Introduction to International Relations

CONTENT

1. A constructive criticism of Michael Tomz's theory of Reputation and International Cooperation.

Michael Tomz theory of Reputation and International Cooperation can be discussed in both positive and negative approaches. If lenders to foreign governments may decide a sovereign country's reputation on its external image or international financial reputation most of the countries are negatively reputed.

For an example, the annual country RepTrak reports assessed Iraq as the worst reputed country for almost a decade. RepTrak publishes reports on the reputation of organizations and places based on market research and media coverage ("RepTrak," 2019).

So, these reports are based on a country's external image and international reputation. The economy of Iraq was very much affected by its civil war, lower oil prices and political uncertainty. But the issuance of a $1 billion, five-year Iraqi sovereign bond on international markets in 2017 was a major success as investors rushed to buy the country' first independent bond sale in more than a decade. This $1billion bond matures in 2023 and brought in $6.6 billion of orders. The yield was fixed at 6.75%. So, it is lower than initial pricing of more than 7% (Hale 2017). It appears that, reputation was not considered by the lenders who bought bonds from this country. The reason could be that Iraq is vastly dominated by the oil sector, and its oil exports have been gradually increasing as a result of its new pipeline and restoration facilities ("Explaining Michael Tomz's Theory," 2019).

Consider Greece as the second example. Its GDP growth rate for 2016 was -0.19 (The World Bank & OECD National Accounts data, 2021). It has also undergone multiple bailouts by the European Union and the International Monetary Fund (IMF) (McBride 2017). The 2008 global financial crisis caused a global recession and it is the worst financial crisis seen in almost 80 years. Greece was the worst affected country of country debts. The amount of money Greece had borrowed is more than it could earn as revenue through taxes. As in 2020, the unemployment rate in Greece was around 15.47% which is the highest unemployment rate of all European Union states (Statista Inc., 2020). And yet there was a positive feedback for the first Greek bond issued in three years in 2017. Greece sold $3.5 billion in five year government bonds. The debt was priced with a yield of 4.625% which was lower than the initial rate given by the government. This shows of course investors and bondholders willingly bought the bonds despite Greece's awful credit ratings and its economic collapse which was at the center of the European zone's sovereign debt crisis. Just a few years ago private bondholders experienced huge losses on Greek debt. But the same bond holders who were burnt out in 2012 retuned to buy the bonds in 2017 (Debnath 2017).

In this line, third example is Argentina. Their debt is $323 billion as of the end of 2019 which it cannot pay back and has been the case for many years. It owes several billion dollars to the IMF and to lenders all around the world. Since its independence in 1816, Argentina has defaulted on its sovereign debts for eight times. Including the world's largest default made by Argentina in 2001 on $100 billion of bonds. The root cause of this mess goes back to several decades. However, 2017 June, Argentina borrowed 2.75 billion USD of 100-year bonds at a yield of 8%, despite its lengthy histories of sovereign defaults. Investors rushed to pour money into the economy and lenders competed eagerly for new issues of government debt. The government of Argentina could increase its overall 2017 foreign currency bond issuance target to $12.75 billion from its previous plan of issuing $10 billion in international bonds.

Considering all these records, we can see that reputation or repayment records are not the main concerns of bondholders or lenders when it comes to buying bonds with regards to international cooperation. If that was the only concern, these bonds sales should have not taken place.

But there are some examples where the reputation caused the lending rejection as well. China's Ministry of Finance failed at a bond auction in 2014, selling $3.3 billion of 1 year debt. This was less than the $4.3 billion in debt the ministry had planned to auction. This bond failure was a result of concerning a Chinese economic slowdown (Badkar 2014). In 2020, some recent corporate bond defaults in China pushed many domestic businesses to cancel their new issuances. At least 57 companies called off plans to issue a combined $6.72 billion of new fixed income securities in the domestic market (Kawase 2020). In 2011 with weakest demand for bonds, German failed in a bond auction. It sold $4.92 billion of 6 billion euro in 10-year auction. The average yield was 1.98%.

Regardless of the reputation these failed bond auctions occurred because of the economic uncertainty of the borrowing country. So Tomz's theory of reputation sustain international lending and repayment has to consider a wide range of factors when it comes to capital mobility in international level.

