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*Enabling Stable Growth in the
Emerging-market Economies*

Roughly once a year—if history is any guide—the managing director of the International Monetary Fund (IMF), the US treasury secretary, and in some cases the finance ministers of other Group of Seven (G-7) countries get a phone call from the finance minister of a large emerging-market economy. The precise details of each conversation differ, but the core does not. The emerging-market economy's finance minister indicates that the country is rapidly running out of foreign reserves, that it has lost access to international capital markets, and that it has perhaps even lost the confidence of its own citizens.

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2004, p. 1.

Record low international interest rates in the 2002–04 period have made the phone calls referred to in the above quote less frequent. With nominal base interest rates in the United States, Europe, and Japan in the 0 to 3 percent range and real interest rates close to zero, it has been easier for emerging-market economies to service their debt, even allowing for large sovereign risk spreads. The debt burdens of many emerging-market economies remain very heavy, however, and most observers agree that if and when interest rates rise again in the richer countries, the phone calls will again have to be answered. The interaction of volatile international capital markets with large accumulated stocks of debt have created chronic macroeconomic vulnerability in a whole class of emerging-market economies, constraining their growth, reducing their capacity to fight poverty, and, at times, constituting a systemic threat to the entire world economy.

It is now again increasingly recognized, not only by left-wing critics but also by mainstream economists, that capital markets are not the incredibly efficient processors of information that market fundamentalists would have us believe. Instead, capital markets display substantial

amounts of herd behavior leading to what no less an authority than Alan Greenspan, in a now much-quoted speech on December 5, 1996, called “irrational exuberance.”¹ Sometimes, of course, irrational exuberance becomes “irrational panic.” Financial markets surge and collapse, often without any discernible change in the “fundamental” economic environment. Eminent economists such as Charles Kindleberger, one of the top international economists of the last 50 years, and Robert Shiller of the younger generation, who is a professor at Yale University and winner of the 1996 Paul A. Samuelson award, have described market volatility, panics, manias, and irrational exuberance in financial markets.²

These books tell the stories of speculative bubbles, market panics, and Ponzi schemes, from the famous Tulipmania of 17th-century Holland to the dotcom bubble of the late 1990s. Their analysis of financial markets shows that reality is much more complex than that suggested by simplistic versions of efficient markets theory. First, it is not true that most actors in financial markets simply behave by rationally evaluating “objective” information about underlying economic and financial variables as it becomes available. It is not so much that people behave in an irrational way, although there are historical examples of outright irrational behavior in financial markets. The problem is more that individually rational behavior does not lead to the efficient market model. In the words of Robert Shiller (2000), “Even completely rational people can participate in herd behavior when they take into account the judgments of others, even if they *know* (emphasis added) that everyone else is behaving in a herd-like manner. This behavior, although individually rational, produces group behavior that is, in a well defined sense, irrational.”

This type of irrationality is due to what the technical literature calls “information cascades.” Shiller (2000, 152) uses a simple story to make his point:

“Suppose two restaurants open next door to each other. Each potential customer must choose between the two. Would-be customers may be able to make some judgments about the quality of each of the restaurants

1. Remarks by Chairman Alan Greenspan at the annual dinner and Francis Boyer Lecture of The American Enterprise Institute for Public Policy Research, Washington, DC. Available at www.federalreserve.gov/boarddocs/speeches/1996/19961205.htm

2. Kindleberger (2001) and Shiller (2000, 2003). See also Eatwell and Taylor (2000). For an analysis stressing the potential of capital markets to create and spread prosperity, see Rajan and Zingales (2003). This book also, however, stresses the need for good regulation and supervision.

when viewing it through the front window, but such judgments will not be very accurate. The first customer who arrives must choose based only on viewing the two empty restaurants and makes a choice. However, the next potential customer can rely not only on his or her own information, based on the appearance of the restaurants, but also—by seeing the first customer eating in one or the other of the restaurants—information about the choice made by the first customer. If the second customer chooses to go to the same restaurant as the first, the third customer will see two people eating in that restaurant. The end result may be that all customers may wind up eating at the same restaurant—and it could well be the poorer restaurant, since there was no real consideration of the combined evidence inherent in all their observations about the two restaurants.”

This story illustrates how herd behavior can lead perfectly rational actors astray. Instead of investors independently assessing the true value of the market and then “casting their vote,” they choose not to “waste their time” in exercising their independent judgment about the market and, instead, follow the herd. There are numerous studies in psychology that document this type of behavior. People will tend to “agree” with the majority, even in cases where they have different priors.³ This type of herd behavior is due to the absence of information about true value or to the willingness of individuals to agree with the majority, even if that means going against their own initial feelings at times.

There is also a different type of herd behavior, however. In the example of the two restaurants, people would not go to the first restaurant if they *knew* that the food was better at an equal price in the second restaurant.

3. Psychologist Solomon Asch, in an experiment to show the power of social pressure on individual judgment, placed his subject in a group of seven to nine people. Asch had coached the rest of the group, but the subject did not know that. The group was asked to answer 12 questions about the lengths of line segments shown to them on cards. Asch's confederates deliberately gave wrong answers to seven of the 12 questions. A third of the time the subject gave the same wrong answers as had been given by the confederates. Asch interpreted his results as due to social pressure. Later, psychologists Morton Deutsch and Harold Gerard reported a variant of Asch's experiment in which the subjects were told that they had been placed anonymously into a group of people that they never saw, would never see, and whose answers the subject could observe only indirectly through an electronic signal (in fact there was no such group). Subjects would give their answers by pressing a button, unobserved by others, and therefore would not need to face the group. And yet the subjects gave nearly as many wrong answers as in Asch's experiment. Deutsch and Gerard concluded that the wrong answers had been given in large part because people simply thought that all other people could not be wrong. See Shiller (2000, 149–50).

There are many situations, however, where people *know* that “values are exaggerated” and buy nonetheless, believing, often correctly, that others will *follow* and hoping they can be the first to exit once the bubble bursts. It is this kind of behavior that again and again has led to the success of Ponzi schemes.⁴ The essence of a Ponzi scheme is that those who set it up pay out very high returns to the initial investors, not by making an actual profit from an economic activity but by using the money of subsequent investors to pay the returns to the initial investors. A fairly recent and dramatic example took place in Albania in the mid-1990s, when a small number of so-called new investment banks were able to attract more than 30 percent of total national income by promising huge monthly returns (often 20 percent or more) to the investors. When the schemes collapsed less than two years after their emergence, the country went into civil war-like disorder. Similar if somewhat less dramatic episodes occurred throughout Eastern Europe in the years of transition to market economy. It is often the case in these episodes that valuations become so ridiculously high that few people believe they reflect real underlying profit opportunities due to actual economic activity. People continue to buy, however, believing that others will also continue to buy and bid up prices further, all the while readying to be the first to exit at signs of trouble. In situations like this, when trouble starts, there is no orderly exit but a stampede, since the only reason people were in the market was that they believed others were still about to enter. When that belief vanishes, the collapse is usually immediate.

