

DEBT SUSTAINABILITY AND MILLENNIUM DEVELOPMENT GOALS IN EMERGING MARKET ECONOMIES

*Yilmaz Akyüz**

*It is not the government that controls the debt,
but the debt that controls the government.*

Fernando Henrique Cardoso

A. Introduction

Debt has been at the centre of the development debate since the 1980s and it should come as no surprise that it is also a main concern in the Millennium Development Goals (MDGs) initiative. The emphasis by the United Nations that debt sustainability should be defined so as to make it compatible with the achievement of the MDGs has raised three interrelated questions (UN 2005a: 18). First, can developing countries be expected to continue to service their existing stocks of debt and at the same time make significant progress towards meeting the MDGs? Second, to what extent does the compatibility between debt sustainability and the MDGs depend on the removal of the existing debt overhang? Third, can developing countries finance the MDGs with newly contracted debt without running into an unsustainable process of debt accumulation relative to their capacity to pay?

So far the debate has naturally focussed on low-income countries and the debt they owe to official creditors. Although governments in some of these countries also carry relatively large amounts of domestic debt and this places important constraints over progress towards the MDGs, such debt is rarely incorporated in analyses of sustainability partly because of lack of adequate

* Former Director, Division on Globalization and Development Strategies, UNCTAD. Paper prepared for the UNDP. I am grateful to Detlef Kotte, Juan Pizarro and Makameh Bahrami of UNCTAD for their assistance with the data used in this paper, to Paul Ladd and Kamal Malhotra of UNDP and Butch Montes of DESA for comments and suggestions. The usual caveat applies.

and comparable data and information, partly because of the focus on official debt-relief initiatives.¹ For these countries a combination of the removal of the debt overhang and provision of grants and concessional loans by multilateral and bilateral donors is generally considered as a key step in global partnership for development as called for by the MDG-8.

It is true that many middle-income countries have either already met the MDGs or are on track to achieve them without facing serious financial constraints (World Bank 2003b: 22). However, with their per capita incomes varying between some \$800 and \$9,400, countries in this group are much more heterogeneous than low-income countries both with respect to several indicators of development and the financial constraints they face. Several middle-income countries including China, Ecuador, El Salvador, Guatemala, Honduras, Paraguay, Peru, and the Philippines have similar or higher proportions of their populations living under the poverty line in comparison with low-income countries such as Cameroon, Côte d'Ivoire, Pakistan and Yemen, and many have larger absolute number of people living in poverty compared with poorer countries. Even in more advanced middle-income countries such as Brazil, Mexico, Thailand and Turkey there are wide pockets of poverty and deprivation at the regional level, and removal of these calls for large amounts of resources as well as targeted interventions.²

There is also considerable disparity among middle-income countries in the financial constraint they face. A large number of lower middle-income countries lack adequate domestic resources or access to international capital markets and rely heavily on official financing. Many of them are severely-indebted and their success in meeting the MDGs depends, *inter alia*, on a deeper cut in their official debt than has so far been offered. These include countries such as Indonesia and the Philippines which lag considerably in the achievement of the MDGs in several areas including child malnutrition and mortality, and maternal mortality. More importantly, their

¹ Estimates given by Christensen (2005) for 27 Sub-Saharan African countries show a domestic debt ratio of 15 per cent of GDP at the end of the 1990s. It is also found that domestic debt is more expensive than external debt and domestic interest payments present a significant burden to the budget.

² On MDGs indicators see WB/IMF (2006: Table A.1 and Box 1.1).

recent progress in most of these areas is highly inadequate due to insufficient public spending – on current trends they are most unlikely to meet the MDGs by 2015.

But not all lower-middle income countries are in the same position, or even less advantaged than richer developing countries. China, for instance, has both adequate domestic resources and access to international capital markets and these should allow it to continue making progress towards meeting the MDGs by 2015. By contrast, several heavily-indebted upper middle-income countries, notably but not only in Latin America, with structural resource gaps and excessive dependence on external capital, face serious trade offs between servicing and sustaining their debts and making satisfactory progress towards the MDGs.

This paper will focus on emerging-markets – that is, countries which have relatively good and regular access to international capital markets and which account for the bulk of developing country debt owed to private creditors. Their debt dynamics are crucially different from that of low-income and middle-income official debtors. The terms and conditions of their debt tend to be highly volatile due to abrupt and unexpected changes in risks assessment by lenders and gyrations in capital flows and exchange rates. The vulnerability of these countries to interruption of their access to international financial markets and rapid exit of capital not only pose the risk of default, but also sharp economic contraction and rapid deterioration in living conditions that can push large segments of the population below the poverty line, as observed in Latin America, Asia and elsewhere during several episodes of financial crisis in the 1990s. Furthermore, the experience shows that even countries with sound macroeconomic policies and excellent track records in development and poverty alleviation may not be spared from the whims of international capital markets.

Section B examines various features of sovereign debt in emerging market economies, including its size, composition and maturity structure, and recent trends. Section C follows with a discussion of the standard framework used for analysis of debt sustainability in emerging market economies, including both fiscal and external sustainability, and the two key issues often left out of debt analyses; dynamic interactions among policy and endogenous variables affecting

sustainability and linkages between fiscal and external sustainability including possible trade-offs between the two. An assessment is also made of the IMF approach to debt sustainability. Section D analyzes the implications of the debt burden for fiscal space and progress towards the MDGs. Section E turns to how the MDGs could be incorporated into the analysis of fiscal sustainability and examines the options available and constraints faced in debt workouts that may be needed on three fronts— public domestic debt, external official debt and external commercial debt. The paper ends with a summary of the main conclusions.

B. Public debt in emerging market economies

Reliable, comprehensive and comparable data on public debt are lacking for most emerging-market economies, including domestic and external liabilities of central and local governments and other public sector entities. Data problems are particularly acute for domestic debt.³ According to estimates by the IMF, the average ratio of total public debt to GDP in emerging market economies is now around 60 per cent, the benchmark established in the European Union and a little below the average ratio in industrial countries. This is divided more or less equally between foreign-currency and domestic-currency debt. A very large proportion of this is owed to private creditors. This share has increased in the last few years since, with the notable exception of Turkey, most emerging market economies have paid off their debts to the IMF, mostly incurred during financial bailout operations at times of crises.

Recent years have seen a significant improvement in the public debt profile of emerging market economies. At about 70 per cent, the average debt ratio of these countries was higher than that of industrial countries in the early years of the decade. It was much higher as a percent of government revenues since the share of these revenues in GDP is lower than in industrial

³ Since the beginning of the decade the Fund has taken increased interest in public debt in emerging markets; see IMF (2003c: chap. 3; 2005d: 16-17; and 2006a: chap. III). Recently there have been efforts to fill the gaps in the data on domestic debt, both in the IMF and elsewhere, at least for the central government; see Mehl and Reynaud (2005) and Jeanne and Guscina (2006). These provide the main sources of the information used in this section.

countries – 27 per cent of GDP in comparison with 44 percent.⁴ Between 2002 and 2005 the average debt ratio declined in 19 out of 25 emerging market economies for which data are available. While foreign-currency debt has declined in Latin America and remained relatively stable in Asia, there has been an increase in domestic-currency debt in almost all regions, with its share in total debt gaining by more than 5 percentage points since the beginning of the decade. Available data show that this is also true for sovereign debt – that is, the liabilities of central governments and central banks, excluding sub-sovereign governments and other public entities (table 1). The share of short-term domestic marketable debt has also declined and the maturity structure has improved.

Nevertheless, there are considerable variations among countries with respect to the debt ratio, relative importance of foreign-currency and national-currency liabilities, and the maturity profile. There has been deterioration in the structure of debt in some countries that could render them more vulnerable to an adverse shift in global financial conditions, including increases in the shares of foreign currency debt (e.g. Chile and the Philippines), short-term debt (Colombia and Thailand) and variable-rate debt (Brazil, Mexico and Venezuela) in total public debt.⁵ In many countries outside Asia, debt ratios are generally higher, maturities are shorter and the shares of both variable-rate domestic debt and foreign-currency debt are greater.⁶

Recent improvements in the debt profile in the majority of emerging market economies have been greatly aided by what the IMF (2005d: 17) calls “unusually favourable combination of circumstances – exchange rate appreciation, historically high growth rates, buoyant commodity

⁴ IMF (2003c: 120). Indeed if a country is structurally unable to raise revenues out of GDP, the appropriate scale variable in the debt ratio is not GDP but government revenues– see Roubini (2001).

⁵ However, it should also be kept in mind that while an increase in the share of the domestic-currency debt reduces the vulnerability to exchange rate swings, it also raises the risk of sharp increases in the interest bill at times of financial instability, particularly since a larger proportion of domestic debt tends to be short-term or at variable rates.

