Tearing Down Walls

The International Monetary Fund 1990–1999

James M. Boughton

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INTERNATIONAL MONETARY FUND

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Before I built a wall I'd ask to know
What I was walling in or walling out,
And to whom I was like to give offence.
Something there is that doesn't love a wall,
That wants it down.

Robert Frost, "Mending Wall" (1914)

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Contents

Figures

Tables

Illustrations

Web documents available at http://www.imf.org/external/pubs/ft/history/2011/index.htm

Foreword

The International Monetary Fund was created in 1944 to be the world's premier financial institution. It is the locus of international monetary cooperation among nearly all of the world's countries. In periods of relative calm, it regularly analyzes and reviews the economies of more than 180 countries and encourages cooperative and multilateral solutions to problems. In times of crisis, it is the first and foremost institution to respond with policy advice and financial assistance. The IMF is rightfully proud of its history, which I am eagerly learning as I begin my tenure as Managing Director. It is a history that should be shared more widely with the world community.

This volume is the fifth in a series of Histories published by the IMF. It continues the tradition of making each History more open and frank than those written earlier. The mandate of the Fund Historian is to write the History candidly and without bias, to approach the subject as an objective scholar and not as an advocate for the institution. This book presents the author's personal views, not those of the IMF, and he takes full responsibility for them. He has had full access to the Fund's archives and its senior officers. Many of the political leaders and finance officials who played crucial roles in the events of the 1990s have shared their own recollections with him to inform and enrich the account. My hope and expectation is that this commitment to openness and transparency will encourage readers to reflect on the challenges that confronted the IMF and to draw their own conclusions about how well the institution did and how we might improve in the future.

The 10 years covered in this volume—1990 through 1999—were years of upheaval, marked by large shocks: financial, economic, social, and political crises that spread around the world without regard for borders or distances. But they were also years of renewal, at the end of which many countries that had long been isolated were enjoying the fruits of international trade and cooperation. As this book emphasizes, it was a time when the political and economic walls that had separated east from west and north from south began to be dismantled. Adjusting to the upheavals was not easy, but few people today would want to rebuild the walls. The central lesson of this book is much the same as what I have concluded from my own experience before I came to the IMF: while the challenges of an open global economy are great, the alternative is not viable. To move forward, to build on the progress of the past two decades and put the stresses of the adjustment behind us, we need multilateralism and cooperation more than ever.

December 2011

Christine Lagarde
Managing Director
International Monetary Fund

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Preface

Background

For my generation—those born during or shortly after the Second World War—the breaching of the Berlin Wall was one of those rare events that divide our lives into the time before and the time that followed. For all of our conscious lives, we had known only a world divided geographically, politically, intellectually, spiritually, and economically by the Cold War. We lived on one side or the other of the wall, and we viewed the other side, if at all, through an Iron Curtain.

That world vanished with astonishing speed and with astonishingly peaceful force in a few weeks before and after November 9, 1989. On that day, the wall that separated East from West Berlin and that had symbolized the isolation of the people of East Germany was breached, and the process of tearing it down began. A wave of liberalization movements spread throughout Central and Eastern Europe, from Estonia in the north to Albania, some 2,000 kilometers to the south.

A craving for political freedom provided the greatest impetus for these movements, but a yearning for economic freedom, participation, and comfort was scarcely less important. Within four years, more than two dozen countries that had long been suppressed from participating fully in the world economy were accepted as members of the International Monetary Fund, a surge that finally realized the 60-year-old dream of the IMF's founders to create a universal institution linking virtually all states in a global financial system.

This book is a history of many separate and often loosely connected events, but in its essence it is a history of the first modern decade without a first, a second, and a third world. It is a history of the beginnings of a world in which events in Mexico could have profound effects on Indonesia, events in Indonesia could have profound effects on the Russian Federation, and events in Russia could have profound effects on Brazil. But it is also a history of the decade that preceded September 11, 2001, when attacks on western civilization forced a pullback behind new divisions defined by culture and religion rather than geography, politics, or economics.

The world without walls born in 1989 was crippled first by a series of financial crises from 1994 to 2001, then by the shock of global terrorism, and finally by the

global economic crisis that began in 2008. Whether the 1990s will turn out to have been a unique and tragically brief experiment with openness or the first giant step toward a noticeably open and stable world economy cannot yet be judged. Clearly, however, it differed radically from the decades that preceded and followed it. It was a decade during which "globalization" exploded in many directions and rose to the forefront of a newly globalized consciousness: first as a beacon of hope and then, all too quickly, as a focus of fear and protest.

This book is the fifth in a series of Histories of the IMF and the second by the present author. The series opened with a chronicle of the institution's origins and first 20 years, written by J. Keith Horsefield, who served as the Fund's first official Historian at the end of a career as its Chief Editor. A companion volume, analyzing several key aspects of the way the Fund's policies evolved through the mid-1960s, was edited by Horsefield and Margaret Garritsen de Vries, with contributions by some of the Fund's most prominent staff members during those formative years. A third volume for that first History collected the official documents that had brought the IMF into being and guided its early development. De Vries, the first woman to reach the level of Division Chief in the Fund, went on to write the next two Histories. Those volumes covered the first and second amendments to the IMF's Articles of Agreement: the amendment that created the special drawing right (SDR) as an international reserve asset in 1969 and the amendment adopted in 1978 that redesigned the Fund's role for an era without monetary gold as an anchor for a system of fixed exchange rates among currencies.

When I was handed the baton to continue this series, I also received a mandate to modernize the treatment of the Fund's history. The IMF, having begun life largely as a club of central banks, had long been cloaked in secrecy. Horsefield's History opened a window onto the Fund, primarily by describing and discussing the critical decisions made by the Executive Board, year by year, through 1965. De Vries continued that practice and expanded it by discussing more fully the role of the staff in developing and carrying out the Fund's policies. My goals in writing the fourth of the Fund's Histories—published in 2001 as *Silent Revolution: The International Monetary Fund 1979–1989*—were twofold: to make the story more scholarly and transparent by documenting the internal records that were my primary source material, and to make it more interesting and understandable by relating the work of the IMF more closely to the political, social, and intellectual developments in the world at large. The history of an institution can be understood only in relation to the world in which it operates. This book aims to continue that quest.

This sequential construction of the institutional history has the advantage of thoroughness, but it poses a challenge for the reader. With the completion of this volume, the official history now runs close to 7,000 pages, bound in 10 volumes. To piece together the evolution of just one type of lending by the Fund might require dipping into all or most of those volumes. At present, only the last two Histories—this one and its predecessor—are in digital form and available online.

In *Silent Revolution*, I included a great many footnotes referring to the earlier volumes as an aid to reconstructing the longer history. I have continued that practice in this work, despite my misgivings about the large number of references to my own earlier work. As a further introduction to the long sweep of the Fund's history, the Prologue to this book reviews the central events and ideas that led to the creation and subsequent evolution of the institution.

Readers interested primarily in the Fund's handling of financial crises may wish to focus on Chapters 7 (Russia), 10 (Mexico), and 11 (East Asia). Those looking for a more general introduction to the history of the institution might want to read the final part of the book (Chapters 15–17) before delving into the more specific issues taken up earlier. Each chapter is intended to be a self-contained treatment of a single topic but also to serve as a portal for those in search of a fuller understanding. Throughout the text, I have included many cross-references to related material in other chapters and references to discussions of earlier developments in the preceding Fund Histories.

A Note on "Fundese"

English is the working language of the IMF, but one could be excused for doubting it. John Maynard Keynes famously (and insensitively) referred to the language of the draft Articles as "Cherokee," by which he meant a language that was as incomprehensible as it was impressive.[1] The tradition has been carried on by the staff. It is not uncommon at the Fund to hear sentences in which almost none of the nouns is a real word, and even the translation needs to be translated. "The MD is asking the DR to purchase SDRs for the first tranche of their PRGF." This hypothetical example may be translated as, "The Managing Director is asking the Dominican Republic to purchase special drawings rights for the first tranche of their arrangement under the terms of the Poverty Reduction and Growth Facility."[2] In that form, the sentence would still make sense only to the cognoscenti. A more straightforward rendering into vernacular English would be, "The boss is asking the Dominican Republic to take the first disbursement of our low-interest loan in the form of a special asset that can only be held here at the Fund or exchanged with another government or central bank." That version, however, would look very odd to an insider. The highly specialized language of the IMF (often called "Fundese") therefore poses particular problems for anyone writing a book on the institution for a general readership.

In addressing this book to readers both inside and outside the IMF (or "the Fund," which is used interchangeably with "the IMF" throughout the book), I have tried to strike a balance between adhering to terminology familiar and clear to insiders and

[1]The Cherokee are a nation of Native Americans, with a distinct language. During the Second World War (when Keynes made his reference), the U.S. Army employed Cherokee and other Native Americans as "code talkers" to convey secret information.

[2]A complete list of abbreviations used in this book follows this Preface.

translating this often arcane language for everyone else. The following are common examples of internal argot and technical language that I have retained here.

- The "authorities" of a country are the senior officials with whom the Fund staff and management discuss economic policies and conditions and who are responsible for formulating and implementing macroeconomic policies. In this context, the term is shorthand for "monetary authorities." The reader might usefully think of them as "the government," but the term applies primarily to treasury or finance ministry officials and to central bank officials who, in some countries, are independent of the government. Executive Directors at the Fund also use the phrase "my authorities" to refer to the officials to whom they report in the countries belonging to their constituencies.
- The "management" of the IMF refers collectively to the Managing Director and the Deputy Managing Directors. The expression is common within the Fund. For example, "management" clears staff documents for circulation to the Executive Board. Use of the term in this History is generally limited to cases in which a Deputy acted on behalf of the Managing Director, two or more individuals were both actively involved, or the record is not clear about which individual was involved.
- The Executive Board is the main decision-making body in the Fund, sitting in "continuous session" (normally meeting two or three days each week). The 22 to 24 Executive Directors who composed the Board in the 1990s represented "constituencies" of from 1 to 24 countries. Executive Directors are officers of the Fund who either are appointed by their governments for an indefinite period (in the largest countries) or are elected by one or more countries for fixed terms of two years. This book refers to Directors by their nationality, which by tradition is almost always within the constituency.[3] Each Executive Director may be represented at Board meetings by his or her Alternate or by an Advisor or Assistant who has been designated as a Temporary Alternate. In such cases, a vote or a viewpoint expressed at a Board meeting might be described as by the "chair" of the country of the Executive Director.[4]
- The Fund's charter, drafted at Bretton Woods, New Hampshire, in July 1944, is its "Articles of Agreement." This book discusses the third and fourth amendments to the Articles. The two earlier amendments may be summarized as follows:
    - The First Amendment, which took effect in 1969, introduced the SDR both as the unit of account of the Fund and as an unconditional line of

[3]The one exception in this period was Oleh Havrylyshyn, who served as Alternate to the Executive Director from the Netherlands from 1993 to 1996. A native of Ukraine (when it was part of the Soviet Union), Havrylyshyn at that time was a citizen of Canada.

[4]Readers seeking a more detailed introduction to the structure and governance of the Fund may wish to begin by reading Chapter 17. Appendix II of that chapter presents a complete list of constituencies and Executive Directors for the 1990s. For a more detailed guide to the operations of the Fund, see IMF, Treasurer's Office (2001).

credit for participating countries. Since that time, the Fund's lending commitments have been specified in SDRs, and disbursements may be made either in SDRs or in convertible currencies.[5] Initially, the SDR was defined as the equivalent of the gold value of one U.S. dollar. In 1974, it was redefined as a basket of 16 currencies. In 1981, the basket was reduced to five. For a further introduction to the SDR, see the Appendix to Chapter 15.

- The Second Amendment, which took effect in 1978, ratified what is commonly known as the "floating exchange rate system." Instead of specifying and maintaining a par value in terms of gold or the U.S. dollar, as before the amendment, each country specifies its own exchange rate policies, which may range from independent floating to pegging against the dollar or another currency (or group of currencies). The Second Amendment aims to promote a "stable system of exchange rates" (as distinguished in an undefined manner from stable exchange rates) through the exercise of "firm surveillance" by the IMF over each member's exchange rate policies. Article IV, completely rewritten for this purpose, is frequently used as a metaphor for surveillance (see Chapter 4).
- Each member country is assigned a "quota" that determines both voting rights and borrowing (or "access") limits. (On this and the following points, see Chapter 15.) Originally, access to Fund resources was limited to 25 percent of quota in any 12-month period and 100 percent of quota cumulatively. Those limits were expanded over time and were always subject to exceptions, but the principle of basing each country's limit on its quota was retained. When a country becomes a member or receives a quota increase, it pays in 25 percent (the "reserve tranche"; see below) of its quota or quota increase in internationally traded (convertible) currencies or SDRs. The remainder is credited as a bookkeeping entry to the country's balance in the General Resources Account (GRA) at the Fund. Therefore, at the moment a country joins, the Fund's "holdings of the member's currency" equal 75 percent of the member's quota. If a country has fully drawn its reserve tranche and has not borrowed from the Fund, and if no other members have made net use of that currency in outstanding transactions with the Fund, then the Fund's holdings of the country's currency will equal 100 percent of quota.
- Starting in 1952, the IMF began referring to "tranches" of access to the resources of the Fund. Each country had potential access to its "gold tranche" (the portion of its quota that it had paid in gold) and four "credit tranches," each equivalent to 25 percent of quota.[6] The only

[5]Note that a statement that the Fund lends a country a given amount of SDRs should be interpreted to imply an amount in currencies and/or SDRs equivalent to the given SDR value.

[6]"Tranche" is also used at the Fund to describe a disbursement under an arrangement, as in the hypothetical example described in the opening paragraph of this section.

tranche mentioned in the Articles was the gold tranche, which was defined and given operational significance in the First Amendment. The credit tranches were defined and made operational only through Executive Board policy decisions on access to Fund resources. With the Second Amendment, the gold tranche was redefined as the "reserve tranche."

- Each member country has unconditional access to its reserve tranche, easy access to its first credit tranche, and access to higher levels of credit subject to increasingly strict "conditionality"—requirements to adjust economic policies. By the 1970s, when countries' indebtedness to the Fund frequently exceeded 100 percent of quota, the individual tranches beyond the first lost operational significance, and most subsequent references distinguished only between the first credit tranche and the open-ended "upper credit tranches." "Stand-by arrangements" (Fund commitments to lend specified amounts of money to member countries at specified intervals, subject to agreed-on conditions), drawings under which would raise the Fund's holdings of a member's currency above 125 percent, are referred to as upper-tranche arrangements.
- Indebtedness to the Fund is generally measured by the Fund's holdings of the member's currency in excess of 100 percent of quota. Exceptions arise when a country chooses not to draw on its reserve tranche before borrowing or draws on one of the Fund's specialized "facilities" in circumstances when such drawings are permitted to "float" relative to the standard tranches.[7] For example, until 1992, if a country borrowed the equivalent of 25 percent of its quota through the Compensatory Financing Facility (CFF), it could borrow another 25 percent under the general tranche policies and still be considered to have drawn only on its first credit tranche.

I generally have eschewed expressions in common usage only at the IMF whenever perfectly good substitutes are more widely understood. A problem arises with regard to the Fund's financial operations, which are uniquely structured. When a member country borrows from the general accounts of the Fund, the amount borrowed is technically a "purchase" of foreign exchange or SDRs in exchange for the country's own currency. The subsequent repayment of the principal is a "repurchase." In legal terminology, this type of financing is technically distinct from a conventional loan contract (and does not involve a contract between lender and borrower), but the economic effects are indistinguishable from a loan.[8] In the 10 years that have passed since *Silent Revolution* went to press, the IMF has become more open to the use of vernacular language to describe its activities. Most notably, the use of "loan" is no longer taboo as a

[7]When a financial institution lends under special conditions, the conventional jargon refers to the process as a lending "window." At the Fund, such windows are usually called "facilities."

[8]The IMF also makes conventional loans, most notably through the concessional facilities discussed in Chapter 13.

description of the Fund's financial assistance. Earlier Histories described such assistance as a purchase or a credit rather than a loan, but in most instances this book adopts the more common terminology. I generally refer to the purchase either as a drawing (on a stand-by or similar arrangement) or as a disbursement, and to the repurchase as a repayment.[9]

In another nod to generally understood usage, I have expressed the amounts of most loans in U.S. dollars rather than in the Fund's unit of account, SDRs. The loans are denominated in SDRs and thus vary over time with the dollar/SDR exchange rate. In responding to the financial crises of the 1990s, wherein the financial goal was to assemble an overall package of financial support from the IMF and other lenders, the share of the IMF in the package was usually set in terms of U.S. dollars and then translated into the SDR equivalent. Accordingly, I have usually relegated the SDR values to parenthetical references.[10]

Sources

The primary written source materials for this book are the documents housed in the archives of the IMF. I was granted unlimited access to the archives, as were Horsefield and de Vries before me. Since 1996, the archives have been open for external researchers upon application to the Archivist. With some exceptions, the Executive Board documents and minutes of Executive Board meetings cited herein are available to the public, given that they were issued more than 10 years ago. Internal documents such as staff memorandums are subject to a 20-year rule. Those cited here are expected to be released on that schedule.[11]

Some documents in the IMF archives were classified "strictly confidential" or "secret" when initially circulated. Documents with those classifications are not available to external researchers, nor to IMF staff without special permission. Whenever I sought to use such material for this History, I requested that they be declassified. Under the rules in effect at the time of these requests, most staff papers and internal memorandums could be declassified upon approval by the issuing

[9]When a member country draws on its reserve tranche, which represents international reserve assets that the member has deposited with the Fund (and in effect still owns), the drawing is not a credit, and the member has no obligation to repay it.

[10]With few exceptions, the exchange rate between dollars and SDRs is the monthly average rate at the time of the reported transaction or commitment. For example, the dollar value of a stand-by arrangement is converted from the SDR value at the exchange rate prevailing at the time of the commitment, not at the exchange rate that prevailed afterward during the life of the arrangement. In the 1990s, the monthly average dollar value of the SDR ranged from a low of $1.30 in April 1990 to a high of $1.58 in April 1995. Its average value was $1.40.

[11]For specific and current information on access to the archives, see http://www.imf.org/external/np/arc/eng/archive.htm or search for "archives" on http://www.imf.org. Footnotes in this book cite Executive Board documents using standard IMF notation: TT/yy/nn, where TT is the type of document, yy is the year of issue, and nn is the number within that year's series of such documents. For a list of document types cited in this History, see section C of the Abbreviations. Citations to internal memorandums and other unnumbered documents include the location of the document in the archives.

department in the Fund. Executive Board minutes and certain other country-related documents such as technical assistance reports required the approval of the country authorities. Most of those requests were granted, but in a few cases the authorities declined to permit declassification. In those cases, I deleted the references and modified the text accordingly. The only significant alterations were to Chapter 11 (on the Asian financial crisis), where the country authorities declined to approve declassification of the minutes of restricted meetings of the Executive Board.

To understand and to convey the context in which relations between the IMF and its member countries evolved, I interviewed officials and former officials from some 30 countries. Most of those interviews were conducted between 2004 and 2009, in the officials' countries. I also interviewed or had informal discussions with more than 100 of my colleagues in the Fund. All of those discussions and interviews were conducted on a background basis, with no recording device and consequently no transcript. Where necessary for clarity, I have inserted footnotes referring to interviews as the source of specific information, though without identifying the individual concerned unless a quotation is given. A complete list of interviewees appears below.

The source material for Chapter 10 (covering the Mexican peso crisis) included interviews, conversations, and direct observations as events unfolded in the first quarter of 1995. At that time, I interviewed most of the senior staff of the IMF involved in the response to the crisis, on the understanding that information from those interviews would not be used before the preparation of this History and that individuals would not be quoted without prior clearance. Interviews with Mexican, U.S., and other country officials were conducted approximately a decade later on similar terms.

All quotations are from printed records unless specifically noted otherwise. Apart from cited documents, the most common sources are the minutes of Board meetings and final texts of speeches. Oral remarks may have departed from the text, but in most cases no record exists of what was actually said. Executive Directors typically prepare statements (known as "grays" in reference to the color of paper on which they were once printed) that they circulate in advance of a Board meeting. The minutes reproduce those statements, introducing them with a sentence stating that the individual "made the following statement." Grays, however, are not read during the meeting. The minutes thus are a mixture of written statements and oral remarks. The latter are rendered into indirect speech and are edited into a consistent style. By convention, the minute writer excises much of the stylistic flavor of the discussion, such as humorous or parenthetical remarks, so that the official record focuses as clearly as possible on the substance of the meeting. In addition, each speaker is given an opportunity to review and edit the text of his or her own remarks before it is made final. The resulting product accurately reflects what each speaker intended to say, but not necessarily what was said during the meeting.[12]

[12]In quoting from the portions of the minutes that are in indirect speech, I generally have taken the liberty of restoring the presumed original form by replacing a past with a present tense.

A particularly important source document is the "Chairman's Summing Up" of an Executive Board meeting. This document, the official record of the sense of the meeting, reflects the input of the staff, the Board, and the Managing Director (or a Deputy Managing Director, in which case the document will be attributed to the "Acting Chairman"). Normally, the staff prepared a draft Summing Up before the meeting, based on anticipation of what Directors were likely to say, and management might have offered revisions at that time. As the meeting progressed, either the Chairman or the staff, or perhaps both, would redraft as necessary, often making major alterations to the substance of the document to reflect the views being expressed around the table. The final draft typically would include careful but vague attributions to the views of groups such as "a few," "some," "several," or "most" Directors.

In general, in each Summing Up, 2–4 Directors are "a few"; 5–6 are "some"; 6–9 are "a number"; 10–15 are "many"; 15 or more are "most"; and 20 or more are "nearly all." An additional qualifier, "several" Directors, lies vaguely between "some" and "a number." A special problem arises with references to the views of the United States, given that U.S. voting power is much larger than that of any other. Occasionally, when the U.S. chair expressed a view different from the others, that view was described as that of "some" Directors, but on other occasions the problem was avoided by use of the passive voice ("the view was held that . . ."). This quantification custom (generally attributed to Leo Van Houtven, the long-serving Secretary of the Fund) was long kept unpublicized by the Fund, although it was first enunciated by the Managing Director in 1983 and was quoted in a footnote in the preface to *Silent Revolution* (Boughton, 2001, p. xxi). It was added to the external website in 2010.[13]

At the end of a Board meeting or—exceptionally—at the beginning of the next meeting, the Chairman would read aloud the draft of the Summing Up. Directors then had an opportunity to comment and to suggest revisions. (Occasionally, further revisions would be suggested a day or two later.) A final text was then circulated and incorporated into the minutes of the meeting. Rarely was any record retained of the various drafts or the comments made upon them. The document therefore must be interpreted as representing the views of Executive Directors, albeit with some reservations.

An additional difficulty arises in attributing the work of the Fund to individuals. The staff works in teams under the direction of the Managing Director. Decisions are made by the Executive Board, and Executive Directors exert additional guidance and oversight through their interventions during Board meetings. References to the decisions and policies of the Fund are, by implication, references to the Executive Board. The Managing Director is selected by and accountable to the Executive Board. Executive Directors are accountable to their authorities. Collectively, the Fund is accountable to its membership. Nonetheless, the work of the

[13]See http://www.imf.org/external/np/sec/misc/qualifiers.htm.

Fund is conducted by individuals on the staff, and a history of the institution would be much poorer for ignoring or slighting their role.

This book makes frequent reference to staff members, especially to the chiefs of staff missions to member countries. The reader should understand that views and arguments attributed to individuals were to some extent developed, conditioned, and tempered by their colleagues, both on the mission teams and at headquarters. As a rule, I have respected the international (not just multinational) character of the institution by not identifying staff members' nationalities, except in the profiles of senior staff and management in the final chapter.[14] By stressing staff contributions while limiting references to personalities and backgrounds, I have tried to strike a balance between portraying the Fund as a monolithic institution driven by rational but disembodied analysis and depicting its policies as shifting by personal predilection. Either extreme would mislead, and I hope that the case studies throughout this book convey a sense of constant tension in the development and application of Fund policies. Mission chiefs and other managers are not interchangeable cogs, but neither are they completely free agents.

Acknowledgments

An institution's written record cannot by itself bring its history to life. I could not have begun to write this book without the help of my colleagues at the Fund who spoke to me about their work and who read and critiqued early drafts of my chapters, and of the many distinguished officials and other individuals from around the world who agreed to be interviewed for this project. Of those, the most important were Michel Camdessus and Stan Fischer, who encouraged me to undertake this work and who generously shared their time, their thoughts, and their memories to make it possible. I would also like to thank the following individuals for agreeing to be interviewed for this book or just for sharing their recollections and insights.[15]

IMF Staff[16]

Charles Adams, Max Alier, Mark Allen, Akira Ariyoshi, Athanasios Arvanitis, Lynn Aylward, Thomas Baunsgaard, Tamim Bayoumi, Andrew Berg, Jack Boorman, Tony Boote, Scott Brown, Jeremy Carter, Adrienne Cheasty, Olga Chmola, Ajai

[14]The Fund's charter specifies that "the staff of the Fund, in the discharge of their functions, shall owe their duty entirely to the Fund and to no other authority" (Article XII, Section 4(c)). On appointment, each staff member must "solemnly affirm . . . that I will accept no instruction in regard to the performance of my duties from any government or authority external to the Fund" (Rule N-14). To an extraordinary degree, Fund staff have demonstrated an ability to operate as international civil servants.

[15]The positions listed for individuals identified with specific countries are not comprehensive. Where two or three position titles are listed, the first ones generally refer to key positions held during the period covered in this book. The last usually indicates the individual's position at the time of the interview. (In a number of cases, these individuals subsequently held higher positions.)

[16]Former staff who held senior government positions in the 1990s are listed under their home country, as are Executive Directors and their staff. Other former staff and retirees are included in this first list.

Chopra, Daniel Citrin, Christopher Clarke, David Coe, Charles Collyns, Sharmini Coorey, Carlo Cottarelli, Milan Cuc, Pierre Dhonte, Donal Donovan, Michael Dooley, Thomas Dorsey, Charles Enoch, Ulric Erickson von Allmen, José Fajgenbaum, Tubagus Feridhanusetyawan, C. David Finch, Matthew Fisher, Hans Flickenschild, Kenneth Friedman, Przemek Gajdeczka, Gaston Gelos, Henri Ghesquiere, Atish Rex Ghosh, François Gianviti, Martin Gilman, James Gordon, Michael Hadjimichael, Sean Hagan, Elliott Harris, Heikki Hatanpää, Ernesto Hernández-Catá, John Hicklin, Peter Hole, Yusuke Horiguchi, Balázs Horváth, Simon Johnson, Meral Karasulu, Mohsin Khan, Deena Khatkhate, Kalpana Kochhar, Desmond Lachman, Kate Langdon, Leslie Lipschitz, Claudio Loser, Alan MacArthur, Walter Mahler, Paul Mathieu, Anne McGuirk, Reza Moghadam, Alex Mourmouras, P.R. Narvekar, Sean Nolan, Roger Nord, Jorge Márquez-Ruarte, John McLenaghan, Hunter Monroe, William Murray, Hubert Neiss, David Nellor, Sean Nolan, John Odling-Smee, Anton Op de Beke, Rolando Ossowski, Mahmood Pradhan, David J. Robinson, David O. Robinson, Franek Rozwadowski, Bassirou Sarr, Ruth Saunders, Garry Schinasi, Stephen Schwartz, Michaela Schrader, Abebe Selassie, Vasuki Shastry, Amor Tahari, Shamsuddin Tareq, Teresa Ter-Minassian, Subhash Thakur, John Thornton, Harry Trines, Wanda Tseng, Patrizia Tumbarello, Tessa van der Willigen, Rachel van Elkan, Leo Van Houtven, Orasa Vongthieres, Jian-Ye Wang, Max Watson, Nissanke Weerasinghe, David Williams, Thomas Wolf, Barry Yuen, Iqbal Zaidi, Alessandro Zanello, and Jeromin Zettelmeyer

Argentina

Domingo F. Cavallo—Minister of the Economy; Chairman, DFC Associates
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Abbreviations and Acronyms

A. IMF facilities and operations

BSFF	Buffer Stock Financing Facility (1969–2000)
CCFF	Compensatory and Contingency Financing Facility (1988–2000)
CCL	Contingent Credit Line (1999–2003)
CFF	Compensatory Financing Facility (1963–88, 2000–09)
CSF	Currency Stabilization Fund (1995–2000)
EAR	Enlarged Access to the Fund's Resources (1981–92)
ECM	External Contingency Mechanism (of the CCFF) (1988–2000)
EFF	Extended Fund Facility (1974–)
EFM	Emergency Financing Mechanism (1995–)
EPCA	Emergency Post-Conflict Assistance (1995–2000)
ESAF	Enhanced Structural Adjustment Facility (1987–99)
FSAP	Financial Sector Assessment Program (1999–)
GRA	General Resources Account
PRGF	Poverty Reduction and Growth Facility (1999–)
RAP	Rights Accumulation Program (1990–)
ROSC	Report on Observance of Standards and Codes (1999–)
SAF	Structural Adjustment Facility (1985–95)
SBA	stand-by arrangement[1]
SCA	Special Contingent Account
SDA	Special Disbursement Account
SRF	Supplemental Reserve Facility (1997–2009)
STF	Systemic Transformation Facility (1993–95)

[1]In this book, the abbreviation SBA is used only in tables and figures, not in the text.

B. Organization of the IMF[2]

ADM	Administration Department (1964–99)
APD	Asia and Pacific Department (1997–)
ASD	Asian Department (1953–91)
CBD	Central Banking Department (1980–92)
CTA	Central Asia Department (1991–97)
ETR	Exchange and Trade Relations Department (1965–92)
EU1	European I Department (1992–2003)
EU2	European II Department (1992–2003)
EUR	European Department (1953–91; 2003–)
FAD	Fiscal Affairs Department (1964–)
HRD	Human Resources Department (1999–)
IEO	Independent Evaluation Office (2001–)
IMFC	International Monetary and Financial Committee (1999–)
MAE	Monetary and Exchange Affairs Department (1992–2003)
MED	Middle Eastern Department (1953–2003)
OAP	Regional Office for Asia and the Pacific (1997–)
OBP	Office of Budget and Planning (1992–)
PDR	Policy Development and Review Department (1992–2008)
SEA	Southeast Asia and Pacific Department (1991–97)
TGS	Technology and General Services Department (1999–)
WHD	Western Hemisphere Department (1953–)

C. Types of IMF documents cited in this History

BUFF	statement submitted by a participant in an Executive Board meeting
DC	Development Committee document
EBAP	Executive Board administrative paper
EB/CGATT	document for the Executive Board's Committee on Liaison with Contracting Parties to the GATT
EB/CQUOTA	document for the Executive Board's Committee of the Whole on Review of Quotas
EB/CQUOTA/MTG	minutes of the Executive Board's committee on quotas
EB/CW/DC	document for the Executive Board's Committee of the Whole for the Development Committee
EB/CWM	document for the Executive Board's Committee of the Whole on Membership

[2]For a complete list of departments and offices, see Appendix I to Chapter 17. The absence of an ending date indicates that the terminology was still in effect at the end of 2010.

EBD	Executive Board document
EBM	Executive Board minutes
EBS	Executive Board special[3]
FO/DIS	Front Office [document for] Informal Distribution
ICMS	Interim Committee document
IS	minutes of Informal Session of the Executive Board
IS/MTG	minutes of Informal Session of the Executive Board
MD/SP	speech by the Managing Director
NB	News Brief
PR	Press Release
SEC/CIRC	Secretary's Circular
SEM	Seminar
SM	Staff Memorandum[4]
SUR	Surveillance – Summing Up or Chairman's Remarks
UNDOC	undocumented paper

D. Other terms specific to the IMF

DSA	debt sustainability analysis
EFM	Emergency Financing Mechanism (1995–)
FDMD	First Deputy Managing Director (1994–)
GAB	General Arrangements to Borrow
GDDS	General Data Dissemination System (1997–)
IFS	International Financial Statistics
LOI	Letter of Intent
MEFP	Memorandum on Economic and Financial Policies[5]
MEP	Memorandum on Economic Policies
NAB	New Arrangements to Borrow
OMD	Office of the Managing Director
PC	performance criterion (as a condition for Fund lending)
PFP	Policy Framework Paper
PIN	Public Information Notice (1997–)[6]
PRSP	Poverty Reduction Strategy Paper (1999–)
SDDS	Special Data Dissemination Standard (1996–)
SDR	special drawing right
WEMD	World Economic and Market Developments
WEO	World Economic Outlook

[3]EBS documents typically relate to the use of Fund financial resources by member countries.
[4]SMs typically relate to Article IV consultations and other surveillance reports.
[5]MEFP and MEP were used interchangeably, with no substantive distinction.
[6]When PINs were introduced in 1997, they were called Press Information Notices. The terminology changed in July 1998.

E. Other international organizations and groups, and related terms

AfDB	African Development Bank
AMF	Asian Monetary Fund (as proposed in 1997)
APEC	Asia-Pacific Economic Cooperation
AsDB	Asian Development Bank
ASEAN	Association of South-East Asian Nations
BCEAO	Central Bank of West African States[7]
BEAC	Bank of Central African States[7]
BIS	Bank for International Settlements
CIS	Commonwealth of Independent States (1991–)
CMEA	Council on Mutual Economic Assistance
EAC	East African Community
EAI	Enterprise for the Americas Initiative
EBRD	European Bank for Reconstruction and Development (1991–)
EC	European Communities (forerunner of EU, 1957–93)
ECB	European Central Bank (1998–)
ECCU	Eastern Caribbean Currency Union
ECOSOC	Economic and Social Council of the UN
ECU	European currency unit (1979–98)
EEC	European Economic Community (component of EC)
EMI	European Monetary Institute (1994–97)
EMS	European Monetary System
EMU	Economic and Monetary Union (program of EC, 1990–99)
ERM	Exchange Rate Mechanism (of the EMS)
EU	European Union (1993–)
FSF	Financial Stability Forum (1999–2009)[8]
FYR	Former Yugoslav Republic (of Macedonia)
GATT	General Agreement on Tariffs and Trade (1948–94)
G7	Group of Seven (major industrial countries)
G8	Group of Eight (G7 plus the Russian Federation) (1998–)
G10	Group of Ten (industrial countries)
G20	Group of 20 (advanced and emerging-market economies) (1999–)
G22	Group of 22 (advanced and emerging-market economies) (1997–99)
G24	Group of 24 (developing countries)
HIPC	Heavily Indebted Poor Countries

[7]Also see Chapter 14, footnote 43.
[8]In 2009, the FSF was reconstituted to become the Financial Stability Board.

IBRD	International Bank for Reconstruction and Development (part of the World Bank Group)
ICC	Interbank Coordinating Council of the Heads of National Banks
IDA	International Development Association (part of the World Bank Group)
IDB	Inter-American Development Bank
ILO	International Labor Organization
JVI	Joint Vienna Institute (1992–)
MERCOSUR	Southern Common Market (in South America) (1991–)
MFG	Manila Framework Group (1997–2004)
NATO	North Atlantic Treaty Organization
NAFTA	North American Free Trade Agreement
OAS	Organization of American States
OECD	Organization for Economic Cooperation and Development
SFR	Socialist Federal Republic (of Yugoslavia)
UN	United Nations
UNCTAD	UN Conference on Trade and Development
UNDP	UN Development Programme
WTO	World Trade Organization (1995–)

F. General terms[9]

GDP	gross domestic product
GNP	gross national product
LIBOR	London interbank offered (interest) rate
NGO	nongovernmental organization
ODA	official development assistance
PSI	private sector involvement (in the resolution of financial crises)

[9]This listing does not include abbreviations for national entities such as central banks.

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Prologue

This overview of the full history of the IMF was developed through a series of lectures and conference presentations from 2003 to 2009. A preliminary version was circulated as an IMF Working Paper in 2004 (WP/04/75). The revised version presented here provides a broader context for the discussion of the Fund in the 1990s that is the subject of this book.

The IMF and the Force of History: 10 Events and 10 Ideas That Shaped the Institution

[Point] III. The removal, so far as possible, of all economic barriers and the establishment of an equality of trade conditions among all the nations consenting to the peace and associating themselves for its maintenance.

Woodrow Wilson
President of the United States
Address to a Joint Session of
Congress on the Conditions of Peace
[Fourteen Points]
January 8, 1918

The International Monetary Fund was forged from failure.

When the heads of government of the great powers met in Paris at the end of 1918, they had before them a blueprint for restoring prosperity and world peace, in the form of U.S. President Woodrow Wilson's Fourteen Points. Six months later, they agreed on the terms of what would become known as the Treaty of Versailles, but key parts of the blueprint had been cast aside. Within a decade, prosperity was lost. In another decade, peace was gone as well. The most famous failure was Wilson's inability to convince the U.S. Senate to confirm the country's membership in the League of Nations. The most disastrous, however, was arguably the failure to lay the groundwork for economic cooperation among the world's great trading nations. Whether U.S. membership in the League would have slowed the slide

toward war in the 1930s is debatable. The effect of the autarkic policies of the 1920s on the collapse of trade and output in the 1930s, however, is well established (Crucini and Kahn, 1996; Irwin, 1998).

When delegations from 44 countries met at Bretton Woods, New Hampshire (United States), in July 1944 to establish institutions to govern international economic relations in the aftermath of the Second World War, avoiding a repetition of the failings of the Paris peace conference was very much on their minds. Creation of an International Bank for Reconstruction and Development would help restore economic activity, while creation of an International Monetary Fund would help restore currency convertibility and multilateral trade. Removing the barriers to trade, as envisaged by Wilson a quarter-century earlier, was not enough. More active and institutionalized cooperation was now understood to be needed.

The failure of Paris was only the first of a series of historical events and ideological transformations to influence the design and work of the IMF and the postwar international monetary system. This prologue surveys critical events of the past century and the shifts in economic theory that had the greatest influence on the Fund, to draw some general conclusions about the force of history on the international monetary system.

Ten Events

The first three key events—the Paris peace conference, the Great Depression, and the Second World War—made the creation of a multilateral financial institution possible and largely determined the form it would take. Subsequent events caused the IMF to alter its practices in various ways to stay relevant in a changing world.

1. The Paris Peace Conference

Economics was not a high priority at the Paris peace conference in 1919. The borders of Europe had to be redrawn one by one, and that task alone took up most of the six months of high-level meetings. Some way had to be found to pay the costs of the war and the costs of rebuilding, and solving that problem was about all the economics that any of the leaders had the patience for. They created the League of Nations, but its economic functions were poorly defined and never solidified into an effective role.[1] They created the International Labor Organization, but its role was specialized and limited.

[1]For all its weaknesses, the League of Nations did undertake certain economic tasks, including lending for financial stabilization. It also demonstrated the potential benefits of multilateral economic cooperation, at least to those who worked there. Its staff included a highly distinguished cadre of economists, several of whom later greatly influenced the IMF through their work (e.g., Tjalling Koopmans, Ragnar Nurkse, and Jan Tinbergen), by joining the staff (e.g., Jacques Polak and Marcus Fleming), or even becoming head of the institution (Per Jacobsson). For an analysis of the economic work of the League, see Pauly (1997). For a brief memoir, see Polak (1994), pp. xiv–xv.

The conference's neglect of economics did not result from a failure to understand the importance of international trade for prosperity and thus for maintaining the peace. As the quotation at the head of this prologue shows, Woodrow Wilson had made this relationship clear in his "fourteen points" speech to the U.S. Congress in January 1918. Instead, the neglect of economics occurred mainly because the limitations of the invisible hand were not well understood. For a generation or more, the international gold standard had provided a measure of stability with little need for overt cooperation. The challenge seemed to be simply to avoid imposing barriers to trade or otherwise interfering with markets.

In the economic turmoil following the war, that passive approach was not nearly enough. Some countries remained on the gold standard, but others did not. Without clear guidance or any institutional check on behavior, competitive devaluations and punitive tariffs became a common temptation for a quick fix to economic ills. Margaret MacMillan (2001) is surely right in arguing that the Versailles treaty cannot be held solely responsible for these and other ills of the twentieth century, but neither can it be absolved from blame.

What does this experience have to do with the IMF? A quarter-century afterward, it was very much on the minds of those who were drawing up the designs for the new institution. In the view of John Maynard Keynes (the head of the British delegation to the Bretton Woods conference), the "contractionist pressure on world trade" brought on by the "special protective expedients which were developed between the two wars" resulted in large measure from futile efforts "to protect an unbalanced position of a country's overseas payments." Creation of an "international clearing union" would obviate the need for such "forced and undesired dodges."[2] Without the clearing union (which eventually metamorphosed into the IMF), the expected persistent creditor position of the United States would depress world economic growth and drive the world back into protectionist policies, regardless of how quickly or how well production and trade could be reconstructed after the war.

