

RECENT RESTRUCTURING OF SOVEREIGN COMMERCIAL DEBT IN THE CARICOM REGION: SOME OUTCOMES AND LESSONS

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Abstract

Public debt overhang is now a prominent feature among Caribbean economies. The protracted drag that the Great Recession is having on output growth in the Region has limited the extent to which fiscal effort and GDP growth can address high public sector indebtedness. Consequently, debt restructuring is emerging as a more common policy option in addressing debt overhang in the Region. This paper attempts to compare the outcomes of six recent debt restructuring exercises in the Region with typical global outcomes, as well as to extract some lessons and identify some emerging issues. The findings indicate that debt restructuring exercises have been less drawn-out on average than they are globally and principal haircuts are infrequent. The evidence suggests that debt restructuring has not gone far enough, leaving debt dynamics susceptible to GDP shocks.

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1. Introduction

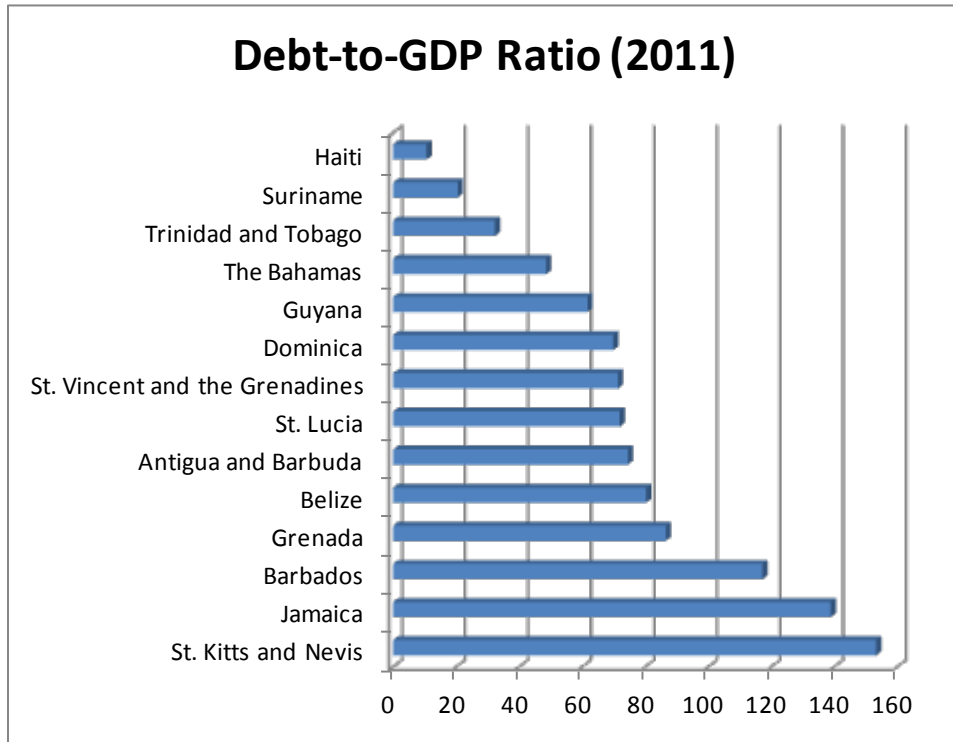
High indebtedness among Caribbean countries remains a pressing development issue. The level of indebtedness among many of these countries threatens to undermine development by diverting resources away from continued development. Additionally, uncertainty about the policy responses that will be necessary to achieve debt sustainability has the potential to stymie investment in those countries that are highly indebted. To some extent, highly-indebted Caribbean countries have made attempts to achieve debt sustainability by implementing revenue and expenditure reforms, while attempting to spur growth by undertaking structural reforms and building social and economic infrastructure. To a large extent, these efforts were offset by a number of factors affecting countries to varying degrees. These factors include the frequent passage of hurricanes and external shocks such as the commodity price shock and the Great Recession. In some sense, the situation was not helped by the vulnerabilities inherent in the high export concentration of most Caribbean countries, together with the low marginal efficiency of public sector capital.

The vulnerabilities associated with high indebtedness forced some of these countries to restructure their debt as a means to either staving off the liquidity problems that the situation created, or addressing the solvency issue once and for all. The experiences have thrown up some lessons that could be used to guide any such restructuring efforts in the future. This paper seeks to extract some of these lessons, but also documents some of the outcomes of these exercises with a view towards comparing them with global outcomes. In section 2, the debt situation is examined to present the backdrop against which debt restructuring in the Region has taken place. In section 3, some theoretical and practical issues relating to debt restructuring are considered. Specifically, a review of the literature in which a theoretical justification for the existence of lending to sovereigns occurs is presented, together with the cost of debt restructuring, as well as the justification for debt restructuring. Section 4 documents typical restructuring outcomes for commercial sovereign debt globally, and by various country groupings. In section 5, some of the key features and outcomes of six recent sovereign commercial debt restructuring exercises are examined. Section 6 examines some lessons that emerge from these exercises, while section 7 concludes.

