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Rising Debt of the Developed World and Implications for Developing Countries

by

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The views expressed are those of the author and do not necessarily reflect the views of UNCTAD

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Outline

- The Global Environment
- Impact on Developing Countries
- What can Developing Countries do?

The Global Environment

- Growing worries about potential spillovers to the rest of the Euro Area
- Increased evidence of global growth slowdown, possible recession in Europe
- Advanced economy capacity to pursue aggressive fiscal and monetary policies reaching limits
- Current and projected debt levels are alarming
- Urgency to undertake fiscal reforms without hurting growth prospects

Advanced economy debt levels continue to grow sharply

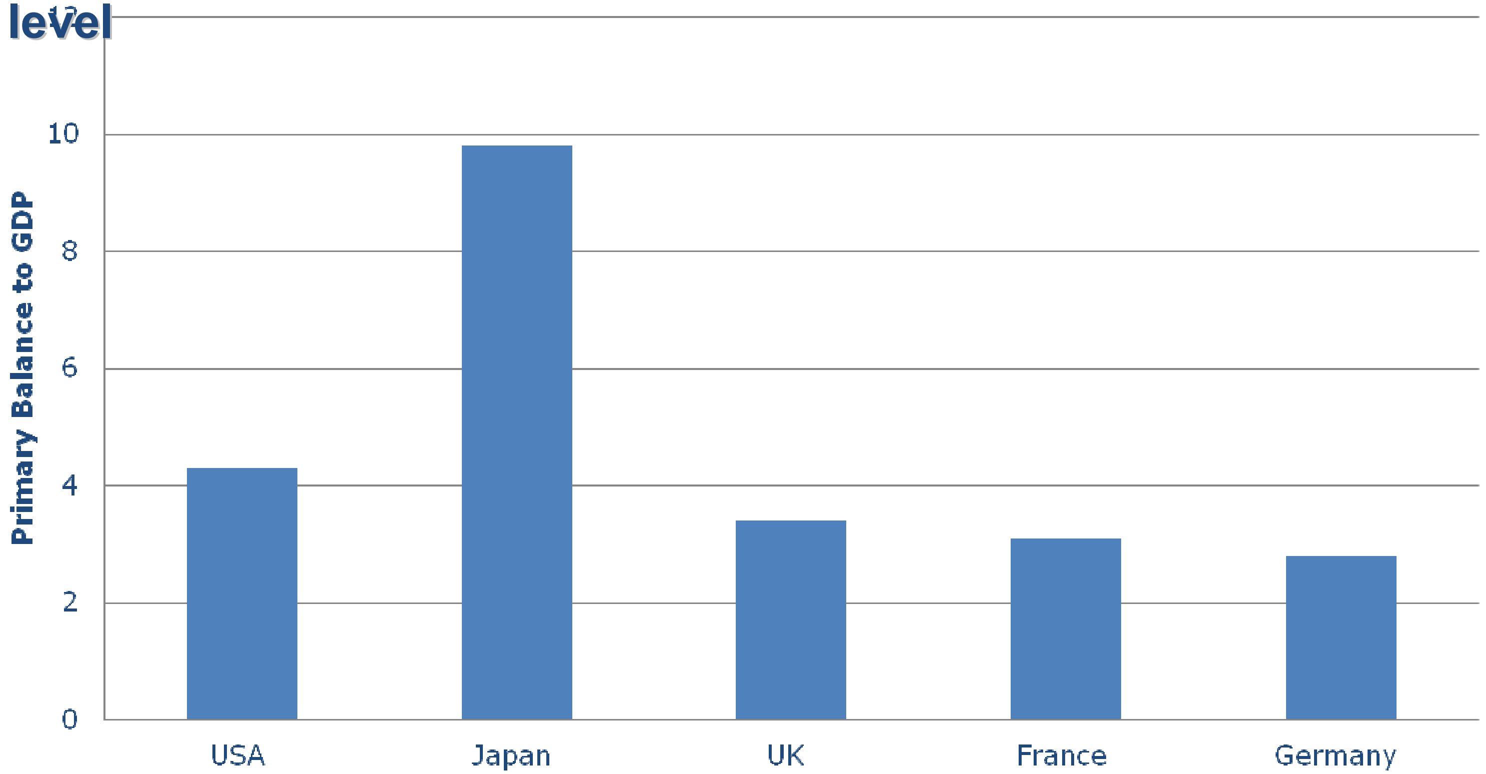
Gross General Government Debt

Debt/GDP	2007	2009	2014	% incr: 2007-14
Advanced G20	78.8	100.6	119.7	52%
USA	63.1	88.8	112.0	77%
Japan	187.7	217.4	239.2	27%
UK	44.1	68.6	99.7	126%
France	63.8	77.4	95.5	50%
Germany	63.6	79.8	91.4	44%

