

Is There Financial Exclusion when Official Lenders Are Considered?¹



By María Bru Muñoz
Banco de España

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Is financial exclusion after default a relevant driver of sovereign default incentives? I find new evidence that suggests that this is not the case, and that there are substantial differences in the behavior of different lenders after a sovereign default. Private lenders tend to decrease their funding to developing countries that have defaulted to banks, bondholders, or to the Paris Club. Yet, the financing from official creditors remains mainly unaffected by the different sovereign defaults, only with some exceptions mostly related to defaults to multilateral lenders. This different pattern for official financing is key since official loans are the main source of funds for developing economies. Given that official creditors continue offering funding to countries even after default, my results cast doubt on the relevance of one of the main elements in sovereign default models, the so-called financial exclusion assumption.

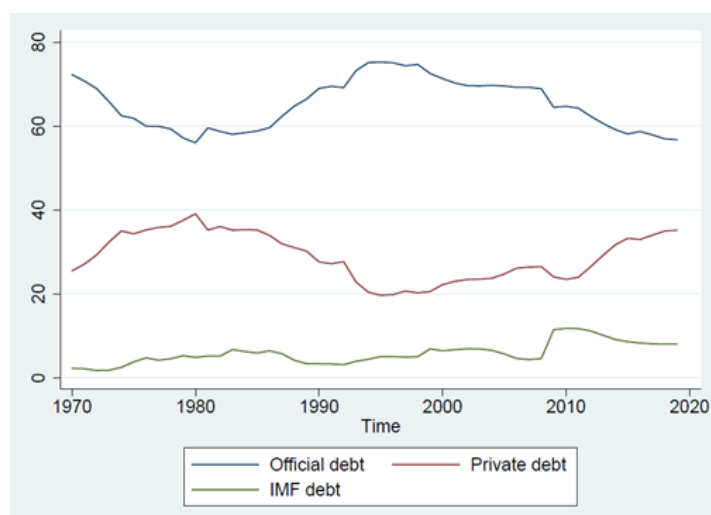
¹ The opinions in this Policy Brief are solely the author's and do not necessarily represent those of Banco de España or the Eurosystem. This Policy Brief is based on M. Bru (2022) "[Financial Exclusion and Sovereign Default: The Role of Official Lenders](#)", Banco de España, Working Paper, 2206.

1. The importance of official lenders

There is a growing interest among macroeconomists about the effects that borrowing from official lenders may have on the overall debt dynamics, and on sovereign default in particular. The canonical DSGE sovereign default model of Arellano (2008) features a country that borrows from a single type of lender, and where debt is issued without commitment. Given the lack of commitment, the only explanation available in these models of why countries pay back their debts is to avoid the penalties associated with the default, namely output losses and financial exclusion. Financial exclusion is defined as the inability of borrowing in international financial markets. It is generally calibrated and broadly understood as the number of years between default and re-access to international credit markets by borrowing either in the form of bonds or bank loans. But both, international banks and bondholders, are private creditors. Within this setting, many studies overlook the fact that countries can usually tap other sources of funding different from international private lenders: official creditors.

Official lenders, i.e. bilateral and multilateral creditors, represent the highest share of debt in developing countries² and offer notably better conditions than private lenders. As shown in Figure 1, debt with official creditors represents approximately two thirds of total public external debt over the period 1970-2019. Furthermore, these numbers have remained relatively stable over the years.

Figure 1: Debt by lender as share of public and publicly guaranteed external debt and use of IMF credit³



In this regard, Horn et al. (2021) underscore that “over the past two centuries, official creditors have played a major role in international finance. [...] This is especially true during times of war, financial crises, or other disasters, when private flows decline and official actors become the chief international lenders” (Horn et al., 2021, p.2). Therefore, it is key to consider official creditors, especially when analyzing sovereign default. This approach is even more important given that as Marchesi et al. (2021) highlight “Despite the fact that official debt

² In the sample I only consider lower-middle and upper-middle income countries according to the World Bank’s 2021 fiscal year classification. For more information on the sample used, please see Bru (2022).

³ Even though the International Monetary Fund (IMF) is usually considered an official lender, it is shown as a separate category in the graph, so the sum of official, private and IMF debt would account for the total stock of public and publicly guaranteed external debt and use of IMF credit.

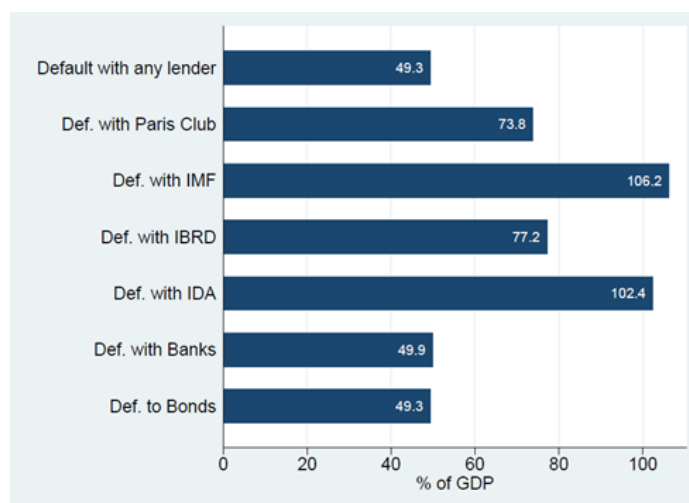
accounts for a substantial share of total sovereign debt (especially in developing countries) and that is expected to increase in the future, there is still too little research on the relative treatment of official versus private defaults.” (Marchesi et al., 2021, p.2).