Harry Dexter White, the chief drafter of the IMF charter for the U.S. delegation, was equally impressed by the need to avoid the passive errors of Versailles. His initial plan noted that during "the last twenty years" (that is, throughout the interwar period), countries had often imposed protectionist policies because they lacked adequate gold reserves, and the plan warned that the same problems would arise and would constitute a major barrier to the growth of trade after the war. An international monetary fund would enable countries in that position to economize on their gold reserves and thus avoid recourse to trade barriers, payments barriers, and bilateral clearing schemes.[3] As early as 1935, when France and Great Britain were contemplating currency devaluations aimed at improving their competitive

[2]First draft of "Proposals for an International Currency (or Clearing) Union," February 11, 1942; Horsefield (1969), Vol. III, pp. 3–18.

[3]U.S. Treasury, "Preliminary Draft Proposal for a United Nations Stabilization Fund and a Bank for Reconstruction and Development of the United and Associated Nations (April 1942)"; Horsefield, (1969), Vol. III, pp. 37–82.

positions but that threatened to spark a vicious cycle of retaliatory actions, White argued that the U.S. Treasury should intervene by encouraging an international agreement to stabilize exchange rates (Boughton, 2002). That led to the Tripartite Agreement of 1936 and set the stage for more comprehensive and institutionalized agreements later on. When the Articles of Agreement for the IMF were adopted at Bretton Woods in 1944, they specified that one purpose of the institution was "to avoid competitive exchange depreciation."[4]

It is important to note that for both Keynes and White, the motivating principle for creating the IMF was to engender postwar economic growth by establishing an institution that would prevent a relapse into autarky and protectionism, not just to avoid a recurrence of the Depression. The impetus was less the Depression than the necessity of rebuilding and engendering economic growth after the war.

2. The Great Depression

Although the Great Depression may not have been the "defining moment" for the international monetary system (as Bordo and Eichengreen, 1998, claimed it to be), it influenced strongly the initial design of the IMF. The Depression amplified the negative consequences of Versailles, as an implosion of international trade interacted with domestic policy errors to deflate both output and prices around the world. It severely tested the confidence of analysts and voters in the efficacy of free markets and strengthened belief in an activist role for the public sector in economic life. It thus became easier and more natural to start discussions on a postwar framework from the assumption that an intergovernmental agency with substantive powers would be beneficial and even essential for the international financial system.

The combined effects of Versailles (the absence of a stabilizing system in international finance) and the Depression were an important influence on the IMF's mandate as adopted at Bretton Woods in 1944. Article I of the Articles of Agreement, which sets out the purposes of the Fund, includes the objective of using IMF lending to provide member countries "with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity." Article IV set out a system for achieving that purpose by establishing a system of fixed but adjustable exchange rates through agreements to be reached under the auspices of the Fund. U.S. Treasury staff made the case for such a system by evoking the specter of what had occurred throughout the interwar period: "Long before the war, the necessary monetary and financial basis for international prosperity had been weakened by competitive currency depreciation, by exchange restriction, by multiple currency devices," and the like.[5] The new institution would obviate the need for such unilateral and destructive actions.

[4]Article I (iii).

[5]U.S. Treasury, "Questions and Answers on the International Monetary Fund (June 10, 1944)," in Horsefield, (1969), Vol. III, pp. 136–82. The quoted passage is on p. 137.

3. The Second World War

The third major historical influence on the IMF was the Second World War, which provided both the impetus and the context for reforming the international system. When the United States entered the war in response to the bombing of Pearl Harbor in December 1941, Treasury Secretary Henry Morgenthau Jr. put Harry White in charge of international economic and financial policy and asked him to come up with a plan for remaking the system once the war was over. As it happened, White had already sketched out a rough plan for an international stabilization fund, and he was able to produce a first draft within a couple of months. On the other side of the Atlantic, Keynes was developing a plan for an international clearing union to be run jointly by Britain and the United States as "founder-States."[6] Though less overtly multilateral than White's scheme, and based on the British overdraft system rather than on White's rather complicated proposal for currency swaps (Boughton, 2002, 2003a), Keynes's clearing union was similar in its essence to White's stabilization fund. Over the next two years of discussion and negotiation, the two plans would meld into a draft for the IMF charter.

The IMF was created in the midst of the war, at the United Nations Monetary and Financial Conference, which convened 44 country delegations at Bretton Woods in July 1944. Keynes had tried to limit the involvement of countries other than Britain and the United States, fearing that a "most monstrous monkey house" would result if all the wartime allies were invited.[7] White, however, insisted on a multilateral conference, partly because he seems to have sensed that the project would otherwise fail and partly because he doubtless wanted to neutralize the force of Keynes's intellect and personality.

The importance of Bretton Woods as a wartime event was that it took advantage of a window of opportunity to create a multilateral financial system. Both before and after the war, the levels of suspicion and national self-interest were too great for such a sweeping agreement to be possible. Even in 1945, when the U.S. Congress and the U.K. Parliament were to ratify the Articles of Agreement, passage was far from easy (Gardner, 1980). Again, White invoked the specter of Versailles. Asked in a House of Representatives hearing what would happen if Congress refused to ratify the agreement, White replied, "I think history will look back and indict those who fail to vote the approval of the Bretton Woods proposals in the same way that we now look back and indict certain groups in 1921 who prevented our adherence to an international organization designed for the purpose of preventing wars."[8] Such arguments carried the day in 1945. Within three years, however,

[6]Keynes's initial work on the clearing union plan is described in Harrod (1951) pp. 526–28; Horsefield (1969) Vol. I, pp. 14–16; and Skidelsky (2000) pp. 199–209. The "founder-States" proposal is in Horsefield (1969), Vol. III, p. 15.

[7]Letter to Sir David Walley (30 May 1944), in Moggridge (1980), p. 42.

[8]Testimony before the U.S. House Committee on Banking and Currency; quoted in Gardner (1980), p. 141.

when negotiators tried to complete the system by creating an International Trade Organization, the multilateralists were outmanned, and the proposal failed.[9]

The other major influence of the war on the IMF was that it left the United States in virtual control of the world economy. With Britain heavily dependent on American largesse, Keynes had few cards to play in his efforts to shape the postwar system to his country's advantage. Of the other major allies, France was equally powerless and the Soviet Union was politically isolated and intellectually detached. As a consequence, the financial structure of the IMF would be based on the U.S. dollar, rather than on an international currency of the Fund's own making. Its lending power would be limited in size and scope, and the Fund would lack most of the powers of a central bank. Its headquarters would be neither in London nor even in New York, but in Washington where the U.S. Treasury could exert a strong gravitational pull. For the next three decades, the IMF would be a dollar-centric institution, with the United States providing most of its lendable resources and effectively controlling most of its lending decisions.

4. The Rise of Multiple Economic Centers

With the war over and the world economy—and world trade—beginning to recover, U.S. economic hegemony gradually eroded. The first region to rise from the ashes was western Europe. Through a combination of national drive, international support—from the U.S. Marshall Plan, the World Bank, and eventually the IMF—and a home-grown multilateralism in the form of the Common Market and the European Payments Union, by the late 1950s, much of Europe was growing rapidly and becoming increasingly open to multilateral trade and currency exchange. The Federal Republic of Germany joined the IMF in 1952 and quickly became one of the world's leading economies. Next came Asia. Japan also joined the Fund in 1952, and by the 1960s it was on its way to joining the United States and Germany on the top rung of the economic ladder. Then the 1970s saw the rise of economic power in Saudi Arabia and other oil-exporting countries of the Middle East. In 30 years, the U.S. share of world exports had fallen to 12 percent from 22 percent, while its share of official international reserves dropped even more dramatically, from 54 percent in 1948 to 12 percent in 1978.

As the balance of economic and financial power became more widely dispersed, more and more currencies became fully convertible for current account and even capital transactions. Trading partners grew at different rates and with different mixes of financial policies. Pressures on fixed exchange rates and on the limited supply of gold and U.S. dollars became increasingly frequent and more severe. The IMF responded in 1969 by amending its Articles and creating special drawing rights

[9]This argument should not be carried so far as to imply that multilateralism died altogether after the Second World War. The establishment of the Marshall Plan in 1947 and the global agreement in 1968 to create Special Drawing Rights are two prominent examples in the positive column.

(SDRs) as a supplement to existing reserve assets, but that action was too limited to deal with the underlying problem of differential pressures. As a result, even before the first oil shock in 1973, the original Bretton Woods system of fixed but adjustable exchange rates had become unviable. The Second Amendment, adopted in 1978, acknowledged that exchange rates among key currencies were likely to float or at least be allowed to adjust more frequently than the old system could have handled.

5. The Cold War

Harry White had worked hard in 1944 to persuade the Soviet Union to join the IMF, in the belief that economic cooperation between the Soviet Union and the United States would be the key to postwar peace and prosperity. The Soviet delegation to Bretton Woods signed the Articles *ad referendum*, but Joseph Stalin eventually refused to ratify the agreement, apparently because he feared (not without justification) that Fund policies would be largely controlled by the west (James and James, 1994). When that tension segued into the Cold War, White's vision of universal membership was dashed. Poland withdrew from membership in 1950. Four years later, Czechoslovakia was forced to withdraw. Shortly after taking power in 1959, Fidel Castro removed Cuba. For more than three decades after Mao Zedong took control of China, the U.S. government blocked efforts by the People's Republic to be seated as China's representative on the IMF Executive Board. Most other countries in the Soviet or Chinese spheres of influence simply did not join. Not until the 1980s would the trend be reversed with the seating of China and renewed membership for Poland (Boughton, 2001b, Chapter 19).

The obvious effect of the Cold War on the IMF was this limitation on membership. In the terminology of the period, membership included the first world and much of the third, but the second was missing from the table. The IMF became largely a capitalist club that helped stabilize market-oriented economies.[10] The more subtle and difficult question concerns the effect on the IMF staff and the staff's analytical work. The bulk of IMF analysis has always been mainstream and centrist, viewed from the perspective of the dominant strain of Anglo-Saxon economics. The leading universities of North America, the United Kingdom, and Australia have been the main training grounds for much of its professional staff. Martha Finnemore, a political scientist who has studied a number of large organizations, has even claimed that the Pentagon displays more intellectual diversity than the IMF.[11]

Would this centrist dominance have been weaker, with a broader range of views on economic policy being represented (perhaps at some cost of efficiency and

[10]Largely, but not exclusively. Yugoslavia was an original member, Romania joined in 1972, Vietnam remained a member after its unification in 1975, the China seat passed to the People's Republic in 1980, and a few more centrally planned economies—notably Hungary and Poland—joined in the 1980s.

[11]Remarks at an Economic Forum on "Governing the IMF" (September 17, 2002); accessed at http://www.imf.org/External/NP/EXR/ECForums/2002/091702.htm. For a similarly critical analysis of the perceived lack of intellectual diversity in the staff, see Momani (2005).

effectiveness), if the Fund's membership had been universal from the outset? That seems unlikely. The shift to universal membership in the 1990s and the corresponding geographic broadening of the staff[12]—in Finnemore's terminology, an increase in "passport diversity"—had little analytical impact. Moreover, the influence of Latin American economic thought—exemplified by the *dependencia* theories of Raúl Prebisch (1971) and others at the UN Economic Commission on Latin America[13]—was never strong in the IMF despite the presence of large numbers of economists from the region on the Fund staff from the outset. Much the same could be said regarding the lack of influence of Austrian and German institutional economics. Analytical diversity and internal dissent have been more prominent in the World Bank (with the same membership) than in the IMF, albeit less so than in the nearly universal United Nations secretariat. The influence of mainstream western thinking at the IMF—an influence that the staff itself would regard with some justification as reflecting best practices in the economics profession—is a more deeply seated phenomenon than can be explained by Cold War politics.

6. African Independence

As discussed in Chapter 14 of this volume, the presence and role of African countries in the IMF increased greatly from the late 1950s through the end of the 1960s as a result of a generalized movement toward independence from colonial rule. The emergence of Africa as a continent of independent nations joining the IMF had a major effect on the size and diversity of the institution, and it required a substantial intensification of the Fund's involvement with and oversight of its borrowers. Most of these countries, especially in sub-Saharan Africa, had and continued to have very low per capita incomes and were among the least economically developed countries in the world. Their economic problems tended to be structural even more than macroeconomic; rooted in the need for improvements in education, health, infrastructure, and governance rather than finance; and more deeply ingrained and persistent than in other regions. When the Fund began providing financial assistance to large numbers of low-income countries in the 1970s, it had to find ways to subsidize its lending, coordinate its assistance with other official agencies, and develop more extensive and structural policy–reform conditions on its lending. In addition, the Fund sharply increased and broadened its provision of technical assistance to member countries, thereby expanding its work further beyond its original boundaries.

Lending to low-income countries also raised the riskiness of the IMF's portfolio of sovereign claims. By the mid-1980s, several African countries had fallen into protracted arrears on their borrowings from the Fund, which forced the institution

[12]As of 2001, a little more than 40 percent of IMF economists were from developing countries. Some 4 percent were from the Russian Federation, the Baltic countries, other countries of the former Soviet Union, or Eastern Europe.

[13]For an overview, see Yergin and Stanislaw (2002), pp. 234–36.

to further reexamine its conditionality as well as its finances. Several countries with protracted arrears—mostly in Africa—were subject to "remedial" measures leading up to the suspension of voting rights. The IMF shifted its lending to low-income countries primarily to separately funded and subsidized trusts, and it coordinated that assistance closely with the World Bank. To qualify for those loans, countries had to develop their own strategies for generating economic growth and reducing poverty. The IMF still emphasized the need for countries to maintain sound macroeconomic policies, but that traditional focus was only the starting point for most of its work in Africa.

7. The Vietnam War

The intensification of U.S. involvement in the Vietnam War in the 1960s and early 1970s would not by itself have had substantial effects on the IMF, other than the direct effect on Vietnam's membership. When the government of South Vietnam was about to fall in April 1975, its officials tried desperately to borrow as much as they could from the IMF. The Fund refused to go along, and within a few months it recognized the Socialist Republic of Viet Nam as the successor government (Boughton, 2001b, pp. 766–67). The larger effect, however, was on the U.S. economy and its external payments position. In combination with a sizeable increase in domestic spending on President Lyndon Johnson's Great Society programs, the rise in external military spending gradually worsened the overvaluation of the U.S. dollar under the Bretton Woods system of fixed exchange rates. In a series of spasms, the system dissolved between 1968 and 1973. With the dollar no longer convertible into gold, the precious metal could no longer serve a central or even a useful function in the international monetary system. The Vietnam War was by no means the sole culprit in this decline, but its catalytic role was substantial (James, 1996, Chapter 8).

8. Globalization of Financial Markets

Private sector financial flows were of limited scope and importance when the IMF was founded. Trade flows were financed largely by trade credits, and most economists considered cross-border portfolio flows to be as much a potential destabilizing nuisance as a potential source of investment capital. Keynes and White, therefore, agreed that the IMF should be given the power to restrict capital flows in situations in which they seemed to be destabilizing. Article VI of the IMF charter prohibited member countries from borrowing from the Fund "to meet a large or sustained outflow of capital," and it empowered the IMF to "request a member to exercise controls to prevent such use" and to declare the member ineligible to use the Fund's resources if it failed to comply. More generally, it recognized countries' rights to impose capital controls as long as the controls did not restrict payments for transactions on the current account.

The range and importance of capital flows began to increase in the 1950s as European countries gradually reestablished convertibility. The first big increase, however, came in the 1970s, with the emergence of the Eurodollar and other offshore financial markets. It was driven further by the accumulation of "petrodollars" by oil-exporting countries in the 1970s and the recycling of those assets to oil-importing sovereign borrowers through large international banks. By the 1990s, cross-border flows had become an essential source of finance for both industrial and emerging-market economies around the world, and the structure of international financial markets had become so complex that their effective size could no longer be measured, much less controlled.

Largely in implicit recognition of these developments, the IMF has never invoked the provisions of Article VI enabling it to encourage the imposition of capital controls. Nor has the prohibition on lending to finance a large or sustained capital outflow ever prevented the Fund from acting, simply because it can always be argued that an unchecked capital outflow will eventually cause problems for the current account. That justification was first made in 1956, when the United Kingdom borrowed to stop a speculative attack on the pound sterling in the wake of the Suez crisis (Boughton, 2001a), and it has been taken for granted ever since.

A second and more important effect of financial globalization was that IMF financing became quantitatively marginalized, in the aggregate and for many potential borrowers. In the early days of the IMF, countries facing a financing gap in their balance of payments could often close it solely by borrowing from the Fund. By the 1980s, the object was more often to "catalyze" other capital inflows by borrowing relatively small amounts from the Fund in support of an agreed-on package of policy reforms, thereby hoping to convince other creditors that the country was a good prospect. What mattered was not so much the quantity of money as the quality of the reforms. Globalization thus fundamentally altered the relationship between the IMF and its borrowing members and between the IMF and other official and private creditors.

Globalization's third effect was to weaken the "credit union" character of the IMF as a membership institution. The original idea was that most countries would probably undergo periods as creditors and other periods as debtors. In the 1950s and 1960s, most of the large industrial countries fit that description. Of the seven largest economies, only Germany and the United States consistently maintained creditor positions in the Fund. By the 1980s, however, all the more advanced economies were able to finance their external payments with private flows, and the IMF's membership became divided into persistent creditor and debtor groups. The presumed commonality of interests among members was correspondingly diminished.

9. Two Decades of Debt and Capital Crises

In August 1982, a two-year gradual worsening of conditions in international debt markets suddenly accelerated, precipitating a major economic and financial crisis. A smattering of countries, including Hungary, Morocco, Poland, and Yugoslavia, had already seen their bank creditors turn their backs in 1981 and the first half of 1982. When the banks suddenly pulled out of Mexico, the crisis took on systemic proportions. Within a few months, Argentina, Brazil, and Chile were also in trouble, and the crisis was continuing to spread. Not until 1990, when world interest rates settled down and the bank debts of the most heavily indebted developing countries were being replaced by Brady Bonds, would it be possible to declare the crisis over (Boughton, 2001b, Part II).

The debt crisis had a transforming impact on the IMF, catapulting it into the role of international crisis manager. Previous international crises—Suez in 1956, the breakdown of the official gold market in 1968, the oil shocks of the 1970s—had intensified the demand for IMF lending without fundamentally changing the way the IMF worked (Boughton, 2000). The 1982 crisis was different because the range and diversity of creditors involved made it unlikely that it could be resolved without the active participation of an outside agent. The Fund's Managing Director, Jacques de Larosière, intervened personally by refusing to approve stand-by arrangements for the crisis-hit countries until he received written assurances from bank creditors that they would share the burden by increasing their lending exposure. This "concerted lending" tactic was the first instance of what later became known as "private sector involvement" in debt workout procedures.

Over time, the Fund's specific tactics changed in response to evolving circumstances, but its role as the central agency for coordinating the resolution of financial crises remained. For better or worse, the Mexican peso crisis of 1994–95, the East Asian crises of 1997, and those that hit Argentina, Brazil, Russia, and Turkey in the next few years all brought the IMF to the forefront of efforts to coordinate temporary official financing, reform macroeconomic and structural policies in the affected countries, and attempt to restore confidence and commitment on the part of creditors and investors. The frequency and the increasing scope and intensity of these crises eventually induced the IMF to reconsider aspects of its strategic analysis, especially regarding the institutional preconditions for a country to enjoy the benefits of a liberal policy toward private capital flows.

10. Collapse of Communism

The fall of the Berlin Wall in 1989 and the dissolution of the Soviet Union in 1991 enabled the IMF at last to become a (nearly) universal institution (Chapter 2 of this volume). In three years, membership increased from 152 countries to 172, the most rapid increase since the influx of African members in the 1960s.

Many of the new members needed to borrow from the Fund, and all of them needed technical assistance and regular consultations. Consequently, the size of the IMF staff increased by nearly 30 percent in six years, with staff members coming from 15 of the new countries. The Executive Board expanded from 22 seats to 24 to accommodate Directors from Russia and Switzerland, and some existing Directors saw their constituencies expand by several countries. As discussed above, this development had little impact on the philosophical underpinnings of the Fund's work. It did, however, broaden the range of issues with which the staff had to struggle. How could formerly centrally planned economies best be transformed and integrated into the world market economy? Should those countries try to reform as fast as possible, or more gradually? What structural reforms were needed, and in what sequence? How could price levels be stabilized when individual prices were still so far out of equilibrium and large excess money balances were still outstanding? How important for stabilization was the independence of the central bank from government control? For the Fund to stay reasonably within its mandate of stabilizing economies and strengthening macroeconomic policies while meeting the genuine needs of its expanding membership required a balancing act that became harder and harder to sustain.

Ten Ideas

While these events were shaping the IMF and in some cases forcing it to adapt to changing circumstances, economic theories were also evolving. Events and ideas often overlapped in their effects on the IMF and the international monetary system.

From the outset, three economic concepts have formed the bedrock of thought at the IMF and have been the basis for much of the Fund's operations: Keynesian macroeconomics, the monetary approach to the balance of payments, and the open-economy macro model. Two of Milton Friedman's great ideas from the 1950s—monetarism and the case for floating exchange rates—were impossible to ignore and had some influence on the IMF as well. Later, several developments shifted the economics profession and the Fund away from a Keynesian fixation on demand management as a means of stabilizing and strengthening national economies.

Some strains of thought influential elsewhere in the profession never took hold at the Fund or seeped in only slowly and hesitantly. Marxism is the obvious example, but there are many others. As noted above, these included the *dependencia* theories influential in Latin America and the institutional economic thought pioneered in Austria and Germany. Models emphasizing the importance and potential weaknesses of financial institutions (associated in particular with the American economist Hyman Minsky) did not gain much traction either, at least until Ponzi

schemes and other threats to financial stability began appearing more frequently in the course of the 1990s.

1. Keynesian Macroeconomics

The IMF was conceived basically as a Keynesian institution. This link should not be surprising, given that Keynes was one of its founding fathers and the other (White) was a New Deal economist who had championed the use of countercyclical monetary and fiscal policy as early as 1932 (Laidler and Sandilands, 2002). The U.S. Treasury's case for creating the Fund stressed that the goal was to use and coordinate macroeconomic policies to prevent recessions and unemployment. "Only through international cooperation," they wrote, "will it be possible for countries successfully to apply measures directed toward attaining and maintaining a high level of employment and real income which must be the primary objective of economic policy."[14] These objectives were accordingly included in Article I, along with world economic growth ("development of the productive resources of all members") and avoidance of contractionary policies ("measures destructive of national or international prosperity").

The Fund staff made a major contribution to Keynesian macroeconomics in the late 1940s by developing the "absorption approach" to the balance of payments. Earlier analyses of the effect of a currency devaluation on the balance of trade stressed the "elasticities" or "expenditure switching" channel, through which a devaluation would make imports relatively more expensive and thus less in demand. In response to a devaluation of the Mexican peso in 1948, Jacques J. Polak (then Deputy Director of the IMF Department of Research and Statistics) prepared a study that set out the conditions under which a devaluation could strengthen the trade balance by raising output relative to expenditure (absorption). Subsequently, Sidney Alexander (1952) fleshed out the underlying theory and gave it its now familiar name.[15]

Some critics of IMF policies have argued that the Fund drifted away from Keynesian principles, particularly in the 1990s, by seeming to emphasize fiscal and monetary discipline over growth. Joseph Stiglitz (2002, p. 38) put this argument starkly, writing that the IMF "has taken on the pre-Keynesian position of fiscal austerity in the face of a downturn, doling out funds only if the borrowing country conforms to the IMF's views about appropriate economic policy, which almost always entail contractionary policies leading to recessions or worse."

This argument is based on a fundamental misconception of both Keynesian macroeconomics and IMF policy advice (Rogoff, 2003). Countries that are unable to finance their external payments position on affordable terms, regardless of whether the initial source of the difficulty was fiscal excess, an adverse terms of

[14]U.S. Treasury, "Questions and Answers on the International Monetary Fund (June 10, 1944)"; Horsefield (1969), Vol. III, pp. 136–82. The quoted passage is on p. 137.

[15]See Polak ([1948] 1991) and Alexander (1952). The evolution of the absorption approach at the IMF is described more fully in de Vries (1987), pp. 16–19. Polak's contribution is discussed in Frenkel, Goldstein, and Khan (1991), pp. 8–10.

trade shock, or other developments, have to restore balance if they are to maintain full employment and growth. Keynes himself acknowledged in his *General Theory* (1936, p. 332) that the early stages of Roosevelt's New Deal, involving "curtailment of current output" through a reduction in unwanted inventories, were "a phase which had to be endured. . . . Only when it had been completed was the way prepared for substantial recovery."

The IMF, or any institution acting in real time to solve economic crises, often gets the required extent of adjustment wrong, and a case could be made that the Fund is biased on the side of caution (Independent Evaluation Office, 2003). The case is probably most persuasive in the context of the Fund's handling of the East Asian crises of 1997, as discussed in Chapter 11 of this volume. But arguing that the Fund's advice is biased is different from asserting that the Fund has the basic idea wrong.

2. The Monetary Approach to the Balance of Payments

A long-standing building block of IMF policy advice is the version of the monetary approach to the balance of payments developed by Jacques Polak in the 1950s. Polak's model emphasized the effects of fiscal policies and credit creation on the balance of payments, working primarily through a Keynesian multiplier process. This exposition contrasted with the "Chicago" version of the monetary approach developed by Harry Johnson about the same time, which emphasized the "essential" role of monetary policy (Polak, 2001). In the classic situation, a country with a fixed or managed exchange rate and an external payments deficit can resolve the imbalance by reducing the domestic credit of the banking system by either fiscal or monetary means. This simple model became the basis for the specification of macroeconomic policy advice and conditionality by the IMF staff. To some extent, it is still an important building block, though in today's world program design extends well beyond its confines (IMF, 1987; Polak, 1998).

3. The Open-Economy Macro Model

Within a few years of the introduction of the Polak model, two members of Polak's staff—Marcus Fleming and Robert Mundell—separately developed the strands of what Rudi Dornbusch would later weave together into the Mundell-Fleming or (perhaps more properly) Fleming-Mundell model (Boughton, 2003b). In the early 1960s, Fleming was a Division Chief in the Research Department (he later became its Deputy Director); Mundell, in a two-year hiatus from his ascending academic career, was an economist in Fleming's division. Fleming extended the Keynesian framework into an open-economy model capable of explaining the distinct effects of fiscal and monetary policies under either fixed or flexible exchange rates. Mundell developed a simpler alternative version of the model and focused on sorting out the dynamic effects of macroeconomic policies under varying conditions.

The Fleming-Mundell model had a great intellectual impact from the time the seminal articles were published. Its emphasis on the effects of capital mobility clearly undermined the intellectual basis for Article VI, which treated the capital account and current account as independent phenomena. The model's practical implications became increasingly apparent after the advent of generalized floating and the growth of capital mobility a decade later. Monetary and fiscal policies were no longer seen as alternative and roughly equivalent means of stabilizing income, as they had been in the Keynesian analyses of the 1950s. Their effects were now known to be distinct and to depend crucially on the exchange rate regime and the degree of capital mobility. Largely as a consequence of this insight, IMF policy advice gradually expanded to incorporate a broader range of macroeconomic policy actions. The "twin deficits" arguments that the IMF used in the 1980s to criticize the United States for its explosion of fiscal and external deficits derived from this line of reasoning. More generally, the econometric forecasting models developed in the Fund's Research Department in the 1980s were essentially sophisticated variants of the Fleming-Mundell model, including the rational-expectations elements introduced by Dornbusch (1976).

4. Monetarism

The emergence of monetarism as a theory of aggregate demand (Friedman, 1956; and Brunner, 1968) probably had less impact on the IMF than on the economics profession at large, and its influence was felt primarily in efforts made to examine and ultimately to reject it. In its crudest form, as contrasted with the more nuanced versions discussed in Gordon (1974), the theory stated that the velocity of money was so stable that policy-induced changes in the money supply would be reliably transmitted to changes in the price level, and that other influences on aggregate prices could be safely ignored. To economists steeped in an open-economy Keynesian tradition and accustomed to looking for patterns in cross-country analyses, none of the elements of this syllogism seemed particularly persuasive. Studies at the IMF tended to show that for most countries one could estimate a fairly stable equation linking some measure of the money stock to prices in a form that was reasonably consistent with the theoretical construct of a demand function. Those equations, however, were functions of interest rates and additional variables subject to influences other than monetary policy, and they displayed few properties that were consistent across countries or over time (e.g., Argy, 1970; Crockett and Evans, 1980; and Boughton, 1991). Similarly, the money supply could not be assumed to be completely controlled by policy, particularly when the exchange rate was fixed or actively managed.

Despite these limitations and misgivings, monetarist theory had a forceful pull when high inflation became a nearly global phenomenon in the late 1970s. Even if the sources of that inflation extended beyond excessive monetary growth, controlling inflation would require reining in monetary growth through a tightening of monetary policy. Heterodox alternatives such as incomes policies had little

appeal in the Fund, and even fiscal policy was generally seen as insufficiently forceful and constrained under the circumstances. When Paul Volcker, as chairman of the U.S. Federal Reserve System, imposed a seemingly monetarist discipline on U.S. monetary policy starting in late 1979, with dramatic effects on inflation, it was hard to resist being swept along. Nonetheless, the staff persisted with the view that inflation *could* be controlled through either fiscal or monetary means—preferably both—and that rigidities in the former meant that "monetary policy has borne a disproportionate share of the burden of such restraint" (IMF, 1983, p. 27).

In a more recent and more nuanced incarnation of monetarism, inflation targeting has had a significant effect on the IMF (discussed further in Chapter 1). The use of monetary policy to pursue price stability (meaning a low rate of inflation) as a single target instead of as part of a broader strategy to balance inflation and employment objectives, and the direct targeting of inflation rather than relying on intermediate indicators such as interest rates or monetary aggregates, captured the imagination of central bankers and economists in the 1990s. The trend began in New Zealand in 1989, was picked up in Canada a year later, and by the end of the 1990s had spread to at least a dozen more countries (Schaechter, Stone, and Zelmer, 2000).

The spread of inflation targeting as a monetary policy strategy provided new opportunities and challenges for the IMF. The opportunity was to try to use this strategy to encourage countries to adopt more-stable monetary policies. In general, the Fund did so, though with the caveat that the right conditions—well-developed financial markets, sound fiscal policies, and an overall stable macroeconomic environment—should be in place before inflation targeting can be expected to contribute to economic performance. In the several years starting in 1995, IMF staff published some two dozen working papers on inflation targeting, most of which focused to some extent on establishing the preconditions for successful implementation either generally or in specific countries.

The operational challenge for the Fund was to adapt program design and conditionality when borrowing countries were targeting inflation rather than using conventional monetary policy instruments. In these cases, variables that were usually the subject of IMF policy conditions, particularly floors on net international reserves and ceilings on domestic credit expansion, were not separately controllable by the central bank. Setting conditions on the inflation rate itself would weaken the Fund's ability to monitor policy implementation because of the lag between policy changes and inflation effects (Blejer and others, 2002). The Fund tried to steer a middle course, adhering to its conventional instruments while monitoring inflation and other indicators as a further check on implementation and consistency.

5. The Case for Floating Exchange Rates

Long before the collapse of the par value system in 1973, economists began to examine whether exchange rates had to be fixed to contribute to economic stability and the growth of international trade. Until the early 1950s, "convertibility" was generally interpreted to mean that a currency could be converted into something else (often, gold) at a fixed price. Milton Friedman (1953), Gottfried Haberler (1954), Friedrich Lutz (1954), and James Meade (1955) challenged that view and established an intellectual position that floating and convertibility could be consistent and that floating need not be destabilizing. Friedman's argument was directed specifically at the Bretton Woods par value system, which he argued was "ill suited to current . . . conditions." Floating, in his view, was "absolutely essential for . . . unrestricted multilateral trade" (Friedman, 1953, p. 157).

The case for floating took a long time to influence thinking in the IMF. As long as the major industrial countries were committed to maintaining a system of fixed rates anchored on a gold-convertible U.S. dollar, the priority in the Fund was to make that system work as well as possible. Canada's decision in 1950 to float its currency was viewed with concern in the Fund as a possible threat to systemic stability (Horsefield, 1969, Vol. I, pp. 272–75). Even after the fixed-rate system collapsed, the committee of IMF Governors known as the Committee of Twenty spent two futile years trying to formulate a viable replacement system. Only when that exercise failed did interest shift toward examining how a stable *system* could emerge in a world without stable exchange rates. That effort led to the idea of IMF surveillance over countries' exchange rate policies, carried out through regular consultations and supplemented by periodic World Economic Outlook (WEO) reports. From that point on, the Fund took an eclectic case-by-case view of what constituted an appropriate exchange rate regime for any particular country (Mussa and others, 2000, Appendix IV). Along with the rest of the economics profession, the Fund staff continued to debate and reflect on whether any general principles could be applied in practice (Rogoff and others, 2004).

6. Supply-Side Macroeconomics

The term supply-side economics took on a variety of meanings over the last quarter of the twentieth century. In the 1970s, it referred to efforts to model the supply side of the economy as an adjunct to Keynesian analysis of the demand side. That line of reasoning, exemplified by the stagflation model developed by Michael Bruno and Jeffrey Sachs (1981, 1985), was influential in the Fund and was reflected in the WEO and other studies as well as in the Fund's policy advice and conditionality. In the 1980s, the term was hijacked by tax-cut advocates who argued either that lowering tax rates would raise tax revenues by stimulating economic activity (Canto, Joines, and Laffer, 1983) or that a shift from taxes to deficit financing would have

no real effects ("Ricardian equivalence"; Barro, 1974). By the 1990s, it branched out to encompass advocates of low interest rates and monetary expansion, on the grounds that inflation would be held in check by productivity growth stimulated by easy money (Kemp, 2001). These radical views never took hold in the Fund.

7. New Classical Economics

The theoretical development with perhaps the biggest post-Keynes impact on the IMF was the reformulation of the micro foundations of macroeconomics in the 1970s and early 1980s. Rational expectations theory seemed to undermine the basis for countercyclical demand-management policy. In its place came the case for stable policies and nominal anchors to underpin stable expectations. The economics of information was being independently developed about the same time, and that work would eventually lead to a synthesis in which the countercyclical effects of monetary and fiscal policies could be more clearly understood. In the meantime, the new classical concepts held the floor.

The Fund did not develop a doctrine on this issue, but its surveillance activities (both in the WEO and in consultations with individual countries) shifted toward putting greater stress on the desirability of a medium-term policy framework and toward skepticism about the efficacy of countercyclical policies. In the early 1980s, it was still possible for the staff working on Japan to advise the government to take expansionary fiscal action to counter a slowdown, while their colleagues working on the United States were endorsing the eschewal of such policies by the Reagan administration (Boughton, 2001b, Chapter 3). The clearest example of the shift in thinking, however, was in the annual consultations with Germany, where the staff gradually abandoned the view that persistently high unemployment was due to weak demand and focused increasingly on rigid labor markets and other supply-side issues as the source of the problem (Boughton, 2001b, Chapter 3).

8. The Silent Revolution

Until the late 1980s, state socialism—government control over economic activity—played a dominant role in driving economic development in many parts of the developing world, in economies as diverse as India, Mexico, and Tanzania. After Julius Nyerere stepped down as president of Tanzania in 1985, his successors gradually liberalized the economy and moved away from policies such as the "villagization" of agriculture and the nationalization of banks. Mexico began liberalizing its international trade policies in the mid-1980s, a move that led to membership in the General Agreement on Tariffs and Trade in 1986 and prepared the way for more comprehensive economic reforms in the following decade. Under Prime Minister Rajiv Gandhi, India also initiated a major liberalization process in the second half of the 1980s. By the end of the decade,

economic liberalization had become a seemingly universal and unstoppable force.

The major effect on the IMF of this "silent revolution"—as the Fund's Managing Director, Michel Camdessus, called it—was to help ease long-standing tensions between the institution and many of its borrowing members and to make it easier to negotiate adjustment and reform programs the Fund could support. By the early 1990s, agreement about the broad features of desirable economic policies was strong enough that the Fund's high-level governing body, the Interim Committee, could unanimously adopt a series of resolutions embodying principles of economic liberalism (Chapter 4 of this volume). The Committee's "Madrid Declaration," for example, noted that the "recent success of many developing countries illustrates . . . the validity of a strategy based on steadfast implementation of strong programs of macroeconomic adjustment and structural reform. The Committee urges other countries to follow a similar bold strategy."[16] That appeal, however, was issued just a few months before the Mexican peso crisis led off a series of financial crises that would eventually force a reevaluation of such policy advice, particularly regarding the liberalization of international capital flows.

9. The Washington Consensus

In 1990, John Williamson labeled the type of policy advice meted out by the IMF and the World Bank—supposedly with the encouragement of the U.S. Treasury—as the "Washington Consensus." Much of what Williamson included in that rubric was similar to the indigenous revolution or evolution in thinking in developing and developed countries around the world. His terminology was, therefore, more a catchy phrase than an accurate pinpointing of the source of these ideas, as he himself later acknowledged (Williamson, 2000, 2003). Nonetheless, it caught on, and after the flurry of financial crises in the second half of the 1990s it became a lightning rod for criticism of globalization in general and the IMF in particular. Although liberalization of capital flows was not on Williamson's consensus list, that controversial aspect of policy reform gradually became popularly associated with the label in a pejorative way. The same countries that had benefited from inflows after the debt crisis faded away now were reeling from the effects of sudden losses of confidence and corresponding withdrawals of capital. By the turn of the century, "Washington Consensus" had become a synonym for a narrow-minded and excessive zeal for laissez-faire market economics.

It is certainly true that the IMF—both officially and in the individual views of most of its professional staff—embraced the policies that Williamson collected under the umbrella of the Washington Consensus. As Stanley Fischer (the Fund's First Deputy Managing Director from 1994 to 2001) put it shortly after he left the

[16] *Annual Report 1995*, pp. 207–8; accessed at http://www.imf.org/external/pubs/ft/ar/2005/eng/index.htm.

Fund, the Washington Consensus was "a useful shorthand description of a desirable basic policy orientation" (Fischer, 2003, p. 6). It is also true that the Fund went through a phase in the 1990s in which the free mobility of capital was seen as an essential ingredient in economic policy, though staff and management were always careful to acknowledge the principle that liberalization had to be underpinned by sound financial systems and prudential supervision of markets. After the East Asian crises, enthusiasm for unfettered capital mobility gradually dissipated.

10. Behavioral Economics and the New Political Economy

The lifeblood of the IMF is its ability to persuade policymakers to take appropriate actions to improve economic outcomes. Throughout the Fund's history, the staff has relied primarily on the power of its economic analysis to bring about welfare-enhancing policy changes. Whether the context is the annual consultation with each member country, the global analysis presented in periodic publications such as the *World Economic Outlook*, or the negotiation of policy reforms to be supported by financial assistance from the Fund, the emphasis has always been on the logic of macroeconomic analysis contained in the models and paradigms discussed above. Beginning in the 1990s, however, the Fund also paid increasing attention to the lessons from a broader range of related disciplines in an effort to improve its success at persuading country authorities to accept and implement its advice.

Several theoretical developments helped impel this evolution in approach. One strand is what George Akerlof (2001) termed "behavioral macroeconomics," which sets out to explain a variety of market imperfections and suboptimal policy regimes based on fundamental principles of human behavior. Another strand was the emergence of a variety of models based on a synthesis of economics and political science, dubbed the political economy of macroeconomics (Drazen, 2000). Developments in game theory and experimental economics further informed these analyses. Relevant applications include principal-agent and public-choice models, both of which provide insights into the circumstances under which Fund policy advice might or might not lead to improvements in global welfare.

The clearest example of the influence of this new political economy on the work of the IMF was the adoption of new conditionality guidelines in 2002. The previous guidelines, adopted in 1979, set limits on the policy changes the Fund could specify as conditions for its lending to a member country. The new guidelines updated those limits to better focus and streamline conditionality, but they also broke new ground by specifying the processes that should guide the staff in its discussions with national authorities and other major stakeholders. The explicit goal of this extension was to promote national ownership of policy reforms and increase the prospects that those reforms could and would be carried out successfully. Much of the staff analysis underpinning the exercise that led to the new

guidelines was based on political economy models (Mayer and Mourmouras, 2002; and Boughton and Mourmouras, 2004).

Conclusions: How Has History Shaped the IMF?

The IMF was created at a particular time in world history—during the Second World War—and was given a structure and mandate that reflected that time and those circumstances. The institution changed greatly in the six decades after Bretton Woods. Much of its lending became crisis-driven, and the Fund's involvement in crisis prevention and resolution correspondingly intensified. To a large extent, the Fund became divided into groups of creditor and debtor countries whose membership changed slowly over long periods. The Fund's membership became much larger, more diverse, and nearly universal, and its responsibilities in global governance increased likewise. The breadth of its involvement in policymaking in member countries, especially borrowing countries, vastly increased, though a concerted effort was eventually made to circumscribe that role.

