Suggestions for Further Reading

For a comprehensive history of the World Bank's first 20 years, see Edward S. Mason and Robert E. Asher, The World Bank since Bretton Woods (Washington, DC: The Brookings Institution, 1973); and Devesh Kapur, John P. Lewis, and Richard Webb, The World Bank: Its First Half Century (Washington, DC: Brookings Institution, 1997). For a critical perspective, see Kevin Danaher, ed., 50 Years Is Enough: The Case against the World Bank and the International Monetary Fund (Boston: South End Press, 1994).

On the 1980s debt crisis and the politics of economic reform, see Robert Devlin, *Debt and Crisis in Latin America: The Supply Side of the Story* (Princeton: Princeton University Press, 1989); Stephan Haggard and Robert Kaufman, eds., *The Politics of Economic Adjustment: International Constraints, Distributive Conflicts, and the State* (Princeton: Princeton University Press, 1992); and Robert Bates and Anne O. Krueger, eds., *Political and Economic Interactions in Economic Policy Reform* (Oxford: Blackwell, 1993).

Four short articles published in the IMF's journal *Finance Development* take a new look at the Washington Consensus; Jeremy Clift, "Beyond the Washington Consensus"; John Williamson, "From Reform Agenda to Damaged Brand Name"; Guillermo Ortiz, "Latin America: Overcoming Reform Fatigue"; and Trevor A. Manuel, "Africa: Finding the Right Path." All appear in *Finance and Development* 40 (September 2003), also available online at http://www.imf.org/external/pubs/ft/fandd/2003/09/index.htm.

CHAPTER 15

Developing Countries and International Finance II: A Decade of Crises

Private flows of capital to the developing world resumed in the early 1990s, but took a form different from their previous disposition. Traditional commercial bank loans such as those at the center of the Latin American debt crisis were increasingly accompanied, and in many instances surpassed, by bond and equity flows. The emergence of large and liquid private capital flows to developing countries contributed to a rash of crises during the decade. The crises began in Mexico in 1994 and continued, almost without interruption, until the Argentinean crisis of 2001–2002. In between, financial crises struck Asia, Russia, Brazil, and Turkey. Indeed, it is not too much of an exaggeration to suggest that, in hindsight, the decade was a period of continual crisis. As governments managed the fallout from one, another began to develop. Without exception, the domestic economic and political consequences of these crises was severe: Economies collapsed, incomes fell sharply, and governments toppled.

The rash of financial crises encouraged governments to contemplate changing the crisis management system. As these new crises struck, governments turned to the debt regime established during the 1980s to manage them. As the scale and the consequences of the Asian crisis began to sink in, dissatisfaction with that regime grew. Some people argued that by applying the logic of stabilization and structural adjustment to Asia, the IMF had worsened the resulting economic crisis, pushing economies into deep recessions. They proposed that the IMF should change how it responds to crises. Others argued that the widespread belief that the IMF stood ready to "bail out" countries in distress itself encouraged the unsustainable private capital flows that created crises. These critics suggested that the IMF get out of the crisis management business altogether. Still others argued that developing countries should reintroduce controls to limit the volume of private capital flows. Criticisms prompted an extended discussion of what reforms could be adopted to reduce the frequency and severity of these new financial crises, as well as to manage them more effectively. Yet, in spite of considerable discussion, little has come of these efforts. Consequently, we move into the 21st century facing the risk of additional crises.

We examine this decade of crisis and crisis management in this chapter. We begin by looking at the series of crises that struck during the 1990s, focusing deeply on the largest of them: the 1997 Asian crisis. We then examine how that crisis subsequently prompted considerable discussion about reforming the international financial system in order to alter how crises are managed and to try to reduce the frequency of such crises in the future. We then turn our attention to the other debt crisis that has dominated North–South relations during the last 10 years, the one involving the world's poorest countries. The chapter concludes by drawing some more general lessons.

The Asian Financial Crisis

Developing countries attracted little new private capital during the 1980s. It was not until the end of the decade and after the reform process had begun to take root that private capital began flowing again to those countries. Private capital flows thus resumed in a changed environment. On the one hand, developing countries' policies toward private capital flows were radically different. Although most governments had restricted such flows into and out of their economies in connection with import substitution, many dismantled these controls in connection with policy reforms implemented during the 1980s and early 1990s. Consequently, it became much easier for private individuals to move capital into and out of emerging markets. On the other hand, liberalization of financial markets in the advanced industrialized countries had decreased the relative importance of traditional bank loans and increased the importance of securities—stocks and bonds—as sources of financing. The growing importance of nonbank capital flows was reinforced by the lingering effect of the Latin American debt crisis; few banks were willing to lend to countries that had so recently defaulted.

These changes combined to alter the composition, as well as the scale, of private capital flows to the developing world. The importance of commercial bank lending diminished, whereas that of bond and equity flows increased. Most private capital flows to Latin America during the 1990s, for example, financed government and corporate bonds and purchased stocks in newly liberalized stock markets. By the mid-1990s, private capital flows to the entire developing world had risen to more than $200 billion per year, about 3 percent of these countries' GDP. (See Figure 15.1.) Asia was the largest recipient of capital inflows prior to 1997, accounting for almost 50 percent of total flows to all developing countries in the first half of the decade. Latin America was the second-largest recipient, obtaining between one-quarter and one-third of all flows to developing countries (IMF 2000).

The resumption of private capital flows generated one crisis after another. The growing importance of bond and equity flows, often referred to as **hot money** because they can be withdrawn from a developing country at the first hint of trouble, increased the volatility of private capital flows to these "emerging market" countries. Although developing countries have struggled with such volatility throughout the last hundred years, volatility increased during the 1990s compared with earlier periods (IMF 2001, 163; World Bank 2001a). Historical evidence suggests that more volatile capital flows have been associated with lower economic growth rates over the long run (World Bank

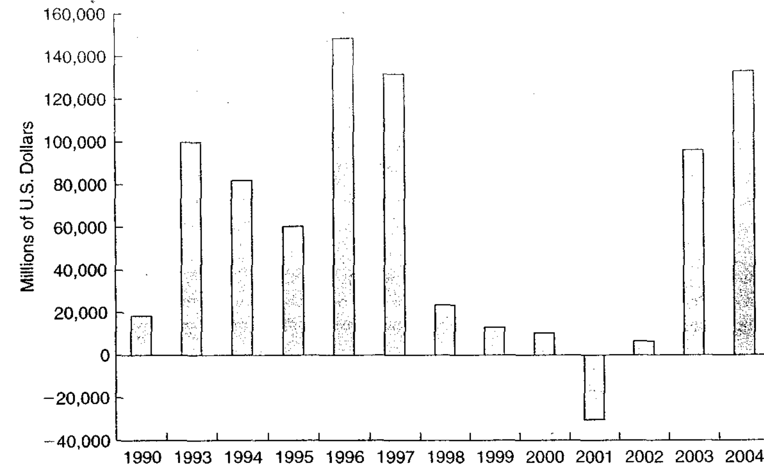


Figure 15.1 Private Capital Flows to the Developing World, 1990–2004.
Source: World Bank, *Global Development Finance 2004,* Various Issues; World Bank, Global Development Finance 2005, Table 1.1.
Note: Excludes foreign direct investment flows.

2001a, 73). In addition, the record of the 1990s indicates that increased volatility of private capital flows is associated with more frequent financial crises that substantially reduce economic growth for a year or two.

Such financial crises became all too common during the 1990s. Mexico experienced the first one in late 1994. Four Asian countries—Indonesia, Malaysia, South Korea, and Thailand—had severe crises in the summer and fall of 1997. Brazil and Russia both experienced crises in 1998. Turkey and Argentina were struck by crises in 2000 and 2001. Each crisis was distinctive in some way, and yet all shared important similarities. (See Table 15.1.) First, each of the countries struck by a crisis maintained some form of fixed exchange rate. In most instances, these governments maintained an adjustable rate, either in the form of a crawling peg or the slightly less restrictive crawling band. Second, each of the countries developed a heavy reliance on short-term foreign private capital inflows.

