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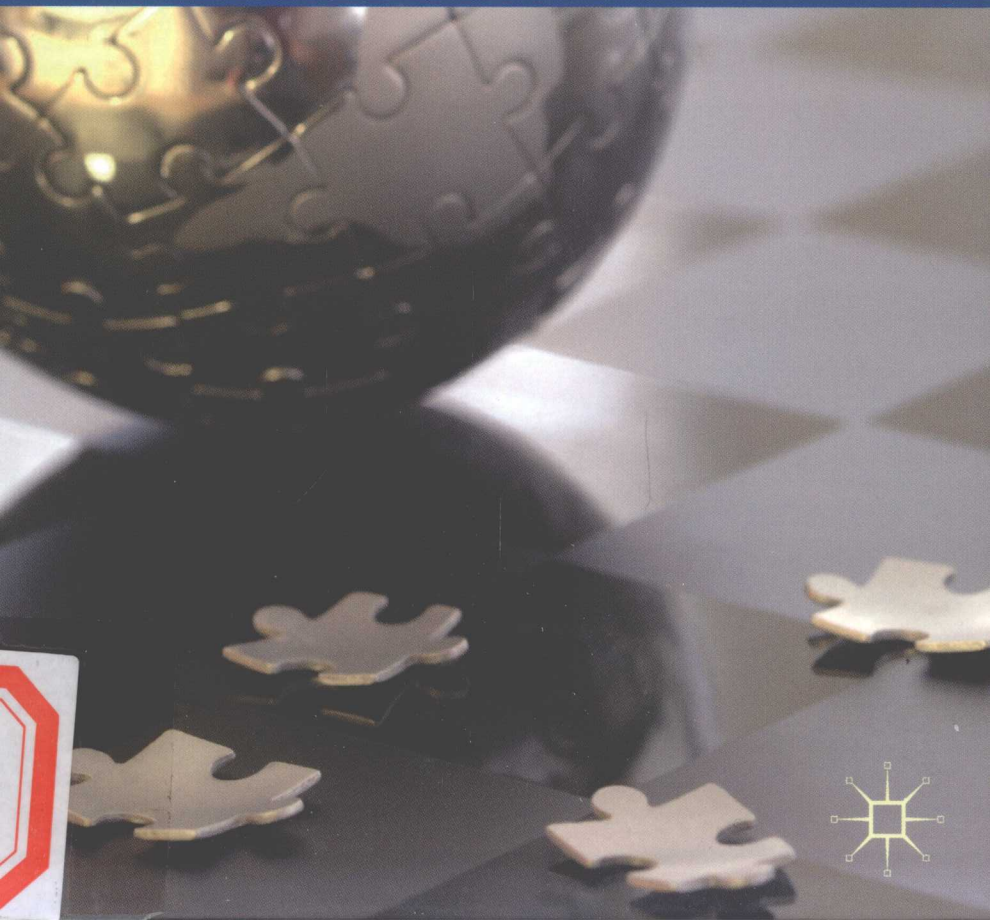
Financialization and Government Borrowing Capacity in Emerging Markets

Iain Hardie



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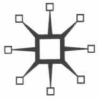

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Preface

This work started with a relatively simple question: why can the governments of some countries borrow so much more than others? At the time I first asked this of myself, it was a question that was largely confined to the emerging markets in which I then worked. To the governments of those countries, it was a profoundly important question. Financial crises were frequent, and they more often than not led to governments having to cut spending and/or raise taxes, usually under an International Monetary Fund programme. Yet for some countries, crisis never occurred, despite, it would appear, ample reasons that it might. Since that time, the 2007–8 financial crisis has clearly brought the question of government borrowing capacity to developed countries. At time of writing, the arguments surrounding the US debt ceiling and future fiscal policy, the possibility of Greece (and potentially others) defaulting, and whether the UK Chancellor of the Exchequer has, or needs to have, a Plan B, are all about government borrowing capacity. The bond market vigilantes, it appears, are out in force, and governments must bend to their will. Yet our understanding of government borrowing capacity remains incomplete, and the vigilantes remain as inconsistent as ever. Economists, political economists and policy makers, many spending a great deal of time on why governments should reduce borrowing, have all failed to answer fully why some governments can borrow more than others.

