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Issues in Restructuring of Domestic Sovereign Debt

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ISSUES IN RESTRUCTURING OF SOVEREIGN DOMESTIC DEBT

IMF staff regularly produces papers proposing new IMF policies, exploring options for reform, or reviewing existing IMF policies and operations. The following document have been released and are included in this package:

- The **Staff Report** prepared by IMF staff and completed on July 21, 2021
- The **Background Paper** prepared by IMF staff and completed on August 19, 2021

The report prepared by IMF staff has benefited from comments and suggestions by Executive Directors following the informal session on September 8, 2021. Such informal sessions are used to brief Executive Directors on policy issues and to receive feedback from them in preparation for a formal consideration at a future date. No decisions are taken at these informal sessions. The views expressed in this paper are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board.

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EXECUTIVE SUMMARY

Restructurings of sovereign debt issued under domestic law—*domestic debt* for short—may become more frequent in the future. Prior to the mid-1990s, with underdeveloped financial markets and widespread capital controls, emerging market and developing economies (EMDE) debt distress was often dealt with via inflation, financial repression and, when necessary, an external debt restructuring (EDR). Since then, the share of domestic debt in EMDEs has been rising, most recently as a result of the COVID-19 pandemic. With a high number of countries at risk of debt distress as a result of the pandemic, domestic debt restructurings (DDR) may be needed more often to restore sustainability.

Domestic debt restructurings avoid some of the costs of external debt restructuring, but also pose unique challenges. Sovereigns have considerable flexibility in restructuring domestic debt, including through changes in domestic laws. A DDR can also potentially limit the external reputational costs of a restructuring, supporting efforts to retain access to external financial markets. At the same time, domestic banks and pension funds disproportionally hold domestic rather than external debt. As a result, sovereign stress can easily spread to other parts of the economy, with potentially serious adverse effects on financial stability and economic activity.

The design of a DDR can play an important role in achieving the required debt reduction target while minimizing risks to the domestic financial system and broader economy. Casting the net wide across claims when identifying the perimeter can support participation in the restructuring by lowering the relief sought from each creditor group. Financial stability considerations play an important role in the design of a DDR. Stress tests prior to the restructuring can provide critical information that informs the design of and need for policy support. Depending on the severity of the spillovers of the DDR to the financial system, the policy response may need to include liquidity support, regulatory measures, recapitalization, and the establishment of a financial sector stability fund.

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CONTENTS

BOXES

FIGURES

ANNEX