

ECONOMIC VIEWPOINT



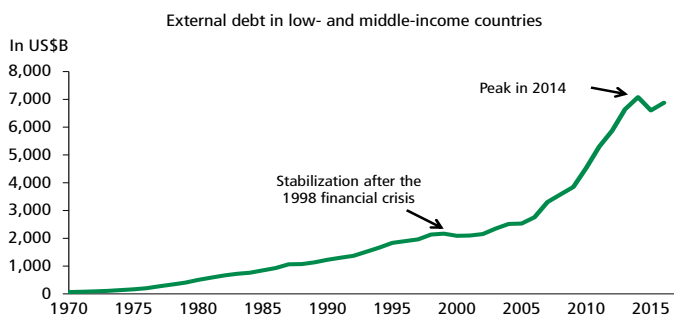
Snapshot of External Debt in Emerging and Developing Countries

External debt is the total amount of all debt owed to foreign lenders. It does not solely refer to the debts contracted by governments, it also encompasses household debt and business debt. A high level of external debt can become a source of financial and economic instability, especially in emerging and developing countries. The consequences in the event of a default can affect several countries. This Economic Viewpoint draws a portrait of external debt in low- and middle-income countries, based on the World Bank nomenclature.¹ Since 2014, external debt in these countries has stabilized on average, but risk factors remain.

External Debt Has Stabilized since 2014

External debt in low- and middle-income countries reached a peak of more than US\$7,000B in 2014. It declined to about US\$6,600B in 2015, then climbed back closer to US\$6,900B in 2016 (graph 1). The last time external debt stabilized like that was after the financial crisis of 1998, which affected several emerging and developing countries.

GRAPH 1
External debt peaked in 2014



Sources: World Bank and Desjardins, Economic Studies

The current level seems closely related to the slowdown in economic growth seen in several emerging and developing countries in the last few years. Some of them suffered from plunging prices for oil and other natural resources. Overall, the interest of foreign investors has waned, which makes financing a growing external debt that much more difficult (graph 2 on page 2). The U.S. dollar's widespread appreciation and the start of an upward cycle for interest rates could also have helped to discourage external debt.

A Debt with Less Risk?

At first glance, the stabilization of external debt suggests that the risk of financial turbulence in emerging countries has declined on average. Expressed as a percentage of gross national income (GNI)², we have seen an increase in the debt's weight however, though it remains less of a concern compared with previous decades (graph 3 on page 2).

The uptrend in the ratio of external debt to export revenues points to a greater risk of insolvency over the long term. The ratio has soared from 63% in 2008 to more than 100% in 2016, meaning that export revenues and other foreign revenues are no longer covering the external debt (graph 4 on page 2). The size of official international reserves is still substantial, although on a downtrend right now (graph 5 on page 2). Reserves can

¹ In the data for 2016, the countries with a national gross income per capita of less than US\$12,235.

² The GNI is the total income collected by national economic agents for a given period. The measure equals GDP plus the net income with the rest of the world.

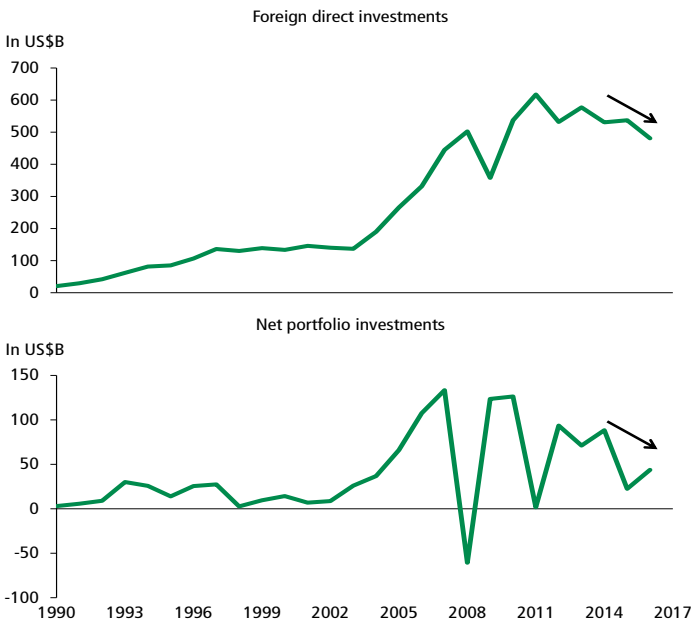
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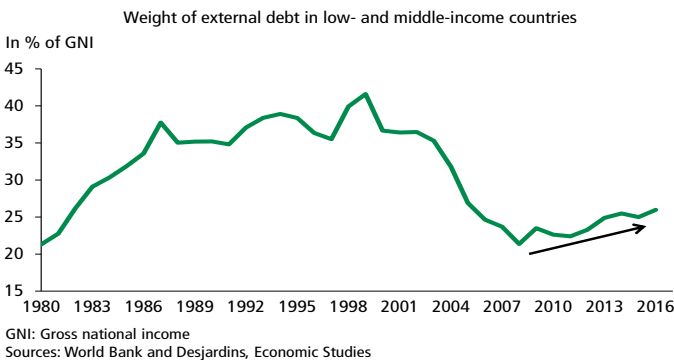
NOTE TO READERS: The letters k, M and B are used in texts and tables to refer to thousands, millions and billions respectively.

