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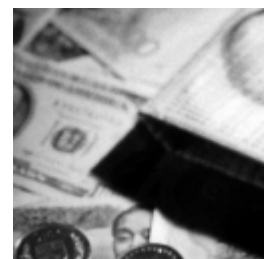
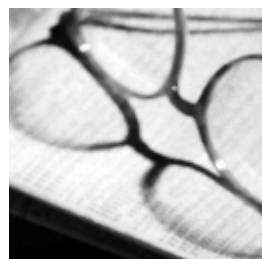
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Recurrent Debt Problems and International Safety Nets

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1. Introduction

Sovereign debt crises in emerging economies have become a recurrent event in the last two decades, reviving the debate on the causes and consequences of “debt cycles.” In a nutshell, debt cycles can be characterized by the following sequence of events: A risky, non-investment grade country issues bonds at high, risk-sensitive interest rates; risk realizes raising the cost of debt servicing; the country is unable (or unwilling) to pay this cost, defaulting on its obligations and validating the non-investment grade stigma.

This cycles, while similar to those generally associated with speculative, high yield-high risk instruments, has been perceived as a policy concern due to a number of distinct implications. On the one hand, the boom-bust pattern implicit in sovereign debt cycles, rather than circumscribed to a particular domestic market, amplifies the business cycle for the emerging economy as a whole, underscoring their characteristically high income volatility. On the other, debt cycles in one emerging economy appear to have, on occasion, deleterious effects on the stability of other emerging markets.

Underlying both the real consequences of the cycles and their contagious nature is the lack of an effective international bankruptcy rule that, as in domestic case, limits the deadweight costs and ramifications of the restructuring process, which in the international context typically involves an extended debt stand-still and a net outflow of capital that deepens the economic malaise at the origin of the crisis. Instead, distressed emerging

¹ The author wishes to thank Tito Cordella and participants at the *World Politics* Conference on The Political Economy of Recurrent Debt, Princeton University, for their useful suggestions, and Daniel Chodos for research assistance.

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countries have counted on support from International Financial Institutions (IFIs) in the form of increasingly large crisis-lending packages.

These packages have been defended as a second best remedy to reduce the costs of crisis for the country as well as to control for their spillover effects on integrated international markets (Fischer, 1999). More often, however, they have faced the criticism that, by providing lenders an opportunity to pull out from a distressed country, they have contributed to undermine market discipline towards emerging borrowers (Meltzer Commission, 2000). Interestingly, this argument is shared both by conservative critics and antiglobalization groups, with one important distinction: while the former rant about the costs of IFI packages for the global taxpayers, the latter point at the (social and economic) costs for the recipient country.

While seemingly difficult to reconcile, the two views center on a moral hazard argument, by which IFI lending “bails out” reckless investors and inept (or opportunistic) policymakers, creating the conditions for new debt cycles in the future. However, the debate has often failed to distinguish the nature of the moral hazard being created, an essential condition to evaluate whether, how and to what extent the IFIs could contribute to reduce the current costs of sovereign debt crises while minimizing their adverse long-run consequences.

In this paper, I revisit the moral hazard arguments in order to discuss alternative approaches to the role of the IFIs. In particular, I distinguish between lender, borrower and government moral hazard, according to how the costs and benefits of IFI intervention are distributed among the relevant players, and argue that it is the latter problem that should be at the center of the debate. In this light, I analyze the consequences of alternative *modus operandi* of the IFIs. I conclude that both casual evidence and economic analysis suggest that an explicit international safety net, by enhancing the expected returns of good policies as perceived by the government, may create the right incentives outweighing hazard considerations and, as a result, may help reduce the incidence of recurrent debt problems.

In order to frame the discussion, it is useful to start by summarizing what we know and do not know about the origins and dynamics of debt cycles. To this I turn next.

2. Debt cycles

Why are some countries prone to recurrent debt crises? While in many cases episodes of sovereign default could be explained by exceedingly large debt-to-GDP ratios, it has been pointed out that what the markets interpret as “sustainable” debt ratios depends on a number of complex considerations by which a 100% ratio in safe Italy or Belgium does not raise any eyebrows while a 50% ratio in risky Argentina or Brazil does.

