“Sovereign” Debt Crisis in the Global South: An MMT View

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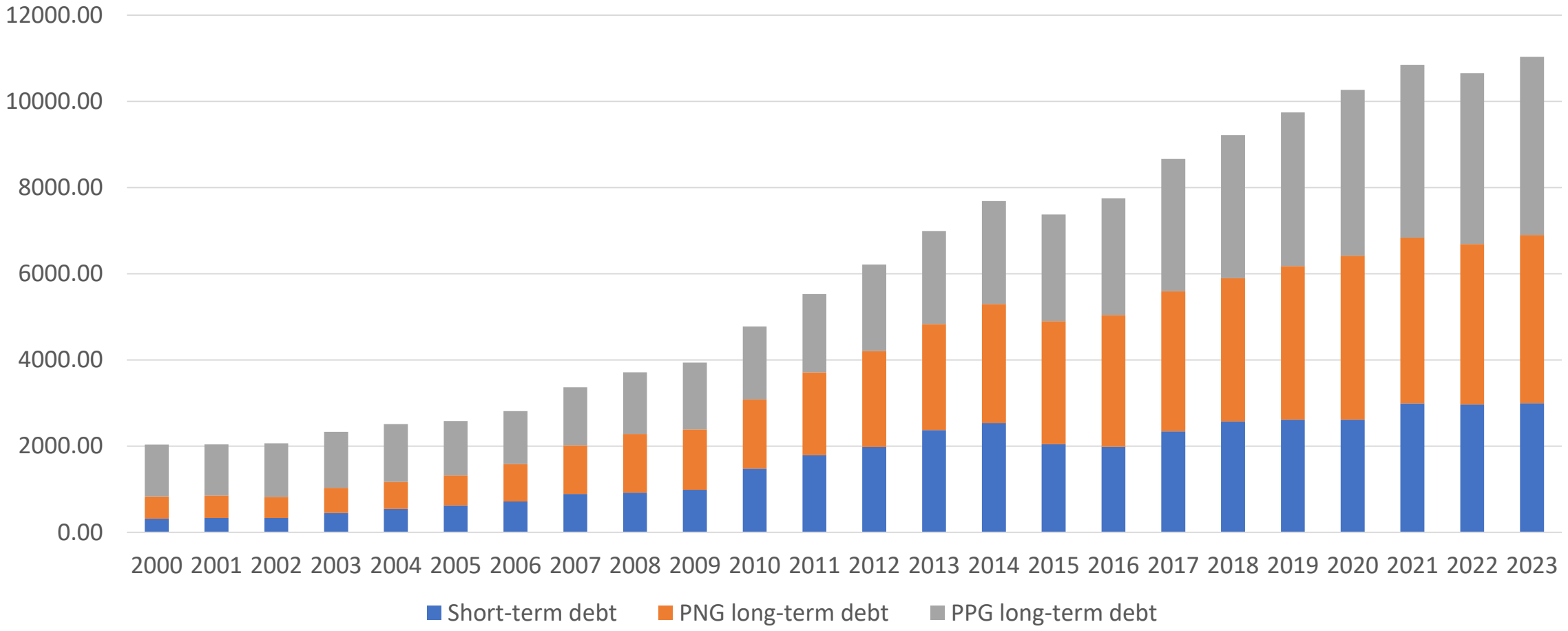
Outline

- Unpacking the ”sovereign debt” crisis: a critical distinction between domestic/local currency debt vs. foreign currency debt;
- Borrowing in FX: Causes and Problems; and MMT on Policy Choices;
- Debt Resolution: Zooming on the IMF and SDRs.

