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Public Debt Vulnerabilities in LICs: current status and proposed solutions

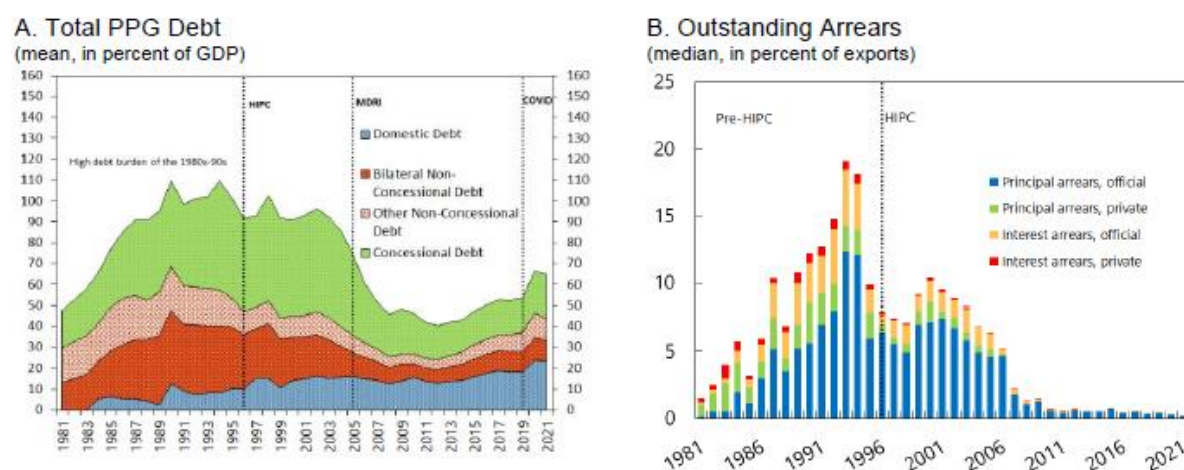
By
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September 2023

As announced in our previous contribution (Cassimon & Mavrotas, 2023), this article zooms in on the current status of debt vulnerabilities built up in recent years and the reactions so far of the international community in terms of recent debt rescheduling and relief initiatives proposed, in comparison with the previous (HIPC) debt crisis period about 25 years ago. It draws on recent co-authored research (Essers & Cassimon, 2022; Cassimon et al., 2023) and comprehensive overview data provided by IMF research (Chuku et al., 2023). We focus on the group of low-income countries (LICs), currently a group of 69 countries, of which 36 are Sub-Saharan African countries.

Figure 1 provides a long-term view of the evolution of the (mean) public (and publicly guaranteed) debt to GDP ratio of these LICs from 1980 until today. It clearly shows the protracted debt build-up during the eighties and nineties, from sustainable to highly unsustainable debt levels surpassing over 100% of GDP in the mid-nineties; it also largely reflected a huge build-up of arrears (as shown in panel B). From 1996 on, and enhanced in 1999, the Heavily Indebted Poor Countries (HIPC) Initiative constituted a major concerted response of the international community to grant substantial, but conditional, debt relief to this subset of LICs, to allow them to regain a sustainable debt. From 2005 on, the Multilateral Debt Relief Initiative (MDRI) provided additional multilateral relief. As can be seen from panel B, a substantial part of the debt relief referred to the cancellation of arrears, with no substantial arrears left after 2006. As seen from panel A, the effects of the HIPC/MDRI initiatives did lead to a major drop of the debt-to-GDP ratios to levels that were considered sustainable and equal to pre-80s levels. From that moment on, however, a new cycle of gradual debt build-up started, with slowly rising mean debt-to-GDP levels, witnessing a sharp increase from the start of the pandemic crisis on, again moving to worrisome levels, especially in a growing number of individual country cases. Despite this growing number of individual countries running into problems again, a fact on which we will go a bit deeper in the next paragraphs, it is clear also from Figure 1 that, from a more comprehensive and systemic perspective, the current situation is still less dramatic than the one we experienced during the previous HIPC era.

