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ADDRESSING THE LOOMING SOVEREIGN DEBT CRISIS IN THE DEVELOPING WORLD: IT IS TIME TO CONSIDER A 'BRADY PLAN'

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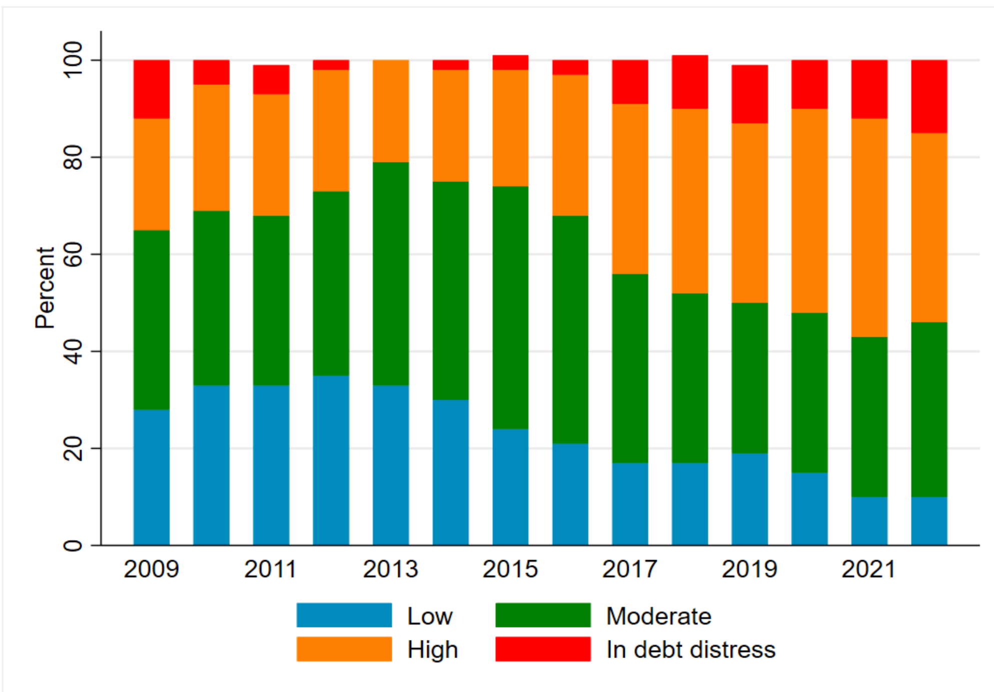
Summary

Among the challenges facing developing countries, none is arguably more crucial than the significantly deteriorated fiscal situation that threatens to erase several years of progress on development agendas. According to some estimates, almost 60 percent of the poorest countries are either in or at high risk of debt distress, nearly doubling since 2015 (Figure 1; World Bank 2022a). Total debt service payments on public and publicly guaranteed (PPG) external debt of the poorest countries rose to over $50 billions in 2021, with repayments now representing 11.3 percent of government revenue in the poorest countries, up from 5.1 percent in 2010 (Figure 2). In most developing countries, the cost of servicing external debt now exceeds expenditures on health, education, and social protection combined (UNICEF, 2021). The current global environment characterized by higher global interest rates and exchange rate depreciations against major currencies is adding to the fiscal challenge by raising the cost of external financing and debt service. Debt service payments for the poorest countries rose 36 percent to over $70 billion last year and are projected to remain elevated through at least 2027 (Figure 3). It is increasingly evident that the Common Framework for Debt Treatments, adopted by the G-20 to help developing countries restructure their debts and address solvency issues and protracted liquidity problems, is facing serious operational challenges. Echoing widely shared concerns about the limitations of the CF, the International Monetary Fund's Managing Director called for changes to it while the World Bank President urged for the acceleration of its implementation. Likely due to the challenges with the CF, out of the 37 countries at high risk of or in debt distress, only four countries have requested assistance under the framework so far. We need a pre-emptive and wholesale approach to restore fiscal sustainability across the developing world and avert a systemic debt crisis.

This policy brief focuses on a group of 77 countries who are eligible for the CF, plus Eritrea, Sudan, Syria, and Zimbabwe who were excluded from the CF because of ongoing arrears with the International Monetary Fund (IMF). Countries eligible under the CF are World Bank's International Development Association (IDA) borrowing countries and/or classified by the U.N. as a "Least Developed Country." Kiribati, Marshall Islands, Micronesia, South Sudan, and Tuvalu were excluded from the analysis due to the absence of data.

