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International Debt: The Past Quarter Century and Future Prospects

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In the mid-1980s and again in the late 1990s, external debt crises in major developing countries posed serious risks to the stability of the international economy. Fred Bergsten and the Peterson Institute for International Economics have played an important role in providing timely research that helped shape policy responses to these crises. This chapter first provides a brief analytical review of these episodes and highlights some of the Institute studies that contributed to the ongoing policy debate. It then turns to a diagnosis of where developing-country debt stands today and considers future prospects for emerging capital markets.

Principal Phases in the Past 25 Years

The external debt of developing countries was not an issue in the first two decades of the postwar period. The widespread defaults of the 1930s had choked off the bond market, and a commodity boom and buildup in reserves in the early postwar period had limited demand for new borrowing. By the 1960s lending was rising again, but primarily in the form of of-

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ficial loans. Nevertheless, by late in that decade there was rising interest in analysis of debt-carrying capacity, in part to identify critical thresholds warranting the rescheduling of export credits by the Paris Club.[1]

Two developments sharply escalated private lending to developing countries in the 1970s, setting the stage for the debt crisis that was to follow: the OPEC oil price shock and the advent of syndicated bank lending at variable interest rates. The former boosted borrowing demand in nonoil developing countries (and the borrowing capacity of those with oil) as well as the supply of foreign capital in the form of OPEC surpluses seeking an investment outlet, abetted by international public calls encouraging this "recycling" of petrodollars. The latter enabled a new form of financial intermediation to replace bonds, the dominant prewar lending vehicle discredited by the interwar defaults. Initially it was little recognized that the surge in bank lending was also potentially placing industrial-country banks in jeopardy.

The International Debt Crisis, 1982–89

Early '80s: Debt Suspension and Concerted Lending

The second oil price shock of 1980, the Volcker interest rate shock of 1979 designed to halt historically high US peacetime inflation, and the severe global recession of 1982 combined to make the rising external debt obligations of major developing countries increasingly precarious and vulnerable to a cessation of new capital inflows. Overly expansive domestic economic policies in many borrowing countries had made them vulnerable to these external shocks. Early signs of the debt crisis included Poland's debt rescheduling in 1981 and Argentina's disruption of debt servicing in early 1982, both related in part to political events (a military crackdown and the Falklands War, respectively). Then Mexico's suspension of payments on external debt in August 1982 marked the onset in force of the Latin American debt crisis. With the exception of Colombia, every country in that region soon was subsequently forced to reschedule external debt. The crisis spilled over to countries outside Latin America as well, as reschedulings of bank debt were forced in Côte d'Ivoire, the Philippines, Romania, and Yugoslavia (World Bank 2004, 66–75).

The stakes were high not only for the debtor countries but also for the industrial countries. For the 13 largest US banks, exposure to just five Latin American countries (Argentina, Brazil, Chile, Mexico, and Venezuela) amounted to an average of 153 percent of bank capital; for one large bank (Manufacturers Hanover) the ratio was 263 percent (Cline 1983, 34). A sudden loss of the bulk of these claims would have threatened bankruptcy for

1. For an early statistical analysis, see Frank and Cline (1971).

much of the US financial system. The vulnerability of European banks was only moderately smaller, as bank claims on the 30 or so largest developing countries stood at about 170 percent of bank capital for France, 120 percent for the United Kingdom, and 50 percent for Germany (Cline 1995, 78–83).

The international policy response was to provide financial rescue packages that involved International Monetary Fund (IMF) lending and "concerted" lending by foreign banks, combined with the rescheduling of debt coming due. In this first phase, there was largely "maintenance of value" rather than debt forgiveness, although there was some modest trimming of interest rates for the rescheduled debt. The IMF acted as the enforcer for collective action by the banks and made it clear that availability of its resources was contingent on new lending by the banks.

The strategy of new lending and principal postponement rather than forgiveness was premised on the diagnosis that most of the major debtor countries had sufficiently strong economies that they could eventually service their debt, so that the problem was one of temporary illiquidity rather than permanent insolvency. This diagnosis was based in part on the view that the "perfect storm" of high oil prices, extremely high international interest rates, and global recession in 1982 would pass and a return to more normal global economic conditions would permit developing countries to grow their way out of the debt crisis, in part through higher exports. The high-water mark of this strategy was in 1984, a year of strong global economic recovery. By 1985 debtor countries were beginning to get frustrated that private voluntary financing was not rebounding.

The Baker Plan, launched in September 1985 by US Treasury Secretary James Baker, sought to shore up the debt strategy by setting a target of $20 billion in new lending by the international banks to 15 (later 17) large debtor countries over three years, carrying further the approach of "concerted lending." Although the popular impression later was that the banks failed to meet these targets, a closer analysis shows that they broadly succeeded in doing so, after taking account of the cases in which countries did not fulfill their conditionality commitments and after recognizing that claim values kept on the banks' books often were falling more from prudential write-downs than from repayments without new lending (Cline 1995, 212).

Late '80s: From Baker Relending to Brady Relief

The collapse of oil prices in 1986 was a severe blow to the strategy of growing out of the debt problem. The damage to oil-exporting debtors such as Mexico, Nigeria, and Venezuela was proportionately much greater than the relief to oil importers such as Argentina and Brazil. There was growing debt fatigue among debtor countries more generally. One reason was that it was becoming evident there was an "internal transfer problem" that supplemented the traditionally recognized external transfer problem of

scarce foreign exchange. Namely, currency depreciation needed to curb imports and boost exports also meant an increase in domestic currency fiscal costs of servicing the external debt, aggravating fiscal difficulties. Perhaps more fundamentally, political perceptions were evolving toward calls for a greater "sharing" of the burden of adjustment by the foreign bank creditors. US congressional sentiment was trending toward concern that US manufactured exports and jobs were suffering to keep up the profits of the banks. New Jersey Senator Bill Bradley called for a plan that involved moderate forgiveness of the debt.

Importantly, a secondary market for bank claims was developing. It typically carried prices in the range of 60 to 70 cents on the dollar in 1986, falling to around 50 cents on the dollar in 1987 after Brazil's suspension of payments. This in turn presented the opportunity for market-oriented debt relief in the form of discounted buybacks. In May 1987, Citibank set aside a large reserve against its developing-country debt, in part to show Brazil it could not be intimidated by default. This move somewhat undermined the notion that preservation of the value of these claims was essential to bank stability, facilitating a move toward debt reduction workout.

In this environment, in late 1988 Mexico once again became the bellwether for the debt crisis as President-elect Carlos Salinas announced that a demand for some debt reduction would be central to his debt policy, presumably for both economic and political reasons. US President-elect George H. W. Bush had met with him and was seen as sympathetic. The new US Secretary of the Treasury, Nicholas J. Brady, became convinced the Baker Plan was not working and would eventually lead to a shift of the debt risk toward the public sector. By March 1989 he announced the Brady Plan, which was designed as a form of voluntary debt relief. The two keys to the plan were the low secondary-market price on the one hand and the offer of long-term collateral for postreduction debt (US Treasury zero-coupon bonds) on the other. Banks agreeing to accept "Brady bonds" could increase their certainty of collection in exchange for a reduction either in interest rate (on "par bonds") or in principal ("discount bonds"). To apply implicit pressure on the banks to agree to debt reduction deals, the IMF changed its policy to allow "lending into arrears," financial support to countries not yet in agreement on debt in default, subject to the country's being engaged in good-faith negotiations with its creditors. Technically the Brady Plan also gave banks the alternative of keeping full face value but providing additional new money, although few availed themselves of this option (in part because "novation" in the Brady bonds in effect gutted the sharing clauses of the preexisting debt). Encompassing first Mexico in 1989, then Venezuela and other countries in 1990, and Argentina and Brazil by 1992, the Brady Plan by 1994 had carried out the conversion of nearly $200 billion in developing-country debt to banks at an effective rate of forgiveness of about 35 percent (Cline 1995, 234).

The Brady Plan had the effect of clearing the air for developing-country access to capital markets. It is arguable that several countries, especially Venezuela, sought and received greater debt forgiveness because of political imperatives than was warranted by their objective situation. Conversely, Chile, with an initially deep indebtedness, eschewed any forgiveness at all.[2] Recent statistical work suggests that the pursuit of unnecessary forgiveness for political reasons has long-term adverse effects on conditions of access to capital markets. Reinhart, Rogoff, and Savastano (2003) identify "debt intolerance" for "serial defaulters," for which safe levels of external debt relative to GDP are much lower than those for other countries. Viewed in this context, it is no accident that three major countries that received Brady relief experienced subsequent debt crises (Mexico in 1994, Brazil in 1999 and 2002, and Argentina in 2002), whereas two that did not seek Brady debt reductions have had no external debt problems in nearly two decades (Chile and Colombia).

