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Item 6 (e) of the provisional agenda

The Arab Financing for Development Scorecard

Debt and debt sustainability

Summary

Overall, debt dynamics in the Arab region are in stark contrast with international trends. The only point in common has been record high external debt stocks. In 2015, while net debt flows into developing countries turned negative for the first time since the 2008 global economic crisis, the Arab region witnessed a surge in debt inflows. While borrowing by developing countries from official creditors (including the International Monetary Fund) has, in general, declined steadily since 2000, the contrary is true of the Arab region. The rise in global debt has been driven by private non-guaranteed and corporate short-term borrowings, whereas, in the Arab region, it has been due to the swelling of public and publicly guaranteed debt.

The political and security situation in the region has fuelled a rise in the cost of sovereign borrowing. Living with debt could have been a component of a policy for maximizing welfare, but for the “inconsistent trinity” that continues to challenge policy-makers: the impossibility of having a fixed foreign exchange rate, free capital movement and an independent monetary policy at the same time. Given the extent of inequality and injustice in the region, current debt trends may well have an adverse impact on intergenerational justice. Sustainable debt policy cannot be charity-based or dependent on exogenous and volatile sources of foreign currency-dominated external finance. The situation in the Arab region is incompatible with the global financing for development framework and achievement of the 2030 Agenda.

The present report looks at whether external debt offers a sustainable means to finance development and whether it should be encouraged at this time in the Arab region. Representatives of member States are invited to consider this report and comment thereon.

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Introduction

1. Commitments on debt sustainability and management contained in the Addis Ababa Action Agenda of the Third International Conference on Financing for Development (FfD), address the interdependent objectives of debt crisis resolution (including debt relief and restructuring) and debt crisis prevention (through the development of tools and analysis for prudent public debt management, the promotion of new financial instruments and improved reliability of debt data).
2. This report is concerned with debt crisis prevention, given that decision-making on sovereign borrowing rests with debtor countries themselves, and looks at whether debt financing is an appropriate means for funding development at this time in the Arab region.
3. According to the Inter-Agency Task Force on Financing for Development (IATF), excessive borrowing can crowd out private credit and investment, and brings about 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 quarters, such as the European Union, debt ceilings are favoured. Although 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, the general consensus is that debt is a claim on future wealth. 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, creating a debt spiral. That 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 debt crisis.
4. In order to determine what constitutes sustainable debt in a given country, the impact of global debt and capital market dynamics need to be factored in alongside statistical examinations measuring debt against macroeconomic performance aside from GDP. Thus, the first part of this report analyzes global debt dynamics and then provides an assessment of debt in the Arab region. The analysis is based on available longitudinal data and cross-sectional debt-time series. 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 yet captured by debt statistics) or announced plans to do so.

I. GLOBAL SITUATION

5. Today, the world is witnessing the biggest debt bubble in history. Global gross debt (public and private) reached \$152 trillion dollars in 2015, the equivalent of 225 per cent of global GDP. Both public debt (\$52 trillion) and corporate and private debt (\$100 trillion) continued to rise. The external debt stocks of developing countries totalled \$6.8 trillion in 2015.
6. The pace of private debt stock growth has been rising since the 2008 global economic crisis as a direct consequence of nominal interest rates turning negative (in other words, banks are being punished for not lending excess liquidity, a situation to be distinguished from negative real interest rates). The rise in global gross debt has been fuelled by social and economic losses (low commodity prices, subdued trade growth and volatile capital flows), environmental challenges (natural disasters, climate change and environmental degradation), and conflicts and humanitarian crises.

A. EXTERNAL DEBT FINANCING

7. The total external debt of developing countries reached its highest levels by the end of 2014, with long-term debt constituting nearly three quarters of their external debt stock and 78.8 per cent of it owed to private creditors. Short-term debt amounted to \$1.8 trillion in 2014, a 60 per cent increase compared with 2010. In 2015, the external debt stock began to decline for the first time in two decades. That was mainly driven by debt repayments of \$184 billion, debt forgiveness and the relative downward effect of debt denominated in currencies other than the United States dollar.

8. Debt-to-GDP ratios in developing countries have been rising steadily since 2008, reaching an average of 26 per cent of GDP by 2015. That ratio is modest compared with levels reached in the early years of the twenty-first century. Declines in export revenues and widening public deficits driven by slow growth and commodity price slumps have triggered greater demand for external financing and led to significant increases in the external debt-to-GDP ratios. From the standpoint of debt sustainability, it is important to consider that debt remains multidimensional. Its analysis should factor in the composition of the debt stock itself and debt service outflows in relation to the country's capacity to repay arrears (for example, external debt as a percentage of GDP, national income and export revenues; and debt per capita).

9. While borrowing by developing countries from official creditors (including the IMF) shrank from 35.7 per cent to 13.6 per cent as a share of total external debt between 2000 and 2015, private external borrowing increased steadily, with the share of private non-guaranteed debt (bond issuances) in total external debt increasing from 0.6 per cent in 2005 to 6.9 per cent in 2014. The fall in borrowing from the IMF was associated with an aversion to that institution's lending conditions. The increase in private debt coincided with a rise in the share of short-term debt in total external debt, which reached 33 per cent in 2013, before easing to 27 per cent in 2015.

