



EXTERNAL DEBT SUSTAINABILITY AND DEVELOPMENT

Session:
**Price slump in commodities:
Financial implications for commodity
exporters**

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COMMODITY SUPER-CYCLE AND DEBT SUSTAINABILITY

A. INTRODUCTION: COMMODITY PRICES AND DEBT-FINANCING OF DEVELOPMENT

The recent contraction of commodity prices poses new and additional development challenges to developing countries. Substantive commodity-price shocks tend to affect a country's macroeconomic fundamentals fairly directly, depending on the role played by the affected commodities in the country's productive and distributional system. For commodity exporting countries, a downswing in the global commodity price super-cycle is usually associated with falling incomes, a decline in government revenues, currency depreciations, deteriorating current account balances, capital outflows and – last not least – rising borrowing costs. Unsurprisingly, financing strategies for development that may have seemed not only feasible but highly reasonable during commodity-price booms, including borrowing in international financial markets, may become unsustainable once a commodity-price downturn sets in. Debts incurred during 'good times' may turn out to be very expensive after all, putting at risk a country's longer-term debt sustainability and, ultimately, its growth and development prospects.

According to UNCTAD's report on "The state of commodity dependence" 2014¹, two thirds of all developing countries were commodity dependent in 2012-13, where commodity dependence is defined as the ratio of the value of commodity exports to the value of merchandise

exports. When this ratio exceeds 60 per cent of a country's total merchandise exports, this country is considered commodity dependent. In the group of least developed countries (LDCs), no less than 85 per cent, or 39 countries, were classified as commodity dependent in 2012-13 according to this definition. Between 1995 and 2013, half of commodity dependent developing countries recorded an increase in their dependence on commodity exports. With the exception of Asia, export concentration – the percentage of the three main exports over total commodity export revenues – also increased in all developing regions since the global financial crisis of 2007/08. However, the percentage of countries for which the three main exports exceeded the threshold of 60 per cent of their total commodity export revenue rose only in Latin America and the Caribbean, remaining stable in Africa and declining in Asia and Oceania.

It is worthwhile keeping in mind that the current downswing in the commodity super-cycle takes place in the wider context of tepid global economic growth and growing global macroeconomic imbalances. In the absence of a functioning international monetary and financial system with the capacity to negotiate necessary macroeconomic adjustments in advanced as well as core developing and emerging economies and to direct the global economy back onto a path of coordinated growth dynamics and collective prosperity, the impact of the downturn in the current commodity super-cycle will be felt sorely in commodity dependent developing countries. This will likely put their various debt-based financing strategies for development at risk, and might eventually also affect their ability to achieve the Sustainable Development Goals (SDGs).

¹ The state of commodity dependence 2014. United Nations Conference on Trade and Development (UNCTAD). United Nations. Geneva 2015.

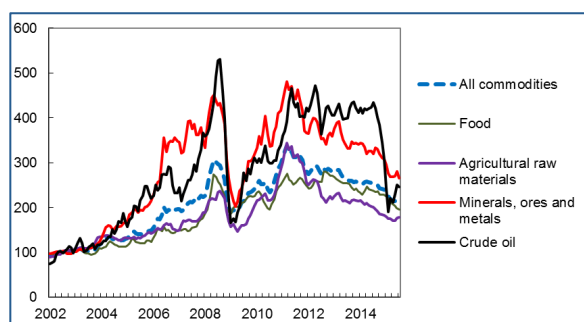
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This short background note summarizes core challenges commodity dependent developing economies face in regard to the sustainability of their external debt strategies in this wider context.

B. THE COMMODITY ROLLER COASTER

There is, of course, nothing new about the current global commodity super-cycle. In so far as records serve, the world has witnessed multiple non-oil commodity super-cycles since the late 18th century, with major political events, such as WWII, shaping their trajectories, to an extent.

The downswing in the current commodity super-cycle that began in 2011 has been pronounced. For now, non-oil commodity prices have declined by around 25 per cent relative to the prices for manufacturing exports, led by metal prices whose fall is expected to reach 22 per cent in 2015 alone. Price falls for crude oils have been the steepest, with the price of Brent crude falling by over 50 per cent between June 2014 and October 2015, to its lowest level since 2009.



