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Global Crisis, National Responses: The Political Economy of Turkish Exceptionalism

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Global Crisis, National Responses: The Political Economy of Turkish Exceptionalism

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With its dilatory and piecemeal fiscal activism and uncharacteristic aversion to IMF assistance, the Turkish government's response to the global economic crisis of 2008–9 diverged considerably from prevalent trends in other major emerging market countries. Underlying this intriguing pattern were Turkey's pre-existing policy and macroeconomic constraints, cognitive lapses on the part of policymakers, and the conjunctural dynamics of domestic politics. The interplay of these factors progressively narrowed the policy space for vigorous action, leading to a motley combination of reactive initiatives that neither offered sufficient protection to vulnerable social groups nor promised sustainable growth in the long run despite rapid short-term recovery.

Keywords: global economic crisis, fiscal stimulus, IMF, emerging markets, Turkey

When Prime Minister Erdoğan claimed the global crisis would 'pass tangent to' Turkey (Cumhuriyet 2008), most observers took it as a routine political gesture to defuse market anxiety at a time of extreme uncertainty. Few could have imagined this sanguine remark, coming a mere four weeks after the collapse of Lehman Brothers, to earnestly express government confidence in the shock-absorbance of an already cooling off Turkish economy, now facing the severest emergency of the postwar international economic order. But Turkish policymakers proved sincere in their optimism. By March 2009, six months into the crisis and despite imploding industrial production and soaring unemployment, Turkey was one of only two OECD countries without a clear fiscal stimulus package in place (the other was Greece), and when the government finally announced one, it was comparatively the smallest among the developing members of the G-20 (IMF 2009; OECD 2009). In the following months Turkey continued to take exception to global policy trends. The scope of fiscal

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measures was gradually expanded, yet in its stepwise character and stark exclusion of popular interests the Turkish stimulus hardly resembled the 'Keynesian resurgence' in various advanced and developing nations. Moreover, unlike dozens of emerging economies that were hit similarly hard by the global meltdown, Turkey remained reluctant to receive International Monetary Fund (IMF) assistance, choosing instead to ride on the expectation effect of a possible deal that nonetheless fell through after one and a half years of well-publicised negotiations.

This article inquires why Turkey, a relatively successful second-generation reformer and the principal client of the IMF over the past decade, diverged so noticeably from its peers during the global crisis of 2008–9 by adopting a puzzlingly delayed, piecemeal, and socially exclusionary response while also rejecting multilateral financing. Focusing on the causes of this policy path is in part motivated by its lacklustre outcomes. Although the Turkish economy bounced back strongly in the first half of 2010, it is hard to disagree with the increasingly common criticism among Turkish economists (see e.g. Özatay 2010; Uygur 2010) that a better coordinated and more inclusive set of measures could have helped the country mitigate the toll it paid during the crisis in the first place – a sharp GDP contraction in 2009, a steep rise in unemployment, and acute impoverishment of the most vulnerable social groups.[1] Nonetheless, with the global turbulence far from over and the wider Turkish strategy yet unfolding, our objective remains not to pass judgement on but to offer some explanation for the policy process thus far.

The analysis begins by locating the Turkish response within dominant policy trends in a sample of large emerging market countries. Next follows a detailed account of Turkish crisis policymaking. We highlight the interplay of three core factors: pre-existing structural weaknesses, cognitive gaps, and domestic politics. Section three examines how the pent-up disturbances of the preceding boom years, in particular a foreign deficit-led growth pattern, fiscal deterioration, and reform fatigue, constrained policy options during the initial stages of the crisis. The Turkish government's failure to identify and address the true vulnerabilities of the economy is discussed in the fourth section. Here the principal culprit was policymakers' learned obsession with monetary and financial stability, which diverted attention and resources away from more pressing real sector and distributive problems at critical stages of crisis management. Section five focuses on how party and interest group politics hindered the formulation of a better coordinated and socially inclusive response. We conclude with the implications of our findings for both Turkish development and policy challenges facing late developers after the crisis.

Neither 'vigorous stimulus' nor 'official financing': the Turkish response in comparative context

The global meltdown of 2008–9 affected emerging market economies through largely identical mechanisms.[2] Hardly any country was spared the tightening of external credit, and nearly all recorded a severe decline in foreign investment and remittances as well as in export demand. And once the turmoil engulfed the domestic market, policymakers everywhere faced a gruelling range of problems from rising unemployment to fiscal deterioration. These basic similarities aside, the scale of devastation displayed considerable variation. Overall, Asian economies proved relatively resilient thanks to strong macro fundamentals and, in several cases, prompt and bold government action. Latin America fared worse, but the regional norm was still one of modest output contraction, often smaller than developed country averages. Central and Eastern Europe suffered the biggest losses as most economies were caught with high current account deficits and some with troubled banking systems. Equally important within these broad regional trends were remarkable subregional contrasts. Indonesia outperformed Thailand and Korea by a wide margin; the destruction in the European periphery left Poland nearly unscathed; Mexico's massive recession stood as an exception to the milder Latin American pattern, and so on.

National responses to the crisis manifest an analogous story of surface similarities laced with sizeable variation, permitting generalisations only of the crudest nature. First, almost everywhere, policymakers adopted monetary and fiscal measures to alleviate the credit crunch and stimulate domestic demand. Central banks lowered interest rates; governments introduced fiscal programmes that encompassed such diverse measures as tax breaks, welfare and employment schemes, and infrastructure investment. Still, the size and composition of these programmes varied radically. A second popular strategy was to seek external funding from international financial institutions to ease the fiscal squeeze, insure against potential balance of payments problems, and signal to foreign investors. From September 2008 onward, no fewer than 25 middle-income countries signed IMF facilities, mostly in the form of standby arrangements, but some also taking advantage of more convenient instruments such as the new Flexible Credit Line (FCL). In addition, several major emerging market countries chose to support their infrastructure projects and social programmes via large World Bank loans.

If there was one tendency to help classify national responses to the crisis, it was that most countries (in particular large middle-income economies such as Turkey) made a commitment to either one of these two common types of strategies – that is, they either announced sizeable, self-financed stimulus plans or sought substantial official external financing for a more restrained approach. The division appears to be related mainly to the *fiscal space* available to policymakers. Fiscal space in this extraordinary context should be understood not merely as a function of government capacity to mobilise revenue or increase expenditure efficiency as somewhat narrowly debated by economists in recent years, but also more broadly as a reflection of domestic political preferences, the legal-institutional environment, and in some cases even regional templates and international considerations.[3] Thus, on the one side were governments endowed with sufficient fiscal space, those that were not only technically able but also politically willing to self-finance a comprehensive recovery package. Included in this *vigorous stimulus* group were most emerging Asian countries as well as some of the strong performers of the mid-2000s elsewhere such as Russia and Brazil, which tried to spend their way out of the crisis while avoiding outside interference. On the other side were countries with more limited fiscal space due to objective or self-imposed barriers. Many countries in the European periphery but also Mexico were in this *official financing* camp. Typically, they passed up the large stimulus option and knocked on the IMF's door instead.

Once chosen, the respective logics of vigorous stimulus and of official financing grow mutually exclusive in a very practical way. If a country opts to spend its way out of the crisis, there is no incentive for it to be willingly constrained by an external actor down that path. But if it chooses to endure the external constraint, meaning it lacks the fiscal freedom or disposition for self-sustained vigorous action in the first place, radically shifting policy via borrowed funds *ex post* would certainly not be the best approach to crisis management. Perhaps this explains why none of the IMF's new FCL clients (Mexico, Poland and Colombia) touched a penny of the record funds made available to them, even though the organisation's revised policy outlook from early 2009 onward did identify some forms of Keynesian spending as a viable recovery strategy, at least in the short run (Broome 2010).

Where does Turkey fit into this picture? Table 1 provides some clues based on figures from the top three economies each of the three main emerging regions of the globe, that is, Central and Eastern Europe, Latin America, and East and Southeast Asia (excluding China). Turkey recorded the third largest output loss in 2009 in this nine-country sample, outperforming only Russia and Mexico. What is disturbing in this statistic is that both Russia and Mexico had their *annus horribilis* in 2009 with additional mishaps aggravating the effects of the global crisis. Collapsing energy prices and demand brought Russia's resource-driven boom to an abrupt halt. To a lesser extent Mexico too was sensitive to oil prices (Saudi Arabia's whopping stimulus of more than 9 per cent of its GDP speaks volumes here), but its economic fortunes were further eroded due to its extreme dependence on the US consumer market, the influenza epidemic, and drug-related violence.

Even then Turkey's −4.7 per cent GDP contraction may not look too bad at first, given worse performances by some major European economies. Particularly worrisome, however, was the disproportionate social impact of the crisis in Turkey. Unlike during the country's domestically generated crisis of 2000–1,

TABLE 1. The global crisis and emerging market countries: impact and policy responses

	GDP growth % 2009	Fiscal stimulus % 2008 GDP	IMF facilities (10/08–12/09)	WB loans (10/08–12/09)
Argentina	0.9	6.4	—	$1,490m
Brazil	−0.2	5.6	—	$2,752m
Indonesia	4.5	2.0	—	$5,331m
Mexico	−6.5	1.6	$47bn	$6,788m
Poland	1.7	1.2	$20.6bn	€1,975m
Russia	−7.9	5.4	—	—
South Korea	0.2	6.2	—	—
Thailand	−2.3	3.4	—	—
Turkey	−4.7	1.1	—	$1,100m

Sources: IMF (2010); UNCTAD (2009); World Bank (online). World Bank figures reflect the sum of loan amounts stated in project documents and not actual disbursement.

the costs of which were somewhat evenly distributed between social segments, the crisis of 2008–9 overwhelmingly crushed the most disadvantaged. Especially alarming was the acute rise in unemployment, from an annual average of 9.9 per cent in 2008 to over 14 per cent in 2009, with non-agricultural employment reaching 17.4 per cent. Most of this damage occurred in small and medium-sized enterprises (SMEs), hitting the unskilled and semi-skilled workforce the hardest. In fact, a World Bank survey finds Turkish firms to have had the highest market exit rate in Eastern Europe, leading to the biggest decrease in permanent employment in the region (World Bank 2009). Yet holding a job did not accord immunity from the crisis, especially for low-income families. Frequently reported arrears, pay cuts, and longer work hours traumatised wage earners; as an indication, from September 2008 to December 2009, the unit wage index in industry dropped by as much as 17.5 per cent (DPT online). The crisis hit the self-employed equally hard; well over 80 per cent of the households in the poorest quintile of this category, concentrated primarily in the informal service sector, reported a noticeable loss of income by mid-2009 (TEPAV et al. 2009).

But Turkey was not just a victim of the global crisis; it also diverged from its peers in its crisis response, the distinguishing feature of which was a lack of clear commitment to either the *vigorous stimulus* or the *official financing* paths. Only Indonesia in our sample displays a comparable indecision, but that is a case more of moderate simultaneous commitment to both policy patterns, and in a country whose relative resilience was not in doubt. By contrast Turkish policymakers did not seem to have seriously committed to either approach despite early and incontrovertible signs of deep vulnerability.

By identifying Turkey as an outlier case, we do not suggest its crisis response was marked by sheer policy stasis. On the official financing side, Turkey did conduct negotiations with the IMF throughout the crisis and even used the process as a quasi-anchor to steer market sentiment. On the fiscal stimulus side, the figure cited in Table 1 (1.1 per cent of Turkish GDP), coming from the only available comparative data set including all the countries in our sample (UNCTAD 2009: 32), is misleading as it reflects March 2009 figures. In actuality, in the spring and summer of 2009, Turkish policymakers announced more comprehensive fiscal measures, the total official cost of which from 2008 to 2010 was expected to reach 4.5 per cent (DPT 2009: 12).

To be clear, the problem with Turkey's stimulus was not its size, but its timing and composition. First, it was delayed far too long, and was implemented on a piecemeal basis. Far from being precautionary, it was reactionary in nature as it took effect only after a slew of economic data indicated a deepening real sector recession, with manufacturing output shrinking by 12 per cent in the fourth quarter of 2008 and then 22 per cent in the first quarter of 2009, the latter figure translating into an unprecedented 14.5 per cent decline in quarterly GDP (TURKSTAT online). Second, and more important, it had an exclusively pro-business orientation, with little emphasis on either infrastructure investment or social protection, areas that received considerable attention in fiscal packages of other large middle-income economies. Argentina and South Africa, for instance, announced large public works programmes. In the case of Brazil, over 40 per cent of the stimulus package was earmarked for infrastructure investment under its Accelerated

Growth Program (ILO 2010). Social spending proved to be an even more popular concern. Indonesia and Thailand invested heavily in social safety nets, and most Latin American countries, including Mexico, enhanced their existing conditional cash transfer programmes.[4] Meanwhile, the massive Russian stimulus involved notable increases in pensions and the minimum wage. South Korea provides a good example of this dual emphasis, with 60 per cent of stimulus spending allocated to public investment and direct transfers to households, and 50 per cent of tax cuts targeting low income individuals (OECD 2010: 51). In contrast, the Turkish package was dominated by tax reductions on consumer durables (rather than on basic goods), corporate tax cuts, and various other entrepreneurial supports.

A fragile boom

The half decade that preceded the current global downturn marked the strongest display of economic performance in Turkey since the 1960s, but it also harboured significant strains and imbalances. Insufficient though these strains are to account on their own for Turkish policy divergence during the crisis, they are crucial to understanding why Turkish policymakers decided to sit out the initial phase of the crisis while their peers across the globe were investing in bold measures to safeguard against the threatened cataclysm.

As in most late developers, the path to the market in Turkey too has been a process wrought with much economic and political instability. Reformers of the 1980s radically broke with the country's state-directed, inward-oriented development strategy, but these early efforts neither insured sustainable growth nor rested upon a durable political coalition struck around a comprehensive vision of policy change. Burdened with severe distributive tensions and intense party fragmentation, the weak coalition governments of the 1990s were caught in a destructive cycle of populist side payments, soaring fiscal deficits, and high inflation at a juncture of unruly integration with global financial markets. In turn the systemic collapse of 2001 ushered in a new round of structural reforms, targeting some enduring institutional weaknesses of Turkish capitalism. Central to this new policy drive were powerful external anchors in the form of successive IMF programmes and stronger prospects of EU membership.[5]

By the time the Justice and Development Party (AKP) came to power, that is, in late 2002, this new phase of neoliberal retuning was well under way. The banking system was restructured with a novel regulatory framework in place, central bank independence was reinforced, the debt management regime was overhauled, fiscal balances were fast improving, and there were comprehensive reform plans in the works in various policy areas from the public expenditure regime to agricultural subsidies and the social security system. Constrained by a strict IMF programme and concerned with derailing the fragile recovery process, the AKP pragmatically committed to this inherited reform drive during the early years of its incumbency – a strategy that seems to have paid off.

Despite occurring in an exceptionally favourable global economic environment characterised by record capital and trade flows, the accomplishments of the AKP's first term in office are hard to ignore (Table 2). Cumulative GDP growth from

TABLE 2. Turkey: selected indicators (2002–9)

	2002	2003	2004	2005	2006	2007	2008	2009
GDP (US$ billion)	232.7	304.6	393.0	484.0	529.9	655.9	742.1	617.6
GDP per capita (US$)	3,403	4,393	5,595	6,801	7,351	8,984	10,745	8,950
GDP growth (%)	6.2	5.3	9.4	8.4	6.9	4.6	0.7	−4.7
Investment (% GDP)	16.7	17.0	20.3	21.0	22.3	21.4	19.9	15.6
Savings (% GDP)	18.3	15.1	15.6	15.7	16.2	15.8	15.6	14.1
Imports (US$ billion)	51.5	69.3	97.5	116.8	139.6	170.1	201.0	140.9
Imports % change	24.6	34.6	40.7	19.8	19.5	21.8	18.2	−29.9
Imports (% GDP)	22.1	22.8	24.8	24.1	26.3	25.9	27.1	22.8
Exports (US$ billion)	36.1	47.3	63.2	73.5	85.5	107.3	132.0	102.1
Exports % change	15.0	31.0	33.6	16.3	16.3	25.5	23.0	−22.7
Exports (% GDP)	15.5	15.5	16.1	15.2	16.1	16.4	17.8	16.5
Current account balance (% GDP)	−0.27	−2.47	−3.67	−4.57	−6.02	−5.75	−5.25	−2.24
FDI (US$ billions)	1.08	1.75	2.79	10.03	20.19	22.05	18.27	7.66
Public expenditure (% GDP)	34.13	31.06	27.21	24.61	23.49	23.76	23.88	28.02
Fiscal balance (% GDP)	−11.47	−8.84	−5.22	−1.06	−0.61	−1.62	−1.97	−4.88
Primary balance (% GDP)	3.29	4.03	4.89	5.98	5.45	4.07	3.48	−0.68
Total public debt (% GDP)	61.4	55.1	49.0	41.6	34.0	29.5	28.2	32.5
External	25.2	17.2	13.4	6.5	4.0	1.3	2.1	2.7
Domestic	36.2	37.9	35.7	35.2	30.0	28.1	26.1	29.8
Private foreign debt (US$ billion)	43.0	48.9	63.9	83.9	120.3	160.1	186.0	176.3
Financial firms	10.2	13.6	21.7	33.3	49.2	58.6	63.0	59.3
Non-financial firms	32.8	35.2	42.2	50.6	71.1	101.5	123.0	117.0
Banks' assets (% GDP)	76.6	69.4	71.2	81.5	86.7	87.3	77.1	87.4
Banks' loans (% GDP)	14.0	14.6	17.8	24.1	28.9	33.9	38.7	41.2
Consumer loans (% GDP)	0.6	1.3	2.3	4.5	6.3	8.0	8.7	9.8
Banks' capital adequacy ratio (%)	25.1	30.9	28.2	23.7	21.9	18.9	18.0	20.6
Consumer inflation %	45.0	25.3	10.6	10.1	10.5	8.8	10.4	6.3
Unemployment %	10.3	10.5	10.3	10.3	9.9	9.9	11.0	14.0

Sources: TURKSTAT (online); TCMB (Electronic Data Delivery System-online); Undersecretariat of Treasury (online); BDDK (online).

2002 to 2007 was in the order of 48 per cent, whereas real per capita income grew by over 35 per cent. Fiscal balance improved significantly until 2006, with high primary surpluses in a high growth environment bringing the ratio of the public debt to GDP down to manageable levels. Chronic inflation, the signature affliction of the Turkish economy since the early 1970s, fell rapidly to single-digit figures. Exports tripled, and foreign direct investment, virtually non-existent before, reached a respectable $20 billion in 2007. Just as remarkable was the surprisingly equitable character of Turkey's economic rebound. With no concerted strategy for poverty reduction, about 6.5 million people, or nearly 10 per cent of the Turkish population, were lifted out of poverty between 2002 and 2006.[6] After a quarter-century of painful policy experimentation, it appeared Turkey had finally passed a critical threshold on the path to high quality growth.

Behind this promising picture were disturbing fragilities. Perhaps the most significant of these was the continued external vulnerability of the Turkish economy. Turkey's trade-driven growth spurt rested on high current account deficits, with the success story of tripling exports overshadowed by the quadrupling of imports. Years of second-generation reform failed to make a real impact on the long-standing Turkish pattern of foreign capital-dependent growth.[7] The main difference with the 1990s was that this dependence no longer manifested itself in the form of a severe sovereign debt problem. Instead the burden was passed entirely onto the private sector, which relied on external funds to compensate for the chronic gap between weak levels of investment and much weaker levels of domestic savings. The Turkish economy remained structurally incapable of fast growth without continuously high foreign inflows, reinforcing in the process some familiar ailments of the 1990s such as high real rates of interest and currency overvaluation (Rodrik 2009).

A second set of issues, stemming from novel characteristics of Turkish growth, aggravated the risks of foreign exposure especially in terms of the social consequences of a potential disruption in trade and capital flows. On the one side was the structure of credit expansion that distinctly favoured high-interest consumer loans over business credit, precluding any qualitative shift in the pattern of weak domestic savings but more importantly leading to an unprecedented rise in household indebtedness (Bakır and Öniş 2010). On the other side was persistent high unemployment of around 10 per cent throughout the period, which led critics to identify the post-2001 experience as one of 'jobless growth' (e.g. Yeldan 2009a). As a result, large segments of Turkish society, especially the vast lower middle class, became disproportionately vulnerable to external economic shocks, for expansion in both credit and investment was now externally driven.

Rendering these fragilities all the more significant was the decline in the AKP's reformist appetite, which had already involved a degree of selectivity, as seen in perennial amendments to the public procurement law of 2002 and systematic efforts to bypass the agricultural subsidy reform of 2001–2. Content with the overall economic performance, the party's attention from 2006 onward shifted toward consolidating its power by defending and expanding its coalitional base. The weakening of external policy anchors, with the EU drive losing momentum and the latest IMF standby agreement of 2005 having mostly run its course, also encouraged the government to reconsider its priorities. By the election year of 2007, a new policy approach had matured that centred on more open deviations from the reformist path, but without endangering what the AKP leadership understood to be the foundations, however fragile, of the rapid growth status quo. Thus, in monetary policy and banking regulation, the government made a point of not interfering with the prerogatives of autonomous agencies. Likewise, policymakers remained committed to privatisation and FDI initiatives. Yet in other policy areas, a more discretionary attitude took hold. The novel public expenditure regime was diluted significantly through numerous amendments to a 2003 law; the agricultural subsidy reform of 2001–2 was overturned altogether by 2007; the long-awaited pension reform of 2008 introduced only minimal changes to an overburdened system. In short, when the world entered recession, the age of radical reformism in Turkey had long drawn to a close (Patton 2007, 2009).

Two distinct indicators of this shift in the AKP's policy concerns are crucial for the present discussion. The first is fiscal deterioration from 2006 onward. The main culprits here were increasing transfers to the ailing social security system and to local governments (Ersel 2009), but the relative easing also included larger agricultural support payments and, more recently, adjustments in the salaries of civil servants. This fiscal expansion of the post-2006 period led to a noticeable decline in the primary surplus; however, it was still quite modest compared with the disastrous record of the 1990s. Its symbolic political meaning was therefore more significant than its actual economic effect, as it implied a shift from stringent neoliberal austerity to what might be termed 'controlled populism' in the spending regime, exacerbating the policy cleavages within both the AKP and the economic bureaucracy and drawing criticism especially from big business.

A second dimension of the government's fading reformism was its reluctance to address the fragilities mentioned earlier. Struggling to preserve the policy equilibrium that delivered fast growth, the AKP grew oblivious to the contradictions of this process. Despite pressures from business organisations, for example, the party continually postponed reforms of the commercial code and the corporate tax regime, both deemed essential for EU harmonisation as well as long-term competitiveness. More important, the accumulating social risks of the period were largely ignored. Rather than take advantage of rapid growth to strengthen Turkey's welfare regime and build modern, efficient arrangements of social protection, the government emphasised selective incentives toward disadvantaged groups according to its own conjunctural discretion.[8] Downplaying underlying tensions in the name of preserving what appeared to be a virtuous economic cycle was shared by other public agencies as well, vividly seen, for instance, in the unwillingness of Turkey's independent banking authority to tackle issues such as consumer protection and competition regulation (Bakır and Öniş 2010).

Consequently, by autumn 2008, a certain dualism characterised Turkish economic and policy performance. On the one hand was the recent legacy of fast and equitable growth and the accompanying belief in policy circles that the economy was on safe ground. From this standpoint, the moderate deterioration in growth and fiscal performance after mid-2007 could have been interpreted as a short break on the part of policy and economic actors, after which a return to the golden age of 2003–6 was perfectly feasible. On the other hand was the retreat from externally inspired reformism and from neoliberal austerity along with a pronounced move toward policy heterodoxy, rooted mainly in the party-political considerations of the AKP rather than representing a well-planned, alternative policy effort to mitigate the macroeconomic and social risks of the Turkish growth path.

The disincentives against an early commitment to a bold response to the global crisis can now be more clearly laid out. The large fiscal stimulus option was hard to justify on at least two counts. First, it was a difficult sell given the government's recent track record of fiscal easing and a projected decline in revenues. The dominant sentiment in the economic administration was that Turkey had to enter the crisis with as strong a fiscal position as possible. Second, given the dependence of the economy on foreign inflows, the economic utility of such a move was not easily calculable. A quick rebound in European import and financial markets could have made the Turkish stimulus an unnecessary adventure; alternatively, a deepening downturn would make it ineffectual. At a time when the global coordination of national fiscal packages was a matter of policy debate, the sure future cost of a premature Turkish plan may have vastly outweighed its unforeseeable gains.

Even stronger objections could be levelled against an early IMF option. Most obviously, Turkey was neither expecting a balance of payments crisis, nor had concerns about its financial system.[9] Its foreign reserves were at an all-time high ($77 billion in September 2008), the foreign component of its public debt was negligible, and its banking system boasted one of the highest adequacy ratios in the world. An agreement at that point would have been merely precautionary. Besides, Turkey had concluded its third consecutive IMF standby arrangement only a few months before, the single such case among emerging market countries in the 2000s. Going back to Fund tutelage in the first difficulty would have put under question any achievements of the post-2001 period and undermined the policy claim about the resilience of the economy, potentially backfiring in the form of eroded investor confidence. Finally, an early IMF agreement would have significantly narrowed Turkey's policy options, making a comprehensive stimulus plan down the road (and consider here that by autumn 2008 the Fund was still rolling out conventional austerity plans for its crisis-struck clients such as Hungary and Iceland) out of question.

The price of stability

Turkey's pre-crisis policy and macroeconomic constraints provide important clues as to why Turkish policymakers were reluctant to make an early commitment to either the vigorous stimulus or the official financing paths. In comparative perspective, there was little unusual about this initial policy attitude. With the exception of a few fiscally fortunate Asian cases, most emerging market countries that did not face imminent financial collapse adopted a similarly cautious, non-binding response at first, letting hard evidence of the damage they were set to incur accumulate for a few months before investing in costly countermeasures. Argentina announced its stimulus package in mid-December; for South Africa it took as long as early February. The prime clients of official financing such as Mexico and Poland agreed to precautionary deals only after the IMF revised (read, loosened) its lending framework in March – though they never actually resorted to these funds.

