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13 Balance of Payments, Debt, Financial Crises, and Stabilization Policies

By the end of the 1970s African economies were plunged into what was to be known as the two '"lost decades."

— Encyclopedia of Twentieth-Century African History, *Dickson Eyoh and Paul Tiyambe Zeleza, editors*

As the sovereign debt workout processes are political at their core, they tend to benefit the powerful at the expense of the powerless.

—Barry Herman, José Antonio Ocampo, and Shari Spiegel, 2010

Global growth is in low gear, the drivers of activity are changing, and downside risks persist.

—International Monetary Fund, World Economic Outlook October 2013—Transitions and Tensions

13.1 International Finance and Investment: Key Issues for Developing Countries

In this chapter, after looking at a country's balance of payments accounts and recent trends in developing-country trade balances, we will examine the dimensions and effects of debt crises in developing countries. We will examine in depth how major debt crises emerged during the 1980s and into the 1990s, and why debt remained a serious impediment to growth in Africa for two decades or more after the crisis hit. These crises are of exceptional importance because of their scope and impact on slowing the development progress of dozens of developing nations over protracted periods; and much has been learned from years of careful study of the lessons from this experience. We appraise how the crisis was addressed first in Latin America (including a case study of Mexico in Box 13.3); how it was finally addressed much later in Africa; and in the process, who bore the burden of stabilization and structural adjustment programs induced by the International Monetary Fund (IMF) and supported by the World Bank. We next examine some of the smaller but significant international crises that emerged in developing countries over the subsequent decades, particularly the East Asian crisis of the late 1990s, and consider how adverse impacts of international debt crises on developing-country citizens might be minimized or prevented. We examine the international legal concept of odious debt and strategies to prevent it (Box 13.4). We conclude with an in-depth

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review of the 2008 global financial crisis that began in the United States but had major direct and indirect impacts on all developing regions. We see how ongoing conditions have potential to lead to future financial crises. Boxes 13.1 and 13.2 provide brief histories of the IMF and the World Bank, respectively.

In Chapter 14, we will extend our analysis of the role of finance in trade to examine the international flow of financial resources, consisting of (1) the flow of private foreign direct investments, primarily via the modern multinational corporation; (2) the recent resurgence of private financial "portfolio investments" in support of newly organized or refurbished "emerging" stock and bond markets; (3) the flow of remittances from migrants working abroad; (4) the flow of public financial and technical resources in the form of bilateral and multilateral foreign aid; (5) the growing importance of private financial and technical assistance in the form of nongovernmental organization programs; and (6) the most difficult, but arguably most important, aspect of aid—helping conflict and postconflict environments.

13.2 The Balance of Payments Account

General Considerations

The extension of our analysis beyond simple merchandise trade into areas related to the international flow of financial resources permits us to examine the **balance of payments** of developing nations. A balance of payments table is designed to summarize a nation's financial transactions with the outside world. It is divided into three components, as shown by the summary in Table 13.1. Note that balance of payments tables are sometimes presented in a revised format that splits the current account into two parts (called the *current account* and the *capital account*) and labels what is here called the *capital account* as the *financial account*. We retain the traditional approach to balance of payments accounting because most of the literature on developing-country debt and its ongoing treatment in the financial press is usually presented in that format. The **current account** focuses on the export and import of goods and services, investment income, **debt service** payments, and private and public net remittances and transfers. Specifically, it subtracts the value of imports from exports (the *merchandise trade balance* of Chapter 12) and then adds flows of the net investment income received from abroad (e.g., the difference between interest and dividend payments on foreign stocks, bonds, and bank deposits owned by developing-country nationals and brought into the country, as opposed to being left overseas, and those securities, if any, of the developing country owned by foreigners plus repatriated profits of multinational corporations). Taking this total ($A-B+C$ in Table 13.1), it subtracts item D, debt service payments, which represents a major component of heavily indebted poor countries current account deficits, and adds item E, net private and public remittances and transfers, such as money sent home by developing-country nationals working abroad (e.g., Mexicans in the United States, Algerians in France, Pakistanis in Kuwait). The final result ($A-B+C-D+E$ in Table 13.1) yields the current account balance—a positive balance is called a **surplus**, and a negative

Balance of payments A summary statement of a nation's financial transactions with the outside world.

Current account The portion of a balance of payments that states the market value of a country's "visible" (e.g., commodity trade) and "invisible" (e.g., shipping services) exports and imports.

Debt service The sum of interest payments and repayments of principal on external public and publicly guaranteed debt.

Surplus An excess of revenues over expenditures.

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TABLE 13.1 A Schematic Balance of Payments Account

Item	
Exports of goods and services	A
Imports of goods and services	B
Investment income	C
Debt service payments	D
Net remittances and transfers	E
Total *current account* balance $(A - B + C - D + E)$	F
Direct private investment	G
Foreign loans (private and public), minus amortization	H
Increase in foreign assets of the domestic banking system	I
Resident capital outflow	J
Total *capital account* balance $(G + H - I - J)$	K
Increase (or decrease) in *cash reserve account*	L
Errors and omissions $(L - F - K)$	M

Source: Adapted from John Williamson and Donald R. Lessard, *Capital Flight: The Problem and Policy Responses* (Washington, D.C.: Institute for International Economics, 1987), tab. 1.

Deficit An excess of expenditures over revenues.

Capital account The portion of a country's balance of payments that shows the volume of private foreign investment and public grants and loans that flow into and out of a country over a given period, usually one year.

Capital flight The transfer of funds to a foreign country by a citizen or business to avoid conditions in the source country.

Cash account (international reserve account) The balancing portion of a country's balance of payments, showing how cash balances (foreign reserves) and short-term financial claims have changed in response to current account and capital account transactions.

Hard currency The currency of a major industrial country or currency area, such as the U.S. dollar, the euro, or the Japanese yen, that is freely convertible into other currencies.

Euro A common European currency adopted by some of the countries of the European Union.

balance, a **deficit**. The current account therefore allows us to analyze the impact of various commercial policies, primarily on merchandise trade but also indirectly on investment income, debt service payments, and private transfers.

The **capital account** (financial account) records the value of private foreign direct investment (mostly by multinational corporations), foreign loans by private international banks, and loans and grants from foreign governments (as in the form of foreign aid) and multilateral agencies such as the IMF and the World Bank. It then subtracts an extremely important item, especially for the major debtor countries: what is called *resident capital outflow* in Table 13.1. To put its importance in perspective, during the 1980s debt crisis, wealthy nationals from many developing countries sent vast amounts of money into developed-nation bank accounts, real estate ventures, and stock and bond purchases; this **capital flight** is estimated to have had a value of up to half the total debt of some debtor nations at the peak of their debt problems.[1] It dwarfed the receipt of private and public loans and investments and was a major contributor to the worsening balance of payments of many developing nations. Capital flight is also a chronic problem where autocratic governments have a shaky hold on power. The balance on capital account is therefore calculated as items $G + H - I - J$ in Table 13.1. Again, a positive balance is a surplus, and a negative one, a deficit.

Finally, the **cash account**, or **international reserve account** (item L), is the balancing item (along with the *errors and omissions*, item M, which reconciles statistical inequalities but is sometimes used as a proxy for disguised or unrecorded capital flows) that is lowered (shows a net outflow of foreign reserves) whenever total disbursements on the current and capital accounts exceed total receipts. Table 13.2 presents a simple chart of what constitutes positive (credit) and negative (debit) items in a balance of payments table. Nations accumulate international cash reserves in any or all of the following three forms: (1) foreign **hard currency** (primarily U.S. dollars, but also Japanese yen, pounds sterling, or the European **euro**)[2] whenever they sell more abroad than they purchase;

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TABLE 13.2 Credits and Debits in the Balance of Payments Account

"Positive" Effects (Credits)	"Negative" Effects (Debits)
1. Any sale of goods or services abroad (export)	1. Any purchase of goods and services abroad (import)
2. Any earning on an investment in a foreign country	2. Any investment in a foreign country
3. Any receipt of foreign money	3. Any payment to a foreign country
4. Any gift or aid from a foreign country	4. Any gift or aid given abroad
5. Any foreign sale of stocks or bonds	5. Any purchase of stocks or bonds from abroad

Source: From *The ABC's of International Finance*, Second Edition, by John Charles Pool et al. Copyright © 1991 by Lexington Books. Reprinted with permission.

(2) gold, mined domestically or purchased; and (3) deposits with the IMF, which acts as a reserve bank for individual nations' central banks (see Box 13.1).

A Hypothetical Illustration: Deficits and Debts

A numerical example might prove helpful at this point. In Table 13.3 on page 684, a hypothetical balance of payments table for a developing country is portrayed. First, under the *current account*, there is a $10 million negative merchandise trade balance made up of $35 million of commodity export receipts (of which over 70%—$25 million—are derived from primary agricultural and raw material products), minus $45 million of mostly manufactured consumer, intermediate, and capital-goods import payments. To this total we add $5 million in payments for the services of foreign shipping firms and $1 million of investment income receipts representing net interest transmitted on foreign bond holdings, subtract $15 million of debt service payments representing this year's interest costs on the accumulated foreign debt of the developing country, and add $2 million of remittance and transfer receipts derived from payments of domestic workers living overseas who send home part of their earnings. Together, all of these items add up to a *deficit* on current account of $27 million.

Turning now to the *capital account*, we see that there is a net inflow of $7 million of foreign private investment, consisting of $3 million of direct investment from multinational corporations in the form of new local factories and $4 million in private loans (from international commercial banks) and private portfolio (stock and bond) investments by foreign individuals and mutual funds (see Chapter 14). There is also a net positive $3 million inflow of public loans in the form of foreign aid and multilateral agency assistance. Note that the gross *inflow* of $9 million in public loans and grants is partly offset by a $6 million capital *outflow* representing **amortization** (gradual reduction) of the principal on former loans. However, as shown in Table 13.4 on page 684, which covers the 1980s debt crisis period, these figures were reversed in the 1980s—the outflow to repay accumulated debts exceeded the inflow of *both* public aid and new refinancing of bank loans. As a result, a $35.9 billion net transfer from developed to developing countries in 1981 became a $22.5 billion transfer from poor to rich nations by 1990 (they turned positive again in the 1990s until substantial new problems emerged for some countries between 1997 and 2002).

Amortization Gradual payoff of a loan principal.

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BOX 13.1 The History and Role of the International Monetary Fund

In July 1944, representatives from 45 countries convened in Bretton Woods, New Hampshire, to plan the terms of postwar international economic cooperation. The economic devastation of the Great Depression in the 1930s, followed by the ravages of World War II, had led to the collapse of international financial markets and precipitous declines in the volume of international trade. The two "Bretton Woods Institutions," the International Monetary Fund (IMF, or simply the Fund) and the World Bank were created to rebuild international goods and capital markets and to restore the war-torn economies of Europe.

The designated roles of the IMF and the World Bank were quite different, though to some extent they were intended to complement each other. It was the prevailing wisdom at the time of the Bretton Woods conference that the stabilization of international capital markets was essential to the resumption of lively international trade and investment. This concern led to the establishment of the IMF, which became responsible for monitoring and stabilizing the international financial system through the short-term financing of balance of payments deficits. The World Bank's complementary role originally involved financing the rebuilding of national infrastructures, though this role has evolved considerably over time (see Box 13.2 on page 686). Later, the General Agreement on Tariffs and Trade (GATT) was established and led to the founding of the World Trade Organization (WTO).

The participants at the Bretton Woods conference established a system of fixed exchange rates in which each country was required to peg the value of its currency to the U.S. dollar, which was directly convertible into gold at $35 per ounce. Initially, it was the responsibility of the IMF to finance temporary balance of payments deficits arising as a consequence of these pegged exchange rates, a role that lasted until 1971, when the system was abandoned and flexible exchange rates took its place.

In the 1970s, a combination of world recession, skyrocketing fuel prices, and falling exports from many developing countries, led to large balance of payments deficits in many of these countries.

Financing from the IMF is "conditional" in the sense that recipient countries must meet a set of requirements based on the purpose of the loan, known as *conditionality*. These conditions are intended to increase the effectiveness of IMF resources by encouraging expedient behavior on the part of debtor governments facing chronic balance of payments troubles. Because the terms of conditionality are frequently considered draconian, imposing the greatest hardship on the poorest households in debtor countries, they have remained tremendously controversial.

Another emerging IMF role was "surveillance" of macroeconomic policy of each member country—but in practice with special emphasis on developing countries—leading to increasing IMF involvement in the development process. The Fund also expanded its role in the provision of information services to the public and technical assistance to developing-country governments.

By 1982, imminent default in a number of heavily indebted developing countries experiencing high inflation, weak export markets, falling terms of trade, and large government deficits threatened to destabilize international financial markets. As the severity of crises in developing countries intensified, private sources of funding shrank rapidly, reducing the liquidity necessary to service debt. To avert widespread default and hence the threat of systemic failure in international capital markets, the IMF undertook exceptional measures to effect adjustment. Its new role was instrumental in restructuring and financing developing-country debt during the debt crisis of the 1980s, the Asian currency crisis of 1997–1998, and the global financial crisis that began in 2008.

In the 1997–1998 Asian financial crisis, normally high-performing countries such as South Korea, Indonesia, and Thailand had to borrow from the IMF under strong austerity conditions—government spending cuts, tax increases, higher interest rates, and

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extensive structural reforms. A widely held view both in these countries and among external critics was that the IMF focus on austerity caused large and unnecessary recessions. Partly in response, governments throughout Asia and elsewhere worked to accelerate exports, repay IMF loans, and expand foreign-currency reserves—one of the factors in the expansion of trade surpluses from the East Asian region. This also gave rise to concerns that the IMF would receive too little income from its outstanding loans.

By 2006, after years of comparative (apparent) stability, the IMF role was newly questioned. Officials such as Mervyn King, governor of the Bank of England, argued that the IMF would have to give large developing countries such as China, India, and Brazil a greater voice in its governance (sometimes dubbed "shares and chairs"). Proposals that the IMF increase its "surveillance" of the balance sheets of developed as well as developing countries have been another topic of debate. Many observers agreed that a reformed IMF might still provide global public goods by publishing economic information and independent analysis, offering private advice to member governments, serving as an intergovernmental convener for cooperative efforts to overcome coordination failures in policy setting and in adjudicating defaults, and serving as lender of last resort. Most rich countries seemed willing to provide more voice for leading developing countries but less open to giving the IMF a more authoritative advisory say over their own economies. The possibility of an IMF successor playing the role of an independent global central bank as called for by some observers seemed even more remote. Although this debate stalled, in the wake of the 2008 global financial crisis, the IMF was again greatly expanded in resources and staff.

