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Sovereign Debt Vulnerabilities in Developing Economies

Which countries are vulnerable and how much debt is at risk?

by Lars Jensen

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Sovereign Debt Vulnerabilities in Developing Economies

WHICH COUNTRIES ARE VULNERABLE AND HOW MUCH DEBT IS AT RISK?

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Glossary

CF Common Framework
DSA Debt sustainability assessment
DSF Debt sustainability framework
DSSI Debt Service Suspension Initiative
EM Emerging market
EMMI Emerging market and middle income
FDI Foreign direct investment
FM Fiscal monitor
GDP Gross domestic product
GNI Gross national income
HIC High income country
IDA International development assistance
IDS International debt statistics
IMF The International Monetary Fund
LIC Low-income country
LIDC Low-income developing country
LMIC Lower-middle income country
LT Long-term
MAC Market access country
MIC Middle-income country
PP Percentage points
PPG Public and publicly guaranteed debt
SDG Sustainable Development Goal
TDS Total debt service
UMIC Upper-middle income country
WB The World Bank
WEO World Economic Outlook

Executive summary

This paper analyzes debt vulnerability indicators across 120 developing (low- and middle-income) economies to identify vulnerable countries. The overall conclusion is that most vulnerable countries identified are not on the verge of a default, but rather risk facing a future of high economic and development costs of having to deal with large debt overhangs. A smaller group of countries will likely remain at high risk of defaulting this and in subsequent years, and in general uncertainties and risks are high. Much will depend on the strength of the economic recovery and continued access to and stability of financial markets.

In total 72 vulnerable countries are identified, 19 of which are severely vulnerable. Our results are presented for individual countries and country-groupings including the group of countries eligible under the Debt-Service Suspension Initiative (DSSI) and Common Framework (CF). Results are summarized as follows.

The DSSI has had limited success with 46 of 73 eligible countries participating and only with a request of $5 billion — roughly equal to 10% of external total debt-service (TDS) scheduled in 2020 for all 73. A full[2] DSSI participation could have freed up $12.2 billion in 2020 and another $9.25 billion in the first half of 2021.

Debt distress and vulnerabilities are not isolated to the poorest (or DSSI- and CF-eligible) countries. Based on sovereign credit ratings for 105 developing economies, two-thirds of 73 emerging markets (EMs) are rated 'non-investment grade', as are all 32 low-income developing countries (LIDCs).

Total debt service (TDS) payments on external public debt at risk ('risky-TDS') is estimated at a minimum of $598 billion for the group of 72 vulnerable countries from 2021-2025, of which $311 billion (52%) is to private creditors.[3] Low-income countries account for 6% ($36.2 billion), lower-middle income countries for 49% ($294.1 billion) and upper-middle income countries for 45% ($268.1 billion) of total. For the year 2021, risky-TDS is estimated at a minimum of $130 billion, of which $70 billion (54%) is to private creditors.

Among the 72 highly vulnerable countries are 49 eligible under the DSSI and CF. Their share of risky-TDS is $211 billion (35% of total) with $63 billion to private creditors. Left uncovered by both the DSSI and CF are 23 vulnerable countries with risky-TDS of $387 billion (65% of total). In 2021, uncovered risky-TDS is estimated at $87 billion. In other words, about one-third of vulnerable countries holding two-thirds of risky-TDS are not covered by the DSSI or CF.

Based on data available for 112 developing countries, we estimate that from 2019 to 2020 the number of countries in breach of their solvency threshold went from 37 to 46 (41% of the sample), of their liquidity threshold from 18 to 26 (23%), and countries in breach of both from 12 to 21 (19%).[4] Based on both estimated number of countries in breach and the severity of these breaches, debt vulnerabilities are not expected to fall significantly in the coming years, and are not likely to return to pre-pandemic levels before 2024/25.

When assessing the current debt outlook, it is important to keep historical trends in mind. Debt relief efforts in the 2000s coincided with a commodity price boom and helped clean up governments' balance sheets and increase their debt carrying capacity. Countries started piling on debt after the 2008 financial crisis,

[2] All 73 countries with their full eligible amounts.

[3] The specific debt measure used is external long-term public and publicly guaranteed debt (LT PPG) from IDS 2021.

[4] Our chosen solvency indicator here is total gross public debt as a percentage of GDP and liquidity is total debt-service payments on external PPG debt as a percentage of revenue.

followed by massive liquidity injections by central banks, which also found its way to developing markets in a 'search for yield.' Consequently, today's average developing country has a much higher exposure to financial markets and roll-over (liquidity) risk. During the past decade of rapidly increasing debt, revenue development has remained stagnant and growth has begun to slow; both these factors are adding to debt vulnerability.

How the vulnerable developing countries will come out of this crisis will depend crucially on liquidity risk in the short term and their ability to undertake quality investments in physical and human capital to boost future growth, as well as external demand for their commodities. For all countries, this will require access to stable and low-cost finance, and for some countries a debt restructuring will have to precede such access. Beyond the short term, re-directing of expenditures, increasing spending efficiency and boosting revenue collection must be given priority.

Introduction

Debt in developing economies has built up fast over the past decade, far outpacing revenue development, and has been followed by a slowing of economic growth. The pandemic therefore hit when many countries were already highly vulnerable, and 2020 saw a record in sovereign credit rating downgrades and defaults.

Uncertainties about the economic recovery and the state of financial markets coupled with high debt vulnerability has led to a widespread belief that the developing world could be on the verge of a major debt crisis. Calls for debt restructurings as well as other faster relief efforts have followed, to help countries cope with the immediate health crisis and avoid jeopardizing their economic recovery. The main initiatives to date are the G20's Debt-service Suspension Initiative, which allows for temporary debt-service suspensions to bilateral creditors, and the Common Framework targeting debt restructurings. Both are limited to 73 of the poorest countries.

But not only the poorest countries need assistance. Only one of six countries that defaulted last year was DSSI-eligible and all were middle-income countries (MICs), and for many MICs debt vulnerability indicators look stressed. Despite this, many vulnerable MICs have still been able to borrow in global capital markets partly thanks to favorable global liquidity conditions conferred by advanced economies' central bank support (Bulow et al., 2020). The extra debt taken on to combat the crisis combined with weak revenue growth will increase debt vulnerabilities in coming years. Should interest rates start to rise, several more countries could move closer to a default. Concerns are mounting that the unprecedented liquidity support is fueling a financial bubble that could lead to global financial instability (WESP 2021).

This paper aims to give the reader a comprehensive overview of sovereign debt vulnerabilities in developing countries.

- Section 1 provides an overview of gross public debt, external public debt-service and the G20's DSSI and CF initiatives.
- Section 2 presents the main analysis of short-to-medium term debt vulnerabilities. The analysis draws on several vulnerability indicators to identify vulnerable countries and groups and provides an estimate of the amount of external debt-service payments at risk. Country results are summarized based on a ranking across five vulnerability indicators.
- Section 3 presents and discusses some of the important global debt trends that have helped