FDL Finance for Development Lab

The pain of a high-interest rate environment:

Five lessons from the new World Bank debt statistics 2024

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The latest International Debt Statistics were released with fanfare, accompanied by a compelling call for debt relief from Indermit Gill, the World Bank's chief economist, in the foreword. He highlights that substantial capital outflows have exited developing countries since 2022, coinciding with the rise in global interest rates. This situation illustrates the significant financial fragility that "frontier markets" get subjected to, as their position at the receiving end of global financial flows makes them particularly vulnerable to monetary shocks. These markets are not only unable to stabilize on their own but also lack the support of an effective global financial safety that can come to the rescue in difficult moments.

In that respect, while 2022 was a disastrous year, 2023 was even worse. This deterioration was exacerbated by the rise of global interest rates, which reached their peak in 2023 – for instance, the US 10-year Treasury reached 4.85% in October 2023, before starting to slide down. The rising interest bill added to an already strained environment, suffering from a series of adverse shocks that significantly impacted developing countries.

We have derived five lessons from the recently released data:

- Capital is still flowing in the wrong direction – and it is getting worse
- Higher interest payments are the leading cause of the 2023 deterioration
- But external debt stocks remain relatively low, and they are falling
- Large leakages from official to commercial creditors continue unabated
- There are important shifts in the composition of private lenders

Together, these trends show that the situation of systemic tightness that exploded in 2022 has further worsened, albeit in a different manner, with heightened pressure from interest payments compared to amortization. Like 2022, we observe the ongoing paradox of low debt levels and high financial pressures. The developing countries' external debts remain limited, but they are concurrently suffering from the withdrawal of bilateral and private creditors at a time when multilateral providers step up their financing. This precarious situation is unsustainable and will end up hurting all parties involved unless properly addressed. However, achieving a pause in outflows remains a collective action challenge.

Beyond aggregates, this serves as a highly valuable data source for assessing the external debt dynamics of developing countries. It will require some time to fully digest the variety of this information. In the coming weeks, FDL will update its country-by-country risk assessment.

FDL Short notes

Lesson 1: Capital is still flowing in the wrong direction – and it is getting worse

The new data show that the general trend of capital flowing out of developing countries is continuing. The bottom-line indicator of cash flow related to external debt is Net Transfers on External Debt (NT), calculated by subtracting debt service (the total of amortization and interest payments) from disbursements. NTs on total external debt measure precisely how the balance of payments is affected by debt flows, while NTs on external public debt measure how the fiscal accounts are affected.

Upper Middle-Income Countries (UMICs) have seen a marked decline in net transfers since 2014 and consistent negative net transfers since 2019. At the other extreme, Low-Income Countries (LICs) saw a total net transfer of around $2 billion in 2023, which continued a downward trend that began in 2013 when net transfers were around $13 billion.

Our primary focus will be on Lower Middle-Income Countries[1] (LMICs – for ease, we will often group low- and lower-middle-income countries together under the acronym of LLMICs), which tend to have thinner domestic markets to absorb shocks. **From 2022 to 2023, net transfers on total external debt turned from a positive low (+$6 billion) to a negative low (-$7 billion) – this marks the first time in a decade that external debt-related transfers have reversed direction, flowing out of the Global South (Figure 1).** While the world was providing $+150 billion in transfers in 2017, and still $+100 billion in 2019, the situation has now turned negative. The dramatic stop of capital flows to developing countries is putting enormous pressure on scarce foreign exchange reserves, prompting impoverishing devaluations and inflation. Although these figures represent global aggregates, there is much heterogeneity, with some countries more affected than others. Still, in total, 60 countries were experiencing negative net transfers on external debt in 2023.

Net transfers on *public debt* in LMICs, a subset of total external debt, have also been on a downward trajectory, dropping from over 2% of GDP in 2017 to below zero in 2022 (Figure 2). This has been reducing fiscal space and squeezing social and investment expenditure, generating social tensions and lowering growth prospects. The good news is a slight improvement in 2023. Thus, in the aggregate, pressure has marginally shifted in 2023 from the budget to the external accounts – 24 LMICs devalued their currency by more than 10% that year.

