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External Debt stress and Domestic Debt Restructuring: Resolving a Paradox

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Abstract

The ongoing sovereign debt crisis in LMICs was signalled by instances of failure to meet external debt obligations denominated in hard currencies. The policy response has included attempts to restructure domestic sovereign debt issued largely in domestic currencies, justified by identifying the crisis as one of excessive aggregate public debt rather than just unsustainable levels of external debt. It is argued that debt stressed governments having high levels of aggregate public debt need to reduce their gross financing needs (foreign and domestic).

This assertion ignores the difference between the stress associated with servicing debt in domestic and foreign currency. Governments can mobilise domestic resources through taxes and central banks have control over domestic currency supply, whereas both have little control over foreign currency availability.

Additionally, domestic sovereign debt holders include citizens deploying their savings to invest, and commercial banks parking resources in 'safe investments'; restructuring that debt through haircuts is bound to be economically destabilising by eroding past savings, being inimical to balance sheets of banks, and thus depressing consumption and investment. This makes implementation of domestic debt restructuring costly and difficult.

Given this context, the paper examines why IMF and global finance insist on domestic debt restructuring by LDCs facing external debt stress as part of conditions associated with provision of emergency BoP finance/restructuring of foreign debt.

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Key Words
CP Chandrasekhar, Sovereign Debt Crisis, Debt Sustainability Analysis, IMF, External Debt, External Debt Restructuring, Domestic Debt Restructuring, Domestic Debt Exchange Programme

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External Debt stress and Domestic Debt Restructuring: Resolving a Paradox

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Introduction

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 see this as just a component of a larger fiscal problem, involving excessively high levels of aggregate—domestic and foreign currency—public debt, rather than as a balance of payments problem. As a result, post-default policy responses in two countries that defaulted on external debt payments following the COVID-19 pandemic—Ghana and Sri Lanka—have combined efforts to restructure foreign currency debt owed to bilateral, multilateral and private creditors with schemes to reduce the level of sovereign local currency debt through forms of domestic debt restructuring (DDR).

The pressures on debtor countries are such that Ghana had to implement a DDR programme even before it obtained IMF Board clearance for the $3 billion loan it was given as a bridge, 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. Sri Lanka finalised a deal with private bondholders only in early July 2024, while Ghana reached an agreement in principle with Eurobond holders in late June 2024. Thus, well before completion of negotiations on the restructuring of all external debt, including that held by private creditors, especially commercial banks and bond investors the promised DDR was implemented in some form in both countries.

Domestic and external sovereign debt

In the IMF's case for inclusion of DDR in debt stress resolution programmes, the identified and defining difference between 'domestic' and 'external' debt is not that the former is denominated in and has to be serviced with domestic currency (which is only partially convertible), while the latter is denominated in foreign currency and has to be serviced in that currency when interest and amortisation payments fall due (IMF 2021). Rather, underlying the perspective that combines domestic and external debt restructuring, 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 (normally New York or UK for private creditors).

The emphasis on legal jurisdiction paves the way for an approach that treats on par dominantly non-resident holders of foreign currency debt and predominantly resident holders of local currency debt. That ignores the crucial difference in the currency composition of external and domestic debt, which in turn arises because the prime drivers of the two kinds of debt are very different. Domestic currency sovereign debt is incurred when the sovereign chooses to expand spending beyond the revenues it mobilises from tax or non-tax sources. It can of course choose to finance its spending with additional taxes today. But if spending demands are large for policy reasons or if revenues cannot be enhanced simultaneously with increased spending requirements (as during the COVID pandemic, for example), it makes sense to borrow and spend. This is because the output increases resulting from such spending can yield taxes that cover a significant part of the costs of borrowing.

Also, the sovereign has the right to mobilise, through tax and other means, the additional domestic resources required to service that debt. This can be an important means of financing debt servicing especially since direct tax to GDP ratios tend to be low in these countries. This room for flexibility that the sovereign possesses when mobilising domestic resources makes sovereign debt in domestic currency a riskless asset. The instrument has the backing of the state, which in turn is seen as capable of mobilising the requisite domestic currency resources to service that debt. This is recognised even in papers from the IMF staple as for example in Gregorian (2023).

Borrowing abroad, sometimes influenced by interest rate differentials, can also be used to finance domestic budgetary expenditures. But that carries the risk of currency mismatch, since budgetary expenditures most often do not directly promote activities that yield earnings in foreign currency. It also carries straightforward currency risk, since any depreciation of the domestic currency vis-à-vis the foreign currency would increase the domestic currency burden of debt servicing. For this reason, governments should normally prefer to borrow in domestic currency to cover their budgetary deficits.

Yet, they are often forced to borrow abroad in foreign exchange because such borrowing adds to the national pool of foreign currency needed to finance a deficit on the current account of the balance of payments. To the extent that foreign direct investment, other equity flows and foreign currency grants are inadequate to cover any excess of spending on imports, incomes transferred abroad, and interest on debt, relative to the foreign exchange earned from exports, tourism, remittances, and so on, borrowing is inevitable. And chronic current account deficits have been the norm in many low- and middle-income countries (LMICs), characterised by the inadequate diversification of economic activity resulting from their subordinate position within an unequal international economic order. That limits exports and increases dependence on imports, leading to trade and current account deficits. It triggers external foreign currency borrowing, though the servicing of that debt in foreign currency compounds external vulnerability. And governments and countries often find themselves borrowing more to service past debt, aggravating that vulnerability. The dynamic of external debt is therefore very different from that of domestic debt.

