Increasing Economic Growth and Stability in Emerging Markets

John B. Taylor

Ownership, Growth, and Stability

The Bush administration's emerging market strategy is an interrelated part of our overall international economic agenda. The agenda focuses on two goals: increasing economic growth and increasing economic stability throughout the world, not only in emerging markets countries, but also in the developing countries and in the industrial countries, including the United States. President Bush's idea is that each country, by following proven economic policy principles and considering its own circumstances, can contribute significantly to greater global growth and stability. His stress is on country ownership of policies, with the United States willing to provide strong support for good policy reforms.

These economic goals have not changed since the start of the administration. Indeed, the challenges of the war on terrorism—especially the need for increased resources for security and for the removal of hotbeds of terrorism—make economic growth and stability more important than ever.

Consistent with these goals was the administration's perseverance in winning back presidential trade negotiation authority: free trade is a key driver of both economic growth and stability. The goals also underlie our economic policy program for the United States where fiscal and monetary policies to combat the recession were implemented in a remarkably timely fashion.

A theme of our pro-growth policy has been productivity growth through job creation in the private sector. Higher productivity is essential for increasing living standards and reducing poverty. The

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keys to raising productivity growth are the rule of law, sound fiscal policy, low-inflation monetary policy, and the reduction in barriers to trade—both external and internal.

Let me now focus on the part of our international economic agenda dealing with financial crises and other instabilities in emerging markets. I will begin by discussing the problems we are trying to solve with this strategy.

Three Related Problems

First, in recent years there has been a marked increase in the frequency and severity of financial crises in emerging markets. A recent McKinsey study, "Dangerous Markets: Managing Financial Crises," puts the 1990s increase at 60 percent compared with the 1980s, and showed that more countries have experienced crises in recent years. But even if there were no increase in the number of crises in recent years, the number would still be too high. The damage caused by economic and financial crises—deep recessions, rising unemployment, volatile exchange rates, sky-high interest rates—create real hardships for people. And the uncertainty caused by economic instability reduces foreign and domestic investment and has negative implications for long-term growth.

Second, there has been a sharp decline in net private capital flows to emerging markets in recent years. Averaging more than $150 billion per year from 1992–97, net private capital flows fell off to less than $50 billion per year in 1998–2000. Guillermo Calvo of the Inter-American Development Bank calls this sharp drop-off a "sudden stop." There are many explanations for this sudden stop, but the increased frequency of financial crises, which has increased volatility and damaged expected profitability, is one reason. Restoring private investment flows into emerging market countries would help create higher productivity jobs and raise living standards.

Third, real interest rates are still very high in many emerging market countries. These high interest rates—caused in part by the risks of financial crisis and the policies that raise such risks—discourage investment in productivity-raising capital. As Secretary O'Neill emphasized, the high interest rates are a burden on the people in the emerging market countries; they are the ones who have to pay the taxes that go to make the high interest payments. If there were fewer crises and more countries followed the policies that merited investment grade ratings, then these interest rates would be lower.

More than anything else our emerging market strategy is designed to address these three problems. The aim is to reduce the frequency

and severity of crises, restore the flow of investment to emerging markets, and increase the number of countries that have investment grade ratings.

Elements of an Emerging Market Strategy

For the strategy to work for the long haul, it must incorporate country ownership as stressed by President Bush. We should be clear that countries themselves—not the United States, not the G-7, not the International Monetary Fund—have ownership over their own policies. But what are the core elements that define the strategy? How do they address the three problems? How do they support country ownership?

An Emphasis on Crisis Prevention

It almost goes without saying that the best way to deal with crises is to prevent them from happening in the first place. This requires close monitoring of country vulnerabilities, and taking appropriate action to reduce those vulnerabilities. At the U.S. Treasury, for example, we have developed a "Blue Chip" index based on numerical crisis indicators from a variety of public and private sources. Of course, all numerical indicators have their own problems. Some indicator models were estimated during periods of fixed exchange rates in which overvalued or undervalued exchange rates have more predictive value for crises. Such models have to be interpreted carefully if a country now has a flexible exchange rate. While the Blue Chip averaging deals with some of the idiosyncrasies, we must back up the indicators with judgmental analysis.

We are also asking that the IMF pay closer attention to vulnerabilities in emerging markets. This requires that the IMF staff concentrate more on the areas most central to its expertise: monetary, fiscal, exchange rate, financial, and debt management policies. The IMF should also limit the number of countries with programs, so that it does not spread itself too thin, and should narrow the range of conditionality in programs. Narrowing conditionality has the added benefit of increasing country ownership.

