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Why are debtor countries hesitant to participate in debt relief initiatives?*

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Developing countries have recently proved reluctant to participate in sovereign debt moratoria and debt relief initiatives. We argue that debtors' (non-)participation can be understood through the lens of real options. Eligible countries compare the net benefits of participating in a debt relief initiative now with the value of waiting and potentially execute their participation option later, when they may have more information on the benefits and costs. Anecdotal evidence and a survival analysis of participation in the Debt Service Suspension Initiative (DSSI) support our real option framing. The real option framework suggest different ways in which participation in debt relief initiatives can be made more attractive to debtor countries.

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If left unaddressed, sovereign debt problems may intensify over time and eventually result in defaults that have large economic costs for the indebted countries themselves and for their creditors (e.g., Asonuma and Trebesch, 2016). So why then is the restructuring of sovereign debt often marked by long delays? Part of the answer may lie in coordination difficulties among foreign creditors, which could give rise to strategic holdout behaviour (e.g., Pitchford and Wright, 2012).

However, also on the side of highly indebted governments there appears to be reluctance to restructure their debt obligations. Limited and postponed participation in recent international debt relief initiatives is a case in point. When the G20 launched the Debt Service Suspension Initiative (DSSI) to assist low-income countries with temporary suspensions of debt repayments during the COVID-19 pandemic, only about two thirds of 73 eligible debtor countries decided to take part – and some jumped in sooner than others. Even more strikingly, the G20's Common Framework for Debt Treatments beyond the DSSI, set up to guide more comprehensive debt restructurings, has so far convinced only a handful of debtor countries to apply, despite high numbers of eligible countries finding themselves in or close to debt distress.

In Cassimon, Essers and Presbitero (2023), we take a debtor-centred point of view and study the potential motivations for participating, or not, in the DSSI and Common Framework. We do so by applying the insights from real option theory to sovereign debt relief (see Essers and Cassimon, 2022). Our work is complementary to Lang, Mihalyi and Presbitero (2023), who show that concerns about potential adverse effects coming from the stigma of receiving debt relief can be misplaced: countries eligible for participation in the DSSI experienced larger declines in borrowing costs compared to similar, ineligible countries.

The DSSI and Common Framework

In its first phase, the DSSI suspended (without cancelling) debt service payments due between May and December 2020 on claims owed to all official bilateral creditors. After a one-year grace, bilateral lenders would be fully repaid over the course of three years and would receive interest on the deferred sums. The initiative was extended twice and expired in December 2021. 73 low-income countries were eligible for the DSSI, but in order to participate they needed to make a formal request to their creditors and be involved in an IMF financing arrangement. The G20 called upon private creditors to provide debt service suspensions "on comparable terms", but ultimately private sector participation in the DSSI was left to be voluntary and did not materialise. Multilateral development banks (MDBs) were kept outside of the DSSI perimeter. In the end, 48 out of the 73 eligible countries made requests to take part in the DSSI, resulting in an estimated USD 8.9 billion of suspended debt service owed to bilateral creditors in 2020 and 2021.

In November 2020, in response to growing concerns about debt distress, the G20 introduced the Common Framework to facilitate orderly debt treatments for DSSI-eligible countries on a case-by-case basis and, again, at the request of the debtor country. The terms of the debt treatment, which could be anything from a short-term debt reprofiling up to a deep restructuring involving write-offs, are coordinated among key bilateral creditors in an ad hoc committee and negotiated with the debtor country. Under the Common Framework, the debtor is required to seek 'comparable' (i.e. at least as favourable) debt treatments from all its other official bilateral creditors and private creditors. At the moment of writing, the G20 and Paris Club creditors had received four Common Framework requests, from Chad, Ethiopia, Zambia (early 2021) and Ghana (early 2023). Only Chad's debt treatment has been fully concluded, while Zambia has signed an agreement with its bilateral creditors and is trying to work out an acceptable bond exchange deal with its international bondholders.

A real option application

We argue that the concept of 'real options' helps to illuminate debtor countries' decisions (not) to participate in initiatives such as the DSSI and Common Framework. Such a real option approach applies the logic of models used in pricing financial (option) instruments to real sector investment decisions (Dixit and Pindyck, 1994). In our case, the basic intuition is that, in considering when to execute their option of participating in a debt relief initiative, eligible debtor countries will only go ahead now when the expected net benefit of doing so exceeds the value of waiting and being able to gather more information about those net benefits (keeping the possibility of participating later).