In order to analyze how official financing affects sovereign default, in my paper (Bru, 2022) I assess the role of official lenders both, as creditors that can suffer a default themselves, and as lenders that can impose, or not, the penalty of financial exclusion. In particular, I question the canonical belief of financial exclusion as an incentive for sovereign debt repayment in both, the empirical literature and in sovereign default models, once official lenders are considered.

2. Heterogeneity across defaults

There exist relevant differences across defaults depending on the creditor that has suffered the default. Using the database developed by Beers et al. (2020) and considering as official lenders the Paris Club, the International Monetary Fund (IMF), the International Bank for Reconstruction and Development (IBRD), and the International Development Association (IDA)⁴, and as private lenders foreign currency bank loans and foreign currency bonds, I find that defaults to official lenders tend to happen when overall debt levels are higher. As shown in Figure 2, total debt as share of GDP in the first year in default with the Paris Club, IBRD, and especially with IDA and IMF is substantially higher than in the first year in default with banks and bondholders.

Figure 2: Public and publicly guaranteed debt as % of GDP in the first year in default with each lender



Also, the probabilities of default to the various lenders are very different, even across official creditors. The Paris Club presents the highest probability of default, while the lowest is for multilateral lenders (IMF, IBRD and IDA). Furthermore, countries do not default to all their creditors at the same time. Indeed, they are usually in default with one lender or at most two simultaneously. This fact shows how countries default selectively, as previously found by Beers and de Leon-Manlagnit (2019), Schlegl et al. (2019), or Marchesi and Masi (2020), since the consequences of default may change across lenders. And one of these consequences is the aforementioned financial exclusion.

⁴ The IBRD and IDA are the two institutions in the World Bank that offer lending to governments in developing countries.

3. Financial exclusion

The inclusion of official creditors as part of the international credit markets that countries may access might challenge the widespread assumption of financial exclusion after default. In order to evaluate this issue, I compare the access to private funds and the access to official funds after countries default to each of the different creditors mentioned in the previous section, that is, the Paris Club, the IMF, IBRD, IDA, international private banks and international bondholders. Thanks to this approach, I find that defaults to several of these lenders, both private and official, imply a reduction in private funds, and the magnitude of the impact is sizable. This evidence suggests that financial exclusion from private financing exists, especially after defaults to private lenders themselves, but also due to the default to other creditors.

However, the financing from official creditors is affected by fewer types of default than that from private lenders. The only defaults that affect official commitments are defaults to multilateral lenders, and their effects tend to be mixed, that is, while a default to the IBRD would involve a reduction in official funds, one to the IMF or IDA would imply an increase in those funds. But defaults to multilateral institutions are rare events, which implies that official creditors maintain their financing to countries after most defaults. This different pattern for official financing is very relevant since official loans are the main source of funds for developing economies.

As a result, the effect of a default on a country's total financing is limited given the virtual lack of financial exclusion from official funds, which questions the relevance of financial exclusion as an incentive for sovereign debt repayment. These findings cast doubt on the way the financial exclusion assumption has been approached and calibrated in the sovereign default literature.

4. Financial terms of official loans

Another key element of official lending is the financial terms of its loans.⁵ Official lenders tend to offer much more favorable terms than private creditors. However, official creditors might penalize borrowers after default by substantially increasing the interest rate or decreasing the maturity. Such event might affect overall debt dynamics, even if it is not strictly speaking financial exclusion. My analysis shows that official financial conditions are not typically affected by defaults, except those to multilateral institutions (IMF, IBRD and IDA). A default to these lenders would imply a worsening of the financial conditions (an increase in the interest rate, a reduction in the maturity or both), which may be related to the multilateral institutions' seniority shown by Schlegl et al. (2019). This result provides a different perspective to the findings in the previous section, where the defaults to the IMF and IDA involved a rise in official funds, since that increase in funds would be accompanied by a worsening of their financial conditions.

In sum, the financial terms of official loans are negatively affected by defaults to multilateral institutions, and only by them. When countries default to any other lender, these financial terms remain unaffected, further supporting the lack of financial exclusion from official lending when countries do not honor their debts with private creditors and with many official lenders.

⁵ I do not analyze the effect of a sovereign default on private financial terms because this issue has been widely analyzed in the literature. It is already well established that countries under default tend to suffer high spreads in international private financial markets compared to normal times.

5. Conclusions

When taking into account official lenders, financial exclusion is found to be, generally, at most partial. Official funds tend to remain unaffected by most defaults. Conversely, sovereign default has a substantial impact on private commitments, which tend to decrease with many types of default, even those to official lenders. Therefore, the main source of financing in developing economies, official funds, seems to follow different patterns in default, allowing countries to continue borrowing after default. These results are further supported by the fact that official lenders do not worsen their financial terms when countries default to private lenders or to the Paris Club.

These findings have significant implications for the sovereign default models that have financial exclusion as a key assumption. These models assume that countries repay their debts to avoid financial exclusion and output losses, but when official lenders are taken into account, financial exclusion does not happen in the aftermath of defaults, or, when it follows, it is typically weak. ■

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About the author

María Bru Muñoz is an economist in the Financial Stability Analysis division of Banco de España. She has previously worked in the Macroeconomics and Fiscal Management Global Practice of the World Bank and in the Economic and Commercial Office of the Embassy of Spain in Washington DC. She holds a MSc in Economic Analysis from Universidad Carlos III de Madrid.

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SUERF Secretariat
c/o OeNB
Otto-Wagner-Platz 3
A-1090 Vienna, Austria
Phone: +43-1-40420-7206
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