



Living with Sovereign Debt: Comments to the IPES 2007

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Structure of Comments

1. Main Conclusions
2. Main Policy Implications
3. Main Implications for IFI's
4. Areas in need of further work

Main Conclusions

- **“It’s Public Debt Structure, Stupid”** (more than Public Debt Levels) that cause LAC proneness to debt crises...*or “it’s the economy, stupid” as economic conditions might largely determine debt structure?*
- **Policy Agenda must then concentrate on improving public debt structure** (more than, or as much as, reducing its level)
- **IFI’ s have a major** (so far largely unfulfilled) **role in helping countries improve public debt structure**, by modernizing their own financial instruments and helping solve international market failures

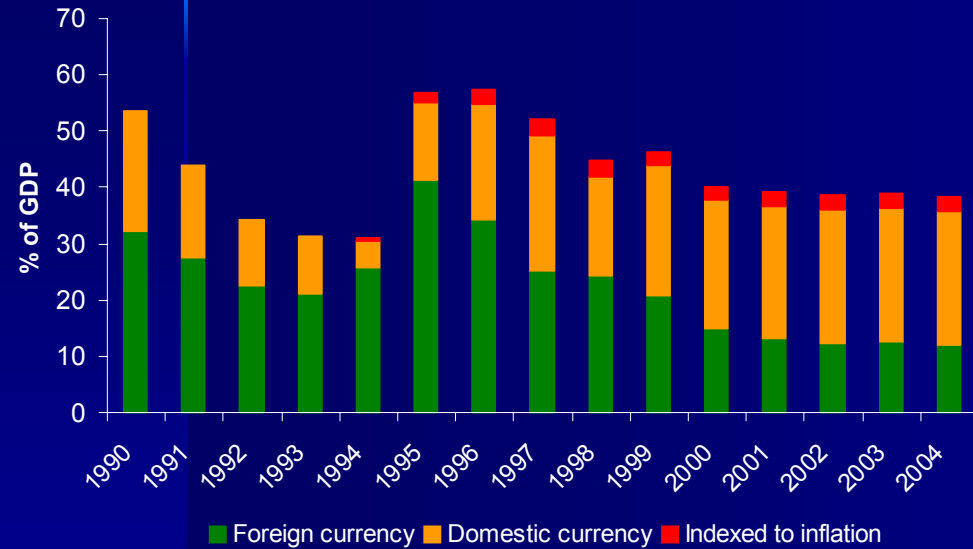
Basically agree, though the report could have explored more the limits that problems in economic policy (eg, credibility of monetary policy) or structure (financial dollarization) impose on debt structure