The New Emerging Capital Markets in the 1990s

Even taking into account the healing influence of the Brady Plan, the resurgence of capital flows to Latin America in the early 1990s was remarkable. Whereas net borrowing from banks excluding change in interest arrears averaged –$2.7 billion annually for the 10 largest Latin American economies in 1987–91, this average surged to $25.3 billion annually in 1992–94 (IIF 1997). Net borrowing from other creditors, mainly in the new bond market for emerging-market economies, swung from –$900 million annually in 1987–89 to an average of $15.3 billion in 1990–91 and $32.7 billion in 1992–93 before falling to $18 billion in 1994 with the runoff in Mexican tesobonos (dollar-denominated treasury bills) in the run-up to the tequila crisis.

Wall Street popularized the term "emerging markets," which no doubt cast a better image than the previous "developing-country debt." More substantively, three factors drove the resurgence. First, there were underlying improvements for the economies, not just in debt fundamentals with Brady Plan help but also in structural and macro policy reforms. Second, the fact that bonds had been excluded in the Brady relief (mainly because they had been too small to warrant the trouble) gave a seeming preferred status to bond flows over bank claims, setting the stage for a sharp ascendancy in bond lending in the 1990s and a shift away from long-term

2. Perhaps the best measure of debt burden from the standpoint of the long-term external transfer problem is the ratio of net interest payments (i.e., interest paid on debt less interest received on external reserves) to exports of goods and services. This ratio reached a peak of 46 percent for Chile in 1984 and a peak of only 14 percent for Venezuela in 1986 (Cline 1995, 52), yet Venezuela received 30 percent forgiveness and Chile none.

syndicated bank loans. Third, the credit cycle in the United States created a lower-interest environment after the 1991 recession and, as was seen again at the beginning of the present decade, in such an environment investors seek yield where they can find it, whether in below-investment-grade corporate bonds or in emerging markets.[3]

Financial Crises: From Mexico to Argentina via East Asia and Russia

The boom, bust, and resurgence of the emerging capital markets over the past 15 years is shown in figure 11.1, which reports net private flows to 30 large emerging-market economies. These flows more than doubled from a total of $73 billion in 1991 to $185 billion in 1993 and nearly doubled again to a peak of $330 billion in 1996. Then, with the outbreak of the East Asian financial crises, they fell in 1997 and again in 1998 to a low of $137 billion before beginning a recovery. Their collapse would have been even greater had it not been for the resilience of direct investment flows. The sharpest downswing in the financial crises beginning in 1997 was in net lending by banks, which fell from a peak of $116 billion in 1996 to a trough of –$59 billion in 1998. Net lending through bonds and other nonbank sources peaked at $89 billion in 1997 but then fell to a low of $6 billion in 2001.

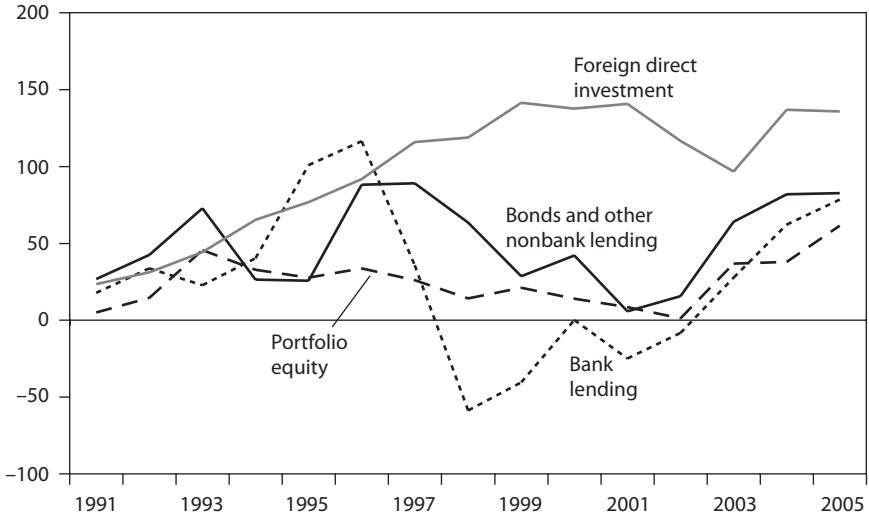
One important pattern for developing-country debt flows in the past 15 years, then, has been volatility. A second has been a steady decline in importance relative to equity flows, especially direct investment. Thus in 1991–93 banks plus bond and other nonbank sources accounted for 57 percent of total net private capital flows to the emerging-market economies; by 2003–05 this share was down to 44 percent. Direct investment alone accounted for 41 percent of total flows by the latter period.

The salient features of the emerging-market boom and bust in the late 1990s are well known. Mexico prefigured the later crises with its 1995 currency implosion. Vulnerable because of a large current account deficit, Mexico experienced a politically triggered runoff in short-term external debt, sharp interest rate increases in response, a severe recession, and a crisis in the banking sector. It also heralded the advent of the new form of financial rescue, which involved high emergency lending from the IMF (and, for Mexico, the United States) but an absence of private debt restructurings, because this time the claims in question were short-term government obligations widely held by investors in capital markets rather than long-term syndicated bank loans held mainly by a short list of large

3. The interest rate on the 10-year US Treasury bond fell from 8.6 percent in 1990 to 5.9 percent by 1993 before rising again to 7.1 percent in 1994 (a factor that contributed to the tequila crisis).

Figure 11.1 Net foreign private capital flows to major emerging-market economies, 1991–2005

billions of US dollars



Sources: Cline (2001), IIF (2006).

banks. By 1996 the seeming success in managing the Mexican crisis coincided with a global liquidity boom marked by falling risk spreads not just for emerging markets but also for high-yield corporate bonds, fueling the surge of emerging-market lending to new highs.

In this environment, short-term bank lending to East Asia rose particularly rapidly. In the case of Korea, these flows were artificially spurred by Korea's liberalization of short-term capital flows combined with the international bank supervision practices that allowed zero risk-weighting for short-term claims on members of the Organization for Economic Cooperation and Development (OECD), which by now included Korea. In contrast, Korea in effect maintained restrictions on the safest form of capital inflow—direct investment.

Thailand initiated and typified the region's ensuing financial crisis. It maintained an overvalued fixed exchange rate in the face of a large current account deficit and reserve levels that (after adjusting for forward operations) were perilously low. The collapse of its exchange rate in mid-1997 eventually set off a round of contagion that hit Korea, which had extraordinarily high short-term debt and extraordinarily low reserves, and Indonesia, where it became clear that the much vaunted growth record was vulnerable to corruption, political upheaval, a weak banking system, and lack of an effective mechanism for collateral recovery through bankruptcy operations in the private sector. Adjustment in the region typically in-

volved sharp exchange rate depreciation, steep increases in interest rates to keep exchange rates from falling even further, and fiscal tightening—the latter subsequently officially regretted by the IMF as overkill in the adjustment programs.

Whereas the Latin American debt crisis of the 1980s had involved long-term bank claims on governments and the tequila crisis involved short-term investor claims on the government, the East Asian crises tended to involve short-term bank claims on banks and corporations, typically linked to relending by domestic banks for speculative real estate and other investments. The crises thus became domestic banking crises that required large public-sector support to the banking systems. For Korea and Thailand, the crises were essentially liquidity crises, and indeed in the case of Korea the conversion of short-term foreign bank loans into three-year, government-guaranteed loans to Korean banks at nonpunitive spreads was a key to the solution. In contrast, in Indonesia the workout essentially took the form of self-awarded debt forgiveness to domestic corporations, which shirked collateral obligations thanks to an ineffective bankruptcy regime.

As in Mexico, in the East Asian crises there were again large IMF support programs; indeed, this time there was a formal adoption of a new IMF lending vehicle for crisis resolution, the Supplementary Reserve Facility, designed to have much higher lending limits than normal relationships to IMF quota. Debate continues to this day on whether the IMF conditions were too severe (and, in Indonesia in particular, too pervasive and intrusive); certainly the collective memory in the region seems to be that they were (in Korea the 1998 recession is called the IMF recession). Many even blame the massive accumulation of reserves in several East Asian economies today on the desire of authorities to avoid ever again being dependent on the IMF. However, reserves have by now far surpassed levels needed for this purpose and instead almost surely reflect the desire to keep exchange rates undervalued and exports highly competitive despite large current account surpluses, as well as the collective action problem that no country wants to be the only one to appreciate and thereby undermine its competitiveness.

Korea and Thailand emerged fairly promptly from their currency and financial crises, and in the region the Philippines avoided severe contagion, and Malaysia weathered it as well (whether or not due to the controversial imposition of controls on portfolio equity outflows). Whereas average real growth for these four countries fell from 6.9 percent in 1996 to 4.2 percent in 1997 and plunged to –8.1 percent in 1998, by 1999–2000 growth was back to about the 7 percent level. Large-scale liquidity support by the IMF succeeded in stemming the crises, albeit with major losses on claims against private corporations in the case of Indonesia.

