# THE POLITICS AND ECONOMICS OF CROSS-BORDER CREDIT/DEBT RESTRUCTURING-THE EXPERIENCE OF THE “PERIPHERY” COUNTRIES

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INTRODUCTION

1. This year, in only a few months’ time we will be going through the 30th. anniversary when Mexico announced that it’s government was unable to pay service on its external debt.
   It was the initial episode of a crisis that on the debtor’s side mainly touched Latin America – although Côte d’Ivoire and our cousins in the Philippines were also involved in it – but brought about 10 years of economic stagnation, the “lost decade” as we got used to label it.
   On the creditor’s side, a banking “krach” that threatened almost all the major institutions, most specifically in the United States, was barely avoided by careful handling of it by the topmost government authorities, even if debatable as to the distribution of its costs between creditors and debtors.
   To-day confronted with the issue after 30 years it seems that little has changed, mostly the same real conflicts but also the same confusion of ideas keep coming back; “*plus ça change, plus ce la même chose*”.
2. A great deal of the confusion arises from focusing on only one aspect of the so-called debt problems – in fact credit/debt problems - normally the debtor’s problems. There are, however, various sides, to credit/debt, and most specifically to cross-border credit/debt matters. Two of them are outright economic and could be classified as a micro and a macro one. The other ones, are legal and political.
3. The one microeconomic side to debt, is very simple but normally forgotten, i.e., what is debt for a party it is a credit for a third one, to each debtor corresponds a creditor; in matters of cross-border debt a creditor resident in a different country. A debtor’s problem, therefore, is simultaneously a creditor’s problem at least as long as the amounts involved are significant.

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4. The macroeconomic side of cross-border credit/debt has to do with the fact that the creditor and debtor principals are not countries in spite of loose talk about creditor and debtor “countries”. Creditors of cross-border debt are mainly financial institutions although in some cases one could see quite a few individuals being involved – what in previous centuries were called widows-and-orphans or Belgian dentists – but not their country as a whole neither their government for similar amounts. Debtors, in quite a few cases are governments in their own countries but also financial and non-financial businesses. Thus, transnational links – links across borders between creditors and debtors not necessarily involving governments – get established and will impinge on ways to workout credit/debt crises. Independently of what happens to the rest of the countries they are resident of, this link – by itself – is dominated by matters of individual advantage and reputation as well as by law, a typical individual creditor/debtor relation although a cross-border one. The ability and willingness to grant credit and to acquire debt across-borders, in the first place, and, thereafter, to collect service on outstanding credit and to honour debt obligations by the principals actually involved in that transnational link, however, would be crucially dependent on the macroeconomic circumstances of their respective countries. In its turn, when the amounts involved are of some significance, both on the upper side and on the downside, creditor-debtor links will have profound effects on the rest of their economies. Thus, cross-border credit/debt could build up a different link, now an international link, between countries or groups of countries.
5. The political problems arise from the two sides of the credit/debt couple. As always there will exist a clear difference between the individual creditor or debtor interest and the social interest in their countries of residence. Particular - private or even government - interest and needs will not necessarily coincide with the interests of their countries at large, neither at the stage of credit/debt accumulation nor when a crisis crops up.

   And the legal side to cross-border debt is dominated – in the case of government debt - by sovereign immunity that stands in the way of usual through the courts – of the country of residence of both parties - collection of credits. And cross-border procedures seriously weakens the capacity of creditors once a court decision has granted them rights to proceed to collect their assets to actually be able to lay their hands on debtor's moneys. Additionally, the legislation under which the original contract was drafted - the creditor's country or the debtors' country one or some element of international law - and the specificities of that legislation do seriously influence a restructuring.

THE MICROECONOMICS OF DEBT; OVER-BORROWING OR OVERLENDING?

6. As there are two sides to any credit operation, credit/debt accumulation has also two sides. "It takes two for tango".
   What is debt for an agent it is credit for another one. As long as there are no repayment problems, it is a harmonious dance both sides of the couple enjoying themselves in their respective roles. But when credit/debt accumulation becomes too large, suddenly the couple breaks up in opposite directions.[2]
   Deregulation of financial systems in the advanced countries – both as to domestic as to international operations – has led, particularly in the case of large institutions, to a significant increase in leverage and in risk taking arising out of bigger competition and concentration additional to the consequences of the elimination of unlimited liability, the "too-big-to-fail" problem and time inconsistency in government various form of support in periods of crises.[3]
   Creditors involved in an "asset bubble" – in their whole portfolio or in a specific section of it – confronted with some "shock" that forces them to cut their exposure in some kind of asset might find themselves in difficulties in running it down. Their exposure having been part of a "bubble" - a collective and not an individual circumstance - any attempt by an individual creditor to sell part of those assets might find that it is just part of a generalised market move and that effectively selling those assets – if possible at all – would demand

[2] To use a more dramatic phrase not arising out of "tango" dancing, "Chuck Prince's disco inferno causes murder on the dance floor", a phrase from Aikman, D.,A. G Haldane and B.Nelson, *Curbing the Credit Cycle", A speech at the Columbia University Center on Capitalism and Society Annual Conference, New York, November 2010.

[3] See, for instance, Haldane, A.G. "Why Banks failed the stress-test", February 13, 2009 and "The $100 billion question", March 2010 both published at the Bank of England website as well as also the joint paper with D. Aikman and B. Nelson, op.cit. For the specific technical limitations of risk modelling see Danielsson, J. "The Emperor has no clothes", Financial Markets Group, London School of Economics, June 2000 and "Risk and crises", VoxEU, February 18th., 2011.

accepting a significant discount on their face value. Either going ahead or not in their sale, at market values their balance sheet will have deteriorated and if significant enough a crisis might emerge for the institution involved. An “asset bubble” having been punctured a creditor’s problem might arise.

“Overlending has led to a “creditor’s crisis”.

“Periphery” – the one old Prebisch term resuscitated in the last couple of years – or Emerging Markets – the expression concocted in the 1990’s – finance in the world of financial globalization has become an “asset class” to be compared with investment grade or non-investment grade placements in their own countries. Therefore, “overlending” to customers in the periphery is no more neither less than participating in a “bubble” in that “asset class”.

How come that financial institutions and investors in the countries of origin of funds have entered in the area of “overlending”? What about all of their vaunted sophisticated risk models? Why is it that supervisory authorities did not introduce regulations or use “moral suasion” to deter institutions and their customers from lending above prudent amounts?

As to lending institutions, for sure, there has been always the incentive to earn well above what they could earn with customers in their own countries and, particularly in the case of lending to governments massive amounts in just one go but assuming totally different risks connected with cross-border lending.

The present crisis has discredited the idea that what authorities have to do is to let bubbles burst to only then deal with them. An “asset bubble” in periphery lending has to be taken as seriously as any other one. Their consequences after the 1970s have become as threatening for the creditor’s side enough for a prudential policy towards these specific bubbles to be developed as well for a well-designed framework for a workout of the ensuing crises to be established.[4]

In spite of the fact, as it will be examined later in more detail, that capital flows behaviour is dominated both in the upside and in the downside by events in

[4] The case of the early 1980’s crisis was a dramatic threat to the stability of the U.S. and the international financial system, as the largest U.S. banks had an exposure to developing countries’ – mainly Latin American countries – of 2.8 times their capital. At the beginning of the misleadingly called Eurozone crisis the exposure of some large “centre” banks in Europe to the “periphery” was supposed to be very large and additionally the size of some of those banks relative to their economies was much higher than that of the U.S. banks back in the 1980’s.

the “centre” countries and by the leverage cycle of large banking institutions, conventional vision, on the contrary, focus on the debtor’s responsibilities. Rather than the debtor having been overwhelmed by the cross-border risk-taking and leverage cycle originated at the ”centre”, it has “overborrowed” beyond its capabilities to service cross-border debt maybe as a consequence of its own circumstances or of those of his/her country of residence. A morality tale or a children’s story - that as brilliantly analysed by Bruno Bettelheim carries powerful metaphorical messages - has been construed to erase any responsibility on the creditor’s side. So that it is up to the debtor and his/her fellow countrymen to swallow a strong measure of “deleveraging” medicine. In the case of government debt austerity measures are usually called for.

