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Sovereign Debt and the COVID-19 Pandemic

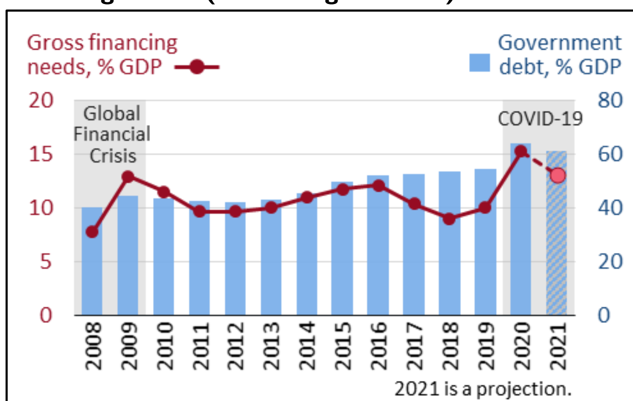
The Coronavirus Disease 2019 (COVID-19) pandemic and the ensuing downturn in economic growth has had significant economic and financial consequence for low-income countries. The World Bank estimates that the pandemic led to 97 million more people being in poverty in 2020. Several countries have already defaulted on their sovereign debt, and many others are at high levels of debt distress, potentially impeding their ability to support recovery.

The United States is participating in two G20 creditor country-led debt relief initiatives. The Biden Administration is requesting $52 million in FY2022 funds from Congress to support these efforts. Members of Congress have also introduced sovereign debt-related legislation aimed at improving the transparency of the scale and scope of creditor countries' sovereign lending (e.g., S. 1169). China is now the largest creditor to developing countries, and some Members have raised concerns about the economic and security impacts of China's economic diplomacy. Some Members have also expressed concerns about the growing complexity of sovereign debt financing and its associated risks.

Debt Vulnerabilities

The debt stock of 120 low- and middle-income countries rose to $8.4 trillion in 2020 (**Figure 1**). According to the World Bank, at the end of 2020, 54% of countries of International Development Association (IDA) were in or at a high risk of debt distress. In emerging market countries, the past year has seen a surge in sovereign defaults. Since the end of 2019, six countries (Argentina, Belize, Ecuador, Lebanon, Suriname, and Zambia) have defaulted on sovereign debt obligations. Public debt in emerging markets (excluding China) is expected to reach 61% of GDP in 2021.

Figure 1. Government Debt Ratios and Gross Financing Needs (Percentage of GDP)



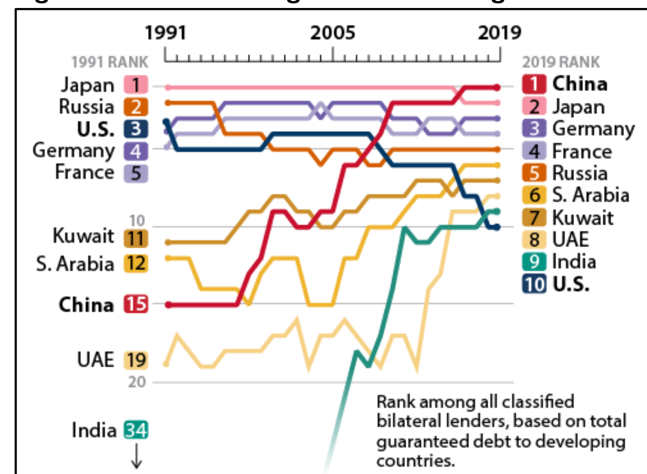
Source: International Monetary Fund; figure created by CRS.

The landscape of sovereign borrowing has changed over the past few decades. Following a sharp decline after the 2005 G8-led Multilateral Debt Relief Initiative, sovereign debt began accumulating during the 2007-2009 global financial crisis and has continued to rise through the COVID-19 pandemic. According to World Bank figures, total external government debt of low- and middle-income countries increased from $1.7 trillion in 2011 to $3.1 trillion in 2019. While the earlier waves of sovereign debt accumulation consisted primarily of bank loans and bilateral borrowing from advanced economies and the multilateral development banks, recent increases in aggregate sovereign debt are largely attributable to China's emergence as a key developing country creditor and the rising use of private sector bonds to finance developing country public debt. Both of these trends have raised new challenges in resolving sovereign defaults.

China's Lending to Developing Countries

Since the early 2000s, China has become the largest creditor to low-income countries, surpassing a core group of traditional donor governments (organized informally as the Paris Club), the International Monetary Fund (IMF), and the World Bank (**Figure 2**). Unlike the IMF, the World Bank, or the 22 countries that compose the Paris Club, China rarely discloses the amounts or terms of its bilateral debt agreements. According to one 2019 National Bureau of Economic Research study, half of China's official lending to developing countries is not reported in World Bank/IMF debt statistics. China is not a member of the Paris Club and, until recently, did not participate in multilateral debt relief initiatives.

