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An effective global debt restructuring framework remains an urgent need, and a supportive element could consist of a change of sovereign rating practices. By integrating severity of financial losses in a default episode, rating agencies could better serve investors, while also incentivising overleveraged governments to seek debt relief. As interest rates rise, the world economy slows and food prices mount, procrastination around debt relief would result in avoidable humanitarian crises.

A more comprehensive debt-restructuring framework is required

Africa's debt crisis has escalated. Public-debt ratios have reached the highest levels in two decades, exacerbated by the pandemic and Russia's war in the Ukraine. Half of all economies of the region are in or at high risk of debt distress according to the International Monetary Fund. A looming food crisis in many countries will make matters much worse. Sovereign debt crises and disorderly defaults are likely.

Delaying the resolution of debt distress raises the spectre of systemic sovereign debt crises. Creditors and borrowers alike keep kicking the can down the road. An opportunity may already have been missed. The unifying Covid-19 crisis has not been used to address Africa's debt more systematically.

The urgency of this crisis is accentuated by many sovereign borrowers' reliance on Eurobond market financing. African bond yields have risen to 12%, underlining a progressive loss of international market access. G4 central banks rapidly tightening rates strains the sustainability of debt of emerging economies, precipitating capital outflows and exchange-rate depreciation. In June, non-resident portfolio flows to emerging markets have been falling for four months in a row. The Institute of International Finance estimates that net bond funding by non-residents to emerging markets (ex-China) will drop this year by over 50%. It is hard to see how Africa would not be disproportionately affected.

A "Common Framework for Debt Treatments beyond the DSSI" of the G20 and Paris Club, announced during November 2020, represented a step in the right direction. However, the Common Framework's emphasis upon short-run debt service savings renders it an inadequate template for comprehensive debt relief. And, to date, it has failed to achieve even its own more limited aspirations.

A more comprehensive debt-restructuring framework is called for. We must not repeat mistakes of the Latin America debt crisis, in which the misdiagnosis and playing for time brought a "lost decade" for the region. The 1980s crisis was tackled effectively only by 1989 with the Brady Plan, which included debt write-offs as a central element. It took the international community seven years to get to that point and only after having exhausted a litany of erroneous liquidity prescriptions, trying to address what was fundamentally a solvency crisis. We must not repeat this mistake. What was a calamity for Latin America would be a tragedy for Africa.

African states need to be incentivised to ask for restructuring of their debt overhang. Only three nations (Chad, Ethiopia, and Zambia) have requested support under the Common Framework. Other countries remain on the fence, partly because of concerns about a negative response from credit rating agencies. Rather than being paralysed by an unjustified fear of stigmatisation, indebted African governments ought to push for more comprehensive relief.

A loss-given-default sovereign rating framework could incentivise comprehensive debt restructuring

Anxiety around rating downgrades is a key factor why governments do not restructure their liabilities. Ghana's Minister of Finance, Ken Ofori-Atta, put, what is a frequent sentiment among debtors, most dramatically: "Are the rating agencies beginning to tip our world into the first circle of Dante's Inferno?" However, sovereign credit rating downgrades – such as Moody's of Ghana earlier in this year, rather than an example of institutional bias against Africa, ought to be seen as a call to action for debtors to reform economic and debt management practices. For Ghana, interest payments amounting to half of government revenue hinder social and economic development. Rating agencies have done their duty by indicating the risk around Ghanaian credit having risen.

Nevertheless, rating agencies should as well look afresh at their methodologies. Ratings are currently measuring the perceived probability of default. How much creditors will lose in the process plays a more limited role in ratings, nor is there a central role for consequences of ratings for national development. The ratings merely rank sovereigns by the expected likelihood that they will miss some payment, however small such losses might be. Amid calls for better alignment of ratings decisions with international development objectives, a loss-given-default (LGD) sovereign rating framework would be a significant step forward bringing such alignment about.

A pre-emptive debt restructuring reduces the likelihood of future disorderly default and deeper losses. Under an LGD rating framework, such a purposeful restructuring could result in a short-run credit rating upgrade, not a rating downgrade. The reason is that an earlier debt restructuring will curtail ultimate financial losses for creditors compared with a currently prevailing strategy of governments hanging on until the bitter end. Under an LGD methodology, the debtor's sovereign rating would fare better under such an early debt treatment and future socioeconomic crisis would be reduced. Such a rating approach could therefore incentivise, rather than discourage, a purposeful and comprehensive renegotiation of debt.

An LGD approach could as well provide better service to ratings users: what investors are interested in is not only whether they may lose some money, but how much they might lose. Current sovereign ratings are nearly silent on this matter. Only LGD ratings could provide this information. LGD ratings could also partially alleviate another bottleneck – pro-cyclicality of rating actions during crises – improving the investment appeal of a country during sensitive phases of debt renegotiation and reducing governments' trepidation of prolonged loss of access to debt markets.

Rating agency Moody's has adopted a loss-given-default framework but only for ratings near or in default. S&P Global Ratings once published estimated sovereign recoveries, which are the flipside of LGD. But after a few years, they quietly dropped this approach. It is now time to revive it. Regulators need to take action to lead rating agencies down this road. It will help creditors and debtors reaching debt restructuring agreements.

The time has come for fresh thinking and to be bold. Doing so would make debt relief more palatable for Africa and for all.

Note: The views expressed in this SOAS CSF Briefing are those of the authors. They do not necessarily represent those of of Scope Ratings GmbH, LBBW Bank, SOAS or the SOAS Centre for Sustainable Finance.

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