> "Resolving the coming wave of debt crises will require not only changes to the international financial architecture . . . but also attention to the domestic political dynamics of countries in crises."

The Unfolding Sovereign Debt Crisis

LAYNA MOSLEY AND B. PETER ROSENDORFF

A new wave of sovereign debt defaults and restructurings is under way. Lebanon, Russia, Sri Lanka, Suriname, and Zambia are officially in default; Argentina, Ghana, Pakistan, and El Salvador are likely on the brink of debt crises. A decade of easy money has come to a crashing end, the result of the COVID-19 pandemic, the war in Ukraine, surging import prices, and rising interest rates globally as central banks respond to inflationary concerns. Many emerging markets are at risk of default, austerity, and economic and political upheaval.

The mechanisms in place for resolving debt crises are insufficient and in need of reform. But such reform will not succeed without taking account of domestic political constraints in both debtor and creditor countries.

BOOM TIMES

Most governments borrow money; these funds are used to improve infrastructure, to smooth spending across the economic cycle, and in many cases to buy political support and help governments remain in office. Governments borrow from other governments, from multilateral development institutions such as the World Bank, from commercial banks, or by issuing bonds in private capital markets.

Debt—a future obligation—is often more attractive to governments than are current taxes. Though debt obligations eventually require repayment, the burdens fall not on current voters or supporters (or even those important for the next election), but on future ones. Even then, many governments can roll over existing debt into new obligations that mature beyond the political time horizons of incumbents.

LAYNA MOSLEY *is a professor of politics and international affairs at Princeton University.* B. PETER ROSENDORFF *is a professor of politics at New York University.*

The sources and terms of government borrowing are varied. Governments that are deemed to be lower risk tend to borrow from private capital markets, and to do so at low rates of interest and with long maturities. Investors have little worry that such governments will default on their debt contracts. The riskiest of governments, by contrast, can borrow only from official creditors—other governments with a desire to provide finance on concessional terms, perhaps because of their strategic or economic interests, or multilateral banks with a mandate to finance development projects at below-market interest rates. Most low- and middle-income countries fall somewhere between these two extremes, borrowing from a range of official and private creditors, on terms which account for their perceived riskiness.

During the past decade, the supply and nature of sovereign finance shifted significantly. Central banks in the US and Europe lowered interest rates in response to the 2008–2009 global financial crisis; consequently, interest rates in private markets remained low for the next decade. Low interest rates in mature markets resulted in many investors turning to so-called emerging and frontier markets, attracted to the higher returns available.

Many governments, including several in sub-Saharan Africa, were able to issue international bonds for the first time. Rather than borrow from traditional sources such as the World Bank, or from the governments of rich countries, these governments now had access to capital from private markets. Private investors tended to pay little attention to political risk; some governments further reduced investors' perceived risk by securing their debts with natural resource revenues.

Developing countries also became more able to borrow globally in their own (local) currencies, paying slightly higher interest rates or borrowing at shorter maturities in order to do so. Prior to the

Downloaded from http://online.ucpress.edu/currenthistory/article-pdf/122/840/9/767102/curh.2023.122.840.9.pdf by guest on 16 February 2025

2000s, countries with a reputation for volatile exchange rates, unstable politics, and poor histories of fiscal management rarely found investors willing to buy debt instruments denominated in domestic currency. In 2005, economists Barry Eichengreen, Ricardo Hausmann, and Ugo Panizza described this as the "original sin" faced by emerging markets: even with solid economic policies and stable politics, developing nations were viewed as too risky for domestic currency borrowing.

The expanded global liquidity of the post-2008 recession era, however, brought a reduction in "original sin" concerns. By the mid-2010s, as much as 90 percent of international bond issuance by developing countries occurred in domestic currencies. Left-leaning governments were, all else equal, especially inclined to choose domestic currency denomination, shifting currency risk from governments to investors.

Aside from bondholders and commercial banks, sovereigns also borrow from private companies that have directly made resource-backed loans, or led syndicates making them. Though this type of lending is not new, it too expanded during the previous decade. For instance, approximately one-third of Chad's debt is owed to commodities trader Glencore and other commercial creditors, and is repaid in part via crude oil shipments.