It is true that financial liberalisation in the last decades has allowed large firms – and indirectly through financial intermediaries a large number of people – as well as governments to take advantage of the cyclical availability of cross-border lending to overcome some of the limitations of their own financial markets both in matters of interest rate levels and maturities. But the recipient’s behaviour in having taken advantage of a surge in the availability of cross-border finance cannot take away the responsibilities of the powerful creditors. As it used to be stated back in the 1980’s it is at least a matter of “co-responsibility”.

THE MACROECONOMICS OF CROSS-BORDER DEBT

7. The individual transnational link between creditor and debtor across borders when generalised in volume and in the number of individuals, firms and maybe government ends up instituting a cross-border or international link between the two economies.

Now the nature of that relationship is of a different character than the individual links. In the case of individual links liquidity and solvency of the specific creditors and debtors are of the essence, besides considerations like risk-taking for the creditor and willingness to honour its obligations in the case of the debtor. Access by the debtor to the currency of denomination of the credit – normally not that of his country of residence - is an additional condition that normally arises in cross-border debt

For their countries as a whole, on the one hand, credits could multiply if the economy of residence of their principals either runs a sizeable current account surplus or their financial institutions intermediate resources funded abroad and recycle them to the country of residence of debtors. The simplest way is through financing of exports of a country with a positive balance both on trade and invisibles. But an examination of gross capital flows show that even institutions – mainly banks – in deficit countries – in terms of their current account – do extend cross-border credit by funding themselves in a third country as argued, for instance, by Prof. Shin. [5] That is the case of United States' banks that have had no problem in extending credit to recipients across-borders in spite of their country running a sizeable current account deficit.

There is a clear consensus that finance in general and also cross-border finance goes through acute cycles as shown in the classic Manias, Panics and Crashes by Charles Kindleberger as well as in the more recent and well-known work of Carmen Reinhart and Kenneth Rogoff and other authors. [6] Research on financial cycles in advanced economies has found that disruptions tend to be long whereas booms are relatively short and cycles have become shorter and synchronization across borders has been increasing over time. [7] Net flows to emerging market countries also showed to be extremely volatile already in the 19$^{th}$ century although the post-Bretton Woods period showed an instability only previously seen in the period between the world wars of the XXth. century and subject to the so-called "sudden stops".[8]

As to the behaviour of gross capital flows – in the case of EMEs distinguishing between capital inflows and capital outflows the current account being a net

[5] See Shin, H.S. "Global Banking Glut and Loan Risk Premium", Mundell-Fleming lecture presented at the 2011 IMF Annual Research Conference, November 10-11, 2011 and published in January 2012 as a working paper at Princeton University as well as in "Global savings glut or global banking glut?",Vox, December 20th. 2011.

[6] See Kindleberger, Ch. "Manias Panics and Crashes", Macmillan, London and Basingstoke, 1978 as well as Reinhart, C. and K. Rogoff " This time is different", NBER Working Paper 13882, March 2008 and their book under the same name, Princeton University Press, Princeton and Oxford, 2009. See also Aikman, D. A. G. Haldane and B. Nelson, *Curbing the Credit Cycle", op.cit.

[7] See Claessens,S.,A.Kose and M.E.Terrones "Financial Cycles: What?How?When?", *CEPR Discussion Paper* No.8379, May 2011.

[8] See Eichengreen,B. and M. Adalet "Current Account Reversals: Always a Problem?", *NBER Working Paper* No.11634, September 2005 and, also, "Is the crisis problem growing more severe?" by Bordo,M.,B.Eichengreen,D.Klingebiel and M.S.Martínez-Peria, *Economic Policy*, April 2001. For the "sudden stop" concept see Calvo, G.. "Capital Flows and Capital-Markets Crises: The Simple Economics of Sudden Stops." *Journal of Applied Economics*, 1998 vol. 1(1).

magnitude - volatility is much larger than for net inflows and they are both pro-cyclical.[9] Moreover, instability and volatility in the terminology of Gabriele, Boratav and Parikh, have been "…characterised by high, rising and unpredictable volatility".[10] Additionally, capital flows have shown to be pro-cyclical, i.e., rather than smoothing income and consumption in the receiving country, they do the contrary with clear negative effects for growth.[11] Moreover, a majority of the writers on the subject place the origin of those cycles on the circumstances and the economic policies of the countries of origin of cross-border finance and, most specifically, on interest rate shocks and the behavior of their financial sector.[12]

There seems to be, however, a shift from the "push" factor being mainly low interest rates in the country of origin of flows to it being a matter of perceived risk in the financial markets of those countries.

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[9] See, for instance, Broner,F.T.Didier,A.Erce and S.L.Schmukler "Gross Capital Flows; Dynamics and Crises, *The World Bank, Policy Research Working Paper* No.5768, August 2011. Network analysis of the cross-border banking system confirms "…that the global banking network is relatively unstable; structural breaks in network connectivity and centrality, and documented volatile interconnectedness rankings for countries, especially borrowers. In the 2002–08 wave of global capital flows, the BRIC countries and high-growth Europe emerge and consolidate their position as highly interconnected borrowers". See Miniou, C. and J. Reyes "A network analysis of global banking: 1978–2009", IMF Working Paper 11/74, April2011.

[10] See Gabriele, A., K. Boratav and A. Parikh "Instability and Volatility of Capital Flows to Developing Countries", *World Economy*, August 2000, vol.23, Issue 8. In their terminology instability is the coefficient of variation of the original series while volatility is the standard deviation of its annual percentage change; in the case of a stationary series the results are identical. These authors, very usefully, introduce a distinction between short-term capital inflows – originated in non-residents - and short-term capital outflows, including both foreign exchange reserve accumulation and private sector placements outside their own country (normally called "capital-flight"), i.e.gross capital flows were considered.

[11] For the pro-cyclical character of capital flows, see, for instance, Lane P. "Do International Investment Income Flows Smooth Income?" Trinity College Dublin and CEPR, May 2001. As to the pernicious effects of instability on growth see Kose, M.A., E.S. Prasad y M. Terrones en "Growth and Volatility in an Era of Globalisation", IMF Staff Papers, vol.52, Special Issue, 2005.

[12] For the specific case of EMEs, additional to the classical paper by Calvo, G., L. Leiderman and C.Reinhart "Capital Flows to the Developing Countries in the 1990's: Causes and Effects", *Journal of Economic Perspectives*, 10, Spring 1996 see also Ferrucci, G.,V. Herzberg, F. Soussa and A. Taylor "Understanding capital flows to emerging market economies", in *Bank of England Financial Stability Review*, June 2004. Their conclusion was: "The main lesson to be drawn is that banking flows and bond spreads are both significantly influenced by push factors, although banking flows relatively less so, possibly due to the nature of the bank-borrower relationship". Chap. 4 in the IMF's Global Financial Stability Report of April 2010 also underlines the role of "supply-side" factors additionally mentioned in later IMF documents. In a recent contribution to this debate Prof. Marcel Fratzscher, studying high-frequency data on portfolio capital flows, arrives to the conclusion that although "push" factors were prevalent in the pre-crisis and recent crisis period it has no longer be the case in the post-crisis period particularly in the case of flows to EMEs. See his "Capital Flows, Push versus Pull Factors and the Global Financial Crisis", *European Central Bank, Working Paper Series*, No.1364, July 2011. Recent events as to flows to these countries might place some doubts on Prof. Fratzscher conclusions; see, for instance, "EM fund flows: running out of puff", Financial Times, March 30th. 2012.

