PRE-DISTRIBUTION AND OWNERSHIP

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SOVEREIGN DEBT: A QUAGMIRE FOR GROWTH AND EQUITY

Mamokete Lijane| *December 2022*

Introduction

The recent rise in sovereign debt will have a profound impact on countries' ability to recover and grow after the Covid-19 pandemic; it will also impact the degree of inequality within and between countries. This paper assesses the impact of sovereign debt on efforts to address global inequality and development. Inequality within countries has been associated with an increase in sovereign indebtedness and, ultimately, an increase in their risk of a sovereign debt crisis. Sovereign debt crises, in turn, lead to greater inequality (Bohoslavsky, 2016). There is thus a reinforcing feedback loop between inequality and high sovereign debt.

Modelling suggests that governments swing between two poles. In one, governments increase debt: They borrow internationally, spend generously on transfers1, and reduce inequality. In the other, governments reduce foreign debt, reduce expenditure and transfers, and increase inequality (Dovis et al., 2016). Globally, we are moving from the former pole to the latter as high debt burdens and reduced access to foreign capital constrain the ability to borrow. Prior experience suggests the coming period will be characterised by rising inequality as countries respond to the pressures brought by high debt burdens. Left unresolved, the prevailing sovereign debt overhang in emerging markets and low-income countries will reinforce the inequality both within and between countries.

Emerging market sovereign debt rose materially between 2009 and 2019 and jumped sharply in the Covid-19 crisis in 2020 (World Bank, 2022) The growth of low-income countries' indebtedness has also been stark. Sovereign borrowing increased after the global financial crisis of 2008 (World Bank, 2022). Governments are always under political pressure to borrow, and pressure increased as global growth slowed after the crisis. The post crisis era was also characterised by the increased availability of debt at low interest rates as global investors searched for better returns in the context of much lower interest rates and growth prospects in their own markets.

A substantial proportion of the sovereign debt of emerging and low-income economies, around 58% in 2021, is denominated in or indexed to foreign currency (Moody's, 2022). The most vulnerable countries, which have higher perceived risk, typically carry the highest proportion of their debt in foreign currencies. Countries that borrow more in foreign currency are more exposed to global market turmoil and are at risk that the mismatch in asset and liabilities erodes resilience in the event of stress.

[1] Transfers: redistribution of income and wealth by means of the government making a payment, without goods or services being received in return. This can take the form of social grants and other payments, and can extend to other social services, such as education and healthcare.

Unlike before, when local investors held the bulk of local currency debt, especially in the larger emerging markets, increasing amounts of debt issued in global capital markets, in local and foreign currency, are owed to foreign interests. The creditor base has also moved from primarily bilateral to mostly private. At the end of 2020, bondholders and private creditors, many of whom are not Paris Club members, held 57% of emerging market external debt, up from 25% in 2008 (World Bank, 2022).

The foreign currency nature of government debt, the predominance of foreign creditors, and the private nature of the holders makes economies vulnerable to capital flight and balance of payments stress when global financial market conditions tighten. Another change in the creditor mix is the rise of China as a bilateral creditor. As at the end of 2017, China – via loans to governments and public entities – had become the largest official bilateral creditor to other states (Horn et al, 2021). Chinese debt, often linked to projects, is typically good for government investment and, arguably, country development. However, a material portion of the loans are "hidden" and unreported to bodies tasked with overseeing government finances. This not only makes it difficult for civil society to exercise democratic oversight of government commitments but could cause complications in cases of debt distress.

High debt levels, especially in foreign currencies and to private creditors, exposes economies to global financial cycles, leading to growth volatility, low growth and procyclicality[2] in monetary and fiscal policy. Where there is a large diversity of debt holders, difficulties with creditor coordination can complicate processes for getting out of distress. Questions have also been raised about the impact of debt on inequality, especially because private creditor interests typically supersede other interests when debt becomes unaffordable for the government.

How countries use the funds raised is a critical determinant of whether debt benefits countries, is equitable, or sustainable. Many countries experienced increases in debt without accompanying enhancements in physical or human capital.

The "search for yield" in the post-global financial crisis period saw global fund managers making large investments into emerging markets and poor countries, with less than appropriate considerations for the risk that these investments entailed. The consequences of governments' reckless borrowing and reckless lending by creditors will be lower growth, and more inequality in emerging and low-income countries. Unless there is some adjustment in the inequitable global financial governance infrastructure which

[2] Procyclicality: policy decisions that reinforce a cycle, instead of offsetting its effects. For example, tightening monetary policy and cutting fiscal deficits in a slowing economy.

favours global finance's interests, debtor countries will disproportionately bear the consequences of these high debt burdens. These would be countries in the global South.

Even prior to the Covid-19 crisis, the rise in debt burdens had already eroded many governments' ability to deliver social goods. Governments are using increasing amounts of resources to service debt. Debt service costs will continue to increase as high global interest rates feed into funding costs. The pressures of high debt service costs may push more vulnerable emerging markets economies into distress. The negative feedback loop from high interest rates into growth, equity and debt sustainability will be a challenge for many, if not most, countries in the global South.

Some governments are already failing to meet their debt obligations to foreign creditors. Many economies have not fully recovered from the Covid-19 lockdown shock. They are now contending with the dearth of capital flows as interest rates rise in developed economies and supply-side shocks to food and fuel prices. The International Monetary Fund (IMF) classifies 60% of low-income countries and 30% of emerging economies as being in, or at risk of, debt distress (Chabert et al., 2022).

The world needs a coherent global policy response to limit the fallout from the effects of high debt levels for emerging and low-income countries. The IMF, the multilateral lender of last resort, has historically been criticised for facilitating the inequity in sharing the losses when countries default by making assistance conditional on anti-poor austerity measures.

The IMF now appears to accept that past debt distress approaches, exemplified by the IMF's famed "structural adjustment programme" should be redesigned to limit negative welfare consequences. However, there is still deep scepticism about whether this rhetorical change is reflected in practice (Kentikelenis et al., 2016). IMF lending is at an all-time high, with more requests coming in from countries in distress (Wheatly, 2022).

The added complication of disparate sets of private creditors and China has made creditor coordination more difficult. Failure to conclude debt workouts speedily might lead to countries remaining in distress and experiencing the negative liquidity consequences of that distress for longer. In 2020, amid the Covid-19 economic crisis, the IMF introduced the Debt Service Suspension Initiative (DSSI), a mechanism to negotiate the delay and rescheduling of debt servicing for eligible countries. This initiative, which came to an end in 2021, was only partially successful (Ahmend & Brown, 2022).

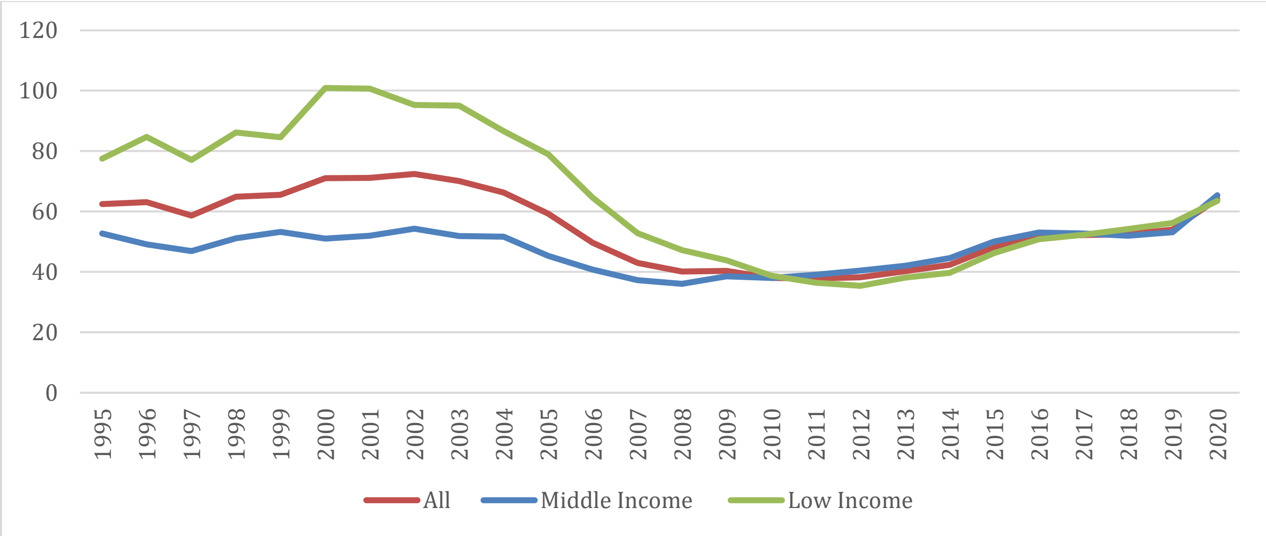
The G20 has agreed to a Common Framework for Debt Treatments to assist with creditor coordination in the event of debt distress, and to enable a quick flow of IMF funding to limit its negative effects. The framework requires creditors to "participate on comparable terms to overcome collective action challenges and ensure fair burden sharing". To date, implementation of this framework has been difficult but appears to be progressing. On 11 November 2022, Chad was the first country to conclude a debt plan with all its creditors. The plan comprised all bilateral lenders, including China and private creditors, under the framework. This is a milestone. But the plan was likely not the final word on Chad and debt distress. It fell short of what the country needed. It did not include a reduction in the country's debt and thus, according to the World Bank, failed to address the problem of long-term debt sustainability (Ramadane, 2022).