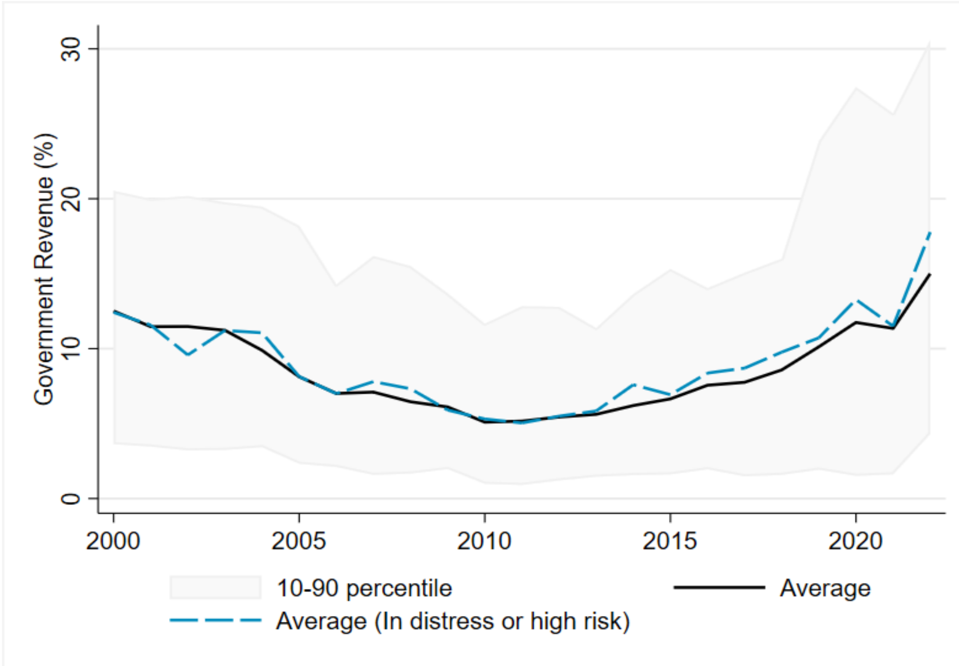
This policy brief only deals with public and publicly guaranteed external debt which is comprised of long-term external obligations of public debtors, including the national government, public corporations, state-owned enterprises, multilateral development banks and other mixed enterprises, political subdivisions (or an agency of either), autonomous public bodies, and external obligations of private debtors that are guaranteed for repayment by a public entity. Data are in current U.S. dollars.

Figure 1. Low-income countries Debt Sustainability Analysis



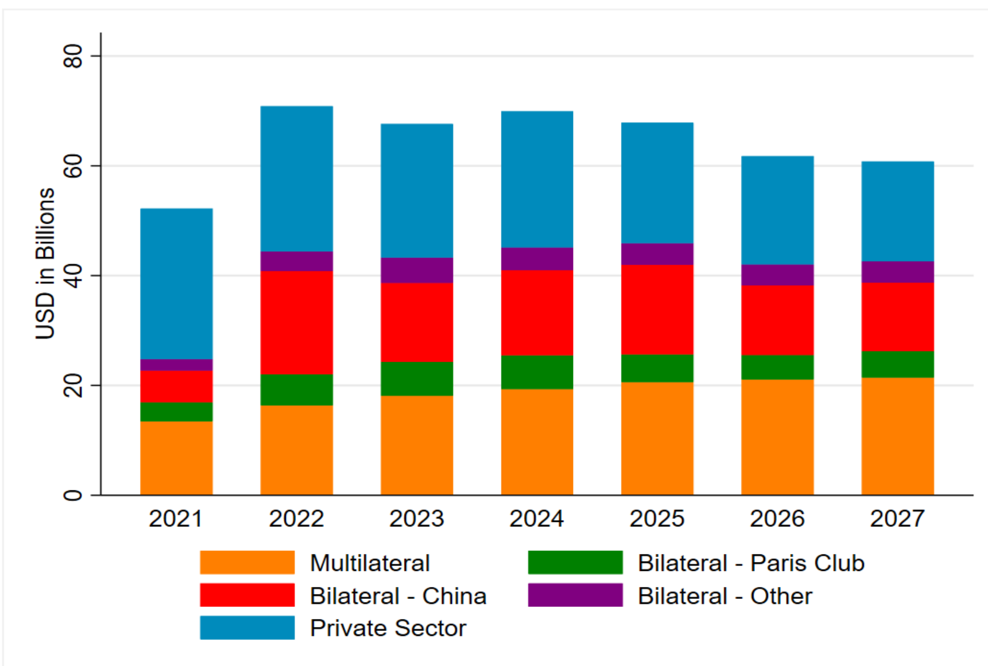
SOURCE: IMF Annual Report (2022a) and author's calculations using the IMF Debt Sustainability Analysis for Low-income Countries (2022).

Figure 2. External PPG debt servicing cost (2000-2022)



SOURCE: Author's calculations using World Bank International Debt Statistics (2021) and IMF World Economic Outlook database (2022b).