Source: Horton et al., 2009

Difficult fiscal adjustments required to return debt to "normal" level

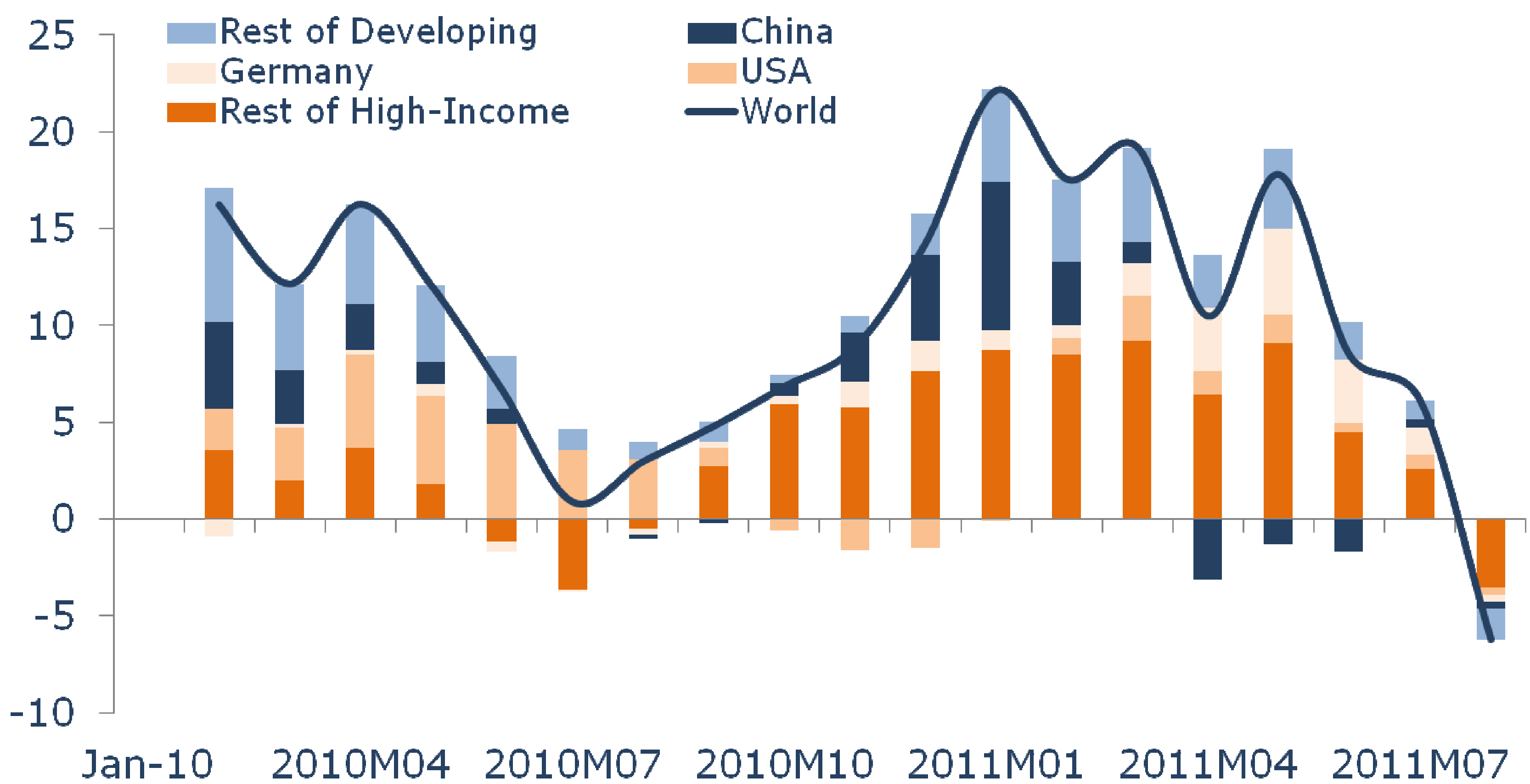
Average primary balance needed to lower debt to benchmark* level



*Half of 2014 level for Japan and 60% for the rest by 2029
Source: Horton et al. (2009)

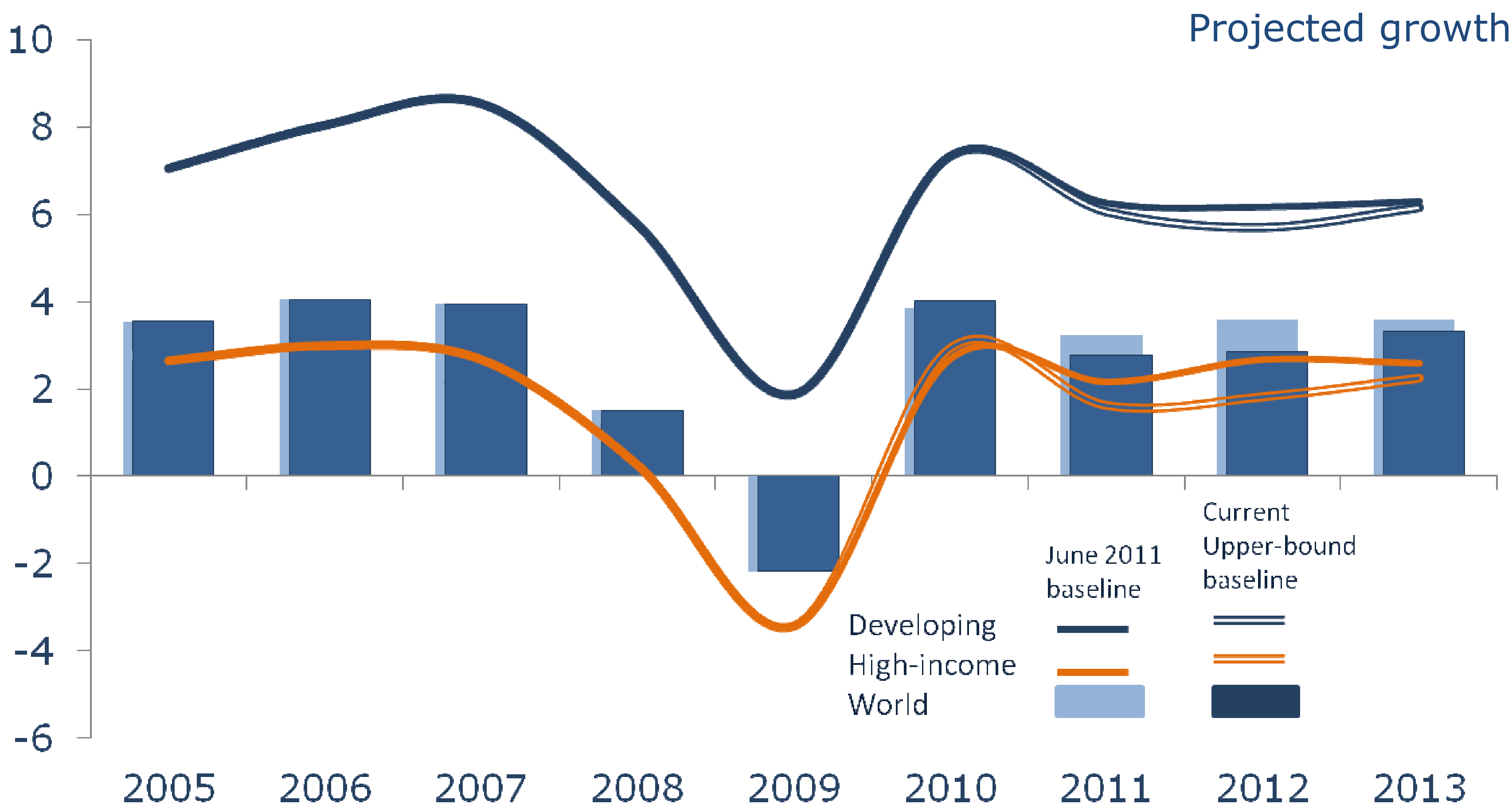
Import volumes appear to have declined sharply in August

