

**SOVEREIGN DEBT CRISES AND PRIVATE SECTOR INVOLVEMENT (PSI)**

**A Preliminary Assessment of the Dominican Republic's Experience**

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# SOVEREIGN DEBT CRISES AND PRIVATE SECTOR INVOLVEMENT (PSI) A Preliminary Assessment of the Dominican Republic's Experience

Jwala Rambarran and Vangie Bhagoo<sup>1</sup>

## 1. Introduction

In May 2003, the Dominican Republic, one of the star performers in the Caribbean region, plummeted into a serious financial crisis characterized by a near doubling in public debt, a wave of currency depreciation, and a generalized loss of confidence. The crisis generated an exceptionally large gross external financing requirement in the order of more than 600% of international reserves, one of the highest ratios of any rated sovereign. In principle, the Dominican Republic had three options to fill such a very large gap. First, obtain a substantial official financing ("bail-out") by the international financial community, involving an exceptional or high access package from the IMF. Ideally, the IMF support would be catalytic, helping to restore investors' confidence and market access so that private capital would meet the residual financing needs. Second, seek full private financing ("bail-in"), also known as private sector involvement (PSI) in crisis resolution, through debt rescheduling or restructuring. Third, pursue a combination of official financing, appropriate forms of PSI, and domestic policy adjustment. After allowing for significant adjustment and with official financing only partly filling the financing gap, the Dominican government had little option but to seek to restructure its sovereign external debt (Eurobonds) under the shadow of default. In May 2005, the government announced that the sovereign debt exchange offer with private creditors was successful, helping to pave the way for a return to external viability.

While the Dominican Republic's experience may be too premature from which to draw too many generalized lessons, this specific debt exchange may present a useful example to the Caribbean countries that are ranked among the top 10 highly indebted emerging market economies in the world (Sahay, 2004). The debt swap may also highlight useful lessons to Grenada which is preparing to restructure its sovereign debt in the aftermath of Hurricane Ivan. In addition, Roubini (2002) indicates that the issue of bail-ins versus bail-outs has spawned a host of highly controversial questions in the debate on the re-engineering of the international financial architecture. Will PSI help to resolve crises or lead to a reduction in financing to emerging market economies? When to do bail-ins and when to do bail-outs, or a combination of both? Is moral hazard a serious issue? Should collective action clauses be introduced into bond contracts? Should PSI be concerted/coercive or semi-voluntary/catalytic? When should access to IMF resources be normal and when should it be exceptional? This study enjoins the debate, providing a Caribbean perspective.

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Accordingly, Section 2 describes the origins of and policy responses to the crisis in the Dominican Republic, emphasizing the role of fundamentals and market signals. Section 3 highlights the factors influencing the success of the sovereign bond exchange. The study concludes in Section 4 with some lessons for those Caribbean economies facing high public debt burdens that may be contemplating the feasibility of sovereign debt restructuring.

## 2. Origins of the Crisis and Resolution Strategy

The crisis in the Dominican Republic did not originate with the sovereign, but the cost of the crisis made the country's debt unsustainable. The crisis in fact originated in the private banking sector following revelations of significant fraud at Banco Intercontinental S.A. (BanInter), the country's third largest bank. Although the central bank intervened in BanInter in April 2003 and financed the payout of its deposits without restrictions, contagion soon spread to two other fraud-ridden medium-sized banks – Bancredito and Banco Mercantil - whose deposits were also guaranteed. The banking sector bailout amounted to 15% of GDP and forced the central bank to issue large amounts of short-term peso certificates of deposits (CDs) at increasingly higher interest rates to mop up the ensuing liquidity. Central bank assistance to these problem banks contributed to a near doubling in public sector debt to 45% of GDP at end-June 2003, a wave of Dominican peso depreciation and double digit inflation, a generalized loss of confidence, and a macroeconomic crisis (see Table 1).

