COVID-19's legacy of debt and debt service in developing countries

Homi Kharas
Meagan Dooley

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Homi Kharas
Senior Fellow,
Center for Sustainable Development
Brookings Institution

Meagan Dooley
Senior Research Analyst,
Center for Sustainable Development
Brookings Institution

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www.brookings.edu/global

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I. Introduction

The economic outlook for developing countries is grim in the wake of COVID-19. Total output in developing countries, sans China, is projected to fall by 5.7 percent in 2020, with a recovery of 5 percent in 2021.[1] Compared to pre-COVID projections, this amounts to an 8.1 percent loss by the end of 2021, worse than advanced countries at -4.7 percent.

The OECD estimates that developing countries will see a drop of $700 billion in private finance in 2020.[2] Already, in the first five months of the crisis, developing countries experienced a portfolio outflow of negative $103 billion.[3] While trade has started to rebound as lockdowns have lifted, foreign direct investment (FDI) flows to emerging and developing countries are still set to fall 30 to 45 percent in 2020.[4] Trade financing has proven particularly vulnerable to shocks in the past, and estimates suggest that $1.9 trillion to $5 trillion will be needed to enable a V-shaped recovery.[5] Remittances, a major source of investment for many developing countries, are also expected to fall by 7 percent this year, and another 7.5 percent in 2021.[6]

Real economy recession, coupled with a weakening of many currencies, will lead to a fall in nominal U.S. dollar GDP of developing countries (excluding China) of 10 percent in 2020. And although developing countries have been far more modest in fiscal support than has been the case in advanced economies, general government debt levels, including foreign exchange debt levels, have continued to rise in 2020, with prospects of further deterioration in 2021. Sovereign debt levels are forecast to rise by 12 percentage points of GDP in emerging markets and 8 percentage points in low-income countries.[7]

Only one sub-Saharan African country has been able to access the sovereign debt market since February.[8] Thirty-six developing countries have been downgraded by one or more of the four largest credit rating agencies. There is every expectation that debt restructuring will loom large on the international policy agenda in 2021.

G-20 leaders, following a call from the African Ministers of Finance,[9] have already agreed to a Debt Service Suspension Initiative (DSSI) for all International Development Association (IDA) countries and Angola to free up fiscal policy space for COVID-19 response efforts.[10] The initiative initially covered all debt

service due between May 1 and the end of 2020, and has since been extended to June 2021.[11]

So far, however, DSSI agreements have only covered $5 billion in debt service due. Doubtless this number will increase, but the agreement falls well short of what developing countries owe: $356 billion in debt service on public and publicly guaranteed debt due in 2021, and another $329 billion in 2022 (see Figure 1). Additional amounts of some $500 billion are also due on private non-guaranteed debt service, amounts that are not yet public liabilities but that, in past debt crises, have become socialized when foreign exchange availability has dried up. In other words, there are significant explicit public debt liabilities and the potential for additional implicit liabilities to arise.

Policymakers must decide what to do. The lessons from past debt episodes are that interventions that are too little, too late result in inefficiencies and significant social and financial costs linked with large-scale debt overhang problems and repeated restructurings.[12] Conversely, too rapid and too large an intervention generates a moral hazard, potentially throws good money after bad, and can seriously affect future access of countries to capital markets.

This paper provides a framework and some evidence for how to arrive at a Goldilocks solution. Debt problems are highly country and context-specific, so we do not attempt a formal analysis or recommendation for any particular country. But we believe that a sketch of the debt servicing landscape for 2021 and 2022 will improve understanding of the differentiated policy response that will be needed.

The main message is simple. Public debt servicing problems go far beyond the DSSI in terms of the number of affected countries. While some countries require proper debt workouts with equitable burden-sharing, the larger part of the problem is one of liquidity—the ability to roll over principal repayments at affordable rates. Organizing this, and at the same time providing a context for external financing of the investments needed to transform economies through sustainable development, is the great challenge in front of the international community.

II. Context

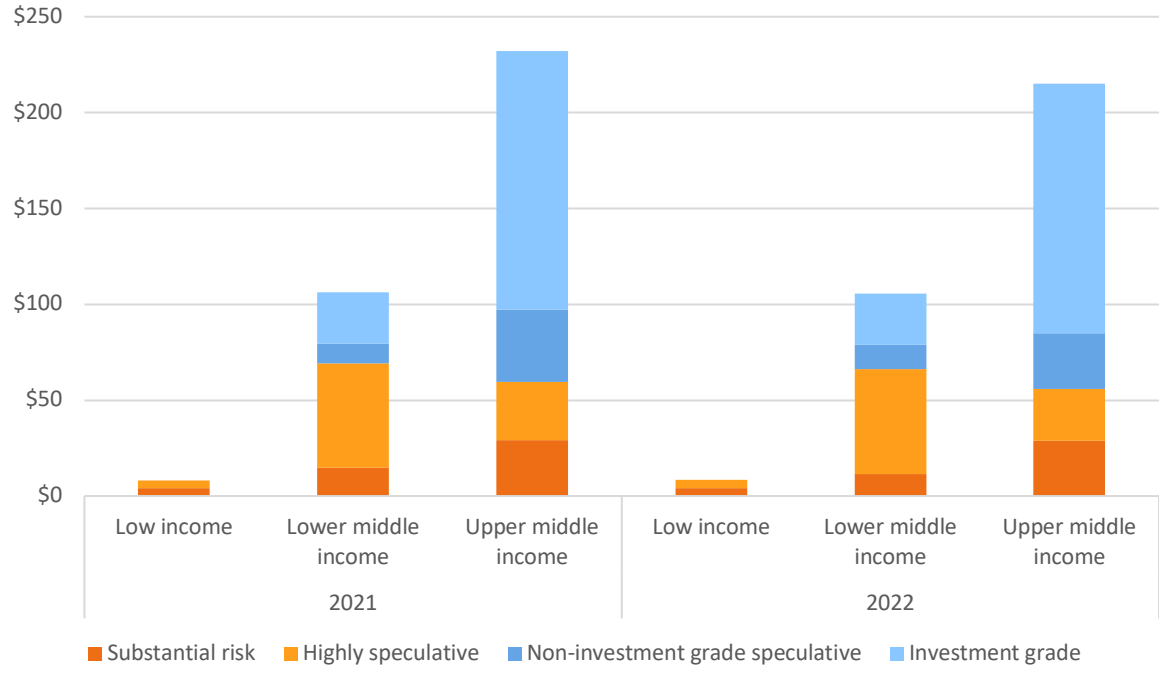
How much debt service is really at risk? To answer this question, we disaggregate the public external debt service obligations by country income category in Figure 1 below. The Figure shows that the majority (roughly 70 percent) of debt service falling due is owed by upper-middle-income countries, most of the remainder is owed by lower-middle-income countries, while low-income countries owe a very small fraction of the debt service due.

