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Debt distress and crisis

WHAT HAPPENS WHEN IT HITS?

BRIEF 4

PSI BRIEFING SERIES - DEBT AND WORKERS

Debt distress and crisis

WHAT HAPPENS WHEN IT HITS?

DEBT-TO-GDP: NOT A MAGIC NUMBER[1]

2015 UKRAINE
DEBT = 80% OF GDP
SOUGHT AN IMF BAILOUT

2018 PAKISTAN
DEBT = 70% OF GDP
SOUGHT AN IMF BAILOUT

2018 USA
DEBT = 100% OF GDP
NO CRISIS (YET)

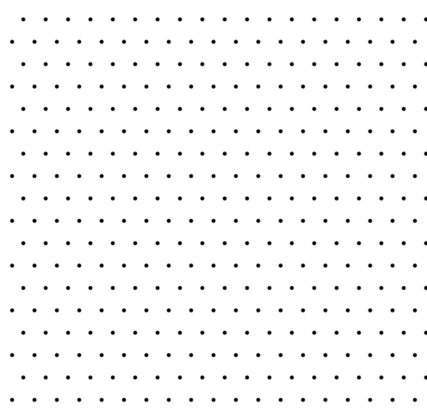
Debt distress occurs when a country's debt-levels and other internal and external factors put it in danger of not meeting its debt obligations. This could result from an ecological disaster, interest rate hikes in other countries, currency depreciation, changes in commodity prices etc.

The first sign is when a country can no longer get a low interest rate from lenders, as investors begin to fear a potential default.

When this happened to Iceland in 2008 and Greece in 2010, both countries were thrown into crisis. But is this inevitable, and what can be done about it?

FROM DEBT SUSTAINABILITY TO DEBT DISTRESS

Being in a position of debt distress - or a debt crisis - is linked to the perceptions of global investors about debt sustainability. As mentioned in Part II of this series, there is no absolute level at which debt to GDP becomes unsustainable – it depends on a range of variables such as future growth projections, productivity and external trading conditions.



Although the US has the highest debt-to-GDP ratio, and its highest since 1946, there is no indication that this is an unsustainable level of debt.

Pakistan currently has little capacity to generate export earnings, and only low reserves of foreign currency – so the country is deemed fragile by investors with a high risk of default, and finds it difficult to attract reasonably priced external financing.

The US, by contrast, is in a unique position because the US dollar is the dominant international reserve currency: a status referred to by one French president (V. Giscard d'Estaing) as "an exorbitant privilege."

What this means is that:

- Overseas institutions and individuals (including governments and banks) who hold US currency are essentially providing the US with an interest-free loan
- The US can raise capital more cheaply since there will always be large purchases of US Treasury Bills (securities) by foreign governments, institutions and companies.
- There is little risk that current national indebtedness will lead to a crisis in the US.

It's clear that not all countries are equal.

As market confidence in a country's debt sustainability falls, lenders start to worry and typically demand higher yields to offset their (perceived) risk. The higher the required yields, the more it costs the country to refinance its sovereign debt. This can prevent a country from rolling over debt and lead to crisis and default.

Outflows – often experienced in the form of sudden capital flight – are a signal for a lack of market confidence. It is market sentiment – rather than real economic indicators - which drives this capital flight.[2]

What this means is governments are at the mercy of the (often self-fulfilling) fears of global financial markets. On top of this, foreign governments are seldom neutral: instead they act to protect investors and banks from their countries from exposure to losses, as was the case in the response to the Greece crisis.

COLLATERAL DAMAGE: FOR THE ECONOMY AND FOR WORKERS

When a country indicates debt-distress (by missing repayments, declaring a standstill on its debt, or seeking bailout from the IMF or others) it often results in an economic crash.

The consequent slump in growth can negate years of positive growth. This was the case for developing countries in the 1980s (such as Mexico, Brazil, Venezuela and Argentina)[3] and for Italy and Greece since the Global Financial Crisis[4].

This can lead to reduced trade, falling foreign direct investment and slowed growth for local business. Confidence in the domestic economy is massively undermined, resulting in job losses, wage freezes and economic and social disruption. As discussed in Part III this series – the vulnerable sectors of the economy are likely to suffer most.

DOUBLE WHAMMY

Working out how (and whether) the debt will be repaid involves the governments of both debtor and creditor countries, private investors and multilateral institutions. The voice of workers is rarely heard in these negotiations, although they bear many of the real costs of economic collapse. This is not new, but it has become more extreme.[5] But the question underlying the negotiations at the time of debt distress or crisis is: who pays the cost of the debt workout?

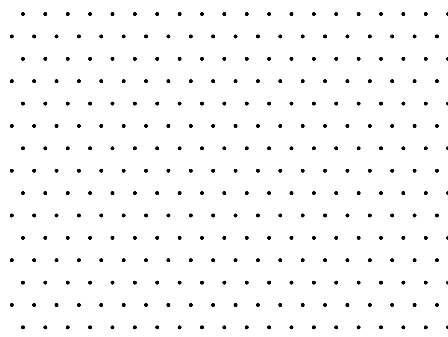
In theory, the consequences of the loan's risk should be distributed among the parties according to the risks accepted as part of the transaction. Thus, in addition to the risks borne by the debtor country:

- Part of the cost should be borne by the shareholders of financial institutions – be they banks or hedge funds.
- Some costs might be borne by the taxpayers of creditor countries, as their banks record losses, lower profits, and subsequently lower tax revenue.

