Why Some Developing Countries Are Better Placed Than the International Monetary Fund To Develop Policy Responses to the Challenges of Global Capital

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

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The International Monetary Fund (IMF or Fund) plays a pivotal role in guiding and shaping the interactions between developing countries and global capital. The Fund advises countries on when and how to liberalise their financial systems and open up to global capital. In addition, for countries with an IMF program in place, the Fund has direct input into the regulations enacted to achieve these ends and the fiscal and monetary policy settings of the country. These functions were not part of the IMF's original role, but over the past twenty-four years (since the inception of the Latin American debt crisis in 1982 (1982 Debt Crisis)) the IMF's role has evolved so that today these functions are central to its mission.[1]

Yet the past two decades suggest that the IMF may not be the best placed institution for this purpose. This Article analyses four developments in the past fifteen years: (1) Argentina's recent economic crisis, (2) the Brady Plan implemented in the early 1990s to address the Latin American debt crisis, (3) Chile's response to increasing capital inflows in the early 1990s, and (4) Malaysia's response to the East Asian economic crisis that commenced in 1997 (1997 Asian Crisis). This Article concludes that some developing countries are better placed than the IMF to develop the policies and regulations that will govern their interaction with global capital and analyses why this might be so.

1. The full text of the purposes of the IMF can be found in *Articles of Agreement of the International Monetary Fund*, art. 1, July 22, 1944, *reprinted in* JOSEPH GOLD, VOTING DECISIONS IN THE INTERNATIONAL MONETARY FUND; AN ESSAY ON THE LAW AND PRACTICE OF THE FUND, at app. ix (1972), *available at* http://www.imf.org/external/pubs/ft/aa/aa01.htm.

I. THE ARGENTINE EXPERIENCE

A. Overview

The 1980s were a lost decade in Latin America in general and Argentina in particular. The 1982 Debt Crisis cast a long shadow over the decade: Latin American countries were net capital exporters as they repaid more than they were able to borrow, causing living standards to plummet and infrastructure to crumble.[2]

In contrast, the years from 1991 to 1998 were a prosperous time in Argentina because the resolution from the creditor's perspective of the debt crisis, through the Brady Plan, encouraged the resumption of net capital flows into the country.[3] Argentina's economy performed particularly well, with gross domestic product (GDP) per capita increasing an exceptional 44% between 1991 and 1998.[4] Argentina "enjoyed its highest rates of growth since the 1920s" and inflation was completely under control.[5] Argentina has a strong base for an economy: a literacy rate of 96.2%, the best educational system in Latin America,[6] and rich natural resources.[7]

In these years, Argentina significantly improved its banking system, more than doubled its exports, increased its infrastructure investments through privatisations, privatised a broad range of industries, experienced significant growth in oil and mineral production, and achieved record levels of agricultural and industrial output.[8] Argentina was a darling of

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2. *See International Economic Issues, and Their Impact on the U.S. Financial System: Hearings Before the H. Comm. on Banking, Finance, & Urban Affairs*, 101st Cong. 181 (1989) [hereinafter *International Economic Issues Hearings*] (statement of Per Pinstrup-Andersen, Professor, Food Economics, Cornell University) ("Severe deteriorations in real incomes, food security and nutritional status among the poor have occurred in several countries during periods of [structural] adjustment."); *id.* at 14-16 (statement of Richard Jolly, Deputy Executive Director of Programmes, UNICEF House); *see also* Jerry Dohnal, *Structural Adjustment Programs: A Violation of Rights*, 1 AUSTL. J. HUM. RTS. 57, 72-74 (1994).

3. For a discussion of the Brady Plan, see *infra* Part II.

4. Miguel A. Kiguel, *"Structural Reforms in Argentina: Success or Failure?,"* COMP. ECON. STUD., Summer/Fall 2002, at 83 (calculating percentage from figure 1). There was a brief hiatus in the growth during 1995 in response to the "Tequila effect," the contagion from Mexico's crisis in late 1994 and early 1995. *Id.*

5. *Id.*

6. Sophie Arie, *Rich Argentina Tastes Hunger: Children Miss School To Beg as Beef and Milk Become Unaffordable Luxuries in a Plummeting Economy*, OBSERVER (U.K.), May 19, 2002, at 28.

7. In the 1930s, on the back of strong beef and grain exports, per capita income in Argentina was on par with Canada, France, and the United States. *See, e.g.*, GUILLERMO E. PERRY ET AL., POVERTY REDUCTION AND GROWTH: VIRTUOUS AND VICIOUS CIRCLES 45 (2006).

8. Kiguel, *supra* note 4. This is not to suggest that many of the privatisations were not deeply problematic. It is always a profound challenge to realise appropriate prices for the privatisation of major businesses and assets in emerging market nations because the range of

the IMF and the financial markets and was toasted "as the best case for 'responsible leadership' in the developing world."[9]

Nonetheless, at the end of 1998, Argentina entered a severe recession. The timing was dictated in part by external factors, including the 1997 Asian Crisis and the August 1998 Russian crisis (1998 Russian Crisis). Together, these events severely limited capital flows to emerging market economies. Accordingly, Argentina had very limited access to new international capital to finance budget deficits and service its debt.[10] However, while these external factors influenced the timing of the crisis, these events did not cause Argentina's recession.[11] The causes will be considered below in Part I.B.

Argentina's recession deepened into a severe crisis in late 2001 when the IMF refused to extend further credit to the nation, due to the IMF's belief that Argentina's economic programs were unsustainable.[12] As commercial lenders followed this lead, Argentina was denied access to capital and defaulted on its US$141 billion external public sector debt.[13] The Argentine government was forced to float the peso, which more than halved in value overnight.[14] Still the crisis continued to deepen. Eventually, on April 19, 2002, the Argentine government ordered the indefinite closure of all banks in Argentina.[15]

As a result of this crisis, a sizable proportion of the Argentine people have been impoverished. UNICEF Argentina is concerned that "stunted growth and reduced mental capacities" will be the long-term

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potential purchasers is not wide. Further, the risk of very favourable prices for well-connected purchasers also exists. The scrupulous and rigorous public accountability procedures that would mitigate against the latter risk are rarely present. Many of the privatisations of the 1990s in Argentina were likely at a deep undervalue.

9. Herman Schwartz, *Chaos in Argentina*, NATION (N.Y.), Jan. 21, 2002, at 3; *see also Argentina: A Poster Child for the Failure of Liberalized Policies? Interview with Lance Taylor*, CHALLENGE, Nov.-Dec. 2001, at 28 [hereinafter *Argentina: A Poster Child*].

10. Kiguel, *supra* note 4.

11. ROSS P. BUCKLEY, EMERGING MARKETS DEBT: AN ANALYSIS OF THE SECONDARY MARKET 21 (1999).

12. *See* Thomas Catan et al., *Bush Pledges To Work with Argentina's Government*, FIN. TIMES (London), Dec. 29, 2001, at 11.

13. Mark Tran, *Argentina Scrambles To Avoid Financial Collapse* (Apr. 22, 2002), http://www.guardian.co.uk/argentina/story/0,,688862,00.html.

14. Andrés Gaudin, *Thirteen Days That Shook Argentina—And Now What?*, N. AM. CONG. ON LATIN AM. REPORT ON AMS., Mar.–Apr. 2002, at 6.

15. David Teather, *Argentina Orders Banks To Close: Government Fears Economic Collapse as Cash Outflow Rises*, GUARDIAN (U.K.), Apr. 20, 2002, at 2. On April 22, 2002, the Buenos Aires stock exchange was closed in an indefinite suspension of banking activity. Tran, *supra* note 13.

consequence of this economic crisis for millions of the nation's children.[16]

Notwithstanding eight years of prodigious growth in the 1990s, since 2000, Argentina has undergone the worst economic crisis in its history (Argentine Crisis)[17] and possibly the worst peacetime economic crisis in world history.[18] How did this happen?

B. Causes of the Argentine Crisis

The principal causes of the Argentine Crisis were the one-to-one peg of the peso to the U.S. dollar, the massive inflows of foreign capital facilitated by the liberalisation of Argentina's capital account,[19] and Argentina's endemic corruption.[20] The first two causes were promoted or supported by the IMF. The contribution of each of these causes, as well as the contribution of IMF policies, will be considered below.

1. The Peso-Dollar Peg

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

Compare Argentina's situation with that of Mexico and Brazil. In the wake of the 1997 Asian Crisis and the 1998 Russian Crisis, capital flows to Mexico declined sharply and Mexico's currency decreased in value, thereby improving the competitiveness of its exports.[21] Similarly,

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16. Arie, *supra* note 6.

17. Kiguel, *supra* note 4; Martin Crutsinger, *IMF Grants Argentina Extra Year To Make Debt Repayment* (Sept. 5, 2002) (on file with the *Tulane Journal of International and Comparative Law*).

18. Duncan Green, *Let Latin America Find Its Own Path*, GUARDIAN (U.K.), Aug. 5, 2002, at 21. One estimate claims that total domestic financial assets shrunk from US$126.8 billion in March 2001 to US$41.5 billion one year later. BUS. MONITOR INT'L, ARGENTINA QUARTERLY FORECAST REPORT: 2002 3RD QUARTER (2002). If these numbers are correct, this financial loss is one of the most massive destructions of wealth anywhere in the world in the past thirty years.

19. Martin Feldstein, *Argentina's Fall*, FOREIGN AFF., Mar.-Apr. 2002, at 8; *Argentina: A Poster Child*, *supra* note 9.

20. Naomi Klein, *Revolt of the Wronged: Argentina Was a Model IMF Student. And It's Still Suffering as a Result*, GUARDIAN (U.K.), Mar. 28, 2002, at 23.