Yet the basis for comparison ends there. A globally popular dose of early policy caution cannot explain the overly delayed, piecemeal, and on the whole limited character of Turkey's stimulus efforts, nor can it account for its ultimate rejection of external financing. A basic run-down of Turkish anti-crisis policies, shown in Table 3, suggests that Turkey did not embrace any clear stimulus measure until March, whereas the more serious employment and investment supports had to wait until the summer of 2009. Even with this eventual widening of the policy repertoire, the Turkish response remained weak in other respects, most notably on the public investment and social protection fronts. Bringing down consumer

Table 3. Main elements of Turkish crisis policymaking

Liquidity supports	• *Interest rates*: TCMB reduces overnight policy rates, incrementally from 16.75% in November 2008 to 6.50% in November 2009	Nov. 08–Apr. 09 fastest
	• *Foreign exchange market*: TCMB resumes intermediation via revived FX Deposit Market; FX reserve ratios reduced; lending and maturity conditions for TCMB FX loans to banks eased	Oct. 08
	• *Capital repatriation*: Asset Peace Law offers tax amnesties for previously undeclared foreign and domestic assets	Nov. 08
	• *Various liquidity*: Interest rates on TL reserves raised; withholding tax on private bonds reduced	Autumn 08
Banking regulation	• *Profit sharing*: BDDK places limits on banks' profit dividends to bolster paid-up capital	Nov. 08
	• *Credit rules*: Tighter regulations for consumer and corporate FX loans; new facility for restructuring nonperforming credit card loans	June 09
Demand stimulus	• *Tax reductions*: Wide-ranging temporary tax cuts on autos, consumer durables, and real estate	Effective Mar. 09–Sep. 09
Industrial supports	• *Export measures*: Eximbank export rediscount credit pool widened, eligibility criteria eased	Dec. 08–Apr. 09
	• *Small and medium-sized enterprise (SME) supports*: Eligibility for SME status widened; enhanced SME loan insurance via Credit Guarantee Fund; new public loan scheme for SMEs	Apr. 09; July 09; Sep. 09
	• *Investment supports*: New sectoral-regional investment subsidy regime, combining corporate tax reductions, social security premium reductions, and interest subsidies	July 09
Employment measures	• *Employment promotion*: Temporary and part-time employment incentives; renewal of existing subsidies for female and youth employment; new scheme for temporary public employment, public internship, and vocational training	Jan. 09; May 09; June 09

prices and investment costs, rather than increasing popular incomes and opportunities, was the principle from which the government operated to stimulate the ailing economy. Among the decisive factors in this peculiar path were the domestic political context, discussed in the next section, and the partly distorted crisis perceptions of Turkish policymakers, examined below.

Underlying the crisis perceptions of Turkish policymakers were some bitter lessons drawn from past calamities. Their 'evoked set' in the neoliberal era consisted of two deadly instances of sudden collapse, in 1994 but far more damagingly in 2000/1, which ingrained Turkey's liberal bureaucrats and politicians with the unshakeable belief that all evil came from fiscal imprudence and financial instability. In their known universe, a 'crisis' was fundamentally rooted in these often simultaneous episodes of mismanagement; it would strike in the form of rapid capital outflows, massive devaluation, and skyrocketing interest rates, and would eventually mature into a full-blown banking and fiscal crisis. Only then would it spread to the real sector through credit and demand channels. In fact, even before neoliberal times, this pattern was not altogether unfamiliar. The crises of 1958 and 1978/9 followed cycles of populist fiscal expansion; the Bankers' Crisis of 1982, at the outset of Turkey's market transition, was a classic case of a bursting credit bubble directly resulting from an attempt at radical financial deregulation. From these recurrent episodes followed the basic wisdom that fiscal profligacy and regulatory forbearance inevitably brought crisis, whereas vigilance on these fronts helped avoid and recover from it. By contrast, a genuine real sector crisis was unheard of in Turkey's postwar economic history.

The way the global crisis broke out, shaking the banking systems of core countries but also of a few emerging markets, fuelled the fear of a repeat of this fisco-financial crisis pattern, leading to policy obsession with assuring stability on both fronts, with two important outcomes. First, policy debate quickly settled on the rather technical question of how to ensure liquidity in the system without putting the fiscal and monetary balance at risk, which triggered some policy synchronisation, around October–November 2008, between the Treasury, the Turkish central bank (TCMB), and the banking authority (BDDK). In early October, the Treasury voluntarily fell behind its borrowing projections, refusing to shoulder the burden of rising interest rates and thus signalling government unwillingness for expansionary policy. 'We do not have the luxury to spend more in an environment of escalating crisis', a bureaucrat put it succinctly (Milliyet 2008a). The inflation-conscious TCMB concurred; it resisted mounting private sector calls for easing the policy rate, and introduced more technical measures to bolster liquidity such as reinstating the FX deposit market, lowering FX reserve ratios, and bumping rates on lira reserves. For its part, the BDDK opposed the idea of extending deposit insurance coverage, and instead called on the banks to retain profits in balance sheets, demanding that they seek authorisation from the agency for issuing dividends. In the meantime, the government frequently repeated its resolve to stick with budgetary prudence. Treasury Minister Şimşek unveiled plans to institute a fiscal rule; Finance Minister Unakıtan denied rumours of tax reductions on autos and consumer durables; PM Erdoğan asked business leaders not to pressure the government for a 'crisis package'.

Only after these assurances, in late November, did the TCMB begin to lower interest rates – much too late according to some observers (Uygur 2010: 29). The government reciprocated by cutting 2009 fiscal allocations for public works and agricultural subsidies, although it stood behind its plans concerning municipal transfers (more on this later).

The agreement to counter the crisis through monetary, fiscal, and regulatory vigilance rather than, say, a large fiscal stimulus which would have been cognitively inconsistent with Turkish policymakers' shared wisdom about effective crisis management had a second important outcome. Assuming this was the right policy mix, they judged that persisting problems in the economy must have been temporary, and caused by lags in perception among economic actors. This was not to say that policymakers were oblivious to the real sector shock, especially from export markets (for one thing, industrial production had been declining since August); rather, having taken the correct steps within their ideational universe, they expected to see at least some improvement in market conditions. But Turkish manufacturing continued its free-fall, with capacity utilisation sliding from 78 per cent in August to 70 per cent in November and a mere 61 per cent in January (TCMB online). As the prospect of economic resilience fell through, an aggressive rhetoric of expectation management ensued, especially on the part of the government, suggesting that the problem with the Turkish economy was more psychological than real.

While employed to scold business leaders that screamed for fiscal activism as well, the actual target of this line of argument was commercial banks, for it had long been taken for granted that beyond all else it was the strength of the Turkish banking system that would have eventually cushioned the effects of the crisis. Yet let alone help out ailing real sector firms, banks proved utterly reluctant to lend, perplexing and angering policymakers at the same time. The TCMB Governor Yılmaz expressed deep dismay at mounting news of prematurely recalled and non-renewed corporate loans despite liquidity-enhancing measures, while PM Erdoğan openly lambasted banks for crisis opportunism (Milliyet 2008b; Radikal 2008). In return, Ersin Özince, the Chairman of Turkish Banks' Association, shrugged off these criticisms forcefully, pointing out that, given the combination of the current conditions and Turkey's excessively stringent banking legislation which stipulated severe criminal responsibility for certain types of loan failure, 'no banker should lend at all' (Milliyet 2008c). However exaggerated, his defence did capture the cold reality that there simply did not exist any concrete incentive for Turkish banks to lend long to firms when they could neither price loans properly nor evaluate even the most trusted clients in the face of a real sector collapse already in progress. Having been forced to hold high reserves and prohibited from engaging in exotic instruments, unlike their counterparts in advanced economies, what worried Turkish banks this time around was not an imminent loss of solvency as had been the case in 2001, but the traditional credit risk that could cause profitability problems in the medium term. Seen this way, the government's stance was indeed ironic. Heavily invested in a paradigm of financial stability, it soon found itself protesting futilely against the rational behaviour of the one sector that was performing fine despite the crisis.

A shift in policy attitude occurred in early 2009, precipitated by the flow of data indicating the depth of the crisis. Erdoğan stuck to his 'tangential effect' argument, but ministers and economy bureaucrats were less confident about the wisdom of the old fisco-financial stability paradigm alone for recovery. The government gradually toned down its criticism of banks, and confirmed preparations of a comprehensive real sector package. But devising a strong, coherent plan would prove more difficult than expected. The primary reason for this could be found in the dynamics of party and interest group politics, examined in the next section. But another concerned the state's asymmetric sectoral capacity heavily skewed toward assuring financial stability.

Briefly, in two decades of wrestling with problems of finance-led globalisation, the Turkish state had accumulated considerable institutional muscle in monetary, fiscal and financial governance as indicated by the dominance over the economic bureaucracy of large, elite organisations such as the Treasury, the TCMB and the BDDK, which had thus far spearheaded crisis policymaking. By contrast, its interventionist capabilities in other economic realms had either stalled, or atrophied considerably, thereby hindering a coordinated real sector response.

Crucial in this regard was the now all-important industrial policy, very much ignored in the 1990s despite significant transformation in the structure of the sector. Neither the State Planning Organisation (DPT), the old stronghold of state-led development, nor the Ministry of Industry and Trade, an ever politicised and relatively small agency, had the institutional preparedness to lead an upgrading drive. In fact, since the heavily subsidised rise of textiles in the mid-1980s, the Turkish state had engaged in little in the way of industrial coordination. Policy debate over the past two decades had focused on how to pull the state out of the productive sector by re-energising Turkey's much-delayed privatisation process, which was accomplished in a remarkably fast manner after 2003 (Atiyas 2009). In such a context, rather than seeking to devise new forms of interventionism, state policy boiled down to clearing the way for private initiatives and letting Turkish firms flourish in a favourable trade environment abroad and long-awaited macroeconomic stability and consumer boom at home. A case in point was the situation of Turkey's thriving SMEs, with the state agency designed to further their cause (KOSGEB) having regressed to a token organisation with minimal funds in the 2000s.[10] The dire conditions the SMEs faced during the crisis would force the government to rejuvenate the agency, although in several ad hoc steps that lacked the consistency and impact of a single major overhaul.

Other policy areas suffered a similar lack of bureaucratic capacity, including such fundamental domains as education and social protection; this might partly explain why they figured much less prominently in the Turkish stimulus plan than those of many other countries. One of the few fortunate domains, meanwhile, was labour policy: since the flexibilising reform of May 2008, there had existed an employment promotion programme, which were to be renewed and expanded from January 2009 onward. But even in this one area of relative bureaucratic preparedness, policy change proceeded in three individual steps rather than a single coherent shot, while its effectiveness remains dubious (Yeldan 2009b).

Managing an economic crisis, politically

The Turkish government's policy response to the global crisis in its initial months was driven by a well-established wisdom of fiscal and financial stability, in turn reinforced by the country's pre-crisis policy and macroeconomic constraints. But with a far more severe economic deterioration than policymakers expected, a broader and more heterodox response slowly emerged from the spring of 2009 onward. Underlying this new policy line was a distinctly political logic of crisis management, as could be traced in the AKP's dealings with the IMF and its relations with domestic collective actors.

During its early years in office, the AKP had a relatively uncontested ride. Rather than emphasise its conservative leanings, the party largely adhered to the agenda of economic reform, democratisation and European integration it had inherited from the outgoing coalition government, for which it was able to garner both elite and popular support in an environment of rapid growth.[11] But severe political tensions sprang up after 2006. Its attempts to consolidate its power, by penetrating the bureaucracy but most vividly during the row over presidency in 2007, put the party increasingly at odds with Turkey's military-backed secular establishment. Meanwhile the external anchors that had helped keep the government on the reformist track were fast weakening as the EU drive reached a standstill and successive IMF agreements neared completion (Öniş 2008). For Turkey's traditional industrial elites, this loss of reformist momentum was the primary factor behind the economic slowdown of the post-2007 period and was reason to reconsider their endorsement of AKP rule.

Yet faltering growth performance was hardly the sole concern of AKP leaders. Although the party increased its votes dramatically in the July 2007 elections, by spring 2008 it faced a Constitutional Court case demanding its closure for regime-inappropriate activities. Strains continued to mount in subsequent months, with a major corruption scandal implicating party rank and file, but most seriously with the high-profile trial against former military top brass along with some noted secular intellectuals concerning a series of alleged coup plots (known as the Ergenekon Case, after the name of the alleged underground organization). Consequently, when the economy entered recession, the AKP had already been forced to tread a much finer political line than a few years before, and was additionally constrained in its policy options given the upcoming local elections in March.

There is no plausible explanation other than this overloaded party-political agenda for the Turkish government's resistance to the IMF throughout 2009. By spring the scale of devastation was so far beyond earlier projections that even the TCMB, sceptical of the need for IMF funds a few months back, was calling for an urgent deal (Radikal 2009b). But negotiations were deadlocked. On several occasions the government claimed that an agreement was to be signed shortly, only to recant a few weeks later that differences with the agency remained unresolved. To many observers this was another example of the AKP overexerting the expectations management channel. Like Erdoğan's optimistic 'tangential effect' argument or the popular government line about the psychological character of the crisis, the constant 'talk' of an IMF deal too was meant to serve as a market-assuring pseudo-anchor at a time of economic free fall – a strategy heavily criticised by business leaders, academics, and former policy figures such as Kemal Derviş, the architect of Turkey's 2001 programme (Milliyet 2009b).

Two sets of factors account for the AKP's unwillingness to accept official financing. One was about the Turkish public's increasingly negative opinion of external actors. In particular, the disappointments encountered on the path to EU membership produced a nationalist backlash in the post-2005 period. In a rare instance of unison among the secular and Islamist creeds, multilateral organisations such as the IMF and the World Bank now drew greater scepticism, and were seen, more than before, as acting narrowly on behalf of powerful Western governments. In an election year during which the AKP's nationalist credentials were frequently called into question, this was a sentiment the government could not afford to ignore. The problem with asking the Fund's help was therefore not merely about contradicting the government claims about the inherent resilience of the economy. More threateningly, it would reinforce the belief about the AKP's weak commitment to national causes, reflected in popular suspicions toward rapprochement with Armenia and widespread opposition to the Kurdish democratic initiative. In response, Erdoğan was careful to frame the party's reluctance toward the IMF as rooted purely in concerns of national sovereignty and pride, lambasting proponents of a deal for failing to recognise Turkey's 'power' in the world and stressing the government preference to 'go our own way with our own resources' (Radikal 2009a).

Second, and underneath this generalised rhetoric of sovereignty and independence, was the more decisive matter of the concrete elements of disagreement between the IMF and the government, which seemed to relate more to party interests than the national interest. Two policy issues stood out as the primary obstacles. One concerned fiscal allocations to municipalities, which the AKP wanted to (and eventually did) ease but the IMF opposed, on grounds that such a move would violate the fundamental principles of responsible public expenditure management. Not surprisingly, the notion of curtailing municipal resources on the eve of local elections was rejected without hesitation by the AKP. The other issue concerned the reform of the tax administration, which both the IMF and the World Bank had advised the government since 2003 to restructure as an autonomous agency. Such a step, they argued, would help strengthen the traditionally weak extractive arm of the Turkish state reflected in widespread tax evasion that had long forced Turkish governments to rely increasingly on regressive, indirect taxes on consumption. But while Turkey's narrow tax base was a problem on which there had always existed broad consensus, fixing it via erecting an autonomous agency was a most unpalatable option for the AKP whose electoral base, like all parties on the right, included wide segments of small and medium-sized entrepreneurs, the self-employed, and rural producers – the prime beneficiaries of a lax revenue regime.

Domestic politics played a crucial part in the timing and composition of Turkey's stimulus efforts as well. Of particular importance here were state–business relations and cleavages within the business community itself. Turkey's two largest business organisations, Türk Sanayicileri ve İşadamları Derneği-Turish Industrialists' and Businessmen's Association (TÜSİAD), representing elite industrial interests, and Türkiye Odalar ve Borsalar Birliği-Turkish Union of Chambers and Stock Exchanges (TOBB), the semi-corporatist umbrella organisation of private entrepreneurs with some disposition toward small and medium-sized firms and commercial capital, were both quick to call on the government for a comprehensive intervention plan to be designed in cooperation with the private sector (Hürriyet 2008a). The relations between these organisations (especially TÜSİAD) and the AKP had already soured in recent years due to the slowdown in reforms. Seeing their calls for vigorous action carried little weight, business leaders now redoubled their criticism, openly attacking the government for its tardy response, to be blamed in return by ministers for 'crisis-mongering' (Hürriyet 2008b; Milliyet 2008d). It is noteworthy that only after MÜSİAD, the representative mainly of the conservative Anatolian capital with organic linkages to the AKP, joined the real sector chorus of crisis malcontents in January, arguing that the economy was in 'intensive care', did the government begin to take more concrete measures (Milliyet 2009a). Assuming the MÜSİAD membership was exposed to similar hardships as the rest of the business community, there is no better explanation for the organisation's lenience toward the government until that point other than partisan loyalty; correspondingly, it was partisan cleavage that retarded the emergence of a unified business appeal for fiscal intervention, overcome only when the economy spiralled into deep recession.

Even then, this late consensus failed to trigger a vigilant anti-crisis strategy. Perhaps as an extension of its perception management approach, the government kept hinting at plans on a wide array of issues, showcased as evidence of its policy activism. In actuality, there were significant delays in their materialisation and shifts in scope. The pattern was thus distinctly reactive and reparative rather than precautionary, with policymakers delivering the least possible at first, until which time they buckled under intensified pressure from the business community as conditions worsened. The wide-ranging tax breaks on autos and consumer durables, the costliest element of Turkish stimulus strategy, did not take effect until late March; still, they failed to quell the business outcry and had to be extended to other goods in April. The new industrial subsidy regime, signalled since October, was finally enacted in June following a new round of protests led by TÜSIAD and TOBB that also triggered a comprehensive cabinet shake-up,[11] whereas the most important support items toward the SMEs, such as the credit guarantee scheme, had to wait until mid-summer. Employment measures too were disclosed in several individual steps from January until June. With such a piecemeal strategy in place, it took the AKP government precisely a year from the outbreak of the crisis to formulate a broader vision of economic policy, outlined in the DPT's Medium Term Programme of September 2009 (DPT 2009).

The reactive character of the AKP's crisis response conformed to the historical pattern of economic policymaking in Turkey (Öniş and Şenses 2007), but its drawbacks were not limited to its delayed and stepwise character. Its composition was also problematic. In the absence of a coordinated recovery plan designed beforehand, measures hastily contrived in response to mounting societal pressures inescapably favoured the better organised and more powerful interests. Thus, industrial and commercial capital that lobbied more effectively than other collective actors emerged as the biggest beneficiary of the government's stimulus efforts. What followed was a selective response that was unmistakably business-friendly in its main orientation, and exceptionally weak on social protection and infrastructure investment. Demand stimulus did not take the form of raising disposable incomes, which could be done either via increases in wages and pensions as in Russia, or on a one-off basis via targeted transfers as in many countries from Chile and Thailand to the US, or through temporary reductions in income taxes of low wage earners as in South Korea. Instead, the dominant stimulus instrument was tax cuts toward consumer durables in overstocked sectors. Likewise, both employment measures and the new industrial investment regime operated on the principle of lowering entrepreneurial costs such as corporate tax reductions, subsidising employers' share of social security premiums, and research and development supports. Meanwhile labour proposals such as enhanced job security or tax cuts on basic goods never even became part of the policy debate (TÜRK-İŞ 2009). About the only items directly targeting lower income households were a minimal increase in unemployment insurance benefits and a limited public employment and vocational training programme. In fact, a UNDP report finds that within a sample of 35 economies Turkey's fiscal plan scored the lowest on the social protection front, with less than 1.5 per cent of its stimulus funds allocated to social spending (Zhang et al. 2009). A similar tendency marked infrastructure investment. If anything, public investment slightly decreased in 2009, contradicting a near-universal trend in countries that did not face a fiscal or financial crisis. These basic trends were consistent with frequent business warnings throughout the crisis that any fiscal incentive the Turkish state provided should have been based on forgone revenue rather than actual spending (Milliyet 2009c).

The only area marked by a semblance of coordination and proactivism in the AKP's crisis response was its foreign economic policy, strategically oriented toward improving Turkey's trade balance by emphasising South–South cooperation. One aspect of this effort has concentrated on reducing Turkey's energy dependency, given that oil and gas constitute its largest import items. To this end the government redoubled its efforts to set up nuclear power plants (contracted out to South Korean firms) while also trying to reinforce the country's strategic position as an energy hub between Asia and Europe by promoting new projects (e.g. Nabucco that includes Russia as the other major partner). More importantly, there have been concerted efforts toward export market diversification to break Turkey's conventional overreliance on the European core. For instance, much emphasis was placed on the possibility of attracting the lucrative Gulf capital to Turkey, a quest in which AKP leaders did not refrain from resorting to cultural themes such as Muslim solidarity, albeit with no discernable success. A more concrete step was the mutual easing of visa requirements with over two dozen Middle Eastern, Asian and African countries to facilitate trade opportunities as well as several bilateral trade agreements. These energy and export market initiatives are actively portrayed by the AKP as evidence of its long-term vision of making Turkey a regional superpower, and by extension evidence of its overall policy activism. Although their contribution to Turkey's long-term recovery remains uncertain,[12] for now they successfully complement the party's rhetoric of working toward policy as well as market independence, an ever appealing message for its Western-sceptic base (Kardaş 2009).

In retrospect, the AKP government was quite effective in its political management of the crisis. It showed skill in diverting attention away from narrow economic issues and portraying itself as a progressive force in Turkish politics through its multiple initiatives on the democratisation front. The strained relationship with the IMF was also projected as a sign of national strength and autonomy. Indeed, the reluctance to sign an IMF programme neatly tied into the overall foreign policy stance that became increasingly assertive, reflecting Turkey's newly discovered self-confidence particularly in relations with its Middle Eastern neighbours. The fact that Turkish politics was deeply divided on issues relating to secularism and identity also helped the government to sidetrack attention from what appeared to be more technical economic matters. The single-minded concern of the principal opposition parties with issues relating to identity and regime stability and, hence, their failure to draw attention to issues like poverty and high unemployment helped the government pass through the local elections of March 2009 without significant loss of popularity. Effective political management of the crisis, however, does not imply that the crisis was well managed on economic grounds. Indeed, given the continuing fragilities of the Turkish economy, the possibility of a quick return to the high-growth equilibrium of the mid-2000s looks slim.[13]

Conclusion

Conforming neither to the official financing pattern nor to the vigorous stimulus path, the Turkish response to the global economic crisis of 2008–9 diverged from dominant policy trends in other major emerging market countries. On the official financing front, Turkish policymakers did hold extended negotiations with the IMF, but apparently only to employ the process as a quasi-anchor to manage market expectations while continuing to harbour deep reservations toward an actual agreement. On the fiscal front, the Turkish stimulus was not only overly delayed but also implemented in fits and starts in reaction mainly to business protest; as such it lacked some typical components of the global 'Keynesian resurgence' such as social spending and infrastructure investment. We have invoked three key factors to account for this deviant response: pre-crisis structural and policy constraints; an orthodox wisdom of crisis diagnosis and resolution narrowly preoccupied with fiscal and financial stability; and domestic party and interest group politics.

Our framework is useful for understanding the interplay of the structural conditions of the economy at the onset of the crisis, the ideational proclivities of policymakers based on present beliefs and past experience, and the coalition building and maintenance strategies of political incumbents in producing national responses to the global economic crisis. Although this argument is articulated for the Turkish context, its basic analytic premise may find broader application in the nascent literature on developing country strategies toward the crisis. The key point is that a synthetic emphasis on structural-economic, cognitive-ideational and domestic-political factors offers a good place to start exploring the universally complex dynamics behind crisis policymaking.

Two aspects of our discussion deserve further attention, indicating the multi-dimensionality of the factors in question. Perceptions of policymakers are shaped not only by the prevailing policy paradigms of key international organisations such as the IMF and the World Bank, but also by the domestic interpretations of past crises. In the Turkish case, the perception of policymakers in 2008–9 was heavily conditioned by the prevailing wisdom of the IMF which emphasised fiscal stability and prudential regulation of the financial system at the expense of other objectives. At the same time, the fact that the initial trajectory of the crisis did not conform to that of domestically generated financial meltdowns of the past, which were manifested through instant shocks such as currency collapse and stock market crash, led to its dismissal as a less serious incident than previous episodes. From this observation followed the policy overconfidence that bold, innovative measures were unnecessary and the prevailing wisdom would easily suffice for recovering from this 'lesser crisis'. Ironically, in their conservative adherence to this wisdom, Turkish policymakers grew less responsive to the newer ideas that emerged in dominant policy circles, such as the recent IMF position that social protection could be made a viable component of fiscal stimulus plans. In the end, past experience also generated a selective interpretation of the evolving international policy ideas.

The policies of the AKP government also illustrate how a government could devise skilful political strategies to sidetrack attention from economic issues during a crisis environment and maintain its broad political appeal in the face of a collapse of growth with severe social consequences. Particularly interesting from a comparative perspective was that the resistance to IMF funding was one such strategy, for it is reminiscent of Brazil's and Argentina's turn away from the agency earlier in the decade. In that sense the Turkish example is the latest confirmation of an emergent trend – namely, popular sentiment toward the IMF in most late developers is so negative that an IMF-free policy can become valuable political capital for mass parties striving to maintain and bolster their popularity. But unlike its Latin American counterparts, Turkey's rejection of official financing has not coincided with shifts in its growth strategy and social policies. Herein lies the main drawback of the Turkish response. Relations with the IMF, along with the AKP's activist foreign economic policy, certainly contributed to the party's effective political management of the crisis. But this short-term political effectiveness does not imply that the response was 'optimal' considering Turkey's long-standing developmental problems such as assuring equitable patterns of income distribution and a high growth path with long-term sustainability. The relatively fast recovery of the first half of 2010 has been fully based on the rebooting of Turkey's foreign inflow-dependent growth machine, with the current account deficit quadrupling since 2009. The return to this pattern, the social as well as economic sustainability of which is at best questionable, as discussed already, indicates that Turkish policymakers did indeed 'let the crisis go to waste',[14] rather than using it is as a window of opportunity to tackle the structural challenges of Turkish development.

This in fact is the crux of the matter not just for Turkey but for many late developers today. Overall, the past decade had been kind to the developing world. High liquidity and record trade expansion in the global economy lifted nearly all boats simultaneously. Not only star performers, but most middle income economies that achieved a semblance of macroeconomic and policy stability managed to take advantage of this fortuitous environment. The global crisis marks the end of this easy period. Countries that were lulled into a false sense of optimism about growth in the mid-2000s are now facing the daunting task of fixing the structural issues which make them vulnerable in harder times. They need to address trade imbalances by readjusting their macro policies and productive sectors; they need to improve their defences against the longer-term risks of foreign-capital dependence; above all, they need to invigorate their mechanisms of social protection to preserve and further the collective gains of their growth spurt. Seen this way, the resolution of the problems that complicated Turkey's crisis response is crucial for designing viable strategies in the post-crisis period across the developing world. Policymakers must break free from the restrictive ideational frameworks that had emerged as a reaction to the instabilities that followed rapid, finance-led globalisation experiments, and re-focus their attention on more conventional developmental concerns such as industrial and social policy. But reorientation along these lines also requires genuinely inclusive political structures and stronger democratic practices to deal with escalating distributive dilemmas. Without such simultaneous ideational and political upgrading, the current sea change in the international economy could easily usher in a period of slow growth–high inequality equilibrium for many countries and provoke new episodes of intense economic and political instability.