In the event, external debt crises result from a shortage of foreign currency liquidity needed to service foreign currency debt. Rarely do countries that default on payments due on foreign currency debt cut themselves off from international financial markets. In fact, they approach the IMF, and accept foreign debt restructuring proposals framed by it in its Debt Sustainability Analysis, with the hope that they would be able to return to the international debt market. This desire to rebuild relationships with foreign creditors is evidence that they would not have defaulted unless a shortage of foreign currency made foreign debt servicing impossible. It is in that sense that external debt levels are considered to be unsustainable. Handling that crisis requires foreign currency debt reduction and access to international liquidity. But 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 practice, the servicing of external debt requires the government of a country, whose currency in not freely convertible, to divert limited foreign currency inflows or foreign reserves to service that debt. 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. The insufficiency of earned foreign currency earnings is what spirals into default on external debt payments and the attendant crisis. So, the challenge is not mobilising domestic currency resources to service external debt, but the need to transform some of those domestic currency resources into dollars. The scarcity of foreign exchange and the inability of these countries to borrow abroad in their own currencies leads to a currency mismatch on their balance sheets, making them victims of the "original sin" (Eichengreen and Ricardo Hausmann 1999).

In sum, the conflation of domestic and external debt ignores a crucial difference between the two—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. The approach emphasising legal jurisdiction seeks to resolve two different kinds of problems using a similar instrument (restructuring involving some loss for creditors) that targets two differently situated actors.

The latter needs emphasising. Restructuring of sovereign or publicly guaranteed foreign currency debt (external debt restructuring or EDR) requires enforcing losses on powerful external creditors, including holders of high yielding sovereign bonds who may have recouped much of their capital and more already, and should also pay some cost for their lack of due diligence. With domestic debt, however, 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. In fact, fiduciary rules usually require asset managers in pension funds and insurance companies to opt for low risk, highly rated government securities. Even commercial banks are often required by statute to hold a certain proportion of government securities in such assets. Getting these entities to accept losses on such holdings, for 'extraneous' balance of payments reasons, would have debilitating economic and distributional consequences.

An uncommon adjustment

One consequence of these features of domestic debt and their differences from those of external debt is that, though borrowing both at home and abroad has been an abiding feature of public finance, DDR was until recently relatively uncommon.[1] Restructurings were largely confined to foreign debt. Thus, a compilation based on secondary sources by the IMF (2021) found that out of 171 debt restructuring events over the period 1980 to 2020, only 63 involved any DDR component, with just 37 being pure DDR exercises. Most of the DDR exercises have occurred in the years after 1990s, less because of domestic debt stress *per se*, but because of the embrace of neoliberal fiscal policies or their imposition by the IMF. "Fiscal consolidation" often required drastic reductions in public debt to GDP levels, leading to DDR exercises.

On the other hand, restructuring during the first major debt crisis decade, 1980-89, was focused on restructuring external debt. In a questionable explanation for this difference by periods, the IMF attributes the small number of DDR episodes in the 1980s and early 1990s to the supposed resort of LMIC sovereigns to "a combination of financial repression and high inflation to reduce the real value of excessive domestic debt". The presumption here, possibly, is that since inflation enhances the nominal value of GDP but leaves the nominal value of accumulated debt unchanged, the debt to GDP ratio, which is the target variable, falls. But once "EMDEs liberalised their financial systems and upgraded their policy frameworks, including by adopting inflation targeting", the IMF argues, that route of eroding the relative value of debt was not open, and they were forced to reduce unsustainable domestic debt as well through restructuring, making DDR more common. The problem with this view is that reducing 'real value' does not get rid of debt. What is more, in practice, there is no clear threshold at which domestic debt becomes unsustainable, necessitating DDR. According to the IMF's data, the pre-restructuring median public debt level relative to GDP was a not too high 70 per cent for countries opting for DDRs. Moreover, "most standalone DDRs occurred either in LICs or in small states", pointing to other kids of weaknesses that necessitate such action aimed at reducing public debt.

It must also be noted that till the 1980s there were limits to the extent of foreign currency debt that could be accumulated by almost all LMICs. External credit flows to these countries occurred only through bilateral or multilateral channels, since private creditors found the economic, political and exchange rate risks in these countries too high to make them viable borrowers. This put binding limits on the volume of foreign

currency debt that could be accessed, given the overall allocations of "aid" or "development assistance" by developed market economy "donors" and the historical factors that influence the share of that kitty each country could access. Since foreign direct investment flows and grants were also determined wholly from the supply side, there were binding balance of payments constraints that operated on countries. If current account deficits exceeded the amount of external finance available, governments could not borrow abroad at will to fund their way out of trouble. Rather they faced balance of payments crises, had to turn to the IMF for emergency financing, and accept conditionalities that required them to reduce domestic absorption and the import bill associated with it. Growth contracted to match forex spending and earning. This was neither a socially defensible or "efficient" way of limiting foreign exchange outgo. Direct or indirect foreign exchange spending was much higher among the upper income deciles of the population, and these sections were likely to be the least effected by a fiscally engineered contraction. In the event, the extent of contraction needed to achieve the target was substantial, and the success of the effort was in question.

