T20 Policy Brief

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Task Force 03
REFORMING THE INTERNATIONAL FINANCIAL ARCHITECTURE

Policy Brief on Domestic Debt Restructuring

C.P. Chandrasekhar, Global Director, Research and Policy, IDEAs (Global)

Jayati Ghosh, Professor, University of Massachusetts, Amherst, (USA)

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Abstract

Recent discussions on sovereign debt crises in low- and middle-income countries (LMICs), arising from their inability to service debt denominated in hard currencies (especially the dollar), have tended to focus on what are seen as excessively high levels of aggregate—domestic and foreign currency—public debt.

This raises three questions. First, what is the rationale for making domestic debt restructuring (DDR) part of the adjustment imposed on countries facing external debt stress or defaulting on external debt? Second, is it legitimate to make the restructuring of domestic debt a part of the process of resolution of what is essentially a crisis resulting from the inability to service foreign debt? Third, what are the economic and welfare consequences of DDR, and would it help to resolve the original problem of the foreign debt crisis?

The obvious difference between domestic and external debt—that the former can be serviced with domestic currency the availability of which the government and the central bank control, while the latter has to be paid for in foreign currency that has to be earned with foreign revenues or new foreign borrowing which the government cannot control—has been ignored. Even if DDR releases domestic resources and increases fiscal space, there is no reason that it would automatically resolve the stress created by unserviceable foreign debt.

Moreover, domestic lenders to sovereigns include domestic banks and ordinary citizens whose savings are invested in government securities (considered riskless) through institutions such as pension funds, insurance companies and mutual funds. Restructuring of domestic debt therefore adversely affects domestic banks and ordinary savers, and has destabilising consequences for the domestic economy.

This brief considers the ways in which debt stress stemming from domestic and external debt can be separated and recommends the alternative policy measures needed to address external debt stress.

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The issue

Recent discussions on sovereign debt crises in low- and middle-income countries (LMICs), arising from their inability to service debt denominated in hard currencies (especially the US dollar), have tended to focus on what are seen as excessively high levels of aggregate—domestic and foreign currency—public debt. As a result, policy responses in two countries that defaulted on external debt payments following the COVID-19 pandemic—Ghana and Sri Lanka—have emphasised actions prior to or as part of an IMF programme, to reduce the level of sovereign local currency debt through forms of domestic debt restructuring (DDR).

This is bizarre, since the insufficiency of foreign currency earnings is what leads to default on external debt payments and the attendant crisis. Obviously, managing that crisis requires access to international liquidity. However, releasing domestic currency resources through DDR does not immediately provide such access. In fact, there is little clarity on how the additional domestic resources, if any, released through DDR would be transformed into the foreign exchange needed to service external debt.

In the IMF's case for the inclusion of DDR in debt stress resolution programmes, this critical difference does not get attention: that 'domestic debt' is denominated serviced in domestic currency, while 'external debt' is denominated in foreign currency and has to be serviced in that currency when interest and amortisation payments fall due (IMF 2021). Instead, for the IMF the identified and defining difference between 'domestic' and 'external' debt is that the former is governed by domestic law and falls in the jurisdiction of domestic courts, while the latter is governed by foreign law and falls in the jurisdiction of courts in those locations.

The foreign currency to service foreign debt must be mobilised through current account inflows or acquired through new foreign borrowing. To avoid an increase in external vulnerability, such foreign exchange should be earnings on the current account, rather than new liabilities used to repay past debt. This issue does not arise with domestic debt since the government has control over and access to domestic currency. It can also change domestic laws to help restructure domestic debt.

The conflation of domestic and external debt also ignores another crucial difference between the two: the former is held largely by residents, whereas external debt is largely held by non-residents. Financial liberalisation has complicated matters a bit, with non-residents holding some domestic debt and residents in some contexts holding sovereign bonds denominated in foreign currency. In Ghana, for example, at the end of September 2022 foreign investors held 9 per cent of a total domestic public debt of 181.4 billion Ghanian cedis. These investors had taken on the currency risk associated with investments in domestic currency bonds and are therefore best treated on par with domestic investors. In Sri Lanka, banks were encouraged to subscribe to dollar denominated Sri Lankan Development Bonds (SLDBs). However, these holdings of foreign currency debt (274 billion Sri Lanka rupees equivalent) amounted to less than 2 per cent of domestic sovereign debt in May 2023 (Government of Sri Lanka 2023). Since foreign residents held 3 per cent in value of these bonds, if they are treated on par with foreign holders of Sri Lankan international sovereign bonds, then it is best to treat the domestically held component of SLDBs also as external debt when restructuring the same.

