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Reference: Duggar, Elena (2021). Country differences call for tailored approaches to debt relief. In: Multinational finance journal 25 (3/4), S. 73 - 83. http://www.mfsociety.org/modules/modDashboard/uploadFiles/journals/MJ~0~p1fnsbai1m12lup18a3m861jk64.pdf.

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Country Differences Call for Tailored Approaches to Debt Relief

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The G-20 Debt Service Suspension Initiative (DSSI) was endorsed effective May 1, 2020, in the midst of an unprecedented fall in government revenues and rapidly rising public expenditure following the COVID-19 shock and resulting deep economic contraction. By the end of 2020, 45 of the 73 eligible countries had participated in the initiative. By March 18, 2021, 24 countries had participated in the extended DSSI. The G-20 DSSI initiative will alleviate liquidity pressures for participating countries, but in general the savings from debt relief under the DSSI are modest relative to the fiscal deterioration brought about by the COVID-19 shock. Countries eligible for the DSSI and the Common Framework for Debt Treatments differ greatly in terms of their debt-to-GDP levels, debt sustainability positions and credit risk, potential benefits from DSSI debt relief, and creditor universe. This diversity will necessitate tailored approaches to debt relief, taking into account country-specific circumstances.

Keywords: DSSI; common framework; sovereign debt restructuring and default; country risk; creditworthiness; debt crisis

JEL codes: F34, H63, H12, H81

I. Introduction

The G-20 Debt Service Suspension Initiative (DSSI) was endorsed in April 2020 to become effective May 1, 2020, and was further extended in October 2020. By the end of 2020, 45 of the 73 eligible countries had

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(*Multinational Finance Journal*, 2021, vol. 25, no.3/4, pp. 73–83
Special Issue: Sovereign Debt, Management, and Restructurings)
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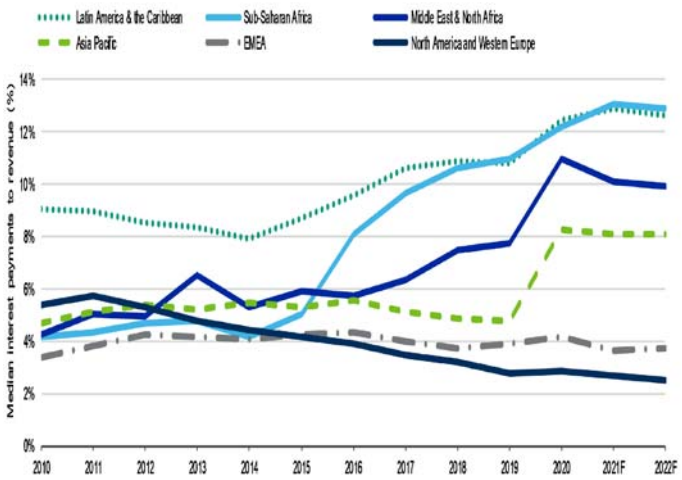

FIGURE 1. Interest Payments to Revenue (%)

participated in the initiative. By March 2021, 23 of these countries, plus one additional country, participated in the extended DSSI, and three countries had commenced negotiations under the Common Framework for Debt Treatments beyond the DSSI.

The DSSI initiative was announced in the midst of the COVID-19 pandemic, during a deep global economic contraction that caused government revenues to fall and expenditures to rise sharply across countries. The economic contraction, as measured by the decline in 2020 real GDP, was unprecedented in many advanced economies and the most severe economic contraction since the Great Depression. In emerging markets, the COVID-19 growth shock was as severe as the GDP contractions during some of the deepest emerging market crises of the past, including the Asian financial crisis in 1997-98 and the Argentinean debt crisis in 2001-02.

On the back of the deep economic recession, Moody's expects debt-to-GDP ratios from the end of 2019 until the end of 2021 to rise by an average of about 20 percentage points (pp) across advanced economies and by nearly 15 pp across emerging markets (Moody's [July 2020]). Given the gradual rise in debt levels in the decade prior to 2020, this would mean that sovereign debt-to-GDP levels would reach an all-time high in many countries.

Low interest rates will support debt servicing capacity in advanced economies. Indeed, measures of debt affordability such as interest

payments to revenue have been declining in the last decade in many advanced economies even as debt levels have risen, as new debt is being issued at lower interest rates than the average interest rates on the existing debt stock. In contrast, debt affordability will worsen in most emerging markets. As Figure 1 shows, Moody's expects the ratio of interest payments to revenue to increase in the Asia-Pacific region, Latin America and the Caribbean, the Middle East and North Africa, and especially in the Sub-Saharan Africa region. In addition, revenues have declined more in emerging markets than in advanced economies and many emerging markets have less revenue generation capacity.

