New approaches to crisis resolution: Weighing the options (A comment)

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New Approaches to Crisis Resolution: Weighing the Options
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It is a pleasure to comment on this fine paper, which combines a clever theoretical model of the caliber of work we associate with Ken Kletzer and a careful extension of the ongoing empirical research of Barry Eichengreen and Ashoka Mody. The paper describes the debate over collective action clauses, which have been considered by the G-7, G-10, G-20, G-22, G-30, Institute of International Finance (IIF), International Monetary Fund, International Monetary and Financial Committee (IMFC), Council of Foreign Relations (CFR), Emerging Markets Credit Association (EMCA), a variety of finance ministries, and others no doubt—although not, to my knowledge, the Boy Scouts of America (BSA). For those who have not received a merit badge in the language of international bureaucrats, collective action clauses allow a specified majority of bondholders to represent the interests of the totality of issuers in renegotiations with the issuer. I argue that:

—the basic premise of the debate on CACs lacks the appropriate historical perspective;

—particulars of some of the arguments are not convincing;

—and the only reasonable answer when the market is evolving is time will tell.

To make these arguments convincing, I split my comments into two parts. The first part addresses the big picture, which is necessary to understand the accumulation of debt in emerging markets and applies to almost all of the recent work on the international financial architecture. The second will consider seven specific issues about the Eichengreen-Kletzer-Mody (EKM) paper.

Virtually every international economist would agree that one of the major unanswered questions in the field is why capital does not flow from rich to poor countries. That, of course, is the title of a famous paper by Robert Lucas,[1] which is why it is called the Lucas paradox.[2] In attempting to fashion a practical resolution to the Lucas paradox, advocates of CACs have often relied on the following chain of logic: [3]

—Since capital flows are insufficient to pull up the capital stock of emerging market economies to industrial standards,

—it must be the case that emerging market economies borrow too little.

—Therefore mechanisms must be found to let them take on more debt.

—Among those mechanisms encouraging debt issuance are CACs.

—Therefore CACs are useful.

The problem is that the second premise is a non sequitur. As shown by Reinhart, Rogoff, and Savastano, emerging market economies do not borrow too little, they borrow too much.[4] A significant fraction of countries are debt intolerant because their weak political systems, unequal income distributions, inconsistent rules of law, and narrow tax bases imply that they cannot reliably service debt. For a country with such problems, to borrow is ultimately to default. If a significant fraction of emerging market economies is debt intolerant, efforts to make it easier to borrow will end in tears because making it easier to borrow will make it easier to default. Moreover, such an emphasis on borrowing will distract from more important (and lasting) mechanisms of fostering direct investment in countries where rates of return should be very high. Making progress on that front is a harder job of improving the legal and political infrastructure of the country and making balance sheets more transparent. That job will not be done quickly and will only prove itself useful over time.

Abstracting from this larger issue of what CACs can or cannot deliver, EKM provide a helpful discussion of the mechanics, theory, and practice of CACs. Their discussion of how the development of the CAC debate evolved is a must read for those interested in the politics of international financial architecture. My specific comments are directed as much to the authors' current work as to their efforts in the future and those of other researchers.

Foremost it is important to remember that history matters. In their section on the evolution of the debate, EKM push the discussion of the problems of sovereign default back to 1981. In fact, between 1500 and 1900, Spain defaulted thirteen times. In the period between 1500 and 1800, France defaulted every thirty years or so. And Mexico has been in a state of default about one-half of the years since 1824, while Brazil has been in default about one-quarter of those years.[5] Why should we think that a problem that has existed for five centuries across several continents can be solved by the stroke of a pen?

This suggests that officials may want to be humble in their ambitions. Some problems may be too big and too basic for the international community to solve. EKM quote Stanley Fischer as saying “when a country’s debt burden is unsustainable, the international community—operating through the IMF—faces the choice of lending to it or forcing it into a potentially extremely costly restructuring, whose outcome is unknown.” I would suggest that we remember Herb Stein’s theorem: anything that cannot go on forever will end. If debt is unsustainable, bookkeeping does not alter that reality. Real resources will have to shift in a manner that the original contractors had not completely anticipated.