21. Liliana Rojas-Suarez, Toward a Sustainable FTAA: Does Latin America Meet the Necessary Financial Preconditions? 1 (unpublished manuscript *available at* http://iie.com/publications/wp/02-4.pdf).

when these and other factors affected Brazil, Brazil's government was able successfully (if a little shakily) to devalue the real forty percent in January 1999, and Brazil neatly sidestepped an incipient crisis in that country.[22] No such exchange rate flexibility was available to Argentina. The Brazilian devaluation was particularly problematic for Argentina because Brazil is Argentina's major trading partner; overnight, Argentine products were relatively more expensive in Brazil and Brazilian products relatively cheaper in Argentina.[23]

In summary, pegging the Argentine peso to the U.S. dollar was always going to be highly problematic over the medium and long term.[24] Over time, unless the external competitiveness of the Argentine economy could at least match that of the U.S. economy, the tied exchange rate would inevitably lead to an overvaluation of the peso relative to the dollar and many other currencies.[25] Argentine exports could have remained competitive if productivity growth in Argentina exceeded the relative appreciation of the U.S. dollar or if private and public sector wages decreased in Argentina.

Such productivity growth in Argentina is all but impossible because the value of the U.S. dollar is driven not only by the strength of its home economy but also by the massive capital inflows from Europe and Asia and by the use of the U.S. dollar as a de facto global reserve currency.

Likewise, reductions in nominal wages are a virtual political impossibility in any country. People will strenuously resist cuts in their nominal wages, while typically not even noticing reductions in the value of their wages when measured in a stronger, appreciating, foreign currency.[26]

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22. William C. Gruben & Sherry Kiser, *Why Brazil Devalued the Real* (July 1, 1999), http://www.dallasfed.org/eyi/global/9907real.html; Edmund Amann & Werner Baer, *Anchors Away: The Cost and Benefits of Brazil's Devaluation* 1 (Univ. of Ill. at Urbana-Champaign, Working Paper, 2002), *available at* http://www.business.uiuc.edu/Working_Papers/papers/02-0122.pdf.

23. Rojas-Suarez, *supra* note 21, at 1-13.

24. Under this law, for Argentina to guarantee convertibility the government had to back each peso in circulation with a dollar or similar hard currency at the central bank. Feldstein, *supra* note 19.

25. *See id.*

26. Anne Krueger, the First Deputy Managing Director of the IMF, puts this economic truth far too gently: "[U]nder a firmly fixed exchange, you need other sources of adjustment to maintain competitiveness." Anne Krueger, First Deputy Managing Dir., IMF, Statements at the National Bureau of Economic Research Conference on "The Argentina Crisis": Crisis Prevention and Resolution: Lessons from Argentina (July 17, 2002), *available at* http://www.imf.org/external/np.speeches/2002/071702.htm. Why the coyness? Perhaps because to be direct would expose how politically unfeasible the IMF-sponsored policies had been.

The Argentine tragedy is that if, once hyperinflation was defeated in 1994, the peso had been allowed to gradually decline in value, growth in the nation's exports and economy might have been strong and sustainable[27]—much as the steady erosion in value of the Australian dollar through the same period empowered that economy.[28]

2. Excessive Indebtedness

The second cause of the crisis was Argentina's reliance throughout the 1990s on international capital to finance budget and current account deficits.[29] Throughout the boom, from 1991 to 1997, Argentina was living, and thriving, on borrowed money.[30] In this, the Argentines were in step with their continent's history. Since Latin American nations gained their independence in the 1820s, they have been unwilling to live within their means whenever debt has been available.[31] Borrowing to finance budget deficits is particularly problematic because it will not generate the foreign exchange needed to service or repay the debt.

The removal of capital controls permitted strong flows of foreign capital into the nation in these years; however, as I have argued elsewhere, stringent prudential regulation must precede the liberalisation of a nation's capital account.[32] "The IMF [itself] has identified 'a robust financial system underpinned by effective regulation and supervision of financial institutions' as the overriding precondition to the liberalisation of a nation's capital controls."[33] This was a lesson learned by the IMF in the late 1990s. In the early- to mid-1990s, the IMF encouraged the contemporaneous development of a nation's prudential regulation and the liberalisation of its capital account.[34] Increasing the quality and extent of prudential regulation is slow and hard work, calling for considerable resources that, particularly in human terms, are often in desperately short supply in developing countries. Alternatively, liberalising capital controls can be achieved relatively swiftly and easily through legislation. For the IMF to promote the simultaneous, rather than sequential, adoption of

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27. Jeffrey Sachs, *A Crash Foretold; Argentina Must Revamp Its Society and Economy for a High-Tech World*, TIME INT'L, Jan. 14, 2002, at 17.

28. *See* ORG. FOR ECON. SURVEYS & COUNTRY SURVEILLANCE, OECD ECONOMIC SURVEY: AUSTRALIA (2000).

29. Kiguel, *supra* note 4.

30. Rojas-Suarez, *supra* note 21, at 10.

31. BUCKLEY, *supra* note 11, at 7-8.

32. Ross P. Buckley, *An Oft-Ignored Perspective on the Asian Economic Crisis: The Contribution of Creditors and Investors*, 15 BANKING & FIN. L. REV. 431, 439-40 (2000).

33. *Id.* at 440-41 (citing INT'L MONETARY FUND, WORLD ECONOMIC OUTLOOK 9 (1998)).

34. *See id.*

these measures proved to be a recipe for disaster first in Indonesia, Korea, and Thailand, and then in Argentina.

A recent audit by the IMF's Independent Evaluation Office into the IMF's role in Argentina in the 1990s found that the Fund's "surveillance underestimated the vulnerability that could arise from the steady increase in public debt—much of it was dollar-denominated and externally held."[35] In short, the IMF's own audit found that Argentina borrowed too much and that the IMF acquiesced in this error.[36]

Argentina in the 1990s stands as strong evidence of a truism that international capital markets are extraordinarily slow to grasp: strong capital inflows generate strong growth that attracts further inflows. Basically, if global capital flows strongly into a relatively small economy like Argentina's or Thailand's, it will boom. The boom, in turn, makes the country attractive to more capital, which, in turn, furthers the boom. This is unconnected to economic fundamentals and typically not sustainable. Foreign capital is not affected by this because it profits in boom times, and without some form of sovereign bankruptcy regime, it suffers limited losses in hard times. In addition, the careers and bonuses of individual bankers are greatly enhanced by the boom-time profits, and when hard times come, the individuals are rarely still in roles in which responsibility for losses can be sheeted home to them in a meaningful way.[37] Much global movement of capital can be attributed to internal reward structures within banks that reward the volume of loans made, and not their quality.[38]

3. Corruption

As always in Latin American financial crises, corruption played an insidious role. Corruption contributed in three ways. First, systemic corruption renders any economy profoundly inefficient as it increases transaction costs. Corruption thus limited the returns derivable from foreign capital in the Argentine economy. Second, through corruption, portions of the capital flows were diverted from their intended destination into the private accounts of politicians, senior civil servants,

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35. *Watchdog Faults Argentina, but also IMF*, 33 IMF SURVEY 229, 230 (2004).

36. *See* INDEP. EVALUATION OFFICE, IMF, EVALUATION REPORT: THE IMF AND ARGENTINA, 1991-2001, at 17-36 (2004), *available at* http://www.imf.org/External/NP/ieo/2004/arg/eng/index.htm.

37. Ross P. Buckley, *A Tale of Two Crises: The Search for the Enduring Reforms of the International Financial System*, 6 UCLA J. INT'L L. & FOREIGN AFF. 1, 15-16 (2001-2002).

38. *Id.*

and leaders of industry.[39] When a significant proportion of the capital never even reaches the account of the debtor, repayment of the full amount will always be problematic. Third, the corruption of the political process in Argentina meant that capital was often borrowed to serve the interests of the elite and the politicians, rather than the best interests of the nation.[40]

Both the IMF and the Argentine government made egregious policy errors in Argentina. Nonetheless, without the rejection of corruption in all forms by the Argentine people, their economy will never function efficiently; their governments will continue to govern in ways that serve the interests of the Argentine elite and international capital, and not the interests of the common Argentine people.[41] The Argentine people must root out corruption from their political and economic systems if they are ever to aspire to a stable economy and first-world living standards. Moral and ethical reform on a national scale is needed.[42]

4. IMF Policies

In many respects Argentina was, throughout the 1990s, a model IMF pupil.[43] Argentina exhibited a degree of compliance with IMF-mandated policies that is rare among developing countries.[44] In

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39. Paul W. Rasche, *Argentina: Test Case for a New Approach to Insolvency?*, STUDIEN VON ZEITFRAGEN, Jan. 5, 2002; Ernest W. Sweeney, *Argentina: The Current Crisis in Perspective*, AMERICA, Feb. 11, 2002, at 19, *available at* http://www/americamagazine.org (search "Argentina the Current Crisis in Perspective"; then follow the "Argentina: The Current Crisis in Perspective by Ernest W. Sweeney" hyperlink); Klein, *supra* note 20.

40. *See* Sweeney, *supra* note 39.

41. The best analysis I have read of this issue is by Professor Luiz Carlos Bresser Pereira. In his words before a committee of the U.S. House of Representatives in 1989:

> But, in spite of the growing evidence of the impossibility of paying the entire debt, a significant portion of the elites in the debtor countries remains willing to try to pay it. We can think of a number of explanations for that attitude—fear of retaliations by the banks, cultural subordination to the First World, willingness to be part of it, identification of the interests of the creditor countries with the interests of the banks, lack of information about the debates among the elites of the creditor countries about the debt, unability [sic] to size up the internal economic crisis in their own countries, identification of firm positions for debt reduction to radical or nationalist political attitudes—but I want in this testimony to underline only one explanation: the elites in general in the debtor countries are certainly not the ones that suffer most from the debt crisis; on the contrary, part of them is taking advantage from the debt.

International Economic Issues Hearings, *supra* note 2, at 339 (statement of Professor Luiz Carlos Bresser Pereira, Former Finance Minister, Brazil).

