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# MEXICAN PERSPECTIVES ON SOVEREIGN DEBT MANAGEMENT AND RESTRUCTURING

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## Key Points

- Currently, there are three major global risks that threaten to trigger sovereign debt difficulties, in particular in developing and emerging market countries: declining oil prices; rising interest rates in the United States; and slow global growth.
- In light of these risks, governments should take preventative measures to reduce their susceptibility to sovereign debt crises. Such measures include sound fiscal management and appropriate structural reforms, as well as improvements to the risk profile of public debt in order to mitigate refinancing and exchange rate risks.
- When severe debt crises occur, it is important to consider the benefits and trade-offs of different types of debt restructuring — namely, debt rescheduling on one hand, and debt reduction on the other. The duration of rescheduling and depth of debt reduction are also important, context-specific factors that influence a country's recovery prospects.
- China is becoming an increasingly important creditor to Latin American governments. Its growing exposure to the region raises questions about how China might respond to sovereign debt crises in cases where it is a major creditor.

## Introduction

On April 22, 2015, CIGI's Global Economy Program co-hosted a workshop with the Mexican Council on Foreign Relations (COMEXI) to discuss Mexican perspectives on sovereign debt restructuring.[1] Taking place in Mexico City, the workshop featured expert participants from the public and private sectors, as well as think tanks and academia.

The purpose of the workshop was to promote dialogue on the timely and important issue of sovereign debt restructuring, and gain insights from a wide range of experts with first-hand knowledge of the country's historical experience and current engagement with sovereign debt issues. From the discussions that transpired, four key themes emerged: global risks; crisis prevention; crisis management; and the growing role of China. This policy brief reviews and elaborates on these key themes.

## Global Risks

The workshop began with a presentation by Mexican Finance Minister Luis Videgaray, who identified three major risks for sovereign debtors in

1 The authors would like to thank, without implicating, Gregory D. Makoff, for helpful comments on an earlier draft of this brief. We would also like to thank Andrés Rozental, member of CIGI's Board of Directors and founding president of COMEXI, for his instrumental role in facilitating this workshop, and Claudia Calvin, executive director of COMEXI, and her staff for organizing it. The CIGI team that attended and participated in the workshop included Domenico Lombardi (director of the Global Economy Program), Gregory D. Makoff (senior fellow) and Skylar Brooks (research associate).

the contemporary global economic environment: declining oil prices; rising interest rates in the United States; and slow global growth. Separately, each of these risks poses significant challenges to debtor countries, especially those in the developing world; together, they constitute something of a perfect storm of bad global economic conditions — an incubator for sovereign debt crises. It is important to note that these same three risk factors coalesced in the early 1980s, contributing greatly to the outbreak of the Latin American debt crisis in 1982. Given their potential to plunge sovereigns into severe debt difficulties, these risks deserve a brief elaboration.

First of all, there is considerable risk associated with the recent and severe global downturn in oil prices, which fell by more than 25 percent between June and November 2014 (Davies 2014). For major oil exporters such as Venezuela, Ecuador and Mexico, such a dramatic price shock weakens their terms of trade and dampens their capacity to generate sufficient amounts of the hard foreign currency needed to repay international debts.

The second risk is linked to the impending tightening of US monetary policy — a move that is sure to cause sizable capital outflows from Latin America and other developing and emerging regions, as footloose funds chase rising interest rates in the US market. Not only are capital outflows often destabilizing, but they can also drain central banks of the foreign reserves needed for debt repayment and make it more difficult for governments to roll over their maturing debt obligations. Making matters worse, the US Federal Reserve's monetary contraction will have the effect of strengthening the US dollar and thereby increasing the relative debt burden for countries that borrow in dollars.

Sluggish global growth, which has prevailed since the outbreak of the 2008 global financial crisis, is the third and final major risk. Unfortunately, slowdowns in the United States, Europe and even China have dampened global demand for developing and emerging economies' exports, again making it increasingly difficult for countries that borrow in foreign currencies to earn the foreign exchange with which to service their debts.

## Crisis Prevention

Sovereign debt crises are often caused by a combination of external and internal factors. Certain levels or types of debt may be sustainable when global conditions are good, but become problematic when conditions turn bad. It is therefore important to ensure that domestic debt policies are designed to withstand potential global shocks emanating from the types of risks identified above. In light of such risks, which wreaked havoc on Latin America in the 1980s and 1990s, participants agreed that governments have to be particularly vigilant in their attempts to *prevent* sovereign debt crises from occurring — or, in other words, to insulate themselves from the potential effects of global shocks.

