THE LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE

EMERGING MARKET DEBT CRISIS

INTERIM REPORT

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INTRODUCTION

In July 2022, the Commission held its fifth evidentiary session focusing on the emerging market debt crisis globally. The panel—comprising speakers Dr Joseph Stiglitz, University Professor at Columbia University, Dr Jayati Ghosh, Professor of Economics at University of Massachusetts Amherst, and chaired by Dr Jerome Roos, LSE Fellow in the Department of International Development of the London School of Economics—discussed the prospects of an impending debt crisis, its fundamental causes, and potential solutions to prevent and mitigate global debt crises.

DEBT CRISES IN CONTEXT

Dr Roos pointed out that the impending debt crisis is not a novel phenomenon: such crises have occurred three times in recent history. Yet, it appears that lessons have not been learnt from these experiences and there is a real concern that the same mistakes have continued to be made in currently emerging crises, only writ large. Indeed, common trends can be observed across these previous occurrences. Typically, it starts with a significant build-up of debt in a period of low interest rates. This is followed by a period of rising interest rates; defaults on debt then begin to proliferate, reaching a critical stage when a significantly large group of countries collectively default on their debts.

Historically, the first global debt crisis occurred from 1982 following the international lending spree in the 1970s, beginning with Mexico defaulting on its payments and subsequently growing into a widespread crisis amongst developing countries in Latin America and beyond. Nonetheless, the economic fallout did not lead to learning among policymakers and, as a result, a similar crisis occurred in the 1990s. This time, it was centred on debts from emerging markets and countries including Russia, Mexico, Brazil, Argentina, and several in Southeast Asia were hit hard by the fallout. Again, lessons from the catastrophe were not learnt, which led to a third debt crisis occurring in the 2000s. The bursting of the dot-com bubble and the effects of the Global War on Terror pushed the United States (US) Federal Reserve Board (Fed) to lower interest rates, spurring a significant uptake of debt. This ultimately culminated in the Global Financial Crisis (GFC) of 2008, which also had residual impact on the Eurozone crisis in 2010.

Following the GFC, historically low interest rates once again drove the most substantive growth in debt in the last five decades, particularly in emerging markets. As investors in high-income countries were unable to make a profit within their domestic markets, many of them channelled their finances towards the global south. While this made available much needed credit, it significantly increased the amount of debt incurred by developing economies. As the world approached the tail-end of the lending spree, there was real concern

of a major debt crisis looming on the horizon. Thirty percent of developing countries and sixty percent of low-income countries are currently under, or on the brink of, debt distress. Under such conditions, Dr Roos warned that any global shocks would potentially upend the existing economic system.

Indeed, Dr Roos suggested that a 'perfect storm' is imminent, one which looks set to unleash the fourth major debt crisis. To begin with, the COVID-19 pandemic unleashed the worst economic recession since World War II, with developing countries taking the brunt of the fallout and still struggling to recover. As such, the economic fallout from the pandemic led to an even greater build-up of debt. Before it could stabilise itself, the additional pressure of the Russian invasion of Ukraine was placed upon an already strained economic system. Specifically, rising food, fuel and fertiliser prices impacted developing countries more severely as they depended on these key inputs for production. The effects of these twin shocks have also been exacerbated by the Fed's and the European Central Bank's (ECB) raising of interest rates.

Collectively, these overlapping developments have placed four significant strains on emerging market economies. First, given interest rate hikes, these economies face steeper debt servicing costs, particularly for debt which is structured on variable interest rates. This assessment was echoed by Dr Stiglitz, who emphasised the significance of the increased strength of the US dollar—most global debt is denominated in US dollars. Further, this potentially leads to greater economic slowdown, which ultimately makes it even harder for these countries to raise sufficient funds to repay their debt.

Second, because of the increased price of imports, developing countries are challenged by a depleting foreign exchange reserve. Third, as the economic environment becomes more volatile, investors have fled from risky investments, leading to capital flight among developing countries as money flows back to high-income economies. Fourth, because of the stronger US dollar, these countries face a rising burden of real debt and growing difficulty in servicing their outstanding obligations. Faced with such stiff challenges, the World Bank has identified at least twelve countries at risk of defaulting in 2023—potentially the largest debt crisis in a generation. Dr Roos worried that the writing appears to be on the wall, as Sri Lanka has tipped into defaulting amidst a range of domestic issues.

CAUSES OF CATASTROPHE

Dr Roos noted that efforts have also been channelled toward understanding the causes of the current emerging debt crisis. One perspective on the issue, which was espoused by the World Bank, was that the crisis was a result of bad policy, citing governments spending beyond their means as the key reason for the current situation.

In response, Dr Stiglitz argued that it is not bad policy which gets countries indebted, but bad financial market behaviour from both borrowers and lenders. Every loan contract between an emerging market country and a creditor is the result of a voluntary contract entered into by two willing parties. On both sides, there exist agency problems, such that individuals who make the decision to extend or take the loan do not necessarily pursue the best interests of the institutions they represent. Furthermore, the flawed incentive structure of financial markets leads lenders to make high risk choices. For instance, in a search for greater yield, creditors—who are supposed to be experts at assessing risk and determining credit worthiness—extend bad loans to high-risk borrowers who end up being unable to service their debts. Although some effort has been made to improve financial markets following the GFC, these efforts have been insufficient.

Similarly, Dr Ghosh agreed that it was not governments overspending that led to the current debt crisis. Comparing the amount of money spent during the COVID-pandemic as a percentage of GDP, she highlighted how advanced economies spent on average ten to thirty percent, while middle- and low-income countries only spent four to six percent and under two percent respectively. Furthermore, while advanced economies were significantly outspending smaller peers, they were protected because they possessed globally acceptable domestic currencies rather than borrowing in dollars or hard currency.

