Addressing Debt Distress in Emerging and Developing Economies

Ugo Panizza

Geneva Graduate Institute &

CEPR

Institute of International Political Economy
Berlin School of Economics and Law
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Outline

- Facts
  - Debt levels and borrowing costs
  - Debt dynamics
  - Fiscal risk
  - Debt spikes and debt reductions
- Policies
  - When solvency is the key issue
  - When liquidity is the key issue
- Takeaways

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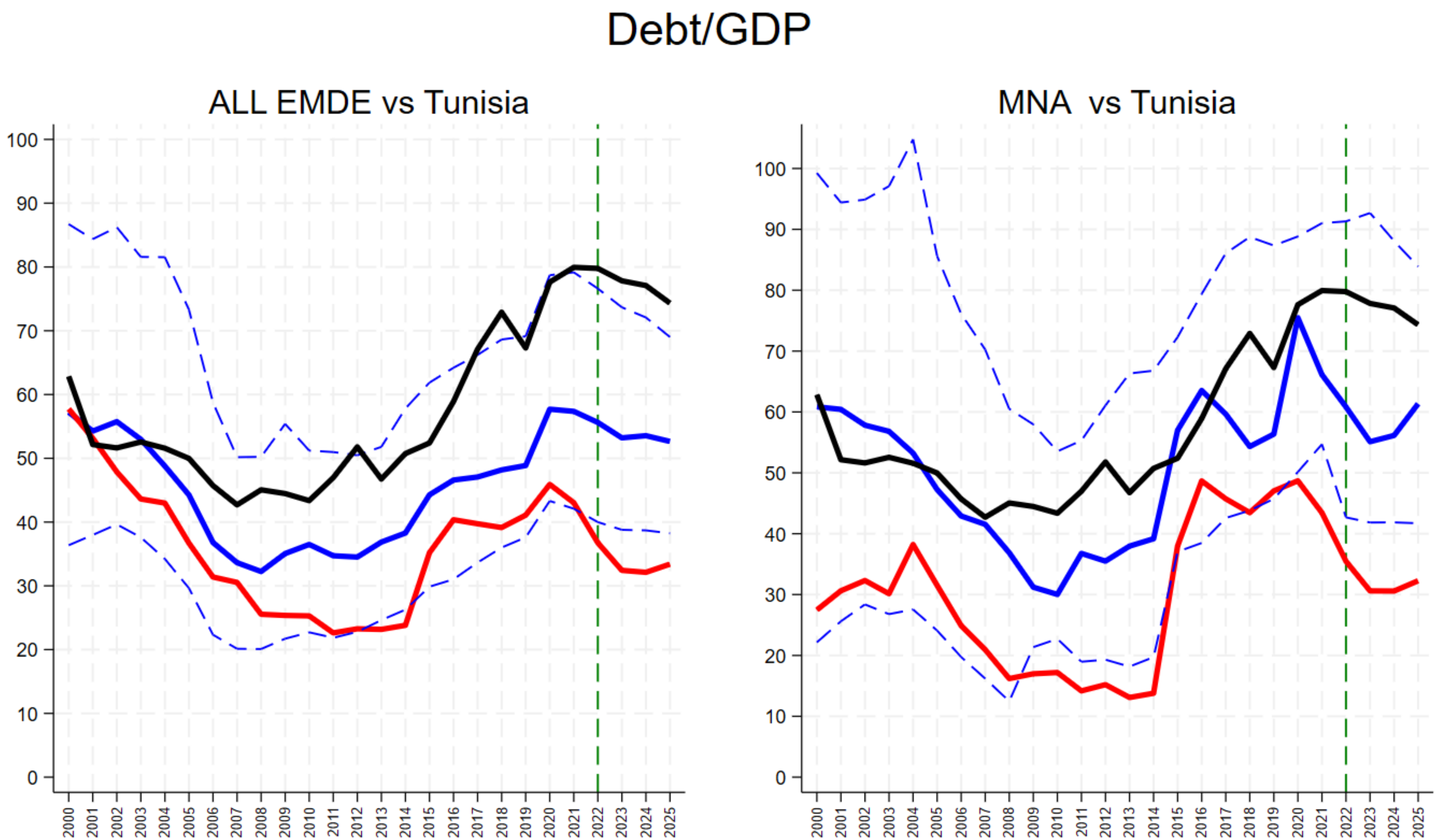
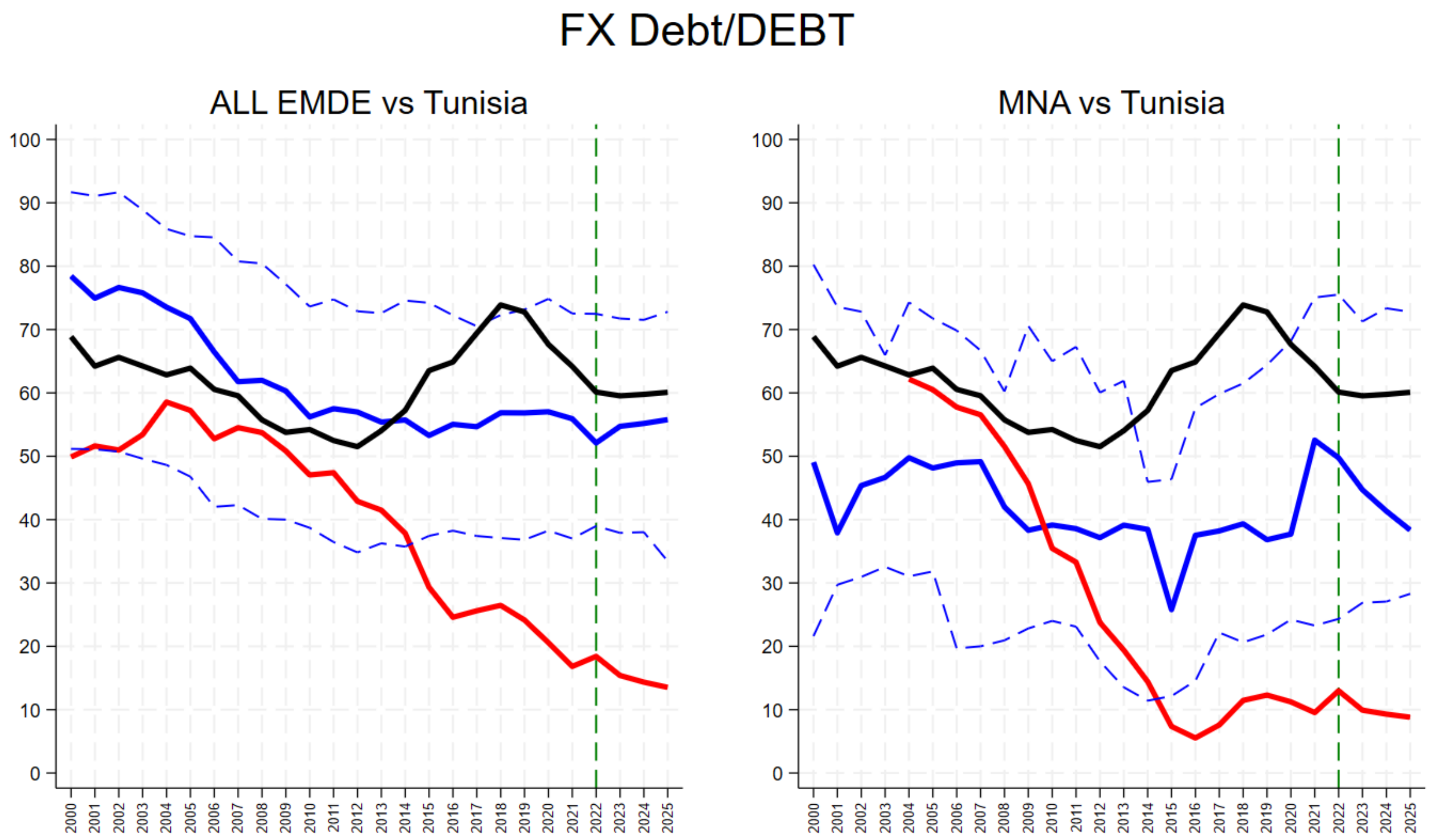
Debt is high…



