Addressing Liquidity Challenges

Memo to the Global Sovereign Debt Roundtable
9 September 2024

The current debate about sovereign debt liquidity challenges in the Global South covers four distinct issues, which are sometimes conflated.

1. **Liquidity vs. solvency crises:** While the problem at hand – the reversal of net debt flows by private and some bilateral creditors – is a typical liquidity problem, the unwillingness of these creditors to roll over their debt partly reflects a loss of confidence in low and middle-income countries' sovereign debt, which is a solvency problem. While the IMF/WB's background note for this workshop emphasizes that low-income countries' debt stocks are lower than what they were before the Highly Indebted and Poor Countries (HIPC) initiative and that debt sustainability analyses mainly reveal a medium-term liquidity problem, these analyses actually show that solvency is a concern, too: see table below. Moreover:

    a. *Liquidity indicators matter most:* Debt stocks matter because they drive future debt flows. But it is debt flows (i.e., debt service) that drive austerity, generate social unrest and political turmoil, and undermine the Sustainable Development Goals.

    b. *Domestic debt makes matters much worse:* The analysis is often circumscribed to external debt. But the dramatic rise in domestic debt, which is also very costly and crowds out domestic private investment, is the elephant in the room. Low- and middle-income countries spend on average more to service their total debt as they spend on education, health, and social protection combined.[1] That does not come across in IMF/WB's debt sustainability analyses because they exclude the total public debt service-to-revenue ratio – the most important indicator of debt sustainability in the eyes of many civil society organizations.

    c. *The thresholds may not be right:* Given the track record of demanding and conceding too little debt relief, too late, past experience (from which the thresholds are derived) is not a good guide for policy. Debt profiles have changed, with a much higher proportion of debt due to expensive private creditors. Low-income countries also ran high arrears before HIPC. That may imply that the current solvency thresholds are too high: low-income countries can carry less debt stock when they do service high-cost debt.

Number of countries breaching IMF/WB thresholds for "high risk of debt distress"

	2020-24	2025+	2025-29	2030+	Never
Liquidity breach	25	21	19	11	39
Solvency breach	26	26	19	18	35
Either	29	33	25	23	30

Source: Oxfam compilation based on https://www.worldbank.org/en/programs/debt-toolkit/dsa
Notes: The table covers the 67 countries subject to the IMF/WB's Debt Sustainability Framework for Low-Income Countries (LIC-DSF) for which data is available. The solvency row includes both the external and total (external plus domestic) public debt stock indicators (debt stock-to-GDP and debt stock-to-exports ratios). Any country breaching the high-risk threshold for at least one of these indicators in at least one year in the relevant period is counted once. For liquidity, only external debt is included (debt service-to-revenue and debt service-to-exports ratios) because the LIC-DSF does not have thresholds for total debt flow indicators. For some countries, the latest debt sustainability analysis is several years old and projects a high risk of debt distress during a period that is now past (2020-24). Ghana and Zambia are counted only in that period because they have recently received debt relief, such that they will presumably no longer be at high risk in 2025.

2. **Short-term vs. long-term crisis:** Liquidity crises are often conflated with short-term crises. Debtors face a short-term challenge to refinance a bundle of debt that comes due at once. Once they manage to roll over these debts, they will be fine. However, the above table shows that the global debt crisis is projected to last over the long-term.

3. **Debt rescheduling vs. cancellation:** Moving from diagnosis to remedy, liquidity crises are often associated with debt rescheduling as the appropriate policy response (since the problem is only excessive bundling of principal repayments), as opposed to debt cancellation for solvency crises. In deep crises where deeper debt relief is required, lowering interest rates can complement rescheduling with very long-term maturities. Such restructuring can provide the same level of relief as cancellation in terms of net present value reduction. Nevertheless, the academic literature indicates that debt cancellation is superior to debt restructuring in terms of resuming economic growth.[2]

4. **Voluntary restructuring vs. default:** Liquidity crises are sometimes associated with the idea that they can be resolved with voluntary, pre-emptive restructuring (i.e., without default). That is the case of the Bridge proposal.[3] The rationale for a voluntary approach is that debt cancellation has proved cumbersome to implement owing to the diversity of creditors. However, (i) the Common Framework is making slow progress thanks in part to the Global Sovereign Debt Roundtable; (ii) making further progress is a matter of political will; (iii) a voluntary approach would face the same diversity of creditors with the same coordination problems; (iv) the looser interpretations of the comparability of treatment principle that such approach would likely entail would make coordination even more challenging; and (v) it would be starting from scratch. Moreover, the various measures envisioned to incentivize all bilateral and private creditors to participate in voluntary restructurings are weak:

    a. *More multilateral funding:* That is certainly much needed. But it is doubtful that it will crowd in substantial private investment when debt stocks remain high (and even rise if the multilateral funding takes the form of (un)concessional loans instead of grants).

