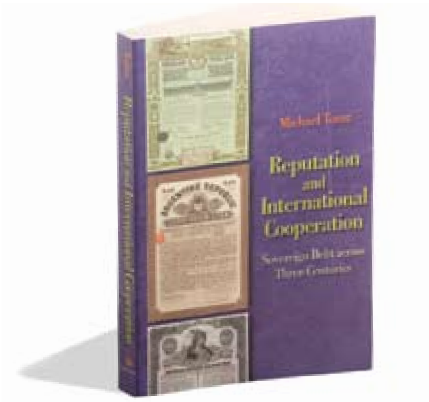
BOOK REVIEWS

Debt default and history



Michael Tomz

Reputation and International Cooperation

Sovereign Debt across Three Centuries

Princeton University Press, 2007, 328 pp., $22.95 (paper).

READERS interested in gaining a better long-run appreciation of the history of sovereign debt default are sure to learn a great deal from Michael Tomz's *Reputation and International Cooperation*.

The first chapter provides an overview of different ways of thinking about the vexing problems of sovereign debt—why countries default, why some default repeatedly, and what leads debtors to repay. Chapter 2 lays out the basics of what Tomz calls a dynamic reputation model, which, he argues, helps to explain the behavior of both debtors and creditors. In his model, which is largely descriptive rather than mathematical, governments have heterogeneous preferences and types of borrowers are not fully revealed to market participants. Hence, creditors form beliefs about borrowers, update these beliefs over time, and use a borrower's reputation to discern whether they should lend and at what rate they should lend. He provides a convenient way of describing the reputation of borrowers at a given point in time—as "stalwarts" (those who always pay), "fair-weather" (those who pay in good times but not always in bad times), and "lemons" (those who don't pay in bad times and sometimes default in good times as well)—and uses this classification to understand the predictions of his model versus other models.

The rest of the book carries out a variety of empirical tests using some impressive, new historical data sets to convince readers that the author's dynamic model of reputation fits the data from three centuries of sovereign lending and borrowing. For a book that focuses mostly on the past rather than on the present, it is somewhat surprising that the narrative, at times, lacks historical nuance. The book paints a picture of history that is stark and always consistent with reputational theory. As a result, it sometimes ignores or understates the importance of historical evidence and data that don't fit the model's predictions and perhaps better fit other models.

These weaknesses are most visible in Chapter 6. Tomz argues that government interventions on behalf of creditors were rare during 1820–1913 and thus not important for regulating debt default. First, he only considers militarized interventions. Turkey (Ottoman Empire), Greece, Egypt, Tunis, Serbia, and Liberia are examples of 19th-century sovereign borrowers that ceded fiscal authority (and hence autonomy) to governments of unhappy creditors after they defaulted on their debt. These interventions—a type of heavy-handed sanctions—were available to creditor governments during the late 19th and early 20th centuries. By omitting these, Tomz understates the overall use of interventions, giving readers the impression that sanctions were too infrequent to have been useful for regulating debt default in the 19th century, and that the timing of default does not coincide with the use of sanctions.

Second, by including the period 1820–69 in his analysis of militarized interventions, Tomz underestimates the effectiveness of sanctions as an enforcement mechanism. Sovereign borrowing during the early part of the 19th century was rife with informational problems, making it difficult to assess why countries defaulted. Governments were likely unwilling to carry out militarized interventions or other forms of heavy-handed sanctions because they were unable to assess why countries went into default; it was simply too politically costly to "go gunning" without sufficient information. However, by the second half of the 19th century, the political economy of international finance had changed considerably. During this age of high imperialism, governments began a race to acquire new colonies and mark certain areas of the world as under their "stewardship." One consequence of this was that finance during this period became linked to strategic considerations. It might not be surprising, then, to find evidence that heavy-handed sanctions were widely used when countries went into default during 1870–1913; indeed, there was a roughly one-in-three chance that a foreign power would impose heavy-handed sanctions.

