23 A debt standstill for developing and emerging market countries

Patrick Bolton, Lee Buchheit, Pierre-Olivier Gourinchas, Mitu Gulati, Chang-Tai Hsieh, Ugo Panizza, Beatrice Weder di Mauro

Columbia University; University of Edinburgh Law School and Centre for Commercial Law Studies, UC Berkeley and CEPR; Duke Law School; University of Chicago; Graduate Institute, Geneva and CEPR; Graduate Institute, Geneva, INSEAD Emerging Markets Institute and CEPR

The Covid-19 crisis has led to a sudden collapse in capital flows to emerging and developing countries, who now face problems servicing their external debts while addressing the growing economic strain of the pandemic. In this chapter, we explain why low- and middle-income countries are particularly vulnerable, discuss what is at stake for the world economy, and present a mechanism to implement a debt standstill which would free significant resources to cover some of the more immediate costs of the COVID-19 crisis.

The COVID-19 crisis has led to a sudden collapse in capital flows to emerging and developing countries. According to estimates by the Institute of International Finance, non-resident portfolio outflows from emerging market countries amounted to nearly $100 billion over a period of 45 days starting in late February 2020. For comparison, in the three months that followed the explosion of the 2008 global financial crisis, outflows were less than $20 billion.[1]

Advanced economies can borrow large amounts at little extra cost. Moreover, they benefit from flight-to-safety funding from national investors liquidating their foreign holdings. In other words, the financing that advanced economies rely on comes in part from emerging market economies where, ironically, the financial needs are more pressing. What's more, in contrast to the 2008 global financial crisis, every emerging

1 https://www.iif.com/Publications/ID/3829/IIF-Capital-Flows-Tracker-The-COVID-19-Cliff

and developing economy now confronts greater borrowing needs at exactly the same time. Therefore, it is not surprising that about 100 countries have already approached the IMF for financial assistance.

An 30 April 2020 op-ed by the Ethiopian prime minister, Abiy Ahmed, describes well the dilemma faced by many developing and emerging market countries:

> *"In 2019, 64 countries, nearly half of them in sub-Saharan Africa, spent more on servicing external debt than on health. The dilemma Ethiopia faces is stark: Do we continue to pay toward debt or redirect resources to save lives and livelihoods?"*[2]

In response to this crisis, the Group of 20 leading economies agreed to a temporary debt service standstill on bilateral official loan repayments from a group of 76 of the poorest countries (the so-called IDA countries).[3] This is a positive first step, but the agreement needs to be extended along two dimensions. First, the exclusive focus on the poorest countries leaves out many low- and middle-income countries that already face severe economic strains. Second, a key constituency missing from the G20 plan is private creditors, whose participation is sought only on a voluntary basis. Although they are not the most important creditors of IDA countries, they are crucial for middle-income countries, where they hold the majority of the sovereign debt.

In the absence of private sector participation, official debt relief in middle-income countries may partly be used to service private creditor claims. Given the expected size of the fiscal needs of these countries, any financial relief dissipated on debt servicing of private creditors' claims will be very costly. Moreover, participation by private creditors cannot be wholly 'voluntary'. If participation is voluntary, relief provided by those private creditors that participate will simply subsidise the non-participants. And history teaches us that a significant number of private creditors will not volunteer to participate.

In sum, for emerging and developing countries to be able to withstand the economic shock, it is imperative to include all private creditors as part of a future debt standstill. This chapter quantifies the problems and describes the main elements of a proposal for a debt standstill which will allow participating countries to finance COVID-19 amelioration policies while providing safeguards for public and private creditors (for further details, see Bolton et al. 2020).

2 https://www.nytimes.com/2020/04/30/opinion/coronavirus-debt-africa.html

3 The International Development Association (IDA) is the part of the World Bank that helps the world's poorest countries. The group of countries targeted by the G20 also includes Angola, which is not an IDA country but it is classified as a Least Developed Country by the United Nations.