Notes

1. The strong GDP rebound of the first half of 2010 (11.7 per cent in Q1 and 10.3 per cent in Q2) was in part due to the 'base effect' of the massive decline during the same period in 2009 (–14.6 per cent in Q1 and –7.6 per cent in Q2). Thus, three years into the crisis, Turkey is still struggling to reclaim its pre-crisis levels of output.
2. See Akyüz (2009), Green et al. (2010), Griffith-Jones and Ocampo (2009), IMF and World Bank (2010), ODI (2010), and UNCTAD (2009) for comprehensive accounts of the impact of and policy responses to the global crisis in emerging and developing countries.
3. Consider, for example, that despite facing a larger fiscal deficit and higher borrowing rates before the crisis, Brazil's stimulus plan ended up several times that of Poland, which has a constitutional limit on public debt. As such, it was not that Brazil was technically endowed with greater fiscal room than Poland; rather, it had the political volition and institutional freedom to stretch its fiscal means. Recent IMF interest in the notion hardly captures these non-technical dynamics for determining fiscal space (see e.g. Heller 2005). For a recent and more heterodox debate, see Roy and Heuty (2009).
4. For instance, *Programa Jefes de Hogar* in Argentina, *Bolsa Família* in Brazil, and *Oportunidades* in Mexico.
5. On Turkey's neoliberal transition in the 1980s and 1990s, see Arıcanlı and Rodrik (1990), Nas and Odekon (1992), Öniş (1998), Cizre-Sakallıoğlu and Yeldan (2000), and Aydın (2005). For the 2001 crisis and the new phase of neoliberal restructuring, see Akyüz and Boratav (2003), Öniş and Rubin (2003), Altuğ and Filiztekin (2006), Öniş (2009), and Öniş and Şenses (2009).
6. Turkish Statistical Institute Databank (TURKSTAT) (online). Figures indicate a sharp decline in poverty rate, from around 27 per cent of the total population in 2002 to less than 18 per cent in 2006. During the same period, the ratio of the population living under US$4.3 per day dropped from 30 to 13 per cent.
7. On Turkey's foreign capital-dependent growth pattern, see Demir (2004) and Yeldan (2006).
8. On Turkish social policy under AKP's early years, see Buğra and Keyder (2006: 222ff).
9. For an early account of Turkey's anticipated crisis-resilience, see Bakır (2009).
10. Established in 1990, KOSGEB (Küçük ve Orta Ölçekli İşletmeleri Geliştirme ve Destekleme Dairesi Başkanlığı—Directorate of Developing and Supporting Small- and Medium-Sized Entreprises) displayed

a model case of institutional drift and decay until mid-2009 when the distribution of new SME supports had to rely on whatever little capacity the agency had accumulated over the past two decades.
11. For the AKP's early years, see Yavuz (2006).
12. Ali Babacan replaced Nazım Ekren as the economy minister with enhanced powers, whereas the finance ministry went from Kemal Unakıtan to Mehmet Şimşek, the former treasury minister. Other changes involved ministers for foreign trade, and for industry and trade.
13. In fact, a fresh report finds that the recent export drive toward Asia, North Africa and the Middle East is far from offsetting Turkey's export losses in the EU market (TEPAV 2010).
14. At the time of writing (September 2010), official growth projections for 2011 and 2012 hovered around 4–5 per cent, far below the 7 per cent 2003–7 average.
15. The phrase famously belongs to Obama's chief of staff Rahm Emmanuel (see New York Times 2008).

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Rethinking the Beijing Consensus: how China responds to crises

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Rethinking the Beijing Consensus: how China responds to crises

Yang Jiang

Abstract This paper discusses the role of the Beijing Consensus type of foreign and economic policymaking in China's development since the Asian financial crisis and in its response to the global crisis, and argues that it has been a double-edged sword, as reflected in several aspects. First, the lesson that China learned from the Asian financial crisis was not the importance of liberalisation but prudence or conservativeness, which despite serving as a shield this time sustains problems in the long term. Second, an obsession with foreign reserves accumulation and the pursuit of political influence have for a long time overshadowed the increasing dependence on the US market, putting China in a dilemma now in both development and diplomatic strategies. Third, centralised decision-making may be faster than democratic processes, but it may also go against the principle of 'scientific decision' as proposed by the Chinese leadership. A prominent feature of China's responses to the crisis is a bias towards state-owned enterprises and the public sector, which exacerbates the existing problems of monopoly, over-capacity, inequality, the regulators being 'captured' by industrial interests and protectionism. Given limited economic resources, domestic political contentions and the questionable credibility of the China Model, it would be difficult for China to practice 'responsible great power' diplomacy or assume leadership in the region or globally.

Keywords Beijing Consensus; China Model; responsible great power diplomacy; great power style; financial crisis; stimulus package.

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1. Introduction

Beijing may laugh at the Washington Consensus floundering in the global financial crisis, but is it possible that China has fallen into the trap of the Beijing Consensus?

Following the Asian financial crisis, the global financial crisis provided China with another golden opportunity to undermine the Washington Consensus, on the one hand by justifying its political economic system for domestic development, and on the other hand by introducing its development model to other countries. China defends its political system for maintaining domestic stability, fitting the supposedly Confucius culture, and for being able to make and carry out decisions swiftly. Beijing also is also proud of its development path for rapid economic growth, and upholds Deng Xiaoping's wisdom of 'crossing the river by feeling the stones'. In a survey of 300 Chinese officials in March 2009, 75% believed that the China Model had undermined 'three predictions' made by the West: communism or socialism would die, Western democracy would prevail, and neoliberalism would be a universal model (*Renmin Luntan* 2009). The Western media also praised China for its swiftness in introducing stimulus packages, which were regarded as helpful for boosting confidence in the global market and particularly beneficial to regional economies. Particularly in contrast to the protracted process of congressional approval in Washington, the ability of Beijing to take quick action is deemed superior for crisis response.

In its foreign relations, since it gained a lot of political capital by maintaining the value of the renminbi (RMB) during the 1997–98 Asian financial crisis, China has positioned itself as a 'responsible great power' (*fuzeren daguo*) in the region and in the world. China praises itself for 'great power style' (*daguo fengfan*), which is opposite to the predatory great powers. In particular, Chinese leaders emphasise China's generosity in allowing smaller countries the advantage in their cooperation and its determination to speak for developing countries at global institutions, an image that bears resemblance to the Western concept of benign hegemony. Beijing points out that the imposition of conditionalities by the International Monetary Fund (IMF) and World Bank on developing countries have destroyed more than ten national economies including Argentina and Indonesia, particularly thanks to neoliberal economic doctrines embedded in the Washington Consensus in combination with the ensuing modern financial industry and greed. The Chinese government and academia proudly claim that China never attaches conditionalities to its aid or loans to other developing countries and it does not intervene in domestic politics. Many developing countries, including those in Africa, have expressed their appreciation of China's non-intervention in their domestic affairs, and their intention to learn from China's development model, for instance by establishing Special Economic Zones and encouraging labour-intensive manufacturing, with the help of Chinese loans, investment and experience.

However, the role of the Beijing Consensus in China's domestic development needs more scrutiny before it can be introduced to other developing nations or indeed lauded within China. Moreover, the image of a benign hegemon is more difficult to sustain in economic crisis as great powers may become more nationalistic and vulnerable.

Therefore, this paper analyzes the ideational and institutional factors behind China's development since the Asian financial crisis and behind its response to the global financial crisis, and discusses the implications of domestic conditions for Chinese diplomacy. It asks the following questions: how has the 'Beijing Consensus' type of development strategy and policymaking affected China's response to the global financial crisis; and what implications do they have for Chinese 'responsible great power' diplomacy?

The rest of the paper is organized as follows. After reviewing the existing literature on the Beijing Consensus and China's responsible great power diplomacy, it analyzes the ideational impacts that the Asian financial crisis had on China. The lessons learned by China then serve as a background to the discussion of China's response to the global financial crisis in the next section, focusing on three major problems: the concentration of distributional power and the resultant 'unscientific' decisions, the bias towards state-owned enterprises, and continued reliance on labour-intensive manufacturing and export. Finally, the implications of the 'Beijing Consensus' type of policymaking and development strategy for China's regional and global diplomacy are discussed, assessing the distance of China from its aspired status of a responsible great power.

2. Literature review

Although the 'China Model' was mentioned as early as 1991, the term 'Beijing Consensus' was dubbed by former *Time* editor Joshua Cooper Ramo (2004) as a challenge to 'the Washington Consensus', and Beijing Consensus (*Beijing gongshi*) has been used interchangeably with the term the China Model (*zhongguo moshi*). Ramo's association of the Beijing Consensus with innovation, sustainability and equitable development is hardly adequate, but despite that or because of it, the Politburo of the China Communist Party (CCP), the core of China's decision-making power, quickly welcomed the spread of the terms 'Beijing Consensus' and 'China Model' in the international media, as they were believed to help enhance China's soft power (Liaowang 2004). However, after the media attention turned to its revisionist connotations, the Chinese government denied that China was trying to teach the China Model to other developing countries or to challenge the existing international order. It states that the China Model means there is no one model for a country; rather, each country needs to search for its own development or political model.

Chinese academia has been debating whether there is one China Model, with many denying this concept (http://theory.people.com.cn/GB/40557/

149513/ index.html; also see Kennedy 2010). China watchers compare the influence of the Washington Consensus and that of the Beijing Consensus, commenting on the soft power of the latter and its threat to the existing international order (Kurlantzick 2007; Kroeber 2008; Rachman 2008). Some have found fault with the Beijing Consensus, mostly in authoritarianism, human rights records, income inequality, a withering state and corruption (Gill and Huang 2006; Kennedy 2010; Yao 2010). Although there is no academic consensus over the definition of the Beijing Consensus or the China Model, this paper uses the official Chinese position for analysis of its policies and holds that the Chinese government has explicitly or implicitly given two important meanings to the Beijing Consensus or the China Model: gradualist development and authoritarian decision-making.

Crises put models to good test. Protectionism is one general concern, and whether great powers are willing and able to provide public goods is another. Despite much rhetoric regarding China's superior model and great power style during the global financial crisis, to date these has not been a study of the role of the China Model in its response to the crisis, and its implications for China's 'responsible great power' diplomacy. Neither has China's response to the global crisis been contextualized in China's development trajectory, in particular its lessons from the Asian financial crisis at the end of the 1990s. Therefore this paper seeks to fill these gaps, with the acknowledgement that the aftermath of the global financial crisis is still rippling, and China's policies may undergo significant changes due to serious external economic pressure, domestic instability or iron-fisted idealistic leaders.

Since the Asian financial crisis, Beijing has tried to establish an image of a 'responsible great power' and demonstrates 'great power style', ostensibly used in contrast to other great powers and the US in particular. Eric Teo (2004) suggests that China was trying to revive the tributary system in Asia, and the title 'the Middle Kingdom' has appeared frequently in the recent media. China has denied such observations, claiming never to pursue hegemony and emphasizing equality among sovereign states. However, Chinese leaders have heralded Confucianism, the core value in the ancient tributary system, for building a harmonious world. China prides itself on its generosity, compassion and sense of responsibility in its diplomacy in Asia and towards other developing countries. Chinese officials emphasize mutual benefit but also claim to follow the ancient tradition of 'giving more and receiving less' (*hou wang bo lai*) in its diplomacy towards smaller countries. Clearly China wishes to achieve the symbolic status of a great power, both in economic and military strength and in cultural and moral achievements. The model that China wishes others to admire and to emulate and the symbolic status that Beijing aspires to resemble the Western concept of benign hegemony (Kindleberger 1975; Kupchan 1998). It is questionable, however, whether China can carry out the responsibilities of a benign hegemon: providing public goods and creating international institutions.

As diplomacy serves China's domestic needs and diplomatic ambitions are constrained by domestic conditions, it is crucial to examine China's domestic political economy and crisis policymaking. There have been criticisms from both within and outside China on the risks with China's crisis rescue measures, predominantly from an economic point of view: excessive debt, inflation and real estate bubbles (e.g. Yao 2010; Kennedy 2010). Less attention has been paid to the political and institutional factors behind those measures, or the continuity of China's policies since the Asian financial crisis. The existing or potential economic woes may have institutional, ideational and political roots that are more persistent than the vicissitudes of economic environments.

While Keynesianism enjoys a renewed interest in developed countries during the global financial crisis, the Beijing Consensus or China Model is placed as an exemplary model for developing and Asian economies. Indeed, Chinese finance officials and scholars have cited Keynes in the wake of the global financial crisis, and the prominent role the Chinese state plays in the economy appears similar to Keynesianism (Zhou 2009; Fan 2010). However, China has achieved too little in domestic income redistribution and social security to qualify as a Keynesian state. In its economic representations, the Beijing Consensus resonates more with East Asian developmental state in terms of heavy state intervention, gradualist liberalization and state-backed industrial policies, focused on promotion of export and national enterprises (Baek 2005; Beeson 2009; Kerr 2007). Pioneered by Japan and followed to varying degrees by East Asian economies, the developmental state was once regarded as the core of the 'East Asian Miracle' (Amsden 2001; Terry 2002; World Bank 1993; Stubbs 2005). However, disillusionment with this miracle emerged during the Asian financial crisis, when the developmental state became closely associated with crony capitalism (Higgott 1998; Noble and Ravenhill 2000; Stubbs 2005). Certainly, putting the blame on neoliberal measures has continued in crisis-hit countries, but with Japan's protracted stagnation and the neoliberal reforms of other smaller East Asian economies, the developmental state has only met the opportunity of revival during the global financial crisis. Perhaps because the phrase 'developmental state' is accredited to its political rival in Tokyo, Beijing prefers to use the terms 'China Model' or 'Beijing Consensus'. It raises the question whether the typical problems with the developmental model exist in China. Many scholars have pointed out that Beijing's reliance on economic growth for its legitimacy may not be sustainable, given rising social inequality and public discontent (e.g. Breslin 2007; He 2007; Schubert 2008). Yang Yao (2010), in his provocative article 'The End of the Beijing Consensus', correctly states that in the past 30 years China has moved toward the market doctrines of neoclassical economics. However, he argues that the Chinese state survived as a Marxist regime because the state's 'predation is "identity-blind" in the sense that Beijing does not generally care about the social and political status of its chosen prey – unlike many governments elsewhere that act to protect and enrich specific social or political groups'. The 'indifference' that he and other scholars characterize the Chinese state with is debatable. Because of development strategy and partial reform, it is possible that even an authoritarian China is captured by certain vested interests, which inhibits further reform and induces policies that exacerbate inequality (Hellman 1998; Feng 2006). The crisis is a good time to investigate whether Beijing has indeed favoured the embedded interests.

The next section will analyze the lessons that China learned from the Asian financial crisis, which serves as a context and explanation for its response to the global financial crisis. The aim is to examine if and to what extent China's Beijing Consensus type of thinking and policymaking have contributed to recurring or even exacerbating problems.

3. What China learned from the Asian financial crisis

China was affected by the Asian financial crisis in terms of reduced exports and foreign investment, but the most important impact the crisis had on China was ideational. The lessons that China learned from other countries and its own experiences during the crisis have since guided Chinese development and diplomatic strategies and only recently received significant doubt. There are three major lessons: desirability of a responsible great power status, caution about financial liberalization and a strategy to promote exports for economic security and growth.

3.1. Desirability of a responsible great power status

China gained a lot of political capital by keeping the value of the yuan and delivering aid to countries hit by the Asian financial crisis (M. Wang 1998; Y. Wang 1998). China stressed that had it devalued the yuan, international speculators would have again attacked the foreign exchange and stock markets of other East Asian countries. Although China's lack of support for the Japanese proposal of an Asian Monetary Fund was a major reason for the proposal's failure, China realised the importance of participating in regional institution building. Chinese policymakers discovered that Japan's New Miyazawa Initiative in 1998, a US$30 billion financial assistance package for the region, was welcomed by Southeast Asian countries, and that Japan's influence in East Asia increased (Sun 2007). Having come under pressure from other Asian countries, China also foresaw that certain mechanism for regional cooperation would inevitably be established, even possibly without the participation of China (author's interview with a Chinese member at the Pacific Economic Cooperation Council (PECC), Beijing, April 2007). This realisation, together with the positive response China received from ASEAN for keeping the value of RMB, prompted China to adopt a more committed stance in regional cooperation. Despite Deng Xiaoping's advice for Chinese diplomacy to '*tao guang yang hui*' (hide the sharpness and accumulate strength), Chinese foreign policymakers judged that it was time for China to also '*yu shi ju jin*' (follow the trend of time) and '*you suo zuo wei*' (achieve something).

Since Zoellick (2005) prescribed the role of a 'responsible stakeholder' in the international system for China, the emphasis on China being a responsible member in the region and in the global society has become increasingly prominent in Chinese official language. Chinese leaders have, on various occasions, underlined China's friendship towards its neighbours and its sense of responsibility for the region. A Chinese phrase that the Chinese leaders often quote goes 'a long road shows the power of a horse, and a long time shows the heart of people' (*luyao zhi mali, rijiu jian renxin*), implying that China's friendship towards its neighbours and other developing countries have passed the test of time, while some Western countries failed. A central claim from the contrast is that China is not a predatory coercive power or hegemony. China argues that its contribution to the region during the crisis showed that China was becoming a great global economic power, but it was under-represented at international financial institutions such as the World Bank, the IMF and the Asian Development Bank (ADB). Beijing also started to highlight its 'great power style', which was to 'give more and take less' and shoulder collective responsibilities. China has since lauded itself for the great power style on various occasions, for example, when China kept the value of RMB during the Asian financial crisis, when it exempted Africa from US$10 billion of debts in 2000, and when Chinese leaders went on shopping sprees across continents during the global financial crisis.

3.2. Caution about financial liberalization

China did not experience a financial or economic crisis when the Asian financial crisis hit most countries in the region, characterized by massive outflow of international short-term capital, sharp devaluation of the national currencies and difficulty with balance of payments. Many Chinese policy elites realized the necessity of economic reform to strengthen domestic institutions and to enhance national competitiveness. In Steinfeld's view (2008), the Asian financial crisis helped the formation of an ideational environment in China that enabled members of the Chinese policy elite like Premier Zhu Rongji to push forward more radical and fundamental market reforms. As a result, China's agenda of 'reform as the salvation of socialism' became replaced by 'markets as the salvation of growth and legitimacy'.

At the same time, Chinese policymakers and scholars became more vigilant of the pitfalls in financial liberalization. Chinese scholars point out that the fundamental reason for the crisis was the inconsistency between domestic reforms and the premature liberalization of the financial market.

Therefore, it is widely held that developing countries should balance reform and liberalization, and that trade integration has more benefits for developing countries than financial integration. In particular, the liberalization of the financial sector should be coherent with the country's economic development and supervisory ability; it should be even more cautious in opening the capital market (Y. Wang 1998; Xiao 2006; Breslin 2003). They believe that China should conduct financial reform in a stable and active manner, and form a financial surveillance system. Moreover, they hold that the crisis did not happen to China despite problems with Chinese banks because China had capital controls, and that giving up capital controls should therefore be the last step of all marketization reforms, after domestic financial institutions have become strong enough to handle international risks and China has established the mechanism to monitor international capital flows, in particular the short-term ones, and it should be done only after floating the currency (Yu 2007). The consensus in China has been that it should only gradually float the yuan because it is believed that the overall health of the national economy is heavily dependent on trade and domestic savings. In particular, Chinese scholars suggest that China should not allow international free capital – or 'hot money' – to enter or leave China freely, for instance by having restrictions on foreign loans of domestic companies and local governments, and that Chinese banks should not allow loans that are not certain to be returned in the future (Fan 1999; Zhong 2008).

Importantly, Chinese scholars criticize the Washington Consensus – with neoliberal economics at the centre – regarding economic reform and liberalization as being not necessarily safe or helpful to East Asian economies, and they hold that China should use discretion when it listens to the advice of the IMF. The reason, they argue, is that privatization and liberalization cannot prevent financial crises but may aggravate or even cause them if not accompanied by comprehensive regulation and supervision. Ding Ningning at the Development Studies Centre of the State Council states that financial internationalization and electronic means of transactions have not increased the transparency of the international market but have exacerbated its instability (Y. Wang 1998).

3.3. Promote export for economic security and growth

Because of the devaluation of regional currencies and hence the reduced purchasing power of consumers in the neighbouring countries, China's growth rate of exports to East Asia declined significantly during the financial crisis. Instead of questioning the export-led model of growth (Breslin 1999), China chose the path to increase exports. One objective was to accumulate foreign reserves in order to prevent anything like the Asian financial crisis from happening to China in the future. Another objective, by accepting the transfer of exports of other Asian countries from the US, EU and Japan to China, China would increase its influence in Asia and promote the image of a responsible great power (author's interviews with scholars at CASS, Beijing University and Ministry of Commerce officials in March and April 2006 in Beijing).

The obsession with accumulating foreign reserves combined with the political will to provide 'market of last resort' for Asian countries thus led to increased reliance of the Chinese economy on export markets in developed countries like the US and EU (Ravenhill 2006). This model continues to bode poorly for China's industrialization, as most Chinese activities in the production chain are low value-added processing.

Further results from this growth model are apparent: pressure from other countries on Beijing to appreciate the RMB, trade disputes, inflation, and an increasing need for multiple markets. Inflation has caused domestic instability in recent years and the government has to use administrative measures to control prices, particularly those of food. In order to gain access to multiple markets, Beijing is actively pursuing bilateral trade agreements, most of which are with developing countries. Even though China tries to show that it has the great power morality of giving more and taking less in trade agreements, including voluntarily giving concessions to ASEAN and Pakistan on agricultural trade through the Early Harvest Programmes, such arrangements cannot completely convince smaller countries of China's benign intentions. For instance, while the Early Harvest Programme boosted ASEAN's exports of tropical produce to China, the increased Chinese export of temperate produce and manufactured goods to ASEAN countries caused resentment among local producers and again stirred up fears of Chinese domination (Bernardino 2004; Wattanapruttipaisan 2003).

4. China's response to the global financial crisis

Beijing has been praised by the international community for its swiftness to inject stimuli into the national economy, which is regarded as indirectly beneficial for other countries because of its demand for goods and commodities. The Chinese government also prides itself on its decisiveness in adopting such measures, which indeed have had immediate positive effects on GDP growth. China's swiftness is often contrasted with American indecisiveness as Washington had a lot of trouble ensuring the stimulus packages could be approved by the Congress, and uncertainty in such a process has led to market fluctuations.

However, it is worth examining whether, apart from the ability to spend money quickly, money has been distributed in a 'scientific' way in China and whether it contributes to 'scientific development', a catchphrase in China's current development strategy. Even though the long-term impacts of the measures adopted by the Chinese government remain to be seen, three problems in China's responses to the global financial crises are highlighted here as a cautionary note to the Beijing Consensus type of decision-making institution and development strategy: the concentration of distributional power and the resultant irrational decisions, the bias towards state-owned enterprises, and continued reliance on labour-intensive manufacturing and export.

4.1. Concentration of distributional power

The power to supply stimulus funding has been concentrated in the hands of very few actors. At the national level, the distributional power is designated to the National Development and Reform Commission (NDRC) and Ministry of Finance (MOF), supported by industry-line ministries. Concentration of power contributed to the swiftness of decision-making and reduced coordination problems, of which Beijing is proud, but such concentration also has far-reaching implications and risks for China's political economy.

After two attempts at government reform to reduce its power, the role of NDRC in Chinese domestic politics is reinforced thanks to the global crisis as it assumed the 'headquarters' position in government crisis response. The NDRC has inherited a conservative position on reform and opening from its former body, the State Planning Commission. During Premier Zhu Rongji's institutional reforms in 1998 and 2003, not only were parts of the State Planning Commission's institutions abolished to reduce the planning element of the state's role in the economy, but also the newly formed NDRC became largely a research and advisory agency to the central government. However, the NDRC has enjoyed increased power in domestic politics under the Hu-Wen leadership. As domestic stability and development problems became increasingly prominent in particular because of simplistic (*cufang*) liberalization, a more heavy-handed approach has been adopted by the government to intervene in the domestic economy. A more aggressive industrial policy is also adopted to promote national champions in global competition. NDRC is a central agency to carry out such macro-economic 'control' (*tiaokong*). It oversees national macro-economic, energy, price, industrial and investment policies amongst others. Because of the heavy control component in its portfolio and its inheritance from its former body, the NDRC represents the visible hand of planning in China's economic governance. Other government agencies call the NDRC a 'small state council' or a super-ministry, because it has departments matching every sector of the economy and holds a higher political position than the ministries.

The concentration of power in the NDRC reached such a level that problems of lack of capacity there and resentment among other agencies started to surface. It was also obvious that China lacked a clear or coherent industrial policy, although it implicitly resides in the NDRC. An important task in the 2008 government 'big ministry' restructuring was to reduce the responsibilities of the NDRC through diverting part of its power to other agencies. The Ministry of Industry and Information Technology (MIIT) was established by adding more 'industrial policy responsibility' to the former Ministry of Information Industry. The State-owned Assets Supervision and

Administration Commission (SASAC) also became more assertive over its power to regulate state-owned enterprises (SOEs).

However, with the onset of the financial crisis, the NDRC assumed paramount power again over the national economy. *The Review of the National Development Plan 2008* and *Development Plan 2009* were drafted by the NDRC, which included the distribution of the RMB 4 trillion stimulus package. The content of the package will be discussed later, but it was obvious that the distribution was decided without wide consultation. An official from a municipal government in Henan province said that the NDRC was pushing local governments to come up with projects to submit for approval, in contrast to the cautious, slow process of vetting investment applications earlier (Liao 2009). At the end of 2008, in order to compete for the first batch of RMB 100 billion, local officials occupied all the hotels near the NDRC. In order to dispatch funds quickly, the NDRC also approved many applications that had been shelved earlier – the quality of those applications then is in question (author's interview, Beijing, 2009). There have been calls to publicize more detailed information about projects funded by the RMB 4 trillion, and problems with its usage have been reported sporadically (Wei 2009).

A lot of money and discretion were also granted to local governments and state banks. The stimulus packages were distributed to provincial governments, to be used in combination with provincial funding for supporting local projects. The central government also distributed 200 billion local government bonds, which may exacerbate the problem of local government debt. State commercial banks at various levels received administrative orders to fulfil quotas for giving out loans within a short time. In the first quarter of 2009, bank loans already reached 4.58 trillion yuan, mostly on infrastructure, public projects and mergers between SOEs, although part of it is also spent on agriculture, innovation and consumer loans (excluding houses) (Sun and Xi 2009). Such a rapid and particularistic distribution increases the possibility of corruption and bad loans. Coastal provinces like Guangdong complained that the first two batches of 100 and 130 billion yuan were heavily tilted towards middle and western regions although coastal areas were most severely hit by the crisis (Su 2009). It was also reported that local governments might not be able to provide the complementary investment needed for the RMB 4 trillion package: RMB 600 billion was needed but an estimated RMB 300 billion was available. However, local governments tried to match the state funding, not least because NDRC made it clear that for the first batch of RMB 100 billion investment, if a local government could not provide complementary funding, its future investment from the central government would be reduced. The two main instruments used by local governments to obtain funding are borrowing from banks and renting out land. Some local governments also set up investment companies for big projects with managers appointed by the Organization Department of the Party, evaluated by the local SASAC, funded by local finance, and projects approved through local NDRCs. Without adequate supervision after the approval of funding, the government bonds could be used first to pay salaries, build houses and buy cars, before they finally go to projects, a similar practice to how the stimulus was dispatched after the Asian financial crisis (Xing 2009).