Figure 2. China's Emergence as a Leading Creditor

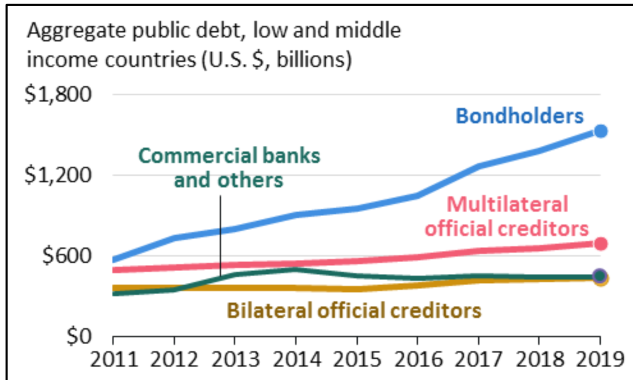


Source: Figure created by CRS based on WB IDS Statistics 2021 data; retrieved from https://t.co/Ppts0t1ORG?amp=1.

Proliferation of Debt Instruments

Since 1989, private international banks reportedly have exchanged distressed loans for tradable bonds at a discount. Many developing countries also have turned to selling bonds in private equity markets, As a result, the bond market has become a key source of public financing globally. Between 2011 and 2019, sovereign bond financing to low- and middle-income countries tripled (**Figure 3**).

Figure 3. External Public/Publically Guaranteed Debt



Source: World Bank International Debt Statistics (IDS).

As the IMF and others note, sovereign debt is the only debt instrument without a bankruptcy mechanism. In lieu of a formal bankruptcy procedure, the international community has relied on contractual solutions for resolving sovereign debt crises, such as including collective action clauses to steer creditor coordination.

Debt Service Suspension Initiative

On April 15, 2020, the G-20 finance ministers, in conjunction with private creditors, announced a temporary debt payment suspension through the end of 2020 for the world's poorest countries, which have been hard-hit by the pandemic-related collapse in commodity prices, export revenues, and tourism. Formalized as the Debt Service Suspension Initiative (DSSI), the effort allows for the temporary suspension of interest and principal repayments on G-20 official bilateral loans. Repayment schedules are to be net present value-neutral, meaning that no debt is actually written off, but rather rescheduled to be paid later. The DSSI was later extended through December 2021. According to the World Bank, the DSSI has delivered more than $5 billion in official debt relief to more than 40 of the 73 eligible countries. Despite appeals from World Bank and IMF leaders, among others, private creditors have not participated in the DSSI.

From Debt Suspension to Debt Forgiveness

While DSSI is providing temporary debt restructuring, the G-20 and the 22 members of the Paris Club, comprising 39 creditors (including China), endorsed a new "Common Framework for Debt Treatments beyond the DSSI" in November 2020 for providing permanent debt forgiveness. Debt treatment options under this framework include extending the duration of sovereign debt and in extreme cases, debt write-offs or cancellation. Unlike the DSSI, Common Framework debt restructuring requires a formal process similar to earlier Paris Club debt treatments, including backing by an IMF lending program and assurances that the debtor will seek treatment from all its creditors, public and private, on comparable terms.

Despite their high levels of debt distress, three eligible countries have requested Common Framework debt relief: Chad, Ethiopia, and Zambia. Many eligible countries reportedly are concerned that seeking debt restructuring, especially with commercial creditors, will lead to ratings downgrades and reduce their future access to financing. Moody's, for example, downgraded Ethiopia's sovereign bonds, in part due to the possibility that a Common Framework agreement might cause private creditor losses.

The risk of private sector debt downgrades has been less of an issue with the DSSI, which has been limited to official sector debt. Despite calls from the IMF and others for the private sector to participate in the DSSI, there has been little private creditor appetite. The Institute of International Finance (IIF), an industry group, has argued that a comprehensive agreement on private sector debt could risk reducing countries' access to the private capital markets.

U.S. Debt Relief and the Role of Congress

Congressional authorization is necessary for the United States to participate in multilateral debt relief efforts. Under authority first granted by Congress in 1993 (P.L. 103-87), an appropriation by Congress of the estimated amount of debt relief is required in advance.

The FY2022 budget requests $52 million for the DSSI and Common Framework. According to Treasury, this funding is necessary to restructure and lower U.S. interest rates charged to the 44 countries that, as of June 2021, had requested payment suspensions under the DSSI. This would put U.S. interest rates in line with those charged by other G20 official bilateral creditors, including China, and fund the cost of debt treatments for poor countries under the Common Framework. Treasury has not provided a country-by-country breakout of the $52 million request.

Issues for Congress

Some in Congress have raised concerns about sovereign debt risks, notably with respect to the lack of transparency of China's lending. For example, in the 116th Congress, the House passed H.R. 5932, Ensuring Chinese Debt Transparency Act of 2020, which would have instructed U.S. international financial institution representatives to "seek to secure greater transparency with respect to the terms and conditions of China's financing" of sovereign debt by country members of these institutions. Efforts are also ongoing at the IMF to improve national disclosure of sovereign debt loans and obligations.

Members may also consider the increased complexity of sovereign debt markets and various public and private efforts to improve coordination among creditors. As debt instruments become more diverse and the creditor base becomes more fragmented, debt risks and the costs of restructurings are increasing.

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