This scenario changed in the years after 1980. Post the oil shocks, OPEC oil surpluses were deposited in the international banking system. Reckless spending abroad by a United States that faced no national budget or balance of payments constraints, because the dollar was the world's leading reserve currency and considered as good as gold, resulted in overseas dollar surpluses. And savings accumulated in US pension and savings funds, were looking for avenues for investment. This triggered a supply side push of capital to new destinations, identified as 'emerging' and 'frontier' markets. This supply side push was only aggravated after the 2008 crisis, when the effort to rescue finance in the metropolitan core led to the adoption of "unconventional monetary policies" in the form of quantitative easing and near zero interest rates. The economic downturn, which was triggered by the COVID pandemic and the response to it, provided one more justification for massive infusions of cheap liquidity by developed country central banks. The result was that the global financial system was awash with cheap liquidity, much of which was mobilised by yield hungry investors willing to ignore the risks associated with large scale lending to LMIC borrowers.

This transformation of global finance not only led LMIC sovereigns to behave as if they too did not face binding balance of payments constraints, since current account deficits could be easily financed with new borrowing, but also resulted in flows of external credit to many LMICS that were far in excess of current account financing needs. LMIC governments also embraced structural adjustment policies that widened

current account deficits and borrowed without caution to finance those deficits. Private creditors emerged as major sources of credit to these LMICs, lending without due diligence, as did a resource-hungry China looking for new sources of raw material and food supplies. What followed was a sharp increase in the number of countries carrying unsustainable "foreign" debt. In that process, delinquent governments used the opportunity to borrow and increase domestic spending to win 'prestige' and legitimacy, since such spending did not lead to inflation. The foreign exchange equivalent of the borrowing could be used to finance imports needed to hold the domestic price level. It was not the price level but the current account deficit that adjusted in response to the external borrowing. As argued below, contraction to reduce foreign currency spending remains the favoured policy even after private players have entered LMIC debt markets, increasing the frequency of balance of payments stress.

It was in the phase marked by an unsustainable foreign debt trajectory that, paradoxically, DDR gained currency. One justification was that unsustainability of debt was the fall out of the aggregate debt level which was at and beyond some identified threshold level, which was seen as being true of both its components, external and domestic debt. The overall debt of the sovereign is being seen as the 'sin' that matters, and not specifically the 'original sin' of borrowing abroad and not being able to borrow abroad in domestic currency and therefore borrowing in dollars. This amounts to ignoring the very different determinants of unsustainability in the two kinds of debt. Domestic currency surpluses cannot service foreign debt. Even if a part of the response to debt stress was reduction in the net present value (NPV) of outstanding external debt, sovereigns would need foreign resources to service remaining debt. The domestic currency resources that may be released through DDR cannot help service that foreign currency debt.

What is clear however is that DDR adds to the level of austerity by hurting domestic agents. Among those agents are pension funds, mutual funds and insurance companies that are institutions that intermediate domestic savings of ordinary citizens. If domestic debt is restructured to reduce its volumes, by forcing haircuts, households suffer losses through erosion of their savings in pension and mutual funds or increases in the insurance premia they would have to pay. The erosion of savings would work back to spending decisions, as they are adjusted to make up for the loss. This is a different 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 investors in

pension funds and mutual funds or even as depositors in banks (in case of a 'bail in' to keep banks solvent). One corollary is that restructuring of domestic debt, by adversely affecting the banks and ordinary savers squeezes the real incomes of sections who cannot be directly held responsible even for current account deficits has devastating consequences with regressive welfare implications.

Besides the pension funds, commercial banks also take a large loss, since domestic banks tend to be the biggest holders of government securities. In 2021, commercial banks held 30 per cent of public debt stock in Ghana, which was much higher than the 20 per cent held by the central bank (Ministry of Finance, Government of Ghana (2021: Table 5.10 p. 28). Over 2021, claims on government averaged around 30 per cent of the total assets of the banking sector.[2] Restructuring this debt by exchanging it for new bonds with a lower net present value would mean significant losses for the banking sector. This can be self-defeating, requiring recapitalisation of the banks with government funds to prevent financial market turmoil and its adverse repercussions for the real economy. Moreover, even if banks survive, restructuring can adversely affect credit flow, resulting in bankruptcies of small- and medium-sized firms and a contraction in investment and consumption spending. The result is a double dose of the austerity medicine.

