ARIZONA STATE UNIVERSITY

GENERAL STUDIES COURSE PROPOSAL COVER FORM

Course information:

*Copy and paste **current** course information from Class Search/Course Catalog.*

College/School	Thunderbird School of Global Management		Department	BGM	
Prefix	TGM	Number	468	Title	States and Markets in the Global Economy	Units: 3

Is this a cross-listed course? No If yes, please identify course(s)

Is this a shared course? No If so, list all academic units offering this course

*Note- For courses that are crosslisted and/or shared, a letter of support from the chair/director of **each** department that offers the course is required for **each** designation requested. By submitting this letter of support, the chair/director agrees to ensure that all faculty teaching the course are aware of the General Studies designation(s) and will teach the course in a manner that meets the criteria for each approved designation.*

Is this a permanent numbered course with topics? No

If yes, all topics under this permanent numbered course must be taught in a manner that meets the criteria for the approved designation(s). It is the responsibility of the chair/director to ensure that all faculty teaching the course are aware of the General Studies designation(s) and adhere to the above guidelines.

Chair/Director Initials ______ (Required)

Course description: **Global managers operate in an international economy that presents tremendous opportunities as well as risks. Globalization has dramatically expanded opportunities for international trade, investment and economic development. At the same time, global managers have to deal with the prospect of trade wars, international financial crises and intensified competition over markets and resources. In addition, international organizations such as the International Monetary Fund, World Trade Organization and World Bank Group have a direct impact on international business operations. Develops analytical tools for understanding the rapidly changing and dynamic global political. With these tools, managers are better prepared to anticipate the risks and take advantage of opportunities in the global economy.**

Requested designation: Global Awareness–G **Mandatory Review:** No

*Note- a **separate** proposal is required for each designation.*

Eligibility:

Permanent numbered courses must have completed the university's review and approval process.
For the rules governing approval of omnibus courses, contact Phyllis.Lucie@asu.edu.

Submission deadlines dates are as follow:

For Fall 2016 Effective Date: October 1, 2015 For Spring 2017 Effective Date: March 10, 2016

Area(s) proposed course will serve:

A single course may be proposed for more than one core or awareness area. A course may satisfy a core area requirement and more than one awareness area requirements concurrently, but may not satisfy requirements in two core areas simultaneously, even if approved for those areas. With departmental consent, an approved General Studies course may be counted toward both the General Studies requirement and the major program of study.

Checklists for general studies designations:

Complete and attach the appropriate checklist

- Literacy and Critical Inquiry core courses (L)
- Mathematics core courses (MA)
- Computer/statistics/quantitative applications core courses (CS)
- Humanities, Arts and Design core courses (HU)
- Social-Behavioral Sciences core courses (SB)
- Natural Sciences core courses (SQ/SG)
- Cultural Diversity in the United States courses (C)
- Global Awareness courses (G)
- Historical Awareness courses (H)

A complete proposal should include:

☒ Signed course proposal cover form
☒ Criteria checklist for General Studies designation(s) being requested
☒ Course catalog description
☒ Sample syllabus for the course
☒ Copy of table of contents from the textbook and list of required readings/books

It is respectfully requested that proposals are submitted electronically with all files compiled into one PDF.

Contact information:

Name Cheri Roberts E-mail cheri.roberts@asu.edu Phone 602-978-7335

ARIZONA STATE UNIVERSITY

Department Chair/Director approval: *(Required)*

Chair/Director name (Typed): Roy Nelson Date: 6/13/16

Chair/Director (Signature): Roy Nelson

Arizona State University Criteria Checklist for

GLOBAL AWARENESS [G]

Rationale and Objectives

Human organizations and relationships have evolved from being family and village centered to modern global interdependence. The greatest challenge in the nuclear age is developing and maintaining a global perspective which fosters international cooperation. While the modern world is comprised of politically independent states, people must transcend nationalism and recognize the significant interdependence among peoples of the world. The exposure of students to different cultural systems provides the background of thought necessary to developing a global perspective.

Cultural learning is present in many disciplines. Exposure to perspectives on art, business, engineering, music, and the natural and social sciences that lead to an understanding of the contemporary world supports the view that intercultural interaction has become a daily necessity. The complexity of American society forces people to balance regional and national goals with global concerns. Many of the most serious problems are world issues and require solutions which exhibit mutuality and reciprocity. No longer are hunger, ecology, health care delivery, language planning, information exchanges, economic and social developments, law, technology transfer, philosophy, and the arts solely national concerns; they affect all the people of the world. Survival may be dependent on the ability to generate global solutions to some of the most pressing problems.

The word university, from universitas, implies that knowledge comes from many sources and is not restricted to local, regional, or national perspectives. The Global Awareness Area recognizes the need for an understanding of the values, elements, and social processes of cultures other than the culture of the United States. Learning which recognizes the nature of others cultures and the relationship of America's cultural system to generic human goals and welfare will help create the multicultural and global perspective necessary for effective interaction in the human community.

Courses which meet the requirement in global awareness are of one or more of the following types: **(1)** in-depth area studies which are concerned with an examination of culture-specific elements of a region of the world, country, or culture group, **(2)** the study of contemporary non-English language courses that have a significant cultural component, **(3)** comparative cultural studies with an emphasis on non-U.S. areas, and **(4)** in-depth studies of non-U.S. centered cultural interrelationships of global scope such as the global interdependence produced by problems of world ecology, multinational corporations, migration, and the threat of nuclear war.

Reviewed 4/2014

Proposer: Please complete the following section and attach appropriate documentation.

ASU--[G] CRITERIA			
GLOBAL AWARENESS [G]			
YES	**NO**		**Identify Documentation Submitted**
☒	☐	**1.** Studies **must** be composed of subject matter that addresses or leads to an understanding of the contemporary world outside the U.S.	Syllabus; textbook; coursepack
		2. The course must match at least one of the following descriptions: (check all which may apply):	
☒	☐	a. In-depth area studies which are concerned with an examination of culture-specific elements of a region, country or culture group**. The area or culture studied must be non-U.S**. **and the study must contribute to an understanding of the contemporary world.**	Syllabus; textbook; coursepack
☐	☐	b. The course is a language course for a contemporary non-English language, and has a significant cultural component.	
☒	☐	c. The course is a comparative cultural study in which most, i.e., more than half, of the material is devoted to non-U.S. areas.	Syllabus; textbook; coursepack
☒	☐	d. The course is a study of the cultural significance of a non-U.S.-centered global issue. The course examines the role of its target issue within each culture and the interrelatedness of various global cultures on that issue. It looks at the cultural significance of its issue in various cultures outside the U.S., both examining the issue's place within each culture and the effects of that issue on world cultures."	Syllabus; textbook; coursepack

Course Prefix	Number	Title	Designation
TGM	468	States and Markets in the Global Economy	Global Awareness (G)

Explain in detail which student activities correspond to the specific designation criteria. Please use the following organizer to explain how the criteria are being met.

Criteria (from checksheet)	**How course meets spirit (contextualize specific examples in next column)**	**Please provide detailed evidence of how course meets criteria (i.e., where in syllabus)**
SAMPLE: 2d: study the cultural significance of a non-U.S. centered global issue	**SAMPLE:** The course examines the cultural significance of financial markets Japan, Korea, and the UK.	**SAMPLE:** Module 2 shows how Japanese literature has shaped how Japanese people understand world markets. Module 3 shows how Japanese popular culture has been changed by the world financial market system. Modules 4 & 5 do the same for Korea and modules 6 & 7 do the same for the UK.
1 (see description for 1 above)	The overall objective of this course is to develop analytical tools for understanding the global business environment al economy. The course covers international organizations such as the IMF, World Bank, WTO and their impact on the business environmen t of countries around the world.	Week 3 includes a case on the IMF and South Korea; Week 5 includes a case on the World Bank's involvement in Chad and Camerron; Week 8 includes a case on "Banana Wars," related to the EU"s dispute over exports of bananas from Latin America.
2a (see description for 2a above)	Every week of this course deals with non-U.S. issues that involve other countries.	See not only Weeks 3 (South Korea), 5 (Chad and Cameroon), 8 (the EU and Latin America) , but also topics involving global economic isues, such as Week 2 (International Monetary Relations and the IMF), Week 4 (the World Bank), Week 6 (the World Trade Organization), and Week 7 (Relations between developed and developing countries)
2c (see description for 2c above)	See above	See above

2d (see description above)	See above	See above

TGM 468: STATES AND MARKETS IN THE GLOBAL ECONOMY

Dr. Roy Nelson

Spring 2015

COURSE DESRIPTION AND OBJECTIVES

Global managers operate in an international economy that presents tremendous opportunities as well as risks. Globalization has dramatically expanded opportunities for international trade, investment, and economic development. At the same time, global managers have to deal with the prospect of trade wars, international financial crises, and intensified competition over markets and resources. In addition, international organizations such as the International Monetary Fund, World Trade Organization and World Bank Group have a direct impact on international business operations. The overall objective of this course is to develop analytical tools for understanding the rapidly changing and dynamic global political. With these tools, managers will be better prepared to anticipate the risks and take advantage of the opportunities they will encounter in the global economy.

The specific objectives of this course are the following:

- To develop tools of analysis for understanding trends and developments in the global economy
- To develop students' abilities to use these tools to assess international economic institutions such as the International Monetary Fund, World Trade Organization, and World Bank Group
- To develop analytical tools for assessing a country's foreign economic policy
- To introduce students to analytical frameworks for country risk analysis

TEACHING METHODS

This course will use a variety of teaching methods including lectures, case studies, third party web videos, individual work assignments, online quizzes, collaborative group learning, and discussion.

REQUIRED READINGS

- David Balaam and Michael Dillman, *Introduction to Political Economy 6*th edition (Pearson, 2013 – e-book or paperback version).
- Roy Nelson, *STATES AND MARKETS, Spring 2015 course pack.*
- *Financial Times* – available free online via IBIC database
- *On-line readings on Blackboard:* These are designated in the syllabus with a + (plus sign).

GRADING

5 Quizzes…………………………………………………….…. 15% (3% each)
Group Research Project…………………………………..…. 25%
Comprehensive Final Exam………………………………..… 50%
Discussion…………………………………………………… 10%

Your final grade is based upon your class standing (the sum of the quizzes, group research project, final exam, and class participation scores).

QUIZZES (15%)
You will take five (5) quizzes. These will test your comprehension of course material, including analytical frameworks/concepts, descriptive content, and cases, that we have covered as we proceed through the trimester. Each quiz accounts for 3% of your grade. Therefore all five quizzes account for 15% of your final grade.

To familiarize yourself with the format and appearance of the online timed assessments used for these quizzes, I have created a Mock Quiz for you to try out (see top of course page). In advance of the first quiz, it is highly recommended that you try out the Mock Quiz. It is your responsibility to familiarize yourself with this assessment format.

The quizzes are open-book, timed assessments in which you will answer several multiple choice and/or true/false questions. You will have 30 minutes to complete each quiz. Each assignment is to be completed individually without the assistance of others, and Thunderbird's Honor Code will be in effect. The honor code not only prohibits the sharing of answers, ***it also prohibits conveying the questions among each other before the time period for the assignment has expired***

GROUP RESEARCH PROJECT (25%) The group research project is a 5-7 page (double-spaced) group research paper on a topic related to the International Monetary Fund (IMF), the World Trade Organization (WTO), or the World Bank Group (WBG). The group project topics and further details will be posted to the course page. Please use the GPE GROUP PROJECT TOPICS discussion forum to express your preference for the project on which you want to work. All the projects are listed – all you need to do is reply to the posted project, confirming your interest in that project. You may indicate a first and second choice. I will do my best to accommodate your preferences.

Please post your reply to the selected project, indicating your interest, by XXX. I will finalize the groups and post the group assignments to our course page.

COMPREHENSIVE FINAL EXAM (50%)
The final exam is comprehensive, covering all the material you learned throughout the course. It will consist of multiple choice questions and one or more essay questions. The essay question(s) which will require you to apply the analytical frameworks you learned in the course.

“VALUE-ADDED” PARTICIPATION (10%)

COURSE SCHEDULE

WEEK 1

TOPIC: **Theories of States and Markets in the Global Economy**: These sessions will explain three major analytical perspectives (and recent variations on these perspectives) for assessing trends and developments in the global political economy. Although they may be called by different names – analytical perspectives, frameworks, ideologies, worldviews, or, in German, *Weltanschauung* – everyone holds them, to one degree or another, and we will use them in evaluating the IMF, World Bank, and WTO from different perspectives.

READ: Balaam & Dillman, *Introduction to International Political Economy*, Chapter 2-4.

DUE: Quiz 1

STUDY QUESTIONS / QUIZ PREPARATION:

1. In lecture we refer to the three main worldviews as "Liberalism, Economic Nationalism, and Marxism." (Balaam and Dillman refer to these as Liberalism, Mercantilism, and Structuralism.) What are the main differences between these views with regard to:
   a. the dominant actors
   b. the role of the state in the economy
2. How would a liberal view the IMF, World Bank, and WTO? An economic nationalist? A Marxist? What would each of these perspectives have to say about Mercosul and the Free Trade Area of the Americas (FTAA, or ALCA)?

   In the lecture, we will refer to Hegemonic Stability Theory as a view off the world that has its roots in economic nationalism. Balaam and Dillman, in contrast, view it as having its roots in liberalism (see pp. 48-49). (Incidentally, our view is correct!) What is the justification for both views?

3. As explained in the lecture, what is the main difference between economic nationalism and dependency theory?

WEEK 2

TOPIC: **Politics and the Management of International Monetary and Financial Relations:** In order to set the context for understanding the International Monetary Fund, we will use the frameworks to analyze the evolution of international monetary relations. We will discuss the emergence and decline of the Bretton Woods system, the evolution of the IMF, different perspectives on the nature of IMF operations, and IMF conditionality. We will also discuss the role of the London and Paris Clubs.

READ: Balaam and Dillman, Chapters 7-8.
+"IMF at a Glance" (from the IMF website)
+“What is the International Monetary Fund?” (from the IMF website)
+Joseph Stiglitz, “The Insider: What I Learned at the World Economic Crisis,” *New Republic*, April 17, 2000, pp. 56-60.
+“The Fund Bites Back,” *The Economist*, 2002, p. 92.
+Barry Eichengreen, “The Globalization Wars,” (review of Stiglitz’s book), *Foreign Affairs*, July/August 2002, pp. 157-164.
+Roy C. Nelson, “Causes and Consequences of Brazil’s 1999 Devaluation of the Real.”

<u>Optional Videos – Links on Course Page</u>:

- Millennium: The IMF and the New Century (short introductory film about the IMF)
- Joseph Stiglitz and Kenneth Rogoff discuss: Globalization and Its Discontents (lengthy, but very interesting – and ENTIRELY OPTIONAL!)

DUE: No Deliverables

STUDY QUESTIONS / QUIZ PREPARATION:

1. For what purpose(s) was the International Monetary Fund created?
2. How has its role changed over the years?
3. What role does the IMF play in maintaining a stable operating environment for international business?
4. What is IMF "conditionality"? What do the typical policy prescriptions of the IMF include?
5. What is “moral hazard”? What are some other criticisms of the IMF?
6. What are the London and Paris clubs, and what are the main differences between them?

WEEK 3:

TOPIC: **Managing the Asian Meltdown: The IMF and South Korea**

READ: *CASE: Gregory P. Corning, “Managing the Asian Meltdown: The IMF and South Korea,” 2000 (GPE coursepack).

Optional Videos – Links on Course Page:

- Commanding Heights: Contagion Engulfs Asia (link on course page)
- Conquering A Crisis—the IMF's role in helping Korea overcome the Asian Crisis

DUE: Quiz #2

STUDY QUESTIONS / QUIZ PREPARATION:

1. Why did this crisis occur?
2. Is Korea to blame, or was it the victim of external economic shocks?
3. What was the IMF's response to this crisis?
4. What are the liberal, economic nationalist and Marxist analyses of this response?
5. What are the main criticisms of the IMF: Feldstein and Sachs view, "moral hazard" view, etc?
6. What response do you believe would have been appropriate, and why?
7. What was the final outcome of this case? Does this support or refute the approach the IMF took to this crisis?

WEEK 4

TOPIC: **Economic Development and the World Bank:** These sessions will discuss the evolution of the International Bank for Reconstruction and Development (IBRD); the International Development Association, International Finance Corporation, MIGA, and the emerging World Bank Group; organization and structure of the World Bank organization; lending policies of the World Bank Group; evolution of the organization; addressing the international debt problem; project, poverty and structural adjustment lending

READ:
+"World Bank Group at a Glance" (from WBG website)
+"World Development Report 2002: Building Institutions for Markets" (summary; from WBG website).
+Steven Pearlstein, "World Bank Rethinks Poverty," *The Washington Post*, September 13, 2000, p. E1.
+"World Development Reports Homepage" (from the WBG website)
+Jessica Einhorn, "Reforming the World Bank," *Foreign Affairs*, January
February 2006, pp. 17-22.

DUE: No Deliverables

STUDY QUESTIONS / QUIZ PREPARATION

1. In what ways is the World Bank similar to the IMF? How is it different?
2. How has the World Bank's approach evolved over time? What are the various phases?
3. Does this reflect a change in the Bank's overall world view?
4. What are the various institutions that comprise the World Bank Group, and what are their individual roles?
5. What is the focus of criticism against the World Bank?
6. How is the Kim era at the World Bank likely to differ from previous eras? What will change, and what will remain the same?

WEEK 5

TOPIC: **The Chad-Cameroon Petroleum Development and Pipeline Project**

READ: *CASE: Benjamin C. Esty and Carrie Ferman, "The Chad-Cameroon Petroleum Development and Pipeline Project" 2005 (GPE Course pack)
+World Bank/IFC Video: Chad-Cameroon Pipeline Project Video
+World Bank Project Update

DUE: Quiz #3

WEEK 6

TOPIC: **International Trade Relations and the Role of the WTO/GATT:** GATT/WTO as an organization; international trade relations and the Rounds of the multilateral trade negotiations; regional economic integration and the state of current trade relations.

READ: Balaam and Dillman, Chapter 6
+"What is the World Trade Organization?"
+"Principles of the Trading System"
+"Settling Disputes: The WTO's Most Original Contribution"
+"The Panel Process: Flow Chart"
+"Who Elected the WTO?" *The Economist*, September 29, 2001, pp.26-29.
+Walden Bello, "Serving the Wealthy, Not the Poor," *The Ecologist*, September 2000.

DUE: No Deliverables

WEEK 7

TOPIC: **Relations Between the Developed and Developing World (North-South Relations):** role of the South in the internationaldivision of labor; structuralism and Raul Prebisch; central tenets of structuralism thought at the national, regional, and international levels; import substitution industrialization; commodity groups and cartels; New International Economic Order (NIEO)

READ: Balaam and Dillman, Chapter 15.

DUE: Group Research Projects

WEEK 8

TOPIC: **Banana Wars: Challenges to the European Union's Banana Regime**

READ: *CASE: "Banana Wars: Challenges to the European Union's Banana Regime" (GPE course pack).

DUE: Quiz #4

WEEK 9

TOPIC: **U.S. Foreign Economic Policy: Predicting/Explaining U.S. Foreign Economic Policy:** approaches to explaining U.S. foreign economic policy; the role of the USTR.

READ: See web links on course page

DUE: No Deliverables

WEEK 10

TOPIC: **CASE: "Standing Up for Steel: The U.S. Government Response to Steel Industry and Union Efforts to Win Protection from Imports"**

READ: CASE: "Standing Up for Steel: The U.S. Government Response to Steel Industry and Union Efforts to Win Protection from Imports" (GPE course pack).

+"Lessons of Steel," *The Wall Street Journal*, December 2, 2003, A18.

DUE: Quiz #5

WEEK 11

TOPIC: **Managing Global Political and Economic Risk:** analytical tools and concepts for country analysis. We will also discuss a capstone case to summarize key issues from the course as well as to introduce students to the practical aspects of analysis/evaluation of individual countries.

READ: On Political Risk:

+Llewellyn D. Howell, "Dealing With Political Risk: A Manager's Toolkit," pp. 167-188 in Political Risk Assessment: Concept, Method, and Management, The PRS Group, Inc., 2001. (REQUIRED)

On Business-Government Relations and Bargaining in Corporate Strategic Alliances:

*Robert Grosse, "The Government-Business Relationship in Latin America," pp. 78-85 (REQUIRED).

*Roy C. Nelson, "Corporate Strategic Alliances and Bargaining in Latin America," International Studies Notes, Spring, 1997, pp. 9-17 (REQUIRED).

DUE: No Deliverables

WEEK 12

TOPIC: Dell's Dilemma in Brazil

READ: *CASE: "Dell's Dilemma in Brazil: Negotiating at the State Level"

DUE: No Deliverables

******* FINAL EXAM*******

Course Alignment Matrix for TGM5XX – STATES AND MARKETS IN THE GLOBAL ECONOMY

Course Objectives	Learning Outcomes	Assessments
To develop tools of analysis for understanding trends and developments in the global political economy	Ability to think analytically in a global context	• Examination • Case Quizzes • Online Discussion Responses
To develop students' abilities to use these tools to assess international economic institutions such as the International Monetary Fund, World Trade Organization, and World Bank Group	Knowledge of the issues that affect the creation of sustainable economic and social prosperity worldwide (i.e., Global Citizenship) Ability to think analytically in a global context Ability to conduct research effectively and efficiently	• Examination • Case Quizzes • Online Discussion Responses • Group Research Project
To develop analytical tools for assessing a country's foreign economic policy	Ability to think analytically in a global context	• Examination • Case Quizzes • Online Discussion Responses
To introduce students to analytical frameworks for country risk analysis	Ability to think analytically in a global context	• Examination • Online Discussion Responses

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MANAGING THE ASIAN MELTDOWN: THE IMF AND SOUTH KOREA

Gregory P. Corning
Santa Clara University

South Korea was devastated by the Korean War, which ended in 1953. More than a quarter of the nation's 20 million people were left as refugees without homes or assets. Recovery from the war was especially difficult because the division of the Korean peninsula left communist North Korea with most of the natural resources and industrial infrastructure.[1] Nevertheless, over the next forty years South Korea achieved spectacular growth rates while pursuing an aggressive government-led development policy. One of the "Asian Tigers," South Korea became a major manufacturer of ships, automobiles, and memory chips. In the mid-1980s, Korean conglomerates like Hyundai, Samsung, and Lucky-Goldstar began to make major inroads into the American market. South Korea's gross national product (GNP) grew at the astounding rate of 11.6 percent in 1986 and 12.5 percent in 1987, worldwide records for both years. The nation became the seventh largest trading partner of the United States and soon ranked as the world's eleventh largest economy.[2] Only a decade later, however, Korea was caught in a painful financial crisis. (See Appendix A for a basic chronology of the events discussed in this case-study.)

