Towards HIPC 2.0 ?

Lessons from past debt relief initiatives for addressing current debt problems

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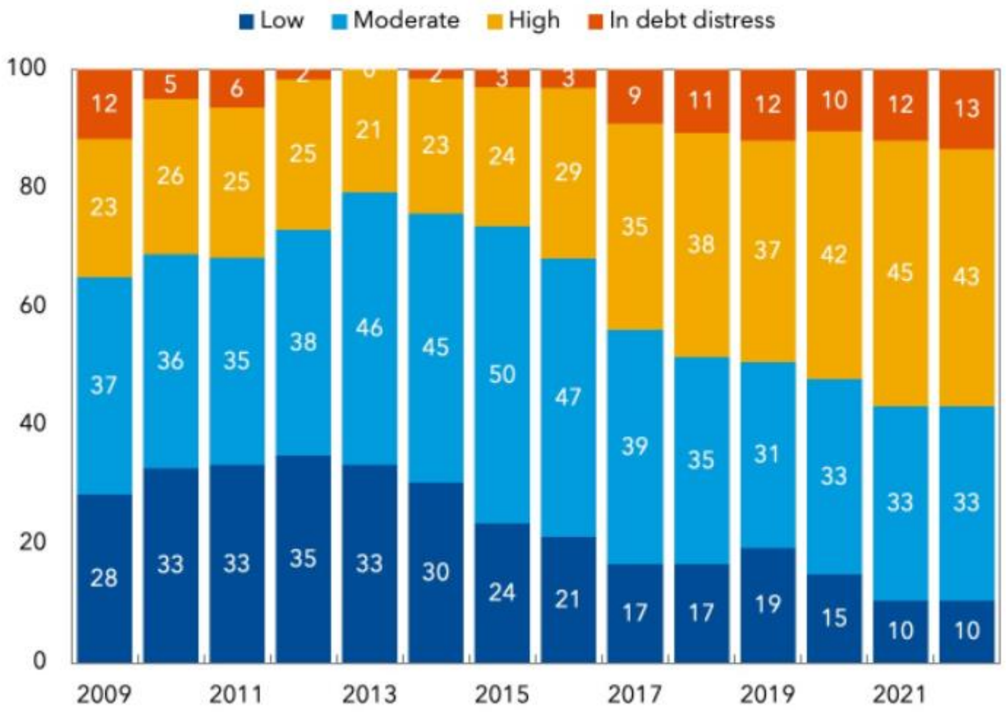
Motivation

- No “systemic debt crisis” (yet), but growing recognition that **comprehensive relief will be needed for several countries**
- Several proposals to go beyond current schemes (DSSI/Common Framework), some with reference to **Heavily Indebted Poor Countries (HIPC)** initiative

Risk of external debt distress

(% of DSSI-eligible countries with LIC DSAs, as of 31 March 2022)



Source: IMF

Our paper / this presentation

- **HIPC's potential as reference point** for dealing with current debt problems

1) What have been **HIPC's key results** ?
    - Huge reductions in debt stocks and service
    - Some evidence on positive effects w.r.t. fiscal space, social expenditures, investment, growth and governance; but causality?

2) What are **key similarities and differences between HIPC and current initiatives** ?
    - Seeing debtors' (non-)participation in DSSI through a *real option* lens

3) What can we **learn from HIPC (+ DSSI/Common Framework)** for future debt relief ?

Main takeaways

- **Copy-paste replication of HIPC seems infeasible and undesirable**

- Still, experience with HIPC (+ DSSI/Common Framework) does hold **valuable lessons for future debt relief**
    - Avoid "delay-and-replay"
    - Take holistic view on increasing resource availability
    - Broad creditor involvement is real challenge
    - Conditionality may increase creditor buy-in but has limits
    - Debtor countries will need to be convinced of net benefits of debt treatment
    - Common Framework's inter-creditor dialogue could serve as basis for more inclusive body/forum

