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Debt crises, political change and the state in the developing world

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Abstract

Dealing with increasing foreign debt has become a key part of government strategy across the developing world, particularly in wake of the payment crises that have shaken south-east Asia, Latin America, Turkey and Russia over the past decade. This working paper seeks to analyze how the political systems in these countries have adapted to the grave problems created by unpayable debt, examining in the process the structure of modern global finance, the history of the state in the developing world, and the demands placed upon governments by sudden rises in poverty and general economic turmoil. Focusing on case-studies of Argentina, Indonesia and Zambia, the paper unpicks the dynamics of these crises, suggesting that certain states have managed to strengthen their freedom of action and authority by recasting their relations with the public at home and with foreign lenders.

Keywords

Foreign debt, developing world, state capacity, sovereignty, debt crisis.

Resumen

La gestión de la deuda externa se ha convertido en una pieza fundamental de las estrategias gubernamentales en todo el mundo en desarrollo, sobre todo tras las crisis de pago que han sacudido el Sudeste asiático, Latinoamérica, Turquía y Rusia a lo largo de la última década. Este documento de trabajo busca analizar la forma en que los sistemas políticos de estos países se han adaptado a los graves problemas provocados por las deudas impagables, examinando en el proceso la estructura del actual régimen financiero mundial, la historia del Estado en el mundo en desarrollo, y las nuevas demandas impuestas sobre los gobiernos, derivadas de los aumentos bruscos de la pobreza y la turbulencia económica general. Por medio de tres casos prácticos, de Argentina, Indonesia y Zambia, este documento de trabajo busca descifrar la dinámica de aquellas crisis, y sugiere que ciertos Estados han logrado reforzar su libertad de acción y su autoridad por medio de una refundación de sus relaciones con la ciudadanía y con los acreedores extranjeros.

Palabras clave

Deuda externa, mundo en desarrollo, capacidad estatal, soberanía, crisis de deuda.

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1. Introduction

The world economy, and with it the economic health of most developing countries, appeared to many commentators at the start of 2006 to be in the midst of a benign period, marked by stable growth, low inflation and minimal interest rates¹. Compared to the financial crises and volatility that characterized much of the previous ten years across large parts of the world - particularly in South-East Asia, Latin America and Russia - this panorama of stable and growing developing nations has undoubtedly come as a welcome surprise.

For the fact remains that foreign debt, and economic collapse caused by failure to honour repayments of debt, has become one of the defining features of relations between the developed and the developing world in the past three decades. Almost all major lower-middle and middle income developing nations – including Mexico, Brazil, Russia, Indonesia, Argentina, Thailand and Turkey – have been directly affected, suffering periods of crisis and steep economic decline as a result of public or private sector default on their debt servicing; in some cases, notably that of Brazil in 1999 and 2002, the mere threat of impending national bankruptcy has been enough to spur a major programme of structural adjustment and fiscal austerity.

Meanwhile, many of the least developed nations have accumulated financial obligations far beyond their budgetary capacities, generating a chronic malaise in these countries' national accounts and stalling concerted efforts to reduce their steep poverty rates. The Heavily Indebted Poor Countries (HIPC) programme, introduced in 1996 by the leading international financial organizations and since extended to 40 countries (33 of them in sub-Saharan Africa), is currently the principal global effort to remedy this problem². Debt burdens in these nations, however, remain significant impediments to development.

Studies of these phenomena are plentiful, and much has been written about the nature of financial market volatility and treatment of risk,

the effects of structural adjustment programmes and the socio-economic consequences of debt crises. In the field of political economy, there is also a general consensus that contemporary international lending and indebtedness broadly conform to a general principle of globalisation: namely, that greater intensity and volume of international economic linkages, in this case those based around the capital account, reduce the freedom of decision of nation-states, above all those in the developing world. The key idea here is that sovereignty in the developing world is being undermined by dependence on private sector creditors and bodies such as the International Monetary Fund, which is taken to represent the interests of the global economic order.

This thesis appears intuitively to be right, and there is little doubt – as this paper will argue – that the HIPC countries have been exposed to just such a model of sovereignty loss. Yet in numerous cases, the crises generated by default have also led to processes of political and social change that do not entirely conform to such a model: Argentina, to take the most recent example, has undergone a profound political convulsion since its financial collapse in December 2001, and has engaged in an ongoing feud with the IMF and holders of its treasury bonds; following its crisis in early 2001, Turkey has elected a moderate Islamic government, and combined fiscal austerity with an increasingly heterodox foreign policy; and most notably, Brazil in October 2002 elected a left-wing president, despite months of market-led concern over the effects that a Workers' Party administration would entail.

In each of these cases, there is also clear evidence that the debt crisis limited governmental freedom of action, often through the letters of intent – incurring pledges of public fiscal surpluses - that the countries were obliged to sign with the IMF. But it is precisely the contradictory and complex nature of the responses offered by democratic polities in these major developing nations to their debt crises that will be the object of this study. Far from conforming to creditors' expectations, these countries have embarked on periods of political transition and reconfiguration that question previous models of ties with the North, previous understanding of democratic politics, and previous models of socio-economic development; the outcome of these processes may as yet be uncertain, but this paper will seek to decipher the dynamics of change, and the way

¹ See "In the best of times, it is prudent to ponder the worst", by Kenneth Rogoff, *Financial Times*, 3/01/2006.

² The goal of the HIPC is to reduce debt stocks in these countries to \$90.6 billion, approximately two-thirds of their current level (Jubilee, 2003; p. 7). As of 2005, 19 countries had reached the so-called Completion Point, making them eligible for unconditional debt relief of \$37 billion.

in which debt has prompted these transformations.

Furthermore, all the economies that were hit by apparently devastating financial crises from the late 1990s onwards are currently (in early 2006) enjoying robust growth, against a backdrop of stability and expanding investment. South-East Asia's major economies, for instance, have recorded their third year of expansion³, whereas Turkey, Argentina and Brazil are all in the midst of a prolonged period of growth, and are enjoying a huge increase in the value of their exports. Part of the reason for this turnaround is undoubtedly a favourable international environment, marked by high commodity prices (above all oil) and low interest rates. Yet at the same time, the new political forces that have taken power in these nations have proved extremely cautious in taking on new debt - both Argentina and Brazil have paid off their IMF debts in their entirety -, while also seeking to preserve underlying macroeconomic stability through low inflation and controlled government expenditure.

This paper will begin by briefly examining the international financial context that has given rise to widespread chronic indebtedness, the volatility with which global markets treat major borrowing nations, and the domestic policy conditions needed for a country to open its borders to free private capital flows, and thereby debt. Attention will then be focused on the characteristics of states in developing world, giving rise to a typology of state-systems, with case studies of countries (Indonesia, Argentina and Zambia) that fall in each of the categories discussed. Chapters 3, 4 & 5 represent the core of this paper, containing a critical study of the social effects of debt on these nations, the political and diplomatic impact of debt crises, and the factors which weaken or reinforce democracy, state capacity and sovereignty as a result. A final analysis will seek to establish a broad model of these effects and incorporate them into an interpretation of global systems of power, which are seen as responding in a contradictory fashion to debt crises, and seeking to resolve these contradictions through the agency of the nation-state, even as this is struggling to reassert its legitimate authority.

At present, the eventual implications of the debt crises and burdens existing across the developing world are unknown, but there seems

little doubt that the vast popular traumas which have afflicted countries such as Argentina, Indonesia and Zambia will shape their societies and politics for decades to come. By studying the dynamics of this process and its consequences for the state, this paper also hopes to reach a clearer understanding of the international community's power structure in an era of global economic integration, and to explain how its management of foreign debt in the developing world reveals a wealth of contradictory values and impulses, which together place burdens, at times impossible, on the sole body that can claim to answer to the will of the people.

2. Global finance and the nature of modern foreign debt

The foreign debt owed by developing nations has grown steeply in the past four decades, to the extent that in 2003 it represented 37.5 percent of the total GDP of the developing world⁴. Its growth, however, has neither been uniform in nature nor even in distribution. Any understanding of how certain developing countries stand exposed to threats of debt default must start with a clear view of where the debt burden is currently allocated, and how it compares with the potential for economic stability and development (and therefore reliable debt servicing) in the regions that are most indebted.

Total outstanding foreign debt from the world's developing nations has risen from just over \$2 trillion in 1995 to stand in 2003 at 2,554 billion dollars. Two regions in particular claim shares of this debt that are far greater than their proportion of developing world GDP: Latin America and the Caribbean, with 779.6 billion dollars of debt in 2003 (32.7 percent of the total debt; 39.8 percent of regional GDP), and sub-Saharan Africa, with 231.4 billion dollars (9.0 percent of total debt; 67.1 percent of regional GDP). Compared to its weighting in terms of both population and economic activity, on the other hand, Asia's share of the debt (including that of India and China) is modest, at only 707 billion dollars (27.57 percent of the total). The one clear exception in that region is Indonesia, with total liabilities standing at 134.4 billion dollars (50.9 percent

³ "All serene", *The Economist*, 25/02/2006.

⁴ Based on figures in *Global Development Finance 2005*.

of its GDP)⁵.

Two dynamics in particular have contributed to the disproportionately high debt levels in Latin America and Africa: in the former, as in much of Asia, the main increases in credit have come from private sector lenders, firstly through bank loans to states in the 1970s, and since then primarily via investment in government bonds, credits to the private sector and portfolio investment, which are thereafter traded in financial markets. Potential growth rates in emerging markets, being considerably higher than those experienced in industrialized countries, have been the principal magnet for such capital, which has sought a maximum return on initial investment; according to the economist Chesnais, the rate of return expected by capital brokers on their investments underwent a sizeable increase in the early 1990s, to end at 15 percent (Chesnais & Plihon, 2003; p. 7), coinciding with a boom in private capital flows to the developing world.

In Africa, on the other hand, most of the debt increase is the result of bilateral and multilateral loans, which together represented 76 percent of the continent's long-term debt in 1998⁶. The accumulation of this official debt – which is far beyond the servicing capacity of many states – has emerged from a variety of causes, most notably the declining prices of raw materials, a history of domestic corruption and poor debt management, and the extreme over-confidence in export diversification and a recovery in commodity prices displayed by the main creditors; one IMF study reported that the credit extended to Zambia in 1983 assumed a four-year 45 percent increase in the value of its main export commodity, copper, when in fact this fell in price by 12 percent⁷.

The claims of creditors over various nations' financial resources, and the need for these nations to attract foreign funds to cover their spending requirements, have assumed a diplomatic and political importance in keeping with the dimensions of foreign debt. Mexico's political trajectory since its default on \$80 billion in public sector debt in August 1982 – a complete abandonment of import substitution in favour of full integration in the global econo-

my – provided one early instance of these effects. Although it was not by any means the first bankruptcy of its kind⁸, the Mexican default served to illustrate how a financial crisis might influence the strategic outlook of a major developing nation. Yet it also gave a first insight, which has since been repeated in numerous other cases, into the structural dynamics of power that underlie the provision and repayment of international credit.

2.1. POWER MECHANISMS IN THE MODERN INTERNATIONAL DEBT REGIME

Indebtedness implies a relationship in which one party, the creditor, has a claim over part of the assets or income of the debtor. Under the rule of law within a modern nation-state, this claim is in the last instance arbitrated by a domestic authority - the judicial system - which can impose punishments on any debtor who refuses to pay. This threat of sanctions is implicit in the normal workings of any credit market in the developed world.

One critical characteristic of the modern international debt regime is the lack of such a vertical mechanism of authority: according to one former director of IMF research, "by their very nature, sovereign debt contracts are not enforceable in the same way that corporate debts contracts usually are"⁹. Attempts to intervene in a country by force so that unpaid debts can be exacted are extremely rare, though both France and Britain in the 19th century strove to do so by taking over ports, seizing assets and running customs offices of other countries (Egypt by Britain, Turkey by France)¹⁰. Instead, continuous financial flows to and from the developing world are dependent on a system of incentives and sanctions that comply with two essential functions: they must be regarded by creditors as sufficient to ensure the steady receipt of future repayments (and thereby a healthy return on capital), and by debtors as less onerous than the complete absence of fresh credit. In the absence of either of these conditions, international financial flows will cease.

⁸ France is reported to have ceased payments on its debt on average once every 30 years from the 1500s to the 1800s. *Global Development Finance 2003*, p. 56.

⁹ Rogoff K., "Emerging Market Debt. What is the Problem?", speech to Sovereign Debt Restructuring Mechanism Conference, 2003.

¹⁰ The United States intervened for similar reasons in the Dominican Republic, Haiti, Honduras and Nicaragua. See *Global Development Finance 2003*, p. 57.

⁵ Figures from *Global Development Finance 2005*.

⁶ *Africa in World Politics: State System in Flux*, p. 63, ed Harbeson J. W. & Rothchild D., 2000.

⁷ *External Debt Histories of Ten Low-Income Developing Countries*, p. 8, Policy Development and Review Department, IMF, 1998.

Recent efforts to regulate these relations within a body of international law – notably through Collective Action Clauses in bond issues and a Sovereign Debt Restructuring Mechanism¹¹ – would certainly provide some order to these relations, and could in principle extend the remit of international law to a defaulted nation's assets; attempts by bondholders to seize Argentina's foreign property following the unilateral moratorium declared by that country's government in January 2002 have already registered some legal victories¹². It nevertheless remains the case that ongoing consent by both parties to the norms of credit and repayment is essential for international financial relations to remain in place, and that the principal disincentive to default is not direct punishment, but ostracism from future credit lines or the global economic order; in January 2004, only Somalia, Iraq, Liberia, Sudan and Zimbabwe were in arrears on their debt obligations to the IMF¹³, a step regarded in financial circles as the principal benchmark of a nation's financial exile.

A second key characteristic of the debt regime, however, is shared in both national and international financial markets. Heavily concentrated debt imperils both repayment by the debtor and the institution that provided the credit: this is best summed up in an old maxim, "if you owe a bank a hundred pounds, you have a problem, but if you owe it a million, *it has*"¹⁴. The threat posed by a major international default to overexposed financial institutions was fully evident in the Mexican debt crisis of 1982, when the world banking system was rendered *de facto* insolvent. More recently, the highly concentrated exposure of the IMF to major developing nations – the five largest borrowers in 2003 (Brazil, Turkey, Argentina, Indonesia and Russia, in descending order) represented 87 percent of all IMF credit – emphasized just how important the constant flow of debt servicing is to the Fund's fiscal sustainability and investment grade¹⁵.

Negotiations between the Argentine government and international financial organizations (primarily the IMF) in the period from December 2001 to the first agreement of September

2003, and then through a number of reviews, have repeatedly been influenced by the Fund's perceptions of the possible damage to its finances from an Argentine default – and of course by tactical use by Argentina of this threat. It is notable in this respect that the 2003 agreement, which effectively rolled over the country's repayment on debt principals (though not interest) for two years, was only sealed once the Argentine government had joined the list of countries in arrears with the Fund, albeit for a period of only two days¹⁶.

