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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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II. The standard framework

4. The theoretical notion of fiscal sustainability is based on the solvency condition that the present discounted value of future primary budget balances should at least be equal to the value of the outstanding stock of debt. On this definition, the public sector cannot be a debtor, and the private sector cannot be a creditor, in present value terms. If there is debt at present, the primary balance should become positive at some date in the future in order for the present value budget constraint to be respected.

5. This concept of sustainability based on the present value budget constraint is problematic because it does not impose specific constraints over debt and deficits at any point in time. Since current deficits are collateralized by surpluses in some distant future, any level of debt and deficits could be compatible with the present value budget constraint.

6. Further, because of the time-variant nature of the key parameters determining solvency, it is not possible to know if a liability position “satisfies the present value budget constraint without a major correction in the balance of income and expenditure”, as in the Fund’s definition of fiscal sustainability.

7. Most analyses of debt sustainability, including by the IMF, rely on a framework based on the proposition that public debt cannot keep on growing relative to national income because this would require governments to constantly increase taxes and reduce spending on goods and services. According to the budget arithmetic the debt ratio increases when the real effective interest rate on government debt exceeds the growth rate of GDP (that is, when the growth-adjusted real effective interest rate is positive) unless there is a sufficient amount of primary budget surplus (see Annex A). A positive growth-adjusted rate rules out a process of Ponzi financing wherein interest on outstanding debt is paid with new debt since this would lead to debt explosion. This is often the case in EMs, and also an assumption made by the Fund in its analyses and projections.

8. While the standard framework describes the conditions for the debt ratio to remain stable, there is no theory to tell us what a sustainable debt ratio is – an issue hotly debated in the European Union. Given the volatility of market sentiments, it is not possible to determine when the lenders will stop lending or demand ever rising compensations for the risks they take. This does not depend on the debt ratio alone, but a host of other factors including the history of default of the country concerned and the nature of its government and institutions. Investor behaviour and risk appetite tend to vary over time, and can be unrelated to fundamentals – sudden stops in lending do not always signal solvency problems.

9. External sustainability is often analysed on the basis of the same framework. It refers to the ability of a country to meet its current and future external obligations without recourse to debt-rescheduling and need for drastic payments adjustments. For the external debt ratio to remain stable or decline between two periods there should be an adequate amount of trade surplus (or, rather, primary current account surplus) – that is, a net transfer of resources abroad as given by the difference between net capital inflows and interest payments.

10. It is generally recognized that poor countries need net transfer of resources at early stages of development in order to close their savings and foreign exchange gaps. This means that initially external liabilities would be rising relative to income. However, with industrial maturity, they should be expected to stabilize relative to income as the economy generates primary current account surpluses to service its external debt.

11. This is also generally true for budget deficits. In low-income countries governments are often unable to generate adequate tax revenues to meet mounting demands for public spending. Since the scope for domestic borrowing and inflationary financing is both limited, deficits are closed largely by external grants and loans. Because there is little external borrowing by the private sector, movements in the balance-of-payments would be mirrored by public finance. This link is weakened in the course of economic development as the public sector starts borrowing at home and the private sector abroad.

III. Shortcomings in the standard framework

a. Endogeneities and feedbacks

12. The standard framework says nothing about the interactions among the key variables that determine the evolution of the debt ratios. Almost all the variables affecting the evolution of public and external debt are endogenous so that a shock to one of them could induce changes in the others. Such feedbacks could be cumulative, leading to vicious or virtuous circles in the evolution of the debt ratio.

13. A realistic analysis of fiscal sustainability should recognize strong interdependencies between economic growth and fiscal policy. Risk premium and the interest rate are not independent of the debt ratio so that a failure to generate adequate primary surpluses to stabilize the debt ratio makes the task more difficult. Currency depreciations increase not only the real interest rates on both public and overall external debt, but also the external debt ratio. They also increase the public debt ratio when the proportion of debt in dollars is greater than the share of traded-goods in GDP.

b. Links between fiscal and external sustainability

14. The standard framework treats fiscal and external sustainability independently without specifying the links between the two.

