Global debt and associated risks

As mentioned above, the fourth wave of debt is the most powerful in terms of scale and growth rate, as well as the number of borrowers that it has "carried away". Whereas the previous three waves were mainly regional – covering Latin America, Southeast Asia, Central and Eastern Europe – the current one is global. Sovereign debt is growing in most emerging markets and in developing economies, which have seen the emergence of so-called frontier issuers, or borrowers with low credit ratings, who have managed to place their bonds. The debt of sovereigns and corporate enterprises in developed economies is increasing simultaneously, while among the latter there is a sharp increase in the share of borrowers that have never had investment-grade ratings and that, in theory, should be excluded from debt markets.

As a consequence of these trends, global debt (a term introduced by the IMF) reached its historical peak in late 2018. According to the IBRD, this figure exceeded $185 trillion or 230% of global GDP and for developed economies, it reached 264% of their total GDP ($130 trillion). Between 2010 to 2018, inclusive, emerging market debt grew 54% (to $55 trillion or 168% of GDP) and by 67% for the least developed nations (their debt increased from $137 to $270 billion). It is hard to overstate the significance of these figures, in particular in view of the experience that shows that a debt-to-GDP ratio for developed economies exceeding 60% is a direct route to debt instability. For other sovereign borrowers, this figure should preferably be even lower.

In terms of assessing the risks of the current situation, the other part of the size of the fourth wave of debt is of equal, if not greater importance: it has risen at a rate that significantly exceeds the growth of key macroeconomic indicators of most sovereign debtors. For emerging markets, the debt growth rate increased from 3% at the start of the period to 7% at the end, while GDP growth fell from 7.1% to 4.2% per year. The same happened in developed economies: debt increased by 3.0-4.7% per year, while GDP growth stalled and gradually fell from 4.5% to 3.0% per year. It is clear that such trends mean that national economies have less ability to generate sufficient financial flows to meet their debt obligations on time.

The destructive potential of the fourth wave of debt also lies in the structure of accumulated debt, which, to a great extent, differs from the structure of the first three waves. Figuratively speaking, in the last few years there has been a change of "actors" in terms of borrowers and, in particular, lenders. In practical terms, this means that previous experience of resolving debt issues may not be in such demand in today's conditions. The most fundamental change is the mass transition of both sovereigns and corporate borrowers to borrowing in the form of bond issues.

Strictly speaking, official debtors have preferred to fund their activities in this way since time immemorial, as they can rely on a wide range of investors and lenders and avoid excessive conditions placed on received funds. However, these opportunities were often not available to them or to everyone. During the first three waves of debt, bank loans were the main form of borrowing, while for international financial relations it was their syndicated analogues. This segment of the international financial architecture underwent major changes after the GFC.

Firstly, global systemically important banks, which in the past generated syndicated lending, fell under strict regulation and were forced to significantly restrict the scope of their credit expansion. They were replaced by the shadow banking sector, or market-based finance, whose subjects – pension funds, insurance companies and other non-banking financial intermediaries (ONBFIs) – used the opportunities provided by quantitative easing and, primarily, the fact that financial markets were flooded with cheap resources. Therefore, the sharp increase in the supply of sovereign and corporate bonds was not accompanied by an increase in the cost of borrowing, which would be expected in market economies. In fact, whereas in 2010 no negative yield bonds were traded on debt markets, in 2019 such bonds were already worth $15 trillion, or 25% of the market, of which $7 trillion of sovereign loans were placed by Austria, Denmark, Finland, France, Germany, Japan, Sweden and Switzerland.

Secondly, local and global debt markets were flooded with corporate bonds issued by issuers with unusually low credit ratings. For example, in the USA, out of $4.8 trillion of traded corporate bonds (data for 2018), $2.8 trillion had a BBB rating and $795 billion were BBB minus. A similar situation could be seen on the European and Japanese markets. Even before the economic downturn caused by the

coronavirus outbreak, there were few encouraging assessments that in a scenario where the financial crisis was half (!) as severe as the GFC, corporate debt-at-risk, i.e. the likelihood that corporate debtors of EU states would default on interest payments from current revenue, could increase to 40% of their total debt. Clearly, the current crisis has only worsened the situation.

Thirdly, during recovery from the fourth wave of debt, borrowing from emerging markets intensified, stimulated by strong demand for their relatively high-yield debt securities. These issuers not only began to feel confident on global debt markets but, more importantly, they successfully implemented an initiative launched by the G20 in the early 2000s to develop local (national) debt bond markets. Over the last few years, these markets have become a key source in financing government budgets and funding the activities of the corporate borrowers of these states. Moreover, investors from developed economies have shown increasing interest in local bonds. As a result, structural changes have greatly expanded and increased the opportunities for borrowers from emerging markets, which can be seen in the previously reported data on the growth rates and volumes of their debt obligations. However, these opportunities are accompanied by increased risks which these debtors are generally unable to manage, either because national institutions are not ready (debt offices and special legislation remain rare), or because of the lack of the required financial instruments in the local currency.

In addition to the traditional currency and interest risks associated with external borrowing, risks have appeared that are determined by cross-border capital flows caused by investors from developed economies entering local debt markets. According to various estimates, for most emerging market countries, the share of debt bonds controlled by non-residents is 45% to 50%, while for some it reaches 80%. On the one hand, this structural "innovation" has a positive effect for borrowers by reducing the cost of borrowing. However, on the other hand, this plays a negative role because of the extreme volatility of the inflow and outflow of investment in local financial instruments, which, naturally, does not increase the stability and sustainability of the national financial market as a whole. Meanwhile, this volatility is mostly based on the active use by foreign investors of carry trade transactions, where local bonds are purchased by borrowing at a low-interest rate on the markets of developed economies and where investment is mainly on the

secondary market. Clearly, the inflow of such borrowed capital will not have much effect on the economic growth and debt sustainability of national economies or the stability of local financial markets.