2. The Debt Situation in the Caribbean

The Caribbean is a highly indebted region. As illustrated in Figure 1, at the end of 2011, three countries had public debt levels greater than 100% of GDP. Even though 100% is a psychological threshold, there is evidence to suggest that at a much lower level, debt begins to affect GDP growth negatively. Using data from 44 countries spanning two centuries, Reinhart and Rogoff (2010) find that for both advanced and emerging economies, debt begins to exert a negative impact on GDP growth when the debt-to-GDP ratio rises above 90%. Interestingly, using data for 12 countries with annual data for 20 years, Greenidge et al (2012) conclude that within the Caribbean, debt begins to affect GDP growth negatively above 55-56% of GDP. This suggests that 10 of the 14 countries represented in Figure 1 are experiencing debt overhang. All of this implies that strategies for reducing indebtedness are critical within the context of the Region.

Figure 1: Debt-to-GDP Ratios in the Caribbean



Comprehensive debt data is not available for all of the 1990s for many countries, but for those countries for which data is available, and from partial data for other countries, indications are that indebtedness began to rise during the 1990s in the CARICOM Region. The available data is illustrated in Figure 2, and shows that for the most part, debt-to-GDP ratios were below 60% prior to the 1990s for all 13 independent CARICOM member countries, with the exception of Guyana and Suriname. However, by 2000, the ratio surpassed the 60% threshold in six of those 11, with two others heading in that direction.

Figure 2: The Evolution of Debt-to-GDP Ratios in the CARICOM Region

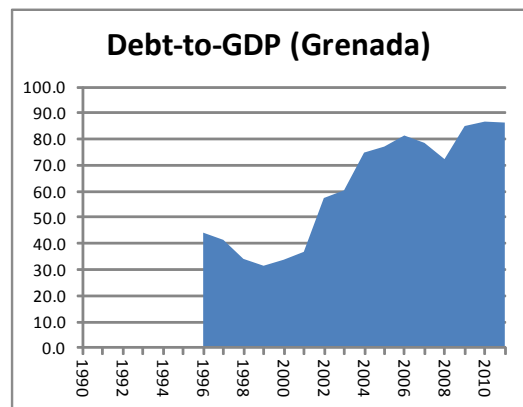
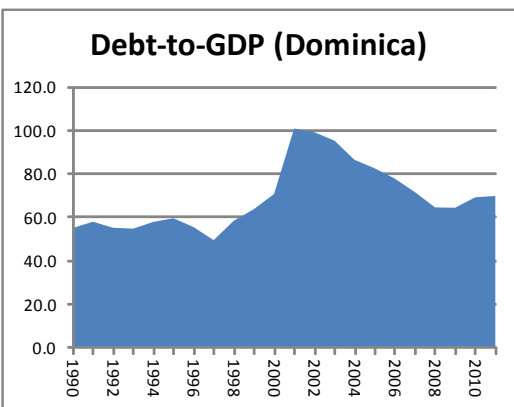
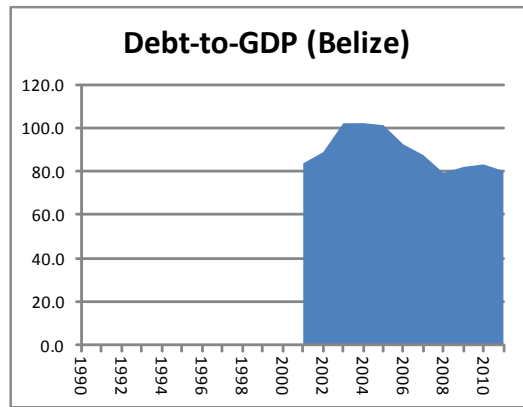
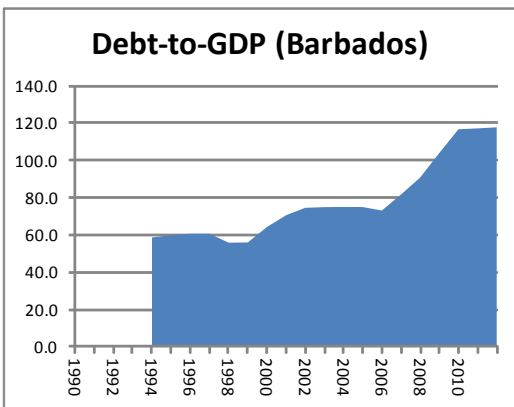
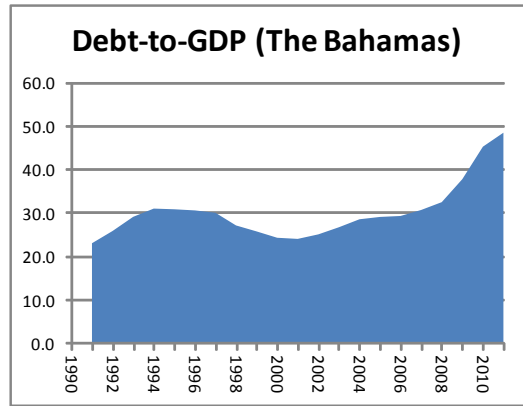
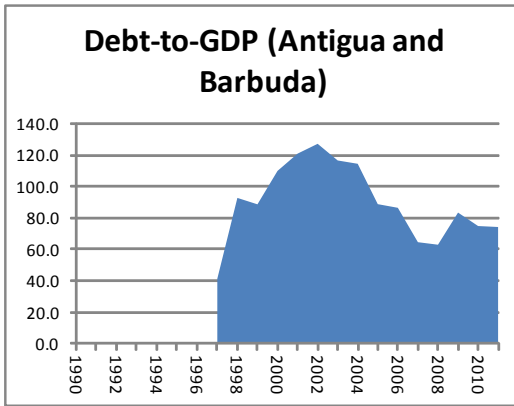