15. The fiscal sustainability framework focuses on the capacity of the government to generate an adequate level of primary budget surplus in order to stabilize its debt ratio, but ignores that servicing part of that debt requires foreign currency. It views fiscal sustainability as an “internal transfer problem”. It does not distinguish between domestic and foreign currency liabilities and it ignores the foreign exchange constraint.

16. Fiscal sustainability is not independent of external imbalances because currency and payments crises alter the key parameters affecting public deficits and debt even when their origins lie elsewhere. That fiscal equilibrium is not sufficient for external sustainability is demonstrated by many instances of currency and payments crises which occurred under sound budgetary positions – e.g. Chile in the early 1980s and East Asia in 1997. None of these crises resulted in sovereign default but, by contrast, the socialization of private debt. Bailouts raised public debt by between 30 and 40 per cent of GDP in Thailand and Korea, and more than 50 per cent of GDP in Indonesia, creating problems of fiscal sustainability in the latter country.

17. In the same vein, the framework for external sustainability focuses on the need for the economy to generate an adequate level of foreign exchange surplus for servicing external debt, but it does not pay attention if public and private debtors each are able to achieve the required surpluses of their incomes over expenditures. It ignores that the division of a given volume of external debt between public and private sectors makes considerable difference in terms of the vulnerability it represents, and that internal transfer problems can be translated into payments difficulties by affecting the behaviour of international lenders. The latter was the case in Latin America during the 1980s when the internal transfer problem was one of the main obstacles to access to international capital markets, which also suggested that external debt servicing difficulties were due to solvency rather than liquidity problems.

c. Possible trade offs between fiscal and external sustainability

18. The variables that enter both public and external debt equations can have asymmetric effects on fiscal and external sustainability. This is the case for growth and exchange rate shocks. An exogenous decline in growth invariably makes it difficult to stabilize public debt while it has two opposite effects on external sustainability; it would raise the growth-adjusted real interest rate and necessitate a higher primary current account surplus to stabilize the external debt, but it would also help generate this surplus by reducing imports. Again, while currency

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.

20. But the very same conditions that improve public finances, notably appreciations, can also lead to a rapid deterioration of the current account. A trade-off may thus emerge between external sustainability and fiscal sustainability. Eventually if capital flows are reversed the public sector could be driven into serious financial difficulties as sharp declines in the currency, hikes in interest rates and the collapse of growth make it very difficult to generate an adequate level of primary budget surplus in order to prevent public debt explosion.

IV. The Fund's approach: an appraisal

a. Sustainability analysis

21. The Fund's approach to sustainability suffers from the shortcomings of the standard framework noted above. It does not capture the dynamic interactions among the key parameters affecting fiscal and external sustainability. It does not have an integrated framework that can link the two and help determine if the conditions required by fiscal and external sustainability are mutually consistent.

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 appear to stabilise the debt ratio and avoid arrears or a need for drastic fiscal adjustments. Otherwise policy adjustment would be called for. With monetary policy often directed to inflation targeting, much of the burden falls on the budget.

24. The base-line projections are stress-tested for alternative assumptions for policy and endogenous variables to assess vulnerability. Key variables are also tested against their historical averages and an alternative no-policy-change scenario to assess the degree of realism of baseline projections and the expected gains from agreed and programmed policy changes.

25. The IMF's analysis of external sustainability follows broadly the same procedures. It starts with baseline medium-term balance-of-payments projections based on assumptions and projections made for a number of variables including exchange rates, growth rates and interest rates. Current account projections provide the basis for the assessment of the medium-term evolution of overall external indebtedness, which are also stress-tested. In its assessment of external sustainability the Fund considers an external debt ratio of 40 per cent as a useful benchmark while recognizing that a greater figure by no means necessarily implies a crisis.

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.

c. Capital flows and sustainability

34. There is a long-standing belief that fiscal imbalances are at the origin of balance-of-payments crises. A particular formulation of this was offered by the so-called Lawson Doctrine that a large current account deficit is not a cause for concern if the fiscal accounts are balanced. Even though this has been discredited by several episodes of currency and payments crises in EMs with sound fiscal positions, it appears to continue to influence the Fund's approach to debt sustainability and its policy advice. Specifically, its policy stance on capital inflows and exchange rates suggests that the Fund is not very much concerned with external fragility as long as it is driven by free market forces – that is, unrestricted capital movements and floating exchange rates – but not when it is due to fiscal profligacy.

