SPR

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Pandemic Sovereign Debt Risks

Presentation at Peterson Institute for International Economics

October 1, 2020

*The views expressed in this presentation are those of the author and do not necessarily represent those of the IMF or IMF policy

Plan

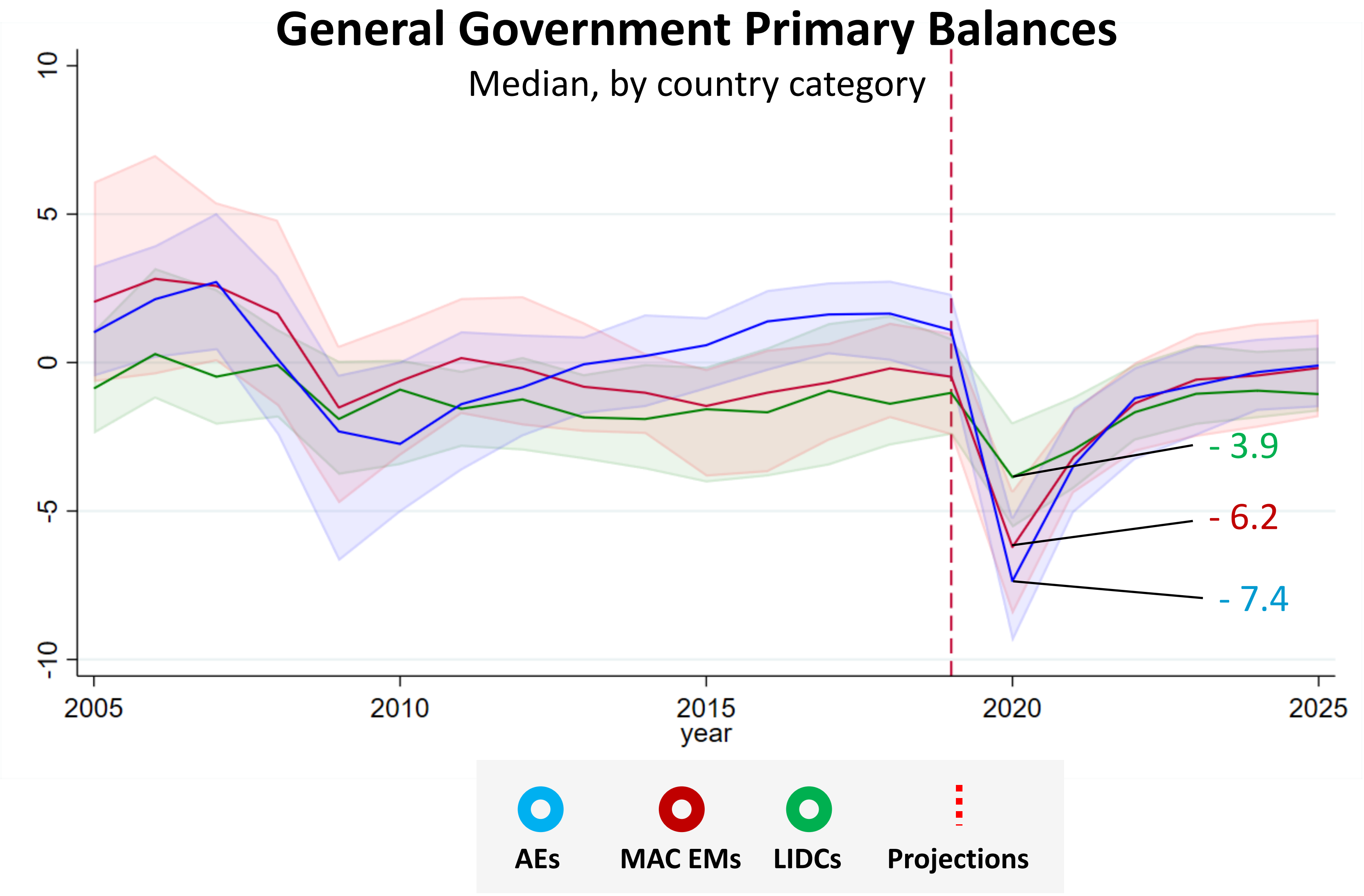
1. Facts: what has happened/is happening
2. Analysis: some tools to quantify the increase in debt risks
    - Long term debt sustainability.
    - Short- and medium-term crisis risks
3. Policy implications

