The global financial architecture and the international debt crisis: An urgent call for reform

C.P. Chandrasekhar & Charles A. Abugre, International Development Economics Associates (IDEAs)

At Issue

April 2023

Despite the far-reaching implications of debt distress and debt defaults in low- and middle-income countries, efforts at resolution are plagued by delay and ineffective when undertaken. This is largely because the solutions, influenced by unreformed international financial institutions and creditor interests, don't address core structural issues that result in periodic crises. The need for reform is urgent and the role of civil society organisations in driving that reform crucial.

The external debt overhang in the Global South has reached crisis proportions. Delays in debt restructuring will devastate already debt-distressed countries and prove brutal for the world's poorest. This will setback human rights progress, as the international community marks the 75th year of the United Nations Declaration on the subject. According to a briefing paper prepared for the G20 summit of finance ministers and central bank governors this September, 52 low- and middle-income countries (LMICs), home to 40 per cent of the world's poorest, were either experiencing debt distress or at high risk of doing so. Despite the adverse implications this has for governments to meet urgently required expenditures to achieve the Sustainable Development Goals (SDGs) and combat climate change, default on debt service commitments seems inevitable in most of these countries, with defaults already declared in Sri Lanka, Ghana and Zambia. While these countries are vulnerable because of excess accumulation of external debt driven by inadequately diversified economic structures that limited exports and increased import dependence, defaults are being triggered sooner than expected because of the external 'shocks' imparted by the Covid-19 pandemic, the hike in advanced economy interest rates, and spikes in global food and fuel prices in 2022, linked in part to the war in Ukraine.

Restructuring external debt is, therefore, urgent. However, often debt restructuring efforts start in earnest only after default. And even then, resolution has been elusive, as the three countries flagged above indicate. Barring the one instance of a deceptive and ineffective "resolution" plan agreed to as part of the G20's Common Framework in Chad, restructuring exercises have been prolonged and unsuccessful (see *Observer* Winter 2022). Zambia, one of the first countries to default after the pandemic broke, is still to find resolution (see *Observer* Winter 2020). Sri Lanka, which defaulted in May 2022 (see *Observer* Summer 2022), is in the midst of a serious economic and political crisis and struggling to get the IMF to release the first tranche of a $2.9 billion loan that would serve as a

C.P. Chandrasekhar taught for more than three decades at the Centre for Economic Studies and Planning, Jawaharlal Nehru University, New Delhi, India. He is currently Senior Research Fellow at the Political Economy Research Institute, University of Massachusetts, Amherst, US. He is a regular economic columnist and co-author of *Crisis as Conquest: Learning from East Asia* (Orient Longman), *The Market that Failed: Neo-Liberal Economic Reforms in India* (Leftword Books), and *Demonetisation Decoded: A Critique of India's Currency Experiment* (Routledge). **Charles Abugre** is a Ghanaian development economist. He has worked as a researcher, lecturer, civil society activist and development professional in several parts of the world. He is currently the Executive Director of International Development Economics Associates (IDEAs). He was previously the Africa Regional Director for the United Nations Millennium Campaign (UNDP) and head of Christian Aid's (UK) Global Policy and Advocacy Division, a Chief Executive Officer at Ghana's presidency in charge of a Special Regional Development Zone, and a member of Ghana's National Development Planning Commission.

bridge, while it negotiates restructuring of more than $50 billion of outstanding external debt. Ghana, which in January 2023 failed to pay interest on a $1 billion Eurobond issue, moved to the default category after a 30-day grace period. The country also announced a domestic bond exchange programme, which will exchange bonds maturing this year or later for new ones with a longer maturity date and zero interest payment in 2023.

Failed debt restructuring mechanisms remain unreformed

These examples are reflective of the failure of the global financial architecture to deal with the devastating effects of shocks experienced by countries that are inherently vulnerable to balance of payments crises. The current crisis began despite past efforts to resolve similar crises through debt relief, such as the Heavily Indebted Poor Countries (HIPC) and the Multilateral Debt Relief (MDRI) Initiatives, launched in the mid-1990s and mid-2000s respectively. These initiatives were implemented only in the poorest countries, neglecting the debt overhang in many lower- and upper-middle-income countries. They reduced external debt levels significantly in some cases, but most of these beneficiaries have returned to debt distress, since traditional restructuring frameworks failed to address – and even worsened – structural bottlenecks that required foreign borrowing to enhance domestic supplies, as global transactions were denominated in 'hard' currencies (see *Observer* Autumn 2022).