Releasing foreign resources

What is more this austerity does not necessarily help resolve any crisis resulting from an inability to service external debt. On closer examination of cases where DDR is being experimented with, there are only three circumstances in which the resources needed to service foreign debt can be mobilised through austerity and the consequent release of domestic resources. First, this can happen when there is no difference in the currency of denomination of foreign and domestic debt. This was the case, for example, in Greece which remained in the eurozone, though its crisis was partly precipitated by its adoption of the euro as domestic currency. But though Greek debt was not in foreign currency given its eurozone membership, it did not have the monetary sovereignty to borrow from a 'national' central bank to repay foreign creditors. It too, therefore, had to resort to austerity measures to curtail imports and 'save' the foreign currency needed to service debt in its own currency remaining after restructuring. As a result, a country that was marked by a level of per capita GDP that was close to the European Union average in 2009, is today the poorest country in the eurozone and the second poorest after Bulgaria in the EU (Romei 2024).

Second, the austerity implied in IMF driven debt restructuring programmes could release *real* resources from domestic consumption which could be exported to earn the foreign exchange to service debt. But this assumes that the capacity to produce these resources was fully utilised before the restructuring. If not, more could have been produced to exploit these potential export markets, without resorting to austerity policies.

The third is that the austerity could contract GDP, which, given any level of import intensity of domestic consumption and investment, would curtail the country's imports and save foreign exchange. In a sense, it is only this outcome of debt restructuring linked austerity programmes that can contribute directly to the servicing of foreign currency debt. Since imports are a small proportion of GDP and are largely driven by inelastic upper income decile demands, the contraction required to 'release' foreign exchange through this process can be severe. This implies that the level of austerity that must be imposed must be severe in cases where the haircuts imposed on external creditors is moderate or small, which is normally the case.

There could be other indirect ways in which 'adjustment' policies can lead to foreign exchange revenues that could help service foreign currency debt. One is the privatisation of public assets through sale to interested foreign buyers. The other is to mortgage future production of raw material or other resources with export markets. The use of oil resources in Suriname as the basis for a Value Recovery Instrument is illustrative of this possibility.[3] These are likely to become more important in transforming domestic resources into foreign exchange to service external debt.

Implementing DDR

Besides the fact that DDR is by no means a viable strategy to address the stress that stems from an inability to service external debt, it also is a strategy that is difficult to implement across different categories of sovereign domestic debt. DDR has proved difficult to implement in a fair and complete fashion, even when it has had adverse consequences for economies and people.

The history and the composition of domestic currency debtholders matter. In Ghana, where commercial banks held more than a third of domestic currency sovereign debt[4] and institutional investors and businesses another 26 per cent, commercial banks that had been recapitalised after the banking crisis of 2017-20[5]

and institutional investors were asked to carry the burden of DDR, while protesting pension funds (accounting for 7 per cent) which refused a first offer, were given a deal that only helped postpone the government's immediate payment commitments. On the other hand, in Sri Lanka, 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 implications.

These differences in the way different categories of creditors are treated under DDR point to the difficulty of setting standardised principles for implementing a scheme which has substantial adverse external effects.[6] These experiences also make clear that a central tenet of the emerging consensus on debt restructuring, which is the need for comparability of treatment, is not easy to ensure in DDR exercises. Thus, not only is the DDR scheme welfare-adverse, and prone to failure, but it also does not meet the requirements of principled and fair treatment.

In Sri Lanka, the government decided that bank insolvency post restructuring would require recapitalisation to an extent that would be self-defeating, since it would force the government to borrow more to finance that recapitalisation, assuming it could find lenders. So the burden of adjustment had to fall on the pension funds, including the Employees' Provident Fund (EPF).[7] Estimates of the losses to be inflicted on pension fund subscribers vary widely. One estimate, which gained traction because it was quoted by the opposition in Parliament and had to be challenged by the central bank governor, placed the loss that the EPF would suffer over 15 years at SLR 15 trillion. The estimate had assumed that the average yield rate on the EPF's portfolio to be 13.52 per cent, as compared to the 9.1 per cent average return offered in the restructuring package. Central Bank Governor Nandalal Weerasinghe held that the 13.52 per cent figure was completely off the mark, and that the pre-restructuring average yield was 11.5 per cent. Even accepting the correction, the 2.4 per cent reduction in yield, when compounded, could make a significant difference (Kotlewala 2023).

A more conservative industry estimate from Reliance capital, which assumed that the securities (treasury bonds, treasury bills, equity, corporate debt, and money market instruments) in which pension fund capital is invested would mature at the end of every year and that the re-investment rates of the money with the Fund not immediately required for the purposes of the EPF Act ranged from just 9 to 14 per cent. Since the new bonds issued under the DDR were to be swapped at face value with existing bonds only the coupon income was considered for calculating the loss. The estimate obtained places the future income lost at 11 per cent when compared with the pre-restructuring income profile, or at around SLR 0.93 trillion. Given the assumptions, even this significant loss estimate is likely to be an overoptimistic, minimal estimate (Reliance Capital 2023). What is clear is that the government's target, expressed to the IMF, is to reduce the outgo on interest paid by the government on securities held by the pension funds by 0.5 percentage points of GDP every year as a contribution to its effort to reduce the gross financing needs as per the IMF's specifications. The DDR exercise was driven by the fiscal consolidation objective, with thr reduction in the primary balance expected to shift from a deficit of 5.7 per cent of GDP in 2021 to a surplus of 2.3 per cent in 2025.

