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Presentation and Comments on the Discussion

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Abstract

The priority should be to conclude debt restructurings swiftly and to clear paths for the global transfers from rich to poor countries that must take place if the world is to have any chance of reversing global warming and the climatic changes that are an existential threat. The existing restructuring frameworks are adequate for countries above the median score of the Human Development Index (HDI), but the outstanding debt of countries below the median should be written down by a trust fund financed by donations from rich countries. The cost to rich countries would be trivial; the benefit would be to unblock channels for financial flows to the poorest countries that are essential for the success of the global campaign against climate change.

The IMF's Debt Sustainability Analysis (DSA) methodology was developed specifically for the Fund's purposes. However, for small open economies, the sustainability of debt depends on the impact of debt service on the balance of external payments. Debt is not sustainable if the cost of servicing leads to a decline in foreign reserves, all other things being equal.

A Perspective on the Prevailing Sovereign Debt Restructuring Architecture in Light of Global Sustainable Development Priorities

The background against which all discussions of sovereign debt must be viewed is the enormous financial transfer from rich countries to poor countries that is necessary to arrest the existential threat to our environment. As I wrote in December 2021, the United Nations Climate Change Conference, COP 26, held in Glasgow in October that year, was a wake-up call to the world.

> The one message that was heard around the world, in all reports from COP 26, was that civilisation everywhere in the world is threatened by current and past human action. Unless humanity manages to change course urgently, the dire consequences of climate change may well

> overwhelm human civilisation before the end of our century. It is not surprising that young people are panicked by this news, because the terrible fate that looms will probably appear within their lifetimes.[1]

I added that "the pledges made at COP 26 do not begin to address the problem, and, like previous undertakings, they are unlikely to be fulfilled in total". Sadly but not unexpectedly, that sentiment was justified by the outcome of the next UN conference on climate change, COP 27 in Sharm El Sheik in November last year. Here is one knowledgeable commentator's assessment:

> All decisions at these U.N. climate conferences – always – are promissory notes. And the legacy of climate negotiations is one of promises not kept.
>
> [COP 27's promised Loss and Damage Fund], welcome as it is, is particularly vague and unconvincing, even by U.N. standards. ….
>
> For developing countries, there is a real danger that this turns out to be another "placebo fund," to use Oxford University researcher Benito Müller's term – an agreed-to funding arrangement without any agreed-to funding commitments.[2]

This is where matters now stand. If we are to reverse the direction of travel with respect to the adverse changes in climate, the funds transfer from rich to poor nations is many times larger than is presently contemplated, as leading international experts such as Lawrence Summers[3] have pointed out. And the amounts being contemplated, following the COP 27 negotiations, are unlikely to be matched with actual commitments.

There is worse to come. A major contribution to the financial transfer from the rich to the poor world is expected to be made by the private sector. The argument is that, precisely because emerging market and developing countries have such a deficit of energy, infrastructure and other development essentials, the returns to investment in such countries should be more attractive to investors from wealthy countries than would be the case for investment at home. The problem, however, is that less wealthy nations cannot afford to pay more, especially for projects with long gestation and where social returns are much higher than private returns. Since a majority of energy and infrastructure projects fall into these categories, we should not expect the private contribution to the needed global transfer to be large. If we are to have a chance to turn things around, the governments of rich nations must find avenues to fund most of the needed transfers to the rest of the world.

This, then, is the setting within which we should assess the arrangements for sovereign debt restructurings. A distinction should be made between countries above and below the median in the rankings of the Human Development Index (HDI), published annually by the United Nations Development Programme. The HDI is the best measure we have of development for all nations, incorporating indices of average income and health and educational status. It is reasonable to assume that the countries above the median will, for the most part, have the capacity to attract private capital for clean energy, sustainable infrastructure and public and social amenities and other desirable investment. What is needed in these cases, is to restore market confidence in their debt, so that private investors can lend with some assurance. Countries in this group have the capacity to finance borrowing at international market

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[1] COP 26 Was a Wake-up Call Heard Around the World | Delisle Worrell

[2] COP27's 'loss and damage' fund for developing countries could be a breakthrough – or another empty climate promise (theconversation.com).