Contribution to growth of global import volumes, 3m/3m saar



Source: World Bank DEC Prospects Group

Growth forecasts have been downgraded over recent months



Source: World Bank DEC Prospects Group

Implications for Developing Countries

Deepening global slowdown impacts through multiple channels

- Lower capital inflows, potential for outflows
- Reduced availability and higher cost borrowing
- Reduced remittances
- Reduced short-term credit availability (e.g. trade finance)
- Slower export growth, reduced tourism
- Banking sector linkages
- Confidence / contagion effects

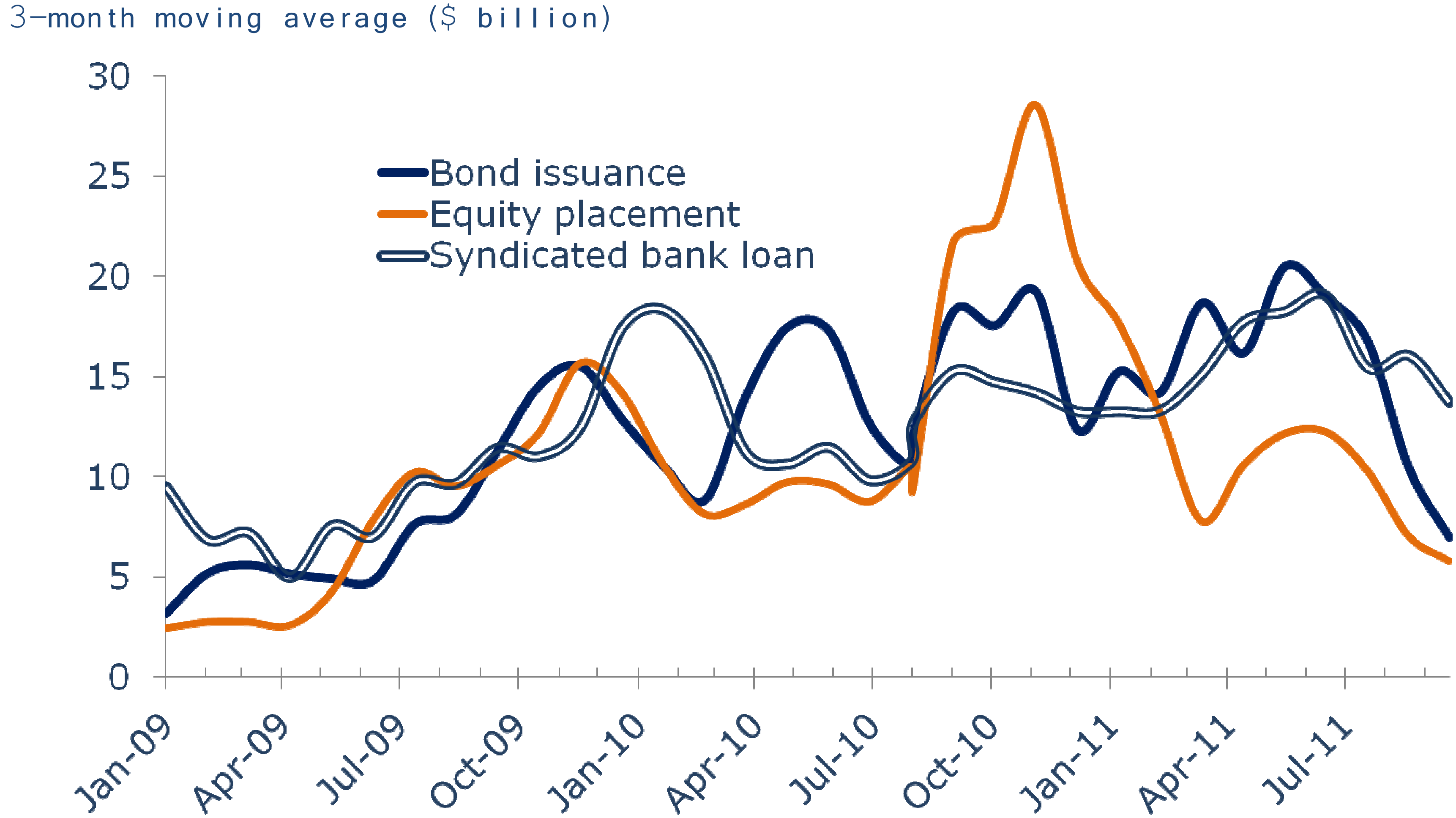
Developing countries now more vulnerable to crisis than in 2008

- Contagion means capital flows have become more volatile – with some countries already drawing-down heavily on reserves
- Governments have much less fiscal space than in 2008
- Countries in ECA and LAC have significant exposure to European banking sector
- Several ECA countries and the CFA are exposed to currency risk
- Countries in ECA and MNA are most vulnerable to a slowdown in European imports