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GRAPH 2
Direct investments and portfolio investments have declined in low- and middle-income countries



GRAPH 3
External debt seems manageable based on revenues, though the situation continues to deteriorate slightly

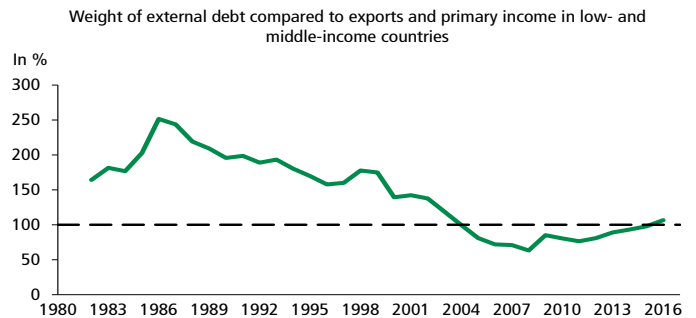


still cover about three times the size of the short-term external debt—the most sensitive portion of the debt—should financial turbulence occur.

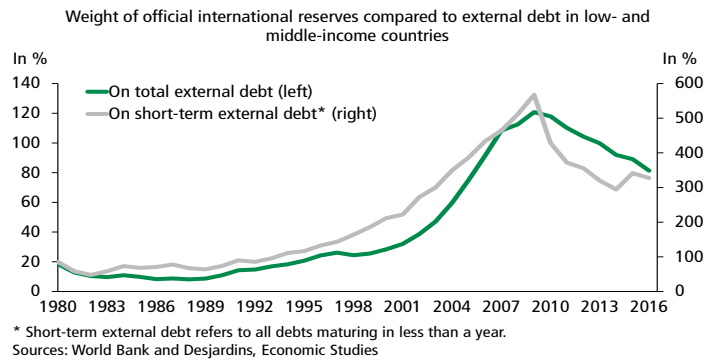
Another plus: After reaching a peak in 2014, the proportion of short-term external debt started to fall (graph 6). However, the average length of new debt contracted also fell (graph 7 on page 3). This could reflect rising concerns among international investors in the long run.

The low level of interest paid on the external debt suggests that it remains largely sustainable. On average, the interest paid by low- to middle-income countries represents less than 1% of their GNI (graph 8 on page 3). Interest represented about 2%

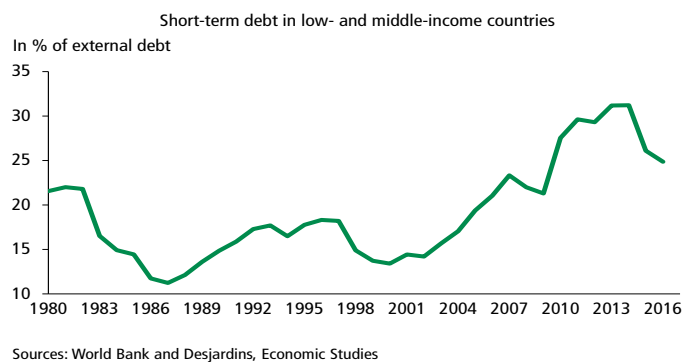
GRAPH 4
Exports and primary income no longer cover external debt



GRAPH 5
Official international reserves are dropping, but they remain high historically speaking