⁶ See IMF (2006a) for structural changes in emerging sovereign debt. Jeanne and Guscina (2006) find that public debt ratio does not differ much between Latin America and Asia but the former region relies a lot more on external debt. According to Mehl and Reynaud (2005) the so-called domestic original sin (inability to issue long-term, fixed-rate domestic-currency debt) is much more serious in Latin America than in Asia.

prices, and an increase in financial market risk appetite.” The contributions of strong growth and exchange rate appreciations to the decline in the average debt ratio amounted to 8 per cent and 5 per cent of GDP respectively, while increased primary budget surpluses⁷ reduced the debt ratio by another 5 per cent. These allowed the average debt ratio in a sample of 25 emerging market economies to fall by 8 per cent of GDP despite the presence of influences pushing in the other direction including the recognition of off balance sheet liabilities and higher domestic real interest rates resulting from a growing practice of inflation targeting and increased issuance of inflation-indexed bonds. Exchange rate appreciations, particularly against the dollar in which much of the external debt is denominated, have also been a major factor in the increase of the share of domestic debt. For a larger group of 37 emerging market economies strong commodity prices and growth accounted for 2 of the 3 per cent improvement in the fiscal balance as a proportion of GDP. In some countries where commodity-related government revenues are important, buoyant prices added to the budget by as much as 6 per cent of GDP.⁸ Many countries enjoying commodity windfalls have been able to reduce their debt stocks – the Brady bonds have virtually disappeared after peaking at over \$150 billion in the 1990s.

According to a decomposition exercise, cumulative fiscal savings during 2002-2005 from a combination of lower interest rates and risk spreads amounted to about two per cent of GDP outside East Asia, reaching to 3 per cent among the most vulnerable countries in Emerging Europe and Latin America and 4 per cent in Africa, West Asia and Middle East (Hauner and Kumar 2005). The same study shows that outside Latin America, the fiscal performance would have shown deterioration without the combined effects of the boom in commodity exports and fiscal savings from favourable global financial conditions, while in Latin America the improvement in budget deficits would have been lower by more than one per cent of GDP.

There can be little doubt that not all recent improvements in the size and structure of public debt reflect the impact of favourable cyclical global conditions. There have certainly been

⁷ Defined as the difference between government revenues including seignorage and non-interest (primary) spending.

⁸ In Mexico, for instance, oil-related income accounts for one-third of public sector revenues— IMF (2003c: 122n).

structural improvements brought about by national efforts for stronger fiscal discipline and better debt management. However, recent empirical work, including in the IMF (2004b: chap. 2, appendix I) suggests that the improved market access conditions and reduced spreads reflect more the impact of global liquidity and increased risk appetite than improved fundamentals in these economies. Consequently, fiscal positions of many of them are vulnerable to a reversal of favourable global cyclical conditions.⁹ Since these conditions benefited more the countries with most fragile debt positions, they also remain the most vulnerable to deterioration. In fact only a few years ago several of them were considered as highly fragile, and some even on the brink of default.¹⁰

Even disregarding that recent improvements are due to exceptionally favourable cyclical conditions that may be liable to reversal, the present ratios are still too high. Most estimates from studies on debt crises in emerging market economies put the so-called safe or sustainable public debt ratio at no more than 50 per cent of GDP. 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 (IMF 2003b: 37). According to the Fund the emerging market economies 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.”¹¹ It is also argued that for the so-called debt intolerant countries the “safe” external debt ratio may be in the order of 15 percent (Reinhart, Rogoff and Savastano 2003).

Indeed, the debt ratios are so high that despite favourable conditions many emerging market economies have had to generate primary budget surpluses amounting to several

⁹ According to the World Bank (2006) the most important potential risks come from the oil market and interest rates. For various channels of transmission of adverse shocks see De Alessi Gracio, Hoggarth and Yang (2005).

¹⁰ In a study by Goldstein (2005) Turkey headed the list of countries vulnerable to deterioration in global economic conditions, with Argentina, Mexico and Hungary also among the most vulnerable countries. Until recently Brazil was also widely expected to face debt servicing difficulties: see Williamson (2002) and Goldstein (2003).

¹¹ IMF (2003c: 142). For other estimates see Moreno (2003: 2-3), Mihajek and Tissot (2003: 16-22), Manasse, Roubini and Schimmelpfennig (2003), and Goldstein (2005: 54).

percentage points of GDP in order to prevent debt explosion (table 2). Even more importantly, in more than half of these economies, primary surpluses still fall short of the amounts needed to stabilize the debt ratios, requiring further increases in the order of 4-5 per cent of GDP (IMF 2005d: 17).

Even after recent improvements current debt ratios represent a reversal of the declines that took place during the first half of the 1990s. Not only does external public debt as a proportion of GDP now exceed the levels of the 1980s, several governments also carry a large stock of domestic debt which virtually did not exist a couple of decades ago. As a result of capital account liberalization an important part of domestic-currency debt has come to be held by non-residents, including hedge fund investors. It is estimated that the share of non-residents in domestically-issued local-currency debt doubled to 12 per cent between 2000 and 2005, in large part due to higher interest rates than the historically low rates on debt issued in major reserve currencies. Some countries including Brazil, Colombia and Uruguay have also started to issue local-currency denominated global bonds at rates below those in domestic markets because of lower jurisdiction spreads (Tovar 2005; IMF 2005a: 44). As non-residents increased their local-currency debt holdings, residents have also started to acquire internationally issued foreign currency debt instruments of their governments. As a result, the conventional distinction between external and domestic debt based on the residency of the holder no longer coincides with the distinction between foreign-currency and domestic-currency debt. External debt is no longer identical with internationally-issued debt since the latter is partly held by the residents of the issuing country. And domestic debt is no longer identical with domestically-issued debt since holders of the latter include non-residents.

Much of the increase in public debt since the early 1990s is accounted for by sharp movements in interest and exchange rates, excessive borrowing during surges in capital inflows and the recognition of off-balance-sheet debt and the realization of contingent liabilities.¹²

¹² These liabilities have two forms; those recognized by a law or contract (e.g. state guarantees for non-sovereign borrowing) and obligations assumed due to public and interest-group pressures- see IMF (2003b: 28-29). In Brazil the recognition of hidden liabilities (the so-called skeletons) accounted for one-third of the rise in net public debt during 1994-2004- see Goldfajn (2002).

Among the latter perhaps the most important factor has been the assumption of private sector liabilities by the public sector or socialization of private debt, often through recapitalization of insolvent banks. Thus, contrary to orthodox thinking which seeks the origins of balance-of-payments and currency crises in public sector debt and deficits, it is in fact the crises triggered by excessive private sector indebtedness that are one of the main reasons for sharp increases in public debt in recent years. In Indonesia, for instance, bailout operations raised public debt by more than 50 per cent of GDP (IMF 2003b: 28n), creating problems of fiscal sustainability despite a good track record regarding fiscal discipline. For Thailand and Korea corresponding figures are 42 per cent and 34 per cent respectively (Hoggard and Saporta 2001: 162) and for Turkey 33 percent (World Bank 2003a: 21). In a sample of 12 countries hit by currency and financial crises, the average post-crisis public debt ratio was higher than the pre-crisis ratio by 36 per cent of GDP (table 3). The collapse of the currency as well as socialization of private debt were the major factors contributing to worsened debt situations. In most cases the increase in debt levels persisted for several years before governments could roll-back the crisis-induced increases in debt ratios (Bolle, Rother and Hakobyan 2006).

C. Debt sustainability: The standard framework

1. Fiscal sustainability

In theory fiscal sustainability is defined as respect of both static and intertemporal budget constraints. The static budget constraint is satisfied if the public sector is able to finance its current expenditures with its revenues and new borrowing, and meet or rollover its maturing liabilities. The intertemporal budget constraint is formulated as respect of the solvency condition that the present discounted value of future primary 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.

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.¹³ 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. On the other hand, since both the underlying economic conditions including the rate at which future primary balances are discounted and the fiscal policy stance vary over time and are highly uncertain, 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.”¹⁴

In practice most analyses of debt sustainability, including by the IMF, rely on a framework based on the recognition 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. The ratio of debt to GDP increases when the real effective interest rate on public 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.¹⁵ A positive growth-adjusted interest 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 emerging market economies.¹⁶ On the other hand, if the growth rate is greater than the real effective interest rate, the debt ratio would be rising only if there is a primary deficit large enough to make debt grow faster than income.

¹³ For a discussion of the problems associated with the solvency constraint see Roubini (2001).

¹⁴ While defining sustainability in this way the IMF (2002a: 5-6) also recognizes the uncertainties involved in predicting both policy variables (expenditures and taxes) and endogenous variables (interest rates and growth rates).

¹⁵ The condition $p \geq [(r - g)/(1 + g)]d$ should hold for the debt ratio to remain unchanged or decline, where p is the ratio of primary surplus to GDP, r the effective real interest rate on government debt (the weighted average of real interest rates on domestic and external debt), g the real growth rate and d the ratio of total public debt to GDP.

¹⁶ In HIPC countries the real interest rate on public debt is close to zero. In addition, these countries also benefit from external transfers to the budget in grants which can be used to pay interest on debt. They can thus incur budget deficits – as much as 7 per cent of GDP according to Cline (2003) – without facing a rising public debt ratio.

