

**SOVEREIGN DEBT IN THE 21ST CENTURY.
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I. INTRODUCTION

Public debt in emerging market countries has risen in recent years to very high levels. In fact, it has been estimated that, on average, the ratio of public debt to GDP among emerging markets now exceeds the average in industrial countries. According to IMF estimates, public debt in emerging markets currently stand above 70 percent of GDP, which compares with figures of some 65 percent in industrial countries.

This is not a healthy trend for several reasons. To begin with, the fiscal burden in emerging markets is much lower than in industrialized countries, and interest costs tend to be significantly higher. By themselves, these facts would counsel lower indebtedness. But in addition, and perhaps most importantly, emerging markets are subject to highly volatile capital flows.

The high average level of emerging market debt raises the issue of whether debt levels are too high in some sense. If this is in fact the case, it is important that we think carefully how to defuse possible threats from this source and how to proceed in those cases that degenerate into so-called "credit events." I will touch upon these two issues, noting that while dealing with defaults is an important task, we should not allow the international organizations to be distracted from their main duty, which should be to help their member countries to stay on a safe course and to deal with their difficulties early on.

Reinhart, Rogoff, and Savastano¹ have recently done an excellent job of putting defaults in historical perspective, and confirming what any sensible observer and policy maker knows: namely, that emerging market countries should approach debt markets cautiously. However, even if emerging market countries may suffer from some degree of “debt intolerance,” the fact remains that two of the benefits of globalization are enhanced access by individual countries to global savings and enlarged investment options for global capital. Clearly, it would be unwise to let these opportunities pass. The challenge, as ever, is to take advantage of the opportunities without running unacceptable risks. Thus, I want to start by mentioning some of the precautions that must be taken to make the most of the promises offered by a global capital market.

II. PRESERVING DEBT SUSTAINABILITY

A recent IMF study finds that the main causes of the surge in emerging market debt of recent years were the balance sheet effects of devaluations, increasing interest costs, the recognition of contingent liabilities, and other “one-off operations” such as bank rescues. While primary fiscal balances have been positive on average, they have not reacted sufficiently to the pressures created by these other factors. These facts suggest immediately a menu of preventive actions:

- **Fiscal reform.** Emerging market countries tend to have relatively low tax revenues. This deficiency limits the debt load they can carry and, given the demands for public spending, creates pressures to increase debt financing. Moreover, a narrow tax base can hardly be made to yield extra revenues in an emergency. So, building up a strong revenue base should be a priority.
- **Prudent fiscal policies.** It is essential to create a track record of forward-looking, prudent management of fiscal policy. In addition to its obvious

¹ C.M. Reinhart, K. S. Rogoff and M.A. Savastano; “Debt Intolerance”, NBER Working Paper Series, WP 9908, August 2003.

benefits, a good track record will be reflected in reduced country risk and borrowing costs. Moving to a higher-grade investment class is an important shield for a sovereign's debt from contagion.

- **Governments should address early on the long term pressures from social security** and other contingent liabilities. Thinking about the words “21st century” in the title of this seminar, it is hard to find a long-term issue that poses as much risk to the public finances of so many countries as the management of social security.
- **Active liability management:** it is a good idea to stretch maturities to preserve liquidity and to moderate exposure to foreign exchange risk, while taking care not to crowd private agents out of the domestic financial markets.
- **We should explore options to share risks between creditors and debtors** through the issue of contingent instruments. Much has been said about growth bonds, but a more viable option would be offered by commodity-linked bonds. In Mexico we have had a positive experience with the issue of petrobonos and with the attachment of oil-related warrants to Brady bonds.
- A **floating exchange rate regime** can help reduce vulnerabilities, because the absence of “one sided bets” inhibits the emergence of balance sheet imbalances in the private sector.
- **Strengthening the prudential supervision of financial institutions.** Although this is not directly a fiscal issue, experience shows that, during an emergency, the need to protect the payments system can require important contributions from the government. So, protecting the payments system also protects the public treasure.

