Roundtable Comments on Monetary and Regulatory Policy in an Era of Global Markets

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In the aftermath of the Asian and global crises of 1997–99, the international community started a process of reform of the international financial architecture. The two main components of this reform were crisis prevention and crisis resolution. There is a lot of consensus on the appropriate policy actions for crisis prevention even if some issues, such as the appropriate exchange rate regimes for emerging markets, are still open. On this issue, some people prefer dollarization, some people prefer floating exchange rates. In this regard, most people agree that middle exchange rate regimes—soft pegs and other crawling pegs—are disappearing. But the most contentious issue in architecture reform is that of crisis resolution, that is, the debate about bail-ins, bailouts, burden sharing, and private sector involvement in crisis resolution—or how to constructively engage the private sector in crisis resolution. This is a central issue in crisis resolution because, when a crisis occurs, large external financing gaps (driven both by current account deficits and large capital outflows) will emerge, and they have to be somehow filled.

What are the three components of crisis solution when such gaps emerge? The first piece is policy adjustment by the country that reduces the external imbalance (current account deficit) and helps to restore investors' confidence and market access. The second piece is official money—International Monetary Fund/International Financial Institutions (IMF/IFI) programs. And the third is the bailing-in of the private sector. Should the private sector be induced to roll over, reprofile, or even reduce its claims on an emerging market and its sovereign? There has been a lot of debate on this issue; over the last few years the G-7 countries have developed a framework for private sector involvement (PSI) in crisis resolution. There is an open debate on whether this framework is too discretionary, too much case-by-case, and whether we should go toward a more systematic rules-based system in PSI policy? I would characterize the current state of the play as one in which the current regime is not truly a case-by-case approach but a regime of constrained discretion or of flexible rules. It 's true that the G7 approach is "case-by-case " but such discretion is constrained by guidelines, principles, criteria, tools, and so on as described in the "Prague Framework, " the consensus approach to PSI reached by the G7 and the IMF at the fall 2000 IMF meetings in Prague. So, G7/IMF PSI doctrine is not a full discretion regime.

This framework has been applied in a number of crisis episodes. In each one of the episodes in the nineties—from Mexico to Asia to Brazil, Russia, Turkey, and now Argentina—

there has been a combination of some official money, some adjustment, and some bail-in of the private sector. One of the things we have learned is that restructurings of sovereign bonded debt are feasible. Three years ago, many argued that this was impossible if you did not have collective action clauses in bond contracts. But bonded debt restructuring was successfully performed in the cases of Pakistan, Ukraine, Ecuador, and Russia, and such restructuring will have to happen again in the case of Argentina. We have also learned that you can also implement semicoercive rollovers or soft rollovers of cross border interbank short-term lines like in Korea, Thailand, Indonesia, Brazil, and Turkey. So there have been a number of case studies of how you can do bail-ins of bank lines and of sovereign bonds. Some bail-ins have been of a soft-PSI nature (Brazil) and some are more coercive (Korea); in some cases countries have defaulted on their sovereign liabilities (Russia, Ecuador, Argentina). Thus, there has been an entire distribution of cases going from essentially a full bail-out, like in Mexico, to defaults, as in the cases of Ecuador and Russia.

There are still a number of open issues in PSI policy. The main open issue is what to do in large, systemically important countries that are important because they are large and therefore object of geopolitical interests and/or they are large in the sense that they contribute to international financial contagion. Instead, in the case of small countries, if reprofiling, restructuring, or reduction of debt has to occur, it ‘s going to occur and incentives to bail out such countries will be more limited.

The question becomes, what are you going to do in the bigger cases like Turkey, Argentina, Brazil, and so on? I think there are a number of open issues that have not been dealt with by the G7 PSI framework. The first question is the trade-off between normal and exceptional packages. What are the conditions under which you allow countries to borrow very large sums in excess of their IMF quota? And in which cases do you not allow this? So, there is an open issue of conditions under which high access is warranted.

The second issue is whether PSI, or private sector involvement, should be coercive as opposed to voluntary. Should you follow a “catalytic “ approach where the IMF provides high access and the country makes appropriate policy adjustments with the hope that investors ‘ confidence is regained and market access is restored. Or, instead, how much should you rely on a more coercive, or what we call “concerted “ approach to PSI, in which you induce a debt restructuring on terms that are not fully voluntary?

