Global Financial Fragmentation and External Debt Sustainability of Developing Countries

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Abstract

The international trade fragmentation and the rise of protectionism are fuelling the fragmentation of financial markets, which increases the cost of funding financial resources. The role of the US dollar in invoicing world trade is declining. There are disturbances in the functioning of the international monetary system (freezing of foreign exchange reserves as a form of financial sanctions, for example). New mechanisms and instruments of international payments, which are expected to reduce costs, as well as the growing use of cryptocurrencies and changes in US monetary policy, weaken the dominant position of the dollar in the international monetary system. The rising U.S. and other developed countries' interest rates increase the cost of servicing the external debt of developing countries. The share of short-term debt in the structure of the total external debt of developing countries is increasing. Due to the change in the structure of the external debt of developing countries and due to the increase in interest rates on the international capital market, the costs of servicing the external debt of developing countries are increasing. The burden of servicing the external debt is growing because more foreign currency is needed to meet external public debt obligations, and the share of external repayments in government revenues is also increasing. The external insolvency and illiquidity risks in these countries are increasing. The sensitivity of developing countries to external shocks is increasing. Some countries are serious candidates for restructuring the repayment schedules. It is necessary to quickly approach the consolidation of the external debt of those developing countries in order to avoid chain effects. The poorest developing countries have the strongest difficulties with external debt sustainability. The paper analyses the level of external indebtedness of developing countries and the external debt sustainability in the environment of growing protectionism and fragmentation of the international capital market.

Keywords: Financial fragmentation, external debt service, external debt sustainability, developing countries

1. Introduction

The position of developing countries in the international capital market is deteriorating as a result of geo-economic and financial fragmentation. The costs of raising funds in the international capital market are inceasing. With the increase in geopolitical distance between countries, these costs increase, so developing countries face increasing costs of new borrowing. Rising geopolitical tensions between major countries can lead to sudden reversals in cross-border capital flows, with greater negative consequences for developing countries than for developed economies. Although fragmentation may bring strategic advantages to some countries, it carries great costs in the aggregate (Aiyar and others, 2023). The reduction of cross-border capital flows after the global financial crisis was mainly due to the withdrawal of large banks to domestic markets (Lane and Milesi-Ferretti, 2018). Restrictions in the capital account have also contributed to the reduction in the volume of capital flows. Countries with less developed financial systems may be more vulnerable to geopolitical shocks because they have limited opportunities to absorb the adverse consequences of those shocks. Financial fragmentation can increase countries' vulnerability to adverse shocks by reducing their opportunities for international risk diversification. Most developing countries have a significant stock of external debt, the servicing of which requires more and more foreign exchange resources. The lower foreign exchange liquidity in those countries reduces their ability to repay external debts, which means that more delays in payments can be expected. The problems are all the greater because of the deterioration in the global economic climate. The rise in interest rates, primarily as a result of countries' efforts to suppress inflation through restrictive monetary policy, brings problems for countries, because services on external loans increase. Developing

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countries are also facing a decrease in export revenues, primarily those countries where raw materials are significantly represented in the export structure. Rising interest rates and fragmentation of the international capital market represent unfavourable circumstances for developing countries. A large number of these countries are forced to use short-term loans to pay off their external debt. Short-term loans carry higher interest rates and contribute to shortening the term structure of external debt. Some developing countries are preparing programs for rescheduling their external debt. External shocks and growing external debt servicing cannot be indefinitely amortised by existing foreign exchange reserves. However, countries that have a larger amount of foreign exchange reserves are less exposed to the risk of external insolvency and illiquidity. The larger foreign exchange reserves can help these countries to mitigate the adverse macro-financial consequences of sudden reversals in international capital flows. This implies that more attention should be paid to the diversification of foreign exchange reserves in order to reduce the risks of geostrategic fragmentation (Arslanalp et al., 2023). This paper points out the consequences of global financial fragmentation on the borrowing of developing countries and their external debt servicing performance. Conclusions are also presented on the external debt sustainability of developing countries and the consequences of developments in the international capital market for these countries.

2. Geopolitical Tensions and Fragmentation of the Global Financial Market

The growth of geopolitical tensions in the world in recent years has significantly contributed to the redirection of capital flows to countries with close political views. A lower level of agreement on various political issues between the countries that approve the loans and the countries that use them usually means a lower inflow of capital to the beneficiary countries[2]. According to IMF (2023) research, geopolitical tensions significantly contribute to the reduction of cross-border banking claims and international portfolio allocation (see Figure 1).

