Professor Michael P. Dooley joined the faculty at the University of California, Santa Cruz in 1992 following more than twenty years service at the Board of Governors of the Federal Reserve System and the International Monetary Fund. His published research covers a wide range of issues in open economy macroeconomics including work on crises in emerging markets, capital controls, international capital movements, debt restructuring, capital flight and liberalization of financial markets.

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The US government's aggressive response to the financial crisis that rocked Mexico in 1994 was an important watershed in the evolution of the international monetary system. For the first time since the debt crisis of 1982 the US government and the governments of other industrial countries responded to a developing country financial crisis with lending that was both timely and large enough to stabilize markets. By any reasonable measure the policy was a success. The crisis was contained, Mexico recovered relatively quickly and was able to repay its obligations ahead of schedule.

The downside of the more aggressive approach to crisis management emerged later with a series of crises in Russia, Eastern Europe and Asia. Simply put, private investors took comfort from governments' commitment to act quickly and decisively to limit the costs of financial crises through official lending. Such a policy allows private investors to liquidate their claims on a country on better terms than would be available without the government backstop. This does not mean that all private lenders are fully insured. Clearly there have been very painful losses to investors following recent crises. When private investors rush to exit and some are left behind. But, on average, the costs of crises to international investors have been reduced and they have responded with more, and less careful, lending.

If we are to continue to enjoy the full benefits of trade with emerging markets, this sequence of crisis, bailouts and more crises will have to be broken. The continued growth and vitality of emerging markets will require open and competitive financial markets. But financial crises can generate very large reductions in economic activity in these markets. A typical crisis reduces growth in developing countries by about five percentage points for four years. This is an important threat to US exports, the availability of imports and to the stability of the international monetary system. Aggressive official lending has helped contain these costs but has encouraged reckless borrowing and lending and more frequent crises.
In a recent paper (http://www.gsia.cmu.edu/afs/andrew/gsia/bm05/final11-6.PDF) I argue that the only approach to this dilemma which is both effective and feasible is for creditor governments to require concessions by private lenders as a condition for their loans to debtor countries. This is sometimes called “bailing in” the private sector and, through the IMF, creditor governments have recently made some small steps in this direction.

If this approach is to have a chance of success, creditor governments and especially the United States must be willing to finance debtor countries for extended time periods while debtor governments negotiate with private investors from a position of strength. It follows that creditor governments and the IMF will have to be much more selective in choosing debtor countries that can effectively utilize financial assistance.

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