With the discretionary power at all levels of government and banks, China's overseas investment, after a period of caution because of previous unwise decisions and host country resistance, is again encouraged to tap into various countries with a higher profile, causing more concerns in other countries and backlashes of economic nationalism. The Chinese way of obtaining natural resources through upstream long-term contracts and continued demand of raw materials have contributed to international price hikes of commodities such as iron ore and copper, which most Chinese importers have to absorb and in turn have added to the costs of Chinese producers and consumers. Although Chinese private carmaker Geely successfully acquired Volvo, the acquisition of Norwegian Elkem by the Chinese state-owned Bluestar has caused concern about the loss of leading technology to China. The China Investment Corporation (CIC), a sovereign wealth fund, and the planned China Investment Corporation II under SASAC are expected to be active in conducting overseas investment, but their capacity to make wise business decisions remain to be seen. For example, the CIC has received wide domestic criticism for huge losses in three major investments in Blackstone, Morgan Stanley and the American Reserve Primary Fund.

Compared with the NDRC, SASAC and MIIT, MOFCOM is a more liberal pocket within the Chinese government, but it cannot do much in a protectionist international environment and under domestic pressure to ensure GDP growth. MOFCOM adopted measures to boost exports, such as resuming export tax rebates on some labour-intensive products that China has traditional comparative advantage in and had been trying to gradually move away from. Such measures are easily subject to international criticism for being protectionist or mercantilist. MOFCOM, with the help of industrial associations, is also busy fighting trade wars, in the form of both responding to anti-dumping allegations and defending restrictions on Chinese exports of raw materials. Certainly, the MOFCOM participates in WTO negotiations, but its room for concession is much constrained by domestic economic and political conditions. In particular, a large number of migrant workers lost their jobs at manufacturing factories in coastal areas and were forced to return to their farmland, some of which no longer existed because of land development and government appropriation. China's negotiations on the WTO Government Procurement Agreement (GPA) is underway, but the China–EU Chamber of Commerce and some of the world's largest companies, including General Electric, Siemens and BASF, have recently complained that China preferred domestic bidders and the investment environment in China in general (Li 2009; Anderlini 2010). Although China is not yet a member of the GPA while the US is, both countries' initiative to encourage the purchase of domestic products suggest that nationalism speaks louder than internationalism.

In short, the distributional power in China's crisis response was concentrated in the hands of a few actors, in particular the NDRC, MIIT and SASAC, which are known for having a cautious attitude towards reform and liberalization. Transparency and consultation are lacking in the distribution and usage of the funds at state and local levels of the government. It is questionable whether such decision-making could be scientific, as the funding is likely to favour a few actors who lobby intensively, to use state resources on projects without enough scrutiny, and to increase the element of planning in the domestic economy.

4.2. Bias towards state-owned enterprises and labour-intensive manufacturing

State-owned enterprises are the major beneficiaries of the stimulus packages. The stimulus plans for ten industries (automotive, steel, non-ferrous metals, textile, equipment and machinery manufacturing, ship manufacturing, information, light manufacturing, petro-chemicals and logistics) have a clear bias towards heavy industries and labour-intensive industries. Statistics from the first quarter of 2009 show that RMB 4.58 trillion of bank loans have gone to the 'second industries' (26.8% increase, cf. 85%, 29% for first and third industries) like real estate, electrical appliances, coal, concrete, metals, port and machinery, which are dominated by SOEs. Each of the industrial stimulus plans was drafted by the NDRC, supported by MIIT, business associations and representatives of big enterprises in the industry. Implementation of the plans are usually monitored by the NDRC and MIIT. In several of them (automotive, shipbuilding, electronics, IT), expansion of SOEs through mergers or alliances is encouraged (e.g. with tax breaks). For example, the drafting group for the shipbuilding industry stimulus plan decided that if small companies could not change businesses or merge with big companies, they had to go bankrupt. Several industry-line ministries jointly requested the State Council to set up an export credit guarantee company at the CIC to help the financing of export-oriented SOEs.

The SASAC is supposed to regulate SOEs and is in charge of SOE reform towards market economy standards. In practice, however, the role of SASAC has always been unclear, particularly whether it is a shareholder, regulator or manager. It is therefore sometimes called 'the great butler of SOEs'. The SASAC held a meeting in January 2009 to set the annual profit targets for state SOEs as a measurement of the performance of their managers, and the Enterprise State Asset Law came into force on 1 May 2009, with the ambition of clarifying and strengthening the role of the SASAC as an investor and asset manager. Despite these measures, the portfolio of SASAC remains unclear. The new law leaves room for several industries to retain a state monopoly, but still it has already met with arguments from enterprises and their line ministries about how to decide the budget of SOEs. SASAC has been investigating the problem of excessive expansion by SOEs since mid 2008, but the government's crisis response clearly encourages expansion of SOEs. Instead of further market reforms, SASAC is authorized by the State Council to design measures to rescue the SOEs with huge losses in the form of cash or the SOEs being taken over by the State Asset Management Corporation. Although the official rhetoric mentioned support for small and medium enterprises (SMEs), reports continue to show the difficulty that SMEs have in obtaining loans. For example, RMB 1.6 trillion went to the railway system but the profitable segments were taken over by SOEs under the Ministry of Railways, leaving small or private enterprises with no incentive to invest (R. Wang 2009).

In short, the stimulus packages strengthened the role of heavy industries, the big SOEs as well as their line ministries in the domestic political economy. The cultivation of SOEs as monopolies runs the risk of creating rents, discouraging innovation as well as foreign investment. And as the power of monopolies grows, it would become more difficult for the state to regulate SOEs or to pursue more balanced development.

4.3. Continued reliance on labour-intensive manufacturing and export

The stimulus packages represent a setback in China's effort to upgrade the industrial structure. The measures encourage China's traditional comparative advantage in labour-intensive sectors and promotes exports despite its rhetoric over stimulating domestic demand. Even though the development model that relies heavily on export of cheap manufacturing goods has created many jobs and accumulated huge foreign reserves for China, the Chinese government has realized many drawbacks of this model. Chinese leaders have started to emphasize sustainable, balanced and 'scientific' development, with an ambition of climbing up the value chain and gradually moving sunset industries out of China.

However, the global financial crisis set the clock back for several labour-intensive sectors. The decision to halt the appreciation of RMB in mid 2008 was one measure to support exports. China also resumed tax rebates for the export of labour-intensive products. The stimulus plan for the textile industry 2009–2011 that came out in April 2009 includes stabilizing export markets, increasing export tax rebates and exploring multiple markets. In another sector that has over-capacity problems, China started a rural movement – a four-year 'electronic appliances going to the countryside movement'. It is led by MOF, MOFCOM and MIIT and uses administrative measures to push up local consumption. The brands being promoted in this movement were chosen from a domestic bid to the China Electronics Import and Export Corporation. Just as the rural movements are Chinese in character, local government measures often follow old Chinese ways of fulfilling tasks. For example, some local governments even imposed quotas for lower-level government units to fulfil. In some places, the sales of electronic appliances did rise because of reduced prices, but there is also evidence that some farmers regard this movement as another trick of the government to try to get money out of their pockets.

The problem of over-capacity was exacerbated as a result of the stimulus packages. For instance, as a result of the support of construction and infrastructure in the RMB 4 trillion stimulus package and the industrial plans for automotive, steel, machinery and shipbuilding, investment in steel production, which hit RMB 140.5 billion in the first half of 2009, was expected to lift the annual capacity to more than 700m tons, compared with domestic demand of about 500 m tons in 2008 (Xinjingbao 2009). At the same time, as mentioned earlier, international iron ore prices rose due to Chinese imports. Domestic overcapacity and reduced demand for steel products has led to the fall of the steel price and bankruptcy of a large number of factories, for instance in Hebei and Jiangsu provinces. The problem of over-capacity became so severe that the State Council made a statement in September 2009 that highly polluting sectors including steel, coke, cement and plate glass must cut capacity, while silicon and wind power producers should pursue more orderly development. With more state components in the economy, the government may be able to strengthen its regulation over SOEs and to cultivate national champions to become global competitors, as well as to monitor risky behaviour such as investment in financial derivatives. However, the effect of such regulations is limited. Not only private companies but also SOEs continue to pursue their own economic interests and strategies regardless of government criticism.

A crucial task of the crisis response was to stimulate domestic demand. However, the original plan for the RMB 4 trillion stimulus package was criticized for not spending enough on social welfare; instead, it focused heavily on the construction of schools and hospitals in this policy area. The expenditure on social welfare was increased in the revised version of the RMB 4 trillion plan, which reflects the influence of public opinion on state policy. The 2009 budget increased the spending on health, education and social insurance by 20%, but the share only increased 0.9%, to 7.1% (cf. 15–30% in developed countries). The government lifted the restraints on residency in Beijing and Shanghai for new university graduates, and ordered some SOEs to hire a certain number of university graduates, but unemployment continues to be a serious problem in China and there is little unemployment subsidy. Stimulating domestic demand in China seems to remain a long-term, challenging task. A central source of China's international power, a huge domestic market, may become merely an illusion.

5. Discussion: implications for the 'responsible great power' diplomacy

Undoubtedly, China seeks the image and status of a 'responsible great power', with its moral and material superiority attributed to the Beijing Consensus or the China Model. However, the above analysis shows that China's development strategy contains significant problems and risks. They not only render the model difficult and even dangerous to copy by other developing countries, but also may compromise China's ideational and material superiority if those problems become serious. As China's response to the global financial crisis shows, it is already constrained by domestic political and economic conditions in providing public goods or showing great power style to smaller countries in Asia or elsewhere.

In trade, measures that promote labour-intensive manufacturing goods are resumed as mentioned earlier, and this intensifies competition with other Asian and developing countries. Reduced exports means large numbers of laid-off workers and possibly social unrest, something Beijing can ill afford. For Chinese leaders, domestic stability is the greatest concern; in other words, a 'harmonious society' precedes a 'harmonious world'. In its pursuit of multiple export markets, China has contributed much more to the creation of bilateral and regional institutions than to the WTO despite widespread criticism that FTAs have spaghetti bowl or noodle bowl effects on world trade. Just as US bilateralism in the 1990s launched a second wave of FTAs, Chinese activism seems to have kickstarted another domino effect. China is still reluctant to accept a multilateral regional trade regime in Northeast Asia or East Asia, largely because of political rivalry with Japan, but also because of concern over potential competition from the products and services of developed Asian countries. At the WTO, China has kept a tough position since its entry, in particular over agriculture, services and intellectual property rights (IPRs). China criticises major Western countries for protectionism during the global financial crisis, but it does not wish to be labelled as the leader of developing countries because 'the distribution of interests at the WTO are very complex and changeable' (author's interview with MOFCOM officials, Beijing, May 2006, July 2009). China has successfully created a category of 'newly accessed members' at the WTO to avoid many further concessions. In finance, the global financial crisis has brought China new opportunities to demonstrate great power style and the superiority of the China Model. In a significant step in May 2009, China agreed to contribute the same amount of money as Japan (US$38.4 billion each) to the expansion of the Multilateralization of the Chiang Mai Initiative (CMIM) reserve pool in May 2009. China also signed bilateral swap arrangements from December 2008 to March 2009 with South Korea, Hong Kong, Malaysia, Belarus, Indonesia and Argentina worth a total of RMB 650 billion. It should be noted that BSAs are a shallow form of financial cooperation and carry low risk for the potential lender. For deeper and riskier forms of financial cooperation, such as exchange rate coordination, China has lacked enthusiasm due to its closed capital account, 'managed floating' exchange rate policy and lack of confidence in its financial institutions. China remains resistant to the idea of an Asian currency and reluctant to build an independent surveillance mechanism in East Asia. However, China has started promoting the usage of RMB in its neighbouring countries and some other developing countries that have close trade ties with China. Apart from the stabilising effect on trade, those measures are designed as gradual steps towards the internationalization of RMB, because China recognises seigniorage as a source of international power, and presages RMB to be one of the international reserve currencies. However, with the risk of insolvency at local governments and state commercial banks, financial liberalization and thus China's role as lender of last resort are still a long way off.

At global financial institutions, China used the opportunity of the global financial crisis to call for an increase of voice from developing countries and prides itself on the rise of the G20 against the G7. At the same time, China is careful not to be burdened by the 'China responsibility' discourse with 'unduly high or even blind expectations'. A researcher at MOFCOM even announced that the China responsibility discourse was just another version of the China threat rhetoric, and China would refuse responsibilities imposed by others for such titles as a surplus country, a debtor country, a savings nation, a big energy consumer or a big CO_2 emissions country (Xinhua 2010). It is not hard to understand China's caution given signals of looming domestic economic problems.

In summary, the lesson that China learned from the Asian financial crisis was not the importance of liberalization but prudence or conservativeness, which despite serving as a shield in the global financial crisis, sustains problems in the long term. Since the Asian financial crisis, China's obsession with foreign reserves accumulation and the pursuit of political influence have overshadowed the increasing dependence on the US market, now causing China dilemmas in both development and diplomatic strategies towards developing countries. The Beijing Consensus type of decision-making may be faster than democratic processes, but it may also go against the principle of 'scientific decision' or 'balanced development' as proposed by the Chinese leadership. A prominent feature of China's response to the crisis is a bias towards state-owned enterprises and the public sector, which runs the risk of monopoly, over-capacity, inequality, the regulators being 'captured' by industrial interests and protectionism. The status of a responsible great power either in the region or in the world remains Beijing's aspiration, still far from reality.

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The Politics of Comparatively Good Times:

Brazil in the Global Financial Crisis

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The global financial crisis of 2007-2009 affected virtually all of the world, but with quite different national experiences. The crisis has been described as "devastating" for developing countries (Woods 2009: 5), although a more detailed look finds that China, India, and Bangladesh continued to grow, with Brazil and East Asia recovering quickly and part of north and sub-Saharan Africa putting in a "fair" performance (Ocampo 2011: 12). The experiences of this comparatively successful part of the developing world cap a decade's unprecedented rise by the global South vis-à-vis the North. The *Economist* newsmagazine calculates that rich countries' share of global GDP (PPP) has dropped from two-thirds to half since 2000 (October 9, 2009, Special Report, 3). Economic failure in wealthy countries obviously accounts for part of this shift, but rapid growth rates in some of the emerging powers do as well. To what extent are these differential outcomes the result of domestic economic policies?

Peter Gourevitch wrote a generation ago that widespread economic crises provide excellent conditions for natural experiments in political economy, as the different country responses lay their internal workings unusually bare (Gourevitch 1984, 1986). The response to crisis, especially initially, arises from the constellation of social and political forces laid down by previous major crises. In Gourevitch's "hard times", the specific pains of the new crisis also ultimately disrupt and rearrange those constellations so that one needs to track the route from new situations to new policy preferences, and from those to new political coalitions and different policy outcomes (Gourevitch 1984: 97-98). Winners and losers in the crisis scramble to re-position themselves in a world that now presents new challenges, competing to push states to take domestic and international postures that are better for them. These are insights about responses to past crises that seem likely to prove useful in thinking about national choices in the wake of the 2007-2009 global financial crisis.

The context of economic crisis and hard times is generally interpreted to mean that winners as well as losers are fighting over a shrinking economic pie. This puts most groups in a defensive position vis-à-vis other domestic actors, as well as seeking protection from economic forces and actors outside national borders. Many will want a change in the political status quo, hoping it leads to economic improvement. As I have just suggested, however, not all countries do equally badly, even in a global financial crisis. My theoretical puzzle in this paper asks how the politics of response differs for countries that are comparative winners in a global crisis. Below, I elaborate a set of expectations about likely outcomes: the comparative country winners will still have winners and losers domestically, but both groups are in a situation where the national economic pie may appear likely to expand, making their cooperation a plausible outcome. Politicians may be able to compensate or reward existing constituencies and even reach out to new ones rather than only distributing economic pain. Political credit claiming and continuity-seeking will replace at least some efforts to place blame and pursue change. Externally, actors are comparatively likely to view international opportunities rather than only threats.

The focus on domestic factors may seem out of place in a study of developing countries' response to economic crisis. More commonly – and based upon a great deal of historical experience of debt and currency crises – developing countries are seen as having little flexibility to find their own way in crisis. Instead, international financial institutions and private market actors work together to restrict their options and force them to adopt particular policies in exchange for emergency financial assistance (e.g., Akyüz 2010; Kaufman and Segura-Ubiergo 2001; Nooruddin and Simmons 2006; Wibbels 2006). I argue here that this constraint is varied rather than unvarying, and that the amount of flexibility depends across crises and countries. I propose that a country's comparative success in a general crisis is again one of the major determinants of the diverging sizes of policy spaces. A comparatively successful country is likely to attract rather than repel private sources of finance. It is less likely to need emergency sources of assistance to pay debts, maintain currencies, and carry out other economic activities. Even international financial institutions will have less leverage to insist on policy concessions from a country whose economic fundamentals are comparatively strong.

In this paper, I use a case study of Brazil, one of the emerging economies, to elaborate these expectations and carry out an initial plausibility review of them. Brazil did suffer a small economic decline in the crisis (-0.2% of GDP in 2009), but its solid macroeconomic situation and considerable domestic demand gave it a foundation for restabilization. Exiting Brazilian President Lula's analysis that "white, blue-eyed bankers" had caused the crisis was widely reported and criticized, but its basic claim that this was the North's crisis is indisputable. I argue here that Brazil's status of being a comparative winner in the global economic crisis opened up greater policy space for it to make its own national choices about how to respond.

This in turn enabled and encouraged Brazilian politicians to go on to expand a set of externally oriented industrial policies that had been created in incipient form over the previous decade. The combination of a strong reserve situation from previous boom years and the government's willingness and ability to spend heavily on infrastructure and development projects – even the support of Brazilian businesses abroad – allowed the governing Workers' Party to satisfy existing constituencies and deepen its support among once-hostile business sectors. The party's candidate won the election for the national presidency in October 2010, and her administration took office with a broad domestic coalition and considerable international presence. As such, the crisis did less to reorient the economic aims and projects that have developed over the last decade than to increase Brazil's ability to achieve them.

Economic Crisis and Political Choice

Before asking how comparative winners respond to global economic crisis, there is a prior question: to what extent is it even possible to speak of political choice in the context of economic crisis? The historical accounting suggests that there may not be much policy space for developing countries. Debt crises in Latin America in the 1980s (Frieden 1991; Stallings and Kaufman 1989; Stallings with Studart 2006) and the currency crises that flashed across the global South in the 1990s (Chin 2010; Woods 2010) saw developing countries forced to adopt politically painful pro-cyclical policies and make structural adjustments in their economies. The primary argument has been that these countries' ability to autonomously choose their development strategies in both ordinary times and in the face of international crises is profoundly limited by their inability to finance such choices domestically (Akyüz 2010; Kaufman and Segura-Ubiergo 2001; Nooruddin and Simmons 2006; Wibbels 2006).

Foreign governments, international financial institutions (IFIs), and private actors in the form of individual firms; currency, stock, and bond markets; and others, all weigh in. In the standard story, they collectively withdraw financing and investments from countries in crisis or refuse to extend more, sending countries scrambling for hard currency. Governments and IFIs then articulate explicit conditions of the policies they require to give funds to developing countries as aid and loans. Global economic rulemaking reinforces their demands. Private actors, meanwhile, are assessing whether they are likely to earn money from investments of various kinds; they weigh both the general country risk situation and specific sectoral developments. Most of the time, they decide against investment.

Quantitative studies of the presence and effectiveness of pressure from international financial actors have found mixed results, both on what policies matter to different classes of financial actors and whether governments respond to their preferences (e.g., Kaufman and Segura-Ubiergo 2001; Jensen and Schmith 2005; Mosley 2003; Mosley and Singer 2008; Nooruddin and Simmons 2006; Wibbels 2006; Wibbels and Arce 2003). Yet case studies can often trace both very direct pressure and very direct response. In 2002, a spokesman for Goldman Sachs told Lula, then a candidate for the Brazilian presidency, that there would be "economic crisis unless Lula strongly signaled neoliberalism"; Lula in turn "explicitly told the Brazilian people that foreigners were concerned about the Brazilian economy and that this would constrain Brazilian policy in the months to come" (Amaral, Kingstone, and Krieckhaus 2008: 146, 148). Thus a first step in the analysis must be to evaluate whether a similar situation obtained in the global economic crisis at the other end of the decade.

While no one has specifically studied whether global losers and winners face similar external pressures for policy conformity in the wake of general crises, a country experiencing economic failure will have many more pressure points. It may well have trade deficits or loans coming due that require short term loans or rollovers from the International Monetary Fund (IMF) or other creditors. Private economic actors are unlikely to see much opportunity for making a profit, and will seek better options elsewhere. The economic slowdown will make the government less able to mobilize resources at home through taxation and the need for compensatory spending will rise. In contrast, comparative winners are likely to find themselves the recipients of at least some private investment, as the best option in a comparative sense if not objectively. Comparative success also lends an aura of respectability to whatever policy options have been followed; if they are not orthodox, orthodoxy may be questioned, certainly by the countries in question. If the country is actually enjoying growth and expansion and not just comparative success, it may well not need the finance that would come with conditions.

Under such circumstances, comparative winners may simply not face significant external constraints on the way they respond to a shared crisis. If this is the case, what *do* they chose? The implicit or explicit assumption in the studies of possible international constraint cited above is that most governments would strongly prefer to respond to economic crises with defensive counter-cyclical policies in the absence of international pressure. This is for political reasons, as populations seek protection against actual or feared economic harm, and so politicians fear political retribution if they cannot respond this way. Gourevitch's own landmark study found that cross-sector, cross-class coalitions backed demand stimulus packages during the Great Depression in countries as different then as Germany, Sweden, and the United States (Gourevitch 1984: 131). Yet even if populations and governments do generally prefer such spending, there are further questions about exactly what policies are chosen and who benefits from them. Here I follow the lead of Gourevitch and others (Cerny 2009; Gourevitch 1984, 1986) and look at the fit between government policy choices and the patterns of policy preferences – for both nationally and internationally oriented policies – of key officeholders, constituencies, interest group, and leading economic actors.

I differ from these past approaches primarily in considering, again, the ways that being a comparative winner in a global crisis may alter the preferences and behaviors of these actors. Perhaps the most fundamental starting point is in the preferences of politicians, who are widely assumed to want to stay in office. In democracies they directly depend on citizen voters to return them there and so have obvious interests in meeting the policy expectations of their constituents, and even expanding their political base to other important social sectors. Authoritarian rulers often find the legitimacy of their rule depends even more heavily on economic performance.

Heading a comparatively successful country is unlikely to change this basic *aspiration* of politicians, but they are considerably more likely to be able to *achieve* it than are leaders of countries in open economic crisis. In part, this is a simple matter of having the financial resources to maintain or even expand rather than cut key parts of national budgets. The comparatively good times also provide important opportunities for politicians to make more credible rhetorical claims about the success of their states – to both domestic and international audiences – and thus to gain political support for symbolic and nationalist reasons as well. Overall, this will be a setting where politicians compete to claim credit for the comparative success, arguing where plausible that it can be traced to their own policies and positions. Those out of government will claim that their earlier policies laid the foundation for success, and that they should be returned to office to continue the policies that set the path. Those in office will simply claim they deserve to stay there.

Even in conditions of general comparative success, domestic actors will vary in the extent to which a particular global economic crisis affects them, and whether that impact is positive or negative. State, business, labor, and financial actors that are closely tied to international markets will be closely affected by developments there. Markets and investments may disappear or appear in new locations, for example. As a consequence, they will seek either protection and compensation – or extra support for taking advantage of new opportunities. Those less closely tied to international markets will be affected primarily by spillover effects into the overall health of the economy, and they may well have quite different policy preferences from the first group.

Comparative country success affects all of these groups in two ways. Once again, there is the straightforward effect that political leaders are more likely to have the resources to compensate particular losers, either because they have managed to set aside resources in advance or because the country continues to experience economic growth. Indeed, losers are more likely to insist on compensation given the perception that they are hurting in a context where many are not. On the other hand, the situation of comparative and possibly actual success may well undermine the zero-sum politics of economic austerity, where the gains of one group are the losses of another since there are not enough resources to go around. There may even be a potentially expanding pie, as domestic growth coincides with an international setting that offers new possibilities for those intrepid enough to take advantage of firesale prices and an economic vacuum. Thus while economic actors are often assumed to want protection in crises, they may be overshadowed by actors who want support as they follow new opportunities in situations of comparative success.

This discussion of policy choices in economic crisis establishes a double empirical task. The first is to investigate whether international economic actors placed significant constraints on Brazil's economic choices in the most recent financial crisis, and the extent to which those constraints – or lack thereof – can be traced to Brazil's comparatively successful trajectory through the crisis. The second is to move on to ask how Brazil's experiences during this crisis shaped the governing Workers' Party's policy choices, and the fit between those and the preferences of their historic constituencies and society as a whole. I conclude that Brazil had a large policy space in this most recent crisis, but it was only partially due to its comparatively successful trajectory, which especially affected the behavior of private market actors. The national response showed strong responsiveness to its comparatively successful position, however, with both the government and some private actors seeing and moving to take advantage of important new opportunities in the international economy.

The Surprising Roominess of Global Economic "Constraints" in 2007-2009 for Brazil

In previous economic crises in Brazil and elsewhere, as just outlined, developing countries have found their policy space significantly constrained by the pressures brought to bear by some combination of global market forces and politically dominant nation-states. In this section, I present a very brief snapshot of Brazil's economic conditions and policy orientation as the crisis began. I then trace how global economic developments created a comparatively open-ended position in the most recent financial crisis for Brazil. I present evidence of fluctuations in currency and reserves values, stock market performance, "country risk", debt levels, and the trade situation. Each of these largely reflects private market actors' evaluations of Brazil's comparative situation. I conclude the section with a discussion of Brazil's interactions with the IMF and other IFIs in this period, as they have been the enforcers of the dominant economic powers' preferences in past crises. For each I assess whether the level of recent permissiveness derives from Brazil's comparatively strong economic situation in the more general crisis, its past national policy choices, or has more exogenous sources.

As a brief economic background, Brazil came into the global financial crisis in the strongest economic shape of its recent history. Notwithstanding market jitters, Lula's administrations (2003-2010) built on the foundation of the Cardoso years (1995-2002) to achieve economic performance that was both expansive and solid (Kingstone 2009). The mid-2000s saw the highest economic growth levels of several decades, matched with real social progress in reducing poverty and income inequality. Exports boomed along with domestic consumption, but traditional tendencies to inflation stayed controlled under sharp government watch. Consumer and business confidence were high. With government revenues and reserves at historic highs, the budget could hold both debt repayments and a new Program for Growth Acceleration (PAC), launched in 2007. The government went further with a new industrial policy plan (*Política de*

Desenvolvimento Produtivo – PDP) in 2008. Both of the new programs used tax cuts, fiscal incentives, and credit lines to steer private actors into infrastructure investments (the PAC) and strategic activities (the PDP) (Barbosa 2010). Together, the programs aimed to lay the groundwork for ongoing growth at home as well as making Brazilian businesses increasingly competitive abroad. As already noted, Brazil saw a small GDP decline in 2009, and then returned to very rapid growth of 7.5% in 2010. Given this Brazilian snapshot, how did the various global economic actors respond?

