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Sovereign Debt: A Double-Edged Sword? Analysing the Intervention of the IMF in the Debt Crisis

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Sovereign debt is important because it helps governments finance development programmes, undertake economic and financial policies, and provide fundamental public services in times of economic crises. Borrowing has the role of stimulating economic development and enhancing public welfare, but too much borrowing could result in fiscal instability, dependence on others, and loss of economic sovereignty. The article discusses the double-edged sword of sovereign debt, its advantages/disadvantages and the causes of sovereign debt crises. It illustrates the dangers of severe debt distress and social distress through case studies of Sri Lanka and Greece, as a result of poor fiscal management and a lack of political stability or external economic shocks. The article also delves into the functions of the International Monetary Fund (IMF) in managing sovereign debt crises, including providing financial aid, conducting debt sustainability analysis, and facilitating debt restructuring discussions. Although IMF intervention is important to provide liquidity and help the recovery phase, it is frequently associated with austerity and structural adjustment policies that can reduce the autonomy of domestic policy choices and have high socio-economic costs. The study goes on to the point that the IMF serves as a stabilising force and a constraint for the debtor countries. It concludes that sound debt management for sustainability is to be accompanied by good governance, fiscal discipline, strengthening of public finance systems and long-term development-oriented policies to reconcile economic stability and maintain national sovereignty.

Keywords: *sovereign debt, sovereign debt crisis, International Monetary Fund (IMF), debt restructuring, public finance.*

INTRODUCTION

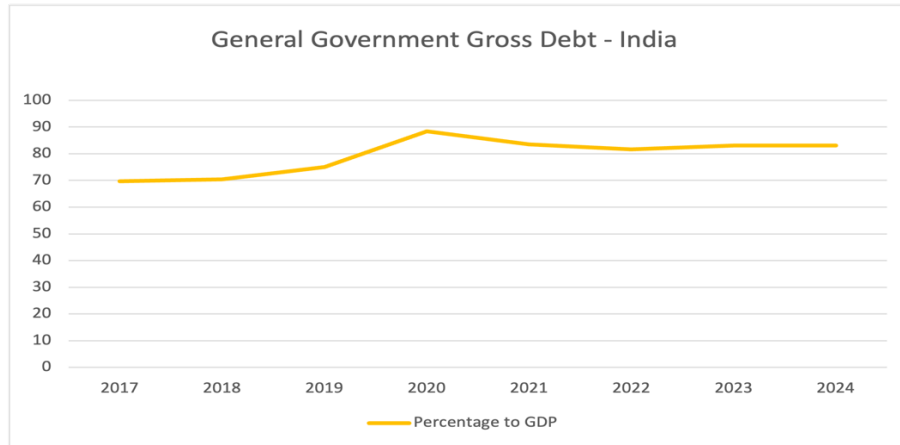
The borrowing of the government to finance their needs is called sovereign debt. It essentially occurs when a nation cannot raise enough funds through taxes, which is the primary source of income. The total amount of money that a government owes is 'sovereign debt'. For example, the government of India is planning to build bullet trains that can benefit a lot of people by improving connectivity, convenience and development. Initially, it might cost a lot, but once it starts its service, it will create profit. Large-scale projects like this come with high upfront costs, making it challenging to cover these costs through taxes. Borrowing can be considered in this situation, as bullet trains can generate profit in the long run. So, the government can repay the loan gradually. Large-scale projects can create job opportunities and improve the standard of living. Now the question is, from whom can it raise the funds? The key lenders include international organisations, foreign governments, private sector entities like pension funds and multilateral development banks. In a way, the government is selling this debt to its citizens with a promise to pay it back in future. During economic downturns and pandemics, sovereign debt helps the government to recover from the crisis without cutting essential services. This borrowing can raise funds without burdening the population with high taxes, thus lowering the immediate financial shock on citizens. Sovereign borrowing also helps the government to provide services when the revenue raised through taxes is low, ensuring liquidity. This borrowing is different from the borrowing of a household or a company. If an economy is going through a recession, some people find it difficult to borrow money as lenders tighten their conditions. Sovereign debt can be used to stabilise the economy without interrupting the services given to the public during the recession. Suppose the government has effectively utilised the debt; this can bring foreign investment and build investor confidence.

