Debt Repudiation, Information and the Rise of Domestic Debt Markets: Comments on “Sudden Stop and Recovery”

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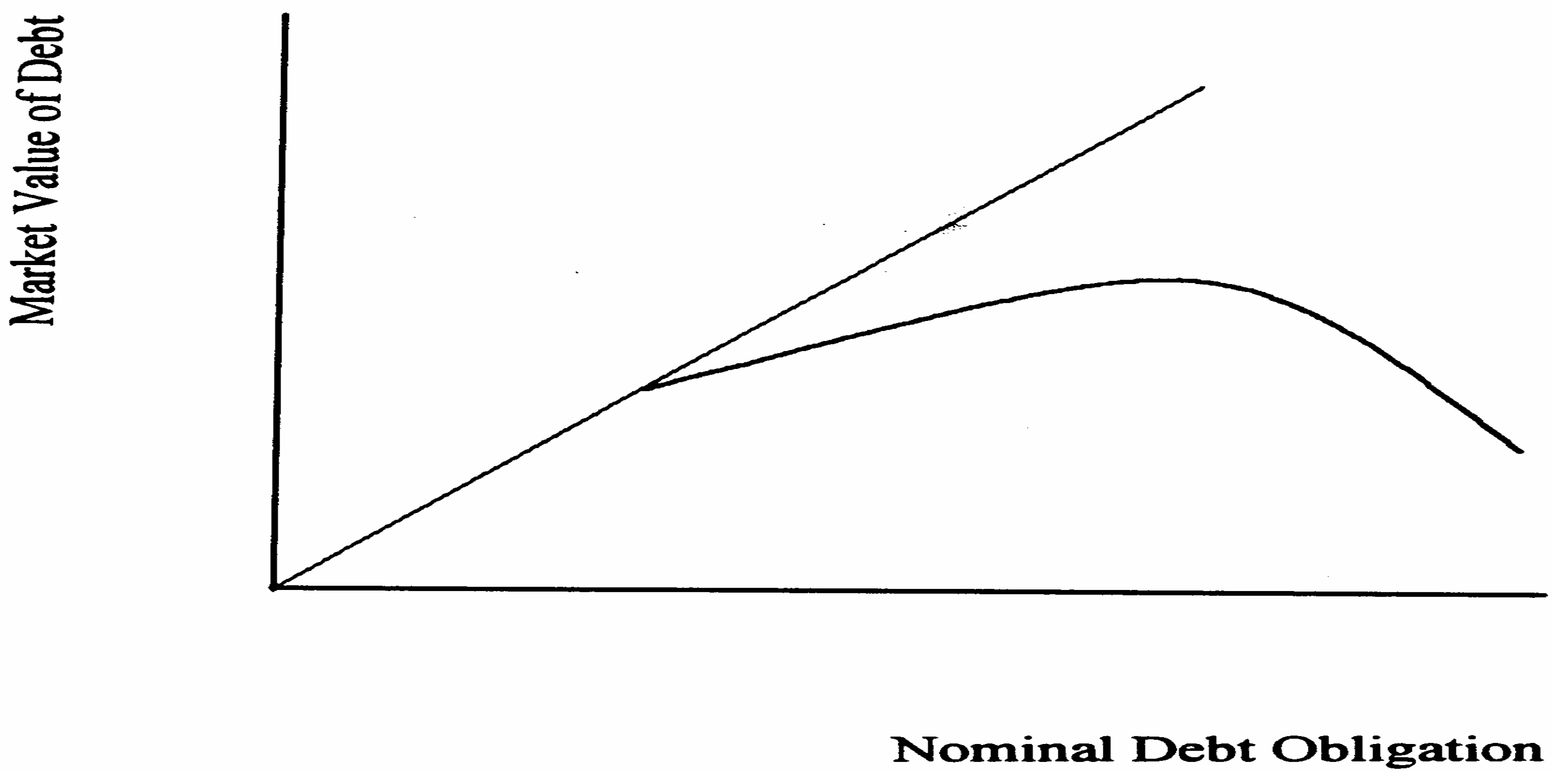
Overview

