Why does the UN chief think a **debt crisis** for the global south is on the way?

Key words:

- **Debt**
- **Interest**
- **Creditor**
- **Debtor**
- **Maturity**
- **Principal**
- **GDP**
- **Debt-to-GDP ratio**
- **Default**
- **Bond**

Learner profile:

Transition Year
Senior Cycle Business
Senior Cycle Economics
Senior Cycle Politics and Society

PLAIN-ENGLISH ECONOMICS

Background

UN chief warns of coming debt crisis for developing world

'Illusion' of stability hides unsustainable borrowing and rising poverty, says Guterres

People queue for food in Sao Paulo. Brazil has borrowed heavily from domestic lenders at interest rates much higher than those available to rich countries © Fernando Bizerra/EPA-EFE/Shutterstock

This guide is based on the article by Jonathan Wheatley of the Financial Times, published on March 29th 2021.

Further figures and support is taken from Eurodad's series of infographics, 'A Debt Pandemic' as well as 'Opinion: Will rich nations finally deliver solutions to the debt crisis?' published on devex.com on March 29th 2021.

Supplementary background information is provided by Financial Justice Ireland in order to ensure comprehension of the text.

Borrowing money

When you borrow money, the person (or bank, or other lender) wants to know that you'll be able to repay them. But how can they know this? For example, when getting a loan to buy a house (called a mortgage), the bank asks to know your income, the security of your income, and how much you have in your savings. Then it subtracts any expenses you already have (e.g. loans you're already paying off). If, after all this (and a few other questions!) the bank thinks that you'll be able to pay back, it will give you a loan.

However, the bank will charge you for this service.

The percentage of a loan you pay to the lender (called a **creditor**) for the service of giving you a loan called **interest**. So eventually, you repay the bank the amount that goes into your bank account (called the **principal**) and the interest. The **maturity date** is when a debt comes due and all principal and/or interest must be repaid to creditors. Once you have a loan you are now called a **debtor** - because you have a debt to pay.

Public/national/ government/sovereign debt

Sometimes, like in crisis, countries need to borrow money. Instead of looking at income, job security and savings, creditors usually look at a country's **economic growth**. This is done by measuring **Gross Domestic Product (GDP).**

GDP is used as an indicator to tell whether the country will be likely to be able to pay back a loan. Creditors compare GDP to debt, to see how likely it is that countries can repay.

GDP is the final value of the goods and services produced within the geographic boundaries of a country during a specified period of time, normally a year. GDP growth rate is an important indicator of the economic performance of a country.

Debt-to-GDP

The debt-to-GDP ratio compares a country's debt to its total economic output (GDP) for the year.

Formula

What country owes (debt)

÷

What country earns (GDP)

Debt-to-GDP (%)

How the formula is used

If this percentage goes above a certain percentage (usually 64%) in so-called developing countries, creditors begin to worry.

If and when economic growth is not large enough to cover paying the interest of debts, creditors usually insist that the government still keeps paying their debt.

This happens even if it means the government has less money to spend on public services like healthcare and education.

This debt is now **unsustainable**.

There's a hole in the bucket

This is like continuously filling a bucket with water (growth) but there's a hole in the bucket that keeps releasing water (interest). If the water (money) is coming out of the hole in the bucket faster than water is going in, it is unsustainable and will only get worse unless something plugs the hole.

Defaulting

If it gets really serious and there is no prospect of getting out of the situation, debtor countries might tell the creditor that they can't pay the debt. This is called **defaulting**.

Why now?

Today, the world is facing a problem of debt unsustainability in developing countries.

This is because the needs of COVID-19, like paying for healthcare and vaccines, has been added to a debt burden that was already very big to begin with!

The UN Chief

This is what the leader of the United Nations, Antonio Guterres had to say about the situation:

In failing to address debt sustainability, "the risk is that we compromise the recovery of the economies of the developing world with catastrophic consequences for people's lives, with an increase in hunger and poverty and dramatic problems with health and education systems, in many cases leading to instability, social unrest and, at the limit, conflict. Everything is now interlinked."