From a sovereign creditworthiness perspective, the most vulnerable countries are emerging and frontier economies, particularly those with high exposure to travel and tourism, volatile commodity prices, and the curtailment of market access. While Moody's expects a rebound in aggregate economic activity in 2021, the economic recovery will be uneven across countries and across sectors (Moody's [February 2021]). Activity will remain heavily constrained in high-contact services sectors, and Moody's does not expect activity in travel and tourism-related sectors to return to pre-pandemic levels for another two years. As a result, growth will remain constrained for a number of countries for several years.

Market access has also been uneven across countries. The COVID-19 shock was unlike previous crises in that financial conditions recovered relatively quickly. For example, compared with the global financial crisis, the COVID-19 financial shock was shallower and shorter. This was due to the unprecedented amount of policy support globally and the fact that most banking systems entered the COVID-19 recession in a stronger position. But while advanced economies and large emerging markets have enjoyed relatively uninterrupted market access, market access has been uneven and more constrained across frontier economies. Episodes of financial market volatility are likely as the recovery proceeds, which will present risks to emerging and frontier economies with significant external refinancing needs if these episodes lead to rapid liquidity tightening.

II. DSSI's Coverage and Past Debt Relief Initiatives

Within this backdrop, the G-20 endorsed the DSSI initiative in April 2020. It is important to note that the DSSI is just one of the measures

global authorities introduced to counter the effects of the pandemic. Policymakers across countries provided a large amount of fiscal stimulus and central banks extended unprecedented support to stabilize financial conditions, partly following lessons learned from the global financial crisis. In addition, the World Bank and other multilateral development banks scaled up their lending to countries. The IMF extended $107 billion in financial assistance in 2020 to 85 countries and also provided $489 million in IMF debt service relief to 29 countries via the Catastrophe Containment and Relief Trust (IMF [2021]).

The DSSI covers more eligible countries than did past debt relief initiatives. Seventy-three low-income countries are eligible for debt relief under the DSSI compared with 39 eligible countries under the Heavily-Indebted Poor Countries Initiative (HIPC) of 1996 and the Multilateral Debt Relief Initiative (MDRI) of 2005. However, the DSSI has provided less debt relief compared with the prior two initiatives. The World Bank estimates that the DSSI provided $5 billion in debt deferral in 2020 (WB [2021]), while the IMF estimates that the HIPC and the MDRI initiatives provided $76 billion and $43 billion in debt relief, respectively, as of 2017 (IMF [2019]). This is partly due to the fact that the DSSI was intended to address temporary liquidity challenges, while the HIPC and MDRI were focused on addressing debt sustainability challenges. All three initiatives focused on providing debt relief on official-sector debt. Conditionality under the HIPC and the MDRI was similar to conditionality under IMF loans. In contrast, under the DSSI, countries simply commit to use funds freed by debt relief towards pandemic spending, to disclose all public-sector debt, and to not undertake new non-concessional borrowing.

About half of DSSI-eligible countries are in Africa. Thirty-seven of the 73 eligible countries are in Sub-Saharan Africa, 15 are in East Asia, 6 are in South Asia, 8 are in Latin America and the Caribbean, 5 are in Europe and Central Asia, and 2 are in the Middle East and North Africa region. Further, 35 of the eligible countries are currently rated by Moody's. And of these 35 countries, 21 had participated in the DSSI as of March 2021.

III. Debt Sustainability and Credit Risk

The DSSI initiative is unlike previous debt relief efforts in that it encompasses countries with vastly different fundamentals. Overall, the

