

Who's afraid of some (not so big or bad) debt relief?

BY ALEXANDER NYE

Original post [here](#).

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By early July 2020, top officials at the [IMF](#) and [World Bank](#) admitted that the Debt Service Suspension Initiative (DSSI), the G20’s debt relief program faced challenges. They hoped to make some progress at the mid-July G20 meetings, but the July G20 meetings [came and went](#) without major action on the program. Considering that the DSSI was supposed to be one of the international community’s marquee responses to the most severe instance of capital flight from developing economies [in recent memory](#), it is important for billions of people that they get the program right.

What is the DSSI?

The G20 launched the DSSI in April to help emerging market governments meet the costs of their COVID-19 responses. (See [here](#) for our earlier analysis). The World Bank estimated that the program would free up to [\\$11.5 billion](#) in debt-service payments from the 77 DSSI-eligible governments (though the number of eligible governments has [shrunk](#) to 73) to official creditors in 2020; they would make up those payments over 2022-24.

Countries participating stand to save somewhere [between 0.1% and 8.4%](#) of their 2019 GDP. However, that \$11.5 billion is not distributed evenly among participants. Pakistan and Angola would receive nearly half of the relief. The relief for Angola would amount to 3.1% of its 2019 GDP, but Pakistan’s translates to only 1.0% of its 2019 GDP.

Unfortunately, the DSSI is falling short. The program is having a difficult time getting enough debtors to participate, is facing roadblocks from some important official sector creditors, and is having trouble persuading private sector creditors to participate at all. Without support from creditors, the DSSI can at best compliment the IMF and World Bank’s COVID-19 aid (see our May 6 [blog post](#)).

Inconsistent creditor participation

Official creditors hold close to two-thirds of the sovereign debt of DSSI-eligible countries. These creditors are government actors (whether coming from the government of a state or an international organization) that extend loans to a country for some government purpose. Bilateral creditors are states that have extended loans to the governments of other states; multilateral creditors are development banks or international organizations like the IMF.

Most bilateral creditors have been willing participants in the DSSI. In some sense this is remarkable, because many of them have a significant proportion of their 2018 debt stock lent to DSSI-eligible countries coming due in 2020. Unfortunately, having a large number of willing bilateral creditors does not necessarily translate into a participant getting a larger proportion of their potential relief under the DSSI.

It is also particularly difficult to understand how bilateral creditors that are not members of the [Paris Club](#) (an informal, yet important group of creditor countries) will implement the DSSI. Three examples of these are the People's Republic of China (PRC), [the United Arab Emirates, and Kuwait](#).

MULTILATERAL CREDITORS

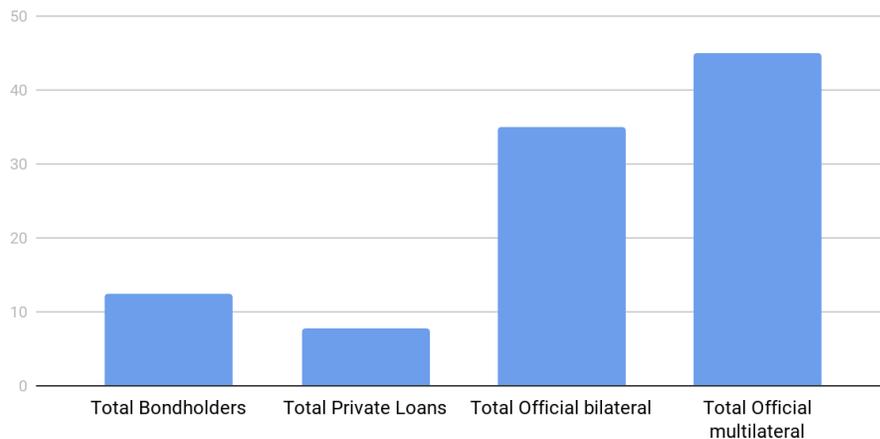
Multilateral creditors usually like to consider themselves lenders that are [de facto](#) senior (in their language, "[preferred](#)") to bilateral creditors and private creditors. They are only [de facto senior creditors](#) because sovereign debt is not subject to a set of laws that formally determine seniority. It is entirely held up by a set of norms. Considering this status, their reluctance to participate in the DSSI themselves would be understandable. This is because they are the creditor group most exposed to DSSI-eligible countries (See Figure 1).

