CareEdge RATINGS

Leveraged Economies and Interest Rate Cycle

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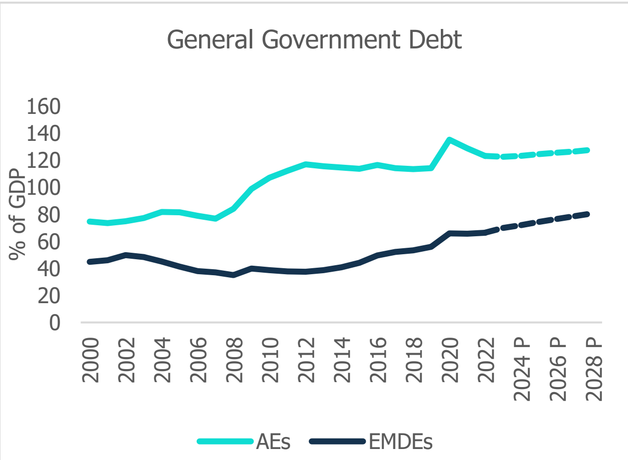
The Covid-19 pandemic, along with subsequent global geopolitical uncertainties, has resulted in a notable upswing in debt levels across both Emerging and Developing Economies (EMDEs) and Advanced Economies (AEs). According to the International Monetary Fund (IMF)'s data on fiscal response to the Covid-19 pandemic, AEs in G20 economies collectively expended approximately USD 15 trillion, a significantly higher amount than the USD 1.8 trillion spent by EMDEs in the G20 list. Despite the absolute spending being greater in AEs, the heightened pandemic-related expenditures have increased debt levels in both EMDEs and AEs (see Exhibit 1).

While debt levels persist at elevated levels, global growth has encountered challenges over the past few years, primarily due to disruptions in the supply chain, the withdrawal of pandemic-related supports, and escalating geopolitical conflicts. Despite some improvement in the global outlook and an increased likelihood of a soft landing, overall global economic growth is still expected to remain below the pre-pandemic average (see Exhibit 2).

Consequently, the elevated cost of borrowing following the steep tightening of monetary policy by most major central banks from 2022 onwards, coupled with a deceleration in growth momentum, will keep debt levels higher as the gap between nominal GDP growth and interest rates narrows. The growing debt levels of both EMDEs and AEs remain a cause of concern. IMF projections indicate that government debt as a percentage of GDP is expected to reach 75.4% and 116.3% by 2028 for EMDEs and AEs, respectively. These figures represent an anticipated increase of 25 percentage points and 14 percentage points above their respective pre-Covid levels.

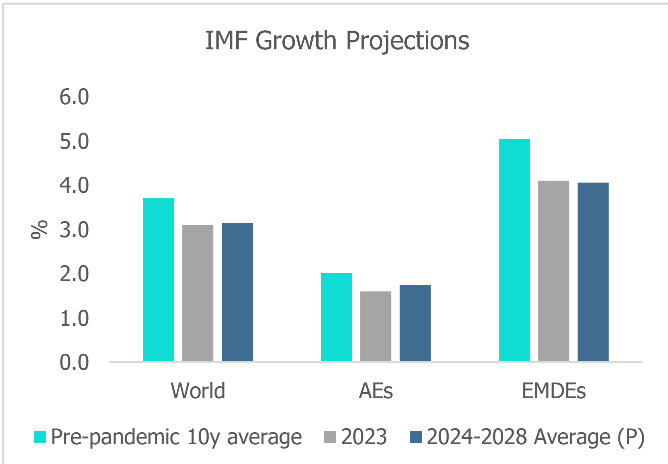
Global discussions have focussed on the debt sustainability of EMDEs because of their economic fragility. Nevertheless, it is vital to acknowledge the growing vulnerabilities present in AEs with higher government debt levels and weakening of debt affordability due to rising interest to revenue ratios. As policy rates in AEs like the US are projected remain above pre-pandemic levels over the medium term, debt sustainability remains a source of apprehension. This report explores these aspects in detail.