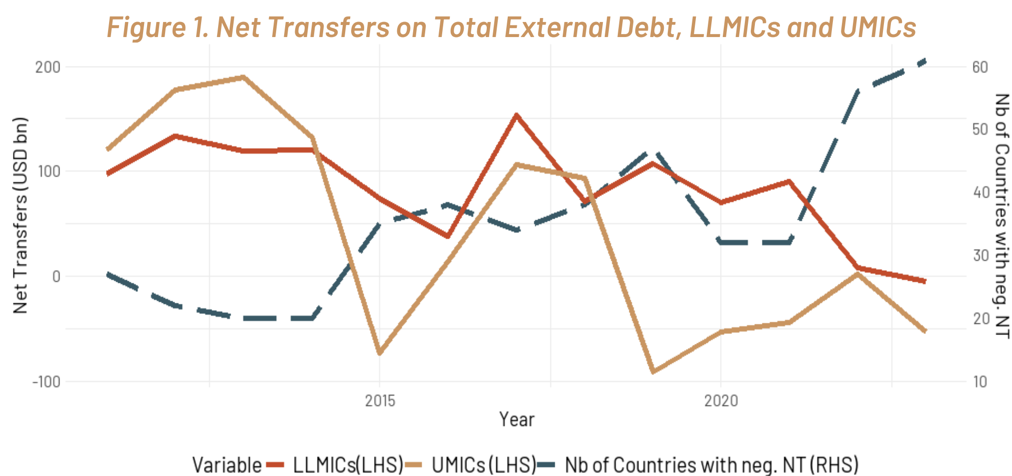
One of today's great challenges is finding ways to reverse the current situation. If funds keep migrating from developing nations to wealthier ones, it will severely impact development efforts, hinder poverty alleviation, worsen income disparities, disrupt social stability, and compromise the green transition.

The further deterioration of net transfers in 2023 is the result of a combination of factors, which will become more apparent in the rest of the paper. The most significant was the sharp rise in interest charges. A second important factor was that short-term loans stopped

[1] We exclude from this sample China, which would otherwise dominate the group, and Ukraine, which continues to draw large amount of finance – in 2023, it received a positive NT of $25 billion.

growing – in contrast to previous years, when hard-hit countries often increased short-term borrowing to partially cushion adverse impact shocks. Together, these two negative factors were sufficient to overtake several positive developments in long-term debt, such as the gradual reopening of the bond market and a (temporary) decline in amortization payments.

Figure 1. Net Transfers on Total External Debt, LLMICs and UMICs



Source: International Debt Statistics 2024

The recent deterioration in net transfers better illustrates the financial stress experienced by developing countries than measures of changes in debt service, a variable that has received much attention as of late. Clearly, as external debt levels have risen, debt service has also risen, whether as a share of government expenditure or of exports. But much of the debt service, and especially its amortization component, is typically refinanced. The real problem arises when this cannot be done anymore, as happened starting in 2022 when access to bond markets closed for most LLMICs. It is the closing of the refinancing market, rather than a rise in debt service by itself, that made the situation much worse. As seen in Figure 2, when expressed as a share of GDP, debt service on both total and public external debts have been high since 2014 - but broadly flat in recent years, while, since 2021, net transfers on both total and public external debt have been collapsing. The latter provides a more precise measure of the effective decline in external financial flows to developing countries in recent years than debt service. Therefore, we will continue to focus more on the trends in net transfers than on debt service for the remainder of this note.