10. External debt repayment by developing countries has increased as a portion of government revenue and has reached its highest level since 2007. Average payments across 122 developing countries are said to have increased from 6.7 per cent of revenue in 2014 to 9.7 per cent by 2016. That represents a hefty 45 per cent increase in debt service outflows, according to the Jubilee Debt Campaign. Net debt flows to developing countries in 2015 turned negative for the first time since 2008. According to IMF International Debt Statistics, developing countries witnessed net debt outflows worth \$184 billion in 2015, a stark contrast to net inflows of \$542 billion in 2014.

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 can reduce currency mismatches for borrowers. The IATF noted in its 2016 annual report that, as a result of the increased volume of domestic sovereign debt, it has become increasingly important to address how sustainable bond issuances can be used in case of fiscal space distress and/or in case of difficulty in maintaining regular debt service payments.

12. As an alternative, the Action Agenda encourages the use of innovative financial instruments. Two schemes have been found to have 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 financing instruments. The latter involve contractual provisions that make debtor's obligations contingent upon pre-defined events or data outturns. They are therefore designed to provide automatic, market-based protection against pre-defined shocks and/or remain contingent on macroeconomic performance.

13. Islamic finance in sharia-compliant instruments has gained considerable traction over the past decade. Some \$2 trillion has been mobilized through such instruments, and the total is expected to double by 2020. Some three quarters of the industry is concentrated in the Arab region. *Sukuk* issuances (Islamic bonds) make up 15 per cent of the Islamic finance industry. In 2014, they were estimated at \$295 billion globally by the Union of Arab Banks. Since 2010, they have grown at an annual rate of 20 per cent. The Islamic Development Bank has also been exploring the use of Islamic social finance channels, namely *zakat* (mandatory alms-giving), to mobilize additional resources to finance social safety nets and associated infrastructure. In 2015, the total *zakat* circulating annually was estimated at between \$232 billion and \$560 billion.

14. Other innovative proposals for channelling development finance include: taxes on currency and financial transactions; carbon and greenhouse emission taxes; air passenger levies; cap and trade schemes; and the leveraging of special drawing rights (SDRs).

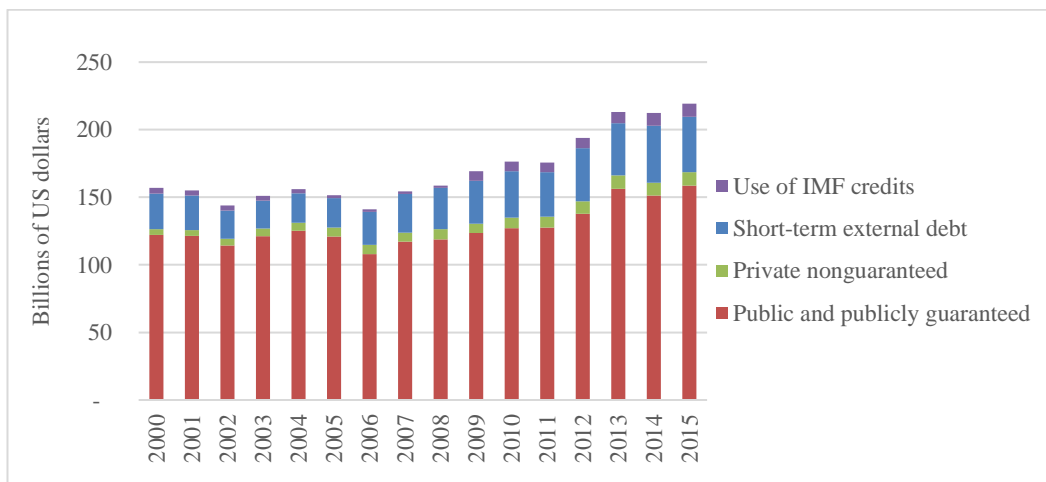
15. In 2010, the United Nations estimated that more than \$100 billion per year of “idle” SDRs in reserve-rich countries could be converted into long-term development finance. By one estimate, taxing CO₂ emissions could raise as much as \$1.9 trillion annually.¹ An additional \$100 billion per year could be mobilized if pledges for additional resources to support climate mitigation and adaptation are met by 2020. It has been estimated that a currency tax of half a basis point on all trading in the four major currencies (the dollar, euro, yen and pound sterling) would yield \$40 billion per year.

16. There is renewed interest among policymakers in benefitting from State contingent debt financing instruments. GDP-indexed bonds could help to mitigate the growing vulnerability of the external debt positions of developing countries. However, such instruments are contingent on investor confidence and their appeal would hinge on assigning them wide interest differentials. The drawback is that an issuing country may face higher repayments if its GDP rises after the date of issuance. Nonetheless, by adopting GDP debt indexation, the debt service-to-gross national income (GNI) ratios of developing countries move more closely to their GNI, which improves their ability to pay off debt.

II. REGIONAL DYNAMICS

17. According to the United Arab Emirates Ministry of the Economy, total foreign debt in the Arab region reached \$922 billion in 2015. The Economist Intelligence Unit puts it at \$987 billion. International debt statistics published by the World Bank in 2017 show that the total external debt stock owed by nine non-oil Arab economies (including short-term debt, long-term private non-guaranteed debt, long-term public and publicly guaranteed debt, and IMF credits) peaked at \$215 billion in 2015 (figure 1). That figure is just over the \$210 billion in financing provided to the United States of America by Kuwait, Saudi Arabia and the United Arab Emirates through their holdings of Treasury Bills.

