The Barbados Economics Society

Barbados' Sovereign Default: What is it?

What does it mean for the Country?

Sentiments of the BES Executive Member, Professor Winston Moore

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The existence of external debt can be important source of financing for Small States.

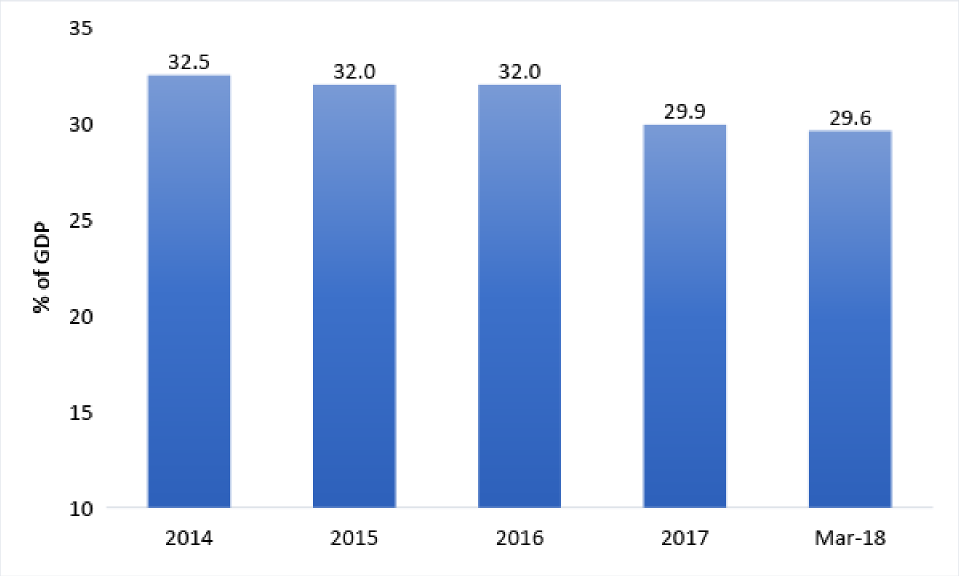
Unlike domestic debt, external debt has been declining since 2015 as it became increasingly difficult to rollover foreign debt due to the island's falling external credit ratings.

Summary

External debt can be an important source of financing for Small States. In many of these countries, production has a high import content. By financing a project using an international loan, it therefore allows a country to minimise the impact of a project on its international reserves. Say for example a country is constructing a new hotel. Many of the inputs involved in the construction phase would require the construction company to purchase goods (e.g. fixtures and fittings) and potentially professional services from abroad. These purchases therefore have the potential to negatively impact on the holdings of foreign exchange of the country during the construction phase of the project. In addition to minimising the negative impact of a new project on foreign exchange earnings, foreign financing might also be necessary if there are insufficient funds available locally to financing a new public-sector project.

At the end of fiscal year 2017/18, the Government of Barbados' external debt obligations were approximately BBD$2.7 billion or approximately 29.6 percent of GDP (See Figure 1). Domestic debt in comparison (including that held by the National Insurance Scheme) was approximately 120.9 percent of GDP at the end of the same period. In addition, external debt, in contrast to domestic debt, has been declining since 2015 as it became increasingly difficult to rollover foreign debt due to the island's falling external credit ratings.

Figure 1: External Debt (% of GDP)



Source: Central Bank of Barbados March 2018 Economic Press Release

Typically, a country runs into debt problems when rising levels of debt make the country more susceptible to sudden stops. The basic definition of a sudden stop is a period of time characterised by a significant and unexpected slowdown in private capital inflows. This reduction in capital inflows leads to a fall in foreign exchange reserves and makes it difficult to continue to pay for imports of goods and services as well as to make payments on external debt. This is very similar to what has happened to Barbados in recent years. Foreign direct investment in Barbados fell from US$316 million in 2014 to US$156 million in 2017. This decline in FDI inflows, along with other factors, resulted in the international reserves falling from US$527 million to US$205 million between 2014 and 2017. Therefore, at the end of 2017, the island's international reserves could only finance about 1.5 months of imports of goods and services - well below the international benchmark of reserves equivalent to 3 months of imports of goods and services.

A default occurs when a country runs into extreme difficulties whilst making payments on its stock of external debt and therefore either misses the date of payment for a principal or interest payment or decides to stop servicing its debt. This is quite similar to problems we run into in our own homes when it might become difficult for us to make monthly payments for our mortgage or car loan.

The main benefit of a country defaulting on its debt is that it gives the country enough breathing room to implement a Structural Adjustment Programme, normally under the auspices of the International Monetary Fund (IMF). This Structural Adjustment Programme attempts to address the underlying cause of the problem driving the demand for debt as well as the balance of payments disequilibrium.

Many Caribbean countries have chosen to restructure their debt in recent times. These include Dominica, Grenada, Belize, Jamaica, Antigua and Barbuda as well as St. Kitts and Nevis. Restructuring exercises have ranged from reductions in interest rates on the government's debt and the granting of longer payment periods; to arrangements where the government negotiates a reduction in the outstanding stock of debt owed to its creditors. The main benefits for these countries were reductions in interest paid on debt that allowed them to reduce recurring expenses and improve their fiscal position, faster economic growth, and lower levels of debt. The key problems with the reprofiling exercise are:

1. The enhancement of financial sector vulnerabilities as financial institutions who own government's debt may incur losses,
2. The high prevalence of reputational risk and loss of future access to the international credit market to finance future investment due to further credit rating downgrades, and
3. The potential for prolonged legal battles with vulture funds.

However, in the absence of access to international credit markets, a financing programme with the IMF provides a cheaper source of foreign financing to stabilize the foreign exchange reserves in the medium term. The ability to regain access to international borrowing and reverse any deterioration in reputational risk will require a sustainable reduction in the government's debt. Ultimately, it will lead to the restoration of Barbados' international credit rating to a more credit-worthy status.