Monetary power and sovereign debt crises: The renewed case for a sovereign debt restructuring mechanism

At Issue

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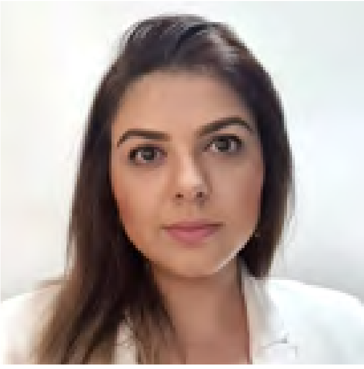
The sovereign debt crises threatening states in the Global South are less about fiscal mismanagement and more about monetary power in the global currency hierarchy, and until that issue is addressed, these states will continue to be vulnerable to debt crises and their punishing consequences. In the absence of a fundamental change in the geopolitics of global money, an equitable shorter-term mechanism is the needed to stave off a new wave of sovereign debt crises.

Contrary to mainstream assumptions on fiscal fundamentals, the solvency of states is critically determined by their monetary power: The ability to issue debt in their own currency and the degree to which such currency performs the functions of money internationally. Sovereign debt crises are not necessarily the product of misfortunes or mismanagement of public finances, rather they are a systemic feature of the current international monetary system. To tackle the increasing risks of disorderly defaults and the crisis of multilateralism, the International Monetary Fund must reckon with the monetary determinants of sovereign debt crises and support the creation of an international sovereign debt restructuring mechanism.

The mainstream view on sovereign debt crises, commonly reproduced in IMF policy, tends to attribute such crises to broad categories of either misfortune or mismanagement. Such factors are said to result in the sovereign's inability or unwillingness to honour its financial obligations, leading to defaults. This view often serves as the basis for moralising narratives that tend to blame the debtor state for its own insolvency and call for the adoption of austerity programmes as a measure of 'responsibility' towards creditors.

While fiscal misfortunes and mismanagement have some explanatory power, such a viewpoint tends to neglect the monetary factors at the root of sovereign insolvency. Liquidity is the key to understand the structural causes of sovereign debt crises. Sovereign insolvency should be conceived not as a state's inability or unwillingness to pay its debts, but rather as inability to continuously ensure or otherwise access liquidity.



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However, global liquidity is unevenly available to states, due to asymmetrical levels of monetary power. As long as the international monetary system is built upon a global currency hierarchy, such crises will not disappear.

The mainstream fiscal-centred approach to sovereign debt crises and its implications for IMF policy

The mainstream approach to sovereign debt crises tends to conceive this question as a matter of fiscal discipline. It is understood that such crises can be avoided through the collection and allocation of sufficient fiscal resources to serve debt obligations. Examples of this include the nominal debt limit established in the United States and the ceiling for aggregate debt based on the debt-to-GDP ratio established in Articles 121 to 126 of the Treaty on the Functioning of the European Union (TFEU) and Protocol 12 on the excessive deficit procedure in its annex.

At an international level, this view is reflected in the IMF's Debt Sustainability Assessment (DSA), which guides all the IMF's surveillance, lending, and disbursement monitoring activities. The DSA's primary policy preference to pursue sustainability is to generate primary fiscal surpluses and reduce the debt-to-GDP ratio, notably through fiscal adjustment. The assessment seeks to evaluate the level of country risk and the risk of a debt crisis, in both cases measured on the grounds of quantitative indicators.

Despite their substantial influence in most legal frameworks governing sovereign debt, fiscal-centred approaches are conceptually incomplete. The practical significance of such premises has been brought into question by policy developments since the 2008-9 global financial crisis (GFC) and, most prominently, the Covid-19 crisis.

> The IMF should rely upon its institutional memory to reinstate its support for an international sovereign debt restructuring mechanism

For example, the approach is insufficient to explain the significant decrease in yields in sovereign bonds of the Eurozone's periphery despite record-high debt-to-GDP ratios, or the gaps between advanced economies and developing and emerging economies (DEEs) in their ability to fund emergency and recovery programmes during the Covid-19 crisis. The latter gains relevance as the economic impacts of uneven recovery from the pandemic and the war in Europe, combined with monetary tightening by central banks, are threatening a wave of sovereign debt crises in DEEs.

The monetary factors underpinning sovereign debt crises

The reason behind the conceptual limitations of mainstream fiscal-centred approaches to sovereign debt is that sovereign debt crises are not only determined by fiscal fundamentals, but also by monetary factors. Crucially, a state's ability to avoid such crises depends on its level of monetary power.

The concept of monetary power, as employed here, includes both the ability of a state to issue sovereign debt in its own currency and the degree to which a national currency is able to perform the functions of money – unit of account, medium of exchange, and store of value – internationally. In particular, money that can function as an international reserve currency is highly sought because it provides security in the face of economic uncertainty. While the relationship between constrained monetary sovereignty and sovereign debt crises can be said to belong to conventional wisdom, currency hierarchy is neglected as a key factor underpinning such crises.

The importance of currency hierarchy as a structural determinant of sovereign debt crises is threefold. First, a state's ability to access liquidity to rollover sovereign debt depends on the hierarchy of its currency in the international monetary system. Capital flows have a cyclical character in the periphery of global capitalism and a countercyclical effect in the core, particularly during busts in the financial cycle, when market participants have an increased perception of risk (see *Observer* Winter 2021). As a result, the fulfilment of sovereign debt contracts from peripheral currency states is significantly affected by global movements that lie beyond their fiscal rules. Ultimately, it depends upon their ability to access financial markets dominated by private and institutional investors and lenders, primarly located in the core.

