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Why the Policy Development Capacity of Some Developing Countries Exceeds that of the International Monetary Fund

by

Ross P. Buckley*

The IMF's track record on developing policy to govern the interaction of developing countries and global capital is not strong. Argentina was an IMF poster-child throughout the 1990s. Its economy imploded in 2001. The Brady Plan provided a resolution of the Latin American debt crisis of the 1980s. Yet the Plan was conceived by Brazil and Mexico, not the IMF. Chile successfully charted its own course through the turbulent 1990s with the adroit use of home grown capital controls. Likewise, Malaysia charted its own course out of the 1997 Asian crisis more advantageously than nations that implemented IMF programs and with policies the IMF vehemently opposed. The lesson is that developing nations need to develop their own innovative solutions to the challenges of global capital and are often better placed to do so than the IMF.

The International Monetary Fund plays a pivotal role in guiding and shaping the interactions between developing countries and global capital. The Fund advises countries upon when and how to liberalise their financial systems and open up to global capital. In addition, for countries with an IMF program in place, the Fund has direct input into the

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regulations enacted to achieve these ends, and into the fiscal and monetary policy settings of the country. These functions were not part of the IMF's original role, but over the past 23 years (since the inception of the Debt Crisis in 1982) the IMF's role has evolved so that today these functions are central to its mission.[1]

Yet the history of the past two decades suggests that the IMF may not be the best placed institution for this purpose. This article analyses four developments in the past fifteen years: (i) Argentina's recent economic crisis, (ii) the Brady Plan implemented in the early 1990s to address the Latin American debt crisis, (iii) Chile's reponse to increasing capital inflows in the early 1990s, and (iv) Malaysia's response to the East Asian economic crisis that commenced in 1997. The article concludes that some developing countries are better placed than the IMF to develop the policies and regulations that will govern their interaction with global capital and analyzes why this might be so.

The Argentine Experience

The 1980s were a lost decade in Latin America in general and Argentina in particular. The debt crisis of 1982 cast its long shadow over the decade: Latin American countries were net capital exporters as they repaid more than they were able to borrow, living standards plummeted, and infrastructure crumbled.[2]

The years from 1991 to 1998, in contrast, were a prosperous time in Argentina as the resolution from the creditor's perspective of the debt crisis through the Brady Plan encouraged the resumption of net capital flows into the country. Argentina's economy performed particularly strongly with GDP per capita increasing an exceptional 44% between 1991 and 1998.[3] Argentina enjoyed its highest rates of growth since the 1920s and inflation was completely under control.[4] Argentina has a strong base for an

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[1] The full text of the Purposes of the IMF can be found in *Article I, Articles of Agreement of the International Monetary Fund* http://www.imf.org/external/pubs/ft/aa/aa01.htm.

[2] See Statement of Per Pinstrup-Andersen, *Food Security and Structural Adjustment* (Statement delivered before the House Committee on Banking, Finance and Urban Affairs hearings on the *International Economic Issues and Their Impact on the U.S. Financial System*, 101st Congress First Session, 4 January 1989) 165, 181, where he said, "Severe deterioration in real incomes, food security and nutritional status among the poor have occurred in several countries during periods of [structural] adjustment"; and Testimony of Dr Richard Jolly, Deputy Executive Director for Programmes, United Nations Children's Fund (Statement delivered before the House Committee on Banking, Finance and Urban Affairs hearings on the *International Economic Issues and Their Impact on the U.S. Financial System*, 101st Congress First Session, 4 January 1989) 14. See also Jerry Dohnal, *Structural Adjustment Programs: A Violation of Rights* 1 AJHR 57 (1994).

[3] Miguel Kiguel, *Structural Reforms in Argentina: Success or Failure?* XLIV(2) Comparative Economic Studies 83, 84 (2002); percentage calculated from Figure 1. There was a brief hiatus in the growth during 1995 in response to the Tequila effect: the contagion from Mexico's crisis in late 1994 and early 1995: Kigel, id, 94-95.

[4] Kiguel, id. 84.

economy: a literacy rate of 96.2%,[5] the best educational system in Latin America and rich natural resources.[6]

In these years, Argentina significantly improved its banking system, more than doubled its exports, increased infrastructure investment through privatisations and otherwise privatised a broad range of industries, experienced significant growth in oil and mineral production and achieved record levels of agricultural and industrial output.[7] Argentina was a darling of the IMF and the financial markets and was toasted as "the best case of 'responsible leadership' in the developing world".[8]

Nonetheless at the end of 1998 Argentina entered a severe recession. The timing was dictated in part by external factors, in particular the 1997 Asian economic crisis and the August 1998 Russian crisis which together severely limited capital flows to emerging markets economies. Argentina accordingly had very limited access to new capital to finance budget deficits and service its debt.[9] However, while these external factors influenced the timing of the crisis, they did not cause it.[10] The causes will be considered in the next section.

The recession deepened into a severe crisis in late 2001 when the IMF refused to extend further credit to the nation, believing its economic programs to be unsustainable. As commercial lenders followed this lead, Argentina was denied access to capital and defaulted on its external debt of some US$ 132 billion.

The government was forced to float the peso, which more than halved in value overnight,[11] and still the crisis deepened. Eventually, on April 19, 2002 the government ordered the indefinite closure of all banks in Argentina.[12]

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[5] Sophie Arie, *Rich Argentina tastes hunger*, The Observer (United Kingdom), 19 May 2002.

[6] In the 1930s, on the back of strong beef and grain exports, per capita income in Argentina was on a par with that in France.

[7] Kiguel, supra 100-101. This is not to suggest that many of the privatisations were not deeply problematic. It is always a profound challenge to realise appropriate prices for the privatisation of major businesses and assets in emerging markets nations for the range of potential purchasers is not wide and because of the risk of very favourable prices for well-connected purchasers. The scrupulous and rigorous public accountability procedures that would mitigate against the latter risk are rarely present. There is much to suggest that many of the privatisations of the 1990s in Argentina were at a deep undervalue.

[8] *Chaos in Argentina*, The Nation (New York), 21 January 2002, 3. See also *Argentina: A Poster Child for the Failure of Liberalized Policies? Interview with Lance Taylor*, Challenge November-December 2001, 28.

[9] Kiguel, supra, 84

[10] Ross Buckley, *Emerging Markets Debt* (1st ed, 1999) 21.

[11] Andres Gaudin, *Thirteen days that shook Argentina – and now what?* 35 NACLA Report on the Americas 6 (2002).

[12] David Teather, *Argentina orders banks to close*, The Guardian (United Kingdom), 20 April 2002. On April 22, 2002 the Buenos Aires stock exchange was closed in an indefinite suspension

Today a sizable proportion of the Argentine people have been impoverished by this crisis and UNICEF Argentina is concerned that stunted growth and reduced mental capacities will be the long-term consequence of this economic crisis for millions of the nation's children.[13]

Notwithstanding eight years of prodigious growth in the 1990s, since 2000 Argentina has undergone the worst economic crisis in its history[14] and possibly the worst peace-time economic crisis in world history.[15] How did this happen?

Causes of the Argentine Crisis

The principal causes of the crisis were the one to one peg of the peso to the US dollar, the massive inflows of foreign capital that were facilitated by the almost complete liberalisation of Argentina's capital account[16] and Argentina's endemic corruption. The first two causes were promoted or supported by the IMF. The contribution of each cause, and of IMF policies, will be considered.

The Peso-Dollar Peg

The peg was an effective means of stabilising inflation, which was critical in promoting local economic activity and in rendering Argentina an attractive destination for foreign capital. However by making one peso equal to one US dollar, Argentina gave up the principal means by which a nation's balance of payments remains in balance and its exports remain competitive: adjustments in its exchange rate.

Compare Argentina's situation with that of Mexico and Brazil. When, in the wake of the East Asian and Russian crises in 1997 and 1998 capital flows to Mexico declined sharply, its currency decreased in value, thereby improving the competitiveness of its exports.[17] Similarly when these and other factors affected Brazil, its government was able successfully (if a little shakily) to devalue the real 40% in January 1999 and thus neatly

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of banking activity: Mark Tran, *Argentina scrambles to avoid financial collapse*, Guardian Unlimited (United Kingdom), 22 April 2002.

[13] Arie, supra.

[14] Kiguel, supra 83; Martin Crutsinger, *IMF Grants Argentina Debt Extension*, Associated Press Online (New York), 9 May 2002.

[15] Duncan Green, *Let Latin America find its own path*, The Guardian (United Kingdom), 5 August 2002. On one estimate total domestic financial assets shrunk from US$126.8 bn in March 2001 to US$41.5 bn in March 2002. If this is correct it is one the most massive destructions of wealth anywhere in the world in the past thirty years. See *Economic Outlook, Argentina Quarterly Forecast Report,* Business Monitor International (London) (2002).

[16] Martin Feldstein, *Argentina's Fall* 81 Foreign Affairs 8 (2002); and *Argentina: A Poster Child for the Failure of Liberalized Policies? Interview with Lance Taylor,* Challenge November-December 2001, 28.

[17] Liliana Rojas-Suarez, *Toward a Sustainable FTAA: Does Latin America Meet the Necessary Financial Preconditions?*, unpublished paper.

sidestep an incipient crisis in that country.[18] No such exchange rate flexibility was available to Argentina.

The Brazilian devaluation was particularly problematic for Argentina. Brazil is Argentina's major trading partner and overnight Argentine products were relatively more expensive in Brazil, and Brazilian products relatively cheaper in Argentina.[19]

In summary, pegging the peso to the US dollar was always going to be highly problematic over the medium and long term.[20] Over time, unless the external competitiveness of the Argentine economy was to at least match that of the US economy, the tied exchange rate would inevitably lead to an overvaluation of the peso relative to the dollar, and many other currencies. The only ways Argentine exports could have remained competitive was for productivity growth in Argentina to exceed the relative appreciation of the US dollar, or for private and public sector wages to decrease in Argentina.[21]

Such productivity growth in Argentina is all but impossible for the value of the US dollar is driven not only by the strength of its home economy, but also by the massive capital flows into that economy from Europe and Asia and by the use of the US dollar as a de facto global reserve currency.