The combination proved perilous. Heavy dependence on short-term foreign capital required the continual rollover of foreign liabilities. The government's ability to roll over these liabilities depended critically upon its ability to maintain foreign investors' confidence in the country's commitment to the fixed exchange rate. In each crisis, events caused foreign investors to lose confidence in that commitment. The trigger for crisis varied. Sometimes it was a political shock, as in Mexico; sometimes it was an economic shock, as in Russia and Argentina; sometimes it was contagion from crises in other regions. In all instances, however, the evaporation of foreign investors' confidence in the government's commitment to the fixed exchange rate triggered massive outflows of private capital that forced governments to devalue and (with the lone exception of

Table 15.1 A Chronology of Crises, 1994–2002

Mexico (December 1994–January 1995)

Exchange Rate: Crawling band pegged to the dollar.

Financing Problem: The Mexican government began issuing short-term debt linked to the U.S. dollar in April 1994 (*Cetes*, analogous to U.S. Treasury bonds) to reduce its interest rate. The value of the *Cetes* issued soon exceeded the central bank's foreign exchange reserves.

Trigger: Unrest in Chiapas province generated a speculative attack in early December.

IMF Support: Mexico secured credits for $48.8 billion, including $17.8 billion from the IMF and $20 billion from the U.S. government.

Fallout: The government devalued the peso by 15 percent on December 20 and then floated the peso on December 22. The peso depreciated from 3.64 per dollar to more than 7 per dollar. Mexico suffered a depression and severe banking problems that prompted government rescues.

Contagion: Speculative attacks spread throughout Latin America and Asia.

East Asia (July 1997–January 1998)

See details in this chapter.

Russia (August 1998)

Exchange Rate: Crawling band pegged to the dollar.

Financing Problem: The Russian government was paying very high interest rates on large short-term debt.

Trigger: Falling prices for oil (the country's major export) and weak growth generated speculative attacks. The government widened the *ruble's* band by 35 percent in August and then floated the *ruble* in early September. The *ruble* depreciated from 6.2 per dollar to more than 20 per dollar.

IMF Support: Russia secured IMF credits of $11.2 billion in July 1998.

Fallout: The government defaulted on its ruble-denominated debt and Soviet-era foreign debt and imposed a moratorium on private-sector payments of foreign debt. The economy fell into recession. Many Russian banks became insolvent.

Contagion: Speculative attacks spread to Latin America, hitting Brazil especially hard. The U.S. hedge fund Long Term Capital Management was pushed to the brink of bankruptcy and was rescued in an effort coordinated by the Federal Reserve Bank of New York.

Brazil (January 1999)

Exchange Rate: Crawling band pegged to the U.S. dollar.

Financing Problem: Growing government debt and a sizable current-account deficit generated large short-term external debt.

Trigger: The Russian crisis and the subsequent collapse of Long Term Capital Management generated speculative attacks between August and October of 1998. Attacks resumed in early 1999 when a state government defaulted on payments to the federal government. The *real* was devalued by 9 percent on January 13, 1999, and then floated on January 18. The currency depreciated from 1.21 per dollar to 2.18.

IMF Support: Brazil secured an IMF credit of $18 billion on December 2, 1998.

Fallout: Mild; growth strengthened in 1999 and 2000. The financial system suffered little.

Contagion: Brazil's devaluation contributed to recessions in Argentina and Uruguay and generated speculative attacks that forced Ecuador to float in February 1999.

Turkey (February 2001)

Exchange Rate: Crawling peg against the dollar and the German mark.

Financing Problem: Large government short-term debt and a large current-account deficit generated heavy dependence on short-term foreign capital.

Trigger: Concern about a criminal investigation into 10 government-run banks in late November 2000 generated a speculative attack. Eight banks became insolvent and were taken over by the government. Investors lost confidence in February 2001 when conflict between the president and prime minister weakened the coalition government. The government floated the lira on February 22, and it depreciated from 668,000 per dollar to 1.6 million per dollar by October 2001.

IMF Support: Turkey secured an IMF credit of $10.4 billion on December 21.

Fallout: The Turkish economy contracted by 7.5 percent in 2001.

Contagion: None.

Argentina (2001)

Exchange Rate: Fixed to the U.S. dollar.

Financing Problem: Large government short-term debt.

Trigger: Speculative attacks against this peg emerged in 2000 and continued sporadically into 2001. The government introduced some exchange-rate flexibility in mid-2001, generating new speculative attacks. The government floated the peso in January 2002 and defaulted on its foreign debt.

IMF Support: Argentina secured a total of $40 billion in credits from the IMF and the advanced industrialized countries.

Fallout: Argentina's economy collapsed into deep depression.

Contagion: None.

Sources: Compiled from information in Eichengreen (2001); Joint Economic Committee (2003); and material on the IMF website (*www.IMF.org*).

Brazil) pushed the country into deep economic crisis. In many instances, the economic crisis toppled governments as well.

The Asian financial crisis of 1997 provides the clearest illustration of the challenges these countries faced. The Asian crisis illustrates how the new international financial crises differ from previous crises. At least three differences are worth emphasizing at the outset. First, the causes of the Asian crisis differed from the underlying causes of previous international financial crises. In contrast to the Latin American debt crisis, the Asian crisis had little to do with government borrowing, but originated instead in weak domestic banking sectors that had recently been liberalized and encouraged to intermediate between domestic and international markets. Second, the Asian crisis differed in scale from previous crises. The volume of capital outflows that Asian countries experienced and the size of the IMF-centered rescue packages that were provided to the countries in crisis were both unprecedented. Finally, the economic and political consequences of the crisis were far more severe than those of previous crises, with some countries suffering economic contractions worse than any experienced by any country since the Great Depression. What is most worrying about the Asian crisis is the possibility that it is not unique, but rather is the first of a new kind of international financial

crisis that periodically will threaten the stability of the international financial system. We examine the Asian crisis in detail in this section, looking first at its origins and management and then turning to its impact on the broader international financial system.

The Asian crisis originated in political and economic dynamics within the four Asian countries that were hardest hit: Thailand, Indonesia, South Korea, and Malaysia. During the late 1980s and early 1990s, these Asian governments liberalized their financial markets to make it easier for domestic banks and firms to borrow on international financial markets. In Thailand, for example, the government created the Bangkok International Banking Facilities in 1992 in an attempt to make Thailand a banking center in Asia. The government hoped that Thai banks would borrow on international markets and then lend the funds obtained to borrowers across Asia. Financial liberalization throughout Asia thus enabled Asian banks to intermediate between international lenders and domestic borrowers. The incentive for such intermediation was powerful. Interest rates in international markets were considerably lower than interest rates inside Asian economies. Asian banks could thus borrow money at a relatively low rate of interest, such as 9 percent, from foreign commercial banks and then lend it to domestic borrowers at a much higher rate of interest, such as 12 percent.

This type of intermediation, however, was risky. Asian banks contracted short-term loans denominated in dollars and other foreign currencies from foreign banks and then offered these funds as long-term loans denominated in the domestic currency to local borrowers. Such transactions meant that Asian banks were exposed to two distinct kinds of risk. First, they faced **exchange-rate risk**, which arose from the possibility that the government would devalue the local currency. Were this to happen, the cost of servicing the dollar-denominated loans in the domestic currency would rise substantially. At the extreme, the domestic currency cost would rise above the payments that Asian banks were receiving from the businesses to which they had lent money. Asian banks were also exposed to the risk that foreign lenders would stop rolling over their short-term loans. Because Asian banks had borrowed on a short-term basis and then made long-term loans, they needed foreign commercial banks to renew the loans they had previously made. Each time a short-term loan was due, the foreign commercial bank would simply extend the loan for an additional 6 or 12 months. If foreign commercial banks suddenly became unwilling to continue this practice, the Asian banks would be forced to repay all of their short-term debt at once. Yet, because these funds were tied up in the long-term loans that the Asian banks had made to local borrowers, the Asian banks would be unable to raise the funds needed to repay their debts to foreign banks. Both risks proved important as the crisis unfolded.

The ability of Asian banks to intermediate safely between international and domestic financial markets was compromised by flaws in Asian countries' financial regulations. The central weakness was a problem called **moral hazard**, which arises when banks believe that the government will bail them out if they suffer large losses on the loans they have made. If banks believe that the government will cover their losses, they have little incentive to carefully evaluate the risks that are associated with the loans they make. If the loans are repaid, banks earn money. If the loans are not repaid, the government—and society's taxpayers—pick up the tab. In such an environment, banks have an incentive to make riskier loans than they would make in the absence of a guarantee from the government. This incentive arises because banks charge higher interest rates to high-risk borrowers. As a result, higher-risk loans, when they are repaid, yield higher returns than low-risk loans. A government guarantee thus creates a one-way bet for banks: lend heavily to risky borrowers and profit greatly if the loans are repaid, yet suffer little if they are not, because the government will bail them out. The danger is that the practice of lending heavily to high-risk borrowers makes a systemwide financial crisis more likely. Banks will lend too much to risky borrowers, and too many of these high-risk borrowers will default on their debt. Banks will therefore lose money, forcing the government to step in and bail them out. The government guarantee thus makes a financial crisis more likely.