The Ghanian experience is more telling. In Ghana, according to the IMF's assessment, the total debt of the government had to be reduced from 109 per cent of GDP to 55 per cent by 2028. Of this 54-percentage points reduction, domestic debt restructuring is expected to contribute 37 percentage points (or more than two-thirds of the total), to bring the ratio down to 72 per cent.[8] The remaining reduction in the public debt to GDP ratio had to be borne by external creditors. Eurobonds accounted for $13 billion of the country's around $50 billion public debt.

As part of DDR, in December 2022, authorities said they were looking to restructure 137.3 billion cedis of domestic loans to overhaul its 575.5 billion cedis of debt. Failing to achieve 100 per cent voluntary participation, they targeted an 80 per cent subscription rate for the domestic debt restructuring to be deemed successful and postponed the deadline five times to improve participation. In addition, 8.4 billion and 2.8 billion cedis respectively in ESLA (Energy Sector SPV) and Daakye (Education Funds SPV) bonds were also deemed eligible for restructuring.[9]

In a first step, in February 2023, bondholders swapped 83 billion cedis of debt or 85 per cent of the 98 billion cedis of debt eligible to be exchanged. But this first step accounted for only about 60 per cent of the

restructuring volume that the government had targeted. The government reopened the domestic debt exchange window in September for those who didn't participate in the first step.

According to the IMF (2023a), in the DDE settled on February 21, 2023, "in total, 85 percent of the face value of bonds held by investors other than pension funds was exchanged…, equivalent to 28 percent of all outstanding domestic debt (which includes, among others, nonmarketable debt, verified arrears and Cocobills). The government offered most bondholders a set of new bonds at fixed exchange proportions with a combined average maturity of 8.2 years and coupons of up to 10 percent (with part of the coupons capitalized rather than paid in cash in 2023 and 2024). At a 16-18 percent discount rate, the final terms of the DDE imply an average NPV reduction of about 30 percent for these bondholders. Individual bondholders were offered an exchange into shorter term debt with higher coupons. Crucially, the completed DDE has also produced very large cash debt relief for the government of almost GHS 50 billion in 2023, relieving pressure on the domestic financing market."

The main aim of the DDEP thus seems to have been to facilitate realisation of the fiscal consolidation targets set by the IMF. The government has been persuaded to accept a sharp improvement in its primary balance, from a deficit of 3.6 per cent of GDP in 2022 to a surplus of 1.5 per cent of GDP by 2025. That amounts an adjustment of just over 5 percentage points of GDP over three years, two thirds of which had to achieved in the first year (IMF 2023a). The DDEP was clearly driven by this target.

The government at first excluded pension funds, which held about 31 billion cedis of government bonds from the domestic debt exchange after labour unions opposed a move that would erode the value of their savings. Subsequently, pension funds were given a revised offer to exchange 29 billion cedis on much better terms. Finally, the unions accepted a plan under which the pension funds will receive more interest payments, but over a longer period of time. The pension funds were to exchange their existing securities — which carried an average coupon of 18.5 per cent — for two new bonds maturing in 2027 and 2028 with an average interest rate of 8.4 per cent. The arrangement included a 5 per cent coupon in 2023 and 2024, instead of the 8.4 per cent the bonds carry. But the government's proposal sought to compensate for that loss, and that resulting from the fact that the local-currency securities that the funds held prior to the swap were to mature earlier than the ones that they'll receive in the swap. The compensation involved transferring additional securities as well as providing an additional cash-payment instrument that offered interest of

10 per cent. Overall, the resulting stream of coupon payments is estimated to ensure a yield of 21 per cent. The government was merely enhancing its fiscal space in the medium-term at no loss to the retirement funds. According to the Finance Ministry: "This alternative offer has been designed to achieve the same average maturity, achieve a better average coupon while alleviating the cash constraint for the government during the initial years after the exchange."[10] Clearly, the effort was to complete the restructuring and appease the IMF and private creditors, over the period of the IMF programme.

This stance with respect to different categories of lenders, which was the opposite of that adopted by the Sri Lankan government, was not without its problems. It has precipitated what is reported to be a loss that is rare in the record of the country's leading banks. Using a 16 per cent discount rate to compute the net present value (NPV) of government bonds valued at GHS 50.6 billion, the losses of 22 banks following the domestic debt exchange programme (DDEP) was estimated at GHS 7.3 billion in 2022, with the private domestic banks and state-owned banks accounting for losses of GHS 4.3 billion while foreign owned banks accounted for GHS 3 billion. Besides there were a number of non-deposit-taking institutions which also suffered losses (Atuahene, Kofi Agyei, and Frinpong 2023).