- Fascinating and valuable comparisons and contrasts of Great Depression with recent international crises
  - Important lessons of history
  - Irving Fisher, debt deflation, and liability dollarization
  - > One more parallel with debt repudiation from 1930s, the so-called “gold clause”
- Have these lessons been learned to reduce financial vulnerabilities and to make sudden stop a thing of the past?
  - Importance of growth of local currency debt markets

Debt Overhang and Debt Deflation

- Much theoretical work has focused on the importance of debt overhang, debt deflation, financial distress, and bankruptcy costs, for both firm and macroeconomic performance:
  - debt overhang leading to underinvestment at the firm level
  - debt overhang also can distort incentives to adopt excessively risky projects
  - distorted investment incentives may exist even if debt can be renegotiated

Debt Laffer Curve



Gold Clause Abrogation in US in 1930s

- Gold clauses were effectively provisions indexing the principal and interest payments of long-terms debt to the price of gold.
- The clause defined repayment obligation in gold coin or the equivalent based on weight and fineness of gold coin at the time the contract was signed.
- Important parallels to issuing domestic debt obligations in a foreign currency (e.g., Asia and Latin America in 1990s)

Departure from Gold and the Role of the Gold Clause during the 1930s

- Beginning in mid-April 1933, dollar falls sharply in terms of gold (see Chart 1)
- Officially devalued by 69 percent to $35 per ounce (from $20.67) in January 1934 and pegged at that rate thereafter.
- Roughly $100 billion of $168 billion of debt (both public and private) contained the clause, thereby raising the debt burden by $69 billion
- GDP in 1933 was $57 billion
- ==> Solution: Abrogation through a Resolution of Congress.

Chart 1: U. S. Dollar Exchange Rates, January 1933 - December 1936.