42. Sweeney, *supra* note 39.

43. Klein, *supra* note 20; Charlotte Denny, *Firefighters Turn on Tap Again*, GUARDIAN (U.K.), Aug. 12 2002, at 19.

44. *See* Feldstein, *supra* note 19.

liberalising the country's capital account by relaxing capital controls, Argentina was implementing IMF policy, and the pegging of the peso to the U.S. dollar was supported by the Fund.[45]

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

> [T]he Argentine experience in the 1990s with bank regulatory reform . . . has been one of the most determined efforts, among emerging market countries, to inject credible market discipline into the relationship between banks and depositors, and into the regulatory and supervisory process. . . . Argentina successfully implemented a system of bank regulation that achieved credible market discipline over banks.[46]

Even with a change of government during the severe recession, this record of compliance continued. Upon becoming President in late 1999, Fernando de la Rua raised taxes and made massive cuts in government expenditure, including a 13% cut in state workers' wages and deep cuts to education spending and pensions.[47] President de la Rua's policies were so unpopular that he was forced out of office halfway through his term after violent street protests claimed twenty-two lives in late 2001.[48]

Fiscal contraction is bad policy in any recession, yet the IMF chose fiscal contraction as the first policy prescription for the 1997 Asian Crisis.[49] The Fund repeated this error in Argentina in 1999. It is imperative that the IMF begins to put the maintenance of functional economies and the human rights of the peoples of debtor nations above the short-term capacities of those nations to service their foreign debts fully.[50]

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45. *See id.*

46. Charles W. Calomiris & Andrew Powell, *Can Emerging Market Bank Regulators Establish Credible Discipline? The Case of Argentina, 1992-1999*, at 41 (Nat'l Bureau of Econ. Research, Working Paper No. 7715, 2000), *available at* http://www.nber.org/papers/w7715.

47. Simon Jeffery, *Crisis in Argentina* (Jan. 4, 2002), http://www.guardian.co.uk/theissues/article/0,6512,623072,00.hmtl.

48. Uki Goni, *Argentina Collapses into Chaos* (Dec. 21, 2001), http://www.guardian.co.uk/argentina/story/0,11439,623448,00.html; Mark Alan Healey & Ernesto Semán, *Down, Argentine Way: How the IMF's Darling Collapsed*, AM. PROSPECT, Jan. 28, 2002, at 12. The protests have not stopped since. *See In Brief: Economic Crisis Leads To Protesting*, HOUS. CHRON., Aug. 27, 2002, at A10; *Argentines Protest Against Government Economic Policies*, XINHUA NEWS AGENCY (China), Aug. 31, 2002.

49. *See* Seth Mydans, *Malaysia Taking Pledge of Austerity*, N.Y. TIMES, Dec. 16, 1997, at D11.

50. The critical assessment of IMF policies in Argentina is a heartening development that suggests, perhaps, the IMF is beginning to learn some of these important lessons. *See* INDEP. EVALUATION OFFICE, IMF, *supra* note 36, at 15.

An increasing number of economists believe that Argentina's troubles stem directly from the country's implementation of IMF policies.[51] Certainly, the IMF's policies have contributed substantially to the Argentine Crisis. The policy lesson from the Argentine experience is that following IMF policies closely provides no insurance against ruinous crises. The IMF lauded Argentina's policy settings throughout the 1990s, yet in late 2001, its economy still imploded. Argentina stands as testament to the fact that the IMF can get the policy settings very wrong.

II. THE BRADY PLAN

A. *Overview*

At first, the international financial community thought the 1982 Debt Crisis was a liquidity crisis and that sufficient fresh capital would allow the debtors to grow out of their problems. This was the premise of the Baker Plan, announced in 1985 and named after the then-Secretary of the United States Department of the Treasury (United States Treasury).[52] But by early 1989, the Baker Plan was a dead letter. Banks had wearied of forever advancing new funds. Countries had wearied of their ever-rising level of indebtedness.[53] IMF austerity programs were no longer politically tenable in Latin America. Their continuation could have led to the overthrow of some of the democratic governments that had come to power during the 1980s and the return of totalitarian regimes to the region.[54] Such developments would have been against U.S. interests. A new approach was needed from the U.S. government. That approach was the Brady Plan.

This new initiative represented a sharp departure from the Baker Plan. While that much initially was clear, little else was. Treasury Secretary Nicholas Brady was deliberately vague[55] in his speech on March 10, 1989.[56] His vagueness reflected the United States Treasury's

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51. Larry Rohter, *The World; Giving Argentina the Cinderella Treatment*, N.Y. TIMES, Aug. 11, 2002, at 14.

52. Peter Truell, *Philippine Accord on Debt Reflects U.S. Strategy Shift*, WALL ST. J., Aug. 17, 1989, at 1.

53. John Calverley & Ingrid Iversen, *Banks and the Brady Initiative*, *in* THIRD WORLD DEBT—MANAGING THE CONSEQUENCES 129, 129-32 (Stephany Griffith-Jones ed., 1989).

54. *International Economic Issues Hearings*, *supra* note 2, at 332 (Statement of Professor Luiz Carlos Bresser Pereira, Former Finance Minister, Brazil).

55. Calverley & Iversen, *supra* note 53, at 133.

56. Secretary Brady delivered his speech to a joint meeting of the IMF and the World Bank in Seoul, South Korea, on March 10, 1989. *See* Nicholas F. Brady, Sec'y of the Treasury, Dealing with the International Debt Crisis, Remarks Before a Conference on Third World Debt (Mar. 10, 1989), *in* DEP'T ST. BULL., May 1989, at 53; *see also LDC Finance: Bankers Are*

incapacity "to orchestrate a full-scale 'plan' and make it work"[57] and its unwillingness to be caught in the middle of the negotiations between creditors and debtors.[58]

Secretary Brady proposed a series of individual market-based transactions in which (1) creditors would be invited to participate voluntarily, (2) debt relief would be tied into the conversion of loans into collateralised bonds, (3) debtor nations would be permitted to repurchase their own discounted debt on the secondary market and (4) debt-equity schemes would be promoted.[59] The proposal was seen as an expression of increased urgency from the United States government about the resolution of the 1982 Debt Crisis, a strong call for the development of capital-market-based solutions,[60] and an official acceptance that some debt forgiveness was essential. At long last, the calls for debt relief seemed heeded.[61]

The first Brady-style restructuring was of Mexico's debt. Mexico's strategic importance to the United States was seen as likely to result in the most favourable precedent for other debtor nations. Negotiations between Mexico and its commercial bank creditors began almost a year before the bonds were issued in late March 1990.[62] It was a slow process dragging hundreds of banks to the table when most were resisting strenuously. Many banks were reportedly "disgusted" with the deal but in the end were forced by their respective central banks to go along with it.[63]

The banks were offered a choice from the following three options for their Mexican loans:[64]

Briefed on Brady Plan, INT'L FIN. REV. (London), Mar. 11, 1989, at 28; *Washington's View on Brady*, INT'L FIN. REV. (London), Mar. 18, 1989, at 29.

57. Calverley & Iversen, *supra* note 53, at 133.

58. *Id.*

59. *See* Lee C. Buchheit, *The Background to Brady's Initiative*, INT'L FIN. L. REV., Apr. 30, 1990, at 29; Leslie Fraust, *Debt Plan Spurs Interest in Securitizing LDC Loans*, AM. BANKER, Mar. 28, 1989, at 55.

60. Fraust, *supra* note 59.

61. Rory MacMillan, *The Next Sovereign Debt Crisis*, 31 STAN. J. INT'L L. 305, 313-14 (1995).

62. *LDC Finance—Mexico*, INT'L FIN. REV. (London), Mar. 31, 1990, at 35; *see also* Bruce Wolfson, *Paving the Paper Trail*, 26 LATINFIN. 49, 49 (1991); *Sorting Out Mexico's Bank Debt; At Last?*, ECONOMIST (London), Jan. 13, 1990, at 74; Jonathan Hay & Nirmaljit Paul, *Regulation and Taxation of Commercial Banks During the International Debt Crisis* 3 (World Bank, Technical Paper No. 158, 1991).

63. *IMF Meeting: Hurricane Heading for Brady Plan*, INT'L FIN. REV. (London), Sept. 23, 1989, at 12; *IMF/World Bank Meeting: Commercial Bankers Say Brady Plan Is a Non-Starter*, INT'L FIN. REV. (London), Sept. 30, 1989, at 8.

64. As the restructuring would result in bonds being issued in the United States, the Securities Act of 1933 would on its face apply. To avoid the complexity and expense of

1. The banks could have their loans converted into newly issued thirty-year bonds paying Libor plus 13/16%. The principal of these bonds would be 65% of the principal of the loans they were replacing. Repayment of this principal would be guaranteed by zero coupon bonds issued for the purpose by the United States Treasury, acquired by Mexico and held in escrow.[65] In addition, there would be a rolling guarantee of eighteen months interest.[66] These became known as "discount bonds" because even though they paid a market rate of interest, their principal amount involved a 35% discount from the loans they replaced.[67]
2. The banks could have their loans converted into bonds with the same face value as the loans they replaced but which paid interest at the discounted, fixed rate of 6.25%.[68] The term and collateral for these bonds were the same as for the discounted principal bonds considered above.[69] These became known as "par bonds" because their face value reflected the full face value (par value) of the loans they replaced.[70]
3. The banks could elect to participate in new loans to Mexico in the coming four years to the extent of 25% of their medium- and long-term exposure to Mexico.[71]

Offering the banks a range of restructuring options allowed them to choose the option that most suited their view on interest rates and debtor prospects and their individual tax, regulatory, and accounting position.[72]

The prospects of the Brady Plan were greatly enhanced by a July 14, 1989, letter from the Securities and Exchange Commission (SEC) to David Mulford, the Under Secretary of the United States Treasury, which

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complying with its strictures, counsel for Mexico obtained a "no-action" letter from the SEC, which provided, in effect, an exemption from registration under the Act for the issuance of the bonds and defined the terms upon which subsequent sales of the bonds could be made in the United States. *See* United Mexican States, SEC No-Action Letter, 1990 SEC No-Act. LEXIS 572 (Mar. 23, 1990) [hereinafter SEC No-Action Letter].

