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## Comments on the paper by Marcus Miller and Sayantan Ghosal 'Managing Financial Crisis in Emerging Markets: New Developments in Review'

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## Introduction

Over the last fifteen years the trade negotiations agenda has come to include more and more non-border issues, and on several occasions the first step has been to obtain a consensus between the involved parties as to its contents and scope. This broadening of the trade agenda has pushed political and co-operation themes towards the periphery, from where good intentions can be shown off without any commitment towards enforcement or results.

The events of 11 September 2001 gave rise to a profound change in the rules of the power exercise in the international sphere. One of the most marked effects of this change has been the increased weight of political-military considerations *vis-à-vis* the economic-commercial logic that used to dominate relations between states and private actors in the 1990s. Furthermore, the orientation and priorities of the trade policy of the main political, military and economic players on the world level are increasingly tending towards not only economic objectives but also those of a political-strategic nature.

The trade negotiations now underway express the more than harmonious overlap of these two processes, combining as they do the broad economic agenda typical of the 1990s, still expanding, with considerations of a political nature. For both the European Union and Mercosur, regional blocs identified with the logic of the “soft power” that was typical of the 1990s, this new world poses significant challenges, and the bi-regional negotiations now being held are

an excellent opportunity for fostering innovations in the field of international relations.

Moreover, the political and co-operative dimension of the bi-regional agreement provides an institutional space for facing up to some of these challenges. In order for this to happen, the key issue is the capacity of the parties involved to “focus” the agenda, that is, to choose priorities that effectively add content to the agreement as a whole, whether through their specific contribution to the relationship between the parties or to the interaction between this dimension of the negotiations and the commercial dimension of the agreement, or through their “systemic” contribution to the emergence of a world order not monopolized by the logic of “hard power”.

The chapters in this volume discuss relevant themes in the area of the so-called “political and cooperative dimension” of the bi-regional agreement between the EU and Mercosur. They should be seen as part of an effort of reflection meant to “focus” –in the meaning given above to this word– the agenda of this dimension of the negotiations.

The text by Sayantan Ghosal and Marcus Miller –*Managing Financial Crisis in Emerging Markets: New Developments in review*– fits into the discussion on the emergence in the developed countries of paradigms for dealing with the “development theme.” On the level of international relations, this theme involves the financial (debts, loans from multilateral organisations, etc.), trade and development aid dimensions, whereas on the national level, for the developing countries, it involves the economic policies practised.

Ghosal and Miller synthesise the recent debate on re-structuring the sovereign debt of developing countries by discussing alternative mechanisms such as Collective Action Clauses (CACs) –already applied by developing countries in some fund-raising operations– and the Sovereign Debt Restructuring Mechanism (SDRM) –a proposal made by the IMF itself and apparently rejected by a vocal coalition of both developed and developing countries.

The authors’ basic reference for the purpose of comparison is the scenario of the *status quo*, the maintenance of which is not implausible, but is nonetheless surrounded by risks and uncertainties. In a context where problems of co-ordination among creditors are mixed with high incentives for debtors to resort to international financial markets, the key issue of Ghosal and Miller’s text seems to

be how to create incentives for institutional innovation in an area where the preference of private actors is clearly for the *status quo*.

There is in fact a parallel between this situation and the dilemmas faced in trade negotiations, although in the financial arena the debates and negotiations are at a far less advanced stage than in the commercial arena. Indeed, as pointed out by Jérôme Sgard (the text's discussant), in the financial field there is a double realisation of (i) the relevance of local regulations and institutions to the stability of the international system and (ii) the difficulty in making national financial regulations harmonious and convergent. This actualises the dilemma between on the one hand a game governed by unilateral actions performed by public and private actors –that is, one based on unilateralism– and on the other hand a game driven by rules agreed upon multilaterally.

Nonetheless, regulating financial markets on the international level involves two inter-related elements that have a low rate of consensus among public and private players. The first is the question of whether or not to regulate, and if so, who should do it, national states or international institutions? The second question is the delicate issue of national sovereignty. In the specific field of re-structuring the sovereign debts of developing countries, the CACs present an intermediate solution to these two problems. The idea of regulation is accepted –the CACs proper– yet the basis for the enforcement of the mechanism is national (the Court located in the US or London). The SDRM in turn inserts to a large extent the idea of supranationality into the concept of a dispute-settling mechanism not far removed from the WTO model.

Certain elements of this debate are not without parallels in the questions dealt with by Álvaro de Vasconcellos in *Back to the Future? Strengthening EU/Mercosur Relations and Reviving Multilateralism*. Indeed, as mentioned by Alfredo G.A. Valladão (discussant of the chapter submitted by Vasconcellos), here too the theme of crisis-administration is present, just as it is in the text written by Ghosal and Miller. In the case of the discussions on international politics and security, there are today several models of crisis administration and “regime change”, all of which to a greater or lesser extent suffer from a crisis of legitimacy.

First there is the model upheld and practiced by the US, based on the unilateral definition of the legitimate use of force, which has attracted few supporters, even from among traditional allies of the

country. Then there is the model of the traditional multilateral system based on UN institutions and enforcement mechanisms, all very vigorous in terms of respect for State sovereignties and for that very reason more and more contested. And finally there is the European proposal of disseminating “soft power” and a new type of multilateralism, whose credibility is under threat from the poor effectiveness of the international initiatives undertaken on several occasions by the EU.

Two world-order scenarios seem to serve as a reference for Vasconcellos’ text. The first is a world order strongly supported by military power –and by the “politics of power”– with two variants, one unipolar and the other multipolar. The second is a system based on universally accepted rules and norms: the “new multilateralism.” This is “new” because this model of world system organisation that began to emerge in the 1990s, characterised by the relevance of the regionalism phenomenon, and by the fact that it is indissolubly linked to the emergence of a global public opinion and the protection of individual rights, above and beyond the established rules of sovereignty. This, then, is a “sovereignty-altering multilateralism”.

Although the EU is the chief bearer of this new multilateralism project, it finds it difficult to assert this identity on the international level and to mobilise its vast “soft power” resources around a coherent policy. These difficulties can be seen not only in the implementation of ambitious initiatives to reset the relations of the European Union with developing countries –such as the so-called “Barcelona process” with non-European Mediterranean countries– but also in relations with the US, which have deteriorated in the last two years, essentially on account of changes in US foreign policy.

With this negative effect on the EU’s capacity to act internationally as the principal pivot of the proposals for a new multilateralism, it becomes more possible that one of the variants of the alternative scenario traced out for world order could emerge, namely, the one based on “hard power”. Besides this, and at the same time parallel to these difficulties, international themes –especially when involving relations with relevant political and economic partners such as the US– tend increasingly to produce divergences among the Union’s Member States. Such divergences crystallise automatic positions of either alignment or conflict with the US, both of which positions contribute towards the emergence of

a non-multilateralist scenario (unipolar in the first case, multipolar in the second).

Vasconcellos proposes that the EU, in its relations with the US, should opt for a “third way” between automatic alignment and the attitude of confrontation. He suggests a “critical engagement”, a more appropriate stance for orienting the permanent and multi-faceted negotiations that characterise bilateral relations (and which will continue to do so in the next few years). A consensus on this “third way” seems plausible, and based on this the likelihood of the EU influencing the positioning of the US would increase significantly.

Mercosur shares with the EU the ambition of an international order ruled by universal norms and painstakingly seeks to assert itself as a soft power on the regional level. Like the EU, the Mercosur countries see relations with the US playing a vital role in their foreign relations. As also happens in Europe, attitudes *vis-à-vis* the US oscillate between automatic alignment and, if not actual confrontation, sheer antipathy. The exaggerated unilateralism of US foreign policy, the politico-military problems of Colombia and Venezuela, and the FTAA trade negotiations dominate the debate on the relationship between Mercosur and the US. In the present circumstances, antipathy has effectively replaced automatic alignment, but the frequent meetings between Presidents Bush and Lula suggest that there is room for, and reciprocal interest in, setting up channels of communication to deal with a complex and constantly changing agenda.

In these circumstances, exploring the convergent views of the EU and Mercosur with regard to a desirable world order cannot just be some *mot d'ordre* void of content and concrete proposals. Ever since the beginning, relations with the US have constituted a key issue on the agenda: in fact, US relations influence intra-bloc relations on both sides, and bi-regional relations, and they also, especially as regards the relations between the EU and the US, make systemic impacts that go beyond these two types of relations. At various stages in the process of consolidating an international identity, and with the availability of likewise highly diverse political capital on the world scenario, Mercosur and the EU face some similar challenges while sharing the basic elements of what should be a world order. Having said that, the adhesion of the Mercosur

Member States to a multilateralism that is less respectful of sovereignties is –to say the least– somewhat conditioned.

Based on the common ground of interests and views shared by the EU and Mercosur, Vasconcellos lists the main items of an agenda of political dialogue and co-operation on the bi-regional level. One of the pre-conditions for the implementation of this agenda is obviously that Mercosur must succeed in overcoming its present crisis and in the short run become consolidated as a customs union and engaged in a process of rules-based integration.

Advances in intra-Mercosur co-ordination and refinement of sub-regional rules also appear as pre-conditions for the proper implementation of an agenda linking trade and co-operation in the paper presented by Renato G. Flores Jr. –*Trade and Co-operation in the EU-Mercosur Free-Trade Agreement*. This is due to the fact that since some of the co-operation projects listed by the author have a relevant regional dimension that requires Mercosur to show a higher degree of cohesion and regulatory convergence in order to make implementation feasible.

The chapter discusses the role of co-operation in trade agreements, attributing to it the function of minimising the potential effects –when the agreements are viewed as public goods– of the fact that trade negotiations tend to be dominated by agents who are identified as being economically directly involved in the process. This does not imply ignoring that the very definition of the themes making up the co-operation agenda of a trade agreement also translates, on a specific level, the economic policy of the negotiation, which generally is more clearly identifiable in the commercial component of the negotiations.

Five priority areas of co-operation are identified:

- agriculture and phytosanitary measures, an area that directly involves questions of access of Mercosur exports to the EU market. With the rise of the level of pre-requisites needed for admission of farming products to the European market, a tendency recently confirmed by the definition of new community norms for the GMOs, the potential for trade friction in this area is bound to grow;

- investments and related measures, where both blocs share a similar view regarding how the WTO treats the theme; this convergence could be explored to the benefit of the results of the Doha Round;



– telecommunications and information technology, where co-operation could involve chiefly standards of networks for cellular telephony and digital television, these being areas where Mercosur is still in the phase of implementation or even of defining standards;

– culture and property rights, where the main proposals for co-operation refer primordially to a common definition of the “cultural enterprise” to which both blocs would grant specific privileges, and secondly to the improvement in both regions of channels of distribution and diffusion of audiovisual products manufactured in the two blocs; and

– dispute-settlement, where a system of previous consultation would be used before opening a bi-regional contention in the sphere of the WTO.

Another relevant zone of potential co-operation is defined by the agenda of structural adjustment, where the European Union enjoys wide experience in drawing up and implementing policies. As a matter of fact, these themes are tending to gain relevance on Mercosur’s internal agenda –even as a result of the FTAA and European Union negotiations. Here again appears the problem of Mercosur’s internal insufficiencies and difficulties, which hinder the carrying out of any project compatible with the new challenges already faced by the bloc.

The truth is that one of the main and most troubling conclusions drawn by the three texts presented here –and in a general sense by the discussions held in this cluster– has to do with the problems faced by Mercosur in order to respond adequately even to an agenda of negotiations typical of the 1990s. And this is in an international context where associations between countries and blocs have to consider, in addition to the themes on that agenda, new questions that are mostly linked to the politics, security and administration of different types of crises.

Accordingly, what Mercosur needs to do, besides concluding its customs union –a complex task in itself– is to add these new questions to its other concerns. In order to associate promoting a new multilateralism with an international identity, Mercosur must consolidate itself as a process of rules-driven integration, re-shape relations between what is regional and what is national in this process, and keep farther and farther away from “sovereignist” multilateralism.

Another important conclusion drawn by these studies involves the close inter-relationship between the intra-bloc, inter-bloc and

systemic dimensions that characterise principally the agenda on politics and security and themes related to international finances. The chapter written by Vasconcellos shows this sort of inter-relationship in the analysis of the dilemmas in consolidating a common foreign policy for the European Union as a “three-level game” that mobilises intra-bloc politics, bilateral international relations with the US, and Europe’s relations with its systemic proposal of regulating the international system: the new multilateralism. Another example of the intensity of this inter-relationship (in this case involving essentially intra- and extra-bloc dynamics) is provided by Mercosur, where the fragility of the process of integration compromises the capacity of the bloc to negotiate and benefit from a co-operation agenda in areas that are relevant to the sub-regional project, as well as seriously jeopardising the possibility that this project will contribute towards a re-definition of the international identity of its members.

Pedro da MOTTA VEIGA

**Security Constraints  
in the post-9/11 International Environment**



## Chapter 1

### Back to the Future? Strengthening EU/Mercosur Relations and Reviving Multilateralism

Any attempt at assessing the potential and the shortcomings of the European Union's foreign and security policy on the basis of EU action in confronting the Iraq crisis would inevitably lead to the conclusion that there is no such thing. This foregone conclusion which is shared by many analysts and commentators is in my view unfounded, despite the blatantly obvious inability of the EU to act in a cohesive and united manner in the face of any major crisis, especially in those cases when its interests do not coincide, but rather conflict, with those of the United States. This, it is also argued here, will increasingly be the case, at least when crises occur outside the boundaries of the European continent. The Iraq crisis merely brought home this reality in a brutal and extreme way.

EU foreign policy, in those areas where it is operative, such as foreign trade and development aid, is that of a civil power, based on a model of development and social cohesion which has had an unequalled impact worldwide; some observers have even described it as a global Scandinavia. Its most innovative and attractive characteristic has been the way in which it has enabled Europe to overcome nationalism for, as Raymond Aron has argued, the extreme nationalism of the Second World War rendered all forms of nationalism illegitimate. It paved the way for Franco-German reconciliation and for the integration of the old Europe, on the basis of multilateral rules and norms and an awareness of common interests.

There can be no doubt that this experience has had a global influence. The growth in awareness of the need to protect human rights

that has accompanied economic and technological globalisation, together with the requirement for environmental protection and compliance with multilateral principles of international behaviour, has been at the root of the popularity of the European model. The attractiveness of this model, together with its sheer economic size, has given Europe a great deal of “soft power”, in terms of Joseph Nye’s four elements of power: economic, national cohesion, military, universalistic culture (Nye, 1990; 2002). Yet Europe still lacks weight in the international arena. Two of Nye’s dimensions of power are missing –unity and military capability– which the US possesses to excess and which would be essential if the US were to act decisively in dealing with crucial international problems.

Mercosur is a regional grouping roughly inspired by the European model. In spite of the fact that all four dimensions of power described above are, and will probably continue to be lacking, other than within the limited confines of commerce, it has exerted a notable measure of attraction *vis-à-vis* its neighbours through the “power of example”. As it develops further its inherent “soft power” dimension, notably in conflict and crisis prevention, Mercosur will potentially come closer to the EU, and their ability to act together in the international sphere will concomitantly increase.

### *Civil-Power Politics: Strong and Weak Points*

The EU acts in the international sphere as an eminently civilian power through a long-term strategy of inclusion which relies on the full panoply of instruments of soft power. In other words, where traditional power politics would seek to pre-empt, civil-power politics seeks to prevent. These are two diverging, and at times conflicting, approaches to promoting international peace and security. EU-style inclusion and prevention –of conflict and crisis– are intended to strengthen the impetus for political reform, development and economic integration and cohesion within societies, on the assumption that these are the very foundations of lasting peace. The EU relies on the virtues of soft power, including where post-conflict reconstruction is concerned.

Success so far in putting to full use soft power instruments outside the boundaries of Europe, when measured against the results achieved, is rather limited. It is questionable, moreover, whether the EU could ever hope to play a leading role in shaping the international

order by soft power alone. Promoting peace and democratisation through the inclusive method has proved to be perfectly suited only within the European continent where the prospect of EU membership was real and political conditionality was thus fully brought to bear. Both the Copenhagen criteria and the Stability Pact, where certain conditions regarding respect for human and minority rights are set out, are exemplary. In other words, the promised reward was far greater than the penalties imposed. Real membership prospects for Turkey have clearly accelerated the pace of democratic reform, and are contributing to democratising political forces, including those of Islamic leanings such as the Justice and Development Party or AK.

As we go beyond the European continent, however, there are not many results to show for policies which by and large have proved to be unco-ordinated at best, and are in several cases inconsistent. A major example is the Euro-Mediterranean Partnership (EMP), commonly known as the Barcelona Process.<sup>1</sup> The EMP constitutes an attempt on the part of the EU to expand the area of peace and stability beyond its boundaries to the south, to include North Africa and part of the Middle East, *i.e.* to a vast region –or regions– where potential or current instability is driven by serious social, economic and political tensions. As a civil power, the EU would need to act on the correct interplay between economic integration and pressing for social and political reform, in a similar fashion to what happened in Europe itself.

The current difficulties of the EMP are a consequence of the lack of coherence, in practice, of the two main components of EU external action: the economic and the political impetus sometimes conflict. While the Union has been laying the foundations of a free trade area within the region by establishing individual association agreements providing for free trade –with the notable exception of agriculture– with the countries of the region, there is much slower progress in those areas related to human rights and democracy. For all practical purposes, EU policy has been ineffectual at best in promoting any

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1. The signatories of the Barcelona Declaration (November 1995) which has established the Euro-Mediterranean Partnership are the members of the European Union plus Algeria, Cyprus, Egypt, Israel, Jordan, Lebanon, Malta, Morocco, the Palestine Authority, Syria, Tunisia and Turkey. Cyprus and Malta are set to become EU members in 2004, and Turkey has been officially accepted as an EU candidate, although contrary to its expectations the Copenhagen European Council, in December 2002, failed to set a starting date for membership negotiations.

change in the status quo, fearful perhaps of a repetition on a much wider scale of the Algerian case and Islamist forces coming to power through elections. Perhaps the Turkish example, and the sizeable gains of the Justice and Development party in the November 2002 elections in Morocco, will contribute to allaying fears of a resurgence of radical Islamist forces coming to power through democratic transition, thereby encouraging the EU institutions to become more involved in effectively confronting the issue of political reform in the south, and actively addressing the related issue of human rights.

European institutions and notably the European Council have consistently abstained from explicitly condemning human rights violations in the southern Mediterranean partner countries. The equally consistent exception is the European Parliament, but in the absence of other than declaratory policy instruments, its solitary voice has little resonance even within Europe itself. The European Commission, it should be noted, supports a human rights network. Although the strengthening of a number of NGOs in the south should be listed as a positive outcome, it must be admitted that the impact of the human rights agenda within the EMP has still to be felt.

In the light of the impact of the current international crisis on European public opinion, and also because the US Administration seems bent on regime change (the main argument in the quest for *post facto* legitimation of the Iraq war), upholding the status quo is no longer a viable policy option. The EU and its Member States find themselves in a position where they are compelled to become proactive in the promotion of democratic transition and respect for human rights under the strain of events and under what will increasingly become the pressure of their own publics. European public opinion is bound to become less tolerant of double standards.

Political transition should therefore be encouraged as a process, and change regarded as incremental and not abrupt or imposed from without. This will require a concerted effort across all the EU institutions and pillars, and the unreserved backing of the Member States. In light of the above, it becomes evident that policy towards the Mediterranean basin must also be designed taking into account one essential dimension of EU foreign policy, namely the coherent interplay of Community institutions, the Council and the Member States.

Another area that powerfully illustrates the shortcomings of the civil-power approach of the EU is Latin America, and Mercosur in particular. Consistency would in this case imply –as opposed to the



outward projection of internally held values or norms— a sort of “reverse conditionality”, whereby the EU should let its own ambition in terms of the international order override purely domestic considerations. If Mercosur is to be a strategic partner of the EU in bringing about an international order based on regionalism, then the Europeans must be able to overcome internal differences related to agricultural policy reform standing in the way of an inter-regional free trade agreement. It should be noted, moreover, that somewhat paradoxically the EU Member States which are more reluctant to accept an overhaul of the Common Agricultural Policy are among the most vocal in pleading (and pledging) to further strengthen relations with Latin America.

Post-conflict reconstruction and nation-building require broadly the same kinds of policy instruments as conflict and crisis prevention, and the EU is deemed thoroughly, and by some uniquely, equipped to deal with both. Andrew Moravcsik,<sup>1</sup> for example, argues that the EU should abandon any attempt at transcending its civil power role, which it would be well advised to perform as a supplement to the exercise of US military power:

Rather than criticising US military power, or hankering after it, Europe would do better to invest its political and budgetary capital in a distinctive complement to it. European civilian power, if wielded shrewdly and more coherently, could be an effective and credible instrument of modern European statecraft, not just to compel compliance by smaller countries but perhaps even to induce greater American understanding. Europe might get its way more often —and without a bigger army (Moravcsik, 2003).

A division of labour along the lines suggested above would require the EU to deal mainly with soft security and to use budgetary and political persuasion to make smaller countries fall into line, while hard security would be the sole preserve of the United States. More importantly, it would require complete convergence between Europe and the United States, and the acceptance of a surrogate role under any circumstances. Should differences arise, these would inevitably lead to serious tension, and EU policy options would ultimately be dictated not by EU parliaments and governments, but rather by the US Congress and the US Administration.

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1. The author, a professor of government, heads the European Union programme at Harvard University.

## *Civil-Power Constraints to Policy Options*

The conflict in the Balkans during the 1990s has powerfully made the case for the limitations and constraints to which a civil power approach inevitably leads, even when the continental process of inclusion is concerned. It was obvious from the early stages of the conflict that any massive amount of aid (which was not forthcoming in any case) associated with the prospect of joining the EU in the distant future, as Jacques Delors pointed out at the time, or any amount of economic clout exercised negatively through sanctions, was powerless to prevent and even less so resolve the conflicts that successively broke out in the region. A “toothless” civilian power was in no position to act decisively in order to prevent conflict and war in the Balkans. There was a military element to either the prevention or the resolution of these crises and conflicts which clearly affected European security, and the wielding of EU soft power, in spite of a clear convergence of views and interests with the United States, tragically proved absolutely ineffectual. Also, the first serious post-Cold War crisis on its very doorstep caught the EU unprepared, and unequipped with the appropriate mechanisms for the formulation of a common policy approach to deal with crises of some magnitude. The EU was deeply divided over the Balkans crisis, and old, seemingly long-forgotten, reflections of different geopolitical cultures, which the process of European construction itself would seem to have long delegitimised, soon re-emerged. These were not resolved but simply glossed over by the incomplete reforms subscribed to in the Treaty of Amsterdam and the half-hearted compromise contained in the Treaty of Nice, where the risks of seeing EU policies sink back into “re-nationalisation” in the post-Cold War environment were not decisively dispelled.

On the eve of the war on Iraq, the huge “deficit of unity” on foreign policy became glaringly apparent. The current rift among EU Member States throws into question whether a European foreign security and defence policy is still a viable option. Leaving aside the issue of credibility, it remains an open question whether it will contribute to or, rather, hamper the ability of the EU to act as a cohesive body in the international arena.

The question before the EU remains the same after the Iraq crisis, though it is perhaps more difficult to answer: whether and how it will be able to build itself into a credible and effective player on the

world scene. The Convention on the Future of Europe has the difficult but crucial task of providing an answer. In order to do so, a number of issues will have to be explored: the international identity of the EU; how unity among Member States can be maintained; how to organise EU-level relations with the US; how to ensure overall coherence between the various components of external action; the role of a defence policy in this context; and, lastly, the specificity of the EU's method of governance.

