Munich Personal RePEc Archive

The Debt Pandemic

Bulow, Jeremy and Reinhart, Carmen and Rogoff, Kenneth and Trebesch, Christoph

Harvard University

1 September 2020

Online at https://mpra.ub.uni-muenchen.de/117468/
MPRA Paper No. 117468, posted 09 Jun 2023 13:17 UTC

Published in:
Finance and Development, , Fall 2020, 12-16 (Washington DC: International Monetary Fund)

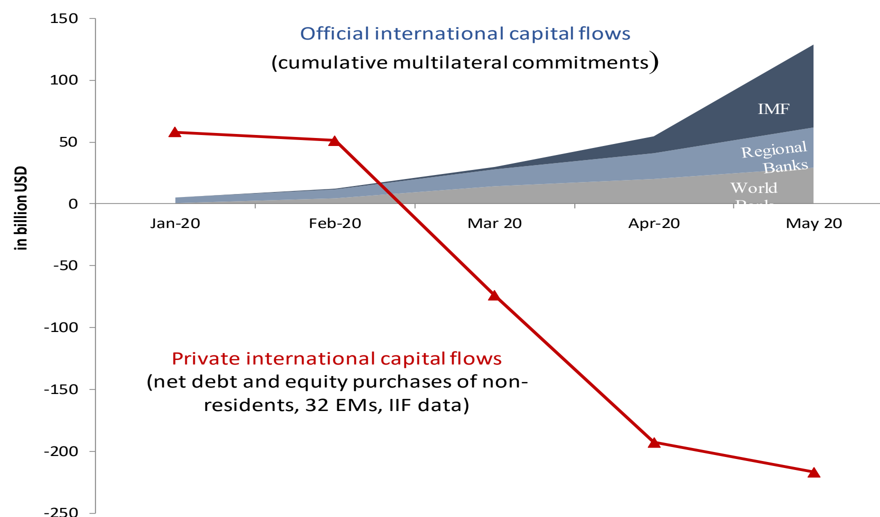
The Debt Pandemic

Jeremy Bulow, Carmen Reinhart, Kenneth Rogoff and Christoph Trebesch[1]

While several developing and emerging market economies were already in debt distress at the outset of 2020, the Covid-19 crisis made the list much longer. For some, a crisis is imminent and for many more the exceptionally low global interest rates may be delaying its timing. We discuss here some of the challenges for sovereign debt workouts.

The rapid infusions of official funds this year by the IMF, World Bank, and other multilaterals aimed to provide much needed funding as government revenues collapsed alongside economic activity and private capital flows came to a historic sudden stop (Figure 1). In addition to new loans from the multilaterals, G-20 creditors granted a debt moratorium to the world's poorest countries and have encouraged private lenders follow suit with little success.

Figure 1. The Covid-19 Pandemic and Official and Private Capital Flows



Sources: IIF, IMF, World Bank, EIB, IADB, AIIB, NDB, AfDB, AsDB.

Notes: Institute for International Finance (IIF) data show that during the 52-week period ending in mid-January 2020, bond and equity portfolio i*nflows* to emerging markets totaled over \$80 billion and by early May the comparable figure registered over \$60 billion *outflows.*

Although many of the poorest countries lack access to private capital markets, the pandemic shock has not yet morphed into a full-blown middle-income emerging market crisis, where the sums would be vastly larger, and where private creditors play a more dominant role. In fact, thanks in part to the

[1] Stanford University, The World Bank, Harvard University, and Kiel University.

favorable global liquidity conditions conferred by massive central bank support in advanced economies, the scale of private capital outflows has moderated and many middle-income countries have been able to continue to borrow in global capital markets, according to the IMF, $124 billion dollars in hard currency loans during the first six months of 2020 (2/3 in the second quarter).