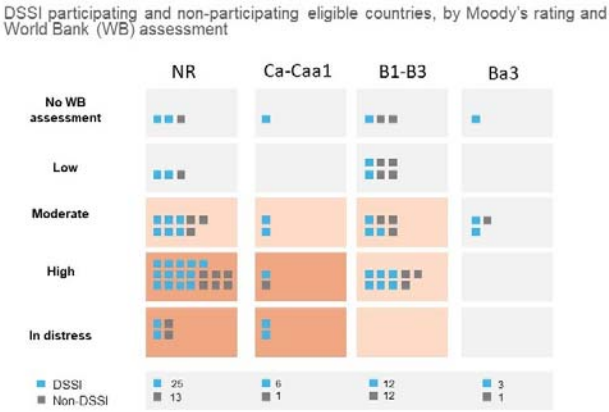

FIGURE 2. Debt Sustainability Positions Across DSSI Eligible Countries

73 DSSI-eligible countries have very different debt sustainability positions and credit risk. Figure 2 shows the World Bank's Risk of Debt Distress assessment and Moody's sovereign rating. The World Bank's Risk of Debt Distress assessments range from "in distress" for six countries, "high risk" for 30 countries and "low risk" for nine countries. Eight countries have no World Bank assessment. Of the 35 countries rated by Moody's, seven are in the Caa1-Ca range, implying very high credit risk, 24 are in the high credit risk B1-B3 range, and four are rated Ba3, which reflects substantial credit risk. Thus, while there is a group of countries at high risk of debt distress, there are also a number of countries whose positions are much better.

A similar picture of wide diversity across countries emerges when examining debt-to-GDP levels. As Figures 3 and 4 show, debt-to-GDP ratios range from about 10% to more than 120% of GDP across the DSSI-eligible countries. The average debt-to-GDP ratio was 58% in 2020. Countries participating in the DSSI have a slightly higher average debt-to-GDP ratio, at 64% vs. 45% for the eligible countries that have not joined the initiative. Overall, eight countries have debt-to-GDP ratios of more than 90% of GDP, and seven of them have taken part in the DSSI.

The potential benefits from DSSI debt relief are also uneven across countries. The 2020 DSSI suspended official bilateral debt service due

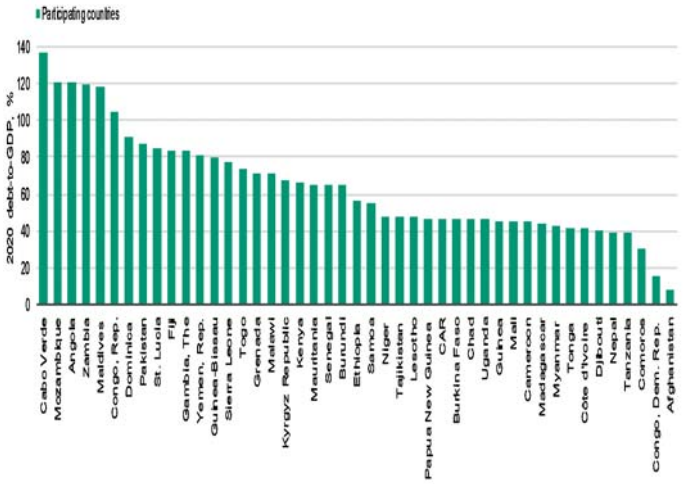

FIGURE 3. Debt to GDP Levels Across DSSI Participating Countries

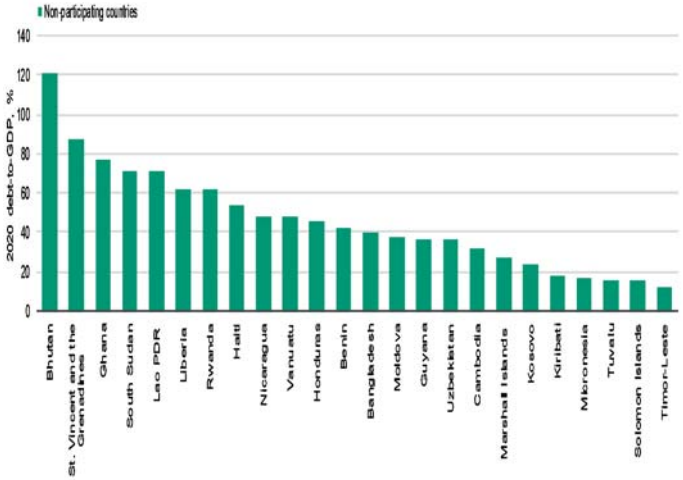

FIGURE 4. Debt to GDP Levels Across DSSI Non-Participating Countries

in the May-December 2020 period and rescheduled it to be repaid over three years with a one-year grace period (i.e., for a total of four years). The extended 2021 DSSI suspends official bilateral debt service due in the January-June 2021 period and reschedules these debt flows to be repaid over five years with a one-year grace period (i.e., for a total of six years).