Moral hazard was particularly acute in many of the Asian crisis countries. Financial institutions had close ties to governments, sometimes through personal relationships and sometimes through direct government ownership. In Indonesia, for example, seven state-owned banks controlled half of the assets in the banking system (Blustein 2001, 94), and relatives and close friends of Indonesian President Suharto controlled other financial institutions. In the past, such relationships had led governments to rescue banks and other financial institutions in distress. In Thailand, for example, the government rescued the Bangkok Bank of Commerce in 1996–1997 at the cost of $7 billion (Haggard 2000, 25). In Indonesia, two large corporate groups rescued Bank Duta (which held deposits from President Suharto's political foundations) after it had lost $500 million in foreign exchange markets. The corporate rescuers were in turn rewarded by the Suharto regime (Haggard 2000, 26). Given this history, foreign and domestic financial institutions participating in the Asian market had reason to believe that Asian governments would not allow domestic financial institutions to fail. This belief in turn led international investors to lend more to Asian banks, and Asian banks to lend more to Asian businesses, than either would have been willing to lend had Asian governments not rescued banks in the past.

In principle, governments can design financial regulations to prevent the risky lending practices to which moral hazard so often gives rise. Banking regulations established and enforced by government agencies can limit the activities that financial firms engage in and thereby confine the overall risk in lending portfolios. In the Asian crisis countries, however, such financial regulation was underdeveloped, and where it did exist, it was not effectively enforced. In Indonesia, for example, any regulator "who attempted to enforce prudential rules . . . was removed from his position" (Haggard 2000, 33). Nor was this kind of treatment restricted to civil servants: The managing director of the central bank was fired in 1992, and the minister of finance was fired in 1996 (Haggard 2000, 33). As Haggard notes, the more general problem lay in the "influence that business interests exercised over legislation, regulation, and the legal process" (Haggard 2000, 38). In other words, the same network of business–government relations that created the moral hazard problem in the first place also weakened the incentives that governments had to develop and enforce effective prudential regulations. As a consequence, there were few regulatory checks on the lending practices of Asian financial institutions.

This regulatory framework enabled Asian banks to accumulate financial positions that could not easily withstand the deteriorating economic conditions that Asian countries began to encounter in late 1996 and early 1997. Deteriorating economic conditions created domestic debt-service problems in two ways. First, Asian countries' exchange rates began to appreciate against the Japanese yen in the mid-1990s. Most Asian governments pegged their currencies to the dollar. When the dollar began to appreciate against the Japanese yen in the mid-1990s, Asian currencies rose in value along with it.

Exchange-rate appreciation made it difficult for domestic firms to export to Japan, one of their major export markets, which in turn created debt-service problems for export-oriented firms. Second, real-estate prices began to fall in late 1996, creating debt-service problems for real-estate developers. In March, the Thai government purchased $4 billion of debt that property developers owed, but were unable to pay to domestic banks. By 1997, therefore, many of the Asian banks' largest domestic borrowers were struggling to service their debts. As a consequence, the number of **nonperforming loans**—loans on which interest payments had not been made for six months or more—held by Asian banks began to grow. Because domestic borrowers could not repay domestic banks, the domestic banks could not easily repay foreign banks. Domestic debt-service difficulties thus began to generate international debt-service difficulties.

Weaknesses in Asian financial systems became a source of general concern in the spring of 1997, when one of Thailand's largest financial institutions, Finance One, was discovered to be **insolvent**; that is, its total liabilities were greater than the value of its assets. The discovery that such an important financial institution was insolvent caused foreign banks to look much more closely at banks throughout Asia. Close inspection indicated that Finance One's situation was not unique; banks all over Asia were facing similar problems. In Thailand, the government suspended the operations of 16 of the nation's largest financial institutions, all of which were unable to raise the cash needed to continue operations. Deteriorating conditions in Asian financial systems and shifting international market sentiment combined to produce a panicked withdrawal of funds from Asian markets beginning in the summer of 1997. Foreign banks that had loaned heavily to Asian banks refused to roll over existing loans and demanded repayment of whatever loans they could. Funds also started flowing out of Asian stock markets.

The panic began in Thailand in May 1997, where it quickly consumed the Thai government's foreign exchange reserves and forced the government to float the baht. The panicked withdrawal of funds from Asia over the next six months struck practically every country in the region. After their experience with Thailand, financial markets shifted their attention to the Philippines, forcing the government to abandon its fixed exchange rate after only 10 days. Attention then shifted to Indonesia and Malaysia in July and August, and governments in both countries responded to massive capital outflows by abandoning their fixed exchange rates and allowing their currencies to float. From there, speculation targeted Taiwan, forcing a devaluation of the Taiwanese dollar, and Hong Kong, where capital flight caused the Hong Kong stock market to lose about one-quarter of its value in only four days. The crisis moved to South Korea in November, forcing the government to float the won by the middle of the month. A total of $60 billion was pulled from the region in the second half of 1997, roughly two-thirds of all the capital that had flowed into the region the year before. An additional $55 billion was pulled out in 1998 (IMF 1999, 92).

As the crisis struck, Asian governments turned to the IMF for financial assistance. The Philippines was the first to do so, gaining a $1.1 billion credit on July 14. The Thai government turned to the IMF two weeks later and was provided $16 billion from the IMF and other Asian countries. Indonesia was able to hold out longer, turning to the IMF only in October and receiving a $23 billion package. South Korea received the most support from the international community, acquiring $57 billion from the IMF and other governments in early December. The sizes of these financial packages were historically unprecedented. The financial support offered by the IMF, other international financial

institutions, and the advanced industrialized countries to the four countries most severely affected by the crisis—South Korea, Indonesia, Thailand, and Malaysia—totaled $117.7 billion.

As in earlier crises, financial assistance from the IMF was conditional upon economic reform. The reforms incorporated into IMF conditionality agreements in the Asian crisis targeted three broad areas: macroeconomic stabilization, reform of the financial sector, and structural reform. Macroeconomic stabilization programs were necessary, the IMF argued, to restore market confidence in the crisis countries and to stem the outflow of capital. Governments were urged to tighten monetary policy by raising interest rates in order to stem the depreciation of their currencies. Tighter fiscal policies were required to generate the financial resources needed to pay for restructuring of the financial sector. Financial sector reforms were based on three interacting components. First, governments were required to close insolvent financial institutions. In Thailand, for example, the government shut down 56 insolvent finance companies, the South Korean government closed nine large merchant banks, and the Indonesian government was required to close a large number of insolvent banks. Second, governments were asked to recapitalize weak financial institutions. Third, Asian governments were required to restructure their financial systems to improve the quality of financial intermediation. Restructuring entailed (1) redesigning financial regulations to promote better oversight, (2) ending close relationships between government officials and financial institutions, and (3) opening the domestic financial services industry to foreign financial institutions. Finally, the IMF required Asian governments to implement structural reforms, including trade liberalization, the elimination of domestic monopolies and other uncompetitive practices and regulations, and privatization of state-owned enterprises. In Thailand, structural reforms targeted the civil service and state-owned enterprises. In Indonesia, the IMF pressed the government to deregulate agriculture and reduce the monopoly position of the national agriculture marketing board. The Indonesian government was also pressed to privatize 13 state-owned enterprises and to suspend the development of auto and commercial aircraft industries.

