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Debt Defaults and Economic Crises: Will This Time Be Different?

by

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Outline

- Sovereign Debt Defaults: The Usual Suspects
- Debt Ratios: The Case of the HIPCs
- The Debt Sustainability Framework

Sovereign Debt Defaults: The Usual Suspects

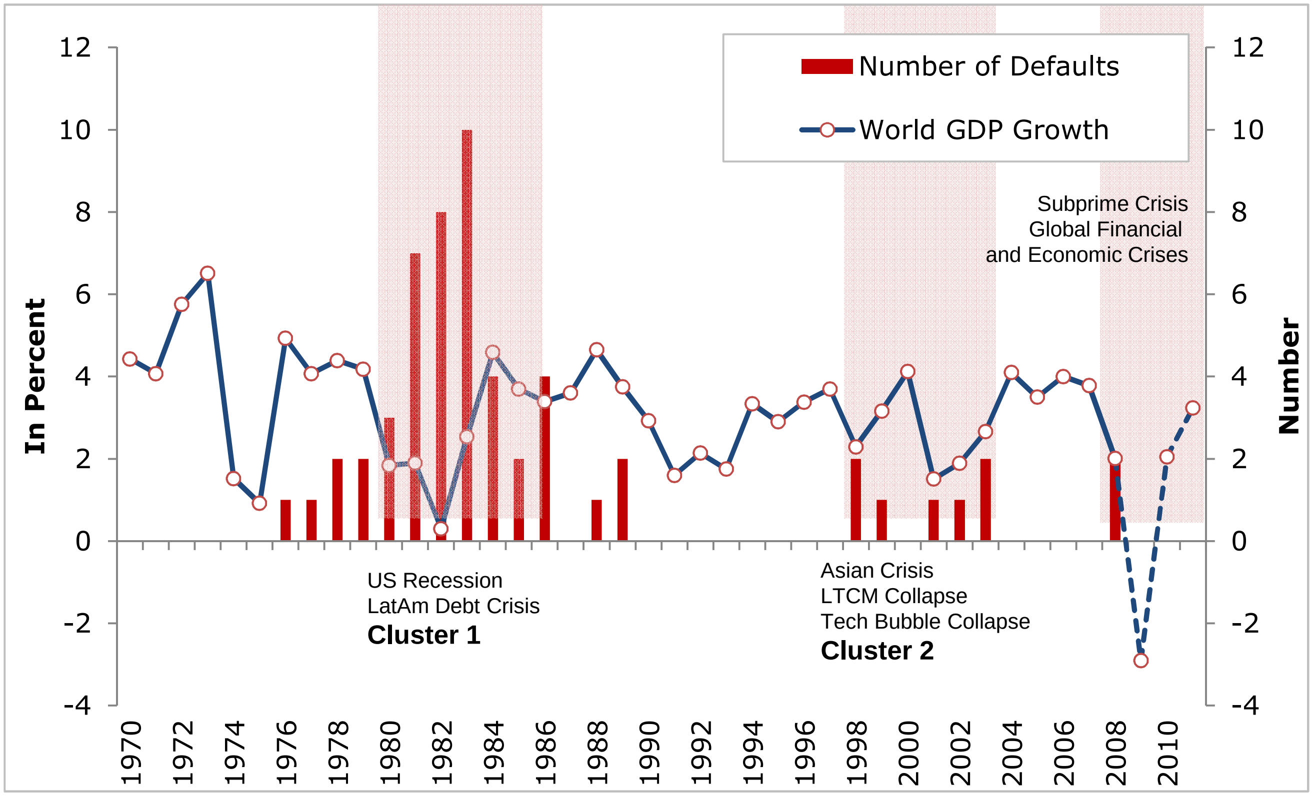
Walter Wriston, Citibank chairman, 1967-1984: "[a] country does not go bankrupt," New York Times, 14 September 1982

- Bad output shocks (defaults are countercyclical)
- Tighter international financial conditions
- Overborrowing

Debt Defaults: The Usual Suspects

- Bad output shocks
  - External shocks
- Domestic macro crises (banking crises; currency crashes…)

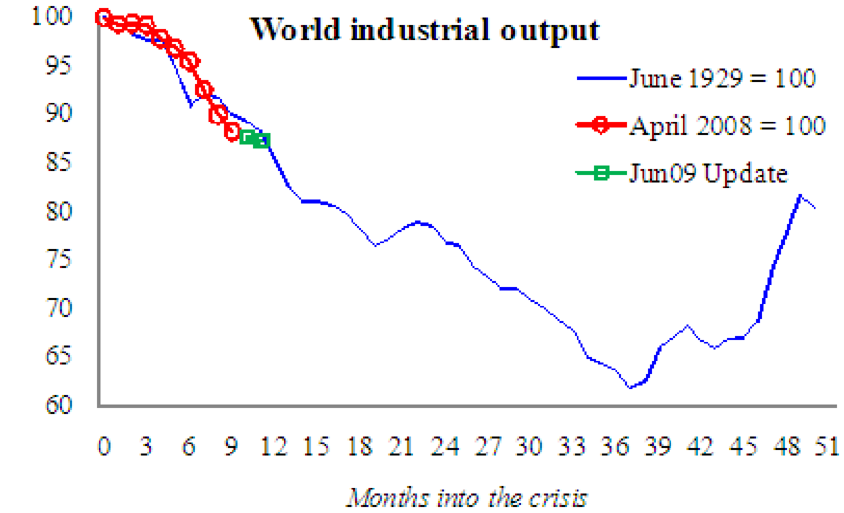
Sovereign defaults and world GDP growth 1970-2012

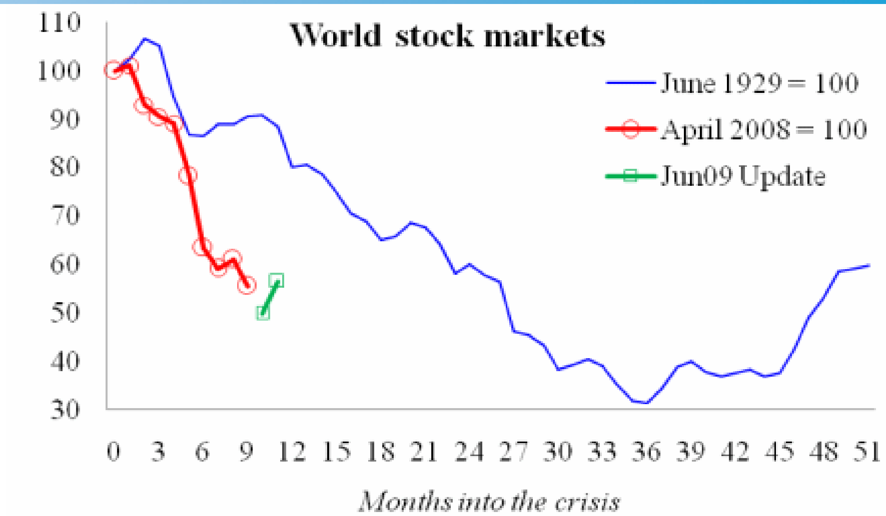


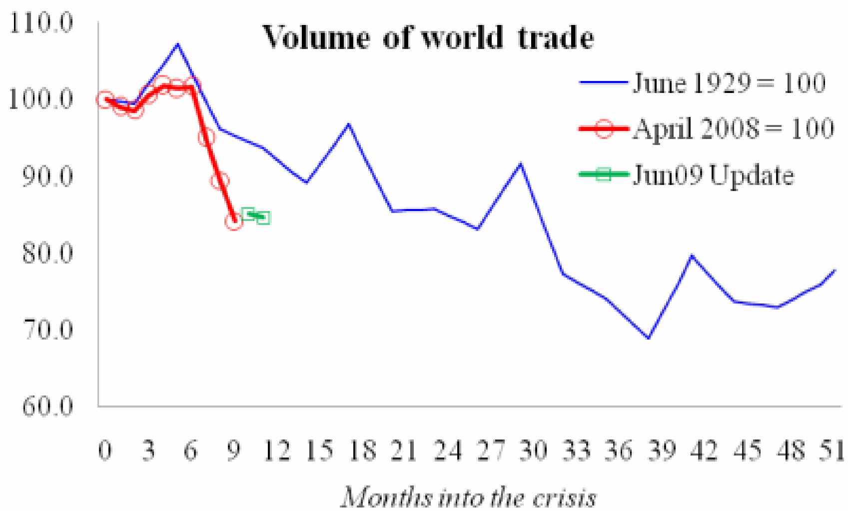
Source: World Bank, Sturzenegger and Zettelmeyer (2006)

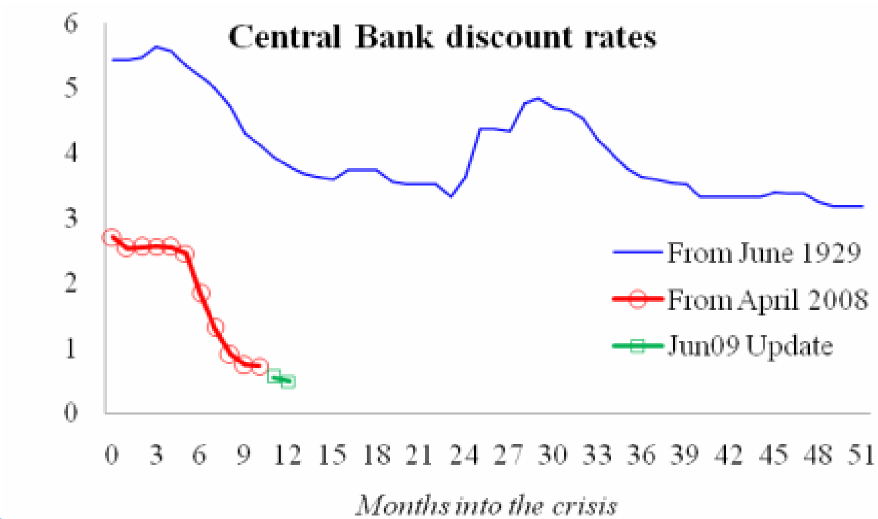
A tale of two depressions

Source: Eichengreen, B. & O'Rourke, K. – "A tale of two depressions", VoxEu, (updated) 06/04/09







