PART I
INTRODUCTION AND OVERVIEW

1 INTRODUCTION

Vinod K. Aggarwal and Brigitte Granville

The problem of international debt rarely seems to leave the headlines. In 2001 and 2002, the drastic devaluation and debt default in Argentina propelled its population into misery. Unfortunately, Brazil may be next. In 1997, East Asia faced ruin; and the Russian default followed soon after, in August 1998. In September 1996, the heavily indebted poor countries (HIPC) initiative was announced by the World Bank and the International Monetary Fund (IMF), not long after the peso crisis in Mexico in the mid-1990s. Previously, in the 1980s, Latin American countries and others in Asia and Africa faced severe debt problems. Going back even further, debt crises and rescheduling were a common phenomenon throughout the nineteenth and twentieth centuries, and even earlier.

Most discussions on sovereign debt start with the assumption that countries should feel obliged to meet their debts in full and on time. The main incentive for sovereign borrowers to repay debt is identified as the potential 'denial of access to foreign finance for an indefinite time after default' (Giannini, 1999: 23). Yet there is little historical evidence that default has led to significant denial of access to external financing.[1] Indeed, frequent debt defaults followed by bailouts have been the rule rather than the exception.[2] In the 1990s, the need for the International Monetary Fund to desvelop ever larger rescue packages for ailing states led to a huge debate. For some such as Friedman (1998), the Asian crisis of 1997–8 was a direct outcome of the encouragement of irresponsible lending in the rescue of Mexico in 1994–5: 'It is not too much to say that had there been no IMF, there would have been no East Asian crisis.' For others such as Fischer (1999), the 1997–8 financial turmoil has shown that an international lender of last resort (LLR) of some kind is needed. Summers (1999: 13) has argued that

[1] See, for example, Cardoso and Dornbusch (1989) and Eichengreen (1991).

[2] Some examples in the 1980s and 1990s of bailouts following debt crises include the 1986–7 Brazilian and Argentine halt in interest payments and IMF lending into arrears; the 1995 IMF and G-7 bailout of Mexico; and the IMF bailouts of East Asian countries and Russia in 1997–8.

'the experience of the 1930s is hardly encouraging regarding the stability of laissez-faire financial systems, be they national or international.' This debate has led to a growing consensus that the economic incentives for lending and borrowing for the private and official sector need to be altered fundamentally.[3]

This emerging consensus has led to two parallel initiatives with respect to lenders and debtors. Concerning official lenders, it is felt that the private sector must not be 'bailed out' but rather be 'bailed in', thereby forcing it to share in the pain of debt rescheduling. This initiative has come to be known as 'private-sector involvement'. This consensus has its origin in the Mexican debt crisis of 1982. Given that the IMF had neither the resources nor the facilities to disburse the necessary financing with adequate speed, governments and the IMF demanded contributions from private banks in exchange for their involvement in official lending and in devising an adjustment programme for Mexico. The procedure of bailing in the private sector became known 'by a variety of names, most politely "concerted lending", more clearly as "involuntary lending", and mostly (by the bankers) as "forced lending"' (James 1999: 6–7). As for debtors, particularly very poor countries, the linkage of debt forgiveness to poverty reduction – codified in the HIPC initiative – has sought to ensure that they use debt relief as a means to achieve long-term sustainable development that will prevent further sovereign debt defaults. Both of these initiatives have made some progress in reshaping the international debt regime, but continue to evolve in an uncertain environment of a fragile international economy.

This book examines the origins of debt crises, debt rescheduling and efforts to create a more enduring solution to the problem of coping with debt. It concentrates primarily on the past 20 years, and draws on a variety of political and economic perspectives. Its focus is on debt owed to both the public and the private sector. The book is interested in systemic aspects of the international financial system as they relate to the onset of international debt problems, as well as in the negotiations involved in rescheduling debt. It is especially concerned with the HIPC initiatives and the prospects for this approach to provide debt relief. It also attempts to provide policy recommendations for dealing with the onerous problem of debt default and rescheduling.