After the 2009 G20 meetings, the IMF announced reforms, including a crisis "firewall" bolstering lending capacity (ultimately almost quadrupling available resources); enhanced crisis prevention lending; more equitable policies for low-income countries and more concessional lending; and enhanced risk analysis. After years of criticism, the IMF announced that structural performance criteria have been discontinued for all IMF loans, including programs with low-income countries, with a new emphasis on social protection, though some of the practical effects remained unclear. Last, but not least, internal governance reform was to ensure better representation of major developing countries, and soon a consensus grew that the IMF managing directorship should not automatically go to a European as it had since its founding. Nevertheless, in 2011, French lawyer Christine Lagarde was elected the managing director of the IMF. Notably, she is the first woman to lead the IMF following 10 male leaders.

From the 2008 peak of the global financial crisis through 2013, the IMF lent countries well over $300 billion. In a historic shift, the years after the crisis saw some Organization for Economic Cooperation and Development (OECD) countries turn to the fund; and as of October 2013, the largest IMF borrowers were Greece, Portugal, and Ireland. Note, however, that these "peripheral" European countries were still considered upper-middle-income developing countries at least through the 1970s; in 2013, S&P Dow Jones reclassified (downgraded) Greece from "developed market" to "emerging market" status. Meanwhile, by 2013, Mexico, Poland, Morocco, and Colombia had the biggest precautionary (or standby) IMF loan amounts in place.

Sources: IMF Web site, http://www.imf.org/external; M. Garritsen de Vries, *The IMF in a Changing World, 1945–85* (Washington, D.C.: International Monetary Fund); Mervyn King's speech, accessed at http://www.bankofengland.co.uk/publications/speeches/2006/speech267.pdf; and Martin Wolf, "World needs independent fund," *Financial Times,* February 21, 2006. The IMF's announced reforms are reported at http://www.imf.org/external/np/exr/facts/changing.htm.

Returning to Table 13.3, we see that a major reason for the perverse flow of financial capital from poor to rich nations was very high levels of resident capital outflow. This capital flight is estimated to have amounted to almost $100 billion during the first half of the 1980s from just five of the principal countries

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TABLE 13.3 A Hypothetical Traditional Balance of Payments Table for a Developing Nation

Item	Amounts (millions of dollars)		
Current account			
Commodity exports			+35
Primary products	+25		
Manufactured goods	+10		
Commodity imports			−45
Primary products	−10		
Manufactured goods	−35		
Services (e.g., shipping costs)			−5
Investment income			+1
Debt service payments			−15
Net remittances and transfers			+2
Balance on current account		−27	
Capital account			
Private direct foreign investment			+3
Private loans and portfolio investments			+4
Government and multilateral flows (net)			+3
Loans	+9		
Debt amortization	−6		
Resident capital outflow			−8
Balance on capital account		+2	
Balance on current and capital accounts		−25	
Cash account			
Net decrease in official monetary reserves			+25
Balance on cash account		+25	

TABLE 13.4 Before and After the 1980s Debt Crisis: Current Account Balances and Capital Account Net Financial Transfers of Developing Countries, 1978–1990 (billions of dollars)

Year	Current Account	Capital Account Net Financial Transfers
1978	−32.1	33.2
1979	+10.0	31.2
1980	+30.6	29.5
1981	−48.6	35.9
1982	−86.9	20.1
1983	−64.0	3.7
1984	−31.7	−10.2
1985	−24.9	−20.5
1986	−46.4	−23.6
1987	−4.4	−34.0
1988	−22.4	−35.2
1989	−18.4	−29.6
1990	−3.0	−22.5

Sources: International Monetary Fund, *World Economic Outlook, 1988* and *1992* (Washington, D.C.: International Monetary Fund, 1988, 1992); United Nations Development Programme, *Human Development Report, 1992* (New York: Oxford University Press, 1992), tab. 4.3.

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involved (Argentina, Brazil, Mexico, the Philippines, and Venezuela)[3] and almost $200 billion over the period 1976–1985. In Table 13.3, it is listed as an outflow of $8 million. The net result is a $2 million positive balance on capital account, bringing the total balance on current and capital accounts to a deficit of $25 million.

13.3 The Issue of Payments Deficits

Some Initial Policy Issues

To finance this $25 million negative balance on combined current and capital accounts, our hypothetical country will have to draw down $25 million of its central bank holdings of official monetary reserves. Such reserves consist of gold, a few major foreign currencies, and special drawing rights at the IMF (these will be explained shortly). **International reserves** serve for countries the same purpose that bank accounts serve for individuals. They can be drawn on to pay bills and debts, they are increased with deposits representing net export sales and capital inflows, and they can be used as collateral to borrow additional reserves.

International reserves A country's balance of gold, hard currencies, and special drawing rights used to settle international transactions.

We see, therefore, that the balance on current account *plus* the balance on capital account must be offset by the balance on cash account. This is shown by the net *decrease* of $25 million in official monetary reserves. If the country is very poor, it is likely to have a very limited stock of these reserves. This overall balance of payments deficit of $25 million may therefore place severe strains on the economy and greatly inhibit the country's ability to continue importing needed capital and consumer goods. In the least developed nations of the world, which have to import food to feed a hungry population and possess limited monetary reserves, such payments deficits may spell disaster for millions of people.

Facing existing or projected balance of payments deficits on combined current and capital accounts, developing nations have a variety of policy options. For one thing, they can seek to improve the balance on current account by promoting export expansion or limiting imports (or both). In the former case, there is the further choice of concentrating on primary or secondary product export expansion. In the latter case, policies of import substitution (the protection and stimulus of domestic industries to replace previously imported manufactured goods in the local market) or selective tariffs and physical quotas or bans on the importation of specific consumer goods may be tried. Or countries can seek to achieve both objectives simultaneously by altering their official foreign-exchange rates through a currency devaluation that lowers export prices and increases import prices. Alternatively or concurrently, they can seek loans and assistance from the World Bank or the IMF. Traditionally, this has required that the countries follow very restrictive fiscal and monetary policies. These have been called *stabilization policies* by the IMF; and termed *structural adjustment* by the World Bank (see Box 13.2), which has made **structural adjustment loans** as part of this process. *Stabilization policies* and *structural adjustment*, both packages of preconditions for receiving loans, are popularly referred to as **conditionality**. These policies are designed to reduce domestic

Structural adjustment loans Loans by the World Bank to developing countries in support of measures to remove excessive governmental controls, make factor and product prices reflect scarcity values, and promote market competition.

Conditionality The requirement imposed by the International Monetary Fund that a borrowing country undertake fiscal, monetary, and international commercial reforms as a condition for receiving a loan to resolve balance of payments difficulties.

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demand so as to lower imports and reduce the inflationary pressures that may have contributed to the "overvalued" exchange rate that slowed exports and promoted imports. In recent years, these institutions have shown somewhat less policy inflexibility, but it is not yet clear whether this trend will continue.

BOX 13.2 The History and Role of the World Bank

The World Bank was created in 1944 as one of the Bretton Woods institutions (introduced in Box 13.1). Over the years, the institutional framework of the World Bank has changed considerably. The World Bank Group (widely referred to in development circles as simply the Bank) consists of five separate organizations. Initially, all bank lending was channeled through the International Bank for Reconstruction and Development (IBRD), the branch of the World Bank established following the Bretton Woods conference. At the time, its principal concern was rebuilding economies shattered during World War II. Loans are offered on commercial terms to borrowing governments or to private enterprises that have obtained government guarantees, but rates are modest due to the bank's high credit rating for its own borrowing.

Largely due to the success of the Marshall Plan, the reconstruction of Europe had become a fait accompli by the late 1950s, at which time the World Bank turned its primary focus toward investment in the poorer economies. In 1960, the International Development Association (IDA) was established to provide credits on concessional terms to countries whose per capita incomes are below a critical level. These favorable terms involve repayment periods that are several times longer than those on IBRD loans and are interest-free. The preferred terms are an out-growth of recognition that low-income countries are unable to borrow at commercial rates because they are more economically vulnerable and the financial returns to investment are slower to be realized.

In 1956, the International Finance Corporation (IFC) was established to lend directly to private enterprise. In addition, through underwriting or holding equity, it is capable of taking direct financial interests in the loan recipients to magnify economic rewards of World Bank investments. Two smaller affiliates are the Multilateral Investment Guarantee Agency (MIGA) and the International Centre for Settlement of Investment Disputes (ICSID).

For the first two decades following World War II, the bulk of World Bank lending was used to finance the building of infrastructure related to energy and transportation, since much of Europe's infrastructure had been destroyed. Rising pressure to increase the flow of funds to poorer nations, following the economic recovery of Europe, led to a similar pattern of investment in developing countries.

It was discovered, however, that infrastructural investments in the developing world failed to produce the same returns as those in Europe due largely to a lack of institutional framework and skilled labor. It became clear that a reordering of investment priorities specific to the needs of developing regions was necessary.

Since that period, the focus of the World Bank has undergone periodic shifts, though it may be more accurate to say that the Bank has added new activities rather than abandoned older ones. The "focus of the decade" is a simple way to characterize the evolution of World Bank activity favored by some economists at the Bank. In the 1950s, the focus was on physical capital; the Bank began similar lending in a growing number of developing countries for infrastructure, such as roads, electrical grids, and dams, and later increasingly for agricultural investments to assist export expansion. By the late 1960s, when Robert McNamara became its president, for the first time the Bank began to direct its attention to poverty reduction and so to put a priority on rural development (or "natural capital"). One focus was on improved access to development resources for small farmers who had been bypassed

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by previous development projects; success was mixed at best, however, and agricultural lending fell drastically in subsequent years. But, in some respects, work on poverty grew through the 1970s, and the Bank has called this its human focus (or *human capital*) period, emphasizing access of the poor to education and health services. But critics argued these efforts were ineffective due to failure to work directly with people living in poverty and comprehend their constraints, or to deal with elites who undermined or siphoned resources from projects.

In the 1980s, as described in this chapter, debt and finance ("financial capital") became the focus. In the 1970s and early 1980s, developing countries took on a lot of debt. The Bank started concentrating on structural adjustment loans—large loans that came with certain conditions on what the country could do with the money, and what kinds of policies they needed to implement, primarily focused on liberalization, marketization, and privatization. The activities of the Bank to a large extent merged with the Fund in this period and were heavily criticized by many economic development specialists and by developing countries. For example, the poor were harmed by the emphasis on policies such as "cost recovery" for services that in many cases in Africa and elsewhere were expected to extend to school and health care fees. The goal of debt reduction was often explicit; primary beneficiaries would include foreign banks. "Structural adjustment" loans were designed to promote a fundamental restructuring of the economies of countries plagued by chronic trade and budget deficits by improving the macroeconomic policy environment with an emphasis on (1) mobilizing domestic savings through fiscal and financial policies, (2) improving public-sector efficiency by stressing price-determined allocation of public investments and improving the efficiency of public enterprises, (3) improving the productivity of public-sector investments by liberalizing trade and domestic economic policies, and (4) reforming institutional arrangements to support the adjustment process. Critics of structural adjustment programs point to the fact that they frequently lead to increased hardships for the very poor and on occasion have substantially reversed the benefits of earlier economic progress. Spokespersons for the Bank now generally present this as a failed period in Bank history that also tarnished their "brand."

By the mid-1990s, the Bank resumed a greater focus on poverty. President James Wolfensohn, in what the Bank calls its "social capital" decade, led a broadening of its focus on social protection. And after years in which many heavily indebted poor countries saw little development—and little progress repaying loans—the Poverty Reduction Strategy Paper (PRSP) approach was introduced jointly with the IMF. Although intended to improve on this experience, it remained very uneven, most obviously because of its weak connection to actual budgets. However, debt burdens did begin to decrease in Africa during the 2000s through various initiatives. The Bank was sometimes criticized in this period for placing too little emphasis on government institutions for fostering development such as coordination and industrial policy. The early 2000s also saw a focus on anticorruption and improvement on governance, in general, and of program management, in particular ("institutional capital"). At the same time, the Bank has been positioning itself in the field of global public goods, focusing on the resolution of global aspects of the financial crisis, public health, vaccines, disease, and climate change brought about by global warming, where officials at the Bank see opportunities for an expansion of its mandate.

As with the IMF, expansion of voting shares and board "chairs" is at the top of the agenda for World Bank reform, along with a growing consensus that the Bank presidency should not automatically go to an American. Nevertheless, in 2012, Dr. Jim Yong Kim (a U.S. citizen born in South Korea) became the 12th president of the World Bank. Kim set about extensive reform measures and in October 2013 committed the Bank to prioritizing twin goals: ending extreme poverty by 2030 and boosting shared prosperity for the bottom 40% of the population in all developing countries.

(*Continued*)

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BOX 13.2 The History and Role of the World Bank (*Continued*)

Sources: John P. Lewis, and Richard Webb, *The World Bank: Its First Half Century* (Washington, D.C.: Brookings Institution Press, 1997), vol. 1. For more details, go to the World Bank's Web site, http://www.worldbank.org. For the Bank's "Poverty reduction strategies," see http://www.worldbank.org/prsp. For poverty-oriented discussions of development efforts, see Frances Stewart, "The many faces of adjustment," *World Development* 19 (1991): 1847–1864; Giovanni A. Cornia, Richard Jolly, and Frances Stewart, *Adjustment with a Human Face* (Oxford: Clarendon Press, 1987); and United Nations Development Programme, *Human Development Report, 1995* (New York: Oxford University Press, 1995). See also Hillary F. French, "The World Bank: Now fifty but how fit?" *World Watch*, July–August 1994, pp. 10–18; Bruce Rich, *Mortgaging the Earth: The World Bank, Environmental Impoverishment, and the Crisis of Development* (Boston: Beacon Press, 1994); Catherine Caulfield, *The World Bank and the Poverty of Nations* (New York: Henry Holt, 1997); Lance Taylor, "The revival of the liberal creed: The IMF and World Bank in a globalized economy," *World Development* 25 (1997): 145–152; Anne O. Krueger, "Whither the World Bank and the IMF?" *Journal of Economic Literature* 36 (1998): 1983–2020; and Howard Schneider, "Wider Impact Eludes World Bank," *Washington Post*, October 9, 2013, p. 13. The influential 2001 Meltzer Commission report that encouraged switching from loans to grants and global public goods support may be found at http://www.gpo.gov/fdsys/pkg/CHRG-106shrg66721/html/CHRG-106shrg66721.htm. Speech by Jim Yong Kim on "The World Bank Group Strategy: A Path to End Poverty, presented at George Washington University, Oct. 2013. The World Bank's Web site is http://www.worldbank.org.

In addition, developing countries can try to improve the balance on their capital account by encouraging more private foreign direct or portfolio investment, borrowing from international commercial banks, or seeking more public foreign assistance (aid). But neither private foreign investment nor a majority of foreign aid comes in the form of gifts (outright grants). The receipt of loan assistance implies the necessity of future repayments of principal and interest. Directly productive foreign investments in, say, building local factories entail the potential repatriation of sizable proportions of the profits of the foreign-owned enterprise. As shown in Chapter 14, the encouragement of private foreign investment has broader development implications than the mere transfer of financial or physical capital resources.