If the events and ideas chronicled here had not affected the IMF along these lines, the institution would have become marginalized and even irrelevant. The motivation for the evolution of the IMF has been the need to meet shifts in demand—shifts in world economic and political conditions—not to satisfy forces from within seeking to reinvent the institution to hang on to a role once the original purpose had faded away. The challenge for the IMF has always been to maintain its vital center—to promote orderly payments adjustment and global financial stability—while adapting its activities to new circumstances and new ideas. Meeting that challenge became increasingly difficult in the 1970s and 1980s, when the advent of generalized currency floating, financial globalization, the need for multilateral crisis management, and financial demands from low-income countries all pressed new functions and responsibilities onto the Fund. By the 1990s, when the Fund had to deal with all those issues plus the need for rapid structural reforms in formerly centrally planned economies—including Russia, with its great geopolitical importance—"mission creep" may have been inevitable.

Even accepting that most of the changes in the Fund occurred for good reasons and probably could not have been avoided in any case, the argument for adhering to a consistent mandate and mission is not diminished. Institutions have limited resources and employ staff with specific skills and experience, and diffusing those resources imposes substantial costs. The commitments by the Fund at the beginning of the twenty-first century (IMF, 2001, 2002) to streamline and refocus its policy conditions, strengthen its cooperation with the World Bank, and initiate a comprehensive review of its structure and practices, were taken in recognition of that imperative. As much as the world had changed, the *raison d'être* for the IMF—compensating for the

limited global reach of the invisible hand, the goal that first led Keynes and White to create institutions to promote multilateral cooperation—remained as vital as ever.

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I

The Evolving Global Role of the IMF

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1

World Without Walls: The Global Economy and the IMF, 1990–1999

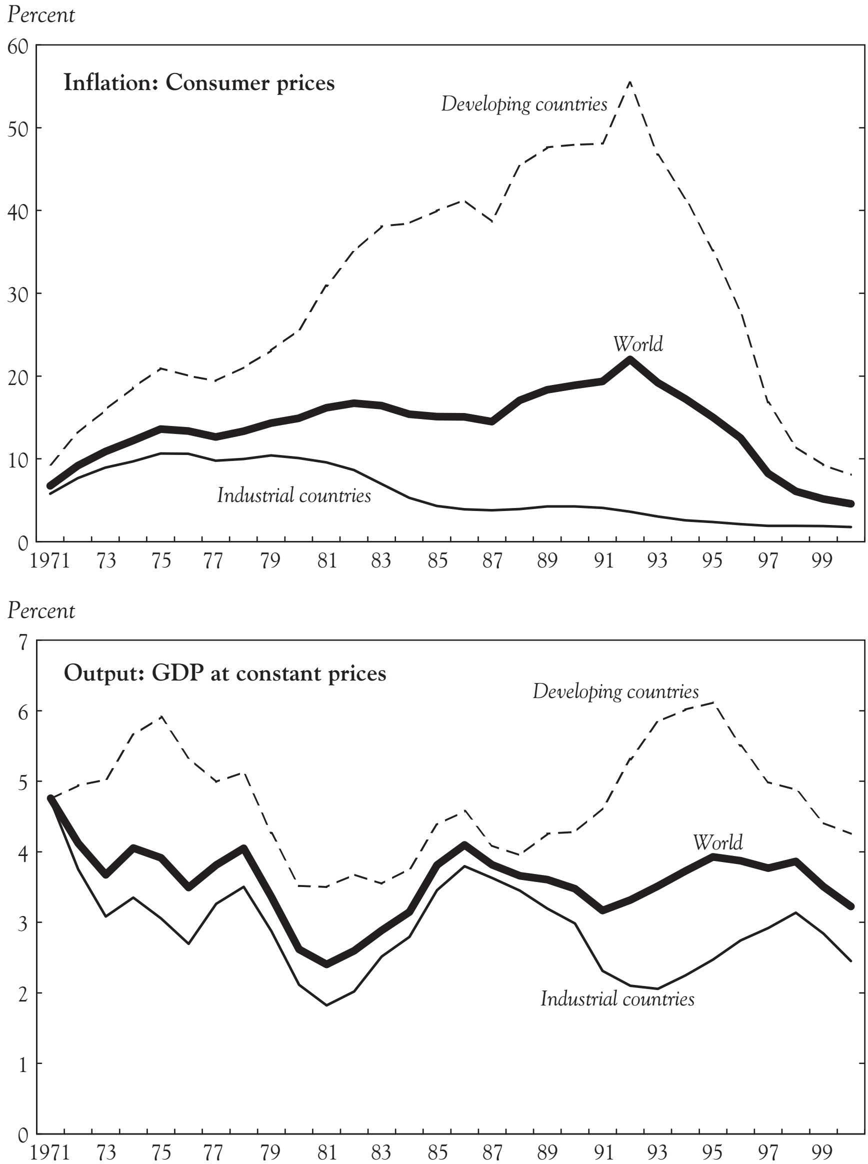
The humorist Mark Twain is often quoted as writing that Richard Wagner's music was "better than it sounds."[1] That ironic judgment might apply more aptly to the world economy of the 1990s. In much of the commentary of the time and in the near-term memories of most who lived through that decade, one heard the drumbeat of crises, unequal distribution of growth, and the pressures many economies felt from the surge in globalization of markets. The financial excesses of the late 1990s would lead to even greater problems a decade later. But when the century ended in an orgy of global celebrations of the arrival of the new millennium, one could have heard above the beating a chorus of achievements: not outstanding by historical standards, but better than they sounded.

The Global Economy in the 1990s

In the last 10 years of the twentieth century, world economic output per capita grew at an annual rate of more than 1.5 percent, a rate well below the first three postwar decades but higher than that of the 1980s (Figure 1.1). By some measures, global income inequality declined, as did inflation, continuing trends that began in the 1980s. Newly emergent economic powers China and India raced ahead, several Latin American countries managed to stabilize their economies after decades of failure, and the Baltic states and other Eastern European countries successfully managed remarkable economic and political transitions. In contrast, the Russian Federation and some of its neighbors found the transition more difficult, much of sub-Saharan Africa recorded little or no growth, and the East Asian "miracle" of the first half of the decade deflated in the second half.[2] In the

[1]Twain ([1924] 2003), p. 338. Twain was quoting Edgar Wilson (Bill) Nye, who originated the quip.
[2]For broad analyses of these trends, see Fischer (2003) and Rhode and Toniolo (2006).

Figure 1.1. World Inflation and Output Growth, 1971–2000
(Five-year centered moving average)



Source: International Financial Statistics.

advanced economies, the gains of the 1990s proved hard to sustain, as a bubble in the valuation of technology companies presaged other major imbalances in the years that followed.

Globally, it was not the best of times, but neither was it the worst. It may have been, in a popular phrase of the era, the "Goldilocks economy": neither too hot nor too cold.

What accounted for the successes? What accounted for the failings? Those questions will continue to occupy economic historians long after this book is complete, because the causes are complex and controversial. The shibboleth that became the focus of this controversy was the "Washington Consensus" (see the Prologue to this book) because it captured clearly and succinctly the popular notion that the world economy was being herded onto a narrow path by a cabal comprising the U.S. Treasury at 15th Street in northwest Washington and the "Bretton Woods twins"—the IMF and the World Bank—just four streets farther west along Pennsylvania Avenue. The serious policy debates, however, were both more specific and broader in scope than the list of issues encapsulated in that inapt phrase.

In discussions about the global economy of the 1990s, four major controversies dominate: the welfare implications of open trade, the wisdom of open capital flows, the strategy for helping low-income countries develop, and the prioritization of reforms in transition countries.

Globalization of Trade

Growth in world output (3.5 percent annually in the 1990s) was driven by growth in international trade (6.8 percent). The growth in trade was driven partly by the increasing openness of international finance (see below) and partly by the success of a widely shared policy agenda to liberalize trading opportunities. At the global level, the great success was the conclusion of the Uruguay Round of trade negotiations in 1994. Begun in 1986 at a ministerial meeting of the General Agreement on Tariffs and Trade (GATT) in Punte del Este, the Uruguay Round was the most comprehensive liberalization of international trade ever undertaken. Although it did not meet all the original goals, the final accord covered trade in manufactured goods, agriculture, services, and intellectual property. Overall, the weighted average tariff rate declined from 7.5 percent in 1990 to 6 percent in 1999. The success of the Uruguay Round also paved the way for the formation of the World Trade Organization (WTO) as a permanent body to oversee compliance with trade agreements and to conduct further negotiations on the remaining unresolved issues.

Also of great importance was the spread of regional trade agreements in all parts of the globe. In Europe, the Maastricht Treaty of 1991 set in motion a process that built on the existing free trade zone to establish the European Union (EU) and totally integrate the economies of most member countries. In Africa, the creation of the West African Economic and Monetary Union in 1994 built on the existing currency union

to work toward establishing a free trade area among the seven (later eight) participating countries. In Asia, the Association of South-East Asian Nations (ASEAN) signed an accord in 1992 committing members to establish the ASEAN Free Trade Area (AFTA). The following year, the seven member states of the South Asian Association for Regional Cooperation (SAARC) set up the SAARC Preferential Trading Arrangement (SAPTA). In South America, four countries—Argentina, Brazil, Paraguay, and Uruguay—established the Southern Common Market (MERCOSUR) in 1991 and began the development of a common external tariff. Four members of the Andean Pact—Bolivia, Colombia, Ecuador, and Venezuela—established a free trade area in 1992. Farther north, Canada, Mexico, and the United States established the North American Free Trade Agreement (NAFTA) in 1994. Altogether, the number of active regional trade agreements reported to the GATT and then the WTO roughly tripled from 1989 to 1999, to about 150 agreements (Fiorentino, Verdeja, and Toqueboeuf, 2006, p. 3).

These regional agreements stirred up their own controversies, as economists debated whether the dominant effect was to stimulate trade or to divert trade away from global competition. In theory, a regional agreement could be welfare improving or reducing, depending on how it was designed and implemented and what assumptions were made about the counterfactual situation. Empirical studies of agreements operating in the 1990s generally found positive but mostly small net effects. In any case, these agreements were proliferating rapidly. The WTO, and by extension the IMF, sought first to encourage nondiscriminatory global trade agreements, but they did not discourage countries from entering into regional arrangements as long as the agreements met certain standards.[3]

The fact that international trade was a stimulus to growth in world output and incomes did not mean that it was necessarily welfare improving. Trade skeptics argued that openness was weakening labor standards, undercutting environmental protection, benefiting strong economies at the expense of the weak, and widening income disparities within countries. Although the evidence for these criticisms was weak,[4] the popular appeal was undeniable. By the late 1990s, a massive backlash was gathering steam and was pulling in an array of protestors ranging from environmentalists and labor activists to neo-Marxists and anarchists. The movement climaxed in November 1999, when several thousand protestors succeeded in severely disrupting and curtailing the annual ministerial meeting of the WTO in Seattle, Washington (United States). Public policy, however, was undeterred, and the decade produced major gains in the globalization of trade.

[3]For a good sample of the debate, see the papers in Ito and Krueger (1997). For a subsequent empirical study of the 1990s, see Soloaga and Winters (2001). The WTO website (http://www.wto.org) has a comprehensive list of regional trade arrangements and an explanation of the rules governing the acceptance of such arrangements.

[4]For a thorough and passionate critique, see Bhagwati (2004).

Liberalization of Financial Markets

Emerging markets saw a major resumption of inflows of financial capital after the resolution of the debt crisis of the 1980s and in response to a general strengthening of macroeconomic policies in many developing countries. These inflows fueled a resurgence of growth in Latin America, helped generate the "Asian miracle," and enabled development in several countries in sub-Saharan Africa. The drive to open financial markets to foreign investors became irresistible. In the second half of the decade, however, inflows essentially stopped, causing great suffering in many emerging markets.

Much of the inflow of private sector capital to emerging markets in the early 1990s took the form of short-term liquid debt instruments issued by large international financial institutions, including "shadow banks" and other nonbank institutions.[5] Those flows were particularly heavy to receiving countries with exchange rates pegged to a key currency or managed with limited flexibility. Because interest rates in such countries were almost certainly much higher than in advanced economies, the returns would be higher as long as the peg held and the borrower did not default or demand a restructuring. Borrowers would then use this short-term capital to finance fiscal deficits or private investment, usually through open currency and maturity positions in which the money was borrowed in U.S. dollars or another key currency and then spent or on-lent for longer-term commitments in domestic currency. On the supply side, the flow of capital was further stimulated by the availability of inexpensive credit in low-interest-rate markets such as Japan. In this "carry trade," speculators could borrow yen at very low rates and invest the proceeds in other currencies at much higher yields.

These capital flows were inherently unstable unless both macroeconomic policies and the overall economic and financial environment in the recipient country remained fully consistent with the established exchange rate. The continued availability of short-term capital thus depended on the preservation of strong confidence on the part of investors. As events throughout the decade would make abundantly clear, investor confidence in these circumstances was inherently capricious and volatile, and the reaction was magnified because many investments were highly leveraged. A modest weakening in initial conditions or even the fear of such a weakening was sufficient to trigger a financial crisis.

None of the apparent solutions to this systemic instability would work reliably or without serious adverse consequences. Imposing capital controls would make it harder for the country to attract the capital it needed to foster economic growth. Tightening monetary and fiscal policies was likely to generate an even larger inflow of capital and increase the prospects for a subsequent collapse. Floating the exchange rate could well

[5]In the vernacular, a shadow bank is a financial institution that performs some of the functions of a commercial bank but is not subject to the same regulations.

have the same effect, first generating an appreciation and then a sudden large depreciation once confidence in continuing stability began to wane.

Because of the difficulty of reforming or controlling international capital flows, the burden of adjustment fell heavily on the very countries that initially benefited from the capital inflows. Cycles in policymaking in the major advanced economies, the short-run nature of capital flows to emerging markets, and institutional and policy weaknesses in the recipient countries all interacted to create a volatile and combustible mix. The second half of the decade, therefore, was characterized by a large number of financial crises and subsequent painful macroeconomic adjustments in emerging markets.

The problem arguably began when the U.S. Federal Reserve began pushing short-term interest rates upward in the early months of 1994 to contain inflationary pressures. As investor interest started to shift from emerging markets to domestic opportunities, developing countries reacted by bidding more aggressively for foreign capital and by loosening policies domestically. Within months, Mexico was in dire financial trouble and in need of a multinational rescue, as detailed here in Chapter 10. Nervousness in international capital markets intensified throughout 1995 and 1996 and erupted into a global "sudden stop" of flows to emerging markets in 1997 and 1998.[6] Thailand, Indonesia, and the Republic of Korea bore the brunt of the withdrawal in 1997, then Russia and Brazil in 1998, but the cessation and its effects were widespread.

By the late 1990s, analysts were debating whether financial markets were characterized by bubbles, a debate spurred by U.S. Federal Reserve Chairman Alan Greenspan when he asked rhetorically in December 1996 whether markets were being driven by "irrational exuberance." The most obvious bubble was in technology stocks, for which a belief in a "new economy" pushed equity values far out of range of historical experience in relation to corporate earnings. As enthusiasm for "growth stocks" accelerated, conventional valuation models no longer worked as expected. The first major casualty was a highly leveraged hedge fund known as Long-Term Capital Management or LTCM. Based in the United States and run by well-regarded financial economists (two of whom were Nobel laureates in economics), LTCM used sophisticated mathematical models to invest in arbitrage opportunities in bond markets, including in emerging markets. When the Russian government defaulted on a large portion of its bonds in August 1998, LTCM had to deleverage its positions in an unfavorable market. Because the fund had borrowed heavily from major banks, the Federal Reserve had to organize a rescue of LTCM in September to prevent a general collapse of international capital markets.[7] The resulting panic affected emerging markets from Brazil to Malaysia to Turkey.

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[6]The term was originated in this context in Dornbusch, Goldfajn, and Valdés (1995) and was employed and popularized in a series of papers by Guillermo Calvo dating from 1998; see Calvo (2005), especially Chapter 9.

[7]For an inside account of the crisis and the role of the U.S. authorities in resolving it, see Rubin and Weisberg (2003), pp. 285–87.

Development of Low-Income Countries

The decade witnessed spectacular growth in the world's two largest low-income countries, but the dominant region of extreme poverty—sub-Saharan Africa—had only limited and mixed success.

In China, some 680 million people—60 percent of the population—were living in extreme poverty in 1990.[8] During the next 10 years, China's economy grew at an average annual rate of more than 10 percent, and the incidence of extreme poverty fell from 60 percent to less than 35 percent of the population. This success was directly due to globalization of trade—China's exports grew even faster, at 15 percent a year, than its overall economy. By directing production toward manufacturing for export more than for domestic consumption, China took greater advantage of the opportunities for trade in goods than did any other country. However, because growth was concentrated particularly in major cities in eastern China, high levels of poverty remained in the more remote areas.

India also began the decade with a very high level of extreme poverty, estimated at 435 million people, more than half the population. Taking a different route toward development from that of China, India took advantage of its large number of well-educated professionals to compete for the global delivery of services. India's growth accelerated sharply after the successful resolution of a fiscal crisis in 1991 and the adoption of outward-oriented economic policies (Chapter 9 herein). For the next eight years, the Indian economy grew at an average annual rate of 6 percent, exports of goods and services grew twice as rapidly, and the incidence of extreme poverty fell below 45 percent of the population.

Growth in China and India was sufficient by itself to put within reach the goal of cutting the rate of extreme poverty in the world by half from its 1990 level by 2015 (the first of the UN Millennium Development Goals). In the rest of the developing world, however, progress in reducing poverty was much weaker in the 1990s. The most entrenched difficulties were seen in sub-Saharan Africa.

Several African countries did enjoy significant economic progress, especially in the second half of the decade (Chapter 14). In East Africa, Tanzania and Uganda experienced good growth in the late 1990s following a strengthening of policies and intensification of international support. In the west, Côte d'Ivoire and other francophone countries experienced a resumption of growth and increased economic stability after the devaluation of their common currency, the CFA franc, in January 1994. South Africa's prospects improved greatly after the end of apartheid in 1994. Also in the south, Botswana continued its record of stability and growth, though progress there—as throughout the region—was held back by the devastating effects of illnesses and death associated with HIV and AIDS.

[8]These estimates are based on the poverty line adopted by the World Bank in 2008, which is an income of US$1.25 a day at 2005 prices; see Chen and Ravallion (2008).

Many other African countries, including some of the largest and those with apparently great potential, experienced persistently disappointing economic performance. In Kenya, widespread corruption offset the advantages of an otherwise well-developed economic system and infrastructure. In the Democratic Republic of the Congo, civil wars negated the expected boost from the overthrow of the kleptocratic dictator Mobutu Sese Seko. In Nigeria, mismanagement and corruption dissipated wealth from oil production and export. For much of the decade, Liberia, Sierra Leone, Somalia, and Sudan were mired in internal and external conflicts, saddled with unpayable external debts, and isolated from the international community (Chapter 16). The sub-Saharan region as a whole consequently showed little overall economic progress.

Globally, even though some very poor countries began to make progress, the potential gains were limited by a falloff in net official development assistance (ODA) resulting from the emergence of "aid fatigue" as a major issue in many donor countries. These declines resulted in part from budget difficulties, in part from the end of the Cold War (which weakened the argument that aid would help stem the spread of communism), and in part from growing disillusionment with the effectiveness of past aid efforts. To a small extent, the drop in bilateral assistance was compensated for by the expansion of multilateral programs such as the IMF's concessional lending programs and the IMF–World Bank debt relief effort known as the Heavily Indebted Poor Countries (HIPC) Initiative. The net inflow of official aid to low-income countries still fell.[9]

Reform of Centrally Planned Economies

Geopolitically, the biggest story of the decade was the collapse of the Soviet Union and the end of its influence on many other countries. Bogged down by its occupation of Afghanistan, economically weakened by a prolonged slump in oil prices, and internally conflicted about how best to reform its disastrously inefficient systems of agriculture, manufacturing, and distribution of goods, the Soviet Union at the end of the 1980s had but a shadow of its once fearsome status as an empire and superpower. Through the Warsaw Pact, it still controlled a vast system of military security that stretched through Eastern and Central Europe and divided the northern hemisphere cleanly into two camps separated by what Winston Churchill famously called the Iron Curtain. Through the Council on Mutual Economic Assistance (CMEA), it still controlled a vast system of production and distribution: internally; across its western, southern, and eastern borders; and as far away as Vietnam and Cuba. All of it was about to end.

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[9]The Development Assistance Committee of the OECD estimated that from 1992–93 to 1997–98 (the period of major decline), net ODA fell from $58.3 billion to $50.3 billion. During the same period, other official flows, including from multilateral institutions, rose from $8.6 billion to $9.9 billion. See Table 2 of the statistical annex of the *2010 Development Co-operation Report*; accessed at http://www.oecd.org/dac/stats/dac/dcrannex.

In fact, the Soviet empire was never as monolithic as it seemed when viewed from farther west. Romania, though a member of the Warsaw Pact, refused to accept a Soviet military presence on its territory, and it pursued an independent foreign policy while participating in the economic system of the CMEA. Hungary was also a member of both groups but oriented its economic policies more toward the European market than did most other members of the bloc. Yugoslavia guarded its independence while allying itself loosely with the Soviet system. The rest of the bloc was more tightly controlled from the center, with all major policy decisions being at least tacitly subject to approval in Moscow. The Berlin Wall was symbolic of a much wider system of control over emigration through the Iron Curtain. The restrictions, however, did not dampen the yearning for freedom and independence palpable throughout the postwar era. Aided by a shift toward *glasnost* (openness) initiated by Soviet leader Mikhail Gorbachev, this yearning gained strength throughout the 1980s.

Gaps in the economic divide gradually widened as early as the 1970s. Romania became a member of the IMF in 1972, joining Yugoslavia as the lone Soviet allies in the still largely capitalist club. Hungary defied Soviet opposition to become a member in 1982. Poland applied for Fund membership in 1980 and was accepted in 1986.[10] In each case, participation in the work of the IMF helped to reduce the country's economic dependence on the Soviet Union and strengthen trade links with western market economies.

The real breakthrough came in 1989, as revolutionary impulses gained strength all along the western rim of the empire. Poland held democratic elections in June; German citizens tore down the Berlin Wall in November; Romanians overthrew the dictator Nicolae Ceauşescu in December; and the "velvet revolution" brought the dissident playwright Václav Havel to power in Czechoslovakia. Each of these countries was poised to convert its economy from central planning to a market system and shift its economic energies toward the west.

Meanwhile, Gorbachev was trying to reform the Soviet economy within the confines of the system Joseph Stalin had perfected in the 1930s. Since becoming president of the country in 1985, Gorbachev had gradually dismantled the most oppressive elements of the system and had tried to open the economy to trade with the west. In retrospect, as detailed in Chapter 6, the sequence of this *perestroika* (restructuring) was all wrong. Without a market structure to lead prices toward a stable equilibrium, the dismantling of a pure rationing system led instead to empty shelves and a dysfunctional production pattern. By 1990, the Soviet economy was weaker than it had been for decades.

Once the revolutions in central Europe were complete, it was only natural that the Baltic republics would insist on breaking free as well. Estonia, Latvia, and Lithuania

[10]Earlier, the trend had been in the other direction. Poland withdrew from the Fund in 1950; Czechoslovakia was expelled in 1954; and Cuba withdrew in 1964. Yugoslavia was an original member. On Hungary and Poland joining in the 1980s, see Boughton (2001), Chapter 19.

had never accepted their forced integration into the Soviet Union. In 1991, each unilaterally declared its sovereign independence, and Moscow no longer had the will to try to stop them. When Ukraine, the largest of the republics other than Russia, followed suit, the union was no longer viable. The dissolution of the Soviet Union in December of that year formally conceded what was already a reality.

Independence was only the beginning. The CMEA was dissolved; central planning was abandoned; and each country had to devise a new economic system and find a way to compete in global markets and avoid economic collapse. The transition was not pretty. Every country, whether a newly independent former Soviet republic or a former member of the CMEA bloc, experienced a substantial decline in output before stabilizing and turning the economy around. The most rapid recoveries came in countries that had histories of experience with markets and citizenries prepared to accept an abrupt switch to market pricing and private enterprise. Less-prepared countries, especially the former Soviet republics, typically underwent more gradual transitions, suffered more horrendous output and employment declines, and began to recover only later in the decade. By the end of the 1990s, however, almost all countries of the former Soviet bloc were experiencing positive economic growth.[11]

The transition away from central planning in the 1990s was nearly universal. To the southeast of Russia, Mongolia embraced capitalism and open markets as strongly as any western country. Vietnam became a strong global competitor. In Africa, Angola, Mozambique, and Tanzania were only the most prominent examples of countries shifting from state socialism to systems with less pervasive government control and more openness to international competition. In the end, only Cuba and the Democratic People's Republic of Korea (North Korea) remained aloof from the crowd of countries making this immensely challenging transition. The nature of the challenges, and the path of the transition, varied from country to country, but the goal was general. Global capitalism, it seemed at the time, had triumphed. It was not just the end of the second millennium. In one view at least (Fukuyama, 2006), it was the "end of history."

The IMF in the 1990s

The 1990s were for the IMF the most challenging and by far the busiest decade in its history. (For a detailed chronology, see the Appendix to this chapter.) The institution was called upon time and again, not only to help a large number of countries stabilize their economies and meet their payments obligations, but also to respond quickly and forcefully to manage international financial crises as they developed, and even to advise countries on the transition from a closed and

[11]For an interim assessment of the first few years of transition by Fund staff who were working on the region, see Banerjee and others (1995). For subsequent assessments at the end of the 1990s, see EBRD (1999) and the papers in Haas, Havrylyshyn, and Sahay (2001).

centralized system to one based on open markets. As an inevitable corollary, this decade was also the most controversial and troubling for the IMF since its founding. The challenges and the controversies affected every aspect of the Fund's role and of its work, from surveillance to lending and from Europe to Africa, from the Americas to Asia.

Ironically, the Fund's decision to become a more open and "transparent" institution (Chapters 3 and 4) further stimulated public criticism of the IMF's role. It opened its archives to the public and began publishing selected reports in 1994, established a public website in 1996, began publishing summaries of consultation reports in 1997, and experimented with publishing complete staff reports on surveillance in 1999. For an institution that had always closely guarded the confidentiality of its deliberations and its relations with member countries, this was a dramatic turnaround. These moves were welcomed by journalists, academic researchers, and nongovernmental organizations, but they also exposed the Fund's decisions and actions to closer scrutiny, much of which led to negative reporting. The resulting criticism was clearly beneficial, inducing the Fund to examine its own thinking and processes more closely, but the adjustment was often difficult.

More generally, the challenges of the 1990s posed a major quandary for the IMF. To be effective, any institution must stay focused on the limited tasks for which it was designed. This dictum is particularly important for the International Monetary Fund, which has deliberately remained small and monocultural to be able to respond nimbly to financial shocks wherever and whenever they occur.[12] This highly concentrated intellectual culture, however, was ill suited to the shocks of the 1990s. The opening of Russia and its neighbors to western trade and finance, the burgeoning burden of official debt in sub-Saharan Africa, and the financial crises that spread across East Asia in 1997–98 all required a much broader field of vision and action.

The ideal solution to this dilemma would have been for the several multilateral agencies to work together with each affected country to design and implement a master plan of reforms leading to a sustainable resolution of the country's problems. Such an approach was not unthinkable, but it was often not practical. For example, as the Soviet Union began to unravel in 1990, a joint task force was formed comprising the IMF, the European Bank for Reconstruction and Development (EBRD), the Organization for Economic Cooperation and Development (OECD), and the World Bank. At the request of the major industrial countries, this task force quickly produced the first comprehensive independent study of the Soviet economy (see Chapter 2). But when the union was dissolved and all the successor states joined the IMF and asked for financial assistance and policy advice, joint or coordinated responses became much less

[12]Monoculture is used here to mean a singular focus on monetary and financial issues by a staff consisting largely of Ph.D. economists specializing in macroeconomics. In other senses, of course, the IMF is a broadly multicultural organization.

feasible. In most cases, the can-do and must-do-now culture of the IMF clashed badly with the must-get-it-right-even-if-it-takes-longer culture of the World Bank and other agencies.

Consequently, the IMF's purview expanded—gradually, but quite perceptibly and ultimately substantially. "Structural" lending conditions—those requiring policy changes other than macro-level monetary, fiscal, and exchange rate policies—had previously been used only exceptionally but now were applied with increasing frequency and extent. Governmental corruption in financial matters, previously viewed as a political issue outside the Fund's ambit, now became a legitimate reason for withholding financial support. Similarly, the Fund's policy advice in its annual consultations with member countries occasionally extended to issues such as curtailing military spending and other "unproductive" activities, avoiding deforestation and other actions detrimental to the environment, and restructuring financial and other regulatory systems.

The architect and champion of this expanding role was the Managing Director, Michel Camdessus. He argued tirelessly that these changes were needed if the IMF was to help countries solve their macroeconomic problems sustainably. The goal was not only to achieve or restore financial stability; it was not only to achieve or restore economic growth while maintaining financial stability. The goal was "high-quality" growth: economic growth consistent with environmentally sustainable development, good governance, and an equitable distribution of income and wealth.

Camdessus introduced the concept of high-quality growth as an objective for the IMF in his 1989 speech to the UN Economic and Social Council (ECOSOC) in Geneva. A year later, in his 1990 ECOSOC speech, he asserted a strong role for the IMF in helping countries achieve high-quality growth: "Our [the IMF's] primary objective is growth . . . high-quality growth . . . growth that is sustainable." Over the next several years, he attempted to define the term more specifically. For example, in a speech given in Malaysia in 1996, he averred that "the words 'high-quality growth' define our actions." He characterized the phrase as "a demanding concept, with at least four dimensions. I believe that growth, to be sustainable, must maintain macro stability, benefit all sections of the community (especially the poorest), and respect national cultures and political freedom."[13]

This ambitious agenda stirred controversy inside the IMF as well as outside. Many on the staff worried that the Fund could not possibly deliver on such aspirations. The staff had a clear sense of the elements of good overall economic policy—the misnamed and much derided, but solidly serviceable, Washington Consensus—but it did not have a model that credibly and reliably linked the specific elements to economic growth, let

[13]The two ECOSOC speeches were MD/Sp/89/5 (July 13, 1989) and MD/Sp/90/13 (July 11, 1990). The 1996 speech was "Challenges Facing the IMF and Malaysia," delivered at a meeting of financial and business leaders in Kuala Lumpur, MD/Sp/96/15 (July 15, 1996); accessed at http://www.imf.org/external/np/sec/mds/1996/mds9615.htm.

alone high-quality growth. Which elements were the most critical, and how could the policy recommendations be prioritized, sequenced, and quantified? At what point did the ooze of corruption or other institutional weaknesses cross the threshold from nuisance to obstacle?

The primary fact remained that the IMF was being asked to try, and it was rightly expected to do its best. The limitations of other institutions are beyond the scope of this History, but—whether real, exaggerated, or imaginary—they were keenly felt by staff in the Fund who had to devise holistic solutions to complex problems not entirely within their own or the Fund's areas of competence and experience. The process was far from ideal, and the outcomes were not always favorable. On the whole, however, even if the Fund allowed its mission to "creep" too much, it usually handled its expanding responsibilities with some caution and not without effect. At the end of this most difficult decade it was still the world's leading institution for macroeconomic surveillance, balance of payments financing, and financial crisis management. It had not gone too far to be able to pull back to a more sustainable mission.

Surveillance

Surveillance—the Fund's oversight of the international financial system and of the exchange rate policies of its member countries—took on its modern form in the mid-1970s, when the major industrial countries indicated clearly they were not going to revive the Bretton Woods system of fixed exchange rates. The intention and the hope was that regular consultations between the Fund and each member country would ensure that countries took seriously their obligations under the newly rewritten Article IV to maintain their exchange rates consistently with fundamental economic conditions. As experience showed, however, defining those fundamentals required as much art as science, and the consequent ambiguities gave every country—whether it had a fixed rate, a floating rate, or some intermediate regime—plenty of room to dispute any allegation about its compliance with the principles of surveillance.

Although the Fund made a concerted and sustained effort to treat every member country alike in conducting Article IV consultations, practical considerations made that premise difficult to maintain. By the end of the 1980s, the effectiveness of surveillance could be characterized by reference to four unofficial but distinct groups of countries. First, for the large industrial and developing countries whose economic policies had significant global or regional consequences, consultations became a way of urging those countries to take proper account of international spillovers and to adopt appropriate and responsible macroeconomic policies. Second, for other developing countries not actively borrowing from the Fund but in some danger of needing to borrow in the near future, annual consultations provided an opportunity for the staff to keep abreast of the situation and to offer advice on ways the country should adapt its policies to avoid a crisis. Third, for countries that were actively borrowing from the Fund,

Article IV consultations were usually folded into reviews of their adjustment and reform programs, with little substantive distinction or independence. Fourth, for smaller industrial countries and for developing countries with strong finances and relatively small spillover effects on their neighbors, consultations were often held less frequently than annually and became primarily a means of offering advice on selected economic policy issues.

The evolution of Fund surveillance in the 1990s is detailed in Chapter 4. Four key issues dominated the process in this period.

First and foremost, the Fund continued to refine its practices to strengthen its potential to identify major problems before they erupted into crises. In the early 1990s, management reestablished a high-level surveillance committee that met regularly to discuss potential crisis situations. The Executive Board also began holding frequent informal and confidential discussions of world economic and market conditions. At the end of 1994, the Mexican peso crisis revealed that stunning gaps in surveillance persisted despite these endeavors. That occurrence spurred a more intensive effort to strengthen surveillance, notably by persuading countries to produce and disseminate more-comprehensive and timely financial data and by establishing standards for financial transparency.

Second, the Fund had to try to strike the right balance between comprehensive and uniform coverage of its consultations—treating every member country the same—and focusing on the countries and the issues that really mattered. In the early 1990s, the Fund had to pull staff away from work on smaller nonborrowing countries to put more resources into analyzing the problems of the large number of new members, especially those from the former Soviet Union. The Mexican crisis forced a reconsideration of this tactic, revealing gaps in the continuity of coverage and demonstrating that well-performing countries might have latent problems that the Fund was unable to discover. The scope of surveillance expanded in the second half of the decade with regard to both countries and issues.

Third, regional issues became more important. Traditionally, surveillance had focused on the policies and performance of each country individually. As the world economy became more integrated, that approach became less effective. Again, the Mexican crisis was a catalyst, because it raised the specter of contagion throughout Latin America. Even more pertinent, the Fund had to find effective ways to analyze regional trade and monetary areas such as the European Monetary System (EMS) and the CFA franc zone. Separate consultations with France, Germany, Italy, and other EMS members were an essential part of the Fund's routine, but they were not the right way to understand the policy issues affecting the monetary union as a whole. Similarly, while Cameroon, Côte d'Ivoire, Gabon, and other members of the CFA franc zone in central and western Africa had distinct economic structures and issues to be analyzed, the monetary union had to be viewed and understood as a whole.

Fourth, the drive to establish international standards for economic policies picked up steam. One direction this drive took was through a series of declarations endorsed by the

IMF's ministerial committee, known then as the Interim Committee (see Chapter 17). That series culminated in what Camdessus took to calling the "eleven commandments." Essentially, those declarations gave an official and global blessing to the Washington Consensus. That movement also engendered practical initiatives for the Fund and the World Bank, notably the preparation of country-specific Reports on Observance of Standards and Codes (ROSCs) and Financial Sector Assessment Program (FSAP) reports. Another direction was an attempt to broaden the Fund's mandate to cover capital flows. Had that attempt succeeded, it would have charged the IMF with guiding a process of orderly liberalization of capital account transactions. The practical outcome of both efforts was a widening of the Fund's surveillance activities to include greater encouragement of more openness and more market- and growth-oriented economic policies.

Lending

To a much greater extent than the earlier Histories of the IMF did, this book focuses on relations between the Fund and its borrowers. In the 1990s, more than 100 countries undertook stabilization programs supported by stand-by, extended, or other Fund lending arrangements. Although the total number of borrowers as a portion of the Fund's member countries was not larger than in some previous periods, the importance of lending in the work of the Fund was significant in the 1990s. In the first few years of the decade, lending to the transition economies and other new members was providing critical life support to countries that could not have coped otherwise. In the second half, large loans—including the largest in IMF history, to Korea—to help manage and resolve a devastating series of financial crises were the dominant feature of the Fund's work. Surveillance and technical assistance were also of great importance, but lending was the lead narrative.

The real story about Fund lending in the 1990s was not an expansion of the amounts or the number of borrowers. The real story was the broadening and deepening of program design and conditionality. From the inception of formal policy conditionality in the early 1950s through the 1980s, the Fund gradually increased and expanded its reliance on this particular tool to ensure that its loans were used effectively. It began when the Fund first offered stand-by arrangements and asked borrowers to promise not to alter exchange rate policies or impose new exchange restrictions while the arrangement was in effect. By the late 1960s, the practice of imposing policy conditions on stand-by arrangements was in general use, and the Fund issued its first conditionality guidelines. In the 1970s, however, the "oil shocks"—two rounds of major increases in world petroleum prices—contributed to general chaos in international trade and finance, in response to which the Fund shifted the majority of its lending into low-conditionality forms by setting up new "Oil Facilities," increasing usage of the Compensatory Financing Facility, and establishing a Trust Fund for lending on

concessional terms to low-income countries. None of those options required countries to make policy commitments beyond a general promise to cooperate with the Fund. In the 1980s, the pendulum swung back: the Oil Facilities had expired, the Fund reduced reliance on the Compensatory Financing Facility, and new trust funds for concessional lending required conditionality similar to that on stand-by arrangements.[14]

By the beginning of the 1990s, policy conditionality was well established and was based on a set of revised guidelines adopted in 1979. Those guidelines generally limited conditionality to macroeconomic policies. The Executive Board repeatedly declined to extend conditions to structural policies, although it allowed exceptions in cases such as Yugoslavia where extensive government intervention in markets made the usual levers of macroeconomic policy less relevant. As explained in Chapter 5, that reluctance then eroded.

The introduction of new member countries making a transition from central planning to market economics meant that structural reform became a priority for much of the Fund's lending. More generally, the broad international acceptance of a market-oriented paradigm—openness to trade and financial flows, transparency in fiscal accounting, avoidance of corruption, acceptance of market-determined pricing, and privatization of production and distribution—made structural conditionality more palatable. More controversially, the Fund occasionally ventured into structural issues less central to macroeconomic stability and growth, including the avoidance of policy actions that might degrade the natural environment and the redirection of government spending away from the military following the end of the Cold War. The main theme, however, was to help countries participate fully in the global marketplace.

In 1994, the Interim Committee—meeting in Madrid immediately after the commemoration of the fiftieth anniversary of the Bretton Woods conference—recommended an increase in Fund lending to countries willing to implement strong reform programs.[15] Shortly afterward, Camdessus summarized the prevailing view in terms that clearly described the confidence the Fund had gained in its own determination of appropriate and even requisite policies for all of its borrowers. As recorded in the minutes of an Executive Board meeting on access policy, the Managing Director

> observed that it was probably a common view of members of the Board that any weakening of conditionality was a disservice to the countries concerned. The necessity of implementing stronger programs underlay the philosophy of the decisions taken in Madrid by the Interim Committee, in his view. Through persuasiveness in its negotiations with its members, the Fund would catalyze stronger programs, thus enabling increased access for member countries commensurate with the strength of their programs.[16]

Camdessus's confidence in the wisdom and viability of Fund conditionality was not universally shared, and it became increasingly controversial as the decade progressed.

[14]This history is described in more detail in Boughton (2001), Chapter 13.
[15]Interim Committee communiqué of October 2, 1994.
[16]Minutes of EBM/94/95 (October 25, 1994), p. 14.

Nongovernmental advocacy groups accused the Fund of interfering with sovereign decision making and of forcing austerity on countries whose circumstances left them little choice but to comply. Officials from borrowing countries generally were more understanding of the need for conditionality but complained that it was becoming too intrusive. Both groups suspected that at least some structural conditions demanded by the Fund were instigated by major industrial countries to further their own economic interests. Academic research began to focus on the potential conflicts between conditionality and national "ownership" of policy decisions.

Simmering controversies over Fund lending practices burst into the open when the Fund was called upon to manage the resolution of financial crises in Thailand, Indonesia, and Korea in 1997 (Chapter 11). In each case, the crisis resulted from a variety of interrelated problems that were mostly structural rather than macroeconomic. In each case, the Fund tried to persuade the authorities to put in place a long list of reforms, some of which were aimed at the root causes of the crisis and some of which were aimed at putting the economy on a more sustainable course over the longer run. In each case, the reform programs ultimately succeeded but only after a traumatic adjustment and a change in government through national elections. Questions about whether the Fund-supported programs were overly ambitious, too broadly structured, and too insensitive to country-specific conditions came to dominate the public discourse. The horrendous initial conditions that caused the crises, the necessity of undertaking deep reforms, and the broad success that the effort finally achieved got lost in the noise.

