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Rebuttal to Carmen Reinhart and Kenneth Rogoff's proposal that Emerging Markets suspend debt payments

By Jan Dehn

The Reinhart-Rogoff proposal

In a recent article in Project Syndicate, prominent academics Carmen Reinhart and Kenneth Rogoff put forward a proposal for a moratorium on Emerging Markets (EM) external debt on the grounds that *"there will be no alternative to ... default."*[1] They argue that the fallout from coronavirus will be *"far worse than anything we have seen in China, Europe, or the United States"*.

According to the two academics, *"the worst of the pandemic is not even expected until later this year"* and the resulting shocks to global trade and commodities will push EM into *"food shortages"*, a *"humanitarian crisis"* and *"most serious financial crisis since at least the 1930s"*.

Crying wolf

This is not the first time that Carmen Reinhart has cried wolf. As recently as May 2018, she argued in a Bloomberg interview that rising US inflation and US rate hikes would sink EM, because *"more than two-thirds of emerging-market debt is dollar-denominated"*.[2] At the time, we issued a brief rebuttal to Reinhart's doomsday predictions, which pointed out some of the more glaring mistakes in her analysis, particularly the erroneous claim that external debt makes up two thirds of EM debt.[3] Since then US inflation has turned out to be a complete non-issue and the Fed has cut the funds rate to zero and embarked on 'QE infinity'.

Enter coronavirus

Now Reinhart and Rogoff have latched onto a new harbinger for the demise of EM debt, namely the coronavirus outbreak. They postulate that the coronavirus situation is so grave that *"any but the most creditworthy"* country – and here they explicitly refer to *"all but AAA rated sovereigns"* – will *"need"* a moratorium. Powerful stuff. After all, not a single EM country except Singapore is rated AAA.[4] Even the United States is not rated AAA.[5] Reinhart and Rogoff are therefore, in effect, proposing that all EM countries default. This is preposterous, in our view. The following sections explain why an EM-wide moratorium is a bad idea and proposes a better way forward to help the subset of vulnerable EM sovereigns.

No need for debt moratoria in most EMs

The first objection to the Reinhart-Rogoff proposal is that it fails to recognise the composition of and credit quality within the EM fixed income asset class, which means that many EM countries simply do not need to default. At USD 26.5trn, EM fixed income now accounts for nearly a quarter of the global bond market and comprises more than 150 bond markets in four individual benchmark indices (hard and local currency, corporate and sovereign debt). The Dollar-denominated sovereign debt universe, which is of particular concern to Reinhart and Rogoff, is only about USD 1.3trn in size, or a mere 5% of the total EM bonds outstanding. This debt has been issued by no fewer than 74 individual sovereigns and a large number of affiliated quasi-sovereign corporations. This means that

[1] See: *"Suspend Emerging and Developing Economies' Debt Payments"*, Project Syndicate https://www.project-syndicate.org/commentary/suspend-emerging-and-developing-economies-debt-payments-by-carmen-reinhart-and-kenneth-rogoff-2020-04

[2] See: https://www.bloombergquint.com/markets/harvard-s-reinhart-says-emerging-markets-worse-than-08-crisis

[3] See: *"A gentle rebuttal to Carmen Reinhart"*, Weekly investor research, 29 March 2018.

[4] Based on Standard & Poor's ratings as of 14 April 2020.

[5] Standard & Poor's rate the following sovereigns AAA: Germany, Netherlands, Denmark, Singapore, Sweden, Norway, Switzerland, Australia, Lichtenstein, Canada and Luxembourg.

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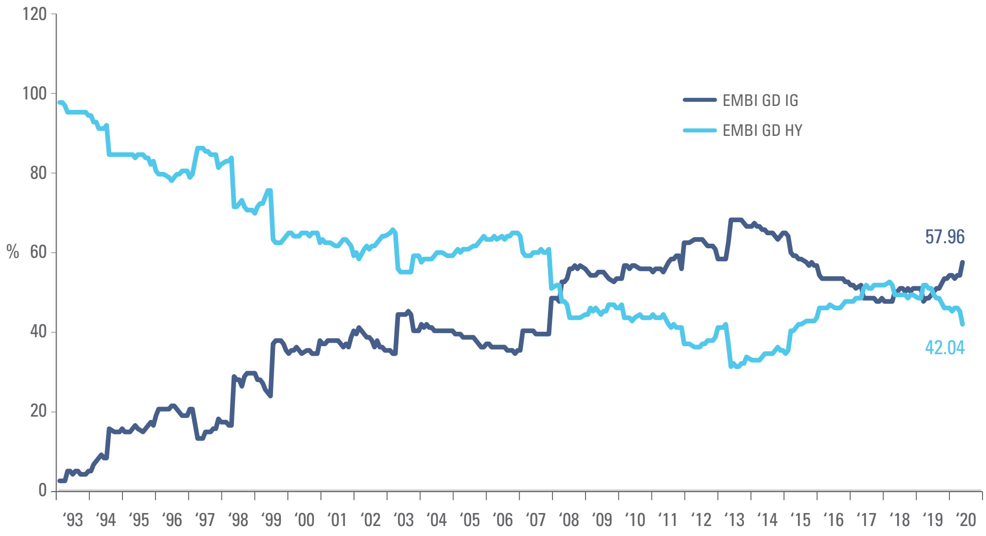
many of the countries, which have issued external debt do not actually have very much of it and to the extent they have it a big chunk is very long-dated. As of the end of March 2020 just shy of 58% of outstanding external debt was rated investment grade, that is, high quality paper (Figure 1).