Figure 3. Total external PPG debt service coming due

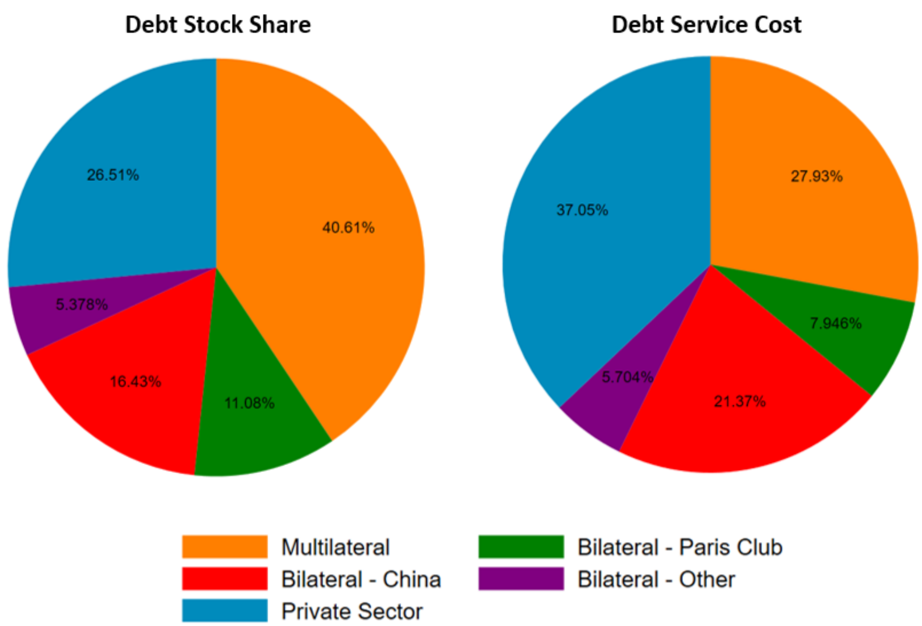


SOURCE: Author's calculations using World Bank International Debt Statistics (2021).

In this policy brief, we propose that the G-20 adopt a Brady-like scheme to accelerate the restructuring of external private sector debt to restore debt sustainability in the affected countries with the following design features.

First, we recommend the creation of a new special purpose fund—the recovery and sustainability fund (RSF)—to be capitalized by International Financial Institutions (IFIs) and bilateral donors. Second, the funds will be used to secure collateral against new tradable bonds—Recovery and Sustainability bonds (RSBs)—issued by participating indebted countries. The guarantees attached to the RSBs will provide credit enhancement and allow countries to issue the new bonds on terms that are more favorable than those of the current stock of private external debt. As shown in Figure 4, despite holding about 27 percent of the debt, the private sector accounts for 37 percent of the debt service due to the higher cost; the median coupon rate is 7.5 percent. The new bonds would also have longer maturities, ideally 30 years. The beneficiary countries could use the proceeds from the RSBs to retire the outstanding balance on the current private external debt.

Figure 4. Share of debt versus share of debt service cost in 2021



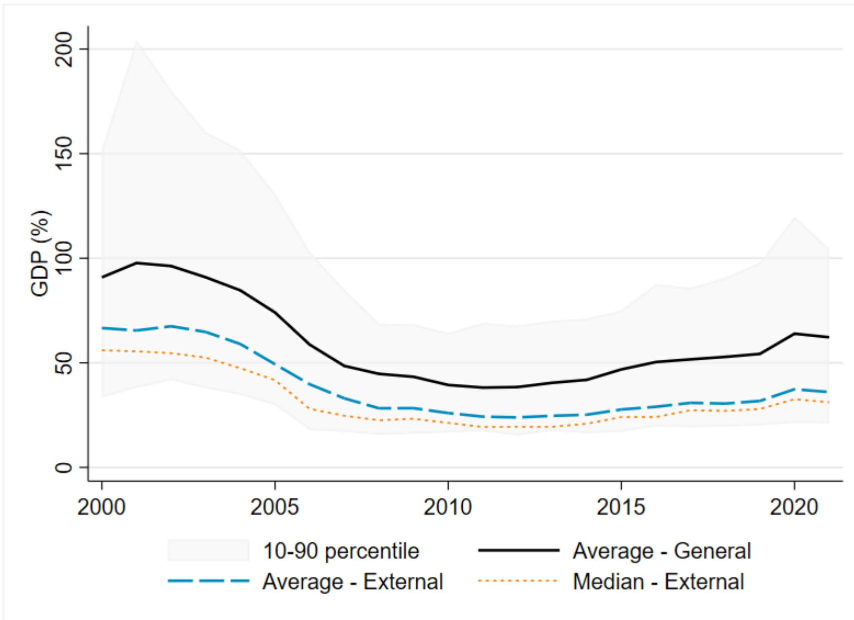
SOURCE: Author's calculations using World Bank International Debt Statistics (2021).

The lower coupon rates on the RSB along with the longer maturity will lead to sizeable reductions in the debt burden to more sustainable levels. We conduct a simple illustrative simulation, which indicates that this scheme could reduce the debt service payments as a share of government revenues by up to 4 percentage points per year for the average developing country, cutting near half the debt service burden in many cases. We further estimate a total reduction in external debt repayment of up to $100 billion over the next five years. In the remainder of the brief, we document the deterioration in sovereign debt situation, review the challenges with the CF, and outline the case for a Brady-like plan.

