Sovereign debt pressures: will we cope?

G-24 Webinar on Emerging Issues on Sovereign Debt

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Outline

1. Debt flows to EMDE’s during this crisis: what has happened so far.

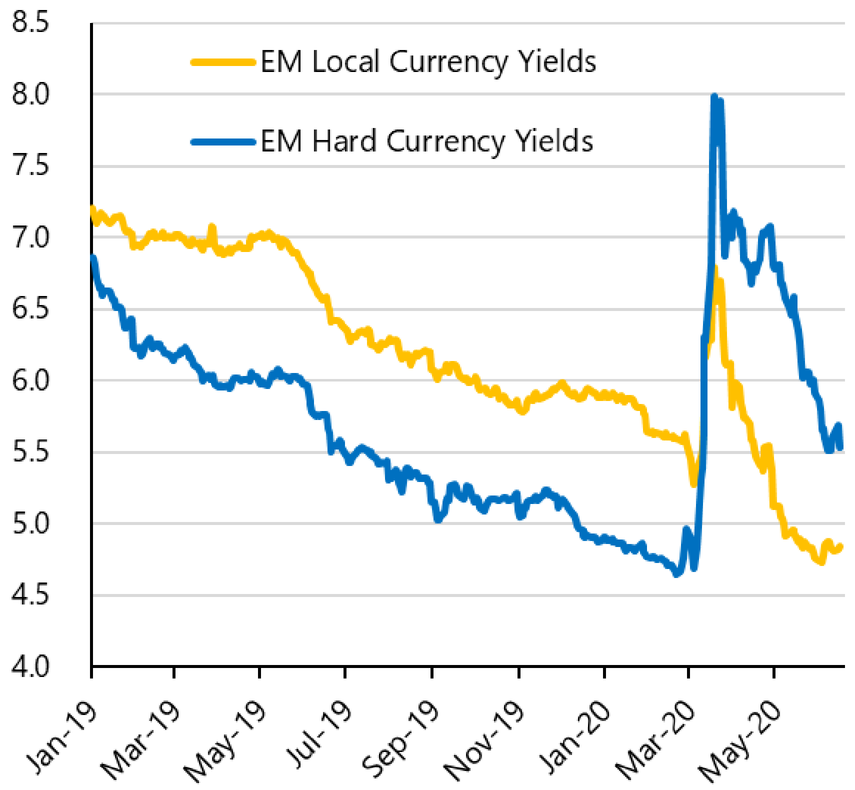
2. Debt flows to EMDE’s during this crisis: what may happen going forward.

3. Implications for crisis management. Can the system cope?

Looking back: between March and June, financing conditions improved dramatically for most EMs

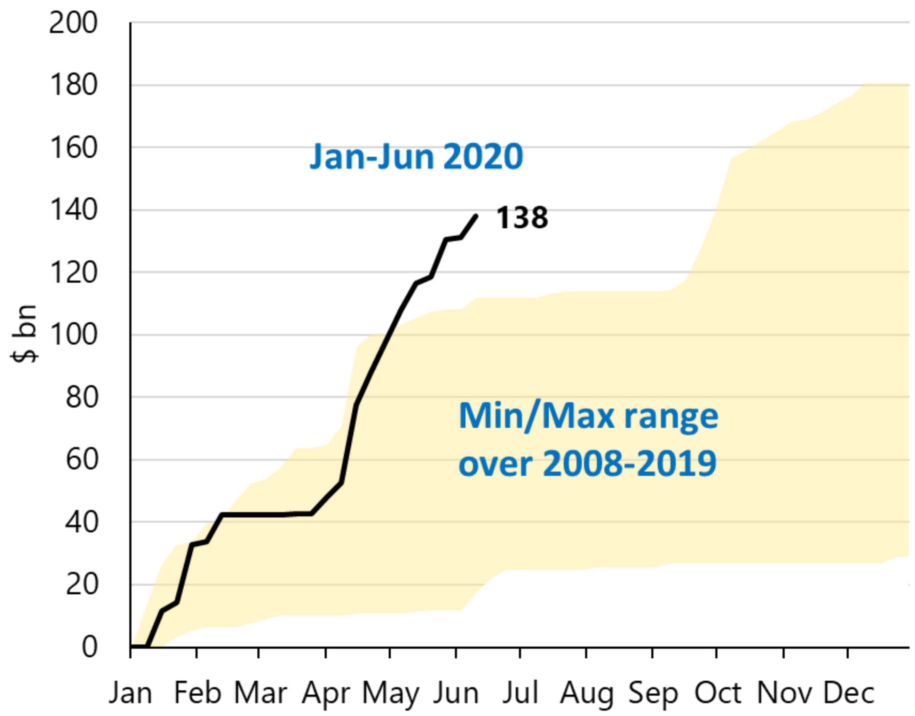
Funding costs back to mid-2019 levels on average