It used to be the case – and it still is up to a point - that one could establish a clear association between low interest rates in advanced – "centre"- economies and an increase in capital inflows to the "periphery" countries. In fact, to a certain degree capital flows tend to be countercyclical vis à vis the performance of the source economies. On the downside of the cycle with interest rates at low levels both due to a dearth of opportunities for investment but also as a consequence of the attempt by monetary authorities to stimulate activity, low interest rates "pushed" investors to search for more profitable placements. The contrary happened at the top of the cycle.[13]

More recently, however, the rapid growth of gross capital flows has been associated with increased leverage of financial institutions.[14] .

In its turn, leverage has been found, for instance by Bruno and Shin, to be cyclical inversely associated with risk premium in the advanced economies (using the VIX index as an indicator) in their words: "The driving force behind emerging economy capital flows turns out to be the leverage cycle of the global banks".[15]

In the first case, capital flows to EMEs worked as a countercyclical force, i.e., in periods of recession when commodity prices and demand in general for the exports from EMEs would weaken because of a recession in advanced countries, the resort to an easy-money policy by the authorities at the "centre" pushing finance towards the less advanced countries would play a compensatory role, at least in terms of balance of payments finance. The

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[13] See, for instance, Suter, C. "Debt Cycles in the World-Economy";Westview Press, Boulder, Col., 1992 . or Pettis, M. "The Volatility Machine"; OUP, 2001, specially Chap.4 "180 years of liquidity expansion and international lending".
The first Secretary General of UNCTAD and previously Executive Secretary of ECLA, Raúl Prebisch, had already detected such a pattern in the 1920s in the case of an Emerging Market of that era, i.e., Argentina. In various issues of the "Economic Review" of the Banco de la Nación Argentina in the years 1928 to 1929, Prebisch describes, for instance, how the "boom" in Wall Street and the tight monetary policy introduced by the Federal Reserve to cope with that era of "irrational exuberance" had driven funds away from the Argentine market that had entered in a previous period of easier money conditions in the U.S. Moreover, Prebisch argued that the volatility of capital flows was one of the two main driving forces behind the "Argentine economic cycle", the other one being the behaviour of exports setting the explanation for the business cycle in Argentina wide apart from the common explanations of those years.

[14] See Gourinchas, P.O. and M. Obstfeld "Stories of the Twentieth Century for the Twenty-First", *NBER Working Paper* No.17252, July 2011, and by Jordà,Ò, M. Schularick and A.M.Taylor "Financial Crises, Credit Booms, and External Imbalances: 140 Years of Lessons" for a much longer period; by the way both works do assert that credit overexpansion and exchange rate overvaluation were the best indicators of a coming crisis.

[15] See Bruno, V. and H.S. Shin "Capital Flows, Cross-Border Banking and Global Liquidity", March 15, 2012 for a formal model.

more recent association with volatility of markets, the 2008-2009 crisis being a case that comes to the mind, reinforces the pro-cyclical character of capital flows.

Besides their cyclical character – with severe consequences for stability and growth – there is abundant literature where it is argued that capital flows to the periphery are at least unnecessary for growth if not directly negative.[16] In one of his contributions to this debate, Prof. Stiglitz asserted that, contrary to habitual opinion, financial globalisation far from bringing in financial discipline to the conduct of economic policy in developing countries is actually the source of the worst excesses in the upswing phase.[17]

As a matter of fact, financial liberalization having made significant progress, the dangers of acquiring excessive foreign obligations has become clear as revealed by the various crises starting maybe with the Mexican "tequila" crisis (the first crisis of the XXI st. century in the words of Michel Camdessus, at that time Managing Director of the IMF).

The lessons of those crises have led to a change in many "periphery" countries policies to prevent excessive accumulation of cross-border obligations, denominated almost only in foreign currency. New regulations for the financial system have been introduced or controls on capital inflows have been applied also to the non-financial sector. In addition, foreign exchange reserve accumulation has become one of the instruments of choice providing

[16] On the matter of the effects of capital inflows for growth see "The Capital Myth: The Difference between Trade in Widgets and Dollars" by Jagdish N. Bhagwati *Foreign Affairs,* May/June 1998 where Prof. Bhagwati states that arguments in favour of cross-border capital flows and the advantages for "periphery" countries of opening up to those flows by the IMF are the consequence of this institution being dominated by what he called – by paraphrasing President Eisenhower farewell speech – the "Treasury-Wall Street Complex". Later contributions to the argument, in fact, came out of precisely the Research Department of the Fund. See, for instance, "Effects of Financial Globalization on Developing Countries: Some Empirical Evidence" by Prasad, E., K. Rogoff, Shiang-Jin Wei y M.A. Kose, March 17, 2003 where to the surprise of the authors a survey of work on the subject showed that capital inflows were not a necessary condition for growth (Joe Stiglitz in his "Capital Market Liberalisation, Globalisation and the IMF", *Oxford Review of Economic Policy*, vol.20, No.11, 2004, while commending the seriousness of the work done by the authors, points out that a different theory than the traditional one, taking into account capital market imperfections, rationality assumptions, etc., would have shown that the empirical results collated by them should have been hardly surprising). In, "Foreign Capital and Economic Growth" by Prasad, E.S., R.G. Rajan and A. Subramanian, Brookings Papers on Economic Activity, Nov.2007 (originally a working paper of the Research Department when Mr. Rajan was its head), the conclusion was that capital inflows are, in fact, negative for growth. Prof. Joshua Aizenman has also made important contributions to this argument showing that countries that self-finance their development show higher rates of growth; see, for instance, his. "Financial Liberalisations in Latin America in the 1990s: An Assessment", *Economic Journal*, 2005.

[17] Stiglitz, J. "Capital Market Liberalisation, Globalisation and the IMF", op.cit.

self-insurance against a reversal in capital accounts.

An active debate on how much and if at all capital controls may be introduced and if foreign exchange reserve accumulation is a proper prudential policy has been developing. The overall conclusion is that both policies can have some positive effects in avoiding an excessive accumulation of foreign obligations and/or providing insurance that either deters capital flight or grants the wherewithal to cope with it.[18]

The IMF, also, has produced some documents that have been understood as a shift in its "opinion" vis à vis the introduction of capital controls. But art. VI, sec.3 of the Articles of Agreement of the IMF states very clearly that member countries can resort to capital account controls as long as they do not disturb the obligatory liberalization of the current account transactions. Therefore, the IMF cannot have an "opinion" unless member countries – an 85% majority of them – are willing to change the Articles of Agreement to eliminate or condition the right to introduce capital controls (something of that sort was taking place in the late 1990's but it was stopped by the experience of the Asian crisis). A majority of those documents referred almost exclusively to the introduction of capital controls by the receiving economies as a tool– in some circumstances – to avoid both their cyclical and more permanent negative effects. More recently, the need to introduce some policies on capital flows on the side of the countries originating them has been envisaged in a more

