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THE GLOBAL DEBT WAVE POST COVID LOOKS MORE MENACING

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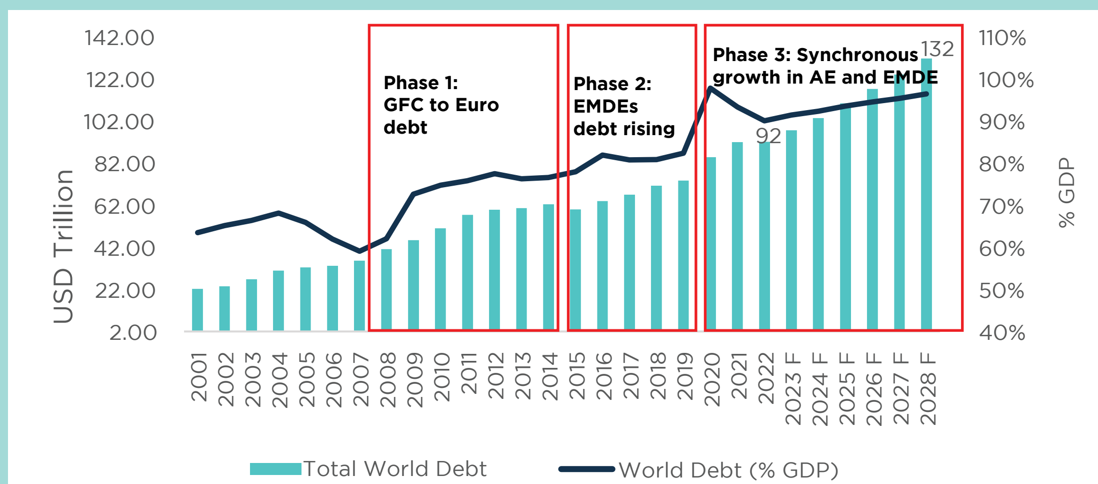
The escalation of global debt has emerged as a major concern in the aftermath of the Covid-19 pandemic, with governments across both advanced and emerging economies implementing a range of direct and indirect stimulus packages to mitigate severe economic challenges. In our Sovereign Rating methodology, debt burden and debt affordability are critical factors as they substantially influence a country's creditworthiness. This report aims to analyse various debt cycles post-2008, examining how the current cycle diverges from previous ones and exploring the potential implications of the surge in global debt following Covid-19.

The International Monetary Fund's (IMF) World Economic Outlook (WEO) Database from October 2023 reveals that global public debt skyrocketed to USD 92 trillion in 2022, accounting for approximately 92% of Global GDP. Nearly USD 19 trillion, or about 20% of this global public debt, has been accumulated since the onset of 2020. Although the pandemic significantly exacerbated the debt scenario, it is important to note that the accumulation of public debt had been on an upward trajectory even before the pandemic. For context, the Global Debt to GDP ratio stood at around 63.9% in 2008 and had increased to 84% of GDP by 2019 (Refer to Exhibit 1).

Exhibit 1 : Global Debt has been Rising after the GFC



Sources: IMF WEO October 2023 Database, CareEdge Ratings

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PHASE 1

GLOBAL FINANCIAL CRISIS (GFC) TO EURO DEBT CRISIS (2008-14)

Advanced economies witnessed a significant jump in their debt levels while Emerging Markets and Developing Economies (EMDEs)debt remained stable post-GFC till 2014.

The seed for the current debt crisis was sown during the GFC in 2008. The GFC necessitated most of the advanced economies to resort to unconventional policy tools such as rolling out large bail-outs, cutting interest rates to near zero and initiating quantitative easing. The crisis which originated in the USA in 2008 ultimately culminated in Eurozone debt crisis in 2013. Public debt as a percentage of GDP for advanced economies rose from 77.8% in 2008 to 104.8% of GDP in 2014 (Refer to Exhibit 2). Countries like Japan, Greece and Italy had their public debt more than their annual GDP even before GFC. By 2013, countries like Belgium, Cyprus, Ireland, Portugal, Spain and the United States of America were added to this club (See Exhibit 3). Greece and Cyprus defaulted on their sovereign debt obligations in 2012 and 2013, respectively, because of unsustainable public debt levels. The economic growth slowed down for the advanced economies considerably to an average of 0.9% (y-o-y) in this period as compared to 2.8% (y-o-y) between 2003-07. The average credit rating for 28 advanced economies declined from AA+ to AA- between 2008 and 2015. For instance, Greece was downgraded from A to CCC and Italy from AA- to BBB*by all the 3 major rating agencies.