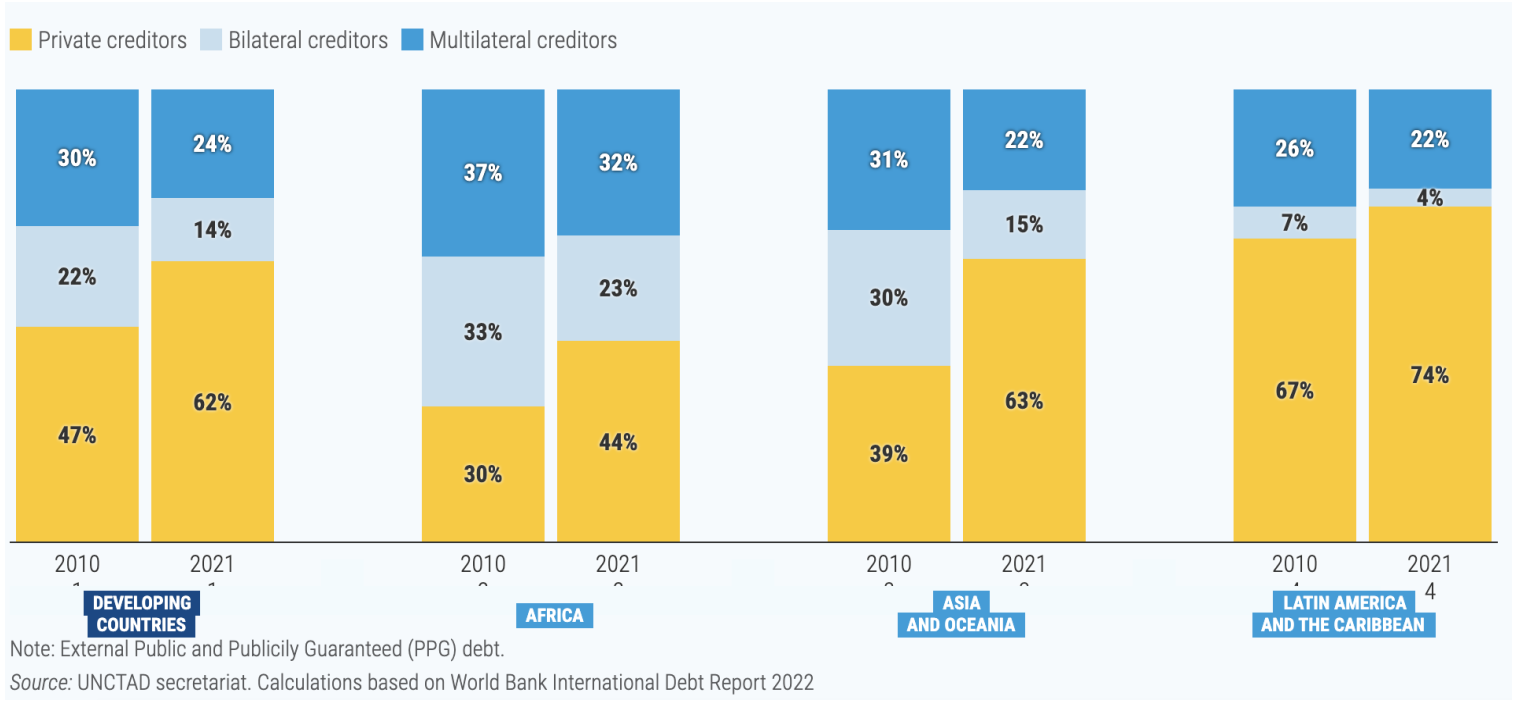
Mounting debt burden

- Rising FX-denominated debt :
  - By the end of 2022, developing countries' external FX debt had reached $11.4T, with half of low-income countries and close to a quarter of emerging market economies in or near debt distress (where a country is unable to fulfill its financial obligations and debt restructuring is required).
  - In 2022, the combined external FX debt stock of IDA-eligible countries hit a record $1.1T—more than double the 2012 level. From 2012 through 2022, IDA-eligible countries increased their external debt by 134%, outstripping the 53% increase in GNI.
- "Lucas Paradox": capital flows from developing to developed countries.
  - Developing countries spent a record $443.5B to service their external public and publicly guaranteed debt (PPGD) in 2022; in comparison, new external loan commitments to public and publicly guaranteed entities in developing countries dropped by 23% to $371B (the lowest level in a decade). Private creditors largely abstained from developing countries, receiving $185B more in principal repayments than they disbursed in loans (UNCTAD 2023).
  - IDA-eligible countries paid a record of $88.9B in debt-servicing costs in 2022.