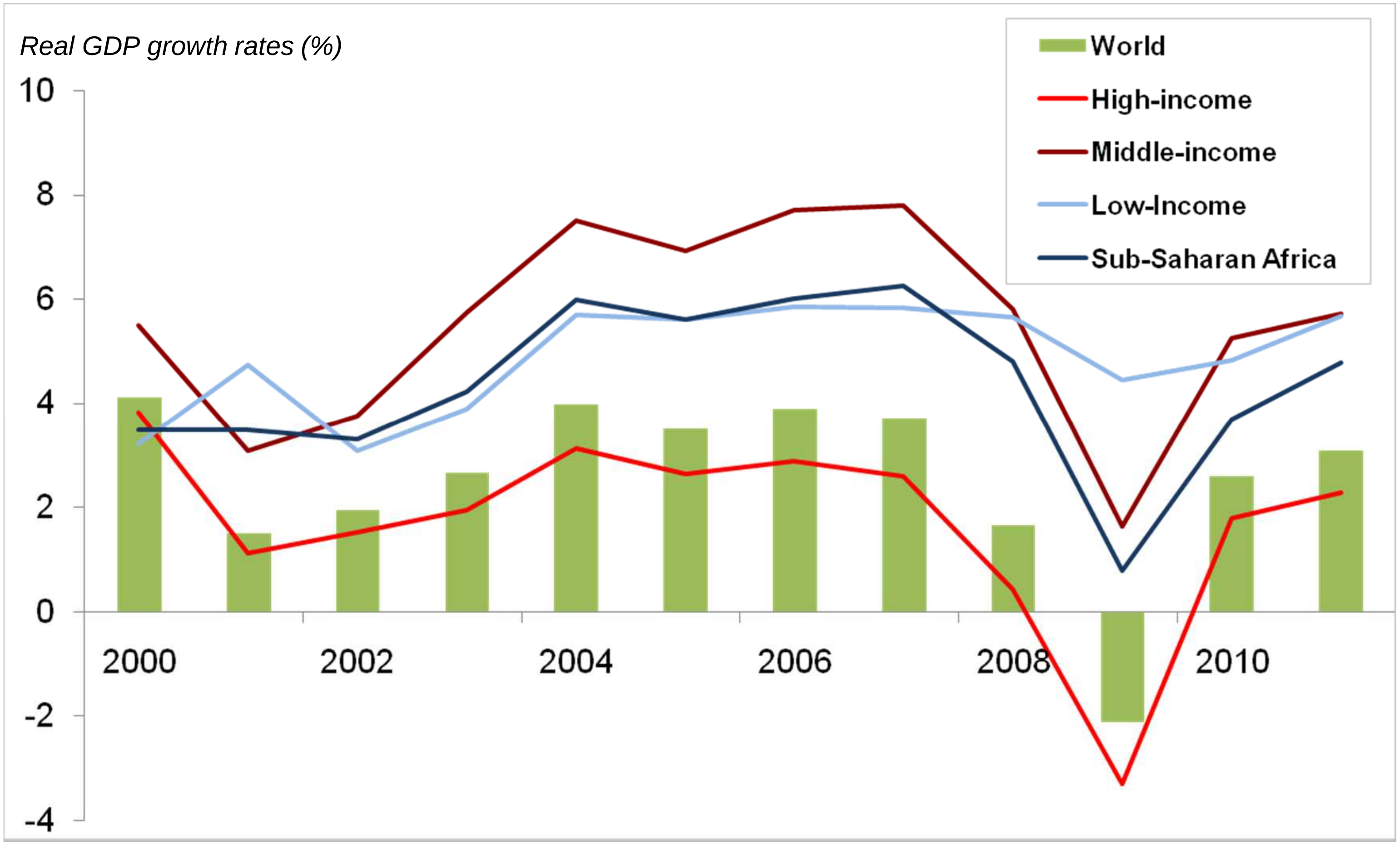


The current crisis will not be a rerun of the Great Depression…

(Source: Brahmbhatt and Pereira da Silva, 2009)

- Larger weight of developing countries in the world economy (24% in 2008 vs. 13% in 1929) plus “decoupling” of underlying trend rates of growth (growth gap = growth in Developing Countries – growth in ICs = 0.8 % in the 1990s/3.5% in 2000-08);
- Larger share of services in global activity (employment in services less volatile);
- Changes in the structure of world trade (greater elasticity of trade with respect to GDP);
- Different policy responses: monetary, financial sector, trade and fiscal policies.

A recovery is underway, but is relatively weak, uneven, and subject to considerable risks (Source: DEC)



Government Debt: Medium Term Prospects (Source: Horton et al., 2009)

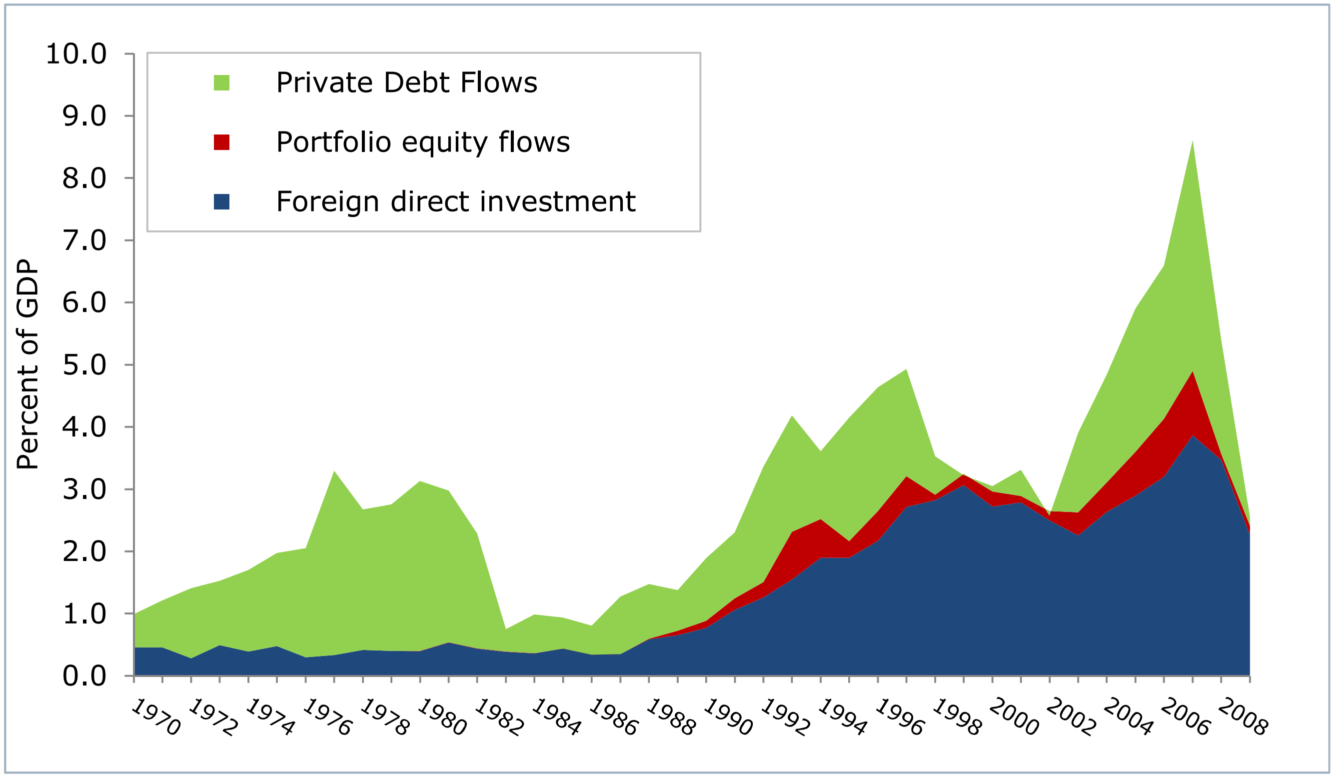
- Significant expansion of public debt in advanced economies

Debt/GDP	2007	2009	2014
Advanced G20	**77.6**	**100.6**	**119.7**
Emerging G20	**37.8**	**38.8**	**36.4**
USA	63.1	88.8	112.0
Japan	187.7	217.4	239.2
UK	44.1	68.6	99.7
Korea	33.0	35.8	39.4
Brazil	67.7	70.1	62.2
China	20.2	20.9	21.3
India	80.4	83.7	73.4
Indonesia	35.1	31.1	28.4

Debt Defaults: The Usual Suspects

- Tighter international financial conditions

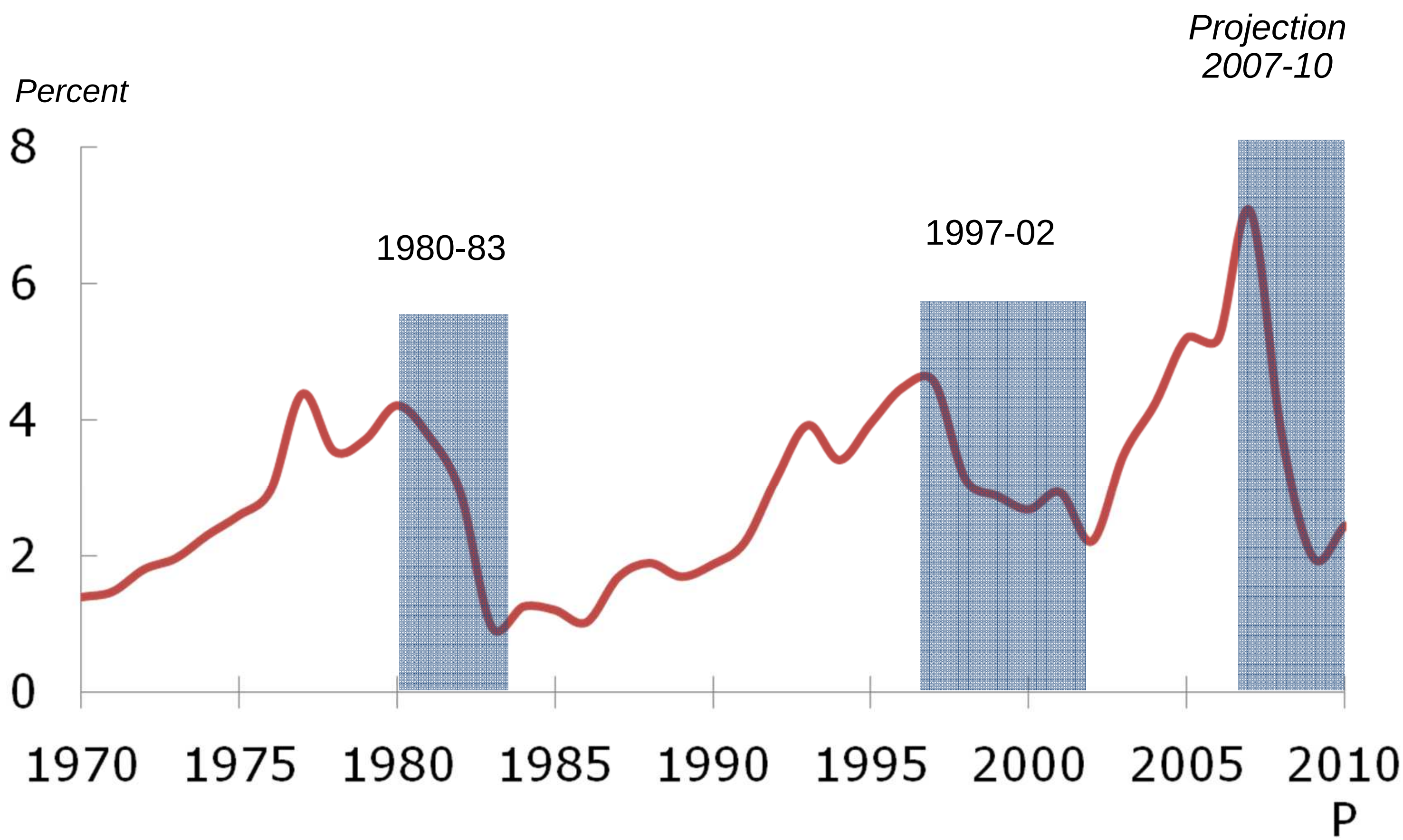
Private capital flows to developing countries as a percent of GDP 1970-2009 (projected)



