

## **SOVEREIGN DEBT CRISIS - A SILENT EPIDEMIC**

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### **ABSTRACT**

A situation in which a country is unable to pay back its government debt is known as a *debt Crisis*. Debt threatens to create a global development emergency in much the same way the pandemic has created a global health emergency.

At the international level, the creditors, not a court, decide whether and under what conditions to require a country to pay its debt.

Poor countries enter into debt crisis more often and suffer the most as loan repayments hamper country's ability to invest in their economic future and IMF support is conditional on the implementation of macroeconomic and structural reforms.

Such debt burden carried by impoverished countries affects citizens in the rich countries as well as Environmental damage caused by them has global repercussions. Hence, nobody is safe until everyone is safe.

Robust macroeconomic, financial, and structural policies can help countries strike the right balance between the costs and the benefits of debt accumulation. Such policies are also critical to help reduce the likelihood of financial crises and alleviate their impact, if they erupt.

### **Introduction**

Similar to individuals who borrow money to pay for their needs, Countries also borrow money from private capital markets, international financial institutions, and governments to pay for infrastructure such as roads, buildings, public services, and health clinics; to run a government ministry; or even to purchase weapons.

Also, like individuals, countries must pay back the principal and interest on the debts they take out. But there are important differences between individuals and countries. If a person

borrow money, he or she receives the money directly and can use it for purposes benefiting the lender. But if a country borrows money, the citizens are not necessarily informed of the purpose of the loan or its terms and conditions.

Whether a government spends on social security, health care, or new fighter jets, it's pumping money into the economy. That boosts economic growth because businesses expand to meet the demand created by the spending. That usually results in new jobs, which has a multiplier effect in stimulating further demand and growth. Deficit spending is a powerful stimulant because the demand is being created now. The cost won't come due until sometime in the future.

As long as the sovereign debt remains within a reasonable level, creditors feel safe that this expanded growth means they will be repaid with interest. Government leaders keep spending because a growing economy means happy voters who will re-elect them.

Basically, there is no reason for them to cut spending. In practice, some governments have used loans for projects that do not meet minimum standards of social, ecological, or even economic viability. Sometimes, these loans have been used to enrich a small group of people. In other cases, although the money was used for legitimate purposes, financial conditions beyond the government's control made loan repayment impossible. A business or a person who falls on hard times and cannot meet his or her financial obligations over time goes bankrupt. A court is appointed to assess the debtor's situation and banks acknowledge that the debtor cannot fully pay his or her debts. But countries cannot file for bankruptcy. There is no such procedure, no arbitrator. At the international level, the creditors, not a court, decide whether and under what conditions to require a country to pay its debt.

### **What is Debt Crisis**

A situation in which a country is unable to pay back its government debt is known as a debt Crisis.

A country usually enters into a debt crisis when the tax revenues of its government are less than its expenditures for an extended period – Primary Deficit.

A country raise money through taxation which is used to finance its expenditure. When tax revenues are insufficient, the government can make up the difference by issuing debt. That can be done by selling government treasury bills in the open market to investors.

A government with a good reputation and little debt history or an established track record of

paying back its loans easily find investors who are willing to lend to it. However, if the debt load of a government becomes fairly large, investors lose their confidence about its ability to pay back, and they start demanding higher interest rates to compensate for the low credibility. This leads to an increased borrowing cost for the government.

As the government find it more and more difficult to roll over its existing debt, investor's confidence deteriorates further over time pushing the cost of borrowing to higher levels, eventually causing the government to default and enter into a vicious cycle of debt.

### **The Impact of International Debt**

Poor countries enter into debt crisis more often due to high levels of inflation, denomination of the debt in foreign currency, decrease of the terms of trade over time, unsustainable total debt service, high income inequality, and high share of agriculture in GDP.

This cost is particularly born by people living in poverty. The massive debt payments that poor countries owe to rich countries and to multilateral creditors like the World Bank and International Monetary Fund (IMF) hamper countries ability to invest in their economic future—whether it be via infrastructure, education, or health care—as their limited revenue goes to servicing their loans. This thwarts long-term economic growth and social and economic development of the country. According to Oxfam International's April 1997 report, Poor Country Debt Relief, "Debt repayments have meant health centres without drugs and trained staff, schools without basic teaching equipment, and the collapse of agricultural extension services."

The aid from other rich countries like the United States is meant to refinance debt payments rather than improving health care, education, and other social services due to the obligation to meet the debt repayments.

