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جامعة الدول العربية

# Factors Affecting Public Debt Sustainability Amid Internal and External Economic Challenges & Possible Solutions

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# Table of Contents:

1. Introduction: Navigating Economic Uncertainty
2. Rising Global and Regional Public Debt Levels
3. Drivers of Public Debt
4. Strategies for Sustainable Public Debt Management (Including Innovative Financial Instruments)
5. The Role of the International Community (MDBs and IFIs)
6. Recommendations





# 1- Introduction: Navigating Economic Uncertainty

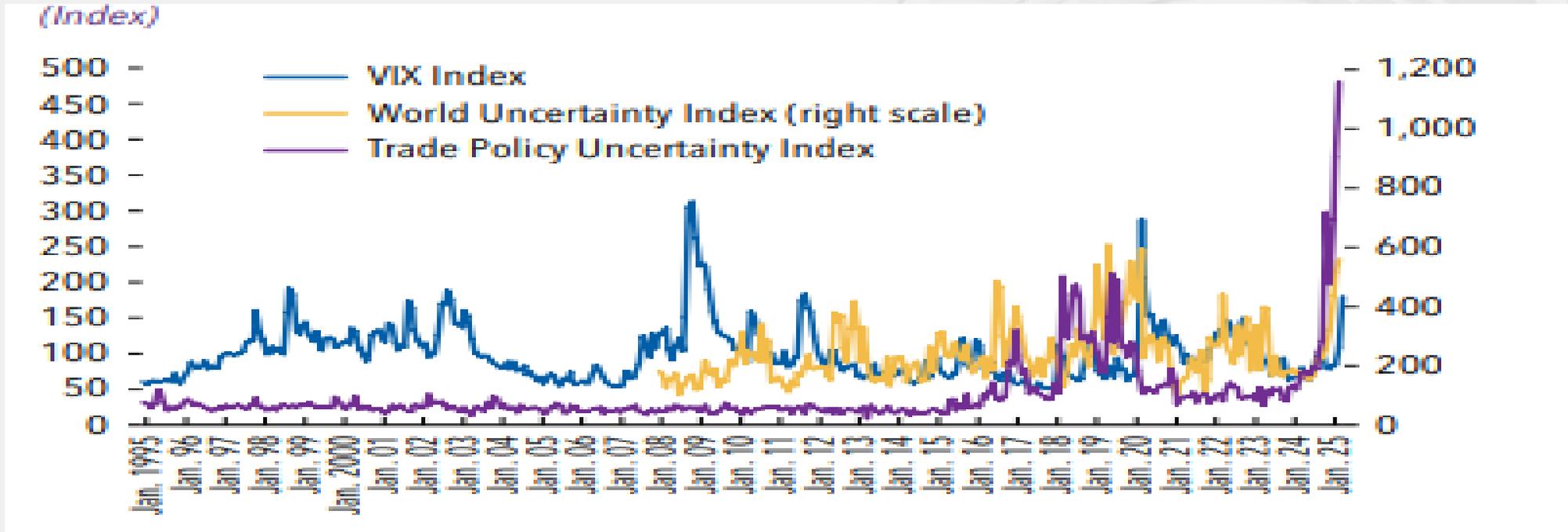
## The Impact of Rising Tariffs and Public Debt

- Elevated uncertainty and significant policy shifts are reshaping global economic and fiscal outlooks.
- Impact of rising major tariffs announcements and countermeasures by other countries, global market volatility, and exceptionally high levels of policy uncertainty, are contributing to worsening prospects and heightened risks.
- Tighter and more volatile global financial conditions may have ripple effects on emerging markets and developing economies, leading to higher financing costs, which impacts commodity prices, resulting in heightened price volatility.
- It is expected that these measures will place additional pressure on public resources and growth, thereby significantly affecting Debt-to-GDP ratios at a time when debt levels are rising in many nations.





# 1- Introduction: Navigating Economic Uncertainty



Source: IMF

- Significant Reduction in the ODAs is adding additional burden on many countries;
- Progress with disinflation appears to have stalled in many countries;
- Growth prospects have been significantly downgraded.
- All these factors together are increasing the global uncertainty.





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# 1- Introduction: Navigating Economic Uncertainty

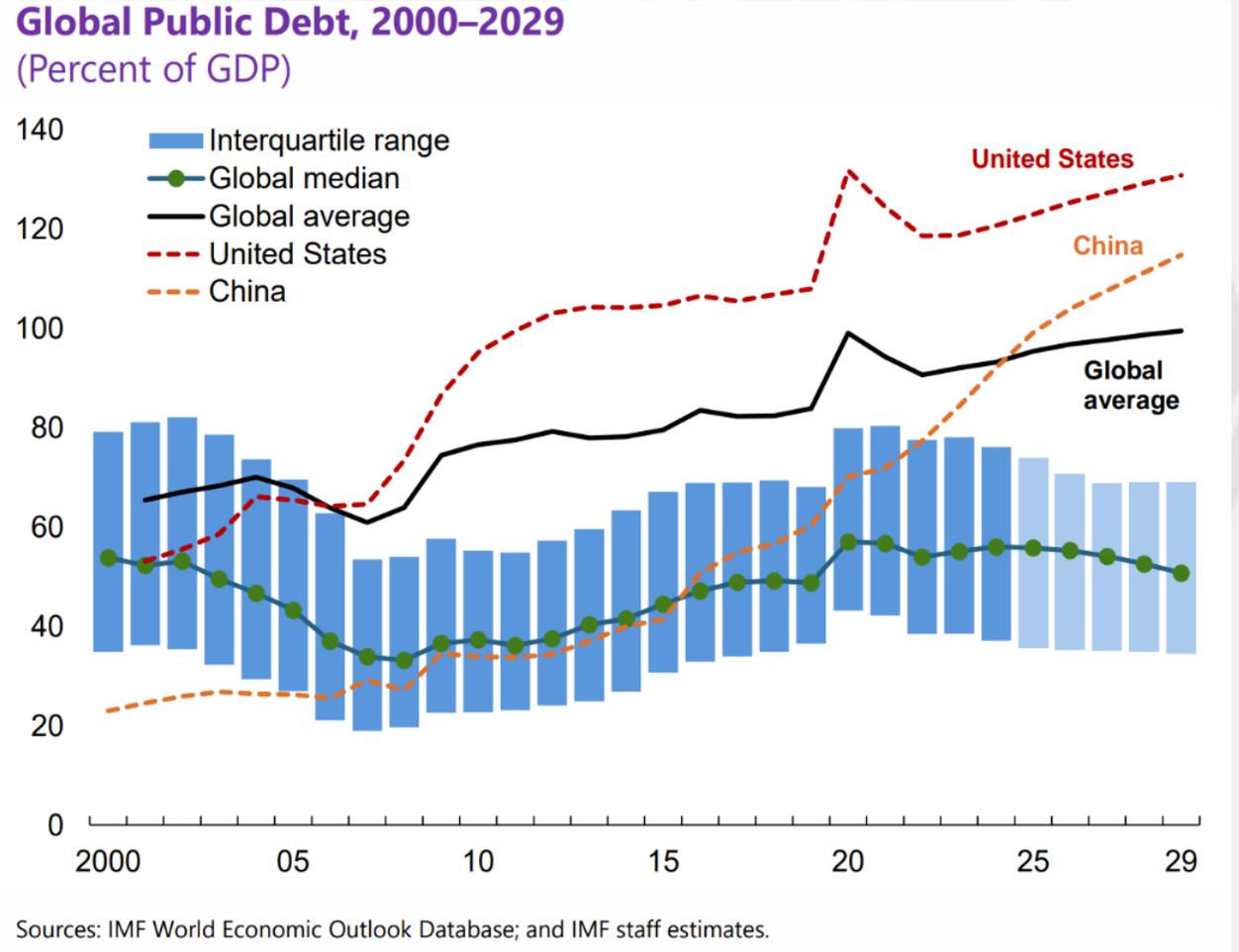
- On the fiscal front, many countries which may further heighten risks from already grappling with stretched budgets, limited fiscal improvements, rising public debt burdens, rising interest servicing costs and substantial gross financing needs.
- In this environment of more volatile financial conditions and heightened economic uncertainty, fiscal policy faces critical trade-offs: face the challenges of balancing debt reduction, building protective buffers reserves against uncertainties, and meeting urgent spending needs, amid weaker growth prospects, all while financing costs remain high.
- These pressures are further aggravated by demographic characteristics such as an increasing population because of increasing fertility rate and life expectancy with rising basic needs such as healthcare, education, public services..etc.





