

Addressing Liquidity Challenges

A conceptual framework

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Introduction

The discussion on the liquidity challenges faced by economies has gained significant traction in public debates, yet the concept itself remains ambiguous. We identify three distinct interpretations of “liquidity challenges.” Conflating these interpretations in current debates can cause unnecessary misunderstandings among the different viewpoints—by clarifying these perspectives, this conceptual framework aims to provide a solid foundation for a meaningful contribution to the policy debate.

First, liquidity challenges are often defined in contrast to solvency, a perspective stemming from corporate finance. This creates a false dichotomy that is misleading when discussing challenges faced by sovereign states. For public debt, sustainability, not solvency, is the more relevant concept. Although there is ongoing debate about the precise definition of debt sustainability, it is widely accepted that it relies on the assessment of future payment capacity and depends on expectations. Second, liquidity challenges are often understood in terms of a country’s ability to roll over its existing debts. Rollover conditions serve as an observable indicator of market participants’ assessment of sustainability, with rollover risk acting as a symptom of potential sustainability issues. In this interpretation, it is important to remember that sustainability remains the anchoring concept and to understand how liquidity constraints impact perceptions and conditions for restoring debt sustainability in times of crisis. Finally, liquidity challenges can also be understood in relation to the amount of financing needed for essential long-term investments, whether for development, climate mitigation and adaptation, or transforming the productive matrix of developing countries.

This conceptual taxonomy lays the foundation for a substantive contribution to the policy debate. The difficulty from the debtor’s perspective arises when a debtor country signals concerns about its ability to roll over its debt—for instance, by expressing interest in a debt-for-development operation or by participating in multilateral debt reprofiling initiatives—or when market confidence in the debtor’s ability to meet its current and future payment obligations wanes. Such signals cast doubts on the debtor’s sustainability. Whether the country



requires only a maturity extension or a full debt restructuring with a significant haircut is secondary; the mere questioning of the debtor's sustainability incurs reputational cost and associated consequences, including credit rating downgrades, higher interest rates, and greater difficulty in rolling over debts.

The implication is that policies should be designed to avoid, limit, or mitigate over-optimism bias. Since reputational costs are nearly unavoidable, debtor countries should firmly pursue restructuring when their debt is unsustainable. This difficult decision will enable the creation of fiscal space for development, which should be the debtor's priority. The International Monetary Fund (IMF), in turn, should consistently apply its own definition of debt sustainability, recognizing that debt-to-GDP ratios are not the only relevant criteria for debt sustainability and that gross financial needs must be considered. Finally, the international community at large should foster multistakeholder spaces—such as those facilitated by the joint IMF–World Bank Debt Relief Mechanism Initiative—to enhance transparency regarding a country's investment needs and debt sustainability throughout the debt cycle.

1. Solvency and Sustainability

In the business context, solvency is a well-defined concept that refers to positive net worth, where assets exceed liabilities. Since debt equals previous primary deficits capitalized by interest, solvency is backward-looking: it depends on past actions. The core issue with applying the corporate concept of solvency to sovereign entities is that countries do not go bankrupt.¹ The Latin root of “solvency” (*solvens*, derived from *solvere*, meaning to “untie” or “resolve”) highlights why the concept is applicable to businesses but not sovereign states: while a company can be dissolved by liquidating its assets, a country cannot be “dissolved.” For analyzing sovereign debt, the relevant concept is sustainability, not solvency. While there is no universally agreed-upon definition, public debt is generally considered sustainable if there is a high probability that the debtor will honour its current and future financial obligations, under certain reasonable assumptions. Sustainability is thus related to the country's ability to meet its intertemporal budget constraints without defaulting. It is also a forward-looking concept whose assessment requires judgments about future events and actions. Given that contracts are incomplete, meaning that they cannot account for all possible future contingencies, errors in assessing future conditions may necessitate restructuring the terms of these commitments.

If solvency is not a suitable concept for the sovereign context, then neither are individual ratios. A common method used to differentiate between illiquid and insolvent countries is to distinguish between those merely facing high gross financial needs and those with elevated debt-to-GDP ratios.² This approach overlooks the role of expectations in liquidity issues and their connection to sustainability. Although ratios offer a clear way to analyze solvency in corporate finance, sustainability relates to how participants perceive future payment ability,

¹ The absence of a bankruptcy procedure makes it difficult for lenders to have any claim on the debtors' assets. At the same time, a sovereign can create fiat money to face its obligations and raise revenues by hiking taxes. See Debrun et al. (2019).

² See Albinet et al. (2023).



which cannot be directly observed. Sustainability involves both future actions and conditions, as well as expectations and their effects on a country's ability to meet its obligations.