The International Monetary Fund and the World Bank makes economic restructuring (Structural Adjustment Programs, or SAPs) mandatory before a country can qualify for debt relief. The restructuring includes reducing inflation, reducing tariffs and other restrictions on foreign trade, removing price controls, and government downsizing; indirectly serving the economic interests of the rich countries. While in the long run they may help a country become more competitive in the global market, in the short run they can lead to local business failures in the face of global competition, massive lay-offs, lower wages, and even less investment by government in education, health, and other social programs leading to more income disparity.

### **The Debt crisis can also affect Human Rights and Environment.**

International debts have to be paid back in creditors currencies, or so-called "hard currencies" like U.S. dollars. The government and entrepreneur have no choice but to mine their natural resources in order to generate hard cash. This exacerbates the harmful environmental practices that prevail in many countries.

Thus, the debt burden carried by impoverished countries affects citizens in the rich countries as well as Environmental damage has global repercussions. Unrest and conflict may arise if the country realizes that all of their natural resources, are not shared within the country, and are often being exported to bring in revenue.

The more the developing countries stay in debt, the more they will feel that they need to milk the earth's resources for the hard cash they can bring in, and also cut back on social, health, environmental conservation, employment and other important programs.

Widespread poverty means that people have less money to buy goods and services from other countries. In addition to the suffering that results from economic stagnation, the United Nations has also linked high levels of foreign debt and a government's dependency on foreign assistance to human rights abuses. Economic distress causes governments to cut social spending, and reduces the resources it has to enforce labour standards and human rights, the U.N. says.

### **Causes of Debt Crisis**

There are three critical differences between sovereign debt and household or business debt that lays the groundwork and causes for this crisis:

1. There is no international bankruptcy court that lenders can go to for fair adjudication. That makes it easier for countries to default.
2. Collateral is not required to secure Sovereign debt. In that regard, it is more like credit card debt than a mortgage or auto loan.
3. Most countries can print their currency to pay off a debt, leading to an even worse situation.

### **Odious Debt**

In international law, odious debt, also known as illegitimate debt, is a legal doctrine that holds that the national debt incurred by a regime for purposes that do not serve the best interests of

the nation, should not be enforceable.

Many poor countries today, begin their independent status with heavy debt burdens imposed by former colonial occupiers or rulers who borrowed without the people's consent and used the funds either to repress the people or for personal gain. the apartheid-era government of South Africa borrowed from international banks and investors to build dams, power plants, and other infrastructure. When the African National Congress (ANC) took power in 1994, it inherited these debts and had to repay so as not to scare off badly needed foreign investment.

- Sovereign debt crises are usually caused when countries rack up too much debt to pay for expenses not causing development, like wars. When they print too much money to pay off the debt, they create an even worse problem of hyperinflation.
- Sovereign debt crises can also be caused by a recession.
  - a) The 2008 financial crisis was the primary reason for Spain's crisis. Even though it had been fiscally responsible, its banks were heavily invested in real estate. When the bubble burst, the government took over its banks' debts.
  - b) The recession also caused Iceland's debt crisis. Icelandic banks invested heavily overseas. When the government nationalized the banks and printed the money to pay off the debt, the value of its currency fell 50 percent in just one week.
- Debt Crisis can also be self – inflicted, like that of U.S Debt Crisis. It was caused by the Congress' disagreement to raise the country's debt ceiling in 2011. They thought it was the only way to force reduce spending and lower the national debt. Their refusal almost made the U.S. default on its debt. They finally raised the ceiling, but only after installing mandatory spending cuts, called sequestration. Congress narrowly avoided falling off the fiscal cliff.

#### **How the Greek Debt Crisis escalated into the Eurozone Crisis.**

In 2001, Greece adopted the Euro as its currency and exchanged its drachmas for euros. In exchange, The EU Demanded that the Greece cut costs to stop racking up more debt. That slowed its economy, making debt repayment even more difficult. Greece entered a deep recession, with a 27.5 percent unemployment rate, political chaos, and a barely functioning banking system. Concern over whether the EU could pay for the Greek crisis soon affected all European bonds, especially Italy, Spain, and Portugal. Within a few years, the EU itself had

slipped back into a recession.

That's another difference between sovereign debt crises and the other forms. If a household or business cuts costs, it will have more money to pay its debts. Since government expenditure is a component of gross domestic product, when it cuts costs, it also reduces economic growth. It would be as if a household stopped eating to pay for its debt. Soon, it would run out of energy to work, making debt repayment even more unlikely.