The interaction of Debt, Growth and Interest

To understand how debt unsustainability has become such a worrying issue, we need to understand how debt, growth and interest interact.

Debt

To raise money to prevent people going hungry, businesses shutting for good etc., countries borrow. This is called **raising debt**. They do this mainly by asking lenders for money (who then become creditors), and then promising to pay back these creditors at a later date.

The creditor has a **certificate** that it can cash in when it's time to be repaid. This certificate is called a **bond**. The lender is then called a **bondholder**, because they hold a bond.

Interest

Just like paying interest to a bank when you get a loan, governments must pay interest to bondholders for the service of giving them a loan. there are a few things that influence how much interest is charged.

Factors that determine interest rates

1. Risk

By loaning money, the creditor takes a **risk** that they won't be repaid. **The riskiness of a loan influences the interest rate**. If it's more risky, the interest rate is higher because that's the reward for taking more of a risk. If there is very little risk, the interest rate is usually lower (there are some other things that influence the interest rate, but risk is a main one).

2. Time

The length of **time** that a bondholder holds a bond also influences the amount of interest they charge. Think about it - which is more risky? If you lend someone money and they say they'll pay it back in a month, or if they say they'll pay it back in 30 years?

The answer is 30 years, because a lot more can happen in 30 years than a month!

3. Economic growth

But there are other things besides time that influences how risky this arrangement might be for the bondholder, and therefore the rate of interest.

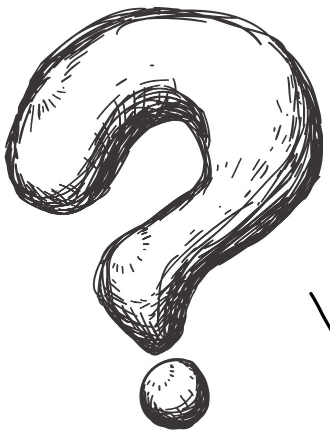
The **rate of economic growth** also influences the interest charged. If the rate of GDP growth indicates that the country will be able to use some of its growth to pay the interest, then the bondholder's risk is reduced.

4. Credibility

However, if growth is uncertain (or not very believable or **credible**) it's less likely that the creditor will be paid back on time or at all, increasing interest rates.

David Lubin, head of emerging market economics at Citi (a very big bank!) said

"If you lack growth credibility — and Brazil, South Africa and Mexico lack it — then the market is not prepared to give you the benefit of the doubt."



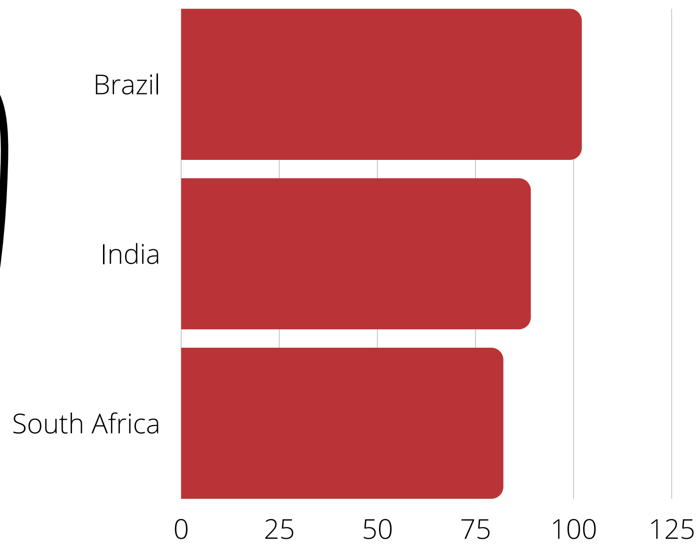
What do you think this might mean for Brazil, South Africa and Mexico?

Why does this matter for global financial justice?