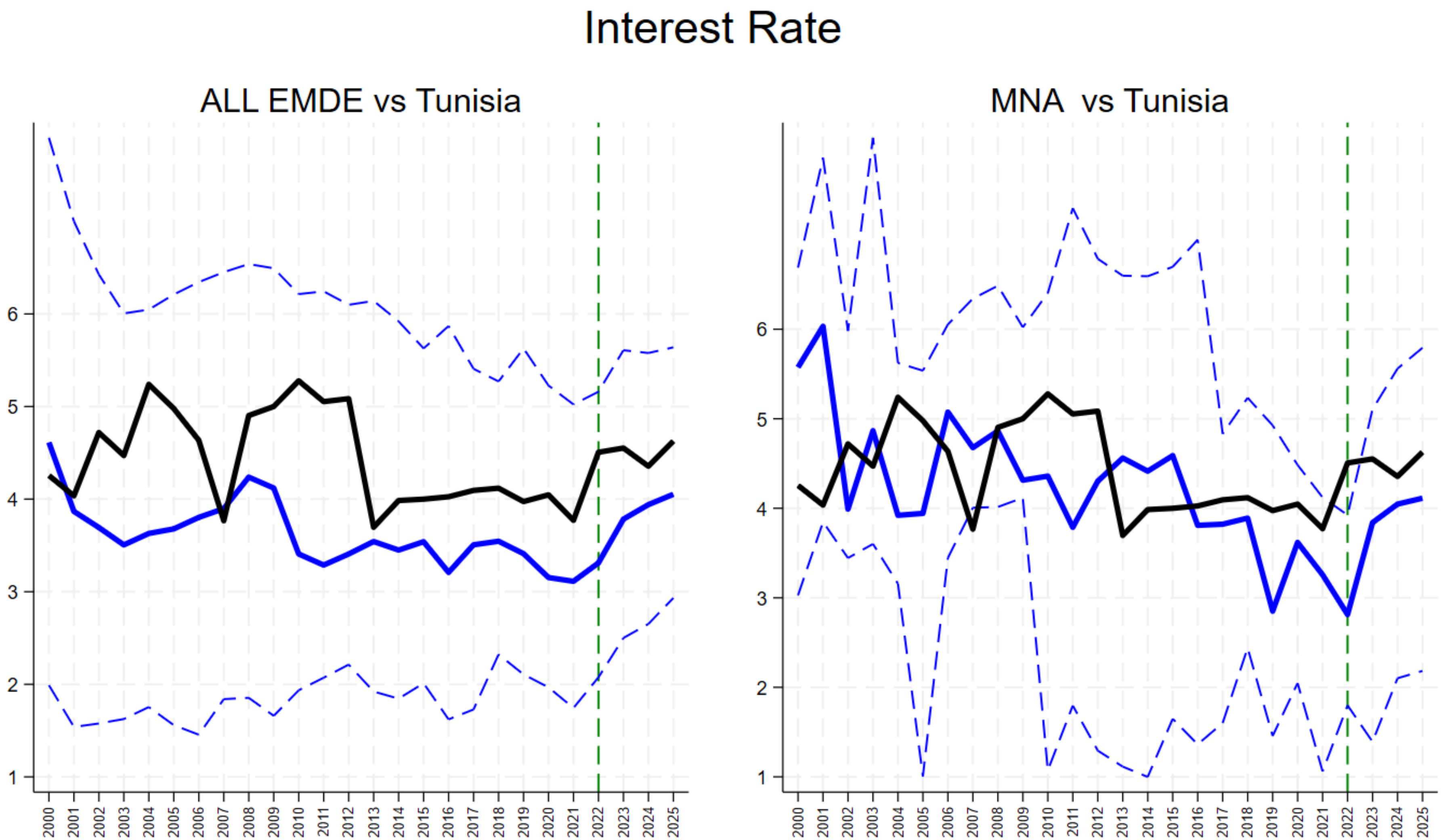
Median **Weighted average (excluding China and India)**

…the share of FX debt has been decreasing, but not everywhere…

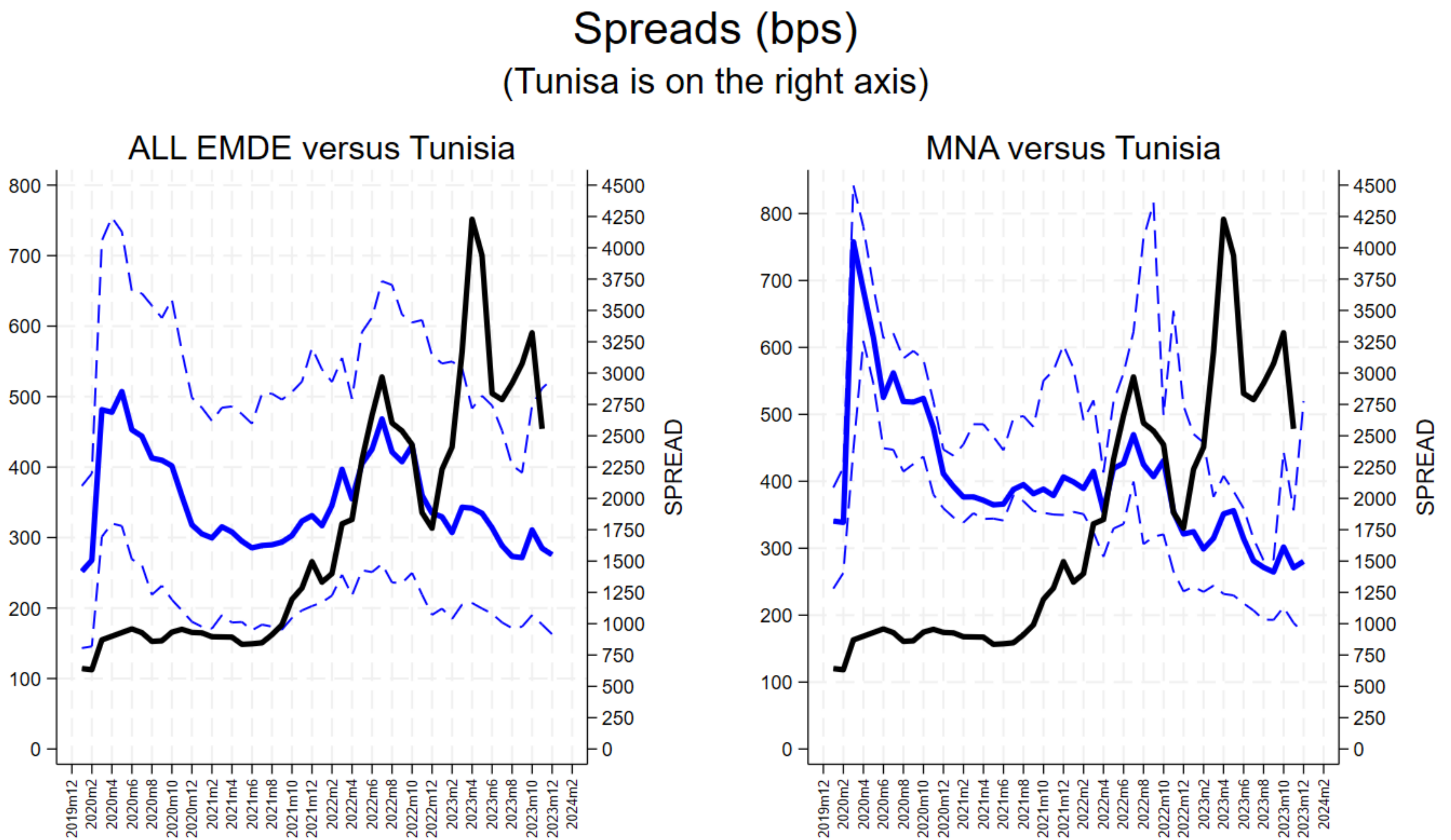


Median **Weighted average (excluding China and India)**

…interest rates are increasing…

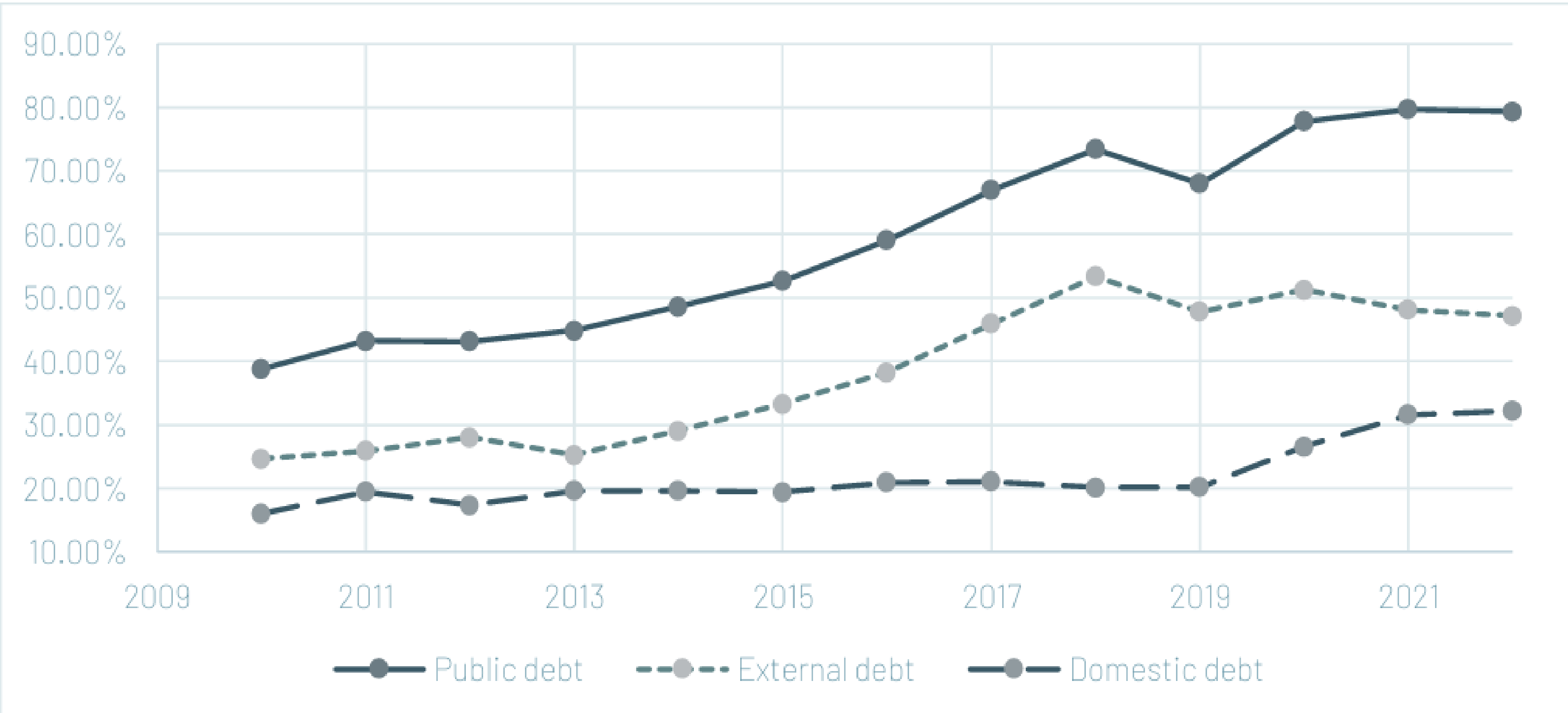


…spreads are high and volatile…



Tunisia: The fastest increase in debt took place over 2010-19 and was driven by external debt; after 2019 domestic debt has become more important…

