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How to Deal with the Sovereign Debt Crisis in the Post-epidemic Era

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Abstract

This paper explores how developed and developing economies manage sovereign debt crises in the post-pandemic era, amidst a backdrop of inflation and slow growth. Fiscal and monetary stimuli in advanced countries increased global debt, with tighter monetary policy dampening domestic demand, weakening real economy investment, and diminishing the impact of expansionary fiscal measures.
Developing nations face higher interest costs due to rate hikes by major economies, and adopting tight policies could lead to financial bubbles and underfunded real sectors. Inflation spikes exacerbate their debt burden, while diversified economies like Germany are more resilient compared to those heavily dependent on a single industry or foreign capital, as seen in Greece.
Post-2023, central banks' shift to monetary easing eases debt burdens in advanced markets, boosts domestic growth, and provides capital inflows for emerging economies, reducing their debt servicing costs and crisis risk.
Tackling the sovereign debt crisis requires international macro-policy coordination, with developed economies considering spillover effects on global economic stability. International support, such as debt relief, is vital to enhance resilience and sustainable development in vulnerable economies. All countries must tailor monetary and fiscal strategies to national conditions to navigate economic uncertainty and mitigate sovereign debt risks effectively.

Keywords: Sovereign debt crisis, Industrial composition, External dependency, Financial stability, Debt sustainability.

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1. Introduction

At present, the global economic situation is at a critical juncture where a developed economy is generally facing an increase in debt burden and a decline in fiscal sustainability. All economies in the world are feeling the pressure of the sovereign debt crisis. Therefore, seeking a comprehensive policy path that suits the national conditions and takes into account economic growth, price stability and debt management has become a major issue that governments around the world urgently need to address.

2. Statement of Issues

In the global economic system, facing the complicated and challenging macro situation of "medium-high inflation and medium-low growth", governments of various countries are caught in a dilemma in their policy choices: whether to adopt an expansionary fiscal policy to stimulate economic growth, or adopt a tight monetary policy to curb inflation in order to achieve healthy and stable development of their own economies? According to Mundell's principle of effective market allocation (the famous "impossible trinity" theory), an expansionary fiscal policy and a tight monetary policy should ideally be implemented simultaneously. However, in practice, the implementation of this strategy is facing severe challenges. First, if the government adopts expansionary fiscal policy under the condition of high inflation and low growth, although it may boost economic activities in the short term, the government debt level will rise due to large-scale public expenditure. If the increase in fiscal revenue brought by economic growth is not enough to offset the increase in debt pressure, the risk of sovereign debt default in the country will increase significantly. International rating agencies may then downgrade the country's credit rating, exacerbating panic in financial markets and causing investors to pay their debts ahead of schedule, thus accelerating the debt crisis.
For developed economies, especially those countries with global reserve currency status, they usually have a certain degree of monetary policy autonomy and flexibility. They can ease sovereign debt pressure, enhance market liquidity and thus buffer the impact of the debt crisis through expansionary monetary policy measures, such as reducing interest rates or implementing quantitative easing policies. However, the situation in developing economies is more complicated and sensitive. If these economies follow the expansionary monetary policies of developed economies, their domestic currencies are likely to depreciate further, which will not only increase the external debt burden, but also cause the overall debt scale to spiral upward, thus greatly increasing the risk of a sovereign debt crisis. On the contrary, if one chooses to tighten monetary policy, although it can promote domestic interest rate increase, local currency appreciation and net capital inflow in the short term to reduce the pressure on government debt, the higher interest rate environment will undoubtedly inhibit domestic demand, hinder investment and consumption in the real economy, and force the government to switch to loose monetary policy to maintain economic growth in the long term, which in turn will

increase the probability of debt crisis.

To sum up, developed economies tend to show greater policy initiative and independence when dealing with high inflation and low growth, while developing economies need to refer to the practices of developed economies and make adjustments according to their own national conditions when formulating macroeconomic policies. When the debt burden of the developed economies is relatively small and the fiscal sustainability is relatively strong, the developing economies can improve their own economic development to a certain extent by imitating their policy measures; However, once the debt burden of developed economies increases and their fiscal sustainability weakens, the probability of a sovereign debt crisis will increase, which will bring more severe economic difficulties and higher risk of debt crisis to developing economies.