The IMF [granted debt service relief to 25 low-income countries](#) from April to October, though some other multilateral development banks have been less cooperative. However, the [World Bank and other multilateral development banks \(MDBs\)](#) have preferred supporting countries by providing more lending and grants to providing debt relief. In late June, the World Bank president [explained](#) that such relief could "hurt the institution's credit rating and impair its ability to lend because the World Bank depends on current borrowers to repay their loans so it can make new ones." Still, [some countries](#) have criticized the multilateral banks for not practicing what they preach.

One might as well ask all multilateral lenders to join the G20 in providing DSSI relief, but for one significant problem. While maintaining the rest of the DSSI's current form, expanding the DSSI to provide relief from multilateral lenders would effectively give private sector creditors a free ride and run counter to the MDBs' [preferred creditor status](#). It would force international institutions that are supposed to be dramatically increasing their lending right now to increase provisioning or suffer increased borrowing costs.

Figure 1

% of Total 2018 Debt Stock for DSSI Eligible Countries by Creditor Type



Data Source: World Bank

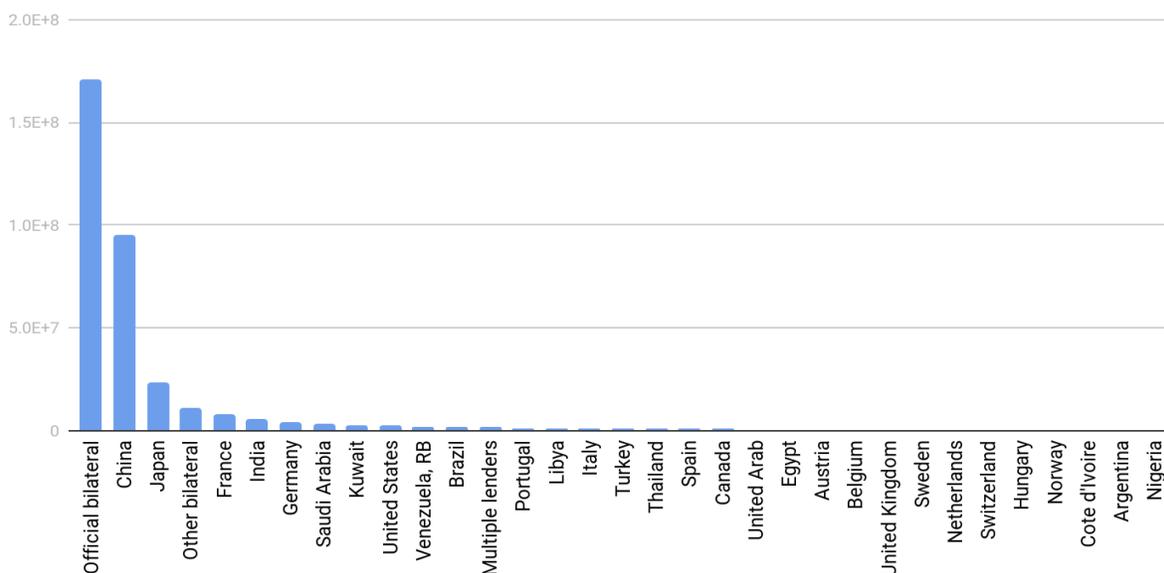
CHINA

The PRC is the most influential bilateral creditor for DSSI-eligible countries. It [accounts for](#) approximately 20% of the total foreign debt owed by DSSI-eligible-governments (and approximately 30% of their 2020 debt service) and has eclipsed the Paris Club in lending (See Figure 2). The PRC's dominance is especially visible in Africa, where PRC lending constitutes [over 25% of the debt stock in seven African countries \(all DSSI-eligible\)](#) at risk of or in debt distress.