Main Policy Implications: Reducing Currency Risks

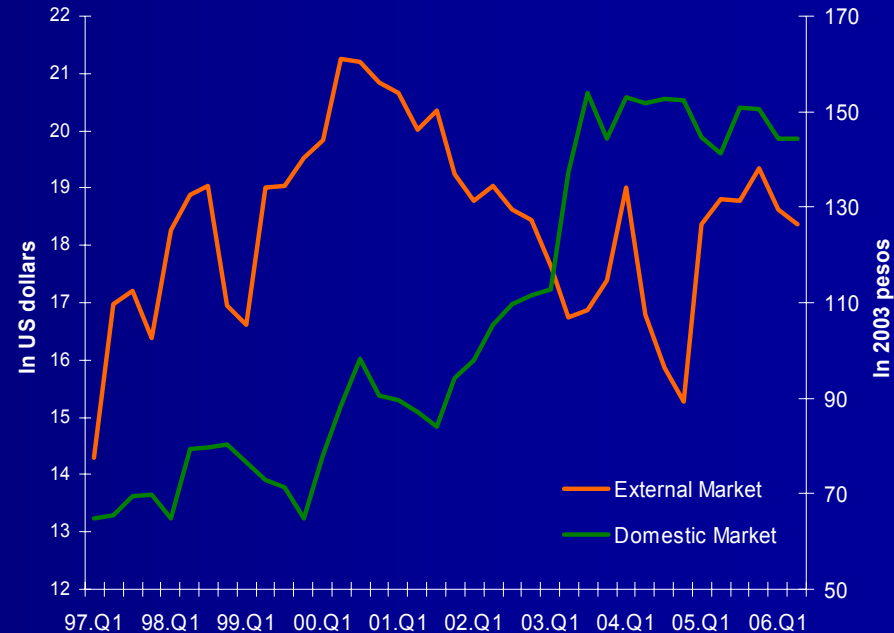
- Continuing the Shift towards Domestic Currency Debt
- Developing Sound Domestic Currency Debt Markets:
 - Prospects brighter than presented given higher credibility of monetary policies, loss of “fear of floating”, higher awareness of currency risks by Governments and corporates and higher commitment to develop debt markets ? Examples: Mexico; Colombia; Chile (success of Infrastructure Bonds); Brazil (incentives to foreign investors in domestic debt markets). See attached slide
 - Less so in economies with financial dollarization? (is Argentina a special case? Advances in Peru)
- *Topics that deserved more discussion:*
 - *Use of Currency Swaps to reduce vulnerabilities associated with the Stock of foreign currency debt: limits? trade offs?*
 - *Issuing in domestic currencies in international markets: separating jurisdictional from currency risk for conservative investors? (is Argentina a special case?)*

Recent successes in developing domestic currency markets

Mexico: Public Debt by Currency composition

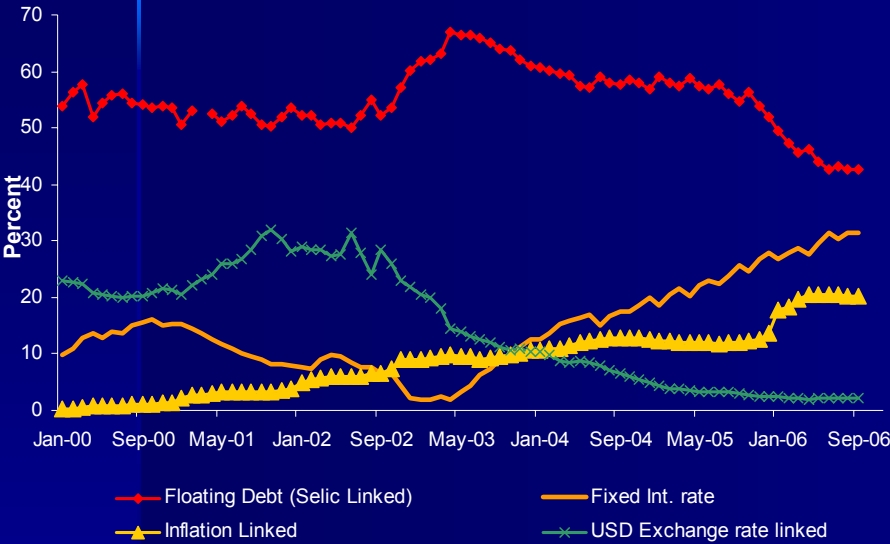


Mexico: Private Bond Issuance (in billions)