The need for a more effective approach to dealing with countries in debt distress has become even more urgent as countries buckle under the pressures of high debt burdens, expensive debt and debt distress. Civil society is advocating for more just outcomes for the people of countries burdened by debt. There are ongoing discussion regarding the reform of the global debt architecture, including, reviewing the principles of responsible borrowing and lending, the use of unregulated financial instruments, and using human rights and development indicators in debt analysis (United Nations, 2021).

How indebted are countries in the global South?

The degree of indebtedness in emerging and developing economies has grown in the past decade (see Figure 1). Sovereign debt levels declined during the 2000s and were at their lowest just prior to the global financial crisis (GFC) in 2008. Debt levels then increased moderately and then jumped in the Covid-19 pandemic crisis in 2020. Median government debt to GDP ratios across both emerging markets and poor countries have risen to above 60%. This does not necessarily spell oncoming distress. But it could be above the threshold beyond which debt can undermine economic activity and the ability to stabilise the economy (Fall et al., 2015).

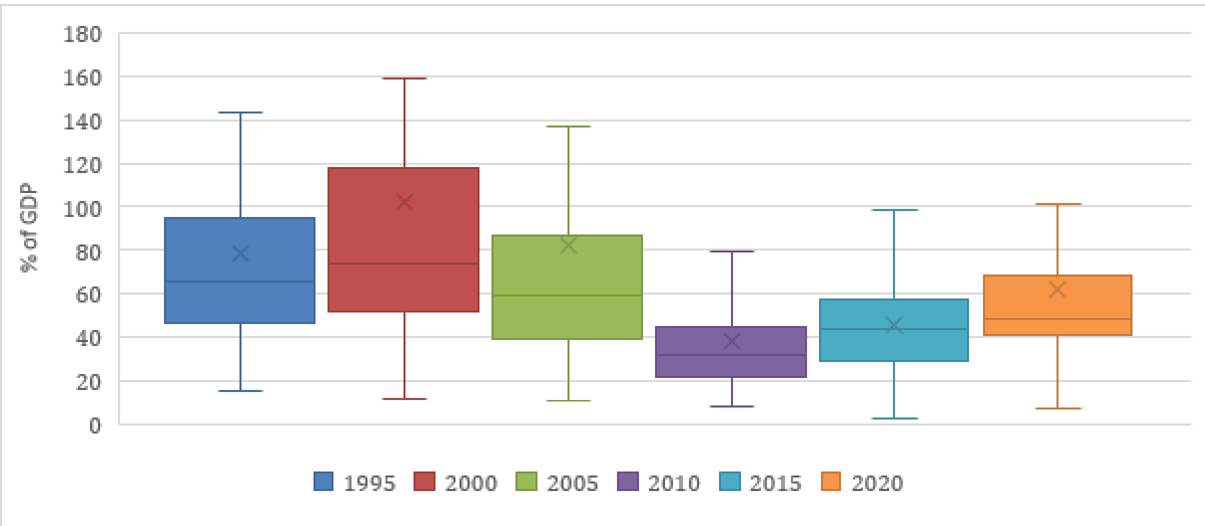
Figure 1: Emerging markets' central government debt to GDP (median)



Source: IMF, author's calculations

Low-income countries had material declines in debt levels in the 2000s, supported by debt relief and restructuring on the back of the World Bank and IMF's Highly Indebted Poor Countries (HIPC) initiative (see Figure 2**).** Figure 2 shows distribution of data into quartiles, highlighting the mean and median (cross). The lines extending vertically indicate variability outside the upper and lower quartile.

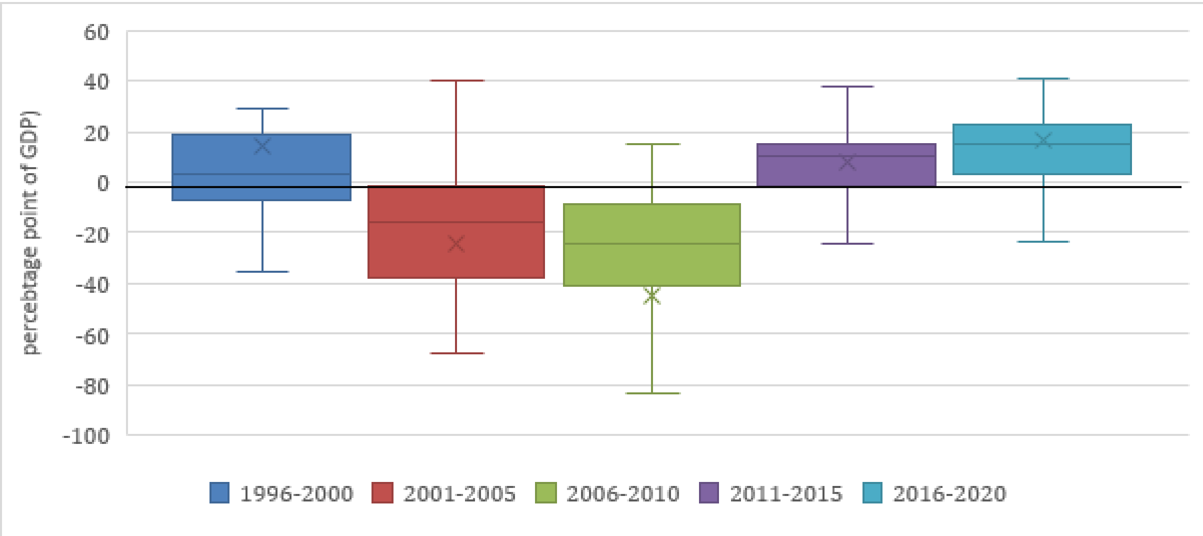
Figure 2: Gross debt levels of low-income countries: Distributions



Source: IMF, author's calculations

The HIPC initiative was launched in 1996 and expanded in 1999. The programme was supplemented by the Multilateral Debt Relief Initiative (MDRI). This allowed 100% relief on qualifying debt from the IMF, the World Bank and the African Development Bank in 2005. The Inter-American Development Bank (IADB) also decided to provide additional relief to five countries in the western hemisphere (IMF, 2021). After aggregate declines from 2000 to 2010, low-income countries' debt levels started to climb again in 2012 when low post-global financial crisis yields spurred a search for returns. Indebtedness moved sharply higher in 2020 due to fiscal responses to the Covid-19 shock (see Figure 3**).** Figure 3 shows distribution of data into quartiles, highlighting the mean and median (cross). The lines extending vertically indicate variability outside the upper and lower quartile.

Figure 3: Low-income country change in debt levels in each five-year period: Distributions



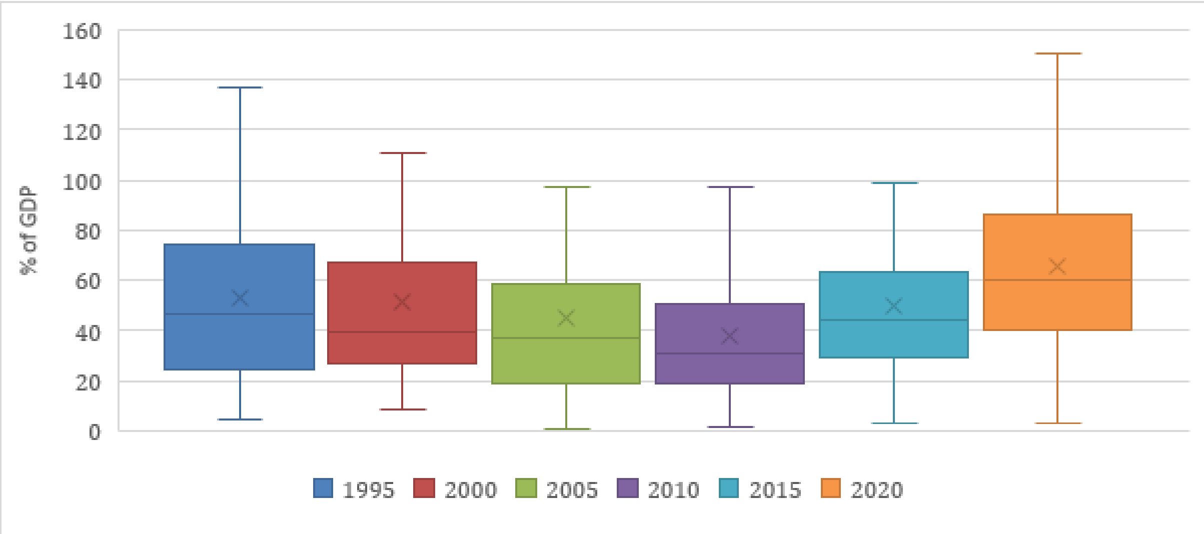
Source: IMF, author's calculations

Apart from Zambia, data shows little evidence that countries that benefitted from HIPC borrowed more in the subsequent period. This suggest either that the "moral hazard"[3] that many were worried about has not materialised, or that beneficiary countries have not had the market access that supported high debt acquisition after the project's conclusion.

Middle income emerging markets were not as indebted as the low-income countries were in the 90s. Even then, median debt levels for these countries dropped from 2000 to 2008 and started rising again in 2012. As with their low-income counterparts, debt levels moved up sharply in 2020. Median debt levels for middle-income countries were just above 60% of GDP in 2020, reflecting an increase of 30 percentage points of GDP versus a decade earlier. Fifty percent of middle-income emerging markets now have debt levels above 60% of GDP. This compares with just 16% of countries with this very high debt levels in 2010 (see Figure 4).