Many episodes of financial market frenzy are not *pure* Ponzi schemes, in that there is some underlying real economic activity and perhaps there are even real profits! Nonetheless, prices are bid up, not so much because of expectations based on careful evaluation of potential profits, but because of herd-like behavior, with individuals following the herd either because they believe the majority must be right (the restaurant example)

4. The US Securities and Exchange Commission summarizes Ponzi schemes as a “type of illegal pyramid scheme named for Charles Ponzi, who duped thousands of New England residents into investing in a postage stamp speculation scheme back in the 1920s.” Ponzi thought he could take advantage of differences between US and foreign currencies used to buy and sell international mail coupons. He told investors that he could provide a 40 percent return in just 90 days compared with 5 percent for bank savings accounts. Ponzi was deluged with funds from investors, taking in \$1 million during one three-hour period—and this was 1921! Though a few early investors were paid off to make the scheme look legitimate, an investigation found that Ponzi had only purchased about \$30 worth of the international mail coupons. Decades later, the Ponzi scheme continues to work on the “rob-Peter-to-pay-Paul” principle, as money from new investors is used to pay off earlier investors until the whole scheme collapses.

or because they believe that others will continue to be “buyers” for a while and that they can always jump away ahead of others. It is a combination of these and some other factors that caused the stock market bubble of the late 1990s. Take the comparison, for example, between the well-established Toys ’R Us retail company and the upstart eToys firm established in 1997, which Shiller also mentions. Shortly after an initial public offering, eToys stock value soared to \$8 billion compared to the value of \$6 billion of Toys ’R Us. This at a time when eToys had sales of only \$30 million, compared to \$11.2 billion for Toys ’R Us, and “profits” of *negative* \$28.6 million, compared to positive profits of \$376 million for the established company! Stories like this can be multiplied, and they led to a huge surge in stock market indices followed by a serious and inevitable retrenchment in 2000.⁵

Foreign exchange markets exhibit elements of the same type of behavior. They cannot, of course, be compared to pure Ponzi schemes, since the value of the currency of a nation always reflects real economic conditions in that country. It is clear, however, that herd behavior is prevalent also in foreign exchange markets. The story of the exchange rate between the dollar and the euro is quite telling in that respect. When the euro was launched in January 1997 at an initial exchange rate of 1.15 dollars to the euro, the most prestigious investment banks, such as Goldman Sachs, predicted publicly that the exchange rate would quickly reach 1.25 dollars to one euro! Instead, the euro quickly retreated and fell to as low as 0.823 dollars to one euro in 2001. Then, starting in 2002, the trend reversed, and on December 31, 2003, the euro surged to the 1.25 dollar exchange rate predicted by the investment banks for 1997! Some may argue that this 30 percent drop in the dollar with respect to the euro in a period of two years reflects changed fundamentals, such as the large increase in the US budget deficit, and they are surely partly right. It is very hard, however, to explain the magnitude and timing of the change by new information about fundamentals. Already in the late 1990s many market players were arguing that the dollar had to fall, citing the huge cumulative current account deficits in the US balance of payments. Nonetheless, market players did not move for a long time and then started to move very rapidly, not because some new important information became suddenly available, but because of strong elements of herd behavior.

5. The Dow Jones Industrial Average tripled from 1994 to 2000, which meant a total increase in stock market prices of over 200 percent. The NASDAQ stock price index is used mainly to track technology stocks. NASDAQ tripled its value from 1997 to 2000.

The same kind of destabilizing, speculative herd behavior has been prevalent with respect to financial investments in emerging markets. These “surges and droughts” have been documented in many studies, including those in a recent book edited by Ffrench-Davis and Griffith-Jones (2003). The magnitude and speed of the swings are such that it is not possible to view them as caused by new information about fundamentals becoming available to market participants.

In 1997–98, overborrowing combined with rigid exchange rate regimes caused disastrous financial crises in Asian countries. Perceived by foreign investors as safe and very profitable outlets for lending, Asian countries had taken advantage of low interest rates; many over-invested in oversensitive export industries and the construction sector. But their basic fundamentals were strong, with high saving rates and relatively sound policies. The Asian crisis started in Thailand and spread to Korea, Indonesia, Malaysia, and the Philippines. Thailand had experienced capital inflows as early as the 1990s. From 1989 to 1994, foreign exchange reserves rose from \$9.5 billion to \$28.9 billion, despite large current account deficits, because capital inflows more than compensated for these deficits. Capital inflows peaked in 1995, when net non-FDI capital inflows reached a staggering 12.6 percent of GDP, and remained at high levels in 1996. Inflows were channeled into the economy mainly as credit to domestic borrowers. Equity prices fell sharply in 1996, and this meant serious trouble, as large amounts of lending by Thai banks and financial companies were secured by real estate. When a worldwide downturn in the demand for key Thai exports combined with these financial sector problems, pressure built up in May 1997 on the Thai baht. By 1997, non-FDI net capital outflows were 14.9 percent of GDP. By July, Thailand’s reserves were depleted and the Thai authorities were forced to let the currency float.

The events leading to the Turkish crisis of 2001 include a similar story of “surge and drought.” At the beginning of 2000, Turkey embarked on a new IMF-supported program featuring a preannounced crawling peg exchange rate regime that would give way to a more flexible “widening band” regime after 18 months. The objective was to defeat chronically high inflation, which had averaged close to 70 percent in the 1990s, and to regain debt sustainability that was threatened by the very high real interest rates that had prevailed for years. The program got off to a good start, as markets “believed” the preannounced path of the nominal exchange rate would be followed, at least for a while. With risk premia declining, short-term capital flowed into Turkey, taking advantage of the

large exchange rate depreciation-adjusted interest rate differentials. The current account deficit widened dramatically by the summer of 2000 without much worry in the financial markets, for inflation was indeed declining rapidly, although not rapidly enough to avoid a significant appreciation of the real exchange rate. The Turkish economy could possibly have digested the real appreciation, at least during the 18-month period for which the exchange rate path was to remain rigid and preannounced, had it not been for serious weaknesses in the banking system translating into large contingent liabilities for the government. The combination of the large current account deficit and the underlying fiscal weakness led to attacks on the Turkish lira first in November 2000 and then again in February 2001. Just as some Asian countries had to give in to overwhelming market pressure, Turkey too had to abandon the exchange rate regime and let the lira float, leading to a massive devaluation in the early spring of 2001. Private short-term capital that had provided an inflow of about 5 percent of GDP in 2000 changed direction, with outflows totaling about 7 percent of GDP in 2001!

At a meeting with the Latin American Central Bank and Finance Ministry Network at the Inter-American Development Bank in 2001, Stanley Fischer, then first deputy managing director of the IMF, evaluated the problem of excessive volatility in capital markets with the following words:

The spread of financial crises is far from random: contagion tends to hit weaker economies more quickly and more forcefully than strong ones. But even so, it is hard to believe that the speed and severity with which crises spread can be justified entirely by economic fundamentals. The contagion in Latin America from Russia's financial crisis in August 1998 is a case in point. One reason to take excess contagion seriously is that an investor panic can itself push an economy from a good to a bad equilibrium: when a country's policies and institutions are subjected to pressure from a reversal of capital inflows, they may crack, appearing in retrospect to justify the reversal of flows that caused the crisis to begin with.⁶

6. Fischer is here referring to the possible existence of multiple equilibria in general equilibrium models. The Asian crisis has led to a renewed interest in general equilibrium models where there can be "jumps" between "good" and "bad" equilibria, triggered by a change in expectations or speculative attacks. See, for example, Krugman (1996), Radelet and Sachs (1998), and Arifovic and Masson (2000) among many technical articles on the subject.

The preceding discussion of financial market imperfections and failures should not be taken to imply that it is possible or desirable to retreat from these markets or that they do not also bring benefits in terms of broadening and deepening global investment opportunities. Moreover, there are signs that market analysts have become more sophisticated and that liability positions of emerging-market countries have become more transparent. This may in the future lead to greater differentiation by country and less herd behavior affecting a number of countries simultaneously. Nonetheless, the experience of emerging-market economies over the last three decades, in conjunction with the much longer historical experience we have with financial markets more generally, strongly suggests the need for stabilizing public policy guidance and regulation, as well as orderly work-out mechanisms that can help countries in crisis. Even the most sophisticated financial markets have always needed both a regulator and a lender of last resort. Moreover, the domain of the market has to be the same as the domain of the regulator. If financial markets have become thoroughly global, there is the need for a global regulator as well as something like a global lender of last resort or, at least, a mechanism to play that role. If we want to have global financial markets, we must recognize the need for global public policy to stabilize these markets.