The standstill described in this chapter has the following advantages:

1. All participating creditors would be treated equally.
2. All issues related to the identification of eligible crisis amelioration expenditures, conditions precedent to drawdowns and post-disbursement monitoring would be centralised and administered by a multilateral institution.
3. It can be implemented immediately, a critical feature as this crisis rages.

It is worth noting that it is likely that many countries will exit the COVID-19 crisis with unsustainable public debts. The proposal described here is not aimed at solving the problems of countries with unsustainable debts; it only recognises that at this stage there is too much uncertainty to assess debt sustainability in emerging and developing countries. The idea of the proposal is to postpone the decision to a moment in which a proper debt sustainability analyses can be conducted.

A standstill on interest payments for the balance of 2020 or slightly longer does not preclude or prejudge a more durable debt restructuring for one of these countries at the appropriate time. The facility envisioned described in this chapter can be considered a de facto senior instrument in such a debt restructuring, the equivalent of debtor-in-possession financing in a corporate insolvency.

Countries that need to apply for a debt standstill may be worried about their reputation in the international credit market. However, it is worth noting that domestic contract law regimes incorporate doctrines that allow the performance of a contract to be suspended (or occasionally avoided entirely) upon the occurrence of events that are wholly unforeseen, unpredictable and unavoidable. For its part, public international law recognises, in a doctrine called ‘necessity’, that states may sometimes need to respond to such exceptional circumstances even at the cost of suspending normal performance of their contractual or treaty undertakings. COVID-19 meets all of the criteria for such an exceptional phenomenon. Countries badly afflicted by this pandemic will need to deploy their available financial resources in immediate crisis amelioration measures. Those funds must be obtained from several sources, including money that had been intended for scheduled debt service. In making these adjustments, the states concerned will not be acting in a discretionary or optional manner; in the truest sense of the word they will be acting out of necessity.

Quantifying the problem

In 2018 developing and emerging market countries (excluding China) had a stock of external debt of approximately $5.9 trillion. About 82% of this debt ($4.8 trillion) was classified as long-term (with original maturity greater than one year), with $2.1 trillion owed by the private sector and $2.7 trillion either owed to or guaranteed by the public sector. Of the public sector external debt, about 40% was owed to the official sector ($600 billion to multilateral creditors and $400 billion to bilateral) and the remaining 60% to private creditors (bonds amounted to $1.3 trillion and bank loans to $380 billion).[4]

One way of estimating the effect of the COVID-19 crisis on the ability of emerging and developing countries to roll-over their external public debt is to assume that these countries will lose market access at least until the end of 2020.[5] If official financing remains constant, net flows tied to long-term debt with official creditors are expected to be $25 billion ($120 billion in disbursements minus $71 billion principal repayment and $24 billion in interest) and net flows with private creditors amount to -$252 billion, as there will be principal and interest payments due ($170 billion and $82 billion, respectively) but no disbursements (which in 2018 amounted to $237 billion). Hence, the estimated shortfall on long term debt flows will be $227 billion.