[18] On the matter of capital controls on the side of their outright advocates one could quote Gallagher, K.P. :"The myth of Financial Protectionism: The New (and Old) Economics of Capital Controls", PERI Working Paper Series, No.278, January 2012 or Bibow, J. "Insuring Against Private Capital Flows: Is it Worth the Premium? What are the Alternatives?", The Levy Economics Institute at Bard College, Working Paper No.553, December 2008. Bibow, in fact, is arguing against the accumulation of foreign exchange reserves as the main way to manage capital inflows to then advocate, instead, for the imposition of capital controls. Additionally, Prof. Aizenman and his colleague Pinto have also produced several papers on capital controls and reserve accumulation; a recent one is Aizenman,J.and B.Pinto "Managing Financial Integration and Capital Mobility; Policy Lessons from the Past Two Decades", The World Bank, Policy Research Working Paper No.5786, August 2011. In a Pigouvian spirit of dealing with negative externalities, see Korinek, A. "Regulating Capital Flows to Emerging Markets: Design and Implementation Issues", November 2010. A different view is that exposed by Magud, N.E.,C. Reinhart and K.S.Rogoff in "Capital Controls: Myth and reality-A Portfolio Balanced Approach", NBER Working Paper No. 16805, February 2011. On the whole, capital controls are seen as an adequate measure to deal with a surge in inflows and in some cases, on outflows (vide the case of Malaysia). Previous to the documents from the IMF quoted immediately after, a Working Paper – WP/09/208 – by Binici, M.,M.Hutchison and M.Schindler "Controlling Capital? Legal Restrictions and the Asset Composition of International Financial Flows", September 2009, using a dataset disaggregated by asset class and by inflows/outflows – the gross capital flows focus – had concluded that capital controls "can affect both the volume and the composition of capital flows" but also that they could significantly reduce outflows, something that is little discussed in the literature referring almost only to capital inflows.

multilateral context.[19]

The IMF, however, seems to be working on subjecting the right to introduce capital controls – under Art. VI, Sec.3 to the strictures of Art. IV on surveillance, so that the introduction of capital controls will fall under the conditionality of the IMF.[20]

As to foreign exchange reserve accumulation the amounts and costs involved also have been subject to active debate. But the experience of resorting to the IMF facilities and having to accept their conditionality has led countries to stick to this kind of self-insurance.

Thus, on the whole developing countries have largely come out of the last serious crisis unscathed although allegations of de-coupling have been exaggerated.

But on the part of the advanced countries very little has been done to prevent what is the other side of the coin, i.e. "overlending" by their financial institutions. As it already has been examined "overlending" has been shown to be the consequence of increased leverage on the part of financial institutions leading to increased risk taking, credit overexpansion and eventually crisis.

In the words of Borio and Disyatat the origin of massive gross capital flows lies in an "excess elasticity" of the monetary and financial system to prevent unsustainable booms in credit and asset prices.[21]

Always with an emphasis in understanding gross capital flows, Prof. Shin

[19] A stream of documents have come out from the IMF either as Staff Papers or more official Working Papers on the matter of capital controls. As to Staff Papers see Ostry,J.D.,A.R.Ghosh,K.Habermeier,M.Chamon,M.S.Qureshi and D.B.S. Reinhart "Capital Inflows: The Role of Controls", February 19, 2010 and Ostry,J.D.,A.R.Ghosh,K.Habermeier,L.Laeven,M.Chamon,M.S.Qureshi and A.Kokenye "Managing Capital Inflows: What Tools to use?", April 5,2011 and as an official paper, IMF "Recent Experiences in Managing Capital Inflows-Cross-Cutting Themes and Possible Policy Framework", February 14, 2011 (this document prepared for a Board Discussion). A more global view to including the main countries of origin of capital flows has come out, for instance, in IMF "The Multilateral Aspects of Policies Affecting Capital Flows", October 13, 2011) and also in IMF "Understanding Financial Interconnectedness", October 4, 2010.

[20] See IMF "The Fund's Role Regarding Cross-Border Capital Flows", November 15, 2010, particularly Section III. and Annex 3 where although accepting some ambiguity it is argued that under Art. IV the Fund could limit the prerogatives of member countries to impose capital controls. This document as the already quoted "Recent Experiences…" where prepared for a Board discussion the second and later one, taking a more cautious position as to the capacity of the Fund to condition application of Art. VI, sec.3.

[21] Borio and Disyatat distinguish "excess savings" from "excess finance" – a consequence of their rightly stressing the difference between savings – a national income concept of income not consumed – and finance – a cash-flow concept meaning access to purchasing power which is independent of saving. See their "Global Imbalances and the financial crisis; Link or no Link?" *BIS Working Paper* No.346, May 2011.

criticizes the notion of a "global savings glut" – and the ensuing generation of balance of payments imbalances - as dominating credit conditions and the financial instability that led to the present-day crisis. In his view, one should focus attention rather on what he calls the "global banking glut", i.e. the rise in cross-border lending dominated by the leverage cycle of global banks as already mentioned for its implications for credit supply conditions and capital flows to the EMEs. [22]

Prof. Obstfeld in a recent paper agrees that the current account imbalances might matter in the long-run for the sustainability of the external position of a country but that credit conditions are dominated by gross capital flows.[23]

The process, bearing in mind the fact that cross-border finance goes through cycles, is highly unstable. The recycling of liquidity by financial institutions could come to a halt for reasons already examined. A "sudden stop" – or the end of the build-up phase of the "Big Fish, Small Pond Problem" - materialises, i.e., no institution or person in the country of residence of debtors is able to access new cross-border finance.[24] In such circumstances

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[22] As in the case of the already quoted papers by Broner,F.T.Didier,A.Erce and S.L.Schmukler. and that of Bruno, V. and H.S.Shin and, again, in this other one by Prof. Shin, emphasis is placed on gross capital flows and not on balance of payments position that besides being a national account rather than a financial concept are a net result of gross inflows and outflows. See Shin, H.S. "Global Banking Glut and Loan Risk Premium", op.cit. as well as in "Global savings glut or global banking glut?",*op.cit*. The position of Prof. Shin is also reflected in work by people at NYU's Stern School of Business, in an specific case, by Acharya and Schnabl. After studying the markets for Asset-Backed Commercial Paper during the financial crisis of 2007-2009, the conclusion is reached that "…global banking flows, rather than global imbalances, determined the geography of the financial crisis". See Acharya, V.V. and P. Schnabl "Do Global Banks Spread Global Imbalances? The Case of Asset-Backed Commercial Paper during the Financial Crisis of 2007-2009, NBER Research Working Paper N0.16079, June 2010. In previous work referring to the case of Peru under the liquidity shock generated to international banks by the 1998 Russian default, Schnabl arrives to the conclusion that "…bank-to-bank lending establishes an international transmission channel for liquidity shocks…"; see Schnabl, P. "Financial Globalization and the Transmission of Bank Liquidity Shocks: Evidence from an Emerging Market", December 2010.

[23] See Obstfeld, M. "Does the current account still matter?´, *National Bureau of Economic Research, Working Paper* No. 17877, March 2012. And in reference to the Eurozone crisis a recent contribution by one of the editors of the Financial Times asserts "The mainstay of the new framework (the recent pact struck by the EU) is **a fiscal pact that enshrines a misdiagnosis** – **that the crisis was all to do with profligate governments, not reckless lending and credit bubbles** (my emphasis); see Alan Beattie, "Pray for no more crises for we govern by default", *Financial Times*, March 8, 2012.

[24] In his contribution to last year's meeting of INET at Bretton Woods, A.G. Haldane rightly criticised the notion of "sudden stop" to suggest a different metaphor. In his view "…the underlying problem may be as much the start as the stop. The seeds of emerging market crises are sown in the build-up phase, as inflows dwarf the absorptive capacity of recipient countries' capital markets.

Capturing that dynamic requires a different metaphor – the "Big Fish Small Pond" (BFSP) problem. The Big Fish here are the large capital-exporting, advanced countries. The Small Ponds are the relatively modest financial markets of capital-importing emerging countries. Past experience suggests that as big fish enter the small pond, this can cause ripples right across the international monetary even if individual debtors, including governments, are running a surplus in their local currency accounts, collectively they will be unable to honour their obligations if their country does not shift to a current account surplus, normally through a positive balance of trade and "real" services.

Now cross-border "overlending" resulting in a "cessation of lending" by the financial institutions in some countries could not only lead to a crisis arising out of the inability or disinterest by the borrowers to honour their obligations in such new circumstances of lack of access to new finance. Even if in the country of residence of debtors reforms are introduced so as to run that necessary surplus in current account, the consequences for the countries of residence of the creditors could be less than fully positive.