Domestic debt can be serviced with little difficulty by: (i) allocating some of the available budgetary revenues for the purpose; (ii) borrowing additional sums in the domestic ‘open’ market; and/or (iii) exercising the sovereign’s right of taxation, which is

always a possible means of mobilising domestic resources, especially since direct tax to GDP ratios tend to be low in these countries.

Yet, the pressures on debtor countries are such that Ghana began implementing a DDR programme even before it obtained IMF Board clearance for the $3 billion loan it obtained, prior to restructuring its external debt. Sri Lanka launched the exercise after receiving IMF support for debt restructuring. In both cases, other than for restructuring agreements and offers made by bilateral creditors, the process of domestic debt restructuring preceded serious negotiations on the restructuring of foreign debt owed to private sources, especially private bondholders. In the event, while complete restructuring of all external debt, including that held by private creditors, especially commercial banks and bond investors, is yet to be completed, DDR has been implemented in some form in both countries.

There are important macroeconomic consequences of domestic debt restructuring that need to be considered. Domestic debt lenders to sovereigns include domestic banks and ordinary citizens. The savings of the latter are often invested in government securities (considered riskless) through institutions such as pension funds, insurance companies and mutual funds. Getting these entities to accept losses on such holdings, for 'extraneous' balance of payments reasons, has adverse economic and distributional consequences.

Imposing a haircut on them to restructure domestic currency debt erodes the savings of those who are not speculators in financial markets but are saving for a future when they would not be capable of earning an income. In many cases, these are forced savings taken from workers as part of some social security provisions like pensions. Such people are then called upon to bear losses when a country faces difficulty servicing foreign debt in foreign exchange—a liability for which they are not at all or only marginally responsible. This can also result in commercial banks taking a hit, suffering losses that can restrict

credit provision and reduce credit availability for investment, housing and consumption spending.

This is a form of austerity, in which the burden is placed on ordinary citizens not just through the recession that reduced public spending triggers, the squeeze that increased user charges and cuts in subsidies impose, or the loss or absence of decent work that slow growth implies. It is a direct attack on savings held by working people as depositors in banks (in case of a 'bail in' to keep banks solvent) or as investors in pension funds and mutual funds. Thus, restructuring domestic debt, adversely affecting banks and ordinary savers, can generate more instability and greater inequality in the domestic economy.

Restructuring domestic public debt in this fashion is clearly aimed at squeezing investment and consumption to release real domestic resources. But even assuming that austerity releases real domestic resources, the problem of transforming those resources into foreign exchange remains. So, the problem of restructuring foreign currency debt owed to private creditors persists and the task of restructuring external debt owed to private creditors remains unfinished. The only argument for such a strategy can be that the recession induced by DDR would contract incomes and thereby reduce imports. In such a case, the recession would have to be steep for enough foreign currency to be 'saved' to repay foreign creditors.

Overall, **conflating domestic currency debt with foreign currency debt shifts the focus away from the central problem: the international economic system allows for large flows of foreign currency debt from official and private sources to the LMICs, but generally does not deliver to those countries the foreign currency needed to service those liabilities.**

In practice, DDR has proved difficult to implement in a fair and complete fashion and has had adverse consequences for economies and people. In Ghana, where commercial

banks held around 33 per cent of domestic currency sovereign debt and institutional investors and businesses another 26 per cent, recapitalized commercial banks and institutional investors were asked to carry the burden of DDR. Meanwhile, protesting savers and pension funds (accounting for 7 per cent), which refused a first offer, have been given a much sweeter deal that postpones the government's immediate payment commitments. The banks are under stress as a result, forcing the government to set up the Ghana Financial Stability Fund (GFSF), which is a $1.2 bn facility to backstop the banking system, insurance companies and other financial sector entities and to address cash flow difficulties that would result from the debt exchange programme. But in a self-defeating fashion, the GFSF is to be funded with borrowing from the World Bank and other international financial institutions. In other words, foreign borrowing is to be enhanced to facilitate domestic debt reduction through DDR.

In Sri Lanka, commercial banks were left out of the restructuring because the central bank decided they would not be able to carry the burden and would require recapitalization that would be self-defeating. Even while designing the DDR, the central bank and government decided to keep debt owed to the banks out of the exercise, because their balance sheets were already burdened with non-performing assets accumulated during the crisis. The central bank's assessment was that banks would not remain solvent if they were forced to take on more losses. And the government did not want to recapitalise the banks, which could require even more funding than the government debt written off by the banks, making the restructuring effort counterproductive. So, most of the burden was placed on pension funds, with regressive consequences that have affected future incomes of poor workers.