I. Understanding the post-HIPC and MDRI debt build up

It has only been about two decades since major creditor countries (a group known as the "Paris Club") and multilaterals adopted the ambitious Multilateral Debt Relief Initiative (MDRI) for outright forgiveness of debt owed by a group of 36 low-income countries. The massive debt relief was conditioned on sound economic management and poverty reduction strategies. The MDRI was the logical advancement of a variety of initiatives for debt relief, the most prominent of which was the Heavily Indebted Poor Countries (HIPC) initiative adopted by the IMF and World Bank in 1996 to address debt overhang in the poorest countries. Low-income countries (LICs) had been borrowing into the 1980s, which led to an increasing accumulation of debt that became unsustainable. These debt relief initiatives, including MDRI, had good intentions and outcomes. Through unloading of the debt overhang, infusion of new loans, improved policies, along with enhanced investment incentives, the overall expectation was that there would be positive economic and social development outcomes. Indeed, for about a decade, most countries experienced reduced debt burdens and economic upturns (Coulibaly, Senbet, Gandhi, 2019). The general government debt level as a percent of GDP declined to 38 percent in 2012 (Figure 5), well below levels leading up to the HPIC initiative.

Figure 5. General government and external PPG debt (2000-2021)



SOURCE: Author's calculations using World Bank International Debt Statistics (2021) and IMF World Economic Outlook (2022b).

Since then, the debt has been rising again. The COVID-19 pandemic was the latest in a series of shocks that contributed to wider budget deficits and the gradual build-up of debt since 2012. The first shock was the 2008 global financial crisis, followed by the 2009 European debt crisis and, importantly, the 2014-2015 oil shock. The latter was particularly devastating for commodity-dependent countries.

These global shocks led major central banks to reduce global interest rates to record low levels for over a decade. The ultra-low interest rate environment facilitated the issuance of private sector debt, notably sovereign bonds by low-income countries, in many cases for the first time, as global investors took on more risk to reach for higher yields.

While all the shocks and the low interest rate environment are proximate causes that facilitated the debt accumulation, the deeper structural issue is the low domestic savings against the backdrop of sizeable financing needs, particularly for infrastructure. Indeed, the need for infrastructure financing played an important role in the emergence of other official bilateral creditors, notably China. So long as domestic savings continue to fall significantly short of investment needs, the countries will remain at risk of running up higher sovereign debt to fill the gap.[1]

[1] In some countries, such as Mozambique and Sudan, poor governance and lack of transparency also contributed to the increase sovereign debt.

As part of the debt relief during HIPC/MDRI, and in addition to structural reforms, some measures were adopted to safeguard against future debt build-up. However, these safeguards have proved largely ineffective. For example, the IDA's non-concessional borrowing policy (NCBP) introduced in 2006 sought to monitor and control non-concessional borrowing of external debt by IDA beneficiary countries. Under the NCBP, beneficiary countries of debt relief were not allowed to issue new external debt on non-concessional terms unless they received waivers in advance. Countries in violation risked reductions in allocated IDA volumes, hardening borrowing terms or both. A 2019 IDA-IBRD review found that enforcement has been weak or lenient with a high frequency of waivers. Also, the multipronged approach for debt sustainability aimed at improving debt analysis and early warning systems, enhancing debt transparency, strengthening debt management capacity, and reviewing of debt policies was first articulated in 2018 after much of the debt build-up had occurred.

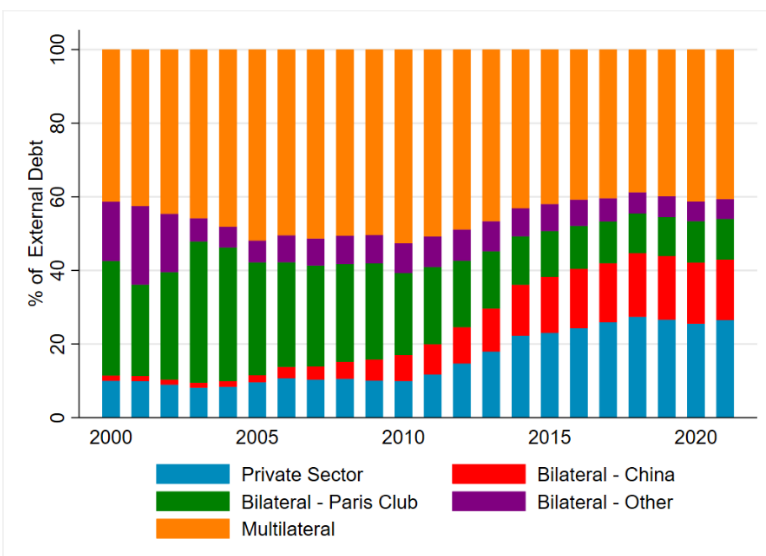
II. Common Framework for Debt Treatment

The COVID-19 pandemic brought economies to a standstill at a time when financing needs to manage the health and economic fallout had increased. The G-20's Debt Service Suspension Initiative (DSSI) postponed almost $13 billion in debt repayments, providing some much-needed fiscal space to the 48 poorest countries who participated (World Bank, 2022c) in the initiative. The expiration of the DSSI at the end of 2021 added to the debt service burden of the beneficiary countries in 2022 onwards.