This should be the essential and recognized global policy role for the IMF. When market fundamentalists who still believe that markets somehow function perfectly with little or no institutional and regulatory framework want to abolish the IMF they are not being inconsistent. But progressive critics who otherwise believe in the need for public policy, and yet want to dispense with the IMF or something like the IMF, make no sense unless they take the extreme view that we should go back to tight capital controls and that countries should pursue autarchic development strategies. Some critics argue that while there is a need for a global regulator, the history of the IMF is such that it cannot qualify for that role and that a brand-new institution is needed. Others stress that it may be desirable to separate the purely regulatory and supervisory function of the IMF from its role as a lender. There is a precedent for this debate at the national level. In some countries the central bank has been both a supervisor and a lender, whereas in other countries these functions have been separated. If one started from scratch, it would probably be better to separate the lending and the regulatory role of the IMF. It is doubtful, however, that it would be feasible or even desirable and cost-effective to create a brand-new International Financial Authority-type institution.

If one believes in the need for public policy and regulation in the financial sphere, one needs a regulator and an agent of public policy, be it a renewed IMF or a combination of the IMF and an international supervisory agency. At the global level, it may be warranted to criticize the actions or the general approach of the existing institution, but one cannot dispense with it or ignore the role it is supposed to play.

The Debt Trap and the Systemic Failure of Current Arrangements

There is another related systemic feature of the current international economy that, interacting with the nature of capital markets, has led to a major systemic challenge that must be addressed. Before the 1980s, most developing country debt was foreign debt owed to official institutions or to banks. With the liberalization and development of capital markets, governments and public entities began to issue bonds in international capital markets as well as at home, discovering a new type of resource to fund public spending. Moreover, financial sector liberalization brought with it, unfortunately, frequent banking sector crises in which governments had to assume the contingent liabilities that had accumulated in the banks. The September 2003 issue of *World Economic Outlook* (WEO) prepared by the IMF contains an excellent analysis of public debt in emerging economies.⁷ Total public debt levels in a group of emerging-market economies rose from about 30 percent of GDP at the end of the 1960s to about 60 percent at the end of the 1980s and to about 70 percent at the end of the 1990s. These debt levels are very high and have created a qualitatively new and very constraining economic environment in these countries. The problem addressed is, broadly speaking, debt sustainability. The report explores the question of when do public debt levels become “too high,” leading to crisis. The WEO explains why these debt levels should be considered too high. Defining a benchmark level of public debt as a debt level that would equate the stock of debt to the present discounted value of future expected primary surpluses in the budget, the WEO arrives at the tough conclusion that the median of such “warranted” public debt-to-GDP ratios would be only 25 percent, compared to the 70 percent actual ratio in the sample of emerging-market countries

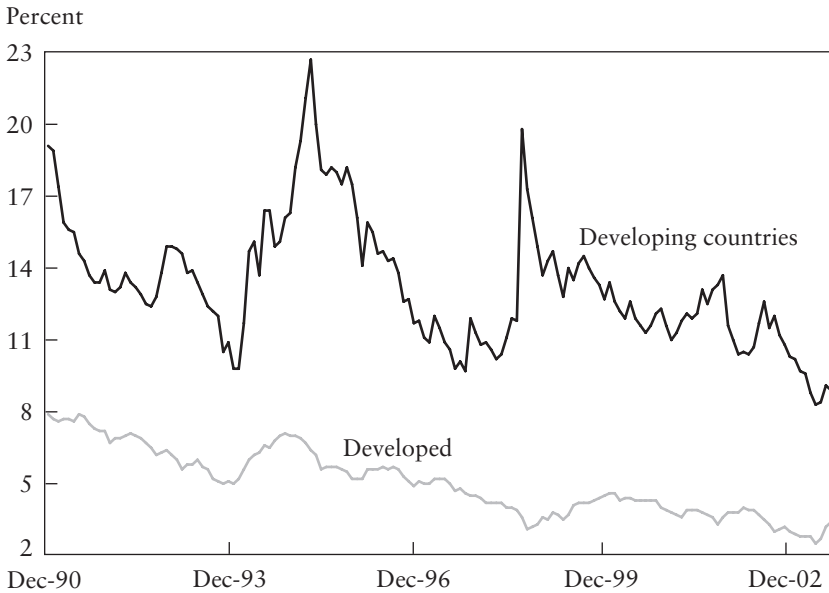
7. The IMF study defines emerging-market countries as the 27 countries in the Emerging Market Bond Index (EMBI) at the beginning of 2002, plus Costa Rica, Indonesia, Israel, and Jordan.

studied! This compares to a benchmark ratio of 75 percent for the sample of fully industrialized countries.

Why is there such a huge difference between these two benchmark ratios? Why should the advanced economies be able to carry so much more debt as a ratio of their GDP than the middle-income countries? As explained in detail in the WEO, the difference is due to the combination of shorter maturities, much lower fiscal revenue-to-GDP ratios, higher variability of that revenue, higher real interest rates, and a track record of lower primary surpluses in emerging-market economies. Because of all of these factors, many emerging-market economies have ended up in what must be called a “debt trap.” Many have debt-to-GDP ratios that are not really sustainable, making them vulnerable to repeated crises of confidence. There are, of course, important differences among emerging-market economies, with many Asian countries in much better shape than countries in Latin America or in the Middle East and North Africa. Nonetheless, it is possible to tell the following “stylized” story for a large number of emerging-market economies.

With debt ratios well above 50 percent of GDP and short maturities leading to the need for substantial rollover of debt every month, there is a constant underlying fear in financial markets that a combination of unfavorable developments could lead to what is called a “debt event,” meaning a sudden inability to service debt on time, with ensuing market panic, surge in interest rates, and pressure on the exchange rate. This kind of event could be triggered by a terms of trade shock, sudden political turmoil, or a serious problem in the banking sector. A confidence crisis could also be caused by “contagion” from a debt event in a different country. To protect against such an event, the “typical” high-debt, emerging-market economy has to run substantial primary budget surpluses and continuously pay a high risk premium on outstanding and new debt. Countries with public debt-to-GDP ratios in the 50 to 80 percent range, paying real interest rates in the 10 to 20 percent range on their domestic currency-denominated debt and in the 5 to 12 percent range on their foreign currency-denominated debt, are likely to need surpluses that are large and politically difficult to sustain.⁸ The high real interest rates exert downward pressure on the growth of GDP, which in turn makes it *more* difficult to reduce the debt-to-GDP ratio. Figure 5.1, taken from the

8. Statistical annexes of IMF Staff Reports collect detailed data on market fundamentals, and these reports are available for a good number of emerging-market countries.

Figure 5.1 *Yields on developing versus developed country debt*

Notes: Developing country yields refer to yields on benchmark emerging-market bond indexes, and developed country yields refer to the average of long-term (10-year) benchmark government yields for the United States, Europe, and Japan.

Source: World Bank 2004 *Global Development Finance Report*. GDF sources for this graph are Bloomberg, J.P. Morgan Chase, and World Bank staff calculations.

World Bank's Global Development Finance (GDF) Report of 2004, shows how large and persistent the difference in interest rates on foreign debt has been between developed and emerging-market economies.⁹ Data on domestic real interest rates are more difficult to assemble in a consistent fashion, but the difference in such rates between emerging and advanced economies is even larger, reflecting the greater exchange rate risk in the former.

In the group of high-debt, emerging-market economies, fiscal policy tends to be procyclical rather than anticyclical, as it is in the mature industrial countries. When there is a recession in an economy that does not have to worry about a debt event, fiscal policy can be expansionary

9. Thanks are due to Himmat Kalsi, one of the authors of the GDF 2004 Report, for sharing this figure and the data behind it.

and attempt to stimulate domestic demand. In industrial countries, government expenditures increase by *more* than national income in a downturn—as should be the case to counteract cyclical recession—and they increase by *less* than national income in an upturn. The same does not take place in a “typical” emerging-market economy because the income decline in a downturn tends to worsen the debt-to-GDP ratio, creating debt event fears that tend to lead to a need to tighten rather than temporarily relax fiscal policy. On the contrary, in an upturn, debt-event fears diminish and governments tend to want to catch up in their expenditures! This makes fiscal policy procyclical rather than anticyclical, a point often emphasized by critics of IMF-backed stabilization programs.¹⁰ While this situation is unfortunate, it is really not possible to avoid it in countries where public debt-to-GDP ratios are high, because relaxing fiscal policy at a time of crisis is likely to lead to fear of default and deepen the crisis. When a crisis strikes, involuntary debt restructuring accompanied by capital controls seems to be the only other option for such high-debt countries, with disruption and costs that are likely in most cases to outweigh the costs of procyclical fiscal policies!