Source: World Bank GDF

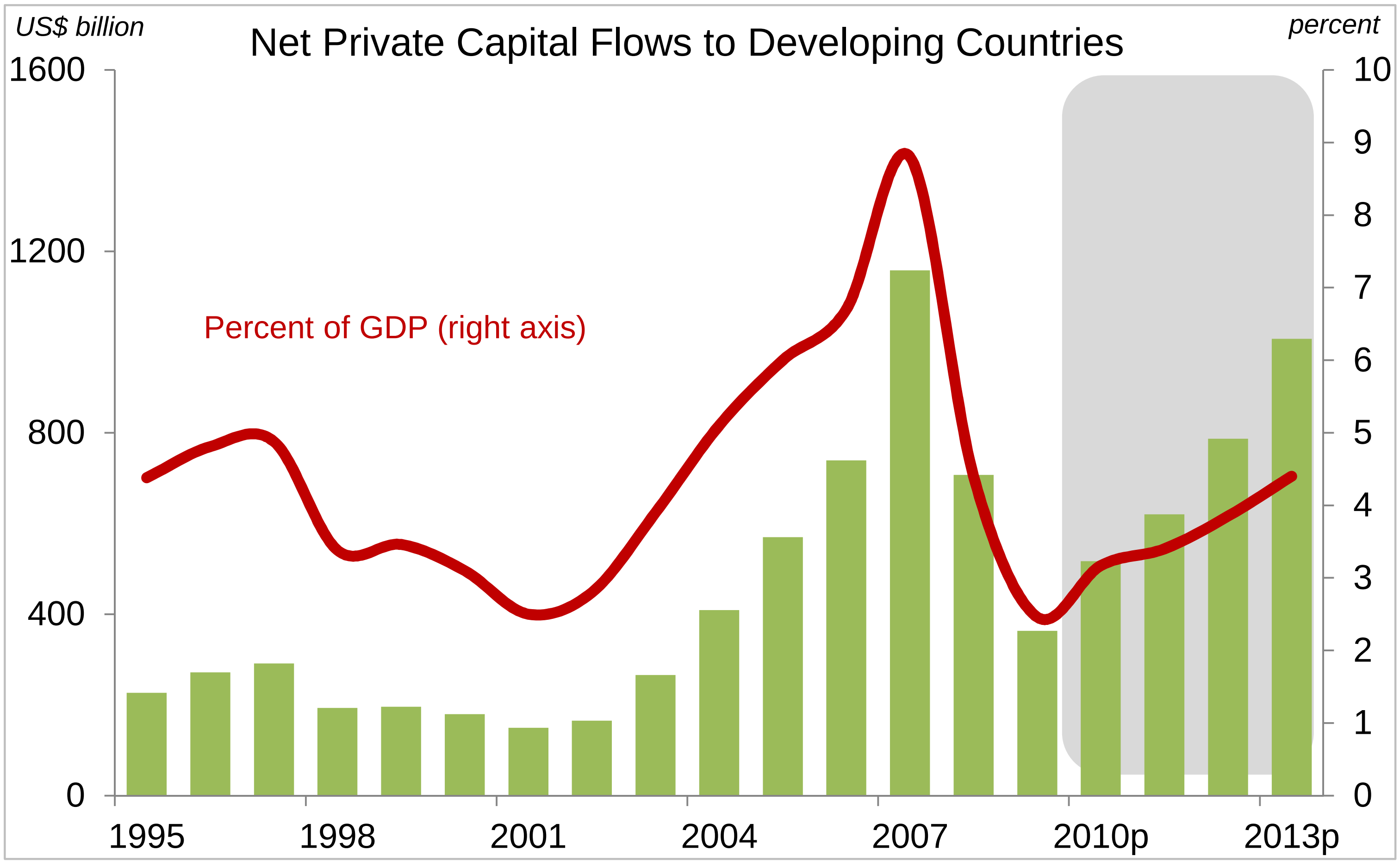
Relative to past downturns the decline of capital flows has been even more dramatic

Net private capital flows / GDP in developing countries

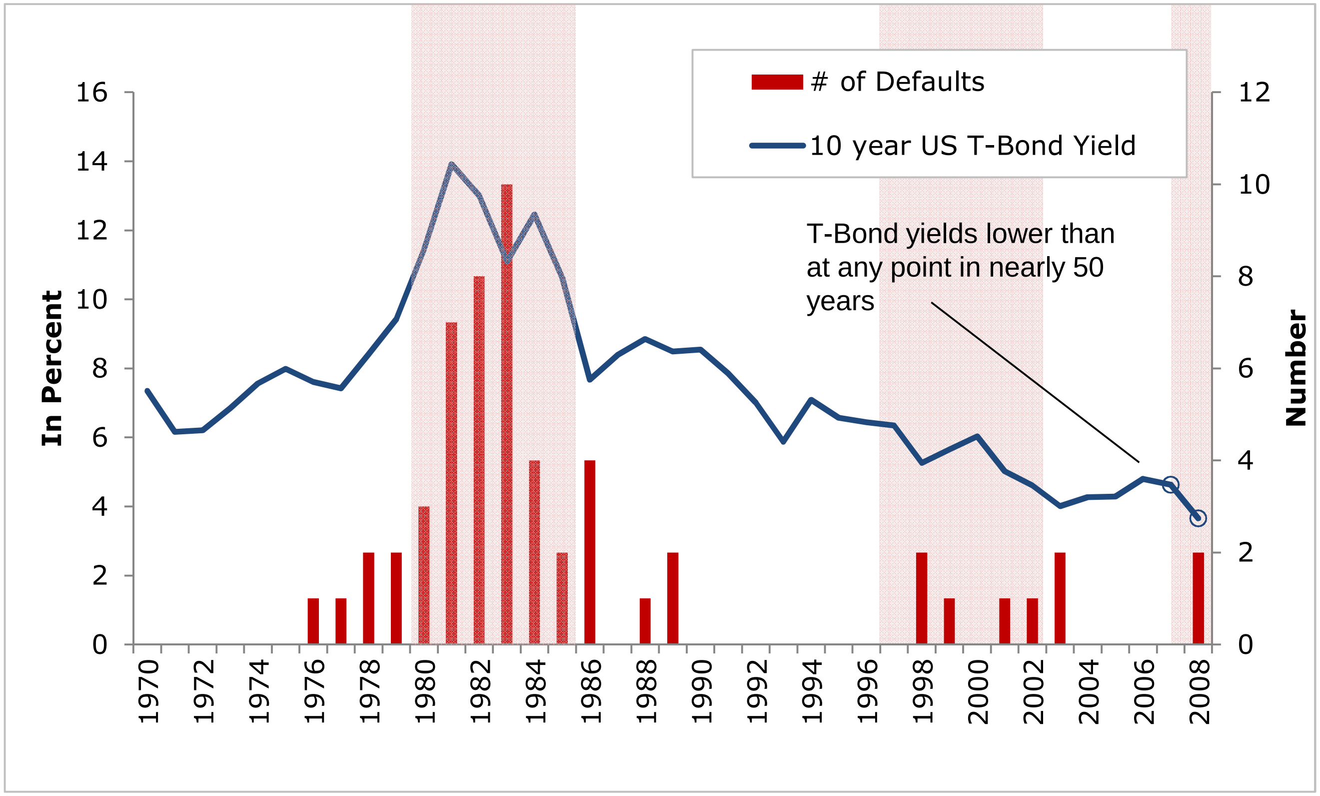


Source: DECPG/GDF 2009

Private capital flows are unlikely to recover to pre-crisis levels for some time

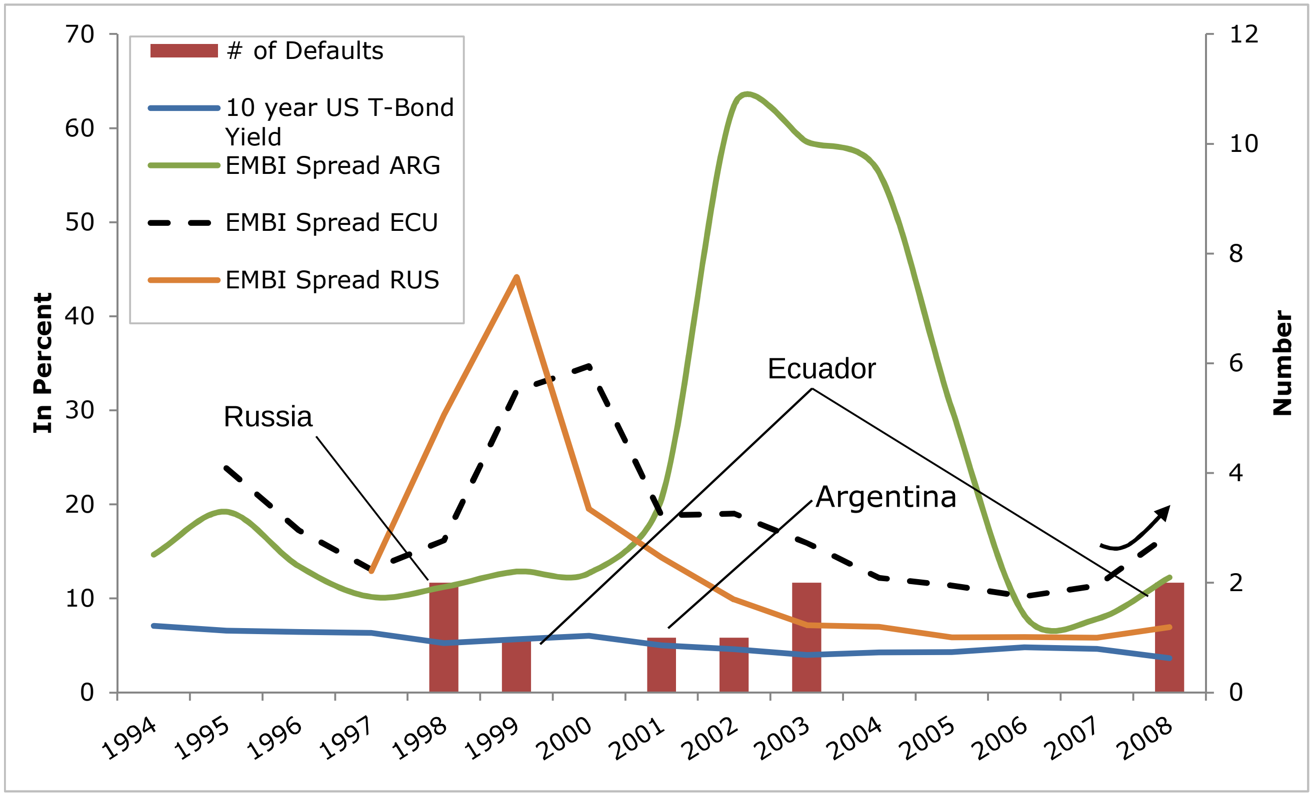


Yields on 10-year US T-Bond and number of sovereign defaults 1970-2008



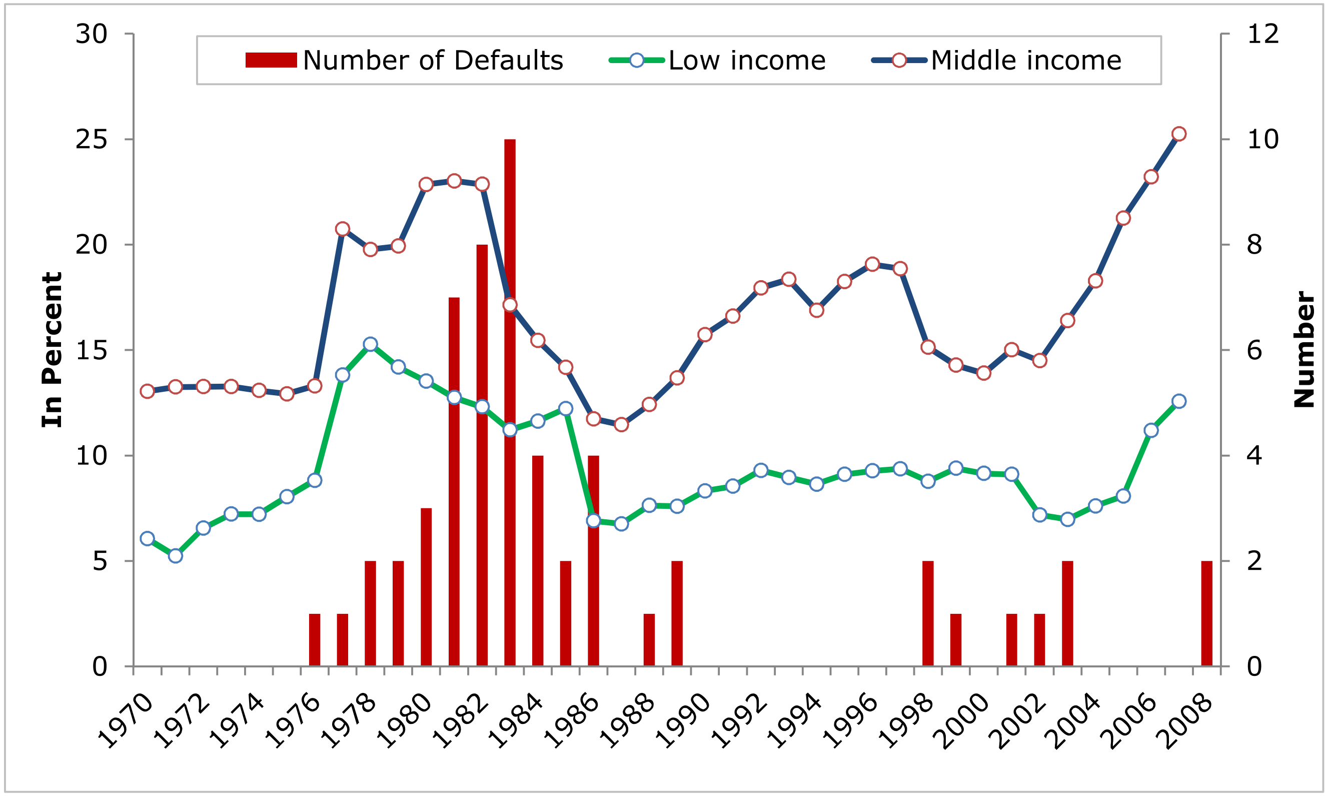
Source: Federal Reserve, Sturzenegger and Zettelmeyer (2006)