**Table 1: Dominican Republic: Selected Macroeconomic Indicators (2002-2004)**

	2002	2003	2004
Real GDP (annual % change)	4.3	-0.4	2
Consumer Price Index (% , end of period)	10.5	42.7	28.9
Consolidated Public Sector Balance (% of GDP)	-2.6	-7.5	-6.7
External Current Account Balance (% of GDP)	-3.7	6.3	5.8
Nominal Exchange Rate (peso/US dollar)	20.05	35.95	28.5
Real Effective Exchange Rate (% change)	-11.4	-27	30
Gross Official Reserves (in Millions of US dollars)	630	276	825
(In months of imports)	1.1	0.5	1.4
Total Public Sector Debt (% of GDP)	26.8	54.3	52.1

*Sources: IMF- Public Information Notice on Dominican Republic, October 14 2003, Bloomberg.*

To address the crisis and set the tone for a soft landing of the economy, the IMF on August 29 2003 approved a 2-year \$600 million Stand-By Arrangement (SBA) with the administration of then-President Mejia. The package was designed to buy time to implement what were recognized as difficult and time consuming fiscal, banking and electricity sector reforms. It was envisaged that the announcement of the package would stabilize the market, reduce real interest rates to levels the government could afford, and take pressure of the peso, which had already fallen by more than 40%. The international financial institutions were to cover \$1.2 billion in the Dominican Republic's financing needs, consisting of \$600 million from the IMF and \$600 million from the World Bank and IDB. Upon approval of

the SBA, the authorities were allowed an immediate disbursement of \$120 million. Without this level of official financing, the central bank would be forced to make substantial purchases in the foreign exchange market to meet the cost of debt servicing, which had more than tripled to 4.5% of GDP in 2003, putting further pressure on the Dominican peso.

<b>Box 1: Dominican Republic – Chronology of Key Events</b>	
<b>May 10 2005</b>	Statement by the IMF Staff on First Review of SBA
<b>May 05 2005</b>	Announcement of Preliminary Results of Exchange Offer
<b>April 21 2005</b>	Statement by the IMF Managing Director to Members of the International Financial Community
<b>April 20 2005</b>	Launch of Bond Restructuring Proposal
<b>March 27 2005</b>	Coupon payment made on 2006 bond
<b>February 14 2005</b>	Coupon payment made on 2013 bond
<b>February 01 2005</b>	IMF Executive Board Approves \$655 million SBA
<b>March 30 2005</b>	Senate approves Law Authorizing Sovereign Debt Restructuring
<b>January 23 2005</b>	Coupon payment of \$27 million due on 2013 Bond
<b>November 24 2004</b>	Statement by the IMF Staff on Agreement for new 2-year SBA
<b>August 16 2004</b>	Inauguration of President Fernandez
<b>June 30 2004</b>	Second Round Voting for Presidential Elections
<b>May 16 2004</b>	First Round Voting for Presidential Elections
<b>February 11 2004</b>	IMF Completes First Review of SBA – Approves \$66 million Disbursement
<b>January 23 2004</b>	IMF Deputy Managing Director to Recommend Completion of First Review of SBA
<b>August 29 2003</b>	IMF Approves 2-year \$600 million SBA
<b>April 2003</b>	Eruption of Banking Crisis

Unfortunately, the IMF-supported program went off-track amid severe policy slippages, intensifying a vicious cycle of macroeconomic instability in late 2003 and early 2004. Monetary policy, which was supposed to remain tight in support of reducing inflation to single digit levels, was abruptly loosened, setting in train a new round of peso depreciation and pressures in the foreign exchange market. The two debt-ridden, loss-making electricity companies were unexpectedly nationalized, at high cost to an already strained budget, delaying critical IMF program disbursements. The central bank began to experience difficulties rolling over its short term debt, relying on debt issues as short as one week.