The combination of volatile capital markets and economies that are on a tightrope because of high debt-to-GDP ratios has created an important systemic problem for emerging-market economies and the world economy as a whole. The high interest rates prevalent in these economies create an attractive short-term investment opportunity for mobile and liquid international capital. It is hard for short-term investors to resist opportunities that offer very high real returns in the bond market.¹¹ The returns can of course be even higher during upturns in equity markets. When things seem relatively stable politically and the debt-to-GDP ratio has gone down a little, thanks to good growth and/or strong fiscal policy performance, short-term capital flows into the typical emerging-market economy, often in the form of surges that can exceed 5 percent of GDP. For a while this sets off a “virtuous” cycle. The exchange rate appreciates, leading to a decline in debt-to-GDP ratios, as a significant part of total debt is denominated in foreign currency. Real interest rates decline in domestic currency terms as the demand for bonds goes up. Real returns

10. See, for example, Stiglitz (2001), who focuses on fiscal policy and the Asian economies, most of which did not have high debt-to-GDP ratios when the crisis struck in 1997. A more countercyclical fiscal policy is possible and desirable in such circumstances.

11. Of course, by definition, these high returns reflect the currency and sovereign default risk premia.

to foreign investors remain very high, however, because of the exchange rate appreciation. This leads to further capital inflows, leading to a further appreciation of the exchange rate and so on.

At some point the cycle reverses itself, however. Real exchange rate appreciation will tend to lower real growth. The current account deficit will widen and the external debt will grow due to the capital inflows. During the capital surge episodes, interest rates decline, but not to a degree that would really remove the underlying debt worries. As soon as the exchange rate starts to depreciate instead of appreciate, domestic interest rates rise again and so does the debt-to-GDP ratio. If, in addition, the capital surge episode has led to a decline in fiscal austerity, as governments take advantage of the good times to fulfill some electoral promises or prepare for the next elections, the rise in the debt-to-GDP ratio might be quite sharp, leading to an acceleration of exchange rate depreciation and a sharper rise in the debt burden indicators. If that is the case, a precrisis or crisis situation develops, bringing with it calls for an even larger primary surplus to restore market confidence. During the crisis “management phase,” IMF money will tend to replace private capital, in a sense bailing out both the country and private creditors and lengthening the maturity of the debt without reducing it. If the stabilization effort is relatively successful, the exchange rate depreciation will stop, the country will again appear as a good short-term investment opportunity to foreign investors, and the whole cycle is likely to start all over again.

Several things must be stressed about this kind of situation, which affects many middle-income and some low-income countries. First, while domestic real interest rates fluctuate over the cycle described above, they consistently remain very high, usually above 10 percent on average over a period of years. This leads to chronic, persistent debt worries. The only way to reduce the debt-to-GDP level for this class of countries to the 25 percent benchmark ratio, or even to something less ambitious in the 30 to 40 percent range, would be to run primary surpluses in the 6 to 8 percent range for an extended period of time and at the same time maintain relatively high growth rates, at least in the 4 to 6 percent range.¹² This is, of course, extremely difficult. It is much more likely that the domestic political cycle will contain episodes of “adjustment fatigue” where the primary surplus falls to much lower levels.

12. The change in a country's debt-to-GDP ratio depends on the combination of initial conditions (the initial ratio), the primary surplus, GDP growth, and the real interest rate adjusted for changes in the real rate of exchange.

It is also quite likely that primary surpluses are achieved at the expense of long-run investment expenditures in the budgets of the countries concerned. It is politically easier to cut investment expenditures in basic infrastructure and education than it is to cut wages and salaries or public employment levels, because the political costs of investment cuts are less immediate. Tight fiscal policy is often accompanied by a decline in the long-term quality of public expenditures. While the aggregate demand-restraining effect of tight fiscal policy can have a short-term, Keynesian depressing effect on growth, very low public investment levels maintained over time have a more damaging negative impact on the long-term growth rate. The combination of adjustment fatigue episodes, during which primary surpluses fall, and mediocre growth performance, partly due to the “anti-investment” nature of fiscal policy, makes it very difficult to achieve significant and sustained declines in the debt-to-GDP ratios. Many emerging-market economies have remained caught in this kind of debt trap for decades.

The costs of the types of financial crisis experienced by East Asian and Latin American countries, as well as Russia, and Turkey, are massive. Stephany Griffith-Jones (2004) has recently estimated the forgone output for the group of countries consisting of Argentina, Brazil, Indonesia, Korea, Malaysia, Mexico, Thailand, and Turkey. In her research with Ricardo Gottschalk, she estimates output loss for those countries in the 1995–2002 period as \$1.250 trillion, or an annual average of \$150 billion! Such figures are huge when compared, for example, to total worldwide foreign aid flows (not more than about \$40 billion a year measured in terms of grant equivalent value of these flows).¹³

An important factor that magnifies the financial crises experienced by emerging-market economies has been referred to as “original sin” and is due to the severe impact these crises invariably have on the balance sheets of the financial and corporate sectors. In 1999–2000, developing countries accounted for 8 percent of world debt, but less than 1 percent of currency denomination. Eichengreen, Hausman, and Panizza (2002) have coined the systemic problem of not being able to borrow in one’s own currency as “original sin.” This problem affects almost all countries except the issuers of the five major currencies: the dollar, the euro, the yen, the pound sterling, and the Swiss franc. A country that suffers from original

13. Griffith-Jones estimates output loss by measuring the difference between projected potential output and actual output over the years, where potential output is taken to be a country’s output trend over the years preceding a major crisis.

Table 5.1 *Impact of the financial crisis on poverty in four East Asian countries, 1997 and 1998*

Percent

Country	Poverty headcount index	
	1997	1998
Indonesia	11.0	19.9
Korea	2.6	7.3
Malaysia	8.2	10.4
Thailand	9.8	12.9

Source: World Bank, *Global Monitoring Report* (2004, 62) adapted from Fallon and Lucas (2002).

sin will accumulate debt that will be heavily denominated in foreign currency and will have an aggregate currency mismatch on its balance sheet. A reversal of capital flows therefore will have serious balance sheet effects as the value of domestic assets declines and the value of debt goes up. Eichengreen, Hausman, and Panizza propose putting together a diversified basket of emerging-market and developing-country currencies (EM Index) in which each currency in the basket is indexed to that country's inflation rate as a disincentive for borrowers to debase their own currency. This proposal led to a big debate on the role of the Bretton Woods institutions, and whether they should issue debt in an EM index, as their AAA ratings would be helpful in creating some market for these bonds.

Another important dimension of the problem relates to the distribution of income. The pressure of capital markets combined with periodic crisis situations has an unequalizing effect on the distribution of income. Sustained high real interest rates act as a mechanism constantly redistributing income to the rich, both across borders to foreign fund owners and, domestically, to the owners of liquid wealth. Moreover, when there is an actual crisis necessitating further fiscal tightening measures, the burden inevitably falls on the poor and middle-income groups rather than on the rich. Overcoming a crisis necessitates reestablishing confidence in financial markets. Financial capital is highly mobile and the capital account liberalizations that were implemented throughout emerging-market economies in the 1980s and 1990s mean that capital can flee very quickly if it wants to. Table 5.1, adapted from Fallon and Lucas (2002) and quoted in the World Bank's *Global Monitoring Report* (2004), describes the impact of financial crisis on the number of people living in poverty in four East Asian countries during the 1997–98 crisis.