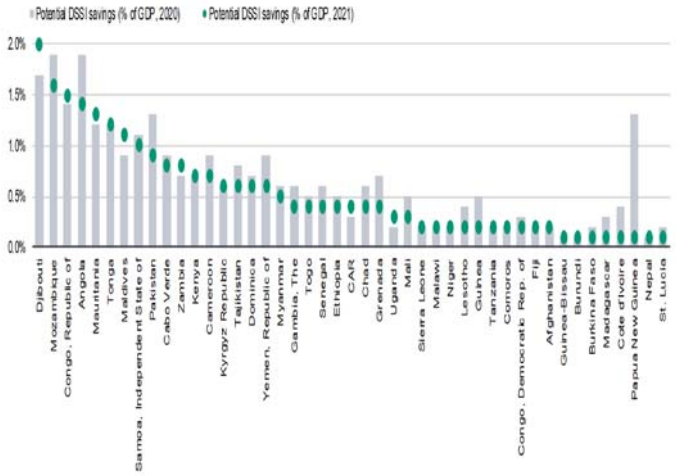

FIGURE 5. Debt Benefits Across DSSI Participating Countries

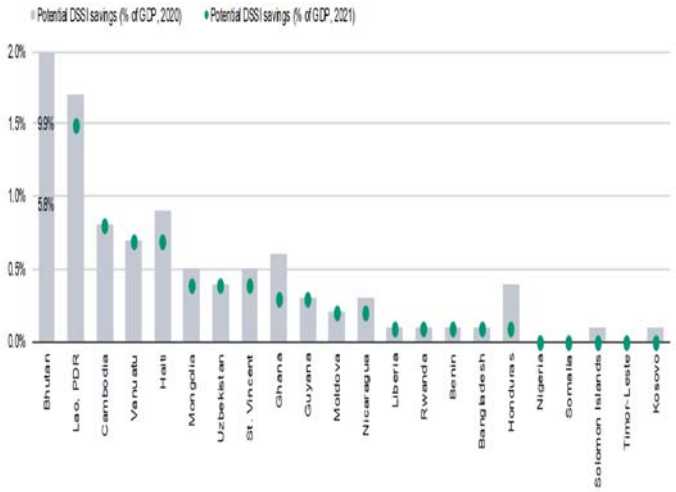

FIGURE 6. Debt Benefits Across DSSI Non-Participating Countries

As Figures 5 and 6 show, the potential savings from the DSSI range from 0% to 2% of GDP in 2020 and 2021 across countries, according to World Bank estimates (World Bank [2020]), except for Bhutan, where potential savings are larger. The average potential DSSI savings represent 0.6% of GDP in 2020 and 0.6% of GDP in 2021 across the 73 countries. This is modest relative to an average expansion of external

financing needs of 5% of GDP in 2020, by World Bank estimates. The median 2020 DSSI savings are 0.6% of GDP for the group of countries participating in the DSSI vs. 0.3% of GDP for non-participating countries.

IV. Creditor Universes and Debt Type

A prominent topic of debate within the international community related to the DSSI initiative has been the question of providing relief on private-sector debt, in addition to relief on official-sector debt. The 2020 DSSI and the 2021 DSSI extension have de facto included only official-sector debt in the debt treatments. But the Common Framework for Debt Treatment beyond the DSSI specifies that any debt relief will require countries to seek comparability of treatment for private-sector debt. From a credit perspective, Moody's has not changed any ratings based on countries' participation in the DSSI initiative and the initiative has so far not resulted in losses on private-sector debt. However, participation in the Common Framework raises risks for private-sector creditors as comparability of treatment provisions could result in losses on private-sector debt (Moody's [March 2021]).

As sovereign debt markets have evolved over time, the creditor universe has become more diverse as well. Over time, the share of domestic debt in the overall debt stock has grown, with local banks serving as major creditors (Moody's [2015]). There is also a larger share of investors who invest on behalf of others, including pension funds, insurance companies, central banks and sovereign wealth funds. In terms of official-sector lending, the Paris Club is no longer the largest official creditor and the role of China as a creditor has grown over time (Moody's [26 November 2020]). As Figure 7 shows, China now represents the largest share in bilateral debt for a number of countries. The role of project financing and secured lending such as commodity-backed lending has increased as well. All of these changes affect creditor coordination, the ability and willingness of creditors to take losses in a debt restructuring, and debtor-creditor negotiations.