Total external debt of developing economies, in billion of US$

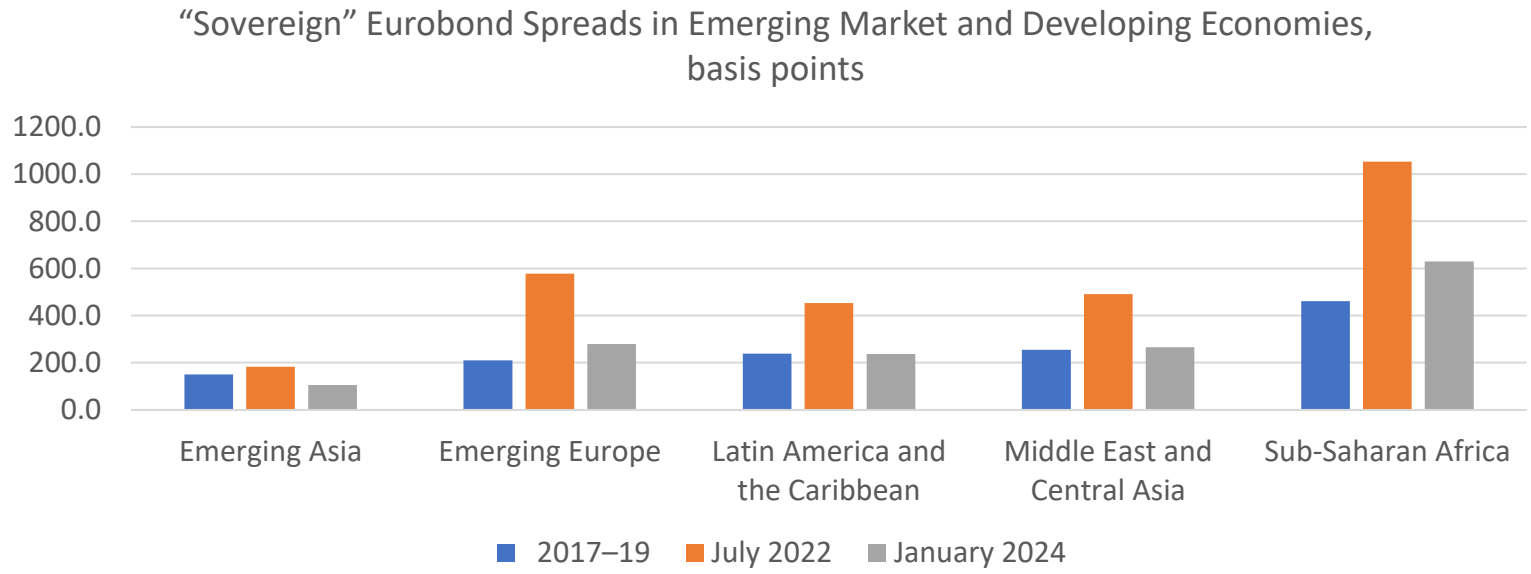


Source: UNCTAD



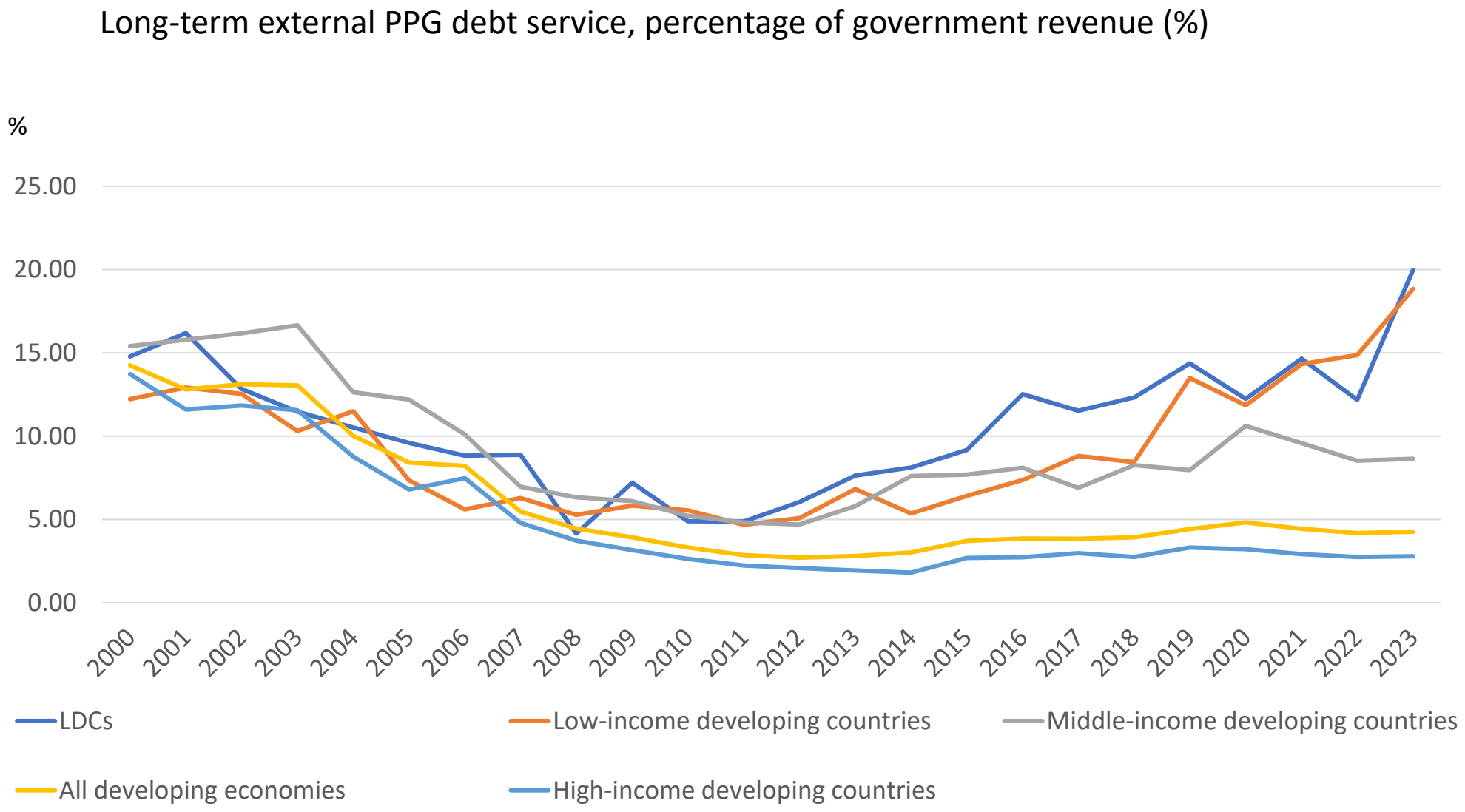
Note: External Public and Publicly Guaranteed (PPG) debt.

Source: UNCTAD secretariat. Calculations based on World Bank International Debt Report 2022



Source: UNCTAD (2024)