Likewise, reductions in nominal wages are a virtual political impossibility in any country. People will strenuously resist cuts in their nominal wages, while typically not even noticing reductions in the value of their wages when measured in a stronger, appreciating, foreign currency.[22]

The Argentine tragedy is that if, once hyperinflation was defeated in 1994, the peso had been allowed to gradually decline in value, growth in the nation's exports and economy

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[18] William Gruben and Sherry Kiser, *Why Brazil Devalued the Real* Federal Reserve Bank of Dallas (1999) http://www.dallasfed.org/eyi/global/9907real.html; Edmund Amann and Werner Baer, *Anchors Away: The Costs and Benefits of Brazil's Devaluation* University of Illinois at Urbana-Champaign College of Business Working Papers, (2002) http://www.business.uiuc.edu/Working_Papers/papers/02-0122.pdf.

[19] Rojas-Suarez, supra.

[20] Under this law, to be able to guarantee convertibility the government had to back each peso in circulation with a dollar or similar hard currency at the central bank: Feldstein, supra, 8.

[21] Kiguel, supra, 85.

[22] Anne Krueger, the First Deputy Managing Director of the IMF, puts this economic truth far too gently: "under a firmly fixed exchange rate, you need other sources of adjustment to maintain competitiveness". Why the coyness? Perhaps because to be direct would expose how politically unfeasible the IMF-sponsored policies had been. See Anne Krueger, *Crisis Prevention and Resolution: Lessons from Argentina* (Paper presented at the NBER Conference on 'The Argentina Crisis', Cambridge, 17 July 2002) www.imf.org/external/np.speeches/2002/071702.htm.

might have been strong and sustainable[23] – much as the steady erosion in value of the Australian dollar through the same period empowered that economy.

Excessive Indebtedness

The second cause of the crisis was the reliance by Argentina throughout the 1990s on international capital to finance budget and current account deficits.[24] Throughout the boom from 1991 to 1997, Argentina was living, and thriving, on borrowed money.[25] In this the Argentines were in step with their continent's history. Latin American nations have traditionally been unwilling to live within their means whenever debt has been available ever since they gained their independence in the 1820s.[26]

Borrowing to finance budget deficits is particularly problematic because this use of the funds will not generate the foreign exchange to service or repay the debt.

The removal of capital controls permitted strong flows of foreign capital into the nation in these years. As I have argued elsewhere, stringent prudential regulation must precede the liberalisation of a nation's capital account.[27] The IMF itself has identified, "a robust financial system underpinned by effective regulation and supervision of financial institutions"[28] as the overriding precondition to the liberalisation of a nation's capital controls. However, this was a lesson learned by the IMF in the late 1990s. In the early-to-mid 1990s the IMF encouraged the contemporaneous development of a nation's prudential regulation and the liberalisation of its capital account. Increasing the quality and extent of prudential regulation is slow, hard work calling for considerable resources which, particularly in human terms, are often in desperately short supply in developing countries. Liberalising capital controls can be achieved relatively swiftly and easily through legislation. For the IMF to promote the simultaneous, rather than sequential, adoption of these measures proved to be a recipe for disaster first in Indonesia, Korea, and Thailand and then in Argentina.

A recent audit by the Independent Evaluation Office of the IMF into the Fund's role in Argentina in the 1990s has found that the Fund's "surveillance underestimated the vulnerability that could arise from the steady increase in public debt, when much of it

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[23] Jeffrey Sachs, *A Crash Foretold: Argentina must revamp its society and economy for a high-tech world* 159 Time International, 14 January 2002, 17.

[24] Kiguel, supra, 101.

[25] Rojas-Suarez, 'supra, 10.

[26] Ross Buckley, *Emerging Markets Debt* (1st ed, 1999) 7-8.

[27] Ross Buckley, *An Oft-Ignored Perspective on the Asian Economic Crisis: The Role of Creditors and Investors* 15 Banking and Finance Law Review 431, 439-440, (2000).

[28] International Monetary Fund, *World Economic Outlook,* May 1998, 9.

was dollar-denominated and externally held."[29] In short, the IMF's own audit has found that Argentina borrowed too much, and the IMF acquiesced in this error.[30]

Argentina in the 1990s stands as strong evidence of a truism that international capital markets are extraordinarily slow to grasp: strong capital inflows generate strong growth that attracts further inflows. Basically, if global capital flows strongly into a relatively small economy like Argentina's or Thailand's, it will boom. The boom in turn makes it attractive to more capital, which in turn furthers the boom.

The resulting boom is unconnected to economic fundamentals and thus typically not sustainable. Foreign capital refuses to face this fact, for it profits in boom times, and without some form of sovereign bankruptcy regime its losses in hard times are limited. In addition, the careers and bonuses of individual bankers are greatly enhanced by the boom-time profits, and when hard times come, the individuals are rarely still in roles in which responsibility for losses can be sheeted home to them in any meaningful way.[31] Much global movement of capital can be attributed to internal reward structures within banks that reward the volume of loans made, not their quality.[32]

Corruption

As always in Latin American financial crises, corruption played its insidious role. It contributed in three ways:

Systemic corruption renders any economy profoundly inefficient as it increases transaction costs in many transactions. Corruption thus limited the returns derivable from the foreign capital in the Argentine economy.

Through corruption, portions of the capital flows were diverted from their intended destination into the private accounts of politicians, senior civil servants and leaders of industry.[33] When a significant proportion of the capital never even reaches the account of the debtor, repayment of the full amount will always be problematic.

The corruption of the political process in Argentina means that capital was often borrowed to serve the interests of the elite and of the politicians themselves, rather than in the best interests of the nation.

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[29] *Watchdog faults Argentina, but also IMF*, *IMF Survey* (Washington, DC), 9 August 2004, 229, 230.

[30] See Independent Evaluation Office (IEO) of the IMF, *Report on the Evaluation of the Role of the IMF in Argentina: 1991-2001* International Monetary Fund (2004) http://www.imf.org/External/NP/ieo/2004/arg/eng/index.htm.

[31] Ross Buckley, *A Tale of Two Crises: The Search for the Enduring Lessons of International Financial Reform* 6 UCLA Journal of International Law and Foreign Affairs 1, 15-16 (2001).

[32] Buckley, 'id, 15-16.

[33] Paul W Rasche, *Argentina: test case for a new approach to insolvency*?, Studien von Zeitfragen, 5 January 2002; Ernest Sweeney, *Argentina: the Current Crisis in Perspective' (2002) 186 America 19.; and Naomi Klein, 'Revolt of the wronged,* The Guardian (United Kingdom), 28 March 2002.

The Argentine people must root out corruption from their political and economic systems if they are ever to aspire to a stable economy and first world living standards. Moral and ethical reform, on a national scale, is needed.[34]

Both the IMF and the Argentine government made egregious policy errors in Argentina. Nonetheless, without the rejection of corruption in all its forms by the Argentine people their economy will never function efficiently and their governments will continue to govern in ways that serve the interests of the Argentine elite and international capital, and not the interests of the common Argentine people.[35]

IMF Policies

In many respects Argentina was throughout the 1990s a model IMF pupil.[36] It exhibited a degree of compliance with IMF-mandated policies that is rare among developing countries.

In liberalising its capital account by relaxing capital controls Argentina was implementing IMF policy, and the pegging of the peso to the US dollar was supported by the Fund.[37]

Throughout the 1990s the Argentine government enacted IMF economic policies. In May 2000, Charles Calomiris and Andrew Powell gave Argentina high marks for its reforms of its banking sector, saying,

the Argentine experience in the 1990s with bank regulatory reform … has been one of the most determined efforts, among emerging market countries, to inject credible market discipline into the relationship between banks and depositors, and into the regulatory and

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[34] Ernest Sweeney, *Argentina: the Current Crisis in Perspective,* 186 America 19 (2002).

[35] The best analysis I have read of this issue is by Professor Luiz Carlos Bresser Pereira. In his words before a committee of the U.S. House of Representatives in 1989, "But, in spite of the growing evidence of the impossibility of paying the entire debt, a significant portion of the elites in the debtor countries remains willing to try to pay it. We can think of a number of explanations for that attitude - fear of retaliations by the banks, cultural subordination to the First World, willingness to be part of it, identification of the interests of the creditor countries with the interests of the banks, lack of information about the debates among the elites of the creditor countries about the debt, inability to size up the internal economic crisis in their own countries, identification of firm positions for debt reduction to radical or nationalist political attitudes -- but I want in this testimony to underline only one explanation: the elites in general in the debtor countries are certainly not the ones that suffer most from the debt crisis; on the contrary, part of them is taking advantage from the debt", Statement of Professor Luiz Carlos Bresser Pereira, *Solving the Debt Crisis: Debt Relief and Adjustment* (Statement delivered before the House Committee on Banking, Finance and Urban Affairs hearings on the "Lesser Developed Countries' Debt Crisis"), 101st Congress First Session, 5 January 1989, 330, 339.

[36] Naomi Klein, *Revolt of the wronged*, The Guardian (United Kingdom), 28 March 2002; Charlotte Denny, *Firefighters turn on tap again*, The Guardian (United Kingdom), 12 August 2002.