Finally, in his analysis, Tomz defines militarized interventions as episodes during which a country used force, displayed force, or directly threatened another country. By this definition, Tomz's analysis underestimates the true effect of sanctions on debtor behavior because it excludes the effects of *perceived* threats of force on sovereign debtors. Historical evidence suggests that sovereign borrowers avoided default or taking on more debt for fear of reprisal by creditor governments. For example, during the Baring Crisis of the 1890s (the largest debt default of the 19th century), the threat of foreign intervention entered into Argentina's decision to settle with creditors, and Brazil opted to reschedule its debts during this period partly because it feared that, if it did not repay, its sovereignty would be in serious jeopardy. Brazil's behavior also suggests that the perceived threat of heavy-handed

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sanctions led many countries to avoid default even when times were tough. It is thus entirely plausible that the other parts of Tomz's study, which seeks to bolster the reputational theory by comparing the performance of debt repayment of sovereigns in good times and bad times, suffer from an observational equivalence problem. Tomz argues countries continue to pay "even in bad times" in order to improve their reputation, but Brazil's response during the Baring Crisis suggests that some countries might have repaid in "bad times" out of fear of being sanctioned.

Perhaps an even clearer example of why creditors repaid in earlier periods is the response of Central American borrowers to the U.S. government's announcement of the Roosevelt Corollary to the Monroe Doctrine in 1904. According to this pronouncement, if a nation in the Western hemisphere maintained its financial obligations, it need not have feared U.S. intervention, but if did not live up to its financial obligations, the United States would enforce claims by acting as an "international police power."

The U.S. government lent credibility to this policy pronouncement by sending gunboats to Santo Domingo in 1905 and taking over customs collection to pay foreign creditors after Santo Domingo defaulted on its external debt and European powers threatened to intervene. Creditors believed the United States might intervene elsewhere and, in response, bid up sovereign debt prices for Central American and the Caribbean countries by 74 percent in the London market in the year following the announcement of the new policy. The effects of U.S. intervention in Santo Domingo had a profound effect on debtor behavior. Countries in the region, which collectively had been in default for 140 combined years until this point, reached agreements with bondholders and were able to issue new debt on European capital markets.

As policymakers and historians are well aware, the world of sovereign lending is messy: why countries default and then choose whether to repay is likely a function of many factors. As this book makes clear, reputation surely matters; but other factors, such as sanctions, have played an important and perhaps leading role during certain periods of history. In arguing for the primacy of reputational theory to explain sovereign borrowing over the past three centuries and dismissing the possibility that particular periods of history may be better explained by alternative models, Tomz undercuts his otherwise careful historical analysis.

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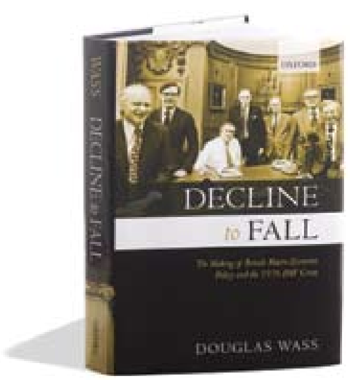
Unhappy memories



Douglas Wass

Decline to Fall

The Making of British Macro-Economic Policy and the 1976 IMF Crisis

Oxford University Press, 2008, 399 pp., £55 (cloth).

THE IMF's 1977 Stand-By Arrangement with the United Kingdom was a big deal, for the IMF as well as for Britain. For the IMF, the loan that it made available to the United Kingdom—still then the country with the second-largest quota—stood for some years as its largest. The arrangement was also one of the IMF's last with an industrial country. For the United Kingdom, as argued in *Decline to Fall*, the IMF—through the arrangement—"played a crucial role" in the resolution of the crisis that had erupted in 1976.

The story of the United Kingdom's 1977 IMF-supported program has been told before, including in the IMF's official history and British ministers' memoirs. The main novelty of this book is that it is based largely on recently released official British documents. And who better to have as a guide to those documents than Sir Douglas Wass who, as Permanent Secretary to H.M. Treasury, was the leading British official in the negotiations with the IMF? (He had earlier been the United Kingdom's Alternate Executive Director at the IMF, in the period leading up to the country's 1967 IMF-supported program.)

Wass uses the documents now available to provide a detailed history of the making of U.K. macroeconomic policy in the period 1974–76 that led up to the IMF-backed arrangement. He tells the story year by year, under the headings of the major policy issues (public expenditure, the exchange rate, and so on), and he tells it memorandum by memorandum and meeting by meeting. This account alone will make the book essential for students of this episode. But the study is also interesting for its review of the conduct and evolution of U.K. macroeconomic policy in the mid-1970s, and for the author's thoughtful and critical assessment of policymaking then, and especially of the work of the Treasury.