Coming on the heals of the East Asian crises, Russia's default and devaluation in August 1998 turned the year into an annus horribilis for emerging-market finance. A collapse in oil prices, inadequate fiscal policy

in the face of weakness in political leadership, chronic capital flight, and failure of an exchange rate–based stabilization program all contributed to the collapse. The government imposed a severe reduction in the value of short-term government bonds denominated in dollars (GKOs). Both the unilateral nature of Russia's actions and the fact that the crisis was the first to involve outright default and reduction of government debt value in the post-Brady period meant that the Russian shock to emerging markets was severe. The average spread for Latin American governments in the JPMorgan Emerging Markets Bond Index (EMBI) soared from 500 basis points in mid-1998 to 1,500 in August, and remained above 1,000 basis points until late 1999 (Cline 2003a, 481).

Contagion from Russia in turn doomed Brazil's attempt to continue the use of an exchange rate anchor for its so far successful Real Plan stabilization program dating from 1994, and by the turn of the year Brazil was forced to depreciate its currency sharply. In early 1999 there were widespread expectations of a return to high inflation in Brazil and even a new round of debt default. However, the government remained committed to fiscal adjustment and the privatization and other structural reforms of the Real Plan. Large and timely IMF support enabled the government to overcome a liquidity problem rather than slide into default. In part because of domestic recession but also thanks to fiscal restraint, Brazilian domestic prices rose far less than might have been feared based on the country's past history of response to exchange rate depreciation. After anemic but positive growth in 1999, Brazil returned to strong growth in 2000.

Ecuador did not fare as well in facing contagion from both Russia and Brazil. Its crisis in 1999–2000 took on systemic importance because as part of the resolution Ecuador became the first country to default on its already reduced Brady debt.[4] Private-market perceptions widely interpreted the move, moreover, to have been encouraged by the IMF. Even so, the impact on emerging bond markets was minimal.

In 2000 through early 2002, Turkey faced a persistent financial crisis and received successively higher IMF support that eventually reached a peak of 12 percent of GDP (Cline 2004, 2005c). The central problem was market doubt about sustainability of public sector debt, which in turn reflected extremely high real interest rates associated with the watershed transition from chronically high inflation to relative price stability, along with delays in privatization and other reforms. As the principal creditors to the government, the domestic banks particularly were in jeopardy. Forceful fiscal adjustment and a high primary surplus helped rebuild market confidence, and by 2004 inflation had fallen to single digits. Turkey had repaid

4. It was not the first to restructure bonds, however. Pakistan did so in 1999, when the G-7 insisted that private bondholders participate in parallel with Paris Club rescheduling. However, the restructuring was essentially on nonconcessional terms, at an interest rate of 10 percent (Cline 2003a).

about one-sixth of its peak IMF debt by the end of that year and more than half by mid-2006 (IMF 2006a).

The next major episode of emerging-market crisis in the troubled five-year period beginning in 1997 was the "3-D" crisis of Argentina, involving default, devaluation, and depression. Argentina's real output had been stagnating since its peak in 1998, reflecting in part the consequences of the fixed exchange rate under the quasi–currency board arrangement. There were external shocks from the sharp devaluation by Brazil, Argentina's largest trading partner; from the surge in emerging market spreads; and from the strong appreciation of the US dollar and hence the peso pegged to it. Recourse to high real domestic interest rates was the primary policy response, but these prolonged the recession and aggravated fiscal weakness, which was compounded by provincial deficits and a shift toward privatized social security accounts. There were increasing doubts about long-run government debt sustainability. A brief attempt to stimulate growth through fiscal incentives was followed by an about-face involving a 15 percent cut in government wages and pensions in July 2001, but by then political coherence was collapsing, in part because of the refusal of Peronist provincial governors to support the Radical Party president. After one last IMF lifeline extended in August (wrapped in ambiguous calls for debt reduction by US Treasury Secretary Paul O'Neill), by the end of 2001 there was a political collapse involving street riots supported by some Peronist groups, and after several riot-related deaths the finance minister and president resigned. The first of a flurry of successors declared a default on debt and devaluation of the currency, which promptly moved the peso from 1 to the dollar to about 3. Ensuing politically motivated measures to soften the blow for Argentine debtors owing dollars brought such anomalies as asymmetric conversion of bank assets and liabilities from dollars to pesos, causing banking system losses as well as a freeze in electricity and telephone rates despite contracts with foreign firms providing for dollar indexation. By 2003 the successor Peronist government of Nestor Kirchner imposed an essentially unilateral debt restructuring of some $100 billion in public debt. Concluded in early 2004, the restructuring was on terms far more severe for creditors than any experienced in the Brady Plan and on a par with the deep cuts usually reserved for heavily indebted poor countries (HIPCs). Crucially, the Argentine default and deep forced forgiveness appeared to have little contagion effect for emerging markets in 2002–04. The discussion below returns to the implications of the Argentine default.

The final major crisis in these difficult years for emerging markets was once again in Brazil, this time because the markets reacted severely when it became apparent that long-time radical leftist candidate "Lula" would likely win the October 2002 presidential election. The IMF called for all candidates in the election to pledge to maintain fiscal equilibrium, and Lula agreed to do so. Once again a large IMF program enabled Brazil to weather the liquidity problem, and after a surge in spreads to levels in the

range of 2,000 basis points in the second half of 2002, by mid-2003 spreads were back down to about 750 basis points. Once again there was a growth recession, but by 2004 relatively strong growth had returned. Importantly, the Argentine example did not prevent Brazil from overcoming its liquidity crisis in 2002. There was no complete market cutoff stemming from Argentine spillover, nor did the G-7 put an end to large IMF rescue support on grounds that Argentina showed this strategy did not work. Instead, the IMF's requirement of presidential candidates' endorsement of fiscal equilibrium reflected the lesson from Argentina that domestic political commitment to fiscal adjustment was an important precondition for large external support.

2002–05: Easy Money and Emerging Markets Redux

Despite the experience with Argentina and the largest default on external debt in history, the first half of the present decade has turned out to be extremely favorable for emerging capital markets. The underlying reason has been the low level of global interest rates and the strong trade performance of developing countries associated with high levels of global growth. Figure 11.2 shows the strong upswing in current account balances in Asia-Pacific and Latin American emerging-market economies from the late 1990s to 2005. There was a smaller upswing in the European and Africa–Middle East emerging-market economies.

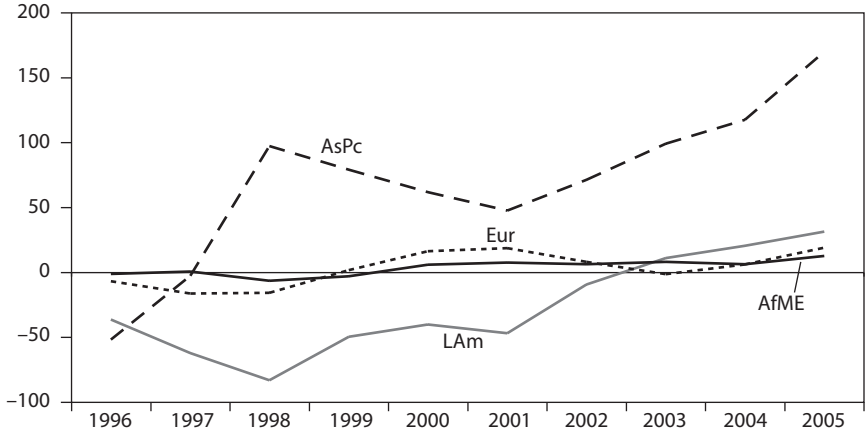
Figure 11.3 reports emerging-market borrowing spreads above US Treasury bond rates. There was a plunge of the US policy (federal funds) interest rate to historic lows in 2002–04. This decline was broadly accompanied by a systematic narrowing of emerging-market risk spreads, as measured by the JPMorgan EMBI.[5] Investors seeking higher yields boosted potential capital supply, even as a swing from current account deficit to surplus for emerging-market economies reduced potential demand, so the price premium for emerging-market borrowers fell sharply.