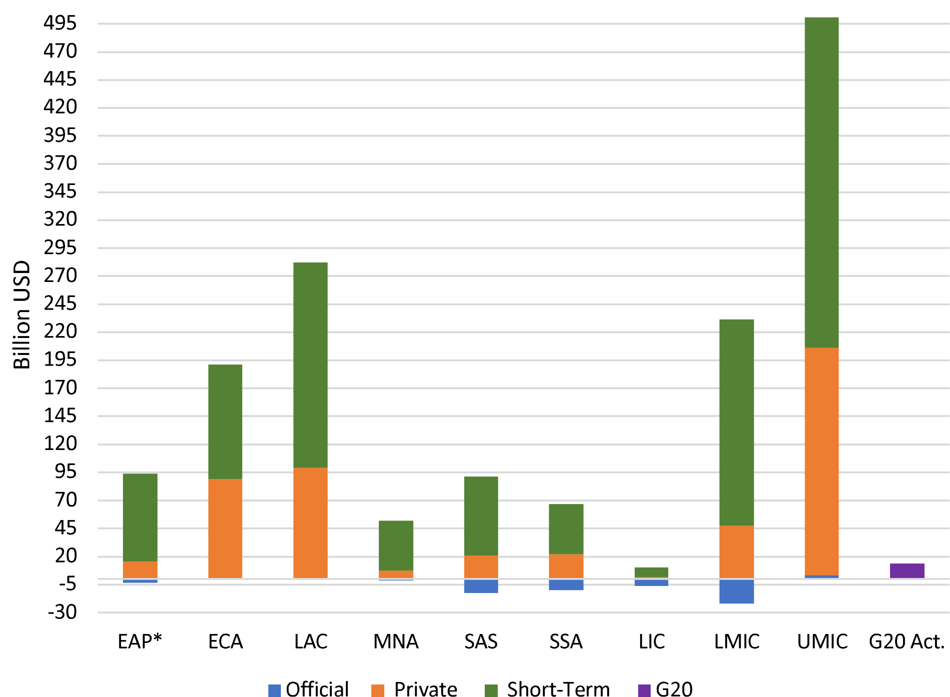
To this figure, we need to add short-term debt. There are no detailed data on the share of short-term external debt owed by public sector borrowers but it could be as high as $500 billion, bringing the total shortfall to $735 billion. This total shortfall provides an estimate of the potential public sector sudden stop, while the total sudden stop would also include equity flows and lending to private debtors.

The recent G20 decision to grant debt relief to the poorest countries focuses on the bilateral debt of the group of countries which are eligible to borrow from the World Bank concessional window (the IDA) plus Angola. The total shortfall for this group of countries is estimated at $36 billion. The principal and interest due by these countries to bilateral creditors (the focus of the G20 action) is $14 billion, less than 2% of our estimates for the public sector sudden stop associated with COVID-19 across all low- and middle-income countries.

4 Table A1 in the Bolton et al. (2020) provides a detailed breakdown.
5 As data on roll-over needs for 2020 are not available, in Bolton et al. (2019) we use 2018 as a proxy.

Figure 1 shows how this shortfall varies across geographical regions and income groups. The most affected region will be Latin America and the Caribbean, followed by Emerging Europe. For Emerging Europe, about 50% of the sudden stop will be associated with the need to service and rollover long-term external debt and the remaining half related to short-term debt flows.[6] For Latin America and the Caribbean, about two-thirds of the sudden stop will be associated with short-term debt rollover needs.[7] The figure also shows that for middle-income countries, 'business as usual' net-official inflows (which tend to be positive and hence have a negative value in our measure of shortfall) cannot be expected to compensate the expected sudden stop in bond and bank financing. The figure also shows that the G20 debt relief of April 16, $14 billion, is very small compared to the total expected shortfall.

Figure 1 Potential public sector sudden stop



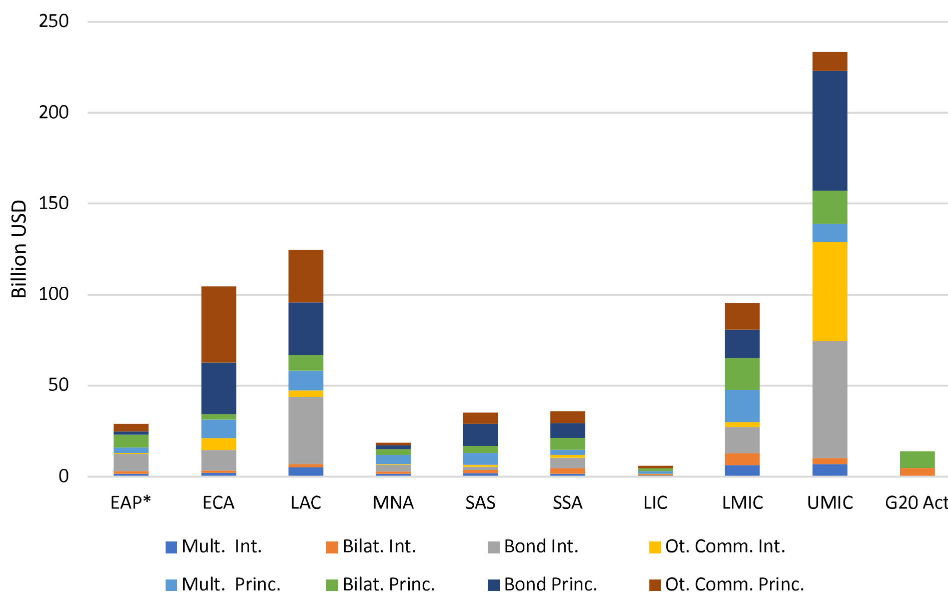
Notes: This figure plots the potential public sector sudden stop across geographical regions and borrowing groups. It assumes business as usual net flows from official creditors. The G20 Act. Bar plots the debt relief measure implemented by the Group of 20 on April 16, 2020.

