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STANDPUNKTE DER CHEFVOLKSWIRTE

Public debt out of control both in and after the pandemic?

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During the pandemic, public debt, which was already high worldwide, has taken another leap upwards. It is true that budget deficits will move lower again once the extensive raft of current support measures has expired. However, the mountain of debt will continue to grow for the time being, since consolidation will be relatively hesitant in many quarters out of consideration for the economic recovery. Important trends and strategies are:

- In the industrialised countries, the surge in debt has proved to be more pronounced, on average, than in the emerging markets. In many places, public debt now exceeds 100 percent of annual aggregate economic output. In order to ensure sustainability, central banks have intervened during the present crisis on a previously unimaginable scale.
- The resulting low-interest-rate environment is making it easier for governments to service the debt they have taken on. However, "growing out" of the debt through nominal growth is only going to be possible to a limited extent. Even if inflation moves somewhat higher in the future, the industrialised countries are more likely to face a growth slowdown for structural reasons such as demographics.
- The current monetary policy also entails noticeable latent risks and side effects, ranging from the risk of inflation "letting rip" to dangers for financial-market stability. Continuing on the deficit-spending tack would therefore be negligent.
- The situation in the euro area is heterogeneous: In Germany, public-debt reduction towards 60 per cent of GDP should definitely be possible even with high public investment. Italy and France are in a much more difficult situation.
- Major emerging economies with unsustainable debt burdens will endeavour to counteract this with IMF programmes. Some over-indebted developing countries will receive debt relief in parallel with IMF programmes. After the crisis is over, however, a sharp renewed increase in debt cannot be ruled out.

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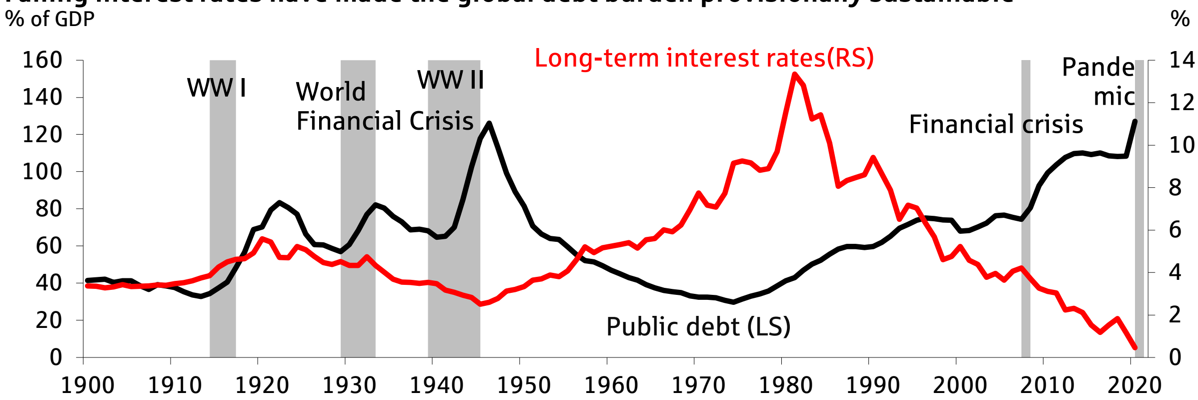
Public debt out of control both in and after the pandemic?

The Covid-19 pandemic has led to a noticeable rise in government-budget deficits and to a sharp increase in debt levels practically everywhere. It is a problem that the current crisis hit many countries whose budgetary "starting position" was anything but solid. Already in the preceding years, public debt as a percentage of gross domestic product had already spiralled up to its highest level since the Second World War in many parts of the world.

Public debt has been rising for decades, not only in (not very meaningful) absolute terms, but also in terms of the dimension which matters, i.e. relative to the size of the respective economy. In the industrialised countries, the nadir was in the 1970s, before the oil crisis and recession caused the first sustained increase in debt since the end of World War Two. Since then, the trend has been pointing inexorably upwards, interrupted only by temporary phases of stabilisation. Internationally speaking, there have been no truly significant reductions in debt ratios. Successes on this front in some small countries such as Ireland or Sweden have been more than offset by the opposite trend playing out in the heavyweight nations/economic areas - first and foremost the USA, Japan, the euro area and China. In the emerging markets and developing countries, the trend towards rising public indebtedness only resumed in the wake of the global financial crisis, from around 2010 onwards. Prior to that, IMF programmes, reforms following the Asian crisis in the emerging markets, and international debt-relief initiatives for developing countries led to a decline in government debt relative to economic output in both these country segments.

In the process, global interest rates have fallen significantly over a large part of what is now almost a five-decade period. Since the early 1980s, global bond yields have been on a downward trend. Nonetheless, it is obvious that the resulting interest-expenditure savings reaped by the public sector have not been used to pay down debt. Instead, the incentive effect of lower interest rates to take on additional debt for ever new government tasks has been clearly predominant. After the fresh jump in public-debt ratios during the course of the pandemic, the question is even more acute than ever: can/will this continue?

Falling interest rates have made the global debt burden provisionally sustainable

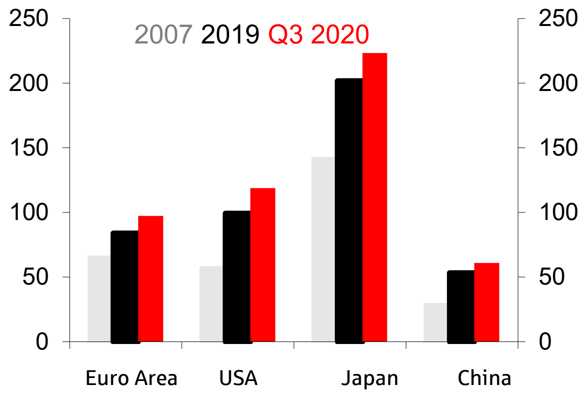


Sources: IWF, Helaba Volkswirtschaft/Research

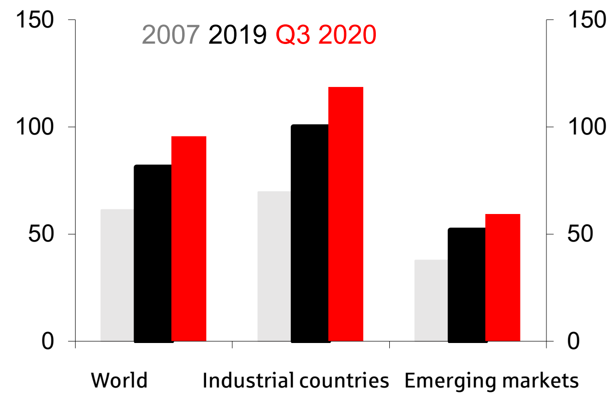
The debt pandemic: What action needs to be taken?