On December 3, 1997, the International Monetary Fund (IMF) approved a $57 billion rescue package for South Korea, the largest for any nation ever The conditions of the IMF rescue forced painful reforms on South Korea that led to severe economic contraction. By April 1998, the unemployment rate had jumped to 8.5 percent, up from 2.5 percent a year earlier. An estimated 10,000 workers were losing their jobs each day.[3] With bankruptcies in the small-business sector rising to record levels, at least one small-business owner was committing suicide each day.[4] The crisis brought a heightened sense of nationalism with Koreans shunning imported goods and angrily criticizing IMF interference in their economy. As layoffs increased, the Korean Confederation of Trade Unions took to the streets with signs reading "IMF = I Am Fired." Major conglomerates like Samsung and Daewoo asked employees to sell their jewelry in order to help the country raise foreign currency and pay off its debts.[5] Meanwhile imported cars and their owners became the targets of angry mobs.[6] South Korea dropped from being the world's eleventh largest economy to the seventeenth largest in a matter of only weeks. How did this happen? Was Korea itself to blame, or was the nation simply the victim of an external economic shock? What was the appropriate response to the

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crisis? And do other nations have any responsibility or self-interest in helping Korea recover?

I. SOUTH KOREA AND THE "ASIAN ECONOMIC MIRACLE"

Between 1965 and 1990, East Asia grew three times faster than Latin America and twenty-five times faster than sub-Saharan Africa.[7] The main source of this achievement was the growth of eight regional economies: Japan; the Four Tigers—Hong Kong, Singapore, South Korea, and Taiwan; and the newly industrialized countries (NICs) of Southeast Asia–Indonesia, Malaysia, and Thailand. The Japanese economy was the first to take off in the 1950s, followed by the Four Tigers in the 1960s and the NICs in the 1970s. Although Japan's growth slowed after the oil crisis of 1973, other regional economies continued to boom into the mid-1990s with low inflation and average annual growth rates approaching 10 percent of gross domestic product (GDP). These economies succeeded, to varying degrees, in the creation of business-friendly environments through policies emphasizing macro-economic stability and legal and financial structures hospitable to private investment. They also supported the accumulation of human and physical capital through investment in education and policies to encourage savings.[8] Some of these nations also guided development through government intervention in the economy. Elite economic bureaucracies attempted to shape investment and production patterns so that national firms would be competitive in international markets.[9] Although there continues to be disagreement over the precise weight of factors explaining growth, there is broad agreement that these countries made tremendous progress over a relatively short period of time. Nowhere is this story of postwar growth more dramatic than in South Korea.

The Rise of South Korea

Korea was brutalized as a victim of both imperialism and the Cold War. From 1910 to 1945, Korea was a Japanese colony. Although colonization brought some development of agricultural and industrial infrastructure, it also brought harsh repression of native language, religion, history and culture. Defeat in World War II brought an end to Japan's occupation of Korea. Yet the peninsula was left divided between communist-backed leaders in the North and American-backed leaders in the South. Tensions between the two finally sparked a civil war when 90,000 men of the People's Army of North Korea, armed mostly with Soviet weapons, invaded the South on June 25, 1950. A United Nations' force under the command of General Douglas MacArthur entered the war on the side of the South in June 1950, and China entered the war on the side of the North five months later. After three years, the conflict reached a stalemate; the armistice signed on July 27, 1953, formalized the divide between South and North Korea. Despite their common culture and history, the two nations have kept an uneasy truce since that day.

South Korea did not develop rapidly in the years immediately after the Korean War. Almost a decade was lost under the leadership of Syngman Rhee, a hero of the anti-Japanese independence movement, who maintained power through a system of patronage financed by the manipulation of U.S. aid programs. The dramatic growth of the modern Korean economy did not begin until Park Chung Hee seized power in a 1961 military coup. Faced with both declining U.S. aid and a need to establish his internal legitimacy, Park focused on economic development.

Park took a personal and highly centralized approach to economic policy. First, he controlled access to credit by nationalizing all banks. Always cautious about foreign influence, the government relied on loans rather than opening the country to foreign direct investment. Second, he centralized the planning, budgeting, and oversight of economic policy in an elite economic bureaucracy that reported directly to him. Third, he cultivated an alliance between the military and a small group of successful businessmen as the means to push development and further consolidate his power. Park used large family-owned conglomerates, known as "chaebol" as the main instruments of growth. Because the state controlled access to credit, these chaebol soon dominated the economy. During the 1970s, the chaebol expanded to penetrate every important industrial sector. From 1972 to 1979, the average number of firms owned by the ten largest chaebol grew from 7.5 to 25.4. Meanwhile, the average number of industries in which they operated grew from 7.7 to 17.6.[10] The chaebol financed this expansion through massive borrowing guaranteed by the state. Indeed, most chaebol borrowed far beyond their net worth. Although a debt-equity ratio of 2:3 is not uncommon among western firms, a ratio of 4:1 was not uncommon among chaebol during the 1970s.

Park was assassinated in 1979. Two months later, Chun Doo Hwan seized power in another military coup. At first, Chun's government faced severe economic problems. The debts from Park's heavy industrialization program in the 1970s, the recession following the 1979 oil shock, and an almost total failure of the rice crop produced a sharp economic downturn. GNP dropped by 5.2 percent in 1980 but with the help of an IMF-supported austerity program the economy soon stabilized. To finance growth and adjustment, Korea borrowed heavily in international capital markets, amassing the fourth largest debt-burden among developing countries. Foreign bankers were not perturbed, however, because Korea's export performance continued to improve. The rise in the value of the Japanese yen following the Plaza Accord of 1985 lowered the prices of Korean exports relative to their Japanese competition. This began an export boom for the chaebol as TVs and VCRs made by Daewoo and Lucky-Goldstar began to appear on American store shelves, and Hyundai automobiles began to compete with entry-level models from Toyota and Nissan. Unknown to American consumers a decade earlier, Korean brands were becoming household names in the United States. Recognition of South Korea's emergence as an advanced, industrial nation is symbolized by the choice of Seoul to host the 1988 Summer Olympics.

The development of South Korea into a major manufacturing nation brought increased foreign and domestic pressure for economic liberalization. Faced with the growing volume of Korean exports, western nations, particularly the United States, pushed for increased Korean imports and opening to foreign investment. In an effort to rein in the power of the chaebol, the Chun government also privatized the banking system, reduced "policy lending" to strategic sectors, and pressed the chaebol to restructur and focus on specialized, primary businesses. However, economic liberalization moved ahead very slowly, due in part to the growing time and energy devoted to political liberalization.

After Chun stepped down from power in 1988, the civilian governments of Roh Tae Woo (1988–93) and Kim Young Sam (1993–98) oversaw a gradual opening of the political system that culminated in the December 1997 election of longtime prodemocracy activist Kim Dae Jung as president. This decade was characterized by painful efforts to come t terms with the human rights violations of the Park and Chun regimes, as well as mostly unsuccessful attempts to wean the chaebol and labor unions from the privileges enjoyed since Park's industrial drive The major chaebol had become so large that banks seldom dared to cut their credit lines. For these chaebol, more assets meant more collateral for bank loans that could be used to buy even more assets. Several chaebol had become so large, and employed so many people, that the government seemed unlikely to ever let them fail. This environment of unbridled expansion was particularly favorable for labor, which became accustomed to the guarantee of lifetime employment.

II. FROM MIRACLE TO MELTDOWN

The Korean Economy in the Mid-1990s

Even before the panic that swept across Asia beginning in July 1997, the Korean economy had begun to encounter some problems. The first was the January 1997 bankruptcy of the Hanbo Group, Korea's fourteenth largest chaebol. At a time of declining steel prices and overcapacity in Korean production, Hanbo's steel unit had amassed $4.39 billion in debt—more than twenty-two times its equity—to build a new steel mill.[11] The bankruptcy of Hanbo Steel led to the collapse of four other group companies and risked bringing down Korea First, one of the nation's largest banks. Prosecutors indicted more than ten people, including four members of parliament and the heads of Hanbo and Korea First, on corruption and other charges related to the collapse of the chaebol. In the frenzy of media and government scrutiny that followed, eight more of Korea's top thirty chaebol crashed, including Kia Motors.[12]

The collapse of so many chaebol in such a short period of time revealed a second, deeper problem in Korea's financial system. Since the Park era of policy lending by nationalized banks, the financial sector had worked on the basis of a cozy system of "connected lending" rather than independent judgments about credit risk and the projected cash flow of borrowers. For decades, western financial institutions had been eager to earn seemingly certain returns by lending to Korean banks to fund the country's economic boom. In turn, Korean banks eagerly loaned the money to credit-hungry chaebol focused on expansion into new businesses. The banks' tolerance for the high debt-equity ratios maintained by the chaebol resulted in Korea amassing substantial foreign debts. At the close of 1996, Korea's foreign debts totaled roughly $180 billion, of which $130 billion was due for repayment within one year.Although substantial, these sums were not so large by global standards as to worry international financial markets.[13] However, the series of chaebol bankruptcies during 1997 meant that a growing share of this debt stood as bad loans that were unlikely to be repaid.

The third development that suggested the potential for future problems was Korea's rising current-account deficit. The current-account, which measures the way that international transactions affect current income, can be thought of as a nation's checking account. It has four major components: (1) exports and imports of merchandise, (2) exports and imports of services, (3) investment and income payments, and (4) government exports/imports and foreign aid. The root cause of Korea's rising current-account deficit was a dramatic slowdown in exports. In 1995, Korean exports had increased by 30 percent whereas in 1996 they increased by only 4 percent. This drop can be traced to a number of external factors including the declining value of the yen, a cyclical glut in the global electronics industry, and increased export competition from China which enjoys much lower labor costs [14]

In short, the Hanbo collapse raised concerns about the health of several chaebol and the reliance on connected lending in the Korean financial system. Adding to these pressures was the slowdown in the export sector. Yet neither the Korean government nor international investors seemed to be questioning the basics of the Korean economic model. As of June 1997, the Korean stock market was plugging along, the won-dollar exchange rate was relatively stable, and international capital continued t flow into Korea. This situation changed dramatically in the following months, however, as a financial panic that began in Thailand spread across Asia.

The Asian Contagion

The Asian crisis began in Thailand during the summer of 1997. By many standard indicators, Thailand was in good shape. The economy had grown at nearly 10 percent for a decade, inflation was low, and the budget was in surplus. However, impressiv growth and lax accounting rules masked growing foreign debt. Eager to capitalize on growth opportunities in Thailand, foreign investors pumped money into that country. Over time, however, these funds went into increasingly speculative investments in sectors like real estate. By 1997, Thai banks held $15 billion in bad debts to real estate investors.[15] A slowdown in exports during 1997 undermined the ability of Thai businesses to service their debts. Growing concern that these businesses might default on their loans increased the risk of a devaluation of the baht (see Appendix B for background on exchange rates). Yet the Thai government feared that a lower baht would increase the cost of foreign borrowing and make heavier the debt burden of firms that had borrowed in foreign currencies. In a desperate attempt to prop up the value of the national currency, the Thai government drained its reserves of foreign exchange by buying up baht on international currency markets. When this failed, the Bank of Thailand could find no other options and within a month the baht fell in value by over 40 percent.

Within days, the Malaysian ringgit came under pressure. Like Thailand, Malaysia had ridden high on a speculative boom financed by high levels of debt. Yet its banking system was better managed and the country had relied more on foreign direct investment than loans, leaving the economy less vulnerable to capital flight. Blaming the crisis on "rogue speculators" and "Jewish financiers," the highly nationalistic government of Prime Minister Mahatir Mohammed refused to seek assistance from the IMF. As Malaysia struggled to defend the ringgit, the Indonesian rupiah also came under sharp attack. After desperately trying to prop up the value of the rupiah, the Bank of Indonesia let the currency float in mid-August. Over the next two months, the value of the rupiah fell by over 30 percent, forcing Indonesia to approach the IMF for help in October. Three Southeast Asian nations had fallen like dominoes within the space of only three months

The Asian contagion then moved north as financial markets began to look more closely at Hong Kong. By almost every measure, the Hong Kong economy was in much better shape than those of Southeast Asia. Yet when Hong Kong raised interest rates to defend its currency against attack, investors once again panicked about the potential for devaluation, and the stock market tumbled. The October 23 plunge of the Hong Kong stock market, which wiped $29.3 billion off the value of stock shares, sent shock waves through international markets. Four days later, the Dow Jones Industrial Average plummeted 554 points—at that time, the biggest point loss ever in a single day.[16]

In addition to its immediate impact on equity markets across the world, the Asian currency crisis raised a number of broader economic and security concerns. First, American, European, and Japanese banks were faced with the prospect of tens of billions of dollars in nonperforming or bad loans t Korean chaebol. The risk of default was especially worrisome to Japanese banks which were the most heavily exposed in the region. Japan was still trying to deal with the crisis in its own fragile banking system that began following the collapse of the bubble economy in 1989. Second, the fallout from the Asian crisis might also be felt in the trading system; export markets for American and European firms in East Asia could dry up while both devaluation of the won and desperate attempts by chaebol to boost their own sales could lead to dramatically lower-priced exports. Finally, there were concerns that the currency crisis could undermine the young democracies of South Korea and Taiwan, complicate leadership succession in Indonesia, and lead to tensions on the Korean peninsula that might destabilize the entire region.

The Panic Strikes Korea

As the Asian contagion spread northward, nervous investors began taking a much closer look at South Korea. The weaknesses in Korea's financial system, the extremely high debts of Korean banks and chaebol, and the worsening of Korea's current account deficit were now viewed as far more ominous than they had been only a few days earlier.[17] Foreign investors began pulling out of the Korean stock market as quickly as they could. The growing flight of capital sent the Korean won down to record lows each day; a free fall of the won was prevented only by restrictions on daily movement of the currency The Bank of Korea intervened heavily in currency markets by buying up won to try to prop up the value of the currency. But this effort met with little success and drained the nation's reserves of foreign currency. As the won continued to tumble, Korea realized it needed financial assistance. It first approached Japan and the United States for funds. Yet neither was prepared to help unless Seoul first went to the IMF. (See Appendix C for background on the IMF.)

South Korea tried to circumvent the IMF because the two had very different views of the roots of the crisis. Korea saw itself as simply a victim of the Asian contagion. Investors became nervous about South Korea because other regional economies had run into trouble. As investors began to pull out of South Korea, the won began to depreciate. Knowing they would suffer losses if they stayed, more investors pulled out of the Korean market. Thus, the crisis was one of investor perception more than anything else. From the perspective of the IMF, the Asian crisis was caused by a mix of macroeconomic imbalances and fundamental structural problems including deep-seated weaknesses in financial institutions and insufficient supervision of banking systems. Seoul knew that IMF assistance would be conditional on bank and corporate restructuring that would destroy the Korean development model.

In mid-November 1997, the IMF's managing director, Michel Camdessus, and his chief Asia negotiator, Hubert Neiss, traveled to Korea and began secret discussions with the Korean government. Worried that news of the discussions might leak out and spark further anxiety in international financial markets, the two men registered under Korean names in a hotel on the outskirts of Seoul and ate meals in their rooms. On November 21, South Korea requested $20 billion in IMF assistance. Within a week, Seoul had increased its request to over $50 billion. Yet the country was still reluctant to have terms dictated by the IMF. When Camdessus returned to Korea in early December, he was greeted at the airport by the deputy minister of finance who handed him an itinerary for the day. The agenda was forty-five minutes of negotiations, a brief meeting with the president, and then a signing ceremony. Resisting Korean efforts to set the agenda, Camdessus promptly insisted on the need for further negotiations. News of failed talks sent markets further down. With its back against the wall, the Korean government found itself with little choice but to accept IMF terms.[18]

III. MANAGING THE MELTDOWN

The IMF Rescue Package

The details of an IMF-brokered loan package totaling $57 billion were announced on December 3, 1997. Each of the following pledged funds: the IMF ($21 billion), the World Bank ($10 billion), the Asian Development Bank ($4 billion), Japan ($10 billion), the United States ($5 billion), the United Kingdom, France, Germany, and Italy ($1.25 billion each).[19] The IMF would provide the initial disbursement of funds whereas the pledges of the United States and other nations would be secondary or back-up financing made available as necessary. These funds were not intended to pay off Korea's short-term debts. Rather, the objective of the package was to replenish Korea's foreign-currency reserves in order to bolster the confidence of creditors, such as Japanese banks and U.S. mutual-fund companies, so that they would reschedule Korea's short-term loans.

The initial disbursement of loans from the rescue package was conditional on Korea adopting a contractionary macroeconomic policy of higher taxes, higher interests rates, and reduced government spending. The combination of higher taxes and reduced spending was intended to reduce the deficit in the current-account and put money aside for economic restructuring. Higher interest rates wer intended to restore confidence in the Korean won by making it more attractive for foreign investors to hold. On the downside, however, high interest rates would also complicate the situation of weak chaebol and banks by increasing the costs of borrowing. The IMF also mandated several structural reforms. It required that Korea: (1) allow foreign investors greater freedom in acquiring shares and majority stakes in Korean businesses, (2) fully open domestic financial markets to foreign banks and insurance companies, (3) require banks to make loans according to western standards of credit evaluation rather than by government fiat, (4) close insolvent banks, (5) reform labor laws to make layoffs easier and make labor markets more fluid, and (6) open the domestic market to imports by lifting restrictions and lowering tariffs.[20]

Taken together,the reforms amounted to a radical transformation of the Korean economic model. Although the IMF did not specifically address the future of the chaebol, the reforms were designed t end both the system of government-sanctioned overloaning by banks and the central place of chaebol in the economy.In forcing banks to adopt western standards of credit evaluation, the reforms would limit the loans available to chaebol for expansion. They would also end the common practice of stronger firms within a particular chaebol obtaining capital for weaker members within the group. While opening the financial sector to foreign banks and insurance companies was intended to hasten the adoption of international standards throughout the financial system, the lifting of import restrictions and lowering of tariffs was intended to end the virtual monopoly of chaebol in the domestic economy. Sectors like the automobile industry that had been virtually closed to imports would now be exposed to the rigors of international competition.

Such changes were likely to bring increased efficiency and greater choice for consumers, but they were also likely to tear further into the social fabric of the nation with the collapse of more chaebol and their subcontractors, as well as bring an end to the guarantee of lifetime employment extended to millions of Korean workers. What was at stake was not simply the shakeout of a few corrupt capitalist tycoons but the way in which everyday people lived their lives as both workers and consumers.

It would not be easy for the Korean leadership to abandon fundamental elements of a model that had worked for so long with such great success. Over the following weeks, Korea seemed to pass from denial to despondency to resignation. Korean officials realized, however, that the IMF's power to push reforms would disappear once it had completed major loan disbursements in the first year. According to one Ministry of Finance official, "all of their [IMF] leverage is gone next year in terms of money . . . After that, the IMF makes $250 million a quarter in loans. That's peanuts."[21] In other words, Korea might be able to outlast the IMF and proceed with reforms at its own discretion.

The immediate results of the IMF rescue package were not promising. The downward spiral of the won continued as chaebol, which had borrowed in foreign currency, needed to sell won in order to pay back their debts. This drove down the value of the won even more and further eroded confidence in Korea.[22] The week after the IMF bailout was announced proved the worst ever in Korean financial markets with the won declining another 27 percent against the dollar. The financial turmoil paralyzed banks and businesses and sent consumers into a panic. The shortage of dollars was so severe that banks became unable to honor letters of credit—bank promises to pay a seller of goods upon delivery. Letters of credit are essential to the smooth operation of international trade; without this trade financing, Korea was unable to earn the export revenues necessary to rebuild its supply of dollars. The shortage of funds in the Korean money market drove interest rates as high as 25 percent; this high cost of borrowing put a strain on even strong businesses. Frightened consumers also began hoarding imported goods such as sugar and flour which had more than doubled in price since November. Tissues and toilet paper also disappeared from store shelves as consumers feared a shortage of imported pulp.[23]

This public unrest put increasing pressure on the Korean political system which was fast approaching a presidential election on December 18. Prior to Korea's November request to the IMF for assistance, the economic situation had not been a major campaign issue. In the week before the election, however, no candidate could escape questions about the crisis which had become the foremost election issue. The crisis put candidates in a particularly difficult position; they could not afford to alienate either voters, who might suffer under a structural adjustment program, or the IMF, whose financial assistance was so desperately needed. Although the three leading presidential candidates all attacked the IMF program to some degree, they were all forced to assent to the IMF's basic terms as a condition for final approval of the December 3 loan package. The crisis also put the IMF in an awkward spot. It was convinced of the need for structural reform but realized that pushing too hard for reform could risk a political backlash in Korea that might destabilize the political system and jeopardize economic recovery. Walking this fine line would be a delicate task and a very different challenge in each of the crisis countries

By late December, the situation confronting newly elected President Kim Dae Jung was desperate. Korea's foreign-exchange reserves were almost gone, and Korean banks were estimated to have bad loans totaling 12 percent of GNP. The stock market was so low that a majority stake in Korean Air Lines was worth only $165 million–the cost of a single Boeing 747.[24] As a result, foreign investors had lost faith in Korea and were reluctant to roll over loans as they came due. The IMF had already disbursed $9.1 billion of the $21 billion it had promised under the bailout. But this was not enough. Working through the Christmas holiday, IMF officials agreed to dispense an additional $10 billion of the committed funds as an emergency bridge loan to prevent default.[25] More important, the U.S. Federal Reserve, the Bank of Japan, and other central banks pressured their leading commercial banks to agree to a rollover of short-term loans or be blamed for a global catastrophe.[26]

IV. THE IMF ON TRIAL: CONFLICTING PERSPECTIVES ON THE KOREAN CRISIS AND THE IMF RESPONSE

Criticism of IMF Policy

One of the most vocal critics of IMF policy in Korea is Martin Feldstein, a Harvard economist and president of the National Bureau of Economic Research. Feldstein argues that the IMF misdiagnosed Korea's condition and so prescribed the wrong treatment.[27] According to Feldstein, Korea's economic fundamentals were solid. GDP grew at roughly 8 percent per year during the 1990s, inflation was less than 5 percent, and the unemployment rate was less than 3%. Korea ran into trouble in 1997 because banks and chaebol had incurred short-term debts far greater than the nation's foreign exchange reserves. Yet total foreign debt was only 30 percent of GDP, much lower than that of most developing countries. In view of this, Feldstein sees Korea's problem as one of temporary illiquidity rather than fundamental insolvency. What Korea needed was not structural reform but a temporary bridge loan and restructuring of its debt to stem the loss of foreign exchange and help maintain bank lending to the nation.