FACTS

The main facts on one slide

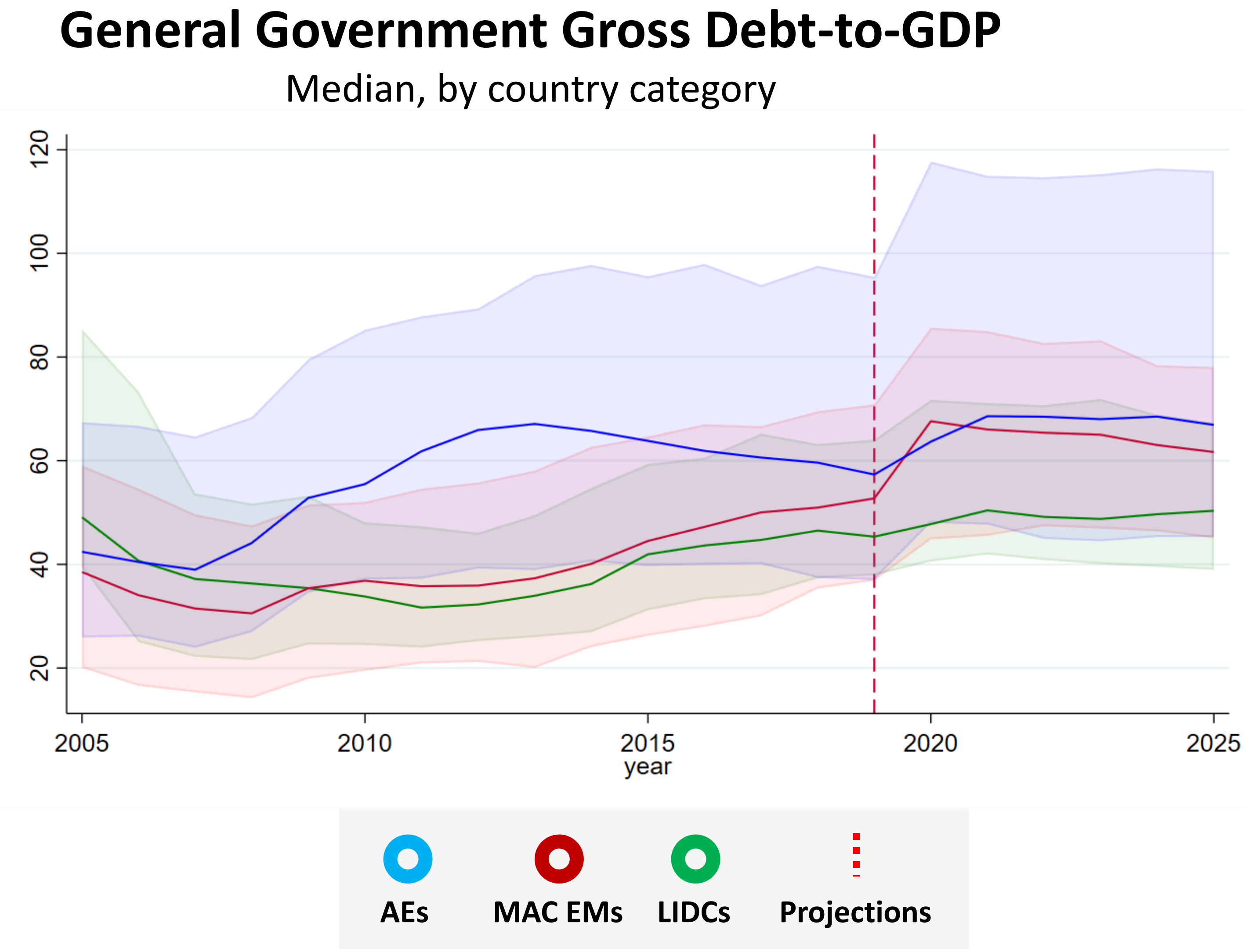
1. Very large fiscal deficits and projected debt increases …
2. … triggering many downgrades in EMs and LICs.
3. But hardly any new debt restructuring/debt distress cases so far.
4. Presumed reason: very easy financings conditions.
   - Historically low borrowing costs (on average)
   - Access to official financing (IMF emergency loans, MDB financing, G20 debt service suspension initiative for LICs.

Growth collapses and large primary deficits …



Note: Shadows indicate interquartile range (median of bottom half of distribution to median of upper half of distribution).

… are projected to result in large average increases in debt



<u>Change in (weighted) average debt levels, 2020-2019*</u>

AEs: 20.0
EMs: 9.1
LIDCs: 6.7

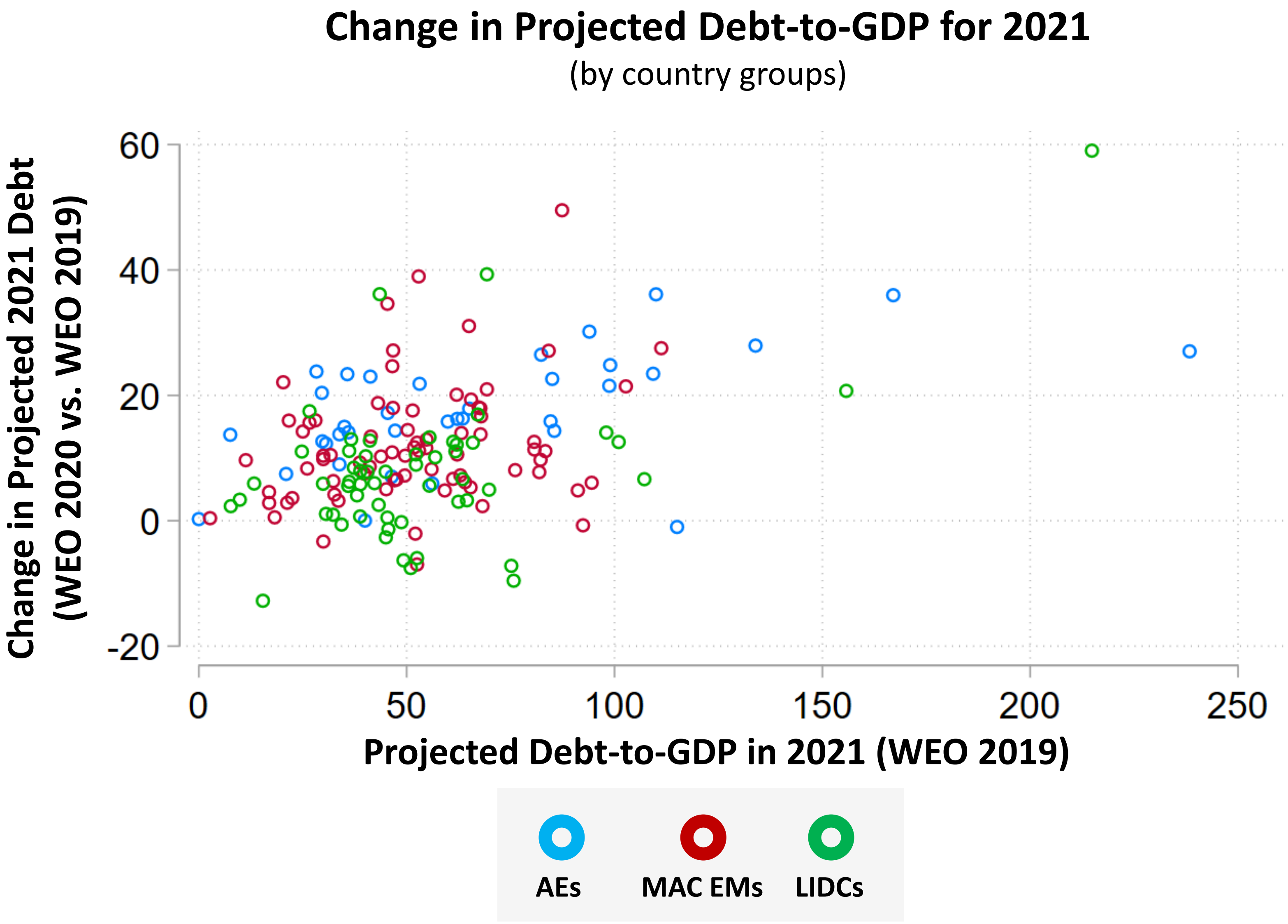
<u>Median of country-level changes 2020-2019</u>