In general, debt sustainability is an elusive concept. However, it would be a good idea to maintain a cushion between a country's actual debt and what might potentially be considered its highest tolerable debt load. Admittedly, this is a form of self-insurance against unforeseeable shocks, which is only a second best idea. But first best solutions are not accessible at present.

It is also worth noting that every effort must be made to encourage the creation of mechanisms that foster debt sustainability and, more generally, crisis prevention. In this regard, I am of the view that the IMF would make a valuable contribution to crisis prevention by keeping a facility like the CCL alive. None of the existing Fund facilities is designed to encourage members to implement sound economic policies, while at the same time helping those with sound fundamentals cope with exogenous shocks. It is precisely the combination of these features and the absence of moral hazard arguments that make the CCL a unique facility, that adequately redesigned would improve substantially the crisis prevention kit. It would indeed be regrettable if the Fund's Board does not obtain at the end of this month the 85 percent majority needed to avoid its expiration.

III. CONTAINMENT OF CAPITAL ACCOUNT CRISES

The economic crises in emerging market economies over the last decade share a number of elements that distinguish them from those observed during the eighties and the first years of the nineties. In particular, contrary to the experience of previous years, most of the recent crises have been characterized by a dual nature. On the one hand, many of them have been accompanied by typical macroeconomic problems such as a large current account deficits and a substantial appreciation of the real exchange rate. On the other hand, they can be considered as essentially capital account crises having as a common element speculative attacks and the presence of herd behavior. Thus, in many cases the virulence of the crises did not correspond to the importance of the problems faced

Naturally, to overcome an economic crisis of this nature, the policy response must aim at tackling both of its dual features. Appropriate fiscal, monetary, and exchange rate policies must be implemented to restore macroeconomic equilibrium. In addition, sufficient external financing must be available to ensure investors that the country will be able to meet its external obligations. Furthermore, under these circumstances the possibility of multiple equilibria arises. If the country is able to implement the policies required in an orderly way, the nature of the problem faced will be essentially one of liquidity. However, if confidence is not restored promptly a solvency problem may arise.

It is evident from the above that the components of a policy package needed to face these kinds of crises are not very different from those recommended in traditional balance of payments problems, that is, a combination of adjustment and financing. The difference in this case is that under the presence of a crisis of a dual nature, the efforts required are much stronger. In other words, an overshooting of both adjustment and financing is needed.

The experiences of Mexico in 1995 and of Brazil in 1999 show the merits of a positive combination of strong adjustment of the domestic policy and adequate international financial assistance. Between 1994 and 1995, the primary surplus in Mexico rose from 2.1% of GDP to 4.7%. Similarly, in Brazil the primary balance moved from a situation of equilibrium in 1998 to an average surplus of 3.5% in the following three years. These efforts, coupled with important resources from the international community, allowed both countries to recover growth, honor their international obligations, and regain access to international capital markets relatively rapidly. Other experiences, such as those of several Asian countries during the 1997 crisis, confirm the adequacy of this approach.

Naturally, these efforts have not been exempt from criticisms. Some of the latter have focused on unsuccessful experiences. The experience of Argentina in 2001

is a case in point. In mid-2001, the Argentine government made a multi-billion dollar debt exchange (the “mega-swap”), with the support of the IMF, that lengthened the maturity of part of its sovereign debt. The operation was designed to reduce cash needs in the period 2001-2005 at a very high cost in the future. Conceding with reservation that the swap could help the Argentine economy in the short run, it was not backed by a sufficiently solid domestic adjustment policy and, in the end, was unsuccessful for that reason. The failure of the Argentine government to implement the domestic adjustment needed to cope with its macroeconomic imbalances has been amply documented.²

Another source of criticism has originated from the potential adverse implications of this approach on moral hazard. While IFIs have played a useful role in many cases, some policy makers and observers fear that large financing packages may create an incentive structure in which investors are not encouraged to pay sufficient attention to default risk. To prevent this problem, they would limit the resources that IFIs devote to assist countries in trouble and some would even hope that a few extra defaults would teach everyone a lesson. While these concerns are understandable, it is important to note that the bulk of the available systematic research has uncovered no evidence to support the contention that moral hazard is a serious problem.

