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The case for high quality productive assets in an era of increasing government debt distress

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Introduction

Given the significant increase in global nominal interest rates over the last two years, households, corporates and governments are finding it increasingly burdensome to refinance their debt. This trend is now manifesting rather acutely among highly indebted governments, raising concerns about the sustainability of their debt profiles and the impact on the developmental prospects of the countries' economies and societies in decades to come. The charts below show that the total value of sovereign debt in default grew from USD 100 billion to USD 186 billion between 2008 and 2021 (Bank of Canada, 2023) and that 58% of Low-Income Countries (LICs) are classified either as at high risk of debt distress or as already in debt distress (World Bank, 2023).

Historically, defaults have predominantly manifested for foreign currency borrowings, but last year's local currency default by Ghana provides increasingly relevant lessons about the relationship between sovereign debt and the developmental prospects of domestic real economies in highly indebted countries.

Tradeoffs between sovereign debt and productive assets

When households and firms increase their leverage, creditors charge higher interest rates as compensation for the higher probability that interest payments and principal repayments will not be made as promised. The same is true of governments, although, unlike firms and households, governments have two special characteristics that can help to shore up their creditworthiness.

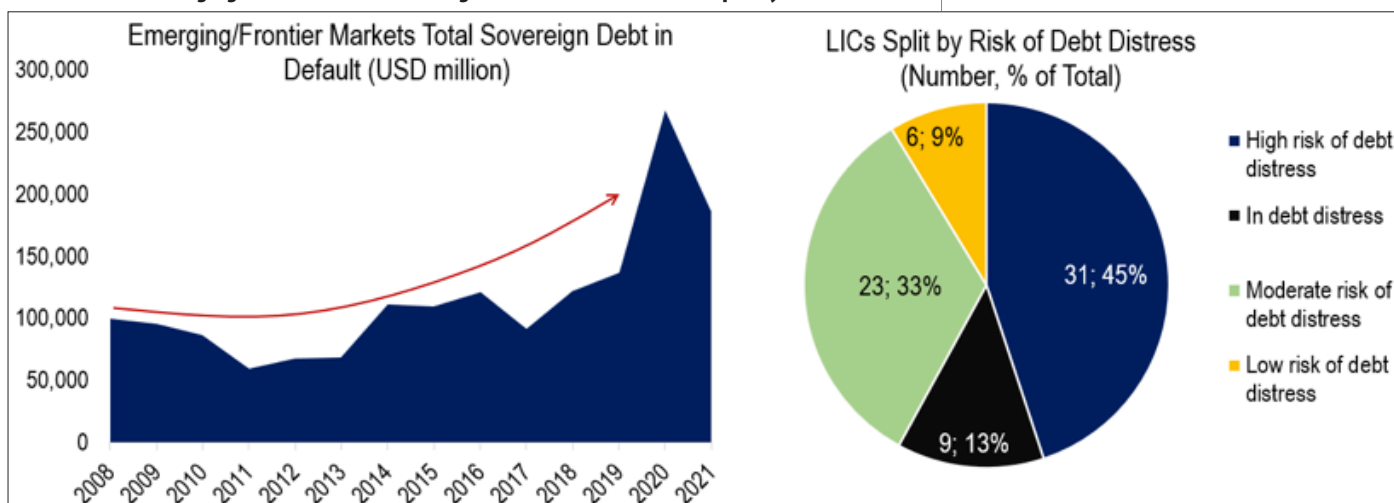
The first special characteristic is the right to create the money of their land.³ When sovereigns borrow in their local currencies, they do so with the knowledge that they can print more money to make good on their promises. This characteristic of local currency government debt has reduced the historical incidence of local currency defaults compared to foreign currency defaults. From an investment point of view, sovereigns' ability to print money is perceived to reduce the credit risk of governments' local currency fixed-income securities, even though being able to print money to service debt has no positive bearing on a government's

inherent creditworthiness from an income sustainability point of view. Consequently, if exercised arbitrarily, printing money to pay off debts has adverse implications for the value of the local currency and its purchasing power relative to the amount of income that the local economy generates. Because lower purchasing power constrains an electorate's consumption, which is rarely a popular outcome, there may even be political consequences.

The second special characteristic that governments enjoy is realized through macroprudential policy requirements for domestic banks, insurance companies and pension funds to lend to their government by investing in the government's debt at prescribed levels. The rationale for this is that government debt serves as a High-Quality Liquid Asset (HQLA) that can be used to strengthen financial institutions' balance sheets and reduce their risks of being unable to meet obligations towards depositors, policy holders and pensioners in the event of financial turmoil.