For each country category, we further divide up debt service obligations in terms of the credit rating of the public obligor. To give an example, Figure 1a shows that around $130 billion of debt service due in 2020 from upper-middle-income countries are obligations of investment grade countries that can readily refinance their obligations in sovereign debt markets; China and Colombia are good examples. A further $40 billion is speculative, but roughly $60 billion is classified as "highly speculative" or carrying "substantial risk." (We are using the categories formed by Trading Economics, an aggregator of economic and financial market data.[13])

Figure 1a shows clearly that there is a considerable amount of debt service at risk that is owed by upper-middle-income countries. This is important as these countries are not eligible for the DSSI program currently in place. A second observation is that debt servicing problems are concentrated in middle-income countries, not low-income countries, an important point as many of the standard prescriptions for managing debt problems, such as the provision of Naples terms under the Paris Club agreement, have been developed with low-income countries in mind. Solutions for middle-income countries must also concern themselves with how to preserve access to private capital markets. Third, within both upper- and lower-middle-income groups countries span the range from being investment grade to having substantial risk of debt servicing difficulties. Any policy intervention must recognize these differences.

Figure 1a. Total debt service on external public debt, 2021-2022, by income group

Billions, current USD



Source: World Bank International Debt Statistics (2021). Credit scores from Trading Economies. Note: A few countries do not have TE scores. These have been interpolated following Kharas and Noe (2018).[14]

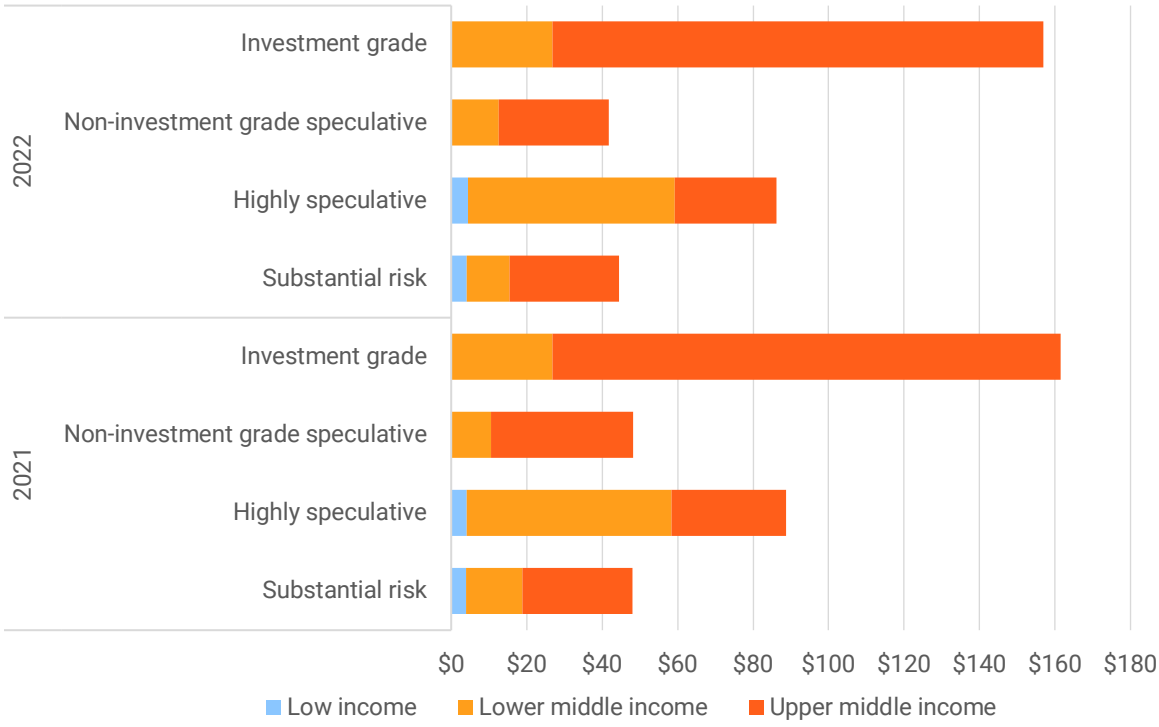
Figure 1b presents the same information but with a different cut. It divides up debt service according to the sovereign rating of the obligor. About $160 billion of developing country debt service in both 2021 and 2022 is owed by 12 investment grade governments.

At the other end of the scale, there is about $40-50 billion of debt service due each year from 34 countries with "substantial risk" of debt default. Some of these defaults have already happened: Zambia in November 2020,[15] Lebanon in March 2020,[16] and Venezuela on its last bond in October 2019.[17] More will follow.

The grey areas, where there is less consensus as to what to do, surround the $140 billion or so of annual debt service owed by speculative borrowers. These amounts are owed by 74 countries, with a combined population of 2 billion people. A case-by-case approach will not be feasible for so many countries, but a single-sized solution would likely be too crude.

Figure 1b. Total debt service on external public debt, 2021-2022, by credit rating

Billions, current USD



Source: World Bank International Debt Statistics (2021). Credit scores from Trading Economies. Note: A few countries do not have TE scores. These have been interpolated following Kharas and Noe (2018).

Classifying countries in this way is useful because the policy implications are so different. Table 1 below provides a quick summary of how many countries and how much debt and debt service due in 2021 and 2022 falls into each category.

Table 1. External public debt stock and debt service due by credit score, billions (current USD)

	Credit score	Substantial risk	Speculative	Investment grade	Total
All developing countries	Number of countries	34	74	12	120
	Debt stock (2019)	$409	$1,239	$1,453	$3,102
	Total debt service (2021-2022)	$92	$265	$318	$676
DSSI eligible countries	Number of countries	25	43	0	68
	Debt stock (2019)	$127	$364	$0	$492
	Total debt service (2021-2022)	$32	$74	$0	$106

Source: World Bank International Debt Statistics (2021). Credit scores from Trading Economies. Note: A few countries do not have TE scores. These have been interpolated following Kharas and Noe (2018).

The policy prescriptions for the two extremes are clear. Investment grade countries can still access global capital markets at reasonable rates. Assuming that the global recovery stays on track, this debt service does not pose a problem and no coordinated action by the international community is needed.

At the other end of the scale, debt default countries require a case-by-case review and, in almost all cases, there will need to be some combination of a debt haircut and a domestic adjustment. There are 34 such countries, with a combined population of 580 million people. Managing the logistics of these workouts will not be easy and the welfare consequences for the populations involved are considerable, so due diligence and fair and equitable treatment are needed. But the mechanics of how to frame country adjustment programs with debt levels brought down to sustainable levels are by now well known. Some of these countries are already engaged in the DSSI program which will make the technical work easier, so the problems should be manageable, albeit painful, but there are also nine countries that are not eligible for the DSSI that fall into this category. Speed and fairness in burden-sharing are the core issues.

The most problematic cases are those in the grey area between countries requiring debt write-offs and countries that have no difficulties in making debt service payments. It is these countries that are the focus of the remainder of this paper. We first lay out a proposed framework for identifying these middling countries, and then make the case that there is a clear role for the international financial institutions (IFIs) to provide an influx of financing to help support this group.

III. Debt resolution framework

The essence of a debt resolution framework is to decide if the problem is one of a liquidity shortage or a solvency problem. Despite former Citibank chairman Walter Wriston's quip that "countries don't go bankrupt," the harsh reality is they do renege on debt service obligations. Carmen Reinhart and Ken Rogoff produced a famous chart showing 189 cases of sovereign default or restructuring in the 100 years between 1915 and 2015, covering 80 different countries.[18]

In almost all cases, insolvency only happens when a government's debt levels are high. This is why a core economic variable in any debt sustainability analysis is the debt-to-GDP ratio. The International Monetary Fund (IMF) uses several thresholds, but chief among these is a belief that developing countries, even those with the strongest policies, should strive to keep debt-to-GDP levels below 55 percent. Hence, the first consideration in a decision-tree framework sketched out in Figure 2 below is to look at whether a country exceeds this threshold or not (the IMF has lower thresholds for countries where the policy framework is worse, in their judgment, but for ease of exposition we have simply used the single 55 percent number here). The somewhat good news is that $83 billion in debt service is due from 47 speculative countries with relatively low levels of debt (below 55 percent debt-to-GDP ratio), while only $54 billion is due from the 27 highly indebted countries.