In contrast, the Emerging Markets and Developing economies (EMDE) showed remarkable resilience during this period. EMDEs growth bounced back rather quickly aided by limited exposure of the domestic financial markets to global financial shocks. Secondly, as the EMDEs debt levels were lower before the GFC, they had enough fiscal space to respond to the GFC effectively. With further support from strong China growth, EMDEs continued to grow at an average of 5.3% (y-o-y) in this period, albeit slower than 7.1% (y-o-y) between 2003-08. Also, the growth differential with advanced economies (EMDE GDP - Advanced Economies GDP) improved by 10 percentage points as compared to the 2003-07 period. Although, the debt to GDP ratio rose for EMDEs from 33.4% in 2008 to 38.5% in 2009 (See Exhibit 2), from then on till 2014 debt levels remained at those levels. The average credit ratings assigned to 68 EMEs remained stable at BBB- in this period.

Overall, at the end of Phase 1 Advanced economies contributed 80% to the overall Global Public debt, while EMDEs contributed only 20% (Refer to Exhibit 4).

*Average credit ratings has been calculated as the average of foreign currency ratings of Moody's, Fitch and Standard and Poor's

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PHASE 2

CHINA'S DEBT SWELL-UP AND **COMMODITY PRICE CRASH (2015-19)**

The debt levels of advanced economies remained high but stable, however, EMDEs saw a significant jump in debt in this phase.

The Public debt to GDP ratio for EMDEs widened from 40% in 2014 to 55% in 2019 (Refer to Exhibit 2). This was primarily led by rising debt levels in China and a fall in global exports largely from EMDEs driven by commodity price crash.

China's Debt Problem-. The investment boom in China lured many local governments of cities and provinces to set up special finance vehicles, borrow heavily and invest in large infrastructure projects. The returns from these infrastructure projects started falling because of years of overbuilding. Moreover, a large part of local government revenues came from selling land leases to property developers. As the demand for these leases slowed, the local government further faced pressure. China's Public debt to GDP rose rapidly from 40% of GDP in 2015 to about 60% in 2019. (Refer Exhibit 5)

Commodity Price Crash: The 2015 commodity price crash had a pronounced impact on the macroeconomic dynamics of the EMDEs. As 2/3rd of the EMDEs are commodity exporters, a commodity price crash meant fall in their export revenues and also government revenues. For example- For countries like Angola and Nigeria, oil revenues account for 90% of export revenues and 70% of government revenues. Additionally, China's growth slowdown further impacted export demand of EMDEs. Real GDP growth for EMDEs slowed to an average of 4% y-o-y between 2014-19 as compared to 5.1% y-o-y between 2008-14. The debt levels of EMDEs excluding China rose from 38% of GDP in 2014 to 45% of GDP in 2015 and 51% of GDP in 2019. Current account deficits and fiscal deficits widened for EMDEs.

While it was expected that advanced economies would start deleveraging, it never came. The debt levels for advanced economies, remained at 104% of GDP, during this period.

The GDP growth differential between EMDEs and advanced economies narrowed significantly to 1.9% between 2014-19 as compared to 4.4% between 2008-13 implying that advanced economies fared better than EMDEs. By 2019, The average credit ratings for advanced economies remained stable at AA- in comparison to 2014, however, the number of countries in the AAA category saw a steady decline to 8% in 2019 from 16% before the GFC crisis, the last ones being Hong Kong and the UK downgraded to AA+ and AA, respectively. The average credit ratings for EMDEs remained stable in 2019 at BBB- vis-a-vis 2014, however the number of EMDE countries in investment grade declined to 50% in 2019, after peaking at 60% in 2014 with Brazil, South Africa and Oman downgraded to speculative grade.

At the end of Phase 2, Advanced economies' contribution to Global Public debt had reduced to 74% in 2019 from 80% in 2014, while EMDEs contribution increased to 26% in 2019 from 20% in 2014(Refer Exhibit 4).