Discussing the holes in Tomz's theories and evidence, if the theory suffers from a weakness, it is from a tendency to make his argument too broadly. Reputation might have affected sovereign bond markets at various periods, but that does not mean that nothing else has ever mattered.

Tomz presume that there are three types of recipients of debts. Stalwarts (always pays debt), fair weathers (pays debts in good times), and lemons (never pays debt; always defaults). Lenders learn about the type of a specific borrower with time. These generalities are about all that the particular chapter contains. It is better if Tomz could use a model in which there is only one type of borrower, one who is always willing to repudiate under the right circumstances. Equilibrium of the lender and borrower is then formed by the probability of repudiation, the penalty of exclusion of payment and the amount of lending. In this way, one avoids the artificial hypothesis of inherent types and can instead try to infer how characteristics of the equilibrium, are affected by circumstances that can be examined empirically. He notes that governments change types because of various domestic political factors, but drops the issue relatively quickly. He notes that “The exact sources of heterogeneity are interesting in their own right, but are not the focus of this book. For the reputational argument to succeed, we need only accept that preferences are diverse” (Tomz 2007). This seems worthy of more attention. Are certain kinds of governments more or less likely to have preferences that favor repayment? Could such knowledge be available to investors...etc. Another possible area of concern could be how the reputation theory could be applied outside of the topic of sovereign debt. The broad theory proposed by Tomz certainly could be applied elsewhere, such as in an examination of the demands made by bargaining partners after the observation of refusal with international agreements.

Another weakness I see In Tomz’s theory is it focuses on disproving alternative hypotheses, with comprehensive empirical tests which shift the reader’s attention far away from his ideas about reputation. Although the later chapters certainly provide strong reason to his theory, the discussion could have used better to explore other issues as well.

2.1 Why do countries default while others repay?

There are many incidents where countries default on their foreign debt and also there can be several reasons in governments for defaulting.

It can be because the country is unable or unwilling to make better out come on its financial responsibilities to repay its bondholders. For an example, default may be the optimal response to severe declines in exports, government revenues, or the output of the goods and services which are traded internationally. Likewise, default may help countries cope with increases in the cost of capital, and would therefore be more likely to occur when world interest rates increase. It could also be the case that defaults offer the most relief when economic deflation cannot be smoothed by additional borrowing. Countries respond to local recessions by borrowing when global capital markets are flushed, and by defaulting when oppressive conditions in international markets make additional borrowing difficult. There are instances where declines in output of a country's economy causes default in some situations in countries but it is not the case always. On this line, one would expect an indefinite and general relationship between quantity of goods or services produced in a given time period by a country's economy and default. Many defaults over the past two centuries have coincided with dramatic collapses in economic activity, and therefore use default as a form of insurance. But there are some proportions of defaults occurred during good times as well. It has seen that countries default when economic circumstances of a country clearly would not cause a deviation of payments. So, it is evident that there isn't a relationship between the output of an economy and defaulting as such. Sometimes it is notable that many of such defaults in good times occurred when political upheavals brought new partnerships to power that favored default for opportunistic or diplomatic reasons. Therefore, we can conclude that defaults occur due to various reasons that include not only economic but also political activities that are based on not only good and bad times, but also on good and bad governments as well (Tomz and Wright 2007).

When it comes to debt repayment and default, there are several explanations we can see in the literature and in practice as well. Let's consider the most known sovereign default and repayment approached in academic thinking.

The literature can be divided into two approaches

- The 'reputation approach' by Eaton and Gersovitz (1981)
- The 'direct punishments' approach of Bulow and Rogoff (1988b, 1989a)

Eaton-Gersovitz approach

In order to maintain smooth consumption amid the ever-shifting investment opportunities, countries value access to international capital markets. If they continue to keep the good name as a reliable debtor, it is easier to pass an economic downturn without much friction. As per Eaton-Gersovitz theory, they assume that creditors have no legal right to seize the countries assets.

The reputational approach, does not need international courts, legal actions or political influences. And the knowledge of how IMF programs are formed is also irrelevant. Instead, repayment process and lending limits depend only on the basics of creating a balance between spending and saving during the different phases of time to achieve a higher overall standard of living (shortly known as consumption smoothing). Too much debt to a country, cam make benefits to retaining capital market access and consumption smoothing benefits go out of balance and it would not be possible to stick in to debt repayment program. Then maintain the reputation, the debtor will have to pay large repayment. That is how the base of reputation equilibrium has formed.