This book does *not* consider the debt experiences of individual states or delve deeply into the domestic political economy of debt, topics that have been addressed at length elsewhere (Haggard 2000). Nor does it formally model the process of debt negotiations between creditors and borrowers.[4]

Part I provides an overview of debt rescheduling from a historical perspective and examines the background and evolution of the HIPC initiatives. In

[3] Miller and Zhang in this volume and Krueger (2001) have argued that the IMF was trapped into bailing out the private sector.

[4] See Aggarwal (1996) and the citations therein for works that model debt negotiations.

Chapter 2, Vinod Aggarwal reviews the background of debt negotiations surrounding the problem of debt default and rescheduling. After outlining the historical context of current debt issues with a brief review of debt crises going back to the nineteenth century, he focuses on the problems in the 1990s, particularly in Mexico and Asia. He argues that creditor governments have played a crucial role in helping to resolve the complexities of debt rescheduling. He observes that although debtors and creditors can come to agreement in the absence of intervention by the official sector, their negotiations have generally been extremely protracted without that intervention as a means to overcome bargaining difficulties. This evidence contrasts sharply with the current enthusiasm in some circles for 'letting the market function'. Specifically, Aggarwal casts doubt on the prospects for a quick resolution of the problems that Argentina and others are facing in the absence of decisive action by creditor governments or the creation of other mechanisms to promote collective action.

In Chapter 3, Brigitte Granville provides an overview and economic analysis of the HIPC initiatives. She sees a clear case for integrating countries' domestic fiscal constraints more deeply into HIPC2 and for moving beyond standardized criteria to an increasingly case-by-case approach. This approach would incorporate qualitative judgments about governance in HIPCs in terms of not only governments' commitment to reform and capacity for it but also the quality of future governments likely to emerge given HIPCs' political systems and culture. She finds that apart from the HIPC scheme itself, the chances of achieving its objectives would be enormously enhanced if much more serious steps were taken to open markets in both developed and developing countries and to put a stop to subsidies – especially to export credits when they produce new debt obligations for poor countries.

Part II turns to an examination of the structure of financial markets and to measurement issues with regard to balance sheets. In Chapter 4, Deepak Lal traces the origins of debt crises in the 1980s and 1990s and considers the lessons that might be learned. He suggests that bank lending, the use of adjustable peg exchange rate] systems and poor domestic macroeconomic and structural policies are at the heart of debt problems. But he also argues that the roles played by the World Bank and the IMF have helped to create, and have subsequently aggravated, the debt crises. He suggests that these institutions have generated a moral hazard problem by encouraging banks to take excessive risks in lending to developing countries and by creating expectations that they will be bailed out if they run into trouble. From a policy perspective, he advocates that the IMF and the World Bank should be eliminated, to remove a major source of debt crises.

In Chapter 5, Daniel McGovern provides an alternative view of the origins of debt crises since the 1980s. He focuses on the increasingly complex array of financial instruments that have been introduced into the market and argues that official intervention has exacerbated the problem of market volatility and risk. In particular, he argues that major problems began after the debt rescheduling in the mid-1980s, when multilateral institutions and governments started pressuring banks to increase their loan loss provisions and accept write-downs on a portion of their loans in order to relieve the debt burden of developing countries. Moreover, the creation of Brady bonds as part of the write-down effort in 1989–93 may have encouraged debtors to seek bond financing in the 1990s. Add the increasing financial integration resulting from deregulation, and the stage was set for a new series of financial crises. Looking forward, McGovern remains wary of calls for more active international regulation of markets, preferring an improvement in the process of debt-rescheduling negotiations.

In Chapter 6, Liz Dixon, Andrew Haldane and Simon Hayes argue that balance sheet disparities played a key role in instigating and aggravating macroeconomic shocks such as the Mexican peso crisis and the Asian financial crisis. Drawing on their theoretical model and the empirical evidence for the link between financial crises and balance sheet positions, they conclude that balance sheet mismatches are critical in recent financial crises. The authors then turn to a discussion of the ways of measuring national balance sheets, focusing on how the nature of debt or equity instruments, the liquidity characteristics of assets and liabilities and the currency of assets and liabilities may all point to debt susceptibility and capital flow reversal. For monitoring balance sheet risks, they consider data provided by the World Bank, the BIS, the IMF and national statistical sources and then discuss the value of alternative indicators of debtor vulnerability thresholds. Lastly, Dixon, Haldane and Hayes consider the initiatives that have been taken by the official financial community to help states manage national balance sheets. They call for better efforts to measure and monitor balance sheets in order to contain financial crises preemptively as much as possible.