To a large extent, this is due to the fact that borrowers from emerging markets are not reducing the issue of foreign currency denominated bonds, which generate their external – country and sovereign – debt. As a result, in 2019, such an important indicator as the debt-to-export ratio reached 350%, which is the same as during the Asian debt crisis. It is remarkable that this figure remained at 250% in 2008. Considering that in the current situation it has become very difficult to increase national exports and debt has grown due to the need for new borrowings, the prospects for this ratio to reach new heights are quite obvious, as are the problems associated with debtors having funds in reserve currencies to service the accumulated external debt (only a few are able to repay their debts).

After the GFC, and in conditions of low interest rates, state owned enterprises (SOEs) from emerging countries became large borrowers on external markets. This is another major change in the structure of global debt. The sum of their debt obligations is measured, like for sovereigns, not in billions but in trillions of US dollars. However, if in the early 2000s the credit ratings of these enterprises were significantly higher than the ratings of sovereign borrowers (some of them were at A minus), in 2019 this indicator slid down to BBB minus and lower. According to a number of researchers, in conditions of low interest rates on the debt markets, SOEs increased their leverage but became less profitable. This is the reason for the downgraded ratings mentioned above and the increased likelihood of being unable to service accumulated debt.

During the recovery from the fourth wave of debt, sovereign borrowers from the least developed countries experienced surprising transformations: many of them had until recently been beneficiaries of two global debt relief initiatives – HIPC and MDRI. In the middle of the second decade of the 21st century, Angola, Gabon, Tunisia, Zambia, Belize, Ecuador, Jamaica and several other sovereigns formed a new category of international borrowers, the so-called “frontier issuers”. These are borrowers who quite infrequently sell non-investment grade sovereign bonds that, nevertheless, have steady demand from investors. The annual issue of such bonds tripled in just five years, and by mid-2019 the amount of traded bonds

reached $200 billion. For comparison, the amount of debt cancelled by creditors as part of the above-mentioned initiatives was just under $150 billion; however, it had been accumulated over several decades.

In addition, the debt structure of the least developed countries has undergone several other major changes. Firstly, there has been a sharp increase in the share of bilateral loans attracted from sovereign creditors that are not members of the Paris Club (the exact amount is unknown as information on this type of borrowing is not made public, but it is in the dozens and even, taking into account Chinese loans, hundreds of billions of US dollars). Secondly, the structure of sovereign debt now includes liabilities secured by property and other assets, for example, future proceeds from the sale of commodities and/or other traditional export goods of the least developed countries. The consequences of this phenomenon – collateral is not usual for sovereign credit operations – are still unclear. However, even without the relevant experience, it is clear that during a debt crisis, there would be serious restrictions on reaching agreements with secured creditors on the conditions for resolving bad debt.

Aggressive borrowing on market conditions, and not on preferential conditions as before, would surely affect the debt sustainability indicators of these countries. In 2013, their debt-to-GDP ratio was 35%, which is generally considered safe. However, by 2018 it had increased to 55%. This is clearly a warning signal for this category of debtors and their creditors and casts doubt on the ability of the least developed countries to continue servicing their accumulated debt, especially if interest rates start to rise and this category of borrowers is unable to access debt markets. Given the financial measures required to deal with the pandemic and its consequences, a further deterioration in the situation can be expected, as these countries have almost no internal funding sources for fiscal measures and, therefore, rely on external borrowing, in particular from MDBs.

So, during the recovery from the fourth wave of debt, significant, if not fundamental changes took place in the global debt structure. First of all, there was a sharp growth in the share of liabilities, which are difficult to fulfil even during economic growth. These are debts of the least developed nations, associated with aggressive non-preferential loans. Then there are the debts of financially unstable enterprises that managed to sell debt bonds to investors, but who then faced well-

known problems in the global economy. Finally, and possibly most importantly, there are debts from borrowing on financial markets and not direct bank loans. For many sovereign debtors, the number of creditors has sharply increased, while one of the key links is still missing from the international financial architecture – a comprehensive debt resolution/restructuring mechanism. Banks have learned how to form advisory committees, often associated with the London Club of creditors, which cannot be said about institutional investors and creditors. The situation is not as smooth as corporate borrowers would like it to be. Many things are decided at the national level by using bankruptcy prevention mechanisms or public financial support. However, “rescue measures”, more often than not, are taken without considering the presence in the corporate debt structure of external liabilities.

Finally, it would be wrong not to mention another feature of borrowing that was unusually noticeable during the fourth wave of debt. In the last decade it has become quite common to use money obtained through bond issues not to increase the production of goods whose sale would generate financial flows sufficient to at least service debt and/or improve physical and social infrastructure, which would significantly decrease production costs, but on consumption (sovereigns) or on share buybacks and even bonus payments (corporate borrowers). This rather harsh conclusion can be supported by the following fact established by the IBRD: between 2002 and 2009 the share of public investment in emerging markets was, on average, 2.1% GDP, while between 2010 and 2018 it fell by 0.9% GDP; in other words it halved against a background of rapid debt growth.

The situation developed in a similar fashion in most developed economies: the credit boom was not always accompanied by a growth in investment. The golden rule of lending where funds are raised in order to increase investment has not found wide acceptance, despite financial theory and centuries of practice demonstrating that the unproductive use of loan capital (paid and repayable money), even without considering the borrower’s debt sustainability, invariably ends in a debt crisis, at best a liquidity crisis or at worst a solvency crisis.