While the standard framework describes the conditions for the debt ratio to remain stable, there is no theory that can tell us what a sustainable debt threshold is (Pasinetti 1998). Indeed, given the volatility of market sentiments and herd behaviour, it would not be possible to form realistic expectations as to when the lenders will stop lending and rolling over their existing claims, or demand ever rising compensations for the risks they take. Clearly 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. Sudden stops in lending do not always signal solvency problems and investor behaviour and risk appetite tend to vary over time (Calvo 2003; Calvo, Izquierdo and Talvi 2003). In practice, however, arbitrary debt thresholds are used to assess if fiscal policy would lead to a path that will violate them – as in the Maastricht Treaty and the Stability and Growth Pact in Europe – or sustainability is judged according to whether fiscal policy allows the debt ratio to be maintained at or below the initial level.¹⁷

2. *External sustainability*

External sustainability refers to the ability of a country to meet its current and future external obligations without recourse to debt-rescheduling and a need for a drastic balance-of-payments adjustment. In theory the conditions for external sustainability are analogous to those for fiscal solvency discussed above. In practice the standard framework is often used also to examine external sustainability. Thus, for the external debt ratio to remain stable or decline between two periods there should be an adequate amount of trade surplus.¹⁸ The amount of surplus needed increases with the external debt ratio and the growth-adjusted real interest rate on external debt. Since the surplus is equal to the difference between net capital inflows and

¹⁷ Another approach emphasizes government reaction to the divergence of the debt ratio from a target threshold; debt is sustainable if government generates an adequate level of primary surplus when the actual debt ratio exceeds the target – Bohn (1995; Croce and Juan-Ramón 2003; IMF 2003c). It is also possible to determine the debt threshold on the basis of the primary surplus that a government can be expected to be able to generate – see Abiad and Ostry (2005). For an earlier discussion of sustainability and debt-stabilizing primary balance see Blanchard *et al* (1990).

¹⁸ That is, $b \geq [(\rho - g)/(1 + g)]e$ should hold where b is the ratio of the trade balance to GDP, e the external debt ratio, and ρ the real interest rate on external debt: $\rho = \{[(1 + i)(1 + \dot{\epsilon})]/(1 + \pi)\} - 1$ where i the nominal dollar interest rate, $\dot{\epsilon}$ the rate of change of the exchange rate (positive for depreciation) and π the rate of inflation.

interest payments on outstanding external debt, it represents a net transfer of resources abroad.¹⁹ Unlike the primary budget balance, the trade balance needed is not directly linked to policy, but determined by a host of variables affecting imports and exports, particularly the exchange rate and the pace of economic activity.²⁰

It is generally recognized that developing countries need substantial amounts of 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, external liabilities should be expected to stabilize relative to income as the economy generates primary current account surpluses to service its external debt.²¹

This is also generally true for budget deficits. In low-income countries governments are often unable to generate adequate tax revenues to meet the demand for public spending. Since the scope for both domestic borrowing and inflationary financing is limited, deficits are closed largely by external grants and loans from multilateral and bilateral donors. 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 government starts borrowing at home and the private sector abroad.

3. *Shortcomings in the standard framework*

a. Neglect of endogeneities and feedbacks

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

¹⁹ The concept of net transfers dominated the debate over debt in Latin America in the 1980s – see Bacha (1990).

²⁰ Although discussions of external sustainability often refer to the trade balance, strictly speaking the relevant variable is the primary current account balance; that is, current account balance minus interest payments.

²¹ For a discussion of external development finance along these lines see Kregel (2004: section VI).

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 ratios.

A realistic analysis of fiscal sustainability should recognize strong interdependencies between economic growth and fiscal policy. An economic slowdown would not only necessitate a higher level of primary surplus in order to stabilize the public debt ratio, but would also reduce government revenues and make it more difficult to generate the primary surplus needed. A pro-cyclical fiscal retrenchment to increase the primary surplus could, in turn, make matters worse by leading to a further contraction. Over the longer-term a path of relatively high primary surplus may be associated with lower growth because of adverse impact of high taxes or low infrastructure spending on private investment (Calvo 2003). Again monetary policy can have a significant influence on the evolution of the debt ratio through its effects on the interest rate.

Perceived risk by lenders is a key factor moving interest rates on both domestic and external debt, and tends to rise with the debt ratio (Reinhart, Rogoff and Savastano 2003). Consequently, if a government fails to generate adequate primary surplus to stabilize the debt ratio, its task can get tougher as the risk premium rises and pushes up the cost of borrowing, which in turn necessitates an even higher level of primary surplus. A vicious circle can be set off through negative feedbacks between the debt ratio and the risk of default; an exogenous increase in sovereign spreads may trigger a perverse dynamics leading to “self-fulfilling solvency traps.”²² Furthermore, worsened risk perceptions tend to lead to currency depreciations (Blanchard 2004) which, in turn, 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 (Calvo, Izquierdo and Talvi 2003). It is usually the exchange rate shock that results in the largest increase of the debt ratio (IMF 2003b: 11). According to an estimate, a 3 per cent devaluation in

²² See Roubini (2001). For a dynamic simulation model based on such interactions between the debt burden and the risk premium see Hostland and Karam (2005).

Brazil has much the same impact on the government debt ratio as a 300 basis-point rise in the interest rate over 12 months or a 1 per cent drop in the GDP growth rate (Goldstein 2003: 12).

b. Neglect of the links between fiscal and external sustainability

A second problem with the standard framework is that it treats fiscal and external sustainability independently without specifying the links between the two. 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 ignores the foreign exchange constraint.²³

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. As seen in Chile in the early 1980s, and Mexico and East Asia in the 1990s such crises can occur despite budget balance or surplus (UNCTAD TDR 1998; Edwards 2001). Even though none of these crises resulted in sovereign default, they increased fiscal fragility because of their adverse effects on growth, exchange rates, interest rates and public sector liabilities, particularly in Indonesia.

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 consider whether public and private debtors each are able to achieve the required surpluses. 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

²³ On internal and external transfer problems see Reisen and van Trotsenburg (1988). For an assessment of the standard framework along these lines see Cline (2003) and Goldstein (2003).

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 (Reisen and van Trotsenburg 1988; Cline 2005).

While a common set of variables influence both fiscal and external sustainability, their effects are not always symmetrical between the two. This is particularly 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.

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. But the very same conditions that improve public finances can also lead to a rapid deterioration of the current account. A trade-off may thus emerge between external and fiscal sustainability. Eventually if capital flows are reversed, the public sector could be driven into 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. Indeed, evidence suggests that surges in capital inflows and currency appreciations often facilitate fiscal sustainability, notably by holding down public debt ratios (IMF 2003c: 119), but such episodes are often followed by currency and debt crises: about 85 per cent of all defaults during 1970-1999 were linked with currency crises (Reinhart 2002).

4. *The IMF approach to debt sustainability*

The Fund's fiscal and external sustainability assessments in emerging market economies follow the standard approach described above. They thus manifest the same shortcomings. The framework used relies on accounting identities and a few behavioural relationships which fail to capture linkages among the key parameters, including feedbacks from monetary and fiscal policies and relations between risk premium, debt ratios, interest rates and exchange rates.²⁴ Further, the Fund does not have an integrated framework that can link fiscal and external sustainability and help determine if the conditions required by them are mutually consistent.

The IMF 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” (IMF 2002a: 42). 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 expected or agreed policies and projections for the parameters directly affecting the debt dynamics. The underlying monetary and fiscal policies are considered sustainable if they appear to stabilise the debt ratio without arrears and defaults. Otherwise policy adjustments would be called for. The baseline 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 in order to assess the degree of realism of the baseline projections and the expected gains from agreed policy changes (IMF 2003b: 25-27; and 2005c).

The Fund's analysis of external sustainability broadly follows the same procedures. It starts with medium-term baseline projections for the current account, private and official capital flows and external debt accumulation, based on assumptions for a number of variables including

²⁴ For an assessment along these lines see Hostland and Karam (2005) and Goldstein (2003).

exchange rates, growth rates and interest rates. Current account projections are derived essentially from the savings-investment balance, building on the medium-term projections for the public sector. 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 ratio above this level by no means necessarily implies a crisis (IMF 2002a: 25).

A major problem with the Fund's sustainability analyses for emerging market economies is that the projections are overly optimistic – something which has also been widely noted and criticised with respect to HIPC's. 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” (IMF 2003b: 9). 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 of GDP for external debt. In financially-constrained emerging market economies, including Argentina, Brazil and Turkey, medium-term fiscal projections persistently showed stabilization of debt ratios while in reality debt levels continued to mount.

More significantly, optimism is greater for countries with IMF programs. In public debt, under-prediction is greater for both low-income and middle-income countries following IMF advice. For external debt, the bias (that is, the difference between projected and realized debt ratios) for all upper-middle income countries is around 4 per cent of GDP compared to more than 7 per cent for those with Fund-supported programs.

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 noted in a report on fiscal adjustment in IMF-supported programs by the Independent Evaluation Office, “there is evidence that investment is consistently overestimated in IMF-supported programs” and that the IMF “programs achieved only about one-half of the programmed improvement in overall and primary fiscal balances (IEO 2003: 4 and 6). As growth and fiscal targets are missed, debt ratios remain above projections.