Following the East Asian crises, the Fund took on board a number of lessons. An internal staff review and another by the Fund's Independent Evaluation Office both pointed to specific failings on the part of the Fund as well as of the national authorities. In the near term, the prime lesson was that balance sheet vulnerabilities in these and other emerging-market countries made the economic downturn from a financial crisis much more severe. The standard macroeconomic remedies, especially through tightening fiscal policies, would excessively exacerbate the downturn and unnecessarily delay recovery. Over the longer term, the broader lessons were that structural policy conditions had to be more tightly focused on the financial imbalances and rigidities that caused the crisis and that policy recommendations had to take full account of spillover and feedback effects between countries. In the following decade, these lessons would lead to a gradual redirection and scaling back of conditionality.

In parallel with the evolution of lending practices, the Fund moved to strengthen its assistance to low-income countries. The general principles were established in 1985, with the creation of the Structural Adjustment Facility (SAF). Loans to low-income countries would be made on concessional terms, with relatively long maturities, using contributed funds other than the Fund's own general resources, and with loan conditions similar to those for other borrowers but with an emphasis on structural reforms aimed at jump-starting economic development and reducing poverty. In 1987, the Fund tripled the funds available for this purpose by creating the "enhanced" SAF

(ESAF). Even so, the amounts the Fund could lend to poor countries were quite small, and the ESAF was still a temporary facility scheduled to lapse in a few years so the contributed funds could be returned.

In the 1990s, the Fund repeatedly extended the life of the ESAF, enlarged its pool of resources, and eventually converted it into a permanent facility (Chapter 13). In 1999, in recognition of the fundamental purposes of the Fund's lending to low-income countries, the ESAF was redesigned and renamed the Poverty Reduction and Growth Facility. Meanwhile, a popular movement was growing worldwide to persuade bilateral and multilateral creditors to forgive the debts of the poorest countries. After several years of resisting calls to include obligations to the IMF in the list of debts to be forgiven, the Fund agreed in 1996 to establish a new program, together with the World Bank, known as the Heavily Indebted Poor Countries (HIPC) Initiative. The program got off to a slow start, but by the end of the decade it began to show results for a few countries with particularly great needs and a track record of relatively good economic policies.

Technical Assistance and Training

In addition to surveillance consultations and financial assistance, the IMF helps its member countries by providing technical assistance. This activity takes several forms, including economics and statistics training for officials; staff missions to assist countries in establishing treasury systems, central banks, national statistics, and other financial arrangements and methods; and the assignment of external experts to countries to provide longer-term guidance. Most of this assistance is provided free of charge and is financed either from the Fund's own administrative budget or from donated resources.

Technical assistance took on greatly increased importance for the Fund in the 1990s. One reason was the influx of new members, many of which were starting from scratch in establishing the institutions of a market economy. They needed expert assistance from many sources. The IMF's role was relatively small in the grand scheme of the transition, but for many countries it was crucially important in the areas in which the Fund's expertise was most relevant. Similarly, as the Fund became more deeply involved in helping a number of developing countries recover from internal or external conflicts, the role of technical assistance in the rebuilding effort was particularly important. As detailed in Chapter 5, the Fund devoted more than twice as much staff time to technical assistance activities in the 1990s than it had in the preceding decade.

A central issue in the provision of technical assistance was whether it should be aimed primarily at institution building and at strengthening a government's general capacity to run the economy or at the more immediate challenges of carrying out a reform program. The expansion and intensification of policy conditionality in the Fund's lending in the 1990s gave rise to a need for technical assistance to help the

authorities carry out the required reforms. That had the advantage of focusing the assistance in areas in which it was most needed, but at the cost of diverting resources from capacity building. To some extent, the Fund's training programs—which also were expanding rapidly—filled this gap. At the end of the decade, the Fund turned its attention more directly to developing a comprehensive plan for providing its assistance more effectively.

Financial Architecture in the 1990s

In July 1994, the Group of Seven (G7) major industrial countries held its annual summit meeting in Naples, Italy. It was the fiftieth anniversary of the international monetary conference in Bretton Woods, New Hampshire (United States), at which the IMF and the World Bank were created. The rallying cry of critics of the Bretton Woods institutions—"Fifty years is enough!"—was very much in the air. As the leaders met, U.S. President Bill Clinton proposed to them that their next summit (which would be held a year later in Halifax, Nova Scotia, Canada), be devoted to reviewing the "international architecture." The institutions set up at Bretton Woods, he suggested, had to be refined to meet the challenges of the twenty-first century.[17] When the G7 finance ministers and central bank governors met in Washington the following April, they "exchanged views on current global economic and financial conditions and issues related to the review of the international economic architecture initiated at the Naples Economic Summit."[18] The Halifax summit communiqué called specifically for a review of the international financial institutions, and "international financial architecture" entered the lexicon of public policy discussions.

As these discussions unfolded, they focused on several interrelated topics, but more on how to tackle problems rather than on how to restructure institutions. One topic was the role of exchange rate policy. The original Bretton Woods system (until 1973) had focused on establishing and preserving stability of exchange rates and anchoring those rates to gold through the convertibility of the U.S. dollar. A more eclectic system had evolved subsequently, and the question naturally arose as to whether it could be made more stable and effective. A second issue concerned the conduct of macroeconomic policies. Specifically, could a rules-based system help stabilize price levels without destabilizing output? Third, should the international flow of financial capital be harnessed, or allowed to roam free? Fourth, what more could be done financially to strengthen the development prospects of the poorest countries?

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[17]See remarks by Karin Lissakers (U.S. Executive Director in the Fund) at a meeting of the Overseas Development Council (March 16, 1995); IMF archives, OMD-AD, Box 11518, "Mexico 1995" (Accession 1998-0106-0006).

[18]G7 statement (April 25, 1995), paragraph 1; accessed at http://www.g8.utoronto.ca/finance/g7dcfin.htm.

Exchange Rate Policy

Several issues arose in the 1990s as countries struggled to devise exchange rate policies that could be sustained in a world of open and volatile capital markets. The overarching issue, as it had been since the advent of generalized floating in the 1970s, was whether to attempt to fix or manage the rate or to let it respond freely to market pressures. If circumstances seemed to favor a fixed exchange rate, a variety of options presented themselves, including use of a currency board, dollarization, or joining a currency union. Rather than advocating a single policy for all countries, the IMF took a case-by-case approach that favored pragmatism over ideology or consistency.

Fix or Float?

The quintessential debate in exchange rate policy is whether a country should anchor its currency's exchange value to something, allow it to float freely in response to market pressures, or take an intermediate approach by managing the rate to attenuate fluctuations. Until the twentieth century, anchoring to a commodity was the only viable or sustainable option. Gold, of course, was the commodity of choice, but many others were tried. Millennia of experimentation culminated in the international gold standard that prevailed from 1879 until the outbreak of the First World War in 1914.[19] The collapse of the gold standard ushered in 30 years of confusion, during which the goal for most countries was to return eventually to gold. The system set up at Bretton Woods in 1944 envisaged a "gold exchange" standard with a strong, gold-anchored U.S. dollar at its center and with "fixed but adjustable" exchange rates providing both the stability of a commodity standard and the flexibility of intelligent management. The end of that system in 1973 led to an era of choice in which management finally triumphed over what John Maynard Keynes famously called the "barbarous relic" of the gold standard.[20]

Early enthusiasm that floating exchange rates would be self-stabilizing and would help equilibrate international trade were dashed by massive swings in key currency rates and increasing trends in current account imbalances in the 1970s and 1980s. A generalized return to fixed exchange rates was unfeasible, owing to the marked differences in growth rates, productivity trends, and susceptibility to shocks across countries. The principal characteristic of exchange rate policy in the 1980s and early 1990s,

[19]The dating of the international gold standard is arbitrary because countries adhered to it and abandoned it at different times. This span begins when the United States resumed the convertibility of dollars into gold and ends when the United Kingdom terminated the convertibility of the pound sterling.

[20]"Barbarous relic" is from Keynes ([1923] 1971), p. 138. For a comprehensive study of the way advances in monetary theory led to the evolution from gold to managed currencies, see Cesarano (2006).

therefore, was a preference for managed floating, soft pegs, or other intermediate regimes.

A major shock hit this limited-flexibility system in 1992 when the exchange rate mechanism (ERM) of the European Monetary System (EMS) came under attack. The sequence began in June after a referendum in Denmark rejected the Maastricht Treaty setting out the process that was to lead to Economic and Monetary Union (EMU) across Europe. That rejection reinforced a market view that European policymakers might not be prepared to take the difficult economic and political steps needed to preserve the existing parities in a monetary union. It also added to speculation that French voters would also reject the treaty in a referendum scheduled for September. On September 8, Finland floated the markka, which had been pegged to the European currency unit, the ECU. Less than a week later, Italy devalued the lira by 7 percent. The first crisis culminated on September 16, which became known as "Black Wednesday," when the British authorities withdrew the pound sterling from the ERM. Italy quickly followed suit.

Calm returned temporarily to the EMS when France narrowly approved the Maastricht Treaty on September 20. Although the Edinburgh agreement of December 1992 enabled Denmark to ratify the Maastricht Treaty in a second referendum in May 1993, speculation against the ERM parities resumed in July. Finally, on August 1, 1993, EMS officials agreed to widen the intervention bands drastically, from ± 2.25 percent to ± 15 percent.[21]

The ERM crisis abruptly shifted the conventional wisdom away from flexible management of exchange rates. Countries participating in the ERM had been committed to a fixed-rate policy, but speculators understood that the option still existed to change parities in cases of duress. That offered an opportunity to test the resolve of participating central banks by placing a one-way bet against the current parities. In fact, speculators made huge profits at the expense of central banks, especially the Bank of England. Although the ERM survived with the widening of intervention bands, confidence in that type of system was badly damaged. In its place, a new predominant paradigm arose: the "bipolar" view, also known as the "corner hypothesis." Floating would work; irrevocably fixed rates would work; but in the bipolar view, any regime in between would be tested by markets and would ultimately collapse.[22]

[21]For a more detailed chronology and analysis, see Buiter, Corsetti, and Pesenti (1998).

[22]An even more extreme view was that only floating rates were sustainable; see Obstfeld and Rogoff (1995). That view had adherents in the IMF in the 1980s—see Quirk and others (1987)—but less so in the 1990s. At the other extreme was the argument for a single world currency. Robert Mundell, in his 1999 speech accepting the Nobel prize in economics, suggested that "the absence of an international currency" was a major "piece of unfinished business" in the international monetary system. In a subsequent speech a few months later, he concluded that a single world currency was politically unrealistic, but he called for a system with just three currencies (the U.S. dollar, the euro, and the Japanese yen) and fixed exchange rates among them; see Mundell (1999, 2000).

In the IMF, the chief advocate of the bipolar view was the First Deputy Managing Director, Stanley Fischer. He applied the logic of the argument to the financial crises that hit Mexico, Thailand, Indonesia, Korea, Russia, and Brazil, all of which had crisis-prone soft pegs. Although an extreme form of the bipolar view concluded that the only viable regimes were pure floating and firmly fixed rates (currency unions, currency boards, or dollarization), Fischer eventually softened his position to exclude only soft pegs from this list. A country might be able to sustain a policy of managing the exchange rate to limit volatility or large swings, but only if it avoided committing to a central rate or a narrow band.[23] Although the Fund as an institution did not take an official view in favor of any specific regime, the bipolar view influenced the general tone of the Fund's policy advice in the second half of the 1990s and for a few years afterward. Gradually, acceptance of intermediate regimes then returned.

For a number of countries in the 1980s, the IMF had advocated targeting the real exchange rate. The logic was that a country with a high initial inflation rate could maintain international competitiveness by steadily depreciating the nominal exchange rate at the same rate as the inflation differential relative to major trading partners. If the country also gradually tightened monetary policy to eliminate the inflation differential, the "real exchange rate rule" could lead to a stable equilibrium while avoiding the loss of competitiveness associated with a fixed rate during the transition. Although both the theory and the practicality of this type of policy had been called into question by the mid-1980s, it still had a certain appeal, especially for countries in Latin America that were trying to overcome persistently high inflation.[24]

Real exchange rate rules generally fell out of favor in the 1990s, as a growing body of cross-country evidence confirmed the inflationary bias of this type of policy (Calvo, Reinhart, and Végh, 1994). Fischer, however, remained cautiously receptive. In his view, the way to escape the inflation trap was to use tight *fiscal* policy to control it. When the South African authorities proposed adopting a real exchange rate rule in 1996, Fischer did not discourage them and cited Chile's experience as a good example.[25] However, the policy did not restore confidence in South Africa's prospects, and a financial crisis ensued (see Chapter 13).

The one great sustained shift toward fixity in the 1990s was Economic and Monetary Union (EMU) in the European Union. With the wide bands established in 1993,

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[23]In Fischer's definitive statement on this topic, he admitted that he and other advocates of the bipolar view "probably have exaggerated their point for dramatic effect" (Fischer, 2001, p. 5).

[24]In a widely cited 1986 paper, Charles Adams and Daniel Gros demonstrated the difficulty of conducting tight monetary policy while pursuing a real exchange rate rule and concluded that such a policy was likely to lead to escalating inflation. The IMF's experience in designing stabilization programs for Yugoslavia in the 1980s provided evidence that the Adams and Gros argument was empirically relevant; see Boughton (2001), pp. 573–78.

[25]Letter from Fischer to Trevor Manuel (minister of finance in South Africa), June 18, 1996; IMF archives, DMD-AD (Accession 1999-0275-0008). In a later paper, Le Fort (2005) concluded that Chile's experience with a real exchange rate rule was not so positive.

the ERM (minus Italy and the United Kingdom) survived its crisis and remained as the anchor for the drive toward full currency unification.[26] Even a major recession throughout the ERM area in 1995–96 did not derail momentum. The EU adopted the Stability and Growth Pact in June 1997, setting ceilings on acceptable fiscal deficits and government debt ratios and specifying convergence criteria for the coordination of policies across the region. That laid the final cornerstone for the introduction of the euro as a currency for all but cash transactions on January 1, 1999, and as a full replacement for 11 European currencies a year later—a move that the Interim Committee called "one of the most important international monetary developments in the post-Bretton Woods era."[27] The euro floated independently relative to other currencies, but all the countries in the euro area were irrevocably committed to the use of this one currency.

Dollarization

For countries that wanted to move to a "hard peg" exchange regime and establish credibility that the peg would not change, the most extreme option was to abandon the local currency altogether. At the outset of the 1990s, a few countries had taken this route. The leader, and the prototype, was Panama, which adopted the U.S. dollar as its currency when it became an independent country in 1904. Many small island states used an internationally accepted currency, such as the Australian, New Zealand, or U.S. dollar; or a major European currency, replaced in 1999 by the euro. Throughout Europe, small states, principalities, and other territories adopted the national currencies of larger contiguous neighbors. Except for Liechtenstein, which used the Swiss franc, they also switched to the euro. Lesotho, Namibia, and Swaziland used the South African rand alongside an interchangeable local currency.

In the late 1990s, interest in dollarization was piqued by the perceived dangers of trying to peg in more normal ways. As noted above, the financial crises in the EMS, Mexico, East Asia, and elsewhere suggested that soft pegs could be broken by large-scale speculation. If floating was not an option because of the risk of instability, then a harder peg might offer a solution.[28] The largest country to consider this possibility seriously was Argentina in 1999 (Chapter 12). The IMF broadly supported Argentina's ambition, but the effort bogged down because of a lack of enthusiasm in the United States. Following the establishment of independence (from Indonesia) in East Timor, Fund staff advised the authorities to delay introducing their own currency and to use

[26]Detragiache and Hamann (1999) presented evidence that a key factor enabling the success of exchange rate–based stabilization in Europe, in contrast to the general experience in Latin America and other emerging markets, was that high-inflation European countries (Greece, Ireland, Italy, and Portugal) had more moderate initial inflation than the comparator countries. Italy rejoined the ERM in November 1996.

[27]Interim Committee communiqué (April 28, 1997), paragraph 6.

[28]For an analysis of "fear of floating," see Calvo and Reinhart (2002), Section III.

the U.S. dollar instead. That recommendation was accepted and became the policy of the new country (Timor-Leste) through the next decade. Also in 1999, Ecuador began making plans to dollarize. The Fund supported that decision and approved a stand-by arrangement for Ecuador shortly after the currency conversion in 2000.

Currency Boards

Several countries introduced currency boards or similar systems in the 1990s as a way to anchor monetary policy against a strong external currency without giving up the seigniorage and other advantages of a domestic currency. In a pure currency board scheme, a country has no central bank as a currency-issuing body. Instead, the currency board holds foreign exchange equal to its monetary liabilities, which serve as the monetary base. The exchange rate between the domestic currency and a key international currency is fixed by law. A legal prohibition on issuing monetary liabilities in excess of exchange reserves should prevent high inflation and strongly discourage speculation against the peg.

In the postwar period before the 1990s, most currency boards were implemented by very small countries with close financial ties to the larger countries whose currencies they were mimicking.[29] The most important example, and somewhat of an exception to that rule, was Hong Kong,[30] which set up a currency board in 1983 to peg the Hong Kong dollar to the U.S. dollar. Then, starting with Argentina in 1991, several countries introduced schemes that were variants on the pure currency board model in which the country retained its central bank but placed legal restrictions on the scope of its activities. Estonia pegged its currency to the deutsche mark by this method in 1992, as did Bulgaria and Bosnia and Herzegovina in 1997. Lithuania introduced a similar scheme in 1994 to peg its currency to the U.S. dollar.[31] In each case, the aim was to overcome weaknesses in the domestic financial market and a record of instability and a concomitant lack of credibility for monetary management by the government.

[29]For a comprehensive list, see Hanke (2002). In the 1990s, the list included Bermuda and the Cayman Islands, linked to the U.S. dollar; Brunei, linked to the Singapore dollar; the Falkland Islands, linked to the pound sterling; and the Faroe Islands, linked to the Danish krone. More-independent currency board arrangements included Argentina, Djibouti, Hong Kong, and Lithuania, linked to the U.S. dollar; and Bosnia and Herzegovina, Bulgaria, and Estonia, linked to the deutsche mark. On that list, the oldest arrangement was Djibouti (1949), followed by Hong Kong (1983), Argentina (1991), Estonia (1992), Lithuania (1994), Bosnia and Herzegovina (1997), and Bulgaria (1997). In the pre–Second World War period, the most prominent examples were in groups of British colonies, notably the countries using the West African pound, the East African shilling, the Southern Rhodesian pound, and the Malayan dollar. For comprehensive studies, see Greaves (1953) and Newlyn (1952). After gaining independence, most formerly colonized countries established central banks.

[30]At the time, Hong Kong was administered by the United Kingdom. After July 1, 1997, the territory was officially designated Hong Kong Special Administrative Region (SAR) of China.

[31]For histories of currency boards, see "Experiences with Currency Board Arrangements," SM/96/302, Suppl. 1 (December 20, 1996), and Hanke (2002).

In most instances in which a country planned to establish a currency board system, both the IMF and the countries with key internationally used currencies responded positively. In 1992, consideration was given to the possibility of using currency boards in the former Soviet Union as a way to preserve the ruble area. In 1998, Camdessus tried to persuade Russian officials to adopt a currency board in the wake of the financial meltdown that summer. He tried again with Brazil in 1999, also to no avail. For other countries, notably Indonesia in 1998, the international reaction was decidedly negative.

In general, the Fund viewed such schemes as desirable in limited circumstances and with certain preconditions in place (see Bennett, 1994; Baliño and Enoch, 1997; and Enoch and Gulde, 1997).[32] Argentina and Bosnia and Herzegovina were clear cases, which the Fund supported from the outset. So was Bulgaria, where the authorities introduced a currency board on the advice of the Fund. In the Baltic countries, Fund staff were initially skeptical, mainly because they thought that an even more rigid scheme—continuing to use the Russian ruble—would be more likely to succeed. Once it became clear that these countries were determined to introduce their own currencies, the Fund supported their decisions to use currency boards as a stabilizing device. Fund advice was favorable to currency boards in a few other cases but not in all. In Indonesia, staff and management feared that the central bank lacked the financial resources to manage a currency board effectively and that the scheme would serve only to help well-connected individuals get their money out of the country at a good rate before the system collapsed.

As the Fund gained experience in examining currency boards, the central dilemma emerged more clearly—other than in small economies with very close links to the host country, eventually (once credibility was well established), the currency board would become a straightjacket preventing the authorities from adjusting to country-specific shocks. The political burden of maintaining tight fiscal and monetary policies during a cyclical downturn would be too great to bear, and the regime would almost surely collapse. As discussed in Chapter 12, the Fund raised this issue with Argentina as early as 1995, but took no further action. Otherwise, the question of how to devise an effective exit strategy from a currency board was not brought to the fore until the end of the decade.[33]

Currency Unions

Another way to gain international credibility for a fixed exchange rate was to enter into a currency union with several other countries. The major currency

[32]For more on the cases discussed here, see Chapters 6 (Bosnia and Herzegovina and Bulgaria), 7 (Russia), 8 (Estonia, Lithuania, and the ruble area), 9 (Argentina), 11 (Indonesia), and 12 (Argentina again, and Brazil).

[33]See, in particular, "The Baltics: Exchange Rate Regimes and External Stability," SM/99/282 (December 29, 1999). For the Baltic countries and for Bulgaria, the intended exit strategy was to adopt the euro as the national currency.

union story of the 1990s was the creation of the euro as the world's second most important currency, discussed above. The applicability of such a system was limited to groups of countries with strong economic ties through trade, and preferably through migration as well. As a result, very few currency unions were formed, and no other new groupings coalesced in the 1990s.[34]

The most enduring currency union was the CFA franc zone in central and western Africa. Created in 1945, the CFA franc was pegged at a single fixed rate to the French franc from 1948 to 1994. As explained in Chapter 14, the IMF supported the preservation of the zone, but staff and management became increasingly worried about the viability of the peg in the late 1980s and early 1990s. After a few years of quiet diplomacy, the Fund helped arrange a devaluation in January 1994 that succeeded in restoring economic growth and the credibility of the currency arrangement. At the time, the zone had 13 member countries. In 1997, Guinea-Bissau became the fourteenth member.

Inflation Control

Modern post-Keynesian macroeconomic theory was developed largely in the 1970s and 1980s with the introduction of expectations-consistent and time-consistent models and state-contingent policy rules. By the end of the 1980s, these ideas formed an integral part of mainstream macroeconomic policy analysis.[35] Much of the policy debate at that time concerned the extent to which rules could be applied without transforming nominal shocks into real instability in national economies. Early proposals for simple rules, such as aiming for steady growth in the stock of money, proved unreliable, and that engendered a spate of research on more-flexible policy models.

Two important ideas entered the mainstream in the 1990s, both of which were directed at linking monetary policy decisions closely to the stabilization of inflation rates at low levels.

The first major idea was inflation targeting. A few countries had experimented with aiming monetary policy solely at price stability, one of the first examples being Sweden in the early 1930s. This tactic was not really practical, though, owing in part to the lack of a reliable model of feedback from expected inflation to current conditions. In 1989, the Reserve Bank of New Zealand achieved a breakthrough when the governor made a contractual commitment (as required by a law enacted by parliament) to keep inflation in a low narrow range. Because the governor's job depended on meeting the target, the policy rule gained a level of credibility that had previously proved elusive. Although it would take a few years before the New Zealand experiment would succeed

[34]Other than those mentioned in the text, the only established currency union (as distinct from the dollarization cases discussed above) was the eight-country Eastern Caribbean Currency Union.

[35]For overviews, see Chari and Kehoe (2006) and Mankiw (2006).

well enough to allow output to rise without raising inflation above the target, it proved that if a central bank could establish a credible inflation target as an anchor for the public's expectations and could set interest rates consistently with that target, then it could use that relationship as an effective basis for conducting monetary policy.[36]

As the decade unfolded, a growing number of central banks adopted inflation targeting. Among the advanced economies, these included Canada (1991), the United Kingdom (1992), Australia (1993), Finland (1993), Sweden (1993), and Spain (1995). Emerging-market countries adopting inflation targeting in the 1990s included Chile (1991), Israel (1997), the Czech Republic (1997), Poland (1999), and Brazil (1999) (see Bléjer and others, 2000; Schaechter, Stone, and Zelmer, 2000; and Bernanke and others, 2001).[37] In most cases, inflation targeting was carried out against the backdrop of a floating exchange rate, as an alternative way to anchor expectations and stabilize the monetary system. As an exception, Chile maintained a crawling-band exchange rate policy and used capital controls to preserve consistency between the two policies.[38]

The popularity of inflation targeting forced a rethinking of the Fund's policy advice and its model of program design. The traditional approach in stand-by arrangements of setting a ceiling on net domestic assets of the monetary authorities or a floor on net international reserves was not as relevant when the central bank was implementing an inflation-targeting regime. Those variables were endogenous and could not be controlled independently of the inflation target (Bléjer and others, 2002). For the Fund, the problem was not that inflation targeting rendered conditionality moot. The problem was just that the Fund had to adapt its program design so that it was specifying conditions on the right instruments. After Brazil adopted an inflation-targeting regime in 1999 in the context of a Fund stand-by arrangement (see Chapter 12), the Executive Board adopted a formal policy on how to handle such cases in the future.[39]

The second, closely related, idea was a monetary rule that used feedback from output gaps to supplement deviations from the inflation target to determine the appropriate adjustments to a short-term interest rate or the monetary base. The Stanford University economist John B. Taylor introduced the rule in an influential paper in 1993. In its simple and widely used formulation, the Taylor Rule suggested that central banks should lower interest rates when output was below its equilibrium level or when

[36]For analyses of inflation targeting in New Zealand, see Archer (1997), McCallum (1997), and Sarel (1999).

[37]The list of countries given here is not definitive or exhaustive; a few other countries also implemented policies closely related to inflation targeting.

[38]For analyses of Chile's policies, see Le Fort (2005); and Ötker-Robe and Vávra (2007), pp. 33–38. Also see Chapter 9, p. 432.

[39]See "Inflation Targeting—Implications for IMF Conditionality," SM/99/296 (December 14, 1999); "IMF Conditionality in the Context of Inflation Targeting: The Case of Brazil," SM/99/296, Suppl. 1 (December 16, 1999); and the Summing Up by the Acting Chairman at EBM/00/1 (January 5, 2000). All three documents may be accessed at http://www.imf.org/external/np/pp/eng/1999/121499.pdf.

inflation was below its target, with the response rates determined by algebraic coefficients. The rule thus allowed for automatic feedback from shocks to policy changes to minimize the real effects. The idea was intuitive, elegant, and easy to apply, either as a supplement to inflation targeting or in a more traditional monetary policy regime. By the late 1990s, it was being widely used both as an analytical tool and as a benchmark for policy decisions by central banks.

Regulation and Control of International Capital Flows

With the liberalization of international capital flows, the question of whether and how to regulate those flows arose. Throughout the decade, liberalization went hand in hand with a general attitude against regulation of financial institutions and markets. That trend was most pronounced in the United States, where a market-friendly approach to regulation culminated in November 1999 with the repeal of the Glass-Steagall Act. Glass-Steagall was adopted in 1933, in the early days of the Franklin D. Roosevelt administration, as a central element—along with a federal insurance program for commercial bank deposits—in the government's effort to protect the public from speculative behavior by banks. It prohibited commercial banks from owning nonbank financial institutions such as investment banks or insurance companies. Repeal was aimed at enhancing the global competitiveness of U.S. banks, but it led ultimately to a wave of speculative investments and loans that collapsed in 2007–08 and set off a global downturn that would come to be known as the "Great Recession." In the 1990s, however, few were warning about the dangers of repeal or of the ensuing speculation.

The Fund adopted a nuanced and not always clearly articulated view of international capital flows. Emerging markets could benefit from inflows of private capital if they had well-developed domestic capital markets and sound macroeconomic policies, but they had to be aware of the risk of instability.[40] In 1993, the IMF staff began warning that short-term capital flows to emerging markets could hit a "sudden stop," with serious consequences for financial stability in the affected countries. In 1995, the Fund revised its policy on surveillance to include a specific warning about unsustainable capital flows, and over the next two years management tried to win approval for an amendment to the Articles of Agreement to give the Fund jurisdiction over the capital account. The aim was to ensure that liberalization would occur in an orderly way and not outpace the development of domestic financial institutions and markets, but the Fund did not make that case very effectively. The campaign was widely interpreted as an effort by the Fund and major industrial countries to push developing countries to open their economies to inflows of foreign capital. The onset of the Asian financial crisis in 1997 effectively killed the effort.

[40]For a more detailed discussion, see "Oversight of Capital Flows," in Chapter 4, pp. 131–41.

The Asian crisis restored interest in the possibility of requiring involvement by private financial institutions in the workout of emerging-market financial crises. Private sector involvement (PSI) in debt workouts first became a major issue for the IMF in 1982, when both Argentina and Mexico were unable to repay their debts to foreign commercial banks. The Managing Director at the time, Jacques de Larosière, informed those countries' bank creditors that the Fund would not lend to the countries unless the banks collectively and simultaneously agreed to increase their own loan exposure. This ploy, which became known as "concerted lending," worked for only a few relatively large and heavily indebted countries, and only for a few years. Its success required the banks to be so heavily exposed that a default would threaten their own solvency, and it required creditors to be homogeneous enough to be identifiable and capable of organization. By the late 1980s, most major international banks had reduced or diversified their exposure to developing countries to the extent that they could resist calls for concerted lending. By the early 1990s, most emerging-market countries had sufficiently diversified their sources of external financing that their creditors and investors were no longer identifiable or homogeneous enough to be easily corralled into collective action.

The Mexican crisis of 1994–95 was resolved without PSI, and the workout enabled most holders of Mexico's short-term debt instruments to be repaid in full at the old, undepreciated exchange rate (Chapter 10). The sudden cessation of capital flows to Thailand, Indonesia, and other countries in East Asia in 1997 laid bare the gaps in the international financial system associated with the absence of an effective way to induce PSI. PSI might have become vastly more difficult than in the 1980s, but it was no less important as a way to limit moral hazard, ensure that official lending would not simply enable private creditors to pull out costlessly, and create the preconditions for an economic recovery.

The Korean financial crisis in December 1997 offered an opportunity to resuscitate PSI, because the bulk of the short-term inflows to Korea were channeled through international banks (Chapter 11). Initially, some major creditor countries—notably the United States—were reluctant to endorse a workout in which commercial banks would be required to participate. After a few weeks of chaos, Fund officials and the G7 finance deputies settled on a somewhat market-friendly solution in which treasuries or central banks would persuade, not force, their banks to participate, and the Fund would help monitor the extent of cooperation and involvement. That became a prototype for operations in other crisis-hit countries, including Indonesia a few months later and Brazil at the end of 1998. At the same time, the Fund began developing a general policy on PSI in the context of Fund-supported programs.

The essence of the staff view on PSI after the Korean crisis was that the first line of defense should always be for the emerging-market country to try to prevent a sudden withdrawal of private credit by developing the institutions of a market economy, providing accurate and comprehensive information to the public, and carrying out a "careful sequencing of capital account liberalization." If those efforts failed, consideration should be given to ways to "overcome coordination failure," for example, by

establishing "creditor councils" to negotiate sovereign bond restructurings; and to strengthening corporate bankruptcy procedures to provide the right incentives for orderly debt workouts. In more extreme crisis situations, the Fund could consider options such as a Korean-style monitoring exercise or lending into nonsovereign arrears. The staff also suggested the possibility of amending the Articles of Agreement to enable the Fund to prevent litigation by vulture funds and other dissident creditors while a country was implementing a Fund-supported program.[41]

The G7 lent its support to this effort at the Cologne summit in June 1999. As part of the summit documentation, the G7 finance ministers and central bank governors set out a detailed agenda for involving the private sector in both the prevention and the resolution of financial crises. Much of the agenda was similar to the IMF staff agenda, but it went further, for example, by calling for "broadening the use of collective action clauses in sovereign debt contracts" and for taking account in workout discussions of a "country's underlying capacity to pay and its access to the markets." The statement concluded by asking the IMF "to develop and define the legal and technical questions involved in implementing the specific approaches identified in the framework agreed here."[42] That led to an adoption of principles by the Fund in the spring of 2000.[43]

The wave of crises that permeated the late 1990s, including the collapse of the LTCM hedge fund in the United States in addition to the shocks that hit emerging markets, also led to the establishment of the Financial Stability Forum (FSF) in February 1999 (Chapter 3). That group brought together financial supervisory officials from major countries to discuss issues related to potentially destabilizing forces such as hedge funds, volatile capital flows, and offshore financial centers where money laundering and other illegal activities could thrive. The FSF, however, was designed to foster cooperation and information sharing, not to devise or implement new regulations.[44]

Assistance to Low-Income Countries

Despite the onset of aid fatigue, donor countries were not entirely neglectful of the needs of low-income countries. In particular, the issue of debt relief, which was put

[41]These options were set out in "Involving the Private Sector in Forestalling and Resolving Financial Crises," EBS/98/139 (August 12, 1998). The staff then produced a series of papers with increasingly specific recommendations, culminating in "Involving the Private Sector in the Resolution of Financial Crises—Further Considerations," EBS/99/194 (October 19, 1999).

[42]"Report of G7 Finance Ministers to the Köln Economic Summit, Cologne, Germany, 18–20 June, 1999"; accessed at http://www.g8.utoronto.ca/finance/fm061999.htm. For a comprehensive overview of the evolution of thinking about and work on PSI in the late 1990s, see Chapter 11 in Rieffel (2003).

[43]For a summary, see *Annual Report 2000*, pp. 45–47; accessed at http://www.imf.org/external/pubs/ft/ar/2000/eng/index.htm. For an example of the Fund's approach to PSI at that time, see the discussion of Ecuador in Chapter 12, pp. 611–16.

[44]For a report on the initial work of the FSF, see the statement by its first chairman, Andrew Crockett, to the International Monetary and Financial Committee in April 2000; accessed at http://www.financialstabilityboard.org/press/st_000416.pdf.

on the table by French President François Mitterrand and others in the late 1980s, was still in an embryonic state at the outset of the 1990s. Under the "Toronto terms" agreed upon at the G7 summit meeting in 1988, official creditors working through the Paris Club were prepared to offer eligible low-income countries reschedulings that would reduce the present value of outstanding claims by a modest percentage. Although better than nothing, it left many countries well short of the capacity to service their debts.[45]

The limited but obvious benefits of adopting the Toronto terms gave rise to a regular exercise throughout much of the 1990s in which official bilateral creditors offered evermore generous terms for debt relief to heavily indebted poor countries (Chapter 13). The steady parade of summit announcements culminated in 1996 with the Lyons terms, which offered reductions in present values of up to 80 percent. (Later, in 2005, official creditors decided to offer total forgiveness.) As that process neared its conclusion, the process of similarly reducing the claims of the IMF and other multilateral institutions got under way, including through the HIPC Initiative (discussed above).

Debt forgiveness thus was a key theme of public discussions and decisions on poor countries through much of the 1990s. The challenge of helping those countries break out of the poverty trap and begin developing more consistently and effectively was, however, much greater than debt relief alone could overcome. A resurgence of ODA, delivered in steadier, more predictable, and more effective ways, was especially important, as were a durable strengthening of economic policies in the affected countries and a more receptive environment for poor countries' exports. This final decade of the twentieth century did not produce the necessary breakthroughs in any of these broader areas, but the approach of the millennium did focus the world's attention on the magnitude of the problem.

In September 2000, at UN headquarters in New York, 189 heads of state or government endorsed the Millennium Development Goals, with specific targets—notably a 50 percent reduction in the incidence of extreme poverty from 1990 levels—to be achieved by 2015. The new Managing Director of the IMF, Horst Köhler, promptly announced the Fund's support for the initiative and pledged the institution to help "make globalization work for the benefit of all."[46] The agreement on the Millennium Development Goals was a real advance, leading to more concrete plans for achieving the goals in the following years. It did not elevate poverty reduction to the top of the agenda for the IMF or for the world's major advanced economies, but it did at least create a framework for ensuring that the needs of the poorest countries would not be neglected.

[45]Before 1988, Paris Club reschedulings typically stretched out maturities and grace periods but left the outstanding present values unchanged. Although the unofficial membership of the Paris Club was much broader than the G7, the official creditors in the Paris Club generally followed the recommendations of the summit declarations.

[46]Opening address to the IMF/World Bank Annual Meetings in Prague (September 26, 2000); accessed at http://www.imf.org/external/np/speeches/2000/092600.htm.

Appendix: Chronology, 1990–1999

Date	World Events	IMF
1990		
January	Poland launches its "big bang" economic reform program.	
February	In South Africa, Nelson Mandela is released from prison.	
March	Estonia and Lithuania declare their independence from the Soviet Union.	
April	China and the United Kingdom ratify an agreement to transfer control of Hong Kong to China in 1997.	
May	Latvia declares its independence from the Soviet Union. Forty countries sign a treaty establishing the European Bank for Reconstruction and Development (EBRD). East and West Germany sign a treaty establishing the deutsche mark as the single currency for the two countries, effective in July.	
June	U.S. President George H.W. Bush announces the Enterprise for the Americas Initiative, aimed at establishing free-trade areas throughout the continent.	
July	European Economic Community (EEC) abolishes restrictions on capital flows among member states, as the first stage of Economic and Monetary Union (EMU). Group of Seven (G7) heads of state and government hold a summit meeting in Houston, Texas (United States). The communiqué calls on the IMF to convene a study (with participation by the International Bank for Reconstruction and Development, the EBRD, and the OECD) of the Soviet economy.	
August	Iraq invades Kuwait, initiating a regional political crisis that will culminate in the Gulf War of 1991.	

Appendix (continued)

Date	World Events	IMF
September	Paris Club adopts Houston terms, providing for more flexible rescheduling of debts of lower-middle-income countries.	
October	Full unification of East and West Germany. The United Kingdom joins the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS), effectively pegging the pound sterling to the European Currency Unit.	Fund staff conduct the first Article IV consultation discussions with Hong Kong.
November		Modification of lending policies to assist countries affected by the regional crisis in the Middle East.
December	Haiti holds its first democratic elections for president, won by Jean-Bertrand Aristide.	
1991		
January	Onset of the six-week Gulf War.	
February	Initial Executives' Meeting of East Asia-Pacific Central Banks (EMEAP), held at the Bank of Japan in Tokyo. The group will meet semiannually as a regional "Group of Ten."	
March	Argentina, Brazil, Paraguay, and Uruguay sign the Treaty of Asunción, which will lead to the creation of MERCOSUR in 1995.	
May	The EBRD begins operating, with headquarters in London. Rajiv Gandhi, former prime minister of India, is assassinated while campaigning to return to office.	The Bureau of Statistics is elevated to the Statistics Department.
June	Chile introduces controls on short-term capital inflows.	

Appendix (continued)

Date	World Events	IMF
July	G7 summit in London. • U.K. Prime Minister John Major invites Mikhail Gorbachev of the Soviet Union to participate in part of the meetings. • The summit recommends adoption of the London terms for debt rescheduling. (See below, in December 1991.)	
August		The Asian Department is replaced by the Central Asia Department and the Southeast Asia and Pacific Department.
September	Soviet Union recognizes the independence of Estonia, Latvia, and Lithuania. In Haiti, President Aristide is overthrown in a military coup. Lewis T. Preston becomes President of the World Bank Group, replacing Barber Conable.	Michel Camdessus is elected to a second five-year term as Managing Director.
October	Cambodia begins to emerge from conflict and international isolation when a peace agreement is signed in Paris.	Signing of Special Association agreement with the Soviet Union.
November	China, Hong Kong, and Taiwan Province of China join Asia-Pacific Economic Cooperation (APEC), raising the group's membership to 15.	
December	Paris Club replaces the 1988 Toronto terms with London terms, under which official creditors will reduce debts owed by low-income countries by up to 50 percent (previously 33 percent). Dissolution of the Soviet Union. Russian Federation, Ukraine, and Byelorussia (Belarus) establish the Commonwealth of Independent States. In Maastricht, the Netherlands, European leaders sign a treaty establishing the European Community as the successor to the EEC and specifying a process leading to EMU by 1999.	Creation of the European II Department, with responsibility for Russia, the Baltic countries, and other countries of the former Soviet Union.