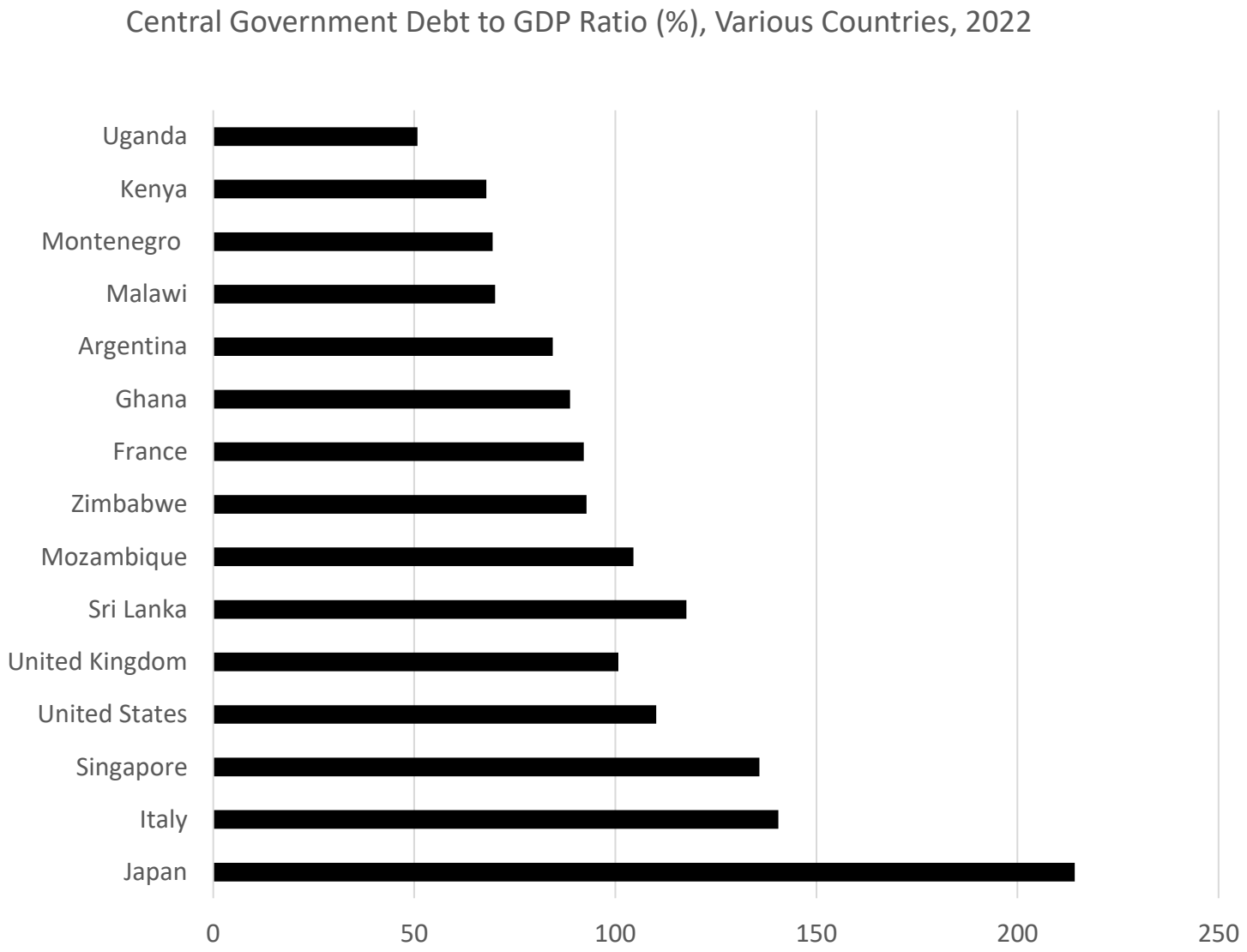
The dire consequences



Source: UNCTAD

- 3.3 billion people now live in countries where interest payments exceed government spending on health or education (UNCTAD 2024).
- To pay international creditors, governments voluntarily adopt or are imposed austerity measures. Austerity is seen as a desirable policy prescription because it frees up government resources to repay external debts and replenish international reserves (Ban & Patenaude, 2019). The most commonly proposed austerity measures in the IMF loans include wage bill cuts and freezes, increases to or the introduction of value-added tax and general public expenditure cuts (Oxfam 2021)
- 26 governments, primarily in Africa and the Latin American and Caribbean regions, had plans to commence or resume fiscal consolidation as early as 2020 and 2021.
- 53 percent of social protests during 2006-2020 were resisting austerity measures and over 10 percent explicitly targeted at IMF conditionality (Ortiz et al., 2022*).*

But here is the irony - countries that have a higher public debt to GDP ratio (but in own/local currencies) do not involuntarily default or incur debt distress.



Source: UNCTAD

- Based on the BIS data, since 2005, emerging countries (upper-middle income), on average, increased their local currency share of sovereign bonds from slightly 70% to close to 80% in 2013 before edging down to close to 75% by 2021. But country-specific experiences vary. Brazil, Mexico, Peru, Chile and Russia were among the countries that have increased the local currency share of sovereign bonds; India and China have increased bond issuance and almost exclusively in local currency. By contrast, Argentina, Bulgaria, Colombia, Hong Kong SAR, Indonesia and Turkey, saw local currency share fell substantially, from 82% to 39%, over the past decade (BIS).
- Other developing countries (low and lower middle income) have less than half their total government debt denominated in local currency, and barely any of these issuers' local currency debt is held abroad, in sharp contrast to the bonds issued by larger EMEs.

- It is a grave mistake to conflate “sovereign” debt in domestic/local currency vs. foreign currency. FX must be earned, typically from net exports, and the inability to obtain FX could force debtor countries to involuntarily default on its FX debt; whereas a monetarily sovereign government can never run out of payments on its domestic/local currency debt.
- In addition, when sovereign debt is held by foreign investors who evaluate returns in dollar terms, their holdings of local currency bonds could be more volatile. It is estimated that one percentage point increase in local currency bond yield is associated with a 3.7% decline in bond price, but the return in dollar terms falls by 6.6%, which could trigger more selling impetus by foreign investors.
- Governments may be attempted or forced to raise interest rates to incentivize the holdings of their bonds and to strengthen their currencies. But raising interest rates mostly fail to work.
- As Mosler (2007) point out: higher rates could accelerate FX reserves loss. First, high rates reduce business profits and consumer spending, slowing the economy and reducing tax liabilities. Second, the higher rate of interest the government must pay to borrow itself puts more of that currency into private sector hands in the form of interest income.

Why borrow in FX?

- Demand side: colonial plunder; partial debt relief from HIPC and MDRI; borrow to finance for budget deficit; borrow to pay for imports; borrow to build FX reserves and stabilize ER; borrow to finance infrastructure and other projects; borrow to refinance existing debt.
  - Profound misunderstanding the cost of debt – borrowing FX to finance domestic spending; perceived cheaper costs of borrowing in FX.
  - Dollar hegemony and the "Original Sin" – need to pay for FX-priced goods and services. "Many developing nations will not find a foreign demand for their domestic currency liabilities. Indeed, some nations could be so constrained that they must issue liabilities denominated in one of these more highly desired currencies in order to import. This can lead to many problems and constraints- for example, once such a nation has issued debt denominated in a foreign currency, it must earn or borrow foreign currency to service that debt. These problems are important and not easily resolved." (Wray 2015, 124)
- Supply side: liquidity glut; pursuit of high yields; profits repatriation; illicit financial flows.

How to reduce foreign borrowing?

- First, distinguish financing constraint from real resources constraint. Developing countries are indeed resources rich, and one of their most valuable resources is the large, young labor force. MMT advocates for a job guarantee (JG) policy where governments could "purchase" all unemployed labor with a wage paid in domestic currency. That is, a monetarily sovereign government (that imposes tax and other obligations, names the unit of account, and accepts the UOA in the settlement of obligations) can purchase any resources for sale in its sovereign currency. There is no fiscal constraint to guarantee full employment (Mosler 2010; Tcheneva 2020).
- Unlike some MMT critics who insist that unemployment in the developing world is due to the supply side constraint (lack of physical capital) and MMT offers policies only for demand management (Aboobaker and Ugurlu 2023), MMT supporters argue that by employing workers in strategic sectors (food, energy, manufacturing and capital goods), a JG program could not only achieve full employment but also structural transformation.
- What about the balance of payment constraint? Again, the need to distinguish financing vs. real constraints. For countries with an acute reliance on foreign imports of food, energy and technologies, a JG program could consider paying wages-in-kind (Wray 2007, 37) and/or impose a (selective) import restrictions.

How to reduce foreign borrowing? Cont'd

- For the perceived financing constraint, MMT suggests a demarcation between savings/funding and credit/financing. The infamous "two gaps" (savings gap and FX gap impede development) theory only lead to wrong-headed policies.
- Instead, financing must come before investment and creation of income, which can then be saved. Financing or credit can be created both at the state level (gov't spends money into existence) and the private banking level (private sector borrows money into existence). State makes sure the public and private money are always traded *at par*. Development financing has been and should be primarily domestic (Liang 2021).
- To overcome financing constraints, developing countries must utilize public money and develop domestic financial institutions, rather than impose fiscal discipline, as well as liberalize and deregulate the financial system to increase domestic savings and attract foreign savings.