## 2- Rising Global and Regional Debt Levels

- More than two-thirds of the 175 economies in the IMF’s latest study have heavier public debt burdens than before COVID in 2020.
- Global public debt has doubled since 2010, reaching a historic \$97 trillion in 2023.
- Global public debt is projected to rise by an additional 2.8% of GDP in 2025, approaching 100% of GDP in 2030 and surpassing the pandemic peak.





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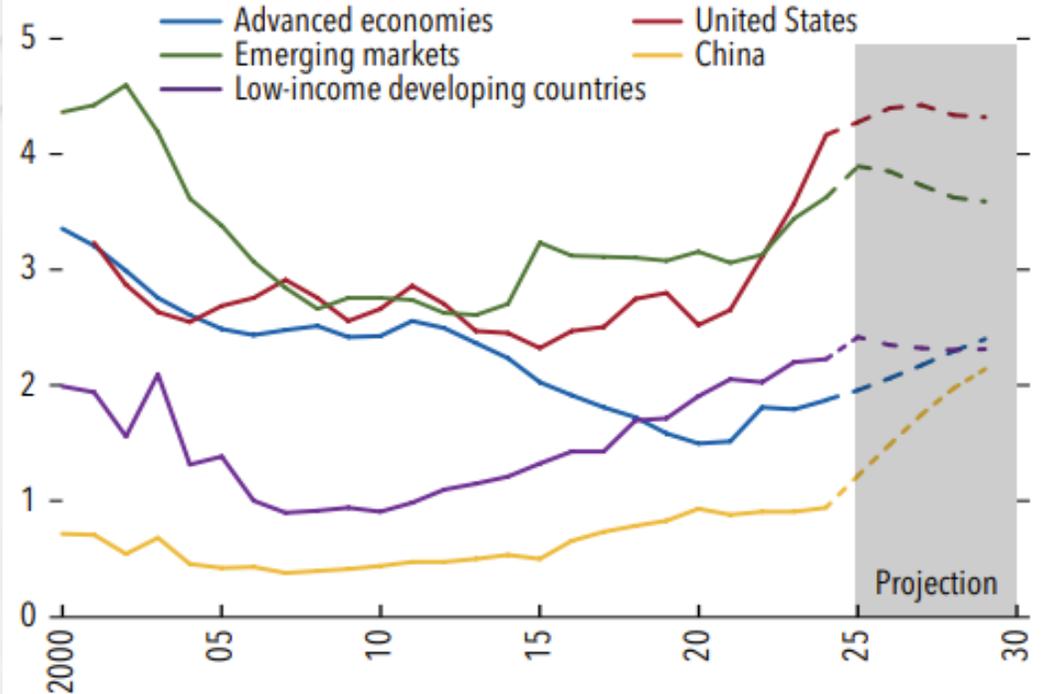
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## 2- Rising Global and Regional Debt Levels

- One of the biggest current obstacles in emerging economies is the scale of debt servicing cost as more than 40% of the world's population live in countries that spend more on debt interest payments than on education or health.
- The worsening burden of debt servicing is diverting essential resources away from development needs in many countries.
- These financial pressures prevent nations from spending on essential services or critical investments needed to attract economic activity, create job opportunities, and strengthen resilience against climate change.



**Figure 1.3. General Government Interest Expenses**  
(Percent of GDP)

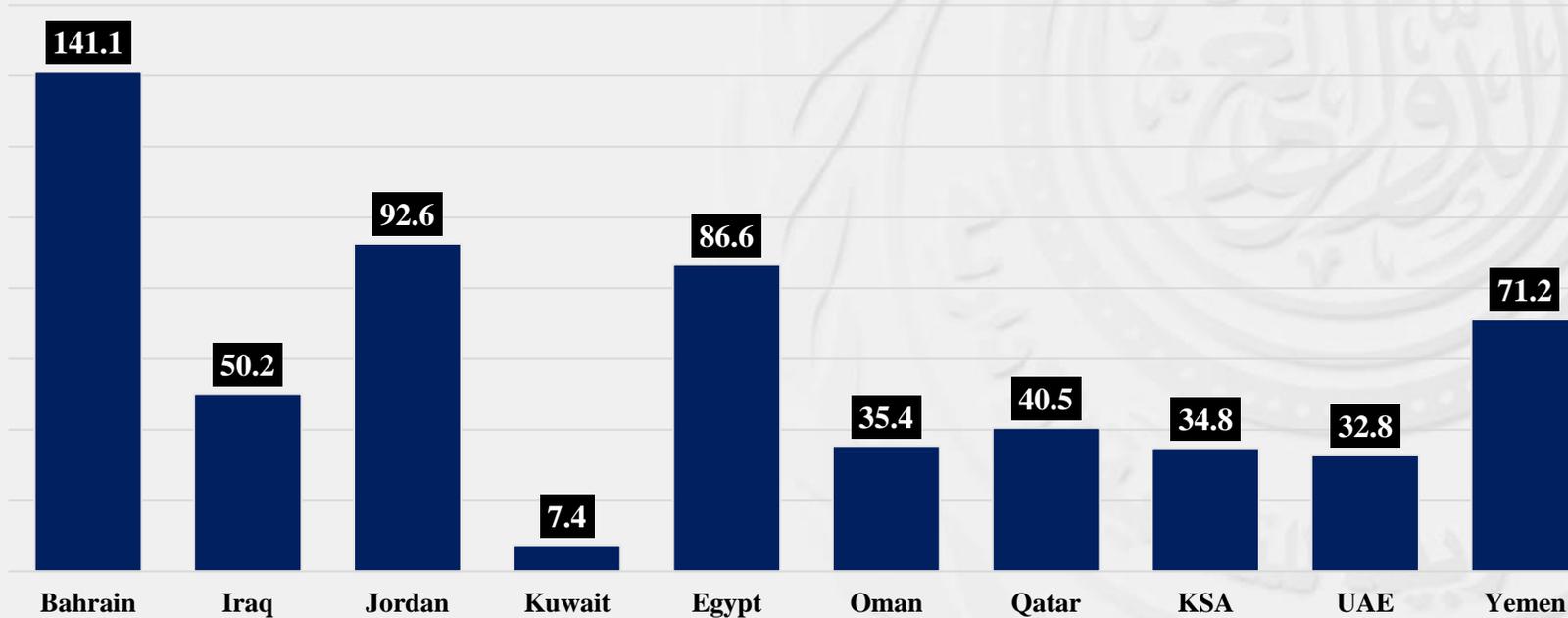


Sources: IMF, World Economic Outlook database; and IMF staff calculations.



