

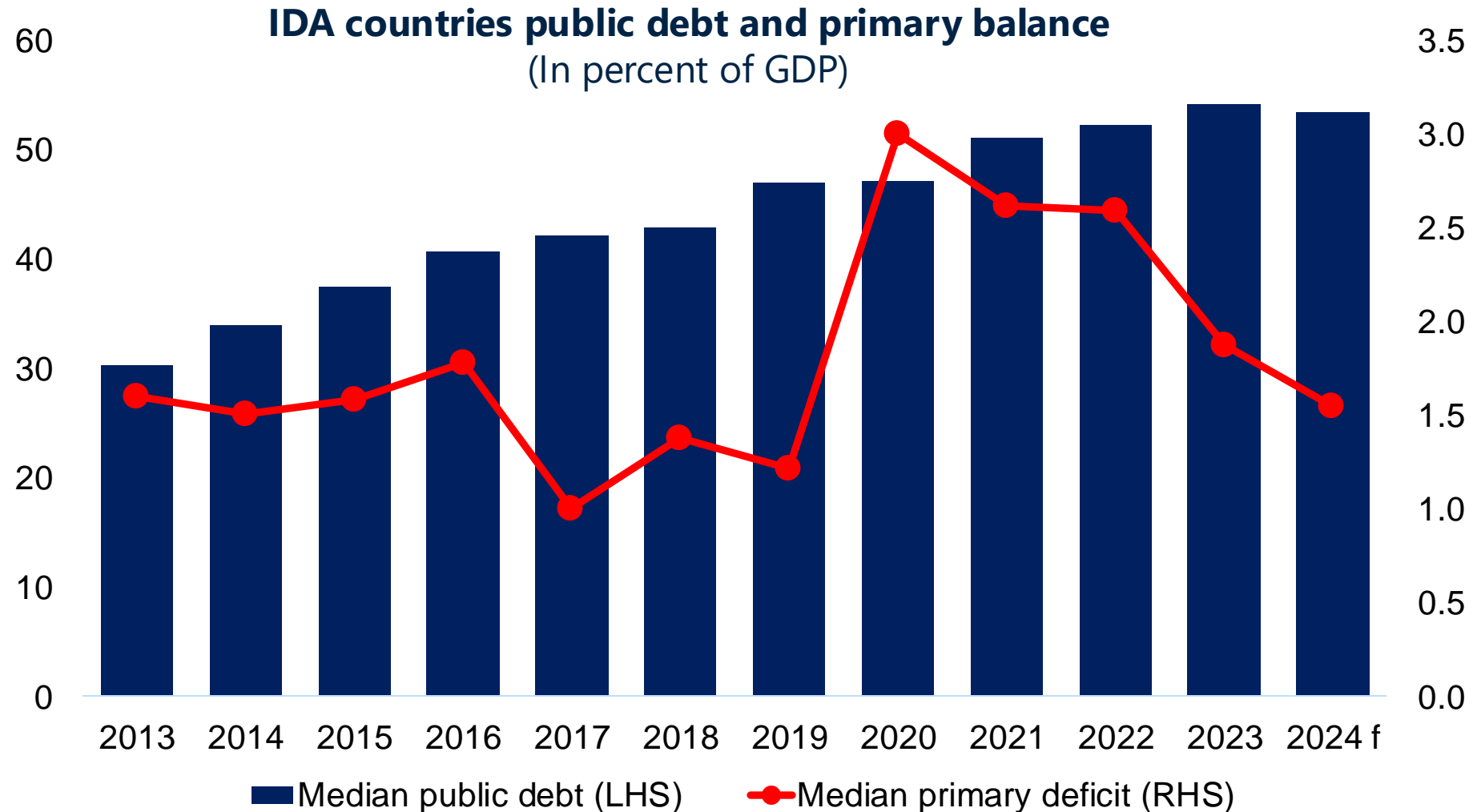
Sovereign-Bank Nexus Risks in Emerging and Developing Economies

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FINANCE AND PROSPERITY 2024

**SPECIAL FOCUS:
SOVEREIGN-BANK NEXUS
CLIMATE AND THE BANKING SECTOR**

Debt levels are at historically high levels despite some recent fiscal consolidation.



Source: World Bank.