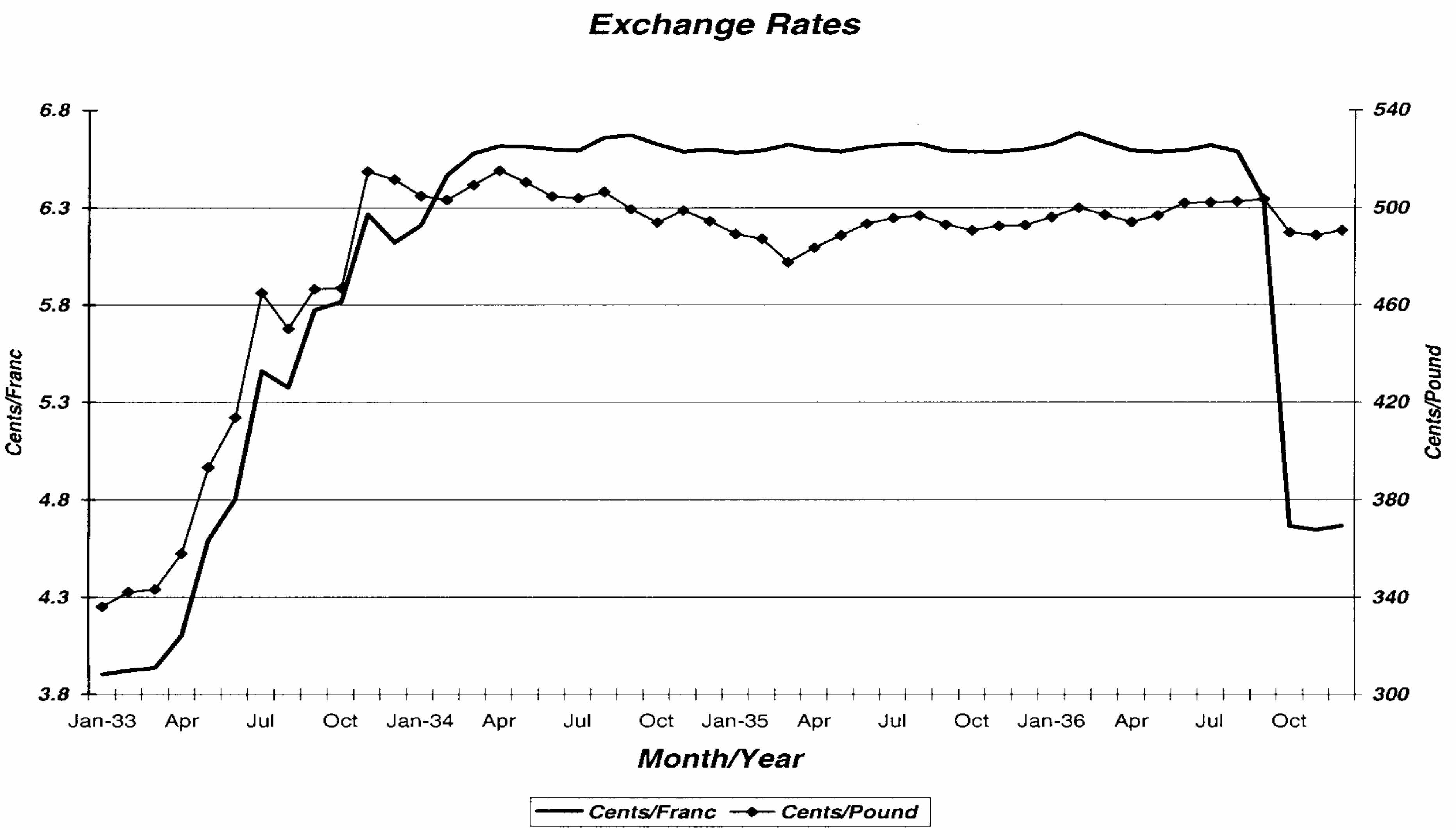