Historically, lending from the PRC has been difficult to analyze. [Data has been selective](#), and there have been quality problems, making it difficult to understand the impact of the PRC on the fiscal situations of many least developed countries (LDCs). The [World Bank](#) has been releasing more comprehensive data as part of the DSSI. Most of the PRC's lending is considered "private," so the PRC's participation in the DSSI will not have a major impact. The PRC is only offering relief on a small portion of its lending, but will be able to benefit from an advantageous negotiation position when it comes to this "private" lending.

Figure 2

Official Bilateral Debt Stock (in \$1000s of USD) of DSSI-Eligible Countries, 2018



Data Source: World Bank

Policy-makers are also slowly getting a better understanding of PRC lending policies as a whole. Chinese lending terms and rates vary considerably by lender and project type. [Johns Hopkins University's China-Africa Research Initiative](#) sorts them into six categories: foreign-aid loans from the Ministry of Commerce; export buyers' credits from banks; foreign-aid loans from China Eximbank, a policy bank; suppliers' credits from firms; and other commercial bank loans.

Although there is limited public information on the terms of the PRC's participation in DSSI and on its offers of debt relief, more details have emerged over the past few months regarding lending to Africa. There is still limited data about its lending elsewhere.

Of the six categories, the PRC defines only the [interest-free loans](#) (category 1) to African countries as official lending that would be eligible for relief under the DSSI. The PRC [said](#) it would cancel interest-free loans to African countries that are scheduled to mature in 2020. But [interest-free loans are only 5%](#) of the PRC's lending to Africa, though forgiving those loans would apparently [be useful](#) beneficiary countries trying to expand their fiscal space. [Some commentators](#) have described the measure as "too little too late."

However, this leaves 95% of the sovereign debt held by Chinese interests formally categorized as private. These debts are largely owed to state controlled and state owned organizations [like policy banks](#). This is reflected in the PRC's guidance for its creditors' participation in the DSSI. The PRC's ambassador to Ethiopia claimed that

[China](#) encourages Chinese financial institutions to respond to the G20's Debt Service Suspension Initiative (DSSI) and to hold friendly consultations with African countries according to market principles to work out arrangements for commercial loans with sovereign guarantees.

This continues the PRC's tradition of negotiating debt restructuring on an informal case-by-case basis outside the view of the Paris Club. Relief from the PRC [does not tend to require](#) that participants refrain from pursuing commercial loans for the rest of the year; and (the PRC [does not require](#) participating countries to pursue relief from private sector creditors based on similar terms. With most Chinese debt categorized as private, the PRC could free-ride on other G20 countries' restructuring efforts. [For example](#), after a country receives debt relief from G20 countries and its official PRC debt, the PRC could impose a more onerous restructuring for its "private" creditors. According to Jan Friederich of Fitch (as well as several other scholars), the PRC should at the very least consider its commercial loans with sovereign guarantees to be [official bilateral debt](#) that is therefore eligible for the standstill. Allowing the PRC count these debt as "private" lending may grant them an advantage in any restructuring process where private creditors are refusing to provide [comparable treatment](#).

As currently designed, the DSSI leaves [some Western countries worried](#) about PRC participation. While fiscal relief is welcome here, there is a perception that the PRC will use its case-by-case negotiations to control participating countries and ultimately infringe on their sovereignty. Some of these fears, as explained by a [recent paper](#) (and [Webinar](#)) from Johns Hopkins University's China-Africa Research Initiative, are not justified. However, a [June 17](#) statement by Xi Jinping on how the [PRC intends to treat its preferential lending](#) via China Eximbank, raises some concerns. In a June 17 speech, Xi Jinping declared that "any related difficulties regarding repayments could be solved by multiple financial or other approaches, such as the PRC adding grants to help bring projects back to life, conducting debt-to-equity swaps, or hiring Chinese firms to assist operation." Some observers have expressed the concern that debt-for-equity swaps might put state-controlled PRC banks in control of companies that had previously belonged to emerging-market governments.