These two key characteristics of relations between states, markets and official lending bodies within the international debt regime have very many different consequences, depending on the particular circumstances of the players involved and the influence that can be exerted on other investors' perceptions: a multilateral loan to a single-export country in Africa, for instance, generally has more binding power over the debtor than a bond purchase in an international market from a major emerging economy. The uncertainty that these conditions generate over whether future repayments will materialize is translated by lending institutions and financial markets into calculations of risk. This "risk factor," which simply means the danger that a country's government (or leading businesses) will fail or refuse to honour their foreign debts, can then be computed into the loan's initial conditions. Risk, in other words, is assumed by the creditors in return for higher rates of return on investment¹⁷.

Markets and investors have a vested interest in reducing the possibility of a default while maximising the return on capital: their logic is therefore to seek out high-growth developing economies and open these economies to free capital movements, while of course insulating their loans against default. Yet given the structural features of international debt discussed above, it is clear that both direct political inter-

¹¹ *Ibid*, pp. 63-68.

¹² "Por la deuda, inhiben bienes del Estado argentino en EE. UU.," *Clarín*, 6/2/2004.

¹³ *Financial Risk in the Fund and the Level of Precautionary Balances*, p. 18, IMF Finance Department, 2004.

¹⁴ "The IMF should stand firm against Argentine blackmail," Martin Wolf, *Financial Times* 28/01/2004.

¹⁵ *Financial Risk in the Fund*, p. 21.

¹⁶ Argentina failed to repay 2.09 billion in SDRs on September 9, 2003, but cleared its obligations on September 11, 2003. The country also went into arrears with the World Bank on October 15, 2002, before repaying \$795.5 million in January 2003. *Ibid*, p. 22.

¹⁷ A host of consultancies now work in field of risk calculation, examining both economic and political conditions. One survey by the Eurasia Group, published in the *Financial Times* 5/2/2004 ("Index puts price on political risk") revealed that of 23 emerging market economies, Nigeria, Azerbaijan, Colombia, Indonesia and Venezuela have the lowest political stability, and Hungary, South Korea, Poland, Mexico and Thailand the highest. According to the group's head, Ian Bremmer, "an emerging market country is a country where politics matter at least as much as economics. It is vital to ask whether state leaders have the willingness and political capital to pay".

vention or effective judicial arbitration are unavailable as means to ensure the continued servicing of debts. The alternative, embraced by the leading world economies since the 1980s, is to sponsor and promote *internal* change: this is indeed the third main characteristic of the debt regime.

Without any legitimate multilateral financial bodies able to enforce their rulings, lending bodies, both private and public, have sought to shape indebted countries in the image they desire – as reliable and transparent debt payers. Loan conditionality has proved one vital source of leverage for the IMF and World Bank since the 1980s; for private lenders, the translation of markets' risk perceptions into higher interest rates on loans or falling exchange rates represent the most important levers over a country's domestic policies. The aim, in short, is to ensure that these markets *converge* with those of the developed world.

The merits of such convergence are hotly contested (see Stiglitz, 2002; Feldstein, 2002). Powerful nations, and the international bodies they dominate, are accused of imposing through conditionality a host of financial reforms – notably free capital access, entry of foreign banks and structural changes to the state – that are too premature for countries' levels of development, undermine vital public institutions and expose these economies to extremely hazardous levels of volatility. Recent pre-electoral market turbulence in Turkey and Brazil has also pointed to how markets in supposedly “converged” countries have established direct mechanisms for expressing political disapproval (or rather, to use the correct financial terminology, for investors to express aversion to potential risk).

Without wishing to enter further into a debate that is rich in literature and controversy, it should be pointed out that convergence, as seen through the eyes of creditors, is a means of correcting the defects of the state in the developing world. As a result, it tends to treat the state as a single, indivisible entity, whose policies can be gauged in quality by the yardstick of convergence to a desired norm (Dollar 2001). In parallel, politicians and officials in developing countries have often sought to bolster their reputation for creditworthiness in international markets by conforming as conspicuously as possible to the criteria set by the markets. Santiso (2004; p. 20) terms the wholesale adoption of liberalization policies in cer-

tain countries in the 1990s as a means to secure “*strategic labels*, bringing visibility in the large landscape of populous emerging markets”.

States in developing countries, however, do not conform to such a straightforward model: they are contested sites, are plagued by internal divisions, and limited in influence by a host of rival powers (business, media, civil society). The financial policies they espouse, therefore, are only sustainable within a wider political context that favours their adoption and implementation. For the markets, on the other hand, a changed context (including a democratic election result) represents “risk”; social and political evolution in any particular country is thus not seen as having any intrinsic merit insofar as it does not lead to the desired market convergence. As we shall see, this view of the state in the developing world has very important consequences.

2.2. EXPLAINING MARKET VOLATILITY IN MODERN DEBT CRISES

The spate of debt crises in the developing world, and particularly those afflicting Asian countries from 1997 to 1998, has underlined the extreme volatility of financial markets in the wake of the abolition of capital controls. Feldstein identifies three factors as underlying the crises of the 1990s, which he regarded as categorically distinct to the national insolvencies of the 1980s: “a combination of unsustainable current account deficits, excessive short-term foreign debts, and weak domestic banking systems” (Feldstein, 2002; p. 4). The two latter characteristics arose largely from the overly rapid opening of the country's financial system and capital account to foreign interests, whereas the former (which triggered the run on the bhat in Thailand) was the result of a fixed and overvalued exchange rate. Mass selling of the bhat, of course, prompted the eventual devaluation in July 1997, and the wave of devaluations and defaults that later affected the whole of South-East Asia, particularly Indonesia.

In this case – and in others – the importance of market perceptions of future circumstances (notably the ability to recoup debts and investments) has proved crucial. The Mexican default of 1982 bore little resemblance to this situation: the government announced that it

could no longer pay its debts in the light of recent hikes in the US interest rates, a decision that was not brokered by any market intermediary. But the transition in debt financing during the past two decades from bank loans to the bond market, and the opening of developing countries to free capital movements, has enabled market activity to arrogate power over two monetary mechanisms that are central to a nation's economic stability and insertion in the world economy: these are the exchange rate, and the interest rate on foreign debt (known as the country spread on US treasury bonds, or the "risk premium")¹⁸.

Exchange rates are critical to the stability of a country's trade pattern and the ease or difficulty with which it services foreign debt, much or all of which is denominated in foreign currencies (above all the dollar)¹⁹. Sudden falls in the exchange rate, as experienced by the Brazilian real in mid-2002, frequently precede debt crises, whereas feverish speculation against the fixed exchange rate served to topple the currency peg and generate wider economic collapse in Mexico, Thailand, Argentina and Indonesia (where the currency, the rupiah, operated on a "pegged crawl" against the dollar). In the case of Argentina, fears over imminent default and devaluation caused a massive capital flight of \$18 billion from March to November 2001, at the end of which Economy Minister Domingo Cavallo declared the infamous "corralito" on bank withdrawals – the pretext to the vast social uprising in Buenos Aires in December 2001.

The interest rate imposed on new bond issues, for its part, determines just how expensive it will be for a state or private enterprise to refinance its foreign debts: the Argentine capital flight mentioned above, for instance, was accompanied by a sharp rise in the spread on new bonds, forcing the government to accept larger repayments over time in a context of incessantly declining revenue²⁰. Lurches in the domestic interest rate, meanwhile, are normally intended to defend an imperilled exchange rate, often at the cost of domestic economic

malaise. Economic activity during the first year of President Luiz Inacio de Silva's administration, for example, was seriously hampered by real interest rates of over 13 percent, derived from the efforts to shore up the Brazilian capital account during the election year crisis²¹.

The effects of these fluctuations on a thriving economy may not prove too harmful. Yet one of the chief characteristics of the international debt regime in the past decade has been the manner in which markets have served to accentuate the economic conditions in a given debtor country, either by inflating a boom, or more seriously, by worsening a recession. Although in principle debt financing should smoothe out a nation's economic cycle, international markets - which obviously seek the highest return possible on their capital investment - will tend to lend to countries that are growing fast, while seeking to recoup investments when those same countries enter a slump or a recession. As a result, the changes mentioned above in interest or exchange rates will tend to arrive at the most sensitive moment for these economies, as the *Global Development Finance* report for 2003 states: "When macroeconomic conditions move against the country, debt markets rightly factor in more risk and thus end up charging more for debt capital. The result is increased strain on the country, and a greater likelihood of crisis and default" (World Bank 2003; p. 11).

Thus the interlocking effects of exchange rate and interest rate fluctuations, especially when they act upon economies that are either in recession or afflicted by structural defects, are crucial to the propagation of grave systemic crises – the type suffered most notably by Indonesia and Argentina. At a certain stage, Krugman and Obstfeld (2000; p. 706) argue, three separate crises will conjoin to devastating effect: a debt crisis in the public and/or private sector; a balance of payments crisis; and a crisis in the banking system. This "triplification", which is mediated by the two rates, lends itself naturally to a social and political convulsion, given the general menace posed to people's jobs, wages and savings.

¹⁸ *The Economist*, "Survey on Global Finance," 1/5/2003.

¹⁹ "97 percent of all debt placed in international markets between 1999 and 2001 was denominated in just five currencies: the US dollar, the euro, the yen, the pound sterling and the Swiss franc. Even well-run emerging economies, such as Chile, cannot borrow in their own currencies." Martin Wolf in the *Financial Times*, 4/8/2004. Economist Ricardo Hausman has described this inability to borrow in one's own currency as "original sin".

²⁰ The so-called *megacanje* (mega-swap), which restructured private debt worth \$55 billion in late 2001.

²¹ "Lula's 100 days," *Financial Times*, 8/4/2003.

2.3. MARKET “IMPERFECTION” OR THE PRICE OF PREMATURE LIBERALIZATION?

Despite general consensus around this account of how global market mechanisms instigate crises, very different interpretations are given as to what motivates the volatility of finance to the developing world, and how excessive lending can transform so rapidly into a total loss of a confidence.

One school of thought, dominant in the investment community, emphasizes that excessive borrowing and lending in a boom period – the Java Stock Exchange in Indonesia, for example, grew from \$2 billion in 1990 to \$117 billion in 1997 (O’Rourke, 2002; p. 24) – results from imperfections in the international capital market (Kaji, 2001.; pp 573-574). Of these, the two most important are the information asymmetry existing between creditors and debtors, and the “moral hazard” represented by the prospect of a bailout from international lending agencies or friendly governments²². The conclusion of this thesis is that only convergence with international financial standards by emerging markets - largely through increasing transparency and creating stricter obligations to repay debt - can sustain stable credit flows. One example of such a reform would be Collective Action Clauses in bond issues, which are expected to reward reliable debtors while raising the cost of borrowing for countries with higher risk levels, thus eradicating irrational credit booms (Eichengreen, Kletzer & Mody, 2003; p. 40). It is also argued that mandatory collective action by bondholders would result in swifter action over defaults (Kletzer, 2003; p. 21).

Yet these reforms would not necessarily tame the exuberance and panic that have tended to characterize the financial markets’ relations with the developing world. Low transactions costs in money markets, and the vital role in these markets of expectations over future values (meaning the fear of crisis often generates panic selling, thus becoming a self-fulfilling prophecy), have combined all too often, converting these ill-grounded financial booms into rapid collapse. In this respect, many commentators have focused not so much on the imperfections in the market that supposedly generate excessive lending, but the socio-cultural dynamics of boom and bust that are intrinsic

²² The Mexican bailout of 1995 was said by orthodox economists to have accentuated “moral hazard.”

to global financial market activity.

According to this account, extending the reach of the market to key economic variables in developing countries only serves to impose this intrinsic volatility - created by profit-driven, interconnected and extremely mimetic markets, all working on the basis of real-time information flows²³ - onto countries with fragile institutions, shallow markets and poorly developed financial systems. “Financial speculation,” writes Gilpin, “is a herd phenomenon in which the seemingly rational action of many individuals leads to irrational outcomes” (Gilpin, 2000. p. 139).

When this “herd” then pulls out of the embryonic capital markets of developing countries – fearing a currency collapse or mass debt default - the damage done has arguably no relation to the real defects of the economy in question. Jeffrey Sachs, Barry Eichengreen and many other economists have insisted that the South-East Asian economies were fundamentally sound at the time of their crises, and indeed the problems faced by all the crisis-hit states in 1997-8 bore little relations to their key variables. South Korea, for example, received a huge subsidized loan of \$57 from the IMF to pay off its private sector creditors, even though its total foreign debt stood at only one third of GDP (Feldstein, 2002; p. 21).

As a result, these interpretations are much more critical of the vested interests of western capital markets – and particularly US Treasury polices in the 1990s – for seeking to open up markets that were not yet ready for such a level of global integration, and which were as a result exposed to severe shocks²⁴. A more gradual approach, following the models of Chile and Malaysia in their timely use of capital controls²⁵, is therefore recommended. Secondly, this point of view suggests that international creditors and developing nations should make much better use of financial tools that do not threaten sudden exogenous shocks (often caused by exchange rate flux), or which disconnect debt servicing requirements from the eco-

²³ “Information and rumours, interconnected in continuous flows, are disseminated at high speeds, generating mimetic components where to imitate ‘the other’ becomes imperative to staying in the game,” Santiso 2004; p. 13.

²⁴ “The evidence suggests that [financial] volatility not only causes bigger ups and downs in output and incomes, it also causes lower average incomes over time.” *The Economist: Survey on Global Finance*, 1/5/2003.

²⁵ Malaysia imposed controls in 1998. Chile dismantled them in 2002 after reaching a free trade agreement with the United States.

conomic reality of a given country: the World Bank has itself posited local currency bonds, project bonds, and bonds linked to a country's economic growth and competitiveness as more suitable mechanisms for stabilizing financial relations between developing countries and global markets (World Bank, 2003; p. 43).

The recommendations cited above, however, remain largely in their infancy. Collective Actions Clauses, for instance, received the backing of the International Monetary and Financial Committee in 2003, and have since been introduced by Mexico, Brazil, South Africa and Korea in recent bond issues (Eichengreen, Kletzer & Mody, 2003; p. 4). Progress is somewhat less apparent in the use of country-sensitive credit mechanisms. Recent local currency bonds in Brazil, India, Korea and Turkey have tended to be short term in comparison with bond issues in foreign currencies (World Bank, 2003. p. 55), whereas the growth-linked bond – proposed by the Argentine government in the IMF summit in Dubai of September 2003 as one of the options for holders of defaulted bonds – has yet to make any significant headway. Even so, the past few years do appear to have brought greater caution in both the provision of credit and in states' willingness to take on new debt: according to the World Bank (2005; p. 6), "international capital markets today are more attuned to, and more discriminating about, development finance than in the past".