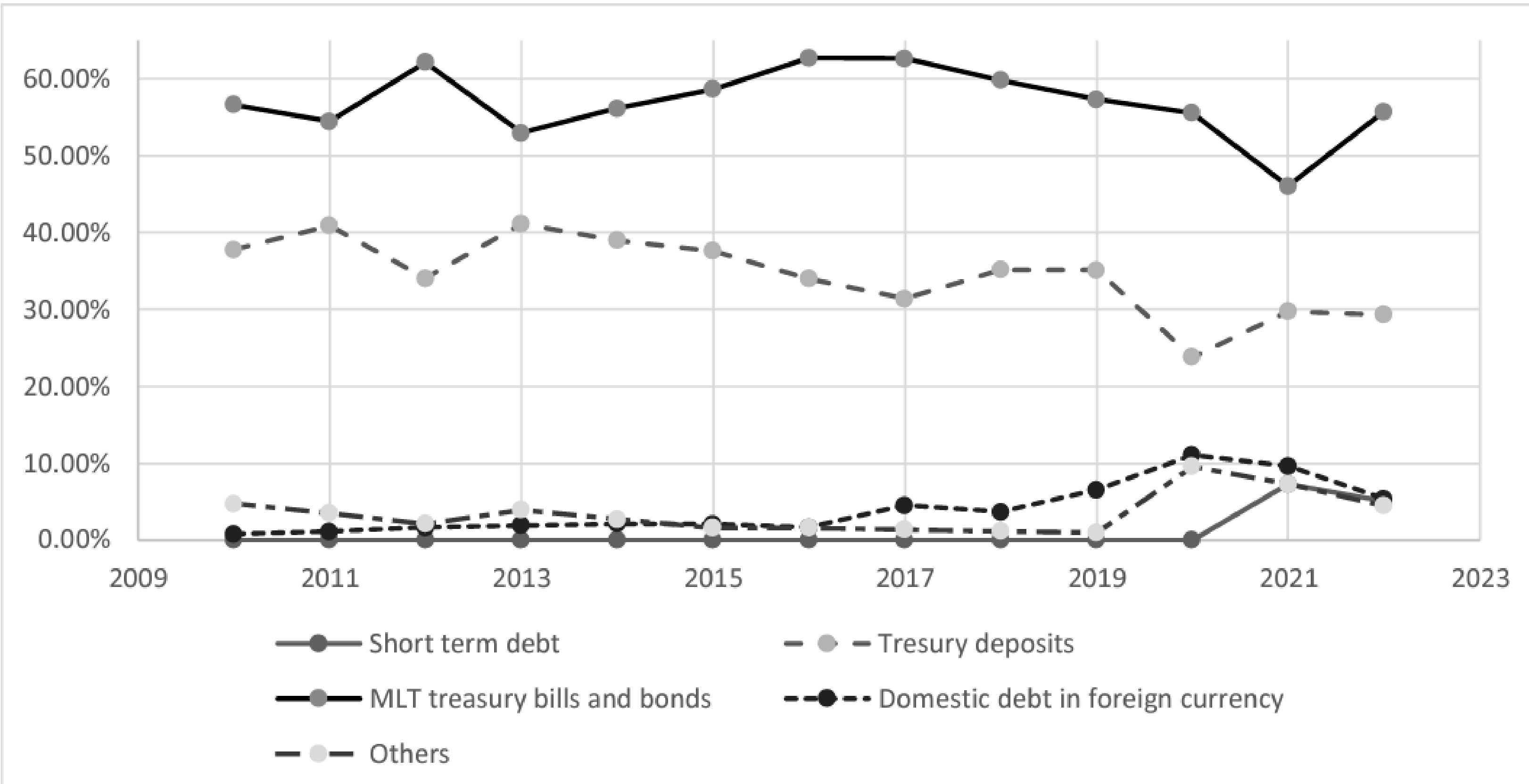
Figure 1. Debt-to-GDP ratios, 2010-22 (%)



Source: Baghdadi and Labidi (2023)

…domestic debt is mostly short-term…

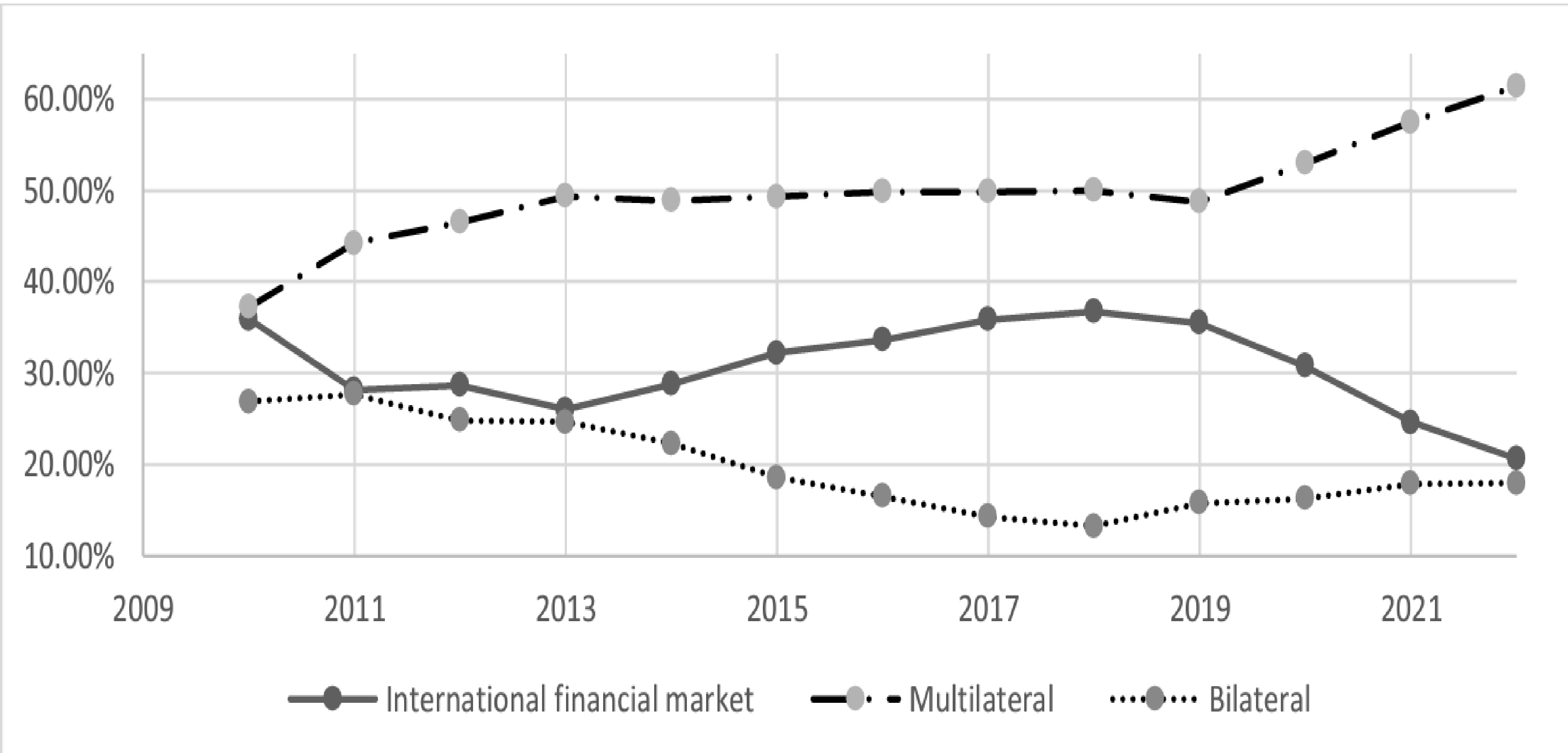
Figure 5. Domestic debt components (% of domestic debt), 2010-22



Source: Baghdadi and Labidi (2023)

…and external debt is now mostly with official multilateral creditors

Figure 4. Composition of external debt (%): 2010-22



Source: Baghdadi and Labidi (2023)