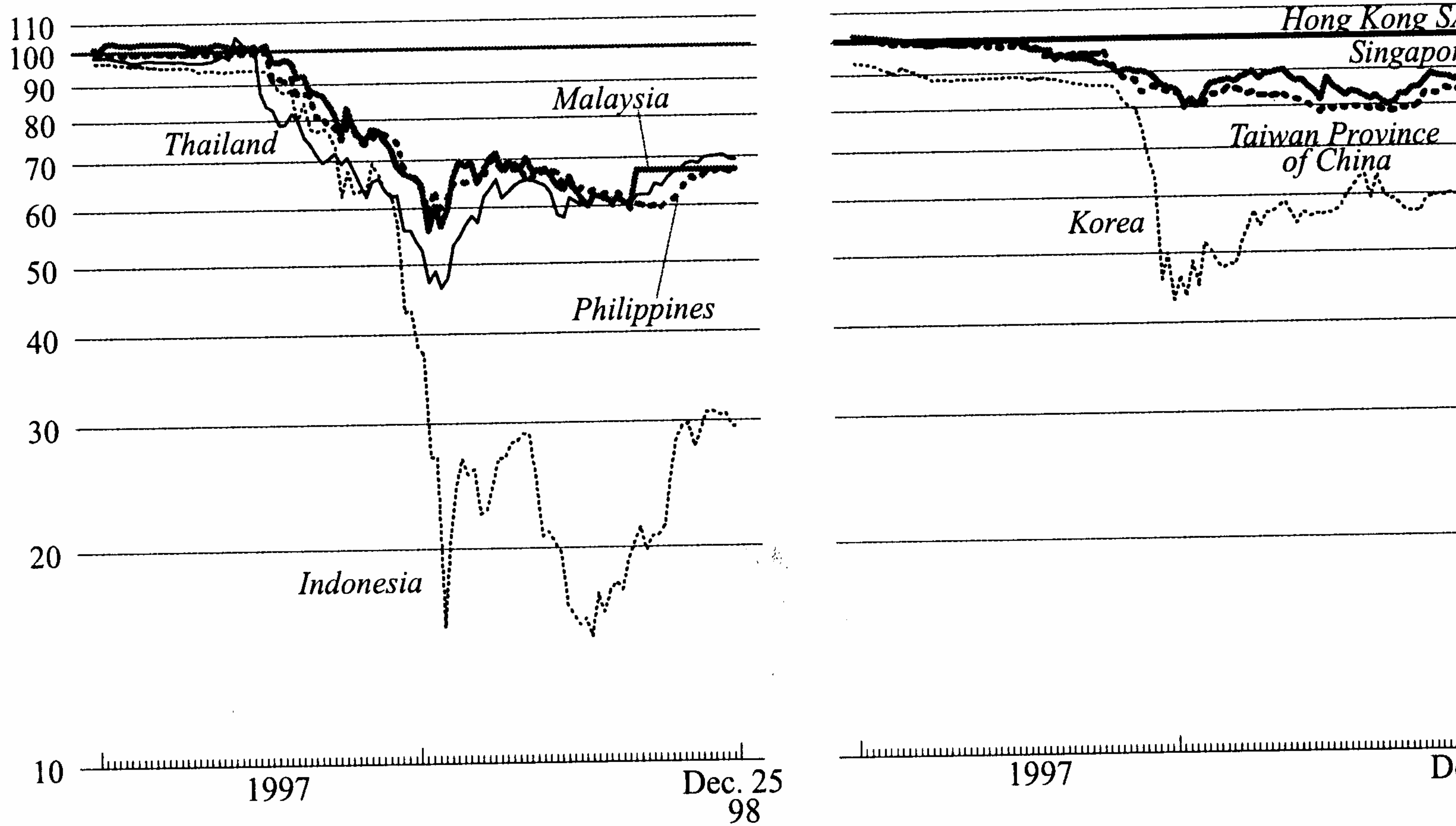


