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## Debt Management: Now the Difficult Part

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*The first years of the 21st century were characterized by more prudent macroeconomic policies in the developing world, the positive impact of debt relief on low-income countries (LICs), and positive growth trends for the world economy, despite the puncturing of the high-tech “bubble” in OECD countries. Until the eve of the financial crisis, many emerging economies were able to reduce the vulnerabilities of their debt portfolios and debt management was being carried out under favorable circumstances. Average maturities increased, reflecting increases in the maturities of new debt issuances, and rollover risks declined. Moreover, the increased availability of local currency financing, reflecting the development of domestic capital markets, and the globalization of the corporate sector in emerging economies underscored the changing landscape of development financing.*

The current global financial crisis is changing this landscape once again. Since 2007, the world economy has slowed significantly: global output declined 0.6 percent (a 3.2 percent contraction in advanced economies) in 2009, and although the global economy is expected to return to a positive growth path in 2010 (4.2 percent), future prospects remain uncertain (World Bank 2010). Moreover, advanced economies are expected to face large public debts, rising real interest rates, and slower growth. The International Monetary Fund (IMF), for example, projects that annual gross domestic product (GDP) potential growth rates in advanced countries will be about a half percentage point less, on average, than precrisis levels if public debt is not lowered (IMF 2010a).

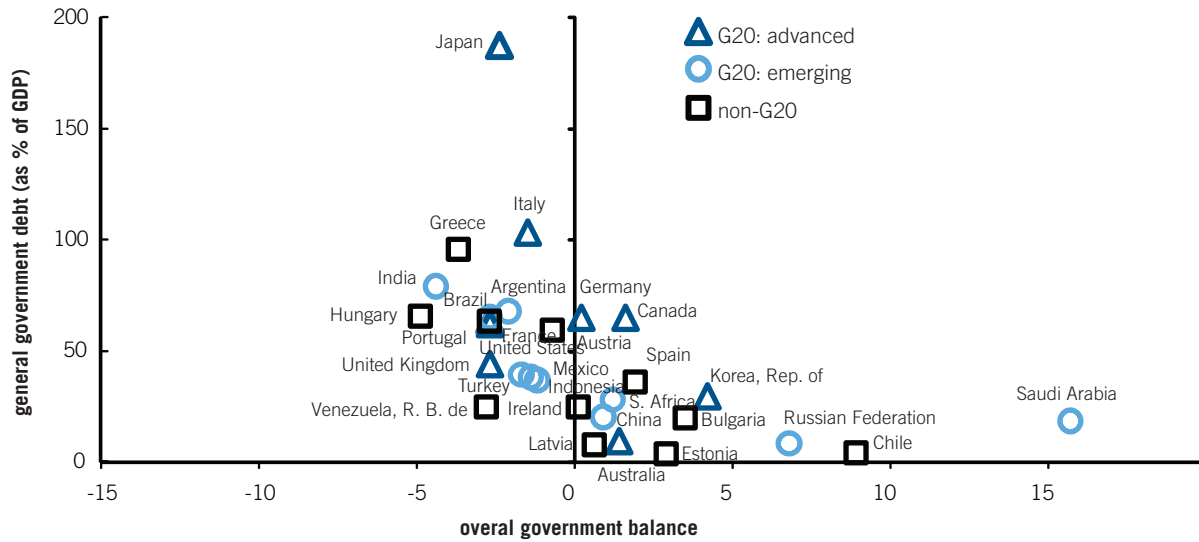
There is broad consensus that many dangers lie ahead in terms of the sustainability of the recovery, including challenges in implementing exit strategies from the massive government interventions that have taken place since 2008 (Primo Braga 2010). Despite the first signs of attenuation of the crisis in the third quarter of 2009, economic indicators still point to significant levels of unemployment and social distress around the world. This crisis has not yet evolved into a systemic sovereign debt crisis,<sup>2</sup> however, the rapid accumulation of public debt and growing fiscal imbalances in many countries, as well as historical precedent, suggest that the possibility cannot be ignored.

Interestingly enough, for the first time in over 40 years, concerns about debt sustainability seem to be concentrated in high-income economies. It is true that developing economies entered this crisis in a much stronger financial position, reflecting better macroeconomic policies, improved debt management practices, and, in the case of heavily indebted poor countries, debt relief. Still, the severity of the crisis and the growing tensions in public debt markets in Organisation for Economic Co-operation and Development (OECD) countries emphasize that there is no room for complacency. This note documents evolving debt and fiscal trends and identifies some of the emerging challenges faced by debt managers in developing markets.