Source: Bolton et al (2020)

For purposes of our analysis in Bolton et al. (2020), we put aside short-term claims that are typically governed by the domestic laws of the issuer and, therefore, more pliable (Buchheit and Gulati 2019). The focus instead is on external debt issued under foreign laws. Here, a coordinated effort by the G20 to apply a generalised standstill to all debt payments due by an emerging or developing country that requests such a pause in payments would go a long way in addressing this issue.

Principal and interest on long-term debt due to private creditors amount to $252 billion and principal and interest due to bilateral official creditors amount to $43 billion.[8] Figure 2 provides a detailed breakdown concentrating on the long-term component of this potential public sector sudden stop. In Emerging Europe, most of the potential public sector sudden stop on long-term debt (80%) is related to the need to rollover maturing bonds and loans, while in Latin America interest payments amount for more than 40% of financing needs (about the same as for the group of upper-middle-income countries).

Figure 2 Public sector external debt service (only long-term debt)



Notes: This figure plots the potential public sector debt service needs across geographical regions, borrowing groups, and creditor groups (Multilaterals, Bilaterals, Bond, Other Commercial Creditors). The dotted bars measure interest payments (Int.) and the solid bars repayment of principal (Princ.). The G20 Act. Bar plots the debt relief measure implemented by the Group of 20 on April 16, 2020.

Source: Bolton et al (2020)

These figures should be interpreted with caution. On the one hand, they may overstate the problem since they assume a complete sudden stop in private sector financing. For instance, at the end of March, Panama managed to issue a $2.5 billion sovereign bond in the international debt market. On the other hand, these figures are likely to greatly understate the problem as they do not take into account funding gaps associated with:

1. the collapse of international lending to the private sector (which accounts for 40% of total long-term external debt developing countries);
2. the sudden stop in equity flows (both portfolio and FDI); and
3. the currency depreciation which will increase the cost of serving foreign currency loans.

An increase in official disbursement equal to all payments due to the official sector could close about 30% of this shortfall in long-term debt ($71 billion in principal repayment and $24 billion in interests), but developing and emerging market countries will still need an additional $200 billion, even if we only focus on long-term debt (more than $600 billion is short-term debt is included).

And these figures assume a constant public sector expenditure and deficit. Hence, they fail to recognise that the sudden stop comes while GDP in emerging and developing economies is expected to contract by 1% in 2020 (with contractions as large as 5% in Emerging Europe and Latin America) according to the April 2020 IMF World Economic Outlook projections, down from 3.7% output growth in 2019. Lower economic activity will reduce tax revenues while government expenditures must increase to protect citizens and the economy. Overall, the IMF estimates that emerging economies' funding needs will total $2.5 trillion, a figure that is likely to be conservative.[9]

Even a dramatic increase in multilateral development bank (MDB) lending will not be sufficient and the private sector will have to be involved in offering relief. The G20 could enable a generalised private sector debt suspension by coordinating a standstill that would apply to all sovereign-debt payments due by emerging and developing economies that requested such a freeze, and that would remain in place until the health crisis passes (Gourinchas and Hsieh 2020).

The standstill may well bring private lending to the countries that request it to a full stop, but for all intents and purposes most of these capital flows have already stopped or even been reversed.