Finally, developing nations can seek to modify the detrimental impact of chronic balance of payments deficits by expanding their stocks of official monetary reserves. One way of doing this is through the acquisition of a greater share of international "paper gold," known as **special drawing rights (SDRs)**. Traditionally, under the workings of the international monetary system, countries with deficits in their balance of payments were required to pay for these deficits by drawing down on their official reserves of the two principal international monetary assets, gold and U.S. dollars. But with the growth in the volume and value of world trade, a new kind of international asset was needed to supplement the limited stock of gold and dollars. Consequently, in 1970, the IMF was given the authority to create special drawing rights. These international assets perform many of the functions of gold and dollars in settling balance of payments accounts. They are valued on the basis of a basket of currencies (a weighted average of the value of four different currencies—the U.S. dollar, the euro, the pound sterling, and the Japanese yen) and constitute claims on the IMF. They may thus be exchanged for convertible currencies to settle international official transactions. As of November 2010, one U.S. dollar

Special drawing rights (SDRs) An international financial asset created by the International Monetary Fund in 1970 to supplement gold and dollars in settling international balance of payments accounts.

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was worth 0.65 SDR. In response to the global financial crisis, the IMF raised the amount of SDRs issued nearly tenfold, to 316 billion. Eventually, the IMF would like to see all international financial settlements conducted in SDRs.

Having summarized some basic balance of payments concepts and issues as they relate to both commodity trade and international flows of financial resources, we can now briefly review some trends in the balance of payments of developing nations and then focus our attention on a detailed analysis of debt problems.

Trends in the Balance of Payments

For most developing countries, the 1980s was an extraordinarily difficult period in their balance of payments accounts with the rest of the world. Prior to 1980, the conventional development strategy had developing countries operating with sizable current account deficits, because imports of capital and intermediate goods were required to provide the machinery and equipment for rapid industrialization. Export earnings paid for most, but not all, of these imports. The financing of these deficits was therefore made possible by large resource transfers in the capital account in the form of country-to-country (bilateral) foreign aid, direct private investment by multinational corporations, private loans by international banks to both developing-country governments and local businesses, and multilateral loans from the World Bank and other international development agencies. Capital-account surpluses, therefore, typically more than compensated for current account deficits so that international reserves were being accumulated.

However, during the 1980s, the developing world experienced a substantial deterioration in both current and capital-account balances. As Table 13.4 shows, the net financial transfers component of the capital account (which includes everything in Table 13.3 except private direct foreign investment) turned sharply negative beginning in 1984. The overall transition amounted to more than $68 billion, comparing the positive $33.2 billion capital account balance in 1978 with the negative $35.2 billion balance in 1988. Meanwhile, a brief period of large current account surpluses, which reflected entirely the Organization of the Petroleum Exporting Countries' (OPEC's) booming export revenues of 1979–1980, abruptly turned negative in 1981 and, as illustrated in Table 13.5, stayed negative until 2000, when they turned positive. One reason for persistent concern has been that the recent positive balances (outside of Africa) have been possible largely because of the wide and probably unsustainable U.S. trade deficit. Commodity exporters were also boosted in recent years by the booming demand from high-growth developing economies, especially China.

The reasons for the decline in current account balances in the 1980s and 1990s included (1) a dramatic fall in commodity prices, including oil; (2) global recessions in 1981–1982 and 1991–1993, which caused a general contraction in world trade; (3) increasing protectionism in the developed world against export from developing countries; and (4) some severely overvalued exchange rates in several key developing economies, such as Argentina. This reversed in the 2000s with large current account surpluses in many middle-income countries. In most cases, these surpluses shrank in the aftermath of the global financial crisis—at least temporarily.

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TABLE 13.5 Developing Country Payments Balances on Current Account, 1980–2009 (billions of dollars)

Country Group Name	1980	1981	1982	1983	1984	1985	1986	1987	1988
Emerging market and developing economies	29.621	−25.712	−52.604	−51.328	−31.097	−32.317	−65.062	−32.642	−44.718
Central and eastern Europe	−14.435	−12.426	−4.715	−7.55	−5.859	−7.517	−8.979	−6.857	−3.048
Developing Asia	−6.893	−11.544	−13.428	−17.145	−9.859	−20.244	−16.665	−5.786	−15.365
Latin America and the Caribbean	−27.677	−43.789	−42.287	−7.501	−1.266	−1.955	−17.089	−9.427	−9.322
Middle East and North Africa	79.021	60.438	24.563	−9.828	−8.55	−1.695	−16.793	−7.705	−8.788
Sub–Saharan Africa	0.519	−17.542	−16.363	−8.736	−4.442	−0.058	−4.943	−1.883	−6.821
	1989	1990	1991	1992	1993	1994	1995	1996	1997
Emerging market and developing economies	−32.1	−18.325	−96.354	−82.433	−120.66	−80.472	−96.838	−68.491	−71.108
Central and eastern Europe	0.816	−4.623	−1.452	−1.577	−14.718	1.441	−10.067	−12.185	−16.167
Developing Asia	−18.814	−11.984	−4.028	−8.57	−28.215	−16.373	−37.330	−30.235	12.435
Latin America and the Caribbean	−4.977	−0.893	−17.374	−34.75	−45.88	−51.962	−38.003	−38.057	−66.134
Middle East and North Africa	−3.575	2.942	−66.776	−26.232	−22.305	−10.81	−3.055	15.760	15.895
Sub-Saharan Africa	−4.057	−2.387	−5.001	−6.53	−5.915	−6.068	−10.030	−4.833	−7.184
	1998	1999	2000	2001	2002	2003	2004	2005	2006
Emerging market and developing economies	−102.725	−11.290	95.837	53.507	82.743	148.898	205.685	407.037	627.183
Central and eastern Europe	−15.681	−23.585	−28.852	−10.852	−18.660	−32.551	−55.253	−60.491	−88.543
Developing Asia	53.826	39.746	42.869	40.755	63.413	83.608	91.573	142.743	271.048
Latin America and the Caribbean	−89.946	−55.521	−48.566	−53.546	−15.823	8.319	20.538	32.789	46.586
Middle East and North Africa	−26.109	16.482	80.643	48.903	33.493	61.796	92.125	207.505	281.474
Sub-Saharan Africa	−15.751	−10.414	1.649	−5.261	−12.732	−11.506	−8.640	−1.653	27.657
	2007	2008	2009	2010	2011	2012	2013		
Emerging market and developing economies	596.905	669.237	253.755	323.275	410.457	380.579	235.848		
Central and eastern Europe	−136.132	−158.981	−48.091	−82.560	−119.330	−79.357	84.844		
Developing Asia	394.913	429.367	276.764	238.819	97.572	108.721	138.461		
Latin America and the Caribbean	6.710	−39.041	−30.267	−62.792	−77.930	−104.474	140.639		
Middle East and North Africa	262.861	346.577	49.063	179.692	417.426	421.076	317.639		
Sub-Saharan Africa	9.346	−3.999	−27.582	−15.432	−17.349	−38.265	−51.996		

Note: Developing economies include what the IMF terms *emerging economies*.
Source of data: International Monetary Fund, *World Economic Outlook Database*, April 2010 and October 2013.

The capital account showed a dramatic turn in the 1980s as a combined result of rising developing-country debt service obligations, sharp declines in lending by international banks, and massive capital flight. During the 1980s, these factors turned what had previously been a positive annual resource flow of $25 billion to $35 billion from developed to less developed countries into a negative annual flow of $25 billion to $35 billion from the developing to the developed world. Behind these trends, however, was the debilitating dilemma of developing-country debt—a historically recurrent problem with important lessons for developing-country policy.

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13.4 Accumulation of Debt and Emergence of the Debt Crisis in the 1980s

Background and Analysis

The accumulation of **external debt** is a common phenomenon of developing countries at the stage of economic development where the supply of domestic savings is low, current account payments deficits are high, and imports of capital are needed to augment domestic resources. Prior to the early 1970s, the external debt of developing countries was relatively small and primarily an official phenomenon, the majority of creditors being foreign governments and international financial institutions such as the IMF, the World Bank, and regional development banks. Most loans were on concessional (low-interest) terms and were extended for purposes of implementing development projects and expanding imports of capital goods. However, during the late 1970s and early 1980s, commercial banks began playing a large role in international lending by recycling surplus Organization of the Petroleum Exporting Countries (OPEC) "petrodollars" and issuing general-purpose loans to developing countries to provide balance of payments support and expansion of export sectors.

External debt Total private and public foreign debt owed by a country.

Although foreign borrowing can be highly beneficial, providing the resources necessary to promote economic growth and development, when poorly managed, can be very costly. In recent years, these costs have greatly outweighed the benefits for many developing nations. The main cost associated with the accumulation of a large external debt is debt service. Debt service is the payment of amortization (liquidation of the principal) and accumulated interest; it is a contractually fixed charge on domestic real income and savings. As the size of the debt grows or as interest rates rise, debt service charges increase. Debt service payments must be made with foreign exchange. In other words, debt service obligations can be met only through export earnings, curtailed imports, or further external borrowing. Under normal circumstances, most of a country's debt service obligations are met by its export earnings. However, should the composition of imports change or should interest rates rise significantly, causing a ballooning of debt service payments, or should export earnings diminish, debt-servicing difficulties are likely to arise.

First, it is necessary to understand a fundamental concept, known as the **basic transfer**.[4] The basic transfer of a country is defined as the net foreign-exchange inflow or outflow related to its international borrowing. It is measured as the difference between the net capital inflow and interest payments on the existing accumulated debt. The net capital inflow is simply the difference between the gross inflow and the amortization on past debt. The basic transfer is an important concept because it represents the amount of foreign exchange that a particular developing country is gaining or losing each year from international capital flows. As you will soon discover, the basic transfer turned very negative for developing nations during the 1980s, causing a loss of foreign exchange and a net outflow of capital.

Basic transfer Net foreign-exchange inflow or outflow related to a country's international borrowing; the quantitative difference between the net capital inflow (gross inflow minus amortization on past debt) and interest payments on existing accumulated debt.

The basic-transfer equation can be expressed as follows. Let the net capital inflow, F_N, be expressed as the rate of increase of total external debt, and let D represent the total accumulated foreign debt. If d is the percentage rate of increase in that total debt, then

$$F_N = dD \tag{13.1}$$

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Because interest must be paid each year on the accumulated debt, let us let r equal the average rate of interest so that rD measures total annual interest payments. The basic transfer (BT) then is simply the net capital inflow minus interest payments, or

$$BT = dD - rD = (d - r)D \tag{13.2}$$

BT will be positive if $d > r$, and the country will be gaining foreign exchange. However, if $r > d$, the basic transfer turns negative, and the nation loses foreign exchange. Any analysis of the evolution of, and prospects for, debt crises requires an examination of the various factors that cause d and r to rise and fall.

In the early stages of debt accumulation, when a developing country has a relatively small total debt, D, the rate of increase, d, is likely to be high. Also, because most first-stage debt accumulation comes from official (as opposed to private) sources in the form of bilateral foreign aid and World Bank lending, most of the debt is incurred on concessional terms—that is, at below-market interest rates with lengthy repayment periods. Consequently, r is quite low and in any event less than d. As long as this accumulating debt is being used for productive development projects with rates of return in excess of r, the additional foreign exchange and rising foreign debt represented by the positive basic transfers pose no problems for recipient nations. In fact, as noted in earlier chapters, this process of debt accumulation for productive investments in both rural and urban areas represents an essential ingredient in any viable strategy of long-term development.

A serious problem can arise, however, when (1) the accumulated debt becomes very large so that its rate of increase, d, naturally begins to decline as amortization rises relative to rates of new gross inflows; (2) the sources of foreign capital switch from long-term "official flows" on fixed, concessional terms to short-term, variable-rate private bank loans at market rates that cause r to rise; (3) the country begins to experience severe balance of payments problems as commodity prices plummet and the terms of trade rapidly deteriorate; (4) a global recession or some other external shock, such as a jump in oil prices, a steep rise in U.S. interest rates on which variable-rate private loans are based, or a sudden change in the value of the dollar, in which most debts are denominated, takes place; (5) a loss in confidence in the ability of a developing country to repay resulting from points 2, 3, and 4 occurs, causing private international banks to cut off their flow of new lending; and (6) a substantial flight of capital is precipitated by local residents who, for political or economic reasons (e.g., expectations of currency devaluation), send great sums of money out of the country to be invested in developed-country financial securities, real estate, and bank accounts. All six factors can combine to lower d and raise r in the basic-transfer equation, with the net result that the overall basic transfer becomes highly negative and capital flows from the underdeveloped to the developed world (as shown in Table 13.5). The debt crisis then becomes a self-reinforcing phenomenon, and heavily indebted developing countries are forced into a downward spiral of negative basic transfers, dwindling foreign reserves, and stalled development prospects. The story of the debt crisis of the 1980s is largely told by the simple analysis of the factors affecting

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the basic-transfer mechanism of Equation 13.2. Against this analytical background, we can now look at the specific details of the 1980s debt crisis and the policy responses in the 1980s and early 1990s, and, in the case of many African and some other low-income economies, into the late 1990s and 2000s.

Origins of the 1980s Debt Crisis

The seeds of the 1980s debt crisis were sown in the 1974–1979 period, when there was a virtual explosion in international lending, precipitated by the first major OPEC oil price increase. By 1974, developing countries had begun playing a larger role in the world economy, having averaged growth rates of 6.6% in 1967–1973. Mexico, Brazil, Venezuela, and Argentina in Latin America, among other nations, had begun importing heavily, especially capital goods, oil, and food. Following outward-looking development strategies, they expanded their exports aggressively. In the face of high oil prices and a worldwide recession, in which the growth rates of the industrialized countries fell from an average of 5.2% in 1967–1974 to an average of 2.7% for the rest of the 1970s, many developing countries sought to sustain their high growth rates through increased borrowing. Although lending from official sources, particularly nonconcessional lending, increased significantly, it was insufficient to meet growth needs. Furthermore, countries with an excess of imports over lagging exports were reluctant to approach official sources, such as the IMF, that might subject them to painful policy adjustments. So the middle-income and newly industrializing developing countries turned to commercial banks and other private lenders, which began issuing general-purpose loans to provide balance of payments support. Commercial banks, holding the bulk of the OPEC surplus (which had jumped from $7 billion in 1973 to $68 billion in 1974 and ultimately peaked in this period at $115 billion in 1980) and facing a low demand for capital from the slower-growing industrialized countries, aggressively competed in lending to developing countries on comparatively permissive and favorable terms. Figure 13.1 portrays the mechanism by which OPEC petrodollars were recycled, starting with Middle Eastern oil export earnings being deposited in U.S. and European banks, which then lent these dollar balances to developing-world public- and private-sector borrowers. Over $350 billion was recycled from OPEC countries between 1976 and 1982.