Accordingly, the HQLA rules place a major focus on sovereign-related securities. All 'Level 1' assets (the

Charts 1 and 2: Emerging and tier Market Sovereign Debt in Default and LICs Split by Risk of Debt Distress



Source: Bank of Canada 2023, World Bank 2023, authors' calculations

highest form of HQLA) are sovereign-related, and 'Level 2A' favors sovereign-related over corporates (assigning a 20% risk weight for sovereign with A+/A- credit ratings, while corporates must be AA- rated or higher). This makes HQLA rules appropriate for the countries in which the sovereigns do not cause financial turmoil, namely, highly rated (AA- and higher) and developed countries with deep and sophisticated markets. However, in the case of lowly rated sovereigns that may pose financial risk to their economies from time to time, these rules may have unintended negative effects. Although the intention of HQLA rules is to enable macroeconomic and financial stability they provide a regulatory underpin for direct lending to government by a captive audience, potentially exacerbating macroeconomic imbalances in environments in which fiscal resources are not managed sustainably. Although a deep discussion of historical examples is beyond the scope of this paper, Giovannini and de Melo (1991) as well as Reinhart and Sbrancia (2011), have provided helpful analyses of the unintended consequences that have historically resulted from direct lending to government by captive audiences across developed and developing countries alike.

In a practical sense, treating the debt of highly indebted governments as the financial backstop for market turmoil is counterintuitive because poor governance of national institutions and inability to refinance government debt efficiently can be the main causes of market turmoil in the first instance. In such circumstances, more subtle concerns also exist about the incentives that are created for lenders who have to

make capital allocation choices between lending to the domestic real economy (which could help expand the government's tax base) and investing in government debt that could further diminish the government's creditworthiness.

These concerns are important because, in order to have non-sovereign-related HQLA, an economy must first have non-sovereign-related liquid assets. An economy cannot have these assets if its market is not allowed to develop. Financial institutions have an intermediation function and structuring capabilities that should be incentivized to crowd institutional investors, who want "replicable and scalable" investments, into liquid securities that generate positive development impact. Yet, they are often driven into sovereign-related securities by macro prudential rules.

The charts below present Ghana and Zambia as two topical case studies that help illustrate the link between sovereign borrowing and domestic private sector credit. The charts demonstrate that, in both cases, the rise in government interest payments as a share of government revenue has coincided with a significant reduction in domestic private sector credit extension, which acts as a constraint on the economy's ability to grow its tax base.

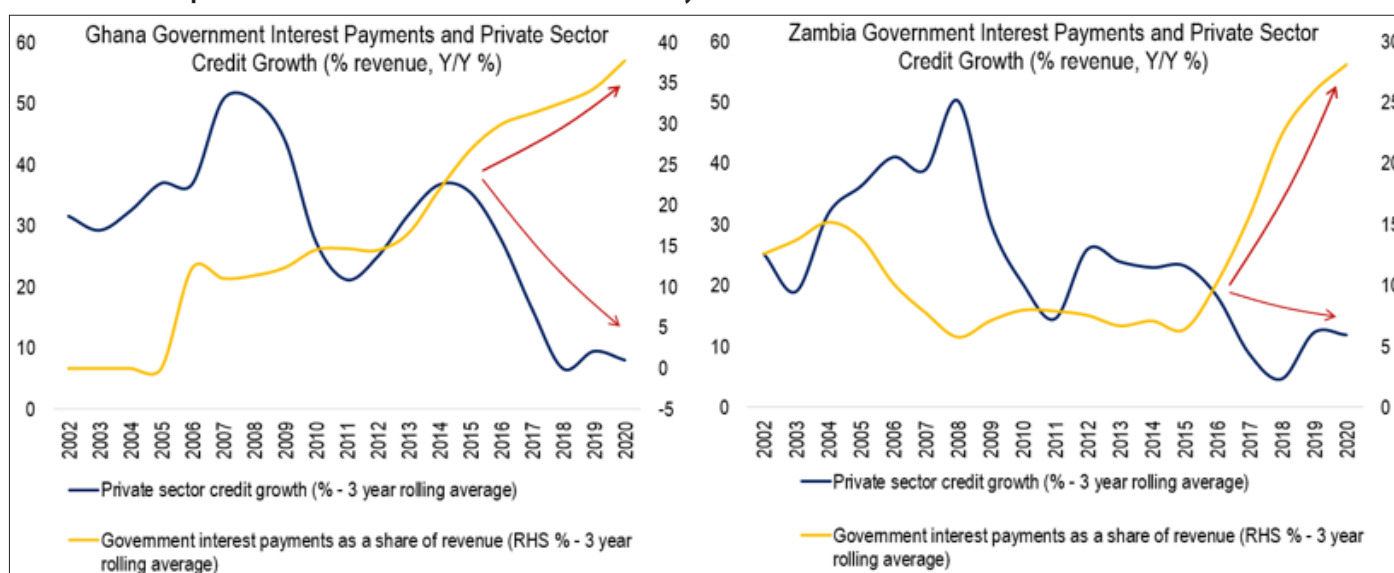
For interest's sake, the charts below show the same measures for a sample of Sub-Saharan African economies for which comparable data are available and all demonstrate similar government debt service and domestic credit growth dynamics.