More constructively, the concern over moral hazard was reflected in the Prague Framework for crises resolution, which urged private sector participation. Certainly, the involvement of the private sector may substitute IFIs financial assistance to a certain degree, but the experience of several countries shows its limits. In the Mexican and the Brazilian cases private sector participation was hesitant and insufficient. In Argentina, the mega-swap already described generated an enormous burden for the years after 2005, which, some analysts believe,

² See for instance M. Mussa, “Argentina and the Fund: From Triumph to Tragedy”, Policy Analyses in International Economics 67, The Institute for International Economics, July 2002.

contributed to the steep rise in the spreads on Argentinean debt in the second half of 2001.

Experience teaches us that IFIs should be involved in the first stages of a crisis. It would be ideal if IFIs could tell whether a given situation constitutes a problem of liquidity or of solvency; but things are seldom that easy. Moreover, the action or inaction of the international community can itself be a determinant of the evolution of the crisis. For this reason, it is crucial that these institutions be ready to provide sufficient support. This is exactly what happened in Mexico, South Korea, Brazil and other cases, and it worked. Now, this approach did fail in the Argentine case, in which support may have continued beyond the point where it ceased being useful. But the cost of making that type of error is much less than the cost of withholding support in a case in which there is a reasonable chance that it will make a difference.

IV. PROPOSALS FOR THE RESOLUTION OF SOLVENCY CRISES

Despite efforts to contain critical situations, some countries will still fall into solvency crises and will need to restructure their sovereign debt. This task, always hard, has become even more difficult in recent times due to the new modalities of sovereign indebtedness, which involve numerous creditors, anonymous and difficult to coordinate. Litigation by rogue creditors, the variety of debt instruments involved, and the range of jurisdictions where debt is issued have also increased the complexity of any restructuring.

While there is broad agreement on the need for a more orderly and predictable debt restructuring framework, there is ample debate on the specifics. Three options have been considered recently: a Sovereign Debt Restructuring Mechanism (SDRM); Collective Action Clauses (CACs); and a Code of Good Conduct.

IV.1. Establishment of a Sovereign Debt Restructuring Mechanism (SDRM)

A couple of years ago, the IMF proposed the Sovereign Debt Restructuring Mechanism (SDRM) as a means to create a sort of international bankruptcy court. Proponents of the SDRM argued that such a statutory proposal would provide an orderly framework for crisis resolution by coordinating and aligning creditor and debtor incentives, while safeguarding the required window for policy adjustment and debt restructuring. It was also argued that the SDRM would promote a better allocation of capital and a more efficient, stable, and predictable international financial system. The search for means to diminish the number of large financing packages supported by the IMF, was another idea behind the proposal to create the SDRM.

However, most emerging countries- including Mexico- together with some industrialized countries and private creditors, expressed strong reservations about the implementation of a statutory approach for a number of reasons that, in the end, caused it to be abandoned. These are some of those reasons:

- The potential negative impact of the SDRM on capital flows to emerging markets.
- The risks that this mechanism could induce a run for the exit among creditors at the first signs of economic trouble.
- The possibility that the SDRM might encourage some debtors to opt for default to avoid the political backlash of implementing required policy adjustments.
- The difficulties of estimating when a sovereign's debt has become unsustainable and of determining the required haircut.

Besides these problems, the SDRM required domestic legislative authorization in most countries to become operational, making its adoption politically unviable.

IV.2. Inclusion of Collective Action Clauses in Sovereign Bonds (CACs)

The contractual approach to sovereign debt restructuring calls for a more widespread use of Collective Action Clauses. It is argued that CACs would facilitate negotiating procedures, promoting early dialogue and coordination between debtors and creditors, limiting disruptive legal actions and setting forth the modalities of sovereign debt workouts, making them more predictable.

