The Evolution of Emerging Market Capital Flows:

Why We Need to Look Again at Sovereign Debt Restructuring

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I. Introduction

As you may know, late last year I suggested that the international community should consider a new approach to sovereign debt restructuring, because we lack adequate incentives to help countries resolve truly unsustainable debt problems in a prompt and orderly way.

What I would like to do this evening is to examine some of the changes in the sovereign debt market that have made this rethink necessary. I will begin by describing how the emerging capital markets have evolved, before turning to the implications this has for sovereign debt restructuring. I will then discuss briefly the ideas we are currently considering.

II. The Ups and Down of Emerging Market Capital Flows

The phrase "emerging market" only came into common use in the 1980s, but capital flows into developing countries of course have a much longer history. Stock markets were operating in Turkey by 1866, India by 1875, and Brazil by 1877. Widespread sovereign borrowing - in the sense that we think of it now - got under way in the late 18th century, when the spread of constitutional forms of government led to more stable nation states that recognized continuing liabilities to lenders. In earlier periods most "sovereign" loans were made to individual rulers. Early pioneers of sovereign lending included Hope & Co in Amsterdam, and Barings and NM Rothschild in London.

International flows of investment capital were particularly robust in the late 19th and early 20th centuries, against a backdrop of free trade and exchange rates fixed under the gold standard. Indeed, flows to developing countries were larger in relation to the world economy during this first "golden age" of financial globalization than they are today. Here in Australia, capital flows financed half of all domestic investment in the late 1880s. Capital was cheaper abroad. In 1884, banks in Sydney had to pay 5.5 percent to attract 12-month term deposits, whereas the New South Wales government was able to sell bonds to overseas investors in London paying just 4 percent.

Private capital flows were interrupted by the First World War, but resumed in the 1920s with US investors now buying large amounts of sovereign bonds. Unfortunately, most of the issuers defaulted in the Great Depression. This turned out to be hugely disruptive.

Net private flows into developing countries did not resume consistently until the 1970s, after private banks had a favorable experience lending to the East Asian tigers, especially South Korea.

The resumption, when it came, was combined with a change in composition. The 1970s were marked by a big rise in syndicated bank lending, especially to Latin America. The money was used to pay for oil imports, the development of import-competing industries, big infrastructure projects, and the defense needs of military regimes. Eventually, this turned out to be unsustainable as investment projects turned sour, US interest rates rose, and global demand slowed. The debt crisis of the early 1980s was the result.

Net private flows into the emerging markets did not pick up again until the early 1990s. But the recovery thereafter was swift, with net inflows rising from $12 billion in 1988 to more than $100 billion by 1991. As in the 1960s, the increase was accompanied by a change in composition. The proportion of gross inflows accounted for by bank loans fell from 70 percent in 1989 to barely 40 percent in 1994, as bond and equity issues once again took center stage.

Inflows into the emerging markets continued despite the Mexican crisis of 1994-5, helped by a steady rise in net inflows of foreign direct investment. Total net private inflows finally peaked at $234bn in 1996, after which the Asian and other emerging market crises prompted a sharp decline. Net FDI inflows have remained around $150bn a year, but last year they were likely outweighed by portfolio outflows. As a result, we may have seen the first overall net private outflow since 1984.

Taking the last two decades as a whole, bonds have risen steadily in importance relative to bank loans, both because of the composition of flows and because the Brady plan converted part of the stock of loans into bonds. As a result, the proportion of outstanding public external debt owed to private creditors that takes the form of bonds has risen from 13 percent in 1980 to 60 percent in 2000.

II. Implications for Sovereign Debt Restructuring

So what does this mean for the handling of sovereign debt problems? The first point to make is that sovereign defaults have been with us for almost as long as sovereign borrowing. Indeed, if we stretch the definition a little, the first recorded sovereign default probably took place as long ago as the fourth century B.C., when 10 of the 13 Greek municipalities in the Attic Maritime Association defaulted on loans to the Delos Temple. Showing secular as well as spiritual acumen, Delos subsequently chose to lend to private borrowers in preference to public authorities.

What of more recent times? Over the last two centuries, according to Standard & Poor's, more than 90 countries have defaulted or rescheduled their debts, and several have done so many times. Defaults have taken place for many reasons, with wars and commodity price shocks among the most frequent triggers.

Despite this rather chequered history, countries still value - and benefit greatly from - the finance that access to international capital markets provides. For the 25 years following the Second World War, capital controls were accepted as the price that had to be paid for maintaining stable exchange rates and retaining some domestic monetary autonomy. But after the collapse of the Bretton Woods system of fixed-but-adjustable exchange rates, industrial countries changed their preferences among Robert Mundell's "impossible trinity" and began liberalizing their capital accounts. Developing countries have moved in the same direction, but more slowly - partly because until recently more of them were trying to combine exchange rate pegs and autonomous domestic monetary policies.

