

A Cheap Lunch for Emerging Markets: Removing International Financial Market Imperfections with Modern Financial Instruments

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Summary. — This paper develops a market-based procedure to significantly reduce the indebtedness of emerging markets by applying an asset-backed security approach to a pool of emerging market bonds. In an extensive simulation study based on historical data, the cumulated interest savings over a horizon of 10 years amount to about 20% of the credit sum on average (with a standard deviation of 8%) and up to 44% for individual countries—dependent on the internal distribution of the surplus. The theoretical structure of the transaction is explicitly derived in cooperation with professionals from major commercial banks, and it implies only negligible implementation cost. The implementation requires neither institutional reforms nor debt forgiveness, but can supplement or substitute previous measures.

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1. INTRODUCTION

The debt problems of emerging markets (EM) constitute an important risk to their economic development (Fosu, 2007) and to global financial markets as is indicated by recent major sovereign defaults, such as in Argentina (2001) and Ecuador (1999–2000), as well as financial crises in which default was prevented only with the help of large IMF loan packages, such as in Mexico (1982, 1995), Brazil (2002), and Turkey (2001). The recent decrease in yields cannot be regarded as an indicator of a sustainable reduction in the default risk of EM—quite to the contrary as it has been caused by the overall bullish fixed income environment and the search of investors for high yielding assets. A future increase in yields is likely to induce a new crisis in the EM—which could give rise to a *déjà vu* so typical of capital markets.¹

So far, most measures and proposals to solve the debt problem have failed to yield significant positive effects or did not succeed due to political resistance, high costs, or opposition by creditors. Two approaches have dominated the discussion of the debt problem so far, namely crisis resolution and debt relief. The original Baker initiative, for example, is aimed at solving the financial crisis through the macroeconomic stabilization of EM and new funds given by multilateral institutions and banks to specific countries. The subsequent Brady plan had some market-oriented elements and combined elements of crisis solution and (partial) debt relief (Cline, 1995). Other approaches included swaps

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of equity for debt or other assets such as commodities. Ultimately, these transactions failed to significantly reduce EM debt (Claessens, Diwan, Froot, & Krugman, 1991; Krugman, 1989). In the late 1990s, the World Bank and IMF introduced the HIPC initiative that focused on the debt reduction for the poorest countries. Again, this approach is not market-oriented but rather promises a reduction of debt owed by the public sector to other sovereigns if the indebted country adopts certain reforms and policies (see Birdsall & Williamson, 2002; Easterly, 2002; MacArthur & van Trotsenburg, 1999). More recently, the IMF proposed the introduction of a sovereign debt restructuring mechanism (Krueger, 2002). Among others, this approach is criticized by Eichengreen and Mody (2003), who argue that the potential aggregation in the case of a restructuring imply *ex ante* rising risk premia.

The current discussion on debt crises is characterized by two extreme positions. On the one hand, there are mainly politicians and non-governmental organizations demanding an unconditional debt reduction. On the other hand, there are commercial banks and investors that are not willing to simply forgive debt. Hence, a practical solution to reduce the debt burden of EM countries should preferably be market-based. In this situation, innovative instruments of the financial markets could be considered. As we argue below, international financial markets are far from being perfect and complete regarding the financing of EM debt. By reducing these market imperfections, the price of capital for EM could be lowered. This can be achieved in accordance with the market using modern financial instruments such as asset-backed securities (ABS) without the need for institutional reforms. The market-based approach avoids most problems characteristic of the classical instruments applied to debt crises like the Samaritan's Dilemma (see Gibson, Ostrom, Andersson, & Shivakumar, 2005). In other words, the imperfect structure of financial markets provides the chance of a cheap lunch for EM that waits to be cooked.

In principle, two classes of regulations and frictions make creditors to charge an extra risk premium from debtor countries and prevent the market for EM bonds from reaching a Pareto optimal equilibrium. Firstly, the capital supply side of global financial markets is institutionally restricted as far as financing EM is concerned. A large number of important capital providers such as insurance companies or pen-

sion funds are subject to restrictions in their investment behavior. In many countries, laws prevent these institutions from holding assets rated below "investment grade" or restrict investments in other than top rated assets. Secondly, information on EM, for example, the political situation or state of public finance, is often of low quality and reliability, which leads investors to demand an event risk premium (Fabozzi, 2001) or a sustainability risk premium (Akemann & Kanczuk, 2005). Wright (2005) emphasizes the limited efficiency in this market due to the impossibility to guarantee the enforcement of a sovereign debt contract.

Using modern capital market instruments we propose a market-based approach, which addresses these problems and could be a significant component of a sustainable sovereign debt strategy. In contrast to previous approaches, our model requires neither changes of the regulatory or institutional settings nor debt forgiveness nor does it imply pledging future cash flows (securitization).² In our approach, a pool of EM bonds is refinanced in an ABS structure, which is handled by an independent intermediate, the so-called special purpose vehicle (SPV), to avoid regulation and coordination problems. This intermediate deals with each country individually and refinances itself in the capital markets.

Pooling the EM bonds provides diversification and lower volatility, thereby reducing the risk premium, which is particularly high for emerging markets due to, among other factors, poor information. In addition, the pool of EM bonds is subdivided in layers of different priorities through subordination and the establishment of a trust fund, which covers the first losses in case of a default on participating bonds. This structure allows generating layers of investment grade ABS and, therefore, to overcome a major imperfection of international capital markets. As new groups of potential investors, which have so far been excluded from investing in EM for regulatory reasons, are able to invest in EM securities, the increased demand for these bonds should lower interest rate payments of EM debtors.

The strict sovereignty of the SPV, the trust fund, which holds the first loss piece, and the well-defined separation of money flows prevent incentives for strategic default. It also reduces the probability of self-fulfilling debt crises as addressed in Chamon (2007). The net profit generated with this financial structure is redistributed to the countries. No direct costs of

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