Jeffrey Sachs, another Harvard economist, concurs with this criticism of IMF policy in Korea. He suggests that investors were less worried about Korea's long-term prospects than what other investors were doing. They understood that Korea would be pushed to default if enough creditors stopped loaning to the country. Gripped by panic, all the investors began rushing for the exits at the same time; no one wanted to be the last out of the building. Like Feldstein, Sachs contends that the IMF should have helped avert this stampede by bringing banks together in mid-1997 to emphasize their collective interest in avoiding a self-defeating panic. Instead, according to Sachs, the IMF made the panic worse; the austerity program of high interest rates and budget cuts, as well as statements about the necessity of structural reform, convinced markets that Asia was headed for a severe contraction. In effect, "the IMF screamed fire in a crowded theater."[28]

Moving beyond the details of the IMF policy response, some critics challenged that the very existence of the IMF itself creates a "moral hazard" problem for both member countries and investors. In this view, borrowers may take excessive risks because they know the IMF will bail them out if they get in trouble. Likewise, investors may not carefully appraise risks and may be too willing to lend to countries with weak economies because the IMF will also come to their rescue. In short, the expectation of IMF assistance for troubled economies creates an incentive for risk-taking that would not otherwise be present.

In addition to these critiques from the academic community, some American firms facing stiff competition from South Korean chaebol questioned the wisdom of IMF policy. According to Steve Appleton, CEO of the semiconductor-manufacturer Micron Technology, "the thought that our tax dollars will go to subsidize competitors and take away our jobs is troublesome."[29] The American public also seemed to question why the United States should support the IMF rescue. According to a *Wall Street Journal*/NBC poll taken at the height of the crisis in December, Americans thought the U.S. should not be part of any IMF plans to lend money to financially troubled Asian nations by a margin of 51 percent to 34 percent.[30]

It is not surprising that some of the strongest criticisms of the IMF came from Korea itself. Some blamed the "overzealousness" of the IMF on political meddling by Washington, suggesting that the Fund had become a tool of the U.S.—its largest contributor (see Appendix D). They pointed to the fact that several of the measures forced on South Korea, such as opening the financial system to foreign banks, were high on America's bilateral foreign policy agenda with Korea. At many points during the negotiations, IMF officials did consult with U.S. officials. The IMF's chief negotiator, Hubert Neiss, several times refined his negotiating position after talking with David Lipton, a senior official at the U.S. Treasury Department, who was in Seoul during the negotiations. After talking with American officials the IMF's managing director, Michel Camdessus also delayed signing of the final loan agreement until all three candidates in Korea's presidential election had assented to its terms.[31] More specific criticism on the technical details of the bailout package came from those working with the IMF. Lee Hun Jae, Chairman of the Financial Supervisory Commission, who played an important part in implementing structural reforms, complained that the IMF's retrenchment policy—higher interest rates, higher taxes, and reduced government spending—increased corporate failures and drove foreign investors away.[32]

The IMF Defends Its Policy

The IMF defends both its macroeconomic policy prescriptions and its recommendations for structural changes in Korea.[33] According to Stanley Fischer, first deputy managing director of the IMF and a former MIT economics professor, the first priority of the Fund was to restore confidence in the Korean won. At the time Korea approached the IMF for help, its foreign exchange reserves were perilously low, and the won had undergone massive depreciation. To restore confidence in the won, Seoul had to make it more attractive to hold the currency; this required raising interest rates temporarily, even if this made life more difficult for Korean banks and chaebol. With their substantial foreign currency debts, the chaebol stood to suffer more from continued depreciation of the won than from higher domestic interest rates

Fischer also defends the structural reform program pushed by the IMF. He argues that weak financial institutions, inadequate bank regulation, and a complex web of opaque relationships among the government, banks, and chaebol lay at the heart of the Korean crisis. It would serve no lasting purpose for the IMF to loan funds to Korea unless these problems were addressed first. John Dodsworth of the IMF's Korea Office acknowledges that the immediate cause of Korea's meltdown was a liquidity crisis that spiraled out of control as investors lost confidence in the Korean market. However, he suggests that deeper structural problems set the stage for the liquidity crisis.[34] In other words, Korea would not have been as vulnerable to the Asian contagion had its financial system been better regulated. In short, the IMF concluded that structural reform was necessary for long-term sustainable growth. Without such reform, Korea would be vulnerable to similar systemic shocks in the future. It was best to fix these problems immediately before having to call on the IMF again.

This basic attitude was taken by the IMF in all countries hit by the 1997 currency crisis, from Indonesia to Brazil to Russia. The Fund pushed a program of reform to increase supervision of financial institutions and to make more transparent the relationships among governments, banks, and corporations. The IMF explains that the scale and scope of needed reforms differed in each case. For example, increased transparency was more important in Indonesia, where the Suharto family's nepotism and crony capitalism defined the financial system, than in Brazil, where the crisis had its root causes in public-sector imbalances. The reforms were likely to be most painful in societies like South Korea and Indonesia where reforms undermined the entire development model.

Finally, the IMF challenged the notion that it creates a moral hazard problem. It argues that rescue funds do not constitute a bailout of irresponsible lenders and borrowers because they are not used to pay off short-term private debts. Rather, rescue funds are used to bolster the confidence of creditor and encourage them to reschedule short-term loans by rebuilding reserves of foreign exchange and helping recapitalize banking systems. Although lenders and borrowers may benefit from an easing of recessionary conditions in the economy, they are not bailed out by the IMF. Further, if IMF packages offered the cheap insurance for risk-taking that critics suggest, countries would be much quicker to approach the IMF for help. Yet the governments of South Korea, Thailand, and Indonesia approached the IMF only as a last resort. The Fund likens the crisis countries to patients postponing visits to the dentist until their teeth have to be pulled.

V. THE ROAD TO RECOVERY

At the start of 1999, Korea enjoyed its first quarter of growth since 1997. By May 1999, only eighteen months after the Korean meltdown began, international markets seemed cautiously optimistic about the future of the economy. The won had stabilized, the current account was in surplus, inflation had slowed, foreign-exchange reserves had risen to a healthy $56 billion—up from $5 billion at the height of the crisis—and short-term foreign debt had dropped by 50 percent from the height of the crisis to $31 billion.[35] Although the IMF and Korean government left their growth forecasts for 1999 unchanged at 2 percent, several U.S. brokerage firms raised their estimates; Merrill Lynch forecast growth of 4.5 percent whereas Morgan Stanley predicted 4.9 percent.[36]

Yet the fallout from the crisis was far from over. On July 23, Korea's benchmark stock index experienced its largest one-day point loss ever when the Daewoo Group, the nation's second largest conglomerate, admitted it needed new loans to prevent bankruptcy. After more than doubling its debt during 1998, Daewoo owed an estimated $55.8 billion, more than the national debt of Poland or Malaysia.[37] Within days, the Korean government ordered Daewoo's domestic creditors to roll over $5.8 billion in loans and provide an additional $3.3 billion to prevent a default on short-term obligations [38] Yet such measures could not save the ailing conglomerate. By January 2000, Daewoo's creditors had reached tentative agreement on plans to dismember the chaebol and auction off its affiliates

The demise of "Dae-woe" is just one example of the painful adjustment process that lies ahead for South Korea. As negotiations on the future of Daewoo progressed, the Kim government moved in late-1999 to ban cross-subsidization among chaebol subsidiaries. This practice involves strong companies within a chaebol obtaining capital for weaker members of the group that could not obtain capital on their own. If the government follows through on this policy, the dismantling or at least restructuring of other chaebol is likely to follow.

At the close of 1999, Koreans were much better off than they had been at the start of theyear. The nation experienced a dramatic turnaround in basic economic indicators in 1999. At the end of theyear, the IMF had revised its estimate for growth in real GDP to 9 percent. Inflation was also low with the consumer price index up less than 1 percent for the year. With both firms and consumers more confident about the economy, private consumption had also increased by 10 percent, a higher rate than in the years immediately preceding the crisis. Meanwhile, the unemployment rate, which averaged 6.6 percent for the year,was also headed downward but was still well above the 2 percent average for 1995 and 1996.[39] Although most Koreans were seeing their lives improve with the gains of recovery, others were sure to suffer with the ongoing fallout from economic restructuring.

QUESTIONS

I. South Korea and the "Asian Economic Miracle"

1. What systemic factors helped shape Korea's development during the first half of the century?
2. What role did Park Chung Hee play in Korea's economic development?
3. What are chaebol?
4. What impact did changes in the global economy have on Korea during the 1980s?
5. How did labor benefit under Korea's developmental state?

II. From Miracle to Meltdown

1. What was the significance of the collapse of Hanbo Steel?
2. What is meant by the term "connected lending"?
3. Why had Korea's current-account deficit increased during 1996?
4. How did the Korean government and investors view developments in the Korean economy during 1996 and early 1997?
5. What is meant by the term "Asian contagion"?
6. What was Korea's initial position regarding IMF assistance?

III. Managing the Meltdown

1. Who contributed to the IMF-brokered bailout, and how were the funds to be used?
2. What conditions came with IMF assistance?
3. What was the initial impact of the IMF program?
4. If economic recovery is threatening to democracy, which should take precedence?
5. How did IMF policy evolve over Christmas 1997?

IV. The IMF on Trial

1. MIT economist Paul Krugman contends that the depreciation of the Korean won and other Asian currencies was not the result of irrational investor stampedes but the result of rational investors contemplating the implications of unsustainable policies. Do you agree with this argument? In other words, do you think structural reform was necessary in South Korea? If so, what would be a realistic time-frame for any reforms you might recommend?
2. Was the IMF's program too intrusive?

a. Did the reforms interfere unnecessarily with the proper jurisdiction of a sovereign government?

b. Was it appropriate to require such far-ranging reforms as liberalization of rules on foreign direct investment?

c. Was structural reform necessary to restore the country's access to international capital markets?

d. What were the risks in the IMF pushing such dramatic reform policies?

3. What do you think about the complaints of Micron Technology? What could/should have been done to address the complaint?
4. U.S. public opinion in December 1997 did not favor U.S. involvement in IMF plans to lend money to Korea and other troubled Asian nations. Why do you think this was the case? Do you agree with this view?
5. Do you think the IMF creates a moral hazard problem? If not moral hazard, what explains unwise lending to South Korea?
6. In 1996, $93 billion flowed into Indonesia, Malaysia, Thailand, and South Korea. In 1997, $12 billion flowed out. How much are foreign lenders to blame for the Asian crisis?
7. How do you think democratization in Korea might affect future economic development?

APPENDIX A
CHRONOLOGY OF THE KOREAN CRISIS

November 17, 1997	The Bank of Korea abandons its effort to prop up the value of the won, allowing it to fall below 1000 against the dollar, a record low
November 21, 1997	South Korea requests IMF aid.
November 22, 1997	South Korean nationalists criticize the IMF loan request as humiliating. President Kim Young Sam apologizes on television for the country's economic malaise.
December 3, 1997	The IMF approves a $57 billion bailout package for South Korea, the largest in history.
December 18, 1997	Kim Dae Jung becomes South Korea's first president elected from the country's opposition party. Within days the won hits new lows.
December 23, 1997	In an unprecedented move, the World Bank releases an emergency loan of $3 billion, part of a $10 billion support package, to South Korea to help salvage its economy.
December 24, 1997	Seoul wins early payment of $10 billion in loans from the IMF and Group of Seven to forestall a default on its short-term debts. In return for aid, South Korea agrees to expedite financial reforms and open its domestic financial market.
January 8, 1998	International creditors agree to a 90-day rollover of South Korea's short-term debt.
January 14, 1998	South Korean labor unions agree to discuss layoffs with business and government leaders. The IMF says that mass layoffs are the only way for Korea to restore financial credibility and draw foreign investment.
January 22, 1998	South Korean officials meet with international bankers in New York in an effort t restructure the country's short-term debt.
January 28, 1998	International banks and South Korea agree on a plan to exchange $24 billion of short-term debt for longer-term loans
February 6, 1998	South Korean unions, government and business reach a landmark agreement to legalize layoffs
May 27–28, 1998	Union workers hold a two-day, nationwide strike to protest the growing wave of unemployment. Since February, firms have been laying off 10,000 workers per day.
July 28, 1998	The IMF announces that it will ease conditions on its $57 billion aid package which has been blamed for rising unemployment and overburdened welfare programs.

This is an edited version of the chronology at http://www.pbs.org/wgbh/pages/frontline/shows/crash

APPENDIX B
BACKGROUND ON EXCHANGE RATES

Foreign-Exchange Markets

By the mid-1990s, the daily volume of foreign exchange trading around the world averaged roughly $1.3 trillion. Many people associate the need for foreign currencies with tourism. When traveling overseas, individuals need some of the local currency in order to pay for meals, hotels, and shopping; they visit the foreign-exchange desk at an airport, bank, or hotel to exchange some of their national currency for the currency of the nation the are visiting. Yet tourism accounts for only a very small percentage of foreign exchange transactions. A much larger source of demand for foreign currencies comes from international trade. Firms and governments need to obtain other currencies in order t make purchases of foreign goods.

A third source of demand for foreign currencies comes from those wishing to invest or buy assets in other countries. The demand for a currency can increase if high interest rates, a strong stock market, or attractively priced real estate or production facilities generate interest in acquiring assets in a given nation. A fourth source of demand for foreign currency comes from speculators who, like investors in equity markets, hope to profit from buying low and selling high.

As the demand for a currency increases, its value also increases or appreciates relative to other currencies. As demand for the U.S. dollar increases, the value of the dollar also increases, meaning that one dollar will be able to buy more of another currency. For example, the exchange rate between the U.S. dollar and the Korean won might move from $1 = 1000 won to $1 = 1050 won. In this instance, the dollar has appreciated relative to the won while the won has depreciated relative to the dollar.

Governments and Exchange Rates

Governments can influence the exchange rate of the national currency through changes in interest rates, inflation rates, tax laws, and so on. All else being equal, a nation's currency tends to depreciate when that nation experiences higher inflation rates. This is because the currency has less purchasing power in its own economy so foreigners are less interested in buying goods from that country. Meanwhile, higher interest rates tend to lead to currency appreciation due to increased demand for the national currenc to purchase government bonds and other interest-bearing assets.

Sometimes a government will purposefully try to depreciate or devalue the national currency in order to reduce a trade deficit. A depreciation of the currency is intended to accomplish two objectives: (1) lower the price of the nation's exports and so increase demand for these exports overseas, and (2) raise the price of imports and so decrease the demand for imports at home. Yet there are important limits on the ability of exchange-rate depreciation to eliminate a deeply entrenched trade deficit. For example, domestic consumers may find foreign-made products superior and choose to continue buying them despite increased prices.

At other times, as in the Asian crisis, governments may take defensive measures to maintain the value of their currencies. If investors or speculator begin to sell their holdings of a particular currency, for example, the government of that nation might sell some of its foreign exchange reserves to buy the national currency in international markets. The intent is to defend the currency by maintaining its value. A rapidly devalued currency can have several negative consequences including: (1) making imported essentials prohibitively expensive, (2) undermining investor confidence in the economy, and (3) sparking further devaluation through the "herd mentality" of financial markets.

APPENDIX C
BACKGROUND ON THE IMF

The IMF was established at the Bretton Woods Conference in 1944 and began operation in 1947. Following the breakdown of stability and cooperation in international monetary relations during the interwar period, governments wished to create a more stable system of exchange rates that would facilitate the expansion of international trade. The IMF was created to monitor exchange rates and to provide members with short-term loans to help them through temporary balance of payments crises. The goal was to discourage efforts to boost exports through competitive devaluations that would disrupt the international trading system. The IMF currently has over 182 member countries. Operating funds come from quotas paid by members according to the volume of their international trade, their national income, and their reserve holdings of foreign currencies. These quotas also determine voting power. The IMF has a staff of over 2,000 professionals from over 100 countries, most of whom work at its headquarters in Washington, D.C.

Today, the IMF performs three main functions The first is surveillance of the health of member economies. The Fund prepares an annual Article IV report for each member that provides an in-depth analysis of economic policies and performance. T ensure the forthright cooperation of members in preparing these reports and to protect fragile economies from speculation in nervous markets, these reports are not made public. The second main function is the provision of technical assistance to finance officials in member countries, especially less-developed economies. The Fund provides training in several areas such as the collection of statistical data and the management of fiscal and monetary policy. This training socializes countries as members of the IMF and helps to standardize the method of gathering and presenting financial data across countries. The third and most visible function of the IMF is lending. Although the lending role of the IMF has evolved with changes in the international monetary system, the historic mission of the Fund has been to extend loans and credits to member countries with temporary balance of payments problems to support policies of adjustment and reform.

In this capacity, the IMF operates like a credit union; countries place deposits in the Fund, which are then available to loan to members who need t borrow and who are prepared to meet IMF conditions. The IMF is seen as a "lender of last resort" for members earning insufficient foreign exchange. For example, if a country were using up its foreign exchange reserves because export earnings had dropped below the cost of imports, it might seek IMF assistance to avoid an abrupt cutoff of imports if reserves were to run out. When a member in crisis approaches the Fund for a loan, the Fund negotiates an economic program to restore macroeconomic stability and lay the conditions for sustainable growth. The loan is typically paid out in installments or "tranched" with each installment contingent on the borrower meeting a mutually agreed upon set of conditions. The borrower is responsible for repaying the loan over time, usually over three to five years

Periodically, the IMF has also created "special facilities" and "concessional facilities" to arrange for member access to credit that extends beyond the Fund's traditional focus on short-term balance of payments adjustment. Examples include the Systemic Transformation Facility, created in 1993, to extend financial assistance to postcommunist economies experiencing severe disruption in their trade and payments arrangements. At the close of 1998, the IMF had credit outstanding to sixty countries totaling roughly $85 billion.

APPENDIX D
SHARE OF TOTAL IMF QUOTAS FOR THE TOP FIVE CONTRIBUTORS (1998)

United States	18.25%
Germany	5.67%
Japan	5.67%
France	5.10%
United Kingdom	5.10%

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Banana Wars:
Challenges to the European Union's Banana Regime

In January 1999, a six-year-old dispute between the United States and the European Union (EU) over the latter's banana import policies threatened to erupt into an all-out trade war. The European banana trade policies had been under attack since 1993, when the EU instituted its first single-market agricultural regime. According to the EU, the banana regime, which granted preferential treatment to fruit imported from former colonies, was necessary to honor existing trade obligations to the ex-colonies and to help them compete against the cheaper Latin American bananas that dominated the world marketplace. But according to the United States and a group of Central and South American banana-producing countries, the complex import system discriminated against Latin American bananas and US and Latin American distribution companies in violation of international trade rules.

Latin American banana growers brought the first challenges against the regime. But by 1994, following a request by US multinational Chiquita Brands International, Inc. and the Hawaiian Banana Producers Association, the Office of the United States Trade Representative had entered the fray, ultimately bringing the case before the recently formed World Trade Organization (WTO). The resultant WTO ruling favoring the US and its Latin American allies, however, did not end the dispute. When the EU adopted a new modified regime in 1998, US and Latin American critics insisted that it was no better than the first. The EU's continued refusal to discuss further changes led to threats of US retaliation and countercharges by the EU that US actions were themselves a violation of international trade rules. The uproar raised questions about international obligations, interpretations of WTO dispute settlement mechanisms, and even whether the banana dispute was a case the US ever should have fought at all.

This case was written by Susan Rosegrant for Robert Z. Lawrence, Albert L. Williams Professor of International Trade Investments at the Center for Business and Government, John F. Kennedy School of Government, Harvard University. (399)

A Fruit of Historic Importance

That policies regulating banana imports could, in the first place, be so complex, and second, appear worth fighting for, was actually not surprising, given the economic and political importance of the fruit within the European Union and throughout the developing world. Although each country had a different set of interests at stake, for most EU members, bananas had taken on a significance that went beyond a mere agricultural commodity.

Colonial powers such as Britain and France, for example, had encouraged banana production in certain of their Caribbean and African colonies for decades, in part not to have to rely on imports of the Latin American "dollar bananas" sold by the dominant US multinationals, Chiquita Brands International, Inc. and Dole Food Co., Inc.[1] After the colonies became independent, they continued to get special access for their bananas under the Lomé Convention, an agreement forged in 1975 by which the EU provided aid, duty free access, and other forms of commercial assistance to its African, Caribbean, and Pacific (ACP) former colonies.[2] Such support was necessary, EU representatives say, because the 12 traditional banana-producing ACP countries could not grow the fruit as cheaply as their Latin American counterparts, or compete effectively in the open market.[3] The trade with ACP countries was substantial, making up about 20 percent of the EU banana market.

Other EU members had very different concerns, however. Some countries had their own banana production to protect, and didn't want cheaper imports to harm domestic growers and traders. Such domestic production supplied almost another 20 percent of EU consumption. Still other countries wanted banana imports to be entirely free of restrictions. Germany, for example, the EU's largest consumer of bananas and one of the top per capita banana consumers in the world, saw bananas as a symbol of post-war prosperity, and rejected all barriers to free trade.[4] By 1993, the strong demand for dollar bananas in Germany and other more northern European nations had given Latin American bananas a 60 percent share of the total EU market.

A jumble of trade measures had resulted from these varied priorities. Spain allowed no imports, relying on domestic production from the Canary Islands. France bought most of its bananas from its territories of Guadeloupe and Martinique, and also gave special preference to

1 Central and South American bananas became known as "dollar bananas" because US companies historically produced and marketed most of the fruit. Chiquita's predecessor, United Fruit Company Limited, established in 1899, had been a dominant—and controversial—presence in Latin America throughout much of the twentieth century.

2 As of 1998, there were 70 ACP members.

3 The main suppliers of ACP bananas to the EU were Cameroon, Cote d'Ivoire, St. Lucia, Jamaica, Belize, and Dominica. Principal Latin American banana suppliers were Costa Rica, Ecuador, Colombia, Panama, and Honduras.

4 Former Chancellor Helmut Kohl brought bunches of bananas with him to East Germany during the post-reunification campaign as a sign of the wealth he pledged to bring to the recently united country.

former colonies Cote d'Ivoire and Cameroon. The United Kingdom was essentially closed to Latin American bananas, buying instead from former colonies Jamaica, the Windward Islands, Belize, and Suriname. Germany, with no banana-producing former colonies and no domestic production, by contrast, had no tariffs or restrictions on imports, and Belgium, Denmark, Luxembourg, Ireland, and the Netherlands imposed only a 20 percent tariff on Latin American bananas.

Strong consumer preferences developed over time further reinforced these historic trading patterns. Although most of the imports were the same species—Cavendish bananas—those from the Caribbean were generally more curved and smaller—often half the size of dollar bananas. Caribbean bananas were the favored fruit of the average British shopper, who claimed their diminutive size made them cheaper on a per banana basis, and easier to slip into a lunchbox. But German consumers preferred dollar bananas, and most German grocers stocked only the larger, more uniform fruit.

