Sovereign debt restructuring for emerging economies in a turbulent global economic environment

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Many emerging economies are currently faced with a perfect storm of soaring inflation, acute shortages of fuel and food (and even medicines in some cases), major disruptions in supply chains, escalating global interest rates, large-scale capital flight of 'hot money,' and sharply depreciating currencies. Alas, it was not supposed to be this way for the emerging economies as they moved through 2022.

In 2021, these economies had shown fairly remarkable resilience in rebounding from the severe adverse impact of the COVID-19 pandemic on their economies, and emerging economies and developing countries taken together were expected to grow at nearly 5% for 2022, as per International Monetary Fund (IMF) projections in October 2021. However, just as the emerging economies and developing countries were entering a second year of economic recovery from the pandemic-related negative growth in their economies, Russia invaded Ukraine in late February and that huge geopolitical development and the economic repercussions that have flowed from it have changed the economic outlook for emerging economies and developing countries fairly dramatically.

In fact, in just the short period between January and April of this year (i.e., in the wake of the onset of the war in Ukraine), the IMF has lowered its projections of growth for emerging economies and developing countries by not insignificant margins. The IMF is now projecting that emerging economies and developing countries will grow by only 3.8% in 2022 and 4.4% in 2023 compared to growth of 6.8% for these economies in 2021.

Two-plus years ago when the COVID-19 pandemic first struck, world oil prices were at all-time lows (and even went into negative territory for a period of time for certain oil futures). As a result, oil-producing countries around the globe were put in a serious economic and financial bind as government revenues generated from taxes and royalties on oil production shrunk.

However, now in the wake of Russia's invasion of Ukraine and the tightening of global oil supplies, world oil prices have reached heights that the market has not seen in recent years with current oil prices at a level of approximately US$120 per barrel.

Furthermore, the war in Ukraine has affected both the availability and price of such basic commodities as wheat and other grains, particularly since Russia and Ukraine have effectively served as a breadbasket for the world. The current acute shortages of wheat and other grains, as well as shortages of fertilizer, that exist in countries around the world, accompanied by the higher price for these commodities, is already having a serious inflationary effect on emerging economies and developing countries.

Moreover, such shortages and the rising prices on foodstuffs could potentially lead to widespread 'food insecurity,' including widespread malnutrition and/or hunger, in the affected countries. Some development experts have not ruled out the possibility of famines in certain countries, and in fact the UN Secretary-General has warned that the war in Ukraine could risk plunging "tens of millions" into famine, as per the *Financial Times*. In addition, pervasive 'food insecurity' can have political consequences: under certain circumstances, it can lead to large-scale demonstrations and rioting against incumbent governments with the attendant possibility of political instability in the affected countries (as has been the case recently in Sri Lanka).

As noted above, with rising commodity prices, the global economy is now faced with significant new inflationary pressures, and these inflationary pressures are being felt particularly hard in a number of emerging economies and developing countries. Inflation was already a concern in many countries pre-Ukraine, but the price hikes on crucial commodities such as oil and grains in the wake of the Ukraine invasion have pushed inflation to even higher levels. Inflation has reached perhaps as high as 8.5% in March 2022 for emerging economies and developing countries, and, according to a report from Brookings, this represents the highest rate of inflation in emerging and developing economies since 2008.

While rising inflation is a major concern for emerging economies and developing countries, another major concern is the rise in interest rates globally. To be sure, even before the start of the war in Ukraine, global interest rates were set to rise in an effort to tame the inflation seen in many countries around the world. Notably, in the course of 2022 and into 2023, the US Federal Reserve is expected to raise interest rates several times by as much as 50 basis points at a time, and this in turn could sharply increase borrowing costs for emerging and developing economies.

Separately, one must take account of important domestic developments taking place in China. The recent COVID-related lockdowns in China as part of its so-called zero-COVID policy, particularly in highly populated urban centres such as Shanghai and Beijing, has led to a significant slowing of the Chinese economy. In fact, many observers believe that China will not be able to meet its economic growth target of 5.5% for 2022, and there is even some speculation that the growth will come in at a much lower level such as at 4% or less.

Since the Chinese economy has widely been viewed as one of the main engines, if not *the* main engine, for economic growth in the global economy in the last decade or longer, a sharp slowdown in the Chinese economy will inevitably have an adverse impact on the overall global growth rate. It will also affect growth rates of many individual economies around the world, including emerging and developing economies.

On the debt front, many emerging economies and developing countries already found themselves in very fragile and vulnerable positions prior to the war in Ukraine. For instance, in a recent report, the World Bank indicated that 60% of low-income countries are now either in a state of debt distress or at high risk of debt distress. In addition, a top economist at JP Morgan Chase recently noted that there are at least sixteen emerging economies whose sovereign bonds are currently trading at distressed debt levels.