[3] Moral hazard occurs when actions incentivise adverse behaviour in economic actors.

Figure 4: Gross debt levels of medium-income emerging market countries: Distributions



Source: IMF, author's calculations

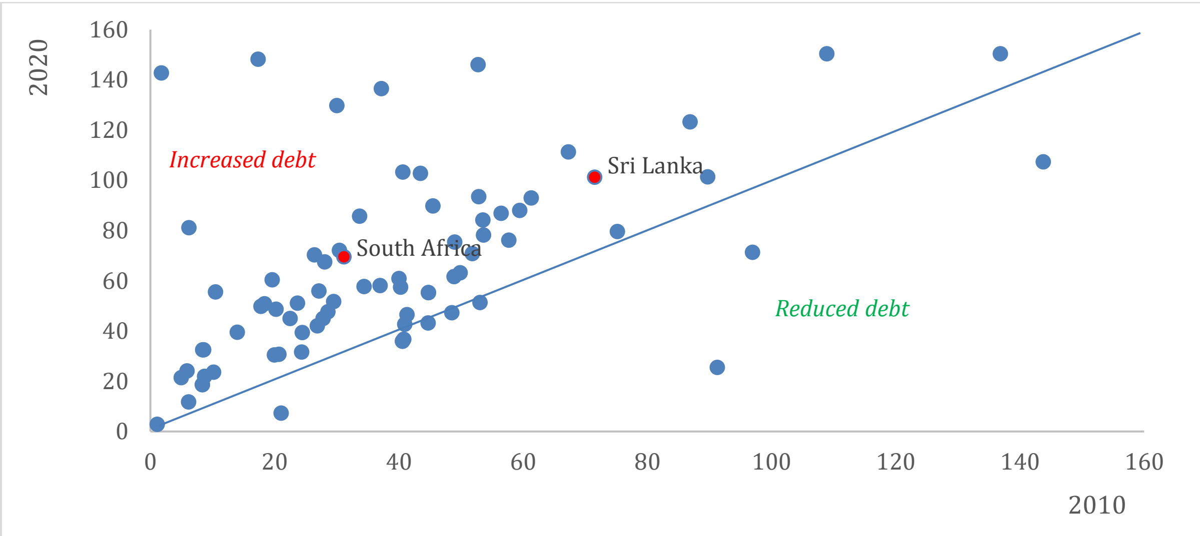
Figure 4 shows distribution of data into quartiles, highlighting the mean and median (cross). The lines extending vertically indicate variability outside the upper and lower quartile. Trends in indebtedness of middle-income emerging markets mimic those of the low-income cohort. On an aggregate basis, countries saw falling debt levels between 2000 and 2010, but debt levels have been increasing since (see Figure **5**). Figure 5 shows distribution of data into quartiles, highlighting the mean and median (cross). The lines extending vertically indicate variability outside the upper and lower quartile.

Figure 5: Change in middle-income emerging markets' debt levels: Distributions

Source: IMF, author's calculations

On balance, emerging market debt increased as a percentage of GDP in all but a few emerging markets between 2010 and 2020 (see Figure 6).

Figure 6: General government gross debt (% of GDP)



Source: IMF

Structure of debt: Who is owed what?

The currency and creditor structure of debt is an important consideration for the impact of debt. The currency in which liabilities are denominated is a well-discussed consideration for debt sustainability and fiscal policy options. Banks and small groups of bilateral and official institutions had historically dominated the creditor structure. The entry of non-bank private creditors and Chinese official creditors in the past 15 years has changed the risk profile of debt in material ways.

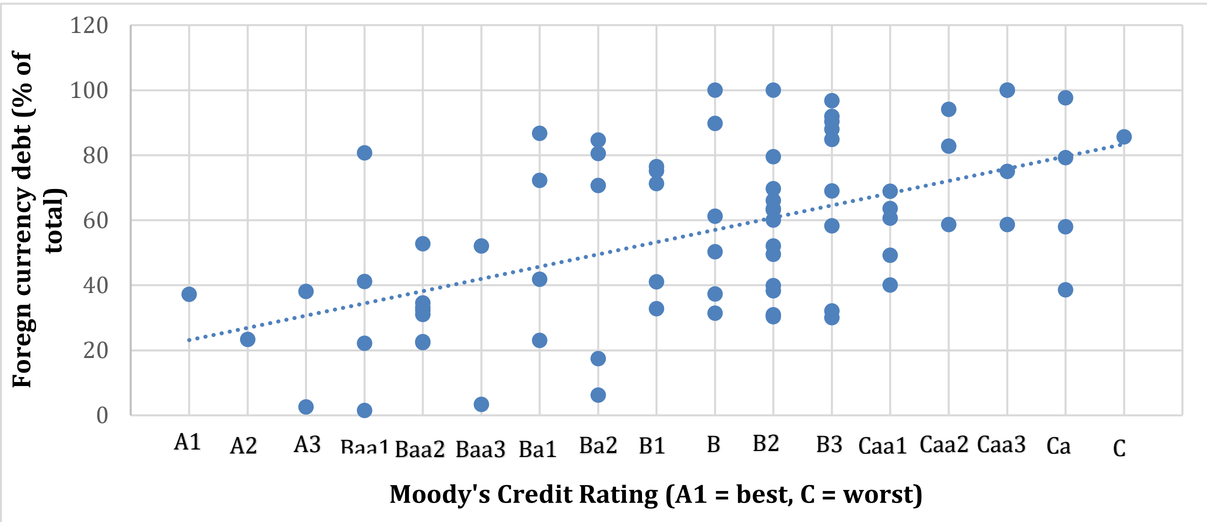
Currency

Emerging market countries typically borrow in other currencies. For developing economies, pressure on the domestic exchange rate can lead to spikes in the cost of servicing hard currency debt. This dynamic can create a fiscal constraint because it links debt servicing costs, sometimes a large portion of fiscal expenditure, to global business cycles.

The literature around the phenomenon of emerging market countries accumulating debt in the currencies of a few large dominant economies (hard currencies), including the US dollar, Japanese Yen, British Pound and the Euro, referred to as "original sin" by Eichengreen and Hausmann (1999) is well developed. Original sin occurs when countries cannot borrow in their own currency or long-term. This results in currency or term mismatch between revenues and liabilities. Original sin can reduce monetary policy effectiveness and lower fiscal flexibility, making countercyclical output stabilisation more difficult. Economies subject to original sin are thus more crisis-prone and more susceptible to shocks (Eichengreen & Hausmann, 2005).

Moody's country data in the countries they rate shows that emerging markets borrow, on average, 58% of their total debt in foreign currency. This proportion varied widely across countries. However, the denomination of debt to foreign currency was positively correlated with GDP and credit ratings (see Figure 7).

Figure 7: Emerging markets' sovereign rating vs debt indexed in foreign currency (% of total)



Source: Moody's Investor Services

This implies that the poorest economies, and those with the lowest credit ratings, were most likely to borrow more in foreign than in local currency. Countries that borrow more in foreign currency are more exposed to global market turmoil. The more vulnerable a country, the more it borrows in foreign currency, which would further increase its economic vulnerability. The negative feedback loop here is obvious.

The aggregate proportion of foreign currency indexed and denominated debt to total has been quite stable in the five years to 2021. However, about half of the countries in Moody's dataset increased their borrowing in foreign currency, and half reduced it over the period. In 2010, Hausmann and Panizza noted the reduction of original sin with countries increasingly borrowing in their home currencies. This has led to an improvement in their ability to implement countercyclical policies (Hausmann & Panizza, 2011).

However, they noted that this improvement was due to countries incurring lower net debt: in other words, abstinence from borrowing.

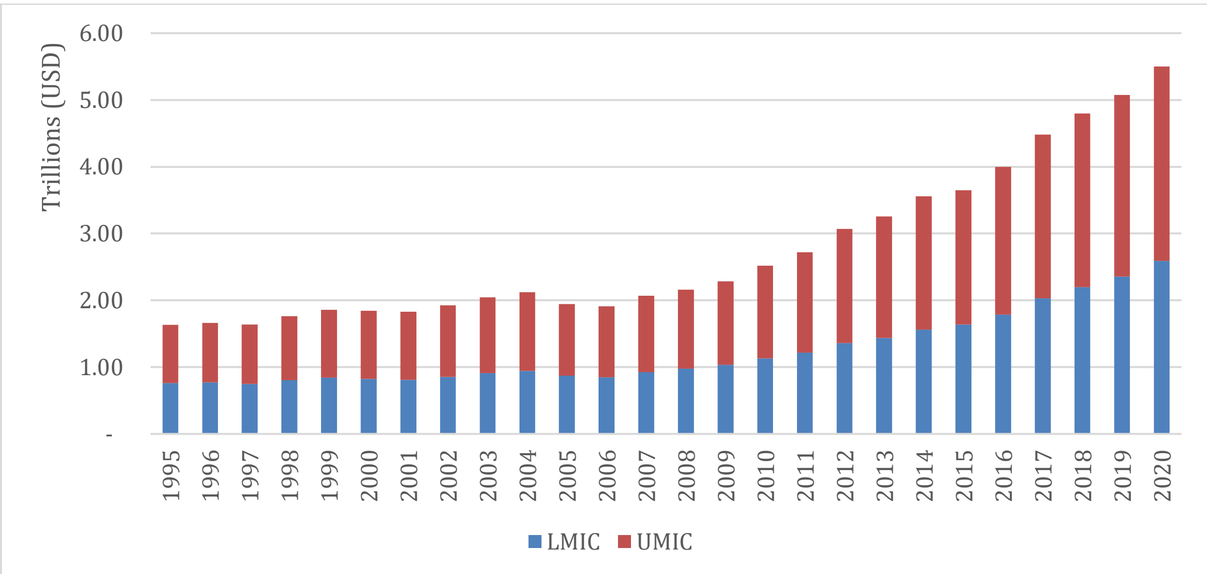
Creditor structure

The change in developing countries' creditor base is another important development. Speculative portfolio investors can, and often do, sell listed debt instruments in a hurry. This affects both price and availability of debt for governments. Private portfolio investors will sell bonds in bad times, when governments most need to borrow, and buy them in good times when tax receipts are at their highest. Diverse creditor groupings can make it more difficult for countries to negotiate debt restructuring. This can lead to prolonged periods of debt distress and low liquidity. The growth of China as a creditor has brought debt disclosure to the fore because the terms and conditions of Chinese loans are often secret. This could lead to either or both limited access to debt and high debt costs for countries.