In 2020, the G-20 also adopted the CF to help the poorest countries restructure their debt and to address solvency issues and protracted liquidity problems. The main objective was to help provide a framework for debt resolution beyond the DSSI. However, it has faced significant operational challenges.

A notable feature of the debt build up compared with that of the pre-HIPC/MDRI era is the diffusion of the creditor base. Indeed, as shown in Figure 6 the share of debt owed to private sector and official bilateral creditors, notably to China, has increased sharply while the share of debt owed to Paris Club creditors and multilaterals has declined. While an increase in the number of creditors can provide a welcome diversification in funding sources for developing countries, it makes debt workout complex. The value addition of the CF was to be inclusive of newer bilateral creditors, like China, and private creditors who would be subject to comparable treatment as other creditors. However, negotiations have proved difficult and protracted in the absence of strong recourse to reign in holdout creditors.

Figure 6. Share of total external PPG debt by creditor



SOURCE: Author's calculations using World Bank International Debt Statistics (2021).

The need to significantly improve the framework and accelerate its implementation has been highlighted by the World Bank (WB) President and the Managing Director of the IMF, among others. Specifically, Georgieva and Pazarbasioglu (2021) call for: 1) greater clarity on different steps and timelines in the CF; 2) comprehensive and sustainable debt service payment standstill for the duration of the negotiations; 3) clarity on enforcement mechanisms of the comparable treatments, including the IMF arrears policies; and 4) the expansion of the eligibility to more countries in need. Currently, a total of 73 low- and middle-income countries (LMICs) are eligible to request treatment under the CF, consisting of countries eligible to borrow from the IDA and the U.N. designated Least Developed Countries (LDCs) who are current on their debt repayment to the IMF and WB.

As pointed out by Ahmed and Brown (2022), the long-drawn-out process with a vague and uncertain end and no interim relief is both challenging for participating countries and discouraging for other countries with serious debt problems. Likely reflecting these challenges, despite a significantly deteriorated fiscal outlook, so far, only four countries (Chad, Ethiopia, Zambia, and Ghana) have asked for debt treatment (See the appendix for key moments in the protracted negotiations that these countries have experienced).

Countries in need of support are hesitant to seek assistance or engage private creditors forcefully out of fear that it will trigger their hard-fought-for sovereign credit standing. At the current pace, the CF alone will not be enough to avert a systemic debt crisis while allowing the countries to pursue their development agendas. A key concern is that the support countries will receive at the end of protracted negotiations will come a bit too late when conditions have worsened and become more costly to resolve.

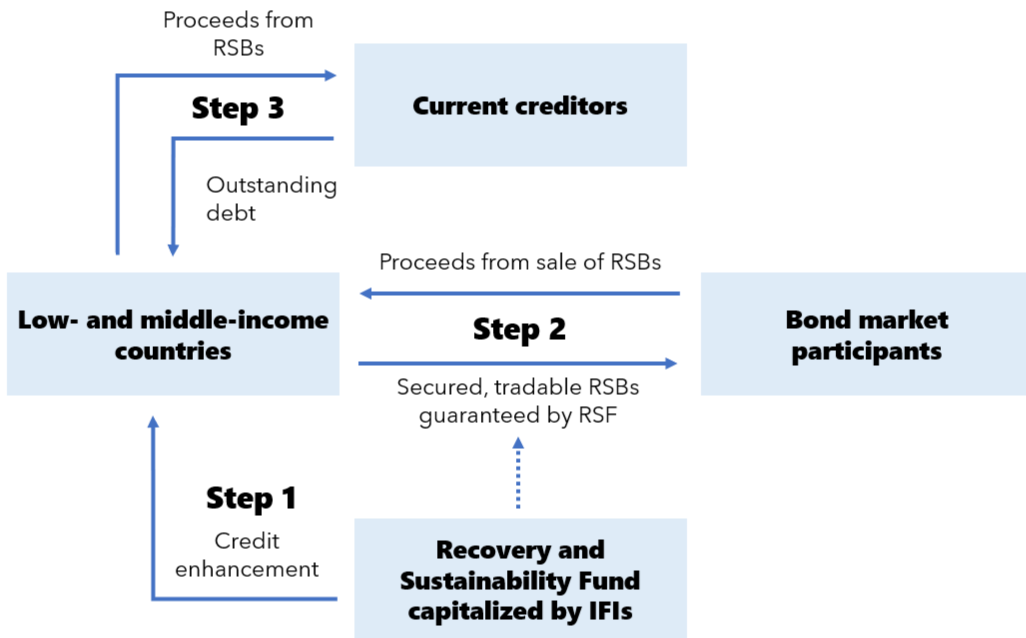
III. A Market-based solution attuned to the Brady Plan