AEs: 13.8
EMs: 10.4
LIDCs: 5.1

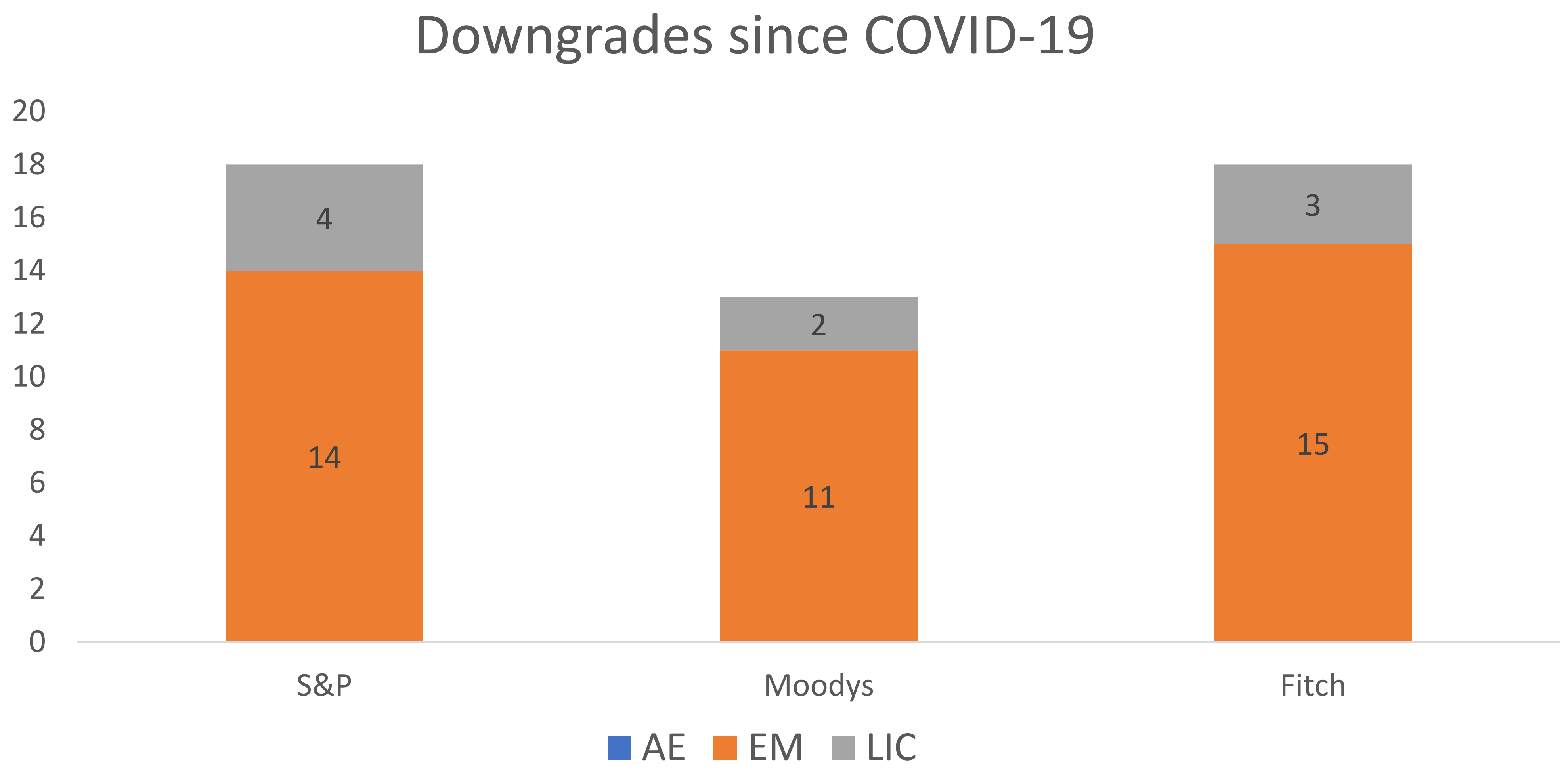
* Refers to change in average debt level (total debt/total PPP-weighted GDP) for each of the three country groups. Median changes refers to the median of all country-level changes within each country group (not to the change in debt for the countries with median debt levels shown in the solid lines in the chart, which would be 6.3 percent for AEs, 14.9 percent for EMs and 2.4 percent for LICs)

Note: Shadows indicate interquartile range (median of bottom half of distribution to median of upper half of distribution).

Projected 2021 debt is up for most countries



Many sovereign rating downgrades …



… but hardly any new debt restructurings/defaults …

Recent sovereign debt restructurings or defaults in EMEs:

Before pandemic

- Venezuela (in default since November 2017)
- Argentina (restructuring announcement 12/2019, completed 9/2020)
- Lebanon (crisis since 10/2019; restructuring announcement and default, 3/2020)

Since pandemic

- Ecuador (restructuring announcement, 4/2020, completed 8/2020)

… and little change in LIC debt distress according to IMF/World Bank sustainability framework for LICs