[3] See Rebuilding the Global Economy: Role of the US Treasury Department | Event | PIIE.

rates, for infrastructure and investments with social returns that exceed private returns. The problem in their case is not the cost of finance but the efficiency of public financial management.

However, highly indebted countries which find themselves below the median rank in the HDI must be treated differently. These are countries where, by and large, the challenge of attracting affordable private funding is formidable, given the risk premiums and external diseconomies of investment which they face. In most of these cases, the target must be to secure the required financial resources entirely from official national and multinational institutions.

The argument, in either case, is not based on considerations of equity, but of practicality. Without the required transfer from rich to poor countries, the goal of reversing the trend towards human self-destruction cannot be achieved. If resources do not move, people will, aggravating global migration tensions, and the positive climate mediation efforts of the rich world will continue to be negated by deterioration in the rest of the world.

The existing debt restructuring architecture is adequate for countries which sit above the median rank in the HDI. This is the case for Caribbean debt restructurings (See the Appendix). All the Caribbean countries which have restructured debt since the turn of the century have HDI scores above the median. Only one of five countries can be said to have had a successful experience, but the failures are not because of any defect in the arrangements for restructuring. Rather, economic performances after restructuring fell short of expectations because underlying weaknesses in public sector performances and financing were not sufficiently addressed.

However, in the case of countries with HDI scores below the median, national and multinational institutions should provide grants to write down completely their outstanding indebtedness. Funds should be provided to cover both official and private debt. I have not tried to compute the total amount of grant funding that would be required, but I cannot believe that it would be as large as the margin of error in total international official debt flows. There seems no purpose to continuing negotiations with countries which have little prospect of achieving an investment grade rating in private markets. Without such a rating, any private financing these countries might receive in the future will be at a cost that prejudices the country's development.

Takeaways

The priority is to have restructurings completed without delay, and in ways which do not prejudice access to new funding, which is the matter to which the world must turn its attention, and with the utmost urgency. In order to clear the decks for the main action, it seems advisable to set up a multinational trust fund to write down the unsustainable outstanding debt of the poorest countries. The countries which sit above the median HDI can regain external credit worthiness by addressing issues of public sector performance, public finances and poorly informed macroeconomic policies. The existing framework for restructuring suffices for this group.

Secondly, in all countries, the main barriers to access to international funding have to do with poor governance, low public sector productivity and misguided macroeconomic policies, matters which depend on the knowledge and capacity of sovereign governments. The more capable governments do have access to affordable private funding, though the costs are arguably above the countries' social rates of return. In comments on a draft of this presentation Federico Sequeda provided examples of countries which have secured private funding in recent years.[4]

Thirdly, a swift conclusion of outstanding debt restructurings is in the interest of all countries. Opening avenues to new and much greater official financial transfers from rich to poor countries is not an act of charity; it is a matter of the survival of the quality of life to which we have all become accustomed. The truth is that we who are privileged to enjoy superior lifestyles will not pass that privilege to our children's children unless we find ways to share the finance and resources at our command with all the peoples of the world.

