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Feature

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# Global Debt Crisis Fuels Instability in Emerging Markets


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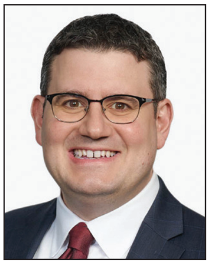
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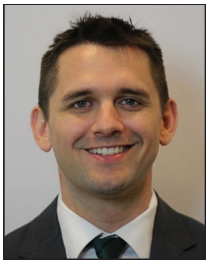
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Nearly 17 percent of emerging-market sovereign debt is trading at distressed levels, comprising approximately $237 billion of the $1.7 trillion owed by governments of developing countries to foreign lenders.[1] This magnitude of sovereign debt trading is indicative of economic unrest in the developing world and the resulting allocation of limited resources to food, medicine and fuel rather than bond coupons. This paradigm has emerged prominently in Sri Lanka over the past several months, as the nation defaulted on its debt and told creditors that it would not repay without an agreement to restructure its obligations.[2] Despite this strategy, protests recently erupted over the country's inability to import goods and provide essential services.[3] Protesters stormed the prime minister's residence and converged on the residence of the president, who resigned over his handling of the economy before temporarily fleeing the country.[4]

Investors and businesspersons with interests in international business dynamics should take note that the crisis in Sri Lanka is neither self-contained nor isolated. On Aug. 11, 2022, Sri Lanka acceded to pressure from the U.S. and India to cancel (or at least postpone) the planned docking of a Chinese naval ship at a key Sri Lankan port.[5] Commentators have noted that there are underlying strategic motivations for preventing China from establishing a military foothold close to the Middle East — just as China bristles at the presence of U.S. naval ships in the region.[6]

As other countries, including Ghana, Argentina, Ukraine, Egypt and Pakistan, run similar risks of default and the associated political strife, they not only endanger foreign investment but become petri dishes for geopolitical maneuvering and widespread economic ripple effects.[7] The starting point for addressing these challenges is understanding the roots of the problem: (1) Why are certain developing countries unable to pay back their debts, and (2) how were they able to borrow so much in the first place?

## Understanding the Challenges that Developing Countries Face When Paying Back Their Debts

Governments developing the infrastructure of their respective countries finance these projects by borrowing money, typically by issuing bonds or notes that may be sold to individuals, organizations or even governments of other countries. Like private debt, the debt accrued by governments, often called "sovereign debt," is repaid with interest at a rate that reflects the risk of default. To determine a government's risk of default, credit-rating agencies will consider numerous factors, including the extent of a government's outstanding debts and its

1 Sydney Maki, "Historic Cascade of Defaults Is Coming for Emerging Markets," Bloomberg (July 7, 2022), *available at* bloomberg.com/news/articles/2022-07-07/why-developing-countries-are-facing-a-debt-default-crisis (unless otherwise specified, all links in this article were last visited on Oct. 19, 2022).

2 Peter Hoskins, "Sri Lanka Defaults on Debt for First Time in Its History," BBC (May 20, 2018), *available at* bbc.com/news/business-61505842.

3 "Sri Lanka Stops Fuel Supply to Non-Essential Services as Crisis Worsens," CNN (June 27, 2022), *available at* cnn.com/2022/06/27/asia/sri-lanka-fuel-non-essential-services-intl-hnk/index.html.

4 Rhea Mogul, "He Fled and Went into Hiding. Why Has Sri Lanka's Deposed Leader Come Back Now?," CNN (Sept. 4, 2022), *available at* cnn.com/2022/09/02/asia/gotabaya-rajapaksa-return-sri-lanka-intl-hnk-dst/index.html.

5 Gerry Shih, Hafeel Farisz & Niha Masih, "Chinese Navy Ship Near Sri Lanka Sparks Diplomatic Standoff," *Wash. Post* (Aug. 11, 2022), *available at* washingtonpost.com/world/2022/08/11/chinese-ship-sri-lanka-hambantota.

6 Teresa Chen, Alana Nance & Han-ah Sumner, "Water Wars: U.S. Counters Beijing's Reaction to Pelosi Visit with $1.1 Billion Arms Sale to Taiwan," *LawFare Blog* (Sept. 28, 2022), *available at* lawfareblog.com/water-wars-us-counters-beijings-reaction-pelosi-visit-11-billion-arms-sale-taiwan.

7 Marc Jones, "The Big Default? The Dozen Countries in the Danger Zone," Reuters (July 15, 2022), *available at* reuters.com/article/markets-emerging-debt-graphic-idCAKBN2OQ0YU.

ability to repay those debts *vis-à-vis* an adequate tax base.[8] Because these factors will vary across different countries, not all sovereign debt is equal.