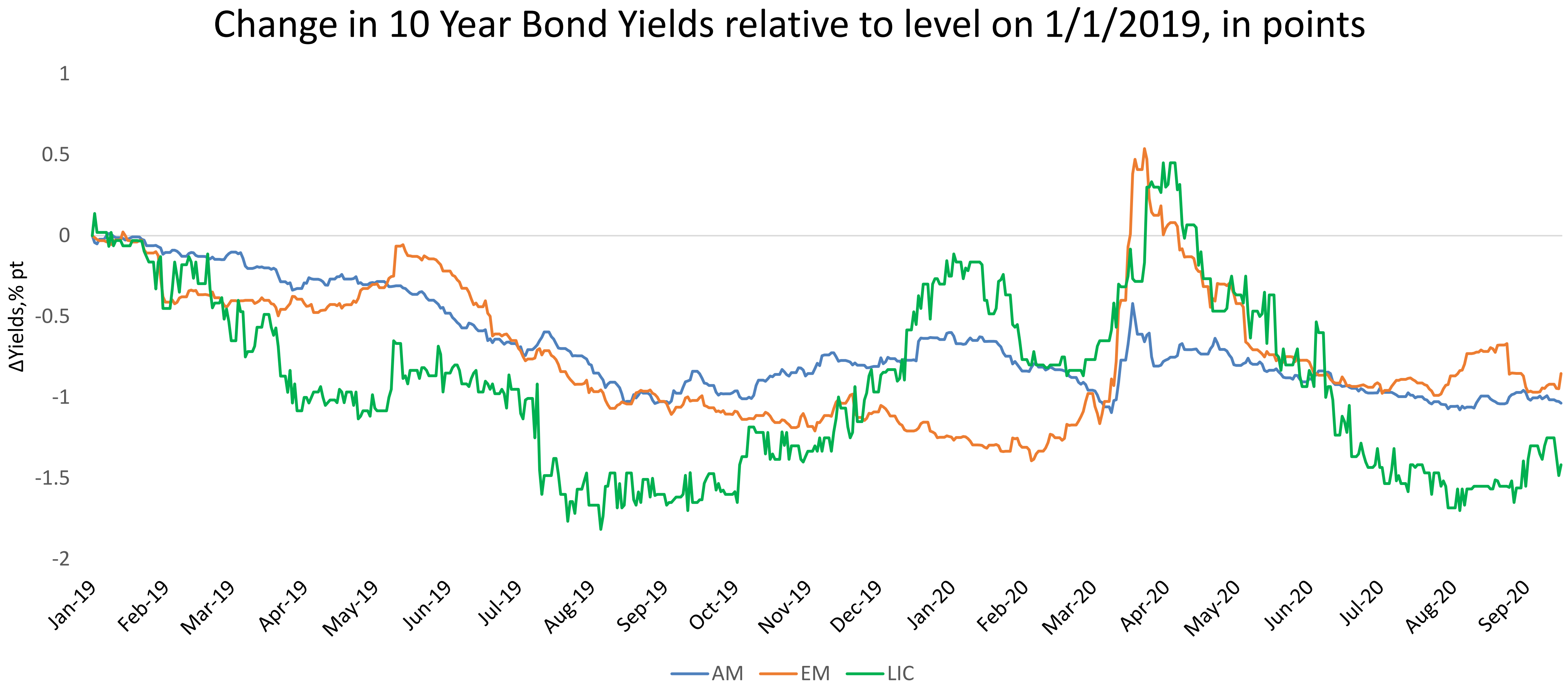
Before shock

- Congo, Rep. of
- Eritrea
- Gambia
- Grenada
- Mozambique
- Sao Tome and Principe
- Somalia
- South Sudan
- Sudan
- Yemen
- Zimbabwe

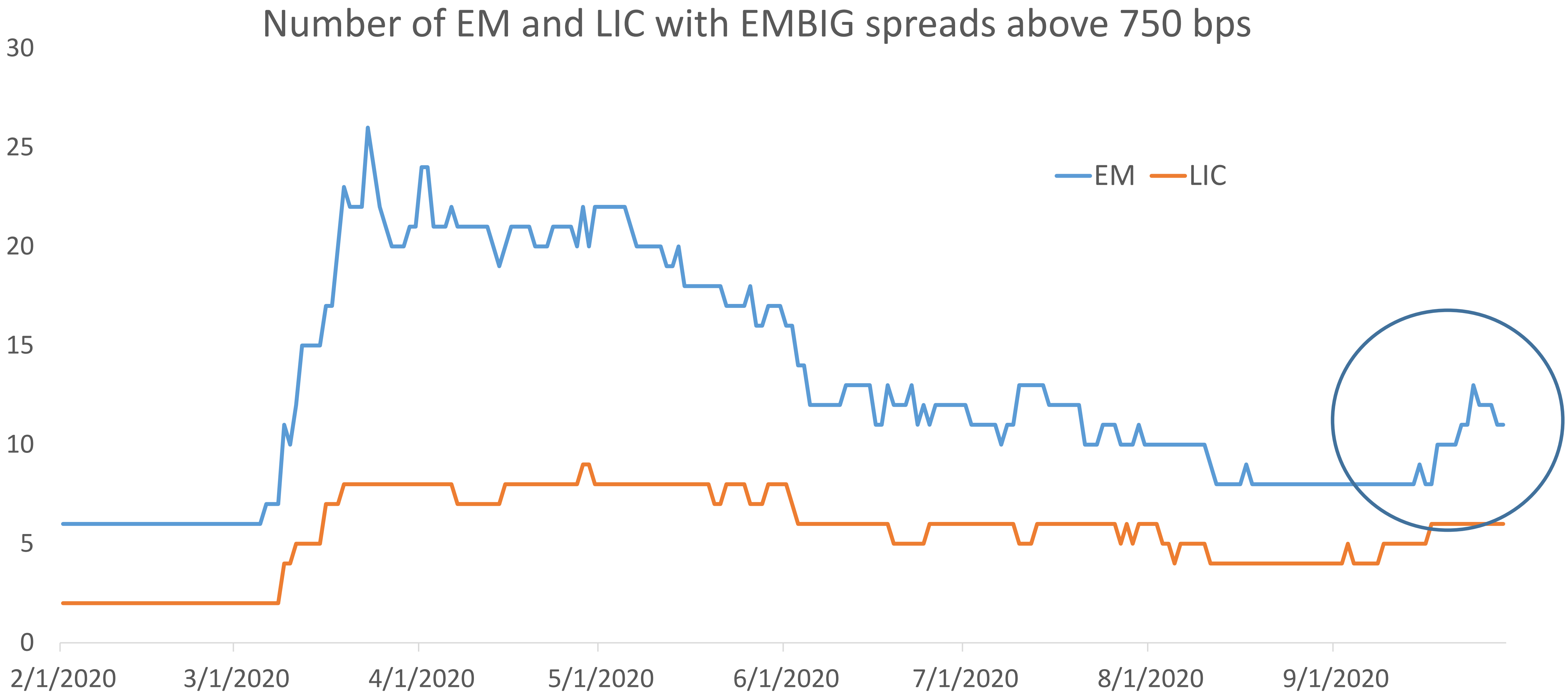
After shock

- Congo, Rep. of
- Eritrea
- Grenada
- Mozambique
- Sao Tome and Principe
- Somalia
- South Sudan
- Sudan
- Yemen
- Zambia
- Zimbabwe

One reason for lack of defaults: very easy financing conditions (following March spike)



