HIGHLIGHTS from Box 1.1: Debt: No Free Lunch

Key Points

- In the current environment of low global interest rates and weak growth, government borrowing may appear to be an attractive option to finance growth-enhancing spending.
- Additional debt accumulation can help promote long-term growth through investment and help stabilize short-term economic fluctuations.
- Costs of high debt include the crowding out of non-interest spending, deterioration of debt sustainability, increased vulnerability to financial crisis, reduced room for and effectiveness of fiscal policy, and slower investment and growth.
- Emerging market and developing economies (EMDEs) need to strike a careful balance between taking advantage of low interest rates and avoiding excessive debt accumulation.
- Better spending and tax policies, as well as greater debt transparency and more prudent debt management, can mitigate risks associated with high debt.

Current macroeconomic environment: Low global interest rates, weak growth. In the current environment of low global interest rates and weak growth, additional government borrowing to finance growth-enhancing spending may appear to be an attractive option. EMDE government bond yields are below long-term averages and EMDE growth is slowing (Figure 1.A).

Evolution of EMDE debt: Post-crisis deterioration. EMDE fiscal positions have weakened since the global financial crisis, pushing government debt up by an average of 15 percentage points of GDP to 51 percent of GDP by 2018 (Figure 1.B). In many EMDEs, financing of debt has shifted toward higher-risk sources, including debt held by nonresidents, issued on non-concessional terms, or at shorter maturity. In tandem with mounting government debt, private sector debt has risen in EMDEs, leading total debt to 169 percent of GDP in 2018, from 98 percent of GDP in 2007.

Benefits of debt: Long-term growth and short-term stabilization. Debt could be used to invest in growth-enhancing projects. Government investment in physical and human capital could help stem the expected slowdown in potential growth and fulfil large investment needs to meet the Sustainable Development Goals. Temporary debt accumulation to finance fiscal expansion can help stabilize short-term macroeconomic fluctuations.

Costs of debt: Deteriorating debt sustainability and increasing vulnerability to crises. When debt is high, the rollover costs can increase sharply during periods of financial stress and trigger a financial crisis—even if, more than half the time, growth rates exceed interest rates, helping set debt on a declining trajectory. A growing debt level could erode investor confidence, requiring a government to pay a rising risk premium on its debt. These pressures can culminate in a debt crisis if investors fear that the accumulation of debt is no longer sustainable (Figure 1.C and D).

Costs of debt: Limiting size and effectiveness of fiscal policy. High debt limits governments’ ability to respond to downturns, in part because debt service crowds out other government spending needs (Figure 1.E). High government debt also reduces the size of fiscal multipliers (Figure 1.F).

Policy implications: Balance trade-offs. EMDE governments need to strike a careful balance between taking advantage of the present low interest rate environment and avoiding the risks posed by excessive debt accumulation. Even if the cost of debt is currently low, it could increase sharply during periods of financial stress. Debt cannot be treated as a free lunch.
Figure 1. Government debt and borrowing costs

Borrowing costs in EMDEs have been historically low since the global financial crisis, despite a slight increase in 2018, while both government and private debt has risen from pre-crisis levels. Financial stress events, especially sovereign debt crises, worsen debt dynamics, lead to credit downgrades and tend to be associated with higher borrowing costs. Higher debt levels are associated with larger interest payments and less effective fiscal policy.

A. EMDE long-term government bond yields

B. Total debt

C. Long-term sovereign debt ratings during crises

D. Long-term interest rates during crises

E. Government debt and interest payments in EMDEs, 2018

F. Fiscal multipliers after 2 years

Sources: Huidrom et al. (2019); International Monetary Fund; Kose, Kurlat, et al. (2017); Laeven and Valencia (2018).

A. Average long-term government bond yields (with maturity of 10 years or close) for EMDEs with long-term foreign-currency sovereign ratings below investment grades and above investment grades in each year. Dotted lines show averages over 2002-07. Sample includes 61 EMDEs.

B. Averages computed with current U.S. dollar GDP as a weight, based on 35 advanced economies and 117 EMDEs.

C.D. Simple averages, as well as interquartile ranges, based on balanced samples. Crises refer to debt crises, as defined in Laeven and Valencia (2018). When there are multiple crises identified within five years, the one with the lowest real GDP growth is counted as an event. Sample includes 16 crisis episodes (Panel B) and 11 episodes (Panel C).

C. The sovereign ratings are converted to a numerical scale ranging from 1 to 21 (higher = better rating).

D. Long-term interest rates refer to nominal 10-year government bond yields, or bond yields with similar maturities.

E. General government gross debt on the horizontal axis and interest payments on the vertical axis. Sample includes 104 EMDEs, excluding small states as defined by the World Bank.

F. Bars show the conditional fiscal multipliers for different levels of government debt after two years. Fiscal multipliers are defined as cumulative change in output relative to cumulative change in government consumption in response to a 1-unit government consumption shock. They are based on estimates from the interacted panel vector autoregression model, where model coefficients are conditioned only on government debt. Values shown on the x-axis correspond to the 10th to 90th percentiles in the sample. Bars represent the median, and vertical lines are the 16-84 percent confidence bands.