2.4. COMPENSATING FOR UNCERTAINTY: THE "BUILT-IN" DEBT CRISIS

In these circumstances, therefore, low enforceability, shared risk and pressures to convergence have formed the basic conditions of power and influence within the international debt regime. Lenders to the public or private sector in the developing world have responded by protecting their future revenue streams in the most straightforward means available: the threat of rapid and comprehensive punishment. "In the absence of better institutions and enforceable rights," argues Rogoff (2003; p. 2), "the high cost of debt crises equilibrates emerging market countries' thirst for debt flows and investors' reluctance to lend. By making defaults extremely costly, risky forms of debt – particularly those that are prone to collective action problems – provide a measure of confidence to international investors." This state-

ment, made by the former head of research of the IMF, is extraordinarily revealing; it admits that deep and lasting debt crises are the one condition on which private lending to the developing world has been rendered possible. Rapid market-led collapse in developing countries is thus the *natural* and *approved* condition for international financing, as can be seen in Asia, Argentina and Brazil. "In other words," continues Rogoff, "default costs provide a punishment that in some sense substitutes for effective property rights at the international level"²⁶.

What is missing from Rogoff's analysis – and which is rightly stressed by recent critics of market euphoria – is the international distribution of power that results from this reliance on the threat of crisis. Rather than establishing fluent and stable financial relations, this system makes the perceptions and requirements of international lenders absolutely central to the demands made on indebted developing countries. On one level, this leads to constant calls by the investment community and the IMF for internal market reforms, which in many cases have no bearing on the actual economic problems of the countries involved (Stiglitz, 2002; p. 40). On another, it exposes these countries to much greater financial demands whenever a global economic downturn enhances major investors' perceptions of risk: "the problem with over reliance on debt financing for development is that the downside to adverse global developments has to be borne completely by developing countries: they must either pay in full or default" (World Bank, 2003; p. 11). In this respect, the net *outflows* of capital from Latin America to private sector creditors in recent years – \$24.8 billion in the 2001 and \$8 billion in 2002 – prove the point argued above that money markets, via their capacity to determine exchange rates, interest rates and the prospect of default, accentuated an already existing regional recession, and far from correcting the economic cycle, in fact worsened it²⁷.

²⁶ One estimate holds that currency and balance of payments crisis over the 1975-1997 period reduced output on average by between 5 and 8 percent (World Bank, 2003, p. 67).

²⁷ The obvious counterpoint to this is that countries are allowed and positively encouraged to over-borrow during times of domestic boom and high global liquidity (Lavagna in Alvarez (ed.), 2003; p. 12). The author adds that this surfeit of money serves to distort economic policy during the boom, and finance unsustainable "macroeconomic fantasies."

2.5. THE DOMESTIC POLITICAL DIMENSION

The unwelcome consequences of any failure to honour debts imposes tight discipline on the government of a developing nation. Later chapters will explore the inevitable social and political turbulence caused by a debt crisis, and particularly by the sort of “triplicated” crisis discussed above; it is obvious that the legitimacy of the regime which has accumulated debt, and relied on credit for the sustainability of its economic policies, is gravely endangered by such a crisis. According to Diamond (1998; p. 34), the particular combination of economic crisis and perceptions of corruption causes the most serious erosion of any government’s legitimacy. Needless to say, few such administrations, either in democracies or dictatorships, survive intact.

In the context of a possible crisis, incumbent administrations will tend to act in their own political interests, and do their utmost to prevent a debt default, a major devaluation or any other shock to macroeconomic stability. The heavily indebted administration or regime in question will tend to have had a thirst for capital (either for public finances or for regime-friendly private corporations), and have tied its survival to the sustainability of debt servicing, repeatedly disavowing any possible change in course: the most dramatic recent manifestation of this tendency came in December 2001, when the IMF’s refusal to provide fresh credit to Argentina²⁸ prompted Economy Minister Domingo Cavallo to file a new budget for the next year, in which cuts of around \$9 billion (or close to 20 percent of total public spending) would be made. Given conditions of recession, high unemployment, falling real wages, and the freeze on bank account withdrawals, there were few beyond Cavallo and President Fernando de la Rúa who regarded the plan as remotely feasible; indeed it seemed to most a scenario *worse* than default.

It is at the stage of impending crisis that the configuration of a country’s political leadership comes to the fore. Pressure on the administration to reorient its economic policy or at least change its leaders become more strident (notably from business, the media and popular protest), causing markets’ fears of collapse to intensify, and eventually provoking a radical

²⁸ An understandable decision given that \$8 billion had been handed over by the Fund in August, only to finance capital flight and withdrawals by large creditors.

change in government: in the case of Argentina, the resignation of the president provided the pretext for default and devaluation; in Indonesia, Suharto’s fall prompted a sudden eruption of popular democracy, and a power vacuum; in Zambia, and under very different circumstances, official debt demands caused a radical shift in the policy of the self-same government, headed in 1987 by Kenneth Kaunda, until he was eventually thrown out of power in 1991.

2.6. THE POLICY “TRILEMMA”: ECONOMICS, POLITICS AND THE STATE

At the heart of any possible reorientation in policy - which is required to contain the systemic shock across the economy - is the bind of global economic integration. The “golden rule” determines that a country cannot have free capital flows, domestic monetary autonomy and fixed exchange rates all at the same time; at most it can have two of the three (Krugman & Obstfeld, 2000; Kaji, 2001, p. 572; Gilpin, 2000, p. 112). Given that free capital flows and fixed or partially fixed exchange rates²⁹ were the operating norms of international finance for many developing countries in the 1980s and 1990s, it is evident that domestic monetary autonomy - control over the money supply and interest rates- was sacrificed by many countries in that period, and handed to the international market.

Indeed monetary policy, as prescribed by the IMF and financial investors in recent crises, has tended invariably towards an emphasis on securing returns to capital and holding up the exchange rate; one highly disputed aspect of IMF policy in Asia, for instance, was the implementation of a contractionary policy of high interest rates (over 20 percent in Korea and other countries) and steep budget cuts. As in Argentina, policies designed to stimulate domestic growth were neglected in favour of efforts to meet the requirements of free capital flows at a stable rate of exchange. In the words of Paul Krugman in November 2001, “Argentine officials are crucifying their long-suffering nation on a cross of dollars”³⁰.

²⁹ There is no explicit IMF advice on the choice of exchange rate systems, but tacit support was given to certain countries’ fixed rates through regular bail-outs aiming to sustain currency levels, eg that to Argentina in August 2001 (Feldstein, 2002; p. 8).

³⁰ “A Cross of Dollars,” *New York Times*, 7/11/2001.

There were notable exceptions to this rule. Malaysia stands out for its decision, fiercely opposed by the IMF, to implement capital controls when it was hit by the Asian crisis. Strict capital controls were in place in China, and are only now being softened. Floating exchange rates in several Latin American nations – currencies fell in 2001 in Chile, Paraguay, Uruguay and Brazil – enabled these countries to withstand some of the worst effects of the global recession and the ensuing “contagion” from Argentina. The current popularity of floating rates in the developing world would indeed suggest this means of adjusting to exogenous shock is now regarded as the most effective of the three policy options (economists traditionally regard this as a preference for competitiveness over long-term macroeconomic stability (Frieden & Stein, 2001; p. 9).

Discussion of this policy bind in purely economic terms, however, fails to shed light on the domestic political depth of the choices being made. There are, for a start, interest groups with clear stakes in the outcome of such a policy choice: “on distributional grounds tradables producers will prefer a depreciated, floating rate, while those heavily engaged in cross-border activities, such as finance, commerce, and foreign debtors, will prefer a fixed rate” (Frieden & Stein, 2001; p. 6). Outside these profit-seeking sectors, the state’s choice of monetary policy might seem to have less direct relevance or interest. But its tangible implications for foreign trade, inflation, money supply and interest rates means that the policy choice made by a government invariably intersects with a host of urgent political and social concerns. The actual nature of the monetary dilemma may not be understood by the general public, yet the preferences each of the three policy options expresses over numerous issues – liberalization, global integration, credit access, public spending, inflation, interest rates – are often central to the political climate in a developing country, and readily interact with other currents of belief to form coherent ideologies, movements and party political support networks³¹.

Furthermore, sudden transitions in the choice of policy will tend to coincide with major political changes, as new forces seek to alter the structure of internal and external relations inherited from a previous, disgraced administra-

tion. In this process, free capital flows, monetary autonomy and fixed exchange rate come to assume significant political meanings through their multiple connections with issues as tangible and electorally significant as regime corruption, national identity, class rivalry and globalization.

Examples of precisely this transition from economic policy choice to public political slogan are numerous. “From outside they accepted the idea that Argentines should earn 100 or 150 dollars a month,” declared Cavallo in 2003 in reference to the IMF’s final refusal to support the peso two years before, “they devalued the aspirations of the Argentines”³². His message was in many ways reflected by Carlos Menem, whose failed election campaign in 2003 appeared to augur an appreciation in the peso and possibly a renewed dollar peg. In Indonesia, meanwhile, the unpayable foreign debts of the private sector became synonymous with the despised rent-seeking of Suharto’s clan, called the Cendana after the street in which they all lived. Foreign business, on the other hand, was demanding a rise in the rupiah to escape worse punishment: “Should Indonesia be able to remain within the global capitalist system, global prices will have to rise” (Forrester, 1999; p. 125).

This political depth in the choices surrounding monetary policy and global financial integration is matched by their influence on state authority and sovereignty. Sovereignty, as we shall see later, can be defined in terms of the relations of a nation-state to other states, or by the legitimacy and effectiveness of its domestic authority. In international terms, a debt crisis subjects the state to the pressures exerted by major financial institutions, multilateral lending agencies and other interested governments³³. At the very same time, the socio-economic and political turbulence within the nation will tend to make the state subject to an uncertain and unfolding scenario (a power vacuum), undermine the legitimacy of public institutions, and even render parts of the national territory outside the complete control of the state. Between the two sets of pressures, the state must seek to remould its authority and sustain its autonomy, without which an

³¹ The radical CTA union in Argentina, for instance, placed capital controls among its chief economic demands in 2002.

³² Speech by Domingo Cavallo on 11/12/2003 to conference at the Real Instituto Elcano, “La seguridad jurídica y las inversiones extranjeras en América Latina”.

³³ In the case of Argentina, one such government is that of Italy, which has sought to defend the interests of its 400,000 owners of defaulted bonds.

end to the underlying economic crisis is inconceivable. The obstacles to achieving this, and the possibility of reaching a new equilibrium at the level of the state, are the concerns of the rest of this paper.

3. Debt and the state in the developing world

The historical European model of gradual state formation – an evolution starting from despotic power and ending in an almost complete penetration of society and public institutions – is not one that developing states have had the time or even inclination to follow. Argentina, a quasi-colony even after the declaration of independence (Hobsbawn, 1994; p. 357), Indonesia and Zambia all received states grafted from Europe, overruling territories that had little previous geographic or cultural identity. The peculiarity of the post-colonial state has perhaps never been more evident than in Indonesia³⁴, which contains 220 million people and 18,000 islands, and which has been the site of several separatist movements (in East Timor, Aceh and Irian Jaya).

Yet it has been the state, first as the leading economic protagonist of development (often via a strategy of import substitution), and later as the guarantor of security and order for a thriving private sector, which has often assumed prime responsibility for the welfare of the developing nation. When successful, as in much of South-East Asia, it has been instrumental to growth and development; when a failure, it has often blocked growth, increased poverty, and destroyed faith in public institutions.

Post-colonial states have generally inherited poor, largely rural, pre-industrial nations – lands over which they sometimes had little control. Their initial priorities were economic development and the realization of national self-determination, strategic goals that were interpreted according to rival doctrines, political cultures and diplomatic aspirations: thus arose

³⁴ Post-colonial Pakistan is possibly a more extreme case, comprising two territories separated by the breadth of India. The independence of Bangladesh in 1971 brought the experiment to an end.

the variety of democracies, dictatorships, planned economies and unregulated markets that have characterised the developing world. A certain convergence toward free-market, electoral democracy does indeed appear to hold beyond a certain level of development, as Fukuyama (1991) postulated: one survey revealed that of 141 countries between 1950 and 1990, no democracy was subverted in any nations where per capita income was higher than \$6,000 – the figure for Argentina in 1975 (Przeworski et al., 2000; p. 98). Before that level, however, the forms of state, its democratic credentials, and its ability to stimulate economic growth are highly variable, and prone to sudden shifts in fashion.

Yet the alternatives of democracy or dictatorship are far from being the only ways to characterise and categorize any given state in the developing world: there is no doubt that the development strategy embraced by democratic states in Botswana and Mauritius can be more fruitfully compared with recent dictatorships in South Korea and Indonesia than with the policies implemented in Jamaica or Venezuela – both of them long-standing democracies (Leftwich, 2000; p. 133). Furthermore, as experts in democracy have observed, it is notoriously hard to make general distinctions between the economic performance (rather than economic status) of democracies and dictatorships: observed rates of growth in poor democracies and dictatorships are virtually identical, although growth under dictatorships does tend to be much more variable (Przeworski et al, 2000; p. 143-144).

In other words, when considering the broad developmental impact of a state – and obviously the effects it has on its citizens' or subjects' welfare – a rather larger set of concepts must be employed in order to gain deeper understanding of the ways in which states configure their relations with civil society, their standing in the international community, and their ability to realize the developmental goals they have set for themselves. Although, as we shall see later, the division between democracies and dictatorships is itself of great significance, two additional variables are required in order to analyse the functions and capacity of the state in the developing world: these are *legitimacy* and *autonomy*.

3.1. A TYPOLOGY OF THE STATE

Broadly speaking, three forms of state have dominated the post-war developing world, each one seeking out a particular equilibrium between democracy, state prerogative and economic development.

The *developmental state* has aimed to bring about rapid modernization of the nation's economy through central planning and targeted stimulation of business activity. This need not mean that the state is a dictatorship: of the eight high-growth developing countries listed by Leftwich (2000; p. 169), three could be counted as democracies (Botswana, Singapore and Malaysia). Yet many rulers and political scientists, concerned by the transitional disturbances posed by rapid growth (above all urbanization, industrialization and secularisation), have maintained that a dictatorship had certain merits in managing a fast development process. "Political disorder is not produced by the absence of modernity, but the efforts to achieve it," wrote Huntingdon (1968; p. 48), and fears over the civil and political strife that democracy would allegedly entail in such unstable circumstances – especially in the context of the Cold War – were used to justify decisions to "postpone" disruptive elections, emasculate legislatures, and prevent the growth of rival political parties with access to the general public. On many occasions, the development state was thus ruled by a communist or military vanguard, each armed with an ideology that served to stress the importance of collective or national integrity over democratic "divisiveness".

A prime example of such a regime is Indonesia, led from 1965 to 1998 by President Suharto. His "new order" sought to bring about vastly improved living standards in the country, and was indeed successful in that respect: per capita income rose on average 4.8 percent per year from 1965 to 1997 (Leftwich, *ibid*). At the heart of this regime was a mixed elite – an estimated 1,000 technical experts, high-ranking military officers and political intermediaries, who together coordinated development and the channels of influence to and from society. Such a state, which in the case of Indonesia gave early support to integration into the global economy³⁵ (in contrast to many deve-

³⁵ Indonesia possessed an open capital regime from 1971, though until the 1990s private capital flows were negligible (O'Rourke, 2002; p. 24).

lopmental states in Africa and Latin America), is said by political scientists to have a greater degree of "autonomy"; its decisions, in other words, are not shaped by public pressures, but by the necessities of future growth and the requirements of coordinating labour, business and public institutions to this end.