Second, a state's fiscal capacity is critically influenced by the position of its currency in the global hierarchy. The cyclical character of global liquidity in the periphery of the international monetary system makes periphery countries more vulnerable to quick withdrawals from contracts denominated in their own currency. This makes a country more prone to exchange rate instability created by international liquidity booms and busts, increasing the likelihood of a sovereign debt crisis. This jeopardises the safety of their sovereign debt, which to a significant extent depends on external factors rather than on their domestic fiscal framework.

Finally, currency hierarchy determines the state's capacity to guarantee the safety of its sovereign debt contracts by acting as a lender of last resort (LOLR), or otherwise, by accessing financing from an international lender of last resort (ILOLR). Guaranteeing involves the state, typically through its central bank, acting as a LOLR in the government bond market to ensure the performability of sovereign debt contracts. This is a precondition for the development of capital and money markets, which have historically depended upon the issuance of government debt guaranteed by central bank money.

During both the GFC and the Covid-19 crisis, the world's core central banks injected vast amounts of liquidity in the financial system by engaging in monetary financing, open market operations, and quantitative easing to de-risk financial assets, including the sovereign debt of their respective governments. Those responses illustrate the capacity of core states to avoid sovereign debt crises by conducting large-scale purchases of sovereign debt, thus keeping bond yields low even in the face of massive bond supply increases in the wake of increased fiscal spending.

However, the LOLR's ability to de-risk financial assets in its jurisdiction is not equally available to less monetarily powerful states. Crucially, a state's ability to guarantee the performability of its sovereign debt contracts while maintaining macroeconomic stability depends on the hierarchy of its currency. Given the higher propensity of investors to dispose of their assets denominated in peripheral currency during bursts in the liquidity cycle, the ability of peripheral central banks to make sovereign debt safe by acting as a LOLR is limited compared to core central banks. Those dynamics, while seldom discussed outside specialist circles, have significantly contributed to the unequal recovery from the pandemic (see *Observer* Summer 2020).

Currency hierarchy is equally critical in establishing the level and conditions under which a state can access an ILOLR. Unlimited, unconditional access to international liquidity amounts to extraordinary flexibility, while limited, conditional access signals a strong boundary in a state's ability to avoid a sovereign debt crisis. Since the GFC, the United States' Federal Reserve has set up a network for unconditional, unlimited swap lines with the world's leading central banks – the Bank of England, the ECB, the Swiss National Bank, the Bank of Japan, and the Bank of Canada. Those arrangements have increased the liquidity available for the parties involved, thereby strengthening their sovereign debt safety by avoiding coordination problems.

However, in contrast with the unconditional, unlimited access to the world's top currency – the US dollar – of those core central banks, access to swap lines is not equally available for other states, with some temporary and limited exceptions to a select group of peripheral currency states in times of crises.

This implies that core currency states can access unlimited, non-conditional reciprocal swap arrangements as an ILOLR, while most peripheral currency states are left with the IMF as their only source of international liquidity. However, IMF financing is subject to significant liquidity constraints posed by the limited resources of the Fund's General Resources Account (GRA). Furthermore, approval of most IMF lending facilities is contingent upon IMF conditionality, which may substantially constrain autonomous decision-making by the debtor state and result in negative economic and human rights consequences (see *Observer* Autumn 2020).

Governing sovereign debt crises in a broken system: A call for urgent IMF action

To correct the monetary determinants of sovereign debt crises, it is essential to reset the international monetary system. This would mean, first, departing from the current dollar hegemony and redesigning the system so that no national currency is able to fully perform the functions of money at an international level. Second, the system must be designed to spread the burden of balance of payments adjustment equally between deficit and surplus countries, thereby incentivizing balanced flows intenationally.

Admittedly, a structural reform of this type would require a major change in the geopolitics of global money that may not be viable in the current circumstances. Yet, the asymmetries and developmental gap posed by the current international monetary order – amidst the prospect of a new wave of sovereign debt crises in DEEs – is set to produce an increasing level of social unrest, with unpredictable consequences for the international community (see *Observer* Spring 2022). In the absence of the necessary reform in the international monetary system, a shorter-term mechanism that establishes a fair, rules-based, expedited solution for sovereign debt crises is urgently required.

However, the IMF has been reluctant to support a statutory mechanism for the collective reorganisation of sovereign debt since the withdrawal of its proposal on a Sovereign Debt Restructuring Mechanism. Presented in 2001 and abandoned in 2003, the proposal included a debt standstill during the restructuring process and a cramdown whereby the agreement of a supermajority of creditors with the terms of the restructuring would have a binding effect on the minority. Instead, the Fund has shifted its policy preference towards the use of collective action clauses (CACs) in bond restructuring. Despite the value of such clauses, they are unable to provide effective solutions amidst the increasing diversification of creditors and lending practices in sovereign debt markets.

It is due to the limitations of CACs that the United Nations Conference on Trade and Development (UNCTAD) and civil society organisations have consistently supported the establishment of a statutory mechanism for dealing with sovereign debt crises. The proposition is ever more relevant as sovereign debt restructuring is increasingly underpinned by geopolitical disputes, as evidenced by the distributive conflict between Western bondholders and Chinese official lenders in recent initiatives such as the G20's Debt Service Suspension Initiative (DSSI) and Common Framework (see *Observer* Spring 2022).

The challenging debt landscape of DEEs amidst the prospect of further fragmentation of multilateralism is bringing the legal governance of sovereign debt crises to the centre stage. It is important that policymakers – including at the IMF – recognise that such crises are not necessarily the product of bad luck or bad decisions by individual governments, but rather a systemic feature of the international monetary system as currently designed. This will allow the Fund to develop a new policy framework that distributes the cost of adjustment between the debtor state and all creditors. To do so, the IMF should rely upon its institutional memory to reinstate its support for an international sovereign debt restructuring mechanism.

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