[37] Martin Feldstein, supra, 8.

supervisory process. … Argentina successfully implemented a system of bank regulation that achieved credible market discipline over banks.[38]

Even with a change of government during the severe recession, this record of compliance continued. Upon becoming president in late 1999, Fernando de la Rua raised taxes and made massive cuts in government expenditure, including a 13% cut in state workers' wages and deep cuts to education and pensions.[39] Mr de la Rua's policies were so unpopular that he was forced out of office one-half of the way through his term after violent street protests claimed 31 lives in late 2001.[40]

Fiscal contraction is bad policy in any recession yet it was the IMF's first policy prescription for the East Asian crisis in 1997, and the Fund repeated its error in Argentina in 1999. It is imperative that the IMF begins to put the maintenance of functional economies and the human rights of the peoples of debtor nations above the short-term capacities of those nations to service their foreign debts fully.[41]

An increasing number of economists believe that Argentina's troubles stem directly from its implementation of IMF policies[42] and certainly the IMF's policies have contributed substantially to the crisis.

The policy lesson from the Argentine experience is that following IMF policies closely provides no insurance against ruinous crises. The IMF lauded Argentina's policy settings throughout the 1990s, and yet in late 2001 its economy still imploded. Argentina stands as testament to the fact that the IMF can get the policy settings very wrong.

The Brady Plan

In the early years the international financial community thought the 1982 debt crisis was a liquidity crisis and that sufficient fresh capital would allow the debtors to grow out of their problems. This was the premise of the Baker Plan, announced in 1985 and named

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[38] Charles W Calomiris and Andrew Powell, *Can Emerging Market Bank Regulators Establish Credible Discipline? The Case of Argentina, 1992-1999* NBER Working Paper Series, No. 7715 (2000) http://www.nber.org/papers/w7715.

[39] Simon Jeffery, *Crisis in Argentina*, Guardian Unlimited (United Kingdom), 4 January 2002.

[40] Uki Goni, *Argentina collapses into chaos*, The Guardian (United Kingdom), 21 December 2001; and Mark Healey and Ernesto Seman, *Down, Argentine Way,* 13 The American Prospect 12 (2002). And the protests have not stopped since: see *Argentine Crisis Fuels Protests*, Assoc Press Online (New York), 26 August 2002; and *Argentines protest against government economic policies*, Xinhua News Agency (China), 30 August 2002.

[41] The critical assessment of IMF policies in Argentina by the Independent Evaluation Office (IEO) of the IMF in *Report on the Evaluation of the Role of the IMF in Argentina: 1991-2001* (2004) International Monetary Fund http://www.imf.org/External/NP/ieo/2004/arg/eng/index.htm, is a heartening development that suggests, perhaps, the IMF is beginning to learn some of these important lessons.

[42] Larry Rohter, *Giving Argentina the Cinderella Treatment*, The New York Times (New York), 11 August 2002, 14.

after the then U.S. Treasury Secretary. But by early 1989 the Baker Plan was a dead letter. Banks had wearied of forever advancing new funds. Countries had wearied of their ever-rising level of indebtedness. IMF austerity programs were no longer politically tenable in Latin America. Their continuation could have led to the overthrow of some of the democratic governments that had come to power during the 1980s and the return of totalitarian regimes to the region.[43] Such developments would have been against U.S. interests. A new approach was needed from the U.S. government. That approach was the Brady Plan.

This new initiative represented a sharp departure from the Baker Plan. That much initially was clear. However, little else was. Treasury Secretary Nicholas Brady was deliberately vague[44] in his speech on March 10, 1989.[45] His vagueness reflected the U.S. Treasury's incapacity "to orchestrate a full-scale 'plan' and make it work"[46] and its unwillingness to be caught in the middle of the negotiations between creditors and debtors.[47]

Secretary Brady proposed a series of individual market-based transactions in which (i) creditors would be invited to participate voluntarily, (ii) debt relief would be tied into the conversion of loans into collateralised bonds, (iii) debtor nations would be permitted to repurchase their own discounted debt on the secondary market and (iv) debt-equity schemes would be promoted.[48] The proposal was seen as an expression of increased urgency from the U.S. government about the resolution of the debt crisis, a strong call for the development of capital-market-based solutions,[49] and an official acceptance that some debt forgiveness was essential. At long last, it seemed, the calls for debt relief were to be heeded.[50]

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[43] Statement of Professor Luiz Carlos Bresser Pereira, *Solving the Debt Crisis: Debt Relief and Adjustment* (Statement delivered before the House Committee on Banking, Finance and Urban Affairs hearings on the "Lesser Developed Countries' Debt Crisis"), 101st Congress First Session, 5 January 1989, 330, 332.

[44] John Calverley and Ingrid Iversen, *Banks and the Brady Initiative* in Griffith-Jones (ed), Third World Debt - Managing the Consequences 129, 129 & 133 (1989).

[45] Secretary Brady delivered his speech to a joint meeting of the IMF and the World Bank in Seoul, South Korea, on March 10, 1989, see Nicholas Brady, *Remarks to a Third World Debt Conference* (Speech delivered at the joint meeting of the IMF and the World Bank), Seoul, 10 March 1989, reprinted in Dep't of State Bulletin, May 1989, 53-56. See also *Bankers are briefed on the Brady plan*, 766 *IFR* (London), 11 March 1989, 28; and *Washington's view on Brady'*767 IFR (London), 18 March 1989, 29.

[46] Calverley and Iversen, supra, 133.

[47] Calverley and Iversen, id,, 133.

[48] See Lee C Buchheit, *The background to Brady's initiative,* IFLR, 29, 30 April 1990; and Leslie Fraust, *Debt Plan Spurs Interest in Securitizing LDC Loans*, The American Banker (New York), 28 March 1989, 55.

[49] Fraust, id, 55.

[50] Rory MacMillan, *The Next Sovereign Debt Crisis 31 Stanford J. In. L.* 305, 313-314 (1995).

The first Brady-style restructuring was of Mexico's debt. Mexico's strategic importance to the U.S. was seen as likely to result in the most favorable precedent for other debtor nations. Negotiations began in earnest between Mexico and its commercial bank creditors in May, 1989 and the bonds were issued in late March, 1990.[51] It was a slow process dragging hundreds of banks to the table when most were resisting strenuously. Many banks were reportedly "disgusted" with the deal but in the end were forced by their respective central banks to go along with it.[52]

The banks were offered a choice from the following three options for their Mexican loans:[53]

1. The banks could have their loans converted into newly issued 30-year bonds paying Libor plus 13/16 percent. The principal of these bonds would be 65 percent of the principal of the loans they were replacing. Repayment of this principal would be guaranteed by zero coupon bonds issued for the purpose by the U.S. Treasury, acquired by Mexico and held in escrow. In addition, there would be a rolling guarantee of eighteen months interest.[54] These became known as "discount bonds" because even though they paid a market rate of interest their principal amount involved a 35% discount from the loans they replaced.
2. The banks could have their loans converted into bonds with the same face value as the loans they replaced but which paid interest at the discounted, fixed rate of 6.25 percent.[55] The term and collateral for these bonds were as

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[51] *LDC Finance – Mexico* 820 IFR (London), 31 March 1990, 35. See also Bruce Wolfson, *Paving the Paper Trail* 26 LatinFinance 49, 49,(1991); *At Last?*, The Economist (London), 13 January 1990, 94; and Jonathon Hay and Nirmaljit Paul, *Regulation and Taxation of Commercial Banks during the International Debt Crisis,* World Bank Technical Paper No 158, U.S. Annex 1, 3 (1991).

[52] *Hurricane heading for Brady Plan*, 794 IFR (London), 23 September 1989, 12; and *Commercial bankers say Brady Plan is a non-starter* 795 IFR (London), 30 September 1989, 8.

[53] As the restructuring would result in bonds being issued in the U.S., the Securities Act of 1933 would on its face apply. To avoid the complexity and expense of complying with its strictures, counsel for Mexico obtained a "no-action" letter from the Securities and Exchange Commission which provided, in effect, an exemption from registration under the Act for the issuance of the bonds and defined the terms upon which subsequent sales of the bonds could be made in the U.S. See Letter from Cleary Gottlieb Steen & Hamilton on behalf of Mexico and Sherman & Sterling on behalf of the bank advisory committee for Mexico to Securities and Exchange Commission, 23 March 1990 and Letter from Securities and Exchange Commission, 28 March 1990 (1990 SEC No-Act. LEXIS 572).

[54] *The Debt Agreement*, Mexico Service (Mexico), 27 July 1989; and A. Gonzalo Santos, *Beyond Baker and Brady: Deeper Debt Reduction for Latin American Sovereign Debtors* 66 NYULR 66, 79 (1991). The acquisition of the collateral for these bonds was funded by $1.3 billion from Mexico, $2 billion from Japan, and $3.7 billion from the IMF and the World Bank: *The Debt Agreement*, Mexico Service, 27 July 1989.

[55] At the time of Mexico's restructuring agreement, July 1989, Libor was 8.81%. The usual interest rate on Mexico's debt was Libor plus 13/16th. The par bonds at 6.25%, fixed, thus

for the discounted principal bonds considered above.[56] These became known as "par bonds" because their face value reflected the full face value (par value) of the loans they replaced.