Aside from preventing public strife, the absence of democracy in the development process has also been regarded as a means to avoid the consensual conservatism that tends to be the hallmark of representative government (Leftwich, 2000; p. 174). It is crucial, however, to distinguish between two different sorts of state autonomy, each of which has very different effects on the welfare and development of a nation. One is the autonomy of a despotic state, commonly found in pre-industrial nations (Weiss & Hobson, 1995; p. 240); the arbitrary use of power by such a state might make it feared, but it has few mechanisms to penetrate society, reliably extract resources or mobilize groups (it is "authoritarian without being authoritative", as explained by Grindle (1996; p. 33)). The other is the autonomy of a "strong state", which is able to implement a genuine growth strategy by harnessing the activities of all sectors in society and relying on widespread legitimacy. Here the autonomy is "embedded": it needs allies and intermediaries across the breadth of society, yet it is able to direct their activities and even shape their perceived interests.

The tension between the two forms of autonomy has been crucial to the long-term success or failure of the developmental state. Without electoral democracy, legitimacy must be sought by other means – most obviously, once slogans of national self-defence or popular rule have lost their impact³⁶, by rising welfare assured by continuous growth. But in an integrated global economy, in which exogenous shocks are commonplace, this source of legitimacy cannot be guaranteed. The chief mechanism through which the state conveys its authority to the rest of society hence comes under direct threat – as was evident in Indonesia – and the state can be drawn from its embedded autonomy to one of authoritarian rule³⁷. It may there-

³⁶ Suharto came to power amid an extremely violent repression of the Communist Party (PKI) from 1964-1965.

³⁷ Suharto's reaction to the protest movement of early 1998 was to revive the Kopkamtib, the secret police that in the repression of the 1960s is estimated to have killed 500,000 people. Prior to his resignation on May 21, he signed three executive decrees to this effect. Of course, the developmental state more commonly moves in the opposite direction – towards greater democracy

by insulate itself from society, but at great cost to its operational capacity.

Furthermore, as Suharto's demise illustrated, developmental states have been plagued by defects generated by their very autonomy: by the 1990s, the collusion between businesses partially or completely owned by Suharto's relatives or cronies, economic policy-makers and political leaders was complete. One effect of this supremely powerful clan network was rent-seeking through government licensed and subsidized industries, such as that of the clove cigarette industry, which was under the control of the president's youngest son, or the national car and aircraft industry (O'Rourke, 2002; p. 46). Likewise, leading banks and private corporations were dominated by regime-friendly executives, a fact that led to excessive lending from the country's central bank (through the so-called Bank Indonesia Liquidity Support) to support them during the crisis; auditors later established that 96 percent of this lending was subject to some form of abuse (Ibid; p. 61).

It is important in this respect to underline that these structural defects did not provoke the crisis that engulfed Indonesia from 1997 to 1998 – contrary to IMF and investment community arguments at the time. But once the crisis had begun, these *rentier* practices were blatantly exposed by the rapidity and scale of the financial collapse. In a context of mass impoverishment, such widely known abuses served only to aggravate the initial loss of legitimacy, and turn the state, as run by Suharto, into the principle *culprit* of the crisis in the eyes of the Indonesian public. (One recent report has indicated that Suharto left power having defrauded Indonesian state coffers of between \$15 billion and \$35 billion dollars, the largest state-led embezzlement ever committed³⁸).

Although clear distinctions in the developing world are by no means easy to make, the principal rival to the developmental state has been what might be termed the *corporatist state*, of which Argentina and several other Latin American nations (Brazil, Mexico, Venezuela) are leading examples. In comparison to the initial circumstances of developmental states – which often arise in rural, pre-industrial nations,

where civil societies were notoriously weak – these states have tended to inherit political systems marked by stronger competing sectoral interests and class conflict. Unable to stand back from society and establish a process of rapid, planned development, the corporatist state has sought to compensate for its weaknesses by reaching pacts with the principal group interests (labour, business, foreign investors, the military and the bureaucracy), and thus guarantee its legitimacy through a combination of orderly economic growth and controlled participation.

One explicit example of such a strategy were the national agreements made in Venezuela in 1958 after years of civil and political strife: one of them, the Worker-Owner Pact, sought to assure a greater share for labour in national income, in return for popular consent to a capitalist model of development; the other, Punto Fijo, effectively promised a share of government posts and patronage for each of the two political parties, regardless of which was the electoral victor. Similar traces of economic policy accommodation and political elitism can be found in the PRI regime in Mexico, in the Liberal and Conservative Party carve-up in Colombia, both military and democratic (Peronist) rule in Argentina, and in the Getulio Vargas epoch of military dictatorship in Brazil. In essence, the corporatist system these countries embraced was designed to appease the main *organized* interest groups through a system of rule by political cartel. It is therefore not surprising that the main challenges to any given cartel have come from previously unorganized interests (the citizenry in Argentina in 2001, the urban poor in Venezuela who participated in the 1989 “caracazo”), or from organized interests that believe their claims have been unfairly neglected (leading to the business-sponsored challenge to PRI in Mexico, or the trade union-based Workers' Party in Brazil).

A first important distinction between the actions of the developmental and the corporatist state is derived from this issue of accommodation with social interests, and thus the states' legitimacy. A developmental state tends not to pacify any given group interest, but either to co-opt it or combat it: Suharto took the former option with the political Islam movements in the 1990s, and the latter with the communist uprising of the 1960s. Corporatist states, on the other hand, will tend to promote political rule based on a coalition of support between competing interests. This need for a

(e.g. South Korea).

³⁸ Figures are from a recent report from the NGO Transparency International. See report “Los presidentes ladrones” in *El País*, 01/07/2004.

coalition does not mean that corporatist states are synonymous with democracy. Support need not always come from the ballot box: in most of the Cold War period, the prevalence of dictatorships and democracies in Asia and Latin America was roughly equal³⁹, and Argentina, though a corporatist state, has spent 39 years between 1930 and 2006 under military rule (the slogan used by the military junta of 1976 to 1983 was that “the ballot boxes are in safe keeping” (Feinmann, 2003; p. 35)). Free elections have often been regarded by corporatist regimes as a threat to the established balance of interests, or “order”. They have been held off with appeals to values such as security, national integrity or hate for the outsider; as a result, the regime pattern has been similar to that of developmental states.

But the corporatist state system does differ in one key respect with respect to democracy. The natural dynamic of a corporatist state is to react, and if possible accommodate, the pressures posed by organized groups. Its environment is one of competing group demands, the effect of which is to stimulate the activities of civil society, create new political forces, and reinforce the clamour for democracy. In the end, the exhausted corporatist dictatorship usually subsides (such as in Spain, Portugal, Chile, Argentina, Uruguay and Brazil), and in recent years has not been revived⁴⁰. The developmental state, on the other hand, will tend to establish highly controlled means of democratic access, and justify the restrictions on wider participation through ideology and myth; its logic is more plainly to create democracy on its own preferred terms, and it reverts to authoritarian patterns without great hesitation⁴¹.

In terms of autonomy – a second main distinction – the corporatist state is at a clear disadvantage. It may seek to work in a coordinating capacity between key groups, as in highly industrialized countries such as Japan (Weiss & Hobson, 1995: p. 4), but its own structural weaknesses, and the entrenched rivalries between social factions, militate against this role.

³⁹ But not entirely. According to the survey by Przeworski et al (2000), over the period 1950 to 1990 democracy has been 12 percent more likely in Latin America than the average given its level of economic development.

⁴⁰ And this in spite of widespread economic decline in the late 1990s and early 21st century.

⁴¹ Vladimir Putin’s Russia may be taken as one example. It remains to be seen whether Indonesia under new president, Susilo Bambang Yudhoyono (elected September 2004), a former general, reverses democratic gains.

The impact on economic strategy is profound: the developmental state seeks to orientate group interests in its economic plans rather than appease them, enabling powerful development agencies (the Economic Development Board in Singapore, the Ministry of Finance and Development Planning in Botswana) to assume strategic control over the economy in ways unimaginable in corporatist states. In the latter, economic decision-making is decided by the ruling coalition to accommodate the greatest number of major group interests. The result, in many corporatist states, is a series of *ad hoc* economic policies, heavily influenced by “concentrated” interest groups such as the financial sector (Frieden & Martin, 2003; p. 129), poorly attuned to the long-term development of the nation, and prone to irresponsible borrowing by the state.

Furthermore, economic policy often becomes a driver of political dispute or accommodation, and not always to its advantage. In the case of Argentina, the coalition around convertibility, which in the presidential elections of 1995 and 1999 assumed the status of an economic *untouchable*, expressed general support for a policy that had apparently eliminated the country’s nemesis, hyper-inflation. The strategic effects of the policy, which gravely affected the country’s trade patterns and internal markets, were simply ignored in the light of convertibility’s *political necessity*.

The contrasts between the two sorts of states, therefore, can be drawn around the different approaches to legitimacy and autonomy. We have already seen that legitimacy, especially in conditions of economic hardship, is a critical dilemma for the developmental state; the more successful states of this ilk, such as South Korea, Japan, Singapore and Malaysia, have made equitable distribution a vital part of their developmental strategy, and have become progressively more democratic as their income levels have advanced. For the corporatist state, on the other hand, political legitimacy is more readily achieved through the access given to key interest groups, and more importantly, by democratic elections. Evidence indeed suggests that citizens tend to weigh a political system’s legitimacy in terms of its capacity to provide certain basic political rights, rather than its socio-economic results (Diamond, 1998; p. 16). But the corporatist state lacks autonomy: it is often trapped inside the logic of its own coalitions, unable to implement desirable (if unpopular) policies, unable to extricate itself

from crisis. Its basic need is thus to seek out new areas of autonomy, where if possible it can declare its prerogative over and above the claims of competing social groups.

The last and third sort of developing world state is found in all regions, but prevails like no other in sub-Saharan Africa: this is the *neo-patrimonial* state. Its chief characteristic is one that is found in both previous state-types, but which in this case is made into operating norm – the state, nominally a public institution, is annexed by a network of personal interests that assume control over state resources, and then deploy these to perpetuate the power of the ruling clan or network. Real politics, therefore, is not concerned with institutionalised state activities, but with informal channels of patronage and corruption (Chabal & Daloz, 2000; p. 139); the recurrent state failures, political instability and chronic debt crisis in Africa have been attributed in part to this distortion of the state into a personal resource.

States of this type have found ideal conditions in areas of great poverty, recently free of colonial rule, dominated by rural activity, dependent on a very few staple exports and equipped with the most fragile initial state structures. The state, in an account given by one eminent political scientist (Herbst, 2003), was unable before independence to “broadcast power” to an entire territory, which has often been filled with rival ethnic groups. Since independence, possession of the state – providing resources from the chief export industries (via ownership and special taxes), along with critical access to international recognition and development aid – has become a greater priority than extending the state’s services to the whole of a national territory, despite several valiant examples to the contrary.

This has had two important consequences for many nations’ public debt and expenditure: in the first instance, the non-institutional environment has been propitious for irresponsible borrowing, and the creation of what has been termed “odious debt”, most notably in Mobutu Sese Seko’s Zaire (1965-1997)⁴². Secondly, regimes have tended to seek broader political support through the coalitions created by informal patronage, and in particular via systems of public subsidy that could appeal to broad

⁴² Transparency International estimates that Mobutu looted \$5 billion (*El País*, 1/7/2004). The country’s HIPC debt cancellation is set to reach \$6.3 billion.

swathes of opinion. In several countries, this involved subsidies for basic goods: in the case of Zambia, one vital subsidy was that for corn-meal, or “mealie-meal”, a staple in the national diet (Grindle, 1996; p. 32). This subsidy’s particular target group was urban wage-earners, yet its perceived distortion to free market operations made it the chief part of government spending identified for elimination by the structural adjustment programme reintroduced by the World Bank in the 1991. In this case –as in the Venezuelan “caracazo” of 1989, which was sparked by a steep increase in bus prices– the regime’s very legitimacy was bound up with its ability to preserve a system of public subsidies that were directly menaced by a debt reduction programme.

The accumulation of public debt by many sub-Saharan nations in the 1970s and 1980s, and the simultaneous collapse in a host of commodity prices in the latter decade and beyond⁴³, has thus caused major convulsions in the nature of the state, and its relations with society. International lending bodies’ prescriptions for streamlined states, liberalized markets and greater exports have failed –with notable exceptions, such as Ghana and Uganda (Tsikata, 2001)– and in many cases served to undermine already fragile public institutions, as well as forcing people to join en masse the informal, subsistence economy (Vergote, 2003; p. 33).

High levels of informality, in both politics and the economy, have resulted in the peculiar condition of these nations: “Africa was lost between state and market” is the conclusion reached by one recent study (Harbeson & Rothchild, 2000; p. 49). Though most restrictions on free market operations have been lifted, above all those involving foreign investment, domestic credit markets and business regulation remain ill-equipped to generate stable domestic growth. Poverty rates have in many cases worsened – Zambia’s, for instance, stood in 2002 at 73 percent⁴⁴– and entire economies have failed to grow or even contracted over the course of the 1980s and 1990s⁴⁵. In place of the promised export diversification and a thriving private sector, sub-Saharan countries have stayed heavily dependent on

⁴³ Cotton prices fell 41.72 percent from 1997 to 2002, sugar by 39.17 percent and tea by 25.87 percent. See Jubilee 2003; p. 19.

⁴⁴ Figures from “Zambia at a Glance,” World Bank. (www.worldbank.org).

⁴⁵ This has been the case for Zambia: GDP fell from 3.9 billion US dollars in 1982 to 3.7 billion in 2002. GDP per capita, meanwhile, fell by 1.9 percent from 1982 to 1992, and 0.9 percent from 1992 to 2002 (Zambia at a Glance, World Bank).

their principal export markets, and thus exposed to a constant downward pressure on their terms of trade, or at the very least wild fluctuations in price (Jesuit Centre, 2003; p. 6).

This environment of economic malaise and instability, however, has not generally led to the type of political and social turbulence witnessed under developmental and corporatist regimes. In saying this, a contrast must of course be drawn between civil unrest and civil war: the poorest countries, where GDP per capita is below \$2000 per annum, are much more prone to internecine warfare. Of the 40 countries covered by the HIPC programme, many, including Mozambique, Rwanda, Sierra Leone, Burundi, Angola, Liberia and Somalia have restored peace in recent years; a further two (Sudan and the Democratic Republic of Congo) are still experiencing armed conflict, even though the latter is at the penultimate stage of reforms required for securing its debt relief package (Jubilee, 2003; p. 8).

Regime change generated by civil protest or a political transition, on the other hand, are much less common than under the other two state systems. The rent-seeking clans that operate states through neo-patrimonial networks have in most cases managed to accommodate democracy without any significant change in political practice: after the fall of the Berlin Wall in 1989, some 47 sub-Saharan states undertook reforms aimed at introducing a multi-party, electoral democracy. Within only a few years, however, the political elite had learnt to manage these new conditions of competitive elections without seeing its hold on power undermined⁴⁶. Instead of participative democracy, many analysts have noted an entrenchment of corruption, clan networks and popular disaffection (Anderson (ed), 1999; p. 243); what is left of civil organization is to be found outside the bounds of political activity.