Yields on 10-year US T-Bond and defaulting issuer spreads



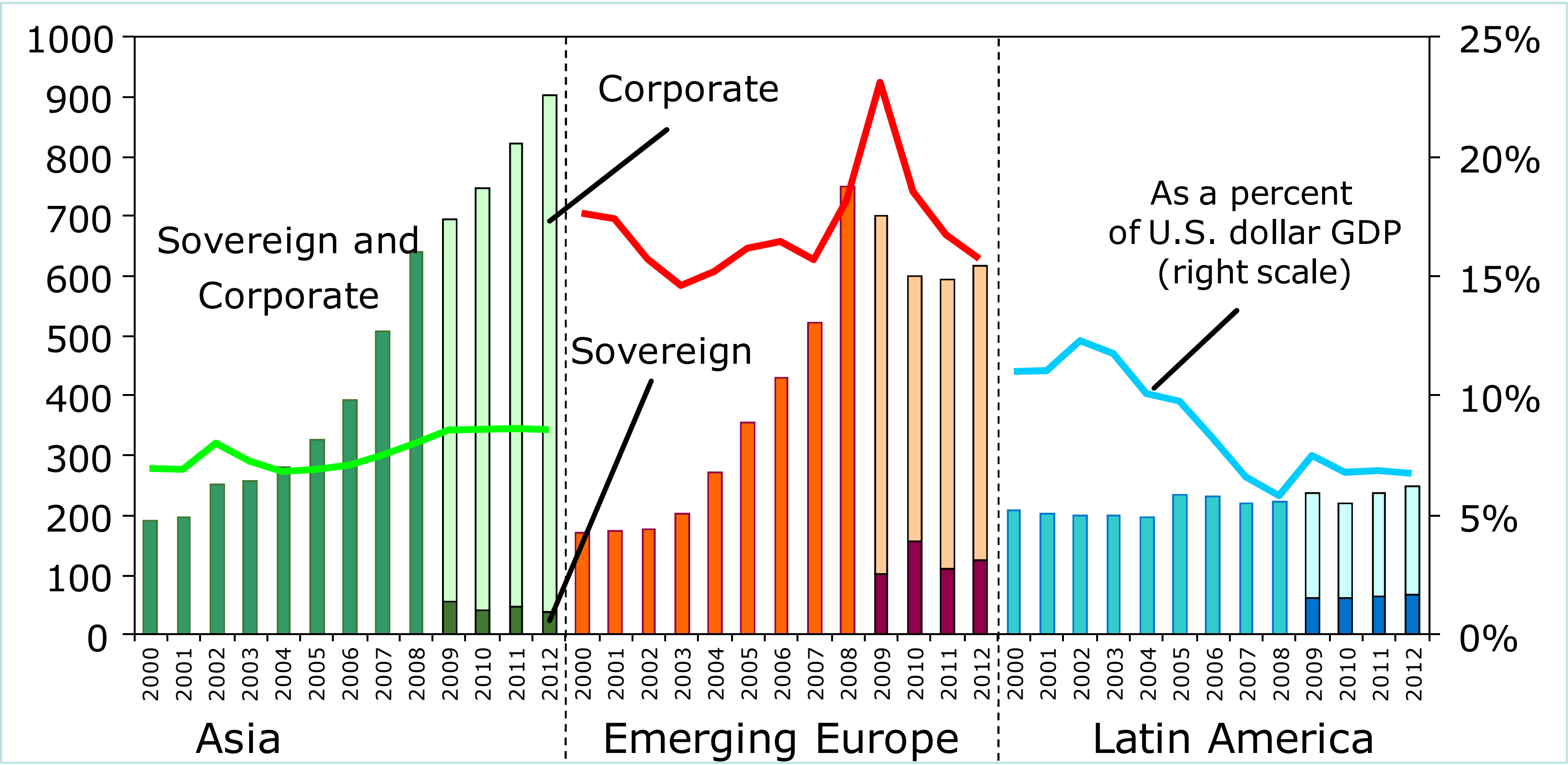
Source: Federal Reserve, World Bank, Sturzenegger and Zettelmeyer (2006)

Short-term debt as percent of total external debt in low and middle income countries



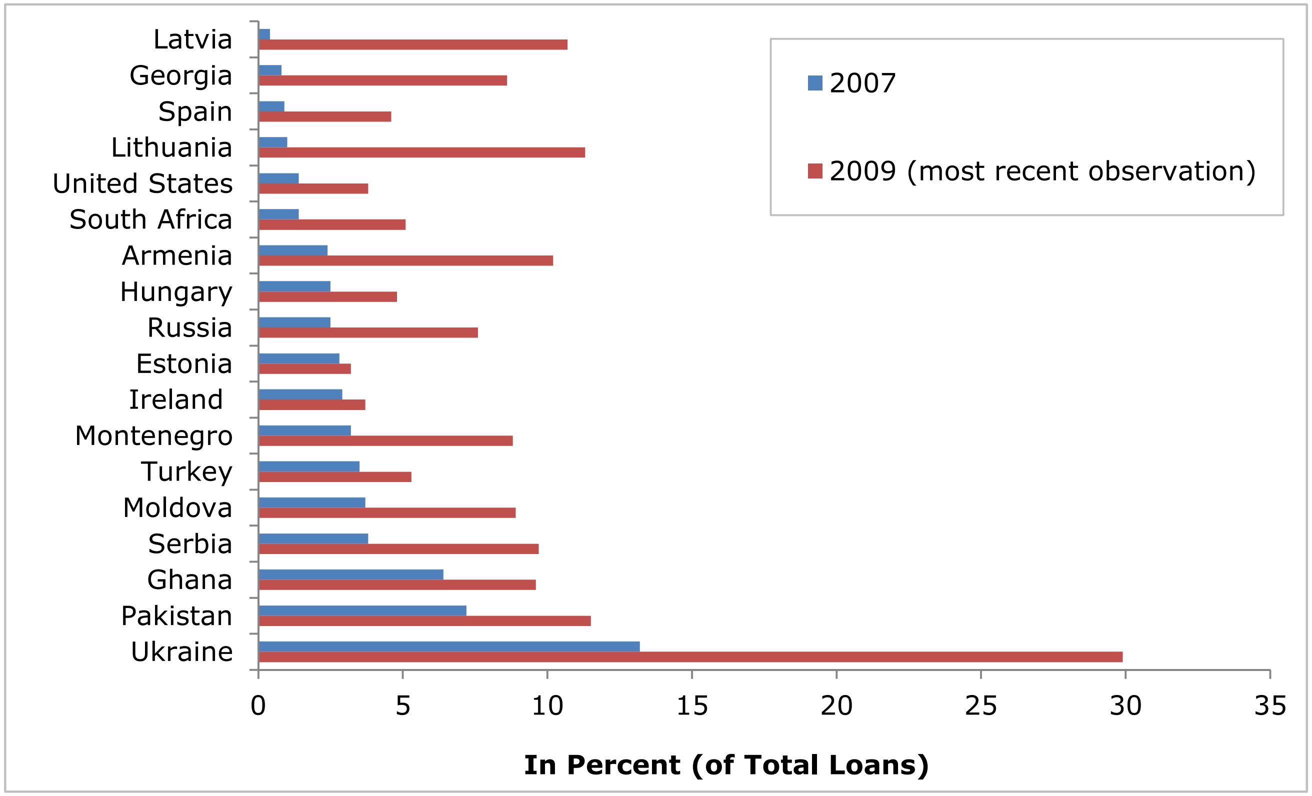
Source: World Bank, Sturzenegger and Zettelmeyer (2006)

Sovereign and corporate external debt refinancing needs ($b)



Source: IMF

Bank non-performing loans relative to total loans



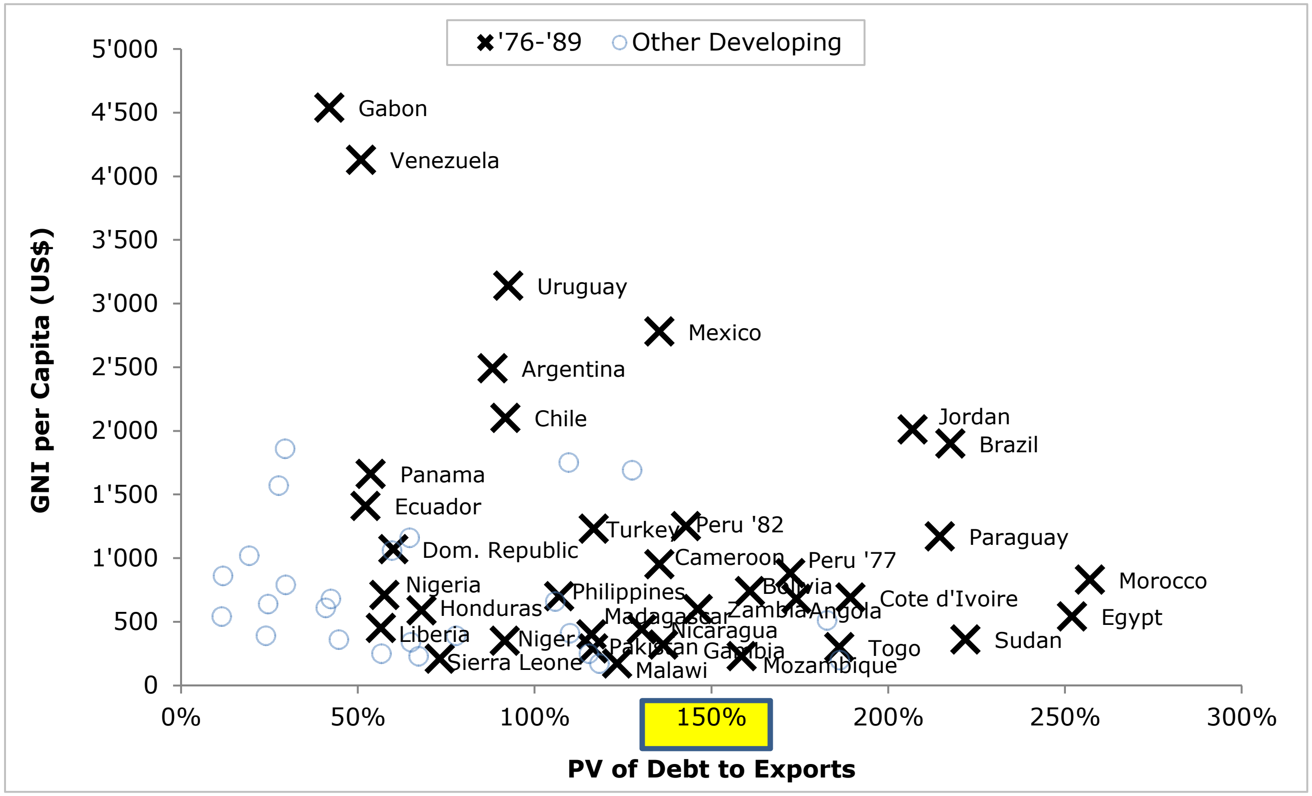
Note: Median across 59 countries = 2.7% in 2007 and 4.4% in 2009
Source: IMF Global Stability Report (Oct. 09), World Bank