### *The EU's International Identity*

The EU is a federation in reverse, in the sense of transferring to the centre those responsibilities that are normally the prerogatives of states in ordinary federal systems, and leaving to Member States those responsibilities – such as foreign policy, defence policy and taxation – that are usually the federal government's province.

The best way to correct this imperfection is not to try to emulate the United States and build a European super-state. Rather, as Jacques Delors, and especially Joschka Fischer in his Humboldt speech, have been suggesting, the EU should become a confederation of states which will continue to share responsibility for a significant number of competencies at EU level, confederate democracy being guaranteed through the Council and the Senate. There is no other way of ensuring dual legitimacy, conferred both by the citizens and the states. A federation of democratic states is a supranational body built on norms and rules that delegitimise power politics among member states.

It is not because of any in-built weakness, as is suggested by American neo-conservatives and particularly Robert Kagan (2002), that the EU favours a multilateral approach, but rather, as Kagan also recognises, because it is a construction based on supranational foundations and laws. Thus the EU cannot act as a player in international politics along different lines from those that regulate relations among its Member States without betraying the expectations of its own citizens and undermining coherence with the values which constitute the foundations of the EU edifice. Interests and values are intermeshed as far as the EU's view of the world order is concerned. Unless the international system is based on norms and rules, the EU will be unable to carve a role for itself as a major world player. Thus the EU is not interested in an international multipolar

order based on an unstable balance of power system, and even less on a bipolar system in which it would confront the United States on the global arena. This is of course not to say that the EU should not seek to become a distinctive pillar of the international system, clearly identifiable as such.

The 2003 crisis in Iraq brings to the fore all the ambiguities of the ongoing debate pitching the notion of Europe as a “traditional power” against that of Europe as a “space”. The British, who traditionally have been the main promoters of the latter idea, have been led into a national reflex of automatic alignment with the United States by the most pro-European Prime Minister they have had since Edward Heath. The EU was seen as having no role at all in the run-up to the crisis and the war, and the only role Britain sees for it is a humanitarian and post-conflict rehabilitation one alongside the United Nations. The French, who have been the traditional supporters of the notion of “Europe as a power”, were those who more clearly reflected the common European interest in the first phase of the crisis up to the time when the Security Council passed resolution 1441, having stood for multilateralism in line with the values that shape the EU itself, although they did so from a “national” perspective, with no serious attempt at rallying the Union behind them.

It is arguable that, not least because it will not be able to bridge internal divisions, the EU’s role as a major world player is conditional upon its ability to shape a world order based on a “new multilateralism” that was indeed emerging in the post-bipolar international system in the 1990s and that is marked by three characteristics.

First by the sense that the international community and the United Nations in particular are responsible for the protection of the rights of individuals, above and beyond sovereign boundaries. It is a sovereignty altering multilateralism. Second, by regionalism, a phenomenon that has become a structural feature of the international system as a whole. And third, by the emergence of a global public opinion, a “second wave” of globalisation, which expresses the desire of civil society to influence or participate in global decision-making, and like the globalisation of trade, finances and services, has pushed the need for global multilateral governance forward. This is a sovereignty-altering multilateralism, which changes the position of the state in the international system (IEEI/Euro-Latin American Forum, 2001: 9).

It could be argued that the right of intervention in sovereign states with or without a UN mandate is the policy that the US Administration is promoting by defending a doctrine of pre-emption. Pre-emption is not synonymous with humanitarian intervention, however. The former is typical of power politics, whilst the latter is a fundamental concept in the development of a multilateral order based on principles and norms that make the rights of citizens the business of the global community. Both are the fruits of the same situation: the dominance of democratic powers in the post-Cold War era. However, they represent radically different views of how that power should be used. Unless they operate according to universally accepted rules, democratic powers will come to be seen as a coalition of “the West against the rest” inspired by a “clash of civilisations” strategy.

The set of principles the EU upholds in the international arena is to some extent enshrined in the Treaty on European Union (TEU) as it currently stands. The Convention has reached consensus towards an expansion of their formulation into the following wording:

The Union’s action on the international scene shall be guided by, and designed to advance in the wider world, the principles which have inspired its own creation, development and enlargement: democracy, the rule of law, the universality and indivisibility of human rights and fundamental freedoms, respect for human dignity, equality and solidarity, and for international law in accordance with the principles of the United Nations Charter. The Union shall seek to develop relations and build partnerships with countries, and regional or global organisations, which share these values. It shall promote multilateral solutions to common problems, in particular in the framework of the United Nations (Draft European Constitution, Title V, Chap. 1, Art III-188).<sup>1</sup>

However, any set of principles agreed by the EU will be severely undermined if full conformity by all Member States cannot be ensured. The TEU states in Article 19 that Member States “which are permanent members of the Security Council will, in execution of their functions, ensure the defence of the positions and the interests of the Union”, and Article 13 requires Member States “to safeguard the common values [and] fundamental interests” of the EU.

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1. This wording was taken verbatim from the report of the Working Group on CFSP. Both documents can be found at [www.european-convention.eu.int](http://www.european-convention.eu.int).

The UK has nonetheless taken part in a military operation in Iraq alongside the United States that the UN Security Council refused to legitimise, having sought and failed to obtain the SC's endorsement of a resolution co-sponsored with Spain and the United States. Leaving aside any judgement as to conformity with the EU's fundamental interests, it is still the case that both France and the UK acted primarily in their individual capacities as permanent SC members, and did little to rally the full strength of EU membership behind them. The Common Foreign and Security Policy (CFSP) was powerless to create a consensus leading to other than a declaratory commitment to the central role of the United Nations in the resolution of the Iraq crisis, which lacked any kind of binding force. The new EU constitutional treaty must therefore establish patterns of accountability so that the European Court of Justice can act whenever the Union, or its Member States, violates its own principles. This means that the Union's vision of the world, which opposes power politics and encourages multilateral international law, should be enshrined in the constitutional treaty.

It is doubtful, however, that the reform of the treaty will succeed in this regard since it is highly unlikely that states can be made to accept such a clear limitation to their freedom of individual action, which goes much further than the statement, however strongly worded, of the general principle of mutual solidarity.<sup>1</sup> The current crisis has powerfully highlighted, however, the staunch support for "multilateral solutions" among European public opinions which suggests that it would back enshrining the set of principles governing the international action of the EU in the treaty, thereby giving them binding force. Should this be the case, the implications in terms of coherent and effective EU action in international security issues would be far-reaching. As noted above, and as the Iraq crisis once again highlights, it is obvious that the EU as such, like any group of states, can not develop a foreign policy which is not based on the set of principles which informs interaction between its member states, such as human rights and multilateralism.

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1. In Article I-13, Para. 2, the draft Constitution does require Member States to bring their foreign and security policies in line with those of the EU: "Member States shall actively and unreservedly support the Union's common foreign and security policy in a spirit of loyalty and mutual solidarity and shall comply with the acts adopted by the Union in this area. They shall refrain from action contrary to the Union's interests or likely to impair its effectiveness".

There is no historical precedent as to whether an effective international actor can emerge on the basis of a rejection of power politics, and it is questionable that the EU could indeed become the first to do so. Many analysts contend that this is unlikely, especially at a time when the international order is decisively shaped by a domineering world power which views the UN as an optional extra.

### *Redefining the Relationship with the United States*

No lasting and stable world order is even remotely possible without the commitment of the United States. However, completing the multilateral order which seemed to be setting itself in place under the impetus of two American presidents as the Cold War drew to a close would seem beyond reach unless there is a significant change in the course set by the current US Administration. It is unquestionable that the decision to invade Iraq was taken unilaterally. But then, when the Bush Administration decided on 12 September 2002 to play the UN card and seek Security Council backing for that invasion, is it inconceivable to assume that the end result would not have been the same, had the two permanent (UK, France) and two rotating (Germany, Spain) EU Members States in the Security Council taken a common stance? It seems safe to assume that their combined strength, backed by the full EU membership, would at least have had a significant chance of influencing the US position. Clearly, the reverse argument has been proven. It is doubtful indeed whether the United States would have been in a position to intervene in Iraq without the participation or the backing of any EU member. Obviously, the rift between EU members is much less about Iraq than about the individual and collective relationship with the United States.

“Critical engagement” –a sort of “third way” between unquestioning alignment and useless head-on opposition– seems to be the best option to govern EU-US relations, because no other would have a chance of winning full backing from the EU Member States. This would presuppose of course that automatic alignment would not necessarily be the rule, and that the EU would be in a position to say “No” to the United States, albeit under exceptional circumstances, without either breaking apart or risking standing accused of seeking confrontation. Whatever the choice, critical engagement or even opposition is condemned to failure if it lacks the

foundations of a solid European convergence that allows the EU to function as a bloc.

During the Bush (senior) and Clinton Administrations, a significant convergence with Europe was forged regarding the creation of a multilateral international order, which smoothed over and attenuated differences. This consensus paved the way for the vast coalition that waged the Gulf War in 1991. The shift in US policy, the break away from a multilateral project, has upset the transatlantic and the European consensus, all the more so because influential members of the current US Administration are not exactly enthusiastic supporters, to put it mildly, of European unity. For the neo-conservatives, Europe is essentially a collection of states that should be bound primarily by solidarity with the United States and not among themselves (Hassner and Vaisee, 2003: 153). It is therefore crucial to move European policy away from an amalgamating “Atlanticism” and towards a Euro-American partnership that would also constitute an important factor in European integration.

### *United in Action*

In order to guarantee overall policy coherence and unity in EU action in the wider international arena, debate within the European Convention has concentrated on six major reform proposals:<sup>1</sup>

- (i) Qualified majority voting in a common foreign and security policy (CFSP), but not a European security and defence policy (ESDP);
- (ii) Creating the post of EU Foreign Minister with the combined functions of the current High Representative and the Commissioner in charge of External Relations;
- (iii) Replacing rotating member states’ presidencies of the EU with a President of the European Union;
- (iv) Paving the way for a wider use of the “reinforced co-operation” mechanism, including in defence;
- (v) Reforming external representation through the single representation of the Eurogroup in the major financial institutions;
- (vi) Creating a EU diplomatic corps.

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1. The proposals put forward by the European Convention, including the Draft Constitution, will subsequently be discussed by Member States in the intergovernmental conference due to start in the late summer of 2003.



The most controversial is the Franco-German proposal to end rotating presidencies, strongly opposed by the smaller states which see it as an attempt to diminish their role; so far it is backed only by Spain, Italy and Britain, and less enthusiastically by Poland. Here lies the main objection to a president of the Union. The smaller states fear they will in effect lose power, and some are also concerned that their special ties with various regions of the world, and the particular focus they bring to EU foreign policy during rotating presidencies, will thus be lost. It is unlikely that majority voting will become the general rule rather than the exception in CFSP, owing to renewed British opposition. Perhaps the best way of combining multiple priorities and sustained focus together with effectiveness has yet to be found as far as EU foreign policy is concerned.

The EU has set a unique precedent in what concerns governance, having devised a multi-layered system of governance which is unique. At the heart of this system lies the wide variety of actors which are involved when it comes to areas such as crisis prevention or, at the other end of the spectrum, economic policy (an area where powers of initiative are the exclusive preserve of the European Commission): the Council, the Commission, Member States, regions, NGOs. To make matters more complex, the system is built on a tripod or three pillars. It is likely that the current reform process will result in a two pillar-system being adopted, one dealing with the Community, CFSP and Justice and Home Affairs (JHA) and another one with defence.

Co-ordinating such a complex system may hinder the EU's capacity for action, but at the same time it contributes to its distinctiveness as an international player, better adapted to the interdependent world in which we live. These inherent features make the European Union ideally suited for long-term crisis-prevention through a comprehensive approach to regions or groupings aiming to address political, social and economic as well as security aspects in a balanced and integrated way. The best example of such an approach so far, in spite of the many shortcomings and failures to translate it into a coherent set of policy options, remains the Barcelona Process.

Attempts at formulating a European security and defence policy are mainly the result of European impotence and American absence in the initial stages of war in the Balkans. Under the impulse of the Franco-British statement issued at the St. Malo summit in December 1998, ESDP officially came into being at the December 1999

European Council in Helsinki. A number of decisions leading to the creation of a 60,000 strong rapid reaction force (which has still to be declared fully operational) and a 5,000 strong international police force<sup>1</sup> were subsequently taken in Feira (June 2000) and Marseilles (November 2000). By the end of 2002, when divisions among EU members concerning the new American strategy became increasingly consequential, ESDP had progressed to the point of securing the reversal of Turkey's veto on the use of Nato assets and capabilities in ESDP operations under the so-called Berlin plus arrangements. This will in principle pave the way for ESDP to take charge of military operations in Bosnia and Macedonia.<sup>2</sup>

From the outset, the question was whether the pragmatic approach put forward by France and Britain (capabilities first) was appropriate or whether the "political deficit", *i.e.* the absence of a clearly formulated conceptual framework and policy guidelines, would indeed become problematic. As the Convention working group on defence has noted, "the ESDP was defined and developed on the basis of the challenges and threats as evaluated in the 1990s". These were largely based on the tragic experience in the Balkans. The assumption was that the major security issues the international community would have to face in the future would be of the same kind as those provoked by the manifestations of extreme nationalism, *i.e.* civil wars resulting in humanitarian tragedies, ethnic cleansing and massive violations of human rights. The EU therefore sought to put together the kinds of military capabilities suited to peacekeeping and peace enforcement, or the so-called "Petersberg missions" as they are termed in the TEU, which in reality encompass the whole spectrum of military missions, with the exception of collective defence.

Today, however, these assumptions are at odds with the international context as it is defined by the United States. The war on terrorism became, from 12 September 2001 onwards, the number-one concern of US security policy, which shifted to homeland defence

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1. The EU police force took over from the UN International Police Task Force in Bosnia-Herzegovina in 2002.

2. The first ever EU military mission, Operation Concordia, was launched on 31 March 2003 as ESDP took over from Nato's Operation Allied Harmony. The app. 300-strong military force is tasked with protecting the EU/Organisation for Security and Co-operation in Europe (OSCE) monitoring mission in place. Operation Concordia is expected to last for six months.

shored up by a doctrine that contemplates pre-emptive strikes or wars as a viable option. Furthermore, the terrorist threat was globalised and associated with that posed by the proliferation of weapons of mass destruction, which formed the backbone of the justification for the invasion of Iraq. The new international security priorities set out by the Bush Administration do not correspond to the world vision held by the EU as such or the vast majority of its Member States, and thus ESDP finds itself thrown into confusion. As far as the fight against terrorism is concerned, the EU has stepped up its co-operation with the United States and accelerated and deepened integration in JHA. The fight against terrorism and transnational criminality (human and drug trafficking) also features prominently in the EU's own international co-operation agenda with other areas of the world.

The EU is reluctant, however, to adopt the international security agenda as defined by the US Administration. The EU as such and the majority of Member States have also refrained from carving a role for the military in combating terrorism at the internal level, other than in clearly exceptional circumstances. The fact that the UK seems prepared to accept unquestioningly the US security agenda does not bode well for European defence. The Franco-British compromise reached in St Malo, which in effect marked the lifting of the British veto on the EU taking on the security and defence dimension is now obsolete. Also, there is much broader agreement on the major threats to world peace as the United States defines them (tyranny, WMD proliferation and terrorism) than about the way it is prepared to confront them even among the security community in countries such as France. In other words, there is a sense that the United States is raising the right questions but giving the wrong answers. One has only to think of the reasons why oil prices surged briefly at the beginning of the Iraq war to be reminded that, unless the EU adopts a purely homeland defence posture, *i.e.* is prepared to confront only those security issues which may have a direct short-term military or economic impact on its well being, then the initial assumptions of ESDP, barring minor adaptations, still hold.

Whatever the case, it should be noted that existing proposals concerning security and defence (together with the major proposals for institutional reform referred to above) have been tabled at the European Convention so far by France and Germany. Reinforced co-operation or a "leading group" ready to proceed with deeper integration in security and defence seems more than ever the way

forward for ESDP out of its present predicament.<sup>1</sup> No one expects, however, a European security and defence policy to be fully credible without the full commitment of the UK. It remains to be seen how Tony Blair will evaluate the fall-out of Britain's participation in the war on Iraq (and perhaps more importantly the subsequent peace) on his project to put Britain at the "heart of Europe". Fulfilling Donald Rumsfeld's prophecy and becoming the leader of a "New Europe Club" within the EU, to be joined by the newcomers, Spain and perhaps one or two others may be rather tempting. But this is one temptation Britain would do well to resist, if it wants to avoid divisions of such gravity within the EU that they may well lead—and the idea is already being floated—to a consolidation of the trend towards a "European vanguard" or less likely to full-fledged political union between France and Germany as proposed by Pascal Lamy and Gunter Verheugen (2003).

### *Mercosur: a Civil Power in the Making?*

During the diplomatic battles in the run-up to the war on Iraq, the high degree of political convergence between Latin America and the EU as a whole in what concerns the international order again became apparent. The positions of France and Germany symptomatically converged with those of Chile and Mexico, the two Latin American representatives on the Security Council in the run-up to the war. Chile arguably championed the collective stance of the Mercosur members and associates, who unanimously stressed that only the Security Council could authorise the use of force to ensure compliance with its own resolutions.

This is not to say that Mercosur's members stand absolutely united when it comes to relations with the United States. While Brazil voiced total opposition to military intervention on the grounds that, in the words of Foreign Minister Celso Amorim, "the war is bound to aggravate instability in the Middle East and stir up

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1. Belgium has promoted a high-level meeting to put forward proposals for the creation of a Defence Group within ESDP. France, Germany and Luxemburg were supportive, and Portugal expressed its interest. The timing of the meeting just after the Iraq war was subject to criticism, however, and the original proposals were watered down ahead of the actual mini-summit held at the end of April 2003 in order to avert accusations of further aggravating the European rift.

the existing tensions between the West and the Islamic world”, Argentina posed as “neutral”. The fact that Mercosur, together with its associate members Chile and Bolivia, felt the need to define a common stance in an international issue of such magnitude is, however, important in itself and indicative of its desire to take a more active role in world affairs.<sup>1</sup> Brazil’s President Lula actually sought a negotiated solution at the UN level in order to persuade the United States to moderate its impatience, and later deplored the fact that the US had resorted to military force without the Security Council’s explicit backing. Another example of this proactive attitude is the “Friends of Venezuela” initiative launched by Brazil with the participation of Chile, Mexico, Portugal, Spain, and the United States.

The common feature is to be found in a clear preference for diplomacy and the defence of multilateralism. At the same time, the fight against terrorism and the region-wide successes in checking weapons of mass destruction proliferation are stressed. As far as the relationship with the United States is concerned, all agree broadly though with different nuances that strategic alliance with the US remains a shared necessity on economic and security considerations alike. There is a marked resemblance, in other words, with the position of the EU *vis-à-vis* the United States.

Mercosur and the EU, whether it is a matter of political elites or public opinions, broadly converge on the following:

- (i) A marked preference for a multilateral (not multipolar) world order;
- (ii) A growing suspicion verging on outright opposition to pre-emption;
- (iii) A profound sense of solidarity with the United States in the wake of the 11 September attacks, demonstrated by the fact that, on Brazil’s proposal, article 11 of the Inter-American Treaty of Reciprocal Assistance (Rio Treaty) was invoked, and Nato for the first time ever invoked Article 5 of the 1949 Washington Treaty.

The panoply of civilian power instruments at its disposal allows the EU to act if not decisively at least to some degree in world affairs. Mercosur has yet to create such instruments and mecha-

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1. Statement issued by the Mercosur+2 Foreign Ministers meeting in Montevideo, 5 February 2003.

nisms. Equally, it has yet to devise a common foreign policy, and its sphere of action is limited to the commercial and to some extent economic arenas. More so than in Europe, therefore, individual states are in practice the sole actors in international affairs and therefore the main EU interlocutors where region-to-region co-ordination in international affairs and security is concerned.

The main items on any inter-regional co-operation agenda would seem to be the following:

- (i) The promotion of a pro-active multilateral agenda with the aim of bolstering the UN's capacity to face major international security issues. The EU, Mercosur and the Rio Group should engage in concerted action in order to co-ordinate positions at the UN and especially at the Security Council level. Issues pertaining to the International Criminal Court and international conventions dealing with the environment should be top priorities;
- (ii) The promotion of a "critical dialogue" with the United States in an effort to lobby American institutions and decision-makers in favour of the multilateralist approach with the aim of "multilateralising" the United States, which remains as indispensable as ever to the resolution of any major international crisis;
- (iii) The joint exploration of the civilian-power approach to crisis prevention and management and post-conflict rehabilitation, namely in what concerns the Andean countries. A common approach to the crisis in Colombia, especially in regard to concerted anti-terror action and promoting democracy and human rights would seem to be the first priority to be addressed;
- (iv) The promotion of a structured region-to-country security dialogue, between the new EU security mechanisms and Mercosur and its members and associates, with a focus on peacekeeping and crisis management.

Two unknowns are essential for the success of EU/Mercosur co-operation. On the one hand is what kind of "animal" the EU will have developed into as the Convention (and the subsequent inter-governmental conference) comes to a close and a constitutional treaty governing a 25-strong EU finally comes into effect. On the other hand is whether the impact of change in Brazil and the new kind of leadership it may provide to Mercosur will enable it to overcome the many existing factors of crisis. Recent statements seem

to indicate that political co-operation is on the rise and its main element seems to be a shared multilateralist stance.

Looking back on the last decade of the twentieth century, the 1990s can be defined as a consolidation of regionalism, with the deepening of the EU, the emergence of Mercosur and the beginnings of the hemispheric FTA. Working towards their shared vision of a multilateral world order based on regionalism may well be the most relevant contribution the EU and Mercosur can make to international peace and security into the twenty-first century.

Álvaro de VASCONCELOS

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## Comments

Alvaro de Vasconcelo's chapter is a very subtle and challenging reflection on the role that democratic regional integration processes, like the European Union or Mercosur, can play, as "civil powers", in reviving and redefining multilateralism in a time when the international order is essentially shaped by the domineering world power of the United States.

The main point of his analysis deals with the lessons that can be drawn from the very process of building a European international identity. The EU today, is cleverly defined as a "federation in reverse", where the centre possesses those responsibilities that are normally the prerogatives of states in ordinary federal systems, leaving to member states those that devolve upon federal governments –foreign policy, defense and taxation. But it is not very likely that the Union can act as a decisive international player without correcting that imbalance. The caveat is that the Europeans cannot –and should not– try to build a European federal super-state emulating the US, for the simple reason that the integration process of their democratic states consists on strengthening a supranational body built on norms and rules that delegitimise power politics among its members. Thus, there cannot be any possible consensus on a common foreign policy based on principles that contradict those that regulate relations among the member states and undermine coherence with the values which are the foundations of the EU itself. Therefore, if it wants to become a major world player, the Union cannot agree to an international "multipolar" order based on

an unstable balance of power system. It needs a “multilateral” international system based on norms and rules.

Another important point raised by A. Vasconcelos is that the principles of the “old multilateralism” embodied in the network of international institutions created at the end of World War II –with the United Nations at its core– is not enough to cope with today’s challenges and threats. Actually, there is a broad agreement in Europe with the major threats to world peace as the United States now defines them (tyranny, proliferation of weapons of mass destruction and terrorism), albeit there is no consensus on how to confront them. And there is also a growing awareness of the need to protect human rights and to develop multilateral principles of international behavior in a world which is every day more interdependent. Therefore, upholding the status quo is no longer a viable policy option, all the more when there is US Administration that promotes “regime change” and “preemptive” military action against “rogue states” as legitimate policy tools. The EU, as well as all the other countries interested in the survival of the multilateral system, are compelled, even by their own public opinions, to be a lot less tolerant of double standards and become much more proactive in the promotion of democratic transitions and respect for human rights worldwide (e.g. the consensual outcry for an American military intervention in Liberia in the summer of 2003). Therefore, a hypothetical world role for the EU is closely linked to its ability to shape a world order that acknowledges the changing position of the state in international affairs and accepts important limitations to state sovereignty. This “new multilateralism” is based on the need for the international community to take responsibility, particularly through the UN, for the protection of the rights of individuals, above and beyond sovereign boundaries, to promote regional integration as a structural feature of the international system and to support rules and institutions that strengthen multilateral governance.

