IMF—Doubling the Dose of Austerity

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Evidence from Ghana and reports from Sri Lanka indicate that the International Monetary Fund has introduced a new condition—reduction through the restructuring of domestic sovereign debt—into its adjustment toolkit for countries facing external debt stress. This tendency to blur the distinction between domestic and external debt has major implications, and amounts to imposing measures that enforce a new and additional form of debilitating austerity on these countries.

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In a barely noticed development, the International Monetary Fund (IMF) has "reformed" and extended the conditions it imposes in return for emergency balance of payments support to less developed countries with stressed external accounts. The evidence of that shift comes from Ghana, the West African nation that moved from external debt stress to default in December 2022. The process is likely to be repeated in Sri Lanka. The change is the decision to require restructuring of both internal and external public debt, and not just the latter, as a condition for IMF support.

Ghana is, of course, still to get IMF Board clearance for the $3 billion loan it has been promised as a basis for restructuring its external debt. But that does not mean it has not begun implementing IMF conditionality. In another recent worldwide change in conditions for IMF support, the Bretton Woods Institution, tasked by Western powers to manage the debt crisis in the less developed world in which their banks and financial institutions are embroiled, has been demanding that potential recipients of bridge finance must show evidence of implementing IMF-designed economic policy reforms before their financing programme is put through the protracted process of clearance. As evidence from Sri Lanka, Pakistan and elsewhere demonstrates, reforms involving some combination of measures such as tax adjustments, subsidy reduction, public sector price increases and devaluation, besides financing assurances from bilateral creditors required to participate in a debt restructuring exercise, precede final clearance of an IMF programme.

Restructuring of Domestic Sovereign Debt

In Ghana's case, those prior requirements have included an exercise involving the restructuring of domestic sovereign debt denominated in domestic currency. This has significant implications. Debt restructuring at the least involves rescheduling in the form of extension of the period over which repayments are to be made, with possibly an initially "grace" period when debt service payments are suspended. But rescheduling per se merely kicks the can down the road, since all payments due must be made after some delay. Rescheduling may be associated with a reduction in the interest rate charged on future debt servicing, resulting in a restructuring of debt with an implicit reduction in the net present value of outstanding debt. And finally, restructuring may require creditors to accept a "haircut" or a reduction of a specified share of every dollar of debt, imposing losses on creditors in a debt-stress context, since they are seen as having taken a risk to earn an interest on the funds they lent.

The problem, however, is that domestic lenders to sovereigns include domestic banks and ordinary citizens whose savings are invested in government securities (considered riskless) through institutions such as pension funds, insurance companies and mutual funds. Restructuring of domestic debt would result in commercial banks taking a hit and suffering losses that can have implications for credit availability and repercussions for the rest of the economy. It would also erode the savings of ordinary citizens who were not speculating in financial markets but securing their surplus funds and setting aside money for a future when they are no more capable of earning an income. These individuals are being called up on to bear losses when a country faces difficulty servicing foreign debt in foreign exchange.

Hitherto, domestic sovereign debt has been rightly treated as different from external debt. It is almost wholly, if not solely, denominated in local currency and held by residents, whereas external debt is denominated in foreign hard currencies, normally the US dollar, and held by non-residents. Though these distinctions are not as complete as they used to be before, they remain the dominant distinguishing characteristics of domestic and foreign debt. Servicing domestic debt, therefore, requires mobilising the requisite domestic currency resources. This can involve some combination of allocating available budgetary revenues for the purpose or additional borrowing in the domestic "open" market and, in what was common practice before neoliberal fiscal reform was embraced by less developed country governments, from the central bank. Since the sovereign has the right of taxation, there was always the possibility of additional resource mobilisation through taxation, especially since direct tax to gross domestic product (GDP) ratios tend to be low in these countries. This room for flexibility that the sovereign possesses when mobilising domestic resources makes sovereign debt in domestic currency a riskless asset. The instrument has the backing of the state, which in turn is seen as capable of mobilising the requisite domestic currency resources to service that debt.

That is, of course, not true of external debt denominated in dollars, the servicing of which requires the government of a country that is not home to a reserve currency to dip into the national pool of foreign currency inflows or foreign reserves to service that debt. Since, not to make a difference to the net external debt position of a country, that foreign exchange must in the final analysis be "earnings" and not new liabilities used to repay past debt, there are limits to the quantity of such resources available. It is the absence of such adequate foreign currency earnings that leads to default on external debt payments and the attendant crisis. That is, the problem here is not the need to mobilise domestic currency resources to service external debt, but the need to transform a chunk of those domestic currency resources into dollars. As a result, the inability of these countries to borrow abroad in their own currencies, leading to a currency mismatch on their balance sheets, was termed the "original sin" by leading mainstream economists such as Barry Eichengreen and Ricardo Hausmann.