The neo-patrimonial state, in other words, has tended towards the form of despotic autonomy discussed above. Unable to achieve any welfare-enhancing modifications to national economic life, it has perpetuated its rule through control of resources and patronage networks, often organized to favour one ethnic clan. Its claims to genuine legitimacy and autonomy, meanwhile, face huge domestic and foreign

⁴⁶ Zambia was an interesting exception in experiencing a major political transition, though as shall be seen, few of the basic conditions of political life in that nation have been altered

impediments. At home, its public support is fragile, and its monopoly on the use of force may be exposed to the threat of armed challenge in particular areas of national territory (particularly where politically underrepresented ethnic groups are in a majority). In the international community, the states have little diplomatic influence, and are subject as a result of their debt burdens to reform programmes that are largely dictated by international lending body orthodoxy: in the words of one recent report on the HIPC, “creditors (to debtor nations) effectively act as witness, plaintiff, policeman, judge and jury in their own court” (Jubilee, 2003; p. 25).

Herein lies one of the principal contradictions in international debt relations as they affect the least developed countries: in order to dictate reforms to these nations, the international community identifies the incumbent powers in a neo-patrimonial state as the rightful interlocutors in any transactions or negotiations. In other words, regimes that count on tenuous support at home, and which tend to operate outside institutional structures and norms, are provided with a major platform for their legitimacy – at the cost of conforming to external economic demands: according to Jackson (1990; p. 25), “never have disparities between the outward forms and the inward substance of sovereign states been any greater than they are today”. This disparity, as we shall observe below in greater detail, gives the neo-patrimonial state a vital space in which to defend its hold on power, silence domestic criticism of its actions, and gain some traction with the exigencies of the IMF or World Bank. In other words, a functioning form of autonomy is secured by the ruling powers, yet without any real sovereignty being achieved that might stimulate public political participation, or generate any noticeable progress in economic development.

3.2. THREE DEBT CRISES

Recent debt crises in each of the three cases under study had momentous effects on the economic and political life of the nation. A brief account of each one is given below:

Three years of recession in *Argentina* had led, by early 2001, to grave doubts among foreign investors and creditors over the country’s macroeconomic stability. High public deficits, most notably in the last years of President

Carlos Menem's government (1989-1999), when the national overspend (excluding provincial deficits) reached \$4 billion (Rock, 2002; p. 80), were identified by financial markets as increasingly unsustainable. In a context of decreasing public revenue, the country's ability to honour onerous debt obligations had become mired in uncertainty: these doubts were translated by the markets into a much higher risk premium on Argentine treasury bonds. This precautionary measure effectively entrenched the breach between the possible tax revenues accruing to the state, and the demands simultaneously being made upon it by creditors.

Domingo Cavallo's tenure as economy minister from April to December 2001, when popular protests forced his resignation and that of President Fernando de la Rúa the next day, was marked by a series of ever more desperate attempts to seal this gap between public income and spending. His chief weapon, a "zero deficit" law that first cut public sector salaries by 13 percent then promised to reduce them in line with each month's deficit requirements, only served to deepen recession. By August, the government had to turn to emergency funding of \$8 billion from the IMF. Its hopes that the funds would restore confidence were dashed: capital flight from March to November 2001 is estimated to have reached \$18 billion, the spread on US bonds rose relentlessly, the monthly public deficit grew larger and the economy continued to contract. The creation, in this period, of numerous paper currencies used by provinces and the Buenos Aires city administration to pay employees, is perhaps the most fitting testimony to the country's nemesis: a monetary drought.

By the second half of the year, it was becoming clear to the IMF and foreign investors that the monetary policy which had ruled Argentina for the past 11 years – convertibility and parity between the US dollar and the peso⁴⁷ – could no longer be sustained. The state, deprived of monetary autonomy by the tie to the dollar, had been obliged to seek a solution to its deficit in fiscal contraction and tightening of the money supply (Perry, 2002). So severe was this tightening that in late November, cash withdrawals from banks were restricted (the so-called "corralito"). Application a few days later for a fresh injection of dollars from the

IMF was refused, forcing Cavallo to file a budget for next year that would have cut public spending by \$9 billion. It was in this context that riots and shop ransacking, in large part motivated by local Peronist political bosses, occurred across Greater Buenos Aires, prompting President De la Rúa's declaration of a state of siege, and as a result the mass protests against his government in the capital on December 20 and 21. The next two weeks saw four different presidents take office amid intense popular turbulence; by the end of that period, a default on private debt had been declared, and convertibility had been scrapped.

The crisis in *Indonesia* was quite different in origin to that of Argentina. Unlike the Latin American nation, the country was neither in recession (growth for early 1996 stood at 8 percent), nor did it possess a particularly burdensome *public* debt (\$65.3 billion in 1995, or 33 percent of GDP). Indeed Suharto's Indonesia had long been regarded within international financial circles as a reliable debtor, having honoured its debts even during a devaluation crisis in 1986 (Forrester, 1999; p. 107). But in contrast to previous episodes of financial turbulence, the country's economy and political system were profoundly affected by the Asian crisis between 1997 to 1998; to explain this, attention must be focused on short-term debt accumulated in international markets, and thus in foreign currencies, by the private sector.

During the 1990s, Indonesia enjoyed a massive boom in foreign capital. The value of the Jakarta Stock Exchange, to take one prominent example, swelled enormously, with the number of companies listed rising from 24 to 282. But capital-hungry local companies also resorted to other, less transparent means to secure investment: many issued 270-day high-interest credit notes, called Commercial Paper. Several larger firms created their own banks (the number of banks operating in Indonesia rose from 124 in 1988 to 240 in 1994 (O'Rourke, 2002; p. 24)), which in turn could attract depositors' and investors' money; this could then be lent at generous rates to the parent company. Through a variety of such mechanisms, prominent companies – many of them with intimate connections to Suharto's clan – guaranteed a constant supply of liquidity and easy rollovers of outstanding debt.

By July 1997, when Thailand devalued, these commercial practices had created a private sec-

⁴⁷ Meaning that each Argentine peso in circulation had to be backed in the central bank's reserves by a corresponding dollar.

tor debt totalling \$80 billion; this sum was around four times the Indonesian central bank's reserves (O'Rourke, 2002; p. 41), and signified a huge increase on the equivalent total for 1990, which stood at just over \$20 billion⁴⁸. Clearly the ability to process this debt depended crucially on the value of the Indonesia currency, the rupiah, against the dollar and the yen. Although there had been little pressure to depreciate the rupiah beyond its "crawling peg" prior to this date, the exogenous shock of the Thai devaluation – and the contagion it generated via panic selling across Asia – exposed these structural weakness in the Indonesian economy, and thereby hastened the crisis that unfolded over the next year.

Throughout the second half 1997, hunger for dollars, particularly from heavily indebted businesses, drove the rupiah to well under half its mid-year value; just as in Argentina, some \$8 billion was transferred offshore in the last three months of the year. Early IMF intervention, via a structural reform programme that included the abrupt closure of 16 banks (announced on November 1), only aggravated this crisis of confidence (as the IMF has itself admitted⁴⁹), while government policy towards its favoured businesses and banks remained largely unaltered.

By early 1998, the inflation caused by devaluation and abusive lending from the central bank to illiquid private banks⁵⁰ had generated soaring food prices, a sharp contraction in real incomes, a series of ethnic riots across the country and an escalating political crisis. Massive rioting across Jakarta's poorest areas (known as the *kampung*) and in other towns in May 1998 testified to the level of popular unrest and to the complete inability of the security forces to cope: three days of violence ended on May 16 with a total of 1,217 deaths and widespread destruction of property (including 122 branches of a bank owned by Suharto's family). On May 21, after 33 years in power, Suharto finally tendered his resignation.

The debt crisis faced by *Zambia*, meanwhile,

derived almost entirely from excessive lending to that country from the IMF and World Bank in the 1970s and early 1980s: some 90 percent of the debt, which now stand at around \$4.5 billion (or 104 percent of the country's GDP, one of the highest debt ratios for developing countries in the world), is owed to bilateral and multilateral lenders (IMF Policy Department, 1998; p. 129). Economic stagnation, beginning in the 1970s, forced the World Bank to recategorize the country from middle income to low income in 1981 (the same decision was taken with respect to Ghana in 1983 and Nigeria in 1990), prompting international lending bodies into making a series of demands for reform to major parts of the domestic economy.

As a result, a fierce decade-long battle ensued between international lending bodies and President Kenneth Kaunda's United National Independent Party government, which resolved to resist the prescriptions of lending bodies, and in parallel with Alan García in Peru, limit debt servicing to 10 percent of export value. This decision, taken in 1987, caused multilateral creditors to halt new loans to the country, thereby provoking a serious public spending crisis and deeper economic turmoil. Just three years later, Kaunda returned to the negotiating table, and agreed to implement a programme of structural adjustment, starting with an end to the abovementioned cornmeal subsidies. Fresh rioting in Lusaka over these plans, which killed 27 people, and widespread exhaustion with Kaunda's 27-year rule, led to his party's defeat at the elections of 1991, and the creation of a new government run by President Frederick Chiluba's Movement for Multiparty Democracy (MMD).

Chiluba's administration instantly embarked on the long-suspended reform programme: cornmeal subsidies were scrapped, many business regulations were abolished, strict budget limits were devised, and a programme of mass privatisation was launched. Even so, it is generally acknowledged that by the mid-1990s, amid continued economic stagnation, the reform plans lost their momentum, and have since dissipated into renewed struggles between multilateral lenders and the Zambian government over budget cuts and privatisation of key business concerns, above all the country's copper mines. According to one recent World Bank-sponsored study, the prevailing mood between the two sides is now one of "mutual distrust" (Devarajan et al, 2001; p. 579).

⁴⁸ Figures from the Asian Development Bank. It should be noted that public long-term debt from 1990 to 1998 only rose from \$47.9 billion to \$67.3 billion.

⁴⁹ "An internal review published in September found the fund's actions contributed to the 13 percent fall in GDP in 1998 that made Indonesia the worst-hit of the Asian crisis economies" according to the *Financial Times*, 15/10/2003.

⁵⁰ From the end of October 1997 to the end of January 1998, cash in circulation increased by 50 percent (O'Rourke, 2002; p. 60).

3.3. THE POLITICAL AND SOCIAL CONSEQUENCES OF DEBT CRISES

In spite of major differences between these countries in the evolution of their crises – most notably in the form of debt involved (private or public) or in the efforts taken to control monetary turbulence (“zero deficit” in Argentina, inflationary financing in Indonesia, vacillating reform in Zambia) – the effects on society and political authority experienced by all three countries reveal a number of significant shared features. Examination of these effects is of course a crucial step towards understanding the dynamics that influence the authority and legitimacy of the nation-state, which in all three cases is exposed to challenges from below (the aggrieved population) and from abroad (creditors, either public or private).

Close examination of the crises and their aftermath in the three case studies reveals four broad effects on society and political authority:

1. *Socio-economic crises and mass impoverishment*

In all three countries, debt crises, particularly in their “triplicated” version, produce a general systemic shock; poverty, as a result, has invariably risen sharply. Statistics from Argentina and Indonesia reveal extraordinary parallels in this respect. In the year to October 2002 in Argentina, for instance, over six million people fell beneath the poverty line, and the poverty rate rose to 57 percent by 2003 from its previous levels of around 30 percent during the 1990s. Impoverishment in Indonesia, meanwhile, provided the main background to the rioting and ethnic tensions of early 1998: one estimate suggests that 210,000 Indonesians fell below the poverty line every day during that year, generating chronic food shortages (so-called *nepot nasi*) in poor areas (Forrester, 1999; p. 107). Figures from the World Bank indicate that the headcount poverty index in Indonesia rose from 15.7 in 1996 to 27.1 in 1999 (CGI, 2003; p. 51).

Heavily indebted countries in sub-Saharan Africa, for their part, are among the poorest countries in the world: in the words of one analyst, the 33 states in the region that joined the HIPC initiative upon its creation in 1996 form “an international under-

class of states on the margins of the globalizing world economy” (Harbeson & Rothchild, 2000; p. 66). The burden of their combined debts at that time, \$215 billion (or twice their total export earnings for a year), can itself be interpreted as a chronic source of continued under-development, economic vulnerability and investment risk: one IMF study found that high debt levels tend to crowd out government social spending, “in part because governments find it politically easier to cut back spending in such sectors because the poor are not usually organized to have a voice in such decisions” (Loko et al, 2003; p. 17)⁵¹.

Debt crises in these countries, often caused by sharp falls in commodity prices, have generally served to turn these underlying vulnerabilities into unmanageable shocks. From 1980 to 1986, for instance, the decline in copper prices caused Zambia’s debt to GDP ratio to rise from 84 percent to 344.4 percent (Grindle, 1996; p. 25), providing the pretext to the reform plans, popular protests and political instability of the next five years. As in other debt-ridden countries in the 1980s, notably Mexico and Brazil, the proportion of Zambia’s budgets spent on education, health and social welfare decreased markedly⁵². Public sector salaries in sub-Saharan Africa, representing one of the few sources of formal employment in these countries, plummeted in turn: the head of the Ugandan civil service earned in 1988 around three percent of the salary earned in 1975 (Ibid; p. 41).

2. *Democratic pressures*

Rapid declines in standards of living, particularly in a context of limited political participation or state legitimacy, tend to generate vociferous demands for democracy. One key motivation is the popular desire to punish the previous regime, whose ostentatious practices often contrast sharply with the reduced purchasing power of the population. Indonesia is perhaps the finest example of this process: around 70

⁵¹ These arguments are contested by Bird & Milne (2003), who insist that the absolute level of debt – rather than the net debt servicing payments in any given year – is irrelevant to a country’s economic performance.

⁵² Interest payments on debt accounted for over 50 percent of government spending in Brazil, Mexico, Peru and Zambia in 1991 (Grindle, 1996; p. 25).

new political parties were created in the aftermath of Suharto's resignation (Forrester, 1999; p. xix) and the lifting on the ban of parties in June 1998. Parliamentary and presidential elections were held the next year, representing the definitive end to Suharto's tightly managed institutional arrangements, and formal controls over civil society organizations and the media have been scrapped: the result has been a "new level of transparency and competition in Indonesian public life" (CGI, 2003; p. 39), evident in the wide range of candidates standing in the presidential elections of 2004.

These moves towards democracy, however, have been contested by elites connected with the institutions that dominate Suharto's regime, which have sought with some success to maintain control over the judiciary and channels of public finance. According to the World Bank, "there are increasing signs that old elites and a set of new players, especially at the regional level, are using 'money politics' to solidify privileged positions in the new political system" (CGI, 2003; p. 39). An identical dynamic of popular calls for greater democracy conflicting with entrenched elite interests was evident in the year following the Argentine crisis: the public image of all state institutions reached unprecedented lows, while new civil organizational forms (neighbourhood assemblies, savers' associations, *piquetero* groups) fought to defend their interests. In the case of Zambia, the democratic convulsions of the early 1990s ended with the reestablishment of a new political elite; efforts to limit democratic participation and openness were initiated in 1996, only to provoke a rapid exodus of foreign donors.