APPENDIX

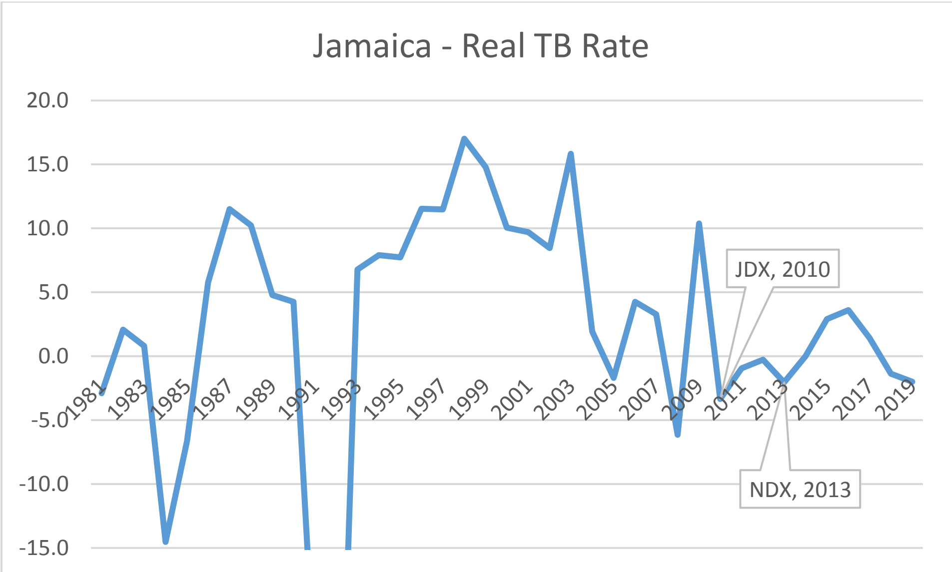
Recent Sovereign Debt Restructurings in the English-speaking Caribbean

There have been sovereign debt restructuring episodes in five English-speaking Caribbean countries since the turn of the century: Barbados, Belize, Grenada, Jamaica and St Kitts-Nevis. The Jamaica debt exchanges of 2010 and 2013 are the only ones that may be considered successful, for reasons we will explain. In the other instances debt ratios may have been temporarily reduced, but the problems that occasioned the debt restructuring were not adequately addressed.

At the time of the Jamaica debt exchanges in 2010 and 2013, the Jamaican economy was trapped in a high interest rate regime which had persisted since the time of major exchange regime changes two decades earlier. In 1991 the Bank of Jamaica announced it would no longer intervene on the foreign currency market to target the Jamaican currency price of US dollars. The value of the local currency plunged, triggering a prolonged period of high inflation. In response the Bank of Jamaica aggressively pushed up the Treasury bill rate. When inflation abated, however, the local financial market resisted the central bank's efforts to depress the Treasury bill rate *pari passu*. As a result, real rates of interest rose above ten percent for a decade until the mid-2000s. Strenuous efforts by the Bank of Jamaica to escape this high interest equilibrium only produced extreme interest instability between 2005 and 2009. The first debt exchange, which attracted full subscription, enabled the country to exit the high interest regime. The real rate of interest turned briefly negative at the time of the 2010 exchange, and the nominal interest rate has remained roughly at the same value as the rate of inflation ever since. The second debt exchange was launched after the Government "failed to capitalize on the fiscal space created by [its predecessor]" (Langrin, 2013), but by then the financial sector had settled into the low interest equilibrium. (See Figure 1.)

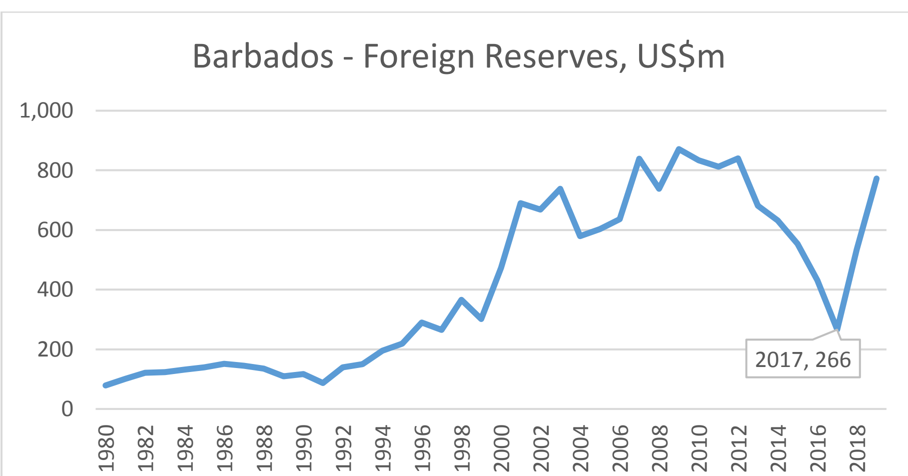
[4] Some examples of low HDI countries with low financing costs: Rwanda (HDI rank 166, issued a bond at 5.5 percent), Ivory Coast (HDI rank 159, issued at 5 percent), Guatemala (HDI rank 135, issued at 3.7 percent), Vietnam (HDI rank 114, trades at 1.2 percent above U.S. treasuries) and Paraguay (HDI rank 103, issued at 3 percent).