### Emerging Issues

Figure 1 captures debt and fiscal variables for selected advanced and emerging countries in 2007, immediately before the onset of the current financial crisis. As illustrated by the location of a large number of economies in the right quadrant of the graph—with fiscal surpluses and debt-to-GDP ratios below 60 percent—many countries were able to respond to the crisis from a position of strength. Figure 2 shows that by the end of 2009, the picture had changed significantly, with many countries now displaying fiscal deficits of more than 5 percent and debt-to-GDP

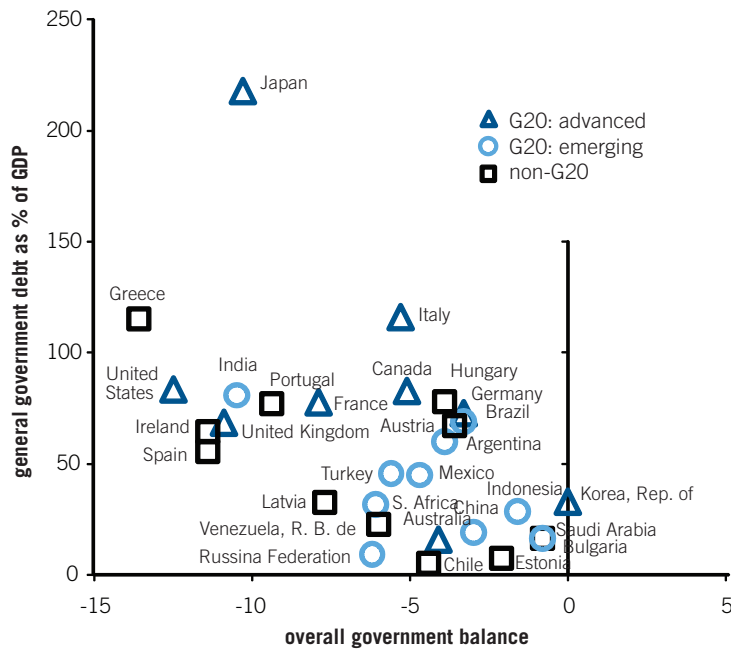
**Figure 1. General Government Balance and General Government Gross Debt, 2007 (% of GDP)**



Source: Authors' calculations based on IMF 2010a.

Note: Debt measures for República Bolivariana de Venezuela are external debt (all other countries are measured in general government gross debt).

**Figure 2. General Government Balance and General Government Gross Debt, 2009 (% of GDP)**



Source: Authors' calculations based on IMF 2010a.

Note: Debt measures for República Bolivariana de Venezuela are external debt (all other countries are measured in general government gross debt).

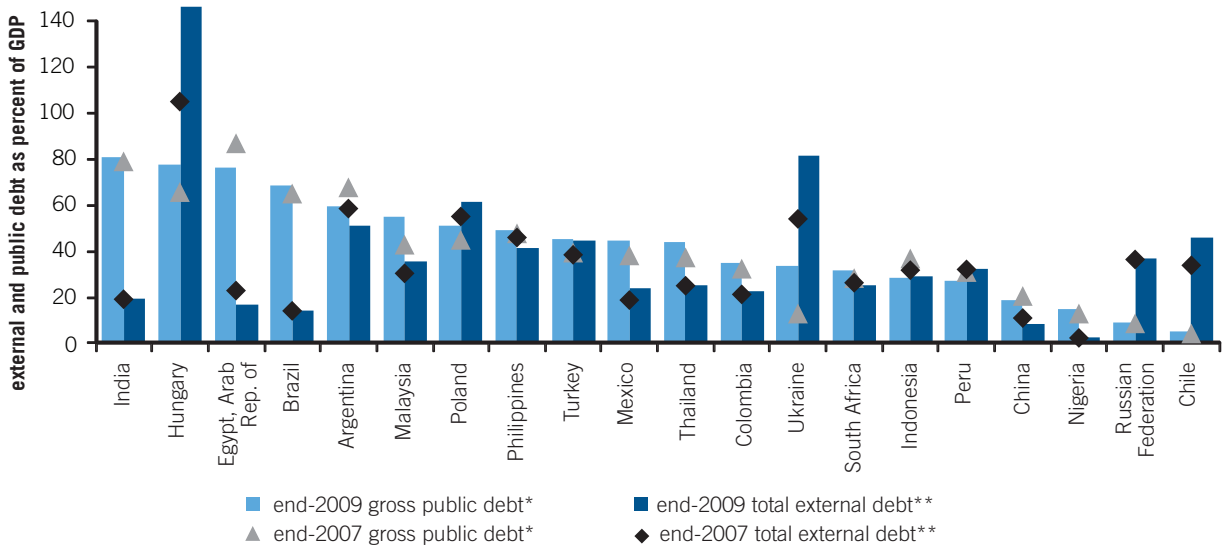
ratios well above 60 percent. In other words, the scope for further expansionary interventions, be it on the monetary or on the fiscal fronts, is now much more limited. The situation is particularly complex in some of the countries in the eurozone,