If debt sustainability, rather than solvency, should anchor conversations around liquidity challenges, and given that sustainability assessments depend on judgment, there are two common errors that debtors and creditors can make when assessing sustainability: being either “too optimistic” or “too pessimistic.” In the former case, debt is deemed sustainable when it is not, known as a “false positive.” In the latter case, a judgment is made that debt is unsustainable when it is not, referred to as a “false negative.” These errors can occur both in normal times when assessing the sustainability of a country's debt position and in times of crisis, when restructuring is needed. Conclusive evidence suggests that the most frequent issue is being “too optimistic,” the so-called “too little, too late” phenomenon.³ This means that debtors and creditors often delay policy actions and debt workouts needed to restore sustainability.⁴

As discussed below, anchoring discussions around liquidity challenges from a sustainability perspective rather than solvency is crucial for designing international initiatives and innovative debt relief instruments.

2. Liquidity as Rollover Risks

A second way of interpreting liquidity challenges is as difficulties in refinancing existing debt. Rollover risks materialize when investors question a country's debt sustainability, be it due to external shocks or due to domestic factors. Elevated rollover risk, often measured by gross financial needs, signals concerns about debt sustainability and indicates that creditors are reluctant to extend long-term debt to the sovereign. According to the IMF definition of debt sustainability analysis (DSA), debt is considered unsustainable if rollover risks are high.⁵ Thus, the relevant question is how external conditions, such as increases in international interest rates and more volatile capital flows, impact debt sustainability assessment both in normal conditions and during crises.

A “lower-liquidity” scenario implies higher interest rates for countries with variable-rate debt and higher refinancing costs in general. In this sense, liquidity shortages worsen sustainability for all countries, with varying impacts depending on the type and maturity of their debt. To return to the pre-interest hike situation (all else remaining equal) would require a tougher fiscal stance that translates into higher primary surpluses. However, such fiscal adjustments can negatively affect growth and payment capacity, at least in the short run. Fiscal

³ See Guzman et al. (2016).

⁴ The incentives problem of kicking the can down the road is further exacerbated by an international financial architecture that is ill-equipped to deliver timely and adequate debt restructurings. In the current context of a more fragmented creditor universe, restructurings have become even more protracted due to intra- and inter-creditor coordination problems, as well as a vast discrepancy in power and coordination between the debtor and its creditors. See Guzman et al. (2024).

⁵ “In general terms, public debt can be regarded as sustainable when the primary balance needed to at least stabilize debt under both the baseline and realistic shock scenarios is economically and politically feasible, such that the level of debt is consistent with an acceptably low rollover risk and with preserving potential growth at a satisfactory level.” See IMF (2021).



consolidations often harm growth and distribution in the short run compared to the pre-consolidation period.⁶ In summary, liquidity squeezes make maintaining debt sustainability more challenging for everyone. In addition, if capital flows become more volatile, refinancing difficulties can contribute to generating doubts about sustainability. This could suggest that liquidity squeezes may lead to overly pessimistic assessments of payment capacity (i.e., false negatives).⁷

This is contrary to what has been suggested in the literature for decades, however. Indeed, evidence indicates that the main risk is not being too pessimistic but overly optimistic. To effectively address sustainability issues, it is crucial to strengthen evaluation methods (such as DSAs), as the IMF has been doing.⁸ It is equally important to actively address biases that result in overly optimistic assessments, which lead to incorrect diagnoses and delay action. Overcoming the “fear of restructuring” and the incentives to “kick the can down the road” is essential, as delaying restructurings results in large negative outcomes for both debtors and creditors alike. Therefore, policy design should avoid, limit, or mitigate optimism bias caused by underlying incentives on both sides.

From the international community’s perspective, this entails avoiding moral hazard issues related to the seniority of new credit tranches, such as those from IMF programs or World Bank loans. These issues can create problems with comparability of treatment and complicate future debt restructurings. If multilateral debt is not clearly earmarked, the funds from international finance institutions may leak out, leaving the country with a debt burden that includes more senior debt used to service debt that could be restructured. A larger exposure to super senior debt may also discourage creditors from refinancing these countries.⁹

To mitigate the risk of “leaking,” requesting voluntary debt rescheduling operations could be a solution (Diwan et al., 2024). However, from the debtor’s perspective, signalling intentions for voluntary actions—such as negotiating with private creditors to extend the maturity of the debt—can lead to a deterioration in the sovereign’s risk indicators. This also applies to countries expressing interest in debt-for-development operations or in participating in multilateral debt reprofiling initiatives.¹⁰ In this context, it’s important to remember that a country facing significant rollover risks is experiencing sustainability problems. The literature clearly shows that debt reduction is key to restoring access to international capital markets for countries in distress (Kogan et al., 2024).

⁶ See Balasundharam et al. (2023).

⁷ This seems to be the argument behind the Bridge Proposal. See Diwan et al. (2024).

⁸ See IMF (2021).

⁹ Krahnke (2023) finds that the “catalytic effect” of the IMF programs is weakened if the size exceeds a certain level, mostly driven by a crowding-out effect due to the IMF’s seniority status.

¹⁰ For example, when Ethiopia, Pakistan, Cameroon, Senegal, and Côte d’Ivoire requested to participate in the Debt Service Suspension Initiative, Moody’s placed them under review for a downgrade (Bräutigam & Yufan, 2023). As stressed by Cassimon et al. (2023) very few countries requested private creditor participation, mostly for fear of negative implications for their credit ratings and financial market access.



