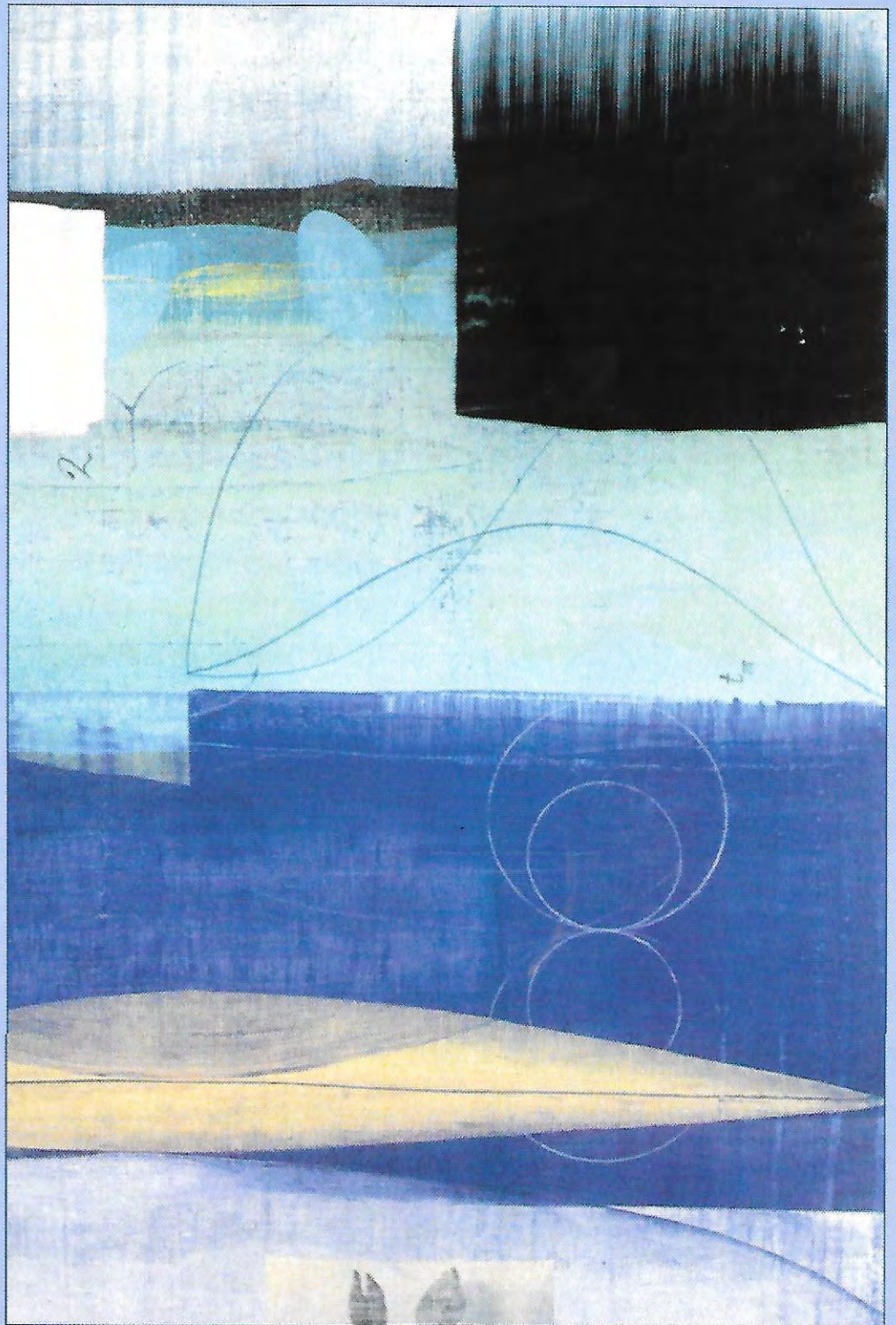


# EMERGING MARKETS INVESTOR

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## Killing the golden goose

-Stop punishing  
the creditors says  
Arturo Porzecanski  
of ING Barings





# Killing the golden goose



Burden-sharing has become an explosive issue. When emerging market countries default on their debts, should bondholders be forced to share the loss with official creditors? *Emerging Markets Investor* has argued that they should. But guest columnist Arturo Porzecanski (left) says this is unfair when governments (developing and developed) are most to blame for the problem

**T**HE RECENT HARDLINE approach adopted by the finance ministries of the leading industrial countries (G-7) towards the private creditors of certain emerging market nations is likely to have adverse repercussions. The new stance consists of telling some countries that in order to qualify for financing from the International Monetary Fund (IMF), or for a debt restructuring from official creditors that constitute the so-called "Paris Club", they must first obtain relief from foreign bank lenders or bond investors. The idea is for private creditors to share the burden of rescuing countries in serious difficulty, either by forgiving some of the debt in question or by arranging for it to be repaid over a much longer period.