Debt Defaults: The Usual Suspects

- **Overborrowing**

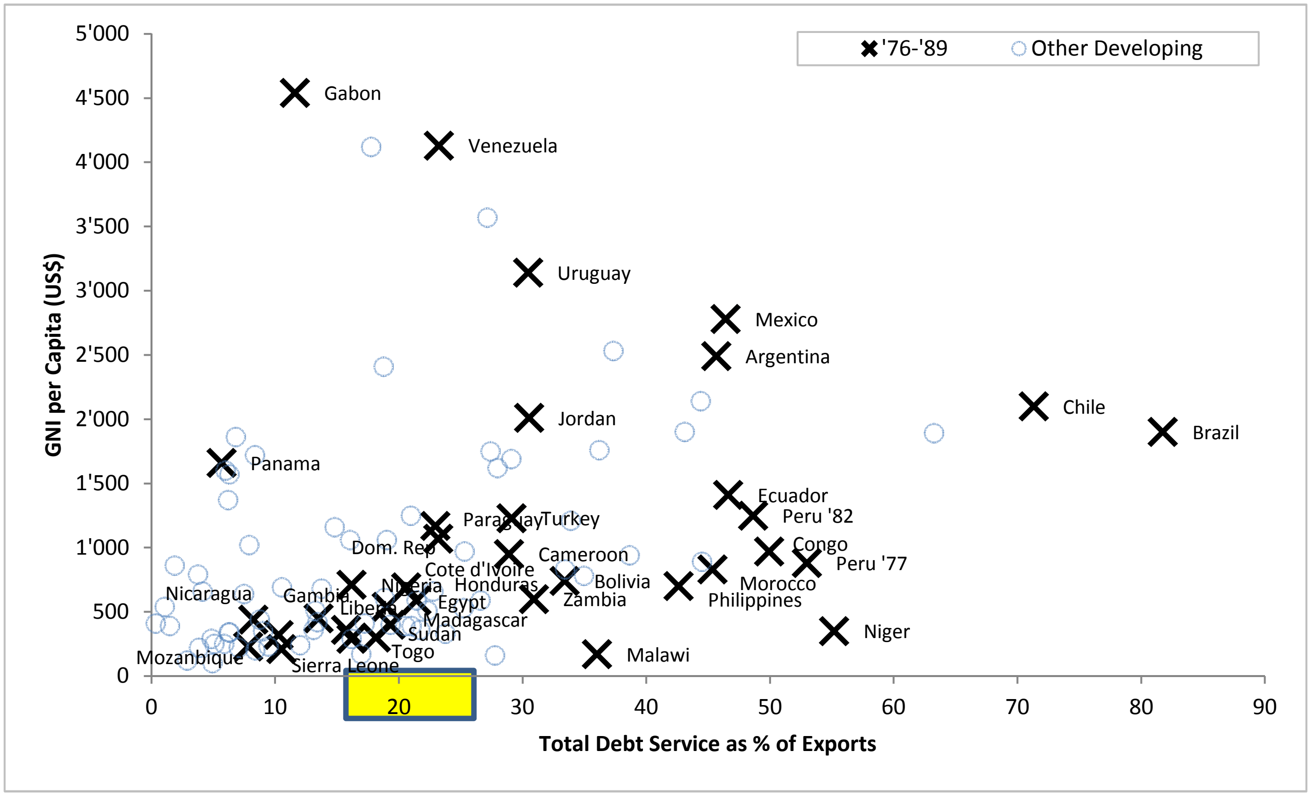
Willingness to pay vs. ability to pay

“Cluster 1” defaults and other developing countries: lessons from the 1980s



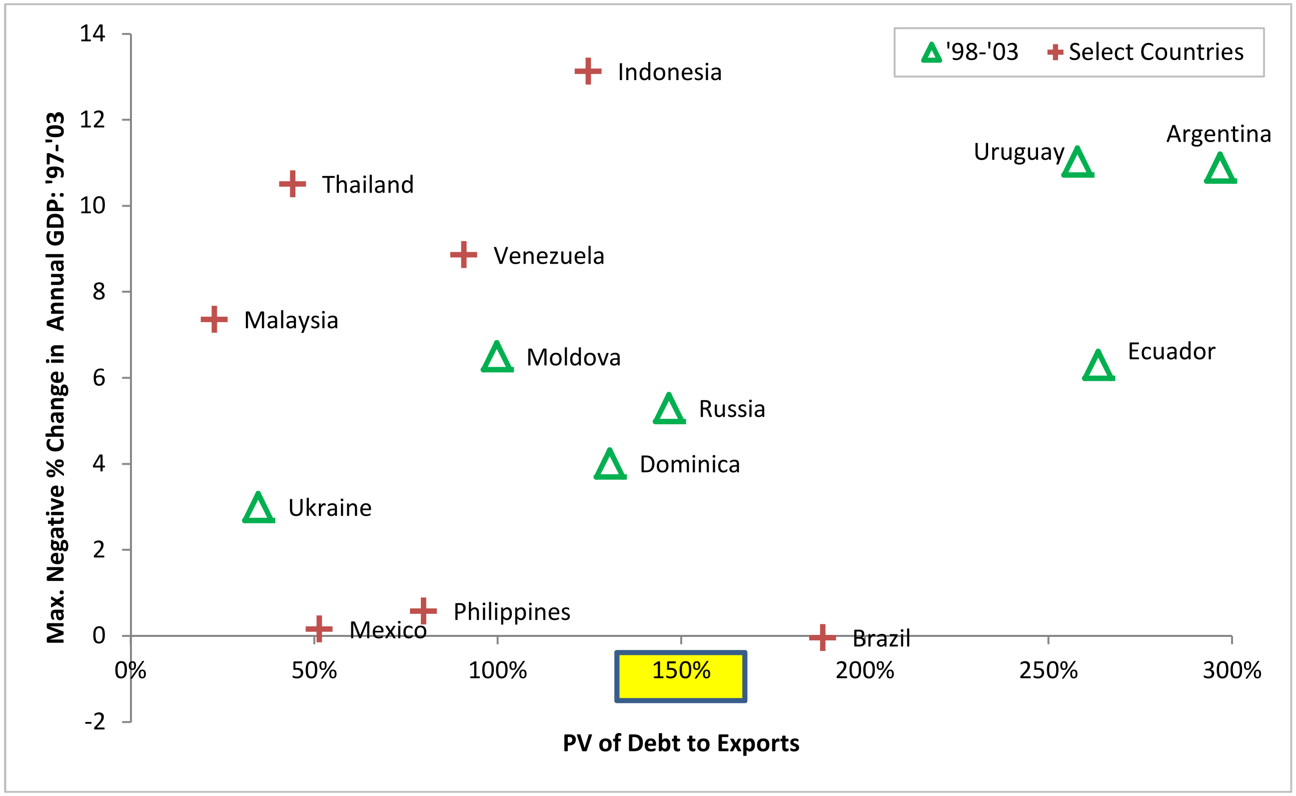
Note: Other Developing Countries include LICs and MICs for whom data was available; year for measurement of developing country ratios was 1980, which represented the lowest level of annual GDP growth during the ‘76-’89 crisis period.
Source: World Bank

"Cluster 1" defaults and other developing countries: lessons from the 1980s



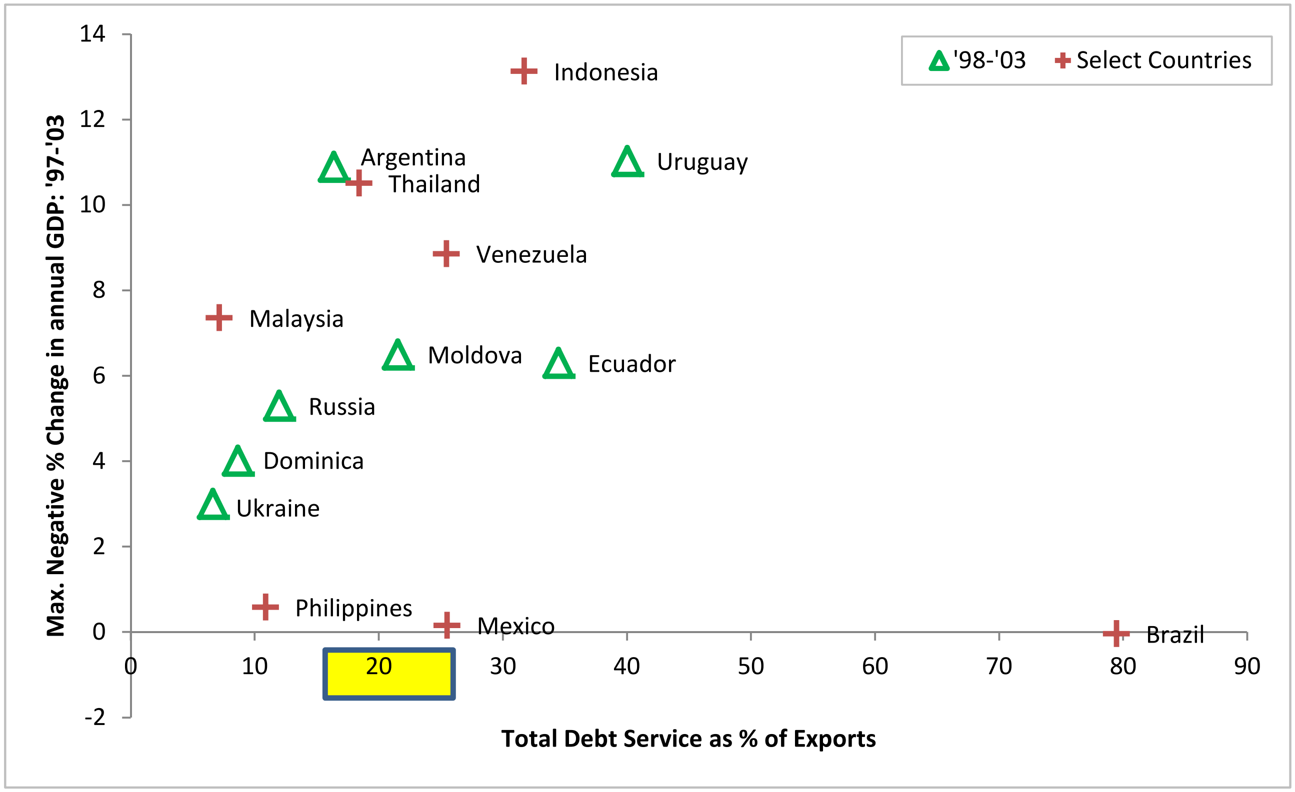
Note: Other Developing Countries include LICs and MICs for whom data was available; year for measurement of developing country ratios was 1980, which represented the lowest level of annual GDP growth during the '76-'89 crisis period.
Source: World Bank

“Cluster 2” defaults and select emerging market countries: Asian crisis



Notes: Select Emerging Market Countries includes countries known to have experienced stress during the ‘97-’03 period; y-axis represents the most severe negative annual growth rate for each country during the crisis period.
Source: World Bank

"Cluster 2" defaults and select emerging market countries: Asian crisis



Notes: Select Emerging Market Countries includes countries known to have experienced stress during the '97-'03 period; y-axis represents the most severe negative annual growth rate for each country during the crisis period.
Source: World Bank

➢The Case of the HIPCs

Primo Braga and Doemeland (2009)

Combined HIPC and MDRI Debt Relief

HIPC Initiative and MDRI: Estimates of Debt Relief 1/
(End-2008 NPV terms, in billions of U.S. dollars)