Although very recently, some EM spreads have been widening again



ANALYSIS

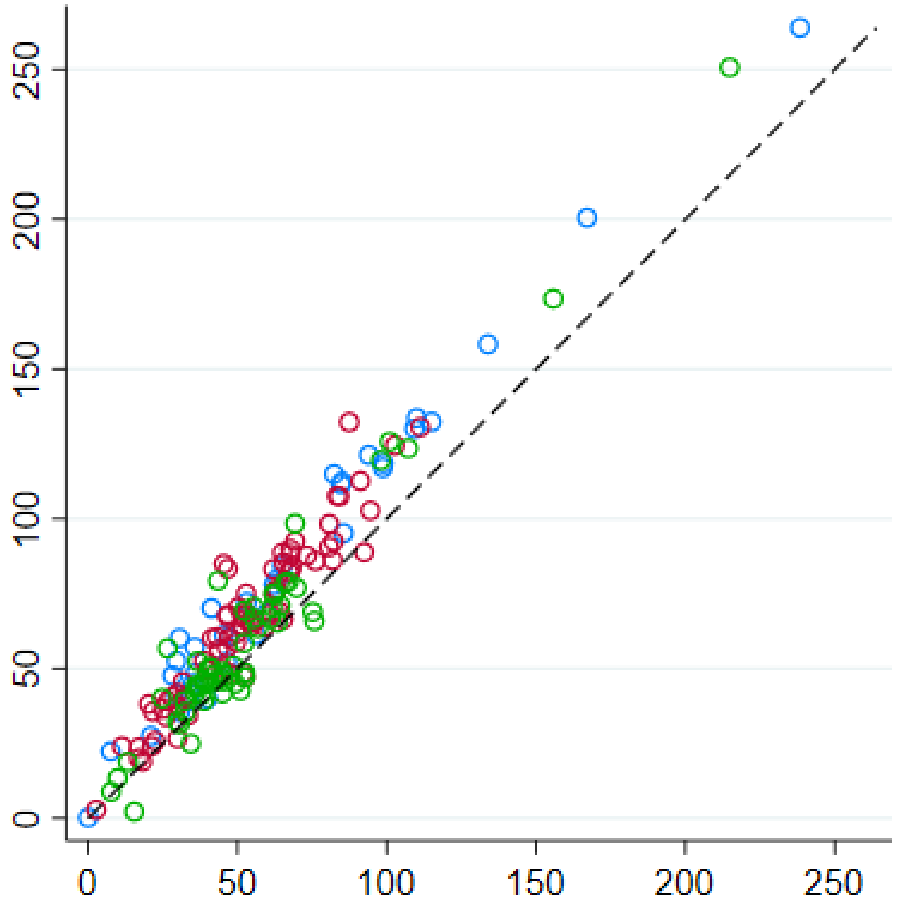
The main results on one slide

1. Based on (baseline) *projected* public debt rises, impact of crisis on long-term debt sustainability for most countries expected to be modest …
    - Intuition: r-g small for most countries, not expected to change much.
    - Main caveats:
        - realization of contingent liabilities (guarantees, banking crisis)
        - “scarring” that affects long term potential *growth* rates (not just output levels)
2. … but large increase in risk of debt crisis over short and medium term.
    - Intuition: very large funding needs over the short and medium term
    - Exposes borrowers to changes in funding conditions and losses of confidence.

Although crisis is expected to trigger a significant increase in debt in many countries …

Projected Debt-to-GDP for 2021, d_{21}

d_{21} from WEO 2020



d_{21} from WEO 2019

Median of country-level changes in projected 2021 debt level (WEO2020 – WEO2019):

AEs: 17.3

EMs: 12.5

LIDCs: 6.3

Change in 2021 projected weighted average debt levels (WEO2020 – WEO2019):

