Lessons from Sri Lanka and Zambia

The IEA/FDL Webinar of the March 17, 2023 discussed the recent debt restructurings agreements of Sri Lanka and Zambia. Moderated by Dani Rodrik, the conversation between Sharmini Coorey, Grieve Chelwa, Jayati Ghosh, and Deborah Brautigam was too rich to allow for a faithful succinct summary. Below are the main messages that the discussion highlighted: the importance of ensuring sound macro-fiscal management to avoid the emergence of a crisis; post-crisis, the necessity to develop adjustment programs that protect the poorest and that can put the country on a new growth path rapidly; and the need to push for international arrangements that foster faster debt restructurings.

The lead up to crisis

The current wave of crises was triggered by a period of excess liquidity in advanced economies, which led to a situation where capital flooded to emerging, developing and even frontier economies in search of higher returns. Consequently, these countries became more exposed to sudden stops in the face of adverse shocks. When a series of negative shocks hit after 2019 (COVID-19, the Russia-Ukraine war, the tightening of monetary policy in advanced economies), many of these countries fell into a debt crisis. Responsibility must be shared between borrowers and lenders, but the poor and vulnerable should be protected.

Debt crises are costly and their negative effects linger. The best way to avoid this is though sound macro-fiscal management. Sri Lanka's debt problems are partly self-inflicted and related to the difficulty of transitioning its institutions from a low-income to a middle-income status. But both Sri Lanka and Zambia had an infrastructure backlog that drove their demand for loans. Borrowing to invest in infrastructure however led to a significant maturity mismatch between financing obligations and growth payoffs. But infrastructure produce wide-ranging benefits, which extend beyond the narrow economic sphere into social gains and even nation-building externalities. Participants stressed the need to have patient capital with proper governance and environmental safeguards to support infrastructure in the future.

Grieve Chelwa: "No narrow calculation of returns would justify the infrastructure projects that were undertaken, but when one looks at the social returns to these projects, they are immense".

In Sri-Lanka, economic growth had also generated a middle-class demand for subsidies and civil service jobs that disciplining institutions were not strong enough to resist. At the same time the government committed policy mistakes, such as implementing unnecessary tax cuts for the benefit of economic elites. In both countries, corruption in procurement increased the cost of large projects. Participants stressed the need for these countries to have stronger, more transparent institutions, and to avoid investing in costly white elephants.

Responding more effectively to crises

Participants stressed that the adjustment programs supported by the IMF remain too dependent on austerity, mainly because of the lack of external financing. To cut fiscal spending and generate new revenues rapidly, these programs focus on removing subsidies (particularly on energy and fuel) and increasing VAT. This pushes much of the burden of debt restructuring to the poorer segments of society. While the programs also support social safety nets, in an inflationary context, social safety nets do not sufficiently compensate for real income lost. The middle class and the elites are more able to lobby to retain some of their advantages.

Participants stressed the need to increase direct taxation, through wealth and income taxes. However, they also noted that it takes time for these taxes to be effective and that the additional revenue generated tends to remain low as long as the economy is in a recession. They also stressed the need to take actions against money laundering and corruption, even if it does not help in the short term.

Speakers criticised the resulting short-term nature of adjustment programs. The lack of foreign exchange liquidity and risks of hyperinflation increase the urgency to stabilize the macro situation. This makes it more difficult for the government to focus on medium term issues. There is however a necessity for these programs to focus more on growing out of the debt problem, a strategy that should be in the long-term interest of both the borrower and its creditors.

Jayati Ghosh. *"Social Safety Nets are not sufficient to protect the poor -- inflation erodes transfers very rapidly. A program that is distributionally fair should tax the rich, include more IMF financing, and have deeper debt relief."*

A main part of the difficulty in squaring this circle is that demanding adequate external debt relief to improve the liquidity situation can prolong the negotiations when it runs into the creditors' reluctance to share the burden adequately. But debtor countries facing a liquidity crisis are unable to bargain effectively in these conditions. This weakens their ability to face the challenge of growth recovery successfully. Strengthening the debtor bargaining power is needed to redress the situation – as would happen if there was a debt service moratorium during negotiaitons. The World Bank should also be more involved in supporting larger new financing, and to add a medium-term perspective.

Improving debt restructurings

The speakers stressed that debt restructurings must converge more deliberately than currently the case. The current delays are partly due to the increased relevance of non-Paris Club creditor countries and private agents. Deals are more complex to strike and remain stuck on how to apply comparability of treatment among different creditors. Introducing new legislation on debt restructuring in creditor countries, especially in London and New York, will help. Another avenue is to introduce most favoured creditor clauses in debt negotiations and the international debt restructuring architecture. Sri Lanka's presidential letter that committed the country to the comparable treatment of its creditors presents another innovative route.

It might take some time to fully involve China in the process, despite its agreement in principle to cooperate in the multilateral process. Part of the difficulties is internal – how to develop the legal and regulatory frameworks in China to allow institutions to take losses without weakening the financial sector unduly.

Deborah Brautigam: "*It took 7 years to develop the Brady bonds, 32 years for the Paris club to give its first net present value reduction, 14 years to come up with the HIPC plan and 25 years to get complete debt write offs from the World Bank and the IMF. China is a new creditor: it will take it some time to get on board.*"

China is also still demanding the participation of MDBs in debt restructurings. Participants were divided on the issue. Those in favour argue that MDBs were associated with unsustainable financing practices, and that past debt write-offs under HIPC had no effect on regaining market access. For those against, sharing losses would eventually damage debtor nations, given that the MDBs are the main providers of new liquidity, and that they would risk losing their AAA ratings, which allows them to act as lenders of last resort, and to keep the costs of their loans low.

Participants recognised that the IMF's demand for full financing assurances *before* a program is approved is problematic: it both generates delays related to getting buy-in from the creditors of a DSA and on its debt restructuring implications, and it forces the debtor country to manage without critical external financing during the negotiation phase, exacerbating the impact on the poor and imposing higher permanent output costs. Alternatives exist to soften this requirement: one option is to start with the IMF-supported adjustment program with a small initial disbursement that allows MDBs and bilateral creditors to provide the liquidity that is urgently needed and debt restructuring discussions to start, and to make the bulk of the disbursements later, after a debt restructuring is reached.

They also noted that there is an unnecessary degree of non-transparency in debt restructuring processes. To ensure a national buy-in and endorsement, all participants felt that the DSA parameters and the adjustment program should be publicly available as soon as the staff-level agreement is reached. Some speakers went further to argue that the staff-level agreement should be open to a national discussion, and to modification, before it goes to the Fund's Board.

Sharmini Coorey: "*The process to reach agreement among the debtor country, all creditors, and the IMF is complicated and is taking way too long. Innovations are needed to shorten the time it takes for a debtor to get to the IMF Board and to formalize comparability of treatment across creditors."*

Participants pointed out that the IMF and MDBs need to be reformed to respond more rapidly and more flexibly to the emerging challenges of the global macroeconomic environment. They noted that financing from these institutions remains too low compared to needs, both when a surge is needed, and to meet the long-term investments of emerging countries.