Figure 1 illustrates the results of the aforementioned IMF (2023) study, according to which an increase in the geopolitical distance between the creditor country and the country of beneficiary of funds in the amount of one standard deviation, leads to a drop in cross-border claims of banks by about 15%. Investment funds showed a greater degree of sensitivity to the same change in geopolitical distance, with a drop in cross-border investments by more than 20%. Apart from portfolio investments and banking capital, foreign direct investments also strongly react to geopolitical factors, with an increase in their sensitivity being registered in recent years (IMF, 2023a, Chapter 4). IMF research (2023) also found that countries with larger foreign exchange reserves and developed countries showed a lower degree of sensitivity to changes in geopolitical tensions.

[2] IMF (2023, p. 89) provides empirical evidence for this thesis.

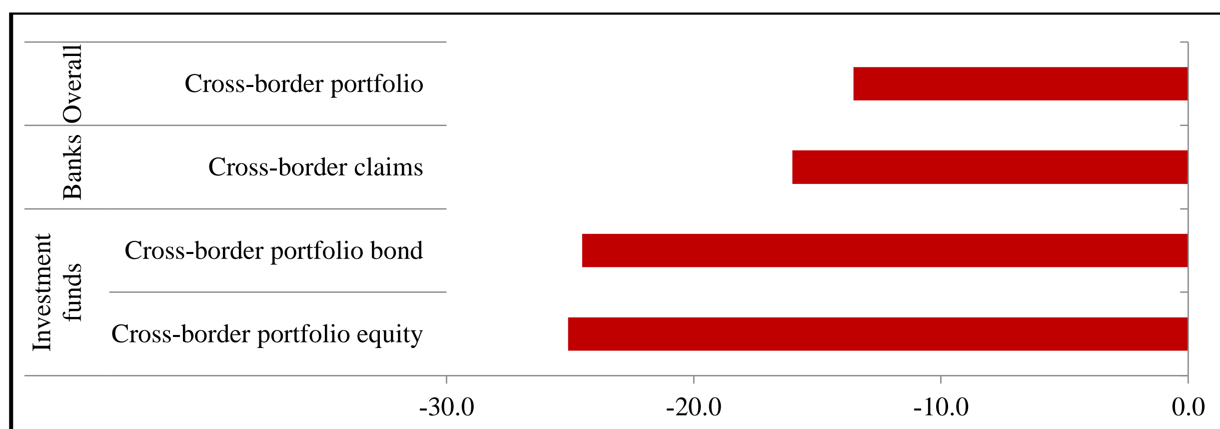

Figure 1: Change in cross-border capital allocation (percent)

Note: The data show a decrease in bilateral cross-border capital flows from the investing country to the capital receiving country, when the geopolitical distance between these two countries increases by one standard deviation during one year. Data for "Banks" do not include international financial centers according to Damgaard and Elkjaer (2017). Voting in the United Nation's General Assembly is used as a measure of distance between countries.

Source: International Monetary Fund, *Global financial stability report: Safeguarding Financial Stability amid High Inflation and Geopolitical Risks* (April 2023), Figure 3.7, Panel 1, p. 91.

For low- and middle-income developing countries, it is significant that the increase in geopolitical distance between creditors and debtors can lead to serious disruptions in the financial sector of debtors, through the growth of borrowing costs. Financial disruptions in the country can cause a decline in the value of the banks' financial assets, with high prospects for a decline in their profitability. In parallel with that, there is a disruption of macroeconomic stability. Sudden reversals in capital flows can further undermine the stability of the banking sector (IMF, 2023, p. 85). Countries that have already reached a significant inflow of foreign capital may face capital flight, and the remaining external debt will be more difficult to service. The costs of new loans will certainly be higher as a result of disruption of the domestic financial sector, due to the growth of risks that lenders include in the interest rate on the loan.

3. The External Debt Stock for Developing Countries

The total external debt of developing countries, according to the UNCTAD (2023) estimate, amounted to US$ 11.4 trillion in 2022, which is more than double the amount of debt a decade ago. The dynamics of borrowing increased during the COVID 19 pandemic.[3] Figure 2 shows the external debt stocks of low- and middle-income countries. The stronger growth of the external debt of these countries is observed after the global financial crisis 2008-2009. After a slight slowdown in 2015, the trend of growth in the external debt of these countries continued. The borrowing is accelerated in 2021. The external debt stocks of low- and middle-income countries nominally increased by 5.6 percent in 2021 (year-end total of US$9 trillion), which represents a jump of about US$0.5 trillion compared to the level in 2020) (Figure 2). The nominal increase in external debt was due to additional borrowing by these countries during 2021 to mitigate the consequences of the COVID-19 pandemic. It was necessary to compensate for the stopped inflow of foreign funds for the implementation of infrastructure projects. In addition, the emergence of trade restrictions on international trade has led to a slowdown in economic activity in these countries. Although the stock of external debt increased in 2021, this nominal growth of 5.6 percent was lower than the average annual increase of 7.9 percent

[3] See UNCTAD, Escalating debt challenges are inhibiting achievement of the SDGs, https://sdgpulse.unctad.org/debt-sustainability/ accessed 28/06/2023.

realised in the period 2010-1019. Over the past decade, the fastest increase in gross external debt was in China (about 262 percent between 2010 and 2021) (World Bank Group, 2022, p. 7). It should be noted that China is not only the largest borrower of foreign loans amongst low- and middle-income countries, but also one of the largest creditors of these countries. China has increased its concessional and non-concessional loans to low- and middle-income countries.