The recent literature has struggled to account for the origins of this surprisingly persistent double standard.³ This persistence has prompted some authors to adopt a historical view. Thus, while Reinhart et al. (2003) point at the long memory of financial markets that punishes countries with a history of defaults, Eichengreen et al. (2003), focusing on the currency denomination of external debt as a critical source of risk, extend the historical perspective to an undetermined past when developing countries would have forgone their ability to borrow in their own currency. Currency of denomination is also highlighted by De la Torre et al. (2002), who emphasize the lack of acceptance of the local currency as a store of value as the reason behind illiquid domestic local-currency markets and excessive borrowing in foreign currencies. However, the historical approach, in any of its varieties, bears the question of why it is so difficult for risky countries to overcome this *non-investment grade stigma*.

In the absence of persistent but yet unidentified institutional factors, the historical emphasis is hard to reconcile with the view of forward looking investors. Moreover, unless we are willing to endorse a deterministic view, we can reasonably assume that institutions and policies are to a large extent endogenous to the economic and social

³ The focus here is not on why particular countries are perceived as more risky than others at a given point in time but, rather, on why a certain class of countries is perceived as more risky all the time.

context. As a result, a number of additional reasons may influence the balance of the graduation tradeoff. In emerging economies, for example, the scope for long-term commitments may be narrowed by large exogenous shocks that raise the costs of maintaining prudent policies, the combination of endemic poverty and a regressive income distribution that increases the cost of self-insurance and countercyclical fiscal policies, and a sometimes excessive political volatility that leads to frequent policy changes.

At any rate, a cursory look at history indicates that countries do indeed graduate from the non-investment grade class by enhancing their credit record, building reputations for sensible economic policy, developing liquid domestic markets and acknowledging the double standard by limiting their external indebtedness, a process that entails a tradeoff between short-run (economic and political) costs and long-run benefits, and calls for long-sighted policymakers (or political institutions).

Supporting the endogenous view of institutions, most recently graduated economies benefited from specific contexts that tended to mitigate the incidence of adverse factors while enhancing the short-run payoffs of the graduation process.⁴ Thus, the combination of an implicit regional safety net and the expected benefits of integration with a developed economy represented by NAFTA for Mexico or by the prospect of joining EMU for former transition economies certainly contributed to boost economic reform and consistent policies and to the gradual undoing of the non-investment grade stigma in those countries.⁵ Interestingly, it is widely acknowledged that in those countries policies have changed for the better (sometimes unexpectedly so), dispelling short-lived moral hazard concerns.

It has to be noted that the exact nature of this regional contexts and their influence on economic policy and on sovereign risk is still an open question. In particular, observers of

⁴ Needless to say, this does not deny that emerging economies can gradually overcome the stigma by themselves, as the Chilean case illustrates.

⁵ Indeed, it is easy to see how these two effects compound with each other. Low borrowing costs due to increased creditworthiness further reduce debt sustainability concerns, and increases the value of preserving creditworthiness.

the European case stress the absence of any explicit supranational safety net within Euroland (let alone accession countries) and emphasize that it is the promise of integration, coupled with credible accession criteria, that worked as an effective commitment device for good policies. According to this view, the strong carrot of integration ensured that governments meet the associated ex-ante conditionality. However, besides trade gains (which can largely be achieved by a free-trade agreement), the other potential benefit from integration comes from nominal and financial stability. In turn, the perception that accession to EMU may enhance stability beyond what would be achieved by a set of good policies hints again at the presence of some implicit safety net that, at least, protects the country against exogenous shocks or liquidity runs, ensuring that these good policies are ultimately rewarded.⁶ At any rate, gains from monetary integration were not an issue in Mexico at the time of the 1994 crisis, where a regional safety net, this time provided by the U.S. Treasury, was effectively put to work with no visible moral hazard consequences.

While this evidence is circumstantial and certainly too recent to judge, it casts doubt on the belief that sound economic policies can only be elicited by increasing the pain on undisciplined governments. Instead, it seems to suggest that safety nets that enhance the gains of good policies may be a crucial ingredient to tilt the graduation tradeoff in favor of long-run concerns, with little moral hazard consequences.

In this light, one can only wonder why the international community cannot create a mechanism that replicates, at least partially, some of the ingredients present in these graduation stories. Moreover, why are international bailouts, apparently similar in nature, subject to such criticism? The answer to these questions may lie in an overstatement of moral hazard concerns based on a misperception of the incentive mechanism implicit in international bailouts.