We propose a solution to the looming sovereign debt crisis that consists of issuing lower cost sovereign bonds with long maturities to substitute for the high-cost sovereign debt that countries currently carry on their balance sheets. This scheme is similar, in spirit, to the Brady bond transactions of the 1980s-1990s to restructure the debt of emerging markets and developing countries. In response to the global debt crisis of the 1980s, then U.S. Secretary of the Treasury, Nicholas Brady, put forward a plan to convert bank loans into tradeable bonds with long maturities. Under the Brady Plan, a debt-distressed country in need of support obtained credit enhancement from the IMF or WB. It then purchased a zero-coupon 30-year U.S. Treasury bond which was used as collateral to issue Brady bonds on the market. The proceeds from the Brady bonds were used to repay bank loans. The outcome for creditors was assurance that the debt would be repaid, even if with some haircuts, and the indebted countries benefited from the restoration of debt sustainability resulting from the lower debt service burden and IMF/WB assisted economic reform. A similar scheme adapted to the current environment could prove decisive in the efforts to address the looming sovereign debt crisis in the developing world.

Design features

The scheme we propose achieves outcomes similar to Brady bond restructuring with some differences. Figure 7, below, provides a simplified schematic illustration. First, we recommend the creation of a new fund, the recovery and sustainability fund (RSF), managed by the WB and IMF with contributions from various IFIs, bilateral donors, and possibly unused SDRs. In the second step, the funds will be pledged as collateral against new tradable bonds—Recovery and Sustainability bonds (RSBs)—issued by participating indebted developing countries. With the guarantees, the RSBs will command a higher credit rating and, hence, lower yields than the yields and interest rates on current external debt owed to private creditors held by developing countries. The bonds would also have long maturities, ideally 30 years, similar to those of the Brady bonds. In the third and final step, the proceeds from the RSBs will be used to retire the outstanding balance on the costly existing debt held by private creditors. The combination of lower yields and longer maturities should lead to significant reductions in debt service to more sustainable levels and help restore fiscal sustainability. Like the Brady Plan, participating countries will agree to negotiated programs with the IMF and WB to restore debt sustainability and commit to full transparency on all current and future issuance of public debt and publicly guaranteed debt.

Figure 7. Design mechanism for Brady-bond-like solution



Simple simulations

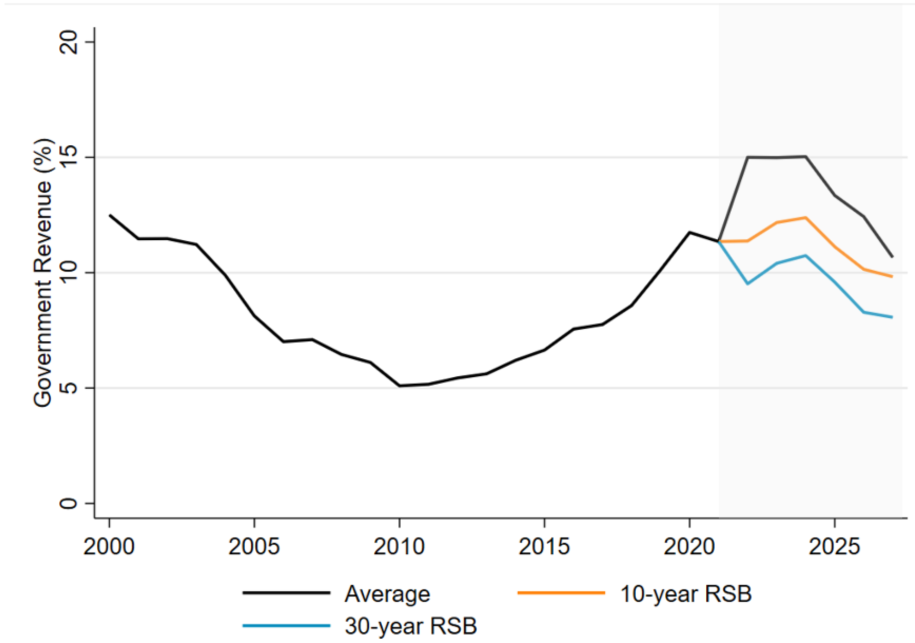
We conduct simple simulations under various maturity scenarios for the newly-issued sovereign bonds. These simulations provide a credible illustration of the potential of this scheme to significantly lower the debt burden of developing counties. A more comprehensive analysis of the country and securities levels will be required to obtain the precise estimates of the impact.

We simulated external debt reductions for 41 LMICs which had complete data on its current debt stock, principal and interest repayments, and total debt service for private sector debt, including both bondholders and commercial debt.