In 1992, however, as the EU prepared to institute a single market for trade the following year, representatives of the 12 EU members met to transform the fragmented set of trade arrangements into a unified banana regime.[5] Because the banana trade system was so controversial, it was the last item the EU addressed. Not surprisingly, given the mix of concerns involved, negotiations within the European Commission dragged on for months, with particular clashes between Germany's free-trade position and France's and Britain's insistence on honoring the Lomé Convention, the agreement designed, in part, to increase trade between ACP countries and the EU by providing preferential access to ACP products.[6]

In fact, the Fourth Lomé Convention, signed in December 1989, had included a separate banana protocol providing a guarantee by the EU on behalf of its member states that ACP banana exporters would not be negatively affected by the shift from member state regimes to a single market regime. For countries like France and Britain, though, the sense of responsibility towards the former colonies went beyond mere legal obligations to encompass an almost moral duty to protect the ex-colonies and assure their economic stability.

As the debate in the EU continued, Latin American and US interests closely followed the evolving negotiations. The EU—with a $5 billion retail market—was the world's largest importer of bananas, constituting about 40 percent of world banana trade. If the EU adopted a regime patterned after the German model, it could be a bonanza for both the producers and the marketers of Latin American bananas, as significant new markets opened for trade. A system modeled on the British or French approach, on the other hand, imposing restrictive measures EU-wide, could prove devastating for the dollar banana industy.

5 Since the close of World War II, the European Community had been gradually moving toward a single market that would allow the free movement of goods, services, people, and capital without regard to country borders. Agricultural policy was the final area to be negotiated.

6 The European Commission, the EU's executive body staffed by each member nation, was the lead agency in drafting the new banana regime.

Unfortunately for US and Latin American interests, the new regime announced in December 1992 favored the latter approach. The trade regime, known as Regulation 404, created a complex system of quotas and licenses that constituted serious barriers to entry in violation of international trade regulations, according to US and Latin American critics.[7] As the different sides staked out their positions, it was clear that the trade policies would face serious opposition. Perhaps no one suspected, however, that six years later, the controversy over the EU banana regime would still be unresolved.

Regulation 404

The EU enacted Regulation 404 in July 1993, for the first time establishing a single European market for bananas. While the regulation was extremely complex, there were certain key aspects that most concerned US and Latin American critics.

To begin with, the regime broke the EU market into three distinct sectors—domestic production; ACP bananas from the former colonies; and Third Country—essentially Latin American—bananas.[8] The provisions on subsidies for domestic production were within reason, observers say, and did not spur significant external challenges.[9] But the regulations governing ACP and Latin American bananas were highly discriminatory, US and Latin American industry representatives charge. ACP bananas, like domestic bananas, faced no duty. In addition, the EU gave each of the 12 countries a specific quota based on its best export year ever up to 1991. The total duty-free ACP quota of 857,700 metric tons, US officials say, was well above what the countries as a group had ever exported to the EU in any given year.

Most troubling, though, from the US and Latin American perspectives, were the tariff-rate quota (TRQ) and the licensing restrictions imposed on Third Country, or Latin American, bananas.[10] To limit the supply of Latin American bananas, the EU set the TRQ at 2 million metric tons, with a tariff of 75 European Currency Units (ECU) per metric ton for bananas brought in under the main quota, and 822 ECU per metric ton for bananas in excess of the quota.[11] Because the tariff rate for bananas imported in excess of the quota was so high, the TRQ effectively limited imports to 2 million metric tons a year, an amount which US trade officials claimed would not only end the average nine percent a year growth that Latin American banana imports to the EU had

7 The full name of the trade regime was Regulation (EEC) 404/93.

8 The actual sector designations were slightly more complicated, including with Third Country bananas an allowance for "Non-Traditional" ACP bananas, that is, ACP bananas imported in excess of historic levels, as well as bananas imported from ACP members that were not traditional suppliers.

9 Domestic producers faced no tariffs and no access limitations, and they received some compensation for loss of income resulting from price reductions due to the banana regime.

10 A tariff-rate quota is the application of a reduced tariff rate for a specified quantity of imported goods.

11 The EU later increased the tariff-rate quota to 2.1 million metric tons in 1994 and 2.2 million metric tons in 1995 to accommodate market growth.

enjoyed over the last decade, but would freeze imports at a level well below Latin America's previous 60 percent share of the EU market.

The TRQ was just the beginning, though. The chunk of the EU market set aside for Latin American bananas was further segmented by a complex licensing system that created three categories of licensed importers and gave each group a specific percentage of the Latin American TRQ. Category A operators—historical traders of Latin American bananas such as Chiquita, Dole, and Ecuador's Noboa Group—got 66.5 percent of the volume. Category B operators—historical importers of ACP and EU bananas—got 30 percent, and Category C operators—newcomers—received 3.5 percent.

According to EU representatives, the different importer categories worked hand in hand with the tariff-rate quota, providing a necessary cross subsidy to ensure that ACP bananas made it to market. Because most banana production in the Caribbean took place on small mountainous farms, as opposed to the large mechanized plantations common in Latin America, the cost of harvesting bananas was much higher, up to $500 a ton versus $160 a ton in Latin America. But by granting Category B operators a guaranteed percentage of the cheaper Latin American production, the theory went, these operators could afford to sell the higher cost ACP bananas. Without this edge, EU representatives said, the quotas and tariff alone were not enough to make trade in ACP bananas profitable.

But according to US and Ecuadoran banana traders, who had historically dominated Latin American banana exports to the EU, ACP farmers were not the sole—or necessarily even the principal—beneficiaries of the plan. For one thing, distributors of bananas grown in EU countries received half the Category B licenses. Moreover, because most Category B operators were EU firms, such as Ireland's Fyffes Ltd. and the UK's Geest, the licensing system effectively handed over to these EU firms almost a third of the Latin American volume previously marketed by US, Ecuadoran, and other Latin American companies.[12] US multinationals like Chiquita, therefore, who had already had their European access cut by the quota, lost an additional share of the market due to the licensing scheme. "The EU just wrapped itself in the flag of the ACP," says one US trade official. "You'd never know that they were doing anything for their own farmers or for their own companies."

Moreover, there was an additional layer to the new licensing regime. The Category A and B operators were divided into three further sub-functions. Within both A and B, 57 percent of licenses went to "primary importers," companies like Fyffes and Chiquita; 15 percent went to "secondary importers," smaller companies handling customs clearance within the EU that might or

12 Geest later sold its banana business to a consortium including Fyffes and the Windward Islands Banana Development and Exporting Companies.

might not be affiliated with one of the primary importers; and 28 percent went to ripeners.[13] Typically, a country imposed a quota by distributing licenses to importers based on historical trading patterns. The EU's licensing regime, however, US trade officials say, created entire new categories of operators with no historic precedence. The only justification for the new categories, critics say, was to build EU support for the regime, particularly in countries such as Germany that had no primary operators or producers benefitting from the other licensing controls. German ripeners who suddenly had been granted licenses to import bananas, for example, could either expand their businesses into importing, or sell the licenses to a company like Chiquita.

According to US trade estimates, the licensing changes automatically transferred about 50 percent of US companies' EU business to EU and ACP firms that had never before distributed Latin American bananas. "There is the feeling," says one US trade specialist, "that the EU agriculture people are incapable of doing anything that isn't discriminatory." (See Exhibit A for a chart prepared by the United States Trade Representative comparing the tariff, quota, and licensing arrangements for EU, ACP, and Latin American bananas.)

A paper funded and published by the World Bank in December 1994 was almost equally critical.[14] The EU regime, the report claimed, cost EU consumers an estimated $2.3 billion a year, and shoppers in countries such as Germany, where trade had been unrestricted, were particularly hard hit. Moreover, most of the so-called quota rents—the excess profits generated as the result of higher prices paid by consumers and others due to the restrictions on competition imposed by a quota system—were flowing not to the ACP banana producers, the paper said, but to the EU firms that were marketing ACP bananas. Either EU policymakers did not understand the impact of their policies, the paper concluded, or they intended to "protect (and expand) the vested interests of EU-based marketing companies. This group is clearly the main beneficiary of the policy. EU consumers, other marketers and Latin American suppliers are clearly big losers."

International Reactions to Regulation 404

The international community did not accept the new EU regime without a fight. Just months before the EU enacted Regulation 404, five banana-producing Latin American countries brought a challenge in the General Agreement on Tariffs and Trade (GATT) against the banana regimes of several individual EU member states, charging that they violated international trade rules.[15] By bringing the GATT challenge when they did, Colombia, Costa Rica, Guatemala,

13 While in the US, large supermarkets usually ripened their own bananas, in Europe many stores relied on designated ripeners who stored the green bananas until they were ready for market.

14 Brent Borrell, "EU Bananarama III," The World Bank, December, 1994.

15 The General Agreement on Tariffs and Trade was drafted in 1948 to provide rules governing world trade. The unofficial organization that arose from the agreement, consisting of the members or contracting parties to the agreement, was also known as the GATT. Though only provisional, the GATT was the only multilateral organization governing international trade until the 1995 establishment of the World Trade Organization.

Nicaragua, and Venezuela hoped to increase their chances of winning a subsequent case against the soon to be implemented single market regime. In fact, in June 1993, before the first GATT panel had even ruled on the original complaint, the same countries requested a second panel to evaluate the new regime going into effect the following month.

The Latin American countries were vindicated. In July, the first panel ruled that the former regimes were GATT incompatible, and a few months later, the second panel found Regulation 404 violated GATT by, among other things, giving a preferential tariff to ACP countries, imposing a tariff quota on Latin American producers whose over-quota rate was above the tariff level which had been negotiated, and imposing licensing requirements that discriminated against new traders. Although it was a victory for the Latin American complainants, however, the rulings had no teeth. Because GATT proceedings required a consensus, it was always possible for a losing party in a trade dispute, in this case the EU, to block adoption of a panel report, a limitation—and in the minds of some, a flaw—that often transformed GATT rulings into diplomatic tools rather than legal proceedings.

US companies had not participated directly in the two GATT challenges. According to industry sources, the Latin American complainants had not wanted direct US involvement, fearing it would transform the case into a US vs. EU fight. Instead, representatives of Chiquita and Dole had worked as advisors, providing assistance and support to their Latin American suppliers behind the scenes.

The US multinationals were also busy at home. In the months before Regulation 404 took effect, representatives of both companies met quietly with officials at the Office of the United States Trade Representative (USTR), the government agency responsible for overseeing US international trade issues, to discuss the possibility of filing a Section 301 case. Section 301, created as part of the United States 1974 Trade Act, provided a formal mechanism by which companies could ask the US government to intervene if they felt they were being harmed by discriminatory trade practices. If a Section 301 investigation found a country had imposed unfair trade measures, USTR had the right under US law to withdraw trade concessions in an amount equivalent to the damage estimated to have been done to US commerce. Either USTR or a company could initiate a Section 301 case, but a company typically would not ask for an investigation unless USTR had indicated it would accept the case.

According to one industry source, however, USTR, which only accepted about 14 cases a year, made it clear that it wasn't interested. "You had the reality of a trade complaint that didn't necessarily strike one as being crucial to American interests," he admits. In particular, he says, the fact that the US was not exporting bananas meant the complaint was not "automatically recognizable as something that needed the immediate attention and action of USTR."

The Framework Agreement

Although USTR had not filed a formal complaint when the EU first enacted Regulation 404, United States Trade Representative Mickey Kantor began to speak out against the banana regime in January 1994. Kantor was particularly concerned by news that the EU was trying to negotiate an agreement with the Latin American GATT complainants that would settle the banana dispute and make it unlikely that they would bring future complaints against the regime.

In March 1994, as the US had feared, the EU and four of the five Latin American countries announced a new Framework Agreement.[16] The agreement, which the EU was to institute in January 1995, provided two important concessions to the Latin American participants.[17] First, each of the four signatories received a set percentage of the third-country quota: 23.4 percent for Costa Rica, 21 percent for Colombia, 3 percent for Nicaragua, and 2 percent for Venezuela. Taken together, these new quotas represented almost half of the third-country market, and, according to US trade officials, gave Colombia, Costa Rica, Venezuela, and Nicaragua a disproportionate share of the quota. In fact, US officials estimated that the non-Framework Latin American countries of Ecuador, Guatemala, Honduras, and Mexico lost 27 percent of their access to the EU market due to the double whammy of Regulation 404 and the agreement.

Second, the agreement created a system of export certificates that essentially mirrored the import certificates on the other side of the ocean. Category B operators—traders that sold ACP or EU bananas—didn't need these export licenses. But Category A operators such as Chiquita now had to obtain export licenses—usually buying them either from local producers or government offices—in order to be eligible for import licenses for the EU market.

The agreement answered many of the complaints of the Framework countries. The quotas provided guaranteed access to the EU market, and the special export certificates provided a new form of revenue for local producers, since producers who had been granted more certificates than they needed could sell them to outside traders like Chiquita. "The EU was not willing to adopt the recommendations of the GATT panel, but they knew that they had to do something," explains Irene Arguedas, minister counselor for economic affairs at the Embassy of Costa Rica in Washington, D.C. "The Framework Agreement was the something they were willing to do."

For a multinational marketer like Chiquita, however, the Framework Agreement was anathema. Panama, Honduras, and Guatemala, countries where Chiquita produced bananas, were expected to lose EU market share because they had no guaranteed quotas. In addition, the country-specific quotas and need for export certificates meant Chiquita could not optimize the performance of its new, larger fleet by buying from the producer country that was the lowest cost provider at

16 Only Guatemala, of the original petitioners, refused to take part.

17 Although never formally investigated, some US trade officials believed that the EU had bribed Latin American representatives to assure their cooperation with the agreement.

any given time. Finally, the company feared that independent producers in the Framework countries would receive a disproportionate share of the licenses, forcing Chiquita to buy extra export certificates, just as it had invested in extra import licenses for Europe.

"What you have here is something that was discriminatory to begin with, and then each new level of discrimination gets added as the EU seeks to pay off another constituent," says a USTR official. "We realize they have difficult domestic problems, but they can't be handled at the expense of its WTO obligations." A US banana industry representative agrees. "The Framework Agreement obviously imposed an additional obligation in terms of coming up with the special export certificates that had to match the licenses granted in Europe," he notes. "To the extent that a company had lots of licenses in Europe and an imbalance in the amount of export certificates they obtained, they were terribly hurt by that. That's what happened with Chiquita."

US Section 301

Dole Food Co., like Chiquita, had opposed Regulation 404 from the start. Even as Dole spoke out against the regime, though, it was positioning itself to operate within its constraints. After Regulation 404 was adopted, the company invested in banana production in Africa and the Canary Islands and formed joint ventures with EU importers, thus qualifying as a Category B importer of ACP bananas and marketer of EU fruit. Dole also bought ripeners in Europe to qualify for an additional share of import licenses. As such, Dole's preferred status allowed it to avoid many of the most restrictive aspects of the regime.

Chiquita, on the other hand, was not well positioned financially to undertake such diversification. Although the company had once had a Caribbean presence, it had divested that part of its business in the 1980s and made major investments in new shipping capacity, apparently with the expectation that the EU would adopt an open banana regime, and that the emerging Eastern European market would greatly increase demand for the company's dollar bananas. The combination of the unexpectedly restrictive single market regime, however, with economic chaos in the countries of the former Soviet Union, had left Chiquita with too many ships and bananas, as well as substantial debt. In 1992, the year before the regime took effect, the company reported losses of $222 million. Although critics insisted that bad business decisions were primarily at fault, Chiquita blamed changes in anticipation of the EU regime for its faltering bottom line.

Chiquita's and Dole's initial talks with USTR about bringing a case against the regime had not been fruitful, but the looming implementation of the Framework Agreement impelled Chiquita to further action. Multimillionaire Carl Lindner, chairman and chief executive officer of Cincinnati-based Chiquita, had long been a generous campaign contributor, and with the Framework

Agreement looming, Lindner stepped up his contributions to both parties.[18] According to a study by the public interest group Common Cause, Lindner, his company, its subsidiaries, and their executives donated almost $1 million to the National Party Committees of the Democratic and Republican parties in 1993 and 1994, making him one of the nation's largest contributors of soft money during that election cycle.[19] "The signals were becoming pretty clear that USTR was not going to pursue this, and I think it was probably about that time when Chiquita realized that raising the interest in this case politically would have an effect on the reaction of USTR as an executive branch agency," says a banana industry representative. "The results speak for themselves."

In the summer of 1994, Chiquita's Washington D.C.-based trade attorney and lobbyist, Carolyn Gleason, became a regular visitor and informal consultant to USTR, providing policy recommendations as well as detailed trade information regarding Chiquita's estimates of damage done to US industry by the EU regime. Gleason also began arranging meetings between Carl Lindner and key politicians and government officials. USTR Mickey Kantor held three meetings with Lindner, two of them hosted by Senate Majority Leader Bob Dole (R-KS).[20]

The effort was well spent. In August, a group of 12 Senators, including Bob Dole, wrote Kantor urging a formal investigation under Section 301 of both the banana regime and the Framework Agreement, and in September, a coalition of 50 US Representatives sent a similar letter. "The express intent of the new export quota and licensing authority is to inflict additional revenue and market share loss on American companies," the Congressional letter read in part. "US companies have suffered a 50 percent decline in EU market share; a substantial loss of customers and associate growers; job losses; massive increases in operational costs, including transport costs; major additional reorganization costs; and significant price-depression in third country markets."

On September 2, the same day that the Congressional letter went out, Chiquita and the Hawaiian Banana Industry Association petitioned the Clinton administration to file a Section 301 case against the EU, as well as separate 301 cases against the four Latin American signatories to the Framework Agreement. As is customary with a 301 petition, USTR had already informally indicated its willingness to take on the case, and, in fact, helped Chiquita prepare the petition. According to the petition, the EU's practices were "unreasonable and discriminatory," restricted US commerce, and threatened the "survivability" of US production.[21] It was Chiquita's hope, says

18 Lindner's holding company, American Financial Group, Inc., had acquired a majority interest in Chiquita in 1984 and moved the company to Cincinnati four years later.

19 Soft money contributions, or donations to political parties, were not subject to the same restrictions as donations to candidates.

20 Brook Larmer with Michael Isikoff, "Brawl Over Bananas," *Newsweek*, April 28, 1997. Senator Dole had no family tie or affiliation with Dole Food.

21 According to data from the US government, Statistics of Hawaiian Agriculture, and the Puerto Rican Department of Agriculture, US production of bananas in metric tons was 63,143 in 1992, 59,684 in 1993, and 54,550 in 1994,

a USTR official, that a fast USTR investigation followed by threats of retaliation could stop the Framework Agreement from going into effect in January.

On October 17, 1994, Mickey Kantor announced that USTR would initiate a Section 301 investigation against the EU, claiming that Regulation 404 discriminated against Chiquita's ability to market and distribute Latin American bananas. The investigation triggered immediate protests on the part of Kantor's counterpart, European Union Commissioner Sir Leon Brittan. Not surprisingly, the 13 Caribbean Community (CARICOM) nations and the Caribbean Banana Exporters Association also decried the Section 301 complaint. According to CARICOM, the EU banana regime didn't discriminate against US companies, but simply guaranteed market access and adequate prices for the less efficiently produced Caribbean bananas in accordance with Lomé Convention obligations. The economies of such nations as Dominica and St. Lucia of the Windward Islands would be particularly devastated, the groups argued, since their production expenses were so much higher than those of Latin American countries, and since they had no other agricultural or industrial product to take the place of bananas. "Populations on the USA's own doorstep would be transformed from hard-working family farmers into mendicant unemployed," declared a CARICOM release. Caribbean representatives also stressed the likelihood that a dropoff in banana production would lead directly to an increase in illegal drug trading.

In January 1995, as the Framework Agreement went into effect, USTR brought similar 301 cases against Colombia and Costa Rica.[22] The US action raised alarm in the two countries, since if the US decided to retaliate, it would likely withdraw concessions granted under such key programs as the Caribbean Basin Initiative and the Generalized System of Preferences. According to Irene Arguedas of the Costa Rican Embassy, the politically and economically susceptible Latin American countries were caught in the middle. If they didn't implement the Framework Agreement, their years of struggle to win better access to the EU market, including the two GATT cases, would be for naught. But if they did implement it, they faced the real threat of US retaliation. "It was ridiculous," declares Arguedas. "The US does not produce any bananas. It was very obvious that the US was enacting this case because of [Lindner]. There were not substantial interests involved."

Indeed, the USTR action, taken on the heels of Lindner's large campaign contributions, raised eyebrows in the US as well as abroad. Particularly suspect, critics claimed, was the fact that USTR had never before taken on a case with so few US jobs at stake. Also significant, noted some observers, was the fact that Dole Food did not participate in the Section 301 complaint.[23] "The

all for domestic consumption. Because the restricted EU market had created a banana surplus outside of the EU, the Hawaiian Banana Industry argued, prices in the US domestic market had been forced down.

22 USTR did not challenge Nicaragua or Venezuela, whose banana exports were too small to significantly affect Chiquita.

23 A USTR staff member, though, who notes that Dole was extremely cooperative whenever USTR requested technical support, explains that Dole had practical reasons for not taking part, since it had invested heavily in ACP and EU operations, and probably hoped to amortize its investments before the regime came to an end.

driving force behind the case is Chiquita," says a US lawyer who backed the Caribbean cause. "Not the governments of any of the countries, but Chiquita, and Carl Lindner in particular."

Taking the Case to the World Trade Organization

Even as Kantor was launching the Section 301 case, the arena for resolving international trade disputes was shifting dramatically. Since the GATT was drafted in 1948, members periodically had refined the agreement and made it more liberal through a series of negotiations known as trade rounds. In the Uruguay Round, the latest negotiation begun in 1986, members had taken up an ambitious and controversial roster of changes that resulted in the creation of the World Trade Organization (WTO) on January 1, 1995. In contrast to the provisional GATT, the WTO was an official international body formed to help promote free trade, serve as a forum for trade negotiations, and settle international trade disputes. While GATT rules were amended and incorporated into the new body, the WTO's agreements covered not only trade in goods, but also trade in services and intellectual property.

During January 1995, in the weeks after the WTO's founding, USTR Mickey Kantor pressed forward on the Section 301 case, declaring that a preliminary investigation showed the EU regime was costing US companies "hundreds of millions of dollars." But although Kantor wrote European Union Commissioner Sir Leon Brittan threatening retaliatory measures if the EU and US could not reach a compromise, several bilateral consultations between US and EU representatives made no headway. The EU, one USTR official says, showed no interest in making changes.

Undoubtedly, the EU's unwillingness to craft a compromise was affected by the deep divisions over Regulation 404 that still existed within the European Community. As recently as October 1994, the European Court of Justice had upheld the regime against a challenge to the licensing provisions brought by Germany, the Netherlands, and Belgium. Indeed, seven EU members, including the recently acceded countries of Austria, Finland, and Sweden, openly opposed the regime. If the European Commission tried to revise Regulation 404, it would reopen strong disagreements among members as to the regulation's fundamental design.