The sensitivity tests appear to be quite ineffective in providing early warning signals. This is because the primary surpluses assumed in the baseline are often 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. In general, the stress-tests are able to say nothing about the likelihood of the simulated shocks occurring or, in the case they occur, if they would culminate in a crisis.

A major reason underlying these shortcomings is that even though the key variables are endogenous and interact dynamically, they are often projected as if independent. The importance of interactions and the need for internally consistent scenarios are recognized by the Fund (IMF 2003b: 26). However, the procedures adopted, including stress tests for more persistent shocks simultaneously to several variables, fail to capture critical vulnerabilities in large part because they do not address dynamic interactions among the variables which play a more critical role in the process leading to crises than the size of the initial shocks.

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

D. Debt, fiscal space and the MDGs

From the point of view of the issue at hand, the central question is if governments in emerging market economies can be expected to be able to both service and sustain their debts and at the same time make satisfactory progress towards the MDGs over the coming years. The latter calls for large public investment in human and physical infrastructure which not only adds

directly to income and employment but also acts as a conduit for private investment, thereby helping to accelerate and sustain growth, much needed for eradicating extreme poverty and hunger as called for by MDG-1. Similarly it also necessitates increased public spending on health and education. This too can make important contributions to long-term growth in addition to its direct impact on human development through progress in several MDGs.

In many countries public finances are not in the shape needed for these tasks to be carried out effectively. As a matter of fact, fiscal policy has long ceased to be an instrument of growth and equitable income distribution. As recognized by the BWIs, during the 1980s and 1990s “growth and poverty objectives were under-emphasized” in the design of fiscal policy (IMF/WB 2006: i). During that period, 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, and 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 in developing countries fell to some 2 per cent of GDP from 6 per cent in the early 1980s. However, this fiscal-adjustment-cum-disinflation process was accompanied by a rapid build-up of public debt, notably domestic debt. Attention has consequently shifted from deficit reduction and price stabilization to the generation of primary budget surpluses and debt stabilization. The principle task of treasury departments has become to sustain debt and avoid arrears and default, and 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.²⁵

Fiscal adjustment in middle-income countries has largely taken the form of spending cuts. On average, government revenues as a proportion of GDP effectively remained unchanged from the early 1980s until the end of the 1990s while expenditures were cut by more than 4 percentage points of GDP (table 4). Interest payments as a share of GDP rose by three-to-four times during the same period and the burden of cuts fell on primary spending. This pattern has

²⁵ See a number of papers in BIS (2003). See also Kaminski, Reinhart and Végh (2004) and UN (2006: chap. IV). For a further discussion see Akyüz (2006: 19-22).

continued in recent years despite the increase in government revenues brought about by the rapid growth and increases in commodity prices.

The brunt of the cuts in primary spending fell on public investment. At the end of the 1970s, public investment in developing countries taken together was around 10 per cent of GDP and in some countries it was even greater than private investment (Everhart and Sumlinski 2001). For lower-middle income countries, it stood just above 5 per cent of GDP in 2005, down from 8 per cent in 1980. For upper-middle income countries, the drop between 1980 and 2005 was steeper, from over 10 per cent of GDP to almost 4 per cent (IMF/WB 2006: 5). In Latin America the decline that started with the debt crisis in the 1980s continued throughout the 1990s and public investment as a proportion of GDP fell even below the levels of some industrial countries with much better human and physical infrastructure (UNCTAD TDR 2003; IMF 2004a). In several heavily-indebted emerging market economies, interest payments as a proportion of GDP now exceed public investment, and the margin is particularly large in Argentina, Brazil, Egypt, Lebanon, the Philippines, Turkey and Uruguay (table 5).

The retrenchment of public investment has gone to such an extent that it has become a major concern to the BWIs. As recognized by the Fund much of these cuts were undertaken as part of fiscal adjustment rather than with the objective of allowing greater room to private initiative.²⁶ In Latin America in the 1980s cuts in public investment were on average more than three times those in current spending. Half of the fiscal adjustment during the 1990s reflected compression of investment in infrastructure which is estimated to have reduced long-term growth by 1.5-3 per cent in that region. In upper middle-income countries public spending on infrastructure was almost halved between the early 1980s and the new millennium, 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 in the early 1980s to almost one per cent in the new millennium (IMF/WB 2006). A sizeable infrastructure gap has emerged since the private sector

²⁶ See IMF (2004a: 9-10). The account given above is also confirmed by more detailed pilot country studies (IMF 2005b) and by a report by IMF/WB (2006) on fiscal policy for growth and development.

has not stepped in and invested as much as expected despite increased emphasis on private-public partnership.

This combination of large infrastructure gaps and meagre public investments reduces the likelihood of making further progress towards the MDGs in several middle-income countries. According to an estimate, these countries would need to invest annually over 5 per cent of GDP in infrastructure in order to meet the MDGs (Fay and Yepes 2003: 11). This figure is not only far above the recent levels of investment in infrastructure, it also exceeds the entire public investment in most middle-income countries. The task becomes much more onerous if account is taken of financing needs in other areas affecting the MDGs such as health and education.

Not only do interest payments on public debt absorb a large proportion of government revenues that could be allocated to the MDGs, but they have also become a major source of increased inequality in income distribution. Unlike external debt servicing, 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 increased financial liberalization and capital mobility which have effectively reduced the ability of governments to tax capital and financial incomes.²⁷ In raising revenues in order to meet increased debt servicing and to stabilize the public debt ratio, the emphasis has been on indirect taxes, notably value-added and consumption taxes, rather than income and property taxes. As noted by the IEO (2003: 10) these have sometimes been “resisted by broad segments of the population because they have been perceived to be inequitable.”

Traditionally government spending is expected to offset the adverse distributional impact of taxation through allocations favouring the poor and underprivileged. In several countries this has largely ceased to be the case with the increased allocation of government revenues to interest payments and the growing importance of domestic debt. Private wealth including government

²⁷ For the impact of liberalization on distribution see UNCTAD TDR (1997) and Cornia (2005).

debt holdings are heavily concentrated even in industrial countries with Gini coefficients ranging between 0.65 and 0.75, and exceeding 0.80 in some cases, much higher than income Ginis of 0.35-0.40.²⁸ There is little data and information on wealth distribution and government debt holdings in developing countries, but these can be expected to be even more concentrated in these countries where income distribution is less equitable and pension funds are generally underdeveloped. Furthermore, the rate of return on government debt tends to be much higher, with real interest rates occasionally reaching double digit figures.

There is now a consensus that developing countries need greater “fiscal space for growth.”²⁹ However, it is not clear how this space could be created. For the BWIs, the fiscal space is defined as 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.... Fiscal space is therefore the gap between the current level of expenditure and the maximum level of expenditures that a government can undertake without impairing its solvency” (IMF/WB 2006: 14). The BWIs propose four different ways for creating fiscal space: improving the efficiency of public expenditures, increasing revenue mobilization, attracting grant aid and exploiting unused borrowing capacity, of which only the first two are relevant for heavily-indebted middle-income countries.³⁰

There can be little doubt that there is scope 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, expanding fiscal space through such means may not always be development friendly—excessive taxation can hurt investment and growth, while efficiency is not always the norm that

²⁸ One half of households own 97 per cent of financial assets in the United States (Honohan 2006) and globally the richest 2 per cent hold half of the world assets (Davies *et al.* 2006). For evidence from developing countries see UNCTAD TDR (1997: 145-148), and Davies and Shorrocks (2005).

²⁹ See Development Committee Communiqué, April 17, 2005. Washington, D.C.

³⁰ IMF/WB (2006: 114). See also World Bank (2007) which provides further analysis and country case studies, highlighting variations in the need and scope for resorting to alternative ways of generating fiscal space.

should govern allocation of public spending. Moreover, it is essential to make a sound judgment on the extent to which these can be relied on for attaining the MDGs, particularly since an important proportion of government revenues are now absorbed by contractual obligations, serious constraints are encountered in taxing business and financial incomes, and resort to highly regressive indirect taxes can defeat the purpose. Thus, scenarios for creating “fiscal space for growth” through spending cuts and tax increases may, once again, prove to be overoptimistic exercises, particularly since the amounts required are quite large, in the order of 4-5 per cent of GDP.

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” (IMF/WB 2006: n39). Traditionally the Fund has been averse to arrears and defaults, insisting that debt should be serviced at any cost. This was 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. It was also quite willing to lend into unsustainable debt positions, as in Russia and Argentina, rather than help countries to restructure debt and relieve the burden in an orderly way as called for by “market discipline”, letting the lenders bear the full consequences of the risks they had taken.