But it has been proved that this reputation-to-repayment model does not work all the time (Bulow and Rogoff 1989). Loans are repaid when the creditors have legal rights such as impeding the country's international trade or to seize its financial assets or even to consider military intervention as a solution.

Bulow-Rogoff approach

Bulow and Rogoff (1988, 1989) same as Eaton-Gersovitz assume that foreign lenders do not have legal rights in debtor country courts regarding repayments. But different to Eaton-Gersovitz, here creditors have rights in foreign creditor country courts. This assumption has seen in action in many foreign country courts where the legal decisions related to sovereign debt contracts have taken. So, in this approach debtors are provoked to repay as with the risk of being punished legally by the creditors' claims.

Apart from these academic thinking of what makes the countries repay their debts, we can find for reasons for this question in practicality as below.

We can see three reasons as to why countries repay the debts. First, countries that reject to pay their debts may have their overseas assets seized by foreign creditors. Second, countries with poor repayment reputations may be cut off from capital markets in the future. Third, unsuccessful countries might receive reduced benefits of international trade. International default might reduce trade in countries for many reasons. Most reasonable cause would be, trade credit may naturally shrink after default. On the other hand, creditors might react to default with reduced trade benefits to discourage any future defaults.

Considering all the information above we can conclude that countries tend to repay their debts because of internal reasons (trade benefits, consumption smoothing, political ideologies, economical deficits or improvements) or external reasons like legal punishments, reputation or sanctions. In this context why do some countries repay and why some others default, particularly has an objective reason. Some studies show that countries with good institutions (property rights, honest government, political stability, dependable legal system, and competitive and open markets) rarely default while countries with government polarization tend to default more (Qian 2012). A possible explanation for this correlation between polarization and default is that polarization leads to failure of coordination between government parties regarding macroeconomic policies and debt policies. As a result, countries with more polarization are more likely to default than others given the same types of external influences.

However, all these evidences proves that the decision of repayment or default really depends on the economic and political circumstances of a country and cannot be framed into a simple equilibrium. I suggest that a model built with all of the different facts we discussed above (economic and political circumstances) can rightly reason the repay or default decision of a country. And also including a parameter to assess the uncertainty of the circumstance will allow the model to handle the probabilities of these factors as well. Such a model will consider the most important internal and external influences on a country so it will be more plausible than the models existed so far with lesser parameters.

1.3 The relationship between international financial institutions, sovereign debtors and private creditors.

An international financial institution (IFI) is initiated by group of countries and subject to international law. Its shareholders are governments, international institutions and other organizations. The best known IFIs were created after second world war to help the reconstruction of Europe and foster international cooperation in world financial systems (Wikipedia contributors, 2016).

In many parts of the world IFIs play a major role in the social and economic development programs. These institutions operate independently and has a broad membership of borrowing and donor countries.

IFIs achieve their objectives through loans, credits and grants to national governments. These funding projects aim on economic and social development areas.

Let’s consider some major IFIs for the purpose of this discussion.

- International Monetary Fund (IMF)
- World Bank
- African Development Bank
- Asian Development Bank
- Caribbean Development Bank
- European Bank for Reconstruction & Development
- Inter-American Development Bank

The IMF supports financially in balance of payments (BoP) difficulties on demand for its member countries. Different to development banks, the IMF does not lend for specific projects. Following a request IMF staff team holds discussions with the government to assess the economic and financial situation, and the size of the country's overall financing needs, and agree on the appropriate policy response (International Monetary Fund, 2020). Before IMF provides lending to a country the country's government and the IMF must agree on a program of economic policies. A country's adherence to attend to the policies, known as policy conditionality, are an integral part of IMF lending. Once both parties agree on policies IMF work further on lending the money.

These policies agreed with countries can be in different forms. IMF has introduced different conditionality arrangements for different types of countries and different circumstances they face. Flexible Credit Line (FCL) and Precautionary and Liquidity Line (PLL) are two of them which has a qualification process to assess a country's credibility to access these arrangements. As per the documentation FCL is for countries with very strong fundamentals, policies, and track records of policy implementation and PLL is designed to provide liquidity to countries with sound policies under broad circumstances, including countries affected by regional or global economic and financial stress (Mutize and Nkhalamba 2020). Apart from these there are other arrangements that IMF offer that has no mention about past track records. Yet this proves IMF do consider past economic performance of a country when lending money even though it is not the case all the time.

