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A PROPOSAL TO ISSUE SDR-DENOMINATED TREASURY BONDS: THE CASE FOR COLOMBIA

November 2022

CENTRO STUDI SUL FEDERALISMO

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November 2022

RTI Paper no. 16

CENTRO STUDI SUL FEDERALISMO

ISBN 978-88-31479-15-8

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A Proposal to Issue SDR-Denominated Treasury Bonds: The Case for Colombia

*by Alfonso Iozzo, Fabio Masini, Albertina Nania**

Introduction

History is marked by several episodes of sovereigns deciding to issue debt denominated in foreign currencies (Dammers and McCauley 2006). With credibility a key feature in financial markets, governments may deem it necessary to commit to repaying debt in a more widely accepted currency when a sovereign's reputation has deteriorated. This, for example, was one of the main reasons for the dollar-denominated bonds issued by European countries that contributed to the growth of the Eurodollar market in the 1970s.

Debt denominated in basket currencies is a more recent innovation, not least because basket currencies were not as common on financial markets until the founding of the European Monetary System in 1979. We can suggest that bi-metallism provided a similar monetary anchor, relying on some sort of basket of both gold and silver, and there are plenty of historical examples of this, at least since the Latin Monetary Union in the late 18th Century.

Bonds denominated in foreign currencies have also contributed to the increasing role of an external (monetary) constraint in forcing domestic policymakers to pursue stable financial policy positions, as has constantly been a key tract of Italian economic policymaking, at least since the late 1970s. It is no coincidence that the infamous and path-breaking work on *The advantage of tying ones hands* came from two Italian authors (Giavazzi and Pagano 1988).

While an assessment of the efficacy of the external constraint in promoting healthy budgetary policies remains controversial, bonds denominated in foreign currencies have provided an effective tool to protect businesses from the risks of foreign exchange rate volatility, thereby helping to stabilise private markets.

The transition towards an increasing role for basket currencies globally is nevertheless currently in jeopardy. Despite dramatic changes in the balance of economic power over the last fifteen years and the increasing pressures towards multilateralisation of the international monetary system, which have had minimal impact on the structure of global economic and monetary institutions, the recent invasion of Ukraine by Russia and the threat to European economic sovereignty through the weaponisation of energy have left no choice but to rely once again on US military assistance and deterrent capacity, which is reflected in a return to the hegemony of the dollar on financial markets.

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Concrete actions are needed to restore the path to economic and financial multilateralisation that reached its peak in August 2021 with the IMF issuing an unprecedented amount of SDRs. Following the speech by the then President of the Central Bank of China in 2009 (Zhou 2009), international institutions realised that solving the Triffin dilemma was becoming a pressing need to ensure the stability of the international economic and monetary system.

Latin America is today in a critical, and at the same time potentially favorable, position to take one of these actions. The political homogeneity of most national governments can revive interest in regional integration and attempt to build a bloc with ambitions to be a global player in a future multi-polar system. Despite a systematic *stop and go* trajectory, regional integration in Latin America has solid historical roots (from Kemmerer's mission between the two World Wars) and, pending the construction of more robust regional institutions, a renewed common strategy towards global multilateralism may prove successful.

Hence the time might be ripe for a proposal regarding the issuing of SDR-denominated Treasury bonds in one or more Latin American countries. A modest initiative, in quantitative terms, by a small country in a key area of the world could provide the trigger for future action in the same direction, helping to develop a liquid market for SDRs-denominated bonds, thereby contributing to relaunching multilateralism worldwide.

Colombia, in particular, could fit this agenda. The recent change in the political majority in the government of the country, the growth dynamics experienced in recent decades, and its financial weakness may provide incentives for an initiative aimed at strengthening the country's credibility on global financial markets. To illustrate the case, we will first briefly recall the pioneering antecedent of Italian ecu-denominated T-bonds issued in 1982; in the second section we describe the macroeconomic situation of Colombia, before providing some concluding remarks.

1. A historical antecedent: Italy, 1982

On March 13, 1979, the European Monetary System was officially adopted. A year later, in June 1980, Robert Triffin launched an initiative in support of a massive spread of ecu-denominated financial assets to strengthen the European capital market (Iozzo, Flor, Tosolini 2014), thus paving the way for many of the initiatives which would lead to the single currency by the end of the decade[1].