The value of the real option depends on a few key parameters or drivers: most notably, the *expected benefits* of participation (temporary debt service savings under the DSSI, or the regaining of debt sustainability under the Common Framework); the *expected costs* (including damages to financial market reputation and administrative/negotiation costs); the *uncertainty* about the benefits and costs (such as doubts about the exact perimeter and treatment of debt claims that fall under the initiatives, and about market reactions to the treatment); and the *opportunity costs* of not (yet) participating (like the foregone suspension of debt service, or even missed investments). For example, higher uncertainty about the benefits of the DSSI or Common Framework for the debtor increases option value and therefore leads to more postponement in the participation decision.

We validate our real option characterisation qualitatively with press statements by debtor government officials on the reasons underlying participation or non-/late participation in the DSSI and Common Framework. Key real option value drivers appear to have played an important role in those deliberations. For example, at the time the DSSI was launched, Benin's Minister of Finance referred to the expected costs of the initiative in an op-ed: "*[T]hese solutions will further tarnish the reputation of our governments and jeopardize their access to future financing. Our countries will suffer from an implied deterioration of their perceived credit quality, which could impact their access to capital markets*". Ghana, which eventually requested a debt treatment under the Common Framework, was initially held back by the great uncertainty surrounding the process. According to anonymous sources close to the Ghanese authorities, quoted by Reuters, "*[they had] been hesitating due to the long delays faced by other countries using the process" and "had sought reassurances that the negotiations can be expedited before proceeding*".

Survival analysis of DSSI participation

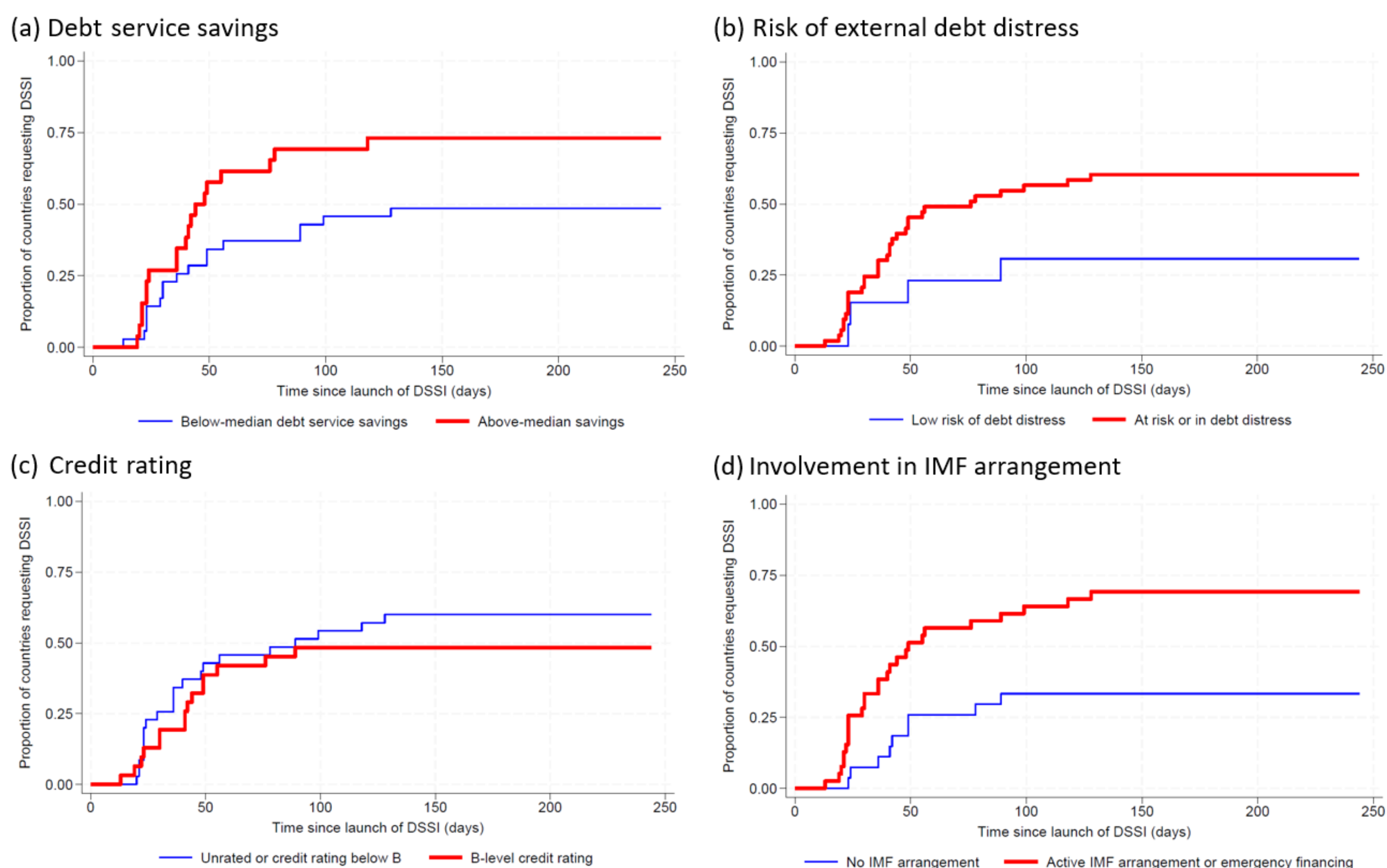
To quantitatively test our real option framing, we conduct a 'survival' or 'time-to-event' analysis using variation in the timing of debtor requests (if any) to participate in the DSSI. We focus on DSSI-eligible countries with sufficient data coverage and their (non-)participation during the first leg of the DSSI (May-December 2020).

