External Debt Policies in Emerging Economies : New Dimensions*

Mr. Chairman and friends,

At the outset, I would like to express my gratitude to Dr.Shanker Acharya, Mr.Ravi Mohan and Mr.Sanjay Kathuria, who gave me an opportunity to attend this seminar on 'Corporate External Debt Management'. The deliberations have indeed been a feast and there is nothing but admiration for the outstanding organisational abilities of all concerned. There has been an ideal mix of participants and subjects. In the previous Seminar on external debt at Trivandrum last year, we had flagged corporate angle to external debt as a priority item. We should all be happy that the suggestion has been acted upon now. Like the proceedings of the earlier seminar which have been published by RBI, I hope CRISIL would arrange to get the papers and proceedings published soon.

A number of valuable suggestions have been made in the Seminar and some of them are particularly relevant to RBI. Some of them require clarifications as to the rationale of current policies and procedures. A few of them need immediate attention while others have to be pursued for the medium-term. They require careful examination. I assure that we in RBI will consider all of them seriously and we seek your advice and cooperation

Let me not try to either summarise the highlights of this seminar or respond to the valuable insights. I intend sharing with you some thoughts on new dimensions `in external debt policies of emerging economies, consequent upon the recent crises in East Asia, Latin America and Russia. New approaches are being advocated in the context of discussions on the new international financial architecture.

The responses to the recent crises, the follow-up consideration of measures to prevent similar crises, and possible actions to meet them when they occur, have covered a wide spectrum of policies. The debate covered many policy issues : domestic and external, macro and micro, financial and regulatory, national and multilateral relating to both developed and emerging economies. Eminent academics have also contributed to the debate. At policy level, there have been discussions in G-7, G-24, and new found G-22, G-33 and Financial Stability Forum, not to speak of Commonwealth Secretariat, UN, IMF, World Bank and BIS. India has been invited to participate in most of these. In all these deliberations, external debt policies were a crucial part. Perhaps, this is an ideal forum to describe these new dimensions briefly and narrate the Indian position.

The new dimensions relating to external debt policies can be analysed under five broad heads, viz., level of reserves and external debt; maturity pattern; issues relating

to short-term debt; policies relating to transparency and standards; and involving private sector in forestalling debt crisis

Level of Reserves and External Debt

There has always been a continuous but inconclusive discussion on the optimum level of reserves. Traditionally, however, the adequacy of reserves has been mainly linked to import requirements. Incidentally, recent experience has shown that countries which were holding large levels of reserves did not necessarily escape the crisis. This shows the importance of appropriate policies and avoidance of excessive comfort from level of reserves. Nevertheless, the level of reserves continues to be an important source of comfort on matters relating to stability in external sector and consequently on domestic economy. Because of the importance of real level of reserves in a transparent manner, there are increasing efforts to measure unencumbered reserves. The emphasis has also shifted from measuring the adequacy of reserves only in relation to imports, to short-term liabilities, in particular short-term debt.

Two notable suggestions in this regard have emanated – one from Pablo Guidotti, Deputy Finance Minister of Argentina, and the second from Bank for International Settlements. Mr.Pablo Guidotti proposed a simple guideline for policy makers in emerging market economies. He suggested that countries should manage their external assets and liabilities in such a way that they are always able to live without new foreign borrowing for up to one year. In other words, usable foreign exchange reserves should exceed scheduled amortisation of foreign currency debts (assuming no rollovers) during the following year. In terms of debt management, this implies a limit on the size of the debt, in particular short-term debt and debt that is falling due for repayment.

The BIS, in its latest Annual Report, recognises the importance of countries preparing themselves for the possibility of sudden outflows, and identifies ways in which reserves can be built up. One way of doing this is to run trade surpluses and what BIS terms as a less disruptive solution is the Argentine proposal, namely to borrow reserves and arrange contingent lending facilities with the private sector. In the view of BIS, “Given the swings of mood in these markets, the authorities might at certain times find it relatively easy and inexpensive to lock-in longer term foreign currency loans for later use. Finally, countries might then make use of the recently announced Contingent Credit Lines offered by the IMF. In conjunction with similar private sector arrangements this would be a joint testimonial to the soundness of the country in question, and could contribute materially to the avoidance of contagion problems”.

In a somewhat similar vein, Chairman Greenspan expressed a view that countries could adopt a "liquidity-at-risk" standard to manage their exposure to financial risks. This standard would give the ex ante probability that a country would avoid new borrowing for one year, based on the level of reserves.

In India, we have been steadily building up reserves by encouraging non-debt creating flows and de-emphasizing debt creating flows. India's foreign exchange reserves have been steadily increasing over the years. For instance, the last three years saw increase in reserves in the range of $4.7 billion in 1996-97, $2.9 billion in 1997-98 and $3.1 billion in 1998-99, i.e. a cumulative $10 billion However, between end-March 1996 and December 1998, India's total external debt increased by a mere $2 billion.