Figure 1.



The Jamaican success contrasts with the contentious Barbados debt restructuring (November 2018 for domestic debt, October 2019 for external debt), which was occasioned by the balance of payments crisis of 2018. The country's foreign reserves plummeted from US$840 million in 2012 to just one-third of that amount by 2017, a level which created apprehension about the stability of the exchange rate. The reason for the haemorrhage was over-manning and falling productivity in the public sector. Years of successive deficits on current operations were financed with local currency borrowing from the Central Bank of Barbados. This local currency spending generated a need for imports which was met by drawing down foreign reserves when the foreign currency market supply fell short of requirements. Unfortunately, the debt restructuring was not accompanied by the reform of the public sector necessary to correct the underlying issues, and the debt levels are once more on the rise. (See Figure 2.)

Figure 2.



The debt restructurings in Belize (2006 and 2013) and Grenada (2005 and 2015) both achieved some temporary alleviation of the burden of external debt servicing, but they are hardly deserving of the attention they have received. The external liquidity situation was not especially tight before any of the restructuring exercises, and the restructurings do not appear to have had much impact on the medium term trends of foreign reserve accumulation. In both cases the underlying fiscal imbalance which led to concerns about debt levels were not addressed, and the sustainability of the fiscal accounts is not assured. (See Figures 3 and 4.)

Figure 3.

