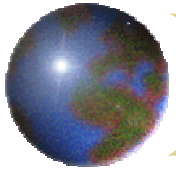


# ***COVERING GLOBALIZATION***

*Shari Spiegel*

April, 2005



## *What do creditors want?*

*For a country to be able to repay its debt...*

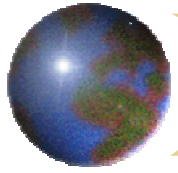
- ✚ *...in the near term*

- ✚ Short-term focus

- ✚ Low debt ratios

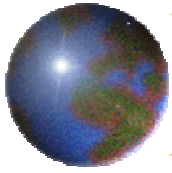
- ✚ It's mostly fiscal – tight fiscal policy

- ✚ Tight monetary policy to fight inflation



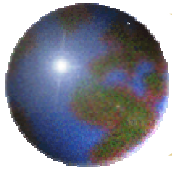
## *Market discipline: is it as good as they say?*

- ✚ Policies to be repaid are not necessarily the same as policies for long term growth
  - ▣ Capital markets short-term oriented
  - ▣ For long-term growth want to be able to stimulate the economy during recessions
    - Loosen fiscal, monetary policies
- ✚ Ratings have similar effect



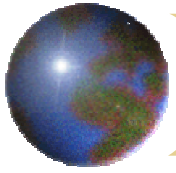
## *From a country's perspective:*

- ✚ Borrowing pushes up credit premiums and interest rates
- ✚ Once a country needs refinancing it is forced to follow market policies to keep borrowing costs under control



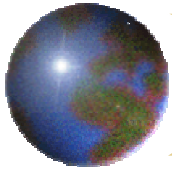
## *From a country's perspective:*

- ⊕ High debt/market discipline limits use of macro-economic policy tools:
  - ⊕ e.g. during a downturn, fiscal deficit naturally widens; countries forced to tighten fiscal policy rather than use it to stimulate the economy
- ⊕ Resources for development go into debt servicing



## *When should a country borrow?*

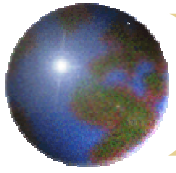
- ⊕ Expected returns should be greater than the interest rate paid
- ⊕ If funds go into productive investment; not consumption
- ⊕ Should limit amount of currency risk (external borrowing)
- ⊕ For sovereigns, long term borrowing based on expected growth
  - ⊠ *(vs. short term market focus)*



## *GDP Growth*

- ✿ *4 countries that defaulted, restructured or rolled over debt*

GDP Growth for 2 years prior to default					
	Year 1	Year 2			
Moldova	-3.4	2.1			
Uruguay	-3.4	-11.0			
Argentina	-3.4	-0.8			
Ecuador	0.4	-7.3			

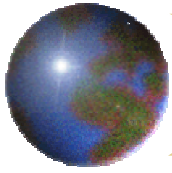


# *How do countries get into debt crises?*

*Some reasons include...*

- ✚ Private sector, bilateral, multilateral borrowing
- ✚ Low growth
- ✚ Often coupled with overvalued currency
  - Currency devaluations (domestically induced – e.g. Argentina; or due to contagion – e.g. Moldova)
- ✚ External shocks

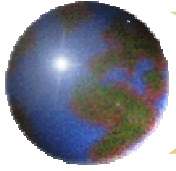




# Argentina

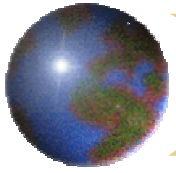
## *Default 2001*

	1999	2000	2001	2002	2003	
DOMESTIC ECONOMY (1993 prices)						
Real GDP % change	-3.4	-0.8	-4.4	-10.9	8.8	
Total Debt % GDP	52.0	53.9	56.2	155.8	127.9	



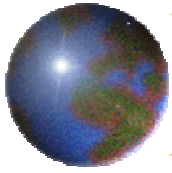
# *When a country runs into problems*

- ✚ What happens?
- ✚ Who bears responsibility?
  - ▣ Debtor for borrowing
  - ▣ Creditor for lending



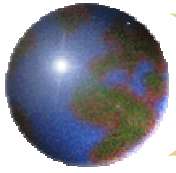
## *Emerging Market Investment*

- ✚ High returns
- ✚ Highest fixed income asset class: Annual return of 17.34% since 1994 (JPM EMBI+)
- ✚ Being paid for high emerging market risk
- ✚ But countries rarely default...
- ✚ and when they do restructure there have been high recovery values (until Argentina)



## *2 questions:*

- ✚ When should countries default?
  - ▣ Investors paid for probability of default
  - ▣ Why are defaults less common than market would predict?
- ✚ High recovery values: what is a successful restructuring?