⁶ Unfortunately, this view is difficult to verify empirically. If the implicit safety net is credible, it is unlikely to be tested as it eliminates the reason for liquidity runs in the first place.

3. The moral hazard problem

Four main players intervene in the moral hazard story in its different –and often diverging– accounts: Private lenders, the borrowing country, the country’s government, and the IFIs (funded by a representative “global taxpayer”).

It is reasonable to assume that lenders invest in high risk-high yield bonds from emerging economies as they do in other non-investment grade assets, calculating risks in a similar way, and making losses when a sovereign defaults as they do when non-investment grade companies in developed countries file for bankruptcy. As any speculative market, emerging debt markets are prone to herd behavior and bubbles, the more so the more illiquid and opaque they are. As in those cases, diversified lenders usually recoup their investment in the form of large coupons that compensate for the probability of a default-related loss. At any rate, unless we are willing to accept that they are systematically fooled into lending at a loss in emerging countries, we can safely assume that lenders would on average make returns on their emerging debt portfolio that are comparable to the risk-adjusted opportunity cost of their capital. Indeed, there is evidence that this is the case.⁷

How can the anticipation of a bailout induce *lender moral hazard*, as often claimed? Only if it increases the returns of speculative investors in non-investment grade countries relative to what they would recoup in the absence of bailouts. In other words, if by limiting losses in bad states, the IFIs act as the lenders’ insurers, with the foreseeable effect of enhancing access to financing (alternatively, loosening the conditions under which financing is granted) in good times.⁸

⁷ See, e.g., JP Morgan (1999) and Klingen et al. (2003). Note that, while at the time of the collapse bonds are likely to be held disproportionately by small uninformed investors, the same can be said, for example, of tech stocks when the Internet bubble finally burst. But inasmuch as the representative investor behaves rationally, the *average* return on these investments will be close to the risk free rate plus the corresponding risk premium.

⁸ Bad (good) times here refer to those states in which a country would (not) default without IFIs intervention.

Note that this does not imply that the IFIs are the ones at the other end of the transfer. In fact, despite the rage of some conservative media, IFIs are almost always repaid and as a result hardly make a loss on such transactions.⁹ It follows that if a bailout entails any transfer to lenders in bad times, the only way in which this could be achieved is by extracting more resources from the defaulting economy than lenders would by themselves.

The fact that the IFIs are repaid in full introduces an important difference with the standard insurance framework that has been used to analyze the borrower moral hazard problem. In particular, in the absence of a subsidy component, and unlike in the case of insurance, risky behavior is costly for the borrower, either immediately in the form of a crisis or over a longer time through the repayment of the IFI support if he chooses to request it. Therefore, *while the IFIs may act as an insurer for the lender, for the borrowing country it plays the role of a lender of last resort.*

The fact that private lenders reap a reasonable return and IFIs break even suggests that whatever inefficiency is introduced by international bailouts has to be born by the borrowing country. Why would the option to a bailout induce moral hazard-related overborrowing from a welfare maximizing government? Moreover, why would such a government request an international bailout in the first place? Here the often cited borrower moral hazard story needs to be qualified, since the country as a whole appears to have little scope, if any, to exploit this lender of last resort facility. Instead, as the borrower is ultimately the government, one could point at a *government moral hazard*, namely, as Jeanne and Zettelmeyer (2001) put it, “a discrepancy between the policymaker’s objective and the domestic taxpayers’ long-term interests.”

This explanation is particularly compelling if the bailout is a zero sum game that does not influence the value (the repayment capacity) of the borrower. Then, the transfer to private

⁹ Jeanne and Zettelmeyer (2001) estimate that the implicit subsidy in IMF lending is relatively small even under a worse repayment record than that reflected in the past. The exceptions are HIPC countries, where official creditors took a cut on their claims. However, as they note, this concerns a set of very poor countries, largely dependent of official debt, that do not overlap with the emerging market group that have been the recipient of recent bailouts.

lenders is financed entirely by the difference between the repayment to IFIs and what the country would have paid lenders in the absence of IFI support. The argument could make a juicy story for antiglobalization advocates: by resorting to the IFIs, a country repays soft (that is, renegotiable) debt by incurring a hard (non-renegotiable) obligation with the IFIs that mortgages part of its future income flows. While the use of IFIs' resources to repay lenders would be suboptimal for a welfare maximizing government, they would make sense for opportunistic (or economically-handicapped) politicians looking to buy some time.