AEs: 20.6

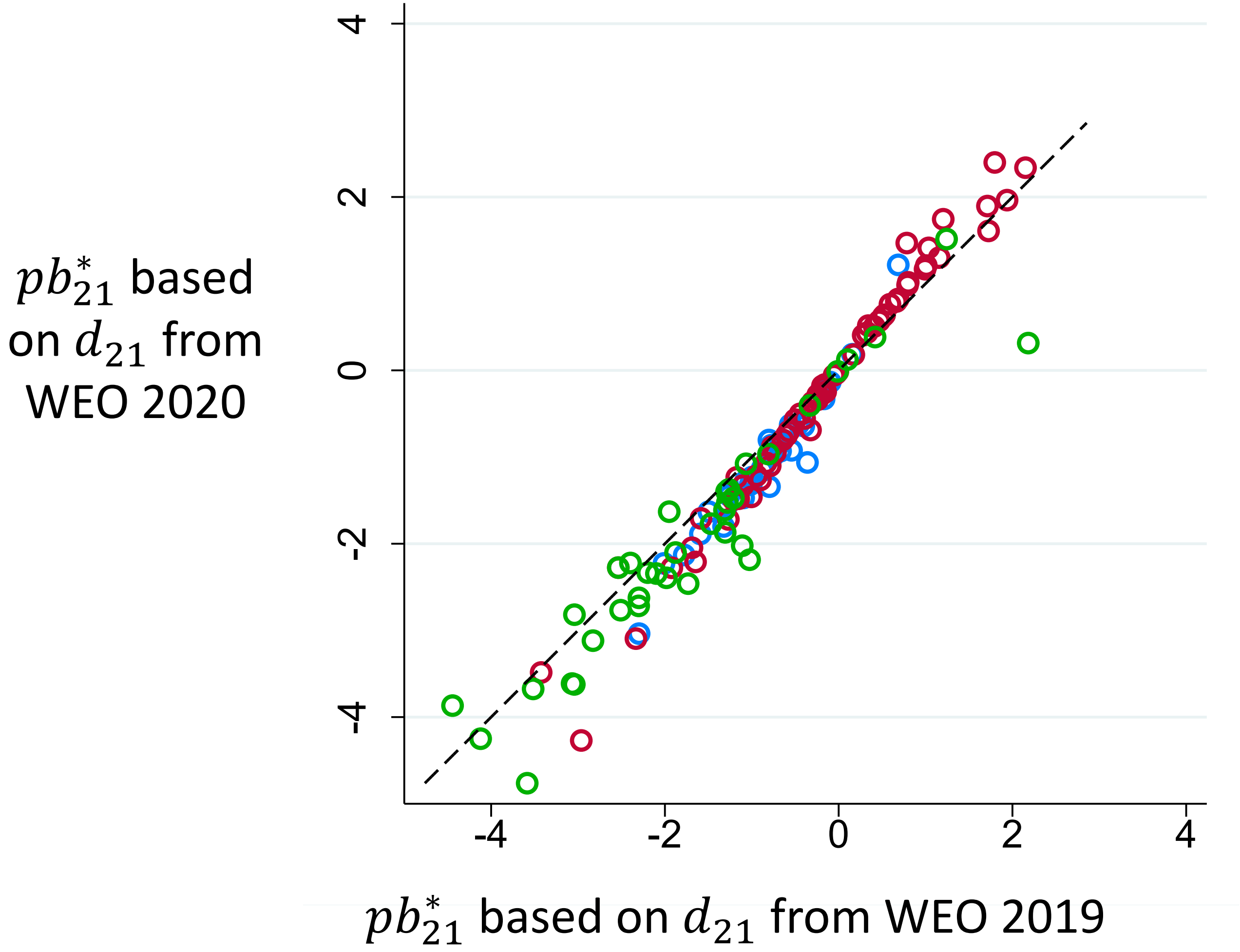
EMs: 6.2

LIDCs: 8.4

… debt-stabilizing primary balances expected to move little.

Reason: low *r-g*, except in some EMs

Projected $pb^*_{21} \cong (r-g)d_{21}$, assuming unchanged, pre-crisis $r-g$

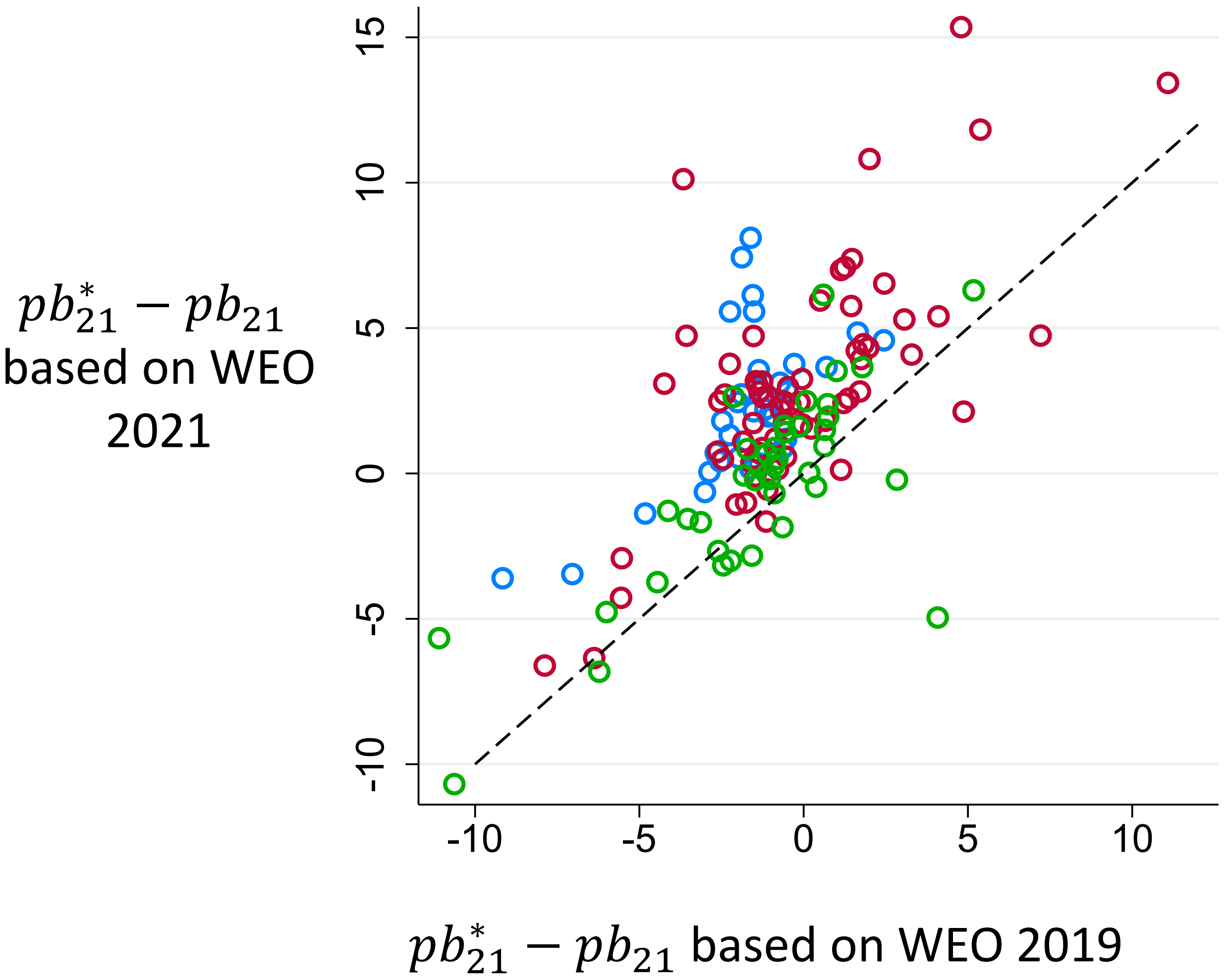


<u>Median of country-level changes</u>
(WEO2020 – WEO2019):
AEs: -0.23
EMs: -0.13
LIDCs: -0.69

Note: Excludes outliers with absolute values for pb* above 5% : Brazil, Burundi, Eritrea, Mozambique, Zimbabwe.