Those frameworks remain unreformed. And the restructuring task has grown more complicated because of several shifts in the external debt landscape, which makes even the limited coordination among creditors that was previously possible difficult. One is the increase in the share of private creditors, especially bondholders, who tend to hold out to minimise any 'haircut' they suffer during restructuring. Thus, generating a consensus is extremely difficult. This is a problem in Ghana, where private creditors now hold almost half its external debt stocks, at 49.3 per cent in 2021, up from 13.4 per cent in 2010 – according to data calculated using figures from the World Bank's *International Debt Statistics* database. Sri Lanka too experienced an increase in private creditor share from 14 to 28.9 per cent over this 11-year period.

The other shift is 'aid fatigue' among developed market economy creditors who have been coordinating their responses to actual or potential defaults on payments of bilateral debt to LMICs through the informal "Paris Club". The volume of bilateral flows and concessional credit from them has been shrinking sharply since the last round of debt restructuring. Bilateral credit as a share of public credit in Zambia declined from 33 to 18.4 per cent between 201 and 2018 before rising back to 33.7 per cent in 2021. This was possible only because of China's entry as a major bilateral creditor to the country, holding between 78 and 87 per cent of that credit. The share of multilateral creditors in Zambia's public debt fell from 77.5 per cent in 2010 to just 21 per cent in 2021.

Not only is the debt crisis upon us...but it promises to intensify, especially given the elevated levels of global interest rates and the slowdown in global income and trade growth

In Sri Lanka, while the share of bilateral credit fell from 44.5 per cent to 28.5 per cent over 2010-21, China's part in that share rose from 19.7 to 69.1 per cent. Overall, China's importance has risen significantly, given its growth and the large dollar surpluses it holds. Given the understanding that the multilaterals cannot take a haircut - as that would affect their preferred creditor treatment, credit ratings and ability to borrow cheaply - the burden is expected to be shouldered by China, which is unwilling to be dictated to on how it should restructure its outstanding loans. This has delayed even a partial resolution.

World Bank and IMF's role in debt restructuring

Besides difficulties arising from the changes in the composition of LMIC external debt, two aspects of the debt restructuring architecture warrant attention. The first is the centrality of the IMF in debt rescheduling negotiations, where the institution provides a small volume of emergency finance, lending into arrears if necessary, in return for significant changes in policies ostensibly aimed at stabilising the balance of payments and restoring the confidence of foreign creditors to revive the capital flows that created the problem in the first place. The former is sought through multiple measures aimed at contracting the system with devaluation, expenditure reduction and regressive means of revenue generation. The difficulty is that this turn to austerity may raise the debt-to-GDP ratio by contracting GDP and widening the current account deficit because it tends by design to aggravate the structural problems that led to excess external debt dependence in the first place.

Sri Lanka is a classic case, where access to $2.9 billion of funding for a country with $57 billion of external debt stocks in 2021 has been made contingent on generating a primary surplus of 2.3 per cent of GDP by 2025, relying on monetary policy as a tool to stabilise prices by raising the policy interest rate from 5 to 16 per cent in little over a year, hiking energy prices to "cover costs", and opting for a market determined exchange rate (when that rate is under severe pressure) in order to "rebuild" foreign reserves. Inflation remains high and the crisis has intensified. In Ghana, not only is public expenditure expected to contract significantly, but domestic bond holders including pensioneers are expected to undergo large haircuts, threatening economic recovery.

The policies recommended by the IMF, believing its intervention would revive capital flows, also foreclose any attempts to limit if not shut out capital flows and restrain the supply side push of capital into developing countries, especially into international sovereign bonds in poorer countries (see *Observer* Winter 2021). These capital flows are incentivised not by the austerity that deflates economies, but by the prospect of procuring state assets and state-owned natural resources that are privatised at deflated prices to keep even minimal government spending going.

Besides the pro-cyclical nature and the inappropriateness of austerity measures as a strategy for resolution of debt crises, the adverse effects these have on the poor and the middle classes trigger social unrest and political instability, and have well-documented negative human rights consequences, making it difficult to implement any debt resolution strategy. This risks worsening the crisis in economies that are already at a near standstill. The IMF also tends to be pro-cyclical in its relations with debt-distressed nations when it imposes counter-productive surcharges on borrowing by heavily indebted countries, which takes interest rates to well above market levels, worsening the debt servicing difficulties these countries are facing (see Inside the Institutions, *What are IMF surcharges?*; *Observer* Winter 2021).

