Dealing with the new wave of debt overhang series

Key takeaways from session 1: A Framework to Evaluate Adjustment-cum-debt Restructuring Deals

Ishac Diwan and Reza Baqir introduced the paper, stressing that **a new wave of debt crises is approaching** and will be quite different from the one in the 1980s, in particular given:

- The more **complex heterogeneity amongst creditors**: multilaterals, private, China (largest credit and new at this) and the public.
- The changing **nature of the growth process**, in response to de-globalization, and to the climate crisis.

"These features suggest the need for a new framework for debt restructuring based on tripartite agreements facilitated by restarting growth." Ishac Diwan

The first principle behind the new framework highlights the priority of embedding the process in a **restructuring of the debtor's economy,** in order to put it on a new **green path**, thus **unlocking new growth opportunities** rather than focusing on liquidation or a punitive approach.

New investments (climate change adaptation, improving food security, digitalisation, clean power generation, etc.) require **new loans, as investment needs of the green transition are larger** than during reforms in the 1980s. New finance needs to be provided early on by the IFIs whilst **leveraging private finance** at the same time.

The second principle is to see debt restructuring deals as 3-way agreements between a debtor, its creditors, and the IFIs:

- The debtor government undertakes adjustment policies – i.e., invest in growth opportunities which will pay off in the future – but can only do so if additional resources are provided
- IFIs/MDBs can safely lend those resources only if the old creditors undertake sufficient debt (and debt-service) reduction
- Old creditors will provide debt reduction only if the IFIs can apply effective conditionality to ensure appropriate adjustment and growth policies are in place.

Reza Baqir continued by first speaking about the experience of Pakistan which has shown that the structural reform agenda often gets crowded out at the expense of the macro targets. He suggested that a longer horizon HIPC-like program may help improve that balance and the cooperation between the IMF and the World Bank.

"A better balance between the structural agenda and the macro targets is crucially needed." **Reza Baqir**

He also suggested improvements in the debt restructuring process to make it faster.

"Rather than ask the debtor to secure financing assurances, why don't the IFIs and bilaterals negotiate directly, for example in DC, where the debtor is also represented at the Boards of the Bretton Woods institutions?" he asked.

He also suggested to rethink the participation of IFIs in burden sharing. The private sector needs to be around the table from the outset, and treated better, since at the end, it will have to refinance IFI loans in order for them to remain solvent.

All discussants praised the focus on growth centred adjustment programs, and tripartite agreements. While the framework provides a good starting point, each discussant expressed some scepticism over particular aspects of the puzzle that would need to be thought about more deeply.

Carmen Reinhart highlighted the length of the process, as private lenders in particular resist debt reduction. In the 19th century, default took many decades to resolve. After the multilaterals came into being in 1946, the process was shortened but for the last one (1980s), the average process took about 8 years. She worried that new money may come to substitute for the debt reduction needed to reduce existing debt overhang.

"I am sceptical of emphasizing new financing as a priority rather than outright debt relief to reduce the debt overhang." **Carmen Reinhart**

She also stressed that during moments of crisis, the drive for firefighting swamps the will to plan for the much needed long-term reforms.

"Unfortunately, I am afraid the climate agenda might end up on the back burner given that there are so many other competing needs." **Carmen Reinhart**

Celestin Monga likes thinking about debt restructuring in game-theoretic fashion, underlining the risk of free riding and ending in a prisoners' dilemma.

He wondered about the real causes of debt crises and how to avoid them.

"In recent years, after HIPC, the quality of governance improved, the growth outlook was positive before the Covid pandemic, and much of the new loans were invested in infrastructure. So why do we have a debt crisis again?" Celestin Monga

He believes that a main reason for the current difficulties is that the **debt contracts are too inflexible** in the face of large negative shocks.

Long-term finance is needed to build infrastructure, but shocks will occur – as reflected for example in the rise of security spending in many African countries in recent years. If debt is not the right financing instrument, what is the alternative?

Shanta Devarajan agreed that the focus on adding a growth dimension to debt restructuring was spot on and that the idea of a tripartite agreement (creditors/ debtors/IFIs) is also a welcome contribution.

"The debtor country's incentive to reform is tricky. It can be tempting to use new finance to delay reforms. How to ensure that it delivers its side of the bargain is a key issue that is often very difficult to resolve." Shanta Devarajan

In Sri Lanka, the debt crisis was due to misguided and reckless policies by the government, such as the tax cut of 2019 that led to a fall in revenue of 8% of GDP. Fiscal deficit ballooned thereafter and by 2020, credit rating agencies rated Sri Lanka to near default levels. Whilst most governments would have gone for restructuring and IMF programmes, Sri Lanka refused and continued to pay its debtors using fiscal reserves financed by Central Bank borrowings. Unsurprisingly, the country ran out of reserves 2 years later, inflation hit 70%, and Sri Lanka defaulted. The question that the Sri Lankan experience suggests is: how to ensure that governments actually take appropriate measures to implement the required growth-oriented policies?

He also stressed that China has not fully bought into the **principle of inter-creditor equity**. This is compounded by the **lack of coordination among Chinese institutions**. Since it is the largest official creditor, China can hold up the process on the debt restructuring for a long time. Geopolitics also need to be taken into account: US/China tensions are being played out negatively in Sri Lanka's debt negotiations.

"We need to find a way to remove geopolitical considerations from debt restructuring processes." **Shanta Devarajan**

Simon Cueva welcomed the paper's emphasis on growth, but he highlighted the complexity of building internal political consensus to address the regulatory weaknesses that need to be fixed in order to implement a credible adjustment programme to can effectively boost growth.

"Many LMICs lack institutional capacity and ability to reach political consensus, meaning that IFIs programmes cannot be overly ambitious." Simon Cueva

This explains why they tend to be more focused on the short term and on macro-economic issues rather than on the long-term structural impediment to growth.

He agreed with the importance of combining debt reduction and new loans. The Green agenda is powerful and may end up leading to an increase in firepower of the IFIs, but the **IFIs do not yet have the will and financial muscle to scale u**p their disbursements considerably.

China is more comfortable rescheduling than providing a haircut, and while this is not aligned with other creditors, he believes that this should be an acceptable way of sharing the burden.

For him, the issue of private sector participation is still wide open, and new mechanisms need to be adopted to incentivise more private sector players.

The chair and participants came back with several questions to the panel, eliciting new important points to be tabled:

- If they do not provide some debt reduction as well, the IFIs will find themselves with a larger share of total debt, which will become more inflexible - **Jeromin Zettlemeyer.**

- Restructuring domestic debt can be useful if it attracts foreign inflows, for example during commercial bank recapitalization - **Reza Bakir**.

- "It is imperative that the US and the UK in taking legislative and other measures that provide their financial sector with incentives to settle more rapidly" -**Jayati Gosh**.