However, this approach will not only discourage future portfolio investment in emerging markets generally, but will particularly discourage it from going to the many countries having only limited access to the international capital markets. Considering the overwhelming importance of private funding in external financing of emerging market nations (see table below), the new hardline policy could well kill the proverbial "goose that has been laying the golden eggs" of international finance.

Understandably, the G-7 governments have grown reluctant to come to the rescue of more and more countries with ever-larger packages of emergency finance. In the wake of the bail-outs for Mexico, Asia, Russia and Brazil, G-7 officials contend that private investors have often destabilised the capital markets by rushing in and

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then rushing out of some emerging markets, leaving the official community to pick up the pieces. The G-7 argue "moral hazard" (lending or investing in the expectation of being bailed out if things go wrong) as a major reason for this errant behaviour, and allege that it is running rampant in international finance and leading to the misallocation and mispricing of risk capital. They also claim that investors must be held accountable and must therefore pay for their miscalculations and misdeeds through a "bailing-in" process – meant to inflict losses on those who took undue risks.

But, properly examined, history will show that, for the most part, it has been governments (both in the developed and developing countries), rather than private lenders and investors that have sown the seeds of the trouble that has since been reaped again and again. Recall the origins of the Mexican crisis, which led to the first of the large bail-out packages. Mexico painted itself into a

corner in late 1994 because the outgoing administration of President Carlos Salinas failed to tighten monetary or fiscal policies, or to let the currency depreciate sufficiently, in response to several confidence-shaking domestic political events. In particular, these were the assassination of Salinas' heir, and a 350 basis point interest rate hike compliments of the US Federal Reserve. To make matters worse, the Mexican government sought to forestall a loss of official reserves and prevent a devaluation by issuing to investors massive amounts of short-term, US dollar-linked securities (the infamous 'Tesobonos') in lieu of peso-denominated Treasury bills (Cetes). When domestic and foreign investors lost confidence in the incoming Ernesto Zedillo administration, the central bank spent most of its remaining international reserves defending the artificial exchange rate. The only way the authorities could meet the demand for US dollars stemming from the redemption of the Tesobonos and avoid a damaging default was to obtain extraordinary financial support in Washington – which they did.

Emerging market governments have been unwilling to let their interest rates and exchange rates reflect adverse economic or political realities. This, coupled with their inability to react to these realities via the monetary or fiscal policies warranted by the circumstances have been the underlying factors that would later get Thailand, South Korea, Indonesia, Russia and Brazil into serious trouble. In these countries, too, matters were made worse by penny-wise, pound-foolish government policies.

Furthermore, long-term foreign direct investment (FDI) in local banks and corporations was discouraged by various government policies

## NET EXTERNAL FINANCING TO EMERGING-MARKET ECONOMIES

(US\$ billions, except where noted)

	1996	1997	1998	1999f
Total	340.0	301.7	189.1	157.6
Private flows	334.7	265.9	136.1	135.5
% of total	98.4%	88.1%	72.0%	86.0%
Portfolio flows	123.5	118.7	61.3	47.7
Foreign direct investment	92.8	113.1	120.2	117.3
Commercial bank credits	118.4	34.1	-45.4	-29.5
Official flows	5.3	35.9	53.0	22.1
% of total	1.6%	11.9%	28.0%	14.0%

Source: Institute of International Finance f=forecast



and attitudes common throughout Asia and Russia, prompting an unhealthy reliance on borrowed funds, as opposed to shareholders' equity for working capital and investment purposes. One reason why this year's currency crisis in Brazil was relatively muted was that, contrary to the norm, the country had actively courted FDI, mainly through privatisations. The arrival of meaningful amounts of FDI, month in, month out, proved quite useful in supporting the currency after it was freed to find a market-determined level.

Finally, most central banks made matters worse by making huge, undisclosed bets in the forward (Thailand) or futures (Brazil) currency markets, misreporting their foreign exchange assets and liabilities (South Korea), and diverting foreign exchange earnings (Russia). To sum up, governments made the wrong policy decisions, misled investors and thwarted market forces – and that is largely why they got into trouble.