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PHASE 3

POST COVID
(2020 ONWARDS)

Synchronous Growth in Debt Levels Across Both Advanced and EMDEs

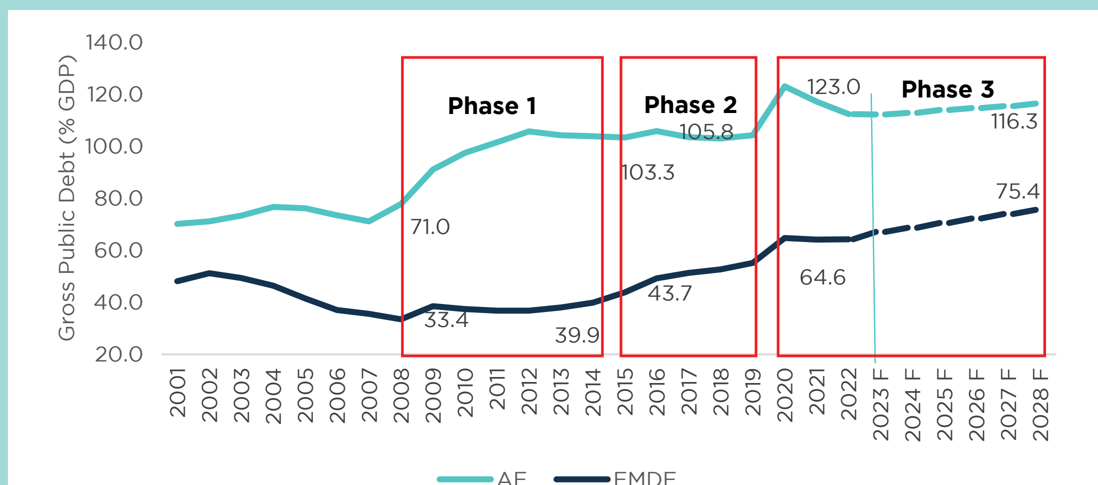
Although debt levels were already substantial prior to the pandemic, the Covid-19 crisis precipitated the most significant single-year increase in global debt since World War II. This growth in debt levels occurred synchronously across both EMDEs and advanced economies.

In advanced economies, public debt surged to 123% of GDP in 2020, while in EMDEs, it reached 65% of GDP, leading to widespread debt distress. Numerous countries launched COVID-19-related stimulus packages funded through extrabudgetary means. Consequently, about 43 EMDEs and 5 advanced economies experienced credit rating downgrades in 2020.

Three years post-pandemic, the debt levels in advanced economies have moderated from the 2020 peaks to 112% of GDP in 2022. According to the IMF's World Economic Outlook October 2023 Database, the debt levels for advanced economies are projected to rise to 116% of GDP by 2028. In EMDEs, the debt level has marginally increased to 64.2% of GDP in 2022, mirroring the 2020 levels, and is expected to escalate further to 75% of GDP by 2028 (Refer to Exhibit 2).

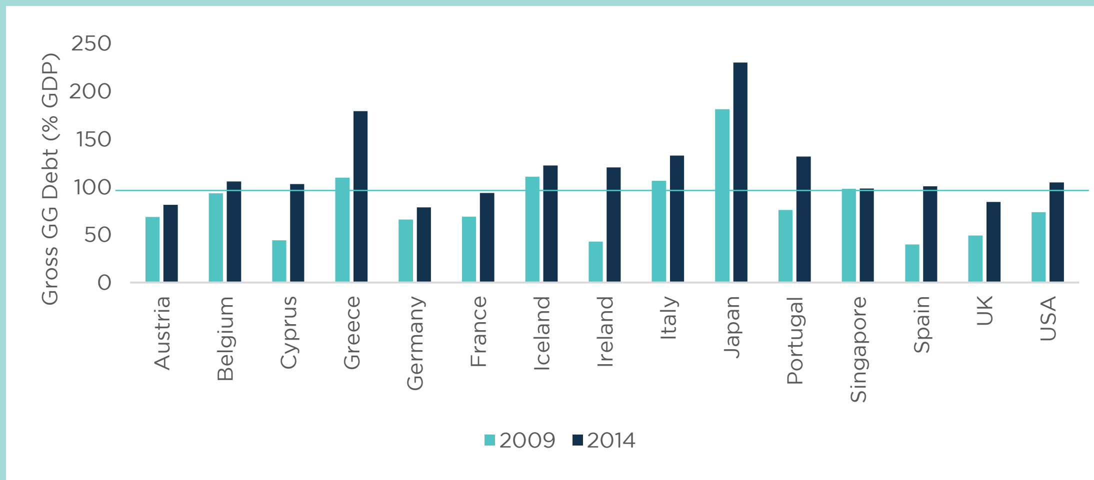
Thus, by 2028, Global Public Debt is expected to surge to USD 132 trillion, of which EMDEs' debt would stand at USD 44.4 trillion (China contributing USD 24.6 trillion, others contributing USD 19.8 trillion) about 33% to the total (Refer Exhibit 4).