Because as balances have to square, a surplus in current account in the country of residence of debtors, will imply that in some other part of the world a deficit has to be run, normally in the country or countries of residence of creditors.

Therefore, even if creditors get back their money without any more lending, some countries will have to accept a reduction in output as a consequence of having to run an external deficit by selling less abroad and importing more. Creditors would be getting paid at the cost – for the rest of their economy of residence or that of another country originally running a surplus – of a reduction in national income. While the country of residence of debtors will be forced to reduce absorption to make room for a current account surplus.

Thus, although at first sight countries are involved in a conflict on the matter of debt obligations being honoured, in fact, there is a common advantage in finding a way to workout the problem with less punishment for their whole economies.

Back in the 1980's a simulation was run with the MULTIMOD model at the IMF about the consequences of a scheme under which governments of the advanced countries – at that time all of them creditor countries – would over a period of 5 years pay half of the service of indebted developing countries, financing the expense by issuing public domestic debt in their own markets. The result was that freeing developing countries from part of the burden of

system, never more so than in today's financially interconnected world. See his "The big fish small pond problem".

debt servicing could have a significant positive effect not only on these countries' economies but also on the economies of the industrialized countries. Briefly, the simulation showed that, for each dollar of debt service reduction, incomes in industrialized countries would increase by significantly more than one dollar, as a matter of fact by even more than a dollar-and-a-half. For the “centre”, therefore, the cost of accommodating the collection by the creditors resident in their countries from the “periphery” ones was a decline - to a multiple of more than one - in activity and income levels.[25]
Mainly for their consequences on the "real" side of the industrialized countries' economies, but also for its possible effect on some financial institutions, difficulties in “periphery” countries finance, therefore, do matter to “centre” countries. Moreover, the direction of the stakes is similar. Both sides win with less debt service.

Thus, there is a two-way relation between economic events in advanced countries, on the one hand, and debt in the “periphery”, on the other. Events in the “centre” dominate the cycle of capital flows to the “periphery” with their arguable positive and negative effects for the recipient countries both in the upside and the downside of the process. In the opposite direction, the way in which having arrived to the last stage of the build-up phase of the “Big Fish, Small Pond Problem” the difficulties in the creditor/debtor relations are worked out will have significant impact on the “centre” economy.

Co-responsibility, therefore has to be assumed and international cooperation could work for the mutual advantage of “centre” and “periphery” countries unless that defaults in debt service by the “periphery” – involuntary restructuring - and the consequent need for bail-outs of financial institutions in the “centre” becomes the preferred solution.

[25] The simulation results were reported in *International Monetary Fund* *“World Economic Outlook”, Appendix, “Medium-Term Scenarios”,* SM//88/52, March 4, 1988, pp.28-31. This appendix was part of the WEO discussed first at the Board of the Fund and later at the “Spring” meeting of what was still called the Interim Committee. But it did not figure in the printed, public, edition of that semester WEO. A similar simulation was performed with the LINK model and reported in *United Nations, World Economic Survey, 1989*, New York, 1989; Box II.5.pp.40-41

THE POLITICAL AND LEGAL SIDE TO CROSS-BORDER DEBT AND DEBT RESTRUCTURING

8. Once again, countries are not as a whole debtors or creditors. Credit and debt accumulation involves specific individuals and institutions, in some cases, governments are principal to one or to both side of the credit/debt relation. But the accumulation of those creditor/debtor links across country borders ends up by building a country to country link. The important question to keep in mind is that not necessarily the interests of individual debtors and/or creditors – even if one of them or both are governments - or of them as a group coincide with those of their country at large. There lies the building ground for the political side of cross border debt both in the upside and the downside of the credit cycle and in moments of debt crises and restructuring.

   A review of the different moments of post WWII cross-border debt accumulation and restructuring will let us explore the political and legal side of the way they were managed.

   a) <u>The crises of the immediate post Second World War period; official lending, the Paris Club and a new role for the IMF</u>

   The crises of the immediate post WWII period did involve governments on both sides of the table. Restructuring – albeit of minuscule volumes compared with what has been later the case and arising mainly out of trade deficits – was a difficult affair but did not involve the private sector on any of both sides.[26] Creditors were fast to get together and the Paris Club – a creditor's cartel although an intergovernmental one - was invented in 1956 to deal jointly with Argentine government debt and later with that of other countries. As it is well known the Club was not and is not an institution but a forum were creditors meet to agree the general lines of a restructuring with the debtor government.

   For the debtor governments that somewhat later were led to agree to a programme with the IMF – originally setup to govern the behaviour of the

[26] An exception among advanced countries were the 1953 so-called London Agreements to deal with German debts, both pre-war and post-war. The post war ones were government to government debts arising out of the Marshall Plan and other "aid" programmes. But pre-war debts involved the private sector both on the creditor and debtor sides. The London Agreements ended with a "haircut" of more than 50 per cent and a grace period of 5 years. See Hersel, Philip "The London Debt Agreement of 1953 on German External Debt: Lessons for the HIPC Initiative" in EURODAD "Taking Stock of Debt; Creditor Policy in the Face of Debtor Poverty", Brussels, 1998.

systemic countries gradually becoming more involved with "periphery" ones - to be able to seat at the negotiating table and for their countries, debt restructuring involved a country-wide adjustment of their economies as well as of the government finances. So that the restructuring episode from that perspective actually implied a crisis, to make room for debt service and accept other elements of an adjustment of their economies that touched different social sectors in their countries. In the creditor countries, admittedly, the negotiations implied postponement of receipts with budgetary consequences, the difference in size between the advanced countries sitting on the creditor's side and the debtor countries being such that the consequences went almost unnoticed.

<u>b) The 1970s return of private international finance; the recycling of "petrodollars" and the "creditor's crisis" of the 1980s</u>

The return of private international finance, mostly beginning in the 1970s in the form of syndicated bank loans – the "recycling of petrodollars"- completely changed the process of lending and borrowing, the actors and the volumes involved. This "recycling" ended up in the generalised crisis beginning in 1982 under the shock of suddenly increased interest rates, entailing an increased debt service – interest on loans was adjusted every 6 months as a fixed margin on LIBOR – but also a reduced demand in advanced countries plus a collapse in primary product prices. Cessation of lending – a "sudden-stop" or the end of a cycle of the "Big Fish, Small Pond" problem– followed, closing the market to refinancing of debt service.

This time, the private sector was involved on both sides of the process. On the debtor's side there were countries like Chile where almost 80 per cent of their external debt was private although more in general government debt was predominant. But most importantly, on the creditors side as mentioned before, the largest United States banking institutions were severely exposed to developing countries' debt.

It was now that what had previously been debt restructurings acquired citizenship of a "debt crisis", in fact, because it had become a "creditor's crisis", a private creditor's crisis combined with the "too big to fail" syndrome. On the debtor's side, also, those beginnings of the process of financial globalization had led to a two-way traffic for their private sectors. Firms, the large ones with connections abroad, took advantage of financing themselves at longer-terms and lower interest rates than those available in their domestic financial sector. And as accompanied as they were by a process of financial opening up, their owners learned to place a proportion of their wealth mainly in the large international banks, something that already in minor amounts was acquired practice through “black-market” operations, the so-called “capital flight” phenomenon. Moreover, sometimes such funds were recycled through intermediaries as lending to their countries of residence even to their same firms but getting registered as external debt (the so-called “back-to back” lending,). Thus, residents of a country could paradoxically become ultimate “foreign” creditors of their own fellow countrymen either directly or through their government. This way, cross-border debt became also a domestic problem where the immediate interest of a group in society – as customers of international banks - differed from that of the rest of the population and of their government.