As a result of all these factors, the total external debt of developing countries more than doubled from $180 billion in 1975 to $406 billion in 1979, increasing over 20% annually. More significant, an increasing portion of the debt was now on nonconcessional terms, involving shorter maturities and market rates of interest, often variable rates. In 1971, about 40% of the total external debt was on nonconcessional terms. This increased to 68% by 1975, and by 1979, over 77% of the debt was on harder terms. Although the increase in nonconcessional lending by official institutions was partly responsible for this rising proportion, the more than tripling of lending by private capital markets played the major role. Together, the large increase in the size of debt and the larger proportion scheduled on harder terms were responsible for the tripling of debt service payments, which rose from $25 billion in 1975 to $75 billion in 1979.

Despite the sizable increases in debt-servicing obligations, the ability of most developing countries to meet their debt service payments during the

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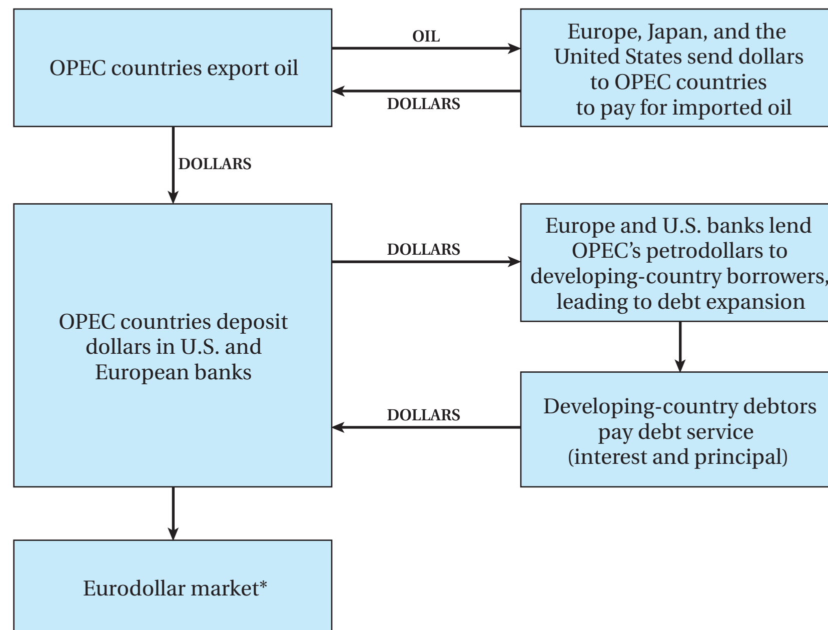
FIGURE 13.1 The Mechanics of Petrodollar Recycling



*Eurodollars are dollar deposits in any bank outside of the United States, not necessarily in Europe only. Rather than send their surplus dollars to the United States, non-U.S. banks began in the 1970s to accept direct dollar deposits, pay interest on them, and lend them directly to developing-country borrowers.

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late 1970s remained largely unimpaired. This was primarily a function of the international economic climate during that period. A combination of declining real oil prices as a result of inflation, low or negative real interest rates, and increased export earnings narrowed current account deficits toward the end of the decade and enabled developing countries to sustain relatively high growth rates, averaging 5.2% during 1973–1979, through massive borrowing.

In sum, the surge in international lending following the first oil shock was largely during the period 1974–1979. In a congenial economic atmosphere, it permitted developing countries to maintain relatively high rates of growth with little debt-servicing difficulty. It also facilitated the recycling of a huge surplus from oil exporters to oil importers through the lending activities of private international banks, and it helped dampen the recession in industrialized countries by providing for increased export demand on the part of developing countries.

Unfortunately, this success was short-lived, and in fact, the surge in international lending that occurred in 1974–1979 had laid the groundwork for all the problems that were to come. The second oil shock, which occurred in 1979, brought about a complete reversal of the economic conditions conducive to

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the success of international lending in the previous period. Now developing countries faced an abrupt increase in oil prices that added to oil import bills and affected industrial goods imports. There was also a huge increase in interest rates caused by the industrialized countries' economic stabilization policies and a decrease in export earnings for developing countries, resulting from a combination of slowed growth in the more developed nations and a precipitous decline of over 20% in primary commodity export prices. Moreover, developing countries inherited from the previous period a huge debt and debt service obligation, which was made even more onerous by burgeoning interest rates and more precarious as a result of the bunching of short-term maturities.

Finally, during the entire period of debt accumulation, one of the most significant and persistent trends was the tremendous increase in private capital flight. It is estimated that between 1976 and 1985, about $200 billion fled the heavily indebted countries.[5] This was the equivalent of 50% of the total borrowings by developing countries over the same period. Fully 62% of Argentina's and 71% of Mexico's debt growth are estimated to have resulted from capital flight. In fact, some researchers have argued that the 1985 level of Mexican debt would have been $12 billion (rather than the actual $96 billion) were it not for the huge private *capital flight*.[6]

Facing this critical situation, developing countries had two policy options. They could either curtail imports and impose restrictive fiscal and monetary measures, thus impeding growth and development objectives, or they could finance their widening current account deficits through more external borrowing. Unable, and sometimes unwilling, to adopt the first option as a means of solving the balance of payments crisis, many countries were forced in the 1980s to rely on the second option, borrowing even more heavily. As a result, massive debt service obligations accumulated so that countries like Nigeria, Argentina, Ecuador, and Peru were experiencing negative economic growth in the 1980s and consequently faced severe difficulties in paying even the interest on their debts out of export earnings. They could no longer borrow funds in the world's private capital markets. In fact, not only did private lending dry up, but also by 1984, the developing countries were paying back $10.2 billion more to the commercial banks than they were receiving in new loans (see Table 13.4).

In the 1990s, the economic situations of developing countries varied greatly: Many experienced positive net transfers, but others remained in crisis. The statistical picture became more complicated after the mid-1990s, with middle-income developing countries increasingly relying on foreign direct investment. Some countries in crisis probably experienced negative net financial transfers.

13.5 Attempts at Alleviation: Macroeconomic Instability, Classic IMF Stabilization Policies, and Their Critics

The IMF Stabilization Program

One course of action that was increasingly but often reluctantly used by countries facing serious **macroeconomic instability** (high inflation and severe government budget and foreign-payments deficits) along with growing

Macroeconomic instability Situation in which a country has high inflation accompanied by rising budget and trade deficits and a rapidly expanding money supply.

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Stabilization policies A coordinated set of mostly restrictive fiscal and monetary policies aimed at reducing inflation, cutting budget deficits, and improving the balance of payments.

foreign-debt obligations was to renegotiate loans with private international banks. The basic idea was to stretch out the payment period for principal and interest or to obtain additional financing on more favorable terms. Typically, however, such debtor countries had to deal with the IMF before a consortium of international banks would agree to refinance or defer existing loan schedules. Relying on the IMF to impose tough **stabilization policies**, a process known as *conditionality*, before it agreed to lend funds in excess of their legal IMF quotas, the private banks interpreted successful negotiations with the IMF as a sign that borrowing countries were making serious efforts to reduce payments deficits and earn the foreign exchange needed to repay earlier loans.[7] There are four basic components to the typical IMF stabilization program:

1. Abolition or liberalization of foreign-exchange and import controls
2. Devaluation of the official exchange rate
3. A stringent domestic anti-inflation program consisting of (a) control of bank credit to raise interest rates and reserve requirements; (b) control of the government deficit through curbs on spending, including in the areas of social services for the poor and staple food subsidies, along with increases in taxes and in public-enterprise prices; (c) control of wage increases, in particular abolishing wage indexing; and (d) dismantling of various forms of price controls and promoting freer markets
4. Greater hospitality to foreign investment and a general opening up of the economy to international commerce

In the early 1980s, numerous debtor countries with greatly depleted foreign reserves, including Mexico, Brazil, Argentina, Venezuela, Bangladesh, and Ghana, had to turn to the IMF to secure additional foreign exchange. By 1992, 10 countries had arranged to borrow a total of $37.2 billion in special drawing rights (equal to approximately $27 billion) from the IMF. During the Asian crisis of 1997, the IMF had to intervene with substantially larger sums of money in an effort to stabilize the shaky economies of Thailand ($3.9 billion in IMF loans), Pakistan ($1.6 billion), the Philippines ($435 million), Indonesia ($10 billion), and South Korea ($21 billion). The IMF became newly engaged in funding and stabilization packages in the wake of the global financial crisis, especially in various hard-hit eastern Europe and former Soviet Union states in 2008–2010.[8] To receive their loans and, more important, to negotiate additional credits from private banks, all these nations were required to adopt some or all of the enumerated stabilization policies. Although such policies may be successful in reducing inflation and improving the balance of payments situation for many developing countries, they can be politically very unpopular (as evidenced by anti-IMF riots in Venezuela, Nigeria, Indonesia, and South Korea in the 1990s) because they strike at the heart of development efforts by disproportionately hurting the lower- and middle-income groups.[9] Alternatively, they have often been viewed by leaders in developing nations as representing a double standard—harsh adjustment policies for developing-country debtors and no adjustment of the huge budget or trade deficits for the world's greatest debtor, the United States. Finally, because IMF policies

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are being imposed by an international agency that is perceived by those of the dependence school to be merely an arm of the rich industrialized nations, stabilization policies are often viewed by this school as measures designed primarily to maintain the poverty and dependence of developing countries while preserving the global market structure for the international banks and private investors (and speculators) from the industrialized nations. For example, in an extensive dependence critique of the IMF and its stabilization programs, Cheryl Payer has argued that the IMF functions within a developed-world-dominated global trading system "as the chosen instrument for imposing imperialist financial discipline upon poor countries" and thus creates a form of "international peonage" in which balance of payments problems are perpetuated rather than resolved. Payer further argues that the IMF encourages developing countries to incur additional debt from international financial institutions, while it "blackmails" them (through threats of loan rejection) into antidevelopmental stabilization programs. This added debt burden thus becomes a source of future balance of payments problems, setting up a vicious circle in which debtor nations have to run faster merely to stay in place.[10]

Less radical observers view the IMF as neither prodevelopment nor antidevelopment but simply as an institution trying to carry out its original, if somewhat outdated, mandate to hold the global capitalist market together through the pursuit of orthodox short-term international financial policies. Its primary goal is the maintenance of an "orderly" international exchange system designed to promote monetary cooperation, expand international trade, control inflation, encourage exchange-rate stability, and help countries deal with short-run balance of payments problems through the provision of scarce foreign-exchange resources. Unfortunately, in a highly unequal trading world, the balance of payments problems of many developing nations may be structural and long-term in nature, with the result that short-term stabilization policies may easily lead to long-run development crises.[11] For example, between 1982 and 1988, the IMF strategy was tested in 28 of the 32 nations of Latin America and the Caribbean. It was clearly not working. During that period, Latin America financed $145 billion in debt payments but at a cost of economic stagnation, rising unemployment, and a decline in per capita income of 7%.[12] These countries "adjusted" but did not grow. By 1988, only two were barely able to make their payments. The same situation prevailed in much of Africa.[13]

Tactics for Debt Relief

The debt crisis of the 1980s, initiated by Mexico's declared moratorium on debt payments in 1982 (which came close to being repeated in 1995), called into question the stability and very viability of the international financial system. Fears were voiced that if one or two of the major debtor countries (Brazil, Mexico, or Argentina) were to default, if a group of debtor nations were jointly to repudiate their debts by forming a **debtors' cartel**, or if more countries followed Peru's early initiative to link debt servicing to export earnings, the economies of Western nations might be seriously affected. Following the onset of the debt crisis, most developing countries were cut off from the international capital market. Emergency meetings between international

Debtors' cartel A group of developing-country debtors who join together to bargain as a group with creditors.

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bankers and government officials of developed nations and developing-country debtors were convened in the financial capitals of the world. This was because Latin American debts alone exceeded the net assets of the largest U.S. banks. Rumors of imminent default led currency speculators to purchase dollars, driving up the dollar's market value in 1983–1984 to a level well beyond its shadow value and adding even further to the dollar-denominated debt burdens of developing nations.

Restructuring Altering the terms and conditions of debt repayment, usually by lowering interest rates or extending the repayment period.

Numerous proposals for relieving or **restructuring** the debt burdens of highly indebted nations have been proposed, with several implemented, at least in part.[14] These have ranged from a new allocation of special drawing rights to restructuring (on better terms for debtor countries) of principal payments falling due during an agreed consolidation period. Most notable have been the Paris Club arrangements, offering highly concessional conditions, the so-called Toronto terms. These bilateral arrangements for public loans permit creditor governments to choose from three alternative concessional options—partial cancellation of up to one-third of nonconcessional loans, reduced interest rates, or extended (25-year) maturity of payments—to generate cash flow savings for debtor countries. For commercial banks, the 1989 **Brady Plan** linked partial debt forgiveness for selected borrowers to IMF or World Bank financial support, guaranteeing the payment of the remaining loans as well as commitments by the indebted developing countries to adopt stringent IMF-type adjustment programs, promote free markets, welcome foreign investors, and repatriate overseas capital. In addition, there has been much discussion of **debt-for-equity swaps**. These are the sale at a discount (sometimes in excess of 50%) of questionable developing-country commercial bank debts to private investors (mostly foreign corporations) in secondary trading markets. These corporations then trade a debtor's IOU for a local state-owned asset, such as a steel mill or a telephone company. Commercial banks are now more willing to engage in such transactions because new interpretations and regulations for U.S. banks permit them to take a loss on the loan swap while not reducing the book value of other loans to that country. For the developing countries' part, they are able through debt-for-equity swaps to encourage private investments in local-currency assets from both foreign and resident investors as well as to reduce their overall debt obligations. Much of the privatization that has occurred in Latin American debtor countries has been financed through these swap arrangements. The flip side of these benefits, however, is the fact that foreign investors are buying up the state-owned real assets of developing nations, such as steel mills and telephone companies, at major discounts. Observers who worry about developed-country penetration into developing economies or the exacerbation of domestic dualistic tendencies are naturally troubled by these debt-for-equity swaps. Between 1985 and 1992, they accounted for over 36% of all debt conversions.

Brady Plan A program launched in 1989, designed to reduce the size of outstanding developing-country commercial debt through private debt forgiveness procured in exchange for IMF and World Bank debt guarantees and greater adherence to the terms of conditionality.

Debt-for-equity swap A mechanism used by indebted developing countries to reduce the real value of external debt by exchanging equity in domestic companies (stocks) or fixed-interest obligations of the government (bonds) for private foreign debt at large discounts.

Debt-for-nature swap The exchange of foreign debt held by an organization for a larger quantity of domestic debt that is used to finance the preservation of a natural resource or environment in the debtor country.