Meanwhile, the shift in US monetary policy towards a restrictive stance has resulted in a dramatic appreciation of the dollar, which has impacted on an already critical macroeconomic situation of high inflation in Europe. The pressures of increasing interest rates were jeopardising the prospects for economic growth, especially in peripheral (or semi-peripheral) countries such as Italy.

It is within this evolving European and international framework that Italian decision-makers were acting in those years. Since the mid-1970s, Italy has seen a general conversion in the theoretical

[1] https://www.cvce.eu/en/education/unit-content/-/unit/32211249-e856-4268-b787-3e816f0764db/e900134f-f97e-4a1f-b0b5-c9b120e5a0c0/Resources#58befa59-13d3-433b-a34a-9d4877f01969_en&overlay

attitude of the economic policy elite governing the country, which has had an impact on the Bank of Italy and the Italian political class, both in the ruling party and the opposition (Cattabrini, Masini 2016). The main protagonists of this change were Carlo Azeglio Ciampi (Governor of the Bank of Italy since October 1979), Filippo Maria Pandolfi (Treasury Minister from March 1978 to October 1980, who was in office when the lira joined the European Monetary System), Tommaso Padoa-Schioppa (who had been seconded from the Bank of Italy to the DG on Economic and Monetary Affairs, of which he was Director from 1979 to 1983), and Beniamino Andreatta (Treasury Minister from October 1980 to December 1982)[2].

The year 1981 marks the so-called *divorce* of the Bank of Italy from the Italian Treasury, whose *marriage* had been agreed upon in the mid-1970s to allow the smooth absorption of Treasury bonds[3]. Ciampi and Andreatta had agreed on the *divorce* as a way to reject political pressure to increase public spending and, implicitly, as a commitment to stabilise exchange rates, as failing to do so would result in expensive debt servicing. The expectation was that this external constraint would help stabilise budgetary demands. The inability of governments at that time to resist this temptation indeed resulted in a skyrocketing increase in the Italian debt-to-GDP ratio from 57% to 94% during the 1980s.

It was also a matter of economic efficiency. Andreatta was simply convinced that an expansionary budgetary position would only increase inflation, rather than boost demand and encourage greater productive capacity; hence the need to return to an external constraint to limit the room for manoeuver (Salsano 2009, 56). As has been observed by Molho (1991, 6): "since the inception of the EMS, a non-accommodating exchange rate policy has been one of the central elements of Italy's fight against inflation. The policy consisted in deliberately keeping the nominal rate of depreciation of the lira below Italy's inflation differential vis-à-vis its main trading partners, so as to force domestic producers to seek cost savings through better wage discipline and more gains in productivity". Hence the remarks by Fabrizio Saccomanni (1989): "the recourse to ECU denominated issues by the [Italian] Republic must be viewed in the broader context of the strategy to achieve non-inflationary financing of the public sector deficit".

Meanwhile, in November 1981, the Italian bank Istituto San Paolo of Turin issued an ecu-denominated 7-year bond, following "an issue of ecu 35 million floated by SOFTE" [the Luxemburgish *Societé Financiére pour les Telecomunications et l'Electronique* s.a.] (Tosolini 2014, 41).

A few months later, in February 1982, the Italian Treasury decided to issue ecu-denominated T-bonds for an amount equivalent to 500m liras (with a maturity of seven years), which became 1,200m by the end of that year. It was a small amount[4], but it would be followed by other issues in the following years. The interest rate was set at 14%, four percentage points below the market rate for similar lira-denominated bonds (at 18% in 1982).

The nominal interest paid was lower – thus giving an incentive to the issuing body (the Italian Treasury) – but would have to be repaid in ecu, thus providing buyers with protection against

[2] Although there has been some discussion of the role of each of them in these changes, a general approach that considers them as a group is still missing in the literature. And the time is ripe for such an analysis.
[3] The Bank of Italy was committed to buy all unsold T-bonds on the market at the price set by the Italian Treasury.
[4] GDP in 1982 was 287.5bn liras and the debt to GDP ratio was 63.1%, equivalent to more than 181bn liras.

depreciation of the lira. In fact, only a few weeks later, the Italian government asked for a realignment within the ecu basket, based on a 6% depreciation of the lira.