The Covid-19 pandemic is already the second crisis in the current, still young, century that has led to a massive increase in public-debt ratios worldwide. The first surge occurred around twelve years ago in connection with the financial crisis. Subsequently, the wall of debt has not been whittled away at - on the contrary, between 2007 and 2019, the ratio even increased worldwide by, on average, another 20 percentage points. The increase has been greater in the industrialised countries than in the emerging markets, partly because the former were more adversely affected by the financial crisis and because they often had easier access to the capital market. There have also been different developments within the industrialised-country segment: one consequence of the European debt crisis was that the increase in debt between 2007 and 2019 proved to be noticeably lower in the euro area than in the USA or Japan.

An unbroken upward trend
Public debt, % of GDP



Same direction, different pace
Public debt, % of GDP



Sources: BIS, Helaba Volkswirtschaft/Research

During the 2020/2021 pandemic, however, governments have really stepped up their game. In the first three quarters of 2020, public-debt ratios leapt by 15 percentage points on a global scale. This has partly been a consequence of shrinking economic activity, but it primarily reflects the impact of extensive economic-support programmes, which in many places have added up to double-digit percentages of gross domestic product. In this crisis too, developed countries have grown their liabilities more than emerging markets.

Admittedly, some so-called modern economic theories argue that the leeway for contracting debt is largely unlimited. But their premise will be undermined at the latest when interest rates rise again. At that point, it will become clear that the current very high deficits and the resulting debt burdens, which are being added to year after year, will not be sustainable beyond the end of the immediate crisis. It would be wrong to succumb to the political temptation to engage in ever more new tasks (climate protection, health protection, etc.) as justifications for debt financing.

So what are the theoretical options for reducing, or at least stabilizing, the debt ratio? In principle, there are three ways (or a combination of these) to achieve this goal.

- First, the public sector can reduce the deficit or even generate surpluses through higher revenues or lower expenditure, as was the case in Germany before the pandemic.
- The second alternative is to reduce the public-debt ratio by means of nominal growth. This has two components: real growth and inflation. Both work in the same direction on the debt ratio, but otherwise have very different effects. A practical problem here is that neither a sustainable increase in real GDP nor in the inflation rate can be brought about directly by the government.
- Finally, the third option is debt restructuring or else a debt haircut, involving public debt being cancelled in part or in full and creditors having to bear corresponding losses.

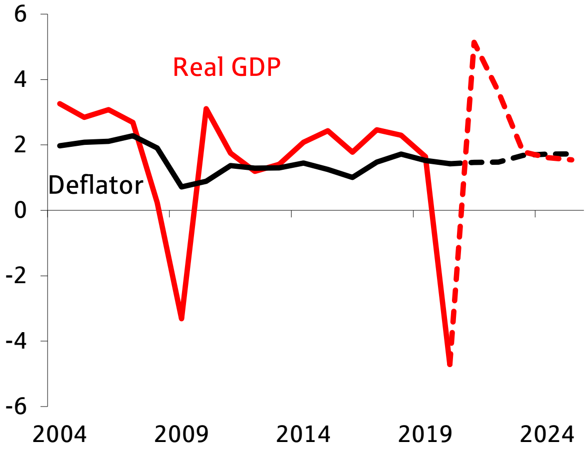
What path can and will governments take in the coming years in order to cope with their debt burdens? The answer, as so often, is: it depends!

Developed countries: Covid-19 pandemic passes, debt remains

The decisive factor is ultimately the currency in which a state contracts its debts. The debts of industrialised countries and of some emerging markets such as China are almost exclusively denominated in their home currency. By contrast, those states that are primarily indebted in foreign currency - most emerging markets, for instance - have to contend with additional restrictions, especially with regard to the exchange rate and to the willingness of foreign economic agents to offer them financing. The countries in Central and Eastern Europe occupy an intermediate position here: In Hungary and Poland, for example, the share of foreign-currency debt comes to 20 to 25 percent.

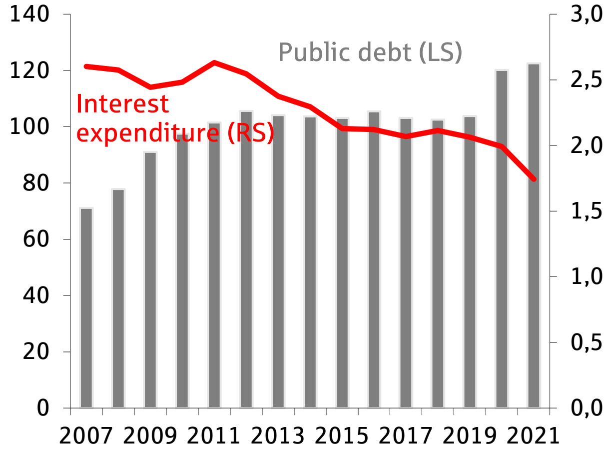
"Consolidation" in the form of lower deficits will automatically play a certain role in the developed world once cyclical activity and tax revenues recover after the crisis and once the immediate fiscal-support measures have dropped out of the equation. This alone will make a significant contribution to deficit reduction; on the other hand, it will not be sufficient to stop, let alone reverse, the debt increase. At the present juncture, there seems to be very little inclination in the capitals of the various countries to embrace a more radical brand of austerity policy. Although this may indeed possibly change after the end of the crisis, it is probably not the most likely scenario. On the contrary, many are even calling for significantly higher government spending in connection with climate change. There are no signs of a noticeably lower government-spending ratio materialising.

