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Introduction

Mexico's financial difficulties in the winter of 1995 were widely seen as only the latest in the series of debt crises that have punctuated lending by the industrialized countries to the developing world. This characterization of the historical record implies, of course, that smooth capital transfers are the norm and disruptions to international financial flows the punctuation marks. The opposite might also be argued: debt-servicing difficulties, the suspension of voluntary lending, and calls for third-party intervention—the constituents of which are called debt crises—are the normal state of affairs. Thus the three short post–World War I periods when large quantities of international portfolio investment took place—1924 to 1929, 1976 to 1981, and 1989 to 1994—were the exceptions. Either way, the repetition of events prompts a search for parallels and policy precedents.

Those who insist that history repeats itself would nonetheless acknowledge that it never repeats itself in precisely the same way. This observation is pertinent to the three post–World War I episodes of large-scale foreign lending and to the crises that followed. Perhaps the most prominent difference across these episodes lies in the method of finance. Although trade credits, fixed-interest securities, and direct foreign investment (DFI) were important in each of the three periods, the three episodes can be differentiated from one another by the distinctive financial market institutions and arrangements that mediated the major part of the flow of funds across national borders.

In the 1920s the U.S. bond market for the first time provided the vehicle for portfolio capital flows from industrial to developing countries. Government bonds were underwritten by investment banks in New York and marketed to institutional and private investors. During the second half of the decade, a large secondary market developed in the bonds of industrial and industrializing economies. For a country seeking access to foreign capital, the critical steps were to establish a relationship with a reputable investment bank and to arrange a successful bond flotation, while the key to retaining access was to ensure that the bonds subsequently traded at prices close to their par values.

In response to the defaults of the 1930s, the bond market fell into disuse. After an extended hiatus during which little portfolio lending took place, commercial banks entered the market in the second half of the 1960s. The volume of bank lending to less developed countries increased enormously during the “recycling boom” that followed the first oil shock in 1973. Money-center banks originated and syndicated dollar loans to developing countries; in contrast to the preceding episode of bond finance, the banks themselves held these obligations. With the subsequent rise of securitization and a secondary market in LDC debt, this process of bank intermediation increasingly resembled the bond finance that had preceded it. Critical differences remained, however. One was the failure to subject the decision to extend a bank loan to the government of a developing country to the market test. Rather, bank loan officers made the decision of their own volition. It had only a muted effect on the market valuation of the bank’s equity.[1] This was in contrast to the era of bond finance, when each bond issue had to float on its own bottom. At that time, a large number of individual

[1]This point should not be overdrawn. Megginson, Poulsen, and Sinkey identify a statistically significant, if small, negative effect of the announcement of syndicated loans to Latin American borrowers on the stock prices of the issuing banks.

investors decided whether to subscribe to each bond issue, thereby subjecting it to a market test.

Following the 1982 debt crisis and the subsequent effort at remedy launched by the Baker Plan in 1985, when commercial banks engaged in limited amounts of concerted lending, the banks withdrew from lending to the governments of developing countries. At the end of the 1980s, when large-scale lending resumed, the new conduit for capital transfer became equity markets. Trade credits, fixed-interest securities, and DFI remain important vehicles (as they were during the two earlier waves of foreign lending), but an unprecedented volume and share of capital flows to developing countries began to take the form of equity purchases by individual investors. These often were made available through their institutional representatives: mutual and pension funds. To a greater extent than in the 1920s, or in the 1970s and early 1980s, these are investments in private and semiprivate companies rather than in government obligations. They are residual claims to the profits that remain after debts to creditors with higher seniority have been serviced. Moreover, they promise a return denominated not in dollars but in local currency.

These differences in the structure of lending by developed to developing countries have had an important influence on shaping the course and consequences of debt crises in the twentieth century. They condition the responses of lending and borrowing governments, of multilateral organizations, and of market participants alike.

We develop these points by highlighting three contrasts between the crises of the 1930s, 1980s, and 1990s. The first one is their scope. While the 1930s crisis was global, that of the 1980s was regional (affecting Latin America, Eastern Europe, and Africa but not East

Asia), and that of 1995 has been isolated—so far—to a single country, Mexico. In part these differences are attributable to the severity of the macroeconomic shock. In the 1930s the crisis was global because the Great Depression was global: all capital-importing countries were rocked by the collapse of the commodity markets on which external debtors relied to generate foreign exchange and by the debt deflation and high real interest rates that disrupted financial markets. Not even countries with light debt loads and flexible economic structures were immune. The crises of the 1980s and 1990s were less general because the macroeconomic shocks that contributed to them—rising real interest rates, as in the 1930s, but not the collapse of production or imports in the industrial world—were much smaller.

In addition to the severity of global economic disturbances, intervention by creditor-country governments and multilateral institutions affected the scope of the three crises. This is the second contrast. In the 1920s, when money-center banks floated but did not hold significant quantities of bonded debt, default did not jeopardize the stability of creditor-country financial institutions. Consequently, default elicited little in the way of a concerted response by creditor-country governments concerned for the stability of their financial systems. In the 1980s, by contrast, the risk to creditor-country banking systems prompted the industrial countries to support early and decisive intervention by the International Monetary Fund. Lending and coordination of debt restructuring by the IMF arguably prevented the crisis from spreading further. In 1995 there has again been intervention, but it has operated not so much via multilaterals like the IMF as through the leadership of the United States. That banks in the developing countries rather than in the leading financial centers are at risk now removes the sense of urgency that attended discussions of the debt crisis in Washington, London, and Paris in the 1980s.[2]

The third contrast between episodes lies in the response of the borrowing countries themselves, which took the form of import substitution in the 1930s, fiscal adjustment in the 1980s, and monetary adjustment in the 1990s. In part the different responses reflected different external conditions. In the 1930s the global nature of the crisis and the absence of intervention to contain its spread prompted developing countries to de-link themselves from the international system. With the collapse of global financial and commodity markets, the capital importers resigned themselves to life without foreign funds. That also meant reduction of external obligations. They adjusted through policies of import substitution, reducing their dependence on foreign markets and foreign capital. In the 1980s export markets remained buoyant even when portfolio lending was suspended, rendering import substitution less attractive. But with the sharp curtailment of further lending to LDC governments, the latter were forced to adjust through budget cuts. Fiscal correction became the principal vehicle for external adjustment. In the 1990s, when foreign capital had flowed heavily to private and semipublic enterprises, governments had not made use of foreign funds to finance their budget deficits to the same extent; hence, there was less need for fiscal correction.[3] But because most

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[2]Congressional populists such as the junior senator from New York argue that U.S. intervention is again motivated by concern for the balance sheets of U.S. financial institutions. A historical perspective prompts skepticism: Why should the Clinton administration have been susceptible to such pressure in the 1990s when more concentrated financial interests failed to secure the assistance of the Hoover administration in the 1930s?

[3]This is not to say that fiscal retrenchment was unimportant. But in the countries at the center of our story, it was small compared to the last time around. For example, while under

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equity claims were denominated in the currency of the borrowing country, foreign investors were exceedingly sensitive to the specter of devaluation. Adjustment was therefore effected through the use of monetary as well as fiscal instruments: Mexico, Argentina, and, most recently, Brazil raised interest rates to reassure equity investors of their commitment to sound currency policies.

External conditions, however, do not provide the entire explanation for the different responses of capital-importing countries. Domestic policies were no less important in the periods leading up to the three crises. In the 1990s many countries sought to sterilize capital inflows through the pursuit of restrictive monetary policies. Governments resisted the temptation to expand their fiscal imbalances by issuing increased supplies of money. Instead, they accumulated international reserves in record quantities, acquiring a cushion that might be used when inflows dried up. (But as the Mexican case illustrates, not all countries used that cushion productively to buy time for adjustment.) The crisis of 1982, by contrast, was preceded by a period of rapid inflation, generated largely by the need to finance budget deficits. Without a cushion of reserves, adjustment was necessarily drastic, and harsh fiscal retrenchment was essential. The late 1920s more closely resembled the 1970s than the 1990s: fiscal policies expanded as capital flowed in; borrowing countries accumulated budget deficits rather than international reserves. But whereas prices were rising rapidly on the eve of the 1982 crisis, they were falling alarmingly in 1931. In the 1980s it was possible for countries to price their exports back into international markets by curtailing their inflation rates; in the

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[3](...continued)
President de la Madrid the Mexican fiscal adjustment was on the order of 10 percent of GDP, this time it appears to be more like 2 percent.

1930s, when falling prices were already severely straining mortgage markets, financial institutions, and labor market conventions, the scope for adjustment along those lines was more limited.

In the remainder of this paper we elaborate these arguments from a historical vantage point. Each of the paper's main sections focuses on one of the three twentieth-century episodes of large-scale lending to developing countries. The goal of each section is to highlight distinctive institutional features of the operation of the lending process and to link them to the response to crises. In the conclusion we synthesize our findings and attempt to glean the policy implications.

The Era of Bond Finance

By the 1920s there was nothing new about the use of bond finance to transfer funds to developing countries. The bond markets of London, Paris, Berlin, and Amsterdam had been the vehicles for massive amounts of capital transfer to the "emerging markets" of the United States, Canada, Australia, Latin America, and Russia in the century preceding World War I.[4] The prewar record was checkered; lending to those and other countries was interrupted by defaults in the 1820s, 1850s, 1870s, and 1890s. But while lending was interrupted periodically, there was no extended hiatus similar to that which began in the 1930s, perhaps because each wave of default was confined to a relatively small number of countries.

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[4]There is a vast literature on pre–World War I foreign lending, synthesized by Fishlow in "Lessons from the Past: Capital Markets in the 19th Century and the Interwar Period," in M. Kahler, ed., *The Politics of International Debt* (Ithaca: Cornell University Press, 1985), pp. 37–94.