The harsh reality is that the burden of debt is largely borne by workers in the debtor countries. The growing power of financial markets and exposure to private investors has led to the increasing use of legal action. What this means is creditors can sue states to pursue debt repayments via domestic courts, often in the creditor's country.

After Royal Bank of Scotland's risky investment decisions brought it to the edge of bankruptcy, the British taxpayer dished out over £40 billion to bail the bank out.

In the 1980s and 1990s, less than 10% of defaults were accompanied by litigation - but since the mid-2000s, 50% of defaults have led to legal action.[6]



Litigation is now seen by some creditors as a way to get a huge (predatory) benefit from debt. And because governments are afraid of the high costs of long court cases, they are settling earlier rather than waiting for punitive court outcomes.[7]

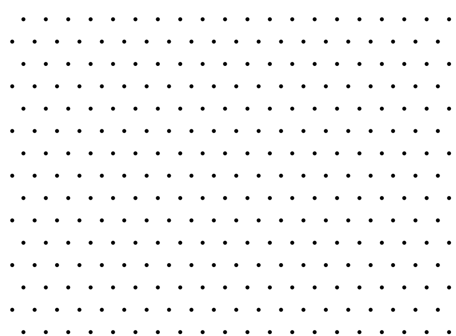
The lack of certainty and fairness in the global debt workout system has created a new market actor - vulture funds - who buy distressed debt cheaply with the sole intention of profiting from the unfortunate situation by manipulating the current flawed rules (see box below).

From the perspective of economic sustainability, pushing the bulk of the burden of sovereign debt onto the debtor country is like putting a person in prison until they repay their debts. It is punitive but it helps nobody.

If a business goes bankrupt, the investor takes a haircut in terms of capital repaid.[8] Bankruptcy laws for business and individuals have evolved this way because punishing debtors with prison was counterproductive – a prisoner cannot repay their debts.

Countries in economic free-fall also have no chance of repaying their debts, either. The workers of the debtor country suffer twice – as the economy is plunged into negative growth - and as the government tries to find the means to repay the debt by cutting services, safety nets and jobs. This is like putting the debtor's family in prison and is not just unhelpful - it is manifestly unjust.

Private creditors are exploiting a system that protects them from risks they would have to bear in any normal transaction.



WHAT ARE "VULTURE" FUNDS?

Some financiers now buy government debt that has defaulted or is at risk of default on the secondary market (at a discount) explicitly so they can sue for full repayment. The "Holdout creditors" can impede debt renegotiations and immiserate debtor states. Hedge funds account for more than two-thirds of all sovereign debt lawsuits in the last two decades.

Because there is no coherent international framework for working out sovereign debt disputes, countries face real challenges in resisting the punitive actions of these Vulture Funds, who can seek to impede debt renegotiations and punish debtor states.

These funds often buy the debt after the majority of original creditors have reached a settlement with the defaulting country. They then sue for the face value of the bonds, plus interest, arrears and litigation costs. One such creditor received a

392% return on the original face of the bond, resulting in profits of up to 2,000%.[9]

This creates a moral hazard, encouraging creditors to avoid settling or renegotiating, knowing they will have more power and reap high returns if they 'hold-out.' These litigations threaten debt sustainability, financial stability and jeopardize sustainable development. They are also unjust: imprudent lending is just as important for sovereign debt crises as imprudent borrowing. Yet the burden tends to fall disproportionately on the debtor side.

For example, after years of battles with creditors following a major crisis, Argentina paid four vulture funds 1-2% of its GDP to avoid being barred from international capital markets.

Some countries have now adopted national legislation to restrict the ability of Vulture Funds to prey on countries which have undergone international debt relief initiatives. These include the Belgian legislation against vulture funds and the UK Debt Relief (Developing Countries) Act 2010.

But in the absence of universal adoption of such laws, countries remain vulnerable to litigation in foreign courts.

UNIONS TAKE ACTION - ICELAND

Iceland might be a small nation but the 2009 crash of its banking sector was one of the largest ever of its kind. For a small community this could have been disastrous. But Iceland recovered much sooner and stronger than feared.

The idea of fair distribution and social cohesion preached for decades by the labour movement played a key role in steering this recovery, says Ögmundur Jónasson - a former head of the Confederation of State and Municipal Employees of Iceland and PSI Executive Board Member. At the time of the crisis, Jónasson was Iceland's Minister of Health and had a frontline perspective on the country's debt crisis.

He explains:

"Iceland, like other Nordic countries, developed a tripartite system of social dialogue between organized labour, the state and municipalities and the employers' associations. This tradition of dialogue had certainly been impaired with the advance of neoliberalism but the tradition was still there and when it became clear that Iceland was on the brink of bankruptcy all these partners knew that there was a need for dialogue and cooperation."

As the country's banking sector crashed, largely as a result of irresponsible investments on the international money markets, the IMF became increasingly politically involved.

"The IMF had a bad reputation in labour circles. As Minister of Health I had several meetings with representatives of the IMF who pushed for public spending cuts - but never do I recall them asking about how the health system was faring. We managed to negotiate a compromise, involving the social partners, where taxes were increased for the better off while alleviated for the lower paid. This gave the state and municipalities increased revenue and the need for cuts was somewhat reduced."

The IMF was made aware from the outset that any harsh proposals- including privatisations, widespread cuts and lay-offs – would not be tolerated in a society where labour unions were to be reckoned with. This in turn strengthened the government's negotiating position.

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