## 2- Rising Global and Regional Debt Levels

### Total Public Debt for Arab Countries in 2025 (% of GDP)

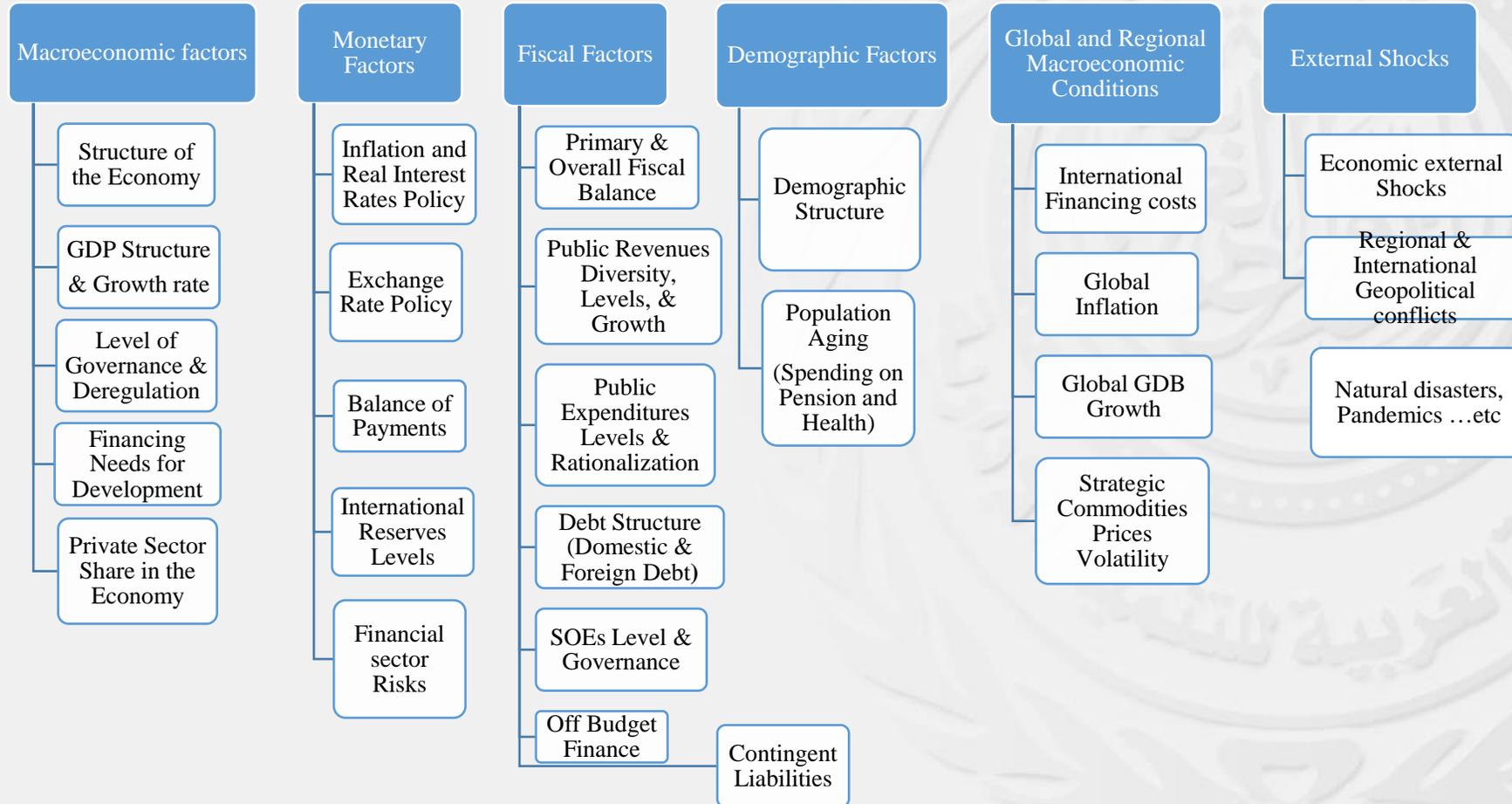


Source: Fiscal Affairs Department IMF





# 3- Drivers of Public Debt





### 3.1- Macroeconomic Factors: Structure of the Economy

Economic structure: whether it is diversified or not plays an important role in the contribution of the level of public debt. If it is single or two sectors driven this may be vulnerable to repeated economic shocks. If it is diversified to many sectors; this can help to reduce the probability of contribution to public debt through:



**Increasing revenues**



**Reducing dependence on certain sectors**



**Improving economic stability**



**Reducing Debt-Related Risks**



**Creating additional Job Opportunities**

- Countries may be heavily dependent on a single sector or two sectors such as oil, gas, or other natural resources or on a specific sector or industry, such as tourism, or agricultural.
- Countries diversifying their economies, focusing on more sectors to have a mix of industries, agriculture, manufacturing, services, tourism, and logistics





## 3.1- Structure of the economy

The main drivers for GDP growth: Increased consumption, investment (including government spending), net trade which together can ensure sustained economic growth.

- USA → Consumer Spending
- France → Government spending
- China → Strong manufacturing sector, significant investments, and robust export trade
- UAE → Increased consumption, investment (including government spending), and trade





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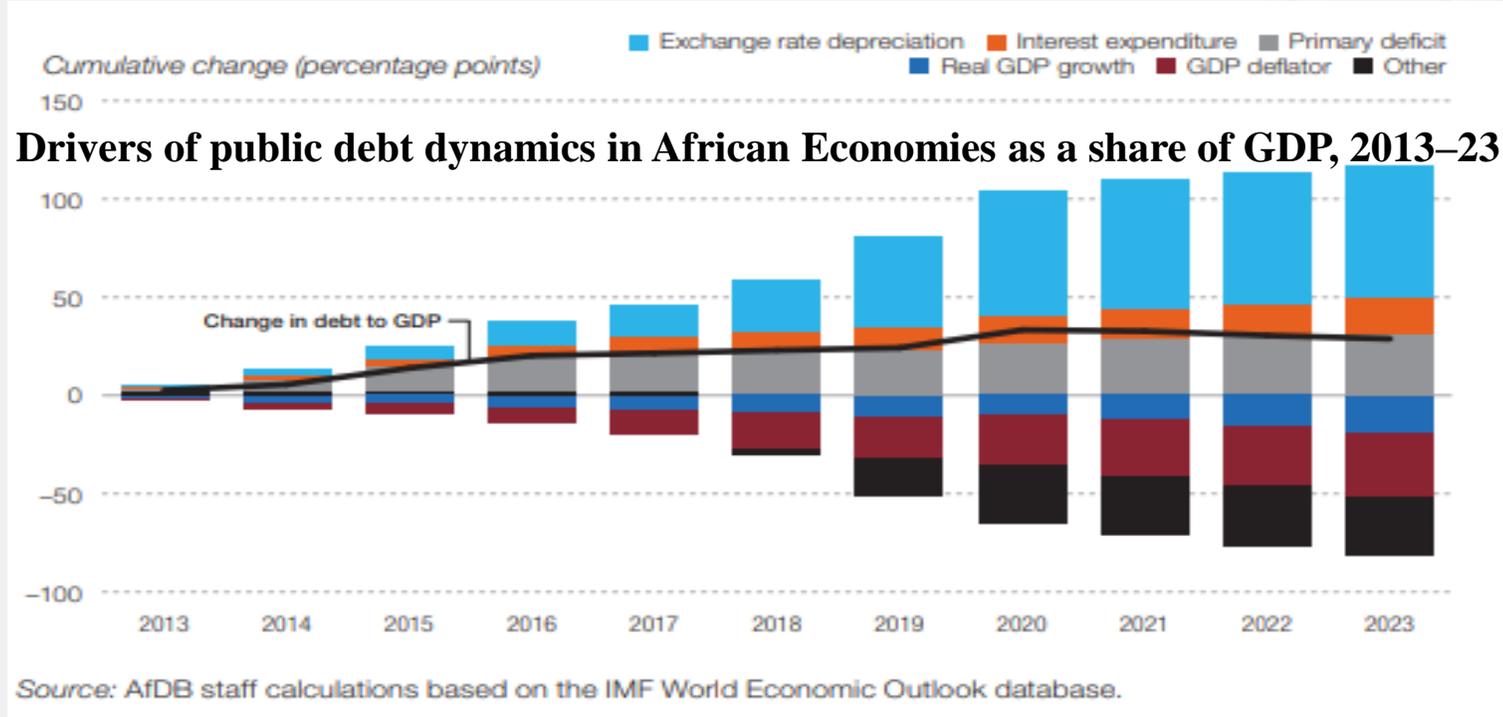
## 3.2- Monetary Factors: Balance of Payments Deficit

