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In Good Times Prepare for Crisis*

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Ira W. Lieberman:
In Good Times Prepare for Crisis – From the Great Depression to Great Recession: Sovereign Debt Crises and Their Resolution
The Brookings Institution, 2018, p. 480
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As an expert of the World Bank, Ira Lieberman has had ample experience with financial crises and their resolution. His knowledge of crisis management theory and the practical skills makes the book an interesting one, which not only shows the historical description of the facts, but presents the whole picture of the debtor-creditor relationship between countries. The author seeks to answer questions such as the following: What are the best techniques for sovereign debt crisis management? Why do debtor countries not pay debt servicing? How do creditors react? How effective is debt restructuring and are there general practices for it? One strength of the book is that the international relations of certain periods are highlighted and attention is drawn to the aspects of political economy.

The interwar period and the Great Depression

In the interwar period, lending increased in spite of the fact that the creditors accounted for huge losses due to the inflation and devaluation caused by the war. International lending increased on the heels of growth, faith in international trade, increasing influence in strategically important areas (e.g. England - India) and the creation of economic and political stability. However, the huge financial resources provided caused economic structural reforms to be postponed. A large part of the credits was spent on social benefits, reorganising the economy and restructuring existing loans, not on increasing future government revenues. Moreover, borrower countries did not introduce fiscal reforms, and so most of the credits were not sustainable.

At the time of the Great Depression, international lending decreased again. Since capital markets were not available for the countries, debt servicing decreased, stopped or was terminated (e.g. Russia). Banks faced a liquidity crisis, and there was

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a need for the appearance of a lender of last resort in the international financial system. At the World Economic Conference in 1933 countries decided to handle each sovereign debt problem on a case-by case basis, relying on the lender and borrower counties' communication and agreement, as an answer to the problems that had developed.

Developing countries sovereign debt crises

Developing countries tried to become politically independent from the Great Powers, but economic independence was indispensable for achieving this goal. For this reason, they borrowed to develop their economy. At the same time, developed countries still lent to increase their influence. International relations led the formation of the credit market. It also occurred that debtors refused debt service on an ideological basis (e.g. Cuba, Vietnam).

In the 1960s, the inflow of capital brought stability to the developing countries, but they could not switch to a self-sustaining model as it turned out when the funds started to decrease. Not only their sovereign debt increased, their debt service was challenged by rising interest rates and a strengthening US dollar, and so they needed debt restructuring. Their banks were financed by short-term loans which showed more and more certain signs of a crisis. The crisis did not stop at the borders, as banks in developed countries also went bankrupt because of the widescale exposures in developing countries.

The increase in oil prices in the 1970s raised government expenditures in the exporting countries, but they soon became debtors again when – due to the fall in oil prices – their extra revenues decreased, credit and debt servicing rose. Thus, oil exporters were not able to prepare for a crisis in good economic times.

Although the problems arising from debtors not being able to service their debts were not handled during the restructuring of loans, it was obvious that there will be more rounds of restructuring programmes. The International Monetary Fund (IMF) played a key role in this process, but their programmes based on fiscal tightening did not prove to be effective. Later, in low income countries alternative solutions were implemented, such as linking debt servicing to the export revenue of certain products. During the ongoing restructuring programmes the practice changed, and they were able to restore trust and capital flow until new crises hit.

Liberalisation of the financial sector and crises in the emerging markets

Liberalisation of financial markets was important because private capital flowed from developed countries to emerging markets and transition economies. Structural reforms and privatisation helped to create jobs and economic growth. Investment funds frequently invested in the capital markets of emerging countries because of the higher growth prospects. However, the inflow of capital made these countries vulnerable to external shocks. Moreover, the governments usually supported the capital inflow and promoted external financing. On top of that, many investments were short term and in foreign currency, and an adequate level of reserves were not built for these exposures, which further increased vulnerability. These high risks were not identified because financial market liberalisation and deregulation were not monitored.