More recently, however, the Fund has been encouraging the inclusion of collective action clauses (CACs) in international sovereign bonds by emerging market economies, with such bonds reaching 60 per cent of the total stock as of end-February 2006, up from 32 per cent at the end of 2002.³¹ On the other hand, its own analysis shows that in several of these countries the

³¹ IMF (2006c). CACs are designed to improve communication between debtors and bondholders and facilitate bond restructuring. There are basically three types: *collective representation clauses* designed to establish a representative forum (e.g. a trustee) for co-ordinating negotiations between the issuer and bondholders; *majority action clauses* designed to empower a qualified majority (often 75 per cent) of bondholders to agree to a change in payment terms in a manner which is binding on all bondholders, thereby preventing holdouts; and *sharing clauses*

debt ratios are unsafe and the burden is excessive. Further, the Fund is quite aware of the vulnerabilities of several middle-income countries to a reversal of favourable global economic and financial conditions. The logic of the matter, therefore, calls for the inclusion of debt restructuring as an option in generating fiscal space for growth.

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” (UN 2005a: para 54). 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 allow satisfactory progress towards the MDGs without an increase in the debt ratio, it would have to be written down. This is also consistent with the new concept of debt relief as adopted in the MDRI where attaining MDGs is seen as the single most important objective.

The primacy of social objectives over debt servicing by public agencies with governmental power is indeed a recognized principle in national legislation in many industrial countries, 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, according to the ruling of the United States Supreme Court, such an authority does not have unlimited taxing power and 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 the 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 of debt

designed to ensure that all payments by the debtor are shared among bondholders on a pro-rated basis, and to prevent maverick litigation.

restructuring pursued by such legislation is to secure the viability of the debtors with governmental powers and to restore their capacity to deliver social services.³²

E. MDGs-compatible fiscal sustainability and debt workouts

Determination of whether the current level of debt is compatible with progress towards the MDGs calls for an assessment based on the insertion of resources needed for the MDGs as an explicit constraint into the debt arithmetic. This would indicate if and to what extent the debt burden exceeds the capacity of the public sector to service and stabilize it after meeting the MDGs-related expenditures – that is, if there is a debt overhang. Removing the overhang would require action on the terms and/or level of debt on three different fronts: external official debt owed to bilateral and multilateral lenders, external debt to private creditors, and domestic debt.

1. Redefining sustainability

The assessment of MDGs-compatible debt sustainability should start with an estimation of the size and composition of government spending needed to meet the MDGs and to provide other public services over the coming years. This should be complemented by an assessment of revenues that could be raised without hindering growth prospects and aggravating income inequality and poverty. Finally, an assessment would need to be made on the basis of projected interest rates, exchange rates and growth rates if the resulting primary budget balance would be sufficient to stabilize the debt ratio or if there is a need for debt relief. Such a process presents a

³² Chapter 9 of the United States insolvency law was first brought into the debate over international debt relief by Raffer (1990 and 1993). A proposal was made by UNCTAD TDR (1986: annex to chap. VI) during the debt crisis of the 1980s to apply the principles of chapter 11 of the same law, which are broadly the same as chapter 9 except that they apply to private debtors. The issue was subsequently raised by Sachs (1995) and revisited by UNCTAD TDR (1998: 89-93) during the East Asian crisis. For further discussion see Radelet (1999) and Akyüz (2002). The idea of establishing orderly workout procedures for international debt goes back even further. In 1942, in a report by the United States Council on Foreign Relations attention was drawn to interwar disputes between debtors and creditors and the need was recognized for exploration of the possibilities of establishing “a supranational judicial or arbitral institution for the settlements of disputes between debtors and creditors” (Oliver 1971: 20).

reversal of the conventional approach to fiscal policy formulation which starts with an assessment of revenue prospects and then obtains the level of primary expenditures as a residual after allowing for interest payments on debt.

In determining the level and composition of MDGs-related expenditures, it would be necessary to assess not only their immediate direct impact, but also their longer-term effects through faster growth and employment generation.³³ In this respect it is especially important to strike the right balance between current and capital spending. While improvements in current living conditions could boost growth over the long term by helping raise productivity, excessive emphasis on achieving quick results by redirecting public expenditures to social sectors may lead to large sacrifices in public investment, with serious consequences for sustaining poverty-reduction programs over the longer-term.³⁴ By contrast, public investment in human and physical infrastructure would not only alleviate poverty, but also help meet several other MDGs which are known to be positively correlated with economic growth. Thus, growth and employment effects of expenditure switching should be carefully measured and the impact of the level and composition of public spending on the MDGs should be assessed with a long-term perspective.

Attention should also be paid to the poverty and development impact of attempts to raise government revenues by increasing user charges and fees for public services, introducing new taxes, raising tax rates or increasing the tax effort. These may not always lead to improvements in indicators of development even when additional revenues are to be spent on the MDGs. They can impede access of the poor to essential public services and aggravate inequalities in income distribution. They can also lower growth in the long term and make it difficult not only to stabilize the debt ratio but also to achieve sustained declines in poverty. For instance in almost half of the 12 countries studied by the World Bank (2007: iii) “the **tax burden** was identified as a disincentive for private investment and growth”, including in heavily-indebted emerging

³³ Clearly these goals can be attained in different ways and this calls for a comparison of costs and benefits of alternative strategies. For a discussion of issues in costing the MDGs see Reddy and Heuty (2005).

³⁴ For possible trade-offs between public capital investment and current social spending in poverty reduction strategies in low-income countries see UNCTAD (2002).

market economies such as Brazil and Turkey. For these reasons, policies designed to raise government revenues, as well as attempts aiming to reorganize and rationalize public spending, should be directly tested for their effects on the MDGs.

Whether primary balances resulting from estimates for MDGs-consistent revenues and spending would be sufficient to stabilize the debt ratio depends on interest rates and growth rates that are expected to prevail over the medium term. In growth projections it is important to account for feedbacks from monetary and fiscal policy, and separate cyclical influences from long-term trends and underlying fundamentals. As already discussed in section B, this is particularly important in the current conjuncture because of several positive cyclical global shocks to growth. Thus, recent growth performance may not be a reliable guide to what can be expected in the coming years.

These considerations are also valid for projections for interest rates. For domestic debt, they depend crucially on the stance of monetary policy. For external debt the evolution of exchange rates is an important determinant of the real interest rate. Currency appreciations resulting from surges in capital inflows to several emerging market economies in recent years have been an important factor in lowering real interest rates on external debt as well as public debt ratios. These can both be reversed as the global boom in capital inflows comes to an end. Therefore, allowance should be made for a possible correction in exchange rates in projecting real effective interest rates over the coming years. This is particularly true in countries where currency appreciations have resulted in a rapid deterioration in trade performance and widened current account deficits, such as Turkey and several central and east European countries. Clearly it would be even more difficult to both sustain debt and meet the MDGs if the recent boom in capital inflows ends with a bust.

Interest rates on external debt of emerging market economies have been quite low in recent years because of historically low policy rates in major reserve currency countries and increased risk appetite among international investors. Policy rates are already on a rising path as a result of the response of central banks to perceived inflationary pressures from rising prices of

oil and non-oil commodities. The upward trend can strengthen if the dollar comes under pressure as a result of mounting fiscal and trade deficits in the United States. This could increase significantly the average cost of external debt in emerging market economies in view of the relative weight of dollar-denominated liabilities. A slowdown in capital flows could also be associated with sharp increases in the risk premia, pushing up further the average cost of external debt.

The configuration of MDGs-compatible primary budget balances and projections for real effective interest rates and growth rates would indicate the level of debt that would “allow the country to achieve the MDGs and reach 2015 without an increase in its debt ratio.” Clearly the MDGs-compatible sustainable levels of debt would vary considerably among countries not only because of differences in the efforts they need to make to meet the MDGs, but also because of differences of indebtedness, fiscal postures, interest rates and potential growth rates. For this reason, the MDGs-compatible debt thresholds would need to be assessed on a case-by-case basis.

When the public debt ratio is above the MDGs-compatible thresholds, debt workouts would be needed to ensure sustainability. This could be done in two ways. First, the debt stock could be reduced through a write-down. This would allow the government both to meet the MDGs-related expenditures and to service its debt while stabilizing the debt ratio at its reduced level. Second, the growth-adjusted real interest rate could be reduced by caps on interest. In this latter case, the debt ratio would be stabilized at its initial level. These would be formally equivalent since they would reduce interest payments on the stock of debt by the amount needed to stabilize the debt ratio at a level permitted by the MDGs-consistent primary balances.

It is possible that an MDGs-consistent threshold may not exist. This would be the case if government revenues are not sufficient to meet primary expenditures and the MDGs-compatible primary balances are negative. It would lead to a process of Ponzi financing – that is, the public sector would be borrowing both to close its primary deficits and finance interest payments. However, such a process need not lead to a debt explosion if faster growth resulting from increased MDGs-related spending, notably investment, leads to increases in government

revenues relative to expenditures, thereby reducing the primary deficit over time. If the initial level of debt is relatively low, the debt ratio could be rising at a decreasing rate, eventually settling at a level compatible with the MDGs.

