

EXECUTIVE SUMMARY

THIS REPORT FOCUSES ON TOTAL GOVERNMENT DEBT in Latin America and the Caribbean, comprising both international and domestic debt. The difference between the two types of debt has narrowed considerably in recent years, as the holders of bonds issued in domestic markets may be international investors and domestic investors may hold bonds issued in international markets.¹ Moreover, instruments such as credit derivatives can be used to shift risk among different investors almost instantaneously, and there is no practical way to trace results of the increasingly large volume of such derivatives. Using total government debt, which is a more comprehensive measure, turns out to be important because focusing exclusively on external debt has led some observers to conclude—erroneously—that government debt is decreasing in Latin America. The complete story is that the ongoing decline in external debt ratios in the countries of the region is often compensated for by an increase in domestic debt. All things considered, the average level of public debt in the region is now similar to that prevailing in the early 1990s.

Examination of the sources of debt growth yields a striking finding: recorded budget deficits play only a secondary role in explaining debt growth in developing countries. Most debt volatility, especially sudden explosions in debt levels, is the result of balance sheet effects due to exchange rate adjustments, the resolution of contingent liabilities, and extra-budgetary items. For example, in the Dominican Republic, the debt-to-GDP ratio rose from 25 percent of GDP in 2002 to 55 percent of GDP by the end of 2003 owing to a costly banking crisis. Debt-to-GDP ratios in Argentina and Uruguay more than doubled in 2002 as a result of currency depreciations in those two countries. This underscores the conclusion that the structure of debt and contingent liabilities often involves more risks than the level of debt itself and that countries need to improve debt management to limit their debt vulnerability.

The international private market has been a prime source of financing for Latin America for over 200 years. Although the international sovereign debt market is liquid and deep, emerging market premiums have been extremely volatile at times, with a tendency to experience large spikes and subsequent reversals, and external factors have often been

¹ Information on total debt is not readily available. Databases such as those included in the IMF's *International Financial Statistics* and the World Bank's *Global Development Finance* contain scant information on domestic debt level and composition. This report introduces a new database for 24 Latin American and Caribbean countries, which the IDB will update and publish regularly.

important determinants of emerging market spreads.² In recent months, however, global conditions have been quite favorable to emerging market borrowers, and spreads have reached record low levels. The report concludes that there are reasons to be optimistic about these trends, but caution is still in order. The favorable market has resulted in part from a strengthening of fiscal policies and the improvement in current account balances, which has reduced dependence on external savings. But it has also resulted, in part, from abundant liquidity in financial markets, from an expansive phase of the world economy and commodity prices, and from expectations of currency appreciation and domestic interest rate cuts, which cannot continue forever.

Lending by multilateral financial institutions and official bilateral sources is also a traditionally important source of finance and continues to represent a fairly stable share in international borrowing, both for low-income economies with no market access and for the emerging market economies in the region.³ Despite charges sometimes leveled against multilateral lending, the report finds no evidence of procyclicality in lending by the multilateral banks, but it does find evidence of a catalytic role of multilateral lending, as increases in such lending tend to be followed by subsequent increases in private lending.

Domestic debt markets, although still less developed than their international counterparts, are gaining importance and can play a key role in reducing vulnerabilities. While Latin America does not have comparatively large bond markets, the size of these markets is commensurate with that of overall financial markets in the region. That is, although Latin American bond markets are not large as a proportion of GDP, they are not small as a proportion of bank credit when compared to those in other emerging regions. Government bonds, in contrast, are very sizable in relation to private corporate bonds. A large government bond market may contribute to market development by providing a reference yield curve but may also raise concerns about crowding out private borrowers. Domestic bond markets provide an alternative to keep financial markets running when domestic banks are unable or unwilling to take additional credit risks in their own portfolios, and these markets can promote the use of domestic currency instruments. The growth of institutional investors, such as pension funds, and the appetite shown by international investors will provide the requisite investor base if the legal and institutional framework is supportive of bond market development.