If the government defaults, it will give the lenders control over domestic fiscal activities and the power to intervene using structural coercion. Heavy reliance on sovereign debt reduces the sovereignty as creditors set out conditions for restructuring. Excessive borrowing can destroy an economy, leading to a cycle of borrowing to repay the debt. The default can also spread to other sectors of a nation. For example, if banks hold government bonds considering them to be safe, default in borrowing made by the government can reduce the price and demand for these bonds, affecting the banking sector. When the repayment issue is only a

temporary problem, economic reforms and fiscal adjustments can be possible solutions. In case of unsustainable debt, approaching creditors to renegotiate the conditions, and thus, sovereign debt restructuring begins. If the interest rate is high, the revenue generated will be utilised for payment rather than focusing on development. High debt levels also affect the country's reputation. Sovereign bonds are subjected to geopolitical risks as well as exposure to global market vulnerabilities. Rupee depreciation could escalate the repayment cost, intensifying the fiscal burden on the government.

Sovereign debt is different, considering the 'default-risk-free' nature that it possesses. The government has the power to levy taxes in the future, which serves as collateral, reducing the risk.¹ The belief that the government will be able to make it up through future taxes to meet its debt obligations makes it attractive. Sovereign debt sounds safe in countries with large domestic debt markets. This confidence cannot be spotted in the case of private debt. A government with a good history of paying back the debt obligations can attract low interest rates, making sovereign debt safe and risk-free. When it comes to developing economies, sovereign debt does not sound safe. If foreign investors hold the debt, the jurisdiction of a foreign court in case of default becomes a big question. Thus, repayment is difficult to enforce. Attaching the sovereign assets is not a feasible solution as these assets are located in the sovereign state. Another major difference between private debt and sovereign debt lies in politics. In a politically unstable nation, the chance of default in repayment increases. Moreover, political leaders prioritise short-term goals and shoulder debt obligations to the next government. The risk of sovereign debt changes from one nation to another. For example, countries with different GDPs that took a debt of an equal amount experience the debt in two different ways. GDP, interest rate and exchange rate of developed countries and developing countries are not the same.

¹ Mr Leonardo Martinez et al., *Sovereign Debt* (International Monetary Fund 2022)



Source: World Economic Outlook Database: October 2024²

Gross debt consists of all liabilities that require payments with principal by the debtor to the creditor at a future date. It includes SDR, loans, and debt securities except for equity and investment fund shares, financial derivatives and employee stock options. An increase in India's sovereign debt levels can be seen from 2017 to 2020. During the pandemic, the government has implemented various measures, including financial support to vulnerable sections, vaccine distribution and various manufacturing sectors experienced a downturn, resulting in declining GDP. After 2021, stabilisation suggests the efforts to handle the sovereign debt. This data is a key indicator of India's sovereign debt situation, highlighting the impact of COVID.

SOVEREIGN DEBT CRISIS

A sovereign debt crisis occurs when a country is unable to pay its debt without any external assistance. It will result in the intervention of an international organisation, severely impacting the structure of the economy. Foreign debt has two consequences, namely debt overhang and credit rationing.³ Debt overhang occurs when a country has high payment obligations restricting its growth and avenues for new investment. Part of the economic gains is utilised for debt repayments. Credit rationing happens when a country is unable to pay its debt and decides to increase the interest rate to boost domestic savings and thus close the gap by accumulating the surplus that can be used for repaying the debt.⁴

² *World Economic Outlook Database: October 2024* (International Monetary Fund, 2024)

³ Eduardo Borensztein, *The Effect of External Debt on Investment* (International Monetary Fund 1989)

⁴ Albert Wijeweera et al., 'Economic Growth and External Debt Servicing: A Cointegration Analysis of Sri Lanka, 1952 to 2002' (2005) Working Paper Series No. 2005-8 University of New England