Figure 1. External debt stock of non-oil economies, Arab region (2000-2015)



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

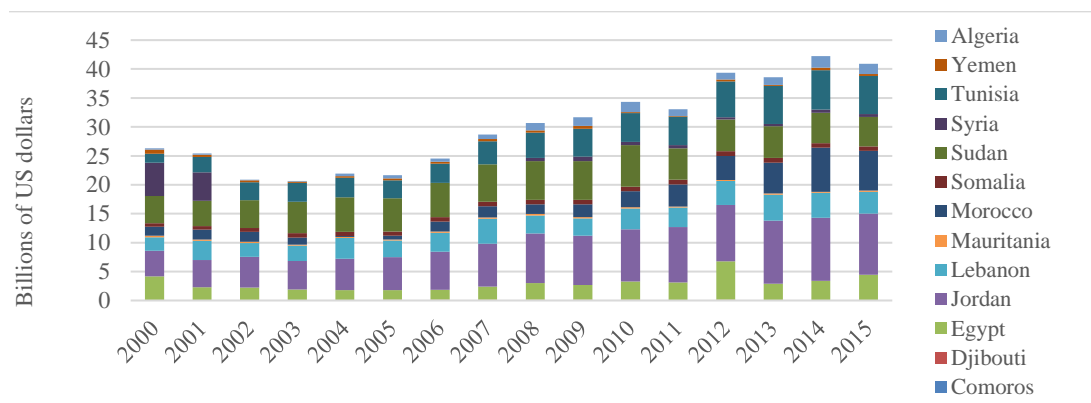
¹ Michael Jakob and others, “Using carbon pricing revenues to finance infrastructure access”, working paper No. 94 (Milan, Italy, Fondazione ENI Enrico Mattei, 2016), p. 22. Available from <http://services.feem.it/userfiles/attach/201511241149154NDL2015-094.pdf>.

18. 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 is \$22 billion. In reality, that country's debt stood at \$50 billion in 2015. Under the "zero option" agreement, the Sudan is to retain all external liabilities after the secession of South Sudan, provided that the international community commits to deliver debt relief. Absent such commitment, the debt would be apportioned between the two countries according to a negotiated formula.

19. The case of Palestine is also complex. At a meeting of the Ad Hoc Liaison Committee for the Coordination of International Assistance to Palestinians, held in New York on 19 September 2016, urgent donor support was requested to address the financial and debt crises facing the Palestinian economy (a \$600 million financing gap and \$1.65 billion in gross external debt). That critical situation was not the result of excessive borrowing, but of the manipulation by Israel of the clearance revenue mechanism, which deprived Palestine of revenues and, according to the IMF, led Palestine to the brink of a debt crisis in 2015. Such complexities, along with those associated with conflict (Iraq and Yemen), civil war (Somalia and the Syrian Arab Republic), political transition (Egypt and Tunisia) and low oil prices need to be taken into consideration as a part of debt distress analysis.

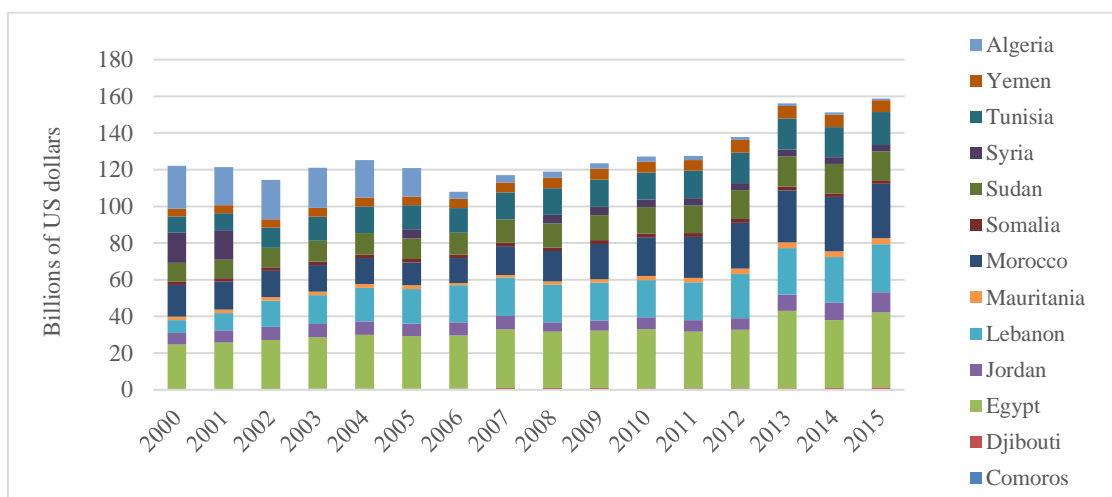
20. Public and publicly guaranteed debt represented 73.5 per cent of the Arab region's total external debt stock in 2015. Long-term debt is much higher than the average 36 per cent registered in other low and middle-income countries. Public external debt has been closely associated with the liabilities incurred and implicit subsidies received by large public sector enterprises, which remain heavily vested in financial markets through state-owned banks. Short-term external debt constitutes 18.2 per cent of the total debt in the Arab region, less than the 27 per cent average for developing countries (figure 2).