65. *Id.* at *4-5, 8-9; Alberto Ganzalo Santos, *Beyond Baker and Brady: Deeper Debt Reduction for Latin American Sovereign Debtors*, 66 N.Y.U. L. REV. 66, 79 (1991).

66. *The Debt Agreement*, MEX. SERVICE, July 27, 1989; Santos, *supra* note 65, at 79. The acquisition of the collateral for these bonds was funded by $1.3 billion from Mexico, $2 billion from Japan, and $3.7 billion from the IMF and the World Bank. *The Debt Agreement*, *supra*.

67. *See* Santos, *supra* note 65, at 79.

68. *Id.* At the time of Mexico's restructuring agreement, July 1989, Libor was 8.81%. The usual interest rate on Mexico's debt was Libor plus 13/16th. The par bonds at 6.25%, fixed, thus represented an interest saving of nearly 3.4%. By way of comparison, 30-year United States Treasury bonds were yielding 8.14%.

69. *The Debt Agreement*, *supra* note 66; Santos, *supra* note 65, at 79.

70. *See* SEC No-Action Letter, *supra* note 64, at *4-5.

71. *The Debt Agreement*, *supra* note 66; Santos, *supra* note 65, at 79.

72. John Clark, *Debt Reduction and Market Reentry Under the Brady Plan*, FED. RES. BD. N.Y. Q. REV., Winter 1993, at 38.

"clarified" the application of the Financial Accounting Standards Board (FASB) *Statement of Financial Accounting Standards No. 15: Accounting by Debtors and Creditors for Troubled Debt Restructurings* (*FAS 15*)[73] to the Mexican Brady restructuring.[74] The relevant part of *FAS 15* provides that if, in full settlement of a debt, a creditor receives assets of which the fair value is less than the recorded value of the debt, then the creditor must record the shortfall as a loss. Where markets exist, the fair value is market value. In the absence of such a market, fair value is to be estimated based on expected cash flows discounted for risk.[75]

Treasury Under Secretary Mulford is commonly regarded as the architect of the Brady Plan, and he had requested, and doubtless shaped, the July 14, 1989, letter from the SEC. In the name of applying *FAS 15* to Mexico's restructuring, the SEC wrote that a loss need not be recognised "[i]f the total future undiscounted cash receipts specified by the new terms of the loan, including receipts designated as both principal and interest, equal or exceed the book value or the loan."[76] This letter is a remarkable document.[77] Upon this criterion, the banks could accept Mexico's Brady bonds in exchange for their loans without having to recognise a loss,[78] notwithstanding that shortly after issue the par bonds were trading at 42% of face value and the discount bonds at 63%.[79] The analysis in this SEC letter represents the apotheosis of the popular international financial crisis game of smoke and mirrors—this letter treated interest as principal and made the value of money in thirty years

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73. FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 15 (1977), *available at* http://www.fasb.org/pdf/fas15.pdf.

74. Letter from S.E.C. to Hon. David C. Mulford (July 14, 1989), *reprinted in* Hay & Paul, *supra* note 62, U.S. Ann. 1 [hereinafter Letter to Mulford].

75. Hay & Paul, *supra* note 62, U.S. Ann. 9.

76. Letter to Mulford, *supra* note 74; *see also* Manuel Monteagudo, *The Debt Problem: The Baker Plan and the Brady Initiative: A Latin American Perspective*, 28 INT'L L. 59, 74 (1994).

77. Upon its manifestly clear meaning, *FAS 15* does not mean to exclude the time value of money from the calculations nor to treat interest as principal. Compare the approach of the Bank of England, where discount bonds were to be placed on bank books at their face value of 65%, with the loss of 35% to be charged to provisions. Par bonds, on the other hand, could be recorded at face value provided the current provisions against Mexican debt were otherwise adequate. *See* Hay & Paul, *supra* note 62, at 43. Given that discount and par bonds were designed to be of equal value and were treated by the international banks as such, this approach, which lays great weight on the face value of the bond and ignores the interest rate, is quite artificial (although not nearly as artificial as the SEC's approach).

78. Monteagudo, *supra* note 76, at 75. The SEC was careful to point out that its analysis of *FAS 15* did not derogate from the general requirements of FASB *Statement of Financial Accounting Standards No. 5*, that loan losses must be recognised when a loan (or bond) is determined to be uncollectible in whole or part. Letter to Mulford, *supra* note 74.

79. *LDC Finance: Indicative Prices for Developing Country Debt*, INT'L FIN. REV. (London), Apr. 21, 1990, at 29.

equal to its current value. By ensuring that Brady bonds could be accepted by banks without provisions or writedowns,[80] and thus without the consequential reductions in profits, provisions or writedowns would have entailed, the SEC made the Mexican restructuring far more palatable for U.S. banks.[81]

This restructuring was of Mexico's medium- and long-term debt to the commercial banks.[82] A great deal of arm-twisting by regulators was required to secure the participation of all banks. Many were very reluctant to participate, but bankers usually find overt pressure from their home regulators difficult to resist. Banks elected to convert 41% of total indebtedness into discounted principal bonds, 49% into discounted interest (par) bonds, and to advance new money for the remaining 10%.[83] Of the three options, new money was to prove by far the most lucrative; Citibank's foresight in taking that option exclusively was richly rewarded.[84] Yet in 1990, substantial pressure was needed to make banks holding the required 10% of exposure agree to advance new money.[85]

This Mexican restructuring was perceived to be a crucial first test of the Brady initiative. Treasury Secretary Brady's proposals were generally treated in the press as entirely novel and without precedent, but the idea had been considered for quite some time.[86] Indeed, the genesis of Brady's proposal was in Latin America, not Washington: the Aztec bonds were developed at Mexico's request in 1988, and there were even earlier proposals by Brazil to convert its foreign debt into thirty-five-year bearer bonds with the same face value as the loans and with below-market fixed

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80. "[B]anks were able to account for both the par and discount bonds issued in Mexico's 1990 debt exchange without recognizing a restructuring loss." Hay & Paul, *supra* note 62, at 114-15.

81. *See id.* at 29. While the exchange of loans for Brady bonds did not lead to writedowns for accounting purposes, an Internal Revenue Service Ruling provided that such exchanges may (and often would) lead to losses for income taxation purposes. *See* Rev. Rul. 89-122 (Nov. 3, 1989), *reprinted in* Hay & Paul, *supra* note 62, U.S. Ann. 5. Hence, banks may well have recorded tax losses from participating in Brady bond exchanges without being required to make writedowns on account of the transaction—a bizarre result which flows directly from defining black as white.

82. Some US$54 billion of medium- and long-term Mexican debt was restructured. Santos, *supra* note 65, at 79.

83. *Third World Debt Strategy: Hearing Before the Subcomm. on International Finance & Monetary Policy of the S. Comm. on Banking, Housing, & Urban Affairs*, 101st Cong. 44-45 (1990) (Statement of William R. Rhodes, Senior Executive—International, Citibank N.A.).

84. Interview with Michael Pettis, Hamilton Arbitrage Fund (Feb. 20, 1996).

85. *Id.*

86. *See Brazil—Time To Securitise Its Debt*, INT'L FIN. REV. (London), Mar. 7, 1987, at 763; *LDC Debt Securitisation*, INT'L FIN. REV. (London), May 7, 1988, at 1444; *Third World Debt: Watch Out—Securitisation Is on Its Way*, INT'L FIN. REV. (London), Dec. 12, 1987, at 3876.

interest rates.[87] The agenda for this restructuring was "established not in Washington, but in Mexico City."[88] Indeed, the U.S. government had initially been strongly resistant to the idea.[89]

A crucial element of the Mexican debt negotiation strategy was the insistence on debt reduction and interest relief. The international financial community resisted any debt relief vigorously. Nevertheless, the Brady Plan was severely criticised for affording inadequate debt relief,[90] criticisms with which this author agrees. With the benefit of hindsight, the banks gained so much from the Brady Plan, they could have afforded to give more to get it.

The actual savings from Brady restructurings are difficult to assess. Moving some of the debt into fixed rate bonds protected the debtors against interest rate rises,[91] but as the general interest rate environment was falling throughout the early 1990s, this did nothing to alleviate repayment burdens relative to having left the debt accruing floating rates. The Brady process did serve an important function in breaking the upward spiral of total indebtedness and reducing the demands on the scarce time of government ministers and civil servants which arose from the periodic restructurings of the 1980s. In John Clark's words:

> The Brady restructurings did not achieve significantly more near-term cash flow relief for debtors than the previous approach. But they did provide a more stable long-run financial framework that, in combination with structural reforms by debtors and a favorable environment of lower global interest rates, helped to restore market access.[92]

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87. *LDC Debt—The Deep Discount Bushfire*, INT'L FIN. REV. (London), Sept. 12, 1987, at 2947. Note, with the exception of collateral, how closely the bonds Brazil proposed resemble the par bonds ultimately issued nearly three years later in Mexico's Brady-style restructuring. *See also International Economic Issues Hearings*, *supra* note 2, at 336-37 (Statement of Luiz Carlos Bresser Pereira, Former Finance Minister, Brazil).

88. *The Debt Agreement*, *supra* note 66. The receptive ear in Washington necessary for Mexico's ideas to gain credence was that of David Mulford, then-Assistant Secretary of the United States Treasury. To his credit, Mulford ran with Mexico's ideas, and when Nicholas Brady became Treasury Secretary, Mulford had a superior who too was willing to listen. Walter S. Mossberg & Peter Truell, *Another Round: Bush Aides Are Likely To Offer a Plan Soon on Third World Debt—U.S. Fears Political Turmoil May Hit Latin America; Banks May Pay Big Price—One Goal: Sparing Taxpayers*, WALL ST. J., Mar. 9, 1989, at 1.