Appendix (continued)

Date	World Events	IMF
1992		
January	Association of South-East Asian Nations (ASEAN) member states sign an accord to establish the ASEAN Free Trade Area.	
February	Civil war in El Salvador ends with the signing of a peace accord in Chapultepec, Mexico.	
April		Eligibility for concessional loans is extended to 11 more countries, bringing the total to 72.
May		The Central Banking Department is replaced by the Monetary and Exchange Affairs Department.
July	G7 summit in Naples, Italy. Russian President Boris Yeltsin attends as a special guest.	The Exchange and Trade Relations Department is replaced by the Policy Development and Review Department.
September	Speculative pressures force Italy and the United Kingdom to withdraw from the ERM.	
October		Opening of the Joint Vienna Institute. Establishment of the Office of Budget and Planning.
November	Bill Clinton elected president of the United States, to replace George H.W. Bush in January 1993.	A 50 percent quota increase takes effect, concluding the Ninth General Review of Quotas. Third Amendment to the Articles of Agreement takes effect, providing for sanctions against countries that fail to cooperate in resolving payments arrears to the Fund.
1993		
April	Seven countries in South Asia establish the South Asian Association for Regional Cooperation (SAARC) Preferential Trading Arrangement (SAPTA).	Establishment of the Systemic Transformation Facility (STF).
May		Kyrgyz Republic is the first country to draw on the STF.

Appendix (continued)

Date	World Events	IMF
July	G7 summit in Tokyo urges the IMF and Russia to reach agreement on a stand-by arrangement and endorses the renewal of the Enhanced Structural Adjustment Facility (ESAF) as part of a strategy for aiding low-income countries.	
August	In response to a resumption of speculative pressures, EMS members widen the ERM intervention bands from ± 2.25 percent to ± 15 percent.	
September	Former IMF Managing Director Jacques de Larosière becomes president of the EBRD (1993–98).	
November	European Union (EU) comes into being as the successor to the European Communities. The first APEC summit meeting is held on Blake Island, Washington (United States).	Eligibility for concessional loans is extended to four more countries, bringing the total to 76.
1994		
January	The North American Free Trade Agreement takes effect in Canada, Mexico, and the United States. Establishment of the European Monetary Institute to guide the transition toward EMU. Devaluation of the CFA franc, the currency of 13 countries in central and west Africa. Seven of the CFA franc countries form the West African Economic and Monetary Union (WAEMU).	
February		Enlargement and extension of the ESAF, formally establishing a successor to the original facility.
March	APEC finance ministers hold their first formal meeting, in Honolulu, Hawaii (United States).	

Appendix (continued)

Date	World Events	IMF
April	The airplane carrying the presidents of Burundi and Rwanda is shot down, touching off a genocidal civil conflict in Rwanda. Trade ministers meet in Marrakesh, Morocco, to sign agreements concluding the Uruguay Round of trade negotiations.	
May	Mexico becomes a member of the OECD. Agreement on Palestinian self-rule in the West Bank and Gaza. Inauguration of Nelson Mandela as president of South Africa.	
June		Revision of management structure, replacing the single Deputy Managing Director (DMD) with three deputies, one of whom is to be designated the First DMD.
July		Prabhakar R. Narvekar and Alassane D. Ouattara assume office as DMDs, serving until January 1997 (Narvekar) and July 1999 (Ouattara).
September		Stanley Fischer assumes office as First DMD, serving until August 2001.
October	A UN military force restores Aristide to power in Haiti. Jordan becomes the first Arab country to sign a peace treaty with Israel.	Interim Committee adopts the Madrid Declaration, setting standards for macro and structural economic policies.
December	Paris Club adopts Naples terms, under which official creditors will reduce debts owed by low-income countries by up to 67 percent. Mexican peso crisis begins.	

Appendix (continued)

Date	World Events	IMF
1995		
January	Uruguay Round agreements reforming the international trading system take effect. World Trade Organization (WTO) is established as the successor to the General Agreement on Tariffs and Trade. Austria, Finland, and Sweden join the EU. MERCOSUR comes into effect.	
February		Approval of a stand-by arrangement for Mexico, the largest financial commitment in Fund history to this date.
April		Final date for initial drawings under the STF.
May	Jacques Chirac is elected president of France, replacing François Mitterrand.	
June	James D. Wolfensohn becomes President of the World Bank Group, succeeding the late Lewis T. Preston.	
July	Vietnam joins ASEAN, raising its membership from six states (Brunei Darussalam, Indonesia, Malaysia, the Philippines, Singapore, and Thailand) to seven. The South Centre is established as a Geneva-based intergovernmental organization of developing countries.	
September		Establishment of the Emergency Financing Mechanism and the policy on Emergency Post-Conflict Assistance.
November	Signing of the Dayton (Ohio, United States) peace agreement ending the conflict in Bosnia and Herzegovina. Assassination of Israeli Prime Minister Yitzhak Rabin.	

Appendix (continued)

Date	World Events	IMF
December	Czech Republic becomes a member of the OECD.	Termination of the Structural Adjustment Facility, which has been fully utilized. Expiration of the STF.
1996		
May	Hungary becomes a member of the OECD.	Camdessus is elected to an unprecedented third term as Managing Director.
June	Chile signs a free trade agreement with MERCOSUR.	
July	EMEAP central banks meet at the governors' level for the first time, establishing an annual practice.	
September		Approval of IMF participation in the Heavily Indebted Poor Countries Initiative.
November	Italy rejoins the ERM. Poland becomes a member of the OECD.	
December	Republic of Korea becomes a member of the OECD. Bolivia signs a free trade agreement with MERCOSUR.	IMF and WTO sign a cooperation agreement. Commitment period for ESAF loans extended by four years, to end-2000.
1997		
January		Adoption of the New Arrangements to Borrow (NAB). CTA and SEA are merged into the new Asia and Pacific Department.
February		Decision that countries completing a three-year ESAF arrangement under the successor facility can apply for a further arrangement.
April		To enhance transparency, the Fund approves issuance of Press Information Notices on Article IV consultations.
May	Guinea-Bissau joins the WAEMU and adopts the CFA franc as its currency.	

Appendix (continued)

Date	World Events	IMF
June	Adoption of the Stability and Growth Pact by the European Council.	
July	Sovereignty over Hong Kong SAR is transferred from the United Kingdom to China. Bank of Thailand devalues the baht, initiating a financial crisis that will spread across East Asia in the coming months. The Lao People's Democratic Republic and Myanmar join ASEAN.	
August		Approval of stand-by arrangement with Thailand.
September		The Board of Governors gives preliminary approval to the Fourth Amendment to the Articles of Agreement, which would provide for a special allocation of special drawing rights.
October	The Asian financial crisis spreads to Indonesia.	
November	The Asian crisis spreads to Korea. Formation of the Manila Framework Group, an assembly of 14 countries involved in managing the Asian crisis.	Approval of stand-by arrangement with Indonesia.
December		Establishment of the Supplemental Reserve Facility (SRF). Opening of the Regional Office for Asia and the Pacific in Tokyo. Approval of the largest stand-by arrangement in IMF history, with Korea.
1998		
April	First meeting of the Group of 22 (G22), a forum for the major industrial and emerging-market countries.	
May	India and then Pakistan conduct tests of nuclear bombs, triggering financial outflows and international sanctions.	

Appendix (continued)

Date	World Events	IMF
July		The Fund activates the General Arrangements to Borrow for the first time in 20 years, to finance augmentation of an extended arrangement with Russia.
August	Russia devalues and defaults on a portion of its sovereign debt.	
September	Near default and central bank rescue of Long-Term Capital Management, a major hedge fund. Future IMF Managing Director Horst Köhler becomes president of the EBRD (1998–2000).	
December		Activation of the NAB to finance a stand-by arrangement for Brazil.
1999		
January	Eleven European countries irrevocably fix exchange rates among their currencies in preparation for the adoption of the euro as a single currency in January 2000.	The European Central Bank is granted observer status in the Fund. A 45 percent quota increase takes effect, concluding the Eleventh General Review of Quotas.
February	Establishment of the Financial Stability Forum (FSF) by the G7. Olusegun Obasanjo is elected president of Nigeria, ending 15 years of military rule. King Hussein of Jordan dies. He is succeeded by his son, King Abdullah II.	
March		The Fund issues its first transparency report, the prototype for Reports on the Observance of Standards and Codes.
April	First meeting of the FSF, chaired by Andrew Crockett. Cambodia joins ASEAN, raising the organization's membership to 10 states.	The SRF is expanded to provide for Contingent Credit Lines for countries with strong policies.
May		IMF and World Bank launch the Financial Sector Assessment Program.

Appendix (continued)

Date	World Events	IMF
June	Formal establishment of the Central African Economic and Monetary Community.	
July		The Administration Department is replaced by the Human Resources Department and the Technology and General Services Department.
October		Enhancement of the HIPC Initiative.
November	Paris Club adopts Cologne terms, under which official creditors will reduce debts owed by low-income countries by up to 90 percent. Kenya, Tanzania, and Uganda sign a treaty reestablishing the East African Community, which had lapsed in 1977. U.S. Congress repeals the 1933 Glass-Steagall Act, which had prevented commercial banks from engaging in speculative activities.	Establishment of the Poverty Reduction and Growth Facility as the successor to the ESAF. Brazil becomes the last major country to accept the Article VIII obligations to refrain from imposing exchange restrictions on current account transactions. Camdessus announces his intention to resign as Managing Director as soon as a replacement is named. He will leave office in February 2000, concluding 13 years in office.
December	First meeting of the Group of Twenty (G20), the successor to the G22.	The Interim Committee is replaced by the International Monetary and Financial Committee. Revaluation of a portion of the IMF gold stock to help finance the Enhanced HIPC Initiative.

Source: Author's compilation.

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2

Becoming a Universal Institution: Expansion of Membership

ANY MEMBER OF THE UNITED OR ASSOCIATED NATIONS IS ELIGIBLE FOR MEMBERSHIP IN THE Fund provided it agrees [to the conditions in the Articles]. . . . No restrictions as to membership should be imposed on grounds of the particular economic structure adopted by any country. . . . [In particular,] to exclude a country such as Russia would be an egregious error.

Harry Dexter White[1]
United States Treasury
1942

When representatives of 45 allied countries met at Bretton Woods, New Hampshire, in July 1944, their intention was to create a set of institutions that would be open to all of those countries as soon as the Second World War was won. Eventually the new Bretton Woods institutions—the IMF and the World Bank—would be open to all other countries as well, including the "enemy states" and any future "liberated states . . . so long as they are willing to agree to conduct their international economic affairs in accordance with principles acceptable to the United Nations" (Horsefield, 1969, p. 73).[2] By the deadline at the end of 1946, 40 of them had become "original members" of the IMF. The Soviet Union and four other countries chose for various reasons not to join. Over time, IMF membership grew gradually, but many countries remained outside, unable or unwilling to commit to the institutional requirements.

Nearly half a century would pass before Harry White's vision of a universal financial institution would finally be realized. By the end of the 1990s, only a few countries—notably Cuba and the Democratic People's Republic of Korea (North Korea)—were

[1]The quotation is from the April 1942 "White Plan" for a Stabilization Fund, reprinted in Horsefield (1969), pp. 63 and 72. Harry Dexter White was the U.S. Treasury official in charge of negotiating a treaty to create the IMF and the World Bank.

[2]The United Nations did not yet exist as a formal institution. (It was created in 1945.) The term "United Nations" in the White Plan referred to the allied countries fighting against the Axis in the Second World War.

still nonmembers of the IMF. This chapter chronicles the events that drove up membership from 152 countries at the end of 1989 to 182 countries a decade later.[3] Particular attention is paid to the former Soviet Union and to the breakup of Yugoslavia, two cases that raised uniquely important issues.

Universalization of the IMF

The surge in IMF membership in the early 1990s was the biggest jump since the influx of newly independent African countries in the early 1960s. By the time it was over, almost all states that would qualify—those with control over their external relations—were in the fold. For the first time since the mid-1950s, the membership of the IMF was almost indistinguishable from the membership of the United Nations (UN). At the end of the 1990s, only seven UN members were not members of the IMF. Neither Cuba nor North Korea had applied for membership, presumably because those governments understood that any such application would be doomed by political opposition led by the United States.[4] The Federal Republic of Yugoslavia (Serbia and Montenegro) had not yet fulfilled the obligations of membership, owing to international sanctions. The other holdouts were extremely small countries: Andorra, Liechtenstein, and Monaco in Europe, and Nauru in the South Pacific. One country—Switzerland—became a member of the IMF in 1992 but did not join the UN until 2000.

On average, the new members in the 1990s (Table 2.1) also were relatively small countries. While the number of members rose by almost 20 percent, the size of the Fund (total quotas) rose by less than 8 percent as a result. Five very small states joined the Fund during this period: three Pacific island countries (the Marshall Islands, Micronesia, and Palau); the oil-rich East Asian sultanate, Brunei Darussalam; and the Republic of San Marino. The latter state covered just 62 square kilometers, had a population of fewer than 24,000 people, and was surrounded by Italy, whose currency it used. Its application to join the IMF was part of an ongoing program to broaden the republic's independent international relations.[5]

The driving force behind the rise in Fund membership was the breakup of the Soviet Union. That event, discussed further below, replaced one nonmember country with 15 new countries, all of which quickly applied for membership. Even before the formal breakup, four countries—Albania, Bulgaria, Czechoslovakia, and Mongolia—that

[3]For an overview of the changes in IMF membership from 1946 to 1989, see Boughton (2001), pp. 963–67.

[4]As discussed below (pp. 76–77), Cuba was an original member of the IMF but withdrew in 1964.

[5]For background, see "San Marino—Calculation of Quota," EB/CM/San Marino/92/1 (August 19, 1992).

had depended on the Soviet bloc for a large portion of their international trade and now needed to reform their economic systems joined the IMF. In addition, the largest economy in Europe—the Federal Republic of Germany (West Germany)—absorbed the provinces of the nonmember German Democratic Republic (East Germany) in October 1990. That merger, which followed from the dismantling of the Berlin Wall the year before, did not change the membership of the Fund but significantly expanded its geographic coverage.[6]

In Africa, the end of civil war in Namibia brought that country into the IMF in 1990. At that point, every country in Africa was an IMF member, and the process of accretion that had started at Bretton Woods but had begun in earnest with the independence of Ghana in 1957 was finally complete. Four years later, Eritrea's secession from Ethiopia added one more African member.

Several more new members resulted from the disseveration of existing states, including Yugoslavia (which became five separate countries in 1992, all of which eventually became IMF members), Czechoslovakia (two countries at the end of 1992), and Ethiopia (two countries after the secession of Eritrea in 1994). Offsetting that trend was the merger of the Yemen Arab Republic and the People's Democratic Republic of Yemen, forming the single Republic of Yemen in June 1990.

Two new memberships, both in Europe but with very different histories, raised important issues and are worth examining in more detail: Czechoslovakia and Switzerland.

Czechoslovakia

Czechoslovakia was not an entirely new member. In fact, its role in the Fund dated from the Second World War, when the Czech government-in-exile participated actively in the negotiations leading to the Bretton Woods conference of 1944. When the war ended and that government resumed power in Prague, Czechoslovakia was one of the 29 countries to ratify the Articles of Agreement and bring the IMF into being on December 27, 1945. The ascendance of a Stalinist regime in 1948 brought this early cooperation to a halt. From 1955 to 1989, Czechoslovakia was remembered at the Fund primarily as the only member that had been forced to withdraw.[7]

[6]Several other countries changed names in the 1990s without altering their membership status. Those changes are listed in the Appendix to this chapter.

[7]Formally, Czechoslovakia was expelled for changing its exchange rate without first consulting with the IMF and for then refusing to provide the data required by the Articles of Agreement, which the Fund needed to assess the new rate. Essentially, Czechoslovakia decided to cease cooperating with the Fund, and the institution then had little choice but to compel the country to withdraw from membership. Pursuant to a decision by the Executive Board and a resolution approved by the Board of Governors, Czechoslovakia's original membership formally ceased on December 31, 1954; see Horsefield (1969), pp. 359–64.

Table 2.1. Changes in IMF Membership, 1990–99

Country	Date	Number of Members	Classification	Department	Constituency[a]	Size (rank)[b]
	January 1, 1990	152				
Republic of Yemen[c]	May 22, 1990	151	Low income[d]	Middle Eastern	North Africa and Middle East	82
Czech and Slovak Federal Republic[e]	September 20, 1990	152	Transition	European I	Belgium	(37)
Bulgaria	September 25, 1990	153	Transition	European I	Netherlands	54
Namibia	September 25, 1990	154	Low income	African	Anglophone Africa	105
Mongolia	February 14, 1991	155	Low income, transition	Central Asia	Australia	150
Albania	October 15, 1991	156	Low income, transition	European I	Italy	152
Lithuania	April 29, 1992	157	Transition	European II	Nordic-Baltic	103
Georgia	May 5, 1992	158	Low income, transition	European II	Netherlands	101
Kyrgyz Republic	May 8, 1992	159	Low income, transition	European II	Switzerland	127
Latvia	May 19, 1992	160	Transition	European II	Nordic-Baltic	112
Marshall Islands	May 21, 1992	161	Other developing	Southeast Asia and Pacific	Australia	182
Estonia	May 26, 1992	162	Transition	European II	Nordic-Baltic	142
Armenia	May 28, 1992	163	Low income, transition	European II	Netherlands	125
Switzerland	May 29, 1992	164	Advanced	European I	Switzerland	14
Russian Federation	June 1, 1992	165	Transition	European II	Russia	9
Belarus	July 10, 1992	166	Transition	European II	Belgium	61
Kazakhstan	July 15, 1992	167	Transition	European II	Belgium	63
Moldova	August 12, 1992	168	Low income, transition	European II	Netherlands	113
Ukraine	September 3, 1992	169	Transition	European II	Netherlands	32
Azerbaijan	September 18, 1992	170	Low income, transition	European II	Switzerland	99

Table 2.1. (continued)

Country	Date	Number of Members	Classification	Department	Constituency[a]	Size (rank)[b]
Uzbekistan	September 21, 1992	171	Low income, transition	European II	Switzerland	77
Turkmenistan	September 22, 1992	172	Transition	European II	Switzerland	133
San Marino	September 23, 1992	173	Advanced	European I	Italy	159
Socialist Federal Republic of Yugoslavia ceases to exist as a state	December 14, 1992	172	Other developing	European I	Netherlands	(33)
Czech Republic	January 1, 1993	172	Transition	European I	Belgium	51
Slovak Republic	January 1, 1993	173	Transition	European I	Belgium	66
Croatia	January 15, 1993[f]	174	Transition	European I	Netherlands	65
Slovenia	January 15, 1993[f]	175	Transition	European I	Belgium	84
Former Yugoslav Republic of Macedonia	April 21, 1993[f]	176	Transition	European I	Netherlands	141
Tajikistan	April 27, 1993	177	Low income, transition	European II	Switzerland	130
Micronesia, Federated States of	June 24, 1993	178	Other developing	Southeast Asia and Pacific	Australia	180
Eritrea	July 6, 1994	179	Low income	African	Anglophone Africa	162
Brunei Darussalam	October 10, 1995	180	Other developing	Middle Eastern	Southeast Asia	102
Bosnia and Herzegovina	December 20, 1995[f]	181	Transition	European I	Netherlands	97
Palau	December 16, 1997	182	Other developing	Southeast Asia and Pacific	Australia	181

Sources: *Annual Reports* and author's calculations.

[a]If the Executive Director for the constituency normally comes from one particular country, the country is listed. Otherwise, the general characteristic is listed.

[b]Based on membership and quotas at end-1999. Figures in parentheses, listed for countries dissolved before the end of the decade, are calculated at the time of new membership or dissolution.

[c]Successor state, following the merger of the Yemen Arab Republic and the People's Democratic Republic of Yemen.

[d]Low-income countries are defined here as those members eligible to borrow through the IMF's concessional lending facilities.

[e]Split into two separate states, the Czech Republic and the Slovak Republic, on January 1, 1993.

[f]Retroactive to December 14, 1992.

As the pressure for economic and political reform pushed across central Europe in the second half of the 1980s, the communist regime in Prague began to explore its options for expanding relations with the established market countries to the west. In 1987, the authorities made discreet inquiries to the World Bank, only to be informed that they would first have to join the IMF. On several occasions in 1988, Czech officials and other apparently well-connected individuals approached Fund staff informally to get information on the way the Fund worked and how a membership application might be received.[8] The first official approach came in March 1989, though not in the expected manner. An official in the Czech delegation at the UN walked unannounced into the IMF liaison office in New York and read from a document he had received from Prague expressing his government's interest in becoming a member of the Fund. The startled lone staff member present in the office at the time, Festus L. Osunsade (Advisor, External Relations Department), immediately informed his superiors in Washington, initiating a somewhat tortured process.[9]

The government soon made a more formal request for the Fund to receive an official delegation in Washington. When that news was circulated in the Fund, it quickly became apparent that some of the main creditor countries, including the United States, would oppose Czech membership because of their political opposition to the communist regime. That put the staff in a bind. The Fund could not legally oppose an application on political grounds, but it would make no sense to encourage a government that had no chance of gaining the Board of Governors' approval. After an internal debate, the Managing Director, Michel Camdessus, agreed that the Fund should take the position that it would have to take time—perhaps a lot of time—to study the Czech economy before it could recommend a quota and complete the membership process.[10]

On May 23, 1989, a five-man delegation came to the Fund, led by Jiri Vetrovsky, director of the foreign exchange department in the ministry of finance. The IMF staff team was led by Patrick de Fontenay (Deputy Director, European Department). Neither the Managing Director nor his Deputy joined the discussions. After three days of

[8]The initial approach is described in a memorandum from L. Alan Whittome (Director, European Department) to the Managing Director, "Eastern Europe," March 26, 1987. For the series of 1988 inquiries, see memorandums for files by Barbara Owen, "Request for Information about Membership Procedures," April 20, 1988; by Ronald Hicks, "Czechoslovakia—Request for Information about Membership Procedures," June 29, 1988; by Graham Newman, "Czechoslovakia," July 27, 1988; and by L.G. Manison, "Czechoslovakia: Contacts with the Fund," August 3, 1988. These documents are in IMF archives, EUR/AI Country Files, Box 8, "Czechoslovakia, 1964–1989."

[9]Memorandum for files by Osunsade, "Czechoslovakia: Enquiries about the Fund," March 3, 1989; IMF archives, EUR/AI Country Files, Box 8, "Czechoslovakia, 1964–1989." Also see report by Camdessus to the Executive Board, in minutes of EBM/89/43 (April 24, 1989).

[10]See memorandum from Leo Van Houtven (Secretary and Counsellor) to the Managing Director, "Czechoslovakia," May 12, 1989, with handwritten response from Camdessus; IMF archives, OMD-AD, Accession 1994-0043-0002, "Czechoslovakia 1989."

cordial and detailed meetings, the Czechs went away disappointed. The message was clear: a resumption of Czech membership was not in the cards.[11]

By November 1989, the permanence of the communist government in Prague was increasingly under threat, as was becoming true in countries throughout the region. In those circumstances, the Czech government stepped up the piecemeal attempts at introducing economic reforms, and it decided to renew the case for membership in the IMF. On December 8, a delegation led by Tibor Gedeon, deputy minister of foreign trade, arrived at the Fund and was received by a staff team led by Jack Boorman (Deputy Director, Exchange and Trade Relations Department). Boorman tried to discourage them again, noting tactfully that the approval process would proceed along "two tracks," one economic and the other political.[12] But even as this meeting was taking place, the regime in Prague was being pushed aside. Weeks of massive popular demonstrations had forced the government to open the political process, and a series of small concessions were quickly accumulating into a "velvet revolution" that would soon bring Václav Havel—a leading intellectual in the democracy movement, a world-famous dissident playwright, and a former political prisoner—to power as president.

The velvet revolution obliterated the tentative explorations of the old regime, but it also initiated a serious inquiry that was warmly received in Washington. From that point on, progress was swift. Czechoslovakia applied for IMF membership in January 1990, began receiving technical assistance from the staff in May, held its first free elections in June, and joined the Fund in September.[13]

The resumption of membership for Czechoslovakia was not the end of this convoluted path. Within a year, a separatist movement gained steam in the Slovak region of the federation. When Havel realized he was powerless to stop it, he resigned as president. The two republics then negotiated an amicable divorce, and Czechoslovakia ceased to exist as of January 1, 1993.

At the last minute, a seemingly minor glitch threatened to derail the IMF's efforts to enable the Czech Republic and the Slovak Republic to assume membership smoothly as successor states. According to the Fund's customary formulas, the staff calculated that the quota, the assets, and the liabilities of Czechoslovakia should be divided so that 69.61 percent would go to the new Czech Republic and the rest to the Slovak Republic. Initially, the governments of both republics agreed to that formula, but a political backlash flared up in the Slovak Republic when the agreement was announced. For all other purposes, the two had agreed to split assets and liabilities so that two-thirds would go to the Czech Republic (66.67 percent, not 69.61). The Slovak

[11]Memorandum for files by Hellmut Hartmann (Assistant Director, External Relations Department), "Visit of Delegation from Czechoslovakia," May 26, 1989; IMF archives, OMD-AD, Accession 1994-0043-0002, "Czechoslovakia 1989."

[12]Memorandum for files by Gardner, "Meeting with Czechoslovakia Officials," December 8, 1989; IMF archives, OMD-AD, Accession 1994-0043-0002, "Czechoslovakia 1989."

[13]The official name of the country at that time was the Czech and Slovak Federal Republic, but Czechoslovakia was in common usage.

authorities appealed to the Fund to reconsider, stressing that the difference was of "enormous significance" for them and that they "cannot proceed on this basis." Nonetheless, on December 30, 1992, the Executive Board decided not to budge. For the Fund, the principle of not allowing countries to decide for themselves how to allocate their quotas overrode the political sensitivities of this specific situation.[14] Fortunately, the Slovak authorities did not pursue the matter, and the succession concluded without further ado.

Switzerland

One other European country joined the IMF in this period. Switzerland had a centuries-old tradition of neutrality and independence from international alliances and memberships. As a neutral country in the Second World War, it did not participate in the Bretton Woods conference, and it stayed out of the UN as well.[15] On a wide range of financial matters, however, Switzerland played important roles. Beginning in 1964, the Swiss National Bank was affiliated with the Group of Ten central banks and with the General Arrangements to Borrow. In 1983, it became a full member of the General Arrangements to Borrow (see Boughton, 2001, pp. 898–99). Despite not being a member of the IMF, Switzerland also was a direct creditor to the Fund, lending to support the Oil Facilities, the Supplementary Financing Facility, and stand-by arrangements for Italy and the United Kingdom in the 1970s; the "enlarged access" policy in the 1980s; and the Enhanced Structural Adjustment Facility Trust beginning in 1987. The end of the Cold War lessened the imperative for neutrality and enabled a gradual shift in Swiss public opinion toward deepening this relationship.[16]

The Swiss government applied for Fund membership in May 1990. Acceptance of that application took an unusually long time, owing to a battle over the size of Switzerland's quota and concerns about the effect of its membership on the composition of the Executive Board (see Chapters 15 and 17). Nearly a year later, in April 1991, the Board of Governors finally approved a resolution offering Switzerland membership in the IMF.[17]

That was not the end of the story. Because of persistent opposition to membership by a significant portion of the Swiss population, the Fund recognized that acceptance

[14]Minutes of EBM/92/157 (December 30, 1992), pp. 3–17. The quotations are from a letter sent to Jacques de Groote (the Executive Director for the constituency that included the Slovak Republic) by the Slovak finance minister "under instruction from the Prime Minister." De Groote read the letter into the minutes of the Board meeting (pp. 3–4).

[15]Beginning in 1948, Switzerland had Observer status at the UN and maintained a mission at the UN's New York headquarters.

[16]Kaeser (2004) offers a detailed account of the domestic background to Switzerland's growing internationalism.

[17]See "Switzerland—Membership," EBD/91/71, Suppl. 1 (March 21, 1991), and "Membership for Switzerland," EBD/91/71, Suppl. 2 (April 24, 1991).

of membership by Switzerland still faced hurdles. Instead of the usual six-month deadline, the resolution approved by the Board of Governors gave Switzerland 12 months to accept the offer of membership. In response, the government quickly submitted legislation to parliament, which adopted it in September 1991. Under Swiss law, however, any group of citizens could call for a referendum on the legislation if it could collect 50,000 signatures by petition. A coalition of civil and religious groups succeeded in doing so, partly by appealing to isolationism and partly by denouncing the IMF as an enemy of the poor and disadvantaged because of its allegedly harsh loan conditions. Government officials responded with strong public appeals that the time had come for Switzerland to take a responsible seat in international forums and institutions.

On May 17, 1992, Swiss voters approved by a healthy margin (55 percent in favor) the decision to join the IMF and the World Bank. Less than two weeks later, but a full two years after the initial application, Switzerland finally became a member of the IMF on May 29.[18] With the fourteenth largest quota, Switzerland was the second largest country to join in the 1990s (after the Russian Federation, ninth largest quota on the list).

The Soviet Union and Its Successor States

The major development that transformed the IMF in the 1990s was the breakup of the Soviet Union in 1991. Until then, the absence of one of the largest and most politically powerful countries in the world had by itself prevented the IMF from having the universal role the founders had foreseen.

The Soviet Union had intended to join when the IMF was founded. In January 1944, the Soviet government accepted an invitation from the U.S. administration to send a team of experts to Washington to discuss the draft Articles of Agreement for the Fund and the World Bank. For the Soviets, the object of those several months of meetings with the U.S. Treasury was both to understand the proposal and to ensure that the institutions were designed to accommodate the peculiar features of their economy: central planning, bilateral exchange, and nonmarket pricing. Joining the Fund would potentially give access to credits, but not automatically, and would be accompanied by the downside of revealing to the world how weak the Soviet economy was at the end of the war. It would also give the Soviet government access to information about the U.S. and other economies, but would require it to reveal much about its own. The balance between these considerations was not obvious, but White—as leader of the U.S. Treasury team—did his best to persuade the Soviets that it was in their interests to join. He personally felt

[18]On April 10, 1992, the Executive Board granted Switzerland a six-month extension of the original deadline for acceptance.

very strongly that U.S.-Soviet economic cooperation was critical to securing the peace and that Soviet membership in the Bretton Woods institutions was essential for that cooperation to flower.[19]

White's diplomacy succeeded up to a point. At Bretton Woods, the Soviet delegation was satisfied with the outcome, and the head of the delegation—M.S. Stepanov, the deputy minister of foreign trade—seconded the motion proposed by Britain's John Maynard Keynes to adopt the Articles as the Final Act of the conference. Along with all of the other 43 heads of delegations at Bretton Woods, Stepanov signed the Articles *ad referendum*. Soviet membership now depended only on the signature of Joseph Stalin as head of government, which was expected to be given before the ratification deadline at the end of December 1945. Although Stalin's advisors continued to recommend approval almost right up to the deadline, Stalin personally decided against joining an organization that would force him to disclose basic data about the Soviet economy and that would likely be dominated by the United States and its western European allies.[20]

For four decades—until Mikhail Gorbachev came to power in 1985 and began to open and transform the Soviet economy—no further serious consideration was given to Soviet membership in the IMF. Although the Fund's membership rose from 40 countries at the outset in 1946 to more than 150 in the late 1980s, the Soviet bloc mostly stayed away (Boughton, 2001, pp. 964–65). The Soviet leaders who succeeded Stalin had little incentive to try, and the United States would have blocked any initiative if they had. Gorbachev, however, ushered in a new era that by 1989 made *perestroika* (restructuring) and *glasnost* (openness) into English and not just Russian words. He was keenly interested in getting economic cooperation from the other major industrial countries, and he was prepared to seek membership in the IMF as part of that more general quest. That Hungary (from 1981) and Poland (from 1986) had clearly benefited from their entry into the Fund and were using it to strengthen economic and political ties to the west was an added incentive.

Getting Acquainted

Although Gorbachev's emissaries approached Fund officials on a few occasions in the late 1980s, nothing could come of the effort until the Soviets overcame the

[19]For discussions of these negotiations and of White's interactions with Soviet officials, see Mikesell (1951, 2000); van Dormael (1978); Boughton (2002); and Boughton and Sandilands (2003).

[20]See James and James (1994), which was based on previously unavailable archival documents.

opposition of the U.S. government.[21] The election of George H.W. Bush in November 1988 to succeed Ronald Reagan as U.S. president, and the dismantling of the Berlin Wall a year later, provided the first real opportunity to do so. When senior U.S. officials, including Alan Greenspan (Chairman of the U.S. Federal Reserve System) in October 1989, began traveling to Moscow regularly to meet with their Soviet counterparts, they saw firsthand how the political system was becoming more open and receptive to cooperation with the west.[22] Gorbachev then saw an opening as Bush was preparing to host the annual summit meeting of the Group of Seven (G7) in Houston, Texas. On July 4, 1990, just one week before the summit was to begin, Gorbachev wrote to Bush, asking for a dialogue with the G7 leading toward "long-term agreements on large-scale credit and investment cooperation" aimed at helping the "transition to a market economy in the USSR." As part of that process, Gorbachev noted with satisfaction, "Soviet contacts with the International Monetary Fund, the World Bank, and the Organization for Economic Cooperation are on the increase."[23] Bush responded quickly and positively by persuading his counterparts at the G7 summit to ask the IMF to convene a multiagency task force to prepare a study of the Soviet economy. The study would, of course, mean little by itself, but it would be an essential first step toward financial and other assistance. It would provide potential donors, investors, and creditors with some guidance on the state of the Soviet economy, and it would provide a test of Gorbachev's willingness and ability to open the country's books to outside scrutiny for the first time.

Michel Camdessus, who happened to be at a meeting in Geneva when the G7 communiqué came out, avidly seized the opportunity. One of the IMF's strengths was its ability to act swiftly and decisively when presented with a new challenge, and this was no exception. Within a week, Camdessus had named Alan Whittome (Special Counsellor to the Managing Director) as his personal representative to coordinate work with the other involved agencies: the European Bank for Reconstruction and Development

[21]Staff members from the European Department made a few trips to Moscow in the late 1980s for informal meetings. In November 1988, a Soviet delegation visited IMF headquarters in Washington to collect information about the way the institution functioned and related to its members. The following March, Thomas A. Wolf (Senior Economist, European Department) met with several mid-level officials in Moscow for a further exchange of information. Another occasional contact was Jacques de Groote (Executive Director for Belgium). De Groote traveled frequently to Hungary, which had been a member of his constituency since 1982. In Budapest and other regional capitals, he met informally with Soviet economic officials and provided basic information to them about the IMF. At no time in the 1980s, however, did these officials directly raise the issue of Soviet membership.

[22]For an account, see Greenspan (2007), Chapter 6.

[23]Letter by President Gorbachev to President Bush, July 4, 1990, unofficial translation (by USSR); IMF archives, "USSR Mission and Reports by Mr. Whittome," Accession 91/118, OMD, Box 1, File 21. This letter was cited by Camdessus to Executive Directors as a basis for increased cooperation with the Soviet Union; see minutes of IS/90/16 (July 16, 1990).

in London, the Organization for Economic Cooperation and Development (OECD) in Paris, and the World Bank in Washington.[24] Camdessus had also named Teresa Ter-Minassian (Deputy Director, Fiscal Affairs Department) to direct the work of the interagency task force that would produce the study and to assemble a team of economists from across the Fund. He had spoken with the heads of the other agencies and had arranged for them to meet in New York on July 21 and then to send a joint letter to Gorbachev formally proposing to do the study.

A few days later, Camdessus, Whittome, and Ter-Minassian flew to Moscow. For Camdessus, it was the first of the dozen or so trips he would make to Russia as Managing Director. The team met with Prime Minister Nikolai Ryzhkov and other senior officials to secure arrangements for doing the study and getting access to data. That visit was followed by a large and unwieldy fact-finding mission involving more than 20 experts, mostly IMF macroeconomists, in mid-August. (Subsequent missions were smaller and broader.) In September, a five-man delegation of Soviet officials headed by Viktor Gerashchenko, the chairman of the Gosbank (the Soviet state bank), attended the IMF/World Bank Annual Meetings in Washington as "Special Invitees" for the first time.[25] Before the end of the year, the task force completed its work, and the first-ever detailed study of the Soviet economy (IMF and others, 1990, 1991) was published.

Even the initial budgetary consequences of this undertaking were far from trivial. The joint study alone drew in some two dozen IMF staff members on a full- or part-time basis, many of whom were working at least double time to keep the project on schedule. In August, a new division was established within the European Department, with responsibility for relations with just one member country (Romania); three nonmembers (Albania, Bulgaria, and the Soviet Union); and the Soviet-bloc trade organization, the Council for Mutual Economic Assistance (CMEA, also known as COMECON). Some staff positions were shuffled into the European Department from other departments, but the Executive Board also approved the immediate creation of five new positions. The leading staff expert on the Soviet economy, Thomas Wolf, was put in charge of the new division. This flurry of activity seemed dramatic at the time, but it was only a small down payment on the much larger increases soon to come.

The study by the joint task force opened a window onto the Soviet economy, but it also served to reveal how little was known and how much more had to become known before the Fund or the G7 or anyone else could provide much help. The 1980s had been a rough decade for the Soviet economy, owing to the disastrous occupation of Afghanistan, the weak prices for Soviet oil exports compared with the boom years of

[24]In an effort to reduce tensions among the four institutions, the G7 communiqué did not specifically designate the IMF as the lead agency. Instead, it suggested obliquely that the study "should be . . . convened by the IMF."

[25]Curiously, it was Viktor Gerashchenko's father who had made the case to Stalin in December 1945 for accepting Soviet membership in the IMF and the World Bank (James and James, 1994).

the 1970s, the pressures of trying to keep up with military and technological advances in the west, and seriously incompetent management of the domestic economy. Even Gorbachev's celebrated but piecemeal moves to liberalize the economy had been costly, because the old command structure had weakened without an effective plan to replace it with market institutions. At the end of this long downward slide, what was the real market value of Soviet output, and how much did each republic contribute to it? How badly had the Soviet Union's gold and foreign exchange reserves been depleted? How large were the fiscal and external deficits, and how would they evolve in the next few years? The data were poor, and the bureaucracy that collected them was—to say the least—unaccustomed to the practice of disclosure.

Despite the uncertainties, the joint study suggested some tentative answers, and it conveyed some important policy messages. Perhaps its core recommendation was that it was simply not possible to transform the Soviet economy quickly into a market system—along the lines of the abrupt shift known as the "big bang" already well under way next door in Poland—because the underlying institutions did not yet exist. The rule of law was not well established, industrial regulation and oversight would have to be developed from scratch, the tax system was rudimentary at best, and the central bank lacked the tools to regulate monetary and credit expansion other than by direct allocation and rationing. What was both possible and necessary was to let prices rise rapidly to market-determined levels, establish a social "safety net" to help the poor absorb the shock, and then move aggressively to stabilize the economy.[26]

Special Association

Completion of the joint study led directly to the next question: Was the rest of the world ready to end the isolation of the Soviet Union and accept it as a full member of the international community? At the close of 1990, suspicions still ran deep, especially in the U.S. government but also in Russia's western European neighbors. The clearest symbol of acceptance would be membership in the IMF. The U.S. government was not ready to drop its formidable opposition to that giant step, but it wanted to encourage and help Gorbachev to keep moving in the right direction. With that in mind, on December 12—just a few days before the study was to be released—President Bush announced that the United States wanted the IMF and the World Bank to establish a "special association" with the Soviet Union.[27]

[26]For an overview and discussion, see the minutes of SEM/MTG/91/1 and SEM/MTG/91/2 (January 18, 1991).

[27]At a White House press conference following a meeting with the Soviet Foreign Minister Eduard Shevardnadze, President Bush announced, "I will propose that the World Bank and the IMF work out with the Soviet Union a special association to give the USSR access to the considerable financial and economic expertise of those institutions"; see U.S. Department of State Dispatch, Vol. 1, No. 16 (December 17, 1990); accessed at http://dosfan.lib.uic.edu/ERC/briefing/dispatch/1990/html/Dispatchv1no16.html.

(This initiative came from within the U.S. government and does not seem to have been discussed with the IMF or others before the president's announcement.) Even that level of recognition was opposed by the British and German governments.[28] They would eventually come along, but in the meantime, the U.S. announcement did not lead to any specific follow-up.

During the next several months, while the IMF and other agencies continued sporadically to send expert teams to Moscow to get a deeper understanding of the state of the economy, the unraveling of the political fabric of the Soviet Union began to accelerate. The three Baltic states were already acting much like independent countries, a status that would be officially acknowledged by Moscow in September 1991. More broadly, a power-sharing agreement was signed on April 23, 1991, at the presidential dacha outside Moscow by Gorbachev and the heads of nine of the Soviet republics. Ignoring a boycott by the Baltic countries and three other republics (Armenia, Georgia, and Moldova), the agreement effectively reconstituted the Soviet Union as a federation of sovereign states, each of which could choose freely whether to stay in the union or leave. At the same time, a parallel Russian government was emerging alongside the Soviet one in Moscow, a process that culminated in the direct election of Boris Yeltsin as president of the Russian Republic in June. By that autumn, the Fund missions to Moscow were meeting with both sets of officials, including those of two separate and independent central banks (the Soviet Gosbank and the Central Bank of Russia).