For example, the U.S. is an economic powerhouse with a sophisticated infrastructure and a large gross domestic product (GDP). Although the U.S. carries substantial debt, lenders believe that the U.S. is more than capable of raising sufficient revenue to service its debts, which is why U.S. debt is popularly called "risk-free."[9] Sri Lanka, on the other hand, does not have a sufficient tax base to support its outsized debts.[10]

Beginning in 2009, Sri Lanka's government began an ambitious spending spree on infrastructure, building airports, stadiums, roads and ports.[11] Betting that these projects would stimulate tremendous growth in its economy, the government borrowed extensively to finance construction and simultaneously cut taxes to attract business to the region.[12] Ultimately, this strategy did not generate returns sufficient to service the debt accrued, and the government began taking on new debt simply to service the old debt.[13] This began the downward cycle toward a sovereign debt crisis.

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As governments begin borrowing new money to pay off prior debt, lenders may start to seriously question a government's ability to pay its growing sovereign debt. To offset the risk of default, lenders will likely ask for higher interest rates on future debt. As interest rates rise, debt service becomes a greater and greater burden on government resources. Eventually, the government may be incapable of rolling over its debt and will be forced to default. In 2020, approximately 71 percent of Sri Lanka's revenue was allocated to debt service.[14]

Compounding the problem for many developing countries are the effects of the COVID-19 pandemic, which has bottlenecked supply chains and curbed international tourism. Most recently, the war in Ukraine also put pressure on countries that heavily rely on imported fuel and food from the region.[15] Further adding to the trauma is the recent appreciation of the U.S. dollar (caused in part by the Federal Reserve's increase in interest rates). The dollar is the world's reserve currency and is used internationally to price goods and settle accounts, and much of the debt of developing countries is denominated in dollars.[16]

For example, in Sri Lanka, 64.6 percent of its foreign debt is owed in dollars.[17] In many developing countries, revenues are realized in the local currency, and due to the strengthening of the dollar, local revenues are reduced in value relative to the dollars owed to foreign creditors. Further, the Federal Reserve's recent interest rate increases make the dollar more alluring to potential investors, resulting in less investment in developing countries.[18]

## Factors Permitting the Accrual of Inordinate Debt

All of this raises a question: How were these countries able to borrow so much in the first place? Unfortunately, there is more than one answer. Following the global financial crisis in 2008, central banks in industrialized countries significantly slashed interest rates. On the hunt for better returns from sovereign debt, lenders turned to lending opportunities with developing countries, such as Sri Lanka or Ghana.

Another explanation for the increased debt of developing countries is a practice critics call "debt-trap diplomacy," a strategy China is often associated with. According to critics, China lends to developing countries in knowingly unsustainable amounts; these loans are often issued for the development of infrastructure that could have important military applications (*i.e.*, ports, roads and airports).[19] Once they are unable to service their debt obligations, targets of debt-trap diplomacy are confronted by a lender (China) asserting control over the strategic assets as part of its strategy to internationalize its economic and military power. Regardless of whether China is deliberately "trapping" countries with debt, the extent to which China is lending to developing countries recently prompted German Chancellor Olaf Scholz to declare that "the next big debt crisis in the global South will stem from loans that China has granted around the world."[20]

A recent example of debt-trap diplomacy at work can be found in the recent events involving a Sri Lankan port. China financed the port for

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8 Neil Kosciulek, "Emerging-Markets Sovereign Bonds: A Risk Worth Taking?," Morningstar (April 27, 2021), *available at* morningstar.com/articles/1034288/emerging-markets-sovereign-bonds-a-risk-worth-taking.

9 E. Napoletano, "The Risk-Free Rate," *Forbes* (June 28, 2022), *available at* forbes.com/advisor/investing/risk-free-rate.

10 *See, e.g.*, Anusha Ondaatjie, "Sri Lanka Proposes Return to Higher Tax Rates to Win IMF Loan," Bloomberg (May 31, 2022), *available at* bloomberg.com/news/articles/2022-05-31/sri-lanka-says-tax-cuts-sparked-crisis-raises-rates.

11 Wade Shepard, "Sri Lanka's Debt Crisis Is So Bad the Government Doesn't Even Know How Much Money It Owes," *Forbes* (Sept. 30, 2016), *available at* forbes.com/sites/wadeshepard/2016/09/30/sri-lankas-debt-crisis-is-so-bad-the-government-doesnt-even-know-how-much-money-it-owes.

12 Uditha Jayasinghe, "Crisis-Hit Sri Lanka Hikes Tax Rates to Maximize Govt Revenue," Reuters (May 31, 2022), *available at* reuters.com/markets/rates-bonds/crisis-hit-sri-lanka-hikes-tax-rates-maximise-govt-revenues-2022-05-31.