However, this interpretation of bailout packages underplays an important characteristic of recent debt crises. In particular, it ignores the fact that a financially distressed country typically faces two alternative scenarios. While insolvent at the high interest rates that characterize liquidity crisis, it can avoid default and repay in full if given enough time, reasonable interest rates and the right incentives. Indeed, this is exactly what a bailout does: a country borrows from the IFIs to repay anxious lenders, and then repays the IFIs loans in full, albeit conveniently refinanced at close to risk-free interest rates over a longer period. Because IFIs recoup their loans, they can lend at rates that private lenders would never accept (particularly when fire-selling the country at the onset of a crisis). In this context, the IFIs play the role of international lender of last resort much in the way than central banks do domestically during systemic crises, by lending to illiquid but solvent governments at normal (pre-crisis) rates until they regain access to private capital.¹⁰

In this situation, the presence of the IFIs may create value for the country in at least two ways: i) by avoiding the cost of default, if defaults have a cost *per se* (that is, beyond and above the cost of the crisis that underlies the default episode); ii) by reducing ex-ante the effective cost of capital for the borrowing country as a result of a lower volatility of

¹⁰ The literature on the domestic lender of last resort have repeatedly highlighted the complexity of evaluating solvency in times of financial distress. Indeed, the chances that central banks end up lending into insolvency are in practice higher than for IFIs.

returns on emerging market debt and a lower associated risk premium.¹¹ In turn, this value represents a surplus that can be distributed between the borrowers and its lenders, in which case a bailout could entail a net gain for both parties involved. The fact that lender and borrower cannot work out a similar arrangement by themselves highlights both the presence of a coordination failure and, more importantly, the importance of the commitment mechanism that the IFIs introduce in the game.¹²

In addition, responsibility for a debt crisis can be, to a large extent, the reflection of exogenous factors beyond the control of the government. While it could be argued that bad luck is always a possibility and that a prudent government should be able to act preventively, reducing exposure to manageable levels through self-insurance in economies subject to extreme external shocks may be prohibitively costly. More importantly, the prevalence of exogenous risk factors detract from the incentives to advance with reforms which payoffs are severely reduced in the event of a crisis.¹³ International safety nets, by reducing the incidence of these factors, may indeed enhance reform incentives rather than weaken them as the moral hazard argument would indicate.

Finally, a debt crisis usually triggers a discussion on the debtor's willingness and ability to pay. Incurring the cost of default (and delaying renegotiation) has been seen as a way of signaling inability to pay (Wells, 1993). Conversely, requesting non-subsidized IFIs support to avoid default could be taken as a signal that the country is willing to pay, but unable to do so at the current refinancing rates.

¹¹ This effect follows directly from the the lower returns demanded by risk-averse lenders on emerging market debt as a result of the reduction in volatility, and should not be confused with the reduction of borrowing costs in good times induced by the anticipation of a bail out.

¹² A borrower moral hazard argument can be recovered if bailouts, by reducing or eliminating the costs of default, relax a welfare maximizing government's incentives to avoid it, leading to less costly, but more frequent debt crises. However, unlike in the presence of government moral hazard, the value created by the bailout is likely to exceed the losses due to moral hazard. In other words, moral hazard, while present, would not be *excessive* in the sense of Mussa (1999). See also Haldane and Taylor (2003) for a similar argument.

¹³ For example, the anticipation of exogenous sudden stops that may derail a process of reforms before it fructifies, may reduce ex-ante the government incentives to reform.

The previous discussion suggests that a discussion of the moral hazard consequences of international safety nets should center on the government's incentives. Government moral hazard, in turn, hinges crucially on the interplay of a number of elements (the government's objectives, the relative importance of exogenous risk, the cost of the default decision, the nature of the government's actions presumably undermined by moral hazard) that require a more careful analysis. To this I turn in the following section.