Our policy of building and maintaining adequate level of reserves while at the same time constraining debt, especially short-term debt, will continue though we would continuously monitor the international debate in this regard.

Maturity Pattern

In many emerging countries, with deregulation and liberalisation, adequate attention has not been paid to the maturity profile of external debt portfolio. In fact, in some cases, even information gathering on this subject was dispensed with as part of deregulation. Determining the maturity was a micro decision left to the final borrowers, whose main consideration was cost. Thus, borrowers in many emerging market economies have tended to borrow short with a view to minimising cost. Creditors lent short-term since they expected their claims to mature quickly. The recent crises showed that this could be risky. The policy dimension relating to an appropriate maturity structure, which was earlier viewed as a micro decision is now being recognised as a macro aspect and a stability issue.

Elongation of the average maturity ensures a sort of private sector burden sharing in times of a crisis. It is important to recognise that the insurance embedded in long-term debt often outweighs the cost.

These issues have direct relevance to corporates' access to external funds, both in terms of cost and the period of borrowings. The cost of borrowings may increase on account of longer maturities, but they will have the comfort of stable flows. In times of crisis, the costs of disruption on account of destabilising flows may far exceed the cost of raising longer-term debt.

There are issues on how the policy makers could promote or ensure an optimal maturity structure. There can be several views on what an optimal maturity itself is. There is one influential view that the average maturity of a country's external liabilities should exceed a certain threshold, say three years.

In India, from 1992, emphasis has been laid not only on the cost and size of debt, but also on the maturity. The desired maturity profile is taken into account in policy articulation and clearance of individual cases. The average maturity of our ECB, as you may be aware, is five years. Basically, considerations of the size, cost and maturity are embedded in the clearance mechanism for ECB.

Thus, the ECB policy, though it is being liberalised gradually, will ensure built-in measures towards an optimal maturity. The instruments by which this objective is achieved will continue to be refined from time to time taking account of international developments also.

Short-term Debt

A major source of vulnerability in the Asian crisis was the large stock of short-term liabilities of banks and corporates. In the short-term liabilities, debt constitutes a contractual obligation and is thus on a different footing. As mentioned, the link between short-term debt and reserves has come to the fore in these deliberations. There is a cost to building up reserves through large debt flows since the cost of debt would generally be higher than return on reserves. However, not all short-term flows are bad and some short-term finance is essential to finance transactions. In fact, it is recognised that trade related short-term credit is not as volatile as non-trade related credit.

Overall, there appears to be a consensus now in favour of restraining the inflow of short-term capital until markets, institutions and regulatory frameworks have been sufficiently strengthened.

There is, however, a growing debate on the means by which short-term flows can be controlled. Major suggestions relate to effective monitoring, tax on spot transactions, varied reserve requirements, increased capital requirements on interbank transactions, changes in capital adequacy requirements of lending banks to non-OECD countries, and discouraging local firms from undertaking external borrowing by imposing taxes. Quantitative controls have also been recognised as effective.

The oft-quoted measure relates to reserve requirements imposed on short-term flows. Chile and Colombia imposed unremunerated reserve requirements of 30 per cent on short-term flows, subsequently reduced to 10 per cent. This represented a tax on short-term holdings. The empirical evidence on its effectiveness is inconclusive.

A favourite for economists has been the never-tried Tobin Tax, though it has often been seriously considered by policy makers. The Tobin Tax proposal envisages a levy of uniform tax on all spot transactions in foreign exchange. The objective is to

discourage a one-night stand by speculators in the foreign exchange market as the tax burden will be inversely proportional to the maturity of flows. Another economist, Dornsbusch seeks a variant of Tobin tax, viz., to impose a tax on all cross-border flows. This is also on the drawing table so far.

Paul Krugman has recently suggested that emerging nations should consider using taxes to discourage local firms from borrowing in foreign currencies. Tax at uniform rate will have a larger impact on short-term borrowings, and will thus operate somewhat similar to Tobin tax.

The role of financial intermediaries, especially banks in short-term flows has figured predominantly in these deliberations. Alan Greenspan has also proposed imposing increased capital requirements on borrowing banks to bring greater discipline on cross-border interbank market.

It is now accepted that just as there is no irresponsible borrowing without irresponsible lending, there is no short-term borrowing without short-term lending. Hence, it is argued that capital requirements in the banking system should be so prescribed as to discourage lending banks also. In fact, the current policy is biased in favour of short-term lending. The current Basle Accord provides that all claims on banks incorporated in OECD countries and short-term claims (i.e. up to one year) on banks incorporated in non-OECD countries carries a risk weight of only 20 percent, whereas long-term claims on banks in non-OECD countries carry a risk weight of 100 per cent. The New Capital Adequacy Framework, which has just been issued by BIS as a consultative paper for comments is reviewing this norm.

Most of the above proposals have the effect of increasing cost of short-term debt. Hence, these developments would be of interest to the corporate sector.