Counting Currency Currency values and the adequacy of foreign currency reserves are both cause and effect of many of the other factors, so I begin with them. Given Brazil's history of hyperinflation, chronic state deficits, heavy external debt, and use of currency policy to manage multiple political and economic goals, markets have been very skittish about Brazilian currencies (the *real* since 1994). In 1999, currency speculators bet heavily against an overvalued *real*, then with a fixed exchange rate against the dollar to control hyperinflation, and eventually forced Brazil into a floating exchange rate. The *real*'s value dropped 42% in about two weeks and then another 8.5% in a day in January 1999 (Flynn 1999: 287). Brazil required a conditioned IMF loan to respond to this crisis, even though part of the pressure on the currency was a knock-on effect of the Asian crises rather than only Brazilian economic fundamentals. Nervous investors again caused a sharp decline in the currency when it became clear that Lula was likely to be elected in 2002 (Amaral, Kingstone, and Krieckhaus 2008: 144-150; Jensen and Schmith 2005). Figure 1 shows a different outcome for the 2007-2009 crisis: strong pre-crisis economic growth was accompanied by an ever-strengthening *real*; then there was an equally strong drop in its value as investors turned to the American dollar when the worst of the crisis hit; and then the *real* quickly returned to strength.

[Figure 1 about here]

The backdrop for the currency situation is that Brazil responded to the 1999 crisis by redoubling efforts to build strong currency reserves. It had begun its first serious attempt to systematically accumulate reserves in 1994, as part of the difficult task of establishing the credibility of its new *real* currency, the fifth national currency in a decade.[1] Thus reserve-building began as an anti-inflation strategy, meant to signal that Brazil would no longer print money to cover deficits and debt payments (Kingstone 2009: 114). After 1999, this motivation was joined with a new self-insurance rationale, with Brazil determined to find its own national solutions to financial and balance of payments crises, and to do so in ways that would allow national development to continue rather than skidding to a halt (Chin 2010: 696). Successive economic crises had left then-president Cardoso criticizing global financial actors for reasons that ranged "from shortcomings in debt-accounting techniques to accusations of sheer ignorance of the economic realities of Latin American countries" (Burges 2009: 86). He and his successor Lula went on to take advantage of positive trade balances in the 2000s to build big reserves in preparation for the next crisis (Chin 2010).

In 1998, Brazil had a then-record high US$ 74 billion in reserves in August, but its efforts to maintain the value of its overvalued real brought those reserves to $42 billion at the beginning of January, and down another US$8 billion by the end of the month (Flynn 1999). In the more recent crisis, Brazil's Central Bank spent US$71.9 billion trying to contain the *real*'s slide in 2008 (Barbosa 2010: 5). It spent another US$26.4 billion by the end of October, 2010 – more than the federal government spent on public investment during the period – trying to prevent the

[1] Brazil's historic national currency was the cruzeiro, replaced by the cruzado in 1986, and then, rapidly, the cruzado novo, the cruzeiro (again), and then the cruzeiro real, which is the full name of the current currency, since 1994.

more recent rise of the *real* (*Estado de São Paulo* 26 October 2010). The same sources show original reserves of US$210 billion in 2008 and, remarkably, an *increase* in the reserves to US$280.1 billion in 2010, even after spending almost US$ 100 billion to manage the currency.

These are the earnings of comparatively good times. The *real*'s rise has many causes and effects, many of them positive for Brazil. The country has been a growth hot spot, with only two quarters of declining GDP. Investors are attracted by the still world-highest interest rates and by the Bovespa stock exchange's potential for big gains, and are bringing dollars in. The international capital inflow itself is generally positive and Brazil would welcome stable foreign investment to help finance its many projects. The danger here is that much of the money could flow out equally quickly, and can produce bubbles of various kinds in the meantime (Ostry, et al 2010: 4).

Public Stock Exchange Stock market performance is another signal of the confidence that private investors have in the future profitability of particular firms and/or countries. Earlier in the decade, the rise of the trade unionist Lula as a presidential candidate coincided with a steep decline in the value of the São Paulo stock exchange (Bovespa). That apparent lack of confidence itself became a factor in the campaign. Close examination of the results shows the Lula's rise was directly associated with a rise in the volatility in the stock market, with financial markets unsure about which policies he was likely to follow (Jensen and Schmith 2005). During the more recent crisis, Bovespa's fate matched the *real*'s almost exactly, showing a very strong runup until the brief "retreat to quality" during the epicenter of the crisis in September-October of 2008, and then a return to strength. Investors flocked to marquee firms like Petrobras, which made major oilfield finds at the end of 2007, as well as lifting the exchange across the board (see

Figure 2).[2] Investors were again clearly in search of economic gains that were unlikely to come from the depressed historic center economies. The volatility of such portfolio investments makes them an unreliable source of long term financing, but they provide critical injections of cash and confidence of a kind that was simply not available historically.

[Figure 2 about here]

Country Risk Ratings Investors were following the lead of private ratings services, which assessed Brazil's "country risk" as stable or improving during the time of the global financial crisis. Standard and Poor's advanced Brazil to investment grade (along with the BNDES and nine other Brazilian companies) in mid crisis in May 2008. Announcing the change, the Brazilian National Treasury described the move as international recognition that Brazil is "a member of a restricted group of countries whose economic policies are considered solid and responsibly conducted", and whose financial markets are "one of the most important destinations of those who search [for] safety on their long-term investments…"[3] Standard and Poor's confirmed the claim several years later, remarking that in comparison with other emerging powers and the median "BBB" grade economies, Brazil had credit weaknesses in its heavy public debt and tax burden that were compensated by its comparatively strong and stable political system (Standard and Poor's 2010: 17). All the major rating agencies have upgraded Brazil since 2008 (Barbosa 2010: 9). Thus while investors' doubt helped to push Brazil towards crisis in 1999 and 2002 (Amaral, Kingstone, and Krieckhaus 2008: 144-146; Flynn 1999), their

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[2] The second dip in May 2010 coincides with a temporary sharp fall in the value of Petrobras' stock price. Petrobras's value had risen steadily after it found the off-shore fields. The BP oil spill catastrophe in the Gulf of Mexico in April 2010 then spooked investors about the prospects of the much deeper Petrobras finds. A few months later, investors' optimism rebounded to make a Petrobras stock issue the largest market capitalization so far (Hochstetler 2010).

[3] http://www.tesouro.fazenda.gov.br/english/public_debt/downloads/Nota_IG.pdf.

confidence in 2008 and since has led to a virtuous cycle from comparative economic well-being to even more solid investment-supported growth.

Public Debt Public sector debt has been a weak spot in the Brazilian economy since its ISI period. Only India among the largest emerging powers has a higher net debt load as a percentage of GDP and pays a higher percentage of government revenues in interest on its debt. Brazil spent about 17% of its government revenues on its debt from 2004-2009, although that figure has dropped with more expansionist spending during the crisis (Standard and Poor's 2010: 6-8). Brazil's net public debt grew from 41.8% of GDP in August of 2008 to 44% of GDP a year later (Barbosa 2010: 8). Both numbers are considerably lower than recent net debt totals, as both the Cardoso and Lula administrations have made quite disciplined repayment of the national debt a priority. Lula even raised the primary surplus target to 4.5% of GDP at first, although current targets are lower, around 2.5% (Kingstone 2009: 117; Standard and Poor's 2010: 10).

In addition to lowering its overall debt burden, Brazil has made several choices that reduce the leverage its debt might give international actors. One is that it made a concerted effort to pay off *all* of its foreign dollar-denominated public sector debt, reaching that status in 2008 (Kingstone 2009: 120). About 90% of its general government debt is now domestic, and most debt through the crisis was issued in local markets. This carries the potential hazard of crowding the private sector out of domestic capital markets (Standard and Poor's 2010: 7, 11), but it reduces foreign influence. The broader policy framework has been one of high taxation rates and low fiscal deficits. As noted in the previous section, this means the country has earned the confidence of ratings groups. This is a heritage of four presidential administrations rather than Brazil's performance in the most recent crisis, although that performance could not have been achieved without this base.

International Trade The global economic crisis has exposed both strengths and flaws in Brazil's trading patterns. In terms of strengths, Brazil greatly benefitted in this crisis from its diversity of trading partners and products, and its limited dependence on trade. The trade shock of this crisis had the widest and deepest impact on the developing world, and the hardest hit were those countries that exported manufactured goods to US and European markets (Ocampo 2011: 11). While this describes an important part of Brazil's export profile, it also sends many primary products to both. More critically, it has diversified its trading partners over recent years so that other Southern countries take about half of its exports. China is now one of Brazil's largest trading partners (Phillips 2010). The fact that developing countries did comparatively well meant that the trade shock for Brazil was comparatively small. There were significant losses for the vehicles, auto parts, and unrefined oil sectors (BNDES International Journal), but those were fairly isolated from other parts of the economy, which saw little drop in demand. Among the emerging powers, only India has similarly low trade dependency, just 25% of GDP in 2007, up from historic levels below 10% (Kingstone 2009: 106).

The growth of trade with China does have longer-term and possibly structural effects that have been hastened by recent crisis. Brazil's floating *real* is almost certainly over-valued by the global marketplace currently, while China's close management of its currency leaves it almost equally undervalued. This means that China is more easily able to dominate export markets that once eagerly bought Brazilian industrialized goods, even in close neighbors and partners like Argentina (Fernández Jilberto and Hogenboom 2007; Philips 2010). Brazilian manufactured products cannot compete against China's in the Chinese home market either. Thus Brazil exports soybeans, vegetable oils, iron ore, wood pulp, timber, and hides to China, and imports machinery, equipment, textiles, plastics, and toys from China (Hirst 2008: 99-100). Putting these various trade effects together, Brazil worries that China is re-relegating it to an international trading position as an exporter of primary and agricultural goods. Over the first decade of the 2000s, primary materials rose from being 22.8% of Brazil's total exports in 2000 to 43.4% a decade later, and industrial exports dropped accordingly (*Folha de São Paulo* 11 July 2010). This is a trading position that Brazil left with a great deal of effort, determination, and cost. It also would not suit the domestic constituencies and plans of the PT, for whom industrial and post-industrial jobs are a major ambition.

Overall, Brazilian trade in the most recent crisis reflects ongoing patterns rather than major changes in actors' policies. The absence of strong policy effects in this crisis – when similar crises in the past brought quick protectionism – is a "dog that didn't bark" (Haggard 2010). It is a general pattern, supported by Brazil and others in the G-20, but exogenous to Brazil's own trade situation.

International Financial Institutions The IMF has been the institutional face of Northern governments' demands that developing countries make major policy and institutional changes in the wake of past financial crises (Chin 2010; Woods 2010). Its hardline responses to the Asian, Brazilian, and Argentine crises around the turn of the century set in motion a series of developments that meant its role in this crisis would be different. For emerging powers like Brazil, the IMF's reluctance to reform its own conditionality policies and to grant them a decision-making role they consider commensurate to their economic strength have led to disengagement from the institution as borrowers (Woods 2010). The self-insurance strategy already noted is one component of this, and Brazil even took pains to pay off its post-1999 debts to the IMF early in order to limit the IMF's structural power over Brazilian economic policy.

A decade later, the IMF found itself without willing borrowers, and so played a very different role. It amended its lending practices in 2009 in what it acknowledged was an attempt "to reduce the perceived stigma of borrowing from the IMF, and to encourage countries to ask for assistance before they face a full blown crisis".[4] The IMF extended special nonconditional credit in the form of a new Flexible Credit Line for countries with "very strong economic fundamentals and institutional policy frameworks". The list of pre-qualified countries was not made public, but Brazil's polite rebuff to the offer was widely reported in its national newspapers. Indeed, financial reporters delighted in the fact that Brazil not only declined this offer, but actually "made a loan to the IMF" instead. This was the language popularly used to describe the government's agreement to purchase US$ 10 billion in IMF notes by 2012 so the Fund can meet the borrowing needs of other countries.[5]

Brazil itself preferred to make bilateral arrangements and use its own reserves. In 2008-2009, Brazil signed bilateral reciprocal currency swap agreements with all three of its largest single-country trading partners, Argentina, China, and the United States. The US Federal Reserve extended just a few of such lines to selected countries also including Mexico, Singapore, and South Korea (Chin 2010: 706). The national treasury gave a loan – 3.3% of GDP – to the national development bank BNDES to allow it to provide special credit for Brazilian enterprises and exports (Barbosa 2010: 5). Thus while earlier crises found Brazil in a position of requiring external assistance, the "comparatively good times" of this crisis – comparatively referring to its own past and to the situation of others in this crisis – meant that Brazil faced few actors able or willing to use its currency needs to limit its domestic choices.

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[4] www.imf.org/external/no/exr/facts/fcl.htm, accessed 10 March 2011. This is an International Monetary Fund Factsheet about the Flexible Credit Line.

[5] http://www.imf.org/external/np/pp/eng/2010/010810.pdf, accessed 11 March 2011. The "made a loan" language appeared in newspapers including the *Jornal do Brasil* and *Globo* April 10, 2009.

Even more direct evidence of Brazil's larger policy space in this crisis came in the IMF's response to Brazil's adoption of capital controls, which it has explicitly rejected in past negotiations with recipients of its loans. After 1999, Brazil had no capital controls except for one on short-term loans in foreign currency. Then in the pre-crash run-up of the *real*, Brazil imposed a 1.5% tax on bond inflows from May to September 2008, trying to discourage the entry of more volatile international funds. That tax, removed as the dollar rose in the so-called "flight to quality" as the global economy crashed, was reinstated as a 2% entry tax on foreign currency inflows for financial and capital market investments in October 2009. In its first year of operation, the IMF concluded that the tax had "worked to change the composition of capital inflows and that they had a small but discernible impact of interest rate arbitrage" – without appreciably reducing inflows (IMF 2010: 33). This temporary tax was raised to 4% at the beginning of October 2010 and raised again to 6% on October 18.

Despite its historic objections to controls on foreign capital flows, the IMF has somewhat reluctantly agreed that this is an acceptable tool for managing volatile financial flows, at least in the context of the ongoing abnormal period (IMF 2010: 35). An earlier IMF Staff Position Note had argued that while individual countries may see little effect on inflows from such controls, cross-national studies show that surges with controls may be comparatively smaller (Ostry, et al 2010: 12). Both IMF documents recommend that capital controls be a final resort, followed only when there is danger of inflation, an already over-valued currency, and plenty of reserves (ibid: 15). While the IMF's specific rationale for its change of heart is unknown, it seems likely that the "very strong economic fundamentals" it acknowledged among countries like Brazil (see footnote 3) and Brazil's larger formal position in international rulemaking influenced the Fund's new flexibility. At any rate, the IMF is granting an experimental policy space that is considerably larger than it often allowed in the days of the Washington Consensus, and has few direct tools to do anything else with Brazil.

Instead, international institutions reached out to Brazil during the crisis, bringing it more closely into global economic rulemaking. The country was high on the list as the G-7 concluded that it needed to include the developing world more systematically, becoming a G-20 of first financial officers and then heads of state in the decade after 1999. Both the World Bank and the IMF belatedly shifted small shares of voting quotas from Northern to Southern countries. Brazil was also added as the Financial Stability Forum became the Financial Stability Board, and became part of the Basel Committee on Banking Supervision, the Technical Committee of the International Organization of Securities Commissions (IOSCO), and the Committee on Payment and Settlement Systems (Helleiner 2010: 284; Woods 2010). These new positions involve both broad policy-framing forums and the more technical forums of international standard setting. A diverse set of developing countries was included alongside Brazil, with not all being "winners" in the 2007-2009 global financial crisis. Mexico, for example, saw its IMF shares increase by the same amount, despite being one of the clearest losers in the crisis (Ocampo 2010). These more-structural changes are apparently due less to the immediate situation and more to the longer-term movement of economic power to large developing countries across the decade.

Conclusion Brazilians like to tell a joke on themselves that says, "Brazil is *the* country of the future – and it always will be." In the last few years, Brazilian diplomats have told this joke too, but they now complete it by saying, "It looks like that future has finally arrived." Brazil was labeled one of the BRICs of an emerging new global economy near the end of Cardoso's second term (O'Neill 2001). While its inclusion puzzled many observers then, the decade since and especially Brazil's recent comparative success appear to have garnered it a more promising global position (Martinez-Diaz and Brainard 2009). In particular, global market forces and the IMF have recognized its current economic strength and strong economic fundamentals in ways that grant it considerable policy space in responding to the current global crisis. The next section focuses on what choices it has made in that space.

Caring for Domestic Constituencies: Bolsa Familia to Bolsa BNDES

In examining Brazil's economic policies in the wake of the global financial crisis, this paper focuses less on the emergency responses (Barbosa 2010; IILS 2011) than on the policies that preceded the crisis and are now being continued and deepened as longer-term responses to Brazil's changing economic priorities in a new global setting. Domestic political considerations have shaped many of these, as a national election drove the governing Workers' Party (PT) to focus on its domestic constituencies. However, the PT also initiated a number of projects that had less to do with its specific existing constituencies (except insofar as they generate jobs) and more to do with reinitiating a state-led, growth-oriented project of economic nationalism (Almeida 2009). As discussed in more detail below, this is not the protectionist economic nationalism of the ISI period. Instead, it is a version that promotes the advance of Brazilian firms abroad, in the context of new global opportunities created by the crisis, akin to what Schrank and Kurtz call open economy industrial policy (Schrank and Kurtz 2005). Big business has never been part of the PT's constituency, but the state-business-labor coalition implied by the new economic nationalism has historic resonance in Brazil (Evans 1979). It would make for a fundamental reshifting of Brazilian partisan politics if it is successful.

The worst of the international economic crisis fell in September-December 2008, coinciding with the October midterm election of the second (and thus final) term of Brazil's popular PT president, Lula da Silva. As such, the response to the crisis in Brazil was inevitably linked to the question of presidential succession, politicizing it more than might otherwise have been the case. Core PT constituencies received special consideration in the policies chosen for response. Economic growth rose even higher on the agenda, and was a national priority that allowed the PT to reach out to new constituencies. As open campaigning began at the end of 2009, Brazil's comparative success was already clear. The presidential campaign therefore explicitly turned on the question of who could claim credit for the relative success: the PT, for overseeing growth and recovery in the 2000s, or the center-right Brazilian Social Democratic Party (PSDB), whose two-term president Fernando Henrique Cardoso preceded Lula and which claimed credit for laying down the foundation of macroeconomic stability on which the PT built. In this section, I will examine how the PT's policy responses addressed particular constituencies and sectors, and then conclude with the credit claims as they emerged in the election.

The Workers' Party was created in 1980 by a coalition of unions, social movements, intellectuals, the progressive Catholic Church, and others who wanted a socialist democratic alternative to Brazil's then-military government (Keck 1992). Those actors continue to form a part of the PT's core constituencies, even as the party has steadily moved away from even a rhetorical commitment to socialism (Samuels 2004). The party acquired a new "constituency" when Lula promised in a "Letter to Brazilians" in 2002 that he would continue Cardoso's macroeconomic stabilization policies if elected, a pragmatic gesture that calmed extremely nervous international financial markets and helped propel him to the presidency in 2003 (Amaral, Kingstone, and Krieckhaus 2008; Kingstone 2009). The PT's traditional supporters chafed at the limits this placed on policy during Lula's first term (Hochstetler 2008), but the renewed focus on economic growth and public investment during the second term was welcomed by most of the political spectrum. The expansive policies and investments of crisis response have therefore generally played well for the PT politically.

Policies for the Poorest The PT has always considered the many very poor Brazilians to be a natural part of its constituency, but that social strata only began to vote for the party in large numbers after Lula became president. They were responding to one of the PT's signature policies, Bolsa Familia (Family Grant). This is a conditional cash transfer program begun by Cardoso in 1997 (inspired by PT and PSDB governors), and greatly expanded under Lula. With roots in both major parties, it is one of the most consensual elements of Brazilian partisan politics (Power 2010: 229). Bolsa Familia is increasingly viewed as an unusually successful version of such programs in addition to being one of the first (IILS 2011). It is credited with having helped Brazil lower its rate of those in extreme poverty by over 1% annually during much of the 2000s, even though the payments are only tens of dollars per month per family. In addition, Bolsa Familia is considered to be a significant component in the recent steady drop of Brazil's GINI coefficient, which has been one of the worst in the world and is still in the bottom decile, even after dropping from .64 to .56 on a 0-1 scale (Mattei 2010).

Bolsa Familia's coverage grew steadily through the 2000s, with an accelerated expansion in 2009. Some 14 million households will receive the transfers by the end of 2010, translating into almost 50 million direct recipients, nearly one quarter of the entire Brazilian population (IILS 2011: 80). Bolsa Familia has been tremendously important for the PT's political legitimacy and its continuing electoral success. Many analysts credit Lula's second term win to recipients, noting that municipalities with many recipients were much more likely to give their votes to him (Hunter and Power 2008).

As a policy for addressing the pains of economic crisis, the Bolsa Familia has another critical feature: it is remarkably cheap, with expenditures in 2009 just 0.4% of GDP (IILS 2011:

80). The long-term deep poverty of many Brazilians means that compensation policies are not nearly as expensive as in developed regions, and thus easier to maintain in crisis without threatening state solvency. The entire package of Brazilian income transfer programs – Bolsa Familia, unemployment insurance, and social security benefits – was 6.9% of GDP in 2002 and had grown to an estimated 9.3% of GDP in 2009. This was enough to stabilize the bottom part of the income distribution and private consumption without being prohibitively expensive (Barbosa 2010: 2). Subsidies for a new housing program that aims to build a million homes for poor and middle-income families in 2009-2010 will cost another 0.30% of GDP (ibid: 9,11).

Organized Labor Lula's relationship with organized labor has been considerably more fraught, not least because expectations for a national Workers' Party administration were very high. Relations reached a nadir during Lula's first term, with a number of public sector unions and more radical party members even leaving the PT and its associated union central, the CUT, to form a breakaway party and union (PSOL and Conlutas) in 2004. Workers swarmed the National Congress building in opposition to the administration's proposed pension and tax reforms in 2003, and gradually absented themselves from the Economic and Social Development Council (CDES), meant to be a new corporatist-style consultative mechanism (Hochstetler 2008). Yet the relationship has increasingly been repaired in Lula's second term, with several notable features. Even the Council has returned as a space for social dialogue on the crisis response (IILS 2011: 45).

One of the most important and least known developments of recent Brazilian political economy is the steady rise in formal employment since 2002 after several decades of informalization (see Figure 3). Private sector employment grew an average of 6.6% annually from 1999 to 2008, while public sector employment increased by 3.6% annually during the same years (Berg 2010: 6). After leveling off at the end of 2009, formal sector employment continues to climb (IILS 2011: 14-15). Job losses after 2007 were just 0.7% of employment, the lowest in Latin America, and a positive contrast even with countries like China, which grew more strongly, but lost more jobs (ibid: 8). The urban unemployment rate was 5.7% in November 2010, below pre-crisis levels (ibid: 12).

[Figure 3 about here]

The sectors hit hardest by export drops in the global recession were cargo vehicles and automobiles, auto parts, and unrefined oil (BNDES International Journal). In the domestic market, demand for consumer durables that are credit-sensitive also declined at the end of 2008, when credit dried up (IILS 2011: 6). The administration gave private industry – especially automobiles, capital goods, household appliances, and inputs to civil construction – special tax breaks in 2008 and 2009 to promote sales and production and injected credit (Barbosa 2010: 6), protecting employment (IILS 2011: xvi). State-controlled Petrobras, which extracts most oil in Brazil, received substantial extra funding from BNDES that is discussed more below. All of these sectors have recovered well, and labor market recovery even preceded GDP recovery in 2009 (IILS 2011: xiv). Industrial real wages rose 1.9% from April 2009 to a year later, and productivity rose even more, by 4.7% (*Valor Economico* 24 June 2010), suggesting a growing pie that is being shared. In fact, the administration and major unions had agreed to steadily increase the minimum wage beginning in 2007 so that workers could take part in the economy's productivity gains. The government kept the promised schedule of increases in 2009-2010. Real and nominal wages continued to increase and inequality continued to drop as a result (IILS 2011: 16-17).

Organized labor supported these policies and outcomes, which were generally favorable to them. They also supported them because they had been consulted along the way. One notable location was in the revived CDES, which appointed a special group of its multipartite membership – government, business, labor, and civil society – to formulate proposals for policies to respond to the crisis. Proposals in 2008 and 2009 generated suggestions that resulted in the job-rich response just noted. The 2008 suggestions included several directed at preventing currency overvaluations as well as recommendations to expand credit lines for production and commercial activities and to maintain public investment through the PAC (IILS 2011: 67-68). Thus while the PT's traditional base was in organized labor and civil society, those actors worked with business leaders to craft crisis response policies that were advantageous to all sides. Labor benefited from credit and investment that supported business because such policies also sustained employment. The accumulated reserves of the previous decade gave the government the funds for both currency management (already discussed) and credit expansion and infrastructure (to be discussed in the next section). It could even continue to pay off some of its public debt, although it also issued new debt.

One final piece that led to a view of common interests in an expanding pie is the unusual role of Brazil's pension funds. In 2009, the resources in Brazil's various pension schemes totaled around US$ 270 billion, about the size of its currency reserves and 18% of its GDP – the 8th largest worldwide and largest in the developing world (Datz 2010: 7). Under Lula, these funds have come to be controlled by fund managers with roots in the PT and unions (ibid: 3) and are increasingly being used as a backup to the government's own investment and growth strategies. One major investor in Petrobras' recent stock capitalization was its own Petros pension fund (Hochstetler 2010). The fact that worker pensions depend on the economic health of their investments – and that those increasingly follow a collective growth strategy – further reinforces the sense of a common interest in the future of Brazilian growth and the companies and banks that drive it.

In light of all these connections, it is not surprising that the CUT union central strongly supported Lula's candidate for presidential succession. So did even the Força Sindical, another major labor central created to be a political counterweight to the CUT in support of parties further right. In the elections of 2010, 62 workers' representatives were elected to the lower house of Congress, with 49 of them from the PT. They were outnumbered by the 169 business representatives who were elected. Surprisingly, 7 of these were also in the labor party PT and the largest group (32) was in the PT's coalition partner, the PMDB (*Valor Econômico* 18 October 2010). Most were affiliated with the opposition, but if this analysis is correct, they should find at least some points of agreement in economic policy.

The Growth Coalition and the "Bolsa BNDES". State-led development has been a consensual, society-wide priority in Brazil almost continuously since the 1930s, preferred across much of the political spectrum and by both military and civilian governments (Kingstone 2009). The years from 1990 to 2002 (dominated by the PSDB) saw an interruption of this preference, with substantial privatization and opening of the economy to international market forces (Montero 1998). Brazil was always among Latin America's slowest and most reluctant liberalizers, however. "Moderate left" in the 2000s, it was "moderate right" in the 1990s. Even its ostensibly private and privatized actors are deeply engaged with the state. Most of the biggest corporations were once state owned enterprises, and some of them still have controlling state ownership and/or significant pension fund investment. State agencies and funding helped with critical technology development and provided contracts and comfortable working relationships, with personnel often rotating between firms and regulatory agencies (Amman 2009; Brainard and Martinez-Diaz 2009; Schneider 2009). This state-society coalition is a powerful force for growth, and while the private economy may prefer the right side of the political spectrum, they are happy to take the contracts and loans of the PT.

