
2021	45.43	27.32	6.46	3.52	11.01
2022	-15.74	32.28	9.81	-6.13	-51.27

The external debt of poorer countries has surged since 2000

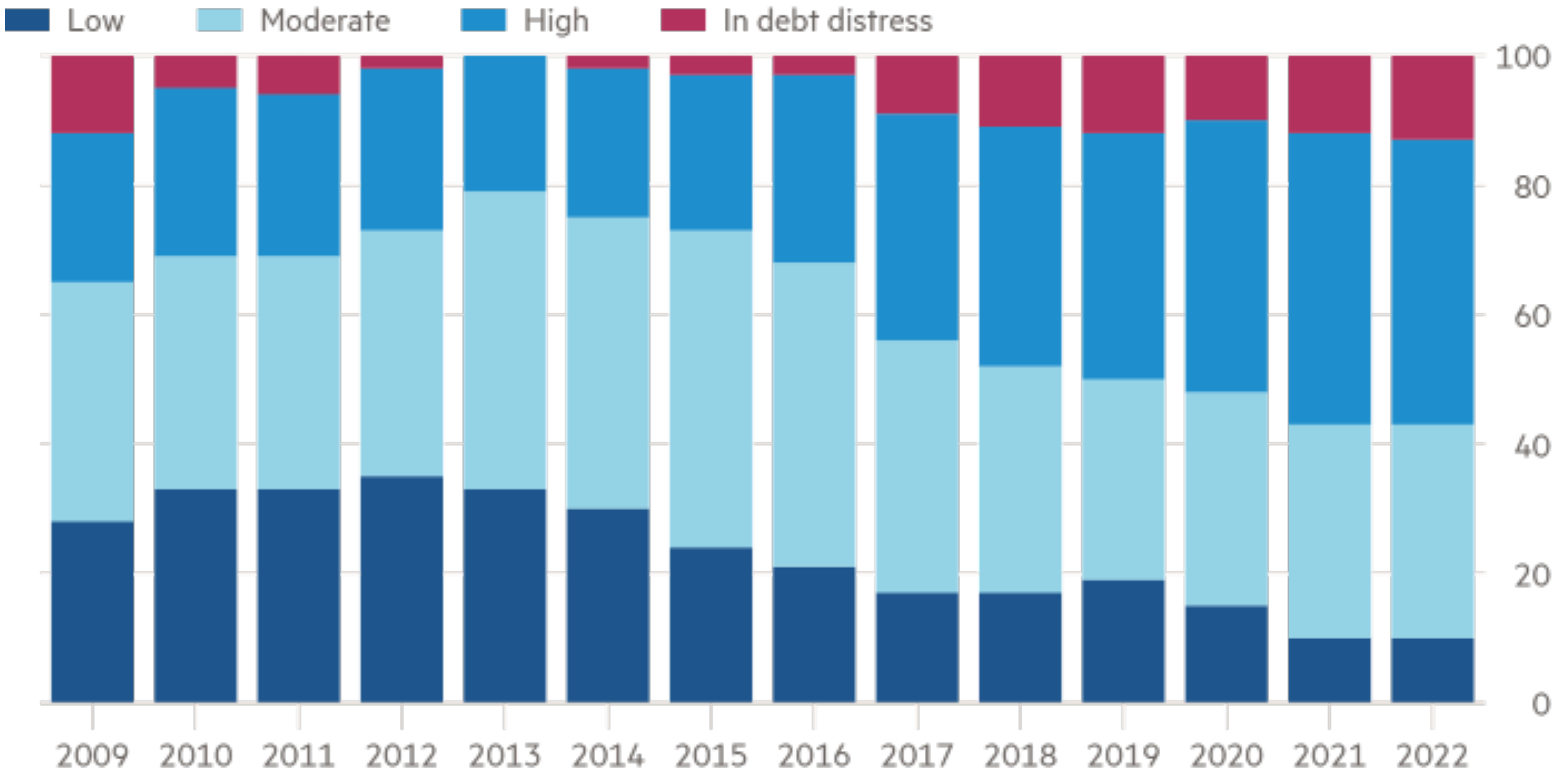
External public debt of low and lower-middle income countries, by creditor ($bn)