Figure 2 (cont'd): The Evolution of Debt-to-GDP Ratios in the CARICOM Region

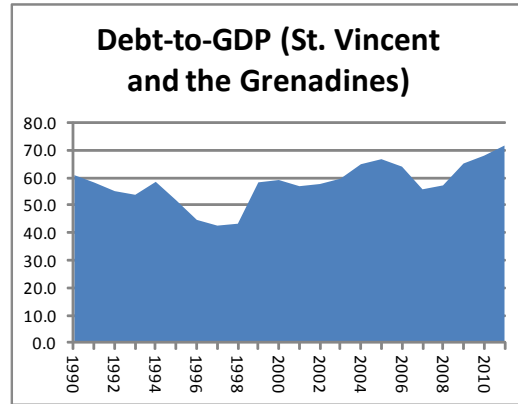
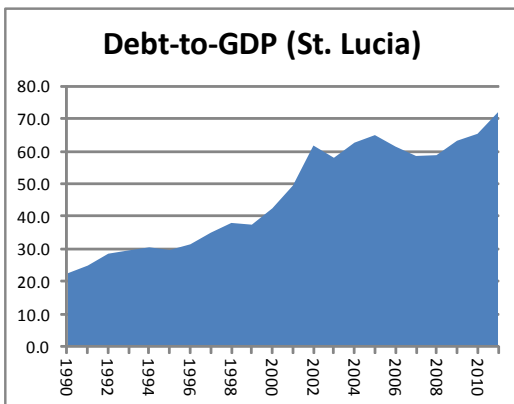
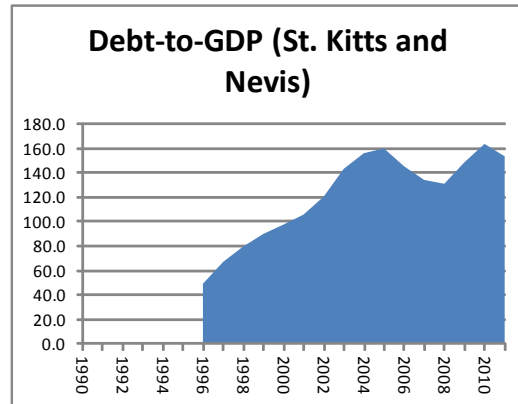
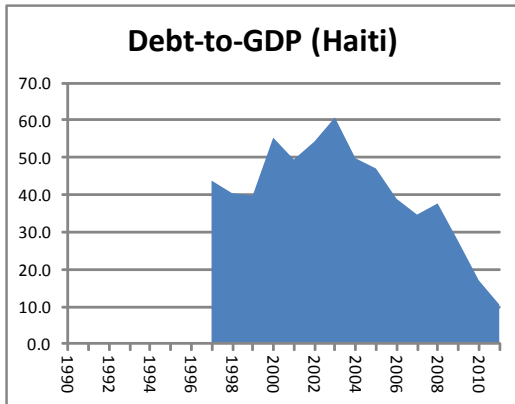
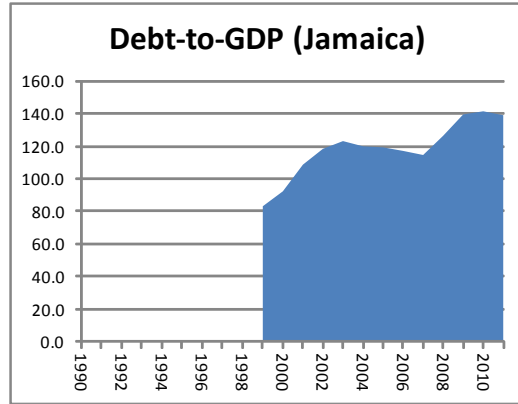
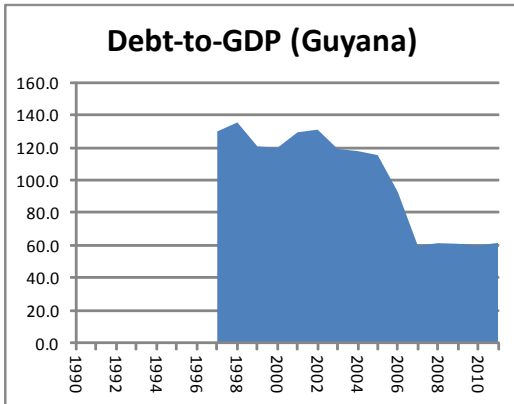
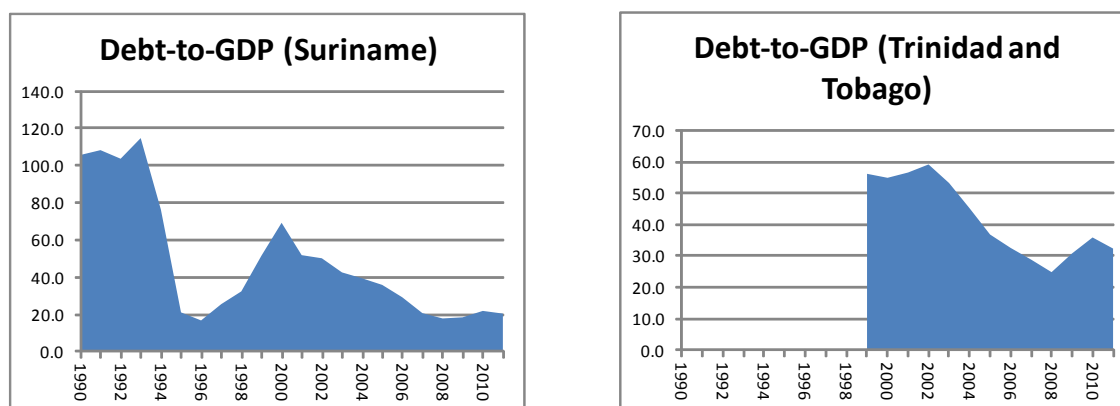