	World Bank Group Debt Relief			Total Debt Relief		
	HIPC	MDRI	HIPC and MDRI	HIPC	MDRI	HIPC and MDRI
All HIPCs	14.7	18.2	32.9	73.9	28.5	102.4
26 Post-Completion-Point HIPCs	10.6	15.3	26.0	38.8	24.4	63.2
9 Interim HIPCs	2.6	2.6	5.2	18.5	3.7	22.2
5 Pre-Decision-Point HIPCs	1.5	0.3	1.7	16.6	0.4	17.0

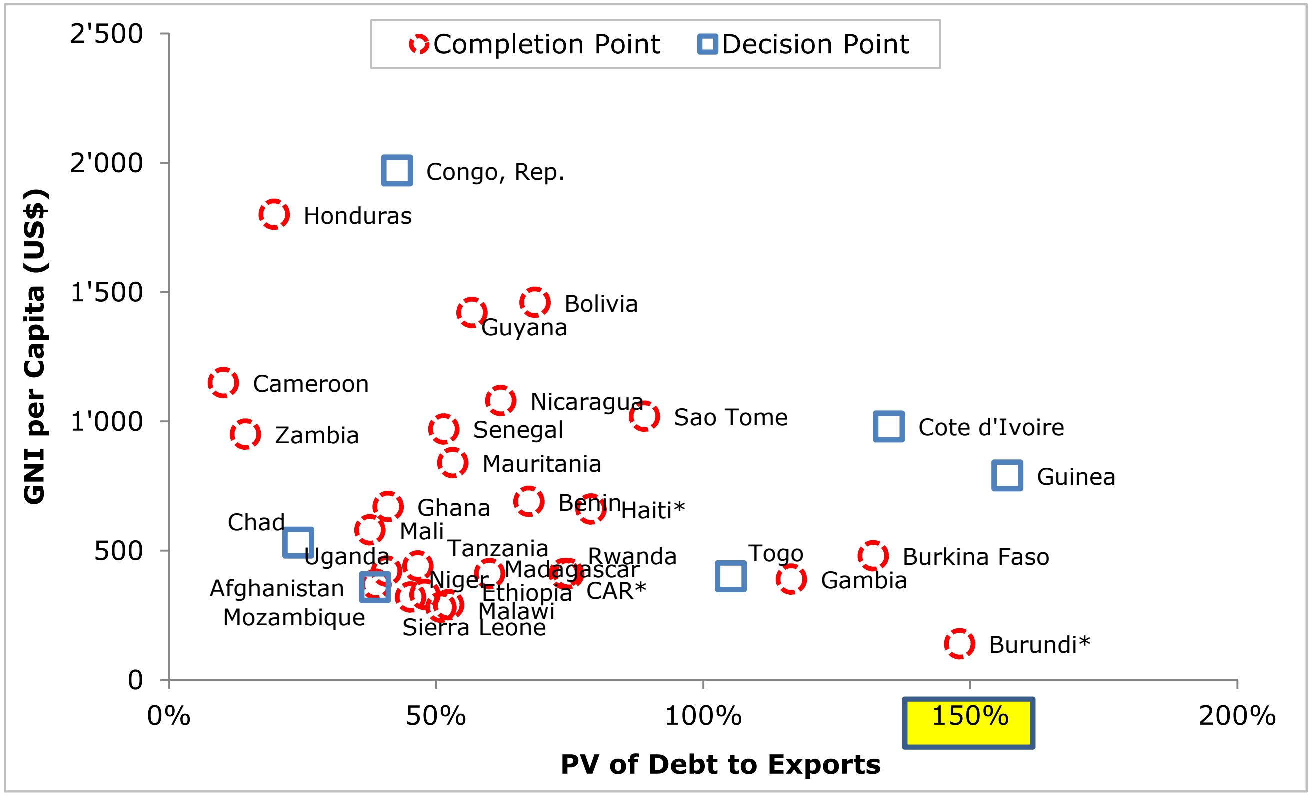
1/ Assumptions include timing of HIPC decision and completion points, and where applicable, of arrears clearance
Source: HIPC Initiative country documents; IDA and IMF staff estimates

Debt indicators of HIPCs have substantially declined since 1999

	35 Post-Decision Point HIPCs 1/	
	1999	2008
NPV of debt-to-exports	457%	121%
NPV of debt-to-GDP	114%	36%
Debt service-to-exports	18%	5%
NPV of debt-to-revenue	552%	151%
Debt service-to-revenue	22%	3%

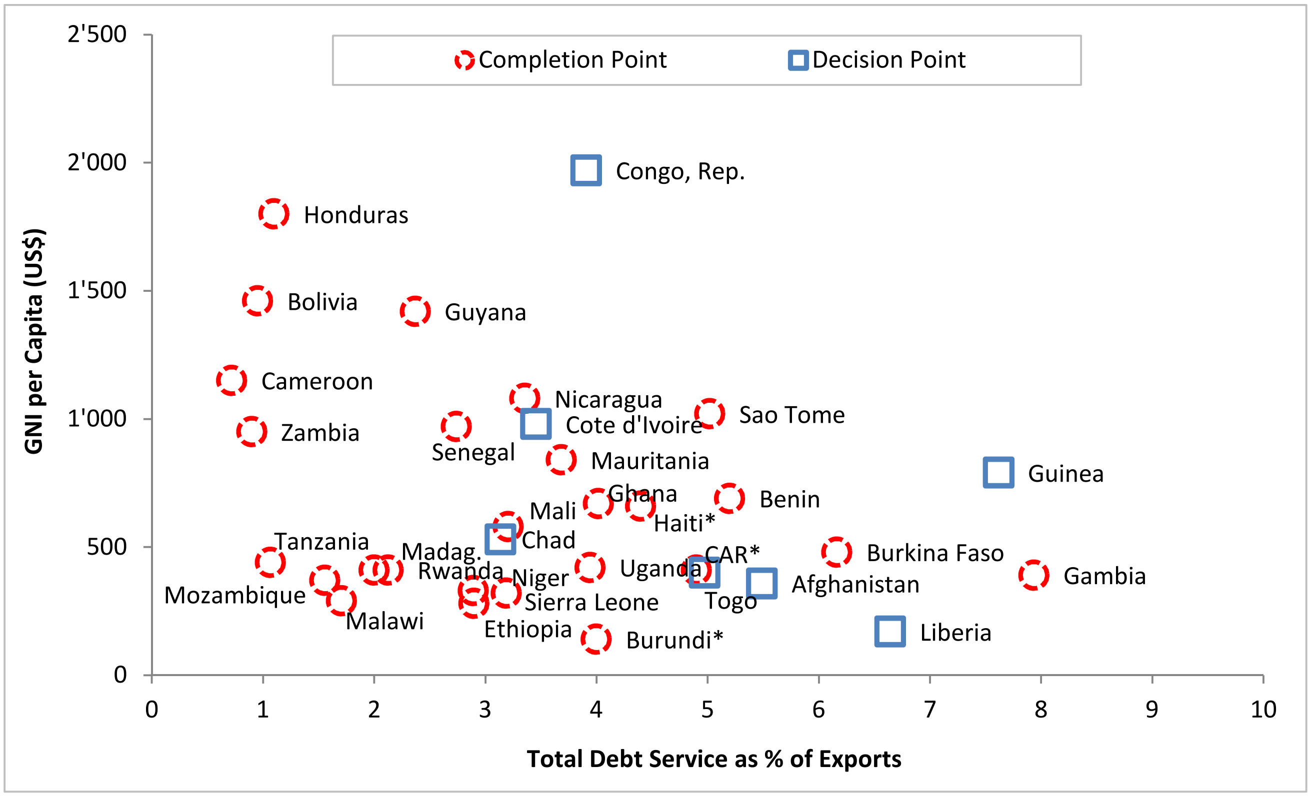
1/ Data are simple averages; subject to data availability
Source: HIPC Initiative country documents; IDA and IMF staff estimates

HIPC 2008 countries



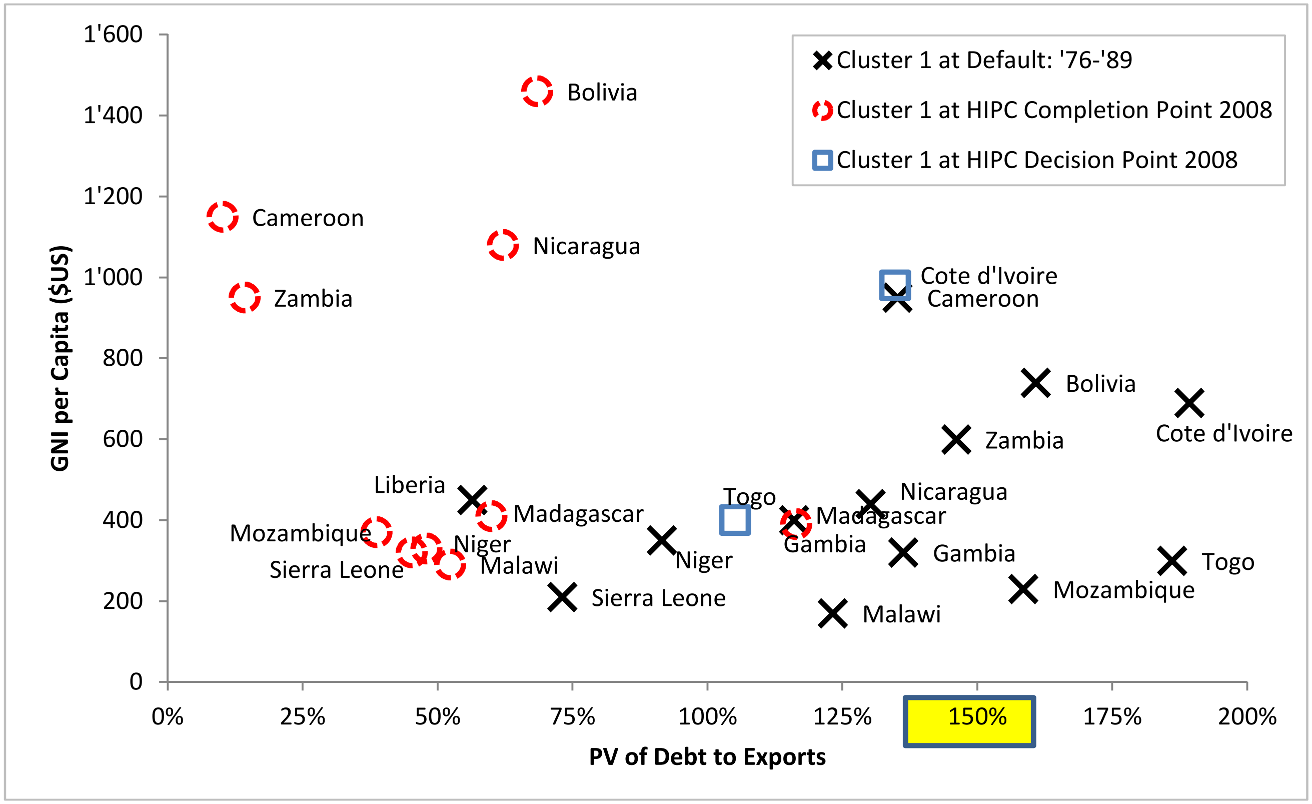
Note: Burundi, Haiti and CAR, due to their recent attainment of Completion Point status, have not yet fully benefitted from debt stock reduction; figures used here are pro-forma for debt stock reduction in 2009. 3 Decision Point countries—DRC, Guinea-Bissau, and Liberia—have PV Debt/Export ratios >200% and are not shown on this graph.
Source: World Bank, CIA World Factbook