An appealing but much less significant swap arrangement is the **debt-for-nature swap**, intended to win commitments by a developing country's government to environmental preservation of such assets as the rain forests in Ecuador or a national park in Costa Rica (see Chapter 10). Most debt-for-nature swaps are carved out by nongovernmental organizations such as the World Wildlife Fund or the Nature Conservancy. They purchase the debtor nation's IOU at a discount from a local bank and then restructure it into local-currency payments,

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which are then used, say, to preserve an endangered natural resource. Since 2000, new debt-for-nature exchanges have been worked out in several countries, including Guatemala, Costa Rica, Cameroon, Peru, Colombia, Jordan, Ghana, Belize, Indonesia, and Jamaica. For example, in 2008, $20 million was provided through the World Wildlife Fund in a project to protect Madagascar's biodiversity while relieving part of its government debt to France.

The problem with most proposals for debt alleviation, including debt-for-equity swaps, is that they require private international banks to initiate or endorse the policies. Most are unwilling to take any steps that would harm their short-run balance sheets. More significant, in the absence of unilateral **debt repudiation** by developing countries (a policy that would hurt both borrowers and lenders in both the short and the long term), most proposals (except debt-for-nature and similar swaps) do not solve the debt problem but merely postpone the day when debts become due, and so another crisis erupts. An often suggested proposal is to develop institutions for unwinding developing-country debt when it becomes unsustainable, in a somewhat analogous way to debt reorganization under corporate bankruptcy. As Barry Herman, José Antonio Ocampo, and Shari Spiegel expressed it in their 2010 study:

Debt repudiation The 1980s fear in the developed world that developing countries would stop paying their debt obligations.

> Many countries have designed national insolvency regimes for corporations that not only wind up hopelessly bankrupt entities, but also seek to salvage firms that with reduced debts can survive as going concerns. The objective in the latter cases, as with insolvent sub-sovereign entities or households (which cannot be "wound up"), is to give a second chance, a "fresh start," and a "clean slate." The ad hoc, partial, and at best loosely coordinated system for addressing sovereign debt crises does not deliver such outcomes.[15]

All in all, the debt crisis underlined the interdependence and fragility of the international economic and financial system. It also demonstrated that not only were developing economies vulnerable to small increases in U.S. interest rates but also that developed countries could be harmed by economic failures or public policies of key developing nations.

Although many developing countries can be held at least partly responsible for the massive accumulation of debts, the adverse economic conditions this often causes are, in most cases, beyond their control. In fact, this adverse economic climate was, in part, precipitated by the industrialized countries' own economic stabilization policies, which led to soaring interest rates, worldwide economic recession, and the resulting decrease in demand for developing-country exports. William Cline estimated, for example, that almost 85% ($401 billion) of the total increase ($480 billion) in the external debt of the non-oil-exporting developing countries between 1973 and 1982 could be attributed to four factors outside of their control: OPEC oil price increases, the rise in dollar interest rates in 1981–1982, the decline in export volumes from most developing countries as a result of the worldwide recession, and the dramatic fall in commodity prices and the consequent worsening of their terms of trade.[16]

The experience of Mexico, the pioneer in debt reduction in the late 1980s, is described in detail in Box 13.3.

Commercial bankers and financiers in the industrialized countries declared the debt crisis over with the signing of a Brady-type restructuring accord with Argentina in April 1992 and with Brazil in July 1992. But, for many countries,

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BOX 13.3 Mexico: Crisis, Debt Reduction, and the Struggle for Renewed Growth

In August 1982, Mexico triggered a debt crisis when it announced that it could not service its debt and would begin a moratorium of at least three months on debt payments to private creditors. Creditor banks, led by Citibank, formed an advisory committee. Mexico sought and received emergency assistance from the International Monetary Fund and U.S. financial institutions. In September, Mexico nationalized its banks and introduced rigorous exchange controls.

In late September 1982, the annual World Bank–IMF meetings took place in Toronto in an atmosphere of panic. The greatest fear was that the stability of the international banking system would be in peril if significant defaults on loans threatened the major banks. The crisis swept through Latin America, Africa, and other developing countries such as the Philippines and Yugoslavia. A plan was devised that saved the banking system but led to what is often regarded as a lost decade (or more) of development in Latin America and Africa.

Mexico was not only the first country to enter a debt crisis but also a pacesetter in resolving it (despite some smaller crises, particularly the so-called Tequila Crisis of 1994). After dramatic debt reduction in the late 1980s and early 1990s, capital inflows have commonly assumed the form of long-term equity rather than debt.

Before 1973, Mexico's external debt, like that of most developing nations, was relatively small, primarily official, and often based on concessional lending. But major OPEC countries received a huge cash windfall from the 1973 oil price rise, and they deposited most of the funds in major U.S. banks. Mexico and other Latin American countries had a ready demand for these funds. Following Citibank chairman John Reed's dictum that "sovereign countries do not default," large banks lent while often overlooking normal criteria of lending risk. The value of outstanding loans increased tenfold in less than a decade. Investment as a share of GDP, however, hardly increased in this period of massive borrowing. Consequently, Mexico did not have the added capacity to produce exports that could generate foreign exchange to repay debt without necessitating a fall in living standards.

Problems in Mexico were aggravated by fiscal deficits and inflation. After Mexico discovered new oil reserves and began producing oil in larger amounts in 1977, the country borrowed more money, with oil as implicit collateral. But this money, too, was not wisely invested, and the oil industry was operated with considerable inefficiency. Exchange-rate appreciation hurt other exports, and non-oil industries were neglected.

If the first oil shock incited a spate of international lending, the second oil shock, in 1979, triggered a reversal of this process as interest rates rose, stagnation reduced the demand for exports from developing countries, and high debt levels made further borrowing more difficult. When real interest rates rose dramatically after 1979, Mexico's debt burden became untenable. In early 1982, Mexico's financial position deteriorated rapidly. The country needed to borrow some $20 billion that year to finance its existing loans and meet its expected deficit. As the year progressed, bank loans were harder to arrange and required a substantially higher interest rate. Inflation rose, and a series of currency devaluations began.

The early years of the crisis were harsh for Mexico. An economic adjustment program under IMF auspices restored economic order. Elements of the typical IMF stabilization packages included liberalization of foreign-exchange and import controls, devaluation, interest-rate increases, deficit reduction, wage restrictions, decreased price controls, and a general opening up of the economy. It was widely argued in Mexico that adjustment without growth would ensue, with negative development consequences.

Real income fell dramatically from 1982 to 1985. By then it had become clear that although the fire was being contained, it was not going out. Although the public-sector deficit fell from about 17 to 8% as a share of GDP, GDP itself had fallen dramatically, and poverty and inequality had risen. No new capital flows were

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forthcoming, and it became clear that a new approach would be needed.

In 1985, U.S. Secretary of State James Baker introduced the Baker Plan. The idea was to get growth to resume in debtor countries so that they could "grow their way out of debt." New funds would be lent to indebted countries that would let growth resume, drawing on private banks, the World Bank, the IMF, and other sources. In return, Mexico and other indebted countries would introduce market reforms that were expected to facilitate the use of new funds in a more efficient and growth-enhancing manner.

Mexico became one of the first countries to participate in the Baker Plan. Mexico acceded to a major debt-restructuring and domestic economy reform program in June 1986. At first, there seemed to be some limited progress. Commercial banks extended over $7 billion in loans and a new rescheduling agreement covering some $54 billion of outstanding debt. In return, the World Bank offered a loan of $500 million.

But Mexico was severely hurt by the big drop in the price of oil of the mid-1980s. The IMF agreed to a special "standby" agreement in which it would make additional credit available to Mexico if the price of oil were to fall below $9 a barrel. The IMF also offered substantial new credit, to be matched by new credits from commercial banks. Mexico introduced far-reaching market-oriented reforms in this period. The most important reason this approach did not work is that commercial banks proved unwilling to do their part in net new lending. These banks committed only a fraction of the loans anticipated in the Baker Plan. The banks' main intention at this time was still to reduce their exposure to developing-country debt, not to increase it.

In the mid-1980s, Mexico became a pioneer of debt-for-equity swaps as an instrument of debt reduction. In these swaps, restrictions on foreign direct investment (FDI) are lifted when foreign investors pay for the asset by presenting Mexican debt paper. These are acquired, usually at a substantial discount, from banks that wish to reduce their developing-country debt exposure. The secondary market for Latin American debt in this period had an average discount of about 50% of face value (sometimes with far steeper discounts). The investor presents the loan to the central bank, which in turn issues local currency that can be used only to purchase a local firm's assets. Sometimes the firm may be a state-owned enterprise, so the transaction facilitates privatization. But debt-for-equity swaps carry the inherent risk of generating inflationary pressures because they usually involve swaps of public debt for private assets. Because the central bank issues funds for the investor to buy a local asset, this represents an addition to high-powered money.

Mexico suspended debt-for-equity swaps in November 1987, officially because of their inflationary effects. Part of the real reason may have been political pressures to limit the share of foreign ownership and control in the economy, though swaps of private debt for private equity continued to be permitted.

In 1988, as the swap strategy lost momentum, Mexico pioneered a new approach to debt reduction. Mexico would exchange some of its outstanding debt, perceived as high-risk, for new debt called *Aztec Bonds* that would be backed by U.S. Treasury bonds bought by Mexico as collateral. An auction would be held, in which banks would bid on how much discount on the face amount of their existing loans they would accept in exchange for the new, more secure bonds. In March 1988, some $2.5 billion of bonds were exchanged for $3.6 billion in bank debt, an average discount of about 33%. A total of some $6.7 billion was offered by banks, but Mexico rejected some of these bids as providing too small a discount. If the results were disappointing in their magnitude, they represented an important innovation, later built on in the Brady Plan.

Eventually, most parties understood that substantial Mexican growth could not resume until the country's large debt burden was substantially reduced, not just rescheduled. With the major U.S. banks out of immediate danger after several years of reducing developing-world exposure, a debt reduction plan was

(*Continued*)

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BOX 13.3 Mexico: Crisis, Debt Reduction, and the Struggle for Renewed Growth (*Continued*)

floated by U.S. Treasury Secretary Nicholas Brady in March 1989.

Mexico was the first country to negotiate debt reduction under the new Brady Plan. Banks were given three options: (1) to exchange loans for floating-rate bonds with collateral at a 35% discount; (2) to exchange loans for bonds with the same par value but with a lower, fixed interest rate; or (3) to lend new money to finance Mexican interest payments, keeping nominal value of the debt they were owed intact. In 1990, some 49% of the banks exchanged $22 billion in debt for lower-interest, fixed-rate bonds, and 41% exchanged $20 billion in debt for the discounted floating-rate bonds. This constituted Mexico's creditor banks' "revealed preferences" from among the options.

Provided that Mexico continued to service the reduced debt successfully, the bonds on deposit in Washington as collateral would earn interest that Mexico would receive, which could be used for debt reduction or investment. From the banks' point of view, the trade-off involved giving up higher-yielding but higher-risk debt for lower-yielding but lower-risk debt. Mexican debt was 63% of GDP in 1983 but fell to 32% by 1993 and 23% in 2003.

There was one major crisis along the way. In 1994, the government attempted to carry out a small devaluation of the peso. But the market saw this step as too little, too late, given the large current account deficit and concluded that the action was a prelude to much larger devaluations in the near future. Speculators, acting on these expectations, forced the hand of the government, which let the peso float until it had lost over half its value. Instability spread across other countries in the so-called Tequila Crisis. By mid-1996, the worst had passed, and Mexico proved immune to the crises that rocked Brazil, Turkey, and especially Argentina in the first years of the twenty-first century. Although the North American Free Trade Agreement and the benefits of bordering the world's largest economy conferred special advantages on Mexico, GDP growth remained sluggish, averaging about 1.5% per capita for the 1990–2008 period. And even adjusted for purchasing power parity, incomes remained just 29% of those in the United States. And Mexico was more negatively affected by the global financial crisis than most developing countries, with a drop in real GDP of about 6.5% in 2009.

Sources: CIA, *World Fact Book: Mexico*; https://www.cia.gov/library/publications/the-world-factbook/geos/mx.html Refik Erzan, "Free trade agreements with the United States: What's in it for Latin America?" World Bank Policy Research Working Paper No. 827, 1992; Sudarshan Gooptu, *Debt Reduction and Development: The Case of Mexico* (Westport, Conn.: Praeger, 1993); Gary Hufbauer and Jeffery Schott, *NAFTA: An Assessment* (Washington, D.C.: IIE, 1993); Robert F. Pastor and Jorje G. Castenada, *Limits to Friendship: The United States and Mexico* (New York: Vintage Books, 1988); World Bank, "World debt tables," various years; and World Bank, *World Development Indicators*, 2010.

especially in Africa, the problem remained extremely serious, and would not be adequately addressed for another decade.

And debt crises may recur, including in middle-income countries. This was vividly revealed in late 1994 and early 1995 when Mexico, one of the great success stories of debt rescheduling, was forced to devalue its currency and seek special standby loans to pay off its short-term debt obligations. Almost half of the private portfolio investment capital that had flowed into Mexico (and other Latin American debtor nations, including Brazil, Argentina, and Venezuela) in the early 1990s was summarily withdrawn. Mexico was then forced to declare a new austerity program, further weakening the already deteriorating condition of its shrinking middle class and its working poor. As

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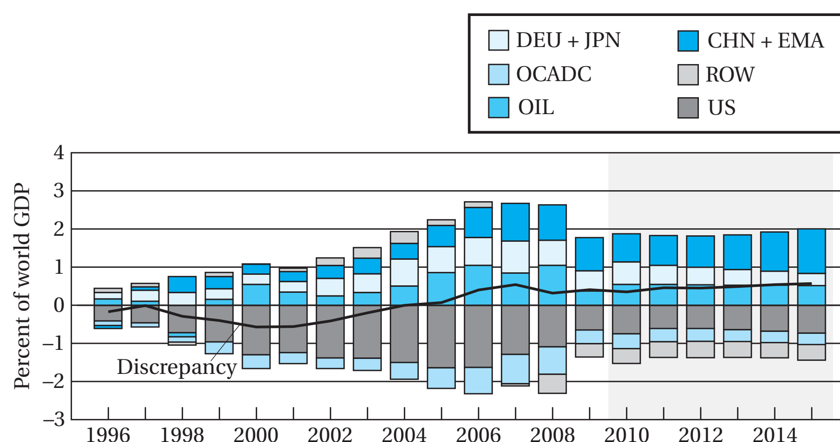
in 1982, the large commercial banks and Wall Street investors were once again surprised by Mexico's move. The "hot money" flows that had been universally hailed as a boon to the Mexican economic reform program now added to its burden of retrenchment as most investors withdrew their funds in the time that it took them to hit their computer keys. The effective debt default in 2001 by Argentina, another purported success story, showed that the debt crisis in developing countries could continue to rear its head.