3. The banks could elect to participate in new loans to Mexico in the coming four years to the extent of 25 percent of their medium and long-term exposure to Mexico.[57]

This approach of offering the banks a range of restructuring options allowed banks to choose the option that most suited their view on interest rates and debtor prospects and their individual tax, regulatory and accounting situation.[58]

The prospects of the Brady proposal were greatly enhanced by a letter of July 14, 1989 from the SEC to David Mulford, Under Secretary of the Treasury,[59] which "clarified" the application to the Mexican Brady restructuring of Financial Accounting Standards No. 15, "Accounting by Debtors and Creditors for Troubled Debt Restructurings" (FAS 15).[60] The relevant part of FAS 15 provides that if, in full settlement of a debt, a creditor receives assets of which the fair value is less than the recorded value of the debt, then the creditor must record the shortfall as a loss. If an active market exists, fair value is market value. In the absence of such a market, fair value is to be estimated based on expected cash flows discounted for risk.[61]

David Mulford is commonly regarded as the architect of the Brady Plan and he had requested, and doubtless shaped, the letter of July 14, 1989 from the SEC. In the name of applying FAS 15 to Mexico's restructuring, the SEC wrote that a loss need not be recognised if "the total future undiscounted cash receipts specified by the new terms of the loan, including receipts designated as both principal and interest, equal or exceed the book value of the loan."[62] This letter is a remarkable document. [63] Upon this criterion

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represented an interest saving of nearly 3.4%. By way of comparison, 30-year U.S. Treasury bonds were yielding 8.14%.

[56] *The Debt Agreement*, Mexico Service, 27 July 1989.; and Santos, id, 79.

[57] *The Debt Agreement*, Mexico Service, 27 July 1989.; and Santos, id, 79.

[58] John Clark, *Debt Reduction and Market Reentry under the Brady Plan* 18 FRBNY Quarterly Review 38, 44-45 (1993-94).

[59] The text of this letter and its attachment is set out in Jonathon Hay and Nirmaljit Paul, *Regulation and Taxation of Commercial Banks during the International Debt Crisis World Bank Technical Paper No 158*, U.S. Annex 1, 126 et seq(1991).

[60] Hay and Paul, id, 159-160.

[61] Hay and Paul, id, 159.

[62] SEC letter and attachment reproduced in Hay and Paul, id, 128. See also Manuel Monteagudo, *The Debt Problem: The Baker Plan and the Brady Initiative: A Latin American Perspective* 28 The International Lawyer 59, 74 (1994).

[63] Upon its manifestly clear meaning, FAS 15 does not mean to exclude the time value of money from the calculations nor to treat interest as principal. Compare the approach of the Bank of England: discount bonds were to be placed on bank books at their face value of 65 percent with

the banks could accept Mexico's Brady Bonds in exchange for their loans without having to recognise a loss[64] notwithstanding that shortly after issue the par bonds were trading at 42 percent of face value and the discount bonds at 63 percent.[65] The analysis in this SEC letter represents the apotheosis of the popular international financial crisis game of smoke and mirrors – this letter treated interest as principal and made the value of money in 30 years equal to its current value. By ensuring that Brady bonds could be accepted by banks without provisions or writedowns,[66] and thus without the consequential reductions in profits provisions or writedowns would have entailed, the SEC made the Mexican restructuring far more palatable for U.S. banks.[67]

This restructuring was of all of Mexico's medium and long-term debt to the commercial banks.[68] A great deal of arm-twisting by regulators was required to secure the participation of all banks. Many were very reluctant to participate but bankers usually find overt pressure from their home regulators difficult to resist. Banks elected to convert 41 percent of total indebtedness into discounted principal bonds, 49 percent into discounted interest ('par') bonds, and to advance new money for the remaining 10 percent.[69] Of the three options, new money was to prove by far the most lucrative and

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the loss of 35 percent to be charged to provisions. Par bonds, on the other hand, could be recorded at face value provided the current provisions against Mexican debt were otherwise adequate (see Hay and Paul supra, 43. Given that discount and par bonds were designed to be of equal value and were treated by the international banks as such, this approach, which lays great weight on the face value of the bond and ignores the interest rate, is quite artificial (although not nearly as artificial as the SEC's approach).

[64] Manuel Monteagudo, *The Debt Problem: The Baker Plan and the Brady Initiative: A Latin American Perspective* 28 The International Lawyer 59, 75(1994). The SEC was careful to point out that its analysis of FAS 15 did not derogate from the general requirements of FAS 5 that loan losses must be recognised when a loan (or bond) is determined to be uncollectible in whole or part: SEC letter and attachment reproduced in Hay and Paul, supra, 129.

[65] *Indicative prices for developing country debt*, 823 IFR (London), 21 April 1990, 29.

[66] "Banks were able to account for both the par and discount bonds issued in Mexico's 1990 debt exchange without recognizing a restructuring loss": Office of the Superintendent of Financial Institutions, Canada, *Guideline: Exposure to Designated Countries, EDC 1990-10, Part E*, reproduced in Hay and Paul, supra, 114-115.

[67] See Hay and Paul, id, 29. While the exchange of loans for Brady bonds did not lead to writedowns for accounting purposes, an Internal Revenue Service Ruling provided that such exchanges may (and often would) lead to losses for income taxation purposes (see 'Internal Revenue Service Advance Revenue Ruling 89-122, on Determination of Amount and Recognition of Gain or Loss, Issued Nov 3, 1989' (26 CFR 1.1001-1) reproduced in Hay and Paul, id, 141. Hence, banks may well have recorded tax losses from participating in Brady bond exchanges without being required to make writedowns on account of the transaction -- a bizarre result which flows directly from defining black as white.

[68] Some $54 billion of medium and long-term Mexican debt was restructured: Santos, supra, 79.

[69] Testimony of William R Rhodes, *Federal News Service* (Washington, DC) 21 March 1990.

Citibank's foresight in taking that option exclusively was richly rewarded.[70] Yet in 1990 substantial pressure was needed to make banks holding the required 10 percent of exposure agree to advance new money.[71]

This Mexican restructuring was perceived to be a crucial first test of the Brady initiative. Secretary Brady's proposals were generally treated in the press as entirely novel and without precedent but the idea had been considered for quite some time.[72]

Indeed, the genesis of Brady's proposal was in Latin America not Washington: in the Aztec bonds, developed at Mexico's request, in 1988, and in even earlier proposals by Brazil to convert its foreign debt into 35-year bearer bonds with the same face value as the loans and below market fixed interest rates.[73] The agenda for this restructuring was "established not in Washington, but in Mexico City".[74] Indeed, the U.S. government had initially been strongly resistant to the idea.[75]

A crucial element of the Mexican debt negotiation strategy was the insistence on debt reduction and interest relief. The international financial community resisted any debt relief vigorously. Nevertheless, the Plan has been severely criticised for affording inadequate debt relief,[76] criticisms with which this author agrees. With the benefit of hindsight, the banks gained so much from the Plan, they could have afforded to give more to get it.

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[70] Interview with Michael Pettis, then of Hamilton Arbitrage Fund (20 February 1996) ("Pettis Interview").

[71] Interview with Michael Pettis, then of Hamilton Arbitrage Fund (20 February 1996) ("Pettis Interview").

[72] See *Third World Debt -- Watch out securitisation is on its way*, 703 IFR (London), 12 December 1987, 3876; and *Brazil - Time to securitise its debt*, 663 IFR (London), 7 March 1987, 763; and *LDC debt securitisation*, 723 IFR (London), 7 May 1988, 1444.

[73] *LDC Debt - The deep discount bushfire*, 690 IFR (London), 12 September 1987, 2947. Note, with the exception of collateral, how closely these bonds proposed by Brazil resemble the par bonds ultimately issued nearly three years later in Mexico's Brady style restructuring. See also Statement of Professor Luiz Carlos Bresser Pereira, *Solving the Debt Crisis: Debt Relief and Adjustment* (Statement delivered before the House Committee on Banking, Finance and Urban Affairs hearings on the "Lesser Developed Countries' Debt Crisis"), 101st Congress First Session, 5 January 1989, 330, 336-337.

[74] *The Debt Agreement*, Mexico Service, 27 July 1989, 6. The receptive ear in Washington necessary for Mexico's ideas to gain credence was that of David Mulford, then Assistant Secretary of the Treasury. To his credit, Mulford ran with Mexico's ideas and when Nicholas Brady became Treasury Secretary, Mulford had a superior who too was willing to listen: Walter S Mossberg and Peter Truell, '*Another Round: Bush Aides Are Likely to Offer a Plan Soon on Third World Debt*, The Wall Street Journal (New York), 9 March 1989.

[75] Statement of Professor Pereira, supra, 330, 336-337, and Lee C Buchheit, *The background to Brady's initiative* (1990) IFLR April 1990, 29, 30.

[76] Santos has described the Plan as "irreparably flawed" for this and other reasons: Santos, supra, 79-80.

The actual savings from Brady restructurings are difficult to assess. Moving some of the debt into fixed rate bonds protected the debtors against interest rate rises;[77] but as the general interest rate environment was falling throughout the early 1990s, this did nothing to alleviate repayment burdens relative to having left the debt accruing floating rates. But the Brady process served an important function in breaking the upward spiral of total indebtedness and in reducing the demands on the scarce time of government ministers and civil servants which arose from the periodic restructurings of the 1980s. In Clark's words,

> The Brady restructurings did not achieve significantly more near-term cash flow relief for debtors than the previous approach. But they did provide a more stable long-run financial framework that, in combination with structural reforms by debtors and a favorable environment of lower global interest rates, helped to restore market access.[78]

In the years following the Mexican restructuring, the commercial banks negotiated agreements with the Philippines, Costa Rica,[79] Venezuela, Morocco, the Philippines,[80] Venezuela,[81] Uruguay,[82] Argentina,[83] Brazil,[84], Bulgaria, the Dominican Republic, Ecuador, Jordan, and Poland.[85]

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[77] In this regard, the restructuring corrected one of the real anomalies of the lending boom of the 1970s—the preponderance of floating interest rates. Ironically, however, interest rates were to fall for the next six years.

[78] John Clark, *Debt Reduction and Market Reentry under the Brady Plan* (1993-94) 18 FRBNY Quarterly Review 38, 62.

[79] For information on Costa Rica's restructuring, see 'Debt Buyback Takes Center Stage in Costa Rican Agreement' (1990) XIII *Bank Letter* 2; Hay and Paul, supra, 5-6.

