Dealing with Sovereign Debt—The IMF Perspective

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Debt is central to the functioning of a modern economy. Firms can use it to finance investments in future productivity. Households can use it to finance lumpy purchases, such as big consumer durables, or a home. Sometimes, however, firms' investments do not pan out or a household's main earner loses his or her job. Countries' legal systems generally recognize that in these cases, debtors and creditors alike—along with society at large—may be better off if there is an orderly procedure for reorganizing debts.

Governments borrow too, of course, but there are no courts to direct a restructuring of ***sovereign*** debts—debts owed or guaranteed by the national government—nor can entire countries be put into receivership. This is where the IMF comes in. Over the past forty years, sovereign over indebtedness has been at the root of many of the balance-of-payments crises experienced by our member countries.

Ideally, an IMF-supported program will seek to resolve these crises by performing a "catalytic" role: namely, a strong belt-tightening and structural reform program implemented by the member government, when coupled with financial support provided by the IMF, will be designed to catalyze the member country's return to market access in a manner that will enable the government to service its debt under the original terms.

When debt becomes unsustainable

There are circumstances, however, where the government's debt level is so high that it is "unsustainable"; that is, where the scheduled debt service exceeds the capacity of the member to service it, even taking into account both a strong adjustment program and significant financial support from the IMF. In these circumstances, it is not feasible—either politically or economically—for the problem to be solved through further belt tightening. Any assessment of debt sustainability needs to be underpinned by realistic—rather than heroic—assumptions regarding future growth prospects, taking into account the reality that economies have often taken longer to recover from crises than was originally expected.

When sovereign debt is unsustainable, the IMF's legal framework precludes it from providing financial support unless the program includes specific measures—normally including a debt restructuring—that credibly address the debt sustainability problem within the medium term. What is the rationale for that requirement? In the absence of such steps, IMF support would not be addressing the member's underlying balance of payments problems, as is required under the IMF's Articles of Agreement. Indeed, a program that fails to address unsustainable debt is likely to exacerbate such problems because it will create further uncertainty regarding the member's future.

One potent source of uncertainty is the role of a big debt overhang in sapping political support for reforms from the public, which could see its sacrifices as primarily benefiting creditors. The uncertainty created by an unresolved debt problem may also deter new investment in the economy, and hence impede the recovery on which program success depends. Unless a program provides a path for a country to regain access to markets over the medium term, the IMF is not in a position to conclude that the program is addressing the member country's underlying problems in a meaningful way.

Assessing viability in terms of a country's ability to re-access markets continues to be relevant when the country is a member of a currency union. Unless there are specific rules that provide for fiscal transfers between the sovereign members of the currency union, a country is not resolving its balance of payments problems sustainably so long as it must depend for an extended period on the support of other union members.

Although considerable work has been done to establish a methodology to guide the IMF's debt sustainability analysis, the application of this methodology still requires the exercise of judgment. In particular, we need to make a realistic assessment of the unique circumstances of each member country. Because the IMF's debt sustainability analysis is central to its own decision making process, this work remains the responsibility of the IMF. We are precluded from delegating it to someone else. The IMF's assessments of debt sustainability are guided by the framework for Public Debt Sustainability and Analysis in Market-Access Countries and The Fund's Lending Framework and Sovereign Debt—Further Considerations.

The IMF's framework for assessing debt sustainability

The IMF uses two main methodologies to assess whether debt is sustainable. The first methodology asks if, by the end of the IMF program and with debt serviced on the original terms, debt ratios to GDP will be sufficiently low or on a clear enough downward path to restore lender confidence and allow the government once again to tap financial markets. The second, which is especially relevant when debt has a long maturity and particularly low interest rates, is to ask whether the country's annual financing needs—to cover gross payments of interest and principal as well as its primary fiscal balance—can reasonably be met by the markets going forward.

In either case, it is critical that in our projections of feasible repayments, we realistically specify levels of primary surpluses that improve debt sustainability over time—rather than levels that would disrupt the economy so severely that tax revenues actually fall and fiscal targets are abandoned. In turn, our judgment will rely on both the country's own circumstances and our extensive experience with other members in distress. The IMF's framework requires it to account for risks to both program implementation and economic forecasts.

For instance, in the recent case of Ukraine, creditors agreed to significant haircuts in order to reduce debt to a sustainable level as suggested by the debt-to-GDP framework. In the case of the ongoing discussions with Greece, we have instead found the framework that focuses on the annual financing need to be more appropriate, mainly because Greece's euro area partners have opted to provide debt relief through very significant extension of maturities and reduction in interest rates, rather than through upfront haircuts.

Providing debt relief

When debt is judged to be unsustainable, there are various ways in which the necessary debt relief can be delivered. Where the debts being restructured are claims held by the private sector, the debt restructuring is normally implemented at the outset of the program or as a condition for the program's first review. Where claims are held by official bilateral creditors, the approach may vary.

For example, if the debt is restructured under the auspices of the Paris Club, specific debt relief commitments are made by each official bilateral creditor at the outset of the program (in the form of the Agreed Minute) and these commitments are subsequently implemented through the modification of the individual loan agreements.

There may be circumstances where official bilateral creditors prefer to make the actual delivery of the debt relief conditional upon the full implementation of the program. Such an approach may be warranted, for example, where there are concerns regarding a member's track record of economic adjustment. In these circumstances, however, the commitment to provide the necessary debt relief—while it may be contingent on the implementation of the program—would need to be made at the beginning of the program and would need to be sufficiently credible.

The credibility of the commitment would need to take into account the specificity of the modalities of debt delivery. An excessively vague commitment would raise uncertainty, including in the markets, regarding the delivery of debt relief, thereby undermining the chances of the program's success. Moreover, while we can agree to make debt relief contingent on the debtor country meeting specific policy targets, such targets need to be realistic for the debt strategy to remain credible.

It is important to emphasize that while debt relief may be needed in order for the IMF to lend, the decision to seek such relief remains a decision of the member. Moreover, in circumstances where debt relief is pursued, the negotiations take place between the member country and its creditors, although the IMF is typically called upon

to explain the basis for the Fund's debt sustainability assessment. Wherever possible, the IMF encourages a member to restructure unsustainable debt without a default, which can be particularly disruptive.

To conclude, when sovereign debts are unsustainable, unless grant financing is available, some degree of debt relief, coupled with a strong but credible adjustment program, is the only means to make the best of a bad situation. Pretending that unpayable debts can be repaid will only sap the effectiveness of the debtor's adjustment efforts, ultimately making all parties lose more than if they had promptly faced the facts.

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