The growth jump will only prove temporary
Industrialised countries, % yoy



2021 - 2025: IMF - forecasts
Sources: IMF, Helaba Research

Lower interest expenditure despite rising debt
Industrialised countries, % of GDP



2021: IMF estimate

Nominal growth can and will also contribute to debt stabilisation. In 2021 and 2022, the industrialised countries will grow significantly more strongly in real terms than the long-term trend due to a rebound effect following the sharp contraction in 2020. Against such a horizon, inflation is also destined to pick up: somewhat higher inflation rates are realistic in the medium term. This turn of events is being offset by various negative effects on real trend growth: in many parts of the world, demographic developments are conspiring to shrink the size of the labour force while, at the same time, health and pension costs (often borne by the public) are rising. Compounding this is the relatively new factor of climate change, which is putting an increasing focus on CO2 reduction instead of on growth maximisation. Even though countervailing technological stimuli, e.g. by virtue of increased digitalisation, are to be expected, trend growth rates in the industrialised countries will still tend to move further downwards.

Even with somewhat higher inflation over the coming five years, this gloomy outlook for the real growth trend dampens hopes of tangible debt reduction via the growth channel.

The debt ratio can only be reduced through nominal growth if interest rates do not rise to an extent that counteracts the positive effect by imposing a heavier interest burden. Now the interest-rate level is, in principle, correlated with nominal growth. To ward off an undesirable rise in interest rates, governments have various levers at their disposal: capital controls are out of fashion in industrialised countries, but state regulators can, for example, compel financial intermediaries and credit institutions to hold government bonds.

Above all, however, it is in the hands of the central banks to depress or repress capital-market yields via lower money-market rates. Such a low-interest-rate policy has contributed to a noticeable decline in yields at the long end of the curve in many countries since the financial crisis. Increasingly, however, central banks are not restricting themselves to lowering short-term interest rates to zero or to below the zero bound into negative territory; they are also buying government bonds to a previously unknown extent, which is generating direct downward pressure on long-term interest rates.

A central bank that, in order to enforce its goals, is prepared if necessary to buy unlimited amounts of government bonds thus becomes the "buyer of last resort" of public debt instruments. For countries that issue bonds in their own currency, this is a fourth option for dealing with debt: "printing money". In effect, central banks create fresh money through their bond purchases. Even if the transaction technically takes place on the secondary market, each bond purchase by the central bank reduces the need to place a corresponding volume of debt instruments with private investors. In turn, the more bonds the central bank holds, the less relevant the interest-rate level becomes for the government budget - interest payments to the central bank are transferred back to the finance minister as part of the central bank's annual surplus and are thus practically eliminated from an accounting perspective.

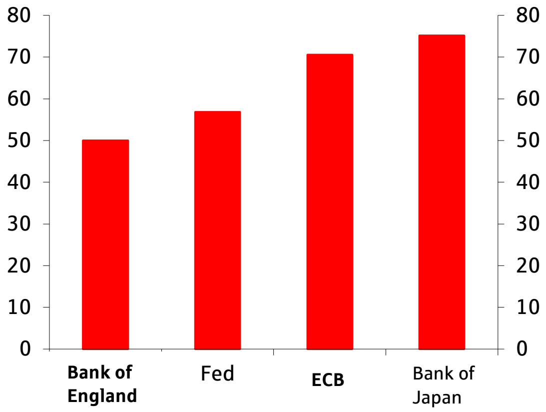
The industrialised countries as a group are likely to rely on a combination of the above-mentioned stabilisation instruments in the coming years. We do not expect retrenchment efforts on a large scale, because the ultra-accommodative stance of monetary policy means that politicians are not required to resort to unpopular tax increases and spending cuts. An, on balance, largely neutral shift in the inflation/growth mix will not allow an economy to "grow out" of debt unless interest rates are kept artificially low at the same time. This is the path most industrialised countries are likely to take over the next few years. A debt haircut is only a very last resort because of the ensuing damage to confidence. Such a debt haircut is not necessary either in industrialised countries if the central bank can be relied on to “do what it takes” in case of doubt.

USA: Both fiscal and monetary policy are at full throttle

Among the world's rich countries, the United States is currently in the most comfortable place. Not because the USA is pursuing a perfect budget policy, it should be noted - in fact, Washington has repeatedly tested investors' patience in recent years. Political disputes about the federal budget and about the debt ceiling have repeatedly led to "government shutdowns" and even to discussions about a possible default. The bottom line is, though, that the United States, as the monopoly provider of the world's reserve currency, can always be sure of solid demand for the Treasury bonds it puts on offer.

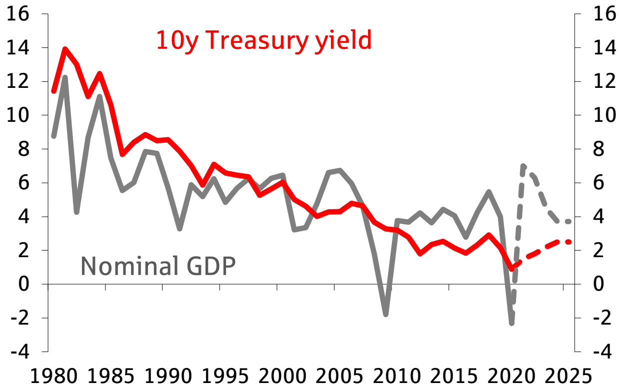
Central banks absorb new debt

Central bank government-bond purchases as a percentage of aggregate new issues (February to September 2020)



USA: Interest rates well below growth rates to 2025

Percentage change in year-on-year terms



From 2021 onwards: Helaba projections

Sources: IWF, Macrobond, Helaba Volkswirtschaft/Research

During the financial crisis, the public debt-to-GDP ratio in the USA increased from just under 60 percent in 2007 to around 80 percent in 2010. Despite a partly involuntary deficit reduction process brought about by political gridlock and a very low key interest-rate level, the debt trend continued to rise to almost 100 per cent of GDP in the period from 2010 to 2019. Even this, however, did not lead to significant risk premiums on Treasury bonds or to higher UST yields.