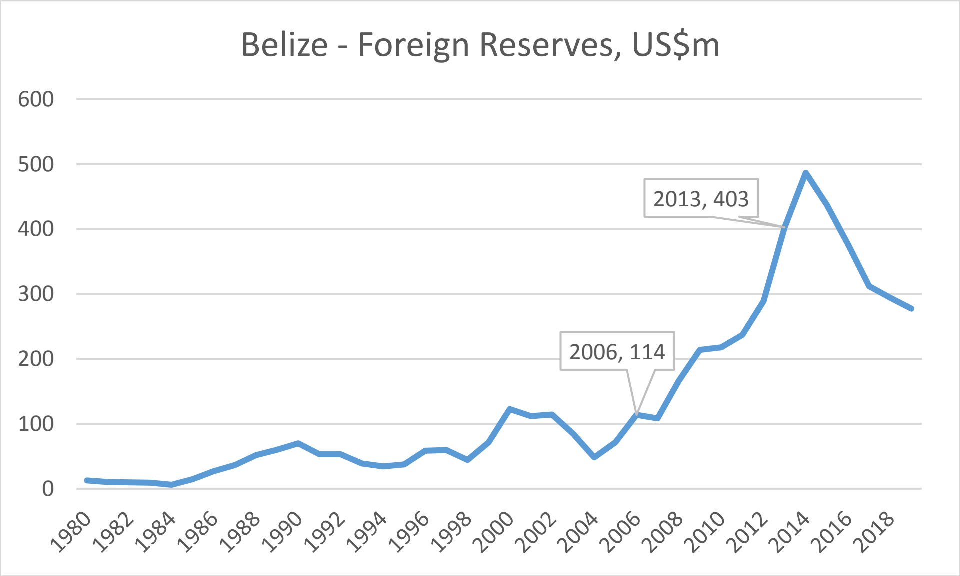
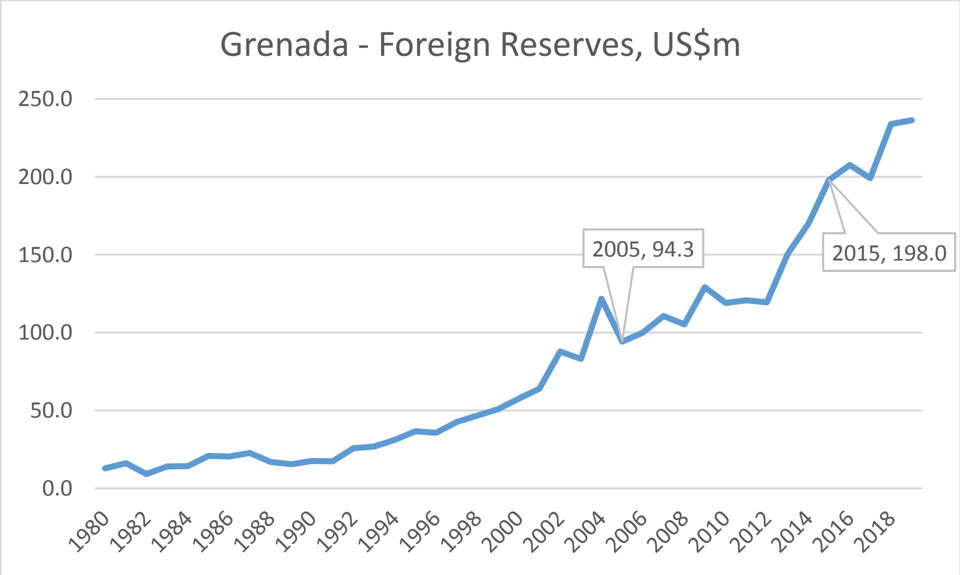
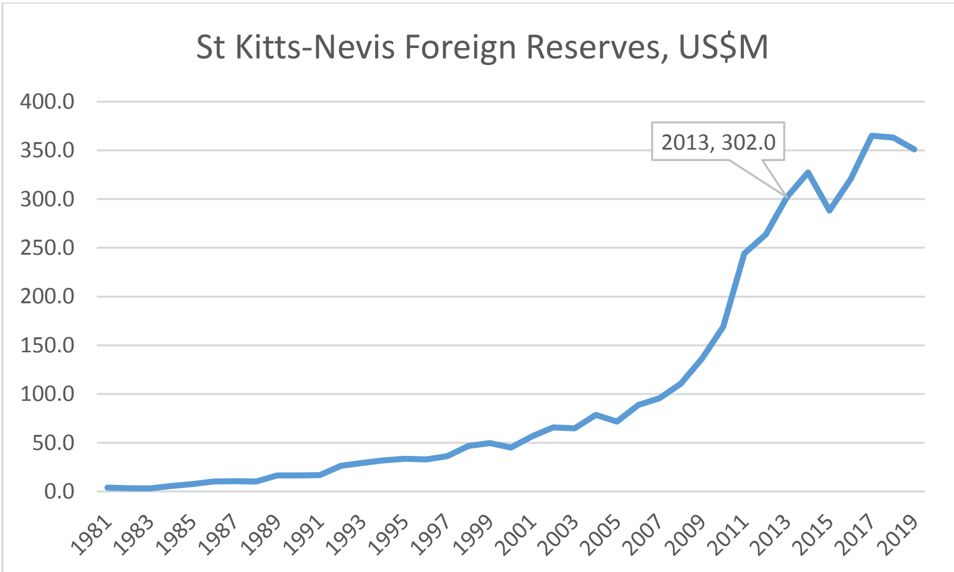


Figure 4.



The restructuring of its external debt in 2013 contributed very little to the efforts to reduce the amount of sovereign debt in St Kitts-Nevis. The apparent fall in the ratio of debt to GDP from 164 percent in 2010 to 105 percent in 2013, mentioned in the 2014 IMF Staff Report, was an accounting exercise, in which the domestic debt was exchanged for equity in a state company that owns almost all the agricultural real estate in St Kitts, formerly the property of the now defunct sugar industry. The exercise had no effect on the GDP, the foreign reserves or the sustainability of the fiscal accounts (Figure 5).

Figure 5.