Many policymakers have contemplated imposing higher taxes on wealth or high incomes when confronted with the need to “find” another 1 or 2 percent of GDP to meet a “strengthened” primary surplus target at the onset of a macroeconomic crisis triggered by debt event fears. I lived through a typical example of this in Turkey at the peak of the 2001 crisis. We had agreed with the IMF in March 2001 on a new and more ambitious primary surplus target of 5.5 percent of GDP and were trying to put together a revised budget that would meet this target. The distribution of income in Turkey is highly unequal, and the pending decline in GDP and employment due to the crisis was going to hurt the poor and threaten many jobs. It would have been very desirable, for equity and social cohesion, to derive greater tax revenue from the rich. The problem is that, in a crisis situation, one needs revenue quickly and cannot wait for the results of a comprehensive tax reform. We considered an income tax surcharge, a tax on liquid wealth, and a windfall gains tax, because many investors that had held foreign exchange before the onset of the crisis had made spectacular gains due to the collapse of the Turkish currency.¹⁴ In the end, we decided reluctantly, however, that any significant measure of that type would accelerate capital flight and increase the degree of panic that was already our biggest problem. We did try, using an amendment added to a bill in Parliament around midnight, to increase the deposit insurance “tax” received on deposits in the banking system, but we failed even at that because of the defection of a group of government deputies during the midnight vote. In the end, there was an increase in the value added tax, increases in taxes on tobacco, alcohol and fuel, and many increases in administered prices. The budget targets had to be met, as usual, by increasing the effective tax burden on the middle- and lower-income groups. We tried to compensate this by direct income support programs to the poorest sections of the population. The 2002 data published by the State Institute of Statistics suggest that we had some success. But we could not impose new taxes on the rich at the height of the crisis. It would have led to a further acceleration of capital flight and would have ended up hurting the country and the poor through a deepening of the crisis.¹⁵

14. In general, changes in tax laws with retroactive effects should, of course, be avoided. But in special circumstances, when large numbers of citizens are asked to accept severe belt-tightening measures, some contribution by the lucky few who benefited from the crisis can promote social cohesion and help prevent deepening of the crisis.

15. See Miller (2004) and Derviş (2004) for an analysis of the Turkish crisis.

To summarize the situation with respect to income distribution, the “structurally” high real interest rates due to sovereign default risk and currency risk, combined with fiscal difficulties during a crisis, impart an *unequalizing* bias to the process of economic development in the typical emerging-market economy. There may, of course, be countervailing forces, such as good education policies, the nature of internal migration, or the particular effects of foreign trade, which could lead to an improvement in income distribution. It will be difficult, however, for such potentially equalizing factors to overcome the unequalizing bias due to the debt trap and the tendency to run into macroeconomic crisis.

The combination of volatile capital markets, often driven by herd behavior and high debt burdens inherited from the past, have created a long-term structural problem for a group of emerging-market, middle-income countries facing chronic debt event fears, chronic high real interest rates, an inability to run countercyclical fiscal policies, and a tendency toward worsening distribution of income. Some countries, particularly in Asia, which never let their debt ratios become excessive, have been able to avoid this trap and insure themselves against future crises by accumulating very large amounts of foreign exchange reserves.¹⁶ Other countries, however, particularly in Latin America but also in Asia and the Mediterranean area, find themselves in this structural debt trap. A concerted effort is needed to help them out of this trap so that their own growth and poverty reduction efforts can succeed and the danger of recurrent financial crises of the type experienced in the 1990s, affecting the world economy as a whole, can be avoided.

Helping Emerging-market Economies Overcome the Debt Trap

The analysis presented above, drawing on the 2003 *World Economic Outlook* as well as many other publications on the topic, suggests that there is a group of middle-income, emerging-market economies that have accumulated a debt burden that will be very difficult to sustain given the cost of that debt, their growth performance, and their capacity to generate primary surpluses. These economies seem condemned to recurring crises.¹⁷

16. Note that the accumulation of massive foreign exchange reserves with low yields itself carries welfare costs. If these resources could be invested at normal yields, the countries in question would gain, provided, of course, they continued to avoid crisis.

17. See Zahler (2004) for an excellent recent overview of capital flow reversals and excessive volatility affecting emerging markets, including a review of various proposals on what to do about it.

They also have to struggle with a chronic tendency for income distribution to worsen due to high real interest rates and the effects of crises on distribution. This group of countries also contributes to systemic risk in the global economy because of the danger of contagion. A crisis in Argentina alone may not pose systemic risk. A crisis that erupts in, say, Argentina and Brazil at the same time could lead to worldwide contagion infecting emerging markets and affecting the global economy as a whole.

It has been easier to manage existing debt burdens in recent years because dollar and euro interest rates have been at historic lows. This has made it possible to carry foreign-denominated debt and has led to a dangerous degree of complacency, despite interest rates remaining high on domestically denominated debt in many emerging-market economies. Given the US twin deficits, there is a fair chance that US interest rates will have to rise again; we may be entering a period where the cost of carrying and rolling over large debt burdens will increase because of the higher cost of large amounts of dollar-denominated debt. This would make an already difficult situation even worse.

For the countries concerned, there are only two ways out of this debt trap. The first is to *grow out* of the trap by a combination of rapid GDP growth and strong fiscal policy with the help of moderate real interest rates, all the while avoiding a crisis that would constitute a major setback on the path to debt sustainability. The other way out would be to be able to negotiate an across-the-board *reduction* in the debt burden with a whole class of creditors.

The past three decades do not offer many examples of countries that have reached very high debt burdens and then successfully grown out of the debt trap.¹⁸ For most of the high-debt emerging-market economies it has been more a touch-and-go story of periods of improvement alternating with periods of deterioration, including years of crisis where progress made over a number of years can be lost in a few months. It is time for the Bretton Woods institutions to focus on this systemic problem and thereby both strengthen the stability of the world economy and help the

18. One important exception is Chile. When the debt crisis erupted in 1982, the total debt-to-GDP ratio was almost 72 percent. Through the aggressive use of a variety of debt conversion plans between 1985 and 1991, Chile retired an estimated \$10.5 billion of debt, most of which was converted into equity in Chilean companies. Chile rescheduled the principal of its debt, but otherwise met its obligations. Chile did not enter into interest arrears, nor did it seek debt reduction under the Brady Plan. It is today one of the few Latin American countries that seems to have escaped the recurrent debt-related crisis syndrome.

hundreds of millions of poor people in the emerging-market, middle-income economies escape poverty.

The financial facilities and program support offered by the Bretton Woods institutions to emerging-market economies should reflect the need to overcome the chronic high debt problem as well as help countries address specific acute crisis situations. It would therefore make sense to offer two types of facilities to emerging markets. The first type of facility would be designed to help overcome the systemic debt trap issue highlighted in the 2003 WEO. The second type of facility would deal with problems arising in specific cases, as is the case for current stand-by programs. The following discussion will focus on the IMF and its lending because the Fund is the lead institution when it comes to debt and balance of payments problems, and because it has larger resources to address these issues. Nonetheless, the World Bank's lending program has always played an important complementary role to IMF resources and should continue to do so. Moreover, the World Bank does have the potential to increase its lending volume to emerging-market economies significantly, even in the absence of an increase in its capital. A more radical reorganization of the division of labor between the two Bretton Woods sisters is also conceivable, giving the World Bank a clear mandate to expand its medium-term lending program in support of more stable growth in emerging-market economies. The discussion below essentially refers to the IMF. But the proposals outlined could also be formulated with the World Bank as the lead agency, although this would require a fairly radical "reweighting" of the two institutions.

What is clearly desirable is an IMF facility in the form of financial support for a medium-term economic program that would help a large number of emerging-market countries grow out of the debt trap and help protect them from contagion and financial crisis. To a certain degree this was the objective of the contingent credit line (CCL) introduced by the IMF Executive Board in 1999. The CCL was designed as a response to the rapid spread of turmoil through global financial markets during the Asian crisis. Favored by the US Treasury during the Clinton administration, the facility would have provided foreign exchange reserves to draw upon in order to bolster investor confidence in healthy emerging markets that are threatened by volatile capital flows and possible contagion.

