

Preventing Debt Crises

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The financial response to the COVID-19 crisis has driven debt building at an unprecedented speed, which has increased the risk of debt distress and the odds of a new debt crisis cycle. Emerging markets and developing economies are most at risk. The public debt vulnerabilities for several countries, especially the poorest ones, were already significant, but the subsequent collapse of many economic activities exacerbated the situation.

Ex-post debt restructuring, as opposed to ex-ante measures to manage debt accumulation, are costly for the country involved and for international lenders, both in terms of negative impact on economic growth, hardship for people, stress for the banking system and capital losses.

Despite the costs and complexity, ex-post intervention when a debt crisis is already under way seems to be the default option for many governments and multilateral institutions. The problem with this approach is that it only deals with problems as they occur and will not help to prevent further instances of debt distress.

The focus should be on preventative measures that assess whether there is a real need to incur new debt—i.e., whether, and under what conditions, countries should incur new debt obligations—and to improve transparency in sovereign borrowing. Although the Common Framework shows some improvements to broaden stakeholders' participation by bringing China into the equation, it is still an ex-post partial solution to a broader problem.

Therefore, there is a need to shift focus before debt piles up to an ex-ante solution paying careful attention to upholding sound macroeconomic policies as the necessary condition for proper debt management, and good practices in the decision-making process related to borrowing. The focus should be on the ex-ante measures: greater transparency, proper debt management, and accountability. Although there are frameworks in place that help stakeholders to improve their situations, such as debt ceilings, golden clauses, or detailed debt management policies, these have not been properly applied given the debt accumulation context. Finally, enhanced transparency and greater accountability, supported by a well-functioning domestic legal system will facilitate accountability.

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