Number of similarities between HIPC and DSSI/Common Framework…

Bold = DSSI participation as of Dec 2021; * = Pre-completion point HIPC

Sources: IMF, World Bank

… but also differences in many aspects

- DSSI/Common Framework **country eligibility** not based on debt sustainability per se
- **Case-by-case / tailoring** of Common Framework: no common terms; anything from short-term reprofiling to deep write-offs (?)
- Common Framework is **not explicitly linked to poverty reduction or development**
- **No expectation of multilateral involvement** in Common Framework debt treatments
- **Initiative to participate in DSSI/Common Framework lies much more with debtor country itself**
  - Debtors' participation decision can be conceptualised using ***real options***

DSSI participation decision by debtor depends on various parameters

- **Benefits**
  - Temporary debt service suspension
- **(Perceived) costs**
  - Reputational harm: credit rating downgrade, higher future borrowing costs (?), etc.
  - Stigma from requirement to request IMF assistance
- **Uncertainty**
  - About costs, as well as exact benefits (DSSI terms/perimeter)
- **Opportunity costs**
  - Foregone suspension of debt service while waiting to participate

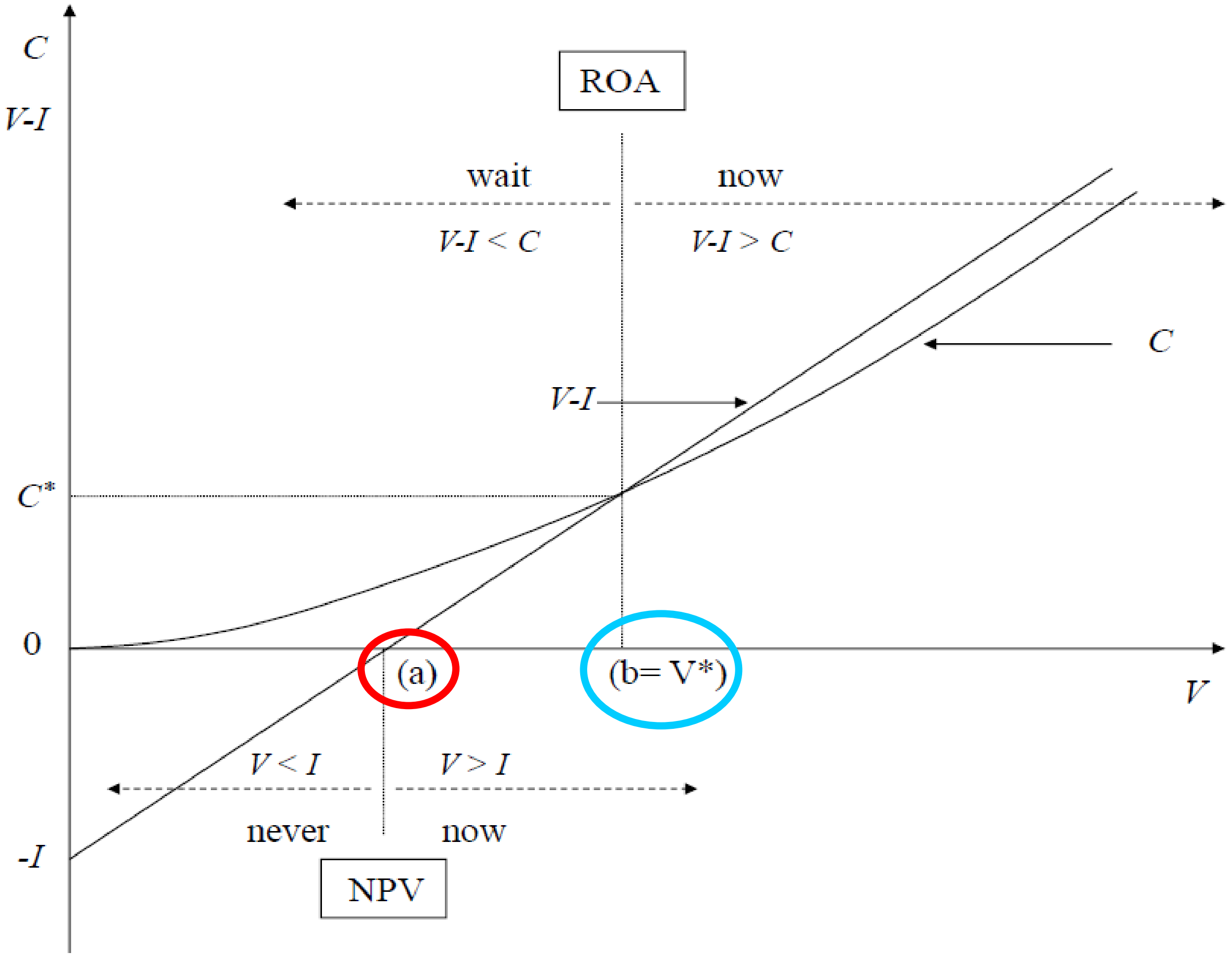
Real option approach: decision-making under uncertainty with flexible timing

