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New debt crises threaten global stability

By Martin Khor

Global debt has jumped alarmingly to US$152 trillion and as capital flows out from developing countries, some facing new debt crises.

Debt worldwide has grown to unprecedentedly high levels and has to be brought down to prevent another financial crisis.

This was highlighted by the International Monetary Fund at its annual meeting in Washington earlier this month.

Other problems facing the global economy include the stagnation in world trade, a decline in commodity prices, and the reversal of capital flows to developing countries.

A recently-released United Nations report has analysed the situation as a third phase in the global crisis that began with the United States in 2008, then spread in a second wave to Europe, and is now moving on to the developing countries.

The IMF said that world debt had reached US$ 152 trillion, a record level. It was 200% of the value of global gross domestic product in 2002, but has risen to 225% in 2015.

The private sector holds two thirds of the total, but government debt has also risen fast, and the IMF warned about the risk of another financial crisis.

"Excessive private debt is a major headwind against the global recovery and a risk to financial stability," said Vitor Gaspar, IMF director of fiscal affairs. "Rapid increases in private debt often end up in financial crises."

Most of this global debt is concentrated in developed countries. The huge jump there has been due to policies of easy money and low, zero or even negative interest rates, and especially to quantitative easing in which Central Banks bought bonds and pumped trillions of dollars into the banking system.

It was hoped that this massive infusion would cause the banks to increase lending to consumers and businesses and thus stimulate economic growth.

However, the real economy did not benefit much. Instead, much of the money went into the equity markets, boosting prices, and to the developing economies as investors searched for higher yield, and this helped to fuel the growth of their debt.

The debt of non-financial corporations in emerging economies jumped from US$9 trillion at end-2008 to over $25 trillion by end-2015, or from 57% to 104% of their GDP.

Foreigners now own unprecedentedly high shares of bonds and equities in the developing countries, which have become vulnerable to the swings of investors' moods and funds, and to resulting financial crises.

When market sentiment or conditions change, the massive inflows can turn into equally large outflows. Indeed, the boom-bust cycle of capital flows has gone through many turns through the years.

Huge amounts left developing countries in the fourth quarter of 2015, and for that year as a whole there was a net outflow of US$656 billion or 2.7% of their GDP, according to the UN Conference on Trade and Development (UNCTAD).

This was a big change from a net inflow of 1.3% of GDP in 2013. This turnaround of 4.4% is much larger than the reversals of capital flows in 1981-3, 1996-8 and 2007-8.

But in recent months the cycle turned again, with the return of fund investors to emerging economies. For example, in Malaysia, after suffering large outflows in 2015, there have been net inflows of funds into the equity and bond markets in the past few months.

Going through these cycles, the debt of developing countries has grown. "Easy access to cheap credit in boom times has led to growing debt levels across the developing world," says UNCTAD's Trade and Development Report 2016.

Developing countries' external debt rose from US$2.1 trillion in 2000 to $6.8 trillion in 2015. Overall debt (foreign and domestic) jumped by over $31 trillion with total debt-to-GDP ratios reaching over 120% in many countries and over 200% in some others.

Now a nightmare scenario is emerging. For many countries, the tide is turning and access to cheap credit has begun to dry up. Says UNCTAD: "Against the backdrop of falling commodity prices and weakening growth in developed economies, borrowing costs have been driven up very quickly, turning what seemed reasonable debt burdens under favourable conditions into largely unsustainable debt."

In some countries, the problem is compounded by currency devaluation (which increases the value of external debt) and lower commodity prices.

These countries are thus hit by multiple whammies – lower commodity prices and export earnings, net outflow of funds, devaluation (which causes their foreign debt to increase), a higher cost of servicing debt, and a slowdown in economic growth.

More and more low-income countries are in a downward economic spiral that has led them into a new debt crisis. They have had to turn to institutions like the IMF and World Bank for bailouts. UNCTAD lists Angola, Azerbaijan, Ghana, Kenya, Mozambique, Nigeria, Zambia and Zimbabwe as countries that have already asked for financial assistance or are in talks to do so.

This points to a shortfall in the international financial system – the lack of an orderly and fair debt workout mechanism which countries facing a debt crisis can have recourse to.

At the national level, the developed countries and some developing countries have corporate bankruptcy laws, aimed at helping companies recover from a debt crisis through an orderly debt workout.

But there is no such debt workout mechanism, with fair burden sharing between debtor and creditors, when countries fall into a debt crisis.

In its absence, indebted countries often face many years of austerity and recessionary conditions imposed by the creditors and rescuing agencies, and with no guarantee that their debt level will even decrease.

With the present record level of worldwide debt and the emergence of a new debt crisis in several countries, especially the poor countries, it is time to consider smarter policies that prevent debt crises, and to manage them properly when they happen.

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