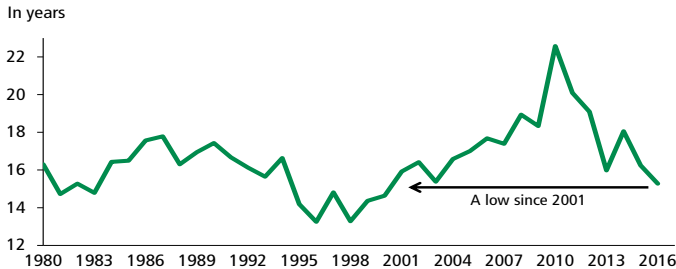
GRAPH 6
Short-term external debt has been declining since it peaked in 2014



of GNI during the 1998 financial crisis. Compared to exports, the interest paid represents 3.5% vs. 8.5% 20 years earlier. We can see however that the recent trend for these ratios is moving upwards, reflecting the fact that interest rates are on the rise (graph 9 on page 3). This ongoing trend could become a major issue in the next few years, especially since the bulk of the external debt is pegged to a variable rate (graph 10 on page 3).

GRAPH 7
On average, the term of the new external debt contracted is shrinking

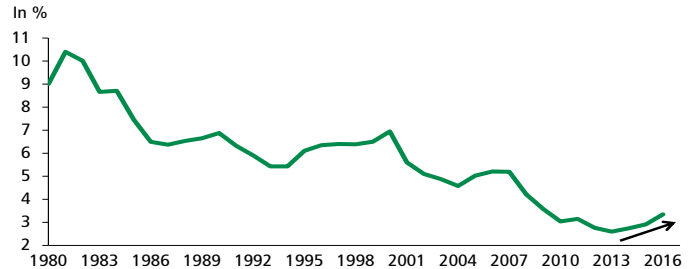
Average maturity of new debt taken out by low- and middle-income countries



Sources: World Bank and Desjardins, Economic Studies

GRAPH 9
The average interest rate has been rising since 2014

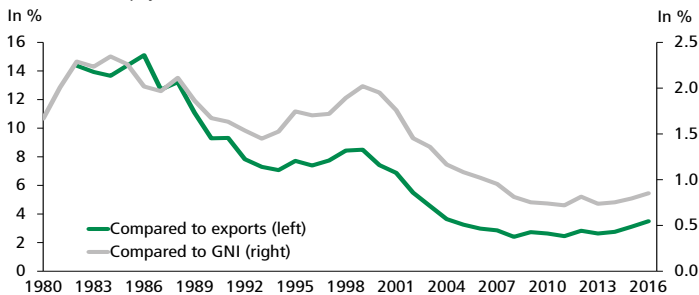
Average interest rate on new debt taken out by low- and middle-income countries



Sources: World Bank and Desjardins, Economic Studies

GRAPH 8
The interest level remains weak

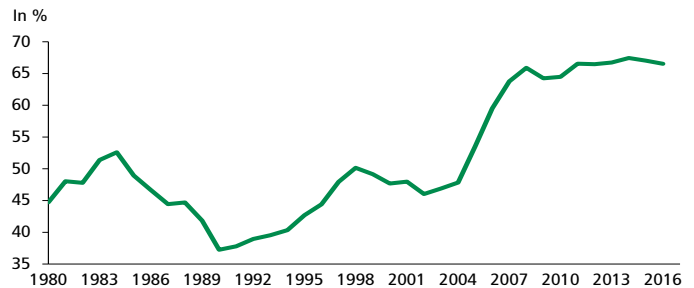
Interest payments on the external debt of low- and middle-income countries



Sources: World Bank and Desjardins, Economic Studies

GRAPH 10
Almost 70% of long-term* external debt is pegged to a variable rate

Portion of variable rate long-term external debt



* Long-term external debt refers to all debts maturing in one year or more.
 Sources: World Bank and Desjardins, Economic Studies

In addition to the interest rate risk, the external debt of emerging and developing countries is sensitive to exchange rate movements. On average, about three-quarters of the public or publicly-guaranteed external debt is in U.S. dollars (graph 11). The less popular fixed exchange rate regimes compare with the 1990s nevertheless lowered the risk of turbulence associated with exchange rates. The greenback's widespread appreciation in 2014 created concerns about the emerging and developing countries, but in the end no major crisis occurred. For one thing, flexible exchange rates do not force countries to boost their interest rates to defend their currencies.