External vs internal creditors

The World Bank's International Debt Statistics database shows that, for a selection of both and low- and upper- middle income emerging market countries, debt obligations to external creditors more than doubled since the global financial crisis of 2008 to 2020. The stock of debt owed to external parties had been quite stable in the 15 years to 2008 (see Figure 8).

Figure 8: Debt obligations to external creditors



Source: World Bank, author’s calculations

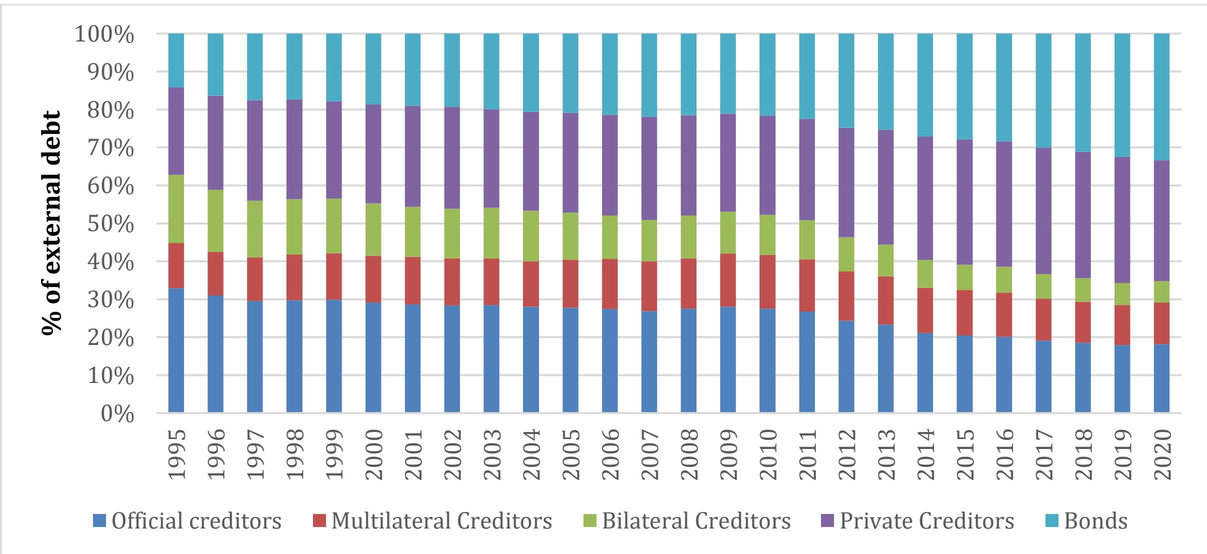
Private vs official creditors

The World Development Report explores financial vulnerabilities in countries caused or exacerbated by the Covid-19 pandemic (World Bank, 2022). The report highlights interlinkages between:

- household and firms,
- governments and central banks,
- the financial sector.

The report observes that in this nexus vicious or virtuous cycles can develop which affect citizens’ economic welfare. One of the loops at play between the financial sector and the fiscus is via bond markets. Since the global financial crisis, private sector creditors have extended large amounts of debt to emerging market countries. Much of this increase was due debt extended by private creditors and raised in bond markets (see Figure 9). At the end of 2020, bondholders, and private creditors, who are not Paris Club[4] members, held 57% of emerging market external debt, up from 25% in 2008.

Figure 9: External debt composition of selected emerging markets



Source: IMF, author’s calculations

Regarding Sub-Saharan African country debtors’ change from concessional to private creditors in the post-global financial crisis period, World Bank economists flagged the resultant increase in debt servicing cost and potential lowering of the threshold for debt distress as points of concern (Calderón & Zeufack, 2020).

[4] The Paris Club is an informal group of official creditors whose role is to find coordinated and sustainable solutions to debtor countries’ payment difficulties.

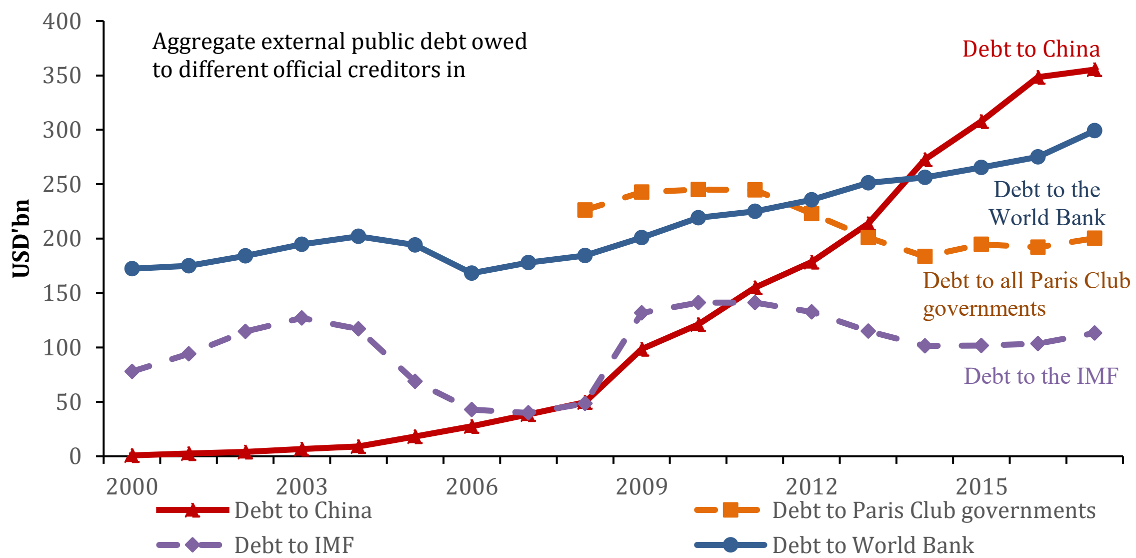
Because private sector loans are granted at higher yields, they raise debt service costs, which increase the risk of debt distress. Unlike with official, multilateral and bilateral creditors, corralling divergent private sector parties in general, and multiple bondholders in particular, can take more time. Achieving alignment across many divergent interests can also be more complicated when debt becomes distressed. Difficulties in getting the Common Framework to deliver results are testament to these coordination failures.

The growth of China as a major emerging market official creditor

China's growth as a creditor since 2000 is notable. As it grew, China increased grant funding and investments in other countries through the 2000s. This investment accelerated when the country announced its Belt and Road Initiative, a programme to invest in infrastructure around the world. This initiative is designed to direct China's global investments to deepen and consolidate its economic relationships with countries around the world. The initiative was first discussed publicly by Chinese President Xi Jinping in September and October of 2013. The country planned to spend a cumulative US$ 6 trillion across 68 countries identified as part of the Belt and Road.

At the end of 2017, China – via loans to governments and public entities – had become the single largest creditor in the world (see Figure 10). Its claims surpassed those of the World Bank, the IMF, or of all 22 Paris Club governments combined (Horn et al., 2021).

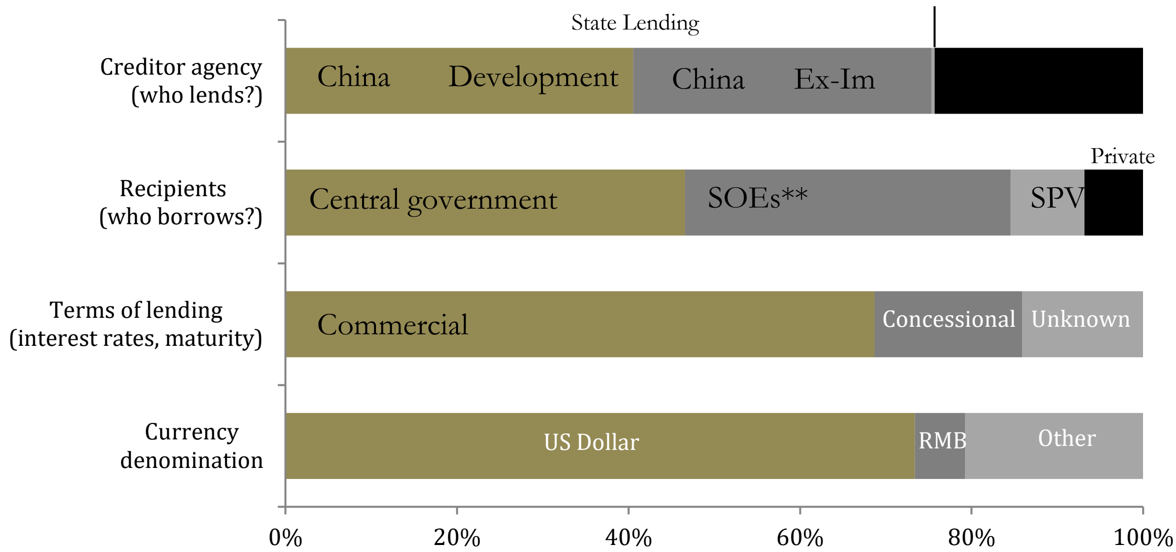
Figure 10: Aggregate external public debt owed to official creditors



Source: Horn et al.,(2021)

China's investments in emerging markets have been broadly constructive. The investments have allowed countries to develop infrastructure they would have not been able to do before (Thornton, 2020). A fair bit of China's lending to emerging markets is to state-owned entities (SOEs) and is directly linked to projects (see Figure 11). This should generate the revenue necessary to service loans.