Exhibit 2 : Debt Trends across Advanced and EMDEs



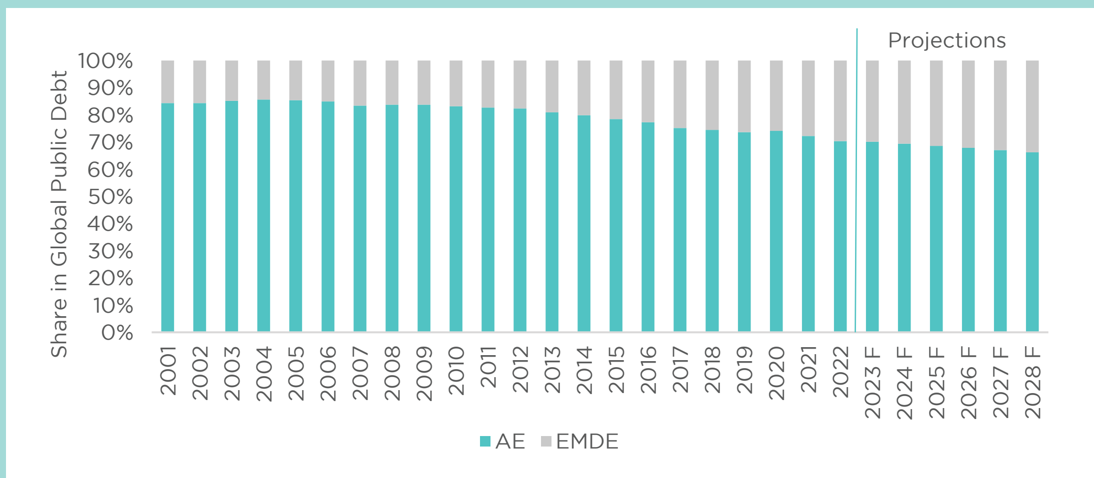
Sources: IMF World Economic Outlook, October 2023, CareEdge Ratings

Exhibit 3: Phase 1: Sharp Rise in Debt Levels Across Advanced Economies



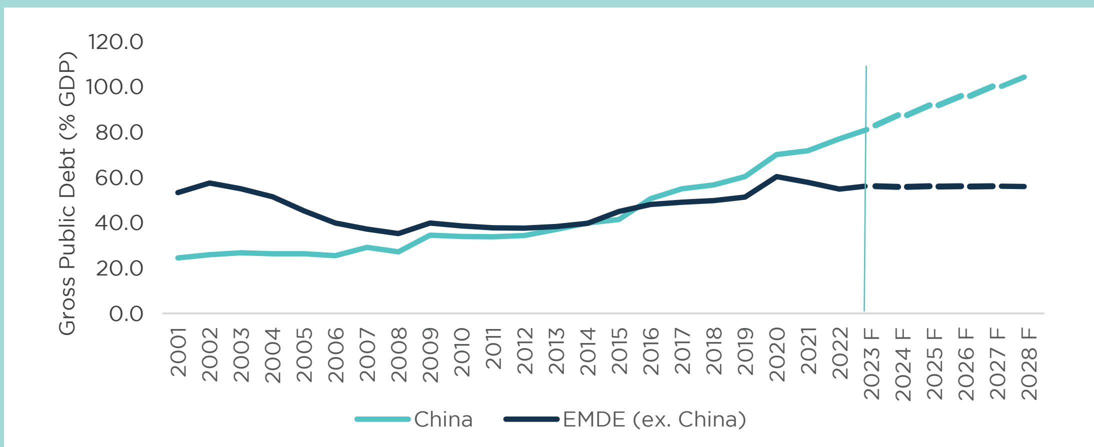
Sources: IMF World Economic Outlook, October 2023, CareEdge Ratings