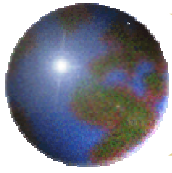
# *Debt restructurings: What is a successful restructuring?*

## ✿ Unilateral Defaults

- ✧ Russia
- ✧ Argentina

## ✿ Market Based Restructurings

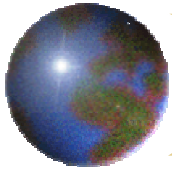
- ✧ Ecuador
- ✧ Uruguay



# *Ecuador: Successful Restructuring?*

## *debt restructuring 2000*

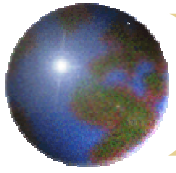
	1997	1998	1999	2000	2001	2002	2003e
DOMESTIC ECONOMY							
Real GDP % change	3.4	0.4	-7.3	2.3	5.1	3.4	3.0
External Debt % GDP	63.9	70.5	97.6	85.1	68.5	66.6	63.1



## *Analyst report: May 2002*

"We do not see at risk the coupon payments on Global bonds in 2002 *as long as* oil prices remain at current levels and the government implements a fiscal adjustment. However, *arrears* with bilateral institutions and suppliers are likely needed in 4Q02 *in order to service external bonds*. A note of caution; ability to pay does not equal willingness."

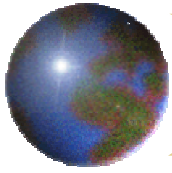
-- *Salomon Smith Barney, Economic and Market Analysis, Country Analysis and Commentary, May 13 2002*



## *Ecuador*

- ✚ Ecuador defaulted on its debt in October 1999 and restructured in July 2000
- ✚ A year and a half later analysts are writing about a potential debt problem
- ✚ Comparability?
- ✚ (the report continued: Public expenditures are not being controlled. We estimate a 2002 fiscal deficit of US\$46 million or 0.2% of GDP.)





# *Uruguay: Successful restructuring?*

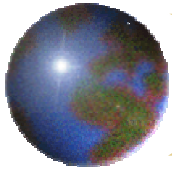
*(~18% npv write-off)*

## *debt rescheduling 2003*

IIF DATABASE: URUGUAY

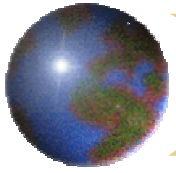
28-Jun-04

	2001	2002	2003	2004f	2005f
Real GDP % change	-3.4	-11.0	2.5	8.0	3.5
External Debt % GDP	83.5	104.8	127.1	121.2	114.0
Total Debt Service % Exports goods, services & income	44.4	49.8	35.0	30.3	56.4



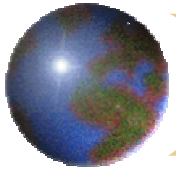
## *Goals of debt restructuring*

- ⊕ Ex-post efficiency: *once bankruptcy is triggered*
  - ⊠ Maximize total value
  - ⊠ Ensure growth: clean slate
  
- ⊕ Ex-ante efficiency: *prior to bankruptcy*
  - ⊠ Equity: Preserve priority of claims defined prior to bankruptcy
  - ⊠ Different regimes => different incentives and actions prior to bankruptcy



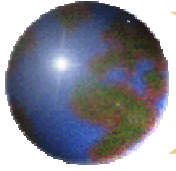
## *Definition of sovereign bankruptcy*

- ✚ When is a sovereign bankrupt? How much can a country afford to repay? No one knows!
- ✚ Creditors and Debtors have vastly different definitions
- ✚ Countries can always raise taxes to pay back creditors



# *Sovereign Debt is different from Corporate Debt*

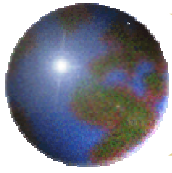
- ✚ Difficult to seize assets
- ✚ No Enforcement Sovereigns never get liquidated
- ✚ Governments cannot be replaced by creditors
- ✚ Sovereigns are vulnerable to exchange rate and banking crises and welfare losses
- ✚ No court (IMF recommended SDRM not on the table)



## *Cost of Sovereign Default*

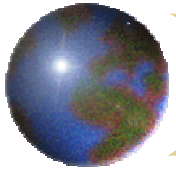
*If there's no enforcement mechanism, why are defaults viewed to be so costly?*

- ✿ Ability to access markets in future?
- ✿ Currency Devaluation?
- ✿ Banking crisis?
- ✿ While uncertainty exists funds are cut off => possible collapse of economic activity?



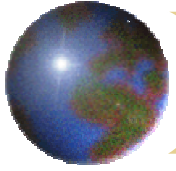
## *Status Quo*

- ✚ Perceived high cost to default
  - ✚ => countries try to avoid it (i.e. Moldova)
  - ✚ => IMF Bailouts
    - => lower interest rates AND
    - => more lending
- ✚ The international architecture combined with bailouts has led to excessive borrowing
- ✚ Creditors and large borrowers resist change



## *Why are EM returns so high?*

- ✿ Paid for risk, but very few defaults, with high recovery values
  - ✿ No mechanism for default (SDRM)
- ✿ IMF bail-outs
- ✿ Spreads still reflect some of the risk, even though countries avoid default at all costs
- ✿ But interest rates are lower than they would be if the probability of default was higher
- ✿ One reason why local markets don't develop and governments borrow on international markets
- ✿ Why there's so much resistance to SDRM



# *Argentina*

- ✚ Precedent?
- ✚ Do small countries have same negotiating position?