Member countries not at risk of an external payments crisis of their own making, but vulnerable to contagion effects from capital account crises in other countries, would have been eligible if they met the following IMF

criteria: no expected need for IMF resources except because of contagion; positive assessment of policies and progress toward adherence to internationally accepted standards; appropriate indicators relating to fiscal balance, economic growth, inflation, capital flows, international reserves, the current account balance and soundness of the financial system; constructive relations with private creditors; progress toward limiting external vulnerability; and a satisfactory medium-term macroeconomic and financial program with a commitment to adjust policies. Access to the contingent credit line required endorsement by the Executive Board of a quantitative quarterly macroeconomic program and structural reform policies, together with a commitment to adjust policies as needed.

A key problem with the contingent credit line was that many countries with sound economies were afraid to give the wrong signal to the markets. They feared that conditions for entry to the CCL were too low; therefore they risked being lumped in the same category with weaker economies. Other countries, on the contrary, feared that after expressing interest they might fail to qualify. In 2000, the IMF introduced several important changes aimed at making use of the facility more attractive. First, the interest rate charges on the contingent credit line were reduced; they were still above lower-tranche stand-by rates, but were lower than rates on the IMF's Supplemental Reserve Facility (SRF), which makes relatively large short-term loans to countries experiencing capital account crises. Second, the disbursement of the first portion of the facility would be more automatic. Yet, no IMF member country used the facility even once and the facility was left to expire in late 2003. The reason for this failure, despite high hopes when the facility was launched, was that it ended up being neither a "lender of last resort facility" that could quickly be drawn on at time of crisis, nor a "protection facility" that would ensure a country against the risk of crisis. Countries that viewed themselves at low risk of crisis did not find it desirable to go through the required prequalification process. Moreover, for these countries, the contingent credit line did not offer financial terms that were significantly more favorable than what they could obtain from financial markets. Countries at higher risk had, or would have had, trouble meeting the prequalification criteria. Some countries also feared the possibility that the potential loss of qualifying status due to a disagreement with the IMF on policy, or a temporary slippage in policy implementation, would send a very negative message to markets that would make things much worse. These problems are real. On the other hand, making access to such a

facility almost automatic for a large number of countries could lead to irresponsible macro policies, as politicians would have a virtual bailout guarantee, causing serious moral hazard problems. Keeping countries qualified to access the facility even if policies deteriorate would lead to the same kinds of problems and would make the IMF co-responsible for the development of a crisis. On the other hand, withdrawing qualification could trigger the crisis itself. These “entry” and “exit” problems could not be overcome, and the contingent credit line was discontinued with instructions to IMF staff to come up with a reformed proposal that could work.

The underlying problem with the CCL was that it was a short-term approach to a long-term problem and focused too much on preventing contagion, whereas the bigger problem is the excessive indebtedness of an important group of emerging-market economies that have to function within an environment of highly volatile international financial markets. This volatility actually tends to be procyclical, and it raises the risk premia on emerging-market debt. What is really needed is a systematic effort to help middle-income countries overcome the debt trap that many of them have not been able to escape.

Stability and Growth Facility

An approach addressing this long-term debt problem could be developed along the following lines. The IMF, in close cooperation with the World Bank, would offer middle-income, emerging-market economies a Stability and Growth Facility (SGF) with the explicit aim of reducing their chronic vulnerability to debt-related problems over a period of time. A participating emerging-market country would agree with the Bretton Woods institutions on a medium-term growth and debt reduction program, the centerpiece of which would be a time path for the growth of real income and the reduction of a set of indicators of indebtedness. The typical qualifying country would be one where there is no current crisis, but where there is a high debt burden and therefore chronic vulnerability. Countries such as Brazil, Uruguay, Ecuador, Turkey, the Philippines, and Indonesia would be among possible candidates. To qualify and to remain qualified, the participating country would have to be certified as having acceptable policies in place, as was the case for the contingent credit line, and also have a medium-term growth program with a path for the primary surplus and structural policies in support of growth that would lead to a substantial reduction in the debt indicators. To overcome the difficulties faced by the CCL, this approach would have three elements that,

taken together, would make it more attractive and more relevant than the contingent credit line.

First, conditionality, i.e., the conditions attached to lending from the Bretton Woods institutions, would be *phased* in such a way that, *given the initial conditions*, the likelihood of upfront disqualification would be low. Take the concrete case of a country such as Turkey. If 2003 is the base, there was no crisis, the realized primary surplus was above 6 percent of GDP, growth was 6 percent, and the consolidated public debt-to-GDP ratio stood at about 70 percent, with an average maturity of less than four years. Let us assume that the target debt-to-GDP ratio for 2010 would be set at 50 percent of GDP and the average maturity would be targeted to extend to eight years. Turkey's medium-term program would have to present a credible scenario, including specific policies that could lead to such a reduction in the debt burden and lengthening of maturities. The starting point would be existing policies, which would then be modified gradually to further strengthen the program. Fiscal policy, for example, would become more growth oriented, with a gradual change in the *structure* of revenues and expenditures, while the *aggregate* primary surplus would be determined every year as a function of the progress towards the desired debt indicators.

Second, once a robust program was agreed upon, the amount of available Stability and Growth Facility financing would be *phased* over the program period. There would *not* need to be a large *upfront* disbursement, and moral hazard would thus be limited. On the other hand, a participating country could count on a *stable source of medium-term financing* that would not be impacted by the ebbs and flows affecting private finance to emerging markets.¹⁹

Third, and this too is important for the scheme to work, Stability and Growth Facility resources would have to be extended *at a price low enough* and in amounts *sufficient* for the debt reduction dynamic to work while the pursuit of social policies aimed at poverty reduction and broad-based growth would not be stalled by lack of fiscal resources. This could be achieved in various ways, all of which, however, would require some resources to allow the IMF to extend the loans at relatively low cost. The cost to the borrower should be close to LIBOR itself, or even slightly

19. The overall supply of private debt capital to middle-income countries often depends on advanced country market conditions, which have little to do with domestic policies in a specific emerging-market economy.

below, as opposed to including a 150 to 500 basis point spread proposed in the various versions of the contingent credit line and available in other IMF facilities, and maturities should be in the 8- to 10-year range. A yearly aggregate volume of lending in the \$20 billion to \$40 billion range would be needed over a decade or so to make a significant contribution to debt reduction and growth for the group of emerging-market economies concerned. The time path for the volume of lending would depend on participation rates and could be structured to first increase and then decrease.

A detailed quantitative model would be needed to analyze precise resource needs and the trade-offs involved between the speed of achieving robust debt sustainability, the primary surpluses and growth rates involved, and the volume of Stability and Growth Facility lending, as well as the pricing of these resources. The cost of the funds would need to be brought down by about 150 to 250 basis points compared to what was foreseen for the contingent credit line. Volumes in the range proposed above would require a significant but not unreasonable amount of resources that would allow for some “blending” between concessional funds and the “normal” resources of the IMF and the World Bank. A reduced interest cost of 200 basis points on an initial flow of \$20 billion would amount to a modest \$400 million the first year. The annual “cost” of allowing “blending” in this form would of course go up as the stock of Stability and Growth Facility debt increases, and could peak in the \$3 billion to \$4 billion range before declining again. A sunset clause should be built into the SGF because it is a program needed to correct a malfunctioning in the way international capital markets have worked over the last three decades. During the decade or so the SGF would be in effect, reforms such as enhancing IMF surveillance with special attention to debt buildups and contingent liabilities, the generalized practice of including collective action clauses in debt contracts and strengthening and widening the use of standards and codes, including codes of conduct for debtors and creditors, should get us to an international environment where the Stability and Growth Facility would no longer be needed or appropriate.