where existing social entitlements and low productivity growth prospects make debt-to-GDP reduction exercises quite difficult.

Confidence in the strength of the recovery of advanced economies remains a question and the process of deleveraging of the private sector in many OECD countries is ongoing. Accordingly, although the debate about the proper timing to unwind public interventions remains fierce (see, for example, Hannoun [2009]); it was clear by May 2010 that developments in European markets had increased the need for credible plans for fiscal consolidation.

Given the growing levels of debt, several questions emerge, including: What if the fiscal stimulus programs were to continue for two to four years more than currently projected? What will happen to public debt if there is no adjustment to the primary fiscal balances in the medium term? What is the degree of fiscal adjustment necessary for countries to either reduce their public debt stock to historical average levels or stabilize it around a certain fiscally sustainable target? If the adjustment is deemed too large to be feasible from a political economy standpoint, what will be the effect of a more gradual adjustment on debt sustainability? While this paper does not aim to answer these important questions, some preliminary findings have already started to appear in the literature. A recent study conducted on a sample of 20 middle-income countries (MICs), for example, shows that the fiscal policy responses in 2008 and 2009 and the related external financing packages have contributed to higher public and external debts in several countries (figure 3; Van Doorn, Suri, and Gooptu forthcoming).

**Figure 3. Increased External and Public Debt Levels in MICs (% of GDP)**



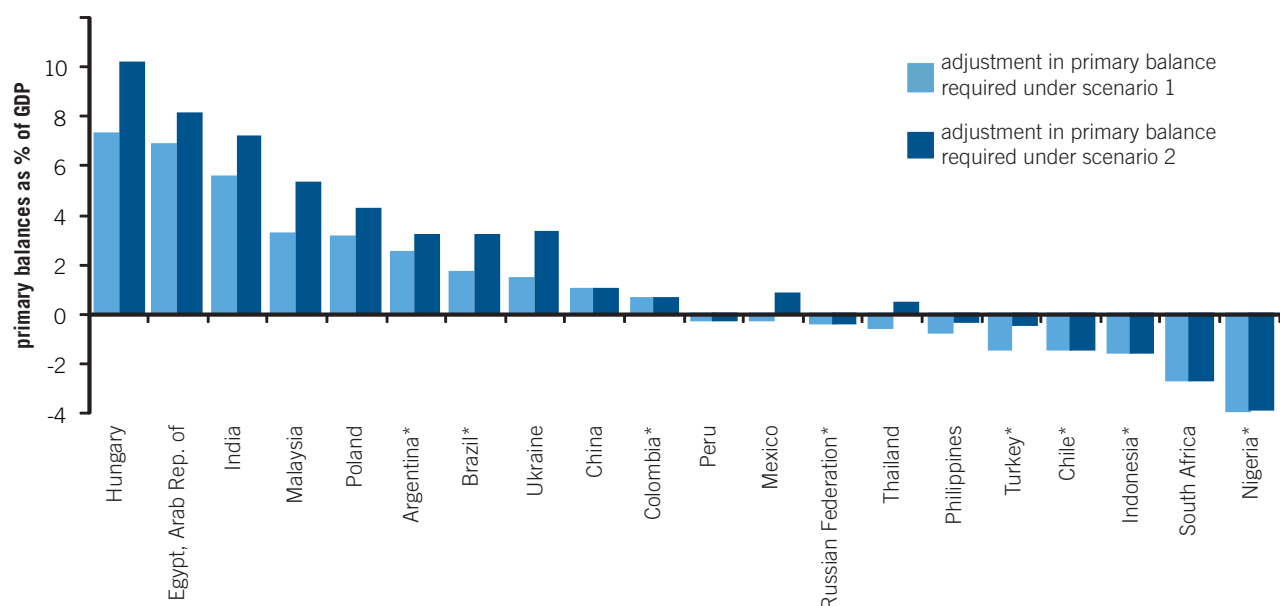
Sources: Van Doorn, Suri, and Gooptu forthcoming; IMF 2010b.