Gorbachev was powerless to stop this rising tide. Instead, he tried to channel it by developing a plan to restructure the Soviet economy as a federation of semiautonomous republics, with a common currency and a common strategy for macroeconomic management. This plan, developed largely by Grigory Yavlinsky, a bright young economist with ties to both Gorbachev and (to a lesser extent) Yeltsin, underwent several transformations. It started as a "400 Days" and then a "500 days" reform plan in 1990 and reemerged a year later as a "Window of Opportunity" and then as a "Grand Bargain" involving a plea for large-scale financial support from the west in exchange for radical internal reforms.[29] In May 1991 and again in June, Yavlinsky went to Washington to try to sell the idea to skeptical U.S. officials and to a more receptive IMF.[30] After being appointed as a deputy prime minister, Yavlinsky spent much of the second half of 1991

[28]File memorandum by Whittome (January 22, 1991) on the January meeting of G7 finance ministers and central bank governors; IMF archives, Accession 91/118, OMD files, "USSR Mission and Reports by Mr. Whittome," Box 1; file "26. G7 Relations."

[29]The fullest treatment is in Allison and Yavlinsky (1991). Many of the details of the plan were developed by a team of academic economists based in Cambridge, Massachusetts, working with Yavlinsky. Leading team members included Graham Allison, Jeffrey Sachs (both of Harvard University), and Stanley Fischer (of the Massachusetts Institute of Technology).

[30]For the U.S. reaction, see Baker (1995), p. 478. For the Fund's reaction, see file memorandum by Wolf, "USSR—Visit of Delegation with the Managing Director" (May 30, 1991); IMF archives, "Russia 1991 - (1)," Country Files, Box 21980, Accession 1995-0180-0007.

developing a plan for Gorbachev (known more simply as the Yavlinsky Plan) for sharing responsibility among the Soviet republics for managing the common currency and the economy of the union.

As the G7 prepared for its next summit meeting, to be held in London in mid-July 1991, relations between the Soviet Union and the outside world had reached a critical moment. On one side was Gorbachev's conception of reforming and liberalizing the Soviet economy with support from the west in the form of large-scale financing and active cooperation on policy advice and technical assistance. Accepting the Nobel Peace Prize on June 5, Gorbachev stressed the "vigorous steps" being taken "to open the country up to the world economy through ruble convertibility and acceptance of civilized 'rules of the game' adopted in the world market, and through membership in the World Bank and the International Monetary Fund."[31] On the other side was an emerging consensus in the G7 to offer public encouragement for reform but only limited financial assistance and only limited recognition in the form of the Special Association with the Bank and the Fund. The rising star of Yeltsin—who traveled to Washington in June to meet with President Bush—complicated Gorbachev's case and strengthened the resolve of the skeptics in the G7.

It was thus a weakened Gorbachev who was invited to attend the London summit. Plaintively, the Soviet leader wrote to each summit leader on July 12 (three days before the meeting was to start), "I am pinning high hopes on the upcoming meeting in London. There is every reason to believe that it may mark a turning point in the efforts to bring about the Soviet Union's organic incorporation into the world economy." Acknowledging that the Soviet economy was in crisis, he continued, "It is our strong feeling that the crisis can be overcome if we make a radical shift toward market economy, carry out destatization and privatization of property, remove multiple bans and constraints, stimulate work effort and business activity, support and foster entrepreneurship." The letter concluded by stressing the importance of membership in "international economic organizations" including the IMF and indicating his willingness to take all necessary steps toward that end. In response, however, all that the unimpressed G7 was prepared to put forward was a vague offer "to assist the integration of the Soviet Union into the world economy" and an invitation to hold further discussions.[32]

In a last-ditch effort to retake control of the process, Gorbachev took both the IMF and the G7 by surprise by formally applying for full membership as soon as the summit

[31]Mikhail Gorbachev, "Nobel Lecture" (June 5, 1991); accessed at http://nobelprize.org/nobel_prizes/peace/laureates/1990/gorbachev-lecture.html.

[32]"Personal Message from President Mikhail S. Gorbachev to Heads of State or Government Attending the G7 Meeting in London"; and the summit communiqué, "Economic Declaration: Building World Partnership"; accessed at http://www.G7.utoronto.ca/summit/1991london/.

concluded.[33] Despite a negative reaction from the U.S. government (Treasury Secretary Nicholas Brady publicly called the application "a tactical error" and "counterproductive"), Camdessus responded favorably and quickly sent John Odling-Smee (Deputy Director, European Department) to Moscow to open discussions on establishing a formal Special Association as a first step toward membership.[34]

On August 19, 1991, a putsch against Gorbachev by hardliners in the Soviet leadership, and Yeltsin's central role in quashing the coup, altered the dynamics of the Soviet drive toward IMF membership. Within the G7, at least three countries—France, Germany, and Italy—now reportedly favored rapid acceptance of Gorbachev's application, though the British and the Americans continued to favor a more limited approach. As a compromise, on August 29 President Bush and Prime Minister John Major met at Bush's summer home in Kennebunkport, Maine, and agreed that the Special Association agreement should be accelerated. The idea was that the Soviets would first work out a credible reform program in conjunction with the IMF and the World Bank. The implementation of that program would induce an increasing level of support from the G7 and other countries and would lead eventually to full membership. Major flew to Moscow to convey the Anglo-Saxon strategy to Gorbachev,[35] followed a few days later by U.S. Secretary of State James Baker. Even without full concord in the G7, the road was clear for the Fund to proceed.

Now under intense pressure from the United States to move quickly in the face of mounting instability in Moscow,[36] Camdessus raced to get the Special Association finalized before the IMF/World Bank Annual Meetings began in Bangkok in mid-October. On September 12, Massimo Russo (Director, European Department) and other staff arrived in Moscow to negotiate the final text of the proposed Special Association. They quickly reached agreement with Yavlinsky, and while they were still

[33]The application was dated July 15, 1991, the opening day of the summit, but it was not delivered to the IMF until July 22; see "Union of the Soviet Socialist Republics (U.S.S.R)—Application for Membership," EBD/91/225 (July 23, 1991).

[34]See memorandum from Massimo Russo to management, "USSR—Back-to-Office Report" (August 13, 1991); IMF archives, "Russia 1991- (1) Country Files," Box 21980, Accession 1995-0180-0007.

[35]Major's rather dispiriting message, in the words of the British ambassador to Moscow, was "pay your debts, tighten your belt, and then we *might* be able to help" (Braithwaite, 2002, p. 249); emphasis added.

[36]Less than two months after complaining about Gorbachev's "counterproductive" application for membership, Brady told reporters in mid-September that he felt the IMF was "dragging its feet. . . . I'm a little disappointed in the bureaucratic inertia . . . it's the most important event in the last 100 years and . . . we still haven't got started" (*Financial Times*, September 18, 1991, p. 2). He then harangued the staff in Moscow and the Managing Director on the same theme, arguing that the Fund should just "invade the place" with staff and advice and not worry about the details or the eventual outcome; see memorandum from Russo to the Managing Director, "USSR—Back-to-Office Report" and attachments (September 24, 1991); IMF archives, OMD files, "Russia 1991- (1) Country Files," Box 21980, Accession 1995-0180-0007.

in Moscow, Gorbachev agreed to the text[37] and submitted it on September 30 to the State Council for final approval. That set the stage for the Executive Board to approve it on September 25 and for Camdessus to go to Moscow on October 5 for a signing ceremony with Gorbachev.[38]

For the rest of 1991, even though the Soviet Union had already unraveled as a viable political entity, both the G7 and the IMF continued to treat it publicly as if it were on its way to becoming a full participant in the world economy. At the beginning of November, the Fund established a permanent office in Moscow, headed by Jean Foglizzo, a former official of the French finance ministry. For the next several weeks, a massive number of Fund staff from seven different departments, along with external consultants and experts from the World Bank, the OECD, the Bank for International Settlements, the European Communities, and western central banks, descended on Moscow. Their goal was to gather detailed information in preparation for designing a comprehensive reform program and helping the Soviet Union—or its successors—prepare for IMF membership. In December, Camdessus announced that he was establishing an entire new department with five divisions "to conduct work on the USSR and its constituent republics, and the Baltic states." Odling-Smee was picked to head the new "European II" department.[39]

Meanwhile, the republics that constituted the Soviet Union were gradually but steadily gaining sovereignty. On September 5, the Soviet Congress of People's Deputies voted to transfer most state powers from the central government to the republics, and it established a State Council to carry out the transfer. The Council then recognized the independence of the three Baltic states as its first official act. Of the 12 remaining republics, 10, including Russia, soon signed a treaty of economic union, based on the Yavlinsky Plan. On October 28, Yeltsin announced his own plan for reforming and liberalizing the Russian economy. On December 8, Russia, Ukraine, and Belarus signed an agreement in Belavezha, Belarus, establishing the Commonwealth of Independent States, a loose association that almost all the other republics would soon join, at least temporarily.

With shocking suddenness, the door had blown open. On December 25, 1991, Gorbachev resigned as president of the Soviet Union. On December 26, the Supreme Soviet formally dissolved the union. U.S. President Bush extended diplomatic recognition to the Russian Federation as the successor state to the USSR and announced his support for Russia to assume the Soviet Union's permanent seat on the UN Security Council. Before the sun set that day, the Soviet embassy in Washington notified the

[37]On October 5, 1991, President Mikhail Gorbachev and Managing Director Michel Camdessus exchanged letters, giving force to the Special Association agreement. The text of the agreement may be found at http://www.imf.org/external/pubs/ft/history/2011/index.htm.

[38]See minutes of EBM/91/125 (September 18, 1991), EBM/91/132 (September 25, 1991), and EBM/91/142 (October 11, 1991). The draft agreement was circulated as "Special Association between the U.S.S.R. and the Fund – Terms and Conditions," EBS/91/161 (September 18, 1991).

[39]Also see Chapter 17 on this change in the context of the IMF's organizational structure.

Michel Camdessus (left) and Mikhail Gorbachev shake hands after signing the Special Association agreement in October 1991. (IMF photo)

IMF that Russia was assuming all the rights and obligations of the Soviet Union in its relationship with the Fund, including the Special Association.[40]

Fifteen New Members

In the end, the Soviet Union never did become a member of the IMF, but all 15 of the countries that emerged from it (Figure 2.1) soon did. The three Baltic countries applied first. Within three weeks of recognition of their sovereignty by the State Council of the Soviet Union in September 1991, Estonia, Latvia, and Lithuania submitted letters to the Fund applying for membership. Ukraine applied as soon as the union was dissolved in December, going so far as to have a letter from President Leonid Kravchuk hand delivered to the Fund on December 27. Russia submitted an application on January 7, 1992, and the other 10 newly independent countries followed suit within two months.

The IMF's initial reaction to this influx of applications was to redeploy staff and other resources from throughout the institution to work on this region. The new

[40]See "Russian Federation—Communication Regarding Special Association," EBD/91/325 (December 27, 1991). Paragraph 6 of the Special Association agreement (which may be accessed at http://www.imf.org/external/pubs/ft/history/2011/index.htm) provided for relations to develop with the republics and not just with the union.

Figure 2.1. The Baltic Countries, the Russian Federation, and Other Countries of the Former Soviet Union

Source: IMF graphics section.
Note: In most commentaries of the early 1990s, including in the IMF in 1992, these 15 countries were usually referred to simply as "the former Soviet Union," or FSU. The Baltic countries resisted that label because their status was different from the others. They had been forcibly annexed to the Soviet Union in 1940, and most major countries had never acknowledged the legitimacy of the annexation. Consequently, the IMF eventually decided not to use the term "former Soviet Union" by itself, nor the abbreviation FSU. Instead, it settled on the awkward phrase, "the Baltic countries, Russia, and other countries of the former Soviet Union." The acronym BRO was deemed to be acceptable in internal documents but not in publications.

department, European II, absorbed most of this shift, and the main technical assistance departments—Central Banking, Fiscal Affairs, Statistics, and the IMF Institute—redeployed staff within their own units and stepped up their hiring of outside consultants. For the next fiscal year, which began in May 1992, the Executive Board approved a substantial budget increase (14.5 percent more than the previous year) so that work on other areas would not suffer and so that the Fund could continue to expand its work on the new members, including setting up small Resident Representative offices in each capital city.

The Special Association agreement provided a framework for the Fund to offer technical assistance to each of the countries of the former Soviet Union without waiting for them to complete the process of becoming IMF members. To get the membership process under way, a critical task for the Fund was to calculate a set of quotas. The difficulty was that many of the statistics upon which the Fund would usually base those calculations—GDP, international trade, exchange rates, and

official reserves—were missing, outdated, or unreliable. After collecting all available data, the staff computed an aggregate quota for the whole of the former Soviet Union and then divided it up based on a "distributive key" that represented a best guess as to the relative sizes of output, trade, and finances of each country. Those calculations then were scaled upward to give Russia 3 percent of total Fund quotas, following the political agreement discussed in Chapter 7. Because Russia accounted for an estimated 63 percent of the total for the former republics, that decision resulted in an aggregate quota for the group of 4.76 percent of total quotas as of April 1992 (Table 2.2).[41]

On April 27, 1992, the Board of Governors approved membership resolutions for 14 of the 15 countries. Azerbaijan's application was delayed slightly by ongoing political turmoil there, but the Governors approved that resolution a week later.[42] Each country then had to accept the conditions before it could become a member. Lithuania responded within a few days, and the others completed the process through the spring and summer of 1992. By the time Turkmenistan became a member on September 22, the whole of the former Soviet Union was in the Fund except for one former republic. Tajikistan was embroiled in a civil war that delayed the government's response for a full year. It became the last of the group to join, on April 27, 1993.

Another issue had to be resolved quickly. Russia's quota was large enough that it could elect an Executive Director by itself, and the others all had to join a constituency with other members. Technically, all 14 countries could have banded together to form a new group and elect a Director, but that was not their desire. If they had wanted to stick together, the Fund would have had to find some way to accommodate the new constituency.[43]

As discussed in Chapter17, this influx of new members could not be accommodated smoothly within the 22-seat structure of the Executive Board. After much debate, the size of the Board was increased to 24 on the understanding that Russia and Switzerland

[41]For an overview of the Fund's preparations, see "States of the Former Soviet Union—Status of Membership and Fund Activities," ICMS/Doc/38/92/6 (April 23, 1992). The total of initial quotas was approximately $6.3 billion (SDR 4,559 million). A general increase in quotas took effect later in the year, raising each quota by 50 percent.

[42]Azerbaijan's political situation was discussed at EBM/92/49 (April 9, 1992). Approval of a request for IMF membership required a majority of votes cast by IMF Governors. No Governor voted against or abstained from any of these 15 resolutions.

[43]The group's proposed quotas, plus their basic votes (250 per country), would have given the 14 countries (excluding Russia) a total of 20,330 votes in an election of Executive Directors. That total was slightly larger than the 18,940 votes of the francophone African countries, which was the smallest existing constituency. Because the presence of the francophone African countries on the Board was essential for the conduct of Fund business, some rearrangement of constituencies would have been required.

Table 2.2. Russia, the Baltic Countries, and Other Countries of the Former Soviet Union: Entry into Membership, Representation, and Initial Quota Shares

				Initial Quota Share (as of April 1992)	
Country	Application Date[a]	Membership Date[b]	Executive Board Constituency	Percentage of Group	Percentage of Fund Total
Russian Federation	January 7, 1992	June 1, 1992	Russia	63.1	3.00
Ukraine	December 27, 1991	September 3, 1992	Netherlands	14.6	0.69
Belarus	February 10, 1992	July 10, 1992	Belgium	4.1	0.20
Kazakhstan	January 13, 1992	July 15, 1992	Belgium	3.6	0.17
Uzbekistan	March 3, 1992	September 21, 1992	Switzerland	2.9	0.14
Azerbaijan	January 7, 1992	September 18, 1992	Switzerland	1.7	0.08
Georgia	March 11, 1992	May 5, 1992	Netherlands	1.6	0.08
Lithuania	September 12, 1991	April 29, 1992	Nordic-Baltic	1.5	0.07
Latvia	September 27, 1991	May 19, 1992	Nordic-Baltic	1.3	0.06
Moldova	January 24, 1992	August 12, 1992	Netherlands	1.3	0.06
Armenia	January 13, 1992	May 28, 1992	Netherlands	1.0	0.05
Kyrgyz Republic	January 24, 1992	May 8, 1992	Switzerland	0.9	0.04
Tajikistan	March 3, 1992	April 2, July 1993	Switzerland	0.9	0.04
Turkmenistan	February 26, 1992	September 22, 1992	Switzerland	0.7	0.03
Estonia	September 9, 1991	May 26, 1992	Nordic-Baltic	0.7	0.03
Aggregate				100.0	4.76

Source: *Annual Reports*, IMF documents, and author's calculations.
[a]Date the application was recorded at the IMF.
[b]Date that membership became effective.

would occupy the additional seats. The Russian authorities preferred not to form a multicountry constituency, and in any case most of the other new members were looking westward for their affinity grouping. Five countries joined the new Swiss

constituency; the three Baltic countries became part of the Nordic group; and the others teamed up with either Belgium or the Netherlands (see Table 2.2).[44]

The Breakup of Yugoslavia

The Socialist Federal Republic (SFR) of Yugoslavia was an original member of the IMF and was one of the few socialist countries that remained in the Fund throughout the Cold War.[45] It was a federation of several dissimilar republics, held together principally through the strong rule and relatively good economic and social management of President Josip Broz Tito. After Tito's death in May 1980, both the economy and the political cohesiveness of Yugoslavia gradually crumbled. Repeated attempts by the IMF throughout the 1980s to prevent an economic and financial collapse by lending money and offering policy advice were ineffective. By the beginning of the 1990s, as Yugoslavia's internal weaknesses were compounded by the collapse of the Soviet-bloc trading system, the outlook was becoming hopeless.[46]

The formal breakup of Yugoslavia began in June 1991 with the secession of Croatia and Slovenia. After the Yugoslav army failed to retake the territory, most major countries recognized both republics as independent states. Slovenia then applied for IMF membership on January 30, 1992. Croatia soon followed suit and applied for membership on April 2. Meanwhile, the Republic of Macedonia declared its independence in December 1991 and applied for Fund membership on June 8, 1992. The Republic of Bosnia and Herzegovina faced a more delicate situation, in that it contained three distinct ethnic populations with different interests and views on independence and on the way the republic should be governed if it did become independent. Nonetheless, a referendum resulted in overwhelming support for a split from Yugoslavia. The government declared independence in March 1992 and applied for Fund membership on April 20. One week later, the two remaining republics, Serbia and Montenegro, announced that they were constituting the Federal Republic of Yugoslavia as the

[44]After these additions, the Nordic constituency became known as the Nordic-Baltic constituency.

[45]The Kingdom of Yugoslavia (1918–41) was dissolved when the country was occupied by the Axis during the Second World War. A new government was established in 1943, and Yugoslavia joined the IMF as the Democratic Federation of Yugoslavia. It became the Federal People's Republic of Yugoslavia the next year. The "Socialist Federal Republic" appellation was adopted in 1963, when a new constitution was approved.

[46]The previous History, Boughton (2001), covers three main strands of the IMF's work with Yugoslavia through the 1980s. The general strategy for designing economic policy and lending conditions in an economy without market-based pricing or conventional indirect macroeconomic policy tools is discussed briefly in Chapter 13, pp. 604–05. The specific strategy for using the real effective exchange rate as a stabilization tool is also covered in Chapter 13, pp. 574–78. The use of "enhanced surveillance" to help restore normal relations between Yugoslavia and its commercial creditors is examined in Chapter 10, pp. 432–35.

Figure 2.2. Successors to the Socialist Federal Republic of Yugoslavia

Source: IMF graphics section.

successor to the larger federation. In a brief period, one country had dissolved into five (Figure 2.2).[47]

This flurry of activity presented the IMF with an unprecedented situation when the several states that emerged from Yugoslavia all wished to continue as separate members. How would one membership be converted into five?[48] The Fund had four options. First, it could declare the SFR Yugoslavia to exist no longer as a state and thereby terminate the membership. Each new country could then apply to become a member in its own right. Second, the Fund could declare the Federal Republic of Yugoslavia (Serbia and Montenegro) to be the successor state and thus the heir of the current membership with all of its quota, assets, and liabilities. In that case, each of the seceding countries could apply for new memberships. Third, the Fund could declare the

[47]In the following decade, the Federal Republic split again, as shown in Figure 2.2, with the secession of Montenegro in 2006 and the separation of Kosovo in 2008.

[48]The closest precedent was the breakup of the United Arab Republic in 1961. That country had been formed in 1958 through the merger of Egypt and Syria. During the three years of the United Arab Republic's existence, the IMF had dealt with it for most purposes as if it were still two states. When the union dissolved, its membership status simply reverted to its former terms; see "Secession of Territories and Dissolution of Members in the Fund," EBD/92/146 (July 14, 1992), pp. 2–3. The breakup of Czechoslovakia, which presented similar issues, came a few months after that of Yugoslavia. The dissolution of the Soviet Union was different in that it had not been a member of the Fund.

former SFR Yugoslavia to be succeeded jointly by the five new states, each of which would automatically be a member with a share of the original member's quota, assets, and liabilities. Fourth, as a variation of that third option, it could divide Yugoslavia's membership but agree to the succession separately for each of the new countries, only after each one qualified.

In September 1992, the UN took the first option, stripping Yugoslavia of its membership and inviting the Federal Republic to apply as a new member.[49] That route was less appealing to the IMF because it would have required activating procedures to dispose of assets and settle liabilities, part of which were by then in arrears (see Chapter 16). The second and third options were even less appealing, in part because of the remote likelihood that the Federal Republic would be able or willing to settle arrears and stay current on its obligations.[50] The UN Security Council was imposing a trade embargo and other sanctions on the Federal Republic as part of an international effort to force a settlement of the armed conflict in Bosnia and Herzegovina, and it was becoming increasingly clear that neither of those two republics would be able to normalize its financial relations with the rest of the world anytime soon.

In December 1992, the Executive Board took the fourth option, which by that time was the only feasible path.[51] It declared that the member state, the SFR Yugoslavia, had been dissolved and had ceased to exist; that is, the new entity, the Federal Republic of Yugoslavia, was not the same country. Each of the five new states would be joint successors and would accede to a share of the Yugoslav membership, but only when each one had fulfilled the requirements of membership. The quota and the financial position of each new member would be a share of the total, with that share being determined by the Fund using its standard quota-based formulas. The shares proposed by the staff and ultimately accepted by the Executive Board and all the new members were as follows:

[49]Each international agency of which Yugoslavia was a member had to make such a determination, based on its own charter and mandate. In addition to the UN, the European Communities and the European Bank for Reconstruction and Development decided that the SFR Yugoslavia had ceased to exist as a state. Those decisions, however, were not binding on the IMF; see "Issues of State Succession Concerning Yugoslavia in the Fund," EBS/92/282 (November 20, 1992), p. 2.

[50]In November 1992, the SFR Yugoslavia had outstanding obligations to the IMF totaling \$216 million (SDR 155.6 million, or 25 percent of quota). It also had used all of its cumulative SDR allocation (SDR 155.2 million). An additional complication under the second option was that the Fund has no power to reduce a member's quota without the member's consent. The full quota of the SFR Yugoslavia would continue to belong to the Federal Republic despite its reduced economic and physical size, while each new state would have to apply for membership and be assigned an additional quota.

[51]These decisions were made "in principle" at EBM/92/146 (December 4, 1992). The staff then prepared a formal decision, which was enacted after further discussion at EBM/92/150 (December 14, 1992).

Federal Republic of Yugoslavia (Serbia and Montenegro)	36.5 percent
Croatia	28.5
Slovenia	16.4
Bosnia and Herzegovina	13.2
former Yugoslav Republic of Macedonia	5.4

Initially, the Fund gave each country one month to agree to its share and to certify that it was prepared to accept the rights and obligations of membership. As expected, the two most economically developed countries—Croatia and Slovenia—met that deadline, paid off their shares of the outstanding arrears, and became members on January 15, 1993 (retroactive to December 14, 1992, the date of the Executive Board decision on succession). Delays in the others forced the Fund to extend the deadline repeatedly for the next eight years.

The Macedonian situation took just a little longer than Croatia and Slovenia because of a political dispute with its southern neighbor. The country applied for membership under the name Republic of Macedonia. The government of Greece objected because it disputed the ethnic identity of the new country and was concerned that statehood under the name of Macedonia could inflame separatist passions in contiguous regions of Greece. In the Fund, Renato Filosa (Italy), the Executive Director whose constituency included Greece, opposed the proposal to offer membership until such time as a name could be agreed on between the Fund and the country "not including the term Macedonia." That position was not supported by other Directors, but everyone wanted to find an acceptable compromise.[52] Eventually, the Board and the Macedonian government agreed to adopt a provisional name that did include Macedonia but not without qualification. Hence, on April 21, 1993, "the former Yugoslav Republic of Macedonia" or FYR Macedonia became a member of the IMF, bringing total membership to 176. (Part of the compromise was that "former" would be an integral element of the country name but would not be capitalized except in the abbreviation FYR.) Although that name was expected to have a short life, it remained in effect throughout the 1990s and beyond.

The tragic persistence of war between major ethnic groups in Bosnia and Herzegovina prevented that country from forming any normal international relations for more than three years. Finally, after North Atlantic Treaty Organization (NATO) forces intervened with a bombing campaign in 1995, the warring parties initialed a peace accord in Dayton, Ohio (United States), and agreed to have its terms enforced by a NATO peacekeeping force. As described in Chapter 6, the Fund was already at work in Sarajevo while the Dayton negotiations were still being organized. Despite the dangerous physical conditions, the mission quickly arranged for the authorities to be

[52]See minutes of EBM/92/146 (December 4, 1992), particularly pp. 4–10. Also see "Issues of State Succession Concerning Yugoslavia in the Fund," EBD/92/282 (November 20, 1992).

able to settle their financial obligations and complete the membership process before the end of the year.[53]

The only component of the original member still in abeyance was the Federal Republic of Yugoslavia (Serbia and Montenegro). The president of Serbia, Slobodan Miloševic, engaged the country in a number of disastrous military engagements in Bosnia and Herzegovina, Kosovo, and other parts of the former FSR Yugoslavia. Those offensives and the government's incompetence at managing the economy prevented any lasting *rapprochement* with the European Union, NATO, or the UN throughout the 1990s.[54] Not until Miloševic was defeated in the 2000 elections (soon followed by his arrest and deportation to the International Court of Justice at the Hague to be tried for war crimes and crimes against humanity) was a new government able to regain international support. The Federal Republic of Yugoslavia (Serbia and Montenegro) finally became a member of the IMF on December 20, 2000.[55]

The Major Remaining Nonmembers

Neither North Korea nor Cuba applied for membership in the 1990s, but both countries initiated informal discussions aimed at breaking down a part of the diplomatic wall separating them from the international economic, financial, and political systems.

North Korea

The catalyst for talks between the IMF and North Korea was the latter's application in April 1997 to become a member of the Asian Development Bank. The Republic of Korea (South Korea) publicly welcomed the initiative, but Japan and the United States opposed it. The application lapsed, but in the meantime the North Korean authorities had also expressed interest in learning more about the IMF.

[53]The settlement of arrears is discussed in Chapter 16. Also see Chapter 5 for a discussion of the Fund's initial lending to Bosnia.

[54]The UN lifted its restrictions in 1996 in response to the Dayton peace accords, but the United States and other countries continued to apply sanctions that prevented the Federal Republic from gaining entry into international organizations. Armed conflict over the Kosovo region of Serbia in 1998–99, a war that eventually drew in NATO forces, further prevented any progress toward peace or stability.

[55]Like the other new states, the date of the Federal Republic's membership was made retroactive to December 14, 1992, to preserve the integrity of the disposition of the former federation's financial position. In 2006, the country split again when Montenegro seceded. Montenegro became a member of the IMF in January 2007. Kosovo seceded from the Federal Republic in 2008 and became a member of the Fund in June 2009.

Because North Korea was a member of the UN, the Fund's liaison office in New York afforded a convenient and discreet venue for making contact. In late July, Justin B. Zulu, director of the New York office, met with North Korea's ambassador to the UN and other senior officials. That meeting led to a formal request for the Fund to send a staff team to Pyongyang on a fact-finding mission. Management responded positively a week later. Up to this point, only a few of the most directly interested Executive Directors were informed of these contacts. The full Executive Board was notified a few days later during an informal meeting.[56]

On September 6, 1997, Margaret R. Kelly (Senior Advisor, Asia and Pacific Department) and two other staff flew to Pyongyang via Beijing for a week of intensive discussions. They provided officials with detailed information about the IMF and its membership requirements, and they received some information and data on the country's economy. Normally, a visit like this would be followed by an application for Fund membership, and there were some indications in that direction. The data the officials provided to the Fund indicated that output had fallen by half in the preceding four years and that the condition of the economy was dire. These officials expressed interest in gaining access to financial help and other assistance from both the IMF and the World Bank.[57]

Shortly after the staff visit concluded, South Korea's Governor in the Fund, Finance Minister Kyong Shik Kang, gave his government's blessing to membership for North Korea. At the IMF/World Bank Annual Meetings in Hong Kong SAR, Kang acknowledged that the idea was "sensitive," but he concluded that it "would expedite [North Korea's] integration into the world economy and contribute significantly to the political and economic stability of East Asia. The Korean Government welcomes North Korea's future participation in these [Bretton Woods] institutions and is ready to support and assist North Korea in the process of meeting the prerequisites of accession."[58]

Support from South Korea did not diminish opposition from Japan and the United States, in the face of which an application from North Korea could not have fared any better than its attempt to join the Asian Development Bank. These exchanges did lead, however, to a formal decision in 1998 for the IMF to provide technical assistance to North Korean officials.[59] Fund staff then made arrangements

[56]For the background to these developments, see memorandum from Bijan B. Aghevli (Deputy Director, Asia and Pacific Department) to the Acting Managing Director, "North Korea," August 11, 1997; IMF archives, Historian's files.

[57]"Democratic People's Republic of Korea—Fact-Finding Report," EBS/97/204 (November 12, 1997).

[58]Statement by the Hon. Kyong Shik Kang, Governor of the Bank and the Fund for Korea, at the Joint Annual Discussion; Annual Meetings Press Release No. 42, September 23–25, 1997; IMF archives, Historian's files.

[59]"Democratic People's Republic of Korea—Request for Technical Assistance," EBS/98/63 (March 30, 1998), and Decision No. 11703-(98/41), adopted April 6, 1998. In compliance with U.S. law, the U.S. Executive Director abstained from approving the decision.

to conduct a one-week workshop in Beijing for those officials, explaining the IMF in more detail. In principle, that workshop was to be followed later by a longer training course in economics. But just as the staff was completing the arrangements for the workshop, the country's authorities requested that it be postponed. The workshop never took place, and the Fund had no further official relations with North Korea for at least another decade.[60]

Cuba

Unlike North Korea, Cuba had no official contact with the IMF during this period, but it did seek and have informal discussions with at least one Fund official.

Cuba had earlier spent nearly 20 years as an IMF member. It participated in the 1944 Bretton Woods conference and joined the Fund as an original member the following year. Fulgencio Batista's government borrowed small amounts in 1957 and 1958, and the last of those loans was still outstanding when Fidel Castro overthrew the Batista regime in January 1959. In 1960, the United States reacted to a variety of alleged economic, political, and human rights concerns by imposing a trade embargo that severely limited the opportunities for profitable international trade. From that point on, the Cuban economy became increasingly dependent on financial support from the Soviet Union. The authorities repeatedly sought to delay repayment of the IMF credits, but in 1963 the Fund finally insisted on settlement. Castro refused, and in 1964 he withdrew Cuba from the Fund. Cuba did, however, gradually repay the loans over the next five years (see Horsefield, 1969, Vol. 1, pp. 548–50; and Boughton, 2001, p. 758). Relations then went dormant.

The Soviet Union's demise in 1991 threw the Cuban economy into a recession that was probably as deep as those experienced in the countries of the former Soviet Union and in the former socialist countries of Eastern Europe. Although Castro was not prepared to discard socialism as an economic framework, he did introduce a few reforms to allow some private enterprise and additional relations with market economies. In that context, he put out a tentative feeler for contacts with the IMF.

In 1993, the Cuban authorities invited Jacques de Groote to visit Havana for a series of meetings with officials of the finance ministry and the central bank. De Groote had served as the Executive Director for Belgium and other countries

[60]See memorandum from Kelly to the Managing Director, "North Korea—Workshop Postponed," October 6, 1998, and related documents on arrangements; IMF archives, OMD-AI, Accession 2002-0270-09, "North Korea through 1999." In 2000, the Fund invited North Korea to send a delegation to attend the Annual Meetings in Prague as "Special Guests." Again, after much discussion, the authorities decided to decline the invitation. The next year, a hardening of diplomatic relations between North Korea and the United States induced the IMF to suspend its efforts to develop further contacts.

since 1973. His constituency had expanded in 1982 to include Hungary, in 1990 to include Czechoslovakia, and in 1992 to include Belarus and Kazakhstan. He was known to have had good relations with Communist Party officials in those and other countries before and during the transition and as a maverick within the IMF in his willingness to deal independently with countries outside his constituency.[61] He therefore was probably viewed in Cuba as someone who might bring an open and positive attitude to the discussion.

De Groote made two trips to Havana, in his personal capacity, in June and November 1993.[62] He met with Castro and other officials and gave them many IMF publications so that they could become familiar with the Fund's work on the process of making a transition from central planning to a market economy. On his return, he reported privately to Camdessus, to the U.S. and European Executive Directors, and to a few staff. Because these visits had been undertaken as a personal initiative, he did not make a formal report to the Executive Board.

Following this initiative, the Cuban government repeatedly sent out indirect feelers to the IMF through the UN's Resident Representative office in Havana. It was not seeking talks on membership, but it was ready to welcome technical assistance from the Fund. Owing to the delicate political status of Cuba, the Fund declined to act on these requests.[63] Even if the Fund had offered its technical advice, it was clear that a return to membership was not an option. As had become clear in the application for membership from Poland in 1981 and in the North Korean episode in 1997, U.S. opposition could constitute a formidable barrier.[64] In this case, though, the expression of interest lapsed without the strength of that barrier being tested.

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[61]Specifically, de Groote had worked closely with the government of Zaïre while serving as Executive Director in the IMF; see Boughton (2001), p. 806n123; and Pound (1990), p. 1.

[62]De Groote was accompanied by Frank Moss, a senior staff member in his IMF office. This account is based primarily on the report that de Groote and Moss prepared for their constituency authorities on their return from the November trip (and later circulated to a number of journalists); see "Winds of Economic Change in Havana," November 23, 1993; IMF archives, OMD-AI, Accession 1996-0129-0002, "Cuba." Also see "Cuba's Slow Road to Reform," *Economist*, February 5, 1994.

[63]See various documents in IMF archives, OMD-OTM, Accession 2002-0270-02, "Cuba." In 1994 and again in 1995, reporters—apparently aware of these feelers—asked Camdessus if the Fund was engaged in membership discussions with Cuba. On both occasions, he denied that any such talks were taking place.

[64]Poland's membership application was blocked from 1981 to 1986 because of the suppression of the Solidarity movement and the imposition of martial law in Poland; see Boughton (2001), pp. 986–91. Although the formal approval of an application requires only a simple majority vote by the Board of Governors, strong political opposition can result in an indefinite delay before a resolution is submitted to the Governors; see Boughton (2001), p. 989n68.

Appendix: Country Name Changes, 1990–99

Effective Date[a]	Previous Name	New Name[b]
November 1990	People's Republic of Mozambique	Republic of Mozambique
August 1991	Democratic Kampuchea	Cambodia
October 1991	People's Republic of the Congo	Republic of Congo
February 1992	Mongolian People's Republic	Mongolia
June 1993	Afghanistan	Islamic State of Afghanistan[c]
August 1993	Kyrgyzstan[d]	Kyrgyz Republic
August 1995	Viet Nam	Vietnam
October 1995	Republic of Kazakhstan	Republic of Kazakstan (new spelling only)
February 1996	Republic of Bosnia and Herzegovina	Bosnia and Herzegovina
May 1996	Republic of Georgia	Georgia
June 1997	Zaïre	Democratic Republic of the Congo
July 1997	Republic of Kazakstan	Republic of Kazakhstan (reversion to previous spelling)
August 1997	Western Samoa	Samoa

Source: IMF documents.

[a]The effective date is the date an official notice was circulated within the IMF, except in cases in which that notice specified a different effective date.

[b]This table lists changes in the official country names used in the IMF. In some cases, different names were in use in the UN or other international agencies. Changes resulting from the breakup or merger of countries are not included here but are discussed in the text where relevant.

[c]Changed to the Islamic Republic of Afghanistan in 2005.

[d]Within the Soviet Union, this republic was known by various names in English, usually either the Kyrgyz Soviet Socialist Republic or Kirgiziya. On seceding from the union in August 1991, the government changed the country's name to Kyrgyzstan (sometimes spelled Kyrghyzstan). It became a member of the IMF under that name on May 8, 1992. The following year, the government adopted a new name, the Kyrgyz Republic, which the Fund recognized on August 30, 1993.

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3

Working Well with Others? The IMF as Team Player

The IMF is an independent agency, but it does not function in a vacuum. As the IMF involved itself more deeply and broadly with countries' structural policies in the 1990s, the issue of political accountability became more pronounced.

The management of the IMF is formally accountable to member countries through its Executive Board and Board of Governors. These bodies are typically delegated oversight through the countries' ministries of finance and central banks. That left four potential gaps in the 1990s. First, the ability of Executive Directors or Governors to influence IMF management was limited by the complexity of reaching consensus within those two Boards. Second, national parliaments or other legislative bodies had only an indirect role through whatever influence they had over the administration of the government. Third, even within each national government, the influence of ministries other than finance—including those with responsibilities for social expenditure or foreign affairs—was indirect and limited. Fourth, other supranational bodies, including the United Nations (UN), had little role in the IMF other than through the power to persuade Fund management or, perhaps, world opinion.

Compounding these limitations was the absence of an effective multilateral political organization to oversee the spectrum of agencies concerned with various aspects of international policy. The UN Security Council played that role on security issues, but no similar body existed for economic and social issues. The Economic and Social Council of the UN (ECOSOC) was created for this purpose in 1946, but with limited powers. Work by multilateral agencies—including the IMF—on economic development, international trade and finance, and the economic and social effects of issues such as population growth, depletion of natural resources, and climate change was conducted in a "silo" pattern by a host of separate agencies. These circumstances enabled the IMF to react quickly in response to financial crises, but made it more difficult to develop comprehensive solutions to underlying problems.

In August 1993, Jacques Delors (president of the European Commission) proposed the creation of an Economic Security Council, analogous to the UN Security Council. This new council would have replaced or supplemented ECOSOC to coordinate and oversee the work of the IMF, the World Bank, the International Labor Organization (ILO), the General Agreement on Tariffs and Trade (GATT), and other multilateral

agencies with economic responsibilities. In Delors's view, such a council would be able to integrate and reconcile countries' economic and social objectives, which would otherwise continue to be a source of conflict.[1] Delors pressed for the plan for at least two years, but it did not gain traction within the groups of major industrial and creditor countries or within these agencies, and it gradually slipped from view.[2] However, an ever-increasing need for mutual cooperation, consultation, and collaboration remained. This chapter reviews the way in which those processes played out in the course of the decade.

No Agency Is an Island

The IMF interacted regularly with a broad range of multilateral institutions. Its most direct and frequent interactions were with its "sister" organization, the World Bank Group. Although the Fund and the Bank had a common parentage, they did not always find it easy to work together effectively.

The Bretton Woods Twins

The original idea, as conceived at Bretton Woods, was quite simple. The World Bank ("Miss Bank," in John Maynard Keynes's felicitous phrase) would make long-term loans, mostly for large public sector projects, initially for postwar reconstruction and later for economic development. Her twin brother ("Master Fund") would lend money for short periods to help countries stabilize their finances.[3] The two activities were to be quite distinct, and there would be no need for the two to collaborate or even consult each other on a regular basis. Over time, as the IMF began lending for longer periods and advising countries on structural as well as macroeconomic policies, and as the World Bank began lending for general development—"structural adjustment" and poverty reduction—more than for specific projects, each inevitably began encroaching on the other's traditional territory. Cooperation and collaboration became essential, but cultural identities and institutional

[1]See "Créer un Conseil de Sécurité Économique," interview with Jacques Delors, *Ouest-France* (August 28, 1993). Delors formally launched the proposal at a speech in Lorient, France, the following day. Also see "EC Chief Proposes Economic Security Council," Reuters News (August 28, 1993).

