An international debt crisis erupted in the early 1980s that was “one of the most traumatic international financial disturbances” of the twentieth century. Debt crises had occurred in the nineteenth century, and widespread defaults on loans in the 1930s had severely disrupted capital flows to Latin America and Southern and Eastern Europe. However, the world was unprepared for the 1980s debt crisis, which threatened the international banking system and many LDCs. This chapter focuses mainly on the origins and effects of the 1980s debt crisis and the strategies adopted to deal with it. The latter part of the chapter discusses the East and Southeast Asian (henceforth “Asian”) financial crisis of the late 1990s, which resulted in the collapse of some currencies and a sharp decrease in capital formation and economic output; and the sub-prime mortgage financial crisis of 2007–2008, which resulted from a speculative bubble in the U.S. housing market that eventually resulted in a global credit crunch and financial failures in many countries. Whereas the economic development aspects of the Asian financial crisis are discussed in Chapter 10, this chapter compares the debt and financial crises and discusses the international management of debt and financial problems.

WHAT IS A DEBT CRISIS?

As discussed in Chapter 6, a country has a current account deficit when its payments abroad are greater than those it receives. A government that finances rather than adjusts to its deficits must borrow from external credit sources and/or decrease its foreign exchange reserves. If the government continues to borrow, it may be burdened with growing foreign debts. The severity of a country’s debt problem depends not only the size of the debt but also on whether the country has the ability and commitment to service its debt repayments. A “debt crisis”
occurs when a state lacks sufficient foreign exchange to make the interest and/or principal payments on its debt obligations. Debt crises vary in severity and in the measures required to resolve them. If the debt problem is temporary, the state has a liquidity problem: It may defer some payments or obtain a new loan to meet its repayment commitments and then repay later on terms acceptable to the creditors. If the debt problem is unsustainable, the state has a solvency problem. In this case, the debtor can regain its creditworthiness only if its creditors reduce the interest or principal payments on its debt. Debt crises may begin as liquidity problems and become solvency problems. In addition to these objective measures of a debt crisis, there are also more subjective definitions. For example, the North defined the 1980s debt crisis as a threat to “the stability of the international financial system” resulting from “widespread difficulties in servicing the mountain of developing country debt.” The South, by contrast, defined the debt crisis as “a crisis of development” which began “for some developing countries after the first oil shock.”

A number of scholars have compared the debt crises of the 1930s and 1980s. One difference relates to the lending mechanisms. Most lending to Latin America in the 1920s occurred through the bond markets, and when LDCs defaulted on their debts in the 1930s, the losses were fragmented among many individual bondholders. By contrast, most lending to middle-income LDCs in the 1970s was private bank lending, and when the debtor countries threatened to default on their loans in the 1980s, the losses were more concentrated in the largest commercial banks. In 1982 the nine largest U.S. banks had loans outstanding to 17 highly indebted states amounting to 194 percent of the banks’ capital and reserves, and a major debt default would have affected the core of the banking system. Northern states and international institutions also had a greater role in the 1980s debt crisis for several reasons. First, creditor governments felt more pressure to intervene in the 1980s crisis because of the threat posed to the international banking system. Second, international institutions that deal with debt problems were almost nonexistent during earlier periods. During the 1980s, by contrast, the IMF pressured private banks to continue lending to LDC debtors, and debtor countries to alter their economic policies. Third, there was no hegemon to deal with the 1930s debt crisis, but the United States filled this position in the 1980s. The United States and IMF orchestrated the response in the 1980s, and the World Bank, the Paris and London Clubs, and the Bank for International Settlements (BIS) had supporting roles.

It is important to be familiar with the terminology used in regard to foreign debt. Debt restructuring agreements alter the terms between the creditor and debtor for servicing a debt, and can take two different forms. First, debt rescheduling agreements defer debt service payments and apply longer maturities to the deferred amount. Debt rescheduling is more likely to be effective if a debtor has a liquidity problem. Second, debt relief, debt forgiveness, or debt reduction agreements decrease the overall debt burden; that is, they include an element of debt reduction or forgiveness. They are more likely to be concluded when a debtor state has a solvency problem. As the following
discussion shows, debt rescheduling was the main form of debt restructuring in the earlier years of the debt crisis, but there was a shift to debt relief for highly indebted low-income LDCs in later years.

THE ORIGINS OF THE 1980s DEBT CRISIS

The debt crisis began in August 1982, when Mexico announced that it could no longer service its public sector debt obligations. This produced shock waves because Mexico had an external debt of about $78 billion, $32 billion of which was owed to commercial banks. However, earlier warning signs of a possible debt crisis had been largely ignored. A number of LDCs, including Zaïre, Argentina, Peru, Sierra Leone, Sudan, and Togo, were involved in debt rescheduling negotiations from 1976 to 1980, and the South's external debt had increased sixfold to $500 billion between 1972 and 1981. Foreign debt was also a growing problem in Eastern Europe, and Poland's debt had reached serious proportions by 1981. After Mexico's 1982 announcement, the debt crisis spread rapidly as private creditor banks moved to decrease their loan exposure to other LDC borrowers. Thus, 25 LDCs requested a restructuring of their commercial bank debt by late 1982, and in 1983 the World Bank reported that "almost as many developing countries have had to reschedule loans in the last two years as in the previous twenty-five years." Partly because of their divergent perspectives, analysts attribute the 1980s debt crisis to a variety of factors, including unexpected changes in the global economy, irresponsible behavior of lenders, irresponsible behavior of debtors, and the South's dependence on the North.

Unexpected Changes in the Global Economy

Some observers attribute the debt crisis to unexpected changes in the global economy. The first external shocks occurred in the early 1970s, when grain and oil prices sharply increased. Major surpluses of wheat and grain had accumulated during the 1960s, leading to a decline in international food prices and production cutback programs in grain-exporting countries such as the United States and Canada. As a result of the cutbacks, the world's grain supply was highly vulnerable to inclement weather and unexpected crop shortfalls in the Soviet Union. In 1972 and 1973 global food stocks fell to their lowest level in 20 years, food grain prices sharply increased, and the volume of food aid was drastically reduced. Oil prices also increased sharply when the Arab OPEC countries limited supplies after the October 1973 Middle East war. Whereas LDC oil and food importers were doubly hit by the food and oil crises, the OPEC states accumulated huge "petrodollar" reserves, which they deposited in the largest commercial banks; and the banks recycled the petrodollars through loans to middle-income LDCs. Thus, from 1974 to 1979 non-OPEC LDCs received about 60 percent of their external finance from commercial bank credits.
Another doubling of OPEC oil prices in 1979 (the “second oil shock”) led to additional private bank loans to oil-importing LDCs, and the banks also offered loans to some oil-exporting LDCs to help develop their industries and diversify their economies. The second oil shock contributed to a severe economic contraction in the North and a sharp decline in the North’s demand for the South’s commodity exports, which made it difficult for LDCs to earn foreign exchange to service their debts. The South’s problems were compounded when the U.S. Reagan administration raised interest rates to limit inflation resulting from the 1979 oil price increases and to facilitate U.S. borrowing abroad to cover its huge federal budget deficits. The creditor banks were providing short-term loans to LDCs at variable interest rates, and the impact of the higher interest rates on LDC debt levels was rapid and severe.\textsuperscript{10} It may seem odd that the debt crisis began with Mexico—an oil exporter. However, oil-exporting LDCs had also borrowed private funds to launch ambitious development projects without anticipating that oil prices would fall sharply after 1979. Thus, unexpected global economic changes in the 1970s and 1980s contributed to external debt problems for LDC oil exporters as well as importers.

Both commercial banks and debtor states often favor this external shocks explanation for the debt crisis because it awards “primary responsibility to economic policy shifts beyond their control.”\textsuperscript{11} However, external shocks do not explain why East and Southeast Asian debtors fared so much better than Latin American debtors (see the following discussion). Thus, the policies of lenders and borrowers must also be considered as explanations for the crisis.

**Irresponsible Behavior of Lenders**

Historical materialists and some interventionist liberals consider irresponsible behavior of creditor banks to be a major cause of the debt crisis. Because banks in New York, London, and elsewhere had a surfeit of OPEC petrodollars, they aggressively increased their loans to the South without giving due attention to the creditworthiness of borrowers or the activities they were financing. The large commercial banks charged extremely low interest rates because of inflationary conditions and the competition among lenders, and they did not give LDCs adequate signals as to when to stop borrowing. After LDC debtors had become overly dependent on commercial bank loans, interest rates rose sharply in the early 1980s, and this heightened the severity of the debt crisis. Thus, the “loan pushing” by commercial banks encouraged “debtor countries to increase their liabilities.”\textsuperscript{12} Critics also argue that Northern governments and the IMF shared responsibility for the bank overlending. After the first oil shock in 1973, the DCs adopted policies that encouraged the flow of private bank funds to the South; for example, central banks in the G10 states provided assurances that they would assist banks recycling petrodollars if they encountered financial difficulties. The IMF also introduced new lending programs for LDC oil importers such as the 1974 oil facility, which encouraged private banks to upgrade their lending activities. Furthermore, the gradual lifting of capital
controls (discussed in Chapter 6) eased the process by which U.S. and Western European banks could recycle petrodollars to the South. From this perspective, creditor banks, DCs, and the IMF shared responsibility for overlending, which was a major cause of the debt crisis.\textsuperscript{13}

**Irresponsible Behavior of Borrowers**

Many liberal theorists, especially orthodox liberals, attribute primary responsibility for the debt crisis to the behavior of borrowing states. They argue that LDCs chose to borrow from private banks in the 1970s to avoid the conditionality requirements of IMF loans. Unlike the IMF, private banks were not inclined (and did not have legal authority) to impose policy conditions on their loans to sovereign governments. Basic IMF principles—that indebted governments should not have unlimited access to balance-of-payments financing and should undergo adjustment measures—were jeopardized because private funds were so accessible. Thus, the IMF warned that

\begin{quote}
Access to private sources of balance of payments finance may... in some cases permit countries to postpone the adoption of adequate domestic stabilization measures. This can exacerbate the problem of correcting payments imbalances, and can lead to adjustments that are politically and socially disruptive when the introduction of stabilization measures becomes unavoidable.\textsuperscript{14}
\end{quote}

Liberals point out that LDC governments sometimes secretly seek IMF conditionality to help them push through unpopular economic reforms. As Robert Putnam notes, international negotiations are a two-level game that may enable “government leaders to do what they privately wish to do, but are powerless to do domestically”; for example, in Italy’s negotiations with the IMF, “domestic conservative forces exploited IMF pressure to facilitate policy moves that were otherwise infeasible internally.”\textsuperscript{15} Uruguay also found an IMF agreement useful in its efforts to impose painful, unpopular economic austerity measures. IMF conditionality raised the cost to domestic interests of opposing economic reform “because a rejection was no longer a mere rejection of... [Uruguay’s] president, but also of the IMF.”\textsuperscript{16} In most cases, however, LDC governments were inclined to follow the path of least resistance and seek private bank loans without instituting necessary reforms.