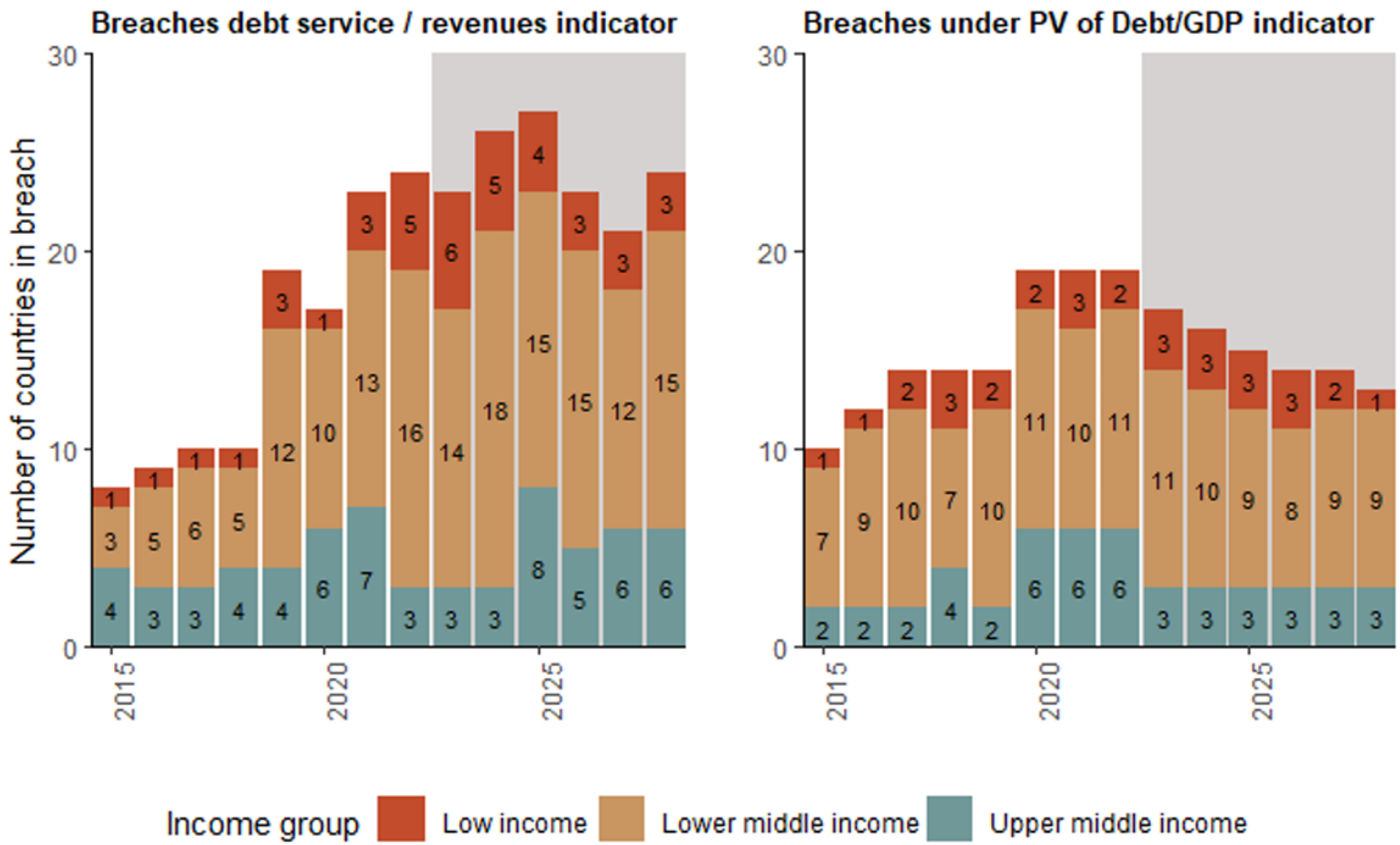
Table 1: IMF/World Bank's Debt Carrying Capacity

Debt carrying capacity (CI classification)	PV of PPG external debt in percent of		PPG external debt service in percent of	
	GDP	Exports	Exports	Revenue
Weak	30	140	10	14
Medium	40	180	15	18
Strong	55	240	21	23

Source: DSF Guidance Note

Source: Albinet, Kessler and Brancher (2023)

Liquidity versus Solvency



Source: Albinet, Kessler and Brancher (2023)

Income Group	Country	IMF-WB ..	Baseline	Pessimistic	
			Flow only	Flow only	Stock breach
Low income	Central African Rep..	High	✓	✓	
	Chad	High	✓	✓	
	Ethiopia	High	✓	✓	
	Gambia, The	High	✓	✓	
	Madagascar	Moderate	✓	✓	
	Togo	Moderate		✓	
Lower middle income	Angola		✓		✓
	Benin	Moderate	✓	✓	
	Cameroon	High	✓	✓	
	Comoros	High	✓	✓	
	Côte d'Ivoire	Moderate	✓		✓
	Egypt, Arab Rep.		✓	✓	
	Guinea	Moderate	✓	✓	
	Jordan		✓	✓	
	Kenya	High	✓		✓
	Pakistan		✓	✓	
	Papua New Guinea	High	✓		✓
	Senegal	Moderate	✓	✓	
	Tajikistan	High		✓	
	Tanzania	Moderate		✓	
	TUNISIA		✓		✓
Upper middle income	Dominican Republic		✓	✓	
	El Salvador		✓		✓
	Gabon		✓	✓	

Source: Albinet, Kessler and Brancher (2023)

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Debt Dynamics 101

- Change in the debt to GDP (d) ratio $\Delta \boldsymbol{d}$=

  - primary balance over GDP $\boldsymbol{pb}$

  - (real GDP growth)X(initial debt/GDP) $\boldsymbol{g d_{t-1}}$

  - (inflation)X(initial debt/GDP) $\boldsymbol{\pi d_{t-1}}$

  + (interest rate)X(initial debt/GDP) $\boldsymbol{i d_{t-1}}$

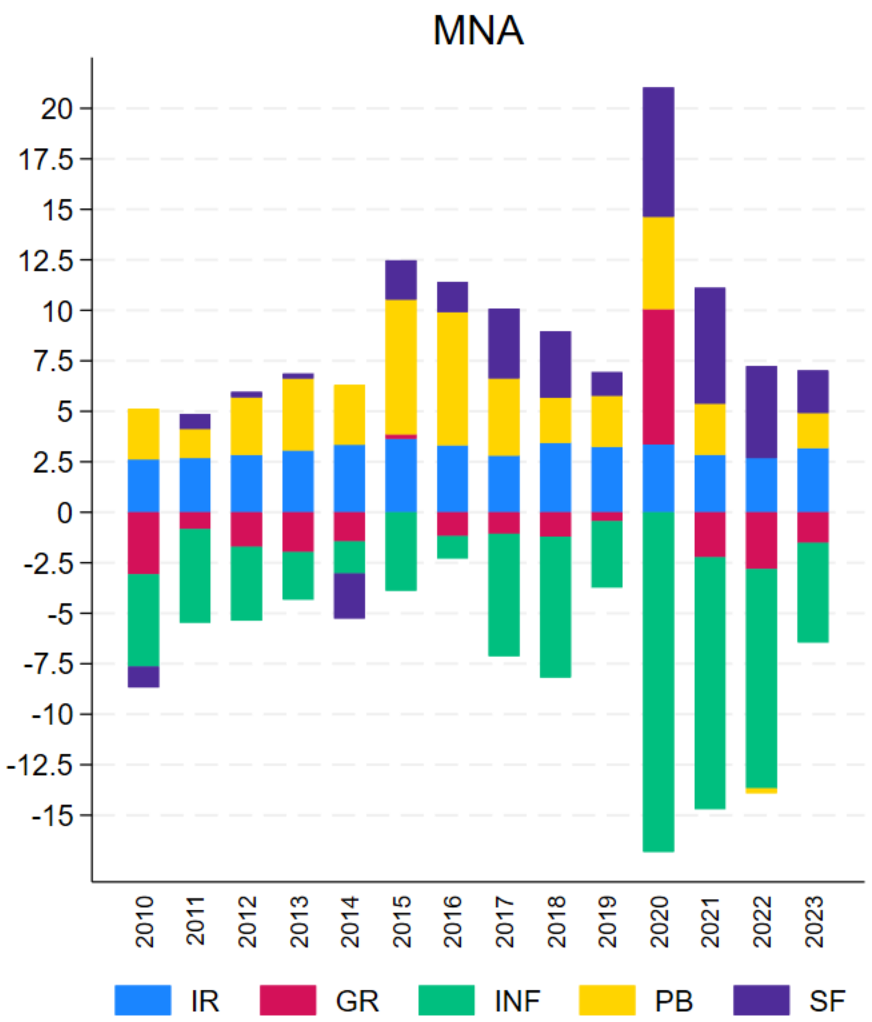
  + stock-flow reconciliation $\boldsymbol{sf}$

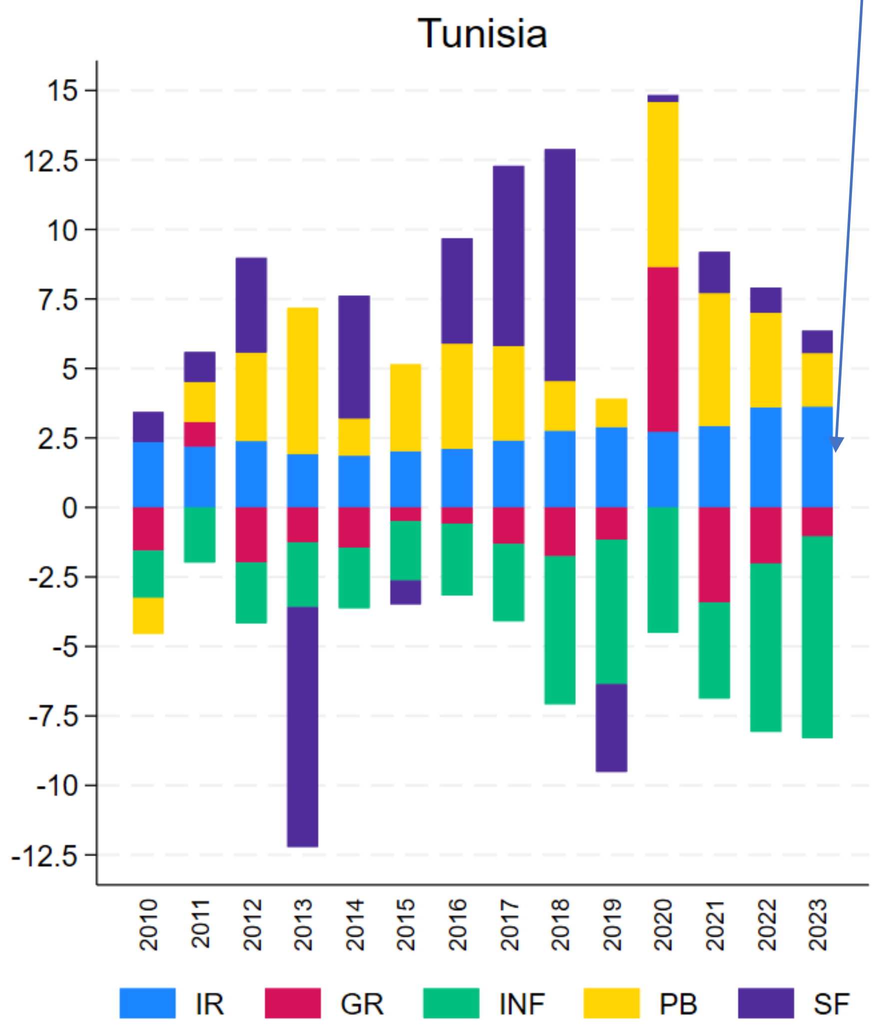
  (AKA, the unexplained part of debt)