Source: World Bank

The proportion of poor countries at risk of debt distress has soared

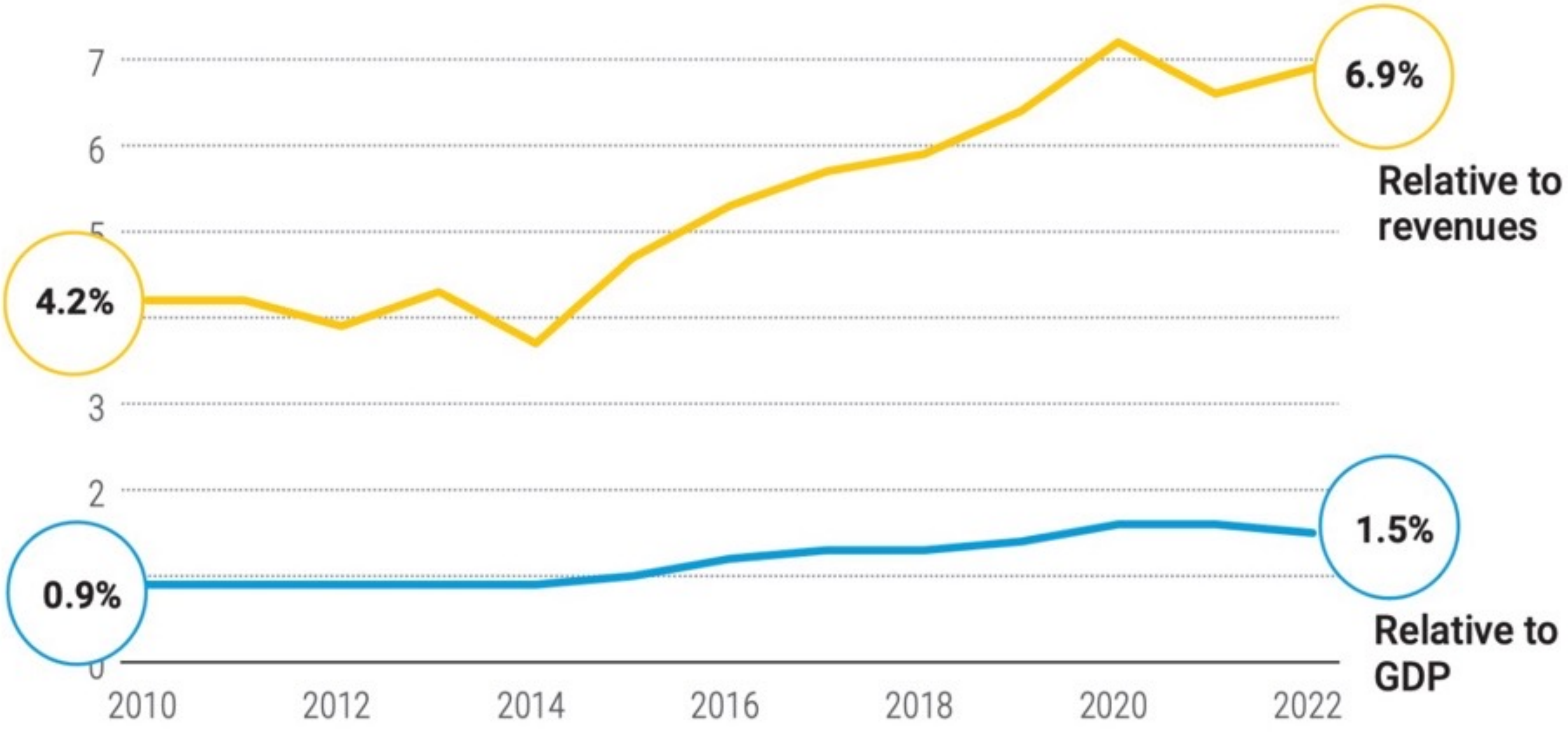
Risk of debt distress (% of DSSI countries with DSA*)



* G20 Debt Service Suspension Initiative countries with Debt Sustainability Analyses
Source: IMF

Figure 8: Developing countries use more resources to pay interest on their public debt

Net interest payments of developing countries as a share of GDP and government revenues



Sources: UN Global Crisis Response Group calculations, on IMF World Economic Outlook (April 2023).
Note: Median shares across developing countries.