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››› Sovereign debt in emerging market economies is a country-specific issue

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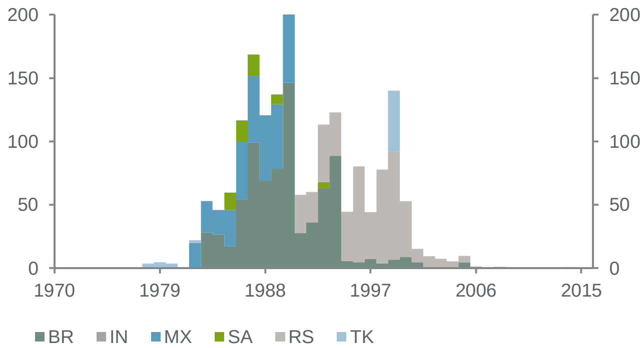
Recently, a strong focus has been placed been on the rising debt of non-financial enterprises and private households in emerging market economies. However, sovereign debt in the large emerging market economies has also increased in the aggregate. Since early 2011, it has relatively continuously risen from 36 to 46 % of GDP. The question therefore arises as to whether any debt sustainability problems can be identified.

Sovereign debt crises with descriptive names such as the ‘Russian flu’ of 1998 or the Latin American debt crisis of the 1980s, in particular, are hard to forget. The fact that there is no uniform definition of sovereign default makes a complete analysis difficult. Especially for debts denominated in local currency, payment difficulties do not have to result in an outright payment default. Instead, governments have other options, including issuing a new currency of lesser nominal value.

The Bank of Canada has made a comprehensive collection of historic data on sovereign defaults[1] available. Mexico, Brazil and Russia were the main emerging market economies that defaulted on their sovereign debt as a result of the crises in the 1980s and 1990s (see Figure 1). Brazil, however, also recorded arrears on interest payments to private and public creditors between 2013 and 2015. That was during the sharp economic slump and fiscal crisis of the federal states. India, South Africa and Turkey have seen comparatively low default values. China has always paid its sovereign debt on schedule since the beginning of the 1970s.

Figure 1: Sovereign defaults

USD in billions



Source: CRAG Database of Sovereign Defaults, 2017.

Level of sovereign debt and financing requirements are just the first indicators

The higher a country’s sovereign debt level, the more likely debt sustainability problems will arise. Follow-up financing can become more difficult and potential growth can be negatively influenced. This is because a country with a higher sovereign debt level usually has to pay higher interest rates, requiring a higher primary surplus (revenue surplus not counting interest payments).

If the actual or forecast sovereign debt exceeds 50 % of GDP, it bears taking a closer look at emerging market economies’ debt sustainability. There are currently large differences between the emerging economies’ sovereign debt levels. Russia is at the lower end of the scale, with gross sovereign debt of only 17 % of GDP, while Brazil tops the list with around 83 % (see Figure 2).

Figure 2: Sovereign debt

in relation to GDP in per cent, IMF forecast for 2017

Source: IMF.

Public financing requirements are the second indicator for an initial debt sustainability assessment. For emerging market economies, new borrowing requirements plus repayments due throughout the year (gross financing needs) should be less than 10 % of GDP. For 2017, the IMF has forecast that Brazil, China, India and South Africa will exceed this threshold (see Figure 3).

Country-specific analysis required to assess debt sustainability

Besides looking at the sovereign debt level and financing requirements, a debt sustainability analysis also needs to consider the maturity structure, whether interest, foreign exchange and inflation rates are pegged and what the creditor structure looks like. For example, the higher the share of debt in local currency, the lesser the impact of exchange rate movements. This reduces crisis susceptibility – even if it does not provide absolute protection.

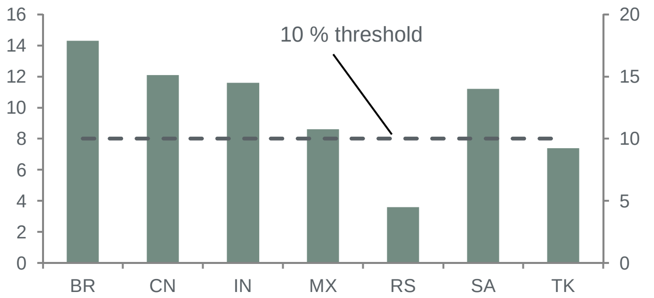
Note: This paper contains the opinion of the authors and does not necessarily represent the position of KfW.

