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

Market Value of Debt

Nominal Debt Obligation
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.

Exchange Rates

Month/Year

Cents/Franc

Cents/Pound
Chart 2: Bilateral U.S. Dollar Exchange Rates for Selected Asian Economies

In U.S. dollars per currency unit; logarithmic scale; January 5, 1996 = 100. Source: [Provide source information if available].

Legend:
- Thailand
- Malaysia
- Philippines
- Indonesia
- Hong Kong SAR
- Singapore
- Taiwan Province of China
- Korea
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.”
COURT BACKS GOVERNMENT ON GOLD; 5-4 FOR BOND PAYMENT IN NEW DOLLAR; BUSINESS SURGES FORWARD, STOCKS RISE

IMPELUS 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.

Highlights of Decisions

WASHINGTON, Feb. 15.—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 footing upon which they (states, municipalities, railroads, &c.) must meet their obligations in determination in the terms of the contract.”

“It requires no acute analysis or profound economic inquiry to disclose the devaluation of the domestic economy would be caused by such disparity of conditions in which it is inserted, these debts under gold clauses should be required to pay the dollar, 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 as states and municipalities may make and some contracts which may limit that authority (constitutional authority of Congress). This authority to enter into such obligations, and that the act of Congress should be enforced.”

“I think that it is clearly shown that these claims interfere with the exertion of powers granted to the Congress ...”

ON GOVERNMENT OBLIGATIONS

“We conclude that the Joint Resolution of June 8, 1933, in so far as it attempted to override the obligation created by the bond suit, suffers a repudiation.”

“The Congress ... is empowered with certain powers to be exerted by the people in the manner with which the Constitution ordains.”

“Having this power to authorize the issue of defense obligations for the payment of money borrowed, the Congress has not been disarmed in its power to destroy these obligations.”

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

RUSH SENDS STOCKS SOARING IN LONDON

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

CONSTITUTION GONE, SAYS McREYNOLDS

Justice Extemporaneously Voices Sharp Dissent on Gold.

No Fear of Inflation Felt—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 by Arthur Koest.

By Arthur Koestl.

WASHINGTON, Feb. 15—Handed by the Chief Justice of the United States, a majority of the 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 billion, and held in effect that government and private contractors must accept, in depreciated currency, the dollar for dollar on interest and principal sums named in the contracts.

The majority and the minority agreement is that the gold-clause repeal in government contracts is constitutional and valid. The majority offered no rejoinder to the minority's criticism on the ground that no damage had been shown, while the four disent.
<table>
<thead>
<tr>
<th>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</th>
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<tbody>
<tr>
<td>Equity Prices</td>
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<td>Corporate Bond Prices</td>
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<td>Government Bonds with Gold Clause</td>
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<td>Government Bonds without Gold Clause</td>
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<td>Commodities Futures Prices</td>
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<td>Foreign Exchange Value of the Dollar</td>
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* 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-ification

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

- Peso-ification 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

<table>
<thead>
<tr>
<th>Country</th>
<th>Date of Issuance</th>
<th>Length to Maturity</th>
<th>Market</th>
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<tbody>
<tr>
<td>Brazil</td>
<td>September 2005</td>
<td>10 years</td>
<td>Global</td>
</tr>
<tr>
<td>Colombia</td>
<td>February 2005</td>
<td>10 years</td>
<td>Global</td>
</tr>
<tr>
<td>Mexico</td>
<td>October 2003</td>
<td>20 years</td>
<td>Domestic</td>
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<tr>
<td>Indonesia</td>
<td>May 2005</td>
<td>10 years</td>
<td>Domestic</td>
</tr>
<tr>
<td></td>
<td>May 2006</td>
<td>20 years</td>
<td>Domestic</td>
</tr>
<tr>
<td>Korea</td>
<td>August 2005</td>
<td>10 years</td>
<td>Domestic</td>
</tr>
<tr>
<td></td>
<td>December 2005</td>
<td>20 years</td>
<td>Domestic</td>
</tr>
<tr>
<td>Thailand</td>
<td>September 2002</td>
<td>20 years</td>
<td>Domestic</td>
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<td></td>
<td>May 2004</td>
<td>10 years</td>
<td>Domestic</td>
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<td>December 2005</td>
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</tr>
</tbody>
</table>

*Source: Bloomberg.*
Yield Curve – Korea Treasury Bond

Source: Bloomberg
Yield curves of domestic fixed rate local currency government bonds

In per cent

Argentina
- Mar 05
- Jan 06

Brazil
- Jun 03
- Feb 05
- May 06

Chile
- May 03
- Feb 05
- Mar 06

Colombia
- May 03
- May 05
- Mar 06

Mexico
- Oct 03
- Feb 05
- Feb 06

Peru
- Dec 04
- Mar 05
- May 06

Venezuela
- Jan 04
- Nov 05

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.
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
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?