

**Economic and Social Commission for Western Asia (ESCWA)**

Committee on Financing for Development in the States Members of the Economic
and Social Commission for Western Asia

First session

Amman, 11-12 December 2019



Item 7 (e) of the provisional agenda

Arab Financing for Development Scorecard**Debt and debt sustainability****Summary**

Overall, debt dynamics in the Arab region contrast starkly with international trends. The only common point is the record high external debt stocks witnessed at the regional and global levels; however, more important than the debt level is its changing composition, terms and servicing. While borrowing by developing countries from official creditors (including the International Monetary Fund) has, in general, declined steadily since 2000, the opposite is true for the Arab region. The rise in global debt has been driven by private non-guaranteed and private sector short-term borrowings, whereas, in the Arab region, it is the result of rising public and publicly guaranteed debt.

Debt management is essential for financing sustainable development. Effective debt management can contribute to macroeconomic and microeconomic stability. To date, however, there is no normalized level that sets the benchmark for external debt levels, and determines when countries lose control of debt dynamics. With global public debt at a record high, it has become critical to assess the impact of Governments' borrowing strategies on the future of their economies and on their ability to repay the principal and service their debt, and for creditors to anticipate future risks and tailor their financing needs accordingly.

Despite having different debt levels in the Arab region, oil-importing and oil-exporting countries are accumulating debt at a fast pace. This increase is mainly driven by a public debt deficit and an increase in government-guaranteed debt. As advanced economies have normalized their monetary policy and started increasing interest rates, the debt situation in the region needs to be carefully monitored. A strategy is therefore needed to ensure that debt remains at a sustainable level.

The Committee on Financing for Development in the States Members of the Economic and Social Commission for Western Asia is invited to consider the findings of the present document.

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Introduction

1. The Addis Ababa Action Agenda establishes two sets of commitments on debt sustainability and debt management to address two distinct but inter-related objectives, namely debt crisis resolution (including debt relief and restructuring), and debt crisis prevention (by developing tools and conducting analysis that improve the reliability of debt data). The present document focuses on external debt crisis prevention, given that decision-making on sovereign borrowing rests with debtor countries. It also considers whether debt financing, primarily external debt, is an appropriate means for funding sustainable development in Arab countries at this point in time.
2. According to the United Nations Inter-Agency Task Force on Financing for Development (IATF), excessive domestic borrowing can crowd out credit for private investment, and holds an economy-wide risk premium. It has been argued that a debt-to-gross domestic product (GDP) ratio exceeding 90 per cent can constrain economic growth, and in some places, such as the European Union, debt ceilings are favoured. Nevertheless, the International Monetary Fund (IMF) has conceded that there is no exact science on what constitutes too much debt, and some observers deny the existence of a set correlation between debt and economic growth. Excessive borrowing and leveraging, along with unforeseen events, can sap lender optimism. Creditors cut lending, leading to a drop-in credit worthiness, and seek higher premiums, thus creating a debt spiral. This can lead to a liquidity crunch and, subsequently, austerity policies, which tend to shrink the economy, making it harder to repay debt. The result is a structural debt crisis.
3. The Action Agenda captures the international community's commitment to assist developing countries in attaining long-term debt sustainability through coordinated policies aimed at fostering debt financing, debt relief, debt restructuring and sound debt management, as appropriate (paragraph 94). It also stresses that debtors and creditors must work together to prevent and resolve unsustainable debt situations. Maintaining sustainable debt levels is the responsibility of borrowing countries; however, lenders also have a responsibility to lend in a way that does not undermine a country's debt sustainability (paragraph 97).
4. To determine what constitutes sustainable debt in a given country, the impact of global debt and financial market dynamics need to be factored in, along with statistical examinations measuring debt against macroeconomic performance other than GDP. The first part of the present document analyses global debt dynamics, and provides an assessment of debt in the Arab region. The analysis is based on available data. It is subject to change, depending on country-specific situations and/or region-wide developments, especially as many countries in the region have recently taken up additional sovereign borrowings not fully factored in international debt statistics, a trend that may adversely affect future propensities to raise enough financing through new debt-gearred instruments and sovereign borrowings.