When it comes to ratings of countries based on their creditworthiness, sovereign credit ratings are a main factor that is being considered. Since ratings provide an indication of the future strength of the issuer, the rating lasts for multiple years and while the issuer is monitored by the rating agency it possible for the issuer to access the capital markets at a lower cost of borrowing (Mutize and Nkhalamba 2020). Sovereign credit ratings give creditors an understanding about the risk related to investing in a particular country in terms of debt and any other political risk. Financial investors generally rely on bond ratings to evaluate the credit quality of specific bonds. Credit ratings indicate the probability of default. All bonds are not subject to default risk. Any security issued directly by the U.S. government is considered free of default risk.

A lot of literature since the 1990s suggests that capital inflows to developing countries are influenced by both global (push factors) and domestic (pull) factors (Calvo, Leiderman, and Reinhart 1996; Reinhart and Reinhart 2008). (Alfaro, Kalemli-Ozcan, and Volosovych 2005) have also found that international capital flows are influenced by government stability, less corruption, and legal decisions. Capital inflows can be in the form of equity or debt and differ on their risk characteristics. Among pull factors, GDP growth, returns on domestic financial assets, and country risk are related. (Alfaro, Kalemli-Ozcan, and Volosovych 2005) found that sovereign risk, allowed to 10-year government bond yields, negatively impacts Foreign Direct Investment flows (FDI net inflows are the value of inward direct investment made by non-resident investors in the reporting economy) both for origin and recipient of the European Union (EU) countries, while banking sector stability (authorized by the share of non-performing loans in total loans) matters for FDI flows from origin countries. (De, Mohapatra, and Ratha 2020) has stated that both absolute sovereign ratings and relative risk ratings are significant predictors of capital inflows of countries.

Considering all the above mentioned literature and sources, it is evident that IFIs considers about a country's ratings and potential risks which in turns a measure of past performance and reputation when deciding a financial bond with the particular country. The reason for such decisions can be understood with the Tomz's theory of reputation as it is because strong track records of policy implementation, credit ratings and sovereign risk are also a part of strong reputation of a country in international arena.

When searching through the literature as well as history we see many incidents on which we can agree with Thacker's argument for relations between sovereign debtors and private creditors.

There are evidences of private creditors intervening in politics in countries in past, dating back to 14th century. The Medicis, Fuggers, Rothschilds, Rockefellers, Morgans, Vanderbuilts and Goulds families (Ewart 2010) are most prominent of them. These wealthy families learned long ago that they could play the causeless ambitions of kings and governments by loaning them money.

The Medici Family of Italy in the 14^{th} Century spent well on gaining power and produced four popes of the Catholic Church. Then their place was replaced by the Fuggers who were there in 15^{th} and 16^{th} century. They were weavers, merchants, venture capitalists and international mercantile bankers who first started providing kings with royal clothing. Then came the banker family, Habsburgs of Austria. They are the origin of all the formally elected Holy Roman Emperors during 1438 -1740, and the rulers of the Austrian, Spanish Empires and several other countries. Then came the 18^{th} - 20^{th} century Rothschilds, Rockefellers, Morgans, Vanderbuilts, Goulds and Pulitzers. They got together and formed the U. S. Federal Reserve under the 16th Amendment. They loaned money to other international banks, kings and governments, most notably the American government.

In the early 20^{th} century, it is very notable that Takahashi Korekiyo a Japanese politician made efforts to get the financial support for Japanese government for the war with Russia (1904 -1905) (Barbasiewicz 2014). These types of financial relationships are called war bonds. Takahashi's efforts to raise funds in Europe and the United States with the support from Jacob Schiff (one of the leading American financiers of the time) who personally accompanied Takahashi while he was in London to support the funding of the war against Russia (Hess 2018). There are numerous examples of private creditors agreeing to finance wars that themselves support, and there is perhaps no better example of this than the war bond.