There have been some concerns about the ability of CACs to deal effectively with debt restructuring problems. The first is that CACs will not solve the problems that might arise in the short and medium term because it may take a decade or longer to include them in most emerging countries' sovereign bonds. Also, wider use of CACs has been hampered by the absence of standard documentation and by a fear that borrowing costs may increase as a result of the inclusion of CACs in debt contracts.

The recent Mexican issue of bonds with CACs in New York seems to have helped move this discussion forward, with other countries following suit. Encouragingly, in the Mexican case as well as in many of the subsequent issues by other emerging countries (Brazil, South Africa, South Korea, Belize, and Guatemala) there was no evidence of any major increase in interest rates spreads. This is especially noteworthy in the case of Brazil, an important borrower with significant country risk, but less surprising in the cases of Korea and Mexico, two issuers of investment grade bonds.

The recent experience of Mexico with the inclusion of CACs in its sovereign bonds sheds some light on these concerns. So, I will try to answer the following questions: Why did Mexico decide to start including CACs in its new bonds issues? Why did Mexico opt to include or exclude particular provisions? and, What have been the results of this strategy so far?

Why did Mexico decide to include CACs?

Mexico decided to test a contractual approach for several reasons. First, because it was thought that this would be a useful mechanism to face potential problems without disrupting the fundamental legal framework of international capital markets; second, because there had been significant progress in developing uniform model provisions for sovereign bond contracts accepted by market participants which would reduce potential first mover problems; third, because Mexico, as an investment-grade issuer, was in a good position to include clauses that would be accepted by the market.

What clauses did Mexico include?

Mexico decided to incorporate both majority restructuring and majority enforcement provisions in line with the recommendation of the G10 Working Group. The provisions included a 75% voting threshold of outstanding principal for changing most important bond terms, a vote by 25% of outstanding principal to accelerate the claims following a default, and a threshold of 75% to amend important non-payment terms instead of the market practice of 66%. There is also a broad definition of those bonds that should be excluded from voting because they are owned or controlled, directly or indirectly, by the Mexican Government.

What does the experience with CACs so far tell us?

In the past few months, Mexico has issued five bonds with CACs. Although there was considerable discussion in the markets, particularly the first time, the bonds were issued successfully with over subscription for this new modality in line with previous issues. At the same time, an analysis of the Mexican yield curve provided no evidence that the price, either at the launch or in secondary market trading, reflected a premium for the inclusion of CACs.

IV.3. A Code of Good Conduct

Another avenue that has been suggested recently as a means to strengthen the framework for crisis resolution, is the design of a Code of Conduct for Sovereign Debt Restructuring. It has been argued that, by providing guidance on how debtors and creditors should behave during periods of difficulties, and by promoting dialogue between them, the Code would contribute to an early resolution of solvency problems.

To develop a Code that could be endorsed by debtors and creditors, a High Level Group was recently created, with the participation of representatives of the private sector, emerging markets, industrial countries, and international financial institutions. This group took as a starting point concrete proposals put forward by the Banque de France and the Institute of International Finance, as well as the experience gained from previous debt restructuring processes and the discussions on the role of CACs and the SDRM.

This working group has fostered rich exchanges of views, reaching a broad consensus on some of the necessary features of a code of conduct: it should be observed voluntarily and applied flexibly on a case by case basis, and it should reflect the interests of debtors and creditors in a balanced way.

Notwithstanding these efforts, there are still many areas of disagreement among issuers and the private sector, and the road ahead is not an easy one. The areas where the most important differences have been found so far include the following:

a) Whether the Code should cover aspects of both crisis prevention and resolution or focus more narrowly on debt restructuring. While issuers in general want the Code to focus or at least emphasize strongly crisis resolution, some private sector participants have attached more importance to crisis prevention. More concretely,

they have insisted on the creation of a standing body of wise men, that would function as a forum for consultation with emerging markets during periods of normal market access and when confidence appears to weaken. For several reasons, among them the existence of Investor Relation Programs already fulfilling many of these functions, issuers consider the creation of this group neither necessary nor recommendable.

b) Whether the Code should specify the situations when a creditor committee should be the preferred option for dealing with debt restructuring. Emerging markets have opposed this proposal, since recent experiences show that neither formal negotiations nor creditor committees are necessary for a successful restructuring. Furthermore, creditor committees might give rise to problems of representation, unfair treatment of creditors excluded from the committee, and legal issues related to the use of market sensitive information. Our view has been that determining whether such committees offer the best avenue for negotiation should be done in the context of each specific situation.