Market jitters have resulted in large-scale sell offs

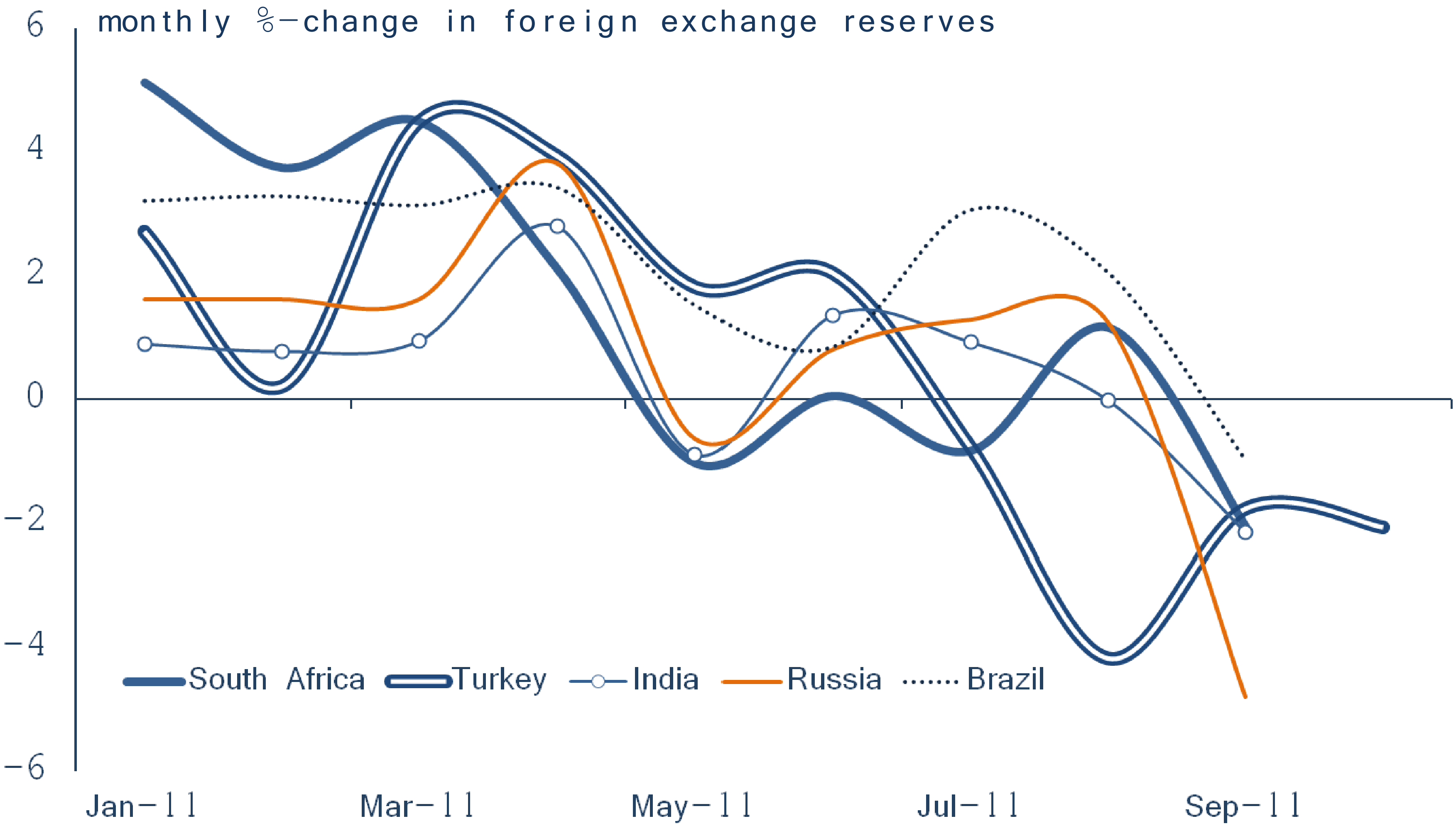
- World stock capitalization declined about $5 trillion (8.2% of global GDP) since end July
- Emerging-market equity mutual funds have posted weekly average outflows of about $2 billion since August.
- Q3 (July, August and September) gross capital flows to developing countries were down 64% and 52% from the same period of 2009 and 2010, respectively