The crisis had severe economic and political repercussions. The financial crisis and the implementation of IMF reform packages precipitated economic recessions throughout Asia. (See Table 15.2.) Indonesia experienced the biggest downturn, with

Table 15.2 Economic Growth and Current-Account Balances in Asia

	1995	1996	1997	1998
		Economic Growth (annual percent change)		
Thailand	8.8	5.5	-0.4	-5.0
Indonesia	8.2	8.0	4.6	-13.7
South Korea	8.9	7.1	5.5	-5.8
		Current-Account Balance (percent of GDP)		
Thailand	-7.8	-7.9	-2.0	6.9
Indonesia	-3.2	-3.3	-1.8	1.6
South Korea	-1.9	-4.7	-1.9	7.3

Source: IMF Annual Report, 1999.

economic output contracting by more than 13 percent in 1998. In most countries, the economic crisis hit the poor the hardest, and as a consequence, poverty rates throughout the region rose sharply. In Indonesia, the number of people living below the poverty line grew from 11 percent of the population prior to the crisis to 19.9 percent in 1998. In South Korea, the poverty rate rose from 8.6 percent of the population prior to the crisis to 19.2 percent in 1998. Deteriorating economic conditions sparked protest and political instability. Political unrest was most severe in Indonesia. Economic crisis sparked large-scale opposition to the corruption, nepotism, and cronyism that had long characterized the Suharto government. As the crisis deepened, opposition to the Suharto regime grew, demanding fundamental political reforms and a reduction of basic commodity prices, particularly of energy and rice. Protests and opposition peaked in May 1998. Four students were killed by the military during an anti-Suharto demonstration at Triskati University on May 12, sparking even larger protests during the days that followed. By May 18, some of Suharto's close associates were asking that he step down from office, and on May 21 he did so. B. J. Habibie assumed the presidency following Suharto's resignation and began the task of economic and political reform.

The economic crisis sparked political change in Thailand as well. Thailand had begun constitutional reform in the early 1990s. Reform had then stalled under competing visions of how the new political institutions should be structured. A new constitution had been drafted in 1997 before the crisis, and its acceptance by the major societal groups was "propelled forward" by the economic crisis. As Haggard (2000, 94) notes, it is "highly doubtful that [this political reform] would have occurred in the way that it did in the absence of crisis circumstances." In addition, the government that had presided over the economy in the years leading up to the crisis was unable to maintain a majority coalition. It was replaced in November 1997 by a new government based on a five-party coalition dominated by the Democrat Party, the oldest political party in Thailand. The Democrat Party was "free of the more egregious patronage, pork-barrel spending, and corruption of its opponents" (Haggard 2000, 94). In Indonesia and Thailand, therefore, the economic crisis provoked a reaction against the corruption of previous governments, mobilized societal support for far-reaching constitutional reform, and brought to power groups committed to economic and political reform.

The years since the crisis have been characterized by political stabilization, gradual economic recovery, and mixed progress on the implementation of structural reform. Economic growth has resumed, and the most severe political instabilities had ended by 1999. What remains, however, is the daunting task of restructuring the domestic financial and corporate sectors (see Lane et al. 1999). This task requires governments to recapitalize weak banks and close insolvent ones. In addition, governments must find some way to reduce the burden of large debt loads on the corporate sector and to help banks cope with large burdens of nonperforming loans. Because of the close relations between business and government in many of these countries, this process of restructuring requires governments to impose substantial costs on politically important domestic actors. As a consequence, structural reform has progressed at different speeds, and with varying degrees of success, across the region.

Today, robust growth has returned to most of the Asian countries that were hard hit by the crisis, and as Anne O. Krueger, first deputy director of the IMF, has noted, the "turmoil of the late 1990s must be a distant memory" (Krueger 2004). Yet, it is important to recognize the many ways in which the Asian crisis continues to shape the international financial system. The crisis suggests that the opening of developing-country financial systems to international capital flows poses new challenges to the international financial system. The crisis also suggests that the stability of the contemporary international financial system depends in part upon the strength of banking systems in the developing countries that are tapping international financial markets. Finally, the crisis highlights weaknesses in the way that the advanced industrialized countries and the international financial institutions manage financial crises. These weaknesses raise concerns about the ability of governments and the IMF to manage future crises effectively and have given rise to extensive discussion about systemic reform.

Reforming the Crisis Management Regime

The Asian crisis forced governments in developing countries and in the advanced industrialized countries alike to reexamine their erstwhile beliefs about the benefits that developing countries realize from unrestricted capital flows and to reevaluate how financial crises are managed. How the Asian crisis will ultimately affect the international financial system depends upon what conclusions are drawn from this process of reevaluation, which is not yet complete.

The Asian crisis caused many academics and policymakers to reevaluate the benefits that developing countries realize from complete financial liberalization and unrestricted integration into the international financial system. As former World Bank chief economist Joseph Stiglitz has suggested, financial liberalization might expose developing countries to "unnecessary risks without commensurate returns" (Wessel and Davis 1998). Such concerns have been most strongly asserted by economist Jagdish Bhagwati of Columbia University (see Bhagwati 1998b). Although the ability to draw on foreign savings can be beneficial, these critics argue, the benefits must be weighed against the costs that result from the crises that unrestricted capital flows seem to generate. Once one performs this balancing, say Bhagwati and others, one will find that there is little net gain from eliminating all capital controls and opening developing economies to increasingly volatile short-term capital flows. As a result, both "the weight of evidence and the force of logic," Bhagwati argues, "point . . . toward restraints on capital flows" (Bhagwati 1998b, 12).

This reevaluation of the costs and benefits of financial integration has led policymakers in two directions. First, governments and, to a lesser extent, the IMF have begun considering whether capital controls might help reduce the volatility of financial flows to developing countries. Policymakers have looked closely at the experience of some developing-country governments that adopted capital controls designed to discourage short-term inflows without discouraging less volatile long-term lending and foreign direct investment (see Ariyoshi et al. 2000; Velasco and Cabezas 1998). In Chile, for example, the government requires a deposit with the central bank equal to 20 percent of the total investment and a stamp tax of 1.2 percent on inflows with maturities of less than one year. Medium- and long-term flows face no such deposit requirements or taxes (Velasco and Cabezas 1998, 147). Malaysia used similar measures in the early

A CLOSER LOOK

CRISIS IN ARGENTINA

The long series of developing-world crises ended, at least for now, with a spectacular crisis in Argentina in 2001 and 2002. Argentina had been the poster child for neoliberal reform. It stabilized and restructured its economy during the early 1990s and subsequently experienced strong growth—indeed, among the strongest in all of Latin America (Krueger 2002). In 2001, Argentina collapsed in a severe economic and financial crisis. The economy shrank by a quarter between 1998 and 2002. Unemployment doubled, reaching 24 percent in 2002. Wages fell sharply, and the poverty rate doubled to more than 50 percent of the population. The economic crisis shook the political system. Argentineans took to the streets, banging on pots and pans in protest of government policy. More than 20 people were killed in these protests. The public and the collapsing economy toppled one government after another, as the country went through five presidents between mid-December 2001 and early January 2002. What went wrong?

Argentina's crisis resulted in part from the consequences of a previous government decision to fix the Argentinean peso to the U.S. dollar in order to control inflation (IMF 2003b). Argentina had been heavily indebted during the 1980s and was still struggling to implement economic reform in the early 1990s. This struggle manifested itself in part in hyperinflation, which peaked at 1,344 percent in 1990 (Joint Economic Committee 2003, 4). In 1991, Argentina passed the Convertibility Law, which established a fixed exchange rate: one peso equaled one dollar. The central bank was required to maintain sufficient dollars to guarantee this exchange rate. Thus, new pesos could be created only when the central bank had the dollars required to back them. Like EU governments, the Argentinean government believed that this fixed exchange rate would provide a credible commitment to low inflation that would break expectations of continued high inflation. Initially, the approach was quite successful; by 1994, inflation had fallen to 4 percent and remained quite low throughout the decade.

The Convertibility Law was less appropriate for the challenging international environment that Argentina confronted at the end of the decade. Having pegged to the dollar, Argentina's export competitiveness became linked to the dollar's strength in international markets. As the dollar appreciated in the late 1990s, the peso rose as well, pricing Argentina's exports out of foreign markets. Competitiveness was further diminished when Brazil devalued the real in late 1998. The overvalued peso, combined with rising global interest rates, pushed Argentina into recession in 1998.

The government could not use macroeconomic policy to stimulate the economy. Because monetary policy was maintaining the exchange rate, the government could not expand the money supply. Fiscal policy was also constrained (IMF 2003b). Government budget deficits throughout the 1990s had generated a government debt of about 50 percent of GDP, and much of this debt was denominated in foreign currencies. Fiscal expansion would require the government to borrow more, raising doubts about its ability to repay the debt. Borrowing would raise interest rates, thereby depressing economic activity. Fiscal expansion, therefore, was unlikely to promote growth. Instead, the government tried to balance the budget, which it hoped would reduce interest rates and spark renewed growth. Balancing the budget proved difficult, however: Politics prevented large expenditure cuts, and revenues fell as economic conditions deteriorated, thereby increasing the expenditure cuts needed to balance the budget.