89. *International Economic Issues Hearings*, *supra* note 2, at 336-37 (Statement of Luiz Carlos Bresser Pereira, Former Finance Minister, Brazil); Buchheit, *supra* note 59.

90. Santos has described the Plan as "irreparably flawed" for this and other reasons. Santos, *supra* note 65, at 79-80.

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

92. Clark, *supra* note 72.

In the years following the Mexican restructuring, the commercial banks negotiated agreements with Costa Rica,[93] Morocco, the Philippines,[94] Venezuela,[95] Uruguay,[96] Argentina,[97] Brazil,[98] Bulgaria, the Dominican Republic, Ecuador, Jordan, and Poland.[99]

B. *The Impact of the Brady Plan*

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

The Brady Plan served the banks in four ways:

1. It gave the banks liquid bonds, rather than relatively illiquid loans, which facilitated the banks selling the assets.
2. It triggered a turnaround in secondary market prices of these assets.
3. It enabled debtor nations to start borrowing and issuing bonds, allowing the banks to earn fees.
4. It signaled the end of the 1982 Debt Crisis.[100]

Although the Brady Plan provided these four clear benefits to the financial community, the banks fiercely resisted it at the time. In the

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93. For information on Costa Rica's restructuring, see *Debt Buyback Takes Center Stage in Costa Rican Agreement*, BANK LETTER, Oct. 30, 1989, at 2; Hay & Paul *supra* note 62, at 5-6.

94. Peter Truell, *Philippine Accord on Debt Reflects U.S. Strategy Shift*, WALL ST. J., Aug. 17, 1989, at 1.

95. Prashant Vankudre, *Brady Bonds*, 26 LATINFIN. 48, 53 (1991); Peter Truell, *Venezuela Reaches Debt Settlement with Major Banks*, WALL ST. J., June 29, 1990, at A4.

96. *Secondary Marketplace: Uruguay's Turn*, 22 LATINFIN. 12 (1990); *LDC Debt: Uruguay To Pay 56 Cents for Debt*, INT'L FIN. REV. (London), Nov. 10, 1990, at 29.

97. Richard Voorhees, *Betting on Brady*, 37 LATINFIN. 14 (1992); *Emerging Markets: Argentine Brady Deal*, INT'L FIN. REV. (London), Aug. 15, 1992, at 24; *Emerging Markets-Banks Get Behind Argentina*, INT'L FIN. REV. (London), Sept. 26, 1992, at 22; *LDC Finance-Argentina: Lots of Work Remains on Agreement*, INT'L FIN. REV. (London), Apr. 11, 1992, at 30.

98. *Emerging Markets—No IMF Letter for Brazil*, INT'L FIN. REV. (London), Mar. 19, 1994, at 49; *Brazil—Waiver Approved*, INT'L FIN. REV. (London), Mar. 26, 1994, at 46.

99. Jordan completed its Brady-style restructuring in December 1993, Bulgaria in July 1994, the Dominican Republic in August 1994, Poland in October 1994, and Ecuador in 1995. WORLD BANK, WORLD DEBT TABLES: EXTERNAL FINANCE FOR DEVELOPING COUNTRIES 4-5, 27-29 (1994); *see id.* at 68-75 (discussing details of the terms of each restructuring); Kenneth N. Gilpin, *Foreign Debt Mop-Up; After Refinancing Brazil, Banks Now Face Just a Few Small Bad International Loans*, N.Y. TIMES, Apr. 18, 1994, at D1 (discussing restructuring generally); *The Next Generation*, INT'L FIN. REV. (London), Apr. 23, 1994 (available on International Financing Review CD-Rom 1996) (same); *Bulgaria—Brady Deal Assessed*, INT'L FIN. REV. (London), May 7, 1994 (discussing Bulgaria's restructuring); Richard Voorhees, *Rejoining the Fold; Ecuador Becomes the Latest Latin American Nation To Agree to a Brady Accord*, 58 LATINFIN. 60 (1994) (discussing Ecuador's restructuring).

100. For a detailed consideration of these four benefits, see Ross P. Buckley, *Turning Loans into Bonds: Lessons for East Asia from the Latin American Brady Plan*, 1 J. RESTRUCTURING FIN. 185 (2004).

words of *The Economist*, "[t]he bosses of most of America's big money-centre banks bristle with rage at any mention of the Brady Plan. They fume at the write-offs they have had to make on their developing-country debt portfolios."[101] At the time, the banks could not recognise what would prove to be in their own best interests.

The Brady Plan also served the debtor nations. The Brady plan signalled the end of the 1982 Debt Crisis, in the perception of the international financial community. This perception mattered because it meant the debtor nations could return to the voluntary capital markets with bond issuances and because foreign investment capital began flowing into the region, albeit slowly at first.

Whether the Brady Plan resolved the 1982 Debt Crisis from the perspective of the debtors is another issue altogether. The debt is still there, being serviced today, in the form of Brady bonds, along with a tremendous amount more borrowed since then. From the perspective of peasants in the fields of Mexico or Ecuador, who receive far poorer health services and education for their children than they would if such a high proportion of their government's income did not go into debt service, it is arguable the 1982 Debt Crisis has never gone away. The Brady Plan did resolve the crisis from the perspective of the creditors, and this has been important in revitalising the region and assisting the debtors through the stimulative effects of fresh capital flows.

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

III. CHILE'S RESPONSE TO INCREASING CAPITAL INFLOWS IN THE EARLY 1990S

By the end of the 1980s, foreign capital was starting to flow again into Chile in increasing amounts. While the rest of Latin America remained mired in the 1982 Debt Crisis, a debt restructuring would not be required for Chile. Its economy was stronger than that of its neighbours, and it was attractive to foreign investors.

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101. *Brady's Bazaar*, ECONOMIST (London), May 12, 1990, at 77; *see also Schulmann Speaks Out*, LDC DEBT REP., Sept. 21, 1992, at 4 ("Forced debt forgiveness was not essential . . . . All parties concerned might be better off today [without it]." (quoting Horst Schulman, Managing Director of the Institute of International Financing)).

The damage to Chile by the sudden cessation of foreign capital inflows in 1982 was still fresh in the mind when Chile's capital account surplus reached 10% of its GDP in 1990. Short-term flows represented one-third of this amount, exacerbating the potential for instability.[102] Fearing a repeat of 1982, Chile introduced capital inflow controls in 1991.

The capital controls had five elements:

1. All portfolio flows including foreign loans and bond issues were subject to the requirement that an amount equal to a set proportion of the flow had to be put on interest-free deposit with the Central Bank for one year irrespective of the duration of the capital inflow. The proportion was initially set at 20%. In May 1992, it was increased to 30%, and then in June 1996, to 10%.
2. Credit lines for trade finance were subject to the same reserve requirements.
3. Bonds issued abroad by local companies had to have an average minimum maturity of four years.
4. Share issuance abroad by local companies was limited to companies with relatively high credit ratings and to amounts no less than US$10 million.
5. Initial investment capital (but not profits) in foreign direct investment could not be repatriated for one year.[103]

The first four restrictions are inflow controls, while the last one is an outflow control. Most international attention focused on the first restriction, the unremunerated reserve requirement. The second restriction, on trade finance credit, is undesirable in that it tends to reduce a nation's international trade but necessary as otherwise the first restriction would be too readily circumvented.

The general consensus is that Chile's controls served to lengthen the average maturity of the capital it received.[104] The clearest lesson from the

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102. Carmen M. Reinhart & R. Todd Smith, Temporary Capital Controls 8 (Aug. 1997) (unpublished manuscript, on file with the *Tulane Journal of International and Comparative Law*).

103. Ramkishen Rajan, *Restraints on Capital Flows: What Are They?* 19 (Inst. of Pol'y Studs., Working Paper No. 3, 1998).

104. Akira Ariyoshi et al., *Capital Controls: Country Experiences with Their Use and Liberalization* 76 (Int'l Monetary Fund, Occasional Paper No. 190, 2000), *available at* http://www.imf.org/external/pubs/ft/op/op190/index.htm; Sebastian Edwards, *How Effective Are Capital Controls?* 14-16 (Nat'l Bureau of Econ. Research, Working Paper No. 7413, 1999), *available at* http://www.nber.org/papers/w7413; Barry Eichengreen et al., *Capital Account Liberalization: Theoretical and Practical Aspects* 49-52 (Int'l Monetary Fund, Occasional Paper No. 172, 1998); Martin Feldstein, *A Self-Help Guide for Emerging Markets*, FOREIGN AFF., Mar./Apr. 1999, at 93; Reinhart & Smith, *supra* note 102, at 9; Rajan, *supra* note 103, tbl. 3; Joseph Stiglitz, *Bleak Growth Prospects for the Developing World*, INT'L HERALD TRIB., Apr. 10, 1999, at 6.

crisis in Mexico in 1995, the 1997 Asian Crisis, and the 1998 Russian Crisis was the danger of excessive short-term indebtedness and other forms of short-term capital inflows.[105] Strong evidence exists that the ratio of short-term debt to foreign currency reserves is a powerful predictor of financial crises and that higher short-term debt levels are associated with more severe crises.[106] Developing countries' needs simply are not met by short-term financing. Accordingly, there is a strong argument for capital controls along Chilean lines that fall most heavily on short-term inflows.[107]

Views are more divided over whether Chile's controls also served to reduce the volume of capital inflows.[108] Certainly, there was a strong initial effect: the capital account surplus fell from 10% of GDP in 1990 to 2.4% in 1991 and short-term debt inflows were virtually eliminated.[109] When capital inflows surged again in 1992, the proportion of the unremunerated reserve requirement was increased, again successfully.[110] Eventually, in 1998, the controls were lifted altogether. This occurred in the aftermath of the Asian crisis when global capital flows to emerging markets nations declined precipitously and there was no longer a need to discourage capital inflows and shift those that were coming in towards longer maturities.[111] Foreign direct investment appears to have been relatively unaffected by the controls.[112]

The controls increased the cost of credit within Chile considerably, particularly for small and medium size businesses that found evasion of the controls difficult.[113] This was a substantial price to pay. Nonetheless, Chile's controls altered the mix of incoming foreign capital in favour of long-term debt and away from instability-inducing short-term debt.