Exhibit 1: General Government Debt is Projected to Rise



Sources: IMF, CareEdge Ratings Calculations

Exhibit 2: Slowing Growth likely to Impact Debt Sustainability when Interest Costs Remain High



Sources: IMF, CareEdge Ratings Calculations

Rising Cost of Borrowing is seen in Global Sovereign Issuances

The issuance of sovereign debt securities reached its peak during the Covid-19 pandemic in 2020, primarily driven by pandemic-related stimulus measures. Following the pandemic, sovereign issuances have declined as fiscal policies normalize. However, they have remained elevated above pre-Covid levels in 2022-2023 (Refer Exhibit 3). Notably, the United States and China have been at the forefront of sovereign issuances.

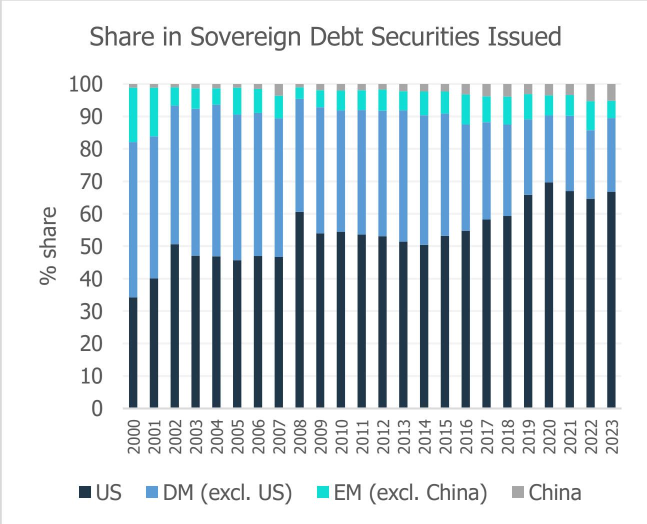
The U.S. has played a dominant role, with its share in total sovereign issuances doubling from 34% in 2000 to a substantial 66% in 2023. Concurrently, China's share increased nearly fivefold, rising from 1.1% in 2000 to 5.1% in 2023 (Refer Exhibit 4). Additionally, the total amount issued by China nearly equaled that issued by EMDEs (excluding China). In AEs, between 2008 and 2021, a significant portion of issuances featured low coupons, influenced by the prevailing low-interest-rate environment. However, since 2022, due to policy tightening, sovereign bonds have been issued at higher coupons (Refer to Exhibit 5).

During the same period, interest rate costs for EMDEs have naturally remained higher than those for AEs, reflecting the greater credit risks associated with lending to EMDEs. Borrowing costs for EMDEs also decreased during the pandemic, as a higher proportion of the amount issued carried coupons in the 0-3% range in 2020 and 2021 (Refer to Exhibit 6). However, with monetary tightening since 2022, the borrowing costs of EMDEs are also experiencing an upward trend.

Exhibit 3: Sovereign Issuances Peaked in 2020 but Remain Elevated

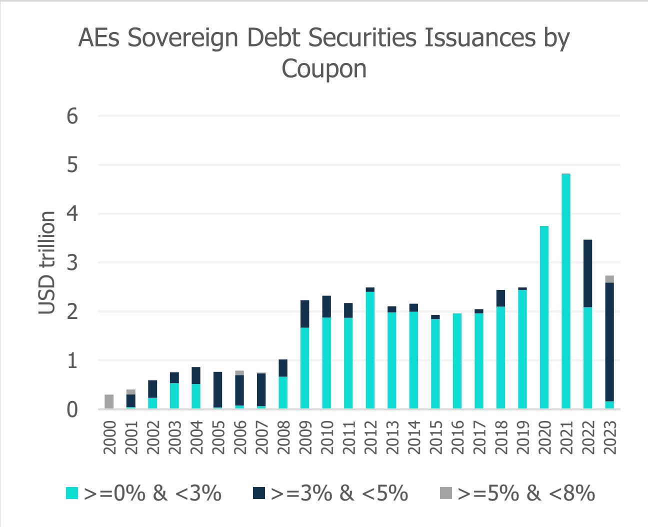
Sources: Refinitiv, CareEdge Ratings Calculations. Data as on November 2023.