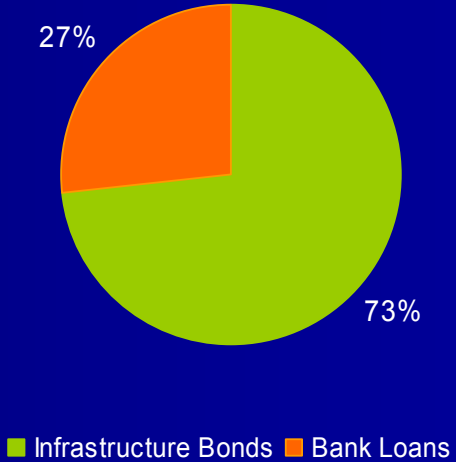


Recent successes in developing domestic currency markets

Brazil Debt Composition



Chile: Infrastructure Project Financing



Main Policy Implications: Reducing Liquidity Risks

- **Use of Inflation Indexed Bonds** in order to mitigate trade offs between currency and roll over risks :
 - *Message clear in Chapters 12, 13, not so in Chapters 2, 7 (where all forms of indexation are lumped together). Clarification: dilution of IPC indexed debt does not require hyperinflation as stated.*
- **Use of contingent debt instruments:** Debt indexed to GDP growth, commodity prices, terms of trade, EMBI or Libor (inverse indexation). *Which is better, when? Is it better to index capital or interest?*
- **Sound Reserve Management**
 - *Optimal level?* Cost of reserves is overstated: higher reserves reduce costs of issuing debt (and of carrying the stock), as liquidity risks are reduced.
 - *Regional Pooling?* Pros and cons? Rules and institutions?
 - *Investing in assets with negative covariance with country GDP*

Main Policy Implications: Controlling the Flow of Debt

- Political and procedural Reforms; Budgetary Institutions
- “Good” Fiscal Rules:
 - *A rigid rule augments pro cyclicity, becomes non enforceable and is thus non credible: it’s just a bad rule (most FRL’ so far tried in LAC)*
 - *Good rules are cyclically (structurally) adjusted -a la Chile. (more on the pro cyclicity issues latter)*
- Commodity Stabilization Funds:
 - *Can be better designed (e.g., Colombia Oil Fund)*
 - *But inherent limitation: cover only part of revenues*
- Revenue Stabilization Funds are natural complements to Good (structurally adjusted) Fiscal Rules

Main Implications for IMF

- Contingent Facility to reduce Contagion risks (and increase counter cyclicality)
- Fiscal assessments and programs should not be based on simple Public Debt Level and Deficit indexes:
 - More emphasis on structure of debt and vulnerability analysis (against multivariate shocks)
 - Use cyclically (structurally) adjusted indexes and goals. Otherwise assessments will be misleading and programs will augment pro cyclicality
 - More emphasis on net worth and inter temporal fiscal solvency analysis

Main Implications for MDB's

- Borrow and lend in Domestic Currencies –in addition to currency Swap offerings- (*specially important in de facto dollarized economies*)
- Provide menu of Contingent Loans
- *Help solve market failures in catastrophic risk insurance*

Areas in need of further work: Debt and Fiscal Sustainability

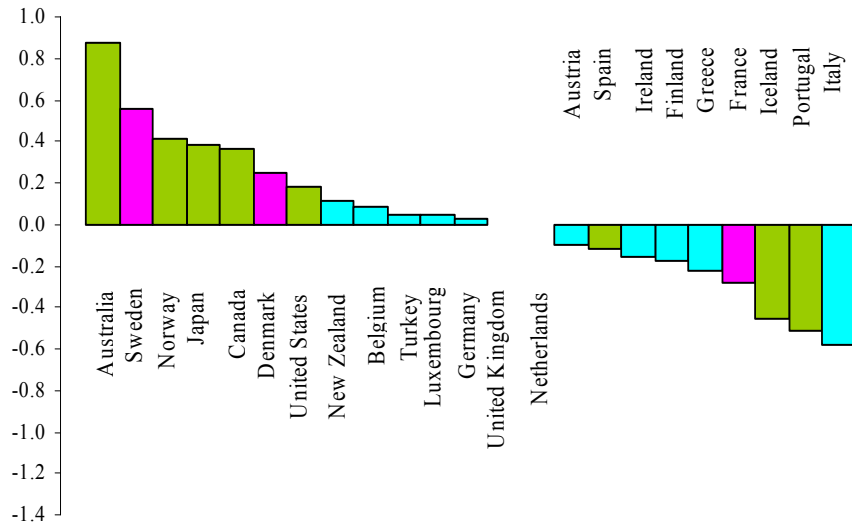
- Need to develop better methods to assess fiscal/debt vulnerabilities to shocks. Craig Burnside (2005)
- Need to better integrate the analysis of public debt in the context of overall fiscal solvency:
 - Implicit versus explicit liabilities (e.g., with respect to pension fund assets)
 - Net worth and inter temporal effects: critical difference of an increase in debt to finance productive infrastructure and public consumption; projects that can be financed by tariffs or tolls versus others; etc. Easterly, Serven and Irwin (2006)