Exhibit 4: Share of EMDEs in Global Debt has been Rising



Source: IMF World Economic Outlook, October 2023, CareEdge Ratings

Exhibit 5: China's Debt Surge is Alarming, EMDEs (excluding China) have also seen a rise though relatively less)



Source: IMF World Economic Outlook, October 2023, CareEdge Ratings

How is the current debt cycle different?
While there have been previous episodes of debt pile-up, the speed and the quantity of rise in debt levels post-Covid has been alarming. Even though the debt remained at elevated levels, lower global interest rates kept the debt servicing costs low for both advanced and EMDEs in Phase 1 and Phase 2. However, with interest rates rising globally in the last year, economies will have to face the pressure of rising interest burden in the latest debt cycle. Secondly, the quantum of debt in distress is also higher. Thirdly, a shift in the composition of bilateral lenders from OECD countries to the rise of other official creditors like China will also have a bearing on the overall debt and sovereign debt repaying capability in the current cycle.

Higher for longer interest rates put a dent in government balances
Following the Global Financial Crisis, advanced economies experienced a prolonged period of secular decline in interest rates. The Federal Reserve (Fed) dramatically reduced the Fed Funds rate by about 400 basis points (bps) from 4.25% in December 2007 to 0.15% in December 2008. Similarly, other major central banks, such as the European Central Bank (ECB) and the Bank of England (BoE), implemented rate cuts of 150 bps and 350 bps, respectively, between 2007 and 2008, followed by further reductions in 2009, bringing interest rates to near-zero levels. By 2014, some economies, including Sweden, Denmark, Switzerland, Japan, and the Euro Area, had entered negative interest rate territory. These ultra-low rates persisted in most advanced economies until 2021, except for the US Fed and BoE, which began gradual rate hikes in 2016.

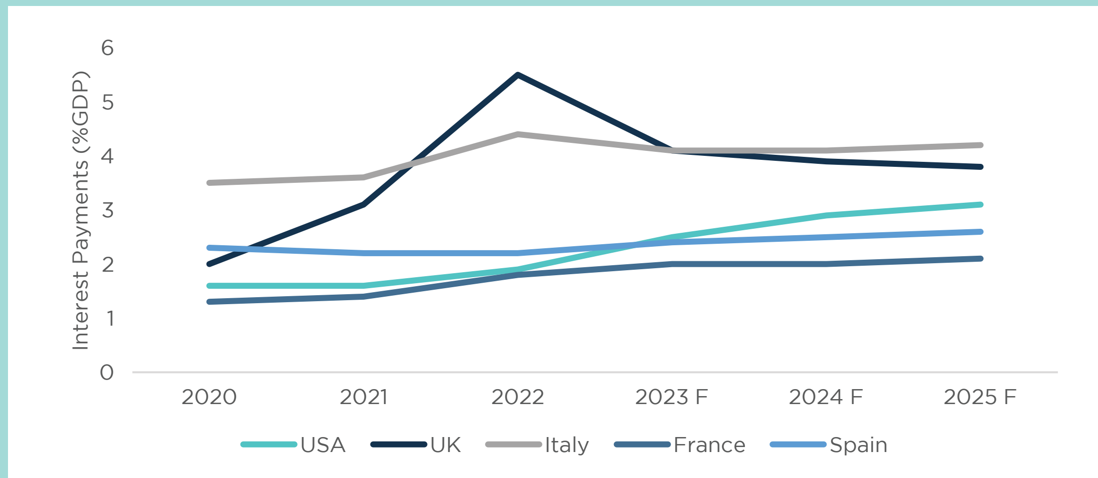
By 2019, interest rates were at 1.6% in the US and 0.75% in the UK. However, in the wake of Covid-19, both the US and the UK reverted to near-zero rate levels. This period of ultra-low interest rates helped advanced economies manage their debt interest payments effectively. In contrast, EMDEs generally maintained relatively higher interest rates, leading to a greater interest burden.

