REFORMS AND POLICY FOR DEBT SUSTAINABILITY

Jan Toporowski

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The following remarks concern commodity export dependent countries, rather than semi-industrialised developing countries with significant manufacturing exports, such as those in East Asia and parts of Latin America. In recent decades, commodity export dependent countries have become integrated into the international financial system, and now face the following circumstances that threaten the sustainability of their governments' debt and fiscal positions:

- Low or falling commodity prices, bringing with them slower economic growth, reduced foreign direct investment, lower revenue for governments, demands for higher government expenditure and therefore widening fiscal deficits;
- Contraction in the liquidity of international financial markets as central banks in Europe and North America move to 'normalise' their monetary policy by ceasing, or reversing, their quantitative easing policies and raising interest rates. This will make it more difficult to roll over existing foreign borrowing, placing the burden of interest and principal repayments on income generated from exports;
- A large expansion borrowing in foreign currency by firms in the respective private sectors of many developing countries;
- Populist pressures in Europe and North America to reduce official aid to developing countries.

The deterioration in debt sustainability is especially ironic, given the two decades that absorbed the energies and resources of governments around the world and international financial institutions in managing and reducing the foreign debt of the least developed countries, only to find that debt rebuilt as developing countries integrated their national financial systems with the international credit system of the financially-advanced economies. Those of us who participated in the international debt crises of the 1980s (then, as now, justified on the spurious grounds of a deficiency of 'savings' in poorer countries), cannot fail to view the rise of developing countries' foreign debt with a sense of *déjà vu*.

In this situation what policy and institutional changes are necessary to stabilise the economies of developing countries in order to prevent the deterioration of the fiscal and debt position of governments in those countries? In the first place there is a need to rebalance their policy framework in order to maintain stable income and expenditure flows in their respective economies and sustain policies towards the achievement of the Sustainable Development Goals and the Addis Ababa Action Agenda to which governments and multilateral agencies are committed.

1. First of all, governments must as far as possible seek to **maintain existing (non-financial) expenditure** in their economies, in order to prevent a deflationary reinforcement of the reduction in FDI that is already taking place. To compensate for that reduction in FDI, governments should expand public investment, in particular in infrastructure and housing where welfare and economic benefits are large, but import costs are small. Failure to do this will reduce economic growth which in turn will negatively impact upon government tax revenues, making the prospects of reducing fiscal deficits recede further into the future.

2. Fiscal imbalances need to be addressed by **increasing taxation**. This is an aspect of fiscal policy that has been incorrectly modelled in developing countries by supply-side policies and tax incentives that attribute mystical powers of economic invigoration to such policies. In general, such modelling does not take into account cash flows in the economy, with the result that such policies have failed to reduce the dependence of African economies on commodity exports or address the housing and infrastructure bottlenecks to economic development. Supply-side policies reduce the tax base, by removing taxes on foreign trade, and seeking to replace those taxes by taxes on retail trade, such as value added tax, where the scope for such taxation is limited by popular demands for subsidies or low prices. A corollary of such tax policies has been the rise in inequalities of income and wealth. This last is a symptom of another feature of developing country economies that is destabilising public and private finances, namely the growth and concentration of private accumulations of liquid or monetary assets.

3. Where do these private accumulations of liquid assets come from? The economic process of for-profit production that characterises free enterprise results in the accumulation of liquid assets (bank deposits or cash) corresponding to the cash profits made from production and exchange. In developing countries, a common consequence of any rise in employment is an increase in the prices of food and basic

necessities, that then concentrates the accumulation of money in the hands of local farmers and property-owners and, in the case of the modern sector of the economy, in the accounts of multinational companies. Primary fiscal deficits and trade surpluses then add to the accumulations in these monetary 'sumps'. They are a cause of financial instability in large part because most developing countries lack the financial markets to tie up this liquidity in financial instruments in the domestic currency. The accumulations then drain out of the economy into foreign, convertible currencies, or do so abruptly when alarms are raised about the prospect of inflation (devaluing the local currency). In the case of foreign-owned funds, this alarm typically arises when companies or funds perceive, or expect, 'macroeconomic imbalances': a combination of fiscal deficits and trade deficits. However, it should be emphasised that it is not these macroeconomic imbalances themselves that directly cause such capital flight. The capital flight cannot take place without monetary accumulations, because it is currencies, and not assets in general, that are traded in foreign exchange markets. In extreme cases, such capital flight can give rise to 'dollarisation', as holders of liquid assets convert those assets into foreign currency, and then proceed to use that foreign currency in their transactions between each other. Such capital flight undermines the exchange rate making foreign borrowing more expensive.

4. The monetary accumulations therefore have important implications for fiscal policy and debt management, as well as the monetary policy (interest rates) that is supposed to keep capital movements in order. Taxation needs to be targeted on accumulations of wealth, not just in order to reduce the liquid assets held by property-owners, but also in order to tie up more of that liquidity in the markets for the property that is being taxed. For example, land is an illiquid asset. But a tax on land payable in the domestic currency obliges landowners to keep money in that currency ready to pay the tax, or to borrow in the domestic currency in order to pay that tax. Wealth taxes, and taxes on luxury consumption are therefore an important way in which governments can reduce fiscal deficits, addressing concerns about macroeconomic imbalances, and promote financial development (in the sense of markets in illiquid assets). Contrary to the widespread supply-side narrative, taxes on wealth or luxury consumption do not affect incentives to invest, since these taxes cannot be reduced by lowering investment (Kalecki 1954).