Although the IMF completed the first review under the SBA in support of a revised program in February 11 2004, approving the disbursement of \$66 million, the program did not achieve its objectives. Markets continued to be sceptical in the run-up to the May 2004 Presidential elections, and the peso remained weak for some time. Few new policy measures were implemented to bring the program on track, especially in respect of fiscal slippages, and external arrears accumulated to official and private creditors. Negotiations with the Paris Club in April 2004 allowed the Dominican government to reschedule its bilateral debt service due in 2004, but required the government to seek comparability of treatment with its private creditors. Most performance criteria and structural reforms were not observed and the Fund staff could not recommend completion of the second review of the SBA, which eventually lapsed.

The electoral victory of former President Fernandez in the first round of voting in May 16 2004, marked a turning point for the Dominican Republic, but very little progress was made on urgently needed fiscal and bank reforms in the subsequent 3-month transition period. At his inauguration on August 16, as the country was approaching default on all categories of its debt, President Fernandez announced an emergency plan for the first 100 days of his administration, emphasizing the need for immediate fiscal tightening, negotiating a new program with the Fund, and honouring the commitment to the terms of the April 2004 Paris Club Agreement. Even though Table 1 shows that macroeconomic outcomes were mixed in 2004, markets responded positively to the policy efforts, initiating a virtuous cycle and a strong bounce back to greater macroeconomic stability. By year's-end, the Dominican peso had recovered to its pre-crisis levels in real terms, helping to narrow the fiscal accounts by reducing electricity sector and debt service costs, and pulling down inflation and interest rates on central bank paper. On February 1 2005, the IMF approved a new 28-month SBA in the amount of \$655 million. After some delay, the Dominican Senate approved on March 30 2005 the authorization for the executive branch to proceed with the exchange offer of the sovereign bonds issued in 2001 and 2003. All 30 (of 32) senators who were present voted in favour of the law.

The focus of the IMF-supported programs appeared to be on fiscal fundamentals and less on the Dominican Republic's liquidity needs over the short-term. How did the market take this? In 2003, the Dominican Republic comfortably issued a \$600 Eurobond at a spread of 496 basis points above comparable US Treasuries, and probably could have raised additional sums without triggering any disruption in the market for its external debt. As the crisis deepened however, access to the international capital markets was curtailed and the domestic debt market began to indicate growing default and devaluation risk.

Kharas et. al. (2002) shows how the domestic interest rate can be decomposed to give estimates of default risk and devaluation risk. Equation 1, which is an expanded form of the familiar interest rate parity equation:

$$i_d = i_f + \text{SRP} + \text{EXR}^* + \text{DRP} \quad (1)$$

where  $i_d$  is the domestic interest rate and  $i_f$  is the risk-free rate; SRP is the sovereign risk premium and captures default risk; EXR\* is the target rate of devaluation against the US dollar; and DRP is the devaluation risk premium, or compensation for the actual devaluation exceeding the target rate. For our analysis, we use the 30-day central bank CD rate. For the risk free rate, we use the yield on 30-day US Treasury bill. We proxy the sovereign risk premium by the weighted average spread of the market yield of the Dominican Republic 2006 and 2013 Eurobonds over that of comparable US Treasury Notes. The target nominal rate of devaluation is calculated as the inflation differential with respect to the US. Finally, the devaluation risk premium is obtained as a residual.