Reflecting this fact, creditor-country experience was reasonably satisfactory, especially in Britain, where capital markets functioned with a minimum of government interference and where export-oriented infrastructure projects were financed in overseas regions of recent settlement. It was least true for countries such as France, whose government sought to use international investment as a foreign policy lever, encouraging investors to finance the fiscal ambitions of Russia, Egypt, and other interventionist states. Understanding the debt crisis of the 1930s therefore requires first comprehending what changed between the prewar and interwar period to cause a global debt crisis, unprecedented in scope, to supersede the more limited defaults of the nineteenth century. Changes in the structure and operation of the markets are not hard to identify. In fact, they affected the origin and destination of foreign funds, the structure of the intermediation process, and the uses to which foreign finance was put.

Many accounts focus on the rise of New York and the relative decline of London and the continental European financial centers as sources of foreign funds.[5] The United States, traditionally a recipient of international capital, first shifted from net capital importer to net capital exporter in the 1890s. During World War I it sprinted to the head of the pack of lending countries. The United States was the one major industrial country whose economy was not severely disrupted by the war; it was the one place where saving naturally exceeded investment, and therefore it was the obvious source of foreign funds.

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[5]See, for example, Ilse Mintz, *Deterioration in the Quality of Foreign Bonds Issues in the United States, 1920–1930* (New York: National Bureau of Economic Research, 1951).

Prior to the war, U.S. lending was predominantly direct investment in railways, sugar mills, and mining ventures in the Western Hemisphere. The war years saw large-scale, officially sanctioned bond flotations on behalf of France, Britain, and other Allied governments. But it was the sale of U.S. government bonds as much as foreign flotations that awakened the American bond market from its dormancy; whereas in 1914 there had been no more than 200,000 bond buyers in the country as a whole, wartime Liberty Loan campaigns raised that number to the millions.[6] Once jarred from its slumber, the bond market was awake for good; where estimates for 1897 show more than 90 percent of U.S. foreign investment to have been direct, by 1930 the share of portfolio investment had risen to more than 50 percent.

U.S. financial intermediaries had to take aggressive steps to compete in this market. They had to secure an agreement with a foreign government or corporation to underwrite a bond issue, and they had to place the bonds with investors at prices that yielded an acceptable profit margin. The inexperience of many U.S. banks may have contributed to subsequent difficulties; Mintz shows that financial institutions that were newly entering the market for foreign debt were disproportionately associated with issues that defaulted in the 1930s.[7]

Financial innovation was a concomitant of rapid expansion. In the 1920s investment trusts played much the same role as emerging-market mutual funds in the 1990s. They pooled the subscriptions of their clients, placed their management in the hands of specialists, and

[6] Lothrop Stoddard, *Europe and Our Money* (New York: Macmillan, 1932), p. 43.

[7] See Mintz, *Deterioration in the Quality of Foreign Bonds Issues in the United States, 1920–1930*.

issued claims entitling holders to a share of their earnings.[8] They facilitated position-taking in foreign securities by investors who would have been deterred otherwise by transaction and information costs. Commercial banks established bond departments and securities affiliates, much in the manner that commercial banks in the 1990s created their own mutual funds.

It is hard to ascertain how well or poorly this process worked independent of the unsatisfactory outcome whose causes we are seeking to comprehend. Senator Hiram Johnson, head of the congressional 1931–32 Foreign Bond Investigation, argued that these structures created pervasive incentive problems. Those who placed their money in investment trusts, such critics alleged, were given an exaggerated sense of the extent of portfolio diversification they enjoyed and underestimated the risks. Those who purchased foreign bonds through the bond departments and securities affiliates of commercial banks failed to realize that these investments entailed sovereign risks unlike those attached to U.S. government securities. The banks, for their own reasons, were loath to advertise the risks. Underwriting divisions pressed securities affiliates and bond departments to place the issues they originated; between 1922 and 1931 the number of national banks with securities affiliates grew more than tenfold. They opened ground-floor branch offices to encourage walk-in business and advertised their wares in the pages of Harper's and The Atlantic Monthly. Having created this infrastructure, bond departments and affiliates then pressed the underwriters to make additional bonds available for placement.

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[8]The role of investment trusts is relatively neglected in the literature; two contemporary discussions are Lawrence M. Speaker, *The Investment Trust* (Chicago: A. W. Shaw, 1924) and Leland Rex Robinson, *Investment Trust Organization and Management* (New York: Ronald Press, 1926).

Come the 1930s, this process was viewed with considerable disenchantment:

> Up to the slump of 1920, these new clients sought the branch-offices. After the slump, the branch-offices sought them. They did it through hosts of young salesmen, carefully schooled in "high pressure" methods of breaking down "sales resistance." Their keynote was pressure—all down the line. The home office kept the branch-offices "on their toes" by a stream of phone calls, "flashes," "pep-wires," and so forth. The branch managers kept the young salesmen all "burned-up" with "pep-talks," bonuses, and threats of getting fired. Everybody in authority demanded "results"; which meant, more sales. Every salesman must sell his "quota." What he sold, how he sold it, and whom he sold it to, did not much matter. Verily, business had got into banking; or, rather, "banking," in the old sense of the word, had been kicked out of doors by business.[9]

Thus, when foreign governments sought access to the New York market they found a ready reception. Many had frequented the City of London or the Paris Bourse before the war: Argentina, Brazil, Australia, and Canada were among the leading borrowers of the 1920s. They were joined by newly truncated Germany and the successor states of the Austro-Hungarian Empire, which were among those that had suffered the most severe wartime devastation and had the heaviest reconstruction costs. Some, such as Germany, were saddled with reparation burdens that placed heavy short-term drains on their balances of payments, encouraging governments to seek external finance to bridge the gap. The high interest rate

[9]See Stoddard, Europe and Our Money, p. 106. Recent research casts some doubt, however, on the extent to which securities affiliates were really at fault. See R. S. Krosner and R. G. Rajan, "Is the Glass-Steagall Act Justified? A Study of U.S. Experience with Universal Banking Before 1933," *American Economic Review* 84 (1994), pp. 810–832.

policies adopted by their central banks to limit reserve losses in turn encouraged foreign investors to purchase their high-yielding securities. As would again be the case in the 1970s and 1990s, the development of new markets in countries in fragile political positions was integral to the lending process.

Reparations and infrastructure investments had to be financed out of government budgets. Central, state, and municipal governments borrowed abroad to finance their operating expenses. While funds sometimes were used for the construction or modernization of roads or port facilities that served to enhance export competitiveness, more commonly they were devoted to paying public employee salaries and transfer payments unlikely to augment export revenues. Clearly, if exports suddenly turned down, servicing these debts would become a very serious problem. Events in the center also shaped the flow of international lending. U.S. interest rates (as proxied by the yield on domestic medium-grade bonds) peaked in 1923 and trended downward through 1928. The decline in yields encouraged U.S. investors to seek more remunerative returns abroad. After 1925 the yield on Lary's sample of foreign bonds consistently exceeded that on domestic medium-grade securities.[10] U.S. foreign lending rose steadily to its peak in 1927–28. Thus, the surge of lending in the 1920s can be understood only as a combined result of financial innovation, the investment trust and bond market revolution, and the downward trend in U.S. interest rates.

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[10]See Hal B. Lary, *The United States in the World Economy* (Washington, D.C.: GPO, 1943).

Figure 1 shows the evolution of debt service relative to exports after 1924. Following Eichengreen and Portes,[11] it distinguishes two groups of countries: those in which default starting in 1931 was minimal or absent, and those that defaulted on a substantial share of their external debts.[12] Debt service relative to exports was higher for the heavy defaulters all through the 1920s and rose quickly during the period of peak borrowing, 1926 through 1928. Figure 2 shows these same data for Latin America and Central and East European debtors.[13] The Latin American debt ratio is consistently higher (not so much because of higher debt stocks, the data suggest, as higher interest rates). This heavier burden is consistent with the fact that Latin American defaults historically began first.[14]

In a period when capital inflows were strengthening the balance of payments, it was possible for countries to accumulate international reserves. Under a gold standard system like that of the 1920s, reserves rose automatically as economies expanded because central banks

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[11]See Barry Eichengreen and Richard Portes, "Dealing With Debt: The 1930s and the 1980s," in I. Hussain and I. Diwan, eds., *Dealing with the Debt Crisis* (Washington, D.C.: The World Bank, 1989), pp. 69–88.

[12]The heavy defaulters are Brazil, Bulgaria, Chile, Colombia, Costa Rica, Germany, Greece, Hungary, Poland, and Uruguay. The light defaulters are Argentina, Australia, Austria, Belgium, Canada, Czechoslovakia, Denmark, Finland, France, Italy, Japan, New Zealand, Nicaragua, Norway, Spain, and Venezuela. Figures reported are unweighted averages of country statistics. Cline notes that this categorization weights the light-defaulter category toward relatively advanced industrial countries, an asymmetry that is important to keep in mind when interpreting the results. See William R. Cline, *International Debt Reconsidered* (Washington, D.C.: Institute for International Economics, 1995).

[13]Latin America includes Argentina, Brazil, Chile, Colombia, Costa Rica, Uruguay, Nicaragua, and Venezuela. Central and Eastern Europe includes Bulgaria, Germany, Hungary, Poland, Austria, and Czechoslovakia.