Furthermore, during the pandemic, the governments in many emerging economies and developing countries undertook unprecedented levels of borrowing in order to help them address the health and economic crises caused by the pandemic. Yet, that high level of borrowing has now left many of these countries vulnerable to serious debt difficulties, if not outright debt distress and debt defaults.

Indeed, some commentators have suggested that the coming period in the wake of the war in Ukraine may see more debt defaults and debt restructurings than at any time since the debt crisis of the 1980s. It remains to be seen, though, whether such prognostications will come to pass, and if so, whether such future sovereign debt defaults will give rise to a systemic crisis as was the case in the 1980s.

Specific types of emerging economies at risk of debt default and/or restructuring

Economies directly impacted by economic fallout from the Ukraine war

Egypt. There is perhaps no starker example of a country more severely impacted from the fallout of the war in Ukraine than Egypt. Egypt has felt the brunt of the fallout in the form of significant wheat shortages and a marked run-up in prices for wheat/grain products.

As Egypt is dependent on Ukraine and Russia for 80% of its wheat imports, the virtual cessation of exports from the war zone (apparently due in particular to the Russian blockade of Ukrainian ports on the Black Sea) is having a dramatic impact on the Egyptian economy. For instance, inflation in Egypt has soared from 5% prior to the war in Ukraine to its current level of approximately 14.5%, according to the *Financial Times*.

Shortages of wheat are also affecting Egyptian society generally given the role of bread as a critical staple in the diet of ordinary Egyptians. And there appears to be a very real prospect of 'food insecurity' for the Egyptian people; indeed, many Egyptians are already having trouble finding adequate supplies of food for themselves and their families (or at least food whose price is affordable to the average Egyptian).

Egypt's tourism industry, a key contributor to the Egyptian economy, is also suffering significantly from the fallout of the war in Ukraine. A large percentage of tourists who travel to Egypt to visit seaside resort areas such as Sharm El Sheikh come from Russia and/or Ukraine, but the war in Ukraine has led to a virtual cessation of this important flow of tourists to Egypt. As a consequence, Egypt has lost a crucial source of foreign exchange, the economic activity generated by the Egyptian tourism industry has plummeted, and many Egyptian workers in the tourism industry are now being laid off from their jobs. Separately, the Egyptian economy has also suffered from the exit of foreign investors, particularly short-term investors who are often referred to as 'hot money.'

Since 2016, Egypt has entered into two separate programs with the IMF that provided Egypt with US$20bn in financing. But now with the war in Ukraine dealing a body blow to the Egyptian economy, the Egyptian government has once again approached the IMF for a new financing package and a new IMF program. It may take some time for Egypt and the IMF to finalise a new program in which Egypt is reportedly seeking financing of several billion dollars, but in the meantime, Egypt has reportedly received billions of dollars in financial assistance from some of the Arab Gulf states.

Economies weighted down by Chinese lending associated with China's BRI program

Overview. With its globe-spanning Belt and Road Initiative (BRI), China has loaned money to countries throughout the emerging markets and developing world for the development of various types of infrastructure, including roads, ports, airports, railways, and power projects. But many of these countries have borrowed huge amounts of money from China for these infrastructure projects, and a number of these countries find themselves with basically unsustainable debt burdens due to their borrowings from China as well as from other financing sources.

Whether China consciously designed a "debt trap" for the countries participating in BRI is a topic of heated debate, but resolving that controversy is beyond the scope of this article. However, for our purposes, the important point is that in a number of countries the Chinese debt, which often sits alongside debt from other financing sources, has left these countries with huge debt burdens or with what some would consider to be in certain cases essentially unsustainable overall debt burdens.

Sri Lanka. Sri Lanka has been a poster child of BRI projects that have gone awry, including most notably the Hambantota port project located in southern Sri Lanka. In that project, Sri Lanka was unable to make the required debt service payments due to China since the port had generated only limited traffic and was therefore not producing anywhere near the expected revenues for the project. To address this situation, China essentially entered into a debt-for-lease swap with Sri Lanka whereby China exchanged the debt that it was owed by Sri Lanka for a 99-year lease on the Hambantota port, thereby effectively shifting control of the port from Sri Lanka to China.

Apart from the Hambantota project, Chinese lenders have financed a number of other BRI-connected infrastructure projects in Sri Lanka, including a port in Colombo, an airport, highways, and even a business hub. In the process, Sri Lanka has incurred huge amounts of debt owed to China, but the debt is not necessarily on very favorable terms since, for example, apparently the interest rates are considerably higher than lending from other sources and the maturities are shorter than other non-Chinese loans.