In the early 1970s, the United Kingdom's policy framework was unlike it is today. Fiscal policy was the main tool used to regulate demand, with the principal aim of maintaining full employment, and monetary policy was supplementary to fiscal policy. Inflation was seen mainly as a cost-push process: dampening it through demand measures, certainly from the 10 percent a year level it had reached in early 1974, "would take a very long time and require substantial unemployment," which was judged unacceptable. The main instrument to combat inflation was wages policy. Wass observes, strikingly, that the Bank of England was therefore not much involved in controlling inflation. The central bank was not independent, and changes in official interest rates were constrained politically as well as by concerns about financial fragility. The pound sterling had been floating, in a managed way, only since 1972.

In late 1973 and early 1974, this framework, already strained by inflationary pressure, was subjected to two traumas—the first oil shock, and the collapse of the incomes policy of the Conservative government as a result of strikes and an election that brought a new (Labour) government to power. Wass sees the origins of the 1976 crisis here, and in the commitments and policies of the new administration.

In 1974 and early 1975, with incomes policy having been delegated to the trade unions, wages accelerated and annual price inflation rose to about 25 percent. The fiscal deficit burgeoned, partly owing to indirect tax cuts intended to reduce inflation by promoting wage restraint, but also because public spending was planned on the basis of "wildly optimistic" assumptions about economic growth. Wass views these assumptions as a major failing of the Treasury in the run-up to the crisis, though at the time disappointing growth performance was hardly unique to the United Kingdom. Externally, official borrowing, facilitated by the increased surpluses of the oil producers, contributed to relative stability of the exchange rate while the current account deficit widened and international competitiveness deteriorated. There was here a "confusion of attitudes" toward exchange rate policy among officials—another Treasury failing.

Wass describes how, during 1975, important policy corrections were made. With the fiscal deficit rising toward 10 percent of GDP, increased attention was paid to its financial implications. Wass sees here a turning point in the conduct of U.K. fiscal policy: conventional "Keynesian" demand effects "no longer held centre-stage," and action was taken to reduce the deficit even in the face of a weak economy. There were also important reforms to the system of budgetary control, which were to begin bearing fruit in 1976. In addition, in mid-1975, the trade unions began to enforce a "norm" for pay increases that was below recent price inflation. Wass describes this as a "watershed" in the control of inflation, albeit with a significant cost in the leverage it gave the trade unions over other elements of policy.

In early 1976, the outlook was not entirely gloomy. With regard to external financing, a Treasury memo advised that "we ought to be able to get through 1976 very comfortably." This proved far too optimistic. Already in 1975 there had been bouts of pressure on sterling; and late that year, the United Kingdom had drawn on the IMF to the extent that it could without substantial conditionality. During 1976, the pressure increased as official holders of sterling balances diversified their portfolios. Fiscal measures failed to stem the tide, and at the end of September, the United Kingdom applied to the IMF for a new Stand-By Arrangement, which would involve more demanding conditionality. Dramatically, this was amid renewed pressure on sterling that stopped the Chancellor of the Exchequer from flying to the IMF–World Bank Annual Meetings in Manila.

In the subsequent discussions between U.K. and IMF officials, the main issues were fiscal adjustment and the exchange rate. Particularly on fiscal adjustment, according to Wass, it became clear in the technical discussions that "there could be no meeting of minds on the logic," because the British officials viewed the IMF's financial programming approach as inapplicable to their economy. The officials were skeptical about the basis for targets for monetary growth, and about the assumed links between the fiscal balance and domestic credit expansion in an economy with an advanced financial system. However, the IMF had more of a meeting of minds with Chancellor Denis Healey, who agreed that monetary expansion on existing fiscal policies was likely to fuel inflation, although he disputed the scale of the adjustment that the IMF sought. Differences were eventually narrowed, partly by the IMF's agreeing to the authorities' commitment to fiscal measures to be taken only if growth in the second year of the program exceeded a certain rate.

Wass describes the agreement as a "huge personal achievement" for Healey and also for Alan Whittome, the leader of the IMF team. Announcement of the agreement quickly had an "extraordinarily favorable" effect on sterling, permitting the reserves to be replenished and interest rates to be reduced. The United Kingdom needed to make only two drawings on the IMF, out of the eight allowed, and it soon began repaying. Wass observes that the crisis was resolved before any of the measures agreed with the IMF had taken effect: the turnaround was a matter of confidence. Subsequent data showed that public spending had been contained, thanks to earlier measures, especially the 1975 reforms, and that the program's public spending cuts amounted, inadvertently, to "overkill." They were largely cancelled during 1977, without damage to the U.K.'s overall fiscal commitments under the program. In Wass's view, therefore, the spending cuts agreed in the program were important mainly as "totemic gestures" to the markets whose sentiment they transformed.