If a country whose growth prospects aren't looking great has lots of debt, but needs more (as is the case for many Global South or emerging market countries, especially during Covid-19), it could end up paying very high interest rates on loans.

What do you notice about the debt of Brazil, India and South Africa?

> A strong economic recovery is being prevented by access to vaccines! It's no coincidence that South Africa and India spearheaded the call for a waiving of intellectual property rights so that they could get more vaccines. Read more here.



Example: Brazil

Brazil's public debt hit 102% of gross domestic product at the end of last year according to the Institute of International Finance. India has reached 89% and South Africa at 82%. Brazil is increasingly worried and need to raise money. Brazil has done this by issuing bonds but promising to pay them back really soon!

Remember, this means they pay less interest to the lenders (because it's less risky for lenders) but the flip-side of that is that Brazil has to pay the whole loan back sooner.

But have they promised to pay back too soon...? If a recovery doesn't come in time, Brazil is in serious trouble.

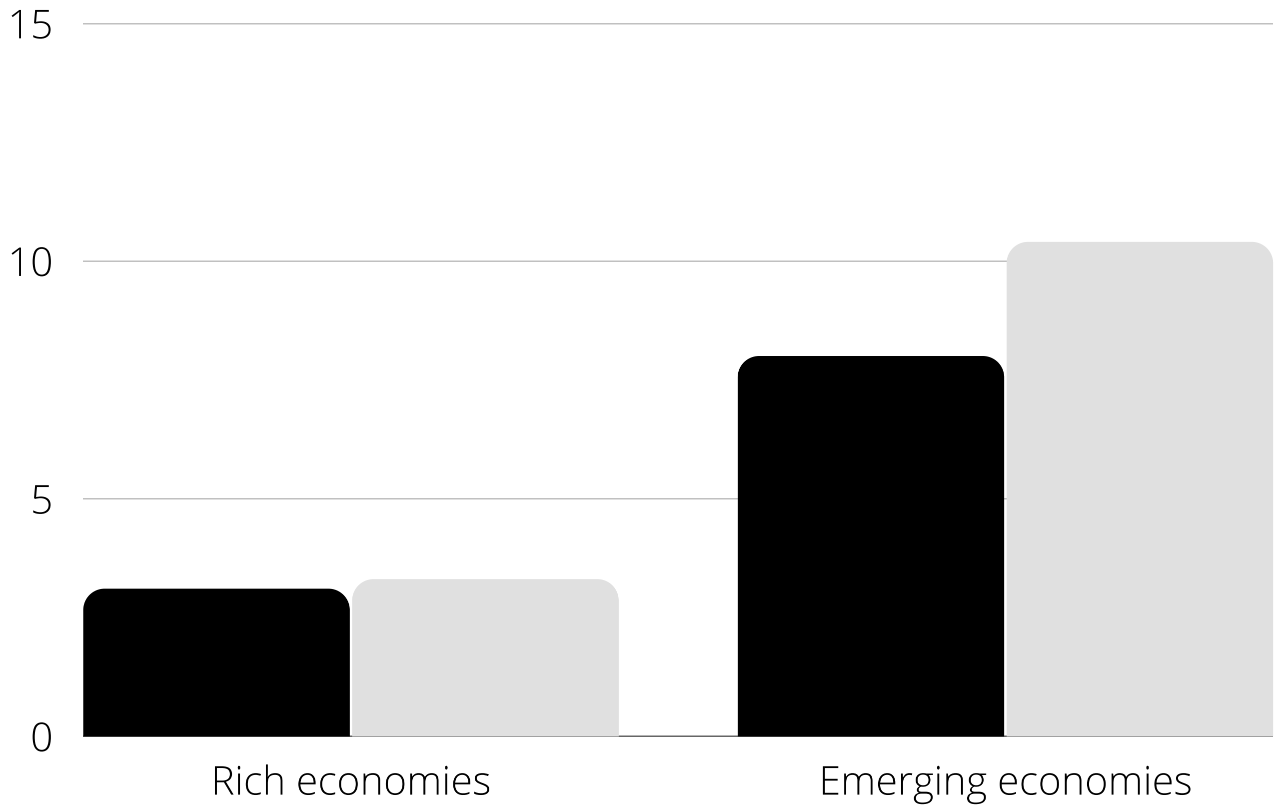
Inequality in Interest Rates -> Injustice?