Many EU members who backed the regime, moreover, believed the EU had already taken a necessary step to bring it into compliance. In December 1994, during the last month of the GATT's existence, the EU and the ACP nations had requested—and been granted—a waiver from international trade rules covering some of the Lomé Convention trade preferences.[24] Specifically, the waiver covered the most-favored-nation clause of Article I of the GATT, which dealt, in part, with rules governing the imposition of tariffs. From the EU and ACP perspective, the Lomé waiver legitimized the preferential regime with the former colonies. But while USTR officials were willing

24 The GATT panels that ruled against the EU regimes in 1993 had advised the EU to obtain such a waiver.

to concede that the waiver sanctioned the tariff on Latin American imports, they insisted that it left many additional trade violations unresolved.

Finally, some EU representatives say they bristled at the idea of changing Regulation 404 just to satisfy Chiquita. "There was a perception that Chiquita's losses may not have been purely due to the restrictions of the regime," says Alison Mable of the UK's Trade Policy and Tropical Foods Division, Ministry of Agriculture, Fisheries and Food. "Many people later came to feel, for example, that Dole, who bought into the B license system and worked within the system, had done OK with the regime."

Although the deadline for the Section 301 case was October 17, 1995, one year after USTR initiated the investigation, the EU Commission by mid-summer still couldn't agree on how to respond. Dole Food had been lobbying all sides for a compromise, but in July the Commission finally decided not to seek a mandate from member states to negotiate with the US.[25] With the Commission at a standstill, USTR faced two choices: forge ahead with a Section 301 retaliation, or bring the case instead to the fledgling WTO.

In some respects, a decision to go to the WTO might have seemed self-evident. After all, the two GATT panels had already set a precedent in finding the EU banana regime incompatible with international trade rules. Yet, it was unclear how different the proceedings might be under the WTO. Historically, complainants had won most GATT cases. But under the WTO, dispute settlement rules were different. While most decisions still had to be reached by member consensus, panel reports could not be blocked unless there was a reverse consensus, or in other words, unless all members voted against adoption. Now that rulings could no longer be blocked, it was possible that the WTO dispute panels would be more cautious about finding a country to be out of compliance.

Moreover, the GATT cases had been brought by banana producers, and many observers, including some in the US, believed that the US, as a banana marketer, did not have a strong GATT case. Instead, the US would probably have to rely on a novel interpretation of the new, and still untested, General Agreement on Trade in Services. In addition, political pressure was building domestically for quick Section 301 action, as Senate Majority Leader Bob Dole, among others, pushed for legislation that would threaten retaliation against Colombia and Costa Rica for their participation in the Framework Agreement.[26]

USTR, however, was reluctant to launch a unilateral challenge right after the WTO had gone into effect. The international community had always hated Section 301 for the ability it gave the US to impose unilateral retaliations. Now, with the advent of the WTO and its new dispute

25 The mandate was necessary to conduct negotiations representing all the EU.

26 During 1995, then presidential candidate Dole flew a dozen times in planes made available by the Lindner family's corporate interests, according to the Federal Election Commission.

settlement procedures, many critics of the policy asserted that Section 301 was no longer a legitimate response in disputes involving WTO members. USTR insisted it was, and, in fact, noted that the US would never have approved the Uruguay Round leading up to the WTO if it hadn't believed its ability to bring 301 cases was still intact. Nevertheless, to retaliate under Section 301 when the ink on the WTO agreement was barely dry, USTR officials conceded, could make the US appear to be thumbing its nose at the new international trade dispute mechanisms. "If we had gone with unilateral sanctions, all we would have done was raised the ire of all the other WTO members, including the member states in the European Community who favored our position," says one USTR official. "You can't have the Community and the Commission united by antipathy to the United States and their unilateral action. You always need some people on the inside helping to bring about change."

A final consideration clinched the decision. The Latin American countries that had not signed the Framework Agreement, such as Honduras and Guatemala, were facing the same set of restrictions that were affecting Chiquita. If these banana-producing nations became co-complainants, USTR officials reasoned, the case before the WTO would be stronger. Moreover, if a WTO panel ruled in their favor, it would not only show that the US was respecting and acting within the new dispute settlement process, it would also put pressure on the EU to do the same. "Presumably," says one USTR official, "the EU would feel shamed into complying with its international obligations."

In September 1995, almost one year after first launching the Section 301 investigation, USTR ended the Section 301 case without a formal finding and initiated a WTO investigation of the EU regime along with Mexico, Honduras, and Guatemala.[27] "We have repeatedly sought changes in the European banana regime to address the discrimination against US companies, but unfortunately the EU has been inflexible," Kantor's statement announcing the action read in part. "We think it is appropriate at this time to resort to WTO dispute settlement procedures and we are pleased that other countries in our region that are also adversely affected by the regime are joining us."[28] In February 1996, Ecuador, which had just become a WTO member, joined the challenge. Ecuador's involvement was particularly key since it was the only Latin American participant with substantial sales to the EU market.

There were reports that the US had needed to persuade Honduras, and Guatemala to participate in the WTO case. Ecuador, however, whose special circumstances made it perhaps the hardest hit of the Latin American countries, needed no such urging.[29] Because it had refused to take part in the Framework Agreement, Ecuador had no specific country allocation, despite the fact that it had some 5,000 independent growers and was the world's largest banana exporter.

27 The US did not drop its separate 301 claims against Colombia and Costa Rica, however.

28 *Inside US Trade*, "US Requests WTO Consultations on EU Banana Import Restrictions," September 29, 1995.

29 Ecuador had not been a party to the earlier GATT cases because it was not a GATT member.

Moreover, unlike Guatemala or Honduras, most of whose exports were handled by US multinationals, Ecuadoran traders—in particular the prominent Noboa Group—handled 80 percent of exports. Yet because Noboa only sold Ecuadoran bananas, it—like Chiquita—could not qualify as a Category B operator, and therefore had to buy many of the licenses it needed to import into the EU market.[30] "I want to be very clear on this, we didn't join in this action because of the US," asserts Teodoro Maldonado, counselor for economic affairs at the Embassy of Ecuador in Washington, and formerly secretary for trade responsible for the banana case in the WTO. "We had our own legitimate concerns."

In January 1996, faced with the imminent threat of US retaliation, Colombia and Costa Rica signed a memorandum of understanding with the US in exchange for an end to the Section 301 case. As part of the agreement, the two countries would support an open EU market for bananas, and would begin distributing their export licenses in a manner more favorable to US multinationals. According to Irene Arguedas, minister counselor at the Costa Rican Embassy, both Costa Rica and Colombia continued to be caught between the jockeying of the US and the EU, with no leverage to influence events. "The countries that suffered the most in the end were the small countries," she declares.

On February 5, 1996, the four complainants, along with new WTO member Ecuador, filed a fresh request for WTO consultations. In retrospect, says one USTR official, EU officials should have realized that if they had negotiated a compromise during the Section 301 phase, the US would have been willing to settle for less. "We wanted some improvement to help US companies out of the worst of it," the official says. "That is what we were looking for—some quick relief."

The Case in the WTO

The WTO process got off to a slow and contentious start. The EU wanted bilateral consultations, in order to deal with each country's complaints individually, and to isolate the US—the most powerful adversary, but the one whose case as a non-banana exporter appeared to be the weakest. The complainants, on the other hand, wanted one multilateral consultation to combine their charges and ensure that the WTO would appoint only one dispute settlement panel rather than five. In mid-March, a compromise was approved. The EU got its bilateral meetings, but the challengers made the same presentations and posed nearly identical questions. In addition, the WTO convened only one panel, as the complainants had desired.

In a typical WTO case, the countries in dispute agreed on the three panelists together, drawing from a permanent list of trade experts who served as individual consultants rather than

30 While joining the Framework Agreement would have won Ecuador a quota, it would not have resolved the licensing issues that were critical to Ecuador as a major banana trader. Indeed, under the regime, the Ecuadoran government estimated that the country's traders were only granted licenses for about one-third of the bananas they imported into the EU, forcing them to buy licenses for the other two-thirds.

country representatives. After the two sides were unable to agree on a panel, however, WTO Director-General Renato Ruggiero in June selected Stuart Harbinson, Hong Kong's permanent representative to the WTO; Kym Anderson, a University of Adelaide economist; and Christian Haeberli, an international trade expert from the Swiss economics ministry.[31] On July 9, the US and the four Latin American countries submitted their first briefs laying out their challenges to the regime.

In an attempt to get maximum leverage, a USTR official says, the US filed as many different claims against the EU regime as possible. While most of the claims of the Latin American countries, as banana producers, focused on trade in goods, USTR claims covered both goods and services.[32] Under goods, the GATT segment of the claims, USTR challenged both the quotas and the licensing systems imposed by Regulation 404 and the Framework Agreement. The services claims brought under the General Agreement on Trade in Services (GATS), on the other hand, were focused on how the regime's licensing requirements had "drastically reallocated, reconfigured, and restricted" the Latin American banana service market, according to the brief.

USTR officials say they felt fairly confident on the goods side, particularly on the issue of Category B licenses, since GATT already had ruled twice on that issue. They were less certain, however, about the service's claims. Not only was this a new area of the regulations, services traditionally had been construed as marketable activities like legal or accounting services, rather than the transfer of goods, and it was unclear if the WTO would accept such an interpretation.

In a July 30 panel submission, and again at the first dispute settlement panel meeting in mid-September 1996, the EU attacked the US brief on several key points. As a non-banana exporter, the US not only had no right to bring a WTO case, the EU argued, it should not be allowed to press claims on behalf of other nations.[33] The US argument that the regime had hurt the ability of its companies to supply services was also faulty, the EU said, because the rules cited dealt with trade in goods, and trade in services was not intended to include the marketing of goods as a service. In addition, the EU defended its preferential treatment of ACP countries, noting that the GATT waiver it had obtained protected precisely the policies that the complainants were challenging.

Because the ACP countries had not been designated as defending parties, representatives of the Caribbean banana-producing nations were relegated to third party status in the WTO proceedings, and could not participate fully in the debates. In the US, however, supporters of preferential trade policies for the Caribbean became more vocal as the WTO process went forward. A public relations campaign organized on behalf of the Caribbean Banana Exporters Association (CBEA), for example, targeted White House and Hill politicians with stories about Carl Lindner's

31 *Inside US Trade*, "Top WTO Official Picks Panel to Settle Dispute Over EU Banana Regime," June 14, 1996.

32 Ecuador, as a banana marketer, also brought claims under services rules.

33 "Fortunately that was defeated," notes a USTR official. "They wanted us out because we were helping the other countries. They figured they might be able to buy out the other countries, I suppose."

large donations in an attempt to counterbalance the pressure that Chiquita was exerting. "From the ACP perspective, Chiquita made a bad corporate decision and didn't like the results, so it glommed onto a legal challenge to try to undo the damage," explains a lawyer involved with the effort.

In addition, representatives of the Caribbean nations spoke out whenever possible on the potentially tragic consequences of US efforts to end the preferential EU regime, including the likelihood that drug trafficking on the US's southern flank would increase dramatically. Caribbean bananas were a small factor in world trade, accounting for only three percent of the world market and about nine percent of the EU market, notes Dame Eugenia Charles, prime minister of the Windward Island of Dominica from 1980 to 1995. But for many fragile Caribbean economies, she says, bananas were key, accounting for 70 percent of Dominica's export earnings, for example. "With the little bit that we grow, we couldn't put any other country out of jobs," she says, "but it could make all the difference in the world to the Caribbean."

Richard Bernal, Jamaica's ambassador to the US, agrees. "Every country, including the United States, realizes that in a free market you make allowances for certain vulnerable participants," he argues. "It doesn't affect the operation of the market if a small percentage of the participants are given some kind of specialized treatment." Adds David Christy, senior associate in the Washington office of Winthrop, Stimson, Putnam & Roberts, and a member of CBEA's legal team assembled to fight the WTO case, "The importance economically of banana trade to many of these countries cannot be overstated, because the boats coming in are bringing in supplies and taking out not just bananas but other goods, so it's really a lifeline. It's the core economic activity that allows all other economic activities to occur."

Kantor tried to placate domestic critics, such as the Congressional Black Caucus, a group of about 40 African-American congressional representatives whose members often supported Caribbean causes. In a memo to Rep. Maxine Waters (D-CA), responding to her concerns over the US challenge to the EU regime, Kantor wrote in part, "I would also like to stress that the United States supports EU tariff preferences for products, like bananas, from African, Caribbean and Pacific (ACP) nations under the Lomé Convention." But, he later continued, "… the Lomé Convention does not require the EU to discriminate in favor of EU firms over US companies. The United States cannot tolerate the EU's licensing system which took away American business and gave it to a few EU firms."

Indeed, USTR stayed firm in its stance that the EU regime was the wrong way to assist the struggling Caribbean economies. According to the agency, the EU's discriminatory policies—supposedly put in place to help the 20 percent of bananas that came from ACP producers—in fact gave preferential treatment to almost 40 percent of bananas sold in the EU, many of which came from relatively affluent EU territories, as well as from countries, such as Cote d'Ivoire and Belize, whose production was almost as efficient as that of Latin America. Moreover, USTR officials argued, while some ACP countries undoubtedly needed some form of support, studies had shown that the EU regime was an extremely inefficient means of providing it. A World Bank study frequently cited by USTR, for example, had found that the EU regime only returned 7.5 cents to ACP countries for every dollar it cost. In addition, USTR noted, although import taxes on Latin American bananas had brought in more than $300 million annually, the EU was only spending about $30 million a year to aid ACP banana production. "We really do believe that there are better ways to help the Caribbean and not hurt Latin America and not hurt our companies," says a USTR official. "That's the basis on which we're operating."

The WTO Panel Reports

On March 18, 1997, slightly more than a year after Ecuador joined in asking for WTO consultations, the WTO dispute settlement panel issued a confidential report that represented a resounding victory for the US and its co-complainants.[34] According to the interim decision, the EU had violated WTO agreements on 16 counts, including violations of the GATT, the GATS, and the Agreement on Import Licensing Procedures. Among the specific EU measures ruled to be in violation of trade rules were the establishment of Category B Operator licenses, the granting of individual country allocations to non-substantial suppliers, such as Nicaragua and Venezuela, and the requirement that export certificates from framework countries be matched with EU import licenses. Although the panel also found the country-specific quotas for ACP countries to be in violation of the GATT, it concluded that the violation was covered by the EU's Lomé Convention waiver.

Particularly significant was the panel's interpretation of the GATS, which agreed with the US argument in allowing the services agreement to apply not only to marketable services, such as accounting, but also to service aspects of goods transactions, such as wholesale marketing. As such, a single trade measure could be found to be incompatible with both the GATT and the GATS. The panel also ruled that a country did not have to be an exporter in order to bring a case involving GATT violations. According to a USTR official, the WTO ruling was a striking validation of the US position. EU officials, meanwhile, were reportedly stunned.

Although the EU appealed most of the findings in June, the WTO Appellate Body report released in September 1997 was another win for the US. The appeals panel not only upheld most of the findings against the EU, it also overruled the original panel's finding that the ACP country quotas were allowable under the EU's Lomé Convention waiver.

If EU officials were disappointed, ACP representatives were shattered by the WTO rulings, according to a lawyer affiliated with the Caribbean defense: "What you have from the perspective of the ACP countries is a clash of two international obligations," he explains. "You have the treaty commitment between the EU and the ACP promising them no diminution in treatment from the

34 The panel issued its public report on May 22, 1997.

past with regard to their banana exports, and then second, you have the arguably conflicting obligations that the EU and its member states have under the GATT and the WTO not to discriminate." He adds: "I think that the WTO—the panel and the appellate body—should have been, and could legally have been, more sensitive to the obligations flowing from the Lomé convention. The focus that we are the WTO, we focus only on WTO issues and everything else is either irrelevant or of tertiary importance, I think that's wrong."

In the wake of the WTO Appellate Body report, USTR officials announced their intent to meet with Caribbean banana producers, and informally put forward a proposal for a new preferential regime. The EU, USTR suggested, could set a higher, though not restrictive tariff on non-ACP bananas. For those most vulnerable ACP producers, meanwhile, the EU could provide additional assistance, for example, in the form of income support, giving farmers the difference between the price they could get in the EU market and a targeted income level. Most Caribbean representatives, however, flatly rejected the suggestion. Christopher Parlin of Winthrop, Stimson, Putnam & Roberts, another member of CBEA's legal team, says that what the US was suggesting was basically a welfare regime for the Caribbean, "which no government in its right mind wants." He adds: "There is a recognition among the Caribbean elites that they will have to find alternatives to banana production, and that bananas are not the long-term solution. What you're talking about is the transition mechanism."

The Road to Compliance

The first few months after the appeal were characterized by the EU's refusal to discuss plans for a new regime, and by USTR's constant prodding. By December, the only commitment the EU had made was to comply by January 1, 1999, at the end of the standard 15-month period allowed under the WTO, and to respect its "international obligations," a statement the US considered suspect, since it could be taken to refer not only to the WTO panel ruling, but also to the EU's Lomé Convention obligations. "We tried to go in there and say, 'Look, can we talk about the WTO-consistent alternatives, what the reports mean, what your options are,'" says one USTR official, "and they said, 'Oh no, we can't because it's internal, and we can't talk to any countries while it's still within the Commission because we haven't even talked to the member states yet." Although USTR officials met periodically with individual EU member states, the meetings appeared to have little impact.

USTR was alarmed by preliminary reports about EU plans, but officials continued to harbor hopes about the makeup of new regulations. Best, says one official, would have been a tariff-only regime, which would have imposed duties on non-ACP countries, but otherwise allowed an unrestricted market. If the EU concluded that a tariff-rate quota was necessary to provide additional protection for ACP producers, the official continues, the EU could have given the largest suppliers—Ecuador, Costa Rica, Colombia, and Panama—allocations of the entire market consistent with their shares in the past, and then allowed all the smaller providers—

including Guatemala, Honduras, and ACP nations such as the Windward Islands—to compete for the rest. Licenses, meanwhile, could be distributed on the basis of historical importing practices in the period prior to Regulation 404. While this system would not be ideal from Chiquita's point of view, the official says, it would at least be WTO-consistent.

The first round of proposed regulations that the European Commission made public in January 1998, however, bore little resemblance to these speculations, and provoked immedate condemnations at the WTO on the part of the US and its Latin American co-complainants. The biggest EU concession, USTR officials say, was the promise to get rid of Category B and ripener licenses. The EU would set up a new licensing system consistent with WTO rules, the Commission announced, but it declined to say just how it would do that, delaying that portion of the regime until later in the year. In addition, the EU dropped individual country quotas for Venezuela, Nicaragua, and the ACP countries, since according to WTO regulations, it could only give such smaller countries specific quotas if it gave a quota to every single banana exporter. Ecuador, Costa Rica, Colombia, and Panama, as substantial suppliers, would get individual allotments of the Latin American quota, although the Commission had not yet said how those country quotas would be determined.[35]

Much to USTR's dismay, however, the Commission proposal kept in place a two quota system—the same tariff-free quota of 857,700 metric tons for ACP countries, and the same tariff-rate quota for Latin American bananas of 2.2 million metric tons at 75 ECU/metric ton.[36] This system, USTR and its co-complainants charged in a joint statement issued February 5, 1998, violated the WTO because by assigning two separate quotas based on the country of origin, the EU had created restrictions for Latin American countries that were not "similar" to those faced by ACP countries. In addition, they charged, the regime did not reflect trade in the absence of restrictions, since it gave ACP bananas a market share that was 40 percent higher than that justified by historic imports, at the expense of Latin American imports. "I think they decided at the outset that they simply didn't want to come into compliance," says a USTR official. "They tried to do the minimal amount."

The Commission proposal was almost as unpopular within the EU as it was in the US. In discussions leading up to a June 1998 vote by the Agriculture Council, Sweden, Germany, the Netherlands, Belgium, Luxembourg, and Italy all favored a system similar to that suggested by the US that would rely on tariffs only, rather than quotas.[37] Denmark felt the Latin American quota was too small, and should be boosted to 3 million tons. France, Spain, and Portugal, on the other

35 Such "substantial supplier" quotas were WTO-compatible as long as they were based on a reference period free of restrictions.

36 An additional allotment of 353,000 metric tons had been tacked on to the tariff-rate quota each year since 1995 to account for demand from the three members that joined the EU that year.

37 The Agriculture Council needed to approve the Commission proposal in order for it to become law.

hand, claimed the proposal didn't include enough protection for domestic growers, such as those in Martinique and the Canary Islands. Only the UK and Ireland seemed solidly behind the plan.[38]

Some US observers speculated that the Commission had postponed the licensing portion of the regime in order to delay USTR opposition. In June, with details on the licensing regulations still unknown, new USTR Charlene Barshefsky sent out strongly worded letters to all EU trade ministers, warning that without changes in the proposal, "… the United States will not hesitate to exercise its full rights under the WTO and take all available actions."[39] Barshefsky was under pressure herself from Senate Majority Leader Trent Lott (R-MS), who wanted USTR—before the Agriculture Council vote—to publish a specific list of EU agricultural products that would be subject to retaliation if the EU did not make changes in the proposed regime.

In fact, though, says one British official, the decision to break the proposal into two pieces had more to do with concerns about getting Agriculture Council approval than with hampering US opposition. Proposal supporters wanted to get the main structure of the regime through the Council in June while the UK, the plan's staunchest supporter, still held the rotating EU presidency. If the first part of the regulations passed, there would be more likelihood of winning backing for the licensing segment, which, since it directly affected the fate of many EU companies, was the most controversial portion of the regime domestically. In addition, under Council regulations, the licensing portion could be decided by a different committee, the Bananas Management Committee, whose rules governing adoption made approval more likely.

At the end of June, the Agriculture Council finally approved the plan, and in October, the Commission announced its licensing proposal. Although the Commission abolished the primary importer, secondary importer, and ripener categories, as promised, it announced that it would award both licenses and country quotas based on imports during 1994 to 1996, a decision that the US immediately denounced. Because the preferential regime giving licenses to ripeners and other new operators was already in effect during that time, USTR officials declared, a new system based on this period would simply perpetuate the wrongs of the previous preferential regime, including giving licenses to companies that had never imported in the past.[40] According to an EU Commission representative, however, the reference period chosen was necessary to win EU support. If the regime had been based on a period before 1993, she says, "you would have had endless litigation from all the [EU] companies that had been quite happily trading with legitimate expectations between 1993 and 1998."

38 *Inside US Trade*, "EU Members Attack Commission Banana Proposal to Settle WTO Fight," February 13, 1998.

39 *Inside US Trade*, "US, EU Set to Clash Over Banana Regime with Threats of Retaliation," June 19, 1998.

40 Had the Commission awarded licenses according to a base period of 1990-1992, a USTR official says, the US would have accepted the licensing plan.