But war is not the only way that private creditors seek to intervene. The most obvious other one is the level of a country's debt. Private creditors do not wish to see the states to which they loan become wasteful or take actions by a government to adjusts its spending levels and tax rates to stabilize the economy that puts their own loans at risk. One interesting example of how debt can be used to affect politics was in fact the result of a private charity's work, the Bill and Melinda Gates Foundation (is an American private foundation founded by Bill and Melinda Gates.). The foundation gave Africa's largest economy a helping hand through their foundation. The foundation paid off a $76 million loan taken from Japan to aid the fight against polio in 2014. The reason for Gates' involvement and Japan not wanting to donate money has an interesting political background. It is because Nigeria has a long history of corruption so granting the money without any conditions would make some of the money been misspent. While the loan wasn't a private one, Gates' became a private actor exercising influence over state policy (the provision of funds towards polio vaccination) through debt.

Another area where private creditors have intervened in lender states is in default and their subsequent restructuring. Paul Singer's Elliott Capital was on a series of hedge funds with Argentina and the 10-year-old debt payment was lapsing behind. In order to collect the debt, the fund tried to claim money deposited by the country's central bank in the U.S. and Europe. And it tried to seize two satellite launch contracts between Argentina and SpaceX. The fund even had the ability to block Argentina from paying other creditors and raising more fund as per the rules of Southern District Court of New York.

As our search goes on, there are numerous other situations where we can that Thacker's argument is relevant to the relationship between private creditors and sovereign debtors from early days to present.

1.1 Why does the IMF get privileged treatment when repaying?

IMF is considered as a lender of last resort all around the world. A lender of last resort (LoR) is an institution, an international organization or a country's central bank, that offers loans to banks or other eligible institutions that are in difficult financial periods or are considered highly risky and near collapse. A LoR mostly lends money when a country cannot borrow from anywhere else.

In conversation with Simon Johnson, a former chief economist at the IMF, interviewed by NPR (an independent, nonprofit media organization in America) has mentioned some facts related to this topic. "Everyone pays. If you want to play in the international economy, if you want to have credit, if you want to have any kind of a normal relationship with the outside world, you need to have a normal relationship with the IMF… It's the IMF on one side and the pariahs of the international community on the other side. You know, who are you going to do business with" (Chace 2012).

Now if we carefully go through the history, IMF was established after the depression of world war II. The hunger for cooperation was high and it was needed as a crucial part of the new economic peace. So, 44 countries put in money and formed an international fund. The idea was that it would, lend out money to stabilize a country in a difficult situation. Over the time IMF became the prominent lender of the last resort with different policy changes for debtor countries.

Today, IMF has different plans for different economies (FCL, PLL) which implicitly stating, as much as any other financial institution, it considers the "past behavior" of a country while lending its money to debtors. Because of these two apparent reasons of reputation concerns and accessing financial institutions internationally without obstacles, countries always tend to repay IMF.

2. An inspection on IMF's raison d'etre and the effectiveness of its projects in countries in general.

In 1944, delegates of 44 countries gathered at a conference held in Bretton Woods, New Hampshire to agree upon a series of decisions to create a new international monetary system to help hyperinflations and deflations of countries after world war II. The Bretton Woods agreement created two new institutions, the IMF and the World Bank, which were established to help build a framework for economic cooperation. A new foreign exchange rate was introduced to the world at this conference where countries established the rate at which its currency could be converted to the weight of the gold. There, it was decided that the world's currencies couldn't be linked to gold, but they could be linked to the U.S. dollar, which was linked to gold. The raison d'etre of IMF was to help manage this system. But with the problems US government faced with money supply for financing the Vietnam war activities, disturbed exchange rate parity and inability of growing gold volume fast, it was not practical for them to subordinate their national currencies to gold. Following that in 1971 United States suspended the conversion of dollar reserves to gold, which in turn disintegrated the Bretton Woods system (Garber 1993).

Collapse of Bretton Woods system was feared by many as a collapsing period of rapid growth of international economy to an end. Yet, the transition to floating exchange rates was relatively smooth, and it helped to adjust to expensive oil rates, when the prices suddenly started going up in Oct. 1973. After the collapse of Bretton Woods, several new efforts tried to replace the global exchange rate system. The most noteworthy effort is the European Monetary System (EMS) and the creation of a single currency, the Euro. But no complete effective effort has been succeeded to replace Bretton Woods on a global level.