There are a number of preventative measures that governments can take to reduce the likelihood of lapsing into a debt crisis. Most participants agreed that sound fiscal management and appropriate structural reforms are the two most fundamental anchors of long-term debt sustainability, and are thus crucial to warding off debt crises. But they also noted the importance of measures aimed at broadening and deepening access to debt capital markets and improving the risk profile of public debt, mainly to mitigate refinancing and exchange rate risks.

Refinancing risk — the possibility of a borrower being unable to borrow new money to repay existing debt when it matures — is most pronounced when a relatively large portion of a government's debt profile is made up of short-term claims. As participants were quick to point out, the rapid rise of short-term US-dollar-indexed bonds ("*tesobonos*") in the Mexican government's funding portfolio helped precipitate the country's financial crisis in 1994. Part of the solution, then, is issuing bonds with longer maturities. In addition to mitigating refinancing risk, this can help sovereigns diversify their investor base, since those who buy long-term investments tend to be considerably different from those who pursue shorter-term strategies. As with the introduction of collective action clauses (CACs), Mexico has led the way in this regard. The average maturity of its domestic sovereign debt has risen from 2.1 years in 2001 to 8.1 years in 2014, while the average life of its external debt reached 19.4 years in 2015 (Videgaray 2015). Uniquely, Mexico has also issued a number of 100-year bonds denominated in British pounds, US dollars and euros.

But issuing debt in foreign currencies carries its own risks: devaluation in the exchange rate will increase the real value (and burden) of a country's external debt,[2] possibly increasing solvency concerns at the same time a country faces other stresses; and foreign investors can be more fickle than domestic investors. As participants observed, the fact that Mexico's short-term *tesobono* bonds guaranteed repayment in US dollars was also a major contributing factor to the country's 1994 crisis.

Today, as a result of a concerted effort over the last 20 years, around 80 percent of Mexico's public debt is borrowed in the form of internal debt instruments denominated in pesos. The roughly 20 percent of debt that remains denominated in foreign currency has a long maturity to offset the risks associated with refinancing in foreign markets. Notably, in addition to issuing 100-year bonds, Mexico has been a leader in the use of liability management transactions to extend the maturity of short-dated bonds prior to maturity. More broadly, in response to the major

2 Exchange rate appreciation, on the other hand, would reduce the real value of external debt.

global risks identified above, Mexico has deployed all of the main preventative measures discussed during the workshop; it has, in other words, adopted a policy mix of fiscal prudence, reform-led growth and sound public debt management.

## Crisis Management

While prevention is ideal, it is widely recognized that financial and debt crises are likely to remain a common enough feature of global economic life. It is thus important for debtor countries, as well as the International Monetary Fund (IMF) and broader international community, to have appropriate strategies and policy tools for dealing with crises when they occur. In many cases, restructuring sovereign debt can be an effective strategy for resolving severe debt difficulties. But even in situations where it is needed, debt restructuring is not a "one-size-fits-all" type of fix. The appropriate type and depth of restructuring depends largely on the circumstances surrounding particular crises. Drawing from the Mexican and Latin American experience, workshop participants discussed the benefits and trade-offs of different approaches to debt restructuring.

There are two generic forms of sovereign debt restructuring: debt rescheduling, which involves extending the maturity of contractual payments into the future and possibly lowering interest rates on those payments; and debt reduction, which involves reducing the nominal value of outstanding debt (Das, Papaioannou and Trebesch 2012). As participants stressed, both approaches can be useful ways of resolving sovereign debt difficulties, but both entail trade-offs. If a sovereign's debt is sustainable over the medium term (something that can be notoriously difficult to discern), debt reduction can inflict unnecessary costs on debtors and, most clearly, their creditors. If debt is unsustainable, the use of debt rescheduling will likely fail to relieve the underlying debt problem and thus prolong the debt crisis, again to the detriment of debtors and creditors alike. The challenge, therefore, is to determine the appropriate approach given the particular set of circumstances a country faces.