Graph 1: *Monthly commodity price indices by commodity group 2002 – 2015 (Aug)*, UNCTAD secretariat calculations.

The main reason for the recent fall in most commodity prices has been an abundant supply, as the investment response to the price boom of

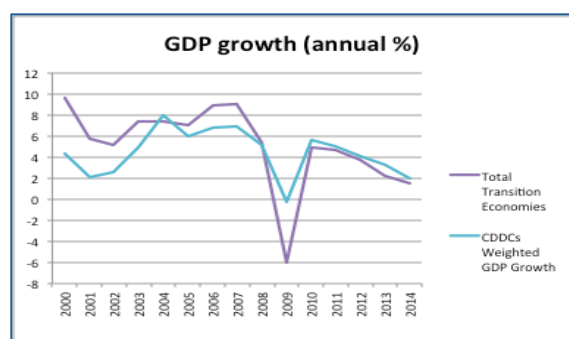
the 2000s has significantly increased production over the past few years. The resulting tendency towards excess supply has been reinforced by weakening demand due to sluggish growth in the world economy more generally and the recent slowdown in a number of large developing economies in particular. Oil markets have been affected by the US shale revolution, with US shale oil production reaching 4.5 million barrels/day in 2015, up from virtually nothing in 2010. Oil prices are expected to stay close to USD 60 for the near future, not least due to the recent decision by OPEC producers to maintain their production shares and pursue a low-price strategy for the time being.

Apart from supply and demand fundamentals, the financialization of commodity markets also continued to influence commodity price developments, as financial investors have been reducing their commodity positions in conjunction with the downturn in prices and returns from commodity derivatives. Another important factor in the commodity price decline has been the strong appreciation of the US dollar since mid 2014.

The impact of lower commodity prices on the growth dynamics of developing regions has varied. Amongst the most affected countries have been some transition economies whose GDP is expected to decline in 2015, in particular the Russian Federation and Ukraine. The four - year period of economic slowdown in Latin America and the Caribbean, continued in 2015, with an estimated growth rate of less than 1 per cent in 2015. South America and Mexico have seen further losses in their terms of trade, coupled with capital outflows since mid-2014. Falling export prices have led to lower tax receipts and have also affected the rate of gross fixed capital formation negatively. Since most governments in the region have managed to keep

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real wages from falling, private consumption has continued to be the main driver of growth in the region, albeit at a reduced rate of expansion.² In the African region the main engines of growth over the past decade have been rising private consumption and infrastructure spending. The main channel through which falling commodity prices have negatively affected the region's commodity exporters has therefore been through reductions in public spending, in particular on capital investments and subsidies. Some African economies, such as for example Nigeria and Angola, have also experienced speculative attacks on their currencies, forcing them to adopt restrictive monetary and fiscal policies that further slow down economic growth. The ongoing deterioration of external terms of trade for commodity exporters in the region is likely to further affect and potentially paralyze bigger investment projects. Asia has remained the most dynamic developing region, estimated to account for almost half of total global growth in 2015. In some Asian economies, falling oil prices have helped to reduce current account deficits, but in particular the region's oil-exporters in West Asia have suffered similar difficulties to those in other developing regions.



Graph 2: *Annual growth rates by country groups 2000-2014.* UNCTAD secretariat calculations.

² ECLAC 2015. Estudio Económico de América Latina y el Caribe. Santiago, Chile.

For commodity dependent countries as a whole, the average GDP growth rate fell from 5.6 per cent in 2010 to 2 per cent in 2014. Total reserves contracted for the first time since 2002, and total government revenue for the group fell the first time since 2009. Although debt ratios vary considerably from country to country, total external debt stocks for the group continued to rise in 2014, as did short-term external debt. As was to be expected, the ratio of total external debt to exports for the group increased from 78 per cent in 2013 to 89.2 per cent in 2014. Over the same period, the ratio of total external debt the same period from 26.6 to 27.9 per cent. Other debt indicators also worsened, with the ratio of debt service to government revenue increasing from 10.7 to 13.4 per cent. Similarly the share of debt service in foreign reserves also rose from 14.4 to 17.7 per cent from 2013 to 2014.