13 *See* Maki, *supra* n.1.

14 "Fitch Affirms Sri Lanka at 'CCC,'" Fitch Ratings (June 14, 2021), *available at* fitchratings.com/research/sovereigns/fitch-affirms-sri-lanka-at-ccc-14-06-2021.

15 *See* Jayasinghe, *supra* n.12.

16 Patricia Cohen, "The Dollar Is Strong. That Is Good for the U.S. but Bad for the World," *N.Y. Times* (Sept. 26, 2022), *available at* nytimes.com/2022/09/26/business/economy/us-dollar-global-impact.html (subscription required to view article).

17 Benjamin Norton, "Real Debt Trap: Sri Lanka Owes Vast Majority to West, Not China," *Multipolarista* (July 11, 2022), *available at* multipolarista.com/2022/07/11/debt-trap-sri-lanka-west-china.

18 *See* Cohen, *supra* n.16.

19 *Compare* Philip Wen, "China's Lending Comes Under Fire as Sri Lankan Debt Crisis Deepens," *Wall St. J.* (Jan. 18, 2022), *available at* wsj.com/articles/deepening-debt-crisis-in-sri-lanka-stokes-controversy-over-chinese-lending-11642514503, *with* Deborah Brautigam & Meg Rithmire, "The Chinese 'Debt Trap' Is a Myth," *The Atlantic* (Feb. 6, 2021), *available at* theatlantic.com/international/archive/2021/02/china-debt-trap-diplomacy/617953.

20 Miranda Murray & Kristi Knolle, "China's Lending Policy Could Trigger Debt Crisis — Germany's Scholz," Reuters (May 27, 2022), *available at* reuters.com/article/germany-religion-scholz/chinas-lending-policy-could-trigger-new-debt-crisis-germanys-scholz-idUSKCN2ND11V.

Sri Lanka in 2012, but took control of the facility in 2017 as a result of Sri Lanka's inability to make debt payments.[21] Shortly thereafter, U.S. Vice President Mike Pence predicted that the port "may soon become a forward military base for China's growing blue-water navy."[22] Years later, Sri Lanka's debt crisis has substantially worsened and the maneuvering has escalated from provocative predictions to negotiations among multiple major world powers regarding the docking of naval ships at a small, distressed country in a strategically important location.

Although critics debate the incentives that drive increased lending to developing countries, the effect is nonetheless one that will lead to sovereign-debt crises. To understand the magnitude, one should consider that over the past 15 years, Sri Lanka's sovereign debt has multiplied from approximately $14 billion to more than $50 billion.[23] Regardless of the driving forces behind excessive sovereign debt, here is the remaining question: What options are available for the honest-but-unfortunate sovereign debtor?

## The Debt-Restructuring Toolkit Available to Sovereign Debtors

In the U.S., the Bankruptcy Code serves as a toolkit filled with precision instruments with which debtors may upright themselves from grim financial circumstances to a brighter, more sustainable future. On the international scene, a robust restructuring regime does not exist, which splinters the sovereign debtor's negotiations with different creditor groups, making consensus difficult to reach. Similarly, a fragmented class of creditors can embolden a sovereign debtor to fully drive the restructuring process and force onerous compromises on the creditors.

For example, during the height of the global financial crisis in 2008, Ecuador declared two government bonds to be "illegitimate," suspending payments before buying the bonds back at 35 cents on the dollar and subsequently retiring them.[24] Conversely, in 2005, holdout creditors (comprised of U.S. hedge funds) rejected Argentina's debt-restructuring plan, which contemplated a haircut of 30 cents on the dollar, leading to a 14-year dispute, during which time the country was locked out of capital markets and suffered severe social unrest. Ultimately, the holdout creditors agreed to a haircut of only 75 cents on the dollar.[25]

However, there are resources to which the sovereign debtor may avail itself, including financing from international bodies such as the International Monetary Fund (IMF). The IMF's main role is to act as a lender of last resort to financially distressed countries. To that end, the IMF creates standards to guide good-faith negotiations between creditors and debtors and acts as an oversight body that determines the debt relief needed by a debtor to implement a successful restructuring. The IMF monitors the debt-restructuring process and provides financing to distressed governments as needed and at 0 percent interest.

As a condition of lending, the IMF requires borrowers to adhere to certain guidelines designed by the IMF to right-size the borrower's finances. In Sri Lanka's case, the government recently agreed to raise taxes on higher-income individuals and corporations, among other changes, in order to access a $2.9 billion loan from the IMF.[26] Despite its benefits, the IMF still has limitations and is not an analog to the powerful Bankruptcy Code. Due to the IMF's limited scope, the terms of the debt instruments themselves have evolved to reflect the possibility of a necessary restructuring.