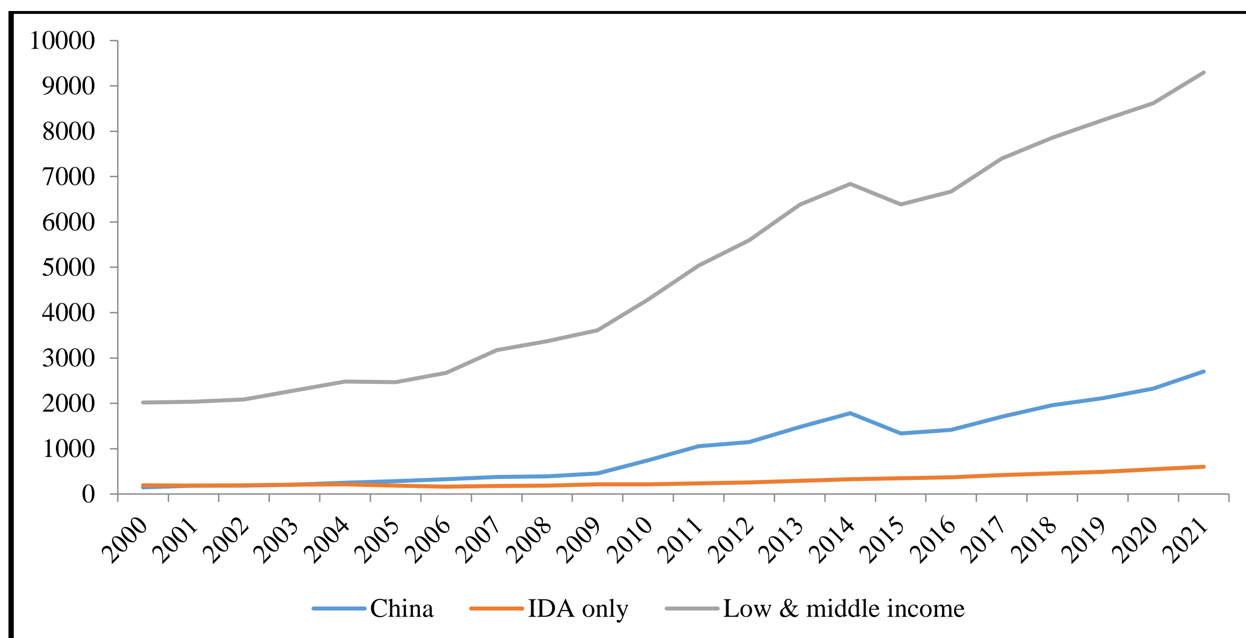

Figure 2: Total external debt stocks of low- and middle-income countries, 2000-2021 (Billion of current US dollars)

Note: Total external debt is debt owed to nonresidents repayable in currency, goods, or services. Total external debt is the sum of public, publicly guaranteed, and private nonguaranteed 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.

Source: Author based on data from the World Bank, which were taken from https://data.worldbank.org/indicator/DT.TDS.DECT.EX.ZS?view=chart Accessed 29/06/2023.

Figure 3 shows that the debt structure of developing countries worsened after 2009, as short-term indebtedness grew at a higher average annual rate compared to the average annual growth rate of long-term external debt. Therefore, the share of short-term external debt in the total external debt stock of developing countries increased from 24.2 per cent in 2009 to 27.7 per cent in 2022 (UNCTAD, 2023). Short-term loans have a changing dynamic and are largely dependent on the demand for trade loans. Trade loans and advance payments make up the dominant part of short-term debt. With the increase in imports, the use of short-term loans also increases. Regarding the long-term debt, the predominant part of the gross long-term public and publicly guaranteed external debt stocks of low- and middle-income countries in 2021 was private loans (61 percent at the end of 2021, and 46 percent in 2010). Much of this debt is due to increased bond issuance, with bondholders now accounting for about 47 percent of low- and middle-income countries' private debt (World Bank Group, 2022, p. 11).

Greater reliance on private creditors results in higher debt servicing costs, as well as difficulties in coordination during negotiations on easing the debt burden. The indebtedness of the private sector has also increased, and there is also an increase in the dependence of this sector on private sources of financing. Although these loans are not guaranteed by the state, the debt of private entities in foreign currency is ultimately a claim on the country's foreign exchange reserves. Namely, if private entities cannot hedge their foreign currency liabilities against foreign

currency denominated assets, then they are referred to domestic foreign currency reserves when repaying loans. Even in the case when the debt of domestic private entities to foreign creditors is in domestic currency, there may be a sudden reversal of loans, which may undermine external debt sustainability.

