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Rethinking Debt Sustainability?

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RUBRICHE

Sovereign debt in times of crises

Carmine Di Noia*

Abstract

This essay explores the dynamics of sovereign debt in crisis times. In particular, it describes how sovereign debt markets are reacting to pressures caused by the war in Ukraine and the COVID-19 pandemic. In doing so, it highlights the key uncertainties facing countries and debt managers, as well as lessons learned so far. It also addresses possible risks on the horizon, including debt distress in emerging markets and the risk of fast-growing outstanding corporate debt becoming public liabilities.

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This article is a revised version of the Keynote Speech delivered at the 2nd Public Debt Management Conference (PDM) held in Rome, on May 26-27, 2022. PDM is an initiative fostered by the OECD, the Italian Treasury and the World Bank.
The opinions expressed here do not necessarily reflect those of the OECD.
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Sintesi - Il debito sovrano in tempi di crisi

Questo saggio esplora le dinamiche del debito sovrano in tempi di crisi. In particolare, descrive come i mercati del debito sovrano stiano reagendo alle pressioni causate dalla guerra in Ucraina e dalla pandemia COVID-19. Nel farlo, evidenzia le principali incertezze che i Paesi e i gestori del debito devono affrontare, nonché le lezioni apprese finora. Inoltre, analizza i possibili rischi all'orizzonte, tra cui crisi del debito nei mercati emergenti e il rischio che il debito delle imprese non finanziarie, in rapida crescita, possa diventare un rischio per le finanze pubbliche.

JEL Classification: E31; G15; G32; H63.

Parole chiave: *Debito sovrano; Stabilità finanziaria; Inflazione; Gestione del debito pubblico; Debito delle imprese non finanziarie.*

Keywords: Sovereign debt; Financial stability; Inflation; Public debt management; Corporate debt

Introduction

This essay discusses sovereign debt in times of crises – a word that is admittedly somewhat disheartening to use in the plural. In the current context of the pandemic and the war in Ukraine, on top of the pressing need to address climate change, however, one can legitimately speak of multiple crises.

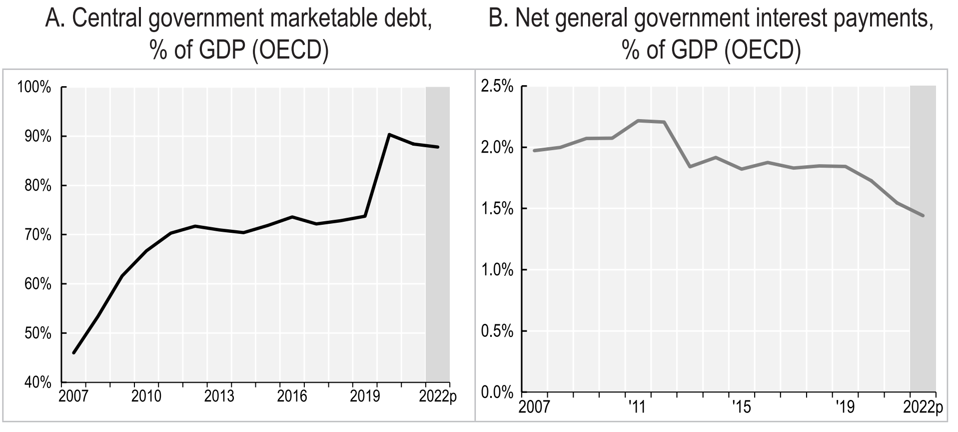
Public debt is particularly sensitive in crisis times. Sharp upward pressure on public borrowing will often coincide with significant financial turmoil and uncertain market conditions, as was the case at the outbreak of the pandemic, to mention the most notable recent example. Crises serve to remind us that sovereign debt is a complex mix not just of macroeconomics, finance and law, but indeed also of politics, both domestic and international.

Against this backdrop, this essay highlights both the key uncertainties facing countries and public debt managers in the difficult current context, as well as lessons learned so far about the management of public debt in crisis scenarios. It finishes by raising some questions about possible risks on the horizon.