EM Sovereign Bond Yields
(Percent Index)



Record debt issuance

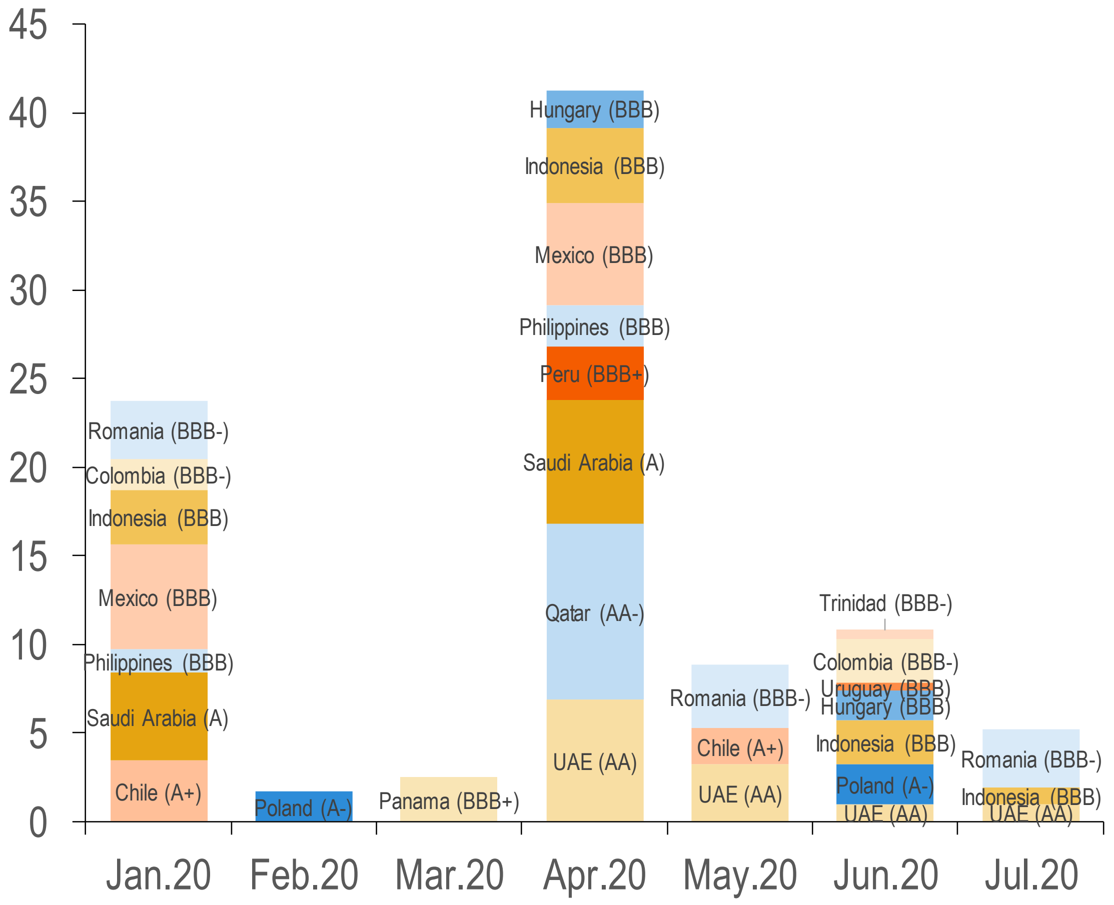
EM USD Sovereign Issuance
(Cumulative since the beginning of the year)