Figure 2. Short-term external debt stocks in the Arab region (2000-2015)



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

21. By the end of 2015, Egypt, Morocco, Lebanon, Jordan and Tunisia accounted for more than three quarters of all long-term public and publicly guaranteed debt held by non-oil producing Arab economies (figure 3). Morocco accounted for 58 per cent of private non-guaranteed external debt held by those countries, followed by Jordan (22 per cent) and Tunisia (13 per cent). They were also the top external borrowers of short-term debt, with Jordan accounting for 27 per cent, followed by Morocco (17.5 per cent) and Tunisia (16.8 per cent). With Lebanon, they ranked top among Arab economies to witness rising external debt per capita: ranging from \$5,300 in Lebanon to \$3,500 in Jordan.

Figure 3. Public and publicly guaranteed external debt in the Arab region (2000-2015)

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

22. Private non-guaranteed debt (long-term external obligations of private debtors that are not guaranteed for repayment by a public entity) represented 5 per cent of the total debt stock in the Arab region in 2015, compared with the significant corporate and private debt in developing countries, averaging 35 per cent. That situation may indicate that Arab private sector operators have not fully exploited capital markets and/or have been inadequately positioned to tap them in the face of competition from higher yielding assets in emerging markets. However, according to a report by the Arab Monetary Fund (AMF), it can also be attributed to: sluggish growth; the crowding out of private sector borrowing by the increasing issuance of public debt; the rising value of the US dollar and associated growth in interest rate differential spreads; and pressures to devalue currency faced by 10 Arab countries, most of them non-oil producers. Other reasons include increased transfer risk and exchange rate restrictions that may have prevented the repayment of obligations.

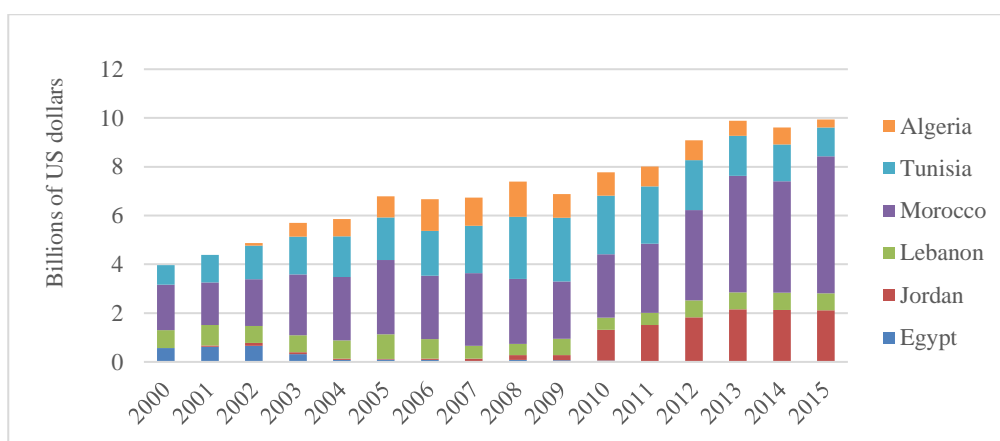
23. The situation also points to increased “de-risking”. Since 2008, the declining appetite for risk among international financial institutions and tighter global scrutiny of money-laundering have fuelled a tendency to de-risk. Institutions may pass on the cost of heightened regulatory scrutiny to private customers in the form of higher fees, restricted credit, and fewer services and products. Businesses unable to absorb the added burden may, in effect, see services discontinued and their financial exclusion increased.

24. In the Arab region, access to formal credit is less than half the global average and remains an obstacle to expansion of the private sector. According to a survey produced in 2013 by the World Bank and the Organisation for Economic Co-operation and Development (OECD), firms identified access to credit as the second greatest deterrent to doing business in the Arab region. That finding is reiterated in successive World Bank Doing Business reports, which confirm that securing business funding is hindered by the poor coverage, scope and quality of credit information available to banks, and by the quality of the legal and regulatory frameworks.

25. More disturbingly, according to a joint IMF-AMF survey released in 2015, 39 per cent of the surveyed 216 Arab banks had experienced a significant contraction in the scale and breadth of their correspondent banking relationships (CBRs) between 2012 and 2015. The level of account closures also appears to be increasing, with 63 per cent of Arab banks reporting the closure of CBR accounts in 2015, as opposed to 33 per cent in 2012. The termination or restriction by financial institutions of CBRs with banks operating in the Arab region has been associated with: the loss of risk appetite on the part of those institutions; changes in legal, regulatory or supervisory requirements in them; the unprofitability of certain CBR services and products; and the sovereign credit risk rating in Arab countries.

26. The relatively stable share of private non-guaranteed debt in the Arab region is not necessarily a guarantee against currency mismatches (figure 4), as when the US dollar appreciates because of an interest rate differential or when national currencies depreciate. A rising dollar not only drives up the cost of servicing debt, but means that more domestic currency has to be posted as collateral. According to the IMF, every annual percentage point increase in the private debt-to-GDP ratio increases the probability of financial crisis by 0.4 per cent. It has been said that the increase in private debt in Morocco between 2014 and 2015 would have raised the probability of government de-risking measures by 9 per cent had that country been subject to an economic shock.