I. GLOBAL DEBT DYNAMICS

5. Today, the world is witnessing the biggest debt bubble in history. Global gross debt reached \$243.2 trillion in 2018, the equivalent of 3 times the size of the global economy (or 318 per cent of global output). Over the past five years, developing countries' public debt rose by 15 percentage points from 36 per cent in 2013 to 51 per cent of GDP in 2018. However, the pace of debt accumulation was much slower at just \$3.3 trillion in 2018. Both public debt (\$65 trillion) and corporate and private debt (\$178 trillion) have continued to rise relative to the \$168 trillion at the onset of the financial crisis. Private external debt of developing countries also increased from 23 per cent to 37 per cent of GDP in 2017, as companies took advantage of low interest rates and excess liquidity.
6. According to IATF, these trends reveal several vulnerabilities (higher public debt levels and increased risks from a shift in debt composition towards more financing on commercial terms, leading to higher debt servicing costs and increased debt restructuring, interest rate, and capital flow reversal risks). Rising debt service obligations pose severe constraints not only in terms of financing the Sustainable Development Goals (SDGs), but also as debt service competes with other public expenditures over available mobilized domestic resources.

A. EXTERNAL DEBT FINANCING

7. By 2018, total external debt for all countries reached \$35.9 trillion.¹ Middle- and low-income countries' total external debt rose by 10 per cent to \$7.1 trillion in 2017.² Regionally, sub-Saharan African countries added almost 16 per cent more external debt, South Asian economies added to external debt stocks by 11 per cent, and economies of the Arab region increased external debt stocks by 12 per cent. This is the first time since 2014 that net debt inflows (\$606.5 billion) exceed equity inflows (foreign direct investment and portfolio equity of \$510.5 billion).³ Sovereign debt levels in developing countries are up from 34 per cent of GDP in 2008 to 49.7 per cent at the end of 2018.

8. Long-term debt represented nearly 75 per cent of the total external debt stock. Net public and publicly guaranteed bond issuance accounted for 85 per cent of net long-term debt inflows from all official and private creditors combined. Short-term debt amounted to \$1.81 trillion and accounted for 25 per cent of the total debt stock. Short-term debt was the fastest growing component of external debt, rising by 19 per cent, while long-term external debt rose 7 per cent in 2017.

9. In 2018, debt-to-GDP ratios in advanced economies decreased to 102.8 per cent. Despite this slight improvement, most developed countries have continued their borrowing spree, leveraging on low-interest rates and stable market conditions. In contrast, the debt-to-GDP ratio in emerging markets and developing economies reached 50.4 per cent. This ratio has been rising steadily from a 2011 level of 37.1 per cent, and it is expected to reach 51.8 per cent in 2019. IMF cautioned that 24 of 59 low-income developing countries are now in a debt crisis or at high risk of facing one. The World Bank indicates that nearly half of developing countries have a debt-to-export ratio exceeding 150 per cent.

10. It is worth mentioning that declines in export revenues and widening public deficits driven by slow growth and the collapse of commodity prices (2014/2015) have triggered greater demand for external financing, especially to take advantage of negative interest rates, which has led to significant increases in external debt-to-GDP ratios. From a debt sustainability perspective, however, it is important to consider that debt remains multidimensional. Its analysis should factor in the composition of the debt stock itself and in debt service outflows in relation to a country's capacity to repay arrears (for example, external debt as a percentage of GDP, national income and export revenues; and debt per capita).

B. DOMESTIC CAPITAL MARKETS AND INNOVATIVE DEBT INSTRUMENTS

11. Dependence on bond issuances in domestic currency has grown in recent years. Those bonds are used to mobilize private capital (domestic and international) to finance domestic development. Domestic-currency denominated debt instruments remain cheap and can reduce currency mismatches for borrowers. In its 2016/2017 report, IATF notes that as a result of increased volume of domestic sovereign debt, it has become more important to address how sustainable bond issuances can be used in case of fiscal space distress and/or of difficulty in maintaining regular debt service payments.

12. Domestic capital markets (including equity, bond and insurance markets) can play a key role in financing economic growth and promoting financial stability. However, there are significant differences in the size, maturity and capitalization of capital markets across economies. An alternative captured in the Action Agenda is the use of innovative financial instruments, including Islamic finance instruments.