Exhibit 4: Sovereign Issuances by US Doubled & by China Increased 5x



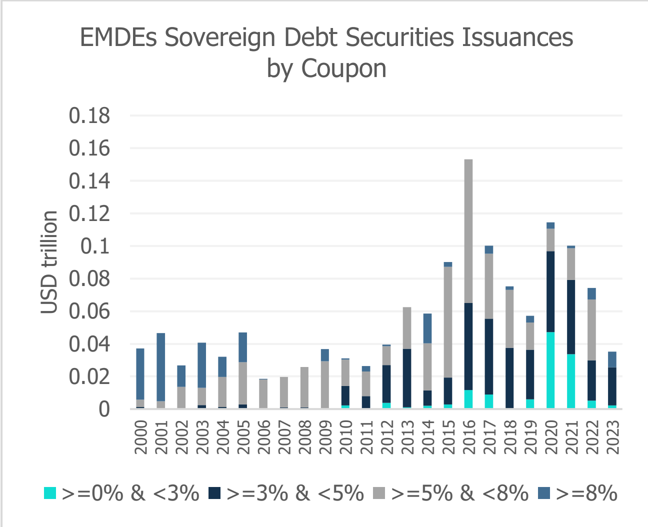
Source: Refinitiv, CareEdge Ratings Calculations. Data as on November 2023.

Exhibit 5: AEs' Interest Costs Rise



Sources: Refinitiv, CareEdge Ratings Calculations. Note: Data covers only fixed-rate USD denominated securities. Data as on November 2023.

Exhibit 6: EMDEs' Interest Costs Also See Uptick

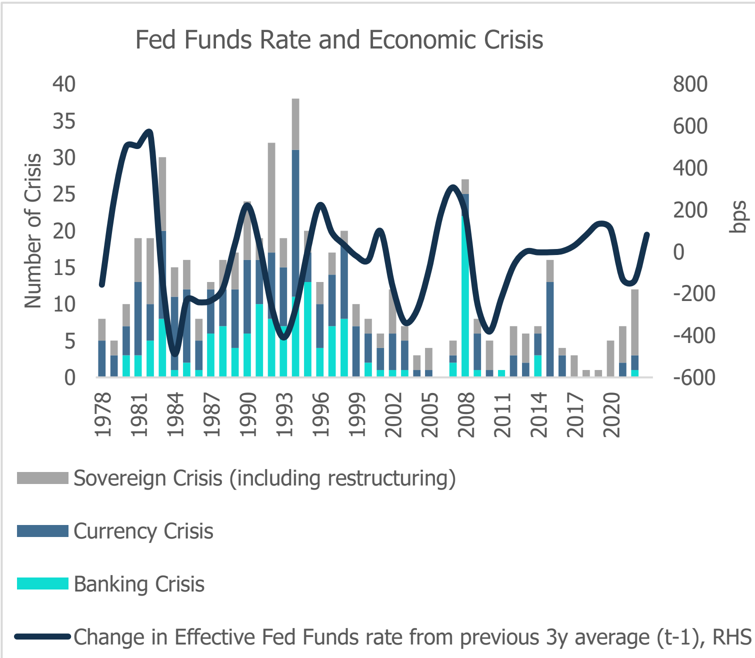


Source: Refinitiv, CareEdge Ratings Calculations. Data as on November 2023.

Every Hiking Cycle Has Broken Something, But Each Cycle is Unique

In each monetary policy cycle, the impact is often felt most strongly in the weakest link among financial markets, the sovereign debt market, banking and real estate sectors, and the foreign exchange (FX) market. The United States, being a major supplier of global liquidity, plays a significant role. When US interest rates rise, it tends to narrow the interest rate differential of the EMDEs with the US, resulting in capital outflows and tighter financial conditions in EMDEs. This heightens the risk of potential financial crises. Data suggests that the number of economic crises (sovereign, current and banking crises) increases with the upward trajectory of the Fed funds rate with a lag of 1 year (Refer to Exhibit 7).

Exhibit 7: Sovereign Crises Up in Last 6 Years



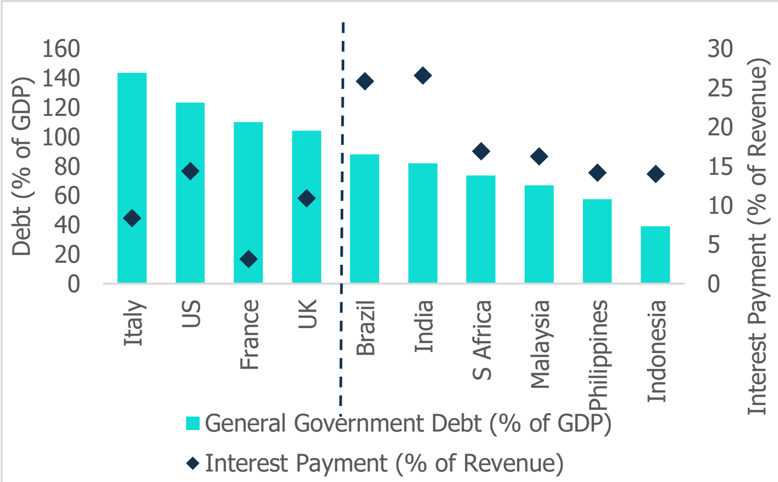
Sources: IMF, Laeven and Valencia (2018), Refinitiv, CareEdge Ratings