Hypothetical scenarios that were examined in this study—to assess the staying power of the fiscal stimulus programs in the sample countries—suggest that if a growth recovery is not sustained in advanced countries and the global outlook remains fragile, the primary balances that most of these countries will need to run in the medium term will be significantly higher than what they have carried in the recent past. Moreover, if the prolonged downturn leads to even more debt accumulation, if rising international interest rates, foreign exchange risk, and a continuous repricing of risk of sovereign credits characterize the new postcrisis reality, it will become more difficult for several countries to reach their respective debt targets (figure 4).

In the case of LICs, the global financial crisis has also impacted their debt positions and associated vulnerabilities. This group of countries is likely to face tighter external financing—dwindling foreign direct investment, commercial lending, and (potentially) smaller aid flows—and contractions in export income. Several of the LICs have increased their reliance on domestic debt to close their widening fiscal financing needs. A recent joint World Bank and IMF study reviewed debt sustainability analyses (DSAs) for 32 LICs for which pre- and postcrisis DSAs were available. Like the MICs, the external and fiscal financing requirements of LICs also increased after the global crisis (World Bank and IMF 2010). In addition, their future levels of GDP, exports, and fiscal revenues are expected to be permanently lower as a result of this global shock. The World Bank and IMF (2010) conclude that, on average, LIC debt ratios are also expected to deteriorate in the near term, particularly for public debt.

Meanwhile, the surge in gross borrowing needs of advanced economies—from US\$9 trillion in 2007 to roughly US\$16 trillion in 2009, with an expected similar level for 2010—is adding to the financial stress under which public debt is being managed (Blommestein and Gok 2009). If general government debt ratios in advanced economies are to be brought back to the precrisis average of 60 percent of GDP by 2030, it will require an 8 percent swing in the fiscal balance from an average deficit of 4 percent in 2010 to a fiscal surplus of 4 percent by 2020 and then maintenance of this surplus for the ensuing decade (Lipsky 2010). The growing level of public debt suggests that the spread between long-term and short-term interest rates is likely to increase over time, even though quantitative easing may delay such a trend. For developing countries, this is likely to imply higher borrowing costs and shortening maturities on new borrowings. Developing countries will be impacted by these developments not only through the cost of capital and reduced global economic dynamism, but also because the massive public interventions of the last two years—in the absence of an orderly unwinding—will foster asset bubbles and speculative waves. Exchange rate misalignments can also contribute to the tensions in the financial system. Speculative attacks against currencies in highly leveraged economies can add to risks by further contributing to the deterioration of private sector balance sheets and may evolve into sovereign debt crises. All of these risks need to be managed on a continuous basis, and risk management should be accompanied by credible, medium-term debt management practices and financing strategies to support the fiscal spending and postcrisis recovery efforts.

**Figure 4. Required Postcrisis Primary Balances Diverge Significantly from Historical Levels (% of GDP)**



Sources: Van Doorn, Suri, and Gooptu forthcoming; IMF 2010b.

Note: Assumptions: debt target is 40 percent of GDP by 2020 if the country's gross public debt was above 40 percent of GDP at end-2009, or to stabilize debt at its end-2009 level if debt was below 40 percent of GDP at end-2009. Adjustment is the difference between the required primary balance to reach the debt target under the two hypothetical scenarios and the country-specific historical primary balance (that is, average of 1996–2001 for countries marked with an asterisk; average of 2002–07 for all other countries). For Chile, Indonesia, South Africa and Nigeria the historical primary balance is larger than the required primary balance, so, in principle, no unprecedented fiscal adjustment will be needed in these countries.