3. Liquidity and Investment

The third approach to understanding a liquidity challenge is to define it in relation to the financing required for addressing national priorities, such as development, climate change, or the transformation of the production matrix. In this context, liquidity should not be evaluated in absolute terms but rather relative to investment needs. A liquidity challenge would occur when the available financing falls short of the target needed to make these essential investments. If investments to finance a green and inclusive economic transformation in the Global South are overlooked, the risk of being too optimistic increases.

To address this issue, global discussions have increasingly focused on enhancing DSAs by incorporating both climate risks and necessary investments. Such an approach recognizes that traditional DSAs may overlook critical factors, such as the financial requirements for addressing climate change. To address this gap, recent efforts have aimed at integrating these elements into DSA frameworks to offer a more comprehensive assessment of a country's debt sustainability.¹¹

The discussion around investment needs has centred on achieving the Sustainable Development Goals and the Paris Agreement targets and, to a lesser extent, on achieving a green, inclusive economic transformation in the Global South. There is significant contention in multilateral debates over both the estimates of these needs and the methodologies to be used to determine them, such as whether to use a top-down or bottom-up approach. The debates on both issues often occur in separate institutional forums, like the G20 and the UN Climate Change Conference process.

Enhanced DSAs require a comprehensive “investment need assessment,” but this figure cannot be objectively determined. While climate risks and investment needs should be factored in when assessing a country's debt sustainability, the existence and accuracy of a universally accepted figure is questionable. Determining investment needs is an inherently political process; from a bottom-up perspective, the foundation for determining this figure should be a democratically accountable process involving parliament, its budget office, and, ideally, wider civil society to address potential trade-offs in investments, such as climate, infrastructure, or social security. In practice, investment needs are often discussed alongside financing strategies. It is only in theory that these two questions—how much is needed and where it should come from—are tackled in a step-wise approach. Even after such a political, inclusive, bottom-up process is concluded, this investment needs figure is going to be disputed by creditors if simply inputted into the DSA. While this is the case with all the figures and estimates included in a DSA, particularly in times of crisis, creditors may rightly question whether simply imputing an investment needs figure into the DSA is not putting the cart in front of the horse. A country's financing needs ought to be covered by comprehensive financing strategies, including robust domestic resource mobilization (DRM) efforts.

¹¹ The IMF has already taken significant steps in this direction by issuing a note specifically addressing these concerns for low-income countries, thereby advancing the integration of climate risk and investment needs into the evaluation process. See IMF (2024).



In this context, fostering multistakeholder forums, such as those facilitated by the Joint IMF–World Bank DRM Initiative (G20, 2024), to enhance transparency throughout the debt cycle concerning a country’s investment needs and debt sustainability is of the essence. While inputs and assumptions in DSAs will invariably be contested by various stakeholders based on their specific interests, increased transparency can make it harder for all parties—both debtors and creditors—to disregard established norms. These multistakeholder settings also offer a valuable opportunity to scrutinize and build trust in investment figures related to Sustainable Development Goals, Paris Climate Goals, and the broader requirements for a green and inclusive economic transition.

Conclusion

Addressing liquidity challenges requires a clear conceptual framework that identifies the specific problems to be dealt with. We outline three primary ways of understanding liquidity and their respective implications for policy-making. Even if readers disagree with the arguments made and their practical implications, we hope they will appreciate the conceptual clarity the taxonomy brings to understanding liquidity.

The differentiation between liquidity and solvency, while useful in a corporate context, is nonsensical for sovereigns. Rather, debt sustainability should be the anchor for any discussion surrounding liquidity challenges. The key question is how liquidity squeezes affect debt sustainability. In this sense, when they arise, rollover risks should be seen as a symptom of concerns around the debtor’s sustainability.

From the debtor’s perspective, signalling concerns about its capacity to roll over debts incurs reputational costs. Given that debtor countries are unlikely to avoid these costs, they should prioritize the creation of fiscal space while pursuing a restructuring. In other words, if the reputational cost cannot be escaped (something that recent history has taught us is extremely difficult, if not impossible, even when the shock is global and external), the debtor country might just as well bite the bullet and get out of it what it can—namely, more fiscal space while pursuing a restructuring. This recommendation is aligned with historical evidence that debtors and creditors alike are more likely to be overly optimistic about debt sustainability rather than too pessimistic.

Policies designed to avoid or mitigate over-optimism bias also apply to the international community’s efforts. The IMF must boldly and consistently adhere to its own definition of debt sustainability, acknowledging that debt-to-GDP ratios are not the sole criteria and that gross financing needs must also be considered. The broader international community should also promote inclusive, multistakeholder platforms—like those facilitated by the Joint IMF–World Bank DRM Initiative—to enhance transparency regarding a country’s investment needs and debt sustainability throughout the entire debt cycle.



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