HIGHLIGHTS from Spotlight 1:
An ounce of prevention, a pound of cure: Averting and dealing with sovereign debt default

Key Points

- *South Asia has the highest average government debt ratio among emerging market and developing economy regions and four countries are rated in or near sovereign debt distress.*
- *The current juncture resembles the circumstances under which the majority of past defaults occurred. Past defaults often failed to lower government debt or borrowing costs in a lasting manner.*
- *Some countries have reduced their default risk by predominantly borrowing from domestic creditors. However, this comes at a price: high domestic shares of government debt have been associated with higher borrowing costs and lower bank credit to the private sector.*
- *With the external environment likely to remain challenging over the next several years, it is important to adopt policies to accelerate sustainable growth and shore up fiscal positions.*

High debt in South Asia. At 86 percent of GDP on average in 2022, South Asia has the highest average government debt-to-GDP ratio among emerging market and developing economy (EMDE) regions. Four South Asian countries are already rated by the Moody's ratings agency or by the IMF/World Bank Debt Sustainability Analysis as in or near sovereign debt distress.

Heightened risk of debt default. Past experience suggests that the current economic environment heightens risks of debt default. The vast majority of defaults since 1979 have taken place within a year of the end of a U.S. monetary policy tightening cycle, in countries without fiscal rules, and in countries with above-median government debt-to-GDP ratios (Figure 1).

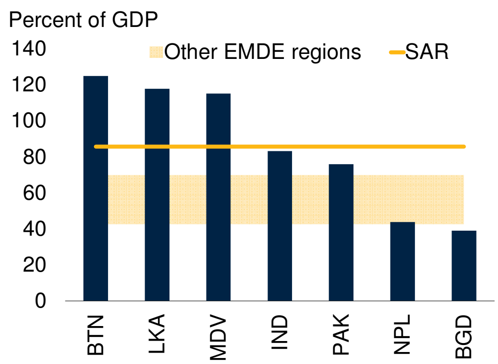
Successful versus unsuccessful defaults. Historically, fewer than two-thirds of sovereign debt defaults reduced the government debt-to-GDP ratio or the effective interest rate on government debt five years later. Sovereign debt defaults accompanied by above-median debt restructurings, domestic or global growth accelerations, and fiscal consolidations more frequently succeeded in reducing government debt-to-GDP ratios or borrowing costs over the following five years.

Mitigating factors in South Asia. South Asia's above-average growth mitigates some of the default risks arising from its above-average government debt-to-GDP ratios. Debt risks in some South Asian countries may also be mitigated by the high share of government debt (on average, more than half) that is owed to domestic creditors. In the past, predominantly domestically financed government debt runups were less likely to end in default than externally financed ones. However, above-median shares of government debt have been associated with higher government borrowing cost, lower debt maturities, and smaller shares of bank credit to the private sector.

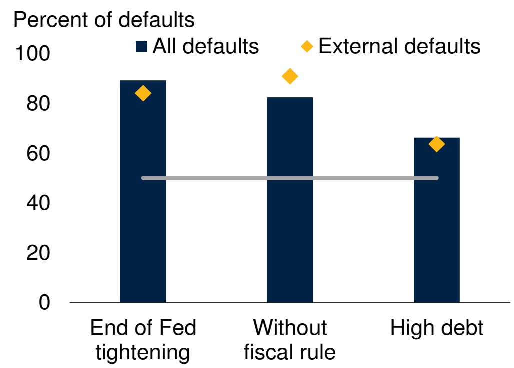
Policy priorities. Slowing global growth, elevated global borrowing costs, and high government debt levels increase the probability of sovereign debt default, and reduce the likelihood that sovereign debt defaults, when they occur, will be successful. But the historical record also suggests that measures to boost domestic growth and put fiscal positions on a sounder footing will improve the chances of success.