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Figure 1: Evolution of Total Public Debt and Outstanding Arrears

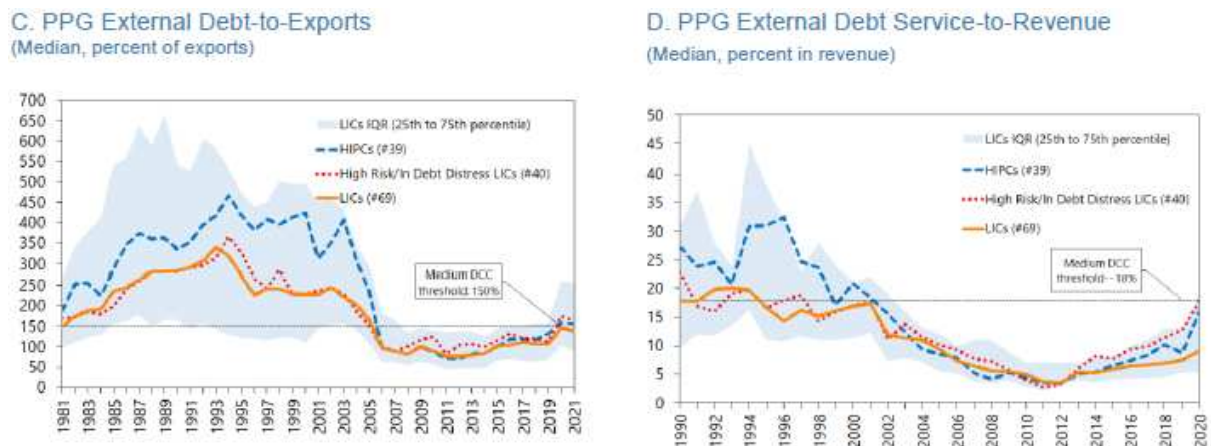


Source: Chuku et al. (2023), Figure 4, p.10.

In order to correctly assess whether a particular debt build-up may reflect debt vulnerabilities and provoke debt problems, we typically refer to proxies of both solvency (such as the debt-to-GDP, debt-to-exports or debt-to-fiscal revenue ratio) as well as liquidity (such as similar debt service ratios), with threshold ratios for these proxies guiding the assessment to determine the level of debt distress of a country. For LICs, such assessments are routinely performed through the so-called Debt Sustainability Assessments (DSA) guided by a standardised framework of assessment, the LICs' Debt Sustainability Framework (LIC-DSF), especially for the external debt part; for more details see e.g. Cassimon et al. (2017). Using this methodology, informed by the most recent DSAs, about 40 of the 69 LICs (so around 60% of LICs) are currently assessed as showing severe debt problems: 28 countries are diagnosed as having a *high risk* of debt distress, and an additional 12 countries already are *in debt distress* (Chuku et al., 2023, p.10).

Figure 2 provides some interesting details of this evolution for different types of LICs, and also for both solvency and liquidity perspectives. More specifically, it looks at the evolution of the external debt-to-exports ratio (as a solvency proxy) as well as the external debt service-to-fiscal revenue ratio (as a liquidity proxy) for the median LIC as well as showing ranges for the 25th to 75th percentile, but also for the HIPC countries subsample (39 countries), and for the subsample of 40 countries currently in high risk of/in distress; for each of the proxies, it also shows the particular threshold values from the LIC-DSF.

Figure 2: Evolution of Solvency and Liquidity Proxies for LICs and some subsamples



Source: Chuku et al. (2023, Figure 6, p.13).

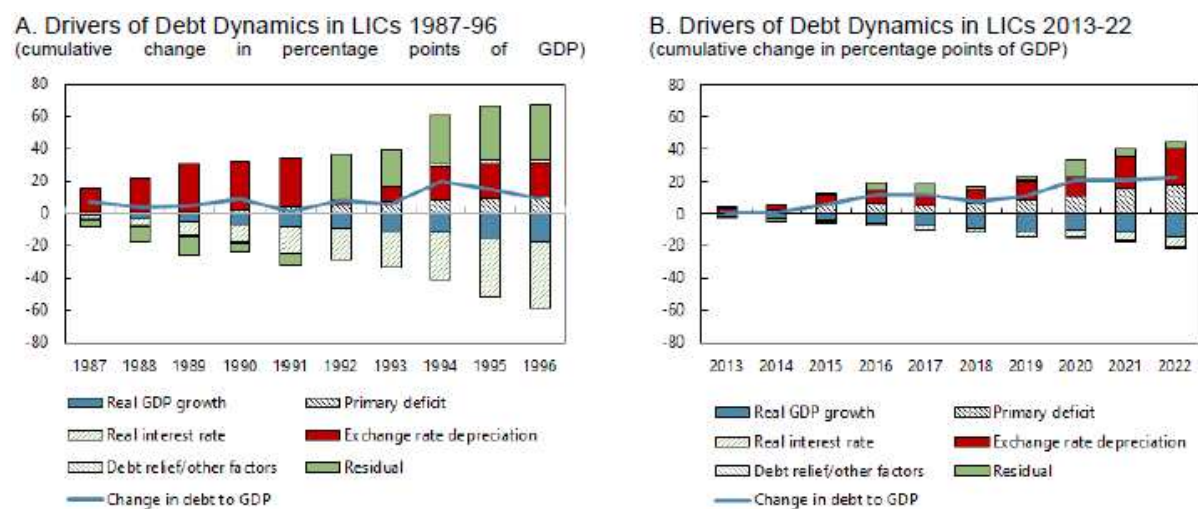
It shows that a growing number of countries, and those 40 in particular, are again currently on the brink of or already breaching the thresholds; at the same time, it confirms our earlier statement that the situation was far worse during the previous HIPC crisis.