Figure 11: Characteristics of Chinese official overseas loans



*The Import-Export Bank of China, ** State owned enterprises, ***Special purpose vehicles

Source: Horn et al., 2021

China tends to lend disproportionately to countries that score low on control of corruption and creditworthiness. This raises concerns about the use of loan funds and democratic oversight of them in those countries since the terms and conditions of Chinese lending are often secret. There has been an improvement in the risk profile of debtors over time. China lends at more expensive commercial as opposed to concessional rates at which multilateral and bilateral funders usually lend (AIDData, 2021). About half of China's official lending is not reported in widely used debt statistics, earning it the moniker of "hidden" debt (Horn et al., 2021; Malik, et al., 2021). Countries' obligations to China are thus shielded from public scrutiny and democratic oversight. It stands in the way of other creditors making informed lending decisions and can stall negotiations when countries are in distress.

AIDdata points out that China has also expanded its lending for infrastructure projects while shrinking the portfolio that supports sovereign borrowers. It has done this by increasing loans to special purpose vehicles (SPVs), state-owned banks, state-owned companies and private institutions. This has blurred the distinction between private and public debt. It has created challenges for prudent public financial management in emerging markets, especially because host governments often guarantee the repayments of these loans.

Flow of risks and value: Who pays and who benefits?

The use of debt can be of great benefit to both debtors and creditors. At best, a cash-poor but opportunity-rich debtor borrows from a creditor and incurs debt. The cash is used to invest in the opportunity and an asset is created. Over time, the creditor is paid back from the value derived from the asset, and the debtor enjoys the benefit of the value of the asset, net of debt service costs. Both the creditor and the debtor benefit from the transaction. The economic argument for sovereign debt is the same.

When used to support public investment and smooth economic cycles, debt can be beneficial and ultimately welfare-enhancing for economies. However, financial market liberalisation and global financial market integration have changed the flow of debt and value between and within countries in ways that are problematic for debtor countries and their citizens.

What is debt used for, and to what extent should it be repaid?

When debt is used to fund productive capacity enhancement, it leads to large downstream benefits and generates the income the country needs to service its debt. In this way, both the debtor and creditor benefit. However, the quality of the use of debt varies widely between countries. This then becomes a critical determinant of whether debt benefits countries and is sustainable. The data on sovereign debt levels is freely available. But data on what debt is used for more difficult to collate. We know that bilateral funding, especially from China, is used for infrastructure investment. Prior to the Covid-19 pandemic crisis, multilateral funding from agencies like the World Bank and the African Development Bank was also often linked to projects.

In contrast, the use of private funding, which accounts for the largest growth of debt between 2010 and 2020, is more difficult to tease out. Private funding, when available, is plentiful and cheap. It is no coincidence that private credit to emerging markets increased during the very low global interest rate environment between the global financial crisis and the Covid-19 crisis, with lenders willing to lower lending criteria. This incentivised governments to borrow recklessly, which has resulted in greater risk of debt distress. Private loans were often used to expand expenditure and for general deficit financing. How the funds were used was questionable, undermining the affordability of the debt stock.

An example of this phenomenon is Ghana, which has slipped into debt distress and is during what is being called the worst economic crisis in a generation. The government has restructured its local currency debt and an external debt service has been suspended, slipping the country into default (Reuters, 2022). Over the course of the 2010s, the Ghanaian government expanded expenditure in anticipation of oil revenues that never reached expectations. Fiscal overspending was particularly high in election years. The country then borrowed to fill the gap, leading to an increase in debt from under 20% of GDP in 2006 to over 100% of GDP currently. Debt service costs have sourced from just 10% in 2006 to between 70% and 100% of government revenues (Savage & Jones , 2022).

The expansion of Eurobond issuance explained almost 70% of Ghana's external debt growth in the period between the financial crisis of 2008 and the Covid crisis in March 2020. The country first issued a Eurobond in 2007, but the bulk of its issuance of securities in foreign markets happened in 2013 and after. Eurobond issuance grew over the years, and loans from international capital markets have grown to just over USD13 billion at the end of 2021 (Ghana Ministry of Finance, 2022). Ghana's 2020 USD3 billion Eurobond issuance was more than 4.5 times subscribed, indicating very strong inventor interest (Bloomberg, 2020). The country further issued USD3.0 billion in novel zero coupon bonds in March 2021 (Reuters, 2021). In its Article IV Consultation document in July 2021, the IMF noted that "Ghana remain[ed] at high risk of external and overall debt distress under the baseline (IMF, 2021).

Many countries experienced increases in debt without accompanying enhancements in physical or human capital. The IMF estimates that only about 60% of public investment in low-income countries turn into public capital like roads and other productive infrastructure (Desruelle et al., 2019). Clearly there is an urgent need to address how governments use debt.

Consideration on repayment of unaffordable debt

A current question is whether countries should be morally obliged to repay historic, arguably unaffordable debt in full. Servicing debt can entail painful trade-offs. Most countries choose repayment over default, even when it is not in their interests. By forcing full repayment of debt and not sharing losses between creditors and debtor countries, global institutional arrangements arguably privileged creditors over the citizens of borrower countries. Roos & Grubacic (2022) identify three mechanisms by which default is discouraged, and enforcement happens. These include:

- the "discipline" imposed by international creditors by locking access to international financial markets should default occur;
- the policy conditionality enforced by international lenders of last resort (normally the IMF) once countries lose or are about to lose access to the private creditor market; and
- the domestic elites in debtor countries who serve to encourage "investor-friendly" views and are rewarded by getting access to funding at lower costs (Roos & Grubacic, 2022).

This dynamic ensures that creditors are not held accountable for their irresponsible lending decisions. Creditors are incentivised to make bad loans which the people of debtor countries will have to repay, even at great cost to welfare. Austerity measures and the redirection of expenditure away from social services often follow high debt levels.

In a webinar[5] hosted by the London School of Economics in July 2022 (London School of Economics, 2022), economics professor Joseph Stiglitz opined that unsustainable debt arrangements were the responsibility of both the governments who borrowed too much, and the creditors who know these debtors would not be able to repay, but still lent to them anyway. Creditors were responsible for assessing the quality of the projects credit was being sought for, and in some cases were even better able to judge their viability. Professor Jayati Ghosh made a further point that creditors are paid for the high risk of default, as evidenced by the very high interest rates emerging and low-income countries pay relative to developed economies. To the extent that creditors have been compensated, they should incur the costs when debt becomes difficult to service. While government agents could not be assumed to be ignorant about the sustainability of the debt they were taking on, creditors would usually be aware of whether the borrowing was beneficial to citizens or not.

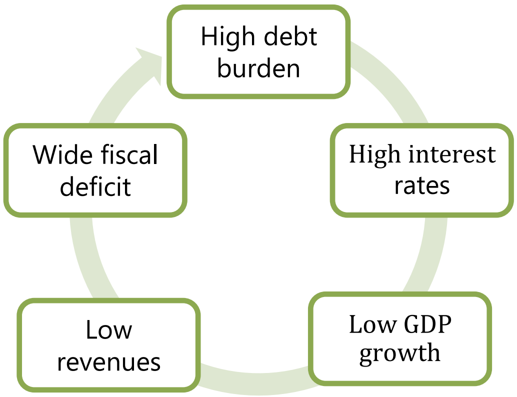
Counting the cost of high debt burdens

High levels of public debt have been assosciated with lower levels of subsequent growth (Woo & Kumar, 2015) because they negatively affect capital accumulation. They depress capital formation and labour productivity (Egert, 2014). Once debt is above a certain threshold, which differs across economies and time, the drag on growth starts. At its most acute, this stress will be in debt distress and default. This closes economies out of debt markets and can lead to economic recession.

The slower-acting manifestation of debt stress is very high debt service costs. These inhibit more productive and welfare-enhancing government spending. High sovereign borrowing costs also influence interest rates in the broader economy and raise the costs of capital for most economic investment. These effects feed into and reinforce each other. Often countries start with high debt, which beget high interest rates, which leads in turn to high debt service costs, lower growth, low revenues, high fiscal deficits and ever higher debt burdens. Left unchanged, this cycle will ultimately result in debt distress (see Figure 12).