Fig 1: **EM sovereign Dollar debt credit ratings (% share of EMBI GD)**

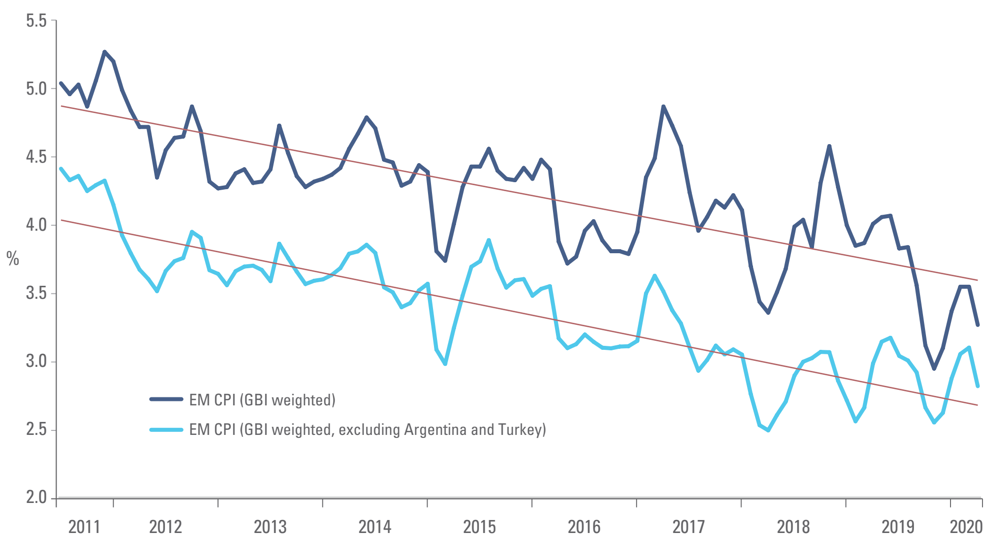


Source: Ashmore, Bloomberg. Data as at 31 March 2020.

Local markets provide room to handle shocks

The Reinhart-Rogoff proposal also appears oblivious to the fact that EM sovereigns today obtain about nine times more financing in their local markets than in external debt markets. The existence of local financing options means that they do not depend on foreign capital the way they did a few decades ago. Moreover, they now have far more domestic policy options available than they used to have. Indeed, when future historians look back upon the Coronavirus Crisis of 2020 they are likely to recognise that the most important lesson was that EM was able to deploy a far wider range of new instruments than hitherto thought possible, including liquidity injections, credit lines, repo facilities, debt buybacks, and even QE. These instruments now make EM local bond markets very similar to bond markets in developed countries. Countries with local market access generally do not need a moratorium; they can even do QE if liquidity in their bond markets is impaired. Besides, years of successful inflation targeting now bears fruit: as Figure 2 shows EM inflation hovers near all-time lows, while real 5-year yields on (mostly investment grade) government bonds currently sit at a comfortable 2.3%. This means that EM central banks have room to cut rates if debt becomes a deflationary drag.

Fig 2: **EM Consumer Prices Index inflation (weighted by the GBI-EM GD)**



Source: Ashmore, Bloomberg. Data as at 31 March 2020.

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Moratoria do not help anybody!

Our biggest objection to the Reinhart and Rogoff moratorium idea is simply that it does not help anyone other than the most vulnerable EM countries (more on that below). Moratoria make it more complicated for countries to access capital in the short term, precisely when they need resources the most to buy medical resources and provide liquidity to ameliorate the economic shock. Debt relief also creates a serious moral hazard problem by benefitting the most prolific borrowers. If moratoria and resulting sharp losses for bond holders become the standard policy response to external shocks, then banks and creditors in general will sharply raise the cost of funding for EM countries, particularly for frontier economies in Sub-Saharan Africa, the Caribbean, and East Asia, which are precisely the countries, which are most finance constrained to begin with and which need infrastructure investment the most. Moratoria would also penalise countries within this group with good track records in the Eurobond markets.