The EU debt crisis was unusual. It was caused by lower-income countries, like Greece and Italy, enjoying the benefits of low-cost debt due to their inclusion in the higher-income EU. That wasn't a problem until investors lost confidence in the Greek government's ability to repay.

### **Evolution of debt – Global Trend**

Global debt has trended up since 1970, reaching around 230 percent of GDP in 2018. Debt has risen particularly rapidly in EMDEs, reaching a peak of about 170 percent of GDP in 2018. Much of the increase since 2010 has occurred in the private sector, particularly in China. Debt in low-income countries has started to rise after a prolonged period of decline following debt-relief measures in the late 1990s and 2000s. Advanced economy debt has been broadly flat since the global financial crisis, with increased government debt more than offsetting a mild deleveraging in the private sector.

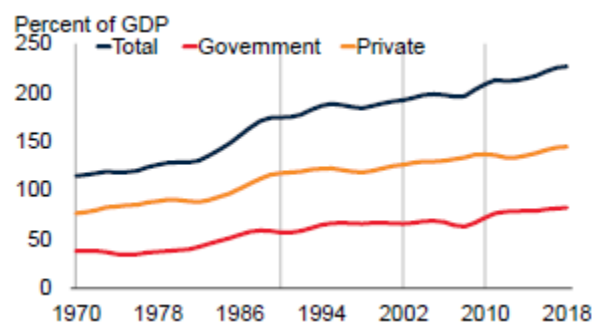


Figure1 – Global Debt; Source: International Monetary Fund; World Bank.

### **The Debt-to-GDP Ratio**

Investors compare the debt to the nation's ability to pay it off. The debt-to-GDP ratio does just that. It divides the debt by the nation's gross domestic product. That's everything the country produces in a year. Investors worry about default when the debt-to-GDP ratio is greater than 77%. That's the tipping point, according to a study by the World Bank. It found that if the

debt-to-GDP ratio exceeds 77% for an extended period of time, it slows economic growth. Every percentage point of debt above this level costs the country 0.017 percentage points in annual economic growth.

The tipping point for emerging market countries is 64%. If the debt-to-GDP ratio is higher, it will slow growth by 0.02 percentage points each year.

### **Debt to GDP Ratio = Total Debt / Gross domestic Product**

Where:

**Debt** is the cumulative amount of a country's government debt

**Gross Domestic Product** is the total value of goods produced and services produced over a given year

- A. When the national debt is below the tipping point, it may improve your life. Government spending contributes to a growing economy. When the debt is moderate, it can boost GDP enough to reduce the debt-to-GDP ratio.
- B. If a nation's Debt to GDP Ratio is 100 %, this means that the Total Debt is equal to the GDP of the Nation .
- C. Higher the Debt – to – GDP ratio, higher its risk of default.

### **Japan's Debt-To-GDP Ratio**

As indicated above, a high debt-to-GDP ratio is undesirable. The debt-to-GDP ratio is commonly misunderstood, as many think that a ratio exceeding 100% indicates a bankrupt or insolvent country. However, a high ratio is acceptable if a country is able to pay interest on its debt without having to refinance or adversely impact its economic growth.

For example, Japan's debt-to-GDP ratio was 253% in 2017 (higher than Greece's 177% in 2017). Although Japan's ratio is significantly higher compared to other countries, analysts put the country's risk of defaulting extremely low. Japan is able to sustain and remain afloat despite a staggering ratio due to the fact that most Japanese government bonds are held by the country's citizens, resulting in extremely low interest rates.

### **Crisis Prevention**

- **Policies matter.**

While there is no magic bullet of a policy prescription to ensure that the current debt wave proceeds smoothly, the experience of past waves of debt points to the critical role of policy choices in determining the outcomes of these episodes.

First, strong monetary, exchange rate, and fiscal policy frameworks can safeguard countries' resilience in a fragile global economic environment. The benefits of stability-oriented and resilient monetary policy frameworks cannot be overstated.

Second, higher government or private debt and a riskier composition of debt are associated with a higher probability of crisis. Hence, sound debt management and debt transparency will help reduce borrowing costs, enhance debt sustainability, and contain fiscal risks.

Third, robust financial sector regulation and supervision can help recognize and act on emerging risks. Financial market deepening can help mobilize domestic savings that may provide more stable sources of financing than foreign borrowing.

Such policies are also critical to help reduce the likelihood of financial crises and alleviate their impact, if they erupt. Although many emerging market and developing economies have better policy frameworks now than during previous debt waves, there remains significant room for improvement.