The maturity of these T-bonds was set at seven years, so it might be interesting to observe how the yield of these ecu-denominated T-bonds evolved compared to the alternative lira-denominated T-bonds of a similar maturity (the 10-year T-bonds), given the depreciation of the Italian lira against the ecu. The following table summarises the trend of the relevant data, in particular the opportunity cost for buyers of the 1982 ecu-denominated T-bond, compared to that for buyers of 1982 10-year standard T-bonds.

Year	Official interest rate on 10-year T-bonds	Depreciation Lit/ecu	Nominal differential yield (Lit 1982)	Lit/ecu depreciation rate	Yearly virtual gain ecu vs Lit
1980	16.5				
1981	19	1,297,316			
1982	**18**	**1,323,664**	-4.00		**-4.00**
1983	17	1,349,728	-4.00	1.97	**-2.03**
1984	16	1,380,817	-4.00	4.32	**0.32**
1985	15	1,447,757	-4.00	9.37	**5.37**
1986	14	1,461,987	-4.00	10.45	**6.45**
1987	11.5	1,494,976	-4.00	12.94	**8.94**
1988	12.5	1,537,341	-4.00	16.14	**12.14**
1989	13.5	1,509,586	-4.00	14.05	**10.05**

The time series of the official interest rate on 10-year T-bonds is provided only for the sake of completeness, but the last column is the relevant one. As the data show, the gain from buying 7-year ecu-denominated T-bonds compared to the standard 10-year T-bond denominated in liras has gradually increased due to the systematic depreciation of the lira against the ecu. The issue of ecu-denominated T-bonds has proved successful for private investors, especially in terms of protecting their savings from exchange rate volatility (at least since 1986, as the above table illustrates).

In summary, it was a win-win move, as buyers profited from a bond protected from exchange-rate depreciation, and the Treasury benefited from steadily declining expectations on the interest rate, thus enabling the cost of debt servicing to reduce in subsequent years.

2. New opportunities: Colombia, 2023

A brief review of the economic history of Colombia since the 1960s[5] identifies three main sub-periods, the last one starting in 1991. Colombia has been a rapidly developing country for the last two decades (Fig. 1); with a steadily increasing growth in per capita GDP (Fig. 2).

[5] https://manifold.bfi.uchicago.edu/read/case-of-colombia/section/c2f4865a-0e0f-4749-8d46-76c59599bd91

Figure 1.

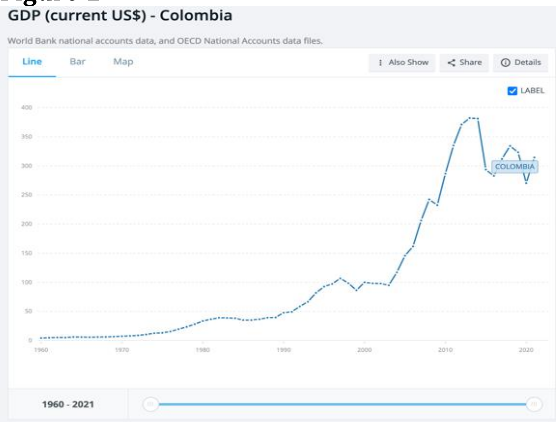
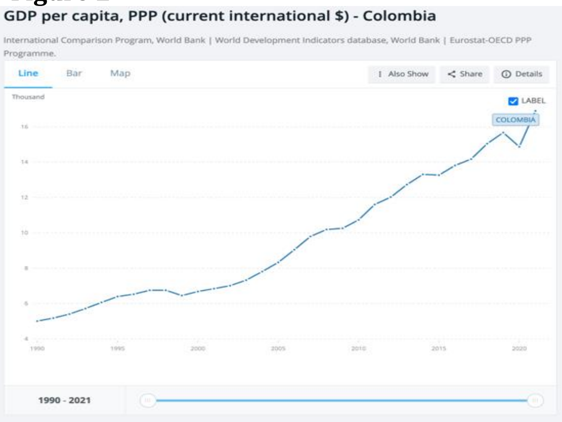


Figure 2.



Source: https://data.worldbank.org/indicator/NY.GDP.MKTP.CD?locations=CO
Source: https://data.worldbank.org/indicator/NY.GDP.PCAP.PP.CD?locations=CO

At the same time, the exchange rate of the Colombian peso has dropped to a record low of 0.0002 against both the euro and the dollar (on average, almost 5,000 pesos would be needed to buy one euro or dollar at the end of October 2022, see Fig. 3).

Figure 3.