The recent official rhetoric from the G7 has been the we should move away from big packages; that was the view of most G-7 countries, with the exception of the United States, at least until recently. But even the current new U.S. administration is, at least in rhetorical term, against big IMF bailouts. But if you look at the events of last year, there has been a split between official rhetoric and actual practice: the actual application of PSI has been in the direction of large official packages in large systemic cases. We have had two large packages in Turkey and Argentina that had little economic justification but were implemented mostly for political reasons. The PSI component in these programs has been extremely soft, if nonexistent, because it was fully voluntary in Argentina (market-based swaps) and a failure ex post in Turkey. Thus, the official rhetoric was no more big bailouts, but twice these countries received large programs with little private-sector participation, especially by foreign investors. Indeed, there has been a political bias toward trying to help countries that are systemically important in one dimension or another. The recent IMF toughness on Argentina is likely arriving too late as economic considerations suggests that the August 2001 $8 billion package was not warranted.

This bias may have worsened after September 11 in the sense that geopolitical strategic considerations are becoming even more important than before. This means that countries like Turkey or Pakistan, or others that are considered important politically, militarily, diplomatically or otherwise, are going to get more support than otherwise—regardless of whether there is an economic case to bail them out or not.

The big debate right now, of course, is whether Argentina is systemically important enough to be bailed out a third time. My answer to this question is that it is not, given the current circumstances. So, in the case of Argentina, you are going to have a bail-in after two attempted bailout packages that have not worked.

An important question in the Argentina discussion will be how to restructure the bonded debt. In all recent episodes—Ecuador, Pakistan, Ukraine, and Russia—the restructuring process has been one based on unilateral exchange offers. Even if there are no collective action clauses, we have learned that we can use unilateral exchange offers that are preceded by market soundings in which the legal and financial advisors of the sovereign figure out what 's the best deal the investors are likely to accept. Then you make a unilateral exchange offer, and in all these episodes 99 percent plus of creditors have accepted the offer to trade their old bonded claims for new ones with better terms for the debtor. So sovereign bonded debt restructurings have been a success.

Some in the private sector found this unilateral exchange approach to be unilateral and unfair to them because there is no negotiation between the sovereign debtor and the creditors. So some are now proposing alternative approaches with formal creditor committees, formal negotiations between the debtor and the creditors, and more reliance than in the past on collective action clauses to make the system more fair and balanced. My view is that the current system of unilateral exchange offers has worked fine and there is no reason to meaningfully change it. There could be long and costly delays with formal negotiations, not just because of the potential conflict between the debtor and the creditors, but also because of the difference of interests among an heterogeneous group of creditors. So with negotiations one would have to solve the collective action problems among creditors even before one could have a negotiation between the creditors and the debtor.

So I am of the view that, for the time being, unilateral exchange offers (with a creative use of exit consents, an ex post use of collective action clauses when available, and appropriate sticks and carrots in the form of sweeteners and enhancements to reduce the deal risk and holdout problems) is still the way to go.

Why is this debate important for Argentina? I think that at this point, there is a consensus that Argentina will to have to restructure its foreign debt and the terms of this restructuring are not going to be voluntary. Rather, the terms are going to be quite coercive. I will also argue that there is soon going to be a change in the exchange rate regime in Argentina. In the case of Argentina, I think that a number of considerations will have to be taken into account in the restructuring. I think that it was a mistake to provide two large support packages and go through a "voluntary " mega-swap. Given the unsustainable debt path of the country, it is now clear that the restructuring will be on much more coercive terms. If there had been a more meaningful PSI early in 2001, in the first or second quarter for example, one could have restructured Argentina 's debt by reducing the coupon and not touching the principal; then it may have been possible to have no haircut on the principal as was the case in Ukraine and Pakistan. Instead, Argentina is now going to turn out more like Russia and Ecuador: there will be a significant haircut on the principal (a sharp debt reduction) because of the worsening economic conditions and the delay in addressing the country 's financial problems early on.

The other problem I see as being a serious one in the debt restructuring process question is the risk of litigation. In all the previous restructuring episodes there was a threat of litigation, but it did not actually occur. Even in Ecuador where the creditors accelerated their claims after the selective default on the Bradies, they never took their claims to court. But Argentina may be much messier and complicated for a number of reasons. First, rather than the three or four financial instruments/bonds as in previous cases, in Argentina there are something like sixty-plus different bond issues—each one of them with different covenant, legal status, and jurisdiction. Second, some investors have already positioned themselves in prelitigation mode by buying a good fraction of some outstanding bond issues (those that had less outstanding float because of the 2001 mega-swap). Third, there are "vulture " investors out there that are positioned to litigate. Finally, the risk of litigation may be higher after the recent Peru-Elliott case. The outcome of this case suggests that litigation might be more successful than it has been in the past. If such litigation strategy were successful again in the future, the risk of prolonged, disruptive and disorderly restructurings would increase. In the past, exchange offers have worked and deals would be completed in a few months with little litigation risk, but things may turn out to be different in Argentina.