1. Going into the crises – not NICE, but not so bad?

To set the scene, let me start by providing a broad overview of the state of sovereign borrowing going into the current crises. It is a familiar story, but one worth repeating to understand today's context. The figures below begin at the cusp of the global financial crisis, in 2007. That crisis, of course, marked the end of the so-called Great Moderation of reduced macroeconomic volatility.

Figure 1 **Public debt in OECD economies**



Note: Shaded areas are projections.

Source: OECD Sovereign Borrowing Outlook 2022; OECD Economic Outlook 110.

The post-crisis environment was also decidedly a break with what Mervyn King once called the **N.I.C.E.**[1] decade, **n**on-**i**nflationary, **c**onsistently **e**xpansionary. It paved the way instead for uneven and sluggish GDP growth as well as elevated unemployment rates, notably in Europe.

But even if it wasn't **nice**, in many OECD countries it was perhaps not so bad either, as far as public debt management is concerned. As the graphs above show, there has been an effective decoupling between interest costs and sovereign borrowing levels in many advanced economies. Panel A of Figure 1 shows how central government marketable debt in OECD countries increased

1 Speech given by Mervyn King, Governor of the Bank of England, East Midlands Development Agency/Bank of England Dinner, Leicester 14 October 2003

from 46% of GDP in 2007 to 74% in 2019, before jumping to over 90% in 2020 as the pandemic led to substantial increases in public expenditure.

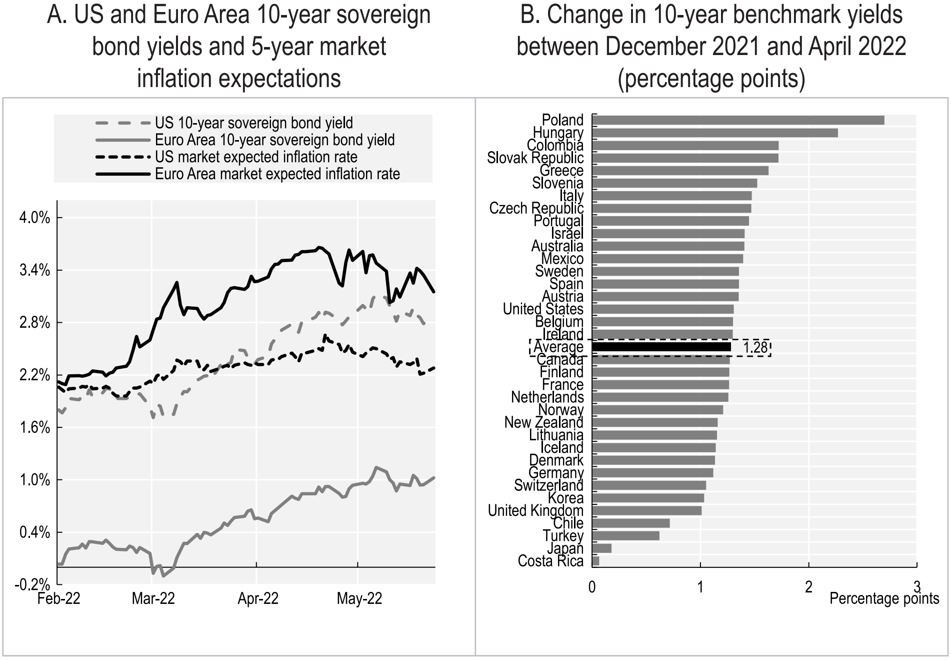
During the same period, net general government interest payments as a share of GDP decreased from 2.7% to 1.7% (Figure 1, Panel B). The correlation between debt-to-GDP and net interest payments to GDP is, strikingly, sharply negative, even as maturities have shown an increasing trend.

This is of course an effect of a prolonged period of extraordinarily accommodative monetary policy in response to persistently low growth and inflation. Those conditions, however, are changing.