[14]It is worth noting that these debt-service-to-export ratios of 10 to 15 percent were modest by the standards of the 1980s and 1990s.

were required to limit the growth of their monetary liabilities to a specified multiple of their international reserves (typically 250 or 300 percent). But nothing prevented central banks from accumulating reserves at a more rapid rate than mandated by the gold standard statutes. Whereas figure 3 shows that industrial production (and, by implication, the demand for money) grew in the second half of the 1920s at the same rate in the light and heavy defaulters, figure 4 shows that gold holdings rose more quickly in the first set of countries, as if they took advantage of circumstances to accumulate a cushion of reserves.[15] But with many countries mechanically following the gold standard rules, the growth of excess reserves was modest and provided an inadequate support when international financial and commodity market conditions deteriorated toward the end of the decade.

What happened starting in 1928 is sufficiently well known to permit brief summary. The Federal Reserve Board, concerned about the heights scaled by the Wall Street stock market boom, raised interest rates in a series of steps. Suddenly domestic bills and bonds became more attractive to foreign investors. Net portfolio lending by the United States declined from more than $1 billion in 1927 to less than $700 million in 1928, with virtually all lending in 1928 concentrated in the first half of the year. Bond flotations on behalf of Germany and South America were hit particularly hard. With the cost of servicing dollar loans running at about $900 million a year, lending through the middle of 1928 had proceeded at a rate sufficient for new capital inflows to finance service on the outstanding debt. When new lending dried up in the second half of the year, the entire bill came due.

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[15]The changes in reserves in Latin America and Central-Eastern Europe move in close parallel through the end of the 1920s.

This interruption to lending came on top of the continued decline in the relative price of nonfood primary commodities. Figure 5 shows that this relative price had been trending downward over the second half of the decade. The decline accelerated in 1929–30 with the slump in industrial production in Europe and the United States and the increase in the relative supply of these raw material inputs. The terms of trade of the heavy defaulters deteriorated dramatically in 1929–30.[16] Measured in terms of wholesale prices, the terms of trade of Latin American countries fell more sharply than those of East European debtors starting in 1929 (figure 6). Together, figures 5 and 6 underscore the importance of the commodity composition of trade: for Latin American countries that exported mainly primary products, the deterioration in export-market conditions was persistent and began to reverse itself only in 1933; for Germany, Austria, Czechoslovakia, and the other more industrialized countries of Central and Eastern Europe, terms-of-trade movements were relatively moderate. Clearly, the depth and persistence of the slump in the industrial world, and its repercussions on primary commodity markets, had much to do with the severity of the debt servicing difficulties of Latin American countries.

The wave of protectionism that started in the United States in 1930 compounded these difficulties. While a debate exists over the effect of the Hawley-Smoot Tariff (which had been imposed partly to aid U.S. farmers in distress) on the Great Depression in the United States, there is no question that by switching U.S. demands away from imported goods in general and imported raw materials in particular, the tariff and similar ones in other industrial countries compounded the primary producers' problems.

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[16]See Eichengreen and Portes, "Dealing With Debt: The 1930s and 1980s," figure 4.3.

The debtors' response was to hold on as long as possible. Countries that were ultimately forced to default first sought to finance their deficits by running down their reserves (figure 4). When the constraints of the gold standard began to bind, they imposed restrictions on various categories of international gold and capital flows and used this room for maneuver to depreciate their exchange rates. Governments cut public spending. They raised taxes, especially import duties, and applied export bounties. These measures worked to strengthen the balances of trade of countries that could no longer finance deficits via capital imports. Argentina, Austria, Australia, Brazil, Bulgaria, Colombia, Germany, Greece, Hungary, Poland, and Venezuela all strengthened their trade balances in 1929. But the further deterioration of international commodity markets and the rise of industrial-country protection in 1930 dealt their efforts a further blow. Bolivia suspended service on its sovereign debts in March of 1931. During the rest of the year much of Latin America defaulted; only Argentina, with close financial and commercial ties to the United Kingdom, and the small Central American republics dependent on the United States, remained solvent. In 1932 default spread to southern and eastern Europe, and 1933 was dominated by default by Germany, the world's largest debtor.

Import substitution was the natural response. The collapse of primary commodity prices and the imposition of tariffs in the industrial world prevented developing-country debtors from exporting their way out of their bind. The depression and the attempt to respect the requirements of the gold standard had already forced severe monetary and fiscal retrenchment. Adjustment to the new circumstances of the 1930s therefore took place by substituting away from imports. Currency devaluation turned domestic spending toward homespun goods. Comprehensive systems of tariffs and quotas, often supplemented by exchange controls, were used to stifle imports. Governments extended credit on favorable terms to import-competing industries to promote their growth.

The import-substitution strategy was associated with reasonably smooth recovery from the crisis of the early 1930s. (See figure 7, where Latin America and Eastern Europe are distinguished.) Eichengreen and Portes[17] and Cline[18] caution that this result need not carry over to other times. Many Latin American countries possessed an array of labor-intensive industries still characterized by limited domestic production and ample opportunity for rapid expansion. Import substitution was attractive not only because of the difficulty of penetrating export markets but also because of the scope for expanding domestic supplies of imported goods. Later, when the easy opportunities for import-substituting industrialization had been exhausted, further pursuit of such policies ran up against skill and technology constraints.

The readjustment of defaulted debts involved a protracted process of negotiation. Then, as now, negotiations were complicated by the existence of a large number of investors. A football stadium would have been required to seat the thousands of bondholders whose assent to the terms of settlement would have been required as a prerequisite for regaining capital-market access. While getting scores of commercial banks to agree on the terms of a rescheduling or a concerted lending program involved significant transaction costs in the 1980s, the transaction costs entailed in debt negotiations in the era of bond finance were more formidable still.

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[17]Ibid.

[18]See Cline, *International Debt Reconsidered*.

To an extent this problem was managed by the intervention of bondholders' representative committees. In Britain, the Corporation of Foreign Bondholders had been in existence since 1868. A private entity, it solicited subscriptions from bondholders and negotiated settlement terms with the debtor. When it announced that the debtor had negotiated in good faith and endorsed the offer as the best that could be expected, bondholders were asked to validate the agreement by registering their opinion with the council or by cashing a coupon with the debtor. Stock market sanctions were then withdrawn, in principle reopening the capital market to the debtor.

Bondholders could and did withhold their consent. There was enough dissent over the terms of settlement and enough debt still in default in neighboring countries that few debtors regained significant bond market access until after World War II. In the United States the process worked even less smoothly. Reflecting the country's late emergence as an international creditor, an organization comparable to the Corporation of Foreign Bondholders (the Foreign Bondholders Protective Council) was established only in 1934. Until then, bondholders had to rely on ad hoc committees that lacked the reputation and authority to negotiate effectively.

A striking characteristic of this process was that it proceeded with a minimum of government intervention.[19] Starting in 1933, the Roosevelt administration attached priority to the reconstruction of international trade, and it refused to use sanctions as leverage on behalf of private investors. The British government was somewhat more interventionist. It used the

[19]Admittedly, the Foreign Bondholders Protective Council had been established partly with the impetus of the U.S. State Department. But State's concern had been not so much to aid American investors as to deflect their demands for assistance.

1932 Ottawa Agreements and the Roca-Runciman Treaty negotiations with Argentina to secure favorable treatment of sterling debts. It threatened to impose clearing arrangements on Germany following that country's default in 1933, leading the latter to resume service on its sterling debts. But such intervention was the exception to the rule.[20]

There were also attempts to coordinate the intervention of national governments through international institutions. The first such scheme proposed to endow the Bank for International Settlements with resources to extend credit to countries seeking to reorganize their debts. Hubert Henderson, an adviser to the British government, proposed in 1931 to authorize the BIS to issue "International Certificates" to help finance countries' debt-service payments and other balance-of-payments obligations. Another 1931 plan, due to Montagu Norman, governor of the Bank of England, and Robert Kindersley, one of the bank's directors, proposed the creation of a new international facility, also possibly housed at the BIS, to make loans to countries unable to obtain finance through normal channels. At the 1933 World Economic Conference organized by the League of Nations, the British proposed the creation of a multilateral "normalization fund" to channel funds to countries seeking to reorganize defaulted debts.

None of these proposals bore fruit. Default on private investments, interwar policymakers repeated, was a private matter. While bank failures were widespread, banks in the creditor countries held only limited amounts of foreign debt; hence, sovereign default was only a minor factor in the financial instability of the 1930s. The fear that their banking systems

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[20]This is the conclusion, for instance, of the Royal Institute for International Affairs, *The Problem of International Investment* (London: Oxford University Press, 1937).

might collapse prompted a variety of unprecedented actions, but extraordinary assistance for sovereign debtors was not one of these. To the extent that high finance was a convenient whipping boy for the economic crisis of the 1930s, there was little popular sympathy for investment trusts and other institutional investors with a stake in foreign debt, especially in the United States.

The Era of Bank Finance

The debt crisis of the 1980s, unlike that of the 1930s, was far more regionally focused in its impact. The IMF group of 15 heavily indebted countries includes ten from Latin America. This section switches to an emphasis on the experience there, with some comment on the contrast with other continents.

In the mid-1960s, as output flagged and inflation mounted even in relatively successful practitioners of import substitution, new policies were sought in Latin America. Tariffs, which had reached extraordinarily high levels, were slowly reduced. Crawling peg exchange rates were introduced in Chile, Colombia, and Brazil as a means of assuring competitiveness in the midst of continuing inflation. Attempts to promote nontraditional exports led to the adoption of special export subsidy programs starting in the second half of the 1960s. As a whole, the period was marked by the relatively rapid expansion and diversification of trade.

Entirely different patterns of development evolved in East Asia and Africa. The former undertook significant reconstruction and embraced a new strategy of rapid export growth joined with substantial increases in savings. Eventually this combination proved extraordinarily successful and initiated the long period of Asian growth that continues today. But time was required for the response. From 1960 through 1970, the weighted average annual growth rate in East Asia was not much higher than the 5.7 percent attained in Latin America. Indeed, in the period from 1965 to 1973, it actually was lower.