Facing few good options, the government began to introduce exchange-rate flexibility in 2001, hoping that devaluing the peso would restore export competitiveness and generate an export-led recovery. The peso's exchange-rate peg was changed from a pure dollar peg to a peg against the dollar and the euro. In June, the government created a separate lower exchange rate for exporters. This tinkering with the exchange rate raised concerns in international financial markets that the government was about to abandon the dollar peg. Such doubts pushed interest rates up (the yield on a 10-year government bond denominated in dollars rose by 20 percentage points, to 35 percent, during 2001) and caused dollars to flow out from Argentina (Federal Reserve Board of San Francisco 2002). These dollar outflows quickly consumed Argentina's foreign exchange reserves—almost 40 percent of the country's reserves disappeared during the first seven months of 2001 (Eichengreen 2001, 11). Dollar outflows made it costly to sustain the fixed exchange rate, for the government had to contract the money supply, thereby placing strong downward pressure on the Argentinean economy.

Argentina turned to the IMF for assistance. The IMF responded by offering support in exchange for a government commitment to meaningful fiscal consolidation. Working with the IMF and individual advanced industrialized countries, Argentina was granted $40 billion of support in March 2000. The country returned to the IMF in January and September of 2001 in search of additional support. When the government proved unwilling or unable to stabilize its fiscal position, the IMF cut off access to its credits in December 2001. Unable to attract additional private funding and unable to draw from the IMF, the government defaulted on $155 billion in government bonds.

Could Argentina have avoided this crisis? In hindsight, it seems that two policy changes could have prevented the crisis. First, the government could have changed its exchange-rate arrangements during the late 1990s after inflation had come down. Establishing a more flexible exchange rate would have enabled exports to recover, and this could have reinvigorated the economy. Second, the government could have consolidated its fiscal position during the 1990s. It could then have used fiscal policy as the recession emerged. Domestic politics prevented both policy changes. The Convertibility Law was popular; it was seen to have cut inflation and restored confidence in the peso. Changing the law would have thus cut against public opinion. Fiscal consolidation was limited by political opposition to the necessary expenditure reductions.

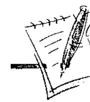
1990s, limiting the amount of foreign deposits held by domestic banks, prohibiting the sale of short-term financial instruments to foreigners, and raising the cost of borrowing from foreigners. The country reimplemented these controls as the 1997 crisis struck (Eichengreen and Fishlow 1998, 63). Supporters of this approach argue that capital controls can reduce the likelihood of financial crises in part because they reduce the total volume of capital inflows and in part because they discourage the more volatile short-term flows while encouraging long-term inflows and foreign direct investment. Others are more skeptical, suggesting that the capital controls used by the Chilean government have had little impact on capital flows into and out of that country (Edwards 1999).

Second, policymakers have become much more aware of the importance of sound banking practices in developing countries. Thus, the IMF and the World Bank have been working with developing-country governments to reform banking regulation and to promote greater transparency in accounting practices. The hope is that such reforms will make it more difficult for banks in other developing countries to develop the financial positions that so weakened banks in Asia.

The Asian crisis has also sparked extensive discussions about reform of the international financial system. These discussions emerged in response to criticisms of the way the IMF responded to the crisis (see Sachs, 1997; Krugman 1998; Stiglitz 2000, 2002; Blustein 2001). The IMF was criticized for the specific contents of the conditionality agreements it negotiated with the countries in crisis. Many observers argued that macroeconomic stabilization programs were inappropriate for those countries. Macroeconomic imbalances were not at the base of the crisis; the crisis countries were running budget surpluses and had low inflation. In this context, macroeconomic stabilization not only failed to address the cause of the crisis, but, the critics contend, also pushed the countries involved into deep recessions (Krugman 1998). Rather than implement austerity measures, the crisis countries should have been encouraged to adopt "stable or even slightly expansionary" macroeconomic policies to counteract the macroeconomic consequences of the financial crisis (Sachs 1997).

Critics also argue that the IMF erred in forcing governments in the crisis countries to close banks. Forced closures, the critics contended, exacerbated fears about financial weaknesses in the crisis countries and, by doing so, precipitated additional financial panic. This problem was particularly acute in Indonesia, where bank closures led to banking crises as local depositors rushed to withdraw their funds. Finally, critics argue that many of the structural reforms that the IMF required had little direct bearing on the immediate problems that the Asian countries faced. As Paul Volcker, former chairman of the Federal Reserve Board, inquired after learning that the IMF had demanded that the Indonesian government dismantle its clove monopoly, "What [do] spice monopolies have to do with restoring financial stability" (cited in Blustein 2001, 212)? In short, critics argue that practically every aspect of IMF programs at the time was inappropriate. The programs worsened the economic situation of the countries affected, rather than restoring market confidence and cushioning the domestic economic fallout from the financial crisis.

Other critics advance a more fundamental critique of the IMF, based on the logic of moral hazard. These critics claim that IMF financial assistance to countries in crisis makes future financial crises more likely (see, e.g., International Financial Institution Advisory Commission 2000; Calomiris 1998; Meltzer 1998). At the core of this critique lies the recognition that IMF financial assistance to crisis countries allows governments to service foreign debt. "The IMF and the principal governments lend money to the Asian governments so that they can pay the interest on their existing banks loans or repay the principal. Extending credit helps the Asian banks avoid default, but the money goes to the foreign banks" (Meltzer 1998). IMF financial assistance, therefore, encourages foreign banks to believe that they can lend to developing countries without having to fear that borrowers in those countries will default. The expectation that the IMF will bail out crisis countries to prevent defaults in turn reduces the incentive of foreign banks to limit their lending to



POLICY ANALYSIS AND DEBATE

CAPITAL CONTROLS

QUESTION

Should developing countries use capital controls to reduce capital flows?

OVERVIEW

The crises of the 1990s provoked a debate about whether developing countries should use capital controls to limit capital flows and thereby protect themselves from the risk of financial crises. Behind this disagreement lies a broader debate about the inherent stability (or instability) of financial markets. Some people argue that financial markets are inherently unstable, being prone to "manias, panics, and crashes" (Kindleberger 2000). Developing countries are particularly vulnerable to these perverse dynamics because they have weak financial institutions, thin (or illiquid) financial markets, and inadequate financial regulations. Consequently, developing countries should not be encouraged to integrate into the international financial system, but should instead tightly regulate the flow of capital into and out of their economies. In addition, governments should strive to attract foreign direct investment and other forms of long-term investments that will not expose them to the instabilities generated by short-term capital flows.

Others argue that financial markets are not inherently unstable. According to this group, financial crises such as those that struck during the 1990s are caused, not by perverse market behavior, but by bad government policies. Sometimes the bad policies are as simple as allowing too much foreign debt to be accumulated by the government. Sometimes the bad policies involve financial regulations that do little to promote prudent behavior by domestic financial institutions. Because financial crises result from bad policies, preventing crises does not require governments to insulate the national economy from the international financial system. Instead, to prevent crises, governments must simply adopt good policies. Should developing countries use capital controls to limit private capital inflows and outflows?

POLICY OPTIONS

- Use capital controls to limit the volume of capital that can flow into and out of the national economy through private transactions.
- Liberalize the capital account and allow private individuals to engage in financial transactions with the rest of the world without restriction.

POLICY ANALYSIS

- What do developing countries give up by relying on capital controls?
- Even though capital controls may limit crises, do they also create any potential dangers?

TAKE A POSITION

- Which option do you prefer? Justify your choice.
- What criticisms of your position should you anticipate? How would you defend your recommendation against these criticisms?

RESOURCES

Online: Do an online search for "capital controls developing countries." Follow the links to some sites that advocate the use of such controls and to some that criticize controls. Look in particular for Kenneth Rogoff's short article called "Straight Talk: Rethinking Capital Controls" and Sebastian Edward's article "The Mirage of Capital Controls."

In Print: See the useful and entertaining exchange between Sebastian Edwards, "A Capital Idea?" *Foreign Affairs* 78 (May–June 1999): 18–22, and Jagdish Bhagwati, "The Capital Myth," *Foreign Affairs* 77 (May–June 1998): 7–12.

high-risk countries. In fact, the critics contend, the expectation of a bailout may even increase the incentive to lend to high-risk countries. Over time, foreign lending under the shadow of IMF bailouts will lead to more frequent financial crises that grow in scale. The Mexican crisis of 1994, critics point out, required a $40 billion bailout; the Asian crisis of 1997 required a $117 billion bailout. Critics contend that the next crisis is likely to be even larger (Meltzer 1998).