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105. Eichengreen et al., *supra* note 104, at 22.

106. Dani Rodrik & Andrés Velasco, *Short-Term Capital Flows* 17 (Nat'l Bureau of Econ. Research, Working Paper No. 7364, 1999).

107. Barry Eichengreen, Capital Controls: Capital Idea or Capital Folly? 5-6 (Nov. 1998) (unpublished manuscript, *available at* http://emlab.berkeley.edu/pub/users/eichengr/capcontrols.pdf).

108. Eichengreen et al., *supra* note 104, at 49-52; Reinhart & Smith, *supra* note 102, at 9; Rajan, *supra* note 103, tbl. 3.

109. Reinhart & Smith, *supra* note 102, at 9.

110. In the short term, the increase in unremunerated reserve requirements was effective; however, by 1996, over 40% of Chile's debt to banks reporting to the Bank of International Settlements had an admittedly residual maturity of less than one year. *See, e.g.*, Edwards, *supra* note 104, at 25.

111. Francisco Gallego, Leonardo Hernández & Klaus Schmidt-Hebbel, Capital Controls in Chile: Effective? Efficient? 4 (unpublished manuscript presented at the Latin American and Caribbean Economic Association 2000 Annual Meeting, Rio de Janeiro, Oct. 12, 2000, *available at* http://www.lacea.org/meeting2000/franciscogallego.pdf).

112. Reinhart & Smith, *supra* note 102, at 9.

113. Edwards, *supra* note 104, at 25.

Additionally, the controls served to reduce rapidly increasing levels of inflows in 1991 and again in 1992.[114]

In conclusion, as long as a developing nation has a thin financial market, unsophisticated private sector risk management techniques, and an unsophisticated and under-resourced capital market regulator, there are good arguments for controls, from time to time, on capital in-flows.[115] This is particularly so in Asia, where high, local savings rates significantly diminish the need for completely open capital markets. As an economy's own capital markets deepen and its regulatory systems mature, it can begin to liberalise its capital account safely. Many developing nations are years away from being in that position.

In the interim, of course, the admonition against free lunches generally holds. Capital controls have costs. They restrict access to foreign capital for investment, increase real interest rates, require expensive public administration, and may reduce the pressure for domestic policy reform.[116] In particular, capital controls require considerable administration, and just as with trade barriers, capital controls can reduce the pressure for, and thus delay, needed policy adjustments.[117] Developing nations must continue policy reform and the development of efficient regulatory institutions, even when controls are in place.

Capital controls are a policy option that the IMF is unlikely to advocate because the United States is the world's largest importer of capital and the strategic interests of the United States and of its banking sector require free capital mobility. While the IMF is often treated in literature as if it were a completely autonomous institution, this is not the case. The strategic direction and policies of the IMF are set in the twice

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114. Ariyoshi et al., *supra* note 104, at 16-17. The authors concluded that inflow controls were partly effective in reducing the level and increasing the maturity of inflows in Malaysia and Thailand and in affecting the composition of the inflows in Colombia and possibly in Chile, but inflow controls were largely ineffective in Brazil. *Id.*

115. Pablo Bustelo et al., *Global and Domestic Factors of Financial Crises in Emerging Economies: Lessons from the East Asian Episodes (1997-1999)*, at 84 (Instituto Complutense de Estudios Internacionales Universidad Complutense de Madrid, Working Paper No. 16, 1999). This was a recommendation of the Council on Foreign Relations in the United States. *See The Future of the International Financial Architecture: A Council on Foreign Relations Task Force*, FOREIGN AFF., Nov./Dec 1999, at 169.

116. *The Perils of Global Capital*, ECONOMIST (U.S.), Apr. 11, 1998, at 52. And, of course, capital flows are not the only mechanism for the transmission of contagion. Even a completely closed capital account will not insulate an economy from trade-related contagion, *Emerging-Market Measles*, ECONOMIST (U.S.), Aug. 22, 1998, at 56, as Taiwan experienced in the wake of the Asian crisis. *See, e.g.*, Robert Wade & Frank Veneroso, *The Gathering World Slump and the Battle over Capital Controls*, NEW LEFT REV. (London), Sept./Oct. 1998, at 13.

117. *See* Ariyoshi et al., *supra* note 104, at 7, 41-42.

yearly meetings of their Board of Governors over which the United States has enormous influence. Nonetheless, as the above case study suggests, inflow controls can play a real role in stabilizing an economy during periods of high and increasing inflows of global capital. When needed, controls are a policy option that developing nations should be ready to implement.

IV. MALAYSIA'S EXPERIENCE IN THE 1997 ASIAN CRISIS

During the 1997 Asian Crisis, Malaysia was the only severely affected country that did not adopt an IMF program.[118] With the benefit of hindsight, Malaysia's choice was demonstrably right for it. Malaysia's policies assisted its recovery from the crisis at least as fast as countries that implemented IMF policies, and Malaysia's poor are significantly better off today than they would have been under IMF policies. Malaysia also benefited in a number of other ways from charting its own course through the crisis.

Malaysia's initial response to the crisis was referred to by many as "an IMF package without the IMF."[119] At the time, while consulting with the IMF,[120] Malaysia's Finance Minister Anwar Ibrahim tightened fiscal policy and made sharp spending cuts.[121] This policy was subsequently altered on an ad hoc basis, until Prime Minister Mahathir Mohamad announced a complete change of policy with the introduction of the National Economic Recovery Program in July 1998.[122] Malaysia's decisive departure from IMF orthodoxy involved an increase in government spending to stimulate the economy, capital controls to allow the government more control over the economy and to prevent the outflow of foreign capital that would have ensued, and a restructuring package for the financial sector.[123]

After this policy turnaround, Malaysia initially implemented a stabilisation process and then undertook the restructuring of its financial

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118. The Philippines did not adopt an IMF program in response to the crisis, because the crisis did not severely affect the country. *See* THE PHILIPPINE ECONOMY: DEVELOPMENT, POLICIES, AND CHALLENGES 4-5 (Arsenio M. Balisacan & Hal Hill eds., 2003).

119. James Kynge, *Ringgit Rallies as Malaysia Unveils Austerity Plan*, FIN. TIMES (London), Dec. 6, 1997, at 3.

120. *See* Michael Shari, *Are These Bootstraps Strong Enough? Malaysia Makes a Bid for Homegrown Restructuring*, BUS. WK., Dec. 15, 1997, at 32.

121. Kanitta Meesook et al., *Malaysia: From Crisis to Recovery* 10 (Int'l Monetary Fund, Occasional Paper No. 207, 2001).

122. PREMA-CHANDRA ATHUKORALA, CRISIS AND RECOVERY IN MALAYSIA: THE ROLE OF CAPITAL CONTROLS 73-76 (2001).

123. Meesook et al., *supra* note 121, at 7-9.

system.[124] The stabilisation process involved the establishment of institutions to purchase nonperforming loans and recapitalise financial institutions. The restructuring phase involved the merger of financial institutions and the development of the local bond market.[125]

Malaysia reduced the amount of nonperforming loans financial institutions carried, recapitalised these institutions, and strengthened the system by closing and merging banks.[126] Like other 1997 Asian Crisis countries, Malaysia also implemented "a blanket deposit guarantee and . . . liquidity support."[127]

Malaysia's two unique responses to the crisis were the introduction of capital outflow controls and the pegging of the ringgit to the United States dollar.[128] Once these policies were introduced, the government was able to ease monetary policy because it was no longer hampered by concerns about the impact on the exchange rate of capital outflows.[129]

The outflow controls[130] blocked all avenues for the transfer of the ringgit outside Malaysia and stopped non-residents from removing portfolio capital from Malaysia for a period of twelve months.[131] After six months passed, a variable exit levy, applying to principal or profit from investments in Malaysian securities, replaced the twelve-month restriction.[132] The ringgit was pegged to the United States dollar in an attempt to prevent speculation in the ringgit.[133]

The introduction of the exchange controls and the currency peg is widely acknowledged as sound policy, even in hindsight by the IMF.[134] In the IMF's review of Malaysia's policies between 1997 and 2000, the changing public sentiment towards these policies is noted:

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124. Mahani Zainal Abidin, *Malaysia's Economy: Crisis and Recovery*, *in* THE FINANCIAL CRISIS IN MALAYSIA: THE ECONOMIC AND POLITICAL CONSEQUENCES 1, 1-2 (1999).

125. *Id.* at 2.

126. *Id.* at 4.

127. Meesook et al., *supra* note 121, at 9.

128. *Id.* at 7.

129. *Id.* at 7-8.

130. Malaysia had itself implemented inflow controls in 1994 but is far better known for these later outflow controls. The inflow controls included, among other things, a ceiling on nontrade and non-investment external liabilities of banks, a prohibition on sales of short-term bonds to non-residents, and a prohibition on non-trade related swaps and forward transactions on the bid side with foreigners. Rajan, *supra* note 103, tbl.4.

131. Meesook et al., *supra* note 121, at 14; Ross P. Buckley, *The Role of Capital Controls in International Financial Crises*, 11 BOND L. REV. 231, 237 (1999).

132. Meesook et al., *supra* note 121, at 14.

133. *Id.*

134. RAMON V. NAVARATNAM, MALAYSIA'S ECONOMIC SUSTAINABILITY: CONFRONTING NEW CHALLENGES AMIDST GLOBAL REALITIES 35 (2002).