Areas in need of further work: Debt and Pro cyclicalities of fiscal policies

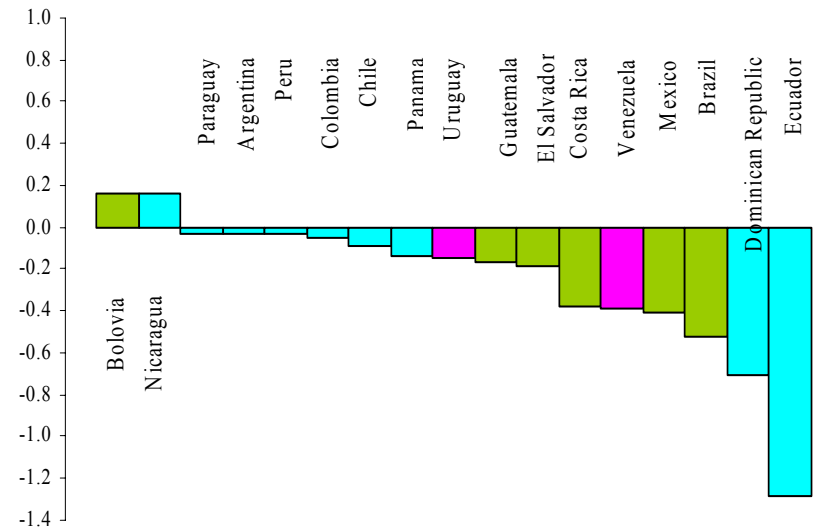
- Pro cyclical biases lead to anti investment and deficit biases.
- Other estimates controlling for endogeneity suggest strong pro cyclicalities of policies in LAC (eg, Fatás and Mihov (2004), Suescún (2005)). In any case, what matters most is the pro cyclicalities of fiscal “results”.
- Need of fiscal rules that at least permit (or amplify) the effect of automatic stabilizers
- Need to increase the size and effectiveness of automatic stabilizers in LAC. Suescun (2005)
 - Improving tax elasticities
 - Incorporating some automatic countercyclical programs

Discretionary Fiscal Policy Response to Cyclical Conditions (structural budget balance)