The next step is to determine whether the current debt trajectory is on a sustainable path or not. There is a simple algebraic formula that shows that in any country the debt-to-GDP ratio will stabilize at some level, without any adjustment to the primary balance, if the nominal growth rate of GDP, g, exceeds the nominal interest rate, i. The intuition is simple. When (i-g) is negative, a country can continue to finance a fixed primary deficit and the debt ratio will stabilize at some point, but if (i-g) is positive, the debt-to-GDP ratio will rise indefinitely unless a large enough primary surplus can be obtained. If the starting point is one where debt is high and (i-g) is large and positive, the size of the primary balance required to re-establish a sustainable debt trajectory may simply be socially unacceptable. It would imply raising taxes and cutting public services to a degree that could trigger a popular revolt. This is the circumstance when a debt haircut is sorely needed.

In our calculations, using ten-year averages (2009-19) for the interest rate and growth rates, (i-g) is negative in most countries. Debt service obligations are split approximately evenly between positive and negative (i-g) countries. However, among the sub-group of heavily indebted countries, most of the debt service appears to be from a small group of 9 countries with positive (i-g), suggesting that solvency issues are likely paramount, while among the low-indebted countries, more debt service is from the negative (i-g) group, suggesting that liquidity issues dominate there.

The final step is to assess whether a country has a "good enough" set of environmentally sustainable and socially inclusive policies in place to ensure that economic growth is actually benefitting its people. If it does, then consideration should be given to providing the country with sufficient resources to grow out of their debt difficulties and even to finance larger primary deficits if those would accelerate sustainable growth. If the policy framework is not judged to be broadly beneficial, then there is a significant risk that growth, if it were to occur, could actually be immiserizing. Under such circumstances, lenders would not want to provide additional resources.

A decision frame of this kind leads to a defined set of differentiated outcomes with different implications for public policy. At one end, heavily indebted countries with weak environmental and social policies provide the greatest challenge. International lenders would want to be conservative about providing new resources into this environment. Existing creditors will need to negotiate with governments as best they can. The outcome may be messy and painful, but absent wholesale political change, options are constrained. There is a significant amount of debt service falling due in 2021 under this category—perhaps $21 billion owed by 4 countries (Montenegro, Jamaica, Bosnia and Herzegovina, and Turkey). In these countries, haircuts may be desirable. There will simply not be enough foreign exchange or government revenue to service the debts. A negotiated solution with adjustments made to raise the primary balance ("austerity") coupled with structural reforms over the medium term will be required. Development prospects are likely to be dim until reforms can take hold.

The international community has more options in places where the policy environment is relatively strong. Economic growth and debt problems may have resulted from natural disaster, or even the current COVID-19 crisis. Some small island states, for example, have been devastated by loss of tourism incomes, others by loss of remittances, each of which can be considered as a temporary

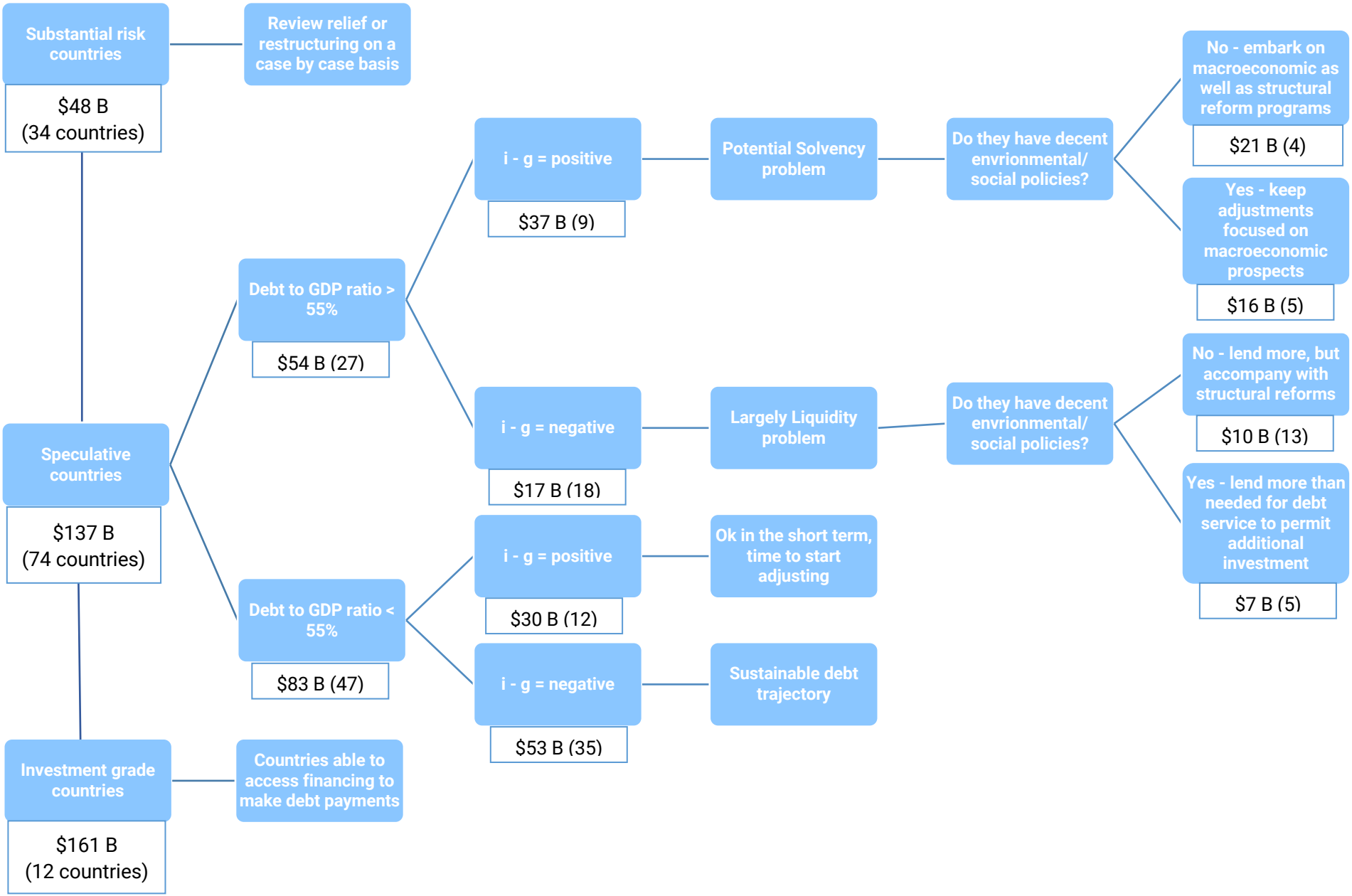
shock. Help from the international community can be construed as a global risk pooling mechanism—it is unfair (and inefficient) to leave countries at the mercy of unpredictable global shocks. There is perhaps some $16 billion in debt service falling due in the 5 countries in this category (Tunisia, Ukraine, Serbia, El Salvador, and Belarus). The big question for the international community has to do with the absorptive capacity of the country. Is growth pre-destined to be low, perhaps because of geographic constraints, or could appropriate investments ignite growth? In the latter case, there is more scope for providing additional liquidity, or extending maturities.

