Global Economic Prospects
June 2017

HIGHLIGHTS from SPECIAL FOCUS 1
DEBT DYNAMICS IN EMERGING MARKET AND DEVELOPING ECONOMIES: TIME TO ACT?[1]

Key Points

- *Since the global financial crisis, fiscal positions in emerging market and developing economies (EMDEs) have weakened and private sector debt has risen.*
- *By 2016, government debt exceeded its 2007 level by more than 10 percentage points of GDP in more than half of EMDEs while fiscal balance on average worsened by about 6 percentage points during this period.*
- *EMDEs have relatively stronger monetary policy frameworks and external buffers than in the past but they may need to shore up their fiscal positions to be ready to deploy counter-cyclical policy in the event of financial stress.*

Debt dynamics in EMDEs. Since the global financial crisis, EMDEs' vulnerability to financing shocks has grown as their fiscal positions weakened and private sector debt increased (Figure SF1.A). The deterioration in fiscal positions was more pronounced in commodity exporters than in commodity importers, partly because of sharp growth slowdowns that accompanied a slide in commodity prices. Deteriorating government debt dynamics have occurred in tandem with mounting private sector debt (Figure SF1.B). By 2016, in almost two-thirds of EMDEs with high private sector debt, government debt was also set on a rising path.

Financial stress episodes. In the run-up to a financial stress episode, a country's debt dynamics typically deteriorate as fiscal balances weaken and government debt increases (Figure SF1.C). However, within two years after a financial stress event, government debt usually returns to a broadly stable path. In 2016, despite lower government debt levels, government debt dynamics in EMDEs compare unfavorably with those on the eve of typical financial stress episodes.

Oil price plunges. EMDE fiscal positions deteriorated sharply during oil price plunges in the past and rebounded as a result of pro-cyclical fiscal tightening (Figure SF1.D). Within two years of these oil price plunge episodes, fiscal positions were restored to close to their pre-plunge levels. Oil-exporting EMDEs entered the most recent oil price drop in mid-2014 with weaker fiscal positions than before previous oil price drops.

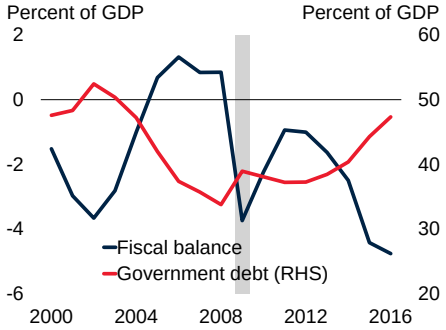
Challenges and Buffers. While monetary policy normalization in advanced economies is expected to proceed smoothly, there is a possibility it could stir financial market volatility. In EMDEs, bouts of financial stress could curtail both private and public sector activity, with weaknesses in both amplifying each other. Although EMDEs have now stronger monetary policy frameworks and higher international reserves, these economies may need to shore up their fiscal positions to prevent sudden spikes in financing cost from forcing them into fiscal tightening (Figures SF1.E and SF1.F).

[1] This Special Focus was prepared by M. Ayhan Kose, Franziska Ohnsorge, and Naotaka Sugawara.

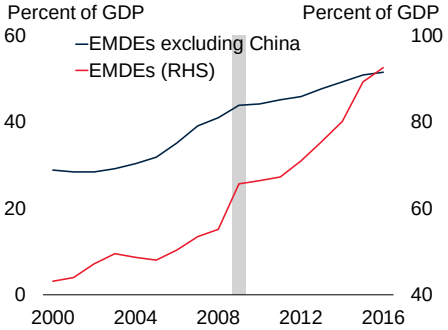
Figure SF1. Fiscal Positions in EMDEs

Fiscal positions in EMDEs have worsened since the global financial crisis, and private sector debt has risen. A deterioration in government debt dynamics at the height of a period of financial stress is reversed within two years after the financial stress episode and terms of trade shock. Current fiscal positions compare unfavorably to those on the eve of past financial stress episodes and commodity price plunges. This is partly mitigated by improved institutional frameworks and international reserves.

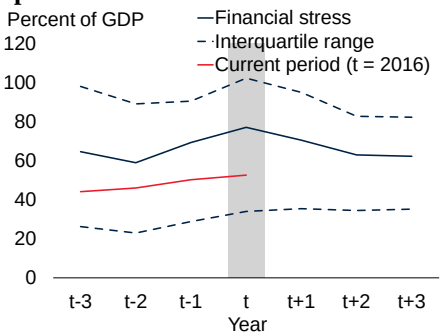
A. Overall fiscal balance and government gross debt



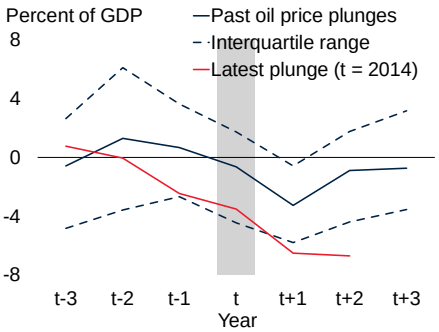
B. Credit to the private sector



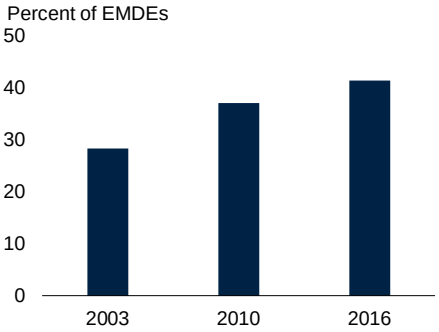
C. Government debt around financial stress episodes



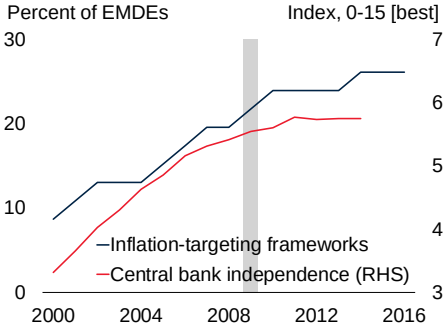
D. Fiscal balance around oil price plunges



E. EMDEs with floating exchange rate regimes



F. EMDEs with inflation-targeting frameworks and central bank independence



Sources: Dincer and Eichengreen (2014), Hammond (2012), International Monetary Fund, World Bank.
A.B. GDP-weighted averages.
A.B.F. The year of global recession (2009) is shaded in gray.
C.D. The year "t" indicates the event year of the financial stress episode (C) or oil price plunge (D). Figures show average government debt (C) or fiscal balances (D) around event years.
C. The red line is shown for reference and based on all EMDEs, although it is not a financial stress episode. Episodes are those compiled by Gourinchas and Obstfeld (2012) and Laeven and Valencia (2013). In any country, when consecutive episodes are identified within the next five years, the one associated with the lowest real GDP growth is used.
D. Based on 36 EMDE energy exporters. Past oil price plunges include 1991, 1998, 2001 and 2008 (World Bank 2015).
E. Floating exchange rate regimes are those classified as floating, free floating, or independently floating.
F. Central bank independence is a simple average and measured as an index ranging from 0 to 15, showing the independence and transparency of central banks, based on multiple criteria in central bank objectives, institutions, operations and policies.