Fears of instability were renewed in 1997 and 1998. South Korea, Indonesia, and Thailand, along with Russia, Brazil, and other countries, borrowed from the IMF under strong austerity conditions. In South Korea and elsewhere, public discussion centered on the view that austerity had led to unnecessarily large recessions, and in response, governments throughout East Asia (and many outside it) worked to accelerate exports, repay IMF loans, and greatly expand foreign-currency reserves over the subsequent decade. This process was greatly abetted by a dollar that was widely viewed as overvalued and accompanying record U.S. trade deficits, which continued to increase.

The current account surpluses of fast-growing Asian economies have to a significant degree mirrored the deficits of the United States (and some other high-income Organization for Economic Cooperation and Development, or OECD economies). These imbalances narrowed somewhat with the global financial crisis (see Figure 13.2). The IMF projected a modest widening of imbalances in coming years. These projections, including the sustainability of imbalances, are uncertain.

But even as debt was resolved in middle-income countries—the priority for banks in that they had much larger loans at stake—the debt crisis dragged

FIGURE 13.2 Global Imbalances



Note: IMF groupings are China and "emerging" Asia (CHN+EMA); a group of European economies with Turkey termed "Other Current Account Deficit Countries" (OCADC); Germany and Japan (DEU+JPN); and oil exporters (OIL). For the rest of the world (ROW), a net current account deficit has opened up, a trend that is projected to continue.

Source: International Monetary Fund, *World Economic Outlook*, October 2010, p. 29. Used by permission of International Monetary Fund.

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BOX 13.4 "Odious Debt" and Its Prevention

Odious debt is a concept in the theory of international law holding that just as contracts signed under coercion are unenforceable, sovereign debt used by an undemocratic government in a manner that is contrary to the interests of its people should be deemed invalid. Such odious debts would represent personal debts of officials of the regime that incurred them, not debts of the state that would be the responsibility of the nation's people.

The concept has a long history; it was implicitly invoked, albeit without its present name, by Mexico following the overthrow of the French-backed Emperor Maximilian I and by the United States on behalf of Cuba in negotiations following the Spanish-American War of 1898 (in which the United States abetted the rebels in the Cuban War of Independence while gaining long-term influence). It was explicitly argued in 1927 by legal scholar Alexander Sack.

Dictators widely alleged to have looted substantial public funds while incurring foreign debt have been found in every developing area; they include Anastasio Somoza of Nicaragua, Ferdinand Marcos of the Philippines, Jean-Claude Duvalier of Haiti, Mobutu Sese Seko of the Democratic Republic of Congo (then called Zaire), and Franjo Tudjman of Croatia. Many of these regimes and others, such as the apartheid government of South Africa, borrowed while also spending heavily on the apparatus of state repression.

Seema Jayachandran and Michael Kremer propose establishing an independent international body to determine which regimes are illegitimate and thereby declaring as legally odious any subsequently incurred sovereign debt. As such, this debt would not be a legal obligation of successor governments. Of course, some unscrupulous lenders might still lend funds at high interest rates if they believed the regimes to be stable. But, in general, these rules should limit dictators' ability to loot and repress while containing the debt burden of poor countries. Indeed, by substantially removing possible future defaulters from the loan pool, these rules could lead to lower interest rates for legitimate governments. We may expect a better long-term outcome to result for the people of developing countries. To help ensure that no further loans are made to regimes that are considered odious, Jayachandran and Kremer point out, legal incentives could be introduced on both the lender and borrower sides. Laws in creditor countries could be made to disallow seizure of a developing nation's assets for nonrepayment of odious debt. And foreign aid to successor regimes could be withheld if they continued to repay odious debts. Note that we would not want new regimes to repay debts incurred by previous regimes after they had been officially designated as odious because this would undermine the attempt to reach a new equilibrium in which such loans would not be extended in the first place.

Jayachandran and Kremer suggest that the concept could be implemented in several ways. For example, even if an international court were not established, the procedure could be followed by the UN Security Council, and some coordination could even be achieved by initiatives of groups of respected nongovernmental organizations (NGOs) and opinion leaders or through some hybrid of formal and informal mechanisms.

Although the proposed odious-debt institution is forward-looking, the perception that some of the debt held by African countries can be characterized as odious is probably one of the reasons why debt forgiveness for highly indebted and low-income countries in Africa has gained such wide international support.

Sources: Seema Jayachandran and Michael Kremer, "Odious debt," *American Economic Review* 96 (2006): 82–92, and "Odious debt," *Finance and Development* 39 (2002): 36–39. Note: Their analysis draws on game theory, in which in repeated games with multiple possible outcomes, or equilibria, making relevant information public can lead to a new equilibrium.

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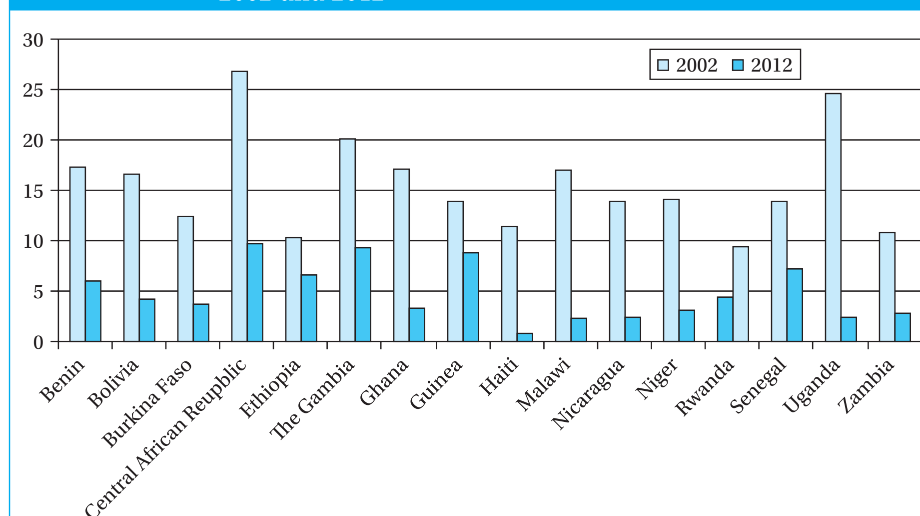
on in a majority of low-income sub-Saharan African countries. The debt in a few of these countries arguably had "odious" origins (see Box 13.4).

Odious debt A concept in the theory of international law holding that sovereign debt used by an undemocratic government in a manner contrary to the interests of its people should be deemed to be not the responsibility of democratic successor governments.

The HIPC Initiative The first initiative to address the problems of **heavily indebted poor countries (HIPCs)** was launched by the group of 8 major industrialized countries (the Group of Eight, or G8) in 1996. They set up an elaborate process for qualifying for expanded debt relief through the international financial institutions, but by 1999, only 4 of the 36 poor countries initially deemed eligible had qualified. The G8 then agreed to set aside approximately $100 billion for "enhanced" debt relief for those designated HIPC countries that demonstrated, to the satisfaction of the World Bank and the IMF, that they were both pursuing "sound policies" and were "committed" to reducing poverty. Commitment was to be demonstrated through what came to be called *poverty reduction strategy papers.*[17] For eligibility, countries had to be classified as low-income (see Chapter 2), face an "unsustainable debt burden that cannot be addressed through traditional debt-relief mechanisms," demonstrate via participation in IMF- and World Bank–sponsored programs "a track record of reform and sound policies," and develop a PRSP. Progress on committing these funds was slower than expected, and the PRSP process (discussed further in Chapter 14) was considered relatively disappointing. Additional funds were committed in 2005. External debt has fallen considerably for many HIPC countries. Figure 13.3 illustrates the decline in external debt service payments as a proportion of national export revenues for a number of HIPC countries, comparing data for 2002 with 2012. As of 2013, of the 39 developing countries defined as potentially eligible for HIPC, 35

Heavily indebted poor countries (HIPCs) The group of the world's poorest and most heavily indebted countries as defined by the World Bank and the IMF, which status may make them eligible for special debt relief.

FIGURE 13.3 Debt Service Ratios for Selected HIPC Countries, 2002 and 2012



Source: Data drawn from http://siteresources.worldbank.org/INTDEBTDEPT/ProgressReports/23514662/HIPC_update_12-19-13.pdf; Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI)—Statistical Update, Dec. 19, 2013, Table 3, page 15, accessed 10 March 2014. .

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had reached their "post-completion points" so that they were receiving their full allocations of debt relief.

But commercial loans are not part of the HIPC process; some private lenders continue to pursue lawsuits to recover African loans. Moreover, even some official lenders are not participating in debt relief. Further, some countries in which debt has imposed hardship are not eligible for HIPC, for example because they are above the low-income line, despite having substantial levels of chronic poverty.[18]

In sum, great progress has been made for much of the developing world, but many countries remain vulnerable going forward.[19]

13.6 The Global Financial Crisis and the Developing Countries

Beginning with the first tremors of the subprime mortgage crisis in the United States in 2007, the world faced a global financial crisis and a "great recession" in the developed economies on a scale that has not been seen since the Great Depression. An examination of the crisis offers insights for global as well as specific developing-country policies.

In mid-2013, the World Bank opined that "the bulk of developing countries are fully recovered from the crisis. Several even risk overheating if policy does not tighten,"[20] although they noted ongoing problems for "developing Europe" and unrest in the Middle East and North Africa.

Unfortunately, the crisis is not yet "history." Barely weeks later, the policy community refocused on a "new emerging markets crisis," with the Indian rupee dropping at a historic rate in August 2013 and other danger signals; this was partly triggered by the prospective reduction of the extraordinary U.S. Federal Reserve (central bank) quantitative easing policy—that itself was a response to the severity of the crisis and its aftermath in the world's largest importer. The immediate crisis was halted, in part by interest rate hikes by some developing countries, most notably India, and by reassuring statements from the Federal Reserve. But the events underlined continued vulnerabilities to tighter credit conditions.[21]

Moreover, the higher commodity prices that propped up export revenues for many developing countries were partly the result of post-crisis fiscal stimulus—particularly the stimulus from China; but growth in China cannot continue much longer at its exceptionally high pace. Lower commodity prices are a potential concern for commodity exporters, while asset price bubbles and excess borrowing could be a problem among fast-growing East Asian economies.

Thus, years after the height of the financial crisis, numerous economic aftershocks continued to reverberate in the developing world. The ongoing great recession in several indebted European "periphery" countries, including Italy, Spain, Portugal, and Greece, were seen as serious threats to the euro's stability—if not to its continued existence as a widely used common European currency; a euro crisis, if it occured, would also portend dangerous spillovers to developing countries including a reduction of demand for their exports.[22]

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Thus, despite the resilience of economic growth in many developing countries in the postcrisis years, residual impacts on the developing world have been substantial, recovery has been incomplete, and serious uncertainties have lingered.[23]

Causes of the Crisis and Challenges to Lasting Recovery

Economists have not yet reached a consensus on the root cause(s) of the crisis; in one view, it would not have occurred had not several things gone wrong at about the same time. In the United States, one factor high on most lists was financial deregulation that was rapid and wide-ranging (and careless in its design and implementation). Deregulation came with repeal of rules separating commercial and investment banking without an adequate regulatory framework to replace it, failure to regulate newly introduced financial instruments, lack of enforcement of remaining regulations, and artificially low interest rates. Fuel for the fire came from public policy encouraging home ownership through subprime lending—underpinned with support of implicitly publicly guaranteed "government-sponsored enterprises," notably Freddie Mac and Fannie Mae—along with the packaging and resale of these loans with understatements of their riskiness. Failure of risk-rating agencies to fulfill their roles was also widely cited.[24] Other developed countries, including several in Europe such as Spain, had parallel financial stability problems that were exposed by the crisis. The result was a fragile financial system, with high leverage and complex and incompletely understood financial securities. The so-called Basel III requirements for bank capital and liquidity to reduce banking risks[25] introduced between 2010 and 2013, along with a U.S. law passed in May 2010 and similar legislation in other countries, were viewed as steps in the right direction but probably not enough to prevent another crisis under some circumstances.

A probable second major factor in the crisis was the chronic international trade imbalances between East Asia, notably China, and the developed countries, particularly the United States, with concomitant capital flows into the United States. This helped keep capital cheap and fueled the housing bubbles in the United States and some European countries. Now, for the first time in decades, sovereign debt problems were raised as possibilities in *developed* countries, most prominently for the so-called EU-5 (Greece, Ireland, Italy, Portugal, and Spain)—note that as recently as the early 1990s, three of these five were still classified as developing countries. Ireland and Greece required dramatic international bailouts in 2010; along with Portugal, they remain the largest IMF borrowers.

Yet, from the start of the crisis, the interest rates the United States and the United Kingdom pay on their high debts was never lower, at first reflecting severe risk aversion in the markets and then "ultra-loose" monetary policy.[26] In response to the crisis, many countries also took on "fiscal stimulus" programs of government spending to prop up very weak demand and prevent the onset of a depression. A majority of economists considered this effort to have been necessary and effective, and evidence supports this. But stimulus programs proved politically unsustainable, and as austerity measures in

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several developed countries, most prominently the United Kingdom and the deficit countries of Europe, were rolled out, in a historical irony in 2010, the IMF called on countries not to cut back on spending nearly as quickly as many governments were planning because of the weakness of demand. An encore of this drama played out in 2013 when the United States abruptly moved into sharp austerity with "sequestration" (automatic, across-the-board, public spending cuts). Just as for developing countries, austerity can have costly social and health impacts for developed countries.[27] More extraordinary, this shift was coupled with brinksmanship in the U.S. Congress, combining a partial government shutdown with a threat to allow default as a domestic political weapon. The resulting unprecedented "voluntary fiscal crises" in 2011 and 2013 created considerable uncertainty and thereby were estimated to have led directly or indirectly to a substantial reduction of U.S. growth, globally reducing demand and magnifying instability.[28]

Most international financial crises since World War II were viewed as "originating" in the developing world. From the Latin American debt crisis of 1982 to the Mexican "Tequila Crisis" of 1994, to the "East Asian Contagion" of 1998, and the Argentine default in 2001, problems were perceived as caused by developing economies' weak financial markets and institutions and unstable political economy. With each crisis, the affected countries were pressured to open and liberalize their economies. As part of IMF and World Bank conditionality agreements, Latin American and African countries essentially were required to privatize state-owned enterprises (see Chapter 15, section 15.6), eliminate regulations, and reduce infant industry protection after their 1980s and 1990s debt crises. And East Asian countries such as South Korea, Thailand, and Indonesia were required to open their economies to more direct foreign investment (see Chapter 14, section 14.2), including in the financial sector, in the late 1990s. One response was a determination to run export surpluses and build up large international currency reserves, a factor pushing up parallel trade deficits in developed countries (see Figure 13.4).[29]

Despite these historical reversals of capital flows, given past pressure from developed countries to adopt policies modeled on their own systems that were said to reduce risks of financial crises, it came as a great surprise to many policymakers in the developing world that this most recent crisis originated in the United States, accompanied by its worst economic downturn since the Great Depression. The global downturn that followed the crisis initially was briefest in many developing countries; also surprising to many was the leading role of some developing countries (most notably China but also India, Brazil, and a few others) in helping to pull many countries out of the recession through their continued economic dynamism. Most economic studies have concluded that the stimulus packages in both developed and developing countries probably kept the situation from getting much worse.