5 LSE IDEAS Webinar: The Emerging Market Debt Crisis, Published 28 July 2022, Podcast at https://www.lse.ac.uk/ideas/podcasts/2022/The-emerging-market-debt-crisis

Figure 12: The negative debt feedback loop that leads to distress



Source: Author

There has been much debate about the threshold beyond which debt becomes a drag on growth. Reinhart & Rogoff (2010) found that sovereign debt above 90% of GDP was associated with lower GDP in both developed and emerging economies. Egbert (2014) found that, where applicable, negative threshold effects kicked in at debt levels between 20% and 60% of GDP. In an earlier study, the threshold where "sovereign debt turns bad" was estimated at 64% for emerging market countries and 77% for developed economies (Caner et al., 2010). Other studies found that this threashold might not be generally observed. This is consistent with the apparent ability of countries to run very high debt levels sustainably. Japan is just such an exmple. It has maintained a debt to GDP level above 200% of GDP without apparent ditress. In conclusion, it appears that while higher debt levels were associated with lower subsequent growth, a common threshold above which this happened was not observed.

High debt levels impose policy constraints

At very high debt levels and under conditions of stress, additional expenditure imposes a cost to the economy. This may be mitigated by the imposition of fiscal management tools and protocols, including fiscal rules (Combes et al., 2017). High debt thus imposes policy constraints either via the need to introduce fiscal rules to manage the costs thereof, or via conditionality imposed by external funders in the case of multilateral support.

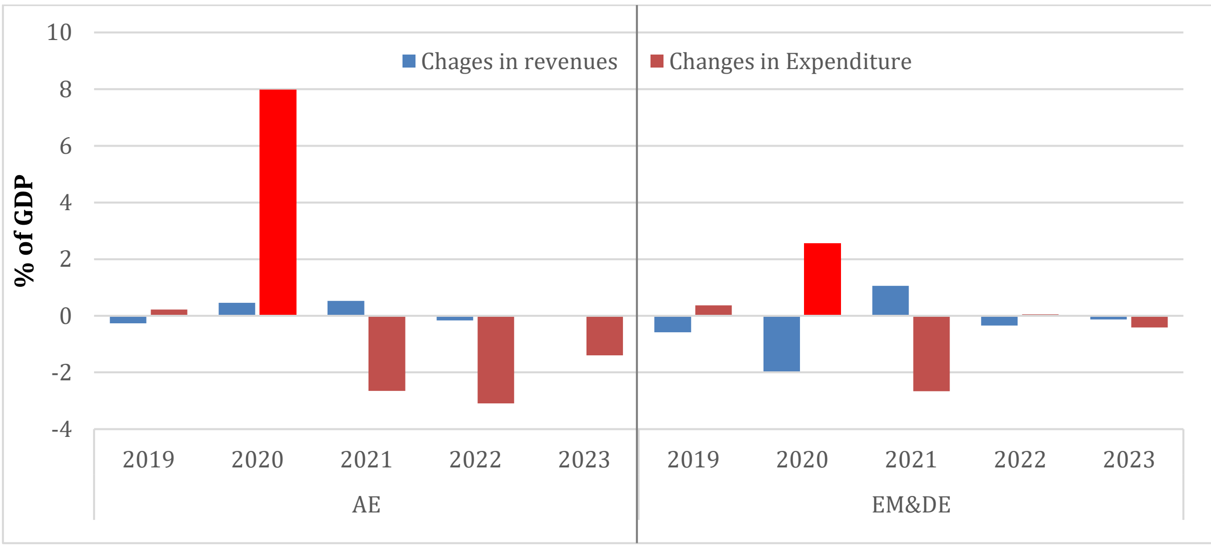
High debt levels limit the responsiveness of monetary and fiscal policy

Many large emerging markets now borrow from foreign investors in their own currency, but they are not insulated from foreign financial shocks. Pressure on local currency denominated bonds is shown to exceed that on US dollar-denominated bonds in periods of global financial stress. This phenomenon is now termed "original sin redux" (Bertaut et al., 2020). Tightness in foreign lenders' financial conditions transmits into sovereign bond markets regardless of the currency of denominations. Emerging markets are vulnerable to capital outflows. While borrowing from foreign investors in the local currency reduces risks, it does not eliminate them (Hoffman et al., 2022).

The misalignment between debtor and creditor countries constrains the ability of debtor countries' fiscal policies to respond to economic cycles. Debt is often available to emerging market economies when the global economy is strong; and it dries up when cyclical headwinds are most prevalent. This leads to pro-cyclical fiscal policy adjustments in emerging market economies. It may even result in insufficient responses to economic shocks.

We saw some of this during the Covid-19 crisis in 2020 and 2021. Poor countries lagged in their response to the economic crisis, even as richer countries expanded expenditure materially (see Figure 13). Emerging markets consequently experienced higher output losses, deeper scarring in their labour markets, and likely more permanent loss of productive capacity. Governments' indebtedness to foreign bond markets has been shown to lead to fiscal austerity (Kaplan & Thomsson, 2017).

Figure 13: Fiscal stance, 2020–23: Change in revenues and expenditures



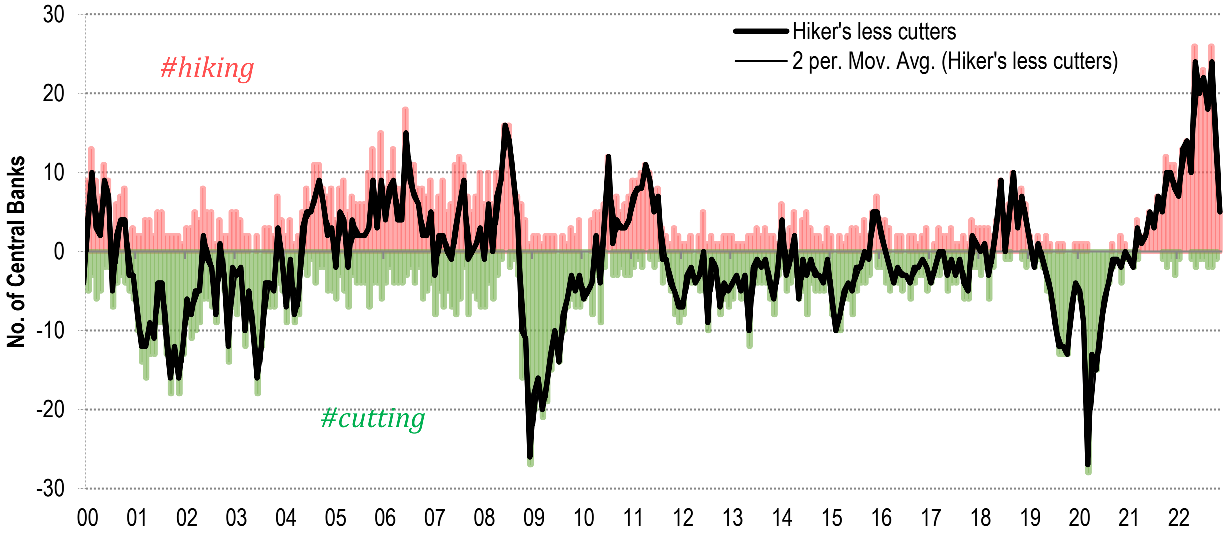
Source: IMF World Economic Outlook, April 2022

Increased financial integration via high debt levels and increased holdings of local currency bonds by offshore investors transmits US and other developed economy central banks' monetary policy tightening into emerging markets. High indebtedness increases sensitivity to changes in US monetary policy in particular. Higher debt in general, and external debt among other factors, increases economic vulnerability to global monetary shocks, especially those emanating from US monetary policy tightening (Iacoviello & Navarro, 2018).

The US Federal Reserve has the worst inflation spike since 1982. Policy rates there are expected to rise to over 5.0%, a level not seen since 2007. Interest rate hikes, together with quantitative tightening,[6] have imposed a substantial shock to global financial conditions. This has resulted in outflows from emerging market economies.

In 2022, we have seen central banks raising rates across the world, even though their local economic conditions vary widely. To date ninety percent of the 38 central banks tracked by the Bank of International Settlements have increased their policy rates in 2022 (see Figure 14).

Figure 14: Global central banks' policy decisions



Source: BIS, author's calculations

Many emerging market economies had not recovered to pre-crisis levels, but they have had to raise interest rates in line with the US Federal Reserve. These countries were subject to capital outflows when the US raised rates and financial conditions tightened. This inability of monetary policy to support growth will constrain the post-Covid-19 growth recovery in many countries.

The burden of high interest rates

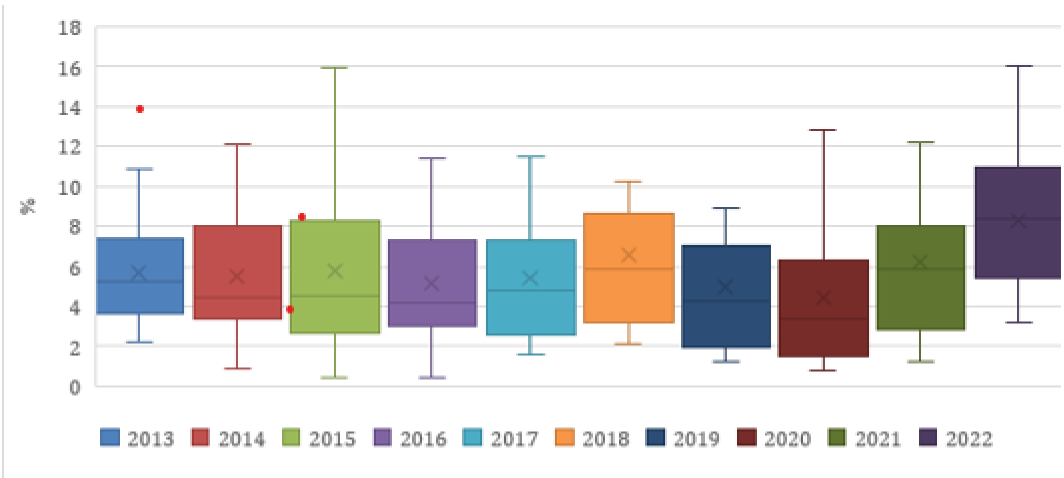
Interest rates reset higher as debt increases and as foreign private investors' holdings increase. Furthermore, the sensitivity of interest rates to debt levels is adversely affected by the extent of private foreign participation in the market. A rise in foreign private holdings of sovereign debt beyond around 20% increases the sensitivity of interest rates to changes in debt levels and increases long-term interest

[6] Quantitative tightening is the policy that reduces the Federal Reserve's holdings of assets, and, in this way reduces money supply.

rates. (Matsuoka, 2021). The rise of rates across the term structure impedes near and long-term economic growth. The challenge might be particularly pronounced for countries whose debt metrics have deteriorated in the past ten years, and who have attracted more external borrowing in any currency.