The concluding section of this chapter considers whether the favorable conditions for emerging capital markets will continue. At the outset, however, it should be stressed that two features of the recent configuration are troublesome. First, it involves a large aggregate current account surplus, rather than deficit, of the major emerging-market economies. This means that in recent years they have been net suppliers of real resources to the industrial countries (mainly the United States) rather than net recipients of resources. This amounts to a perverse flow of capital and resources in terms of the standard theory of capital flows and development, in which return on capital is presumed to be higher in developing countries than in industrial countries and so capital and accompanying real resources are

5. EMBI through July 2004; EMBI+ thereafter.

Figure 11.2 Current account balances of major emerging-market economies, 1996–2005

billions of US dollars

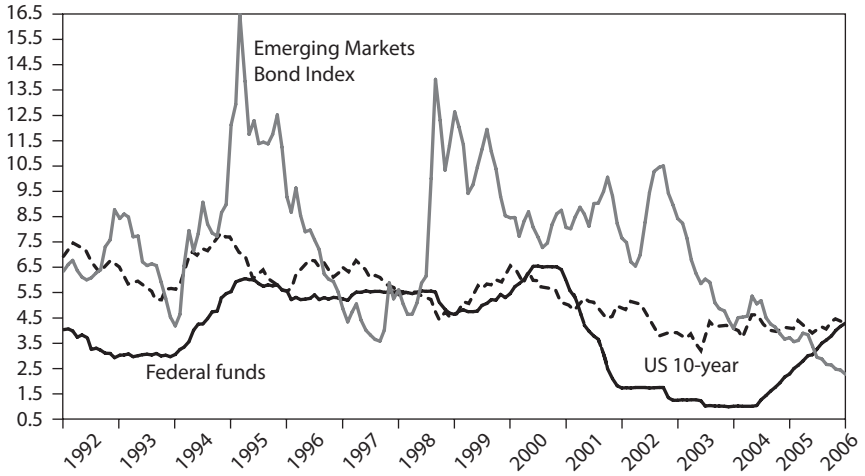


AfME = Algeria, Egypt, Morocco, South Africa, Tunisia
AsPc = China, India, Indonesia, Korea, Malaysia, Philippines, Thailand
Eur = Bulgaria, Czech Republic, Hungary, Poland, Romania, Russia, Slovakia, Turkey
LAm = Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Uruguay, Venezuela

Source: IIF (2006).

Figure 11.3 US interest rates and emerging-market spreads (EMBI), 1992–2006

percent



Note: Data are monthly for the years indicated and January of 2006.

Sources: IMF (2006b); JPMorgan, MorganMarkets.

presumed to flow from the industrial countries to the developing countries. Second, this unusual pattern has been the counterpart of a rise in the US current account deficit to historically high levels. The large US deficit poses a risk to both the US and global economies, and if US external adjustment does not occur smoothly, the result could be a severe shock for developing countries.

HIPC Debt Relief

A final key feature of global debt in recent years has been the arrival of debt forgiveness for HIPCs, the logical consequence of successive episodes of official debt relief for these countries, starting with bilateral debt. The Paris Club initiatives for granting forgiveness of bilateral debt owed by low-income countries constitute a string of metropolitan names each successively increasing the extent of forgiveness. Starting with the "Toronto terms" of 1988 forgiving a third of the debt for low-income countries, the bilateral donors deepened their forgiveness to 50 percent in London (1991), 67 percent in Naples (1995), 80 percent in Lyon (1996), and 90 percent in Cologne (1999). As the bilateral reductions were seen as insufficient, donors turned to including the multilateral agencies in debt forgiveness, albeit with arrangements whereby industrial countries made them whole for the losses.

Multilateral forgiveness began with the HIPC initiative of 1996, designed to cut the debt-export ratio of 41 heavily indebted poor countries to no more than 200 percent, followed by the enhanced HIPC initiative in 1999 seeking to cut the ratio to no more than 150 percent (Birdsall and Williamson 2002, 23). For 40 countries identified as having unsustainably high external debt, up to 100 percent of the debt owed to the IMF, World Bank (International Development Association, or IDA), and African Development Bank can be forgiven. Beneficiaries must develop a Poverty Reduction Strategy Paper (PRSP) and establish a favorable track record on economic policies. After a country is declared eligible at the "decision point," it receives interim relief, and if sound policies are continued and at least one year of the PRSP is implemented, the country can reach the "completion point" of the maximum multilateral relief identified as necessary. Twenty-nine countries have reached the decision point, and together with another 11 countries potentially eligible, the total present value of their debt eligible for HIPC relief in 2004 was $61 billion (IMF 2006a). As of early 2006 the HIPC initiative had reduced the debt of 18 countries by $19 billion, cutting their debt ratios in half. However, in 8 of the 13 postcompletion-point countries, the debt "ratios once again exceed HIPC thresholds" (Independent Evaluation Group 2006, vii).

The broad lesson of debt relief for poor countries would seem to be that official assistance to such countries should not have been in the form of

loans in the first place but grants. So far this lesson has translated into only a modest shift in IDA and other official assistance toward grants and away from loans, in part because of some donors' fears that without future reflows the agency will not be in a position to provide new support to the countries that need it at that time.

As for the potential impact of HIPC relief, perhaps not too much should be expected, as the effect is primarily psychological rather than economic. The economic burden of HIPC debt was low even without relief because most of the debt was concessional. The average interest rate on total debt for HIPC countries in the aggregate was only 1.6 percent in 1997 and 1.1 percent in 2003, compared with 6.2 and 4.8 percent respectively for Latin America and the Caribbean (World Bank 2005a).[6] This means that even though the reported total debt was 98 percent of GDP in 1997 and 80 percent in 2003, the interest burden was only 1.6 percent of GDP in 1997 and 0.8 percent in 2003. In contrast, for Latin America and the Caribbean interest payments on external debt amounted to 2.5 percent of GDP in 1998 and 2.1 percent in 2004, considerably higher than for the HIPCs despite a much lower ratio of reported debt to GDP (39 percent in 1998 and 43 percent in 2003).[7] For its part, principal repayment tends not to pose the same type of liquidity risk for official assistance as it does for private flows because countries following sound policies tend to receive relatively reliable new inflows of assistance that offset (or more) maturities coming due (Cline 2003c).[8]

Institute Research and International Debt Policy

From the very beginning, the Institute has been deeply involved in analysis on the evolving issues in international debt policy, as shown in table 11.1. The outbreak of the Latin American debt crisis in 1982 came in the first full year of the Institute's existence. By September 1983 I had prepared a monograph providing projections that indicated prospective improvement in debt-export ratios in association with increased exports from global recovery, correction in the overvalued dollar, and reduction in abnormally high global interest rates (Cline 1983, 1984). The study supported

6. The estimates here for the HIPC members are obtained from aggregate data on low-income countries after subtracting the corresponding data for the four large non-HIPC countries in this grouping: Bangladesh, India, Nigeria, and Pakistan.

7. In addition, some donors may tend to provide lower volumes of new aid than they would have done if the countries had been making repayments, limiting any net flow impact of forgiving the debt.

8. There are other reasons for HIPC debt forgiveness, including the fact that tied aid is less efficient than untied debt service avoided. The point is simply that hopes for the impact of HIPC relief should not be exaggerated.

Table 11.1 Institute contributions to policy analysis on international debt

Publication	Type	Content
Cline (1983)	Policy Analyses in International Economics (PA)	Assesses debt crisis risk to global financial system and describes model of global macro conditions needed for resolution of liquidity problem
Cline (1984)	Book	Provides a more complete analysis of debt crisis, projections
Bergsten, Cline, and Williamson (1985)	PA	Reviews progress to date in managing the global debt crisis; calls for Mexico-type packages (lower spreads, new lending) and other improvements
Lessard and Williamson (1985)	PA	Calls for new instruments such as commodity-linked bonds to improve international financing after the debt crisis
Cline (1987)	PA	Provides menu approach to concerted lending, including discounted buybacks as exit tax; elaborated on Baker Plan
Williamson (1988)	PA	Calls for shift from concerted lending to voluntary debt reduction; prefigured Brady Plan
Cline (1995)	Book	Offers a retrospective on evolution of the debt crisis and international policy; includes quantitative analysis of 1983–84 model forecasts versus outcomes
Calvo, Goldstein, and Hochreiter (1996)	Conference volume	Provides early evaluation of tequila crisis of 1994 and implications for emerging markets
Goldstein (1998)	PA	Provides overview of East Asian financial crises
Noland et al. (1998)	PA	Predicts large upswing in East Asian trade balance as consequence of financial crises
Eichengreen (1999)	Book	Rejects radical architecture proposals, supports an active IMF
Hills, Peterson, and Goldstein (1999)	Book	Calls for limiting IMF lending to 100 to 300 percent of quota but adding a new contagion facility for systemic events, financed by SDR issue

(table continues on next page)

Table 11.1 Institute contributions to policy analysis on international debt *(continued)*