We assume a 30 percent haircut on outstanding private sector external debt and a coupon rate of 5 percent. We also assume that no new private sector debt is added to the stock. The coupon rate is on the lower end of those of existing sovereign bonds due to the credit enhancement, but with about 150-basis points spread relative to U.S. Treasury bonds of equal maturities. The principal and interest repayments are spread in equal amounts each year until the bond reaches maturity. With these assumptions, we simulate two different maturity scenarios at 10-year and 30-year bonds.

The potential impact on total external debt service is estimated, for each maturity scenario, by the difference between actual debt service repayments to the private sector. The simulations represent an oversimplification of what the scheme will be in practice but with comparable outcomes. For example, we assume a single representative bond per country. In reality, countries' debt stock consists of multiple bonds with different terms and maturity structures as well as other private loans. The analysis, based on the average nonetheless, provides an illustration of the potential impact of the proposed scheme to reduce the debt burden. The reduction in debt burden stems from the haircut, lower yields on the new bonds due to the credit enhancement afforded by the guarantees, and the maturity extension. Assuming also that the issuance of these RSB bonds has no butterfly effect on government revenue, we estimate that debt repayments as a share of government revenues decline by 2.5 percentage points on average for the 10-year scenario and an average of 4.0 percentage points for 30 years. This amounts to reductions in total debt service repayments of between $60 and $100 billion over the next 5 years for the 77 developing countries.

Figure 7. Average simulated external PPG debt service



SOURCE: Author's calculations using World Bank International Debt Statistics (2021) and IMF World Economic Outlook database (2022b).

Discussion and practical considerations

The policy brief outlines a simplified framework for swift and proactive resolution of debt sustainability in the developing world. Implementation would require more work on some important practical aspects. The first practical consideration is the selection of countries who are eligible to participate in the Brady-like solution. We propose that the scheme target all the countries that are eligible for treatment under the CF, particularly those in or at high risk of debt distress, and include Eritrea, Sudan, Syria, and Zimbabwe.

The resources needed to capitalize the fund will depend on the size of the external private sector debt in need of restructuring and the negotiated haircuts. We estimate that all private sector debt for the 77 countries amounts to about $170 billion. Under our baseline assumption of 30 percent haircut, the maximum amount of funds needed to capitalize the RSF is $120 billion. This assumes a one-for-one guarantee. The amount could be less with other guarantee mechanisms that do not call for less than one-for-one.

Another consideration is the nature and structure of the guarantees. During the Brady Plan, the U.S. Treasury provided leadership and facilitation with the issuance of zero-coupon U.S. Treasury bonds that served as collateral. The WB can play this role, including the issuance of a similar zero-coupon bond leveraging its AAA rating or other guarantee instruments. The funding sources for the RSF would come from contributions from IFIs and bilateral donors. The SDRs can also provide important catalytic funding if recycled creatively to adhere to the restrictions on their use. One approach could be to transfer the SDRs to eligible IFIs to bolster their balance sheets and facilitate their participation.

As with the Brady Plan, participating countries will work closely with the IMF and the WB on a negotiated and inclusive plan to restore the macroeconomic fundamentals of their economies. To make RSBs even more attractive, investors in RSBs can also be given preferred creditor status with requirements of full prepayments of RSBs before the countries can issue new private debt that contributes to the buildup of debt. The countries will also commit to full transparency on all new PPG debts. The contracts governing new debts will contain no confidentiality provisions. With these measures, the risks of default on the RSBs will be minimized. The very low number of defaults under the Brady plan—only four countries—is a reassuring historical experience.

Moral hazard has often been an important consideration in the formulation of debt restructuring. The concern is that countries benefitting from the restructuring will likely take on more debt in the future. The fact that many beneficiaries of past debt relief have accumulated debt to unsustainable ends lends some support to this concern. The recommendations to tighten the guardrails on the ability of countries to take on non-concessionary debt and the full debt transparency requirements are mitigating factors. Moral hazard on the creditor side is mitigated by the haircut involved in the restructuring process. All told, concerns about moral hazard are outweighed by the benefits of averting a systemic debt crisis.

For indebted countries, the plan will significantly reduce the debt burden, restore fiscal sustainability, and free up resources to finance economic development agendas. Concerns about the possibility of sovereign credit downgrades due to participation in the plan are also outweighed by the benefits. In cases where countries experience downgrades, they will likely be short lived. The restructuring and accompanying measures to strengthen the economic fundamentals will facilitate a shorter return to market. Finally, the guardrails to control the issuance of new debt on non-concessional terms for the duration of the program suggests that the downgrades will likely be inconsequential.

The private sector might condition participation on comparable treatment, an approach that is sanctioned by the CF. We suggest two options. The first option is to use the haircut under this scheme as a baseline for negotiations with official creditors. The other option is for the bilateral official creditors to contribute significantly to the RSFs in amounts that are at least comparable to the haircuts applied to private creditors. With success of the program, official creditors will get their funds back at the outset which minimizes their losses. The assurance to collect on their debts provides an incentive for them to participate. The incentive for private sector participation is the assurance of recouping a sizeable share of their investment as well as the option to exit from their current positions and improve the risk-return profile of their portfolios. The incentives outlined above can be enhanced if IFIs announce their intention to continue lending to countries running arrears. Even so, participation is not guaranteed. It will require strong political will to obtain the necessary cooperation.