- A persistent balance of payments (BOP) deficit in net importing countries (goods or services), leads to:
  - **Increased Foreign Debt:** The country accumulates more foreign debt to finance its imports.
  - **Weakened National Currency:** A BOP deficit can put downward pressure on the country's currency exchange rate, making it more expensive to import goods and services in addition to increasing inflation, value of debt and debt service.
  - **Economic Vulnerability:** A reliance on foreign borrowing makes the country more vulnerable to economic shocks or changes in global interest rates.
- To finance this BOP deficit, countries need to find ways to acquire foreign currency. This often involves:
  - **Borrowing from the international markets/lenders,** increasing external debt.
  - **Selling assets** to foreign entities.
  - **Utilizing foreign exchange reserves** to cover the shortfall.





# 3.2 - Currency Risk: A Threat to the Financial Stability of LMICs & African Debt



- Over 80% of development finance loans are provided in hard currencies.
- Foreign currency debts often having longer maturities, with highly volatile foreign exchange rates, leading to higher total costs and can seriously impact the resilience of borrower..
- USD-denominated debt as a currency risk premium is priced in higher macro-economic instability and inflation in LMICs.

- Depreciation in ERs has been the major driver of LMICs and Africa’s debt increase of more than 50% between 2013-2023.



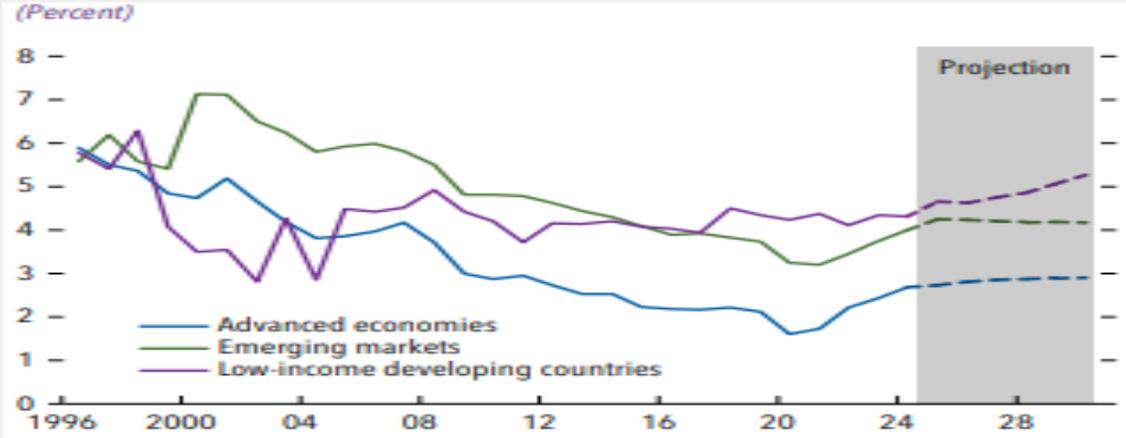
- LICs/LMICs are loaded with unhedged foreign currency debt and therefore vulnerable to currency and interest rate fluctuations.
- Countries with high-risk credit ratings saw the value of their currency fall by nearly 80% against the US dollar from 2000 to 2024, with the cost of redeeming the principal of a 20-year USD bond issued in the early 2000s being five times higher in 2024 (the Global debt Report,2025).



# 3.2 - Monetary Factors: Interest Rate Risk

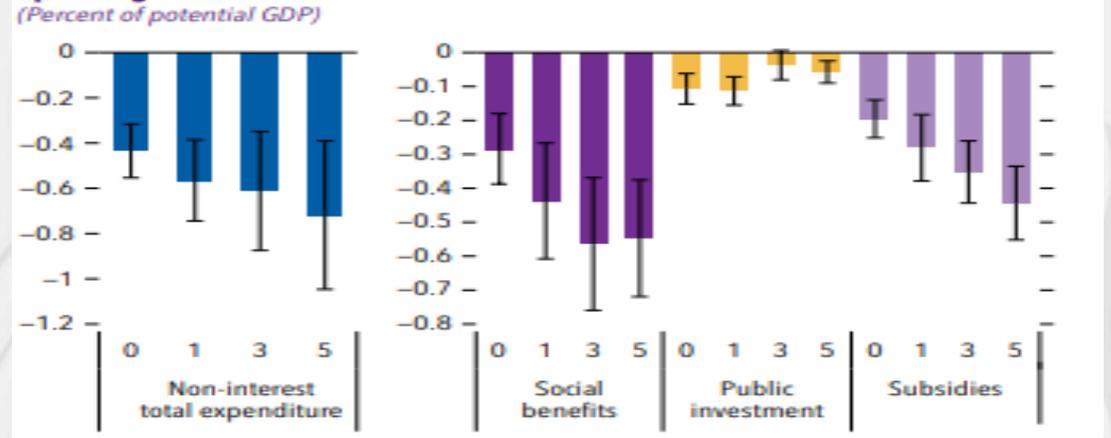


### Effective Yields on Government Debt



Source: Fiscal Monitor Report, April 2025

### Crowding-Out Effects of Interest Expenses on Other Public Spending



Source: Fiscal Monitor Report, April 2025

## Factors contributing to rising interest rate:

- The increased financial market volatility
- larger-than anticipated fiscal deficits, due to escalating spending pressures, including increased infrastructure and defense spending,

A challenging landscape of high inflation

Initiatives to mitigate the potential impact of tariffs



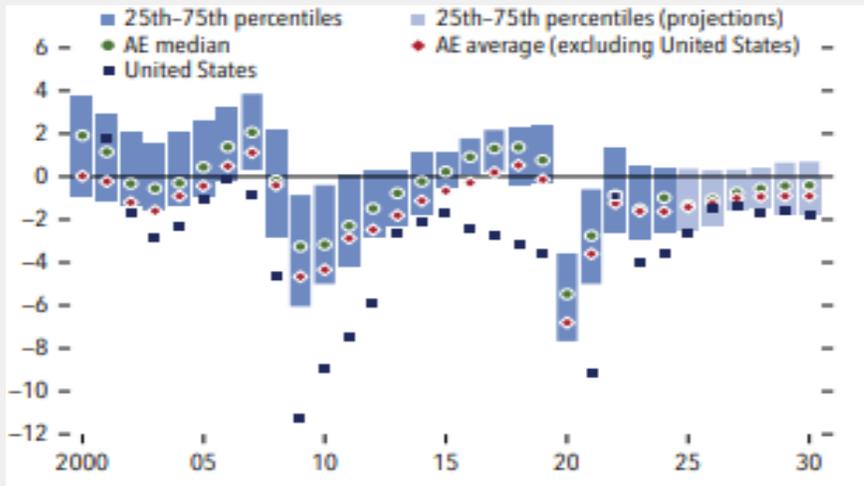
Empirical evidence from 75 advanced and developing economies indicates that a 1 % of potential GDP increase in interest expenses typically results in a permanent reduction of about 0.6% of potential GDP in noninterest expenditures in the medium-term.