In addition to imprudent borrowing, liberals also attribute the debt crisis to the domestic policies of borrowing states. Although some LDCs used commercial bank loans to finance productive investments and economic growth, a number used the funds to make poor investments, increase public expenditures, import luxury consumer goods, and pay off corrupt officials. Some LDCs reacted to the debt crisis in a timely manner with readjustment policies, but many others demonstrated unwillingness or inability to change. Liberal economists often contrast the strong economic performance of Asian debtors such as
South Korea and Indonesia during the 1980s with the weak performance of Latin American debtors. (A notable exception was the weak performance of the Philippines.) Whereas Latin Americans employed protectionist import substitution policies, East Asians adopted outward-oriented export-led growth policies that put them in a stronger position because exports provided foreign exchange for servicing their debts.17 Thus, Table 11.1 shows that the three largest debtors were Latin American when the debt crisis erupted in 1982; the debts of Brazil, Mexico, and Argentina exceeded $92, $86, and $43 billion, respectively. Table 11.1 shows that South Korea, Indonesia, and the Philippines also had substantial debts in 1982, exceeding $37, $24, and $24 billion, respectively; but the stronger export position of the Asians (except the Philippines) enabled them to service their debts better than the Latin Americans. To assess a country’s ability to service its debt, economists use the debt service ratio, which measures the ratio of a country’s interest and principal payments on its debt to its export income. The lower the debt service ratio (and debt-to-export ratio), the more favorable are the prospects that a country will meet its debt obligations. Table 11.1 shows that the debt service ratios of Malaysia and Indonesia were as low as 10.7 and 18.1 percent in 1982, while the debt service ratios of Brazil and Chile were as high as 81.3 and 71.3 percent.

Those who question the orthodox liberal view that LDC behavior was the main factor explaining the debt crisis point out that LDC governments with good

### TABLE 11.1 Total Debt, and Debt Indicators, 1982 (U.S.$ in Millions)

<table>
<thead>
<tr>
<th>Region</th>
<th>Country</th>
<th>Total Debt</th>
<th>Debt/Exports (%)</th>
<th>Debt Service Ratioa (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Latin America</td>
<td>Argentina</td>
<td>43,634</td>
<td>447.3</td>
<td>50.0</td>
</tr>
<tr>
<td></td>
<td>Brazil</td>
<td>92,990</td>
<td>396.1</td>
<td>81.3</td>
</tr>
<tr>
<td></td>
<td>Chile</td>
<td>17,315</td>
<td>335.9</td>
<td>71.3</td>
</tr>
<tr>
<td></td>
<td>Colombia</td>
<td>10,306</td>
<td>204.3</td>
<td>29.5</td>
</tr>
<tr>
<td></td>
<td>Mexico</td>
<td>86,019</td>
<td>311.5</td>
<td>56.8</td>
</tr>
<tr>
<td></td>
<td>Peru</td>
<td>10,712</td>
<td>255.9</td>
<td>48.7</td>
</tr>
<tr>
<td></td>
<td>Venezuela</td>
<td>32,153</td>
<td>159.8</td>
<td>29.5</td>
</tr>
<tr>
<td>East and Southeast Asia</td>
<td>Indonesia</td>
<td>24,734</td>
<td>116.3</td>
<td>18.1</td>
</tr>
<tr>
<td></td>
<td>Republic of Korea</td>
<td>37,330</td>
<td>131.6</td>
<td>22.4</td>
</tr>
<tr>
<td></td>
<td>Malaysia</td>
<td>13,354</td>
<td>93.4</td>
<td>10.7</td>
</tr>
<tr>
<td></td>
<td>Philippines</td>
<td>24,551</td>
<td>297.8</td>
<td>42.6</td>
</tr>
<tr>
<td></td>
<td>Thailand</td>
<td>12,238</td>
<td>130.0</td>
<td>20.6</td>
</tr>
</tbody>
</table>

*aDebt service ratio: the ratio of a country’s interest and principal payments to its export income
intentions often lacked the political capacity and support to institute necessary economic reforms. They also charge that orthodox liberals ignore the fact that the debt crisis was *systemic* in nature; “the simultaneous onset of the crisis in more than forty developing countries” indicates that some contributing factors were external and largely beyond LDCs’ control. Furthermore, Asian LDCs such as Thailand, Malaysia, Indonesia, and South Korea, which liberals identified as following responsible policies during the 1980s debt crisis, experienced a severe financial crisis in the late 1990s (see later discussion).

**The South’s Dependence on the North**

Historical materialists argue that the 1980s debt crisis stemmed not only from proximate factors, but also from the long-term structural nature of capitalism. Thus, dependency and world-system theorists view debt crises as extreme instances of a “debt trap” that exploits LDCs in the periphery and binds them to DCs in the core. Some writers draw linkages between debt crises and the legacy of colonialism. The colonial powers established a division of labor in which the colonies provided agricultural products and raw materials to the metropole and served as markets for the metropole’s manufactures. This pattern still characterizes the export and import structures of many LDCs, preventing them from earning the foreign exchange necessary for development. Although some LDCs are industrializing, they cannot escape from their indebtedness because they remain dependent on the core for technology and finance. Historical materialists also point to foreign aid as a cause of debt crises because more than half of all official development assistance (ODA) is disbursed as loans. A substantial share of World Bank financing is disbursed as *hard loans* with high interest rates and shorter repayment periods (see Chapter 10). Development assistance is another mechanism for transferring surpluses from the periphery to the core, because a large share of foreign aid is required simply to cover LDC repayments of past aid disbursements. Historical materialists conclude that public as well as private external finance perpetuates LDC dependency:

> If they seek official help on softer than commercial terms, they have to accept outside scrutiny . . . and accept conditions which doom their efforts at industrial, diversified development. If they accept suppliers’ credits on commercial terms in order to go through with their cherished projects, they are caught anyway when the payments come due before they are able to meet them.

Like other interpretations of the debt crisis, critics question the views of historical materialists. Liberals argue that dependency theorists attribute LDC debt problems solely to external causes beyond their control and avoid looking at the *domestic* sources of LDC problems—traditional attitudes, domestic inefficiencies, corrupt political leaders, and a reluctance to follow liberal economic policies. It is safe to conclude that *all* the preceding views on the origins of the
debt crisis have some validity. Unexpected food and oil price increases during the 1970s encouraged LDCs to increase their borrowing, and the world recession after the 1979 oil price increases added to the debt load of many LDCs. Although these unexpected global changes made the debt crisis more likely, irresponsible behavior of commercial banks, DCs, and LDCs exacerbated the crisis. Furthermore, the South’s long-term structural dependence on the North increased the vulnerability of LDCs to protracted debt problems. A Mexican finance minister identified the multiple causes of the debt crisis and the widespread failure to foresee it, when he stated,

The origin of the debt itself is clearly traceable to a decision by both developing and developed countries that . . . resulted in the channeling of tens of billions of dollars to the debtor community of today. . . . The whole world congratulated itself on the success, smoothness, and efficiency with which the recycling process was achieved. We all were responsible.21

THE FOREIGN DEBT REGIME

Before discussing the world reaction to the 1980s debt crisis, we describe the foreign debt regime that monitored and managed the crisis. A debt regime was more evident in the 1980s than in the 1930s because a global hegemon (the United States) and an institutional framework (the IMF and World Bank) existed to deal with the 1980s crisis. The mechanisms for coping with a debt crisis before World War II included unilateral actions by the creditors or debtors and two-party solutions in which debtors and creditors negotiated agreements. Postwar debt settlements, by contrast, have been three-party affairs involving IOs such as the IMF and World Bank and informal groups such as the Paris and London Clubs. The United States has acted as a third-party hegemon in the postwar period, pressuring for debt settlements and coordinating settlement efforts. In recent years the members of the G7/G8 summits have acted to supplement U.S. hegemony by taking collective responsibility for dealing with foreign debt issues.22

Some regimes encompass only one sector or issue while others are broader in scope, and specific regimes are nested within more diffuse regimes; for example, the textile and agricultural trade regimes are nested within the global trade regime.23 Although the global trade regime principles, norms, and rules provide a general framework, textile and agricultural trade have their own unique characteristics and have been treated as exceptions by the GATT/WTO. This chapter views the 1980s foreign debt regime as a specific regime nested within a more diffuse balance-of-payments financing regime because foreign debt crises are a specific, more extreme type of balance-of-payments problem.24 Although creditors and debtors have negotiated agreements throughout the postwar period, pressures resulting from the 1980s debt crisis produced more coordinated, longer-term efforts to establish rules and decision-making
procedures that we normally associate with an international regime. A basic principle of the balance-of-payments financing regime is that an adequate but not unlimited amount of financing should be available to states to deal with their balance-of-payments deficits. A second principle is that those providing the financing may attach conditions to it to ensure that recipient states correct their balance-of-payments problems. The balance-of-payments regime principle of conditional lending was threatened in the 1970s because private banks recycled petrodollars as loans to debtor countries with minimal conditions and very low interest rates. Although these bank loans were readily available to middle-income countries (MICs) and NIEs during the 1970s, low-income countries (LICs) lacked creditworthiness and remained dependent on loans from the IMF and donor governments. Thus, Table 11.2 shows that private bank loans in 1980 accounted for only 6 percent of LIC debt but for 38 percent of MIC debt and 65 percent of NIE debt. ODA, by contrast, accounted for 67 percent of LIC debt in 1980 but for only 25 percent of MIC debt and 4 percent of NIE debt. The willingness of private banks to provide finance to the more creditworthy LDCs limited the IMF’s ability to set conditions for these borrowers.

However, private banks responded to the 1980s debt crisis by quickly limiting their loan exposure, and the MICs and NIEs therefore had to look to the IMF, World Bank, and government aid agencies for assistance with their growing debt problems. This dependence on official financing provided the IOs and the U.S. government with considerable leverage in establishing the foreign debt regime. As with the pre-1970s balance-of-payments regime, the basic principle of the debt regime revolved around conditionality—the provision of new loans and debt rescheduling were contingent on the debtor countries’ commitment to market-oriented reforms. However, the 1980s debt regime differed from the pre-1970s regime in some important respects. First, the IMF (with U.S. backing) adopted a new role when it pressured private commercial banks in the 1980s to continue providing loans to debtor LDCs. Second, creditor groups such as the Paris and London Clubs met much more frequently in the 1980s and 1990s than in earlier periods. Third, both the IMF and World Bank provided structural adjustment loans to indebted LDCs and transition economies. These SALs were conditioned on more demanding requirements—that loan recipients adopt orthodox liberal reforms such as deregulation, privatization, and greater openness to trade and foreign investment. The following sections discuss two other groups of actors in the global debt regime—the transition economies of Eastern Europe and the FSU that became debtors along with the LDCs, and the Paris and London Clubs that coordinated the actions of creditors. The changing roles of the IMF and World Bank in the foreign debt regime are examined later in the chapter.