The key for an unconvertible currency

- Importantly, countries should adopt a floating ER system to ensure that the government spending is not constrained by the ability to convert its domestic currency into foreign currencies or any other commodities (Wray 2014, Mosler 2007).
  - "All we claim is that with a sovereign, floating currency a government of a developing nation can "afford" to employ all its domestic resources that are willing to work for the domestic currency." (Wray 2014)
- In addition to the floating ER, a list of supportive policies are helpful to relieve the real, external constraints: strategic investments in food, energy and tech to reduce import *dependency*; carefully evaluate the costs of foreign borrowing and minimize it; capital controls (size, composition, sectoral distribution and durations of capital inflows); balance-sheet management of the BoPs (match inflows and outflows to mitigate currency and duration mismatches); industrial policies to climate up value-chain; trade regulations; regional cooperation in trade and finance; and reform of the global financial architecture (Liang 2024).
  - "the MMT principles apply to all sovereign countries. Yes, they can have full employment at home. Yes, that could lead to trade deficits. Yes that could (possibly) lead to currency depreciation. Yes that could lead to inflation pass-through. But they have lots of **policy options** available if they do not like those results. Import controls and capital controls are examples of policy options. Directed employment, directed investment, and targeted development are also policy options." (Wray 2012)

Exchange Rate Arrangements, 2014–22

(Percent of IMF members as of April 30)[1]

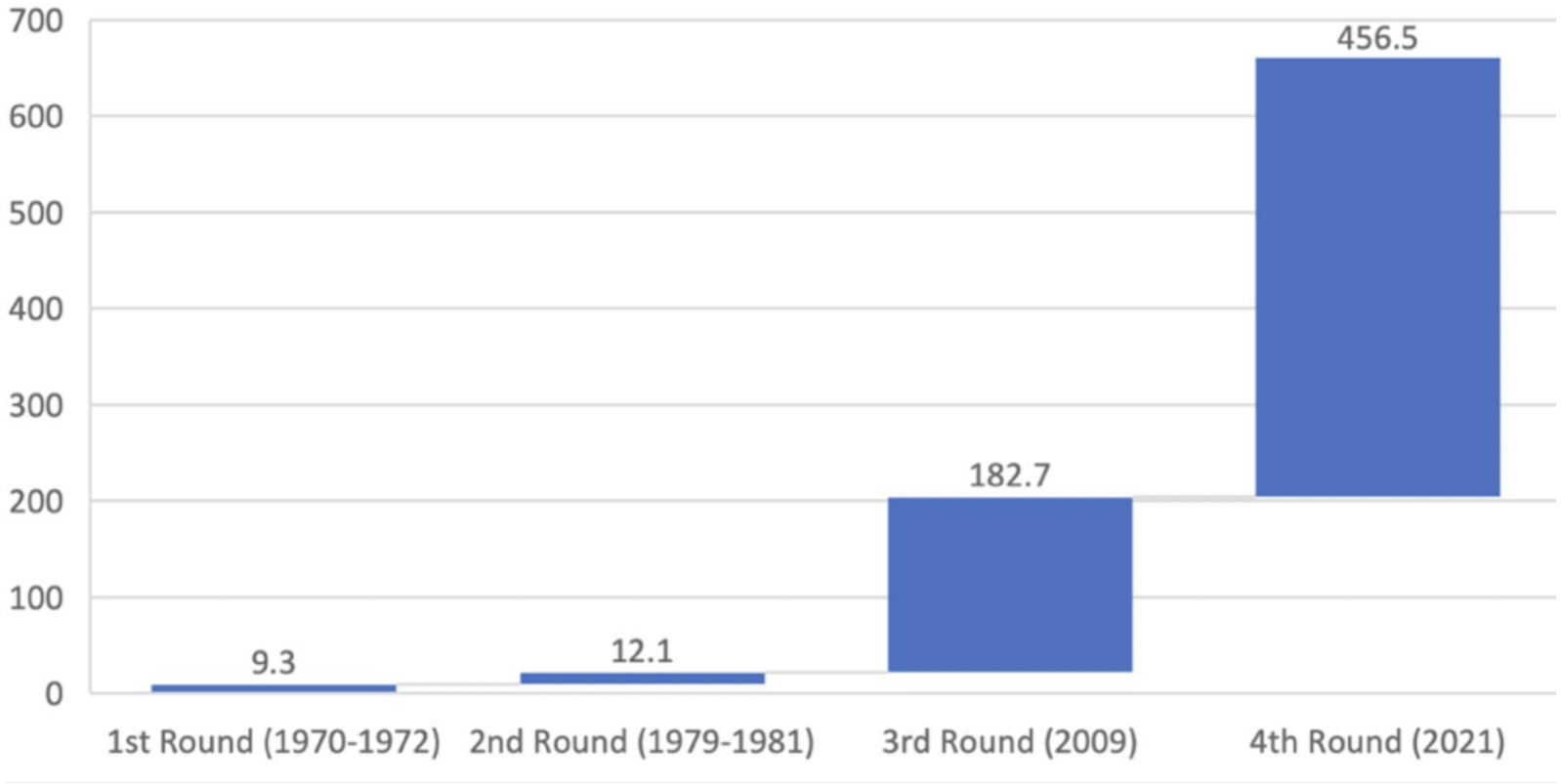
Exchange Rate Arrangement	2014	2015	2016[2]	2017	2018	2019	2020	2021[3]	2022[4]
Hard peg	13.1	12.6	13.0	12.5	12.5	12.5	12.5	13.0	13.4
No separate legal tender	6.8	6.8	7.3	6.8	6.8	6.8	6.8	7.3	7.2
Currency board	6.3	5.8	5.7	5.7	5.7	5.7	5.7	5.7	6.2
Soft peg	43.5	47.1	39.6	42.2	46.4	46.4	46.9	47.7	46.9
Conventional peg	23.0	23.0	22.9	22.4	22.4	21.9	21.4	20.7	20.6
Stabilized arrangement	11.0	11.5	9.4	12.5	14.1	13.0	12.0	12.4	11.9
Crawling peg	1.0	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.5
Crawl-like arrangement	7.9	10.5	5.2	5.2	7.8	9.4	12.0	12.4	12.4
Pegged exchange rate within horizontal bands	0.5	0.5	0.5	0.5	0.5	0.5	0.0	0.5	0.5
Floating	34.0	35.1	37.0	35.9	34.4	34.4	32.8	33.2	34.0
Floating	18.8	19.4	20.8	19.8	18.2	18.2	16.7	16.6	18.0
Free floating	15.2	15.7	16.1	16.1	16.1	16.1	16.1	16.6	16.0
Residual									
Other managed arrangements	9.4	5.2	10.4	9.4	6.8	6.8	7.8	6.2	5.7