While the government uses many vehicles for development finance, I will focus here on the largest, the BNDES. Begun in 1952 as the sole supplier of long-term credit in the country, this national development bank continues to provide nearly all long-term investment credit, while the Bank of Brazil provides agricultural credits (Stallings and Studart 2006). Inadequate credit is generally a problem for developing countries, and has been a particular stranglehold for Brazil. For several decades, Brazil's real interest rates have been among the highest in the world, with some of the largest spreads. Public investment has been very low and private investment has not replaced it (Hausmann 2008; Stallings and Studart 2006). In Lula's second administration, his government began to address the credit problem by funneling ever-larger quantities of money through BNDES, a process that has accelerated after the crisis hit. As Figure 4 shows, the disbursement totals are increasingly large. Even in 2004, before funding took off, BNDES' development spending was greater than the Inter-American Development Bank's spending for all of Latin America and approached the World Bank's global total (Stallings and Studart 2006: 247). BNDES loaned three times as much as the World Bank in 2010 (*Estado de São Paulo* 10 March 2011).

[Figure 4 about here]

The funds themselves are loaned at concessional rates and generally for comparatively long time frames. BNDES does not take deposits, and its new financing comes largely from a labor charge and deposits from the national treasury. The latter used its comparative financial flushness to top up BNDES' coffers several times in recent years, mostly through bond issues.

With loans granted at 6% interest and largely financed with public bonds with 12% yields, they represent a rather substantial transfer of resources from taxpayers to individual businesses and must generate considerable growth externalities to enable eventual bond repayments. Especially as the funds are used to support Brazil's large internationalized firms, they may draw the attention of foreign governments, much as the Canadian government challenged subsidies of Embraer at the WTO at the end of the 1990s. No disputes or queries have been tabled at the WTO in this more recent round, however, again suggesting a larger policy space.[6]

Already in 2007, a blogger for *Veja* newsmagazine had christened this spending the "Bolsa BNDES", a kind of conditional cash transfer program for firms, and the name was picked up and used in the recent campaign. The figures dwarf those spent on Bolsa Familia, which never received more than US$ 5.32 billion/year through 2008 for 11 million families (Mattei 2010: 17). The BNDES spending totaled about US$ 95 billion from 2008 to June 2010, and is highly concentrated. One newspaper calculated that 57% of BNDES' disbursements during that time went to just 12 firms, the parastatals Petrobras and Eletrobras and ten private firms, including three construction firms (Andrade Gutierrez, Camargo Corrêa, and Odebrecht) and Vale (mining), Votorantim (cement, pulp and paper, and others), and JBS (meatpacking) (*Folha de São Paulo* 8 August 2010).[7] This is compatible with BNDES' own calculation that large firms received 82.5% of its credit disbursements in 2009 (IILS 2011: 53). While the concentration is notable, the list does include Brazil's very large firms that have equally large financial needs (Schneider 2009). Much of this is PAC spending, and contributes to the growth

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[6] http://www.wto.org/english/tratop_e/dispu_e/dispu_by_country_e.htm, accessed 13 March 2011.

[7] These calculations were based on the loan recipients BNDES announces, a subset of the total. The individual firms are all discussed in Amman (2009) and Schneider (2009).

in formal employment. Another notable dimension is the way this money has been used to finance Brazilian businesses' advances outside Brazil.

Bolsa BNDES abroad. A strongly valued *real* hurts the ability of Brazilian producers to sell their products abroad and to compete with imports at home. Combined with international economic recession, however, it presents excellent conditions for Brazilian companies to expand externally, either through acquisitions or through other kinds of foreign direct investments. These opportunities are a match for successive administrations' interests in raising Brazil's international profile and for innovating a 21st century version of an industrial policy. Here I will focus on the specific role of the BNDES in facilitating this new stage of Brazilian economic participation. As already noted, the Brazilian state and BNDES funding have been critical in growing these businesses to their current size and competiveness at home, preparing them for a larger role (Amman 2009; Schneider 2009). The new role is "the large step from regional heavyweights to true multinationals", as the subtitle of a recent book on Brazilian multinationals puts it (Ramsey and Almeida 2010).

The idea of greater international involvement by Brazilian business occurred around 2000-2002 to a number of actors simultaneously: the foreign ministry Itamaraty, BNDES, the Ministry of Manufacturing and Industry, and business leaders themselves (Burges 2009: 111-113). The economy had reached an unusual degree of macroeconomic stability, with hyperinflation convincingly tamed since 1994 and the 1999 currency upheavals now settled. As newly market-oriented firms considered moving abroad, the critical limit remained the question of finance for their activities. Major pieces of that finance have eventually come from BNDES, with the components of an international role put in place gradually over the last decade and even longer. The current crisis simply represents acceleration and scaling up of those developments –

and allows Brazil to do it more cheaply. In addition, Brazil's large policy space in the current crisis makes such experimentation possible.

Official trade finance in Brazil had modest beginnings in the 1960s, but was scaled back in the 1980s and had to be essentially recreated from scratch (Sucupira and Moreira 2001: 92-92). In 1991 BNDES began to provide supplier credits for capital goods sold to other Latin American countries in an agreement among Latin American central banks. The program was renamed BNDES-EXIM in 1997, when it began to function like a full-fledged exim credit facility, offering both pre- and post-export credit lines to suppliers and foreign banks. Just two years later, disbursements had reached $2.1 billion dollars annually and were 20% of the total BNDES disbursements (ibid: 93). The graph shown above (Figure 4) confirms that exim disbursements continued to grow rapidly through the 2000s, although they were eventually dwarfed by the rise in total disbursements. BNDES created subsidized export credits in June 2009 to support national firms, but had phased them out by February 2011 (*Valor Econômico* 14 February 2011).

BNDES is a *national* development bank, and its mission is explicitly formulated in terms of national economic development. A part of its financial resources comes from a labor charge (the *Fundo de Amparo ao Trabalhador*) and part from the treasury; its mandates specifically enjoin it to improve domestic employment and development. Supporting exports was fully compatible with that mission; supporting businesses in going beyond the border required reinterpreting "economic nationalism" to be something near the conceptual limits of even such a flexible concept (Helleiner 2002). The translation is a vision of supporting "national champions" to become "multinational champions". The policy has antecedents in government support for Embraer becoming a global player in the manufacture of small jetcraft (Schrank and Kurtz

2005), but now has been scaled up.

As BNDES explains the policy on its Portuguese-language website, "The development of an export sector that is more dynamic and better integrated into the world economy and the rise in the competitiveness of economic production on a global scale responds to BNDES' objective of strengthening the internal market, as these function as powerful tools to elevate the productivity and efficiency of Brazilian firms." The English language version is interestingly different with a similar section explaining: "In addition, the BNDES supports the internationalization of Brazilian companies, aiming at increasing their competitiveness which, in turn, propels the global economy."[8] BNDES's increasing ability to raise international sources of its own funds for disbursement from international bond issues, multilateral organizations, and fomentation agents completes the circle of closer international economic integration.

On the ground, this shift to supporting multinational champions took shape as neighboring Argentina went into its own currency-based crisis in 2001. Both the Brazilian ambassador to Argentina and a group of 180 Brazilian businessmen who did business in Argentina independently argued that BNDES should be able to play some role in financing Brazilian FDI there as a response. Then-president Cardoso supported the proposal, if the investments were "commercially viable" (Burges 2009: 111-112). A 1997 rule change had allowed indirect FDI finance; now a 2002 change allowed direct FDI support as well (Sennes and Mendes 2010: 167). Direct FDI support includes financial support or working capital related to constructing or acquiring or modernizing plants and branches as well as acquisitions of

[8] This is my translation of the website's explanations of BNDES support for exports and international insertion, http://www.bndes.gov.br/SiteBNDES/bndes/bndes_pt/Areas_de_Atuacao/Exportacao_e_Insercao_Internacional/index.html.

corporate interest (if complementary to exporting).[9] BNDES may provide financing through loans or by raising capital through bonds and securities, supporting at most 60% of the investment.

The change to direct FDI support was controversial both inside and outside the bank, and the first actual loan for FDI was approved only in 2005, when BNDES financed the meatpacker JBS-Friboi to buy a Swift meatpacking plant in Argentina (Sennes and Mendes 2010: 168). The loans for FDI continued to only trickle in across the 2000s, and carried clauses that required the projects to include substantial percentages of Brazilian exported goods. The rhetoric surrounding these loans often greatly exceeded the actual credit until quite recently. Burges, for example, discusses how BNDES would finance substantial parts of a South American infrastructure-for-integration project (IIRSA) (Burges 2009: 120-123), but the project's website shows BNDES funding only two paving projects for a total of US$ 415.2 million, out of 524 total projects.[10] After the crisis, however, quantities of direct FDI support did jump (see Table 1).

[Table 1 about here]

While BNDES does not report on individual projects because of confidentiality clauses, Angola topped the list of country-recipients in both years and received 36.7% of the total funding of this kind in 2008-2009, presumably to support Petrobras's large new oil concessions there. Itamaraty often releases the text of short speeches by Lula or Foreign Minister Celso Amorim commemorating specific lines of credit or initiatives. In November 2009, for example, Lula

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[9] http://www.bndes.gov.br/SiteBNDES/bndes/bndes_en/Institucional/The_BNDES_Abroad/internationalization.html

[10] http://www.iirsa.org/proyectos/Proyectos.aspx, accessed 6 October 2010.

reported that between 2005 and 2009, BNDES had given Argentina support for US$1.2 billion for infrastructure and industry and another US$1.5 billion for gas pipelines, sanitation, and water. Another US$4.5 billion line of credit was under consideration.[11] Brazil had offered Venezuela a US$10 billion credit line earlier for projects that involve Brazilian businesses (*Folha de São Paulo* 22 May 2009). These kinds of open credit lines to Brazil's neighbors are apparently an innovation in regional finance, although they are related to the loans Venezuela made in South America earlier in the decade when it had oil revenues to spend (Burges 2007). The difference is that Brazil links them quite clearly to Brazilian firms and the export of Brazilian goods and services, and BNDES insists on conventional commercial viability while Venezuela's BANDES did not. Conversely, in May 2009, BNDES signed an agreement with the Chinese Development Bank to bring in US$ 10 billion of Chinese money for investments in Petrobras and its new oil finds. The two banks also agreed that each would open a branch in the other country.

In 2008, the Lula administration decided to introduce another set of changes as part of a broader and more explicit internationalized industrial policy (the PDP mentioned above). Among the changes, BNDES now began to set up offices abroad, beginning in 2009 with an office in Uruguay for Mercosur activities and to support Brazilian interests in South America. The next step was an investment holding company in London. This BNDES Limited is meant to increase Brazilian visibility in a major global financial center and to support Brazilian businesses as well as to facilitate the activities of foreign investors who want to begin to act in Brazil. An

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[11] www.itamaraty.gov.br. While these provide substantive information, there is no evidence that they are a complete record of BNDES foreign spending, and do not usually specify which Brazilian companies benefit from the lines of credit.

International Area within the bank coordinates all these activities.[12]

Of all the parts of the Lula administration's development agenda, this is the one that has drawn the most overt partisan criticism. From the beginning, the PSDB has criticized the "Southist" orientation of the Lula government, and it has challenged the growing international orientation of BNDES in regular interventions in the National Congress. The party accuses the administration of constantly conceding to its neighbors, putting their interests above Brazil's own. Its criticisms are in the language of more traditional versions of Brazilian economic nationalism (cite) – although the PT criticized the PSDB administrations of the 1990s in very similar terms for its projects of privatization and economic opening (Burges 2009). In fact, one of the PSDB's major uses of BNDES was to carry out privatization of SOEs (Montero 1998), showing the malleability of an organization whose exact purposes and activities can be readily changed by presidential and institutional decrees as long as they remain broadly compatible with the legislated mandate of promoting "national development". In recognition of this flexibility, a Senator from the DEM party (part of the PSDB's opposition coalition) introduced a bill in November of 2009 forbidding the use of BNDES funds abroad, but it has not advanced far in a legislature controlled by the PT coalition. Despite the PSDB's closer political ties to business owners, it is hard to imagine that the latter would favor this change.

Claiming and Giving Political Credit. Economists will eventually weigh in with their (probably opposed) evaluations of the economic value of these policies. Political assessments are already in, however. In the 2010 presidential campaign, the candidates of both the parties that have contested every presidential election since 1994, the PT and PSDB, stressed their intentions to continue the current economic model, even as they squabbled over how much of it

[12] http://www.bndes.gov.br/SiteBNDES/bndes/bndes_en/Institucional/The_BNDES_Abroad/

is a PSDB legacy. The PSDB claims credit for the stabilization policies that laid the model's macroeconomic fundamentals in the 1990s. They point out that no one was willing to invest in Brazil as it endured hyperinflation, chronic large government deficits, and foreign-restricting legislation. Lula largely followed the stabilization policies, but the PT counters that its other choices were responsible for the economic growth and social improvement that came only after Lula took office (Power 2010). In any case, the desire of both major parties to claim credit for the model and recent economic outcomes is a sign of the very different politics of comparatively good versus hard times.

Lula's chosen successor, Dilma Rousseff, won by a decisive 10% margin in the second round of the presidential election in October 2010. Rousseff was hand picked by Lula to compete for the presidency, her first elected position, and was considered an unlikely choice at the beginning of the campaign. She was an integral part of the development coalition and project of his two administrations, however. She began her national political career as Minister of Mines and Energy, putting together smaller versions of similar coalitions between state actors, public finance, and private construction and engineering firms to build hydroelectric dams and redouble Petrobras' energy initiatives. Later she headed the PAC, which enlarged the model into the investments and activities seen here. She was a major player in the inter-ministerial team that drafted new legislation for Petrobras' major oil finds, putting in a larger role for the state and ensuring greater revenues for the state – by the legislation, to be used for investments and social programs – but keeping room for private actors (Hochstetler 2010). If doing comparatively well abroad implies political continuity at home, she is the embodiment of continuity of Lula's development strategy, especially in the crisis years. Her win shows that this is what electorates want.

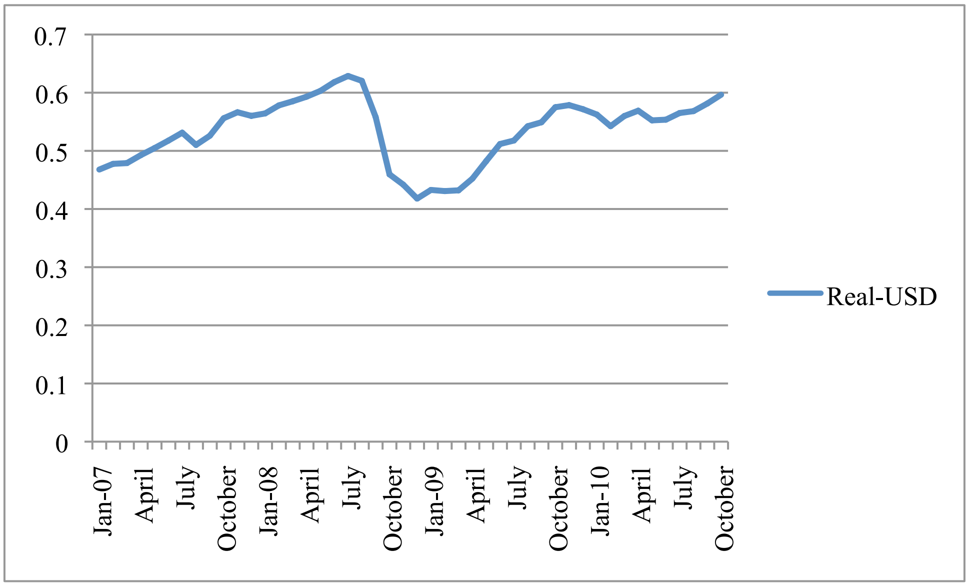
Conclusion

Looking at the experiences of Brazil in the most recent global financial crisis, it appears that the politics of comparatively good times are different from those of hard times. When crisis hits, states doing comparatively well do not face the same external constraints of those who do badly. Private economic actors are if anything overenthusiastic in sending resources to the currency, stock markets, and other investment opportunities in states like Brazil. Foreign governments and IFIs cannot exercise the same controls through conditions on finance when none is needed. The net result is that there may be considerable policy space to pursue national development strategies, even in the broader context of global financial crisis.

In the case of Brazil, politicians from several parties and many economic sectors already had imagined an expansive strategy for national development. It built on macroeconomic stability and improving social conditions, but added a significant injection of public credit and support for expansion. When the crisis hit, those plans accelerated and even crossed the national boundary, as national champions were supported in efforts to expand further in the context of emerging opportunities in the global shutdown. While strong partisanship prevailed in a presidential election with competing claims for credit for the comparative economic success, the policy responses to crisis in fact crossed partisan and sectoral lines. A job-rich recovery with sustained social programs pleased the governing PT's traditional constituencies, and formed a virtuous circle with the credits and infrastructure spending that sustained business. The PT was rewarded with its three presidential administration in a row.

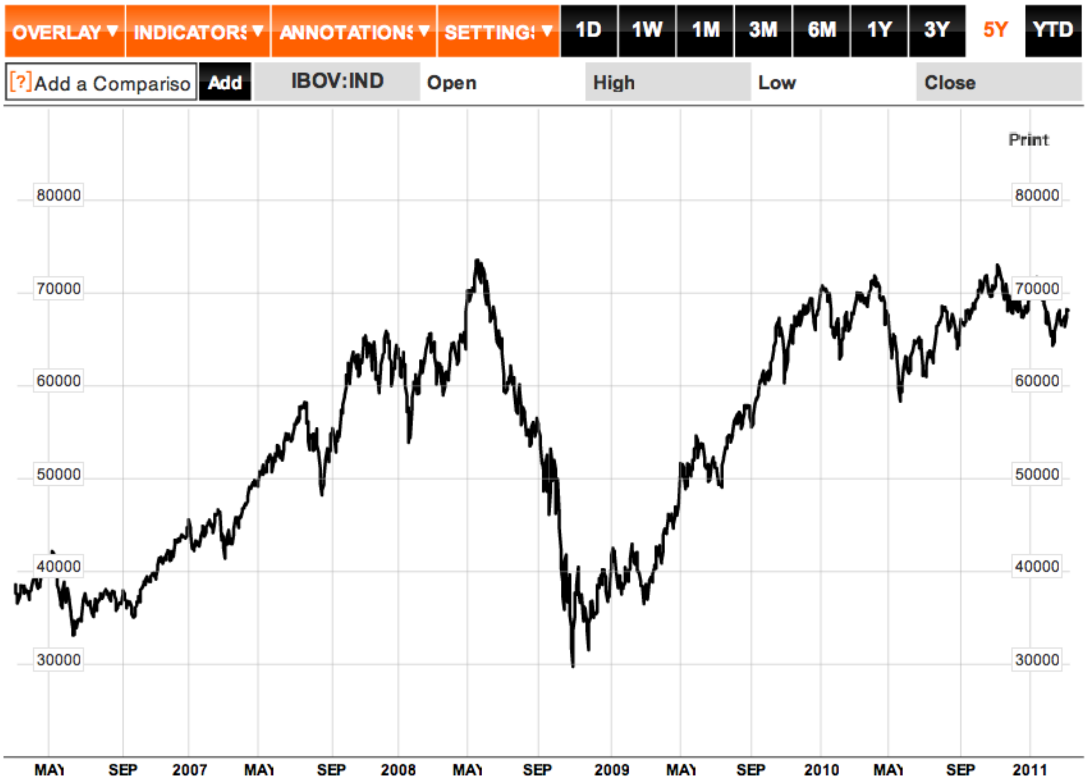
While these are not the patterns of the countries undergoing Gourevitch's hard times, similar analytical strategies proved useful here as well. The key is the recognition that not all countries will do equally badly, and that variation results in distinct patterns of coalition formation and orientation to the international economy. The next step is to see if these patterns hold up in a broader comparative context of other countries enjoying comparatively good times.

Figure 1. Average monthly value of the Brazilian *real* in US dollars.



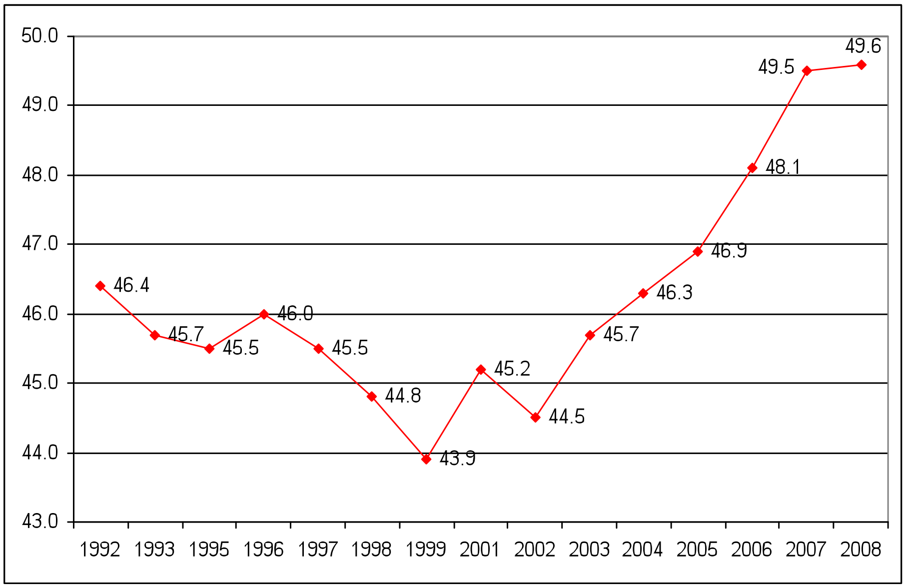
Source: http://www.x-rates.com/d/USD/BRL/hist2007.html

Figure 2. Performance of the Bovespa (São Paulo stock exchange), 2006-2011.



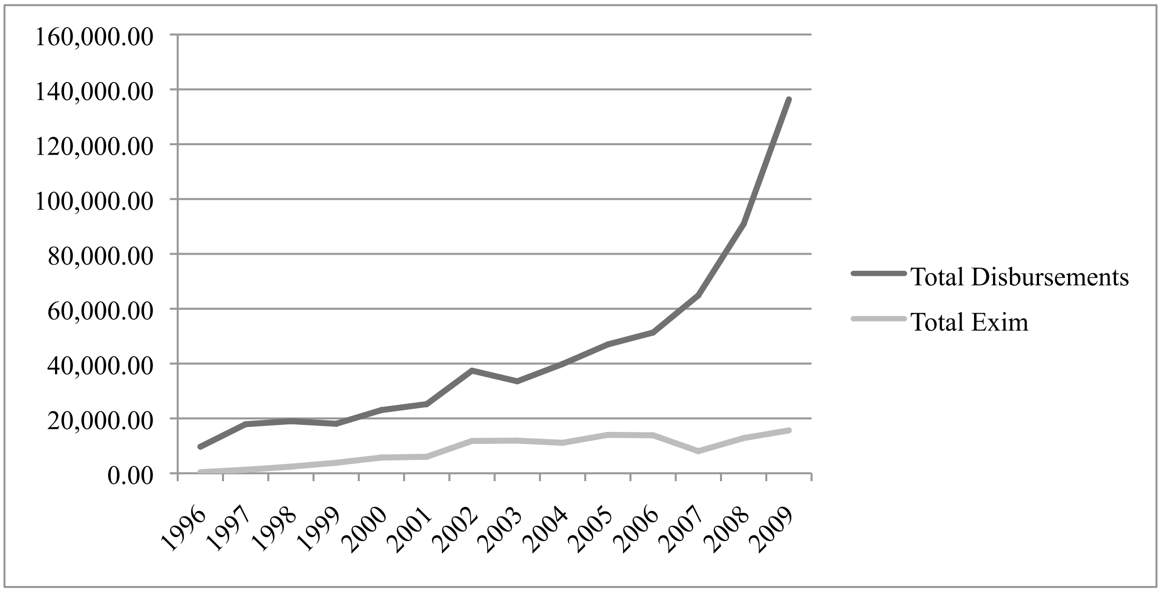
Source: http://www.bloomberg.com/apps/quote?ticker=IBOV:IND.

Figure 3. Share of Formal Employment in Brazil, 1992-2008 (percent)



Note: Workers aged 16 years and older. Does not include the rural areas of the Northern states, with the exception of Tocantins. The PNAD survey was not undertaken in 1994 or 2000.
Source: Berg (2010: 6).

Figure 4. BNDES total and Exim disbursements, 1996-2008.



Source: BNDES, in millions of reais, not corrected for inflation.

Table 1. Foreign Trade Support (Direct Operations) by Country

Contracting Country	2008 Contracts (US$)	2009 Contracts (US$)
Angola	497,962,791	755,967,067
Argentina	25,252,785	497,720,240
Chile	5,526,000	
Costa Rica	70,840	501,640
Cuba		79,840,351
Dominican Republic	161,794,167	220,852,660
Ecuador	339,263	55,250
El Salvador		59,275,514
Equatorial Guinea	7,860,978	
France		177,297,415
Honduras	60,000	
Japan		80,080,000
Mexico	53,200	37,543
Netherlands		41,900,467
Paraguay	819,000	1,219,000
Peru	335,800	224,000
United Kingdom		107,899,299
United States	435,070,888	250,825,520
Uruguay	350,000	
Venezuela	9,382,651	
Total	1,144,878,363	2,273,695,966

Source: BNDES:
http://www.bndes.gov.br/SiteBNDES/bndes/bndes_pt/Galerias/Arquivos/consultas/projetosAEX.pdf, accessed 26 March 2010.
Note: Direct Operations in the area of Foreign Trade primarily consist of financing for foreign public entities with the aim of enabling the export of Brazilian goods and services, with the resulting international contracts being subject to confidentiality and commercial secrets clauses. The table presents the destinations of the Brazilian exports supported by BNDES and the value financed by country for two 12-month periods ending in December, 2008 and December, 2009.

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Losing Control: Policy Space to Prevent and Mitigate Financial Crises in Trade and Investment Agreements

Kevin P. Gallagher*

This article examines the extent to which measures to mitigate the current financial crisis and prevent future crises are permissible under a variety of bilateral, regional and multilateral trade and investment agreements. US trade and investment agreements, and, to a lesser extent, the World Trade Organization, leave little room to manoeuvre with capital controls, despite increasing evidence that certain controls can prevent or mitigate crises. Investment rules under the treaties of most capital-exporting nations allow for at least the use of temporary controls as a safeguard measure. The article offers a range of policies that could be deployed to improve US investment rules.

Key words: Financial crises, trade agreements, capital controls

1 Introduction

At least since the Great Depression of the 1930s, and very much so in the run-up to and the wake of the current financial crisis, some nations have relied on capital controls as one of many possible tools to mitigate or prevent the financial instability that can come with short-term inflows and outflows of capital. In the bubble years before the current crisis became acute, nations such as China, Colombia, India and Thailand regulated inflows of capital in order to stem these bubbles. When the crisis hit, countries like Iceland, Indonesia, Russia, Argentina and Ukraine put capital controls on outflows of capital to 'stop the bleeding' related to the crisis (International Monetary Fund, 2009).