Risk factors: A second Covid-19 wave, high debt and more sovereign downgrades

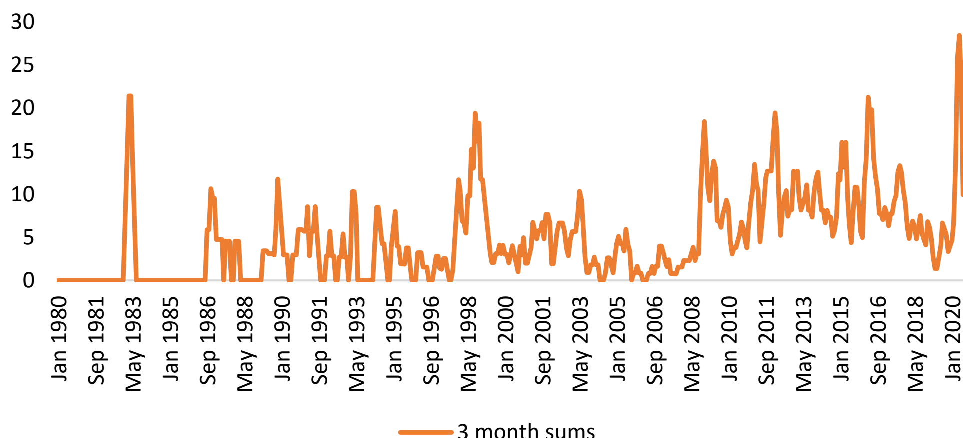
Why might policymakers still be concerned about sustained emerging market (EM) market access? Despite the recent calm, the riskiest period may still lie ahead. The first wave of the pandemic is not over. Experience from the 1918 Spanish flu epidemic suggests the possibility of an even more severe second wave, especially if takes until mid-2021 (or later) for an effective vaccine to become widely available. Even in the best-case scenario, international travel will face roadblocks for some time to come and uncertainty among consumers and firms is likely to remain high. World poverty has risen sharply, and many will not be returning to work when the crisis passes. The political ramifications of the crisis in advanced economies are also still unfolding, with risk that the threats to globalization, already rising before Covid-19, will intensify.

Although many EM governments have been successful in tilting their borrowing to local currency debt, this trend has not always included EM corporates, which have continued to accumulate foreign currency debt. It is folly to assume that in the event of severe duress, governments will watch many of their private corporate national champions fail; the United States and Europe have not done that.

Even as some EMs are securing new loans, overall private funding has been in dramatic retreat (in addition, workers' remittances are also expected to drop by more than 20% this year). The pandemic has created the same or greater budgetary stresses on EMs and developing countries as on advanced countries. Health systems must be strengthened, support must be provided for citizens whose lives are affected most acutely. Borrowing needs have skyrocketed and are poised to rise further as the cumulative economic damage mounts.

The surge in financing needs has been accompanied by a new wave of sovereign downgrades. As Figure 2 highlights for the major credit rating agencies for 1980-2020. The large spike since Covid-19, has persisted even as the major advanced-economy central banks have eased and surpasses the peaks during prior crises. EMs and developing country debt have also been relatively disadvantaged by the creation of central bank facilities that support national corporates.

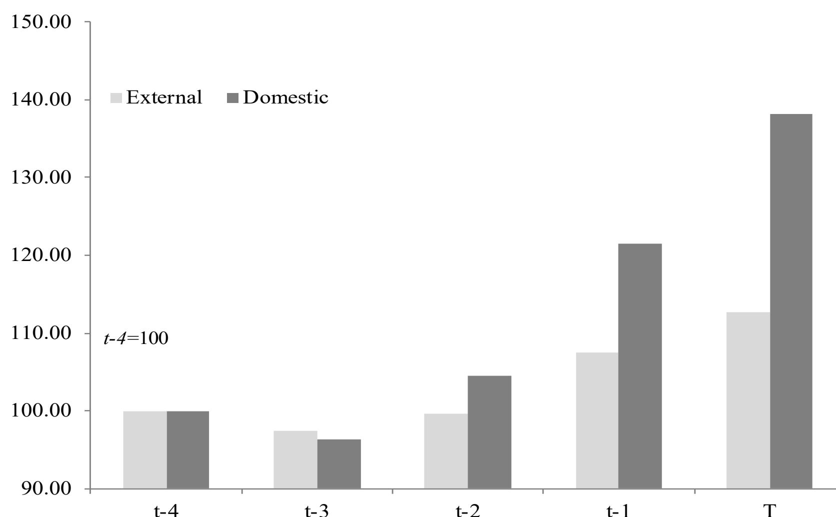
Figure 2: Credit Agency Downgrades of Sovereign Debt, 1980-2020



Sources: Fitch, Moody's, Standard and Poor's, and Trading Economics.

Is it unusual that countries can keep on borrowing if risk of a default is so high? Figure 3 shows external and domestic sovereign borrowing in the runup to default in 89 episodes from 1827-2003. The bars show the ratio to debt (converted to US dollars) in that year relative to *t*-4, where *t* denotes the year of default. As the figure illustrates, the "typical" experience is a sharp rise in borrowing in the runup to default. Not only does external borrowing rise ahead of default, but domestic borrowing rises by more. One can hope that this time is different, but examining the past there is nothing inconsistent between the unfolding dynamic and heightened default risk.

