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Minutes

Session I. World Economic and Financial Outlook

Carmen Reinhart began the session by noting that the IMF is in the process of revising downward its world economic forecasts in light of the events of September 11 and subsequent data. These revisions accompany an already unusual period of synchronicity, and recession, in the three principal regions in the world economy, namely the United States, the European Union, and Japan. The only notable exceptions to this trend are China and India, relatively small and insulated economies in comparison to the major regions. The net result of these trends is a global "recession with growth." While all growth forecasts have declined since September 11, predictions have become increasingly dispersed, with a clear division between optimistic and pessimistic views, particularly in the case of the United States.

These global trends have had a generally negative impact on Latin America. While Mexico has suffered commercially from soft U.S. demand, the region as a whole has suffered in financial terms from stagnant capital flows including foreign direct investment.. Latin America has experienced further negative impacts from the post-September 11 decline in tourism demand and a general weakening in prices of primary goods. As oil prices have also declined, the net impact on the region's oil-importing countries remains uncertain.

Latin America's economic difficulties, combined with a diminished appetite for risk in bond markets, have raised spreads and resulted in markets' treating emerging market debt as a high-risk instrument roughly substitutable with NASDAQ equities. Nonetheless, the speed and strength of the U.S. recovery, which expected in the second half of 2002, may increase capital flows to the region and help to reduce financial fragility. .

Other participants raised a variety of issues. Guillermo Calvo noted that the region's difficulties may be linked to high debt levels, as risk premiums have increased while other interest rates have declined, a departure from previous patterns. Guillermo Perry observed that capital flows are varying greatly across the region, with little or no co-movement among countries, as capital markets distinguish among emerging economies. A worsening of conditions in Argentina, however, could bring about a generalized perception of risk in the region and greater co-movement.

Session II. Latin American Economic Outlook: Trends and Perspectives

Francisco Rodriguez's presentation took as its point of departure a questioning of the current conventional wisdom regarding Venezuela's fiscal preparedness for adjusting to recent declines in oil prices. In spite of a perception of procyclical fiscal policies, he stated that during the most recent oil "boom" Venezuela introduced a variety of measures designed to promote stability. These measure have included fiscal reforms, which have lessened rigidity in public spending, and tax reforms designed to increase revenue collection. While government expenditures grew during the latest period of high oil prices, he noted that this expansion marked a return to historical levels and that government expenditures as a percentage of GDP were comparable to the shares of other countries in the region. Moreover, these increases largely involved increases in debt service payments or long-term investments such as social welfare expenditures and public works. Others present, though, noted the Venezuelan government's continued high reliance on oil revenues and the possibility of excessive optimism through using nominal rather than constant Bolivar values.

Ernesto Talvi assessed Latin America's current economic situation as the convergence of negative external conditions and a painful macroeconomic adjustment within the region. External conditions include declining commodity prices and terms of trade, as well as higher spreads since the onset of the current Argentine crisis. The region's difficulties are exacerbated by stagnant capital flows, including a decline in portfolio flows, and foreign direct investment remains concentrated in Mexico and Brazil. The current stagnation in capital flows, however, may represent the aftermath of large-scale foreign acquisitions of businesses in the region during the structural reforms of the 1990s. Other external factors influencing the region included the Russian default's effect of slowing emerging market recovery, as well as slowing industrial production in the G-3 countries.

The region's macroeconomic adjustment features an environment of both declining investment and rising exports, with constrained consumption. In spite of consequent improvements in current accounts, real exchange rate depreciation has led to a deterioration of public sector balances, as well as a contraction of domestic lending. These adjustments have proven particularly difficult for countries with pre-existing macroeconomic problems such as Argentina, though even more solidly based countries such as Brazil remain vulnerable to variations in the global economy and emerging market contagion.

Ilan Goldfajn offered several assessments of the regional situation. In spite of a recent decline in foreign direct investment, he noted that FDI remained relatively stable and, like Mr. Talvi, suggested that a one-time boom resulting from structural adjustment may have ended. He then noted that the recent regional downturn's roots in investment rather than spending would limit the role of monetary policy. He stated that in Brazil the consequently limited room for anticyclical measures might suggest a possible role for action by international financial institutions in smoothing the country's economic cycle in order to preserve previous gains.

