Until the eve of the financial crisis, sovereign debt management in developing countries was being carried out under favorable circumstances. The period 2000–07, for example, was characterized by lower local interest rates and a reduced reliance on short-term external borrowing. The increased availability of local currency financing, reflecting the development of domestic capital markets, and the globalization of the corporate sector in emerging market economies underscored the changing landscape of development financing.

The global financial crisis is changing this landscape once again. Since 2007, the world economy slowed significantly—global output declined 0.6 percent (a 3.2 percent contraction in the case of advanced economies) in 2009. 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

This paper relies extensively on Primo Braga (2010) and Gooptu, Suri, and van Doorn (2010).
domestic product (GDP) growth rates in advanced countries will be about a half percentage point less, on average, than precrisis levels.

There is also broad consensus that many dangers remain ahead in terms of the sustainability of the recovery, including the challenges in implementing exit strategies from the massive government interventions that took place since 2008 (Primo Braga 2010). In spite of 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. So far, this crisis has not yet evolved into a systemic sovereign debt crisis. The rapid accumulation of public debt and growing fiscal imbalances in many countries, however, and historical precedent suggest that one cannot simply dismiss such a possibility. Interestingly enough, for the first time over the past four decades, 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 underscore the fact that there is no room for complacency. In what follows, we document evolving debt and fiscal trends and identify some of the emerging challenges faced by debt managers in developing markets.

**Emerging Issues**

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, and positive growth trends for the world economy, in spite of the puncturing of the high-tech “bubble” in OECD countries. Many emerging economies were able to reduce the vulnerabilities of their debt portfolios over the past decade. Average maturities increased, reflecting increases in the maturities of new debt issuances, and as a consequence, many countries entered the crisis facing lower rollover risks.

Figure 12.1 captures some of the key debt and fiscal variables for a relevant set of advanced and emerging countries in 2007, immediately
before the onset of the 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 12.2 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 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 much more limited now. The situation is particularly complex in some 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

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**Figure 12.1** Many Countries Were Able to Respond to the Global Crisis from a Position of Strength... Overall Fiscal Balances and General Government Debt, 2007

Source: Authors’ calculations.

Note: Debt measures for Bulgaria, República Bolivariana de Venezuela, and Chile are gross public debt, external debt, and public sector gross debt, respectively.
developments in European markets had increased the need for credible plans for fiscal consolidation.

Given the growing levels of debt, several questions emerge in a medium-term context. These include: What if the fiscal stimulus programs were to continue for an additional 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 that countries need to make 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 deemed credible from a political economy standpoint, what will be the effect of a more gradual adjustment on debt sustainability? While this chapter does not aim to answer these important questions, some preliminary findings on some of them have already started to appear in the literature. A recent study undertaken for 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 12.3) (Gooptu, Suri, and van Doorn 2010).

Hypothetical scenarios that were examined in this study—to assess the staying power of these fiscal stimulus programs in this sample of 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 done in the recent past. Moreover, if the prolonged downturn leads to even more debt accumulation, this will make it more difficult for several of these countries to reach their respective debt targets if rising international interest rates, foreign exchange risk, and a continuous repricing of risk of sovereign credits characterizes the new postcrisis reality (figure 12.4).

In the case of low-income countries, the global financial crisis has also affected 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 them have increased

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**Figure 12.3** The Crisis Has Brought with It Increased External and Public (Including Domestic) Debt Levels in MICs

Sources: Gooptu, Suri, and van Doorn 2010; International Monetary Fund, World Economic Outlook database.
their reliance on domestic debt to close their widening fiscal financing needs. A recent joint World Bank–IMF study reviewed debt sustainability analyses (DSAs) for 32 low-income countries (LICs) for which pre- and postcrisis debt sustainability analyses were available. Like the MICs, the external and fiscal financing requirements of LICs have 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–IMF study concludes 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 maintaining of this surplus for the ensuing decade (Lipskey 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. This is likely to imply higher borrowing costs and shortening maturities for developing-country new borrowings. Developing countries will be affected not only by the implications of these developments for the cost of capital and by less dynamism in the world economy, but also by the massive public interventions of the past two years—in the absence of an orderly unwind—that will foster asset bubbles and speculative waves. Exchange rate misalignments can also contribute to the tensions in the 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 these risks need to be managed on a continuous basis going forward. This should be accompanied by credible medium-term debt management practices and financing strategies to support the fiscal spending and postcrisis recovery efforts.