[80] Peter Truell, *Philippine Accord On Debt Reflects U.S. Strategy Shift*, The Wall Street Journal (New York), 17 August 1989.

[81] Prashant Vankudre, *Brady Bonds,* 26 *LatinFinance* 48, 53 (1991); and Peter Truell, *Venezuela Reaches Debt Settlement With Major Banks*, The Wall Street Journal (New York), 29 June 1990.

[82] *Uruguay's Turn,* 22 *LatinFinance* 12*,* (1990); and *Uruguay to pay 56 cents for debt*, 852 IFR (London), 10 November 1990, 29.

[83] Richard Voorhees, *Betting on Brady,* 37 LatinFinance 14 (1992); *Argentina: lots of work remains on agreement*, 924 IFR (London), 11 April 1992, 30; *Argentine Brady deal*, 942 *IFR* (London), 15 August 1992, 24; and *Banks get behind Argentina*, 948 IFR (London), 26 September 1992, 22.

[84] *No IMF letter for Brazil*, 1022 IFR (London), 19 March 1994, 49; and *Brazil - Waiver approved*, 1023 *IFR* (London), 26 March 1994, 46.

[85] Jordan completed its Brady-style restructuring in December 1993, Bulgaria in July 1994, the Dominican Republic in August 1994, Poland in October 1994 and Ecuador in 1995. See Kenneth N Gilpin, 'Foreign Debt Mop-Up; After Refinancing Brazil, Banks Now Face Just a Few Small Bad International Loans', *The New York Times* (New York), 18 April 1994, D-1, col 1; See *No IMF letter for Brazil*, 1022 IFR (London) 19 March 1994, 49; World Bank, *World Debt Tables, 1994-95*, 4-5 & 27-29 and see 68-75 for the detailed terms of each restructuring; *Bulgaria - Brady*

The Impact of the Brady Plan

It is today generally accepted that the securitisation of loans into bonds under the Brady Plan served both the international banks and the debtor nations.

The Brady Plan served the banks in four ways:[86]

1. It gave the banks liquid bonds, rather than relatively illiquid loans, which facilitated the banks selling the assets.
2. It triggered a turn-around in secondary market prices of these assets.
3. It enabled debtor nations to start borrowing, and issuing bonds, again, from which the banks earned fees.
4. It signaled the end of the debt crisis.

Given these four clear benefits to the international financial community it is instructive to note that the banks resisted the Plan at the time, fiercely. In the words of *The Economist*, "the bosses of most of America's big money-centre banks bristle with rage at any mention of the Brady plan. They fume at the write-offs they have had to make on their developing-country debt portfolios."[87]

At the time, the banks could not recognise what would prove to be in their own best interests.

The Brady Plan also served the debtor nations. The Plan signaled the end of the debt crisis, at least in the perception of the international financial community, and this perception mattered, because it meant the debtor nations could return to the voluntary capital markets with bond issuances, and that foreign investment capital began flowing into the region, albeit slowly at first.

Whether the Plan resolved the debt crisis from the perspective of the debtors is another issue all together. The debt is still there, being serviced today, in the form of Brady bonds along with a tremendous amount more borrowed since then. From the perspective of peasants in the fields of Mexico or Ecuador, who receive far poorer health services and education for their children than they would if such a high proportion of their government's income did not go in debt service, it is arguable the debt crisis has never gone away. But the Brady Plan did resolve the crisis from the perspective of the creditors,

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deal assessed, 1029 IFR (London), 7 May 1995; *The next generation*, 1027 IFR (London), 23 April 1994; Richard Voorhees, *Rejoining the fold; Ecuador becomes the latest Latin American nation to agree to a Brady debt reduction accord* 58 LatinFinance 60 (1994).

[86] For a detailed consideration of these four benefits, see Ross Buckley, *Turning Loans into Bonds: Lessons for East Asia from the Latin American Brady Plan* 1 Journal of Restructuring Finance 185 (2004).

[87] *Brady's bazaar*, The Economist (London), 12 May 1990, 81. See also the comments of Horst Schulman, Managing Director of the Institute of International Finance, who said, "Forced debt forgiveness was not essential ... All parties concerned might be better off today [without it]", reported in *Schulman Speaks Out*, LDC Debt Report, 21 September 1992, 4.

and this has been important in revitalizing the region and thus assisting the debtors through the stimulative effects of fresh capital flows.

The critical policy lesson, for the purposes of this article, is that the creative thinking required to conceptualise the Brady Plan was done in Sao Paulo and Mexico City, not Washington, D.C. David Mulford brought to the table a willingness to listen to the ideas of the debtors that had been absent in his predecessors. But the critical conceptual work was done by the debtor nations, not by the U.S. Treasury or the IMF.

Chile's Response to Increasing Capital Inflows in the Early 1990s

By the end of the 1980s foreign capital was starting to flow again into Chile in increasing amounts. While the rest of Latin America remained enmired in the debt crisis, it was clear a debt restructuring would not be required for Chile. Its economy was stronger than that of its neighbours and attractive to foreign investors.

The damage caused to Chile by the sudden cessation of foreign capital inflows in 1982 was still fresh in the mind when Chile's capital account surplus reached 10 percent of its GDP in 1990. To exacerbate the potential for instability, short-term flows represented one-third of this amount.[88] Fearing a repeat of 1982, Chile introduced capital inflow controls in 1991.

The capital controls had five elements:[89]

1. All portfolio flows including foreign loans and bond issues were subject to the requirement that an amount equal to a set proportion of the flow had to be put on interest-free deposit with the Central Bank for one year irrespective of the duration of the capital inflow. The proportion was initially set at 20 percent. In May 1992 it was increased to 30 percent, and then in June, 1996 reduced to 10 percent.
2. Credit lines for trade finance were subject to the same reserve requirements.
3. Bonds issued abroad by local companies had to have an average minimum maturity of four years.
4. Shares issuance abroad by local companies was limited to companies with relatively high credit ratings and to amounts no less than US $10 million.
5. Initial investment capital (but not profits) in foreign direct investment could not be repatriated for one year.

The first four restrictions are inflow controls, the last is an outflow control. Most international attention has focused on the first restriction, the unremunerated reserve requirement. The second restriction, on trade finance credit, is undesirable in that it tends

[88] Carmen M Reinhart and R Todd Smith, *Temporary Capital Controls* (1997), National Bureau of Economic Research Draft Paper, 7.

[89] RS Rajan, *Restraints on Capital Flows: What Are They?* The Institute of Policy Studies Working Paper No. 3 (Singapore) 3 (1998), Table 3.

to reduce a nation's international trade but necessary as otherwise the first restriction would be too readily circumvented.

The general consensus is that Chile's controls served to lengthen the average maturity of the capital it received.[90] The clearest lesson from the crises in Mexico in 1995, East Asia in 1997 and Russia in 1998 was the danger of excessive short-term indebtedness and other forms of short-term capital inflows.[91] There is strong evidence that the ratio of short-term debt to foreign currency reserves is a powerful predictor of financial crises, and that higher short-term debt levels are associated with more severe crises.[92] Short-term financing is simply not suitable, in the main, for the needs of developing countries. There is accordingly a strong argument for capital controls along Chilean lines that fall most heavily on short-term inflows.[93]

Views are more divided over whether Chile's controls also served to reduce the volume of capital inflows.[94] Certainly there was a strong initial effect: the capital account surplus fell from 10 percent of GDP in 1990 to 2.4 percent in 1991 and short-term debt inflows were virtually eliminated.[95] When capital inflows surged again in 1992, the proportion of the non-renumerated reserve requirement was increased, again successfully.[96] Eventually the controls were lifted altogether, in 1998, when, in the aftermath of the Asian crisis global capital flows to emerging markets nations declined precipitately and there was no

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[90] Ariyoshi, Habermeier, et al, *Country Experiences with the Use and Liberalization of Capital Controls'* International Monetary Fund [23] (2000) http://www.imf.org/external/pubs/ft/capcon/index.htm; Sebastian Edwards, *How Effective Are Capital Controls?* NBER Working Paper No. W7413, 11 (1999) http://www.nber.org/papers/w7413; Barry Eichengreen and Michael Mussa, *Capital Account Liberalization: Theoretical and Practical Aspects* (1998) IMF Occasional Paper No 172, 49-52 (and the sources there cited); Martin Feldstein, *A Self-Help Guide for Emerging Markets,* Foreign Affairs 93 (1999); Carmen M Reinhart and R Todd Smith, *Temporary Capital Controls*, Draft Paper, 8 (1997); RS Rajan, *Restraints on Capital Flows: What Are They*' The Institute of Policy Studies Working Paper No. 3 (Singapore) 3 (1998, Table 3; Joseph Stiglitz, *Bleak Growth Prospects for the Developing World*, International Herald Tribune (New York), 10-11 April 1999, 6.

[91] Eichengreen and Mussa, 'supra, 22.

[92] Dani Rodrik and Andres Velasco, *Short-term Capital Flows* NBER Working Paper No. W7364 (1999).

[93] Barry Eichengreen, *Capital Controls: Capital Idea or Capital Folly*? http://emlab.berkeley.edu/pub/users/eichengr/capcontrols.pdf.

[94] Eichengreen and Mussa, 'supra, 49-52; Reinhart and Smith, supra 8; and Rajan, supra, Table 3.

[95] Reinhart and Smith, id, 8.

