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What are the factors that could lead to another EM sovereign debt default like Sri Lanka?

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On 12 April 2022 the BBC reported that Sri Lanka had said it will temporarily default on its foreign debts amid its worst economic crisis in over 70 years. This South Asian country recently experienced mass protests as it suffers food shortages, soaring prices and power cuts. Government officials said the impact of the pandemic and the conflict in the Ukraine made it impossible to pay its creditors and it would shortly start talks with the International Monetary Fund (IMF) on a loan programme to get its economy back on track. The most recent news reports say that the IMF "bailout" could be three months away, but in the interim, Reuters reported on 26 April that the World Bank had agreed to provide Sri Lanka with USD 600 million in financial assistance to help meet payment requirements for essential imports. Yet just this week, the Sri Lanka Prime Minister Mahinda Rajapaksa resigned as the crisis in the country worsens.

Recently a London market insurer asked me what other Emerging Market (EM) countries I thought had the potential to be the next Sri Lanka with a sovereign or major corporate debt default. It was a good question and got me thinking about what are the increased risk factors that could be the triggers for more such defaults. I consider there are three:

1) ***EM debt levels*** - The recent increase in official debt levels and the existence of 'hidden debt' absent from the official figures

2) ***Rising Interest rates*** - The rapid emergence of global inflation / rising interest rates and the impact this could have on demand for fixed income lending

3) ***Food and energy insecurity*** - The rise in food prices and food insecurity, as well as energy prices, mainly linked to the Russia / Ukraine conflict, and the possibility this could lead to political unrest and changes in regime, especially in those poorer countries where the cost of food and energy is a far larger component of their imports and personal expenditure.

EM debt levels

In March 2022 the IMF published an article 'Shining a Light on Debt'. The thrust of the article was that for economic recovery and crisis prevention hidden liabilities must be revealed. To summarise the analysis:

a) EM countries typically have a shorter maturity of public debt

b) A common feature of debt crises has been a sudden jump in debt levels (of course accelerated by Covid), and large depreciations of exchange rates, plus

c) Governments assuming so-called contingent liabilities of state owned corporations, subnational governments, banks and corporations.

d) After 2014 many EM countries started to borrow heavily from countries outside the 'Paris Club', particularly from China. Much of this borrowing remained 'off radar 'in official reported debt figures.

This hidden debt is starting to be disclosed. In the last year the World Bank International Debt Statistics identified and added USD 200 billion previously unreported debts to their debt statistics.

Rising Interest rates

Over the last six years the yield on 10-year US Treasury bonds has increased from 1.47% in 2016 to now 2.96% in 2022.

The impact of the yield increase has been a fall in the current 10-year US Treasury bond prices of 8.77% in less than three months from February to April 2022.

The market consensus is that the 30-year bull market in fixed income has ended. Falling bond prices are leading to huge principal losses, in turn leading to redemptions from funds, in turn meaning a progressively smaller pool of funds available for any country or major corporate borrowing requirements. Additionally falling fixed income prices are impacting bank balance sheets – as banks in general hold highly leveraged portfolios fixed income portfolios.

Food and energy insecurity

Substantial Inflation of any asset leads to relative (financial and economic) winners and losers amongst the importers and exporters of those assets. But the Number One asset inflation that can rapidly lead to social and political turmoil and even regime change is food inflation. The Number Two socially disruptive asset inflation is energy inflation. Currently the world is experiencing both.

Many of EM countries have historically been heavily dependent on food imports from Russia and Ukraine via the Black Sea trade route. But, due to the Russia/Ukraine conflict trade through the Black Sea has virtually stopped.

Agriculture is a key export and external currency earner for Ukraine and Russia sees disrupting these exports as a form of economic warfare applying financial pressure on Ukraine as well as applying disruptive pressure on their agricultural importing clients.

Some examples:

- 44% of Libya's wheat supply in 2018 was from Ukraine
- 77% of India's domestic supply of sunflower oil came from Ukraine in 2019. In China it was 63%

- Russia supplies Turkey with 60% of wheat imports via the Black Sea
- Egypt buys almost 66% of the wheat it consumes in the international market, with Russia and Ukraine making up 80% of these imports
- Sub-Sahara Africa imports 40% of the wheat they consume from Russia and Ukraine.

And, for Sub-Saharan countries this economic warfare can pose an existential threat. According to US Department of Agriculture figures the average imports of wheat by these countries in 2020/21 and 2021/22 was over 26 million tons and it is estimated that by June, only two months from now, their stocks will be down to 3.7 million tons.

Geopolitics

As the situation in Sri Lanka shows sovereign debt issues can have a geopolitical effect as well. As reported in the Wall Street Journal on 8 May 2022 India seems to have been a stronger supporter of Sri Lanka in its financial crisis than China. Indeed, India gave Sri Lanka its full support in the latter's negotiations with the IMF on its financial rescue package, but China did not. This seems to have led to several important commercial gains by India in its competition for influence in Sri Lanka among India, China and the West.

Some good news

Zambia – on 23 April 2022 Reuters reported that China had told the IMF and World Bank Spring Meeting that it is willing to participate in the effort to restructure Zambia's foreign debt estimated to be USD 17.3 billion.

IMF Managing Director, Kristalina Georgieva said People's Bank of China governor, Yi Gang, told her that Beijing would join the Zambia creditor committee, which is a big step forward in restructuring Zambia's debt. Until then China had been identified as the only creditor stalling progress towards easing that debt. Yi, she added, had also committed to the Common Framework debt restructuring process, launched by the Group of 20 (G20) in response to the coronavirus pandemic.

Congo – according to Bloomberg on 5 May 2022, just last week, the Republic of Congo plans to issue Eurobonds linked to oil warrants to refinance its outstanding energy debts to commodity traders Glencore Plc and the Trafigura Group. Since this transaction is being used to refinance existing debt, it will not increase the country's debt obligations and reportedly gives the Congo the ability to hedge its debts against the cycle of oil prices by linking the interest on the bonds to the oil price.

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