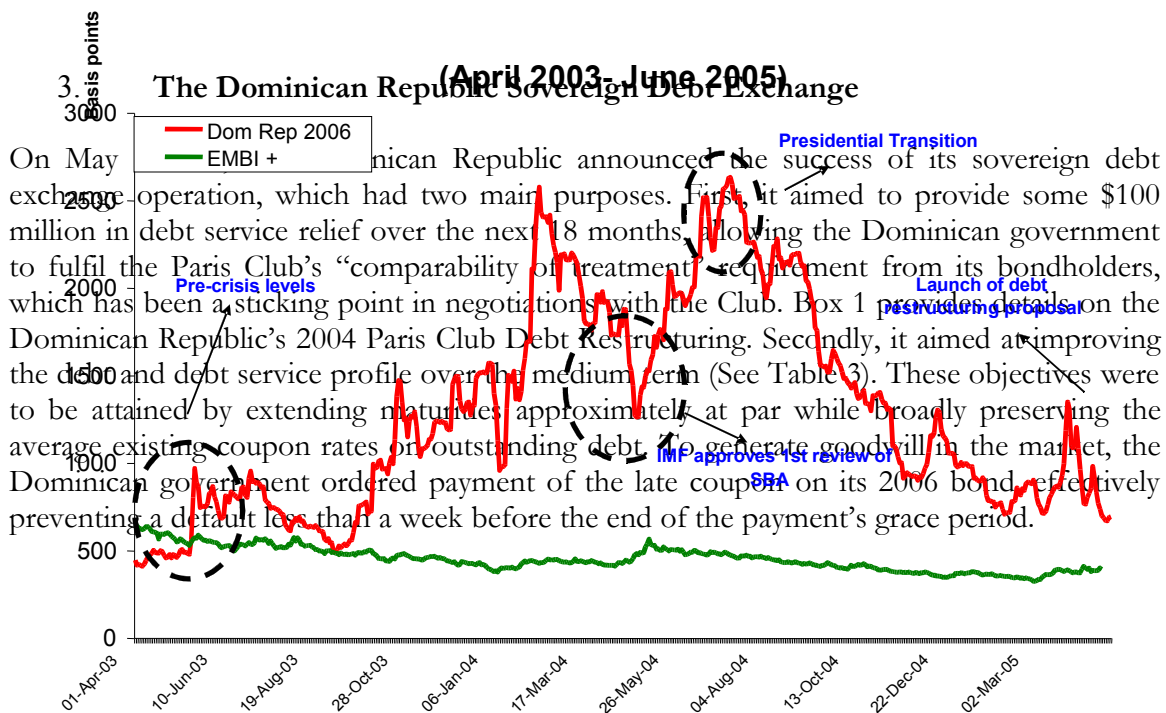
**Table 2: Dominican Republic – Default and Devaluation Risk Premia**

Date	CD Rate (%)	Sovereign Risk Premium (basis points)	Devaluation Risk Premium (basis points)
<b>2003</b>			
15-Apr	21.9	501.6	-1512.6
29-Aug	27.4	549.9	353.1
<b>2004</b>			
11-Feb	48.8	1656.4	739.6
16-May	58.7	1561.6	4205.4
16-Aug	54.4	1601.1	5126.9
24-Nov	28.9	818.9	3867.1
<b>2005</b>			
14-Feb	25.2	770.6	1501.4
27-Mar	16.7	838.3	1000.7
20-Apr	10.7	665.6	137.4
28-Apr	8.6	599	-37

*Source: CMMB Research Centre*

Table 2 shows estimates of the sovereign risk premium and the devaluation risk premium for key dates between April 2003 and May 2005. It shows that devaluation risk became very acute by early February 2004 rising to 740 basis points, while default risk jumped to over 1,600 basis points in the 3-month transition period to President Fernandez's assumption of office. By end November 2004, the sovereign risk premium had more than halved after the announcement of negotiations on the 2005 IMF package, it nevertheless remained above the level of 800 basis points. Both risk premiums began falling from February 2005, following the approval of the new IMF-supported program and consultation with the market on the elements of the proposed debt strategy. The default risk premium narrowed significantly upon completion of the debt exchange offer, in light of expectations that the offer would improve the short-run debt dynamics.

**Figure 1: Dominican Republic - Sovereign Risk Premium**



**Table 3: Dominican Republic: Composition of Public Sector Debt**

	2000	2001	2002	2003	est. 2004
	In millions of US dollars				
<b>External</b>	<b>3684</b>	<b>4177</b>	<b>4636</b>	<b>5984</b>	<b>6166</b>
Official	2986	3014	3144	3486	3694
Private	698	1163	1231	2258	2128
	In millions of Dominican Republic pesos				
<b>Domestic</b>	<b>23490</b>	<b>15747</b>	<b>21300</b>	<b>92103</b>	<b>140265</b>
Central government	19158	12486	14394	32095	42136
Central Bank Certificates	4332	3261	6905	60008	98129
<b>Memo items</b>	In percent of GDP				
<b>Total public sector debt (in % of GDP)</b>	<b>25.8</b>	<b>23.3</b>	<b>26.8</b>	<b>54.3</b>	<b>52.1</b>
External debt	18.5	19	21.5	36.6	33.5
Domestic debt	7.3	4.3	5.3	17.7	18.6
<i>of which: Central Bank Certificates</i>	1.3	0.9	1.7	11.9	12.6