2. A turning of the tide?

Inflation is picking up pace again, fuelled at least in part by pandemic and war-related supply chain issues. In response, central banks are shifting to tighter monetary policy positions, unwinding their asset purchasing programmes and raising interest rates.

Figure 2 **Benchmark bond yields and inflation expectations**



Note: Inflation expectations are 5 years.

Source: Refinitiv; OECD Sovereign Borrowing Outlook 2022.

Panel A of Figure 2 shows how the 10-year yield has increased rather significantly in 2022 in both the US and the Euro Area. Market inflation expectations have also picked up compared to recent years, although still remain at relatively modest levels.

Panel B of Figure 2 indicates that all OECD countries saw their 10-year benchmark yield increase between December 2021 and April 2022, and all but a handful by more than 1 percentage point.

It is still too soon to say whether this represents a more permanent, widespread increase in inflation levels and expectations, but it is clear that macroeconomic change is afoot, with consequent effects on sovereign debt markets.

3. Twin crises, triple pressures

Against this brief background, three key pressures facing sovereign debt markets, and how they relate to the twin crises of the pandemic and the war in Ukraine, should be considered.

The first pressure is a general surge in government borrowing, and in future borrowing needs. This relates to the current crises – the most evident example is the cost of dealing with COVID-19, illustrated by the fact that gross borrowing by OECD governments jumped by 70% in 2020.

However, this shock increase in public spending to fight the pandemic only constitutes one among many fiscal pressures. Aside from crisis spending, there are also more structural issues. Firstly, ensuring an equitable and sustainable green transition will require significant investment, public as well as private. It is a non-negotiable cost. This impact can already be seen. For example, while still in the early stages of development, the ESG-labelled sovereign bond market has grown significantly in recent years. More than 30 countries have issued ESG-labelled bonds, and the amounts issued have more than tripled since 2019.

Secondly, there is a demographic shift towards ageing populations in many developed countries, simultaneously reducing the tax base and increasing public expenditure related to old age. This will inevitably add additional strain on public finances.

Already, OECD governments are estimated to borrow more than 14 trillion US dollars from the markets in 2022. Net borrowing requirements are estimated at around 3 trillion US dollars, which is twice as much as pre-pandemic levels.

The second pressure is inflation, as briefly mentioned above. The pick-up in inflation is partly an effect of the current crises, as supply chain disruptions from both the pandemic and the war in Ukraine are leading to price increases globally, notably in food and energy.

As central banks around the world tighten their positions, we will see higher interest rates in a context of very elevated debt levels – and significant refinancing needs. Between now and end-2024, OECD government have more than 20 trillion US dollars' worth debt coming due.

The unwinding of central banks' asset purchase programmes will also lead to a shift in the investor base, increasing the yield-sensitivity of bondholders and likely putting further pressure on borrowing costs.

The third pressure is more abstract, but an important challenge nonetheless. It refers to the general high degree of current uncertainty, in terms of the economy, in terms of financial markets and, of course, in terms of geopolitics. This clouded outlook exacerbates the other two pressures, making borrowing needs more difficult to estimate and the nature of the current inflation difficult to assess.

For example, how long will the war and the sanctions last, and what will the subsequent geopolitical landscape look like? What will be the cost of reconstruction? Will there be entirely new global supply chains, and if so, what will the inflationary impact be? Can COVID-19 be said to be over from a public finance perspective, or is there a risk of a resurgence, or a new variant that would cause another sudden shock to public finances? Is there a risk of another pandemic altogether? What is the nature of the current inflation? These are all critical questions to consider when designing a public debt management strategy, but at this stage one can only guess what their answers will be. "Life, as Kierkegaard noted, can only be understood backwards, but must (unfortunately) be lived forwards".