Figure 3. The run-up in domestic and external debt on the eve of external default:
Eighty-nine episodes, 1827-2003



Source: Reinhart and Rogoff (2009)

Financing needs have been and remain massive and synchronous across a broad swath of countries. At the same time, we have made the case here that also brewing in the background is a growing need for debt restructuring in numbers that we had not seen since the debt crisis of the 1980s. Official creditors should be prepared to act as needed.

Challenges for sovereign debt workouts

To make sure as much aid as possible gets through to debtor country citizens, it is very important to **assure inter-creditor equity and fair burden sharing, especially between the official and private creditors.** Although theoretically the official sector is a senior creditor to the private sector, much of the historical experience suggests otherwise.

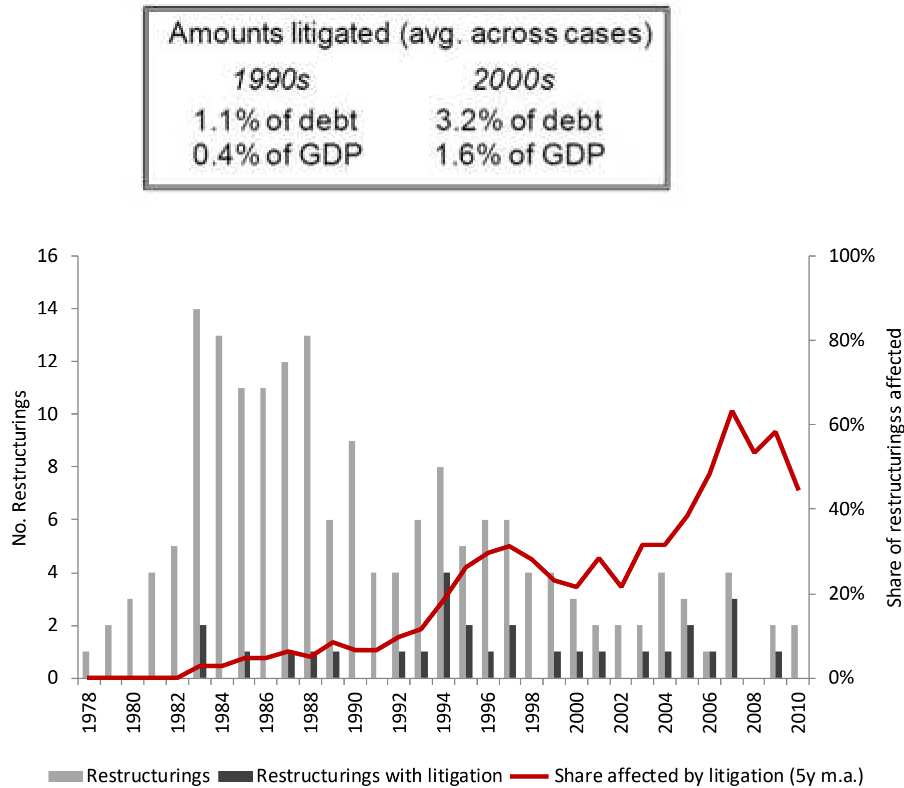
Bulow and Rogoff (1988a, and Bevilaqua, Bulow and Rogoff, 1992) show that during the 1980s emerging market debt crisis, private creditors were quite successful in pulling out funds as official creditors went in ever deeper; their tests reject the hypothesis that private creditors regards official debt as senior. A similar dynamic was at play in the European debt crisis, where investors did take some losses in Greece, but not before a large part of their funds had been pulled out (Zettlemeyer, Trebesch, and Gulati, 2013). Horn, Reinhart and Trebesch (2020) look at two centuries of private and official lending, and found this to be a recurring pattern: when private investors retrench, official lenders often step in. Of course, this pattern of lending only speaks to the lack of risk sharing by private creditors and is silent on the pecking order of debt repayment.

A recent analysis comparing creditor losses (haircuts) of official and private creditors by Schlegl, Trebesch, and Wright (2019) raises further doubts about the supposed seniority of official sector loans. Nonetheless, they show that historically the IMF and World Bank have enjoyed clear seniority thanks to their position atop the official sector. For instance, in the Greek crisis other official creditors who had already restructured their debts so as to not demand any cash for years to come were nonetheless persuaded to renegotiate and contribute additional funds to Greece so that the IMF, ECB, and private creditors could be repaid in full without restructuring (and in the case of private creditors without any implicit agreement to make new loans).