One might ask whether it is worth it to try to introduce blending in the form of an interest cost reduction element into the Stability and Growth Facility. The volume of resources proposed for the cost reduction amounts (cumulatively) to only a few percentage points of total emerging-market debt. While the proposed enhancement does complicate the proposal, it would have a crucial catalytic role in allowing the “package”

to work. SGF resources would be the most desirable resources available to highly indebted emerging-market economies, not only in terms of being reliable and coming with reasonably long maturities, but also in terms of interest costs. This desirability would be helpful in facilitating the internal reform processes. It would also demonstrate the willingness of the international community as a whole to shoulder some part of the burden accumulated in the past and to help accelerate growth and fight poverty in the economies concerned. It is the *combination* of continued internal reforms, within a framework that is considered helpful and legitimate by domestic citizens, and a steady long-term source of finance at moderate cost that would be the key to success.

One attractive way to raise the additional resources required for an effective Stability and Growth Facility would be to use special allocations of special drawing rights. The use of SDRs for developmental purposes and to finance global public goods has been considered in the past and most recently proposed by George Soros (2002). The Soros proposal is different in its primary objective in that it aims at providing grants for specific global public goods or poverty reduction programs rather than country loans.²⁰ The logic of using special drawing rights, which is to *raise resources* and achieve an *equitable burden sharing* that avoids the free rider problem among donor countries, is the same, however.

When discussing the pros and cons of the creation of special drawing rights in the context of the Soros proposal or as a means to lower the interest cost of a Stability and Growth Facility as discussed above, it is worth stressing that given the orders of magnitude involved, there is no danger that SDR creation would have any significant impact on world inflation. Total world GDP and total world reserves amount to about \$40 trillion and \$2.5 trillion, respectively. If the world economy were to grow at about 3 percent per annum, a relatively modest projection, total reserves could grow by about \$75 billion a year without increasing the total reserve-to-income ratio. The creation of several billion dollars worth of special drawing rights a year, which is all that would be needed for an SGF that lends at a cost close to LIBOR, would not, therefore, have any noticeable inflationary impact on the world. There could of course be other means to finance some blending for emerging-market economies. Various forms of international taxation have been proposed. The pros

20. The Soros proposal could of course be implemented separately and in addition to what is proposed here. See the discussion below on least-developed countries.

and cons of various international resource mobilization mechanisms to support development objectives will be discussed in greater detail in chapter 6, as the discussion on how best to raise these resources should look at overall needs, and resources are needed in much greater amounts for the least-developed countries and then for emerging-market economies.

Building a more robust international financial system by helping a whole group of emerging-market economies out of their debt trap is a global public good. The Stability and Growth Facility would also allow for more effective poverty reduction in the emerging-market economies and reduce the somewhat arbitrary “all-or-nothing” approach of providing highly concessional aid or grants to the poorest countries, while middle-income countries, where most of the poor actually reside, can only access funds at close to commercial cost. Finally, if implemented gradually and within growth-oriented macroeconomic frameworks, it would not be disruptive of existing global financial markets. On the contrary, in the long run, by contributing to more rapid and stable growth worldwide, everyone would benefit.

In some ways, the Stability and Growth Facility would be the middle-income country companion to the Poverty Reduction and Growth Facility (PRGF) that exists for poor countries.²¹ The degree of concessionality would be much lower and the focus would be explicitly on much more robust debt sustainability in the medium term. To qualify, countries would have to have already achieved at least short-term stability and not be in immediate danger of a debt-related crisis. Conditionality would be needed, but it would be geared to growth and indebtedness *outcomes* along the medium-term growth path and would not have to be as intrusive and comprehensive as in crisis situations or in the case of countries with much weaker governance structures.

The IMF would retain its “normal” stand-by program option, although a country could not simultaneously be in a stand-by and a Stability and Growth Facility program. The stand-by option would be available for countries that need immediate assistance in the face of a financial

21. The PRGF is the IMF’s low-interest lending facility for poor countries. The annual interest rate on loans is 0.5 percent, and repayments begin 5 1/2 years after the first disbursement and end 10 years after the disbursement. Repayments are made semiannually. The targets and policy conditions in a PRGF-supported program are drawn directly from the country’s Poverty Reduction Strategy Papers. Eligibility is based principally on the IMF’s assessment of a country’s per capita income, drawing on the cutoff point for eligibility to World Bank concessional lending, which at the time of this writing was 2001 gross national income per capita of \$875.

crisis. In stand-by programs, conditionality will have to remain more comprehensive, reflecting the needs arising in crisis situations and the danger of moral hazard. The stand-by programs would be targeted at helping overcome an actual or imminent crisis in individual countries, whereas the Stability and Growth Facility program would have the objective of reducing the chronic vulnerability to crisis that characterizes a whole category of middle-income countries that carry debt burdens that are too heavy.

As mentioned above, the World Bank rather than the IMF could be chosen as the lead institution offering and managing an SGF type program. This would require, however, a major strengthening of the World Bank's capability to deal with macroeconomic and growth issues in an integrated and programmatic manner. If one were to go that route, the IMF would hand over the area of long-term macroeconomics to the World Bank, restricting itself to a strictly short-term focus. All things considered, and given the current functioning of the institutions, it may be easier to work within a model where the IMF takes the lead on the SGF, working closely with the World Bank on the policy issues, and with the World Bank complementing the overall SGF lending with operations at the sectoral level that would form an integral part of the SGF-supported, long-term debt reduction and poverty eradication strategy.

Crisis Management and Sovereign Debt Restructuring

A program through the Stability and Growth Facility would not include support for upfront debt reduction, and the countries qualifying for SGF support would be those that could through their own efforts and with some modest help, in the form of a small amount of interest cost reduction or blending conveyed through the IMF facility, attain robust long-term debt sustainability. There may be a group of countries or "country situations," however, where growing out of the debt trap even with SGF type support will not be a realistic option. Such extreme situations are usually due to relatively sudden and very large surges in debt due to a banking crisis or a massive devaluation, or both. A recent example has been Argentina, where by 2001 the nation's public debt had clearly become unsustainable. In such cases, there is a need for orderly debt reduction within the framework of something that resembles a Chapter 11 bankruptcy proceeding, which exists for similar situations in the case

of enterprise debt within a nation-state.²² With these considerations in mind, and in response to the issues raised by Argentina's collapse in 2001 and 2002, IMF first deputy managing director Anne Krueger proposed a Sovereign Debt Restructuring Mechanism (SDRM) to deal with the serious collective action problems that arise in such crisis situations.²³ The potential benefits of moving quickly to restructure debt before a crisis hits with full force, destroying an economy and its remaining capacity to generate debt service capacity because of massive dislocation, should be clear also to creditors. In the short run, bringing into existence a type of Stability and Growth Facility would not diminish the need for a Sovereign Debt Restructuring Mechanism for countries outside the scope of the SGF and threatened by massive disruption. In the long run, however, a successful Stability and Growth Facility program would of course reduce the likelihood of debt situations requiring statutory or indeed voluntary restructuring from arising.

After a lively debate, during which the IMF refined the original proposal, the "Krueger approach," which would have provided for a *statutory* mechanism for orderly debt reduction to be achieved by an amendment to the IMF's Articles of Agreement, was shelved by the IMF governors at the 2003 Bretton Woods annual meetings in Dubai. Opposition to the approach came from the US Treasury, major private creditors (expressing themselves through the International Institute of Finance), some other rich country governors, and some emerging-market governments that feared that embarking on a Sovereign Debt Restructuring Mechanism would raise the cost of their access to international markets.

22. Chapter 11 is the part of the US Bankruptcy Code that contains the provisions for court-supervised reorganization of debtor companies. Under Chapter 11, debtors are permitted to postpone all payments on debts in order to reorganize their businesses. While other bankruptcy proceedings seek to have the debtor's assets sold and have all the creditors paid as much as possible, Chapter 11 seeks to give debtors some room in order to allow their businesses to recover and all creditors to be fully compensated. Most member countries of the Organization for Economic Cooperation and Development (OECD) are slowly moving towards a Chapter 11-type system, replacing more informal procedures.