Capital flows to developing countries faltered in August/September



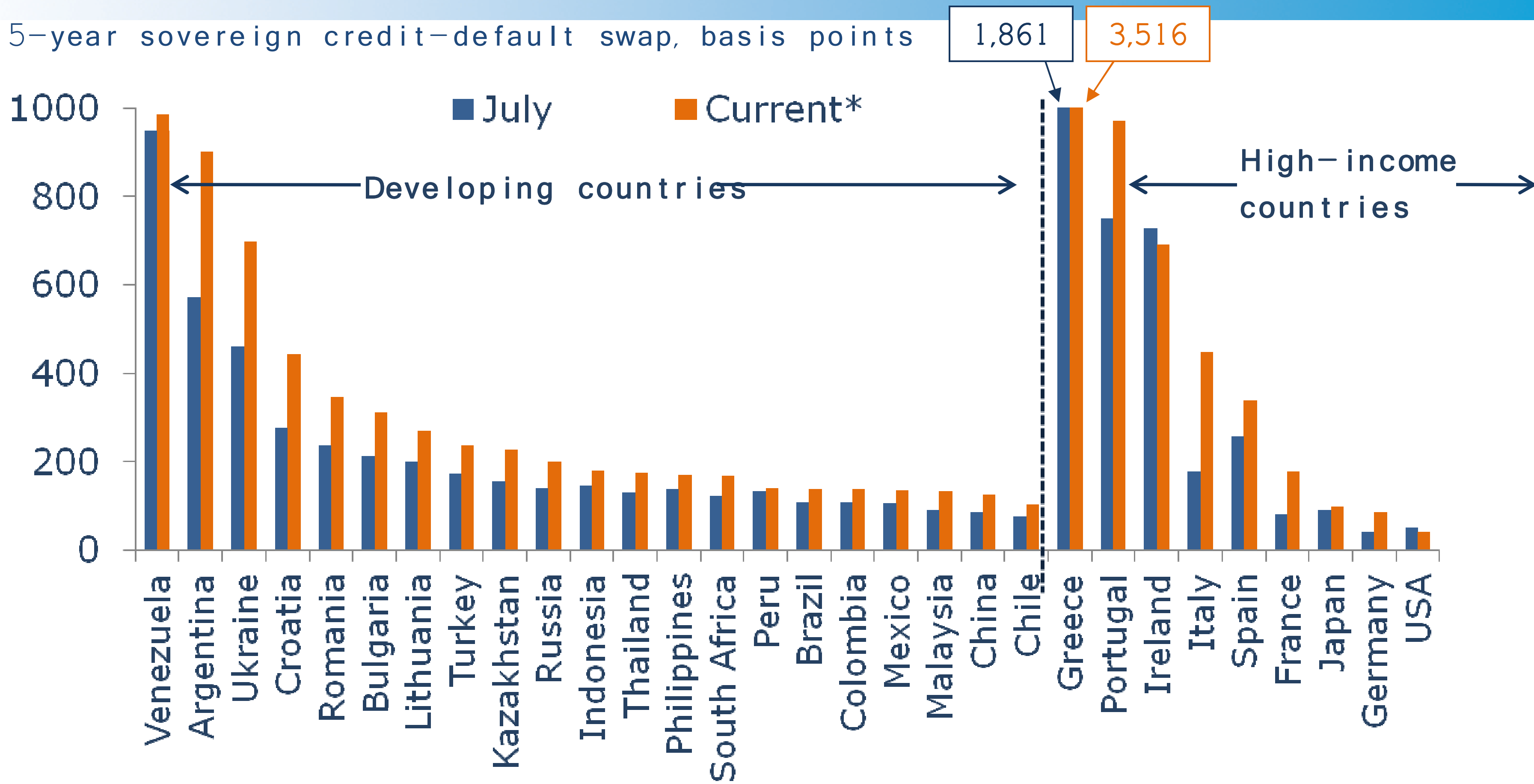
Sources: World Bank DEC Prospects Group, using data from Dealogic

Reserves have been drawn down in some countries



Sources: Thomson Datastream and World Bank DEC Prospects Group

Contagion has increased sovereign credit default swap rates worldwide

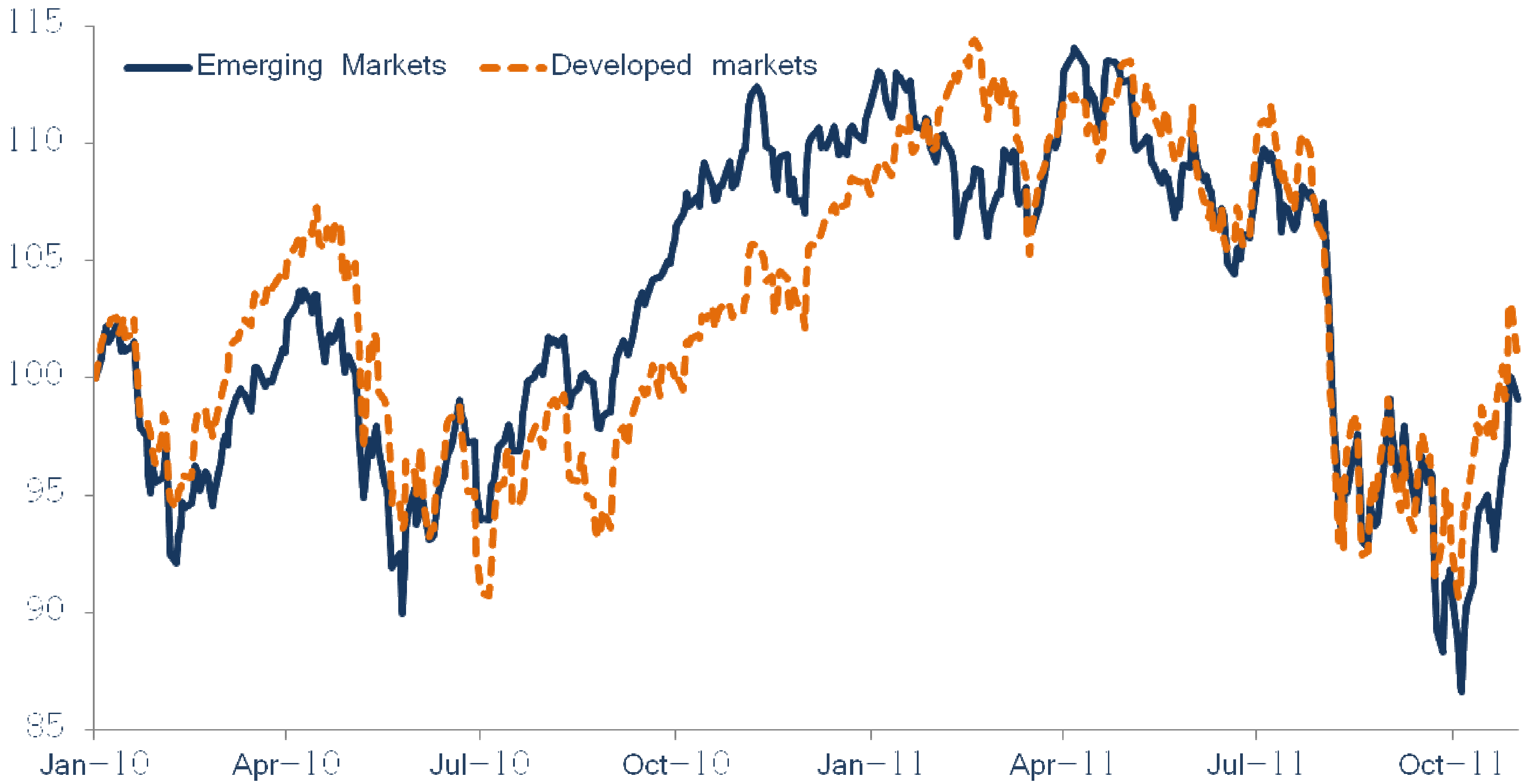


* As of October 31st, 2011.