Alejandro Werner surveyed a Mexican economy "hit twice" by global economic conditions and declining oil prices. A sharp slowdown in the second half of 2001 has particularly affected tourism, remittances from Mexicans living abroad, and consumption, all of which have caused downward revisions of Mexican growth forecasts for 2001-2002; employment rates have also suffered. More favorably, tight monetary policy in 2000 and reductions in inflation and real exchange rates have held down spreads, which leaves Mexico well-positioned to benefit from a U.S. recovery. Under these circumstances Mexico is addressing the recession primarily through the mildly countercyclical measure of postponing deficit reduction by one year.

Keynote Address, John Taylor

John Taylor began by noting the current dominance of a "bipolar" approach to national currencies. According to this approach, countries are most likely to benefit by either pegs (including related measures such as currency boards and outright dollarization) or flexible approaches (including explicitly flexible rates, inflation targeting, and interest rate policy), but not intermediate policies. He noted that while dollar-based pegs are useful in fighting inflation, as countries are forced to follow U.S. monetary policy, he emphasized that other countries' central bankers would not influence U.S. policy.

He additionally addressed two technical areas. Within the inflation-targeting model of flexible exchange rates, he questioned excessive reliance on overnight interest rates as a policy instrument and suggested potential uses of monetary aggregates as an alternative instrument. He further questioned the tendency to resort immediately to policy as a response to exchange rate movements, as these movements are frequently temporary and policy instruments may better address issues such as inflation and output; measures specifically addressing exchange rates may also produce indirect effects with unforeseen consequences.

Turning to U.S. views on emerging market financial issues, he made several points. First, the United States supports growth in the number and flows of emerging markets. Second, as the official sector's resources are limited, official assistance should be based as much as possible on countries' prior actions rather than ex post conditions, which are difficult to monitor and frequently violated. Third, the private sector should not be pressured into supporting an official sector agreement. Fourth, he noted that U.S. policy is taking into account that financial markets are increasingly differentiating among countries and that the danger of automatic contagion has decreased. With respect to Argentina, he noted that the United States has encouraged and approved of recent Argentine cooperation with the IMF and measures such as maintaining convertibility, reducing fiscal problems, and restructuring debt, measures to which markets have begun to respond.

Addressing questions from Ricardo Hausmann, Mr. Taylor stated that it is unclear whether an international bankruptcy court is appropriate, and that the United States remains neutral on other countries' decisions regarding dollarization. Addressing questions from Guillermo Perry and Eduardo Fernández-Arias regarding the Contingent Credit Line, he noted that, while totally eliminating ex post conditions might be difficult, something close to that situation could be valuable; countries qualified for participation through prior actions might thus be able to obtain quick assistance.

Session III. Analytical Aspects of Sovereign Debt Restructuring: Swaps and Buybacks

Surveying the economics of sovereign debt swaps and buybacks, Fernando Broner and Eduardo Fernández-Arias noted that the effects of restructuring are to generate value (in the event of success), to change transfers between a country and its creditors, or, in the case of a failed restructuring, to destroy value. Successful restructurings generate value by eliminating the distorted incentives of debt overhangs, making financing available to the private, and eliminating negative equilibria in debt markets. Transfers can occur if restructuring increases the price of debt, which favors creditors; on the other hand, if new senior debt is involved, the price of debt may decline and favor the debtor. The presenters subsequently described possible outcomes involving primarily voluntary restructurings. Other factors that can enter into debt swaps and buybacks include legal issues, the costs of default, effects on new lending, and creditors' levels of demand and risk aversion.

Discussing the legal context of sovereign debt, Lee Buchheit drew the distinction between the two principal types of bonds and their implications for debt restructuring. The first, ruled by English law, includes a majority-action clause that allows 75% of bondholders attending a meeting to alter any clause of the debt agreement. The second type, ruled by New York law, requires unanimity on changes to payment terms but allows other changes at levels of 50 percent or 66 2/3 percent.

Creative use of provisions in debt agreements issued under New York law provides a possible means for avoiding the holdout problem in debt restructuring. With improved guarantees for new debt, cooperating creditors can be induced to disfigure non-payment clauses of the previous bond. The exercise of "exit consent" thus affects the size of the relative judgment available to holdouts and changes long-term incentives. The question remains, however, of whether too many changes might be construed as affecting payment clauses and violating the original bond's terms.

Presenting a proposal on debt restructuring procedures, Adam Lerrick questioned the notion of voluntary restructuring from the perspective of creditors. His proposal, based on joint research with Allan Meltzer, calls for a sovereign default with three simultaneous announcements: the suspension of debt payments to the private sector; an offer to restructure debt at a minimum restructured value; and a lender-of-last-resort agreement with the IMF that allows debt holders to sell defaulted claims for a cash support price below the minimum restructured value for a limited time. This proposal is designed to prevent panics and maintain liquidity by providing price floors while discouraging holdout behavior through limited-time guarantees.