[2]IMF Managing Director Michel Camdessus opposed the idea on the grounds that it would undermine the authority of the Fund's Executive Board; see his report at EBM/96/12 (February 12, 1996), p. 3.

[3]Keynes christened the IMF and the World Bank as "twins" in a speech at the inaugural meeting of Governors, in Savannah, Georgia (United States), in March 1946. The speech was reproduced in full in Harrod (1951), pp. 631–32.

jealousies made an effective relationship difficult to achieve (see Boughton, 2001, pp. 995–1005; and Malan, 2007, Section 2).

By 1990, the two institutions, which faced each other across 19th Street in northwest Washington, DC, had agreed in very broad, general terms how to divide responsibilities between them. The 1989 "Concordat" assigned responsibility to the IMF for all purely macroeconomic issues and to the World Bank for most structural issues.[4] That left a lot of ambiguity as fodder for turf disputes. The Bank still regarded any issue that affected a country's development prospects as its legitimate concern, even if it was a purely macroeconomic matter such as exchange rate policy or a financial issue such as the strength and oversight of banks and other financial institutions. The IMF still regarded any issue that affected a country's financial stability as its legitimate concern, even if it was a purely structural matter about which it had relatively little expertise, such as privatization policy. Maintaining an overvalued exchange rate could damage a country's competitiveness in international markets and thus weaken the government's ability to carry out a development program supported by the Bank. Failure to privatize inefficient, corrupt, or heavily subsidized state-owned enterprises could damage a country's financial stability and thus weaken the government's ability to carry out an economic reform program supported by the IMF. Such overlaps gave rise to legitimate issues and made a strict delineation of responsibilities impractical and impossible to define properly.

The overlap in responsibilities increased substantially in the 1980s and even more so in the 1990s. The chief causes in the 1980s were the 1980 decision by the World Bank to begin making Structural Adjustment Loans, the onset of the international debt crisis in 1982, and the establishment of the Structural Adjustment Facility (SAF) and the Enhanced SAF (ESAF) in the Fund in 1985 and 1987, respectively. In the 1990s, further increases in overlap were engendered by the involvement of both institutions in the transition economies of the countries of the former Soviet Union and other formerly socialist states; by the persistence of payments arrears to both institutions by several countries; by the establishment of the Heavily Indebted Poor Countries (HIPC) Initiative as a joint venture in 1986; and by the intensification of the Fund's interest in structural issues in both its surveillance activities and its conditional lending.

In April 1992, the Managing Director of the Fund (Michel Camdessus) and the President of the World Bank (Lewis T. Preston) issued an addendum to the Concordat spelling out the way their institutions were supposed to work together in assisting the states of the former Soviet Union. The addendum committed the staffs to cooperate at all stages of work, from the assessment of countries' needs and the prioritization of reforms, to the development and negotiation of programs, coordination with other

[4]For the full text of the Concordat, see Boughton (2001), pp. 1056–62.

institutions whenever needed, and the assessment and mobilization of overall financial assistance.[5]

The addendum to the Concordat outlined an ambitious agenda. If successful, it would usher in a new era of cooperation far beyond the standard practice up to that point. In particular, the addendum envisaged the preparation of "comprehensive tripartite documents," which would set out a medium-term economic strategy for each country. These documents were to be prepared jointly by the staffs of the Fund and the Bank and the national authorities. Management saw this process as essential for proper coordination—not only of the two Bretton Woods institutions, but also the European Bank for Reconstruction and Development (EBRD) and donor countries—for assisting countries that were going to need to put major structural changes in place while trying to maintain some measure of financial stability.

The precedent for tripartite documents was the preparation of Policy Framework Papers (PFPs) for countries applying for loans on concessional terms from the special funds administered by the IMF and the World Bank. Since the time the PFP process had been set up in 1986, some Executive Directors from middle-income developing countries had feared that the Bank and the Fund might try to extend the process and subject them to the same requirements. When Alexandre Kafka (Brazil) saw the proposed addendum, he objected and called for a discussion of it by the Executive Board. He got a little support on the substantive issue, but most Directors agreed with Camdessus that a system of formal coordination was necessary in these circumstances. Jack Boorman (Director, Policy Development and Review Department) assured the Board that the new process would be applied flexibly, and the Board agreed to go along with it.[6]

The addendum seems to have served to spur cooperation, but the envisaged practice of jointly producing formal documents similar to PFPs did not materialize.[7] The informality of Bank-Fund collaboration had the advantage of not impeding either institution's assistance to transition countries, but problems slipped through the cracks occasionally. Perhaps the most serious example arose in 1995, when the Russian Federation inaugurated a privatization program eventually known as "loans for shares." As explained in Chapter 7, this scheme allowed a few well-connected Russians to buy large state-owned enterprises at auction, at prices well below true market value.

[5]"Bank/Fund Collaboration on the States of the Former Soviet Union," EBD/92/97 (April 29, 1992).

[6]Minutes of EBM/92/67 (May 27, 1992), pp. 18–35. Support for Kafka's objection came from Godert A. Posthumus (Netherlands), who was concerned about a blurring of institutional responsibilities (p. 26), and from Renato Filosa (Italy), who was concerned about adding a time-consuming layer of bureaucracy to the Fund's work practices (p. 28).

[7]When an Executive Director asked John Odling-Smee (Director, European II Department) whether the staff would prepare a tripartite document for Russia, he replied that "there did not appear to be an immediate need to formalize arrangements in a document. The staff would certainly continue to work closely with the World Bank on structural issues and on the program in general." Minutes of EBM/92/102 (August 5, 1992), p. 33. That turned out to be the general approach.

Although the Fund was negotiating terms for a stand-by arrangement at the time, no one on the staff questioned the propriety or wisdom of the scheme, apparently because they believed that the World Bank staff would spot any problems. The scheme gave rise to a powerful class of extremely wealthy individuals popularly known as oligarchs, with disastrous economic, political, and social consequences. Whether the Bretton Woods institutions could have done anything to stop it is doubtful, but the failure to raise an alarm was a clear institutional fault.

The Fund and the Bank continued to refine their collaboration procedures throughout the 1990s. As an early example, the approval of Rights Accumulation Programs (RAPs) in 1990 for countries with payments arrears to the Fund (see Chapter 16) required close collaboration for clearing arrears. Even if a country was current in its obligations to the World Bank, the Bank's help was needed to arrange for donor financing at the completion of the program. The 1991 RAP for Zambia raised an additional issue. The Bank was prepared to lend to Zambia through its Special Program of Assistance for Africa, but that would require Zambia to repay the Bank first and the Fund only later. On an ad hoc basis, the two institutions agreed on procedures for the sequential clearance of arrears and for an overall plan to provide ongoing financial assistance afterward.[8] A year later, in parallel with the RAP for Peru, the Bank developed a "workout" arrangement that enabled it to prepare a lending program once Peru cleared its arrears to both institutions.

In 1995, the staffs jointly developed new procedures for cooperating on public expenditure issues, including annual reviews of general policy advice and meetings between country teams to develop common agendas, priorities, and work programs.[9] The next year, the Group of Ten (G10) commissioned Mario Draghi (director general of the Italian Treasury and chairman of the G10 finance deputies) to prepare a report on financial stability in emerging economies. An outcome of that report, which was endorsed at the Group of Eight (G8) summit meeting in Denver, Colorado (United States), in June 1997, was a request for the Bank and the Fund to improve their cooperation in their efforts to strengthen financial systems in emerging markets. This was an area in which both the Bank and the Fund had interests and responsibilities, but the staffs had not yet developed uniform procedures to ensure that their work was comprehensive but not duplicative.

In August 1997, just as the Asian financial crisis was unfolding, the staffs circulated a joint paper responding to the Draghi report. Although written in broad and general terms, it promised close collaboration in all relevant areas, from the general evaluation of member countries' financial systems to advice on restructuring and to the handling of crisis situations. On the whole, the Executive Board was not convinced that these promises would suffice to produce adequate cooperation in what was becoming a

[8]For an overview, see "Six-Monthly Report on Overdue Financial Obligations to the Fund—Progress under the Strengthened Cooperative Strategy," EBS/91/41 (March 12, 1991), pp. 8–16.

[9]"Bank-Fund Collaboration on Public Expenditure Work," EBD/95/123 (September 7, 1995).

crucial field, especially for the Fund. The Board called for further work, and in September 1998 the staffs produced a more detailed set of proposals. That report set out specific procedures and established a Bank-Fund Financial Sector Liaison Committee to oversee the process.[10] As discussed in Chapter 4, the work of the committee soon led to the joint Financial Sector Assessment Program, which became a major ongoing Bank-Fund program in the following decade.

Also in 1997–98, the Fund commissioned an internal review and then an external review of ESAF operations. Both reviews called for better coordination with the World Bank Group's International Development Association. The two institutions were lending to the same low-income countries—the Fund in support of macroeconomic stabilization, the Bank in support of development programs—both with the overall goal of promoting sustainable economic growth. Coordination was hampered not only by a lack of formal guidance and procedures, but also by suspicion and antagonism on the part of staff on both sides of 19th Street. To untangle this knot, the staffs proposed a pilot program. For a few select countries, they would try to work together and with the national authorities to develop comprehensive strategies aimed at accelerating reforms, particularly for public expenditure and financial sectors; limit any adverse social effects of reforms; and attract additional credits, including from international private sector investors, to help finance longer-term productive investment.[11]

Finally, in time for the IMF/World Bank Annual Meetings in September 1998, Camdessus and World Bank President James D. Wolfensohn issued a comprehensive report on collaboration that reaffirmed and updated the Concordat.[12] It summarized and synthesized the procedural changes put in place since 1989 and formalized the institutional arrangements for ensuring effective collaboration. By then, as the document explained, Camdessus and Wolfensohn were meeting on a set schedule to discuss any issues that had to be resolved at the highest level. Similarly, the Fund's Deputy Managing Directors and their Bank counterparts (known as Managing Directors) were meeting regularly. At the operational level, Boorman and Masood Ahmed (Vice President of the World Bank and head of its Poverty Reduction and Economic Management Network) had responsibility for guiding the collaboration process.

Judging how well collaboration worked in the 1990s is a matter of perspective. Camdessus's and Wolfensohn's working relationship appeared to be cordial and productive, but Wolfensohn reportedly spoke disdainfully about Camdessus within the Bank and even talked about preparing for "war" with the IMF (Mallaby, 2004,

[10]The first paper was "Bank-Fund Collaboration in Strengthening Financial Sectors," SM/97/200 (August 1, 1997). It was discussed at EBM/97/85 (August 22, 1997). The follow-up paper was "Review of Bank-Fund Collaboration in Strengthening Financial Sectors," SM/98/224 (September 2, 1998).

[11]See "Distilling the Lessons from the ESAF Reviews" (July 1998), accessed at http://www.imf.org/external/pubs/ft/distill/index.HTM. For more on the ESAF reviews, see "From the ESAF to the Poverty Reduction and Growth Facility, 1999" in Chapter 13, p. 643.

[12]This report may be accessed at http://www.imf.org/external/pubs/ft/history/2011/index.htm.

pp. 209–10). Some IMF mission chiefs had effective working relationships with the corresponding country directors in the Bank, while others found the Bank staff to be slow to respond or indifferent to the Fund's needs. Correspondingly, some Bank staff found their Fund counterparts to be dogmatic and quick to draw conclusions. The glass was half full, but the shortfall was a continuing source of concern.[13]

Other Multilateral Agencies

In addition to its interactions with the World Bank, the IMF had regular but generally less frequent contacts with a wide range of other multilateral agencies. This group included organizations concerned with general macroeconomic and structural issues such as the Organization for Economic Cooperation and Development (OECD), where IMF staff regularly attended meetings of the Economic Policy Committee and its working parties; and various regional groups such as the European Union and the Association of South-East Asian Nations. It included institutions concerned primarily with finance, such as the Bank for International Settlements (BIS), where the Fund's Managing Director often attended meetings of the governing board, and the two staffs occasionally interacted on projects; and the Paris Club of official bilateral creditors, which depended heavily on the Fund for certification of sound policies in countries applying for debt relief. In the context of concessional lending and the clearance of arrears, the group included collections of donor countries, both in the formal sense of the aid agencies of groups such as the European Union and in the more ad hoc formulation of donor groupings for specific low-income countries. It included agencies concerned primarily with trade, in particular the GATT and its successor, the World Trade Organization (WTO). It included the UN General Assembly and several UN agencies such as the UN Development Program (UNDP), the International Labor Organization, and the UN Children's Fund (UNICEF), where staff collaborated from time to time.[14]

In the 1990s, the IMF's relations evolved in important ways vis-à-vis the UN. In addition, three new institutions—the European Bank for Reconstruction and Development, the World Trade Organization, and the Financial Stability Forum—required close cooperation from the Fund.

[13]In 2007, the Fund and the Bank commissioned an external review panel, chaired by Pedro Malan (former finance minister of Brazil), to recommend additional measures to improve collaboration; see Malan (2007).

[14]Relations with most of these agencies during the 1980s were covered in Boughton (2001), pp. 1005–17.

United Nations

As a "specialized agency" of the United Nations, the IMF operates under an agreement with the UN that grants it autonomy in all of its decisions. Although the UN General Assembly has no authority over the IMF, the Fund has a responsibility to consult and interact with the UN and its other relevant agencies on matters of mutual interest. That liaison became more frequent and detailed in the 1980s and still more so in the 1990s. Throughout this period, the Managing Director participated in meetings of the UN's Administrative Council on Coordination and in ECOSOC, both of which met regularly at the agency head level. On two occasions in 1999, the Fund's Executive Directors met as a group with the ECOSOC ambassadors. The Fund maintained liaison offices at UN headquarters in New York and in Geneva, where the GATT and a number of UN agencies were located. Fund staff, both from those offices and from headquarters, participated in agency deliberations. Under the terms of a 1989 agreement, the Fund conducted UNDP-financed training and technical assistance projects for member countries.[15] Also at the country level, the Fund's Resident Representatives generally maintained working relationships with the UN's local staff.[16]

As the IMF accepted a more extensive role in advising countries on structural policies, it relied increasingly on the UN to establish goals and standards on many issues. Camdessus participated in a series of high-level UN-sponsored international conferences in the 1990s that bore on topics that were becoming more important to the IMF. Three conferences were particularly consequential:

- The UN Conference on Environment and Development, held in Rio de Janeiro, Brazil, in June 1992, provided a framework for the IMF's new focus on environmental sustainability in its policy advice.[17]
- The International Conference on Population and Development, held in Cairo, Egypt, in September 1994, resulted in a Program of Action, which the Fund supported through its efforts to persuade countries to cut back on unproductive spending and increase spending on social programs.[18]
- In March 2005, the UN-sponsored World Summit for Social Development in Copenhagen, Denmark, reinforced the impetus for the Fund to help

[15]See "Technical Cooperation Agreement between the IMF and the UNDP," PR/89/33 (July 17, 1989. For the text of the Executing Agency Agreement, see http://untreaty.un.org/unts/60001_120000/25/13/00048628.pdf.

[16]An overview of the Fund's relations with the UN in the 1990s was set out in "IMF-UN Collaboration," SM/97/114 (May 7, 1997).

[17]"United Nations Conference on Environment and Development," SM/92/147 (July 31, 1992); and "Outcome of the United Nations Conference on Environment and Development," DC/92/18 (September 1, 1992). Camdessus addressed the plenary session of the summit conference, and two IMF staff attended. On the Fund's focus on environmental issues, see Chapter 4.

[18]Camdessus's speech to the Cairo conference (MD/Sp/94/11, September 7, 1994) stressed the importance of "high-quality growth" as an overarching objective of the Fund's policy advice.

countries redirect spending toward social programs. It also spurred the Fund to strengthen its liaison with the ILO in Geneva.[19]

In addition, staff participated in the Fourth World Conference on Women in Beijing (September 1995). That meeting produced a detailed declaration that included several goals that further informed the Fund's work on social issues. More directly, it persuaded Camdessus to initiate a program to promote greater diversity on the staff, directed by a newly appointed Special Advisor on Diversity. That program led to substantial increases in the proportion of women in senior managerial posts at the Fund.[20]

One practical field in which the IMF played an important role in the work of the UN was in international statistics. Notably, Fund staff participated actively in the preparation of the 1993 revision of the System of National Accounts, which serves as the main conceptual framework for the consistent preparation and presentation of macroeconomic data across countries. The 1993 System of National Accounts was developed and published jointly by the UN, the IMF, the World Bank, the OECD, and the European Commission.

Regional Development Banks

At the beginning of the 1990s, three regional development banks provided specialized lending, technical assistance, and training to their respective member countries: the African Development Bank, based in Abidjan, Côte d'Ivoire; the Asian Development Bank (AsDB), with headquarters in Manila, the Philippines; and the Washington-based Inter-American Development Bank. In general, the IMF's interactions with these institutions were similar to those with the World Bank, though less formalized and less frequent. Whenever the Fund was lending to a country that was also borrowing from one of the regional banks, the staffs would coordinate their efforts, but on a case-by-case basis as circumstances warranted.

The dismantling of the Berlin Wall in November 1989 inspired President François Mitterrand of France to call for the establishment of a new regional bank to help finance the restructuring of Central and Eastern European countries into market economies. An international agreement established the EBRD the following year, and it began operating in 1991 with headquarters in London.

Collaboration between the IMF and the EBRD began immediately. EBRD staff participated in the preparation of the initial study of the Soviet economy, which was led by the IMF and published by the World Bank in 1991. (The Paris-based OECD also

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[19]See Camdessus's speech to the Copenhagen conference, MD/Sp/95/4 (March 7, 1995). The staff also prepared and circulated a background paper for the conference, "Social Dimensions of the IMF's Policy Dialogue," SM/95/13 (January 19, 1995). In October 1995, the Interim Committee spelled out specific avenues for cooperation between the Fund and the ILO; communiqué (October 8, 1995), paragraph 12; *Annual Report 1996*, p. 203.

[20]For a review, see speech by Margaret R. Kelly (Director, Human Resources Department) to a special session of the UN General Assembly (June 5, 2000); accessed at http://www.imf.org/external/np/speeches/2000/060500a.htm.

participated.) In 1992, the EBRD and the IMF joined forces with the BIS, the OECD, the World Bank, and the government of Austria to found the Joint Vienna Institute as a training center for officials from transition countries. In the field, the Fund and the EBRD coordinated their technical assistance operations, with each concentrating on its own area of expertise. Throughout the 1990s, the EBRD focused primarily on countries' restructuring needs, while the Fund had primary responsibility for macroeconomic policy advice.

World Trade Organization

The WTO came into being in January 1995 as a replacement for the GATT. The IMF had a well-established formal relationship with the GATT, under which the GATT had oversight of member countries' trade restrictions and the Fund had oversight of currency exchange restrictions related to international trade. (A gap existed in that system, in that the membership of the GATT was much smaller than that of the Fund.) The two institutions shared information routinely and served as observers in certain meetings of the other's principal bodies. The Fund supported the various rounds of GATT negotiations to reduce tariffs and other trade barriers, both publicly and by helping countries adopt policies conducive and appropriate to open trade regimes. Fund staff participated actively in the GATT Committee on Balance of Payments Restrictions.

The creation of the WTO did not fundamentally alter these working relationships, except that the WTO had a permanent Geneva-based secretariat with which the IMF could interact more extensively. The Fund immediately signaled its readiness to intensify working relationships accordingly.[21] In December 1996, the WTO held its first ministerial conference, in Singapore. Camdessus represented the IMF, gave an upbeat speech about the complementarity of the WTO and the Fund, and signed a formal agreement of cooperation that defined the future working relationship.[22]

Relations proceeded smoothly, although the Fund got entangled in the web of antiglobalization protests that were aimed principally at the WTO in the late 1990s. Those protests culminated in the disruption of the WTO ministerial meeting in Seattle, Washington (United States), at the end of November 1999. When the street protests grew violent, many delegates were unable to get to the meetings, which were then seriously delayed. Both Camdessus and Stanley Fischer (First Deputy Managing Director) attended the Seattle meetings. Camdessus—when he was finally able to deliver his address—made the case for open trade as essential for the reduction of global poverty: exactly the opposite of what many of the protesters seemed to believe.[23]

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[21]See minutes of EBM/95/1 (January 6, 1995), especially the Chairman's concluding remarks, pp. 56–59; and "Fund/WTO Collaboration—Next Steps," EB/CGATT/95/1 (March 9, 1995).

[22]This agreement may be accessed at http://www.imf.org/external/pubs/ft/history/2011/index.htm.

[23]See "A New Round of Trade Negotiations: An IMF Perspective," remarks by Camdessus to the Third Ministerial Conference of the WTO in Seattle, MD/Sp/99/26 (November 30, 1999).

For the time being, the message was swallowed up by coverage of the demonstrators outside. Several years would elapse before trade liberalization would fully regain its momentum. In the meantime, antitrade demonstrators continued to try to disrupt the semiannual ministerial meetings of IMF and World Bank Governors held in Washington and abroad.

Fischer participated in a closed meeting in Seattle hosted by U.S. President Bill Clinton, who was trying to develop a strategy for integrating environmental and labor standards with the WTO's trade agenda. The IMF, the WTO, the World Bank, and several other multilateral organizations were implementing an "integrated framework" for providing trade-related technical assistance to low-income countries. The idea was to help the least-developed countries use international trade productively as part of their overall strategies to reduce poverty and achieve strong and sustainable growth. The Seattle meeting kicked off a general interagency review of the framework, which up to that point had fallen short of its objectives.[24]

Financial Stability Forum

In the late summer and fall of 1998, the world economy was being rocked by a financial crisis that nearly brought down the Russian banking system and the too-large-to-fail hedge fund Long-Term Capital Management (LTCM), and that was threatening Brazil and other emerging markets. In response, the Group of Seven (G7) finance ministers and central bank governors asked Hans Tietmeyer (president of Deutsche Bundesbank) to prepare a report and recommend ways to enhance cooperation among national supervisory and regulatory agencies with oversight of financial institutions. Tietmeyer's report, issued in February 1999, noted that much work was already being done in various institutions, including the IMF. It rejected the notion that "sweeping changes" were needed. Instead, it recommended establishing a Financial Stability Forum (FSF) to bring together and coordinate existing efforts and thereby avoid both wasteful duplication of effort and the risk of gaps in coverage (Tietmeyer, 1999).

The G7 ministers and governors endorsed the Tietmeyer report at a meeting in Bonn, Germany, on February 20.[25] At the time, it appeared that relations between the FSF and the IMF were likely to be rocky. From the IMF's perspective, locating the new group in Basel, Switzerland, posed a potential threat to the legitimacy of the Fund's own growing responsibilities in oversight of financial sectors, and the FSF's limited membership could not be expected to provide global coverage. For their part,

[24]The Integrated Framework for Trade-Related Technical Assistance to Least Developed Countries was launched in October 1997 by the IMF, the UNDP, the UN Conference on Trade and Development (UNCTAD), the World Bank, the WTO, and the International Trade Centre. For Fischer's report on the Seattle meetings, see minutes of EBM/99/129 (December 3, 1999), pp. 3–4.

[25]"Communiqué of the G-7 Finance Ministers and Central Bank Governors," FO/DIS/99/24 (February 22, 1999); accessed at http://www.g7.utoronto.ca/finance/fm022099.htm.

the financial regulators setting up the FSF saw the Fund as an inappropriate institution for carrying out this task. The challenge was to find a way to delineate responsibilities so that each agency could contribute effectively in its own sphere.

Camdessus participated in the Bonn meeting, expressed his support for the establishment of the FSF, and agreed that the Fund would participate in the work of the new group. The G7 founded the FSF as a small organization with a secretariat based at the BIS in Basel and staffed by people consigned by the BIS, the IMF, the World Bank, France, and Singapore.[26] Andrew Crockett (general manager of the BIS) was named to chair the FSF for a three-year term. The forum itself was to meet roughly twice a year, normally in conjunction with the spring and fall meetings of the Interim Committee, beginning with a meeting at IMF headquarters in Washington on April 14, 1999. In September, the Interim Committee granted the FSF observer status and invited Crockett (who was already an observer in his capacity as head of the BIS) to report on the progress of the forum's work. By that time, membership in the forum had already expanded beyond the G7 to include Australia, Hong Kong SAR, the Netherlands, and Singapore.

For the first stage of its work, the FSF established three working groups to develop recommendations relating to "highly leveraged institutions" (hedge funds and the like), international capital flows, and offshore financial centers. IMF staff participated in each of these committees, which began work during 1999 and issued reports the following April.[27] By then, a generally smooth working relationship had been established.

Other Stakeholders

In addition to the institutions with which it had formal relationships, the IMF engaged from time to time with other stakeholders in the world economy. Many of those stakeholders were critical of the Fund's focus on financial stability, which seemed to conflict with the imperative to raise spending on health, education, and other basic human needs. More specifically, many people perceived the Fund to be focused excessively on imposing "austerity" on unfortunate countries, either through its conventional macroeconomic adjustment programs or through "shock therapy" in transition countries. The dominance of large creditor countries in the governance of the IMF reinforced the view that the Fund favored their interests over those of smaller and poorer countries.

[26]In a related development in 1999, IMF staff participated in the work of the BIS Basel Committee on Banking Supervision; see "Staff Participation in Architecture Meetings," SEC/CIRC/99/72 (June 29, 1999).

[27]For more on the initial work of the FSF and the role of IMF staff, see "Financial Stability Forum—An Update of Activities—April-October 1999," SM/99/277 (November 19, 1999).

Engaging with one's critics is never easy. Part of the Fund's agenda in reacting to criticism was outreach, to try to clarify its views on the nature of the relationship between financial stability and economic development. For that purpose, Fund officials met occasionally with parliamentary and other legislative bodies, though usually informally to avoid conflict with the normal channels of communication that ran through a country's monetary authorities. Beginning in 1995, the Fund conducted a regular series of training seminars, mostly through the Joint Vienna Institute, for legislators from transition countries. A second part of the Fund's engagement agenda was to draw on the assistance and expertise of civil society, religious leaders, and academia to refine the Fund's policies, policy advice, and loan conditions to take better account of each country's social needs. The project to turn the Fund into a "listener" did not sit comfortably with the traditional culture of the institution, but it was taken seriously in the 1990s and was promoted by the Fund's management team.

Nongovernmental Organizations

Until the late 1990s, staff interaction with nongovernmental organizations (NGOs) was intermittent and often testy on both sides. Neither the Fund nor most NGOs saw the other as a natural ally, and the Fund's culture and traditions of secrecy and independence only increased the width of the gap.[28] As the Fund began opening up, publishing more of its papers and information on its website and in hard copy, and expanding its outreach programs, relations began to improve.

A notable example of interaction with NGOs came in 1999, when the IMF and the World Bank undertook to enhance the HIPC Initiative. This debt-relief program for low-income countries was being heavily criticized as offering too little relief too slowly to too few countries. The institutions were committed to improving it but were reluctant to weaken the strict qualification requirements. How could they deliver greater relief more quickly, while still ensuring that the relief would not be wasted by countries with inadequate policy reforms?

As part of the preparation for a review of the initiative, the staff solicited inputs from the public through a posting on the IMF website and by holding a series of public seminars in both developing and advanced countries. Within a few months, more than 40 NGOs, several multilateral agencies, and a number of individuals had submitted

[28]Aside from outreach activities by staff, most of which were organized by the External Relations Department, Camdessus made a point of addressing the broad ethical and social context of the Fund's work in speeches to NGOs. In 1994, for example, he addressed a Washington meeting of church leaders on "an integrated approach to development: ethics, the economy, and the social issue," MD/SP/94/1 (January 13, 1994). In Dublin that summer, he addressed the Irish Debt and Development Coalition (a group of 70 NGOs working to persuade creditors to forgive debts of low-income countries) on "economic progress in the developing countries and the role of the IMF," MD/SP/94/7 (June 10, 1994). He glumly reported that the audience in Dublin seemed "skeptical . . . driven more by ideology and a bureaucratic approach . . . than by a desire to listen to the Fund's point of view"; minutes of EBM/94/54 (June 17, 1994), p. 3.

comments and proposals, which the staff then circulated in full to the Fund's Executive Directors. Organizations submitting material included advocacy NGOs such as Bread for the World, Friends of the Earth, Jubilee 2000, the Mozambican Debt Group, and Oxfam International; religious groups such as the All African Council of Churches, Catholic Relief Services, Christian Aid, and the Vatican; multilateral institutions; and academics and other involved individuals. To promote the digestion of these submissions, the staff summarized the key points in a separate paper.[29]

By presenting the NGO proposals to the Executive Board in a framework that stressed what could be achieved and how the proposals might improve the HIPC Initiative, the staff allied itself with at least some of the civil society concerns about the limitations of the original initiative. At the same time, some of the advocacy groups lobbied the U.S. Congress and other national legislative bodies in favor of increasing budget support for the initiative. After some discussion, the Fund and the World Bank approved a number of changes to accelerate the relief schedule and sharply increase the size of the program and thus the depth of debt relief that it could provide (on which, see Chapter 13). The outreach program and the implicit alliance with NGOs were judged to be a success. When the Fund undertook to revise its conditionality guidelines in 2001, it again drew heavily on interaction with external stakeholders to develop specific proposals.

Academia

Throughout the 1990s, the most troubling criticism of the IMF came from highly respected academic economists rather than from individuals or groups pursuing political interests. In most cases, disputes arose over specific issues about which legitimate opinions could differ. The most prominent examples related to the Fund's handling of the East Asian financial crises in 1997–98. As output losses piled up in Thailand, Indonesia, and the Republic of Korea, many economists questioned whether the Fund had reacted appropriately or had just jerked its institutional knee and demanded austerity as it allegedly had in every previous crisis. Even if the tone of the debate was occasionally less than genteel and the censure too often overstated (as discussed in Chapters 11 and 12), the Fund had to—and did—take the academic criticism to heart and refine its models and its policy advice accordingly.

As a general practice, the IMF frequently reached out to academic economists for both technical and policy advice. As Director of Research from 1986 to 1991, Jacob A. Frenkel—a highly regarded academic economist in his own right—recruited an impressive group of university professors, including Joshua Aizenman, Guillermo Calvo, W. Max Corden, and Assaf Razin, to spend a few months or years at the Fund

[29]"HIPC Initiative—Perspectives on the Current Framework and Options for Change," EBS/99/52 (April 2, 1999); and Suppl. 1, Volumes I and II (April 12, 1999). The World Bank conducted a similar outreach campaign in parallel with that of the Fund.

pursuing their own research on Fund-related projects and mentoring the career staff. Frenkel's successor, Michael Mussa, continued that practice and brought in senior economists such as Willem Buiter, Barry Eichengreen, and Nouriel Roubini. Separately, the IMF Institute organized internal training courses and seminars that were often taught by leading academics.

Interaction between the IMF and external analysts was not always smooth, especially when the Fund was thrust into a central role in managing financial crises. In a few cases, criticism of the Fund became sufficiently entrenched to make productive dialogue difficult. One such case involved Harvard University Professor Jeffrey D. Sachs. In the 1980s, Sachs advised several governments in Latin America that were negotiating programs with the IMF, most prominently Bolivia. That work sometimes put him in conflict with the Fund because Sachs pressed for debt relief for Latin America long before the Fund and its major creditor members were willing to go along. Most of the time the relationship was cordial. Sachs was an occasional visiting scholar in the Fund's Research Department, and he generally supported the Fund's macroeconomic policy advice. In 1989–90, Sachs was an advisor to the newly elected government of Poland, and his input was valued by the Fund staff team as they helped the authorities devise a radical reform program. This tense but productive interaction then deteriorated.

In the early 1990s, Sachs was an advisor to the Russian government and was lobbying publicly for massive additional financial support for Russia. Throughout 1991 and 1992, he tried to convince western governments, particularly that of the United States, to recognize that Russia needed both direct financial aid and forgiveness of much of its Soviet-era debt, or else its economy would face a rapid slide into the chaos of hyperinflation. As detailed in Chapter 7, the amount of western aid fell far short of what Sachs and others calculated to be needed. By the fall of 1992, Sachs was convinced that the IMF was a major part of the problem, because of a tendency to just "take directions from western governments" and not act on what it knew to be an impending humanitarian disaster. In a letter to the *Washington Post* coauthored with David Lipton, Sachs complained about the Fund's "dreary record" in Russia, its "blunders," and its "remarkably bad advice." Getting more personal, he urged the U.S. Congress to condition any quota increase for the Fund on "fundamental management changes." The Fund quickly returned fire, and the *Post* published a reply by Deputy Managing Director Richard D. Erb on what he called the "faulty analysis" of Lipton and Sachs.[30]

For the rest of the decade, Sachs continued to criticize the IMF, mostly from afar. Although many on the staff readily acknowledged that much of his criticism was well taken, they also felt that the passion level had to be toned down before a useful

[30]Sachs and Lipton (1992), p. C1; and Erb (1992), p. A18. Lipton was a former IMF staff member who was then a Fellow at the Woodrow Wilson International Center for Scholars. The "take directions" accusation was in Sachs (1991).

dialogue could resume.[31] Eventually, a *rapprochement* of sorts occurred. In 2002, Sachs accepted an invitation to speak at the Fund's annual research conference, at which he called the Fund's record in low-income countries "dismal" but offered specific suggestions on ways to improve it.[32] In 2003, the Executive Board invited him back for a private seminar on the Fund's role in the global effort to achieve the Millennium Development Goals.

Another prominent case involved Joseph E. Stiglitz. Having already achieved academic fame as professor of economics at Princeton, Oxford, and Stanford universities, Stiglitz went to Washington in 1993 to join the Council of Economic Advisers under U.S. President Bill Clinton. He became council chairman in 1995, and in 1997 he was tapped to be Senior Vice President and Chief Economist at the World Bank. In that last post, with what the journalist Sebastian Mallaby characterized as "loud carping," he became one of the fiercest and most vocally persistent critics of the Bank's sister institution, the IMF (Mallaby, 2004, p. 210). Not content to criticize the Fund's policy advice, he chose to vent his frustration in personal terms that went well beyond Sachs's more muted phrases. The IMF, Stiglitz concluded, was staffed overwhelmingly by "older men" and "third-rank students from first-rate universities" who "act as if they are shouldering Rudyard Kipling's white man's burden" (Stiglitz, 2000). That and other intemperate diatribes saddened and angered staff at the IMF who had long admired Stiglitz's formidable technical contributions to economics (for which he was awarded the Nobel Prize in 2001). As with Sachs, the possibility of a meaningful dialogue was burned in the heat of passion.

The IMF and the "G's"

In 1961, the central banks of the countries with the 10 largest economies formed a group that called itself the "Group of Ten" or G10. Their original purpose was to establish the General Arrangements to Borrow (GAB) with the IMF as a supplementary means of preserving the stability of their exchange rates. As the system of pegged but adjustable exchange rates that had been designed at Bretton Woods in 1944 came under increasing pressure in the late 1960s and early 1970s, the G10—

[31]Part of the difficulty was that passion led easily to hyperbole, as in: "The IMF is so obsessed with price stability it doesn't think very hard about anything else," as Sachs wrote in the *Economist* (June 29, 1996). Such assertions were difficult for the staff to debate through rational discourse. Also see the discussion in Chapter 11, pp. 558–59, regarding the Fund's response to Sachs's (and Joseph Stiglitz's) criticism of its handling of the crises in East Asia in 1997–98; and the final section of Chapter 12 for a more detailed review of criticisms of the management of those crises.

[32]Sachs spoke at a panel discussion on "Promoting Better National Institutions: The Role of the IMF." The discussion was published in *IMF Staff Papers*, Vol. 50 (2003), Special Issue, pp. 21–41.

which dominated international finance at the time—came to constitute an informal and self-appointed steering committee for the international financial system.

Partly in response to the growing influence of the G10, developing countries formed the G77 in 1964 and then the much smaller but still broadly representative G24 in 1971. The G24 also gained an influential role, especially for the deliberations of the joint IMF–World Bank Development Committee.

In 1973, as exchange rates were beginning to fluctuate among the major currencies, the U.S. Treasury Secretary organized a small, informal group of leading industrial country finance ministers, which soon became known as the G5. Two years later, a slightly larger group of heads of state and government began holding annual summit meetings as the G7. By the late 1980s, that grouping had supplanted the G5 and was meeting regularly at both the summit and the ministerial levels.[33]

At the outset of the 1990s, the key groups for discussions of international finance and macroeconomic policy coordination were the G7 (industrial countries) and the G24 (developing countries). The G10 central banks also continued to meet to oversee the GAB and to discuss other matters of mutual interest.[34] By the end of the decade, each of those groups was continuing to meet and to play important systemic roles, but the old industrial country groups were gradually being overtaken by updated configurations. At the summit level, the G7 absorbed Russia into its group and became the G8, as discussed in Chapter 7. Then in 1999, the G20 aligned as a new group with a membership that included developing as well as industrial countries. (For the membership of these groups, see Table 3.1.)

The Commanding Role of the Group of Seven

By far, the most important group with influence on the IMF in the 1990s was the G7. Its finance ministers and central bank governors met at least twice a year, immediately before the spring and fall meetings of the Fund's Interim Committee, and usually one or two other times in response to specific events. At each of those meetings, the IMF Managing Director was invited to participate in the portion of the meeting covering global economic and financial developments, during which he summarized the world economic outlook and the key macroeconomic policy issues as seen by the IMF. When the group turned to a discussion of exchange rates and other intra-G7 policy issues, they closed the meeting, and Camdessus had to leave.

The ministerial meetings of the G7 typically concluded with a common position on IMF matters that were to be discussed by the full Interim Committee the next day.

[33]For more on the development of these various groups, their geographical dispersion, and their relationship to the IMF, see Boughton (2001), Chapter 4.

[34]Aside from meetings to discuss the IMF and the GAB, the main venue for G10 meetings was the BIS. At the finance deputies level, the OECD's Working Party 3 had a similar membership.

Table 3.1. Major Country Groups in the 1990s

G7	G8	G10	APEC	G20	G24
Canada	Canada	Canada	Canada	Canada	
France	France	France		France	
Germany	Germany	Germany		Germany	
Italy	Italy	Italy		Italy	
Japan	Japan	Japan	Japan	Japan	
United Kingdom	United Kingdom	United Kingdom		United Kingdom	
United States	United States	United States	United States	United States	
	Russian Fed.		Russian Fed. (1998)	Russian Fed.	
		Belgium			
		Netherlands			
		Sweden			
		Switzerland[b]			
			Australia	Australia	
		Observers	Brunei Darussalam		
		BIS	Chile (1994)		
		EU	China (1991)	China	
		IMF	Hong Kong[a] (1991)		
		OECD	Indonesia	Indonesia	
			Korea, Rep. of	Korea, Rep. of	
			Malaysia		
			Mexico (1993)	Mexico	Mexico
			New Zealand		
			Papua New Guinea (1993)		
			Peru (1998)		Peru
			Singapore		
			Taiwan Province of China (1991)		
			Thailand		
			Philippines		Philippines
			Vietnam (1998)		
				Argentina	Argentina
				Brazil	Brazil
				India	India
				Saudi Arabia	
				South Africa	South Africa
				Turkey	
				EU	
					Algeria
				Participants	Colombia
				IMF	Dem. Rep. of the Congo
				World Bank	Côte d'Ivoire
					Egypt
					Ethiopia
					Gabon
					Ghana
					Guatemala
					Iran, Islamic Rep. of
					Lebanon
					Nigeria
					Pakistan
					Sri Lanka
					Syrian Arab Republic
					Trinidad and Tobago
					Venezuela

Source: Author's compilation.
Note: APEC = Asia-Pacific Economic Cooperation.
[a]On July 1, 1997, the territory became the Hong Kong Special Administrative Region (SAR) of China.
[b]Switzerland became the eleventh member of the G10 in 1984.

All G7 participants were also represented on the committee and on the Fund's Executive Board. On the Board, they controlled almost 50 percent of the voting power. The Interim Committee (or, from 1999, its successor the International Monetary and Financial Committee) was an advisory body that operated by consensus rather than by weighted voting. In most circumstances, however, the G7 had a controlling influence on the committee's conclusions, both because of its high voting power in the Executive Board (which would have to adopt and implement any policies recommended by the ministerial committee) and because it would have already coalesced on a common position the previous day.

The G7 finance ministers also had a major advantage in that their heads of state or government were meeting annually in the world's most highly publicized and closely watched summit meetings. Those summit meetings had begun with the express purpose of discussing international financial matters. Although the agendas had gradually broadened to focus more on security issues, economics and finance continued to be highlighted. Whenever the finance ministers needed an extra push to get their program accepted internationally, they could usually count on the summit leaders to include a related paragraph in their own communiqués.

A further reason for the effectiveness of the G7 was its "finance deputies" structure. Each meeting of the finance ministers was preceded by a meeting of deputy ministers, who not only prepared the agenda but also tried to reach consensus to the extent possible. Throughout the 1990s, the finance deputies included at least a few strong personalities and some highly skilled and experienced officials who were able to forge tentative agreements for their ministers to endorse. When Gordon Brown, the finance minister for the United Kingdom, was elected Chairman of the Interim Committee in 1999, he drew on his experience with the G7 structure to establish a similar system of deputies meetings for the committee.