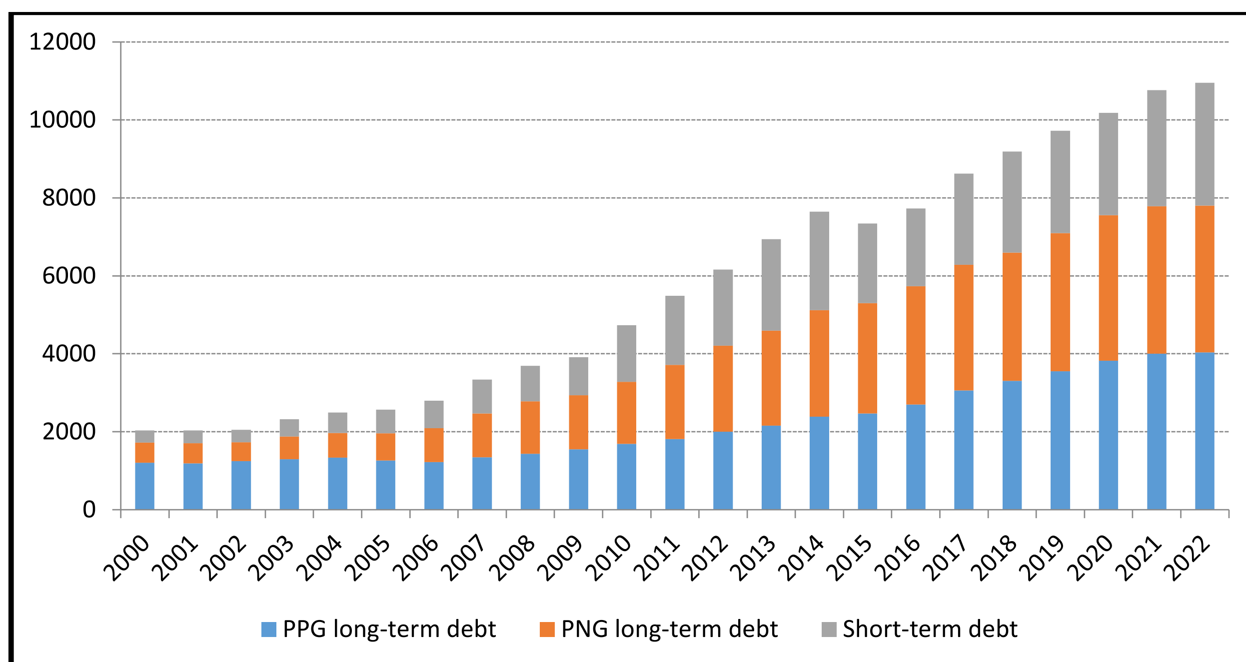

Figure 3: Total external debt of developing countries, 2000-2022 (Billions of current US dollars)

Note: Figures for 2022 are UNCTAD estimates. Data does not include IMF credit lines. PPG – Public and publicly guaranteed; PNG - private nonguaranteed.

Source: UNCTAD, Escalating debt challenges are inhibiting achievement of the SDGs, Figure 1. https://sdgpulse.unctad.org/debt-sustainability/ accessed 28/06/2023.

The external debt stocks of low- and middle-income countries are concentrated in a smaller number of countries. Eleven countries accounted for 72 percent of the gross external debt stocks at the end of 2021. A characteristic change in the concentration of low- and middle-income countries' external debt stocks is the increase in China's share of the total, which rose from 17 percent in 2010 to 29 percent in 2021. In 2021, the International Monetary Fund made (made) the largest allocation of special drawing rights (SDRs) to date, US$650 billion, to help countries overcome the crisis caused by the COVID-19 pandemic (World Bank Group, 2022, p. 8).

Table 1 shows the relationship between external debt and gross national income (GNI) by groups of developing countries classified by income level. The extreme growth of external debt took place in IDA-eligible countries and in low-income countries. For low-income countries, external debt as a share of GNI increased from an average of 17.1 percent in 2010 to 48.5 percent in 2021. This is a significantly higher increase than for middle-income countries, where the growth of that indicator was more moderate during the observed period.

The growth of this indicator means that poorer developing countries are allocating an increasing part of their national income to pay off their external debt. In this way, the participation of domestic accumulation in financing the economic development of those countries is reduced. The slowdown in economic development makes it difficult to make structural changes in the domestic economy in accordance with the trends in the world market. This reduces the country's competitiveness on the world market, which can affect the drop in foreign exchange earnings.