The post–financial crisis period also was marked by the rise of China as a significant source of credit. China's Belt and Road Initiative (BRI), formally launched in 2013, provided financing for a range of infrastructure projects in a large set of developing countries. BRI loans were part of a broader program of Chinese economic diplomacy that included making direct foreign investments through state-owned and state-linked Chinese firms, expanding export markets for Chinese products, and securing Chinese access to resource-based commodities abroad. As of 2022, 146 countries had signed BRI cooperation agreements. China (and the policy banks that provide much of the credit associated with BRI) now stands as the largest bilateral official (government) creditor.

NEW LENDERS, NEW PROBLEMS

External debt has reached record levels. In 2021, the overall external debt burden of developing countries stood at $11.1 trillion, compared with $4.1 trillion in 2009 and $2.1 trillion in 2000. Of this external debt, $6.5 trillion was owed or guaranteed by governments. Relative to national income, external debt stood at 23 percent of gross domestic product in 2008, and 31 percent in 2021, among developing countries. The share of external debt accounted for by bond financing grew from 27 percent in 2000 to 51 percent in 2020.

Countries have borrowed more, and from a wider range of creditors. For instance, in 2007, following its discovery of oil, Ghana issued its first internationally listed bond and secured its first large loan from China. As political scientist Alexandra Zeitz's research details, this financing allowed Ghana to reduce its dependence both on foreign aid (rather than on loans) and on traditional sources of aid and loans (including the World Bank). The government touted its new access to capital markets as a validation of the country's economic progress and its climb up the development ladder. But Ghana today finds itself in need of a debt restructuring.

Credit from private capital markets or from Chinese policy banks also allowed governments to avoid the conditions typically attached to funds borrowed from the International Monetary Fund (IMF), the World Bank, and various regional development banks. These conditions—some specific to a funded project, others related to macroeconomic policy—often were viewed as constraining debtor governments' autonomy. Loans from China or international bond issues typically were more expensive, in interest rate terms. But they came without formal conditionality, though they might have included implicit promises to grant favorable market access to China, among other things. (And countries facing debt problems now sometimes turn to China, as Sri Lanka did in 2020, rather than to the IMF.)

The pandemic only added to debt-related challenges.

Debt instruments are diverse not only in their sources, but also in their transparency. Loan amounts, terms, and conditions sometimes are disclosed publicly; in other cases, they are known only to the debtor government and the creditor entity. Some governments are drawn to debt instruments with significant opacity—citizens, legislatures, and members of the political opposition may be unaware of the terms, or sometimes even the existence, of the loans. Our recent research found that governments with a general inclination to opacity in their fiscal practices

Downloaded from http://online.ucpress.edu/currenthistory/article-pdf/122/840/9/767102/curh.2023.122.840.9.pdf by guest on 16 February 2025

tended to access credit from commercial banks rather than from bond issues, and from bilateral official creditors (including, but not limited to, China) rather than from multilateral financial institutions.

In 2013 and 2014, government officials in Mozambique created three new state-owned enterprises, which then borrowed more than $2 billion (approximately 12 percent of Mozambique's GDP) from commercial banks Credit Suisse, VTB, and BNP Paribas. These loans were taken out without parliamentary approval, in violation of Mozambican law as well as the IMF lending program in place at the time. When the loans came to light in 2016, Mozambique lost access to budget support from various multilateral development lenders, and a corruption probe ensued.

Though Mozambique is an extreme case, linked to a massive scandal involving private bankers as well as government officials, many sovereign loans also involve some degree of nondisclosure. Governments may not disclose all their existing debts; the terms of their debts (the amount, interest rate, maturity structure, and the like) may not be available to their publics or their creditors. In some cases, debt burdens are greater than official statistics indicate.

Rising distress

Creditor diversity and debt opacity make dealing with emerging debt distress more difficult. Low-income developing countries saw their debt service burdens rise from 3.3 percent of government revenues in 2012 to 9.4 percent in 2019. This rise was partly due to an expansion of the amount of debt, and partly the result of greater reliance on more expensive commercial (especially bond market) and Chinese credit. In 2020, private creditors accounted for nearly 62 percent of developing countries' external debt, up from 43 percent in 2000.

In December 2019, the IMF warned that more than 40 percent of low-income developing country governments were at high risk of debt distress, or already experiencing it. In 2020, 51 countries (including 44 emerging/developing economies) suffered downgrades to their sovereign credit ratings, which measure a country's ability and willingness to repay its debts.

The pandemic only added to the debt-related challenges, as developing country governments faced larger expenditures related to public health, declines in demand for their export products, and reductions in tourism revenues and remittances from overseas diaspora members. At the same time, as global investors sought safety rather than returns, the supply of available credit declined. This increased risk aversion made the refinancing of existing debt more expensive.