¹ Total external debt is debt owed to non-residents, repayable in currency, goods, or services. Total external debt is the sum of public, publicly guaranteed, and private non-guaranteed long-term debt, use of IMF credit, and short-term debt. Short-term debt includes all debt having an original maturity of one year or less and interest in arrears on long-term debt. Data are in current United States dollars.

² For comparative purposes, the external debt stocks of developing countries totalled \$6.8 trillion in 2015.

³ World Bank Group, International Debt Statistics, 2019.

13. Two other schemes have had significant implications for sustainable development financing: debt-swap arrangements (swapping a public debt obligation for a specified public expenditure programme, including debt-to-health and debt-to education swaps), and State Contingent Debt Instruments (SCDIs). The latter involves contractual provisions that make debtors' obligations contingent upon pre-defined events or data outturns. They are therefore designed to provide automatic market-based protection against pre-defined shocks (humanitarian crises, natural disasters, etc.), and remain contingent on macroeconomic performance or the price of commodities such as oil to reduce debt payments in times of low fiscal revenue.

14. In 2017, Islamic finance in Sharia-compliant debt instruments grew to \$2.4 trillion.⁴ An increase in geopolitical risks in the Arab region, global interest rate increases, tightening of global liquidity conditions, and rising trade tensions are expected to slow down issuance. S&P expects that the global *sukuk* volume in 2018 will be \$70-80 billion, compared with \$97.9 billion in 2017.⁵

II. REGIONAL EXTERNAL DEBT DYNAMICS

15. In 2017, the total external debt stock owed by Arab economies reached an all-time high of \$317 billion (figure 1). This represents an increase of 11 per cent compared to 2016 figures. This level is slightly above the \$269.7 billion in financing provided by Kuwait, Saudi Arabia and the United Arab Emirates to the United States of America through holding treasury securities.⁶ The biggest increase dollar wise in 2017 was due to a rise of public and publicly guaranteed debt, especially in Egypt where it increased by \$12 billion. Despite this increase in Egyptian external debt, the level is deemed manageable as most of the debt has a medium (23.6 per cent) and long-term (59.3 per cent) maturity.

16. Reliable data and statistics in the Arab region on external debt, wealth assets and contingent liabilities are patchy. According to the World Bank's International Debt Statistics, for example, the external debt of the Sudan was \$21.7 billion in 2017. In reality, the country's debt stood at \$53.3 billion in 2017. Under the 'zero option' agreement, the Sudan would retain all external liabilities after the secession of South Sudan, provided that the international community committed to delivering debt relief. Without such a commitment, the debt would be apportioned between the two countries according to a negotiated formula. According to IMF, the Sudan lost three-quarters of oil production, two-thirds of exports, and half of fiscal revenues in the secession.

17. In 2017, public and publicly guaranteed debt represented 63 per cent of the region's total external debt stock (figure 2). This level is considerably higher than the average 37.4 per cent for low- and middle-income countries. The latter tend to leverage on private non-guaranteed external debt for financing needs. In contrast, short-term external debt represented 17.4 per cent of total external debt, lower than the 26 per cent average registered for low- and middle-income countries.