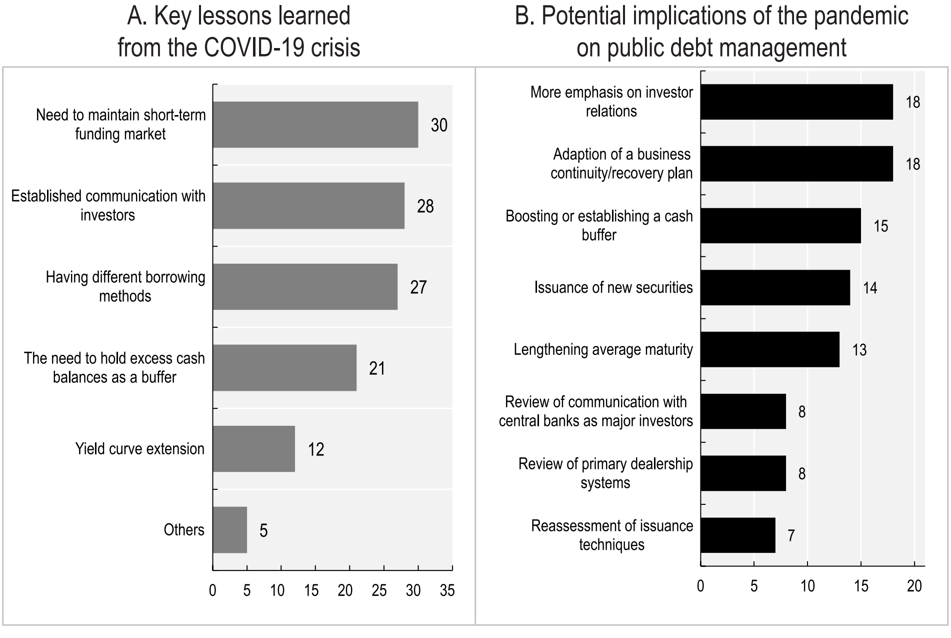
4. Implications and lessons learned from the pandemic

Still, in the midst of all this uncertainty, some clarity remains and we are learning as we go. The members of the OECD Working Party on Public Debt Management have responded to a survey on the key lessons learned from dealing with the COVID-19 crisis. As Panel A of Figure 3 shows, the most commonly cited lesson is the need to maintain a short-term funding market. Several countries, including Germany and Italy, have focused on repo activity to improve cash management, provide more flexibility in issuance plans and support market liquidity. Another interesting point raised by many countries is the importance of having different borrowing methods in place – be it auctions, syndications or private placements. Several debt management offices also relied on cash buffers in the wake of the pandemic, when market conditions were acute.

In the survey, respondents were also asked about the main implications of the pandemic on public debt management. More than a third are considering reviewing long-term funding strategies because of increased debt levels following the pandemic. Change, in other words, is definitely taking place.

Also as a result of the pandemic, many countries are considering changes in investor relations, cash buffers and business continuity plans. Several want to extend their maturity profiles.

Figure 3 **Lessons and implications of the COVID-19 crisis on public debt management**



Source: OECD Sovereign Borrowing Outlook 2022 (2021 OECD Survey on Primary Market Developments).

The general trend seems to point towards a greater focus on resilience against unexpected outcomes – or, if forced to use the plural again – against crises.

5. Risks on the horizon – emerging market debt distress?

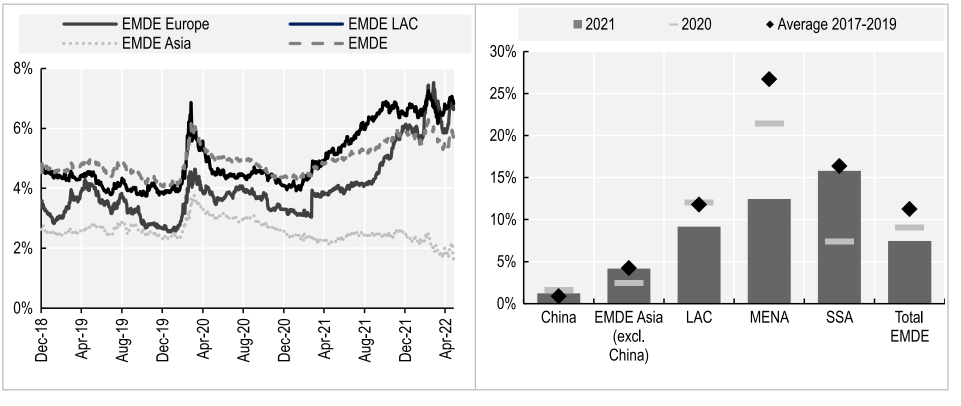
Recent years have shown all too well that difficulties tend to cluster together, and that new ones may be waiting around the corner. It is therefore useful, and indeed prudent, to consider what a next crisis might look like. I will raise two possible such scenarios. The first is the prospect of a scenario of debt distress in emerging markets.