Chart 2: Bilateral U.S. Dollar Exchange Rates for Selected Asian Eco

In U.S. dollars per currency unit; logarithmic scale; January 5, 1996 = 100. Source



Examine Asset Price Responses to Supreme Court Decision (Kroszner 2004)

- Argument before the Supreme Court January 8-11, 1935 receives widespread front page coverage

- "Bombshell" of question from Chief Justice to the Attorney General on January 10 and expectations of government winning decline

- NY Times page 1 headline 2/18/35:

  "Capital Tense, Expects Decision on Gold Today....Leaders are Confident But There Is No Indication of What the Supreme Court Will Decide."

ork Times.

New York Times Company.

LATE CITY EDITION
POSTSCRIPT
WEATHER—Cloudy with light snow today; tomorrow colder.
Temperatures Yesterday—Max., 40; min., 38.
Detailed Weather Report, Page 42.

I T R

, FEBRUARY 19, 1935.

TWO CENTS In New York City. | THREE CENTS Within 200 Miles | FOUR CENTS Elsewhere Except in 7th and 8th Postal Zones.

COURT BACKS GOVERNMENT ON GOLD; 5-4 FOR BOND PAYMENT IN NEW DOLLAR; BUSINESS SURGES FORWARD, STOCKS RISE

IMPETUS GIVEN TO TRADE

Ending of Uncertainty Renews Advance in General Activity.

FELT IN PRIMARY MARKETS

Rapid Spread to All Lines of Merchandise Is Expected Within This Week.

STOCKS TAKE SHARP RISE

Bedlam and Confusion Follow the Decision—Trading for an Hour Swamps Ticker.

The forward surge of business activity, abruptly checked more than a month ago, when the gold clause cases first came up, was renewed yesterday, following the Supreme Court decision.