Post-Covid, supply chain disruptions and the Russia-Ukraine conflict triggered inflationary pressures, prompting central banks to increase interest rates. Since 2021, policymakers have raised rates by an average of 400 basis points in advanced economies and approximately 650 basis points in EMDEs. In the US, the policy rate has escalated to levels around 5.3% in 2023, the highest in 22 years. Persistent core inflation in major economies, particularly the US and parts of Europe, has led to expectations of sustained high interest rates. These increased rates have posed significant challenges for governments in both advanced economies and EMDEs, with rising interest payments and servicing costs.

For heavily indebted advanced economies like the UK, USA, Italy, France, and Spain, interest payments on public debt as a percentage of GDP have been increasing (Refer to Exhibit 6). Higher interest payments constrain fiscal capacity for other essential expenditures, such as health and education. Furthermore, advanced economies often issue inflation-indexed bonds, which exacerbate the interest burden due to payouts linked to inflation. On average, less than 10% of the debt in advanced economies is inflation-indexed. However, the UK and Italy have notably higher proportions of inflation-indexed bonds, accounting for 25% and 12% of their total public debt, respectively. For instance, the UK's interest payments reached USD 138 billion in 2022, significantly higher than initial government forecasts, primarily driven by high inflation. Additionally, the cost of new borrowings has risen, evidenced by widening yields. According to the OECD Sovereign Borrowing Outlook 2023, the coupon rate on new debt issuances for advanced economies doubled from 1.1% in 2021 to 3.3% in 2022.

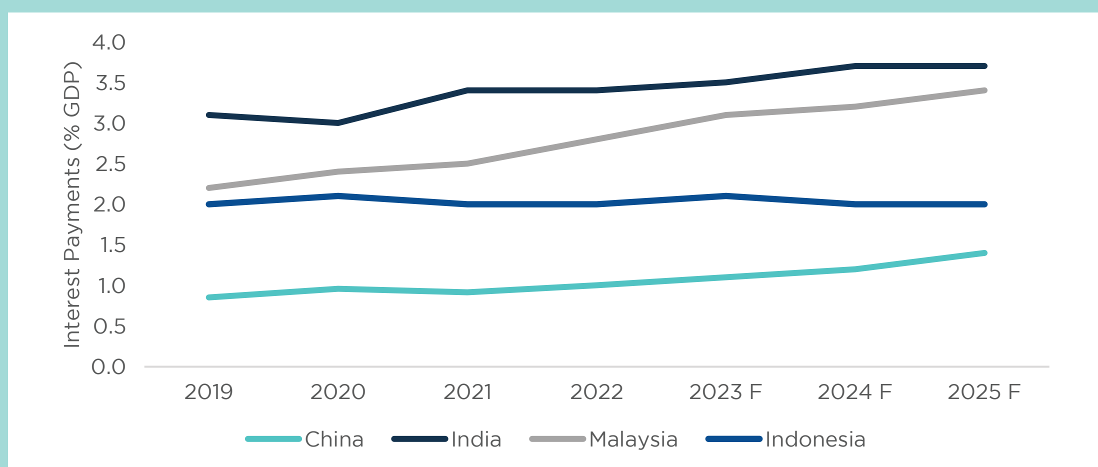
EMDEs inherently face higher interest burdens and borrowing costs due to increased credit risks. Leveraged EMDEs like China, India, and Malaysia are likely to see rising interest burdens (Refer to Exhibit 7). Low-income EMDEs with substantial public debt, such as Sri Lanka, Ghana, Zambia, and Pakistan, are particularly affected by the increasing interest rate burden. As per the OECD Sovereign Borrowing Outlook 2023, the coupon rate on new debt issuances for most EMDEs rose from 3-5% in 2021 to 5-8% in 2022.