Because market confidence is typically lower for emerging economies than advanced ones, these markets are much more sensitive and exposed to the three pressures discussed above. This is evident from Panel A of Figure 4 below, which shows the spread of emerging market local currency bond yields over the US 10-year yield. Across most regions, with the exception of Asia, it has increased sharply in recent months. In Latin America and Europe, spreads are now higher than in April 2020. This creates substantial refinancing risk for debts coming due, as is already clear in some countries.

Figure 4 **Emerging market yield spreads and share of foreign currency issuance**

A. Emerging market local currency bond yield spreads over US 10-year

B. Share of foreign currency issuance by emerging market group



Note: EMDE = emerging markets and developing economies; LAC = Latin America and the Caribbean; MENA = Middle East and North Africa; SSA = Sub-Saharan Africa

Source: OECD Sovereign Borrowing Outlook 2022.

As monetary policy positions in reserve currency countries begin to shift, many emerging economies may be exposed to substantial capital outflows. This has the potential of dealing a significant blow to emerging markets. The most obvious is the direct effect on interest costs for floating rate debt. To the extent that they have borrowed in foreign currencies, increasing interest rates in the currency issuer country may possibly also, *ceteris paribus*, lead to a local currency depreciation. This makes it more expensive both to service the debt and to import goods and services.

As Panel B of Figure 4 shows, the share of foreign currency debt in total emerging market issuance not negligible, in particular in sub-Saharan Africa and the Middle East and North Africa, even if the latter has decreased its share of foreign currency borrowing over time.

This is all taking place in a context of highly elevated emerging market borrowing. Repayment difficulties in certain countries will be all but inevitable. That makes it imperative to have a well-functioning mechanism for handling debt restructurings in emerging markets. Global coordination will be essential, and must reflect the changing creditor landscape. For example, China, which is not a permanent member of the Paris Club of creditors, is the largest bilateral creditor to a large number of emerging economies.

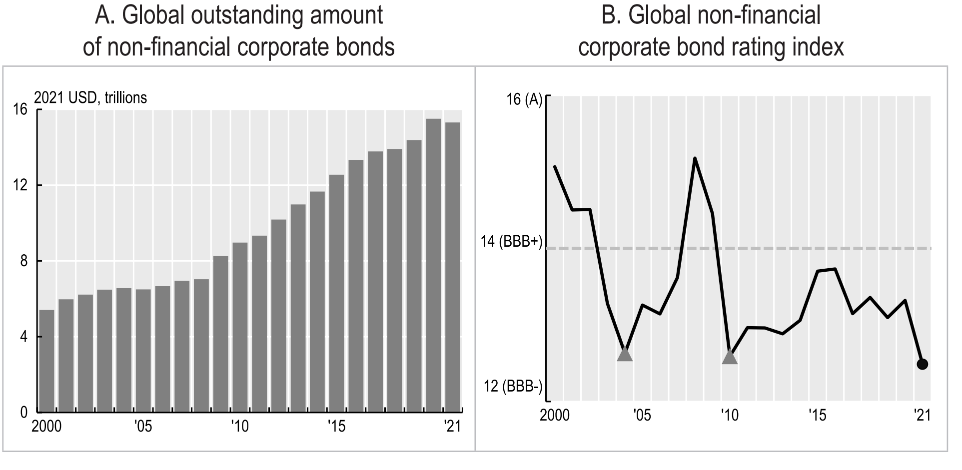
It should be one of the international community's key priorities to ensure that there is not a full-blown emerging market debt crisis. It is our duty to avoid the loss of hard-gained poverty reductions and living standard increases.