A third scenario follows the branch of the decision frame where (i-g) is negative. Here, even though the country may be already highly indebted, the chances are greater for a growth-oriented solution. Debt dynamics become more favorable over time. The pressing issue is to get through the next few years. There are various forms through which liquidity can be provided. Debt suspension is already available for DSSI countries, but other mechanisms of maturity extension, roll-overs, and defensive lending can be used by creditors. Where the country has a sound policy framework, it will also be the case that extending new credits for additional investments will hasten a return to creditworthiness.

The last scenario follows the branch of low initial indebtedness. This is where the bulk of debt service coming due currently lies, perhaps $83 billion. By and large, we would categorize these countries as having primarily liquidity constraints, subject to the same assessments as above—more ambition on new lending for countries with relatively favorable policies, more caution for those where growth levels are low, or where the sustainability of growth is suspect.

Figure 2. Debt Response Decision Tree

Totals beneath each box show the total debt service due in 2021 and the number of countries in each category (in parentheses)



To recap: Our objective in providing this kind of decision frame is to understand the landscape and give orders of magnitude to alternative country scenarios. We find that the majority of developing country debt service falling due in 2021 and 2022 is from countries where liquidity is the most pressing issue. Liquidity is needed both to roll-over existing debt as well as to finance new investments to accelerate growth in cases where the policy environment for sustainable and inclusive growth is reasonably strong. Solvency appears to be a smaller problem at this stage, although it may still affect about $85 billion of debt service falling due, combining both the debt service from countries with substantial risk and the debt service from those with high initial levels of debt and unfavorable debt dynamics. Crucially, when we look at which countries have availed of the DSSI, we find them almost exclusively in the group of countries with a liquidity problem.

IV. Implementing the framework

Initial conditions—the external debt-to-GDP ratio

Table 2 below shows the 42 developing countries that had external debt-to-GDP ratios above 55 percent in 2019. Only 19 of these countries are eligible for DSSI, of which 11 are currently participating.

Table 2. Countries with external debt-to-GDP ratios over 55 percent, 2019

Country	External debt-to-GDP ratio	Country	External debt-to-GDP ratio
Venezuela, RB	263%	Jordan	77%
Mongolia~	227%	Djibouti*	77%
Montenegro	149%	Papua New Guinea*	75%
Lebanon	139%	Belize	73%
Mozambique*	137%	North Macedonia	71%
Zambia*	119%	Mauritania*	71%
Sudan	118%	Serbia	70%
Somalia~	114%	El Salvador	67%
Bhutan~	110%	Sri Lanka	67%
Kyrgyz Republic*	99%	Belarus	65%
Georgia	98%	Moldova~	63%
Tunisia	97%	Albania	63%
Jamaica	96%	Argentina	62%
Nicaragua~	93%	Rwanda~	61%
Cabo Verde*	92%	Bulgaria	60%
Lao PDR~	92%	Sao Tome and Principe*	59%
Armenia	87%	Turkey	58%
Kazakhstan	87%	Senegal*	58%
Bosnia and Herzegovina	83%	Zimbabwe	57%
Tajikistan*	82%	Cambodia~	57%
Ukraine	81%	Angola*	55%

Source: World Bank International Debt Statistics and World Development Indicators. GDP data for Eritrea, Somalia, and Venezuela come from IMF World Economic Outlook (Oct. 2020). * indicates DSSI participating countries. ~ indicates DSSI eligible countries who have not yet opted in.

Debt dynamics—the interest/growth differential

Table 3 shows the i-g ratios for selected countries that have a debt-to-GDP ratio above 55 percent (full table for all countries available in Annex 1). The table shows the heterogeneity amongst countries. Mongolia, for example, has been growing at 11.7 percent per year for a decade, on the back of large increases in mining output, achieved through heavy investments financed from abroad. Conversely, the Sudan has seen its economy shrink considerably over this period.

Mongolia is a classic case of a country facing a potential liquidity problem. Most of its debt is private, linked to the mining sector. It enjoys a sizable primary surplus on its fiscal accounts that it is using to pay down public debt. The Sudan has a higher likelihood of facing a solvency problem. Even though it has been accumulating debt at very concessional rates (at 0.5 percent, Sudan's average interest burden is among the lowest of all countries), the debt burden keeps mounting over time in relative terms as the economy shrinks. Absent significant structural reform to restore growth, Sudan will inevitably be faced with on-going debt difficulties.

Another noteworthy feature of Table 3 is the large variance in the average interest rate faced by countries. Take the example of Jamaica. For several historical reasons, Jamaica has borrowed significant amounts from private capital markets, including domestically. Given its vulnerability as a small island, and high levels of public debt, Jamaica faces a high average interest rate that far exceeds its growth rate. It has therefore had to run large primary surpluses (recently surpassing 7.5 percent of GDP for the central government) to bring debt down towards a sustainable level and trajectory. As part of its COVID-19 response, Jamaica has slowed its debt reduction program and loosened fiscal policy, using the proceeds of an emergency loan extended by the IMF (utilizing its rapid financing instrument) as well as loans from multilateral development banks.

Table 3. Average 10-year nominal interest rate on external public debt vs. GDP growth (2009-2019)

Country Name	Debt-to-GDP	Average interest rate (2009-2019)	Average GDP growth (2009-2019)	i-g differential	
Mongolia~	227%	2.1%	11.7%	-9.6%	Negative
Montenegro	149%	3.4%	2.8%	0.6%	Neutral
Sudan	118%	0.5%	-9.3%	9.8%	Positive
Kyrgyz Republic*	99%	1.3%	6.1%	-4.8%	Negative
Tunisia	97%	2.9%	-1.1%	4.1%	Positive
Jamaica	96%	6.0%	3.2%	2.9%	Positive
Nicaragua~	93%	1.6%	4.2%	-2.6%	Negative
Cabo Verde*	92%	1.1%	1.5%	-0.4%	Neutral
Ukraine	81%	3.8%	2.8%	1.1%	Positive
Jordan	77%	2.6%	6.1%	-3.5%	Negative
Papua New Guinea*	75%	1.9%	7.9%	-6.1%	Negative
Mauritania*	71%	1.9%	4.9%	-2.9%	Negative
El Salvador	67%	5.8%	4.4%	1.4%	Positive
Sri Lanka	67%	2.8%	7.2%	-4.3%	Negative
Rwanda~	61%	1.4%	5.9%	-4.6%	Negative

Source: World Bank International Debt Statistics and World Development Indicators. * indicates DSSI participating countries. ~ indicates DSSI eligible countries who have not yet opted in.