**Adopting a Sovereign Balance Sheet Approach to Minimize Fiscal and Debt Risks**

The debt and fiscal paths reviewed in the previous section underscore the importance of renewed attention to sovereign debt management. The traditional external debt sustainability assessments will continue to be an important ingredient of the analytical toolkit, but they need to be complemented by closer examination of public debt (that is, encompassing both domestic and external debts) 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 governments in the context of their responses to the crisis.

Conventional debt sustainability assessments for low- and middle-income countries highlight the country-specific characteristics, focusing
on the nature and size of shocks that affect a country’s debt and debt service profile and on the potential for fiscal response to these shocks, given its fiscal space at any point in time. However, the lessons from the East Asian financial crisis of the late 1990s and the recent global financial crisis underscore the need for debt sustainability analyses 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 since heightened market uncertainties in international capital markets lead to a flight to quality. Investors are wary of rising interest rates across countries and stringent fiscal consolidation ahead unless growth resumes in their respective economies.\(^2\)

The ability of governments to make payments on their debt obligations (domestic and external), and to 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 its 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 their regulatory and macroeconomic functions. This approach helps one to look into the nature of the risk characteristics of 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, noting how sensitive they are to changes in real interest rates, currency movements, and shifts in terms of trade (Wheeler 2004, 77–90).

**Concluding Remarks**

The coordination of exit policies from the massive fiscal interventions of the past few years will pose major challenges for governments around the world. While simultaneous fiscal expansion helped thwart the global economic slowdown in 2008–09, the story is more complicated when it comes to unwinding these fiscal programs and entering 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. A case can be made that 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. The difficulties of dealing with entitlement reforms (for example, pension and health reforms) and the temptation to postpone adjustment in view of continued weaknesses in the private sector (reflecting the ongoing deleveraging process), however, underscore how challenging the political economy of fiscal consolidation will be.

Markets will be closely monitoring the evolution of fiscal positions around the world, and those economies that are not able to implement their 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, with the increasing importance of infrastructure spending by the public sector to renew the growth process in several countries through the issuance of sovereign guarantees or by the reliance on public-private partnerships, the role of contingent liabilities requires renewed attention. They may pose substantial balance sheet risks for a government. As the experience of the East Asian Financial Crisis in 1997 bears witness, when contingent liabilities are realized, they become a potential source of future call on tax revenues and can be a major factor in the buildup of public sector debt. Experience shows that particularly important in this regard have been contingent liabilities associated with capital injections into the banking system or in the recapitalization of public sector enterprises (Wheeler 2004, 103–10). The rapid buildup of public debt that has been observed in advanced countries and is now being witnessed in middle-income countries is highly correlated with these “hidden deficits.”

Experiences of many countries, such as Colombia, Hungary, New Zealand, South Africa, and Sweden, suggest that the 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 for entities that benefit from such contingent liabilities of the government; 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 in order to avoid surprises.

**Notes**

1. There is extensive literature on the correlation between banking crises and sovereign debt crises. See, for example, Reinhart and Rogoff (2009).
2. Blanchard, Dell’Ariccia, and Mauro (2010) have noted that the degree of post-crisis fiscal adjustment that will be necessary is “formidable” if one were to consider the aging-related challenges in pensions and health care that the advanced economies face. They highlight the importance of creating ample fiscal space by harnessing future economic booms and by adopting credible commitments to reduce their debt-to-GDP ratios, including through frameworks (and fiscal rules) that help limit spending increases in economic boom periods. Better automatic stabilizers will help as well.

**Bibliography**