4. Government moral hazard¹⁴

A standard treatment of government moral hazard would start by assuming that a government can always implement certain "good" policies that result in a sustainable growth path (and, in turn, a lower probability of facing a debt crisis), at the expense of other "bad" policies that entail a private gain for the government (inefficient expenses with a short-run political payoffs, fund diversion, or simple inaction to save the political costs of reforms) that is not reflected one-to-one in the welfare of its constituency.

On the other hand, it would also be reasonable to assume that the incidence of government actions (both on economic performance and on the probability of a crisis) depend on exogenous factors beyond the control of the government and, in particular, weakens as these factors deteriorate.¹⁵ Cordella and Levy Yeyati (2003) provide an intuitive example for the case of financial institutions that can be extrapolated to the sovereign context: In the event of a catastrophe (a war, a devastating earthquake), the country is likely to face a crisis irrespective of the nature of past policies. Moreover, the political payoffs of good policies are likely to be reduced during the crisis (the more so the deeper the crisis) and, in the limit, would be zero if the crisis brings down the government that implemented them. But then the expected payoffs of these policies at the time their implementation is being considered decline with the probability of facing a catastrophe, tilting the balance in favor of inefficient policies with immediate returns.

¹⁴ This section borrows heavily from the analysis in Cordella and Levy Yeyati (2004).

¹⁵ For the purposes of my analysis, it is immaterial whether adverse conditions are driven by a self-fulfilling liquidity run on the country's assets (Morris and Shin, 2003), a regional sudden stop (Calvo et al., 2003), or sharp swings in commodity prices (for commodity exporters) or exchange rates between reference currencies (for countries under a fixed exchange rate regime).

Finally, to capture the tradeoff between enlarging the stick and sweetening the carrot implicit in the discussion of section 2, we need to assume that, in the absence of a safety net, a crisis may trigger a default that imposes *additional* costs (relative to those associated with the underlying financial crisis) on the local economy. Then, IFIs could induce discipline by threatening to withdraw assistance, using default costs as the stick.

This basic framework is enough to derive the basic ingredients of the moral hazard debate, and the two main approaches that it engendered. If the stick (that is, the *political* cost of default) is large enough, a *credible* threat not to intervene would induce a government to avoid default at any cost, and good policies, inasmuch as they reduce the probability of a crisis, would be implemented. If so, international bailouts can only detract from this disciplinary effect and, some would conclude, should be banned in order for the threat to be credible. By extension, according to this view, any amendment to the international financial architecture conducive to alleviate default costs would conspire against policy discipline.

If, on the contrary, the IFIs recurrently bail out countries facing a debt crisis (so that assistance, while not explicit, can be reasonably anticipated *ex-ante*), the incentives to avoid default costs would be replaced by the carrot of a higher expected political payoff of good policies in the unlucky event that the country is hit by an adverse shock. Similarly, the anticipation of liquidity assistance can help prevent self-fulfilling liquidity runs against the country's assets due to coordination failures unrelated with the policies in place, further strengthening the link between reform effort and final outcomes. Finally, inasmuch as a full-blown crisis reduces the chances of the incumbent to stay in office, an international safety net, by containing the effects of the crisis, would increase the expected payoffs over future periods, the more so the longer the time horizon of the incumbent government.

It follows that the final score between these “stick” and “carrot” approaches, as gauged in terms of their impact on the quality of the policies, will depend on: i) the size of the stick;

ii) the relative incidence of exogenous shocks and self-fulfilling runs, iii) the correlation between the success of good policies and financial stability; and iv) the incumbent's horizon.

In particular, a carrot approach would dominate in cases where default costs (as perceived by the government) are limited, the political rewards of good policies depend crucially on macroeconomic stability, destabilizing shocks and runs are frequent, and incumbents maximize over long horizons.

On the other hand, from a political perspective, it is essential to note that the extent to which the stick can be credibly hardened may be, in practice, rather limited for a number of reasons. First, politicians can readily blame external factors (predecessors, the international environment, "evil lenders" and even the IFIs) for the dismal income effect of default, thereby reducing their political cost. Secondly, a debt crisis, as noted, could trigger, at least in the short-run when gross inflows collapse, a zero-sum game in which default on external obligations crowds in resources to be spent domestically. In this case, it is easy for a government to build support for a stand still on external debt to reduce pressure on the local taxpayer or to prioritize domestic creditors. Thus, episodes in which political backing increases after a government declares default are not unheard of.