- **Conventional cost-benefit/NPV rule**: go ahead whenever benefits ***V*** are at least equal to costs ***I***, or ***V-I* ≥ 0**

- **Real option rule:** decision-maker (debtor) compares value of exercising option now with value of keeping option alive (***C***): go ahead only when ***V-I* ≥ *C***; otherwise wait until more information is available

- Explains **waiting and switching behaviour**
  - Higher **opportunity costs** and lower **uncertainty** imply earlier execution of option

Real option approach vs. NPV rule

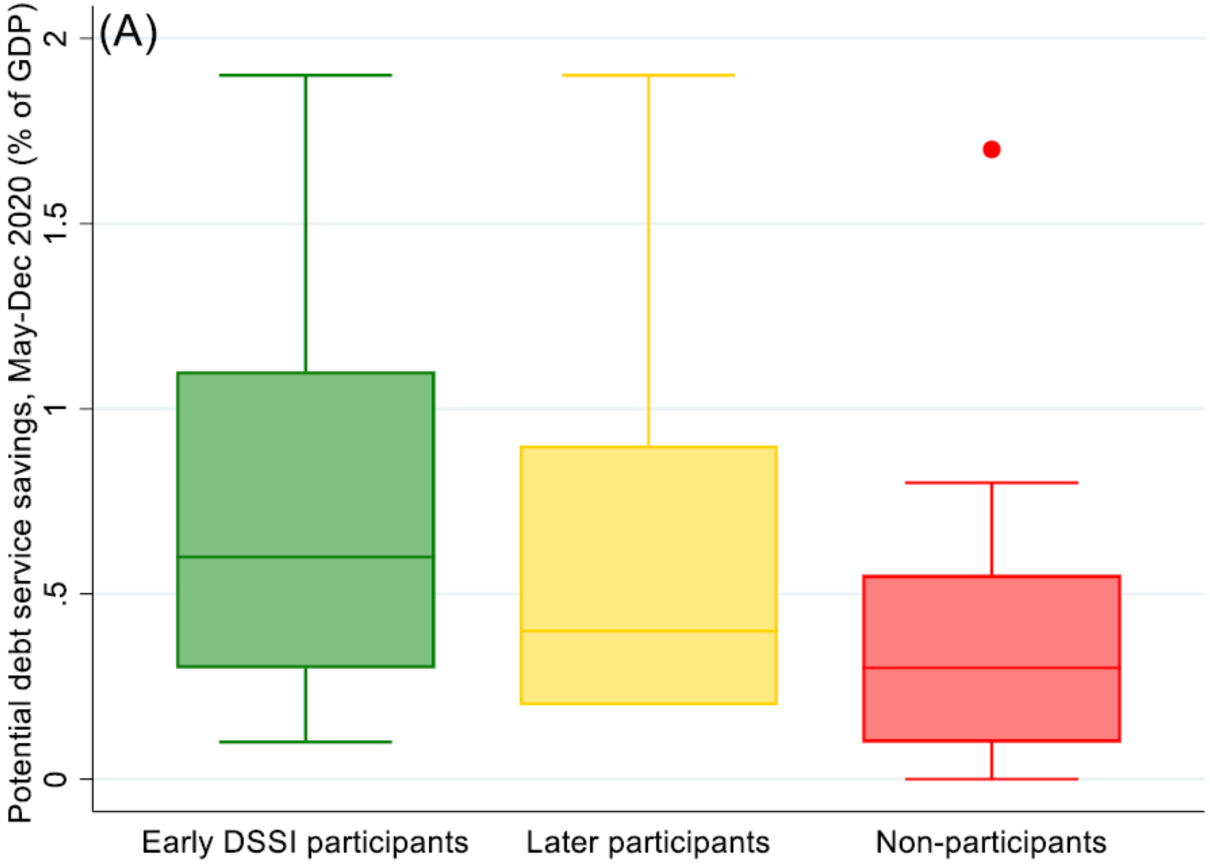


Source: Cassimon et al. (2016)

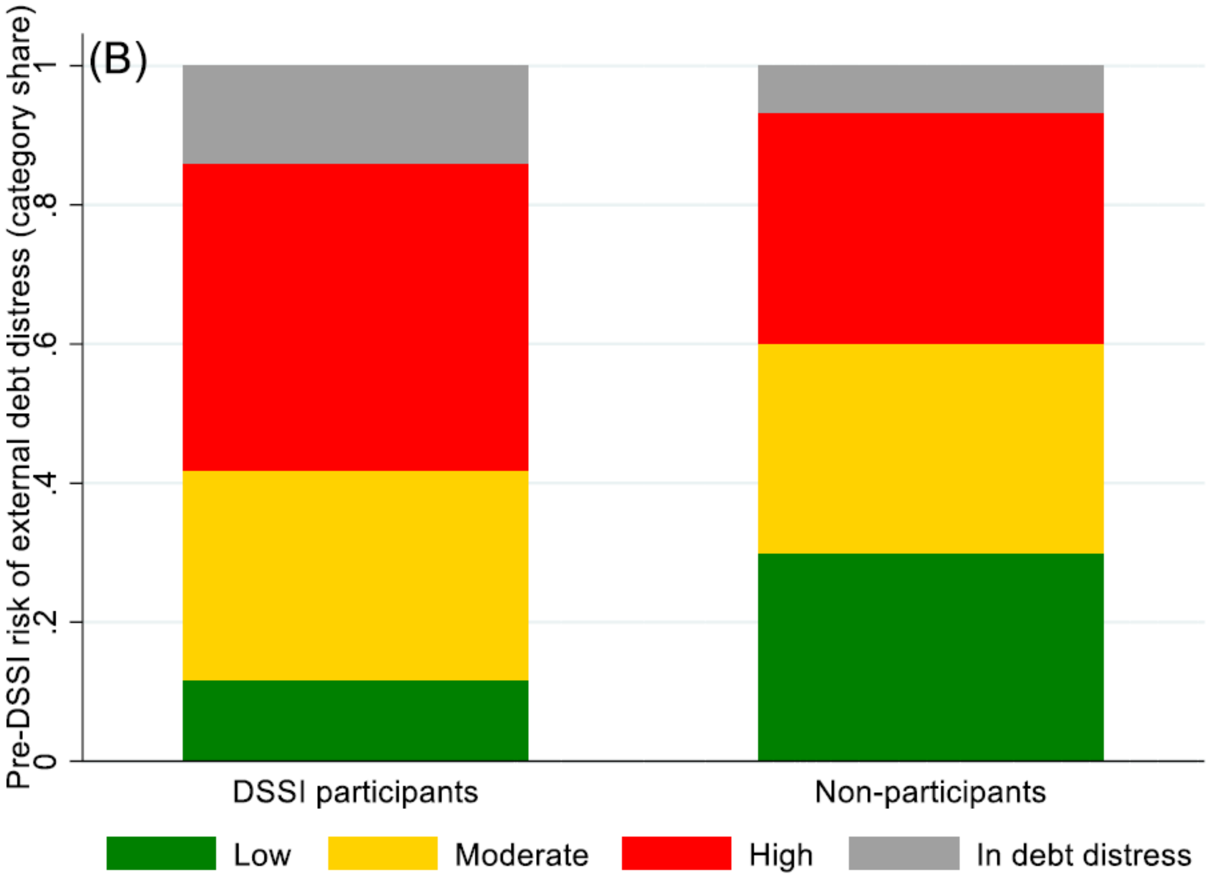
Empirical support for *real option*-like dynamics in DSSI participation

