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DEBT SUSTAINABILITY IN EMERGING MARKET ECONOMIES
A CRITICAL APPRAISAL

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I. Introduction

1. Until recently the work on debt sustainability in the BWIs concentrated on low-income countries, primarily in the context of the HIPC initiative. The analysis has been limited largely to external sustainability because the debt problem of these countries is seen primarily as an external transfer problem. The fiscal dimension came as an afterthought, leading to additional indicators. As repeatedly argued by its critics, and also sometimes recognized by the BWIs, the HIPC sustainability framework lacks a strong analytical rationale.

2. Attention has turned to debt sustainability in emerging markets (EMs) in the past few years after a series of crises, notably in Argentina. A framework has been developed by the IMF for both fiscal and external sustainability because of the growing importance of public domestic debt and private external debt. Domestic debt now accounts for half of the total sovereign debt in EMs. External borrowing by the private sector as a proportion of GDP has been rising in many EMs, but falling in the public sector.

3. The Fund is quite transparent about its analysis of debt sustainability in EMs and, at times, even self-critical. This is partly in response to criticism from some governments about the degree of realism of its projections and its failure to anticipate debt servicing difficulties. In any event it should be commended because it contributes to a better understanding of the issues at stake.

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III. Shortcomings in the standard framework

depreciations make it more difficult to stabilize the public debt ratio, its effect on the current account tends to be benign.

19. These imply that there can be a precarious link between external financial conditions and sovereign debt sustainability. A combination of lower international interest rates, increased appetite for emerging-market risks, surges in capital inflows and currency appreciations reduces the real effective interest rate and the public debt ratio, thereby improving the conditions for fiscal sustainability. Fiscal conditions can improve further if these impulses push growth above its potential level. A stronger-than-normal growth would not only reduce the primary budget surplus needed to stabilize the public debt ratio, but would also make it easier to generate it.

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22. The IMF's analysis of fiscal sustainability focuses on the stabilization of the public debt ratio at some initial level or convergence to a target when debt is considered to be in excess of prudent levels "while leaving open the question of whether the level at which the debt ratio is likely to be stabilized is appropriate." Unlike its approach to HIPC external debt, it does not apply a single threshold for fiscal sustainability in EMs.

23. It starts with a baseline scenario wherein the time path of the debt ratio is projected, usually over a 5-year horizon, on the basis of the expected or agreed policies, and of projections made for key parameters directly affecting the debt dynamics. The underlying monetary and fiscal policies are considered sustainable if they

b. Optimistic projections

26. A major problem is that the Fund's debt projections are overly optimistic. They "show not only a stabilizing debt ratio by the end of the projection horizon, but nearly always a decrease in the debt ratio relative to the starting point." In over 40 sustainability assessments prepared as of 2003, the median projected decrease of public debt over the five year horizon is about 12 per cent of GDP. This figure is 17 per cent for external debt. In several EMs, notably financially constrained, high-debt countries such as Argentina, Brazil and Turkey, medium-term fiscal projections persistently showed stabilization of debt ratios while in reality debt levels continued to mount.

27. More significantly, optimism is greater for countries with IMF programs. In public debt, under-prediction is greater for all categories of countries with IMF programs, including low-income and middle-income countries. For external debt, the bias (that is, the difference between projected and realized debt ratios) for all upper-middle income countries with and without Fund programs is around 4 per cent of GDP, compared to more than 7 per cent for those with Fund-supported programs.

28. A main reason for the under-prediction of debt ratios is over-optimistic assumptions about economic growth, often based on unrealistic projections about private investment and exports. Since fiscal targets are based on assumptions about growth they also fail to materialize. As growth and fiscal targets are missed, debt ratios remain above projections.

29. Furthermore, the sensitivity tests appear to be quite ineffective in providing early warning signals. This is because the baseline scenarios leave adequate slack to accommodate the shocks simulated in stress tests. Often the primary surpluses assumed in the baseline are large enough to project sizeable declines in debt ratios so that when they are stress-tested for adverse shocks, they prove sufficient to ensure relatively stable debt ratios.

30. A comparison of stress tests with the observed behaviour of the main macroeconomic variables in the run-up to past episodes of external debt crisis in 24 countries show that these variables in fact moved in the two years prior to crises by similar amounts assumed in stress tests, and the external debt ratio remained within the upper bounds. However, these tests could say nothing about the likelihood of such shocks or that they would indeed culminate in crises.

31. A major problem underlying these shortcomings in the Fund's sustainability assessments is that the key variables are often projected as if they are independent. In particular, there is a tendency to underestimate the impact of monetary and fiscal policy on growth-adjusted real interest rates. For the same reason, the analysis is inadequate for handling cumulative processes involving growth, government revenues, risk spreads and interest rates, and the rate of exchange.