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### Primary Balance in advanced economies



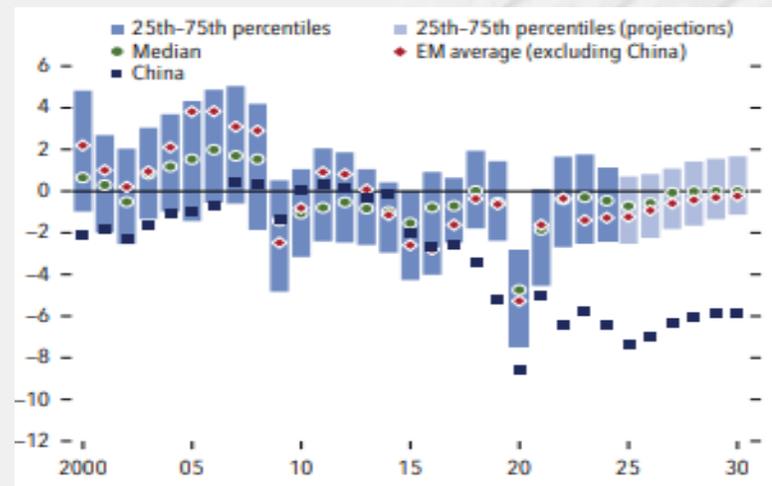
Fiscal Monitor Report : April 2025

## 3.3- Fiscal Factors: Primary Balance

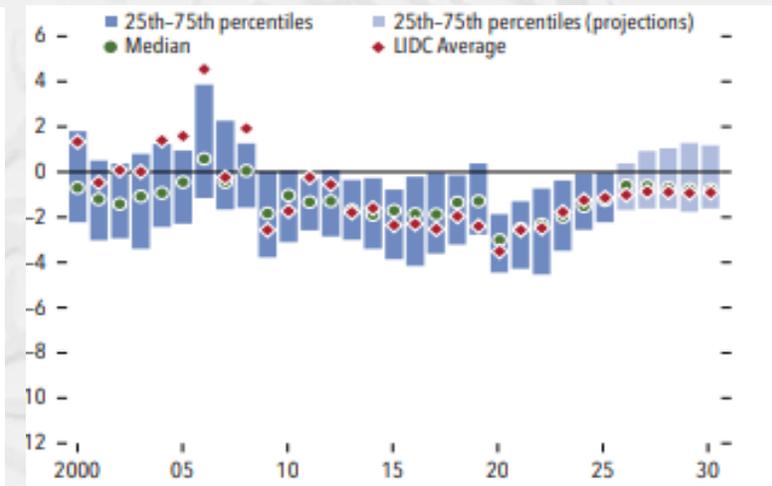


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### Primary Balance in emerging markets



### Low-Income developing countries



- Budget deficits levels in many countries remained elevated in 2024. The fiscal outlook is influenced by many factors such as public investment, economic conditions, fiscal and monetary policies, uncertainty, tariffs, financial and demographic conditions ..... Etc.
- The primary balance-to-GDP ratio is a key contributor to changes in the public debt ratio. **A primary deficit increases the public debt stock** because it requires the government to borrow funds to finance the deficit, to the extent that other debt-creating flows (e.g., the government's financial assets) are not used to finance the deficit.





### 3.3- Below the Line Operations Impact on Public Debt

#### **In EMs and particularly in LICs, Stock Flow Adjustments (SFA)\* explain a significant part of debt accumulation:**

- There are several reasons that result in Stock Flow Adjustments including:
  - Existence of off-budget funds,
  - Realization of contingent liabilities such as SOEs or bank recapitalization, arrears, cash vs. accrual accounting differences between fiscal balance and debt
  - Transfers to state-owned enterprises and/or contingent liabilities can offset debt reduction efforts.

These “below-the-line” operations can increase debt, despite improvements in the primary.

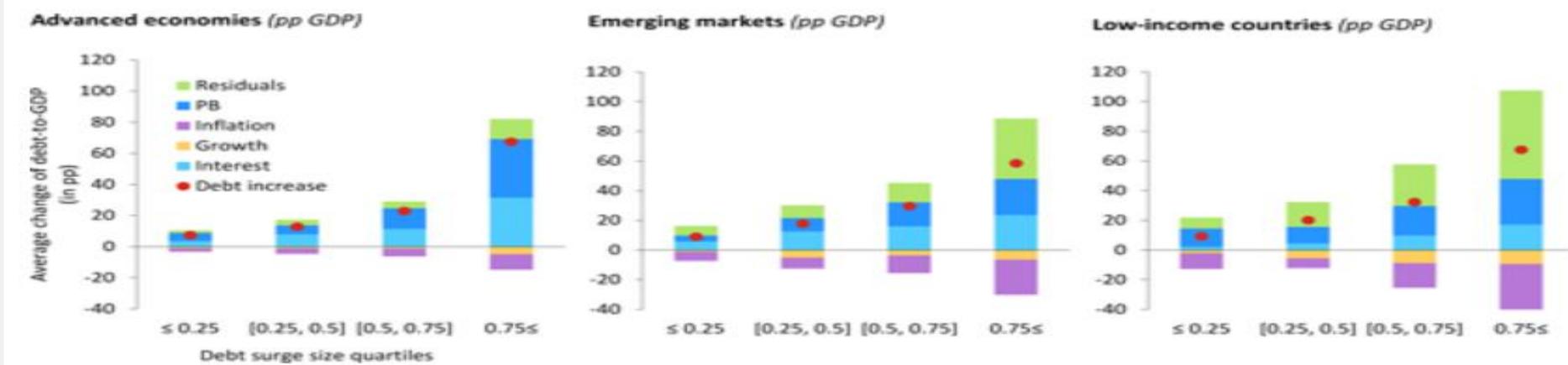
#### **\*Stock Flow Adjustments (SFA)**

Represent the difference between the change in government debt (stock) and the annual deficit or surplus (flow)





### 3.3- Public Debt Drivers among Income Group



Source: IMF Debt Surges—Drivers, Consequences, and Policy Implications, 2024

- IMF report (2024) quantifies the contributions of various components to the debt surge episodes, namely those of **real GDP growth, nominal interest expenses, the primary balance, and inflation.**

1- **AEs and EMs**, primary deficits and interest payments are the main drivers of debt surges. However,

2- **EMs**, Stock Flow Adjustments (SFA) are another important contributor to larger surge episodes.

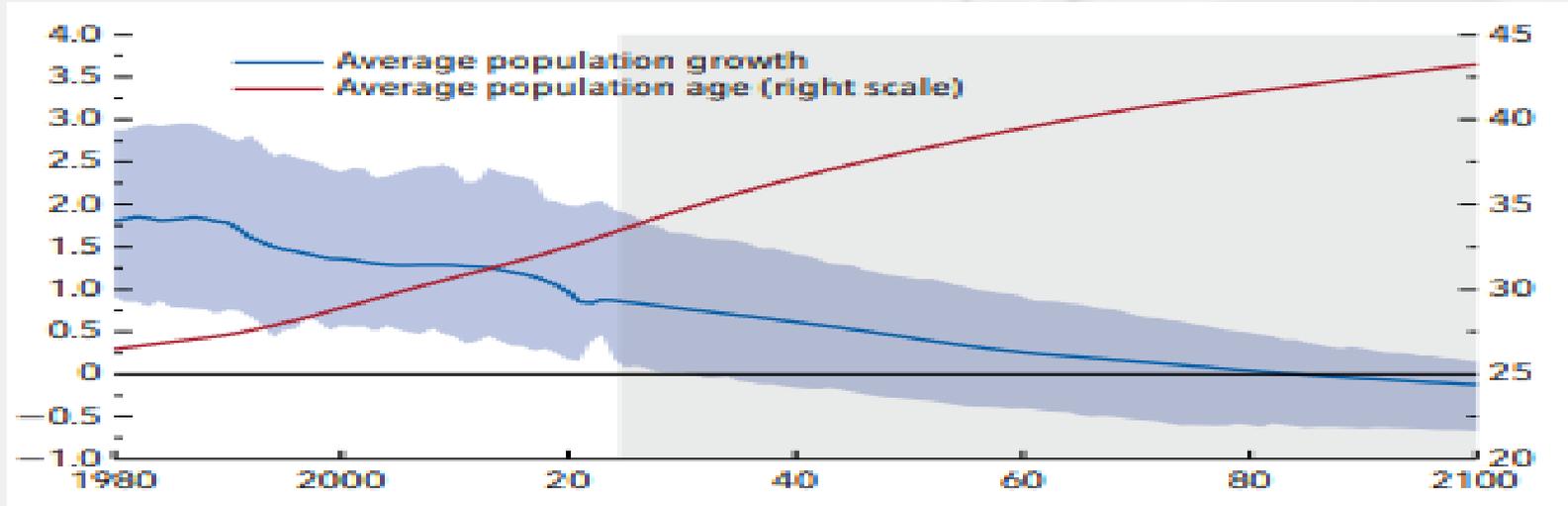
3- **LICs**, Stock Flow Adjustments (SFA) play an overwhelming role across all debt surge brackets with primary deficits