In attempting to provide that answer for emerging market countries, this book starts with a central claim: governments can effectively borrow as much as markets will lend them at an interest rate that maintains solvency. Models of debt sustainability – in truth little more than calculations of whether current debt levels will rise or fall in future years – must include in their assumptions the future cost of government debt. If the sustainable level of government debt in one country is twice that of another because the cost of the first country's government debt is much lower, an obvious question is this: why can one country borrow more cheaply than the other? Since interest rates are likely to rise most dramatically at times of market stress, it is also necessary to ask why one country's borrowing costs rise less at such times than another's.

Attempts to answer these questions have looked at a number of issues. Investor policy preferences regarding low inflation, central bank

independence and (more controversially) the partisan position of the governing party have all been highlighted. Somewhat unhelpfully for this study, those preferences appear to include low levels of government debt. Important as investor policy preferences undoubtedly are, they cannot provide a complete answer. It is also necessary to understand how investors might react to policies and events they do not like. In considering this, many authors in International Political Economy have asked how patient or impatient, sticky or skittish, financial investors are. This study seeks to build on this work, focusing on the heterogeneity of government bond market investors, their varied likelihood of exit and short selling and the reasons behind that variation. It considers domestic and international investors within a single analysis, and presents a single framework, financialization – defined as the ability to trade risk – for that analysis. As highlighted here, the ability to trade risk goes far beyond issues of government regulation, and by focusing on areas outwith the usual focus of political economists, the study reaches a conclusion that questions the policy recommendations of the International Financial Institutions: governments with less (more) financialized government bond markets can borrow more (less). Increased financialization is not the solution, but the problem.

In the process of researching and writing this book, I have built up many debts. Ironically for a study that treats financial market actors as rational and self-interested, the book could not have happened without 126 interviewees being prepared to give up large amounts of their time to help me. Anonymity prevents proper acknowledgement, but I would particularly like to thank Rola Rizk and Tekin Cotuk for their help in Lebanon and Turkey respectively. Within academia, many have given their time. John Ravenhill provided initial inspiration and ongoing advice, and David Howarth's patience in getting his points through my obduracy is greatly appreciated. Improving comments on various forms of the work came from, among many others, Donald Mackenzie, Mark Aspinwall, Chad Damro, Eric Helleiner, participants on a number of panels at the International Studies Association and the British International Studies Association IPE Group annual workshop and anonymous referees. Participants at the Warwick Manuscript Development workshop 2010 were especially helpful, particularly Jeff Chwieroth and Len Seabrooke. Financial support from the Economic and Social Research Council for this research is gratefully acknowledged. Last, but most definitely not least, without the support of my wife, Rachel, there is no chance that this book would have been finished.

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Introduction

How much can governments borrow from private markets? As governments across the developed world struggle with the fiscal consequences of the recent financial crisis, the view that they could borrow 'as much as they wish' (Griffith-Jones 1991: 117) has been supplanted by questions indicating far greater constraint and less certainty: Why are markets refusing Greece further lending with government debt at 115 per cent of Gross Domestic Product (GDP), while Japan approaches debt levels of twice GDP with little evidence of market concern? Will other European countries, some with government debt levels similar to those of Greece, share Greece's difficulties, with all the implications that might entail for the future of the European Union? Are the UK government or the opposition correct in their claims on the market's requirements regarding the speed of deficit reduction? Even in countries not facing an outright refusal by markets to lend further, the government's capacity to borrow – to spend in excess of income – has become a key influence on government policy. The *Financial Times* (22 April 2009) put the situation facing the then British Chancellor of the Exchequer starkly: 'he cannot open the [spending] taps – the markets will not let him'. After the United Kingdom's inconclusive 2010 election, the leading civil servant advised the haggling politicians that the markets would require a government with a parliamentary majority, and therefore a coalition.