$$\Delta \boldsymbol{d} = -\boldsymbol{pb} + (\boldsymbol{i} - \boldsymbol{g} - \boldsymbol{\pi})\boldsymbol{d_{t-1}} + \boldsymbol{sf}$$

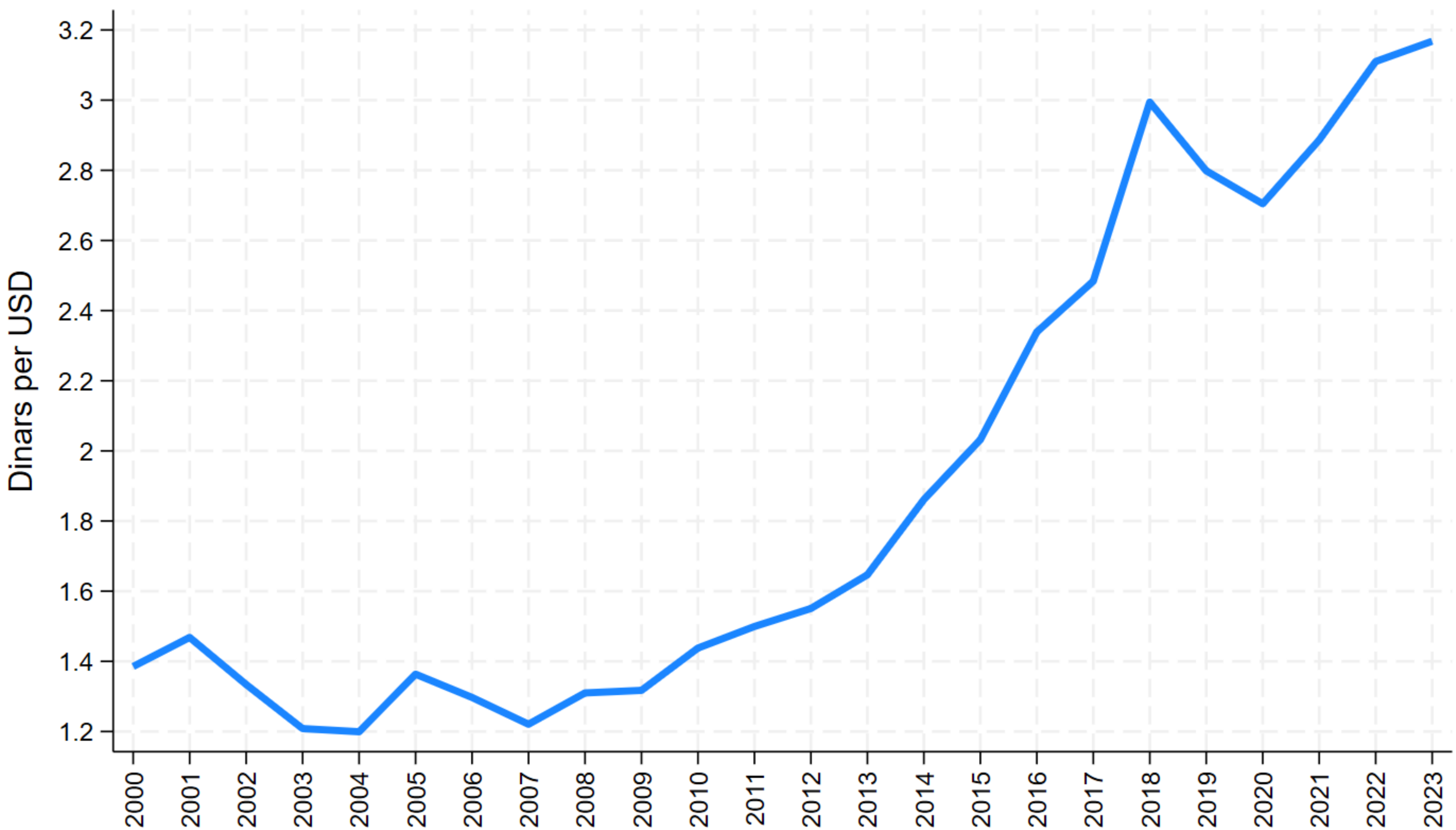
The Drivers of Debt Dynamics

Growing

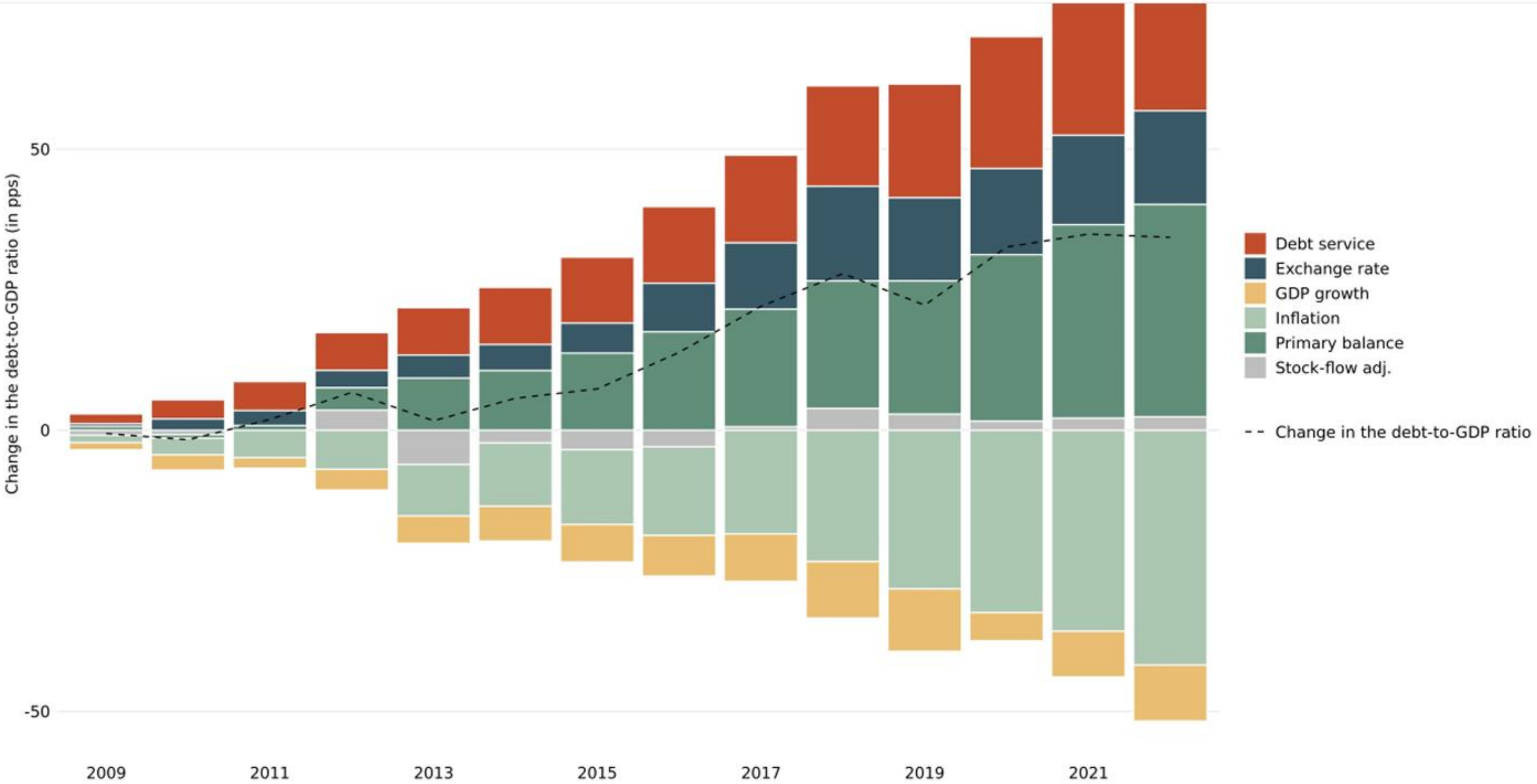




Tunisia: Exchange rate



A slightly different perspective



Source: Baghdadi and Labidi (2023)