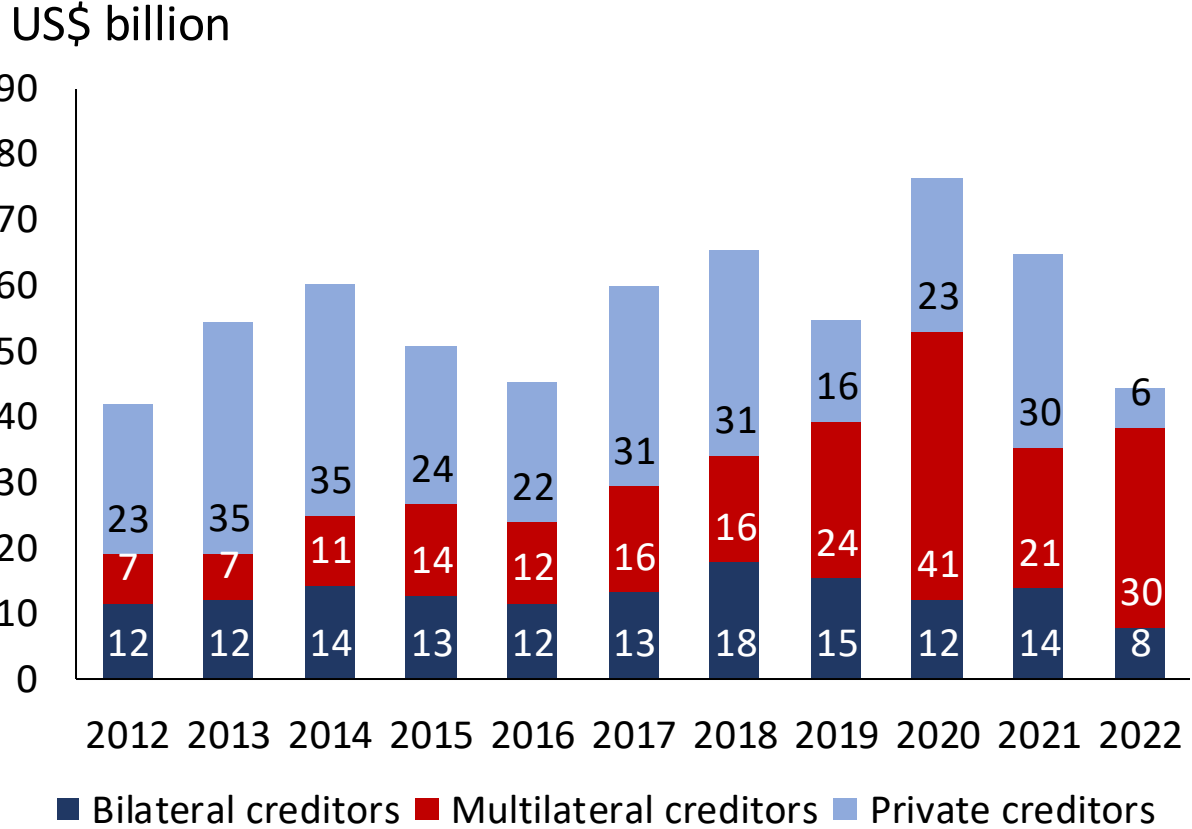
IDA countries are expected to face large gross (fiscal) financing needs, while net debt external inflows to IDA countries have been shrinking.

Gross Financing Needs for IDA countries
(as % of GDP)



Source: LIC-DSA Database.