The governments of the middle-income 'emerging market' countries (for discussion of the term, see Mosley 2003: 103) might be forgiven for a certain amount of *schadenfreude* as they contemplate these struggles. The availability of private sector financing has, for them, long impinged on both government policy decisions and election campaigns. The 2010 UK election may have seen (muted) arguments about deficit reduction, but in 2002 the market's fear of a left-wing president

in Brazil necessitated an IMF rescue programme which committed all candidates to fiscal restraint. In exchange, 'we can run a campaign without a sword to our necks' (successful candidate Luis Inácio Lula da Silva, quoted in the *Financial Times*, 9 August 2002), but the result was limited electoral choice. Brazil's net public sector debt to GDP had at this point moved above 60 per cent in what was termed a 'death spiral' (Krugman 2002: 2), and the *Financial Times* concluded in an editorial (15 October 2002): 'At current market rates, even an optimist would admit Brazil is insolvent'. On 9 August 2002, economist Barry Eichengreen forecast default (Santiso 2004: 23). As a Greek politician might have reason currently to envy the borrowing capacity of Japan, so at that moment Lula might reasonably have envied Lebanon's ability, for all its troubles, to sustain net government debt in excess of 160 per cent of GDP with no sign of market constraint, or even the fact that in 2001, the net debt of the Turkish public sector could exceed 90 per cent (IMF 2006a: 35) before an IMF rescue and fiscal restraint proved necessary. Indeed, the Greeks might also have reason to cast envious glances in Lebanon's direction: as Robert Peston, the BBC's business correspondent, noted on the 27 April 2010 UK national news, the yield (and therefore borrowing cost) for two-year Greek bonds was 'almost 12 per cent more than even a country with a troubled history like Lebanon'.

Government borrowing capacity

This study therefore considers a seemingly simple question: why can some governments sustain far higher debt burdens than others? By looking at case studies of three countries, Brazil, Lebanon and Turkey, the book provides an explanation for emerging-market governments' highly varied capacity to borrow from private markets. It is therefore interested in the level of government debt relative to the size of the economy at which governments cannot increase borrowing and/or refinance existing debt. At this point governments must choose between fiscal restraint (reducing the gap between government income and expenditure by increasing taxation and/or reducing government spending), borrowing from international financial institutions (whose conditions will almost inevitably include fiscal restraint) or default. This point is seen here as a debt crisis.[1]

For some countries, even such a broadly defined crisis may never come, for varied reasons. For economic and political reasons, governments may choose to maintain debt levels well below the point at which market constraint may apply. Similarly, the motivation of deficit

reduction may be partisan and/or economic. Even where politicians cite market constraint to justify their actions, reductions in borrowing can be seen as a 'there is no alternative' response to market constraint, as 'giving the markets what we think they may want in the future – even though they show little sign of insisting on it now' (Wolf 2010), or as justification for a partisan policy position. Frequently, however, and particularly (though clearly not only) for emerging market governments, the limits of finite borrowing capacity are actually faced. At this limit, markets may refuse not only to finance further increases in indebtedness, but also to refinance the existing debt, or will only purchase further debt at interest rates that are themselves unsustainable. In other words, solvency and liquidity are for governments inextricably linked; if financial markets will lend to governments – provide liquidity – at sufficiently low interest rates, governments will remain solvent. What is striking are the highly variable levels of government debt at which the constraint on borrowing capacity occurs, and, for some countries, the very high levels of government debt that can be sustained without facing that constraint.

The importance of government borrowing capacity

As noted, the ability to borrow represents the ability of a government to spend beyond its income. It is therefore a key determinant of government capacity to intervene in the economy in both the short and long term. Any shorter-term intervention such as support for the banking system or Keynesian fiscal stimulus depends on the ability to borrow. Borrowing can also be attractive for politicians focused on the short-term electoral cycle (see Geddes 1994 on Latin America). 'Eventually the debt would have to be repaid. For a politician, however, eventually is a long time, certainly farther in the future than the next election' (Frieden 2006: 381; see also Alesina and Tabellini 1992). Very possibly, repayment is a problem not for the next government, but the next generation of voters. The level of debt at which further borrowing is impossible, and debt reduction must begin, varies across countries. The ability to delay fiscal retrenchment is therefore similar to the 'power of delay' seen by Cohen (2006) as a key part of monetary power. Borrowing capacity represents the ability to delay bringing the government back to fiscal balance. Of course, power is best seen as relational, and unlike current account imbalance, one country's fiscal deficit is not directly other countries' fiscal surpluses. Nevertheless, although it may be an extreme view to claim that '[d]ebt is a national security threat,

one of the greatest we know of',[2] the link between borrowing capacity and military spending has been seen as a direct contributor to a British victory in the Revolutionary and Napoleonic Wars (Dickson 1967; Ferguson 2001: 398),[3] as was allied countries' ability to borrow in the United States during the First World War (Frieden 2006: 131). During the cold war, 'a crucial advantage enjoyed by the United States was the ability to finance increased arms spending by selling bonds to the public' (Ferguson 2001: 406).