Bond yields across many emerging market economies have risen to the highest levels in a decade (see Figure 15). This is because of both deteriorating local fundamentals and a worsening global inflation and financial market backdrop. Figure 15 shows distribution of yields into quartiles, highlighting the mean and median (cross). The lines extending vertically indicate variability outside the upper and lower quartile. Emerging markets' debt in US$ has also become more expensive.

Figure 15: Local currency bond yield distribution as at 30th October 2022

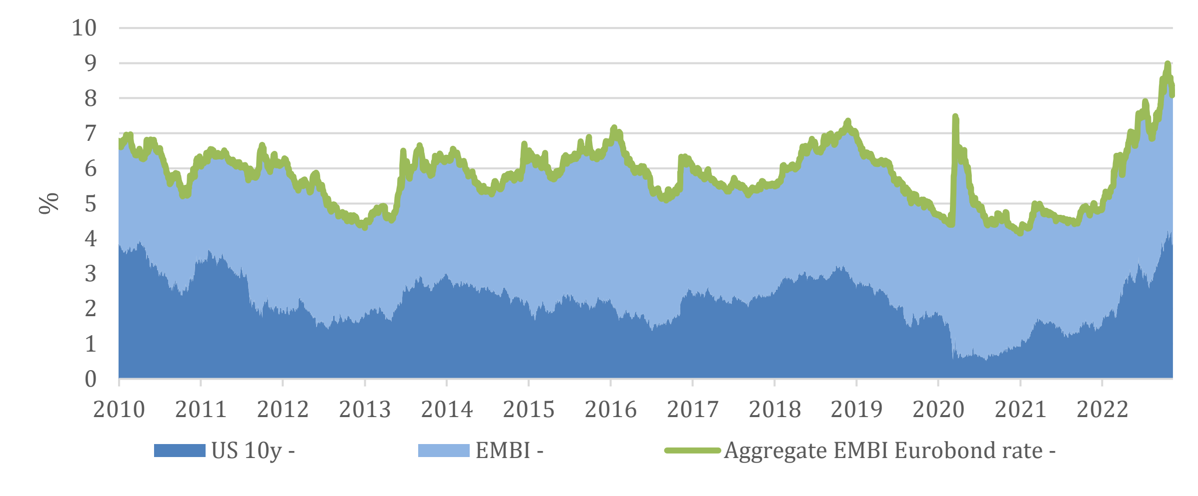


Including South Africa, Turkey, India, Indonesia, Malaysia, Philippines, Thailand, Brazil, Mexico, Columbia, Russia, Romania, Israel, Czech Republic, Chile, South Korea and Peru.

Source: Bloomberg, author's calculations

Prevailing rates for emerging market bonds, measured as the sum of the US treasury bond yields and the emerging market bond index (EMBI) spread, soared to over 8.1% from 4.8% in December 2021 (see Figure 16**).** The variability between spreads of bonds of different tenors and across the different credit qualities is also high. Moody's data shows that spreads of emerging market Eurobonds are as low as 0.6%, for short-dated bonds of A-rated sovereigns, and as high as 9.5% for long-dated bonds of B-rated governments. Governments, when they issue, are borrowing shorter-duration debt at higher rates.

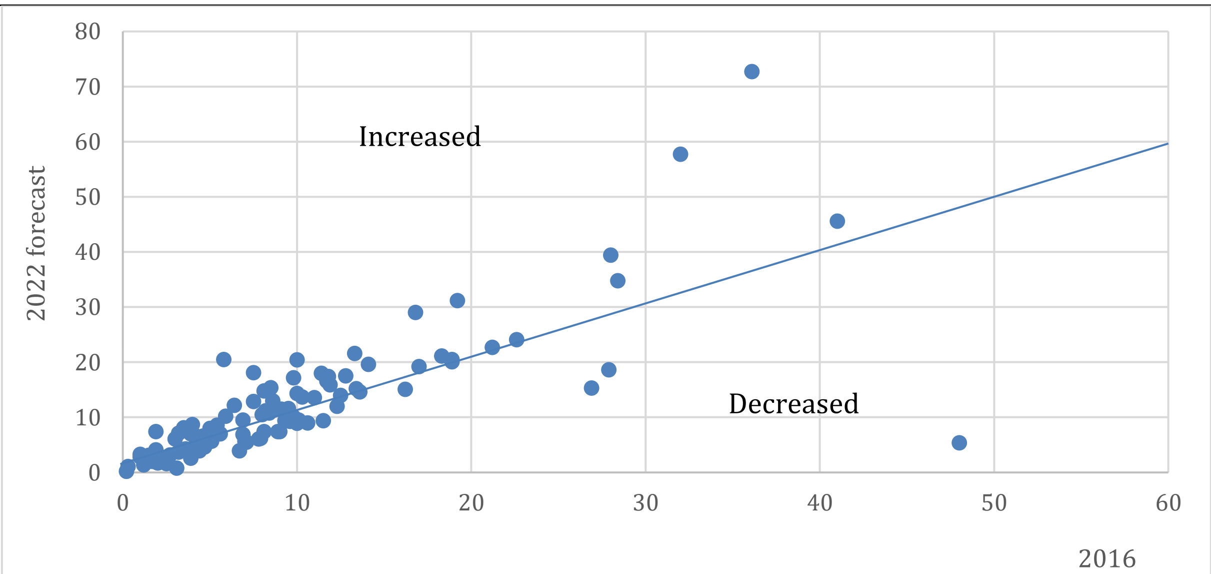
Figure 16: Aggregate emerging market Eurobond yields



Source: Bloomberg, author's calculations

For countries with high debt levels, the recent rise in interest rates will negatively affect debt service costs as countries refinance maturing debt. Debt service costs as a percentage of GDP increased in the five years to 2021 for 72% of emerging markets rated by Moody's (see Figure 17). In 2016, only 33% of emerging market countries, excluding China, covered by Moody's used more than 10% of revenues to service debt. In 2022 that proportion has grown to a half.

Figure 17: Interest payments (% of revenues)



Source: Moody's Analytics, author's calculations

Over time, debt-service costs are prioritised ahead of other spending. For example, in South Africa, debt-service costs are forecast to grow on average by more than 12% each year over the medium term; and core spending has been cut to accommodate these escalations. Debt service costs are expected to be the largest expenditure line item, ahead of welfare-enhancing expenditure, including primary education and healthcare (Sachs, 2022).

Debt distress will deal a multi-year blow to growth in the global south

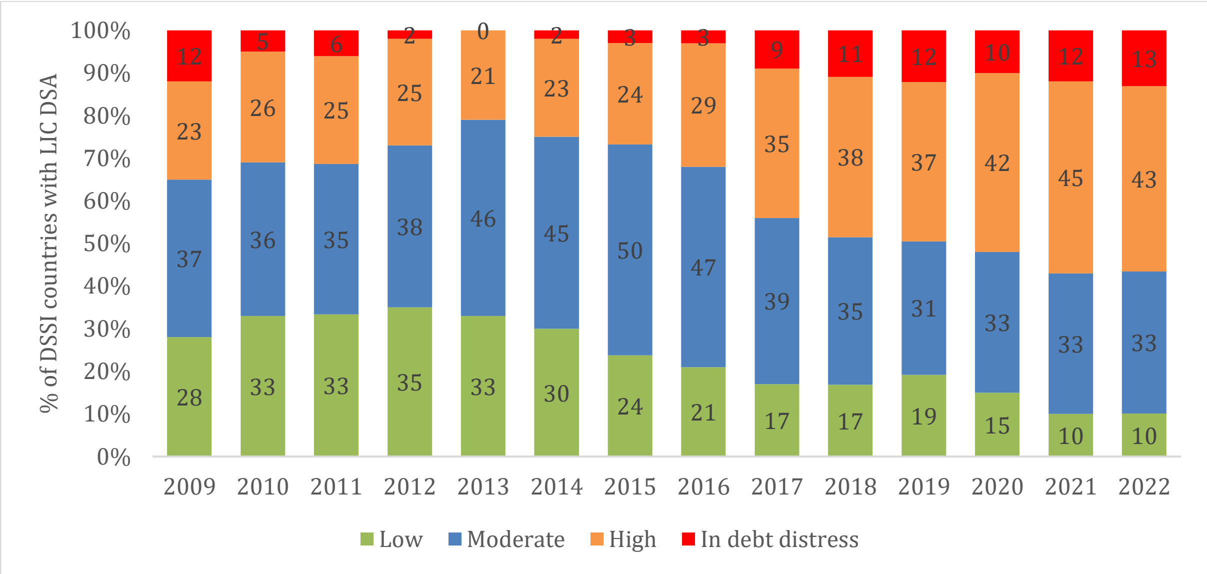
Debt distress is the most acute and destructive implications of high indebtedness. Avoiding restructurings and resolving debt distress timeously will be critical if the negative effects are to be contained.