Figure 2 (cont'd): The Evolution of Debt-to-GDP Ratios in the CARICOM Region



One of the main factors that contributed to the rise in indebtedness was the period of transformation for many Caribbean countries that started in the mid-1990s. Preferential access to Europe was being dismantled, and there was a reorganization of production that not only slowed income growth, but also needed to be facilitated by public sector investment in critical infrastructure. On the supply side, there was also a deepening of regional capital markets, facilitated by an oil-price increase that boosted national savings in Trinidad and Tobago towards the end of the 1990s. This capital market deepening resulted in increased access of Caribbean governments, especially those in the eastern Caribbean, to greater access to commercial financing. Prior to this period, development financing in the region was dominated by the IFIs, with project financing focusing on rates of return. The rise of commercial financing lessened the focus on returns on public sector capital expenditure, which could have contributed to the implicit divergence between expenditure/debt growth and income growth.

According to Gold et al (2012), domestic debt accounts for approximately 60% of total debt among independent CARICOM members. In Antigua and Barbuda, Belize, Dominica, Grenada, St. Vincent and the Grenadines and Guyana, the average is lower, at just over 31%, but in the others, the average is 70%. The main holders of domestic debt are commercial banks and other financial institutions. Social security schemes play significant role in this regard. Commercial and other creditors account for 52% of external debt, while multilateral lenders account for approximately 34%.

3. Sovereign Debt Restructuring: Some Theoretical and Practical Considerations

On the face of it, the existence of markets for sovereign debts appears to be somewhat of an anomaly. Unlike the case with private debtors, the legal mechanisms available for enforcing repayment by sovereign debtors are not straightforward. In the event of a default, legal penalties exist, but they are far more limited than those at the corporate level. Nevertheless, these markets exist. Since the 1980s, there have been some attempts to explain in theory why sovereign lending occurs in spite of the practical difficulty of enforcing repayment. In a seminal paper, Eaton and Gersovitz (1981) begin from the premise that countries are unlikely to be one-time borrowers, and the reputational risks associated with non-payment of debt, and by extension, debt restructuring, provide incentive to ensure that sovereigns attempt to maintain a good payment record. The underlying assumptions that bring Eaton and Gersovitz to this conclusion are that sovereign borrowing on international capital markets constitutes insurance against output shocks, and that non-repayment of loans would result in permanent exclusion from these

markets. If debtors have no other way of insuring against output shocks, then the threat of exclusion from markets is a sufficient reason to repay debts. Wright (2005) comes to the same conclusion beginning from the premise that borrowing is based upon the need to secure capital for production.

The notion that permanent exclusion from credit markets could constitute the basis of a lending equilibrium was challenged, especially since it is not an empirical reality. Consequently, Sachs and Cohen (1982), Bulow and Rogoff (1989) and Fernandez and Rosenthal (1990) constructed a theoretical argument focusing on direct punishments as the basis for repayment, including seizure of the assets of the defaulting country that are held outside of the country's borders, as well as the denial of trade credits. Another group of articles including Cole and Kehoe (1995), Eaton (1996) and Kletzer and Wright (2000) pinpointed the possibility that payments due to countries that defaulted could be intercepted by creditors in pursuit of amounts owed to those creditors. Kletzer and Wright also worked with the possibility that a post-default relationship ends up with a defaulting country re-entering the capital market under conditions that are perhaps more onerous than permanent exclusion, and these assumptions generated a lending equilibrium as well. A third strand of literature looked at the indirect implications of non-repayment. Cole and Kehoe (1998) examined the impact that the need to preserve relationships with third parties could have on the incentive to repay. These relationships could be with foreign direct investors, for example. In similar vein, Sandleris (2005) Catau and Kapur (2006) and Kapur et al (2007) underpinned their analysis with the notion of signals that sovereign default may send about the economy.

The theoretical debate begs the question as to the empirical costs of debt restructuring. Cruces and Trebisch (2011) demonstrate that debt restructuring has a lasting impact on the borrowing conditions of a government post-restructuring. Using all 180 sovereign commercial debt restructurings since 1978, they find that for every 20% increase in principal haircut, bond spreads increase by 170 basis points. They find that although the impact decreases over time, it is still significant up to six years after the debt restructuring. Cruces and Trebisch also find that a 20% increase in the haircut is associated with a 50% lower likelihood of being able to re-access capital markets after the debt restructuring.