9 https://www.imf.org/en/News/Articles/2020/03/27/tr032720-transcript-press-briefing-kristalina-georgieva-following-imfc-conference-call

The proposal

Implementation of an emergency standstill, particularly for commercial creditors of middle-income countries, presents a challenge. Some countries will have dozens of external debt instruments with hundreds or even thousands of individual creditors. Attempting a bespoke standstill negotiation for each of those instruments is impractical. It would take months at the very time when the debt relief is needed most critically. No individual commercial creditor or group of creditors will be in a position to prescribe eligible uses for the money that would otherwise have gone toward debt service, much less be in a position to monitor and verify how those funds are actually spent. Individually negotiated amendments to existing debt instruments will inevitably produce a welter of incongruent conditions, financial terms, covenants and so forth, probably at ruinous legal expense. Therefore, all creditors will be asked for the same relief – a standstill on interest payments for a prescribed period. Since a bespoke implementation of that request will result in choppy, inconsistent outcomes among affected creditors, in Bolton et al. (2020) we suggest a streamlined approach as follows:

1. The World Bank or the multilateral development bank for the region concerned would open a central credit facility (CCF) for each country requesting this assistance. The CCF would specify the eligible crisis amelioration uses for drawings under the facility, as well as the arrangements for monitoring the use of proceeds.
2. In view of the nature of this emergency, each CCF should have terms (interest rate and amortisation) that will not aggravate the post-COVID-19 financial position of the beneficiary country.
3. Once a CCF is in place for a country seeking this assistance, the debtor country would notify each of its bilateral and commercial creditors that interest payments on existing debt instruments falling due during the prescribed standstill period will be directed to (and reinvested in) the CCF. Each lender would also receive a formal request from the debtor country seeking the lender's acknowledgment that the reinvestment of the interest payment into the CCF (and the crediting to the lender's account of a corresponding interest in the CCF) will constitute a full discharge and release of the borrower's obligation in respect of the relevant interest payment.[10]
4. The threshold decision about whether to seek a standstill on interest payments for a limited period will rest in the discretion of each sovereign debtor.

10 Communications addressed to creditors with an implicit "No RSVP Necessary" message have a long tradition in sovereign debt workouts (Buchheit 1991).

Participating countries with principal amortisations falling due during the standstill period will need to defer those amounts. Such deferral could be handled in one of several ways discussed in detail in Bolton et al. (2020).

Protecting reputation

Countries may be worried that requesting a standstill would hurt their reputation. There is one measure that the official sector could take and that may jointly protect the reputation of debtor countries which will use the facility described in this chapter and assist them if legal challenges are raised by minority creditors to these arrangements.

In any public statement about these measures and the global emergency that gave rise to the measures, the G20 could recognise that both official sector institutions and the debtor countries are acting out of necessity, referencing Article 25(1) of the Articles on State Responsibility promulgated by the International Law Commission in 2001.[11]

By publicly stating the purpose of the debt relief – namely, the necessary relief from debt obligations to help debtor countries face the global emergency engendered by the COVID-19 pandemic – the G20 would play an important certification role of the extreme and exigent circumstances they are facing. Depending on the law of the jurisdiction where a holdout creditor may elect to pursue its legal remedies, such a public statement by the G20 may assist the sovereign debtor in defending its action as the minimal necessary to respond to the exigent circumstances of the pandemic.

Past economic crises, whether in the US or elsewhere, have sometimes led to political interventions to suspend debt payments or to make other modifications to the terms of debt contracts. Such interventions may be necessary and do not automatically undermine credit markets. In some instances, they have actually had the opposite effect, resurrecting debt markets following the intervention. The reason why debt markets recovered was that creditors had anticipated widespread default in the absence of any modification of the repayment terms, and they were pleasantly surprised by the

11 Article 25(1) *Necessity*:
Necessity may not be invoked by a State as a ground for precluding the wrongfulness of an act not in conformity with an international obligation of that State unless the act:
(a) is the only way for the State to safeguard an essential interest against a grave and imminent peril; and
(b) does not seriously impair an essential interest of the State or States towards which the obligation exists, or of the international community as a whole.
International Law Commission (2001).

intervention that had the effect of reducing the risk of default.[12] Creditors on average preferred the certainty of receiving a reduced repayment to the very uncertain prospect of being made whole.