Figure 1. Government debt challenges in South Asia

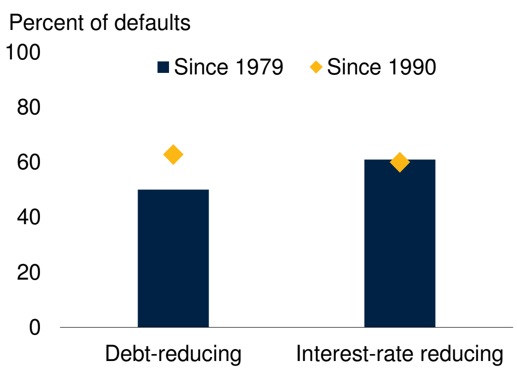
A. Government debt, 2022



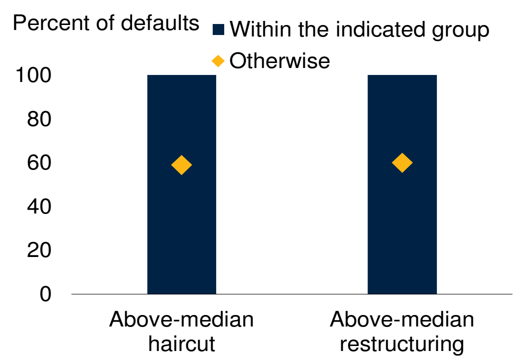
B. Shares of defaults in the most common circumstances



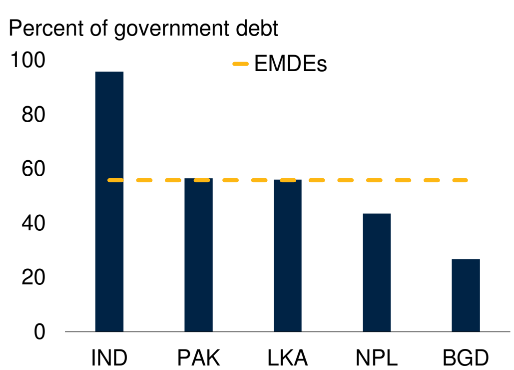
C. Share of successful defaults



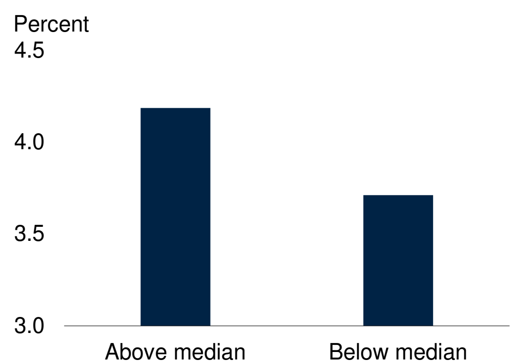
D. Share of debt-reducing external defaults, by restructuring terms



E. Share of domestic debt



F. Effective government interest rates, by domestic share of government debt, 2010–22



Sources: Asonuma and Trebesch (2016); Cruces and Trebesch (2013); Erce, Mallucci, and Picarelli (2022); IMF (various staff reports); Kose et al. (2022); World Bank.

A. Unweighted averages (at 2010–19 average prices and market exchange rates). Yellow shaded area indicates range of GDP-weighted averages of other EMDE regions. Yellow line indicates GDP-weighted average for South Asia (SAR).
B. Share of all defaults that occurred in the year of the end of U.S. Federal Reserve tightening cycle as defined in World Bank (2022) or in the subsequent year. Share of all defaults that occurred in countries without a fiscal rule or in countries with above-median (across the full EMDE sample) government debt at the time of default. All defaults include defaults on domestic and external creditors; external defaults refers to defaults on external creditors. Gray line denotes 50 percent.
C. Default episodes are differentiated between those that featured lower ("Successful") or higher ("Unsuccessful") government debt-to-GDP ratios or effective interest rates on government debt five years after the default than in the year of default. Based on 177 domestic or external default episodes in 64 EMDEs during 1979–2018.
D."Above-median restructuring" indicates above-median size of restructured debt in percent of total government debt at time of default, as calculated by Cruces and Trebesch (2013). "Above-median haircut" indicates above-median market haircut at time of default, as calculated by Cruces and Trebesch (2013). Sample includes 88 external debt defaults since 1979, of which 43 occurred from 1990 onwards.
E. Latest data are for 2021. Domestic government debt for Nepal, Pakistan, and Sri Lanka (from various IMF Article IV staff reports) is domestic currency-denominated debt; for Bangladesh and India (from Kose et al. 2022) domestic government debt is debt held by domestic residents. Unweighted average for EMDEs.
F. Unweighted averages for 2010–22 for EMDEs with above-median or below-median share of domestic debt of government debt.