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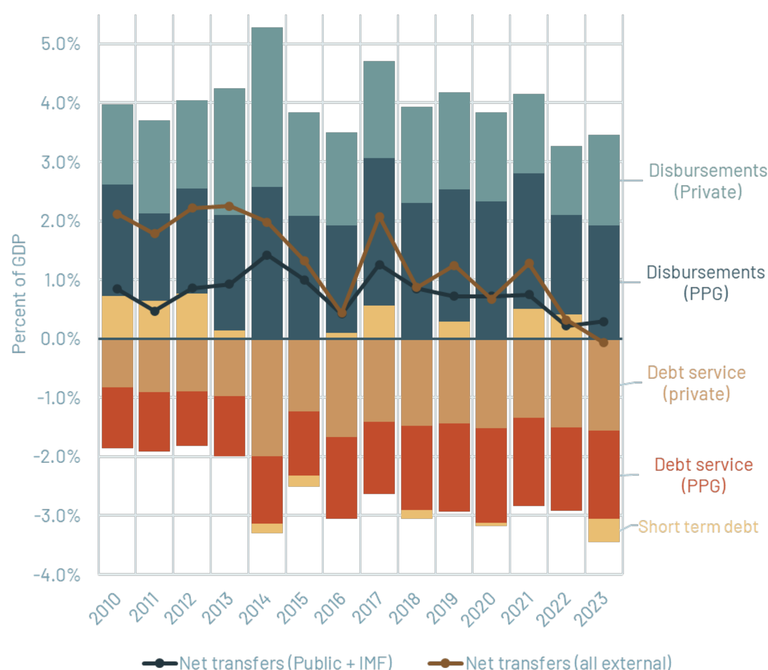
Figure 2. Net Transfers vs Debt Service – LLMICs



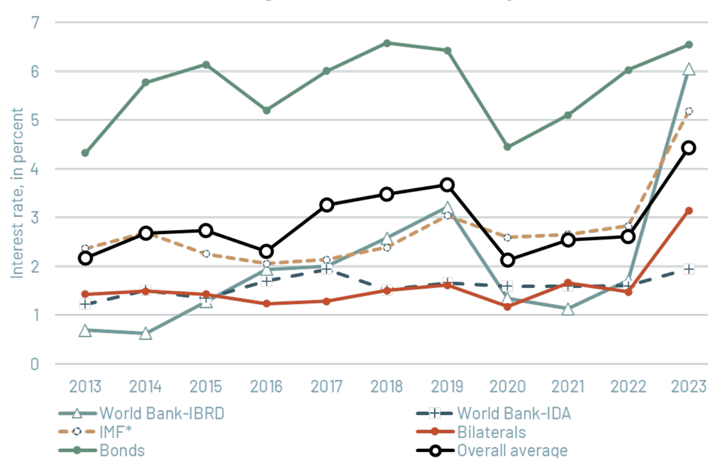
Source: International Debt Statistics 2024.
Note: TED stands for total external debt. PPG stands for public and publicly guaranteed long term debt.

Lesson 2: Higher interest payments are the leading cause of the 2023 deterioration

The major negative news in 2023 is the significant rise in the interest bill, which went up across the board by nearly $36 billion for the group of LMICs. To put things in perspective, interest payments amounted to $60 billion in 2020 and $108 billion in 2023, an increase of 80%, when debt stocks had increased by just 13% over the same period. If it was not for the increase in interest payment, net transfers to LMICs would have improved substantially in 2023, as disbursements on long-term debt rose and amortization payments went down during the year.

The most significant increases in interest payments occurred for MDB loans, private sector bank loans, and short-term debt – each growing by roughly $10 billion in the case of LMICs. Interest payments on bonds, however, remained relatively stable, being mostly contracted on a fixed interest rate basis. Figure 5 shows the steep rise in interest rates on new loans that began in 2021, especially for MDBs and the IMF, whose financial model tends to pass short-term interest rate change to its lenders. MDBs have tools to mitigate these fluctuations, which could be used more proactively.

Figure 3. Interest rates charged on new loans, by various creditor groups



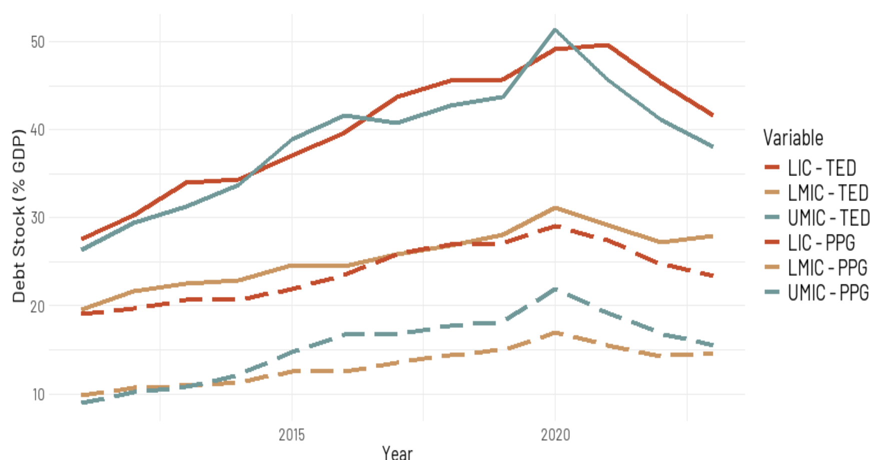
Source: International Debt Statistics 2024, IMF Finances

Note: IMF rates are de facto rates computes on interest payments over stock.

