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The Unequal Cost of Debt: Why Emerging Markets Pay More Than Advanced Economies

Egypt as a Manifestation of the Financing-Cost Challenge



Why the Interest in the Growing Financing Challenges despite Domestic Reforms?

Sovereign borrowing costs have become an increasingly important concern for emerging economies, particularly as global financial conditions continue to influence the cost and availability of financing. While domestic economic reforms and stronger fiscal positions can improve a country's financial standing, they do not always translate into more favorable borrowing conditions.

This challenge is particularly relevant for emerging markets, which often face financing conditions that differ significantly from those of advanced economies. Even when domestic economic indicators improve, external developments and changes in investors' perceptions can continue to place pressure on borrowing costs.

This Economic Lens examines why emerging markets face higher sovereign financing costs than advanced economies, focusing on the interaction between global financial conditions and country-specific risks. Egypt is examined as a clear manifestation of this challenge.

What is Happening?

What Is Different About Emerging Markets, Especially Those in the South?

Global benchmark interest rates and sovereign spreads can move in different directions. A country may improve its fiscal position and receive a credit-rating upgrade, reducing its sovereign risk premium. However, its overall financing cost may still increase if global benchmark rates rise or if investors demand higher returns because of changing market conditions. As a result, perceived country risk may remain relatively high in emerging markets, particularly in countries of the Global South, including African economies.

In addition to these challenges, emerging markets, particularly those in the Global South, face a number of structural problems that affect their financing conditions. They also operate under different conditions from advanced economies. They may rely on currencies they do not control and remain exposed to changes in international liquidity and investor risk appetite. As a result, external financial conditions can affect their financing costs even when domestic fiscal indicators improve.

The Case of Egypt

Egypt provides a clear example of how improvements in domestic economic conditions do not necessarily translate into lower sovereign borrowing costs. In October, Egypt received a credit-rating upgrade from Moody's, from Caa1 to B3, following a period of fiscal consolidation and economic reforms. Although this improvement was expected to reduce the country's sovereign risk premium, yields increased instead. This illustrates that credit-rating improvements do not automatically translate into lower market financing costs, particularly when wider market conditions and investor sentiment move in the opposite direction.

The way markets and credit-rating agencies assess sovereign risk also differs. Over the previous two years, Egypt's credit default swap (CDS) spread and risk premium had declined significantly as markets reflected the country's reforms and policy decisions. Rating agencies, by contrast, tend to be backward-looking because their assessments rely on historical evidence and committee decisions, while markets adjust immediately to new information and can therefore be more volatile. The recent episode was driven not only by the increase in the US benchmark rate, but also by capital outflows and the market repricing that followed; the outflows were more damaging than the rate increase itself.

The scale of these flows helps explain why their effects can be disproportionate. Portfolio investment over the previous two years was estimated at around USD 30 billion, equivalent to approximately EGP 1.5 trillion, or 10% of total public debt of about EGP 15 trillion. Although the USD 3 billion outflow represented only around one-tenth of these accumulated inflows, it was associated with a 10–12% depreciation of the pound.

Locally issued debt held by foreign investors is not equivalent in stability to local-currency debt held by domestic, long-term investors. While foreign portfolio investment can provide additional financing, sudden withdrawals can create exchange-rate pressure. At the same time, relying heavily on domestic banks to finance government debt can crowd out private-sector lending, as banks' balance sheets may become concentrated in treasury bills. This highlights the importance of managing capital inflows, including through sterilization measures, rather than relying on them without considering the risks they create.

What Do These Developments Mean?

These developments highlight several structural vulnerabilities in emerging markets' debt-financing systems.

First, domestic fiscal discipline is necessary but not sufficient. Improvements in fiscal balances, economic reforms, and credit ratings can reduce sovereign risk premiums, but they cannot fully offset increases in global benchmark interest rates or sudden changes in investor sentiment. Countries may therefore face higher financing costs despite improvements in their domestic economic fundamentals.

Second, the structure and composition of debt matter as much as its overall size. Countries that rely heavily on foreign-currency finance face greater exposure to exchange-rate fluctuations, particularly when their projects generate revenues in local currency but require repayment in foreign currency. This creates a currency mismatch that increases debt-servicing pressures when domestic currencies depreciate. Latin American economies have historically experienced greater currency vulnerabilities, while several ASEAN economies have benefited from greater reliance on local-currency finance.

Third, the depth of domestic financial markets determines a country's ability to absorb external shocks. Economies with developed capital markets, pension funds, insurance companies, and other institutional investors have a broader base of long-term finance. This provides alternative funding channels and reduces dependence on external financing. By contrast, shallow financial markets can limit access to stable, long-term funding and increase vulnerability to external shocks.

Finally, distinguishing temporary market volatility from a structural deterioration in investor confidence is essential. Short-term capital outflows may reflect global uncertainty rather than a deterioration in economic fundamentals. However, persistent outflows accompanied by worsening economic conditions may indicate deeper structural problems. Policymakers therefore need to distinguish between temporary market reactions and long-term developments when designing their responses.

What Can Be Done About It?

The analysis points to a key result: emerging markets cannot prevent global financial shocks, but they can strengthen their domestic economic and financial conditions to reduce the negative effects of these shocks on their borrowing costs and financial stability.

Given current global market conditions, domestic reforms remain essential in limiting the extent to which external developments translate into higher financing costs. This requires a combination of measures, including deepening domestic bond and capital markets, encouraging institutional investors such as pension funds and insurance companies to provide long-term local-currency financing, and extending government debt maturities to reduce refinancing and rollover risks. Diversifying funding sources and instruments, including access to alternative financing markets and currencies, can also help reduce reliance on a single source of finance.

In addition, managing short-term foreign portfolio flows prudently, maintaining sufficient fiscal flexibility, and strengthening coordination and communication between fiscal and monetary authorities can help

countries respond more effectively to changing market conditions. Cooperation with multilateral development banks to develop credit-enhancement mechanisms can further attract private investment into viable projects without relying exclusively on sovereign guarantees.

Egypt's experience illustrates why these measures matter. Improvements in domestic economic fundamentals and credit ratings do not necessarily translate into lower borrowing costs when global benchmark rates, investor sentiment, and capital flows move in an unfavorable direction. Therefore, strengthening domestic financing capacity and institutional resilience does not prevent the effects of global financial developments; rather, it helps limit their disproportionate negative effects and supports more sustainable sovereign financing conditions.