ITUC statement on Domestic Debt Restructuring (DDR)

Prepared ahead of the Global Sovereign Debt Roundtable on DDR organised by the IMF on 15 September, 2023.

Workers and ordinary citizens bear the extraordinary consequences of national debt crises over the short and long term

Workers bear the main consequences of debt crises. These include declines in production and investment that threatens jobs; wage pressures and loss of bargaining power; collapsing exchange rates leading to higher prices or shortages of essential goods such as food, fuel and medicines; fiscal consolidation and lost opportunities to invest in SDGs or universal social protection, and austerity measures including new taxes and the withdrawal of subsidies that can cushion the cost-of-living crisis without any adequate replacement.

At the same time, workers are significant holders of domestic debt within domestic bank savings, as small investors and through national pension funds. It is important to note the pension contributions of workers represent deferred wages and that any losses in the value of these funds or in pension rates effectively acts as a stealth wage cut. It is increasingly these long-term savings of workers that provide domestic financial systems with the capital they need to achieve growth and development in their country investments, such as in businesses and job creation, investments in human capital and public services, and investments in resilience and a just transition.

Such funds are uniquely exposed within the scenario of DDR and as such a significant potential effect is that it pushes greater risk and real losses onto those holders of debt least responsible for the crisis, least aware of and protected from shock and most exposed to the economic consequences of the restructuring. This imbalance threatens the possibility of a solid recovery and erodes the solidarity required for shared sacrifice to overcome an economic crisis. It effectively undermines the legitimacy and success of any economic recovery programme.

Pension funds have become forced lenders of last resort to governments and are highly restricted in their investment options

Domestic financial systems have absorbed the majority of governments' financing needs in recent years across low- and middle-income economies.[1] Many governments have been shut off from international capital markets by the Covid-19 pandemic and the subsequent tightening of global financing conditions. In that same period, the support of international financial institutions has not matched countries' social spending needs. As a result, domestic debt has become the main available source of financing to ensure the functioning of public services, as well as the chief means of alleviating the social and economic impact of the pandemic. In the long term, any DDR is liable to result in higher domestic interest rates and credit rationing that make productive investments more costly and less likely in the future.

In addition, domestic banks and pension funds are more constrained than other classes of creditors in their investment decisions. Governments make full use of regulatory tools to increase mandatory holdings of domestic debt while sometimes maintaining artificially low rates of return, including through the use of financial repression. These policy choices may facilitate stability or growth and must be

[1] IMF, Global Financial Stability Report, April 2022

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evaluated in each specific context. However, it cannot be argued that the risk taken by these investors when investing in government debt is adequately captured by financial returns in a similar manner as those accorded to Eurobond holders.

These circumstances should be considered when allocating losses in a public debt restructuring – they show that the starting position of domestic pensioners and savers is completely different from that of foreign creditors.

Policy frameworks must recognise key differences between external and domestic restructuring

The significant social and economic costs related to DDR require that any decision to undertake one must carefully weigh up the costs and benefits and consider its effects on fairness and social cohesion as well as growth. DDRs must not be motivated *ex ante* by a desire to signal either a commitment to broader restructuring or its depth; likewise, the expected results of any DDR should not be viewed as a baseline or benchmark or be used to serve as a variable of adjustment for external debt restructurings within the calculations of other creditors. Any approach that seeks comparable treatment between foreign and domestic creditors should be excluded, since this fails to capture the costs already incurred by domestic creditors through an economic crisis, especially workers who bear a major share of it. These costs are only exacerbated by inflation or devaluation, which participants in the domestic economy are exposed to as workers, consumers and savers.

These essential differences must be recognised within policy frameworks that have proved inadequate during recent restructuring episodes. In particular, the current architecture for sovereign debt restructurings incentivises the implementation of unnecessary domestic debt restructuring by debtor countries. Recent policy developments in Zambia and Sri Lanka illustrate this point:

- In 2022, Zambian authorities announced that they would exclude domestic debt from their restructuring. However, the inclusion of non-resident holdings of domestic debt in the IMF's external debt sustainability analysis, conducted on a residency criterion, created an incentive for foreign creditors to demand the restructuring of domestic debt. The uncertainty this caused resulted in severe disruptions to Zambia's domestic debt market.

- In Sri Lanka, the IMF's debt targets focusing on gross financing needs and foreign-currency debt service created an incentive for foreign creditors to demand DDR to ensure that the government could maximise the share of foreign-currency debt service in gross financing.

External creditors have demonstrated a willingness to take advantage of such opportunities to lobby for financial burden sharing from their domestic counterparts. This is unjustified and counterproductive, and we call on the IMF to ensure that its policy frameworks and analyses are developed in ways that ensure they do not incentivise this development.

Where a domestic debt restructuring is unavoidable, a fully financed social safety net is key to limiting the economic toll

In certain situations, the enormous accumulation of domestic debt creates unsustainable dynamics that cannot be corrected by treating only the external portion of the debt. To continue servicing domestic debts, governments often incur arrears, including a postponement of salary and pension payments. Such arrears also suffocate domestic suppliers, causing additional pain to workers.

Where DDR is unavoidable, a formal and transparent approach to resolving debt vulnerabilities is necessary.

In such cases, the IMF program and analysis, to the extent that it forms the bedrock of negotiations, should be designed to take account of the full costs involved with such a domestic restructuring. More specifically, fiscal projections should reflect the likely fiscal costs resulting from the damage done to the domestic financial sector, so that any estimated recapitalisations and compensations must not be borne by the public in the face of other priorities, especially social spending.

The IMF should ensure that the design of its programs also fully accounts for the costs involved in implementing adequate social protections to alleviate the impact of a potential DDR on workers' pensions and savings. If the impact of a DDR is matched with an accurate assessment of necessary social spending from the government, this would clearly illustrate the trade-offs involved and in turn reduce the incentives for external creditors to use domestic debt as a variable of adjustment to reduce their own responsibilities. Indeed, the net impact of such an assessment on available cashflows for external debt service would be minimal. Anything less simply shifts the burden onto those least able to bear it.

Domestic debt restructurings must go through a comprehensive democratic process

DDR entails major socio-economic implications which underpin the need for them to unfold within a comprehensive democratic process, ensuring adequate levels of transparency and accountability through social dialogue.

In any restructuring there is a risk that the outcome and the allocation of losses could be driven by the respective strengths of vested interests and the relative lobbying efforts of each creditor group. Within such a power ranking, there is a risk that workers' pension savings may even be seen as 'easy pickings' for creating more space for the protection of domestic banks and external creditors, yet such an approach threatens long-term growth and legitimacy in the system, to the detriment of all involved.

A democratic approach to restructuring, characterised by social dialogue, is both the only way to ensure a fair allocation of losses and ensure the legitimacy of the outcomes, as costs are borne by the population.

Summary

Considering all the arguments above, we call for a careful, transparent and holistic assessment of the costs and benefits at stake for different parties when considering the inclusion of domestic debt in restructurings, and a stronger policy framework for assessing and managing the trade-offs and difficulties of such a DDR where they are unavoidable, within democratic national processes that includes social dialogue with trade unions.

A correct approach cannot be captured by a simple mathematical formula or legal dictum, and requires a holistic assessment that considers the unique position of workers as both wage-earners and as constrained investors, and the many channels through which they are impacted by a sovereign restructuring.