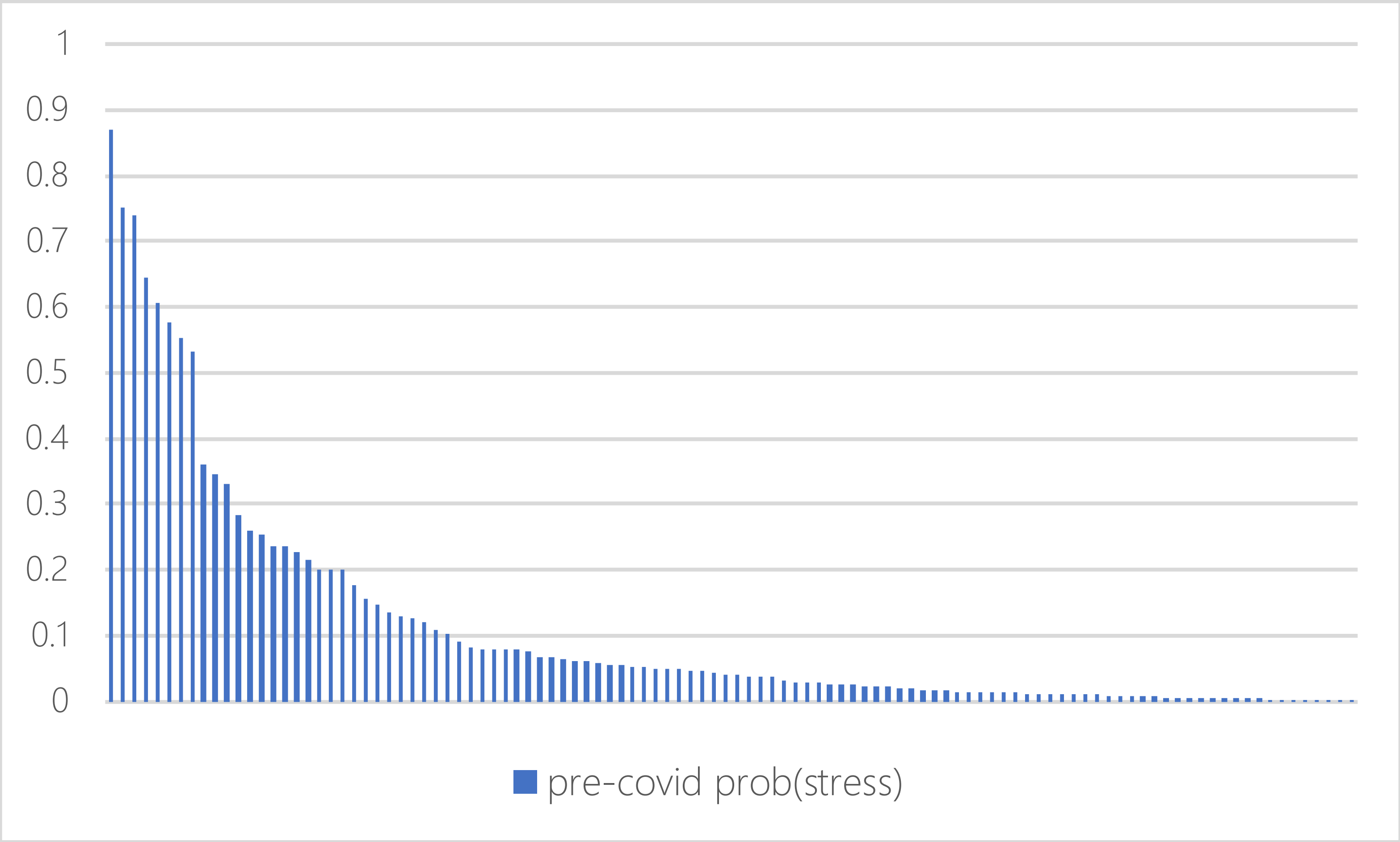
However, projected *adjustment need* in 2021 is higher, due to effect of pandemic on projected *actual* primary balance

Projected debt stabilizing pb_{21}^{*} − projected actual pb_{21}



<u>Median of country-level changes</u>
(WEO2020 – WEO2019):
AEs: 3.4
EMs: 2.2
LIDCs: 1.2

Risk of short-term debt stress based on a logit model predicting debt distress



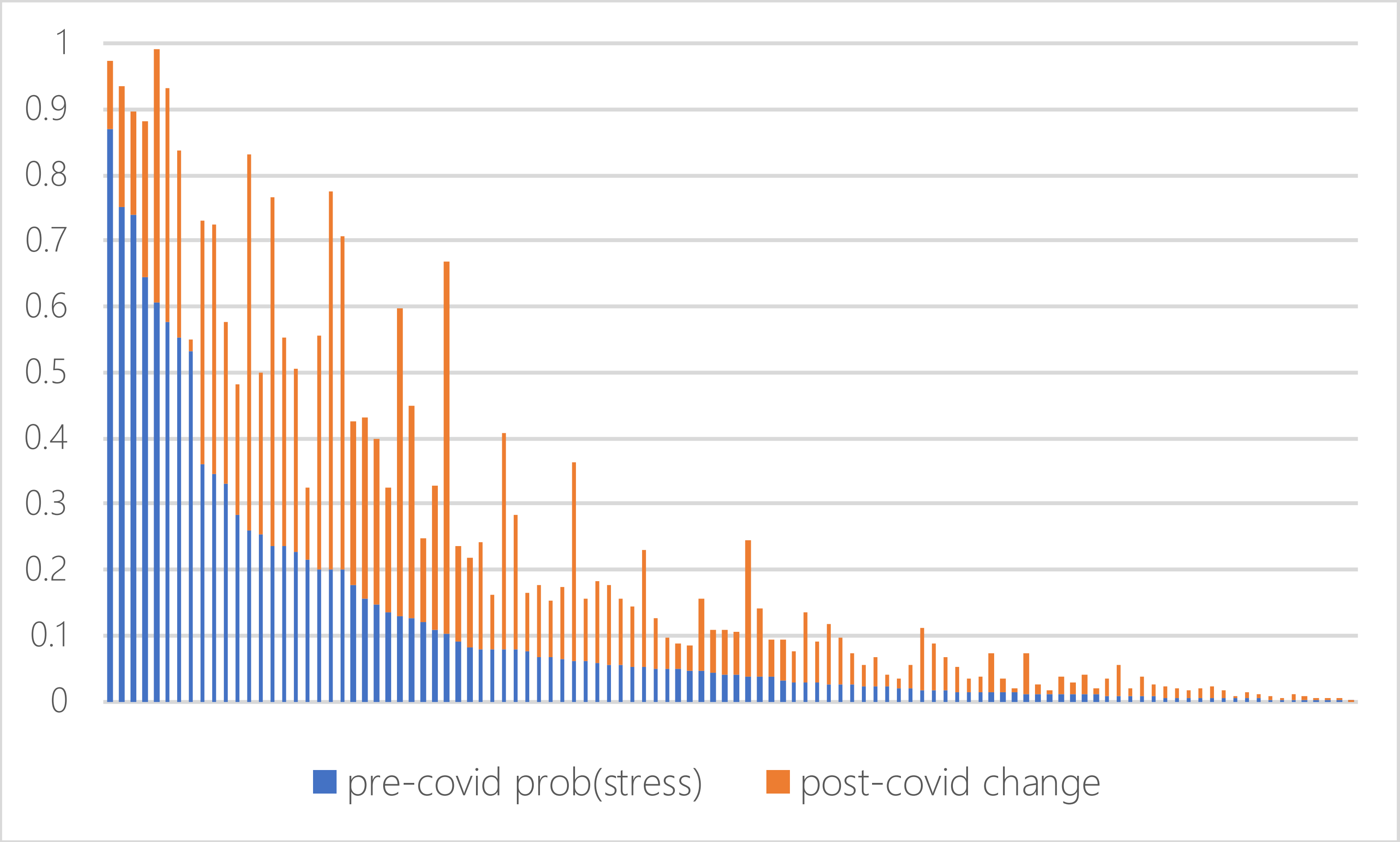
<u>LHS variable</u>: stress event dummy (including crises that trigger IMF programs but no restructurings)