For Africa the 1960s were a final period of postwar expansion. Rather than finding a new model, as was true in Asia, or experimenting as Latin America did with new state impulses to development, the continent saw more of the same. Africa soon began experiencing negative rates of per capita income growth from which it has begun to emerge only recently. Similarly, for much of South Asia the 1960s were a period of disappointingly slow growth.

Substantial private capital inflows first became available to developing countries in the late 1960s. The Euro-dollar market was in pursuit of new borrowers and found them primarily in Latin America. Governments had the luxury of financing additional imports and increasing public sector outlays without private retrenchment. Domestic policies retreated from the regulation that had become widespread during import substitution. Prices were allowed a larger role in the allocation of resources.

Military governments, whose domain expanded in these years, still saw a role for the public sector. The Brazilian miracle of the late 1960s and early 1970s was a clear descendant of the earlier era of import substitution, not to be confused with the outward-oriented policies pursued by South Korea and Taiwan. The domestic market still dominated, thereby affording advantage to Brazil and Mexico, the largest Latin American countries, both of which managed their highest rates of expansion in this period. Even Argentina, despite its failed attempt at stabilization under military rule in 1969, succeeded in achieving its peak growth rates in these years, at least until the 1990s.

This period of adaptation, which saw improvement in growth performance region-wide, was brought to an end by the international disequilibrium ushered in by the oil price rise in 1973. The post–oil-shock experience in Latin America was conditioned by the almost universal willingness of governments to take on debt in order to sustain imports. In this respect, the Latin American model once again deviated from the Asian model, where acceptance of immediate price increases rather than reliance on debt finance dominated.

Debt looked like a winning strategy in a world where real interest rates were low, as they remained until the late 1970s. But there was a shift from debt-led growth in the years before 1973 to debt-led stagnation thereafter. Even where accompanied by continuing growth, the strategy was precarious. It led to a marked increase in debt exposure that proved decisive when interest rates rose and new inflows were curtailed at the end of the decade.

In the meantime, countries took advantage of borrowing. In the Southern Cone, led by a newly militarized regime in Chile receiving guidance from the "Chicago Boys," monetarism became the rage. Its downfall was associated with an excessive capital inflow that became impossible to sustain in the 1980s. Mexico was a substantial borrower, relying on newfound oil resources as a magnet for capital; after the second surge in oil prices in the midst of the Iran-Iraq conflict, there was virtually no limit to the external finance available to the country. In Brazil, balance-of-payments deficits financed domestic expansion, albeit at decelerating rates and with rising inflation. Expanding debt inhibited growth but also deterred devaluation because of the implications of increased service payments on outstanding obligations. Only Colombia was able to avoid indebtedness, with rising coffee prices and receipts from illicit drug traffic providing needed resources. Its problem became accommodation to an external boom rather than adjustment to a substantial oil tax.

For Latin America as a whole, the period after the first oil shock showed a deceptive ability to adapt—or rather, a lack of necessity to do so. Foreign finance was readily available. Growth remained high, reinforcing military rule throughout much of Latin America. The precariousness of the Latin American situation was revealed only after a new rise in oil prices, an abrupt increase in real interest rates, and a recession among members of the Organization for Economic Cooperation and Development coincided in the early 1980s. But, contrary to what Angus Maddison has argued, it was not that governments had continued to follow blindly the original import substitution bias of the 1950s. Maddison states that: "The economic growth performance of Latin America since 1973 has been abysmal. . . . there has . . . been a certain continuity in economic policy attitudes since the 1930s and the liberal international order which was created by OECD countries and has influenced policy in Asia has left them virtually untouched."[21]

In fact, the major factor contributing to the instability of these countries was that they had shown a capacity to depart from earlier policy commitments. What influenced the outcome was their asymmetric opening to the world economy, combining vast financial flows with much more limited trade penetration.

New fiscal distortions substantially reduced countries' room for maneuver. For growth to continue in the late 1970s, the governments of Brazil and Mexico had to resort to rising

[21]Angus Maddison, *Two Crises: Latin America and Asia, 1929–38 and 1973–83* (Paris: OECD, 1985), p. 53.

deficits and the nationalization of economic activity. Stop-go macroeconomic policies were only a prelude to the stop-stop policies that became necessary in the 1980s. A situation of renewed external dependence and rapid change in the international economy offered an illusion of permanence.

The strategy did not work so badly for a time. Growth rates were not substantially depressed. Investment ratios remained respectable. The marginal propensity to save out of external borrowing was, on the whole, the same or greater than that out of domestic income. There seems to have been no difference in this regard between Indonesia and Korea on the one hand and Brazil and Mexico on the other. Nor do the Asian countries, particularly Korea, seem to have been spared entirely from mistakes in investment.

The real difference lay in the response to the second oil shock. Latin America, particularly the Southern Cone and the oil exporters, continued to borrow and paid the consequences when rising real interest rates and accompanying industrial country recession brought matters to a head. Table 1 provides a comparative perspective, distinguishing four negative effects on the balance of payments. First is the terms-of-trade effect; second is the rise in real interest rates; third is the impact of reduced OECD growth on the exports of developing countries; and fourth is the shift in the willingness of commercial banks to continue to lend, measured as the change in the ratio of capital flows to gross product.

Two conclusions emerge. One is the greater impact on Latin America, Colombia excepted, of interest rates and capital supply as opposed to terms of trade and OECD recession effects.[22] The more open East Asian economies were buffeted by deteriorating trade conditions, while Latin America was more sensitive to changes in financial markets.

The second and critical point is the importance of measuring shocks relative to exports rather than gross national product (GNP). Upon doing so, as in table 1, the immediate necessity of attending to the balance-of-payments crisis that did Latin America in can be seen; imports declined by $40 billion, more than 40 percent in volume terms between 1981 and 1983.

When Mexico defaulted (appropriately enough, on Friday, August 13, 1982), the countries of the Western Hemisphere were plunged into difficulties that have persisted until very recently. Growth ceased, and what was proclaimed by some to be another temporary balance-of-payments adjustment turned into the region's longest period of negative development in the century. National income per person, including the negative effects of a 36 percent terms-of-trade decline, stood at the end of 1993 at around 90 percent of its 1980 value.[23] By contrast, the 1980s were a period of vigorous expansion in much of Asia.

Latin American adjustment passed through four stages.[24] First there was a phase of drastic balance-of-payments correction between 1982 and 1984. Between 1981 and 1984 the

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[22]The reason is straightforward: the former depend on the debt/GNP ratio rather than the export/GNP ratio.

[23]Economic Commission for Latin America (ECLA), "Preliminary Overview of the Latin American and Caribbean Economy, 1993," *Notas sobre la Economía y el Desarrollo* no. 537/38 (December 1992), p. 39.

[24]For a summary of the literature up to the new commitment to debt reduction, see Albert Fishlow, "From Crisis to Problem: Latin American Debt," in R. Wesson, ed., *Coping with the Latin American Debt* (New York: Praeger Publications, 1988). For the subsequent evolution of the Brady Accords, see *International Capital Markets*, published by the IMF, in the early 1990s.

continent's imports fell by 45 percent. So rapid was the decline that World Financial Markets could speak of "lasting resolution of the LDC debt problem."[25] Instead, difficulties worsened in the second phase. Associated with softening international prices and declining export earnings, banks were not inclined to lend more but rather were committed to reducing their exposure to the region. Latin America was forced to deal with the crisis through a more fundamental realignment than had been imagined.

The third phase began with the Baker Plan in 1985, which was a tripartite strategy dependent on the banks, international institutions, and country adjustment. As this effort failed to secure needed bank support, it eventually gave way to the Brady Plan, which allowed, for the first time, substantial reduction of country indebtedness to banks. The policy became a reality in 1988, when Citibank wrote down its developing-country loans, and was confirmed the following year by the settlement of the outstanding Mexican debt at a price of about 65 cents to a dollar. Other countries soon settled at parallel discounts, larger for smaller countries such as Bolivia and Costa Rica, and comparable for those holding large stocks of debt.[26]

A fourth phase of restructuring has followed. Beginning in 1991 there was a sudden and unanticipated flow of capital into the region, which is discussed further below. Latin America was again a place for foreign funds to go. This progression, from import surplus to

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[25]*World Financial Markets* (October-November 1984), p. 1.

[26]The various relief packages did not reduce debt drastically; indeed, the IMF estimated that only about 8 percent of total obligations were reduced. Note, moreover, that the external debt of the region mounted to some $490 billion at the end of 1993, almost three times exports. While total interest payments as a percentage of exports have declined, rising interest rates would greatly complicate the situation. See ECLA, "Preliminary Overview, 1993," tables 20–22; and *World Economic Outlook* (Washington, D.C.: International Monetary Fund, May 1994), p. 95.

export surplus back to new import surplus, traces the evolution of the region's external accounts, shown in figure 8. Note the decline of the Latin American ratio of current account to gross domestic product (GDP) after 1982 and its subsequent rise after 1990. Note also the contrast with Asia, which mirrored the Latin American decline beginning in 1983 but had an earlier recovery and a spontaneous adjustment after 1991. During this latter period, when capital flooded into Latin America, the Asian countries were able to reduce their deficits autonomously.

What has been left out so far is the restructuring of domestic economies, which has shown itself in three areas. First, there has been a structural shift in government fiscal capability, and with it a decline in inflation rates. Brazil was virtually the last country in the region to introduce its new currency, the real, on July 1, 1994, and to mount a serious effort to limit inflation. Second, there has been a significant shift of ownership from public to private hands. And third, there has been a reduction of tariffs and quotas and greater reliance on internal productive capability.