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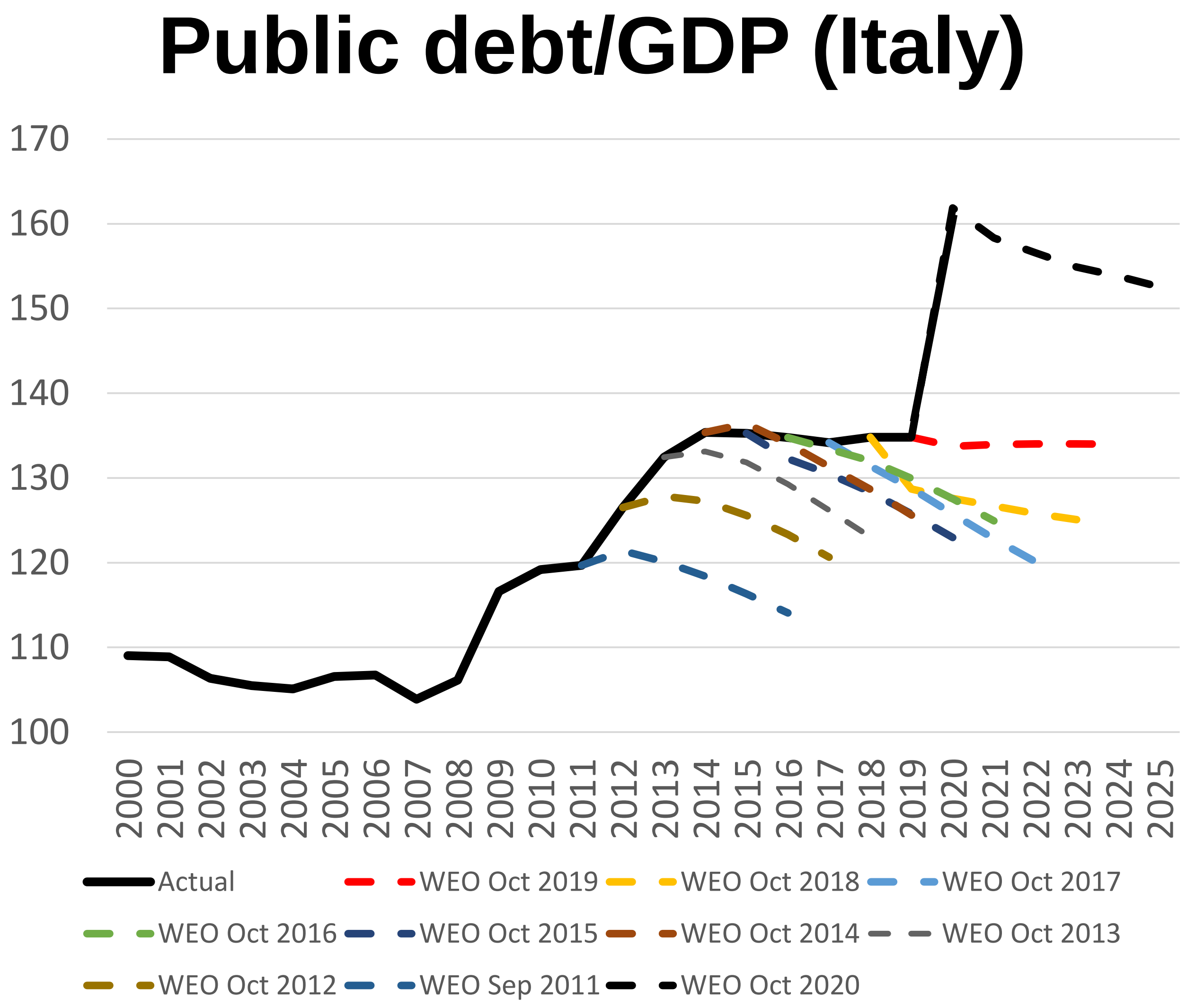
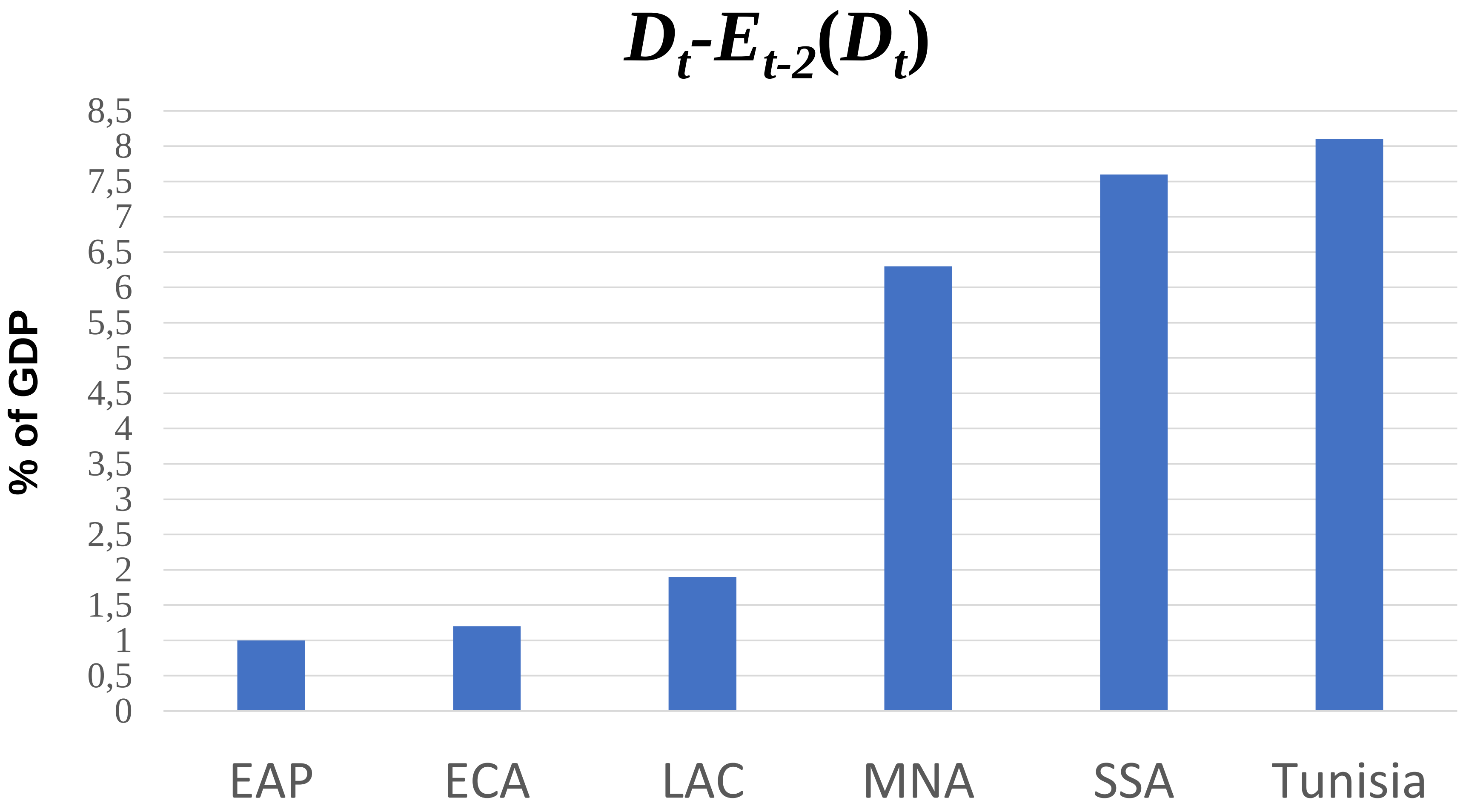
Fiscal risk

- **Definition**
  - Large or systematic deviations of fiscal outcomes from their expected values
- **Sources**
  - Macro shocks (GDP growth, exchange rate, inflation, and interest rate)
  - Policy shocks (policy slippages and change in government policies)
  - Realization of contingent liabilities
  - Strategic forecasts

Fiscal risk in a nutshell



Outturns minus forecasts



Source: Panizza (2020)