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Argentina: A Tanzi chronicle

Vito Tanzi

Argentina: An Economic Chronicle

How One of the Richest Countries in the World Lost Its Wealth

Jorge Pinto Books, New York, 2007, 164 pp., $19.95 (paper).

VITO TANZI, the former long-time Director of the IMF's Fiscal Affairs Department, knows Argentina well. Over the past four decades, he traveled to Argentina about thirty times and lived there for a combined period of more than one year. This book is a history of Argentina from the perspective of his periodic visits and contacts. Although Tanzi focuses on the economic and fiscal problems of Argentina, the span of his book is broad.

Argentina: An Economic Chronicle is a thoroughly enjoyable memoir, with stories of encounters with presidents and ministers, artists and intellectuals, politicians and journalists, and taxi drivers and Italian immigrants. It collects the impressions—over four decades—of a European visitor to Argentina, as he tries to decipher the national culture and history, reflects on the fate of the many Italian immigrants to that land, describes places of stunning natural beauty (it was not all work and no fun after all), and relates the (inevitable) experiences of the frequent international traveler, including strikes, scary flights, and food poisoning.

Tanzi must also be fond of Argentina because it served to inspire the "Tanzi effect." (In Argentina, this is often called the "Olivera effect," in honor of Professor Julio Olivera of the Universidad de Buenos Aires, who also wrote about fiscal lags at about the same time.) The Tanzi effect explains that the real value of tax revenues falls in high inflation, as a consequence of the usual time lags in the collection of taxes—for example, between the moment when income is earned and when income tax is paid. With high inflation, this lag implies that by the time the government receives the money, its purchasing power has already depreciated, and the money will not go as far in purchasing goods or paying salaries (that often become indexed to inflation faster than taxes). At moderate rates of inflation, the Tanzi effect is negligible; at triple-digit rates and higher, it can be devastating. Argentina has, unfortunately, been the perfect subject for Tanzi's observations and estimates of the fiscal lags' effect.

Although the book is not technical, and does not contain charts or equations, Tanzi makes a serious attempt to explain the inexplicable secular economic decline of Argentina. One hundred years ago, he notes, Argentina's exports accounted for 7 percent of world exports, and its per capita GDP was higher than France's and twice as large as Italy's. The economic history of Argentina is a history of un-development. What caused this economic tragedy? Fiscal mismanagement, pure and simple, is Tanzi's answer. Since the Peronist regime started to create an overextended welfare state in the 1940s, the country became unable to balance the fiscal accounts ever again. This resulted in decades of persistent inflation, punctuated by devastating hyperinflation episodes, because the central bank was the ultimate source of finance for the fiscal disequilibrium. When, in 1991, Argentina adopted a currency regime that precluded central bank financing of the government deficit and effectively eliminated inflation, the fiscal imbalance resulted in an explosive accumulation of government debt, which ended in a notorious sovereign bond default by end-2001. This is where the book may prove especially controversial. Tanzi thinks that the IMF lending to Argentina during the 1990s was largely responsible for the debt accumulation that resulted in the financial crisis. Whatever one thinks of the IMF's advice to Argentina at the time, which in fact was much more nuanced than commonly thought, this does not change the fact that global private markets were anxious to lend almost unlimited amounts to Argentina at the time. Granted that markets charged a higher interest rate than the IMF, but would this detail have stopped the borrowing and spending?

But what has been the ultimate cause of the secular impossibility to balance the books of the state? Many have blamed a famously abysmal taxpayer compliance. Taking off from the joke that "Argentines are Italians who speak Spanish and think that they are British," Rudi Dornbusch commented that the "problem of Argentina is that the unions are British but the taxpayers are Italian." But culture alone does not explain poor taxpayer compliance. A system with huge tax rates and almost no compliance enforcement can destroy taxpayer culture, even in Finland. In fact, tax revenues have increased significantly over time, and at least part of the credit goes to the recommendations of an IMF mission that Tanzi headed in 1989, along with the 1990s' high growth rates and falling inflation (the other side of the coin of the Tanzi effect). Unfortunately, government spending grew more or less in line with tax revenues, and the fiscal disequilibrium did not close. Tanzi says that Argentina is "a society that over the long run wanted a level of public spending larger than what it was prepared or able to finance (through taxes or other ordinary revenues)." But why? Argentina's inexplicable decline is still unexplained.

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