Publication	Type	Content
Haggard (2000)	Book	Argues that business-government ties spurred East Asian growth but also moral hazard and vulnerability to shocks; concludes that crisis advanced reform
Goldstein, Kaminsky, and Reinhart (2000)	Book	Provides empirical analysis of variables for predicting currency and banking crises
Dobson and Hufbauer (2000)	Book	Argues for extensions of Basel II reforms to further address moral hazard
Kenen (2001)	Book	Supports rule-based IMF rescue packages, mandatory standstills, collective action clauses, and floating exchange rates
Birdsall and Williamson (2002)	Book	Calls for (a) expanded HIPC debt and inclusion of Pakistan, Nigeria, (b) the use of IMF gold to finance, and (c) contingent further relief
Mussa (2002)	PA	Critiques Argentine fiscal imbalances leading to debt crisis and IMF decision to provide more support in 2001
Williamson (2002)	Policy Brief	Counters Goldstein on Brazilian debt sustainability
Krueger (2002)	Speech	Offers first statement of revised Sovereign Debt Restructuring Mechanism (SDRM) proposal
Taylor (2002)	Speech	Offers first statement of Treasury preference for collective action clauses (CACs)
Miller (2002)	Policy Brief	Argues that CACs and SDRM are compatible
Goldstein (2003)	Working Paper	Argues that Brazil's debt is unsustainable
Roubini and Setser (2004)	Book	Judges calls for an end to IMF rescue packages unrealistic, but seeks sharper IMF differentiation and insistence on debt restructuring when needed
Goldstein and Turner (2004)	Book	Calls for more attention to currency mismatches as means of crisis prevention
Williamson (2005)	PA	Calls for measures to reduce boom-bust cycles in emerging markets capital flows

HIPC = heavily indebted poor country
SDR = special drawing rights

IMF adjustment programs as the centerpiece for coordinated new lending by banks to treat the crisis as one of illiquidity rather than insolvency warranting bankruptcy-like treatment. This approach promised earlier reentry of debtor countries into capital markets, as well as less risk to the banking sectors in industrial countries, than an alternative involving default and bankruptcy-type workouts. One challenge of the approach was achieving collective action among banks, which otherwise had incentives individually to be free riders (Bergsten, Cline, and Williamson 1985). A subsequent study (Cline 1987) set forth a menu approach to this issue, including the option of "exit bond" relief granted by those banks seeking not to participate. This broad approach was adopted in the Baker Plan of 1986. Soon Williamson (1988) was shifting the emphasis further toward voluntary arrangements for debt relief, taking advantage of the by then low secondary market prices of debt. This emphasis presaged the Brady Plan adopted one year later.

By the mid-1990s it was possible to carry out an early retrospective analysis of the international debt crisis of the 1980s. In Cline (1995) I revisited my earlier projections, decomposing the gap from eventual outcomes into model error and assumption error. My early projections proved to have been broadly correct about global recovery, a correction in the dollar, and a moderation in interest rates. They had overpredicted global inflation, however, so nominal dollar export magnitudes turned out considerably smaller than projected (and hence lower relative to nominal external debt) and real interest rates turned out higher than projected. The projections had not anticipated the collapse of oil prices in 1986. Commodity prices lagged behind projected levels at first but caught up by the late 1980s. Tests rejected the theory that the debt strategy was internally inconsistent by virtue of falling terms of trade resulting from export expansion, as the heavily indebted countries did not in fact boost their shares in world commodity exports. The model had not incorporated prospective capital flight, which meant that the actual buildup in debt was much greater than projected. The retrospective analysis concluded that for nonoil countries following prudent domestic policies, the original strategy was broadly correct, as shown by the outcomes for Chile and Colombia. More broadly the study suggested that a much earlier adoption of debt forgiveness as the international strategy would likely have meant that many debtor countries would not have adopted the structural changes (trade liberalization, privatization, fiscal adjustment) that were vital to their subsequent growth prospects.

As indicated in table 11.1, by 1998 there began a five-year period in which the Institute published a large number of studies on the evolving financial crises in emerging markets and on appropriate changes in international financial architecture to avoid or deal with similar crises in the future. By 1999 there was an intense debate on whether the IMF should halt the large rescue programs typified first by Mexico in 1995 and then by

Korea, Thailand, Russia, Brazil, and later Argentina and then Brazil again. Hills, Peterson, and Goldstein (1999) essentially called for an end to such programs, whereas Kenen (2001) and Roubini and Setser (2004) recognized the need for them, albeit with caveats. Also during this period there arose a heated debate about a new quasi-bankruptcy mechanism for international debt, including at an April 2002 Institute conference where IMF First Deputy Managing Director Anne Krueger (2002) presented the case for such a mechanism on the first day and US Treasury Under Secretary John Taylor (2002) presented the opposite case and supported the alternative of collective action clauses on the second day. Among the most intriguing of the Institute contributions was the intramural disagreement between Morris Goldstein (2003), who in 2002 judged that there was a 70 percent chance Brazil would default by the end of 2003, and John Williamson (2002), who judged that it would not. Williamson proved right.

The discussion below returns to the substance of some of these issues. Suffice it to say that if the publications list of the Institute provides a barometer for tracking the salient issues of the day, financial crises in emerging markets were a predominant concern in the late 1990s and the first three years of this decade.

Prospects and Key Policy Issues

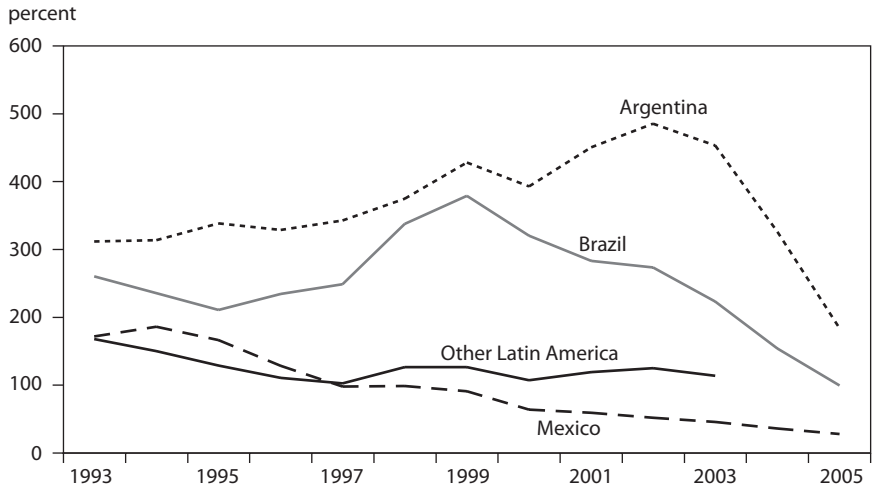
Trends in Debt Indicators

The most recent emerging-market financial crisis was the Brazil scare in 2002. As reviewed above, the rebound in private capital flows to emerging markets, rising current account balances, and falling risk spreads (figures 11.1 through 11.3) all suggest benign debt conditions during the past three years. It is useful to review further evidence on recent debt trends before considering future prospects.

One measure of the burden of external debt is the ratio of gross debt minus external reserves, or "net debt," to exports of goods and services. Although this measure does not take into account variations in the interest rate, and hence understates the reduction in debt burden associated with falling global interest rates, it does provide a gauge of potential burden when and if interest rates return to more normal levels. Figures 11.4 and 11.5 show the trend in this measure since the mid-1990s for major Latin American and Eastern European debtors respectively.

There have been dramatic declines in the ratio of net external debt to exports of goods and services for several major debtors. For Mexico the ratio fell from 185 percent in 1994 to 28 percent by 2005; for Brazil, from 379 percent in 1999 to 99 percent; for Argentina, from 428 percent in 1999 to 183 percent (and the latter overstates because of the concessional nature of postrestructuring debt). For Poland and Hungary the ratio fell from an

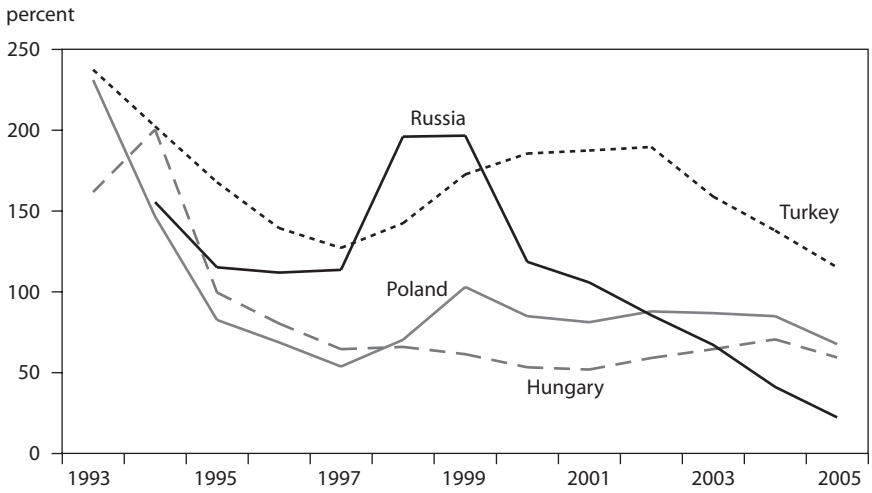
Figure 11.4 Net external debt as a percent of exports of goods and services: Latin America, 1993–2005



Note: Gross external debt minus reserves.