There has been some evidence to suggest that debt restructurings result in effects on trade and output. Sturzeneger (2002) estimates that output losses from debt restructuring are around 2% of GDP. De Paoli et al (2009) find that the output loss could be as much as 5% of GDP, and can persist for up to 10 years, depending on the duration of arrears. However, using higher-frequency (quarterly versus annual) data, Levy-Yeyati and Panizza (2011) find that falling output precedes debt restructuring. In relation to trade effects, using a panel gravity framework covering the period 1948 to 1997, Rose (2005) finds that bilateral trade falls by about 7% after Paris Club debt restructurings, with the effect lasting for as much as 15 years. Martinez and Sandleris (2008) replicate this study, except that they also test for bilateral punishment by affected creditor countries. While they find no evidence of a larger than average fall in the trade between affected creditor countries, their results corroborate the findings of Rose (2005) by indicating a general reduction in trade after a Paris Club restructuring.

There is evidence that sovereign debt restructuring can spill over into foreign direct investment and private sector access to credit. Fuentes and Saravia (2010) show that FDI flows are reduced by as much as 2% of GDP as a result of debt restructuring. The results were based on Paris Club data, and indicate a very specific relationship, with the fall being directly associated with the source country that is affected by the default. Arteta and Hale (2008) find that access to foreign borrowing by domestic private sector

firms fell by over 20% in the wake of sovereign debt restructuring, after controlling for other factors that would affect the dependent variable. Das et al (2010, 2011) corroborate this evidence, finding a fall of 40%, while finding that the impact is stronger for commercial debt restructuring than for official debt restructuring.

Sovereign debt restructurings can affect domestic financial institutions. On the asset side, the balance sheets of financial institutions can be affected by debt reduction. Income streams can also be reduced as a result of reduced coupons. In some countries, the liability side can be affected by deposit withdrawals and interruption of credit lines that affect the ability of financial institutions to mobilize resources. Some debt restructuring episodes have been known to increase interest rates, thus affecting the cost of funds. Large country episodes such as the Mexican debt default in 1982 and the Brazilian debt moratorium in 1987 resulted in significant negative effect on financial market valuations.

The costs notwithstanding, debt restructuring is sometimes necessary, and can in fact be rationalized. Wright (2002) argues that in an atomistic bond market without creditor collusion, a haircut that reduces the debt-to-GDP ratio could increase the creditworthiness of the beneficiary country, resulting in quick post-restructuring access and lower spreads. A debt restructuring can improve government's debt dynamics, and this can be seen by beginning with the budget constraint faced by a typical government. Specifically, the excess of expenditure over revenue will result in an increase in the net accumulation of liabilities, whether liabilities increase, financial assets fall, or some combination of these two occurs. This budget constraint can be summarised and expressed symbolically by the following equation:

$$e_t D_t^* - e_{t-1} D_{t-1}^* + D_t - D_{t-1} = i_t^* e_t D_{t-1}^* + i_t D_{t-1} - PB_t + O_t \quad (1)$$

where D represents domestic-currency-denominated debt; D* represents foreign-currency-denominated debt; i represents the average effective interest rate on domestic-currency-denominated debt; i* represents the average effective interest rate on foreign-currency-denominated debt PB represents the primary balance (revenue and grants less non-interest expenditures), e represents the exchange rate; O represents a residual that captures changes in financial assets, takeover of debt, debt write-off, or principal haircuts¹; and t represents time. Equation (1) assumes that there is no central bank financing of the government's deficit. Equation (1) can be manipulated to express terms as percentages of nominal GDP to generate the following equation:

$$\Delta d^T = \left[\frac{i_t^* (1 + \dot{e}_t) - g_t}{1 + g_t} \right] e_{t-1} d_{t-1}^* + \left[\frac{i_t - g_t}{1 + g_t} \right] d_{t-1} - pb_t + o_t \quad (2)$$

where d^T represents the total debt stock in relation to GDP; g represents the growth in nominal GDP; \dot{e} is the proportion change in the exchange rate; and the other lower-case letters represent their upper-case counterparts in equation (1) divided by nominal GDP. If the exchange rate is fixed, and debt is

¹ This balancing item is essential because equation (2) is an accounting identity, and while traditional cash accounting standards would recognize the fall in debt that results from a principal haircut, there would not be a counter entry. This balancing item is therefore necessary to ensure balance.

denominated either in domestic currency or the currency against which the domestic currency is pegged, then the debt dynamics equation can be represented as:

$$\Delta d^T = \left[\frac{i_t - g_t}{1 + g_t} \right] d_{t-1} - pb_t + o_t \quad (3)$$

where the automatic debt dynamics component of the equation (2), that is, the first two terms on the right-hand side of equation (2), collapses into one term, which is the first term in on the right-hand side of equation (3).

Debt restructuring can proceed in one of two ways. First, debt can be restructured in a manner that lengthens maturities, possibly with a reduction in interest rates. Such an operation is usually referred to as a debt refinancing operation. Alternatively, a debt restructuring can involve a reduction in the face value of the outstanding debt. This operation is referred to as a debt reduction. The benefits deriving from debt rescheduling are usually in relation to liquidity, but a lengthening of maturities and a reduction in interest rates still reduces the net present value of the debt stock. A debt restructuring that takes the form of a rescheduling with lower interest rates will have the effect of lowering the interest rate component of equations (2) and (3). The impact on the debt-to-GDP ratio is not significant in the initial period, but all other things remaining equal, the operation improves the time-path of the debt-to-GDP ratio. A debt restructuring that involves both a principal haircut and a lowering of interest rates will have more significant consequences for debt dynamics. In the initial period, there is an immediate decline in the debt-to-GDP ratio. This comes via the last term in equations (2) and (3). In subsequent periods, debt dynamics are improved via two routes. First, the lower interest rates will tend to lower the debt-to-GDP trajectory. Second, the now lower renders debt dynamics less sensitive to adverse growth and interest rate shocks.