- **Accumulate debt with care**

Borrowing, when well-spent and sustainable, could support growth. Waves of broad-based debt accumulation have typically coincided with global upturns amid accommodative monetary policy and financial market development. However, about half of rapid debt accumulation episodes at the country level were associated with financial crises. Episodes of rapid government debt accumulation were more likely than episodes of rapid private debt to be associated with crisis, and were costlier than crises following rapid build-ups of private debt.

- **Use debt efficiently**

Combination of weak global growth and low interest rates make government debt accumulation an appealing option for developing countries to boost growth-friendly spending. However, it is critical that the debt be used for productive purposes to boost potential growth as painfully learned from the experience of the past. Crises were common in countries that borrowed heavily



to finance state-led industrialization, war or real estate markets.

### **Resolution of crises**

Many, though not all, crises were resolved by policy programs of adjustment and structural reform supported by financing from the IMF, World Bank, and other multilateral bodies and partner countries.

**Debt restructuring:** Among many case studies of sovereign debt crises, many ended with default and restructuring of debt (Argentina, Cameroon, Mexico, Nigeria). These cases were more common in the 1980s, 1990s, and early 2000s. Debt restructuring was often prolonged and occurred well after the initial sovereign debt crisis hence can be considered as a prevention measure.

**Reforms:** IMF support is conditional on the implementation of macroeconomic and structural reforms. For many developing countries in the 1980s, crises were the trigger for policy changes to allow greater exchange rate flexibility and strengthen monetary policy regimes.

### **Debt Relief**

**IMF /World Bank support:** The money that the IMF and World Bank provides to these countries can be used to pay off existing debt and thus improves their economy. Once the debt, if at all, has been paid in full, the remaining money can be used for other organizations/assets that could help to improve the well being of the country as a whole. The countries that did not use IMF support typically had stronger fundamentals, including lower public debt and larger international reserves (Colombia, Kazakhstan, Malaysia).

The IMF's analytical work helps identify sovereign debt risks and provides policy advice on how to address these risks at an early stage. Jointly with the World Bank, the IMF fosters debt transparency and supports countries in strengthening their capacity to report and manage their public debt.

### **Highly Indebted Poor Countries Initiative (HIPC)**

- The heavily indebted poor countries (HIPC) are a group of 37 developing countries with high levels of poverty and debt overhang which are eligible for special assistance from the International Monetary Fund (IMF) and the World Bank.
- The HIPC Initiative was launched in 1996 by the IMF and World Bank, with the aim of ensuring that no poor country faces a debt burden it cannot manage. Since then, the

international financial community, including multilateral organizations and governments have worked together to reduce to sustainable levels the external debt burdens of the most heavily indebted poor countries.

- In 2005, to help accelerate progress toward the United Nations Sustainable Development Goals (SDGs), the HIPC Initiative was supplemented by the Multilateral Debt Relief Initiative (MDRI). The MDRI allows for 100 percent relief on eligible debts by three multilateral institutions—the IMF, the World Bank, and the African Development Fund (AfDF)—for countries completing the HIPC Initiative process. In 2007, the Inter-American Development Bank (IaDB) also decided to provide additional (“beyond HIPC”) debt relief to the five HIPCs in the Western Hemisphere.
- The countries face common challenges, including preserving peace and stability, and improving governance and the delivery of basic services. Addressing these challenges will require continued efforts from these countries to strengthen policies and institutions, and support from the international community.

**National Debt Bailout-** Getting rich nations to forgive your national debts or hand you cash is a strategy that has been employed more than a few times. Many nations in Africa have been the beneficiaries of debt forgiveness. Unfortunately, even this strategy has its faults. For example, in the late 1980s, Ghana's debt burden was significantly reduced by debt forgiveness. In 2011, the country is once again deeply in debt.

The underlying causes of the debt crisis are the continued dependence on commodity exports, as well as borrowing and lending not being responsible enough, meaning that new debts do not generate sufficient revenue to enable them to be repaid. Defaulting on national debt, can lead to going bankrupt. Restructuring payments to creditors is a common and often successful strategy for debt reduction. North Korea, Russia, and Argentina have all employed this strategy. The drawback is that it becomes harder and more expensive for countries to borrow in the future after a default.