32. The importance of interactions among key determinants of fiscal and external sustainability and the need for internally consistent scenarios are, in principle, recognized by the Fund. However, the procedures adopted fail to capture critical vulnerabilities. For instance the recognition that shocks do not happen in isolation but occur simultaneously and persist longer than that permitted in the standard stress tests has prompted the Fund to adopt more persistent shocks simultaneously to several variables. Although this might help better identify the extent of optimism in baseline scenarios, it does not address dynamic interactions among the variables which play a more critical role in the process leading to crises than the size of initial shocks.

33. More importantly, the persistent bias towards optimism in projections by the Fund about private investment, growth and fiscal adjustment raises questions about the soundness of the underlying macroeconomic theory and the policy recommendations flowing from it. The finding that the margin of prediction error is greater for countries under its supervision suggests that monetary, fiscal and exchange rate policies promoted by the IMF programs are not generating an economic environment, notably with respect to growth, interest rates and exchange rates, that are capable of producing the kind of stable debt ratios assumed in its projections.

down arbitrage flows even though upward pressures on their currencies were much more moderate and their current account positions much more favourable than Turkey.

40. These matters are of particular concern in the current conjuncture of the world economy because of vulnerability of several EMs to adverse changes in global environment. As recognized by the IMF the past few years have seen exceptionally favourable global economic and financial conditions including historically low interest rates and spreads, a weak dollar, strong commodity prices, and a pace of economic growth unprecedented for several decades.

41. These have made a major contribution to the decline in the public debt ratio in EMs from around 70 per cent of GDP in 2001 to some 60 per cent in 2005. The contribution of exchange rate appreciations alone is almost 5 per cent of GDP. For a group of 37 EMs, strong commodity

the poor. Under these circumstances scenarios built for "greater fiscal space for growth" may once more prove to be highly optimistic, particularly since the amounts required are quite large.

52. The BWIs do not consider debt restructuring among the ways and means of creating fiscal space. This option is relegated to a footnote and left to the discretion of creditors: "Debt forgiveness and debt relief initiatives by creditors have the effect of creating fiscal space for developing countries." Traditionally the Fund is known to have been averse to arrears and defaults, insisting that debt should be serviced at any cost. This is most clearly seen at times of the crises in the 1990s when the single most important objective of its interventions was to keep countries current on their debt payments to private creditors and to maintain capital account convertibility, even though such a policy response often pushed the economies into deep recessions and increased poverty. The Fund was also quite willing to lend into unsustainable debt positions, rather than helping countries with heavy debt burdens to restructure and relieve some of the burden, and letting the lenders bear the full consequences of the risks they have taken – as called for by "market discipline".

53. More recently, however, the Fund has been encouraging the adoption of CACs in international sovereign bonds with such bonds now reaching 60 per cent of total stock of EMs sovereign bonds. Its own analysis also shows that in several EMs the debt ratios are very high and the burden is excessive. The logic of the matter, therefore, calls for inclusion of debt restructuring as a major option in generating fiscal space for growth.

54. This is exactly what the UN report on MDGs does. It drops the primacy of debt servicing over all other economic and social objectives in the management of public finances and defines sustainability as "the level of debt that allows a country to achieve the MDGs and reach 2015 without an increase in debt ratios." In doing so the report in effect considers debt restructuring, including write offs, among the principal ways of generating fiscal space – if the level of debt does not leave enough space for meeting the MDGs without an increase in the debt ratio, it would need to be reduced.

55. The primacy of social objectives over debt servicing by public agencies with governmental power is indeed a recognized principle in some national legislations, notably by chapter 9 of the United States insolvency law. The latter in effect allows an insolvent municipality to give priority to social objectives over debt servicing if it is unable to service its debt and at the same time provide basic social services essential to the welfare, health and safety of its community. Furthermore, the United States Supreme Court has ruled that such an authority does not have unlimited taxing power and that tax increases that would depress the living standards below a minimum guaranteed level for the benefits of its creditors cannot be tolerated. The law thus enables a municipality to petition the court for protection against its creditors through a temporary standstill, and submit a plan for restructuring of its debt, including rollovers under original or new terms and write offs. The main objective is to secure the viability of debtors with governmental powers and to restore their capacity to deliver social services.

V. Debt workouts

56. Despite the highly favourable global conditions, the debt burden in several EMs is excessive and may prove to be unbearable in the coming years, particularly if there is a sharp cyclical downturn. The key question then is: what options are available to lessen the debt burden and to re-divert resources towards growth and poverty reduction? Here a distinction needs to be made among three different types of public debt: domestic debt, external official debt to bilateral and multilateral lenders, and to private creditors.

57. Much has been written on possible solutions to the problem of internal debt, but no one has done so more forcefully and with greater persuasiveness than did Keynes in his analysis of what he called “progressive and catastrophic inflations” in Central and Eastern Europe during the early 1920s (see Annex B). Of the three possible solutions, Keynes considered capital levy superior to both repudiation and monetization/inflation on grounds both of expediency and of justice. There can be little doubt that there are serious political difficulties in going for such a solution. A capital levy can also have adverse effects on the pace of economic activity and the

stability of the banking system which additional measures that need to be taken may not be fully offset. Moreover, for obvious reasons neither a capital levy nor any other measure that would place a sizeable burden on the rentier class can be successfully applied when the capital account is open and the currency is fully convertible, but again temporary suspension of convertibility and standstills may not fully prevent capital flight. However, none of these would pose more serious problems than the other options if the debt proves to be unbearable – messy defaults and monetization and runaway inflation.