35. A lesson drawn from the recent history of crises in EMs is the importance of preventing large exchange rate appreciations and current account deficits, particularly when they are driven by short-term capital inflows. As noted, such a process may not only lead to currency and payments crises but can also have serious consequences for fiscal sustainability and public debt. Evidence suggests that episodes of rapid improvements in fiscal sustainability associated with surges in capital inflows and currency appreciations are often followed by currency crises and debt servicing difficulties. About 85 per cent of all defaults during 1970-1999 were linked with currency crises. It is also notable that credit rating agencies are pretty accurate in predicting defaults because downgrades usually follow currency crises, even though they rarely anticipate currency crises.

36. Although in theory floating is expected to dampen short-term capital inflows by giving rise to exchange rate risks, in reality it can lead to nominal and real appreciations when there is an increased appetite for risk and arbitrage margins are large. It is also agreed that the scope for monetary policy to eliminate arbitrage margins in relatively high inflation economies is limited. So is the ability of central banks to absorb large inflows of foreign exchange and to sterilize their effects on domestic liquidity and the exchange rate. Under such conditions, controls over capital

inflows may be the only effective way for preventing appreciations, asset bubbles and a rapid deterioration in the current account.

37. The Fund has been ambivalent towards capital controls, including market-based measures such as unremunerated reserve requirements used by Chile, Colombia and others. This is also noted by the Independent Evaluation Office (IEO) in its report on the IMF's approach to capital account liberalization. It has also been optimistic about sustainability of capital inflows to EMs – an issue emphasised in a report on surveillance by an independent group of experts. It advocates fiscal tightening and greater exchange rate flexibility to prevent appreciations at times of strong surges. However, again as recognized by the IEO, none of the standard policy measures recommended by the Fund is a panacea, and each involves significant costs or otherwise brings about other policy dilemmas.

38. It has been argued that “the IMF has learned over time on capital account issues” and “the new paradigm ... acknowledges the usefulness of capital controls under certain conditions, particularly controls over inflows” (IEO). However, this is not reflected in the policy advice provided by the Fund in Article IV consultations. More importantly, the Fund refrains from requesting changes in monetary policy and capital account measures to slowdown arbitrage flows and check currency appreciations even in countries under its supervision. In the 1990s it supported exchange-rate-based stabilization programs relying on short-term capital inflows at the expense of growing financial fragility. More recently Turkey, the only major emerging market economy still under the Fund's supervision, has also been going through a similar process, with a sharply appreciated currency and a current account deficit of almost 8 per cent of GDP. But the Fund has done little to check this process; it has actually given further momentum by constantly praising the tight money-cheap dollar policy pursued under its supervision.

39. To my knowledge no country with a Fund program in recent years has ever attempted to control capital inflows even when they were visibly problematic. Argentina and Thailand, both without Fund programs, have recently introduced unremunerated reserve requirements to slow

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 prices and growth accounted for 2 of the 3 percentage point improvement in the fiscal balance as a proportion of GDP. According to a decomposition exercise, cumulative fiscal savings during 2002-2005 from lower interest rates and risk spreads amounted to about two per cent of GDP outside East Asia; 3 per cent among the most vulnerable countries in Emerging Europe and Latin America; and 4 per cent in Africa, West Asia and the Middle East.

42. Despite these improvements, at around 60 per cent of GDP on average, the level of public debt and the consequent fiscal burden in EMs continue to be of a major concern. Most estimates from studies on debt crises in EMs put the “safe” or sustainable public debt ratio at no more than 50 per cent of GDP. For external debt this is said to be as little as 15 per cent in the so-called “debt intolerant” countries. Evidence shows that over 1970-2001, more than half of sovereign debt crises occurred at debt ratios below 40 per cent of GDP, and two thirds at ratios below 60 per cent of GDP. According to the Fund the EMs generally fail to ensure sustainability once public debt exceeds 50 per cent of GDP, and the “sustainable public debt level for a typical emerging market economy may only be about 25 per cent of GDP.”

