HIGHLIGHTS from Box 1.1:

How has the Pandemic Made the Fourth Wave of Debt More Dangerous?[1]

Key Points

- *The COVID-19 pandemic has caused a surge in debt levels in emerging market and developing economies (EMDEs). Government debt is expected to have increased by 9 percentage points of GDP in 2020—its largest one-year increase since the late 1980s.*
- *The pandemic has exacerbated existing debt-related risks and vulnerabilities. Several countries have already defaulted on their debt, and more are at high risk of debt distress.*
- *The global community needs to act rapidly and forcefully to make sure the latest wave of debt does not end with debt crises in EMDEs, as has been the case previously. The Debt Service Suspension Initiative (DSSI) and G20 common framework are important first steps in this process, but additional solutions may be needed where debt is unsustainable.*

Sharp rise in debt. As a result of deep output collapses combined with unprecedented policy stimulus, debt-to-GDP ratios are set to rapidly reach new highs. Among EMDEs, government debt alone is expected to rise by 9 percentage points of GDP, while corporate indebtedness is also likely to sharply increase (**Figure 1**). These increases come on top of an existing "wave of debt" which began in 2010. Similar earlier waves of debt ended in widespread debt crisis, including the Latin American debt crisis in the 1980s, and East Asian financial crisis in the late 1990s.

Implications of the pandemic. The pandemic has made the ongoing wave of debt even more dangerous by increasing its risky features. The sheer magnitude and speed of the debt buildup heightens the risk that not all of the borrowed funds will be used for productive purposes. For now, unprecedented monetary policy accommodation has calmed financial markets, reduced borrowing costs, and supported credit extension. However, amid the economic disruption caused by the pandemic, historically low global interest rates may conceal solvency problems that could surface in the next episode of financial stress or capital outflows. In addition, recent policy moves may erode some of the improvements that have occurred in EMDEs in monetary, financial and fiscal policy frameworks, central bank credibility, and fiscal sustainability.

Consequences of inaction. Previous waves of debt ended with widespread financial crises. When debt resolution was protracted, growth was slow to recover, leading to a lost decade of growth in Latin America and, in low-income countries, several years of negative per capita income growth.

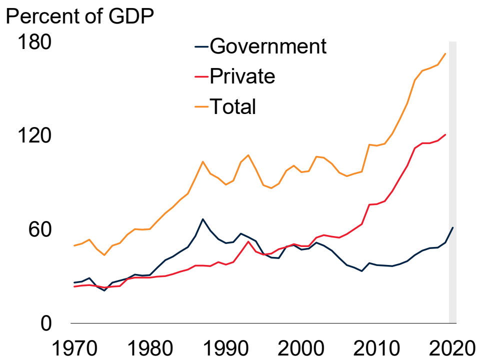
Difficult policy decisions. Dealing with debt overhangs will be a key policy challenge. The DSSI is a critical first step that provides breathing space for low-income countries. However, it does not address underlying debt sustainability issues. The G20 common framework is also a step to help coordinate debt relief among bilateral creditors, including China. That said, for some countries that face unsustainable debt burdens, a return to solvency may only be possible through reductions in the value of debt. These challenges are exacerbated by the increased complexity of creditors and limited debt transparency. Additional measures to strengthen the transparency of borrowing processes and borrowing amounts and terms are needed.

[1] Since 1970 there have been four "waves" of synchronized debt buildup among EMDEs. The first three of these ended in widespread financial crises: the Latin American crisis in the 1980s, the East Asian financial crisis in the late 1990s, and the global financial crisis in 2008-09. The fourth wave, which began in 2010, is the largest, fastest, and most broad-based of these.

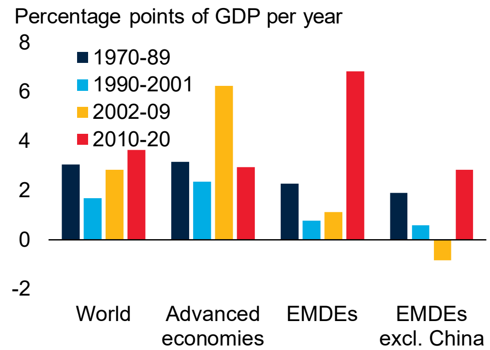
Figure 1. The fourth wave of debt and the pandemic

The pandemic has made the fourth wave of debt even more dangerous by strengthening its risky features. The sheer magnitude and speed of the debt buildup runs the risk that not all of it will be used for productive purposes. For now, unprecedented monetary policy accommodation has calmed financial markets, reduced borrowing cost, and supported credit extension. However, amid the economic disruption caused by the pandemic, historically low global interest rates may conceal solvency problems that will surface in the next episode of financial stress. At present, several countries are already in, or at risk of, debt distress.

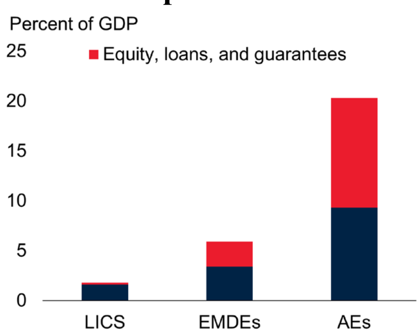
A. Debt in EMDEs



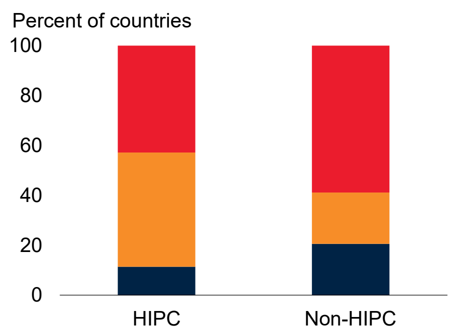
B. Annual average change in total debt



C. Fiscal measures in response to the COVID-19 pandemic



D. Risk of external debt distress in selected countries



Source: Haver Analytics; IMF; Kose et al. (2017, 2020); Kose, Sugawara, and Terrones (2020); OECD; World Bank.

A. Aggregates are calculated using current GDP in U.S. dollars as a weight, based on data for up to 182 countries, including up to 145 EMDEs. Shaded area refers to forecasts.B. Rate of changes calculated as changes in total debt-to-GDP ratios over the denoted periods, divided by the number of years in each of them. Total debt is defined as a sum of government and private debt. Aggregates are calculated using current GDP in U.S. dollars as a weight. Total debt in 2020 is obtained under the assumption that it changes at the same pace as in government debt in respective country groups.

C. Data are as of June 12, 2020. Country groups are weighted by GDP in purchasing power parity-adjusted current US dollars. Revenue and spending measures exclude deferred taxes and advance payments.

D. Defined as in IMF (2020). Based on a sample of 69 economies with available data, as of September 30, 2020.