Ever since the beginning of the pandemic, US fiscal policy has been firing on all cylinders. Based on the latest IMF figures, the federal deficit jumped to almost 16 percent of GDP in 2020 and is expected to decrease only slightly in 2021. The national debt, meanwhile, shot up by around 20 percentage points of GDP over the past year and is continuing to gain altitude. The Fed cut the fed funds rate, its key policy rate, back to virtually zero in 2020 and launched an extensive bond-buying programme, initially designed to stabilise the financial market and now aimed at stimulating the economy. The true test of how long Fed Chairman Powell and his team will continue these emergency measures after the end of the pandemic, just to do the Treasury a favour, is not yet visible.

We expect that the economic environment and the inflation trend will not lead to a first interest rate hike stateside until 2023 and that the subsequent rate-hiking process will be extremely slow. The rise in capital-market interest rates is likely to be correspondingly gradual: in the period until 2025, the interest-rate level - using the yield on ten-year Treasuries (2020-2025 projected average: 1.9 percent) as a proxy - should remain significantly below the nominal growth rate (3.8 percent). The sustainability of US government debt is unlikely to become an issue under these circumstances.

Heterogeneous developments across the euro area

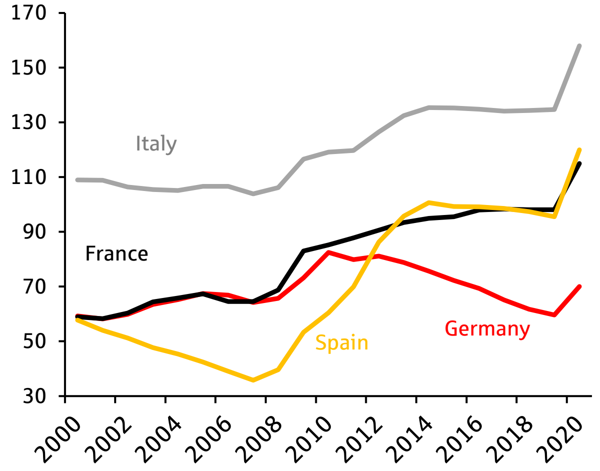
Public debt across the euro area declined by almost 10 percentage points to 84 percent of GDP between 2014 to 2019. The outbreak of the coronavirus pandemic put an end to this trend. In the third quarter of 2020, the collective public-debt ratio was standing at 97.3 percent of eurozone GDP. The difficult situation caused by the pandemic means that a ratio of well over 100 percent is on the cards for this year. Due to the heterogeneous structure of the countries in the euro area, an analysis of the entire currency area is not very useful - it makes more sense to look in more detail at major member states as cases in point.

The German public-debt ratio climbed by a shade more than 10 percentage points to 70 percent of GDP in 2020. The budget deficit, which is expected to reach at least 3.5 percent of aggregate economic output this year, will feed through to an even heavier public-debt load in 2021. Debt reduction can only be brought about by a negative interest rate/growth differential and/or by a positive primary budget balance in the years ahead. There is, in fact, a good chance of this happening. Nominal growth in Germany is estimated to work out at 4 percent p.a. through to 2025. This is significantly higher than the nominal yields on 10-year bonds, which are expected to rise only marginally into positive territory from their current level of -0.3 percent by the end of 2025. Germany's primary balance (i.e. the budget balance net of interest payments) was invariably in surplus in the period between the financial crisis and the outbreak of the coronavirus pandemic - readings of over 2 percent of GDP have been recorded since 2016.

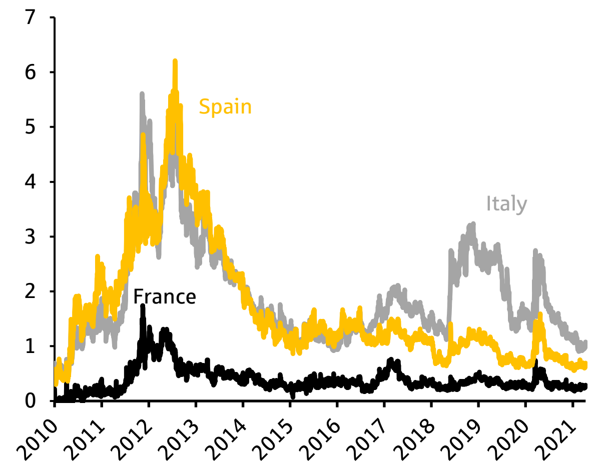
Whether this turns out to still be feasible after the crisis depends on the budgetary policy of the new federal government scheduled to be elected in September. Even if extensive public-sector investment is envisaged in order to stimulate growth, it should still be possible to keep the primary budget balance marginally in surplus. It should therefore be possible to scale back the high level of social benefits necessitated by the pandemic to a "normal" level. Some of these funds could be mobilised for investment. At the end of the day, as after the financial crisis, Germany should manage to push its public-debt ratio back towards the Maastricht limit of 60 percent of GDP. That would be an important prerequisite to be in a position to effectively combat a possible further crisis sometime in the coming years.

The situation in Italy is much less auspicious, for its public-debt burden currently corresponds to 154 percent of GDP and is likely to exceed the 160 percent threshold once the crisis is over. The boot-shaped peninsular suffers from chronically weak growth: between 2010 and 2019, nominal annual GDP growth amounted to only 1.2 percent, a third of the level in Germany. Such sluggish growth south of the Alps is attributable to structural deficits, e.g. in education and research, in public administration and in the judicial system. In addition, as in the case of the Federal Republic, a decline in the working-age population has to be braced for. Over the forecast period through to 2025, we are only looking for nominal growth of around 3 per cent per year thanks to the catch-up process which should kick in after the crisis. Underlying growth potential in Italy is below 1 percent even at current prices. Capital-market rates (as measured by the 10-year Italian BTP) are likely to rise from the current level of 0.7 percent to higher than 1 percent in the medium term. This already shows that Italy needs a positive primary budget balance merely to stabilise the debt level. True, this was being achieved before the crisis broke; however, there is reason to fear that a possible further crisis would lead to a renewed surge in the public-debt ratio, without debt consolidation having taken place beforehand.