5. A second important aspect of the policy framework that needs to be addressed to meet the challenge of lower commodity prices and international illiquidity, is the

question of **debt management**. Wherever possible, governments should be financing their deficits in domestic currency markets through the issue of financial obligations at the longest possible maturity. Domestic currency debt has the advantage that it is 'hedged' by a government's assets and income in that same currency: government assets in foreign currencies consist overwhelmingly of their foreign currency reserves. Even where such reserves may be large enough to manage current commitments on total (private and public) foreign debt, they may not be large enough in the event of capital flight, or a need to roll over short-term debt. A second advantage of domestic currency borrowing, a government can manipulate the terms of borrowing in its currency, where the central bank sets interest rates, or through operations along the yield curve, if markets are sufficiently developed. Thirdly, the issue of longer-term domestic obligations helps to keep the monetary accumulations in an economy tied up in domestic financial markets, and therefore less prone to capital flight. When the central bank issues domestic currency reserves against the value of the new foreign currency reserves, it will often sell domestic currency bonds to 'sterilise' the increase in the money supply. But this is becoming less common as central banks in developing countries move towards inflation-targeting as their policy framework.

6. By contrast, **foreign currency debt**, can easily become a burden on a country's earnings from exports, in particular as those earnings are threatened by low commodity prices. It should be emphasised that it is not only government foreign currency debt that poses this threat, but also private sector foreign currency debt. Unless the private sector has assets abroad, its foreign currency debt payments are a claim on the foreign currency reserves of a government that cannot be refused without causing a currency devaluation that can dramatically increase the domestic resource costs of government foreign currency debt. Moreover, where governments are weak or have limited domestic political legitimacy, taxation to service foreign borrowing or the conditions under which external loans are given become a target of political opposition. Taxation and political reform come to be regarded as foreign impositions, weakening the political authority necessary for effective governance.

7. In this context, the recent **Eurobond borrowing** of African governments deserves special mention. While there is no doubt that such borrowing adds to the foreign currency reserves of a governments, this is not a *net* addition, but merely the foreign currency counterpart of a new foreign currency liability. Given the prospect of

reduced liquidity in the international financial markets, the possibilities for refinancing this debt will be small, within the ten-year maturities of most of these bonds. Alternative methods, such as the diaspora bonds that have been pioneered in Africa by Ethiopia and Nigeria, are limited by the wealth of the countries' respective diasporas. Nigeria, for example, raised $300mn through its issue in 2017. But this is a very small fraction of its total, or even net Eurobond issue. Another alternative is the issue of foreign currency bonds to domestic residents. Such issues may be useful in draining foreign currency from the economy to prevent dollarization. But again, the amounts that can be raised are insignificant by comparison with the government foreign currency debt in general.

8. An important influence on the fiscal and debt position of governments in poorer developing countries is the **foreign aid** that they receive from governments in wealthier countries. Much of this aid has been enhanced by co-financing with development banks, multilateral agencies and private sector institutions. Such co-financing is likely to be reduced as international liquidity contracts.[i] Nevertheless, it is important that aid flows should continue, and that they should support the fiscal positions of governments in order to avoid deflationary effects as government expenditure is reduced.

9. The final challenge at this stage of the international financial and commodity cycles is **the absence of an institutional mechanism that could convert foreign currency debt into domestic debt**. This is essential if governments of developing countries are to have control over their debt and the terms on which it is serviced (see points 5 and 6 above). The matter is made more urgent in view of the appreciation of the US dollar, by approximately 20% over the last five years. On the one hand this appreciation has off-set the decline in export commodity prices, which are priced in dollars. On the other hand, however, since most developing country foreign debt is denominated in US dollars, the increase in the foreign exchange value of that currency has also increased the domestic resource cost of that debt.

   In the financially advanced countries this conversion of foreign currency debt into domestic currency debt is readily effected and has even been institutionalised in foreign exchange swaps market. The Bretton Woods institutions, the IMF and the World Bank, have under fairly strict conditionality, participated in arrangements for refinancing government foreign debt in emerging markets and developing countries, and finally in the writing off of foreign debt since the Highly Indebted Poor Countries Initiative in 1996. But this refinancing has remained in foreign currencies, rather than converting the debt into domestic currency debt. The difference is important because, as indicated above, domestic currency debt is more manageable by governments, and its issue contributes to financial development in a way that foreign currency debt does not. Among larger emerging markets (for example in Mexico between 1989 and 1994) such a conversion of government debt into domestic currency debt was made possible by a favourable conjuncture in the international financial markets and portfolio capital inflows. However, very few developing countries (South Africa, perhaps) have capital markets on such a scale as to absorb such a manoeuvre. In any case, such a conversion through the capital markets transfers government foreign debt to the private sector, making that sector even more vulnerable to the depreciation that inevitably follows the reduction in investment that accompanies this kind of expansion in indebtedness. This is an important reason why the arrangements for such conversion need to done in a multilateral official framework.

Conclusion

The deterioration in the finances of many governments in developing countries and the squeeze on international financial liquidity threaten the fiscal balances and debt sustainability of those governments. To avoid this governments need to rebalance fiscal policy towards maintaining government expenditure, but increasing revenue, so that fiscal deficits are reduced without austerity. Foreign aid can support such rebalancing by sustaining government expenditure. The stability of government debt can be assisted by debt management and the conversion of foreign government debt into obligations in domestic currency. But this last will require support from international financial institutions, including not just financial support, but also a change in their operating procedures.

Acknowledgement
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Reference

Kalecki, M. (1954) 'The Problem of Financing Economic Development' in J. Osiatyński (ed.) *Collected works of Michał Kalecki* Oxford: The Clarendon Press 1993.

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[i] In turn, such contraction is likely to cause difficulties for existing co-financed projects as they require refinancing.