As will be shown in this article, the economic evidence is fairly strong about the use of capital controls, especially on a temporary basis. However, there is concern that the myriad trade and investment treaties across the world may prohibit the use of measures to prevent and mitigate financial bubbles and subsequent crises. A number of studies examine the policy space for industrial development, but very few examine that for measures pertaining to financial stability (Kolo and Wilde, 2009; Shadlen, 2005; Gallagher, 2005; Anderson, 2009a and b; Mayer, 2009). This article conducts a comparative analysis to pinpoint the extent to which nations have the policy space for capital controls in the world economy.

The major findings of this research are shown in Table 1. Policy space under the World Trade Organization, US bilateral investment treaties (BITs) and free trade

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agreements (FTAs), and other BITs and FTAs by other capital-exporting countries is presented. Under no regime are capital controls permitted for current transactions unless they are sanctioned by the International Monetary Fund. For the capital account, however, there is interesting variation.

Table 1: Policy space for capital controls: a comparison

	WTO	US BITS/FTAs	Other BITS/FTAs
Permissible capital controls			
current	no	**no**	no
capital			
inflows	no[a]	**no**	sometimes
outflows	no[a]	**no**	no
Safeguard provisions			
current	yes[b]	**no**	yes[b]
capital			
inflows	no	**no**	yes
outflows	yes	**no**	yes
No. of countries covered	69	58	
Dispute resolution format	state-to-state	investor-state	investor-state
Enforcement instrument	retaliation	investor compensation	investor compensation

Notes: a) capital controls fully permissible for countries that have not committed to liberalising cross-border trade in financial services; b) permitted only under IMF approval.

The WTO allows for countries to deploy capital controls on both inflows and outflows as long as they have not committed to the liberalisation of certain financial services. If a country has made commitments in financial services, restrictions on inflows are not permitted. However, it will be shown that there are safeguard measures that may apply. In terms of recourse, if a country that has liberalised financial services does restrict capital inflows or outflows, it could be subject to a dispute panel that could rule that the measures be brought against it.

US BITs and FTAs do not permit restrictions on inflows or outflows. If a country does restrict either type of capital flow, it can be subject to investor-state arbitration whereby the government of the host state would pay for the 'damages' accrued by the foreign investor. The BITs and FTAs of other major capital exporters such as those negotiated by the European Union, Japan, China and Canada, either completely 'carve out' host-country legislation on capital controls (hence permitting them) or allow for a temporary safeguard on inflows and outflows to prevent or mitigate a financial crisis. The US does not have either measure. However, a handful of FTAs have recently allowed for a grace period under which foreign investors are not allowed to file claims against a host state until after the crisis period has subsided.

Following this brief introduction, the article is divided into four more sections. Section 2 provides a brief overview of the economic theory, policy and evidence regarding capital controls. Section 3 examines policy space for capital controls under the WTO. Section 4 conducts a comparative analysis that juxtaposes US treaties alongside the WTO and the regional and bilateral treaties of other major capital-exporting countries. Section 5 summarises the key findings and offers policy recommendations.

2 Capital-account liberalisation and capital controls: theory and evidence

Advocates for capital-market liberalisation argue that, by liberalising the flows of international capital, developing countries would benefit by getting access to cheaper credit and investment from developed markets, thus promoting growth and stability. Indeed, conventional theory implies that investment tends to flow to developing countries, where the marginal returns may be higher (Barro, 1997). This view, based on the assumption of perfect capital markets, has been largely discredited by the recent experiences of currency crises (Ocampo et al., 2008). International capital flows tend to be pro-cyclical, creating excess inflows during booms, and causing capital flight in moments of instability, thus further aggravating crises.

Moreover, it has been shown that capital-market liberalisation in developing countries is not associated with economic growth (Prasad et al., 2003). Indeed, the most recent research has shown that capital-market liberalisation is associated with growth only in countries that have reached a certain institutional threshold – a threshold that most developing countries have yet to achieve (Kose et al., 2009). This is partly due to the fact that the binding constraint for some developing-country growth trajectories is not the need for external investment, but the lack of investment demand. This constraint can be accentuated through foreign capital flows because such flows appreciate the real exchange rate, thus reducing the competitiveness of goods and reducing private-sector willingness to invest (Rodrik and Subramanian, 2009).

Capital controls have been found to stabilise short-term volatile capital flows: they can give policy-makers additional policy instruments that allow them more effective and less costly macroeconomic stabilisation measures; they can promote growth and increase economic efficiency by reducing the volatility of financing and of real macroeconomic performance; and they can discourage long-term capital outflows (Ostry et al., 2010). The literature on capital controls generally discusses at least six (somewhat overlapping) core reasons why nations may want to deploy them (Magud and Reinhart, 2006). These can be referred to as 'the six fears' of capital flows:

(i) *fear of appreciation*. Capital inflows cause upward pressure on the value of the domestic currency, making domestic producers less competitive in the international market, and hurting exports and therefore the economy.
(ii) *fear of 'hot money'*. The large injection of money into a small economy may cause distortions, and eventually a sudden reversion if foreign investors try to leave simultaneously.

(iii) *fear of large inflows*. Large volumes of capital inflows, even if not all hot money, can cause dislocations in the financial system.
(iv) *fear of loss of monetary autonomy*. A trinity is always at work. It is not possible to have a fixed (or highly managed) exchange rate, monetary policy autonomy and open capital markets. Specifically, when central banks intervene in the exchange market, buying foreign currency in order to curb the appreciation of the exchange rate, they effectively increase the domestic monetary base. Trying to raise interest rates to offset this effect causes more capital inflows, as foreign investors rush in to take advantage of higher yields.
(v) *fear of asset bubbles*. Raised by Ocampo and Palma (2008), this was a particularly important issue in the 2008 financial crisis, since the bursting of the real-estate bubble was the root cause of the banking crisis around the globe.
(vi) *fear of capital 'flight'*. Capital may rapidly leave a country in the event of a crisis or because of contagion (Grabel, 2003; Epstein, 2005).

Table 2 presents a sample of various types of capital controls that have been deployed by countries to address these fears.

Table 2: Capital controls and capital-management techniques

Inflows
Restrictions on currency mismatches[a]
End use limitations[b]
Unremunerated reserve requirements[c]
Taxes on inflows
Minimum stay requirements
Limits on domestic firms and residents borrowing in foreign currencies
Mandatory approvals for capital transactions
Prohibitions on inflows
Outflows
Limits on ability of foreigners to borrow domestically
Exchange controls
Taxes/restrictions on outflows
Mandatory approvals for capital transactions
Prohibitions on outflows

Notes: a) borrowing abroad only allowed for investment and foreign trade; b) only companies with foreign currency reserves can borrow abroad; c) percent of short-term inflows kept in deposit in local currency for specified time.
Sources: Ocampo et al. (2007); Epstein et al. (2008).

Economists usually differentiate between controls on capital inflows and outflows. Moreover, measures are usually categorised as being 'price-based' or 'quantity-based' controls. Table 2 lists examples of controls on inflows and outflows, though sometimes the distinction can be murky (Epstein et al., 2008; Ocampo et al., 2007). Examples of quantity-based controls are restrictions on currency mismatches, and minimum-stay requirements and end-use limitations. Many of these have been used by countries such as China and India. Examples of price-based controls include taxes on inflows (Brazil) or outflows (Malaysia). Unremunerated reserve requirements (URR) are both. On the one hand, they are price-based restrictions on inflows, but they also include a minimum-stay requirement which can act like a quantity-based restriction on outflows.

Controls are most often targeting foreign-currency and local-currency debt of a short-term nature. Foreign direct investment (except for FDI in the financial sector) is often considered less volatile and worrisome from the standpoint of macroeconomic stability. Inflow restrictions on currency debt can reduce the overall level of such borrowing and steer investment towards longer-term productive investments and thus reduce risk. Taxes on such investment cut the price differential between short- and long-term debt and thus discourage investment in shorter-term obligations. Outflow restrictions and measures are usually deployed to 'stop the bleeding' and keep capital from leaving the host country too rapidly.

Table 3: Literature on the effectiveness of capital controls

	Reduce the volume of capital flows?	**Alter the composition of flows?**	**Reduce real exchange-rate pressures?**	**Make monetary policy more independent?**
Controls on inflows				
Brazil	Unclear	Yes	No	Unclear
Chile	Unclear	Yes	Unclear	Yes
Colombia (1993)	Yes	Yes	Yes	Yes
Colombia (2007)	No	Yes		
Czech Republic	No	Yes		
Malaysia (1989)	Yes	Yes		
Malaysia (1994)	Yes	Yes	Yes	Yes
Thailand	Yes	Yes	Yes	Yes
Croatia		Yes		
Controls on outflows				
Malaysia (1998)			Unclear	Yes
Spain	Unclear		Unclear	Unclear
Thailand	Yes		Yes	Yes
Multi-country studies	Yes	Yes	Yes	No

Source: Magub and Reinhart (2006); IMF (2010).

The literature on the effectiveness of capital controls is too vast to cover here. However, two comprehensive assessments have recently been conducted. In sum, the literature strongly supports the use of capital controls on inflows. Evidence on outflows is more controversial. Magud and Reinhart (2006) conduct the most assessment of the literature to 2006. In their analysis, they express concern over the lack of a unified theoretical framework to analyse the macroeconomic consequences of the controls, the heterogeneity of countries and control measures, the multiplicity of policy goals and what constitutes ‘success’. As most studies investigate a few country cases (mainly Chile and Malaysia), it is difficult to make generalised conclusions from the literature in the field. Theirs is the most valiant attempt to overcome these shortcomings. What is more, they also ‘weight’ the findings in the literature with respect to their econometric rigour.

To summarise, say Magud and Reinhart, ‘capital controls on inflows seem to make monetary policy more independent, alter the composition of capital flows and reduce real exchange rate pressures’. In terms of outflows, it is clear that such provisions were successful in Malaysia, but it is not so clear in the case of other countries.

In a February 2010 *Staff Position Note,* the IMF staff reviewed all the evidence on capital controls on inflows, pre- and post-crisis and concluded:

> capital controls – in addition to both prudential and macroeconomic policy – are justified as part of the policy toolkit to manage inflows. Such controls, moreover, can retain potency even if investors devise strategies to bypass them, provided such strategies are more costly than the expected return from the transaction: the cost of circumvention strategies acts as ‘sand in the wheels’. (IMF, 2010)

To come to this conclusion, this recent and landmark IMF study reviews the experiences of post-Asian-crisis capital controls. In addition, the IMF conducted its own cross-country analysis in this study, which also has profound findings. The econometric analysis examined how countries that used capital controls fared versus countries that did not use them in the run-up to the current crisis. It found that countries with controls fared better: ‘the use of capital controls was associated with avoiding some of the worst growth outcomes associated with financial fragility’ (ibid.: 19).

There has even been some attention by prominent economists to the need for restrictions on outflows. Calvo (2009) argues that capital controls could be deployed to dampen the impact of capital flight during crises. Even in ‘normal’ times, however, he argues that prudential regulations should sometimes be coupled with foreign-exchange restrictions to reduce capital flight.

To summarise, there is an emerging consensus in the economics profession regarding capital controls. Capital controls, especially those on inflows, are increasingly seen as a prudential measure for developing countries hoping to prevent and mitigate financial crises.

3 Policy space for capital controls at the WTO

This section examines the extent to which the WTO grants nations the policy space to deploy capital controls. The key of WTO law that covers capital flows is the General Agreement on Trade in Services (GATS). The GATS is currently the only binding multilateral pact that disciplines capital controls, though specific countries may have certain freedoms if their governments in place in the 1990s did not make widespread commitments in the financial-services sector. More specifically:

(i) A member is most protected from a WTO challenge over capital controls if it committed no financial-services sectors to GATS coverage in any mode.
(ii) However, even countries that have made widespread commitments in financial services may have recourse – if challenged – to various exceptions, although these have not been tested and the record of WTO exceptions in other contexts is not reassuring.
(iii) The policy space for controls on *current-account* transactions defers to the IMF.

3.1 The General Agreement on Trade in Services (GATS)

The GATS is part of the Marrakesh Treaty that serves as an umbrella for the various agreements reached at the end of the Uruguay Round of GATT negotiations that established the WTO. It provides a general framework disciplining policies 'affecting trade in services' and establishes a commitment for periodic future negotiations. The GATS is divided, on the one hand, into a part on 'General Obligations', which binds all members. These include the obligation to provide most-favoured-nation treatment to all WTO members (Article II), and some disciplines on non-discriminatory domestic regulations that are still being fully developed (Article VI).

On the other hand, the GATS also includes a part dealing with 'Specific Commitments', which apply only to the extent that countries choose to adopt them by listing them in their country-specific schedules. These cover primarily the disciplines of Market Access (Article XVI) and National Treatment (Article XVII) (Raghavan, 2009).

Numerous annexes cover rules for specific sectors: the Annexes on Financial Services are of particular relevance for capital controls. However, trade in services occurs across the four services modes discussed in the GATS in general:

Mode 1: Cross-border supply is defined to cover services flows from the territory of one member into the territory of another member (for example, banking or architectural services transmitted via telecommunications or mail).

Mode 2: Consumption abroad happens when the consumer travels outside the country to access a service such as tourism, education, health care and so forth.

Mode 3: Commercial presence occurs when the user of a financial service is immobile and the provider is mobile, implying that the financial-service supplier of one WTO member establishes a territorial presence, possibly through ownership or lease, in another member's territory to provide a financial service (for example, subsidiaries of foreign banks in a domestic territory).

Mode 4: Presence of natural persons is when financial services are supplied by individuals of one country in the territory of another.

IMF analysts have found that about 16 countries have significant Mode 1 commitments in financial services, while around 50 each have significant Mode 2 and 3 commitments for the sector. This includes most OECD countries (Valckx, 2002; Kireyev, 2002).

Generally speaking, GATS negotiations and commitments follow a 'positive list' approach, whereby countries only commit to bind specified sectors to GATS disciplines. This stands in contrast with a 'negative list approach', which is more common for goods negotiations and in most FTAs. In a negative list or 'top-down' approach, negotiators assume that all sectors will be covered in some way, apart from a handful that are listed by particular countries.

WTO members have recourse to binding dispute-settlement procedures, where perceived violations of GATS commitments can be challenged and retaliatory sanctions or payments authorised as compensation.

3.2 Capital-account liberalisation, capital controls and GATS

Unbeknownst to many, GATS commitments require the simultaneous opening of the capital account. Those countries that make commitments under Modes 1 and 3 for financial services are required to permit capital to flow freely to the extent that it is an integral part of the service provided – though some exceptions may apply. GATS Article XVI on Market Access contains a footnote (8) that references capital liberalisation:

> If a Member undertakes a market-access commitment in relation to the supply of a service through the mode of supply referred to in subparagraph 2(a) of Article I [i.e. Mode 1] and if the cross-border movement of capital is an essential part of the service itself, *that Member is thereby committed to allow such movement of capital*. If a Member undertakes a market-access commitment in relation to the supply of a service through the mode of supply referred to in subparagraph 2(c) of Article I [i.e. Mode 3], *it is thereby committed to allow related transfers of capital into its territory*. (emphasis added)

While Modes 1 and 3 are explicitly referred to here, Article XI, paragraph 2 also refers to capital liberalisation:

> Nothing in this Agreement shall affect the rights and obligations of the members of the International Monetary Fund under the Articles of Agreement of the Fund, including the use of exchange actions which are in conformity with the Articles of Agreement, provided that *a Member shall not impose restrictions on any capital transactions inconsistently with its specific commitments regarding such transactions*, except under Article XII or at the request of the Fund. (emphasis added)

Taken together, these provisions indicate that a country that makes GATS financial-service commitments in the modes of cross-border trade (Mode 1) and establishment of commercial presence (Mode 3) may explicitly be required to open its capital account. In such instances, the country's ability to deploy capital controls *related to capital inflows* would be restricted. The text is silent on whether capital controls related to capital outflows are similarly disciplined.

As an aside, capital-account transactions are not restricted under the IMF Articles Agreement, and thus countries are free to choose whether capital controls are part of their arsenal to prevent and mitigate financial crises. However, a distinction needs to be made with respect to *financial services* and *capital flows*. Under the GATS countries liberalise specific types of financial services, such as banking, securities, insurance and so forth – which does not necessarily imply capital movements or changes in fundamental capital-account regulation.

However, there are scenarios where the liberalisation of financial services will require an open capital account. The IMF cites the following Mode 1 example, where 'a loan extended by a domestic bank to a foreign customer using internationally raised capital creates international capital flows and international trade in financial services. To the extent that a financial services transaction involved an international capital transaction, the capital account needs to be opened for the former to take place freely' (Kireyev, 2002). Another study by an IMF official provides examples of how the GATS Mode 1 essentially requires the liberalisation of a capital account:

> to the extent that a member restricts its residents from borrowing from non-residents, a member's commitment to allow banks of other members to provide cross-border lending services to its nationals would require a relaxation of this restriction. Similarly, if a member also makes a commitment to permit non-resident banks to provide cross-border deposit services, such a commitment would require the member to liberalise restrictions it may have imposed on the ability of residents to hold accounts abroad. In these respects, the GATS serves to liberalise the making of both inward and outward investments. (Hagan, 2000)

This is echoed in a recent book by Sydney Key who says: 'The bottom line is that if a country makes a commitment to liberalise trade with respect to a particular financial service in the GATS, it is also making a commitment to liberalise most capital movements associated with the trade liberalisation commitment' (2003: 963). The WTO, in a recent Note (2010), quoted from Key's work to make the same point. In other words, liberalising cross-border trade in financial services (Mode 1) may need an open capital account to facilitate such trade, which, of course, results in international capital flows. A similar scenario can be outlined in terms of Mode 3 liberalisation. A loan extended by a foreign bank to a domestic client requiring capital to be transferred from the parent company of the foreign bank to its subsidiary abroad would also require an open capital account. In any event, it is worth noting that WTO panels are not bound by the IMF's distinction between service transactions and capital flows.

If a country has not listed cross-border trade in financial services (Mode 1) or commercial presence of foreign services (Mode 3), that country may be free to deploy capital controls as it sees fit. Indeed, numerous developing countries have not 'listed' the liberalisation of cross-border trade in financial services nor Mode 3 commitments under the GATS. According to the WTO, the majority of them made relatively fewer commitments in financial services related to capital markets (WTO, 2010).

It is also possible that certain types of measures may be more GATS-compliant than others. Article XVI, paragraph 2 is seen as a non-exhaustive list of the types of financial services whereby a host nation 'shall not maintain' restrictions on the flow of capital. The list does not explicitly mention any of the capital controls and other capital-management techniques found in Table 2 of this study. A case could therefore be made that capital controls of the kind shown in Table 2 are not even covered by the GATS.

If a country's capital controls were found to be in violation of its GATS commitments, it could invoke one or more exceptions in the GATS text. A first option would be to claim that the measure was taken for prudential reasons under Article 2 (a) of the Annex on Financial Services. This exception reads:

> Notwithstanding any other provisions of the Agreement, a Member shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system. Where such measures do not conform with the provisions of the Agreement, they shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement.

Inflows controls such as unremunerated reserve requirements or inflows taxes could be argued to be of a prudential nature, especially given the new IMF report discussed earlier. However, the sentence stating that prudential measures 'shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement' is regarded by some as self-cancelling and thus of limited utility (Tucker and Wallach, 2009; Raghavan, 2009). Others, however, do not see the measure as second-guessing but rather 'as a means of catching hidden opportunistic and protectionist measures masquerading as prudential'(Van Aaken and Kurtz, 2009). Yet others point out that, in contrast with other parts of the GATS that require a host nation to defend the 'necessity' of the measure, there is no necessity test for the prudential exception in the GATS. This arguably gives countries more room to deploy controls. Indeed, Argentina lost cases related to controls under BITs because they failed such a 'necessity test'(Burke-White, 2008). Countries have requested that the WTO elaborate on what is and is not covered in the prudential exception, but such requests have fallen on deaf ears (Cornford 2004). And at the time of writing, the prudential exception has not been tested.

If a country's capital controls were found to be in violation of its GATS commitments in financial services, it could also invoke Article XII 'Restrictions to Safeguard the Balance of Payments'. Paragraph 1 of Article XII states:

> In the event of serious balance-of-payments and external financial difficulties or threat thereof, a Member may adopt or maintain restrictions on trade in services on which it has undertaken specific commitments, including on payments or transfers for transactions related to such commitments. It is recognised that particular pressures on the balance of payments of a Member in the process of economic development or economic transition may necessitate the use of restrictions to ensure, *inter alia*, the maintenance of a level of financial reserves adequate for the implementation of its programme of economic development or economic transition.

The next paragraph specifies that such measures can be deployed as long as they do not discriminate among other WTO members, are consistent with the IMF Articles (thus pertaining only to capital-account controls), 'avoid unnecessary damage' to other members, do 'not exceed those necessary' to deal with the balance-of-payments problem, and are temporary and phased out progressively.

It may be extremely difficult for a capital control to meet all of these conditions, especially the hurdles dealing with the notion of 'necessity' – a slippery concept in trade law that countries have had difficulty proving. Moreover, concern has been expressed about the extent to which the balance-of-payments exception provides countries with the policy space for restrictions on capital inflows that are more preventative in nature and may occur before 'serious' balance-of-payments difficulties exist (Hagan, 2000). If a country does choose to use this derogation, it is required to notify the WTO's Balance-of-Payments Committee (described below).

Table 4 lists the 36 nations that have committed to scheduling the liberalisation of some combination of Modes 1, 2, and 3 under the GATS (Valckx, 2002). They would be the most prone to being disciplined under the GATS. Finally, there is not a reassuring record of countries being able to invoke exceptions at the WTO.

Table 4: Countries most vulnerable to actions against capital controls under GATS

Countries		
Argentina	Japan	Panama
Australia	Kuwait	Philippines
Bahrain	Kyrgyz Republic	Qatar
Canada	Latvia	Romania
Ecuador	Macau	Sierra Leone
Estonia	Malawi	Singapore
Gabon	Mauritius	Solomon Islands
Gambia	Mongolia	South Africa
Hong Kong	Mozambique	Switzerland
Hungary	New Zealand	Tunisia
Iceland	Nigeria	Turkey
Indonesia	Norway	United Arab Emirates
		United States

Source: Valckx (2002).

3.3 *Capital controls and current transactions*

Capital controls on the inflows or outflows of dividends, interest payments and the like are *current-account* restrictions. Remember that, as a rule, the IMF Articles of Agreement do not permit current-account restrictions. However, the IMF may recommend diversion from those rules during a crisis and/or under an IMF financial programme. In these circumstances, Article XI, paragraph 2 of the GATS applies. It states that the IMF has jurisdiction over these types of circumstances and the GATS does not apply. Therefore, when a country is permitted by the IMF as part of an IMF financial programme to pursue capital controls on current transactions, as has been the case with Iceland in 2008-9, then the WTO has no jurisdiction over the use of controls.

When a country seeks to pursue capital controls related to the current account and such actions are not part of an IMF financial programme, it has the potential to do so but has to submit a request to the WTO's Balance-of-Payments Committee.

3.4 The Balance-of-Payments Committee

Any capital control involving capital- or current-account restrictions must be submitted to the Committee on Balance-of-Payments Restrictions, which was established for the earlier BOP safeguard under the GATT, and was traditionally responsible for consultation dealing with trade restriction for balance-of-payments purposes. The same body and procedures now apply to financial and other services.

The Committee has never pronounced on any current- or capital-account restrictions related to financial services, but the GATS text specifies that consultations related to these matters can evaluate whether the capital management techniques (CMT) meet the various criteria outlined above, whether 'alternative corrective measures … may be available', and 'in particular' whether the measure is progressively phased out.

This is a unique procedure in the GATS. While the WTO compatibility of a country's domestic policy is normally tested only through formal dispute-settlement proceedings, CMTs face an additional set of hurdles and proceedings under Article XII.

Returning to some of the key questions outlined above, the following can be said about the WTO in relation to capital controls. While the WTO's financial-services provisions remain untested in formal dispute settlement, they nonetheless represent the world's only multilateral body with enforcement capacity to discipline capital controls, on terms that provide less policy space than the IMF Articles of Agreement. Capital controls may be disciplined under the WTO for approximately 50 of its members. If a country has made commitments in financial services, restrictions on inflows are explicitly mentioned in the market-access provisions of the GATS (though not one capital control is explicitly listed in the non-exhaustive list) but outflows may also be covered. In terms of compliance, the potential penalty for non-compliance is sustained cash payments or cross-retaliation rights to a large set of complaining countries. When countries file claims, the dispute-resolution process is 'state-to-state' rather than 'investor-state' which will be discussed later in this article.

4 Capital controls in US trade and investment treaties

The US has engaged in investment treaty-making since its War of Independence through what were called Friendship, Commerce and Navigation treaties. The successors to these agreements are bilateral investment treaties (BITs), which the US has been negotiating since 1977. The US did not invent BITS; Europeans have BITS going back to 1959. Indeed, there are now close to 2000 BITS in existence. Beginning with NAFTA in 1994, US Free Trade Agreements also have investment provisions analogous to those found in BITs. Finally, BITs and FTAs also include provisions on financial services.

The US has concluded 46 BITS since 1977, and more recently has used very similar language to the BITS as part of investment chapters in 12 US FTAs (Vandevelde, 2008). This section reveals that US-style investment rules run far deeper and include many more limitations on the ability of nations to deploy capital controls. Specifically, US investment rules:

- elevate the rights of US capital investors over those of domestic capital investors, whereby US investors can file claims against violating parties through an investor-state dispute-settlement process and receive financial compensation for violations, while domestic investors do not have such rights;
- do not permit restrictions on both capital inflows and outflows; and
- provide no clear exceptions for balance-of-payments exceptions, though some FTAs provide a grace period for filing investor-state claims.

This section is in two parts: first, a short background on the purpose and main provisions of US BITS and investment components of FTAs; second, an examination of the extent to which countries may deploy capital controls under US BITS and FTAs.

4.1 Investment provisions in US BITS and FTAs

BITS and investment provisions in US FTAs have evolved over time to have at least five general features. Normally, through an inter-agency process and with input from outside experts and interests, the US puts together a 'Model BIT' that serves as the template for negotiations for BITS and FTAs:

> The model would be tendered to the other party at the beginning of negotiations with the hope that agreement would be reached on a text that did not differ substantively or even in a significant stylistic way from the model. If too many departures from the model were demanded by the other party, then no BIT would be concluded. (Vandevelde, 2008: 1)

Scholars have characterised the model BITS and subsequent treaties as occurring in three 'waves': from 1981 to early 1989, where 35 BITS were negotiated; from the early 1990s to 2002, where the NAFTA and a handful of BITS were signed; and from 2002 to the present, where FTAs with Chile, Singapore and Central America were negotiated (Vandevelde, 2008). Table 5 lists all US BITS and FTAs with investment provisions based on the various models. In 2009 the US engaged in a review of the 2004 Model BIT that formed the core of most US BITS and investment components of FTAs. The new model was scheduled for release in mid-2010 and may be used for negotiations of BITS with China, India and Brazil, and in FTA negotiations with Pacific nations.

