OVERVIEW

Another global wave of debt underway…

The global economy has experienced four waves of broad-based debt accumulation over the past 50 years. In the latest wave, underway since 2010, global debt has grown to an all-time high of 230 percent of gross domestic product (GDP) in 2018. The debt buildup was particularly fast in emerging market and developing economies (EMDEs). Since 2010, total debt in these economies has risen by 54 percentage points of GDP to a historic peak of about 170 percent of GDP in 2018. Following a steep fall during 2000-10, debt has also risen in low-income countries to 67 percent of GDP ($268 billion) in 2018, up from 48 percent of GDP (about $137 billion) in 2010.

Why this study?

The size, speed, and reach of the postcrisis debt buildup in EMDEs raises concerns about its potential consequences for macroeconomic and financial stability. To shed light on these consequences, this study presents the first in-depth analysis of four waves of debt accumulation, puts the current debt wave into historical perspective, analyzes national episodes of debt accumulation, examines the links between debt accumulation and financial crises, and draws policy lessons. The study employs a wide range of approaches, including event studies, econometric models, country case studies, and a detailed review of historical episodes.

Three historical waves: All ended with crises

Before the current wave, EMDEs experienced three waves of broad-based debt accumulation. The first wave spanned the 1970s and 1980s, with borrowing primarily accounted for by governments in Latin America and the Caribbean region and in low-income countries, especially in Sub-Saharan Africa. The combination of low real interest rates in much of the 1970s and a rapidly growing syndicated loan market encouraged these governments to borrow heavily.

The first wave culminated in a series of crises in the early 1980s. Debt relief and restructuring were prolonged in the first wave, ending with the introduction of the Brady Plan in the late 1980s for mostly Latin American countries. The Plan provided debt relief through the conversion of syndicated loans into bonds, collateralized with U.S. Treasury securities. For low-income countries, substantial debt relief came in the mid-1990s and early 2000s with the Heavily

Indebted Poor Countries initiative and the Multilateral Debt Relief Initiative, spearheaded by the World Bank and the International Monetary Fund.

The second wave ran from 1990 until the early 2000s as financial and capital market liberalization enabled banks and corporations in the East Asia and Pacific region and governments in the Europe and Central Asia region to borrow heavily, particularly in foreign currencies. It ended with a series of crises in these regions in 1997-2001 once investor sentiment turned unfavorable.

The third wave was a run-up in private sector borrowing in Europe and Central Asia from European Union headquartered "mega-banks" after regulatory easing. This wave ended when the global financial crisis disrupted bank financing in 2007-09 and tipped several economies in Europe and Central Asia into recessions.

Historical waves: Many similarities but some differences as well

The three waves of debt began during periods of low real interest rates and were often facilitated by financial innovations or changes in financial markets that promoted borrowing. The waves ended with widespread financial crises and coincided with global recessions (1982, 1991, and 2009) or downturns (1998 and 2001). These crises were typically triggered by shocks that resulted in sharp increases in investor risk aversion, risk premiums, or borrowing costs, followed by sudden stops of capital inflows and deep recessions. The financial crises were usually followed by reforms designed to lower vulnerabilities and strengthen policy frameworks. Many EMDEs introduced inflation targeting, greater exchange rate flexibility, fiscal rules, or more robust financial sector supervision in the aftermath of crises.

There are some important differences among the first three waves. The financial instruments used for borrowing have evolved as new instruments or financial actors have emerged. The nature of EMDE borrowers in international financial markets has changed, with the private sector accounting for a growing share of debt accumulation through the three waves. The severity of the economic damage done by the financial crises that ended the waves varied among them, and across regions. Output losses were particularly large and protracted in the wake of the first wave, when the majority of debt accumulation had been by governments. Meanwhile, in many EMDEs, improvements in policy frameworks after the first two debt waves played a role in mitigating the adverse impact of the global financial crisis that marked the end of the third wave.

The fourth wave: Similar to previous waves but larger, faster, and broader

The latest wave of debt accumulation began in 2010 and has already seen the largest, fastest, and most broad-based increase in debt in EMDEs in the past 50 years. The average annual increase in EMDE debt since 2010 of almost 7 percentage points of GDP has been larger by some margin than in each of the previous three waves. In addition, whereas previous waves were largely regional in nature, the fourth wave has been widespread with total debt rising in almost 80 percent of EMDEs and rising by at least 20 percentage points of GDP in just over one-third of these economies.

The current wave of debt accumulation bears many similarities to the previous three waves. Global interest rates have been very low since the global financial crisis and the ensuing search for yield by investors has contributed to narrowing spreads for EMDEs. Some major changes in financial markets have again boosted borrowing, including through a rise of regional banks, growing appetite for local currency bonds, and increased demand for EMDE debt from the expanding nonbank financial sector. As in the earlier waves, vulnerabilities have mounted in EMDEs as the current wave has proceeded amid slowing economic growth.