43. Not all recent improvements in the size and structure of public debt in EMs reflect the impact of favourable cyclical global conditions. There are certainly structural improvements

brought about by efforts for better fiscal discipline and debt management. However, recent empirical work, including in the IMF, suggests that improved market access conditions and reduced spreads reflect more the impact of liquidity and increased risk appetite than improved fundamentals in EMs. Consequently, many of these countries are extremely vulnerable to a reversal of favourable cyclical conditions. Since favourable conditions benefited more the countries with most fragile debt positions they also remain the most vulnerable. The debt ratios are so high that despite favourable conditions many EMs have had to generate primary surpluses amounting to several percentage points of GDP in order to stabilize them. More importantly, in more than half of the EMs primary surpluses still fall short of the amounts needed, requiring further increases by 4-5 per cent of GDP.

d. Public debt and fiscal space for growth

44. There is now a consensus that many developing countries need greater “fiscal space” to allow the public sector to invest in infrastructure and to provide social services badly needed to accelerate growth and reduce poverty. This is all the more important because fiscal policy has long ceased to be an instrument of growth and equitable income distribution in developing countries— or, as put by the BWIs, during the 1980s and 1990s “growth and poverty objectives were under-emphasized.”

45. In the past two decades the single most important objective of fiscal policy was to reduce budget deficits from the very high levels reached as a result of economic contraction and increased interest payments, in order to check monetary expansion and bring inflation under control. This objective had largely been attained by the end of the 1990s when the median fiscal deficit fell to some 2 per cent of GDP from 6 per cent in the early 1980s. However, this fiscal-adjustment-cum-disinflation process has resulted in a rapid build-up of public debt, notably domestic debt. As a result attention has increasingly shifted from deficit reduction and price stabilization to generation of primary budget surpluses and debt stabilization. The principle task of treasury departments in many EMs has become to sustain debt and avoid arrears and default—

all other objectives of fiscal policy have been subordinated to debt management. Increased public indebtedness and financial fragility has also promoted pro-cyclical fiscal policy, adding to expansion and bubbles during financial booms and to deflation during busts.

46. The fiscal adjustment in middle-income countries in the 1980s and 1990s largely took the form of spending cuts rather than revenue increases. With interest payments as a proportion of GDP rising by three-to-four times during the same period, the burden fell on primary spending, notably public investment. For lower-middle income countries taken together, public investment stood just above 5 per cent of GDP in 2005, down from 8 per cent in 1980. For upper-middle income countries, the drop was steeper, from over 10 per cent of GDP to almost 4 per cent. In several heavily-indebted EMs, interest payments now exceed public investment and the margin is particularly large in Argentina, Brazil, Egypt, Lebanon, Philippines, Turkey and Uruguay. For a sample of 14 EMs, average public investment is now around 3.5 per cent of GDP while interest payments exceed 5 per cent.

47. Much of the fiscal adjustment in the 1990s was through compression of investment in infrastructure, which is estimated to have reduced long-term growth in Latin America by between 1.5 and 3 per cent. In upper-middle income countries spending on infrastructure was almost halved between the early 1980s and 2000, coming down to less than 2 per cent of GDP. In lower-middle income countries the decline was even more dramatic, from above 4 per cent of GDP to almost one per cent. A sizeable infrastructure gap has emerged in several regions since the private sector has not stepped in and invested as much as expected despite increased emphasis on private-public partnership.

48. Mounting interest payments not only compete with public investment and social spending, but they have also become a major source of increased income inequality. Unlike interest payments on external debt, government revenues used for interest payments on domestic debt do not constitute a net transfer from the private sector, but entail intra-private sector redistribution depending on the incidence of the tax burden and the distribution of public debt holdings. The tax system in developing countries has become more regressive with financial

liberalization and increased capital mobility which has reduced the ability of governments to tax capital and financial incomes. In raising revenues needed for increased debt servicing the emphasis has been on indirect taxes, notably value-added and consumption taxes, “rather than income and property taxes”, which have sometimes been “resisted by broad segments of the population because they have been perceived to be inequitable” (IEO).

