3 - 3

Lessons from MACs on Public Debt Sustainability and Growth

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This paper aims to extract lessons on public debt sustainability from MACs for policy practitioners from LICs, especially those which are exiting from the HIPC-MDRI process and beginning to tap both the international capital markets via Eurobonds and the domestic debt market via treasury bills and bonds.[1]

Our approach is guided by pragmatism. We start with a discussion of the main empirical findings from the MAC debt crises of the last decade:

- **How stabilization is viewed has changed:** A new mindset is needed, focusing on the government's intertemporal budget constraint instead of short-run fiscal deficits and inflation.

- **Market plays a key role in deciding what level of debt is sustainable:** Rules-of-thumb on what constitutes a safe debt-to-GDP threshold (such as the Maastricht criteria or even those generated by cross-country regressions) are of limited use and could lead to unjustified complacency.

- **Fiscal fundamentals dominate financial engineering:** 'Debt intolerance' ('it's the country's fault') finds more empirical support than 'original sin' ('it's the market's fault and appropriately engineered instruments will solve the problem').

- **How MACs have been seeking debt sustainability:** As a rule, MACs have been seeking to lower indebtedness (measured by the debt-to-GDP ratio) in order to spur growth. They have adopted common policies after the crises which began in 1997-98: shift towards domestic debt and flexible exchange rates; run higher primary surpluses; build up reserves; and in many cases, strengthening financial and fiscal systems.

- **MACs have been relying on themselves:** What countries themselves have been doing in response to the public debt crises after 1997 is much more significant than what the IFIs have been able to do to help; nor have there been any market innovations in terms of new borrowing instruments. Self-insurance (understood as a comprehensive fiscal and financial package) is the name of the game.

How MACs Have Been Trying to Achieve Public Debt Sustainability

In addressing their debt sustainability problems, MACs have four basic options: pay off the debt by running higher primary fiscal surpluses; restructure their debt in the hope of lowering its burden using market-based, voluntary methods; inflate away their debt; and default and restructure their debt (the last two are connected because a default is usually accompanied by a scramble for the exits, leading to an exchange rate collapse and inflation).

Raising the primary surplus is likely to be more successful in lowering the debt burden: (i) the more debt tolerant a country is (better inflation and credit history); (ii) the stronger the government's balance sheet; and (iii) the stronger the microfoundations for growth (NB: (i) and (ii) tend to go together).

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[1] HIPC: Heavily-Indebted Poor Countries Initiative. MDRI: Multilateral Debt Relief Initiative. LICs: low-income countries, typically without access to the international capital markets. MACs: market access countries, with such access, also known as emerging market countries.

Voluntary market-based restructuring tend to be ineffectual in reducing the present value of debt burdens because no creditor would voluntarily accept such a reduction (this is essentially the Modigliani Miller theorem applied to a government - the government's ability to pay and hence the present value of the claims on it are eventually determined by the present value of taxes, which in turn is influenced by growth prospects. A voluntary restructuring is unlikely to affect these variables). This finding is inspired by the unsuccessful debt restructurings attempted by Russia in July 1998 and Argentina in June 2001. In general, when debt sustainability problems are present, financial engineering is unlikely to work and could even backfire. (A recent study by the Inter-American Development Bank, IDB 2007, zeroes in on debt structure rather than debt levels as the central issue. We disagree.)

The major MACs all had a similar policy response to the crises of 1997 and after: run higher primary surpluses; shift towards flexible exchange rates and domestic debt; and build up reserves. While these policies have been paying off in all the MACs, the East Asian countries and Turkey saw more immediate results in terms of reducing indebtedness and restoring long-run growth than Argentina or Brazil. Argentina resumed growing in 2003 and has been growing rapidly since, but concerns remain about debt dynamics and subnational fiscal policies. Brazil has been growing throughout but at a relatively slow rate, although this is picking up.

Public Debt and Growth

In connecting public debt and growth, the first obvious port of call is stabilization. A summary of the empirical literature which guided policy thinking up to the crises of 1997-98 is contained in Fischer (1993), which linked growth to fiscal deficits and inflation. Post 1997, the focus has shifted to the government's intertemporal budget constraint, including considerations such as: is the real exchange rate overvalued; are contingent liabilities adequately reflected; are the micro foundations for growth strong. For MACs, balance in the government's intertemporal budget constraint (i.e. sustainable debt dynamics) is going to be a prime determinant of macroeconomic vulnerability and hence lasting stabilization as a support to growth

A second channel linking public debt and growth is volatility. MACs with higher debt-to-GDP ratios and problems of sustainability are likely to be more vulnerable to downside risks (we are talking about the potential for disruptive crisis, not just business cycle ups-and-downs). There is also likely to be greater uncertainty about future inflation and tax rates, as well as the path of the real exchange rate. Such uncertainty effectively serves as a tax on investment, dampening growth.

A third channel is that cutbacks in public investment because of debt sustainability concerns could hurt private investment through the creation of infrastructure gaps (public infrastructure investments and private investment are complements). This is the "fiscal space argument" (Calderon, Easterly and Serven 2004 and Serven 2007); but MACs have generally been trying to first bolster creditworthiness before doing something about the infrastructure gap. Besides, incurring additional debt to invest in infrastructure could push up real interest rates, both 'crowding out' private investment and worsening debt dynamics.

But the above is more about how public debt can impede growth. Can it serve to spur growth? First we have to understand what drives growth. We explore this question in the context of the Washington Consensus, the recently released findings of the Commission on Growth and Development (GC 2008) and the 'growth diagnostics' framework of Hausmann, Rodrik and Velasco (2005) to highlight the importance of the public finances and the government's intertemporal budget constraint.

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