- DSSI-eligible countries that decide to participate (earlier) tend to be those with higher potential debt service savings and higher risk of debt distress

Debt service savings, by DSSI participation status



Risk of external debt distress, by DSSI participation status



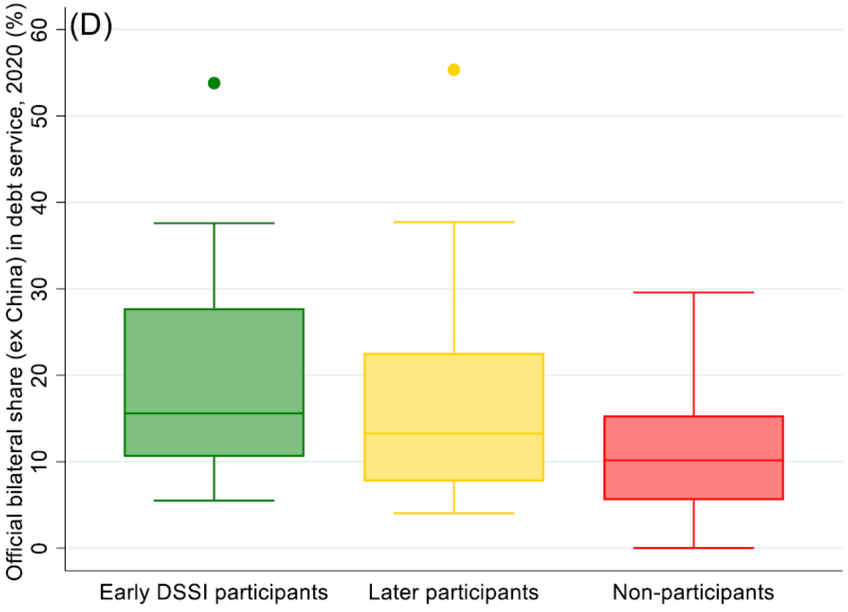
Sources: IMF, World Bank, Paris Club

Empirical support for *real option*-like dynamics in DSSI participation (2)

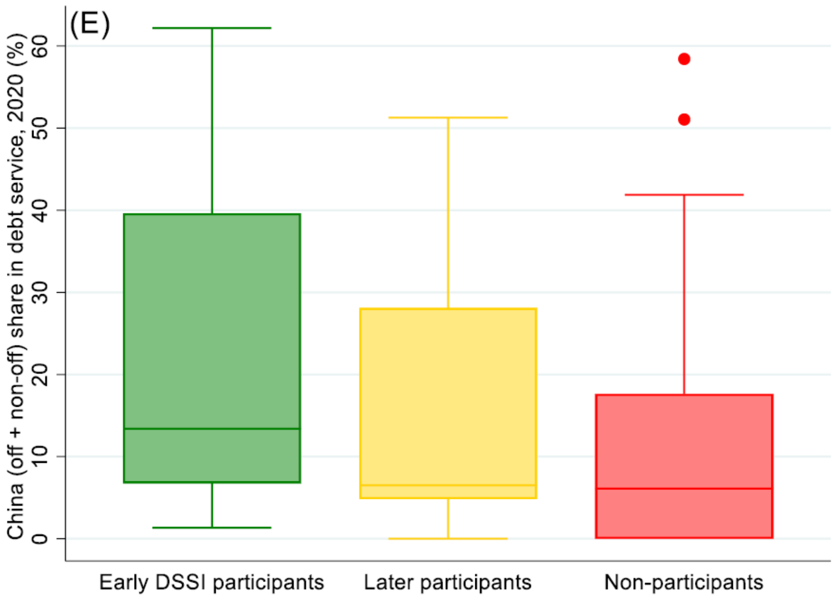
- DSSI-eligible countries that decide to participate (earlier) tend to have higher debt service obligations to official bilateral creditors and China, and lower obligations to bondholders