49. Generally, government spending is expected to offset the adverse distributional impact of taxation by favouring the poor and underprivileged. This has largely been impaired with the growing importance of domestic debt and increased diversion of government revenues to interest payments. Private wealth including government debt holdings are heavily concentrated even in industrial countries with Gini coefficients ranging between 0.65 and 0.75, much higher than income Ginis of 0.35-0.40. This is more so in EMs where incomes of large segments of population are not high enough to allow financial savings and pension funds are underdeveloped. Furthermore, inequality is aggravated by very high real rates of return on government debt, which occasionally reach double digit figures.

50. A key question is how to create greater “fiscal space for growth” under such circumstances. For the IMF, the fiscal space is what is left after servicing debt: it “refers to a government’s ability to undertake spending without impairing its solvency, that is without impairing its present and future ability to service its debt.” Four different ways are proposed for creating greater fiscal space: improving the efficiency of public expenditures, increasing revenue mobilization, attracting grant aid and new borrowing.

51. There is no doubt that scope exists in many countries to improve the efficiency of public spending, to reduce waste and to ensure a better allocation of primary expenditures. It is also possible to achieve sizeable increases in revenues through better tax administration and increased taxation. However, it is important to make a realistic judgment about the extent to which these can be relied on, particularly since an important part of government revenues is now absorbed by contractual obligations and there are constraints over taxing business and financial incomes because of footloose capital, and over raising indirect taxes because of their adverse impact on

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, procyclical macroeconomic tightening, and unequal distribution of the burden between debtors and creditors.

Annex A: The Standard Framework for Debt Sustainability

A. Public debt

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

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

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

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

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

$$r = \beta \rho + (1 - \beta) \rho^* \quad (3)$$

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

$$\rho^* = \frac{(1 + i^*)(1 + \hat{\varepsilon})}{(1 + \pi)} - 1 \quad (4)$$

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

$$p \geq [(r - g)/(1 + g)] d \quad (5)$$

B. External debt and the balance-of-payments

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

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

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, $\varepsilon TB^*/Y$ where TB^* is the trade balance in dollar terms). From the balance-of-payments identity:

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

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:

$$b \geq [(\rho^* - g)/(1 + g)] e \quad (8)$$

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 them 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.

The remaining, the scientific, expedient, the capital levy, has never yet been tried on a large scale; and perhaps it never will be. It is the rational, the deliberate method. But it is difficult to explain, and it provokes violent prejudice by coming into conflict with the deep instincts by which the love of money protects itself ... Once currency depreciation has done its work, I should not advocate the unwise, and probably impracticable, policy of retracing the path with the aid of a capital levy. But if it has become clear that the claims of the bond-holder are more than the taxpayer can support, and if there is still time to choose between the policies of a levy and of further depreciation, the levy must surely be preferred on grounds both of expediency and of justice.

There is a respectable and influential body of opinion which, repudiating with vehemence the adoption of either expedient, fulminates alike against devaluations and levies, on the ground that they infringe the untouchable sacredness of contract; or rather of vested interest ... Yet such persons, by overlooking one of the greatest of all social principles, namely the fundamental distinction between the right of the individual to repudiate contract and the right of the State to control vested interest, are the worst enemies of what they seek to preserve. For nothing can preserve the integrity of contract between individuals, except a discretionary authority in the State to revise what has become intolerable. The powers of uninterrupted usury are too great. If the accretions of vested interest were to grow without mitigation for many generations, half the population would be no better than slaves to the other half.

These conclusions might be deemed obvious if experience did not show that many conservative bankers regard it as more consonant with their cloth, and also as economising thought, to shift public discussion of financial topics off the logical on to an alleged ‘moral’ plane, which means a realm of thought where vested interest can be triumphant over the common good without further debate. But it makes them untrustworthy guides in a perilous age of transition. When ... we enter the real of State action, *everything* is to be considered and weighed on its merits. Changes in death duties, income tax, land tenure, licensing, game laws, church establishment, feudal rights, slavery, and so on through all ages, have received the same denunciations from the absolutists of contract, who are the real parents of revolution.

¹ “Public finance and changes in the value of money”, chap. 2 of *A Tract on Monetary Reform* in *The Collective Writings of John Maynard Keynes*, vol. IV, Cambridge University Press, 1971, pp. 53–55.