The emerging market countries themselves, of course, have the primary responsibility to help prevent crises. Adopting prudential standards, providing greater transparency, keeping debt levels and inflation low, developing domestic bond markets, reducing currency or duration mismatches, avoiding soft pegs, and choosing either a flexible exchange rate or full dollarization are all good parts of a crisis

prevention strategy. It is our policy to encourage such reforms in emerging market countries.

Reducing Contagion

A second element of our emerging market strategy is aimed at reducing contagion from one crisis country to other countries. Reducing contagion is another form of crisis prevention.

In the early days of the administration we felt that there was an excessive emphasis on contagion. After many discussions with investors and traders, we found much more differentiation between countries and between policies than had previously been assumed. We spoke out that contagion was not "automatic." We stated that our support for large-scale financing at the IMF would not be based on unfounded claims of contagion without evidence that there were fundamentals at work linking countries. Then, using econometric analysis to bolster our views, we distinguished between direct links from one country to another—which clearly exists in neighboring countries like the United States and Mexico—and the automatic spread of bad market events from one country to another without such links.

Our policy to reduce contagion had two other dimensions, which can be illustrated in the case of Latin America. First, we welcomed a new IMF program for Brazil in August 2001 at the time that the crisis in Argentina started heating up. The program was for $15 billion, much smaller than the previous Brazilian program, but something that could provide a cushion. Our support for Uruguay was aimed at limiting the impact of the Argentina crisis on Uruguay, though in this case there was much more direct or fundamental interdependence between the two countries. Second, we have moved gradually in implementing our new strategy regarding limits—accepting a waiver in Argentina in the spring 2001, and then agreeing to an augmentation—so as to give markets time to adjust. Observe also that this policy of supporting countries that are following good policies, but are negatively impacted by a crisis in a nearby country, preserves incentives for country ownership. In contrast, the alternative of supporting bad policies in the crisis country due to fear of contagion effects undermines incentives to follow good policies.

As with any change in policy, assessing its impact takes time, but one of the most profound and beneficial changes in emerging markets visible in 2001 was that contagion among different emerging market countries was reduced dramatically. After the Argentine default there was no significant effect on interest rates in other parts of the emerging market world: Asia, Africa, and emerging market Europe. More-

over, economic growth in emerging market countries outside of Latin America did not deteriorate following the Argentine crisis. Even within Latin America, good policy in countries such as Chile and Mexico is being rewarded by good economic performance. Investors are differentiating much more carefully among emerging markets.

We have continued to emphasize the points made early in the administration that contagion is not inevitable and that uncritical acceptance of claims of contagion should not constitute the basis for large-scale official sector financing.

Limiting Access and Clarifying Official Sector Responses

The third part of the strategy is to place limits on official sector finance and to be as clear as possible about those limits. The policy challenge is to move gradually in the direction of less reliance on large official packages, so that investor expectations can adjust smoothly to new official sector policies. In our view, there should be no lending into unsustainable debt situations, but full implementation of a new access limit policy will require a new process to deal with sovereign debt as described below.

Clarifying the size of official financing packages is essential to increasing predictability in the market, to curbing excessive risk-taking, and to providing the right incentives for country ownership of good policies. In a further effort to clarify official sector responses, we believe that the official sector should seek to avoid ad hoc interventions using coercive official sector tactics.

As a first step to creating limits, we have established a policy of avoiding the use of large-scale bilateral loan assistance; in other words, the IMF must be the main source of emergency support. This allows the availability of IMF resources to act as a natural budget constraint on official financing packages. In this vein, the United States has made clear that it is not now in favor of an IMF quota increase. As Secretary O'Neill stated, "Limiting official resources is a key tool for increasing discipline over lending decisions." Limiting official resources in this way also places more accountability at the IMF where technical development of loan programs takes place.

So far the administration has adhered to these policies on access. Consider some examples. Turkey and Argentina are two countries that were in crisis or near crisis since the start of this administration. Each was already on a large IMF program. The new programs for Turkey in May 2001 and February 2002 did not involve large-scale bilateral support from the United States or the other G-7 countries. The program for Turkey entailed strong prior actions; the policies

have been implemented and the program has been on track with favorable economic results.

Similarly, an augmented program for Argentina in August 2001 did not entail bilateral loan support. In the case of Argentina, however, it became clear by the end of the year that the debt was unsustainable and policy was off track. For this reason, the administration decided to stop supporting IMF lending to Argentina in December. The recent programs for Uruguay and Brazil also did not have long-term, large-scale bilateral support. Because there was no such bilateral support, the overall size of the 2002 program for Brazil was smaller than the overall package in 1998, though the IMF support was larger.

Note that there was a four-day bridge loan from the U.S. Exchange Stabilization Fund to get the Uruguayan banks to open as soon as possible; as noted above this was designed to deal with the impact of Argentina on the banking sector in Uruguay.