The IMF, World Bank, and Transition Economies

Chapter 2 noted that the Soviet bloc countries were not IMF and World Bank members for most of the early postwar period. Before examining the role of
<table>
<thead>
<tr>
<th>Income Group</th>
<th>1971 Total Debt</th>
<th>1975 Total Debt</th>
<th>1980 Total Debt</th>
<th>1982 Total Debt</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>ODA (%)</td>
<td>Private Banks (%)</td>
<td>ODA (%)</td>
<td>Private Banks (%)</td>
</tr>
<tr>
<td>LICs</td>
<td>$18</td>
<td>74</td>
<td>$40</td>
<td>73</td>
</tr>
<tr>
<td>MICs</td>
<td>$25</td>
<td>45</td>
<td>$40</td>
<td>33</td>
</tr>
<tr>
<td>NIEs</td>
<td>$32</td>
<td>16</td>
<td>$72</td>
<td>9</td>
</tr>
</tbody>
</table>

ODA = official development assistance

LICs = low-income countries

MICs = middle-income countries

NIEs = newly industrializing economies

*Total debt figures in billions.

these countries in the foreign debt regime, this chapter discusses how they joined these institutions; a country cannot join the World Bank (“the Bank”) without first becoming a member of the IMF. As Table 11.3 shows, Yugoslavia was a member of the IMF and the Bank from the time they were established. This is not surprising in view of Yugoslavia’s defection from the Soviet Bloc in 1948 and its moves to develop a nonaligned foreign policy. Yugoslavia was also adopting worker self-management and market socialist policies that were more compatible with the liberal economic orientation of the Bretton Woods institutions. In contrast to Yugoslavia, Poland and Czechoslovakia left the IMF and the Bank in 1950 and 1954 (Czechoslovakia was expelled for not paying its dues), because membership in these institutions conflicted with their status as satellite countries in the Soviet bloc. Table 11.3 shows that Romania joined these institutions in 1972. Although Romania was still a Soviet bloc member, it

<table>
<thead>
<tr>
<th>Year</th>
<th>IMF</th>
<th>World Bank</th>
</tr>
</thead>
<tbody>
<tr>
<td>1946</td>
<td>Poland, Czechoslovakia, Yugoslavia, and China (founding members of IMF and World Bank)</td>
<td></td>
</tr>
<tr>
<td>1950</td>
<td>Poland withdraws from IMF and World Bank</td>
<td></td>
</tr>
<tr>
<td>1954</td>
<td>Czechoslovakia ousted from IMF and World Bank</td>
<td></td>
</tr>
<tr>
<td>1972</td>
<td>Romania</td>
<td>Romania</td>
</tr>
<tr>
<td>1980</td>
<td>People’s Republic of China (PRC) replaces Taiwan in IMF and World Bank</td>
<td></td>
</tr>
<tr>
<td>1982</td>
<td>Hungary</td>
<td>Hungary</td>
</tr>
<tr>
<td>1986</td>
<td>Poland</td>
<td>Poland</td>
</tr>
<tr>
<td>1990</td>
<td>Czech and Slovak Federal Republic, Bulgaria</td>
<td>Bulgaria</td>
</tr>
<tr>
<td>1991</td>
<td>Albania, Lithuania</td>
<td>Albania, Czech and Slovak Federal Republic</td>
</tr>
<tr>
<td>1992–1997</td>
<td>Russian Federation, other FSU³ Republics, Croatia, Slovenia, Macedonia, Czech Republic, Slovak Republic, Bosnia and Herzegovina (IMF and World Bank)</td>
<td></td>
</tr>
<tr>
<td>2000</td>
<td>Serbia/Montenegro (IMF and World Bank)</td>
<td></td>
</tr>
<tr>
<td>2007</td>
<td>Montenegro (IMF and World Bank) (Serbia continues membership of former Serbia/Montenegro)</td>
<td></td>
</tr>
</tbody>
</table>

³FSU = former Soviet Union

had distanced itself politically from the Soviet Union and viewed the Soviet-led Council for Mutual Economic Assistance (CMEA) as hindering its development. As an IMF and Bank member, Romania could receive their loans, upgrade its economic relations with the West, and further its political objectives. Despite Romania's slow moves toward economic reform and its sizable foreign debt, it became a member of these IOs without going through a transition phase. Western states disregarded these economic issues because Romania's membership produced new divisions within the Soviet bloc. Although Romania provided sensitive economic information to the IMF and the Bank, they agreed not to disclose this information in their statistical reports.

The case of the People's Republic of China (PRC) was also atypical. The IMF and the Bank treated the China case as a representation rather than a new membership issue, and in 1980 they permitted the PRC to take the China seat from Taiwan. The PRC's decision to "return" to the Bretton Woods institutions in 1980 followed a radical change in its policies. Mao Zedong had adopted an inward self-reliance policy in the 1950s to early 1960s, and China's policies became even more autarkic from 1966 to 1969 during the Cultural Revolution. However, the Cultural Revolution created so many political and economic problems that China began to adopt more open policies. China's commercial contacts with the North increased, and the UN General Assembly voted to seat the PRC delegation in 1971. After Mao's death in 1976 and the arrest of cultural revolutionaries, the PRC launched the Four Modernizations program to increase economic productivity and develop a more active role in the global economy. Thus, China viewed membership in the IMF and the Bank as a means of gaining access to capital for its development. Several factors facilitated China's reentry application in the negotiations, including active U.S. support and a compromise agreement on the Taiwan issue.

After the PRC's takeover of the China seat in 1980, Hungary and Poland requested accession in 1981. Unlike Romania, Hungary was much closer to meeting the IMF's normal economic requirements. Hungary's New Economic Mechanism (NEM) had increased its economic decentralization, outward economic orientation, and international competitiveness in the late 1960s; and in the 1970s and 1980s it introduced other economic reforms. Hungary sought IMF membership to safeguard these reforms and get assistance with its foreign debt, which resulted partly from its development plans. Poland's debt problems were much more serious, because it had borrowed in international financial markets during the 1970s instead of introducing meaningful economic reform. Poland needed to reassure the financial community that it was committed to servicing its debt in the early 1980s, and IMF membership would be helpful in this regard. Although Hungary was admitted to the IMF and the Bank in 1982, Poland's application was stalled by its imposition of martial law in 1981; it was not until 1986 that Poland was admitted to the Bretton Woods institutions (see Table 11.3).

Poland was the last Eastern European country to become an IMF and Bank member before upheaval in the Soviet bloc transformed East–West relations.
Mikhail Gorbachev’s attempts to revive the Soviet economy through economic restructuring (perestroika) and political openness (glasnost) failed, but his policies contributed to a series of revolutionary changes. These included the disintegration of Communist regimes in Eastern Europe in 1989, the unification of Germany in 1990, and the independence of the Baltic states and formal dissolution of the Soviet Union in 1991. Czechoslovakia and Bulgaria joined the IMF and the Bank in 1990 and 1991, but the most significant change was the accession of Russia and other FSU republics in 1992 and 1993. Russia was facing an economic crisis, and the IMF and Western donors offered it a $24 billion assistance package in return for its commitment to decrease its budget deficit and inflation rate.

The Bretton Woods institutions have worked together to help the transition economies move toward market reform. The IMF has taken the lead in this process, estimating financing needs, providing policy advice, and setting conditions for reform. The Bank has offered technical assistance and funding for infrastructure, the development of market incentives, the privatization of state monopolies, and the creation of a legal framework for the emerging private sector. However, tensions have existed between the transition economies and the Bretton Woods institutions because of their different economic outlooks. The addition of so many new members has also put pressure on IMF and Bank resources, and LDCs sometimes charge that the transition economies receive better treatment. These charges seem to have some validity. For example, one study revealed that Romania, Poland, and Hungary received more IMF loans than expected on the basis of economic criteria; and Russia was able to borrow more funds in relation to its IMF quota than other countries when it joined the IMF in 1992. This favored treatment demonstrates that security as well as economic factors affect IMF lending decisions. However, the charges of favored treatment do not seem to apply to all transition economies; for example, a 1990 study concluded that the IMF and the Bank did not give special treatment to China. Despite the charges of special treatment, the membership of transition economies has enhanced the universality of the Bretton Woods institutions.

The Paris and London Clubs

Three types of negotiations occurred between creditors and debtors to deal with the 1980s debt crisis. First, the IMF and World Bank agreed to provide SALs to debtor governments in exchange for the debtors’ commitment to follow prescribed policies to deal with their balance-of-payments problems. The other two types of negotiations involved meetings between the debtors and less formal creditor groups: the Paris and London Clubs. The Paris Club is an informal group of creditor governments, which in most cases are OECD members. The London Clubs (also called private creditor committees and bank advisory committees) are composed of the largest commercial banks. The Paris and London Clubs have no charters or formal institutional structures, and their memberships vary with each rescheduling negotiation. The ad hoc nature of
these clubs stems from the creditors’ view that negotiations should be low profile and that debt rescheduling should be unusual occurrences. Thus, the Paris Club has no legal status or written rules, no voting procedure (decision making occurs by consensus), and no regular office (meetings are usually held in the French Ministry of Finance). The Paris Club’s origins stem from a 1956 meeting of 12 European creditor states to negotiate a rescheduling of Argentina’s foreign debt. Argentina was in arrears to the governments, and the meeting provided a multilateral rescheduling forum instead of uncoordinated bilateral reschedulings. Paris Club meetings were originally limited in number, but they became much more frequent as debt problems increased. Thus, the Paris Club concluded more than twice as many agreements in the 7 years from 1978 to 1984 as it did in the previous 22 years, and the 1978 to 1984 agreements deferred $27 billion of debt service obligations. Participants in Paris Club meetings include the debtor government; the main creditor governments; and representatives of the IMF, the Bank, UNCTAD, and regional development banks. The Paris Club emphasizes three basic principles in its deliberations—imminent default, conditionality, and burden sharing:

- The **imminent default principle** is designed to limit debt rescheduling to states with a serious, justifiable need. To avoid unnecessary negotiations, the Paris Club will not even consider a request unless the debtor has substantial external payments arrears and is likely to default on its payments.
- The **conditionality principle** stems from the creditor governments’ concerns that the debtor services its debts on schedule. Thus, the debtor must conclude an IMF arrangement with conditionality requirements before the Paris Club will agree to negotiate. In the rare cases where the debtor was not an IMF member at the time of rescheduling (e.g., Poland, Cuba, and Mozambique), the Paris Club established its own conditionality.
- The **burden sharing principle** requires all creditor states to provide relief in proportion to their loan exposure to the debtor state. This principle helps avoid the problem of free riding, and it applies to creditor banks as well as states. Thus, the Paris and London Clubs cooperate with each other.\(^\text{32}\)