Widespread criticisms of the IMF's role in managing financial crises sparked a reform process christened "strengthening the international financial architecture" (see Eichengreen 1999; Goldstein 2003). As one component of this reform process, advanced industrialized countries have been examining possible changes in two broad areas of IMF practices. First, discussion has focused on whether to reduce the scope and the detail of IMF conditionality agreements. There is widespread agreement that the IMF has overextended itself in developing structural reform packages; the typical IMF agreement contains about 50 such reforms (Goldstein 2003). Policymakers are discussing whether the IMF should "return to the basics" in designing conditionality agreements, focusing on macroeconomic stabilization and limiting structural reforms to clearly related areas. Second, discussions have concentrated on reducing the potential for moral hazard. The size of, and the interest rates attached to, IMF credits have been at the center of these discussions. There appears to be general agreement that the size of IMF loans must be reduced. Smaller loans would make it more difficult for private creditors to expect to be bailed out in the event of a crisis. There also appears to be agreement that the charges attached to IMF loans should be increased. Higher charges would raise the cost of turning to the IMF for assistance, perhaps giving governments greater incentive to manage their financial systems so as to avoid crises. Discussions about strengthening the international financial architecture have been continuing since 1998, but they have yet to produce substantial results.

In the meantime, the participants in private capital markets appear to have drawn their own conclusions from the series of crises and made adjustments of their own. The composition of capital flows to the developing world has changed greatly in the years since the Asian crisis. (See Figure 15.2.) Flows of private debt-based capital (bank loans and bonds) fell sharply after 1997 and now constitute a smaller fraction of total flows. Direct investment flows have remained quite robust, however, and, as a consequence, now make up the majority of flows to developing countries. The changing relative importance of these different types of capital flows reflects lessons drawn from the spate of recent crises by capital importers and lenders. Developing-country borrowers are increasingly wary of the negative risk associated with bank and bond-based capital flows. Consequently, demand for such flows has fallen. For their part, private lenders have become increasingly concerned about the risks they face when lending to these emerging markets and have pulled back. As a result, flows of private capital over the last few years are dominated by direct investment, which carries no obligation of repayment and cannot be transferred at the first sign of trouble. One might note the similarity between the current composition of private capital flows to the developing world and the composition that characterized the early postwar period.

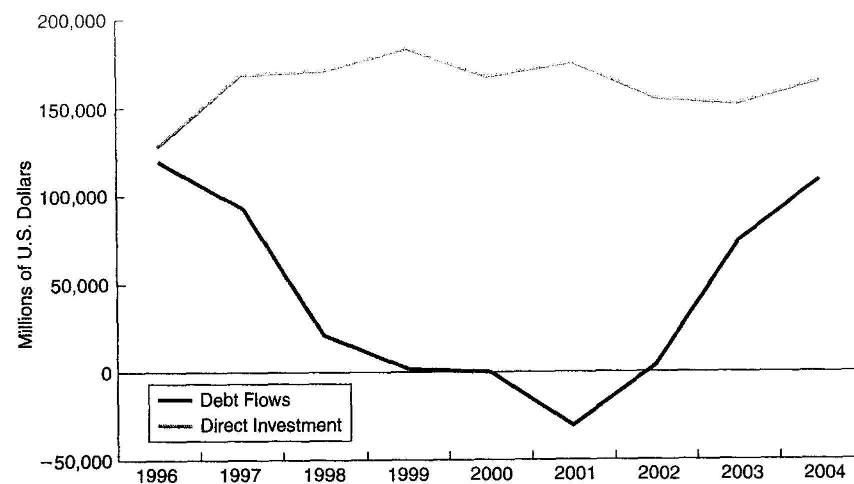


Figure 15.2 Private Capital Flows, 1996–2004.
Source: World Bank, *Global Development Finance 2005,* Table 1.1.

The Heavily Indebted Poor Countries

Crises in the emerging market countries were not the only international financial problem to preoccupy governments during the last 15 years. Considerable attention has also been focused on the equally serious, if quite different, debt problem that plagues the world's poorest nations. Together, the world's poorest countries, the majority of which are located in sub-Saharan Africa, owe about $200 billion to foreign creditors. Most of this debt is owed to official lenders—to the World Bank and the IMF or to governments in the advanced industrialized world. Payments to service this debt in 1999 (before the latest debt-relief initiative had taken effect) amounted to slightly more than $3 billion, a sum equal to 21 percent of government revenue and 15 percent of export earnings. The countries that owe this debt are poor. Roughly half of their combined population of 615 million people live on less than $1 per day, and for at least 10 of these countries, per capita income was lower in 1999 than it had been in 1960.

These large debt burdens were accumulated, as large debt burdens had been accumulated in other countries, in response to internal and external dynamics. On the one hand, domestic political pressures encouraged governments to expand their expenditures well beyond their revenues. The expansion of the civil service and the creation of too many unproductive state-owned enterprises, combined with the excessive consumption expenditures of some authoritarian rulers, generated a large appetite for foreign capital. Official creditors sometimes collaborated in this perverse dynamic, providing loans because the borrowers were important political allies rather than because the projects they proposed represented a wise use of foreign funds. International

factors also played an important role. The oil shocks of the 1970s, rising interest rates during the early 1980s, and declining terms of trade all generated a greater demand for foreign capital. As a consequence, the foreign debt owed by the 41 heavily indebted poor countries rose from $60 billion in 1980, to $105 billion by 1985, to $190 billion by 1990, and to almost $200 billion in 2000 (IMF 2000).

In absolute terms, sub-Saharan Africa's total external debt is only a fraction of the debt incurred by Latin American governments during the 1980s or by Asia during the 1990s. Yet, measured as a share of GDP, this debt is almost as large as the debt that propelled Latin America into crisis in the early 1980s. And in many cases African debt-service ratios have been much higher than Latin America's 1980s ratios. Africa's total external debt in 1983 was 38 percent of GDP, compared with 48.1 percent in Latin America, whereas debt-service ratios for the African group stood at 34.7 percent in 1985 (Lancaster and Williamson 1986, 40–41). Debt-service ratios were even larger in some African countries. One study estimated that in 1985, on the basis of debt-service ratios prior to debt rescheduling, the six African countries "most seriously affected" by the crisis had ratios ranging from a low of 47 percent in Zaire to a high of 123.9 percent in Sudan. Even in those six sub-Saharan African countries judged by this same study to be only "moderately affected" by the crisis, debt-service ratios ranged from a low of 25.6 percent in Zimbabwe to a high of 45 percent in Uganda (Jaycox, Gulhati, Lall, and Yala- manchili 1986, 51). Thus, even though Africa's external debt was smaller in absolute terms than Latin America's debt, debt-service ratios for some African countries were higher than even the worst cases in Latin America.

Such heavy debt burdens have depressed economic growth in sub-Saharan Africa. Facing large debt payments, governments are forced to devote a sizable share of their available domestic resources to debt service. These resources are therefore unavailable to finance domestic investment. The large debt burdens also make it impossible to attract new foreign capital. Private lenders are unwilling to lend to countries that are unable to service their existing debt, so private capital flows are not an option. Official lenders also are increasingly reluctant to offer new loans. As the scale of the debt problem grew, the World Bank and the IMF, as well as many of the bilateral donors, became increasingly focused on restructuring existing debt rather than on providing new loans, and any new loans that were forthcoming were typically offered primarily to facilitate debt service. As a consequence, large debts essentially forced countries to forgo access to fresh foreign capital.

The large debt burden also reduces the incentive that governments have to undertake economic reform. As we saw in the Latin American debt crisis, many of the economic gains from reform accrue to foreign lenders. Governments, as well as powerful interest groups, recognize this dynamic. Consequently, few are willing to accept the economic costs and the social disruption entailed by the fundamental economic reform necessary to climb back onto a sustainable platform. As a result, heavily indebted societies become trapped in poverty, unable to service their debt, unable to attract new foreign capital, and lacking the incentive to implement the painful reforms that could lead to a resumption of growth. Some argue that such debt-induced poverty traps are most likely in societies, like sub-Saharan Africa, that suffer from "intrinsically low productivity" caused by geographic isolation, small internal markets, adverse ecologies (fragile soils, water stress, malaria), high fertility rates, and a recent history of civil or international war (Sachs 2002).