This is why many people in the private sector these days are, paradoxically, in favor of changes in the restructuring regime to ensure orderly restructurings. Until recently, many in the private sector were against stand-stills, against collective action clauses, against the idea of an international bankruptcy regime. These days, however, some creditors strongly support collective action clauses to avoid disorderly litigation and ensure the possibility of a majority cramdown against possible holdouts. There is a new openness about changing legal regimes to make restructurings more orderly.

Finally, I would like also to talk briefly about exchange regimes in general and Argentina in particular. My view is that the currency board in Argentina is essentially dead now. At this point, Argentina is going to move toward dollarization or to a floating exchange rate regime. Clearly, the current currency board regime is not sustainable. The question of dollarization is a complicated one with several pros and cons. My view is that Argentina should move to a float. In terms of long-run criteria, Argentina does not satisfy the criteria for optimal dollarization given the nature of shocks it is exposed to, its low degree of openness, and the lack of synchronization of its business cycle with the U.S. one. Also, if dollarization were to be considered there would be the question of at which exchange rate level to implement dollarization. Would you dollarize at the current parity, or would you dollarize after devaluing the peso? If you were to dollarize at the current parity, you wouldn 't solve the competitiveness problem that Argentina has today, and this would discourage a recovery in growth and the trade balance. And if you would dollarize after devaluing, the balance sheet effects deriving from liability dollarization would be the same that you would have with a floating exchange rate. So to devalue and dollarize does not solve the balance sheet problems that you have with a float. Argentina should rather float and deal with the consequent balance sheet effect via debt restructuring.

Therefore, the question is how to deal with the balance sheet effects. In Argentina, it's going to be an ugly mess regardless of which currency regime is chosen. While the float is the least damaging option, after a float the country will have to address the balance sheet effects on governments, banks, corporations, and households that derive from the large net foreign currency liabilities existing at the sectoral and aggregate level. These balance sheet effects are especially severe because, in most cases where a currency peg is broken, there is an initial sharp overshooting of the real exchange rate relative to its fundamental value. Thus, the balance sheet effects are severe and that means that moving to a float is not going to be simple. You might have to freeze deposits in order to avoid a bank run or impose capital exchange controls to avoid an overshooting. In either case, the debt restructuring process is going to be difficult and messy.

In general, what then is the appropriate exchange regime for emerging markets? We know that middle regimes have disappeared because pegs and soft pegs have collapsed in currency crises from Mexico to Asia, Brazil, Russia, and Turkey. These soft peg middle regimes have disappeared. We also know that other middle regimes, like crawling pegs and bands, are disappearing because countries like Poland, Israel, Colombia, Chile, and others that had some sort of crawling peg/band have moved away from them toward greater exchange rate flexibility. The view is that we now have only two corners: either hard pegs or some kind of float; of course, in emerging markets you do not see a pure float exchange rate regime but something closer to a managed float.

Until recently, there was a view that hard pegs in the form of currency boards could be a successful corner. This meant that you didn 't have to go all the way to the corner of dollarization if you had a hard peg. However, at this point, hard pegs look like soft pegs and this means that currency boards do not have much of a future. The currency board in Argentina is going to collapse soon—one way or another. Even in countries like Hong Kong, there is now a significant policy discussion about phasing out the currency board regime. You may also remember that last year Turkey effectively had a regime that was a semi-currency board in the context of a forward-looking crawling peg. Turkey 's quasi-currency board collapsed as well.

Thus, at this point it looks like the exchange rate regime choice that an emerging market may face is whether to go to a managed float on one side or move all the way to dollarization at the other corner; i.e., the "hard " peg corner of currency boards may soon disappear. In my view, most emerging markets with openness to international capital markets should go toward a floating exchange rate regime except those countries that, based on factors such as their trade relations with the United States, their business cycle synchronization, and other criteria, make a good case for dollarization. For all the countries, the best choice may be a float. We know that a floating regime is not a panacea—its needs macroeconomic and fiscal and monetary stability to work well. It also needs some other kind of monetary anchor for inflation expectations like inflation targeting, for example. We also know that balance sheet effects may be serious under floating exchange rates when currency values move sharply. So floating by itself may not be a perfect regime but it is likely to be a better alternative than dollarization for most emerging market economies.