Sources: World Bank (2005a, 2005b), Deutsche Bank (2006), IMF (2006b).

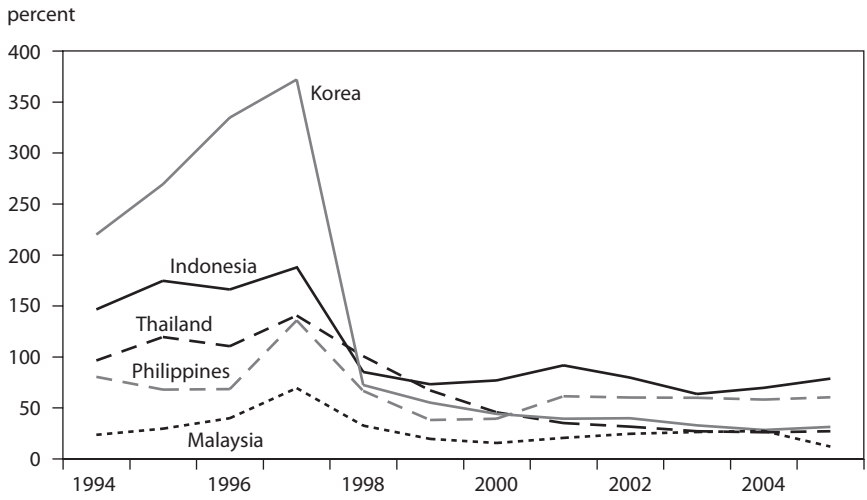
Figure 11.5 Net external debt as a percent of exports of goods and services: Eastern Europe, 1993–2005



Note: Gross external debt minus reserves.

Sources: World Bank (2005a, 2005b), Deutsche Bank (2006), IMF (2006b).

Figure 11.6 Short-term external debt as a percent of external reserves: East Asia, 1994–2004



Sources: World Bank (2005a, 2003), Deutsche Bank (2006).

average of about 200 percent in 1993–94 to about 63 percent in 2005; for Russia, from a peak of 197 percent in 1999 to only 22 percent in 2005; and Turkey's ratio has also fallen substantially, from 190 percent in 2002 to 115 percent in 2005. For most of these countries, the declines in the ratio have been driven by sharply rising exports and reserves, as the nominal amount of external debt has tended to rise slowly (with the exception of a significant decline in Argentina after 2003).

For East Asia, the late-1990s financial crises were driven more by a liquidity crunch from high short-term debt than by high underlying total debt burdens (with the partial exception of Indonesia). A more relevant gauge for trends in that region is the ratio of short-term external debt to external reserves. As shown in figure 11.6, this ratio surged in the mid-1990s to a peak in 1997 but fell sharply thereafter in the region. Short-term external debt reached as high as 372 percent of reserves in Korea in 1997[9] and a range of about 150 to 200 percent in Thailand, the Philippines, and Indonesia that year. Only Malaysia maintained relatively low short-term debt (its financial stress arose from portfolio equity outflows rather than the runoff of short-term debt). By 1999, all five of the East Asian crisis economies had short-term external debt well below reserves, and as of 2005 the average ratio was about 40 percent.

9. The figure for Korea includes debt of overseas branches of domestic financial institutions.

In sum, the external debt indicators tend to confirm that there has been a substantial improvement in the external transfer problem for the major emerging-market economies since the late 1990s. It is less clear that the potential internal transfer problem has improved. Indeed, the IMF devoted an issue of its *World Economic Outlook* in 2003 to an analysis of what it considered troublesome levels of public debt in emerging-market economies. Among its conclusions were the following:

> High public debt is a cause for concern in many emerging market economies. At about 70 percent of GDP, the average public debt ratio in emerging market economies now exceeds that in industrial countries.… [H]istorically, many emerging market economies have not generated large enough primary budget surpluses to ensure the sustainability of their public debt. . . . [T]he sustainable public debt level for a typical emerging market economy may only be about 25 percent of GDP . . . emerging market economies as a group have failed in the past to respond in a manner consistent with ensuring fiscal sustainability once public debt exceeds 50 percent of GDP. (IMF 2003, 141–42)

The fundamental equation of debt sustainability is as follows:

$$1) s_p \geq (i^* - g)d$$

where s_p is the primary (i.e., noninterest) fiscal surplus as a percent of GDP, i^* is the real interest rate, g is the real growth rate, and d is the ratio of public debt to GDP. If this condition is not met, public debt rises as a percent of GDP.[10] Because real interest rates tend to be higher in emerging-market economies than in industrial economies, conventional thresholds for industrial-country public debt (such as the 60 percent ceiling set in the European Union's Maastricht Treaty) will tend to overstate the level of sustainable public debt in the absence of correspondingly more ambitious primary surplus targets.

Table 11.2 reports the path of the public debt to GDP ratios of major emerging-market economies over the past decade. These trends are far less reassuring than those for the external debt burden relative to the export base.[11] The data also reveal the vicissitudes of debt crises in recent years, for example in the large run-up in Argentina's public debt ratio in 2002 with the currency devaluation and consequential ballooning of external public debt relative to GDP, followed by a reduction with debt re-

10. As an approximation. More specifically, if in addition the rate of currency depreciation is r, the share of public debt denominated in foreign currency is ϕ, and the rate of inflation is p, the condition for debt to remain at an unchanged fraction of GDP becomes: $s_p = d\ \{[i^* - g + r\phi] / [1 + g + p]\}$. See Cline (2003b).

11. Note, however, that the data do not deduct government assets and so tend to overstate. For example, in the case of Brazil, after deducting government deposits and other public assets (most of which are relatively liquid), net public debt was about 52 percent of GDP in 2004 rather than the 72 percent gross figure shown in the table.

Table 11.2 Public debt as a percent of GDP, 1995–2005

Country	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Argentina	34.4	36.4	35.4	38.2	43.5	45.6	53.7	134.6	138.1	125.0	69.2
Brazil	38.9	41.0	41.2	55.5	79.2	74.1	70.6	72.0	78.3	71.8	74.8
Hungary	n.a.	n.a.	64.2	61.9	61.2	55.4	52.2	55.0	56.7	57.1	58.4
India	71.4	67.8	68.3	69.5	69.9	71.7	74.7	79.3	79.3	78.8	79.5
Indonesia	n.a.	15.2	24.7	44.6	86.2	92.9	82.8	75.5	68.0	69.4	63.1
Korea	7.3	7.5	13.6	30.4	32.3	30.3	36.8	33.3	32.5	31.8	29.7
Mexico	42.9	36.2	37.1	41.2	42.8	40.0	40.5	40.9	41.6	38.3	39.5
Philippines	75.7	65.0	64.3	94.7	101.5	109.8	104.8	112.5	118.2	109.8	107.7
Poland	n.a.	n.a.	44.0	39.1	40.3	36.8	36.7	39.8	43.9	41.9	42.5
Russia	40.7	32.8	55.0	79.4	88.8	56.8	42.9	36.5	26.8	21.7	14.1
Thailand	11.5	14.1	36.9	44.0	54.0	57.0	57.1	53.8	49.4	48.8	45.9

n.a. = not available

Source: Deutsche Bank (2006).

structuring by 2005. Importantly, in the East Asian economies a common pattern was a surge in public debt following the banking sector crises of the late 1990s and public-sector bailouts of the financial systems.[12]

Future public debt depends on the current fiscal deficit, and on this criterion the major emerging-market economies seem to be better positioned. Table 11.3 reports the average nominal fiscal balance as a percent of GDP in 2003–05 for 28 major developing economies. It also reports average real growth and inflation. What can be defined as the "marginal debt ratio," or the increase in public debt as a fraction of the increase in nominal GDP, can be approximated as, essentially, the nominal fiscal deficit relative to GDP as a fraction of the sum of real growth plus inflation.[13] If the fiscal deficit rate and nominal growth rate are sustained in-

12. More favorably, Russia's public debt ratio has fallen sharply with the combined influence of large primary surpluses associated with oil revenue and negative real interest rates on debt.

13. Debt grows by the fiscal deficit as a percent of GDP multiplied by GDP. Nominal GDP grows by the nominal growth rate multiplied by GDP. So the ratio of additional debt to additional GDP equals the ratio of the fiscal deficit as a percent of GDP to the nominal growth rate. More precisely: $z = f/[(1 + g/100)(1 + p/100) - 1]$, where f is the fiscal deficit as a percent of GDP, g is the real growth rate (percent), p is the inflation rate (percent), and z is the increase in public debt as a percent of the increase in nominal GDP, or the marginal debt ratio. This approximation implicitly assumes the GDP deflator rises at the same rate as the consumer price index.