In discussions following the presentations, Lee Buchheit observed that the success of restructuring measures depends on the ex post price of debt, and that uncoordinated creditors risk losses. He also noted that debt restructuring is likely to move either in the direction of supranational intervention, such as an International Bankruptcy Court, or increasing actions by the investor community to discipline holdout creditors. He viewed an investor-driven approach as preferable, though, as an International Bankruptcy Court could be driven by geopolitical rather than economic concerns. In regard to explicit restructuring proposals such as Lerrick's, Ricardo Hausmann raised the question of whether investors might increase future perceptions of a sovereign's risk and ultimately raise the cost of borrowing for other emerging markets.

Session IV. Argentina: Diagnosis and Resolution

Ernesto Talvi discussed the current Argentine crisis in terms of its origins and the prospects for debt restructuring. Although Argentina's public debt dynamics were favorable at the time of the Asian debt crisis, the subsequent decline in non-oil commodity prices and rising capital costs halved year-on-year growth, a situation aggravated by rising country risk in the wake of the Russian financial crisis and further loss of access to credit. These external shocks essentially negated domestic measures such as improvements in tax collection and reductions in public expenditures.

In this environment debt restructuring faces serious challenges, as high country risk effectively raises deficits and produces a contraction in economic activity. At the same time, the increasingly uncompetitive peso holds down badly needed tradable receipts even while corporate debt is held in U.S. dollars. Should debt restructuring fail, other policy proposals include the following: de-dollarization followed by devaluation or floating; devaluation accompanied by recapitalization of the corporate and restructuring of public debt; and a fiscal devaluation consisting of import fees and export subsidies.

Ricardo Hausmann observed that Argentina's problems have stemmed primarily from crises of investor confidence rather than excessive government spending. This situation has more recently been exacerbated by current account deficits resulting from high debt payments and low exports. In order to lower the real exchange rate and adjust relative prices, he proposed converting deposits to pesos at the current rate in order to preserve purchasing power, followed by allowing the currency to float while maintaining low interest rates. This solution is designed to improve exports and thus provide for the long-term adjustment of relative prices.

Guillermo Perry stated that Argentina's debt appeared sustainable as recently as July of this year, and that external shocks rather than excessive spending have provoked the current crisis. He suggested policy solutions including the conversion of domestic but not international accounts to pesos, as well as a debt restructuring that is unlikely to be completely voluntary, as such an arrangement may prove too time-consuming. He noted that restoring credibility and avoiding a run on bank deposits would require a constitutional change instituting an independent Central Bank.

Following the presentations, Guillermo Calvo noted that the real exchange rate is important for the financial as well as the real sector, and in Argentina the real exchange rate is misaligned by approximately 50 percent. Calls for pegging the peso to a dollar-euro basket do not address this underlying issue; at the same time, devaluation may incur social costs. A central problem that must be addressed, he noted, is whether Argentina's problems derive from trade or capital markets. The present convertibility regime, however, generates solvency problems by disadvantaging tradable productions and making non-tradable production less risky. Under these circumstances a default is necessary and inevitable in order to provide flexibility in policy responses.

Among other participants, Alejandro Werner questioned whether converting deposits to pesos will have the desired effect of lowering interest rates and whether investors will approve of such a measure. Adam Lerrick stated that devaluation may create additional confidence problems at a time when Argentina already suffers from diminished confidence as a result of frequent policy changes. Matthew Fisher observed that no plan alone will solve Argentina's problems, and that a change in underlying institutions is essential for the country's fiscal and monetary structure and its productive private sector. Ernesto Talvi warned that unilateral debt writedowns or repudiation could raise the cost of capital to the private sector. Guillermo Perry noted that Argentina faces a choice between de-dollarizing the economy or changing the structure of its commerce.

Session V. Crisis Resolution: Bankruptcy Institutions for Sovereigns

Discussing sovereign bankruptcy procedures, Adam Lerrick proposed means for default without disruption that would strike a middle ground between bailouts and defaults that risk contagion and panic. Defaults with orderly debt writedown and restructuring can provide a liquid, functioning market for restructured debt and impose market discipline on future borrowing. Reiterating his proposal of Session IV, he noted that such a default could be achieved through simultaneous announcements of a suspension of debt payments to the private sector, a short-term restructuring of debt, and utilization of IMF credit for immediate debt buyouts and price support. The minimum restructured value of debt is made credible by a statement of the assumptions on which that value is based. Unlike a bailout, an orderly default is expected to discourage holdout behavior by providing floor values and to discourage overly optimistic investment and moral hazard by ensuring that creditors share in losses.