Vasconcelos is well aware of the strengths and weaknesses of a global role based solely on “civilian power”. The EU is quite successful as regional player on the European continent, promoting peace and democratization through a strategy of inclusion and prevention of crisis. But this strategy can function only when the prospect for outside states to become effective members of the Union is real and when political conditionality can be fully brought to bear.

In fact, when the promised reward is far greater than the penalties imposed. This “soft power” approach has had far less results to show when applied to other parts of the world, including close regions that are vital for EU security policy –the Mediterranean and the Balkans– or for that matter, Iraq or Sub-Saharan Africa. Actually, the Europeans found themselves deeply divided by historic perceptions and distinct post-colonial interests, as well as by the fact that, concerning these issues, the main political incentive of a “soft policy” –inclusion into the EU– is out of question.

The truth is that there is no law –and no multilateral norms and rules– without some kind of a policeman. In the real world today, no lasting and stable order is even remotely possible without the commitment of the United States, which is the only player with a global military and diplomatic reach. As long as the US, of course, is also committed to playing by the rules. Like it or not, it was the American military strength, controlled by a strong democracy, that served as the *ultima ratio* for the “old multilateralism” embodied in the UN Charter. On the assumption that Europe, for the time being, cannot fully play the power game –which, anyhow, would have no chance of winning full backing from EU member states– the core issue therefore is it’s relationship with the US. But due to the huge “hard power” asymmetry, how can the Europeans avoid a mere surrogate role, restricted to “soft security” (post-conflict reconstruction and nation-building), leaving hard security decisions and implementation to the United States? For Vasconcelos, the solution is “critical involvement” in order to have a chance of actually influencing US policy and getting round the dilemma of either an automatic alignment, or a principled but vain opposition that, in any case, will always threaten European unity.

For such a strategy of “multilateralizing” the United States to have some credibility, the first condition should be that European policy moves away from the traditional, amalgamating, “Atlantism” and towards a more balanced Euro-American partnership. But the second condition is that it cannot be solely a European endeavor. The EU needs allies that share the same view and objectives in world affairs. The biggest the coalition of democratic civil powers, the most likely it will be that US policy can effectively be influenced. Today, regarding the international order, there is no other partner than Latin America that has such high degree of political convergence with the EU. This is particularly true concerning

the Mercosur which Vasconcelos describes as a civil power in the making, despite the fact that it is even farther behind Europe on devising something looking remotely like a common foreign policy. If the EU could override its purely domestic considerations (e.g. its hyper protectionist agricultural policy) in order to accelerate the advent of the Association Agreement between the two blocs, one could envisage some form of efficient biregional political cooperation for the promotion of a pro-active multilateral agenda and a more structured security dialogue.

The trouble with this sophisticated civilian power agenda is that, to be credible, it has to give convincing answers to international crisis situations when the use of force is necessary and legitimate. Without taking full responsibility for the security of the international community and of a multilateral system based on norms and rules, EU and Mercosur will have no other option than accepting to remain wholly dependant on American military capabilities and thus, on Washington's vision, decisions and political good will. Vasconcelos's paper bumps on a circular paradox: "new multilateralism" needs civilian powers to support it and military "teeth" to defend it, but these civilian powers cannot become military powers without destroying their own self and the multilateral system. Hence, Europeans and Latin Americans are confronted either with accepting *nolens volens* a surrogate role vis-à-vis the US power or with trying to revert to an implausible multipolar system, based on a balance of power, that could be more dangerous than today's situation and in which the huge power asymmetry will anyhow guarantee American hegemony for a long time.

As a matter of fact, Vasconcelo's reflection opens a trail for further developments of new ideas on this crucial link between the necessary strengthening of multilateralism and international law enforcing. If civilian powers –that are vital for the functioning of a multilateral international system– want to have a preeminent role on the decision-making process about world security, they will have to take multilateralism seriously, including on the issue of the use of force. The resurgence of the debate on the role of the United Nations Military Staff Committee and of a hypothetical UN force is a symptom of this renewed motivation to tackle this challenge. Does that mean that civilian powers should accept deep limitations on their sovereignties in order to plan and organize their military capabilities as part of a multilateral rapid reaction law-enforcing

expeditionary force? Is this perspective incompatible with “national defense” or “European defense”? What should be the responsibilities of regional organizations and can they still be based on the non-intervention principle? Are the biggest European and Latin American countries ready to contemplate the rewriting of the UN Charter’s Chapter VII so it can respond to new threats, like terrorism and proliferation, and legitimize the systematic defense of human rights principles, which implies sometimes the use of force and what the French call *droit d’ingérence*? Can all this be enough to convince the United States to play –and even to lead– by multi-lateral rules? These are some of many questions that should be dealt with in future research programs of our Working Group.

Alfredo G. A. VALLADÃO



# The Monterrey Consensus and a New Development Paradigm





## Chapter 2

# Managing Financial Crisis in Emerging Markets: New Developments in Review

### *Introduction and Outline*

Section 1 provides a summary of the debate on Sovereign Debt Restructuring. To this end, we report on a recent conference in Paris, on March 9, 2003 sponsored by Institut français des relations internationales (IFRI) and the Institute for International Economics (IIE) to air the principal issues before the Spring Meetings of the IMF and World Bank.<sup>1</sup> In the light of Mexico's issue of debt that includes Collective Action Clauses (CACs) –and of cool market reception accorded to the IMF own proposal by the market– we focus on the current prospects for CACs; for *Code of Good Conduct*; and for IMF's own “bankruptcy” proposal, a *Sovereign Debt Restructuring Mechanism* (SDRM). After surveying these three proposals, we consider the incentives for continued reform.

In section 2, we discuss a model of sovereign debt crises that combines problems of *creditor coordination* failure and debtor's incentives. It involves a canonical two-player game of *creditor coordination* with multiple equilibria, where the choice of equilibrium is subject to the *moral hazard* constraint that the sovereign debtor must retain the incentive to service its debt. It is quite likely that this incentive constraint rules out the “no-crisis equilibrium.”

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1. The relative merits of *statutory change* backed by the IMF and *voluntary contractual change* promoted by the US Treasury were discussed in a similar IIE forum a year before; see Miller (2002).

Instead, the equilibrium following debt default may be one in which creditors randomise between quitting and staying; or even one in which they all quit, depending on how severe the incentive problem is. In general, there are too many crises. We go on to discuss briefly how interest rates will depend on the equilibrium selected and how the model might be calibrated to the data, with parameters chosen so as to generate sovereign spreads that vary over a range running from 300 to 7000 basis points. The possible perverse effects of unregulated financial liberalisation are also discussed using this framework.

In section 3, we discuss how the incidence of crises might be reduced by international sovereign bankruptcy procedures, involving “contractibility” of sovereign debtor’s payoffs, suspension of convertibility in a “discovery” phase and penalties in case of malfeasance. In relation to the current debate, this is more akin to the IMF’s Sovereign Debt Restructuring Mechanism than the Collective Action Clauses which some promote as an alternative. But the decision taken at the IMF Spring Meeting to put the SDRM on the back burner together with the recent developments in the market for sovereign debt suggest that Collective Action Clauses are far more likely to go ahead than the IMF’s SDRM. In the light of Mexico’s issuance of sovereign debt in NY in February 2003 containing Collective Action Clauses, we study the impact of such clauses on creditor coordination. We begin by extending the two creditor model studied in previous sections to the case with  $n$  creditors, allowing for the possibility that creditors have asymmetric information about future project net worth. We then study a special case of this model with three agents. From the Bayesian equilibria of this game we derive the probability of uncoordinated sovereign debt crises without collective action clauses and show that introducing Collective Action Clauses lowers this probability.

Section 4 turns to political economy matters. After a brief outline of general issues, we examine “political contagion” in Latin America. We argue that wide-spread support for debt default in Argentina may have led to the high sovereign spreads seen in Brazil as Lula surged ahead in the polls. We analyse how a self-fulfilling crisis has been avoided by a combination of short-term IMF financing in exchange for the incoming president’s commitment fiscal prudence together with a process of “learning to trust Lula” on the part of creditors.

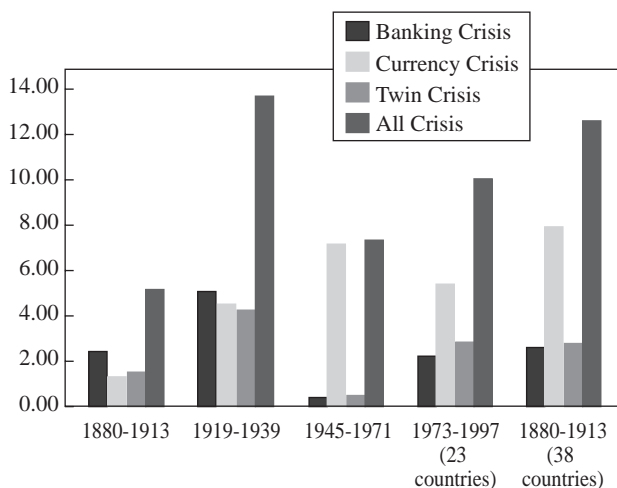
## Sovereign Debt Restructuring: Where Things Stand

### Introduction and Summary

*The trigger for change.* Why change the current international financial architecture? Has it not served the world well since the Bretton Woods System established at the end of World War II gave way to floating rates in the early 1970s? These questions deserve some response, however brief, before turning to the sometimes arcane details of the current debate.

The single most striking piece of evidence of the inadequacy of the status quo is the high incidence of financial crises, particularly since 1973. As indicated by data provided by Bordo (2002) and Eichengreen (2002), the frequency of crises since 1973 was about 10% per annum for a each country in a sample of 21 mainly developed economies (for which data is available since 1880) and about 12% for a wider sample of 56 countries including emerging market economies, see right hand bars in Figure 1 below.

Figure 1. *Crisis frequency (percent probability per year)*



Source: Michael Bordo (2002).

This frequency (of about one in ten) is *approximately double what it was under the Gold Standard 1880 -1913*, the earlier period of financial globalization (when each country faced a one in twenty risk of crisis in any year). It is higher than in the Bretton Woods era

of pegged-but-adjustable exchange rates and limited capital mobility running 1945-73.<sup>1</sup> With the exception of the interwar period, 1919-1939, which includes the Great Depression, it is the highest incidence of crises since 1880.

As Rogoff (2003) has recently noted: “private flows to emerging markets are remarkable for their unpleasant side effects –wild booms, spectacular crashes, over-indebtedness, excessive reliance on short-term and foreign-currency denominated debt, and protracted stagnation following a debt crisis. [There] is an excessive reliance on ‘dangerous’ forms of debt, such as foreign-currency denominated debt and short-term debt, which aggravate the pain of crises when they occur”.

Though increasing world trade and the scope of market forces more generally has undoubtedly raised per capita incomes dramatically, the same claims cannot be made for the growth of international markets in sovereign debt.<sup>2</sup> Has the growth of debt markets enhanced growth? Has it reduced the volatility of consumption? It is hardly surprising that the answer as to the social value of emerging market debt flows provided by in-house research at the IMF is at best ambiguous, Prasad *et al.* (2003).

*A summary of the debate.* What goes wrong with bond markets? and what can be done about it? A recent paper by Nouriel Roubini and Brad Setser (2003) addresses just these questions. It is with some trepidation that one seeks to summarize this synthesis. Nevertheless Figure 2 may prove a useful guide to the cut and thrust of the debate that follows. On the left hand side are the potential problems ailing markets in sovereign debt –a veritable catalogue of disaster. In the columns of the table are the various solutions

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1. As Rogoff (1999) had earlier put it: “The 1990s financial crises have brought a sharp contraction of lending to the developing world, and there is a serious concern that the fallout will continue to inhibit international capital markets for some time to come. The exact timing and nature of speculative attacks on emerging market economies is a topic of great debate [b]ut in the majority of cases, there is little question that the attacks were exacerbated by the way that many developing country governments chose to open their capital markets radically to the rest of the world during the early 1990s.”

2. Kenneth Rogoff is not the only one speaking out against too much sovereign borrowing by emerging markets in the form of bonds and bank loans, and relying too much on foreign-currency-denominated (or foreign-currency-indexed) debt; in this regard, see Goldstein (2003).

Figure 2. *Roubini and Sedser's Catalogue of Woe: and Four Modes of Resolution*

		(1) Status Quo		(2) CACs	(3) Codes (numbers refer to Figure 4)	(4) SDRM	
			(Plus)				
a)	Rush to the exit	IMF/G7 Bailouts	Stand-stills with capital controls		CGC # 1	STAY on payments	
b)	Rush to the courthouse	Acceleration Clauses		Acceleration Clauses	CGC # 1	STAY on legal action	
c)	DIP finance	IMF/G7 "Lending into arrears"		Seniority for new lending		SENIORITY for new lending	
d)	Holdouts or Free-riders	Exit/consent swaps		Super-majority voting (SMV)		Super-majority voting (SMV)	
e)	Aggregation Problem between creditors	Paris and London Clubs + IMF Programme	2-stage swaps: NY Club		CGC # 5	FORUM for Dispute Resolution	
f)	Coordination between creditors, debtors and IFIs	Paris and London Clubs + IMF Programme	Linking of 3 Clubs		Roadmap CGC # 6	IMF Programme with conditionality	
g)	Debtor moral hazard	IMF Programme			CGC # 7	IMF Programme	
← Cohen and Portes →							
				← IMF Endorsement →			

offered to mitigate these problems, beginning with that labelled the status quo,<sup>1</sup> *i.e.* how things have evolved without fundamental reform of the system. This phrase, used by Roubini and Sedser, should not be taken to imply situation of stasis, as there has in fact been a good deal of evolutionary development in the last few years –the use of exit consents swaps as a form of “Private Sector Involvement”, to give but one example.

1. When augmented by the two items in parentheses, this yields the Status Quo Plus.

The status quo has proved crisis prone, as we have seen above. But, as Daniel Cohen and Richard Portes (2003, p. 1) argue in their elegant study of “IMF Reform”, it also shows signs of unsustainability: “The absence of a framework for orderly workouts increases the pressure on the IMF and G7 to step in with bailout packages, because a disorderly workout appears too unpalatable”. The IMF faces what has been called a “time consistency trap”<sup>1</sup>: it would like to “Just say No” when member countries in crisis call for liquidity support; but because the alternatives are so dire this is not credible. There is concern that investors, knowing that their lending is underwritten by the implicit promise of IMF-led bailouts, may lend recklessly.<sup>2</sup> But there comes a time when the sheer size and speed of capital flows must overwhelm the efforts of well-intentioned personnel manning the pumps.<sup>3</sup> What then? The various alternatives listed in the next three columns may be considered in turn.

### Collective Action Clauses (CACs) [see column 1 of Figure 2]

An answer proposed much earlier, shortly after the Mexican crisis of 1994/5 in fact, is that of inserting collective action clauses (CACs) into private bond contracts so that they can be restructured when a super-majority of say 75% of creditors agree to do so, see Eichengreen and Portes (1995) and the Rey Report (1996). In this respect bonds are made more like equities, as their pay-outs can, at the discretion of the creditors, be made state-contingent. Indeed, as Roubini and Setser (2003, pp. 20-21) point out, “Bonds governed by English law typically allow a qualified majority to amend key financial terms. [But] those emerging markets that typically issue dollar bonds governed by New York law were reluctant to change the documentation they use in New York or to shift their dollar issuance to London”. They go on to conclude that “the challenge is actu-

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1. This is discussed in more detail in Miller (2002), for example.

2. “[T]he availability of IFI support gives a false sense of security to investors, which magnifies booms in the run-up to the crisis (as in Russia in 1998)”. Rogoff (2003) §1.

3. Perhaps December 1997 was the defining moment, when the market failed and the money ran out. The IMF could not find sufficient funds from IFI and G7 sources to prevent default by Korea, an OECD member. Default was only averted by a coordinated rollover of banks short-term investments orchestrated by G10 finance ministers and central banks – a form of government-induced suspension of convertibility.

ally quite simple: changing market practice in bonds governed by ‘New York law’”.

Until February 2003, when Mexico issued a billion dollars of twelve-year debt in New York containing CACs at a very respectable 3 1/8th percentage point spread over US treasuries, there seemed to be an insoluble problem – what Cohen and Portes (2003, p. 23) call the “CACs 22”, another manifestation of the time-consistency trap. In their words:

Both issuers and underwriters [in New York] are trying to sell bonds and fear the chilling effect of “prenuptial agreements”. Most important, however, is that lenders expect bailouts as long as there is no alternative, established procedure for Private Sector Involvement. As long as the official sector provides bailout packages, there is no incentive for the markets to want CACs; but there must be bailouts in the absence of an alternative that would limit the costs of default.

Not surprisingly, the Mexican initiative commanded great attention at the Paris meeting. Somehow Mexico had boldly escaped from CACs 22. Was this a signal of hope for emerging markets? Or was it proof that Mexico has grown to be the very Houdini of the emerging economy bond markets? The message was mixed. Mexico currently has strong balance of payments, high foreign exchange reserves, buoyant oil revenues and investment-grade rating: so it seemed a good time to go to the market. But this may be cold comfort for those not so well placed.

Three innovative aspects of the Mexican CACs were indicated: (a) a 75% super majority vote to change financial terms; (b) an increase from 50 to 75% of the vote needed to change non-financial terms, and (c) a minimum requirement of 25% of the outstanding principal for acceleration (with a 50% requirement to de-accelerate). These clauses, whose significance we further analyse below, may be just what the doctor ordered; but the circumstances needed for a propitious launch seem daunting.

Roubini and Setser (2003) and some London market participants argued for standardization of CACs “to minimize the number of moving parts”. But, in a subsequent Newsletter, Michael Gavin (2003, p. 5) of UBS Warburg commended the Mexican initiative on the grounds that “the covenants in the recent issue were not meant as a final, take-it-or-leave-it offer on a template that would be applied rigidly to its future issues”.

The response of discussants, faced with a checklist of key questions by the chair, are summarised in Figure 3.

Note that the position taken by Cohen and Portes, who argued for standardised contracts of mandatory issue in key financial sectors, contrasted sharply with the more flexible and voluntary position taken by the market.<sup>1</sup> Roubini and Setser (2003, p. 14) propose a step-by-step compromise, beginning with encouragement and moving further if necessary: “If other New York law issuers do not follow Mexico’s lead, the official [sector] should be prepared to go beyond jawboning to arm-twisting, and eventually to seek regulation or legislation that would require the use of clauses. This really does not require G-7 coordination, or changes in IMF policies. It does require a willingness on the part of US authorities to impose change on the market if those countries that typically issue in dollars using New York law do not move on their own”.

Figure 3. *Bergsten’s checklist of key issues: and the variety of replies*

	F. Bergsten’s questions	Market players (including Mexico)	Academic (cf. Cohen/Portes paper)
Q1	Should CACS be standardized	London argued for standard contracts, NY and Mexico preferred flexibility (on, for example, engagement clauses)	Standardization recommended
Q2	How much official pressure needed? Moral suasion or regulation?	No comment  Moral suasion perhaps, but no more	History suggests pressure needed to enforce CACS  Key financial centers to prohibit issues without CACS.
Q3	Implications of CACS for Bail-outs	None	Will ease the pressure for IMF bailouts

## Code of Good Conduct

Jean-Claude Trichet of the Banque de France presented a proposal that found considerable support, namely the formulation of

1. The point was made that, to provide the right incentives such voluntarism might need to be matched with a “cap” on official finance, as proposed by the Bank of Canada and the Bank of England.



rules of good conduct together with a “road map” to guide debtors, creditors and others involved in debt restructuring.<sup>1</sup>

The stated objective of the Code of Good Conduct (CGC) is to develop a comprehensive non-statutory framework, which seeks to address debt-servicing problems while preserving to the maximum extent possible contractual agreements. Indeed, a Code carefully listing what is expected from all parties concerned in times of sovereign financial distress could provide a pragmatic way for stakeholders to optimise their behaviour. This framework is intended to incorporate “best practices” which are not mandatory but rather of a contractual or voluntary nature.

Figure 4. *Banque de France’s Code of Good Conduct*

Code of Best Practices for Sovereign Restructuring: Nine main principles and best practices	
1.	Early engagement with creditors
2.	Fair information sharing among all interested parties
3.	Fair representation of creditors
4.	An expeditious and cooperative process
5.	Comparable treatment among creditors
6.	Fair Burden Sharing between debtor and creditor
7.	Good-faith negotiation
8.	Preservation of the debtor’s financial situation
9.	Rapid restoration of debt sustainability

A warm welcome for this proposal on behalf of the creditors has been provided by Michael Gavin (2003, p. 6), who also drew out the implications it might have for the debate in general:

The code would not of course be legally enforceable, but that doesn’t mean that the norms that are laid out in such a code would not provide some useful guidance (and moral suasion) going forward. [Indeed] the combination of CACs and Code would probably solve so many of the political and substantive problems that now plague the restructuring process, that the case for an SDRM to solve the few remaining problems would be tough to sustain.

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1. Richard Portes suggested that such a code is more in the French tradition, while the NY Club for sovereign debt restructuring debt he proposed is more accord with the Anglo-Saxon custom and practice.

Others such as Roubini and Setser (2003, pp. 10-11) are more sceptical:

No matter what the Code aims to do, particular attention needs to be given to the set of incentives that will lead all parties to have an interest in abiding by a non-binding Code. In theory, adherence to the Code during the restructuring could be a condition for creditors' final agreement on restructuring terms. However, this raises obvious problems of time consistency. If the debtor dithers for a few years before [it] finally gets its act together and then puts forward an acceptable proposal, creditors are unlikely to turn the proposal down just to punish the debtor for failing to live up to a code immediately after its default. A code of conduct potentially could help to facilitate a restructuring well before most bond contracts contain collective action clauses. Most proposals are not intended to substitute for efforts to introduce of new clauses into bond documentation.

Something like the Code of Good Behaviour is surely needed to promote more efficient coordination between the parties involved –debtors, creditors and IFI's: but a voluntary code has no power to enforce decisions on minority creditors. This is the main reason why it was seen as complementary with CACs.

### The IMF's Proposal for a Sovereign Debt Restructuring Mechanism

Finally, IMF economists had the opportunity to describe and defend the statutory innovations<sup>1</sup> they had been pursuing for many years –much more actively since they were encouraged by Paul O'Neill to look for a “better way” than simply providing bailouts.

Jack Boorman, head of PDR during the Asian crisis and now special advisor to the Managing Director, welcomed the incorporation of CACs into sovereign bond contracts and the promotion of a Code of Good Conduct. Worthy as they may be, however, he judged them inadequate to handle sovereign debt restructuring on their own.<sup>2</sup> To start with, the clauses incorporated in Mexican sovereign debt are not nearly as ambitious as those proposed by John Taylor

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1. The major features of the SDRM have been indicated in the summary Figure 2. They include a stay on debt payments; seniority status for new creditors; Super Majority Voting by creditors in each class of debt; the prospects for aggregation across classes; and last of all a Dispute Resolution Forum.

2. For more details on his position see Boorman (2003).

(2002) when the US Treasury backed contractual changes a year before: and the code advocated by the Bank of France and groups of bond traders have not yet been agreed. More fundamentally, he asserted that, in handling problems of aggregation across creditors, “synthesising by contract” is not possible –thus challenging the view of New York financiers Morgan Chase who claim that two-stage swaps can do the job. Finally he concluded that CACs are a complement, but not an effective substitute, for SDRM; and made it clear he thought the IMF needed extra statutory powers to do its job properly.