[96] However, while in the short-term the increase in unremunerated reserve requirements was effective, by 1996 over 40% of Chile's debt to BIS reporting banks had an admittedly residual maturity of less than one year: Sebastian Edwards, *How Effective Are Capital Controls?* NBER Working Paper No. W7413, 25 (1999) http://www.nber.org/papers/w7413.

longer a need to discourage capital inflows and shift those that were coming in towards longer maturities.[97]

Foreign direct investment appears to have been relatively unaffected by the controls.[98]

The controls increased the cost of credit within Chile considerably, particularly for small and medium size businesses that found evasion of the controls most difficult.[99] This was a substantial price to pay. Nonetheless, Chile's controls altered the mix of incoming foreign capital in favour of long-term debt and away from instability-inducing short-term debt, and they served to reduce rapidly increasing levels of inflows in 1991 and again 1992.[100]

In conclusion, for as long as a developing nation has a thin financial market, unsophisticated private sector risk management techniques and an unsophisticated and under-resourced capital market regulator, there are good arguments for controls, from time to time, on capital in-flows.[101] This is particularly so in Asia, where high local savings rates diminish significantly the need for completely open capital markets. As an economy's own capital markets deepen, and its regulatory systems mature, then it can safely liberalise its capital account. Many developing nations are many years away from being in that position.

In the interim, of course, the admonition against free lunches generally holds. Capital controls have costs. Controls restrict access to foreign capital for investment, increase real interest rates, require expensive public administration and may reduce the pressure for domestic policy reform.[102] In particular, capital controls require considerable

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[97] Francisco Gallego, Leonardo Herdanez and Klaus Scmindt-Hebbel, *Capital Controls in Chile: Effective? Effecicient* (Paper presented at the Latin American and Caribbean Economic Association 2000 Annual Meeting, Rio de Janeiro, 12 October 2000) 4 http://www.lacea.org/meeting2000/FranciscoGallego.PDF.

[98] Reinhart and Smith, supra, 8.

[99] Edwards, supra.

[100] The conclusion of Ariyoshi, Habermeier, et al (Ariyoshi, Habermeier et al, *Country Experiences with the Use and Liberalization of Capital Controls* International Monetary Fund [23] (2001) http://www.imf.org/external/pubs/ft/capcon/index.htm) is that inflow controls were partly effective in reducing the level and increasing the maturity of inflows in Malaysia and Thailand, and in affecting the composition of the inflows in Colombia and possibly in Chile but were largely ineffective in Brazil.

[101] P Bustelo, C Garcia and I Olivie I, *Global and Domestic Factors of Financial Crises in Emerging Economies: Lessons from the East Asian Episodes (1997-1990)* (1999) Instituto Complutense De Estudios Internacionales Working Paper No. 16, 78. This was a recommendation of the Council on Foreign Relations in the U.S.: see *The Future of the International Financial Architecture; A Council on Foreign Relations Task Force* (1999) Foreign Affairs (New York) 169.

[102] The perils of global capital, The Economist (USA), 22 August 1998, 52. And, of course, capital flows are not the only mechanism for the transmission of contagion. Even a completely closed capital account will not insulate an economy from trade-related contagion (*Emerging-market measles*, The Economist (US) August 1998, 52) as Taiwan experienced in the wake of the

administration, and just as with trade barriers, capital controls can reduce the pressure for, and thus delay, needed policy adjustments.[103] Policy reform and the development of efficient regulatory institutions must be continued apace by developing nations even when controls are in place.

Capital controls are a policy option that is unlikely to ever be advocated by the IMF because the U.S. is the world's largest importer of capital and the strategic interests of the U.S. and of its banking sector require free capital mobility. The IMF is often treated in the literature as if it were a completely autonomous institution, but in fact the strategic direction and policies of the IMF are set in the twice yearly meetings of their Board of Governors over which the U.S. has enormous influence. Nonetheless, as the above case study suggests, inflow controls can play a real role in stabilizing an economy during periods of high and increasing inflows of global capital. Controls are a policy option that developing nations should be ready to implement, when needed.

Malaysia's Experience in the Asian Economic Crisis

Malaysia was the only severely affected crisis country not to adopt an IMF program during the Asian crisis that began in 1997.[104] With the benefit of hindsight, Malaysia's choice was demonstrably right for it. Malaysia's policies saw it recover from the crisis at least as fast as countries that implemented IMF policies and the poor in Malaysia are significantly better off today than they would have been under IMF policies. Malaysia also benefited in a number of other ways from charting its own course through the crisis.

Malaysia's initial response to the crisis was referred to by many as an IMF package without the IMF.[105] At the time, in consultation with the IMF,[106] Finance Minister Anwar Ibrahim tightened fiscal policy and made sharp spending cuts.[107] This policy was subsequently altered on an ad hoc basis, until Prime Minister Mahathir announced a complete change of policy with the introduction of the National Economic Recovery Program in July 1998.[108] This decisive departure from IMF orthodoxy involved an increase in government spending to stimulate the economy, capital controls to allow the government more control over Malaysia's economy and to prevent the outflow of foreign capital that would have ensued, and a restructuring package for the financial sector.

Asian crisis. See also Robert Wade and Frank Veneroso, *The Gathering World Slump and the Battle over Capital Controls* 231 New Left Review 13, 40 (1998).

[103] Ariyoshi, Habermeier, supra.

[104] The Philippines did not adopt an IMF program in response to the crisis, because it was not severely affected by it. See Arsenio M. Balisacan and Hal Hill (eds) *The Philippine Economy: Development, Policies and Challenges* 4-5(2003).

[105] Mydans, S. (1997). Malaysia is ready to Inflict its own Economic Medicine.

[106] Id.

[107] Fund, I. M. (2001). Malaysia: From Crisis to Recovery.

[108] Athukorala, P.-C. (2001). Crisis and Recovery in Malaysia: The Role of Capital Controls.

After this policy turnaround Malaysia initially implemented a stabilisation process and then undertook the restructure of its financial system.[109] The stabilization process involved the establishment of institutions to purchase non-performing loans and recapitalise financial institutions. The restructure phase involved the merger of financial institutions and the development of the local bond market.[110]

Malaysia reduced the amount of non-performing loans being carried by financial institutions, recapitalised these institutions and strengthened the system by closing and merging banks.[111] Like other crisis countries it also implemented 'a blanket deposit guarantee and liquidity support'.[112]

Malaysia's two unique responses to the crisis were the introduction of capital outflow controls and the pegging of the ringgit to the U.S. dollar.[113] Once these policies were introduced, the government was able to ease monetary policy, because it was no longer hampered by concerns about the impact on the exchange rate of capital outflows.[114]

The outflow controls[115] blocked all avenues for the transfer of the ringgit outside Malaysia and stopped non-residents removing portfolio capital from Malaysia for a period of 12 months.[116] After 6 months had passed, the 12-month restriction was replaced with a variable exit levy applying to principal or profit from investments in Malaysian securities.[117] The ringgit was pegged to the U.S. dollar in an attempt to prevent speculation in the ringgit.[118]

It is widely acknowledged, even by the IMF with hindsight,[119] that the introduction of the exchange controls and the currency peg was sound policy.[120] In the IMF's review of

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[109] Mahani Zainal Abidin, *Malaysia's Economy: Crisis and Recovery* in Mahani Zainal Abidin and Zakaria Haji Ahmad (eds), The Financial Crisis in Malaysia: The Economic and Political Consequences 1, 2(1991).

[110] Mahani Zainal Abidin, id, 2.

[111] Mahani Zainal Abidin, id, 74.

[112] Fund, I. M. (2001). Malaysia: From Crisis to Recovery.

[113] Ibid.

[114] International Monetary Fund, id, 16.

[115] Malaysia had itself implemented inflow controls in 1994 but is far better known for these later outflow controls. The inflow controls included, among other things, a ceiling on non-trade and non-investment external liabilities of banks and a prohibition on sales of short-term bonds to non-residents and non-trade related swaps and forward transactions on the bid side with foreigners: Rajan, supra, Table 3.

[116] International Monetary Fund, supra, 23; and Ross Buckley, *The Role of Capital Controls in International Financial Crises* 11 *Bond Law Review* 231 (1999).

[117] International Monetary Fund, id, 23.

[118] International Monetary Fund, id, 23.

[119] Ariyoshi, Habermeier, et al, supra.

Malaysia's policies between 1997 and 2000 the changing public sentiment towards these policies is noted:

Market assessment turned more positive, however, as it became clear that Malaysia's macroeconomic policies were not out of line, that the undervalued pegged exchange rate was contributing to the rapid recovery of exports and output, and that financial sector reforms were being vigorously pursued.[121]

Malaysia's response to the crisis also involved significant financial sector reform, which the IMF notes 'led to substantial improvement in the sector's performance'.[122] This approach has subsequently met with IMF approval:

The multiprong strategy involving Danaharta and Danamodal to acquire NPLs and recapitalize banks, as well as the CDRC to facilitate debt workout by large borrowers, represents a credible plan to restructure Malaysia's financial sector.[123]

Malaysia managed its economy successfully without the IMF. Its expansionary fiscal policy prevented the economy from going into further recession. This policy stimulated the economy, which improved confidence. The expansionary fiscal policy and the improved confidence then combined to improve domestic demand.[124]

The expansionary approach is not novel. Indeed, most economists recommend expansionary fiscal settings in times of recession. However, to be able to adopt these expansionary policies, Malaysia had to impose capital controls for otherwise the expansionary policies would have provoked an exodus of foreign capital that would have more than counteracted any stimulative effect the expansionary policies could have delivered.[125] The capital controls were a novel step.

Capital controls had been suggested in this context by Paul Krugman.[126] He stressed that such controls (i) should only be temporary because of the way they distort the

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[120] Ramon V Navaratnam, *Malaysia's Economic Sustainability: Confronting New Challenges Amidst Global Realities* (1st ed, 2002).

[121] International Monetary Fund, supra, 3.

[122] International Monetary Fund, id, 71

[123] International Monetary Fund, id, 64

[124] Mohamed Ariff and Azidin Wan Abdul Kadir, *The Near-Term Outlook for the Malaysian Econom*' (Paper presented at the ISEAS Regional Conference, Singapore, 6 January 2000) 2.