The London Clubs received their name because many of their meetings were held there in the 1980s. Like the Paris Club agreements, a single debtor and its creditors negotiate London Club agreements, and the debtor must normally commit to IMF adjustment policies. However, whereas a relatively small number of states can agree to reschedule loans at Paris Club meetings, the coordination problems for the far more numerous private creditors are more complicated. Private creditors coordinate their activities by establishing bank advisory committees for the various debtor countries which the largest international banks (those holding the most loans outstanding) attend. The international banks on each committee bargain with each other and with the debtor country to establish the debt rescheduling terms and then present the agreement to smaller creditor banks for ratification. Although the largest creditors would like to limit their loan exposure to a troubled debtor, they realize that
the debtor state could default if all creditors withheld loans. The major international banks have a common interest in successful debt restructuring because of their high loan exposure and their long-term interest in the stability of international capital markets. Smaller creditor banks, by contrast, have fewer loans at risk and less interest in maintaining the international credit system; thus, they are reluctant to ratify restructuring agreements that require them to provide additional loans. Because smaller creditor banks often think on the basis of individual rationality (see prisoners’ dilemma in Chapter 4), there is a danger that all banks could defect and that massive debtor default could disrupt the international banking system. To prevent a Pareto-deficient outcome, the large international banks pressure the smaller banks to avoid free riding and participate in the debt restructuring agreements. As discussed in the next section, this system of private creditor committees worked effectively in earlier years but was insufficient to deal with the 1980s debt crisis.

Historical materialists and LDC debtors are often critical of the Paris and London Clubs. When a single debtor meets with all its major creditors at the bargaining table, the creditors can exert stronger pressures on the debtor state. The case-by-case approach of the Paris and London Clubs also prevents debtors from developing a united front, and it ignores the systemic nature of the 1980s debt crisis by operating on the assumption that each debtor’s situation can be treated individually. Furthermore, historical materialists criticize the two clubs for their emphasis on IMF conditionality as a prerequisite for negotiations. Thus, at the UNCTAD V conference in 1979 the G77 sought to replace the Paris and London Clubs with an international debt commission more attuned to LDC interests. Although the creditor governments agreed to invite an observer from UNCTAD to future Paris Club negotiations, it did not agree to create an international debt commission. Thus, the creditors continue to set the rules and procedures for Paris and London Club negotiations.

**STRATEGIES TO DEAL WITH THE 1980s DEBT CRISIS**

The debt crisis was more prolonged than expected, and the creditor states and international institutions gradually adopted more activist policies as milder measures proved to be insufficient. The United States and the IMF were two of the main actors involved in devising and implementing strategies. Although the IMF had lost some importance with the collapse of the pegged exchange rate system and the increase in private bank lending in the 1970s, the 1980s debt crisis placed it “back at the center of the international financial system, first as a coordinator in a crisis, and then . . . as a source of information, advice, and warning on the mutual consistency of national policies.” The IMF’s central role stemmed largely from the U.S. administration’s view that multilateral institutions could best implement DC policies on debt issues. Unlike the United States, the IMF could exert pressure on LDC debtors and private banks without causing major protests over U.S. government interference. When G7 summit meetings began to address international debt issues in
the late 1980s, the major economic powers to a degree replaced U.S. hegemony with collective responsibility for LDC debt problems.\textsuperscript{36}

The international debt strategies had three major objectives: to prevent the collapse of the international banking and financial systems; to restore capital market access for debtor countries; and to minimize economic dislocation and restore economic growth in debtor states. The strategies to achieve these objectives can be divided into four phases:

2. The Baker Plan, which continued the private involuntary lending and put new emphasis on official lending (1986–1988).
4. Initiatives for the poorer LDCs (1996 to the present).

**Emergency Measures and Involuntary Lending: 1982–1985**

The United States, the IMF, and other creditors first reacted to the debt crisis with a “firefighting” strategy, providing short-term emergency loans to Mexico, Brazil, and other LDCs to avert a 1930s-style financial collapse. The BIS provided some bridging finance to LDC debtor states until IMF loans were approved.\textsuperscript{37} This emergency lending was followed by a medium-term strategy, in which the IMF induced private banks to engage in involuntarily lending (politely termed concerted lending in official circles). Involuntary lending refers to “the increase in a bank’s exposure to a borrowing nation that is in debt-servicing difficulty and that, because of a loss of creditworthiness, would be unable to attract new lending from banks not already exposed in the country.”\textsuperscript{38} Before the debt crisis, the London Clubs were quite successful because the largest international banks induced smaller banks to engage in involuntary lending when necessary in debt restructuring agreements. Only nine states had to restructure their commercial debts from the mid-1970s to 1982, so interbank coordination was sufficient to manage the debt situation. Although the IMF helped supervise debtor economic policies, its involvement was quite limited during this period. However, the 1982 Mexican debt crisis drastically altered the debt management system. The large international banks were unable to cope with the massive scope of the debt crisis, and many small banks in the U.S. Southwest with loans outstanding to Mexico were unwilling to increase their loan exposure. Thus, the IMF had to intervene:

In November 1982, the Fund’s Managing Director . . . took the unprecedented step of establishing mandatory levels of forced private lending before the IMF would sign a stabilization agreement with Mexico. This bold action, repeated in the Brazilian case, was a turning point in the treatment of sovereign debt. It staked out a new leadership role for the Fund, and a new relationship between the Fund and private banks.\textsuperscript{39}
The IMF also insisted that debtor states develop adjustment programs as the price for debt rescheduling and new lending. Thus, realists argue that creditor states operating through the IMF managed the debt crisis; the crisis posed such a major threat to the international financial system that only states could mobilize sufficient resources to deal with it. Furthermore, only official pressures could induce banks to continue lending to debtors and force debtors to meet conditionality requirements. Liberals, by contrast, emphasize the IMF’s role as an international institution in managing the debt crisis, and they reject the realist view that the IMF was simply following creditor state instructions. The IMF and creditor states in these early years assumed that the debt crisis was a short-term problem stemming from the temporary inability of LDCs to service their debts. However, many LDCs could not resolve their debt problems even after adjusting their policies. Although the early firefighting tactics dealt with the immediate crisis, economic activity and investment in most debtor states declined, and adjustment programs in LDCs hindered their economic growth. Private commercial banks were also reducing their loan exposure despite IMF pressures, and this forced the IMF to assume an increasing share of the lending risk. When James A. Baker III became U.S. Secretary of the Treasury in 1985, he therefore adopted a more structured approach to the debt crisis.


In 1985 Secretary Baker provided a formula for dealing with the debt crisis and extended debt repayments over a longer period; but he did not change basic assumptions about the best strategy to follow. As was the case in the 1982–1985 period, the Baker Plan underestimated the insolvency problem confronting many LDCs and did not offer any debt forgiveness. Instead, the Baker Plan emphasized the postponement of debt payments, the provision of new loans, and changes in debtor country policies. This strategy rested on the assumption that “debtor countries could grow their way out of debt and could expand their exports enough to reduce their relative debt burdens to levels compatible with a return to normal credit market access.”

The Baker Plan focused mainly on 17 middle-income heavily indebted LDCs as the target group for international debt measures. As Table 11.4 shows, 12 of the “Baker-17” states were Latin American and Caribbean, and the list did not include low-income LDCs that were heavily indebted to official (rather than private) creditors. Table 7.4 lists these 17 countries in order of their gross external debt in 1985, shortly before the Baker Plan was instituted. As the table shows, the four countries with the highest debts in 1985 (Brazil, Mexico, Argentina, and Venezuela) were all Latin American. However, a country’s debt servicing abilities also depend on its debt service ratio (see Table 11.1) and its debt as a share of GNI. Table 11.4 shows that the LDCs with the highest gross external debts ranked well below some poorer and smaller LDCs in terms of debt as a percent of GNI. Thus, external debt as a percent of GNI for the three largest debtors in 1985, Brazil, Mexico, and Argentina, was 50.3, 55.2, and 84.2 percent, respectively. The debtors on the list
with the highest debt-to-GNI ratios were Jamaica (234.9 percent), Bolivia (176.6 percent), and Cote d’Ivoire (154.2 percent).

Although the Baker Plan focused mainly on middle-income LDCs and underestimated the severity of the debt problem, it recognized that the debt crisis was becoming a longer-term issue. Thus, the Baker Plan shifted emphasis from short-term balance-of-payments adjustment to long-term structural change and the resumption of economic growth in LDC debtor states. Thus, the World Bank and Inter-American Development Bank (IDB)—with their longer-term loans—assumed a more central role. The Baker Plan proposed that the multilateral development banks double their lending to $20 billion over three years and that the private banks also lend $20 billion. In return, the debtors were to liberalize their trade and investment policies and privatize state firms. These reforms marked a major change from Latin America’s protectionist import substitution policies.

### TABLE 11.4 Gross External Debt and External Debt as a Percent of GNI for the Baker-17 Countries, 1985 and 1997 (U.S.$ in Millions)

<table>
<thead>
<tr>
<th></th>
<th>1985</th>
<th>1997</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Debt</td>
<td>EDT/GNI (%)</td>
</tr>
<tr>
<td>Brazil</td>
<td>106,148</td>
<td>50.3</td>
</tr>
<tr>
<td>Mexico</td>
<td>96,867</td>
<td>55.2</td>
</tr>
<tr>
<td>Argentina</td>
<td>50,946</td>
<td>84.2</td>
</tr>
<tr>
<td>Venezuela</td>
<td>35,334</td>
<td>—</td>
</tr>
<tr>
<td>Philippines</td>
<td>26,622</td>
<td>89.1</td>
</tr>
<tr>
<td>Former Yugoslavia</td>
<td>22,251</td>
<td>48.2</td>
</tr>
<tr>
<td>Chile</td>
<td>20,384</td>
<td>143.3</td>
</tr>
<tr>
<td>Nigeria</td>
<td>19,550</td>
<td>25.1</td>
</tr>
<tr>
<td>Morocco</td>
<td>16,529</td>
<td>136.6</td>
</tr>
<tr>
<td>Peru</td>
<td>12,884</td>
<td>85.3</td>
</tr>
<tr>
<td>Colombia</td>
<td>14,245</td>
<td>42.6</td>
</tr>
<tr>
<td>Cote d’Ivoire</td>
<td>9,745</td>
<td>154.2</td>
</tr>
<tr>
<td>Ecuador</td>
<td>8,703</td>
<td>77.4</td>
</tr>
<tr>
<td>Bolivia</td>
<td>4,805</td>
<td>176.6</td>
</tr>
<tr>
<td>Costa Rica</td>
<td>4,401</td>
<td>120.8</td>
</tr>
<tr>
<td>Jamaica</td>
<td>4,068</td>
<td>234.9</td>
</tr>
<tr>
<td>Uruguay</td>
<td>3,919</td>
<td>89.7</td>
</tr>
</tbody>
</table>