As the economy stops growing and begins to shrink, the government's ability to provide essential services declines. Health care and education, for example, are costly to provide, and spending on such services typically declines in heavily indebted countries. Governments also increasingly lack the resources required to maintain critical infrastructure, such as the transportation network (roads, rails, and ports). The declining quality of government services and the deteriorating infrastructure push the country even further behind. Declining health and education expenditures cause labor productivity to fall, and the deterioration of critical economic infrastructure renders the country even less attractive to foreign investors. These developments pose an additional burden that must be overcome in order to return to positive economic growth.

Because African debt is owed to official rather than private creditors, the African debt crisis emerged slowly instead of bursting suddenly onto the scene, like the crises in Latin America and Asia. African nations were not subject to the sudden shutoff of lending that happened in Latin America or to the sudden reversal of capital flows that struck East Asia. Instead, the African crisis developed slowly and steadily during the 1980s and continued to grow during the 1990s. As a consequence, the general public was slow to recognize the growing African debt problem. Instead, because Africa's debt never imperiled private lenders, its debt problem was managed by the advanced industrialized countries through low-profile negotiations throughout the 1980s and 1990s. It wasn't until the Jubilee 2000 movement that African debt was thrust into public view.

Governments managed the African debt crisis by using essentially the same negotiation and rescheduling process that was used to manage the Latin American debt crisis. African governments negotiated stabilization and structural adjustment packages with the IMF and World Bank, which then provided additional financial support, and existing debt was rescheduled. Because African governments' creditors were official lenders, however, rescheduling took place in the Paris Club rather than in the London Club. Created in 1956, the **Paris Club** brings the debtor government together with its creditor governments. The IMF and the World Bank, as well as the UNCTAD and the OECD, attend as observers. In the early years of the African crisis, 85–90 percent of a country's debt would be rescheduled under terms that provided a five-year grace period and a further five years for repayment. Paris Club agreements are conditional upon the debtor government's willingness to negotiate stabilization and structural adjustment programs with the IMF and World Bank (Lancaster and Williamson 1986, 42–43). Like the London Club reschedulings, Paris Club agreements were not originally intended to forgive debt. Instead, they were aimed at restructuring the payment schedule to provide the government a bit of breathing room.

By the late 1980s, the official creditors were concluding that the heavily indebted countries would never be able to repay their debts and that the level of debt service was having strongly deleterious consequences on those countries' economic performance. As this recognition took hold, governments began to offer debt reduction packages to the most heavily indebted poor countries. The Paris Club provided the forum for these debt reduction agreements. The first debt forgiveness terms were offered by governments in 1988. Under these terms, bilateral debt could be reduced by as much as one-third. In 1991, bilateral creditors expanded the terms to allow as much as a 50 percent debt reduction. The size of the debt reduction was further increased in 1994, with a maximum of a 67 percent reduction and a minimum of 50 percent. All of these

initiatives focused on bilateral debts and excluded debt owed to multilateral organizations (the World Bank, the IMF, and regional development banks). Debt reduction was offered on a case-by-case basis through negotiations between the debtor government and its bilateral creditors in the Paris Club.

The results from these initial debt reduction programs were disappointing. In spite of reducing foreign debt by around $60 billion through this process, debt-service burdens actually increased for the poorest countries (IMF 2000; Easterly 2002, 125–126). Responding to pressure from a coalition of nongovernmental organizations and religious groups, the World Bank and the IMF launched the **Heavily Indebted Poor Countries (HIPC)** debt initiative in September 1996 in an attempt to reduce the debt. The most novel aspect of the HIPC program was that, for the first time, debt owed to multilateral lenders would be reduced. All previous debt relief measures had focused on debt owed to other governments, or bilateral debt. With HIPC, officials finally recognized that debt owed to the World Bank, the IMF, and the regional development banks would also have to be reduced.

Eligibility for the HIPC initiative was limited to the world's poorest countries. Moreover, in its initial design, the program was not intended to eliminate all foreign debt in these countries. Instead, the goal was to reduce foreign debt to sustainable levels, with sustainability defined by the international financial institutions as a debt-to-GDP or debt-to-export ratio at which a government can service the debt without needing additional debt relief or further rescheduling within the Paris Club (Van Trotsenberg and MacArthur 1999). The IMF and the World Bank estimated that the typical country that completed the program would see its debt reduced by two-thirds and its debt-service ratio cut in half.

Like other IMF and World Bank programs, the HIPC initiative involved a high degree of conditionality. The initiative is structured around a two-stage process. In the first stage, supposed to last no longer than three years, the government must work with domestic groups, the IMF, and the World Bank to develop a Poverty Reduction Strategy Paper (PRSP). The PRSP describes the macroeconomic, structural, and social policies the government will adopt in order to foster growth and reduce poverty. It also details how the government will use the resources freed up by debt service. During this stage, the government must establish a track record of implementing the strategy presented in the PRSP. At the end of the stage, the country reaches a "decision point," at which time the IMF and the World Bank conduct a debt-sustainability analysis to determine the country's eligibility for debt forgiveness. If the country's foreign debt is above 150 percent of its export earnings, the country is eligible for a debt reduction, and the World Bank, the IMF, and bilateral creditors would forgive enough of the country's debt to return it to a sustainable position.

The country then passes to the program's second stage, which is intended to enable the government to further demonstrate the strength of its commitment to the strategy established by its PRSP. "[T]he second period has no pre-determined length. It lasts until a government has satisfactorily implemented the key structural policy reforms agreed at the decision point, established macroeconomic stability, and adopted and implemented a poverty reduction strategy." Once the IMF and the World Bank conclude that the government has satisfactorily implemented its program, the country reaches the "completion point" and exits the HIPC initiative. Upon the country's reaching the completion point, the full amount of debt relief committed at the decision point would be granted.

Table 15.3 Countries in the HIPC Initiative, July 2006

Countries Having Reached the Completion Point	
Benin	Mauritania
Bolivia	Mozambique
Burkina Faso	Nicaragua
Ethiopia	Niger
Ghana	Rwanda
Guyana	Senegal
Honduras	Tanzania
Madagascar	Uganda
Mali	Zambia
Countries at the Decision Point	
Burundi	Guinea-Bissau
Cameroon	Malawi
Chad	Republic of Congo
Democratic Republic of Congo	São Tomé and Príncipé
The Gambia	Sierra Leone
Guinea	
Countries at Pre Decision Point	
Central African Republic	Myanmar
Comoros	Somalia
Côte D'Ivoire	Sudan
Lao PDR	Togo
Liberia	

Source: World Bank 2006, "Multilateral Debt Relief Initiative Fact Sheet," *http://siteresources.worldbank.org/INTDEBTDEPT/Resources/MDRIFactsheetpublicfinal.pdf* (accessed June 21, 2006).

By the end of 2004, eighteen countries had reached the completion point and been granted a total of $29 billion of debt forgiveness. (See Table 15.3.) Another 12 countries had progressed beyond the decision point and were anticipating $27 billion of debt relief. According to the World Bank, total debt for the HIPC-eligible countries fell from $80 billion to $28 billion under the program, whereas annual debt service fell from $4.9 billion to $2.6 billion. As a result, the World Bank argues, the foreign debt burden of the HIPC countries were comparable to foreign debt burdens in other developing countries (World Bank 2004). Debt-to-export ratios in both groups now stand at about 142 percent; debt-to-GDP ratios in both groups are around 35 percent. The World Bank claims that as debt burdens have fallen, government expenditures on poverty reduction programs have increased. In 1999, such expenditures accounted for only 5.5 percent of national income; by the end of 2003, they had risen to 7.3 percent. These expenditures are still lower than they are in other developing countries, but they appear to be moving in the right direction.

The HIPC initiative was an important step in the management of the debt burden. However, many observers, including a large NGO-led movement, argued that the program was not sufficiently ambitious (see, e.g., Roodman 2001; Birdsall and Williamson

2002). In particular, critics charged that HIPC failed to fully resolve the debt crisis, and that a full resolution required 100 percent forgiveness. By the fall of 2004, when an American plan to forgive 100 percent of the debt owed by the world's poorest countries leaked to the press, it was becoming apparent that at least some governments in the advanced industrialized countries were reaching the same conclusion (Blustein 2004c). The Group of Eight (G-8) initially discussed 100 percent forgiveness at the annual IMF–World Bank meetings in October 2004. Gordon Brown, Great Britain's finance minister, observed that "there's a growing consensus that the next step is [to give poor countries] up to 100 percent debt relief" (Blustein 2004a). This emerging consensus strengthened in the next six months. In early June, 2005, the G-8 finance ministers met in London and jointly proposed that the World Bank, the International Monetary Fund, and the African Development Fund (ADF) forgive all of their claims on the countries in the HIPC process. This first official call for 100 percent cancellation was reaffirmed by the G-8 heads of state one month later at the G-8 Summit in Gleneagles, Scotland.