One of the reasons this situation is unjust is because there is a big contrast between the proportion of interest paid by rich and emerging economies respectively.

Public debt service (the amount they pay annually on debt repayments) for advanced economies (rich countries) averages 3.3 per cent of government revenues, up from 3.1 in 2019. So not that big of a change.

However, most emerging economies will spend 10.4 per cent of revenues on interest payments in 2021, up from 8 per cent in 2019.

Is this fair? What do you think?



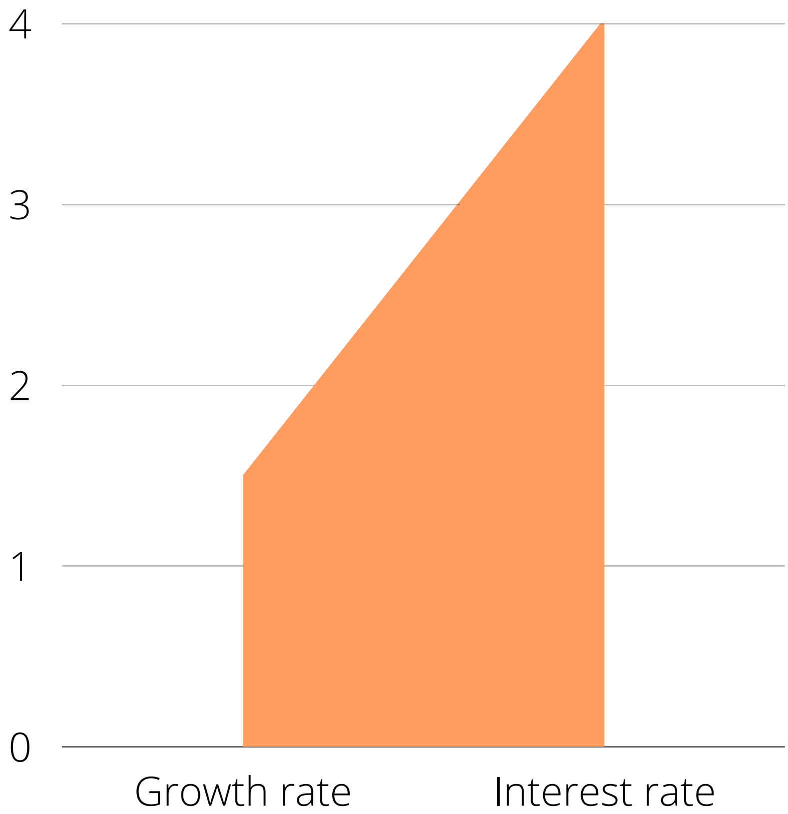
Public debt service change between 2019 and 2020

Example: South Africa

If the rate or speed of GDP growth is smaller than the rate of interest, the country will struggle to pay the interest as well as ensure adequate public services.

David Lubin

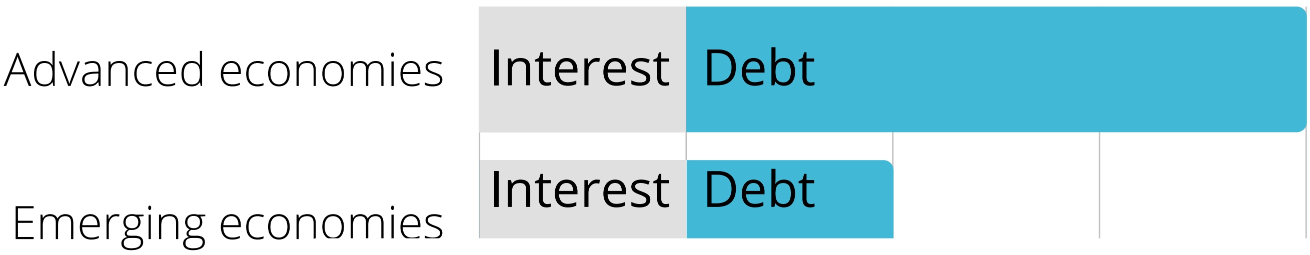
"The long-term real interest rate in South Africa remains close to 4 per cent, which is absurdly high when the potential growth rate in the economy is about 1.5 per cent."