In the decade leading up to the crisis, fast-growing developing countries were relying heavily on exports to the United States and other developed countries. In response to the crisis, in 2010 President Obama announced an objective of doubling U.S. exports in five years. China rejected pressure from the United States and other countries to stop resisting market forces for its

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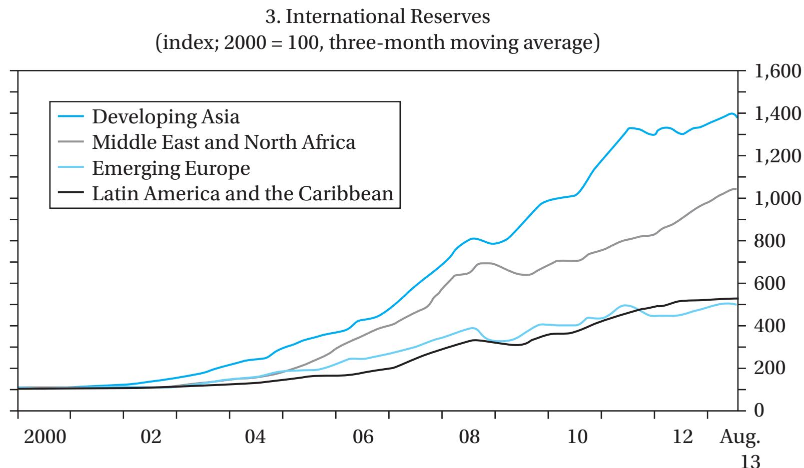
FIGURE 13.4 International Reserves (Index 2000 = 100, three-month moving average)



Source: IMF, *World Economic Outlook Transitions and Tensions*, October 2013, Fig. 1.10, panel 3, p. 10, http://www.imf.org/external/pubs/ft/weo/2013/02/. Used with permission,

exchange rate to rise, though eventually appreciation did take place. Policymakers in most leading economies also hoped for growth through expanded exports, and out of this grew what were apparently competitive efforts to also lower the value of their relative exchange rates to make their exports cheaper. But exchange rates are relative, so not all countries can devalue at once! In late 2010, Guido Mantega, finance minister of Brazil, stated publicly what many officials had been stating privately—that the world had moved into an "international currency war." The remarks renewed fears that the global economy still faced risks not seen since the 1930s. Soon the IMF and the World Bank had weighed in with warnings about the dangerous drift in international economic policy. The issue of competitive depreciation of currencies shared center stage with concerns about slow recovery at the fall 2010 IMF–World Bank annual meeting. And yet it was extremely unlikely that misaligned exchange rates could have been the sole cause of a crisis of this scope, and it was at best very uncertain that realignment of exchange rates would be enough to resolve the problems caused by the crisis or to prevent a new one. But Mantega's declaration in January 2011 that "this is a currency war that is turning into a trade war" got the attention of many policymakers—tensions perhaps later diffused by opportunities to export to China, India, and other large middle-income countries. The subsequent slowdowns in China and India are being watched closely.[30]

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Economic Impacts on Developing Countries

We now review nine areas of impacts.

Economic Growth In 2007 and the first half of 2008, developing countries were affected less than developed countries, but in the second half of 2008, the impact was quite severe in most developing regions, continuing through 2009. As the 2009 *World Investment Report* put it, "Developing countries weathered the global financial crisis better than developed countries, as their financial systems were less closely interlinked with the hard-hit banking systems of the United States and Europe." A debate ensued as to whether this reflected autonomous self-sustaining, developing-world growth or was vulnerable to an inevitable move back to more normal monetary policy in industrialized countries. With the 2013 announcement that—with signs of renewed growth in the United States—the large round of extraordinary Federal Reserve "quantitative easing" would be "tapered" (gradually phased out), world interest rates shot up in anticipation, threatening further reductions in developing country growth rates that had already been slowing. Significant concerns about a reduced flow of low-cost capital were raised at the G20 meetings in Russia in September 2013. In October 2013, the IMF opined that:

> The world economy has entered yet another transition. Advanced economies are gradually strengthening. At the same time, growth in emerging market economies has slowed. This confluence is leading to tensions, with emerging market economies facing the dual challenges of slowing growth and tighter global financial conditions.

IMF Economic Counsellor Olivier Blanchard also wrote that

> Unusually favorable world conditions, including high commodity prices and rapid financial market development, increased potential growth in [emerging market or developing] economies during the 2000s, and in a number of them, there was a cyclical component on top. As commodity prices stabilize and financial conditions tighten, potential growth is lower, leading in some cases to a sharp cyclical adjustment.[31]

Both the IMF and World Bank stressed continued underlying fragilities and uncertainties, some due to factors unrelated to the developing world. A key example is the uncertainty caused by political conflict in the United States over fiscal policy (notably the threats to allow default on federal debt unless additional budgetary and programmatic concessions are made).

Exports Exports fell drastically in the immediate aftermath of the crisis. World trade volumes fell 14.4% in 2009, the largest drop in decades, but then rebounded strongly before returning to modest growth from 2011.

Developed-countries' austerity programs were a factor in their declining trade deficits. Going forward, to reduce its deficits, the United States has been widely expected to establish a higher savings rate while the dollar depreciates further (although the savings rate actually fell in 2013). New records in asset prices brought with it some fears of a temporary return of the bubble economy, precipitating an even worse crisis than last time, with a larger impact on exports—but there is no consensus on the extent to which new bubbles (if any) are forming. It remains unclear whether other developed-country markets will open to the extent seen in the United States and United Kingdom during the bubble period. The U.S. and a majority of European governments have made

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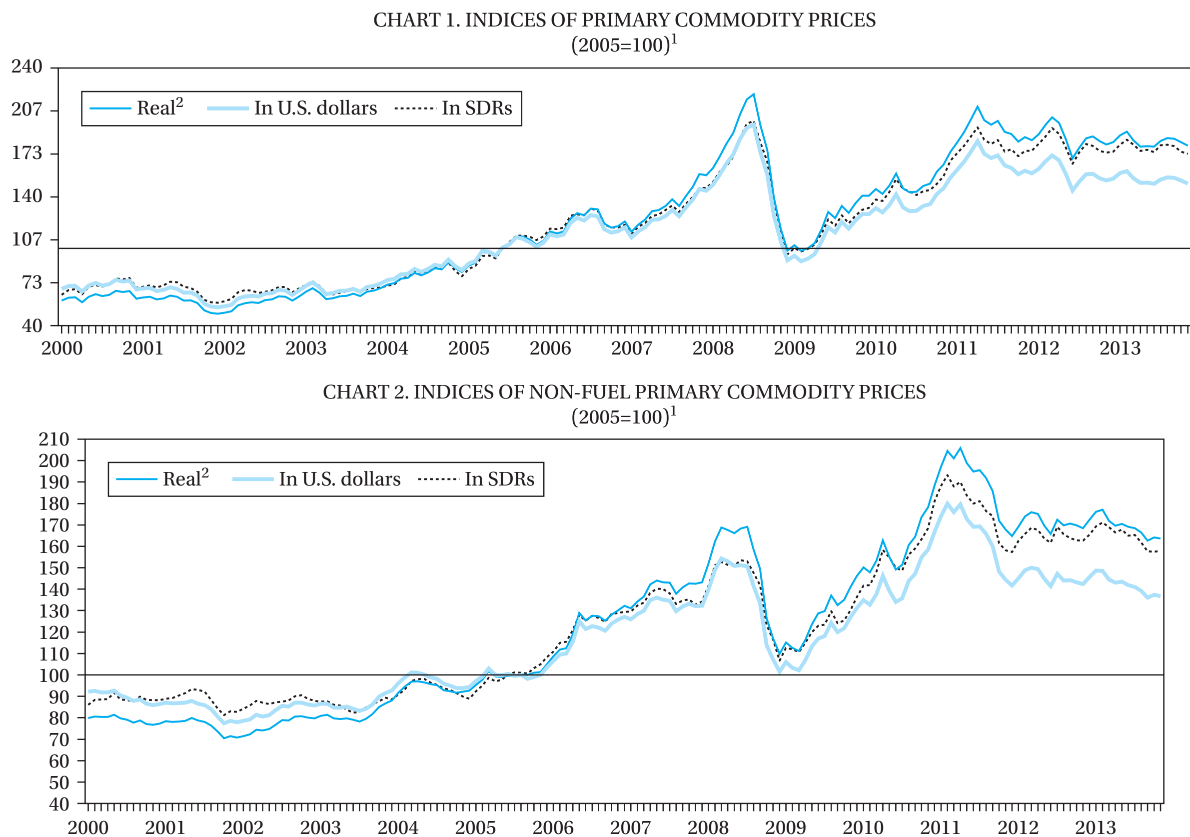
strong statements of their determination to reduce budget deficits and increase savings, measures that would be associated with fewer imports from developing countries. Many analysts have continued to view the euro as the most likely flashpoint for any new crisis, with inadequate follow-through on previous initiatives. Japan (like Germany and some other European economies) remains a strongly export surplus country as its population continues to age. Again, with the outlook doubtful for rapid increases in exports to developed countries, the emphasis has turned to trade among developing countries.

Initial loss of commodity revenues were substantial. The United Nations reported that "developing countries still suffered a 31 percent decline in the value of their exports in 2009".[32] Subsequently, commodity revenues rebounded with increases in both prices and quantities delivered. However, commodity prices had peaked by 2011; and at the end of 2013 remained below the 2008 and 2011 peaks (see Figure 13.5). Commodity prices may fall further as growth in China decelerates.

FIGURE 13.5 Indices of Commodity Prices (Total and Non-Fuel), 2000–2013



Source: IMF, http://www.imf.org/external/np/res/commod/Charts.pdf, update of October 10, 2013. Used by permission of the IMF.

[1]Indices comprise 60 price series for 44 non-fuel primary commodities. Weights are based on the 2002-2004 average of world export earnings.

[2]Deflated by US CPI

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The IMF examined one of the central questions of the crisis for economic development: Do financial crises have lasting effects on trade? The research examined the evidence since 1970 and found that imports remained depressed even in the medium term after banking crises, while exports from the crisis countries were relatively unaffected. Countries with banking crises that also had higher current account deficits generally experienced *larger* declines in imports. This finding supported concern that opportunities for developing countries to expand exports to the United States and to the significant number of European countries that experienced banking crises will be more limited for several years, yet another factor underscoring the renewed priority placed on trade among developing nations.[33]

Foreign Investment Inflows A United Nations Conference on Trade and Development (UNCTAD) study concluded that "the global crisis curtailed the funding available for FDI" and noted that "FDI inflows to developing and transition economies declined by 27 percent to $548 billion in 2009, following six years of uninterrupted growth. While their FDI contracted, this grouping appeared more resilient to the crisis than developed countries…. Their share in global FDI inflows kept rising: for the first time ever, developing and transition economies are now absorbing half of global FDI inflows.… Following almost a decade of uninterrupted growth, FDI flows to Africa fell to $59 billion—a 19 percent decline compared to 2008—mainly due to contraction in global demand and falling commodity prices."[34]

For Africa, the trend toward an increasing fraction of FDI inflows originating in China and other developing countries has apparently been enhanced by the crisis. The share of these so-called emerging investors in FDI to Africa increased on average from 18% in the 1995–1999 period to 21% in 2000–2008. In subsequent years, this share has continued to rise. The UNCTAD *2010 World Investment Report* concluded that investments from emerging investors "proved more resilient than FDI from developed countries."[35]

Although 2007 saw a record $2 trillion in global FDI, in the aftermath of the crisis, FDI fell sharply; five years later, in 2012, the total was only $1.35 trillion (just two-thirds of the record). But in 2012, developing countries received more than half of FDI inflows for the first time—an extraordinary $703 billion. Moreover, by 2012, developing nations themselves were the source of over 30% of FDI outflows ($426 billion of the $1,391 billion total).[36] Yet again, we see a striking, albeit very unevenly distributed, shift to developing countries and to their interactions with each other. (Further details on foreign direct investment in economic development are found in Chapter 14, section 14.2.)

Developing-Country Stock Markets At first, a flight to safety caused the volatility of developing-country stock markets to increase greatly. But prices subsequently resumed their rise, and markets deepened in a few rapidly growing economies, notably China and India. More details about developing-country stock markets are to be found in Chapter 15 (sections 15.1 and 15.4).

Aid Aid has risen modestly since 2001, but only a modest portion of the promised increases has been delivered, most likely due in part to the impact of the crisis and subsequent recessions in the high-income donor countries

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(foreign aid is covered in more detail in Chapter 14, section 14.4). But as aid remained below historical levels, other financial flows such as worker remittances, FDI, and portfolio investment flows increased by many times more than the declines in aid (see Figure 14.2). Yet, for the least developed countries, aid is needed as much as ever. There are strong political pressures against any increase in aid, let alone maintaining its current levels, in the United States, the United Kingdom, and other high-income donor countries. In past periods of prolonged recession or fiscal restraint, high-income countries have cut bilateral aid. Indeed, according to the United Nations, in 2012 official aid from developed countries was $125.6 billion, which represented a 4% decrease in real terms from 2011, which was, in turn, another 2% below the level of official aid in 2010. To the extent that aid targets human development and safety net programs, this could harm the poor beyond the impact of slowed growth. People living in extreme poverty are sometimes isolated from markets, but some receive and may depend upon foreign assistance. Charitable giving remained relatively stable; specialists cited the dramatic rebound of U.S. stock market valuations.[37] In sum, prospects for reversing the slide in—let alone expanding—official and unofficial development assistance likely depend on the extent of growth in donor nations.

Distribution of Influence among Developing Countries There have always been divisions in the developing world. During the Cold War, countries were asked to take sides, aligning themselves with the United States and other NATO countries, or the Soviet Union, or China. These conflicts spilled over to the nonaligned movement, which included countries with clear alliances. It is true that from the 1950s through the 1970s, there was a wide economic gulf between middle-income Latin America and low-income Asia. But economic inequality among the developing nations was not discussed. Most countries were growing but at a slow rate. This began to change as rapid growth in Asia spread from a few countries prior to 1980 to a majority of the region in the following three decades, while Africa particularly lagged. Even as the crisis accelerated, some developing countries, most notably China but also countries such as Brazil, found that they had increased global influence. But the growing economic inequality among developing nations became even sharper.

Worker Remittances Remittances to developing countries from migrant workers had reached a record $336 billion in 2008 (though less than 10% of this went to the low-income countries). But this fell significantly in the aftermath of the crisis, followed by significant recovery. These remittances have been an important factor in the progress of poverty reduction in recent years, and the consequences will grow if remittances do not pick up more quickly (see Figure 14.4 in Chapter 14).