## 3.4- Demographic Factors

### Global Population Aging (%)



Source: World Economic outlook Report, April 2025

Decline in fertility and increase in longevity are bringing sharp changes in the age structure of economies, as follows:

- 1- Increasing old-age dependency ratio weighs on growth and strains public finances on account of higher spending on pensions and health care.
- 2- The expected length of working lives relative to retirement influences individuals' saving behavior, driving up aggregate savings, tend to place downward pressure on interest rates.
- 3- Physiological aging also influences individuals' labor supply and retirement decisions, with implications of interest rates and economic growth.





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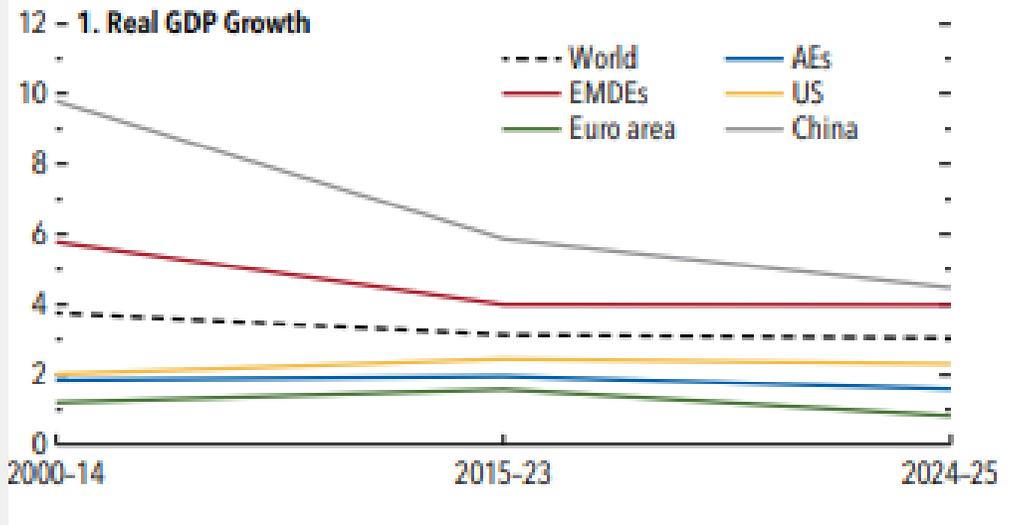
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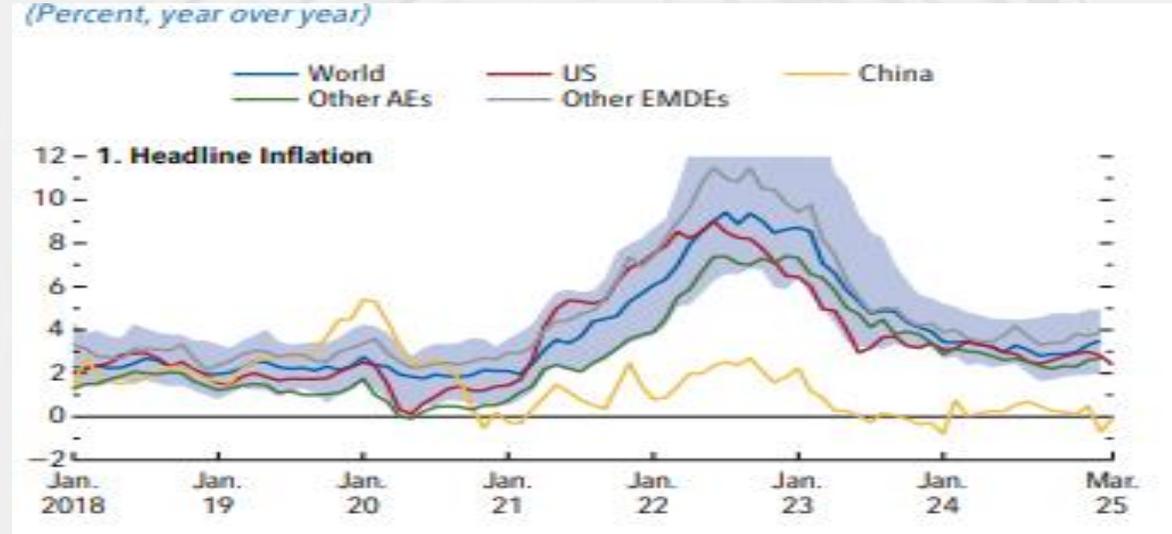
# 3.4- Global Macro Economic Conditions Affecting Public Debt

## Global Growth Performance & Forecasts



Global growth is forecasted to reach 2.8 % this year and 3% next year, a cumulative **downgrade of about 0.8%** relative to IMF January 2025 , leading to increasing **Public Debt**

## Global Inflation trends



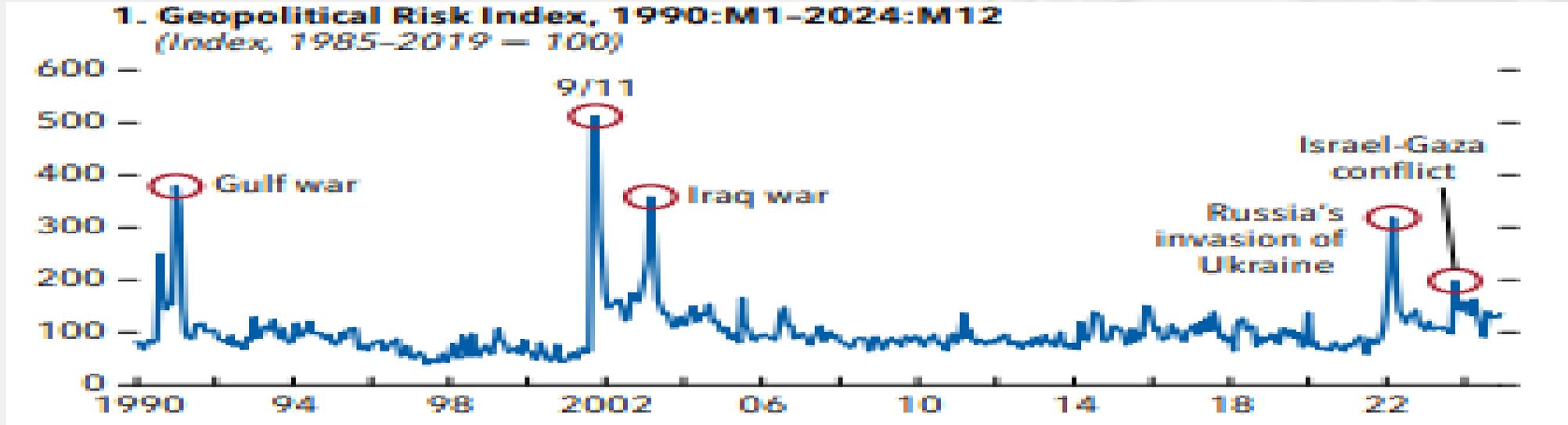
The global inflation forecasts at 4.3% for 2025 and 3.6% for 2026, after reaching the peak of inflation ratios in previous years, Pushing Central Banks to tighten their Monetary Policy by **increasing the Interest** rate ratios, leading to increasing public debt