Sovereign debtors and their creditors, when negotiating debt instruments, are increasingly including specific terms and conditions that contemplate a possible future restructuring. For example, these debt instruments increasingly feature collective-action clauses (CACs), which provide that if a supermajority of bondholders (often 75 percent) vote in favor of a restructuring, the minority bondholders are bound by this decision.[27] CACs have evolved over time and now apply across multiple bond issuances, thus a CAC in one bond issuance is effective to subsequent bond issuances. The forecasted effect of a CAC provision is an elimination of the problem of holdout creditors in future sovereign-debt restructurings.

Another trend that is becoming more commonplace in sovereign debt instruments is the inclusion of a creditors' committee provision. Although creditors' committees are common in the U.S., they are much less utilized in sovereign debt restructurings. In addition, because there is no U.S. Trustee available to convene a creditors' committee in sovereign-debtor cases, their formation is left to the parties to negotiate. Therefore, the parties may incorporate an "engagement clause," which commits the parties to designate a creditors' committee with which the sovereign debtor will negotiate in good faith.[28] Relative to the Bankruptcy Code, these provisions appear to offer little comfort in the way of cohesion and predictability, but collective-action mechanisms (such as those previously outlined) are nonetheless strong tools that aid a sovereign debt restructuring.

## Takeaways

On the horizon, the eurozone may experience a resurgence of sovereign debt crises not seen since the Great Recession. For example, Greece's government debt-to-GDP ratio, which stood at 127 percent in 2009, reached 211 percent in 2020. In addition, Italy's mountain of debt recently reached €2.88 trillion, which eclipses by far the €300 billion debt accrued by Greece prior to its sovereign debt crisis in 2009.[29] Current trends suggest that Europe's problems will

21 *See* Shih, *supra* n.5.

22 "Remarks by Vice President Pence on the Administration's Policy Toward China," Trump White House Archives (Oct. 4, 2018), *available at* trumpwhitehouse.archives.gov/briefings-statements/remarks-vice-president-pence-administrations-policy-toward-china.

23 *See* "Sri Lanka External Debt 1970-2022," Macrotrends, *available at* macrotrends.net/countries/LKA/sri-lanka/external-debt-stock.

24 Naomi Mapstone, "Ecuador Defaults on Sovereign Bonds," *Fin. Times* (Dec. 12, 2008), *available at* ft.com/content/7170e224-c897-11dd-b86f-000077b07658 (subscription required to view article).

25 Daniel Bases, Richard Lough & Sarah Marsh, "Argentina, Lead Creditors Settle 14-Year Debt Battle for $4.65 Billion," Reuters (Feb. 29, 2016), *available at* reuters.com/article/us-argentina-debt/argentina-lead-creditors-settle-14-year-debt-battle-for-4-65-billion-idUSKCN0W2249.

26 Gerry Shih, Niha Masih & Hafeel Farisz, "Sri Lanka Reaches Tentative Deal with IMF for $2.9 Billion Bailout," *Wash. Post* (Sept. 1, 2022), *available at* washingtonpost.com/world/2022/09/01/sri-lanka-imf-bailout.

27 "Progress Report on Inclusion of Enhanced Contractual Provisions in International Sovereign Bond Contracts," IMF (September 2015), *available at* imf.org/en/Publications/Policy-Papers/Issues/2016/12/31/Progress-Report-on-Inclusion-of-Enhanced-Contractual-Provisions-in-International-Sovereign-PP4983.

28 Lee Buchheit, Guillaume Chabert, Chanda DeLong & Jeromin Zettelmeyer, "The Sovereign Debt Restructuring Process," IMF (Sept. 4, 2018), *available at* imf.org/-/media/Files/News/Seminars/2018/091318SovDebt-conference/chapter-8-the-debt-restructuring-process.ashx.

29 Elisabeth Krecké, "The Euro Area Could Be at Risk of a New Sovereign Debt Crisis," GIS (July 6, 2022), *available at* gisreportsonline.com/r/debt-crisis.

only grow worse as Russia's invasion of Ukraine prompted European nations to invoke costly sanctions and pursue expensive alternatives to Russian energy, while inflation simultaneously accelerates.

Regardless of the impending troubles in Europe, the trend seems clear that more and more budgets of developing nations will be allocated to debt service, which will lead to a decrease in quality services and a corresponding fall in economic output. Austerity and raising taxes will only go so far, and as a result, foreign investors should anticipate increasing demands to restructure sovereign debt obligations. Sovereign-debt restructuring — like corporate-debt restructuring — is typically bitter medicine, but it may also be the only practical solution for rehabilitating and enabling the sovereign debtor to fund creditor recoveries while averting humanitarian crises. abi

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