Lesson 3: External debt stocks remain relatively low, and they are falling

Is there a systemic external debt crisis brewing? On average – and it is important to recall that a lot of variation occurs around those averages – external debt stocks are not exploding. After more than a decade of rising external debt stocks, they have been coming down for the last three years. Whether public or total external debt, stocks in low-income and upper-middle-income countries are falling. Lower middle-income countries present a slight exception in 2023: external debt has risen by one percentage point. Several countries might be on the cusp of default. However, in the big picture, the pressures around flows continue to be much more concerning than that around stocks. A forthcoming FDL publication will produce an assessment of which countries are threatened by tensions around their stock of debt versus the flow.

Figure 4. External Debt Stocks (% GDP) – Total, and Public



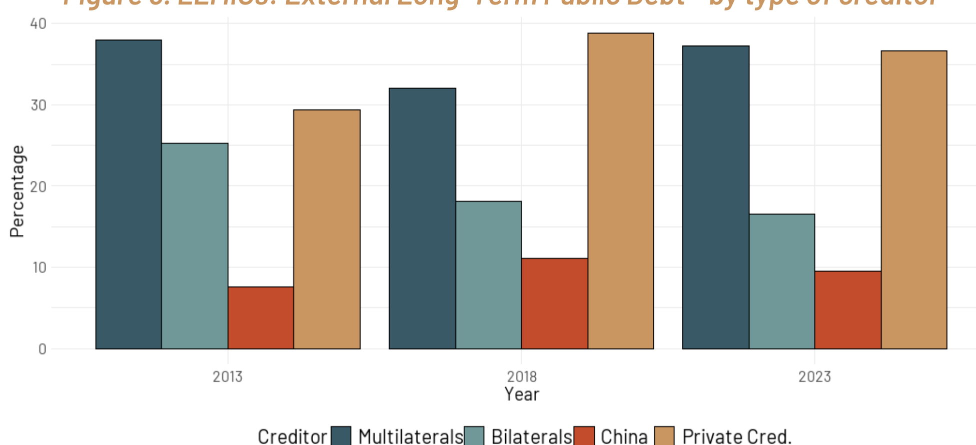
Source: International Debt Statistics 2024

Note: TED stands for total external debt. PPG stands for public and publicly guaranteed long-term debt.

The decline in debt levels is both good and bad news: it is a sign that new borrowings have slowed down, likely squeezing budgets and the availability to invest, but it also suggests a reduction in vulnerabilities. This makes it even more important to find ways to reduce the flow problem. But despite recent advancements in more clearly identifying the problem, significant progress remains elusive. The main reason is the other main characteristic of debt stocks – their high level of creditors' heterogeneity, and the high share of inflexible MDB debt, which makes collective action more difficult (Figure 4).

After more than a decade of rising external debt stocks, they have been coming down for the last three years. Both external debt and external public debt in low-income and upper-middle-income countries are falling relative to GDP, with lower middle-income countries a slight

Figure 5. LLMICs: External Long-Term Public Debt - by type of creditor



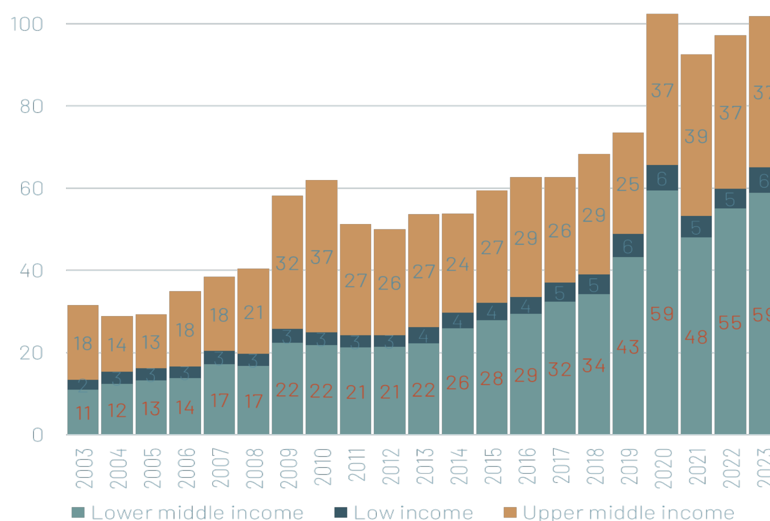
Source: International Debt Statistics 2024