Even in the US, the current interest rate cycle has seen pressures among regional and smaller banks. However, broadly following the GFC (Global Financial Crisis) in 2008, instances of banking crises have decreased due to the implementation of Basel Norms (international regulatory standards for banking supervision). In contrast, over the last six years, there has been an increase in instances of sovereign crises, particularly driven by fiscal issues in smaller economies across Africa and Latin America.

Despite Higher Debt in AEs, Lower Interest Rates Aided Debt Serviceability

AEs enjoy lower interest rates compared to emerging economies, leading to more manageable debt serviceability even with high debt levels. For instance, for US the General Government debt as percentage of GDP is at a high of 123%, however, the debt affordability (Interest/ Revenue) is relatively healthy at 14.4%. Similarly for the UK, while the general government debt is at a high of 104%, interest to revenue is at a low of 10.9%. In contrast, some of the emerging economies, even with relatively lower debt levels have very high interest to revenue. For instance, for India, the GG debt to GDP ratio is at 82% but the interest to revenue is much higher at 26.6%. Similarly, for Brazil with a general government debt of 88%, it has interest to revenue of 25.9% (Refer Exhibit 8). In most advanced economies, the implementation of ultra loose monetary policy in the aftermath of the 2008 global financial crisis resulted in very low interest rates for a long period of time. However, this scenario has undergone a shift in the post COVID period. The world's central banks have unleashed the steepest series of interest-rate increases in decades during their last two-years drive to tame inflation. Even though a policy easing cycle is anticipated to start this year, it is unlikely that the rate cutting cycle will be steep thereby keeping interest rates above the pre-pandemic levels, especially in the AEs. The US Fed has specifically highlighted that interest rates are likely to remain higher for longer.

Exhibit 8: Despite Higher Debt in AEs, it continues to face lower borrowing costs

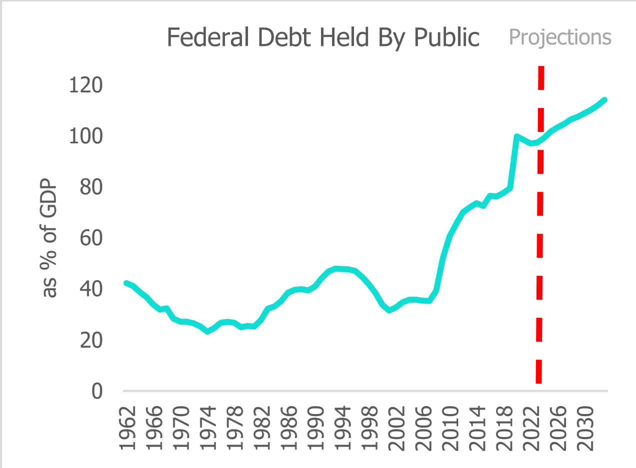


Sources: IMF, Reuters CareEdge. Based on latest available data

Interest Burden to Increase for the Advanced Economies

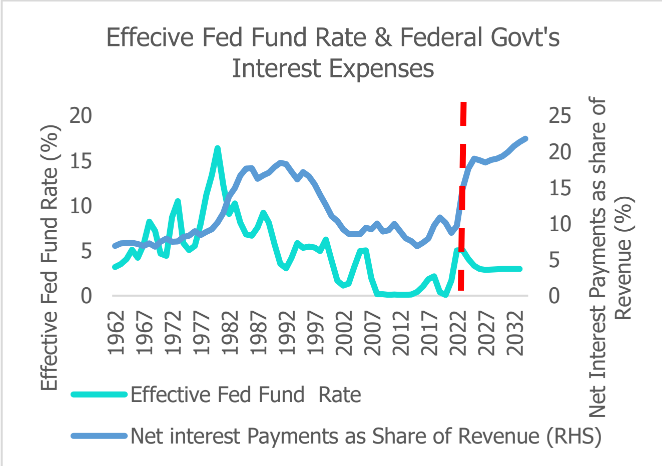
The US government's finances are in the spotlight for investors as higher interest rates are expected to put upward pressure on government spending and debt issuances. The pandemic spending bills that supported the economy raised the ratio of Federal debt held by the public to GDP close to 97% in 2023 from 79.4% four years ago (Refer Exhibit 9). This is a ~6% annualised growth rate in government debt in 2023, against a historical annual increase of ~2.5% since GFC.