Moreover, even at the macroeconomic level, it is not obvious that defaults increase the cost associated with a crisis in a significant degree. Indeed, a casual look at recent episodes suggests that output losses during crises are immediate and that the recovery path differ very little according to whether default can be avoided or not (Figure 1).¹⁶

Finally, even in the case in which default costs are so large that moral hazard concerns dominate, a carrot approach could be desirable on welfare grounds. While default costs could in theory be raised to induce as much discipline as desired, inasmuch as default

¹⁶ The recent crises in Argentina and Uruguay in 2002 are a case in point. Both countries suffered a decline in output of close to about 12%, despite the fact that only Argentina defaulted on its debt. Moreover, although at the time of this writing the resolution of the debt crisis is still pending, the economy rebounded strongly, growing a cumulative 16% in the subsequent two-year period.

costs are “mostly wasted resources, larger sticks, if feasible, would lead to more disciplined, but poorer countries” (Cordella and Levy Yeyati, 2004). Hence, the distinction increasingly made in the literature between real hazard (immediate economic and social costs) and moral hazard (future costs in terms of insufficient reform).¹⁷

It is this last argument, rather than the impact on incentives previously discussed, that underlies the prevalence of the carrot approach in most of the 90s. More recently, moral hazard concerns appear to have moved the IFIs towards an intermediate stance: While they continued to provide support during the build up of the crisis, they repeatedly attempted to send a message consistent with the stick view, warning countries that assistance will be selective, limited and ultimately uncertain. However, it is difficult to find a clear rationale for this “constructive ambiguity” approach. On the one hand, the standard *ex-post* conditionality on future policies does very little to solve the moral hazard problem. It cannot undo the consequences of past decisions, and is rather difficult to enforce once the assisted country is back on its feet. On the other hand, any discretionary component in the provision of assistance introduces an element of uncertainty that can only detract from the positive incentives of the safety net. As a result, the current approach is dominated by an explicit contract by which the IFIs commit to assisting the borrower country under the same verifiable conditions.

The intuitive idea that *ex-ante* conditionality could strengthen the right incentives to the extent that the carrot of access to the assistance facility is large enough to ensure compliance is in line with the view that, from a moral hazard perspective, assistance should benefit countries that are willing but unable to pay –that is, countries with a good policy record derailed by an adverse exogenous shock. Unfortunately, the degree to which policies can be measured with the accuracy that such a contract would require is rather limited. Moreover, there is always the chance that the withdrawal of assistance to non-complying countries in distress, implicit in the design of a contingent safety net, is not enforced *ex post* due to their geopolitical importance, their impact on the rest of the

¹⁷ See Mussa (1999).

financial community or even the reputation costs of being blamed for the final collapse of the country.¹⁸

There is no easy way out of this conundrum. One option consist in conditioning assistance on observable macroeconomic shocks that increase the probability that the crisis is due to the shock rather than to wrong policy choices.¹⁹ Unfortunately, there are arguably few variables, if any, that could be regarded as fully exogenous for this purpose. On the other hand, the measurement problem could be mitigated by requiring a minimum set of conditions that are at the same time universally recognized as best practices, and readily verifiable. Specifying the elements of this set largely exceeds the scope of this paper. For the present discussion, it suffices to note that, while most potential candidates are likely to be contested on one ground or another, Maastricht-type of conditions on measurable variables like the fiscal deficit, the debt to GDP ratios and the inflation rate, are more operational and may provide a reasonable second-best alternative.

At any rate, while the specifics of ex-ante conditionality are still a fruitful area for research, it has to be noted that the existing limitations should not be used to dismiss the option of explicit safety nets altogether. Indeed, under fairly general conditions, it can be shown that an *uncontingent* safety net could still generate the right incentives, particularly in externally vulnerable countries where crises are largely driven by exogenous shocks.

5. Final remarks

The case against international bailouts based on moral hazard concerns seems to be questionable based both on empirical and theoretical grounds. Of all the varieties of moral hazard discussed in this context, government moral hazard, namely, the tendency

¹⁸ These reputation costs should not be underplayed. They underscore the difficulties in gathering local political support for reforms in line with those required by IFIs, and may even empower political programs build upon the opposition to such reforms.