Source: IMF- Public Information Notice on Dominican Republic, October 14 2003 and June 26 20 02.

The following were the key features of the Dominican government's bond restructuring proposal:

- **Voluntary and Cooperative.** The authorities emphasized the voluntary nature of the swap, convincing bondholders that there was no alternative to accepting the exchange except default. From early on, consultations took place with investors, allowing the Dominican government to explain its economic and financial position to bondholders while listening to their suggestions and concerns. The exchange was open for a very short period, only two weeks.
- **Limited Approach.** The authorities limited the restructuring to the 2006 \$500 million and 2013 \$600 million eurobonds, both of which were exchanged for new bonds with maturities five years longer. In addition, 100% of the coupon payments on the new bonds due in 2005 will be fully capitalized and 50% of the coupons for 2006 will be capitalized, rather than paid out in cash, resulting in an increase in the respective principal amount of the new bonds. Non-cash payments will be in the form of new bonds. This would restructure more than 50% of the Dominican Republic's total external debt to private creditors. The country's Brady bonds were excluded from the offer.
- **No Haircut and Some Sweetener.** The restructuring involved an extension of maturities but no haircut on either principal or interest in terms of a potential debt write-off. The Net Present Value (NPV) of the exchange was neutral relative to the current price of the old bonds. All recent successful bond exchanges have involved some form of sweetener. In the Dominican Republic case, the new bonds will amortize during the last five years of their life, instead of a bullet maturity payment. To reduce the duration of the new bonds, principal payments will be made in ten equal semi-annual instalments on the new 2011 bonds starting in March 2007 and on the new 2013 bonds starting in July 2013. In addition, post-restructuring yields of the new bonds offered some 7-10 basis points of upside potential from current prices.
- **Subject to Exit Consent Amendments.** By tendering the old bonds, investors would consent to amendments to the terms of the old bonds that would: (i) eliminate the ability of holders of the old bonds to attach payments made on the new bonds; (ii) delete all cross-default and cross-acceleration provisions in the old bonds; and (iii) remove the requirement to maintain the listing of the old bonds on the Luxembourg Stock Exchange.
- **Inclusion of Collective action clauses (CACs).** The new bonds issued under New York securities law include CACs, under which the Dominican government will be able to change the payment terms of any individual bond series with the consent of investors representing at least 75% of outstanding principal of that series.
- **No Seniority of Exchange Bonds.** The new bonds will be unsubordinated and unsecured obligations and will rank equally in right of payment to all of DomRep's existing and future unsubordinated debt and unsecured external obligations.
- **High Participation Rate.** Bondholders tendered a total of \$1,030 million, a participation rate of 93.6% and well in excess of the 85% threshold. Of the 2006



bond, 91.2% was tendered and of the 2013, 95.7%. Disincentives to hold outs included the stated risk that the Dominican government may opt not to pay the old bonds.

Shortly after Dom Rep announced its bond exchange offer, S&P downgraded the rating on the country's 2006 and 2013 bonds to D from CC, which is not surprising given their imminent restructuring. In February 2005, S&P had lowered its rating on the Dominican Republic to SD, based on arrears to private commercial bank creditors. Based on the favourable resolution of the bond exchange and the conclusion of an agreement with commercial banks, S&P upgraded Dom Rep's sovereign rating to B in June 2005. Fitch upgraded the country to B upon completion of the exchange.