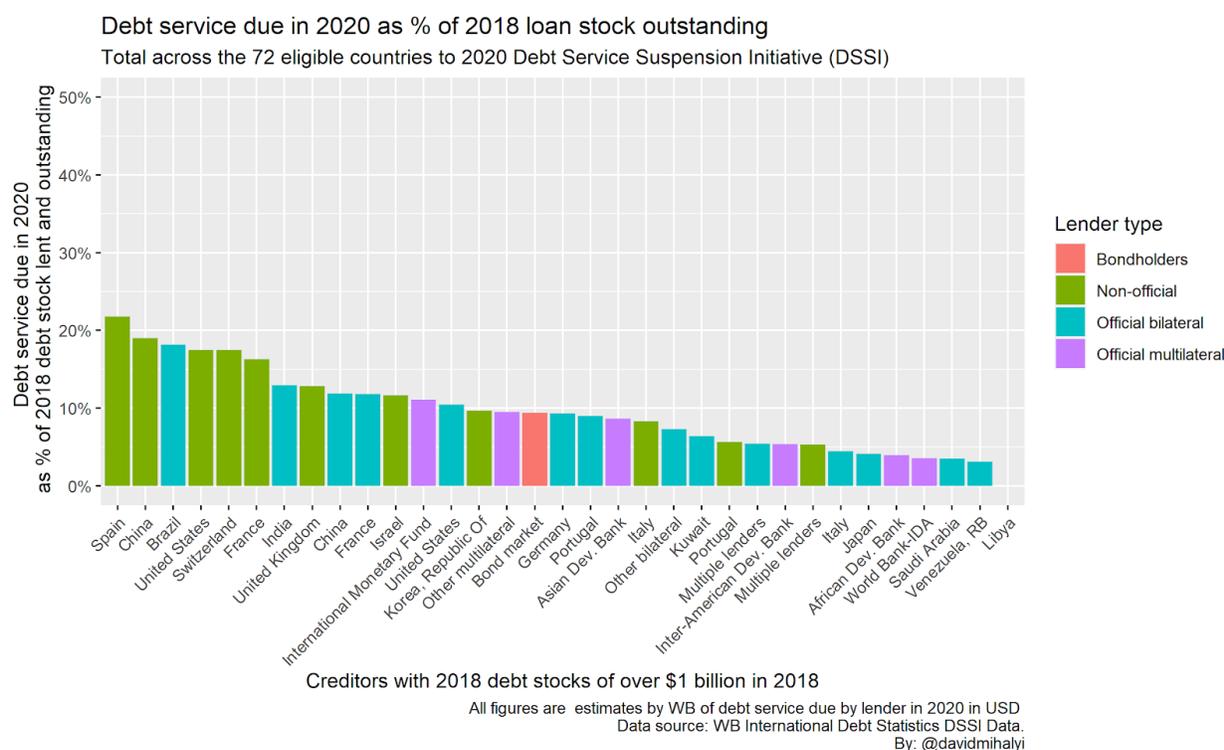
As for Chinese government or Chinese government controlled creditors, most of the [concerns](#) have been about potential asset seizures that look like something out of the late nineteenth century. Fortunately, it does not look like the PRC is moving toward a policy of taking advantage of countries in debt distress. A [John Hopkins University research team](#) said that "there were no 'asset seizures' in the 16 restructuring cases" involving the Chinese government in Africa and they had "not yet seen cases in Africa where Chinese banks or companies have sued sovereign governments."

PRIVATE SECTOR CREDITORS

Private-sector participation has been limited, although private-sector creditors have a smaller proportion of their lending to DSSI countries coming due this year than a

number of the major official creditors (See Figure 3, in which “non-official” refers to private-sector loans).

Figure 3



The DSSI relies on private-sector creditors to participate voluntarily in the program. While the lack of a bankruptcy code for sovereign debt means that all sovereign debt workouts are technically voluntary, The president of the World Bank [recently called](#) for greater participation.