Net Debt External Inflows to IDA Countries, 2013-2022

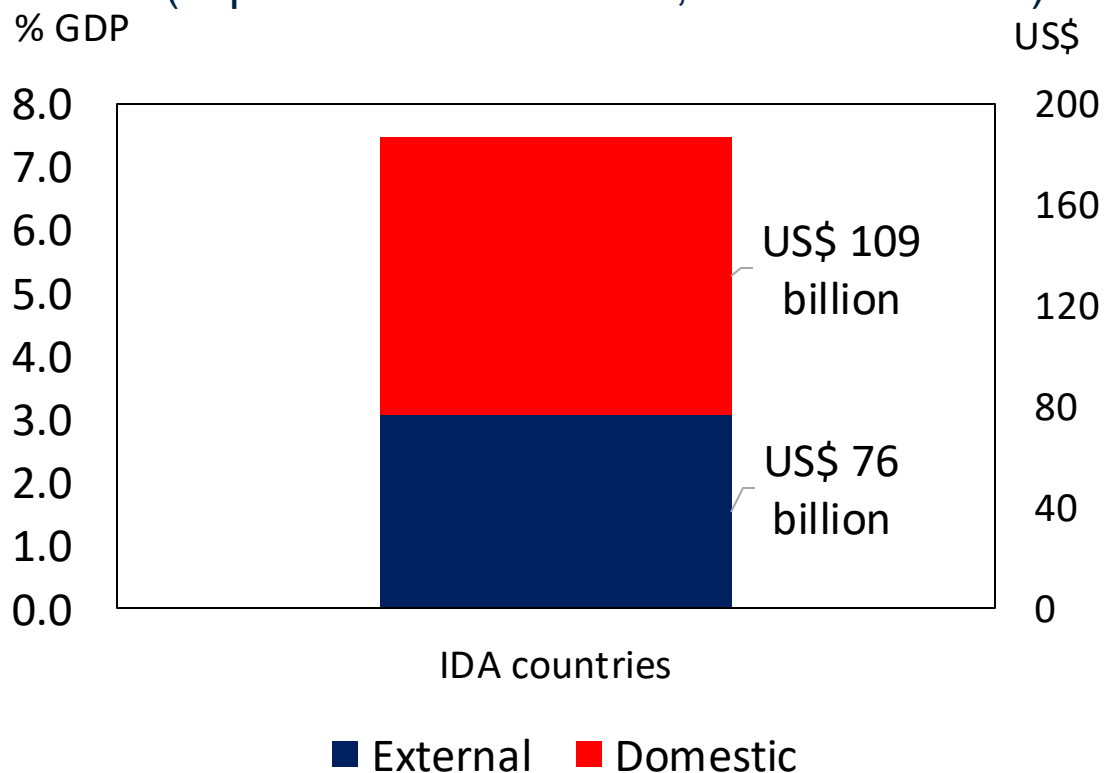


Source: LIC-DSA Database.

Domestic + external debt service for 2024 is 7.5% of GDP in IDA countries, more than they spend on health and education combined.

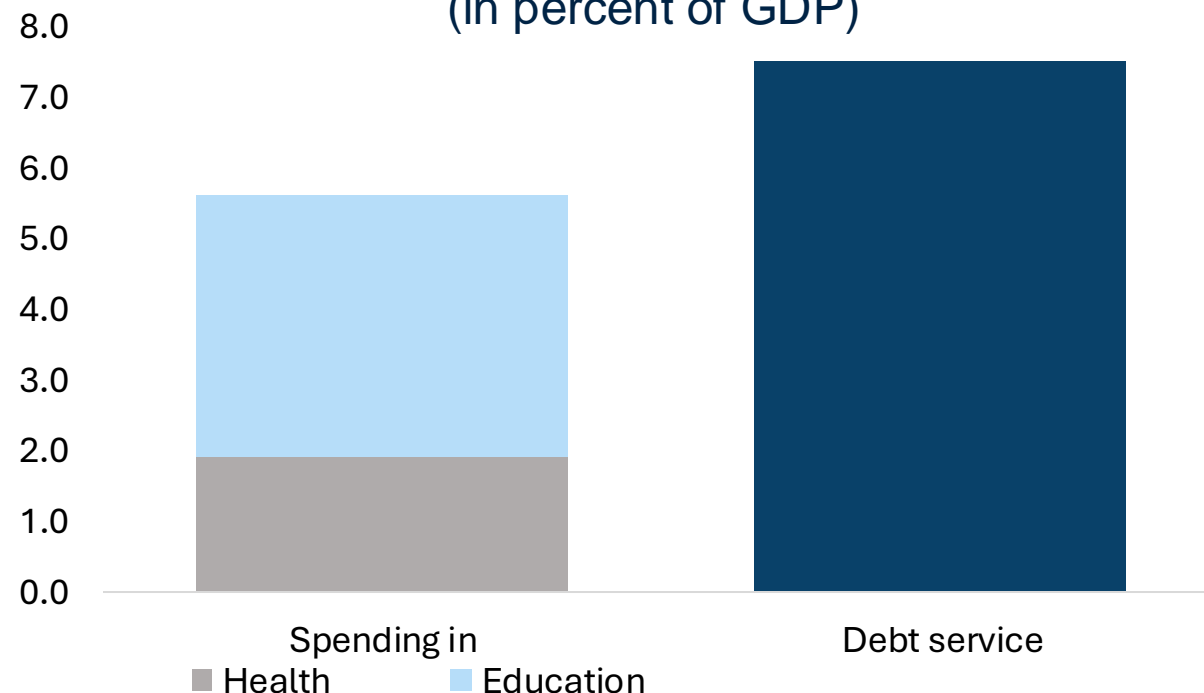
2024 total debt service in IDA

(in percent of 2024 GDP, and USD billion)