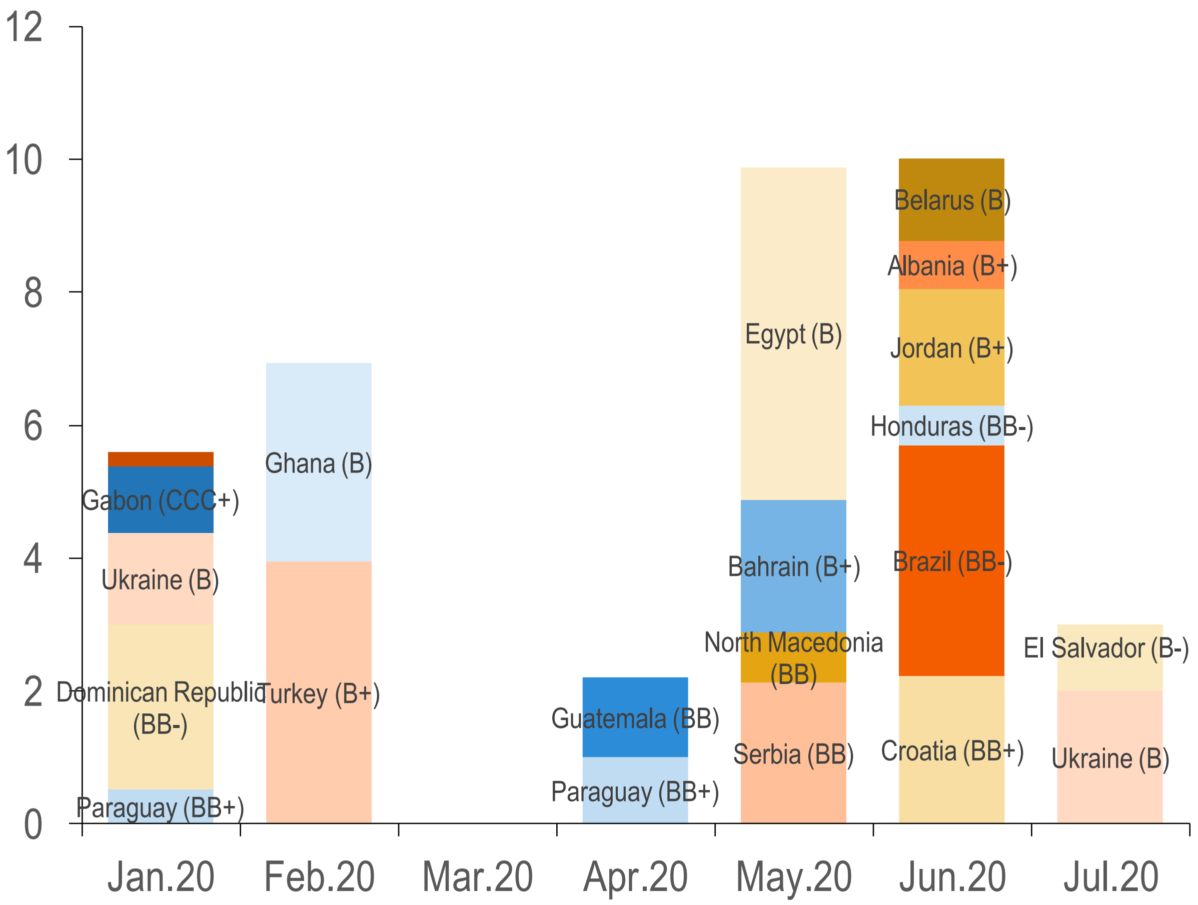
Sources: Bloomberg, Dealogic, JP Morgan,

Eurobond issue booms in April (IG), May and June (HY)

Eurobond Monthly Investment Grade Sovereign Issuance
(USD bn)

