SERD POLICY TALK (SPOT)

EVENT SNAPSHOT

MANAGING DEBT SUSTAINABILITY RISKS


People doing bank transactions during the COVID-19 pandemic in Cambodia (Photo by Chor Sokunthea).

BACKGROUND. The coronavirus disease (COVID-19) pandemic has severely disrupted global economic activities and reversed some of Asia's hard won economic and development gains. Global output contracted by 3.3% in 2020. (IMF 2021) In Asia, $1.3 trillion of output and 61 million jobs were lost due to the pandemic. About 78.3 million people also joined the ranks of the extreme poor—most of them in South and Southeast Asia—as economic activities slowed. (ADB 2020)

Global debt levels have soared as governments pursue fiscal stimulus measures to mitigate impacts of the crisis. By the end of 2020, the global debt stock—both publicly- and privately-held debt—had increased by $24 trillion to $281 trillion. The global debt-to-gross domestic product (GDP) ratio hit 355.8%, rising by 35 percentage points, more than double the increases observed in 2008–2009 during the global financial crisis (GFC). During the same period, emerging Asia accounted for about a quarter of the global debt and its debt-to-GDP ratio surged by 32 percentage points to reach 298% of GDP.

In 2020, the Asia COVID-19 response reached $3.6 trillion, equivalent to about 15% of the region's GDP. As a result, the aggregate fiscal-deficit-to-GDP ratio in the region also increased from 5.0% in 2019 to 9.8% in 2020. In turn, the average government debt-to-GDP ratio in Asia rose by 9 percentage points to 64.7% in 2020. The ratio has already reached worrying levels in some countries, including Sri Lanka (100%), India (90%), Pakistan (87%), and the Lao People's Democratic Republic (Lao PDR) (68%).

CHALLENGES. Rapidly expanding debt can harm financial stability and undermine economic recovery. While debt can play a critical role in buttressing the economy in the wake of COVID-19 shocks, incurring debt beyond sustainable levels will restrict fiscal space and may stop an economy from meeting all its current and future financial obligations. Excessive levels of debt will also crowd out resources that are meant for infrastructure investments or human capital development that are the bedrock of long-term growth.

Corporate and household debts have also risen rapidly in some Asian economies, facilitated by the low interest rate environment that has persisted since the GFC. This trend is expected to continue with fiscal stimulus measures, accommodating

About **SPOT**

The ADB Southeast Asia Department features conversations on new ideas and developments beyond office walls. SPOT aims to inspire people to explore issues outside their normal area of work, encourage active interaction among the participants, and ignite debate from varied perspectives and approaches.

Event **Details**

Focusing on Debt Sustainability

24 June 2021, 3 .00 pm-4.00 pm (Manila time)
via MS Teams

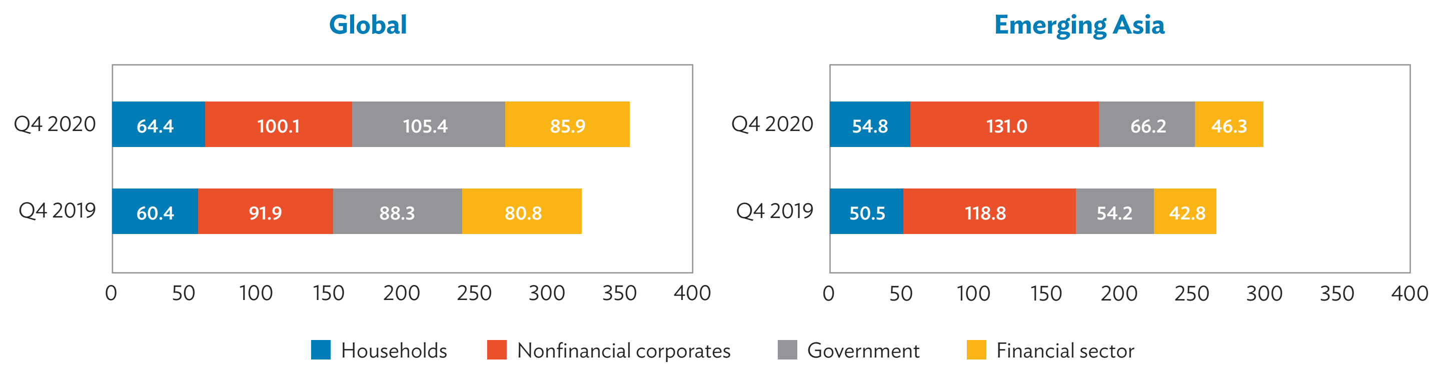
Speakers:
Lei Lei Song
Regional Economic Advisor,
SAOD