Exhibit 9: Current Debt Levels in US Close to Record High & Projected to Increase Further



Sources: US Congressional Budget Office, CareEdge Ratings

Exhibit 10: Federal Govt's Interest Expenses to Hit Record ~21% of Revenue by 2032

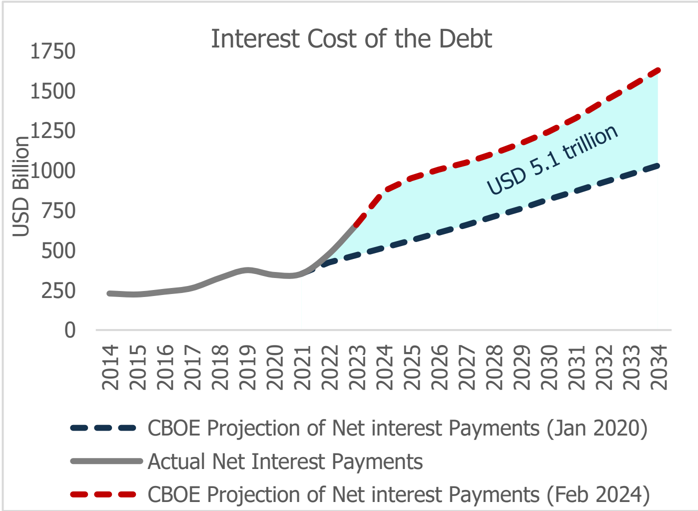


Sources: US Congressional Budget Office, CareEdge Ratings

Even though, we see the US Federal Reserve starting its rate-cutting cycle this year, the effective fed funds rate is likely to stay above pre-pandemic levels over the next decade (as per CBOE). Higher debt burden coupled with a higher cost of money will put pressure on the US budget as the net interest payment is projected to cross 20% of revenue by 2032 from 9.7% in 2022 (Refer Exhibit 10), as per CBOE. This would be the highest level seen since the 1960s.

Comparing, the pre-pandemic projections i.e. the projections made in January 2020 of the US net interest payments with the latest projections of February 2024, we try to capture the overall increase in interest burden due to pandemic related debt increase and the recent tightening cycle leading to higher interest rates, on the federal budget. Our analysis suggests that from 2020-2034, the net impact in terms of higher interest payments stands at USD 5.1 trillion (Refer Exhibit 11). Viewing this through the lens of opportunity cost, suggests a potential diversion of resources from productive expenditures toward meeting higher interest expenses.

Exhibit 11: The impact of higher debt and higher cost of borrowing is expected at ~USD 5.1 trillion

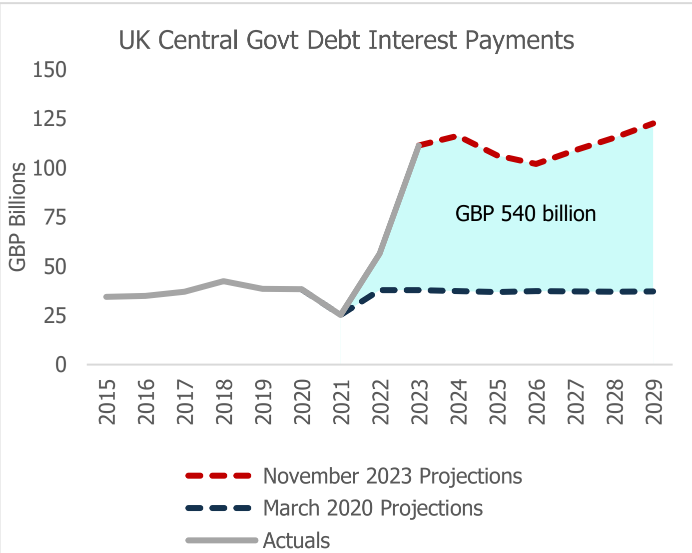


Sources: US Congressional Budget Office, CareEdge. Jan'20 projections are extended from 2031 based on historical trend.