Recommendations

1. Foreign and domestic currency debts are different, because governments can mobilise domestic resources to service liabilities in domestic currency. But tying the decisions to restructure both internal and external public debt, as an explicit or implicit condition for IMF support when addressing balance of payments difficulties, deprives governments of their fiscal policy autonomy. *It is therefore crucial, for safeguarding domestic policy space and ensuring the independence and autonomy in policy making of LMIC governments, to avoid linking external and domestic debt restructuring, especially when the international community is seeking to address external debt stress.* G20 governments must reframe the Common Framework and influence the IMF to ensure it does not encourage or demand DDR when supporting the restructuring of external debt.

2. *When the issue at hand is external debt stress or default on payments due on external debt, the immediate focus should be resolving that problem*, rather than diverting much needed attention from the problem by focusing on aggregate debt, i.e. both foreign currency and domestic currency debt of the sovereign. This too calls for G20 action vis-à-vis the IMF.

3. Since debt sustainability is often linked to the ratio of debt to GDP, it depends not just on the volume of debt but also the level and rate of growth of GDP. The corollary is that sustainability cannot be restored if GDP growth is dampened. Therefore, an approach that addresses the problem of debt stress using measures that have a contractionary impact on GDP is self-contradictory. But that is what the recession induced by DDR does.

External debt stress must be alleviated without harming GDP growth, which makes DDR unfit for its purpose.

4. *Efforts at external debt stress resolution should focus on reducing to sustainable levels the outstanding net present value level of* ***external*** *debt and adopting measures to reduce dependence on or indiscriminate resort to external borrowing*. The principal objective is not to win back creditor confidence but to reduce foreign currency credit/creditor dependence. Therefore, the focus should be not on reducing public borrowing per se but on reducing borrowing in foreign currency.

5. *Restoring external debt sustainability requires significant haircuts on the part of creditors. This should not be restricted to bilateral creditors alone but should also apply to multilateral and private creditors.* The view that multilateral creditors should be allowed to retain their privileged creditor status and high ratings, with no haircut must be rethought. This is especially because flows of bilateral credit from Paris Club members have diminished over time, and now credit from that source flows largely through multilateral channels. On the other hand, in many contexts new bilateral creditors like China have increased their share in such credit. Hence, exempting multilateral credit from restructuring generates controversies related to the comparability of treatment of different bilateral creditors. Moreover, private creditors, who because of the much higher interest rates they charge and the shorter maturities for which they lend, tend to have recouped much of their dues, should be required to accept reasonable haircuts. The effort should not be aimed at appeasing them but persuading them to accept comparable treatment.

6. *At present, there is a moral hazard resulting from an implicit or explicit assurance to private creditors that resources needed to meet debt servicing requirements would be mobilised through the recessionary consequences of an IMF programme involving DDR and backed with foreign funding.* Such assurances encourage private creditor tendencies to hold out for a 'better deal' with small 'haircuts' or small reductions in the net present value of outstanding debt, and encourage excess flows of creditor capital to developing countries without due diligence.

7. *Besides avoiding the encouragement of excess flows of yield-thirsty capital to the LMICs, there is need to enable and facilitate measures adopted at the national level in the LMICs to precent excess inflows of capital.* The problem needs to be prevented, rather than resolved after occurrence. This is crucial for ensuring policy space that can at least partially counteract the possibility that the external debt crisis does not precipitate a serious developmental crisis.

8. *A programme designed to alleviate external debt stress should also attempt to reduce the import intensity of domestic production and consumption.* It is futile to wait for a collapse of foreign reserves to enforce measures to curtail imports. So, governments must intervene proactively to prevent such a collapse by reducing import dependence. This would require short-run measures to limit non-essential imports with appropriate tariffs or quantitative restrictions, and a medium-term strategy of building competitive domestic capacities to service a larger share of both final and intermediate demand.

Outcome scenario

Focusing on external as opposed to aggregate sovereign debt and abjuring DDR as a component of a programme to address external debt stress or default, avoids imposing the burden of the adjustment on sections of the population that are not responsible for the crisis and are least capable of bearing the consequences of that crisis. That imposition is all the more unjustifiable, because the release of domestic resources does not help address the problem of foreign exchange shortage and has adverse effects on GDP, which run counter to ensuring overall debt sustainability. Making DDR a component of the adjustment programme increases public opposition to the programme and makes even DDR difficult to implement. On the other hand, abjuring DDR helps to mobilise support for adjustment strategies.

Also, precluding DDR helps to focus attention on the prerequisite for any successful adjustment, which is deciding the quantum of external debt reduction to be accepted by private, bilateral and multilateral creditors. DDR diverts attention from this crucial task. In practice, implementing a form of DDR appears to have been easier than negotiating a restructuring of private creditor debt. However, it has proved difficult to implement in ways aligned with the compatibility of treatment principle. It is likely that efforts not to link external and domestic debt restructuring will face opposition from strong interests, but such opposition must be resisted since this measure is inappropriate to address the problem at hand.

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