But now Sri Lanka is going through a very severe economic crisis as its economy has basically been devastated from the fallout of the war in Ukraine, and there has also been political turmoil in Sri Lanka in the last few months with large-scale protests against the government. As reported by Reuters in late April, "Prolonged power cuts and shortages of fuel, food and medicines have sparked nationwide protests."

In May, Sri Lanka defaulted on two foreign bonds, and this represented the first sovereign default in Asia in over twenty years. Sri Lanka appears to have virtually depleted all of its foreign exchange reserves—it reportedly only had US$50m in available foreign exchange reserves at the end of April—so it has been unable to afford essential imports such as food, fuel, and medicines.

Sri Lanka has received financial assistance from certain countries to help tide it over, but it has also recently gone to the IMF seeking a new financing package and new IMF program. Apparently, discussions between the Sri Lankan government and the IMF are still ongoing.

Yet, the level of dysfunction, disarray, and human misery currently existing in Sri Lanka is such that some observers are even calling Sri Lanka a 'failed state'.

Other countries. Apart from BRI projects in Sri Lanka, there have been a number of very high profile and costly BRI projects in other countries that have proven to be problematic for various reasons and where the relevant sovereign has incurred significant amounts of Chinese debt to fund the projects in question.

To cite just a few examples, such projects include the Chinese-Pakistan Economic Corridor. (CPEC) in Pakistan (which is actually a collection of many different infrastructure projects), the single-gauge railway (SGR) in Kenya connecting Nairobi to Mombasa, and the highway in Montenegro linking its Adriatic coast with neighboring Serbia (but traversing very mountainous terrain).

Projects such as these can become uneconomic if there is insufficient demand and/or if there are construction delays, cost overruns, quality issues, and so forth. In the meantime, the sovereign may have taken on considerable debt to finance such projects, and, notwithstanding the potentially adverse project economics discussed above, the sovereign may still be required to service its BRI-related debt to its Chinese lenders (together with any other sovereign debt it may have outstanding), assuming it can. However, it may not be able to do so, thereby resulting in a possible sovereign debt default and/or sovereign debt restructuring.

Economies where sovereign debt travails have been an ongoing challenge

Argentina. Argentina recently sealed a deal for a new arrangement with the International Monetary Fund (IMF), its 22nd such arrangement with the IMF since 1958. As part of a new Extended Fund Facility (EFF), Argentina will receive a new loan from the IMF of approximately US$44bn. Without this new loan, Argentina would not have been in a position to make the two large debt service payments to the IMF that were falling due in late March since Argentina had basically depleted its available foreign exchange reserves.

In return for the loan, Argentina will now be subject to an IMF program that focuses, among other things, on reducing inflation, zeroing out Argentina's primary fiscal deficit by 2025, gradually reducing Central Bank financing of Argentina's fiscal deficit, boosting Argentina's foreign exchange reserves, and raising interest rates.

Nonetheless, it was hardly a foregone conclusion that Argentina and the IMF would be able to reach a deal on a new loan and a new program before a de facto deadline of late March at the time those two debt service payments fell due to the IMF. Actually, it literally came down to the wire with the IMF Executive Board only approving the new loan and program on March 25.

With its new arrangement, Argentina seems to be temporarily off the hook, but few observers expect the new deal between Argentina and the IMF to proceed exactly as planned. For instance, there will be a range of complications caused by the war in Ukraine, such as the impact that the rising prices for Argentina's oil imports will have on inflation levels in Argentina. Moreover, Argentina's president, Alberto Fernández, is up for re-election in October 2023. Thus, his willingness to strictly implement the IMF program may be shaped to one degree or another by domestic political considerations, especially with respect to politically sensitive matters such as the reduction of fuel subsidies called for under the new IMF program.

Finally, the IMF itself has recognised what it has called the "exceptionally high" risks to the successful implementation of the new program for Argentina due to external factors, including fallout from the war in Ukraine, as well as social and political considerations in Argentina, such as the long-standing hostility of many Argentineans towards the IMF.

Venezuela. The Venezuelan government (the Republic of Venezuela) and its state-owned oil company, PDVSA, have a combined estimated US$150bn-US$200bn of total outstanding debt and other liabilities, but Venezuela has been in default on this debt for some time. For various reasons, including the fact that the Venezuelan regime led by Nicolás Maduro is considered a pariah regime by numerous Western countries, there have not been any serious debt restructuring discussions or negotiations between the Maduro regime and its creditors in the last few years since Venezuela's original bond defaults in late 2017.