But it is not only emerging market governments that bear all the responsibility for the crises. Governments throughout the industrialised countries must also share some of the blame for the underlying conditions that led to the recent upheavals. For instance, the 1988 Basle Accord on banking supervision decided that bank exposures to sovereign governments that are members of the Organisation for Economic Cooperation and Development (OECD) ought to have a zero risk weighting against capital requirements. This encouraged a leap in commercial bank lending to Mexico and South Korea once those countries were admitted into the OECD (in 1994 and 1996, respectively).

Recognising this mistake, the Basle regulators are now proposing to discard OECD membership as a criterion for the assignment of country risk weights. The G-7 and the IMF are also to

blame for the recent turmoil, because they never insisted that emerging market countries abolish the artificially controlled exchange rate regimes that proved incapable of coping with the changing times. This was a surprising omission, given that the "Washington Consensus", flogged incessantly by the IMF and the World Bank throughout the 1990s, encouraged every other kind of price and market liberalisation. How could countries be instructed to open up their trade and capital accounts and not be told to make their currency regimes more flexible? On the contrary,

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the G-7 and the IMF always tolerated – and frequently underwrote through IMF loans or large-scale rescue operations – all kinds of currency pegs and bands that were counterproductive and untenable over time. These pegs and bands encouraged massive interest-arbitrage operations on the part of private lenders and investors, both foreign and domestic, thereby setting the stage for uncontrollable reversals once the currency regimes looked vulnerable to collapse. This collective G-7 failure to bury the Bretton Woods regime led the former US Treasury Secretary Robert Rubin to announce earlier this year that the US government would no longer support rescue operations to prop up artificial exchange rate regimes. This policy was later confirmed by Rubin's successor, Larry Summers.

Improved policies on the part of OECD and emerging market governments have the potential to prevent future financial crises, and it is encouraging to see many such constructive policies being implemented. By now, most countries in Asia and Latin America have adopted market-determined exchange rate regimes. The regimes will discourage

"dumb-money" interest-arbitrage operations and safeguard official international reserves for true financial emergencies. Many governments are now regularly reporting their vital statistics (for example, their foreign-currency-denominated assets and liabilities), disclosing more details on their policy intentions, following increasingly transparent "rules of the game" and minimising market interventions and distortions. All this will enable lenders and investors to make more informed decisions and to deliver market warnings early to policy-makers. Most countries are also taking steps to fortify their banking systems, even by encouraging foreign investment into what traditionally has been a sheltered industry; and they are exercising prudent supervision by curbing currency, interest rate and maturity mismatches. The OECD countries, for their part, are finally providing good advice on exchange rate and banking matters. Also, the IMF is disclosing more information to the markets than ever before.

However, it is discouraging to see the G-7 governments also adopting an uncompromisingly hard line towards private lenders and investors. This course will backfire, negating the benefits of the many constructive measures being put in place. Evidently, the G-7 governments have concluded that there is too much "moral hazard" in the international financial system – lenders and investors have grown so accustomed to being bailed out that they must now be disciplined – so that defaulting on obligations to private creditors has become a requirement for receiving support from the G-7. The new policy was inaugurated by the Paris Club of official creditors in September 1998, when US\$4 billion of Indonesia's



*Michel Camdessus, IMF managing director (left) and Ecuador's President Mahuad. But will the IMF's new hardline stance be a help or a hindrance to Ecuador's debt problem?*



obligations to export, clean and retrain all agencies were rescheduled. This was on the condition that a \$350 million commercial bank loan, which amortised during the 'consolidation period' (the time when rescheduled debts to the Paris Club fall due), was also restructured.

Indonesia has since complied, and the loan was rescheduled last March. This episode was followed by another precedent-setting Paris Club instruction to Pakistan in January of this year. In exchange for a rescheduling of US\$3.3 billion of principal and interest payments due to official agencies, Pakistan was told that it should reschedule both commercial bank loans and Eurobonds maturing this year and next. The loans have since been restructured; the Eurobonds remain under threat of a restructuring.

The IMF has also adopted the new "get-tough" attitude. A year ago, Ukraine was pressured by the Fund into restructuring its maturing Treasury bills. Since then, the IMF has conditioned its lending to the country on the restructuring of other securities, including Eurobonds falling due this year and next. IMF assistance to Romania has hinged on the country raising new funds (US\$450 million) in the international capital markets. Since potential investors in a Romanian Eurobond sense they may be walking into a restructuring trap, the country has been unsuccessful in placing a new issue. In recent months, Ecuador has sought IMF assistance but was rebuffed until it ceased to service its obligations to Brady bondholders. To qualify for assistance, the country has since been pressured to default on other securities, including Eurobonds and other dollar-denominated Treasury bills, and pushed to obtain debt forgiveness from all bondholders, even ahead of a Paris Club restructuring.