In addition, when crises hit – normally a triple one of devaluation, debt and domestic financial institutions – private firms managed through various means - under the threat of going bankrupt - to transfer a large proportion of their obligations to governments that had their own debt problems. To the “external transfer” problem arisen out of the dearth of foreign debt refinancing of debt service an amplified “domestic transfer” problem from the private to the public sector was added The burden of adjustment channeled through government attempts at increasing revenues and reducing expenditure to make room for debt service fell, precisely, on the rest of society; but failures to generate a primary surplus of several points of GDP led to serious instability as resort was taken to deficit financing plus expansion of domestic debt.

The threat on the financial sector in the countries of residence of creditors being so serious, after an initial hesitation, governments, most specifically the U.S. government, rather than allowing “the markets” to workout the problem, started intervening directly and indirectly through the IFIs in the process (the amount of official bilateral credits was really reduced compared with those granted by the private institutions).[27]

[27] On the creditor’s side it was Donald Regan, the Secretary of the Treasury of President Reagan at

The IMF was first called forward jointly with the institution of “Steering Committees” – now private creditor’s cartels – that the creditor banks had set up. Only thinly disguised – as later under the Asian crisis mentioned by Prof. Bhagwati (the “Treasury-Wall Street Complex”) the hand of the U.S. Treasury and that of the Federal Reserve were guiding the whole process - fortunately sometimes above the heads of the IMF bureaucracy and sections of its Board (mainly Northern European countries including Germany) - Latin American debt, although in the hands not only of U.S. banks, being considered mainly a responsibility of the U.S. government as the Polish debt problem only a year before had been considered as the responsibility of the German government. Later, the Multilateral Development Banks – through so-called “structural loans” or less euphemistically “fast disbursing loans” - had to get involved (the “Baker Plan”) as the short-term character of the Fund’s facilities became inadequate for a long drawn process.

But government intervention was shown to be seriously misguided. In the first instance, something that would repeat itself up to the very end of the 1990s, no policy of “haircuts” from private banks that had got themselves into such trouble was imposed. Admittedly, the degree of exposure of the largest banks made it almost unfeasible in the case of more than one country. But no direct “bail-out” from government funds was envisaged either, although in some countries provisioning was tax deductible.

A strategy gradually developed from case to case – “centre” countries refusing to deal with the problem as a global one – the “muddling through” that could be labeled as the “revolving door” one, i.e. instead of “clearing the decks” in just one coup – or several graduated ones - by directly bailing-out their banks from their exposure to such a volume of problematic assets, rescheduling of principal repayments and some “fresh money” – always less than interest payments - both from banks and from IFIs were granted to debtor governments.

Disbursement from the banks and the IMF was made a necessary condition of

that time to advocate that “the markets” should take care of the problem as in a normal case of debt over-accumulation. On the debtor’s side, Gral. Pinochet also pronounced himself that private firms foreign indebtedness was something that the government shouldn’t get involved into. Mr. Regan soon lost his job and Gral. Pinochet decided to change opinion to assume also the responsibility of negotiating restructuring of private debt.

each other making the negotiation a truly complicated affair to reach a joint deal (made even more complex by the need to simultaneously deal with official bilateral debt through Paris Club renegotiations that incorporated the concept of "burden sharing" i.e., the effort made by banks had to be equivalent to that of governments seating at the Club).

Severe adjustment by the "periphery" – under a negative shift on the average of around 5 points of GDP in external transfer of resources - was made a condition for being worth of receiving some finance from banks and the Fund. This way, "periphery" countries were supposed to be able to generate the necessary domestic – from the private to the public sector - and external transfer of resources to pay for debt service.[28]

The "revolving door" strategy, of course, meant that governments would receive some resources with one hand and with the other use those funds to repay creditor banks in addition to their own resources,. The whole process was made more chaotic due to the IMF insistence in tranching their disbursements, quarter by quarter, to control fulfillment of conditionality so that the indebted economies were faced with an extraordinary degree of uncertainty, the "short-leash" side to it.

The result was the "lost decade" for the sake to adjust to what in fact was a maladjustment of at least the major advanced economy, running a voluminous fiscal deficit countered by a restrictive monetary policy that by the end of the 1980s was threatening their own financial systems, first with the Savings&Loans crisis and the bank difficulties at the beginning of the 1990s that finally convinced the authorities in the U.S. to reduce interest rates.

Banks however, use those years to reduce their net exposure to cross-border problematic debt by building up their loan loss reserves. Before the end of the decade many of the large banks – Citibank in the first place – were ready to get rid at a big discount - in the by then highly developed secondary market for debt documents – of a large part of their portfolios. For the creditors,

[28] Most countries, through import compression aided by generalised balance of payments crises leading to significant devaluation of their currencies, were pretty fast to achieve current account surpluses. And in countries were the export sector was government owned – like in Chile or Venezuela – the foreign surplus once obtained almost automatically sorted out the "domestic transfer" problem. That was not the case, for instance, of either Argentina or Brazil among the largest debtors. Both countries resorted to deficit finance and/or massive issues of domestic debt to materialise the internal side of the transfer problem with serious consequences for their stability.

therefore, the “muddling through” cum “revolving door” strategy was eventually crowned with a success. By the end of the decade, the “creditor’s crisis”, the true crisis, had faded away.

On the other side, the indebted countries – dominated by what was called as “adjustment fatigue” – started falling into arrears in their debt service, a strategy that at least in the cases of Costa Rica and Bolivia was supported by the IMF that in 1989 introduced the “lending into arrears” policy, allowing the Fund to continue disbursing resources even if countries were not up-to-date in their debt service to banks. The generalization of partially falling into arrears was also condoned implicitly by authorities in the U.S. and had become even if precarious a gradual way to introduce “haircuts” in the foreign obligations of indebted countries.

The development of a secondary market for bank loans to the “periphery” and the willingness and capacity – in terms of solvency – of big banks to accept the discounts implied in selling their portfolios in that market led to the “Brady Plan”. Brady Plan agreements were debt and debt service (DDSR) reduction operations with commercial bank creditors receiving financial support from International Financial Institutions (IFIs) and the Export-Import Bank of Japan. As announced originally the "Brady Plan" exclusively granted support to <u>voluntary</u> market-based operations.[29] The debtor country, of course, was subject to IFIs' approved policies as a condition to receive support for the operation.

Consequently, "Brady Plan" operations were, first, onerous -- although partially financed -- for the debtors and, second, participation by banks was basically <u>voluntary</u>. The results of the application of those two principles were materially important. First, by having to provide collateral at their cost, debtors were early forced to divert significant resources from either consumption or investment to the debt reduction operation. Second, banks being in the position of opting out of the specific debt or debt service reduction options, not surprisingly their actual payoff was positive. Rather than selling their “toxic”

[29] The debt reduction mechanisms applied were either cash buybacks of debt -- at a discount - or exchange of previous debt instruments for new "enhanced" ones involving either a cut in face value (Discount Bonds) or in interest rates (Par Bonds). "Enhancements" of new instruments took the form of collateral against future payments of principal and interest contributed by debtors. Debtors had to finance the "enhancements" out of their own reserves or with funds lent by the above mentioned agencies.

loan portfolios in the secondary market at large discounts they could now receive easily saleable bonds their face value and first years of service supported by riskless collateral.