The dire predictions of debt crises made on the eve of the pandemic as well as during its first year did not play out immediately. But 2022 brought yet another round of challenges to developing countries, and a greater sense that such crises are imminent. The newest problems include Russia's invasion of Ukraine, which has exacerbated a rise in global commodity prices.

While such price increases are a boon to commodity exporters, they present difficulties for most developing countries. Sri Lanka, for instance, struggled to pay for food and fuel imports, experiencing severe shortages and record levels of inflation after a decade of fiscal mismanagement by its government. In April 2022, the government suspended payment on all sovereign bonds, initiating what would become the first default in the country's history. The broader economic crisis in Sri Lanka generated mass protests, forcing President Gotayaba Rajapaksa to flee the country in July.

Another recent challenge is rising global interest rates. As the US Federal Reserve and the European Central Bank have raised rates to address growing concerns about inflation, the costs of securing new debt and refinancing existing obligations have increased. Relatedly, the strong and surging US dollar has added to the difficulty of managing debt denominated in foreign currencies. Climate shocks, such as the severe floods in Pakistan in 2022, further intensify the financing challenges in low- and middle-income countries.

Searching for a solution

In the early 2000s, efforts to create a Sovereign Debt Restructuring Mechanism under the auspices of the IMF failed. Today, there is no international analogue to domestic bankruptcy procedures. Restructuring sovereign debt—which can entail reducing the principal owed as well as lengthening the maturity period or lowering the interest rate—has occurred on a case-by-case basis. Ad hoc restructuring makes it difficult for creditors and debtors to know what to expect, further increasing the temptation to hold out—often with negative consequences.

In May 2020, the Group of 20, or G20—an intergovernmental group including 19 countries and

Downloaded from http://online.ucpress.edu/currenthistory/article-pdf/122/840/9/767102/curh.2023.122.840.9.pdf by guest on 16 February 2025

the European Union—launched the Debt Service Suspension Initiative (DSSI). They did so in response to concerns about the capacity of developing countries' governments to balance debt servicing with needed pandemic responses. The DSSI allowed a set of 73 heavily indebted low-income countries to suspend interest payments on their bilateral official debts—owed to governments such as the United States, France, and China—through the end of 2021.

The DSSI entailed only a postponement, rather than a reduction or a cancellation, of debt service. It was based less on an assumption that some debt burdens were excessive, and more on the worry that pandemic-related spending would interfere with debt servicing. Some eligible governments avoided requesting DSSI relief, in part because private market actors, such as credit rating agencies, threatened to downgrade their credit ratings if they acknowledged any difficulties. Nevertheless, by its end in December 2021, 48 countries had opted into the DSSI, postponing $12.9 billion in debt-servicing payments.

Notably, private sector creditors (the major holders of many developing countries' debt) did not participate in the DSSI. The World Bank's 2022 *World Development Report* estimated that governments with distressed debt have an average of 20 unique creditors, often including bondholders, commercial banks, multilateral development banks, and bilateral official creditors. The same diversity of creditors that allowed governments to better match their forms of borrowing with their domestic political and economic aims complicated the effectiveness of the DSSI, not to mention the resolution of debt crises more generally.

The political economy of sovereign debt is a two-level game.

In November 2020, recognizing the complex debt challenges faced by many countries, as well as the limited scope of the DSSI, the G20's finance ministers and central bank governors announced a new initiative: the Common Framework for Debt Treatments beyond the DSSI. Crafted in conjunction with the Paris Club—an informal group of official bilateral creditors, of which China is an observer but not a full member—the Common Framework promises debtor countries a streamlined and routine process for addressing debt distress. It also incorporates "new" official creditors (most importantly China), and is available to the same set of countries eligible for the DSSI. In announcing the Common Framework, the G20 noted the importance of involving private sector creditors in debt relief and restructuring.

A NEW DEAL?

Thus far, only Chad, Ethiopia, and Zambia have requested debt relief under the Common Framework. Sri Lanka is considered too wealthy, based on its pre-crisis income per capita, to meet the criteria.

The Common Framework restructuring process has been slow to get under way, with Zambia currently furthest along. The process begins with a debt sustainability analysis (DSA), conducted by the IMF and the World Bank, to assess the government's debt servicing needs for the short as well as the long term. The aim is to identify how much debt relief will be necessary to render the debt servicing burden feasible.