Developed Countries



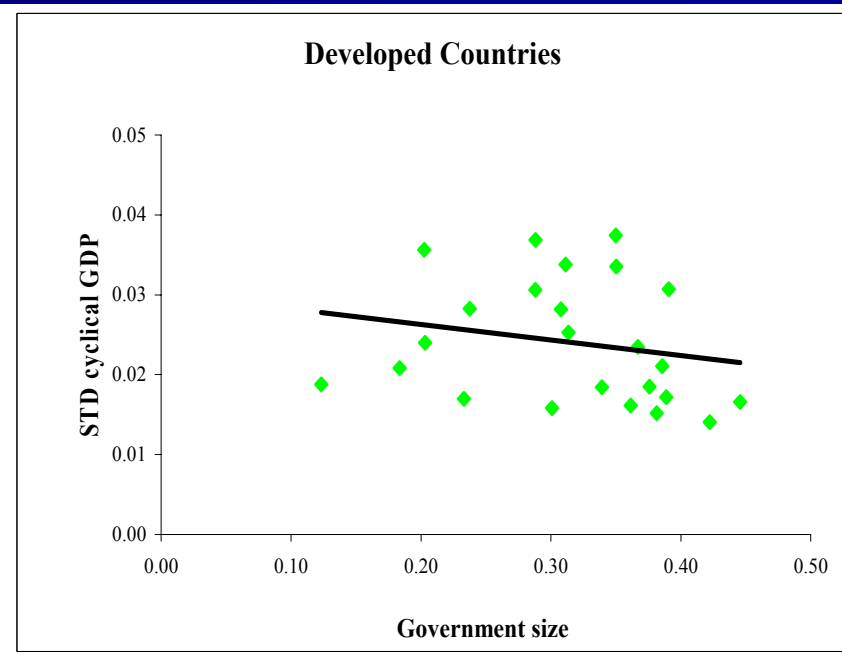
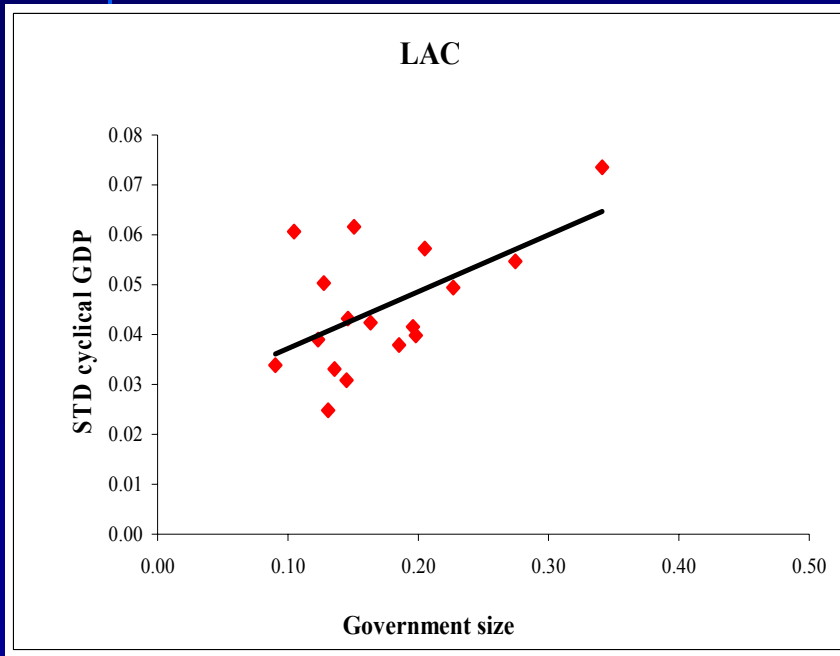
LAC



5% significance
 10% significance
 Not significant

- The present figures report IV country-by-country estimates of the sensitivity of the structural budget balance (as a ratio of potential output) to changes in the output gap. Positive coefficient estimates denotes a counter-cyclical response in fiscal policy.
- Source: Suescún (2005)

The Stabilizing Role of Government Size



Pro cyclicality and public investment

- Countries with more pro-cyclical fiscal policies tend to show a higher anti-investment bias:

$$\phi_i = -0.072 - 0.009\beta_i + \varepsilon_i$$

(0.00)** (0.031)**

i= 80 countries, p-values are in reported parenthesis

- where:
 - ϕ_i is the *trend* component of public investment to GDP ratio (proxy of investment bias)
 - β_i represents the pro-cyclicality of current public expenditure

Areas in need of further work: Dealing with Vulnerabilities in Fully Dollarized Economies

- Dollarized economies can get into debt deflation problems when facing adverse shocks (either to the current or capital account)
- Should (can) they develop debt indexed to non tradable sectors prices? Or just use more debt indexed to GDP, commodity prices, terms of trade, EMBI or Libor (inverse)?
- Do they need countercyclical fiscal rules more potent than other countries?

Areas in need of further work: Catastrophic Risk Insurance

- Market failures: premiums sky rocket and markets virtually disappear in the wake of major disasters
- Need for wide pooling of risks: a coordination problem?
- Role of IFI's: recent initiatives
 - Caribbean fund to cover Sovereign liquidity risks
 - Mexican proposal to create a multilateral agency for wide risk pooling
 - Dealing with moral hazard problems