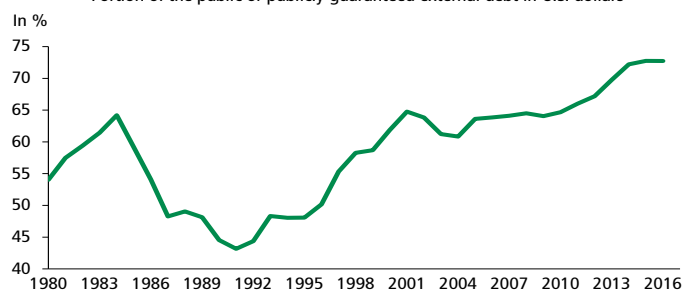
China, the Debt Champion

The bulk of external debt is concentrated in just a few countries. The total of the 15 biggest debts combined represents more than three-quarters of the total external debt held by low-and middle-income countries. China holds the lion's share, with a total debt exceeding US\$1,400B in 2016 (graph 12 on page 4). It is however a low debt level compared to China's big GNI.

Brazil comes in second for the size of its external debt, with Russia following close behind. Expressed as a proportion of its GNI, Brazil's external debt ranks close to the average of 26% for low- and middle-income countries, while Russia's level is

GRAPH 11
Most of the debt held by low- and middle-income countries is in U.S. dollars

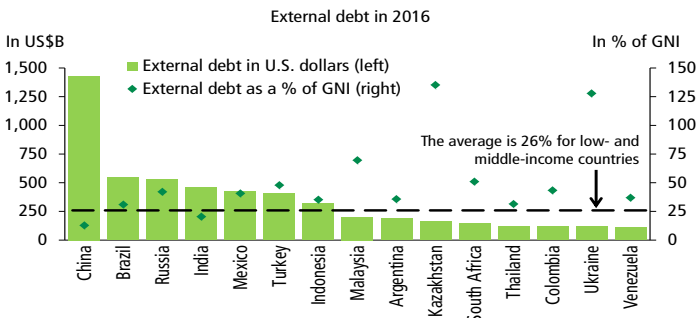
Portion of the public or publicly-guaranteed external debt in U.S. dollars



Sources: World Bank and Desjardins, Economic Studies

higher. Mexico, Turkey and Indonesia all have an external debt ratio that compares to Russia's. Of the 15 most indebted low-and middle-income countries around the world, Kazakhstan and Ukraine have the highest debt ratios. Kazakhstan greatly benefited from previous investments in the oil industry but today the country is suffering from the impact of weak oil prices. As for Ukraine, the conflict with Russia in 2014 dealt a blow to the country's financial health.

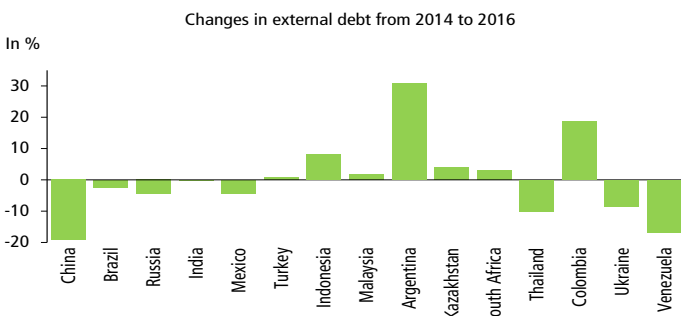
GRAPH 12
The 15 most indebted low- and middle-income countries



GNI: Gross national income
Sources: World Bank and Desjardins, Economic Studies

The external debt in several countries has fallen in the last few years. China once again stands out on this score; it slashed its external debt by 20% (graph 13). Venezuela, currently in the grips of a financial crisis, also managed to cut its debt considerably; the country now resorts to increasing its money supply to meet its financial obligations. Argentina and Colombia recorded the sharpest increases in their external debt. Indonesia's external debt has also spiked by 8% since 2014.