The change in fiscal capability and inflation is major, as is evident in figure 9. In most countries it has been a continuous process, especially over the last three years, of increasing government command of revenues and expenditures. The fiscal balance has also benefited from lower international interest costs. Overall, the region's fiscal balance swung from a deficit of the order of three percent of GDP in 1989 to a surplus of one percent in 1993.[27] Moreover, more than two-thirds of the countries saw improvement.

[27] Ibid.

This recovery was due mainly to increased public sector revenues. Still, the somewhat skeptical position of the Economic Commission for Latin America requires recognition:In only a few countries . . . can the fiscal accounts be said to be structurally balanced. For this to be the case, current income must be solidly backed by a stable tax base, which in turn is consistent with a level of current spending that can support the normal functioning of government administration and the provision of basic social services. The tax base must also be able to support the public investment required to revamp and develop infrastructure necessary for economic growth and enhanced social equity.[28]

It is too early to tell whether such caution is justified. But the efforts at stabilization of recent years, if continued, promise to respond to a major need of countries in the hemisphere. It is no accident that price inflation has been dramatically reduced. Excluding Brazil, inflation in Latin America, as measured by consumer prices, fell to only 19 percent in 1993, less than half its 1991 value, and extraordinarily lower than the more than 1,000 percent registered in 1990.[29]For the first time in the post–World War II period the region has made a commitment to fiscal soundness. Figure 9 illustrates this by plotting the ratio of the fiscal deficit to GDP for the Latin American and Asian countries. The earlier stability achieved in Asia is clear. After a decline forced by lack of foreign finance in 1982 and 1983, Latin American deficit ratios increased again, before finally declining in the late 1980s. And Brazil has finally shown movement toward greater stability with its real plan.

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[28]ECLA, "Preliminary Overview, 1992," *Notas sobre la Economía y el Desarollo* no. 537/38 (December 1992), p. 2.

[29]ECLA, "Preliminary Overview, 1993," p. 1 and table 5.

Latin America thus has begun to emerge from the 1980s with greater fiscal discipline. Contributing to it has been a willingness to entrust the private sector with more responsibility and control. Sales of nationalized enterprises have accounted for sizable revenues, from one percent to four percent of total government receipts in recent years. Airlines, telephone and telegraph operations, steel facilities, and countless other enterprises have been turned over to private hands. In contrast to the 1970s, when external debt assisted the state in financing its needs, a radically different model has emerged. For the new strategy to work, however, private investment must be sustained and rationalized. If the shift to private hands is simply a one-time event, the benefits will not be realized.

Thus, privatization should not be viewed simply as part of the process of fiscal reform. It encompasses a broader conception of the role of the state. Enterprises that are sold should not merely be those able to yield an immediate return to public authorities. Rather, the objective must be to improve economic efficiency continuously.

A third important policy modification has occurred in the governments' strategy for promoting domestic production. Latin America began the post-1950 period committed to import-substituting industrialization. Import barriers were erected to allow domestic sectors to develop. Already by 1960 it was evident that protection was not working; only Brazil and Mexico, with their large domestic markets, had succeeded in growing. But it was not until the balance-of-payments crisis of the 1980s that all countries in the region moved to freer trade.

Tariff reductions in recent years have been spectacular. Virtually everywhere the value of domestic production subject to restriction has been reduced substantially and the average tariff lowered significantly.[30] A sharp decline in real exchange rates also has been undertaken to reduce imports and encourage exports. Unfortunately, the inflow of capital has resulted in a significant exchange rate appreciation in many countries in recent years. This movement may be contrasted with the stability of the Asian real exchange rate. (See figures 10 and 11.)

This current Latin American appreciation has contributed to the sharp rise of imports since 1990. Between 1990 and 1993, the region's imports grew from $94 billion to $148 billion, an average annual increase of almost 15 percent. The only large country whose behavior is at variance with this pattern is Brazil, which continued to repress imports until 1993, but then subsequently sharply increased its foreign purchases.

Latin America is thus a different region from what it was a decade ago. Its fiscal situation has improved. Inflation is under control for the first time since the 1950s. Bloated public sectors have been compressed, and the increased efficiency of tax collection has yielded additional revenues for public authorities much in need of them. Barriers to trade have been substantially removed, and a commitment to greater competitiveness has emerged. These changes are due to the brute force of the readjustment forced on the region. No longer do people have faith in the ability of state managers to plan. Instead, as elsewhere around the globe, new reliance on markets is the rule.

The Era of Equity Finance

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[30]It now stands at little more than 20 percent, compared to close to 50 percent before tariff reduction began. ECLA, *Estudio Económico*, 1991 (Santiago de Chile, 1993), vol. 1, table 13.

The age of equity finance can be dated from the end of the 1980s.[31] The international diversification of investment portfolios by pension funds and life insurance companies in the United States, prompted by regulatory changes, is one factor. Another is the liberalization of financial markets and growth of mutual funds—and the reluctance of the money-center banks to commit funds again to emerging markets. These combined to initiate a wave of equity investment to Latin America and Asia.[32] Investment was further encouraged by declining U.S. interest rates, which enhanced the creditworthiness of indebted countries and encouraged mutual fund managers to search for yield overseas. Various observers—Calvo, Leiderman, and Reinhart, for example—conjectured that portfolio equity flows were likely to be sensitive to changes in international interest rates and therefore subject to sudden reversal. Subsequent events would prove them correct.[33]

Capital inflows to Latin America matched and then exceeded those reached during the peak of bank lending (1978–81), with $24 billion in 1990, $40 billion in 1991, $64 billion in 1992, $69 billion in 1993, and $42 billion in 1994. The flow was more modest relative to GDP

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[31] A good review of the trends is Linda L. Tesar and Ingrid M. Werner, "U.S. Equity Investment in Emerging Stock Markets," *World Bank Economic Review* 9 (1995) pp. 109–129.

[32] In a parallel with the 1920s, Hale remarks that the surge of lending in the 1990s and the negative reaction to the 1994 peso devaluation were "magnified by the moral hazard problems resulting from Wall Street's big investment in emerging market research and investment banking departments. Many firms had downplayed Mexico's exchange rate vulnerability because they were afraid that it might jeopardize the deal flow required to cover their expensive overhead at a time when Wall Street's domestic business was in recession." See David Hale, "Emerging Markets After the Mexican Crisis," unpublished manuscript, Kemper Financial Services, Inc. (1995).

[33] Guillermo A. Calvo, Leonardo Leiderman, and Carmen M. Reinhart, "Capital Inflows to Latin America: The 1970s and the 1990s," International Monetary Fund Working Paper (Washington, D.C., 1992).

or exports, reflecting the growth of the recipient economies in the interim: whereas the balance on capital account reached 7.4 percent of GDP in 1981, it was "only" 3.8 percent in 1991.[34] Mexico and Bolivia were the only Latin American countries for which inflows as a share of GDP substantially exceeded the levels reached ten years before, in the first case reflecting the enthusiastic reception accorded the North American Free Trade Agreement (NAFTA) in financial circles, in the second reflecting the exceptional difficulties in which the Bolivian economy had been mired a decade earlier. Flows to Asia similarly exceeded the levels reached the previous decade, absolutely if not as a share of GDP.

What is not so widely appreciated is the importance of trade credits, bonds, and direct foreign investment in the 1990s. As late as 1991, flows of DFI into Asia and Latin America were four times as large as portfolio equity. In 1992 the ratio fell, but only to three times as large. DFI was associated with deregulation and privatization in a way that had no parallel in the 1920s or the 1970s.[35] There was an important contrast between Asia and Latin America, with the latter relying less heavily on DFI and more on foreign investment in equity and bonds.

In the 1990s, as in the 1920s and 1970s, foreign lending was encouraged by a decline in interest rates in the center.[36] Falling interest rates in the United States encouraged a search

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[34]Ibid., table 1.

[35]The recent wave of DFI is also distinctive for the extent to which it is concentrated in sectors newly exposed to international competition, in contrast to the situation in the 1920s when it was concentrated mainly in extractive industries and in the 1970s when it was used to jump tariff walls. See Guy V. G. Stevens, "Politics, Economics and Investment: Explaining Plant and Equipment Spending by U.S. Direct Investors in Argentina, Brazil, and Mexico," International Finance Discussion Paper, no. 490 (1994), International Finance Division, Board of Governors, Federal Reserve System.

[36]In this context, foreign lending should be understood to include the repatriation of
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for yield by mutual fund portfolio managers attracted to emerging markets. They enhanced the creditworthiness of developing countries already saddled with a burden of floating-rate debt. Chuhan, Claessens, and Mamigni conclude that external factors explain about half of the variation in bond and equity flows from the United States to six Latin American countries and somewhat less for Asia.[37] The lower share for Asia may reflect the greater weight of DFI insensitive to interest rates in the region's capital inflows; in addition, Latin American countries have a higher share of variable-rate debt (57 percent in 1993, according to IMF estimates), which heightens the region's sensitivity to global interest rates. Calvo, Leiderman, and Reinhart reach an analogous conclusion.[38] Fernandez-Arias similarly finds that lower international interest rates explain the largest share of the variation in recent capital inflows to developing countries.[39] The exceptions are Mexico, where an improving domestic investment climate played the dominant role, and Argentina, where improving country creditworthiness has been key. That countries such as Peru experienced increased capital inflows as early as 1990, when they were still experiencing severe financial difficulties, is consistent with this view of the strong influence of external effects.

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[36](...continued)
flight capital (that is, the foreign assets of domestic investors).

[37]See Punam Chuhan, Stijn Claessens, and Nlandu Mamigni, "Equity and Bond Flows to Latin America and Asia: The Role of External and Domestic Factors," Policy Research Working Paper, no. 1160 (Washington, D.C.: The World Bank, 1993).