The trade-off for policymakers in countries that face sovereign debt restructurings of private-sector debt is between the benefits of debt relief and the potential cost of loss of market access and inevitable higher future financing costs. The duration of market exclusion and heightened financing costs will depend on the external environment and

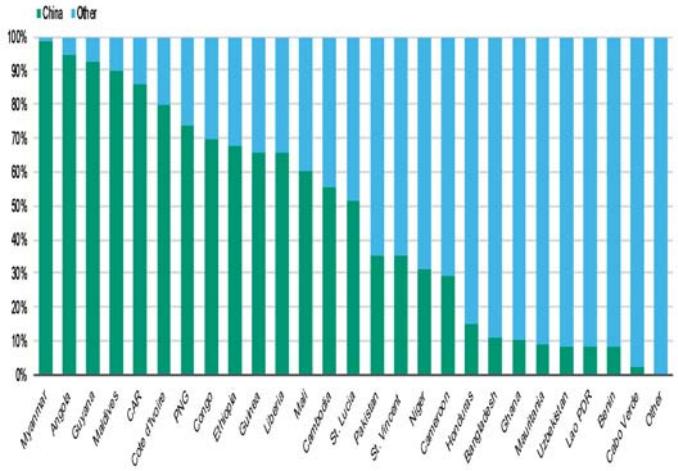

FIGURE 7. Share in Bilateral Debt

creditors expectations for future policy, growth and debt sustainability. It is likely that the current low-yield environment and the global and external nature of the COVID-19 shock will result in shorter periods of market exclusion than might otherwise be the case, but, in Moody's view, country-specific circumstances will matter. Moreover, the historical record on market re-access post-default sends a cautious message. Moody's has found that between 1997 and 2019, the average period of market exclusion was relatively long, at 6.1 years after default and 4.9 years after default resolution. Moody's has not found evidence that market re-access has become quicker in more recent years, even though default resolution has become faster over time (Moody's, August 2020).

V. Sovereign Defaults

Given the large increases in debt levels globally, the fact that economic activity in some countries will remain impaired for several years, and the exposure of some emerging and frontier market economies to capital outflows and curtailment of market access, Moody's expects the deterioration in sovereign creditworthiness to persist for a few years. As Figure 8 shows, sovereign defaults were elevated in 2020. Moody's observed six bond defaults of rated issuers in 2020 compared with one

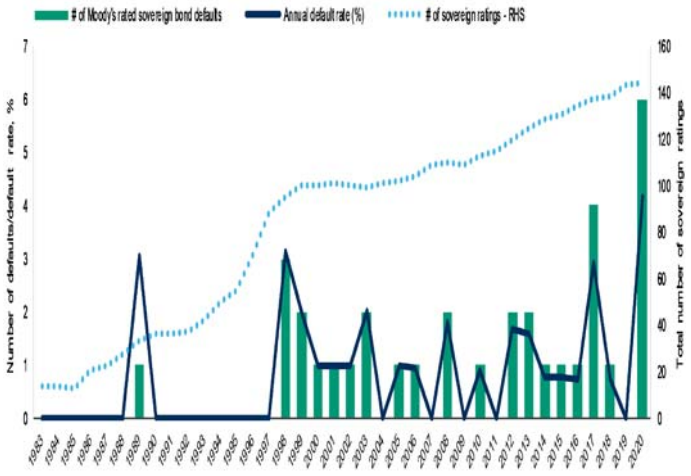

FIGURE 8. Moody's Rated Sovereign Defaults

to two per year, on average, in the previous decades. Moody's sovereign outlook for 2021 is negative (Moody's [November 2020]) and as of the end of 2020, 18 sovereign ratings were in the Caa-C category. That represents 13% of Moody's 144 sovereign ratings, an elevated percentage relative to previous years. Medium-term sovereign credit implications will ultimately depend on the strength of the economic recovery and on the ability of governments to reverse debt trajectories ahead of future shocks.

VI. Concluding Remarks

The COVID-19 shock will contribute to unprecedented increases in debt levels globally. While debt affordability is improving in many advanced economies due to low interest rates, debt affordability in emerging and frontier markets is deteriorating across regions. The G-20 DSSI initiative will alleviate liquidity pressures for participating countries, but in general the savings from debt relief under the DSSI are modest relative to the fiscal deterioration brought about by the COVID-19 shock. Countries eligible for the DSSI and the Common Framework differ greatly in terms of their debt-to-GDP levels, debt sustainability positions and credit risk, potential benefits from DSSI debt relief, and creditor universe. This diversity will necessitate tailored approaches to debt relief, taking into account country-specific circumstances.

Overall, sovereign defaults were elevated in 2020 and may remain so in 2021. The most vulnerable sovereigns are emerging and frontier economies exposed to tourism, volatile commodity prices and loss of market access. But medium-term sovereign credit implications will ultimately depend on the strength of the economic recovery and on the ability of governments to reverse debt trajectories ahead of future shocks.

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