GRAPH 13
The external debt is down in most indebted countries

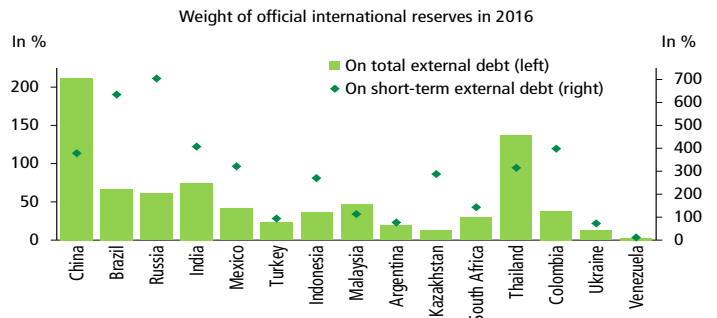


Sources: World Bank and Desjardins, Economic Studies

The Most At-risk Countries

The debt levels and recent developments help to pinpoint the countries that are at risk of financial turbulence, but these indicators are not perfect. Analyzing the scope of a country's international asset reserves provides a few more clues. On this score, China comes out on top with reserves that are more than twice the size of its total external debt (graph 14). The other three main emerging countries—India, Russia and Brazil—also have substantial reserves that cover 60% or more of their external debt. If we only focus on the short-term portion of the debt, most of the 15 countries examined here have sufficient reserves to meet their financial needs. However, Turkey, Argentina, Ukraine and Venezuela do not appear to have sufficient reserve levels to meet their financial needs.

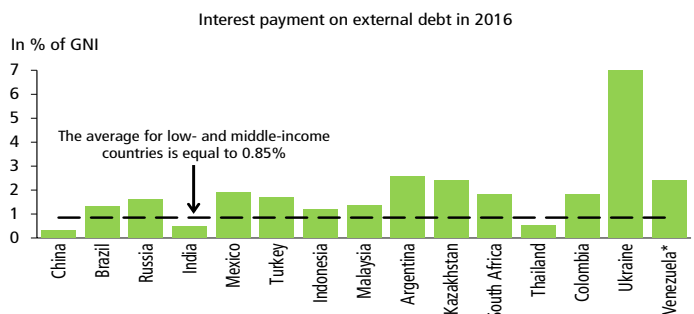
GRAPH 14
China has the biggest official international reserves



Sources: World Bank and Desjardins, Economic Studies

Considering that climbing interest rates are likely to be the main challenge in the coming years, we have to know which countries will be more sensitive to this issue. On average, the interest paid by low- and middle-income countries on their external debt is about 0.85% of the country's GNI. Of the most indebted countries, only China, India and Thailand pay less interest than this average (graph 15). Ukraine ranks first with an interest payment of 7% of GNI, but any country paying close to 2% or more is cause for some concern considering that this ratio should rise in the next few years. Thailand's interest payment was more than 4% of GNI during the 1998 financial crisis. The payment in Argentina reached a similar level during the 1999–2000 crisis.

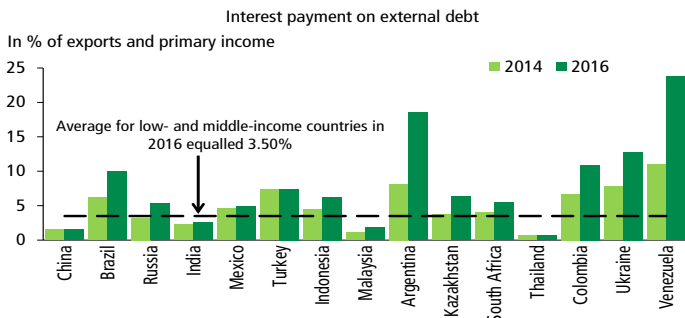
GRAPH 15
Most indebted emerging countries pay above-average interest rates



GNI: Gross national income; * The most recent data for Venezuela is from 2013.
Sources: World Bank and Desjardins, Economic Studies

Interest payments based on export revenues also seem high in several countries (graph 16 on page 5). The situation has deteriorated, especially in the last few years due to lower export revenues mostly in the oil industry and other natural resource sectors. China is not affected by this new environment. Very little changes have also been noted in Mexico and Turkey, but the ratio of interest payment to exports in both cases is still above average. If export revenues fail to recover, solvency in several countries could deteriorate further in the medium term.