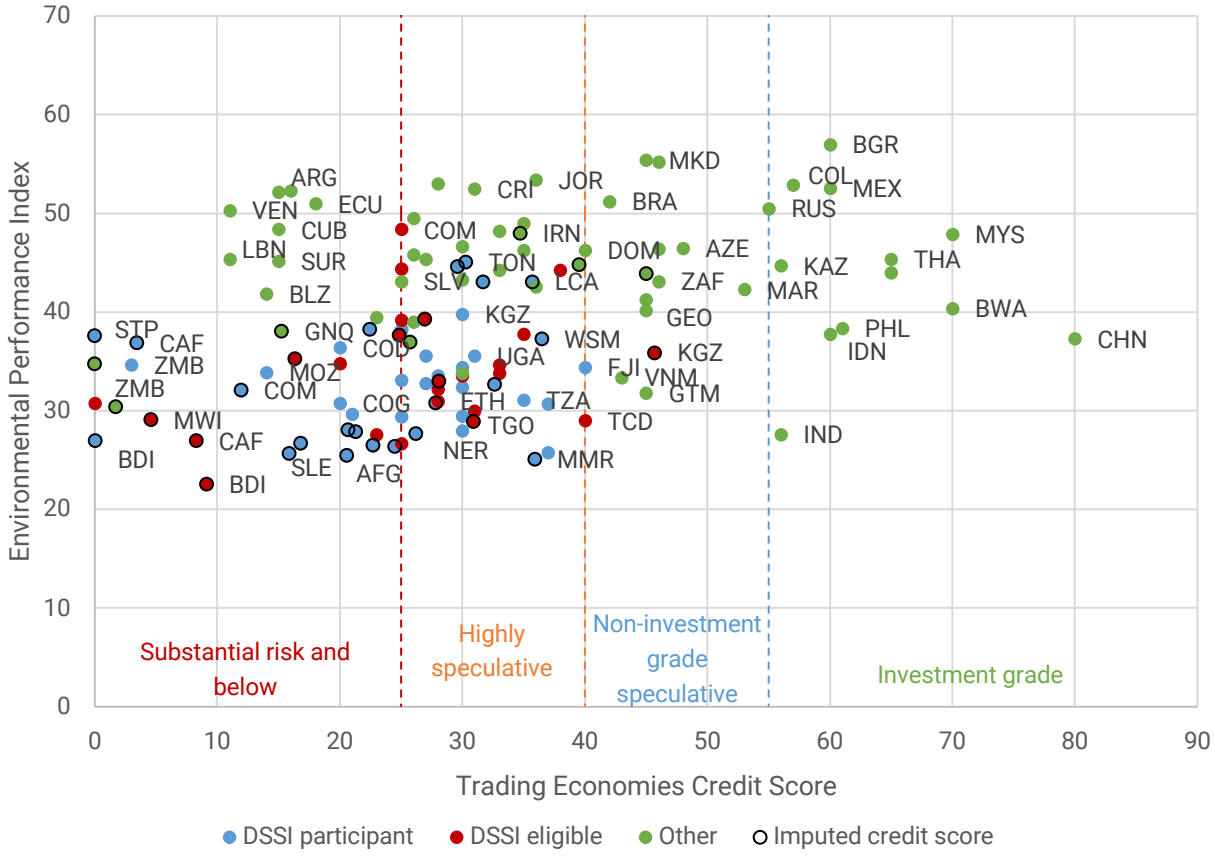
Environmental and social policies

In the analysis above, ten-year averages of interest rates and economic growth were used as proxies for long-run performance. But true long-term growth depends on quality; both the environmental sustainability and the social inclusiveness of growth underpin multi-decade performance.

In Figure 3, we look at how countries rank on Yale's Environmental Performance Index, which assesses countries along 32 indicators relating to environmental health and ecosystem vitality.[19] The figure shows some tendency for more creditworthy countries to have better environmental policies—unsurprising as both are linked to per capita income levels and to levels of government effectiveness. DSSI countries are highlighted

in blue and countries that are eligible for DSSI but have not yet taken advantage are colored red. There has been considerable discussion about using the DSSI to promote environmental goals, through debt-for-nature swaps, for example, but the data below suggest that the recipient countries are not yet ready to embrace sound environmental stewardship as part of their sustainable development programs.

Figure 3. Credit score vs. Environmental performance

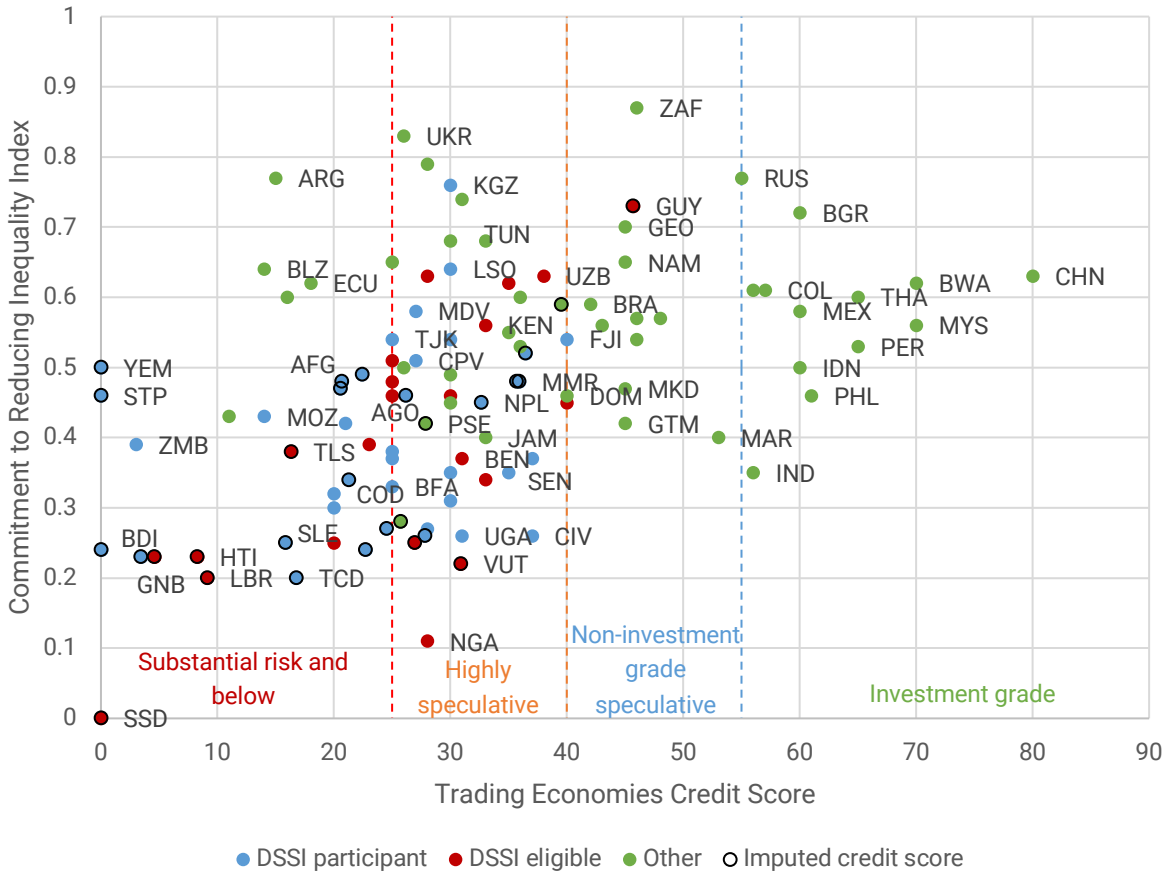


Source: Trading Economies and Yale Environmental Performance Index (2020). Note: A few countries do not have TE scores. These have been interpolated following Kharas and Noe (2018).