The question that occupies experts' and policy-makers minds the most, at this point, is for how much longer the current downturn in the commodity super-cycle will last: Does the recent recovery in the downward trends of some commodities signal an early turning point (by historical comparisons) or is this just a temporary reprieve before the next price slump? The answer very largely depends on how China's economy will fare in the near to medium-term future: Its decelerating GDP growth since 2010 has been a driving factor behind weakening commodity prices, and - in the continued absence of strong and sustainable economic expansion in either the US or Europe - China's demand for commodities will remain central to the commodity roller coaster. There is little to indicate that China could repeat its expansionary response to the global financial crisis in the current situation: This response has led to structural imbalances in the Chinese economy

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and, of course, has left in its trail an enormous mountain of debt. Impending economic transformation in China, from an export-led to a domestic-market and consumer-led growth strategy may eventually be inevitable, but is for the time being surrounded by uncertainty.

C. CHALLENGES TO EXTERNAL DEBT SUSTAINABILITY FOR COMMODITY-EXPORTERS – THE CATCH 22

A downturn in the commodity super-cycle constitutes a negative exogenous shock to commodity-exporters: The factors that drive commodity super-cycles are mostly beyond the control of any one individual economy, certainly in the case of most commodity dependent developing economies.

At the same time, developing economies also face the need to finance their various development strategies, including through external indebtedness. External debt³ is not a problem in itself. Indeed, debt instruments are an important element of any financing-for-development strategy. But external debt sustainability can be put at risk when foreign borrowing is unrelated to productive investment and/or precisely when a net debtor country is exposed to negative exogenous shocks.

Importantly, in the current global economic environment, commodity dependent developing economies face a ‘double-whammy’ of external shocks: In addition to the current commodity price slump, they are also exposed to a secondary exogenous shock arising from their

increased risk (and cost) exposure to largely unregulated international financial markets.

In principle, foreign capital inflows could help developing countries, whether commodity dependent or not, to borrow cheaply during downturns and to repay debt during better times. This, however, presupposes, that foreign capital inflows respond passively to demand from developing countries.

As UNCTAD's *Trade and Development Report 2015* argues in more detail, this is not the case at present: Capital inflows to developing economies are largely driven by economic policy conditions and decision-making in advanced economies, and are in fact pro-cyclical: That is, they are relatively cheap – certainly compared to high domestic interest rates in many developing economies - during a boom and become expensive during a bust.

This easily creates a catch-22 situation, for developing country commodity exporters: When the downturn in commodity prices hits, they will have to continue to contract increasingly expensive debt, not only to keep their economies from contracting too sharply, but also to repay earlier debt, contracted during boom times.

Of course, how badly commodity exporters will be affected by a downturn depends to some extent on their policy regimes and initiative during boom times. Some commodity dependent countries have well-functioning commodity stabilization funds, such as Chile with copper, or have been prudent enough to build up high levels of foreign currency reserves as a self-insurance against negative exogenous shocks, such as, for example, Bolivia and some oil-exporters in West Asia.

³ For a more in depth discussion see Chapter 5 (External Debt and Debt Crises: Growing Vulnerabilities and New Challenges) of the UNCTAD *Trade and Development Report 2015*.