One of the prominent cases in the sovereign debt crisis is the Sri Lankan economic crisis, which occurred due to political instability, bad governance and external debt burdens.⁵ To cover the fiscal deficit, the central bank printed money, and the Sri Lankan rupee devalued by 80 percent. Due to the outbreak of COVID, the tourism sector also collapsed, and Sri Lankans suffered a shortage of essentials like food and fuel and witnessed skyrocketing prices. For years, the difference between the income and expenditure of the Sri Lankan Government was negative.⁶ In March 2020, even though the government approached the IMF for financial assistance, it didn't receive a favourable response as the massive tax cut was not consistent with the assessment of the IMF. The government started to address the crisis without understanding the root cause, in the hope that the economy would be able to revamp itself.

The financial crisis of 2008 paved the way for the Greek sovereign debt crisis.⁷ The new government in 2009 claimed that the previous government concealed the extent of the deterioration of public finance. Government revenue started to collapse, and the budget for the next year failed to convince the market. The austerity measures adopted by Greece, including a reduction in the salaries of health professionals, layoff of temporary workers and a substantial portion of people started living their lives under severe financial pressure.⁸ Austerity measures come at a great cost, affecting the mental and physical health of every citizen.

Other sovereign debt crises, like Argentina debt crisis, the eurozone debt crisis, the Lebanese debt crisis, etc., share common causes like political instability, poor fiscal management and governance practices. The possible solutions to recover from this hardship are the

<<https://www.une.edu.au/about-une/faculty-of-science-agriculture-business-and-law/unebs/research/occasional-paper-series/economics/economics-2004-2007/pdfs-economics-2004-2007/econ-2005-8.pdf>> accessed 26 November 2025

⁵ 'Case Study: World Bank Group Supports Crisis-Hit Sri Lanka's Efforts to Reduce Interest Rate Risk on its Loans' (*World Bank*) <<https://thedocs.worldbank.org/en/doc/c05c262a4523099a8023c174b0becbbe-0340012023/original/Case-Study-Sri-Lanka-interest-rate-fixings.pdf>> accessed 25 November 2025

⁶ *THE SOVEREIGN DEBT CRISIS IN SRI LANKA: CAUSES, POLICY RESPONSE AND PROSPECTS* (UNDP Regional Bureau for Asia and the Pacific, 2022)

⁷ George Alogoskoufis, 'Greece's Sovereign Debt Crisis: Retrospect and Prospect' (2012) Hellenic Observatory GreeSE Paper No 54

<https://www.researchgate.net/publication/265891999_Greece's_Sovereign_Debt_Crisis_Retrospect_and_Prospect> accessed 17 December 2025

⁸ Charis E Kubrin et al., 'The Debt Crisis, Austerity Measures, and Suicide in Greece' (2022) 103(1) *Social Science Quarterly* <<https://doi.org/10.1111/ssqu.13118>> accessed 17 December 2025

intervention of international organisations like the IMF, debt restructuring, austerity measures and credit default swaps market and encouraging the domestic debt market.

ROLE OF IMF

IMF supports the member countries in managing the risk involved in debt and resolving debt distress.⁹ IMF provides advice on how to address these risks at an early stage and provides technical support for member countries to develop a debt management strategy. IMF is not involved in making restructuring decisions for a nation. It helps to overcome lack of financing, procrastination, asymmetric information and lack of coordination. A country approaches the IMF seeking advice and financial assistance before making a detailed restructuring plan. IMF, after analysing the status, determines whether the debt is sustainable or not.¹⁰ IMF evaluates two main factors while deciding and assisting a country in making a restructuring plan. First, it examines whether the restructuring plan aligns with the economic strategy of a nation, and second, it ensures that the government can remain financially stable in the long run while meeting its payment obligations.