<u>RHS variables</u>:

- Level of debt/GDP
- Change in debt/GDP
- VIX
- Governance
- Past share of crises
- CA balance
- REER changes
- Lagged credit to GDP gap
- Reserves-to-GDP
- Share of currency union members in stress

Pre-covid: average prob(stress in next 2 years) = 11.1%

Risk of short-term debt stress (within 2 years) has doubled …



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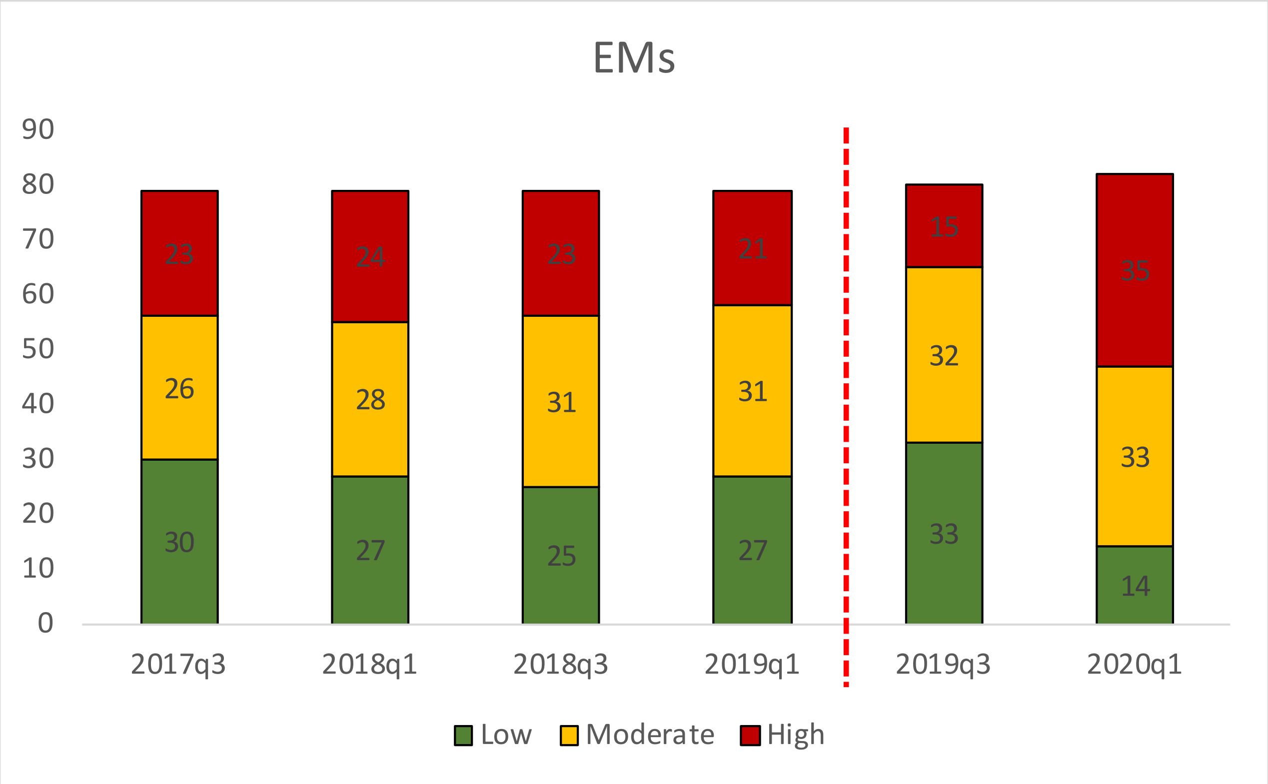
Pre-covid: average prob(stress in next 2 years) = 11.1%
Post-covid: average prob(stress in next 2 years) = 24.0%

Risk of fiscal crisis based on a machine learning model and IMF country team judgment



Note: red dashed line denotes methodological break (adoption of machine learning model as basis for team judgment). High/moderate/low risk refer to countries with risks above the 80 percentile, between the 50th and 80th percentile, and below the 50th percentiles of all model-based ratings based on data for the last 15 years.
References: Moreno Badia et al (IMF WP 2020); Hellwig (forthcoming IMF WP, 2020).

IMPLICATIONS

Pandemic crisis will lead to ...

1. Additional cases of long-term unsustainable debt (expect few)
2. Additional debt crises (expect more)

Defaults

Pre-emptive debt restructuring +reform/adjustment

Financing + reform/adjustment

Defaults

Role of policy: steer outcomes toward the middle (green) boxes.

Main policy challenges

1. Need to reconciling easy financing/low borrowing cost with incentives to seek address debt vulnerabilities early.
   - Challenge for DSSI extension
2. Need an efficient pre-emptive restructuring framework, for both privately held claims and official bilateral claims
   - Message of IMF paper for G20: restructuring of privately held claims has worked ok, but room for improvement.
   - Common framework for G20 creditors, building on Paris Club procedures, would be highly desirable.