3. *Relocation of public authority*

Intimately connected with this pressure towards democracy is the tendency for civil groups, particularly those that suffer most acutely from the systemic crisis, to seek out new authority structures; in extreme cases in sub-Saharan Africa, this has involved bypassing conventional state structures, and replacing patronage-based political networks that are no longer able to provide vital resources with a series of informal community structures. Within Argentina, the trend towards barter clubs

(*trueque*), *piquetero* groups and neighbourhood assemblies also manifested a general public need to find a means of survival outside the normal institutions of the state and market.

Meanwhile, the political turbulence caused by debt crises will often entail a vacuum in power that can entail internecine institutional warfare, or the entrenchment of a new system of authority. Indonesia clearly experienced the former in the period 1998-1999, during which time various outbreaks of civil unrest were heavily influenced by different political factions. The military repression in East Timor, for its part, seems to have been heavily influenced by the political ambitions of General Wiranto, the armed forces commanders under Suharto from 1994 to 1998, who has been identified by UN prosecutors as a chief culprit for the killing of 1,400 people in East Timor in 1999⁵³. In Argentina, on other hand, the crucial power-brokers throughout the crisis period were provincial political leaders, most of them from the Peronist party.

4. *Intervention from abroad*

Pressure from abroad on a country to honour its debt repayments, or at least attempt to carry out reforms so that debt servicing can be restored to normality, is an intrinsic part of all these crises. As discussed earlier, there is no direct means to enforce these demands, but the costs for a state of failing to comply in any way with creditors' wishes are high: in the case of Zambia, the freeze on credit caused by the halt to the reform programme in 1987 was particularly disastrous.

Making the provision of future credit dependent on domestic structural reform is the principal means by which international lending bodies and foreign investors seek to influence any given nation; indeed many financiers regard such crises as the ideal opportunity to bring about the changes (or "convergence") they long for. In a study of the Asian crisis, Feldstein (2002; p. 28) argues that "mandatory" changes went far beyond what was necessary to stabilize the individual economies or to allow them to

⁵³ Wiranto was also a candidate in the 2004 presidential elections, but lost out in the first round in July.

regain voluntary access to the global capital markets.... The Fund's managing director, Michel Camdessus, once commented that the crises were a blessing in disguise because they provided the Fund with the opportunity to improve the economic structure and governance of these countries". Yet as we shall see more clearly in the next chapter, these structural demands are not always successful: Malaysia flouted IMF advice by adopting capital controls; Argentina has watered down or ignored structural prescriptions from Washington; and Zambia regularly violates its own promises.

4. Debt and sovereignty

The socio-political effects of debt crises, which were discussed in the previous chapter, point to a general weakening of the state and traditional authority. Taken in combination, popular impoverishment, demands for greater participation by recently mobilized social groups, a shift in allegiance to new sources of authority and increased intervention from foreign powers would appear to sap the state of its legitimacy and autonomy. Similar processes of political degeneration – involving an expansion of competing social claims combined with a weakening of the state's capacity to resolve or reconcile them – are of course to be found in many instances across the developing world, with or without a debt crisis to provoke them. This combination, for example, lies at the root of Huntington's study of political instability in developing countries (Huntington, 1967), while Kohli's account of governability within India points to the contradiction between a highly politicised society of multiple competing factions and an excessively over-personalized state as the key to that country's rising violence and public disorder in the late 1980s: "the state is omnipresent, but feeble; it is highly centralized and interventionist, but seems powerless" (Kohli, 1990; p. 8).

Debt crises, however, are markedly distinct in one particular way: whereas the political evolution discussed by Huntington and Kohli relies upon a domestic momentum, driven largely by economic and social modernization, foreign debt crises are the result of a mismatch between domestic financial resources and international demands. Throughout such pe-

riods, as seen in the previous chapter, foreign creditors and international financial institutions seek to exert their influence, and will take every opportunity to bring about lasting change in the indebted countries' economic structures so as to ensure reliable debt servicing in the future. In terms of the concepts of legitimacy and autonomy, the state appears to be threatened both from within and from outside: foreign creditors and lending bodies do not necessarily recognize the importance for the state of satisfying domestic interests or maintaining basic welfare levels (thereby threatening state legitimacy)⁵⁴, nor do they leave the state to devise its own policies and development initiatives (a threat to autonomy).

Analysing the state in a developing country solely through the conceptual tools of legitimacy and autonomy, however, has a limited scope. Both are of greater value when applied exclusively to the domestic arena; indeed, they refer almost entirely to the relations between a state and the society that it governs, whereas foreign interference only exerts any direct influence on the autonomy of the state – and even then within the limits postulated in chapter 2. A more valuable concept to deal with the complexity of this three-way interchange between society, state and foreign powers is sovereignty, which can broadly speaking be defined as the freedom of action of a nation-state, and the capacity to implement the policies that it has freely chosen

4.1. THE NATURE OF SOVEREIGNTY

Sovereignty, though used with great frequency to describe the rights and entitlements of a nation-state, is far from being a clear concept, or even one that is normatively desirable in all cases. European Union countries, for instance, are said to have "bargained away" sovereignty in an effort to gain greater traction over shared concerns, such as integration with the global economy, crime or the environment (Keohane, 1995; p.177). Sovereignty is also regarded as a lesser concern in cases where violations are human rights have been perpetrated on a mass scale by any given state, or when that state has

⁵⁴ The recognition of the domestic balance of forces is of course a delicate matter. In the case of Zambia, the IMF and World Bank pushed for reform (above all the end to maize subsidies) in the face of popular resistance, as manifested by the riots in Lusaka and Kitwe of June 1990. The institutions were nevertheless much more content to implement the reforms via a supportive government after October 1991.

infringed on the sovereignty of others.

Sovereignty, therefore, can be lost, exchanged or overruled. Its precise dimensions – as compared to the remit of international law, for instance – fluctuate according to changes in the international diplomatic environment, leading some experts to label sovereignty as an “ever-changing description of the essential authorities of the state” (Heller & Sofaer, in Krassner (ed.), 2001, p. 45), and therefore as little more than a working tool by which state leaders and diplomats agree to operate. Yet even if this pragmatic interpretation is accepted, it remains clear that the concept itself contains several dimensions which are important to dissect.

According to Krassner ((ed.) 2001; chapter in Smith et al (eds), 1999), the concept of sovereignty should be unbundled into four separate elements so as best to encapsulate its domestic and international significance. These are:

1. Interdependence sovereignty: the ability of a government to control activities that are transnational in origin, but reach within a nation-state’s border (e.g. crime, environmental damage, terrorism).
2. Domestic sovereignty: the capacity of state in any given polity to exert authority and ensure that its policies are implemented.
3. Westphalian sovereignty: the exclusion of influence over a country’s domestic affairs by an external authority.
4. International legal sovereignty: the international recognition of a state.

Clearly, as Krassner himself explains, it is uncommon for all four branches of sovereignty to be respected to precisely the same degree, or for them to respond identically to political or diplomatic changes: in the case of European Union legislation, for instance, Westphalian sovereignty may be said to have reduced in member-states in return for greater interdependence sovereignty. Likewise, Krassner observes that “in a situation in which domestic sovereignty is problematic, international recognition can enhance the position of rulers by signalling to constituents that a ruler may have access to international resources such as alliances and sovereign lending” (Krassner (ed.),

2001; p. 10). As we shall see below, this sort of sovereignty exchange is crucial to understanding the state during and after debt crises.

For the moment, we should recognize that the two-way process of sovereignty – understood as the state’s capacity to exert authority at home and secure its status abroad – enhances the largely domestic concepts of legitimacy and autonomy, though at the cost of greater complexity. Furthermore, we must acknowledge the dominant view of sovereignty and debt in development literature: namely, that the intensity and significance of global financial flows are emblematic of globalization, and that they intrinsically undermine the sovereignty of the nation-state by transferring power to markets, or to states or blocs with global economic influence (largely via the powers invested in international lending bodies). This perspective is embraced by Strange (1996), and is reflected in many studies of individual countries: “current approaches to resolving the debt crisis of developing countries, especially Zambia, allow creditors including the IMF and World Bank to contravene national sovereignty of independent states” (Jones Zulu, 2003; p. 11).

4.2. SOVEREIGNTY IN THE LEAST DEVELOPED COUNTRIES

It is undeniable that an extremely large number of states in the developing world – and above all the 38 countries currently included in the HIPC initiative – have been systematically weakened by the effort to meet the demands of both foreign and domestic interests in a context of scarce resources. In many such places, policy initiatives and choices are decided almost entirely by the main donors (Devrajana et al, 2001; p. 21), while a largely passive political management within the country seeks to maintain its bases of power. Recurring conflict between these two main claimants on the state is now often shaped by threats to withdraw aid or debt relief if major reforms are not introduced: in 2003, for instance, nine countries in the crucial interim period of the HIPC initiative were considered by the IMF to be “off track”⁵⁵, while Zambia was itself menaced

⁵⁵ The period in question is that between Decision Point and Completion Point, where the most significant amount of debt relief is provided. The latest information (March 2006) from the World Bank indicated that 18 countries have reached Completion Point (qualifying for \$37 billion in debt relief), 10 Decision Point, and 10 Pre-Decision Point (see www.worldbank.org/hipc)

with a cut of \$1 billion in debt relief if it did not privatise its national bank, ZNCB (Jubilee, 2003; pp 17-18)⁵⁶.

Domestic political elites in these countries, meanwhile, seek ways in which to placate or confront donors' demands, knowing all the while that they may themselves be thrown out of power if they are unable to satisfy domestic constituencies in the process. But even in the event of intense political competition at home, foreign donors' criteria still tend to prevail in decisions over which reforms should be applied to the economy and major institutions. This, and the continuous friction between domestic elites, donors and domestic social groups, helps generate what has become the key characteristic of many sub-Saharan and Andean states: inaction and passivity in the face of demands made either abroad or at home.

Development initiatives in heavily indebted countries are almost entirely the work of donor-imposed policy and expertise, on whose funds the initiatives entirely depend, while the state is restricted to an incomplete presence in the national territory. In Latin America, this translates into the absence of social rights (basic welfare and steady employment) for all but a minority⁵⁷, and in Africa by a similar minimal provision of basic services, aggravated by an outright lack of state authority in certain areas. In essence, we may talk here of what Robert Jackson calls "negative sovereignty": the states in question may be legitimated by their presence in the United Nations and their relations with international financial institutions, and thus have "international legal sovereignty" as defined above, but within their territories they are weak, dependent on foreign development aid, powerless to improve public welfare, and often representative of one minority part of society.

4.3. SOVEREIGNTY IN THE LOWER TO MIDDLE INCOME STATES

At the same time, there is growing evidence that in other indebted countries – principally those in the lower to middle income bracket,

with significant populations and in certain cases geo-strategic importance – the account given above of states weakened by their dependence on donor approval and a growing lack of domestic authority does not entirely hold. In countries such as Brazil, Turkey, Argentina, Indonesia and Mexico, debt crises have had profound effects on the shape of political power. They have been instrumental in redefining the basic structure of relations between state, society and the private sector, in the process creating new approaches toward foreign lenders and business.

This is not to say, however, that the resulting transformations have been uniform in character. The moderate Islamic government of Recep Tayyip Erdogan's Justice and Development party (AKP), for example, has achieved a high level of macroeconomic stability, stayed "on track" with IMF prescriptions, and established near total control over the state since coming to power in November 2002: the AKP "completely dominates the political landscape, both locally and nationally" asserted one recent report on the country⁵⁸. Brazil, Indonesia and Mexico, meanwhile, have all witnessed important shifts in the composition and outlook of the state in the wake of major debt crises, notably the election of the Luiz Inácio da Silva's Workers' Party in Brazil (October 2002), the government of Megawati Sukarnoputri in Indonesia (from 2001 to 2004) and both the shift of the Institutional Revolutionary Party (PRI) toward free-market orthodoxy under Carlos Salinas de Gortari (1988-1994) and the end to the PRI's hegemony in 2000 in Mexico.

In contrast to the current Turkish state, however, these new-style states have been frequently under threat, or menaced by their evident weakness – most notably in Indonesia, where according to a donors' report, "the high hopes that the *Reformasi* movement would break the hold of the vested interests behind the corruptions, cronyism and nepotism of the Suharto era have not been realized" (CGI, 2003; p. 39). All these countries have nevertheless sought to follow IMF policy, albeit with reluctance and the need to placate significant domestic opposition in the process. Their economic policies have endeavoured above all to be prudent, aiming to avert possible crises by taming inflation, reining in government spending, and avoiding unnecessary debt.

⁵⁶ The government finally invited bids for 49 percent of the bank in 2005.

⁵⁷ According to a major UNPD report (2004; p. 26), "the tendencies found in relation to social citizenship are very disturbing, and constitute the main challenges facing Latin American democracies".

⁵⁸ Special Report on Turkey, *Financial Times*, 27/4/2004.

Argentina is at present the exception, in seeking to combine a confrontational policy with international lenders and an effort to reform and re-legitimize the state. As in Turkey, the post-crisis governments of Eduardo Duhalde and Néstor Kirchner have managed to restore a single-party hegemony (that of the Peronists), and to secure high levels of public approval following their efforts at institutional reconstruction and a return to economic growth (at annual rates of between 8 and 9 percent from 2003 to 2005). The sustainability or flexibility of this political strategy – particularly once the country's economy reaches its full capacity and renewed foreign credit is required – has yet to be established.

4.4. BUILDING STATE CAPACITY IN POST-CRISIS ENVIRONMENTS

There is no doubt, then, that the five countries listed above have experienced one form or other of systemic shock resulting from debt crises, and have soon after embarked on a major political reconfiguration. In contrast to the HIPC nations, all five can be considered developmental or corporatist states – in other words, states that have traditionally espoused policies based on public intervention and economic progress, and which have had at one stage the means to implement them. Instead of the passivity and opportunism that characterise the indebted neo-patrimonial state, which tends to view reforms imposed by donors as a strategic ploy to lever more financial aid (Devarajan et al., 2001; p. 586), debt crises in these countries have tended to foster a new economic equilibrium and domestic political settlement, in which efforts to transform the role and efficacy of the state are fundamental.

Achieving this, however, is far from easy. As we saw in the previous chapter, debt crises produce major social and economic convulsions, undermine traditional channels of political authority, and expose the state to intense pressure from abroad. To assure economic stability and the creation of new institutional arrangements, the state – while under clear threat – must make full use of the legitimacy and autonomy it has at its disposal.

In other words, the attempted regenerative processes described above depend crucially on securing public approval (legitimacy), and finding spheres of political influence in which the

role of the state in decision-making and coordination is vital, and where it preferably faces few or no challenges from home or abroad to its own initiatives (autonomy). If the state is thus able to enhance its independent capacity, the key question then arises of how its sovereignty – defined in both domestic and international terms – has been affected.