Table 1: External debt-to-GNI rations for income and lending categories, 2010 and 2019-21 (Percent)

	Year			
Country groups	2010	2019	2020	2021
Low- and middle-income	21.4	26.3	28.5	25.7
Excluding China	25.6	36.1	40.5	36.3
Income classification:				
Low-income	17.1	48.5	52.5	48.5
Middle-income	21.6	26.0	28.2	25.4
Lending classification:				
IDA-eligible (IDA only and blend)	20.0	32.8	36.8	36.2
IBRD	21.6	25.8	27.8	24.9

Note: See box O.2 (p. 5) in the table source for more information on World Bank income and lending classifications. GNI = gross national income; IBRD = International Bank for Reconstruction and Development; IDA = International Development Association.

Source: World Bank Group, *International Debt Report 2022*, 2022, Table O.1, p. 5.

The deregulation of the international financial market and the liberalisation of capital account in developing countries have created a suitable environment for borrowing abroad. The expansive monetary policy and low interest rates in developed countries have supported such an orientation in developing countries. The change in the structure of the total debt of developing countries and the growth of the total amount of external debt led to an increase in the cost of servicing external debt. The external debts of developing countries are largely denominated in US dollars. The depreciation of the currencies of developing countries against the dollar has made it even more difficult to service external debt. The growth of external debt is an indicator of the accumulation of systemic risk and the sensitivity of indebted countries.

4. Tendencies of External Debt Servicing in Developing Countries

The external borrowing conditions of developing countries differ from country to country. For low-income countries, the International Monetary Fund and the World Bank have established a benchmark within the external debt sustainability matrix. Table 2 shows these values.

Table 2: Debt burden thresholds and benchmarks in the DSF

	Present value of external debt (in percent of)		External debt service (in percent of)		Present value of total public debt (in percent of)
	GDP	**Exports**	**Exports**	**Revenue**	**GDP**
Strong	50	240	21	23	70
Medium	40	180	15	18	55
Weak	30	140	10	14	35

Source: The IMF-World Bank Debt Sustainability Framework for Low-income countries, https://www.imf.org/en/About/Factsheets/Sheets/2023/imf-world-bank-debt-sustainability-framework-for-low-income-countries Accessed 02/07/2023.

The framework shown in Table 2 implies permanent debt sustainability analysis according to the projected debt burden of the country in the next ten years, as well as the country's vulnerability to economic shocks. The country's debt-carrying capacity is classified into three categories (strong, medium, and weak). Based on the established thresholds, countries with stronger macroeconomic performance can accumulate a larger amount of foreign debt. Based on these thresholds, the risk of total and external debt is assessed in four categories: low risk; moderate risk; high risk, and in debt distress (arrears and debt restructuring, for example). Thresholds change from time to time. On 31.05.2023. a large number of countries are classified as "Debt Distress".[4] This actually means that these countries already need coordinated help

[4] See https://www.imf.org/external/Pubs/ft/dsa/DSAlist.pdf

from international financial institutions (primarily the IMF and World Bank) and official and private creditors in order to avoid their financial collapse. Financial investment strategies of global investors are mostly based on benchmarks. Most of the financial wealth is managed by a small number of investment funds, which generally focus on the performance of a group of countries, rather than on an individual country. Therefore, these strategies are sensitive to the macroeconomic developments of a group of countries. Such guided investment strategies often amplify changes in financial conditions by initiating synchronised flows of portfolio investments in developing countries.

The share of external debt service in exports of goods and services measures the country's ability to properly service external loans. Therefore, the changes in this ratio represent important information about the sustainability of external debt. If this indicator tends to increase, then the risk of regular repayment of external debt increases. In that case, the country may fall into a state of external insolvency. Figure 4 shows the tendencies of this indicator for several groups of developing countries.