Nonetheless, in early March 2022, there was a brief flurry of excitement around Venezuela when the Biden administration dispatched a few high-level envoys to meet with President Nicolás Maduro for the principal purpose of exploring the possibility of easing existing US sanctions against Venezuela's oil sector that were put in place by the Trump administration. Evidently, the idea was to replace as much as possible the expected shortfall in oil imports to the US resulting from US sanctions against the importation of Russian oil with oil imported from Venezuela.

Despite the fact that Venezuela remains in default on approximately US$60bn of bond debt, the price of some of the outstanding bonds of the Republic of Venezuela and PDVSA rose briefly by a few cents on the dollar on news of the meetings between the Biden administration officials and the Maduro regime. Apparently, the expectation at least among traders in Venezuelan bonds was that the talks might lead to a lifting of some of the US sanctions on the Venezuelan oil industry.

Yet, after strong blowback from the US Congress about making a deal with the authoritarian Maduro regime, the Biden administration initiative appears to have fizzled out. Thus, notwithstanding the early burst of excitement among certain traders in Venezuelan bonds with respect to the recent Biden administration initiative, there does not appear to be any near-term prospect of a restructuring of Venezuela's debt, particularly since the Maduro regime remains in power and has not committed in any way to meaningful political change in Venezuela or even to conduct truly meaningful discussions with the opposition.

Other recent sovereign debt developments

Failure thus far of G-20 'Common Framework' initiative

In November 2020, the G-20 group of nations announced a "Common Framework" initiative for debt restructuring. The idea was to bring non-Paris Club bilateral creditors that are members of the G-20 such as China and India into a Paris Club-type process for restructuring sovereign debt. (China is now the largest bilateral creditor to developing countries.) The Common Framework was designed to provide for a coordinated process involving all major official creditors of a particular sovereign so that members of the Paris Club and non-members of the Paris Club could work together in a joint process on sovereign debt restructurings.

The Common Framework also called on private creditors, when restructuring sovereign debt, to provide debt treatment that is "comparable" to the treatment provided by official creditors in their Paris Club-type debt restructuring process. However, the Common Framework did not address how the notion of "comparability of treatment" would be enforced.

In practice, though, the Common Framework has not gained much traction at all. Only three sovereign debtors—namely, Chad, Ethiopia, and Zambia—have applied for 'treatment' under the Common Framework. Yet, as of now, none of those three countries has completed a sovereign debt restructuring under the Common Framework.

Thus, even as the need for something like the Common Framework may increase significantly in the current unsettled or even turbulent global economic environment, the future for the Common Framework as a useful tool for sovereign debt restructuring remains highly uncertain.

Debt-for-nature swaps

Perhaps one of the few bright spots in the area of sovereign debt restructuring in recent times concerns the use of a debt-for-nature swap involving Belize, the small Central American country whose economy is heavily dependent on ecotourism. In 2021, Belize needed to restructure a US$553m so-called 'superbond' it had issued because it did not have the resources to pay the debt service on the bond.

But with the help of The Nature Conservancy (TNC), a non-governmental organisation, Belize was able to enter into a restructuring transaction whereby it achieved a huge reduction in its outstanding debt burden in exchange for Belize making a series of commitments to protect and conserve the enormous but delicate barrier reef that lies off the Caribbean coast of Belize. The commitments Belize made included, among other things, agreeing to spend US$4m annually until 2041 on marine conservation efforts and doubling its so-called 'marine protection parks' from 15.9% of its oceans to 30% by 2026.

Thus, this was a classic win-win situation. Belize achieved huge debt reduction (equivalent to 10% of its annual GDP) and the global community achieved commitments for additional conservation and protection of an ecologically vital barrier reef. Going forward, it will be interesting to see the extent to which a Belize-type debt-for-nature restructuring will be replicated by other sovereign debtors with important but potentially endangered ecological assets and whose debt is trading at a deep discount.

Conclusion

The rising level of debt distress in many emerging economies and developing countries in the wake of the war in Ukraine (and lingering economic effects of the pandemic) could well give rise to a very high number of sovereign debt defaults and sovereign debt restructurings. Unfortunately, however, the machinery for sovereign debt restructuring has not changed much in recent years apart from some modifications in sovereign bond contracts, including refinements in collective action clauses (CACs) so that they provide for aggregated voting as opposed to series-by-series voting.

In particular, there is still no bankruptcy-type legal regime for sovereigns (unlike for corporate debtors) nor is there any centralised forum where sovereign debt disputes and restructurings can be negotiated, mediated, arbitrated, and/or otherwise resolved. Thus, the existing global financial architecture has a glaring gap, and that could prove to be detrimental to the resolution of the many sovereign debt defaults and restructurings that are expected in emerging economies and developing countries in the coming period.

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