Sovereign default crises entail significant and persistent growth dislocations, the extent of which depends on how long it takes to resolve the default. Debt crises are over when debt sustainability and access to capital markets are restored. The post WW II mean and median periods over which defaults were resolved were at 5 and 7.9 years respectively (Reinhart C. M., 2022).

There are large negative economic responses to adverse US monetary shocks across countries. The primary channel of transmission of adverse monetary policy adjustments in the US for developed economies was exchange rate and trade. However, in emerging markets, financial fragility appeared to account for the bulk of the negative effects (Iacoviello & Navarro 2018). The impact of recent US tightening could be a cascade of defaults across emerging markets.

The end of global capital flow spikes is associated with a significant increase in sovereign default risk (Reinhart et al., 2016). Given that we are at such a juncture in global financial markets, it is no surprise that financial debt distress is rising. Global shocks explain clustered defaults where multiple governments default in quick succession, and the default decision themselves are sensitive to world interest rate changes (Singh, 2019). In April 2022, the IMF estimated that the proportion of low-income countries it surveys in or at high risk of debt distress had risen to 60% compared to half that proportion in 2015 (Chabert, et al., 2022) (see Figure 18).

Figure 18: DSSI Eligible countries IMF DSA



DSSI: Debt Service Suspension Initiative, LIC: Low-income Countries, DSA: Debt Sustainability Analysis

Source: IMF Blog: Restructuring Debt of Poorer Nations Requires More Efficient Coordination, 2022

The global governance response to countries in debt distress

A coherent and effective global policy response is needed to limit the fallout from debt distress for emerging and low-income countries. IMF crisis multilateral funding has historically failed to help countries get onto sustainable paths. IMF structural adjustment programmes include giving financial support to countries on condition that they implement certain structural reforms. The reforms are typically focused on fiscal, monetary and financial sector policy, but often include reforms in other areas as well. The IMF's structural adjustment programmes have been criticised for having adverse distributional consequences in recipient countries.

IMF conditionality typically focuses on fiscal policy, external sector, financial sector, and external debt. The fiscal "reforms" the IMF typically asks for entail reducing government expenditure, reducing public sector wages and sometimes lowering public sector employment. All of these are "reforms" that disproportionately affect the poor. Trade and foreign exchange liberalising reforms can erode protections for low paid workers. The benefits of financial market liberalisation accrue mostly to the wealthy. Monetary policy reforms which, on balance, have been beneficial to economic performance, can also lead to high interest rates, which benefit savers over borrowers. The negative distributional effects have been shown to persist over the medium term (Forster et al., 2019).

The IMF has been at pains to move away from its image as a draconian organisation enforcing unsuitable and unjust advice and conditions on vulnerable developing economies. At least rhetorically, it has softened its widely perceived "old agenda of maintaining macroeconomic stability, income and wealth inequality, gender inequality, corruption, and climate change" (Wolf, 2019). However, there is still deep scepticism about whether this rhetorical change is reflected in practice. IMF conditionality was reincorporated in many of the reform designs it claimed to no longer support in the post global financial crisis era. And policies introduced to reduce the negative social consequences were not adequately incorporated into programme (Kentikelenis et al., 2016).

The Covid and post-Covid period is an occasion for the new IMF and multilateral financial institutions to emerge. In the midst of the Covid-19 crisis in 2020, the G20 introduced the Debt Service Suspension Initiative (DSSI), a mechanism to negotiate the delay and rescheduling of debt servicing for eligible countries during the Covid-19 economic crisis. This initiative was able to disburse US$13 billion in 2020 and 2021 to the 48 countries which signed up for it. This programme was only a partial success because only official creditors participated. Outside of the DSSI, multilateral funders came forward with a myriad of other fiscal support packages. Private sector creditors did not extend debt relief, instead they came forward with "nearly $90 billion of new lending, including $14 billion to the DSSI countries" (Ahmend & Brown, 2022). This DSSI ended in 2021.

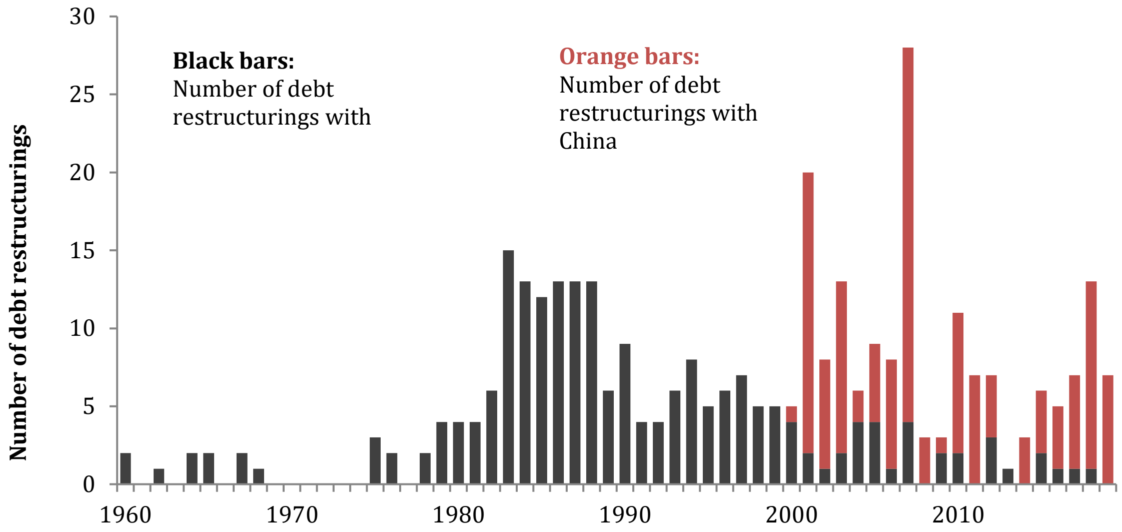
In recognition of the continuing challenging outlook for debt in low-income and developing countries, the G20 reached an agreement on a Common Framework for Debt Treatments in 2021. This approach is intended to assist with creditor coordination to:

- deal with liquidity and solvency issues of countries;
- hasten suspension of debt payments and restructurings; and
- enable a quick flow of IMF funding to limit the negative effects of debt distress.

The framework is failing to deliver on its promise. It is a case-by-case approach to countries leading to protracted negotiation. Countries try to access the framework once all other options are exhausted. Some creditors, including China and the private sector, have not been keen participants when countries have gone the Common Framework route. This led to protracted negotiation periods and debtor countries' reluctance to enter negotiations because of their unwillingness to lose access to important lenders. The framework is caught up in the complexity of global geopolitics and is not living up to its promise of creditor coordination.

China's lending to emerging markets has further complicated the picture. There is the growing frequency of defaults and restructurings to Chinese lenders, which, like the associated debts, also remains hidden as missed payments and restructuring details are not disclosed (see **Figure 19**). Chinese creditors seldom provide debt relief through reduction of the debt liability in their loan restructurings. Countries with distressed debt could have serial restructurings (Horn et al., 2022), an outcome that would plunge countries in debt distress for much longer.

Figure 19: Sovereign Restructurings: Chinese vs private external creditors



Source: Horn et al. (2022)

Countries highly indebted to Chinese creditors, and in distress, will turn to traditional IMF funding when shocks erode underlying loan collateral. They often endure much stricter conditionality on fund support (Kern & Reinsberg, 2021). This implies that the typical policy constraints imposed by multilateral lenders in times of distress will be more stringent in this China-lending era, potentially making policy less responsive to citizens' needs.

Conclusion: Sovereign debt will worsen inequality

Sovereign debt is integral to macroeconomic policy and has profound implications for, and is the result of, global and local political economy. The past decade has seen the overall increase in sovereign debt in emerging markets and low-income countries, and the rise of debt to foreign private interest and to China in particular. This will likely be one of the key constraints for pro-social policy in the post-Covid era

At low levels, sovereign debt is almost a non-issue, and can be an enabler to growth and welfare enhancement. At high levels, it can become the primary driver of macroeconomic policy and have profound effects in aggregate welfare and inequality both within and between countries.

Figure 20: The negative inequality/sovereign debt cycle

Source: Adapted from Bohoslavsky (2016)

High levels of sovereign debt and sovereign debt crises will, in the immediate aftermath, depress economic output, raise inflation, raise unemployment, and can depress labours' share of income. In most instances, sovereign debt crises lead to increasing poverty levels, a consequence that is worsened by the fiscal austerity response governments adopt in response. All these serve to worsen inequality, as the illustration adapted from Bohoslavsky (2016) (Figure 20.) illuminates.

Inequality within countries has been associated with an increase in sovereign indebtedness and ultimately, an increase in risk of sovereign debt crises. These sovereign debt and expenditure boom-bust cycles are evident in emerging markets. It looks likely that we are going into a period of expenditure retrenchment, and therefore higher inequality in the global South. Prior experience suggests that the coming period will be characterised by rising, not falling, inequality as countries respond to the pressures brought by these high debt burdens, whether they default or not.

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