Germany and Spain made progress prior to the outbreak of the coronavirus crisis
Public debt in % of GDP



The ECB is keeping spreads low
Spreads on 10-year government bonds over German Bunds, in %



Sources: Macrobond, Helaba Volkswirtschaft/Research

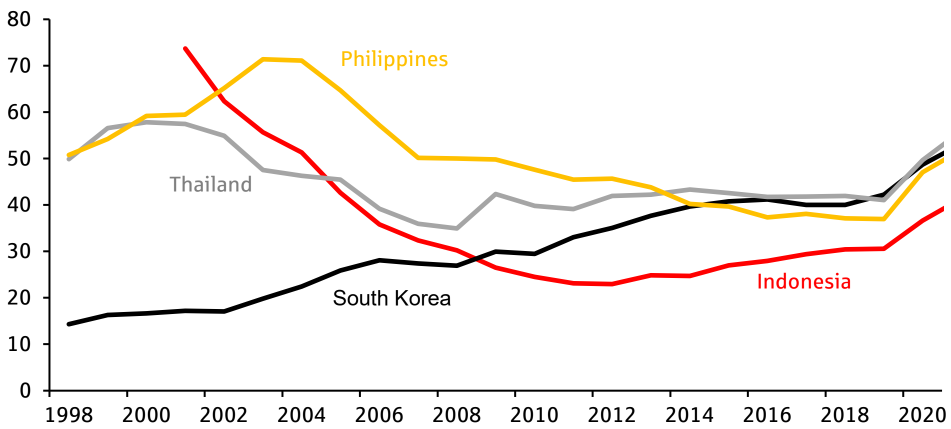
Only structural reforms can offer a way out of this dilemma, yet these are difficult to implement politically. Hopes of reforms have risen somewhat with the new "technocratic" government under Mario Draghi. But even the funds to be disbursed by the EU Reconstruction Plan (EU Next Generation) are not going to resolve the debt problem. Italy could receive up to 209 billion euros from the EU Recovery and Resilience Facility. Although 85 billion euros will come in the form of transfers, by far the greater part will be via low-interest loans that will increase the country's debt pile. Transfers will only be approved if implementable projects, e.g. in the areas of digitalisation and sustainability, are presented by Rome. The country's debt mountain will not be made smaller by this; at best, the projects will contribute to a higher potential growth rate.

In the case of France, the yield spread vs. German Bunds demonstrates that the country enjoys a high level of confidence in the capital market. A default is perceived to be highly unlikely. Nevertheless, France too is plagued by structural problems, the resolution of which has been pushed into the background by the coronavirus pandemic. The country has not succeeded in reducing a public-debt ratio that was driven higher by the financial crisis. Moreover, it is questionable whether the French government will embark on a consolidation path after the Covid-19 pandemic has ended. This is also true for Spain, which is being particularly stricken by the current massive shortfalls in the tourism sector. The situation on the Spanish labour market can probably only be eased in the medium term. It is thus difficult for policymakers to convince the electorate that a consolidation strategy is required.

Emerging and developing countries: Has nothing been learned?

Many emerging markets and developing countries are struggling, not for the first time, with problems of over-indebtedness. The last major emerging-market crisis was triggered by a credit boom in the 1990s and culminated in the so-called "Asian crisis" of 1997/98. Foreign debt exceeded currency - reserves, provoking speculative attacks against local currencies in the region. Indonesia, South Korea, Thailand and the Philippines were hit hardest. Indonesia, Korea and Thailand had to ask the IMF for support, with the Fund subsequently granting aid amounting to 35 billion US dollars. In parallel to this, other multilateral and bilateral lenders provided assistance loans to a value of 85 billion US dollars. In addition, the monetary-policy stance was made more restrictive and the countries involved had to shift to a strict fiscal consolidation course. As a result, debt was initially stabilised in all crisis-ridden countries (the exception proving the rule here being South Korea) before gradually declining in the following years.

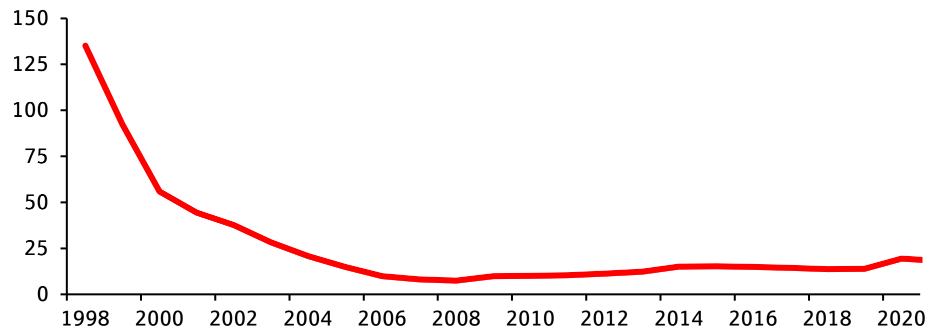
The Asian crisis was surmounted with IMF support
Public debt in % of GDP



Sources: Macrobond, IWF, Helaba Volkswirtschaft/Research

The Asian crisis quickly spilled over to other countries. In the summer of 1998, Russia as well was compelled to apply to the IMF for an aid programme. Here, too, foreign debt and declining government revenues had become a problem due to a slump in oil prices. Russia responded to the crisis by floating the exchange rate and by defaulting on its domestic public debt. Thanks also to further reforms under the IMF programme, this led to a massive reduction in the national debt from 135 percent of GDP in 1998 to 56 percent within the space of just two years. Russia managed to lighten its debt burden further still in the following years, helped in part by a vigorous rebound in oil quotations. Since 2005, the country’s public-debt ratio has been below 20 percent of GDP.