This article will focus on the treaties completed up to and including the 2004 Model BIT, the last being the BIT with Rwanda and the FTAs with Peru, Colombia, Panama and South Korea (the last three signed but not ratified at the time of writing).

Table 5: US BITs and FTAs

Countries with BIT	
Albania	Jordan
Argentina	Kazakhstan
Armenia	Kyrgyzstan
Azerbaijan	Latvia
Bahrain	Lithuania
Bangladesh	Moldova
Bolivia	Mongolia
Bulgaria	Morocco
Cameroon	Mozambique
Congo, Democratic Republic of (Kinshasa)	Panama
Congo, Democratic Republic of (Brazzaville)	Poland
Croatia	Romania
Czech Republic	Senegal
Ecuador	Slovakia
Egypt	Sri Lanka
Estonia	Trinidad and Tobago
Georgia	Tunisia
Grenada	Turkey
Honduras	Ukraine
Jamaica	Uruguay
Countries with FTA	
Australia	Israel
Bahrain	Jordan
Canada	Mexico
Chile	Morocco
Costa Rica	Nicaragua
Dominican Republic	Oman
El Salvador	Peru
Guatemala	Singapore
Honduras	

Sources: http://tcc.export.gov/Trade_Agreements/Bilateral_Investment_Treaties/index.asp; http://www.ustr.gov/trade-agreements/free-trade-agreements

In terms of coverage, whereas the earliest BITS and FTAs focused almost solely on foreign direct investment, contemporary treaties cover both inflows and outflows of virtually all types of investment, including equities, securities, loans, derivatives, sovereign debt and the financial-services facilitators of such flows. According to Vandevelde (2008), there are five general components of US BITs and subsequent provisions in US FTAs:

(i) *Minimum standard of treatment* that an investor should enjoy, including national treatment and most-favoured-nation states in both the pre-establishment and post-establishment rights. On an absolute level, US investors are to receive 'fair and equitable treatment and full protection in accordance with customary international law'.
(ii) *Restrictions on expropriation.* BITS and FTAs strictly forbid the direct or indirect expropriation of US investments without prompt and full compensation.
(iii) *Free transfers.* US nationals and firms must be permitted to freely transfer payments in and out of a host country 'without delay'. This will be discussed in detail below.
(iv) *No performance requirements.* US BITS forbid nations from imposing performance requirements such as local content rules, joint venture and research and development requirements, export requirements, rules related to personnel decisions, and so forth.
(v) *Investor-state arbitration.* In stark contrast to dispute settlement under the WTO and all other aspects of FTAs other than investment rules, US firms have the right to binding arbitration of disputes related to violations of the agreements. As is the case with most BITS across the world, foreign firms do not have to file claims through governments but can take a claim to an arbitral panel, often the International Centre for the Settlement of Investment Disputes (ICSID) at the World Bank, for any perceived violation of the above principles.

In addition to these core elements, US treaties often have some so-called 'exceptions' such as for essential security, matters related to taxation (where there is another body of US international law), and others. Finally, post-2004 BITS have putative limitations on the ability of host states to reduce environmental or labour laws to attract foreign investment. Before moving forward, it should be underscored that these treaties elevate foreign-investor rights over those of domestic investors, as they do not require the host country's firms to liberalise their investments, nor do they permit host-country investors to use investor-state arbitration (Hagan, 2000). Table 5 lists those nations with a BIT or FTA with the United States.

4.2 Capital controls and US BITS and FTAs

The free transfer of funds to and from the US is a core principle of US BITS and FTAs, as well as those of most other capital-exporting countries. When a host country violates this principle, or if capital transfers violate the other principles, a country could be subject to an investor-state arbitration claim where it could be sued for damages. All the US BITS and FTAs therefore restrict the ability of host countries to deploy capital controls (Anderson, 2009a). Argentina, after its crisis in 2001-2, was subject to numerous such claims in hundreds of millions of dollars.

All US BITS and FTAs require host countries to permit free transfers without delay of all types of covered investments. Moreover, financial services are covered in BITs and comprise a separate chapter in FTAs. Analogous to the GATS, if a country commits to liberalising financial services, the free flow of such investment is covered there as well. It should be noted, however, that under the services chapters of FTAs, dispute resolution is state-to-state.

Over the years US treaties have listed numerous types of investments covered, such as securities, loans, FDI, bonds (both sovereign and private) and derivatives. Treaties also make a point of saying that such a list is non-exhaustive. Taken together, the transfers provisions, along with the other principles of the agreements, ensure that an investment can enter and leave a country freely. If such an investment is restricted, a host country can be subject to arbitration.

Of all the treaties the US has signed, there is only one clear exception to this rule, the balance-of-payments exception found in NAFTA. Article 2014(1) can be invoked when the host state 'experiences serious balance-of-payments difficulties, or the threat thereof'. Like similar exceptions at the WTO and OECD, use of the exception must be temporary, non-discriminatory, and consistent with the IMF Articles of Agreement (thus capital controls can only be aimed at capital-account transactions if approved by the IMF).

4.3 'Cooling-off' provisions

As discussed earlier, Chile is a nation that has deployed capital controls with some success. The US negotiated FTAs with Chile and Singapore (which had also used capital controls in the wake of the 1997 Asian crisis) at the turn of the century; both came into force in 2004. The limits in the US model on capital controls became major sticking-points for both countries. In fact, during the negotiations with Chile, US trade relations head, Robert Zoellick, had to intervene with the Finance Minister of Chile to salvage the negotiations over this issue. During the negotiations the US negotiated a 'compromise' that, with some variation, has been used in agreements with Singapore, Peru and Colombia. Interestingly however, it has not become a matter of practice. Such a cooling-off period was not included in the 2004 Model BIT nor the FTAs with DR-CAFTA,[1] Panama and others.

The compromise has since become known as the 'cooling-off' provision, whereby the US cannot file a claim as in violation of the investment provisions until a period of one year after the provision has been deployed. The cooling-off periods are illustrated in an Annex to the agreements. The rationale would be that the host country may need to address or stem a financial crisis and that it should not be subject to claims in the middle of such action. However – and this is important – the cooling-off period allows a foreign investor to sue for damages related to capital controls that were deployed during the cool-off year, but cannot file the claim until after that year. In other words, an investor has to wait one year to file a claim related to capital controls to prevent and

1. United States, Dominican Republic and Central American Free Trade Agreement.

mitigate crises, but that claim can be for a measure taken during the cooling-off year (Hornbeck, 2003).

It should also be noted that these provisions are not mutual. The cooling-off period is only for investors suing 'a Party other than the United States'. Finally, the Annexes agree that, once the claim is brought, only 'actual reduction of the value of the transfer' counts as a loss. Loss of profits, loss of business, and other similar consequential or incidental damages cannot be recovered. All of these agreements include some exceptions to the Annex, instances where the cooling-off period and limitation on damages do not apply: payments on current transactions, on transfers associated with equity investments, and loan or bond payments.

The cooling-off language triggered controversy in the US, leading to hearings specifically on the subject on 1 April 2003 at the Subcommittee on Domestic and International Monetary, Trade and Technology of the Committee on Financial Services in the House of Representatives (US House of Representatives, 2003). The lively hearings, chaired by Congressman Michael Oxley (R-Indiana, majority), with the minority head being Barney Frank (D-Massachusetts), revealed that most Republicans were against the use of capital controls, whereas Democrats favoured more flexibility.

The leading advocate for restricting capital controls was John Taylor, then Under-Secretary of the US Treasury for International Affairs in the Bush Administration. As a Stanford University economist he had become famous for the 'Taylor Rule' which sets a formula for inflation targeting. Insiders thus began referring to the cooling-off provisions as the 'Taylor Provisions'. Interestingly, the hearings included harsh rebuttals to Taylor from Nancy Birdsall of the Center for Global Development, Jagdish Bhagwati of Columbia University, and Daniel Tarullo, then of Georgetown University and now on the Board of Governors of the US Federal Reserve System. These individuals are staunch supporters of free trade in goods, but argued that capital-account liberalisation without exceptions is dangerous from the economic and foreign policy perspectives. Congresswoman Carolyn Maloney (D-New York, now chair of the Joint Economic Committee) argued in favour of flexibility. At the hearings, Barney Frank famously remarked that 'ice is in the eyes of the beholder', arguing that the cooling-off period still effectively restricts Chile and Singapore from using capital controls.

Around the same time senior IMF officials in the legal department wrote articles arguing that BITS should have at least temporary derogations for balance-of-payments difficulties and that the cooling-off period was not sufficient. Hagan (2000) expresses concern that if one nation forbids a host country to use capital controls on a temporary basis but the host country is permitted to use controls under agreements with other nations, then the controls will be discriminatory in nature and will lead to distortions. Siegel (2004), who called the cooling-off provisions 'draconian', expressed concern that the US transfers provisions raised jurisdictional issues with the IMF. The US provisions call for free transfers of all current transactions but, unlike WTO, OECD and other capital exporters, the US provisions do not include mention of the ability of the IMF to recommend capital controls as part of a financial programme. Siegel argues that FTAs 'create a risk that in complying with its obligations under the FTA, a member could be rendered ineligible to use the Fund's resources under the Fund's articles' (Siegel, 2004: 4). Finally, in meetings with IMF officials concern was expressed over the lack of consistency between US agreements and others. For instance, South Korea has a broad exception under the OECD codes and its other BITs, but not with the US. Which measure holds?

4.4 Illustrative discussion of capital controls and violations of US investment rules

It should be clear from the above discussion that capital controls are in fundamental violation of the core principle in US trade and investment treaties that requires the free transfer of funds without delay. That said, it is important to understand exactly how these provisions work in relation to various types of controls. Such an exercise reveals that it is possible that some kinds of capital controls may be able to slip through US investment rules. However, given that there are no derogations in US treaties, such possibilities are far from certain. Some of the avenues in which capital controls could be actionable under US BITs and FTAs are exhibited in Table 6.

Table 6: Possible conflicts between capital controls and US agreements

Capital control	Potential conflict
Restrictions on currency mismatches	Absolute violation of transfers and services provisions; diminishes value of investment
Unremunerated reserve requirements	Absolute violation of transfers provisions; diminishes value of investment and analagous to an expropriation if an investor wanted to retrieve its funds during the 'minimum stay' portion of the URR
Taxes on inflows	Relative violation of pre-establishment national treatment; diminishes value of investment, could be seen as expropriation
Minimum-stay requirements	Absolute violation of transfers provisions analagous to an expropriation if an investor wanted to retrieve its funds during the 'minimum stay'
Taxes/restrictions on outflows	Absolute violation of transfers and services provisions, possible expropriation

Source: Compiled by the author.

Capital-inflow restrictions such as unremunerated reserve requirements (URR), minimum-stay requirements, and outright prohibitions on certain types of inflows are designed to keep out or slow down the flow of short-term inflows into an economy. On the surface, restrictions on inflows may escape violation because an investor has to show that s/he has been 'damaged' or that the value of an investment has been diminished in order to file a claim. Instruments to prevent an investment before it occurs may therefore have more 'cover' under the agreements. However, restrictions on inflows violate the ability of investors to have market access and national treatment pre-establishment. A claim could arise simply on those grounds, or because an investor that may have made regular previous investments in a host country and suddenly cannot could claim that s/he no longer enjoys fair and equitable treatment and the minimum standard of treatment under the agreement. What is more, if an investor wanted to pull funds from a country that were held by a URR or minimum-stay requirement (as a form of outflow then), the capital control would restrict the free transfer out of the country and clearly be subject to a claim – as would almost all the other outflows measures listed in Table 2. Indeed, not only are restrictions on outflows violations of transfers provisions, they can also be seen as expropriations. Moreover, if a country has committed to liberalising financial services under the services chapter of an FTA, all inflows and outflows that pertain to the (negatively) listed service could not be restricted.

One other possible avenue for policy space may be available for limits by domestic firms or domestic residents in borrowing or lending abroad. Remember that investment rules do not cover domestic investors, nor are domestic investors able to resort to investor-state dispute settlement. On the surface, such a provision would not be subject to a claim as a violation of the transfers provisions because such restrictions do not consider a covered investment. However, it may be possible that a claim could arise by an investor arguing that national treatment principles had been violated. By restricting US banks from lending in dollars it could possibly be claimed that a country is treating its domestic currency more favourably. An investor may attempt to claim that a measure of this kind is in violation of fair and equitable treatment for the reasons discussed above.

One window that would appear to be available to countries is the ability to tax capital inflows and outflows. Brazil taxed inflows of capital in late 2009; Malaysia taxed outflows in 1999. All US treaties have a chapter or series of paragraphs discussing taxation, saying that 'nothing in Section A shall impose obligations with respect to taxation measures'. But it distinguishes between traditional taxation and taxation that may be expropriating. Thus the evidence is not clear-cut. In one of the numerous cases against Argentina in the aftermath of its 2000-1 crisis, an ICSID tribunal ruled that a tax on outflows was tantamount to an expropriation (Salacuse, 2010).

It may be possible that a country can claim that actions taken during a financial crisis are measures needed to protect its essential security. Language like that of Article 18 of the 2004 US Model BIT is found in most treaties:

> to preclude a Party from applying measures that it considers necessary for the fulfillment of its obligations with respect to the maintenance or restoration of international peace or security, or the protection of its own essential security interests.

The article does not mention economic crises *per se* but 'all tribunals that have considered the matter thus far have interpreted the rules broadly enough to include such crises' (Salacuse, 2010: 345). However, tribunals differ greatly over how grave the difficulties may be. In Argentina again, only one of three tribunals ruled that it could not be held liable for actions it took to halt its crisis (Salacuse, 2010). A key matter is whether or not a measure taken by a country to stem a crisis can be seen as 'self-judging'. In other words, can the country deploying the control be the judge of whether or not the measure taken was necessary to protect its security? The language quoted above in the 2004 Model BIT, which says 'that *it* considers' is now seen as meaning that a measure is self-judging (because of the '*it*'), but Argentina's BITs with the US and others did not include such precise language at the time.

Finally, Article 20.1 of the 2004 Model BIT includes a provision on prudential measures that has almost the exact language found in the GATS under domestic regulations. It reads:

> Notwithstanding any other provision of this Treaty, a Party shall not be prevented from adopting or maintaining measures relating to financial services for prudential reasons, including for the protection of investors, depositors, policy holders, or persons to whom a fiduciary duty is owed by a financial services supplier, or to ensure the integrity and stability of the financial system. Where such measures do not conform with the provisions of this Treaty, they shall not be used as a means of avoiding the Party's commitments or obligations under this Treaty.

This language is only to be found in the US-Rwanda BIT that is yet to be ratified, and is not found in US FTAs. Regarding capital controls, the US government has stated that it is not its intention that controls be covered under this provision (United States Department of State Advisory Committee on International Economic Policy, 2009). As discussed earlier, some have expressed concern that the last sentence of this paragraph may be self-cancelling; others see it as quite flexible (Key, 2003; Raghavan, 2009; Stumberg, 2009; Tucker and Wallach, 2009; Van Aaken and Kurtz, 2009).

5 US investment provisions vs those by other major capital exporters

The investment provisions in US FTAs and BITS stand in stark contrast to the treaties of other major capital-exporting nations. This section reviews the measures in the OECD codes of liberalisation, and some specific treaties by the European Union, Canada, Japan and China.

5.1 OECD codes

In many respects the OECD has the most expansive investment rules, since they cover all types of capital flows whether from the current or capital account. However, it also has the broadest level of temporary derogations. Similar scope and derogation can be found in the OECD-sponsored Multilateral Agreement on Investment (MAI), which has never been agreed upon. In terms of policy space for capital controls under the OECD Codes and the MAI:

(i) members (OECD members) are expected to liberalise both the current and capital account;
(ii) members have a broad but temporary derogation where capital controls on both inflows and outflows are permitted; and
(iii) the OECD's draft MAI included a broad derogation analogous to that of the Codes.

Incorporated in the early 1960s, two legally binding 'Codes' govern capital flows in OECD countries: the Code of Liberalisation of Capital Movements and the Code of Liberalisation of Current Invisible Operations – usually referred to as the Capital Movements Code and the Current Invisible Code. These codes cover all types of investments – inflows and outflows from the current and capital account – and require their liberalisation.

Initially, speculative capital was excluded from the Codes on the grounds that short-term capital would disrupt the balance-of-payments position of OECD members and make it difficult for countries to pursue independent monetary and exchange-rate policies. This was changed in 1989 when a group of countries led by the UK and Germany argued that all OECD members by then had sufficiently sophisticated money markets to be able to withstand liberalisation of short-term flows. All countries that acceded to the OECD since 1989, regardless of their level of development, also liberalised their capital accounts fully to include short- and long-term maturities. South Korea, however, in its accession argued that it should have a grace period to open its capital account gradually as it developed. The OECD denied this request, conditioning membership on an open capital account. In the end, South Korea conceded (Abdelal, 2007).

Alongside the broad mandates for OECD countries, there are also broad exceptions. Article 7 (in each set of Codes) holds 'clauses of derogation' that govern the temporary suspension of commitments. Under these safeguards a country may suspend liberalisation. Article 7b allows a member to put in place temporary capital controls; to stem what may 'result in serious economic disturbance in the Member State concerned, that Member may withdraw those measures'. Article 7c is the balance-of-payments exception. 'If the overall balance of payments of a Member develops adversely at a rate and in circumstances, including the state of its monetary reserves, which it considers serious that Member may temporarily suspend the application of measures of liberalisation taken' (OECD, 2009). Greece, Iceland, Portugal, Spain and Turkey have all used the derogation. The OECD permitted them to do so because they were seen to be at a lower stage of development relative to the other members of the OECD (Abdelal, 2007).

The OECD-sponsored Multilateral Agreement on Investment was launched in 1995 as an attempt at a global treaty that would have similar provisions to the Codes – for OECD and non-OECD (developing) countries alike. The draft text of this treaty included a broad safeguard for capital controls and other measures for balance-of-payments problems. In the end the MAI was abandoned in 1998 (OECD, 1998).

5.2 BITS and FTAs for other major capital exporters

The EU, Japan, Canada, and increasingly China are major capital exporters. Each of them has numerous BITs and FTAs with countries across the world, and their BITs have roughly the same general characteristics as are found in US BITs. However, in the case of the use of capital controls to prevent and mitigate financial crises, the BITs and investment provisions of all BITs and FTAs by these exporters contain either a broad 'balance-of-payments' temporary safeguard exception or a 'controlled-entry' exception that allows a country to deploy its domestic laws pertaining to capital controls.

Examples of the balance-of-payments approach can be found in the EU-South Africa and EU-Mexico FTAs (Mexico also negotiated such a provision in NAFTA), the Japan-South Korea BIT, and the ASEAN agreements. The Korea-Japan BIT contains language that clearly allows for restrictions on both inflows and outflows, presumably inspired by the 1997 crisis. The BIT states that nations may violate transfers provisions (a) in the event of serious balance-of-payments and external financial difficulties or threat thereof; or (b) in cases where, in exceptional circumstances, movements of capital cause or threaten to cause serious difficulties for macroeconomic management, in particular, monetary or exchange-rate policies (Salucuse, 2010: 268).

'Controlled entry' means that a country's domestic laws regarding capital controls are deferred to. Canada's and the EU's FTAs with Chile and Colombia each have a balance-of-payments safeguard *and* a controlled-entry deferment (Canada Foreign Affairs and International Trade, 2009). As an example of controlled entry, the investment chapter of the FTA between Canada and Colombia has an Annex which states: 'Colombia reserves the right to maintain or adopt measures to maintain or preserve the stability of its currency, in accordance with Colombian domestic legislation.'

Controlled-entry provisions are to be found in BITS as well. The EU does not sign many BITS as a union, but its individual Member States do. The China-Germany BIT states that transfers must comply with China's laws on exchange controls (Anderson, 2009b). In the case of China, this country has to approve all foreign inflows and outflows of short-term capital (IMF, 2009).

Interestingly, EU Member States' BITS vary a great deal. Some, like the China-Germany BIT and the UK-Bangladesh BIT, allow for a country to defer to its own laws governing capital controls. On the other hand, Sweden and Austria have US-style BITs with no exceptions whatsoever. However, the European Court of Justice ruled in 2009 that the BITS of Sweden and Austria with several developing countries were in violation of their obligations under the EU treaty. While this treaty requires EU Members to allow for free transfers, it also allows them to have exceptions. The Court found that the treaties of Sweden and Austria were incompatible with the EU treaty and that such treaties would need to be renegotiated to include exceptions to the transfer provisions (Salacuse, 2010).

Echoing concerns expressed by the IMF earlier in this article, host countries facing a diversity of commitments through different treaties can cause jurisdictional issues and economic distortions. The pending US-South Korea Free Trade Agreement is illustrative of the jurisdictional issue. If South Korea decides that it needs to deploy controls on inflows as a prudential measure to prevent a crisis, it may have all the leeway to do so under the exceptions to the OECD codes, but not under the FTA with the United States. A conflict over which regime should prevail could arise. This could be further accentuated if the IMF was asked to conduct a country programme for South Korea and advised it to deploy capital controls.

The US FTAs with Chile and Colombia just discussed are examples of potential discrimination problems. If Chile or Colombia wished to deploy a non-discriminatory URR to all short-term capital inflows, their treaty commitments would not permit the measures to be truly non-discriminatory. They would only be able to apply the measure to the EU or to Canadian firms and capital, not to capital flowing from the United

States, thereby distorting capital markets and defeating the purpose of the non-discriminatory prudential measure.

Returning to some of the key questions outlined above, the following can be said about the BITS and FTAs in relation to capital controls. The US holds 58 signed or pending BITs and FTAs with other countries. Almost all capital controls are actionable under these treaties. Recourse can be in the form of a one-time compensatory pay-off.

6 Summary and recommendations for policy

This article has shown that US trade and investment agreements, and to some extent the WTO, leave little room for deploying capital controls to prevent and mitigate a financial crisis. This is the case despite the increasing economic evidence that certain capital controls can be useful in this respect. It also stands in contrast with investment rules under the treaties of most capital-exporting nations.

That having being said, there is room for developing countries to deploy capital controls to prevent and mitigate financial crises under the following circumstances:

(i) the controls are on capital, not current, transactions unless sanctioned by the IMF;
(ii) the country has not committed to financial services under the GATS at the WTO; and
(iii) it does not have a BIT or FTA with the United States.

In terms of the WTO, close to 100 nations have not made financial-services commitments under the GATS and are therefore free to deploy whichever type of capital control on capital-account transactions they see necessary. However, the 37 economies listed in Table 4 have made significant commitments on either Modes 1 or 3 for financial services and could be significantly vulnerable to actions against the use of capital controls.

Those nations that still retain the policy space to deploy capital controls and have not reached the threshold (identified by Kose et al., discussed earlier) necessary to withstand capital-account liberalisation should pursue Mode 1 (cross-border trade in financial services) commitments with caution in the Doha Round. As this article has shown, such commitments implicitly require an opening of the capital account. Moreover, they should exercise even more caution in terms of Mode 3 (FDI in financial services) commitments. The IMF study discussed in this article shows that those developing countries that liberalised FDI in financial services fared worse during the current crisis (Ostry et al., 2010). Regarding those countries that have already made commitments with respect to financial services under the GATS (the countries in Table 4), their only recourse will be the untested exceptions for prudential regulation and balance-of-payments exceptions.

Many countries fall under this category, of course, including China, Brazil, India and others which frequently deploy capital controls either on a permanent or temporary basis to ensure macroeconomic stability. A more plausible option is reforming current and future agreements. Especially in the wake of the current global financial crisis, countries should co-ordinate their policies so as to avoid discrimination and jurisdictional inconsistency. Based on the analyses in this article, there are 5 nonexclusive examples that the US could consider that would give countries the proper policy space for capital controls:

(i) Remove short-term debt obligations and portfolio investments from the list of investments covered in treaties. This has been raised as a possibility by actors ranging from the IMF to civil society (Hagan, 2000; International Institute for Sustainable Development-IISD, 2005).
(ii) Create 'controlled-entry' Annexes in BITs and FTAs analogous to the Canada-Chile, Canada-Colombia, Chinese, and EU agreements with those countries. Controlled entry grants a nation the full ability to use capital controls on capital-account transactions as it sees fit.
(iii) Design a balance-of-payments exception that covers both inflows and outflows, such as the provisions found in the Japan-South Korea BIT.
(iv) Clarify that the Essential Security exceptions cover financial crises, and that measures taken by host nations are self-judging.
(v) Resort to a state-to-state dispute-resolution process for claims related to financial crises, analogous to the WTO and the other chapters in most FTAs.

The last recommendation is an important one. Scholars argue that under a state-to-state dispute-resolution system the state can take a much broader view regarding financial stability than an individual firm can. Whereas individual speculative firms may stand to lose from a capital control in the short term (unless their clients default, of course), the net welfare benefits of a measure may be positive. The state is seen as being in a better position to 'screen' for such benefits and also to weigh a dispute case against a variety of other geopolitical and economic concerns it may have with a host country. Given that BITs and FTAs currently lack state-to-state dispute systems with appropriate screening mechanisms, some scholars predict that these will be used most by the private sector to file claims in response to measures taken to mitigate the global financial crisis (Van Aaken and Kurtz, 2009).

Leading political scientists have been puzzled as to why the US continues its policy of capital-account liberalisation, given the economic evidence, the treaties of its peers, and given that it has been shown in the political-economy literature that governments should favour capital controls (Alfaro, 2004). Cohen (2007) attributes the US stance to a combination of ideology and domestic politics. Regardless of the party in power in the US, Treasury officials and Presidential advisers have largely held neo-liberal beliefs and training. Perhaps more importantly, Cohen illustrates that while the costs of capital controls are directly felt by a handful of politically organised US constituents – Wall Street – the beneficiaries are diffuse and do not feel the direct effects. Thus a collective-action problem persists where Wall Street organises around capital-account liberalisation.

The arguments posed by the community lobbying against flexibilities for capital controls in the US are threefold. It is argued, first, that capital controls simply do not work and that US treaties help nations get rid of sub-optimal policy; second, that such controls hurt US investors by restricting their ability to mobilise funds; and third, that changing these treaties would send a signal that earlier treaties are problematic and jeopardise commitments previously taken.

The evidence and politics may be changing. As discussed earlier in the article, the evidence in favour of many capital controls is positive. Secondly, the current crisis has made it clear that, while it is recognised that some individuals in the short term may incur damage, that damage may be minimal relative to what it could be in a crisis. Stability among our investment partners helps US investors and exporters have more certainty with regard to markets. Crises could lead to defaults and large losses to US assets and export markets. And crises can cause contagion that spreads to other US investment and export destinations. Thirdly, the US may now be more sensitive, given that it has taken numerous prudential measures in the wake of the current crisis – measures that may not survive the scrutiny of various trade and investment treaties with capital exporters who have investments in the US (Van Aaken and Kurtz, 2009).

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