IDA Spending on Health and Education, and Debt Service in 2024

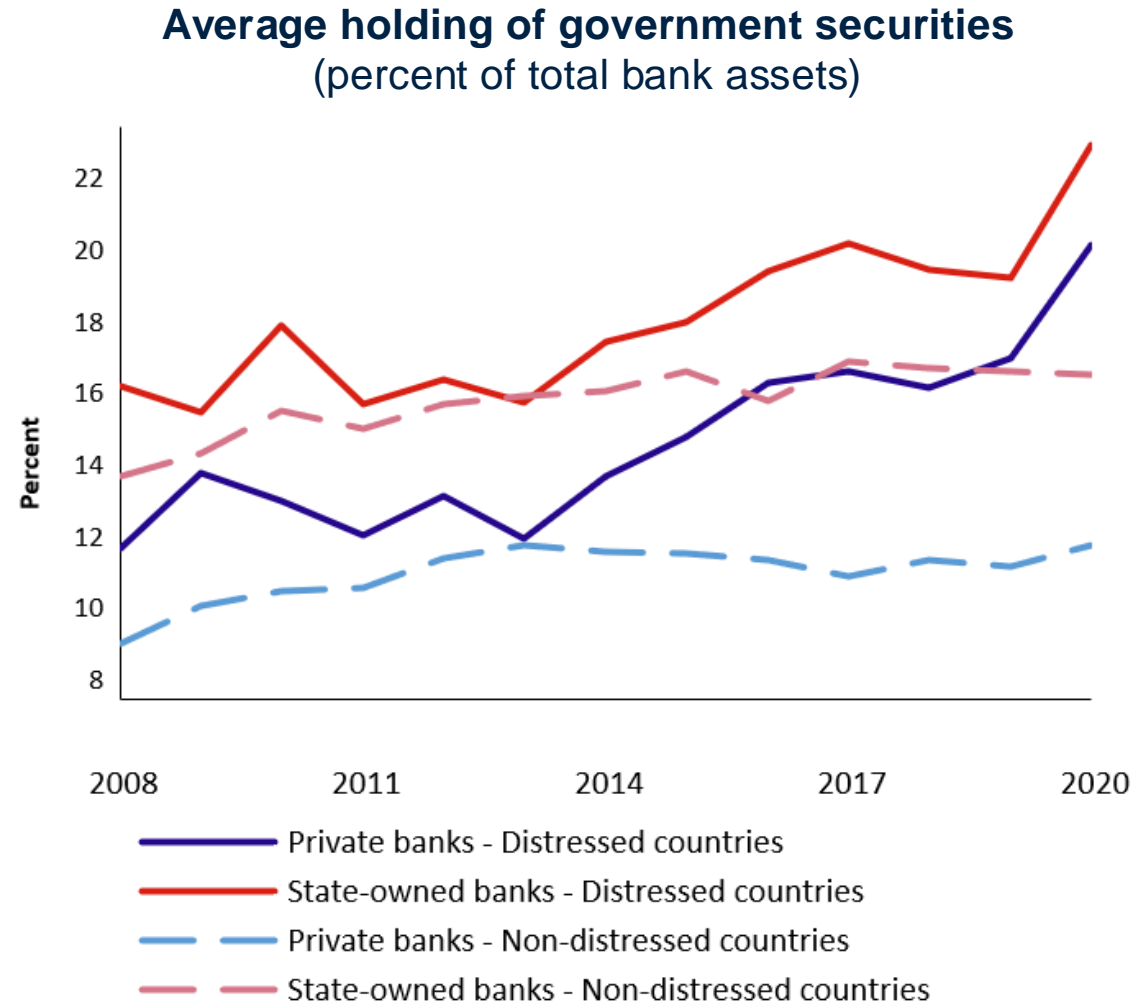
(in percent of GDP)