National episodes of debt accumulation: Debt distress more likely

At the individual country level, EMDEs have historically undergone recurrent surges of rapid debt accumulation. When these episodes took place in many economies, they collectively formed the global waves of debt discussed above. A closer examination of national episodes offers a more granular perspective on the causes and consequences of debt accumulation.

Since 1970, there have been 519 national episodes of rapid debt accumulation in 100 EMDEs, during which government debt typically rose by 30 percentage points of GDP and private debt by 15 percentage points of GDP. The typical episode lasted about eight years. About half of these episodes were accompanied by financial crises, which were particularly common in the first and second global waves, with severe output losses compared to countries without crises. Crisis countries typically registered larger debt buildups, especially for government debt, and accumulated greater macroeconomic and financial vulnerabilities than did noncrisis countries.

Although financial crises associated with national debt accumulation episodes were typically triggered by external shocks such as sudden increases in global interest rates, domestic vulnerabilities often amplified the adverse impact of these shocks. Crises were more likely, or the economic distress they caused was more severe, in countries with higher external debt—especially short-term—and lower international reserves.

Unsustainable policies: A recipe for debt distress

Most EMDEs that experienced financial crises during debt accumulation episodes employed various combinations of unsustainable macroeconomic policies and suffered structural and institutional weaknesses. Debt buildup had often funded import substitution strategies, undiversified economies, or inefficient sectors that did not raise export earnings or had poor corporate governance. Many of these economies had severe weaknesses in their fiscal and monetary policy frameworks, including poor revenue collection, widespread tax evasion, public wage and pension indexing, monetary financing of fiscal deficits, and substantial use of energy and food subsidies. In addition, crisis countries often borrowed in foreign currency and managed their exchange rates, while regulation and supervision of banks and other financial institutions were frequently weak. Several EMDEs that experienced crises also suffered from protracted political uncertainty.

End of the current wave: Will history repeat itself?

Although EMDEs have gone through periods of volatility in the current wave of debt accumulation, they have not experienced widespread financial crises. The exceptional size, speed, and reach of debt accumulation in EMDEs during the fourth wave, however, should give policy makers in EMDEs pause. Despite the sharp rise in debt, these economies have experienced a decade of repeated growth disappointments and are now facing weaker growth prospects in a fragile global economy. In addition to their rapid debt buildup, they have accumulated other vulnerabilities, such as growing fiscal and current account deficits and a shift toward a riskier composition of debt. Thus, despite exceptionally low real interest rates, and prospects for continued low rates in the near-term, the current wave of debt accumulation could follow the historical pattern and culminate in financial crises in these economies.

A sudden global shock, such as a sharp rise in interest rates or a spike in risk premiums, could lead to financial stress in more vulnerable economies. Among low-income countries, the rapid increase in debt and the shift from concessional toward financial market and non-Paris Club bilateral creditors have raised concerns about debt transparency and collateralization. Elevated debt in large EMDEs could amplify the impact of adverse shocks and trigger a downturn in these economies, posing risks to global and EMDE growth.

Policies matter!

Although 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. Specific policy priorities ultimately depend on country circumstances, but four broad strands of policies can help reduce the likelihood that the current debt wave will end in crisis and, if crises were to take place, to alleviate their impact: policies to manage the composition of debt, strong macroeconomic and financial policy frameworks, sound financial sector policies, and robust business environments and institutions.

First, higher government or private debt and a riskier composition of debt (in terms of maturity, currency denomination, and type of creditor) 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. Creditors, including international financial institutions, can spearhead efforts in this area by encouraging common standards, supporting capacity building, and highlighting risks and vulnerabilities through timely analytical and surveillance work.

Second, robust monetary, exchange rate, and fiscal policy frameworks can safeguard EMDEs' resilience in a fragile global economic environment. The benefits of stability-oriented and resilient monetary policy frameworks cannot be overstated. Flexible exchange rates can discourage a buildup of substantial balance sheet mismatches and reduce the likelihood of large exchange rate misalignments. Fiscal rules can help prevent fiscal slippages, ensure that revenue windfalls during times of strong growth are prudently managed, and manage and contain risks from contingent liabilities. Revenue and expenditure policies can be adjusted to expand fiscal resources for priority spending.

Third, proactive financial sector regulation and supervision can help policy makers identify and act on emerging risks. Financial market deepening can help mobilize domestic savings, which may be a more stable source of financing than foreign borrowing.

Fourth, in several crisis cases, it became apparent that borrowed funds had been diverted toward purposes that did not raise export proceeds, productivity, or potential output. Apart from effective public finance management, policies that promote good corporate governance can help ensure that debt is used for productive purposes. Sound bankruptcy frameworks can help prevent debt overhangs from weighing on investment for prolonged periods.