The Battle Lines are Drawn

As the EU proposal moved forward during the summer of 1998, Dole Food, which over the last five years had increased its EU market share as Chiquita's share fell, continued to call for a negotiated solution. "What Dole was trying to do was to broker a solution, to find the common ground and build on that," explains Frank Samolis, a partner in the Washington law firm of Patton Boggs who represented Dole on a variety of legal and regulatory issues. "A legal victory on paper in the WTO is one thing, but actually coming up with a change in the system is another, and we thought the chances of doing that were going to be far better under some sort of compromise proposal."

No compromise appeared likely, however. Based on the first part of the plan approved in June 1998, USTR had already concluded that the new EU regime was out of compliance. The US and its co-complainants asked for an expedited WTO dispute settlement panel both in July and September to rule on the validity of the plan, but the EU blocked both requests, claiming that the regime could not be judged until the licensing portion was approved. Nor did the EU respond to US requests to reconfigure the regime based on USTR's interpretation of the WTO ruling.

In July, USTR warned the EU that unless it brought the new regime into compliance, the US planned to retaliate. According to Article 22 of the WTO's dispute settlement rules, a USTR official says, the timeframe during which a complainant could ask the WTO Dispute Settlement Body for permission to withdraw concessions was very limited. In this case, the official says, the only time that the US could make this request and take advantage of the reverse consensus rule—which would prevent the EU and ACP countries from blocking the request unless all members were opposed—would be within 30 days of the new regime's implementation, or by January 31. The Dispute Settlement Body would then have to grant the US request within 30 days of the regime's implementation, or by February 1, 1999, unless the EU requested arbitration to negotiate the amount of the retaliation. The 30 days allowed for that process would delay US retaliation until March 3, 1999.

The EU, however, insisted that the US interpretation was dead wrong. Article 21.5 of the new regulations, EU officials said, clearly stated that for a complainant to withdraw concessions, the WTO first had to rule that a trade measure was out of compliance. Because the WTO had made no such ruling, they claimed, any US retaliation would constitute a unilateral action taken outside the jurisdiction of the WTO—an action that the EU would challenge in the WTO.

This reading of the rules, though, USTR officials countered again, was flawed because it could result in an endless loop of litigation, an eventuality that WTO members had never intended. If the EU made only minor changes, for example, but refused an expedited panel, the entire dispute settlement process could start again, including consultations, panel hearings, rulings, appeals, and another 15 months in which to comply. At the end of this two- to three-year period, if the EU instituted a third regime that was still out of compliance, the entire process theoretically could begin again.[41]

By October, the impasse had drawn Congress back into the fray, with several members calling for USTR to publish a list of products that would be subject to retaliation if the US decided to withdraw concessions.[42] "We sold the Uruguay Round to Congress on the basis of our automatic ability to retaliate at the end," says one USTR official. "There's no way any business or exporter in the United States could consider the WTO an efficient process if all it is is endless litigation. Why should we do any trade agreements if nobody complies with them and all they do is use up US government resources?" After a group including House Speaker Newt Gingrich (R-GA) met with Carl Lindner on October 2, Gingrich and Senate Majority Leader Lott wrote President Clinton less than a week later warning of Congress's plan to pass legislation forcing the US to withdraw concessions from the EU unless the regime had been proven to be WTO-compatible.[43] The House debated such a bill on October 10, but chose not to take action after White House Chief of Staff Erskine Bowles delivered a letter to Congress pledging to retaliate under Section 301 if the EU did not meet its WTO obligations.

According to a Republican House staff member who helped draft the bill, while Lindner's involvement was clearly key, the case's significance went beyond Chiquita.[44] "Considering that the administration is supposed to submit a report on the WTO to Congress in the year 2000, and that there's an opportunity for Congress to vote to back out of the WTO," she says, "it's pretty important to make sure that we are on record as having not only won cases, but gotten a fair implementation as a result." More immediately, the aide says, the outcome of the bananas dispute was viewed as likely to affect EU behavior concerning a second WTO decision that favored the US, a ruling against the EU's ban on beef raised with growth hormones. USTR needed to set a strong precedent in bananas, officials believed, to ensure that the EU would comply in the beef hormones case, a dispute that had direct impact on the US as a major beef exporter.

In mid-December, the EU requested a new WTO panel, in essence to judge whether the US would be violating trade rules if it retaliated against the EU without the WTO having found the

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41 WTO members planned to take up the apparent contradiction between Articles 22 and 21.5 as part of a review of the Dispute Settlement Understanding to be initiated during 1999.

42 It was necessary to publish such a list for public comment before retaliation could occur.

43 Lindner's generous contributions to both parties had continued. Lindner and his wife were fourth on the *Mother Jones* magazine's 1998 list of top contributors to political parties, having donated $536,000 from January 1997 through August 1998.

44 It had not been an easy year for Chiquita. On May 3, 1998, the *Cincinnati Enquirer* ran an incriminating 18-page series outlining a number of improper business practices and questionable dealings on the part of Chiquita in Latin America. However, after learning that the lead reporter allegedly stole voice mail messages from Chiquita in researching the series, and facing a likely Chiquita lawsuit, the *Enquirer* ran front-page apologies renouncing the articles over a period of three days, beginning June 28. In addition to firing the reporter, whom Chiquita also sued, the *Enquirer* paid the company a sum reportedly in excess of $10 million. Despite the *Enquirer* retraction, a Securities and Exchange Commission investigation of some Chiquita practices was continuing.

banana regime to be out of compliance.[45] At the same time, USTR officials were keeping a close eye on Ecuador, fearing that the country might strike a deal on the side with the EU for a larger share of the Latin American market, thus hurting Chiquita and splintering the complainants' united front.[46] On December 21, meanwhile, USTR published a retaliation list that would place tariffs on about $520 million worth of EU imports, concentrating on goods that would not disrupt American commercial interests, that would have a minimal impact on US consumers, and that originated in those countries most supportive of the regime. Products that would be subjected to a 100 percent tariff, effectively doubling the price of the goods, included pecorino cheese, sweet biscuits, handbags, cashmere sweaters, and Christmas ornaments. "Everyone loves to rail against the US's so-called unilateralism," says a USTR official. "But you know what? We didn't get the EU's attention until we put that list up. How many years has it been? It's unfortunate, but that's the way it works."

The $520 million figure, meant to represent the annual export revenues lost by Chiquita and Dole due to the regime, was well below what Chiquita alone had requested as damages, but was at the high end of estimates prepared by an inter-agency team of government economists charged with the unenviable task of calculating a damage assessment in the highly complex case. Among the factors complicating the calculations were the many different ways in which the EU could conceivably make its regime legal, as well as the fact that there was no recent period during which a free market had existed in the EU to use as a basis for comparison. According to a staff economist at the Council of Economic Advisors who helped come up with the damage estimate, USTR and the team were also constrained by political pressures. If the estimate was much higher than what the WTO ultimately approved, US companies would probably feel let down by USTR's performance. If, on the other hand, the estimate was too low, Congress might question the usefulness of the WTO or press for more direct involvement in international trade disputes. "One of the things we were very aware of throughout the whole process was whether this was going to be OK for the people who were putting the political heat on in the first place," the economist recalls.

An Elusive Resolution

As the new year began, observers were mystified as to how the dispute would ultimately end. On January 12, the WTO Dispute Settlement Body convened a new panel, in response to requests by Ecuador and the EU, to determine whether the new EU banana regime complied with the WTO judgment, but a ruling was not expected until April.[47] On January 20, the US, Honduras,

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45 The Dispute Settlement Body did not immediately convene such a panel.

46 Although the EU had given Ecuador 26.17 percent of the tariff-rate quota, the largest piece, Ecuador considered the allotment restrictive and unrepresentative of its actual imports to the EU market over the previous three years.

47 The US opposed the panel, fearing that the EU could use an ongoing evaluation of the banana regime's WTO consistency as an additional argument against US retaliation. It was also unclear whether the EU would try to use the panel to evaluate compliance, or to rule on the legitimacy of the planned US retaliation. Ecuador, on the other

Mexico, Guatemala, and Panama requested consultations with the EU to discuss a last-minute compromise, but no immediate date was set.[48] Meanwhile, the two Windward Islands of St. Lucia and Dominica—claiming their economies would be devastated if the EU regime ended—blocked the agenda for the WTO Dispute Settlement Body's planned January 25 meeting, thus temporarily stopping the US from requesting permission to retaliate against the EU for non-compliance. The meeting continued on the 29th, however, and the US made its official request. USTR, an official says, "was not budging on our right to go and get a reverse consensus on the request for retaliation. That was fundamental to us."

When the EU asked for arbitration on the amount of retaliation, the WTO named as arbitrator the same three-member panel that was already considering the request of Ecuador and the EU to rule on the regime's compliance. Although the compliance decision was not due until April, the US still hoped the WTO would deliver a report March 2 authorizing it to impose sanctions on EU products beginning the following day.

As the dispute dragged on, however, and the possibility of a trade war appeared increasingly likely, some critics of US policy questioned why the trade wrangle had ever begun. "On one hand, I concede that there's a legal case here," says a lawyer who supported the Caribbean position. "I just don't believe that every legal case was meant to be brought. This is a case study in the abuse of the WTO process by private interests, namely Chiquita. And I think the United States and the system are going to pay dearly for it."

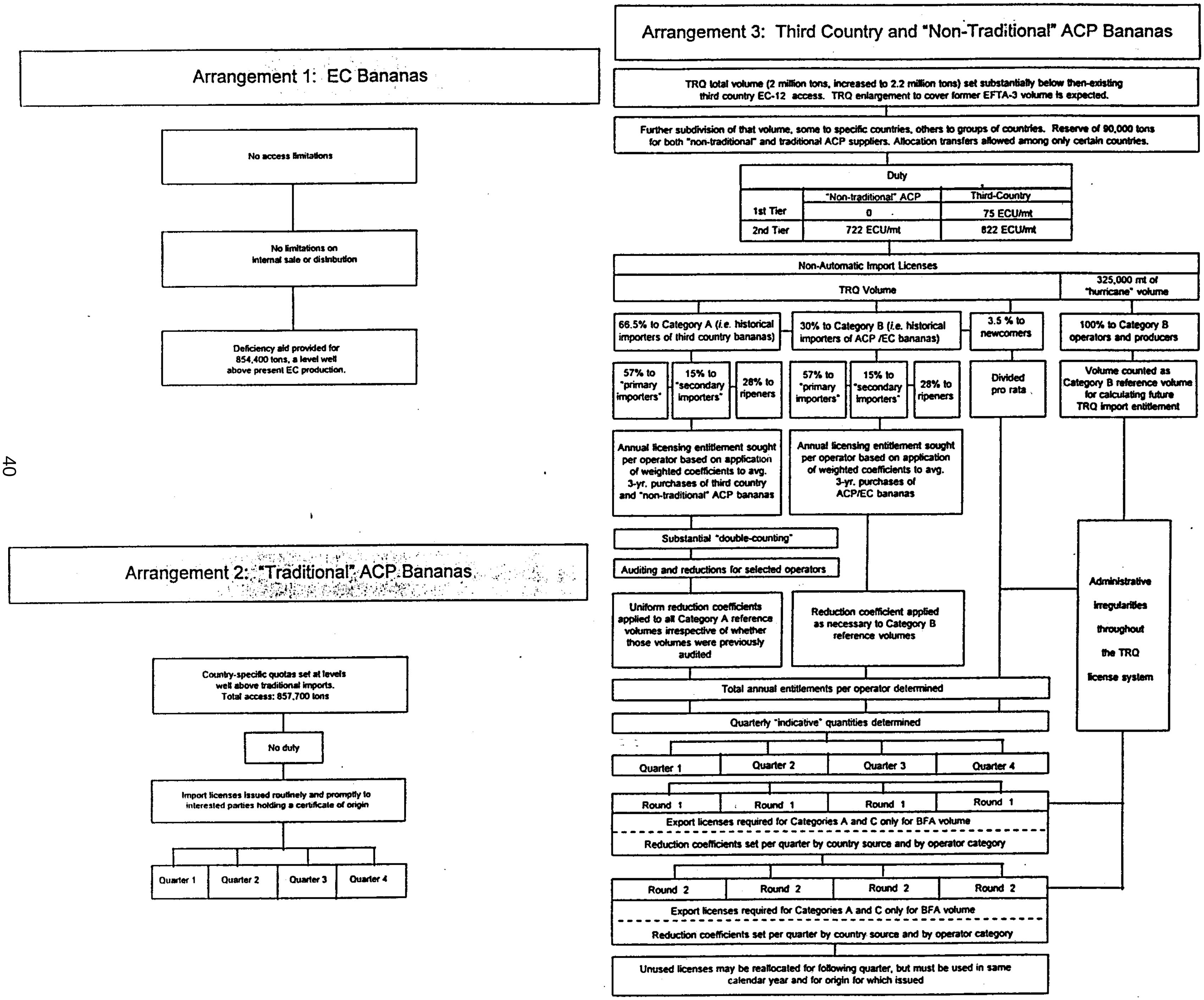
US trade and government representatives, though, couldn't disagree more. "There was a discriminatory regime, and the US went to the WTO—as it should have—and won," says one banana company representative. "It's hard to argue with the judgment that this was a case worth taking on." Peter Scher, USTR's chief negotiator on agricultural issues, agrees. "What's at stake here is the credibility of the World Trade Organization," Scher declared after USTR published its retaliation list in December. "This is the first case in which any country has essentially refused to comply with rulings of the WTO."[49] Indeed, if the US didn't insist that the EU comply on the banana regime, another USTR official notes, it would not only weaken all US trade agreements, but would call into question the power and legitimacy of the entire WTO. "We've got something big on the line," the official says. "It's way beyond bananas."

hand, in hopes of protecting its relationship with the EU, was apparently trying to avoid further escalation of the dispute. *Inside US Trade*, "US to Request WTO Consultations with EU to Resolve Banana Fight," January 15, 1999.

48 Panama, which joined the WTO in September 1997, was not a member when the original complaint was filed. Ecuador asked to join the consultations a few days later.

49 David Sanger, "Clinton Fires First Shot in the Banana War," *The New York Times*, December 22, 1998.

Exhibit A
Regulation 404



BENJAMIN C. ESTY

The Chad-Cameroon Petroleum Development and Pipeline Project (A)

On June 6, 2000, the World Bank's and the International Finance Corporation's (IFC) Boards of Directors were scheduled to vote on whether to approve funding for the $4 billion Chad-Cameroon Petroleum Development and Pipeline Project. The project presented a unique opportunity to stimulate economic development in Chad, one of the poorest countries on earth, yet it entailed substantial environmental and social risks. Compounding these risks was an unstable political structure: Chad had been in various states of civil war since gaining its independence in 1960, and was currently run by a president who had a history of oppressing people and violating human rights.

Although heated debate surrounded this project, the most contentious issue was how Chad would use its share of project cash flows. According to the projections, Chad would receive up to $125 million per year from the project, an amount that would increase government revenues by more than 50%. Critics argued that the revenues could be used to fund further oppression. To address this concern, the World Bank Group had proposed an innovative revenue management plan that would isolate Chad's share of project revenues and target them for poverty reduction programs. Whether this plan would work and what would happen if it did not were two questions that the directors had to resolve before they could approve the deal. Yet the alternative, rejecting the proposal, seemed to run against the Bank's mission of alleviating poverty around the world especially given Chad's impoverished condition and limited opportunities for development.

The Project

A consortium of oil companies including Conoco, Chevron, Exxon, and Royal Dutch/Shell discovered oil in Chad in the early 1970s, but suspended development of the fields in 1979 due to increasing civil unrest. Frustrated by the situation, Conoco withdrew and Chevron sold its stake to Elf Aquitaine. Almost 15 years later, a reorganized consortium began conducting economic and environmental feasibility studies for an oil field development project in Chad connected to the coast via a pipeline through Cameroon (see **Exhibit 1**). After the studies yielded positive results, the consortium signed memoranda of understanding (MOU) with the two countries' governments in February 1996.

In November 1999, Shell and Elf unexpectedly dropped out of the consortium citing concerns over project economics (oil was at $10.00 per barrel); analysts also cited friction with ExxonMobil.[1] Six

Research Associate Carrie Ferman prepared this case under the supervision of Professor Benjamin C. Esty. This case was developed from published sources. HBS cases are developed solely as the basis for class discussion. Cases are not intended to serve as endorsements, sources of primary data, or illustrations of effective or ineffective management.

months later, Petroleum Nasional Berhad (Petronas) and Chevron joined the consortium with 35% and 25% stakes, respectively. ExxonMobil remained the leading shareholder with 40%.

With total revenues of $185 billion, a "AAA" debt rating, and operations in more than 100 countries, ExxonMobil was one of the "super majors" in the oil industry. (**Exhibits 2a** and **2b** show summarized financial statements.) Like other large oil companies, ExxonMobil operated four major divisions: 1) Upstream Operations explored for and produced both crude oil and natural gases; 2) Downstream Operations refined, transported, and sold these products; 3) Chemicals manufactured and marketed petrochemicals; and 4) Coal, Minerals & Power did mining and power generation. Despite the range of activities, ExxonMobil was known for its strength in Upstream Operations, which accounted for three-fourths of its earnings. With 58 major exploration projects under way in 1999, the company had one of the strongest upstream portfolios in the industry.

In all of its businesses, ExxonMobil made environmental responsibility a priority:

> A core value of ExxonMobil is to conduct its operations safely and in an environmentally sound manner. ExxonMobil's policy is to conduct its business in a manner that is compatible with the balanced environmental and economic needs of the communities in which we operate. We are committed to continuous efforts to improve environmental performance throughout our operations.[2]

The company, however, had a tainted environmental record largely due to the Exxon Valdez oil spill in 1989. The single-hulled tanker hit a reef spilling 11 million gallons of oil along the pristine Alaskan coastline. Following the spill, ExxonMobil paid $1 billion in damages, began using double-hulled tankers for most of its fleet, and significantly enhanced its environment control systems to the point where many viewed it as an industry leader in setting and enforcing environmental standards. Nevertheless, critics pointed to a recent speech by Chairman Lee Raymond to the World Petroleum Congress as a reason for concern. While arguing for a sensible trade-off between environmental protection and economic development, he warned developing countries to avoid excessive environmental controls that could discourage foreign investment and hinder development.[3]

Petronas, the second largest shareholder, was owned by the Malaysian government and was responsible for developing the country's oil and gas resources. Since its incorporation in 1974, Petronas had become a fully-integrated oil and gas company engaged in upstream and downstream operations. At the time, the company operated 40 fields in 24 countries throughout Asia and Africa.

The third sponsor, U.S.-based Chevron, engaged in a broad range of energy-related activities. The company relied on its upstream business for current revenues and income as well as long-term growth. Chevron was especially active in Africa with projects in Nigeria, Angola, and the Republic of the Congo. The company also owned a 50% stake in Caltex, a downstream operator active in over 60 African, Asian, and Middle Eastern countries.

Project Description

The sponsors planned to develop the $3.7 billion project in two parts: a $1.5 billion Field System to extract oil from the Doba Basin in Chad, and a $2.2 billion Export System to transport oil to the coastal city of Kribi (see **Exhibit 1**). The Field System would consist of 300 wells in three fields, a treatment facility to upgrade the oil, and an operations center to support production. Geologic studies confirmed by independent consultants estimated that the fields contained total proven plus probable reserves of 917 million barrels, and could produce up to 250,000 barrels per day using known technologies.* The Export System would consist of a 670-mile (1,070 km) pipeline buried one meter (3.3 feet) underground. It would contain a monitoring system to detect leaks and be connected to a floating storage and offloading vessel, a stationary, single-hulled tanker capable of holding two million barrels of oil. The sponsors agreed to buy all of the output at market prices in proportion to their ownership shares. Production would end by 2032, at which time the project would end.

According to the plan, an unincorporated joint venture known as the Upstream Consortium would own and finance the Field System. (**Exhibit 3a** contains a diagram of the corporate structure.) Tchad Oil Transportation Company (TOTCO), a special-purpose entity incorporated as a joint venture between the Upstream Consortium and the Chad Government, would own the Chad portion of the pipeline. Cameroon Oil Transportation Company (COTCO), an incorporated joint venture between the Upstream Consortium and the Chad and Cameroon Governments, would own the Cameroon section of the pipeline. EssoChad, a wholly-owned subsidiary of ExxonMobil, would be responsible for project coordination and upstream operations.

Assuming construction began in 2000, and the contractors met the schedule approved by independent consultants, the project would be completed in 2004. During construction, the project would employ as many as 7,000 people; it would employ 500 to 800 people once operations began. Most of the skilled workers would be foreigners, but ExxonMobil hoped that 80% of the employees during operation would be local citizens with extensive training and other skills enhancement.[4]

Financial Projections[5]

The sponsors chose to use corporate finance for the Field System and project finance for the Export System. This structure facilitated equity participation by the host governments and issuance of limited-recourse debt by the pipeline companies (the sponsors would guarantee debt repayment through, but not after, completion). The Treasurer of Exxon Exploration Company explained the firm's policy:

> (We) most often borrow centrally. This has minimized borrowing costs by capitalizing on deep, efficient markets, and drawing on the cash flow support of our global operations….despite our predilection for funding most projects from central sources, we believe project finance can make a constructive contribution to managing risk of projects in a number of areas…However, project finance is not a panacea. We need to assess whether the added costs entailed are worth the various risk mitigation steps achieved.[6]

The proposed structure included $2.3 billion of equity, of which $2.2 billion would come from the private sponsors (see **Exhibit 3b**). The International Bank for Reconstruction and Development (IBRD) and the European Investment Bank (EIB) had agreed to lend the host countries funds to finance their equity stakes. IBRD, a member of the World Bank Group, would lend $77 million while the EIB, the financing institution of the European Union, would lend $42 million.

The $1.4 billion of project debt would come from three sources: the International Finance Corporation (IFC), two export credit agencies (ECAs), and the capital markets. IFC, also a member of the World Bank Group, would make a $100 million "A loan" for its own account and up to a $300 million "B loan" for syndication to other institutions. The two ECAs, Coface from France and the US Export-Import Bank (US Exim), would arrange $600 million of bank financing. ECAs agreed to

* Based on geological and engineering data, *proved* reserves are expected to be recovered with reasonable certainty; *probable* reserves are more likely than not to be recovered (at least 50% probability); *possible* reserves are less likely to be recovered (at least 10% probability). These definitions are from the Society of Petroleum Engineers and World Petroleum Congress.

arrange financing in exchange for commitments to buy French and U.S. equipment for the project. Finally, COTCO and TOTCO would issue $400 million in bonds. When all the financing was in place, TOTCO and COTCO would have leverage ratios of 62% and 64%, respectively (see **Exhibit 3a**).