The G-7 attitude towards private creditors is based on premises that, for the most part, simply do not hold true. Take all the official concern about excessive moral hazard in international finance, for

instance, investors were not making decisions on the assumption that they will be bailed out, they would have flooded Mexico with short-term loans and investments in the past four years – but they have not done so. Mexico was a near-death experience for many portfolio managers back in 1994–95, and quite a few lost their jobs, even though investments in Tesobonos – though not in other assets – were recouped.

A case in which moral hazard did rear its ugly head was Russia before its August 1998 devaluation and default. Indeed, there were many

## “Politically motivated lending on the part of the G7 and the IMF can mislead the financial markets and prompt the misallocation of capital resources”

lenders and investors who piggybacked on G-7 and IMF support for that country. Their mistake was to trust the official assurances emanating from Moscow, Washington and the leading European capitals about how the country was on the mend and how the rouble would not be devalued. But all that the case of Russia proves is that politically motivated lending on the part of the G-7 nations and the IMF can mislead the financial markets and prompt the misallocation of capital resources. Without this condition, moral hazard will not run rampant. Will the fact that the IMF is now lending again to Russia, purely to ensure repayments to itself, prompt renewed portfolio investment into that country? Surely not, especially since the Russian debacle was a "death experience" for many portfolio managers.

Now consider the argument that private lenders and investors have escaped losses and must be taught a lesson in pricing risk appropriately in the future. The proposition strikes loan officers and portfolio managers as absurd. Lenders and investors have endured huge mark-to-market losses in Asia, Russia and elsewhere in emerging markets in recent years – whether in their exposures to currencies, equities, fixed-income securities, derivatives, properties, banks or corporations. This is precisely why the investor base with a stake in emerging markets has been decimated – consider the withdrawal of portfolio capital from many markets and the sharp reduction in trading volumes and new-issuance activity. Will the imposition of additional losses on lenders and investors in the likes of Indonesia, Pakistan and Ecuador deliver greater discipline? It is foolish to suppose so. It will merely dry up all lender and investor appetite for riskier countries, especially those (mostly in the single-B credit rating category)

that are likely to turn to the Paris Club or the IMF for financial assistance. And the risk is that, beyond the less significant nations, major debtor countries such as Argentina and Brazil will find it hard to access the capital markets out of perfectly justifiable investor concern that the IMF will declare by fiat that their Bradys, Eurobonds or Treasury bills must be rescheduled.

The case of Ecuador is particularly disheartening. Here is a country in serious trouble – but not at all because foreign commercial banks and private investors poured in funds recklessly and then pulled them out, destabilising the economy. Ecuador faces a crushing debt-service burden not because of large-scale payments due to private lenders and investors but, rather, because of the mountain of payments coming due to official bilateral and multilateral agencies. Back in 1994, private creditors agreed to forgive 45% of all principal falling due and accept payment for the remainder in up to 30 years, or else to grant equivalent, permanent debt relief in the form of 30-year bonds paying a concessional interest rate of as little as 3% a year. In sharp contrast, the Washington-based multilateral agencies and the OECD export credit and foreign aid agencies represented by the Paris Club granted no comparable treatment: they merely postponed obligations falling due. This is why the payment of interest on Ecuador's Brady bonds represents less than a quarter of the government's total external debt-service bill. Foreign bondholders are not a cause of Ecuador's cashflow woes, but lack of realistic generosity on the part of the OECD governments is a major contributing factor. It thus boggles the mind to see that the G-7 and the IMF are demanding that Ecuador seek debt relief from private creditors for the second time – as if to "bail them in", when the fact remains that it is the official community that has been bailing itself out.

G-7 and IMF encouragement of defaults such as Ecuador's is creating widespread suspicion among lenders and investors that the rules of engagement in international finance have changed in a way that is neither fair nor sensible. Consequently, private capital will walk away from dozens of low-income countries with weak credit histories – the single-B or unrated credits – leaving them wholly dependent upon G-7 and IMF financial support. Other, marginally more creditworthy nations – the low-double-Bs – will find themselves paying an additional risk premium to compensate lenders and investors for the possibility that they, too, will be ensnared by the G-7/IMF "get tough" attitude. Many needy countries will soon be looking back at the 1990s and wondering who cooked the golden-egg-laying goose of international finance. ■

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### Ecuador bond performance

