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State-contingent debt instruments for sovereigns: Can they be made «to work»

by

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The views expressed are those of the author and do not necessarily reflect the views of UNCTAD.

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State-Contingent Debt Instruments for Sovereigns

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Several developing countries have experienced debt distress recently

- **Grenada** – initiated OSI and PSI in **2014** (completed in 2015)
- **Mozambique** – initiated PSI restructuring in **2016**
- **Chad** - initiated PSI in **2017**
- **Gambia** - initiated OSI in **2017**
- **Congo, Republic of** – considering measures to restore debt sustainability (**2017**)
- **Venezuela** – seems to have initiated restructuring discussions with some creditors (**2017**)

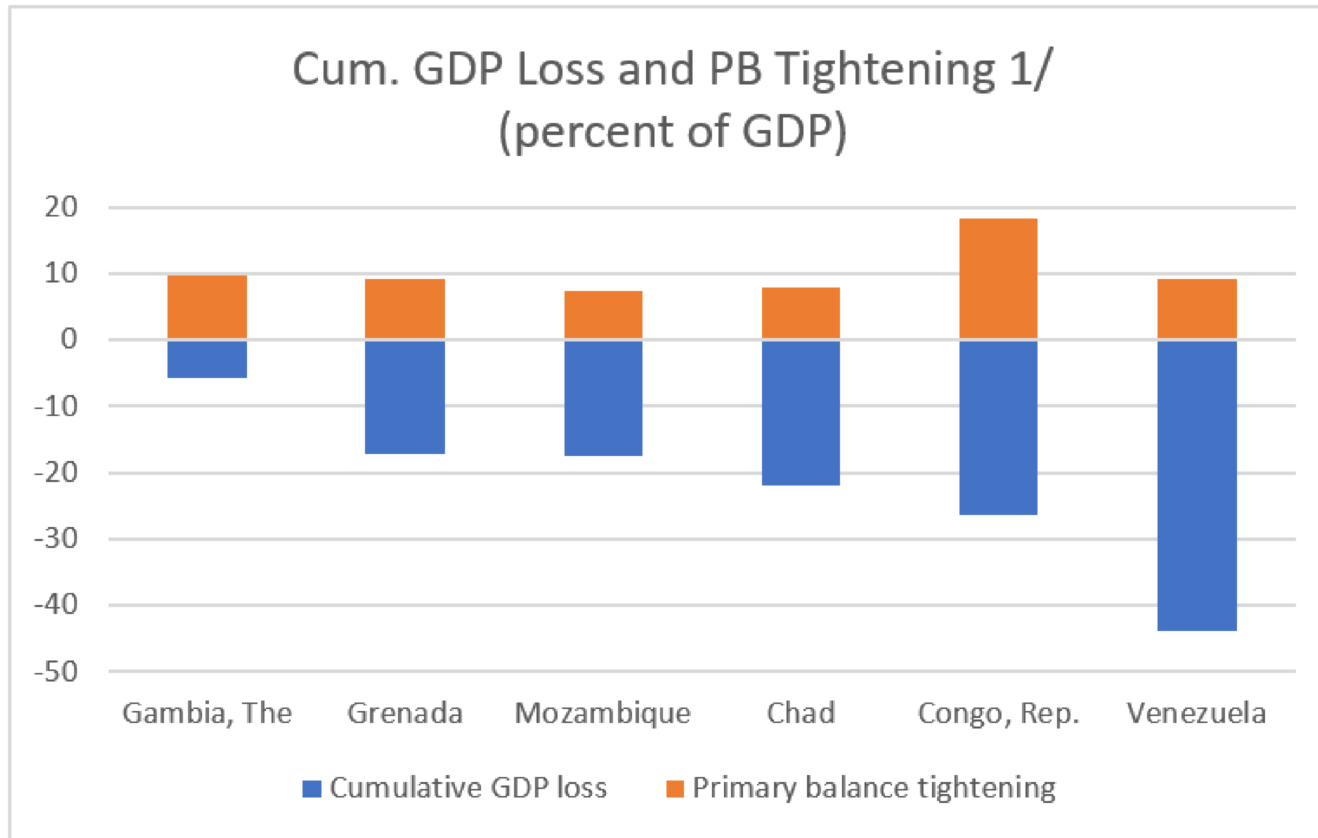
The culprit in most cases was a large, negative, *insurable* exogenous shock

Country (est. restructuring year)	**Catalyst**
Chad (2017)	Oil price decline (2014-15)
Grenada (2014)	Hurricane Ivan (2004)
Gambia (2017)	Regime change, governance (2016-17)
Mozambique (2016)	LNG price decline, adverse weather (2014-15)
Rep. of Congo (2017)	Oil price decline (2014-15)
Venezuela (2017)	Oil price decline (2014-15)

Actions taken ahead of the shock?