In China, Brazil and South Africa, almost all sovereign debt – more than 90 % – is in domestic currency. In Mexico the share is nearly 80 %, in Russia 70 % and in Turkey 63 %. None of the countries falls below the 40 % threshold, which the IMF has set to assess if a country's debt profile is high risk.

There may also be vulnerabilities resulting from a strong need for external financing, volatile economic growth or a high need for fiscal adjustment. Contingent liabilities, such as guarantees to banks or state-owned enterprises, also have to be assessed. After all, experience shows that bank, debt and currency crises can mutually reinforce each other. Sovereign debt and its development must therefore be assessed and analysed in a differentiated manner to reflect the many influencing factors. That is also why, in its public debt sustainability analysis of market-access industrialised and emerging economies, the IMF does not pass an overall verdict on their risk of a debt crisis either.

Figure 3: Financing requirements

in relation to GDP in per cent, IMF forecast for 2017



Source: IMF.

Current assessment of debt sustainability shows mixed picture

Below we summarise the main findings of the IMF's current public debt sustainability analyses of the major emerging market economies:

- Brazil: Debt sustainability risks are high and result from both high levels of debt and high financing requirements. Even if the country follows through with its ambitious fiscal reform, its debt ratio will continue to rise until 2023. Both debt levels and financing requirements are vulnerable to shocks. In addition, growth prospects are moderate and debt costs are high.

- China: The assessment depends on how the local authorities' debt develops. If all expenditure is included in the budget and investment not included in the budget plan is stopped, the public debt ratio can be anticipated to rise only gradually. But contingent liabilities can become a problem in this scenario as well. If, in contrast, municipal financing instruments outside the budgets continue to be used and the new budget law is not rigorously implemented, then the debt ratio will rise much faster and stabilise only at a very high level.

- India: Debt levels and financing requirements call for closer assessment. Given the robust growth prospects and manageable interest costs, the government finances are, however, regarded as sustainable. Yet a cyclical downturn and contingent liabilities, for example from the recapitalisation of banks, would drive debt levels and financing requirements upwards.

- Mexico: Sovereign debt is regarded as sustainable and appears to be quite resilient against various shocks. The debt profile, especially the high proportion of international creditors, poses a variety of risks. But this is counteracted by the long maturity of debt, which also reduces risks for follow-up financings. Nevertheless, assessments by (international) investors, external financing requirements and foreign currency debt also constitute vulnerabilities.

- Russia: Low government debt levels and financing requirements, as well as a lack of special factors, make a detailed examination unnecessary.

- South Africa: Sovereign debt is generally regarded as sustainable but it would rise significantly if economic growth were to languish over a longer period of time or contingent liabilities were to materialise. The latter are mainly composed of guarantees for loans to state-owned enterprises. In addition, there are aggregate economic vulnerabilities resulting from rising risk premiums or increasing external financing needs, as the current account deficit is already high.

- Turkey: Because of relatively low debt levels and financing needs, its sovereign debt is generally regarded as sustainable. But as in the case of South Africa, Turkey's debt profile indicates vulnerabilities resulting from external financing needs (of the aggregate economy). Likewise, a slump in economic growth or the realisation of contingent liabilities would lead to a significant rise in debt levels.

Conclusion

Among the large emerging market economies, Brazil is notable for the sustainability risks of its sovereign debt. Debt ratios of other countries are, however, also vulnerable to various shocks. In addition to sovereign debt sustainability, countries need a certain degree of fiscal scope to be able to adopt support measures in the event of a cyclical downturn. If that scope is not available to them, the consequence may be a pro-cyclical fiscal policy – because then austerity has to be applied during a crisis. ■

[1] Overdue sovereign debt includes outright defaults (Beers, D. and Mavalwalla, J. (2017), Database of Sovereign Defaults, Bank of Canada Technical Report No. 101):

- Debt service was not paid on the due date or within a certain grace period.
- Payments were not paid within the term specified under a guarantee.

Also included are events that lead to financial losses for the creditors of the government debt:

- Agreements between governments and creditors to reduce interest rates and/or extend maturities of outstanding debt.
- Swap offers from governments to creditors in which existing debt can be exchanged against new debt at less favourable terms.
- Buyback of sovereign debt titles with substantial reductions from their nominal value.
- Conversion of government foreign currency debt into new local currency debt at less favourable terms.
- Government debt for equity swaps (usually in connection with privatisation programmes) at less favourable terms.
- Levying of retroactive tax in order to raise funds to pay back government debt.
- Issuance of a new currency of lesser nominal value.