To be sure, creditors generally do not expect that the promised repayment of their debt contracts will always be honoured. They understand that there could be circumstances when it would be essentially impossible for the debtor to meet its obligations. Had they been able to clearly and precisely anticipate these circumstances, they would have modified the terms of the contract to reflect these necessities and thereby avoided a wasteful and unnecessary default.

For many reasons, most debt contracts are highly incomplete and do not contain provisions prescribing how the parties will react to such contingencies. To name just one, it is very difficult to specify precisely in advance the exact form of a contingency such as a global pandemic that would merit lowering debt obligations in this event. Ex post it is easier, of course, to identify the contingency. The political intervention in debt contracts in these events serves the role of completing incomplete debt contracts. By certifying the event and by modifying the terms of the debt contract in ways that the contracting parties themselves would have wanted had they been able to, the intervention, far from undermining credit markets, helps support these markets.[13]

Not all interventions are beneficial in this way. It is important that they take place only in highly unusual and urgent circumstances that are outside the debtor's control ('acts of God'). Unusual circumstances are precisely the ones that are hard to describe and include in a debt contract. By certifying that such an event has occurred and by acting accordingly, the G20 would ensure that contract terms will be modified only when absolutely necessary and when the modifications are likely to support credit markets.

To summarise, debt suspension in a crisis provides ex-post economic benefits by avoiding a costly default and by relaxing the liquidity constraint of debtors. These ex-post economic benefits do not negatively affect credit markets ex ante even when suspension in rare circumstances is anticipated. The reason is that the contracting parties themselves would have included lower debt obligations in these circumstances.

12 See Kroszner (2003) and Edwards et al. (2015) on the positive effect on debt markets of the repudiation of the gold indexation clause in debt contracts during the Great Depression.

13 See Bolton and Rosenthal (2002) for an analysis of how ex-post political intervention in debt contracts can be seen as a way of completing incomplete debt contracts.

It is the inability of the contracting parties to describe these circumsta[14]nces ahead of time that explains the incompleteness of the debt contract. But the contracts can be completed through political intervention in times of exigency.

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14 Moral hazard and the concern that the doctrine of necessity will be liberally applied to future events should be allayed by the fact that COVID-19 is a truly exogenous once-in a generation event. The latter point is supported by the following facts: (i) official forecasts point to the deepest global recession since the Great Depression; (ii) global lockdown policies which are more stringent than those adopted during World War II; (iii) unprecedented monetary and fiscal policies adopted by all advanced economies and several emerging market countries.

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About the authors

Patrick Bolton is the Barbara and David Zalaznick Professor of Business at Columbia University and visiting Professor at Imperial College London.

Lee C. Buchheit retired in 2019 after a 43 year legal career. He holds a variety of academic appointments including as an honorary professor at the University of Edinburgh Law School and a visiting professor at the Centre for Commercial Law Studies in London.

Pierre-Olivier Gourinchas is Professor of Global Management and director of the Clausen Center for International Business and Policy at UC Berkeley and CEPR Research Fellow.

Mitu Gulati is on the faculty of the Duke Law School. His research focuses on sovereign bond contracts.

Chang-Tai Hsieh is the Phyllis and Irwin Winkelreid Professor of Economics at the University of Chicago and a member of the International Growth Centre’s Steering Group.

Ugo Panizza is Professor of Economics and Pictet Chair in Finance and Development at the Graduate Institute of International and Development Studies, Vice President of CEPR and Director of the International Center for Monetary and Banking Studies (ICMB).

Beatrice Weder di Mauro is Professor of International Economics at the Graduate Institute of Geneva and Distinguished Fellow at the INSEAD Emerging Markets Institute, Singapore and President of CEPR.