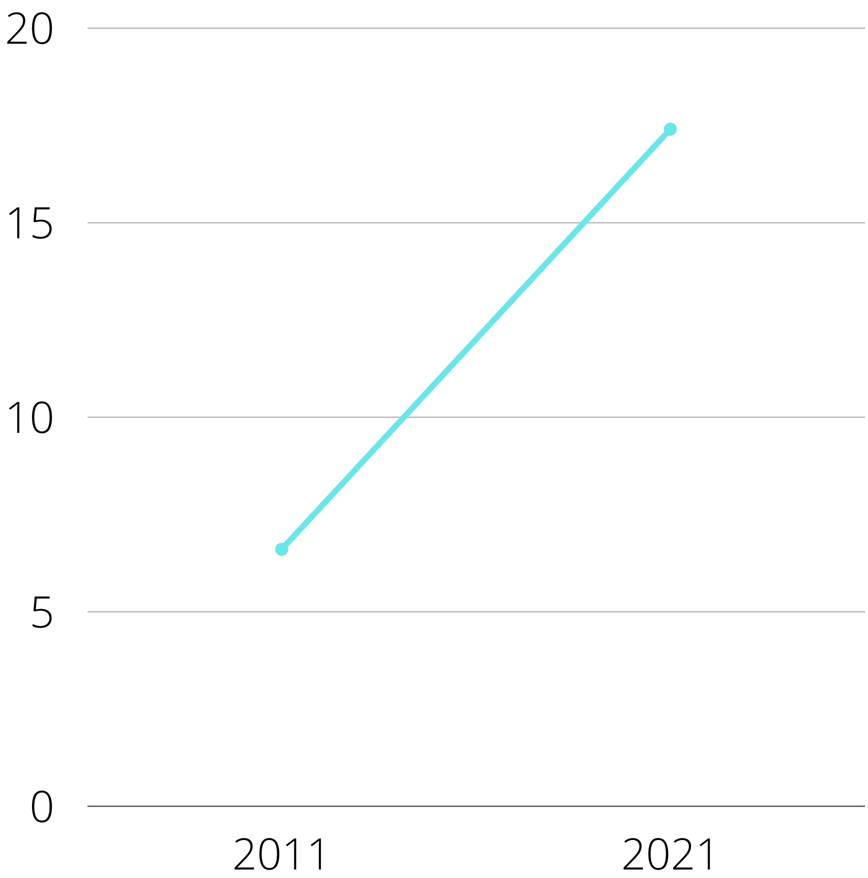


Remember, when economic growth is not large enough to pay the interest of debts, a large portion of that growth is used to pay off interest, with an increasingly smaller amount left for public services.

Example

In 2021, the amount governments in emerging economies spend on interest payments will equal the spending of advanced economies — about $860bn for each group — **even though advanced economies have borrowed roughly three times as much as emerging economies.**





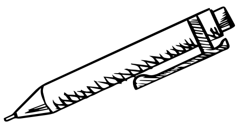
What's more, the share of government revenues (income) in developing countries used to meet external debt service (interest) has increased from **6.6% to 17.4% between 2011 and 2020.**

Reflection

Is this fair?

So how should the debts of low and middle income debts be dealt with?

What do you think? Write below.



This project has been undertaken with funding from Irish Aid's WorldWise Global Schools. Irish Aid's WorldWise Global Schools is the national programme of Global Citizenship Education for post-primary schools in Ireland.