Similarly, we look in Figure 4 at how countries score on Oxfam's Commitment to Reducing Inequality Index, which assesses how government health, education, social protection, taxation, and workers' rights policies contribute to or reduce inequality.[20] This is one metric of assessing if economic growth is benefitting the bottom 40 percent of the income distribution. We again find that while most DSSI eligible countries are clustered towards the bottom, there are a number of countries in the speculative categories that have a reasonably strong commitment to inclusion. This provides some

reassurance that providing liquidity to keep countries out of an imminent default will indeed benefit the poorer segments of the population.

Figure 4. Credit score vs. Commitment to reduce inequality



Source: Trading Economies and Oxfam Commitment to Reducing Inequality Index (2020). Note: A few countries do not have TE scores. These have been interpolated following Kharas and Noe (2018).

These two metrics are merely illustrative, but they show that many developing countries currently facing liquidity constraints have reasonably strong environmental and social inclusion policies that would support long-term sustainable growth. These are the countries where it is particularly important to ensure that the current crisis does not become converted into a debt crisis with long-term negative implications for development.

V. More liquidity, more debt: Could it be serviced?

With target countries identified—those with the potential to outgrow their current liquidity constraint, with moderately good policies and credit scores—we argue for a big financing push as a preferred option to restore creditworthiness, in place of the more commonplace austerity programs. The question is whether such financing, which would inevitably take the form of additional debt, could be serviced, and if any lender would be prepared to offer it. The latter problem of a "debt overhang" is particularly serious with regard to private creditors. The "debt overhang" refers to situations where new creditors are unwilling to lend for a project because part of the proceeds of any successful project goes towards making whole existing creditors.

Multilateral institutions, however, have a natural advantage due to their preferred creditor treatment (meaning they get repaid first before other creditors). Additionally, they are able to mitigate risk through direct engagement on policy reforms with national governments and strong and trusted relationships developed through country-based offices.

Multilateral creditors are also able to offer loans at better terms than other creditors, which makes this type of debt more sustainable for developing countries. Part of the reason for the debt problems now faced by many developing countries is that they have borrowed heavily from private capital markets, at higher interest rates and shorter maturities than multilateral debt. Even in the low-income countries now eligible for the DSSI, private creditors make up the fastest growing segment of debt.[21] As Table 4 below shows, DSSI countries have a total of $90 billion in principal and interest payments on medium- and long-term debt due in 2021 and 2022, 70 percent of which is owed to official multilateral and bilateral creditors. Other developing countries with a speculative credit rating (excluding DSSI countries), on the other hand, have $191 billion in debt service due in the next two years, with 40 percent due to official creditors. Debt terms vary widely by creditor. In 2019, the average interest rate on multilateral debt to DSSI countries was 1.7 percent, with a principal repayment rate of 3.6 percent. Bilateral debt had a 2.5 percent interest rate and 5.8 percent repayment rate. Bondholder and non-official creditor rates were much higher, with interest rates at 6.1 percent and 4.6 percent respectively, and repayment rates of 8 percent and 22 percent.

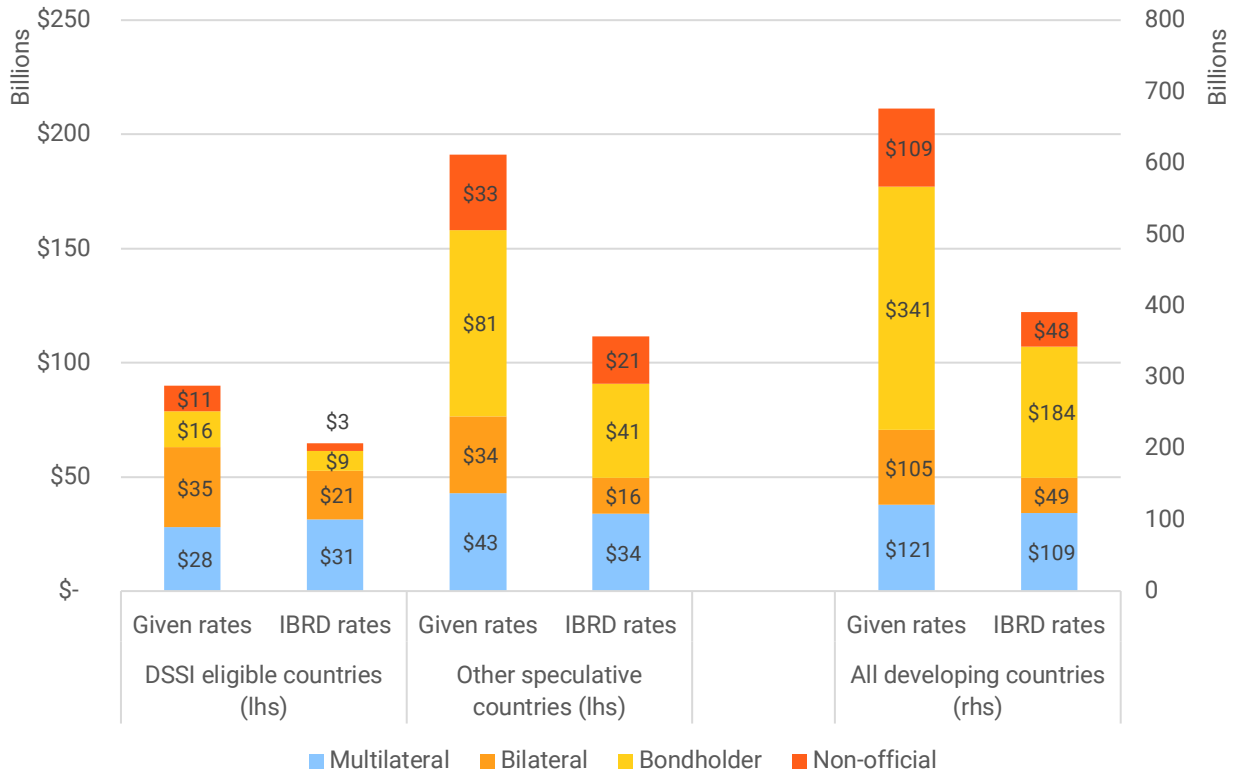
Table 4. Total debt service, public and publicly guaranteed debt, 2021-2022
Billions current USD

		Multilateral	Bilateral	Bondholder	Non-official	Total
DSSI countries	Principal	$22	$28	$7	$10	$66
	Interest	$6	$7	$9	$2	$24
	Total	$28	$35	$16	$11	$90
Other speculative countries	Principal	$34	$25	$46	$21	$126
	Interest	$9	$9	$35	$12	$65
	Total	$43	$34	$81	$33	$191
All developing countries	Principal	$94	$82	$209	$82	$466
	Interest	$27	$23	$132	$27	$210
	Total	$121	$105	$341	$109	$676

Source: World Bank International Debt Statistics (2021). Other speculative category includes all developing countries with speculative or highly speculative credit ratings, excluding DSSI countries.

