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Debt relief? Thanks, but no thanks!

Developing countries have been hit particularly hard by the effects of the pandemic. So why have some rejected debt relief?

Read this article in German.

In April 2020, the G20 offered the 73 least developed countries a temporary suspension of their debt servicing to the G20 and all members of the Paris Club. The aim of this Debt Service Suspension Initiative (DSSI) was to release funds in these countties to help contain the coronavirus pandemic.

While the virus itself is taking the highest toll in industrialised and large emerging economies, the recession triggered by the pandemic is hitting the countries of the Global South particularly hard. Because of the slowdown in global supply chains, the downturn in tourism and the falling demand for raw materials, government revenues are declining and economic growth is collapsing.

Deferring debt servicing by means of a moratorium makes sense in this situation because, unlike disaster and development aid, it mobilises funds that are already in the country. They are available immediately and there are no transaction costs. However, as of 1 September 2020, only 43 countries had accepted the initiative. Of the remaining 30, eleven have explicitly rejected the offer. Why?

The fear of a downgraded credit rating

In principle, there are two reasons for rejecting the moratorium, each with a different degree of plausibility. One group of countries does not find the offer attractive because the funds released are too limited in absolute and/or relative terms in relation to overall economic output. Therefore, the bureaucratic effort of negotiating with individual bilateral creditors is not in any reasonable proportion to the fiscal leeway that can be gained.

In two of the countries, the amount involved is less than USD 2 million and in five it is less than USD 5 million. In ten of these countries, the amounts involved may be significant in absolute terms, but relative to economic output – the relief is not even 0.2 per cent. For this reason, it would be easier to seek external subsidies or potential savings in public budgets.

In fact, Fitch, for example, had threatened to downgrade Cameroon's rating in the early stages of the initiative, but then left the country's 'B' rating unchanged after the government accepted the DSSI.

The second reason is significantly less plausible, but politically more interesting. Kenya is a good example: at USD 802 million, or about 0.8 per cent of GDP, it is one of the countries that could have benefited most from the moratorium, in both absolute and relative terms. Already in mid-May, Finance Minister Yatani announced that Kenya would not make use of the DSSI initiative, so as not to jeopardise the country's rating by the major agencies. If, by availing itself of the moratorium, Kenya were to be downgraded by Fitch, Moody's, and Standard & Poor's, this would increase the refinancing costs for its debts with private foreign creditors and thus amount to a losing proposition for Kenya.

In fact, Fitch, for example, had threatened to downgrade Cameroon's rating in the early stages of the initiative, but then left the country's 'B' rating unchanged after the government accepted the DSSI. Instead of making use of the DSSI, Kenya wants to negotiate bilaterally with the individual creditor governments regarding debt relief – and this is where things get confusing. With €212 million in claims on Kenya, Germany would have been considered relevant for a bilateral initiative. To date, however, the German delegation from the Paris Club has not been approached by the Kenyan government. Apparently, despite the economic situation that has deteriorated dramatically as a result of coronavirus, Kenya has waived debt relief without anything in its place.

Forcing the private sector to participate

Is the fear of an interest-related downgrade by the rating agencies plausible? This question of course applies not only to Kenya, but to other important countries among the DSSI candidates who have access to the international capital market, such as Cambodia, Ghana, Laos and Mongolia.

In fact, back in May, Fitch and Moody's did not downgrade Kenya's

rating, but did downgrade its outlook from ‘stable’ to ‘negative’. In contrast to the threat against Cameroon in April, the detailed reasons that Fitch has published do not even mention possible relief through the DSSI. Rather, it cited the sharp drop in tourism, the resulting slowdown in growth and the increase in debt due to the growing deficit anticipated by the agency.

The assumption that making use of a moratorium offered by public creditors would lead to a deterioration in the rating relevant for private investors is based on the idea that a debtor granted this benefit would turn out to be a bad debtor. Private creditors like to cultivate and communicate this idea to persuade their sovereign debtors to continue servicing those debts, even in existential crises such as the coronavirus pandemic, despite the high opportunity costs and dubious debt sustainability.

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In the early phase of the initiative, both the head of the World Bank and the chairman of the Paris Club had emphatically demanded that the private sector be forced to participate, but then they did not dare take advantage of the opportunity for such enforcement. In July, the Paris Club had to sheepishly admit that it would not use options such as its equal treatment clause, which is usually standard in debt rescheduling agreements. As a result, waiving the obligation to public creditors ensures the continued satisfaction of private claims – although the public waiver really should have been used to finance the fight against the pandemic.

The G20 can correct its mistake

Would compulsory involvement of the private sector lead to downgrading and thus to a deterioration in market access? Although many individual factors play a role in determining interest rates, future prospects of repayment are much more important than past performance – provided that a country has not arbitrarily and unnecessarily suspended payments. An argument can be made that the debtors should not have allowed themselves to be intimidated.

As the reasons given for the limited devaluation by Fitch show, the agencies that use more than forty indicators for the assessment, look primarily at a country’s future ability to service its debt, which is of course

not negatively impacted by the waiver of claims by individual creditors, but rather positively, if at all. Where moratoriums were granted in the past moratoria in response to disasters, this had no negative impact on countries' access to the capital market. One excellent example is the Paris Club's 2005 moratorium of public creditors for Indonesia and Sri Lanka when they were struck by a tsunami.

Even where poorer countries have received not only moratoriums but also comprehensive debt relief from their private creditors, access to the capital market has not worsened, but – as logic would suggest – has improved. The best example is the multilateral debt relief initiative for heavily indebted poor countries in the early 2000s, the so-called HIPC/MDRI initiative (Heavily Indebted Poor Countries Initiative and Multilateral Debt Relief Initiative). As a result of the debt relief, some of the HIPC countries have received a rating and access to the Eurobond market for the first time ever.

For example, after a long, extensive and painful rescheduling phase for everyone involved, Argentina had such unimpeded access to the international capital market from 2015 onwards that the liberal Macri government was able to drive the country into a new sovereign debt crisis within only three years. And as long as investors in the Western countries are looking at zero interest rates at home, bonds issued by emerging and developing countries will not lose their attractiveness – regardless of whether there have been moratoriums or debt rescheduling.

At the meeting of finance ministers during the annual meeting of the IMF and World Bank in October, the G20 will have the opportunity to correct a flaw in the design of the DSSI. Proposals on how the private sector could be forced to share the burden are on the table: these include the Paris Club's equal treatment clause to a UN Security Council resolution, the internationalisation of the British 'anti-vulture fund' act and the creation of a central credit facility in the World Bank. That would be very good news for a global containment of the pandemic and a quick recovery of the global economy.



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