[38]See Guillermo A. Calvo, Leonardo Leiderman, and Carmen M. Reinhart, "Capital Inflows and Real Exchange Rate Appreciation in Latin America," IMF Staff Papers, no. 40 (Washington, D.C.: International Monetary Fund, 1993), pp. 108–151.

[39]See Eduardo Fernandez-Arias, "The New Wave of Private Capital Inflows: Push or Pull?," Policy Research Working Paper, no. 1312 (Washington, D.C.: The World Bank, 1994).

This surge of lending was curtailed in the second half of 1994. The research mentioned earlier suggests that the series of interest rate increases undertaken by the U.S. Federal Reserve played an important role. The parallel with 1928–29 and 1981–82 is unmistakable.

In addition, 1994 was marked by a series of unsettling political events in Mexico, the single largest importer of capital. The size of Mexico's current account deficit, the failure of investment to rise significantly along with capital inflows, and the high real exchange rate had already unsettled some observers.[40] (For statistics see table 2.) Then came a peasant revolt in the southern state of Chiapas at the beginning of the year and the assassination of Partido Revolucionario Institucional (PRI) presidential candidate Luis Donaldo Colosio in March. Superimposed on rising U.S. interest rates, Mexico was suddenly a less attractive place in which to invest.

A decline in capital inflows from eight percent of GDP to zero would have required a difficult adjustment under the best of circumstances. As 1994 was an election year, Mexican officials had an incentive to delay. They expended international reserves to prevent the peso from depreciating more rapidly than their rule; one-third of the total was used to fend off the attack on the peso that followed Colosio's assassination. The Bank of Mexico allowed an expansion of domestic credit at an annual rate of around 20 percent to sustain consumption

[40]See, for example, Rudiger Dornbusch and Alejandro Werner, "Mexico: Stabilization without Growth," Brookings Papers on Economic Activity 1 (Washington, D.C.: Brookings Institution, 1994), pp. 253–313. Mexican investment as a share of GDP did rise modestly from 1989 to 1991 but not subsequently. The real effective exchange rate, calculated as the Mexican consumer price index divided by a trade-weighted average of trading partner CPIs multiplied by their respective dollar currency prices, rose by some 25 percent between 1991 and 1994.

and support a weak banking system. Off-budget spending by the government's development bank further primed the pump.

Thus, when President Ernesto Zedillo was inaugurated on December 1, 1994, he found that the cupboard was bare. Indeed, some days before, an apparent agreement to devalue by the Salinas government was vetoed by departing Finance Minister Pedro Aspe. What made the reserve situation worse was Mexican speculation in anticipation of a devaluation: IMF numbers show that some $4.6 billion of capital outflow by nationals occurred just prior to the devaluation in mid-December. The Bank of Mexico again intervened to support the currency but withdrew from the market when reserves fell to $6 billion. On December 20 it widened the trading range for the peso, effectively devaluing the currency by 15 percent, which only incited further capital outflows. The next day the currency was allowed to float and sank like a stone, falling below seven pesos to the dollar soon after the turn of the year. The Mexican stock market tumbled along with the currency.

Notwithstanding reference to "the tequila effect," this most recent crisis has been largely limited to one country. Despite subsequent difficulties in Argentina and Brazil, neither has suffered a Mexico-style crisis. Other Latin American countries, such as Chile and Colombia, were little affected by the Mexican affair. Thailand and Hong Kong, which had done the least to limit capital inflows in the preceding period, experienced the greatest difficulties when portfolio investment reversed direction; while both raised domestic interest rates, neither was forced into a major reorientation of policy.

It may be hard to deny that there exists contagion in financial markets and that the Mexican affair negatively affected the willingness of investors to lend to other industrializing economies, but in contrast to the 1930s and 1980s the current crisis has nonetheless been limited geographically and in extent.[41]

One reason is that U.S. interest rates have begun to come down again, reflecting the deceleration of growth in the United States. This enhanced the creditworthiness of indebted countries and again encouraged the search for yield by U.S. portfolio managers. But a more fundamental reason is the extent of policy reform in Latin America and Asia. In contrast to the early 1980s, government budgets are in balance. Savings rates are respectable, although admittedly more so in some places than in others. In countries that suffered high inflation during the previous decade, a new anti-inflation consensus has emerged. Policy credibility may be far from perfect, but it is greatly enhanced relative to the inheritance of the early 1980s, providing some insulation from destabilizing shocks.

This new policy stance has had significant macroeconomic benefits. In Chile and Colombia, for example, the real exchange rate has been kept more stable out of concern for export competitiveness. Throughout Latin America, import controls have been removed. Deregulation and privatization have increased the responsiveness of the export sector. This new flexibility allows economies to cope more easily with shocks, as even Mexico illustrates through the massive correction of its current account deficit and unprecedented expansion of exports in 1995.

Hence, the recent crisis could be perceived as the consequence of an unfortunate conjuncture of economic and political circumstances unique to Mexico rather than a reflection

[41]See Sara Calvo and Carmen M. Reinhart, "Capital Inflows to Latin America: Is There Evidence of Contagion Effects?," unpublished manuscript, The World Bank and International Monetary Fund (1995).

of inconsistent policies in the emerging markets generally. Mexico's singular dependence on capital imports reflected its proximity to the United States and the successful conclusion of NAFTA negotiations. Its rapid monetary expansion in the semester leading up to the crisis was a result of electoral politics. Its inadequate savings rate reflected the recent liberalization of consumer goods imports and encouragement of domestic demand. Its unwillingness to adjust the exchange rate in the period preceding the election, as had been done prior to every previous presidential inauguration since 1976, reflected the policy's special sensitivity in light of NAFTA as well as the retiring president's candidacy to head the newly founded World Trade Organization. Clearly, the incoming Zedillo administration inherited significant handicaps. Criticizing its attempts to manage the crisis has nonetheless become popular sport. Among its shortcomings was a failure to recognize how the situation had been transformed by the advent of equity finance. Arguably, equity investors are more sensitive than bondholders and banks to expectational effects. Even more than other investments, portfolio equity flows are driven by expectations of capital gains, as investors herd in and out of markets. This makes mutual fund investors exceptionally sensitive to changes in international interest rates, something the Mexican authorities failed to take into account. It also means that the groundwork for policy changes such as devaluation have to be laid carefully in order to avoid surprising investors in a way that leads them to conclude that everything gold has turned to dross.[42] Failure to do this accounts for the market's negative reaction to the December 20

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[42]Hale describes the contrast as follows: "The . . . vulnerability which the peso crisis has exposed is the greatly increased sensitivity of securitized capital flows to adverse news events compared to commercial bank lending and foreign direct investment, the primary sources of private capital for developing countries before the 1990s. Managers of mutual

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devaluation.[43] The Zedillo administration then confounded the problem by attempting to treat Mexico's new creditors like the creditors of the 1980s. It assumed a continuing business relationship, as Mexico once had with the banks, where one did not exist.

For all these reasons, then, the crisis, when it came, was unusually severe. Whether it justified the exceptional support extended by the Clinton administration and the IMF is too large a question to answer definitively here. The arguments against "the bailout" are two. One is that the United States has little economic interest in Mexico.[44] Mexico in 1994 took only ten percent of U.S. merchandise exports, amounting to less than one percent of U.S. GDP. It is hard to argue that U.S. prosperity, either generally or specifically, hinges on the Mexican market. To the extent that illegal immigration will be promoted by economic difficulties south

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funds and pension funds have different attitudes toward currency devaluations than commercial banks or multinational companies. Commercial banks with dollar loans do not object to currency depreciation in developing countries with large trade deficits because they can improve the credit rating of the country by boosting exports at the expense of domestic consumption. Multinational corporations also can benefit from a currency devaluation if they are using the country as an export base. The portfolio managers of mutual funds and pension funds operate under different constraints. Although they understand that currency devaluations are sometimes a necessary component of an economic restructuring program, they do not like unpredictable exchange rate holdings in cases where they are large holders of debt and where the equity market is dominated by companies oriented toward domestic consumption." See Hale, "Emerging Markets After the Mexican Crisis."

[43]Here the contrast with Brazil is striking. Brazil introduced more flexibility into its exchange rate early in 1995 but phased in the new regime, first shifting the existing band and then widening it. While the markets' reception of the new Brazilian policy was not entirely positive (the real plunged to its new floor the day after the band was shifted), the reaction soon stabilized. One reason was the much greater reserve level when Brazilian policy altered.

[44]See Anna J. Schwartz, "Trial and Error in Devising the Mexican Rescue Plan," in *Shadow Open Market Committee, Policy Statement and Position Papers*, March 5–6. Public Policy Studies Working Paper Series, William E. Simon Graduate School (Rochester: University of Rochester Press, 1995), pp. 101–109.

of the border, increased border surveillance is a more direct and efficient method for dealing with the problem than a $50 billion bailout.

This view defines U.S. interest in Mexico narrowly. It ignores the political reaction in Mexico to paramilitary operations along the border, minimizes the potential growth of U.S.-Mexican trade and investment, and attaches no value to U.S.-Mexican cooperation in the Caribbean and Central America. It ignores the fact that a full-scale meltdown in Mexico might have led to the perceived failure of the U.S.-promoted model of liberalization and privatization, with negative repercussions throughout the developing world.

The second argument against intervention is moral hazard. The analogy with deposit insurance is direct, because the U.S. bailout can be interpreted as extending insurance from the U.S. Treasury to depositors in Mexican banks.[45] Aid like that provided by the United States, if expected to be extended with regularity, can encourage risk-taking by the recipient government. That Mexico has had a financial crisis in every election year since 1976, and received assistance from the U.S. Treasury or the Federal Reserve Board since 1982 ($1.8 billion in 1982, $3.5 billion in 1988, and $20 billion in 1994) can be taken as evidence of this danger. The caveat is that attaching stringent policy conditionality to the loan and collateralizing it with state oil revenues may mitigate this danger. It remains to be seen whether the conditions like those imposed on monetary policy in 1995 can really be met.