Additionally, moratoria would perversely impact the development of domestic bond markets in many countries. Subsidiaries of international banks and local banks would reduce operations in these countries and long-term saving rates would decline, thus eroding the capacity to ever develop local bond markets and become financially self-sufficient, such as Brazil, Chile or South Africa.

Incredulity

We think most governments in EM countries with established domestic bond markets would strongly reject the Reinhart-Rogoff's proposal for EM wide moratoria. They do not find the idea of defaulting on external debt in the least appealing, because it comes with considerable stigma. Quite apart from the fact that many EM countries do not need to default, they view Dollar yield curves as an essential part of the financial infrastructure to help corporates to price bonds.

EM countries today are generally aware of the value of having choices in their sources of finance. They want to keep open all avenues for accessing capital, whether it be bilateral or multilateral, public or private markets. Wary of being placed into any type of dependency on conditionality imposed by International Financial Institutions (IFIs), why would they opt to default and become beholden once again to the IMF or the World Bank?

Vulnerable EMs

What, if anything, can be used from the Reinhart and Rogoff proposal? Emphatically, we do not agree with the idea of encouraging EM countries to default. After all, many EM countries have worked hard to gain a toehold in financial markets, so why force them to give it up at the first sign of market volatility?

Still, Reinhart and Rogoff are right to highlight that vulnerabilities do exist in a smaller sub-set of EM countries. The countries in this group tend to be smaller and typically less developed economies without local markets of sufficient depth and breadth to meet all their financing requirements. Since they depend on issuing bonds overseas or borrowing from multilaterals and banks in order to invest and fund their budgets, they are vulnerable to the severe market failures that occasionally occur during major risk aversion events in global markets. During such risk aversion events they tend to get cut off from financing precisely when they need market access the most, often without any regard to the quality of their policies or their economic fundamentals. Granted, this happens to most EM countries during bouts of risk aversion, but this particular sub-group is especially exposed, because it has no domestic sources of finance.

A better way

We believe that there is a far better way forward than encouraging such countries to default. For the 'payers' and the countries with good economic track records within this subgroup, there should be immediate access to multilateral facilities, such as the IMF's Rapid Financing Instrument (RFI), when global market failures occur.

In the current context of coronavirus, World Bank expertise should be deployed to build healthcare infrastructure at a rapid clip. The IMF has already pledged to expand the funding to frontier markets from USD 50bn to USD 100bn, which is a step in the right direction, but in our view the entire framework for supporting this vulnerable group of countries must be placed under review.

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A new framework for dealing with global market failures

Specifically, it is high time that IMF and other IFIs recognise that global markets regularly fail dramatically. An entirely new set of 'global macro prudential' policy instruments should be developed for deployment precisely during such market failures.

These new instruments can be thought of as the international equivalent of every central bank's macro prudential tool set for dealing with domestic market failures. Also, IFIs with specific mandates to support longer-term development objectives, such as the World Bank, should place far greater emphasis on promoting the development of local bond markets in the poorest EM countries, including encouraging pension reform, issuance of local bonds, index inclusion, setting up market makers, etc.

Conclusion

Prominent academics, such as Carmen Reinhart and Kenneth Rogoff have a special responsibility to ensure they offer the best possible advice. After all, their views are taken seriously and never more so than during crises, when policy makers and investors alike lack conviction. When they cry wolf in the middle of major market dislocations they only exacerbate herd dynamics and worsen already serious market failures, which hurt most vulnerable countries in the world.

Reinhart and Rogoff are right to draw attention to these vulnerable countries. However, it is important to recognise that these countries only make up a subset of EM and in our view it is outright wrong to call for all of them to default.

The time-honoured way to handle transitory shocks is to employ credit prudently, that is, to borrow. This speaks for putting in place measures that enable the most vulnerable EM countries to maintain their foothold in global financial markets during bouts of risk aversion.

As Reinhart and Rogoff correctly point out, EM now accounts for 41% of global GDP, and 60% of global GDP if adjusted for purchasing power. At a time when developed countries are struggling with major fallouts of their own from the coronavirus outbreak, it is not in anyone's interest to see defaults across the board in such a large part of the world economy. Rather, now is a good time to address the obvious global market failures, which, tragically, still sometimes precipitate precisely the worst possible outcomes.

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