As renewed application of "Brady Plans" has been part of more recent debates it would be useful, just for the record, to make it clear that the true result of the application of the Brady Plan, at the end of the 1980s and beginning of the 1990s, was an increase of 12 per cent in the volume of foreign obligations measured at market prices of the first seven candidates. [30]

Lessons that could have been learned from the 1980s crises. First and foremost, financial globalization is a risky environment in which only the most powerful agents in a position to compel being "bailed out" by their governments in their turn capable of mobilizing massive resources are able to survive without serious damage.[31] Second, that the "muddling through" cum "revolving door" strategy was extraordinarily inefficient resulting in a lost decade for the countries of residence of debtors but additionally in loss of output and incomes in the countries of residence of creditors.. Third, that the crisis was unleashed by a sudden shift in monetary policy started in the U.S. and transmitted to the rest of the advanced countries, intended to cope with the imbalances of those economies..[32]For all the talk about globalization and international cooperation, policies respond to each countries' demands at least in the way that they are interpreted by their governments. Fourth, that superior alternatives existed either – as resulted out of the already quoted experiment with the IMF's MULTIMOD model by more public refinancing – at lower advanced countries interest rates - or by the introduction of "haircuts" in creditors portfolios thus compensating their profitable previous "overlending". As it happened "periphery" countries were forced to pay for the advanced

[30] Such an estimate is included as Table 1.5 in this author's "A Report on Developing Countries' Finance and Debt with Commercial Banks" (unpublished report prepared for the 1993 Trade and Development Report produced by UNCTAD).

[31] The aggregate funds provided by governments at the apex of the present day crisis is estimated to have reached only in the U.S., U.K. and the Eurozone, some US$14 trillion or a quarter of world GDP. "Yet there is one key difference between the situation today and that in the Middle Ages. Then, the biggest risk to the banks was from the sovereign. Today, perhaps the biggest risk to the sovereign comes from the banks. Causality has reversed." From Alessandri, P. and A.G. Haldane "Banking on the State", Bank of England, November 2009.

[32] A back of the envelope calculation could easily show that had US$ real interest rates gone back not to the negative levels of the end of the 1970s but to those of say the 1960s, a more normal decade, indebted countries had in just a year adjusted their economies so as to be able to fully comply with their external debt service and consequently again become creditworthy.

economies disequilibria and to preserve the lending banks balance sheets. In terms of domestic distribution, however, in the advanced economies, the non-financial economy – business and workers – had to relinquish income, jobs and profits for the sake of protecting the big banks.

In the "periphery", through loss of output, high inflation and general instability, all sections of population but a small wealthy section of society with significant funds placed abroad – having transferred most of their obligations without being asked for a reasonable quid pro quo in terms of tax revenues - were made to pay for the adopted strategy.[33] And their governments became powerless struggling to find space for the highly augmented debt service and with their policies subject to quarterly inspection to comply with what later was baptized as the "Washington Consensus" (pace John Williamson whose summary of the policies was much more moderate than what was actually imposed through conditionality).

The result of it all could well have been the worst of both worlds. Markets, in fact, were not left to work out the debt because of the economically unacceptable process of wholesale bankruptcies and financial crisis. But reluctant public intervention did not assure either an efficient solution - increased jobs and activity - or a socially equitable one. The whole process - and this is a particularly important consideration for the young democracies of most developing countries but also for the older ones of other continents - was far removed from public accountability and examination by the democratic structures of government.

<u>c) The early 1990s renewed credit cycle to the "periphery" and the chain of crises in the last half of the decade and the beginning of the next one; bonds and credit rating agencies; CACs and "Private Sector Involvement" (PSI) make their entrance</u>

The already mentioned early 1990s reduction of interest rates – and not the Brady Plan – was the reason for significant relief in debt service and also a "push" factor for a new wave of capital flows towards the periphery. As always

[33] A perusal of the figures provided by the BIS in its Quarterly Review about the volume of deposits in the banks surveyed for their statistics from residents in the various countries showed a sudden increase to very high volumes from Uruguay a relatively small country. Protected by very strict bank secrecy Argentine residents had decided to even placed abroad – at a very short distance – the part of their savings that they still kept in Argentina lest the government would decide to confiscate them even if partially to compensate transfer of debt obligations to public accounts.

memories in the financial markets are almost inexistent and the "pull" factor infinitely less important than the "push" one..[34]

This time, aided by the placing in the markets of the "Brady bonds", in most cases, debt operations were configured as bond issues – like those that fell into default in the 1930s - rather than bank loans, although short-term bank credit lines expanded and was significant in the case of several countries.

At that point in time "rating agencies" make their entrance *en force* providing marks to guide investors in those bonds. And with those bonds traded in international exchanges, derivatives were created and a role, for instance, that of deciding if a debt restructuring implied a "default" or a "credit event" was acquired by a private organization of derivative traders. [35]Regulations on, for instance, banks having been linked to ratings of their portfolios, these private unaccountable organizations have an enormous sway on decisions by those having issued bonds. A reduction in rating of a bond or on the whole bunch of those issued by the government of a country – a "falling angel" – entailing at least an increase in the cost of financing. More in general "periphery" countries and their governments – as well as increasingly even advanced countries - have become dependent on the opinion of those agents, opinions that not only reflect a rather conventional – and mistaken – view of what is right and wrong in economic policies but that repeatedly have failed to, for instance, predict crisis. In fact, as it happens to many institutions and traders in the financial markets their opinions tend to flock together, following the "beauty contest" pattern described by Keynes more than half a century ago..

Memories being short - aided by economic history having been erased from most curricula in economics at least in the U.S. – the question of how to deal with a crisis in bond debt suddenly had to be faced when the "Tequila" crisis erupted in early 1995. How would a crisis be handled now that there was no

[34] Attention should be paid to the fact that those flows were directed, to some significant extent, to countries that had for all practical purposes defaulted on their debt obligations only up to a few years before the new wave had arrived. Brazil undergoing inflation rates of 30 per cent per month and not having closed its Brady Plan agreement already in 1992 was receiving a true flood of new inflows.

[35] As we all know rating agencies are almost only three and as to the derivatives traders we are referring to ISDA (International Swaps and Derivatives Association) created back in 1985.

"Steering Committee" as a counterparty to a negotiation?. [36]

That first crisis of the 21st. century, as baptized by Michel Camdessus, at that time head of the IMF, was handled mainly by massive deployment of resources from the Fund – breaking all rules about "access limits" or the relationship between the amount put at a disposal of a government and the countries' quota – and by the U.S. government through a reinvention of the role of an inheritance from the late 1930s, the Exchange Stabilization Fund.[37]

The intervention was a clear success as the crisis was over pretty soon and a large proportion of the resources granted to the Mexican government were not actually put to work. Massive "International Lender of Last Resort" intervention did prove to be efficacious.

In spite of such a success, various official bodies and academics continued studying the question of possible procedures of renegotiation of cross-border debts in the form of bonds. Three conclusions came out of an almost official document of the G10. The introduction of "Collective Action Clauses" (CACs) was the first one, and the other two were the notion that the IMF could be ready to grant "lending into arrears" – and that in some circumstances countries could be justified to at least temporarily stop servicing their debt obligations - plus the addition of "Private Sector Involvement" (PSI).[38]

The Asian crisis arrived before any of those proposals had been fully adopted. If anything the principle of PSI was applied in a sui generis way in the case of Korea – as later in that of Brazil and more recently by the "Vienna Initiative" in the case of Central and Eastern Europe – by demanding banks to maintain their levels of interbank lending.[39]

It took the Russian default of 1998 – when some banks actually incurred in significant losses - for PSI to be applied in later cases. Under the traditional application of "burden sharing" among the various kind of creditors – that had

[36] Having examined that the individual interests of lenders – banks in the 1970s – do not necessarily coincide with those of society at large, the role of "Steering Committees" as negotiators, however, was never the right one as they could not be asked to take into account the externalities involved in their decisions.

[37] Mexico was granted a support by the IMF equivalent to 690 per cent of its quota, when the normal "access limit" is 3 times the quota.

[38] See Group of Ten "The resolution of sovereign liquidity crises; A report to the ministers and governors prepared under the auspices of the deputies", May 1996. The G7 had asked for such a report in its meeting at Halifax, Canada, on June 1995, right after the Mexican crisis.