*EDT/GNI (%): Total external debt as a percentage of gross national income

bLatin American and Caribbean countries

Despite its positive features, the Baker Plan encountered major obstacles because of unexpected changes in the global economy. For example, international oil prices collapsed shortly after the Baker Plan was announced; this upset the recovery plans of oil-exporting debtor states such as Mexico and gave oil-importing LDCs less incentive to adopt economic reforms necessary for their recovery. The Baker Plan also did not achieve adequate results in terms of LDC economic growth, and many LDC debtors refused to comply with IMF conditionality requirements (e.g., Brazil declared a moratorium on paying its debts in 1987). Furthermore, commercial banks sought to reduce their loan exposure, and the lending risks continued to shift from private banks to governments and multilateral agencies. The multilateral development banks also disbursed less funding than the Baker Plan had anticipated, and debt repayments began to exceed the funding LDCs received in new loans. The net transfer of financial resources to LDCs fell from +$29 billion in 1982 to −$34 billion by 1987, and the net resource transfer to the Baker-17 countries fell from +$11 billion to −$17 billion during the same period. In sum, debtors experienced serious economic problems during the Baker Plan period because their debt repayments greatly exceeded their access to new financing. From 1981 to 1988, real per capita income in most South American LDCs declined in absolute terms, and living standards in many LDCs fell to levels of the 1950s and 1960s. Thus, some analysts refer to the 1980s as a “lost development decade.” Although the Baker Plan’s failure resulted partly from unforeseen events such as the collapse of international oil prices, critical theorists view the plan as an “attempt to maintain the fiction that the debt crisis was only temporary and could be surmounted if all parties cooperated.” Many debtors were caught in a vicious circle in which their debt burdens hindered their economic growth, and their slow growth prevented them from overcoming their debt problems.


The Baker Plan’s failure to promote economic recovery raised concerns about U.S. exports to Latin America and about the effects of continued debt problems on the revival of democratic governments in the region. Riots in Caracas, Venezuela, in February 1989 in reaction to government austerity measures provided further evidence that the Baker Plan was insufficient. In March 1989, U.S. Treasury secretary Nicholas Brady sanctioned the idea of debt reduction, or forgiving some LDC debts to commercial banks, referred to as the Brady Plan. After the major economic powers resolved their differences on this issue at the July 1989 G7 summit, the IMF adopted the Brady Plan; from that time on, the G7 finance ministers became much more involved in foreign debt issues. Mexico was the first LDC to conclude a Brady Plan debt reduction agreement because it had the largest debts, was liberalizing its economy, had a good track record of adjustment, and was strategically important to the United States.
Like the Baker Plan, the Brady Plan handled debt on a case-by-case basis, with each debtor negotiating separately with its creditors, and it linked the easing of credit terms with the debtor's acceptance of IMF and Bank conditions for liberal economic reform. However, the Baker Plan had rejected debt reduction on the grounds that banks would not lend to countries if they failed to pay their debts, and that LDCs would be able to repay loans if the debt repayment period was extended. The Brady Plan, by contrast, recognized that some highly-indebted LDCs could not regain creditworthiness and that extending the debt repayment period without debt reduction had not returned the debtors to economic growth. The Brady Plan stipulated that U.S. private banks that reduced the principal or interest on LDC debt would receive guarantees of repayment on the remaining portion of debt. The IMF and the Bank would help finance these guarantees, and Japan also committed funds for this purpose. Brady Plan agreements were concluded for 12 LDCs from 1990 to 1994, and for 5 more LDCs from 1995 to 1997. Although the Brady Plan was an improvement over the Baker Plan, it did not resolve all the debt problems of the Baker-17 countries. Table 11.4 compares the external debt for the Baker-17 in 1985 (the year before the Baker Plan was instituted) and in 1997 (the last year that a Brady Plan agreement was concluded). As Table 11.4 shows, the external debt for all but three of the Baker-17 (Yugoslavia, Costa Rica, and Jamaica) increased from 1985 to 1997. Most of these countries were Latin American, and the total foreign debt of Latin America’s states increased from $425 billion in 1987 to more than $600 billion in 1997. In 1997, Latin America was paying about 30 percent of its export earnings to service its debts, and it owed about 45 percent of its combined GNI to foreign creditors. However, a country’s creditworthiness depends more on its debt-to-GNI ratio than on its foreign debt, and the Brady Plan helped restore the creditworthiness of most of the Baker-17 countries. As Table 11.4 shows, the external-debt-to-GNI ratio was lower in 1997 than in 1985 for most countries other than Nigeria, Cote d’Ivoire, and Ecuador. (IMF data were not available for Venezuela and the former Yugoslavia.)

The Brady Plan’s greatest shortcoming was that it dealt only with commercial bank debt. It offered little to low-income LDCs because most of their debt was to governments and international financial institutions. Thus, 11 of the 17 Brady Plan agreements were concluded with the Baker-17 group (mainly middle-income LDCs), and 2 of the agreements were with Eastern European countries (Poland and Bulgaria). In the 1990s the debt situation was far worse for the low-income LDCs, and after the Brady Plan helped restore the creditworthiness of the Baker-17, “the G7 finally mustered enough political will in the mid-1990s to tackle the debt problems of the poorest countries.”

**Initiatives for the Poorest LDCs**

The total external debt of Sub-Saharan African countries increased from $56.2 billion (U.S.) in 1980 to $147 billion in 1990, and their external debt...
service payments (interest and principal) on long-term loans rose from $4.5 billion to $11.1 billion. Thus, by the early 1990s it was evident that the poorest, heavily indebted LDCs needed more debt relief. The 1996 G7 summit in Lyon, France, addressed this problem by establishing the **Heavily Indebted Poor Countries (HIPC) Initiative**, a plan to alleviate the debts of the poorest LDCs to multilateral institutions. The IMF and the Bank had previously refused to permit debt rescheduling of their loans because this could damage their high credit ratings, and the presence of the IMF director general and World Bank president at the Lyon G7 summit facilitated agreement on the HIPC initiative. The HIPC initiative was designed to reduce the debts of eligible countries to a sustainable level so they could service them without incurring loan arrears or hindering their economic development. The HIPC countries have high debt-to-export ratios, high debt-to-GNI ratios, and low enough incomes to be eligible for soft loans from the Bank group’s International Development Association (IDA) (see Chapter 10). Forty-one countries initially met these criteria: 33 in Sub-Saharan Africa and the other 8 in the Americas and Asia. The HIPC program involved a demanding two-stage process, with each stage lasting up to three years. During the first stage, the HIPC country had to implement an IMF and Bank-supported economic reform program. If the IMF and the Bank determined that debt relief was insufficient, the country entered the second stage, where it received some debt relief and financial support from bilateral and commercial creditors and the multilateral institutions. The HIPC initiative was therefore a slow process, and the debt situation of many of the poorest LDCs was not improving. The costs of the debt crisis were also not spread evenly within debtor states, and the poorest and most vulnerable people were the most adversely affected.

A London-based civil society organization with worldwide connections called **Jubilee 2000** responded to the debt problems of low-income LDCs with a debt forgiveness campaign. Jubilee 2000 is composed of mainly religious but also some secular NGOs from around the world. Beginning in 1998, Jubilee 2000 called for full debt relief for low-income LDCs by the year 2000 and outlined proposals to accelerate the HIPC process, increase assistance levels, and broaden the eligibility criteria. The rapid economic relief offered to more prosperous LDCs affected by the 1997 Asian financial crisis showed that DCs could move swiftly when foreign investment and the stock market were affected, and Jubilee 2000 demanded similar treatment for low-income LDCs. Jubilee 2000 also engaged in mass demonstrations; for example, it formed a human chain of 50,000 people around the convention center at the 1998 G7 summit. In response, the 1999 G7 summit agreed to establish an **enhanced HIPC initiative**, and the IMF and the Bank adopted the major elements of the G7 proposal. The enhanced initiative more than doubled the amount of debt relief and made the HIPC initiative faster (LDCs received debt relief more quickly), broader (it applied to more countries), and deeper (it permitted more debt relief). However, the poorest LDCs continued to have serious indebtedness problems. For example, the countries with the highest external debt as a percent of GNI
in the 2001–2003 period were low-income LDCs such as Sao Tome and Principe (723 percent), Liberia (603 percent), Guinea-Bissau (369 percent), the Republic of the Congo (242 percent), the Democratic Republic of the Congo (222 percent), Mauritania (218 percent), and Sierra Leone (216 percent). In 2005, the World Bank listed 27 of the low-income LDCs as “severely indebted,” 17 as “moderately indebted,” and only 14 as “less indebted.” Although the Bank also listed a number of middle-income LDCs as severely and moderately indebted, most of them had reestablished their creditworthiness as a result of the Baker and Brady plans.

In view of the continuing problems of the poorest LDCs, the 2005 G8 Summit proposed that they be eligible for 100 percent cancellation of their debt owed to the major multilateral lenders. The IMF and World Bank refined this proposal and established the Multilateral Debt Relief Initiative (MDRI) in 2006. IMF members with low per capita incomes that have their debts reduced under the Enhanced HIPC Initiative are eligible to have the rest of their debt to the IMF, World Bank, and African Development Bank cancelled under the MDRI. Despite the gradual expansion of debt relief programs for the low-income LDCs, it remains to be seen whether they can overcome the internal and external structural problems underlying their debt problems. It is therefore necessary to look at the overall effectiveness of the debt reduction strategies.