Russia has achieved a sustainable reduction in public debt
Public debt in % of GDP



Sources: Macrobond, IWF, Helaba Volkswirtschaft/Research

HIPC and MDRI initiatives - the first major debt cancellations

In contrast to the situation for emerging markets, international assistance to many developing countries went beyond IMF programmes. In 1996, a special debt-relief programme called the Heavily Indebted Poor Countries (HIPC) Initiative was launched for a group of 39 fully or partially eligible low-income countries (33 of these in Africa, 5 in Latin America and 1 in Asia) that were suffering from widespread poverty as well as being saddled with high levels of debt. This initiative, spearheaded by the IMF and the World Bank, aims to ensure that no poor country is additionally burdened by excessive and unsustainable debt.

Private and non-Paris Club creditors have been reserved about debt relief

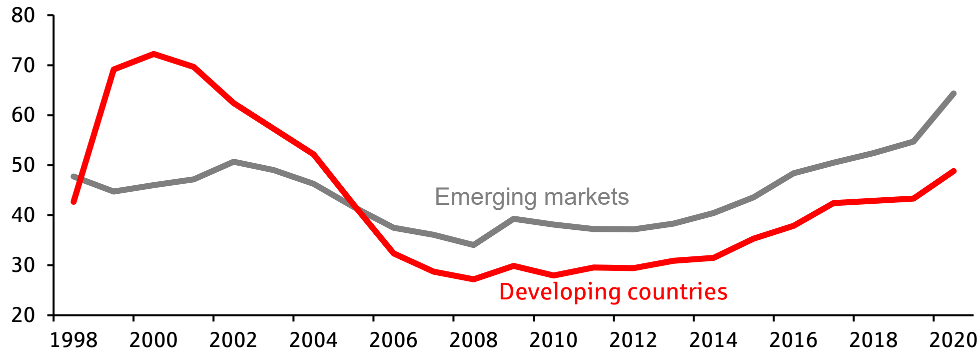
To participate in the initiative, the first step is for a country to develop a poverty-reduction strategy ("decision point") and to demonstrate its willingness to reform within the framework of IMF and World Bank programmes. In the second step ("completion point"), further reforms are necessary as well as a successful implementation of the poverty-reduction strategy for at least one year. So far, 36 countries have received full debt relief from the IMF and other creditors. The initiative is still in operation. In March 2020, Somalia reached the "decision point," and only a few weeks ago it was confirmed that Sudan will be allowed to participate in the HIPC initiative, with the East African country expected to reach the decision point at the end of 2021. Otherwise, only Eritrea is still among the "Pre-Decision Point Countries".

Overall, the HIPC initiative has been a success. But there have been problems nevertheless. It is true that the major creditors (the World Bank, the African Development Bank, the Inter-American Development Bank and all Paris Club creditor countries) have contributed their full share of the allocated debt relief. Smaller multinational institutions, public non-Paris Club creditor states and commercial creditors have chipped in only a small amount to the initiative. The aggregate cost of HIPC-related debt relief for the 36 countries that have already received full debt relief is around 77 billion US dollars.

The HIPC Initiative made an important contribution towards reducing the debt carried by developing countries from 50 percent of GDP in 2002 to just over 40 percent in 2005. However, given the low revenue base of many developing countries, even a public-debt-to-GDP ratio of 40 per cent imposes heavy burdens which crowd out funds earmarked for poverty reduction. As a consequence of this, the G8 demanded in June 2005 that the IMF, the World Bank's International Development Association (IDA) and the African Development Fund (AfDF) should waive 100 percent of their claims on HIPC countries. Pursuant to this, the IMF drafted the Multilateral Debt Relief Initiative (MDRI) in November of the same year. The MDRI allows all developing countries with a per-capita income of less than 380 US dollars per year to receive debt relief from the IMF, regardless of whether or not they have participated in the HIPC initiative. HIPC countries with per-capita income above this limit have been eligible for debt relief from an existing pool of funds managed by the IMF but provided by individual countries. All countries participating in the HICP initiative have taken part in the MDRI. To date, the cost of MDRI debt relief comes to 42.4 billion US dollars.

The examples we have looked at - the Asian crisis, the HIPC initiative and the MDRI - show that the issue of over-indebtedness is not new for many emerging markets and developing countries. Through IMF programmes and debt-relief initiatives, it proved possible to reduce overall public indebtedness for both country groups prior to the onset of the global financial crisis in 2008. Since then, however, the trend has reversed. Unlike at the turn of the century, this time it has been the emerging markets that are weighed down by higher debt levels than the developing countries. For both groups, it was becoming increasingly clear even before the pandemic that things could not go on like this in the longer term. Yet the pandemic has accelerated this development: last year, public debt rose by ten percentage points to 64 percent of GDP in the emerging markets and by six percentage points to 49 percent of GDP in the developing countries.

There was a trend towards rising public debt even before the coronavirus crisis struck
National debt in % of GDP

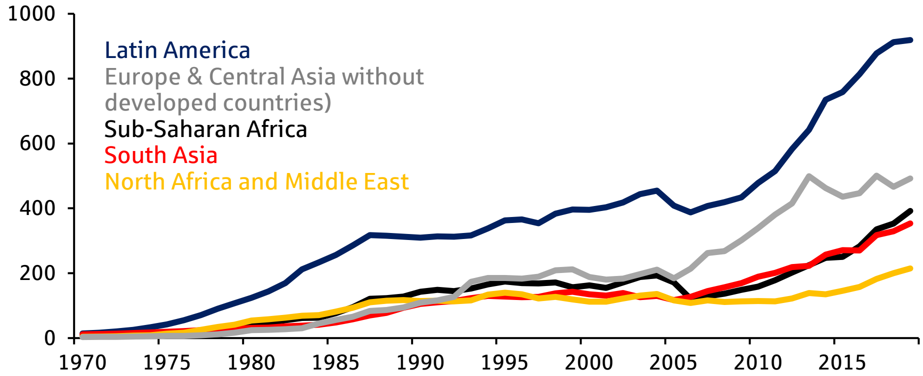


Sources: Macrobond, IWF, Helaba Volkswirtschaft/Research

The Achilles' heel has been foreign debt

Particularly the sharp spike in foreign debt has become a problem. In order to profit from the low interest rates available in the industrialised countries and from investors' search for yield, poorer countries too have been increasingly taking out loans on a foreign-currency basis for about ten years now.