What are the reasons for this recent build-up, and are they different from those driving the HIPC era build-up? Figure 3 sheds some more detailed light on this drawing on results from applying conventional (public) debt dynamics analysis. This approach identifies the main drivers of the *change over time* of, say, the public debt-to-GDP ratio (Δd) as a combination of three main drivers: (i) the primary budget balance (b , also expressed in GDP terms), (ii) the difference between the real interest rate paid on the debt, r , and the real GDP growth rate, g (multiplied by the debt-to-GDP ratio at the start of the period, b_{t-1}), and (iii) the so-called 'stock-flow adjustment' (sfa) term. In its simplest equation form:

$$\Delta d = b + (r - g)b_{t-1} + sfa$$

(For more details see e.g. Cassimon et al., 2008; Arslanalp and Eichengreen, 2023). Obviously, debt increases to the extent that the public sector runs a (primary) budget deficit, but the change of debt-to-GDP ratio over time is also driven by 'r-g': as long as the growth rate of GDP exceeds the average interest rate paid on the debt, this term has a downward effect on the debt-to-GDP ratio evolution. Next to those two basic drivers, actual observed changes in the debt ratio can be strongly influenced by these stock-flow adjustments; the latter term accounts for a number of additional effects such as debt relief obtained during the period, exchange rate changes and other residual effects (such as arrears).

Figure 3: Decomposition of debt change drivers

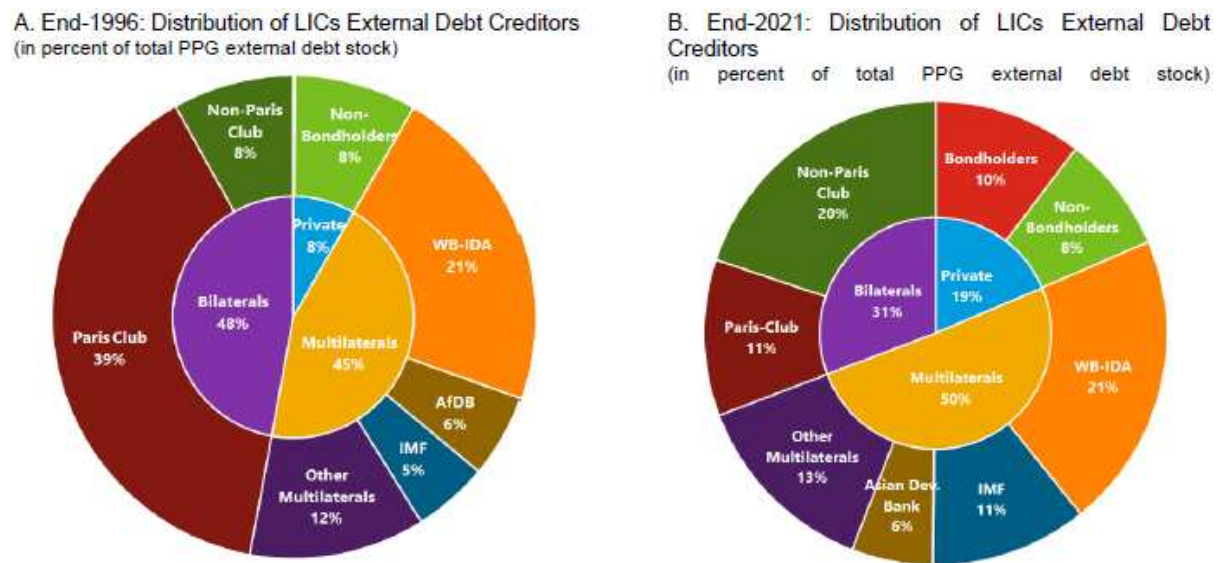


Source: Chuku et al. (2023, Figure 9, p.18).