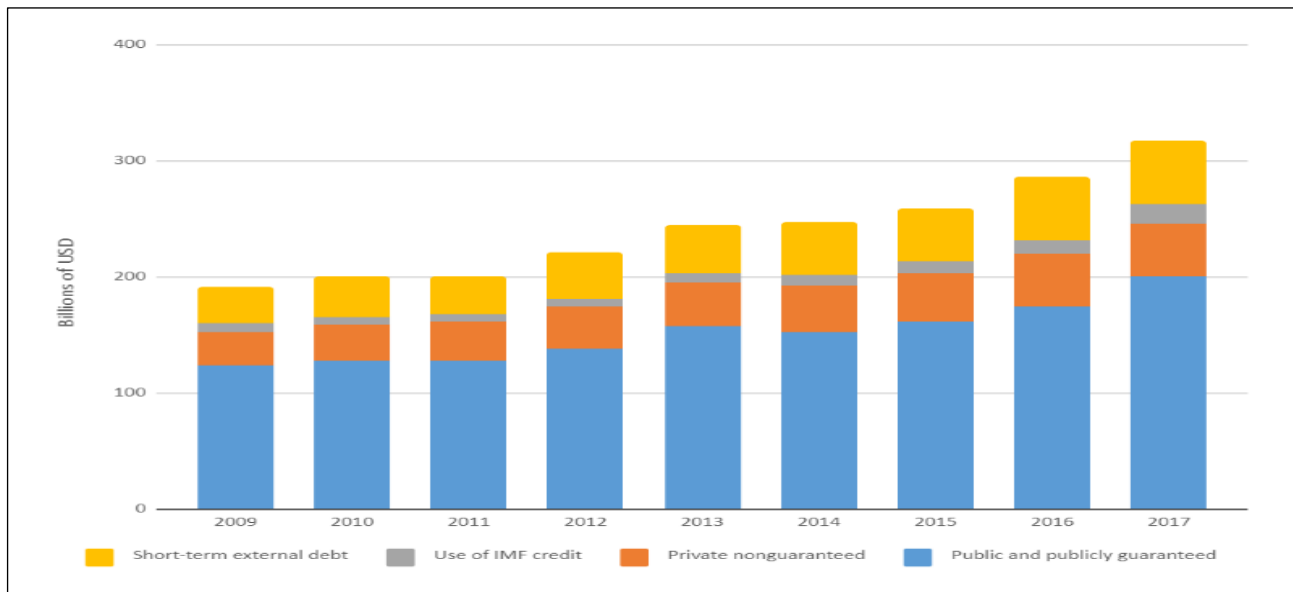
18. By the end of 2017, Egypt, Jordan, Lebanon, Morocco and Tunisia accounted for 82.24 per cent of total long-term debt (public and publicly guaranteed) held by non-oil producing Arab countries. These countries were also the highest external borrowers of short-term debt, accounting for 82.9 per cent of total short-term debt held by non-oil producing Arab countries (figure 3). Lebanon accounted for 74 per cent of private non-guaranteed external debt held by those economies, followed by Morocco with 17.5 per cent and Jordan with 5 per cent.

⁴ Arabian Business, Islamic finance industry grows 6% to be worth USD 2.4trn, 2018. Available from <https://www.arabianbusiness.com/banking-finance/398813-islamic-finance-industry-grows-6-to-be-worth-24trn>.

⁵ Gulf News, Slowing GCC issuance stalls global sukuk market, 2018. Available from <https://gulfnews.com/business/banking/slowing-gcc-issuance-stalls-global-sukuk-market-1.2284294>.

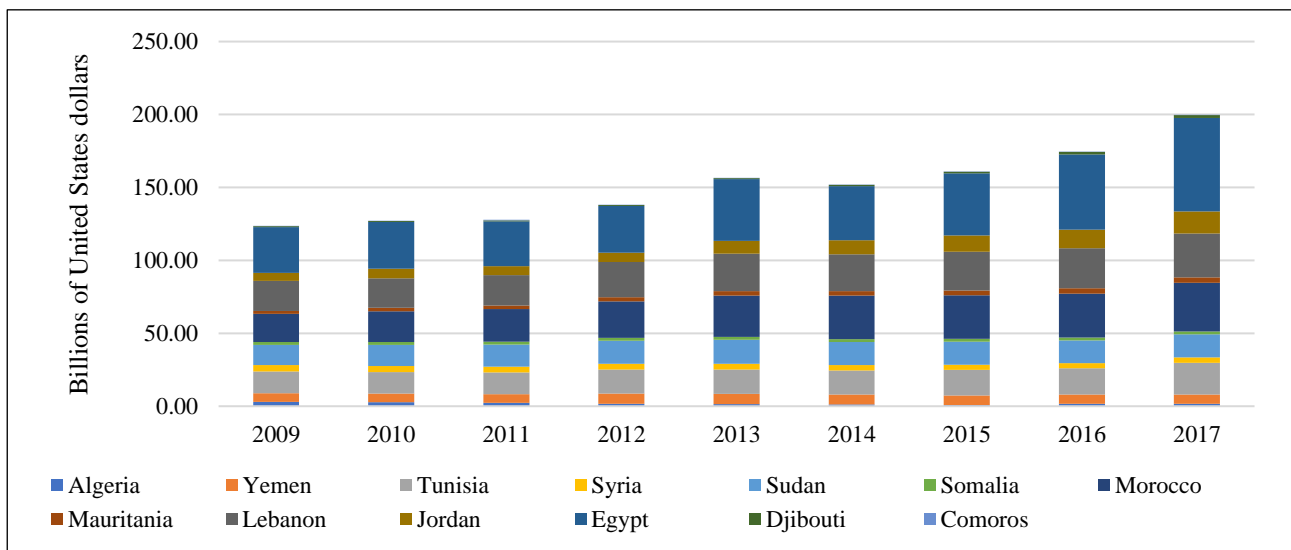
⁶ Department of treasury/Federal Reserve Board, Major foreign holders of treasury securities, 2019.