Our main explanatory variables are as follows. As a first measure of the benefits of the DSSI we take the (potential) debt service savings as a percentage of GDP for the year 2020, as estimated by the World Bank. We also calculate the shares of total external debt service that were projected to be paid to either official bilateral creditors (excluding China) or to Chinese (official and non-official) creditor agencies in 2020. The idea here is that a higher exposure to bilateral creditors implies larger and more certain benefits from DSSI participation, as most of them were quick to subscribe to the DSSI. Any lowering of the risk of external debt distress by the DSSI would be most valuable for eligible countries deemed riskier. Hence, we construct a dummy variable for eligible countries classified to be at low risk of debt distress vs. at moderate/high risk of or already in debt distress, according to pre-DSSI IMF-World Bank assessment. We also consider the projected share of external debt service going to international bondholders in 2020, with a higher exposure to bondholders implying larger perceived

risks of any reputation losses from participating in the DSSI. Similarly, we look at eligible countries' latest pre-DSSI sovereign credit ratings. Finally, another perceived cost we account for is that of having to request an IMF arrangement, a formal requirement for DSSI participation that may take some time to fulfil and could possibly carry stigma. This is of course only a concern for countries that did not yet have an active IMF arrangement at the time of the DSSI launch. We create a dummy for whether or not a country had already received COVID-19-related emergency financing or was involved in a full-fledged IMF arrangement.

As a first pass, we plot the so-called Kaplan-Meier 'failure functions' for different splits of DSSI-eligible countries based on the just-described explanatory variables (see Figure 1 for a selection of splits). These functions correspond to the cumulative proportion of eligible countries that have requested to participate in the DSSI at each point in time, as observed from the start of the DSSI to its end.

Figure 1: Debtor countries that stood to benefit more or had less to lose, were quicker to request DSSI support



Notes: For more details, including exact variable definitions, see Cassimon, Essers and Presbitero (2023).