This figure shows the disaggregated relative importance of the different drivers of the recent period (2013-2022) as compared to the HIPC crisis period (1987-1996). Primary deficits and valuation effects from exchange rate depreciation (affecting public debt in foreign currency) remain the two most dominant upward drivers of debt accumulation in LICs in both eras; this is especially the case in the most recent years; for the recent period, it also shows that the combination of low interest rates and positive growth rates have typically resulted in ‘r-g’ being a downward driver of debt change. This figure also again confirms the huge difference in overall magnitude of these effects between the two periods, something that was already visible from Figure 1.

A major additional striking difference between the two eras refers to the changes in the composition of the public debt. First of all, as again it is clear from Figure 1, the domestic component of the public debt has significantly increased in the recent period. More specifically, it has doubled on average, from around 19% in the mid-nineties to 35% by end-2021. Secondly, and more strikingly, also the composition of the external creditor has been drastically modified. Figure 4 provides details that again compare both periods, reflecting the situation end-1996 (panel A) versus that of end 2021 (panel B). It clearly shows that there has been a clear shift away from traditional bilateral Paris Club creditors toward non-Paris Club creditors on the one hand, and commercial creditors, especially bondholders, on the other hand. This transformation makes the creditor landscape more diverse but also more complex to handle, especially in times of debt problems and need for debt restructuring.

Figure 4: LICs External Debt creditor composition (end 1996 versus end-2021)



Source: Chuku et al. (2023, Figure 11 , p.21).

In response to the recent debt build-up and growing debt vulnerabilities, the international community, led by the G20, has so far responded with the creation of the Debt Service Suspension Initiative (DSSI) in May 2020 and the Common Framework for Debt Treatments beyond the DSSI (henceforth the Common Framework, CF) in November 2020. The DSSI provided a temporary (i.e. until end-2021) and ‘net present value (NPV)-neutral’ suspension of debt service payments on claims owed to all official bilateral creditors, meaning that lenders would be fully repaid later and would receive interest on the deferred sums. Therefore, strictly speaking, it did not constitute debt relief, but merely liquidity relief; other creditor groups were invited to participate ‘on comparable terms’, but did not, generally focusing their efforts to providing more (emergency) liquidity. Eligibility was open upon request to 73 debtor countries (IDA-only countries and/or LDCs, hence almost identical to the LICs group). Additionally, and in response to growing solvency-type debt distress concerns, G20 also launched the Common Framework, aiming to facilitate timely and orderly debt treatments for the same 73 DSSI-eligible countries on a case-by-case basis and, again, at the request of the debtor country. In principle, the Common Framework can be used to implement anything from a short-term debt reprofiling up to a deep debt restructuring with large NPV reductions or nominal debt write-offs, determined based on a full-fledged IMF-supported programme and DSA, and on the collective assessment of the participating official bilateral creditors; unlike in the DSSI, establishment of ‘comparability of treatment’ by other creditor classes would not simply be encouraged but rather be a formal requirement; o.a. lack of transparency (including on participation of Chinese parties, see e.g. Brautigam and Huang, 2023) and the failure to agree on comparability of treatment are a few reasons that complicate the current set-up (see details in e.g. Essers and Cassimon, 2022; Cassimon et al., 2023).

Hence, so far, progress has been limited. One striking feature, unlike the HIPC-era, was the reluctance so far of eligible countries to opt into the two processes: in the DSSI, in the end only 48 of the 73 countries participated, while in the CF, only 4 countries so far formally opted in (Chad, Ethiopia, Zambia and Ghana). More than before, debtor countries seem to be confronted with a trade-off between benefits and costs of participating, with costs referring mainly to reputational worries, and both of them fraught with uncertainty about its actual value; this all

seems to lead to a ‘waiting to participate’ attitude, a hypothesis stated in Essers and Cassimon (2022), and validated empirically in Cassimon et al. (2023). Of the 4 countries that opted in, only one process so far (for Chad) came to a concluded agreement. Although an approach that is more similar to the previous HIPC-solution, i.e. an initiative proposing a uniform, comprehensive scheme may not be feasible and probably also not desirable (given the more heterogeneous state of individual country debt vulnerabilities and creditor constituencies), the current deadlock is threatening to increase the future welfare costs of resolution. Hopes are also built on a more inclusive process, like the UN-initiated Global Sovereign Debt Roundtable that brings together a limited number of stakeholders from a broader set of creditors to bridge disagreements in implementing a debt restructuring process, with progress hopefully to be achieved at the current UN General Assembly (UNGA) meeting.

Finally, more ambitious debt resolution proposals are being put forward that try to kill two birds with one stone, in trying to establish a closer link between curing debt problems and solving environmental problems, i.e. earmarking debt (relief) to green use, simultaneously propagating debt and environmental sustainability. In our next contribution we will zoom in more in detail to this class of proposals.

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