Starting in a few sensitive primary markets, the revival of buying activity is expected to spread rapidly before the end of the week to all the major merchandise lines, in which forward contracts had been held back by the uncertainty surrounding the gold cases. The decision yesterday was hailed on all sides with deep satisfaction as a definite aid to the restoration of confidence.

The security markets rose sharply on an outburst of buying. For a time after the reading of the opinion at the New York Stock Exchange, there was bedlam. For an hour there was the utmost confusion in interpretations of the decision, and speculation was held in check. But active stocks soared from 1 to 10 points between noon and 1 o'clock and retained about

Highlights of Decisions

Special to THE NEW YORK TIMES.

WASHINGTON, Feb. 18.—Some main points in the Supreme Court's decisions in the gold-clause cases follow:

ON PRIVATE CONTRACTS.

"The devaluation of the dollar places the domestic economy upon a new basis. * * * The income out of which they (States, municipalities, railroads, &c.) must meet their obligations is determined by the new standard * * *."

"It requires no acute analysis or profound economic inquiry to disclose the dislocation of the domestic economy which would be caused by such disparity of conditions in which, it is insisted, these debtors under gold clauses should be required to pay $1.69 while respectively receiving their taxes, rates, charges and prices on the basis of one dollar of that currency."

"The contention that these gold clauses are valid contracts and cannot be struck down depends upon the assumption that private parties and States and municipalities may make and enforce contracts which may limit that authority (constitutional authority of Congress). Dismissing that untenable assumption, the facts must be faced.

"We think that it is clearly shown that these clauses interfere with the exertion of powers granted to the Congress * * *."

ON GOVERNMENT OBLIGATIONS.

"We conclude that the joint resolution of June 5, 1933, in so far as it attempted to override the obligation created by the bond in the suit, went beyond the Congressional power."

"The Congress * * * is endowed with certain powers to be exerted on behalf of the people in the manner and with the effect the Constitution ordains."

"Having this power to authorize the issue of definite obligations for the payment of money borrowed, the Congress has not been vested with authority to alter or destroy those obligations."

"Plaintiff has not shown or attempted to show that in relation to buying power he has sustained any loss whatsoever. On the contrary, * * * payment to the plaintiff of the amount which he demands would appear to constitute not a recoupment of loss in any proper sense, but an unjustified enrichment."

RUSH SENDS STOCKS SOARING IN LONDON

Buyers in Streets Clamor for American Shares—Money Flows Homeward.

NO FEAR OF INFLATION FELT

CONSTITUTION GONE, SAYS M'REYNOLDS

Justice Extemporaneously Voices Sharp Dissent of the Minority on Gold.

REPUDIATION, HE ASSERTS

CONGRESS IS CENSURED

It Exceeded Power on Federal Bonds—No Suits Allowed.

AS NO DAMAGE IS SHOWN

Government Elated, Considers Legislation to Cover Loophole Left for the Future.

HUGHES READS OPINION

With Him Are Stone, Brandeis, Roberts, Cardozo—Minority Sharply Attacks Ruling.

Gold decisions and reactions on pages 12 to 17 inclusive.

By ARTHUR KROCK.

Special to THE NEW YORK TIMES.

WASHINGTON, Feb. 18.—Headed by the Chief Justice of the United States, a majority of five members of the Supreme Court today overrode their four colleagues in the cases growing out of the repeal of the gold-payment clause in public and private contracts by the Seventy-third Congress, involving more than 100 billions, and held in effect that government and private creditors must accept, in depreciated currency, dollar for dollar on interest and principal sums named in the contracts.

