A principled approach to Domestic Debt Restructuring

Note to Finance Ministers for the Global Sovereign Debt Roundtable of October 2023

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Ishac Diwan and Martin Kessler,

Finance for Development Lab[1]

The Global Sovereign Debt Roundtable (GSDR) provides a unique platform for debtor countries to request changes in the restructuring process. Domestic Debt Restructuring (DDR) is probably one of the most difficult choices for a Finance Minister, particularly when facing unhappy external creditors whilst dealing with challenging circumstances at home. This paper proposes simple principles that debtor countries could voice in this forum. Domestic debt is defined as market debt instruments issued in local currency under domestic law, regardless of the residency of their holders. These can be domestic (banks, pension funds, individuals, etc.) and, sometimes, external investors.

When in crisis, restructuring domestic debt is always a difficult decision, both economically and politically. Yet, there is limited consensus on the best paths forward to effectively deal with domestic debt. Citizens in highly indebted countries end up "paying" several times what they should. This is due to the adjustment process but also to inflation and depreciation, or accumulated domestic arrears. Restructuring domestic debt will add to this already heavy burden. It might be necessary at times, but it is in the interest of the borrowing countries to ensure that economic growth and poverty gains remain protected in the process.

DDR is increasingly gaining importance but there is no practical guide that can be followed to ensure its effective implementation. No consensus has yet been reached on sequencing or on the parameters. Some principles related to External Debt Restructuring (EDR) are already well-established but they often turn out difficult to implement in practice. In theory, the quantity and the structure of treated debt should aim to re-establish external debt sustainability, whilst losses are allocated to creditors based on the comparability of treatment principle. There is no common interpretation for these terms when it comes to each particular restructuring. They are the subject of fierce negotiations but at least they exist and in the absence of anything better, they have provided a framework for numerous Paris Club restructurings and are also reflected in the Common Framework[2].

When it comes to domestic debt, there are no guiding principles, be they soft or hard. This is opening the door to important questions : When should domestic bondholders bear some of the burden of a debt adjustment? To what extent? Whenever there is a technical void in the process, politics often take over, and the coalition with the strongest voice usually tends to win; this may be foreign creditors. The current focus on global financial reforms, including those related to debt treatment, offers an opportunity to fill this vacuum.

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[2] The key sentence for the determination of the envelope: "[…] The restructuring envelope that is required, will be based on an IMF-WBG Debt Sustainability Analysis (DSA) and the participating official creditors' collective assessment, and will be consistent with the parameters of an upper credit tranche (UCT) IMF-supported program."
And for the allocation: "The key parameters will be established so as to ensure fair burden sharing among all official bilateral creditors, and debt treatment by private creditors at least as favorable as that provided by official bilateral creditors."

What principles should be adopted to take advantage of this opportunity? Many competing needs lie in the balance during a DDR but long-term growth and protecting gains in poverty reduction should always remain the utmost priority. Programs should be designed to protect the poor, avoid domestic macro-economic, financial or social doom-loops. The development of well-functioning domestic debt markets is essential in providing the financial foundation for economic growth. Sharing the burden of adjustment also equally means that restructuring parameters should ensure the gains stemming from reforms or positive exogenous shocks are fairly shared between domestic and foreign creditors.

Those principles may seem simple and obvious, but they are not always necessarily central in domestic debt restructuring. Ministers should propose two reforms to ensure they are included:

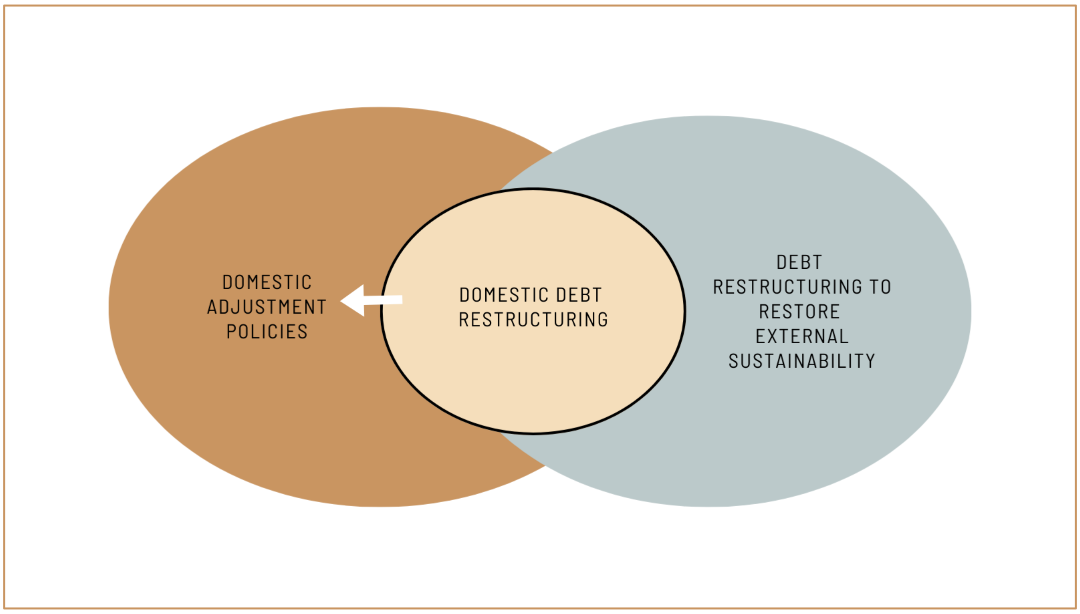
1. DDR should be considered as part and parcel of the domestic adjustment program. This should imply the same level of consultation, preparation and ownership as other policies included in a program. It should remain a separate process from external restructuring considerations.
2. The costs of DDR implementation should be fully assessed, relying on a careful cost-benefit analysis, including on distribution of losses. This assessment should be anchored in Debt Sustainability Analyses.

1. DDR processes should be a part of the adjustment program

Debt crisis policies rely on difficult decisions including allocating costs between different corrective economic policies that may focus on several competing interests: creditors (external and domestic), government and citizens. Historically, the IMF has been the main architect of this process in the context of its lending programs. As a lender of last resort, it will only intervene if it is confident that the government's policies will restore debt sustainability with sufficient certainty. What it means is that when an IMF program is established, a set of economically and politically feasible policies is agreed to restore fiscal stability, and, if necessary, external debt restructuring (EDR). Although it defines the restructuring envelope, the IMF is careful not to intervene in the negotiation of debt contracts, which is a sovereign responsibility.

As for the domestic debt restructuring (DDR) process (Figure 1), it is sitting rather uncomfortably somewhere between an IMF program and the need to restructure debt. In practice, it is not always obvious to determine where DDR belongs. It could be considered alongside other fiscal measures as a way to improve overall fiscal balance; or it could be part of the external debt restructuring process, once all other policy options have been exhausted. We argue that debtor countries should clearly articulate domestic policies, including DDR, in the broader adjustment framework and avoid making it a process competing with EDR.

Figure 1: The Venn Diagram of IMF programs



Source: Authors

Ministers should make clear that DDR is part of the adjustment program. When looking at policy options to make debt sustainable, DDR is a tool to consider. It can reduce the envelope of other adjustments – raising taxes, reducing spending – and thus protect the most vulnerable. Front-loading adjustment of the primary balance is often a very challenging task, whereas DDR can allow to reduce pressures on the initial years of the program. In addition, when real interest rates are high, often a sign of dysfunction of the domestic bond market, and when maturities are relatively short, debt service can be significantly reduced through DDR. In other cases, it might be too disruptive, or too shallow to be effective.

This implies that DDR should not be considered by default, nor should criteria to allocate losses be automatic, such as using comparability of treatment principles. Indeed, the allocation of DDRs will depend on many considerations, mostly related to the ability to bear losses, and those considerations should be separated from the negotiations with external creditors. Comparability of treatment only applies to EDR when official bilateral creditors are involved. Furthermore, residents are subject to a range of losses beyond that of restructuring – inflation, depreciation, additional taxes or lower revenues, etc. In this regard, the parameters and objectives of DDR should be quantified early in the process, so that it is immune to pressures from external creditors.

2. The design and implementation of DDRs should explicitly be taken into account at the onset

As part of the adjustment program, benefits will be limited by the "DDR Laffer Curve". In recent work, the IMF (2021) has devised some practical considerations: countries should pay attention to financial stability to avoid banking crises which would be self-defeating; and broaden the perimeter of restructured debt to reduce effort required on each instrument. They should minimize NPV losses and, if possible, avoid face value reductions. The benefits of DDR are the clearest when markets have been "pathologic" in the period preceding a crisis (with high and unsustainable interest costs), and thus weigh heavily on current spending. In that case, benefits might dominate costs.