Source: DRS, MPO. IMF SDR, MTI and FCI GP staff calculations.
 Note: Domestic debt service includes short-term debt from previous year

Source: BOOST database and World Bank country reports, latest available data

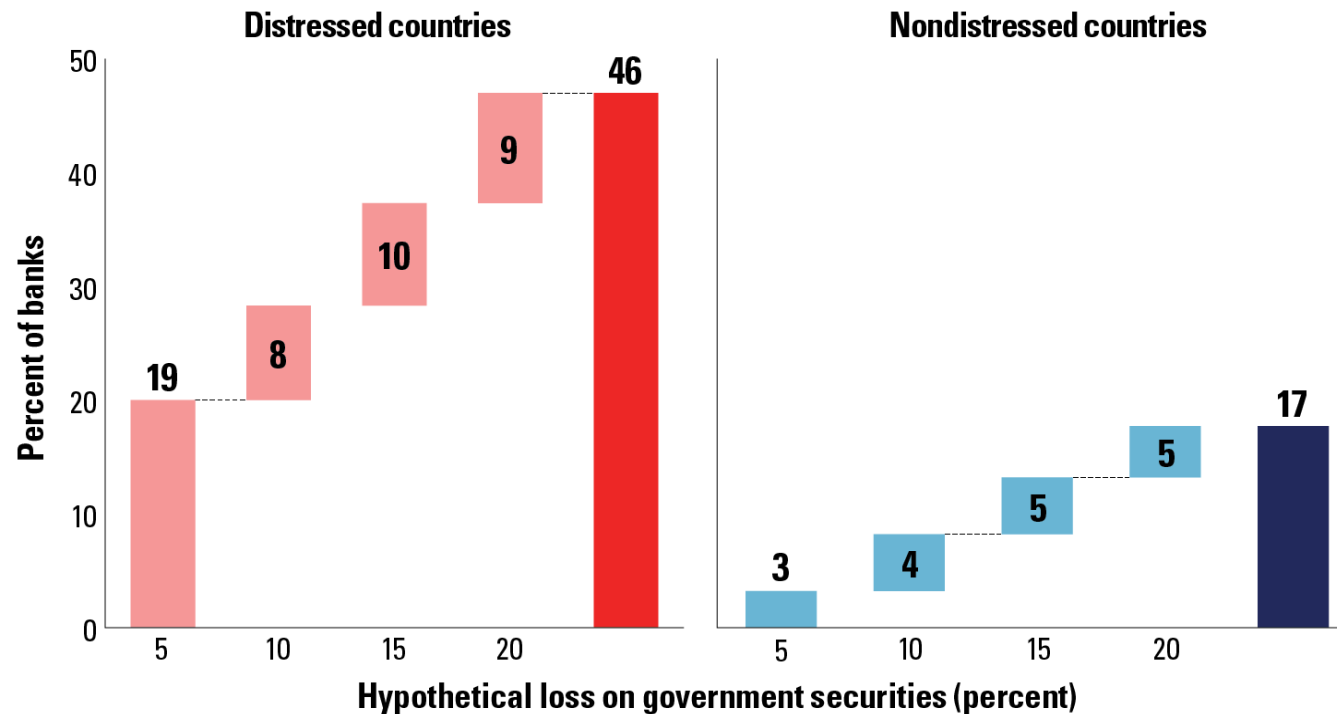
Sovereign-bank nexus—now at its highest level in decades—is higher in countries under macroeconomic distress.



Source: World Bank staff calculations based on Fitch Connect and Panizza 2023.

A higher sovereign-bank nexus can contribute to serious financial sector risks, especially in countries experiencing macroeconomic distress.