The majority and the minority agreed only on one point—that the gold-clause repeal in government contracts was unconstitutional. But the majority offered no redress to the litigating contract-holders, on the ground that no damage had been shown, while the four dis-

Asset Prices Changes upon the Supreme Court Announcement Permitting Abrogation of the Gold Clause, February 18, 1935, consistent with High Distress Costs and Debt-Deflation Costs

Equity Prices	Higher*
Corporate Bond Prices	Higher*
Government Bonds with Gold Clause	Lower
Government Bonds without Gold Clause	Higher
Commodities Futures Prices	Higher
Foreign Exchange Value of the Dollar	Lower

* Firms that are closer to distress, that is, firms with lower debt ratings and higher leverage, experience a greater increase in their equity and bond prices than do other firms upon announcement of relief.

Implications for Peso-fication

- Potential benefits of sharp, clean break and system-wide restructuring

- Peso-fication similar to abrogation of gold clause
  - But “asymmetric” attempt at redistribution is the opposite of clean and system-wide
    - Caused massive disruption in Argentina

Have Sudden Stops Stopped?

Improvements Since Previous Crises

- Increased issuance of local currency debt, reducing liability dollarization, hence the problems of Fisherian debt overhang
- More flexible exchange rate regimes
- Better information
- Current account surpluses that reduce dependence on foreign financing
- More self-insurance (opposite of concerns about moral hazard of IMF “bail outs”)

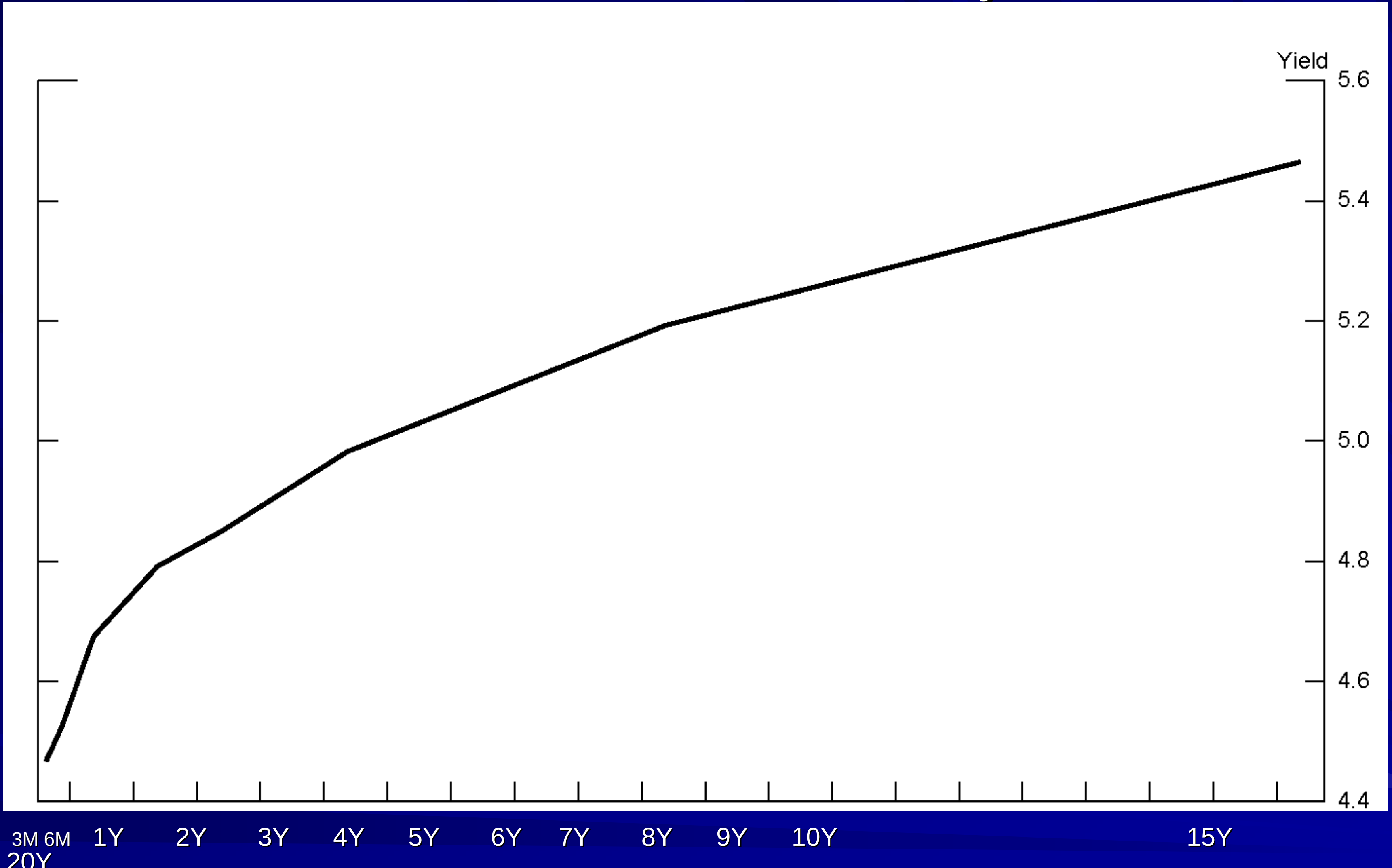
Increased Issuance of Local Currency Fixed-Rate Debt

