The Exchange

Glencore aftershocks will reach the sovereign debt markets

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Ivan Glasenberg, Glencore CEO © Getty Images

Glencore's decision last week to cut its dividend, sell off assets and scale back its mineral production in an effort to repair its balance sheet has once again brought into sharp focus the challenges facing the natural resource industry. Over the past year, virtually every commodity across the composite index — metals, minerals, energy and foodstuffs — has suffered a notable decline in price. The one-year return on gold is down roughly 8 per cent, copper prices have declined more than 13 per cent and oil has fallen nearly 50 per cent.

Notwithstanding the carnage in the commodity markets, many emerging market producer countries still have relatively unfettered access to the international debt capital markets. This is helping to mask the fact that many of them (commodity exporters in particular) will increasingly struggle to fund their large budget gaps, and a full-blown global sovereign credit crisis could develop.

Less than two months ago, for example, Zambia sold $1.25bn of an 11-year bond into the international capital markets. This transaction was its third in the past three years, comes on the back of a billion-dollar transaction in April 2014 bringing the total to $3bn — and was oversubscribed with market demand outstripping supply 1.7 times.

Yet, Zambia — a world-leading commodity exporter with 95 per cent of its export revenues earned from mining, and 85 per cent of that from copper and cobalt — was specifically named by Glencore as a country (the Democratic Republic of Congo was identified as being another) that would suffer mine closures, hurting public tax revenues.

More generally, many commodity economies now find themselves on the perilous path of falling public revenues and rising debt obligations; thus we have all the makings of a sovereign credit crisis. Just as worsening economic growth prospects become more entrenched across emerging countries and are accelerated by China's economic woes (hitting trade and flows of foreign direct investment), the anticipation of rate rises in the US and the taper of quantitative easing have led to rising capital outflows, depreciating emerging currencies and an increasing cost of dollar-denominated debt.

In Zambia's case, the cost of sovereign debt has soared more than 350 basis points in three years, prompting a credit ratings downgrade and a caution from Fitch, the rating agency, that it could "struggle to fund its increasingly large budget gap".

Zambia is not alone in issuing international debt. In 2015, nearly $15bn has been placed by governments heavily dependent on mineral export revenue, including Peru (over $3bn of issuance), Kazakhstan ($4bn), Colombia ($2.5bn), and the Dominican Republic (nearly $4bn).

Worse still, there is mounting evidence that borrowed funds are not being used for much-needed infrastructure investment in recipient countries. The current energy crisis in southern Africa, which has left more than 300m people in darkness with no access to electricity for up to 16 hours a day, is just one manifestation of chronic under-investment by nations that have had access to the international debt capital markets over the last decade.

The decision by investors to finance sovereign borrowers who could struggle to repay comes in part from the myopia of professional managers who are rewarded for beating the benchmark today with relatively few concerns for what happens tomorrow, and in part from yield-seeking in a persistent globally low interest rate environment.

Yet it is not just investors who could get hurt. As Brazil's unfolding woes remind us, the aftermath of a credit crisis is almost always accompanied by fiscal tightening — rising taxes and cutbacks in spending — that proves destructive to household demand, hurts job prospects and further curtails growth by capping investment by local international businesses.

Market participants can be somewhat forgiven for their intrigue in the stock price volatility of the over-levered and severely impaired commodity industry. However, the broader impact and more insidious effects of the commodity price rout should not be forgotten. Such a narrow market perspective overlooks the damage caused by penalising (and withdrawing capital from) the commodity companies on the one hand, while continuing to provide debt capital financing (albeit at ever higher yields) to the very governments that rely on the success of the corporate mining operations.

To continue to finance some of these governments is to ignore the potential knock-on effects through contagion to a multi-trillion stock of emerging market and frontier debt, and thus a sovereign credit crisis in the making.

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