Figure 1. External debt stock, by category, Arab economies (excluding high income), 2009-2017



Source: ESCWA based on International Debt Statistics, World Bank. Available from <http://datatopics.worldbank.org/debt/ids/>.

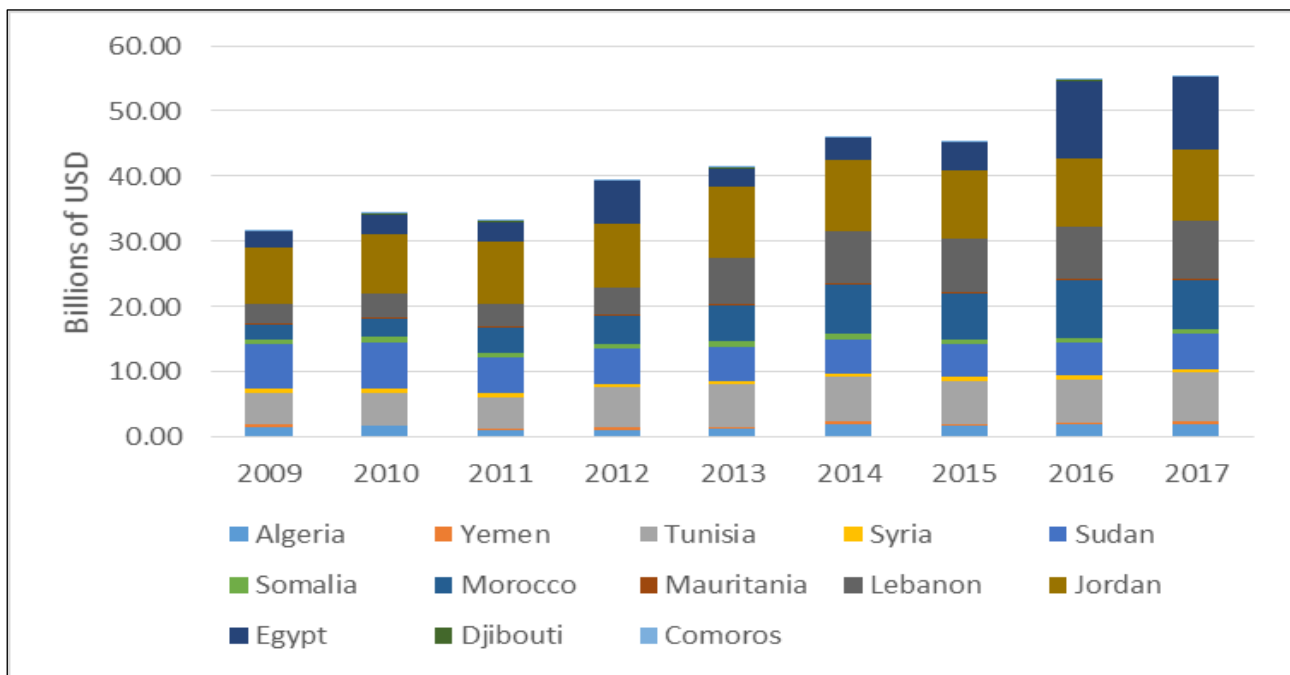
Figure 2. Public and publicly guaranteed external debt stock, Arab region (excluding high-income economies), 2009-2017



Source: ESCWA based on International Debt Statistics, World Bank.

