Public Webinar – Emerging market debt: The growing threat to political stability

Introduction

The webinar covers global debt and the risks that it poses to political stability and is a collaboration between Oxford Analytica – part of FiscalNote – and the insurer Willis Towers Watson (WTW). The webinar comes at an important time. Debt is hardly a new issue. But it assumes greater significance in the wake of rising interest rates, spiking inflation, the ongoing war in the Ukraine and the enduring shadow of the COVID-19 pandemic. To that, we can now add the conflict that has broken out between Israel and Hamas.

The webinar also comes at a convenient time. Oxford Analytica produces a political risk index for WTW twice a year. The second iteration of the index for 2023 is in production and will be publicly available in the coming months. Part of this index this time will focus on the issues highlighted in this webinar.

The webinar begins with an assessment of the conventional methods of measuring public debt and suggests potentially better approaches to this issue. Next comes an assessment of the political risks associated with emerging markets and the debts they have, followed by consideration of various debt case studies from the Middle East and North Africa.

Rory MacLeod: Economic analysis of emerging market debt

The standard approach to analysing emerging market debt confuses flow with stock. The correct way to analyse the problem for local currency debt is to see the debt service as a percentage of the government tax base. The correct way to analyse foreign currency debt is to see the debt service versus exports growth. Third, the most vulnerable countries in the context of emerging markets debt will be smaller high-export countries, as their exports are not necessarily diversified and an already large export sector puts practical constraints on the ability to expand it further.

One of the most obvious errors in the standard analysis can be called the ‘United Nations problem’. By mid-July 2023, nearly 29% of emerging markets countries were trading at distressed spreads. If Burkina Faso, for instance, is trading at a distressed level and Brazil is not, that is not as important as it would be if the countries were reversed. This is because Brazil is more important for the global financial markets and economy and geopolitical stability. Therefore, when looking at percentage numbers, it is worth considering what countries are being represented.

The second issue in the standard analysis is to confuse debt stock with flow. At issue here is that some countries may appear to have high debts and yet they have in reality far more capacity to manage these debts than other countries in similar positions might. This affects any calculation of the full picture of a country’ debt situation. Another factor to consider is the effect of inflation on debts, and interest rates.

To analyse debt more effectively, a distinction must be made between debts denominated in the local currency and those that are held in foreign currencies. It is also important to assess where a debt is held. When considering local currency debt held locally, what matters is the tax base and the proportion of government revenue that is used to service its debts. For governments, it is ideal if the interest rate on the debt is less than the nominal growth rate of the country’s gross domestic product, since a larger economy will mean more tax income for the government.

When considering foreign debt – which is the cause of the current debt crisis – the most important factor is exports. Increasing exports helps to grow the home economy and bring in foreign or ‘new’ money, which then can be used to pay down debts more quickly. The necessary statistic here is therefore the average ratio of total external debt versus exports. Since 2010, economies both large and small have seen this ratio double.

Another factor to consider is that countries are not always able to pay down their debts and therefore have to seek to refinance them. This affects their interactions with institutional lenders and international donors. Emerging markets are vulnerable here since they are on the receiving end of the lenders' terms, including interest rates. It is therefore vital for them to expand their exports to help pay down debt, and to grow the home economy.

Diversifying exports is also important since this avoids over-reliance on particular products or sectors and offers up more opportunities to expand the export sector. However, this is in some cases easier than others: countries that already have large export sectors may struggle to keep expanding their exports, especially if they are already diversified.

Sam Wilkin: Political implications of the debt crisis

From a political risk perspective, public debt immediately raises the question of state stability. This is because debt, especially if there is a lot of it, can lead to government austerity and spending cuts, which themselves can lead to social unrest. For example, protests have been seen before now when governments have cut subsidies, for instance for public transport. There is a strong statistically significant link between government spending cuts and social unrest in various forms, including political assassinations, mass protests and violent riots.

When the correlation between austerity measures and social unrest is assessed in more recent data, however, it is found that the relationship between the two appears to be the opposite of what earlier research has shown. This is because recent years have in general not seen the world and many of its countries in 'austerity mode'; governments were expanding their spending. Following 2010, and certainly the COVID-19 pandemic of 2020-21, major government spending expansions were seen, even in emerging markets, which often have limited fiscal room to operate.

In 2022 and 2023, protests in Europe and Latin America have generally been driven by the increasing cost of energy – where countries need to import this – and protests by workers in response to inflation rates rising. Protests were more common in countries that allow collective bargaining.