According to Richard Peet, the IMF adheres to neoliberal policies, suggesting a one-size-fits-all solution framework for every context, which requires reducing tariff barriers.¹¹ The low-income countries that borrow from the IMF pay interest rates, service charges and a fee. Peet further argues that most of the time, the IMF gives very little of a country's external requirement. The IMF has a responsibility to conduct surveillance and provide financial assistance to countries facing balance of payment issues. But this help comes with stringent conditions by making countries implement austerity measures and structural adjustments, which result in economic hardships. However, despite the tremendous controversy over austerity measures and their impact on decreasing demand, investment and economic growth, many policymakers, during the Greek sovereign debt crisis, saw them as unavoidable.¹² Fiscal expansion would have increased borrowing in Greece and potentially made its debt unsustainable, considering its weak production base, high dependence on imports, the high prevalence of tax evasion and lack of access to international financial

⁹ Martinez (n 1)

¹⁰ Annie O Krueger, *A New Approach to Sovereign Debt Restructuring* (International Monetary Fund 2002)

¹¹ Richard Peet, *UNHOLY TRINITY: THE IMF, WORLD BANK AND WTO* (2nd edn, Bloomsbury Publishing 2009)

¹² Vassilis Monastiriotes et al., 'Austerity measures in crisis countries: results and impact on mid-term development' (2013) 48 *Intereconomics* <<https://doi.org/10.1007/s10272-013-0441-3>> accessed 01 May 2026

markets. So, austerity became a polarising and crucial part of the policies pursued by the IMF to achieve fiscal stability and tackle the sovereign debt issue. Austerity measures tend to disadvantage the poor and the most vulnerable; they restrict access to public services and social welfare programmes and are disproportionate to their needs. Furthermore, fiscal consolidation without structural reforms can only deal with symptoms, not causes, of debt problems. But while austerity may help achieve this short-term fiscal stability, it is not enough to ensure sustainable growth, social protection and economic resilience, unless it is coupled with long-term policies.

Sometimes the government is forced to implement the policies designed by the IMF, hindering sovereignty. Due to excessive borrowing, the government need to follow policies that are not aligned with its economic goal. In the global economic system, there is a lack of representation for developing or emerging economies, and the decisions are made by the wealthiest nations. Pete states that there are situations where the IMF failed to implement recovery, leading to economic crisis and poverty.

The IMF also sets out a path to facilitate negotiations between creditors and the sovereign and provides ‘independent information’ amid uncertainty.¹³ But this function of the IMF varies from country to country, leading to unpredictable debt restructuring. In 2006, the authorities of Belize declared their intention to execute a cooperative agreement with external creditors as a part of sovereign debt restructuring. They hesitated to sign an IMF-backed program, especially the adjustment program cause of the fear of implementing austerity measures and other policies to stabilise the economy. Moreover, IMF programs create a negative reputation, undermining investor confidence, and Belize feared that IMF conditions would lead to abandoning its currency peg to the US dollar.

In a nutshell, domestic, institutional, political, economic and social factors shape the decision of every government, and the IMF can play a significant role from different dimensions during sovereign debt restructuring. At times when a country has lost all its access to international financial markets, financial assistance and foreign exchange provided by the IMF becomes the saviour. IMF is also a provider of information, which is important to

¹³ Javier Diaz-Cassou et al., ‘Recent Episodes of Sovereign Debt Restructurings: A Case-Study Approach’ (2008) Banco de Espana Occasional Paper No 0804
<<https://www.bde.es/f/webbde/SES/Secciones/Publicaciones/PublicacionesSerias/DocumentosOcasiones/08/Fic/do0804e.pdf>> accessed 05 January 2026

overcome heightened uncertainties as well as information asymmetries. But the IMF loan, coming with austerity measures, leads to poverty and slow economic growth. The conditions can undermine sovereignty, and a deregulation approach can cause financial instability.

Countries should develop frameworks that can guide long-term sustainability rather than focusing on short-term financial needs. Fiscal discipline during economic booms and sustainable development projects like 'green investment' shall be given priority to achieve long-term economic growth. A comprehensive audit mechanism to analyse the effectiveness of previous policies and the performance of the previous government is essential to fill the gaps in the deterioration of finances. In an evolving economy, governance and foresight are important to safeguard sovereignty.