While [creditor groups](#) have started collaborating on restructuring plans for countries like Zambia, where they already expect a significant debt restructuring. But there is not much public reporting about private-creditor participation in the DSSI. This may be because many of the participating countries are [too afraid](#) of the impact on their credit rating to ask. Countries have thus far [only put forward informal requests](#) to private creditors for forbearance under the DSSI.

Private creditors, particularly bondholders, are an extremely powerful group. Although the PRC is currently the most significant lender to DSSI-eligible countries overall, [bondholders are the largest creditor](#) in ten countries (Côte d’Ivoire, Grenada, Ghana, Honduras, Mongolia, Nigeria, Rwanda, Senegal, St. Lucia, and Zambia) (see Figure 1). Bondholders and private lenders have only offered relief on an [ad hoc basis](#) and [do not release much data](#). It is also difficult to understand whether some of these loans are actually from the private sector, especially for lending by state controlled banks in the PRC. Another set of loans difficult to understand are those from trade

creditors. These are “secured” generally by the proceeds of selling the collateral to the lender at a given price. One recent example of restructuring with trade creditors comes from [Angola](#), which is currently negotiating with its oil importers and [pays some of its debts](#) to the PRC using oil cargo.

A corollary to this issue is that since a large portion of foreign-denominated debt is under New York or London law, many holdout investors might attempt to enforce their claims in domestic legal systems when countries are unable to restructure their debt and default. This could imperil any kind of an effective restructuring and cause problems for future restructurings. The worst case scenario would be a repeat of [Argentina’s tussles with Elliott Capital](#) and NML Capital, where the hedge fund litigated for fifteen years, [seized](#) an Argentine navy ship, and pushed Argentina into [technical default](#).

Lack of debtor participation

Three months into the DSSI, a little under 60% of the 72 eligible countries have said that they will participate. The [World Bank](#) said that 42 of the 72 eligible countries are participating in the DSSI as of July 13, and on June 30, the [Paris Club said](#) that 32 of the eligible countries have officially requested a standstill under the DSSI. Only 18 of the 32 countries mentioned by the Paris Club had signed a MOU implementing the standstill by June 30 (Burkina Faso, Cameroon, Chad, Comoros, Dominica, Ethiopia, Grenada, Guinea, Ivory Coast, Kyrgyzstan, Mali, Mauritania, Myanmar, Nepal, Niger, Pakistan, Republic of Congo and Togo).

Several design flaws in the DSSI hinder participation among eligible countries, box out countries that need the aid, allow some official creditors to stay out of the fold, and incentivize private creditors to stay out of the program. (See our earlier analysis [here](#)).

THE RISK OF A DOWNGRADE FOR A SMALL REWARD

The small size of the program and the prospect of credit ratings downgrade made eligible countries [think twice](#) about participating. The public sector side of the DSSI is not freeing up much fiscal room globally. While creditors seem to be making a huge deal out of the DSSI, Fitch describes the program as follows

[While emergency support](#) from the [...] G20 Debt Service Suspension Initiative (DSSI) provided useful fiscal and external financing, [the program was] [...] “moderate in size” at around 1.2% of GDP.

One Atlantic Council article said “[some African governments](#) are signalling that they prefer to preserve their hard-earned credit ratings by trying to stay current in their obligations.” This is because “[any suspension of interest payments](#) would probably trigger ratings downgrades for borrowing nations and limit future access to private capital,” something that isn’t attractive to states or financial institutions. The stigma may have been enough to make some large economies backtrack from participating in the DSSI. On June 23, [Nigeria backtracked](#) on its efforts to restructure its official debts, which it began back in May. Countries with [outstanding Eurobonds](#) are also vulnerable

to stigma because of the “strict terms of their Eurobond repayment plans, as well as a fear of losing market access to private creditors for a prolonged period.”

[Much to the chagrin](#) of the IMF, ratings agencies have amplified the stigma that participants would face. Various statements from [ratings agencies](#) indicated that participation in the DSSI would indicate increasing credit stress (which creditors would then price in by increasing the interest rate they lend to the country at). They were just as unhelpful when it came to private sector debts, [saying that](#) private-sector participation in the DSSI might count as a default (which would effectively lock the country out of the markets).

