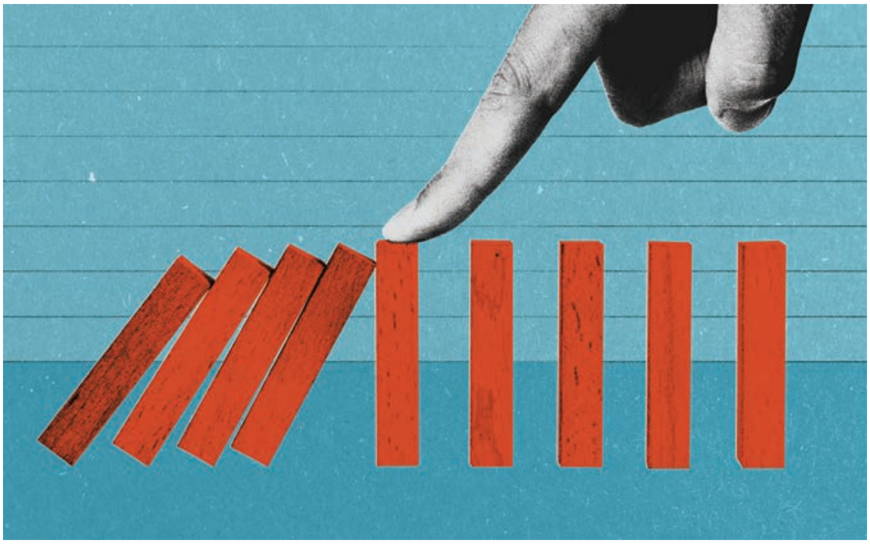

How to Deal with Debt's Downside

Anne O. Krueger

International arrangements for rescuing countries from debt distress must be improved

Mounting debt in developing economies is a growing concern. Some countries, including Sri Lanka and Zambia, have already declared that they cannot service their debts and have sought international assistance. Many others face onerous debt service obligations amounting to several percentage points of GDP.

Debt is a blessing and a curse. It enables developing economies with promising prospects to finance the investment in roads, schools, hospitals, and other areas they need to turn those prospects into realities. If investment produces the expected high rate of return, countries can service their debts. That was the case in Korea in the 1960s.

Back then, Korea was a poor country with a low saving rate of less than 10 percent. It borrowed about 10 percent of GDP a year, but its fast-growing economy generated such high investment returns that its debt servicing ratio actually fell. Over time, its domestic saving rate rose so that it could sustain strong investment-led growth without recourse to foreign debt. Today Korea is among the world's richest nations.

Debt, however, can become a problem when it's used to finance current consumption or poorly conceived investment. When investment doesn't pay off, the borrowing country is made poorer because it must still service the loans it took out to finance it. The likelihood that further borrowing will produce higher returns usually falls because mounting concerns about creditworthiness push up interest rates. If the borrower's economic prospects worsen, creditors can and do refuse to roll over debt.

Range of risks

When deciding whether to extend additional credit to a developing economy, lenders must weigh up a range of risks, from the country's macroeconomic policies and prospects to possible swings in the prices of its principal commodity exports. Sometimes promises of policy reform by an incumbent or incoming government—perhaps in conjunction with an IMF program—can convince lenders that the country will restore its creditworthiness. In these cases, lenders usually agree to roll over maturing debt.

But when government policy produces poor results and politicians refuse to change course, lenders will likely insist on repayment when debt falls due. The result is a debt crisis. Balance of payments pressures can become so acute that the borrower cannot even pay for imports of essential goods and services.

That was the case in Sri Lanka in 2021. When the crisis hit, the country could afford imports only of essentials, such as food and fuel. Buses did not run, so people couldn't go to work. Many factories could not obtain raw materials, intermediate goods, or spare parts. Lengthy power outages were common. Economic activity fell sharply, by 7.8 percent in 2022 and a further 3.8 percent in 2023. Grocery stores emptied of essential goods. Inflation spiked.

Three things had to happen for Sri Lanka to rebuild its credibility and set the stage for recovery and sustainable growth. First, the country needed a source of foreign exchange to buy essential imports to restart power plants, fac-

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Illustration by Chantal Jahchan

tories, transport, and other essential services. Second, it needed debt restructuring so that lenders could be confident that debt would be serviced. And third, it needed domestic policy reform.

Political resistance

Without policy reform, foreign exchange might have provided some short-term relief. But Sri Lanka would not have received private financing for imports until it resolved the problem of unsustainable indebtedness. The situation became so dire that protestors overthrew the government. Policy reform became possible only when a new president took office in 2024.

Politicians are almost always cautious about reform that is likely to encounter stiff political resistance. The choice, however, is between short-term pain or letting the situation get worse and causing even more pain in the long run. The big risk is that reforms do not go far enough and fail. The reformers themselves are then unfairly blamed.

The IMF plays a supporting role in resolving challenges like Sri Lanka's. It is the institution responsible for safeguarding the international monetary system. Its core strength is its ability to assess a country's macroeconomic situation. The Fund has financial resources that can be lent (usually for not longer than three to five years) to support countries in difficulty. But the IMF charter states that it can do so only when there are reasonable assurances that the borrower will be able to service the loan. Sri Lanka's authorities and the IMF agreed to a reform program. However, Sri Lanka also needed to restructure its debt to deal with its arrears and regain access to international credit markets.

Holdout creditors

When a country was in serious difficulty in years past, sovereign lenders met through the Paris Club. They would discuss a program to restore growth and creditworthiness on which the country's authorities and the IMF had already reached an understanding. Private creditors also met. The IMF was consulted as the country and its creditors negotiated debt service adjustments—often a "haircut" (a reduction in the face value of outstanding debt) and perhaps a pause in payments. When all parties agreed to the restructuring plan, the IMF would then lend (often in conjunction with new loans from bilateral sovereign creditors).

In the past decade, however, China has become a large sovereign creditor but has chosen to remain outside the Paris Club. While it has granted debt relief in many cases, it does not have fully developed internal processes for considering haircuts and has given its lenders only limited discretion to reschedule debt service payments.

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Sri Lanka was one of the first countries with China as a large creditor to reach a point where its debts proved unsustainable. It took almost two years for the rest of the international community to work out an agreement that satisfied the Chinese, and the IMF program was delayed by nearly a year as a result. This prolonged the pain for Sri Lankans.

Clearly, the IMF cannot be expected to lend if creditors and private lenders suspect their loans will be used to finance debt service to a holdout country. In Sri Lanka's case, no creditor would restructure, and so the IMF could not resolve the country's problems. At the same time, delays restructuring debt while awaiting the holdout creditor's decision piled pressure on the crisis-stricken country and pushed back economic recovery.

A better way

We must find a better way to address the problem of developing economy indebtedness. At a minimum, countries in crisis must be able to develop a restructuring plan with the IMF, the Paris Club, and other creditors. There must be a stronger arrangement (beyond the incentives of the IMF's lending into arrears policies) under which a holdout sovereign creditor will not receive debt service payments until it accepts the same terms as other creditors. It would be even better for China to join the Paris Club.

An internationally agreed procedure and tribunal where creditors and debtors alike could present their claims would be better still. The tribunal could determine a settlement that enables normal economic activity and sustainable growth to resume while also giving creditors as fair a settlement as possible under the circumstances. With debt problems mounting, it's time to reform existing arrangements. F&D

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