There are five principal forms in which the state can acquire greater margin for manoeuvre through its claims to autonomy and legitimacy in the aftermath of debt crises:

1. *The state as a go-between*

Perhaps most importantly, the state throughout a debt crisis remains the sole interlocutor between the country and international lending bodies, and is thus in a privileged position to determine the national response to foreign creditors' demands. Where the state is neo-patrimonial, this status is largely exploited through leaders' effort to "play the game" of conditionality, and thereby secure funds while not depriving themselves of power or resources; in many cases, the state's main bargaining tool is in fact its own internal disorder, and the danger of violence or civil war should aid not be forthcoming (Chabal & Daloz, 2000; p. 167; Jackson, 1990; p. 34)⁵⁹. Similarly, in Indonesia from 1998 to 1999, many outbreaks of ethnic violence appeared to have been sponsored by factions of the state or political forces (most notably the repression East Timor, the anti-Chinese and Christian riots in North Jakarta, and the killing of dozens of Muslims in East Java⁶⁰), with the aim both of justifying limits on democracy and attracting additional international aid

Rather than resort to such tactics, however, corporatist and developmental states generally seek to consolidate their status as the key conduit for communication between numerous domestic constituencies and foreign creditors; as such, they can define the nation's post-crisis strategy on behalf of multiple affected groups, and claim

⁵⁹ In this respect it is interesting to note that donor aid to Zambia began to increase in the late 1990s due to fears of regional instability and war (Devarajan et al (eds), 2001; p. 578).

⁶⁰ See O'Rourke (2002), pp 170-171; 186-187; 274-280. According to the author, the UN Security Council envoys to East Timor in September 1999 "reported [...] that the military was able to 'switch the violence on and of at will.'"

unrivalled authority. The resulting strategy of the government is essential to its own identity, and can even anchor its entire social and economic ideology. In Argentina, President Kirchner and former Economy Minister Roberto Lavagna regularly portrayed their stance in negotiations with the IMF in terms of support for the poor, defence of the nation-state, and the exercise of legitimate authority: “[The debt] is the responsibility of bad Argentine governments, but also those who backed them”, Kirchner declared before Congress in March 2003. “[It will not be paid] at the cost of the hunger and poverty of thousands of Argentines, generating more poverty and conflict”.

Leaders of Brazil, Indonesia, Mexico and Turkey, on the other hand, have tended to stress their fiscal responsibility, and ability to maintain social order and economic growth by adhering strictly to the terms of IMF programmes⁶¹. Even so, all these latter states have managed to gain a certain autonomy in debt talks in accordance with the so-called “Schelling Conjecture,” which stipulates that one side in a negotiation (namely, the state) can “often benefit from having [its] hands tied” by domestic constituencies or a legislature (Frieden & Martin, 2003; p. 124); as a result, the state can extract more generous debt conditions through the strategic use of its own domestic opposition or the prospect of widespread social unrest.

2. *Economic independence*

A degree of independence in economic policy after the crisis is crucial to re-establishing a modicum of state autonomy and legitimacy; if none can be established, i.e. if the state is entirely dependent on donor funds for its budget needs and thus lender-imposed economic orthodoxy, then its authority and capacity to meet domestic demands is gravely affected.

One key source for this economic independence lies in the balance of trade: both South Korea after the 1997-8 crisis and Argentina post-2001 began their economic recoveries by posting huge trade surpluses.

Aside from stabilising the currency and replenishing spent central bank reserves, the imposition of taxes on Argentine exports – over 50 percent of which in 2003 were agricultural goods⁶² – boosted public revenues at a critical time. In Korea, a collapse in imports and increase in exports enabled the country to acquire \$50 billion in reserves by late 2000, and shortly after graduate from its much-despised IMF programme (Feldstein, 2002; p. 20 & 30). Likewise, Brazil’s economic recovery, which appears destined to entrench the reforming Workers’ Party government, has been anchored in a massive increase in exports: foreign sales have risen 63 percent from 2002 to 2004, and the trade surplus in the year to August 2004 amounted to \$31.6 billion, “the largest for any emerging market except for oil-exporting Russia”⁶³.

As discussed above, a key feature of the search for economic dependence has been prudence: in all the countries mentioned above, national authorities have been intent on controlling inflation and government spending, with the clear aim of ensuring macroeconomic stability and averting future appeals to international lenders.

Such prudent, export-driven recoveries have enabled these countries to alter the basic terms of their relations with the world of international finance. This process, which is still in its infancy, could prove crucial for the evolution of a new structure of power between the developed and developing worlds; for the moment, however, it can be interpreted as a reassertion of national economic policy over the Washington-led demands for global “convergence”. Argentina and Brazil both announced that they would pay off their entire IMF debts at the end of 2005, a declaration that President Kirchner honoured within weeks⁶⁴. Turkey’s government for its part has suggested it will not need the IMF beyond 2008⁶⁵, and Indonesia is considering a si-

⁶¹ “We have to think of what Brazil will be like in 15 or 20 years, and create a solid base for the governments that come in the future.” President Luiz Inácio da Silva, quoted in *El País*, 20/06/2004.

⁶² Argentine exports in 2003 totalled \$15.6 billion, 54 percent of which were farm products; \$2.37 billion came from exports of soya, largely to China.

⁶³ “Selling Brazil,” *Financial Times*, 15/9/2004.

⁶⁴ Kirchner’s formal announcement of the intention of paying back \$9.8 billion in debt in December 2005 stressed that “this debt has constantly been the vehicle for interventions because it is subject to periodic reviews, and has been the source and more and more demands that contradict themselves and get in the way of sustainable growth.” *Clarín* 16/12/2005.

⁶⁵ “Seeing it through,” *Financial Times* 22/02/2006.

milar strategy. Meanwhile, support in academic circles and in developing countries for limited capital controls appears to be on the rise, boosted by the evident economic successes in countries such as India, China and Vietnam that have enjoyed long periods of protection for their industries (Williamson, 2004; p. 15).

Obviously, in countries such as Zambia, whose major debt crisis coincided with falling commodity values, there is virtually no way to export out of a crisis, nor to establish any sort of buffer around national economic policy⁶⁶.

3. Geopolitical considerations

The geopolitical importance of certain nations also provides a vital resource for weakened states to salvage their authority and restore their finances without excessive interference from abroad. Perhaps the most salient recent example has been the \$19 billion rescue package for Turkey in 2001; similarly, the bailout of Mexico in 1994-5 was intimately connected with that country's new status as part of the North American Free Trade Association, while the \$30 billion funding package for Brazil in the summer of 2002 can in part be interpreted as a signal of support for a bastion of fiscal prudence and economic orthodoxy in a region suffering the after-effects of the Argentine crisis and a rise in left-wing political forces⁶⁷. Throughout the 1990s, Russia's ability to attract IMF loans was similarly derived from the sheer political and strategic weight of the country, and the global significance of its post-Soviet transformation. In the absence of diplomatic or strategic significance, a country may seek to reinforce its geopolitical weight and position in debt negotiations through close association with regional allies: Argentina under President Kirchner has been noticeably active in this respect, and has repeatedly sought to win Brazilian backing in its dealings with the IMF⁶⁸. Li-

kewise, the 1997-8 crisis has prompted greater moves toward regional integration in South-East Asia, above all via regional trade blocs and accords.

4. Exploiting divisions between creditors

Many states have also managed to gain a degree of independence from the demands of foreign creditors and donors by exploiting the divisions between them. The Zambian state, for instance, has managed to maintain a limited freedom of action by adeptly drawing funds from different sets of donors according to its political leanings of the time. This intriguing strategy began in the 1980s, when the government of President Kenneth Kaunda twice cancelled structural adjustment programmes agreed with international lending bodies (in 1983 and 1987). On the latter occasion, Norway, Japan and the UNDP reacted by increasing their financial contributions (Devarajan et al, 2001; p. 570). In stark contrast, the decision by many bilateral donors (including the United States, Norway, Sweden, Holland, Germany and Japan) to cut off aid in 1996 was motivated by signs that President Chiluba's government was veering towards repressive authoritarianism and one-party rule ahead of elections that year. The World Bank and IMF, however, did not alter their funding during this bilateral hiatus, arguing that the economic reform programme required support. On both occasions, the Zambian state found means to gain aid by effectively picking the donors it wished to receive money from.

A similar approach – namely differential treatment of donors/creditors so as to maximise the state's freedom of action – was adopted by Argentina in the midst of its recent crisis. The decision to default on payment of its privately held debt (i.e. servicing of 160 different issues of bonds and other financial mechanisms⁶⁹) was taken days after the fall of President De La Rúa's government. In March 2005, the Argentine government announced that its offer to pay back a quarter of the value of these bonds had been accepted by over 75 per cent of private investors. Argentina's clear

⁶⁶ According to Tsikata (2001; p. 23), the first five years of donor-backed reform in Zambia after 1991 brought a stagnant GDP, no major progress in diversifying exports, and a steady fall in per capita income and employment.

⁶⁷ Of course another objective was to tie the Workers' Party to certain tight fiscal targets before the election.

⁶⁸ Not entirely successfully, however: Brazil failed to support the deal reached between Argentina and the IMF in September 2003, while Brazilian Foreign Minister Celso Amorim has stressed the difference between the two countries' approaches to the Fund ("El canceller Amorim reiteró

que Brasil apoya pero no imita," *Clarín* 9/4/2004).

⁶⁹ "Argentina logra carta blanca del FMI," *El País* 21/9/2004.

reluctance to pay was made possible by the sheer difficulties in coordinating a response amongst so many creditors, and by the absence of any mechanisms in financial markets to exert direct power so as to extract the funds (as discussed in Chapter 2). Meanwhile, the post-crisis government in Buenos Aires initially kept up payments to the IMF, World Bank and Inter-American Development Bank in the hope of receiving an emergency funding package, before changing tack and threatening to withhold funds until a deal to roll over future repayments was made. This tactic, first embraced in October 2002, and used again in September 2003 and March 2004, was based on the possible harmful effects of any Argentine default on the IMF, 16 percent of whose outstanding credit was held by that country in 2004⁷⁰.

5. *Democratic legitimation*

Lastly, and perhaps most obviously, the state in a developing country can gain enormous impetus and popular legitimacy by replacing a disgraced regime, restoring democracy and/or taking power following a general election. As Diamond has observed (1998; p. 51), many governments in Latin America have enjoyed “legitimacy by default” – in other words, they receive support by dint of not being the previous administration. When this previous administration is synonymous with the creation of vast foreign debt – as is the case for President Carlos Menem in Argentina and Suharto in Indonesia – then the new government is often able to blame its predecessor for social and economic problems, justify any failure to make rapid progress, and define its ideology by contrasting it with a figure of general public contempt⁷¹. As Kirchner observed in a recent interview: “Governing Argentina is an extremely hard task. That’s why I always say we are still in hell. But we have managed to rise up two steps”⁷². This approach has been further fortified by a global loss of legitimacy by the IMF, which has admitted to grave po-

licy errors in its treatment of Argentina⁷³, Indonesia and other countries affected by the Asian crisis.

The shortcomings of this approach, however, lie in the limited duration of intense public dislike for the previous regime; this is perhaps best revealed by the downfall of Megawati’s government in Indonesia in 2004, only five years after she and Islamic moderate Abdurrahman Wahid trounced the ruling party (Golkar) in election in July 1999.

In the case of Turkey and Brazil, new governments elected by large majorities in 2002 have also striven to distance themselves from the failures of previous administrations, yet without seeking to enact major changes in economic and fiscal policy; indeed, despite their progressive or populist credentials, both governments have emphasised fiscal austerity and low inflation as priorities. Yet at the same time, the two administrations have used their electoral momentum to bring about important and long-awaited policy initiatives – reforms aimed at gaining entry to the EU in Turkey, an overhaul of the social security scheme in Brazil – and appear on course to establishing new political hegemonies within their countries. As mentioned above, both are also currently seeking to change the terms of their relations with international debt servicing programmes, in the hope of securing greater national freedom in economic policy⁷⁴.

5. The state in the nexus of global power

The two preceding chapters have sought to explain the conflicting influences on the capacity of the state in the aftermath of major debt crises. A particular focus has been laid on those factors which affect the autonomy and legitimacy of the state, on the assumption that these two characteristics are essential to any assessment of how free the state is to act, and how effective its policies may prove. Should the state prove unable to retain any freedom or effec-

⁷⁰ “Which is the victim,” *The Economist* 4/3/2004.

⁷¹ “Odious debt” for its part describes an excessive debt burden accumulated by extremely corrupt regimes for patrimonial use (notably the case in the Central African Republic and the Democratic Republic of Congo), and has proved an effective weapon for least developed countries in seeking to gain generous debt relief from international lenders.

⁷² Interview with Néstor Kirchner, *Clarín* 23/5/2004.

⁷³ “IMF urged to tighten oversight of crisis policies,” *Financial Times* 30/6/2004.

⁷⁴ Turkey has already raised the minimum wage in spite of IMF pressure not to do so (*Financial Times*, 25/6/2004).

tiveness, then it is destined to face a crisis in its authority over a nation – and thus become a “negative sovereign.” If a state can avoid this fate, then it might once again be able to lead a concerted development policy in its country and enjoy a high degree of political support. The contrast between these two outcomes illustrates just how high the stakes are in each case.

5.1. POST-CRISIS LEGITIMACY AND AUTONOMY

In terms of state *legitimacy*, both centrifugal and centripetal influences are evident in the wake of debt crises. Rising poverty and unemployment, political instability and scepticism over the state’s ability to make any difference to economic conditions generate a shift towards alternative sources of authority – which may at extremes lead to outright distrust of the state, manifested in moves toward community-based rule and private measures of self-protection (Wallerstein in Smith et al (eds), 1999; p. 31). On the other hand, the electoral competition that often follows debt crises, in combination with its new status as the nation’s chief economic and financial coordinator, can greatly enhance public support for the state, particularly when the debt burden and economic chaos is ascribed to the sins of a previous regime.

This tension between these contrasting influences on state legitimacy is reflected most clearly in divergent public attitudes towards democracy – the system governing all the countries in this study. Whereas satisfaction in the democratic system often falls sharply in times of economic distress, support for democracy as the rightful or most effective system of rule can remain very much higher: this apparent contradiction is regarded by Diamond (1998; p. 33) as the result of the differential weighting given to the political performance (guarantee of freedoms, basic rights, institutional stability, expression of national identity) and the economic record of a regime. Argentina, in particular, registered marked increases in support for the democratic system in 2000 (reaching 70 percent) even as satisfaction with the system’s results fell to close to 50 percent⁷⁵; these contrasting trends have continued in recent years.

⁷⁵ Results of 2000 Latinobarómetro survey.

A similarly nuanced account can be given of a state’s *autonomy* after a crisis. Though they are placed under intense pressure from competing social demands and from the requirements of foreign creditors and donors, the largely informal and hybrid nature of the international debt regime, along with the supportive contribution of economic, geopolitical and democratic dynamics, mean that a state can secure for itself a margin of freedom in which to act. Yet the question remains: is this autonomy effective, meaning the state can direct and coordinate the nation’s economic and social recovery? Or is this a version of “coercive” or “despotic” autonomy (Weiss & Hobson, 1995; p. 240), which has little power to extract resources from the nation or mobilize any sort of economic activity?