While public borrowing can be applied to worthy projects, it would be naive to ignore political influences that may cause the use of debt to drift away from its legitimate purposes. In particular, decentralized fiscal procedures, widespread fiscal transfers from the central government to states and provinces, and unstable political systems may lead to wasteful borrowing and exacerbate vulnerabilities. One mechanism for ensuring that debt policies are not distorted by political influences is fiscal rules that include limits on the budget deficit, debt, or public spending at various levels of the government, such as those included in the fiscal responsibility laws of several Latin American countries. But fiscal rules can be an ef-

² These global factors include the behavior of interest rates in large advanced economies, and also sudden stops in capital inflows triggered by events sometimes far removed from Latin American economies, as well as contagion effects that spread a market panic to a whole group of countries in the same asset class.

³ In fact, the share of official lending in total public debt in the region was higher in 2004 than in the early 1990s, although this was partly reversed in 2005–2006 after Brazil and Argentina repaid their debt to the International Monetary Fund, and will be further undone by Mexico's planned repayment of its debt to the multilateral development banks.

fective mechanism only when the overall institutional framework supports their credibility and enforcement.

It must also be recognized that excessive levels of debt can become a burden on public spending commitments and reduce available resources for poverty-fighting social expenditure. This points to potential benefits of the current debt relief initiatives aimed at helping low-income countries to reach the Millennium Development Goals. Although the empirical studies reviewed in this report do not find strong evidence that past debt relief operations have succeeded in increasing social spending, the fiscal space created by the current, wide-ranging initiatives would provide a broader opportunity for such increases to occur. In fact, there is some preliminary evidence that debt relief brought about under the auspices of the Heavily Indebted Poor Countries initiative has been more effective at increasing social spending than was the case in previous debt relief initiatives.

Debt management and fiscal policies must aim at enhancing sustainability and how it is perceived in markets. The techniques of debt sustainability analysis have undergone radical improvement in recent years, and the new approaches described in this report are part of that trend. These new techniques explicitly consider the fact that variables such as exchange rates, interest rates, and economic growth, for example, are highly volatile in emerging markets and that this high volatility interacts with the debt structure to have a substantial impact on the evolution of debt. From the viewpoint of investors, evaluating debt sustainability implies determining what debt level triggers debt default or restructuring. Finding this level is complicated in the case of sovereign debt because, in contrast to a firm, the point at which a government becomes financially bankrupt is not precisely defined. The theoretical economic literature has traditionally seen the sovereign as calculating the cost implied by a debt default and comparing it to the burden of servicing the country's debt to decide whether or not to keep meeting debt obligations. This type of strategic behavior is not in line with what has been observed in practice. Sovereign defaults most often occur after a country's economy has gone through a serious downturn and other measures have failed. If anything, the empirical evidence suggests that sovereign default does not happen when governments do not need, or do not anticipate the need of, financing from their creditors, but rather in the wake of grave crises.

DEBT POLICIES

In addition to the adoption and implementation of prudent fiscal policies, limiting the risks of sovereign finance should also focus on improving debt management and developing domestic bond markets. Experience has highlighted two key sources of vulnerability: debt denomination (foreign currency debt) and debt maturity (short-term debt). Policies aimed at reducing these vulnerabilities are complicated by the fact that there may be a trade-off along these two dimensions. For example, shifting to domestic currency debt often requires employing short-maturity instruments. Inflation-indexed instruments provide an alternative that can help improve the terms of the trade-off between denomination and maturity, as it may be possible to issue long-term inflation-indexed instruments at moderate cost, because investors are protected from the risk of unexpected inflation. Past experiences in which financial indexation spearheaded widespread indexation of wages, pensions, etc., and created a situation of stubborn inflation and inflexibility of relative prices may make govern-

ments wary of such instruments. Still, some countries have been successful in using indexed financial instruments widely without perceptibly worsening inflation persistence.