> Market assessment turned more positive, however, as it became clear that Malaysia's macroeconomic policies were not out of line, that the undervalued pegged exchange rate was contributing to the rapid recovery of exports and output, and that financial sector reforms were being vigorously pursued.[135]

Malaysia's response to the 1997 Asian Crisis also involved significant financial sector reform, which the IMF notes "led to substantial improvement in the sector's performance."[136] This strategy has subsequently met with IMF approval: "This multipronged approach [involving Danaharta and Danamodal, two financial companies, to acquire nonperforming loans and recapitalize banks, as well as the Corporate Debt Restructuring Committee to facilitate debt workout by large borrowers,] has proved to be a credible plan in the restructuring of Malaysia's financial sector."[137]

Malaysia managed its economy successfully without the IMF. The government's expansionary fiscal policy prevented the economy from going into further recession. This policy stimulated the economy, which improved confidence. The expansionary fiscal policy and the improved confidence then combined to improve domestic demand.[138]

The expansionary approach is not novel. Indeed, most economists recommend expansionary fiscal settings in times of recession. However, to be able to adopt these expansionary policies, Malaysia had to impose capital controls because the expansionary policies would have provoked an exodus of foreign capital that would have more than counteracted any stimulative effect the expansionary policies could have delivered.[139] The capital controls were a novel step.

Capital controls had been suggested in this context by Paul Krugman, an economics professor.[140] He stressed that such controls (1) should only be temporary because of the way they distort the

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135. Meesook et al., *supra* note 121, at 3.

136. *Id.* at 71.

137. *Id.* at 74.

138. Mohamed Ariff & Azidin Wan Abdul Kadir, The Near-Term Outlook for the Malaysian Economy 2 (2000) (unpublished manuscript *available at* http://bookshop.iseas.edu.sg/).

139. *See* Abidin, *supra* note 124, at 5-6; Meesook et al., *supra* note 121, at 13. Another way of saying the same thing is that controls "allow domestic policy makers to break the links between interest rates and exchange rates, so that interest rates can be lowered without incurring the cost of a currency devaluation." Giancarlo Corsetti, Paolo Pesenti & Nouriel Roubini, *What Caused the Asian Currency and Financial Crisis? Part II: The Policy Debate* 24 (Nat'l Bureau of Econ. Research, Working Paper No. 6834, 1998), *available at* http://papers.nber.org/papers/w6834; *see also* BARRY EICHENGREEN, TOWARD A NEW FINANCIAL ARCHITECTURE: A PRACTICAL POST-ASIA AGENDA 56 (1999).

140. Paul Krugman, *Saving Asia: It's Time To Get Radical*, FORTUNE, Sept. 7, 1998, at 74.

economy, (2) should never be used to defend an over-valued currency, and (3) could provide a government with breathing space in order to undertake reforms during a crisis and must "serve as an aid to reform, not an alternative."[141] Malaysia's use of controls met all of these principles. After three years the controls were all but gone.[142] Malaysia exercised monetary discipline and did not use the controls to inflate the currency, inflate the economy, or bail out companies.[143] It used the breathing space afforded by the controls to implement financial and corporate reforms.[144] The IMF noted that "[t]he successful experience of the 1998 controls so far is largely due to the appropriate macroeconomic policy mix that prevailed at that time"[145] and that the controls were effective because they "were wide ranging, effectively implemented, and generally supported by the business community."[146]

While capital controls of the type implemented in Malaysia can be circumvented in various ways (notably through the settlement of commercial transactions, dividend payments, intra-firm transfers, and misinvoicing) there was limited circumvention in Malaysia because of the design and enforcement of the controls.[147] The controls were designed to affect all channels for the movement of the ringgit offshore, while allowing current account transactions and direct foreign investment.[148] This selectivity minimised circumvention of the controls by leaving open certain options for investment in Malaysia through channels the government did not consider problematic from the perspective of capital flows.

A. Pegging the Currency

The decisive and unorthodox crisis policy of pegging the ringgit to the United States dollar gave the government more control over its economic policy and prevented speculation in the ringgit.[149] The danger of a pegged exchange rate is that it may be, or become over time,

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141. Open Letter from Paul Krugman to Prime Minister Mahathir (Sept. 1, 1998) (*available at* http://web.mit.edu/krugman/www/mahathir.html).

142. K.S. Nathan, Economic Slowdown and Domestic Politics: Malaysia Boleh? 4 (2001) (unpublished manuscript, *available at* http://bookshop.iseas.edu.sg/).

143. Abidin, *supra* note 124, at 6.

144. Meesook et al., *supra* note 121, at 13.

145. *Id.* at 63.

146. Int'l Monetary Fund [IMF], *Malaysia: Selected Issues*, at 18, IMF Staff Country Report No. 99/86 (Aug. 1999) (prepared by Kalpana Kochhar et al.) [hereinafter International Monetary Fund].

147. Meesook et al., *supra* note 121, at 54.

148. *Id.*

149. *Id.* at 50.

overvalued, as was the case for Argentina as the 1990s progressed. Malaysia avoided this danger.[150] In fact, Malaysia pegged the ringgit at an undervalue, which boosted exports.[151] This undervaluing also served as "an incentive for retaining funds in the country."[152] The peg reportedly "reduced uncertainty and made it easier for business to plan."[153] As Ramon Navaratnam noted, there has been widespread acknowledgment of the efficacy of Malaysia's currency peg.[154]

B. *Comparative Economic Performance of Malaysia*

To compare Malaysia's rate of recovery with other 1997 Asian Crisis countries, we can use the comparative GDP growth rate as a rough indicator. The following table outlines the percentages of GDP changes for the main crisis countries before the crisis in 1995 and as Asia was recovering from the crisis in 1999.

Table 1. Percent Change in GDP of Selected Countries 1995-1999[155]

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

This table shows Malaysia as second only to the Republic of Korea in its rate of recovery in 1999. It also shows that Malaysia's negative rate of growth in 1998 was significantly less than Indonesia's and Thailand's, and not much more than Korea's. The most comparable 1997 Asian Crisis country to Malaysia, considering its level of development and the maturity of its system, is Thailand.[156] The above table shows Malaysia recovered slightly quicker than Thailand.

Others agree with this assessment.[157] Merrill Lynch described Malaysia's recovery as "one of the most impressive ever."[158] Ethan

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150. *Id.* at 13.
151. *Id.*
152. *Id.*
153. International Monetary Fund, *supra* note 146, at 10.
154. NAVARATNAM, *supra* note 134, at 35.
155. CEIC Data, http://www.ceicdata.com (last visited Nov. 15, 2006).
156. ATHUKORALA, *supra* note 122, at 95.
157. Abidin, *supra* note 124, at 7.
158. Antonia Marika Viczany et al., *Australian Business Attitudes to Malaysia*, *in* MALAYSIAN BUSINESS IN THE NEW ERA 29 (Chris Nyland et al. eds., 2003) (citation omitted).

Kaplan and Dani Rodrik wrote that "[c]ompared to IMF programs, we find that the Malaysian policies provided faster economic recovery, smaller declines in employment and real wages, and more rapid turnaround in the stock market."[159] And in late 1999 the Economic Strategic Institute noted that "despite the bad press it gets as a result of Prime Minister Mahathir's critical comments about speculators, Malaysia is the best story in the region."[160]

C. The Social Effects of Malaysia's Policies

Malaysia's policies had a far more benevolent impact on Malaysian society than did the IMF's policies in other 1997 Asian Crisis countries.[161] Pre-crisis economic policy in Malaysia involved extensive affirmative action to improve the position of the native Malays (Bumiputras).[162] The Malaysian government was experienced in using economic policy to support social policy and did not forget this interrelationship during the crisis. As a result, the Malaysian government's policies did not affect the poor as harshly as IMF policies did in other 1997 Asian Crisis countries. In the words of one commentator, "the costs were not borne primarily by the poor and dispossessed, as occurred in some neighbouring states with great consequent social costs."[163] And, as Prema-chandra Athukorala of the Australian National University noted, "the new policy measures enabled Malaysia to achieve recovery while minimizing social costs and economic disruptions associated with a more market-oriented path to reform."[164]

D. Reasons for the Success of Malaysia's Policies

There are a number of possible reasons for the success of Malaysia's policy response to the 1997 Asian Crisis. These include:

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

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159. Ethan Kaplan & Dani Rodrik, *Did the Malaysian Capital Controls Work?*, at i (Nat'l Bureau of Econ. Research, Working Paper No. 8142, 2003), *available at* http://papers.nber.org/papers/W8142.

160. ATHUKORALA, *supra* note 122, at 93 (citation omitted).

161. Chris Nyland et al., *Economic and Social Adjustment in Malaysia in the 'New' Business Era*, *in* MALAYSIAN BUSINESS IN THE NEW ERA, *supra* note 158, at 1, 2.

162. MAHATHIR BIN MOHAMAD, THE WAY FORWARD 85 (1998).

163. Nyland et al., *supra* note 161, at 2.

164. ATHUKORALA, *supra* note 122, at 113.

Each will be considered.

1. Malaysia's Experience as an Economic Manager

Given the high level of government involvement in its economy since independence, Malaysia is an experienced economic policy maker.[165] Malaysia gained experience in imposing temporary capital controls in 1994, in response to speculative short-term capital inflows.[166] Ismail Muhd Salleh of Malaysia's Institute of Strategic and International Studies and Saha Dhevan Meyanathan of the World Bank note that in the three decades since 1960, "Malaysia has achieved growth, equity and structural transformation in an ethnically diverse society."[167] The country did so by focusing on social enrichment as the goal of economic growth, rather than on economic performance as an end in itself.[168]

2. Controls as a Response to a Financial Panic

One indisputable cause of the 1997 Asian Crisis was a self-fulfilling panic by investors.[169] In former Federal Reserve Chairman Alan Greenspan's words, the reaction of the markets to the problems in Asia was based on "a visceral engulfing fear."[170] Jeffrey Sachs, an economics professor, went so far as to say that there was no reason for the financial panic except panic itself.[171] This panic took the form of "a self-fulfilling withdrawal of short-term loans."[172] In the face of rapid capital outflows, unconventional tactics may be the only thing that can protect an economy.[173] Jagdish Bhagwati, an authority on trade and development, expressed this sentiment memorably: "Markets may do something when you have done nothing wrong and you may have to do something wrong in order to convince the markets that you are doing something right!"[174]

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165. ISMAIL MUHD SALLEH & SAHA DHEVAN MEYANATHAN, THE LESSONS OF EAST ASIA: MALAYSIA: GROWTH, EQUITY AND STRUCTURAL TRANSFORMATION 1 (1993).