Source: https://www.xe.com/currencycharts/?from=USD&to=COP&view=10Y

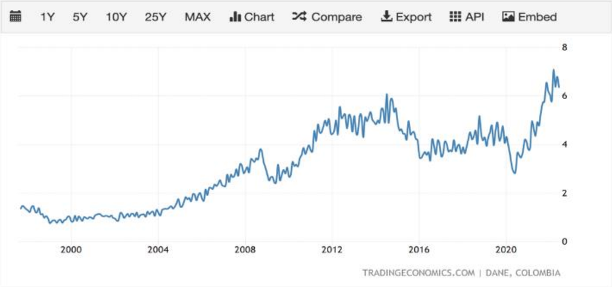
Although the discount rate in Colombia dropped dramatically and stabilised around the 5% target since the early 2000s, it has recently jumped to almost 10%, following the general rise in interest rates across the world (Fig. 4).

Figure 4.

Source: https://tradingeconomics.com/colombia/interest-rate

Despite this forced increase in interest rates to avoid capital flight, savings in the national currency are not safe from the loss of purchasing power against foreign goods and services. Over the past 20 years, imports have increased (in value) from $1bn to around $7bn (Fig. 5).

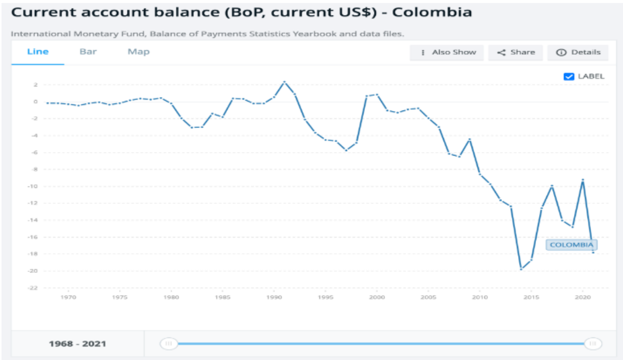
Figure 5.



Source: tradingeconomics.com

This has led to an increase in the current account deficit (Fig. 6).

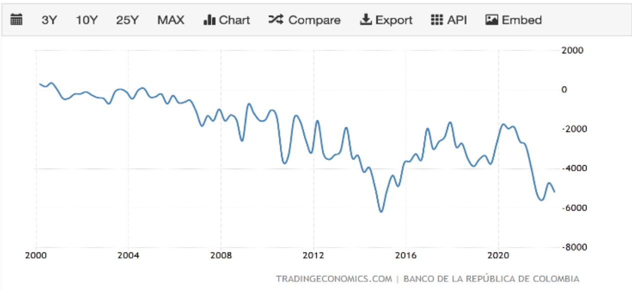
Figure 6.



Source: tradingeconomics.com

This increased exposure of the domestic market to foreign markets is causing a record deficit in the (official) capital account of almost $6bn (Fig. 7).

Figure 7.



Source: tradingeconomics.com

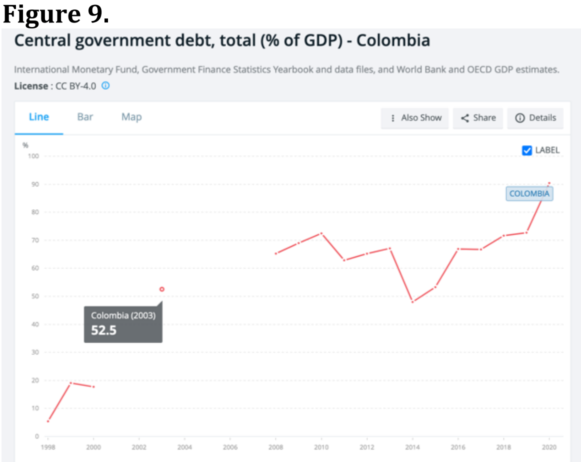
The interest paid on 10-year government bonds is currently reaching 12% (Fig. 8), a figure that could become unsustainable for the Colombian Government, reducing the room for manoeuver for expenses to support the welfare state.

Figure 8.

Source: http://www.worldgovernmentbonds.com/bond-historical-data/colombia/10-years/

Given the expected dynamics of government spending and debt (Fig. 9), servicing this debt could become extremely expensive.

