Find more at http://www.downloadslide.com

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

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

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

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

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

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

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

13.1 International Finance and Investment: Key Issues for Developing Countries

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

Find more at http://www.downloadslide.com

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

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

13.2 The Balance of Payments Account

General Considerations

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

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

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

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

Surplus An excess of revenues over expenditures.

Find more at http://www.downloadslide.com

TABLE 13.1 A Schematic Balance of Payments Account

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

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

Deficit An excess of expenditures over revenues.

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

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

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

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

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

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

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

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

Find more at http://www.downloadslide.com

TABLE 13.2 Credits and Debits in the Balance of Payments Account

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

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

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

A Hypothetical Illustration: Deficits and Debts

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

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

Amortization Gradual payoff of a loan principal.

Find more at http://www.downloadslide.com

BOX 13.1 The History and Role of the International Monetary Fund

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

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

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

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

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

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

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

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

Find more at http://www.downloadslide.com

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

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

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

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

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

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

Find more at http://www.downloadslide.com

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

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

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

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

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

Find more at http://www.downloadslide.com

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

13.3 The Issue of Payments Deficits

Some Initial Policy Issues

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

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

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

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

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

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

Find more at http://www.downloadslide.com

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

BOX 13.2 The History and Role of the World Bank

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

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

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

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

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

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

Find more at http://www.downloadslide.com

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

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

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

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

(*Continued*)

Find more at http://www.downloadslide.com

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

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

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

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

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