In India, we carefully monitor short-term debt. We maintain a difference in treatment between trade and non-trade related debt. The authorities sanction short-term debt over six months on a case-by-case approval of purpose, amount and terms, within a sub-ceiling of total external commercial borrowings ceiling. NRI deposits are controlled through specification of interest rates or interest rate ceilings for different maturities in respect of deposits in select schemes. According to the latest Status Report on External Debt circulated by the Ministry of Finance, our short-term debt is very very modest by all criteria.

The international consensus on the need for controlling short-term debt vindicates our policy thrust with regard to discouraging short-term flows. We will have to continue with the objective of restricting short-term flows, though the means of doing it could be refined from time to time in consonance with domestic and to some extent, global developments.

Policies Relating to Transparency and Standards

A major area of concern has been lack of transparency in regard to macroeconomic and financial health. The issue of transparency has generated some debate. Transparency cannot be one-sided – say only by public systems and not corporate sector. Transparency provides information and inference is a matter of interpretation or judgement. There are country specific circumstances also that govern the degree of transparency, which includes timing of some disclosures.

India is one of the earliest members of the SDDS of the IMF. The RBI provides upto date weekly data on all relevant macroeconomic and financial indicators through the Weekly Statistical Supplement to the RBI Bulletin, which is available on website. In addition, the RBI and Government disseminates as much information as possible through monthly, quarterly and annual publications.

The World Bank, IMF, BIS, OECD and other international institutions are active in the evolution of standards relevant for the functioning of domestic and international financial systems. These cover wide range of areas including data dissemination , fiscal, monetary and financial policy transparency (IMF), banking regulation and supervision (BIS), securities market regulation (International Organisation of Securities Commissions), insurance regulation (International Association of Insurance Supervisors), accounting (International Accounting Standards Committee), Auditing (International Federation of Accountants), Bankruptcy (United Nations Commission on International Trade Law) and Corporate Governance (OECD, World Bank and Basle Committee). In addition, work relating to improving the robustness of payments systems, general principles of good practices in social policies, identifying practices and structures that support deep and liquid forward markets is in progress.

It would be interesting to see how these standards evolve. While it may not be possible for all countries to adopt these standards completely and promptly, countries will have to take account of these standards, depending on individual country circumstances.

Increasingly, these international standards will have to be adapted to suit local requirements. These will have an impact on our corporates trying to access international markets in terms of costs and regulatory compliance. Corporates will need to impute these into their debt management strategies.

Role of private Sector in forestalling Crisis

The efforts to involve the private sector in debt management has many objectives, viz., bring about more orderly adjustment process, limit moral hazard, strengthen market discipline, help protect countries against volatility and contagion. The idea is to institute mechanisms in place before any crisis takes place – so that resolution of the crisis is more orderly.

While there is consensus regarding the need for private sector to share the burden, discussions in the various fora have centred on the mode of burden sharing. Ideas that are being considered include contingent credit lines, embedded call options, debt-service insurance, bond covenants, bankruptcy procedures, debt standstill and creditor-debtor councils.

Basically, these mechanisms bind private sector participants to either provide additional funds, or reduce debt service burdens in times of crisis without creating moral hazard or disrupting the normal market conditions. For instance, countries could contract market based Contingent Credit Lines with commercial banks to trigger liquidity support in times of crisis. If the credit lines are fairly priced, they could provide effective insurance against adverse market developments. Call options in interbank credit lines would provide the basis for extension of maturities during times of trouble. Standstill arrangements will allow private sector to give additional borrowing when there has been default on existing debt. Creditor-debtor councils could serve to improve the flow of information. Bond and debt covenants could introduce sharing clauses, provisions for the modification of terms by qualified majorities will speed up the negotiation process. There is also a suggestion that G-10 countries could start including these new contractual terms in their fresh sovereign bond issues in order to initiate the demonstration effect.

Another proposal relates to universal debt rollover option with a penalty. The idea is that all foreign currency debt should have attached to it an option, exercisable at the discretion of the borrower, to roll over the liability at a penalty rate.

It is too early to comment on how these suggestions would evolve. These deliberations and their outcomes are of interest not only to Government of India and RBI, but to the corporates, since these would impinge on their operations. I trust that financial intermediaries are closely following these developments. RBI would welcome and indeed invite suggestions in these matters.

When I started this address, I expressed happiness over the focus on corporate angle to external debt in this seminar. Encouraged by the response, I have a suggestion for the next seminar. It would be worthwhile if the next seminar focuses on external debt management by financial intermediaries, viz., banks, development financial institutions and non-bank financial companies. The discussions could include risk management systems.

Friends, in conclusion, I would like to place on record the excellent ambience and hospitality of Hotel Yak and Yeti.

Thank you.

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* Valedictory Address by Dr.Y.V.Reddy, Deputy Governor, Reserve Bank of India at Seminar on Corporate External Debt Management organised by CRISIL with participation of The World Bank and Ministry of Finance, Government of India, at Kathmandu, Nepal, on June 11, 1999. Dr.Reddy is thankful to Dr.A.Prasad for his assistance.