These analyses leave room for debate. Zambia's DSA, for instance, envisions no restructuring of domestic-issued bond debt, even though some of these instruments are held by foreign investors. Governments, especially those already facing economic downturns, may question whether a debt servicing burden that is deemed "sustainable" by technocrats in Washington is politically survivable in Lusaka or Colombo.

Once the DSA is complete, the government is first tasked with negotiating with its official creditors (G20 governments); they are later obligated to request terms from private creditors, so that no one type of creditor bears a greater burden. Zambian authorities have set a goal of reaching an agreement with the official creditors' committee by the end of 2022.

Creditor committees typically insist that the debtor country reach an agreement with the IMF, which extends new financing in exchange for reforms intended to restore macroeconomic stability. In late August 2022, the IMF's executive board approved such an arrangement for Zambia, promising $1.3 billion in financing over 38 months, conditional on a "homegrown reform plan," and assuming "timely restructuring agreements" with external creditors.

Of course, governments do not always meet the conditions agreed to in IMF programs. Even when they do, these programs do not necessarily prevent

Downloaded from http://online.ucpress.edu/currenthistory/article-pdf/122/840/9/767102/curh.2023.122.840.9.pdf by guest on 16 February 2025

the return of crises. And governments may view such programs as detrimental to their political survival, since they tend to impose costs (in the form of spending cuts, higher taxes, or other policy changes) on some domestic constituents.

As of this writing, nearly two years have passed since Zambia's default. Its negotiations with creditors drag on. It is not clear that debtor governments have much sense of the Common Framework's likely timeline and outcomes. Most governments have domestic political incentives to delay stabilization efforts and requests for IMF assistance. They may want to avoid imposing pain on their domestic supporters, even if reforms are necessary for a debt restructuring deal.

Private creditors, meanwhile, have expressed scant willingness to offer debt forgiveness. Such moves reduce private investors' profit margins, and they can provoke domestic backlashes in creditor countries. But long-lasting defaults impose greater pain on developing countries' citizens, prolonging human suffering as well as exclusion from global capital markets.

ROOM FOR IMPROVEMENT

The Common Framework promises "an open and transparent" negotiation process, giving "due consideration" to the specific concerns of the debtor government or any participating creditors. Yet official creditors thus far have been slow to agree among themselves, and private creditors are still almost entirely excluded until the later stages.

Although China (and the state-connected policy banks—the China Development Bank and the Export-Import Bank of China—that have done much of its overseas lending) is not a full participant in the Paris Club, it has been participating in the Common Framework process for Zambia, co-chairing the creditor committee with France. While China has offered some concessions, some of its lending practices—especially the lack of transparency surrounding some of its loans and terms, as well as the degree and terms of its earlier bilateral restructurings—have likely added to restructuring difficulties.

When creditors do not have good information about a debtor country's debt exposure, restructuring becomes more difficult. (These information problems also can stem from a lack of capacity in debtor countries; debt management offices often are not well resourced and may not have a complete picture of all government agencies' foreign obligations.) China has sometimes argued, depending on the debtor country, that its loans are "private" (because they are made by policy banks, rather than directly by the government) and not "official." Some critics claim that China is using "debt trap diplomacy"—collateralizing loans with resource revenues or taking control of infrastructure projects after repayment difficulties—to gain strategic footholds, especially in Asia and Africa.

According to the World Bank's International Debt Statistics, as of the end of 2020, China accounted for only 10 percent (and bilateral official creditors in total for 26 percent) of the public external debt of low- and lower-middle-income countries. It is worth recognizing that China's participation in global financial institutions and debt restructuring efforts likely depends in part on its own domestic politics. After years of BRI expansion, Chinese financial market elites may tire of its leaders granting debt relief to other countries, either unilaterally or in conjunction with multilateral institutions. While the central bank and finance ministry have generally been supportive of debt relief, the policy banks have sought to avoid losses from writing down debts.

It would be a mistake to attribute all the delays in debt restructuring to Chinese intransigence. Creditor coordination is also hamstrung by diverse creditors' competing interests. Some creditors are motivated by risk and return; others by geopolitics and strategic goals; still others perhaps by an interest in policy reform.

Progress on the Common Framework requires the participation of private creditors, which may—as the DSSI experience suggests—be even more difficult to obtain than the cooperation of official creditors. Private lenders account for the largest share of Zambia's external debt, holding approximately 46 percent of the total. More than half of the Sri Lankan government's outstanding debts are owed to bondholders, many of them US- and European-based institutional investors.