Source: IMF (2023)

Debt Crisis Resolution: Zooming in on the IMF

- The IMF was set up as an IFI to maintain international financial order. The SDRs issued by the IMF are used as “reserve assets” where debtor countries could use SDR holdings to make direct payments to member countries or to exchange SDRs for “hard” or usable currencies to meet debt obligations.
- However, the IMF emergency lending based on the SDR system often comes too little, too late and too much strings attached.
  - First, there is insufficient allocation of the SDRs; only four rounds of allocations since their inception;
  - Second, most of the SDRs allocations go to the developed countries who don’t really need them;
  - Third, IMF conditionalities worsen debt countries’ economy and ability to pay.

Four Rounds of SDR Allocations, Billion of SDRs



In the most recent round of allocation, an SDR allocation of as much as $3 trillion was needed, given the scale of the financing challenging emerging markets across the world (UNCTAD 2023). But the US agreed on a $650 billion allocation, as this figure was the most that could be approved without the Congress's approval. Low-income developing countries received about $21B worth (3%) of SDRs, with emerging and developing countries receiving a $275B (45%) boost to their reserves. The remaining $354B (54%) of SDRs will go to advanced economies.

United States Senate
WASHINGTON, DC 20510

March 24, 2021

The Honorable Janet Yellen
Secretary of the Treasury
Department of the Treasury
1500 Pennsylvania Ave. NW
Washington, DC 20220

Dear Secretary Yellen:

We are deeply concerned by your support for a proposal to have the International Monetary Fund (IMF) allocate new Special Drawing Rights (SDRs), without congressional approval, to purportedly help poor countries respond to the COVID-19 pandemic. As you are aware, SDRs are backed by IMF member countries' fiat currencies, the largest component being the American dollar. The proposed allocation of SDRs would be inappropriate, ineffective, and a wasteful use of taxpayer dollars that would end up benefiting repressive regimes and state-sponsors of terrorism. We strongly urge you to abandon your support for this proposal.

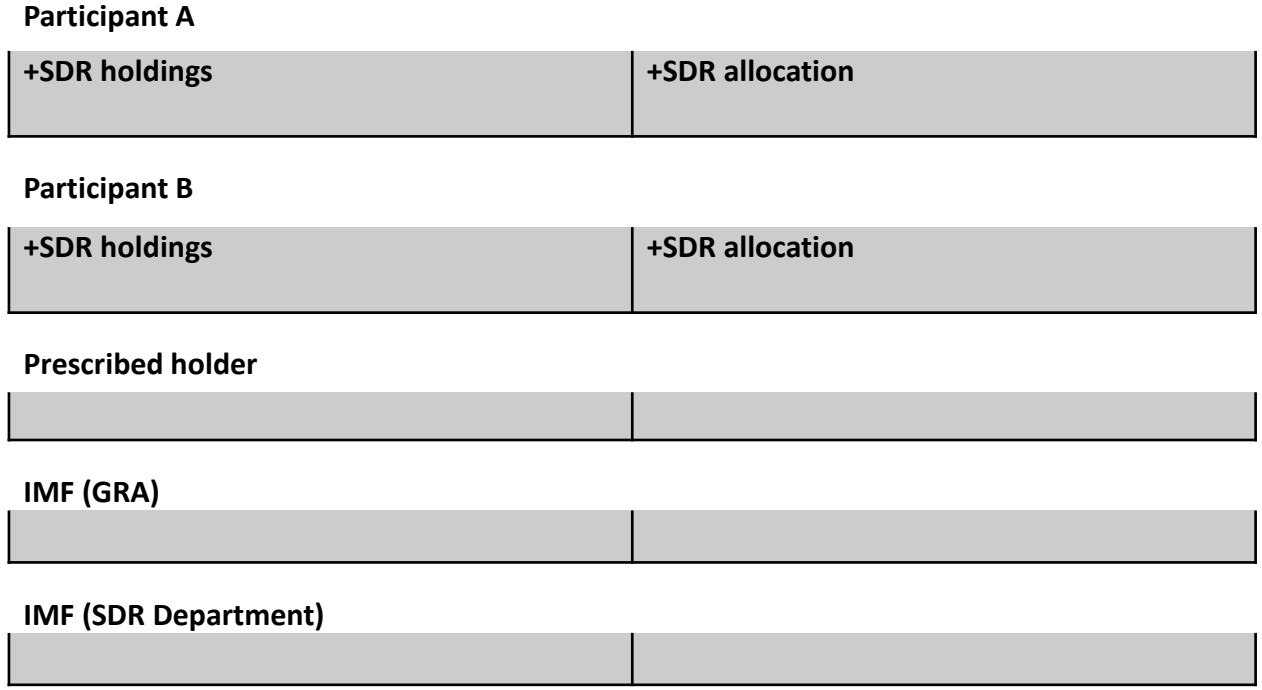
Under the IMF's own rules, general allocations of SDRs should only occur when necessary to meet a long-term global need for reserve assets. Currently, there is no such need. While some poor countries may have a need for foreign aid, SDR allocations are not meant to be used as a back door for providing such aid. The IMF has other more suitable tools for aiding poor

This inappropriate distribution of foreign aid does not come without costs. To the contrary, it comes at a permanent cost to the U.S. taxpayer. IMF members can demand that a fellow member nation exchange SDRs for hard currency. Ultimately, SDRs can be redeemed from the U.S. government by foreign countries for dollars in the form of "loans" that do not have to be repaid. These dollars come from the U.S. government, which would need to issue debt to obtain sufficient dollars to meet an SDR demand. That debt will need to be repaid by current and future taxpayers.