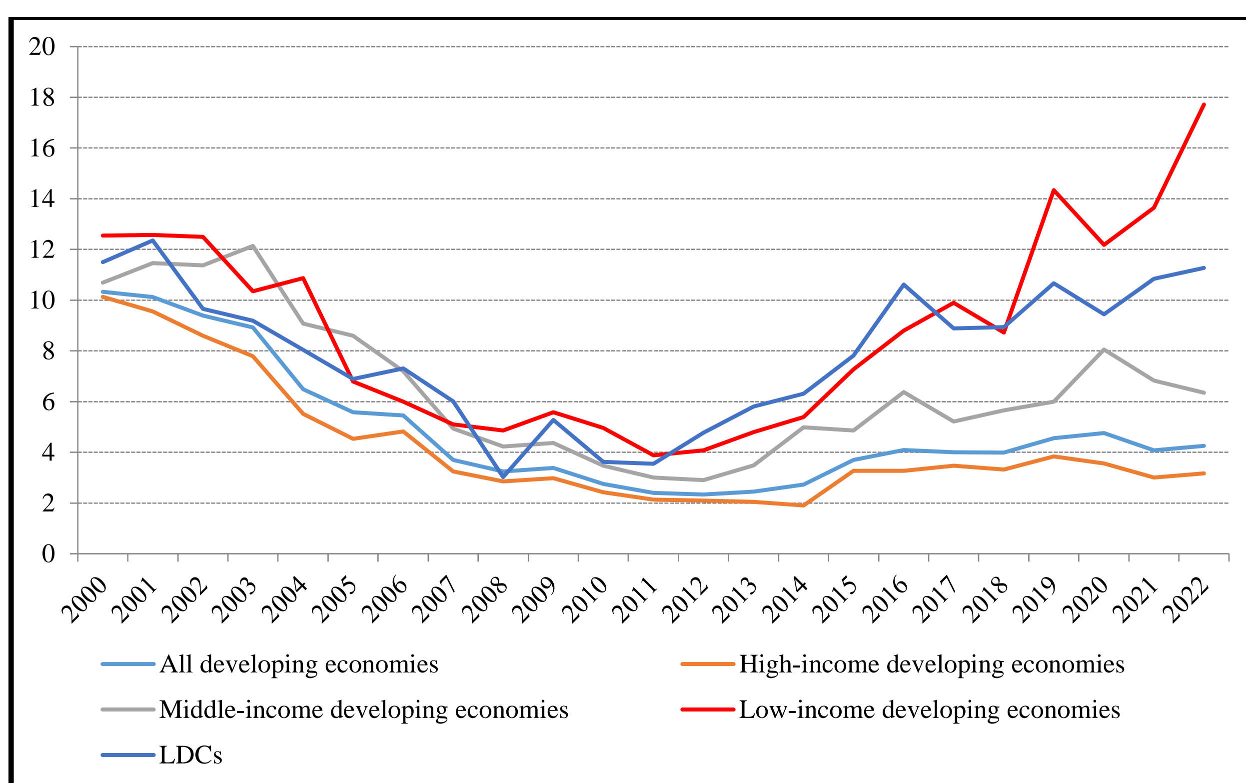

Figure 4: Debt service for developing countries (Long-term external PPG debt, percentage of exports of goods and services)

Note: Figures for 2022 are UNCTAD estimates. Groups follow UNCTAD's definition.
Source: UNCTAD, Escalating debt challenges are inhibiting achievement of the SDGs, Figure 2. https://sdgpulse.unctad.org/debt-sustainability/ accessed 28/06/2023.

According to figure 4, it can be seen that high-income developing countries had a stable value of the share of external long-term PPG debt service to export revenues, which in the past ten years ranged from 2 to 4 percent. In other developing countries, a significant growth of this indicator was registered. A distinct growth of this indicator is observed in low-income developing countries. The growth of this indicator was also significant in middle-income developing countries, although significantly lower than in low-income developing countries. Poorer developing countries are facing an increase in debt service as a percentage of

government revenues (this indicator has reached almost 20% in 2022, which is a big jump compared to about 5% in 2012). It actually shows that poorer developing countries are exposed to a double pressure regarding the sustainability of external debt: export revenues are uncertain due to the decline in world trade, and at the same time, an increasing part of government revenues is absorbed by the repayment of public and publicly guaranteed debt. Difficulties with external debt servicing are also experienced by middle-income developing countries with a large external debt burden. The external debt sustainability problems of these developing countries are increasing after the covid-19 pandemic. Growing external debt absorbs more and more resources of a developing country. The ability to respond to exogenous shocks with foreign exchange reserves also decreases, because their amount decreases in relation to the growing short-term external debt. The ability of developing countries to overcome liquidity crises caused by external shocks is reduced. The financial vulnerability of developing countries has been heightened following the crisis during the COVID-19 pandemic. Many countries already need help to restructure their external debts in order not to fall into a debt repayment crisis.

Figure 5 shows the share of total external debt service to gross national income for low- and middle-income countries. In both groups of countries, this indicator increased after 2010. In recent years, this growth has been particularly pronounced in low-income countries. After a temporary minor decline in 2020, this indicator reached almost 4 percent in 2021 for the group of low-income countries. Considering the growth of interest rates on the international capital market in 2022 and 2023, further growth of this indicator can be expected for both groups of countries. In middle-income countries, a smaller decline in this indicator can be observed in 2021, although these countries had a higher value of this indicator throughout the observed period. The position of the least developed countries is similar to the values of this indicator for low-income countries. The increase in external debt service to GNI ratio shows that developing countries are allocating a larger part of their income for the orderly repayment of foreign loans, which reduces the available income for domestic investment. Earlier in this text, it was pointed out the problem of the reduction of export revenues, primarily in raw material exporting countries, which is also a problem for less developed countries. This can have negative consequences on the economic growth of these countries and their export competitiveness. Namely, with a decline in export performance and less investment, developing countries may lose their position in exports, which further complicates the sustainability of their external debt.