The high volatility underlying emerging markets' economies and global financial markets creates an argument for introducing into debt contracts contingencies with equity-like features that allow for more efficient sharing of risk. These are instruments that offer lower payoffs during bad times and higher payoffs during good times, which would make them safer for investors and would afford governments the opportunity to manage their fiscal policy stance better over the business cycle. Interest payments could be indexed to commodity prices, the terms of trade, or the rate of growth of GDP. Another option would be to obtain contingent coverage directly from international financial markets through the use of derivative contracts. In practice, however, many futures and option markets lack depth and liquidity and therefore offer only limited scope for insurance. The lack of markets for contingent instruments is more acute in the case of events such as fluctuations in tourism revenue, hurricanes, and other natural disasters. Fortunately, financial market innovation is increasing the scope for using this type of market coverage, as in the case of the recent operation by Mexico securing earthquake insurance for three at-risk geographical areas.

It should be noted, however, that obtaining some form of market insurance, through either derivative contracts or indexed debt, faces a fundamental *domestic* obstacle. By their very nature, these contingent instruments work as an insurance policy for the country as a whole. Because their costs must generally be paid up front, but their payoffs may not occur until years later, the reasons for purchasing the insurance instruments can be easily misunderstood by the public, and they can become a political liability. This may provide little incentive for politicians to enter into large-scale contracts of this type. The international community could contribute to the surmounting of this obstacle by promoting studies and disseminating information about the benefits of these types of instruments.

The development of domestic bond markets is another key component of a strategy of safer sovereign finance. These markets hold the promise of providing a stable investor base for government debt and offsetting—at least to some degree—the risk of sudden stops and volatility in international markets. Moreover, domestic markets are a natural venue for debt denominated in domestic currency, and the benefits of a well-developed domestic currency bond market would also extend to the private sector.⁴ There is the risk, however, that governments might attempt to capture the resources of institutional investors, such as pension funds, through regulation or moral suasion, which again underscores the importance of prudent fiscal policies in ensuring the success of any policy of encouraging the development of domestic markets.

THE ROLE OF THE INTERNATIONAL FINANCIAL INSTITUTIONS

In recent years, the international community has focused on the process of resolution of debt defaults with the widespread introduction of collective action clauses in debt contracts. But the *prevention* of debt crises has not made the same kind of progress. In this area, there is a great deal that the international financial institutions (IFIs) could do.

⁴ Although several Latin American countries have placed some local currency issues internationally, the widespread international practice for emerging economies has been to issue local currency bonds in their domestic markets.

The IFIs could design workable, fast-disbursing credit facilities to offset rollover risks. Such facilities should work in much the same way as a central bank lends to domestic financial institutions, which is an effective deterrent to a possibly self-fulfilling run. Rather than limiting themselves to loans to governments, the IFIs could develop a strategy to respond to certain global emergencies more effectively by directly acting on international markets. Although this type of intervention has so far been outside the toolkit of the IFIs, a set of well-established rules could avoid any anticipated pitfalls.

The IFIs could also help make member countries' own efforts to prepare for emergencies more effective. In recent years, countries have attempted to gain a measure of protection against sudden stops by accumulating large international reserves. This is a generally expensive and inefficient self-insurance strategy. There have also been initiatives in Latin America and East Asia to gain efficiency and financial backing by partially pooling the reserves of several countries. The IFIs could assist in these efforts both at the technical level, refining operational methods and access rules, and by providing financial support. Moreover, as these initiatives are regional and risks are often regional by nature, there would be clear advantages to creating agreements that span several regions.

The IFIs also have an important new role to play as facilitators of reforms aimed at limiting the risk of sovereign finance. The IFIs can promote the development of markets for local currency instruments and new contingent debt instruments in various ways. The debt instruments used by governments today were mostly designed in an era preceding financial globalization, and there is room for improvement in widening the spectrum of instruments. The IFIs can provide assistance with the design of new instruments, and they can help to overcome the externalities and start-up costs of new markets and attract new investors, including by issuing their own debt securities with the contingencies promoted for country insurance.

Finally, the IFIs could change the nature of their own loans to member countries by offering a wide menu of domestic currency loans and contingent facilities and thus contribute to the dedollarization process.