Sources: Bloomberg and World Bank DEC Prospects Group

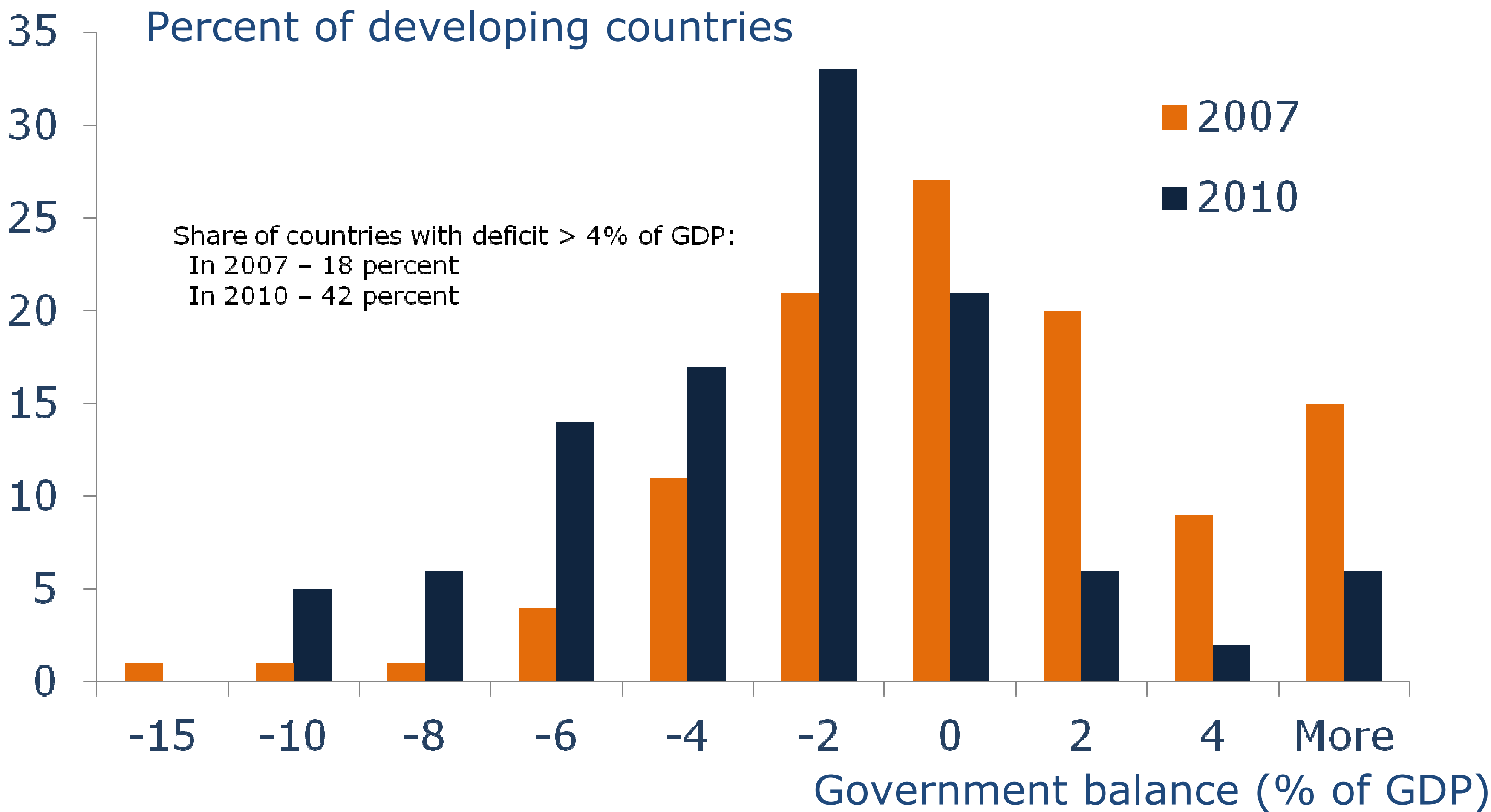
Turmoil has hit developing countries equity markets hard as well

MSCI equity indices, Jan. 2010 = 100



Sources: Bloomberg and World Bank DEC Prospects Group

Fiscal deficits have risen sharply in many developing countries



Source: World Bank DEC Prospects Group

Global environment has become much more precarious

BOTTOM LINE:

- Developing countries' fundamentals remain strong but contagion is generating potentially strong headwinds

- For developing countries, prospects going forward will depend on further progress in appeasing market worries and extent to which uncertainty passes through in ways that further damage confidence and growth