There is a slippery slope when direction to the market place comes from above by government officials rather than developed within the private sector. The painful reality is that regulations and codes of conduct lag privatesector initiative. For instance, as EKM note, CACs cannot help when there are multiple issues that lead to an aggregation problem. One relevant example of that problem is Argentina, which has more than eighty bonds outstanding.

In such circumstances there is no simple fix. Among the solutions mentioned by EKM are, first, incorporating into bond contracts two-step CACs that aggregate before moving to majority rule and, second, arm twisting investment banks. As the number and variety of issuers expand over time, may it become the reality that the international community will ultimately arrive at suggesting tango clauses that involve ten or fifteen steps in the debt resolution process?

But is one, in fact, not looking forward but looking back? One has to wonder whether the focus on CACs is not fixing the last crisis. As they themselves note, EKM are looking at mechanisms that help mitigate external debt crises of the type that did not apply to Mexico in 1994, Korea and Indonesia in 1997, and Russia in 1998. Again, as the number and variety of issuers expand over time, where will the line be drawn, or will lines be drawn everywhere—in international and domestic as well as public and private-sector debt contracts?

Perhaps I am pessimistic by nature, but I was struck when EKM noted that "it is unlikely that we will see more countries incurring large amounts of short-term foreign-currency indexed or denominated debt by issuing ninety-day dollar-linked notes (like Mexico in 1994) or allowing their banks to borrow ninety-day money offshore in dollars (as in Thailand and South Korea). Borrowers and regulators better appreciate the special risks of short-term funding and advantages of medium- and long-term bonds." The fact is that economists like to say that investors learn over time, but the evidence does not support that assertion. [6]

There is a question that goes unanswered in the paper. Indeed it is a question that all the work on collective action clauses must address: why are CACs not included voluntarily in debt issued in New York despite their inclusion in London offerings? EKM's hypothesis is that New York lawyers lack the practice with this profitable clause, even though their partners abroad regularly employ it. Another way of phrasing this hypothesis is that major securities law firms in New York must not have access to e-mail. Might there not be something deeper at work than an information imperfection?

As with any paper that melds theoretical and empirical work by multiple authors, it is an open issue whether the model and regressions fit together. In particular EMK estimate regressions using a standard vector of explanatory variables, which includes for each debt instrument the maturity, fixed versus floating, characteristics of the issuer, volatility of exports and other macrovariables of the domicile of the issuer, and conditions in emerging markets generally. The problem is that most of these variables are endogenous in the theoretical model. In that sense their regressions should be thought of as providing helpful stylized facts that aid in interpreting the model rather than a strict test of a well-defined hypothesis.

In conclusion, this is an important paper that addresses an issue that has been at the forefront of the discussion of the international financial architecture. The authors' empirical finding, that CACs lead to tighter interest rate spreads for countries that enjoy relatively higher credit ratings but do the opposite for those countries with a weaker track record, is thought provoking—as it implies that CACs may lead to greater discrimination on the part of investors.

But the fact that officials and staff of finance ministries and international financial institutions have been so focused on CACs may be an implicit criticism of the net contribution of the work on the international financial architecture. When I am asked about CACs, I usually give a simple answer: any argument that relies on international securities lawyers to promote a welfare-improving change must be overstated. At this writing, it is impossible to generalize from the very limited experience with sovereigns issuing collective action clauses. More important, worrying about effects measured in basis points with sizable standard errors misses the larger point—emerging market economies borrowed too much, not too little, and helping them to borrow more may not be helping them.

Endnotes

1. Reprinted in Lucas (2002).

2. This idea was actually modeled in an earlier paper by Gertler and Rogoff (1990).

3. EKM are more careful than most to avoid this simplistic line of reasoning.

4. Reinhart, Rogoff, and Savastano (2003).

5. Reinhart and others (2003).

6. See Kaminsky, Reinhart, and Végh (2003).

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