In Part III, the contributors provide a series of analyses of managing debt crises. In Chapter 7, Stephany Griffith-Jones focuses on how to prevent debt crises and how to deal with them when they occur. In reviewing instruments that governing bodies have developed to try to prevent debt crises, she finds that some progress has been made, notably in the IMF's Contingency Credit Line, which is intended to aid countries affected by financial crises in neighbouring states, and the Financial Stability Forum (FSF), a talking-shop for developing international financial regulation. However, progress has been asymmetrical, in three respects. First, it puts a heavy burden on the developing countries, which must make changes to national laws while leaving unchanged the regulations on private international financial institutions. Second, it fails to provide developing countries with a powerful voice in institutions that govern international finance. Third, it has not sufficiently addressed the problems of low-income countries.

She then turns to the prospects of improving international information and regulation, arguing that the IMF, the FSF and especially the BIS pool information on rapidly changing international financial markets so that central banks can access it easily. Griffith-Jones also examines the need for better international regulation, which would benefit both less developed countries and private financial institutions, and calls for the regulation of international portfolio investment.

In Chapter 8, Robert B. Gray provides a sharply different viewpoint. He challenges the prevailing assumption that private finance does not share enough of the burden of debt rescheduling in emerging markets, arguing that the private sector has become more and more involved in resolving and preventing financial crises. In tracing debt rescheduling from the Brady plan to the 1994 Mexican peso crisis, he suggests that the latter marked a turning point in crisis-resolution strategies. The Brady plan involved close cooperation among creditor governments, public financial institutions such as the IMF, and private banks; but since 1994, creditor governments have favoured a market-led solution. Gray also argues that 'burden-sharing' can lead to creditors being pressured into generous rescheduling by politically motivated Paris Club governments and that a disproportionate rescheduling burden on investors may lead to a precipitate fall-off in lending to emerging markets. Banks should adopt a generally accepted 'code' of good market behaviour. In addition, freely negotiated debt restructurings are more desirable than the 'concerted lending approach' of the 1980s; the Paris Club's 'comparable treatment' norm should be re-examined; and debt negotiations should be both more transparent and less protracted.

In Chapter 9, Marcus Miller and Lei Zhang call for a focus on creditor coordination rather than liquidity provision as the best way to handle sovereign liquidity crises. They argue that because of potentially adverse effects on incentives, the above-quota 'official liquidity injections' (that is, bailouts) in Mexico and East Asia point to the need for standstills followed by debt restructuring. This strategy could incorporate the use of *ex ante* financial contracts that specify guidelines to be followed in adverse circumstances; debt standstills (that is, temporary measures to reduce the net payment of debt service); and various procedures for restructuring, and possibly write-down, that currently exist only for corporate debtors. The authors examine how the IMF might act like a bankruptcy court to protect debtors from premature liquidation, thereby remedying the current situation in which the international community must either lend to a country with an unsustainable debt burden or force it to undergo a potentially costly and uncertain restructuring process. They consider as an alternative the creation of an international debt-restructuring agency – perhaps to be called the Basle Club – that could act in place of the IMF.

A postscript, bringing Miller and Zhang's discussion up to date, provides an account of the two main proposals for debt-restructuring now being considered, namely the Collective Action Clauses (CAC), proposed by John Taylor of the US Treasury, and the Sovereign Debt Restructuring Mechanism (SDRM), advocated by Anne Krueger of the IMF. It is argued that the two proposals are complements rather than substitutes: the threat of SDRM may, for example, persuade the private sector to design the appropriate contracts.

