REGIONAL PERSPECTIVES

THE IMF MUST LEAD ON DEBT SUSTAINABILITY

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When considering the economic and development challenges of developing economies in the face of the climate crisis, most people tend to view debt as a complicating factor at best and a source of many of our problems at worst. There are good reasons for this. Rising public debt across the developing world—and the surging interest bills that accompany it—is diverting public funds from already underfunded health and education programs. It threatens to push more countries into outright distress and more people back into poverty.

Yet there is no escaping the fact that debt will continue to be a critical component of the funding developing economies need to meet their sustainable development goals—particularly climate resilience—and fulfill their economic development potential more generally. The challenge, therefore, is to both lend and borrow "better." What does this mean?

Reform of its lending arrangements for middle-income countries is overdue

Well, for sure it means ensuring that public borrowing is anchored in sustained fiscal discipline. However, it also means avoiding debt that is very likely to prove unsustainable. While overall debt sustainability is determined by multiple factors, experience teaches us that the rate of economic growth is the most important driver of debt dynamics. There is a simple rule to help determine when the terms of new borrowing are unlikely to prove sustainable over time, at least when it comes to cost: put simply, rates of interest that are likely to exceed the rate of future nominal growth cannot be considered sustainable. The more such rates feature across a public debt portfolio, the greater the likelihood of sovereign debt distress in the future.

Flawed framework

Although there has been much focus on the very high interest rates paid by some developing economies on their Eurobond issuances since the start of 2024, the problem of unsustainably high borrowing costs is also evident in lending by the official sector. In fact, the recent rise in global interest rates has revealed a flawed IMF lending framework for middle-income countries that no longer supports debt sustainability. It is in desperate need of reform.

MICHAEL D CADOGAN/ALAMY

People clean sargassum seaweed from a beach in Barbados.

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Let's start with the central issue of cost. At the start of the millennium, surcharges were introduced on all IMF lending to middle-income countries through the General Resources Account (GRA), which includes Stand-by Arrangements (SBAs), Extended Fund Facilities (EFFs), and Rapid Financing Instruments (RFIs). The surcharge structure comprises a level-based surcharge of 2 percent on GRA borrowing that exceeds 187.5 percent of quota and an additional 1 percent "time-based" surcharge on the portion of GRA credit above this threshold that is outstanding for more than 36 months (or 51 months in the case of the EFFs).

The IMF introduced these surcharges when it was trying to extinguish the flames of the first emerging market debt crises, including by burning through its own capital. The underlying objective of the new surcharges was to dissuade large and prolonged borrowing from depleting the IMF's resources, particularly among higher-rated emerging market sovereign borrowers. The surcharges worked well, and these countries quickly regained investment grade ratings after the crisis. Years later the approach worked well again: Organisation for Economic Co-operation and Development countries that had been forced to borrow from the Fund during the global financial crisis were able to prepay their IMF liabilities once the worst of the instability problems had subsided, thanks to deep domestic capital markets.

But the world has changed radically over the past 25 years. For a start, the IMF has gone from having precautionary balances of $6.2 billion as of April 1999 to approximately $33 billion as of April 2024. It has also succeeded in making a much-needed pivot, gradually expanding its role as a lender of last resort to become a partner of some of the poorer and most fragile countries in the world at a time when their access to liquidity has been severely compromised.

The scale of IMF lending has also increased. In fact, 187.5 percent of quota is no longer a big deal: as of April this year, 21 middle-income countries had borrowed above this level from the Fund. Compared with a decade ago, the average per capita income of countries with active EFFs has fallen by a factor of 4.

Yet the Fund's surcharge regime remains unchanged and has exposed fragile sovereign borrowers to the full force of rising world interest rates, even though the IMF is now well capitalized and does not rely on market borrowing to fund its lending arrangements.

Surcharge regime

As of June this year, the minimum all-in interest rate payable on GRA disbursements (this covers SBA, EFF, and RFI disbursements) had surged to 5.1 percent a year, with sovereigns paying 7.1 percent on the portion of their drawings that exceeds 187.5 percent of quota. GRA liabilities outstanding for three years or more (or four in the case of the EFF—less than halfway to final maturity) now have a record interest rate of 8.1 percent. The IMF cannot argue that its lending programs have debt sustainability at heart when its own lending to middle-income countries cannot be considered sustainable.

This is a problem the IMF must address. Incentivizing sovereign borrowers to repay the IMF is not wrong in itself, but it is wrong in a world where

most GRA borrowers have no reliable access to alternative sources of sustainable financing. The IMF's surcharge regime needs to be reformed urgently—either through a radical overhaul that includes caps that take into account the interest rate cycle or preferably by scrapping it outright.

But costs are not the only area of IMF lending that needs urgent reform. Tenor matters, too. Take the EFF—an instrument designed to address balance of payments imbalances caused by structural weaknesses in the economy. It is widely accepted that structural reform is a complex task that takes time to implement and years to bear fruit. Yet in the EFF we have a lending instrument that disburses over only three or four years and has to be repaid in seven (on a weighted average basis). A facility that is so constrained is simply not fit to support structural reform at a time of "polycrisis" and in light of the increasingly devastating effects of the climate crisis.

Perpetual programs

It should come as no surprise, therefore, that so many middle-income countries are locked into perpetual programs, borrowing from the IMF just to repay the IMF. This is not good for sovereign borrowers, it is not good for the IMF, and it is not good for the people the IMF is meant to serve.

Forty-five years have passed since the EFF was last reformed, in 1979. Fresh thinking on IMF support for middle-income countries from what we know to be dedicated and capable management and shareholders is long overdue.

It is therefore fortunate that the IMF, under its current leadership, has in recent years already demonstrated a capacity for fresh and innovative thinking, often moving before others. This was evident in the quick rollout of the RFI and the Rapid Credit Facility soon after the pandemic broke out and the subsequent allocation of a record $650 billion-equivalent in SDRs. More recently we have seen the introduction of the Resilience and Sustainability Facility—a facility funded by rechanneling a portion of the new SDRs and designed to help finance climate resilience and adaptation for countries that already have an IMF upper-credit-tranche arrangement. Critically, this new facility has a final maturity of 20 years and carries no surcharges.

As they confront the multiple crises of the early 21st century, middle-income countries need lending arrangements that are fit for purpose. It's time for the IMF to switch its attention to fundamental reform of its existing lending arrangements for middle-income countries.

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REGIONAL PERSPECTIVES

A CONSENSUS IS FORMING FOR IMF REFORM

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For over eight decades, the IMF has stood as a pillar of global macroeconomic and financial stability. Originating from the Bretton Woods conference attended by 44 delegations, the IMF now encompasses 190 member countries, with Africa's 54 members forming the largest regional group. This growth reflects a significant evolution from the original framework designed to support the gold standard of fixed exchange rates. The collapse of that system 50 years ago shifted the IMF's role from underwriting fixed exchange rates to promoting flexible exchange rates.

The IMF must listen to the needs of its global membership and adapt to emerging challenges

In response to these shifts, the IMF has evolved into a development financing institution. Its current portfolio stands at $112 billion spread across 90 countries, translating to just over $1.2 billion per borrower. Excluding Argentina ($32 billion), this figure falls to $900 million per borrower, and further to just under $700 million when excluding the top three borrowers (Argentina, Egypt, and Ukraine), which account for 46 percent of the portfolio.

If a conference akin to Bretton Woods were convened today, it would likely focus on the inter-