4. Global Debt Restructuring Outcomes

In this section some key outcomes in relation to sovereign debt restructuring are examined at the global level. Specifically, there is a focus on the time that it takes to settle restructuring exercises; the creditor losses on the face value of the instruments; and the relief that restructuring countries effectively gain from restructuring exercises. These outcomes are taken from Wright (2011), and cover restructuring exercises of debt owed to private creditors during the period 1989-2004. The data covers 90 debt restructuring exercises by 73 different countries.

On average, it takes 7.4 years to complete a debt restructuring exercise. However, there are differences in the average completion time depending on the level of development. Debt restructuring in the average low-income country takes 9 years, while the average upper middle-income country takes 5.5 years. Across geographical clusters, sub-Saharan African country restructuring exercises were completed in 8.5 years; 7.5 years in Latin America and the Caribbean; and 4.5 years in Europe and Asia.

Creditor losses, calculated as principal haircuts as a percentage of the total debt outstanding, averages 38%. In this category as well, there are differences across debtor groups. Low-income country principal haircuts exceed 50% on average, while upper-middle income country haircuts average 38%. In terms of

geographical country groups, Sub-Saharan countries average 50%, East Asia and Pacific countries average 38%; and European, Central Asian and LAC average 30%.

The data suggests that debt restructuring does not necessarily result in restructuring countries being better off in terms of their debt-to-GDP ratios. Although the average restructuring country benefited from a 38% reduction in the face value of its debt, the debt-to-GDP ratio at the completion of the exercise was slightly higher. Spectacularly, lower income countries exited debt restructuring with debt-to-GDP ratios that were 60 percentage points higher than at the beginning of the process; and lower middle income countries fared much worse, with debt-to-GDP ratios that were 70% higher. By contrast, upper middle income countries exited debt restructuring with debt-to-GDP ratios that improved by 10 percentage points.

5. Key Features and Outcomes of Recent Sovereign Debt Restructuring in the Caribbean

In this section, the commercial debt restructuring components of six debt restructuring exercises in the Caribbean are examined. These debt restructuring exercises are recent, in that they have occurred within the last decade. Also, they are debt restructuring exercises that were initiated by the country, as opposed to being set off by qualification for relief under the Highly Indebted Poor Country initiative, as with Haiti's recently-initiated debt restructuring process. Some stylized facts related to those six exercises are presented in Table 1. Half of these exercises were pre-emptive, in that the exercises were completed before the government missed any payments on its debt. The other half occurred after the government defaulted on its debt.

Table 1: Recent Debt Restructuring Exercises in CARICOM Countries

Country	Type of Restructuring	Announcement of Restructuring	Final exchange Offer	Date of Exchange	Final Settlement	Duration	Debt exchanged (USD)	Debt Reduction
Dominica	Post-Default	Jul 2003	Apr 2004	Sep 2004	Jul 2012	8.5 years	Domestic – 76.2 mn External – 190.7 mn	30%, 20%, 0%
Grenada	Preemptive	Oct 2004	Sep 2005	Nov 2005		1 year	External Commercial (190 mn) Domestic Commercial (86 mn)	0%
Belize	Preemptive	Aug 2006	Dec 2006	Feb 2007	Feb 2007 (0.5% still untendered)	0.5 years	External Commercial (516 mn)	0%
Jamaica	Preemptive	Jan 2010	Jan 2010	Feb 2010	Feb 2010	1 month	Domestic - 7.6 bn	0%
Antigua and Barbuda	Post- default	2009				Ongoing	External Commercial Domestic Commercial (555 mn)	0%
St. Kitts and Nevis	Post-Default	Jun 2011	Feb 2012	Apr 2012		Ongoing	External Commercial (94 mn) Domestic Commercial (546 mn)	50%, 0% Assets swaps

The table tends to suggest that, for the most part, these recent debt exercises in the Caribbean have not taken very long to complete. Dominica is an outlier in this regard, having taken 8.5 years between announcement and completion. This is higher than the global average cited in the previous section, and reflected one holdout that held a substantial portion of Dominica's outstanding commercial debt. Even

though Antigua and Barbuda's debt restructuring program has been ongoing for approximately three years, the government has been undertaking a phased approach to its debt restructuring, focusing on different categories over time. The limited sample tends to suggest that debt restructuring programs that involve no reduction in face value are settled more promptly. The Grenada, Belize and Jamaica exercises involved no debt reduction, and were completed in relatively short time periods. The bonds that replaced the restructured debt in Belize and Grenada included lower interest rates that "stepped up" after some period, and the net present value reduction inherent in these two exchanges and that of Jamaica were approximately 21%, 34% and 20%², respectively, which are lower than those of Dominica (50%) and St. Kitts and Nevis (61% and 73%).

The apparent greater palatability of debt restructurings that involve no debt reduction might be based on the fact that commercial banks and other financial institutions are the main holders of commercial debt in the region. A debt rescheduling reduces income, but it does not affect capital unless there is a change in the risk weighting. On the other hand, a haircut affects capital, and depending on exposure, could push capital adequacy below acceptable limits.