    b. *National "anti-holdout" legislations:* They are certainly much needed, too. But they are only triggered when debtors default. While the shadow of such laws may marginally increase private creditors' willingness to negotiate pre-emptive restructurings, it is doubtful that they will generate enough cash flow to restore positive debt flows from private creditors. The same holds for collective action clauses in bond contracts facilitating present value-neutral reschedulings or debt-for-nature swaps. They are good ideas with limited potential impact.

    c. *Strengthening the IMF's lending into official arrears policy:* That is again very welcome. But that, too, is only triggered when debtors default, has a limited impact on pre-emptive restructuring negotiations, and is unlikely to restore positive debt flows from bilateral creditors.

    d. *Guarantees:* Taxpayers underwriting the restructured debt to the private sector does have the potential to restore positive debt flows from the private sector. However, it is tantamount to bailing out the private sector much like giving grants to debtors in the context of negative debt flows from private creditors – which is what policymakers say they want to avoid. It is also unsustainable because debt stocks would remain high; official creditors would find it difficult to scale back guarantees.

Overall, dealing with the so-called liquidity crisis with voluntary debt rescheduling processes would be a reckless gamble. Too much rests on the assumption of a quick resumption of growth in debtor countries. Too many things can go wrong – from ongoing adverse global conditions that this note did not even touch on, to implementation failures of a complex and shaky plan, and to ongoing weaknesses in debtor countries themselves. We have seen this movie before: low-income countries lost a decade of economic and social development while their creditors buried their heads in the sand and kicked the can down the road before finally conceding the inevitable debt relief under HIPC. Yes, policymakers must increase multilateral funding and adopt national anti-holdout legislations, and it is good that the IMF strengthened its lending into official arrears policy, but, no, guarantees must not be profusely handed out, and instead debtors must harness the courage to default,[4] and creditors to offer generous debt cancellation.

---

[1] Martin, Matthew and David Waddock (June 2024) "Resolving the Worst Ever Debt Crisis: Time for an Ambitious initiative?", Norwegian Church Aid. https://www.kirkensnodhjelp.no/contentassets/c1403acd5da84d39a120090004899173/ferdig-time-for-a-nordic-initative-lowres-ny-september.pdf

[2] Independent Evaluation Office (2021) "Growth and Adjustment in IMF-Supported Programs", International Monetary Fund. https://ieo.imf.org/en/our-work/Evaluations/Completed/2021-0909-growth-and-adjustment-in-imf-supported-programs
Forni, Lorenzo, Geremia Palomba, Joana Pereira and Christine Richmond (2016) "Sovereign Debt Restructuring and Growth", International Monetary Fund Working Paper 16/147. https://www.imf.org/external/pubs/ft/wp/2016/wp16147.pdf
Meyer, Josefin (2024) "200 Jahre Staatsschuldenkrisen: Wiederholte Umschuldungen können mit höheren Gläubigerverlusten einhergehen", DIW Wochenbericht 6/2024, pp.83-89. https://www.diw.de/de/diw_01.c.892029.de/publikationen/wochenberichte/2024_06_1/200_jahre_staatsschuldenkrisen___wiederholte_umschuldungen_koennen_mit_hoeheren_glaeubigerverlusten_einhergehen.html#section4
Reinhart, Carmen (2015) "Sovereign Debt Relief and its Aftermath", HKS Working Paper RWP15-028. https://www.hks.harvard.edu/publications/sovereign-debt-relief-and-its-aftermath

[3] Diwan, Ishac, Martin Guzman, Martin Kessler, Vera Songwe, and Joseph Stiglitz (July 2024) "An Updated Bridge Proposal: Towards a Solution to the Current Sovereign Debt Crises and to Restore Growth", Finance for Development Lab. https://findevlab.org/news_and_event/the-bridge-proposal-a-solution-to-the-current-sovereign-debt-crises/

[4] Syed, Murtaza (28 August 2024) "Break the taboos propping up unsustainable debt, pleads a former central banker", The Economist. https://www.economist.com/by-invitation/2024/08/28/break-the-taboos-propping-up-unsustainable-debt-pleads-a-former-central-banker