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In addition to the destabilising pro-cyclicality of international capital flows and the associated rising borrowing costs during downturns, debt refinancing strategies that rely increasingly on access to largely unregulated international financial markets (including through trading of domestic sovereign bonds in secondary bond markets) bring two further risk factors:

First, in many middle income economies cheap capital inflows have led to the build-up of high levels of external corporate debt, much of which may not be sustainable under less favourable economic conditions. In emerging market economies, external corporate debt has risen from USD 4 trillion 2004 to USD 18 trillion only a decade later⁴, fuelled to a considerable extent by extensive quantitative easing in the leading advanced economies. The bulk of this debt is still in bank loans and domestic currency denomination, but the share of bond debt is rising, and within this component, the share of foreign-currency denominated bond debt. In recent years, private sector debt insustainability has often been at the heart of subsequent public finance crises, in particular in advanced economies, since governments often have no choice but to shift large amounts of failed private debt onto public balance sheets. With corporate external debt now on the rise in many developing economies – and on a meteoric pace in some cases, such as for example, Peru – a repeat of the pattern of ‘private-turned-public’ debt crises, such as the Latin American crises of the 1980s and the East Asian Crisis of the 1990s, is certainly on the cards.

A second risk factor are hidden debts. These can pose formidable challenges that become apparent only when things start to go wrong.

An example are public-private partnerships, an increasingly popular financing tool for infrastructure investment, in particular. As many experiences, for example in Latin American economies, highlight, public-private partnerships have a mixed record, at best, in terms of efficient overall outcomes. They have, however, a substantial record of shifting risk to governments, often in the form of unquantified downstream liabilities, i.e. hidden debt.

The African story so far

These links between different types of external shocks – commodity price slumps and capital reversals coupled with rising borrowing costs – and external debt sustainability affect all commodity dependent economies, in one way or another. However, recent alarm signals indicating a possible return of sovereign debt crises to Africa are particularly illustrative of the sudden vulnerabilities commodity exporters currently face in regard to their debt sustainability.

When the global financial crisis hit the world economy in 2007, Africa stood out as a main exception to the financial and economic meltdown that followed. While most other countries and regions were gradually pulled into the maelstrom of widening debt crises, Africa's success in avoiding financial crises turned the region into a major beneficiary of booming international lending: Historically low debt-to-GDP ratios, averaging well below 30 per cent of GDP following the debt relief initiatives of the 2000s, a long run of high prices for African commodities, low interest rates, high levels of public investment and high growth rates all combined to make Africa an attractive destination for capital in search of quick profits.

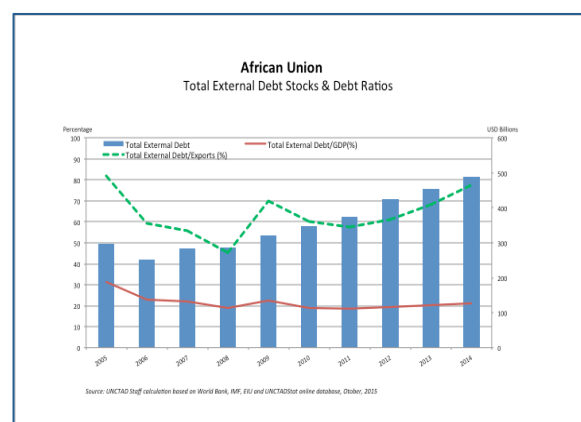
⁴ International Monetary Fund. 2015. Global Stability Report, Washington DC September, p.84

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But this bright picture is now fast undergoing revision: For example, at 75 per cent Ghana's debt-to-GDP ratio is nearly as high as it was just before its debt relief and Mozambique's debt-to-GDP ratio has crossed the 60 per cent threshold this year, up from 9% in 2006 just after receiving its debt relief. And Kenya, that did not qualify for debt relief initiatives, has now reached the 60 per cent mark, too. If one looks beyond this fairly rough indicator of potential trouble ahead, to take account of factors such as large and persistent account deficits, debt compositions and projections for future public debt payments, a growing number of African states - apart from Ghana and Mozambique also Ethiopia, Senegal, Tanzania, Zambia, Burundi and Malawi - can be considered at high risk of either a private or public sector-led debt crisis.

