The New Thrust of Fiscal Conservatism

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In a new turn to its advocacy of a conservative fiscal stance amidst a recession, the International Monetary Fund in the April 2022 edition of its "Global Financial Stability Report" has called for reining in bank credit to governments as a way of weakening the sovereign–bank nexus that was strengthened during the pandemic and ostensibly threatens bank stability. What is side-stepped is the real possibility that this additional thrust to limit government borrowing would only contribute to an intensification of the recession, adversely affecting bank profitability and increasing rather than reducing bank fragility. The IMF's case seems to be driven by its ideological adherence to fiscal conservatism rather than any effort to address the vulnerabilities that have heightened bank fragility during the prolonged crisis affecting the world economy.

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In the April 2022 edition of its "Global Financial Stability Report" (Chapter 2), the International Monetary Fund (IMF) has made a case for reducing or capping bank lending to governments on the grounds that excess lending by banks to governments, driven by a sovereign–bank nexus strengthened during the COVID-19 pandemic, threatens banking stability. In the IMF's view, this incipient fragility requires governments to not only better "target" spending and implement tighter medium-term fiscal frameworks but also curtail bank lending to sovereigns. To that end, the IMF argues, governments in emerging markets should intervene to implement (i) prudential measures that discourage excess holding of sovereign bonds by banks; and (ii) measures such as "capital surcharges on banks' holdings of sovereign bonds above certain thresholds," which would restrain bank lending to sovereigns. In addition, the report suggests that, though there is "no consensus" on "changes to the regulatory capital treatment of risks from sovereign exposures," the Basel Committee should consider initiating a discussion on the issue to possibly prescribe higher risk weights for bank holding of sovereign debt. If these recommendations from the IMF are accepted by governments and central banks, they would narrow access to what is an important source of financing of government expenditures in many countries.

The effort to target bank lending to sovereigns is one more step in the neo-liberal push to limit proactive fiscal intervention by governments. Advocates of neo-liberal economic policies have in the past combined a call for a business-friendly and lenient tax regime that incentivises private investment with a case for capped fiscal deficit-to-gross domestic product (GDP) and debt-to-GDP ratios. The IMF and the World Bank, besides self-appointed independent spokespersons for global finance, have been vocal advocates of this position. Justified with misplaced arguments that debt-financed spending necessarily triggers inflation and/or crowds out private investment, the cap on government borrowing requires curtailing state expenditure to ensure that reduced mobilisation of tax revenues does not result in enhanced debt exposure. Even during the Great Recession and the COVID-19 pandemic when depressed demand and the need for stimulus spending forced advocates of neo-liberal fiscal policies to dilute the fiscal conservatism they espoused, deficits were discouraged and austerity was imposed in many contexts, especially in developing, "emerging," and "frontier" markets.

For governments expected to provide adequate physical and social infrastructure as well as undertake some redistributive spending that mitigates the effects of income and asset inequality, this call for fiscal conservatism has been difficult to accommodate. This has meant that in contexts other than those where dependence on the IMF or World Bank financing forces acceptance of such conservatism, violation of the tenets of this ideological stance was common. Mere prescription of rules of thumb such as poorly justified maximum levels of fiscal deficit or debt-to-GDP ratios were inadequate to enforce adherence. And methods other than persuasion were needed to get the governments to own and implement a conservative fiscal stance.

Over time, the effort at enforcing fiscal conservatism has targeted access to sources used to finance government deficits. If the flow of finance from the principal sources used to cover budget deficits was cut off or reduced, governments would have no option but to adopt a conservative fiscal stance. An early target was government borrowing from the central bank or the component of the budget deficit that was "monetised." These monetised deficits were erroneously identified as being more inflationary than deficits financed through "open market" borrowing, which in most contexts consisted largely of borrowing from the banking system. Government borrowing from banks was seen as amounting to a net draft on the savings of the private sector, involving no incremental demand infusion that can prove inflationary. Lending to government by the domestic banking system was seen as a process of redirecting credit from the private to the public sector. It was therefore a preferred mode of financing deficits as compared to borrowing from the central bank. In practice, however, banks almost always have the capacity to deliver additional credit to the government and do not have to reduce lending to the private sector to meet additional demands from the public sector.

Monetised deficits were also opposed on the grounds that access to such "on-demand" borrowing from the central bank would encourage fiscal profligacy and undermine the central bank's ability to pursue an independent monetary policy. Privileging central bank "independence," neo-liberal policy advocates made a case for severely limiting or doing away with the practice of borrowing by governments from the central bank.

Even if governments adhered to this principle, they could still borrow from the "open market" and peg their expenditures at levels that involved overall budget deficits and aggregate borrowing relative to the size of the economy that were considered "imprudent." To prevent this, the power wielded by the IMF, the World Bank, and the international financial capital was mobilised to persuade governments to tie their own hands by passing legislation that set ceilings for the level of the fiscal deficit-to-GDP ratio and the public debt-to-GDP ratio and defined a path along which those ratios must decline over a specified time span. To realise such stringent goals, governments needed to cut spending, necessitating austerity measures in countries where fiscal headroom was reduced massively as a result of such measures.