3. Background

Since the outbreak of the COVID-19 epidemic in early 2020, the scale of global debt has shown an unprecedented expansion. According to the latest report released by the International Finance Association (IIF), the total global debt had climbed to a record high of nearly US$ 310 trillion by the end of 2023, a significant increase of about 30% from the level at the beginning of the epidemic. Among them, 65% of the new debt in 2023, or more than $1.89 trillion, came from the massive fiscal stimulus and monetary easing policies of developed economies to cope with the pressure of economic recession.[2]

Under this macro-economic background, the global economy is facing the risk of "stagflation" with medium-high inflation and medium-low growth. Take the United States as an example. In 2023, the Federal Reserve raised the benchmark interest rate four times in a row in order to contain the persistently high inflation rate, and the cumulative rate increase reached 100 basis points, resulting in the liquidity crunch in the global financial markets. Not to be outdone, the European Central Bank took decisive action to contain the inflationary pressure in the region, raising interest rates six times in a row, and its monetary policy stance turned to obvious hawks.

However, the massive accumulation of debt and the consequent rise in interest rates have posed severe challenges to the fiscal sustainability of economies. Developing economies are more sensitive to changes in the external environment due to their relatively weak economic base. The increased debt burden has significantly increased the likelihood of a sovereign debt crisis. According to the data of the World Bank, the debt of some low-income countries has approached or exceeded 60% of GDP, and the debt dilemma is especially prominent.

At the same time, the developed economies have not been spared, suffering from the impact of multiple negative factors, such as slowing economic growth, high public debt and aging. The risks of financial crisis and sovereign debt crisis have

[2] Detailed data come from China Banking Research Institute and Financial Times.

become increasingly prominent. For example, Japan's government debt has exceeded 250% of its GDP, making it one of the countries with the highest debt ratios among the developed countries, which undoubtedly poses a potential threat to global economic stability.

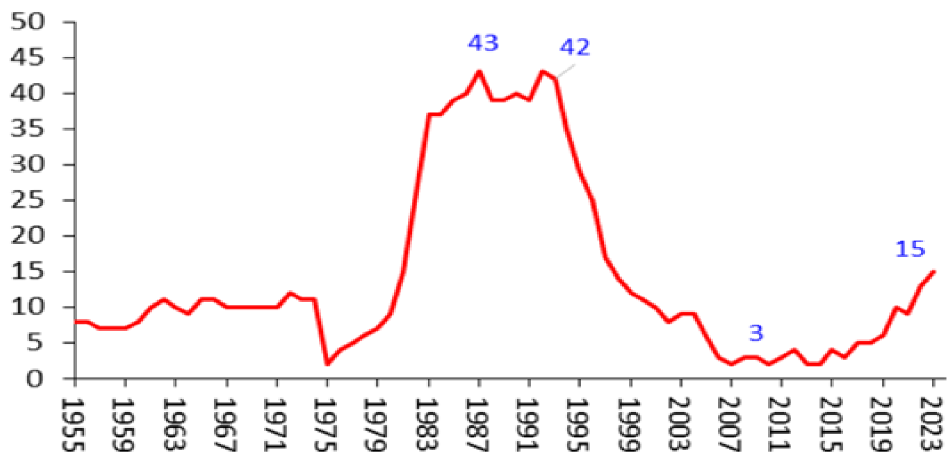

Figure 1: Number of countries in debt default, 1955-2023[3]