Table 11.3 Recent fiscal performance in major emerging-market economies, 2003–05 averages

Country	Fiscal balance/GDP (percent)	Inflation (percent)	Real GDP growth (percent)	Marginal debt ratio (percent)
Argentina	2.3	9.1	8.9	–12.4
Brazil	–3.6	9.4	2.6	29.8
Bulgaria	1.2	4.5	5.2	–12.5
Chile	1.2	2.3	5.3	–16.0
China	–1.7	2.3	10.0	13.6
Colombia	1.2	2.3	5.3	–16.0
Czech Republic	–4.1	1.6	4.6	64.5
Hungary	–6.0	5.0	4.0	64.4
India	–9.1	5.7	7.9	64.5
Indonesia	–1.3	7.8	5.2	9.7
Korea	0.9	3.3	3.9	–12.7
Malaysia	–4.4	1.9	5.9	56.0
Mexico	–0.4	4.4	2.8	5.9
Philippines	–3.7	5.0	5.3	35.3
Poland	–4.3	2.2	4.1	68.2
Romania	–1.4	12.1	5.8	7.5
Russia	4.7	12.4	7.2	–22.9
Slovakia	–3.3	6.2	5.2	28.0
South Africa	–1.7	3.6	4.1	22.0
Thailand	0.0	3.1	5.9	–0.4
Turkey	–8.4	12.8	7.4	39.8
Venezuela	–3.4	22.9	6.5	11.0

Source: Country InfoBase, Deutsche Bank Research, www.dbresearch.com (accessed April 27, 2006).

definitely, the average ratio of debt to GDP should converge to the marginal ratio. On the basis of the *World Economic Outlook* study just cited, it might be suggested that somewhere in the range of 40 percent might be about as high a marginal public debt ratio as would be comfortable for an emerging-market economy.

It turns out that most of the major emerging-market economies have a lower marginal debt ratio than this range. Indeed, several of them had fis-

cal surpluses on average in 2003–05 (Argentina, Bulgaria, Chile, Colombia, Russia, and Korea), meaning that the marginal debt ratio was negative and the average debt ratio was being pulled down. The main exceptions to favorable fiscal performance in this period were in Eastern Europe, where the Czech Republic, Hungary, and Poland all had marginal debt ratios of about 65 percent; the ratio was also high in Malaysia (56 percent) and India (65 percent). The marginal debt ratio was below 30 percent in Brazil, China, Indonesia, Mexico, Romania, Slovakia, South Africa, and Venezuela (in addition to the list of countries with fiscal surpluses). In Turkey it was right at the notional 40 percent ceiling, and in the Philippines it was below but close to this threshold.

Overall, recent fiscal performance in major emerging-market economies appears relatively favorable, a positive factor that helps offset the sobering levels of public debt stock relative to GDP shown in table 11.2. Two major caveats are, first, that these three years have been ones of exceptionally high global growth, so a considerable portion of the favorable fiscal performance is likely to have been cyclical and, second, that several countries in the past have tended to build up "discovered" or "skeleton" debt not captured in the annual fiscal balances.

Architectural Debates and the IMF's Role

During the past decade a few central issues have dominated the debate about global financial arrangements for managing debt and financial crises in emerging-market economies. The area with the easiest agreement has been the push for transparency as a key means of crisis avoidance. The IMF's development of the Special Data Dissemination Standards (SDDS) has been a signal achievement, putting pressure on countries to report data in a timely fashion. The Web sites of central banks and finance ministries in many emerging-market economies now provide for free a wealth of data that in earlier decades was either not available, not up to date, or obtainable only through visits to the countries. Another, more controversial issue area has been the prolonged move toward Basel II standards for international banks, with its shift toward risk-based weighting for capital requirements. Some worry that this reform will provide an undue advantage for large banks capable of mounting their own sophisticated internal models; others, that the new regime will cause a disadvantage for developing countries where firms are often not rated by the standard rating agencies. At the most general level, however, it must be seen as salutary that the international community is seriously seeking to fine-tune capital requirements as part of a process of strengthening financial systems, especially considering the intensive consultation with the private sector in the process.

Perhaps the most contentious policy debate has been on whether there should be large rescue packages when financial crises arise. In Cline (2005c)

I recapitulate the case for such support and for the IMF as a lender of last resort. This role is essentially based on analogy to the Bagehot principle domestically that in a panic, the central bank should lend freely to banks with collateral but not to those that are insolvent, in order to avoid unnecessary defaults and economic disruption. The corresponding distinction between liquidity and solvency crises is also central to the policy analogy.

Major financial rescue operations have indeed been large. Outstanding IMF claims on crisis countries reached peaks of 5.5 percent of GDP in Mexico in 1995; 4.9 percent in Korea, 2.9 percent in Thailand, 8.7 percent in Indonesia, and 7.1 percent in Russia in 1998; 1.6 percent in Brazil in 1999; 5.2 percent in Argentina in 2001 (surging to 14.1 percent in 2002 with the devaluation and plunge in dollar GDP); 12.1 percent in Turkey in 2002; and 5.6 percent in Brazil in 2003 (Cline 2005c, 300–301). We can thus say that the median lender-of-last-resort financial rescue involves IMF lending amounting to about 6 percent of GDP and that in the extreme cases the amount reaches about twice this high.

There have been two criticisms of such lending. First, it is seen by many as leading to moral hazard for private-sector lenders, encouraging them to take undue risks and overlend. In Cline (2004) I briefly review the literature on this issue and suggest both that the moral hazard concern is not well borne out by the facts and that after the massive private-sector losses on Argentine debt, this concern surely must be seen as passé. Second, there is the fear that the IMF could become overcommitted to a handful of superdebtors and incapable of carrying out its normal functions. It turns out that except for Turkey, the large recipients (even including Argentina) have now repaid the IMF so fully that the institution faces the problem of too little investment income on its lending spread because of a dearth of clients, so this concern has also not been supported by experience. Instead, the broad picture of IMF lender-of-last-resort action is one of a majority of crucial successes (sequentially Mexico, Korea, Thailand, Indonesia, Brazil twice, and most likely Turkey) accompanied by a limited number of failures (Russia and Argentina). Even in the failure cases, the debtors fully repaid the Fund.

Another and related debate has been about "private-sector involvement" (see Cline 2003a, 2004). Mexico's crisis in 1994–95 was the first dominated by short-term capital market obligations rather than bank claims. Whereas the London Club and its bank advisory committees had provided a vehicle for bank rollovers and reschedulings in the 1980s, the more dispersed holdings of government securities lacked a comparable mechanism. US Treasury Secretary Robert Rubin stated that if he could have found a way to make private-sector investors pay for the Mexico bailout, he would have done so. Successive G-20 and other G-member meetings in the late 1990s called for private-sector involvement (PSI) as a necessary part of financial rescues. The high-water mark for public-sector arm-twisting in this direction was probably the Ecuador default on Brady bonds in 2000, which was

widely perceived to have been counseled by the IMF as a means for forcing PSI. There was important PSI in the Korean crisis, but it was of the more familiar London Club variety as the banks converted short-term claims on Korean banks into three-year government-guaranteed paper. Similarly, there was PSI in the Brazil 1999 episode that involved a voluntary undertaking by foreign banks to roll over short-term credits so long as Brazil was meeting its policy commitments. My view has been that PSI should be achieved in the most voluntary manner possible commensurate with successfully overcoming the crisis, in order to minimize subsequent cutoff from capital market access. Once again, however, the massive Argentine default has (or certainly should have) altered the terms of the debate. It is no longer plausible to depict emerging-market crises as a one-way bet favoring private investors. Having lost some $60 billion in Argentina, private investors can reasonably take the position that they have already done their part to rebalance PSI relative to official lender-of-last-resort operations for a long time to come.

Aside from lender-of-last-resort rescues, international arrangements for debt restructuring have been the other hottest issue in the architectural debate. With the transition from developing-country debt dominated by syndicated long-term bank loans to a structure dominated by bonds and other securities, there was growing concern by the late 1990s that it would prove impossible to carry out debt restructurings for this much more dispersed investor base. There was concern that "rogue creditors" would not cooperate and would thwart the restructuring process. The image of massive public-sector bailouts for the benefit of private bondholders, not least including the ill-fated final large disbursement to Argentina in August 2001, made the political environment ripe for proposals that instead facilitated restructurings orchestrated by the public sector.

It was in this environment that Anne Krueger proposed the Sovereign Debt Restructuring Mechanism (SDRM) to deal with cases of unsustainable sovereign debt. In its initial incarnation (Krueger 2001), the SDRM gave a relatively heavy hand to the IMF. A country could come to the IMF and seek approval of a standstill. There would be an international treaty with the force of law authorizing the IMF to approve a standstill, which would involve foreign exchange controls. There would be a mechanism to "bind minority creditors" seeking to oppose a workout agreed to by the majority. Domestic debt would likely have to be included in the workout. The SDRM was to be modeled on the domestic bankruptcy process and like it would include preferred creditor status for new borrowing. The IMF would leave the terms of the restructuring to the debtor and its creditors, however, rather than dictating them; and the sanctioned standstill would expire after a given period of time.