Creditor group shares of external debt service, by DSSI participation status

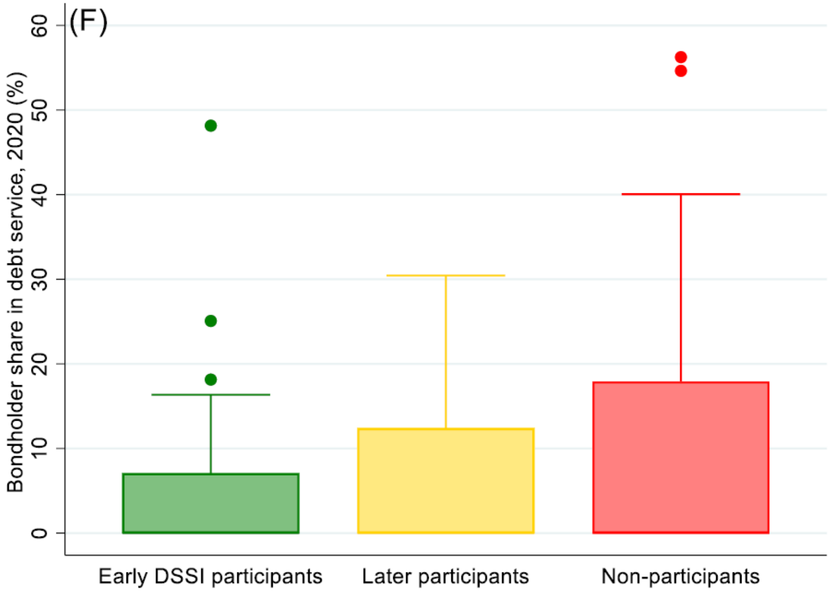
Official bilaterals (excl. China)



China (official + non-official)



Bondholders



Sources: IMF, World Bank, Paris Club

Further anecdotal evidence of waiting and switching behaviour

- *We fear we might unnecessarily create a crisis … The G20 debt relief initiative does not offer optimal benefit given the structure of Kenya's debt portfolio… Kenya is taking a cautious approach of seeking debt relief from bilateral creditors to safeguard its sovereign credit rating*

  - Ukur Yatani (Treasury Secretary of Kenya), 15 May 2020

- *We have been reluctant in the past because of the attendant unintended consequences in terms of those holding private debt… But now after getting a bit of assurance that it is a matter that can be managed, we are now strongly considering joining the arrangement*

  - Ukur Yatani, 17 Nov 2020

- *In principle, the prerequisites of the Common Framework are attractive…[but] we need to better understand what to expect from the framework and to see what the successful examples are*

  - Ousmane Mamoudou Kane (Economy Minister of Mauritania), 9 Nov 2021

Sources: Lang et al. (2022), Reuters, Bloomberg

Lessons from HIPC (+ DSSI/Common Framework) for future debt relief

1) Restoring debt sustainability

- **Avoid "delay-and-replay"** in case of clearly unsustainable debts
- Increased creditor base heterogeneity justifies **more flexible and differentiated approach** than under HIPC
- **Extension to vulnerable MICs**

2) Increasing resource availability

- **Holistic view**: complement debt relief with other net transfers, incl. additional grants and concessional lending
- Consider **debt overhang** and consequences of debt relief for **financial market access**

3) Creditor involvement and burden-sharing

- Ensure **non-Paris Club creditors** remain engaged
- Key to **involve commercial creditors**; combination of carrots and sticks
- **Multilateral involvement** as in HIPC/MDRI **seems not on cards**

Lessons from HIPC (+ DSSI/Common Framework) for future debt relief (2)

4) Appropriate conditionality

- Conditionality (on use of proceeds or performance targets) may **increase creditor buy-in**
- **Don’t overdo it**; mind transaction costs and country ownership

5) Attractiveness to debtors

- **Clarifications** about timeline, procedures and likely market reactions
- **Demonstration effects** of effectively handling first few cases
- **Debt service standstill** during negotiations

6) Preparedness for the future

- Common Framework’s **case-by-case approach may not suffice when crisis becomes “systemic”**
- CF’s inter-creditor dialogue could serve as **stepping stone towards more inclusive advisory body or forum**

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