Governments worked alongside officials from the multilateral institutions in the following months to iron out final details, the most important of which was who would bear the cost of debt cancellation. Governments announced the final agreement, christened the **Multilateral Debt Relief Initiative** (MDRI), at the IMF–World Bank meetings in March 2006. The cost of cancellation, estimated at $50 billion, is financed through contributions to the multilateral lenders by the advanced industrialized countries. Although the United States initially pushed the multilateral institutions to bear these costs, the World Bank and the IMF argued that this would take resources away from new development projects. Asking the multilateral organizations to bear the costs of 100 percent forgiveness, therefore, would come at the expense of other things. The MDRI links debt cancellation to the HIPC process. When countries reach the HIPC completion point, the IDA, the IMF, and the ADF cancel 100 percent of their claims. Seventeen countries benefited from debt cancellation in July 2006. Twenty-one additional countries will benefit as they move through the HIPC process over the next couple of years. The hope, of course, is that by eliminating the burden of debt for the world's poorest societies, governments will dedicate the resources previously directed to debt service to critical social programs such as health and education.

Conclusion

At the beginning of the 21st century, developing countries are facing new challenges in managing their relationship with the international financial system. On the one hand, international financial integration over the last 20 years has greatly expanded developing countries' opportunities for attracting foreign capital. Yet, those countries seem incapable of escaping from a repeating cycle of overborrowing, crisis, and adjustment that lies at the center of their difficulties. As we have seen, this cycle typically starts with changes in international capital markets. Petrodollars increased the supply of foreign capital to many developing countries during the 1970s, and the dynamics of international financial integration increased the supply of foreign capital to Asian countries during the 1990s. Developing countries have exploited the opportunities

presented by changes in international financial markets with great enthusiasm. By reducing the constraints imposed by limited savings and limited foreign exchange, foreign capital allows developing countries to invest more than they could if they were forced to rely solely upon domestic resources. The problem, however, is that developing countries eventually accumulate large foreign debt burdens that they cannot service and are pushed to the brink of default. Impending default causes foreign lenders to refuse additional loans to developing countries and to recall the loans they had made previously. Now shut out of international capital markets, developing countries experience severe economic crises and implement stabilization and structural adjustment packages under the supervision of the IMF and the World Bank. This cycle has repeated twice in the last 25 years, once in Latin America during the 1970s and 1980s and once in Asia during the 1990s. Although the specific details of each cycle were distinctive, both cases were characterized by the same pattern of overborrowing, crisis, and adjustment.

These cycles are driven by the interaction between developments in the international system and those within developing countries. The cycle is driven in part by interests and institutions in the international system over which developing-country governments have little control. The volume and composition of capital flows from the advanced industrialized countries and the developing world have been shaped in large part by changes in international financial markets. The buildup of debt in Latin America during the 1970s was made possible by the growth of the Euromarkets and the large deposits in these markets made by OPEC members. The buildup of large foreign liabilities by many Asian countries resulted in part from the more general increase in international financial integration during the late 1980s. The ability to service foreign debt is also influenced by international developments. In the Latin American debt crisis, rising American interest rates and falling economic growth in the advanced industrialized world made it more difficult for Latin American governments to service their foreign debt. In the Asian crisis, the dollar's appreciation against the yen made it more difficult for Asian borrowers to service their debt. Finally, the advanced industrialized countries, the IMF, and the World Bank have established the conditions under which developing countries that are experiencing crises can regain access to foreign capital.

Interests and institutions within developing countries have also played an important role. Domestic politics influences how much foreign debt is accumulated and the uses to which it is put. In the 1970s, Latin American governments made poor decisions about how to use the foreign debt they were accumulating, thereby worsening their situation when the international environment soured. In Asia, governments failed to regulate the terms under which domestic banks intermediated between foreign and domestic financial markets, thereby weakening domestic financial systems and sparking an erosion of investor confidence in Asia. A country's ability to return to international capital markets following a crisis is contingent upon policy reform. Domestic politics often prevents governments from speedily implementing such reforms. Thus, even though it might be tempting to place the blame for the cycle solely on the international financial system or solely on developing-country governments, a more reasonable approach is to recognize that these cycles are driven by the interaction between international and domestic developments.

Key Terms

Exchange-rate Risk
Heavily Indebted Poor Countries Initiative (HIPC)
Hot Money
Insolvent
Moral Hazard
Multilateral Debt Relief Initiative
Nonperforming Loans
Paris Club

Web Links

Perhaps the most useful site providing information on the Asian crisis, as well as on most contemporary issues in the international financial system, is the one maintained by Nouriel Roubini at the Stern School of Business at New York University. It can be found at *http://www.stern.nyu.edu/globalmacro/*.

The World Bank Website on the Heavily Indebted Poor Countries (HIPC) Initiative and the MRDI can be found at *http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTDEBTDEPT/0,,menuPK:64166739~pagePK:64166681~piPK:64166725~theSitePK:469043,00.html* (though it might be easier to go to http://www.worldbank.org and search for MDRI).

The IMF website on the HIPC initiative is at *http://www.imf.org/external/np/exr/facts/ hipc.htm*. You can find a useful overview of the MDRI at *http://www.imf.org/external/np/exr/facts/mdri. htm*.

Jubilee debt campaign websites can be found at *http://www.jubileeusa.org/jubilee.cgi* and *http://www.jubileedebtcampaign.org.uk*.

Suggestions for Further Reading

On the Asian financial crisis, see Stephan Haggard, The Political Economy of the Asian Financial Crisis (Washington, DC: Institute for International Economics, 2000); Paul Blustein, The Chastening: Inside the Crisis That Rocked the Global Financial System and Humbled the IMF (New York: Public Affairs, 2001); and Joseph E. Stiglitz, Globalization and Its Discontents (New York: W.W. Norton & Company, 2002).

An excellent examination of the politics of economic reform in sub-Saharan Africa is Nicolas Van de Walle, *African Economies and the Politics of Permanent Crisis, 1979–1999* (Cambridge: Cambridge University Press, 2001).

For the HIPC initiative, see Nancy Birdsall and John Williamson, *Delivering on Debt Relief: From IMF Gold to New Aid Architecture* (Washington, DC: Center for Global Development and Institute for International Economics, 2002), and David M. Roodman, *Still Waiting for the Jubilee: Pragmatic Solutions for the Third World Debt Crisis*, Worldwatch Paper 155 (Washington, DC: Worldwatch Institute, 2001).

CHAPTER 16

Globalization: Consequences and Controversies

The last 15 years have seen the emergence of a political backlash against globalization. This opposition has been most visible in a series of large protests, mostly peaceful but sometimes violent, staged at annual meetings of the World Trade Organization, the Group of Eight, the International Monetary Fund and World Bank, and the World Economic Forum. Behind the drama of public protest, however, the antiglobalization movement has articulated a number of criticisms of the global economy. The critique is multifaceted, ranging from the claim that globalization is widening global income inequality to the assertion that it is contributing to the degradation of the natural environment. What binds the many nongovernmental organizations and individuals that constitute the antiglobalization movement is opposition to a global economy that they believe prioritizes corporate and commercial interests over other concerns. As one scholar has written, "there is . . . an overarching umbrella uniting the backlash: opposition to corporate control of the global economy" (Broad 2002, 3). What binds the many reforms that the movement has proposed is the desire to shift this perceived balance so that other concerns are placed on equal footing with corporate interests.

Defenders of globalization dispute all of these assertions and question the logic of the reforms the antiglobalization movement proposes. On the one hand, the defenders of globalization dispute most of the criticisms that are advanced. Globalization is the solution to the problems of income inequality and poverty, not their cause. Although working conditions in many developing countries are not up to Western standards, in most instances, these factories offer the best opportunities that a worker in the developing world has ever had. Finally, the defenders of globalization recognize that economic activity has an impact on the natural environment, but claim that this impact can be positive as well as negative. On the other hand, the defenders question the rationale for the reforms proposed by the antiglobalization movement. Because they don't agree with the antiglobalization movement's criticisms, they see little need for reform. And even when they do see problems, they doubt that restricting trade is the most effective solution. Instead, they see such reforms as an effort to reconstruct protectionist practices into the global economy that will reverse the gains that have been achieved.