Reality of SDR allocations, transactions and dollar creation

- The SDR is an international reserve asset. The SDR is not a currency, but its value is based on a basket of five currencies (IMF).
- Under the SDR system, there are three types of member balance sheets: first, one institution of each member state, called “participant”. Most participants are central banks, some treasuries (e.g. the US Exchange Stabilization Fund) or “off-balance-sheet fiscal agent”. Second, the IMF itself, represented by the General Resource Account (GRA) and third, 20 organizations approved as prescribed holders (e.g. ECB, BIS, etc).
- In a new SDR allocation, the balance sheets of all Participants expand symmetrically on both sides by creating ‘SDR holdings’ as an asset and “SDR allocation” as a liability Importantly, all other balance sheets that are part of the SDR system remain unaffected by the SDR allocation (Galicia-Escotto 2005).

Currency	Weights determined in the 2022 review
US dollar	43.38
Euro	29.31
Chinese Renminbi	12.28
Japanese Yen	7.59
Pound Sterling	7.44



- SDR transactions: the main purpose for which the SDR system has been used in the post-Bretton Woods era is to lend currency, which has been created outside of the SDR system, from one member of the system to another. There two transaction types, including exchange SDR holdings into usable currency, or use SDR holdings for direct payment to members. Three mechanisms: transactions by agreements; the GRA's lending facilities; and IMF-sponsored trusts concessionary lending.
- Transaction by agreement can include creation of the USD when it involves the ESF purchasing SDR holdings from a participant. The ESF creates SDR certificates as its liability and require the Federal Reserve to buy it. In this case, the Fed expands its balance sheet on both sides and creates new USD liquidity, which it channels into the SDR system mediated by the ESF. The maximum volume of SDR Certificates that can be issued equals the ESF's SDR holdings (Special Drawing Rights Act of 1968, Sec. 4a). As of April 2024, the Fed holds $29.7B SDR certificates, compared to $167B SDR holdings.

Balance sheets with dollar creation via transaction by agreement

Exchange Stabilization Fund

+ SDR holdings **+ ESF account at the Fed** **- ESF account at the Fed** **+ SDR holdings**	**+SDR allocation** **+SDR certificates**

Federal Reserve

+ SDR certificates	**+ ESF account** **+ FX reserves of A** **- ESF account**

Participant A

+ SDR holdings **+ FX reserves in USD (at the Fed)** **- SDR holdings**	**+SDR allocation**

U.S. Reserve Assets (Table 3.12)

Millions of dollars, end of period

	Asset	Apr 2024
1	Total	241,602
2	Gold stock[1]	11,041
3	Special drawing rights[2 3]	165,500
4	Reserve position in International Monetary Fund[2 5]	29,746
5	Foreign Currencies[4]	35,316

Austerity doesn't work to reduce debt but create enormous socio-economic harms

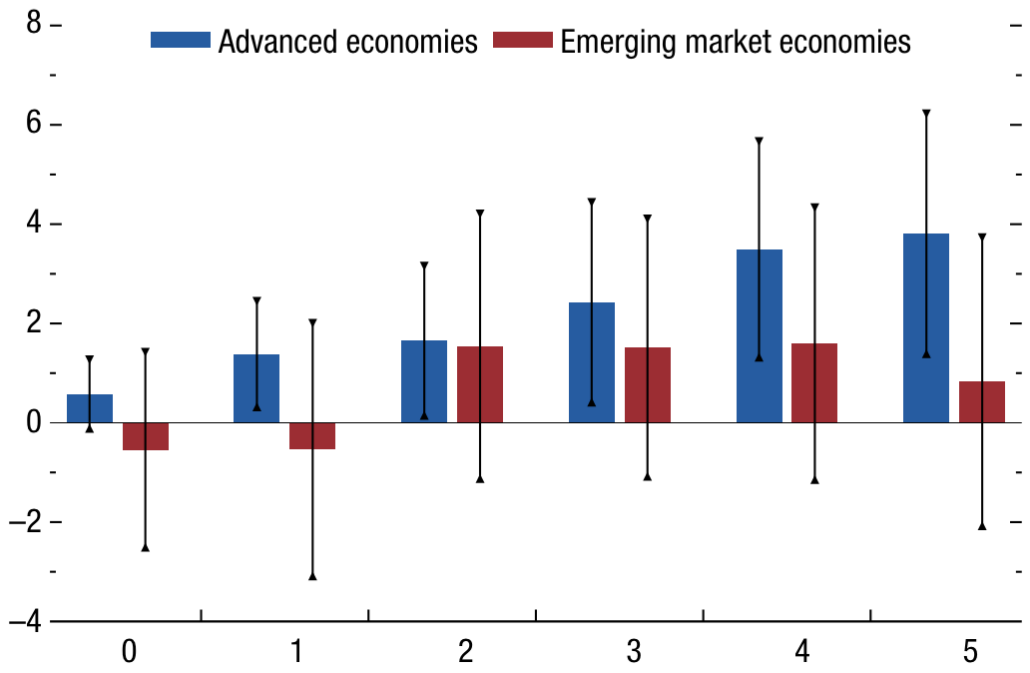
Austerity does not reduce debt to GDP ratio based on IMF's own research (IMF 2023).

In Kenya's case, the primary fiscal deficit has decreased from -4.2% of GDP to -.4% from 2020-2023, but debt to GDP ratio has climbed from 63% to 71%, because interest payment eats up 4-5% of GDP per year (IMF 2024).

In Argentina's case, primary fiscal deficit has reduced from -2.9% of GDP in 2023 to a surplus of 1.1% of GDP, but it is paying external debt services of $16.8B in 2024, or ~3% of GDP.

Figure 3.3. Effect of Fiscal Consolidation on Debt to GDP
(Percentage points)

On average, fiscal consolidations do not reduce debt-to-GDP ratios.