Looking to 2024 and beyond, it seems unlikely that many cost-of-living-related protests will be seen: inflation rates are likely to keep declining and food and fuel prices should also fall. Next year onwards is likely to see pressure within governments to cut budgets and control spending. The International Monetary Fund (IMF) predicts that the largest spending cuts are likely to come in Bhutan, Greece, Japan, Russia and Slovakia. Protests are again likely to flare around this austerity and are most likely, as the IMF's research suggests, in democratic countries where the population have the freedom to protest. In less democratic countries, protests are less likely but if they do happen, are more likely to damage economic growth and social equity.

Warwick Knowles: Understanding emerging debt and political instability in context

To assess emerging market debt via Middle East and North Africa case studies, assessment will be made of Egypt, Jordan, Lebanon and Morocco, with some reference also to Turkey.

Looking at the debt-to-income ratio of these countries, Egypt's external risk stands out. This risk has grown far more than any of the other countries since 2010. Lebanon's external debt has grown the lowest, even though Lebanon is the country most in crisis as it has borrowed huge sums from its domestic markets, and it was highly indebted in 2010 compared with the size of its economy at that time.

Looking at indicators that give a more effective idea of the risks of a country not being able to meet its debt servicing requirements, Lebanon's indicators are worse than the other countries, but Egypt appears to be the most vulnerable, with almost one-third of its export earnings needed to meet its external debt servicing requirements. Jordan has a high level of short-term debt commitments, which can create repayment problems; Jordan will either have to pay these debts or find a way to refinance them.

Morocco is better placed in terms of its debt situation. The country also stands to benefit from efforts to build up its export base, partly due to global economic trends towards near-shoring and friend-shoring. The country is geographically near to Europe and benefits from relatively cheap labour that is also skilled. This should help in attracting investment over the medium term.

Turkey has been an outlier: the country's indicators have all improved since 2010. Instead, the problem for Turkey is more to do with the country's political situation.

Regarding Lebanon, the country's economic and political crisis has unfolded quickly. The economy has collapsed, and Lebanon has seen debt defaults. The country's banks are now themselves effectively bankrupt, and most savers cannot access their US dollar savings. This has not been helped by the dysfunction in the political system, including politicians prioritising sectarian interests over national needs. There is in Lebanon a close relationship between social unrest and government spending, including when in 2019 the government tried to introduce taxes on mobile telephones. The government pulled back on this after large protests but in so doing ended up defaulting on debt servicing.

Question & Answers

What will be the impact of the situation that has arisen between Israel and Hamas on the Middle East and North Africa region, as well as on market sentiment generally?

Warwick Knowles: The situation is likely to be contained and a second front seems at present unlikely to open, although this could change and rapidly. In this sense, at the moment the impact on the global economy is unlikely to be significant. Individual industrial sectors will be affected, such as airlines and tourism – for example, people could be less inclined to visit Egypt or Jordan.

Sam Wilkin: The situation is likely to be a very unwelcome shock for Egypt, bearing in mind the country's existing economic vulnerability. It is also worth highlighting that if hostility were to escalate between Iran and the United States, it would be very disruptive to shipping and oil, something that would bring back food and fuel price spikes.

With the coming government expenditure cuts, could the risk of political protests and instability be managed with better phasing or targeting of planned spending cuts?

Sam Wilkin: The IMF is sensitive to political instability and is therefore trying to counterbalance austerity with broader social spending floors. However, sustainable solutions can often require spending cuts, and these can outweigh any social spending floors. Additionally, many government spending programmes are maintained for political reasons; getting rid of this spending could bring easily popular protests.

What are the ways in which the emerging market debt crisis could be resolved without a major blow up and widespread defaults? Who, or what, are the sources of lending?

Rory MacLeod: The most important path to resolving the debt crisis is providing liquidity to the emerging markets. This could come from multilateral institutions, although it is not certain that they will have sufficient money to meet demand. The other method to achieve liquidity would be for the US Federal Reserve to extend swap lines to friends and allies in emerging markets. In terms of sources of new funding, it could be that the current tensions between China and the United States could play out to the benefit of the Global South, as both countries might compete with each other for influence and strategic position through the aid they give to emerging markets.

Are any of the oil rich countries vulnerable to debt at present?

Warwick Knowles: Among the oil rich countries, Bahrain is probably the most vulnerable. The situation in Oman was problematic up until 2020. But since then, higher oil prices and a more defined economic policy under new leadership has helped Oman to cut its debt substantially.