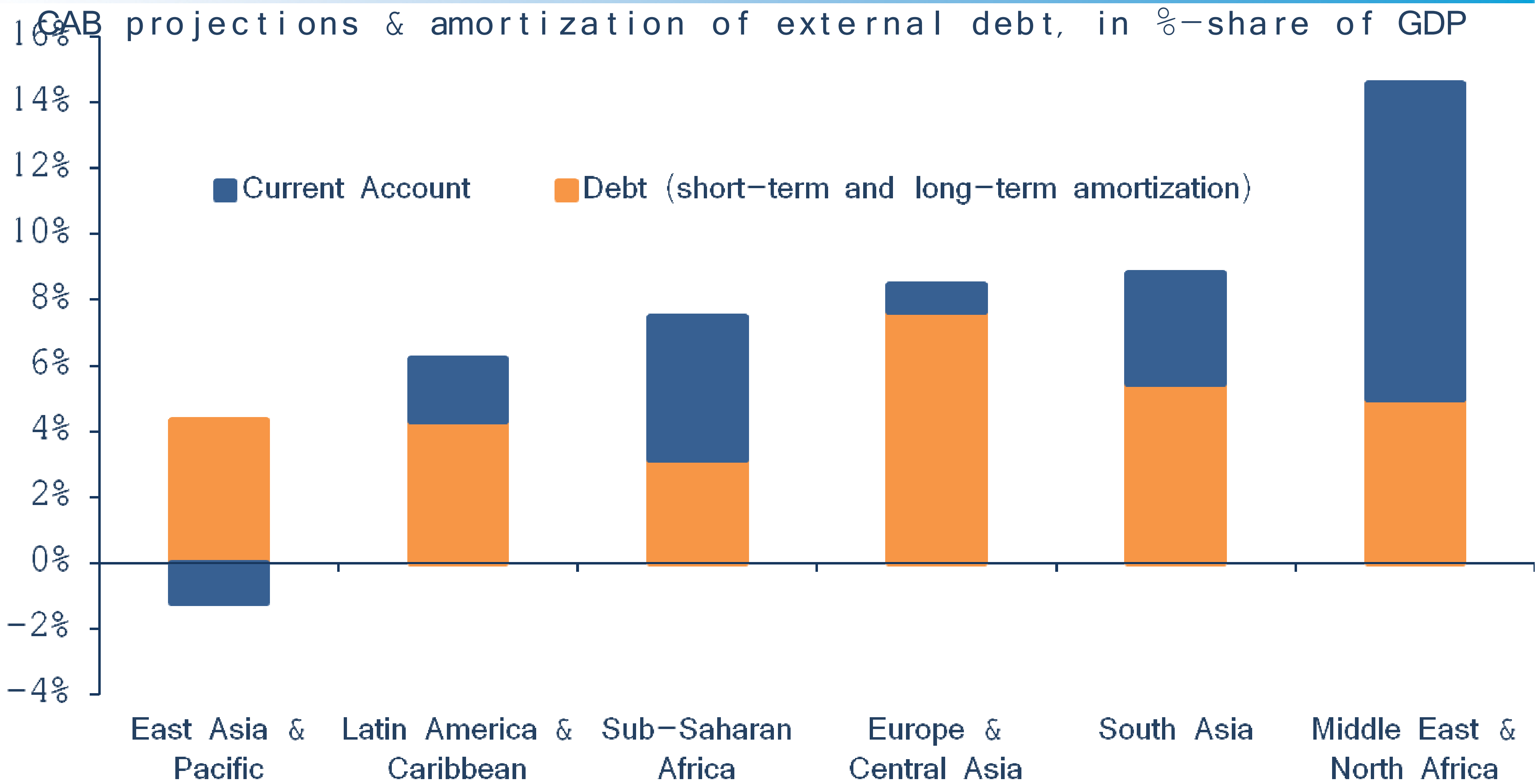
Impact on Middle-Income Countries

- Debt rollover risks
  - Capital flight to safer havens
  - Increased cost of financing (spreads)
  - Shorter maturities more attractive (steeper yield curves)

- Crowding out risks
  - Increased financing requirements in rich countries

- Exchange rate risks

Estimated external financing needs for developing regions in 2012



Sources: World Bank DEC Data and Prospects Groups

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Sound Economics for Growth and Poverty Reduction
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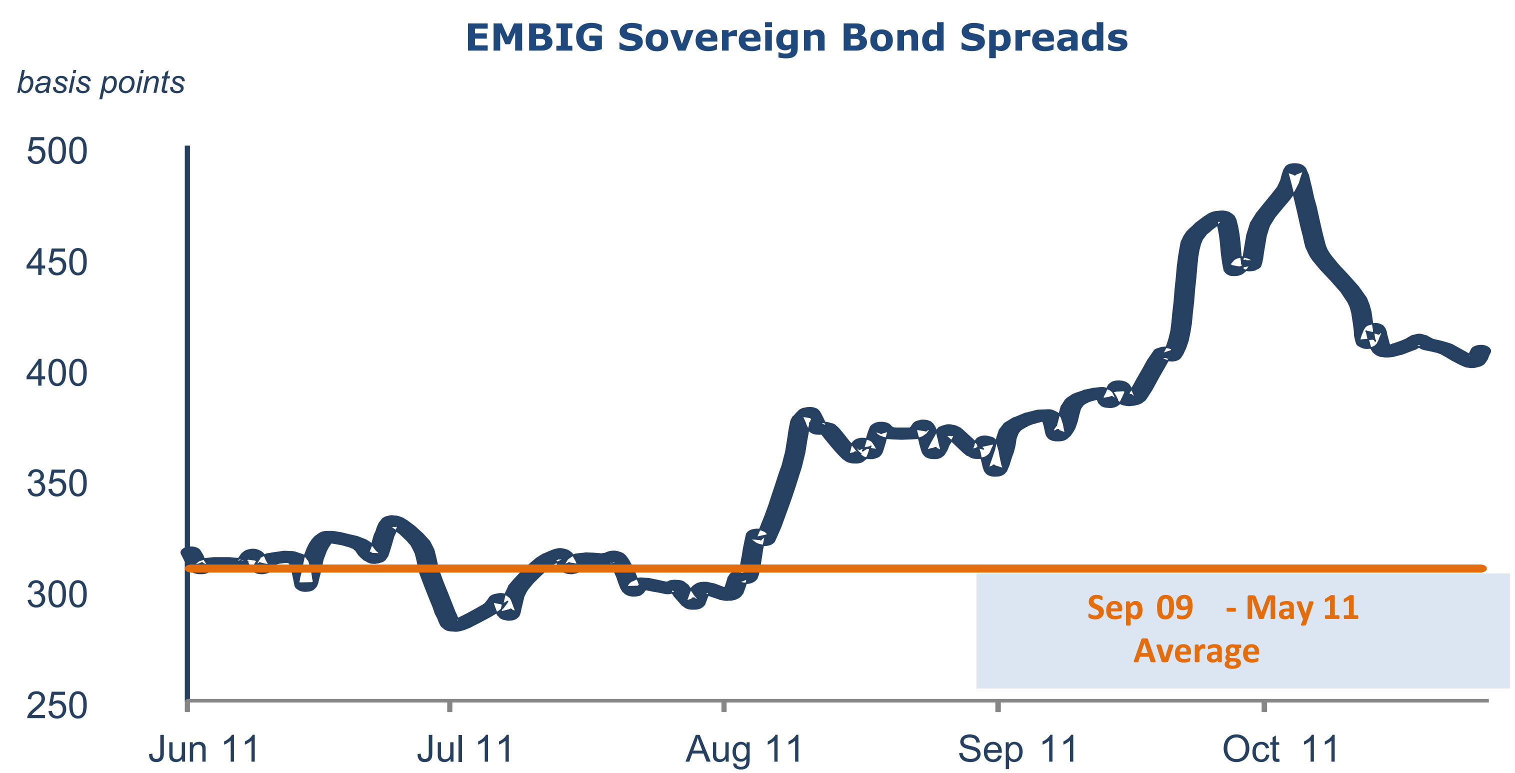
Emerging market bond spreads have gone up