[125] Mahani Zainal Abidin, supra, 5; International Monetary Fund, supra, 13. Another way of saying the same thing is that controls 'allow domestic policy makers to break the links between interest rates and exchange rates, so that interest rates can be lowered without incurring the costs of a currency devaluation': Giancarlo Corsetti, Paolo Pesenti and Nouriel Roubini, *What Caused the Asian Currency and Financial Crisis? Part II: The Policy Debate* National Bureau of Economic Research Working Paper 6834 (1998) http://netec.mcc.ac.uk/WoPEc/data/Papers/nbrnberwo6834.html. See also Barry Eichengreen, *Toward a New Financial Architecture: A Practical Post-Asia Agenda* (1st ed, 1999) 56.

[126] Paul Krugman, *Saving Asia: Its Time to Get Radical*, Fortune Investor (New York), 7 September 1998.

economy,[127] (ii) should never be used to defend an over-valued currency and (iii) could provide a government with breathing space in order to undertake reforms during a crisis and must 'serve as an aid to reform, not an alternative'.[128] Malaysia's use of controls met all of these principles. After three years the controls were all but gone.[129] Malaysia exercised monetary discipline and did not use the controls to inflate the currency or the economy or bail out companies.[130] It used the breathing space afforded by the controls to implement financial and corporate reforms.[131] The IMF notes that the 'successful experience of the 1998 controls so far is largely due to the appropriate macroeconomic policy mix that prevailed at that time'[132] and that the controls were effective because they 'were wide ranging, effectively implemented, and generally supported by the business community'.[133]

Whilst capital controls of the type implemented in Malaysia can be circumvented in various ways (notably through the settlement of commercial transactions, dividend payments, intra-firm transfers and mis-invoicing) there was limited circumvention in Malaysia because of its design and enforcement of the controls.[134] The controls were designed to affect all channels for the movement of the ringgit offshore, whilst allowing current account transactions and foreign direct investment.[135] This selectivity minimised circumvention of the controls by leaving open certain options for investment in Malaysia through channels the Government did not consider problematic from the perspective of capital flows.

Pegging the currency

The decisive and unorthodox crisis policy of pegging the ringgit to the US dollar gave the government more control over its economic policy and prevented speculation in the ringgit.136 The danger of a pegged exchange rate is that it may be, or become over time, overvalued as happened in Argentina as the 1990s progressed. Malaysia avoided this danger.137 In fact, Malaysia pegged the ringgit at an undervalue, which boosted

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[127] Paul Krugman, *An Open Letter to Prime Minister Mahathir* Massachusetts Institute of Technology (2003) http://web.mit.edu/krugman/www/mahathir.html at 4 July 2003.

[128] Id.

[129] K.S. Nathan, *Economic Slowdown and Domestic Politics: Malaysia Boleh?* 12 Trends in Southeast Asia 4 (2001).

[130] Mahani Zainal Abidin, *Malaysia's Economy: Crisis and Recovery'*in Mahani Zainal Abidin and Zakaria Haji Ahmad supra, 6.

[131] International Monetary Fund, supra, 54.

[132] International Monetary Fund, id, 6.

[133] International Monetary Fund, 'Malaysia: Selected Issues' (1999) 18.

[134] International Monetary Fund, id, 54.

[135] International Monetary Fund, id, 54.

[136] International Monetary Fund, id, 50.

[137] International Monetary Fund, id, 13.

exports.138 This undervaluing also served as 'an incentive for retaining funds in the country'.139 The peg reportedly 'reduced uncertainty and made it easier for business to plan'.[140] As Navaratnam notes, there has been widespread acknowledgment of the efficacy of Malaysia's currency peg.[141]

Comparative economic performance of Malaysia

To compare Malaysia's rate of recovery with other crisis countries we can use the comparative gross domestic product (GDP) growth rate as a rough indicator. The following table outlines GDP changes for the main crisis countries before the crisis in 1995, and then as Asia was recovering from the crisis in 1999.

Year	Malaysia	Indonesia	Korea	Thailand
1995	9.8	8.2	8.9	8.9
1996	10.0	8.0	6.8	5.9
1997	7.5	4.5	5.0	-1.8
1998	-7.5	-13.2	-6.7	-10.4
1999	5.4	0.2	10.7	4.2

Source: CEIC Data Company Limited

This table shows Malaysia as second only to the Republic of Korea in its rate of recovery in 1999. It also shows that Malaysia's negative rate of growth in 1998 was significantly less than Indonesia's and Thailand's, and not much more than Korea's. The most comparable crisis country to Malaysia, considering its level of development and the maturity of its system, is Thailand.[142] The above table shows Malaysia recovered slightly quicker than Thailand.

Others agree with this assessment.[143] Merrill Lynch described Malaysia's recovery as 'one of the most impressive ever'.[144] Kaplan and Rodrik wrote that 'compared to IMF programs, we find that the Malaysian policies provided faster economic recovery… smaller declines in employment and real wages, and more rapid turn around in the stock

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[138] International Monetary Fund, id, 13.

[139] International Monetary Fund, id, 13.

[140] IntInternational Monetary Fund, id, 10.

[141] Ramon V Navaratnam, *Malaysia's Economic Sustainability: Confronting New Challenges Amidst Global Realities* (1st ed, 2002) 35.

[142] Prema-Chandra Athukorala, *Crisis and Recovery in Malaysia: The Role of Capital Controls* (1st ed, 2001) 95.

[143] Mahani Zainal Abidin, supra, 1.

[144] Quoted in Marika Viczany, Tan Sri, Ramon Navaratnam, Koi Nyen Wong and and Tim Thornton, *Australia's Business Attitudes to Malaysia*in Chris Nyland, Wendy Smith et al (eds), *Malaysian Business in the New Era* (1st ed, 2003) 29, 29.

market.'[145] And in late 1999 the Economic Strategic Institute noted that "despite the bad press it gets as a result of Prime Minister Mahathir's critical comments about speculators, Malaysia is the best story in the region."[146]

The social effects of Malaysia's policies

Malaysia's policies had a far more benevolent impact on Malaysian society than did the IMF's policies in other crisis countries.[147] Pre-crisis economic policy in Malaysia involved extensive affirmative action to improve the position of the native Malays (Bumiputras).148 The Malaysian government was experienced in using economic policy to support social policy, and did not forget this interrelationship during the crisis. As a result, the Malaysian government's policies did not affect the poor as harshly as IMF policies did in other crisis countries. In the words of one commentator, 'the costs were not borne primarily by the poor and dispossessed, as occurred in some neighbouring states with great consequent social costs'.149 And, as Athukorala noted, 'the new policy measures enabled Malaysia to achieve recovery while minimizing social costs and economic disruptions associated with a more market-oriented path to reform'.[150]

Reasons for the Success of Malaysia's Policies

There are a number of possible reasons for the success of Malaysia's policy response to the crisis. These include:

- Malaysia's experience as an economic policy maker.
- The appropriateness of capital controls as a response to a crisis of confidence.
- Malaysia's understanding of its own economy.

Each will be considered.

Malaysia's experience as an economic manager

Given the high level of government involvement in its economy since independence, Malaysia is an experienced economic policy maker.[151] Malaysia had experience in imposing temporary capital controls in 1994 in response to speculative short-term capital

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[145] Ethan Kaplan and Dani Rodrik, *Did the Malaysian Capital Controls Work?* National Bureau of Economic Research Working Papers (2003) http://papers.nber.org/papers/W8142.

[146] Prema-Chandra Athukorala, supra, 93.

[147] Chris Nyland et al, *Economic and Social Adjustment in Malaysia in the 'New' Business Era* in Chris Nyland et al (eds), Malaysian Business in the New Era (1st ed, 2003) 2.

[148] Mahathir bin Mohamad, *The Way Forward* (1st ed, 1998) 85.

[149] Chris Nyland et al, supra 2.

[150] Prema-Chandra Athukorala, supra,113.

[151] Ismail Muhd Salleh and Saha Dhevan Meyanthan, *Malaysia: Growth, Equity and Structural Transformation* (1st ed, 1993) 1.

inflows.[152] Salleh and Meyanthan note that in the three decades from 1960 'Malaysia achieved growth, equity and structural transformation in an ethnically diverse society'.[153] It did so by focussing on social enrichment as the goal of economic growth, rather than on economic performance as an end in itself.[154]

Controls as a response to a financial panic

One indisputable cause of the Asian crisis was a self-fulfilling panic by investors.[155] In Alan Greenspan's words, the reaction of the markets to the problems in Asia was based on a 'visceral engulfing fear'.[156] Jeffrey Sachs goes so far as to say that there was no reason for the financial panic except panic itself.157 This panic took the form of 'a self-fulfilling withdrawal of short-term loans'.158 In the face of rapid capital outflows, unconventional tactics may be the only thing that can protect an economy.159 Bhagwati expresses this sentiment memorably: 'Markets may do something when you have done nothing wrong and you may have to do something wrong in order to convince the markets that you are doing something right'.[160]

Appropriateness of home grown economic policies

Economic recovery is best achieved with policies that suit the condition of the economy in question.[161] One explanation for the success of Malaysia's policies is that it understood its own economy well, and was able to design a particularly appropriate set of policies for it. Similarly, because Malaysia implemented its own reform program, rather than having it imposed from the outside, the program seems to have been implemented more rigorously than were the reforms in IMF program countries. This claim is supported by

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[152] Reinhart and Smith, supra, 10; Prema-Chandra Athukorala, *Capital Mobility, Crisis and Adjustment: Evidence and Insights from Malaysia* in Dipak Dasgupta, Marc Uzan and Dominic Wilson (eds), Capital Flows Without Crisis? Reconciling Capital Mobility and Economic Stability (1st ed, 2001) 255, 257.