Bulow and Rogoff (1988b, 1992) argue, using a bargaining theoretic model of international borrowing and debt negotiations, that these outcomes should not be surprising. After all, the official sector internalizes the objective function of foreign lenders to some extent (think Northern European banks in the case of Greece), and at the same time also cares about stability and welfare in the borrowing country. Such altruism, in turn, "weakens" the official sector's bargaining position, most importantly vis-a-vis private creditors. Thus official creditors may be left holding the bag for the bulk of the losses even when they start with little of the outstanding debt, as in Greece during the European debt crisis.

A further challenge are new **holdout and litigation tactics by private investors** to resist large debt write-downs and restructurings. A thorough analysis is beyond the scope of this paper, but Figure 4 illustrates the trend rise in lawsuits coincident with the trend decline in restructurings (from Schumacher, Trebesch and Enderlein 2018). This is by no means proof of causation but given the past success of the private sector in getting an outsized share of repayments in debt restructurings, it is disconcerting.

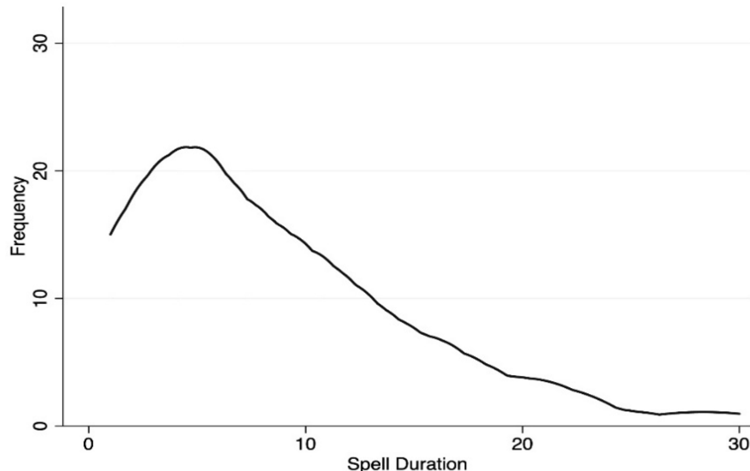
Figure 4. Sovereign debt restructurings with and without litigation



Source: Schumacher, Trebesch and Enderlein (2018)

Even more disconcerting is the **how protracted debt crises can become**. As former Citibank chairman William Rhodes famously said during the debt crisis of the 1980s: "'It is easy to get into a debt moratorium. It's tough to get out."; Figure 5 shows that default spells have taken, on average, 8 years to resolve (median is 7 years) and typically involve multiple restructurings, as documented in Clemens, Meyer, Reinhart, and Trebesch (2020). Unfortunately, this should not be surprising when one thinks of debt restructurings as a bargaining game where the country debtor is often (rightly) willing to exchange higher future debt for lower payments now, fully intending to again restructure debt as necessary (as in Bulow and Rogoff, 1989). And creditors may often be willing to evergreen debt in order to temporarily flatter their balance sheets. Thus, both theory and evidence suggest that the Covid-19 crisis could, in the worst case, lead to another "lost decade" in development, with long delays in debt resolution.

Figure 5. Frequency distribution of the duration of default spells: 95 episodes, 1970-2015



Debt restructurings with private creditors can drag on. For about 2/3rds of cases it takes over 4 years.
Descriptive statistics (in years)
Mean: 8.4
Median: 7
Max: 30,
Observations: 95

Source: Meyer, Reinhart, Trebesch, von Luckner (2020).

Tools to navigate a wave of debt restructuring

How can the official sector be more effective in making sure that efforts to provide aid and new funding primarily end up benefitting the citizens of debtor countries impacted by the pandemic rather lining the pockets of creditors?

How can debt restructuring be made more expedient?

Many ideas are being debated and some are further along in implementation. Three of the more pragmatic in real time include: more transparency on debt data and debt contracts, realistic economic forecasts that incorporate downside risks, and support in legal negotiations involving the re-contracting of sovereign debt..

It is of the utmost important that the World Bank, IMF, and the G20 continue to insist on strengthening the transparency of debt statistics. A new and significant complication in assessing the external indebtedness of many developing countries involves China, which has become the largest bilateral creditor in recent years. Unfortunately, China's lending is often shrouded in nondisclosure clauses and a full picture is still elusive. More granular data on private sector creditor exposure may facilitate, in case of debt distress, more expedient creditor-debtor negotiations and allow both creditors and governments to identify which bonds are at risk of holdout or litigation tactics. As noted, lawsuits and derailed debt restructurings have been on the rise. An encompassing transparency initiative would include, for instance, credit default swaps that shift lender composition overnight. Money is fungible, but knowing the players involved and the amounts owed allow the international community and the citizenry of affected countries to better monitor how scarce resources in a time of crisis are being deployed. The accounts for the country itself must become more comprehensive, with improved data on domestic debt and debt owed by state-owned enterprises. Accounting for pension burdens is also an increasingly important element, as recent debt workouts in sub-sovereigns Detroit and Puerto Rico vividly illustrate.