Exhibit 6 : Interest Payments Rising for Leveraged Advanced Economies



Source: Latest IMF Article IV for Respective Countries

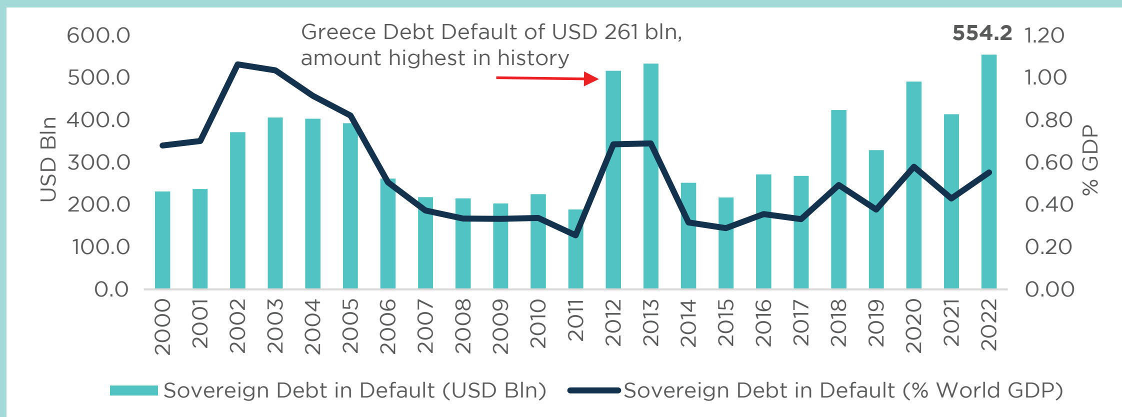
Exhibit 7: Rising Interest Burden in Higher Indebted EMDEs



Source: Latest IMF Article IV for Respective Countries

Quantum of Debt Distress is Highest in Phase 3
As the rise in debt levels was rapid, the quantum of debt distress has also been rising steadily. Since 2020, about 19 economies have either defaulted on their debt obligations or restructured debt with 7 in 2022 alone. These numbers seem very high when compared to 11 sovereign defaults or debt restructuring events across countries between 2008-19. According to the Bank of Canada-Bank of England database on sovereign defaults, the total sovereign debt in default amounted to USD 554 billion in 2022, about a 34% jump as compared to 2021. Total sovereign debt in default as a per cent of World GDP was 0.6% in 2022, the highest since 2014.
(Refer to Exhibit 8)

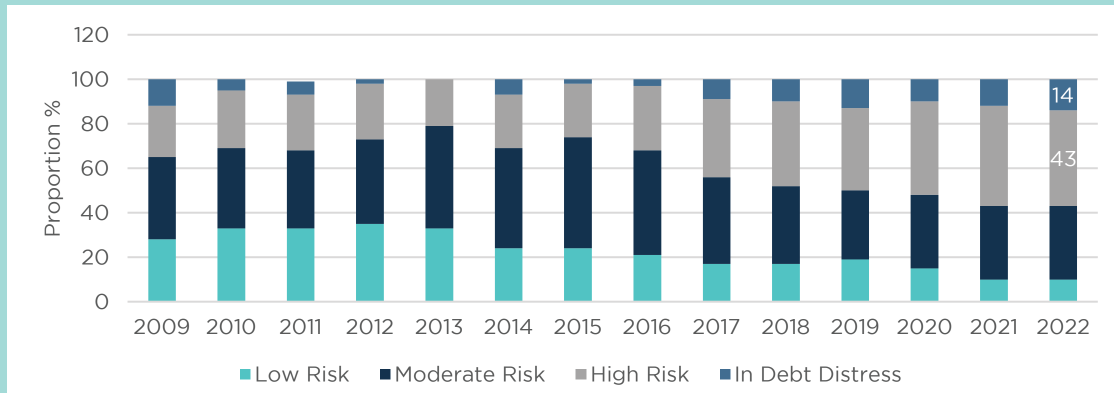
Exhibit 8 : Quantum of Debt in Default Rising Steadily



Source- BoC-BoE Sovereign Debt Default Database, CareEdge Ratings

The World Bank and International Monetary Fund (IMF) produce ratings for countries that are low-income and typically cannot tap international debt markets for funding under the Low-Income Country Debt Sustainability Framework. Rating levels include “in distress” as well as “high risk,” “moderate risk” and “low risk” of future debt distress as per the country’s last debt sustainability analysis. There are currently 67 countries under this framework. The proportion of countries in high-risk and debt distress has doubled to 57% in 2022 since 2015. (Refer to Exhibit 9). Thus, while debt distress is generally on the rise, default risk in low-income countries is worrying.