On the other hand, one commentator from Fitch Ratings said private sector participation that ends up counting as a default was not “[sufficiently likely to affect sovereign ratings](#).”

AVAILABILITY OF CHEAP CREDIT

The [urgency of DSSI relief](#) has faded for some debtor countries that have been able to issue new foreign-currency debt at low rates, thanks to extraordinary liquidity injections by central banks across the world. For example, [Brazil](#) found that the combination of a swap line from the Federal Reserve, large foreign currency reserves, and very limited foreign currency debt was enough to [convince investors](#) to buy its new issue of eurobonds. [El Salvador's](#) comparably expensive recent eurobond issuance indicates that this only really applies for foreign currency denominated debt) instead of participating in the DSSI and suffering a potential ratings downgrade.

The new borrowings have helped participating countries meet their debt payments for the time being. However, if the crisis continues for many months and fiscal costs continue to rise, they may find themselves in need of debt restructuring later in the year

In response to the damage of a second wave, the bond market's exuberance might go away and the cheap financing will dry up. When that happens, a number of debtor countries are going to ask for debt restructurings, and might actually have worse economic fundamentals than they had going into COVID-19. Creating even more leverage today, even if it is more convenient than negotiating a standstill or a haircut, may mean that restructuring is that much more painful for creditors. Those creditors may fight that much harder for each dollar.

Comparable treatment

The DSSI's failure to include the norm of “[comparable treatment](#)” has also been a barrier to the program's effectiveness. This norm holds that private creditors must endure similar (though not necessarily the same) haircuts or restructurings as the official creditors in a restructuring. Comparable treatment helps states keep private sector creditors from free-riding on their relief.

If private creditors were to refuse to abide by the comparable treatment norm, official creditors would effectively lose their informal senior status and would have less incentives to provide debt relief.

It's unclear where the DSSI stands on comparable treatment. The [DSSI's language](#) only [states that](#) "Private creditors will be called upon publicly to participate in the initiative on comparable terms." But the [IIF \(the International Institute for Finance\) interprets](#) this language to mean that "the comparability of treatment mechanism used by the Paris Club customarily will not apply to the private sector response to the DSSI."

Debt sustainability

The DSSI, like any other debt suspension, only solves liquidity problems. While we know that the DSSI was meant only to reduce pressure on sovereigns so they could spend money on their response to COVID-19, [it is becoming clear](#) that the crisis may still create unsustainable debts for many countries in the Global South. The World Bank [has said](#) that the many countries already faced unsustainable debt burdens, which are now growing to "crisis levels."

Some larger emerging market economies that may have such issues have been moving toward structural reforms in order to please the market. This is in spite of the fact that they are going to have to continue spending generously on their response to COVID-19. If the DSSI eligibility were extended for middle income countries [facing major ratings cuts or debt distress](#) and those countries received a sufficient amount of international financial assistance, these additional countries might benefit from participating. For example, South Africa is going through some [major problems right now](#) and announced [R230 billion in cuts over the next two years](#), while the country was still in the midst of major outbreaks. With an assistance like DSSI, South Africa could make up for lacking fiscal room caused by self-imposed structural reforms to respond to the COVID-19 crisis.

The DSSI might not actually offer a net increase in fiscal room for participants if some advanced economies are successful at changing the accounting rules for aid. This would constitute a [backlash](#) to the program from the official sector. If advanced countries start counting forbearance or forgiveness of debts as official development assistance, they might correspondingly decrease the overall amount of aid they give. A [number of EU countries](#) that loan frequently and give most of their aid as loans are considering this change. Under the [revised rules](#), donor countries could also "claim incentives both for offering riskier loans and then for restructuring or writing them off as debt relief." While some might say this is a benign change, others "fear that further watering down rules on debt relief could be used by donor countries to artificially inflate aid budgets" without increasing the amount of support for recipient countries. A meeting was supposed to take place on this topic in late July, but no information on it is available.