Figure 4. Private non-guaranteed debt in non-oil Arab countries (2000-2015)

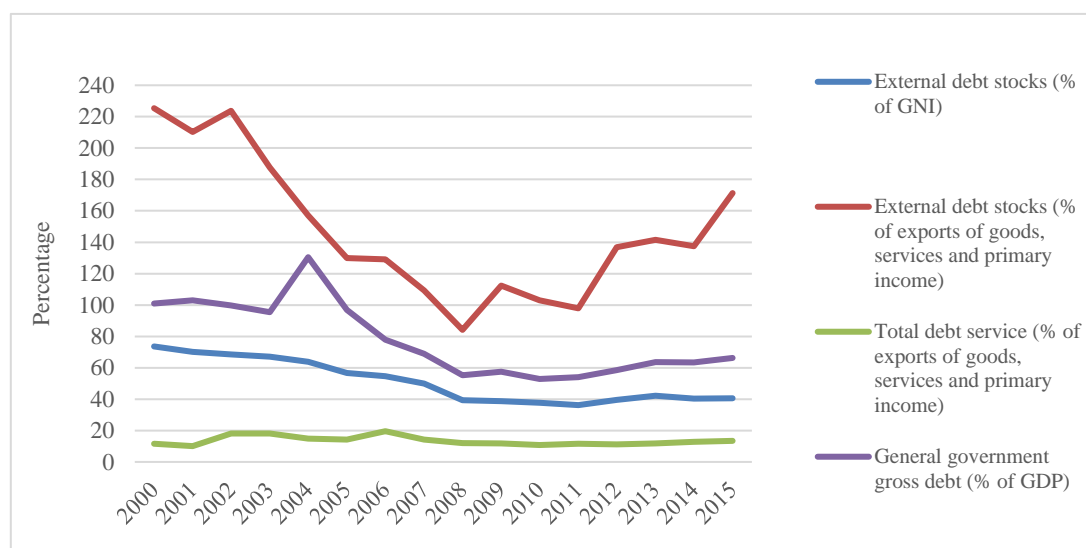


Source: ESCWA based on International Debt Statistics, World Bank.

27. As a percentage of GDP, total external debt in the Arab region increased by nearly 25 per cent between 2011 and 2015. That figure disguises still more significant increases in the debt-to-GDP ratio registered by a number of Arab least developed countries, including Djibouti (70 per cent) and Mauritania (71.5 per cent). Among low and middle-income Arab economies, the debt-to-GDP ratio for Tunisia and Lebanon has risen steadily since 2011, reaching record highs of 64 per cent and 57.6 per cent in 2015 respectively, according to the AMF. Egypt maintained the lowest debt-to-GDP ratio of the region's non-oil economies. In Morocco, the comparatively low debt-to-GDP ratio of 32 per cent in 2015 nevertheless represented an increase of more than 40 per cent since 2011.

28. Debt-to-GNI ratios in the Arab region have been rising steadily and in 2015 reached a level one and half times higher than the average registered for developing countries (25.8 per cent). Only Egypt maintained a significantly lower ratio (14 per cent). Jordan, Lebanon, Mauritania and Tunisia have the highest debt-to-GNI ratios in the region, albeit only Mauritania, Morocco and Tunisia witnessed deteriorations of more than 5 percentage points between 2011 and 2015.

29. Using relative debt weights against different macroeconomic performance measures, the weighted external debt to proceeds from exports and primary income in the region amounted to 171 per cent in 2015 (figure 5), compared with an average of 97.8 per cent for low and middle-income countries. Since 2011, the external debt to-GNI, debt-to-exports and gross government debt-to-GDP ratios in Arab countries have all risen.

Figure 5. Weighted average debt ratios in the Arab region (2000-2015)

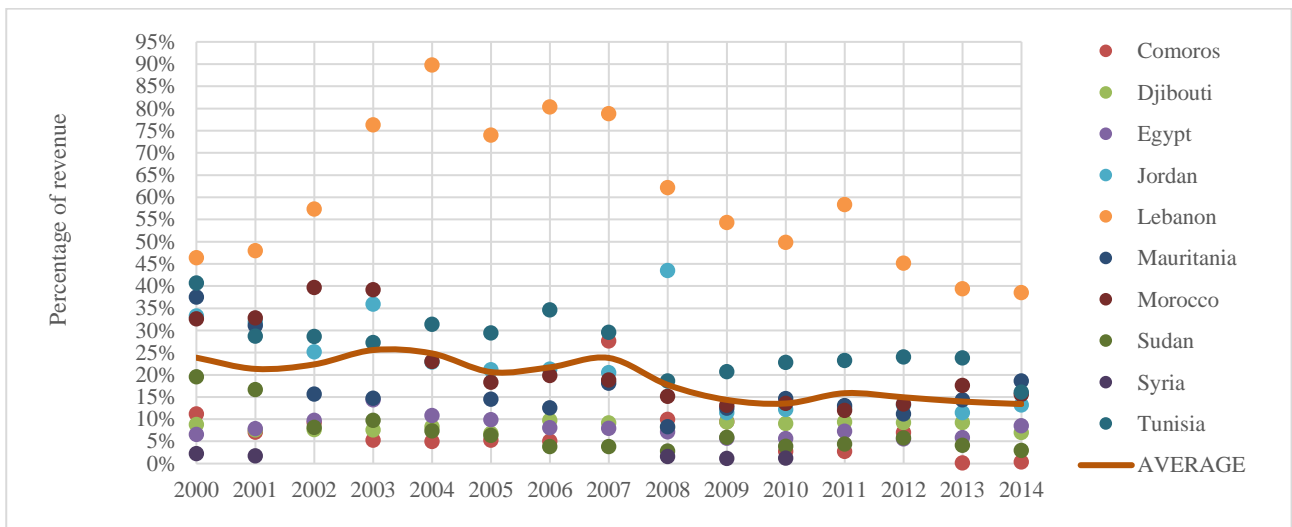
Source: ESCWA based on International Debt Statistics, World Bank.