The issue of the remaining 6.4% of bonds that were not tendered will be addressed by the government, but this is unlikely to have any negative impacts on the liquidity and price of the new issues.

#### **Box 2: The Paris Club Restructuring**

On 16<sup>th</sup> April, the Paris Club concluded an agreement with the Government of the Dominican Republic, consolidating around US\$155 million of maturities falling due between 1 January 2004 and 31 December 2004 and US\$38 million of arrears due to Paris Club creditors. One of the main reasons for the rescheduling is to reduce debt service due to Paris Club creditors during 2004 from US\$479 million to US\$293 million.

The rescheduling was done under the classic terms, where all credits are repaid progressively over 12 years, including 5 years of grace. Official Development Assistance (ODA) loans rescheduled at a rate not higher than the interest rate of the original loans. Other loans will be rescheduled at a market interest rate (known as the appropriate interest rate) defined on the basis of risk-free rates for the currency considered. On a voluntary and bilateral basis, each creditor may also undertake debt for nature, debt for aid, debt for equity swaps or other debt swaps.

#### **Technical Note:**

The stock of debt owed to Paris Club creditors as at 1 January 2004 was estimated at US\$1561 million, out of which US\$687 million of pre-cut off date debt, and US\$874 million of post-cut off date debt. The cut off date, which is 30 June 1984 for the Dominican Republic, is used by Paris Club creditors for the sole internal purposes of the Paris Club agreement for official bilateral creditors. When the debtor country first meets with the Paris Club, the 'cut-off date' is defined and is not changed in subsequent Paris Club treatments and credits granted after this cut-off date are not subject to rescheduling. Thus, the cut off date helps to restore access to credit for these debtor countries.

*Source: [www.clubdeparis.org](http://www.clubdeparis.org)*

#### 4. Conclusions

Crisis resolution through sovereign debt restructuring is in the interest of both the private and public sector alike. The Dominican Republic experience may highlight several lessons to many Caribbean countries that are grappling with onerous public sector burdens and debt servicing difficulties. (See Table 4)

The weak fiscal position of the governments in the Eastern Caribbean region has deteriorated sharply in recent years, marked by high public debt burdens, and the accumulation of substantial arrears in some cases (Antigua & Barbuda). Public sector debt has risen in most countries in the region, ranging between 40-135% of GDP at end-2004. In Antigua & Barbuda, Dominica, Grenada, and St. Kitts & Nevis the public debt-to-GDP ratio is above 100% (See Table 4). Such an environment places pressure on the currency board arrangement, which is crucial to maintaining macroeconomic stability in the region.

**Table 4: Caribbean Debt Situation**

Primary Fiscal Balance	Total Public Debt		
	Low to Medium Debt 0 to 50%	High Debt 50 to 90%	Very High Debt Higher than 90%
Higher than 5%			Jamaica
0 to 5%	The Bahamas, Trinidad and Tobago	Barbados, Belize	Dominica
Less than 0%	Suriname, Dominican Republic	St Vincent & the Grenadines, St Lucia	Grenada, Guyana, St Kitts & Nevis, Antigua & Barbuda

*Source: CMMB Research Centre*

Without corrective action, these high debt levels raise the chance of a financial crisis. Many governments are now attempting to reduce the high public debt levels through a combination of fiscal consolidation, growth, asset sales, and more active debt management.

Antigua & Barbuda introduced a Personal Income Tax, St. Kitts announced the closure of the sugar industry, and Dominica is undertaking fiscal adjustment in the context of an IMF-supported program.

## **Grenada**

Just over a year after the Grenadian economy was flattened by Hurricane Ivan, the government commenced an offer to exchange new US-dollar and EC-dollar bonds for a substantial portion of its external and domestic bonds, commercial loans and guaranteed debt. The initial terms of the debt exchange offer envisaged no haircut on principal despite the critical fiscal situation, full capitalization of past due interest, and coupons that increase over time from 0.85% to 8% per annum.

