

Sri Lanka: Poor countries and their debt burdens

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Well before the pandemic, developing countries had experienced multiple waves of debt accumulation in the era of globalisation

Among the many emergencies that the world economy faces post-Covid is debt distress. The problem has devolved into a crisis of epic proportions in poor economies. The present dominant narrative does not adequately capture this differential impact.

That underlying narrative is simple. The stimulus measures governments had to adopt to address the Covid-19 pandemic raised state expenditures, widened budget deficits, and enlarged sovereign debt.

With revenues squeezed by a recession-induced by the pandemic and the partial and complete lockdowns that followed, governments had to borrow to finance increased spending. This caused a spike in public or government debt.

Governments also supported the victims of the “sudden stop” in economic activity with loans or guarantees for cash-strapped firms and small businesses. Many opted to rely on these lines of credit to stay afloat. Hence, private debt also spiked. Dominated narratives say these events paved the way for a crisis.

This narrative of the source of the debt crisis is backed by evidence of debt in 2020. For example, the World Bank, in its assessment of Global Economic Prospects in January 2022, noted that, “In 2020 total global debt reached 263% of GDP, its highest level in half a century. The buildup has been broad-based, with rapid growth in both government and private debt; advanced-economy and emerging market and developing economies (EMDEs) debt; and external and domestic debt.”

This generalised assessment, however, misses out on some important details. Developed countries were indeed major borrowers and absorbed a large share of incremental debt. But they gained, not lost, from the financed expenditures, which set off a recovery however inadequate. Among developing countries, not all could borrow to try and spend their way out of the crisis. Already burdened with legacy debt many poorer countries could not borrow more or had to use any additional debt they accessed to service old loans.

This is visible clearly in the case of external debt, crucial for poorer countries that need foreign exchange to import essentials they do not produce. A lot of this developing country debt is foreign debt. Well before the pandemic, external debt stocks of all low and middle-income countries rose from \$4.36 billion in 2010 to \$8.25 billion in 2019 or by an average of \$432 billion a year.

But not all developing countries had near-unlimited freedom to borrow and spend. A few countries dominated the ‘market’. For example, China alone accounted for a significant share of external borrowing by low and middle-income countries (LMICs) in 2020. External debt stocks of all low and middle-income countries rose that year by \$441 billion.

By excluding China, this figure falls to \$206 billion. Without China, the average increase in the external debt of the LMICs stood at \$279 billion a year during 2010 to 2019. External debt fell to \$206 billion in 2020, partly because a part of the new debt went to service past debt. Clearly, the ability of these countries to borrow more was eroded during the difficult pandemic year.

This raises two questions. Given the country's large foreign reserves, why did Chinese entities dominate borrowing abroad among developing countries? In an increasingly marketised economy, decentralised decisions by firms seeking to exploit easy access to foreign finance at low-interest rates most likely led to this outcome.

Sovereign guarantee

The second question is why governments in poorer countries, borrowing by which was considered safer because of government backing or a 'sovereign guarantee', were not able to borrow more. The answer to the second question lies in the effect that the legacy of past debt had on the capacity of countries to borrow in foreign exchange.

Well before the pandemic, developing countries had experienced multiple waves of debt accumulation in the era of globalisation. Ayhan Kose and his colleagues at the World Bank, in a much-cited study, identify four waves of global debt accumulation since 1970. That was not all bad news.

Some countries used such borrowing for good effect and grew faster. Others, especially the poorer ones, unable to service that debt, found themselves afflicted by crises.

The pandemic added to their problems by massively reducing their limited foreign exchange earnings and setback efforts, to resolve the fragility generated by this pre-existing legacy of debt.

Given this historical context, focus on the pandemic's contribution to debt accumulation misses out on a larger, long-term weakness. As highlighted by the Sri Lankan crisis, long-term weakness stems from several sources.

First, inadequate diversification of economic activity leads to a wide gap between the country's pattern of consumption and ability to produce, necessitating wide-ranging imports and large foreign exchange outflows. Second, liberalisation increases the import intensity of consumption and investment in these economies, worsening the balance of payments problem.

Third, a tendency on the part of governments to embrace business-friendly, neoliberal regimes that rely on tax concessions to incentivise and stimulate the private sector. A corollary is that committed and otherwise unavoidable expenditures have had to be financed with borrowing, leading to debt accumulation.

Finally, many developing country governments borrowed excessively during the years after the financial crisis 2007-09, when, in response to the Great Recession that followed, central banks in the developed countries adopted easy money policies that resulted in the flow of large volumes of extremely cheap credit through the international financial system.

After a decade of reduction, government debt rose sharply after the global financial crisis in advanced economies and EMDEs alike. As a result, by 2019, EMDE government debt had reached its highest level since 1993.

The difficulty is that the accumulated external debt must be serviced with and settled in foreign currency that many of these countries are not in a position to earn. It is this stock of external debt

that proves a problem, especially in periods when foreign currency earnings fall and reserves are eroded because of a shock like the Covid-19 pandemic.

It was this already vulnerable world burdened with debt that was hit by the Ukraine invasion, which shut off supplies from two significant global exporters of oil products and food, reducing access to and inflating the dollar value of these critical commodities. That has worsened the crisis in many countries.

Thus, the problem is not always the profligacy of developing country governments or just shocks like Covid or the Ukraine war, which worsen an already desperate situation. The problem is embedded in global inequality, the structures it reproduces and the global embrace of neoliberalism. Without a coordinated global effort to resolve that, with the developed countries bearing much of the burden, the problem is likely to fester.

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