Conceding that the original SDRM proposal may have been “Fund-centric”, he claimed that current proposals are “creditor-centric”. Figure 5 below provides a schematic comparison of the original proposal of November 2001, SDRM-1 with the revision provided in 2002, SDRM-2; it also indicates how these plans attempt to replicate key features of corporate bankruptcy procedures under Chapter 11 of the US Code. As indicated by the asterisks in the table, under the revised plan creditors can specifically decide: *a*) on extending the temporary stay on debt service, *b*) on the provision of seniority for DIP finance, *c*) on the restructuring of each class of debt. In addition, Mr Boorman said, creditors can terminate proceedings.

Michael Mussa, head of IMF Research till mid-2001, offered scant support. He reiterated a point made by his IIE colleague Ted Truman (2002) to effect that, of the last eight crises handled by the IMF, Argentina is the only case for which the SDRM is directly relevant. In any case, he argued against the ex-post revision of private contracts as the right way to proceed. The IMF, he argued, should “Just say No!” But, as Jack Boorman was quick to point out, “You have to ask what is going to happen then” (*i.e.* if you say no). “If there is not a reasonable process”, he noted, “then your answer is affected.”

The implication that the IMF simply said yes was promptly challenged by Matthew Fisher. The failure to achieve a pre-default deal in Argentina was not for lack of trying, he said: Mr. Cavallo was talking of administering a “haircut” in late 2001, for example. But how could one secure collective action without CACs? The only solution was the use of exit consent swaps: but there was a risk that these might lead to a collapse of banking system. If a prior default could have been done it would have been great: but it was not possible.

Figure 5. Chapter 11 and Sovereign Debt Restructuring Mechanism (SDRM)

	Features	Chapter 11 bankruptcy	SDRM	
			Original SDRM (2001)	Revised SDRM (2002/3)
(a)	<i>Stopping a grab race</i>	Payments standstill <i>plus</i> automatic legal stay	Payments standstill <i>plus</i> automatic stay	No stay but hotchpot remedy
(b)	<i>Financing reorganisation</i>	Preferred status for new money (DIP finance)		Preferred creditor status for new money* <i>plus</i> limited IMF lending
(c)	<i>Restraining holdouts</i>	Supermajority voting <i>plus</i> cramdown	Supermajority voting <i>plus</i> arbitration	Supermajority voting by the unsecured creditors
(d)	<i>Restructuring debt</i>	Negotiations under court supervision	Negotiations supervised by IMF <i>plus</i> IMF programme	Negotiations supervised by neutral agency <i>plus</i> IMF programme

\* to be decided by creditors.

Kenneth Rogoff, Michael Mussa's successor in the IMF Research Department, dismissed the view that the status quo is just fine. He tried to shift the whole perspective of discussion, noting that "It's not the asset class (sovereign debt) we want to secure –it's resources for Emerging Market Economies." He argued that the current system is unduly biased towards debt flows<sup>1</sup> and spoke persuasively of the need to rechannel capital flows into other instruments. (This was an echo of what he had earlier called My Plan in Rogoff (1999), where he proposed a short term run-down of bond markets, see Addendum below.)

### Strategic considerations

*The IMF and its critics.* Key points made on each side are outlined in what follows. In conclusion, however, we argue that the situa-

1. For further details see Rogoff (2003), "Emerging Market Debt. What is the Problem?"

tion is in reality one of fine balance: in reshaping the architecture as in restructuring debt, blocking minorities can play a key strategic role. If SDRM is put on the back burner, it is important that PSI be revived as a threat to keep CACs coming.

On one side of the final debate were the protagonists for market voluntarism, backing CACs without an SDRM, happy to make common cause with the Banque de France and its voluntary Code of Good Conduct. Market participants took this view. On the other side was the IMF, willing to endorse these changes, but fighting still for fundamental statutory reform along the lines charted by Anne Krueger. A compromise was offered by Daniel Cohen and Richard Portes. Drawing on the history of sovereign debt restructuring before the IMF was created, they proposed non-voluntary CACs, together with institutional changes to promote creditor co-ordination – a New York Club, for example.

Speaking for the debtors, Agustín Carstens of Mexico noted that fears of moral hazard had led to IMF to encourage private sector involvement. With the suspension of automatic bailouts, he claimed reckless investors have been excluded from emerging markets. But capital flows have declined; and Mexico alone had received 70% of capital flows to Latin America last year. To bring other countries back to the market, creditors wanted CACs plus Codes. He criticised the SDRM for what he termed insurmountable problems of unconstitutionality and unpredictability, and recommended that the IMF – “the best working international institution” – should not put itself at risk in pursuing this initiative any further.

Michael Dooley (Deutsche Bank) speaking for the creditors, acknowledged that the status quo is very costly and argued that CACs are useful particularly if supplemented by the Code of Good Practice and a Forum for negotiations. But he was highly critical of the SRDM, which he described as a radical change where the debtor plus the IMF determine “when bond contract become equity contracts” and the IMF reserves the right to get out before private creditors!

In response, Kenneth Rogoff (IMF) reiterated his view that capital flows in the form of equity played an important and stabilising role in world capital markets. He also pointed out that the IMF typically commits itself to supplying loans at times when no one else is willing to do so: stripping the IMF of seniority would reduce funding to zero, he said, “But how would that help?”

Finally, Michael Mussa (IIE) observed that efforts to promote the SDRM are “premature” –but argued that the proposal should not be dropped. To put it into action, however, there needs to be a demonstrable case– maybe Argentina if private negotiations fail.

*Strategic Considerations.* If proposing SDRM was premature, as Michael Mussa suggests, was the whole exercise a waste of time? If it is put on the back burner, will this affect incentives for reform? Some insights may be gleaned from a strategic analysis where one treats the evolution of the IFA as the outcome of a game between the IMF and the creditors. A rudimentary version is outlined in Figure 6 that follows, designed to capture the game as it first appeared in the Fall of 2001 when Paul O’Neill asked the IMF to look into creating an SDRM. Note that payoffs for either player are ranked with letter grades where  $\alpha > \beta > \gamma > \delta$ .

As formulated here, the IMF simply chooses whether to push the SDRM or not, while the creditors decide whether or not to implement CACs. The payoffs are shown in the Table, with that for the IMF shown first and for the creditors second. It is assumed that the IMF rates the achievement of SDRM as an  $\alpha$ , the adoption of CACs without an SDRM as  $\alpha \beta$ , and the Status Quo without either, as  $\alpha \delta$ . But the creditors take the opposite view: for them the status quo is just fine,  $\alpha$ ; CACs are acceptable,  $\beta$ ; but the SDRM is a monster from another planet,  $\delta$ . (So it is pretty much a zero-sum game.) For the IMF with a green light for reform, as in the Fall of 2001, it is evident that pursuing the SDRM is the dominant strategy (always yields  $\alpha$ ). This leaves creditors choosing whether or not to add CACs; which they do as this gives them some more control of proceedings.<sup>1</sup> The Nash equilibrium of this game, shown in bold in the bottom right cell, predicts major developments in the international financial architecture, with the changes both to private contracts and statutory procedures.

Figure 6. *The situation in the Fall of 2001: IMF leads “twin-track” reform*

		Creditors	
		NO CACS	CACS
IMF*	No SDRM	$\delta, \alpha$	$\beta, \beta$
	SDRM	$\alpha, \delta$	$\alpha, \beta$

\* Assuming no veto of the SDRM.

1. In addition, of course they can lobby for changes in the SDRM to give creditors more control.

This may be how things appeared to the IMF early in the process, but neither the market nor many borrowers have supported SDRM; and if they don't want it, the US Congress is unlikely to approve.<sup>1</sup> [It takes 85% of the vote to change the IMF's Articles of Agreement and the US has the power to block such changes on its own: other major debtors countries like Mexico and Brazil would doubtless have joined a blocking coalition.<sup>2</sup>] On the other hand, Mexico has incorporated CACs in its latest NY bond issue. An interesting feature of the clauses incorporated was that, while the Super-Majority Vote for changing financial terms was cut from unanimity to 75%, the required vote to change non-financial terms was increased from 50% to 75%. Why so? Because creditors who accept such CACs thus reduce their exposure to exit consent swaps, *i.e.* avoid involuntary Private Sector Involvement [PSI].

This is important if we assume that reform efforts in the near future will focus on CACs, together with the option of using exit consent swaps acting a credible threat. In Figure 7, where the IMF now chooses whether or not to use PSI, the payoffs are as the previous Figure 6 except that we change the IMF "payoff" in the bottom right hand corner from  $\alpha$  to  $\gamma$  to reflect the difficulty of implementing PSI with Mexican-style CACs.

Where CACs are structured in this way, pursuing PSI is not a dominant strategy on the part of the IMF. But it can still function as a threat. This can be seen most clearly with the aid of Figure 8, which shows the options available at different stages, assuming that creditors can implement CACs before the IMF forces PSI.

Starting at the second stage, it is clear that the IMF will not enforce involuntary PSI if CACs have been implemented –thanks to the anti-exit consent swap provisions. It will do so otherwise, however, to avoid a return to the status quo ante. Faced with this state-contingent IMF response (shown by the dark arrows in the lower part of the figure), how will the creditors behave? With their preferred outcome of No CACs and No PSI ruled out, their best option is to implement CACs –otherwise they get will be faced with exit consent swaps!

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1. And of course, Mr. O'Neill is no longer holds office.

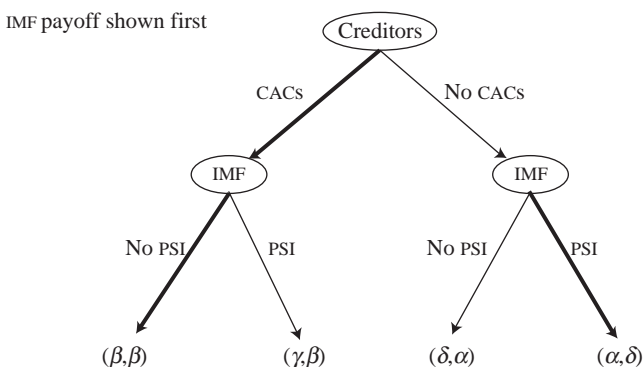
2. See Leech (2002, p. 389). Table 1 for an evaluation of voting power on such matters at the IMF.

Figure 7. The current situation: IMF backs CACs with threat of PSI

		Creditors	
		NO CACs	CACs
IMF*	No PSI	$\delta, \alpha$	$\beta, \beta$
	PSI (exit consent)	$\alpha, \delta$	$\gamma, \beta$

\*Assuming that PSI becomes less feasible when CACs are implemented

Figure 8. Will the Market continue with CACs to avoid PSI?



## Conclusions

Mexico has taken initiative of including CACs in its New York debts; and Brazil has been quick to follow. Or will with SDRM on the back burner and no alternative incentives for change, is there a risk that the whole movement to reform the international financial architecture could go back to square one? Roubini and Setser have proposed a step-by-step process of pro-activism by the US regulatory authorities as one means of providing the right incentives. Reactivating the threat of Private Sector Involvement implemented by exit consent swaps is another.

But the progress of time and the process of learning may also change payoffs and incentives. Thus, up until a few weeks ago, it was widely thought that issuers would only be willing to pay the premium demanded by the market for CACs if they were under the threat of the SDRM. The Mexican placement was made without the need to pay a premium, however, and the bond continues to trade well the buy-side shows growing recognition that CACs are a good idea. (It is notable, for example, that Uruguay has announced that



it plans to use CACs in its forthcoming debt operation.) So there is some ground for optimism that the momentum toward CACs can be maintained even if the SDRM is put on the back burner.

We might consider three possible lines of development. First, if creditors in sovereign bond markets –like those in London corporate markets– come sufficiently to appreciate the benefits of CACs, they will be no need for regulatory enforcement nor PSI as a threat. So it will be a world of CACs and Codes.

Second, if the resolution of the Argentine situation drags on for a long time, things may look very different. There could be a loss of confidence in market –driven solutions and all bets will be off– as the need to avoid any repetition re-ignites the search for systemic reform. With demonstrable reason to reconsider the SDRM, for example, the strategic equilibrium might return to what it was in 2001 with renewed pursuit of the twin-track approach. This could lead to a world with new contracts and new Articles for the IMF.

Third and, in our view, most likely, is an evolutionary outcome where CACs *will* be widely adopted (but will not prove to be sufficient to handle solvency crises on their own); where the SDRM *will not* be adopted because it is too ambitious, but CACs will be combined with Codes and with IMF involvement to supply emergency funding and impose conditionality. In practice, this will constitute a mechanism for restructuring sovereign debt in all but name!

#### Addendum: K. Rogoff (1999) My “Plan”: and a Criticism

The main problem with the present system is that it contains strong biases towards debt finance, especially towards intermediation by banks, and does not adequately support equity finance and direct investment. If flows to developing countries took the form of equity and direct investment, there would be an automatic device for risk sharing. Country runs could still lead to sharp drops in local stock markets, but there would be no liquidity effects, no need for a lender of last resort or a crisis manager.

In Bulow and Rogoff, we recommend restricting countries’ ability to waive sovereign immunity as means of discouraging the mediation of debt contracts in industrialized country courts. Instituting an international bankruptcy court might be an alternative means to the same end. As a result of such a policy change, there could be a significant transition period where capital flows to certain countries were reduced. Lenders would avoid countries lacking either sound legal systems for enforcing commercial contracts, transparent and fair reg-

ulatory systems, or favourable histories of treatment towards foreign investors. However, countries that want to draw on world capital markets will have a strong incentive to develop institutions that would support foreign investor confidence. By the same token, they will have an incentive to develop fair, transparent, and well-regulated equity markets to help attract capital flows.

In the concluding discussion of the Paris meeting, Ricardo Hausmann appeared to criticise such a plan. While he agreed that capital markets have not provided for efficient risk sharing, he argued that for the IMF to walk away violated the Monkey Principle: “Don’t throw away the vine you’re on, before you have another to go to.”

### *Co-ordination Failure and Moral Hazard: the Full Information Case*

#### Introduction

In criticising the conventional wisdom –also known as the Washington Consensus– Guillermo Calvo of Inter-American Development Bank has argued that emerging market finance is subject to market failures with potentially disastrous consequences. At the UTDT summer workshop in Buenos Aires in August 2002, indeed, he proposed that whether or not a theory of sovereign debt crisis includes “sudden stops” should be a crucial test of its empirical relevance for emerging market finance, see Calvo *et al.* (2002). In his recent book on the international monetary system, Tirole (2002, pp. ix-x) evidently takes much the same perspective: he begins by referring to the wide consensus that has emerged among economists that “capital account liberalisation... was unambiguously good. Good for the debtor countries, good for the world economy” but goes on to note “that consensus has been shattered lately. A number of capital account liberalizations have been followed by spectacular foreign exchange and banking crises.” Following Russia’s partial foreign debt repudiation in August 1998, for example, generous inflows to Latin America came to a standstill; and sovereign interest rate spreads rose to over 1600 basis points on the Emerging Market Bond index (EMBI+).

These developments –together with the collapsing currencies and soaring sovereign spreads facing many Latin American countries in 2001/2– have put in question traditional explanations for

financial crises, based on current account and fiscal deficits. They suggest the need to focus on the intrinsic behaviour of capital markets.

The focus of this section is on how problems of creditor co-ordination interact with debtor's incentives to generate excessive crises. In the academic literature, these issues are typically treated separately. In explaining "bank runs", for example, the classic paper by Diamond and Dybvig (1983) demonstrates the possibility of multiple equilibria in financial markets, but takes as given the structure of demand deposit contracts (*i.e.* the right of depositors to withdraw on demand) and the choice of investments by the bank. To help select the "good" equilibrium, three institutional mechanisms were discussed—provision of liquidity, suspension of convertibility and deposit insurance. Analogous co-ordination problems arise in connection with emerging-market bonds and similar proposals have recently been made with respect to sovereign debt. Stanley Fischer (1999), Radelet and Sachs (1998) and Truman (2001), for example, have emphasised official provision of liquidity; while Krugman (1998) called for capital outflow controls to protect East Asian currencies (*i.e.* a suspension of convertibility). There has not been much talk of explicit insurance, Soros (1998) and Jeanne (2001) being exceptions: but an additional possibility has been widely discussed, that of revising the nature of sovereign debt contracts themselves. Eichengreen and Portes (1995), Buchheit and Gulati (2000) and Taylor (2002) have advocated the insertion of collective action clauses to assist creditor co-ordination.

Proposals like these, designed to solve creditor coordination problems, have been criticised for failing to take into account their effect on sovereign debtors' incentives. Barro (1998, p. 18), for example, suggested that bail-outs can increase the probability of sovereign default, stating that "bailouts increase 'moral hazard' by rewarding and encouraging bad policies by governments and excessive risk-taking by banks". With reference to \$42 billion support package for Brazil in 1998, for example, Barro asked: "How did the Brazilians qualify for this support? They did so mostly by not exercising sound fiscal policies. If their policies had been better, they would not be in their current difficulties and would not qualify for IMF money". After further discussion of the bailouts for Mexico and Russia, he concluded: "The IMF might consider changing its name to the IMH— the Institute for Moral Hazard".

Typically, debtor's moral hazard has been considered in a separate strand of the literature which focuses on the use of punishment strategies in models of repeated interaction. In Bulow and Rogoff (1989a), for example, trade sanctions are the punishment mechanism to prevent strategic default. But since their bargaining model assumes a single creditor lending to a single debtor, creditor coordination problems are not discussed. Nor are they addressed in Kletzer and Wright (2000), who use a repeated game model to study how restricting access to capital markets can check moral hazard.

A convincing treatment of sovereign debt crises and their resolution needs to combine creditor co-ordination and debtor incentives in a consistent framework. The details of such a framework are provided in Ghosal and Miller (2003). They may be summarised briefly as follows.

Consider a canonical two-player game of creditor coordination where neither creditor can make a credible commitment not to quit where there is a default, even when shocks are temporary. Given default, this coordination game has three Nash equilibria. One in which creditors simply rollover lending (stay, stay); a second in which both creditors pull out (quit, quit), and a third in which they randomise between staying and quitting in a way which is determined by the payoffs of the game. Which of these will be chosen? Assume the best outcome will be selected which is consistent with maintaining debtor's incentives to service its debts. If guaranteed rollovers (stay, stay) undermine debtor's incentives, this leaves the choice between randomised quitting or quitting for sure. Whichever of these is selected, however, it is in general true that there is excess quitting. (The reason for this is that the parameters which determines randomised quitting are independent of the debtor's incentives.) So the termination probability is higher than necessary for incentive purposes and there are too many crises.

Our analysis implies that guaranteed bail-outs will not solve the underlying causes of a sovereign debt crises; and that the market equilibrium needed to provide the right incentives is excessively prone to financial crisis (*i.e.* to sudden stops in capital flows). How can bond markets be made more efficient? This is considered in Section 3 but first we look at the implications of our framework for sovereign spreads and for unregulated financial liberalisation.

## Implications for Sovereign Spreads

As discussed in Section 2.1 above, emerging market sovereign spreads over US Treasuries responded sharply to the Russian default. From a level of between 400 and 500 basis points earlier in 1998, they peaked at over 1600 after the Russian default in August and then fell to somewhere between 700 and 800 in 2000. In 2001, Argentine debt suffered spreads of 2000 basis points and above, as did Brazilian debt in the summer of 2002. (After leaving the currency peg, Argentina has recorded even higher spreads of around 7000 basis points.) Ghosal and Miller (2003) show how their framework might be calibrated to fit recent data, using illustrative parameters so as to generate sovereign spreads that vary over a range running from 300 to 7000 bps, depending on which of the equilibria is selected.

There are those who argue that the doubling of sovereign spreads seen in Brazil in 2002 is largely due to contagion from the Argentine crisis. The framework discussed here could also be used to look at contagion. Masson (1999, p. 267), for instance, argues that “pure contagion involves changes in expectations that is not related to country’s macroeconomic fundamentals” and suggests that “by analogy to the literature on bank runs (Diamond and Dybvig, 1983), attacks on countries which involve a simultaneous move from a non-run to a run equilibrium seem to be relevant for recent experience in emerging market countries.” To include contagion on this definition, we need only relax the assumption that the market selects the most efficient incentive compatible equilibrium between creditors: a move from a mixed strategy equilibrium to the pure strategy of quitting unconnected with any change in fundamentals would count as contagion on Masson’s definition; and, as numerical calibration indicates, could double sovereign spreads.

## Possible Perverse Effects of un-Regulated Financial Liberalisation

Financial liberalisation in the absence of appropriate regulation can increase the risk of financial crisis (Goldstein, 1997; Kaminsky and Reinhart, 1999). It may, for example, make it easier to ship money out of the country to evade taxes.<sup>1</sup> But what if liberalisation also cuts the cost of exit in the co-ordination game? (A fall in legal costs makes quitting more attractive: so, in the mixed strategy equilibrium, the probability of staying must be increased to balance the

expected pay-offs of quitting and staying –and this increases the continuation probability of the game.) The new mixed strategy equilibrium could then fall afoul of the no-shirking constraint: hence, in the face of default for any reason, only the threat of certain withdrawal will be sufficient to check debtor’s moral hazard. The results could be dramatic: our calibrations suggest that it could raise the sovereign spread from 800 to 2000 bps.

Is this more than a theoretical curiosum? As Tobin (1999, p. 73) notes: “In the ‘bailout’ packages for East Asian economies, further cross-border financial liberalization was one of the conditions imposed by the IMF and the US Treasury for official loans. This was a surprising requirement, given the evident facts that excessive private external short-term debt was, if not a cause of the crisis, a serious aggravation of it, and that banking and financial institutions seemed to need more regulations in several respects as well as fewer in other respects.” Pressure to increase competition in financial markets may also be counterproductive in the absence of appropriate financial regulation (Hellman *et al.*, 2000).

### *SDRM and CACS*

In this section, we consider a bankruptcy procedure involving temporary stay on creditor litigation and discovery process for determining the underlying causes of default. A key element of the procedure is that when the sovereign debtor in default is found to have made little or no effort, its private payoffs will be reduced ex post. To provide the right incentives, it is crucial that the mechanism for doing this should have been agreed ex ante, as would be true if a ruled-governed public agency is involved. Moreover, we argue that privately issued bond contracts are unlikely to achieve the same result.

The mechanism we describe incorporates features of the bankruptcy procedures advocated by the IMF (Krueger, 2002) –though, unlike the IMF’s proposal, it is not restricted to cases of “insol-

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1. “The very large measurement error in world current-account positions (a deficit larger than \$100 billion for 1996), with recorded payments of capital income being much greater than recorded receipts, gives credence to the suggestion that a substantial portion of international capital movements is tax-avoiding in motive.” (Cooper, 1998, p. 14).

veny”. We conclude, therefore, that the institutional approach to sovereign debt restructuring proposed by the IMF is, in principle, capable of increasing bond market efficiency. What the rules should be –and whether the IMF as currently constituted is the appropriate public agency to implement them– are policy issues that remain to be discussed. In related work, Tirole (2002) has recently emphasised the “common agency problems” affecting sovereign borrowing: the contracting externalities which may lead to over-borrowing and excessive short-term debt, and the collective action problems that prevent efficient roll-over and restructuring. Though our focus is somewhat different –we take both the amount and maturity structure of sovereign debt as given– the analytical approach we use has many features in common, including the assumption that there are debtor payoffs which cannot be secured by creditors (*i.e.* are not “contractible”) and the links that are established between *ex post* resolution procedures and *ex ante* debtor incentives. Our institutional recommendation for increasing the contractibility of the debtor payoffs is not unlike Tirole’s proposal to increase the “pledgable income” of the sovereign debtor. (Like Tirole, we have focussed on the problems that can arise from contracts which pose problems of creditor coordination. For simplicity we have assumed that creditors all share the same information: but the information asymmetries stressed by Calvo would greatly enrich the analysis.)