Assessing the Effectiveness of the Debt Strategies

The international debt strategies had three main objectives: to prevent the collapse of the international banking system, to restore capital market access for the debtors, and to restore economic growth in the debtor countries. The Baker and Brady plans were most successful in achieving the first two objectives. In regard to the first objective, by the late 1980s “the banks were no longer in the serious jeopardy that they faced at the outset of the debt crisis.” From 1982 to 1992, the loan exposure of U.S. banks to the Baker-17 highly indebted countries fell from 130 percent of the banks’ capital and reserves to only 27 percent; the loan exposure of French banks fell from 135 to 23 percent. In regard to the second objective, Latin American debtors were able to return to the international financial markets far more rapidly after the 1980s debt crisis than after the 1930s crisis. Liberal economic theorists view these two criteria as the most important for assessing the effectiveness of the debt strategies, and they therefore believe that the Baker and Brady plans were fairly successful. Some liberals question whether debt reduction for the poorest LDCs in the HIPC and MDRI initiatives is necessary, because the two main liberal objectives of the debt strategies have been achieved. They argue that debt reduction is “too easy to get” and simply relieves “countries’ immediate budget constraint, allowing them to persist with bad economic policies.” Historical materialists and some interventionist liberals by contrast see the third objective—restoring economic growth in LDC debtor countries—as the
most important, and they considered the Baker and Brady plans to be largely ineffective. For example, one critic argued that the IMF and major creditor states were concerned with increasing "the immediate payment capacity of the debtor nations and not their development." Historical materialists also believe that the debt strategies required more sacrifice from LDCs than from DCs and international bankers, and they therefore argue that "the debt crisis is by no means over yet; a banking crisis may have been tidied up, but a development crisis is in full swing."56

The Baker and Brady plans did in fact have serious shortcomings in regard to the third objective of restoring LDC economic growth. This was especially true for the low-income LDC debtors that were not on the Baker-17 list. As discussed, the Baker and Brady plans focused on debt to commercial banks, and they did not provide relief for debt to the IMF and World Bank. Because the poorest LDCs were highly dependent on IMF and Bank loans, the Baker and Brady plans were of little use to them. The North should be credited for gradually developing more assertive debt strategies, shifting from debt rescheduling under the Baker Plan to debt reduction under the Brady Plan to debt relief for the poorest LDCs under the HIPC and MDRI initiatives. However, it always took a new crisis before the IMF, the Bank, and DCs upgraded their debt relief efforts, and it remains to be seen whether the new initiatives will deal with the debt problems of the poorest LDCs. The HIPC and MDRI initiatives recognize that debt relief is sometimes necessary, but successful debt management requires more than debt reduction. It "depends on a country's ability to achieve high growth and foreign-exchange generation—thereby containing debt-to-GDP, debt-to-exports and debt-to-revenues at reasonable ('sustainable') levels."57

TRANSITION ECONOMIES AND FOREIGN DEBT

To this point, we have discussed the effects of the debt crisis on LDCs. However, the transition economies in Eastern Europe and the FSU were also foreign debtors in the 1980s and 1990s. The Soviet bloc countries contended with many of the same economic problems as the South, including balance-of-payments deficits, declining terms of trade, and stagnating economic growth. The need for financing also caused Soviet bloc countries to look to the IMF and World Bank for support. Thus, Hungary and Poland joined these institutions in the 1980s, partly to deal with their growing debt problems. Eastern Europeans borrowed heavily on international financial markets in the 1970s to finance industrial investment. However, the oil price shocks, poor investment decisions, economic inefficiency, lack of export competitiveness, and high interest rates on their foreign debt created severe economic problems. Thus, Eastern Europe experienced a debt crisis as early as 1981 when an acute foreign exchange shortage forced Poland to negotiate a rescheduling of its debt with official and private creditors. Poland had financed an ambitious industrial investment program with external funding, but its exports were insufficient to service its debt."58
Like the South, Eastern European countries followed different strategies to deal with their foreign debt; the two basic strategies were referred to as the Polish and Czech-Hungarian models. The Polish model involved large debt buildup followed by repeated debt reschedulings and eventually official debt reduction, partly based on political considerations. Poland’s debt to the Western DCs increased from $7.6 billion in 1975 to $22.1 billion in 1980, and in 1981 it had the highest debt and debt service ratio in the Soviet bloc. Poland’s growing economic problems resulted in severe economic austerity measures and the formation of the anti-Communist Solidarity Movement, and when the Polish government responded to the Solidarity Movement by imposing martial law in December 1981, the West imposed trade sanctions and suspended debt repayment talks. Although private banks agreed to refinance some Polish debt, Western governments did not resume rescheduling negotiations on official debt until Poland ended martial law in 1983.

From 1981 to 1990, Poland had seven reschedulings of its commercial bank debt and five reschedulings of its official debt. When a democratically elected government replaced the communists and began to promote structural change in early 1990, the West gave Poland assistance under the Brady Plan. Western governments, which held two-thirds of Poland’s debt, offered a 50-percent forgiveness of its official bilateral debt at Paris Club negotiations in 1991; the Paris Club had previously offered a maximum forgiveness of only 33 percent to LDCs. Under pressure from the G7, commercial banks also agreed to reduce Poland’s private debt by 45 percent. Bulgaria followed the Polish model, and the private banks agreed in principle to a substantial reduction of Bulgaria’s debt in late 1993 (most of Bulgaria’s debt was private). Czechoslovakia and Hungary were also affected by the debt crisis, but unlike the Polish–Bulgarian model they tried to maintain their creditworthiness with more prudent economic policies. For example, in 1981 Hungary had the highest per capita debt in the Soviet bloc and the second highest debt service ratio after Poland. However, Hungary joined the IMF and the Bank in 1982 and instituted ambitious economic reforms. As a result of their more prudent policies, Hungary and Czechoslovakia did not require the debt relief measures that were offered to Poland and Bulgaria.59

As with the LDCs, the differing debt strategies of transition economies stemmed partly from domestic economic and political factors. For example, Poland’s large debt buildup followed political events that prevented the government from taking decisive action to deal with its debt problems. Władysław Gomułka’s removal as first secretary of the Polish Communist party in 1970 resulted in decentralization of the party and divisions within the top political leadership. When serious economic problems resulted from high oil prices and declining exports in the late 1970s, workers were able to resist austerity moves because Poland’s political leadership was so fractured. The leaders attempted to raise prices and hold down wages, but massive strikes by workers forced them to reverse these moves. An austerity program was introduced in 1981 when the military took control in Poland and dominated the Solidarity Movement; but that resulted in hardship and further protests.60 In contrast to
Chapter 11 • Foreign Debt and Financial Crises 365

Poland, domestic politics contributed to more prudent economic policies in Hungary. Although Hungary instituted some austerity measures, it also adopted reforms to increase economic efficiency and give profits and prices a larger role in resource allocation. The suppression of the 1956 Hungarian revolt had led to several developments that contributed to these economic reforms. For example, Hungary turned from one-person leadership to collective leadership, which introduced a limited market mechanism and a more balanced development strategy. Hungarian supporters of economic reform also “sought not to weaken the [Communist] party but to use it to pursue their particular economic goals.”

When Hungary confronted debt problems, its earlier reforms enabled it to meet its debt service obligations much more effectively than Poland.

Despite the different development strategies of Eastern Europeans, their debt problems also resulted from external events largely beyond their control. For example, they suffered economically from increased dependence on imports from nonsocialist states, the collapse of the Soviet bloc’s CMEA in 1991, and deteriorating terms of trade as the Soviet Union ended subsidized oil exports. Bulgaria is a prime example of a state affected by external events: The breakup of CMEA had major consequences for Bulgaria because of its export dependence on the Soviet Union, the Gulf War adversely affected Bulgaria’s exports to Iraq, and the war in Yugoslavia disrupted Bulgarian export routes to Western Europe. The structural transition to market-oriented economies produced further instability in Eastern Europe, and domestic output fell by almost 25 percent in 1990 and 1991. Thus, a combination of internal and external factors contributed to Eastern Europe’s foreign debt problems.

THE IMF, THE WORLD BANK, AND THE DEBT CRISIS

The IMF and World Bank had a central role in the 1980s debt crisis, and the crisis altered the relationship between these two institutions as they adopted new overlapping functions. This was not the original intention of the Bretton Woods negotiators, who wanted the IMF and the Bank to have separate functions; thus, they excluded specific references to the South in the IMF Articles of Agreement and assigned the development function to the Bank. Whereas the IMF was to provide short-term loans to any country with balance-of-payments problems, the Bank was to provide long-term loans for reconstruction and development. (The South was later mentioned in the second amendment to the IMF Articles of Agreement.) The only direct linkage between the two organizations was that membership in the IMF was a prerequisite for Bank membership. However, the Bank began to infringe on IMF territory in the 1960s. Diverging from its practice of providing loans for specific development projects, the Bank provided program lending to India for balance-of-payments support; and it linked its loans with conditions that India should reform its policies. The Bank justified its actions by asserting that India’s balance-of-payments deficit resulted from long-term development problems. However, the IMF
argued that the Bank’s balance-of-payments funding with conditionality infringed on its functions. In 1966 the two organizations signed an agreement to avoid further overlap, but it did not fully differentiate their responsibilities.\footnote{62}

Several changes in the 1970s increased the overlap between the IMF and Bank functions. First, the IMF lost its role of stabilizing exchange rates when the Bretton Woods system of pegged exchange rates collapsed. The IMF’s other function of providing loans, in which there is potential overlap with the Bank, therefore became more prominent. Second, the IMF initially provided loans to all countries, but by the late 1970s it was lending almost exclusively to LDCs—the same countries receiving Bank loans. Third, although the Bank’s Articles of Agreement (Article 3, Section 4) state that it should provide loans for specific projects “except in special circumstances,” some LDCs needed development funding for purposes other than specific projects. In 1971, the Bank therefore decided that program loans of the type they had provided to India in the 1960s were appropriate under some circumstances. The Bank’s program loans to finance commodity imports have distinct similarities with IMF loans for balance-of-payments purposes.\footnote{63} However, the main reason for increased overlap was the 1980s foreign debt crisis. The IMF’s short-term loans for balance-of-payments problems with 3- to 5-year repayment periods were inadequate for LDCs with longer-term debt problems, and it therefore began to provide medium-term SALs with repayment periods of 5–10 years. The Bank’s long-term loans for development projects with repayment periods of 15–20 years were also not what LDC debtors required to deal with more immediate balance-of-payments problems, and like the IMF, the Bank provided medium-term SALs to debtor countries. Although the IMF still provided short-term balance-of-payments loans and the Bank provided long-term development loans, they both were now providing medium-term SALs to indebted countries.\footnote{64}

The greater overlap of IMF and Bank functions has increased both conflict and the need for collaboration. The overlap also raises questions as to whether two institutions are necessary, and the Economist predicted in 1991 that a merger between the two “makes sense, and in time it will happen.”\footnote{65} Despite this prediction, the IMF and the Bank both perform important functions. First, the Bank group is composed of five institutions, and it is already too large for efficient management (see Chapter 10); joining the Bank and the IMF would compound the problems related to size. Second, development issues are highly complex, and a range of institutions are needed to provide advice and loans. Although historical materialists argue that IMF and Bank policies are virtually identical, liberal economists point to IMF–Bank disputes as an indication of competing perspectives. Third, IMF and Bank responsibilities extend well beyond providing loans to LDCs. Although the IMF’s monetary role declined when the pegged exchange rate regime collapsed, the IMF continues to advise states on monetary issues, and it could play a more important role in future monetary and financial issues. As discussed in Chapter 10, the Bank is a source of economic expertise on development issues. Finally, the breakup of the Soviet bloc, the financial crises, and the economic problems in Sub-Saharan Africa provide sufficient economic challenges for
both institutions. Whereas the IMF has coordinated actions to deal with Eastern European and FSU debt and the Asian financial crisis, the Bank has coordinated aid efforts in Sub-Saharan Africa.\footnote{66}

Although IMF–Bank collaboration is partly designed to avert institutional conflict, the South is highly suspicious of these moves. Historical materialists and the debtors often criticize IMF conditionality as an unwarranted infringement on LDC sovereignty, and they argue that the liberal economic conditions on IMF and World Bank loans hinder LDC development. Moves toward IMF–Bank collaboration concern the South because of possible cross-conditionality, in which an IMF decision that a loan applicant is uncreditworthy also prevents the applicant from receiving Bank funding. Although the IMF and the Bank rule out cross-conditionality in a formal, legal sense, they sometimes practice it informally.\footnote{67} Critics also charge that IMF and Bank SALs put the onus of adjustment on LDC debtors and vulnerable groups within LDCs, even though the North shared responsibility for the debt crisis. The SAL prescription for improving LDC balance of payments is to reduce spending for social services, lower wages, produce more for export than for local consumption, and end subsidies for local industries. However, poorer LDC women who manage the household are the most severely affected by IMF and Bank pressures for a reduction in funding for public services. Thus, poorer women pay the price for structural adjustment programs through increased unpaid work and a deterioration of health and nutrition.\footnote{68} IMF and Bank officials argue that structural adjustment aimed at market efficiency and decreased public sector involvement can be compatible with social welfare goals, but they have not convinced their critics.