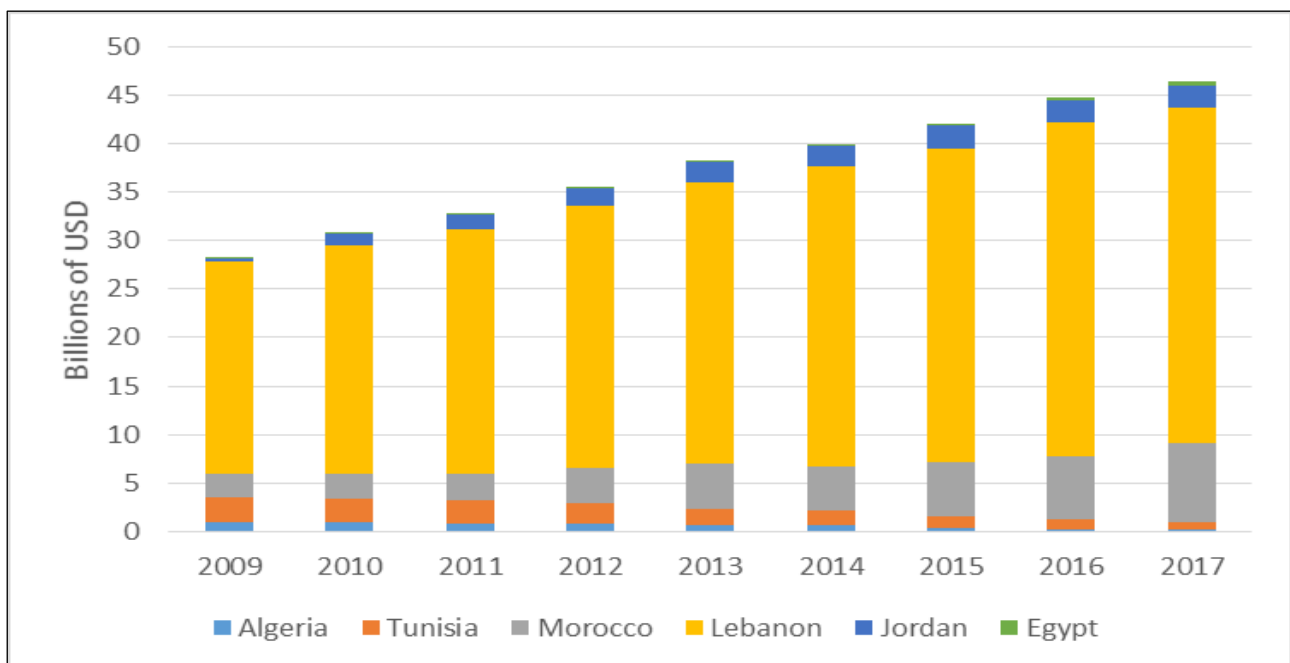
19. In 2017, private non-guaranteed debt represented 15 per cent of the total debt stock in non-oil Arab countries (figure 4). This ratio is significantly lower than the ratio of low- and middle-income countries for private non-guaranteed debt which stands at 37.4 per cent. This situation indicates that the Arab private sector has not fully exploited the capital markets. The 2017 annual report of the Arab Monetary Fund (AMF) reiterated the need for capital market development in the region, and stressed its positive impact on the economy. It should be noted that Lebanon is an outlier: its private non-guaranteed debt to total debt reached 47 per cent.

**Figure 3. Short-term external debt stock, Arab region
(excluding high-income economies), 2009-2017**



Source: ESCWA based on International Debt Statistics, World Bank.

**Figure 4. Private non-guaranteed external debt, Arab region
(excluding high-income economies), 2009-2017**



Source: ESCWA based on International Debt Statistics, World Bank.