Rising external debt is the main problem
Government and government-guaranteed external debt, in billions of USD



Sources: Macrobond, Weltbank, Helaba Volkswirtschaft/Research

The pandemic ruthlessly exposes the extent of the debt problem

As long as sufficient currency reserves were available, foreign debt was not a problem. But already in recent years, the IMF and the World Bank warned about the dangers attendant on a further increase in debt and about mounting risks to debt sustainability. Ravaged by the coronavirus pandemic, many emerging markets and developing countries slid into recession last year as well. Tax revenues and export earnings have collapsed, making it impossible for many of the poorest countries to maintain their debt service. In May of last year, the G20 accordingly launched the Debt Service Suspension Initiative (DSSI) to grant low-income countries whose public finances are in dire straits due to Corona a temporary suspension of debt-service payments, initially until the end of 2020.

This initiative was later extended until mid-2021 and then again, at the end of this March, until 15 October 2021. Last autumn, World Bank President David Malpass signalled that this initiative was not enough and brought debt relief into play. In response, the G20 defined a “Common Framework for Debt Treatments", which was duly approved by the IMF and the World Bank.

On this basis, Chad, Ethiopia and Zambia have now applied for debt relief. Over 70 countries are eligible to participate in the initiative, and some of them will very likely be forced to ask for debt relief as well. At last count, of the 69 poorest countries, 7 were already in default, 29 others were classified by the IMF as "at high risk of debt distress", 23 "at moderate risk" and only 10 "at low risk". This makes it plain that the assessment of debt sustainability requires a country-specific approach. Measures such as debt rescheduling, IMF programmes and reforms must be adopted especially in the case of those countries where the burden of debt service is particularly onerous.

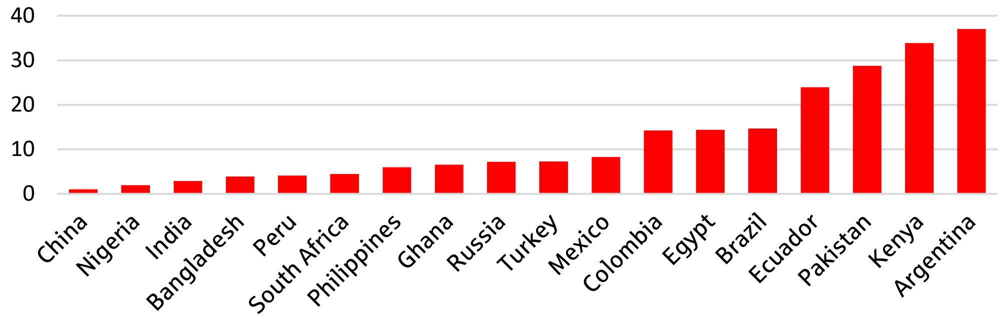
A two-tier trend: emerging markets - developing countries

In the large emerging markets of Brazil, Russia, India, China and South Africa ("BRICs"), debt service in foreign currency is manageable. Brazil has the highest ratio on this score - almost 15 percent. Apart from in Argentina, it is mainly in the world’s poorest countries such as Kenya, Pakistan, Ecuador or

Ethiopia where at least 20 percent of export earnings had to be used to service the government's debt even before the pandemic. The coronavirus shock has led to dwindling export revenues in most countries, thus further increasing the debt-service burden.

Especially the world's poorest countries are groaning under the weight of debt service

Government and government-guaranteed debt service as % of exports, 2019



Sources: Macrobond, Weltbank, Helaba Volkswirtschaft/Research

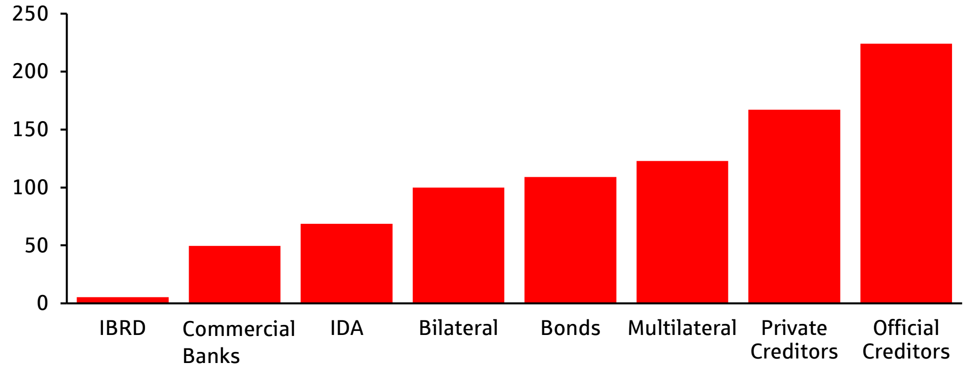
Debt rescheduling has repercussions on creditworthiness

Where vulnerable emerging economies are resorting to IMF programmes, cancellation of debt payments is being discussed for developing countries at this year's IMF Spring Meetings. This raises the question of who should be involved in such restructuring measures. Most of the countries eligible for such debt cancellation are in sub-Saharan Africa. A closer analysis reveals that the countries in this region have mostly taken out their loans with official creditors (IMF, World Bank, sovereign states). In order for an effective reduction of the debt burden and thus of the debt-service burden to be achieved, this group of creditors would presumably have to shoulder the biggest load. Yet loans from the World Bank and IMF only carry a low interest rate anyway. That is why the debt-reduction framework proposed by the G20 calls for "fair burden sharing across all creditors". Some private creditors are likely to join the initiative. However, it is uncertain whether bond-holders will be "bailed in," as countries fear negative consequences for their credit ratings.