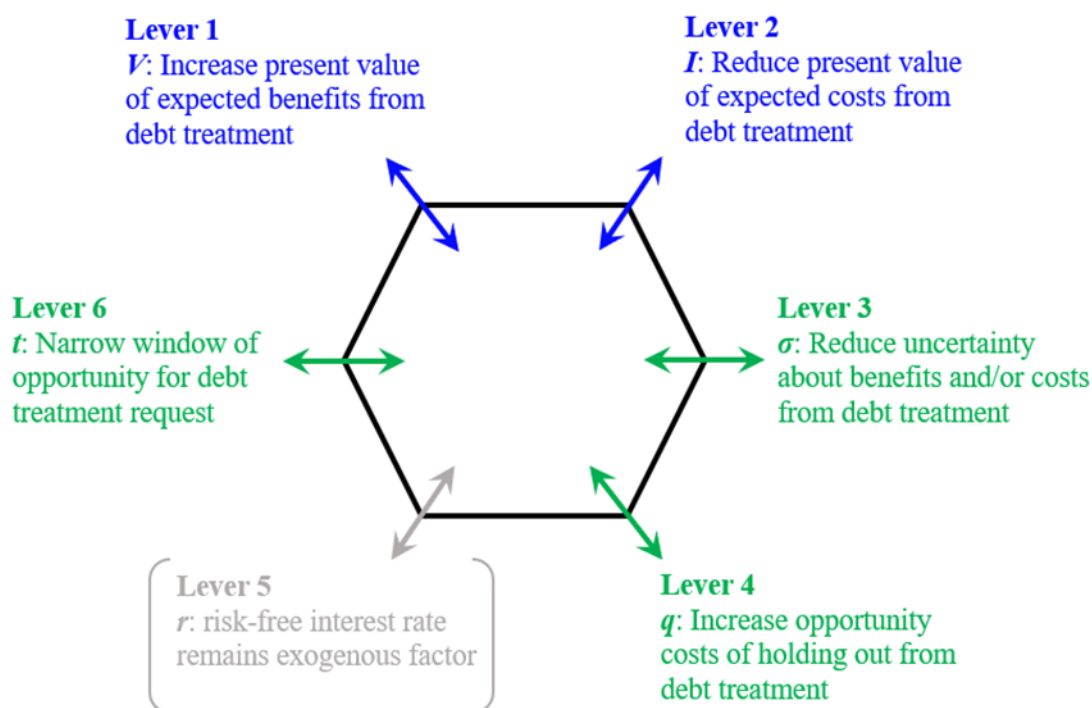
In line with the real option framing outlined above, we find that debtor countries that stood to benefit more from DSSI participation, due to higher expected debt service savings (see panel (a)), larger exposures to willing official bilateral creditors, or higher pre-existing risks of debt distress (panel (b)), were quicker to apply for DSSI support. Conversely, debtor countries that had more to lose in terms of market reputation, because of larger exposures to bondholders or better credit ratings (panel (c)), or that faced the hurdle of having to request an IMF arrangement first (panel (d)), were less likely to make an early DSSI request.

As we show in Cassimon, Essers, Presbitero (2023), these results broadly survive when we estimate the effects of the different variables in multivariate survival models, and when including extra control variables in the model, such as GDP per capita, expected GDP growth, the expected fiscal balance or government health expenditures.

Making debt relief initiatives more attractive to debtors

Next to helping us better understand past DSSI and Common Framework (non-)participation, our real option framing can be used to structure ongoing discussions on how to make future DSSI- or Common Framework-(like) debt treatments more attractive for eligible debtor countries to join – and to join earlier rather than later. The real option approach suggests different policy levers that international creditor fora, such as the G20 and Paris Club, or international financial institutions, such as the IMF and World Bank, could pull (see Figure 2).

Figure 2: A real option approach suggests different policy levers to encourage earlier requests for a debt treatment



Notes: The symbols/letters of the different levers refer to the parameters of the basic (Black-Scholes) option valuation model. For more details, see Cassimon, Essers and Presbitero (2023).

A first set of potential policy interventions works through the levers of increasing the expected benefits and/or reducing the expected costs of debtor participation in a debt treatment. This includes the possibility of temporary debt service standstills during debt restructuring negotiations (see Georgieva and Pazarbasioglu, 2021); increased emphasis on post-treatment growth (see Baqir, Diwan and Rodrik, 2023); the protection of new financing in the wake of a debt treatment; and technical assistance and capacity building support to lower the administrative costs of any debt restructuring.

Other policy proposals focus on the reduction of uncertainty for the debtor. For starters, a further clarification of the debt treatment procedures and an indicative timeline for the various process steps involved would help to anchor debtor countries' expectations. Various other technical issues need to be spelled out more clearly, like the expected perimeter of the debt eligible for treatment, or how the required 'comparability of treatment' will be assessed and enforced in practice (see Rivetti, 2022). Also, the likely consequences of a debt treatment for credit ratings and market access need to be better understood.

Several of these questions have been recently discussed in the Global Sovereign Debt Roundtable (GSDR), a new forum co-chaired by the IMF, World Bank and the G20 Presidency which brings together a select group of official bilateral creditors, private creditor representatives and debtor countries. The GSDR aims to build greater common understanding among key stakeholders involved in debt restructurings and finding solutions to current shortcomings (transcending specific debt treatment cases). While the GSDR may be able to resolve some of the technical problems raised, demonstration effects matter too. Above all, actual (and faster than hitherto) progress on the ongoing restructuring cases would boost the confidence of debtor countries in seeking debt treatments under the Common Framework and beyond.

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