All US-dollar denominated claims will be offered new bonds denominated in US dollars and all EC-dollar denominated claims will be offered in EC dollars, and the new bonds being offered by the Grenadian government will mature in 2025. After creditor dissatisfaction mainly with the coupon rates, the terms of the exchange offer were later revised, with the new coupon rates ranging between 1% and 9%.

Grenada announced that creditors holding around US\$ 175 million of eligible claims (about 67% of total claims) have indicated that they intend to tender their eligible claims in the exchange offer. Standard and Poor's has assigned the proposed 2025 bonds a rating of B-, while the rating on Grenada was maintained at SD, selective default. Upon successful completion of the exchange offer, the country's long term foreign currency sovereign credit rating may be upgraded to B-.

Although Grenada has made some progress over the past year and the international community has given tremendous financial support, the financing gap in 2005 and beyond still proves challenging. Thus further aid from the international community as well as from the private sector is vital. The revisions are expected to result generate high participation (85% of total principal amount of eligible claims) which would help contribute to improving Grenada's debt dynamics and the overall recovery process.

## **Belize**

Since 1999, the Belizean government has been racking up high debt levels, with the central government's debt-to-GDP ratio increasing from a modest 39.1% to a significantly high level of 82.2% at the end of 2003. In 2005, the country's short-term external financing needs are approximately \$96 million, compounded with the relatively low level of foreign reserves of approximately \$50 million. On 1 June 2005, Standard and Poor's lowered the credit rating on Belize to 'CCC-' from 'CCC'. The outlook on the long term ratings was maintained at negative. This was in response to government's announcement that it will seek to extend the maturity profile of its commercial external debt through bilateral discussions with creditors, but it does not intend to seek an IMF program that entails financing. The general government debt is forecasted at 98% of GDP by the end of 2005.

While there is some optimism regarding Belize's ability to service its 2005 debt, the outlook for 2006 is not as bright. It is estimated that Belize owes approximately \$56 million in principal repayments and \$61 million in external interest due in 2006. The likely year-end level of reserves, projected at around \$100 million, is insufficient to meet the country's debt obligations in 2006. Without market access, the government will have to consider the option of debt restructuring.

## **Lessons**

A number of possible lessons for PSI can be drawn from the Dominican Republic's sovereign debt restructuring experience.

First, it is difficult to design an international rescue package to deal with wavering confidence and weak fundamentals at the same time, because the interaction between high default risk and high devaluation risk can be complex. It is very likely that the moral hazard explanation became more dominant after the debt restructuring plans, when market signals on devaluation and default risk took a decided turn for the worse. The insurance argument in the form of an IMF-supported program probably played an important role as well. Moreover, the IMF left the design of the debt operation to the authorities and their advisers, while focusing on assurances that financing gaps and debt sustainability were addressed.

Second, a bail-in or the imposition of losses on private investors can be valuable in improving public debt dynamics, but is difficult to include in a reform package. When default risk and devaluation risk are already high, the loss to creditors to restore fiscal balance may be so large that they head for the exits anyway. While a private investor haircut may be best undertaken in a crisis atmosphere, this was not done in the case of the Dominican Republic.

Third, there must be well-founded confidence that the package is indeed moving the economy to a "good" equilibrium. Policy inconsistency only adds to the costs. In the case of the Dominican Republic, the very crisis that the second package sought to avert contained the foundations for future recovery. It brought about a temporary suspension of access to market borrowing for the government, which is forcing fiscal and power sector reform. It also brought about a real depreciation which is helping tourism and industry.

Fourth, a cooperative debt exchange can achieve high participation across a wide range of investors, but only if investors agree on the necessity of debt relief and if the exchange is part of an economic reform program. Extensive consultation helped to build consensus and allowed investor input in the design of the exchange. Preserving principal and coupon rates greatly helped improved participation.

Ultimately, the Dominican Republic experience showed that designing a reform package which implements fundamental reforms while simultaneously reaching an agreement with creditors is less costly than waiting for the market to force the same set of actions. Hopefully, other Caribbean countries moving into the valley of debt will come quickly to this realization.

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