**THE 1990s ASIAN FINANCIAL CRISIS**

This section discusses the 1990s East and Southeast Asian financial crisis (or the Asian financial crisis). Of particular interest are the challenges the crisis posed to the IMF and international financial stability and the proposals that emerged to improve the “international financial architecture.” Chapter 10 discusses the crisis in the context of international development. As discussed, international bank lending to LDCs sharply declined during the 1980s as a result of the foreign debt crisis. In the 1990s, private capital flows to middle-income LDCs increased again, but there was a change in the source of this capital. Whereas commercial bank lending was of primary importance in the 1970s and 1980s, portfolio investment, or the purchase of stocks, bonds, and money market instruments by foreigners, was much more important in the 1990s. Foreign direct investment, or the foreign ownership or control of assets, also increased during the 1990s (see Chapter 9). Indeed, the net private capital flows to 29 “emerging market economies” increased from $35 billion in 1990 to $334 billion in 1996. (Emerging market economies are LDCs able to attract private capital flows.\footnote{69}) This revival of capital flows resulted from LDC economic reforms in response to the debt crisis, the success of the Brady Plan debt reductions, higher interest rates in the South, and a freeing of capital
controls on investment in LDCs. However, some economists expressed concerns that these capital flows were volatile and “could be reversed easily.” Their concerns were soon realized when capital inflows to Mexico halted rather suddenly in 1994. This section devotes primary attention to the 1997–1999 Asian financial crisis because “it was the sharpest financial crisis to hit the developing world since the 1982 debt crisis.”

The Asian financial crisis began in Thailand in July 1997, when there was a massive run on its currency, the baht. The roots of this crisis can be traced to the early 1990s, when capital inflows to Thailand rose dramatically even though the country’s economic and financial conditions were deteriorating; Thailand’s current account deficit was increasing, its property prices were declining, and Thai banks were incurring a sizable foreign currency debt. Like other East Asian currencies, the baht was pegged to the U.S. dollar, and Thai exports became less competitive when the dollar’s exchange rate rose against the Japanese yen. Thus, Thailand had to allow its baht to float because of downward pressure on the currency. Despite government efforts to bolster the baht, capital outflows caused the currency to lose 48.7 percent of its value over the next six months, and this resulted in a sharp decrease in the country’s assets and growth. After the baht began to depreciate, the currencies of other Asian countries such as Indonesia, South Korea, Malaysia, the Philippines, and Singapore also came under severe downward pressure. All of these countries experienced rapid outflows of capital, depreciation of their currencies, and dramatic declines in their stock markets. Most of these countries also had recessions, banking crises, and lower economic growth rates. Thus, Thailand, Indonesia, and South Korea had to seek IMF and World Bank loans to bolster their currencies and economies. The economic problems also led to political problems, with major demonstrations resulting in the resignation of Indonesia’s President Suharto, and transfers of power in Thailand, South Korea, and the Philippines.

The main concerns of the 1980s debt crisis had related to the overall indebtedness and high debt-service ratios of many LDC governments. However, in the Asian financial crisis the debts of governments such as Thailand, Indonesia, and South Korea to private and official creditors were relatively small. Domestic banks and private companies in Asia, by contrast, had borrowed heavily from foreign creditors, and they owed large amounts when capital flows were reversed. The Asian governments had the difficult and expensive tasks of overhauling insolvent banking systems and restructuring corporate debt. In sum, while the 1980s debt crisis resulted from “unsustainable current account deficits and poor macroeconomic fundamentals,” the “Asian crisis was essentially a ‘capital account crisis.’” As Chapter 10 discusses, the financial crisis proved to be only a temporary setback, and the Asian economies have generally resumed their rapid rate of growth. However, there were concerns that financial crises could recur because of the increased capital flows. Thus, the major DC governments proposed a number of reforms to strengthen global governance in finance, or the international financial architecture.
Chapter 11 • Foreign Debt and Financial Crises

The annual G7 summits played an important role in the architecture exercise, which began in 1995 in response to the Mexican financial crisis and evolved in response to the Asian crisis and a financial crisis in Russia. The architecture exercise led to the creation of new IMF lending facilities, efforts to strengthen the financial infrastructure in LDCs and transition economies, and a debate regarding the role of the IMF and its conditionality requirements. Major objectives were to develop better strategies to prevent and resolve financial crises. *Crisis prevention* involved identifying vulnerable countries before they experienced crises and fostering compliance with international standards to produce financial stability. *Crisis resolution* involved reforming IMF policies and involving private creditors in efforts to resolve financial problems of LDCs and transition economies. Prescriptions for the best measures to reform the international financial architecture depend on one's theoretical perspective, and the following discussion compares the views of four groups:

1. Orthodox liberals.
2. Those combining orthodox and institutional liberalism.
3. Those combining interventionist and institutional liberalism.
4. Historical materialists.

As discussed in Chapter 4, orthodox liberals promote freedom of the market to function with minimal interference from the state. Thus, liberals such as Milton Friedman see the problems with international finance as stemming from inadequate domestic institutions and policies, not from the freeing of capital flows. From this perspective, the 1994 Mexican peso crisis resulted from an overvalued exchange rate and inadequate attention to the country's trade and budget deficits and foreign debt; the 1997 Asian financial crisis stemmed from inaccurate financial reporting, pegged exchange rates, and banks offering questionable loans to businesses with political connections. Freer global capital flows were not responsible for the Asian financial problems. On the contrary, capital flows maximize efficiency because they are directed to countries with balanced budgets, stable markets, and low inflation rates. International regulation to limit risky behavior in capital markets would be harmful, and all capital controls should be abolished. Some economists believe that a *lender of last resort* is necessary for states with financial problems and that the IMF could perform this function if it had more financial resources. A lender of last resort “is an institution that is willing and able to supply unlimited amounts of short-term credit to financial institutions when they are threatened by a creditor panic.” However, orthodox liberals argue that the best way to prevent capital flight and speculative attacks on a state's currency is to eliminate the problem of *moral hazard*. Moral hazard refers to the idea that protection against risk encourages a person or state to engage in riskier behavior. If a lender of last resort exists, states facing financial crises are more likely to engage in risky and irresponsible behavior because they can always count on the lender to rescue them. Some orthodox liberals criticize the IMF and the Bank for contributing to moral hazard by providing development assistance, debt bailouts, and balance-of-payments support.
The second group of scholars combines orthodox and institutional liberalism. Like the first group, they believe that inadequate domestic policies are the main factors increasing a country’s vulnerability to financial crises, and that the Asian financial crisis stemmed more from “crony capitalism” or overly close connections between business groups and governments than from financial contagion. Unlike the first group, however, they see an important role for international financial institutions such as the IMF and World Bank in ensuring that LDCs and transition economies follow transparent, liberal economic policies. Thus, they favor strong IMF conditionality requirements to ensure that states are subject to the discipline of the marketplace and IMF policies that “legitimize financial liberalization” and block “tendencies to move toward increased state regulation of international financial flows.”

The third group of scholars combines interventionist and institutional liberalism. As liberals, they assume that the failure of countries to follow liberal economic policies interferes with efficiently functioning markets. As interventionist liberals, however, they feel that unrestrained markets are not beneficial and that measures must be taken to protect society (see Chapter 4). In finance, currency traders often buy and sell for profit without taking account of fundamental economic conditions, and this produces unnecessary volatility in capital flows and foreign exchange markets. Thus, financial markets are likely to perform better when regulated. The third group also emphasizes the need for a well-funded international lender of last resort. Without such a lender, financial crises may increase and detract from global economic efficiency and development in LDCs and transition economies. Many theorists in this group have been actively involved in the debate regarding the international financial architecture. For example, some members of this group responded to the Asian financial crisis by supporting the Tobin tax, which Nobel Laureate James Tobin first proposed in 1972. Tobin’s proposal called for “an internationally uniform tax on all spot conversions of one currency into another, proportional to the size of the transaction.” Although Tobin recommended a tax of only 1 percent, he believed that it would discourage short-term speculative capital flows and generate revenue that could be used for purposes such as combating international poverty. Many supporters of the Tobin tax argue that it would help reduce the risk of global financial crises and provide the international community with some of the profits flowing from international capital mobility. However, critics of the Tobin tax range from orthodox liberals who insist there is nothing wrong with the financial markets, to others who argue that such a tax would not be effective. Whereas currency traders in times of crisis would disregard a small tax, a larger tax would seriously interfere with financial markets. As institutional as well as interventionist liberals, the third group proposes numerous reforms in IMF and World Bank transparency, accountability, and conditionality requirements. They also support the idea that the IMF should become a lender of last resort.

The fourth group of scholars are historical materialists who view the Asian financial crisis as another example of the corrupting power of international capital. Unlike interventionist liberals, they think that the IMF and the Bank are
unreformable, and (like some orthodox liberals) they therefore favor the abolition of these institutions. For example, one study concludes that “the international financial institutions require Third World countries to adopt policies that harm the interests of working people.” Until recently, the second group (orthodox and institutional liberals) had the most influence in discussions of the international financial architecture. However, the third group (interventionist and institutional liberals) has been gaining more influence as a result of the global financial crisis which began in the first decade of the twenty-first century.

THE GLOBAL FINANCIAL CRISIS—2008 TO ?