These dynamics give rise to references to the term 'doom loop' (or, less colloquially, to the term the

'sovereign-banking nexus') because the interdependencies have an interesting circularity. When yields on long-term government bonds reach certain levels, capital providers start preferring the income from so-called 'risk-free' sovereign securities to lending to domestic households and firms. Ordinarily, this should not be a problem if sovereign borrowing is deployed in ways that lift national income levels sufficiently to make the debt service costs sustainable. However, in most cases, a rise in sovereign yields is a symptom of government income being insufficient to fund government ambitions. At some level, the rise in government yields becomes circular when it reduces the incentive to lend to income-generating domestic firms, which then experience weaker business cycles and revenue growth squeezes. Of course, this is circular because a government's principal source of income is taxes on the domestic economy, so, when this income falls, or does not grow fast enough relative to debt repayments, the government may engage in further borrowing that lifts its leverage ratios (e.g., debt-to-GDP or debt-to-revenue) further.

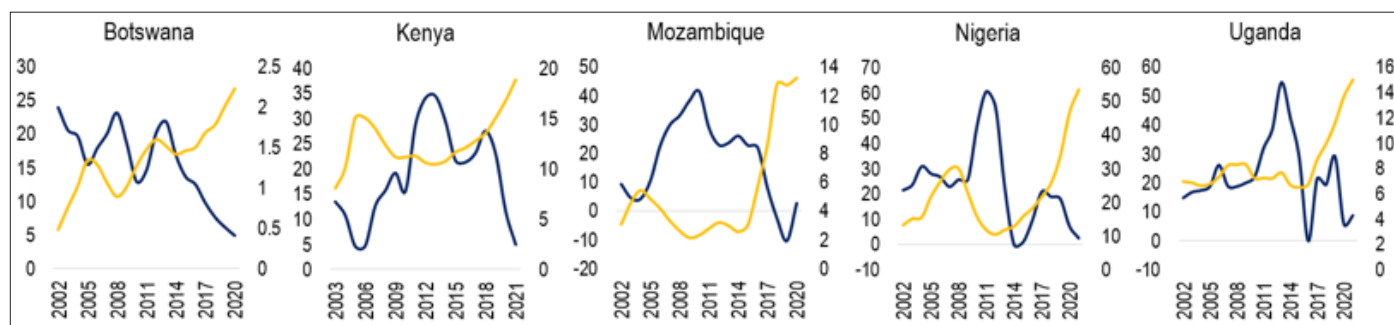
Although they are pervasive, these dynamics also present unique opportunities for financial market development through enabling financial institutions to invest in assets that more closely resemble the high-quality productive assets (HQPA) that can generate the income needed to put government debt on a more sustainable trajectory.

Charts 3 and 4: Comparison of Ghana and Zambia Government Interest Payments as a Share of Revenue Relative to Private Sector Credit Growth



Source: Fitch Connect Database (2023); authors' calculations

Charts 5 - 9: Comparison of Botswana, Kenya, Mozambique, Nigeria and Uganda Government Interest Payments as a Share of Revenue Relative to Private Sector Credit Growth



Source: Fitch Connect Database (2023); authors' calculations

Future prospects

The developmental constraints imposed by excessive government debt are avoidable at three levels. The first is that governments do not have to borrow to the point of over-indebtedness in the first instance. Although inherently avoidable, this is primarily a political issue over which market participants have limited influence. The second level where over-indebtedness imposes developmental constraints is closer to market participants' control. Development finance institutions (DFIs) and multilateral development banks (MDBs) in particular have an important role to play in helping develop liquid markets for high quality productive assets that contribute to domestic income producing capital formation (rather than depleting it). Here, the Bank for International Settlements already recognizes MDB funding as HQLA and progress made by some DFIs in working with domestic regulators to classify some of their funding instruments as HQLA alternatives to government debt securities is noteworthy – and such initiatives should be developed to include a diversity of productive and liquid assets. The third level where over-indebtedness imposes developmental constraints is that private sector capital allocators should appreciate that investing in over-indebted government debt is not a risk-free activity: high yields indicate high risks. Greater recognition of sovereign credit risk should make private sector capital allocators more sanguine about investing in the real economy when assessing opportunities and trade-offs.

References

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Footnotes

1. Writing in his personal capacity.
2. The views expressed herein are those of the author and do not necessarily reflect the views of their employer.
3. There are exceptions. For example, in the European Union, the institutions of the Economic and Monetary Union are responsible for euro issuance, monetary policy and price stability.