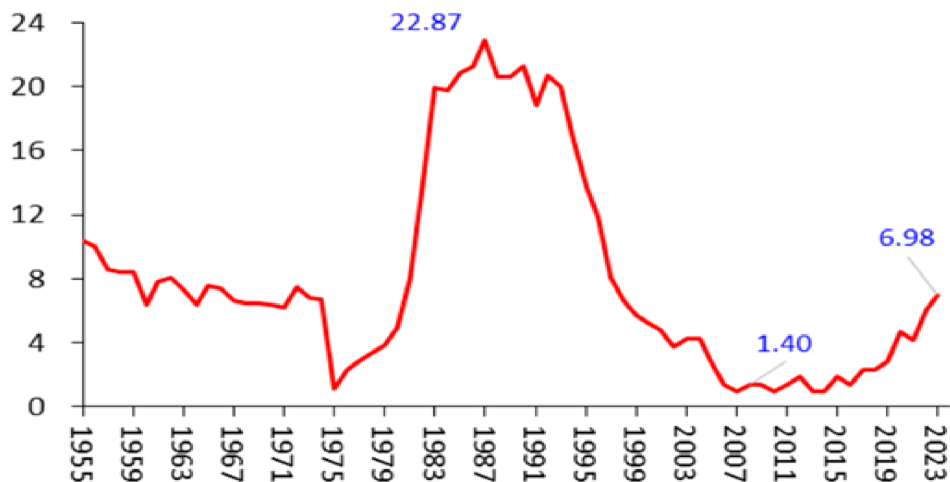

Figure 2: Proportion of Countries in Debt Default[4]

[3] Picture from Lu Feng: How to Deal with a New Round of Global Sovereign Debt Risks? - National Development Research Institute of Peking University (pku.edu.cn)

[4] Picture from Lu Feng: How to Deal with a New Round of Global Sovereign Debt Risks? - National Development Research Institute of Peking University (pku.edu.cn)

4. Analysis

4.1 Reasons for Increased Debt in Developed Economies

4.1.1 The impact of the epidemic

In response to the impact of the COVID-19 epidemic, governments have increased spending on public health care and social welfare, while tax revenue, the main source of fiscal revenue, has been sharply reduced due to the impact of the domestic economic downturn. In order to maintain the stability of fiscal expenditure and fulfill the previous policy commitments, governments need to borrow external debt to achieve their policy objectives.

4.1.2 The impact of Russia-Ukraine conflict and other emergencies

The outbreak of the conflict between Russia and Ukraine has directly led to the crisis in the supply of important energy sources such as natural gas, causing the global energy price to soar. As a major importer of energy, developed economies have seen a sharp increase in energy spending, forcing governments to borrow foreign debt to buy energy.

4.1.3 Weak economic growth

As the main source of fiscal revenue, taxation is closely related to the economic development of various countries. Since 2022, the global GDP growth rate has been declining for two consecutive years. Affected by the decline in corporate profits and the decline in residents' income, the government revenue will drop significantly. In order to ensure fiscal balance, governments have successively borrowed foreign debts.

4.1.4 Central banks in major economies raise interest rates

Over the past two years, the developed economies have raised interest rates rapidly, and the proportion of foreign debt interest in financial expenditures has increased rapidly. This has greatly increased the pressure on foreign debt interest payments. The US Treasury Department estimates that the net interest cost of US government expenditure in FY2023 amounted to US$ 659 billion, an increase of US$ 184 billion as compared with FY2022, accounting for 2.5% of GDP.

4.2 Financial problems caused by high debt of developed economies

A country's economy can develop healthily only when the debt-servicing pressure brought by the country's foreign debt is offset by the increase in fiscal revenue brought by the country's economic growth. However, it is regrettable that the developed economies have not achieved domestic economic growth while their debts have increased, which has to a large extent triggered people's worries about the financial crisis and sovereign debt crisis in the developed economies. However, there are two main reasons why the high debt of developed economies causes financial problems:

- **The functioning of domestic institutions and mechanisms is hindered**

Take the United States as an example. In 2023, the United States successively experienced financial crises such as hitting the debt ceiling and insufficient federal funds, which forced its credit rating and credit outlook to be lowered, causing people to worry about government debt default.

- **Space for fiscal policy to work is squeezed**

For the developed economies with slow economic recovery in the post-epidemic era, they need to implement expansionary fiscal policies to achieve rapid economic growth, but their sovereign debt pressure has increased significantly due to the impact of interest rate hikes by the central banks of major economies. In order to maintain relatively reasonable sovereign debt pressure and avoid default, these developed economies have to implement fiscal policies with less expansion, and the effect of fiscal policies has been greatly reduced.

4.3 The negative impact of economic policies in developed economies

Under the complicated and challenging macro background of the global economic pattern of "medium-high inflation and medium-low growth", both developed and developing economies have encountered significant difficulties in the choice and implementation of monetary and fiscal policies. Developed countries generally adopt a combination of tight monetary policies and expansionary fiscal policies to stimulate economic growth. However, practice has proved that the effect of this strategy is not satisfactory, but has produced a series of negative effects.