The central argument in the book

The best way for governments to maximize their borrowing capacity may appear obvious: develop the government bond market to the maximum degree possible, thereby increasing the market's attractions to the full range of investors. Governments should seek to maximize the ability to trade risk in their bond markets, because the greater financial development, the greater government borrowing capacity. Certainly, this represents a fair summary of international financial institution ('IFI') advice. This book, however, argues almost exactly the opposite. Only in the very early stages of market development does borrowing capacity increase, and thereafter capacity falls. Defining financialization as the measure of the ability to trade risk, it is argued that, *ceteris paribus*, the more (less) financialized a government bond market, the lower (higher) the capacity of governments to borrow, relative to the size of the economy, on a sustainable basis.

The financialization of a government bond market is a combination of both the financialization of the structure of the market and of the investors active in that market. The ability of an individual investor to trade risk in a particular market is a function not only of the financialization of the government bond market structure (i.e., the constraints on the trading of risk in the particular market), but also of the financialization of the investor (i.e., their own ability to trade risk). The financialization of the investors that dominate a particular market will interact with the financialization of the formal market structure to determine the ability of all investors to trade risk in that market. More (less) financialized investors are likely to increase (decrease) the financialization of market structure and more financialized markets attract more financialized investors. Despite this interaction, structure and actors can usefully be considered separately.

Less financialized markets allow higher levels of debt-to-GDP in two ways: (1) By supporting lower interest rates; and (2) By reacting to

situations that precipitate, or could precipitate, a debt crisis in ways that make crisis either less likely or less severe.

The financialization of both market structure and of the investors increases the ability of investors to exit, but it is also necessary to move the analysis beyond both standard conceptions of the ability to exit as the selling of securities and also beyond the view of investors' choice as solely between retaining an investment and exit. First, hedging – entering into a financial transaction that offsets another, thereby leaving an investor with no market risk – must also be seen as exit. This is important because investors may be able to hedge, and therefore mirror the impact of exit, in situations where actual exit is not possible.[4] Second, the ability to take risk also includes the taking of short positions – selling securities that are not previously owned. An investor with a short position has not exited a market, as they retain an interest in the performance of that market, but it is not the same as retaining an investment (a 'long' position) as the interest is in prices falling. It is argued here that the ability to short represents a significant increase in the financialization of a government securities market, and, by making a debt crisis more likely, reduces government borrowing capacity.[5]

Furthermore, leverage – borrowing to increase investment – means it is necessary to move beyond the ability to exit to consider the necessity of exit. In a falling market, investors that have borrowed money to finance their investments may have to sell existing positions. As a result, the increased financialization of leverage makes it more likely that investors will have to sell in the event of market weakness, making crisis more likely and more severe. The withdrawal of investment from institutional investors can also force their exit (see Shleifer and Vishny 1997), and the ability to withdraw varies according to investor type: low from pension funds, for example, and high from mutual funds. Performance measurement similarly varies across investors, and can force, not require, or even prevent exit for different investor types.

It is also necessary to broaden the consideration of investor interests and behaviour further. Less financialized investors can see financialization as contrary to their interests, and therefore act in ways that hinder that financialization (see Chapter 2). Their inability to exit or to benefit from market weakness can also result, particularly in crisis or potential crisis (or market stress) situations, in increased investment or other activities that support the government's ability to manage crisis and to borrow (see Chapters 2 and 3). Unfinancialized investors are necessarily neither passive nor unsophisticated, and their activities go beyond simply not exiting an investment.