It is evident from Figures 2 - 5 that Barbados is the only one of these countries which had a problem of fiscal sustainability. Worrell et al (2015), demonstrates that, in the small open economies of the Caribbean, whenever "the combined impact on foreign currency demand of Government external debt service and the wealth effects of domestic debt results in an excess demand for foreign exchange, government will, in time, exhaust the country's foreign reserves in its attempts to service the debt" (Page 5). In other words, an unsustainable fiscal balance will show up as pressure on the foreign exchange market, whether government borrows abroad or from the central bank. The converse holds: the absence of excess foreign currency market pressure is a reliable indicator that fiscal balances are sustainable, whatever may be the underlying problems of public sector productivity and inefficiency in the allocation of resources. Both Grenada and St Kitts-Nevis are members of the Eastern Caribbean Currency Union; the contribution to the collective foreign reserves assigned to them, based on changes in their monetary bases, continued to trend upwards during the restructuring episodes. The same is true for the foreign reserves of Belize. Barbados is the only one of the five that clearly has a fiscal trajectory that is unsustainable, reflected in the decline in foreign reserves to 2017. Worrell (2017) shows that the problem is rooted in declining public sector productivity which produces structural deficits on the fiscal current account. Although foreign reserve levels have been restored thanks to borrowing from the IMF and other official sources, the public finances are not yet sustainable. The terms of the domestic debt restructuring impair the government's ability to borrow domestically in the medium term, perhaps longer.

Comments on the Discussions at the Conference

Careless restructuring of domestic debt may impair financial stability

In his remarks Mark Flanagan observed that the restructuring of domestic debt should be carefully designed and executed to avoid consequences that may create financial instability. The Barbados 2018 experience provides evidence of the lasting damage that results from a poorly executed restructuring of domestic debt. The mistakes made by the authorities included:

- Writing off fifty percent of the earning assets of the National Insurance Fund, with the result that actuarial calculations now indicate that the Fund will become illiquid in the middle of the next decade, rather than in mid-century. Understandably, this has created widespread anxiety, especially among those in mid-career.
- The write-down of the Government debt held by the Central Bank of Barbados, which has left the Bank deeply insolvent.
- Imposing unacceptable terms on private individuals and non-financial institutions by aggregating their debt with that of the National Insurance Fund, to achieve a majority of debt holding (in terms of dollar value) in favour of restructuring, in spite of rejection by a large majority of private holders.
- Coercing banks, insurance companies and other financial institutions into accepting terms on replacement bonds which resulted in major losses and the closure of several institutions.
- Replacing the bonds held by individuals (most of which had previously been rolled over at maturity) with new bonds a below-market rates, with monthly and quarterly amortisation, beginning immediately, and with horizons up to fifteen years.

The damage to the domestic financial and capital markets has been deep and lasting. Commercial bank profitability has been reduced and banks have responded by reducing services to the public; the largest private companies have forsaken the local capital market; several insurance companies have folded; much private financial wealth has been destroyed; the liquidity of pension funds, and the income of non-governmental organisations, cultural institutions and companies has been impaired; five years later there is little appetite for Government debt. Domestic savers now have no low risk investment instruments other than real property.

The IMF's Debt Sustainability Analysis (DSA) is appropriate for the Fund's purposes, but is not suitable for private creditors or countries