Given the varied terms on debt, we conduct the following thought experiment: what could countries save if all debt was available on non-concessional multilateral terms? The best terms on International Bank for Reconstruction and Development (IBRD) flexible loans are currently 1.75 percent interest on a 20-year loan.[22] If all debt were available on these terms, total debt service in 2021 and 2022 would fall from $90 billion to $65 billion, or $25 billion saved (Figure 5), just for DSSI countries. Other speculative countries, excluding DSSI, would save $79 billion over two years. The savings would be considerably higher if extended to all developing countries—about $285 billion.

Figure 5. Total debt service due 2021-2022, public and publicly guaranteed debt, under current and IBRD terms



Source: Author's calculations, based on World Bank International Debt Statistics (2021). Other speculative category includes all developing countries with speculative or highly speculative credit ratings, excluding DSSI countries.

VI. Policy implications and conclusion

The next debt crisis is looming, but it doesn't have to be catastrophic. We've learned from past debt episodes that proactive actions can prevent large scale debt overhang problems and repeated restructurings and that the reverse is true—delayed action leads to major costs for both creditors and debtors.[23] Though there are some countries at serious risk of insolvency, the majority of countries currently face a liquidity crisis—if given support to get over the hump, these countries can grow their way into debt sustainability. What's more, many of these countries are moderately creditworthy, with decent environmental and social inclusion policies, and could benefit from expanded fiscal space. The constraining factor for most is access to financing on affordable terms, which due to poor credit ratings in many developing countries, restricts access to capital markets by both sovereign governments and private businesses.

If indeed the major problem is liquidity, as we have argued, then some proposed solutions, such as auctions to buy debt at below-face-value prices, or debt/nature swaps, would not help. They are more helpful as part of the package to deal with solvency problems.

The current international policy response—the DSSI—is inadequate in four major ways. First, it fails to distinguish appropriately between countries with liquidity problems and those with solvency problems. Second, it restricts eligibility to a few low-income countries, although serious debt servicing problems also will likely occur in middle-income countries, including some upper-middle-income countries. Third, it does not address the liquidity problems of private business in developing countries—banks and large corporations—who are suddenly faced with much tighter capital market conditions because of the difficulties of their sovereign governments. Fourth, it does not provide for the expanded fiscal space needed by many governments to reset economic growth onto a sustainable path in the aftermath of this crisis.

For each of these issues, the IFIs are a natural vehicle to provide financing and policy and institutional support to mitigate risk.

The most urgent need is to prevent countries with speculative debt ratings from falling into full-fledged debt crises in the next couple of years. It is likely that official financing, preferably through the IMF and multilateral development banks, will be the main source of this liquidity.

The IMF could provide liquidity through a combination of a new issuance of Special Drawing Rights (SDRs) and a program to voluntarily reallocate SDRs from countries with a surplus to those in need. It also has available its standard array of liquidity support mechanisms.

These are not enough. Multilateral development banks (MDBs) must also step in to provide additional liquidity. Several have already done so, using policy-based lending.

Both the IMF and MDBs, however, are limited in terms of their firepower and will need additional resources. Without additional resources coming from these institutions, developing countries will be forced to adjust to debt servicing difficulties through austerity programs, at high welfare cost.

Additional resources do not mean more grants from rich country governments, although those would be welcomed by developing countries. They can also come from relaxing policy guidelines at the MDBs.

For example, IDA could be authorized to borrow more in international capital markets and on-lend the proceeds to its clients. MDB caps on debt/equity and other financial ratios could be relaxed to permit them to do more. MDBs could further stretch their resources by encouraging countries to take on policy-based guarantees rather than policy-based loans. Evaluations suggest considerable incremental leverage can be generated through the use of these instruments.[24]

Guarantees can also be used to develop facilities that can be used by private debtors in developing countries, as proposed by UNECA in their Liquidity and Sustainability Facility.

Our simulations show that changing financial terms to match those available from IBRD would create substantial fiscal space for developing countries. With financing at these terms, some countries that are currently at risk of a debt overhang problem might be able to grow out of it. Looking at countries with debt-to-GDP ratios higher than 55 percent, we find that if debt were available on IBRD terms, the i-g differential would shift to negative in Lebanon, Jamaica, Ukraine, El Salvador, Argentina, Montenegro, Belize, North Macedonia, and Angola.

Obviously, all creditors are not going to lower their rates to IBRD terms, but this exercise points out just how varied the terms of debt are amongst developing country lenders. The DSSI has already identified two important principles that are foundational to any

debt work-outs: equal treatment for each class of creditors, and full transparency on loan details. It should also start to prioritize provision of affordable debt by encouraging MDBs to take on a larger role. In fact, our simulations suggest that the savings that would accrue to developing countries by transforming the profile of their financing would far exceed the deferred payments currently being achieved by countries availing of the DSSI.

There are two priorities for the international community. First, they need to identify and quickly resolve debt problems of countries where insolvency looms. In standard debt reduction packages of the past, the process to reach a decision-point of partial debt relief is typically at least three years and full debt relief comes much later when a completion point is reached. This multi-year process should be accelerated this time around.

Second, there needs to be a big push to lower the cost of capital for all developing countries, something that can be most easily done by expanding lending and guarantees from MDBs by a far greater amount than is currently envisaged.

Tackling upcoming debt issues in the next couple of years is a priority because many countries still need fiscal space to respond to COVID-19 and the global recession, but also because without clarity on debt, there can be no foundation for the external financing needed for transformational change towards sustainable development and global de-carbonization.

Annex 1

Table 5. Average 10-year nominal interest rate on external debt vs. GDP growth (2009-2019)

Country	Debt-to-GDP	Average interest rate (2009-2019)	Average GDP growth (2009-2019)	i-g differential	
Venezuela, RB	263%	5.5%	-13.4%	18.8%	Positive
Mongolia	227%	2.1%	11.7%	-9.6%	Negative
Montenegro	149%	3.4%	2.8%	0.6%	Neutral
Lebanon	139%	6.4%	4.2%	2.2%	Positive
Mozambique	137%	1.1%	2.3%	-1.2%	Negative
Zambia	119%	2.6%	4.2%	-1.6%	Negative
Sudan	118%	0.5%	-9.3%	9.8%	Positive
Bhutan	110%	2.7%	7.1%	-4.4%	Negative
Kyrgyz Republic	99%	1.3%	6.1%	-4.8%	Negative
Georgia	98%	2.7%	5.1%	-2.4%	Negative
Tunisia	97%	2.9%	-1.1%	4.1%	Positive
Jamaica	96%	6.0%	3.2%	2.9%	Positive
Nicaragua	93%	1.6%	4.2%	-2.6%	Negative
Cabo Verde	92%	1.1%	1.5%	-0.4%	Neutral
Lao PDR	92%	1.6%	12.0%	-10.5%	Negative
Armenia	87%	2.1%	4.7%	-2.6%	Negative
Kazakhstan	87%	2.6%	4.6%	-2.0%	Negative
Bosnia and Herzegovina	83%	1.5%	1.3%	0.2%	Neutral
Tajikistan	82%	1.7%	5.0%	-3.3%	Negative
Ukraine	81%	3.8%	2.8%	1.1%	Positive
Jordan	77%	2.6%	6.1%	-3.5%	Negative
Djibouti	77%	3.1%	12.2%	-9.1%	Negative

