Foreward, *Sovereign Debt Management*, Rosa M. Lastra and Lee Buchheit (Eds.), Oxford University Press, New York, NY, 2014, pp. vii-ix.

FOREWORD

This book radiates with the warmth of friendship for Lee Buchheit and the deep admiration for his work by the leading scholars, economists, and practitioners in the field of sovereign debt management. But the book is much more than a Festschrift. It is a definitive treatment of the field of sovereign debt crisis management, which has become one of the most difficult and crucial policy issues facing the global economy.

Such a comprehensive treatment would not have been possible without Lee Buchheit. More than anyone else, through his writing, speaking, advice-giving, and actually implementing policy, he has defined the field of sovereign debt crisis management, and has usefully identified its common elements across many different types of countries and periods of time.

I had the opportunity to work particularly closely with Lee Buchheit while I was Under Secretary for International Affairs at the US Treasury a decade ago. As the leading light in the field, he was the person to reach out to on sovereign debt problems. He gave sensible advice on broad reform issues, such as the introduction of collective action clauses into sovereign debt of emerging market countries. And he gave actionable solutions to really tough specific cases, such as the need to achieve a large write-down of Iraq's debt run up during Saddam Hussein's regime.

At the Treasury I saw him immerse himself into these difficult problems and come up with practical answers, as he has done many times before and since, most recently with his cogent analysis of the eurozone debt crisis. Indeed we at the Treasury took advantage of his generosity and consulted him so much that I later wrote in my book about that period that he was 'coming to Treasury so often that he seemed to be on the staff.' [1]

As Lee has patiently and clearly explained to me many times, there are several key common elements in sovereign debt crises, whether one is talking about those that began in emerging markets countries in the 1980s and continued through the 1990s, or those that began in some of the more advanced countries of Europe today.[2] You can see these elements in all the chapters of this book.

First is the *cause*, which Lee characterizes as 'excessively easy credit'. In the early 1980s crisis, the easy credit was caused by the huge revenue flows from the oil exporting countries into banks as oil prices surged with the oil shocks of the 1970s. These funds flowed from the banks and into the emerging markets in the form of loans to the governments, perhaps induced by the expectation that the IMF or the official sector would come to the rescue if repayments or sovereign defaults became a problem. The inflationary monetary policy by the Fed and other central banks which continued into the late 1970s helped to accommodate this excessively easy credit.

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[1] John B. Taylor, *Global Financial Warriors: The Untold Story of International Finance in the Post-9/11 World* (New York: WW, Norton, 2007), 111.

[2] Lee C. Buchheit, 'The Eurozone Debt Crisis In Historical Perspective', 2 February 2011.

In the case of the eurozone crisis, fiscal and monetary policy was the underlying cause. Many eurozone countries were reluctant to follow the sensible fiscal policy as laid out in the Maastricht Treaty. The resort to deficits and the resulting growth of government debt was likely exacerbated by the setting of interest rates too low by the European Central Bank in 2003–05, which was in turn partly due to the low interest rates set by the Fed.

The second element in the typical sovereign debt crisis is what Lee Buchheit calls the *trigger*, something which makes it clear that the 'music has stopped' or will soon stop because of the realization that the government's debt has become too big to service or roll over. In the 1980s, the trigger was the decision by the Federal Reserve under Paul Volcker to end the inflationary policies and raise interest rates dramatically. As the later performance of the American economy in the 1980s and 1990s demonstrated, Volcker made the correct decision, but it had the short run consequence of significantly raising debt service and making roll over of debt in many emerging markets nearly impossible. In the case of the eurozone crisis, the trigger was the great recession and economic growth slowdown associated with the 2008 financial crisis. But in the absence of these triggers, most likely there would have been some other trigger.

Once the trigger is pulled, the third element of the story—the government policy response—comes into play, and this is usually the place where Lee Buchheit is called into the scene as well. Policymakers typically respond in a series of chaotic political decisions under a great deal of uncertainty in which they seem to have no good choices. Private sector lenders and sovereign borrowers both call for a bailout of some kind from the official sector, which consists of the large developed countries and the international financial institutions, especially the International Monetary Fund. The lenders and borrowers argue that a bailout is necessary to prevent a painful default or an equally painful restructuring of the sovereign debt. Either default or restructuring, they argue, would harm the people in the country as well as the individual investors and financial institutions who would suffer the write down. Those in favour of a bailout further argue that contagion to other countries will amplify these costs. Policymakers and politicians find it hard to resist such arguments, but they are urged to do so by those who say that the bailout will cause moral hazard, make future crises more likely, and that taxpayers should not be bailing out investors who took on too much risk.

The choice is often starkly put as painful bailout or painful default.

Frequently, public officials attempt to avoid this hard choice. They 'kick the can down the road' hoping that higher economic growth and more revenues will help resolve the sovereign's problem. But rarely does the delay tactic work, and, as Lee has argued many times, it usually makes the problem worse. The eventual adjustment—including a bout of severe austerity—is more difficult than it would have been if a prompt decision had been made. In the 1980s the initial calls for bailout were resisted, leading to a period when private sector lenders and sovereign borrowers tried to scramble to delay or prevent defaults and write-downs with new money loans from the banks. Eventually the 1980s debt crisis ended, but only when sovereign debt was restructured in the 1990s.

Lee Buchheit's long experience has given him unique insights and a special appreciation for the incentives that drive policymakers in these situations. That is why he is so often called on and listened to. There is a certain tragic inevitability to the process. When you brief him on the details of a particular sovereign debt case, and explain the positions of all the parties, and then listen to his reaction, you know you are talking to someone who has seen this movie before.

This experience is why Lee Buchheit has been so constructive in the ongoing quest for reform. In his view there is usually no need for a stark choice between bailout and chaotic default. Indeed in many cases, he argues, there are other options, especially if you prepare for them in advance. Putting collective action clauses into sovereign bonds is one way to prepare for a smooth, relatively painless restructuring with little or no contagion. When such clauses are part of the bond contract, sovereign borrowers and lenders can achieve an orderly restructuring of the debt. Thanks to Lee's strong support, collective action clauses were part of the reform process for emerging market debt a decade ago, and that has helped reduce the likelihood of governments mismanaging a bailout-default choice. For these reasons, the IMF exceptional access framework was revised to reduce the likelihood of bailouts in emerging markets, and that has led to more responsible fiscal and monetary policy in many emerging market countries, making them less prone to crises.

Ironically, the problems that faced emerging markets a decade ago have returned to plague Europe, and there is thus still much need for reform. Fortunately, Lee Buchheit and the other authors of the chapters in this book are on top of the problem. The analysis and recommendations found in their contributions are exactly what is needed to bring about such reform, and thereby begin to remove or at least mitigate this continuing source of economic turbulence in the world economy.

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