Finally, we extend the complete-information 2-creditor model studied in the previous section to the case of  $n$ -creditors and asymmetric information to study the impact of introducing collective action clauses: and we show that introducing CACs always reduces the probability of uncoordinated debt crisis.

## Sovereign Bankruptcy Procedures as a Commitment Device

In Section 2.1, we argued that, in the absence of institutional innovation, there will be excessive disorderly default in equilibrium. Could this be reduced by institutional change?

Where creditors can, in event of default, exercise some legal claim over the assets of the sovereign state or its citizens, there is a good case for a bankruptcy procedure. This might involve the following elements. *Ex ante*, the sovereign agrees to bargaining in good faith after default, and to this end *establishes some “contractibility” on assets in favour of the creditors*. This might involve

waiving sovereign immunity and agreeing that some foreign interest payments and loans<sup>1</sup> could be diverted in favour of creditors as part of the bargaining process. Note that this enhanced “contractibility” must also have the effect of reducing private payoffs to the sovereign; otherwise it will not have the desired incentive effects.

When a default occurs, however, the sovereign debtor is afforded *protection by a temporary stay on creditor litigation*. This legitimises the suspension of payments and also prevents litigation (by “vultures”) from inhibiting negotiations, Miller and Zhang (2000). Furthermore, it provides a breathing space for a “*discovery*” *process* where efforts are made to establish the underlying causes of default (and to determine whether it was due to a bad shock or poor effort). If this reveals the debtor to have made appropriate effort and to be suffering from an exogenous shock, bargaining would involve *debt restructuring* –the lengthening of debt maturities for temporary shock, and some write-down for a permanent shock known to be outside the control of the debtor. But if the debtor is revealed to have made little or no effort to arrange its financial and fiscal affairs, then *it will be penalised with payoffs changed ex post in ways that have been agreed ex ante*. (It is to make this possible that the debtor must have agreed to make some private payoffs contractible.)

Along similar lines, Eaton (2002, p. 5) observes: “One role that an international bankruptcy court could play is in clarifying the extent of the sovereign’s malfeasance in a default, and applying penalties appropriately.” He goes on to note that: “Tougher sanctions in response to malfeasance that leads to default is ultimately in the interest of sovereign countries, as it enhances their access to credit.”

Before turning to the institutional implications, consider two special cases. First is where the reasons for default are known as soon as it occurs, *i.e. without* a discovery phase. Here, there is no need for an extended bankruptcy procedure. If the default is due to an exogenous shock, liquidity can be provided right away. If the default is due to lack of effort, then the debtor’s payoffs are changed *ex post* in ways that have been agreed *ex ante*. This is perspective

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1. Eaton (2002, p. 13) discusses the idea that “a portion of any loan be held in escrow at the time that it is extended. The escrow account would be turned over to the sovereign as it repaid its loan according to schedule. Upon declaration of a standstill, however, funds would be paid instead to creditors.”



taken by Olivier Jeanne (2001) who argues that “the institution that brings the economy the closest to the first-best is a ‘crisis insurance fund’ that bails out all governments with a rollover crisis *conditional on the fiscal adjustment*” (p. 19, italics in the original). Under his proposed scheme, moral hazard is neutralized by denying bailouts to countries that have not implemented the fiscal adjustment. Jeanne notes, however, the crisis fund would probably have to be a rule-based public agency, first because of “time to verify”<sup>1</sup> and second because private insurance contract for sovereigns cannot be made contingent on fiscal effort which is under their control.

At the other end of the spectrum is the special case where the discovery phase is completely unrevealing, so the indeterminacy as to the causes of default can never be resolved. In these circumstances, the contractibility over private benefits cannot be exploited, and “constructive ambiguity” appears to be the only solution, the expected costs to creditors with reflected in sovereign spreads.

### Institutional Implications

If financing development by issuing bonds exposes emerging markets to excessive crisis, one response is to limit the use of such debt instruments, Rodrik (1998). Some economists (e.g. Stiglitz, 1998; Williamson 1995, 1999) have discussed the use of explicit *inflow controls* such as those used in Chile intended to change the composition of flows in favour of longer term investment rather than hot money.<sup>2</sup> As Cordella (1998) points out, inflow controls which succeed in shifting the structure of external financing may increase rather than decrease the total volume of finance available for development: “taxes on short-term capital flows by avoiding rational panics, can improve the expected returns of investments in emerging markets, and thus increase the total volume of funds entering the country” (p. 6). In time of crisis, however, the use of *outflow controls* may well be considered, both as a way of conserving scarce foreign currency and of lowering domestic interest rates, Krugman (1998).

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1. A private insurer would have strong incentives to renege the contract ex post (by not lending in the event of bad news). Even if one assumes that the private insurer can be forced by a court to lend later, it would be too late” (Jeanne, 2001, p. 21).

2. China attracts massive FDI inflows but strictly limits other forms of external finance.

The debate between John Taylor and Anne Krueger is, of course, premised on the widespread continuation of bond finance for emerging markets countries *without* sovereign immunity, as is our own discussion of the bankruptcy procedure –where we see an important role for a rule-governed public agency to supply a commitment mechanism which makes private payoffs accessible to the creditors *ex post*. It may be that the required control over the *ex post* behaviour of the debtor could be achieved by official “IMF conditionality” which governs the actions of the sovereign whose debt is being restructured. (Applicants for debt restructuring in the Paris Club are required as a matter of course to agree a programme with the IMF before negotiation with creditors begin.) Thus IMF programmes could play an important role in the international bankruptcy procedure described above.<sup>1</sup> To check moral hazard, of course, it would have to be known in advance that “conditionality” would be used to achieve the contractibility of private payoffs, *i.e.* the “rules” need to be clear.

As an alternative to an SDRM, Collective Action Clauses have the attraction that they are voluntary and market driven. As discussed earlier, however, there are two problems of implementation, first the need to replace outstanding contracts, by swaps for example, and second the need to aggregate across different instruments, possibly by two-stage debt swaps, see Table 1. Even supposing both can be solved, we believe that private bond contracts, which are typically incomplete and involve creditors deciding what to do *ex post*, are unable to deliver the required degree of protection and pre-commitment. Contracts incorporating Collective Action Clauses do not prevent creditors from suing provided there is a blocking minority in favour, Thomas (2002). Moreover, contracts with majority action clauses may fail to be renegotiation proof after a discovery phase in which the debtor is effort level is confirmed to be “bad”, as the debtor may renege on commitments to

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1. How does this differ from what happens with IMF “bail-outs” where private creditors who wish to exit can do so using emergency official funding and the IMF can impose conditionality so as to secure repayment? (Jeanne and Zettlemeyer, 2000 provide evidence that official funding is almost always repaid.) If this is known *ex ante*, is it not as if creditors can secure commitment from the debtor? Yes but, given the possibility of exit, they do not have the appropriate incentives: there is a problem of investor’s moral hazard where private creditors fail to monitor. The bankruptcy procedures advocated by Anne Krueger explicitly prevent creditor exit so as to avoid this problem.

make *ex post* transfers. In other words, a hold-up problem may ensue as now the sovereign debtor has all the bargaining power.<sup>1</sup> Anticipating this, even with majority action clauses, creditors may choose to terminate the project.

Table 1. *CACs and SDRM: Some key issues*

	Problems of Implementation	Problems of Operation
Collective Action Clauses (voluntary, market driven)	(a) "Transition" (b) "Aggregation"	Not litigation proof Not renegotiation proof
SDRM (involuntary, statutory)	Change of IMF Articles needed	Subject to geo-political & ideological pressures

An SDRM backed by an international organisation, acting on behalf of the international community, can solve such a hold-up problem by making the sovereign's payoffs attachable *ex post*. In other words, our analysis of the reason for excessive crisis leads us to choose an SDRM mechanism rather than private contracts. The implementation of the SDRM will, however, require a super-majority vote to change the Articles in the IMF, something that United States alone can block. Even assuming that the Articles can be changed, two delicate issues need to be considered: whose private payoffs should be attached *ex post*; and to whom should responsibility for overseeing such attachment be delegated? Answering the first question involves issues of political economy which we discuss in Section 4 below. As for the second question, Stiglitz (2002b) argues that, being dominated by creditors' interests and having adopted the "free market mantra of 1980s", the IMF is not well suited to devise and implement strategies for remedying capital market failures. In response to financial crises in East Asia and Latin America, however, the organisation has shown itself willing to contemplate inflow controls and standstills as part of an SDRM. It is true that recommending outflow controls (and enforced capital repatriation) would not be consistent with its normal practices and procedures.

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1. This situation arises in Kiyotaki and Moore's (1997) model of credit cycles where the hold-up problem can only be solved by the provision of collateral.

## Asymmetric Information, Creditor Coordination and CACS

The widespread adoption of Collective Action Clauses is far more likely that the creation of a formal SDRM. As reported above, Mexico (and subsequently Brazil) have already issued sovereign debt in NY containing Collective Action Clauses. How will this impact on creditor coordination? We begin by extending the two creditor model discussed in Section 2 to the case with  $n$  creditors, allowing for the possibility that creditors have asymmetric information about future project net worth. We then study a special case of this model with three agents. From the Bayesian equilibria of this game we derive the probability of project termination without collective action clauses and show that introducing collective action clauses lowers the probability of uncoordinated sovereign debt crisis.

*Creditor coordination with asymmetric information.* Consider the following variation of the  $n$ -creditor model in Ghosal and Miller (2003) and Ghosal and Thampanishvong (2003). A sovereign is embarking on a bond-financed investment project, costing  $K'$ , which lasts only 2 periods. All finance is now supplied by  $n$  identical creditors each of whom has invested  $b$ . Each creditor is promised a return of  $r$  in period 1 and  $(1 + r)$  in period 2. So long as resources available cover these payments, *i.e.* cash flow in period 1 is great than  $nrb$  and cash flow in period 2 is greater than  $(1 + r)nb$ , the project will run to completion. There is an unanticipated, exogenous temporary shock (bad luck) that lowers that sovereign's capacity to pay in the first period the amount that is due to the bondholders under their contract. The failure to comply with the terms of the debt contract constitutes default. However, conditional on default, it is common knowledge that the project net worth is  $P$ ,  $0 \leq P \leq (1 + r)b$ . We will assume that there is incomplete information about  $P$  and creditors receive privately observed signals of the true value of  $P$ .

Assume that acceleration requires a minimum of 25 % of creditors to act. Label an individual creditor by  $i$ ,  $i = 1, \dots, n$ . Each creditor chooses an action  $a^i \in \{Quit, Stay\}$ . Let  $N_{a,Q} = \{i, a^i = Q\}$  and  $N_{a,S} = \{i, a^i = S\}$  for an action profile  $a = (a^1, \dots, a^n)$ . Let  $N$  be the set of integers between  $\frac{n}{4}$  and  $n$ .

Consider function  $\bar{g}: N \rightarrow R$  such that

$$\bar{g}(x) = \min \left\{ (1+r)b, \frac{\bar{Q}}{x} \right\} - L, \quad x < n, \quad \bar{g}(n) = \frac{\bar{Q}}{n} - L, \quad \text{where } \bar{Q} \text{ is}$$

the recovery amount if the project is terminated in period 1. If  $x$  creditors accelerate their claims, project terminates. The creditors who accelerate when the others  $(n-x)$  do not, reckon to recover either their initial investment  $b$  plus interest  $rb$  or the full quit value

$\left(\frac{\bar{Q}}{x}\right)$  minus the privately borne legal costs of quitting  $L$ , leaving the

rest of creditors with the residual as in a grab race. If  $n$  creditors accelerate their claims, the project terminates, and each creditor receives the recovery amount divided by total number of creditors  $(n)$  minus the privately borne legal costs of quitting  $L$ .

Consider also the function  $\bar{l}: N \rightarrow R$  such that

$$\bar{l}(n-x) = \max \left\{ \frac{\bar{Q} - (1+r)bx}{n-x}, 0 \right\} \quad \text{where } x < n. \quad \text{Here, liquidation (in asset grab race for a firm) allows the first mover to exit without much loss of value but liquidation is costly for other creditors.}$$

$\bar{l}(n-x)$  is residual payoff for the second mover in the asset grab race. Remark that  $\bar{l}(n-x)$  is well-defined for all  $x \in N$  as we must have  $(1+r)bn > \bar{Q}$ ; otherwise, the sovereign debtor would have enough resources to service her debt and would not default in the first place.

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Payoffs of creditors are specified as follows:

Suppose  $a$  is such that  $x = \#N_{a,Q} \geq \frac{n}{4}$  (more than 25% of the creditors choose to accelerate their claims or choosing to quit)

Then, if  $a^i = Q$ , the payoff to creditor  $i$  is  $\bar{g}(x)$ ,

If  $a^i = S$ , the payoff to creditor  $i$  is  $l(x)$ .

Suppose  $a$  is such that  $\#N_{a,Q} < \frac{n}{4}$ ,

if  $a^i = Q$ , the payoff to creditor  $i$  is  $P - L'$ ,

if  $a^i = S$ , the payoff to creditor  $i$  is  $P$ ,

where  $L' > 0$  and  $L > L'$ .

The legal cost  $L'$  reflects the fact that an individual creditor, who unsuccessfully tries to accelerate the project, incurs a legal fee for doing so but as the project is not terminated, obtains his continuation payoff  $P$ , net of this cost.

Instead of working directly with these gross payoffs, for computational purposes, it is convenient to work with normalized payoffs specified as follows. Define the function  $g: N \rightarrow R$  such that  $g(x)$  is decreasing in  $x$ ,  $g(x) > 0$  for  $x < n$  and  $g(n) = 0$ . Consider function  $l: N \rightarrow R$  such that  $l(n-x)$  is decreasing in  $x$  and  $l(n-x) < 0$  for all  $x \in N$ . Suppose  $a$  is such that  $x = \#N_{a,Q} \geq \frac{n}{4}$ . Then,

if  $a^i = Q$ , the payoff to creditor  $i$  is  $g(x)$

if  $a^i = S$ , the payoff to creditor  $i$  is  $l(n-x)$

Suppose  $a$  is such that  $\#N_{a,Q} < \frac{n}{4}$ . Then,

if  $a^i = Q$ , the payoff to creditor  $i$  is  $\gamma - \varphi$

if  $a^i = S$ , the payoff to creditor  $i$  is  $\gamma$

where  $\varphi > 0$ .  $\varphi$  captures the fact that an individual creditor who unsuccessfully tries to accelerate the project, pays a small but strictly positive cost and therefore receives a continuation payoff of  $\gamma$ , net of this cost and  $\gamma \in [-K, 1]$  and  $0 < K < 1$ , where  $\gamma$  is the continuation payoff if the debt is rolled over/creditor not accelerate her claims and the project continues to the next period. Let  $q(\cdot)$  denote the probability distribution over  $\gamma$ . Each creditor observes a privately observed noisy signal  $\sigma^i$  of  $\gamma$ , where  $\sigma^i \in \{\gamma - \varepsilon, \gamma + \varepsilon\}$ , where  $\varepsilon > 0$  and  $i = 1, 2, \dots, n$ . Conditional on  $\gamma$ , the signals are independently and identically distributed over  $\{\gamma - \varepsilon, \gamma + \varepsilon\}$  according to the distribution  $\{p, 1-p\}$ , where  $0 \leq p \leq 1$ .

Remark that the strategy profile where all creditors choose to quit irrespective of their signal is a Bayesian equilibrium. There exist other Bayesian equilibrium in threshold strategies. In what follows, for simplicity, we restrict attention to the case with 3 creditors. Consider a threshold strategy where for some  $\bar{\gamma} \in [-K, 1]$ ,  $0 < K < 1$  such that for each creditor  $i$ ;  $i = 1, 2, 3$ , (i) if  $\sigma^i > \bar{\gamma}$  then creditor  $i$  stays (ii) if  $\sigma^i \leq \bar{\gamma}$  then creditor  $i$  quits.

*Bayesian Equilibria with three Creditors.* To consider other Bayesian equilibrium in threshold strategies, one needs to fix an individual  $i$ . Then, from the perspective of this creditor, there are two other creditors using the threshold strategies. Consider the case when creditor  $i$  observes a signal  $\gamma$ . Assume that conditional on the true states of the world, the probability distribution is independent across creditors. Given that  $\gamma$  is the signal of creditor  $i$ , the posterior distribution over states of the world is  $\gamma - \varepsilon$  with probability  $1 - p$  and  $\gamma + \varepsilon$  with probability  $p$ . Hence, these  $\gamma - \varepsilon$  and  $\gamma + \varepsilon$  are two true states of the world for the other two creditors.

Conditional on  $\gamma - \varepsilon$ ,

The other two creditors observe same signal  $\gamma - 2\varepsilon$  with probability  $p^2$

One creditor observes a signal  $\gamma - 2\varepsilon$  while the other creditor observes a signal  $\gamma$ . This occurs with probability  $2p(1 - p)$

The other two creditors observe same signal  $\gamma$  with probability  $(1 - p)^2$ .

Conditional on  $\gamma + \varepsilon$ ,

The other two creditors observe same signal  $\gamma$  with probability  $p^2$

One creditor observes a signal  $\gamma$  and the other creditor observes a signal  $\gamma + 2\varepsilon$ . This occurs with probability  $2p(1 - p)$

The other two creditors observe same signal  $\gamma + 2\varepsilon$  with probability  $(1 - p)^2$ .

We first establish that creditors will use the Bayesian equilibrium. To this end, suppose that threshold of creditor 1 is given by  $\bar{\gamma}$ . Since in this context, we focus on only the symmetric threshold strategies, the threshold of other two creditors are also given by  $\bar{\gamma}$ , at some Bayesian equilibrium. Then,

Two other creditors quit with probability  $[(1 - p)p^2 + (1 - p)^2 2p + (1 - p)^3 + p^3]$

One creditor quits and the other creditor stays, this occurs with probability  $2p^2(1 - p)$

No creditors quit. This occurs with probability  $(1 - p)^2 p$

Let's consider the payoffs of creditor  $i$ :

If creditor  $i$  quits ( $a^i = Q$ ), his payoff is

$$g(3)[(1 - p)p^2 + (1 - p)^2 2p + p^3 + (1 - p)^3] + g(2)[2p^2(1 - p)] + g(1)[(1 - p)^2 p], g(3) = 0$$

If creditor  $i$  stays ( $a^i = S$ ), his payoff is

$$l(1)[(1-p)p^2 + (1-p)^2 2p + p^3 + (1-p)^3] \\ + l(2)[2p^2(1-p)] + (1-p)^2 p[\bar{\gamma} + \varepsilon(2p-1)]$$

As  $\bar{\gamma}$  is the switching point (threshold), creditor  $i$  must be indifferent between quitting and staying, *i.e.* solving for  $\bar{\gamma}$  which satisfies the equation that payoff from staying equals to the payoff from quitting. This implies we must have that

$$g(2)[2p^2(1-p)] + g(1)[(1-p)^2 p] \\ = l(1)[(1-p)p^2 + (1-p)^2 2p + p^3 + (1-p)^3] \\ + l(2)[2p^2(1-p)] + (1-p)^2 p[\bar{\gamma} + \varepsilon(2p-1)] \\ [-l(1)][(1-p)p^2 + (1-p)^2 2p + p^3 + (1-p)^3] \\ + [g(2) - l(2)][2p^2(1-p)] \\ = (1-p)^2 p[\bar{\gamma} + \varepsilon(2p-1) - g(1)] \\ - l(1) \frac{[(1-p)p^2 + 2(1-p)^2 p + p^3 + (1-p)^3]}{(1-p)^2 p} \\ + [g(2) - l(2)] \frac{2p}{(1-p)} = \bar{\gamma} + \varepsilon(2p-1) - g(1)$$

Solving for  $\bar{\gamma}$  yields,

$$\bar{\gamma} = -l(1) \frac{[(1-p)p^2 + 2(1-p)^2 p + p^3 + (1-p)^3]}{(1-p)^2 p} \\ + [g(2) - l(2)] \frac{2p}{(1-p)} - \varepsilon(2p-1) + g(1)$$

It follows that conditional on default the probability of project termination is given by  $Q(\bar{\gamma}) = \int_{-K}^{\bar{\gamma}} q(\gamma) d\gamma$ .

*The impact of collective action clauses.* What is the effect of introducing collective action clauses in this set-up?

In the bonds issued by Mexico with collective action clauses, three things change. First, the percentage of creditors required to accelerate the debt conditional on default increases. Second, once acceleration occurs, the percentage of creditors required to change the financial terms is lowered to 75% from 100%. Third, the percentage of creditors required to change the non-financial terms is increased from 50% from 75%.



Suppose we still assume that acceleration requires a *minimum* of 25% of creditors to act. The effect of introducing collective action clauses then can be modelled as reducing the absolute value of both  $g(\cdot)$  and  $l(\cdot)$ . By doing so, we see that  $\bar{\gamma}$  falls. As  $Q(\bar{\gamma})$  is increasing function of  $\bar{\gamma}$ , the probability of project termination falls as well.

What happens when acceleration requires a minimum of 50% of creditors to quit? In this case, the payoff structure of the creditor coordination game changes as follows. Define the function  $g: N \rightarrow R$  such that  $g(x)$  is decreasing in  $x$ ;  $g(x) > 0$  for  $x > n$  and  $g(n) = 0$ , where  $x$  is the number of creditors who accelerate the claims. Consider the function  $l: N \rightarrow R$  such that  $l(n-x)$  is decreasing in  $x$  and  $l(n-x) < 0$  for all  $x \in N$ . Suppose  $a$  is such

that  $x = \#N_{a,Q} \geq \frac{2}{3}$

if  $a^i = Q$ , the payoff to creditor  $i$  is  $g(x)$

if  $a^i = S$ , the payoff to creditor  $i$  is  $l(n-x)$

Suppose  $a$  is such that  $x = \#N_{a,Q} < \frac{2}{3}$

if  $a^i = Q$ , the payoff to creditor  $i$  is  $\gamma - \varphi$

if  $a^i = S$ , the payoff to creditor  $i$  is  $\gamma$

where  $\varphi > 0$ ;  $\gamma \in [-K, 1]$  and  $0 < K < 1$ . By computation, it is checked that the Bayesian equilibrium threshold is now given by

$$\bar{\gamma}' = -l(1) \frac{[(1-p)p^2 + 2(1-p)^2p + p^3 + (1-p)^3]}{2p^2(1-p)} + g(2) - \varphi \frac{(1-p)}{2p} - \varepsilon(2p-1)$$

Note that as  $\varphi > 0$ ,  $l(2) > 0$  and  $g(1) > g(2)$ , and  $\bar{\gamma}' < \bar{\gamma}$  and again the probability of project termination falls.

We summarize the above discussion as the following result:

**Result 1.** *Introducing collective action clauses always reduces the probability of project termination.*

While this result involves three creditors, Ghosal and Thampanishvong (2003) show that the conclusion goes through in the more general case with  $n$ -creditors –and with debtor moral hazard.

## *Political Economy Aspect of Sovereign Debt Crisis: the Case of Brazil*

The source of the debtor's incentive problems in the model studied in Section 2 lies in the "non-contractible" nature of the payoffs to the sovereign debtor, *i.e.* the latter gets benefits which cannot be appropriated by creditors in case of default. What determines the non-contractible payoffs of the government –and therefore the probability of default– is often a matter of political economy. In what follows, we first pose a number of key questions; and then focus on a specific issue: "political contagion" in Latin-America.

### Key Issues for Research

How representative are the government's priorities of the preferences of its own citizens? What are the consequences of political parties with different ideologies being elected? What happens if creditors can anticipate the consequences of regime change? These are some of the questions that need to be tackled: and on which we would very much welcome suggestions.