- Local currency fixed rate debt has become common (perhaps original sin was not so original)
- Yield curves exist where they didn't before
- Real long rates relatively low and generally declining over last few years
- Global "conundrum" of flat yield curves with low real and nominal long rates

Recent Issuances of Long-Term Emerging Market Debt in Domestic Currencies			
	Date of Issuance	Length to Maturity	Market
Brazil	September 2005	10 years	Global
Colombia	February 2005	10 years	Global
Mexico	October 2003	20 years	Domestic
Indonesia	May 2005	10 years	Domestic
	May 2006	20 years	Domestic
Korea	August 2005	10 years	Domestic
	December 2005	20 years	Domestic
Thailand	September 2002	20 years	Domestic
	May 2004	10 years	Domestic
	December 2005	10 years	Domestic

Source: Bloomberg.

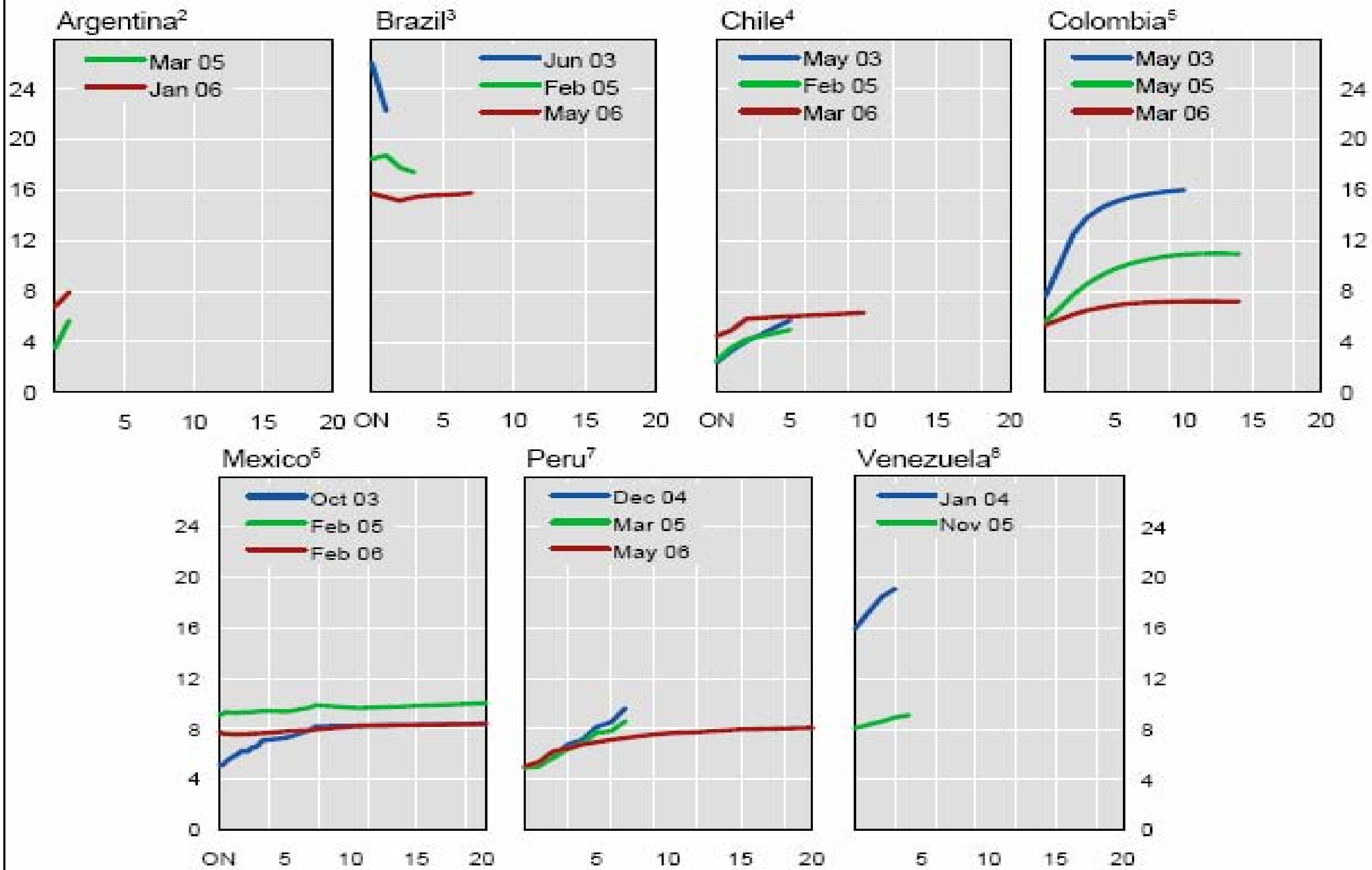
Yield Curve – Korea Treasury Bond



Source: Bloomberg

Yield curves of domestic fixed rate local currency government bonds[1]

In per cent



[1] Remaining maturities in years (ON = overnight). [2] Lebac. [3] Swap rates; long-term; government bonds (NTN-F). [4] Central bank issues. [5] Zero coupon yield curve. [6] Cetes and government bonds. [7] Government bonds, secondary market. [8] Government bonds (Vebonos), auctions.

Source: National data.

Graph 4

Why global “conundrum”?

- Global savings glut explains real long rates being lower
- But nominal rates also low
  - Lower inflation outcomes
    - Worst performers not nearly as bad as earlier (see Kroszner 2003)
  - Lower inflation expectations from Consensus Economics surveys
  - > Greater central bank credibility

Why Greater Credibility?

- Key is a change in the ability and incentives of a government to pursue a high inflation policy

- Four Factors driving this change:
  - 1) Financial innovation and physical dollarization increasing “currency competition”
  - 2) Deregulation and greater global competition
  - 3) Greater awareness of costs of inflation
  - 4) Changes in central bank institutions

Concluding Assessment of Policy Implications and Issues

Global Policies

- Greater trade and capital openness fosters the competitive pressures that alter cost-benefit trade-offs to pursuing a high inflation policy
- Fixed exchange rates were once promoted as an effective means of enhancing monetary policy credibility but recent experience not consistent with this
  - “De-dollarization” and more flexible regimes working reasonably in a globally competitive environment

Concluding Assessment of Policy Implications and Issues

Domestic Policies

- Benefits of longer-term and more local currency borrowing, including possibly greater ability to do long horizon planning by both the private and public sectors as well as greater growth associated with deeper local financial markets
- Value of maintaining credible and sound fiscal and monetary policy
- Perhaps excessive self-insurance?