There then ensued a debate between what was called this "statutory" approach to debt restructuring and the alternative "contractual" approach.

The latter, soon espoused by the US Treasury (Taylor 2002), sought to incorporate collective action clauses (CACs) into future bonds in order to overcome the problem that in bonds issued in New York (but not in London) unanimous consent of bondholders was required for changes in terms. The private sector soon mobilized in support of this approach, in part for fear of the SDRM alternative and its risk of politically imposed workouts tending toward the disadvantage of creditors. Without US Treasury support (despite earlier sympathetic signals from the secretary), the SDRM did not prosper, notwithstanding a reformulation attempted to make the IMF seem less the judge and jury and more a disinterested facilitator.[14] Mexico and other major borrowers were concerned that creation of an SDRM could cast doubt on their market access, and within a year Mexico led the way for the alternative approach by issuing bonds with CACs, seemingly at no risk spread penalty. CACs have become standard in new issues, although it is unclear how long it will take for the bulk of outstanding emerging-market debt to shift from previously issued obligations that require unanimous creditor consent for restructuring to new CAC-based obligations.

Viewed with some distance from that period, two observations stand out about the SDRM. First, sovereign restructurings of bonds have turned out not to be as difficult as the call for such a mechanism assumed. Pakistan, Ukraine, and Ecuador, not to mention Argentina, carried out restructurings, often using an "exchange offer" involving a proposal by the sovereign with a relatively short time period for bondholders to respond. Finding the bondholders proved not to be difficult, and responses were typically positive when reasonable terms were proposed. Second, the "rogue creditor" problem turned out not to be severe, and instead Argentina showed that it was the "rogue debtor" problem that could be more serious. Indeed, the premise that "the debtor would need protection from legal action after the suspension of payments" (Krueger 2001) has not been borne out, as shown by the experience of frustrated creditors of Argentina who still have nothing to show for years of litigation efforts.[15] In short, the problems the SDRM was designed to solve do not seem to have been compelling, in part because many of the financial crises were not associated with sovereign default on bonds.

14. In her initial formulation, Krueger (2001, 6) had already stated, "The international community is not going to impose the terms." In her subsequent speech to the Institute in April 2002, she further emphasized that terms of the restructuring would be based on agreement between the debtor and a supermajority of creditors and that "the Fund would not be empowered to make decisions that would undermine the enforcement of creditor rights" (Krueger 2002, 5).

15. In contrast, at the time there was much talk about a case in which Peru paid off a creditor (Elliott) to avoid legal action regarding payments on Brady bonds.

The Implications of Argentina

A clear-eyed look at debt restructuring today requires thinking carefully about the implications of the Argentine outcome. First and foremost, the Argentine default on some $100 billion and its essentially unilateral restructuring on arguably confiscatory terms has not caused a wave of international contagion against emerging-market economies. On the contrary, as shown above, emerging markets have rebounded vigorously from the financial crises of 1998–2002, albeit with the spur of low US interest rates. If creditors had taken the lesson that Argentina proved emerging-market sovereign bonds were unreliable, this would not have happened and at the very least spreads would have trended up instead of down. Instead, creditors seem to have concluded that each country makes and must live with its own reputation as creditworthy or uncreditworthy, and the spread of guilt by association to other countries is both unwarranted and unprofitable. This tends to weaken somewhat the case for large financial rescue packages, because it suggests that in contrast to what was perceived in the Mexican rescue of 1994–95 as well as the East Asian crises that followed, the stakes of sovereign default seem more likely to be confined to the country in question rather than the financial system as a whole. Both diagnoses may have been right at their respective times, given the evolution of emerging markets from a new phenomenon in the early 1990s into an increasingly standard part of international investors' portfolios more than a decade later. In any event, the potential for avoiding needless economic collapse, even if just for the country itself, still provides ample basis for lender-of-last-resort action.

Second, it should be asked whether the Argentine experience warrants reviving the call for the SDRM or something like it. The naïve argument might run as follows: If before the private sector didn't like the risk of IMF-imposed solutions, by now private firms and investors may realize that what Argentina did to them was far worse than what would have occurred under IMF auspices. However, it is extremely implausible that Argentine authorities would have played by the rules of an IMF-led SDRM workout and that the end result would have been much different. The country's wrenching political change at the end of 2001 brought to power much more populist forces. They would have been unlikely to adopt restructuring terms along more market-friendly traditional Brady Plan lines (e.g., 35 percent forgiveness instead of 70 percent) just because of the option of going to the SDRM; similarly, it is unlikely there would have been any agreement within the time limit set by the SDRM.

Another false lesson of Argentina would be that emerging-market economies can default with impunity. Argentina's high growth rates in 2003–05 might cast that illusion, but they have merely restored the economy to its level of 1998. The confidence for private-sector investment to build for

the future has surely been undermined not only by the handling of the debt problem but by an associated set of populist policies ranging from unilateral revision of public utility rate agreements with multinational firms to price controls as the means of curbing inflationary consequences of undervaluation.

With respect to international policy on debt restructuring, the central lessons of Argentina are, first, that political sustainability must be at the heart of any decision for dealing with the crisis and, second, that once again it has been shown that resolving debt problems is essentially a case-by-case process rather than one that neatly fits standard treatment, especially when the international environment is benign and the roots of the problem are basically national rather than international.

The United States as the New Super-Debtor

Under today's conditions an essay on international debt would be remiss to omit the emerging issue of US external debt. In accounting terms, the United States is already the largest debtor nation in history, with net international liabilities of $2.5 trillion at the end of 2005 (BEA 2006). In terms of economic burden, the United States is just now transitioning into debtor status, as the higher rate of return on foreign direct investment than on foreign holdings of US assets kept the capital income balance positive through 2005, despite a large negative asset balance. With the US current account deficit at about 7 percent of GDP and on present trends on a path toward about 10 percent by a decade from now despite some dollar correction already, the US external imbalance poses a major risk for the international economy. Even with a smooth adjustment, the rest of the world will face the challenge of shifting the source of demand away from reliance on growing trade surpluses with the United States. This shift had better be sooner rather than later if it is to avoid being wrenching and disruptive. Otherwise there is ample scope for a global interest rate shock and recession in a hard landing for the dollar and the US and global economies (Cline 2005a).

The key to a smoother rather than harsher adjustment is for the United States to eliminate its fiscal deficit and for China and other developing countries (especially in Asia) to stop intervening in exchange markets to prevent the appreciation of their currencies, as well as a market-driven further appreciation of the euro, yen, and other major currencies against the dollar. The IMF seems to be groping toward a role in addressing this emerging potential crisis by embarking on "multilateral surveillance," but more forceful coordinated action is needed along the lines of the 1985 Plaza Agreement but with much wider participation of key economies, reflecting the change in the world economy over the past two decades (Cline 2005b).

Conclusion

Emerging-market economies have shown major improvements in recent years, as reflected by sharply falling borrowing spreads and favorable fiscal trends. However, US external adjustment will be key for a return of international capital markets to their more normal function of facilitating growth in developing countries through the provision of capital from excess saving in industrial countries. The recent phenomenon of reverse flows of resources is fundamentally perverse. The mercantilist notion that developing countries need undervalued exchange rates to keep exports and growth going, the premise of the Bretton Woods II hypothesis (Dooley, Folkerts-Landau, and Garber 2004), also seems misguided. Instead, a reorientation toward domestic demand for investment, including in infrastructure, would seem essential to a more sustainable pattern of global growth.

If this correction can be carried out, it seems highly likely that net flows of capital and resources to emerging-market economies can make an important contribution to global development over the coming decade and more. Fiscal prudence in developing countries will be a key to ensuring that such flows not get out of hand and foster renewed cycles of boom and bust, just as fiscal correction sooner or later will be essential for the United States if it is to be a positive force for, rather than an increasing threat to, sustainable global growth.

It seems unlikely that any major change in international financial architecture will be needed for a favorable functioning of international capital markets, apart from a more active process (with or without the IMF) for carrying out exchange rate realignments needed as part of the correction of US external imbalances. Increasingly each of the major debtor countries will be evaluated on its individual merits, and capital markets will maintain normal transactions with those among them that continue to demonstrate political maturity and sustain market-friendly and fiscally prudent policies. If occasions do return raising the potential need for official financial rescue, there is sufficient favorable evidence on past results that the IMF and industrial countries should step up to the plate and provide large liquidity support, if needed, to countries pursuing sound economic policies.

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