Note: Private creditors to both public and private debtors. "Bilaterals" are ex-China. China includes all Chinese creditors, private and public.

Lesson 4: Large leakages from official to commercial creditors continue unabated

A spectacular trend in the way governments are financed in developing countries since COVID-19 is the quick rise in financing from MDBs. In 2023, total new disbursements were at their highest historically, with $102 billion in new loans. When Ukraine is included, multilateral disbursements reach $127 billion. Disbursements from MDBs to LMICs reached nearly $60 billion in 2023, also an all-time high - nearly three times more than in 2010 and twice more than in 2018 (Figure 6). While there were fears that the big push linked with COVID-19 would end prematurely, MDBs have continued to find ways to leverage their balance sheet further and improve disbursements. This is bearing fruits, but more ambitious efforts will be needed to triple disbursements again by 2030, along the plans approved by India's G20.

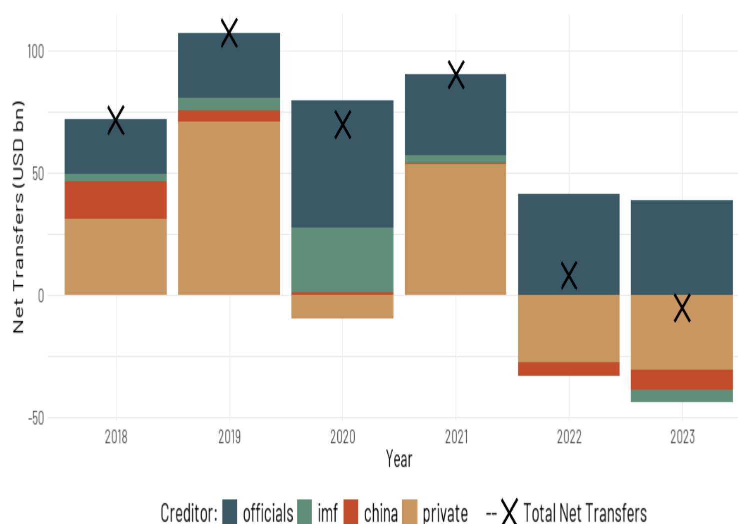
Figure 6. New flows from MDBs to developing countries



Source: International Debt Statistics 2024
Note: Net flows are disbursements minus amortization

But while the MDB's big push is continuing, it has been leaking out entirely in 2023, like in 2022 – to private creditors and, to a lesser extent, to China (Figure 7). In 2023, this was mainly due to the recent rise in global interest rates, while the main driver in 2022 was a reduction in net flows. This leakage hurts countries, unable to benefit from the scaling up of MDB flows to smooth external shocks and initiate a recovery of investment and growth. But moreover, it also hurts the multilateral system, because this loss of aid effectiveness is also going to make it more challenging to convince MDBs' shareholders to increase their capital infusion. Moreover, progress on development and on the climate transition is unlikely to take place in the absence of an important contribution by private flows.

Figure 7. Net Transfers by creditor type for LLMICs



Source: International Debt Statistics 2024
Note: Official creditor includes MDB and ex-China bilateral creditors. Private creditors include PPG, non-guaranteed debt, and short-term debt

An unsettling finding is that the IMF – the main instrument of the Global Financial Safety Net -- is proving to be unable to smooth the global interest rate shock when it is at its peak, even though the PRGT and RST are well capitalized. Net transfers from the IMF to LLMICs have collapsed from the $22 billion surge of 2020 to close to zero since. This dramatic fall reflects a decline in disbursements (from $24 billion at the height of the COVID-19 pandemic, to only $8 billion in 2023), larger amortization payments (from $2 billion to $7 billion), and much higher interest payments (from $0.7 to $5.8 billion, due to high interest rates and to surcharges). This was sufficient to make net transfers from the IMF to the LMICs close to zero in 2022 and at $-5 billion in 2023.