Historically, high levels of state autonomy have been underwritten by limits to democracy: these constraints enabled authorities to pursue fixed and highly orthodox economic policies, providing for deeper integration into the global economy without succumbing to the pressures of domestic discontent. Perhaps the best example of this is the monetary discipline of the “gold standard,” established by Britain in the 19th century: “until World War I, virtually no country put into question the priority given to the fixed parities of the gold standards. There was scarcely any awareness that central bank policies could be directed to goals such as employment” (Eichengreen, 1996; p. 277).

But as Eichengreen and others have argued, the rise of democratic systems across the world has stripped the historic “insulation” around economic and fiscal policy, and subjected them to the test of electoral popularity. No longer is it as easy for the state to abstain from use of its own domestic economic levers in response to problems such as high unemployment; if they do, political elites risk the wrath of the electorate.

Meanwhile, and in accordance with the policy “trilemma” discussed in chapter two, states in the developed world resorted in the decades following World War II to capital controls as a means to safeguard national economic policy initiatives, particularly where these policies revolved around import substitution. By the 1970s, in the midst of intensifying international economic relations and the decline of the Bretton-Woods system, both the developing and developed world moved progressively toward floating exchange rates - present in 50

percent of IMF members in 1994 in place of 25 percent in 1984 (Ibid; p. 273)⁷⁶.

Yet as we have already seen, this trend did not last long. Global economic ties, the threat of sudden market-driven devaluation and the increased role of the IMF and World Bank in sponsoring adjustment programmes, served in many cases – notably in South-East Asia and Latin America- to discredit the floating exchange rate as a means to protect a nation's economy. Many countries were thus persuaded into abandoning the last bulwark of independence in monetary policy; autonomy was traded in for the promise of investment, support from financial institutions, and growth.

In trying to rectify the errors of the past – which are of course dramatized by a debt crisis- the state must in effect create a new coalition at home at the same time as attaining a new equilibrium in its relations with the world of international finance. The key problem here, and thus the essence of the current dilemma for the state in the developing world, is that the autonomy expected from each side is radically different: whereas domestic interests expect free use of economic policy levers to compensate the woes of unemployment, low wages and poverty, foreign creditors expect the state to act independently from democratic pressures (as in the era of the “gold standard”) so that it can honour its financial obligations.

Using the concepts introduced in chapter 3, we should say that a certain “coercive” autonomy is sought by creditors, and an “embedded” autonomy by domestic interests. The “converged” state is a model of precisely the autonomy that financial markets require⁷⁷, whereas domestic interests insist on no more than an authentic nation-state, acting in the interests of the general public. It is perhaps no coincidence that the IMF and markets' favourite in the 2004 Indonesian elections, the eventual victor Yudhoyono, has portrayed himself as a strongman, able to “make the international community comfortable”⁷⁸.

⁷⁶ The exceptions to the latter – notably Argentina from 1991 to 2001- have tended to be those countries that have wished to insulate economic policy (and avoid inflation) by making it impossible for democratically elected governments to interfere with the money supply

⁷⁷ And not just the market. Certain conservative analysts agree that democracy in the developing world is no panacea, and should be restricted in particular circumstances. See Zakaria, 2004.

⁷⁸ In “Democracy has taken root – but voters still hanker after a strongman leader,” *Financial Times*, 5/7/2004.

Indebted democratic states in the developing world are thus constantly being forced to adopt different stances and navigate between two very different discourses in an attempt to reconcile the need to service debt and the need to serve the public. It is only to be expected that this oscillation in state autonomy produces high public expectations, an excessive burden of foreign pressure, and great fragility in the political system. It is also natural that after a major debt crisis, marked by sharply declining living standards and widespread public discontent, the state in the affected country will seek to redesign its working conditions both at home and abroad, establishing a novel approach to government at home and a new deal in its relations with the world of international finance and the global economy. Perhaps most importantly, as we have discussed, this sort of crisis hands certain countries the tools needed to achieve such a new settlement.

5.2. SOVEREIGNTY AND GLOBAL POWER

In light of these developments, we can reframe the issue by considering how a state's sovereignty is affected. Is there an inevitable trend toward “negative” sovereignty, or can some new sort of “positive sovereignty” be attained in developing countries, allowing the state more substantial freedom in the policies it chooses to implement? Does the international debt regime and global economic integration necessarily impose a “golden straightjacket” (quoted in Rodrik, 2002; p. 14), and require that democratic politics and nation-state systems be progressively narrowed and debilitated?

The study of debt-affected countries in the preceding chapters would suggest that only provisional conclusions can be given to these questions. Certain states can hold off foreign creditors' demands, and can undergo renewal in legitimacy and autonomy. Yet this will tend to occur in an environment of weakened authority, economic uncertainty and popular discontent: inevitably, the state becomes a contested site, in which political leaders seek out new bases of support and undertake changes in the governing ideology.

One way to conceptualise the new dynamics in state sovereignty is to explore the basic systems of global power in the modern world – as applied by states, multilateral institutions and non-governmental bodies- and the manner in

which foreign debt is treated and interpreted by each system. Following on from the work of John Boli (in Krassner (ed), 2001), we may divide the operations and objectives of the world political system at present into three broad categories:

1. *Liberal economic order.* This includes the major lending bodies, both public and private, and the regulated system of free trade. Its fundamental ideology is one of increasing global welfare through a legally-defined system of free-market activity and reciprocal payment obligations.
2. *World citizenship.* Encapsulated in the Millennium Development Goals, and supported by the UN system as a whole, this power system emphasizes the attainment of certain welfare objectives due to their moral significance and their beneficial effect on humankind.
3. *Nation-states.* Here the stress is placed on the rights and entitlements of highly institutionalised, spatially-defined political units, which are taken to represent and act on behalf of the interests of the people who live in a given territory.

Debt, of course, is a critical issue for all three systems. For the first, it is a necessary and legitimate component of international economic relations; debt defaults only serve to impede the normal fluidity of such relations due to the rupture they entail in reciprocal obligations. The second regards heavy debt burdens as a threat to public welfare, state budgets and economic growth; this harm evokes fierce moral condemnation when countries with low levels of development are obliged to engage in excessive debt servicing. But in the third case, that of the nation-state system, debt is essentially regarded as a transaction that must be carried out between the citizenry and the global economic order; states may seek to play one against the other (as we have seen in Africa and other cases), but in most cases they endeavour to balance the two sets of demands with a minimal loss of authority.

As we have seen, this transactional role of the state enables it to secure a degree of legitimacy and autonomy even in the context of falling living standards. At the same time, however, the post-war vision of the state as an energizing and mobilizing force in its country's economy

and society – as the principal agent for development – appears to have been sidelined, both by dominant liberal ideology of the 1990s (encapsulated in the “Washington Consensus,” (Williamson, 2004)), and since then by the limits on independent action and economic policy that derive from a country's insertion in the ever more interdependent global economy.

As regards those nations affected by high levels of foreign debt, “positive sovereignty,” or the notion that a state can freely harness its international status and its domestic authority at one and the same time in its quest for economic and social development, is made yet more problematic by intense competition between domestic public demands and the requirements of international finance. Unable to attain international financial support for the cause of domestic welfare, the countries on view in this study have been forced to establish new approaches to demands laid upon them. Each country has learnt to depend on its diplomatic or economic strengths to gain some leeway. Each one has been highly cautious in its economic policy, tying its hands either through accords with the IMF, or through its own self-imposed financial discipline. And each appears to have decided that once the crisis is resolved, the terms of its engagement with the global economy and financial markets will have to alter, so as to prevent any return to the volatility that proved so prevalent in the 1990s.

This new sovereignty may not be “positive,” but it does manifest a classic transaction within the terms of the concept. Unable to reconcile the different systems of world power as they operate today, the populous nation-state in the developing world appears to be seeking to transfer some of its free choice over domestic policy, particularly economic policy, for an increase in “Westphalian sovereignty”: namely, the exclusion of another country's influence over domestic affairs. It is curious perhaps to consider that this new dynamic in relations between the poorer and richer segments of the globe stands in contrast to the process of integration within regional blocs such as the European Union, in which a loss in “Westphalian sovereignty” is tolerated for greater traction over domestic concerns.

For the moment, these broad considerations remain in the realm of speculation. It is hard, as certain economists have argued (Bergsten, 2005), to draw valid systemic conclusions from recent developments, and especially befo-

re these new systems are tested by adverse global economic conditions. The fact remains, however, that the state in the developing world, left in recent years to resolve the contradictions between global power systems, is on the quest for a new set of prerogatives in a hostile world.

6. Conclusions

Looking back over the last 60 years, the political and economic changes in the developing world have been remarkable. This paper has attempted to give an insight into that transformation by concentrating on one of its key aspects: the interrelations between these developing countries and the world of global finance.

Initially regarded by development economists as a means to lift impoverished countries out of their chronic cycles of low saving and low investment, financial credit has progressively shifted in character in the last few decades. Bank loans and official development aid began to pale in the 1990s against the vast sums of private investment being deposited, albeit briefly, in certain major developing countries, in the obvious hope that investors could cash in on high rates of growth.

Yet as was discussed in chapter 2, these credits depended for their existence upon an informal structure of power, a rapid extension of market prerogatives after the end of the Cold War, and shifts in the collective sentiments of increasingly interconnected financial brokers; in combination, these could, and did, provoke a financial stampede out of developing countries. The authorities in these countries, meanwhile, simply failed to understand -or preferred not to consider- the full consequences of taking on greater debt, especially when this debt depended on economic variables quite beyond the governments' control. The result, as witnessed across the developing world from 1997 to 2002, was a series of crises causing grave economic damage to millions of people.

It is rash, however, to conclude an account of debt and development at that juncture. The same countries that were three or four years ago in deep crisis, or said to be on the verge of collapse, now appear to be thriving economically. Their governments appear bold and

decisive. In some cases, notably those of Indonesia and Argentina, it might seem to an outside observer that financial collapse has even served the nations' long-term interest.

How can this be? This paper has sought to sketch some answers to this question by focusing on the political evolution of developing countries in recent decades, and in particular the effects of the creation of many new democracies in both developmental and corporatist states. The resulting public and electoral pressures on government, in turn, have stripped states of their former "autonomy" in certain policy areas, not unlike the way insertion in the global market has limited governments' economic freedom of action. In extreme cases, such as the nations in the HIPC programme for heavily indebted countries, policy has simply been prescribed by the IMF and World Bank, causing government officials to resist temporarily, cave in, or resort to a stance of semi-cooperative passivity.

For more populous and powerful developing countries, on the other hand, the catastrophic loss of autonomy and legitimacy following a major debt crisis can generate a thorough reorientation of the state. Impoverishment, mass distrust of authority and disdain for the ancien régime combine to generate new electoral majorities and political ideologies. The state, formerly trapped between the pressures of a discontented populace and the exigencies of financial markets, discovers a margin for manoeuvre; enough, at least, to strike out a new course, in which it endeavours to regain sovereignty by fiscal and monetary self-discipline, or by spurning the credit relations and political alliances on which disgraced previous governments depended.

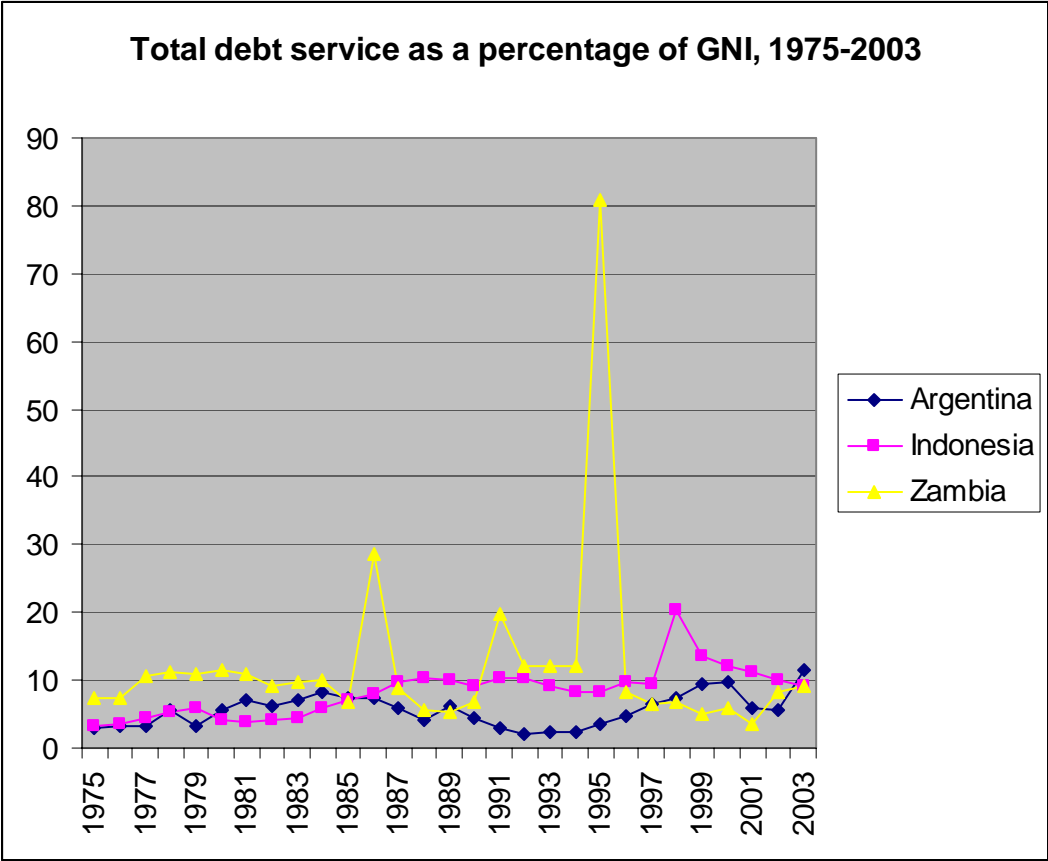
We do not know at present the outcome of this process. It may be, as some economists have speculated, that favourable global economic conditions have underwritten these rapid recoveries - and that, as yet, there is no durable alternative "model" for medium-sized democracies but ever greater integration into financial markets and the global economy. Yet it is also true that the decade of debt has proved a watershed for major developing countries, out of which a new set of priorities has been established, foremost among which is the importance of rebuilding an active and sovereign state.

Appendix

Table 1
Total external debt of developing countries, 1997-2003 (billions of dollars)

	1997	1999	2001	2003
All developing countries	2,109.7	2,346.6	2,260.5	2,554.1
East Asia & Pacific	526.3	538.6	502.0	525.5
[Indonesia	136.2	151.2	134.0	134.4]
East Europe & Central Asia	391.2	503.5	507.8	676.0
Latin America & Caribbean	670.4	771.8	749.2	779.6
[Argentina	128.4	145.8	154.1	166.2]
Middle East & North Africa	151.3	155.8	142.1	158.8
South Asia	149.6	162.0	156.2	182.8
Sub-Saharan Africa	220.8	215.0	203.2	231.4
[Zambia	6.97	6.407	7.27	6.468]

SOURCES: World Bank and IMF.



SOURCE: World Bank.

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