Alternatively, the effective rate on public debt could be brought down below the growth rate through interest caps, allowing the growth-dividend to take care of rising indebtedness. The government would still be borrowing to meet both its primary deficits and interest payments, and its total debt would be growing, but the debt ratio would not be increasing if the rate of interest is lowered sufficiently relative to the growth rate. If primary deficits resulting from increased MDGs-related expenditures are so high that interest capping could not stabilize the debt ratio, then the only way of attaining fiscal sustainability and meeting the MDGs would be to provide additional grants. This is the case in several low-income countries. For most highly-indebted emerging market economies, however, adequate debt relief in one of the two ways above can be expected to ensure compatibility.

2. *Orderly debt workouts*

Evidence suggests that growing and inflating out of debt is not generally a viable option for heavily-indebted emerging market economies. In 26 cases of sizeable reductions in public debt in such economies in recent history, 19 were associated with a debt default (IMF 2003c: 140). There can be little doubt that debt restructuring can lead to large costs, particularly when executed in a disorderly way. However, “when the debt profile doesn’t look like it’s going to stabilize at a reasonable level under the most likely scenarios, **not** restructuring is going to be even more costly policy” (Goldstein 2003: 28). Indeed Russia and Argentina provide two recent examples of high costs in economic contraction and financial sector instability from delays in timely and orderly restructuring. What is a reasonable level of debt no doubt depends on the implications of sustaining it for economic growth and development since debt could be stabilized while the economy is caught in a low-growth, high-poverty trap. The view that severe costs in terms of the long-term growth capacity justify debt write offs now finds support even in the mainstream literature (Roubini 2001). This clearly extends to cases where stabilizing debt

proves to be incompatible with the MDGs even after allowing for significant improvements in the mobilization and use of budgetary resources. In such cases, an MDGs-compatible solution to the debt overhang would call for mechanisms for orderly and satisfactory workouts for sovereign debt owed both to official and private creditors.

a. Official debt

Several emerging market economies such as Indonesia and the Philippines have relatively large stocks of official debt, both to bilateral and multilateral donors (table 1). In Indonesia, for instance, official debt accounts for a quarter of total sovereign debt and is owed mostly to bilateral creditors. These middle-income countries are very much in the same position as highly-indebted low-income countries not included in the HIPC initiative. In so far as their bilateral debt is concerned they now come under the so-called Evian approach agreed among the G-7 countries in October 2003.

This approach is designed to provide more flexible debt restructuring through the Paris Club in coordination with private creditors to secure long-term sustainability and reduce the likelihood and severity of financial crises in debtor countries through an orderly, timely and predictable debt workout.³⁵ It brings no fixed terms and will apply to all non-HIPC and middle-income countries when they request a debt rescheduling. The debt relief remains tied to IMF structural adjustment programs and is expected to be delivered in a three-stage process involving first flow treatment and then stock re-profiling and stock reduction, depending on the financial needs of the countries concerned and the results of sustainability assessments on a case-by-case basis. The ultimate decision regarding debt sustainability rests with the creditors, based on an analysis conducted by the IMF. Debt reduction will continue to be given only in exceptional cases and when the need is clearly demonstrated in the debt sustainability analysis. Debt restructuring would not be granted as an alternative to more expensive sources of financing.

³⁵ For a detailed description of the Evian approach see the Paris Club website: www.clubdeparis.org/en/index.php; Ocampo, Kregel and Griffith-Jones (2006: 119-121); and IMF (2006c).

Kenya was the first country receiving relief under this approach in the form of flow rescheduling. Iraq received a comprehensive treatment on the basis of the conclusion of a debt sustainability analysis that 80 per cent debt stock reduction would be needed to ensure sustainability. More recently Nigeria has received comprehensive treatment in two phases under an IMF Policy Support Instrument, effectively eliminating its entire debt to the Paris club through write offs and buy backs, using its oil windfalls.

The success of the Evian approach in providing adequate debt relief and achieving long-term sustainability in middle-income countries with large stocks of bilateral debt would depend very much on whether assessments of sustainability would treat the internationally agreed development goals as an explicit constraint over debt servicing and show greater realism than has been the case so far. The approach makes a vague reference to the “financing needs” of debtors and emphasizes “efforts to adjust fiscal policy” in securing sustainability. If sustainability continues to be judged on the basis of how much debt and debt servicing a country can tolerate without adequate attention to its implications for development and poverty, the approach is unlikely to bring much improvement over the official debt relief initiatives so far in removing the debt overhang.

A major concern in this respect is the role given to the IMF in the assessment of sustainability and in tying debt treatment to the pursuit of an IMF program. Given the poor record of the Fund in these areas, the influence of its major shareholders in the Fund’s decisions and the risk of political considerations dominating debt-relief outcomes, it might be highly desirable to delink the Evian approach from the IMF, and leave debt sustainability analysis to an independent body of experts, appointed with the consent of the debtors. The Fund and the Bank could provide inputs to this process in their respective areas of work – e.g. financial projections, particularly for interest rates, exchange rates and capital flows in the case of the IMF and fiscal prospects and the link between the size and composition of public spending and the MDGs in the case of the Bank. United Nations agencies can also contribute to this process in their areas of expertise. Debtor countries should also be allowed to submit their own analyses of sustainability.

b. Sovereign debt to international markets

Strong global growth and unusually favourable conditions in international financial markets in recent years have created considerable complacency and served to obscure continued weaknesses and vulnerabilities in several emerging market economies. Still, as already noted, many of these countries have been unable to make significant progress towards the MDGs at the national and/or sub-national level. With the reversal of favourable cyclical conditions, they may find it even more difficult to undertake basic social services and investment needed to meet the MDGs while servicing their debt according to the original terms and conditions or avoiding a process of Ponzi financing. In either case they could end up in a crisis— a sharp cutback in lending, rapid exit of capital, collapse of the currency and a severe contraction in output and employment with attendant consequences for the achievement of the MDGs.

However, the international financial architecture is still missing effective arrangements to avoid such an outcome and bring about orderly resolutions of debt crises. Because of absence of a multilaterally agreed legal system to address sovereign solvency problems, the practice tends to be disorderly and ad hoc, and favours creditors – more so for middle-income countries than low-income debtors to official creditors. Very often the IMF is involved in coordinating and resolving debt servicing difficulties, be it due to solvency or liquidity problems, based on an adjustment program agreed with the debtor country (Akyüz 2002). The Fund seeks a voluntary agreement with creditors, but its position is asymmetrical – while it has a significant leverage vis-à-vis sovereign debtors it cannot impose appropriate terms and conditions on creditors, since even where CACs are introduced, bondholders can hold out and opt for litigation in search of a better deal. More importantly, there is often a conflict of interest because the Fund itself is a creditor, and private creditors to the sovereign debtors are often the citizens of the countries which are major shareholders of the Fund. Restructuring on such a basis has rarely secured sustainability where there were problems of solvency – rather, it provided relief through maturity rollover at penalty rates in cases where debt servicing difficulties were due to liquidity shortages. Similarly, many countries who have taken the alternative option of seeking a quick agreement on

market terms have done so without obtaining much reduction in their debt levels and securing sustainability.³⁶

Arrangements needed to provide fair, efficient and orderly debt workouts were extensively discussed after the East Asian crisis, drawing on certain principles of national bankruptcy laws noted above. Their aim should be to prevent financial meltdown and economic crises as well as facilitating an efficient and equitable restructuring of debt which can no longer be serviced according to the original provisions of contracts. It should be efficient, as in national bankruptcy procedures, in containing the damage inflicted on the debtor and allowing rapid recovery and growth. It should also be fair in the distribution of the burden, and particularly making creditors bear the full consequences of the risks they have taken— risks which have already been compensated by handsome premiums. The principles that need to be adopted include:

- A temporary debt standstill accompanied by suspension of capital account convertibility. The decision for a standstill should be taken unilaterally by the debtor country and sanctioned by an independent panel rather than by the IMF because the countries affected are among the shareholders of the Fund which is itself also a creditor. This sanction would provide an automatic stay on creditor litigation.
- Provision of priority financing, automatically granting seniority status to debt contracted after the imposition of the standstill. The IMF should lend into arrears for financing imports and other vital current account transactions, but not to bail out creditors.
- Debt restructuring including rollovers and write-offs based, in principle, on negotiations between the debtor and creditors, and facilitated by the introduction of automatic rollover and CACs in debt contracts, and an impartial arbitration process to settle disputes in the case of failure to reach agreement over the terms of restructuring.

³⁶ For recent market-based bond swaps see Herman and Spiegel (2007).

The Fund appeared to be moving in this direction at the end of the last decade with rising opposition to bailout operations from European and other governments and the increased frequency of crises in emerging markets. The IMF Board first recognized that “in extreme circumstances, if it is not possible to reach agreement on a voluntary standstill, members may find it necessary, as a last resort, to impose one unilaterally”, and that since “there could be a risk that this action would trigger capital outflows ... a member would need to consider whether it might be necessary to resort to the introduction of more comprehensive exchange or capital controls.”³⁷ Although the Board was unwilling to provide statutory protection to debtors in the form of a stay on litigation, preferring instead “signalling the Fund’s acceptance of a standstill imposed by a member ... through a decision ... to lend into arrears to private creditors”, the Fund secretariat was in favour of establishing a formal sovereign debt restructuring mechanism (SDRM) to “allow a country to come to the Fund and request a temporary standstill on the repayment of its debts, during which time it would negotiate a rescheduling with its creditors, given the Fund’s consent to that line of attack. During this limited period, probably some months in duration, the country would have to provide assurances to its creditors that money was not fleeing the country, which would presumably mean the imposition of exchange controls for a temporary period of time” (Krueger 2001: 7).