[45]See Lee Hoskins, "Mexico: Policy Failure, Moral Hazard and Market Solutions," in Shadow Open Market Committee, Policy Statement and Position Papers, March 5–6. Public Policy Studies Working Paper Series, William E. Simon Graduate School (Rochester: University of Rochester Press, 1995), pp. 25–46.

The arguments in favor of the bailout are also two in number. One is contagion: default by Mexico would have spread to other countries, setting back reform and liberalization efforts in Argentina, Brazil, Thailand, and other semi-industrialized nations. The counterargument is that widespread policy reform in Latin America and elsewhere in the developing world would have caused investors to pause before generalizing Mexico's problems. Nor does there exist much systematic evidence of contagion; economic analysis of its extent is still in its early stages.[46]

The second justification for the bailout is predicated on the existence of multiple equilibria. In this view, the markets overreacted to the Mexican devaluation in a way that unnecessarily aggravated the crisis. Timely intervention prevented the markets from shifting Mexico from the good to the bad equilibrium. Sachs compares flight from the peso and from Mexican debt to a self-fulfilling bank run.[47] Mexico had nearly $30 billion of tesobonos (dollar-denominated public debts that began to be issued in 1994) due in 1995. Though the tesobono stock was only some ten percent of 1994 GDP, it was large relative to the Bank of Mexico's reserves and hence vulnerable to a self-fulfilling run.[48] So long as investors renewed their

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[46]See Calvo and reinhart, "Capital Inflows to Latin America." Calvo and Reinhart find some evidence of contagion in a model in which the determinants of capital flows to four small Latin American countries are a function of their standard determinants plus a contagion proxy (namely, capital flows to four large Latin American countries). Their results can be questioned, however, on the grounds that they model the standard determinants of capital flows in a simplistic way.

[47]See Jeffrey Sachs, "Do We Need an International Lender of Last Resort?," Princeton Essays in International Finance (Princeton: Princeton University Press, forthcoming).

[48]Models of self-fulfilling debt runs include Guillermo Calvo, "Servicing the Public Debt: The Role of Expectations," *American Economic Review* 78 (1988), pp. 647–661; Alberto Alesina, Alessandro Prati, and GuidoTabellini, "Public Confidence and Debt

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maturing tesobono subscriptions, nothing prevented the government from servicing them indefinitely. But each potential creditor realized that if other creditors refused to roll over their tesobonos, Mexico could be forced to default even if its low debt/GDP ratio implied long-term solvency. The December 20 devaluation provided a focal point for investors to coordinate such action.[49] Their failure to roll over maturing tesobonos pushed the Mexican authorities to the brink of default. It forced them to raise interest rates to extraordinary heights and caused the exchange rate to plummet to the point where public support for economic reform was jeopardized. Lender-of-last-resort intervention by the United States can be justified on the same grounds as central bank support for an illiquid but solvent bank.[50]

This position is given even greater weight by Mexico's successful return to the capital market in July; an initial $500 million issue was doubled as a consequence of great investor interest in two-year floating rate notes. To be sure, a substantial five percent premium over

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[48](...continued)
Management: A Model and a Case Study of Italy," and Francesco Giavazzi and Marco Pagano, "Confidence Crises and Public Debt Management," in R. Dornbusch and M. Draghi, eds., *Public Debt Management: Theory and History* (Cambridge: Cambridge University Press, 1990), pp. 94–124 and pp. 125–152.

[49]The work of Rogers is consistent with this hypothesis. It shows that a plausible proxy for default risk (the ratio of dollar- to peso-denominated bank deposits) increases with the peso's expected rate of depreciation. See John H. Rogers, "The Currency Substitution Hypothesis and Relative Money Demand in Mexico and Canada," *Journal of Money, Credit and Banking* 24 (1992), pp. 300–318, and "Convertibility Risk and Dollarization in Mexico: A Vector Autoreggressive Analysis," *Journal of International Money and Finance* (1992), pp. 188–207.

[50]However compelling this story, it is also possible to argue that the negative reaction of investors reflected the disarray in Mexican policy and fears that trade union and business support were absent. While the idea of multiple equilibria is suggestive, it requires further substantiation.

the London Interbank Offered Rate also played a role, but Mexico's sharp reduction in domestic income was equally important.

Policy Implications

It is too early to distill definitive policy implications from the events of 1994–95. But we hazard some provisional thoughts about options for managing international capital flows in the future. Mexico, or some variant thereof, can be expected to happen again.

What is clear from recent events is that international capital markets can "turn on a dime" (if not a peso). Capital flows can reach high levels relative to the GDPs and domestic financial markets of developing countries. They can reverse direction abruptly. They are sensitive to global economic conditions and industrial-country interest rates in particular. Events in individual countries can disrupt the flow of external finance to other external borrowers. For all these reasons, developing countries are vulnerable to capital-account shocks not of their own making—now more than ever, given the increasing importance of interest-rate and expectation-sensitive portfolio equity flows.[51] And adjustment to those shocks can be painful on both political and economic grounds.

What policy response should this recognition prompt? Mexico attempted to obtain assistance bilaterally, appealing to the United States. One important lesson of the Mexican episode is that bilateral solutions are not feasible. While markets move swiftly, politicians do

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[51]This is evident once again in the wake of the Mexican crisis, which has been marketed by a "surprisingly" rapid resumption of lending to emerging markets. No explanation for this pattern would be adequate without reference to the decline in U.S. interest rates associated with decelerating economic growth.

not, especially when the question is aid to foreigners. The separation of powers that is the American government's strength also permits electorally-minded politicians to delay fire-brigade operations. The Clinton administration's inability to guide its Mexican aid package through Congress drove it to make exceptional use of the Treasury's Exchange Stabilization Fund. It will be harder to do so a second time, given how this unilateral action antagonized the congressional opposition. Nor does the Exchange Stabilization Fund possess the resources to deal with a larger crisis, or two crises simultaneously; even in January 1995 the administration had to secure significant supplementation from the IMF. To the extent that the IMF's willingness to go the extra mile reflected personal connections between senior administration and IMF officials, it is unlikely to be so supportive of a U.S.-led operation again. And the United States is unlikely to evince the same willingness to shoulder the risks of a fire-brigade operation for a country more distant from its own borders. Clearly, an alternative to bilateralism is needed.

Some would settle for encouraging the more timely publication of economic statistics as a way of strengthening market discipline. If the markets are better able to identify countries whose positions are approaching unsustainability, rising interest rates and declining capital flows will force governments to act more quickly. Some who doubt the adequacy of the discipline applied by even well-informed markets—for whom the problem, after all, can be too much information, not too little—recommend more timely monitoring of debtor countries by the IMF, which would operate an "early-warning system" that publicized in advance impending instability.

It is not obvious, of course, that the IMF is better positioned than the markets to discern signs of impending danger; traders, after all, have very considerable profits at stake. But both financial disclosure requirements for domestic firms floating securities as well as a Securities and Exchange Commission with the power to open firms' books and to verify that the information disclosed is accurate are well accepted. It can be argued that the IMF, by virtue of its lending capacity, is well positioned to play this role in an international setting. However, it may also worry that issuing a warning that causes the markets to draw back may aggravate economic problems in the borrowing country and jeopardize any IMF Structural Adjustment Program in place. A mandate for the IMF to issue early-warning signals may not be incentive compatible, in other words. And even with IMF guidance, it is not clear that the markets will react to impending problems by smoothly raising the price and restricting the availability of credit to the debtor; historical experience suggests that the markets have a tendency to overreact, with periods of complacency suddenly giving way to a sense of crisis.

In some ways, the virtual unanimity that more and better information is necessary enables portfolio fund managers to find an excuse for their poor predictions. Once there is fuller information, the next crisis will fail to be foreseen for other, and also initially profitable, reasons. So fuller knowledge alone will not suffice to avoid future difficulties.

That reality, and the existence of political and economic costs to rapid domestic adjustment in response to shifts in the direction of capital flows, creates the standard theory-of-the-second-best case for a mechanism for insuring against those reversals. This is the basis for the argument that the resources of the IMF should be augmented by doubling the General

Agreements to Borrow (GAB) to $56 billion, as agreed by the Group of Seven leaders at the June 1995 Halifax summit.

The adequacy of the facilities that are currently being contemplated is questionable, however. The Mexican bailout required $50 billion and an IMF contribution that was larger than any previous loan it had made. The Argentine loan was $8 billion. If it is believed that a danger of contagion exists, then there is reason to worry that future crises will not be limited to one or two countries. In such a setting $56 billion may not suffice. And it is hard to believe that the U.S. Congress or European governments would agree to more. In addition, large drawings relative to the size of countries' IMF quotas are subject to strict conditionality; securing a letter of intent typically requires extended negotiations between the IMF and the government. As the Mexican crisis illustrates, it may be difficult or impossible to agree to the necessary conditionality in the days or hours that the markets permit.

This situation encourages the consideration of facilities that would be self-financing and automatically disbursing. Kenen has proposed a special IMF matching-fund facility to deal with Mexico-style problems.[52] A country experiencing large capital inflows would be encouraged to make deposits at the IMF equal to, say, twice its quota. In return it would be entitled to draw some multiple of that quota. Kenen suggests that a country making such a deposit would be allowed to draw twice its quota without those drawings counting against its right to access other IMF facilities and without first securing a letter of intent. Because the

[52]See Peter B. Kenen, "Reforming the International Monetary System: An Agenda for the Developing Countries," in J. J. Teunissen, ed., *The Pursuit of Reform* (The Hague: Forum on Debt and Development, 1993), pp. 19–41.

increase in IMF resources would come through deposits, the IMF would not have to seek approval for an increase in quotas or authorization to borrow on capital markets.