This challenge was a key topic of conversation during the workshop. Here, discussions drew heavily on Mexico's experience in the 1980s, beginning with the outbreak of its debt crisis in 1982 and culminating in the Brady Plan of 1989.[3] From 1982 to 1988, the general approach to crisis management relied mostly on bit-by-bit debt rescheduling, whereby maturities on debt that was coming due were extended by a few years at a time. Sovereigns were also provided with fresh financing from their creditors — namely large commercial banks in the United States and, to a lesser extent, Europe and Japan — as long as the IMF approved of the debtor country's macroeconomic policies (Fischer 1987). The hope was that rescheduling, combined with new lending, would provide debtors with enough breathing space to get their proverbial houses in order and, having done so, weather what was thought to be a temporary liquidity crisis. To be sure, a large motivation for the rescheduling approach was fear among the IMF, Western governments and the commercial creditors that deeper debt reduction would trigger a collapse of the major money centre banks that had significant exposure to developing country debtors, especially in Latin America (ibid.).

As participants noted, the problem with this bit-by-bit rescheduling was that it did little to relieve underlying debt problems in the context of a perfect storm of bad economic conditions. Indeed, slow growth, high interest rates on debt payments and net capital outflows ensured that no amount of fresh financing or piecemeal rescheduling would restore the solvency of countries, such as Mexico, that were carrying very large debt burdens and hemorrhaging money abroad. According to a participant who was actively involved in managing Mexico's public debt during the crisis, a sizable reduction in the principal of the debt was needed. Without a reduction in principal, no reduction or rescheduling of interest payments would be sufficient to meaningfully reduce the country's overall debt burden, which was acting as a serious constraint on growth and therefore perpetuating a vicious cycle of indebtedness.

After eight years of stumbling through the crisis of the 1980s, the Brady Plan finally offered a more decisive solution, one that involved substantial debt relief and a long-term extension of maturities. It is important to note, however, that the Brady Plan was only introduced as a viable initiative once the relevant commercial banks had reduced their exposures and built up capital buffers enough to withstand the losses associated with debt reduction. To an extent, then, the sequencing of crisis management efforts was dictated by the needs of large commercial banks in the core creditor countries.

The 1980s debt crisis offered up a great many lessons. As one participant emphasized, it revealed the limitations of rescheduling when deeper debt reduction is in fact needed. It also, according to another participant, showed that the length of maturity extensions is an important determinant of the effectiveness of a rescheduling. While the standard three-year reschedulings that were granted to several Latin American countries during the early and mid-1980s did little to provide the necessary breathing room and resolve underlying debt problems, the 30-year maturity extensions offered by the Brady Plan were instrumental in calming markets and introducing greater certainty and stability, which in turn helped to revive investment, boost growth and restore investor confidence in countries' long-term creditworthiness.

Currently, the IMF is considering a new approach to lending: in cases where it is unclear whether a country's public debt is

3 For a detailed analysis of the Brady Plan, see Clarke (1993-1994).

sustainable or not in the medium term, the Fund would require the country to reschedule — or "reprofile" — its debts as a condition for receiving IMF financing.[4] Under the new approach, debt would be rescheduled for the duration of an IMF program. While greater use of debt reprofiling is to be welcomed, the ideal length of a rescheduling is context specific. In some cases, rescheduling for the duration of an IMF program may suffice. In the case of the 1980s debt crisis, however, relatively short three-year reschedulings only prolonged the problem; ultimately, much longer maturity extensions were needed. This episode thus raises the question of whether it is appropriate to tie the length of rescheduling to the duration of an IMF program ex ante.

In addition to the potential benefits of debt reduction and lengthy rescheduling, the 1980s crisis also highlighted the importance for crisis-ridden countries of laying out a clear and credible plan for recovery, often with support from the IMF. When appropriate restructurings are coupled with a credible reform plan, noted participants, markets generally respond positively, easing pressure on the debtor and contributing, at least in part, to a self-fulfilling recovery.

In terms of more contemporary crisis management tools, participants also discussed the strengths of the market-based, contractual approach to sovereign debt restructuring. In doing so, they applauded Mexico's consistent leadership in helping to advance sovereign bond contract reform. Back in 2003, Mexico became the first emerging market economy to include CACs in its sovereign bond issuances. More than a decade later, in 2014, it was again the first major emerging economy to issue the newer and stronger CACs designed by the International Capital Market Association (ICMA) — or CACs 2.0 as one participant referred to them (see Makoff and Kahn 2015).

While Mexico was commended for being a leader in this domain, participants made clear that Mexican officials have always moved consistently with the market consensus on debt policies. As one participant noted, Mexico would not have implemented CACs, or CACs 2.0, if the market had not endorsed them. The implication: although Mexico has consistently taken the lead in adopting market-friendly solutions to sovereign debt problems, it is unlikely to pursue approaches that do not generate market support. Indirectly but importantly, then, the discussion seemed to highlight the critical role of private creditors in setting the parameters of acceptable (or desirable) reform in sovereign debt restructuring.