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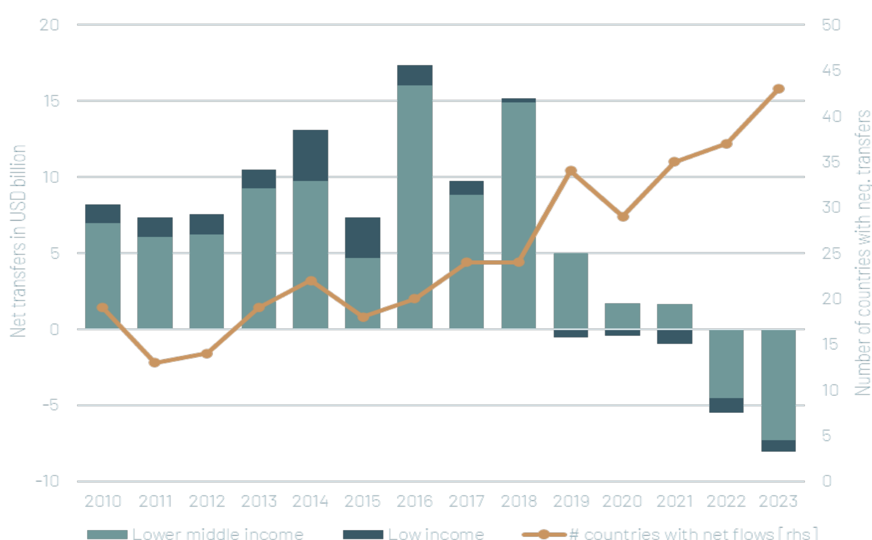
Also noteworthy, in 2023, China still had not restarted its lending operations to the Global South: out of 80 LMICs, 42 were making net payments to Chinese creditors (Figure 8).

Figure 8. Net Transfers to Chinese creditors by LLMICs



Source: International Debt Statistics 2024

Lesson 5: There are important shifts in the composition of private lenders

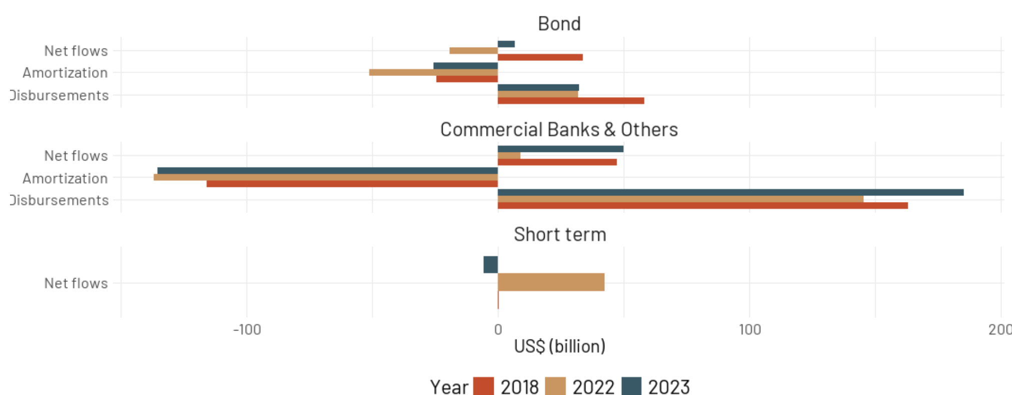
The big change in 2023 for LMICs came from the short-term debt market. Short-term flows did not increase in 2023, after being the main instrument for increased debt in 2021-22, because the yield curve was inverted for most of the year (short-term interest rates were above long-term), while longer-term markets started reopening, providing cheaper alternatives. Indeed, long-term borrowing rebounded, in contrast, from -$25 to $22 billion.