Specific economies within the Eurozone and the UK are also susceptible given the elevated levels of government debt and higher interest rates compared to pre-pandemic levels. Additionally, the region is grappling with a significant economic deceleration, exacerbated by higher dependencies and economic spillovers arising from the conflict in Ukraine. The United Kingdom's economy has recently entered a technical recession, marked by two consecutive quarters of contraction. Moreover, the growth prospects for the Euro Area are also not optimistic, as economic growth is projected to remain below 1% for the year 2024. A slower growth can increase the vulnerability of these nations.

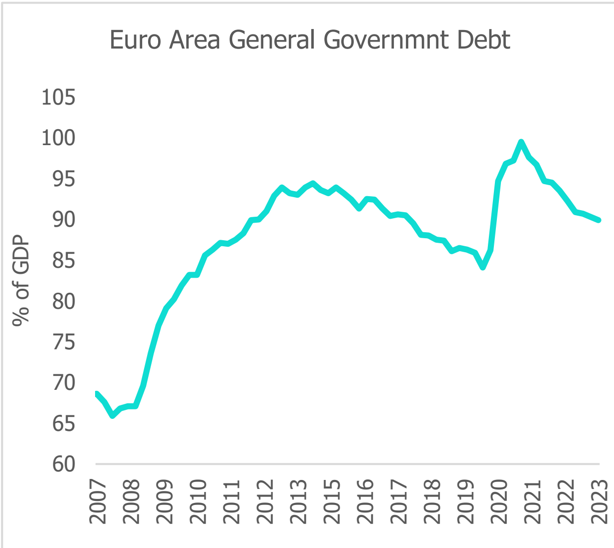
For UK, the Government's interest expenses (% of revenue) costs are already on upswing as it doubled from 5.4% in 2020 to 10.9% in 2022. Comparing the official pre-pandemic interest outlay projections of the UK's central government to the latest estimates reveals a substantial increase in the total interest outlay going ahead. The differential of projections made before the pandemic and the latest indicates a rise of approximately GBP 540 billion in interest outlay for central government over the span of a decade since the onset of the pandemic (Refer to Exhibit 12). In the Eurozone, although there has been a significant correction in the percentage of government debt relative to GDP, the overall debt levels continue to persist at elevated rates. Notably, countries such as Greece (with general government debt to GDP at 166%), Italy (141%), France (112%), Spain (110%), Belgium (108%), and Portugal (108%) continue to grapple with very high debt levels. With the rise in interest rates, their interest expenses are also expected to go up, though the increase is relatively lower than that for US and UK. For example, in Italy, the anticipated trajectory indicates that interest expenses as a percentage of revenue are set to increase from approximately 7% in 2020 to 9.3% by 2027. Similarly, in Spain, the corresponding projection reveals a climb from 5.4% in 2020 to 6.6% by 2027.

Exhibit 12: UK's Central Government Interest Outlay to Rise by GBP 540 billion Since Pandemic



Sources: Office for Budget Responsibility, CareEdge Ratings. Mar'20 projections are extended from 2026 based on historical trend.

Exhibit 13: Despite Consolidation, Debt Remains High in Eurozone



Sources: EuroStat, CareEdge Ratings

The Way Ahead

The predominant focus of global policy discourse has often revolved around concerns about the debt sustainability of EMDEs, acknowledging their economic fragility. However, it is equally crucial to recognize the escalating vulnerabilities within the AEs as well. While the economic challenges of EMDEs are undoubtedly a reality, the evolving dynamics also underscore the increasing susceptibility of AEs to various factors that could impact their financial stability and resilience. Soaring debt levels, slowing economic momentum, elevated cost of money and geopolitical fragmentation are some of the factors that will continue to impact debt sustainability of AEs. This shift in perspective highlights the need for a more comprehensive understanding of global economic risks and vulnerabilities, transcending the traditional narrative that predominantly focuses on EMDEs. The escalation in risk carries significant implications when viewed through the lens of sovereign credit ratings, particularly for AEs that traditionally enjoy relatively higher ratings.

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