First of all, at the level of developed economies, through tight monetary policy, i.e. raising the benchmark interest rate, we try to restrain the inflationary pressure from the money supply side and reduce the total amount of domestic currency in circulation in the market, so as to achieve the goal of stabilizing prices. At the same time, the higher interest rate environment promotes the appreciation of the domestic currency in the foreign exchange market, attracting foreign capital inflows and providing additional financial support for domestic economic construction. However, it should not be ignored that the high interest rate environment also exerts a restraining effect on domestic demand, resulting in a decrease in residents' willingness to consume and a cautious investment, which in turn affects the overall consumption demand and investment expenditure. What is more noteworthy is that international capital tends to flow to non-real economic sectors such as finance and trust in pursuit of higher returns, which not only aggravates the problem of "turning the real economy into the virtual economy", making the real economic sectors lack the necessary financial support, but also seriously threatening the stability of the economic system.

At the same time, the effect of the expansionary fiscal policies adopted by the developed economies is limited by the interest rate increase measures of the major economies in the world, and their effect is greatly weakened. The original intention

of the government to increase fiscal expenditure to boost the economy has not been translated into the expected growth momentum. The actual policy dividends received by the enterprises are not sufficient to support the improvement of their operating efficiency, thus failing to achieve the tax growth expected by the government, thus increasing the risk of fiscal deficits. In addition, the reduction of fiscal revenue will directly lead to the decrease of the government's debt repayment ability, which may lead credit rating agencies to lower their sovereign credit ratings and increase the probability of default, thus significantly increasing the possibility of a sovereign debt crisis.

Looking at the developing economies again, the difficulties they face are even more severe. On the one hand, affected by interest rate hikes in major developed economies, developing economies, as debtor countries, have to bear a higher debt interest burden. Debt service pressure has increased sharply and the risk of debt default has also increased. On the other hand, if these economies follow the example of developed economies to implement tight monetary policies to contain high inflation, although they can alleviate the inflationary pressure to a certain extent, the ensuing influx of "hot money" may lead to excessive frothiness in the financial market, leading domestic capital to flow to the financial industry on a large scale. The capital supply needed for the development of the real economy is seriously insufficient, which will pave the way for the future financial crisis. If one chooses to tolerate high inflation moderately and hopes to stimulate export growth and increase national income through devaluation of the local currency, the debt burden will be further increased, leading to a decline in sovereign credit rating and accelerating the outbreak of sovereign debt crisis.

To sum up, both developed and developing economies, when facing the dilemma of "moderate to high inflation and moderate to low growth" in the global economy, must carefully weigh the comprehensive application of monetary and fiscal policies, and fully consider the linkage effect of international financial markets and the characteristics of industrial structure, in order to find a policy path that can effectively curb inflation and effectively promote the development of the real economy, so as to avoid or mitigate the risk of sovereign debt crisis.

4.4 The combination of the European debt crisis to explore the factors affecting the effectiveness of the policy

In the global economic tide, countries at different stages of economic development have significant differences in their responses to the same economic policies and their affordability. This phenomenon was vividly and profoundly reflected in the European debt crisis in 2009. At that time, the same tightening of monetary policy and foreign capital inflows had very different effects on developed and developing economies. Greece, Ireland and other countries have borne the brunt of the financial crisis due to the irrational industrial structure. The sovereign debt crisis broke out rapidly. Germany and other countries successfully resisted the first shock of the crisis by virtue of their sound industrial structure and strong economic resilience,