166. Reinhart & Smith, *supra* note 102, at 10; Prema-Chandra Athukorala, *Capital Mobility, Crisis and Adjustment: Evidence and Insights from Malaysia*, *in* CAPITAL FLOWS WITHOUT CRISIS? RECONCILING CAPITAL MOBILITY AND ECONOMIC STABILITY 255, 257 (Dipak Dasgupta, Marc Uzan & Dominic Wilson eds., 2001).

167. SALLEH & MEYANATHAN, *supra* note 165, at ix.

168. *Id.* at 48.

169. Buckley, *supra* note 32, at 441.

170. Paul Kelly, *IMF Tightens the Screws on Suharto*, AUSTRALIAN, Mar. 11, 1998, at 13.

171. JEAN TIROLE, FINANCIAL CRISES, LIQUIDITY, AND THE INTERNATIONAL MONETARY SYSTEM 44 (2002).

172. *Id.*

173. EICHENGREEN, *supra* note 139, at 56.

174. ARIEL BUIRA, AN ALTERNATIVE APPROACH TO FINANCIAL CRISES 10 (1999).

3. Appropriateness of Home-Grown Economic Policies

Economic recovery is best achieved with policies that suit the condition of the economy in question.[175] One explanation for the success of Malaysia's policies is that it understood its own economy well and was able to design a particularly appropriate set of policies for it. Similarly, because Malaysia implemented its own reform program, rather than having it imposed from outside, the program seems to have been implemented more rigorously than were the reforms in IMF program countries. This claim is supported by the IMF: "Malaysia has moved ahead of other crisis countries in respect to formulation of prudential regulation, resolution of nonperforming loans, restoration of capital adequacy, and implementation of a bank consolidation program."[176]

An example of the lack of political will seen in many other 1997 Asian Crisis countries was evident in Indonesia's implementation of reforms. According to one respected commentator, within days of signing the US$40 billion accord with the IMF, "economic reforms seemed to disappear from the [Indonesian] Government's agenda."[177]

E. Conclusions on Malaysia's Experience

Malaysia's economic policies during the 1997 Asian Crisis, on balance, delivered slightly better, and certainly no worse, economic results than those in countries under IMF programs. This should be unsurprising. In reforming its system, Malaysia was implementing home-grown policies, not those imposed by an external supranational institution. Policies developed abroad are rarely likely to be adopted and enforced with the enthusiasm and rigor of those developed at home. This is a simple fact of human nature. We all more willingly do what we choose to do, rather than what we are told to do. So, if for no other reason, one should expect more rigorous implementation and enforcement of home-grown policies, which is precisely what was seen in Malaysia relative to other 1997 Asian Crisis countries that were under IMF programs.

In addition, Malaysia's policies during the crisis were better suited to its specific circumstances than the policies in IMF program countries. Malaysia's history of economic affirmative action in relation to its

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175. Abidin, *supra* note 124, at 6.

176. Meesook et al., *supra* note 121, at 15.

177. David E. Sanger, *I.M.F. Now Admits Tactics in Indonesia Deepened the Crisis*, N.Y. TIMES, Jan. 14, 1998, at A1.

Bumiputra population was accommodated during the crisis in a way that an IMF program was unlikely to do.

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

Malaysia's refusal to adopt IMF policies also allowed it to keep control of its own economic destiny. This was preferable because it meant Malaysia could act solely in its own best interests. Unlike the IMF, it was not responsible for protecting the international financial system as a whole. Retaining control of economic policy also ensured that decision-making power in Malaysia remained with those who were elected to represent its citizens.

While Malaysia's policies may have made no large difference to its "bottom line" during the 1997 Asian Crisis, there were many important ways in which they were good for Malaysia. Given that Malaysia's policies certainly delivered no worse economic results than IMF policies elsewhere in the region, there can be no doubt that Malaysia's decision not to request IMF assistance and instead pursue its own path out of the 1997 Asian Crisis was right for Malaysia.

F. A Positive Postscript: The Avoidance of Moral Hazard

A further bonus of Malaysia's approach was the avoidance of the substantial moral hazard occasioned by the IMF-organised bailouts of Indonesia, Korea, and Thailand.[178] A central tenet of IMF policies is that markets allocate resources best. However, the IMF is inconsistent; it often does not allow markets to allocate losses in bad times. This engenders moral hazard. Moral hazard arises whenever a financial actor does not bear, or anticipate bearing, the full risk attached to its actions.[179]

Indonesia, Korea, and Thailand were required to use the bailout loans arranged by the IMF to repay the credits that were then due, i.e., the debts owed to short-term creditors.[180] Systemically, this was foolish because it encouraged the extension of short-term debt, the very type of debt that renders an economy more vulnerable to volatility. It also

178. *See, e.g.*, Buckley, *supra* note 32, at 433-35 (explaining the moral hazard resulting from IMF-organized bailouts in Indonesia, Korea, and Thailand, and the ways in which it contributed to Russia's economic meltdown in 1998).

179. *Id.*

180. *See, e.g.*, Merrill Goozner, *IMF Seeks Money System Shakeup; Agency Moves Toward a Financial Police Role*, CHI. TRIB., Apr. 17, 1998, at 1.

shielded the short-term creditors from the losses that would otherwise have ensued, and for which the high interest rates they had received were compensation.[181]

This meant that in the following year, 1998, short-term creditors pumped massive amounts of credit into Russia to claim returns as high as 50% or 60% per annum on short-term Russian government bonds while relying on an IMF-arranged bailout for the repayment of principal. In the words of Desmond Lachman of Salomon Smith Barney, "Anybody who questions that Russia's fundamentals were worthy of investment . . . wasn't operating in the markets at the time. . . . Most [investors] who did take positions on Russia were doing this on the argument that Russia was too big to fail and that the G-7 [nations] would . . . bail them out."[182]

The proper operation of the market would have led to an earlier and more gradual withdrawal from investing in Russia, but it was profoundly affected by the moral hazard of an anticipated bailout.[183] Russia's geopolitical significance, in particular, meant investors were very confident that it would not be allowed to default on its financial obligations.[184] Such were the consequences of the IMF short-circuiting the market mechanism with its bailouts of the 1997 Asian Crisis countries. Malaysia's policies avoided this problem.

V. LESSONS

The most important lesson from this survey is that debtor nations need to develop their own creative and innovative solutions to their own financial problems. The conceptual thinking that came to fruition as Brady bonds was done in Sao Paulo and then refined and then developed in Mexico City.[185] The Brady Plan was not developed in Washington, D.C., notwithstanding its name and the assumptions of most commentators. It is critical that developing countries do not rely upon the IMF, World Bank, or United States Treasury to do the creative thinking needed to deal effectively with their specific situations.

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181. Jeffrey D. Sachs, *Power Unto Itself*, FIN. TIMES (London), Dec. 11, 1997, at 21.

182. Desmond Lachman, Managing Dir., Emerging Mkts. Econ. Research, Salomon Smith Barney, Remarks at the International Monetary Fund Forum: Financial Markets: Coping with Turbulence (Dec. 1, 1998), *available at* http:www.imf.org/external/np/tr/1998/TR981201.HTM.

183. Timothy L. O'Brien, *When Economic Bombs Drop, Risk Models Fail*, N.Y. TIMES, Oct. 4, 1998, at C4; *Splendid Isolation No Longer*, INT'L FIN. REV. (London), Aug. 15, 1998, at 1.

184. "Many [investors] refused to believe the United States and the International Monetary Fund would allow Russia to collapse until it actually happened." Jonathan Fuerbringer, *After Russian Lesson, Bond Prices Remain Stable in Latest Crisis*, N.Y. TIMES, Jan. 14, 1999, at C1.

185. *See supra* Part II.

In developing its own solutions to its own problems, a nation can, of course, engage external expertise.[186] At Mexico's request, JP Morgan had major input into the development of the Aztec bonds for Mexico in 1987 and 1988, and some of the lessons from these bonds were incorporated into the design of the Brady bonds.[187] But the history of the Brady Plan suggests strongly that debtor nations need to devise their own solutions to their own problems and then "sell" the solutions subtly to the international financial community.

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

The other principal lesson flows from a comparison of Malaysia's and Argentina's experiences. Malaysia successfully charted its own course out of the 1997 Asian Crisis using, among other measures, capital controls to which the IMF was, at the time, implacably opposed. Argentina, on the other hand, pursued IMF orthodoxy to the point of economic collapse.

Developing countries, at least those with the resources to operate sophisticated economic ministries, may well be better placed to develop innovative and effective policy responses to the challenges of global capital than is the IMF for several reasons. First, the country's domestic treasury and ministry of finance are more likely to understand their own economy better than outsiders. The influence of culture and local institutions on economic performance is strong. Policies crafted without a deep understanding of the culture and local institutions are less likely to succeed and policies that succeed in one institutional setting may not succeed in another.

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

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186. For a rich resource of research on the economic challenges facing developing countries and potential solutions to the challenges, see the Web site of the International Development Economics Associates, http://www.networkideas.org (last visited Nov. 11, 2006).

187. *See, e.g.*, Wolfgang Saxon, *Rodney B. Wagner, 74; Arranged Loan for Mexico*, N.Y. TIMES, Apr. 3, 2005, at 36.

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

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