With respect to IMF lending, we believe the higher the level of exceptional access for individual countries the greater should be the analytical justification for this access. The IMF has introduced a new analytical framework for debt sustainability analysis, which should help strengthen early identification of unsustainable situations. We also would like the IMF to put in place a process to ensure that any decision to provide exceptional levels of financing be supported by a formal exceptional access report.

Improved Predictability in Sovereign Debt Restructuring Processes

A fourth element of our emerging market strategy is to create a more orderly and predictable process for debt restructuring. The aim is not to reduce the incentives for sovereign governments to pay their debts in full and on time. Rather the aim is to reduce the uncertainty about restructurings. There is currently a great deal of uncertainty about the restructuring process. This uncertainty complicates decisionmaking. A more predictable sovereign debt restructuring process for countries that reach unsustainable debt positions would help reduce this uncertainty. It would thereby lead to better, more timely decisions, reducing the frequency and severity of crises.

Two approaches to an improved restructuring process have been suggested. One approach uses collective action clauses (CACs). It is often called the *contractual approach*. It would have sovereign borrowers and their creditors put new clauses into their external bond contracts. The clauses would provide a roadmap describing as precisely as possible what happens when a country decides it has to

restructure its debt. In this way the contracts would create a more orderly and predictable workout process. The official sector—in particular the U.S. Treasury and the G-10—have outlined some broad parameters for this approach. Within these parameters, sovereign borrowers and their creditors would work out the details as the new bonds are issued. The parameters are that there should be (1) a majority action clause allowing a certain percentage of bondholders to change the financial terms of the bond, (2) an engagement/ representation clause to facilitate information flow between sovereign borrowers and their creditors and provide for the election of a bondholders' representative, and (3) a clause limiting disruptive legal action.

The other approach is *statutory*. It is frequently called the sovereign debt restructuring mechanism (SDRM). It would endeavor to achieve these restructuring goals by statute. This approach, which is being developed by the IMF staff and management, is more centralized. It would require that the IMF articles be amended or another international treaty be created. A newly created forum would coordinate creditors and debtors and be empowered to handle certain disputes, particularly as they relate to verification of claims. This approach would also deal with aggregation across different debt issues and provide for uniform treatment for instruments from different jurisdictions. To handle disputes relating to aggregation and to provide uniform treatment under the contractual approach, an arbitration process could be included in the clauses if borrowers and their creditors agreed.

I believe that we have made substantial progress in this area. In April 2002, the Finance Ministries and Central Bank Governors of the G-7 countries agreed on a historic G-7 Action Plan for emerging markets. The plan called for the immediate introduction of CACs into sovereign debt contracts and further development of a SDRM. In September, the G-7 reiterated support for this approach. Moreover, the G-7 stated that any sovereign—including any member of the G-7—that issues bonds governed by the jurisdiction of another sovereign should include CACs. That is the strongest statement of support for CACs ever issued by the G-7.

Likewise, representatives from the private sector and many of the emerging market countries have stated their general support for the introduction of CACs and have worked to further refine the specific form that those clauses would take. On September 26, 2002, representatives of the private sector and senior officials from the G-7 and from some key emerging markets met at the U.S. Treasury—the first meeting of this kind ever. The purpose of the meeting was to discuss key aspects of CACs.

The views expressed by these three groups are important for determining how to proceed in the future. All of the G-7 officials reiterated their governments' support for incorporating CACs now and for continuing to work on a more specific proposal for the SDRM. The private sector supported the CACs, but strongly rejected the SDRM. Many of the emerging market countries expressed support for the CACs; many also expressed disapproval of the SDRM.

With support for CACs from the private sector, from the official sector, and from some key emerging market countries, the time appears ripe for moving ahead and actually putting such clauses in new issues. This would be a tremendous step forward. Any delay would be most unfortunate. It is only when the new clauses are in some actual bonds and trading in these bonds takes place that people will be able to judge their effectiveness.

Good public policy entails considering all options and choosing the one that works better than the alternatives. I have highlighted several objectives—encouraging country ownership, reducing the frequency of crises, increasing private capital flows to emerging markets, and raising investment ratings of countries. For those who are convinced that the clauses are superior to the SDRM, the best strategy is to move ahead and introduce such clauses. If there is convincing evidence that clauses do a better job of achieving these objectives than the SDRM or a combination of clauses and the SDRM, then the clauses will be the instrument of choice in this administration's strategy for emerging markets. Similarly, if the SDRM or a combination can be shown to work better for achieving these objectives, then we will support such an alternative.

Conclusion

We have made good progress in crisis prevention, in reducing contagion, in limiting access to large-scale financing, and in creating more orderly sovereign debt restructurings. To further progress in this last area of debt restructuring, we need a framework through which the private sector and the emerging market countries can move ahead.