The base case financial projections assumed the fields would produce 883 million barrels of salable crude oil out of the 917 million barrels of reserves. With an average price of more than $15 per barrel, total revenues would be $13.7 billion (see **Exhibit 4a**). Distributions to Chad, Cameroon, and the private sponsors would come in the form of royalties, taxes, and dividends (see **Exhibit 4b**). Because the majority of Chad's distributions would come in the form of royalties, its returns were closely tied to project revenues. In addition, it was scheduled to receive a $25 million payment from Chevron and Petronas at financial close, a payment for tax benefits received when they joined the consortium.[7] As a pipeline owner, Cameroon's returns would be a function of pipeline volume. **Exhibit 5** provides a matrix of returns given various oil price and volume scenarios.

Sensitivity analysis revealed that project returns were driven by oil price and volume assumptions. The Bank's technical staff and independent consultants confirmed that actual reserves could vary from 595 million barrels of proven reserves to 1,038 million barrels of proven, probable, and possible reserves. Price assumptions were based on Brent Crude prices, which had ranged from $9 to $42 per barrel over the last 18 years, with an average price of $20 per barrel (see **Exhibits 6a** and **6b**). Given the acidic, corrosive nature of Doba Basin oil, analysts expected it would sell at a discount of 10% to 20% below Brent Crude.[8] Even with the discount, the price was well above the project's finding and development costs of $5.20 per barrel.

Chad (Tchad)

Shortly after gaining independence from France in 1960, Chad erupted in a civil war, with rebel groups in the north fighting against the government in the south. Conflict raged through most of the 1960s and 1970s, and escalated through the 1980s. According to a government study, over 20,000 people were killed and thousands more were tortured during this period.[9]

General Idriss Déby, a French trained army officer and opposition leader, came to power in 1990 after staging a coup against the government. One political analyst described him this way:

> Chadian President Idriss Déby is a warlord…few credible analysts would argue that Déby is anything other than an African strongman, whose weapons purchases dwarf levels of social spending in one of the world's poorest countries, where incidents of political violence continue.[10]

As recently as 1998, Déby's troops had massacred 100 unarmed civilians and imprisoned Ngarléjy Yorongar, a member of Parliament and leading opposition figure, after he criticized the pipeline project.[11] That year, Amnesty International and the U.S. State Department criticized Déby's regime:

> State security forces continue to commit extrajudicial killings, and they torture, beat, abuse and rape persons. Prison conditions remain harsh and life threatening. Security forces continue to use arbitrary arrest and detention. Although the Government detains and imprisons…it rarely prosecutes.[12]

Many years of political instability severely hampered Chad's economic development. Since Déby seized power, output levels had declined, the government had consistently run budget deficits, and the external debt had more than doubled (see **Exhibit 7**). Whereas public aid and foreign investment came largely from international development institutions such as the World Bank and the International Monetary Fund (IMF), the war had significantly reduced overall investment.

As of 1999, Chad was one of the poorest and least developed nations in the world, and showed few signs of reversing its slow decline (see **Exhibit 8**). Approximately 80% of the 7 million citizens lived on less than $1.00 a day.[13] Except for oil, the landlocked country had few natural resources and lacked even rudimentary infrastructure needed for development: there were only 267 kilometers (166 miles) of paved roads in a country almost three times larger than France, no railways, poor telecommunications (two phones per 1,000 people), and irregular electricity supply.[14] In terms of living conditions, poor nutrition and unsafe water—less than 25% of the population had access to clean water—contributed to a life expectancy of 49 years and an infant mortality rate of 115 deaths per 1,000 births, compared to 78 years and 3 to 6 deaths per 1,000 births in developed countries.[15] In fact, more than 20% of children born in Chad died by age five. Based on these conditions and other similar statistics, the United Nations ranked Chad 167 out of 174 counties in terms of development.

Cameroon

Cameroon gained its independence from France in 1960. The country developed its oil resources and agricultural sector, but a severe drop in commodity prices in the mid-1980's threw the country into a decade-long recession. Gross domestic product (GDP) fell by more than 60% from 1986 to 1994.[16] The government, with support from IMF and the World Bank, implemented several reform programs in an effort to improve accelerate growth and alleviate poverty.[17] The economy responded favorably and grew at an average rate of 5% per year during mid to late 1990s.[18]

Despite the improvement and favorable relative position vis-à-vis other African countries, Cameroon was still a very poor nation, ranking 134 out of 174 countries on the UN Development Index and 99 out of 99 countries in terms of corruption according to Transparency International, a non-governmental organization (NGO). (See **Exhibit 8**.) In addition, activists criticized President Biya's administration for its human rights record. Amnesty International reported:

> Large numbers of people were extrajudicially executed in the north of the country. Torture and ill treatment by the security forces remained routine, and prison conditions amounted to cruel, inhuman and degrading treatment, resulting in high mortality rate. Critics of the government…were harassed, arrested and imprisoned. Thirty-six were convicted after an unfair trial before a military tribunal.[19]

World Bank Involvement

By any measure, Chad was one of the riskiest places on earth to invest. The sponsors had stated, and commercial bankers had concurred, that they would not invest without some kind of protection against political risk.[20] The sponsors considered including one or more multilateral development agencies as partners in the deal. The Treasurer of Exxon Exploration Company explained:

> Political risk associated with large-scale projects in the developing world is a reality that must be thoughtfully assessed and carefully addressed in project planning…While the involvement of multilateral institutions and other lenders adds complexity, their presence can enhance country commitment and mitigate political risk.[21]

The World Bank was a logical choice to approach because it had extensive lending and policy experience with developing countries, and had been working in Chad and Cameroon for many years.

Founded in 1944, the World Bank Group's mission was to stimulate economic development and alleviate poverty in its 183 member countries. Under the leadership of President James D.

Wolfensohn, the Bank was the largest source of development assistance in the world, providing more than $15 billion in loans to developing countries in 1999 alone. With operations in more than 100 countries, the Bank invested in development projects and acted as the lender of last resort for countries with no other borrowing options. It carried out its operations through five distinct entities, each of which focused on a different aspect of development:

- **International Bank for Reconstruction and Development** (IBRD) provided market-based loans and development assistance to help governments in middle-income countries;
- **International Development Association** (IDA) provided subsidized loans, technical assistance, and policy advice to the poorest countries;
- **Multilateral Investment Guarantee Agency** (MIGA) provided investment guarantees;
- **International Center for Settlement of Investment Disputes** (ICSID) helped resolve investment disputes between foreign investors and host countries;
- **International Finance Corporation** (IFC) advised investors and was the largest source of debt and equity financing for private-sector projects in developing countries. The IFC had a reputation for acting as an "honest broker" between the public and private sectors and for structuring fair deals.

Over the previous 25 years, the Bank had been involved with numerous projects around the world, including at least 10 major pipelines. Besides earning an average pre-tax financial return of 22%, more than 70% of the Bank's investments achieved their development objectives according to the Bank's Operation Evaluations Department.[22] However, projects in Africa and in the oil and gas sector experienced lower returns and greater problems than other projects in the Bank's portfolio.[23]

When the sponsors first approached the Bank about participating in the deal, senior management was immediately intrigued by the idea of a major development project in Chad. First, the project was commercially viable, and it would be the Bank's responsibility to ensure that the host countries received returns that were commensurate with the risks they would bear. Second, the project could help jump start Chad's listless economy. President James Wolfensohn wrote:

> We think that the project provides the best, and perhaps only opportunity for Chad to reduce the severe poverty of most of its population….Chad's development prospects can only be improved significantly through the use of this traditional energy source….We know this undertaking will involve significant risks. Translating Chad's oil revenues into services which will help the poor directly will be a difficult challenge—as it has been in many countries. But we believe it is a challenge which a development institution like the World Bank Group must take up.[24]

And third, the Bank could play an important role in protecting the environment as well as indigenous people. On its route to the coastline, the pipeline would cross 17 rivers and five habitat zones. These zones were home to rare plant life and endangered species. The forest regions were also home to more than 11,000 Bakola people, known as pygmies. As hunters and gatherers, and the region's oldest known inhabitants, the pygmies depended on the vegetation, land, and wildlife for survival.

While Bank participation had clear benefits, there were risks if it chose not to participate. For example, the sponsors might abandon the project and look to invest in safer countries. A World Bank economist recognized this possibility:

> Chad is not the only country with untapped petroleum reserves. Exploration is underway right across the continent to find new oil sources - which could prove cheaper and more accessible. If Chad does not seize this opportunity, it may well pass the country by.[25]

Another, and potentially worse, outcome might be if the Chadians developed the oil fields with other neighboring countries. The Sudanese government had recently financed a pipeline without the Bank, and was using revenues to fund a civil war.[26] In addition, Libya's President Muammar Qaddafi had been urging President Déby to drop his deal with the westerners and ship oil through Libya.[27] Although the U.S. State Department classified both Sudan and Libya as terrorist nations, they were, nevertheless, potentially feasible options for exporting oil.[28] Because much of the rebel opposition and fighting was based in northern Chad, these routes would entail considerable risk.

After weighing the opportunity against the alternatives, the Bank agreed to work with the sponsors in 1995. They began with an extensive consultation process that included meetings with both supporters and opponents. During this process, the Bank, sponsors, and host governments enlisted advice from 45 scientists and environmental engineers, hosted 145 meetings with 250 international NGOs, and held nearly 900 village meetings. An Esso-Chad spokesperson commented:

> The public consultation process for the Chad Export Project has been one of the most extensive consultation efforts ever undertaken in Africa for an industrial development project. Few similar projects in Europe or North America have held so many village-level public consultation meetings over such a wide area.[29]

The Bank insisted, and the governments and sponsors agreed, that the process should be conducted in an open and transparent way. Towards this end, they posted data collected from environmental surveys on the web, placed project-related information in 17 reading rooms in and around affected areas, and distributed nearly 700 copies of the draft Environmental Assessment (EA). After five years of review and public debate, the sponsors published the final, 3,000-page EA for comment. The 19-volume study contained contingency plans for almost every aspect of the project. There were plans for, among other things, waste management, oil spills, regional development, indigenous peoples, offsite environmental enhancement, community health, compensation and resettlement, induced access management, decommissioning, cultural properties, environmental monitoring and management.

The analysis and contingency planning addressed three key topics—environmental impact, indigenous people, and long-term sustainability—and led to numerous changes to the sponsors' original plans. For example, after careful analysis using satellite imagery and aerial mapping, the sponsors changed the pipeline route in Cameroon to protect the natural habitat and human settlements in the Mbere Rift and Deng Deng forests. The sponsors also increased the benefits for indigenous people under the Compensation and Resettlement Plan. Following these and many other changes, a World Bank report concluded:

> …although there is uncertainty in estimating incremental environment and social costs, most of these potential costs will be mitigated and/or compensated for by the Private Sponsors, and any remaining impacts are expected to be negligible in comparison to the large benefits that Chad and Cameroon stand to gain from the project.[30]

To address sustainability, the Bank established capacity-building programs in both Chad and Cameroon. Through these programs, the Bank hoped to develop the fiscal, legal, regulatory, and managerial infrastructure needed to develop the country's petroleum sector and minimize the project's adverse impact.[31] Concern regarding this last point generated the greatest opposition and led the Bank team to propose a Revenue Management Plan (RMP), something that had never been tried before.

Revenue Management Plan

Based on previous experience, the Bank had learned that a large influx of oil revenues could lead to economic distortion, corruption, and waste. With almost $14 billion in revenues and $8 billion in total distributions, the Bank feared Chad would be susceptible to these same problems. To prevent history from repeating itself, the Bank designed, with input from the Chadian government, a Revenue Management Plan. World Bank President Wolfensohn commented:

> Natural resource "booms" are difficult to manage. This is why our knowledge of other countries' experience has been crucial to designing the project. In Chad, in particular, we want to make certain that the country's new wealth will be invested for the well-being of all Chadians. With our help, the Chad Government has developed a revenue management program that targets oil revenues to key development sectors that are at the heart of its poverty alleviation strategy.[32]

According to projections, Chad would receive $1.8 billion of cash flow from the project in the form of income taxes, royalties, and dividends. Over the first 10 years of production (2004 to 2013), income taxes would represent 16% of he total while royalties and dividends would represent the remainder. Under the RPM, the government would have discretion over how to spend the income tax revenues as long as they were used for general development purposes. In contrast, the royalties and dividends would be deposited into a Special Petroleum Revenue Account and distributed in the following way: 10% would be deposited in foreign financial institutions and used to finance poverty reduction programs for future generations. Of the remaining 90%, 85% would be deposited in Chadian commercial banks and used to finance development programs in five high-priority sectors: education, health and social services, rural development, infrastructure, and environment and water resources.[33] The other 15% would go to the government budget and programs in the Doba region. The $25 million payment from Chevron and Petronas was not covered under the RMP.

Oversight and control of the RMP would occur at several levels. The World Bank and Chadian government would approve a detailed annual expenditure program that had to be reviewed by a newly-formed oversight committee. The committee's nine members—seven from government and two from civil society (one from an NGO and one from a trade union)—would be appointed for terms of three to five years. Each year the committee would publish a review of operations that was subject to an external audit. The World Bank would monitor the full program and retained the right to review all expenditures. To ensure acceptance of the plan, the Bank made implementation of the RMP a contractual obligation under the proposed IBRD and EIB loans. As an added incentive, the Bank explicitly linked the government's performance under the RMP to future World Bank lending.[34]

In 1998, the Chadian government took the first step towards implementation by passing a law that supported key elements of the plan including provisions to establish the oversight committee and various auditing procedures.[35] To further demonstrate its commitment to economic reform and development, the government privatized 45 out of 50 state-owned enterprises, cut the size of the army in half, and reallocated public expenditures to increase development efforts.[36]

Opposition

Right from the start, critics attacked the project on all fronts. An official from a Chadian environmental agency complained:

> There is not one example in Africa where oil has led to development. Look at Nigeria, Angola, the two Congos, and Gabon. They all have an overabundance of oil, and what do they have to show for it? We can even say that the exploitation of oil has retarded their development. What are the chances that things will be any different in Chad or Cameroon[37]

while a report from the Environmental Defense Fund criticized the World Bank for participating:

> The World Bank's involvement…sets a disturbing precedent of public support for oil development which experience and analysis show has detrimental social and environmental impacts with few development benefits….The project as currently designed has little chance of delivering the claimed benefits to sustainable development while carrying major risks of irreparable environmental and social disruption. [38]

In particular, environmental groups such as Friends of the Earth, the Sierra Club, and the Rainforest Action Network pointed to deforestation and oil spills as serious risks. The potential for the greatest damage was in the Atlantic Littoral Forest zone in Cameroon where it would be necessary to clear land to make room for roads, storage depots, and worker housing, not to mention the pipeline itself. The decision to bury the pipeline only increased the chances of groundwater contamination and made it more difficult to repair damage. An environmentalist noted:

> Even with the latest state-of-the-art technology, oil leaks in pipelines can go undetected until a huge amount of damage has been done. The most sophisticated technology has a detection capacity of a leakage of 0.002% of the oil passing through. [T]his means that under the best of circumstances 2,000 gallons could leak a day without being detected. [39]

And when the oil reached the coast, it would threaten two national reserves containing endangered marine life and the Lob Waterfalls, one of the few waterfalls in the world that flowed directly into the ocean. An oil spill in this area could cause irreversible environmental damage.

Social activists, too, joined the chorus of criticism. They claimed the Indigenous Peoples Plan was incomplete because it did not create a specific agency to oversee social issues as required under Bank policy, nor did it establish on-going programs to address future social issues.[40] They also condemned the implementation strategy described in the Compensation and Resettlement Plan. According to one activist:

> …there are numerous examples in Africa and throughout the world, where the Bank has not been able to implement this provision and where poor and vulnerable groups, which are the ones who usually have to be forcibly resettled, suffer greatly as a result of resettlement and are unable to re-establish their livelihoods.[41]

The most vehement opposition, however, centered on the Revenue Management Plan. While one study described it as "massively flawed,"[42] another from Harvard Law School said, "The law is vague in essential parts and lacks the detail necessary to ensure effective oversight…As it is, the law can be seen at best as only a first, and clearly insufficient, step."[43]

Critics were particularly concerned about the allocation of funds. Whereas the RMP spelled out broad categories for expenditure, it did not give specific details regarding permissible expenditures by type and region. Funds directed to one region could be used entirely for infrastructure rather than addressing serious social or health problems.[44] An even greater concern was the fact that the government could change the revenue allocation every five years.

Luc Lampiere, a visiting fellow at Harvard Law School's Human Rights Program, and co-authors noted several problems with the local support needed to make the plan work:

> While the law itself represents a remarkable breakthrough in linking private investment, development, and human rights, it has little chance of succeeding without the will of the authorities or the confidence of the population….According to one high ranking diplomat in Chad, the authorities understood that the law was necessary for World Bank support, but have little intention of allowing it to affect local practice.[45]

The Lampiere report continued:

> Oil will not lead to development in Chad without real participation, real transparency, and real oversight, none of which currently exists. The proposed revenue management plan and the law that was essentially imposed on the Chadian authorities is, at best, a first step in that direction." [46]

Criticism also focused on the oversight committee's composition and powers. Only two of the nine members were from civil society and there were no stipulations to guarantee that they remained faithful to their organizations.[47] Moreover, the RMP did not specify how decisions would be made or how voting power would be determined.[48] Finally, the committee did not possess the right to obtain information (e.g., subpoena power), authorize distributions, or publish opinions on the project.[49]

On a more fundamental level, critics attacked the RMP as an infringement of sovereign rights. Peter Rosenblum, Associate Director for Harvard Law School's Human Rights Program, commented:

> At the core is a challenge to the sovereignty of undemocratic rulers…Previously, no one would have interfered in the relations between an oil company and an African state. He who ruled the state controlled its resources…There is still hope of a delicate balance, where the World Bank strengthens loan conditions that reinforce the democratic process in Chad and enable the Chadian people to better determine how their resources should be spent. That would still threaten the sovereignty of leaders, but would also empower the people.[50]

In the opposition's eyes, the project was not going to benefit the people of Chad and Cameroon. Instead, the most likely beneficiaries would be the project sponsors. Korinna Horta, an economist and environmentalist from Environmental Defense (a U.S.-based non-profit organization), expressed her concern:

> The private sector—the oil companies and the commercial banks—are taking cover behind publicly funded or guaranteed institutions, be they the World Bank group or the export-credit agencies of individual countries….What we have is a financial structure where private sector risk is comfortably cushioned by public funds intended to help the poor in a politically unstable area of Sub-Saharan Africa. What emerges is a case of corporate welfare.[51]

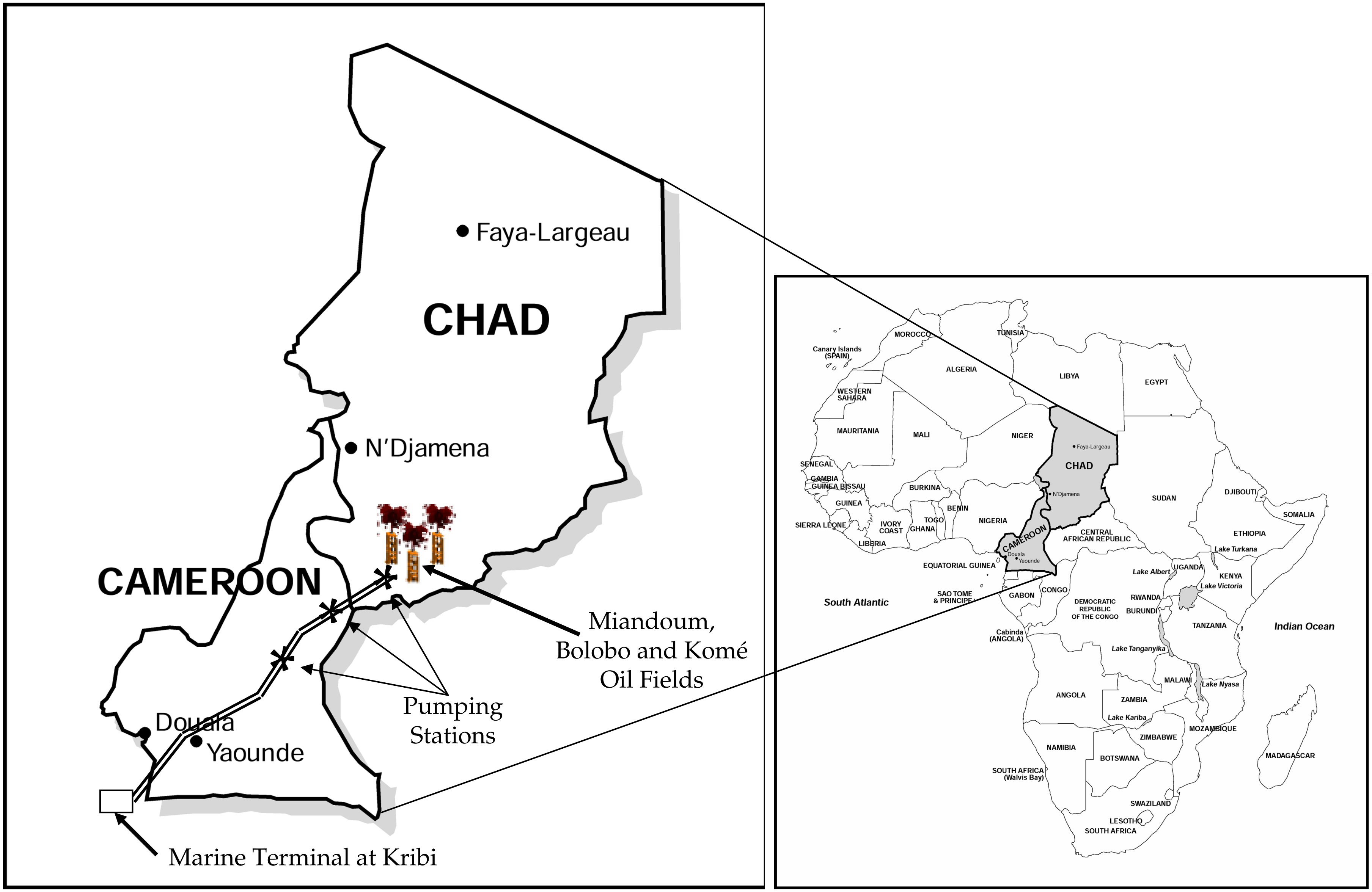
Conclusion

On June 6, the Bank and IFC directors would have to decide whether to approve the funding request. After studying the project for five years, it seemed like they had addressed and corrected the most serious concerns. Though committed, World Bank officials still expressed some concerns:

> One can say it is a bit of an experiment, but it is not a choice between not doing it or doing it…If we don't do it today, somebody will develop (the project) without the safeguards (we are putting into the deal). [52]

As an institution dedicated to poverty alleviation, how could the World Bank turn its back on the only opportunity to effect change in one of the poorest, most underdeveloped nations in the world? Mr. Madavo, a Bank Vice President, stated, "It's very, very important that the World Bank, as an economic institution, not become so risk adverse that it would only do the sure thing."[53] He went on to say, "If it succeeds, wouldn't that be wonderful for a story to be written 20 years from now…that the World Bank stood up, did its homework, supported something that made a tremendous difference to Africa?"[54]

Exhibit 1 Chad-Cameroon Petroleum Development and Pipeline Project



Source: Casewriter.