Ghana Commercial Bank (GCB), the largest lender, posted a 593.4 million cedis ($50.5 million) net loss for the year to end-December 2022. Standard Chartered Bank Ghana Ltd., the biggest by market capitalisation, reported a loss of 297.8 million cedis. The impairments have slowed domestic lending in the country.[11]

According to an assessment from Fitch Ratings: "The restructuring of several domestically issued debt instruments in 2023 inflicted large net present value losses on sovereign domestic creditors and significantly weakened the banking sector's capitalisation. Most of the accounting losses were incurred in December 2022, when the initial proposals for the restructuring were announced. We believe the true capital impact is masked by two factors. Firstly, the discount rate that banks used to determine the fair value of the new bonds was low, reducing the impairment charges they were required to incur. Secondly, banks have been permitted by the BoG to phase in the impact of the impairment charges on regulatory capital over four years."[12]

Ironically, these losses have occurred following a rise in public debt that was at least partly triggered by a major recapitalisation of the banking sector in 2018.[13] Financial mismanagement and alleged malfeasance in two banks, UT Bank and Capital Bank led to their forced closure and subsequent merger with GCB. The licences of as many as nine banks were revoked as part of the clean-up.[14] Other banks too were required to strengthen their capital base to a new minimum requirement of 400 million cedis (up from just 120 million), by mobilising additional capital, through one or both of two means: fresh capital injection and capitalization of surpluses.[15] By the end-2018 deadline, 23 banks had met that requirement. While sixteen banks had done this through the specified means (capital injection and capitalisation of surplus), the remaining could not. Through a set of mergers, the seven were reduced to three banks, partly supported with equity capital from pensions funds invested through the Ghana Amalgamated Trust. Five years later, the recapitalised banks were being hit with losses, that would also affect the pension funds exposed to the banking system (Obuobi, Nketiah, Awuah, Gyanwah Amadi 2020).

Not surprisingly, the government intends to use a newly established Ghana Financial Stability Fund, to address the impact of the Domestic Debt Exchange Programme (DDEP) on the financial sector. The Ghana Financial Stability Fund (GFSF) is a $1.2-1.5 billion facility to backstop the banking system, insurance companies and other financial sector entities and address cash flow difficulties that would result from the debt exchange programme.[16] In another contradictory action it is to be funded with borrowing from the World Bank and other international financial institutions. Foreign borrowing is to be enhanced to facilitate domestic debt reduction through DDR (Inveen 2022).

Realising that DDR exercises are prone to failure the IMF has sought to make it the government's responsibility, despite the origins of such exercises in IMF recommendations. Thus, a summary of the IMF's position states: "The decision to restructure domestic debt or not is always the sovereign's prerogative and entails the responsibility to limit the damage and help mitigate the effects of a restructuring on the domestic economy… The net benefit calculation will determine whether or not the domestic debt should be part of a restructuring, together with external debt, or on a standalone basis." (Breur, Ilyina, Pham 2021; IMF 2021).

Actual intent

These conceptual and practical features of DDR suggest that the intent of the exercise is very different from its claim to be a means of reducing debt stress and rendering debt sustainable. Rather, it principally serves as a means to realise irrational domestic fiscal consolidation targets, and to divert attention from the central problem of the unsustainability of excessive external debt levels resulting not least from the subordinate position of these countries in an unequal world order. That serves a further purpose. It diverts attention from the observed massive inadequacy of the haircuts imposed on external creditors, excepting for bilaterals, in the recent episodes in which the restructuring of domestic and external debt have been conflated. Multilateral creditors have not been required to take any haircuts, and IMF debt sustainability assessments have recommended extremely moderate haircuts for foreign creditors.

Besides this, conflating domestic and external debt consciously or otherwise helps serve one more objective. It allows using the opportunity provided by an external debt crisis to get desperate governments to implement a major IMF-style ‘fiscal consolidation’ and ‘adjustment’ programme involving extremely unpopular austerity measures.

In Sri Lanka the IMF’s DSA (2023), focusing again on aggregate debt reduction, recommended reducing the “gross financing needs” (GFN) of the government—or its overall new borrowing requirement plus debt maturing during the year—from 34.6 per cent of GDP to an annual average of less than 13.6 per cent over 2027-32. As compared with this 60 per cent reduction in gross financing, the outflow on account of foreign debt servicing is expected to fall only from 9.4 per cent of GDP to 4.5 per cent of GDP. This is because the haircut required of foreign creditors, other than bilaterals, is limited—nil in the case of the multilateral development banks and an inadequate sum in the case of private creditors.

The IMF estimates that the required external det restructuring in Sri Lanka would involve a temporary debt moratorium in 2022 of $2.8 billion and a reduction in debt servicing by a total of $14.1 billion over 2023-2027 (debt relief). The reduction in principal payments over 2023-27 is to be realised by a combination of extended maturities, especially for bilaterals, besides some haircuts in terms of reduction in the NPV of outstanding debt, mainly for private creditors. According to estimates, in the case of Sri Lanka, haircuts for private bondholders (whose bond holdings were at one point trading at a low of less than 40 cents to

the dollar in global markets) is to be limited to a modest 30 per cent or less. In the event, to meet foreign exchange financing needs, the government is expected to begin issuing new sovereign bonds of $1.8 billion (1.8 per cent of projected GDP) in 2027, with increases in line with GDP growth thereafter, suggesting that repayments of reduced foreign debt would be sustained with new foreign borrowing. This is simply a repeat of the unfortunate trajectory that brought the Sri Lankan economy to the current mess.