These recent debt restructuring exercises also suggest that nominal creditor losses have not been significant in the Region. Four of the six exercises did not involve principal haircuts. In the case of St. Kitts and Nevis, creditors were offered a choice of a 20-year bond with 40% reduction in the face value, or a par bond with a 45-year maturity structure. As it turned out, less than 15% of the restructured debt actually involved a principal haircut, although the maturity of the par bond meant that the net present value reduction was greater than that of the discount bond. The St. Kitts and Nevis debt restructuring also involved the exchange of debt for land, which, depending on the direction in which the real estate market goes in that country, could well result in a gain by the creditors on the restructuring.

In an effort to estimate the effective relief that resulted from the debt restructuring exercises in the region, Table 2 shows comparisons the debt-to-GDP ratios at the end of the year prior to that in which the debt exchange offer was made, the end of the year in which the exercise was completed; and end-2012 projected. Apart from Grenada and Jamaica, the debt restructuring exercises in the region appear to have provided effective relief when assessed on the basis of the debt-to-GDP ratios. The operation in St. Kitts and Nevis is not complete, but the IMF projects that there should be a fall in the ratio to around 100% of GDP by the time the legal processes are completed for the asset swaps³. Antigua and Barbuda's debt restructuring exercise is ongoing, but for the most part, their debt-to-GDP ratio has been improving since the beginning of the process, although it is expected that 2012 will see a reversal of the downtrend that has been evident since 2009.

² The net present value estimates were computed by the IMF, and have different discount rates.

³ See IMF (2012)

Table 2: Effective Debt Relief from Debt Restructuring Exercises in the CARICOM Region

Country	Debt-to-GDP at Yearend Prior to Debt Exchange Offer	Debt-to-GDP at End of the Year of Debt Restructuring Completion	Projected Debt-to-GDP at End-2012
Dominica	95.3	70.7	70.7
Grenada	75.1	81.6	88.5
Belize	92.5	87.6	78.1
Jamaica	139.5	141.4	145.9
Antigua and Barbuda	83.7	n.a.	82.4
St. Kitts and Nevis	153.4	n.a.	n.a.

Source: IMF database.

6. Lessons of Experience

There are some important lessons that can be extracted from the recent debt restructuring exercises in the CARICOM region. One of these is the vulnerability to shocks inherent in a high debt-to-GDP ratio. As is shown in equations (2) and (3), the higher is the debt-to-GDP ratio, the more responsive are changes in the ratio to any shock that affects growth, or interest rates for that matter. This was particularly evident in Grenada in 2004, when the damage from hurricane Ivan caused a 3% reduction in GDP. The debt-to-GDP ratio increased by almost 15 percentage points, and only 3.8⁴ percentage points of this resulted from the primary balance. A similar vulnerability was evident in St. Kitts and Nevis, where the primary balance averaged around 2.5% of GDP between 2005 and 2010. This primary balance, which was one of the highest in the ECCU⁵ area, in addition to the low interest rate on the debt stock relative to the GDP growth rate, contributed to a reduction of 28 percentage points in the debt-to-GDP ratio between end-2005 and end-2008. However, the high vulnerability to growth shocks inherent in the high debt-to-GDP ratio caused a reversal in the direction of the debt-to-GDP ratio when GDP declined by a cumulative 8% in 2009-10. The vulnerability in Jamaica is even starker, in the sense that the Government of Jamaica has been running primary balances averaging around 8% of GDP for the last decade. Yet the debt-to-GDP ratio continued to climb because of the high interest rate relative to GDP growth, together with the sensitivity to this relationship caused by the high debt ratio. The vulnerabilities inherent in a high debt-to-GDP ratio may be consistent with the existence of a debt-to-GDP threshold above which there is an elevated risk of debt distress. This is consistent with the Debt Sustainability Analysis framework developed by IMF/IDA, where the probability of debt distress is linked to key debt and debt service ratios, together with the quality of the policies and institutions of the countries⁶.

A second lesson is that debt restructuring should be part of a comprehensive reform program supported by key stakeholders. Equation (3) suggests that changes in the debt-to-GDP ratio result from a number of factors operating in tandem. A comprehensive reform program builds credibility and demonstrates commitment, but it also builds consensus by demonstrating burden sharing. Such a program should aim

⁴ In many Caribbean countries, there are changes in the debt-to-GDP ratio that are not covered the first two items on the right-hand side of equation (3). In essence, some of this residual might represent portions that are not recorded as expenditure, but “came out in the wash” through the financing that was required to effect them. In such cases, it may be that the primary balance is higher than it should be. This phenomenon was particularly evident in Grenada in 2004 and 2005, where there were significant residuals, probably resulting from the impact of the hurricane damage on public finance management systems (see Durant (2007))

⁵ The Eastern Caribbean Currency Union area is comprised of Anguilla, Antigua and Barbuda, Dominica, Grenada, Montserrat, St. Kitts and Nevis, St. Lucia and St. Vincent and the Grenadines.

⁶ See, for example, IMF/IDA (2006).

to generate optimum primary balances and GDP growth through appropriate structural policies; minimize interest cost and borrowing risks; and combine these with burden sharing by creditors as necessary. Debt restructuring can have significant costs, as discussed previously, and policy credibility is a useful way of mitigating these costs. Creditors are rational, and the anecdotal evidence surrounding formal and informal negotiations between governments and creditors suggests that the latter are more likely to accept debt restructuring when there is a demonstration of fiscal effort and recognition that the restructuring exercise is part of a credible and comprehensive fiscal program. The involvement of the international financial institution community operating in the region also provides comfort by convincing stakeholders that the program is credible.