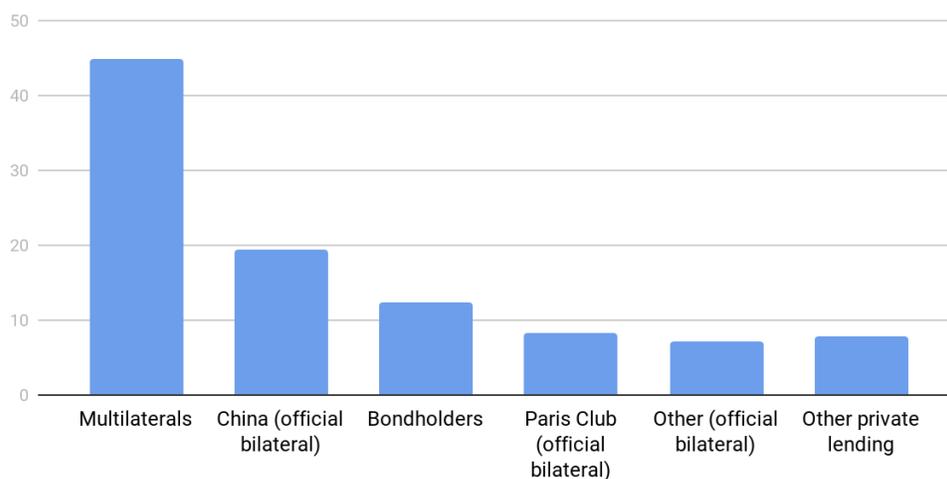
Discussion on proposed solutions

The G20, IMF, and World Bank are [considering](#) revisions to the DSSI. A press kit for a July 8 meeting of G20 finance ministers clarified that countries who request the DSSI from official bilateral creditors will not be obligated to “make the same request to private creditors.” This emphasized the idea that “[comparable terms](#)” is significantly more watered down than “comparable treatment.” That same kit also notes that the G20 is considering having multilateral creditors participate in the DSSI. This signals that the World Bank and the African Development Bank might be changing their position on providing their own debt relief. Additionally, the G20 has pointed to multilateral lenders as actors that could reduce volatility in private sector financing flows by providing co-financing or credit enhancement. The latter could take the form of partial sovereign guarantees by multilateral lenders alongside an SPV that would distribute securitized DSSI sovereign debt. As for the program’s future, the G20 will use IMF analysis to determine the extent that support beyond DSSI is needed.

Another interesting idea would be to categorize certain lending of policy banks or state influenced banks as official-sector lending in exchange for imposing a uniform solution on the bondholders of some of the [lower-middle income countries](#). This might distribute the pain of restructuring equally, as bondholders and Paris Club members together take up a similar share of DSSI-eligible country debt stock to the PRC (see Figure 4). In exchange for the PRC bringing its nominally private lending out of the shadows and into DSSI participation, these other countries would use a combination of legislation, supervisory tools, and regulations to force relevant bondholders to participate in the DSSI. While supervisory tools and regulations provide a mix of carrots and sticks to facilitate bank participation [as seen in the 1980s debt crisis](#), bondholders are much more difficult to corral.

Figure 4

Total DSSI-Eligible Country Debt Stock further broken down by Creditor Type (%)



Data Source: World Bank

The IEL Collective, a legal scholarship group at University of Warwick, [proposed a way to bring bondholders into the fold](#) in the UK by amending the Debt Relief (Developing Countries) Act, 2010. [The Debt Relief \(Developing Countries\) Act, 2010](#) limited the debts that can be reclaimed via litigation if those debts are from countries benefiting from the IMF's [Heavily Indebted Poor Countries \(HIPC\) Initiative](#). The IEL Collective proposes to grant a “statutory standstill to all DSSI-eligible countries on qualifying debt owed by the country that are governed by English law.” Similar to bankruptcy legislation, this amendment would suspend the execution and enforcement of such debt contracts that are under English law. This is important because English law governs a major portion of the sovereign bonds owed by DSSI-eligible countries.