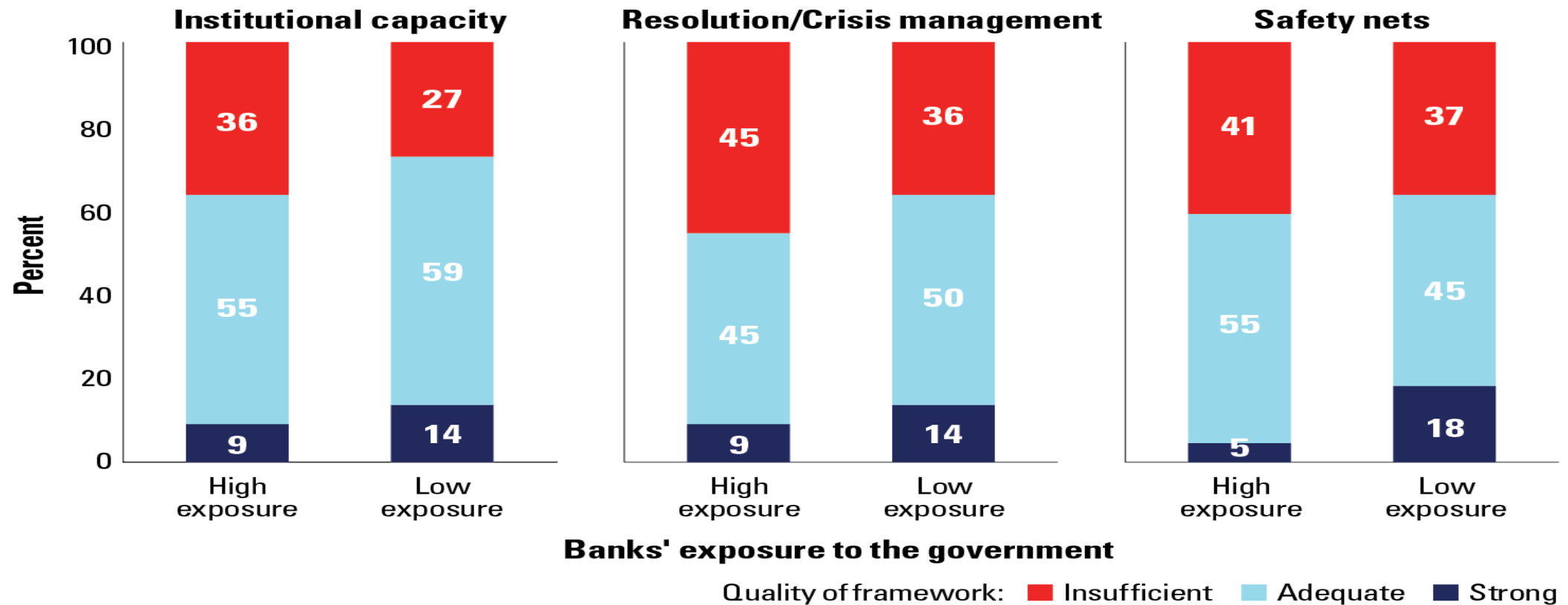
Share of undercapitalized banks following different amount of losses on banks' government debt holdings
(percent of banks as of June 2023)



Source: World Bank staff calculations based on Fitch Connect

Countries with a higher sovereign-bank nexus often have weaker institutional frameworks.

Strength of the institutional framework by countries depending on the share of bank lending to the government
(percent of countries in sample)



Sources: World Bank staff calculation based on based on IMF International Financial Statistics data and World Bank staff assessment.

Dealing with debt vulnerabilities requires a comprehensive approach.

- **Structural reforms and domestic resource mobilization** (e.g., tax policy and administration reforms, spending efficiency, development of strong domestic capital markets, reforms to enable private sector participation across the economy, trade facilitation)
- **External financial support** (e.g., net positive external flows on the aggregate over a period of time)
- **Actions to reduce debt servicing burdens** (e.g., liability mgt operations)

In addition, banking authorities can take concrete steps to foster more prudent risk-taking by banks and strengthen financial sector resilience in EMDEs.

- EMDE banking authorities' actions **are insufficient alone**; comprehensive fiscal and macroeconomic stability measures are crucial for **public debt sustainability**.
- **However**, banking authorities can take steps to address the sovereign-bank nexus including:
 - Implementing **granular disclosure requirements** for banks' public sector exposures to enhance market discipline.
 - **Carefully considering the benefits and drawbacks of capital charges** on banks for holding excessive government debt **in local currency**.
 - Encouraging the establishment of **stronger bank capital buffers**, setting up effective **financial safety nets**, ensuring **coordinated institutional decision-making**, and regularly **conducting bank stress tests**.
 - Promoting the **growth of domestic capital markets** and the **institutional investor base** over the medium term.