30. However, when debt service is indexed to provide an indication of repayment and sustainability potentials, Lebanon stands out. Its ratio of debt service to government revenue (excluding grants) reached 40 per cent by 2015, well above the regional average of less than 15 per cent. Nonetheless, that relatively high ratio represents a significant drop from 89 per cent in 2004, which was largely attributed to high gross domestic debt. At the time, Lebanon's external debt had increased due to the sovereign and commercial borrowing arrangements that resulted from the Paris II Conference, which took place on 23 November 2002. The steep drop in the debt service ratio ensued from the rescheduling of maturities and decreases in lending costs due to the Paris aid package and following a 28 per cent increase in government revenue (as a result of the 2002 reforms that witnessed a widening of the tax base, improvements in tax administration and the introduction of value added and consumption taxes). Thus, while debt accumulation continued at a slower pace (due to high interest rates on domestic debt), the debt-to-revenue ratio remained more or less stable (as the Central Bank intervened to buy government treasury bills and resell them at discounted rates, temporarily bearing the cost of such a spread).

31. This is confirmed by external debt servicing as a percentage of export revenue, which, at 18 per cent in 2015, was less than the average five-year trend for that country. Indeed, the IMF and other international financial institutions have concluded that a debt-to-GDP ratio of 185 per cent in Lebanon is "less alarming than in other countries" and that, with broad money supply (M3) at nearly three times the size of GDP, it is possible to allow for higher debt-to-GDP ratios (albeit for a transitional period only) without the risk of imminent collapse. Broad money supply in Lebanon stood at 2.6 times its GDP in 2015. The situation is slightly different, however, in Jordan, Mauritania and, to a lesser extent, Tunisia, where the debt service-to-government revenue ratios have been increasing in tandem with rises across several other indicators, including debt service to exports, the debt stock to GNI, debt to reserves and external debt per capita (figure 6).

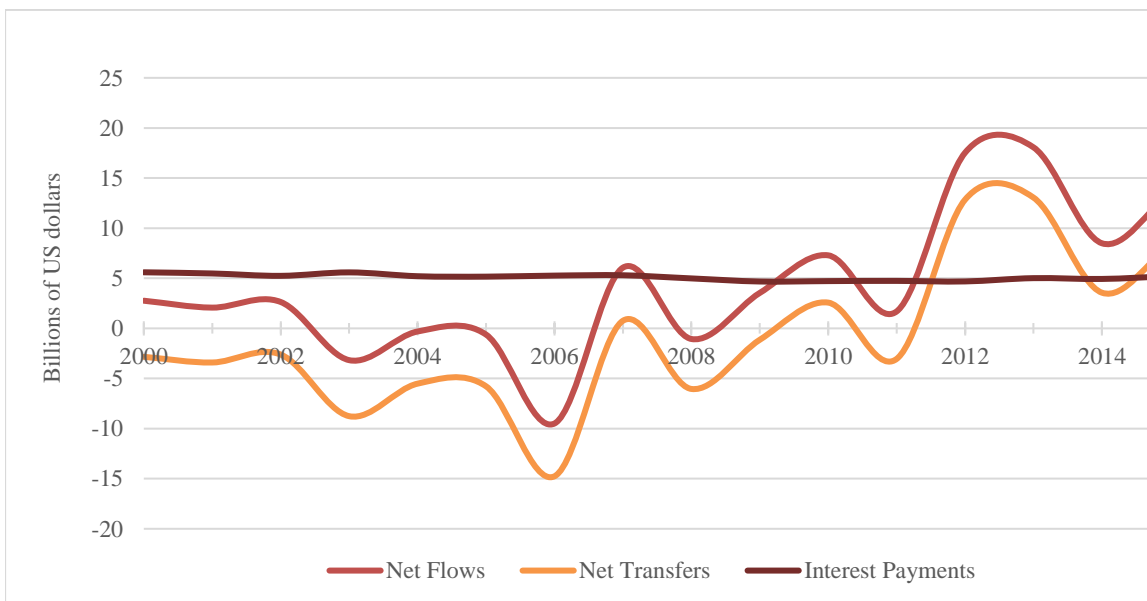
32. In 2015, market-based debt (bonds) constituted nearly 95 per cent of public and publicly guaranteed debt in Lebanon, as opposed to 7.5 per cent in Egypt, 50 per cent in Jordan, 17.5 per cent in Morocco and 24 per cent in Tunisia. They are among the few non-oil economies in the region that were able to leverage debt financing from international markets unassisted, albeit not free from an interest rate spread. At a time when official development assistance (ODA) from OECD Development Assistance Committee members and non-DAC ODA is withering, some argue that external debt could be leveraged by contracting it at concessional rates from multilateral institutions, or with the assistance of loan guarantees, as in the cases of Egypt, Jordan and Tunisia.