A third lesson is that debt restructuring should take cognizance of medium-term resource capacity plus make allowance for a reasonable shock. The restructuring exercises by Grenada and Belize included the exchange of existing debt for instruments with step-up interest rates. The step-up interest rates were premised on an assumption that the GDP growth rates would increase sufficiently to ensure that the automatic debt dynamics component of equation (3) would impart a downward effect on the debt-to-GDP ratio. For example, the so-called super-bond issued by Belize in 2007 in exchange for outstanding external commercial debt bears an interest rate that increases sequentially to 8.5% by 2013. At that time, the automatic debt dynamics are likely to be increasing the debt-to-GDP ratio, as GDP growth rates have not risen enough to allow them to exceed the average effective interest rate. Consequently, the Government of Belize has announced a second debt restructuring. A similar difficulty has occurred with respect to Grenada's restructured debt, although the Government of Grenada has not announced a second debt restructuring. The coupon interest rate on the bonds issued by Government was 2.5 percent through 2011; increased to 4.5 percent during 2012–13, and rise further to 6 percent (2014–15), 8 percent (2016–17), 8.5 percent (2018), and 9 percent (2019–25). The rise in the interest rate, accompanied by a lower-than-expected GDP growth rate, has created adverse debt dynamics for Government, which are affecting the ability of the Government to service its debt. The evidence suggests that in some of the debt restructuring exercises, sufficient allowances were not made for the possibility of the depth or length of the sluggishness of regional economies.

A fourth lesson is that the debt profile limits restructuring options. As already noted, domestic debt dominates the debt profile of regional governments. An unsustainable fiscal situation within the context of heavy exposure of domestic financial institutions to their sovereign requires a delicate balance between fiscal effort and burden sharing by creditors. Both of these options, if overused, have the potential to undermine macroeconomic stability and growth. For example, in the Jamaica debt restructuring, which was limited to domestic commercial creditors, stress testing had to be conducted to ensure that the stability of the financial sector would not be compromised by the operation. Where bondholders are presented with a choice between a discount bond and a par bond with a much longer maturity structure and lower interest rate, financial institutions that are heavily exposed will tend to opt for the par bond because their exposure would render the discount bond option deleterious to their capital adequacy position.

A fifth lesson that has emerged is that consultation with creditors is key to high participation rates, but can be at expense of relief. The experience with debt restructuring exercises in the Region suggests that there is a trade-off between consensus and relief. Holdouts can be costly, both in terms of the legal costs associated with dealing with the holdouts, but also in relation to the capital market access problems that

can arise when holdouts are significant. As an example, the Government of the Commonwealth of Dominica did not engage in any non-domestic commercial borrowing while their commercial holdouts were being settled.

A sixth lesson is that domestic debt is easier to settle than external debt. Domestic bondholders are closer to the economic situation and the government's fiscal situation, which usually makes them more likely to understand the policy imperatives for restoring fiscal sustainability. At the same time, they are more invested in the restoration of fiscal sustainability and the development implications that it implies. This usually means that they are willing to arrive at a reasonable combination of fiscal effort and creditor burden sharing. Litigation is more likely to be pursued by external bondholders, especially since, depending on the size of the holdings, there is the potential to free ride on the improved fundamentals that can come from the debt restructuring.

A seventh lesson is that debt restructuring may be easier to advance if it involves IFI support in the form of partial credit guarantees. A partial credit guarantee is a credit enhancement arrangement where the IFI promises to settle debt service payments up to a predetermined amount in the event of a default. Such an operation can improve the creditworthiness of the instruments, and can have more than a psychological effect on bondholders. The Caribbean Development Bank provided a partial credit guarantee to facilitate the debt exchange of the Government of St. Kitts and Nevis.

7. Conclusions

This paper examined the some of the main features and outcomes associated with six recent debt restructuring exercises in the Caribbean. Debt restructuring exercises have not taken as long as they typically take across the globe, with the Dominican restructuring being the most protracted. Nominal creditor losses have not been large, presumably to protect the domestic financial sector and ensure high participation rates. That notwithstanding, the debt restructuring exercises have provided some effective relief when judged on the basis of the change in the debt-to-GDP ratios. A number of lessons were extracted from these exercises, including the elevated probability of debt distress inherent in high indebtedness, together with the need to ensure that debt restructuring is sufficient to provide the fiscal space necessary reduce vulnerabilities to likely shocks. Other lesson included the need to immerse debt restructuring within a comprehensive program for achieving debt sustainability, supported by development partners. This has the impact of building credibility and support among burden sharers. It also seems apparent that debt profile limits the debt restructuring options available to a government, and that domestic debt is easier to settle than external debt.

There is no doubt that debt restructuring should be a last resort, as it has a number of costs associated with it. Globally, debt restructuring has been linked to temporary loss of access to credit, higher bond spreads, output and trade losses, lower foreign direct investment and private sector credit flows, and financial sector instability. Regionally, Dominica did not have access to foreign commercial credit while its debt restructuring exercise was unsettled, but there have been no studies on the existence and dimension of these costs in the region. That notwithstanding, the possibility of these costs should be considered before embarking on a debt restructuring exercise. Moreover, the interconnectedness of regional financial institutions, and the paucity of alternatives to sovereign debt may mean that there could be spillover effects that extend beyond the restructuring country. These are some areas in which future research can be undertaken.

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