Consider an issue that has prominent in the current Argentinean crisis, namely that those responsible for managing the economy have exited, leaving debt for others to pay. In extreme cases, sovereign debtors may appeal to the principle of "odious debt" where a state may justifiably repudiate obligations incurred by tyrants no longer in power, Birdsall and Williamson (2002) and Kremer and Jayachandran (2001). (This may currently apply to Iraq which has \$100 billion of foreign debts incurred under the administration of Saddam Hussein.) We assume that this does not apply in the case of Argentina: but nevertheless it appears that rich and well-informed citizens were able to take their capital out of the country, thus avoiding the precipitate depreciation of the peso.<sup>1</sup> If rich private residents have made enormous capital gains in local currency by exporting dollars from the country –now in default for lack of dollars to service its debt– should they not participate in the cost of clearing up the ensuing chaos? Could the state not demand payment

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1. Smallhout (2001) noted that "the net external interest burden is actually quite modest, external debt payments were \$12.5 billion in 2000 or about 4% of GDP... But Argentines earned an estimated \$6.4 billion or just over 2 % of GDP." In addition, there may have been private capital flight of \$20 billion dollars in 2001 before the collapse of the peso.

of capital gains tax on the assets “marked to market”, for example; or in extremis enforce repatriation in order to ensure the realisation of capital gains (and a massive inflow of dollars)?

This question involves issues of legitimacy and fairness which we do not tackle here. Instead, motivated by recent events in Brazil, we consider how a vote of no confidence in the Left-wing candidate can threaten financial crises and how the international financial institutions can help.<sup>1</sup>

### Contagion and Political Risk in Brazil

After the collapse of the Argentine Currency Board in late 2001, capital flows to Latin America dried up; and in Brazil, country risk rose to over 20% in summer of 2002. Being the dominant economy of the region, operating with a floating exchange rate, inflation targets and an internationally respected governor, why, then, should Brazil have suffered the same borrowing costs as pre-default Argentina?

Some economists believe that the sudden increase in the sovereign spreads in Brazil might have been caused by *regional contagion*, which triggered a shift of equilibrium in a multiple equilibria context. But, this cannot adequately explain why Brazilian spreads went up in line with Mr. da Silva’s popularity. We argue instead that the contagion may operate through domestic politics in Brazil. We suggest that there was “guilt by association” as the preceding December 2001 default in Argentina on its sovereign debt obligations damaged the reputation of the Left-wing party in Brazil, triggering exaggerated bond spreads before Lula’s election.

In their analysis of the pre-election term structure of future rates, Favero and Giavazzi (2002) have noted that the risk spreads showed a marked increase not at but after the election, specifically in Spring 2003 when the Left-wing party takes office and would rise further thereafter. In actual fact, sovereign spreads have fallen steadily since the election. It is as if the markets have been willing to revise their extreme views in the light of the observed behaviour of the incoming administration: the appointments it has made and the commitments it has undertaken with the IMF, for example. In the

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1. Section 4.2 summarises a recent paper, Marcus Miller, Kannika Thampanihvong and Lei Zhang (2003). An earlier version of the paper is available as CSGR Working Paper No. 113/03.

paper referred to, we use a model of Bayesian learning to show how avoiding default itself and how the IMF acting as lender of last resort and as a pre-commitment device could lead to the restoration of confidence and a fall in post-election sovereign spreads.

*Sovereign Spreads and Political Risk.* Technically, the influence of political factors on sovereign spreads can be analysed by emphasising differences of preference between two political parties: Left-wing and Right-wing, competing for power along the line of Alesina (1987). Assume, as a polar example, that the Right-wing party is always expected to honour its debts, while the opposing Left-wing is always expected to default and restructure. Then, in the run up to the election, creditors can use the *ex ante* probability of each party being elected to form the expected rate of default –with the outcome of the election determining whether or not default actually takes place.

Consequently, with a Right-wing party in power, but an election looming, sovereign spreads will tend to move in line with opinion polls, as in Brazil 2002 where spreads increased as Mr. da Silva's popularity soared. As the polls swung in favour of Mr. da Silva, sovereign spreads increased sharply: from around 7% in March 2002, to around 20% in September, as Lula moved from under 30% to over 40% in the public opinion polls.

That the Left-wing party automatically repudiates its debts is an extreme assumption. Nevertheless, it may capture panic in financial markets, when there are exaggerated fears of an untried Left-wing candidate.

*Learning.* Interestingly, in the months following the election of Mr. da Silva as President, sovereign spreads on the country's bonds declined from a peak of 23% in the Fall of 2003 to around 13% in January, 11% in March 2003 and around 8% in June 2003. They must fall further if Brazil is to be able to honour its debts in the medium term; but there is evidence that markets are getting over their initial panic at the prospect of a Left-wing administration.

To account for this decline in sovereign spreads after the election, we appeal to a model of "learning". In the Alesina-style political-economy model referred to above, it is assumed that policy preferences of both parties are well known. In fact, there was considerable uncertainty about what Lula's economic policies might be. Thus, the markets initially expect default with high probability

but revise this down if no default takes place. This learning process conditional on observing no defaults cause the sovereign spreads to continually subside much as has been observed.

The prediction of the political-economy approach, together with learning, is that sovereign spreads will widen before the election as the chances of a Left-wing party taking power increase; they will increase momentarily as electoral uncertainty is resolved by a Left-wing victory; but they will decline over time as (conditional on observing no defaults) the markets learn to trust incoming government. But how can the government buy the time needed for learning? Here there is a role for the IMF.

*How the IMF handles confidence crises.* The danger that high risk spreads might trigger default by a Left-wing government when it comes to power can it seems be avoided by the IMF acting both as a lender of last resort and as a pre-commitment device. With the supply of emergency funding to fill the financing gap; and, with an appropriate Letter of Declaration to implement sound fiscal policy and eschew default signed by an incoming government, the IMF together with the incoming Left-wing party can overcome the confidence crises.

*Summary and Conclusion.* In the summer of 2002, John Williamson examined Brazilian fundamentals and politics; concluded that markets had panicked; and commended that the IMF for its policy intervention. In similar fashion, we interpret the Sudden Stop and high sovereign spreads as reflecting the “political equilibrium” in a context where the behaviour of the potential Left-wing president is very uncertain contagion may arise as markets and masses unthinkingly transpose events from neighbouring Argentina to Brazil. The IMF, it seems, can –and did– play an important role in combating this contagion. Perceptions of radical repudiation may fade as candidates of all parties publicly promise to control fiscal deficits and abide by existing debt contracts, signing Letter of Declaration to the IMF as a form of pre-commitment in exchange for a package of immediate financial support. As models of learning suggest, prior probabilities of a radical repudiation will be revised over time if debts are honoured and repudiation resisted. This has, we believe, taken place in Brazil; and if continued, it offers the prospect of real interest rates falling sufficiently to allow for continued growth without default.

Lula probably owes his financial survival to orthodox IMF policies: how far this has compromised his own political agenda is an interesting and open question.

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Marcus MILLER\*

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## Comments

Marcus Miller's chapter addresses a key issue in the debate on the regulation of capital markets, asking which contingent rules are optimal in order to achieve the best trade-off between allocative efficiency and financial stability. While at national level this problem has been at the heart of central bank and regulatory agency development since the nineteenth century, it still has to be dealt with at international level. Since the stability of globalised markets is clearly an issue for all participating economies, this raises a global issue. The objective must be, to some extent, to define this issue conceptually. Is it a true international public good, which should thus be produced by a specific, international or even supra-national actor? Or do we only observe an aggregation effect, or an externality jointly produced by decentralised, national regulators –in which case their stronger co-ordination would improve the workings of international markets?

The actual topic discussed within this complex question is the restructuring of sovereign debt. The main elements of the puzzle are not new. Twenty years ago, the (mainly) Latin American debt crisis was dealt with agonisingly, and in an extremely inadequate manner. However, the rules of interactions for the main actors –leading private banks, the debtor states and the IMF– were simple, straightforward and quite resilient. They did deliver the long expected results after 1989: a large-scale reduction of sovereign debt, and the early return of debtor states to primary capital markets. A second dimension was thus added: bank credits were

exchanged against tradable bonds –called Brady Bonds– which created almost overnight a large liquid market for a whole new set of debtors from “emerging” economies, that is, sovereign economies, but also para-statal, banks, privatised utilities, private conglomerates, etc. The market which emerged therefore proved much larger than anything experienced since the pre-World War I era. It also proved uniquely complex. The structure of traded contracts became extremely varied and, rather than being operated by a few dozens international, well-known banks, markets became populated not only by a diverse and fragmented set of debtors, but also by investors (banks, investment funds, insurance companies, etc.).

This introduces the problem with sovereign debt –which concerns only a sub-section of globalised markets. If a sovereign state defaults on its international debt and drops out of the market, investors are confronted with the century-old problem of what to do next. Moreover, there are other problems: of how to co-ordinate with other investors, with whom there are the same basic interests; of how then to meet debtors and negotiate a reasonably fair way out of the default; of what then happens if the sovereign state refuses to negotiate in good faith; of what to do if some creditors do not agree, for instance, with a debt reduction and call up the London or New York courts in order to defend their initial contractual rights; of how to avoid stalemate; and of whether globalised markets can resist the repetition of such experiences, where an increasing number of states remains for years in default?

*Miller's Paper Deals With These Issues, Under Three Main Headings*

First, a game-theoretic model shows that sovereign debts are exposed to self-fulfilling liquidity crises, of the Diamond and Dybvig type, which may create an incentive for the debtor to default. This should not be considered an irrational decision, taken by panicky, incompetent, possibly corrupt governments: situations can emerge where a default –or a moratorium, or capital controls– becomes a rational answer to the crisis. Hence, at least implicitly, the policy issue is how to make these decisions as disruptive as possible, namely, how to design and integrate them into the legitimate set of policy instruments to be relied upon by governments, without for example causing an immediate break with the IMF.

The second model that Miller proposes aims to compare the efficiency of three of the principal approaches to sovereign defaults

discussed over the past years. The conclusions are clear: there is a hierarchy in terms of the desirability of the respective approach.

The *status quo*, where defaults are treated on an *ad hoc* basis, with no or few contingent rules, is the worst option: it maximises the risks of stalemate, which would cause the worst losses for the debtor country as for the investors, while threatening the development, if not the survival of globalised capital markets. The second worst (and second best) solution is the reliance upon a contingent Collective Action Clause (CAC) which would be written into the debt contracts, on an *ex ante* basis. Critically, investors would thus adhere to a qualified majority clause which would state how the rights of minority bondholders could be changed, without any outside intervention (for instance of the judicial type). The risk that the negotiation would constitute a “hold-up” by minority dissenters could therefore be eliminated, although only at the level of each bond issue, *i.e.* each contractual structure. This leaves open the question of co-ordination between bonds, differentiated by their maturity, types of holders, legal origin, unit of account, etc. This is the main problem for Miller, as for most opponents to CAC. In a nutshell, they are better than no rule at all, but the perimeter of collective action, that is, the definition of the public good they aim to produce, is still too narrow, leaving too much to be achieved by improvisation and by opportunistic tactics.

The answer should therefore have a broader reach, should be more centralised and be probably less voluntary, *i.e.* less “market-friendly”. It is exemplified by the so-called Sovereign Debt Restructuring Mechanism (SDRM) proposed by the IMF under successive variants, between November 2001 and April 2003. In this case, co-ordination between investors is eventually enforced by a new “statutory” or “proto-judiciary” body, which would have the right to force upon *all* minority bondholders the decision taken by a qualified majority of *all* investors in the defaulting state’s debt, whatever type of security they hold. The risk of a strategic stalemate is thus fully and formally addressed, just as in the case of bankruptcy procedure for a private business at national level. The counterpart to this remarkable capacity however is not trivial: private contracts are broken up by a public actor –a serious matter in any market economy– and this actor is supra-national, since it should cover debt contracts issued in different countries. Critically, this new body should receive the capacity to block litigation by minority investors, bypassing the national jurisdiction on which the

contract initially depended. In other words, states would not be the ultimate guarantors of private contracts within their own jurisdiction – a most important innovation.

The last part of the chapter deals with recent decisions made by IMF main shareholders, and their possible consequences. Apparently the policy debate on sovereign is now closed – at least the scope of possible directions is at least now much reduced, compared with the terms discussed above: the SDRM proposal has been dropped *de facto* at the “Spring meeting” of April 2003, and CAC may have won the day. The second best/second worst option seems actually to have come out on top after three countries – Mexico, Brazil and Uruguay – included CAC into one bond issue each, launched in New York. While CAC had been standard practice in London for decades, resistance to their generalisation came from the US, and especially from its financial private sector. So, apparently, in the coming months or years, Wall Street may adopt the City practice, which may become universal so that at least the microeconomic structure of sovereign debt contracts will become more homogenous.

As Miller rightly underlines, this re-coordination is not yet assured although the main uncertainty, for now, seems to be more long-term : it is whether CAC-based markets will have the capacity to solve even the larger and more complex defaults – say of the Argentine type. But even the hard tests are confronted, the discussion on the respective merits of the statu quo, CAC and SDRM still sheds light on at least four broader issues of “international financial architecture” : they are still there and will keep weighing on the future of international capital markets, on crisis prevention and crisis management.

### *Three Questions on the Future (and crisis) of Global Markets*

(i) SDRM was not just about collective action between bond investors and their debtors. Contrary to the CAC option, it also addressed problems of economic policy, *i.e.* stabilisation strategy. Most remarkably, it introduced the notion of a stay on capital movement, to be decided by the country itself in an early version of the proposal, and later as a joint decision with investors. In other words, the logic of an out-of-market, negotiated way out of the crisis could have been extended by fiat to a large array of capital flows, if actors considered this the best way to control the liquidity crisis

and preserve the potential for recovery. In other words, if they considered that the common good called for an extension of the perimeter of negotiation, they could enforce it. The beauty of proposal, however, was that such a decision, which is now only a unilateral, highly disruptive one, taken by the sovereign, would have been endorsed by investors as well. Indeed, the preparatory papers, published by the Fund in 2002, addressed *de facto* all types of public debt (bank credit, official Paris Club lending, domestic public debt) and how their restructuring could be co-ordinated with that of bonds.

A current key question, as regards future crisis management, is whether the Fund will keep defending as a valuable instrument its *de facto* recognition of capital controls or stays (although obviously one of last resort). Will it accept an agreement with a country which has adopted such measures? Will the Fund then confront the US Treasury if the latter, possibly under the influence of the US financial sector, resists such a controversial move?

(ii) This discussion raises a wider problem, which goes to the very core of the financial architecture debate: can it be envisaged that a supra-national body could be endowed with the authority to intervene *ex post* in a private contract? As recalled above, historically the regulation of domestic capital markets has very much revolved around this question: not only that of *ex ante* constraints on the freedom of contract, but also that of *ex post* ones. In this case, the experience of developed countries tells us that there is no such thing as the absolute sanctity of contracts: there are well-known situations where the liberty of contractors should be curtailed, in order to preserve the common interest, for example with an orderly adjustment of prices and quantities. Here one can mention the intervention by the supervisor into failing banks, the automatic suspension of share trading in the case of an excessive fall in prices or, of course, the case of a bankruptcy procedure. However, such interventions are always critical and, if mismanaged, they can easily backfire and affect both the future workings of markets and the credibility of public regulators. The objective is thus to delineate in advance the conditions under which there would be intervention in markets, how these interventions would take place, and the guarantees investors would receive of non-discrimination.

Post-war multilateralism assumed that such legal authority should remain wholly within the realm of sovereign states, just as

litigation on private contracts should remain under national jurisdiction. Neither the Fund, nor the UN nor even the WTO has been granted such capacity: the latter has now received quasi-judicial powers, but it only arbitrates conflicts between sovereign states, so that it condemns or withholds policy (e.g. tariff) decisions, not private contracts between firms. Only the EU has developed full-fledged judicial power, complemented more recently by anti-trust powers. In the case of SDRM, though, the scope of such new power was clearly delineated, and in a rather narrow definition, it did represent a major breakthrough in terms of international law and economic regulation.

CAC leads in completely the opposite direction. Whereas SDRM would have entailed a dramatic step towards supra-national regulation, national jurisdiction –especially that of New York and Great Britain– has won the day. With the further legitimising and reinforcement of a market-friendly, contractual approach to restructuring, their authority over the settlement of debt conflicts has also increased. They will become key players in any future debt crisis. Whereas common wisdom sees a need for global regulators and enforcers as a bulwark of financial globalisation, the trend here is to drift “below” traditional multilateralism, as embodied by the IMF. The growing international reach of national (mainly US) jurisdictions is a remarkable example, but the role of private arbitration, possibly working “in the shadow of the law”, is another. Rather than pointing towards a global super-state, or embryonic forms of such a state, these trends recall the *Lex Mercatoria* of the late Middle Ages: a set of commercial rules developed mostly by international traders and bankers of the day, often on a self-enforced basis and supported, when necessary, by local or royal governments also.

(iii) Obviously, such developments are called for by the rapid growth of international markets, that is, the ever-growing volume of internationally-traded private contracts. These were, to some extent, also widespread in the pre-1914 era. The underlying issue, however, is the degree to which the stability of global markets can safely be based upon such rules and conflict-settlement methods. Do they produce, on an aggregate basis, a reasonably consistent and resilient infrastructure for international exchange? In case of a systemic crisis, to what extent do (or should) they rely upon the last resort guarantees provided by sovereign states or their institutions of collective action? This was an underlying question of the SDRM



proposal, which came to be defended by the Fund as a “back-up” framework. Rather than working as a standard arena, it would have incited investors and sovereigns to work-out their debt problems in a more informal, rapid manner before calling for heavy-handed intervention into contracts.

A last issue, still visible in the background, is more political, as it raises issues of social legitimacy: are contractual, decentralised regulations providing enough guarantees of fair treatment for the weaker players of the game? We can think, for instance, of individual investors, such as the hundreds of thousands of Italian savers caught in the Argentine default? Or of holders of local debt titles and bank deposits? Or, more broadly, of countries with limited leverage in Washington and New York? This is the old issue of classical political philosophy –as much as of economics. The aggregation of decentralised contractual exchange, as of contract-based arbitration, does not always offer a guarantee that the best social solution will always be attained. Such was the supposition behind the SDRM proposal, just as with bankruptcy procedures at national level. This is the reason, whatever the workings of CAC-based capital markets, for the continued existence of the issues raised by the Fund. Under this or any other guise, they will inevitably pop up again on the international scene, as long as global market will keep their capacity to affect our living conditions directly.

Jérôme SGARD



## Enhancing the Co-operation Pillar of the Negotiations



## Chapter 3

# Trade and Co-operation in the EU-Mercosur Free Trade Agreement

### *Introduction*

Since the 1996 EU-Mercosur Framework Agreement, the European Commission (EC) has emphasised the co-operation aspects of any trade relations, something that has gained importance in the present negotiations for a Free Trade Agreement.

Co-operation, for the EC –and, in particular, for its External Relations Directorate General– encompasses a very broad array of issues, going beyond the strictly economic sphere. Sustainability of democratic regimes is one of them, considered to be a key area and a background to other relationships and agreements. Even within the economic and trade context, the number of issues and projects can easily be very high, as they can relate to manufactures, services or agriculture, as well as investment and macroeconomic questions, not to mention the closely related fields of education and culture.

At the Sixth Meeting of the EU-Mercosur bi-regional negotiations committee, held in Brussels in October 2001, the Subgroup on Economic Co-operation “agreed on joint draft texts in the fields of Scientific and Technological Co-operation, Energy, Transport, Telecommunications, Information Technology and Information Society”, as reported in its Final Conclusions. Agriculture and the environment were also on the agenda.

All this makes a clear point in favour of devoting more attention to co-operation issues and opportunities within the EU-Mercosur

context. Moreover, as is well known, trade negotiations are progressively becoming the tip of an iceberg, comprising a complex network of activities and instances which involve, complement and make possible the actual trade flows –a fact that also generates the need for more co-operation among the future members/partners in any eventual agreement.

It is impossible within the scope of the present chapter to cover the variety of issues under the broad umbrella of trade and co-operation. This report aims at shedding new light on, or stressing, a few selected themes considered important for the EU-Mercosur Agreement. After a general outline of the trade and co-operation nexus and the feasibility of the broad co-operation agenda the EU would like to implement, we analyse, in separate sections, four sectoral issues: phyto-sanitary and agricultural co-operation; foreign direct investment; telecommunications and information technology; and cultural co-operation (the trade-related aspects).

The four issues chosen have a number of implications. The first and third perhaps do not need any intellectual justification, their importance being clearly evident. Co-operation on investment has progressively received attention, and involves multiple actions, ranging from the set of “business facilitation practices” to specific themes, such as the streamlining of legislation and protocols on both sides, and the question of remittances, not to mention the creation of a level playing-field regarding right of establishment, something that has been somewhat biased in favour of the EU. The cultural side has important connections with relevant trade aspects, in particular the question of intellectual property rights, over and above constituting a *point d’honneur* for many EU Member States, most notably France.

In section 4 of the report we launch a new idea –a more strategic option, indirectly contained in the EU agenda: mechanisms for co-operation in dispute settlement in the WTO, something that could positively enhance a harmonious link between a regional integration agreement and the multilateral stance.

In section 5, a broader view is recast, introducing a few other specific points where synergies may occur between the two sides. The discussion contributes to a deeper analysis of the proposal, framing it under different categories. Of course, many other areas remain outside it. A key area relates to the well-known question of structural adjustment. The EU has enormous experience in this

area, while Mercosur will soon be required to adopt a regional –as opposed to a national– position on it. The Agreement creates a good opportunity to tackle the structural adjustment issue, and connected ideas, under the co-operation heading. This and all the previous findings form the conclusion of the report, in section 6.

### *General Analysis of the Trade and Co-operation Nexus – A Critical View of the EU's Co-operation Agenda in the Bi-Regional Negotiations*

#### A Theoretical Framework for Analysing Co-operation Efforts in Regional Integration

According to certain international relations theories, co-operation among nations is an outgrowth of individual desires, capacities and choices. Within the context of regional integration agreements (RIAs), Devlin (2002) is perhaps the first attempt to establish a logical basis for analysing the co-operation dimension. Drawing on Sandler (1992), he sees regional integrations as an impure public good, which co-operation beyond the trade sphere may help to bring closer to a pure, non-exclusive (true) public good. He introduces the idea of the “trade and co-operation nexus” (T+C), involving systematic co-operation in both trade-related and non-trade areas, and thoroughly analyses the intensity of the (T+C) in different existing preferential agreements. Particular attention is given to the EU cases, notably the EU-Mercosur negotiations.

Economists have long tried to introduce the concept of public good into discussion of the international political-economic system. Kindleberger (1973) used it to develop his version of hegemonic theory, though its later contributors preferred instead to draw on Olson (1965).<sup>1</sup> The idea of impure public goods is also not new, and can be found, for instance, in the development of club theory by Buchanan (1965) and others, in the mid 1960s.

Economic theory tells us that the basic characteristics of a public good are *non-rivalry* –when the good is consumed by one individual, another is not pre-empted from consuming it at the same time,

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1. We are not going to touch on nor discuss the ideas of hegemonic theory here. Those interested in the subject –which is regaining attention, thanks to the present world situation– can find perceptive reviews in Gowa (1993) and Keohane (1984).

or rather, rationing of the good is *not desirable*— and *non-excludability*— preventing others from sharing in the benefits of the good’s consumption is not possible, or rather, rationing of the good is *not feasible*.<sup>1</sup>

Dwelling on Devlin’s idea, we would add that the complexity of RIAs nowadays has greatly contributed to blurring the perception of the above characteristics in a given agreement. Indeed, the complexity almost forces the main negotiators—diplomats, in many countries—to look for help in specialised groups of society, or class organisations directly concerned with the particular issue at stake, naturally excluding large segments of the population who remain unaware of, or do not understand, the potential benefits that could accrue to all. The result is that, at least psychologically, *non-excludability* is impaired. Once this happens, *non-rivalry* may easily become empty, as many people do not know how to participate in the benefits of the integration. *Non-rivalry* can also be impaired, due to the different time required for each benefit to become reality (see, for instance, Flôres (1996)). This may trigger competition among the interested and well-informed on the sequencing in implementing the agreement’s measures.