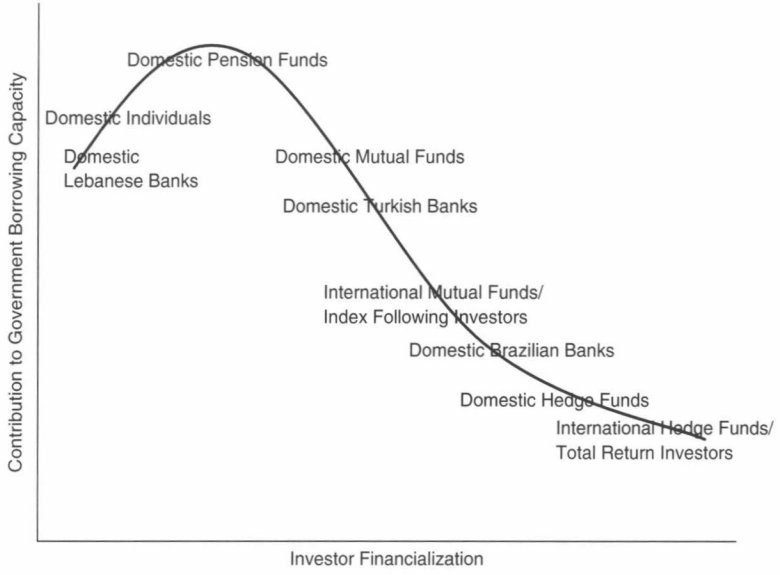

Figure 1.1 Investor financialization and government borrowing capacity

Central to understanding borrowing capacity is therefore the heterogeneity of investors in government bonds, both domestic and international, and the different investors dominant in particular government bond markets. Different investor types, and variations in investors of the same types, have a varied impact on government borrowing capacity. Less financialized investors, if dominant in a market, will generally allow higher levels of government borrowing, although in the early stages of investor financialization, borrowing capacity increases. This variation is set out in Figure 1.1, considering case studies of three countries: Brazil, Lebanon and Turkey.

Existing views on borrowing capacity

The IFIs have well-established views on minimizing the risk of debt crisis and therefore, by implication, on maximizing the debt levels at which they might occur (although reduced levels of government debt is almost invariably the IFIs' policy recommendation): increase demand for government bonds, and maximize the stability of that demand, by attracting investors with the broadest range of opinions (IMF, 2003b; Committee on the Global Financial System 2007). This reduces yields,

and, by increasing the likelihood of sellers and buyers meeting, reduces volatility. The argument is that by increasing the tightness – reducing transaction costs – and depth – the ability to absorb large transactions – of markets, resilience – the ability to withstand shocks – is increased. Investors should be able to follow the broadest range of investment strategies, including short selling, and be able to reverse those strategies easily. In brief, governments should increase the ability of investors to trade risk.

This study challenges these views and resultant policy recommendations, and differs from previous attempts to explain borrowing capacity. Existing explanations can be divided broadly into three (occasionally overlapping) approaches. The first looks at economic variables to explain sustainability. The sustainable level of government debt is modelled using a variety of assumptions. A number of these assumptions – most obviously the current government fiscal balance and growth rates – clearly play a significant role in ascertaining the future direction of debt-to-GDP levels, but sustainability remains difficult to ascertain with any precision (Daseking 2002; IMF 2002; 2006b: 28; for a critique of such models, see Goldstein 2003). Analysis can lead to such conclusions as '[f]or years now, Lebanon has been able to sustain a government debt-to-GDP ratio which is well beyond levels deemed sustainable' (IMF 2006b: 28; see also Schimmelpfennig and Gardner 2008). The second approach to answering the question, which is frequently included in the models of debt sustainability just mentioned, is to examine the composition of government debt: short maturities increase refinancing risk, and debt with variable interest rates and/or denominated in foreign currency will see its cost, measured in the domestic currency, rise as markets fall. For example, the work on 'original sin' (e.g., Eichengreen, Hausmann and Panizza 2002; Eichengreen and Hausmann 2005) shows the problems of borrowing denominated in foreign currency, while analysis of 'domestic original sin' looks at the issues of short-term and/or variable interest rates (Mehl and Reynaud 2005). The increased risks involved in certain types of borrowing are now well recognized, but the solution lies not in government borrowing strategies, but in the willingness of investors to buy long-term, fixed-rate domestic currencies (Ciarlone, Piselli and Trebeschi 2006).

Both these approaches therefore ignore the fact that, at heart, borrowing capacity concerns the actions of bond market investors. At low levels, the amount of debt is the result of government decisions. These in turn can be influenced by such factors as a federal structure of government or the nature of veto players in government policymaking. At higher