In such circumstances, the raison d'etre of IMF was certainly questioned but the IMF's role in lending to countries with BoPs difficulties made it an indispensable part of the international monetary arena, especially after the oil price shocks. In 1970s IMF responded to the challenges created by the oil price shocks by adapting its lending instruments. The two oil facilities set up by IMF (in 1974 and 1975) helped the importer face the already anticipated inflation and deficits of accounts in the face of increasing oil prices.

Even though IMF could not establish an international exchange rate to date, their raison d'etre was expanded to include lending money as a last resort to countries with BoP challenges. Today IMF works on three major areas.

Surveillance: Monitoring economic and financial developments and providing policy advice on crisis prevention.

Money Lending: Lending money to countries with BoPs difficulties, providing temporary financing, supporting policies aimed at correcting the underlying problems and providing loans to low income countries for poverty reduction.

Technical assistance and training: Providing technical assistance and training in its areas of expertise.

Apart from these IMF plays a major role against terrorism and money-laundering.

Assessing the effectiveness of IMF, there are instances they have received criticisms on the effectiveness of their programs. Since the establishment, IMF's policies and programs have been criticized in different perspectives most of which are transparency, effectiveness, accountability, moral hazard and conditionality. IMF was blamed for responding to crisis either too slowly or too quickly and for providing wrong solutions. Among the other criticisms, IMF programs being time consuming to negotiate and often being ineffective is most notable.

These complaints can be divided into four types.

(1) Fund programs and conditionality are inappropriate: Here, the concerns are, the approach to policies is based on the control of demand, little concern with BoPs weaknesses of the productive system, making large costs to borrowing countries through losses of output and employment, policy conditions making the politically damaging effects on the country.

(2) Fund's modes of operation and inflexibility: The inflexibility of negotiations damages the sovereignty of states and make governments refrain from taking the measures they are supposed to implement.

(3) Its credits and programs are small, expensive and short-term: The programs are short term for economies whose BoPs problems are rooted in structural weaknesses. The loans are criticized for their short maturity periods and the near-commercial rates of interest.

(4) The fund's drive is not aligned with its original expectations: The fund is dominated by few major industrial countries who pay little attention to developing country views and use their power to foster their own interests.

Following are two examples for success and failure of IMF projects.

Jordan was severely affected by its war with Israel and a major economic recession. In 1989, with inability to pay its loans and high unemployment rates the country had a struggling economy. As a solution Jordan agreed to a series of 5-year refinements with the IMF. The unemployment rate continued to increase as 230,000 Jordanians returned to country as Iraq invaded Kuwait and also because of the Gulf War. During the period of 1993-1999 IMF lent 3 fund facility loans to Jordan. As a result, Jordanian government could launce massive development and refinements projects of taxing, privatization, foreign investment and better trade policies. As in year 2000 Jordan could admit to World Trade Organization (WTO) and in 2001, they signed a free trade agreement with USA. The overall debt payment also went down to a manageable level and the country could launch a debt restructuring program as well. This is a one example of how IMF can successfully foster a country to a stable economy through their projects.

On the flip side, in 1985, Tanzania decided to contact IMF as a solution to their broken and indebted socialist state economy. As the first steps, the country's trade barriers were lowered, government programs were cut and the state owned industries were sold. These measures taken affected the country negatively. Their healthcare services were free of charge and the refinements made them charge the patients. With this, the AIDS rate shot up to 8% as well. The once free education system also started charging children so the school enrolment rate dropped from 80% to 66%. As a result, the literacy rate of the country decreased by nearly 50%. Also, from 1985-2000, gross domestic product (GDP) income of Tanzania decreased from $309 to $210. This is a one example how the IMF's one size fits all projects does not apply to all the situations.

The IMF has a very important role as the lender of last resort to the world economy. Through the use of surveillance, lending and technical assistance, it plays a vital role in identifying, analyzing and providing solutions to the problems of world economies. Yet the effectiveness of their programs has had their fair share of successes and failures. And also, countries like the United States and Europe have historically dominated the governing body (Seabury 2020). With such influences and defects in transparency and their interventionist approach to influence exchange rates of countries, the effectiveness of IMF depends on the state of the economy of the countries in problem and how appropriate the approach they undertake to reform the problematic areas as well.

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