The SDRM proposal submitted contained innovative mechanisms to facilitate sovereign bond restructuring for countries with unsustainable debt in bringing debtors and bondholders together whether or not bond contracts contained CACs, in securing greater transparency, and in providing a mechanism for dispute resolution (IMF 2003a). However, the provision for statutory protection to debtors in the form of a stay on litigation was not included. While the proposal discouraged litigation by bondholders (through the application of the so-called “hotchpot” rule), this would not be adequate to prevent financial meltdown since currency runs could take place whether or not bondholders opt for litigation. The proposal also gave considerable leverage to creditors in seeking their permission in granting seniority to new debt, and considerable power to the Fund vis-à-vis the proposed Sovereign Debt Dispute Resolution Forum in determining debt

³⁷ See IMF (2000). For further discussion of the debate in the IMF see Akyüz (2002: 123-128).

sustainability.³⁸ However, even this diluted version of the proposal could not elicit adequate political support and had to be withdrawn, and the attention has shifted to CACs in sovereign bond contracts, and contractual and voluntary mechanisms.³⁹

The existing void in the international financial architecture for mechanisms to deal with sovereign debt is a cause for concern in view of fragilities associated with excessively high debt ratios, the risk of a sharp reversal of favourable global cyclical conditions, and the urgency of removing the debt overhang to provide adequate fiscal space for the MDGs. While CACs in bond contracts provide a solution to the collective action problem and holdouts, they do not prevent currency and balance-of-payments crises, resolve conflicts among different classes of creditors such as banks, bondholders and multilateral lenders, or secure orderly, efficient and fair resolution of debt problems so as to attain sustainability subject to constraints of multilaterally agreed development goals. Much the same is true for the SDRM. To achieve these objectives, in addition to such mechanisms designed to resolve problems of collective action and holdouts, there is a need for arrangements for an independent assessment of sustainability subject to the MDGs constraints; a dispute settlement body placed beyond the reach of the IMF and its major shareholders; granting automatic seniority for new debt; and protection of debtors against litigious investors (the so called “vultures”) through internationally sanctioned stay on litigation.

c. Domestic debt

Domestic debt has gained added importance in recent years because it accounts for a growing share of total public debt and carries higher interest burden than debt incurred internationally, particularly where controls over interest rates and balance sheets of financial institutions have been dismantled. Reduction in domestic debt burden may be called for even where debt is “macro-economically” sustainable because of the need to create fiscal space for the

³⁸ See IMF (2003a) for a description of the SDRM and background information.

³⁹ For an account see UN (2005b: chap. V) and Herman and Spiegel (2007).

MDGs and because it has become an instrument of displacements in income distribution at the expense of the poor to an extent much greater than external debt.

There are basically three ways of reducing the domestic debt burden. First, through monetization and acceleration of inflation. Second, mandatory restructuring through bond exchanges at discounted values or by offering par value bonds at lower than market interest rates, as used for international bonds in the Brady plan and, more recently, for domestic bonds in Russia and Argentina. Finally, through taxation designed to affect a wealth transfer from bond holders by the amount of debt to be reduced through redemption. These could be supplemented by measures designed for maturity transformation, but such steps would address liquidity rather than solvency problems except where interest costs can be lowered or growth rates can be lifted permanently through maturity transformation.

Much has been written on the pros and cons of these methods of solving 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 Box 1). Inflation clearly remains now, as then, not only a more regressive but also a less efficient method of debt reduction than the other two alternatives because economic disruptions it can cause are likely to be much more serious. Besides, its scope is limited since in many countries an important part of public debt is either short-term or indexed to inflation.

Mandatory restructuring involving debt cancellation or imposition of below-market ceilings on interest rates on existing public debt is not very much different from a capital levy because it in effect implies a tax on bondholders. On the other hand, even though there can be serious political difficulties in introducing a capital levy on bondholders,⁴⁰ it would likely cause less serious legal handicaps than cancellation and interest ceilings because taxation is an

⁴⁰ Such difficulties are exemplified by the eventually abortive attempt of another famous twentieth-century economist, Joseph Schumpeter, during his seven-month tenure as Minister of Finance in Austria in 1919— see Stolper (1994, Part IV).

accepted sovereign discretion while mandatory restructuring could be seen as a violation of contractual obligations – indeed, some countries have erected constitutional barriers against such moves.⁴¹

The question of whether sovereign domestic debt should also be covered by the SDRM was discussed extensively during the debate on the proposal. It was excluded from the SDRM on grounds that governments typically had at their disposal tools for restructuring domestic debt. However, it was recognized that such restructuring could be called for to attain sustainability, secure inter-creditor equity and improve the willingness of international bond holders to agree to adequate debt reduction, and that a case by case treatment would be required taking into account the possible effects of restructuring on the domestic banking system and the capital market (IMF 2002b; 2003a).

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. Even though capital control measures for residents may not be fully successful in stemming capital flight, the cost of leakages is likely to be small relative to that of carrying the debt burden, particularly when what is at stake is fiscal rather than external sustainability.

Since the main purpose of domestic debt relief is to improve the conditions of the poor through a better allocation of public resources, it is important that these are not offset by adverse effects of restructuring on private sector investment and economic activity. According to a view, however, this should not be a cause for concern: rational individuals should not consider government bonds as net wealth because fiscal solvency requires that they must ultimately be redeemed with the revenues from increased taxation.⁴² On this view, since at any point in time private wealth includes savings undertaken in the past in anticipation of the additional taxes

⁴¹ For a discussion of legal difficulties in restructuring domestic debt see IMF (2002b).

⁴² For this so-called Ricardian equivalence theorem see Barro (1974) and Bernheim (1989).

required to redeem debt, a reduction in government debt should have no major effect on total net private wealth or aggregate private spending whether it is engineered through a capital levy or a mandatory write down since their effects would be balanced by reduced future taxes. However, since the theory rests on unrealistic assumptions such as complete rationality, intergenerational altruism, absence of uncertainty about the timing and amount of future taxes, a capital levy or mandatory restructuring would not be neutral in its impact on private spending and asset holding. Therefore it would need to be accompanied by offsetting increases in government spending to offset their deflationary impact on economic activity. But this is exactly what could be achieved through increased social and investment spending for the MDGs made possible by reduced debt servicing.

Moreover, in order to reduce possible adverse social and financial effects of a mandatory restructuring or a capital levy, it would be necessary to differentiate among different classes of holders and different types of public sector liabilities. For instance, short-term government paper (e.g. Treasury Bills) held by the banking system as part of capital, reserve and liquidity requirements or central bank bills and notes designed for open market operations could be exempted or accorded a special treatment in order to prevent damage to the payments system and avoid systemic risks. Again, certain classes of holders such as pension funds or small investors can be given special treatment to prevent adverse consequences on pensioners and wage earners. The scope for such a differentiation would be greater where public liabilities are issued as registered rather than bearer instruments. Briefly, while it may be necessary to seek relief on domestic sovereign debt for reasons of sustainability and distributional and inter-creditor equity, the method to be used and the manner in which it would be applied to different classes of instruments and investors would vary depending on the specific circumstances facing each sovereign debtor.

Box 1: 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 (1971: 53-55) characterized the debt problem and possible solutions to it in the following terms:

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 realm 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.

F. Conclusions

There can be little doubt that low-income countries generally encounter much greater challenges in making progress towards the MDGs and tighter financial constraints. However, the debt burden is heavier in many emerging market economies. Even where debt levels are similar or lower relative to GDP, interest payments are a multiple of those in low-income countries because of much higher interest rates. Although their capacity to meet higher interest payments is also greater, it is not clear if this always compensates for their disproportionately heavier debt burden. Furthermore, debt servicing difficulties in emerging market economies are often associated with a sudden interruption of their access to external financing since international financial markets tend to be more procyclical than official creditors.⁴³ For these reasons “safe” debt ratios appear to be higher for HIPCs than for middle-income countries.⁴⁴

Assessment of debt sustainability in emerging market economies is also more complex because of greater instability of the key parameters moving the debt ratio. Many middle-income countries are as vulnerable to supply shocks as low-income countries because of their continued dependence on commodity production and exports, including oil and non-oil commodities. They are considerably more vulnerable to financial shocks because of greater variability and uncertainty of the terms and conditions of their debt and access to international financial markets, including for reasons unrelated to their own circumstances such as swings in global liquidity conditions or the risk appetite of international lenders. The existence of a large and growing stock of external debt by the private sector also increases their fiscal vulnerability to balance-of-payments and exchange rate disturbances. Moreover, the increased share of domestic public debt poses dilemmas in monetary policy since efforts to restore price stability in response to shocks can aggravate fiscal difficulties.

⁴³ There is evidence that aid is also procyclical— see UN (2005a: chap. IV) and World Bank (2005: chap. 5).