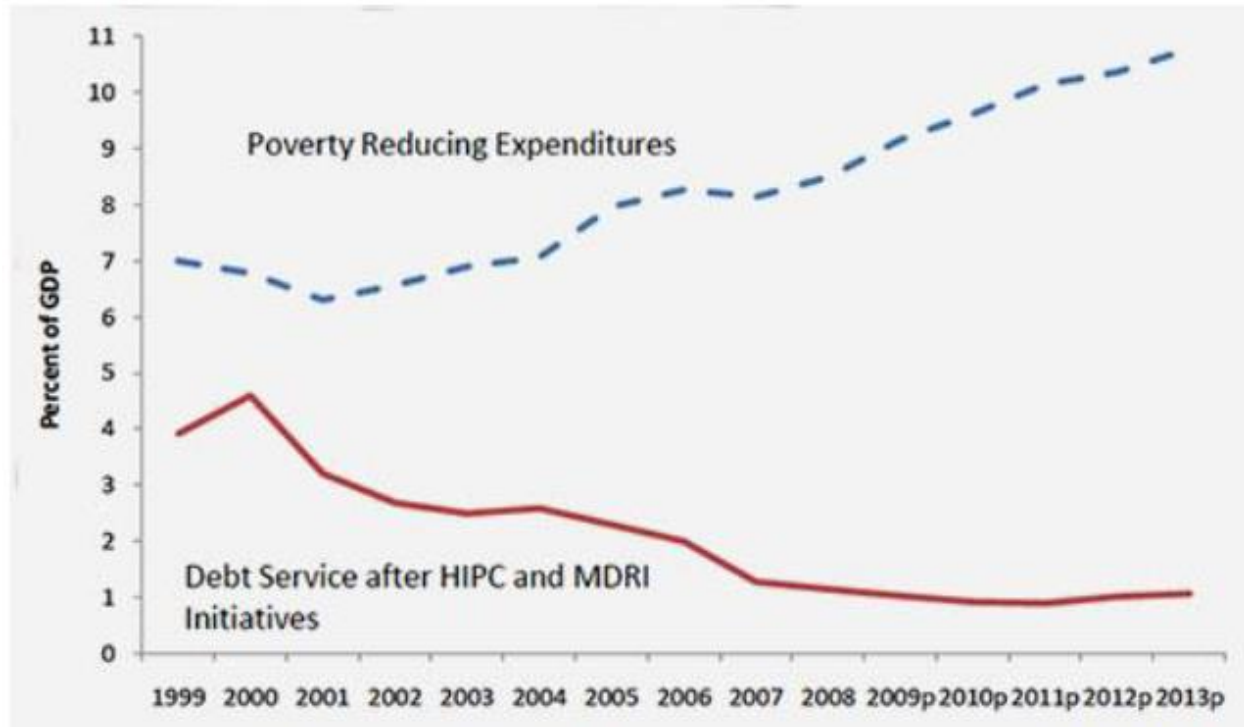
### **Jubilee 2000 Campaign**

- Jubilee 2000 was a global campaign that led ultimately, to the cancellation of more than \$100 billion of debt owed by 35 to foreign creditors.
- Greater awareness in debtor nations of the nature and scale of the debt. This challenged the corruption behind much lending and borrowing, and increased accountability of governments to their people for foreign lending and borrowing.

- Ms Pettifor was Director of the UK Jubilee 2000 Coalition. As effective leader, she travelled widely to support Jubilee 2000 campaigns in countries as diverse as Japan, Peru, Germany, Ghana, Honduras, Nigeria and the United States until the campaign was disbanded – as scheduled – at the end of 2000.
- The resulting savings were subsequently used to reduce poverty, and to fund health and education programmes in many countries.

### **World Bank Report, September 2009**

#### Average Debt Service and Poverty Reducing Expenditures



Sources: HIPC documents and IMF staff estimates. \*Prior to 2008, figures represent debt-service paid, and thereafter, debt service figures are projected

### **Conclusion**

Debt threatens to create a global development emergency in much the same way the pandemic is creating a global health emergency.

*“For the countries, it should be obvious that they are not now shielded from the effects of their*

*bad decisions. They may receive temporary financial assistance, but they also inevitably go through a very difficult economic period before recovery takes hold. No country would opt to go through what Mexico went through, or what various Asian countries are going through now."*

Robert Rubin (1998)

Former U.S. Secretary of the Treasury

On prevention versus crisis management, we have done better at the latter than the former. It is doubtful that this will change as the memories of the crisis fade and financial market participants and their regulators become complacent.

If policy makers are fortunate, economic growth will provide a soft exit, reducing or eliminating the need for painful restructuring, repression or inflation.

Debt accumulation is more likely to be benign when debt is well-used for growth-enhancing purposes and when its composition is carefully managed to maintain resilience to financial market disruptions. This requires not only prudent government debt management but also robust financial system regulation and supervision as well as sound corporate governance.

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