While this does sound straightforward, the IEL Collective's proposal does have some significant flaws. Preventing execution and enforcement does not restrict creditors from declaring a default if a participating country does not pay. It also might actually improve liquidity for these countries' sovereign debt, as the law would bring some sense of certainty to creditors, especially in situations where creditors are already expecting default. This means that countries may, at least temporarily, subject themselves to further ratings downgrades by participating. The political economy of finance in the United States and New York also mean that passing anything like the IEL Collective's proposal in the US would require lots of political will. Unfortunately for the US, such political will is currently in short supply.

Alternatively, as proposed by Sean Hagan of Georgetown University Law Center, the IMF can change its lending policy for the remainder of the COVID-19 crisis. The [IMF could state that it will only lend contingent on a debt standstill](#) for private and official creditors. In circumstances where countries did not really need the standstill, these countries would avoid a more painful debt restructuring. In more pessimistic circumstances, on the other hand, “you would at least have the private sector there, because it would have stood still, and you would be able to use those claims as part of the restructuring process.” This would also artificially boost the IMF's leverage over private and official creditors. With more leverage, the IMF could drive broader creditor participation in the DSSI and eventually reduce stigma for countries that wish to access the program. One bonus is that this approach emphasizes that the IMF is a creditor that has seniority over every other; there should be no circumstance where IMF liquidity funding is being used to bail out financial institutions holding those sovereign loans instead of being used to ameliorate the pandemic in the country. This would require a number of policy summersaults to work. For one, the IMF has to make it clear that the debtors have no choice but to ask for a standstill if they want IMF funding.

The [United Nations Economic Commission for Africa](#) issued its own proposed solution. They wish to have the international community offer credit enhancement along the lines of the [Brady Plan](#) that ended the Latin American debt crisis of the 1980s. The [credit enhancement](#) took the form of creditors fully collateralizing the principal of participants'

new sovereign debt issuance with 30-year zero-coupon U.S. Treasury bonds. This reduced the liquidity risk premiums for these sovereign bonds.

The pros of this plan are that we know how to implement it and [there is already some support](#) for it in central banks as well as [think-tanks](#). Unfortunately, it's a little early to go for a Brady plan, as we haven't even gotten to the solvency stage of the crisis. We don't know what risks governments will be taking on when they provide credit enhancement. During the Brady Plan, governments had some idea of the risk they were taking on and that is a key reason why they were willing to provide credit enhancement for Brady bonds.

One approach from [Eric LeCompte](#) of the Jubilee USA Network is a new kind of financing and debt restructuring process to deal with the needs of countries responding to COVID-19. The new program would essentially build on the foundations of the IMF [Highly Indebted Poor Countries](#) (HIPC) program, which granted participating countries total debt relief from the IMF and other creditors. Based on LeCompte's comments, HIPC would amount to something like a bankruptcy process for eligible sovereigns that would balance the interests of creditors and debtors. This dovetails with decades of calls for a formal sovereign bankruptcy process as well as calls to write off "[odious debts](#)" used to line the pockets of corrupt governments instead of being used to benefit the borrower.

Efforts in the early 2000s nearly brought a [sovereign debt restructuring mechanism](#), an international legal structure for sovereign debt that would look much like an international bankruptcy code, into existence. Unfortunately, the US Treasury as well as a number of developing countries rejected the program.

Instead, the international community opted to start including Collective Action Clauses (CACs) in sovereign bond issues for a more decentralized approach to organizing debtors and preventing holdout creditors from torpedoing restructurings. The CAC approach has been sufficient to keep enough creditors from supporting a sovereign debt restructuring mechanism, but could be threatened by two things. First is the extremely weak fiscal state of the emerging market. In the event of a second wave of COVID-19, the economic impact could be brutal enough to trigger another flight-to-safety, right when emerging market economies need the money to respond. Financial institutions that have stocked up on emerging-market debt will find their balance sheets under such pressure that a number of them may not accept haircuts. This, on its own, is not enough to doom CACs, but recent events in Argentina point to [unhappy creditors and debtors](#) threatening to torpedo the consensus on using collective action clauses. If CACs were to fall by the wayside, a sovereign debt restructuring mechanism could again be an attractive option.