### 3.5- External Shocks

External risks remain elevated against a backdrop of multiple conflicts



Source: Global Financial stability Report- April 2025

- External Shocks, particularly natural disasters, pandemics, trade tensions and military conflicts, significantly impact public debt and financial stability, according to the IMF's April 2025 Global Financial Stability Report (GFSR) and World Economic Outlook (WEO).
- These factors can lead to increased sovereign risk premiums, higher borrowing costs, heightened volatility in financial markets, and potential financial contagion





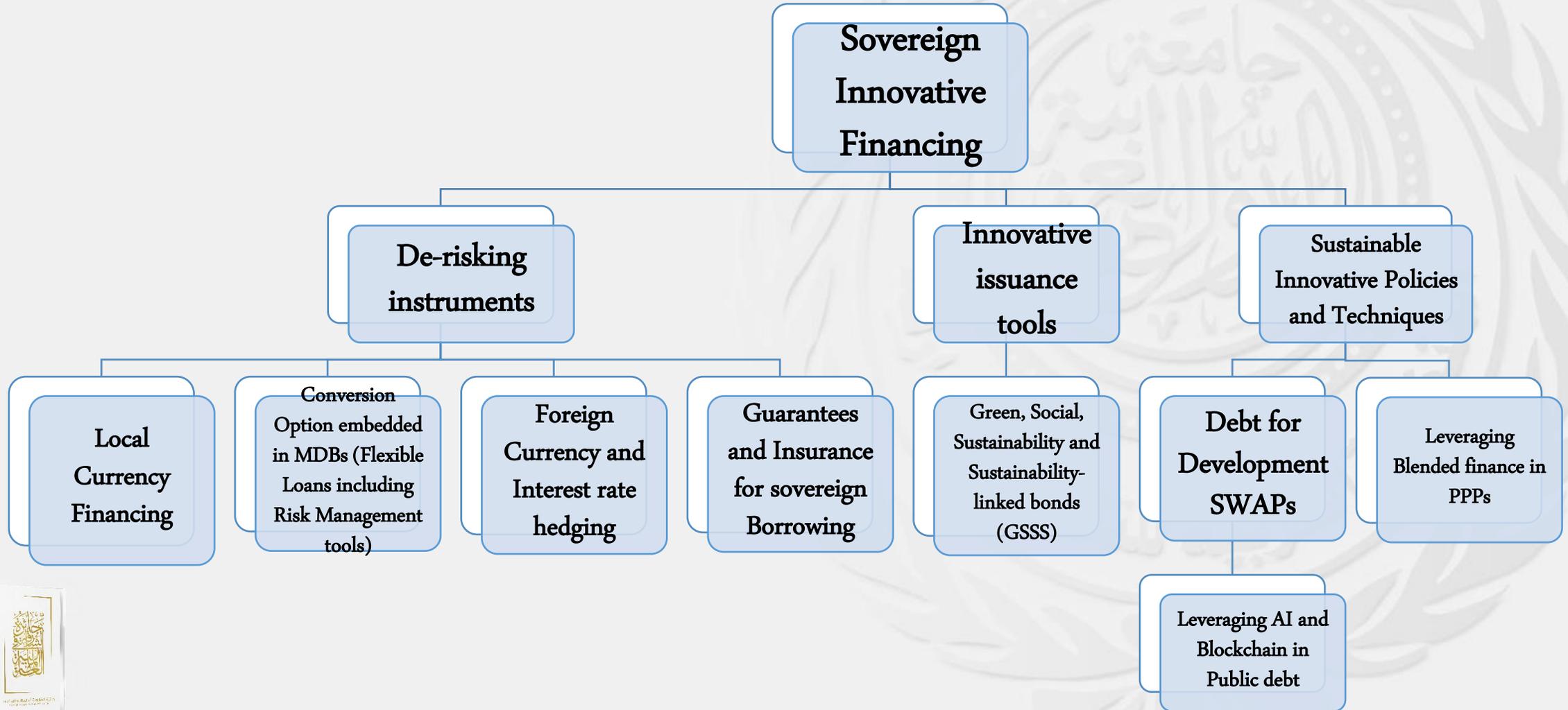
## 4- Strategies for Sustainable Public Debt Management (Including Innovative Financial Instruments)

- Debt management relies on policies that strengthen the elements of sustainable debt management, through implementing prudent debt management practices and the establishment of a durable institutional framework. This can be done through:
  - Implement a credible medium-term fiscal framework with strong oversight and fiscal rules. This can be helpful in anchoring expectations about the future path of fiscal policy.
  - New borrowing should be consistent with fiscal spending and deficit plans.
  - Prioritize debt that finances productive spending which can lead to higher income that may ultimately offset the cost of debt service and help balance the risks to debt sustainability.
  - Expanding the investor base to attract a wider range of market participants.
  - Diversification of financing instruments, including sovereign sukuk, project financing bonds, green bonds and innovative Financial Instruments.





# Innovative Financial Instruments enhancing Public Debt Sustainability





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## **Reduce Cost of Financing**

MDBs and IFIs can lend to DCs at rates that are lower than private finance and scale up long-term concessional finance for them at rates closer to those paid by developed countries.

○ The IMF announced the reduction of their general charges and surcharges by 36%. ○ Some MDBs have commitment fees and surcharges on their concessional products, which need to be revised.

## **Innovative Financial Instruments**

- MDBs and IFIs can support DCs in using Innovative Financial Instruments such as Debt for Development SWAPs at scale , providing TA and credit enhancements.

## **Credit Enhancement**

- MDBs and IFIs can provide credit enhancements instruments such as guarantees, grants and conversion mechanisms, to manage risks in order to enable investments in development-oriented projects.

## **Local Currency Lending**

MDBs and IFIs need to consider expanding their local currency operations for domestic oriented investments and raising local currencies through on-shore and off-shore local currency bonds.



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## 5- The role of The International Community (MDBs and IFIs)



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### Scaling Up Grants, Concessional Financing and Instruments for Debt Reduction

- MDBs and IFIs can scale up grants and concessional financing such as IDA, PRGT, RST, AsDF, AfDF, AIIB Special Funds, IDB concessional financing, EBRD concessional financing facility, etc. These funds support low-income countries with concessional financing to achieve macroeconomic stability, reduce poverty and promote economic growth.
- The G20 Common Framework for Debt Treatments was set up in 2020 to provide **low-income countries** with orderly and coordinated debt restructurings with broad creditor participation with G20, Paris Club and other official creditors in a single committee.
- As of December 2024, four countries have applied to the Common Framework: Chad, Ethiopia, Ghana and Zambia.
- The Global Sovereign Debt Roundtable (GSDR) was established in 2022 by the IMF, WB and the G20, to strengthen multilateral co-operation and coordination, aiming to accelerate restructuring processes, and address challenges in resolving sovereign debt crises.