1. Windfall funds established in some commodity-producers, but spent before the shock
2. Not much impetus to develop domestic debt markets in boom years (resort to external commercial borrowing instead)
3. Importantly, no significant ex-ante insurance taken out against these shocks

The accompanying pain in terms of growth and procyclical fiscal tightening has been considerable



Source: IMF staff calcuations

Note: GDP loss is estimated using the average real GDP growth +/- 5 years from crisis year

*Plus **undesirable** debt management actions taken under stress:*

- **Collateralized** debts (Chad and Congo)

- Heavily **discounted** debt (Venezuela)

- **Undisclosed** borrowing from aggressive lenders (Mozambique)

There must be a better way, but among existing avenues to strengthen resilience, there are limitations

Buffers

Inefficient solution globally; vulnerable to be spent in good times

Long-term local currency bonds

Many EMLICs can't issue in needed amounts; can guard against refinancing but not solvency risks

Natural catastrophe insurance

Not a financing instrument, typically quite expensive

Commodity hedges

Only available over short-term, subject to counterparty risk

Official liquidity support

May not be available on a timely basis or accessible for all countries

Is inaction and restructuring an OK way to proceed?

- In ***theory***, debt can be restructured to restore debt sustainability
- In ***practice***, there are **delays:**
  - Recognition lag (gambling for resurrection)
  - Decision lag (too little too late)
  - Implementation lag (process takes time; need to deal with holdouts)
- And **costs**:
  - In terms of growth and market access
  - Very high for disorderly defaults!
- **Gaps in architecture** complicate collective action
  - Still large stock of CAC-less bonds, and countries may have other commercial loans
  - Blurred boundary between commercial and official claims
  - Rise of creditors with no established resolution mechanism (non-Paris Club, regional development agencies)

Enter… State-Contingent Debt Instruments (SCDIs): *"Automatic" debt relief when needed!*

- SCDIs tie sovereign's debt service obligations to "state variable":
  - *continuous* measure of repayment capacity: e.g. **GDP**, **wages, commodity prices**
  - *discrete* event affecting repayment capacity: e.g. **natural disasters, export shock**

- "Adjustment mechanism" can be designed to:
  - **reduce** debt payments: e.g. GDP- or commodity-indexed bond
    - Can stabilize debt/GDP or debt/exports ratio
  - **defer** debt payments: e.g. extendible maturity bonds; loans with adjustable grace periods
    - Can stabilize gross financing needs

- States facing large exogenous shocks would benefit most:
  - **Commodity exporters ==>** commodity-indexed bonds
  - **Small states ==>** "hurricane clauses" in conventional bonds
  - **Other EMLICs reliant on FCY borrowing ==>** growth-indexed fixed principle FCY bonds

Creditors do offer these in small volumes; and, for a price, might offer more

Investors exist already

- *Domestic pension funds* **==>** Uruguay's wage-indexed bonds (2016)
- *International insurers/reinsurers* **==>** Grenada's "hurricane clause" (2014)
- *Agence Française de Développement* **==>** Adjustable grace period loans to AFR countries
- [Plus, investors in "inflation-linked bonds": $2.7tn globally (o/w $400bn issued by EMs)]

And more seem interested

- *Sovereign wealth funds:* to diversify GDP risk globally
- *Natural hedge investors:* e.g. in commodity-importing countries
- *EM/frontier investors:* for yield/diversification across countries
- *Islamic finance investors:* Shiariah-compliant commodity-linked bonds

Pricing not prohibitive

- Shocks hitting EMLICs weakly correlated with major financial market indices
- Yield premium < 50 bps for GDP-linked bond

What does a country need to pursue these?

Non-DMO

- **Model contracts…**
  - To set out clear methodology to calculate cashflows
  - Lay out contingencies where data availability or reliability concerns arise
  - "London Termsheet" offers a good example
- **Independent/competent statistical agency**
  - Data quality/integrity critical for government-controlled state variable (e.g. GDP)
  - Less important if SCDI linked to "exogenous" variable: international commodity price; natural disaster (e.g. assessed by CCIRF), trading partner GDP/imports…

DMO

- **Mandate for debt management offices**
  - Finance ministries need to authorize DMOs to integrate SCDIs in their strategies
  - Willingness to bear some cost for risk-mitigation
- **Strengthening DMO capacity**
  - SCDIs can be complex to understand, explain to investors
  - Credible issuance plans in face of (likely more) pro-cyclical investor demand

How can a country better analyze cost-benefit options of various designs: **An IMF Toolkit**

Calculates debt, deficit, gross financing needs under range of customizable scenarios:

(i) types of SCDI; (ii) share in total debt; (iii) types/sizes of shocks; (iv) yield premium demanded by investors…

	"Linker"	"Floater"	"Extendible"
Example of state variable	Level of nominal GDP, level of a commodity price index	Real GDP growth rate, commodity price change	commodity price shock, natural disaster, export shock
Adjustment mechanism	Principal linked to GDP. Coupon varies somewhat	Coupon linked to the growth, but principal fixed	Pre-defined extension of the principal by a few years
Main purpose	Stabilizes debt/GDP	Provides debt service relief during recessions	Provides substantial liquidity support
Example	Debt/GDP 130% 120% 110% 100% 2016 2017 2018 2019 2020 2021 2022 2023 2024 2025 2026 2027 2028 2029 2030 Linker - 25% share of sovereign financing 100% conventional bonds	Debt/GDP 130% 120% 110% 100% 2016 2017 2018 2019 2020 2021 2022 2023 2024 2025 2026 2027 2028 2029 2030 Floater - 25% share of sovereign financing 100% conventional bonds	GFN/GDP 25% 20% 15% 10% 2016 2017 2018 2019 2020 2021 2022 2023 2024 2025 2026 2027 2028 2029 2030 Extendible - 25% share of sovereign financing 100% conventional bonds

Thank you

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