In addition to the above, it is worth noting that there are many features of the Code that have not been discussed yet.

Another challenge faced by the Code, given its voluntary character, is to ensure that it will be observed. The problem is that the parties involved face different incentives and there are no mechanisms to enforce compliance. To put it differently, it is very difficult to reach a situation of equilibrium in a game of frequently opposing interests and where no arbiter exists. Taking care that the Code is relevant, well balanced, flexible and owned by the potential users should contribute to alleviate this problem. Naturally, the adoption of measures to enhance market awareness of the Code would also be of help.

In sum, while there is a widespread view that a Code of Good Conduct for Sovereign Debt Restructuring could be a useful instrument for dealing with future

solvency problems, there is still a lot of work to be done to make this proposal a reality, and it is not clear yet whether these efforts will be successful. The recent G20 communiqué calling for further efforts among issuers and market participants to develop a workable code of conduct and encouraging G20 members to participate in these efforts, provides some grounds for optimism in this regard.

V. CONCLUSIONS

Sovereign debt will remain a tool for the diversification of portfolio risks and a form of financing public sector deficits in emerging markets. However, issuing and buying emerging market country debt is a serious business, and ensuring that sovereign debt markets function well poses two challenges for the international financial community: keeping emerging market country debt within safe levels, and reacting correctly when a capital account crisis might threaten to unravel the finances of a sovereign debtor. If this is done, sovereign debt can continue to play a useful role for investors and borrowers.

For this to happen, country governments must follow prudent policies and foster an environment where private agents will also act responsibly. During periods of stress, governments should be willing to act vigorously. This will involve costs, including so-called precautionary recessions. Such costs, however, are of an order of magnitude smaller than the costs of a full blown crisis and its aftermath, and they can be minimized through the prior establishment of a track record of prudent behavior.

At the same time, it is important to stress that the magnitude of capital account reversals can be such that, without the decided support of the international financial institutions, even sovereign borrowers that undertake important adjustment can risk default. The timely and forceful intervention of the international financial institutions can make a difference, keeping private investors involved and helping a borrower navigate a liquidity crisis.

The need for this type of intervention has been recognized in practice, as it becomes evident when one looks at the size of some of the IMF-led emergency financing packages of the last decade. However, it is important not to send the wrong signal. The recent emphasis on the SDRM and similar mechanisms risked creating the impression that defaults would be looked upon favorably. It is true that, once a default occurs, it causes enormous distress, and it would be good to have ready procedures to reduce the intensity of that pain. However, care should be taken not to destroy the perception that defaults should always be last resort events.

For this reason, voluntary, market based approaches to dealing with sovereign debt problems seem to be the best option. At this stage, the design of a code of conduct that might provide a framework for the orderly resolution of debt events without fostering moral hazard, combined with a wider use of collective action clauses in sovereign bonds, appear as the most reasonable route to follow.

In closing, I want to stress that we have learned a lot from the numerous financial crises observed in emerging markets during the last decade. The need to keep strong public finances in a permanent way, the challenges raised by balance sheet mismatches and the role played by policies such as flexible exchange rate regimes to alleviate the accompanying risks, the importance of strengthening financial institutions and their supervisory and regulatory frameworks, the crucial role of transparency, accountability, and the provision of better information to markets, and so on. Although, as I have already noted, improving the framework for crisis resolution is a must, in trying to build a more stable world economy we should also strive to transform all these lessons into concrete actions of tangible results..