Exhibit 2a Summarized Income Statements for Project Sponsors ($US in millions)

	ExxonMobil [a]	Chevron [a]	Petronas [b]
Revenues	$185,527	$36,586	$15,955
Costs and other deductions	165,678	29,600	9,207
Depreciation, deletion, and amortization	8,304	2,866	937
Interest and debt expenses	695	472	657
Total costs	174,377	32,938	10,801
Income before income taxes	11,150	3,648	5,154
Incomes taxes	3,240	1,578	1,837
Net income	**7,910**	**2,070**	**3,317**

Exhibit 2b Summarized Balance Sheets for Project Sponsors ($US in millions)

	ExxonMobil [a]	Chevron [a]	Petronas [b]
Assets			
Current assets	$31,141	$8,297	$13,379
Fixed assets less depreciation and depletion	94,043	25,317	15,988
Other assets	19,337	7,054	2,621
Total assets	**144,521**	**40,668**	**31,994**
Liabilities			
Current liabilities	28,163	5,455	8,377
Total debt	18,972	8,608	10,455
Other liabilities	33,920	8,856	2,567
Total liabilities	81,055	22,919	21,399
Shareholders' equity	63,466	17,749	10,595
Total liabilities and shareholders' equity	**144,521**	**40,668**	**31,994**
Number of employees	80,000	31,000	18,500
Numbers of common shares outstanding (mil.)	3,477	713	n/a
Stock price as of December 31, 1999	$80.56	$86.63	n/a
S&P Debt Rating	AAA	AA	BBB

Source: Company Annual Reports.

[a] As of December 31, 1999.

[b] As of March 31, 2000, exchange rate US$1.00 = Malaysian Ringgit (RM) 3.80.

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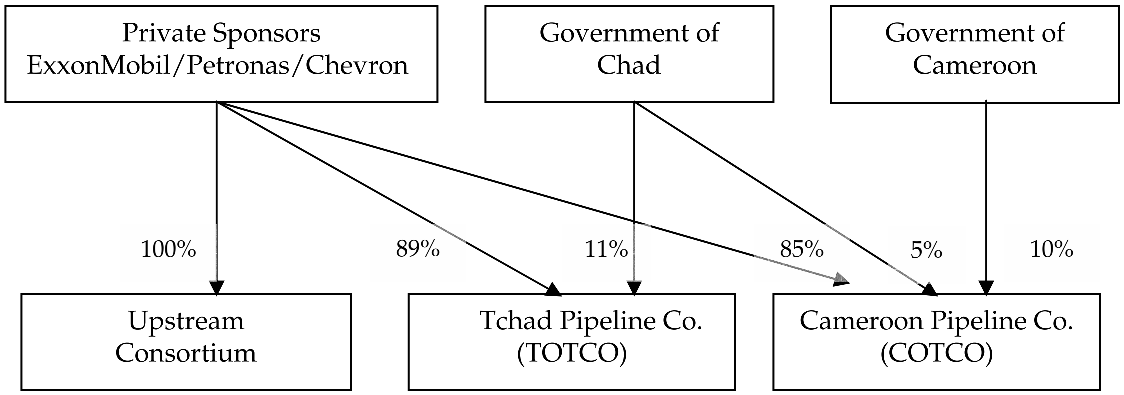
Exhibit 3a Corporate Structure



	Upstream Consortium	TOTCO	COTCO
Debt	$0	$199	$1,201
Equity	1,521	123	680
Total Capital	1,521	322	1,881
Debt/Total Capital	0 %	62 %	64 %

Source: The World Bank and IFC Project Appraisal Document, April 13, 2000.

Exhibit 3b Sources and Uses of Cash ($US in millions)

Uses of Cash

Field System		
Chad	$1,521	40.8%
Export System		
Chad	229	
Cameroon	1,338	
Subtotal	1,567	42.1
Interest and finance costs	458	12.3
Debt service reserve fund	177	4.8
Project Total	**3,723**	**100.0**

Sources of Cash

Debt:		
Capital markets bond	$400	10.7%
IFC A - Loan	100	2.7
IFC B - Loan	300	8.1
Export credit agencies loans	600	16.1
Total	1,400	37.6
Equity: [a]		
ExxonMobil	883	
Petronas	772	
Chevron	551	
Subtotal	2,206	59.2
Chad Government		
IBRD	33	
EIB	15	
Subtotal	47	1.3
Cameroon Government		
IBRD	44	
EIB	27	
Subtotal	70	1.9
Total	2,323	62.4
Project Total	**3,723**	**100.0**

Source: The World Bank and IFC Project Appraisal Document, April 13, 2000, Annex 3.

[a] Portions of equity financing to be provided as subordinated loans and other forms of quasi equity.

Exhibit 4a Project Financing and Cash Flows [a] (nominal, $US in millions)

	Financing					Project Cash Flow								
Year	Private Sponsors Equity	Chad Equity	Cameroon Equity	Total Debt	Total Debt & Equity [b]	Capital Invest. [b]	Volume (mm bbl)	Price Per Barrel	Total Rev.	Operating Costs	Other Uses of Cash [c]	Total Operating Cash Flow	Total Debt Service	Debt Service Coverage Ratio
2000	$24	$9	$13	$315	$361	$304	0	$0	$0	$0	$0	$0	$0	-
2001	298	6	10	312	626	736	0	0	0	0	0	0	0	-
2002	611	9	15	467	1,102	1,101	0	0	0	0	0	0	0	-
2003	559	8	14	283	864	864	0	0	0	0	0	0	0	-
2004	409	11	18	23	461	519	42	14.29	600	100	67	433	205	2.1x
2005	305	4	0	0	309	137	81	14.64	1,186	184	108	894	348	2.6
2006	0	0	0	0	0	16	81	14.78	1,197	174	16	1,007	337	3.0
2007	0	0	0	0	0	13	81	14.94	1,210	175	33	1,002	249	4.0
2008	0	0	0	0	0	13	81	15.05	1,219	182	13	1,024	191	5.4
2009	0	0	0	0	0	1	79	15.20	1,201	181	1	1,019	148	6.9
2010	0	0	0	0	0	1	65	15.28	993	166	1	826	106	7.8
2011	0	0	0	0	0	1	51	15.57	794	151	1	642	83	7.7
2012	0	0	0	0	0	1	39	15.59	608	137	1	470	66	7.1
2013	0	0	0	0	0	1	32	15.88	508	131	1	376	57	6.6
2014	0	0	0	0	0	1	28	16.07	450	125	1	324	46	7.0
2015	0	0	0	0	0	1	25	16.20	405	122	2	281	37	7.6
2016	0	0	0	0	0	1	23	15.87	365	120	1	244	29	8.4
2017	0	0	0	0	0	1	20	16.55	331	119	0	212	8	26.5
2018	0	0	0	0	0	1	19	16.11	306	150	2	154	0	-
2019	0	0	0	0	0	1	17	16.53	281	115	2	164	0	-
2020	0	0	0	0	0	1	15	16.93	254	113	2	139	0	-
2021	0	0	0	0	0	1	14	16.79	235	111	2	122	0	-
2022	0	0	0	0	0	1	13	17.08	222	109	2	111	0	-
2023	0	0	0	0	0	1	12	17.33	208	109	1	98	0	-
2024	0	0	0	0	0	1	11	17.45	192	106	2	84	0	-
2025	0	0	0	0	0	1	10	18.10	181	106	1	74	0	-
2026	0	0	0	0	0	1	9	17.33	156	101	1	54	0	-
2027	0	0	0	0	0	1	7	18.00	126	95	2	29	0	-
Total	2,206	47	70	1,400	3,723	3,722	855		13,228	3,182	263	9,783	1,910	
Stated Total (2000 – 2032)						**3,737**	**883**		**13,721**	**3,183**	**n/a**	**9,857**	**1,909**	

Source: The World Bank and IFC Project Appraisal Document, April 13, 2000, Annex 5; and casewriter estimates.

[a] These figures ignore some early oil cash flows from 2000 to 2004 and some final cash flows from 2028 to 2032. In addition, the World Bank released only summary data, which means some elements of cash flow are missing. As a result, certain annual cash flows may exhibit discrepancies, and the calculated total cash flows across all years may not match the stated totals in the exhibit or the case. The "Other Uses of Cash" column is an attempt to eliminate some of these discrepancies–it is based on casewriter estimates.

[b] Excludes $15 million of project preparation costs.

Exhibit 4b Participant Revenue Projections [a] (nominal, $US in millions)

		Chad Returns					Cameroon Returns				Private Sponsors Returns		
Year	**Cash Flow Available to Distribute**	Royalty	Upstream Tax	Pipeline Tax	Share of ROE [b]	Total	Transit Tax	Pipeline Tax	Share of ROE [b]	Total	Upstream Cash Flow	Share of ROE [b]	Total
2000	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0
2001	0	0	0	0	0	0	0	0	0	0	0	0	0
2002	0	0	0	0	0	0	0	0	0	0	0	0	0
2003	0	0	0	0	0	0	0	0	0	0	0	0	0
2004	405	22	0	1	8	31	17	0	12	29	19	166	185
2005	547	55	0	14	11	80	33	1	18	52	141	243	384
2006	670	70	0	8	10	88	33	0	16	49	369	218	587
2007	774	81	0	5	10	96	33	0	15	48	448	214	662
2008	833	89	0	2	10	100	33	0	15	48	498	209	707
2009	871	96	0	22	8	125	32	1	14	47	543	179	722
2010	720	78	0	26	6	110	27	11	12	50	425	149	574
2011	559	59	0	22	6	87	21	10	11	42	304	135	439
2012	404	41	0	19	5	65	16	8	10	34	189	121	310
2013	319	32	0	17	5	54	13	7	9	29	132	110	242
2014	277	39	70	9	1	119	12	3	3	18	113	32	145
2015	244	39	74	4	0	117	10	2	1	13	112	6	118
2016	215	36	66	4	0	106	9	1	1	11	101	6	107
2017	204	35	62	2	0	99	8	1	1	10	95	8	103
2018	154	28	43	2	0	72	8	1	0	9	66	7	73
2019	164	29	47	2	0	78	7	1	0	8	72	7	79
2020	139	26	39	1	0	66	6	1	0	7	60	6	66
2021	122	24	33	1	0	59	6	0	0	6	52	6	58
2022	111	22	30	1	0	53	5	0	0	5	46	6	52
2023	98	20	25	1	0	47	5	0	0	5	40	5	45
2024	84	18	22	1	0	41	4	0	0	4	33	5	38
2025	74	17	20	1	0	39	4	0	0	4	25	5	30
2026	54	14	16	1	0	31	4	0	0	4	15	4	19
2027	29	11	5	1	0	17	3	0	0	3	5	3	8
Total	8,071	981	552	167	80	1,780	349	48	138	535	3,903	1,850	5,753

Source: The World Bank and IFC Project Appraisal Document, April 13, 2000, Annex 5; and casewriter estimates.

[a] These figures ignore some early oil cash flows from 2000 to 2004 and some final cash flows from 2028 to 2032. In addition, the World Bank released only summary data, which means some elements of cash flow are missing. As a result, certain annual cash flows may exhibit discrepancies, and the calculated total cash flows across all years may not match the stated totals in the exhibit or the case. For example, the "Cash Flow Available to Distribute" column does not equal the sum of the total distributions to each of the three sponsors in every year.

[b] The share of dividend distributions received as an equity holder in COTCO and/or TOTCO.

Exhibit 5 Projected Returns [a]

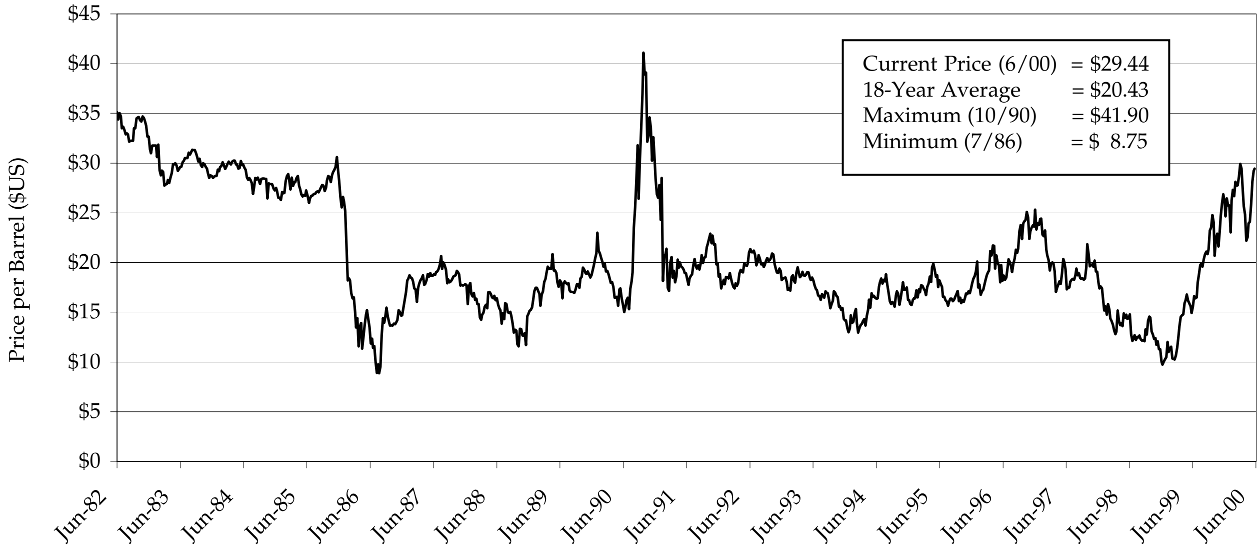
	Net Present Value (NPV) [b] (in $US millions)			Internal Rate of Return (IRR)		
	Chad	Cameroon	Private Sponsors	Chad	Cameroon	Private Sponsors
Reserves: 595 mm bbl						
Price = $12.00/bbl	$108	$92	$(917)	42%	34%	<0%
Price = $15.25/bbl	205	104	(344)	60	35	<0
Price = $18.50/bbl	330	101	235	75	35	13
Reserves: 917 mm bbl						
Price = $12.00/bbl	271	148	(98)	56	39	9
Price = $15.25/bbl	463	144	706	70	39	18
Price = $18.50/bbl	822	141	1,361	84	39	25
Reserves: 1,038 mm bbl						
Price = $12.00/bbl	337	162	198	60	41	12
Price = $15.25/bbl	603	158	1,045	75	40	21
Price = $18.50/bbl	1,170	156	1,614	90	40	27

Source: The World Bank and IFC Project Appraisal Document, April 13, 2000, Annex 4.

[a] Project benefits are generated through the sale of the project's crude oil in international markets. Calculated returns may vary from stated returns because of early (2000-2004) and late (2028-2032) cash flow.

[b] Discounted at 10% to year-end 1999.

Exhibit 6a Brent Crude Prices from June 1982 – June 2000 ($US per barrel)



Source: Adapted from Datastream data.

Exhibit 6b Capital Markets Data as of June 2000

Maturity	U.S. Treasury Yields	Brent Crude Futures Prices ($ per bbl)	Light Sweet Crude Futures Prices ($ per bbl)	Projected Prices for World Oil ($ per bbl) [a]
1 month	-	$29.19	$29.01	-
3 months	5.70%	26.34	27.89	-
6 months	6.24	25.26	26.47	-
1 year	6.30	22.91	24.21	$23.81
2 years	6.58	20.09	21.13	21.80
3 years	-	18.56	19.46	20.98
4 years	-	-	18.43	20.73
5 years	6.43	-	18.17	20.57
7 years	-	-	-	20.58
10 years	6.19	-	-	20.88
20 years	-	-	-	21.76
30 years	5.94	-	-	-

Sources: Bloomberg and casewriter analysis.

[a] Based on projections from the Energy Information Administration's *Annual Energy Outlook, 2001* (in constant 1999 $US). The World oil price is an annual average acquisition cost of imported crude oils to U.S. refiners.

Exhibit 7 Chad Country Data: 1990 – 1999

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Government Finances										
Total revenue ($US, millions) [a]	$293	202	269	279	158	197	216	221	196	175
Total expenditures ($US, millions)	$379	352	509	360	306	289	407	333	306	266
Net revenues ($US, millions)	($87)	(150)	(241)	(81)	(148)	(91)	(191)	(112)	(110)	(91)
Budget balance (% of revenue) [b]	-29.6%	-74.1	-89.6	-29.0	-93.8	-46.2	-88.5	-51.0	-56.5	-52.3
External debt (current $US, millions)	$524	629	723	768	828	902	997	1,026	1,092	1,142
External debt/Gross Domestic Product	30.1%	33.5	38.4	52.5	70.2	62.7	62.1	68.0	64.9	74.6
Output										
Gross domestic product (current $US, millions)	$1,739	1,877	1,882	1,463	1,179	1,438	1,605	1,508	1,682	1,531
Gross national product/capita (constant 1995 $US)	$226	242	255	206	215	210	212	215	224	216
Interest and Monetary Rates										
Inflation (Consumer Price Index)	-0.17%	4.19	-3.14	-7.07	40.43	9.06	12.39	5.62	12.14	-6.80
Lending rate	18.50%	18.15	17.77	17.46	17.50	16.00	22.00	22.00	22.00	22.00
Deposit interest rate	7.50%	7.50	7.50	7.75	8.08	5.50	5.46	5.00	5.00	5.00
Exchange rate (CFAfr per $US)	272.26	282.11	264.69	283.16	555.20	499.15	511.55	583.67	589.95	615.70
Other										
Aid per capita (current $US)	$54.61	44.82	39.47	35.95	32.96	35.24	42.92	32.12	22.98	25.08
Current account balance (% of GDP)	-2.62%	-3.49	-4.55	-7.97	-3.20	-2.53	-4.69	-5.56	-5.99	-10.49
Foreign direct investment (% of GDP)	0.00%	0.21	0.11	1.04	2.30	0.90	1.12	0.99	0.95	0.98
Illiteracy rate (% of population 15 and over)	72.31%	71.04	69.72	68.33	66.92	65.39	63.89	62.29	60.62	59.00

Sources: The World Bank's World Development Indicators 2001 and IMF International Financial Statistics.

[a] Chad currency is the CFA Franc (CFAfr), which has fixed parity with the French Franc: CFAfr 100 = FFr 1.00.

[b] Does not include financial grants or other forms of assistance.

Exhibit 8 African Development, Macroeconomic, and Political Risk Data (1999 unless otherwise noted)

Country	Population (000)	Life Expect. (years)	Access to Improved Water Sources (% of pop.)	United Nations Develop. Rank [a] 1998	Gross National Product ($ mil.)	GNP per Capita ($)	GNP per Capita Growth 1989-99 (%)	Total Debt (% of GDP)	Govn't Surplus or Deficit (% of GDP)	Euromoney Country Credit Rating [b] Sept. 1999	ICRG Composite Risk Rating [c] May 2000	Corruption Perception Rank [d]	Country Credit Rank [e] March 2000
Chad	**7,500**	**49**	**24%**	**167**	**$1,600**	**$200**	**-0.7%**	**74.6%**	**-10.6%**	**27.2**	**NA**	**NA**	**132**
Cameroon	**14,700**	**56**	**44**	**134**	**8,500**	**580**	**-2.5**	**83.6**	**-3.2**	**28.1**	**59.9**	**99**	**115**
Algeria	30,000	71	70	107	46,600	1,550	-0.9	58.6	-0.5	32.3	55.5	NA	91
Angola	12,400	46	32	160	27,000	220	-9.9	194.7	-13.1	24.4	45.5	NA	130
Benin	6,100	53	50	157	2,300	380	1.7	58.8	-2.3	29.7	NA	NA	118
Botswana	1,600	46	70	122	5,100	3,280	1.6	10.8	-2.6	51.1	83.0	24	39
Burkina Faso	11,000	44	-	172	2,600	230	0.9	54.9	-10.9	31.4	62.3	NA	107
Burundi	6,700	42	-	170	800	130	-4.5	157.6	-7.6	NA	NA	NA	136
Central African Rep.	3,500	44	-	166	1,000	290	-0.8	83.4	-8.7	25.6	NA	NA	NA
Congo Republic	2,900	48	-	139	1,900	670	-6.6	245.3	-8.1	25.0	48.8	NA	142
Dem. Rep. of Congo	49,800	49	-	152	-	-	-7.6	-	-7.4	20.0	44.8	NA	139
Cote d'Ivoire	14,700	46	72	154	10,600	720	1.5	132.2	-0.8	31.2	55.8	75	97
Gabon	1,200	53	67	123	3,800	3,090	-0.8	88.4	1.2	33.4	67.5	NA	102
Ghana	18,900	60	56	139	7,500	390	1.9	81.0	-6.0	38.8	57.5	63	82
Libya	5,400	70	90	72	-	-	-	-	-	16.1	68.5	NA	80
Malawi	10,800	42	45	163	2,000	180	1.2	131.4	-11.1	30.3	61.3	45	104
Mali	10,900	50	37	165	2,600	240	0.2	118.6	-8.1	31.9	65.8	NA	119
Niger	10,500	46	53	173	2,000	190	-1.3	80.1	-6.6	28.0	62.3	NA	125
Nigeria	123,900	53	39	151	38,400	310	0.4	92.8	-7.4	31.2	55.5	98	112
Sudan	29,000	55	50	143	9,400	330	-	218.3	-0.8	19.0	NA	NA	140
Togo	4,600	49	-	145	1,500	320	-0.8	89.3	-5.8	29.7	59.5	NA	117
Sub-Saharan Africa	2,417,000	49	-	-	-	500	-	-	-	-	-	-	-
World	6,000,000	66.5	78	-	-	5,130	-	-	-	-	-	-	-

Sources: World Bank, United Nations, African Development Indicators, Transparency International, and Institutional Investor Online Edition.

[a] The United Nations Human Development Index (HDI) provides a rating of health, education, and income across 174 countries. The rank ranges from 1 (high) to 174 (low).

[b] Euromoney's country rating assess the risk of investing in an economy based on nine analytical, credit, and market indicators. The scores ranges from 0 (most risky) to 100 (least risky).

[c] The International Country Risk Guide (ICRG) provides a rating composed of 22 variables in three subcategories of risk: political (100 points), financial (50 points), and economic (50 points). The composite risk rating equals the sum of the individual ratings divided by two: 0.0 to 49.5 is very high risk; 80.0 to 100.0 is very low risk.

[d] Transparency International's Corruption Perception Index (CPI) score relates to perceptions of the degree of corruption as seen by business people, risk analysts and the general public. Transparency International ranks 99 countries from highly clean (1) to highly corrupt (99).

[e] Institutional Investor ranks 145 countries based on information provided by economists at global banks and securities firms. Higher numbers represent a greater chance of country default.

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