## China's Emerging Role

The last major discussion of the day focused on the emergence of China as an increasingly important creditor to Latin American governments. According to Gallagher and Myers (2014), who maintain a database on Chinese lending to Latin America, Chinese loans to the region in 2010 were "more than those of the World Bank, Inter-American Development Bank, and U.S. Export-Import Bank combined." Their database also reveals the magnitude of Chinese lending to individual countries. Venezuela has by far received the most, with around US$56 billion in Chinese loans, but Brazil (US$22 billion), Argentina (US$19 billion) and Ecuador (US$10.8 billion) have also received sizable sums. In addition to sheer size, participants observed that, in a number of ways, Chinese lending differs from that of Western governments, multilateral lenders (namely the IMF and World Bank) and private market creditors. Most importantly, China lends without policy conditionality, to relatively riskier sovereigns, and presumably for reasons that are geopolitical as well as economic.

Unlike Western official sector lenders — both individual governments and multilateral institutions — China does not place policy conditions on its loans to sovereign governments. This "no strings attached" approach to lending is consistent with China's broader commitment not to interfere with the sovereignty of other states (Anshan 2007). To be sure, China does put certain conditions on its financing, mostly to promote Chinese industry and to mitigate the risk of default in the borrowing country. For example, Gallagher, Irwin and Koleski (2012, 19) found conditions in almost every loan to Latin American countries "requiring the borrower to purchase Chinese construction, oil, telecommunications, satellite, and train equipment." Although purchase requirements are still a type of condition, they are qualitatively different from the kind of IMF or World Bank policy conditions that require countries to cut government spending, privatize state-owned firms, and liberalize trade and finance.

Another way in which Chinese lending practices differ from those of more traditional creditors has to do with the nature of the borrowers. Much of China's lending goes to countries that are either in default with private foreign creditors, such as Argentina and Ecuador, or considered too risky to be able to borrow on affordable terms from international capital markets, such as Venezuela (Gallagher and Myers 2014). In these cases, Chinese lending helps to fill the financing gap that has resulted from a lack of access to private capital markets. Indeed, as Gallagher, Irwin and Koleski (2012, 8) report, "Chinese banks loaned disproportionately large amounts to these high-risk countries, compensating for the lack of sovereign debt lending."

4 See IMF (2014); for an overview of the reprofiling option, also see Brooks and Lombardi (2015).

China is willing to lend to countries with questionable creditworthiness, partly because its lending is motivated by non-financial objectives, such as securing resources, providing export markets and investment opportunities for Chinese firms, expanding its diplomatic relations with foreign government and enhancing its overall global influence. It is also willing to lend to these countries because it uses its own, less conventional strategies to mitigate the risk of default in borrowing countries. The most important of these strategies is probably the use of commodity-backed finance, which accounts for a large portion of all Chinese loans to Latin America (Brautigam and Gallagher 2014).

While it is clear that China is playing an increasingly prominent role in sovereign lending in Latin America and elsewhere, participants pointed out that there remains considerable uncertainty surrounding the country's operations, goals and future role in the region. A general lack of transparency is partly to blame, noted participants. But there is also a great deal of uncertainty about how China might respond to future developments in the region. How, for example, might China deal with sovereign defaults and/or debt restructurings in cases where it is the principal, or at least a major, creditor?[5]

## Conclusion

Drawing on the history and experience of Latin America, the workshop provided a number of key insights that help to navigate the contemporary challenges of sovereign debt. Among other things, it pointed to the main global risks that threaten to trigger sovereign debt crises, in particular in the developing world; it outlined preventative measures that countries can use to help insulate themselves from the full effects of such risks; it revealed the benefits and trade-offs of different strategies and tools used to manage debt crises once they occur; and it directed attention to the emerging, and potentially transformative, role of China in the region. Going forward, the key will be to build on these insights to inform more effective national, regional and global approaches to sovereign debt management and restructuring.

5 Participants at a similar workshop, entitled African Perspectives on Sovereign Debt Restructuring, also expressed concerns regarding this question. See Brooks, Lombardi and Suruma (2014). For an indepth discussion of China's engagement with sovereign debt restructuring, see Wang (2014).

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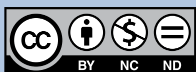

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