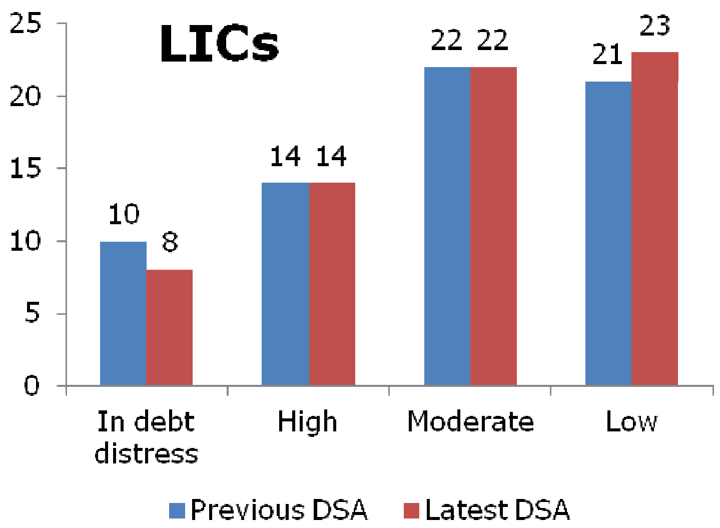
Source: JP Morgan.

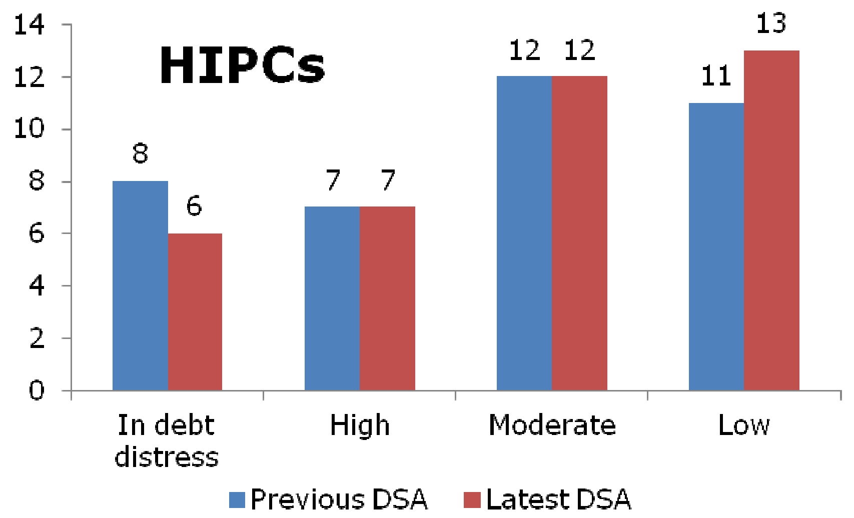
Impact on Low-Income Countries

- Access to international capital markets put on hold (eg. Zambia, Tanzania)
- Strained balance sheets of developed countries may lead to reduced aid flows and greater reliance on non-concessional borrowings by Low-Income Countries
- Potential adverse impact on debt sustainability

Debt distress ratings
April 2010 vs. September 2011

- One third of Low Income Countries and one quarter of HIPCs* remain at high risk of debt distress or in debt distress
- No post completion point HIPC is in debt distress





*HIPC: Heavily Indebted Poor Countries

What can Developing Countries do?

Risk management is key

- External events have had—and will continue to have—a significant impact on financial conditions in developing countries.
- While not the source of global difficulties, developing countries will be scrutinized as well.
- Markets will closely monitor fiscal positions and punish the poor performers.
- Best response is pursuit of **credible** medium term fiscal and debt management strategies.
- Technical assistance and capacity building efforts from IOs can support these efforts.

Debt sustainability is only one aspect of prudent debt management

Debt Sustainability		
Debt Management		Long Term Debt Sustainability
DeMPA (process)	MTDS (debt composition)	DSF-LICs/FSA-MICs (debt level)

Debt management issues

Critical issues facing today's debt managers:

- How to close an increasing financing gap and finance a country's development needs at low cost with a prudent degree of risk, especially at a time when conditions in **financial markets are severely constrained**?
- Given limited external financing options, how can potential benefits from **developing domestic markets** be exploited at a low cost and prudent degree of risk?
- **Given the efforts by many governments to strengthen their balance sheets over the past decade**, how can these sounder public debt structures be protected?
- Since the crisis implies substantial long-term macroeconomic adjustments, **how should debt management strategy reflect the new reality**?

Concluding remarks

- **Expansion of public debt has been massive in advanced countries**. Countries need to adopt strategies so as to reassure markets of the public sector's solvency. A credible medium-term strategy that safeguards fiscal sustainability is key
- **Slower world economic growth and higher cost of capital** will mean a more difficult environment for developing countries seeking to accelerate growth
- **Debt sustainability in LICs** needs to be carefully evaluated if there is an increase in non-concessional borrowings
- **Debt management** practices are going to assume greater importance in this changing environment

Thank You!

For more information:
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