When the ideal characteristics do not entirely apply, one has an impure public good. The arguments in the previous paragraph demonstrate that modern RIAs can often indeed qualify as *rather impure* public goods. Apparently, there are only two ways of minimising these effects, turning the regional integration into a “better”, or less impure, public good.

The first is a broader participation of civil society in the debates on the agreement, in order (ideally) to include the whole population in the process of tailoring the integration (public) good. This has been taking place in some ways, though sometimes the excessive politicisation of the debate creates other problems, one being the polarisation of arguments into marked ideological corners. Undoubtedly, a new challenge to the modern RIA’s negotiators and constructors is going to be how to open the debate to society’s vast majority without allowing it to stall in a few yes-or-no emotional positions.

The second is a comprehensive (T+C), that will engage other groups beyond the negotiators and trade-related actors, increasing

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1. See, for instance, Stiglitz (1988).



the awareness and understanding of the integration, while boosting its purely trade aspects. This may substantially enlarge the number of people concerned with the integration, at the same time conveying a different dimension of the process. Alongside the inevitable tit-for-tat of trade and market access negotiations, a sense of common goals and achievements may be created.

Without being a panacea, co-operation does seem to be an important tool for modern RIAs. Nevertheless, it shares a political economy dimension with trade negotiations. Clearly, the choice of the favoured areas, and related projects, can also be viewed as the outcome of interactions among domestic “co-operation lobbies”, or of optimising different political co-operation functions,<sup>1</sup> and the joint acceptance of the co-operation agenda can, at least in principle, be seen in the light of a now external interaction of these forces.

Without denying this view, we take it as a second-order consideration, which might be useful in certain instances. Fundamentally, it does not invalidate the role outlined above for co-operation, in the sense of enlarging the perception *of and the involvement in the integration process*.

### A Critical View of the EU Co-operation Efforts

The EU seems to have long been aware of the powerful role of a (T+C), having sometimes started solely with co-operation measures that eventually evolved into a (T+C) in their third or fourth generation agreements.<sup>2</sup> Usually, once an agreement in the (T+C) spirit is signed, the Commission issues a country (or group of countries) paper, detailing the co-operation initiatives and the budget for funding them from the EU side. Though in previous negotiations, like those with Mexico, interim or partial agreements were signed during the course of the negotiation process, the Mercosur-EU negotiations follow the *single undertaking* principle, all dimensions of the agreement being closed at the same time.

In spite of their undeniably pioneering aspect, the EU’s co-operation efforts have not been free from criticism. The first relates to the well-known “Brussels bureaucracy”, which has many times slowed down considerably initiatives which had been received with

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1. Depending on which political-economy-of-trade model the reader prefers.

2. Devlin (2002) also provides a good survey of this process with each (developing country) EU partner.

great enthusiasm when first proposed. The second, a criticism common to perhaps all co-operation projects, is that part of the funds reverts to EU firms and consultancies, co-operation almost serving as a way of generating revenues for different EU providers. Finally, most co-operation programmes are over-ambitious, dealing with too many areas/projects. Devlin (2002) correctly, and cautiously, states that co-operation projects should not be too numerous, at the risk of a poor implementation of too many initiatives producing a final negligible impact. The combined result of these shortcomings is that for some people EU co-operation is just rhetoric –a coherent and beautiful rhetoric, given its emphasis on democratic and human values– but not much more.

Few and well-focused projects seem the optimal starting point for building a successful (T+C) nexus. In this chapter we have been faithful to this idea. The five dimensions discussed in the next two sections work in a perspective not too far from the (T+C) role outlined above, although more restricted. They exploit two of the important purposes of a (T+C): first, as already mentioned, to facilitate and boost actual trade flows; second, to help create *an enabling environment for more trade and economic relations*. This is why classical, as well as key, EU co-operation measures in the socio-political dimension –like building or strengthening democratic institutions, or poverty alleviation– are not discussed here. This is also why, especially within the latter purpose, the discussion of “Mechanisms for dispute settlement co-operation in the WTO” has been introduced into the study. As far as we know, this is an innovation; nobody on the two sides seems to have thought of creating ways to follow up the broad EU-Mercosur *contentieux*, with the simultaneous purposes of keeping a constructive dialogue going and avoiding tit-for-tat measures that hinder trade and business opportunities.

The four co-operation areas we single out in section 3 may give rise to both country and bloc co-operation initiatives, as will be summarised later. Nearly all of them share the side-effect of an improvement of standards and quality in general, enhancing the competitiveness of the economies involved. Co-operation in dispute settlement is clearly at a bloc, or regional, level and may provide an original way of improving relations between the two common markets.

## *Sector-Specific Co-operation and its Possible Impact Within a Trade and Development Framework*

### Phyto-sanitary Measures and Agriculture

The Uruguay Round Agreement on the Application of Sanitary and Phyto-sanitary Measures (SPSM) opened the way to the protectionist use of internal food safety regulations against competitive foreign suppliers. The Agreement was reasonably careful in relating, in its Annex A, international standards and recommendations for food safety to those in the Codex Alimentarius Commission, and, for animal health and zoonoses, to those of the International Office of Epizootics. Unfortunately, as with other GATT/WTO devices –notably the anti-dumping code–, the agreement’s well-intentioned articles soon acquired a double-edged meaning, being used for bad as well as good purposes. Moreover, all the procedures involved in Annex C –Control, Inspection and Approval Procedures– can easily be performed faster or slower, according to the purposes of the (potential) importer.

The EU has a strict internal food safety policy – usually rigorously applied to its domestic producers –, which makes easier and more palatable protectionist use of the SPSM. In Mercosur, Brazil, for instance, has been very restrained in the use of the Agreement, the only complaint against it having originated, ironically, from the EU, regarding its seed-potato exports.<sup>1</sup> However, the Agreement may cause problems if closer trade relations take place between the two blocs. In order to avoid this, we identify an important co-operation line in all aspects related to meat and animal products in general.

Mercosur has enjoyed a reasonably good reputation in its meat exports to the EU, which can still give it a competitive edge over new entrants like Poland –that, were it not for being reasonably far from meeting the EU requirements, could damage its market share. However, problems have been marring this reputation. The first is the serious epidemics that have attacked various Uruguayan herds. Secondly, there have been problems in Brazil regarding the EU traceability requirements for bovine meat. Though these have not yet been used as a trade restriction, the EU authorities have signalled

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1. These exports amounted to around US\$1 million, and the complaint was recently settled at the April 2003 meeting of the (WTO) Committee on Sanitary and Phyto-Sanitary Measures.

that fulfilling such requirements is an important condition for supplying the EU market. Co-operation in the definition and application of the sanitary measures and, in the particular case of traceability, *in the proper checking and measurement techniques*, is perhaps the best way to ease tensions on both sides and to pave the way for a fuller and more open trade in agriculture between them.

Another area concerns co-operation on the genetically modified organisms (GMOs) issue. Traditionally, attitudes towards GMOs in the US and the EU have been seen as in opposition to each other, the former being seen as open to transgenics and the latter as strongly resistant to their introduction.<sup>1</sup> The reality is more complex however, not only does unanimity with respect to GMOs not exist in the US, but the EU is progressively admitting some GMOs. Mercosur, as a whole, would broadly be placed between these two poles, with Argentina leaning closer to the US approach—95% of its soya output comes from transgenic seeds—and Brazil being nowadays one or two steps further than the EU's position. The EU has tough regulations on labelling and traceability of products that, somewhere in the production chain, have used GMOs. These regulations are due to become stricter following new requirements to be issued by November 2003. In the Brazilian case, transgenic soybeans are the major target, given the country's position as a main soya exporter and the diversified use of this crop in other agricultural and animal produce. At present, many issues are at stake, including the minimum percentage of transgenics that would make labelling mandatory. This is crucial because the lower the percentage level, the higher the costs of labelling for the producer. Given Mercosur's intermediate position on this hot topic, and the initial stage of regulatory and safety measures for wider use in a main exporter like Brazil, co-operation in GMOs policy is an important area where the more convergence is achieved, the higher the gains for both partners, either in their reciprocal trade or in a common external GMOs policy.

## Investment and Related Issues

Foreign direct investment (FDI) is a recurrent theme in Mercosur. All member states want to attract as much FDI as possible and, in the past, relations have not been smooth in this field, as

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1. For those interested in acquiring more information on this theme, Chrispeels and Sadava (2003), especially chapters 18 and 20, is a good modern reference.

internal competition for FDI has occasionally evolved into almost conflictive situations. FDI discussions involve different dimensions, ranging from the relatively vague idea of a level playing field to specifics like remittances policies. Nevertheless, the Mercosur countries have more in common with the EU than with the US or other developed nations in their international position regarding foreign investment. This common view could act as a starting point for a scheme of fruitful co-operation.

The Colonia Protocol, dealing with investment rules for the Mercosur common market, lies semi-abandoned, a vivid example of the difficulties surrounding the subject. Given that not even in the EU is one faced with a fully harmonised situation, the two blocs could develop a serious co-operation programme with the limited objective of having a single, bloc-to-bloc policy on FDI. This would be a wonderful incentive for Mercosur to press forward with its own set of common rules, while both blocs would try to design basic criteria applicable to all member countries.

Advancing the proposal is not too difficult, and could give rise to a rich set of case studies. Indeed, EU FDI in Mercosur is mainly the concern of five members –the UK, Germany, France, Spain and Portugal, the other actors –like the Netherlands or Sweden– having a more limited and less diversified presence. On the other hand, Mercosur FDI in the EU is mainly located in Portugal and Spain. A specific-to-general approach, in which rules and procedures would first be fine-tuned with the main agents –in the light of the concrete questions currently at stake– and then submitted to the corresponding general bodies, could bear interesting fruit within a short time horizon. The EU experience –in this case, more in its failures than in its successes– would be of extreme value, creating an area of actual interchange and effective building up of both common markets.

## Telecommunications and Information Technology<sup>1</sup>

Telecommunications is a domain where deep interplay takes place among not only the goods and services sectors but also the connected rules, protocols and standards. It is impossible to discuss trade in telecoms services without a view on the related impact

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1. This sub-section draws partially on Viana (2003). Those interested in acquiring more information of the technical concepts and procedures mentioned here should consult a specific (though not too technical) work like Horrocks and Scarr (1994), for instance.

on the telecoms and information technology equipment trade *and* on the constraints imposed by specific standards and other global technical definitions. Moreover, it is the sector where regulation has moved farthest, posing complex problems whose solution may again considerably affect the goods and services trade, as well as foreign direct investment in the sector.

The EU-Mercosur negotiations on telecommunications adopted as a starting point the annex to the fourth GATS Protocol known as the Reference Paper on Basic Telecommunications Services. This was an important move since, at the WTO, while the EU adopted the Reference Paper, Argentina is the only Mercosur country to have done so. Brazil, Mercosur's biggest telecoms market, presented in April 2001 a proposal on the adoption of the Reference Paper. However, it met with opposition from Japan, China, the US and the EU itself, particularly because of restrictions on foreign ownership of telecom firms. So, while convergence seems to be likely within the EU-Mercosur agreement, at Geneva the impasse continues.

Two crucial areas stand out as key co-operation nexuses in this context. The first is the migration from second (2G) to third generation (3G) of cellphone networks, a process highly dependent on the structure and technology of the existing 2G network. This is because the basic universal standard for 3G technologies –the IMT-2000 defined by the International Telecommunications Union (ITU)– is, as often happens, broad enough to accommodate different specific technologies. The new 3G environments, beyond permitting the long-awaited *global roaming* facility, will achieve almost total convergence among fixed and mobile voice services, data and image transmission, Internet and multimedia services. This means a prospectively huge enterprise in both blocs, especially in Mercosur where telecoms penetration lags behind the EU (see Table 1).

Co-operation here means serious business, with the possibility of very significant gains in the medium to long run. The point of departure is in the EU's favour as establishment of the 2G network has not yet been completed in Mercosur. In Brazil, for instance, a heated debate is taking place, as Vésper, the local representative of the US firm Qualcomm, wants to extend an acquired right to exploit cellphone services in the 1.8 GHz band to the 1.9 GHz band. The latter has in principle been assigned by the Brazilian regulator to 3G services, and use of it by Vésper would place the firm's cellphone technology, the CDMA (Code Division Multiple Access), at a vantage point as regards the competing GSM (Global Standard

Mobile) technology for 3G migration.<sup>1</sup> The whole affair is doubly strategic because, ironically, half of the existing cell-phones networks are neither GSM nor CDMA, but rather use the phased-out TDMA (Time Division Multiple Access) technology and are in the process of being replaced by the two competing standards.

Table 1. *Telecoms penetration in Mercosur and the EU; a few indicators (2001)*

	EU	Mercosur
Telephones <sup>a</sup>		
fixed .....	55.4	17.7
mobile .....	72.4	13.9
Internet users <sup>a</sup> .....	31.4	3.9
Personal computers <sup>a</sup> .....	30.0	5.1
Households with TV <sup>b</sup> .....	147.0	47.6

<sup>a</sup> per 100 people ; <sup>b</sup> absolute number in millions  
Source: International Telecommunications Union.

The GSM technology, present in 193 countries, is dominant in the EU. This actual example shows how co-operation in this area might have significant trade spillovers. Moreover, even after having decided how migration to the 3G environment will be carried out, there remains scope for co-operation on the various stages of the process.

The second area is digital TV, an innovation that, though nowadays less overemphasised as *the* technical revolution in multimedia reception, will still have a profound impact on future developments in information (and entertainment) transmission. Again, though the EU has already defined its standard –the DBV (also adopted by Australia, New Zealand, India and Singapore)– things have not yet been settled in Mercosur. Argentina has already opted for the competing ATSC standard (adopted by Canada, South Korea, Taiwan and the US). If Brazil adopts the DBV, or a hybrid form, there will be significant motives for technical co-operation in this area.

A third issue, perhaps as relevant as the two previous ones, is Internet access and penetration. Both in Mercosur and in the EU, there are clear signs that Internet traffic will progressively dominate

1. It is, of course, completely outside our purpose –and entirely senseless– to state a position or judgement on the issue. Vésper claims that its decision is backed by Resolutions issued by ANATEL, the national telecoms regulator.

telecommunications flows. This will have a great impact on the structure of the equipment industry and the costs of the service providers. To overcome or attenuate this impact, more *peering-backbone* connections, in which a peripheral internet user is directly connected to an internet backbone (provided flows on both sides of the connection are approximately equal), will be needed. No Mercosur country has such a connection at present, which amounts to higher internet costs for all its members, as backbones are located either in the US or the EU. Co-operation in order to implement such cost-reducing measures, as well as on the issues of taxation and the use of broadband connections, is clearly needed.

In the telecoms galaxy, there are many other areas where co-operation makes sense. Examples could include information gateway entry and utilisation rights; spectrum, numbering, naming and addressing management; pricing and cost accounting policies; open systems and networks interconnection, or customers and universal service requirements.<sup>1</sup> Given the purposes of this paper, however, the three cases outlined above would seem to illustrate why telecoms qualify as a key co-operation area.

Finally, it is worth reminding ourselves that, contrary to the US, where telecoms (internal) deregulation dates at least from the famous Modification of Final Judgement by Judge Greene which exploded ATT's monopoly in 1982, the EU, like Mercosur, started the process only recently, and currently faces problems which are similar to those of Mercosur. Co-operation, even in a broad way, on the difficult economic, technical and institutional questions which lie in the fuzzy border separating the telecoms and competition regulators can make a lot of sense, as well as being fruitful for both regions.

## Culture

Culture and education are the most important areas of co-operation in assuring a long-term, stable and ever closer relationship between two groups of nations. The problems created by the successive EU enlargements, since that following the *Delors Initiative*, and the tragic way in which fragmentation has taken place in the

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1. Many of these terms may sound rather technical to the reader: they are. In a digital technology environment, numbering –*i.e.*, user identification– for instance, has become a crucial issue, raising specific and complex problems.



Balkans have attracted the attention of RIA researchers to the former Austro-Hungarian Empire. Though still a puzzle to some, there is nowadays a certain consensus stating that only the addition of the common threads –and the ensuing uniform and detailed, though massive, administrative procedures, going many times down to district level– forged by a particular branch of German culture, flexible enough to accommodate key Slav and Magyar influences, can explain the incredible survival and unity, over its last few decades, of a power already in shambles.<sup>1</sup>

Cultural links, and the galaxy of common (or similar) habits, patterns, rules and attitudes derived from them, constitute a solid way of bringing nations together. No wonder there is the continuing fight between the US film and entertainment industry and its EU counterparts: much more than an economic issue is at stake. At the same time, an encompassing integration such as the EU desires with Mercosur can only be achieved through the strengthening of cultural and educational links.

It is in education, rather than in culture in general, that the EU co-operation initiatives have perhaps been more successful. In Mercosur, and in the whole of Latin America as well, out of the seven special projects administered by the EuropeAid Co-operation Office of the EU, two aim at the interchange of students, academic staff, building up common research projects and the development of joint degrees (see Table 2). In other aspects of culture, particularly the entertainment industry, co-operation is more limited, although, for instance, in the movie sector, joint ventures between Mercosur and EU groups (especially those in Latin countries) are signalling a promising future.

To include here all possibilities of co-operation in this vast area would be to make, on a smaller scale, the same mistake usually made by global EU initiatives: too many projects, which are then almost certainly candidates for inefficient management. As in agriculture or telecoms, we have a more targeted proposal.

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1. The literature on the Habsburg Austro-Hungarian Empire is enormous and, of course, much of it has nothing to do with the issues in this chapter. Classical, and not very difficult or massive, works like Blanning (1994) and Taylor (1948, 1954) can, however, be of value. Conybeare and Sandler (1990) is also interesting, and less distant from our theme.

Table 2. *The main EU co-operation programmes in Latin America (2002)*

Programme	Area – main purpose
AL-INVEST	Investment – to encourage small and medium-sized EU and LA firms seeking co-operation
ALFA	<b>Education</b> – promotion of higher education
URBAL	Urbanism – to establish direct and lasting links between EU and LA cities
ALURE	Energy – to encourage an optimal and more rational use of energy
ATLAS	Business – economic co-operation through a network of Chambers of Industry and Commerce
@LIS	Information Technology – to promote the benefits of IT and bridge the gap of the digital divide
Alβan	<b>Education</b> – reinforcement of the EU-LA co-operation in higher education; training in the EU for LA professionals

Source: European Commission – DG External Relations.

Irrespective of the existing projects –and welcome new ones– co-operation funds within the framework of the agreement can be directed at three objectives. The first would be to achieve a common definition of a cultural firm, which would enjoy specific privileges in both regional spaces, being eligible for particular concessions in the other bloc and, sometimes, identical working and performing conditions. The concessions would mean greater flexibility and ease in its mobility and activities throughout the two blocs, while the identical conditions would open up the possibility –at the discretion of the local sponsoring authorities, such as, for instance, festival organisers– for the firm to enjoy the same grants, facilities and liberties given to local ones. This is a bold proposition which would demand further study, but undoubtedly represents a step forward in closer cultural co-operation. Eventually, both sides could create a (modest) joint fund to support these firms' travel and activities abroad.

The second proposal is concerned with audiovisual services, where inevitably there are individual identities on both sides of the Atlantic and, in spite of a greater lack of capital on the Mercosur side, the two blocs are in competition with each other. Mercosur films are well received in the EU, and the same applies, in principle,

to those of the EU; however, both lack powerful distribution channels. Outlets should not be restricted to the classical theatre or the projection room; DVDs, videos and television –where Brazilian soap-operas especially have a market still to explore– are very important alternatives. Again, it may be hard to believe that, given the enormous and systematic pressure that the US industry puts on Brussels for total liberalisation of this sector, the EU would be able to make a special opening for Mercosur. However, the point here is not GATS-plus rules for Mercosur –a subject to be discussed in the trade in services negotiations–, but co-operation between the two sectors aiming at improving distribution channels and increasing penetration in each other’s region. Certainly, between a GATS commitment and local regulations –for instance, regarding the hours per-week allowed to non-EU soap-operas and films on a regional TV channel– there is room for manoeuvre; which, without damaging the non-discrimination clause, can be used to the benefit of the partners.

The third project relates to property rights. The culture industry is one of the main sectors where problems related to intellectual property rights occur. In this area, not only counterfeiting –of CDs, DVDs and similar media– is an issue. Due and rapid appropriation of rights, in the multiple instances when they generate revenue in the cultural world, is also problematic. Co-operation would entail a project to streamline procedures on both sides, so that rights and royalties could be quickly collected and remitted, and at the same time enforcement would receive special attention.

### *Dispute Settlement Co-operation in the WTO*

Annex 2 of the Uruguay Round, “Understanding on Rules and Procedures Governing the Settlement of Disputes”, represented a major departure from the existing (GATT) mechanism to solve disputes among contracting parties. In particular, two entities, the Dispute Settlement Body (DSB) and the Appellate Body (AB), were created within the WTO, with the sole purpose of administering the rules and proceedings in the Understanding and, in the case of the Appellate Body, functioning as a last resort (see, for instance, Palmetier and Mavroidis (1999)).

It is not the aim of this section to discuss the encompassing impact of the “Understanding” and the pros and cons associated with the increased weight of juridical content and procedures in the

WTO mechanism for the settlement of disputes. Sticking to the undeniable facts, the first finding is that the frequency of use of the DSB and its panels surprised even the more optimistic defenders of the “Understanding”. Secondly, panels have up to now behaved in a quite neutral way, it being fair to say that no evidence of bias in favour of a particular member –especially the more powerful ones, as some feared– can be produced. It is within this context of a very active DSB that our proposal is put forward.

From January 1997 to March 2001, out of all the panels *concluded* at the DSB (or the AB) there were 14 involving the EU and at least one Mercosur member. In only two of these, did both blocs/ members figure as third parties; in the remaining twelve, at least one Mercosur member or the EU figured either as complainant or accused (see Table 3). These panels covered a variety of WTO agreements and, as is usual, it took about 12 to 18 months to reach a final decision.

The amount of time spent in reaching a decision and the uncertainty as to whether the losing side will implement the conclusion are serious shortcomings of resorting to the DSB. If the decision is not implemented, or even when it is immediately applied, the question of sanctions is a further problem. Even when enforcement is feasible, which is not always evident, sanctions frequently backfire, with the winner also losing some of its trade welfare. Moreover, especially in Mercosur countries where legal assistance on trade/WTO law is not very well developed, individual exporters, when in trouble, do not know which is the better option: to use the DSB at Geneva or to appeal to the domestic commercial defence system, in a local court. Finally, as panels engage directly in the case, without the help of a preliminary analysis of the juridical aspects of the problem, it is not uncommon to find them stalled in a controversial matter involving different, conflicting international treaties or commitments.

Table 3. *DSB (or AB) concluded panels where both the EU and at least one Mercosur member took part (January 1997 to March 2001)*

	Number of cases
As complainant and accused .....	3
As complainant, accused and third party .....	1
As either complainant or accused and third party .....	8
Both as third party .....	2
Total .....	14

Considerable time and energy would be saved if, within a co-operation framework, a previous consultation system for any potential dispute at the WTO were created. The system would undertake a preliminary analysis of the juridical foundations of the complaint, trying to reach a friendly solution. In this effort, both parties would make an evaluation of the costs and benefits of engaging in a WTO panel, as opposed to the gains made from a quick, internal (to both) solution. Advice on the best legal ways to conduct the case would also be provided.