The problems of these countries are increasing due to the growing current account deficit, so additional borrowing from abroad is necessary. Some poor countries are now increasing their foreign debt further in order to serve existing foreign debt. New loans are contracted at higher interest rates. The structure of new debt in most countries is changing in favour of short-term financial loans, which at the same time carry higher interest rates, so the debt burden is increasing. To that should be added the risks related to the potential appreciation of the US dollar, which can further increase the burden of servicing existing foreign debt. The effects are the same for middle-income countries. The increase in the interest rates on the international capital market in 2022 and 2023 could make it harder to reach the additional external liquidity for this group of countries as well. The position of these countries on the international capital market is deteriorating, with growing risks of external insolvency and the impossibility of regular repayments of foreign loans. Insolvency stress may encourage banks to reduce risk-taking, by reducing lending to the home economy, which will affect economic growth (IMF, 2023, p. 91). A rapid increase in interest rates on the international capital market, along with growing pressures of fiscal consolidation for external debt sustainability, will further slow down the recovery of these countries, and push them towards low growth rates in the medium term. Current geopolitical tensions in the world can generate major disruptions in international trade

and capital movements, with severe consequences for developing countries and countries in transition.

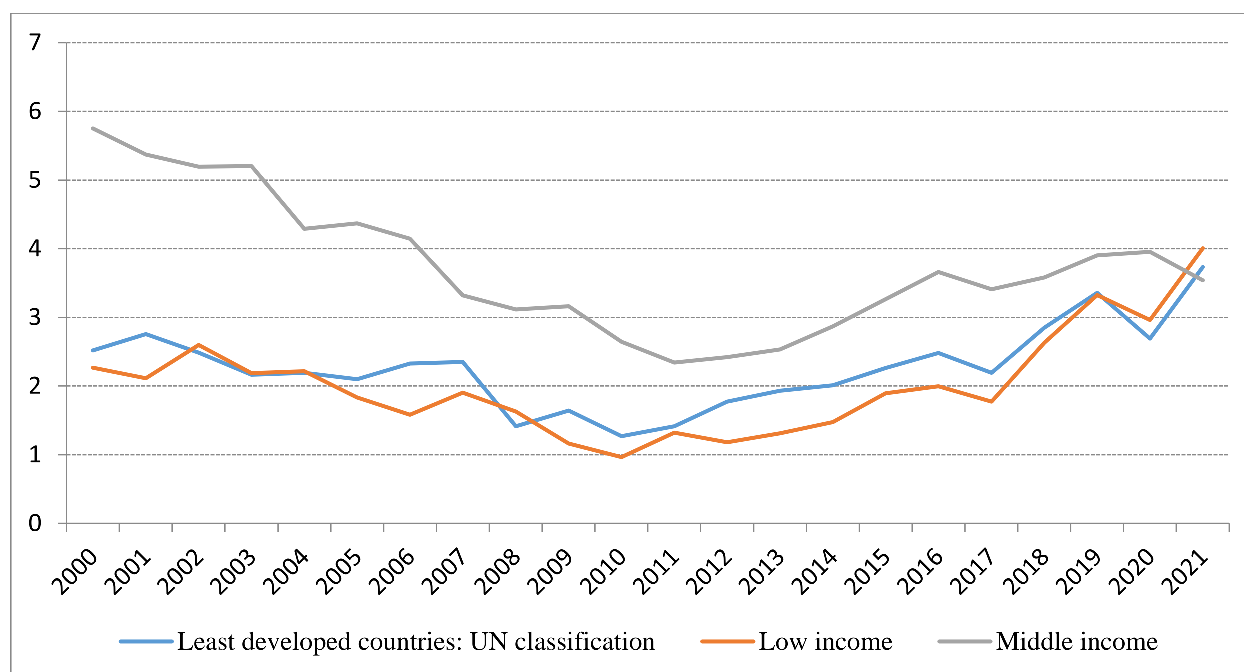

Figure 5: Total debt service (% of GNI)

Note: 1)Total debt service is the sum of principal repayments and interest actually paid in currency, goods, or services on long-term debt, interest paid on short-term debt, and repayments (repurchases and charges) to the IMF. 2) Low-income countries include those countries that had a per capita national income (GNI) of $1,085 or less in 2021, and middle-income countries include countries whose per capita national income in 2021 was between $1,085 and $13,205.

Source: Author based on data from the World Bank, which were taken from: https://data.worldbank.org/indicator/DT.TDS.DECT.EX.ZS?view=chart Pristupljeno 29/06/2023.