The IMF was created for the period of fixed exchange rates and relatively high barriers to capital mobility. Its lending tools were therefore initially designed to deal primarily with current account crises, in which a country - because of bad luck and/or bad policies - lacks the foreign exchange with which to pay for necessary imports. The rationale for Fund lending under these circumstances is to provide a financial cushion, so that the country can get its policies back on track without crushing its economy or resorting to trade barriers, competitive devaluation, or other destructive measures.

This rationale for Fund assistance - to avoid trade restrictions or economically inefficient measures - is as valid today as it has always been. But in a world of increasingly large and volatile private capital flows, the way we fulfill this role has had to adapt.

In the 1980s, the Fund became a key player in the management of financial crises for the first time. It insisted it would only lend to countries embroiled in the debt crisis if other creditors - mostly commercial banks - agreed to reschedule and provide new money. "Concerted lending" worked for a while, but the banks became more wary as the extent of the debt problems became clear and as bank balance sheets improved. This made it more difficult for the Fund to support strong adjustment programs.

In response the Fund revised its debt strategy by declaring that it would be prepared to lend to countries that were in arrears to their bank creditors. These arrears became a substitute for the rescheduling and new money that had earlier been provided on a voluntary basis. This new approach was largely successful. The official sector provided upfront funding to support debt reduction, which generally took the form of exchanging bank debt for "Brady bonds" collateralized with US government securities.

In the 1990s the Fund has had to confront a new kind of capital account crisis, in which countries suffer a sudden and catastrophic loss of investor confidence - because of shocks, policy weaknesses, contagion effects, or a combination of these factors. This creates a severe balance of payments problem as the country lacks the capital to meet the demand of foreign creditors and domestic investors trying to flee.

The official community's first response has been to try to prevent crises more effectively. This has involved strengthening the Fund's surveillance of national policies and international markets; improving communication between the official and private sectors; and offering contingent financial support to countries with demonstrably sound policies. But to help manage crises more effectively, the Fund also created in 1997 the Supplemental Reserve Facility. This allows the Fund to lend larger sums than it normally would, over short periods and at higher interest rates, to support a country that is making a determined effort to strengthen its policies.

But it would be neither feasible nor desirable for the Fund to meet all the financing needs of a country facing a capital account crisis - especially if its debts are truly unsustainable looking forward. For one thing, unlike a domestic central bank, the Fund cannot print money. Its financial resources are limited - concretely and also by the reluctance of our members to see official resources used to bail out private creditors. Moral hazard remains a legitimate concern: private institutions will be tempted to lend and invest imprudently if they believe that the Fund is standing by to ensure debtors can repay if things go wrong.

So what if a country does find itself with a truly unsustainable debt burden? One way or another, it will have to be restructured. And it is better for the debtor, most of its creditors, and for the international community, if this can be done in an orderly way. To that end, it may be necessary for the official sector to encourage private creditors to roll over their existing commitments and to limit their demands for repayment.

In the 1980s, the debt restructuring process - once it finally got under way - was protracted, but mostly orderly. As the bulk of outstanding private debt to emerging markets took the form of syndicated bank loans, you could get the holders of 85 percent of a country's debt together simply by gathering 15 people round a table. They also had powerful incentives to cooperate: similar institutional interests; a desire to secure future business from the debtor; a reluctance to go against the wishes of regulators; and a legal obligation to share proceeds of litigation with fellow creditors, because of cross-default clauses in bank lending.

But, as we have seen, we now live in a very different world. The proportion of the emerging market debt stock held in bonds has quadrupled. And bondholders are more numerous, anonymous, and difficult to coordinate than banks. Most do not seek long-term relationships with the debtor or fear the arm-twisting of regulators. Bondholders also have greater incentives to sue delinquent creditors, because unlike banks they do not have to share the proceeds of litigation. The situation is further complicated by the growing variety of debt instruments and derivatives in play. All this increases the "collective action problem" of getting agreement among creditors on the terms of a restructuring - even if almost all of them would benefit.

In response to these changes, the IMF sought to create an environment more conducive to orderly workouts in 1999 by extending its willingness to lend to countries in arrears to their banks to countries in arrears to their bondholders. Paralleling the original decision on bank debt 10 years previously, this allowed the Fund to give moral support to a standstill on debt repayments. But experience in applying this has been limited. It was not necessary in Pakistan's restructuring in 1999 or Ukraine's in 2000. The Fund did however lend into arrears in Ecuador in 1999.

In each of these cases, fears of disruptive litigation proved unduly pessimistic. But the threat litigation continues to pose to orderly restructuring was underlined more recently when an aggressive holdout creditor in effect held Peru to ransom; it persuaded courts in the US and Europe to prevent Peru from servicing its Brady debt until the holdout creditor was paid. Rather than go into default, Peru settled.

