How to Prevent a Sovereign Debt Disaster

A Relief Plan for Emerging Markets

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A placard that reads “your wealth is our poverty” in Buenos Aires, Argentina, May 2020

Agustín Marcarian / Reuters

o fight the coronavirus pandemic and the economic devastation it has caused, countries around the world have piled on extraordinary amounts of debt. For the developed countries
of East Asia, Europe, and North America, this has not been a problem. They have issued several trillion dollars in government bonds at rock-bottom interest rates. What is more, nervous investors have flocked to these bonds, which are usually seen as safe investments in times of duress.

For the poorer nations of the world, the story is very different. They too need to borrow and spend to alleviate the crisis—in many cases, more so than rich countries. But they are not seeing anywhere near the same level of enthusiasm for their bonds among private investors. As a result, more than 100 countries have had to turn to the International Monetary Fund for emergency assistance. The IMF has already approved 25 major grants to some of the poorest countries, including Afghanistan, Haiti, and Yemen. But it will not be able to meet the extraordinary financing needs of the developing world, which the fund itself expects to exceed $2.5 trillion.

Without additional financing, the governments of many low- and middle-income countries will have to choose between saving their people and servicing their debt. Some of these countries, such as Argentina and Lebanon, were already on the verge of default and unable to borrow additional funds from international markets before the pandemic hit. But many more have been plunged into crisis by the coronavirus pandemic and the investor exodus that followed in its wake. Unless export markets and commodity prices rebound quickly, even countries that forgo vital spending on public health and economic recovery could end up defaulting on their debts.

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In short, a tsunami of sovereign debt distress is coming. And the choice for the private creditors of low- and middle-income countries is simple and stark: agree to an orderly process of debt mitigation that shares the burden and limits the damage or demand
immediate repayment and set off a wave of catastrophic defaults that sweeps many countries—and their creditors—away.

DROWNING IN DEBT

The private sector’s initial response to the coronavirus crisis seemed promising. On April 9, the Institute of International Finance—an association of the world’s largest commercial and investment banks, insurance companies, and asset management firms—issued an open letter recommending that both government and commercial creditors reschedule interest payments for the poorest countries until the end of 2020.

Since then, however, the IIF and its members have backtracked. In a letter released on May 1, the IIF warned that even requesting a suspension of debt service payments from the private sector could have dire consequences. Moreover, such a request is likely to involve a lengthy and arduous process of renegotiation, and there is no guarantee that any relief will be granted. In other words, a country may suffer all of the negative consequences of having asked for a deferment without actually receiving a deferment on many (or any) of its payments. The letter also pointed out that fiduciary duties to investors, contractual commitments, regulatory requirements, and national laws could stand in the way of a suspension. The IIF’s message is clear: “Buck up and pay up. Or else.”

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In the end, the IIF is defending the interests of private creditors, and these creditors would prefer that other parties—namely, national governments, the World Bank, and the IMF—foot the bill for the pandemic. By refusing to defer debt service payments, private creditors hope to reduce the amount of their money that debtor countries redirect toward pandemic mitigation—an obvious benefit to them. So far in this game of financial brinkmanship, governments have been the ones to blink first. On April 15, the G-20, a collection of 20 of
the world’s largest economies, announced that it would unilaterally suspend debt service payment to official creditors for 76 low-income countries that request forbearance.

The G-20 could have conditioned their forbearance on matching private-sector participation. After all, countries seeking debt relief from the Paris Club, one of the major groups of creditor countries, have a legal obligation to seek “comparable treatment” from commercial creditors. But for reasons of political expediency, they did not. As a result, the taxpayers that fund G-20 governments have seen their generosity simply bleed out to pay commercial creditors. Until the international community steps in with a proposal that shifts the incentives for private creditors, these investors will continue to resist accommodating debtor countries and may ultimately force these cash-strapped governments to divert their dwindling resources to servicing their private debt.

LIGHTENING THE LOAD

To avoid a catastrophic string of defaults, governments and private creditors must share the burden of providing debt relief. This is a matter both of fairness and of ensuring adequate funding. But a successful debt relief scheme cannot rely on the initiative of individual creditors, since they are unlikely to soften their opposition to debt deferment under the current circumstances, and in any case, relief provided by participating creditors would simply go toward debt service payments to nonparticipating ones. For that reason, we have proposed a mechanism that would allow poor countries to initiate the debt deferral process without having to coordinate among all of their separate creditors.

Our plan calls for countries to redirect interest payments on both government and private debt into a central credit facility, a temporary bank of sorts. The credit facility would then lend the deposited interest payments back to governments at low rates on the condition that these loans go exclusively toward coronavirus mitigation. For their part, the creditors to whom these interest payments were owed would receive a stake in the credit facility proportional to the size of the deferred debt service payments. Payments on the principal would be deferred separately.
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Our approach could be implemented quickly and would result in all creditors receiving identical treatment. We estimate that it could provide up to $800 billion in loans to low- and middle-income countries. Even those countries that have expressed concerns about asking private creditors for debt relief—such as Benin, Pakistan, and Rwanda—would find that this proposal addresses most of their creditors’ concerns. What is more, the plan gives debtor countries the power to initiate the deferral process and requires creditors to opt out rather than in, thereby solving the collective action problem.

What happens if some creditors decide to hold out and litigate for the missed payments? This is unlikely, because the claims of any individual creditor will be small—a couple of interest payments—and probably not worth litigating over. On top of this, any creditor that attempted to use a country’s failure to pay to request immediate repayment of the entire debt would merely catapult the country into an irreversible debt crisis—something that the country and its creditors might otherwise have been able to avoid. Perhaps most important, creditors are unlikely to face a sympathetic judiciary in any jurisdiction that has been devastated by the coronavirus and its economic fallout. In some jurisdictions, the international law doctrine of necessity may be invoked to justify a temporary suspension of debt service. That doctrine allows countries facing extreme situations to spend on public welfare and health rather than service their debts.

The worst may be yet to come. In the poorest countries, private creditors hold only ten percent of sovereign debt. In many middle-income countries, by contrast, the private sector holds more than 80 percent. Commercial creditors have already expressed their reluctance to defer the debts of the poorest countries. It would be a mistake—an expensive mistake—to allow them to free-ride when middle-income countries come calling in a few months’ time.
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