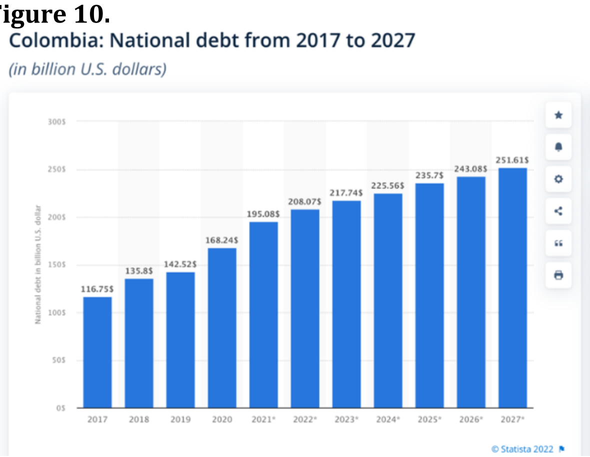
Figure 9.



Source: https://data.worldbank.org/indicator/GC.DOD.TOTL.GD.ZS?end=2020&locations=CO&start=1998&view=chart

A public debt, which in absolute terms is expected to reach $217bn next year (Fig. 10), needs buyers.

Figure 10.



Source: https://www.statista.com/statistics/531426/national-debt-of-colombia/

Here lies an incentive for the Colombian government to explore the possibility of investing in international credibility, by issuing a multi-annual SDR-denominated T-bond.

However, there are at least three features to be considered. First, data show that the market for domestic bonds has become increasingly international since 2014[6] and that in 2019, in Colombia, 33% of its Treasury bonds were already denominated in foreign currencies[7], mostly in US dollars. The recent turbulence in international currency markets, with the dramatic appreciation of the US dollar, will nevertheless force the government to find more money to repay this foreign debt at maturity.

Second, one major short-term benefit would be the reduction in the burden of servicing that debt, which is sold at a lower interest rate. Third, as the SDR is a basket of currencies, its value is relatively stable, especially in times of global economic hysteria.

It is true that the dollar might currently be at its peak, but the exchange rate of the peso against the dollar may not be able to profit from the (potential) decrease in the external value of the US currency. It should not be difficult to find an interest rate that would appeal to domestic investors, while protecting against turbulence in the exchange rate markets and providing a widespread commitment to stabilise both monetary and budgetary policies. The price, maturity, and all other technical aspects of these issues could be subject to further investigation if the political will emerges.

For those who might have concerns about this move, we should probably emphasise that there is no need for a major (in quantitative terms) issue. As was the case for Italy in the early 1980s, what proved to be crucial was the signal to financial markets and businesses that planning several small issues could serve the purpose of a growing convergence of interests between the absorption of such new bonds from foreign markets and the need to increase and spread confidence in the positive effects of such a move.

This issue would provide a further incentive to other countries to make a similar choice, thus strengthening the commitment of Latin America to act in line with the multilateralisation of the international monetary system, which would consequently boost not only Latin American countries and the dynamics of regional integration (with their positive spillover effects) but also the whole world order.

Concluding remarks

In the early 1980s, with a rapidly evolving regional monetary integration in Europe and a global framework of rising (US-led) interest rates, the Italian Treasury bet on the issuing of ecu-denominated Treasury bonds, based on the expectation that this would represent a win-win situation for both buyers and sellers (the Italian Treasury).

[6] https://www.bis.org/publ/bppdf/bispap113_f.pdf

[7] https://economicresearch.bnpparibas.com/Views/DisplayPublication.aspx?type=document&IdPdf=38520

For buyers, the incentive has been to bet on the deprecation of alternative saving options, as the 10-year T-bonds in liras, as well as gain the benefit of a currency basket that would allow for lower transaction costs in trade. For the Treasury and the entire system of Italian public administration, it was a bet on the commitment to pursue a credible stabilisation policy, thus assisting the process of lowering inflation and interest rates. From both these points of view, the move has proved to be successful.

We have suggested here that a similar experiment today could give Latin America, in particular the Colombian economy, the opportunity to become a new global player in terms of promoting the use of SDRs and their implicit multilateralisation project.

Colombia's weak financial position, combined with the excellent macroeconomic performance in terms of growth in recent decades, may suggest that an investment in international credibility could prove successful. Moreover, this decision could lead the way towards strengthening regional integration in Latin America, in view of a new international monetary order, relying less on the hegemony of the dollar (or an ill-conceived duopoly) and more on an equitable balance of power and sharing of the burden of adjustments to address global macroeconomic imbalances.

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