Such an approach allows governments to make careful decisions regarding its domestic creditors. The design of DDR should take into account the profile of debt holders. Recent cases have illustrated how different governments treat creditors differently, and this degree of freedom should remain. An important exception is the group of non-resident holders (NRH) of domestic debt. While a differentiation may be difficult in practice, the main problem they raise is one of capital flight, which can be addressed using capital flow management measures. Other practical considerations include legal possibilities to restructure (Clifford Chance 2023). Impact on long-term credit can also blunt the efficacy of DDR: as credit tends to contract after DDRs (Erce 2023), especially as they add to other liquidity pressures which accumulate with domestic arrears. Including central bank holdings should also be subject to careful assessment, given associated monetary policy risks.

Implementation is key: because those are fraught political process, they should involve deep consultations. DDRs are difficult politically, and require careful engagement and consultation of stakeholders: unions, pension funds, banks, etc. Once announced, a DDR should be fast, to avoid sudden interest spikes. Those two imperatives are in obvious tension, and contribute to making DDR a high-wire task. In addition, both the central bank and the ministry of finance should be aligned as DDR often includes both monetary, financial and fiscal implications.

At the same time, speed is of the essence, as flow costs can overtake stock gains. Even when they do not trigger outright crises, DDRs can be costly for the government, sometimes undoing a part of its fiscal savings. Utmost attention to implementation is necessary. A country in external distress relies on its domestic markets, especially prior to the IMF program (which will unlock some amount of financing). As a result, proceeding to a DDR, or even simply announcing it, will increase risk premia and interest rates. With short maturities, and often predominant reliance on treasury bills, the flow impact of interest cost can undo the relief obtained by reducing coupons on the stock.

These considerations may be of technical nature but they translate into a simple ask from ministers to the GSDR: demanding that the IMF provides a toolbox to assess those options, embedded within Debt Sustainability Analyses. The centrality of the IMF Debt Sustainability Analyses (jointly conducted with the World Bank for Low-Income Countries) in determining the country envelope should be acknowledged: it is in large part driving country decisions. Those frameworks should be adapted to maximise countries' degrees of freedom and implementation space. Complements that should guide countries in making their decisions would include the impact of an external restructuring on market access, and a more systematic assessment of DDR on financial systems, and income distribution.

Conclusion

Domestic debt is larger than in the past – and often a heavier weight on the interest bill than external debt. It is likely that the frequency of its implications in restructuring will increase. Countries should be able to implement it in a coherent policy framework, presumably within an IMF program. The GSDR is an opportunity for ministers to protect their policy frameworks in times of crises.

Annex: What is the Global Sovereign Debt Roundtable?

In early 2023, the IMF, the World Bank and the Indian G20 presidency established the "Global Sovereign Debt Roundtable" (GSDR). This is an ad-hoc group of country officials with a mix of Paris Club and non-Paris Club members as well six "borrowing" countries at various stages of debt negotiations (Ecuador, Ethiopia, Ghana, Sri Lanka, Suriname, Zambia). The private sector (banks, bondholders) is also represented.

Since debt resolutions were too slow and conflictual, the aim of this forum is to provide a platform to discuss debt restructuring matters at both political and technical levels. While they do not have an official status, GSDR discussions offer an opportunity to get to a common understanding on restructuring processes.

The GSDR is an opportunity: it offers the possibility for finance ministers of developing countries to express their views. To do so, they need a united perspective, and the technical background to defend positions that will apply in their own negotiations and beyond. This is where think-tanks play an important role: providing policymakers with the knowledge and tools to defend a fairer debt restructuring process.

The first meetings of the GSDR took place in March and April 2023 – they helped clarify the Preferred Creditor Status of Multilateral Development Banks, requested the IMF to speed up the publication of its Debt Sustainability Analyses, etc. Those are small and fragile agreements, but they have provided enough reasons to continue the process into 2024.

The next important agenda item is that of domestic debt restructuring (DDR). In a workshop in mid-September, the IMF discussed with country representatives, private creditors, experts, what should be the rules around the involvement of domestic creditors.

During the 2023 IMF/World Bank Annual Meetings in Marrakech, Finance Ministers will meet and chart a path forward on structural issues linked to Domestic Debt Restructuring (DDR). This briefing puts forward a few principles that ministers from the six participating countries could defend to improve the architecture in favour of future debtor countries.