Debt Dynamics & Forecast Errors

$$\frac{d_t - E_{t-1}d_t}{d_{t-1}} =$$

$$(i - E_{t-1}i) +$$ **INTEREST Forecast Errors**

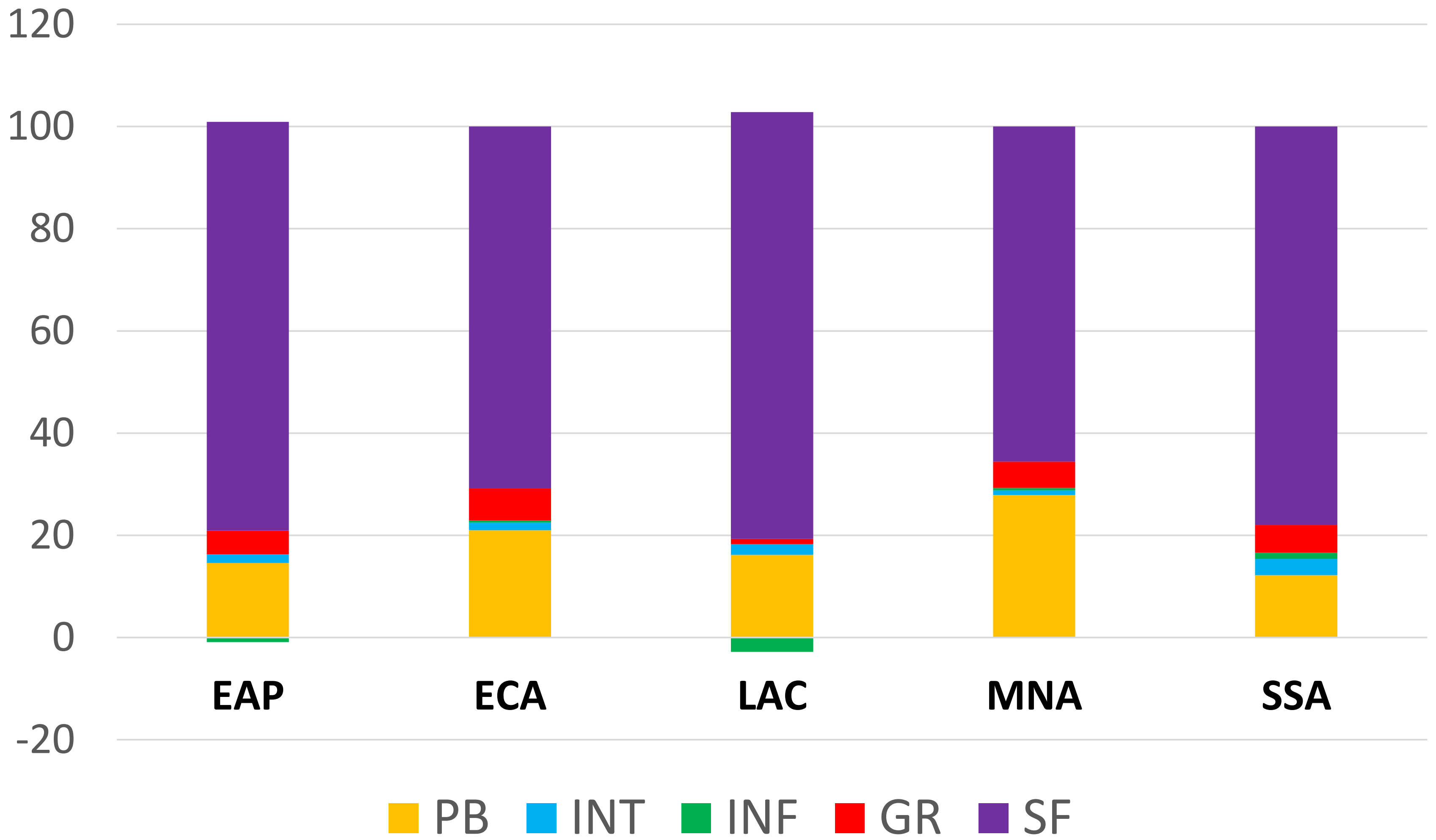
$$-(\pi - E_{t-1}\pi) +$$ **INFLATION Forecast Errors**

$$-(g - E_{t-1}g) +$$ **GROWTH Forecast Errors**

$$-\frac{pb_t - E_{t-1}pb_t}{d_{t-1}} +$$ **PRIMARY BALANCE Forecast Errors**

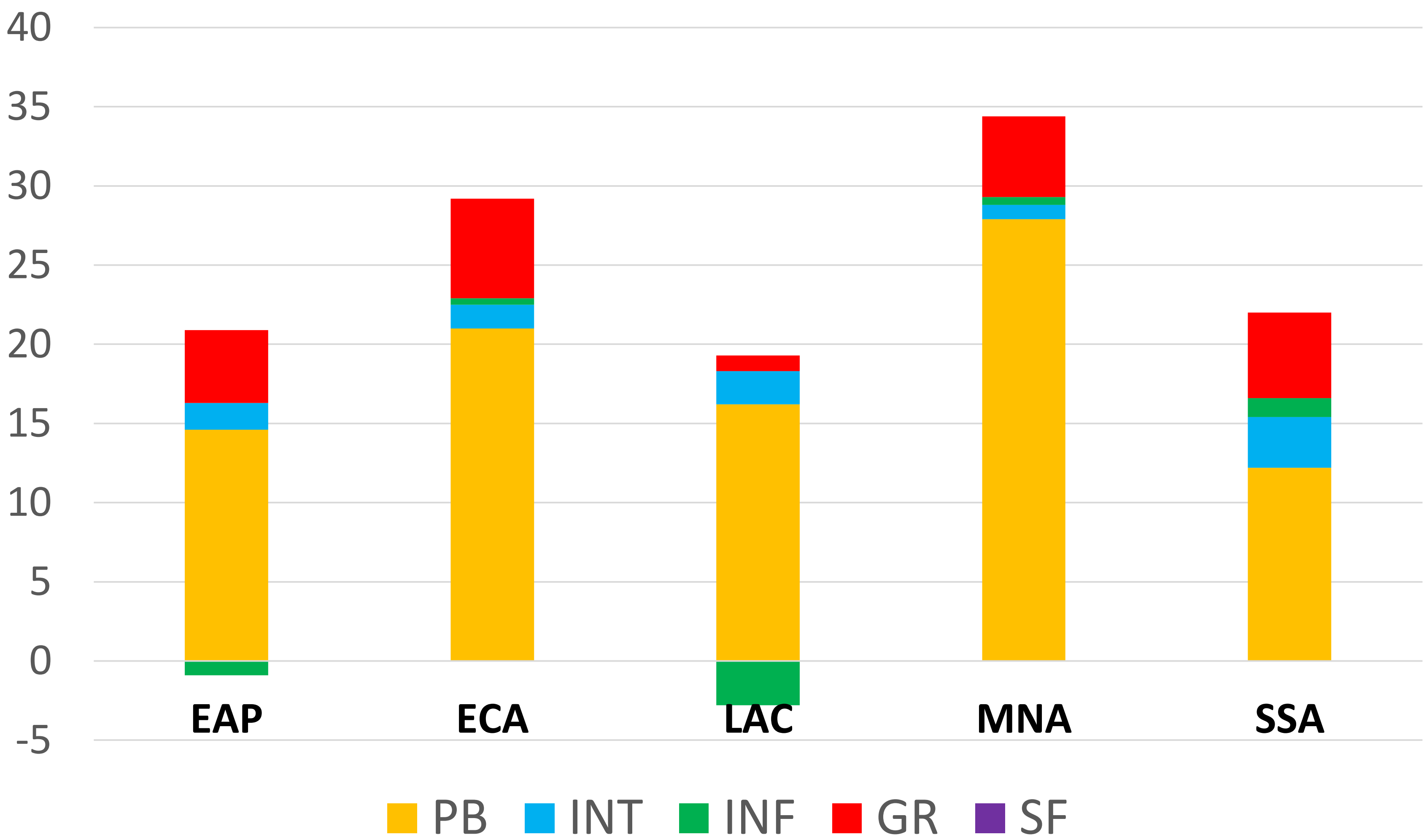
$$+\frac{sf_t - E_{t-1}sf_t}{d_{t-1}}$$ **STOCK FLOW RECONCILIATION**

Components of debt risk



Source: Panizza (2020)

Components of debt risk



Source: Panizza (2020)

Fiscal risk and the exchange rate

	(1)	(2)	(3)	(4)
GRxGT	-1.537***	-0.133	-1.479***	-0.131
	(0.240)	(0.291)	(0.215)	(0.288)
GRxBT	-2.099***	-0.382**	-2.048***	-0.451**
	(0.496)	(0.152)	(0.527)	(0.176)
BT	0.00353	0.0343*	0.00241	0.0364**
	(0.0113)	(0.0177)	(0.0110)	(0.0180)
DXR	**-0.0212**	**-0.242*** **	**-0.0430**	**-0.250*** **
	(0.0524)	**(0.0511)**	**(0.0548)**	**(0.0564)**
INF			0.987**	-0.0886
			(0.376)	(0.0893)
N. Obs	291	1,216	291	1,213
N. Cy	26	163	26	163
Cy FE	Yes	Yes	Yes	Yes
Sample	**AE**	**EM&DEV**	**AE**	**EM&DEV**

Robust standard errors in parentheses; *** p<0.01, ** p<0.05, * p<0.1

Source: Panizza (2020)