In Ghana, though the government resorted to DDR early in order to placate foreign creditors, efforts to restructure debt began after suspending interest payments on $13 billion of eurobonds. In the negotiations, there are sharp differences on the volume of haircut to be imposed on external creditors between the government and international lenders. According to the government's plans, about $20 billion of foreign loans were to be included in external debt restructuring, of which $14.6 billion were from commercial creditors. Though China is Ghana's biggest bilateral creditor holding $1.7 billion of debt compared to the $1.9 billion held by Paris club members,[17] China's exposure was much less than in other contexts and small when compared to that of commercial creditors. Though a badly designed DDR has been implemented, the task of addressing the consequences of the 'original sin' that precipitated the debt crisis remains unfinished. The "agreement in principle" with bondholders reportedly involves a haircut of 37 per cent, up a few points from an earlier 33 per cent offer that even the IMF rejected (Dontoh and de Rosario 2024).

Some policy implications

The above analysis points to the following policy conclusions:

1. Foreign and domestic currency debts are different, because governments which can mobilise domestic resources to service liabilities in domestic currency. 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*.

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 to the problem by focusing on aggregate debt, i.e. both foreign currency and domestic currency debt of the sovereign.

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. That is what the recession induced by DDR does. *External debt stress must be alleviated without harming GDP growth. This is not what DDR does, making it unfit for purpose.*

4. *Efforts at external debt stress resolution should focus on 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, focus should be not on reducing public borrowing *per se* but 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 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. If not,

within a comparability of treatment framework, haircuts considered acceptable to private creditors would set for a ceiling on the volume of debt reduction.

6. *The 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, in order to win back their confidence, needs to be recognized.* Such an assurance that creates an impression that foreign currency to service external debt would be sucked out would not only 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, but also 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 appreciate and facilitate measures adopted at the national level in the LMICs to precent excess inflows of capital*. The problem needs to be pre-empted, not just 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.

9. *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 of imports. So, governments must intervene proactively to prevent such a collapse by reducing import dependence. This would require in the 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.

Notes

[1] I am grateful to Bob Pollin for detailed comments on an earlier draft of this paper. Discussions with Jayati Ghosh in the course of writing the paper shaped its final form. An earlier version of the paper was presented at the PERI-IDEAs conference on “Debt and Climate Justice”, 3-5 May 2024. Comments by participants at that conference are also gratefully acknowledged. None of them is however responsible for any errors that remain.

[2] It is not that DDR has not been resorted to, but the instances were fewer and the circumstances special. See for example, Aitor and Díaz-Cassou (2010).

[3] Banks of Ghana figures as collated in CEIC Database.

[4] Suriname managed a restructuring agreement with private holders of two Eurobond issues in 2023, on terms that are revealing. The restructuring linked the implied haircut to a value restructuring instrument (VRI) that promises access to potential royalties from oil resources. Since larger oil exports are expected to improve the debt repayment capacity of the borrower, they are also seen as reason to give creditors a better deal. As per the terms of the VRI, creditors will be eligible for 30 per cent of potential royalties in excess of $100 million from a yet to be exploited oil block (Block 58) for a period extending to 2050. See https://www.reuters.com/markets/suriname-bondholders-reach-debt-restructuring-deal-sources-2023-05-03/#:~:text=The%20deal%20to%20restructure%20Suriname’s,government%20 said%20in%20a%20statement.

[5] Commercial banks reportedly held 65 billion cedis of the Government of Ghana’s 190 billion cedis of outstanding domestic debt, with the domestic banking system funding roughly 35 per cent of the 158 billion cedi increase in domestic debt since 2015. See https://www.intelligenceafrica.com/macroblog/article/1.

[6] Although the exchange was in principle voluntary, banks were persuaded to participate because the risk-weighting of the old bonds was increased to 100% from 0% and non-participating banks were not eligible for liquidity support from the Ghana Financial Stability Fund. See https://www.fitchratings.com/research/banks/final-terms-of-ghanas-sovereign-domestic-debt-restructure-to-still-hurt-banks-capital-15-02-2023.

[7] The IMF attempts to address this by calling on governments to ‘cast the net wide’, in the sense of including all or most categories of holders of government debt in the restructuring process so that the losses incurred by each holder are smaller, as well as to put in place mitigating measures for those suffering losses. (Breur, Ilyina, Pham 2021; IMF 2021).

[8] While participation of pension funds was in principle voluntary, the tax to be imposed on the capital of non-participating institutions was so high that it made little sense not to participate.

[9] According to one estimate: In the final and revised domestic debt exchange programme (DDEP), the Government issuer of Treasury bonds (Daakye and ESLA) valued at GHS 87 billion would save approximately GHS12.4 billion (14%) after the DDEP while making savings of GHS 7.2 billion on dollar denominated local bonds valued at $742 million. The Government saved GHS 4.5 billion (58.4%) on the Cocoa bills valued at GHS7.7 billion while the government made savings of GHS37.6 billion (53%) on the Bank of Ghana’s marketable and non-marketable bonds valued at GHS 70.9 billion. On the Pension fund bonds valued at GHS29.6 billion, the government made no savings (0%) on the DDEP because of their complete exemption from the program. The government made total savings of GHS 61.7 billion on the Government bonds valued at GHS 203 billion. See https://www.myjoyonline.com/debt-overhang-debt-reduction-and-crowding-out-the-case-of-ghanas-domestic-debt-crisis-2022-23/.