HIPC 2008 countries



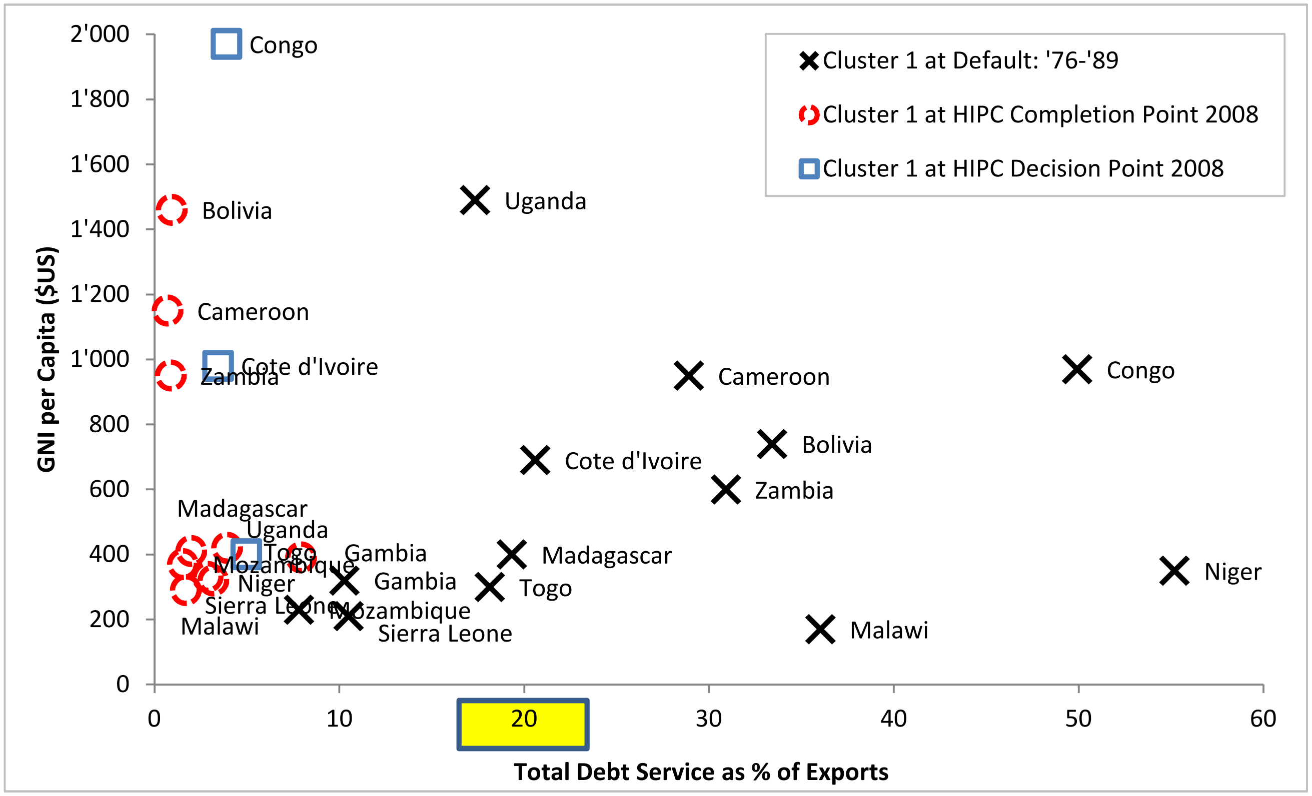
Note: Burundi, Haiti and CAR, due to their recent attainment of Completion Point status, have not yet fully benefitted from debt stock reduction; figures used here are pro-forma for debt stock reduction in 2009. 2 Decision Point countries—DRC and Guinea-Bissau—have Total Debt Service/Export ratios >10% and are not shown on this graph.
Source: World Bank, CIA World Factbook

Cluster 1 countries now in the HIPC Initiative: past versus 2008



Note: Liberia—currently a HIPC Decision Point country—had a PV Debt/Export ratio >200% at end-2008 and is not shown here.
Source: World Bank

Cluster 1 countries now in the HIPC Initiative: past versus 2008



Source: World Bank

- The Debt Sustainability Framework

The DSF in a nutshell

- Framework developed jointly by the World Bank and the IMF (2005):
  - Brings greater consistency, discipline, and transparency to sustainability analyses
  - Allows for better informed policy advice
  - Allows for cross-country comparability
- Objectives: to support the efforts of LICs to meet their development goals without creating future debt problems by:
  - Supporting LICs' borrowing decisions in a way that match the financing needs with their current and prospective ability to repay
  - Allowing creditors to tailor their financing terms in anticipation of future risks
  - Help detect potential crises early so that preventive action can be taken

The DSF in a nutshell (cont.)

- It is a tool (***thermometer***) aimed at <u>informing</u> Bank-Fund analyses on countries' debt vulnerabilities (***diagnostic***), allowing better informed decision making by donors, lenders and borrowers (***treatments***).

How the DSF works: three pillars

- 20 year projections of debt burden indicators in baseline, alternative and stress test scenarios.
- For ***external debt*** such indicators are compared against country specific (policy dependent) thresholds:

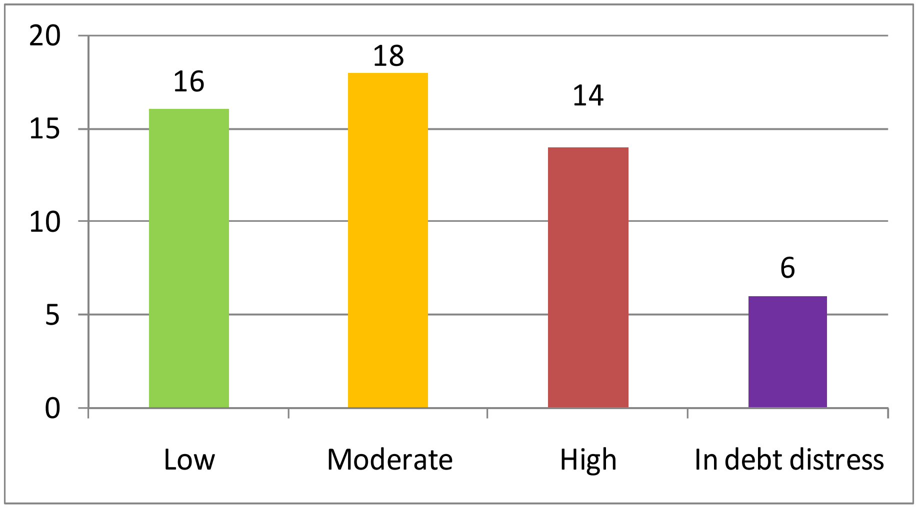
Table: Debt Sustainability Framework Thresholds

	PV of debt in percent of			Debt service in percent of	
	Exports	GDP	Revenue	Exports	Revenue
Weak Policy (CPIA $\leq$ 3.25)	100	30	200	15	25
Medium Policy (3.25 < CPIA < 3.75)	150	40	250	20	30
Strong Policy (CPIA $\geq$ 3.75)	200	50	300	25	25

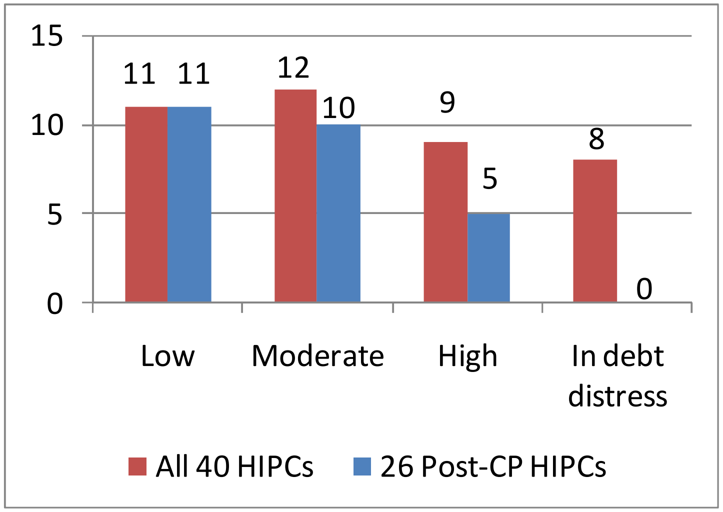
- Risk ratings of **low**, **moderate**, **high**, or **in debt distress** are assigned to countries.

Risk of debt distress

IDA-only countries



HIPCs



In the case of IDA, the graph reflects only countries for which a DSA is available. The graph for HIPCs includes: Bolivia and Honduras (both Blend countries) and Somalia (for which a DSA is not available)

Debt sustainability and the crisis

- Debt sustainability indicators are likely to deteriorate due to the fall in exports and government revenues, and (eventually) the increase in debt service;
- For some countries rollover and accelerated repayment may be an issue;
- Debt sustainability indicators may deteriorate even further as governments implement fiscal stimulus packages.

Debt sustainability prospects

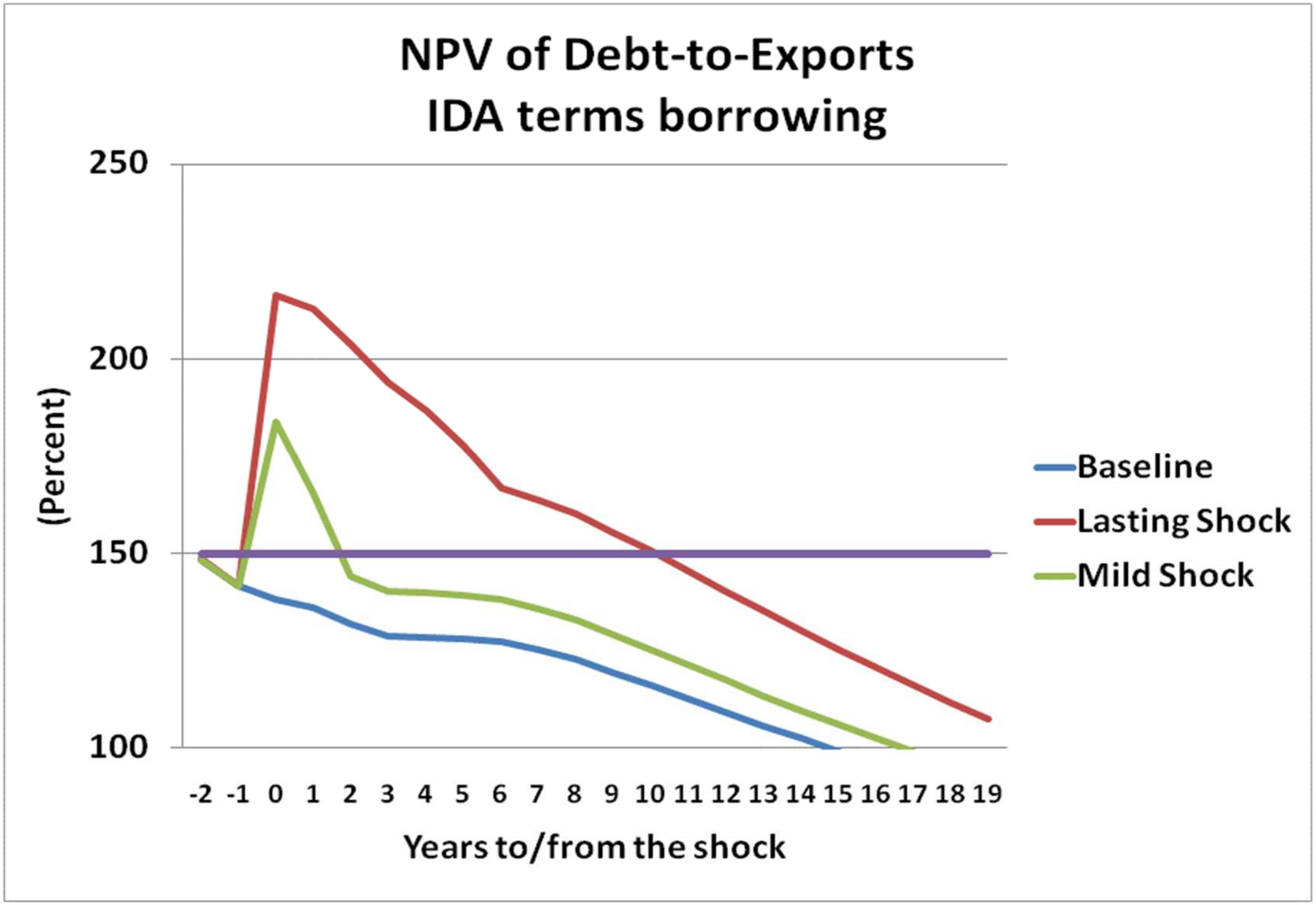
- A critical issue is **how long the crisis will last.**
- A short lived crisis will have a small effect on debt sustainability as relevant analysis is of a long term nature (e.g., the Debt Sustainability Analysis is forward looking, 20 yrs);
- In contrast, a protracted crisis will have a more lasting effect on debt sustainability.