# 6- Recommendations for Governments & Central Banks

## Fiscal Sustainability relies on DDD Pillars

Diversification: Not to relying specific source of revenue such as petroleum, tourism or others

Deregulation: through enhancing the investment climate

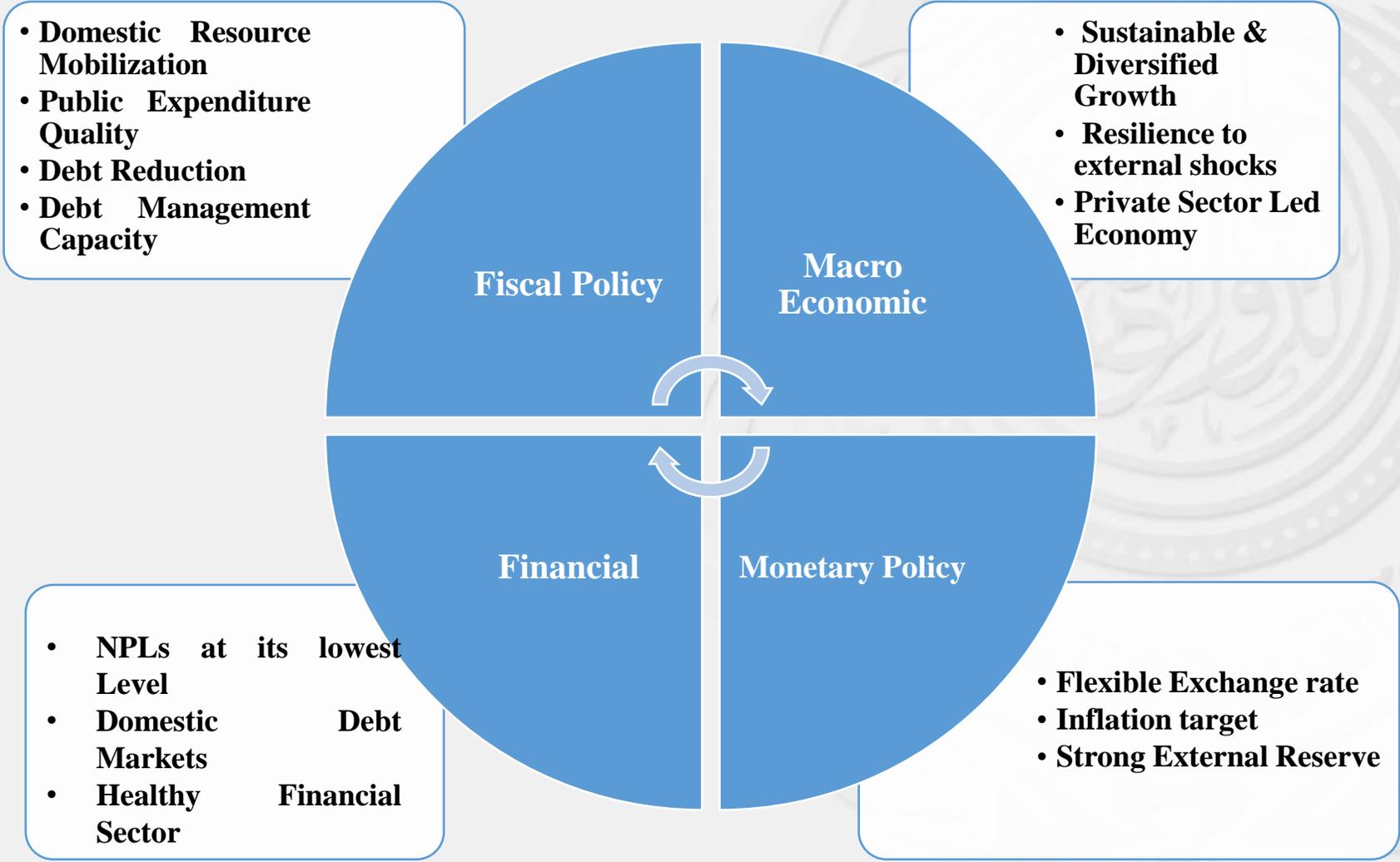
Digitalization: By increasing dependency on Automation and Tokenization

- Diversifying the economic structure is an important strategy for reducing public debt and improving economic stability and sustainable growth.
- Developing New Sectors: such as technology, tourism, manufacturing and agriculture.
- Providing Investment Incentives: provide incentives for investment, such as tax reductions, subsidized financing, and simplified procedures.
- Promoting FDIs: Attracting FDIs can help develop new sectors and create additional job opportunities.
- De-regulation: increase governance, reduce procuracy, boost private sector role in the economy and attract more FDIs.
- Digitalization: increase the role of the automation, digitalization and AI to increase productivity and efficiency.





# 6-Recommendations: Domestic Strategies to Strengthen Sustainability





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## 6- Recommendations: For Monetary, Fiscal and Monetary Policies



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In light of this uncertainty, countries need to apply policies to reduce debt such as:

### 1- At Macro Level

- **Countries should focus on boosting growth**, with emphasis on productivity boosting structural reforms. Nominal GDP should move at a faster pace compared to debt levels.
- **A gradual fiscal adjustment within a credible medium-term framework** is crucial for countries to reduce debt with prudent debt management strategies, build fiscal buffers against uncertainties, accommodate priority spending, and improve long-term growth prospects.
- **Adopt energy subsidy reforms** by phasing out energy subsidies and rationalize public wage bills while safeguarding public investment and upgrading social safety nets.
- **With limited fiscal space**, implement gradual and credible consolidation plans and allow automatic stabilizers, like unemployment benefits, to work effectively. Any new spending needs should be offset by spending cuts elsewhere or new revenues.
- **Economies with aging populations** should reprioritize expenditures, advance pension and health care reforms to generate savings that can be used to support social programs and infrastructure investments and pursue active labor policies for their working-wage labor force, including migrants





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## 6- Recommendations: Monetary, Fiscal and Monetary Policies

### 2- Fiscal Policy

- EMDEs should reduce spending and increase revenues by reforming tax systems, remove inefficient tax incentives, broadening tax bases, and improving revenue administration.
- Establishing credible medium-term fiscal frameworks.
- Implementing active cash management, strengthening expenditure controls, enforcing expenditure ceilings and fiscal rules
- Strengthening fiscal risk management to minimize the direct (higher debt levels) and indirect cost (higher probability of debt staying high);
- Timely and orderly debt restructuring alongside fiscal adjustments is essential for countries facing debt distress, using the G20 Common Framework
- Keeping prudent debt management mindful of creditor and currency composition
- Medium-term debt management strategies should be developed simultaneously with fiscal frameworks to incorporate the potential impact of financing risks in the fiscal policy outlook.
- Seeking using innovative financial instruments in cooperation with MDBs and IFIs such as Credit enhancements mechanisms including guarantees, insurance, local currency financing and hedging instruments



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## 6- Recommendations: Monetary, Fiscal and Monetary Policies MDBs and IFIs in supporting Public Debt Sustainability



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### **3- Monetary Policy & Financial Level**

- Allowing exchange rate flexibility, supported by prudent fiscal and monetary policy, to help avoid building up large external imbalances.
- Continue Inflation Targeting, with a data driven approach.
- Use Financial Instruments such as Derivatives and Hedging for better managing risks to help reducing costs and insure projectable public expenditure stability and avoid fluctuation in payments.
- EMDEs should prioritize deepening local currency bond markets to reduce reliance on external debt and mitigate exchange rate risks.

### **4- International Community (MDBs and IFIs) Level**

- Reforming the G20 Common Framework by integrating middle income countries and operationalizing the “3-pillar approach” proposed by the IMF and World Bank, providing the conceptual framework for these countries with Sustainable debt but are faced with elevated debt service challenges
- Provide sovereign guarantees, insurance and other forms of credit enhancement to support borrowing countries in accessing markets at sustainable rates.
- MDBs and IFIs can support Local currency lending and using hedging instruments for managing risks
- Updating credit rating agencies methodologies to issue long – term sovereign ratings and supporting using innovative financial instruments.





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