and showed more lasting stability in the subsequent market fluctuations.
Take Greece as an example, the country's industrialization process is relatively late, the industrial structure is relatively single and biased towards primary product processing, and the products exported are mostly agricultural and sideline products and primary processed products with low added value, while the imported goods are mainly of high technology content and high added value, resulting in a serious imbalance in the trade structure. When global interest rates rose, a large number of low-cost capital poured into these countries, ostensibly to promote economic growth, but in fact it increased the domestic economy's over-reliance on foreign investment, forming a fragile illusion of prosperity. However, once the external environment changes, especially the international capital flow reverses, these countries are unable to effectively absorb or disperse the negative impact of the withdrawal of foreign investment due to the lack of a solid industrial foundation and diversified industrial support, thus causing the economic bubble to burst and the sovereign debt crisis to erupt [1].
On the contrary, Germany, as an established industrial power, has a diversified industrial structure and high competitiveness. It can efficiently use foreign capital to promote the development and upgrading of its real economy. At the same time, it also makes its economic bubble smaller when facing the pressure of capital outflow. The economic system has enough resilience to buffer the impact and avoid the rapid deterioration of the sovereign debt crisis [1].
From a historical and realistic perspective, both developed and developing economies, a reasonable industrial structure and a low degree of foreign dependence are the key to a country's response to the sovereign debt crisis. On the one hand, a solid and diversified industrial foundation acts as a line of defense, which can prevent the domestic economic bubble from collapsing instantly when foreign capital withdraws and guarantee the stability of economic fundamentals; On the other hand, reducing dependence on external markets will help reduce the increase in import costs and balance of payments deficits brought about by higher interest rates, ensure balance of payments and enhance macroeconomic autonomy and stability. Therefore, when formulating macroeconomic policies, countries should fully consider their own industrial structure characteristics and the impact of foreign dependence in order to steer the course in the global economic storm [2].

4.5 The impact of the suspension of interest rate hikes in major economies

In the second half of 2023, central banks in major economies such as the Federal Reserve and the European Central Bank slowed down their interest rate hikes. The Federal Reserve raised interest rates by 100 basis points four times during the year, suspended interest rate hikes four times, and hinted in December that the interest rate hike cycle was over; The European Central Bank suspended interest rate hikes in October after raising rates six times in a row in the first three quarters. Global monetary policy is changing from tightening to easing, and international capital flows are expected to reverse.

Under the premise that capital flows are relatively free in today's world, a country's interest rate rise will lead to the appreciation of its own currency and the inflow of foreign capital. A drop in interest rates would lead to a devaluation of the domestic currency and an outflow of foreign capital. For the developed economies, the benchmark interest rate will be at a higher level after the interest rate hike is stopped, and the consumption and investment demand of residents will still be suppressed. Therefore, they will tend to gradually cut interest rates, stimulate domestic consumption, investment and exports, and promote economic growth. The policy trend will change from controlling moderate and high inflation to changing the trend of moderate and low economic growth. At the same time, with the implementation of the loose monetary policy, the debt-servicing pressure faced by the major developed economies will be reduced. They can repay their debts by issuing bank notes and other means, and the sovereign debt crisis will be effectively alleviated.

For developing economies, when major economies adopt loose monetary policies, on the one hand, international capital flows from developed economies to developing economies, and the economic conditions of developing economies can be effectively improved in the short term; On the other hand, developing economies' debt interest rates will be reduced, their debt-servicing capacity will be relatively enhanced, their debt-servicing pressure will be reduced, and the probability of a sovereign debt crisis will be reduced.

5. Conclusion

As the global economy is facing the complicated dilemma of "medium-high inflation and medium-low growth", the international community urgently needs to strengthen in-depth coordination and efficient coordination at the macro-policy level in order to jointly cope with the uncertainty of the global economy. When formulating monetary policies, developed economies should show a high degree of prudence, fully weigh their own economic conditions, and at the same time, thoroughly consider the possible spillover effects and linkage effects of their monetary policy adjustments on the world, especially on developing economies. This requires them to not only focus on the stability of their own economies, but also take into account the overall balance of the global economy when making policy choices of tightening or easing.

On the other hand, international institutions such as the IMF, the World Bank and major creditor countries should actively play a more responsible role by implementing practical measures such as debt restructuring, limited debt relief and exemption to effectively reduce the debt burden of developing economies and help them get out of the debt crisis so as to achieve a more sustainable development path. For those developing economies with relatively weak economic bases, it is particularly crucial to enhance their financial risk prevention capabilities. They need to further improve the domestic financial risk monitoring system and management mechanism, and establish a financial firewall that can effectively resist external shocks. At the same time, the Bank will improve its keen insight and quick response

capability to fluctuations in international financial markets, strengthen the management of cross-border capital flows and risk warning, prevent potential shocks from large-scale cross-border capital inflows and outflows, and ensure the stability and health of the macroeconomic environment. Only in this way can all economies be guaranteed to share the dividend of global economic growth under the background of global economic turmoil and inject lasting impetus to the recovery and development of the world economy [3].

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