There are a number of factors that induce less developed country governments to be overcome by that sin by borrowing abroad in dollars. Such borrowing helps finance foreign exchange expenses that are essential or necessary. Interest rates in global markets for even LDC borrowers have been much lower in recent years, encouraging foreign borrowing for even domestic currency expenses. Domestic interest rates tend to be high because of neo-liberal monetary and fiscal policies that avoid so-called "financial repression" in the form of controlled interest rates. And, it allows deviant leaders to finance unwarranted and profligate foreign spending. However, in normal circumstances, domestic debt

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tends to be a much higher proportion of total public or sovereign debt and interest on that debt are much higher than that on foreign debt measured in domestic currency terms.

Whatever the combination of factors that led to the accumulation of external debt, that stock can prove excessive if net foreign exchange revenues prove persistently inadequate to finance serving costs. There is a limit to which such debt can be serviced with new borrowing, since creditors would tend to hold back. When that happens, unlike in the case of domestic debt that can be managed with appropriate policies, external debt stress or debt distress becomes unmanageable. Immediate restructuring of terms or even a reduction in the size of debt may become unavoidable if repayments are to be revived and sustained.

Implications

What the change in IMF policy conditionality, which adds domestic debt restructuring to its bucket list of reforms, does is that it blurs this serious difference between domestic and external debt. The shift in focus has two implications. First, the overall debt of the sovereign is being seen as the "sin" that matters, and not specifically the "original sin" of borrowing abroad and not being able to borrow abroad in domestic currency and therefore borrowing in dollars. Second, the principal problem for less developed countries faced with "debt stress" is no more being seen as their inability to earn the foreign exchange needed to service external debt, because of their subordinate position in an unequal international order, but the fact that their overall public debt is so high that the ratio of debt servicing costs to budgetary revenues (not receipts) is far too high. In the event, fiscal consolidation is being treated on par with or even being privileged relative to balance of payments consolidation.

From its origins in the Polak model, IMF-style adjustment was focused on correcting balance of payments imbalances by compressing output, so that at any given import intensity, or ratio of imports to GDP, the import bill can be reduced. This, together with a measure, such as devaluation of the currency, aimed at squeezing out more exports from the system, was expected to deliver correction. In the Polak model, based on a monetarist view that output is a function of the level of money supply, the onus of adjustment was placed on restraining the supply of money. That adjustment was to occur through a reduction of central bank lending to the government.

In time, the onus of adjustment was shifted to the fiscal side of the macroeconomy: governments were required to stop monetising their deficits or financing them with borrowing from the central bank, and the overall excess of expenditures over revenues, or the fiscal deficit to be financed with borrowing had to be curtailed, by law if needed. This had the added advantage from the perspective of finance capital in that it increased the fiscal space available to the government to meet foreign commitments, while simultaneously working to reduce deficits on the balance of payments. Since all this had to occur within a framework of taxation that was supposed to incentivise private savings and investment, the way in which the adjustment was to be achieved was through a curtailment of spending, the burden of which inevitably fell on capital and welfare expenditures. Austerity imposed through fiscal contraction, or mediated through government spending, was seen as the way to ensure balance of payments adjustment.

What the recent shift in IMF policy entails is adding to the level of austerity aimed at ensuring "adjustment" by forcing a reduction in the stock of public debt through restructuring that hurts largely or solely domestic agents. Among those agents are pension funds, mutual funds and insurance companies which are institutions that intermediate domestic savings of ordinary citizens. If domestic debt is restructured to reduce its volumes, by forcing haircuts, households suffer losses through erosion of their savings in pension and mutual funds or increases in the insurance premia they would have to pay. The erosion of savings would work back to spending decisions, as they are adjusted to make up for the loss. Banks also take a large loss, since domestic banks tend to be the biggest holders of government securities. This can be self-defeating, requiring recapitalisation of the banks with government funds to prevent financial market turmoil and its adverse repercussions for the real economy. Moreover, even if banks survive, restructuring can adversely affect credit flow, resulting in bankruptcies of small- and medium-sized firms and a contraction in investment and consumption spending. The result is a double dose of the austerity medicine.

We must recall that the turn in IMF conditionality being discussed occurs in a context where it has emerged as the principal intermediary in external debt restructuring efforts, even though the share of governments from the developed world that dominate its voting structure has fallen dramatically over time relative to that of commercial banks, private bondholders and one major bilateral creditor, namely China. Given that context, the IMF's new insistence on the reduction of public debt through a restructuring of aggregate debt—foreign and domestic—seems merely a way of insidiously exploiting its position within a changing configuration of power to promote an agenda that forces deflation on poor countries.

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