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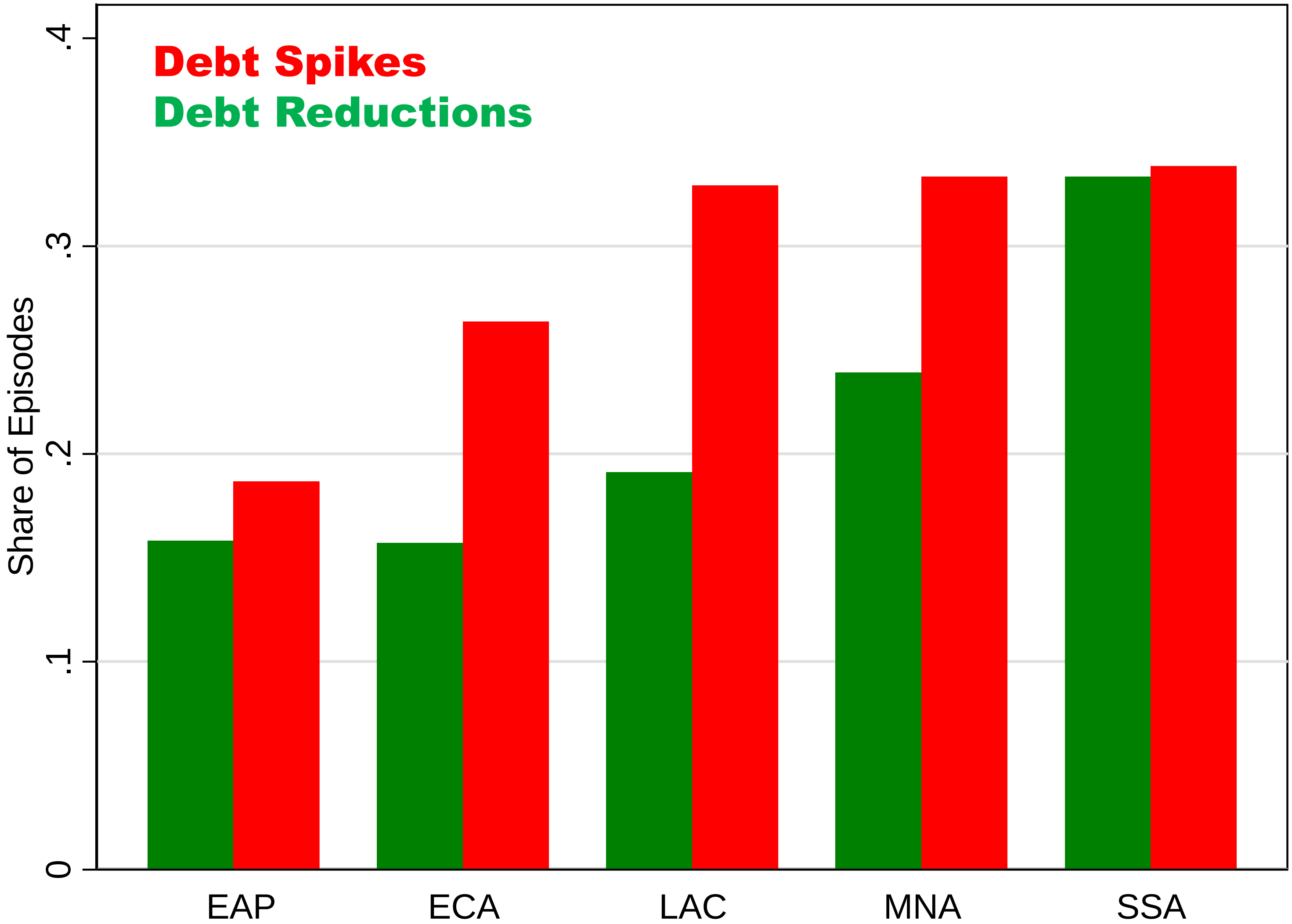
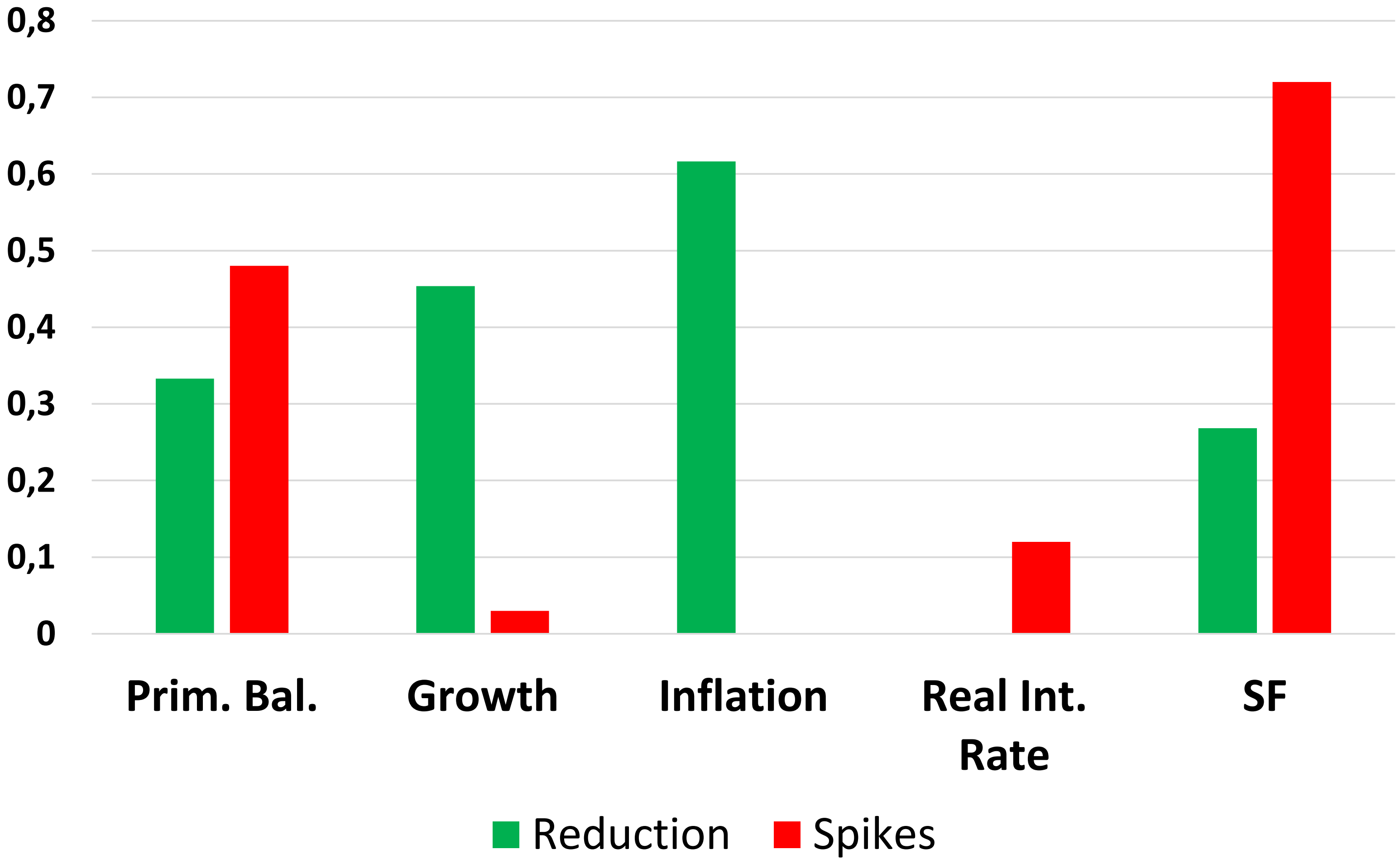
Debt Reductions and Spikes



Source: Panizza and Powell (2023)

The drivers of debt reductions and spikes



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A sovereign debt crisis can be a painful experience for both the debtor and its creditors; a mismanaged sovereign debt crisis can be a catastrophically painful experience

(Buchheit and Gulati, 2010)

Problems with the current non-system for the resolution of sovereign debt crises

1. Debt renegotiations take too long, their outcome is uncertain and, in general, they do not restore debt sustainability
2. Creditors' coordination and the holdout problem. This is amplified by the presence of new (AKA China) bilateral creditors
3. Lack of private interim financing
4. Overborrowing caused by debt dilution
5. Delayed defaults (and a personal story)

Solutions that do not work and a solution that might work

- **Common framework**
  - Not working, even where it is supposed to be working
  - Not applicable to middle income countries (there is also a problem with different debt sustainability frameworks)
- **CACs**
  - Do not cover all types of debt and does not address all problems
- **SDRM**
  - Difficult, but this is where we should go
    - Saying that something is difficult and it will require time and effort is not a good excuse for not trying.
      - In 1961, President Kennedy announced the goal of sending an American safely to the Moon before the end of the decade.
      - On July 20 1969 (nearly six years after President Kennedy's death) Neil Armstrong walked on the moon.
    - The best time to plant a tree was 20 years ago. The next best time is now.

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…well, provide liquidity

- But this isn’t easy because the international lender(s) of last resort is (or are) too small
- Let’s think again about the Covid-time DSSI
- It was a good idea in principle, but…
  - Targeted to a relatively small group of countries
  - Private sector participation remained an aspiration
- We had a more ambitious proposal

Centre for Economic Policy Research
POLICY INSIGHT No.103
April 2020

Born Out of Necessity: A Debt Standstill for COVID-19

Patrick Bolton[1,7], Lee Buchheit[2], Pierre-Olivier Gourinchas[3,7], Mitu Gulati[4], Chang-Tai Hsieh[5,7], Ugo Panizza[6,7], Beatrice Weder di Mauro[6,7]

[1]Columbia University, [2]Professor (Hon), University of Edinburgh, [3]UC Berkeley, [4]Duke University, [5]University of Chicago, [6]Graduate Institute Geneva, [7]CEPR

Our idea: The official sector coordinates a standstill

- A multilateral institution creates for each participating country a central credit facility (CCF) allowing the country to use stayed debt service
- The CCF is monitored by the multilateral institution to ensure that the payments that otherwise would have gone to creditors are not wasted
  - The CCF would specify the eligible crisis amelioration expenditures, as well as the arrangements for monitoring the use of proceeds
- All creditors will be asked to provide the same debt relief

Our idea: The official sector coordinates a standstill

- The CCF will have terms (interest rate and amortization) that do not aggravate the financial position of the beneficiary country
- The debtor country notifies each of its bilateral and commercial creditors that debt service will be directed to the CCF
- Some countries will have unsustainable debt positions after the crisis abates
  - The standstill on interest payments does not preclude a more durable debt restructuring at the appropriate time
  - A CCF will be a de facto senior instrument, the equivalent of debtor-in-possession financing in a corporate insolvency

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Takeaways

- Debt levels are high and borrowing costs are high and volatile
    - Good news: more liquidity than solvency problems
- The main driver of debt growth, fiscal risk, and debt spikes is the “unexplained part of debt”
    - Strongly correlated with exchange rate depreciations when FX debt is large
    - Good debt management is very important
- Reforms to the international financial architecture are needed to deal with solvency and liquidity problems
    - SDRM
    - Generalized standstills