There were several roots of the crises in emerging markets, but a banking crisis was one common feature in all. The Mexican banking crisis occurred because of devaluation, and it spread to nearby economies as well. The East-Asian crisis was caused by bubbles in the real estate market and the indebtedness in foreign currency, while in Turkey the high inflation, the undercapitalised bank system and devaluation of the currency were the culprits. In Argentina, banks found themselves in an unfavourable situation because of high exchange rate risk on the customer side and bad economic policy decisions. The fiscal deficit, decreased exports, and short-term external financing led to payment repudiation of the bondholders, and the debt was not settled for years. The case of Argentina perfectly represents one of the main messages of the book, which is that countries, in which interest payments threaten internal stability, have an interest in choosing bankruptcy.

International organisations took part in crisis management as lenders of last resort. Not only government bailouts participated in improving the economic situation, but the IMF, World Bank, G7 and the USA as well.

The 2008 crisis in the developed markets

Most crises were V shaped, followed by a boom, but after the 2007–2008 crisis there was no quick recovery, and the recession had an L-shaped form in developed countries. Unemployment increased, GDP decreased and credit increased. The USA and Japan transformed into debtor countries from creditors, and despite the fact that neither is threatened by a sovereign debt crisis as the author thinks, they have less room for crisis management.

The Japanese crisis was one of the first episodes of the crises in developed countries, as a credit-deflation spiral emerged. The private sector was indebted, which narrowed the fiscal opportunities. Stock and commodity prices decreased, which led to non-performing loans resulting in a banking crisis. Fiscal stimulus only created a larger deficit rather than any results, and the effect of the austerity policy escalated the financial crisis.

The epicentre of the 2008 crisis was the USA. The main factors which caused the crisis were: the housing price bubble, an increase in subprime loans, the indebtedness of the population, low interest rates, which encouraged leverage, banking deregulation which created financial conglomerates, and the underregulated shadow banking system and its connection to the financial system of the world. These factors not only resulted in high leverage but also in undercapitalisation, and the risks in the system were identified neither by the financial and regulatory institutions nor by the credit rating agencies. As the subprime loan market started to fall apart, international financial institutions followed the way.

In the USA, they attempted to manage the problems and organise banking bailouts on a case-by case basis, but after the collapse of Lehman Brothers, which was followed by the spread of the crisis, it was necessary to find a systematic solution. The FED cut the interest rate to nearly 0 per cent, announced QE programmes, expanded its balance sheet, restored trust and became the lender of last resort to other central banks. As the trade balance and the budgetary position are both negative, the author thinks the USA is not prepared for the next crisis.

The crisis had an impact in Europe as well: the banking crisis evolved into an economic crisis, and in some cases a sovereign debt crisis appeared as well. The European Central Bank, the European Commission and the IMF served as lenders of last resort for countries dealing with problems. Greek sovereign debt nevertheless remained at a high level after the crisis, and according to the author, the current level is still unsustainable and threatens the stability of the euro area. The United Kingdom quickly recovered from the crisis because it had its own monetary policy and the Bank of England served as a lender of last resort to the UK economy. By contrast, the countries in the euro area were unable to pursue a self-supporting monetary policy which could help their economic growth. The author says the EU is not yet in the stage of a boom, when there is a time to prepare a for crisis.

All in all, one main conclusion of the book is that the sovereign debt crises are recurring, and thus it is possible to prepare for them. The problem is that several countries accumulate debt in good economic times which makes them vulnerable to shocks. The author thinks we are still vulnerable to a future crisis. However, he ignores the fact that in a recession, coming after a crisis, it can be a part of a natural process to increase the debt level as occurred in the last years, because austerity policies are not effective in these times. Of course, it is true that if we look in the future, the bubbles on housing and stock market can be signs of future crises and it is worth it to prepare for them. But the author does not make clear economic policy recommendations which leaves us with sense of lacking something, because he highlights main problems but does not bring up solutions. In spite of that, the book can be a valuable guide to those, who would like to understand the established debtor-creditor relationship between countries.