Immediately after Ethiopia announced its intention to seek a restructuring of its sovereign debt under the G20 initiative, rating agencies downgraded the country's creditworthiness, citing possible bond-holder involvement ("bail-in"). Although Ethiopia is very likely to be able to avoid recourse to the capital market because of the small size of its bond (one billion US dollars, equivalent to about 4 percent of the nation's external debt), this has deterred other countries. Kenya, for example, has announced that it will not be making use of the G20 framework and has instead applied to the IMF for a programme. The fact that three countries - Ethiopia, Chad and Zambia - have already had recourse to the G20 debt-restructuring proposal makes it evident that the initiative is being used despite fears of negative effects on the markets. It is therefore quite possible that further countries will come on board and participate.

Most loans to sub-Saharan African countries have been granted by official creditors

Sovereign and government-guaranteed external debt, in trillions of USD



Sources: Macrobond, Weltbank, Helaba Volkswirtschaft/Research

Accordingly, debt relief for sub-Saharan Africa was an important item on the agenda at the annual meetings of the IMF and the World Bank Group which took place at the beginning of this April. A new approach is supposed to combine debt relief with sustainability. The two Bretton Woods institutions are planning a platform to advise poor countries when it comes to financing climate and conservation activities. Significant debt relief is to be granted in return for a clear commitment to climate protection. In principle, this works like the HIPC and MDRI initiatives, whose declared objective was to free up - resources for poverty reduction by means of debt relief. Under the new approach, though, the resources mobilised are to be dedicated to the fight against climate change.

Regardless of whether the countries apply for IMF programmes, only participate in the G20 Debt Service Suspension Initiative (DSSI), or else are awarded outright debt relief, the impact on the financial markets is likely to be limited. In the shape of Ghana (dollar-denominated bonds to a value of 5 billion US dollars in the current year) and Kenya (dollar-denominated debt instruments to a volume of 12.4 billion US dollars bonds in the period to June 2022), the first developing countries are already planning their return to the international capital market. The example of Argentina also shows that capital markets sometimes have a rather short memory: in 2016, an agreement was reached with hedge funds on outstanding debts that had not been serviced since 2001 and, in the same year, the South American country made a spectacular return to the international capital market by placing bonds worth 16.5 billion US dollars.

Conclusion

The very heterogeneous situation in which industrialised, emerging and developing countries find themselves means that there is no one "silver bullet" for dealing with high public debt. What is clear is that the problem is going to preoccupy us in the foreseeable future - it is easy enough to get into debt but hard to extricate oneself again.

In the industrialised countries, the new, considerably higher, debt levels will probably, to a large extent, become "the new normal". The question of the threshold at which government debt becomes critical has not only been a subject of controversial debate since the work of Kenneth Rogoff and Carmen Reinhardt. However, the case of Japan, with a current public-debt ratio of around 260 percent of GDP, clearly illustrates that country-specific factors play a sizeable role and that a simple statement such as "at X percent public debt becomes a problem, below that level everything is fine!" is overly simplistic.

Our conclusion that debt sustainability will probably, in principle, prevail in the industrialised countries over the coming years due to the commitment of central banks and because of the low-interest-rate environment should not blind one to the potential dangers. The further rise in the public-debt level and increasing central-bank interventions entail ever greater risks and side effects. It would not be entirely devoid of problems if only the status quo was to be preserved for a longer period of time: the negative/low-interest-rate environment inflicts damage on traditional banking business, and the flood of liquidity aids and abets possible bubbles on the financial or real-estate markets. "Guaranteed" low interest rates prop up unprofitable companies and lead to carelessness. Investors have a growing incentive to take greater risks in search of returns, even if, ex ante, they cannot always see in detail what such risks are going to involve.

On top of these concrete threats to financial stability, inflation risks are also on the increase. If monetary custodians feel compelled to ignore noticeably rising inflation rates out of consideration for the state of public finances, inflation could "let rip," as it did in the 1960s and 1970s. Among other things, that would entail noticeable and potentially undesirable distributional effects. The past has shown that an inflation process, once underway, can only be halted again at very high cost.

Finally, the sustainability of public debt, while probable from today's perspective, is by no means assured. If there is no significant reduction in the debt level, then a fresh upward leap during the - inevitable - next crisis will already start from a new record level. At the same time, it should be noted that governments are simultaneously accumulating substantial "off-balance-sheet" pension liabilities that are not included in the official debt figures.

Economists argue about the causes of the current low-interest-rate environment. But if we do not really know why interest rates are currently so low, then there will naturally be a great deal of uncertainty about how long things are going to stay this way. It would therefore be grossly negligent to simply take on more and more debt in keeping with the mantra "It doesn't cost anything!" A noticeable ratcheting-up interest rates - for example in response to higher inflation or for demographic reasons - would give rise to considerable problems in many industrialised countries. If out-and-out or extensive monetisation of government debt is not regarded as a viable alternative, the only remaining options would be an extremely painful consolidation process or else debt restructuring. When taking on new debt, it is therefore more important than ever to pay attention to the growth-promoting effect of its intended use.

Because of their high level of external debt, most of it taken on in foreign currency, emerging markets and developing countries, unlike industrialised nations, cannot simply ask their central banks for support. IMF-underwritten reforms will be the first choice for over-indebted emerging markets. The world's poorest countries will receive debt relief. Does this rule out a new wave of over-indebtedness in the future? A look at the past urges that this is not necessarily the case. While many large emerging markets have indeed learned their lessons and are now in a better position than they were at the time of the great Asian crisis that erupted more than 20 years ago, the developing countries have once again fallen into the debt trap over the last decade. Something similar is conceivable in the future. After all, the credit offers that are bound to materialise again, especially due to investors' hunt for yield in the low-interest-rate environment generally prevailing in industrialised countries, will seem simply too tempting to turn down. It is quite conceivable that a bout of debt relief will be followed by another debt rally in the years ahead. Mechanisms to align the international financial system in such a way that such a noxious rally can be effectively prevented were not discussed at this year's IMF Spring Meetings.

Disclaimer

This position paper by the DSGV Chief Economists does not necessarily reflect the stance of DekaBank or the stance of the respective Landesbanken and savings banks

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