Figure 6. Debt service as a portion of revenue in non-oil Arab countries



Source: ESCWA based International Debt Statistics, World Bank.

Figure 7. Debt flows and transfers in non-oil Arab economies



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

33. By calculating the net transfers on external debt, the analysis reveals that, since the turn of the century, the Arab region for the most part witnessed net outflows until 2011 (figure 7). The accumulation of external debt from 2011 was associated with a moderate increase in interest repayments (10 per cent on average between 2011 and 2015), indicating that net debt inflows have mostly come in the form of concessional aid or lending. However, in the same period, it was found that, on average, for every dollar of public and publicly guaranteed debt borrowed in the Arab region, \$2.19 were paid back as principle and interest arrears on the outstanding debt stock.

III. OBSERVATIONS AND CONCLUSIONS

34. There can be no one-size-fits-all norm regarding a sustainable level of external debt stock, and relying entirely on debt-to-GDP ratios as a measure can be misleading. At one point, the debt-to-GDP ratio in Japan reached a high of 247 per cent, yet debt remained relatively benign in relation to its macroeconomic foundations and growth resilience. Argentina (2001), Greece (2009) and the Russian Federation (2014) faced sovereign debt crises with considerably lower debt-to-GDP levels at 127 per cent, 152 per cent and 35 per cent, respectively. Some have argued that, as long as the debt-to-GDP ratio remains fairly stable over the medium term, debt stock is sustainable irrespective of its level. The World Bank considers foreign debt to be unsustainable when its ratio to export revenues exceeds 150 per cent, which would suggest that the exposure to external debt of all Arab non-oil economies is unsustainable. The IMF considers that countries seeking access to its resources and in which the projected debt-to-GDP ratio exceeds 50 per cent, with a current or projected gross financing needs-to-GDP ratio above 10 per cent, require close scrutiny.

35. Each sovereign debt crisis is driven by its own debt and growth idiosyncrasies. However, one common feature that emerges from the study of debt crises around the world during the past century is that they were all preceded by a rise in private and corporate debt, in absolute terms and in relation to GDP. Once accumulated, private debt can constrain demand and eventually lead to a loss of confidence (downgrade in credit worthiness). The situation can be aggravated, as was the case with the eurozone crisis that began in 2009, when this is coupled with massive cross-border capital outflows that trigger interest rate hikes and/or currency depreciations that raise the cost of servicing debt and feed inequality.

36. The growth trajectory of private and corporate debt in the external debt profiles of non-oil producing Arab countries may seem benign, as it has remained relatively stable over the years, unlike in a number of emerging economies. The ratio of private non-guaranteed and short-term debt to GDP in Egypt, Morocco, Lebanon and Tunisia is much lower on average than in low and middle-income countries globally. The exception is Jordan, where the ratio amounted to 33 per cent in 2015. In other non-oil Arab economies, private debt has been close to non-existent, a situation that, however, reveals another predicament: the private sector's inability to tap capital markets.

37. The political and security situation in the Arab region has effectively raised the cost of public borrowing. The increase in sovereign bond spreads and associated rise in debt and in the cost of debt servicing have been amplified where large net foreign liabilities and large foreign currency debts exist. Third party debt guarantees go some way to mitigating the situation, dampening the spreads on external bond issuances. Some Arab countries, such as Egypt and Morocco, have resorted largely to domestic currency bond issuances to finance their fiscal deficits. However, excessive domestic debt is associated with high interest rates, which reduce the level of private fixed capital formation and crowd out private and foreign direct investment. External debt assessments therefore need to factor in three other priority areas of the Addis Ababa Action Agenda: fiscal space and domestic resource mobilization; international development cooperation; and international private finance.

38. In deciding whether external debt should be encouraged, beyond current levels, in order to finance sustainable development (through Keynesian-type public investment and/or increased social expenditures), the social returns on such investment/expenditure need to be weighed against the possible rise in sovereign spreads and costs associated with growing public or external debt. The question needs to be asked: will the level of external debt put a country on the wrong side of the debt Laffer curve (when the accumulation of debt beyond a certain ceiling adversely affects growth)? Moreover, the investment (capital or social) is subject to diminishing returns, and their intensity remains contingent on whether there is a need to raise taxes to service the higher demand for external debt (in other words, a U-shaped debt Laffer curve with different tipping points for different economies).

39. Arab economies face the double jeopardy arising from high external debts stocks, costly debt servicing and, at times, even higher public domestic debt. It has already been noted that domestic borrowing, although

limiting currency risk, can generally carry a higher interest rate than bilateral official financing and international market borrowing, and excessive domestic borrowing can provoke a domestic banking crisis, and crowd out private credit and investment.