Obviously, the commodity price bust is an important part of the explanation for this turn of events in (some) African economies. But that many African states increased their exposure to market risks through external borrowing is another important element of the story. External corporate debt is still very low in most African economies compared to other developing regions, and most foreign borrowing is public. Between 2008 and 2014, external sovereign bond issuance rose roughly tenfold, from just USD 1 billion to USD 18 billion. In recent years, the amount of debt some African states could have sold to international investors seemed almost limit⁵ less. But the costs of this debt strategy are now being felt: Thus, copper producer Zambia, for example, recently issued a bond yielding 9.8 per cent compared to 5.6 per cent in 2012. Recent bond yields are also up for

Ghana's latest issues and maturities are shortening across the board. In many economies steep currency depreciations in the wake of increased capital outflows further add to this hike in borrowing costs.



Graph 3: *Total External Debt Stocks and main Debt Ratios. African Union*, UNCTAD secretariat calculations. October 2015..

The overall outlook for most African economies is still very solid. The continent's economies are expected to be the fastest growing in the world in 2016 (at around 6 per cent), and debt-to-GDP ratios are still relatively low by international comparisons. But the main lesson to be learned from past debt crises, such as the Asian Financial Crisis of 1997, is precisely that in today's highly financialised economy (investor) perceptions - whether right or wrong - are often more important than facts: Good fortunes can be reversed very fast, and regional contagion is a distinct possibility. In addition, these vulnerabilities to debt sustainability are particularly worrisome for a continent that would have to grow at two-digit rates to meet only a single of the seventeen newly adopted sustainable development goals - 'no poverty' - by 2030, and that has adopted a very ambitious development Agenda 2063.

⁵ Reuters, "Downgrade potential in emerging markets elevated warns S&P", 28 October 2015, <http://in.reuters.com/article/2015/10/28/emerging-ratings-idINKCNOSM23L20151028>

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With the international economic environment likely to worsen in the near to medium-term future, and with an increase in US interest rates highly likely before the end of 2015, the prospects for commodity dependent developing countries in general are not optimistic. As a result, their access to international capital markets will come at higher costs and may become difficult altogether, in some cases. Leading credit rating agencies, such as S&P and Moody, have recently made it known that the potential for credit rating downgrades of emerging market countries and companies has increased markedly.⁶

D. POLICY IMPLICATIONS

External debt will remain an important financing instrument for commodity dependent economies, not only to cope with downswings in the commodity super-cycle, but also to finance long-term development and structural changes that will help decrease their commodity dependency.

Part of the responsibility to ensure that external debt can function in this way as an efficient financing tool for productive investment and development lies, of course, with national governments and their adoption of sustainable and sensible macroeconomic policy adgendae. Apart from building ‘insurance’ buffers during good times – e.g. through stabilization funds and high reserve accumulation –, choosing

innovative debt instruments can be a useful option to consider. GDP- indexed or commodity linked bonds can help reinforce counter-cyclical policies and increase resilience to negative external shocks. In addition to choosing safer debt instruments, where accessible, strengthening debt management capacity to ensure the effective management of day-to-day public liabilities is important. Managing and assessing market-based risks to debt sustainability requires a higher level of sophistication than in the past due to the increased complexity of portfolios, and is critical when an increasing share of external sovereign debt is contracted in international financial markets.

But however carefully external debt is managed by governments, debt crises may still happen, especially in situations in which exogenous shocks to the economy play a major role. ff In this case, it is equally critical that governments can take recourse to fair and efficient debt workout mechanisms to minimize social and economic costs and ensure that the economy is returned to a sustainable growth past as soon as possible. More generally, unless the international community accepts its share of responsibility for stabilizing international financial markets, helping global economic growth back on its feet and facilitating efficient and fair sovereign debt restructuring processes, when needed, external debt vulnerabilities in commodity dependent economies (and in developing countries as a whole) will remain very high, and external debt a potentially volatile and costly financing instrument for growth and development.

⁶ See e.g. Reuters, “Downgrade potential in emerging markets elevated warns S&P”, 28 October 2015, <http://in.reuters.com/article/2015/10/28/emerging-ratings-idINKCNOSM23L20151028>, and “Sovereign ratings to stay under pressure next year – Moody’s”, 4 November 2015, <http://www.reuters.com/article/2015/11/04/ratings-moodys-idUSL8N12Z42320151104>