IV. Concluding remarks

There is broad consensus that: 1) there is a coming spate of debt crises; 2) it will be devastating for the developing world and set countries back on their development agendas; and 3) the CF will not be effective at averting it, at least not in its current formulation.

In this policy brief we propose a market-based solution similar to the Brady Plan of the 1980s but adapted it to better reflect the current debt situation and environment. Our simple simulations point to the potential for this approach to restore debt sustainability in the developing world while minimizing the resources needed to do so. More comprehensive analyses will be required to better calibrate the benefits of this new scheme at the country level. The scheme can be enhanced to simultaneously address debt sustainability and climate change by structuring some of the new bonds as “green” bonds, which create more demand and push coupon rates even lower.

Historical experience reveals that incremental approaches to systemic debt restructuring delay recoveries. Decisive action, on the other hand, results in lower costs for both creditors and debtors. For example, in the 1980s, it took several years to enact the Brady Plan, and the delay resulted in two lost decades of socio-economic development for the affected countries. Policymakers should learn from that era and avoid the same mistakes by considering innovative, proactive, and decisive approaches such as the one outlined in the policy brief. It is within reach if there is political will, commitment, and strong leadership.

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Appendix 1

Experience with the Common Framework: The case of Chad

April 2020 | Chad requests for disbursement under the Rapid Credit Facility (RCF) to help meet urgent balance of payment needs; IMF approves disbursement under the RCF to help meet urgent balance of payments needs

July 2020 | IMF approves second round of disbursements under the RCF

January 2021 | Chad becomes the first country to ask for debt treatment under the Common Framework; Chad reaches staff-level agreement with IMF on Extended Credit Facility (ECF)

April 2021 | Creditor committee formed, including China, France, India, and Saudi Arabia

June 2021 | Initial agreement reached with Chad and bilateral creditors to reprofile or reschedule Chad's debt to 2024

December 2021 | IMF Extended Credit Facility of $571 million approved for Chad

October 2022 | Creditor committee determined that no debt relief from official bilateral creditors is "currently needed given the surge in oil prices." Bilateral creditors agreed to reconvene to discuss debt relief if oil prices fell enough

November 2022 | Final debt treatment agreement reached by Chad and its official and private creditors to restructure its $3 billion in external debt; agreement calls for reprofiling or rescheduling on Chad's debt in 2024

December 2022 | IMF completes first and second reviews of the ECF enabling disbursements to Chad

Reactions | Chad Finance and Budget Minister Tahir Nguilin said "he regretted the decision not to provide debt relief now." IMF applauded the deal for providing Chad with adequate protection against downside risks and bringing the risk of debt distress to moderate by the end of the IMF-supported program. World Bank President David Malpass criticized the deal saying "The agreement reached by the creditors provides no immediate debt reduction. As a result, the debt service burden of Chad remains heavy and is crowding out priority expenditures on food, health, education, and climate."

Appendix 2

Experience with the Common Framework: The case of Zambia, Ethiopia, and Ghana

Zambia

November 2020 | Zambia becomes first African country to default since the start of the COVID-19 pandemic

February 2021 | Zambia requests debt treatment under the G-20 Common Framework

June 2022 | Creditor committee formed with representatives from countries who have eligible claims on Zambia, with China and France co-chairing the committee

July 2022 | Creditor committee commits to provide long-term debt relief to be finalized in a Memorandum of Understanding

August 2022 | IMF approves $1.3 billion Extended Credit Facility for Zambia

October 2022 | World Bank approves concessional development financing, a credit of $100 million to help restore fiscal and debt sustainability

Next steps | Creditor committee needs to agree to specific modalities on debt relief and discussions need to be had with private creditors for comparable treatment

Ethiopia

February 2021 | Ethiopia requests debt treatment under the G-20 Common Framework

September 2021 | Creditor committee formed with representatives from countries who have eligible claims on Ethiopia, with China and France co-chairing the committee

July 2022 | Creditor committee reaffirms commitment to work to find an "appropriate solution" to Ethiopia's debt vulnerabilities

Next steps | IMF needs to identify and approve an appropriate program for debt relief, creditor committee needs to agree to specific modalities on debt relief, and discussions need to be had with private creditors for comparable treatment

Ghana

December 2022 | Ghana defaults on most external debt

January 2023 | Ghana formally requests for debt treatment under the G-20 Common Framework; Creditors are in talks to form creditor committee

Next steps | IMF needs to identify and approve an appropriate program for debt relief, creditor committee needs to be formed and needs to agree to specific modalities on debt relief, and discussions need to be had with private creditors for comparable treatment

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