Poverty In developing countries, the crisis affected earnings more than employment. In the aftermath of the crisis, lower growth reduced the rate of poverty reduction in most developing countries, and in many countries, the number of people living in poverty increased. The *2010 Millennium Development Goals Report*,

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drawing on "newly updated estimates from the World Bank," estimated that an additional 50 million people were living in extreme poverty in 2009 than would have been the case without the crisis and projected "some 64 million by the end of 2010 relative to a no-crisis scenario, principally in sub-Saharan Africa and Eastern and South-Eastern Asia." One of the important impacts was a slowdown in the rate of hunger reduction.[38] The 2010 *Millennium Development Goals Report* estimated that "poverty rates will be slightly higher in 2015 and even beyond, to 2020, than they would have been had the world economy grown steadily at its pre-crisis pace." The most recent evidence shows poverty falling impressively in most of the developing world, but unfortunately not much in Africa despite its improved economic growth rates (see Chapter 5, Figure 5.13).

Health and Education Jed Friedman and Norbert Schady used household data to develop an econometric model to project infant deaths and report that "our estimates suggest that there will be on the order of 30,000 to 50,000 excess deaths in Africa in 2009—deaths that would not have taken place had the subprime crisis which began in the United States not spread to African countries." They find that "the bulk of the additional children who will die is likely to be found among poorer households (in rural areas, and those with lower education levels) and is concentrated among girls." Impacts generally differ across countries; another 2010 study projected deteriorations specifically in schooling, child labor, and access to health services in Burkina Faso, and on hunger in Ghana.[39]

Differing Impacts and Continuing Challenges across Developing Regions

Asia During the period from September 2008 to March 2009, there was a dramatic slowdown and in some cases major reversal of the high export growth and GDP growth that the East Asian region, including China, had come to take for granted. The subsequent rebound was strong but uneven.

China China weathered the initial crisis well, partly due to its own massive stimulus package of almost $600 billion, a much higher share of GDP than the corresponding U.S. package (of about $800 billion).[40] The government announced a new strategy of greater reliance on domestic demand for growth. But hallmarks of a housing market and commercial property bubble are being reported in China; the bursting of such a bubble would probably have a significant impact on the global economy. Infrastructure and other investment levels have also been at historically unprecedented levels, with nearly half of output represented in investment in official statistics but a significant fraction of it apparently yielding low returns. China's economic policymakers appear focused on decreasing reliance on basic exports that rely on processing of imports for modest value added before re-export. Improving domestic processing and reliance might also positively affect what is widely viewed as a currency imbalance.[41] Moreover, China's growth has been decelerating from unsustainable levels that have continued longer than previously expected, partly as a result of the boost from the post-crisis stimulus package

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and subsequent lending policies. Further deceleration of growth in China seems likely. One reason is that total debt rose very rapidly from about 130% of GDP in 2008 to about 200% in 2013. A particular concern is off-the-books local government debt, which the National Audit Office of China reported has skyrocketed to almost $3 trillion in the three years to June 2013. As growth slows further in China, export earnings from developing country exports to China may decrease. Growth in China is examined in detail in the end-of-chapter case study for Chapter 4.

China and the Exchange Rates Controversy China also found itself under considerable pressure to allow its currency to increase in value in the aftermath of the crisis. In comments apparently directed as much to the United States as to China, in Fall 2010 the finance minister of Brazil announced the world had moved into an "international currency war." Brazil then doubled the tax on foreign purchases of bonds to keep its currency, the real, from appreciating via capital inflows, and other countries, including Japan, intervened to decrease the value of their currencies. Jean-Claude Juncker, chair of the eurozone finance ministers, said, "We think the Chinese currency is broadly undervalued." IMF Managing Director Dominique Strauss-Kahn said that "there is clearly the idea beginning to circulate that currencies can be used as a policy weapon.…Translated into action, such an idea would represent a very serious risk to the global recovery…[and] any such approach would have a negative and very damaging longer-run impact." International currency and trade wars were major factors that made the Great Depression "great." The response from China's premier Wen Jiabao was to note the thin profit margins of export companies, and he said that with revaluation, "many of our exporting companies would have to close down, [and] migrant workers would have to return to their villages. If China saw social and economic turbulence, then it would be a disaster for the world."[42] Undoubtedly, it would have both an economic and a political impact. While adjustments are inevitable, there is no credible scenario in which a trade war, or anything approaching it, would have anything but negative effects on the prospects for economic development. These issues remained contentious but managed diplomatically through 2013, with slow but significant appreciation of China's currency.

East Asia and Southeast Asia other than China The five high-income economies in the region—Japan, Singapore, Taiwan, South Korea, and Hong Kong—remain dependent on exports for growth by global standards, and all experienced substantial declines in exports. Expressed in U.S. dollars, exports dropped by 25%, with GDP declining between 15 and 30% in the second half of 2008 and first half of 2009. However, just as the scope of the shock was unanticipated, the scale of the subsequent rebound was also surprising. (The economy of South Korea is examined in-depth in the case study at the end of this chapter).

Recovery in middle- and low-income countries, including Indonesia, Vietnam, Cambodia, Malaysia, and Thailand, was also strong; three of these five countries reported negative growth after the crisis, but no greater a decline than 2.7%. Demand from China helped raise exports from East and Southeast

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Asia overall. The World Bank noted that China's "infrastructure outlays also underpinned demand for regional and raw materials used in construction, from countries such as Indonesia, Papua New Guinea, and Lao People's Democratic Republic."[43] The role of China in the region has continued to grow. However, tensions over that role were a factor in the push for a new Trans-Pacific Partnership and smaller regional agreements. In the 2011–2013 period, growth continued among countries in this region, but with wide variations.

India Initially, the Indian economy weathered the financial crisis relatively well. During the crisis, the central government fiscal deficit rose to nearly 7% of GDP. This was in part a planned stimulus to maintain growth during the crisis period. Like most other countries that ran up the fiscal deficit after the crisis, leaders and economic policymakers in India now wish to reduce the deficit substantially, if not run a compensating fiscal surplus for a time. On the other hand, expenditures on poverty programs are increasing, with new government nutrition programs to have a much expanded reach—some commentators found this a very hopeful sign, given the continued severity of poverty, in general, and malnutrition, in particular, still prevalent in India. The opposition criticized these programs as a political move intended to influence the 2014 general elections.[44]

GDP growth in India fell from its torrid pace of nearly 10% in 2007, to less than 4% in 2008, reflecting the impact of the crisis. It then recovered dramatically to almost 8.5% in 2009, and to nearly 10.5% in 2010—the first time growth ever topped 10% in India. But since that time, growth has dropped, to about 6.3% in 2011, then to just 3.2% in 2012, with the preliminary estimate for 2013 less than 5%.[45] The manufacturing sector had a full-year period of decline. Also viewed as a concern for the future was India's growing dependence on energy imports.

Even today, however, over half of the labor force in India works in agriculture. Barriers to global finance in India have helped insulate India's still relatively closed economy, but this also suggests there are other untapped gains from trade. India is working to develop more active economic and political relationships with developing countries in Asia and with such nations as Brazil and South Africa.[46]

Latin America and the Caribbean Despite concerns that the crisis would quickly lead to a repeat of past crises in the region, many countries weathered the initial shocks relatively well. Mexico suffered an economic contraction of about 6.5% in 2009, in the wake of the crisis, due to close economic ties in the United States and amplified by the outbreak of the H1N1 flu virus. When the peso was driven to record lows in December 2008, Mexican firms suffered foreign derivative losses. While growth rose to about 5% in 2010, it fell back to less than 4% in both 2011 and 2012.[47]

While growth of remittances bounced back and remained strong in most regions, they stayed weak in Latin America and the Caribbean, where growth decelerated due to U.S. economic weakness and policy changes.[48]

Argentina was hit hard by the crisis, rebounded very strongly in 2010 and 2011, but then slipped back into slow GDP growth—less than 2% in 2012.

Brazil at first weathered the crisis well, with 6% growth in 2007 and 5% growth in 2008, in no small part due to the boost from commodity exports, particularly to

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China—now its largest trading partner. But as its currency, the real, appreciated, exports were curtailed. After that point, growth was volatile, turning slightly negative in 2009, then surging to about 7.5% in 2010; but growth then dropped to 2.7% in 2011 and fell below 1% in 2012. As per capita growth slowed to a standstill, popular unrest emerged. Growth in Brazil is examined in greater detail in the end-of-chapter case study for Chapter 1.

Africa Low levels of trade, coupled with relatively high commodity prices for its exports, in some ways helped insulate sub-Saharan Africa from the brunt of the crisis. The problem of educated unemployment was exacerbated, as new university graduates in the region were having even more difficulty than usual in finding employment that matched their qualifications. This is also true in North Africa and the Middle East, where it was a factor in the Arab Spring revolts.[49]

Although commodity prices were off their peaks, they remained relatively high, due in significant measure to demand from Asia, and commodity exports continued to fuel growth (see Figure 13.5). If growth in Asia remains high, commodity prices may remain higher than in the previous quarter century. But as we have seen, the recent trend is one of modest price declines. As mentioned earlier, prospects for improved aid flows have at best become more uncertain, with modest declines in recent years; and the prospects of further growth of remittances from families working abroad are unclear.[50]

Middle East and North Africa (MENA) Recovery has been very sluggish in much of the MENA region, as growth has continued to be slow in the 2011–2013 period in several important countries.[51] This is despite the fact that governments in the region undertook expansionary fiscal policies. Countries that saw the overthrow of their governments during the Arab Spring revolts, namely Egypt, Tunisia, Libya, and Yemen, are having mixed success at economic recovery. In 2013 in Egypt, the new turmoil also created economic and political uncertainty and led to a further drop in investment and tourism. The economic breakdown in Syria has tracked the brutality of its civil war. Even in countries that have not experienced turmoil, some "spillovers," including investor perceptions, have led to falls in economic activity. On the other hand, oil exporters have benefited from prevailing relatively high oil prices (albeit well below the precrisis peak), even as the economies of oil importers such as Egypt have been negatively affected.

Prospects for Recovery and Stability

In the years following the crisis, international financial institutions and many private forecasters predicted that developing countries would lead a global recovery, which would be a milestone in the history of development.[52] The World Bank, along with the IMF and other forecasters, indicated that risks are to the downside. Indeed, there are at least five reasons for caution:

1. After growth in the United States, Europe and Japan remained significantly below historical levels for six years following the crisis, and there were doubts that faster growth could resume in most OECD countries for some time to come—even given that recessions after financial crises

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historically were deeper and longer lasting than other downturns. Large trade deficits of high-income countries, most notably but not only in the United States, have fallen, and seem unlikely to come close to previous heights. The trade balance for Europe as a whole is moving from deficit to surplus. This makes dependence on exports to high-income countries, including the United States, a shaky foundation at present on which to build growth. If growth in major middle-income countries continues to slow significantly in line with forecasts, this puts export-led growth as a development model at greater risk.

2. Fiscal deficits have been high in virtually all high-income OECD countries, but falling rapidly, reducing demand; deficits are unlikely to return to previous levels. But in most countries, government debt is now much higher than before the crisis. There is less room for fiscal policy to respond with stimulus in the event of another crisis.

3. Market perceptions of the risk of sovereign default are high—though, in a historic reversal, less so for developing countries on average than for a number of developed countries. A default or major debt restructuring in Europe could threaten the solvency of banks beyond this group, with the potential for a return to broader crisis.

4. The risk of deflation (which occurred during the Great Depression and in Japan during its “lost decade") remains higher than normal. This compounds any other difficulties of emerging from a new crisis. The quantitative easing in the United States was a response to this risk, but it also led to a lower value of the dollar—a major concern of developing-country exporters. The low interest rates in the United States due to quantitative easing also fueled capital outflows to middle-income countries, which may prove temporary after the taper of quantitative easing in 2014 and a possible return to historic interest rate patterns.

5. Benefits of exporting manufactures to high-income countries (see Chapter 12) are still present. But the opportunity to do so is threatened due to very slow growth, worsened credit constraints, and perhaps even an increase in disguised protectionism in the developed countries. Such conditions may lead to reduced growth in developing countries, and a reduced pace of technology transfer from developed to developing countries.

One indicator to watch over the next few years is whether developing countries can continue to rely more on exports to each other, as well as internally generated demand. If they can build on recent trends and make this transition, development may be more rapid and setbacks less likely than has been expected during the crisis or in the decades preceding it.

Opportunities as Well as Dangers?

In Chinese symbols, crisis is formed from the symbols for two other words: *wei*, a symbol for danger or great peril, and *ji*, which can serve as the symbol of opportunity or turning point. Like many difficult translations, scholars differ on what *ji* means in this usage. But it introduces a question: Throughout

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the developing world, the unfolding crisis and its aftershocks were viewed with fear—what would happen to markets for their vital exports? But there is no doubt that many policymakers in China, and in other fast-growing developing nations, quickly came also to view the crisis as a great opportunity and a critical turning point.

As the G8 lost some of its central role, this was paralleled by a relative rise of the G20, a broader group of nations, including leading developing countries, whose prominence in the 2008 and 2009 meetings to respond to the crisis was a historic event in economic and political relations between developed and developing worlds. However, after the worst of the crisis abated, the sustainability of a prominent G20 role was unclear. The emergence of China as a possible regional engine of growth could allow less dependence on exports to Western markets, although several countries in the region were also alarmed about China's intentions. And several African nations have become enthusiastic about the emergence of China as a commodities investor as a counterweight to long-powerful Western companies.[53]

But hopes have been dimmed in many parts of the developing world for open and stable access to developed-country markets. Since the 2008 crisis, politicians have considered it inexpedient to be viewed as extending "concessions" on trade. The crisis also revealed to developing countries that despite the assurances of WTO rules, the United States, the European Union, and other advanced regions could effectively get away with reverting to protectionism, at least in the short run, when they found it to be politically expedient. For example, the U.S. stimulus package contained "Buy American" provisions; these were challenged but, for the most part, prevailed. Similar requirements were found in the packages of other high-income countries. These served as sobering reminders that the benefits of exporting to historically more open U.S., Canadian, UK, and other markets could not be taken for granted; alternative strategies in domestic demand-led growth and greater reliance on trade between developing countries will also be pursued.

The Trans-Pacific Partnership being negotiated would include high-income Australia, Canada, New Zealand, and the United States (and quite possibly Japan), along with developing countries Mexico, Peru, Chile, Malaysia, and Vietnam, plus city-states Singapore and Brunei. Despite a modest WTO accord in 2013, the trend toward negotiating regional trade agreements and circumventing the WTO appears to be accelerating, with uncertain ramifications.

Overall, recovery in the developing world from the global financial crisis proved far more rapid than many analysts had originally predicted—even as it was worse than expected for many developed countries, particularly in Europe. Yet, as we have seen, many questions remain about the strength and stability of economic growth and development in the coming years.