20. In 2015, a joint IMF-AMF survey found that 39 per cent of the 216 surveyed Arab banks saw a contraction of their correspondent banking relationships (CBRs) between 2012 and 2015. A follow-up survey was conducted in 2018. This survey focused on the direct and indirect effects of CBRs on banks operating in

the Arab region. Nearly one-third of banks experienced a decline in the number of CBRs since 2012. About 30 per cent of participants indicated a moderate or significant impact on their ability to transact in the United States and Europe. Of those that experienced a withdrawal or restriction of accounts, most were able to find replacements but at an increased cost. Almost half of respondents' banks viewed that AML/CFT and sanctions related reasons were behind the termination/restriction of accounts.⁷ This contraction has hindered access to capital markets for the region.

21. Debt as a percentage of GDP has increased by an average of 22 percentage points each year since the adoption of the Action Agenda in 2015, as an average for those countries.⁸ Several factors have contributed to the increase in debt, namely weaker growth in the region, increased financing costs associated with rising risk premiums, deteriorating current account balances, and the impact of monetary policy tightening. Among high-income Arab countries, Bahrain is about to breach the 90 per cent debt-to-GDP level. In the case of non-oil exporting Arab countries, most of their debt-to-GDP ratios are hovering around 100 per cent. Lebanon (150 per cent), Jordan (96 per cent), Egypt (92.5 per cent) and Mauritania (97.5 per cent) have managed to keep their debt-to-GDP ratio within the same range over the past couple of years. On the other hand, the Sudan saw its debt-to-GDP ratio increase from 121.6 per cent in 2017 to 167.5 per cent in 2018. Rising public debt requires diverting more public funds towards debt service, rather than spending them on social services.

22. A clear indication of a Government's repayment capacity and sustainability potential is the debt service-to-government revenue ratio. Lebanon stands out followed by Tunisia. In 2017, 45 per cent of the Lebanese Government's revenue was used to service its external debt obligations, the highest in the region. Currently, most of the Government's revenue is channelled towards debt servicing, public sector wages, and transfers to *Electricité du Liban*- the national electricity company. In 2018, the Finance Ministry issued \$5 billion in Eurobonds and exchanged them with Lebanese pound-denominated treasury bills from the Central Bank. The swap operation led to a growth in foreign-currency debt and reduced debt servicing costs by \$1.5 billion. Lately, however, the primary balance is no longer keeping up with the payments needed to service debt. With increased risk of payment ability, the Lebanese Government needs to renegotiate its debt obligation with its creditors to bring down the cost of debt servicing.

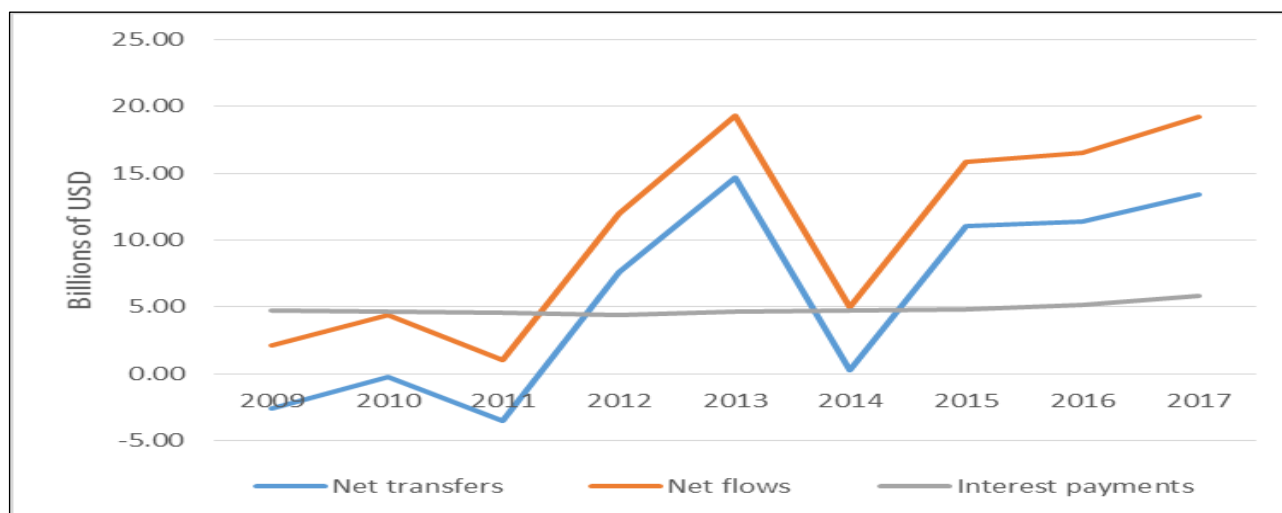
23. In April 2018, France hosted CEDRE, an international conference in support of Lebanon. The main objective of this conference was the development and strengthening of the Lebanese economy as part of a comprehensive plan for reform and infrastructure investments, as prepared by Lebanese authorities and presented at the conference. The outcome of the conference was \$11 billion of loans and grants for Lebanon by the international community. Lebanon can benefit from these funds once pledged reforms and sounder fiscal management are adopted. These funds will be accessed at lower interest rates, thus decreasing debt servicing for the Government and creating room for economic growth.