Lee Buchheit posed the alternatives available for addressing sovereign bankruptcies as a choice between coercive measures imposed by the official sector and self-discipline by investors in order to rein in mavericks. He noted that, while the feasibility of an international bankruptcy court is uncertain, investors might fear that such an institution would serve as an extension of G-7 politics and act accordingly. He further questioned whether sovereign bankruptcy is a truly justifiable issue because, while payment of debts is usually possible, this is true only if payment is made a sovereign's top priority or assets are attached; both of these conditions are difficult to impose or enforce. He additionally questioned the recent restructuring proposal by IMF official Anne Krueger, noting that its voluntary approach did not address the problem of holdout creditors, and that an automatic stay on payment is necessary after, rather than during, restructuring.

Mohamed El-Arian divided issues involving debt workouts into areas where much is known, where some facts and trends can be surmised, and where much remains to be known. It is generally agreed that the current workout process, or lack thereof, is highly suboptimal from the perspective of countries, investors, and international financial institutions. Present options lead to overshooting of variables, which can lead to contagion and slow recovery. In addition, the investor changes from long-term to opportunistic investors and ultimately shrinks, and fund managers' ability to raise funds is limited because there is no way to price risk. In this environment international financial institutions are repeatedly exposed to a choice between bailing out investors and doing nothing.

It is widely suspected that there is a vacuum to be filled in workout procedures, and it will be filled either by orderly international arrangements or disorderly precedents at the country level. The latter, like current procedures, would continue to empower holdouts. While bailouts and debt stabilization funds represent short-term actions, the Lerrick-Meltzer approach appears favorable, though not simple. It also appears likely that investors are increasingly able to distinguish among emerging markets.

A variety of questions remain unanswered. First, which official sector institution is willing to take the lead in addressing this issue? Second, how long will it take to address technical and legal issues? Third, how can roles of "judge and jury" be assigned in an international forum? Fourth, how will countries react to any initiatives undertaken? Finally, how will consultations with creditors take place?

Matthew Fisher presented the case for an international bankruptcy mechanism in terms of creating incentives for the resolution of future crises, while noting that any proposal under consideration could not be implemented in time to address Argentina's present situation. The goal of such a mechanism would be to provide an orderly resolution while preserving the operation of credit markets. A bankruptcy mechanism's success would depend on being perceived by creditors as fair, and would include the following features: a temporary stay on creditor litigation, mechanisms for financing during a workout, and imposition on all creditors of a settlement acceptable to a large number of creditors. These procedures would maintain sovereigns' incentives to avoid bankruptcy, namely preserving reputation, avoiding litigation, and avoiding risks of economic dislocation such as impacts on the banking system. Creditors prefer bailouts, but if it is clear that bailouts are not forthcoming most creditors would benefit from orderly arrangements and vulture behavior would be discouraged. For such an arrangement to prove successful, the IMF would have to specify precisely the terms it would offer regarding the adjustment of the non-interest current account, funds to the banking system, and ex post fund restrictions. Unresolved questions concerning a bankruptcy mechanism are the possibility of combined higher spreads and lower flows, and what might happen if debtors negotiate in bad faith.

Augusto de la Torre stated that, while proposed institutional arrangements cannot address current concerns, present arrangements provide imperfect, ad hoc substitutes. These measures, combining coercion and burden-sharing and undertaken with international financial institution participation, have proven partially successful. In the case of Ecuador, however, the inability to discern between liquidity and solvency problems has left no clear role for international financial institutions' participation. A variety of additional lessons can be drawn from Ecuador's recent experience. First, in small countries, the combination of confidence problems, discernment problems, and "fussiness" in economic assumptions and modeling can lead to a potentially explosive situation. Second, countries lacking a framework for debt workouts are at maximum risk of litigation. Third, without a predetermined workout process, countries face the dilemma of whether to negotiate. Fourth, deals can be struck quickly if holdouts are combined by exit consents or other measures.