The second, nascent, shift in the international financial architecture is the effort to make the World Bank the principal hub to recycle global surpluses (see *Observer* Spring 2023), with a major change in the Bank's role from direct financier and 'unsuccessful' derisking agent tasked with using public funds to 'crowd in' private finance. This, combined with the decline of bilateral flows from the Paris Club, has two implications: Firstly, it provides a justification for advanced nation governments to reduce engagement and opt out of supporting debt distressed countries with new finance. Secondly, it diverts even pre-existing capital flows from North to South into de-risking supposed public-private partnerships, whose profits accrue to the private sector while the risks are borne by the public (see *Observer* Autumn 2022, Summer 2020). That only diminishes the support from these sources in the form of the flows needed to ensure workable and sustainable debt reduction solutions. As the IMF has recognised, such projects also create significant contingent liabilites (see *Observer* Autumn 2022)

Workable solutions to the debt crisis require a more democratic and representative multilateral system

These tendencies in behaviour and policy do not make these institutions fit for purpose in handling either the debt crisis - or the climate challenge. This points to several directions in which reform of the international architecture should proceed. First, to move away from treating the IFIs as the principal institutions to address global challenges,

Sri Lanka Protests #GoHomeGota2022 #SriLankaEconomicCrisis
Credit: Nazly Ahmed

especially since their voting structure no longer corresponds to the changed structure of geopolitical relations and global financial flows (see *Observer Autumn 2022*). Multilateral intervention would be fair and workable only if the voices of nations that are important hubs for recycling surpluses and those that make the policy adjustments to resolve the chronic external debt problem are heard. A new institutional structure where the voices of the principal creditor and debtor nations are equal needs to be fashioned if efforts like the G20's Common Framework are to yield results. An informal debtors' coalition to assess debt sustainability, monitor aid negotiations on debt restructuring, and create a template for the globally implemented policy framework is needed. This must be supported by major creditors when restructuring is undertaken. Fashioning this change requires the vigorous intervention of democratic forces and global and national civil society organisations, since national governments may not find it in their interest to go down this path.

To the extent that the Bank and the Fund remain important hubs in the international financial architecture, the public resources channelled through them need to be directed more purposefully to furthering realisation of the SDGs and global climate goals. Spending by global institutions must be directed to projects that deliver global public goods. These are inevitably projects that yield substantial social benefits but low pecuniary returns. So, the funding must be concessional. To enhance investments in such projects, the World Bank, in particular, must leverage the sovereign guarantees it is implicitly granted by its shareholders and the insurance against default that it enjoys by treaty to mobilise the low-cost capital needed to enhance financing of such projects. In addition, the only conditions imposed on such lending should be on the nature of projects that would be financed and not stabilisation and structural adjustment measures that do not address crucial challenges and worsen the situation in these debt-stressed contexts.

These changes in the international policy environment are not just imperative but need implementation with a sense of urgency. Not only is the debt crisis upon us, with attendant devastation and reduction in capacity to handle the challenges of our time, but it promises to intensify, especially given the elevated levels of global interest rates and the slowdown in global income and trade growth. The delays witnessed in contexts like Zambia and Sri Lanka are alarm signals that the international community and civil society organisations at global and national levels cannot and must not ignore. It is time the Global North matched its supportive rhetoric to mark the 75th anniversary of the Universal Declaration of Human Rights with substantive action on the ground.

April 2023

BRETTON WOODS project

Bretton Woods Project
33-39 Bowling Green Lane
London EC1R 0BJ
United Kingdom
Tel: +44 (0)20 3122 0561
info@brettonwoodsproject.org

The Bretton Woods Project is an Action-Aid-hosted project, UK registered charity no. 274467, England and Wales charity no. 274467, Scottish charity no. SC045476. This publication is supported by a network of UK NGOs, the C.S. Mott Foundation, the William and Flora Hewlett Foundation and the Well-spring Philanthropic Fund.

@brettonwoodspr
facebook.com/BrettonWoodsProject
www.brettonwoodsproject.org