Debt sustainability and the crisis

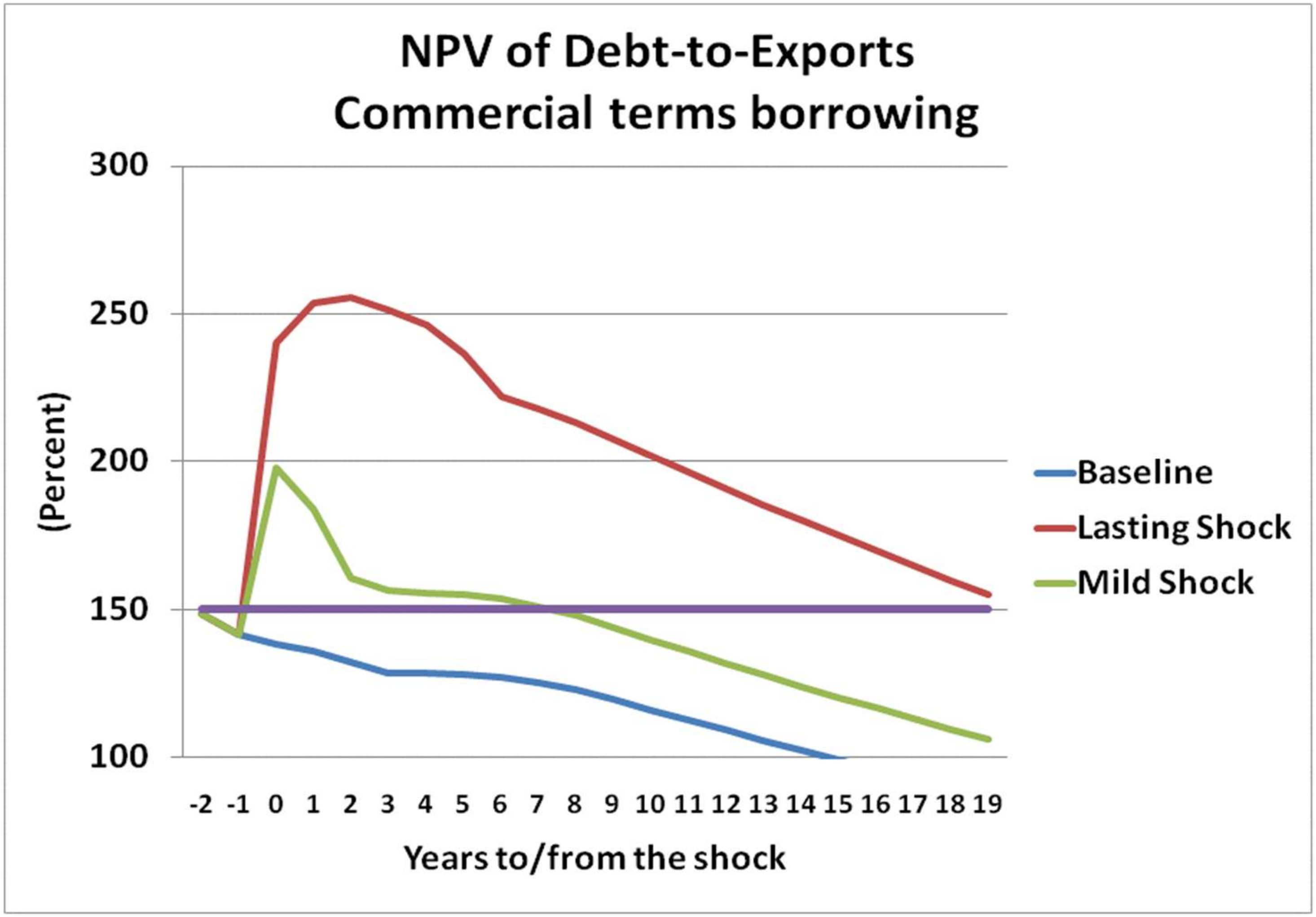
Two scenarios/shocks with different financing conditions

	YEAR						
	1	2	3	4	5	6	7
(A) Exports: % deviation with respect to baseline	30	25	20	15	10	5	0
	20	10	0	0	0	0	0
(B) Conditions of additional financing incurred to maintain consumption and expenditures constant	**(i) IDA terms**: 40 yrs; 10 yrs grace period; 0.75% interest						
	(ii) Commercial: 10 yrs.; no grace period; 5% interest						

Debt sustainability and the crisis

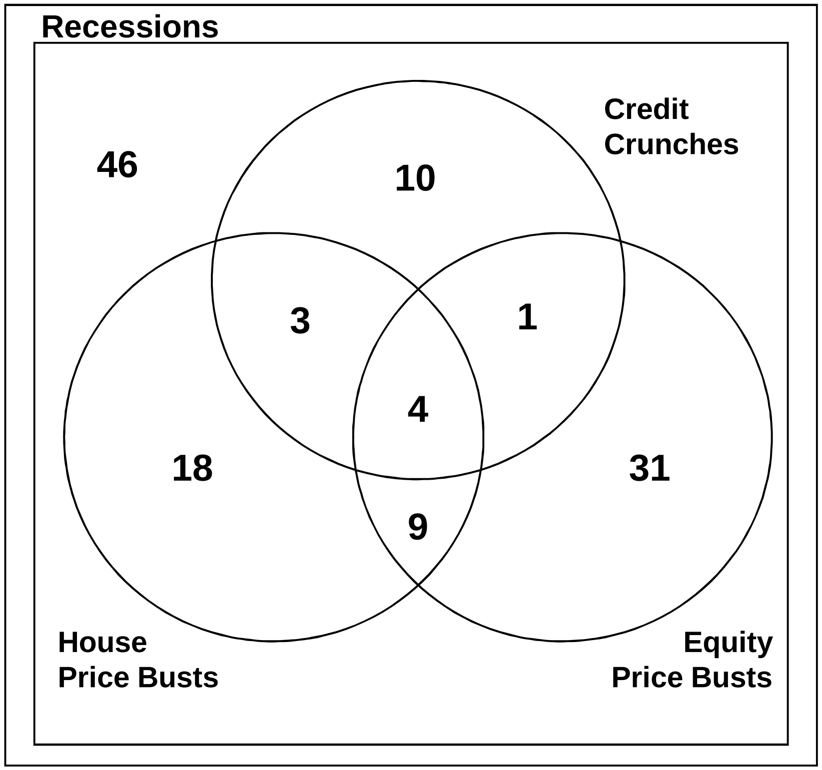


Debt sustainability and the crisis



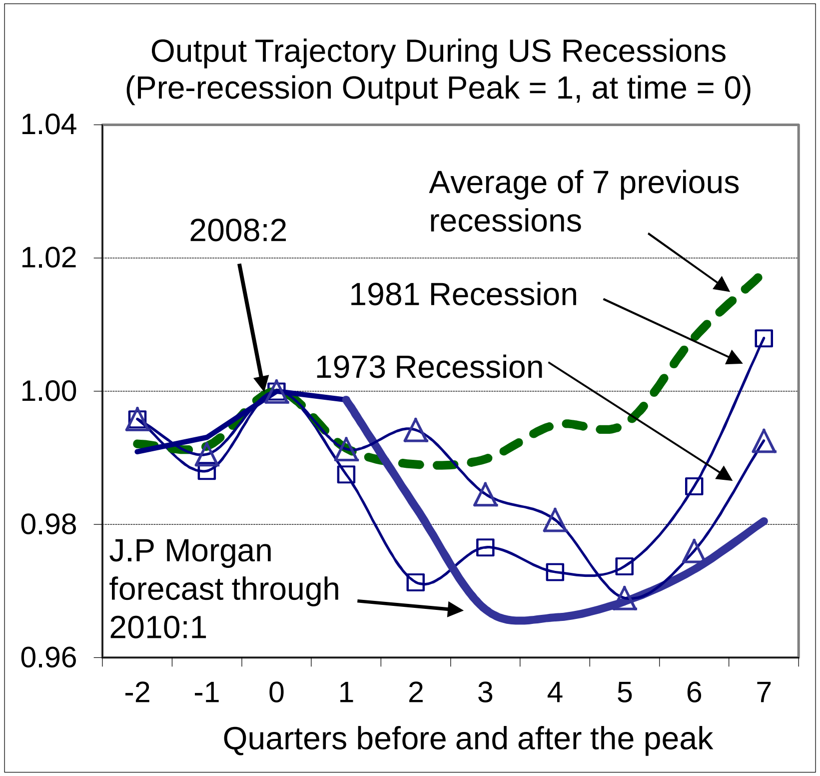
A protracted crisis?

Recessions, Crunches, and Busts



Source: Claessens, Kose, Terrones (2008)

Output Trajectory During U.S. Recessions



Source: JP Morgan

- Current crisis is one of four of the past 122 recessions to include a credit crunch, housing price bust, and equity price bust
- Average of past US recessions has shown that it has taken 5-6 quarters before pre-recession output levels were regained; current recovery will take longer

Debt management and the crisis

While a debt sustainability analysis focuses on the long-term sustainability of debt, which is influenced by both its level and composition, a debt management framework focuses on how the composition of debt is managed.

The crisis creates particular challenges for debt managers:

- How to close an increasing financing gap and finance a country's development needs at low cost with a prudent degree of risk, especially at a time when conditions in **financial markets are severely constrained**?

- Given limited external financing options, how can potential benefits from **developing domestic markets** be exploited at a low cost and prudent degree of risk?

- **Given the efforts by many governments to strengthen their balance sheets over the past decade,** how can these sounder public debt structures be protected?

- Since the crisis implies substantial macroeconomic adjustments, **how should debt management strategy reflect the new reality**?

Concluding remarks

- **Will this time be different? "Yo"** (cross border collaboration, reciprocal currency swap lines among Central Banks to address foreign currency liquidity shortages, reserve "cushions," debt relief…);
- **Slower world economic growth and higher cost of capital** will mean a more difficult environment for developing countries seeking to accelerate growth and progress toward the MDGs;
- Financial crisis: **scale of policy responses is country specific**, but, given the procyclicality of the financial system, it is important to coordinate financial sector reform and to synchronize macroeconomic responses;
- **The severity of the downturn highlights the need for an increase in high-impact fiscal expenditures.** But embedding stimulus packages in a credible medium-term strategy, that safeguards fiscal sustainability, is key;
- **Expansion of public debt will be massive in industrialized countries**. Countries need to design exit strategies to the ongoing fiscal interventions and to introduce growth-enhancing reforms to reassure markets of the public sector's solvency;
- **Debt sustainability implications for LICs:** a function of the crisis duration. Implications of non-concessional borrowing need to be carefully evaluated;
- **Debt management:** the crisis further underscores the importance of debt management practices and makes the Debt Management Facility even more relevant;

Concluding remarks (cont.)

- **DSF Flexibility** -- G20 April 2009 Communiqué: IMF and World Bank to review the flexibility of the DSF and report to the IMFC and the Development Committee at the 2009 Annual Meetings;

- The review focused on:
  - Investment-growth nexus
  - Treatment of remittances
  - Threshold effects
  - Treatment of state-owned enterprise debt

- In addition, the **WB/IMF (2009)** paper proposes changes to some operational aspects of the DSF. The Staff Guidance Note is being updated. Adjustments are also being made with respect to the IMF's debt limits policy and IDA's Nonconcessional Borrowing Policy.

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Thank You

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