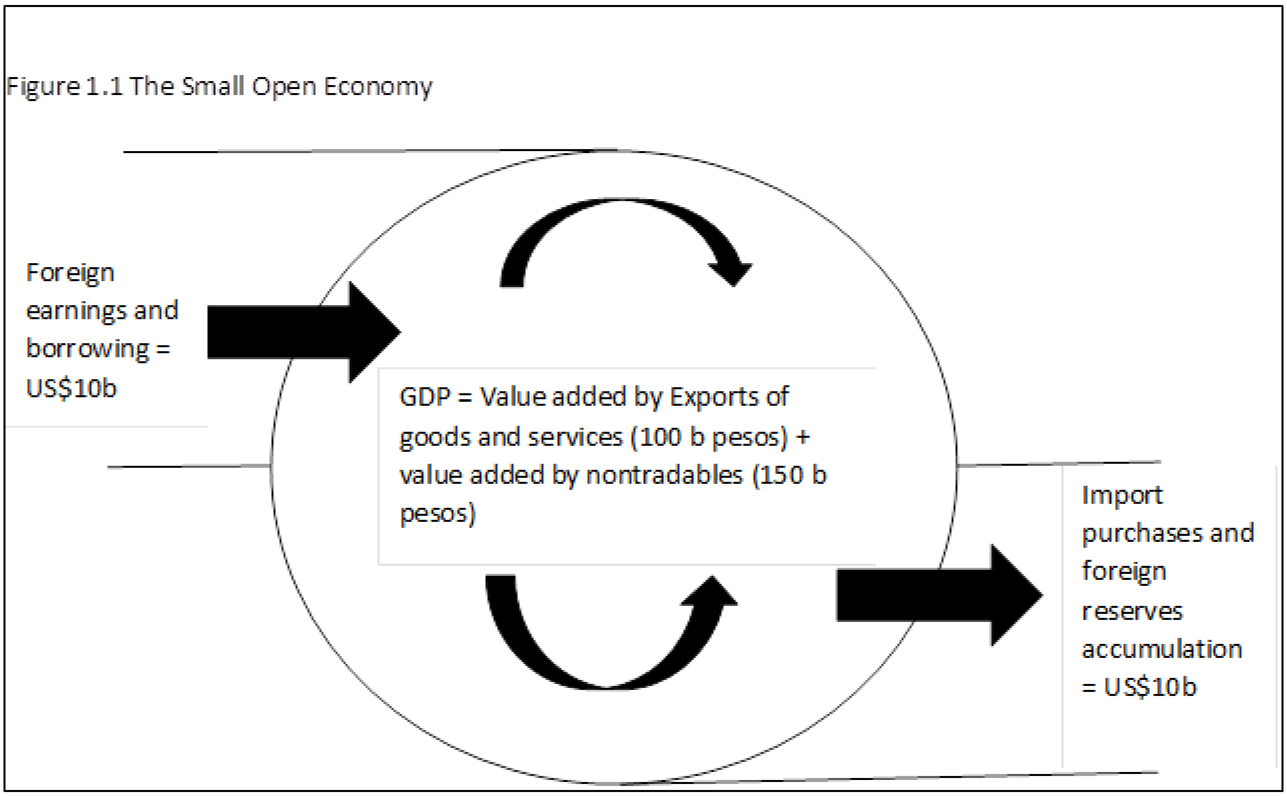
Yan Liu reminded the meeting that a sustainable DSA[5] is a requirement for all IMF lending. The DSA methodology projects economic growth and compares with the cost of debt service. That is appropriate because the Fund's Board has a responsibility to the institution's members to ensure, as far as is reasonable, that countries will be able to meet their interest and repayment obligations. The Fund applies a sophisticated analysis, based on a readily available metric, the debt to GDP ratio, to provide a comparable picture for all countries. The DSA has its deficiencies, but it fits the Fund's purposes.

[5] The DSA is a methodology developed by the International Monetary Fund for use in the debt of member countries.

Rafael Molina pointed out that creditors are more narrowly focussed on the metric that most nearly indicates a government's ability to service its obligations to them, that is, the primary surplus, which is the revenue that remains after government has met its non-interest expenditures. Creditors, credit rating agencies and financial advisors also monitor a range of macroeconomic variables, because government finance does not take place in a vacuum, but their main focus is on the probable effect of these factors on the primary surplus. They also lean heavily on Staff Reports of the IMF, understandably, because the Fund disposes of data and analytical muscle they cannot hope to match.

Neither of these approaches is appropriate for policy makers in small open economies; for them, sustainability is defined by the external account, and the foremost indicator of a sustainable external account is the level and trend in the country's foreign reserves. Chapter One of Worrell (2023) explains that all economic activity in a small modern economy is fuelled by foreign currency (pages 5-6); economic activity is sustainable only when the inflow of foreign currency is sufficient to cover all external payments, including debt service (see Figure 6,borrowed from Chapter One). When the magnitude of national debt is the reason that available foreign currency inflows are insufficient, the debt is not sustainable. The foreign reserves, rather than the debt to GDP ratio, is the indicator on which small countries must focus.

Figure 6, From Worrell (2023)



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