Country	Debt-to-GDP	Average interest rate (2009-2019)	Average GDP growth (2009-2019)	i-g differential	
Papua New Guinea	75%	1.9%	7.9%	-6.1%	Negative
Belize	73%	3.7%	3.6%	0.1%	Neutral
North Macedonia	71%	2.6%	3.0%	-0.4%	Neutral
Mauritania	71%	1.9%	4.9%	-2.9%	Negative
Serbia	70%	3.5%	1.3%	2.2%	Positive
El Salvador	67%	5.8%	4.4%	1.4%	Positive
Sri Lanka	67%	2.8%	7.2%	-4.3%	Negative
Belarus	65%	4.2%	2.2%	2.0%	Positive
Moldova	63%	1.7%	8.2%	-6.5%	Negative
Albania	63%	2.4%	2.4%	0.0%	Neutral
Argentina	62%	6.3%	3.0%	3.2%	Positive
Rwanda	61%	1.4%	5.9%	-4.6%	Negative
Bulgaria	60%	3.1%	2.7%	0.4%	Neutral
Sao Tome and Principe	59%	0.5%	8.6%	-8.1%	Negative
Turkey	58%	4.6%	1.6%	3.0%	Positive
Senegal	58%	2.5%	3.8%	-1.3%	Negative
Zimbabwe	57%	0.5%	8.3%	-7.8%	Negative
Cambodia	57%	1.0%	10.0%	-9.0%	Negative
Angola	55%	3.3%	3.0%	0.3%	Neutral
South Africa	54%	4.5%	1.7%	2.7%	Positive
Costa Rica	48%	5.4%	7.3%	-1.9%	Neutral
Ecuador	48%	5.1%	5.6%	-0.5%	Neutral
Samoa	48%	1.3%	3.8%	-2.5%	Negative
Congo, Rep.	48%	1.1%	1.2%	-0.1%	Neutral
Dominica	47%	2.7%	2.0%	0.7%	Neutral
Guinea-Bissau	47%	0.7%	5.0%	-4.2%	Negative

Country	Debt-to-GDP	Average interest rate (2009-2019)	Average GDP growth (2009-2019)	i-g differential	
Maldives	47%	1.8%	9.3%	-7.5%	Negative
Morocco	46%	3.0%	2.5%	0.5%	Neutral
Sierra Leone	46%	0.8%	4.9%	-4.0%	Negative
Vietnam	45%	1.8%	9.5%	-7.6%	Negative
Vanuatu	45%	1.3%	4.2%	-2.9%	Negative
Grenada	45%	2.4%	4.8%	-2.4%	Negative
Liberia	44%	0.9%	5.7%	-4.8%	Negative
St. Vincent & Grenadines	43%	2.9%	2.0%	0.8%	Neutral
Gabon	43%	4.5%	3.3%	1.2%	Neutral
Paraguay	43%	3.3%	5.5%	-2.2%	Negative
Colombia	43%	4.8%	3.4%	1.5%	Neutral
Tonga	41%	1.6%	3.5%	-1.9%	Neutral
Gambia, The	41%	1.4%	2.0%	-0.6%	Neutral
Uganda	41%	1.0%	3.3%	-2.3%	Negative
Dominican Republic	40%	4.2%	6.3%	-2.1%	Negative
Ghana	40%	2.5%	9.9%	-7.4%	Negative
Central African Republic	40%	0.5%	0.8%	-0.3%	Neutral
Eritrea	39%	0.6%	0.7%	0.0%	Neutral
Honduras	39%	2.7%	5.6%	-2.9%	Negative
Lesotho	38%	1.7%	3.3%	-1.6%	Neutral
Egypt, Arab Rep.	38%	2.3%	4.8%	-2.5%	Negative
Uzbekistan	38%	1.7%	5.6%	-3.9%	Negative
Mexico	37%	5.9%	3.4%	2.5%	Positive
Guyana	37%	1.5%	7.6%	-6.1%	Negative
Togo	37%	1.8%	5.0%	-3.1%	Negative
Pakistan	36%	2.0%	5.2%	-3.2%	Negative

Country	Debt-to-GDP	Average interest rate (2009-2019)	Average GDP growth (2009-2019)	i-g differential	
Indonesia	36%	3.1%	7.6%	-4.4%	Negative
Kenya	36%	2.2%	9.9%	-7.8%	Negative
Bolivia	35%	2.4%	9.0%	-6.5%	Negative
Guatemala	35%	4.4%	7.4%	-3.0%	Negative
Thailand	33%	1.4%	6.8%	-5.4%	Negative
Cameroon	33%	2.1%	4.1%	-2.0%	Negative
Azerbaijan	33%	2.2%	0.8%	1.4%	Neutral
Cote d'Ivoire	33%	2.6%	9.2%	-6.6%	Negative
Malawi	32%	1.0%	2.2%	-1.1%	Neutral
Chad	32%	2.2%	2.0%	0.1%	Neutral
Tanzania	31%	0.9%	8.1%	-7.1%	Negative
Brazil	31%	4.4%	1.0%	3.4%	Positive
Kosovo	31%	4.0%	3.4%	0.5%	Neutral
St. Lucia	30%	4.3%	4.2%	0.1%	Neutral
Mali	30%	1.0%	5.6%	-4.6%	Negative
Ethiopia	29%	1.4%	11.5%	-10.1%	Negative
Russian Federation	29%	2.3%	3.4%	-1.0%	Neutral
Madagascar	29%	0.8%	3.9%	-3.1%	Negative
Peru	28%	5.1%	6.5%	-1.4%	Neutral
Niger	28%	1.2%	5.9%	-4.7%	Negative
Benin	27%	1.3%	4.0%	-2.7%	Negative
Haiti	26%	0.5%	2.6%	-2.1%	Negative
Yemen, Rep.	26%	0.8%	0.9%	-0.1%	Neutral
Solomon Islands	25%	1.3%	9.1%	-7.8%	Negative
Burkina Faso	23%	1.0%	5.3%	-4.3%	Negative
Comoros	23%	0.4%	2.8%	-2.4%	Negative

Country	Debt-to-GDP	Average interest rate (2009-2019)	Average GDP growth (2009-2019)	i-g differential	
Philippines	22%	6.4%	7.9%	-1.5%	Neutral
Guinea	22%	1.2%	7.3%	-6.1%	Negative
Nepal	21%	0.9%	9.1%	-8.1%	Negative
India	19%	1.3%	7.9%	-6.6%	Negative
Burundi	19%	0.7%	5.4%	-4.7%	Negative
Bangladesh	19%	1.0%	11.4%	-10.4%	Negative
Fiji	18%	5.8%	6.8%	-0.9%	Neutral
China	15%	1.8%	10.9%	-9.1%	Negative
Myanmar	15%	2.5%	7.5%	-5.0%	Negative
Eswatini	14%	3.8%	2.1%	1.7%	Neutral
Afghanistan	14%	0.4%	4.4%	-4.0%	Negative
Nigeria	12%	1.9%	4.4%	-2.4%	Negative
Timor-Leste	12%	1.2%	8.7%	-7.5%	Negative
Congo, Dem. Rep.	11%	4.7%	9.8%	-5.1%	Negative
Botswana	9%	1.4%	6.0%	-4.6%	Negative
Algeria	3%	2.4%	2.2%	0.2%	Neutral
Turkmenistan	1%	2.5%	7.3%	-4.8%	Negative
Iran, Islamic Rep.	1%	3.2%	0.7%	2.5%	Positive

Source: World Bank International Debt Statistics (2021) and World Development Indicators (2020)

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