[153] Ismail Muhd Salleh and Saha Dhevan Meyantahn, *Malaysia: Growth, Equity and Structural Transformation* (1st ed, 1993) ix.

[154] Salleh and Meyantahn, id, 48.

[155] Ross Buckley, *An Oft-Ignored Perspective on the Asian Economic Crisis: The Role of Creditors and Investor*s 15 Banking and Fin. L. R. 431, 431-454 (2000).

[156] Quoted in Paul Kelly, *IMF tightens the screws on Suharto,* The Australian (Surry Hills), 11 March 1998, 13.

[157] Quoted in Jean Tirole, *Financial Crises, Liquidity, and the International Monetary System* (1st ed, 2002) 44.

[158] Quoted in Jean Tirole, id, 44.

[159] Barry Eichengreen, *Toward a New Financial Architecture: A Practical Post-Asia Agenda*, (1st ed, 1999) 56.

[160] Quoted in Ariel Buira, *An Alternative Approach to Financial Crises* (1st ed, 1999) 10.

[161] Mahani Zainal Abidin, supra, 6.

the IMF: "Malaysia has moved ahead of other crisis countries in respect to formulation of prudential regulation, resolution of nonperforming loans, restoration of capital adequacy, and implementation of a bank consolidation program"'.[162]

An example of the lack of political will seen in many other crisis countries was evident in Indonesia's implementation of reforms. According to one respected commentator, within days of signing the US$40 billion accord with the IMF, "economic reforms seemed to disappear from the [Indonesian] government's agenda".[163]

Conclusions on Malaysia's Experience

Malaysia's economic policies during the Asian crisis, on balance, delivered slightly better, and certainly no worse, economic results than those in countries under IMF programs. This should be unsurprising. In reforming its system, Malaysia was implementing home-grown policies, not those imposed by an external supranational institution. Policies developed abroad are rarely likely to be adopted and enforced with the enthusiasm and rigor of those developed at home. This is a simple fact of human nature. We all do more willingly what we choose to do, rather than what we are told to do. So, if for no other reason, one should expect more rigorous implementation and enforcement of home-grown policies – which is precisely what was seen in Malaysia relative to other Asian crisis countries that were under IMF programs.

In addition, Malaysia's policies during the crisis were better suited to its specific circumstances than those in other IMF program countries were suited to their circumstances. Malaysia's history of economic affirmative action in relation to its *Bumiputra* population was accommodated during the crisis in a way that an IMF program was unlikely to do.

Malaysia's policies were also preferable to those of the IMF because they had a more benevolent impact on the poor. Fiscal austerity almost inevitably takes money from programs that benefit the poor. Malaysia's approach was more equitable. It did not punish the poor to repay capital that had principally benefited the rich when it had flowed into the country.

Malaysia's refusal to adopt IMF policies also allowed it to keep control of its own economic destiny. This was preferable because it meant Malaysia could act solely in its own best interests. Unlike the IMF, it was not responsible for protecting the international financial system as a whole.

Retaining control of economic policy also ensured that decision-making power in Malaysia remained with those who were elected to represent its citizens.

While Malaysia's policies may have made no large difference to its "bottom line" during the crisis, there were many important ways in which they were good for Malaysia. Given that Malaysia's policies certainly delivered no worse economic results than IMF policies

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[162] International Monetary Fund, supra, 15.

[163] David E. Sanger, *IMF Reports Plan Backfired, Worsening Indonesia Woes*, The New York Times (New York), 14 January 1998.

elsewhere in the region, there can be no doubt that Malaysia's decision not to request IMF assistance and instead pursue its own path out of the Asian Economic Crisis was right for Malaysia.

A Positive Postscript: The Avoidance of Moral Hazard

A further bonus of Malaysia's approach was the avoidance of the substantial moral hazard occasioned by the IMF-organised bail-outs of Indonesia, Korea and Thailand. A central tenet of IMF policies is that markets allocate resources best. However, the IMF is inconsistent -- it often does not allow markets to allocate losses in bad times. This engenders moral hazard. Moral hazard arises whenever a financial actor does not bear, or anticipate bearing, the full risk attached to its actions.[164]

Indonesia, Korea and Thailand were required to use the bail-out loans arranged by the IMF to repay the credits that were then due, i.e. the debts owed to short-term creditors. Systemically this was foolish because it encouraged the extension of short-term debt, the very type of debt that renders an economy more vulnerable to volatility. It also shielded the short-term creditors from the losses that would otherwise have ensued, and for which the high interest rates they had received were compensation.[165]

This meant that in the following year, 1998, short-term creditors pumped massive amounts of credit into Russia to claim returns as high as 50% or 60% per annum on GKOs (short-term Russian government bonds) while relying for the repayment of principal on an IMF arranged bail-out. In the words of Desmond Lachman,

> Anybody who questions that Russia's fundamentals were worthy of investment … wasn't operating in the markets at the time. … Most [investors] who did take positions on Russia were doing this on the argument that Russia was too big to fail and that the G-7 nations would … bail them out.[166]

The proper operation of the market would have led to an earlier and more gradual withdrawal from investing in Russia but it was profoundly affected by the moral hazard of an anticipated bail-out.[167] Russia's geo-political significance, in particular, meant investors were very confident that it would not be allowed to default on its financial

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[164] For a consideration of the moral hazard engendered by the IMF-organised bail-outs of Indonesia, Korea and Thailand in 1997 and the ways in which it contributed to Russia's economic meltdown in 1998, see Ross Buckley, *An Oft-Ignored Perspective on the Asian Economic Crisis: The Role of Creditors and Investors* 15 Banking and Fin. L. R. 431, 43 (2000).

[165] Jeffrey Sachs, *IMF is a Power Unto Itself* (2003) Nouriel Roubini's Global Macroeconomics and Financial Policy Site http://www.stern.nyu.edu/globalmacro/AsiaCrisisSachsViewFT1297.html.

[166] IMF Economic Forum, *Financial Markets: Coping with Turbulence* International Monetary Fund Forum, (1998) http:www.imf.org/external/np/tr/1998/TR981201.HTM.

[167] Timothy O'Brien, *When Economic Bombs Drop, Risk Models Fail*, The New York Times (New York), 4 October 1998*; Splendid isolation no longer,* (1998) 1246 IFR 1.

obligations.[168] Such were the consequences of the IMF short-circuiting the market mechanism with its bail-outs of the Asian crisis countries. Malaysia's policies avoided this problem.

Lessons

The most important lesson from this survey is that debtor nations need to develop their own creative and innovative solutions to their own financial problems. The conceptual thinking that eventually came to fruition as Brady bonds was initially done in Sao Paulo and refined and developed in Mexico City.[169] The Brady Plan was not developed in Washington D.C., notwithstanding its name suggests it was and most commentators assume it was. It is critical that developing countries do not rely upon the IMF, World Bank or the U.S. Treasury to do the creative thinking needed to deal effectively with their specific situations.

In developing its own solutions to its own problems, the nation can, of course, engage external expertise.[170] At Mexico's request, JP Morgan had a major input into the development of the Aztec Bonds for Mexico in 1987 and 1988 and some of the lessons from these bonds were incorporated in the design of the Brady bonds. But the history of the Brady Plan suggests strongly that debtor nations need to devise their own solutions to their own problems and then 'sell' the solutions subtly to the international financial community.

The subsidiary lesson from the Brady Plan is that in promoting innovative, home-grown policies, it may be most useful to allow those in powerful developed nations to take credit for the ideas generated in the debtor nations, as a way of promoting their adoption and implementation.

The other principal lesson flows from a comparison of Malaysia's and Argentina's experiences. Malaysia successfully charted its own course out of the Asian Economic Crisis using, among other measures, capital controls to which the IMF was, at the time, implacably opposed. Argentina, on the other hand, pursued IMF orthodoxy to the point of economic collapse.

Developing countries, at least those with the resources to operate sophisticated economic Ministries, may well be better placed to develop innovative and effective policy responses to the challenges of global capital than is the IMF. Some reasons are:

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[168] "Many [investors] refused to believe the United States and the International Monetary Fund would allow Russia to collapse until it actually happened": Jonathon Fuerbringer, *After Russian Lesson, Bond Prices Remain Stable in Latest Crisis*, The New York Times (New York), 14 January 1999.

[169] See text accompanying International Monetary Fund, *Malaysia: Selected Issues* (1999) 18.

[170] A rich resource of research on the economic challenges facing developing countries, and potential solutions to the challenges, can be found on the website of the International Development Economics Associates at http://www.networkideas.org/.

The domestic Treasury and Ministry of Finance are more likely to understand their own economy better than outsiders. The influence of culture and local institutions on economic performance is strong. Policies crafted without a deep understanding of the culture and local institutions are less likely to succeed and policies that succeed in one institutional setting may not succeed in another.

Home-grown policies are more likely to be implemented and enforced rigorously than those imposed by the Fund. IMF programs in Thailand, Indonesia and elsewhere were hampered by ineffective implantation and enforcement in a way that Malaysia's economic program was not. This is human nature – edicts imposed from outside will rarely be as welcomed as readily or implemented as thoroughly as those developed at home.

The model under which a strong IMF directs and guides the debtor nation's economy does not necessarily promote the development of the skills needed in the local finance ministry, and does not promote the confidence that the nation can direct its own affairs successfully. Self-confidence in economic policy setting is a highly desirable trait within developing country governments and its promotion should be nurtured.

The developing nation as policy maker has a narrower responsibility, and thus simpler job, than does the IMF. The national government's job is to do the best for its people. The IMF strives to do so, but also strives to implement policies aimed at developing a healthy and stable international financial system. To make matters more complex still, in discharging its role, the IMF is subject to the direction and instruction of its member governments, the most influential of which are the larger OECD nations.