⁴⁴ For a comparison between HIPCs and middle-income countries in these respects see Cline (2003).

There is an increased and widespread awareness in the developing world that external debt has become the single most important factor compromising their ability to make progress in development and reducing their national policy autonomy vis-à-vis financial markets and multilateral financial institutions (Akyüz 2007). This in fact underscores the recent efforts by many countries to reduce their external debt to private creditors and bilateral and multilateral lenders, and to accumulate large international reserves as a self-insurance against a future global financial crisis, taking the opportunity created by commodity windfalls. This stands in sharp contrast with the behaviour of many developing countries in the 1970s when enhanced creditworthiness resulting from higher commodity prices and export revenues was used to increase borrowing from international financial markets.

In several cases, however, the steps taken to build insurance against potential volatility and shocks entail large opportunity costs in terms of poverty alleviation. Increased public revenues have been translated into primary surpluses to service and reduce debt rather than being used for much needed public investment in human and physical infrastructure. Even then the debt ratios continue to be extremely high, well above the levels considered as safe, and primary surpluses generated are inadequate to prevent further increases. Thus additional resources are needed not only to make progress towards the MDGs but also to stabilize the debt ratios. There may be some scope for raising revenues and rationalizing expenditures, but these are unlikely to provide adequate space.

The prospects for making significant progress towards the MDGs are therefore quite dim even under the unlikely scenario of continued favourable global conditions. Should these conditions be reversed sharply, it may not be possible to sustain debt even at current levels of MDGs-related spending. Consequently, for several middle-income countries reducing the debt burden appears to be the only viable option for creating adequate fiscal space for the MDGs without running into a debt trap. However, there are no mechanisms in place to provide orderly and adequate workouts for sovereign external debt, owed either to official or to private creditors. Addressing this gap in the international financial architecture remains an important ingredient of success in meeting the MDGs.

For some emerging market economies with a relatively large stock of debt owed to official creditors, attaining MDGs-compatible sustainability calls for fundamental changes in the official debt initiatives so far pursued. The Evian approach no doubt constitutes a positive step in seeking long-term sustainability through a more flexible debt restructuring, but it can only deliver its promises if two key principles are observed in its application. First, debt sustainability analyses should treat the resources needed for the MDGs-related spending as explicit constraints over debt servicing. Second, sustainability analyses should be entrusted to an independent body, established with the consent of debtors, and carried out with greater realism than has been the case so far, in a transparent way and with contributions from several related parties including the debtors and relevant multilateral institutions. The results of such analyses should be put into practice by both debtors and creditors – debtors by undertaking the fiscal reforms needed, and creditors by providing adequate debt relief.

For most emerging market economies removing debt overhang calls for orderly workout procedures for their debt to private creditors. However the global financial architecture is still missing such arrangements. While the growing inclusion of CACs in international bond contracts will be helpful for bringing debtors and creditors together for contractual debt workouts, they would not necessarily result in the removal of the debt overhang. Moreover, they are designed to resolve rather than prevent financial crises. Nor would a revival of the SDRM be an adequate step in these directions. An effective mechanism should combine three key principles of crisis prevention and resolution in national bankruptcy laws: temporary standstills with stay on litigation, lending into arrears and statutory debt restructuring. However, a genuine reform would not be possible as long as markets expect that the IMF would continue to lend into unsustainable debt positions and bail them out at times of crises. Nor would many over-indebted countries be willing to give political support to reform if they know that they can rely on the Fund to step in and defer the problem, even though such relief comes with intrusive conditionality, procyclical macroeconomic tightening, and unequal distribution of the burden between debtors and creditors. Thus a genuine reform should start with IMF lending practices.⁴⁵

⁴⁵ For the problems with IMF bailout operations see Akyüz (2002 and 2005) and (Goldstein (2003).

In addition to multilateral initiatives, attention also needs to be turned to domestic debt burden in a growing number of emerging market economies. This is necessary not only to secure equitable treatment of domestic and external creditors. It is also needed because continued servicing of domestic debt contracted at very high interest rates and concentrated in the hands of a small number of bondholders with highly regressive taxes causes greater difficulties in making progress towards the MDGs than servicing external liabilities. Inflating out of domestic debt is not a desirable option, but if more orderly and equitable ways cannot be found, governments facing serious fiscal difficulties may eventually be tempted to take such a course, with attendant consequences for macroeconomic stability, income distribution and growth. A capital levy on bondholders and/or a mandatory restructuring involving bond swaps at reduced values or lower interest rates must be preferred on grounds both of expediency and of justice, as argued by Keynes, but the precise combination of these methods and the way they should be applied would vary according to specific circumstances facing individual countries.

Table 1: Sovereign Debt in Selected Emerging Markets

	Sovereign Debt ^a (Percent of GDP)	Official Debt ^b (Percent of GDP)	Share of Forex Debt ^c (percent)		Short-Term Debt Share ^d (percent)	
	2004	2004	1996	2004	1996	2004
Turkey	83	11	37	29	67	13
Philippines	81	23	16	44	54	43
Brazil	74	8	34	25	37	26
Colombia	57	9	30	31	0	4
Hungary	57	0	47	27	28	30
India	55	7	0	0	27	8
Poland	53	8	30	16	45	13
Indonesia	52	24	22	3	0	0
Malaysia	51	3	5	9	6	2
Chile ^e	41	2	24	53	22	11
South Africa	39	0	3	10	5	5
Venezuela	32	2	79	57	8	9
Korea	28	1	0	3	4	0
Thailand	28	3	71	9	0	26
Russia	23	10	19	61	63	0
Mexico	21	1	73	31	38	20
Czech Republic	18	0	7	8	0	0
China	18	2	7	2	12	2

Source: IMF (2006a)

- a. Liabilities of central government and the central bank.
- b. Debt owed to official creditors
- c. Foreign-currency denominated bonds (issued both domestically and abroad) in percent of total bond debt.
- d. Short-term domestic debt in percent of total domestic marketable debt.
- e. Includes debt issued by the central bank.

Table 2: Primary Fiscal Balances in Emerging Market Economies
(In percent of GDP)

	1998	2002	2005
Russia	-1.3	3.4	8.4
Turkey	4.5	0.7	6.7
Chile	1.6	-0.1	5.5
Ecuador	-1.0	4.5	3.7
Argentina	0.9	0.9	3.7
Brazil	0.6	2.4	2.9
Philippines	2.6	-0.6	2.8
South Africa	3.0	2.9	2.7
Uruguay	0.2	-1.4	2.6
Lebanon	-2.1	2.8	2.3
Indonesia	0.8	3.4	2.2
Mexico	0.7	0.4	1.4
Peru	0.8	-0.2	1.4
Venezuela	-0.8	-1.5	0.9
Thailand	-2.3	-0.2	-0.4
India	-0.9	-1.3	-0.4
Malaysia	0.7	-2.9	-1.1
Ukraine	0.4	1.8	-1.2
Colombia	-3.5	-2.9	-1.2
Poland	0.8	-1.9	-1.6
Hungary	-0.2	-4.5	-2.2

Source: IMF World Economy Outlook Database and J.P. Morgan
Emerging Markets Research.

Table 3: Public Sector Gross Debt and Financial Crises^a
(Per cent of GDP)

	Pre-crisis Average	Post-crisis Average
Korea (1997)	12	39
Mexico (1995)	43	42
Thailand (1997)	16	47
Ukraine (1998)	30	51
Brazil (1998)	44	75
Russia (1998)	52	82
Ecuador (1999)	66	82
Indonesia (1998)	25	95
Philippines (1998)	83	100
Turkey (2001)	60	101
Uruguay (2002)	58	115
Argentina (2001)	45	135
<i>Average</i>	<i>44</i>	<i>80</i>

Source: Bolle, Rother and Hakobyan (2006)

a. Crisis years in brackets

Table 4: Fiscal Adjustment in Middle-Income Countries^a
 (Changes in percent of GDP in comparison with 1980-84)

	1995-1999	2000-2005
Revenues		
Lower-middle income	0.4	2.2
Upper middle income	-0.7	-0.4
Expenditures		
Lower-middle income	-4.1	-2.7
Upper middle income	-4.4	-2.7
Interest payments		
Lower-middle income	1.5	1.7
Upper middle income	0.9	1.6
Primary expenditures		
Lower-middle income	-5.6	-4.4
Upper middle income	-5.3	-4.3

Source: IMF/WB (2006)

a. General government

Table 5: Public Investment and Interest Payments – 2006
(Percent of GDP)

	Investment	Interest Payments
Argentina	3.4	6.5
Brazil	1.5	6.0
Colombia	6.3	4.6
Egypt	3.1	6.1
Lebanon	2.8	11.7
Indonesia	5.5	2.6
Morocco	2.5	3.7
Mexico	4.2	2.8
Pakistan	4.4	3.1
Peru	2.6	2.0
Philippines	2.4	5.6
South Africa	3.1	3.1
Turkey	4.4	8.8
Uruguay	2.9	4.4

Source: IMF World Economic Outlook Database.

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