Exhibit 9 : Rising Debt Sustainability Risks in Low Income Countries



Source- IMF LIC-DSA Database

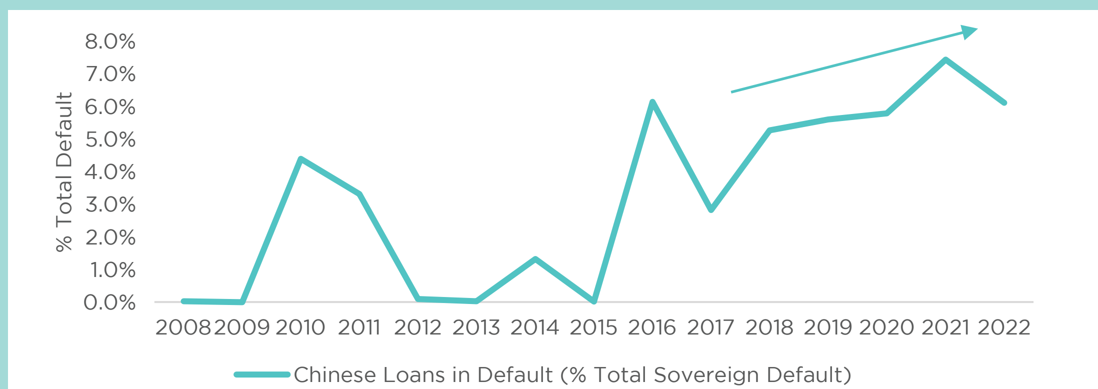
Change in the Composition of Bilateral Lenders Over the past decade, bilateral loans from China, India, and the Gulf States have seen a considerable increase. Among these, China's lending activities have garnered significant attention. Data from the World Bank indicates that loans from China escalated from USD 333 billion in 2012 to USD 952 billion in 2022, marking a CAGR of 11%. Predominantly, these loans were extended to low-income developing economies, oil-exporting nations like Ghana, countries involved in the Belt and Road Initiative (BRI) such as Sri Lanka and Pakistan, as well as small economies in close geographical proximity to China, like Laos and Cambodia, and some smaller European economies.

Given the limited access to IMF loans for high-value infrastructure projects, emerging and especially low-income economies have increasingly turned to China as an alternative funding source. China's investment in critical infrastructure projects has not only facilitated trade links but also positioned the country as a significant player in the global economy. The IMF reports that China’s share in the external debt of low-income economies rose from 2% in 2006 to 18% in 2020. Meanwhile, the share of multilateral organizations like the IMF and the

World Bank decreased from 55% to 48% in 2020.

However, despite the potential benefits, Chinese loans have heightened the debt vulnerabilities of recipient countries. This is due to the substantial size of the loans and the relatively higher interest rates. The World Bank notes that loans extended by China to low-income countries typically carry a premium of around 3-4% over the federal funds rate. In contrast, loans from the IMF and other multilateral organisations are generally concessional. Additionally, there have been concerns regarding the transparency of Chinese loans, as limited information is available about their terms and conditions. According to the Bank of Canada - Bank of England Sovereign Default database, the total Chinese loans in default as a percentage of total sovereign debt in default stand at 6.1%, a figure that was negligible before 2008. (Refer to Exhibit 10)

Exhibit 10: Share of Chinese Loans in Default has been Rising



Sources: BoC-BoE Sovereign Default Database, CareEdge Ratings

Conclusion

The recent surge in global debt has been remarkable both in its rapid ascent and sheer volume. Following the global financial crisis, debt levels in advanced economies escalated significantly, whereas EMDEs initially demonstrated resilience. However, the endurance of EMDEs in maintaining stable debt levels was disrupted post-2015, primarily due to commodity price shocks and a notable increase in Chinese debt. During this time, while the debt levels in advanced economies remained elevated, they were relatively stable.

The scenario shifted post-2020, with both advanced economies and EMDEs experiencing a synchronous rise in debt levels, thereby raising concerns about debt sustainability. The era of "higher for longer" interest rates has led to increased borrowing costs for government debt, subsequently elevating debt service costs. In 2022, the volume of debt in default expanded to USD 554 billion, marking a 34% increase from the previous year and indicating a broadening of credit risks.

Additionally, there has been a change in the composition of bilateral lenders, with China emerging as a prominent official lender. While Chinese loans have often been mutually beneficial for both the creditor and the debtor, they have also heightened the external vulnerabilities of the recipient economies.

Addressing a debt crisis typically involves a heterodox mix of policies, including fiscal prudence, productivity enhancement, and policy reforms. However, given the current fragile state of economic recovery, the process of debt deleveraging could be protracted and more challenging than anticipated.

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Celebrating 30 Years

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