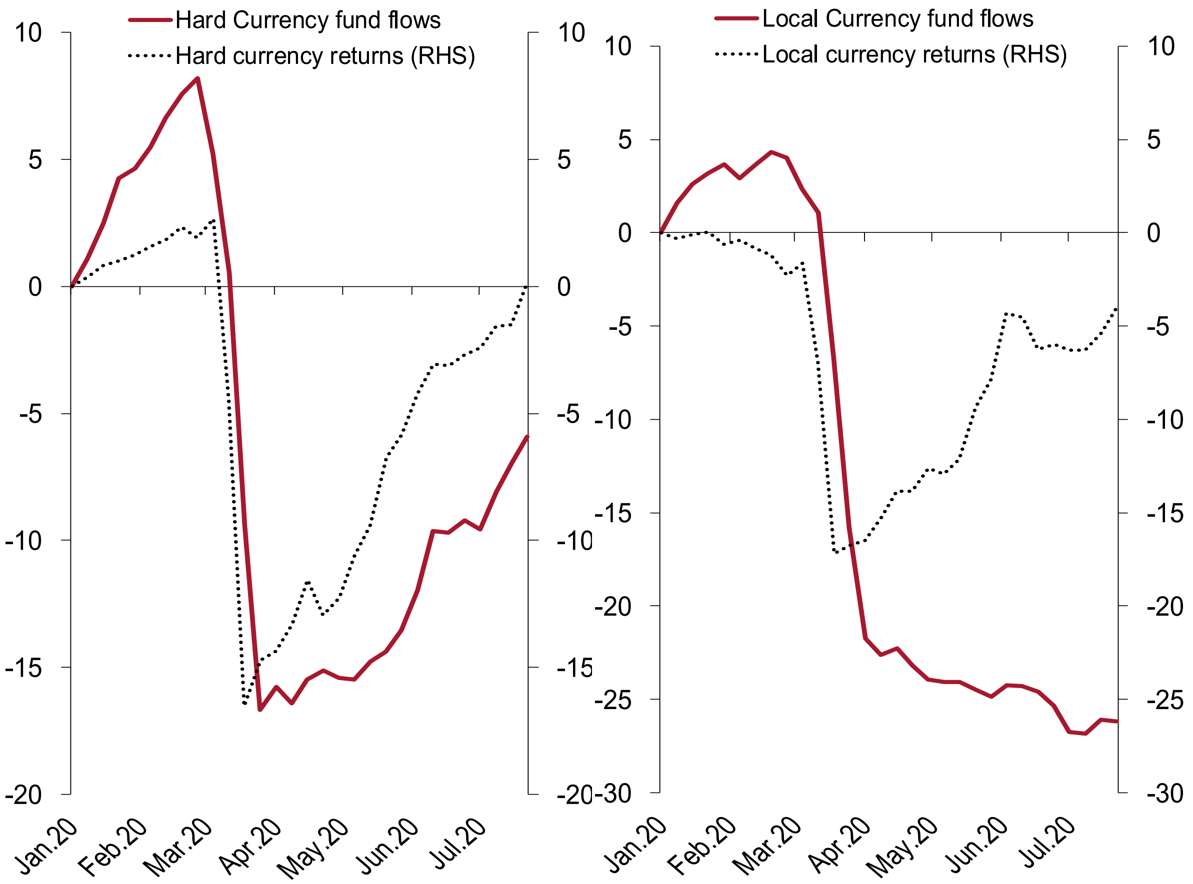


Eurobond monthly High Yield sovereign issuance
(USD bn)

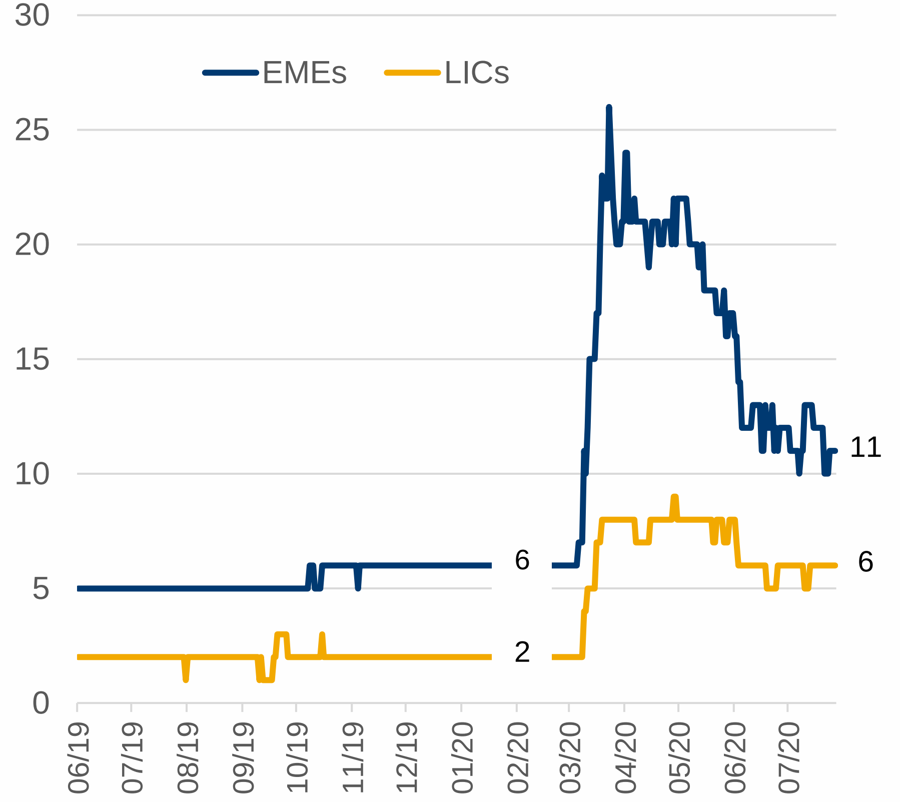


However, capital flows have not fully recovered, and some countries remain cut off from debt markets