¹⁹ Formally, the condition must satisfy Milgrom's (1988) monotone likelihood ratio property, namely, that the relative likelihood that a crisis country chose the good policy (rather than the bad one) is higher if the condition is present. This avenue is proposed by Levy Yeyati and Cordella (2003) for the case of a domestic lender of last resort.

of short-sighted policymakers to exploit the short-run benefits of the safety net disregarding the costs of future repayments, appears to be the crucial source of concern. But even in this case, an explicit safety net could indeed create the right incentives while reducing the welfare cost of avoidable defaults, particularly in emerging economies subject to severe exogenous shocks. Ideally, such a safety net would entail incurring the cost of complying with ex-ante conditionality in order to reap the benefits of financial stability. However, even in the case in which conditionality cannot be written in terms of specific policy variables, Maastricht-type access criteria could still go a long way to induce the right policy incentives.

The view that emerging countries are irremediably plagued by “crazy populists” or chronic opportunists that can only be disciplined through the infliction of economic pain seems to ignore the fact that institutions are largely a reflection of the conditions under which they develop and the incentives that these conditions generate. Thus, a belated punishment to countries in disgrace may only promote the same shorttermism and populism that it attempts to fight. By contrast, both the recent evidence and the economic analysis suggest that a structure of incentives that ensures that good policies are properly rewarded may foster political support for the implementation of sustainable policies. In this context, despite misguided moral hazard concerns that have obscured the debate so far, the design of an explicit international safety net is still the most promising alternative to reduce the incidence of recurrent debt problems in emerging economies.

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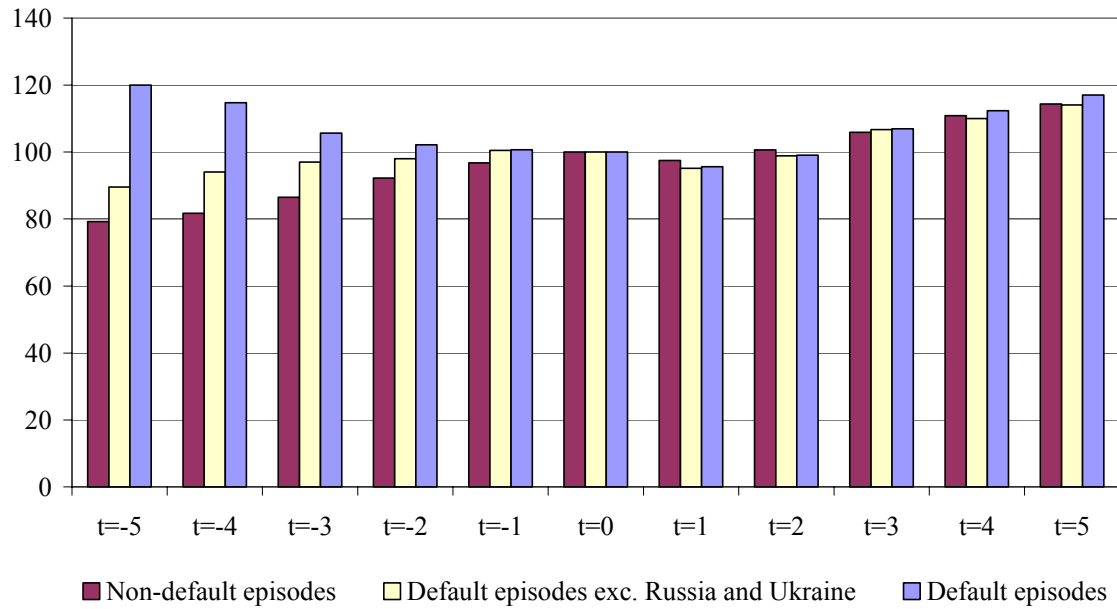
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Figure 1. Systemic Crises and Defaults
(base=100 for pre-crisis year)



Non-default episodes: Argentina 1989, 1995; Brazil 1990, 1998; Indonesia, 1998; Mexico 1995; Malaysia, 1998; Philippines, 1998; Thailand, 1998; Turkey, 1994; Venezuela, 1994.
 Default episodes: Argentina, 2002; Ecuador, 1999; Pakistan, 1998; Russia, 1998; Ukraine, 1998.