58. Several EMs have relatively large stocks of official debt, both to bilateral and multilateral donors. In Indonesia, for instance, official debt accounts for a quarter of total sovereign debt and is owed mostly to bilateral donors. These middle-income countries are very much in the same position as highly-indebted low-income countries not included in the HIPC initiative. They now come under the so-called Evian approach, designed to provide more flexible debt restructuring through the Paris Club in coordination with private creditors to secure long-term sustainability. Once again, however, assessment of sustainability is left to creditors, to be conducted by the IMF on the basis of the framework above. For this approach to deliver its promises, the assessment would now needs to show a lot greater realism than has been the case so far.

59. For the large majority of EMs, a multilateral framework for orderly sovereign debt workout is still missing – as pointed out by the title of one of the presentations here. Despite some shortcomings the SDRM proposal, as originally flagged by the IMF secretariat, contained innovative mechanisms to facilitate sovereign bond restructuring. However, it has subsequently been diluted because of the opposition from financial markets and the United States government; the provision for statutory protection to debtors in the form of a stay on litigation has been dropped, creditors are allowed to be given considerable leverage in seeking their permission in granting seniority to new debt, and the Fund significant power in determining debt sustainability. Even this diluted version of the proposal could not elicit adequate political support and has been put on the backburner.

60. Indeed, the impetus for reform has generally been lost since the turn of the millennium because of complacency due to the recovery of capital flows to EMs. This could prove to be problematic in the coming years. If widespread opposition against large-scale IMF bailouts succeeds, countries that may be facing rapid exit of capital and unsustainable debt burdens could be forced into messy defaults. If not, we will be back to square one with all the baggage that comes with IMF bailout operations including creditor moral hazard, intrusive conditionality, pro-

Annex A: The Standard Framework for Debt Sustainability

A. Public debt

Define the ratio of total public debt to nominal GDP as:

$$d = (D + \quad E_p^*)/Y \qquad (1)$$

where D is domestic-currency debt, the exchange rate (domestic currency per dollar) and E_p^* is public debt dominated in dollars. From the budget identity:

$$d_t = d_{t-1}\,[(1 + r_t)/(1 + g_t)] - p_t \qquad (2)$$

where g is the growth rate, p the ratio of primary surplus to GDP, and

$$r = \quad + (1 \quad) \quad ^* \qquad (3)$$

the weighted average of real interest rates on domestic debt ( ) and external debt (*) with the weights given by the shares of domestic and external debt.

$$^* = \frac{(1 + i^*)\,(1 + \quad)}{(1 + \quad)} - 1 \qquad (4)$$

is the real interest rate on external debt in domestic currency terms, i^* the nominal dollar interest rate, the rate of change of the exchange rate (positive for depreciation) and the rate of inflation. For the debt ratio to remain unchanged or decline:

$$p \times [(r - g)/(1 + g)]\; d \qquad (5)$$

B. External debt and the balance-of-payments

Define the ratio of external debt in domestic currency terms to nominal GDP as:

$$e = \quad E^*/Y \qquad (6)$$

where E^* is total external debt in dollars including external public debt (E_p^*). Let b stand for the ratio of trade balance in domestic currency terms to nominal income (that is, TB^*/Y where TB^* is the trade balance in dollar terms). From the balance-of-payments identity:

$$e_t = e_{t-1}\,[(1 + \quad ^*{}_t)/(1 + g_t)] - b_t \qquad (7)$$

gives the time path of the ratio of external debt to GDP, assuming that public and private sectors borrow abroad at the same rate. For the external debt ratio to remain unchanged or decline:

$$b \times [(\quad ^* - g)/(1 + g)]\; e \qquad (8)$$

Annex B: KEYNES ON DEBT AND INFLATION

In writing on what he called "progressive and catastrophic inflations" in Central and Eastern Europe during the early 1920s, Keynes characterized the debt problem and possible solutions to it in the following terms:[1]

The active and working elements in no community, ancient or modern, will consent to hand over to the ***rentier*** or bond-holding class more than a certain proportion of the fruits of their work. When the piled-up debt demands more than a tolerable proportion, relief has usually been sought in one or other of two out of the three possible methods. The first is repudiation. But except as the accompaniment of revolution, this method is too crude, too deliberate, and too obvious in its incidence. The victims are immediately aware and cry out too loud; so that, in the absence of revolution, this solution may be ruled out at present, as regards ***internal*** debt, in Western Europe.

The second method is currency depreciation ... The owners of small savings suffer quietly, as experience shows, these enormous depredations, when they would have thrown down a Government which had taken from the a fraction of the amount by more deliberate but juster instruments ... It follows the line of least resistance, and responsibility cannot be brought home to individuals. It is, so to speak, nature's remedy, which comes into silent operation when the body politic has shrunk from curing itself.