[39] Learning from the Korean experience, banks holding credit lines in Brazil had drastically reduced their volume as the crisis approached.

been applied to banks during the renegotiations in the 1980s – in 1999 the Paris Club extended the concept to bondholders and placed as a condition on Pakistan, Ukraine and then Ecuador, that bondholders had to accept a “haircut” financially equivalent to the reductions the Club was granting.

The preoccupation almost obsession about private creditors sharing the effort in a debt restructuring remained and gave birth to twin proposals, the first one, the wholesale introduction of CACs in all bond issuance and, the second one, Ms. Krueger’s proposal of the “Sovereign Debt Restructuring Mechanism” (SDRM).

Wall Street, of course, was less than happy with any of those proposals which had been supported by the International Monetary and Financial Committee, at the IMF, in its meeting in the second half of 2002. Eventually, the SDRM was ditched and the generalized introduction of CACs was accepted; Mexico as in many other occasions took the initiative and issued bonds with CACs with no difficulty showing that the financial market could accept such a preventive move to facilitate a restructuring in case of need.

In fact, the issuance of bonds with CACs was giving way to a stratification of issuing countries, i.e., those countries the financial markets thought as improbable to have to restructure their debts could easily issue a bond with CACs – in such case was only a formality – while the other ones were the probability of restructuring would be high – and therefore in need of those clauses to facilitate a renegotiation - would be denied acceptance of their use.

Turkey and Brazil underwent new crisis but there was no novelty in the way in which they were managed. With minor variations the “Revolving Door” cum “Short Leash” strategy was also applied in their case, in spite of all the strongly worded proclamations against creditor’s “moral hazard” and that governments and intergovernmental organizations (or “the plumbers and carpenters” in the words of the then Secretary of the Treasury of the U.S.) should stop “bailing-out” private creditors.[40]

The traditional “periphery” countries, however, did learn a lesson out of the

[40] By the way, such an expression was also a case of misleading public opinion about the facts of the case, i.e., governments receiving IFIs funds with extremely few and minor – in terms of volumes – exceptions have punctually paid service on their debts to IFIs; if anything the U.S. and other members of the Fund not resorting to its facilities have been perceiving interest on the amounts lent to other countries.

previous 1990s and early 2000s crises, even if not fully in some cases and , as we have already examined, against the opinion of the IMF and many other well-meaning sources. Some dampening of capital inflows has been applied by quite a few countries – and recently intensified under a new new credit cycle – and reserve accumulation – in preparation for a “rainy day” - has become generalized, all in a context of attempts to avoid domestic generated disequilibria. Thus, these countries have gone unscathed through the last crisis without themselves undergoing one, only just a passing deceleration in their growth rates having anyway become the “locomotive” of the world economy.

The other major rue new event was the default by Argentina in early 2002 followed in 2005 by a unilateral offer to exchange the old debt for a new one at discounts bordering two-thirds of the original face value. The result was on the whole successful and the long process of previous negotiations – accompanied by limited support from the IMF – encountered a laissez faire attitude from the government of the U.S.[41] The case of Argentina set a precedent of a totally different kind of debt renegotiation with no support of the IFIs and significant PSI. As many commentators have pointed out it has set an example of another way to deal with excessive credit/debt accumulation. This case, also, renewed the question of the activity of “vulture funds”.

d) The renewed 2003-2008 credit cycle to the “periphery”; the crisis shifts from the developing countries to the European “periphery”.

A renewed cycle of capital flows to the periphery in the period 2003-2008 almost erased the discussion of debt renegotiations from the public agenda. In a way what had been accumulated in the late 1990s and early 2000s about the issue was left in the past. It took the crisis of 2007-20xx, in the “centre” countries and the increasing difficulties of the European “periphery” – including Ireland – and their creditors to maintain a normal flow of finance going, for the debate to come back again, unfortunately with less than full consciousness of what had been tried or at least discussed only 10 years before.

[41] On the cavalier attitude of the U.S. government to the massive default and debt renegotiation of Argentina see Helleiner, E. “The strange story of Bush and the Argentine debt crisis”; Third World Quarterly, vol.26, No.6, 2005.

The “muddling through”, leading to the“revolving door” cum “short-leash” strategy made a strong comeback. Lack of prevention allowing for “asset bubbles” in some cross-border credits to develop and when the bubble bursts the same medicine is repeatedly applied based on the same wrong diagnosis of the problem of overlending/overborrowing. Only so-called “Private Sector Involvement” (PSI) started making some way, in the ongoing negotiations of the Greek crisis.

In search of an explanation for resisting a change to amore economically efficient and socially justifiable strategy, one might easily resort to assume that it is outright silliness, the incapacity to understand the “fallacy of composition” that makes “public vices”, a recession, out of “private virtues”, honouring one’s debts.[42]

There is also the question of the “short-leash” and the temptation to use conditionality to redirect the economy of the debtors towards what are supposed to be the right policies, those consecrated in the “Washington Consensus”. [43]

But above all there predominates the power of large financial institutions that against all their proclamations in favour of the free working of “markets” repeatedly make governments intervene when faced with trouble but even most importantly they have been able to project over governments and public opinion their vision of the world. In the case of cross-border debt, to which they are party to, the image of debtor governments or even of whole countries as irresponsible – how come that responsible institutions were lending money to irresponsible customers – and therefore subjects of a morality tale has been efficiently construed under which those governments and countries are supposed to absorb not a few spoons but barrels of castor oil to purge the rot

[42] The sacrosanct principle of honouring debts, whatever the conditions and circumstances unavoidably takes us back to a scene in Shakespeare’s “The Merchant of Venice”: “*Portia*: Therefore, lay bare your bosom. *Shylock*: Ay, his breast; **So says the bond**: doth it not noble judge? Nearest his heart: those are the very words. *Portia*: It is so Are there balance to weigh the Flesh? *Shylock*: I have them ready. *Portia*: Have by some surgeon, Shylock, on your charge, to stop his wounds, lest he do bleed to death. *Shylock*: **Is it so nominated in the bond?** *Portia*: It is not so express’d; but what of that? ‘Twere good you do so much for charity. *Shylock*: I cannot find it; **‘tis not in the bond**. (my emphasis).

[43] For a presentation of the argument of how via conditionality of the rather small “International Lender of Last Resort” support, the crisis led to a Copernican shift in policies in the direction of the “neo-liberal” – to use a catchword – vision, see Ugarteche, Oscar “The debt as a lever for economic policy change. A tale of two continents”; Research in Money and Finance, SOAS, London, August 2011.

out of their system. Phrases from another epoch come to one's mind. "Liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate". And further: "It will purge the rottenness out of the system. High costs of living and high living will come down. People will work harder, live a more moral life". That was the advice of Andrew Mellon – his Secretary of the Treasury – to President Hoover. [44]

The words of Keynes comes to one's minds: "…In short, I do not believe that any of these tributes will continue to be paid…They do not square with human nature or agree with the spirit of the age.

If there is any force in this mode of thought, expediency and generosity agree together, and the policy which will best promote immediate friendship between nations will not conflict with the permanent interests of the benefactor".[45]

But in fact it is not only a matter of generosity. It is one of mutual advantage that of entering a "concerted" strategy of all-around burden sharing with due respect to democratic institutions and social justice. And also a matter of not unleashing political forces that we all thought that were a question of the past. Otherwise, most probably a proliferation of defaults will take place. In the best of the cases, they would be sorted out not in a chaotic way but learning from the Argentine case.

[44] p.30 in "The Memoirs of Herbert Hoover"; Vol.3 "The Great Depression 1929-1941". The Macmillan Company; New York, 1952.

[45] Keynes, John Maynard "The Economic Consequences of the Peace"; Macmillan and Co. St. Martin's Street, London, 1920, p.264.