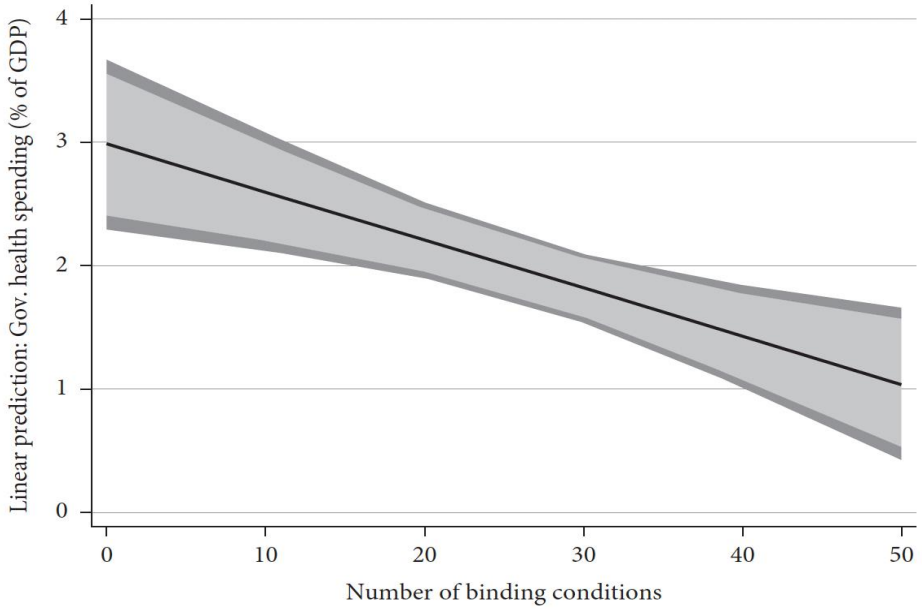
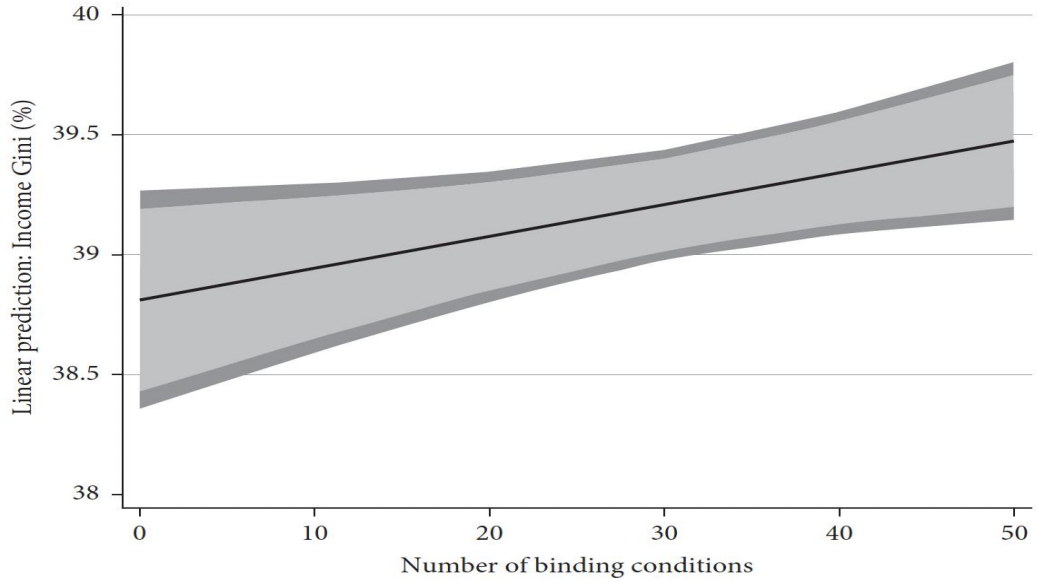


Figure 4.7 Effect of IMF conditionality on government health spending (% of GDP), with 95% and 90% confidence intervals



igure 5.4 Effect of IMF conditionality on income Gini, with 95% and 90% onfidence intervals

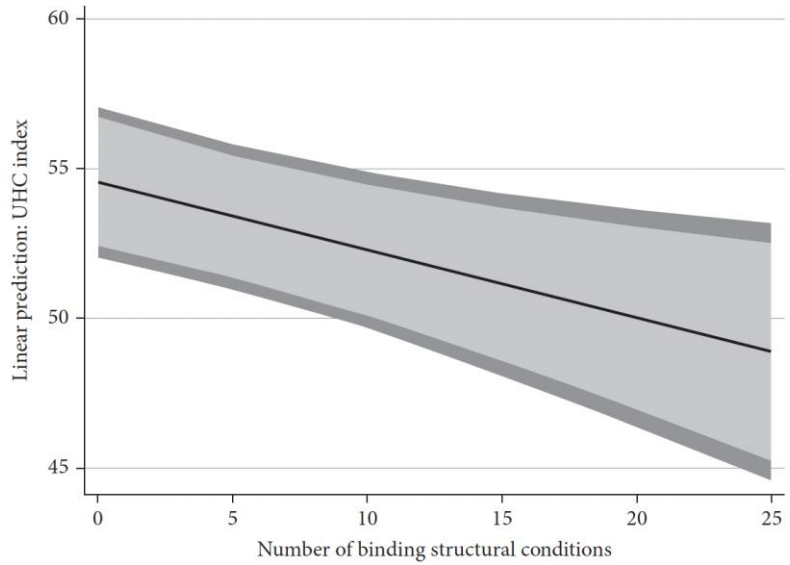


Figure 6.7 Effect of IMF structural conditionality on coverage of essential health services, with 95% and 90% confidence intervals

Note: Predictive margins based on structural conditions in Table 6.5. Darker shading indicates 95% confidence intervals; lighter shading indicates 90% confidence intervals.

Source: Kentikelenis and Stubbs 2024

Major takeaways:

- Create domestic financing to mobilize domestic resources, esp. labor;
- Adopt flexible ER and limit borrowing in FX – monetary sovereign governments do not involuntarily default on local currency debt;
- Reform the international financing architecture – IMF SDR allocations do not use the US tax payer money.