Beyond recurrent issues, Dr Stiglitz also highlighted two factors that make the current crisis more complex than before. First, in recent years, there was a shift from solely bank lending to that which includes bonds. As such, borrowers today owe to multiple creditors, making it difficult to resolve debt-related disputes where more stakeholders are involved. Further, this makes it harder to implement debt restructuring solutions, particularly as different creditors compete to get repaid. Second, China has emerged as a significant lender and, like with private investors, the structure and conditions of their loans are not made transparent. This makes it difficult for other lenders to make clear judgements on the credit worthiness of countries.

Nonetheless, Dr Ghosh disagreed that China is the problem and attributed greater responsibility to private investors. She emphasised that, as a creditor, China provides loans on better and longer terms. Furthermore, it only provides a small portion of the loans among countries in severe debt distress. Additionally, private investors enter willingly into risky loan agreements with developing countries in pursuit of greater returns. However, when these risks manifest, these same investors then turn to financial institutions to seek their money back from borrowing countries. In essence, these investors thus willingly make bad loans for profit, yet are unwilling to bear the financial costs contingent on making such risky decisions.

Further, Dr Ghosh pointed to bad policymaking on the part of developed economies and financial institutions as another key factor. Specifically, these parties encouraged emerging market economies to enter into debt agreements which are extremely risky. This was achieved through measures such as liberalising their capital accounts or permitting private sector and sovereign bond lending. As a result, many developing countries took on debt that was far beyond what they could service. Dr Ghosh emphasised the case of the International Monetary Fund (IMF) continually encouraging Sri Lanka to utilise sovereign bond lending, even though the country had a spotty track record—having been in sixteen prior IMF programmes.

DEALING WITH DISASTER

That debt crises recur does not mean that greater efforts should not be taken to resolve and mitigate them. Indeed, Dr Stiglitz emphasised that the costs of these debts are significant, even for countries which have not defaulted on their debt. Countries that are indebted must often funnel money away from other policy initiatives in order to service their debts, with detrimental effects on citizens' welfare. Dr Stiglitz also emphasised the need to develop a better way of managing country risks, potentially with significant impact on climate change. High-risk premiums disincentivise investment in climate projects within developing countries, and without these essential funds those countries have limited prospects of reducing emissions, ultimately dampening global efforts at addressing climate change.

Dr Stiglitz argued that dysfunctional financial markets were also a feature of earlier crises. There was a 'fantasy' that minor tweaks to the existing system through collective action clauses would sufficiently resolve inter-creditor issues. Nonetheless, these reforms have proved less effective than imagined.

More pointedly, Dr Ghosh emphasized that the debt crisis was forecasted and yet financial institutions failed to adequately react to these warnings. Thus, it is imperative that financial markets be reshaped to manage the current debt crisis and mitigate future ones.

As an alternative, Dr Stiglitz strongly advocated for better legal frameworks regarding debt issues: the establishment of an international bankruptcy court and a legal framework to manage global debt related issues in creditor countries. There is also a need to implement a debt restructuring framework. An example of this is the one which the United Nations sought to implement, although it was ultimately not adopted due to resistance from creditor countries.

Beyond this, Dr Stiglitz also recommended reforms specific to the IMF. Although the IMF has made available $650 billion of funds as part of its Special Drawing Rights (SDRs) scheme, the programme can still be expanded. He also argued that consideration needs to be made regarding the recycling of SDRs to ensure that developing countries who need them most are able to have priority access. Further, IMF programmes need to reduce their focus on austerity measures, which make it harder for countries to manage their debt.

Similarly, Dr Ghosh was strongly in favor of reforming IMF programmes. A positive example is the debt relief package received by Germany in 1951 which included a fifty percent debt write-off, with the other half split between loans and grants. Importantly, the loans were designed to be long-term and the debt servicing was pegged at three percent of the value of national exports. Such a structure generated a positive loop as creditors were simultaneously incentivised to seek more exports from Germany. While this unique arrangement may have been a result of the then unique geopolitical situation, a similar programme—albeit on a smaller scale—could feasibly be implemented today for developing countries facing debt crises due to factors outside of their control.

Finally, Dr Stiglitz also pointed to the need to develop better financial markets, where capital can be made available in a countercyclical manner. This could be done by replacing pro-cyclical rating agencies and dampening short term capital flows. Crucially, greater transparency is also needed in debt markets. Dr Ghosh suggested the possibility of creating a global system to purchase distress debt, which would help provide relief to developing countries, particularly from private investors. ■

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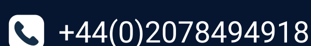
LSE IDEAS

LSE Global Economic Governance Commission

The LSE Global Economic Governance Commission is a forum for debating and redesigning global economic governance.

COVID-19 has presented the world with a new Bretton Woods moment. It has exposed the fragilities of the global monetary order and the dislocations in the global trading system. With economic damages rising and tax revenues falling, it has presented a new crisis for global development and demonstrated the overdue need for global tax coordination. As states have struggled to band together to overcome their shared challenges, it has made clear the difficult road ahead for the global climate agenda.

To steer the much-needed transformation of the rules, practices, and institutions of the global economy, The London School of Economics and Political Science and LSE IDEAS have convened the LSE Global Economic Governance Commission. The Commission brings together leading academics and policymakers around five core domains of global economic governance: monetary policy, trade policy, development policy, tax policy, and climate policy. The Commission hosts public and closed-door panels, lectures, and workshops on all matters relating to global economic governance. Event details are announced online by LSE and LSE IDEAS.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