The global financial crisis is different from the 1980s debt crisis and the 1990s Asian financial crisis because it began in the North rather than the South, specifically in the United States. However, there are similarities between these crises, regardless of their origins. As discussed, the global financial crisis began with a subprime crisis in the U.S. housing market that resulted in a global credit crunch and financial failures in many countries. U.S. housing prices and home ownership increased dramatically in the late 1990s, and investing in a house seemed to be a means of gaining financial security. Relatively low interest rates contributed to increases in house prices and in mortgage financing. A substantial share of this mortgage financing was through subprime mortgages, which are mortgages for borrowers who do not qualify for market interest rates because of income level, credit history, size of the downpayment, and/or employment prospects. The high prices made it profitable to build houses, but this resulted in an oversupply and U.S. house prices began to fall in mid-2006 at an accelerating rate. Lower “teaser” mortgage rates that mortgage lenders had initially provided to entice possible homeowners were also coming up for renewal at higher rates. Many subprime borrowers who could not pay the higher rates had to default on their loans, and they ended up owing more than the value of their houses because of the declining prices. The U.S. subprime crisis has had serious repercussions around the globe, because the subprime mortgages were packaged and sold to investors in many countries. The credit crisis has also led to defaults in other areas besides housing such as automobile loans and credit card payments.

What are some of the similarities between the subprime crisis and the previous two crises? Although the subprime crisis began in the United States, one can draw some parallels between U.S. subprime borrowers and LDCs in the previous two crises, because subprime borrowers (like LDCs) are poorer and more vulnerable to financial distress. Critical theorists pointed to “loan pushing” by international banks recycling OPEC petrodollars as a cause of the 1980s debt crisis, and mortgage pushing by highly assertive mortgage lenders was a cause of the current crisis. As with the international banks in the 1970s, the mortgage lenders did little to assess borrowers’ ability to repay their loans, and they encouraged people who were credit risks to borrow in the subprime mortgage market. Subprime lenders also sought to persuade legislators to forgo
regulations restricting lending to borrowers with poor credit ratings. For example, one of the largest U.S. subprime lenders (Ameriquest Mortgage Company) reportedly spent more than $20 million on political donations. Rating agencies such as Moody’s, Standard and Poor’s (S&P), and Fitch issued some warnings about emerging problems in the subprime market, but critics argue that their warnings were too little and too late. U.S. House Committee hearings on the subprime crisis have pointed to possible conflicts of interest because of services that the rating agencies provide to mortgage lenders. Mortgage buyers also bear some responsibility for the subprime crisis just as LDC borrowers bore some responsibility for the 1980s debt crisis. Many mortgage buyers were overly complacent about their personal debts, accustomed to living beyond their means, and inclined towards having unrealistic expectations. As Robert Shiller points out, mortgage buyers as well as sellers were susceptible to an irrational “contagion of ideas” that the housing boom would continue indefinitely. As was the case with the 1980s debt crisis and the 1990s financial crisis, this contagion of ideas seemed to blind both the credit agencies and those in responsible positions such as Alan Greenspan of the Federal Reserve, Ben Bernanke of the Council of Economic Advisers, and President George W. Bush to the severity of the emerging problems. Although the 2008 global financial crisis began in the North, the resulting credit crunch has been felt strongly in the South. Thus, many LDCs have turned to the IMF for assistance, as they did in the 1980s debt crisis and the 1990s Asian financial crisis.

We can also find similarities between the possible solutions to the three crises. As with the 1980s debt crisis and the 1990s financial crisis, it is first necessary to have a “firefighting strategy” to deal with the immediate problems created by the bursting of the housing bubble and its aftermath. An immediate problem in all three of the crises was the inability or reluctance of banks and other lending agencies to provide credit and finance. In the 2008 global crisis, DCs and some LDCs and transition economies have instituted huge bailout programs for their banks and other institutions. As with the Asian financial crisis, there is a debate between those calling for even more assistance and those warning that too much assistance could encourage risk taking because of “moral hazard.” After the immediate problems are dealt with, there is the more difficult problem of restructuring the financial system to prevent a recurrence of the problems. In the 1990s financial crisis, many referred to this as reforming the “international financial architecture.” In the current crisis, there is a need for greater transparency and tighter regulation of the banking and financial industry.

Despite the similarities, there are also some major differences between the previous crises and the 2008 global financial crisis. First, whereas the G7/G8 provided the political support for dealing with the earlier debt and Asian financial crises, the G20 is having a more important role in dealing with the 2008 crisis. This is an indication of the growing power of some emerging countries such as the BRIC economies, and of some shift in economic power from the West to Asia. Second, a major cause of the 2008 crisis is the
imbalance of foreign exchange reserves, with the United States having a massive foreign debt, and emerging countries such as China, South Korea, and some OPEC members having growing reserves. Thus, IMF lending resources will now depend more on some emerging countries, and they are demanding a greater role in IMF and World Bank decision making. In an April 2009 meeting, the G20 agreed to complete a new balance of power in the IMF by 2011, with some changes in the weighted voting, and in the selection of the IMF and World Bank heads on the basis of merit and not by nationality. Third, the 1990s Asian financial crisis resulted in strong criticisms of the IMF to the point where some observers were questioning the future of the organization. The 2008 crisis has given the IMF a new sense of purpose, because the G20 has decided to give it a substantial increase in resources to deal with the financial problems of poorer countries. Finally, the 2008 crisis more than the previous crises has raised questions about the adequacy of the unrestrained market, and there has been a noted shift back toward interventionist liberalism with similarities to the post–World War II period.

Considering IPE Theory and Practice

What is the relevance of the IPE theoretical perspectives for the 1980s foreign debt crisis? Most observers agree that unexpected changes such as the food and oil crises of the 1970s were a major cause of the debt crisis. However, orthodox liberals also see imprudent borrowing and inefficient domestic policies of LDCs as major causes. Historical materialists focus instead on the irresponsible behavior of commercial banks and creditor governments and the long-term dependency of LDCs. In response to the debt crisis, DCs, the IMF and the World Bank induced, the debtors to adopt liberal economic policies, and views sharply differ regarding the effects of these debt strategies. Liberal economists argue that the strategies were quite successful, because they prevented the collapse of the international banking system and restored capital market access for many indebted states. Although the debtors’ policy changes caused hardship for some groups and individuals, the long-term effects of the shift to economic openness benefited LDCs and transition economies. Realists and historical materialists, by contrast, argue that liberals ignore the effect of inequality among states on the debt issue. Although globalization facilitated the transmission of liberal values to the DCs, these values were imposed on LDC debtor states. Furthermore, historical materialists argue that the debt strategies required far more sacrifice from LDC debtors than from international banks and that IMF and World Bank conditionality requirements served the needs of international capital. IMF requirements that debtors reduce social expenditures, increase exports, remove
restrictions on capital flows, and
devalue their currencies had a nega-
tive impact on the poorest and
weakest societal groups.

Assessments of the 1990s
Asian financial crisis, like the 1980s
debt crisis, depend on one’s theo-
retical perspective. Orthodox liber-
als attributed the Asian financial
crisis mainly to inefficient domestic
policies, and they opposed interna-
tional controls on capital flows.
Whereas some extreme orthodox
liberals argue that the IMF and the
Bank should be abolished because
they contribute to moral hazard,
others encourage these institutions
to strengthen their conditionality
requirements to ensure that LDCs
and transition economies are sub-
ject to market discipline. Interven-
tionist liberals by contrast see some
degree of control over capital flows
as necessary and argue for institu-
tional reforms making the IMF and
the Bank more transparent and
accountable. In contrast to orthodox
liberals, interventionist liberals also
call for a lender of last resort. The
harshest critics of international capi-
tal flows are historical materialists,
who argue that the IMF and the
Bank are agents of international
capital and are unformable.
Interventionist liberals were the
most supportive of developing a
new international financial archi-
tecture that would ensure adequate
transparency and regulation of
domestic and international financial
systems, provide sufficient interna-
tional official liquidity in crisis con-
ditions, and create mechanisms for
orderly debt management and
development finance. However,
progress in developing a new finan-
cial architecture has been limited,
largely because of differences
between DCs on the one hand and
LDCs and transition economies on
the other.

The lack of financial reforms
was a major factor contributing to
the 2008 global financial crisis,
which differed from the previous
two crises because it originated in
the North, in particular in the
United States. As with the previous
two crises, there are competing
views of the causes of the U.S.
subprime mortgage crisis, with
some casting blame on the sub-
prime lenders and the rating agen-
cies, others blaming the subprime
borrowers, and still others refer-
ing to the lack of regulation in
global financial relations. There is
also a lack of agreement on the
best means of dealing with the
crisis, with some warning that bail-
ing large banks and corporations
out will lead to “moral hazard” and
others warning that the banks and
corporations are “too big to fail.”
As with the 1990s, the subprime
mortgage crisis has led to calls for
major financial reforms. The main
global actors failed to establish a
new international financial archi-
tecture after the 1990s financial
crisis, and it remains to be seen
whether they will be more suc-
cessful in reforming the domestic
and international financial systems
after the 2008 global financial
crisis.
Questions

1. What are the liberal and historical materialist views regarding the causes of the 1980s foreign debt crisis?
2. Do liberals and historical materialists believe that the debt strategies have successfully dealt with the worst aspects of the debt crisis? Do you feel that debt reduction is necessary or that it contributes to moral hazard?
3. How did the 1980s debt crisis differ from the 1990s Asian financial crisis? What are the similarities and differences between the 2008 global financial crisis and the two earlier crises discussed in this chapter?
4. What are the views of orthodox, institutional, and interventionist liberals and historical materialists regarding the best means for reforming the international financial architecture? Was a new financial architecture developed as a result of the 1990s Asian financial crisis?
5. What is the relationship among the London Clubs, the IMF, and the Paris Club in dealing with foreign debt? Why do you think some of the most important institutional groupings such as the Paris Club, the London Clubs, the G7/G8, and the G20 are so informal?
6. What were the strengths and weaknesses of the Baker Plan, Brady Plan, and HIPC and MDRI Initiatives? How do you explain the fact that the Baker and Brady plans did not address the problems of the poorest LDC debtors?
7. What are the competing theoretical views of the causes, and remedies for, the 2008 global financial crisis? Which of these views do you find most convincing? Do you think that the 2008 global financial crisis is likely to have an effect on U.S. economic hegemony?
8. How have the roles of the IMF and World Bank, and the relationship between these two institutions, changed as a result of the foreign debt and financial crises?

Further Reading


### Notes


Chapter 11 • Foreign Debt and Financial Crises


43. Payer, Lent and Lost, p. 97.

44. Paul R. Krugman, “Debt Relief Is Cheap,” Foreign Policy 80 (Fall 1990), pp. 141–152.


52. Cline, International Debt Reexamined, p. 70.


Part 3 • The Issue Areas