Part IV examines the problems and possibilities of governance and debt, particularly within the HIPC initiative. In Chapter 10, Thomas M. Callaghy explores the dynamics of Paris Club debt negotiations in the context of the 11 September 2001 attacks. He argues that the changed geopolitical circumstances will make politics more critical than ever in determining debt negotiations, and points to the increased risk of financial contagion. Callaghy finds, first, that within the context of debt negotiations over the past 20 years, the instances of debt rescheduling have not tapered off significantly in number since the end of the 1980s debt crisis. Instead, the focus of rescheduling has, with a few major exceptions, shifted to poor-country debtors. Second, the outcome of debt negotiations has become more favourable to debtors over the years, which he attributes to the 'ratchet effect', in which generous terms granted by the Paris Club to a debtor country set the norm for future negotiations. Often, initial concessions are granted to debtors owing to the political motives of creditor countries; and these then become the norm for debt resolutions regardless of the debtor's political situation, especially if structural conditions in debtor countries make repayment difficult or impossible. Callaghy predicts that Paris Club negotiations are in for another round of 'ratcheting up' in the aftermath of 11 September, as in the case of US concern for Pakistan, and that the presence of financial and political 'double crises' have put the international system in a precarious position. Volatile capital flows and weak growth in OECD economies make it likely that debt crises will worsen in the short term.

In Chapter 11, Edward Fogarty looks at the case of the HIPC initiative as a potential model for a new form of international governance. The HIPC story is largely one of contention and reconciliation between international NGOs and key international financial organizations. NGO networks such as Jubilee 2000 took up the issue of poor-country debt in the early 1990s, and through their effective advocacy and increasingly sophisticated grasp of the technical details of debt they managed to catalyse the transformation of the existing multilateral debt regime. However, once the NGOs overturned the old regime they found themselves facing new responsibilities as leading players in the institutional arrangements; they shared responsibility for generating and implementing debt relief policies with their erstwhile foes the IMF and the World Bank. Through the new system based on the Poverty Strategy Reduction Papers, the debt NGOs have found themselves to be partners with the international financial institutions (and also creditor and debtor governments) in a form of 'decentralized governance' of poor-country debt relief programmes that resembles the policy networks seen in the European Union and the United Nations. As the aftermath of 11 September slowly suffocates the anti-globalization movement, their new responsibility suggests a potentially new role for advocacy networks of NGOs in world politics – to be important actors in the creation and operation of new forms of governance as well as critics of existing structures.

In Chapter 12, Peter M. Haas examines the development of environmental regimes and debt regimes over the past 30 years and probes the link between them. His focus is on the political structure in which environmental regimes emerged and on the actors and institutions that influenced state environmental policy, the evolution of environmental governance and the aggregate effects and effectiveness of different types of regime. Drawing on the literature of linkage theory, he shows that in the 1970s and 1980s increased international concern emerged as a result of several highly publicized environmental disasters in the 1960s. International institutions adopted new missions and policy frameworks based on an improved understanding of ecosystems. In the 1990s, globalization led to deeper shifts in public consciousness on environmental issues and to a greater number of political actors putting pressure on states and other key actors. All of these factors led to the creation of new constituencies for environmental protection. Haas also explores different factors that influence state choices and regime stability, including national leadership, NGOs and civil society, international institutions and the role of the knowledge community. He concludes with a discussion of the implications of environmental governance on debt forgiveness, arguing that the prospect for linking debt relations to the environmental regime tactically, based on power considerations, is modest because of the relative weakness of NGOs versus states. Furthermore, substantive linkages based on knowledge are unlikely because although debt forgiveness will free economic resources, there are many competing demands for these resources and environmental protection is not a high priority. In short, Haas argues that sustainable development and debt forgiveness will prove difficult to reconcile.

In Chapter 13, Aggarwal and Granville attempt to draw some lessons from the varied opinions expressed in this volume. Consensus seems to emerge on four themes: big bailouts should end; the role of the IMF should be limited; disorderly workouts are costly; and although good economic policies should be rewarded, political discretion means that bailouts are generally driven by creditor governments. These views suggest that a major focus of debt restructuring should be on the reform of *ex ante* contracts and on enhancing cooperation between private and public creditors. These changes, rather than the creation of new institutions or a significant modification of the IMF's role, appear to be much more politically and economically *practicable*.

As this outline demonstrates, the origins of debt crises, their resolution and reforms of the financial system remain controversial topics. Dramatically different opinions exist on each of these aspects of the debt problem. We hope that this volume will provide readers with a sense of the richness of the issues that continue to be tackled by scholars and policy-makers both from a theoretical and an empirical standpoint.

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