Whether this strategy would survive legal challenge in future cases is unclear, but Peru's experience does illustrate a general point: that the trend in the size and composition of emerging market finance over the past two decades has been making orderly restructuring more difficult and is likely to continue doing so in the future.

One response has been for the international community to encourage countries to include collective action clauses in the contracts of the bonds they issue. These limit the ability of holdout creditors to disrupt a restructuring, and are generally found in international sovereign bonds issued under English law.

They are not, however, a silver bullet. First, a large part of the outstanding stock of bonds does not contain these provisions, and many are not due to mature for many years. Second, sovereigns frequently prefer to exclude such clauses precisely to signal to potential lenders that they are determined to repay. And third, collective action clauses only bind holders of the same bond issue. So they are of little use when a country needs a broad restructuring covering a wide variety of debt instruments.

III. A New Approach to Sovereign Debt Restructuring

It is against this backdrop that Fund staff and management have been discussing the possibility of a new approach to sovereign debt restructuring. At present, the understandable fear that restructuring will prove difficult and disorderly encourages creditors to scramble to get their money out when a country gets into difficulties - in order to beat others to it. The same fear deters debtors from starting the process. Our goal is to create stronger incentives for creditors to remain involved of their own volition and not to rush for the exits, and for debtors to start an inevitable process soon. Even if we can get debtors and creditors to come to the negotiating table only a month sooner, the capital outflows and further declines in economic activity that we could avoid during that chaotic period would make the exercise worthwhile.

We believe that the best way to put these incentives in place would be to create a predictable legal framework that in all probability would need to be activated only very rarely. We have drawn inspiration from domestic bankruptcy regimes.

The new approach would allow a country to request a limited period of legal protection from its creditors while it negotiates a restructuring, in return for an obligation to negotiate in good faith and pursue corrective policies. The request would only be granted if the country's debts were judged truly unsustainable. Finally, once the terms of a restructuring have been agreed upon by a big enough majority of creditors, any dissenters would be bound to accept the same terms on offer.

Most creditors should welcome such an approach. The threat of a disorderly workout means that the value of creditor claims currently falls more sharply on the secondary market when a country gets into trouble than it would likely do in a more predictable environment. To be sure, some creditors relish disorder as it allows them to buy distressed debt more cheaply. But most should favor a framework that would help preserve the value of their claims. At the end of the day, any truly unsustainable debt has to be restructured - the only question is how painfully.

The framework would need to have the force of law throughout the world, to prevent litigious creditors shopping around to find jurisdictions where they could enforce their claims. This could perhaps best be achieved by creating a treaty obligation through an amendment of the IMF's Articles of Agreement. If this were approved by three-fifths of our members holding 85 percent of total voting power, it would be binding on all our members. This of course means that the new approach would need very broad support in the international community.

The mere presence of a predictable formal framework should then encourage debtors and creditors to get together and reach agreement of their own accord. As in well-designed domestic bankruptcy regimes, most restructuring would likely take place "in the shadow of the law" rather than through formal activation of the mechanism.

I believe that a scheme of this sort would not only help make crisis management easier, but that it would also help prevent crises. The international community's backing for such an approach would demonstrate once and for all that there isn't a limitless well of official money from which private creditors can expect to draw when their loans or investments go wrong. This means of course that the Fund cannot come to a restructuring with fresh money. If it were to do so, we can be sure that the creditor and debtors would end up a dollar apart for every dollar the Fund brought to the table. Fresh official financing at this stage would end up in the creditors' pockets.

However, while creditors and debtors were negotiating, the Fund could be working with national authorities to help develop a sustainable set of economic policies conducive to restoring growth.

By creating a more predictable environment for workouts, the new approach would also have the advantage of helping private investors and lenders discriminate more effectively between good and bad risks. This could make it easier and cheaper for emerging market countries with strong policies to access private capital. In the process it would increase the efficiency and stability of the global financial system.

Needless to say, there are numerous legal and practical issues that have to be addressed before we could put forward a concrete proposal. These include: the institutional arrangements for the operation of the framework; the rules for triggering the stay; the tools to guarantee good behavior by the creditor; and the scope of the debt to be covered by the stay. We look forward to discussing these issues in more detail with our board and with other interested parties in the coming months.

IV. Conclusion

Let me briefly conclude by noting that much has been done to strengthen the international financial system in recent years. But the absence of better incentives to ensure the orderly resolution of unsustainable sovereign debts remains a serious weakness. The changes I have described in emerging capital markets tonight make it more important than ever that we are prepared to consider fresh approaches.

Even if this new approach were to be put in place, debt restructuring would remain an economically painful process - and one that debtors will rightly remain reluctant to enter into. But a more orderly framework would be of benefit to everyone concerned.

Thank you.

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