In discussions following the presentations, José de Gregorio stated that for many countries participation in an international bankruptcy court is unfeasible for domestic political reasons. Fabio Barbosa, addressing Matthew Fisher's proposal, raised questions of eligibility, price-setting, and possible effects on domestic investors. Ernesto Talvi suggested that different proposals could be seen as complementary rather than mutually exclusive, though Mohamed El-Arian suggested that the complementary use of different instruments might prove unfeasible. Eduardo Fernández-Arias asked how current proposals might address solvency problems masked by liquidity. Elaborating on his proposal, Matthew Fisher stated that international bankruptcy would involve only temporary protection, with extensions available only after countries showed proof of protecting creditors' assets and that at present the means of financing international bankruptcy measures are uncertain.

Session VI. Instruments to Cover Liquidity and Contagion Risks: What Can IFIs and Countries Do?

Eliot Kalter provided a survey of the Contingent Credit Line in terms of its purpose, eligibility for participation, and possible revisions to its terms. The CCL is primarily intended to reduce vulnerability to contagion by augmenting a country's foreign exchange reserves, though it may also help to prevent speculative attacks and provide a seal of approval for a country's economy. Eligibility is based on a country's adherence to strong if not perfect policies and the existence of potential risks from contagion rather than policy. These criteria can be summarized as the following: no expected need for funds, positive policies and adherence to international financial standards, constructive relations with private creditors, and a satisfactory macroeconomic program. Proposed revisions include reducing countries' surcharge and contingency fees and making payment of the first third of the funds disbursed more automatic.

Ilan Goldfajn observed that the fundamental challenge for a Contingent Credit Line is to achieve a balance between the procyclical behavior of markets and the anticyclical behavior of governments and international financial institutions. Additional problems include the signaling value of applying for CCL eligibility, as no country has yet done so, and procedures for withdrawing from CCL participation. Further questions involve how automatic CCL assistance should be and the evaluation of the following factors: balance of payments and contagion risk, definition of circumstances beyond a country's control, appropriate economic programs, and a country's commitment to adjust its policies. The latter especially invites the possibility of ex post conditions.

Alejandro Werner discussed the CCL from the perspective of Mexico's experience with a private-sector contingent credit line involving a consortium of banks. This mechanism was utilized during the Russian financial crisis, but functioned imperfectly due to the participants' lack of experience. Greater international financial institution involvement in such mechanisms thus appears appropriate to support emerging markets. At the same time, in spite of being a suitable candidate for CCL participation, Mexico has not yet applied because of the uncertain signaling effects.

Eduardo Lizano noted that the CCL could prove useful for smaller countries, which have only a limited presence in financial markets and are more vulnerable to contagion than larger markets. In particular, CCL participation could support smaller countries' ability to place bonds on the market, ensure liquidity, and provide protection from capital flight and speculative attacks. Given the size of these countries' economies, these benefits could be obtained with only a relatively minor commitment on the part of the IMF.

Guillermo Calvo presented a potential alternative to the CCL in the form of an Emerging Market Fund. The EMF is designed to prevent a sudden stop that would drive the economy into a bad equilibrium, avoid the negative externalities of a sudden stop, and address other second best considerations associated with market incompleteness. Funded by highly liquid G-3 bonds, the EMF would cushion fluctuations of an emerging market bond index by intervening in markets if that index falls by more than a given percentage relative to a moving average of the same index. Depending on market trends, which EMF intervention would not change, the EMF could realize gains or suffer losses; possible areas of discretion include adjusting fees to reward countries for good behavior and temporarily leaving crisis epicenter countries out of the index. Potential problems in the proposal include moral hazard and adverse selection, and a current absence of provisions for addressing upward risks.

Among the participants, José de Gregorio suggested that EMF action might prove analogous to currency intervention, which is frequently limited in its scope. Liliana Rojas-Suárez posed questions regarding the size of the EMF and whether it might be used for political rather than economic ends. Ricardo Hausmann raised the issue of how Central Banks might use CCL disbursements, and suggested that the IMF's list of countries eligible for CCL participation could be made public to provide a seal of approval for their policies. Adam Lerrick stated the CCL's feasibility might be limited because governments might need to make politically difficult decisions ex ante in order to qualify and the IMF may be unable to relinquish the use of conditionality. Enrique Mendoza highlighted the underlying issue of making a distinction between genuine contagion and other phenomena. Guillermo Perry also noted this difficulty and suggested that the EMF could utilize an automatic trigger based on the EMBI+. Alejandro Werner observed that a CCL or related proposal should include a definite time horizon and include a strike-price without qualitative standards; in addition, these proposals may place the private sector at a disadvantage. Moisés Schwartz emphasized the need to maintain financial resources while not providing disincentives to banks, and cautioned that an EMF might diminish the informational value of prices.