6. Risks on the horizon: private risks becoming public liabilities?

There is also a risk relating not to sovereign, but to corporate debt. Corporate indebtedness has been increasing sharply since the 2008 financial crisis. At the end of 2021 the total amount of outstanding non-financial corporate bonds globally had reached 15.3 trillion US dollars (Figure 5, Panel A). That is more than twice the amount in 2008.

In parallel to this increase, the credit quality of the outstanding debt has been decreasing. The average weighted credit rating of non-financial corporate bonds has fallen to just half a notch above speculative grade in 2021 – the lowest figure on record (Figure 5, Panel B). It should also be considered that several central banks are exposed to corporate bonds. This, in turn, exposes the market to a change in investor base as purchasing programmes end and central banks withdraw from the market, likely pushing up yields, as mentioned above.

Figure 5 **Benchmark bond yields and inflation expectations**



Source: OECD Capital Market Dataset.

Add to this mix the growth in leveraged loans and a picture of a relatively risky corporate debt landscape emerges.

The crucial point in all of this is that these currently private risks could become public liabilities in times of financial distress. It may happen directly, in the case of a bailout, or indirectly if a debt crisis were to cause an economic slump that requires fiscal stimulus. For this reason, public debt managers should also keep an eye on developments in private borrowing.

However, against this possibly gloomy background, it is worth remembering that disaster is never inevitable. We must be vigilant in the face of these risks, and others we have not thought about yet. Still, we are learning more every day, and must continue to do so.

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Rethinking Debt Sustainability?

This issue of *Economia Italiana* – **editors Lorenzo Codogno, LSE, and Pietro Reichlin, Luiss** - deals with public debt sustainability and fiscal rules. Many beliefs about the benefits of current fiscal and monetary policies could change because of the risks associated with the energy crisis, the war in Ukraine, the return of inflation and the green transition. The volume contains several contributions by leading experts on the following questions: *Is debt sustainability a cause of concern within the Euro Area? How should we consider revising the Stability and Growth Pact in the European Union? Are the energy transition and the pandemic risks good reasons to build up EU-level fiscal capacity?* In the introduction to this monograph, we will touch upon some of these issues and discuss why they are important.

Ripensare la sostenibilità del debito?

Questo numero di Economia Italiana – **editor Lorenzo Codogno, LSE, e Pietro Reichlin, Luiss** - tratta della sostenibilità del debito pubblico e delle regole fiscali. Molte convinzioni sui benefici delle attuali politiche fiscali e monetarie potrebbero cambiare a causa dei rischi associati alla crisi energetica, alla guerra in Ucraina, al ritorno dell'inflazione e alla transizione verde. Il volume contiene diversi contributi dei maggiori esperti sulle seguenti questioni: *La sostenibilità del debito è fonte di preoccupazione nell'area dell'euro? Come dovremmo considerare la revisione del Patto di stabilità e crescita nell'Unione europea? La transizione energetica e i rischi di pandemia sono buone ragioni per costruire una capacità fiscale a livello europeo?* Nell'introduzione di questa monografia, gli editor trattano alcuni di questi temi e spiegano perché sono importanti.

Essays by/Saggi di: Lorenzo Codogno, and Pietro Reichlin; Carmine Di Noia; Ludger Schuknecht; William R. Cline; Lorenzo Codogno, and Giancarlo Corsetti; Martin Larch; Cecilia Gabriellini, Gianluigi Nocella, and Flavio Padrini; Marzia Romanelli, Pietro Tommasino, and Emilio Vadalà; Angelo Baglioni, and Massimo Bordignon; Paul Van den Noord.

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