[10] https://www.myjoyonline.com/debt-overhang-debt-reduction-and-crowding-out-the-case-of-ghanas-domestic-debt-crisis-2022-23/ and Atuahene, Kofi Agyei, and Frimpong (2023).

[11] Ghana also restructured domestic dollar bonds and cocoa bills. Investors in foreign currency denominated notes agreed to swap $741.7 million out of $809 million eligible bonds for two new securities maturing in 2027 and 2028 that pay 2.75 per cent and 3.25 per cent respectively. And, the country's cocoa-industry regulator offered 13 per cent on five new bonds maturing in 2024 through 2028 to investors who tendered 7.7 billion cedis out of their existing 7.9 billion cedis of cocoa bills for the new notes. The coupon on the domestic dollar bonds was reduced from an average of 5.4 per cent on the old notes while the old cocoa bills paid about 30 per cent.

[12] According to intelligenceafrica.com: "Most banks earn 35-50% of their income from domestic government securities, with the latter constituting c.30% of total assets. Prior to … the agreement, under the first iteration of the Debt Exchange Program, the government was expected to be saving c. GhS62bn (7.8% of GDP) in interest and amortization payments, with banks expected to forego c. GhS27bn in income. This would have more or less wiped out the banking system's net interest income for the year in 2023 – for reference, net interest income was GhS12.8bn during the first 10 months of 2022 according to data from the Bank of Ghana." See https://www.intelligenceafrica.com/macroblog/article/1. The assessment notes that despite high bank exposure to government securities, "Ghana faces the tangible risk of setting off a negative feedback loop, where the debt exchange triggers bank distress and a sharp reduction in lending to the private sector."

[13] https://www.fitchratings.com/research/banks/ghanaian-banks-profits-help-capital-recovery-after-sovereign-default-27-02-2024#:~:text=Fitch%20Ratings%2DLondon%2D27%20February,early%202023%2C%20Fitch%20Ratings%20says.

[14] Atuahene, Kofi Agyei, and Frimpong (2023), reports that: "According to the Ministry of Finance and Economic Planning Annual Debt Review (03/2019), a large part of the 2018 public debt stock additions of GHC 11.1 billion resulted from the banking sector bail-out program of the government." According to the Bank of Ghana: "Banks' total investments comprising bills, securities and equity increased by 27.0 percent to GH¢48.45 billion in December 2019 compared with the 33.6 percent growth recorded for the same period in December 2018. The sharp growth in total investments in 2018 was largely due to the special (long-term) resolution bonds issued to Consolidated Bank Ghana (CBG). This led to long-term investments increasing by 115.8 percent in December 2018, while short term investments contracted by 24.5 percent. A year after this development, growth in long term investments (securities) normalised to 30.1 percent (GH¢33.03 billion) in December 2019, while short-term investments (bills) picked up by 21.1 percent to GH¢14.98 billion as at end- December 2019." Bank of Ghana (2020).

[15] "Four of these banks underwent a process of asset and liability transfers to healthier banks—a strategic move designed to preserve banking operations and customer deposits without the usual turmoil associated with bank failures. The remaining five banks were amalgamated into the newly formed Ghana Consolidated Bank, a bridge institution that was capitalized by the state to ensure a smooth transition and continuous operation of banking services." (Dzokoto 2024). "Parallel to these closures, the BoG instituted a significant policy shift by raising the minimum capital requirement for banks nearly fourfold, from GH¢120 million to GH¢400 million (approximately US$83 million), effective December 2018." "In a further step to support indigenous banks struggling to meet new capital requirements, the government established the Ghana Amalgamated Trust (GAT). This financial vehicle was designed to pool funds from various investors and acquire equity stakes in five indigenous banks. After compounding annually at a rate of 22% for 6 years, a beneficiary bank that received an initial sum of 200 million cedis would have a final amount of approximately 659.46 million cedis. However, given the hostile economic environment at that time, most of these banks placed these funds into government securities, which later suffered losses due to the Debt Exchange Programme." "The GAT bailout, rather than providing relief, has become an albatross around the necks of the beneficiary banks, significantly worsening their financial positions."

[16] "The consolidation process did not end with the commercial banks. In 2019, the BoG extended its clean-up campaign to smaller financial institutions, closing 411 entities that included a broad spectrum of microfinance companies, micro-credit institutions, savings and loans companies, finance houses, a leasing company, and a remittance company." *Ibid*.

[17] According to IMF Country report (23/168), the World Bank, other donors and the government of Ghana were expected to provide GFSF the equivalent in Cedis of US$1.5 billion to facilitate the build- up of capital buffers for qualifying banks

[18] Data from the International Institute of Finance (IIF).

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