EPFR EM Debt Dedicated Fund Flows and Returns
(Cumulative YTD USD bn and percent)



Number of countries with US$ spreads above 750 basis points



Looking forward: continued easy conditions—for a shrinking group of countries that retain fiscal space

Debt flows will be the result of two opposing forces: (1) continued very easy conditions in advanced economies; (2) shrinking room for additional borrowing in EMDEs, as debt ceilings are reached.

Three groups of EMDEs.

1. Solvent countries: benefit from relatively easy financing conditions and ample official safety nets (including IMF precautionary facilities).

2. Conditionally solvent countries: risk losing market access, but retain access to official borrowing (with standard conditionality).

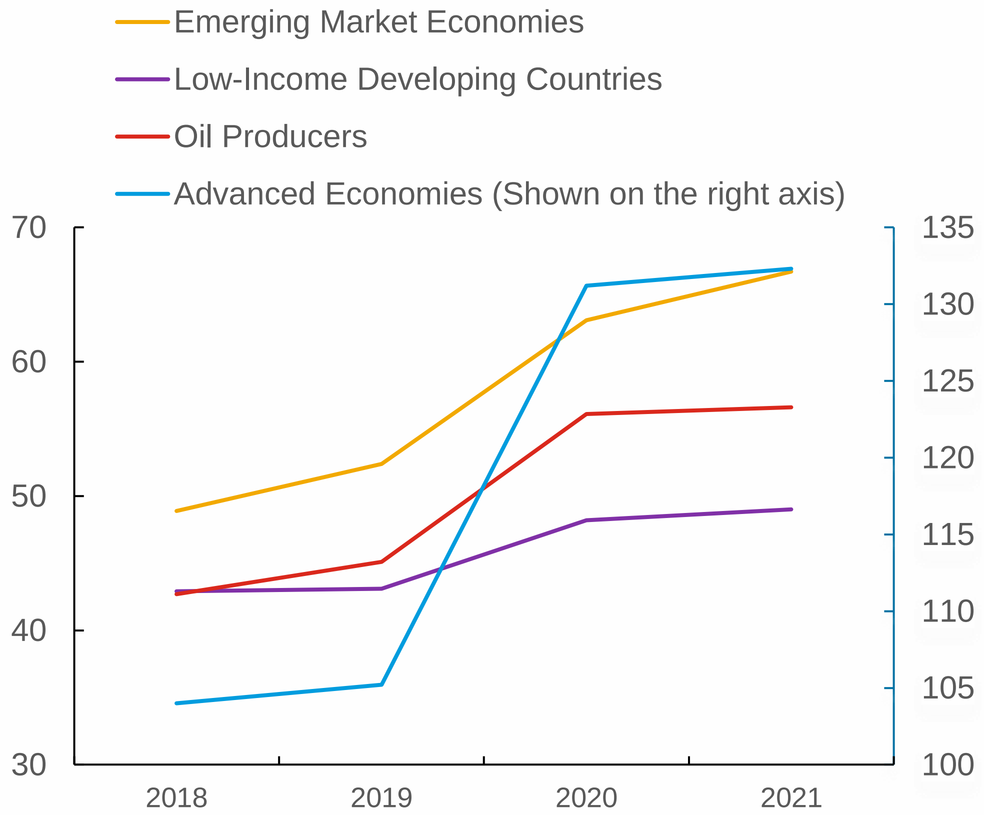
3. Insolvent countries (unsustainable debts): no market access; access to official borrowing only conditional on a debt restructuring.

As the pandemic crisis drags on, more countries will move from 1 to 2 and from 2 to 3.