24. Despite a sharp increase in external debt for non-oil rich Arab countries, interest payments rose moderately. This indicates that most debt inflows and stockpiles entailed concessional elements and/or have long maturities. Moreover, Arab Governments have made use of an era where negative interest rates dominate (figure). According to the Global Sovereign Indebtedness Monitor, nine Arab countries (Egypt, Jordan, Lebanon, Libya, Mauritania, Morocco, Sudan, Tunisia and Yemen) are reaching critical debt levels.⁹

⁷ AMF, IMF, World Bank, Correspondent Banking Relationships in Arab Countries, 2019.

⁸ For the region as a whole, the average debt-to-GDP ratio (weighted) increased from nearly 33 per cent in 2008 to 46 per cent in 2016. The high GDP of oil-rich countries and their corresponding low debt to GDP significantly reduces the regional aggregate debt-to-GDP.

⁹ Erlassjahr, Global Sovereign Indebtedness Monitor, 2018.

Figure 5. Debt flows and transfers in non-oil Arab countries, 2009-2017

Source: Global Sovereign Indebtedness Monitor 2019; ESCWA based on International Debt Statistics, World Bank.

25. According to Dalberg’s regional director for the Middle East and North Africa, public debt financing must be used sparingly, especially in countries that are already at or approaching the brink of debt unsustainability. It is, of course, primarily the responsibility of developing countries to manage their debts, but it is also incumbent on lender countries and organizations, including China (which provided 44 per cent of the value of new loans to developing countries between 2013-2017), other bilateral lenders, the World Bank (the largest single source of multilateral credit, providing 18 per cent of total loans) and other development banks, to avoid creating situations where new lending drives countries to take on unsustainable debt levels;¹⁰ and to study the implications of issuing any further external sovereign debt bonds in national currencies instead of in foreign currencies.

26. A three-pronged strategy has been proposed to ensure that debt remains a viable means of sustainably financing the region’s development. The strategy should include the following: a strong component of multilateral debt relief to aid countries facing a heightened risk of debt distress; a structural and deleveraging component for non-oil exporting Arab economies (based on growth, raising consumption, and a return to normal interest rates/inflation); and a balance sheet deleveraging component to avoid the crowding out of the private sector, underinvestment and tightening liquidity (through debt repayment, asset purchases and restructuring private debt), and to overcome the adverse impact of de-risking that has led Arab banks to lose CBR with foreign banks, thereby hindering access to capital markets.

27. A key gap in the international financial architecture is the absence of a multilateral debt workout mechanism – a debt workout institution and a legal framework¹¹ – that can restructure the whole debt stock of a country in crisis in one single and speedy process. The mandate to do so already exists through the outcomes of financing for development (FfD) summits and resolutions adopted by the United Nations General Assembly, notably resolution 69/319. It is worth recalling that the International Civil Society Group on FfD rejected any normative hierarchy between loan contracts and human rights treaties, and stated that governments must prioritize human rights spending over debt service when allocating budgets.

¹⁰ Financial Times, Emerging markets face a new debt crisis, 12 March 2019.

¹¹ According to the 2019 Financing for Sustainable Development Report, “it is thus time to revisit existing mechanisms for debt workouts to determine ways to improve their efficiency. Areas ripe for progress may include exploring ways to strengthen creditor coordination, and creditor and debtor dialogue, along with specific elements of debt workouts, such as standstills”.