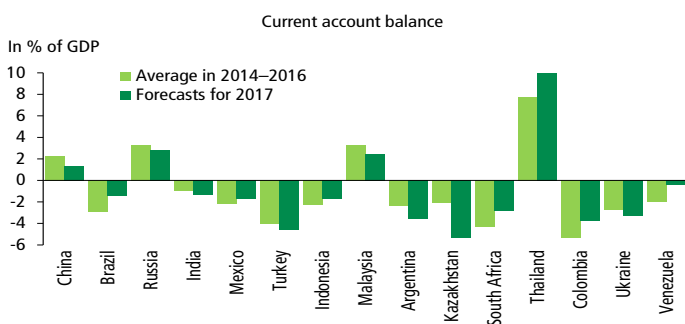
GRAPH 16
The drop in exports and primary income eroded the solvency rate



Sources: World Bank and Desjardins, Economic Studies

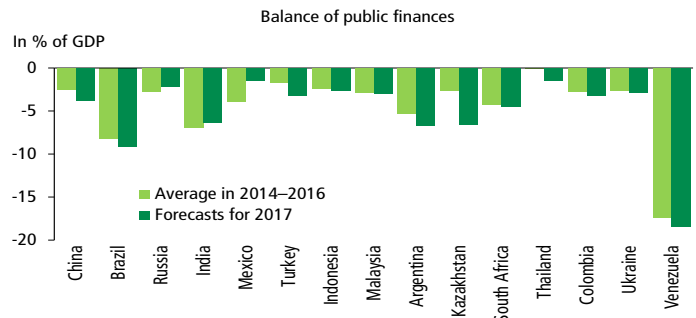
Solvency will also depend on future borrowing needs. Persistent current account deficits are a good indicator of a country’s need for foreign capital. Yet, most of the countries examined here have accumulated such deficits (graph 17). But some countries have improved their situation however, such as Brazil and South Africa. Examining changes in public deficits also provides clues, since they often mean a subsequent increase in foreign loans. Developments on this front seem to be signalling a downtrend in several countries (graph 18). Mexico has made significant strides, with Russia and India showing softer advances. At more than 5% of GDP, India’s public deficit is nevertheless high; it is within the same scope as in Brazil, Argentina and Kazakhstan. Venezuela is in a class by itself with its deficit close to 20% of GDP—another sign of this country’s substantial financial hardships.

GRAPH 17
Several countries are racking up current account deficits



Sources: International Monetary Fund and Desjardins, Economic Studies

GRAPH 18
The deterioration of public finances is putting more pressure on foreign loans



Sources: International Monetary Fund and Desjardins, Economic Studies

No Threat to the Global Economy—for Now

Examined from a global standpoint, the external debt situation in low- and middle-income countries appears to be under control. The good news is that debt has stabilized since 2014. That said, climbing interest rates are a big risk factor. Combined with the erosion of export revenues in several countries in the last few years, the risk of insolvency could rise. Fortunately, most countries have sufficient official international reserves to cover their short-term financial needs. Once these reserves run out however, their level of vulnerability to a new shock rises significantly.

A risk analysis of the countries carrying the heaviest external debt shows that some are already in a precarious position, especially Venezuela. That said, a country in the grips of financial hardship has to have considerable economic swagger to have an impact on the rest of the world. China carries significant economic heft but its external debt appears to be easily sustainable. A few risk elements were flagged in other large-scale economies such as Brazil, India, Indonesia, Mexico, Russia and Turkey. The snapshot of Turkey’s external debt points to a precarious situation (table 1 on page 6). A default in Turkey would not systematically send shock waves through the global economy, unless the resulting global uncertainty triggers a steep deterioration in other emerging and developing countries’ financial position.

TABLE 1
Summary of weaknesses raised in the main emerging countries

	<u>BRAZIL</u>	<u>INDIA</u>	<u>INDONESIA</u>	<u>MEXICO</u>	<u>RUSSIA</u>	<u>TURKEY</u>
External debt/GNI significantly above average			✓	✓	✓	✓
Interest paid/GNI significantly above average				✓	✓	✓
Interest paid/exports significantly above average	✓		✓			✓
Limited official international reserves						✓
Persistent current account deficit with no significant improvement		✓	✓	✓		✓
Substantial or sharply deteriorating public deficit	✓	✓				✓

GNI: Gross national income.

Source: Desjardins, Economic Studies

Monitoring the changes in external debt is a worthwhile exercise. Other risks could increase the risk of insolvency in the next few years, such as rising protectionism that could further cut export revenues and potentially stifle the free flow of capital. Increased exchange rate volatility could also make a complicated situation even more difficult.

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