The increase of the reference interest rates of the central banks in developed countries encourages the general growth of interest rates in the world. The efforts of developed countries to curb inflation by means of a restrictive monetary policy have the effect of increasing interest rates, which impairs the ability of most developing countries to properly service their external debt. Similar problems are encountered by countries in transition. Uncertainty in the international capital market translates into higher risk premiums, primarily in the case of developing countries (Altig et al., 2020).

In many developing countries, the growth in public debt has coincided with the growth of the current account deficit. In fact, foreign borrowing made it possible to finance increased imports, which led to an increase in the current account deficit. Some countries with an unstable budget balance and current account take short-term and long-term loans from different sources, which can cause a twin deficit in the long run (Asteriou et al., 2021). The outlook for global economic growth is rather weak, contributed to by global fragmentation. High public debt can limit a country's ability to use fiscal policy as a countercyclical measure during a recession. Damaged confidence in the country's economic prospects would reduce private investments and thus economic growth. Lower economic growth rates exacerbate fiscal risks, which encourages the growth of the risk premium. Interest rates can be higher than the rate of economic growth, hence the problem of external debt servicing arises (BIS, p. 59).

When rising public debt creates a gap in advance between aggregate demand and aggregate supply, there must be some automatic mechanism that restores the balance between supply and

demand. This mechanism enables the transfer of income between sectors of a given economy (transferring income), which can lead to a weakening of economic growth.

The credit rating of many developing countries is low ("substantial risk, extremely speculative or default") and subject to deterioration. Almost 40 percent of all developing countries (52 countries) with this rating have severe debt problems and are forced to use extremely expensive market-based financing (UN, 2023, p. 124).The mentioned 52 countries make up only 2.5% of the world economy but 15% of the world's population. A declining credit rating increases the cost of new borrowing. Lenders can tighten credit conditions for countries that fall into debt repayment difficulties. Several developing countries are included in the G-20 Common Framework (renegotiating their debt) program for external debt rescheduling, although large debtors are ineligible to participate in this program. This is why there is a risk of systemic debt crises. Debt write-offs for many low-income developing countries is a much-needed comprehensive solution, in order to prevent their further impoverishment and ensure minimal investment to maintain living standards. Given the large influence that a small number of private credit rating agencies have on the access of developing countries to the credit market, their influence should be mitigated by insisting on greater transparency of the standards they use when estimating credit ratings.

A worsening of the global indebtedness of developing countries in 2023 and 2024 may lead to a situation where some countries will not be able to repay their debts, with accompanying financial turmoil in the country. This would slow down the economic growth of these countries.

5. Conclusion

The external debt service burden of low-income and middle-income countries has increased over the past decade. A rise in interest rates on the international capital market, stimulated by the efforts of the central banks of developed countries to bring down inflation, sharply increased the costs of servicing external debt for developing countries. Part of the increase in external indebtedness of these countries is attributed to borrowing to overcome the crisis due to the COVID-19 pandemic. On the other hand, export revenues of developing countries that export raw materials have fallen sharply, and food and energy prices have risen. As a result, many developing countries have less disposable export revenues, so they are forced to take on additional external loans. An additional problem for these countries is an increase in the share of short-term loans in the total external debt. New short-term loans are needed for repayment of external debt. These loans carry higher interest rates. The increase in the external debt service burden is accompanied by a reduction in investment, so that the growth rates of these countries are decreasing. Therefore, the increase in the total stock of foreign debt and the repayment of the debt of low- and middle-income countries that fall into financial difficulties require that a mechanism for facilitating and reducing foreign debt be established at the global level. The shift in the indebtedness structure of these countries towards a greater share of short-term loans as well as the dominant participation of private creditors, impose the need to include all creditors in the process of easing the external debt burden. Many developing countries may find themselves in a situation where they cannot pay off their due obligations on foreign loans without restructuring their external debt or writing off part of the debt. International financial institutions and official creditors also demand greater transparency in the external borrowing flows of developing countries. The World Bank is actively involved in these discussions at various international forums, in order to agree as soon as possible on solutions that should enable the sustainability of the external debt of developing countries. Improving external debt transparency can help to achieve debt and fiscal sustainability in these countries.

Facing growing inflationary pressures, central banks continue to raise interest rates. The global rise in interest rates will make it difficult for developing countries to refinance their foreign

currency-denominated debt. Before the Covid-19 pandemic, the world was going through a period of low interest rates and high liquidity, which favoured additional borrowing by developing countries. These countries borrowed on the commercial market and from official creditors who are not members of the Paris Club. The growing share of private loans in the structure of the total debt of developing countries has increased their exposure to external shocks and sudden capital flow reversals. External debt servicing costs have increased. Growing difficulties in servicing foreign debt may lead to the redirection of capital from developing countries to developed countries as safe destinations. Therefore, it is necessary to act preventively now to prevent the outbreak of the debt crisis, in order not to repeat the eighties of the last century.

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