It will get worse

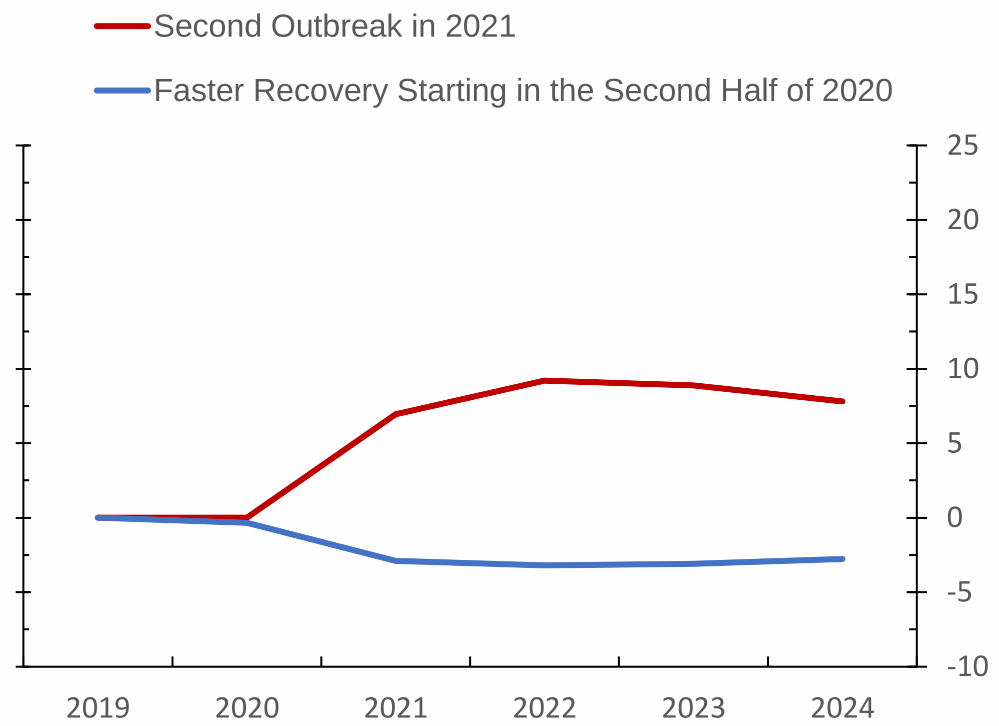
This may or may not mean that debts become unsustainable.

General Government Gross Debt Projection, 2018–21 (Percent of GDP)



Source: World Economic Outlook update, June 24, 2020

Sensitivity Analysis for EME Government Debt/GDP projection (Percentage point deviation from baseline)



Restructuring unsustainable debts: the standard (case by case) approach

1. Country at risk of losing or has lost market access—asks for IMF support.

2. IMF determines if debt is sustainable; if not, required “envelope” of debt relief.

3. IMF supported program conditional on a process being in place that restores debt sustainability. Typically requires: (1) a credible restructuring offer to private creditors under way; (2) an agreement in principle with (or credible and specific assurances from) official sector creditors.

4. Program typically catalyzes support from other IFIs, including World Bank; fresh money from bilaterals. Provides finance to (again) solvent country until market access is restored.

Could this approach get overwhelmed?

The number of countries looking to multilateral agencies for support and running into legal disputes with creditors could make this the worst emerging-market debt crisis since the 1930s at least, said Kenneth Rogoff, chief economist of the IMF from 2001 to 2003 … "They can't handle that—the New York and London courts can't, the IMF can't," he said. "It is a case of too many patients coming to the hospital at once." (WSJ, July 27 2020)

Not so sure.

- So far, no *systemic* debt crisis (thanks to relatively easy global financial conditions).
- Even if we get one: the debt restructuring/IMF "hospital" is run by (existing) country by country "wards". Courts come in later, if at all.
- Problem in the 1980s was not that the system was overwhelmed, but that the system confused solvency crises with liquidity crises. We have learned.

This does not mean there is no problem

1. Procrastinating debtor countries (ask for help too late).

2. Difficult private creditors/holdouts.

   - “Enhanced CACs” help, but not a panacea:

     - Only around 50 percent of stock;

     - First “tests” delivering mixed results. Creditor collusion in response to greater flexibility?

     - Do not help coordination between bond holders and other claim holders (banks, commodity traders … no CACs);

     - Presence of collateralized debt.

3. A new challenge: *official* creditor coordination (Paris Club vs. non Paris Club)

Overcoming these problems if things gets bad

- IMF assurances policies can help address some of the free riding/coordination problems across creditor classes (require assurances to achieve high participation).

- Most creditor coordination failures can be solved *by the debtor*, given sufficient legal and political cover.

- It is in the power of the official sector (e.g. G20, UN security council members) to provide such cover:
  - “State of necessity” (Bolton, Buchheit et al)
  - Domestic legislation (or in the case of the U.S., Presidential Executive Order) that curtails power of holdouts to enforce
  - UN security council declaration that acts *internationally* with the same effect.

- But doing so requires a common sense of purpose among the big countries.