Realistic and unbiased growth forecasts that factor in downside risks are critical in avoiding the trap of underestimating a countries near term financing needs and overestimating its capacity to service its existing or fast approaching debt commitments. Although official projections for global growth were famously over-optimistic over the period 2007-2015, some detailed studies of IMF forecasts show that they do not systematically exhibit biases and are not worse that consensus private forecasts (see for example, IMF Independent Evaluation Office, 2014). However, as IMF historian James Boughton (2001) notes, that during much of the 1980s debt crisis, there was a persistent dose of overoptimistic growth expectations, especially in Latin America. Our aim here is not to critique official forecasts but to underscore that realistic forecasts, particularly recognizing the fragility of highly-indebted countries, can to faster resolution of any crises that may arise. Earlier detection of insolvency and identification of cases where large write-downs are necessary are no guarantee for a faster resolution but are a step in that direction. The track record of averaging 7-8 years for debt workouts is hardly encouraging. Even cutting that process in half counts as significant progress.

Legal steps in jurisdictions that govern international bonds (importantly but not exclusively, New York and London) or where payments are processed can contribute to more orderly restructurings by modifying legislation in ways that promote a more level playing field between sovereign debtors and creditors. For instance, legislation to cap the amounts that may be reclaimed from governments bonds bought at a deep discount from countries approaching default. Legislation to support a majority restructuring, which would allow a sovereign and a qualified majority of creditors to reach an agreement that would then be made binding on all creditors that are subject to the restructuring is another example.

The global pandemic is a once a century shock that merits a generous response from official and private creditors towards emerging markets and developing economies, including preserving the global trading system, and helping them countries to weather debt problems. The support needs to be forthcoming, regardless of what progress can be made in better managing debt workouts. However, the more official aid and soft loans can go towards helping needy citizens around the globe, and the less such assistance ends up as debt repayments to uncompromising creditors, the better.

References

Boughton, James, *Silent Revolution: The IMF, 1979-1989* (Washington DC: International Monetary Fund, 2001).

Bulow, Jeremy and Kenneth Rogoff, “Multilateral Negotiations for Rescheduling Developing Country Debt: A Bargaining-Theoretic Framework,” *International Monetary Fund Staff Papers* 35 (December 1988), 644–657.

Bulow, Jeremy and Kenneth Rogoff, “The Buyback Boondoggle,” *Brookings Papers on Economic Activity*: no. 2, 1988, 675–698.

Bulow, Jeremy and Kenneth Rogoff, “Sovereign Debt: Is to Forgive to Forget?” *American Economic Review* 79 (March 1989), 43–50.

Bulow, Jeremy and Kenneth Rogoff, “A Constant Recontracting Model of Sovereign Debt” *The Journal of Political Economy* 97 (February 1989), 155–178.

Bulow, Jeremy, Kenneth Rogoff and Afonso Bevilaqua, “Official Creditor Seniority and Burden Sharing in the Former Soviet Bloc,” *Brookings Papers in Economic Activity* 1: 1992, 195–222.

Horn, Sebastian, Carmen M. Reinhart, and Christoph Trebesch, “ Coping with Disasters: Two Centuries of International Official Lending NBER Working Paper 27343, June 2020.

IMF, Independent Evaluation Office, IEO Evaluation Reports: IMF Forecasts, (Washington DC: International Monetary Fund, 2014).

Meyer, Josefin, Carmen M. Reinhart, Christoph Trebesch, and Clemens von Luckner, “Serial sovereign debt restructurings and delay: Evidence from the 1930 and 1980s default waves” mimeo, Harvard University, (2020).

Reinhart, Carmen M. and Kenneth Rogoff, *This Time is Different: Eight Centuries of Financial Folly* (Princeton: Princeton University Press, 2009)

Schlegel, Mattias, “Which are the most senior creditors for sovereign debt?” World Economic Forum

Schumacher, Julian Trebesch and Henrik Enderlein, “Sovereign Defaults in Court”, CEPR Discussion Papers 12777, March 2018.

Zettelmeyer, Jeromin, Christoph Trebesch and Mitu Gulati, “The Greek debt restructuring: an autopsy,” *Economic Policy* 28 (75) 513-563.