Peter Rosenkranz
Economist,
ERCI

Jhelum Tini Thomas
Senior Public Management Specialist,
SEPF

Moderator:
James P Villafuerte
Senior Economist, SERC

IMPACT OF COVID-19 ON DEBT-TO-GROSS DOMESTIC PRODUCT RATIOS



Note: Emerging Asia includes: People's Republic of China; Hong Kong, China; India; Indonesia; Malaysia; Pakistan; Philippines; Republic of Korea; Singapore; Thailand; Viet Nam.
Source: Institute of International Finance Global Debt Monitor, February 2021

monetary policy, and emergency liquidity support, pushing real interest rates to zero and possibly into negative territory. Non-financial corporate debt levels have reached 124.5% in Singapore and 122.7% in Viet Nam. Household debt-to-GDP ratios have reached 81.1% in Thailand and 68.2% in Malaysia.

Another key risk is the region's reliance on US dollar funding. An examination of the relationship between private debt and an index of currency stress—a proxy of financial vulnerability—found that a country with private debt-to-GDP ratio at the top 25% of the sample suffered 12.6 percentage points more depreciation than a country with low private debt (at the bottom 25%), other things being equal. Other studies also pointed to the significant association between public debt and financial vulnerability during periods of financial stress.

KEY MESSAGES. To manage increasing debt vulnerability risks, governments need to consider these actions: (i) address immediate liquidity risks, (ii) pursue greater coordination within government, (iii) consult with external stakeholders, (iv) revise the debt management strategy and borrowing plan, (v) enhance risk monitoring, and (vi) strengthen fiscal and budget management principles. In addition, it is critical that governments improve their monitoring of existing contingent liabilities, including the debt servicing profile, especially during crisis periods.

While managing debt sustainability is important, fiscal consolidation should be carefully calibrated and implemented in a phased manner. There are lessons in 2008 that need to be learned and governments should call for a return to fiscal "discipline" only after solid recovery takes hold. The COVID-19 resurgence across Asia means that spending for vaccines, medical supplies, and social assistance needs to be prioritized to contain the pandemic and to vaccinate a large proportion of the population. Only after tackling the health crisis can Asian economies start to normalize and grow again. Once the recovery is well underway and economic growth has normalized, the region can start to consolidate fiscal positions, introduce structural tax reforms, and reduce debt levels.

Loan restructuring and lackluster economic growth will affect the quality of loans and lead to more nonperforming loans (NPLs). Thus far, temporary financial relief extended to the corporate sector has prevented a significant build-up of NPLs, but once this is phased out or interest rates rise because of tightening monetary policy in the US, the sectors that were hardest hit by the pandemic will once again suffer the brunt. Governments need to prepare and strengthen NPL resolution mechanisms and develop NPL markets to allow for a swift disposal of banks' NPLs as they rise.

Public and private debt are interrelated as private debt booms and busts may force governments to bail out troubled financial institutions. It is critical that countries maintain sufficient levels of foreign exchange reserves and that they strengthen such financial safety nets as bilateral and multilateral currency swap arrangements, which can provide emergency dollar liquidity in times of crisis. Governments should also consider putting in place a broader regulatory framework encompassing both public and private debt.

ADB Support

The ADB supports fiscal sustainability and public finance management (PFM) of its developing member countries, to manage debt sustainability risks. These include boosting revenue mobilization, strengthening budget-policy linkages, improving the quality of budget spending, and providing institutional and capacity building support to PFM. In the Philippines, ADB has provided support to strengthen tax and fiscal policy capacity on recent comprehensive tax reform programs as well as rationalizing tax incentives to ensure sustainability of reforms. In Indonesia, ADB has targeted reforms to improve the quality of government spending on key priorities on health, education, social protection, and infrastructure. In the Lao PDR, ADB has focused on reforms in public finance legislation, medium term fiscal forecasting and strengthening the budget cycle for more timely, effective information for policy makers. In Cambodia, ADB has aided the government to strengthen overall PFM systems in program budgeting, revenue strategy, debt management, and strengthening internal controls and audit.