Given the adverse economic and social consequences such expenditure reduction can have, many governments were unable to realise these targets and resorted to "unacceptable" levels of debt-financed spending by borrowing from the banking system. This possibly explains the IMF's more recent case that even lending by banks to sovereign governments must be limited, not just because government deficits have to be curtailed but because a spike in bank lending, especially in response to the COVID-19-induced crisis, has strengthened the "sovereign–bank nexus" in emerging markets to a degree where these countries have become "vulnerable to macro-financial stability risks." In fact, the "Global Financial Stability Report" presents a strong version of this argument, starting with the premise that public debt in emerging markets is already at elevated levels. Bank lending, it notes, financed a large share of the response to the COVID-19 pandemic. According to the IMF: "In emerging markets, the discretionary fiscal response to the pandemic averaged about 10 percent of GDP during 2020–21." In the event, domestic sovereign debt exposure of banks

> touched 17% of total banking sector assets in 2021—as the additional government financing needs (resulting from the pandemic) have been met mostly by domestic banks amid declining foreign participation in local currency bond markets and a generally limited domestic investor base.

Hence, it is held that if sovereign borrowing is raised further, debt sustainability concerns are bound to rise. Moreover, since close to half of the stimulus took the form of equity, loans, and guarantees, "the corporate sector has become highly dependent on the continuation of policy support in cases where the economic recovery has yet to firmly take hold."

All this, it is argued, matters for several reasons. First is that growth in emerging markets is projected by the IMF's *World Economic Outlook* to be weaker relative to the pre-pandemic period at a time when the ability of governments to use its own resources to spend or cut taxes to support the recovery is under strain. This is likely to further increase the public debt-to-GDP ratio, thereby increasing sovereign debt risk. Second, monetary policy "normalisation" in the advanced and emerging economies could raise borrowing costs and make debt rollover more difficult to negotiate. This could make it "more difficult for both sovereigns and banks to obtain funding, while also leading to sharp currency depreciations (or a currency crisis) that further strain sovereign and bank balance sheets." These trends could adversely affect debt sustainability in countries where banks are excessively exposed to sovereign debt. Third, in case bank stress increases in today's more trying circumstances, governments would need to step in and support the banks, further weakening the sovereign balance sheet. Increased bank stress is already visible in many countries with a high ratio of non-performing assets to advances. Finally, reduced governmental capacity to support the real economy can keep growth low, increasing corporate vulnerabilities and bank losses and amplifying sovereign stress.

In sum, direct exposure to sovereign debt in circumstances that (i) reduce the value of government debt; (ii) reduce access to a governmental safety net because of sovereign stress (or fiscal conservatism); and (iii) encourage fiscal "consolidation" that reduces the stimulus for growth and affects bank profitability, all combine to increase bank vulnerability and financial system fragility. Sovereign stress could lead to bank fragility or vice versa.

The IMF's elaborate discussion on bank fragility resulting from excess sovereign lending has two components to it. One is to provide a summary of the myriad ways in which economic circumstances resulting from the long-delayed and anaemic recovery from the Great Recession that followed the global financial crisis, the impact of the COVID-19 pandemic, and the fallout of the ongoing war in Ukraine have heighted financial fragility in advanced economies and emerging markets. The other is to argue that the bank fragility, which resulted from these circumstances, has been heightened by the increased exposure of banks to sovereign debt, thus necessitating a reduction in such exposure using multiple measures.

These two components are obviously contradictory. What the current situation demands is enhanced state spending to both stimulate the economy and provide safety nets for the most vulnerable. And since there are limits to raising tax revenues in the midst of a recession, it must be borrowing in domestic currency that must finance much of that spending by government. An important source of such borrowing is the banks. To foreclose that option is to worsen the recession and increase bank fragility as the IMF report implicitly recognises.

To justify the adoption of this contradictory stance, the IMF has chosen to treat banks' holding of sovereign assets as being similar to their holding of private sector debt; this is patently wrong. The probability of default on domestic currency sovereign debt is low, given the ability of the sovereign to tax in the future to meet debt service commitments. This makes debt-financed state spending crucial in the current context, with the caveat that spending patterns and supportive policies should be such as to keep inflation within the acceptable limits.

Moreover, increased bank exposure to the sovereign is more a consequence of the crisis than its cause. While even in normal times, some holding of sovereign debt by banks is "enforced" through the imposition of liquidity requirements, a significant share of the increase in such holdings in troubled times is a reflection of the flight to safety away from debt provided to stressed private operators. Downplaying this, the IMF's report goes as far as saying that the stress induced by both government and private borrowing in these troubled times is similar based on its observation that "sovereign and bank credit risk remain closely tied in emerging markets, as reflected by the positive correlation between sovereign and bank credit ratings." The reality is that this relationship is led by sovereign ratings. As the report acknowledges:

> While downgrades of firms and sovereigns may both be driven by a deterioration in economic fundamentals, sovereign downgrades are more likely to cause the downgrades of highly rated firms because of rating agencies' ceiling policies. These policies often require that firms' ratings remain at or below the sovereign rating of their country of domicile.

Any sovereign ratings downgrade results in a simultaneous downgrade of corporate debt, but a fall in corporate debt ratings need not affect the sovereign ratings at all. In other words, what similar sovereign and bank credit risk ratings show is that the crisis is of a kind where the stability of many sovereign borrowers is also in question. Not because the sovereigns have borrowed too much, but because they have not found a way of pulling their economies out of the recession.

The IMF has no meaningful recommendations to offer on how governments could do that. All it seems to be concerned with is pushing for the further weakening of government by cutting off access to bank credit, which will only worsen the recession and increase bank fragility.