In its current form, the Common Framework's sequencing arguably leaves these private creditors out in the cold. Commercial creditors are only informed of the size of the haircut (the loss imposed on creditors in a debt restructuring) after official creditors have reached an agreement among themselves. Private creditors may question the DSA's assumptions, as they did with Zambia's in September 2022. They may not want to share the costs of debt restructuring and relief, despite their involvement with a sovereign borrower. Their motives typically differ from those of official

Downloaded from http://online.ucpress.edu/currenthistory/article-pdf/122/840/9/767102/curh.2023.122.840.9.pdf by guest on 16 February 2025

creditors, which may have strategic reasons to offer relief and worry less about material returns. Private creditors may be tempted to litigate—suing debtor governments for violating the terms of bond contracts—rather than accept terms comparable to those agreed to by official creditors.

A voluntary mechanism such as the Common Framework faces real difficulties in compelling these private creditors to act. The IMF's recent policy shift regarding "lending into arrears," giving the IMF the option of providing finance to countries in default to private creditors, could help get uncooperative creditors on board, since they would no longer have as much ability to hold up the broader restructuring process.

Another possibility is that governments of powerful countries, especially the United States and the United Kingdom, could compel private creditor participation. A few months ago, the World Bank suggested that statutory measures—legal changes and actions in key financial centers like New York and London—could require greater private-sector involvement. However, the countries currently struggling with high debt burdens may be too small to get enough attention from wealthy national governments to induce them to change domestic debt contract law. A debt crisis in Chad, Ethiopia, or even Sri Lanka is unlikely to capture the attention of lawmakers in the New York state legislature or the UK Parliament. To raise private creditors' cost of nonparticipation, debt and development activists instead might use a version of the "naming and shaming" strategies often deployed by corporate social responsibility campaigns on labor and environmental issues.

The scope of the Common Framework also may need to be expanded to include middle-income countries, many of which had high debt burdens even before the coronavirus pandemic. In recent weeks, Sri Lanka's government has made presentations to various official creditors and bondholder committees in an effort to cobble together a Common Framework–like process.

Some debt activists are calling for a more radical approach involving debt forgiveness rather than restructuring. High debt servicing burdens, they argue, make it very difficult for developing countries to make progress in areas such as education, health, and climate change mitigation and adaptation. Reducing debt burdens would allow governments to direct their attention to issues fundamental to their populations' well-being.

THE DOMESTIC POLITICS OF DEBT

In the absence of support for a more radical approach, debtor governments must decide whether the Common Framework is attractive. But governments worried about their survival in office are unlikely to participate in a process that includes severe IMF-backed austerity measures, typically known as structural adjustment programs. For the international financial architecture to work, it must be cognizant of the domestic political constraints faced by borrowers, particularly in times of economic crisis or ahead of elections.

The political economy of sovereign debt is a two-level game (to use a phrase coined by political scientist Robert Putnam in the late 1980s). At the international level, governments bargain with creditors, and creditors bargain with each other. Governments may attempt to convince creditors to accept larger haircuts, while creditors may pressure governments to commit to structural adjustment prior to the receipt of debt relief or the extension of new financing.

At the domestic level, governments (whether facing debt crises or not) worry about their political survival. Any choice a government makes—restructuring, default, or timely repayment—has distributional consequences. Some groups bear a burden; others reap benefits. To what extent will a default damage the interests of domestic holders of debt? Will austerity harm constituents with political voice? How might default affect politically well-connected local firms' access to foreign credit? How does the proximity of national elections complicate decisions regarding whether to pursue or delay economic reform? Debt restructuring is, fundamentally, a domestic political challenge.

Any solution to any country's debt crisis therefore must work at both the domestic and the international level. Resolving the coming wave of debt crises will require not only changes to the international financial architecture, now marked by the presence of a diverse set of creditors, but also attention to the domestic political dynamics of countries under stress. These dynamics vary across time and across countries, making "one size fits all" solutions inadequate for addressing the end of the easy money era. Rather, creditors and international organizations must work with debtor countries' governments to find workable solutions to the two-level game of sovereign debt. ■

Downloaded from http://online.ucpress.edu/currenthistory/article-pdf/122/840/9/767102/curh.2023.122.840.9.pdf by guest on 16 February 2025