Even if countries were prohibited from making deposits equal to more than, say, three times their quotas and therefore from drawing more than four times their quotas, there remains the danger that a small number of debtors could drain the facility of funds quickly.[53] The equivalent of a depositor run on a bank—strategic behavior among the depositors, with some drawing on their entitlements purely in order to prevent the others from draining the facility first—can even be imagined. Thus, such a facility still would have to be capitalized with increases in quotas or resources from the GAB.

All insurance poses a danger of moral hazard; unless strong conditions are attached to IMF lending, countries will be encouraged to increase their reliance on foreign capital and pursue policies that heighten their vulnerability to capital-account disruptions. Investors will be encouraged to lend to emerging markets if they expect that they will be bailed out by an injection of IMF resources. Whether the IMF can prevent the erosion of market discipline is an open question. Doubts feed skepticism about the advisability of such an expanded facility. If it proves impossible to arrange coinsurance through the IMF, then countries will have to insure themselves. They do this to some extent by sterilizing capital inflows—that is, by swapping foreign assets for government bonds—and accumulating reserves during boom periods. Many countries adopted this strategy during the recent wave of capital inflows. Chile, which accumulated reserves reaching ten percent of GDP between 1989 and 1994, led the

[53] In addition, the kind of sterilized and unsterilized intervention required for a developing country to accumulate reserves on the requisite scale can be costly.

pack. But given the speed and magnitude of shifts in the direction of capital flows, even substantial reserve accumulations do not provide much margin for comfort. And the costs of accumulating reserves rise with the magnitude of the accumulation. Most countries acquire reserves through sterilized intervention in order to avoid increasing the money supply and fueling inflation. In a situation where domestic and foreign assets are imperfect substitutes (as is the case in developing countries), there will be downward pressure on bond prices and upward pressure on interest rates. (It will be most severe where the domestic bond market is thin, as in Korea in the 1980s.) This is the purpose of the intervention, of course: to raise interest rates and damp down the consumption encouraged by the capital inflow. The problem is that it will operate most directly on the rates the government pays and increase the deficit of the government and quasi-public enterprises.[54]

Governments also can insure themselves against a quick reversal of capital flows by tightening fiscal policy, which will damp down private-sector demand and, by lowering interest rates, discourage capital inflows (the opposite of the effect of sterilized intervention). The urgency of public pension reform in countries experiencing large capital inflows is often cited in this connection. In practice, however, pension reform is contentious and protracted. More generally, it is hard to fine-tune fiscal policy with the precision needed to manage erratic and sudden swings in capital flows.[55]

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[54]Larrain reports that the interest costs of sterilization amounted to some one-half percent of GDP in Colombia and Chile. See Felipe B. Larrain, “Exchange Rates and Reserve Management with Large Capital Inflows,” Catholic University of Chile (unpublished manuscript, 1995).

[55]Even countries such as Thailand and Mexico, which were able to engineer sharp
(continued...)

The other way for countries to insure themselves against the domestic costs of a sudden capital outflow is to use taxes and tax-like devices to limit inflows.[56] Restrictions or taxes, for example, can be placed on the ability of banks to borrow offshore. This method can be thought of as an open-economy variant of the standard types of prudential regulation to which all national banking systems are subjected.

The fact that governments are the lenders of last resort in the event of banking crises leads them to adopt measures designed to limit the exposure of banks to various kinds of risks that could bring down the country's financial system. In developing economies open to international financial markets, a leading source of such risk is offshore borrowing by banks, particularly borrowing in foreign currency. This link is evident recently in both Mexico and Argentina, where the weakness of the banking system and its vulnerability to a sudden reversal in the direction of international capital flows fed on one another. In Malaysia, for example, limits on non-trade-related swap transactions were imposed on commercial banks in 1992. The central bank discouraged inflows in early 1994 by limiting banks' holdings of foreign funds, raising the cost of holding foreign deposits, imposing ceilings on the net external liabilities of domestic banks, and prohibiting the sale of short-term financial instruments to foreigners.[57]In Indonesia, starting in October 1991 all state-related offshore commercial

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[55](...continued)
fiscal corrections, did not succeed in heading off large capital inflows and preventing the emergence of substantial current account deficits.

[56]It is also possible to discourage inflows by taxing or controlling outflows, since foreign investors will be discouraged by impediments to repatriating their funds.

[57]The effectiveness of these measures was arguably enhanced by the announcement that they were temporary (which encouraged foreigners to delay their investments rather than
(continued...)

borrowing was made subject to new prior approval by the government, and annual ceilings were imposed for new commitments over the next five years. Limits were imposed on individual banks' net open-market foreign exchange positions, and a separate limit was placed on their off-balance-sheet positions. The central bank then announced that short-term swap operations could be undertaken only at its initiative. As a result, the inflow of portfolio capital to both countries was dampened.

In November 1994 India sought to curb capital inflows by ordering firms raising funds on international capital markets to keep the money abroad until it was needed for specific projects and by banning their use of warrants (which give investors the right to buy shares at a fixed price at a future date). The Mexican crisis had little effect on any of these countries, in contrast to a temporary reaction in neighboring Thailand, which did not limit capital inflows in this way.[58]

In Latin America, Chile restricted capital inflows starting in 1991. The Chileans required firms borrowing foreign currency to deposit a 20 percent reserve in a non-interest-bearing account with the central bank for a period of one year. In 1992 the reserve requirement was raised to 30 percent. Colombia imposed a similar requirement, at a rate of 47 percent, in September 1993. The non-interest-bearing deposit is to be maintained for the duration of the foreign loan and applies to all loans of 18 months or less, except for trade

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[57](...continued)
to attempt to evade the controls). In fact, some Malaysian controls were relaxed or removed when the volume of international lending fell off in the second half of 1994.

[58]See Reuven Glick and Ramón Moreno, "Responses to Capital Inflows in Malaysia and Thailand," Weekly Letter, Federal Reserve Bank of San Francisco, 95–14 (1995), pp. 1–3.

credit. In August 1994, Colombia, in response to continued capital inflows and complaints by exporters about their loss of competitiveness, extended the deposit requirement to all loans of 60 months or less (again excepting trade credit) at a cascading rate that fell from 140 percent for funds of 30 days or less to 42.8 percent for five-year funds. In addition, foreigners are prohibited from investing in the Colombian bond market. In October 1994, in response to the real appreciation caused by the combination of a fixed nominal peg and large capital inflows, Brazil imposed a one percent tax on foreign investment in the stock market and raised the tax on Brazilian companies issuing bonds overseas from three to seven percent. Having eased this requirement in the wake of Mexico, Brazil has acted again in August 1995 to check a rapid accumulation of reserves.[59]

It is noteworthy that the Mexican crisis had little impact on Chile and Colombia, whose capital inflows disproportionately took the form of DFI, in contrast to Argentina, which had not limited inflows significantly. Where foreign investment amounted to one-third of Argentine stock market capitalization prior to the Mexican crisis, the comparable figure for Colombia was one-twentieth. Admittedly, these countries also differed in other respects: the success of Chile in raising its domestic savings rate also helped it to limit its dependence on foreign capital; this is in contrast to Mexico and Argentina, where the savings share of GDP

[59]The Brazilian tax on equity investments by foreigners, paid at the time of purchase, will therefore fall more heavily on short-term investors and is designed to encourage a buy-and-hold strategy.

fell in the years following the resurgence of lending.[60] But controls on inflows surely helped the first set of countries weather the storm.

The diverse experiences of these countries confirms the feasibility of measures to stem capital inflows. Such policies can moderate inflows without repulsing foreign investors and causing the country to lose all access to the capital market. While evasion becomes more serious the longer controls remain in place, it does not appear to be so pervasive as to vitiate the controls' entire effectiveness.

There is still another way to organize international help, but this comes after the fact. We refer to various schemes that seek to provide a means of permitting international bankruptcy, in analogy to domestic access to this possibility. To the extent that the purpose of bankruptcy procedures is to provide a standstill on payments, such an option already exists insofar as countries can invoke it unilaterally; we saw this in the 1980s, when several countries suspended debt service payments. But other provisions of bankruptcy proceedings—assigning seniority to new money and implementing a plan to restructure the firm's operations—have no analog in the sovereign setting. Unfortunately, schemes to create a full-fledged international bankruptcy court encounter very serious obstacles. Such a court would not possess the power to seize collateral, nor would it "replace" the government of a country in the way that bankruptcy courts in the United States can replace the management of a reorganized firm. Bankruptcy statutes in different countries differ significantly, making it unlikely that governments could agree on the structure of a plan. Modest reform to enhance the orderliness

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[60]his factor does not similarly complicate efforts to evaluate the effects of controls in Malaysia and Thailand, since the savings share actually rose in Thailand while falling in Malaysia over the four years following the reinitiation of lending.

of workouts may be feasible (as proposed by Eichengreen and Portes), but not a full-fledged bankruptcy procedure.

International capital flows have much to recommend them. But in a world of distortions, there is a valid argument for marginal interventions to limit their magnitude. Investors dislike controls that raise questions about a government's commitment to open markets, as do international institutions, which fear that they will be adopted instead of, rather than in addition to, policy reforms.[61] These are legitimate fears. But those who laud the benefits of open markets and caution that governments can abuse the privilege of intervening in their operation are under an obligation to offer alternatives. In particular, they should be in the forefront of those calling for an expanded IMF facility and for new procedures for dealing in more orderly fashion with debt crises when they occur.

[61] See International Monetary Fund, *World Economic Outlook*, October 1994 (Washington, D.C.: International Monetary Fund, 1994).

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