23. Anne Krueger's first public announcement of the Sovereign Debt Reduction Mechanism proposal was in November 2001 at the National Economists' Club. After Krueger made a few more public speeches on the SDRM mechanism, the IMF published a pamphlet entitled "A New Approach to Sovereign Debt Restructuring" in April 2002. The IMF Executive Board published a paper later in 2002 further discussing the design of possible sovereign debt restructuring mechanisms. Related proposals have been made before by academic economists.

What has been agreed upon instead is to encourage the use of collective action clauses in new emerging-market debt. This decentralized, market-oriented approach championed by the US Treasury would have sovereign borrowers and their creditors put a set of collective action clauses into their debt contracts. The clauses would describe in advance and as precisely as possible what would happen in the event of a restructuring, including majority action clauses that would allow a supermajority of creditors to agree on terms binding for all.

It is possible that over time—where “time” may mean six to eight years—widening the use of collective action clauses may qualitatively change the environment in which debt restructuring for crisis countries takes place. Once a substantial proportion of debt instruments carry these collective action clauses, work-outs may become more orderly and sovereign debt restructurings may begin to look more like their domestic corporate counterparts. In this context, and as a further contribution to measures reducing the risk of crisis, it may also be very useful to consider the EM Index proposal by Eichengreen, Hausman, and Panizza, and have the World Bank and the regional development banks support the creation of emerging-market debt denominated in a basket of emerging-market currencies rather than dollars, euros, or yen, so as to mitigate the currency mismatches on the balance sheets of the public or private sectors of emerging-market economies. All these steps taken together, and implemented over a number of years, could create a much healthier and robust environment for emerging-market economies at the beginning of the next decade. As recently stressed by Roubini and Setser (2004) quoting Truman (2002), however, the international bonds of sovereign governments are only one component, and often not even the major component, of a country’s public debt. Short-term bank loans and domestic debt are often larger than international bonded debt.

In the near-term future, it is almost certain that some emerging-market countries will suffer from serious financial crisis. For such countries, old-style stand-by arrangements with strong conditionality and substantial IMF resources, supplemented in some cases with debt restructuring and debt reduction, remain unavoidable, despite the high economic, social, and political costs involved. The hope should be that decisive implementation of a Stability and Growth Facility type approach, outlined above, incorporating a small part of interest cost reduction, could gradually reduce the number of countries that remain vulnerable to financial crisis and could eliminate the frequency of crisis management-oriented

stand-bys. The early functioning of a Sovereign Debt Restructuring Mechanism would hasten the process by allowing middle-income countries with very large debt burdens and close to a crisis situation to reduce their debt and gain access to a sustainable growth path. After a certain amount of debt reduction, they could thereby qualify for the Stability and Growth Facility, instead of having to go through much more disorderly work-outs involving huge resource and welfare losses that end up being partly borne by the world economy as a whole because of contagion effects and a degree of disruption in growth and trade that could be avoided if a more orderly process was possible.

It may be of interest to contrast the proposals made here with those of former IMF research director Kenneth Rogoff in a recent article in *The Economist* at the onset of the Bretton Woods sisters' 60th anniversary.²⁴ Rogoff essentially argues, very much along the lines of Meltzer, that private capital markets are today sufficiently developed to make lending by the Bretton Woods sisters redundant. Development *grants* by the World Bank are okay—but neither institution should make *commercial* loans. It is quite true that if all that the sisters do in their lending is exactly what commercial banks do or what can be obtained in the bond market, there is no need for them. But neither “crisis lending” nor the type of lending through a Stability and Growth Facility proposed here can be provided by private lenders. And such lending is needed—it can improve welfare both in the countries concerned and in the world as a whole—provided of course that it is carried out appropriately and with the right kind of political support. Moreover, the all-or-nothing approach to concessionality prevalent in much of the official discussions is strange. Countries with incomes below a rather arbitrary cutoff point get outright grants or highly concessional loans. If average income had been a few hundred dollars higher, there would have been no grant element at all, even though the country may contain large numbers of very poor people. Would it not be more logical to graduate concessionality and introduce some blending for the lower-middle-income, emerging-market economies, which must also contribute to meeting the Millennium Development Goals?

24. See Kenneth Rogoff, “The Sisters at 60,” *The Economist*, July 24, 2004. Incidentally, I do fully agree with parts of Rogoff's analysis: “If Brazil had been given only an additional \$15 billion in August 2002 instead of \$30 billion, I believe its program would have collapsed. What good is it to throw a man ten feet of rope if he is drowning in 20 feet of water?” True. But why suggest that there should be no rope at all? Would it have been better to let Brazil drown? And having kept it afloat, would it not be smart to actually try to cure the chronic illness and forestall future crisis with a Stability and Growth Facility?

To summarize, it would make sense to group IMF facilities under two broad headings: (i) resources designed to help emerging-market economies that are not in crisis and pursue reasonable policies, but that are vulnerable because of a high debt burden accumulated in the past, grow out of the debt trap that constrains their development and worsens their income distribution; and (ii) resources deployed in countries where there is a crisis and policymakers are willing to undertake tough adjustment measures. Some of the countries in the latter category are likely to need actual debt reduction complementing the IMF-backed program. (Both types of countries could continue to have access to the Compensatory Financing Facility to help cushion external shocks due to sharp terms of trade changes or natural disasters.) The Stability and Growth Facility would deal with the first category of countries and, in contrast with the contingent credit line, would not just be an insurance program against contagion, but a program to address the fundamental vulnerability of a whole category of emerging-market economies so well documented in the IMF's own 2003 *World Economic Outlook*. It would be a long-term program dealing with a long-term issue. Programs coming under the second heading and taking the form of stand-bys would address actual or near crisis situations that, unfortunately, will continue to arise in the coming years. I do not believe that it is desirable to make a distinction within the second category between large countries, which could trigger systemic risk, and smaller countries, which cannot have systemic impact.²⁵ It is very difficult to define and measure systemic risk. Moreover, it is not always clear whether those who have proposed such a distinction have in mind purely financial risk or also wider geopolitical considerations. Finally, it does not appear equitable at all to allow extraordinary access to IMF resources for some countries in crisis and not for others. Such a distinction would undermine legitimacy. It would be better to have clear rules and policies applicable to all irrespective of size or purely political considerations. Risk arising from individual country situations would be addressed within a fair and transparent framework equal for all. The long-term systemic risk coming from the excessive indebtedness of a whole group of middle-income countries would be

25. The distinction between systemic risk countries and others has often been made, including by Larry Summers when he was still secretary of the treasury, during an important speech at the London Business School (December 1999) in the aftermath of the Asian and Russian crises. Systemic risk has never been defined, however. The implicit assumption seems to have been that the G-7 (or the United States all by itself!) will define it case by case.

addressed by the Stability and Growth Facility. It is worth stressing one more time that the high indebtedness of this group of countries constitutes a serious obstacle not only to macroeconomic stability and growth, but also to any attempt at improving very unequal distributions of income.

Alongside the management of its lending facilities, the IMF would continue to carry out its surveillance, monitoring, and data dissemination functions for all countries. It is true that the development of private markets and institutions worldwide, as well as the “learning” that has taken place, including in the private sectors of many emerging-market economies, has led to a situation where part of the surveillance and monitoring is now carried out by the markets and private institutions. This does not, however, obviate the need for IMF surveillance, which provides a comprehensive and longer-term global perspective and remains less prone to passing fads and moods that often affect private markets. In addition to pure surveillance, it may be worthwhile to encourage the IMF to develop financial insurance mechanisms that would be available to all members in good standing. Insurance works, however, only if preexisting debilitating conditions do not exist! It is likely, therefore, that an insurance-like system would only become generally workable once the “illness” of excessive indebtedness has been cured by a Stability and Growth Facility type approach and once mechanisms are in place that would greatly diminish the chances of the illness recurring.