Such co-operation requires the establishment of a permanent group or committee responsible for the tasks outlined above, to be consulted whenever a potential conflict arises. The proposal then encompasses the dispute settlement procedure discussed in the ongoing negotiations. This procedure relates only to disputes that emerge within the framework of the agreement, while *the co-operation envisages deals with all potential WTO cases*, going beyond those inside the agreement flows. Moreover, as Table 3 shows, often one bloc is involved in the case, while the other enters only as a third party. The co-operation mechanism would also be a privileged source of information, with the blocs exchanging views and strategies even when only one of them constitutes a main party.

Finally, better guidance could be provided on choosing between a domestic commercial defence case and a WTO panel. This is a crucial point where a great deal of misunderstanding exists. Reciprocal ignorance, on the part of EU exporters regarding the Mercosur members' defence systems and, by Mercosur, on the (voluminous and) elaborate EU foreign trade legislation, accounts for a considerable waste of time and resources in the solving of cases which do not necessarily justify a panel, even though they may cause damage to either the exporter or the domestic competitors.

Implementation of this is not difficult, as the basic cell would be the body created for the agreement, which –in the co-operation project– would receive supplementary funds for performing its enlarged activities. We estimate a considerable gain in time from such a co-operation mechanism.

### *Application to the Present EU-Mercosur Negotiations*

We have outlined in the previous sections a moderate portfolio of co-operation initiatives. The five dimensions briefly discussed make for a manageable, though still significant, group. In this

section we move back to a global view in order to make a finer judgement of the proposal. An initial point to be noted is that the several ideas/projects can be classified according to different criteria. Table 4, which will guide the present analysis, shows that the overall result is a high diversity of project types.

The first criterion deals with the actors in the co-operation –is it to be the nations, or individual economic agents and social groups? As in many areas of trade relations, both can be true. The projects allow for varied forms of interaction; while, in a common food safety policy regarding transgenics, as in a common statute for cultural industries, governmental involvement will be profound –though not exclusive–, in the telecoms projects individual firms and providers will probably play a much more prominent role.

This begs the question whether, in certain cases, one is really dealing with co-operation, or with a fairly crude facilitation measure, that will clearly benefit a specific group of firms/providers on one or both sides. In other words, here the political economy dimension of co-operation emerges.<sup>11</sup> This distinction is sometimes hard to identify, but we do not think it is a criterion for rejecting a co-operation effort.

Where to trace the dividing line depends on whether the co-operation project drastically limits or excludes other alternatives –as in the case of a competing standard– or, on the contrary, on whether it improves competition among alternatives, while help to qualify the decision-making process. Looking at the column “Restricts?” in Table 4 we see that this possibility exists for five out of the ten projects, and is more marked in two of them. Such a situation is, to a certain extent, inevitable when dealing with fundamental technical or juridical matters (all five projects are in this class). Of course, taking the blunt example of the 3G standard in telecommunications, once the decision has been taken, there is no point in blocking a co-operation initiative that will eventually contribute to a better implementation of the choice already made.

In spite of their diversity in other dimensions, all the projects *can be viewed* as trade-enhancing (column 4, Table 4), and therefore, as economic co-operation. This has a practical significance because economic co-operation, in contrast to either financial and technical or social and cultural, has not yet been concluded in the negotiations and, if need be (and desired), all the proposals can be brought under this umbrella.

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1. See the comment at the end of section 2.1 (p. 109).

Table 4. *The proposed projects classified into several dimensions*

PROJECTS	Actors?	Restricts?	Trade-enhancing?	National or regional?	Needs homework?
1. Sanitary & safety	States	No	Yes	Regional	Maybe (M)
2. GMOs policy	States	May	Yes	National/ regional	Yes (M+EU)
3. Rules harmonisation (FDI)	States	No/may	Yes	National/ regional	Yes (M+EU)
4. 3G migration	1. Firms, 2. States	No/may	Yes	National	No
5. Digital TV	1. Firms, 2. States	May	Yes	National	No
6. Internet links	Firms	No	Yes	National/ regional	Maybe (M+EU)
7. Cultural firm	States	No	Yes	National/ regional	Maybe (M+EU)
8. Audiovisual	Firms+ States	No/may	Yes	National/ regional	Maybe (?)
9. I. property rights	States	No	Yes	Regional	No
10. Dispute settlement	States	No	Yes	Regional	Yes (M+EU)

Most projects have a truly regional perspective, as opposed to a country basis. This will demand greater cohesion from Mercosur in designing consistent regional co-operation programmes. As a side-effect, co-operation will also help to deepen the integration, this being the last classificatory dimension (“Needs homework?”). Perhaps the best example in this case is the investment protocol, and the related harmonisation measures.

There are also synergies and inter-relationships between the ten projects. Though the telecom projects (4-6) bear a technical character, they can produce externalities for two of the cultural ones, namely, 7 and 8. Project 3 can have an impact on at least 4-9, the latter also impacting on 3. The dispute settlement co-operation in project 10 could boost the benefits accruing from all the other projects. As expected, due to their very specific character, the agricultural proposals stand aside from the others. Nevertheless, they

are important building blocks in the task of drawing together the EU and Mercosur sectors.

Thus, the proposal passes through varied checks and seems to touch on different areas that can be reached only through co-operation, making for a fairly representative agenda for achieving the public good objective mentioned in section 2.1.

## *Closure*

The co-operation initiatives outlined here could make for a diversified and engaging agenda, ultimately broadening the perception and impact of the Agreement. Classic areas of emphasis for the EU, like political co-operation and strengthening of democratic institutions, have been deliberately omitted. However, other possibilities still remain. A key possibility relates to structural adjustment. The EU has enormous experience in this area, while Mercosur must soon take a regional –as opposed to a national– stance on it.

Before the Argentinian crisis, some authorities in Brazil raised the idea of extending Banco Nacional de Desenvolvimento Econômico e Social (BNDES) services to a Mercosur-basis, at least for selected sectors. Though the proposal met with mixed reactions within the country, it is slowly gaining wider support. At the same time, many policy-makers in Mercosur would like to see on an EU-Mercosur co-operation agenda a huge “structural adjustment project”, with possibly a percentage of funds coming from the Brussels coffers. Though the Agreement provides a good opportunity for tackling the structural adjustment issue under the co-operation heading, we find it completely far-fetched –in fact, a waste of time and energy– to count on EU money for Mercosur structural adjustment problems. A superficial analysis of the difficulties caused by the shifts in the EU structural funds programme, from the Iberian/Mediterranean members to the enlargement countries, and of the increasing demands the latter continue to make, shows that there is no room for an extra-territorial, Southern Cone initiative in this field. Without doubt, Mercosur must face the regional funds problem, but must tackle it with its own resources and creativity.

The above case offers a good example with which to close this paper. Indeed, two points are worth bearing in mind when analys-



ing a (T+C) like the one proposed. First, the co-operation agenda should be clear, compact and as precise as possible. Its projects can (and should) be varied, touching different dimensions within the regional space and sensitising agents at different levels. But clarity of objectives is mandatory, to allow for accountable country papers, in which targets can be matched to efforts and costs. Nevertheless, a second point brings to mind that big issues outside the agenda should not necessarily be avoided in a global, more general stance. It would be foolish not to use the immense experience the EU has had with structural adjustment questions when designing Mercosur's measures in this field. But this can be done in a global co-operative mood, without specific commitments. If, by chance, a clear project on the subject is identified, with mutual benefits, then nothing should prevent it from appearing on the next co-operation agenda.

Renato G. FLÔRES Jr.

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## Comments

The Flores chapter is very good and immediately captures the role of Cooperation in trade and integration initiatives: a useful tool to increase the “purity” –and hence social welfare– of public goods.

Regional integration and trade is a “regional” public good. These agreements are “impure” public goods because benefits (and costs) are not necessarily shared equitably among partners and within their respective societies. Given the increasing importance of trade in the determination of welfare during an era of globalization, coupled the expanding coverage of modern trade agreements to issues “behind borders” (domestic policy), there is an ever growing awareness of civil society about trade negotiations and interest in influencing their direction and impact.

Given this situation, negotiators not only increasingly consult their legislatures on trade strategies, but also parallel that with direct dialogues with representatives of civil society. Nevertheless, it is the role of negotiators to mediate different interests and lobbies in the broader interest of maximizing national welfare, *i.e.* creating regional public goods that are as pure as possible.

The need to purify regional public goods is related to social equity –broadening the distributional impact– but also has political economy considerations. In effect, “rivalness” and “excludability” –elements of impure public goods– can set off intense opposition to trade initiatives by marginalized groups. It is well known that “winners” are disperse in society while losers are concentrated.

The latter therefore can more easily identify their interests and coordinate positions.

A Trade and Cooperation (T&C) nexus can contribute to the purity of regional public goods. This is because Cooperation programs can advance collective social benefits of an agreement before closure of negotiations; can assist negotiators in their technical capacity to negotiate and implement welfare-enhancing agreements and can help to more equitably distribute the benefits during the transition to free trade.

(T&C) nexuses are especially helpful in North-South agreements where developing country partners face asymmetric relations in terms of capacity and impact.

The European Union (EU) conceptually approaches this issue in an innovative way. In effect, the EU creates a (T&C) nexus with their partner as part of a three pillar single undertaking for free trade, cooperation and political dialogue that emerges out of what the EU's calls Association Agreements. This is in contrast to the (T&C) nexus in the Western Hemisphere Summit Process which has a loose and relatively uncoordinated link between T and C. Flores correctly warns about the need to avoid a proliferation of C initiatives that can create unmanageable dispersion and dilution of attention and resources. Indeed, he emphasizes the need to focus on a few strategic areas with programs that have measurable outcomes, benchmarks, and pre-programmed support resources.

In this spirit, Flores proposes a narrowly focused (T&C) nexus in the process of negotiating a EU-Mercosur Association Agreement with the objective of (i) facilitating and boosting actual trade and (ii) creating an enabling environment for better trade and economic relations.

The focus on trade is appropriate. While political vision is the "mother" of integration, trade is its "father". Indeed, it is hard to imagine a broad initiative like the EU Association Agreement moving forward without a serious core of free trade and trade-related cooperation.

Flores chapter comes up with a number of proposals for trade-related cooperation. They presumably are meant to anticipate a full-blown Association Agreement, which some hope to see emerge in 2004.

There are a myriad of potential and helpful initiatives that could be put into Flores' tight cluster. All the initiatives he cites are good

ones. But if I use some additional criteria for selection I can question the convenience of at least a few of them.

I will interpret Flores intention as to promote Cooperation that is designed to deliver benefits of trade before a free trade area is actually negotiated and also serve to keep parties constructively engaged in the production of trade-related public goods during the difficult, and sometimes conflictive, process of negotiating an FTA. The criterion I will suggest is that (i) the programs should not intrude on the trade negotiators themselves (the FTA pillar of the process) and (ii) should be relatively quickly agreed on, which means avoiding thorny issues.

Based on these criteria some of Flores proposals may be questioned. The entire area of investment is extremely sensitive and clearly a touchy area of negotiations; maybe progress on Cooperation would be slow, and if conflictive, even have negative spillover effects on the negotiations themselves. GMOs put Mercosur in the middle of the EU-US WTO conflict and differences in policy in Mercosur itself. Perhaps Cooperating in this area is premature until world regulations are clarified in the WTO and Mercosur works out its differences.

Meanwhile, the telecoms Cooperation is certainly relevant, but I would avoid cooperation initiatives on telecoms deregulation until the EU better defines its internal approach. Until then efforts at Cooperation may end up in confusion. Culture is an excellent area, but definition of a cultural firm is one component I would avoid because it seems to me to be a topic better suited to the FTA negotiations; so too intellectual property rights issues. As to the “innovative” proposal on dispute settlement cooperation, I would agree it is innovative, helpful and “viable”.

But my major reservation about the proposals is that all of them curiously enter most difficult and sensitive topics. On the whole I would prefer Cooperation in less controversial areas where quick results could be achieved. For example development of a Mercosur-EU Customs Guide in paper and electronic form; while not very exotic, it could help importers and exporters. Cooperation to give shape to the EU-Mercosur Business Forum’s Plan of Action for Business Facilitation would also introduce trade-building measures that could be financed by the EU as well as the IDB Multilateral Investment Fund.

In sum, the proposals for cooperation are imaginative, elegant, constructive and some are probably “doable”, like the SPS, in the movie distribution. But more “plain vanilla” proposals might be realized more quickly, generate trade benefits, deliver a sense of quick success and spill over to a more positive attitude for accelerating conclusion of the important EU-Mercosur Association Agreement.

Robert DEVLIN

# Contributors, Seminar Program and Participants





## Contributors

Robert DEVLIN, Since 1994, he has been an economist at the Inter-American Development Bank in Washington, D.C., and currently is Deputy Manager of the Integration and Regional Programs Department. Formerly, he had worked since 1975 with the United Nations Economic Commission for Latin America and the Caribbean, in Santiago de Chile; his last position was Deputy Director of the Division of International Trade, Finance and Transport.

Devlin has a Ph.D. in Economics from American University, Washington D.C. He has published four books and numerous articles in the area of international economics and economic development.

Renato G. FLÔRES Jr. is Professor at the Graduate School of Economics (EPGE), Fundação Getulio Vargas, Rio de Janeiro. He is a specialist in international trade policy and modelling –areas where he publishes regularly– and has been particularly interested in regional integrations, in all their aspects, and the interplay between economics and law in international trade.

Sayantana GHOSAL was educated at Bombay, Delhi, Paris and Louvain-la-Neuve. He has taught at Warwick since 1997. He has several papers in academic journals including the *Journal of Economic Theory*, *Journal of Mathematical Economics*, *Journal*

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Marcus MILLER was educated at Oxford (PPE) and Yale University (Ph.D and is currently Professor of Economics and Director of Graduate Studies at the University of Warwick. He was previously professor at Manchester and lecturer at the London School of Economics and has taught as a visiting professor at University of Chicago Business School and Princeton University. He is currently Co-Director of the Centre for Study of Globalisation and Regionalisation, University of Warwick (see [www.csgr.org](http://www.csgr.org)); Research Fellow, CEPR, London; and Visiting Fellow at IIE, Washington. He acted as advisor to the Treasury Committee of the House of Commons (1981); was Houblon Norman Fellow at the Bank of England (1982); serve as joint director of International Macroeconomics Programme at CEPR (1986/91); and has several times been visiting scholar at the Federal Reserve Board, the IMF and the World Bank in Washington.

Together with Sayantan Ghosal, Jonathan Thomas and Lei Zhang, he is involved in an ESRC project on “Moral Hazard and Financial Institutions” and studies international financial institutions at the CSGR; see for example, “Creditor co-ordination, moral hazard and sovereign bankruptcy procedures” (joint with Dr. Ghosal) published in the *Economic Journal* (2003).

Pedro da MOTTA VEIGA is a partner at EcoStrat Consultores (Rio de Janeiro) and works on trade negotiations as well as trade and industrial policies issues. He is a permanent consultant to Confederação Nacional da Indústria and member of the technical coordination of Coalizão Empresarial Brasileira, of the Advi-

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Mercosur Chair of Sciences Po  
**Working Group on EU-Mercosur Negotiations (WG)**

First Cluster Workshop  
**Political Issues in the EU-Mercosur Negotiations**

with the support of  
**Inter-American Development Bank**  
and  
**Câmara de Comércio França-Brasil**



**April 11, 2003**

Maison de France - 9:30 am to 7:00 pm  
Avenida Presidente Antônio Carlos, 58 -13º andar  
Rio de Janeiro (Centro)

## Friday, April 11<sup>th</sup>

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9:30 – 9:45 am

### Opening Session

Alfredo Valladão – WG Coordinator – Professor - *Mercosur Chair of Sciences Po*, France

Pedro da Motta Veiga – First Cluster Coordinator – Permanent Consultant, *CNI*, Brazil

9:45 – 10:50 am

### The Monterrey Consensus and a New Development Paradigm

New approaches to development policy : new rules for managing sovereign debt crises and for granting development aid

*Moderator* : Alfredo Valladão – WG Coordinator - Professor *Mercosur Chair of Sciences Po*, France

*Speaker* : Marcus Miller – Professor – *University of Warwick* – United Kingdom

*Discussant* : Jérôme Sgard – Professor – *Université de Paris-Dauphine and Senior economist of CEPII*, France

10:50 – 11:20 am

### Coffee Break

11:20 am – 12:30 pm

### Security Constraints in the post-9/11 International Environment

Multilateralism and the US role, impact in the EU-Mercosur negotiations process and the political dialogue between the two regions.

*Moderator* : Pedro da Motta Veiga – First Cluster Coordinator – Permanent Consultant, *CNI*, Brazil

*Speaker* : Álvaro Vasconcelos – Director - *IEEI*, Portugal

*Discussant* : Alfredo Valladão – Professor – *Mercosur Chair of Sciences Po*, France

1:00 pm

**Lunch** at the Restaurant Le Champs Elysées - Maison de France 12º andar

2:30 – 4:00 pm

### **Enhancing the Cooperation Pillar of the Negotiations**

Cooperation and structural adjustments in the Agreement, EU-Mercosur cooperation and sustainable development

*Moderator* : Alfredo Valladão – WG Coordinator - Professor *Mercosur Chair of Sciences Po*, France

*Speaker* : Renato Flôres Jr. – Professor – *Fundação Getúlio Vargas*, Brazil

*Discussant* : Robert Devlin – Deputy Director IRDP – *Inter-American Development Bank*, Washington

4:00 – 4:30 pm

### **Coffee Break**

4:30 – 6:00 pm

### **Conclusions and Policy Recommendations**

*Moderator* : Alfredo Valladão – WG Coordinator - Professor *Mercosur Chair of Sciences Po*, France

*Speaker* : Pedro da Motta Veiga – First Cluster Coordinator – Permanent Consultant, *CNI*, Brazil

6:15 pm

### **Cocktail**

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Admission is restricted to registered participants only. Registration forms must be sent at : [chaire.mercosur@sciences-po.fr](mailto:chaire.mercosur@sciences-po.fr)

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Mercosur Chair of Sciences Po  
**Working Group on EU-Mercosur Negotiations (WG)**

First Cluster Workshop  
**Political Issues in the EU-Mercosur Negotiations**

with the support of  
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 and  
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 Avenida Presidente Antônio Carlos, 58 -13° andar  
 Rio de Janeiro (Centro)

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## Discussions



## Chapter 4

### Summary of Discussions

The Special Session discussions on Cluster 1 focused on the themes suggested by the papers presented, and were synthesised in a debate on the conclusions reached and policy recommendations.

The first theme involved the recent evolution of the discussion on “international financial architecture”, the emphasis being on the analysis of some of the main proposals in circulation over the last few years concerning the re-structuring of emerging country sovereign debt. The discussion highlighted the instability of the *status quo* as a result of “financial globalisation” and its effects on the capital account of emerging economies, which some participants claim adopted a “premature liberalization” in the 1980s and 1990s. This unstable situation encourages the formulation of proposals for dealing with developing country debt, but these incentives have proved insufficient to achieve any consensus as regards new ways to manage the financial crises of such economies.

The discussion also stressed the fact that financial globalisation paradoxically makes the local legal and institutional aspects more relevant from the point of view of preserving global stability. This affirmation should generate a tendency towards harmonising rules and standards, but this process is hindered by the heterogeneity of cultures and legal practices, as well as by the efforts of national states to preserve their sovereignty.

Two models of financial crisis management were discussed in greater detail, based on the paper: Collective Action Clauses – CACs and the Sovereign Debt Restructuring Mechanism– SDRM.

The discussions pointed out that these models produce different combinations of relationships between supra-national and national regulatory instances, and that some developing countries (including several in Latin America) display a certain resistance to models based on supra-national regulatory instances, without having made a proper assessment of the pros and cons of each respective alternative.

The second theme focused on the issues of international politics and security developed in the paper. A first area of debate involved the concept of “new multilateralism”. This new multilateralism is characterised by its distance from some key concepts of traditional multilateralism, namely, “sovereignism” and the absolute respect for the rights of states. It should also not be mistaken for multipolarism, since it is incompatible with an international order based on “hard power”. Seen in this way, new multilateralism produces a non-unipolar order in which “soft power” is predominant. Attention was drawn to the fact that the Mercosur countries –and South America in general– resist any notion of multilateralism that is less enthusiastic in its respect for national sovereignties.

Those attending the debate agreed that promoting multilateralism in a context strongly marked by the tendency to unipolarity constitutes a vital challenge for the countries and groups of countries that invest in a world order based on the exercise of “soft power”.

The issue of the impact of the increased tension between Europe and the US regarding the Mercosur countries also came into the discussion. In general terms, it was understood that the crisis between the partners to the North entailed certain costs for Mercosur countries, having lost their already relatively fragile status of the “third voice” in the Atlantic triangle.

The third theme of debate was how to treat the dimension of co-operation –and above all trade-related co-operation– within the Mercosur–European Union agreement. The chapter suggested that the dimension of cooperation would contribute to attributing to the agreement the characteristic of a “public good”. This served as the starting point of the discussions and produced a series of debates. This function of the dimension of co-operation was questioned from two different angles. The first emphasises that the co-operation agenda is moulded by the same logic of political economy that affects the other themes on the negotiations agenda, and accord-

ingly does not constitute the proper mechanism for making a trade agreement into a public good. The second argument complements the first. It defends the position that the proper mechanism for turning the agreement into a public good would be not so much to include a chapter on co-operation as to establish institutionalised channels of dialogue between the state and social groups, with a view to negotiations.

Another sphere of discussion involved selecting priority areas for a bi-regional agenda of co-operation. It was emphasised that if there were movements for this agenda to contribute to the trade agreement as a public good, then the initiatives proposed should be capable of producing positive externalities that are not “captured” by specific commercial interests. This question is particularly relevant when co-operation involves defining and establishing standards. In this situation it can end up contributing to the production of trade flows which are exclusively appropriated by certain private actors.

The fourth topic of discussion was the synthesis of the main conclusions and recommendations drawn from the special session. There was convergence on the idea that the current models of crisis-management, both in the field of international politics and finance, lack legitimacy, and at present are a source of instability and uncertainty. This realisation is not sufficient –and here lies the paradox of the present situation– to induce the consolidation of new paradigms of risk and crisis administration on the international level.

In the political field, different models –European and those of the US and the UN– compete with one another, but all of them find it difficult to become hegemonic. In the financial field, more daring proposals such as the SDRM seem condemned to failure, at least in the short-term, while some very cautious steps are being ventured with the introduction of CACs.

Another aspect dwelt upon in discussing the conclusions was the relevance of the relations between both Mercosur and Europe *vis-à-vis* the United States. Such relations, besides being fundamental to the two blocs from the economic and political point of view, have a direct effect on intra-bloc cohesion in the two groups of countries. For the Europeans, the author of the paper proposes a strategy of “critical engagement” in their relations with the US, but the debate did not specify what the equivalent of this strategy would be in the case of Mercosur.

The discussions at the session dedicated to conclusions also emphasised the need to go deeper into the theme of the emergence of new paradigms of international treatment of the question of development. The debate on re-structuring the emerging country sovereign debt is just one part of this issue. It seems very important to have a clearer view of the “implicit projects” which sustain comprehensive proposals in the dimensions of finance, trade, aid and developing countries’ domestic policies.

One item that was consensually stressed in the final discussions has to do with the challenges that Mercosur will need to face in order to adapt its agenda to the new international scenarios being delineated. In the opinion of some of the participants, the growing relevance of political and security-related themes on the international agenda, and the internal fragilities of Mercosur, together exert pressure on the integration project. Inability to respond to the challenges of the newly-born century will not only compromise the outcome of the trade negotiations in which Mercosur is involved, but will also tend to relegate the sub-regional project to the field of historical irrelevance.

Pedro da MOTTA VEIGA