## Adopting a Sovereign Balance Sheet Approach

This review of debt and fiscal paths underscores the importance of refocusing on sovereign debt management. The traditional, external DSAs will continue to be an important ingredient of the analytical toolkit, but they need to be complemented by a closer examination of public debt (encompassing both domestic and external debt) and medium-term fiscal sustainability analyses by the respective authorities on a regular basis. Special attention will now need to be given to managing not only the composition of sovereign debt portfolios, but also the expanding array of contingent liabilities incurred by government responses to the crisis.

Conventional DSAs for low- and middle-income countries highlight country-specific characteristics, focusing on the nature and size of shocks that affect a country's debt and debt service profile, and the potential for fiscal response to these shocks, given fiscal space at any point in time. However, the lessons from the East Asian financial crisis of the late 1990s and the current global financial crisis emphasize the need for DSAs to consider the wider liabilities of the public sector. Countries with high sovereign debt ratios, large fiscal deficits, and growing contingent liabilities are especially at risk of contagion because heightened market uncertainties in international capital markets lead to a flight to quality. Investors are wary of rising interest rates across countries and the prospect of stringent fiscal consolidation that lies ahead.

The ability of governments to make payments on their debt obligations (domestic and external) and minimize future risks to their public finances can be enhanced by implementing a credible, medium-term debt management strategy and creating an institutional capability to monitor and manage contingent liabilities. To this end, a sovereign balance sheet approach to debt management will be useful in managing the financial and credit risks associated with carrying out regulatory and macroeconomic functions. This approach focuses on the risk characteristics of the assets and obligations that the government manages, and the types of financial flows associated with them. In practice, this entails an examination of the cash flows generated by the key assets (or asset classes) of the government and monetary authorities to see how sensitive they are to changes in real interest rates, currency movements, and shifts in terms of trade (Wheeler 2004, chapter 4).

## Conclusion

The coordination of exit policies from the massive fiscal interventions of the last few years will pose major challenges for governments around the world. While simultaneous fiscal expansion helped thwart the global economic slowdown of 2008–9, the story is more complicated when it comes to unwinding these fiscal programs and moving toward a path of fiscal consolidation. Simultaneous fiscal consolidation is likely to constrain the dimensions of economic recovery, at least in the initial stages of fiscal retrenchment. If the fiscal consolidation is

focused on stabilizing entitlement spending-to-GDP ratios (a must for countries facing demographic pressures) and letting discretionary interventions expire, the required adjustment can be achieved. However, the difficulties of dealing with entitlement reforms (for example, pension and health reforms) and the temptation to postpone adjustment because of continued weaknesses in the private sector (reflecting the ongoing deleveraging process) exacerbate the challenges of fiscal consolidation.

Markets will be closely monitoring the evolution of fiscal positions around the world, and economies that are not able to implement consolidation plans will face increasing difficulties in financing their debts. In this context, international coordination (and monitoring) can play a positive role in helping enhance the credibility of national strategies and by giving “ammunition” to financial authorities to resist short-term pressures associated with political cycles.

Finally, because of the increasing importance of public infrastructure spending in renewing the growth process through the issuance of sovereign guarantees and/or by the reliance on public-private partnerships, the role of contingent liabilities requires renewed attention. Contingent liabilities may pose substantial balance sheet risks for governments, as demonstrated by the East Asian financial crisis in 1997. When contingent liabilities are realized, they become a potential source of future call on tax revenues and can be a major factor in the build-up of public sector debt. Experience shows that contingent liabilities associated with capital injections into the banking system or in the recapitalization of public sector enterprises are particularly important (Wheeler 2004, chapter 6). The rapid build-up of public debt that has occurred in advanced countries, and is now occurring in MICs, is highly correlated with these “hidden deficits.”

Experiences of many countries, such as Colombia, Hungary, New Zealand, South Africa, and Sweden, suggest that a government’s exposure to contingent liabilities can be substantially reduced through better, more complete monitoring and reporting; better risk-sharing arrangements; improved governance and regulatory regimes; and sound economic policies that minimize the possibility of these contingent liabilities from being realized in the first place. Debt managers around the world will have to pay close attention to the evolution of contingent liabilities and their impact on public debt to avoid surprises.

## Notes

1. This paper relies extensively on Primo Braga (2010) and Van Doorn, Suri, and Gooptu (forthcoming).
2. There is extensive literature on the correlation between banking crises and sovereign debt crises. See, for example, Reinhart and Rogoff (2009).

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