Since the late 2000s, the bond market has played a crucial role in providing private finance for LMICs (and UMICs, excluding LICs), growing in the decade until 2021 twice faster than bank loans. Moreover, unlike banking loans that went mostly to firms, borrowing in the form of bonds was largely done by states. **However, after 2020, bond issuances for this group significantly dropped, plummeting from nearly $100 billion in 2017 to only around $30 billion in 2022.** For UMICs, new bond issues have shrunk from a height of $170 billion in 2017, but they remained large at about $70 billion in 2022. In 2023, the LMICs' access remained similarly limited, and UMICs borrowings started to recover (to about $90 billion). For the LMICs, amortizations were lower than in 2022, resulting in an improvement in net transfers. The rising debt wall anticipated from 2024 to 2026 will make things much harder.

The bond market has continued to recover, and to re-open more widely to developing countries in 2024 as global interest rates started to fall. **But borrowing rates for the LMICs remained high and above their growth rate – for example, Kenya re-entered the bond market at around 10%, Senegal at around 7.7%, and Cote d'Ivoire at 6.6%.**

Bank loans – to states and to private companies – were not as affected as the bond market by the recent macro-cycle; they dipped less and are recovering faster. Compared to 2022, loans from the banking sector increased by $40 billion for LMICs in 2023, especially towards the private sector. Syndicated finance for governments, at least in this data set (and one problem with this market is its opacity, even to World Bank statisticians), were, however, not as active. In sum, the race between the bond market and the syndicated banking sector remains open, with no clear emerging winner so far, despite loud predictions of the demise of the bond market. Currently, the stock of bonds stands at close to $500 billion in LMICs – mainly to governments, and the stock of bank loans stands at $750 billion, mainly to firms.

Figure 9. Net Flows to LLMICs, by type of private creditor



Source: International Debt Statistics 2024

What kind of debt crisis?

The World Bank's International Debt Report 2024 has been met with disappointment and anger, and rightly so: the 2023 picture painted by the new data is a continuation of the disastrous previous year. It reveals a very difficult environment for LMICs, with heavy pressures on reserves and fiscal space, which show no signs of easing. 2024 is unlikely to be much better, given that interest

rates have remained high while new flows from markets, bilateral lenders, and China have not picked up appreciably. This means that the illiquidity crisis continues unabated, leaving many LMICs unable to refinance maturities coming due and invest in basic needs. For many UMICs and LICs, too, external resources continue to be low, if not to dwindle.

New data shows that net transfers are concerning, but that there is not that much to be gained by focusing on stocks. The cost of debt and the direction of flows create unnecessary fiscal pressures at a time of high needs.

However, the new data indicate that despite rising political and social tension due to low net transfers to developing countries, a widespread wave of defaults is not imminent. This is because there is little benefit in drastically lowering the face value of relatively modest debt levels at this time. Although some countries with higher debt ratios may consider defaulting, many others remain in a challenging "grey zone", where the financial strain poses risks of social and economic disruptions, yet their external debt levels is not substantial enough to justify a strong push for debt reduction which risks wounding their credit ratings and unsettling their market access for years to come.

In this gloomy situation, disbursements from MDBs are particularly crucial for mitigating the capital outflow from LMICs. Yet, despite reaching record disbursement levels, a substantial portion is lost in repayments to other creditors, effectively bailing out commercial lenders. The primary victims of the situation are the LMICs themselves, but these trends also hinder the MDBs' own aid effectiveness. Even though IDA just concluded a historic $100 billion round, it is hard to imagine a major scale-up of MDB capital until these massive leakages are contained.

Ideally, the Global Financial Safety Net should smooth external shocks. In practice, however, it remains way too small, given the scale of the challenge. Since LMICs, and some LICs as well, have started accessing the capital markets after 2009 and new bilateral loans since 2000, a much larger safety net has been needed. Until it is enlarged, LLMICs will have to continue to rely – as a second best - on MDB counter-cyclical resources to smooth global shocks. But crucially, other creditors must also participate in the effort for this extra support to be effective – as outlined in our Bridge proposal.

It is uncertain if interest rates will decrease further in the short term. Even if they do, many developing countries have seen a decline in their credit ratings over recent years, making it difficult for them to access private markets at rates lower than their own growth rates – a necessary step for improving their creditworthiness. The risk, if no action is taken soon, is that the debtor countries, their creditors, and the multilateral system as a whole would end up badly hurt down the road by an avoidable systemic debt crisis.

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