40. An “inconsistent trinity” influences debt management strategies in Arab countries and their ability to maintain: a fixed/managed exchange rate or price stability (in order to reduce exchange rate risks and manage debt burdens); sovereign debt sustainability based on free capital flows (reducing reliance on foreign borrowing and anchoring the issuance of local bonds); and independent monetary policies or financial stability. In order to retain access to international capital markets, economies have to choose between reducing currency risks by stabilizing the exchange rate, thereby hitching interest rates to foreign rates and forgoing autonomous monetary policy, or stabilizing the domestic economy by adjusting interest rates to domestic conditions, but letting the exchange rate fluctuate.

41. The analysis shows that, by 2015, several non-oil Arab economies were showing signs of debt distress as many breached their historic averages in all but a few debt indicators:

(a) At one extreme, Djibouti, Mauritania, Somalia, the Sudan and Yemen show high levels of distress, alongside debt service fatigue (debt-to-export proceeds in those countries ranged between 193 per cent and 430 per cent). The deteriorating terms of trade in Mauritania led its debt service-to-exports ratio to an all-time high of 215.5 per cent in 2015. Djibouti, Somalia and the Sudan require debt relief measures to regain access to external financing (as in the case of the Comoros, which was granted a debt relief package that resulted in a decline in all of its debt and debt service indicators). External debt in those economies is unsustainable, as reflected by the continued stockpiling of late arrears;

(b) The external debt exposure of Lebanon is also leaning to the high-risk end of the spectrum. That is reflected in the growing spreads that have come with consecutive credit downgrades as a result of the country maintaining the highest ratios of debt to GDP, GNI and external debt per capita in the region. Debt service consumes nearly 40 per cent of government revenues and remains highly sensitive to the volatility of remittance inflows and the domestic financial sector’s willingness to buy government debt. With soaring debt service, the refinancing cost associated with extending the maturities of domestic short-term debt would be substantial, leaving limited room to consider an excessive external financing or borrowing strategy;

(c) In Jordan, private and short-term debt have been rising in absolute terms and in relation to its overall debt stock, leading to hikes in risk premiums matching those experienced by advanced emerging economies. Gross debt in Jordan witnessed successive leaps over the five years to 2015. The rising public domestic debt stock seems to be restraining growth recovery and private investment. Structural adjustments and fiscal consolidation are needed to boost growth and generate sufficient revenues to service debt;

(d) Tunisia remains vulnerable to exchange rate swings that could translate into higher debt service burdens. The country’s external vulnerability indicators worsened by 50 per cent in the five years until 2015. External debt stock in relation to GDP, GNI and export revenues is among the highest in the region and has deteriorated since 2011. Nonetheless, Tunisia has announced plans to explore the appropriateness of further external borrowing, given growing financing needs;

(e) Of the non-oil producing Arab countries, Egypt holds the largest external debt stock, mainly in the form of medium to long-term public guaranteed debt owed to multilateral institutions. Government domestic public debt denominated in foreign currencies (considered part of the external debt) holds a one-year maturity and is mainly held by State-owned banks. That situation creates interest rate and exchange rate risks for public banks and aggravates the debt burden (debt to export proceeds) and debt affordability (interest payments to government revenue). Because the country’s Medium-Term Debt Management Strategy advises against increasing foreign currency borrowings to deal with the fiscal deficit and carry out necessary social infrastructure spending, there are plans to increase external debt by 6 per cent, in order to raise between \$1.5 billion and \$3 billion a year until 2019;

(f) External debt in Morocco has been rising since 2012, but remains relatively low and sustainable at 32 per cent of GDP. Its external debt profile holds limited risks given the long maturities associated with its multilateral debt. However, debt stock in terms of GNI and export proceeds increased beyond their five-year average baseline. External vulnerability indicators remain resilient, however, as fiscal consolidation has progressed and inflows of foreign direct investment reduce the need for external borrowing. Strong export growth has also helped to lower the debt service-to-export ratio;

(g) In recent years, oil-exporting economies have faced growing fiscal deficits (which, according to the IMF, could reach \$565 billion by 2021). That problem has been addressed by running down reserves and through domestic bond issuances purchased by domestic banks (which have since witnessed declining profitability and tightened liquidity). External sovereign bond issuances and sukuk reached \$72 billion in 2016, more than five times their 2015 levels. Kuwait, Oman and Saudi Arabia plan to further tap international debt markets. Iraq, however, abandoned plans to issue sovereign bonds due to the prohibitive interest rates sought by investors. Indeed, the prospects for tighter global liquidity associated with a normalization of US interest rates and a weaker growth outlook would raise the cost of market-based issuances. Those conditions exacerbate the challenges facing the region and may lead to a growth in sovereign borrowing spreads. Sovereign yields on Gulf Cooperation Council US dollar-denominated bonds, for instance, increased by 10 basis points in 2016.

42. According to the Global Sovereign Indebtedness Monitor, 116 countries are showing signs that debt is reaching critical levels and the debt situation in 89 developing countries worsened in the four years to 2015. It cites Jordan, Lebanon, Mauritania, the Sudan, Tunisia and Yemen as being vulnerable and likely to witness renewed debt distress/crises.

43. A three-pronged strategy is essential to ensure that debt remains a viable means of sustainably financing the region's development. It should include: a strong component of debt relief mustered multilaterally to aid countries facing a heightened risk of debt distress; a structural and deleveraging component for non-oil 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), as well as to overcome de-risking practices that have compelled Arab banks to curtail CBRs with foreign banks, thereby hindering access to capital markets.