A clear example of the G7's operational role occurred in May 1990, when the group's communiqué noted that the "Ministers and Governors . . . agreed that a 50 percent increase in IMF quotas would provide the Fund with the resources to fulfill its central responsibilities in the world economy. They also agreed on the need for strengthening the IMF arrears strategy as an integral part of the quota review."[35] That agreement brought an end to a battle about whether and by how much to increase quotas in the Ninth General Review (Chapter 15) and linked that compromise to new punitive measures on countries with long-standing payments arrears to the Fund (Chapter 16). After a contentious debate, the Interim Committee ratified the package two days later. Similarly, in October 1998, G7 ministers endorsed the idea of the IMF providing "contingent finance" for countries with "sound policies." Although the general idea had been debated for years without a resolution, the Interim Committee put it back on the agenda the day after the G7 met. The Fund established the "Contingent

[35]"Statement of the G7 Finance Ministers and Central Bank Governors" (May 6, 1990); accessed at http://www.g7.utoronto.ca/finance/fm900506.htm.

Credit Line" six months later (Chapter 5). These are but two examples of a general pattern established in the 1990s.

Ministers from developing countries, including those in the G24, were usually less cohesive, less able to muster a controlling bloc of votes, and less well supported by an analytical secretariat. An important exception to the limited effectiveness of the G24 arose in 1994, when ministers from developing countries blocked a proposal from the G7 for a one-time allocation of SDRs designed to benefit primarily the transition countries that had recently joined the IMF. As discussed in Chapter 15, developing countries saw the proposal as structured in ways that were antithetical to their own interests, and they succeeded in blocking it until it was suitably modified a few years later. That success, though, remained exceptional.

APEC and the Group of 20

The dominance of the G7 did not go unchallenged. An Australian initiative led to the creation of the Asia-Pacific Economic Cooperation (APEC) forum in 1989, with 12 member countries (21 by the end of the 1990s) on both sides of the Pacific Ocean (Table 3.1). By 1994, APEC had evolved from an informal forum into a large regional body with an ambitious goal of gradually converting the whole region into a free trade area. Instead of meeting only at the general ministerial level, it had also become a forum for political leaders meeting at the summit level. Its membership included the three main industrial countries outside of Europe (Canada, Japan, and the United States), smaller industrial countries (Australia and New Zealand), and several of the newly emerging market powers (all the "Asian tigers" plus Mexico and Chile).[36] In 1998, APEC membership expanded again to include Peru, Russia, and Vietnam.

The 1993 APEC summit, held on the northwest Pacific coast of the United States, called for APEC finance ministers to begin meeting annually. At the first such meeting, in Honolulu, Hawaii (United States), APEC ministers asked the IMF to prepare a study of capital flows "into and within" the region. That study (Khan and Reinhart, 1995) analyzed the benefits and risks of the free flow of capital and highlighted the importance of strengthening banking systems and other financial sectors to minimize the risks. In 1995, again at the request of APEC ministers, IMF staff conducted a study of the effects of exchange rates on trade and investment in the region.[37]

Beginning at a meeting of APEC finance ministers in Kyoto, Japan, in March 1996, the Managing Director was usually invited to participate, similar to his participation

[36]In economics literature and journalism in the 1990s, the term "Asian tigers" was frequently applied to a loosely defined group of rapidly developing economies in east Asia. Here, it refers to the Asian developing countries in APEC, as listed in Table 3.1.

[37]"Exchange Rate Movements and their Impacts on Trade and Investment in the APEC Region," SM/95/267 (October 12, 1995). The study was conducted by a Research Department staff team led by Takatoshi Ito (Senior Advisor).

in the G7 meetings. On that first occasion, Camdessus noted that global and regional economic prospects were bright, but he agreed with the ministers that the Pacific region was at risk from possible adverse shifts in sentiment by international financial markets.[38] A year later, that shift hit with a vengeance, first in Thailand and then across the whole spectrum of emerging-market countries. The role of APEC as a forum for bringing those countries together with the advanced economies where financial markets were headquartered was manifest.

The next breakthrough came at an APEC summit meeting in Vancouver, British Columbia (Canada), in November 1997. The Asian financial crisis was at full steam: the economies of Thailand and Indonesia had already boiled over, and Korea was about to blow. Many of the finance officials who accompanied their political leaders to Vancouver had just been to Manila, where U.S.-led opposition had killed a Japanese proposal for an Asian Monetary Fund that would have weakened the regional influence of the IMF. In its place, they had agreed on the Manila Framework as an ongoing regional process to supplement and complement the IMF (see Chapter 12). To solidify that outcome, the APEC heads of state and government reaffirmed that "the [global] role of the IMF remains central. . . . We urge rapid implementation of the Manila Framework."[39]

To push ahead with the financial reform agenda, the political leaders in Vancouver directed APEC's finance ministers and central bank governors to work toward further development of financial and capital markets to promote "freer and stable capital flows in the region." At the same time, U.S. President Clinton initiated a redirection of that effort to include countries well beyond the Pacific rim. When the U.S. Treasury organized the next round of finance meetings, it included several non-APEC members, including all the European members of the G7, the Latin American powers Argentina and Brazil, and such other emerging markets as India, Poland, and South Africa. It left out several of the smaller APEC members that were less relevant to the financial reform agenda. This new grouping met first at the deputies level in February 1998, at the Willard Hotel in Washington. It thus became known briefly as the Willard Group. By the time it met at the ministerial level in April, also in Washington, it was calling itself the Group of 22.

Initially, the major focus of the work of the Group of 22 was to improve oversight and coordination of supervision, standard setting, and governance of financial sectors. The Asian crisis had revealed severe weaknesses in those domains and had underscored the need to link macroeconomic analysis and financial sector development. Accordingly, the group commissioned three working parties to prepare reports on strengthening financial systems, enhancing transparency and accountability, and managing

[38]Report by the Managing Director at EBM/96/24 (March 20, 1996), pp. 3–4.

[39]"APEC Economic Leaders' Declaration: Connecting the APEC Community," issued in Vancouver, Canada, November 25, 1997; accessed at http://www.apec.org/apec/leaders__declaration.html.

international financial crises. IMF staff were invited to participate in each working party as observers. The groups produced reports that were discussed at a second ministerial meeting in the margins of the IMF/World Bank Annual Meetings in October 1998.[40]

For a brief period in 1999, this new group expanded to become the Group of 33. In that guise, it held a series of seminars on issues related to the international financial system. Then, in preparation for the annual G8 summit in Cologne, Germany, in June 1999, the G7 finance ministers pledged to "work together to establish an informal mechanism for dialogue among systemically important countries within the framework of the Bretton Woods institutional system."[41] The G7 ministers and governors followed up by organizing a meeting of themselves along with ministers and governors from 12 other countries and the European Union, in Berlin, Germany, in December 1999. That configuration proved to be a success, and the G20 was born.

APEC continued to meet as a regional forum, but the G20 was destined to become the main body for steering the discussion of financial matters at the global level. The Managing Director of the IMF, the President of the World Bank Group, and the Chairs of the International Monetary and Financial Committee and the Development Committee participated as permanent *ex officio* observers. Fund staff helped prepare background documentation for the G20 meetings and participated as observers in the deputies' meetings. Although the G20 lacked the constituency structure that enabled the ministerial committees of the Fund and the Bank to represent nearly all of the world's countries, it was far more representative than the G7 and included all the systemically important emerging-market and advanced economies. The participation of emerging-market countries greatly enriched the ability of policymakers in advanced countries to understand the way international capital markets were really functioning. The creation of the G20 thus bridged a gap in the architecture and offered some hope for a more effective and legitimate steering system for the twenty-first century.[42]

Transparency and External Relations

From its inception in the aftermath of the Second World War, the IMF operated largely in secrecy with little direct contact with the general public. As a financial institution and a confidential advisor to governments and central banks, the Fund would have faced a conflict if it had chosen to discuss publicly the details of its

[40] See "Reports on the International Financial Architecture" (October 1998), at http://www.imf.org/external/np/g22/. Jack Boorman was the IMF observer for each of the working groups.

[41] "Report of G7 Finance Ministers to the Köln Economic Summit, Cologne, Germany, 18–20 June, 1999"; accessed at http://www.g8.utoronto.ca/finance/fm061999.htm.

[42] For a detailed official history of the origins and first decade of the G20, see http://www.g20.utoronto.ca/docs/g20history.pdf. The membership of the G20 is listed in Table 3.1.

operations or its advice. Until the 1980s, the main vehicles for publishing its work were its *Annual Reports*, its research journal *IMF Staff Papers*, the monthly *International Financial Statistics* and other statistical publications, and—from 1969—the periodic volumes of History of which the present volume is the latest. The launch of the *World Economic Outlook* reports and the Occasional Papers series in 1980 opened a chink in the citadel, but the principle that privacy trumped transparency remained intact.

In the course of the 1990s, the culture of the IMF shifted massively toward transparency. The change did not come easily.

Those who opposed opening the Fund to public discourse raised several issues. First, the willingness of country authorities to divulge confidential information to the Fund could be compromised if the Fund adopted a policy of releasing more information to the public. Second, Fund advice could be less effective in persuading governments to change course if made publicly rather than in confidence to the authorities, owing to possible political ramifications. Third, national ownership of good economic policies could be threatened if those policies came to be associated publicly with the IMF rather than with the government. Fourth, confidentiality was inherent in financial relationships. Even though the Fund was not a bank, it was a lender, and it had to negotiate the terms of its lending. Opening that process to public scrutiny could lead to political opposition that, in turn, could undermine the success of the negotiations. Fifth, the staff's ability to be forthright in its reporting could be undermined if its reports were destined for publication, either because of reluctance to embarrass a member government or because of concern that a forthright analysis of a country's economic problems could undermine confidence and worsen the outcome.

These were strong arguments in favor of the status quo, but privacy also had its costs. First, the secrecy of the Fund's deliberations and of its interactions with members inevitably damaged the Fund's credibility with those who were excluded, especially because of widespread perceptions that a few major creditor countries dominated the Fund's decision making. Second, such secrecy inhibited public dialogue about how the institution could be improved. Third, by the 1980s secrecy was hampering the Fund's ability to provide clear signals to commercial creditors, potential creditors, and investors. In the 1990s, that failing was becoming increasingly troubling as private lending spread to more and more countries, as those countries became increasingly dependent on private financing, and as private creditors and investors remained reliant on signals from the Fund as a major input to their assessments of creditworthiness.

In the early 1990s, a wide crack opened in the wall of secrecy when a number of national central banks began adopting inflation-targeting strategies (see Chapter 1). An integral part of any inflation-targeting regime is clear communication to the public, so that the central bank's policy actions will be transmitted efficiently to financial markets. Suddenly, it became commonplace for central bank governors and other senior officials to speak publicly about current policy decisions. Periodic publications became more current and detailed. It was not yet a universal revolution, but

the demonstration effect was powerful.[43] The rationale for the IMF to restrict its own dissemination of views on and advice to central banks was correspondingly weakened. One of the strongest academic advocates for transparency in policymaking at that time was Stanley Fischer. His arrival at the Fund in 1994 as First Deputy Managing Director helped greatly to guide the cultural transformation. On his departure seven years later, he regarded the "transparency revolution" at the Fund as one of the most important changes during his tenure.[44]

Much of the initial internal pressure for change came from the United States. During the 1990 review of Fund surveillance, Thomas C. Dawson II (United States) emphasized his authorities' preference for "disseminating the Fund's views on member countries to the public," and he complained that the staff seemed "leery of letting too much sun to shine on exchanges between the Fund and its members."[45] By the time of the 1994 conference in Madrid commemorating the fiftieth anniversary of Bretton Woods, the view that the Fund should be open and transparent was almost universally accepted, at least as a general principle.[46] Specific support for publication of Article IV consultation reports took several more years to achieve a majority, during which time the Fund gradually began publishing more and more summary information on the conclusions of selected consultations (see Chapter 4).

By the end of the decade, this form of transparency had become a generally accepted principle in most regions of the world, but with qualifications. The 1998 report of the G22 working group on transparency and accountability, cochaired by Mervyn King of the Bank of England and Andrew Sheng of the Hong Kong Monetary Authority, gave a strong push to the Fund and other international financial institutions. The report concluded these agencies should "adopt a presumption in favor of the release of information, except where release might compromise confidentiality." It supported the publication of most Fund-related documents, including Letters of Intent, Public Information Notices, Policy Framework Papers, and background papers to consultations, but the group could not agree to a recommendation to publish full staff reports.[47] Nonetheless, the following year the Fund began publishing the full text of its staff reports, though only with the concurrence of the country concerned.

[43]For an overview and analysis of these developments, see Mishkin (2007), Chapter 5. For an analysis of the rationale for central bank secrecy, see Lewis (1991).

[44]Stanley Fischer, "Farewell to the IMF Executive Board" (August 30, 2001); accessed at http://www.imf.org/external/np/speeches/2001/083001.htm.

[45]Minutes of EBM/90/108 (July 9, 1990), p. 36. U.S. attitudes on transparency evolved during the 1980s. As described in Boughton (2001, pp. 145–46), in 1985 the U.S. Executive Director blocked—over the objections of most other Directors—publication of an analytical study of U.S. fiscal policy that the country's authorities felt was politically sensitive. Even at that time, however, U.S. officials generally were pressing for publication of more documents by the Fund.

[46]See Boughton and Lateef (1995), especially the summary on p. 19.

[47]"Report of the Working Group on Accountability and Transparency" (October 1998); accessed at http://www.imf.org/external/np/g22/.

Another important manifestation of the cultural shift was the decision to open the Fund's archives to public use. Article IX, Section 5, of the Fund's Articles of Agreement states unequivocally: "The archives of the Fund shall be inviolable." For the first 50 years, the Fund took that rule literally. Anyone not on the staff who wanted access to official documents of the Fund would have to make a specific application, normally through the Executive Director for his or her country. If the document pertained to another country, the Executive Director for that country would also have to acquiesce. The request would then be circulated to the full Executive Board. In the absence of any objection, it would be deemed approved on lapse of time. Typically in the 1980s and early 1990s, the Fund would receive a handful of such requests each year, most of which would concern research related to incidents three or more decades earlier. Most requests would be approved, but the complex approval process was sufficiently daunting and complex to discourage many researchers from applying.[48]

In December 1994, Camdessus proposed opening the archives to the general public for documents that were at least 30 years old. The Board signaled its general approval for the proposal, which was similar to policies adopted earlier by a number of major central banks and other institutions.[49] Preparation of the archives for public use took another year, and the Board gave its formal approval in January 1996. The U.S. Executive Director, Karin Lissakers, argued in favor of a shorter release date—possibly as short as 10 years—while a few Directors expressed concerns about compromising confidentiality. At the end of the debate, the 30-year rule was adopted as proposed.[50]

Shortly after opening the archives, the Fund established an external website, http://www.imf.org. The site went live in September 1996 with general information about the Fund and access to current publicly available documents such as the *Annual Report*, press releases, and the Data Dissemination Standards Bulletin Board. The Fund subsequently began publishing more documents, including Public Information Notices and Staff Reports, and the number and range of documents available through the site grew dramatically. By the end of the 1990s, web-based publication was the norm.

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[48]As of late 1995, the Fund had approved a total of only about 30 requests: roughly two a year since the first access guidelines were approved in August 1981. (Before 1981, the Fund had granted access to archival documents for an external researcher only once, in 1963.) See "Opening of the Fund Archives," SM/95/303 (December 1, 1995), p. 3n; and minutes of EBM/81/118 (August 31, 1981), pp. 19–23.

[49]Minutes of EBM/94/110 (December 15, 1994), pp. 34–87.

[50]Minutes of EBM/96/2 (January 17, 1996), pp. 55–66. The release dates were subsequently shortened. In March 1999 (with an effective date of September 9), the Fund agreed to grant public access to most Executive Board documents (other than minutes of Board meetings) that were more than five years old and to other Fund documents (including Board minutes and internal memorandums) that were more than 20 years old. In November 2002, Executive Board minutes were made available with a 10-year delay. In April 2003, the release date was shortened to 10 years for most other documents related to Board meetings. In all cases, a general exception was specified for documents classified "Strictly Confidential" or "Secret."

The controversies that swirled around the Fund's handling of the Asian financial crisis of 1997–98 persuaded Fund management to step up engagement with the public, including with parliaments and other legislative bodies that would have to approve future increases in financing for the institution. Funding for the New Arrangements to Borrow (NAB) and the quota increases under the Eleventh General Review both depended crucially on approval by the U.S. Congress. To nudge congressional consideration along, in the first quarter of 1998 Camdessus accepted invitations from the U.S. Senate Budget Committee, the House Banking and Financial Services Committee, and the Congressional Black Caucus, and met informally and privately with them to brief their members on the key issues. Senior staff also briefed a number of members of Congress or their staffs. In October, both houses of Congress approved the enabling legislation. The perceived success of this effort eventually led to the establishment of a permanent and broad program for outreach to legislative bodies in all member countries.

Also in the late 1990s, the Fund decided to commission external evaluations of its work in selected areas. Camdessus made a cautious start in this direction in 1995 when he asked a retired department director, L. Alan Whittome, to prepare a report on weaknesses in IMF surveillance. This decision was cautious, not only because Whittome was too close to be considered an external evaluator, but also because the report was held in strict secrecy within the Executive Board and a very small group of senior staff (see Chapters 4 and 10). Nonetheless, it set a precedent through its frank and thorough examination of the shortcomings that had prevented the Fund from identifying the problems that led to the Mexican peso crisis that began in 1994.

The Whittome report was followed in 1998 by an evaluation of the ESAF by a group of external experts led by Kwesi Botchwey, a former finance minister of Ghana who was then with the Harvard Institute for International Development. Similarly, in 1999 an external committee led by John Crow, a former governor of the Bank of Canada, prepared a report on the conduct of Fund surveillance. Both the Botchwey report and the Crow report were published and posted on the IMF website. By then, management and the Executive Board were satisfied that external evaluation served a useful purpose for the Fund. The stage was set for the creation of a permanent Independent Evaluation Office in 2000.[51]

[51]See "Evaluation of IMF Work," accessed at http://www.imf.org/external/np/eval/index.htm, and the Independent Evaluation Office (IEO) website, http://www.ieo-imf.org/. Two other external evaluation reports were initiated in 1999 and completed in 2000, before the establishment of the IEO: one on IMF research, led by Frederic S. Mishkin, professor of economics at Columbia University (New York); and one on the adequacy of procedures for determining quotas in the Fund, led by Richard N. Cooper, professor of economics at Harvard University. The Mishkin report may be accessed at the first website listed in this note. For the Cooper report, see http://www.imf.org/external/np/sec/nb/2000/nb0090.htm and Chapter 15.

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Global Oversight: Strengthening and Broadening IMF Surveillance

The modern concept of IMF surveillance dates from the 1978 amendment of the IMF Articles of Agreement, which introduced an entirely new Article IV.[1] Before that amendment, member countries that maintained restrictions on current account transactions were required to consult regularly with the Fund about their plans to reduce and eventually abandon those restrictions. Those discussions were known as Article XIV consultations, under the terms of the article that specified members' and the Fund's obligations regarding the maintenance and removal of exchange restrictions. Some of the countries that had already removed their restrictions and had agreed not to impose new ones volunteered to hold regular consultations with the Fund under the terms of Article VIII, focused primarily on the consistency of the country's macroeconomic and exchange rate policies. The Second Amendment established a new system of Article IV consultations, obligatory for all members, and it expanded the concept of surveillance to cover exchange rate policies, broadly defined.[2]

For a dozen years after 1978, as chronicled in the previous History (Boughton, 2001), the Fund experimented with ways to make the vague concept of surveillance effective and fully operational. Surveillance continued to evolve in the 1990s, but not always successfully. On the positive side, the international community made progress toward agreeing on what constitutes good economic policies, which sharpened and focused the Fund's policy advice. At the same time, surveillance activities broadened from the initial focus on macroeconomic stabilization to devote much more attention to structural policy issues such as the efficiency of labor and product markets. By mid-decade, it was nonetheless becoming painfully clear that surveillance was not effectively identifying the preconditions for economic and financial crises. That realization led to an intense but frustrating effort to strengthen the crisis-prevention function. The first two sections of this chapter examine these issues.

[1]The text of Article IV and the principal Executive Board decision on how this work should be conducted are reproduced at http://www.imf.org/external/pubs/ft/history/2011/index.htm.

[2]Technically, Article XIV consultations remained obligatory for all members that had not yet accepted the obligations of Article VIII. In most cases, those consultations were folded into the new Article IV discussions. For a more detailed history through 1989, see Boughton (2001), Chapter 2, especially pp. 67–74.

The inadequacy of surveillance over the economic policies of the largest industrial countries was the subject of much discussion and debate in the public arena in the 1990s. This was an irreducible problem, in part because of the limited menu of available sanctions. Countries with no need to borrow from the Fund and willing to risk the disapproval of the international community could freely ignore the Fund's counsel, and often did. In some cases, discussed in this chapter's third section, poor effectiveness arose from a lack of force, clarity, or prescience in the Fund's advice.

In addition to Article IV consultations, which the IMF generally called bilateral surveillance, the staff prepared periodic studies of regional and global economic and financial developments. The general appellation for these activities was multilateral surveillance, a term that was first applied to the World Economic Outlook (WEO) and later generalized.[3] Multilateral surveillance was mandated by the new Article IV, Section 3(a), which required the Fund to "oversee the international monetary system in order to ensure its effective operation." The staff was already conducting the WEO exercise annually, and the amendment of the Articles merely raised its profile. Over time, the WEO and a companion activity to monitor international capital markets grew into the two flagship publications of the Fund.[4]

The Practice of Surveillance in the 1990s

Historically, the primary concern regarding surveillance has been to increase its effectiveness as an influence on policymakers. Article IV, as amended in 1978, sets out the obligations of each member "to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates." That requirement has been interpreted in ways that have made it difficult to judge that a member country is not in compliance. Consequently, the ability of the Fund to use Article IV consultations as a means to identify shortfalls in members' policies and to agree with the member on a solution has been severely circumscribed.

[3]The first use of the term in the Fund was in March 1978. During an Executive Board meeting on how to conduct surveillance once the Second Amendment came into effect in April, R.J. Whitelaw (Australia) noted that the Fund should be "looking at the economies of several countries and their interactions together, as was indeed done in the world economic outlook exercise. . . . No particular weight should be placed either on bilateral or on multilateral surveillance, because both had a role to play"; minutes of EBM/78/36 (March 20, 1978), p. 8.

[4]The history of the development of the WEO is covered in Boughton (2001), Chapter 5. Also see Hacche (2009).

Consultation Procedures

Throughout the 1990s, the Fund conducted periodic—generally biennial—reviews of the principles and implementation of surveillance with the aim of overcoming these limitations. It also instituted procedural changes aimed at improving the continuity and coverage of surveillance. These changes included holding periodic informal Executive Board meetings on World Economic and Market Developments (WEMD). At each of these meetings, which were held from four to seven times a year starting in February 1993, the staff reported on developments in a selection of countries thought to have systemic spillover effects on other countries, to be vulnerable to economic shocks, or to be otherwise affected by issues of concern to the Fund.

WEMD meetings were held in restricted session, without formal minutes being prepared, so that Directors could have an unfettered interchange. Initially, the WEMD sessions focused mainly on systemic developments arising in the G7 countries. Later, especially after the 1994–95 Mexican peso crisis, coverage expanded and refocused on developments in emerging markets. In addition to staff reports on individual countries, these sessions usually included a report on systemic developments by Michael Mussa (Economic Counsellor and Director of the Research Department). Mussa had an extraordinary ability to convey complex economic analysis in a way that was understandable, respectful to his audience, and often humorous; on one occasion, he even broke into song. These informal meetings thus had an aura that elevated them further in their importance in the Fund.

Also in 1993, management revived the Surveillance Committee, a group of senior Fund officials that had met semiregularly from 1978 to 1986. The original committee, usually chaired by the Managing Director, was disbanded when its deliberations became too routine. The new committee, usually chaired by the Managing Director or one of his deputies, was much more active, meeting as often as once a week to identify vital cases and to guide the Fund's priorities in focusing surveillance activities.[5] It met throughout the remainder of the decade and beyond.

One procedure that fell into disuse in the 1990s was the practice of holding "supplemental consultations" with members in cases in which the Managing Director judged that a change in exchange rate policies might be in order. Under a 1979 decision by the Executive Board, the Managing Director was empowered to initiate informal discussions with a member, report informally to Executive Directors on the findings, and then call a supplemental consultation if warranted by the circumstances. That procedure was invoked twice in the 1980s: in 1982, in response to a currency devaluation by Sweden that some of its neighbors thought to be excessive; and in 1987, in response to

[5]"Biennial Review of the Implementation of Surveillance over Members' Exchange Rate Policies and of the 1977 Surveillance Decision," SM/95/22 (January 26, 1995), p. 18. The work of the previous Surveillance Committee is described in Boughton (2001), p. 103.

an undervaluation of the Korean won that had become a thorn in relations between the Republic of Korea and the United States (Boughton, 2001, pp. 104–06, 108–19, and 128–30).

At the conclusion of the 1993 biennial review of surveillance, the Fund modified the procedures for calling a supplemental consultation with the goal of removing the stigma attached to the process and thus expanding its usefulness. Previously, to call for a supplemental consultation, the Managing Director would have to find that "a modification in a member's exchange arrangements or exchange rate policies or the behavior of the exchange rate of its currency may be important or may have important effects on other members."[6] Although that language was not intended to convey an inherently negative message about the country's policies, it came to be interpreted that way. Hence, the staff was reluctant to use the procedure, and countries were loathe to be subjected to it.

The new language approved in 1993 indicated that the Managing Director could initiate the process "whenever he considered that important economic and financial developments were likely to affect a member's exchange rate policies or the behavior of the exchange rate of the member's currency." This new wording encompassed external developments, including natural disasters, that could require a country to adjust its economic and exchange rate policies.[7] Despite these good intentions, the perception of a stigma persisted, and the procedure remained unused.

The Mexican peso crisis induced the Fund to try to direct its surveillance more effectively to foreseeing and preventing financial crises. As soon as the dust began to settle after the Executive Board approved a massive stand-by arrangement for Mexico in February 1995, Managing Director Michel Camdessus called L. Alan Whittome out of retirement to prepare a report on how to accomplish such a shift. Whittome, a former director of both the European Department (EUR) and the Exchange and Trade Relations Department (ETR), went to work immediately and completed the report in six weeks.

In a highly controversial decision, Camdessus insisted that the Whittome report should be discussed by the Executive Board in the strictest confidence. To ensure that the report would not get bogged down and watered down in the Fund's painstaking internal review processes, Camdessus had given Whittome unrestricted access to all relevant documents and personnel at the Fund and dispensed altogether with internal reviews. No one from the Managing Director on down had an opportunity to comment on it before it was circulated to Executive Directors. That made it potentially explosive, but Camdessus wanted the Board to have an unfettered assessment of the issues.

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[6]Decision No. 6026-(79/13), adopted January 22, 1979; reproduced in Boughton (2001), p. 130.

[7]"Summing Up by the Chairman, Biennial Review of the Fund's Surveillance Policy," SUR/93/15 (February 3, 1993), p. 3. Also see "Biennial Review of the Fund's Surveillance Policy," SM/92/234 (December 30, 1992), pp. 17–18.

Each Executive Director was given one copy of the report, with each copy uniquely numbered on every page to discourage leaks. The Board discussion was in restricted session, with very limited attendance. When a member of the U.S. Congress asked the U.S. Treasury for a copy of the report, Camdessus and Stanley Fischer (First Deputy Managing Director) tried to block the transfer. This extraordinary effort at secrecy for a document intended to provide guidance on the Fund's future consultations with member countries would turn out to be one of the last such decisions before the Fund's gradual but ultimately dramatic shift toward openness.

Whittome made five key recommendations for strengthening the Fund's ability to detect the preconditions for financial crises, based on specific weaknesses he found in the Fund's handling of consultations with Mexico.[8]

- First, surveillance should be continuous whenever the staff has concerns about the risks of major problems developing. The annual consultation cycle is not sufficient in such cases unless staff resources are dedicated to following developments affecting the country throughout the year and unless staff keep management well informed. Throughout 1994, the staff assigned to follow the Mexican economy had additional responsibilities that may have kept them from thoroughly analyzing problems as they emerged.
- Second, the Fund should encourage members to provide, and preferably to publish, key economic data in a comprehensive and timely manner, and plainly and publicly. Mexico's policy of publishing its foreign exchange reserve position just three times a year, although not unique among emerging-market countries, had limited the ability of Fund staff and market analysts to judge the effects of shifts in financial and political conditions.
- Third, the culture of the Fund should adjust to give less "benefit of the doubt" to member countries when the staff finds indications of weaknesses in economic conditions or policies. As long as the Mexican economy appeared to be performing well, the confident tone of the authorities had had a mesmerizing effect on the Fund.
- Fourth, the staff should develop more intensive contacts with capital markets and other outside groups, and the area departments should take information from these groups more seriously. Although some private analysts had been as upbeat as the Fund in the second half of 1994, others had sounded warnings persistently without the Fund taking much notice.
- Fifth, consultation reports should be written more clearly, with sharper analysis and with conclusions stated more boldly and incisively. A careful reader might have been able to find muted cautions hidden within the staff's reports on Mexico, but few would have found any reason for alarm.

[8]"Mexico—Report on Fund Surveillance, 1993–94," EBS/95/48 (March 23, 1995).

The Executive Board responded favorably to the Whittome report and took its recommendations seriously.[9] Even so, little action was taken to strengthen the practice of surveillance. The prevailing view seemed to be that the weaknesses identified by Whittome were peculiar to Mexico. As discussed in Chapter 10, the annual consultations with Mexico happened to have been concluded long before the crisis hit, the authorities happened to have personal star power and good personal relations with Fund management, and the crisis had been initiated by specific political events that were unlikely to be repeated. Not until a new and more generalized wave of shocks in 1997 again highlighted the shortcomings would management and the Board realize how systemic these issues really were.

Coverage of Issues

The practice of surveillance faced an inevitable and constant tension between (a) comprehensive and consistent coverage of key issues and (b) selectivity in coverage aimed at focusing on the most important issues in a particular country at a particular time. Throughout the 1980s, those decisions were left primarily to the mission chief in each case, with a general expectation of selectivity. Exchange rate policy was always the central focus, but the way it was treated and its relation to other macroeconomic policies were hard to get right.

The most specific overall guidance to the staff on conducting Article IV consultation discussions was contained in a 1977 Executive Board decision setting out the "principles and procedures" for conducting bilateral surveillance under the new Article IV, which was about to take effect. Paragraph 3 of the 1977 decision decreed that the staff should assess each country's exchange rate policies by examining them in relation to the country's balance of payments, its "general economic situation and economic policy strategy," and "the conditions that are necessary for financial stability, the promotion of sustained sound economic growth, and reasonable levels of employment."[10] In other words, Article IV consultations were to be comprehensive examinations of each country's overall macroeconomic policy and conditions. The standards against which success could be judged were left vague.

The first guidance note to staff on how to conduct Article IV consultations was prepared in ETR and issued in 1980.[11] The note was approved by the Managing Director but was not discussed or reviewed by the Executive Board. On the substance of consultation reports, that note simply reproduced the wording of the 1977 decision.

[9]See minutes of EBM/95/33 (April 4, 1995).

[10]The 1977 decision, along with the new Article IV, may be accessed at http://www.imf.org/external/pubs/ft/history/2011/index.htm.

[11]Memorandum from C. David Finch (Director of ETR) to Heads of Department, "Guidance Note on Article IV Consultation Reports," June 9, 1980. IMF archives, Historian's files. ETR was the forerunner of the Policy Development and Review Department (PDR).

For the 1991 biennial review of surveillance, the staff prepared—for the first time—a formal operational guidance note for consideration by the Executive Directors. In its final version, the 1991 guidance note stressed that exchange rate policies—whether to peg, manage, or float the exchange rate, and how to go about it—should be examined "within the framework of macroeconomic *and related structural* policies" (emphasis added) and with an eye to whether these policies were "conducive to the achievement of reasonable price stability, sustainable external positions, and orderly economic growth." The note also encouraged the staff to use its own judgment in choosing topics and to aim for "selectivity rather than uniformity of coverage of subjects."[12]

This guidance was still vague, but it clarified the framework a bit. A more substantive breakthrough came in 1995, when the Executive Board approved a new and more specific guidance note. That note called for staff reports to include a "candid assessment of . . . exchange rate policies based on an evaluation of balance of payments developments, including the size and sustainability of capital flows." As appropriate, reports also were to cover "financial market developments . . . cross-country comparisons . . . [and] deficiencies in data quality and/or lack of timely reporting."[13] As discussed in more detail in the next section of this chapter, these prescriptions and the increased specificity responded in large part to the continuing weaknesses in surveillance that had been unmasked at the end of 1994 by the financial crisis in Mexico. The final revision in this decade came in 1997, when the Board approved a new guidance note that was substantively similar to that of 1995 but with more detail on the kinds of structural policies that staff reports might cover.

To make a "candid assessment" of a country's exchange rate policies, the staff had to have an effective methodology for assessing whether the exchange rate was at an appropriate level, or at least within an appropriate range. In the late 1980s and early 1990s, the staff generally was skeptical of the ability of monetary authorities to aim at exchange rate levels that could be maintained consistently without generating competitive or inflationary pressures. Many on the staff were also skeptical about their own ability to determine whether a particular rate was in or out of an appropriate range except in the most egregious cases of misalignment.[14] Nonetheless, the Fund had to try.

Toward the end of 1994, the Research Department (RES) initiated a project to make its exchange rate assessments more systematic and consistent, starting with the

[12]The guidance note was attached to the Summing Up for the 1990 review and was approved with some amendments at EBM/91/15 (see minutes, pp. 13–15). Much of the note dealt with procedural matters, but paragraphs 3 and 7 specified priorities for the coverage of issues in Article IV and other surveillance reports. This note may be accessed at http://www.imf.org/external/pubs/ft/history/2011/index.htm. Also see "Conclusions of the Biennial Review of the Implementation of Surveillance over Exchange Rate Policies and of the 1977 Surveillance Decision," SM/91/27 (February 1, 1991), pp. 5–6.

[13]This note is excerpted at http://www.imf.org/external/pubs/ft/history/2011/index.htm.

[14]The evolution of Fund advice on exchange rate policy in the 1980s is covered in Boughton (2001), pp. 84–88.

major industrial countries. Together with the Policy Development and Review Department (PDR), RES began developing a model-based methodology for assessing the exchange rates that would equilibrate macroeconomic (internal and external) balances of these countries. Once this work was under way in the spring of 1995, management established an interdepartmental group, the Coordinating Group on Exchange Rate Issues (CGER), that brought together staff from PDR and RES (as cochairs) with those from the relevant area departments to oversee these assessments.

As a basic methodology, the CGER chose to continue the emphasis on macroeconomic balances the Fund had relied upon since the late 1970s, as opposed to purchasing power parity or its variants. That is, the assumption was that each country had a sustainable external payments balance (not necessarily zero—it could be positive or negative, according to relative time preferences for aggregate consumption and other assumptions) and a sustainable internal balance. An internationally linked macro model would then generate the corresponding exchange rates, subject to further assumptions about the mix of other policies.[15]

Over time, this methodology played an increasingly important role in the Fund's work. Initially, it provided a consistency check against the estimates made by country-specific methods used by the economists working on the major industrial countries. By the late 1990s, it was being applied to smaller industrial countries as well, and the staff was working on models for emerging-market countries. In this period, the CGER did not result in the Fund declaring any country to be out of compliance with Article IV or to have a fundamentally misaligned exchange rate, but it enabled staff assessments to be more specific. In the early years of the following decade, when the methodology was being applied more broadly, the staff used the CGER methodology to support its conclusion that the U.S. dollar was "substantially out of line [i.e., overvalued] with medium-run fundamentals."[16]

Coverage of Countries

Another ingredient of surveillance was to ensure continuity and comprehensive coverage. From the outset, the Fund set a goal of holding annual consultations with every member country. That goal proved to be impractical, but it continued to serve as a beacon toward which the institution could and should strive. Holding less frequent discussions would risk missing important changes in circumstances and possibly failing to foresee a looming crisis. That risk had manifested itself in 1982 with the eruption of the Mexican debt crisis in mid-August. The Executive

[15]For an exposition of the CGER methodology, see Isard and Faruqee (1998).

[16]"Methodology for Current Account and Exchange Rate Assessments," SM/01/152 (May 24, 2001), p. 31. In the published version of that paper (Isard, Kincaid, and Fetherston, 2001), the United States was identified only as "Country A," and the "illustrative" assessment was that its exchange rate was "substantially stronger than its medium-run equilibrium level" (p. 17).

Board had finished the Article IV consultation a few weeks earlier, but that had been the first full review of the Mexican economy in more than two years.[17] Both management and the Board concluded that the long gap had left the Fund unable to provide adequate warnings and advice, and they committed themselves to improving the coverage and continuity of bilateral surveillance. Within a few years, however, the increased pressure on staff and Board time took its toll, and the balance swung back toward greater selectivity.

At the outset of the 1990s, the Fund was using two methods to achieve the right balance. First, for countries judged to be both well-enough managed that they would not need much assistance from the IMF and small enough that any problems would not spill over onto other countries, the Fund aimed to hold consultations every 18 or 24 months, rather than annually. Second, for countries of somewhat greater international importance but where economic problems were minor, the Fund could apply a "bicyclic" procedure. Putting a member country "on the bicycle" meant that the staff would hold discussions with the authorities and prepare a report once each year, but the Executive Board would discuss the report and reach conclusions only every other year. In the off-years, the written report would be less detailed, with the objective of reducing both staff and Executive Directors' time.[18]

Many of the country officials from bicyclic countries or those with long consultation intervals, the Executive Directors representing these countries, and the staff assigned to work on them resented being relegated to this inferior status. As of 1990, 34 countries were on the bicycle, 9 were on 24-month cycles, and 2 were to be examined every 18 months.[19] That reduced the number of annual Board meetings slightly, but at the cost of some loss of continuity in coverage and intermittent grousing about the classification of countries.

During the 1990 review of surveillance, the Executive Board agreed to modify the bicyclic procedure somewhat. Instead of circulating the off-year reports for information, the staff would circulate them to Executive Directors for approval on a lapse-of-time basis, with the understanding that any Director could ask for a meeting.[20] That decision did little to assuage hurt feelings, and it minimized the already small gains in

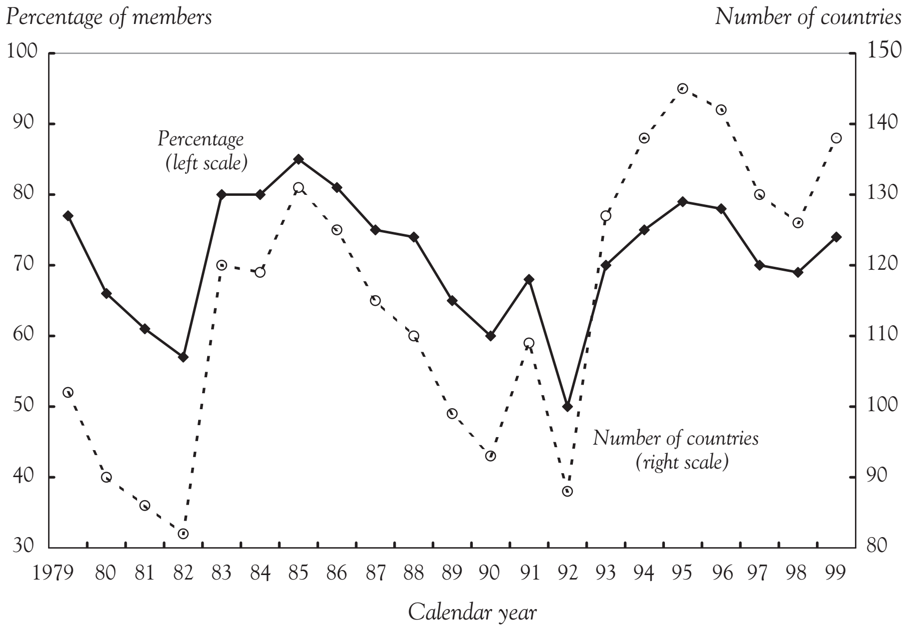
[17]The gap in Mexican surveillance in the late 1970s and early 1980s is discussed in Boughton (2001), pp. 282–88.

[18]The bicyclic procedure was established for this purpose in 1987; see Boughton (2001), pp. 95–97.

[19]"Biennial Review of the Implementation of the Fund's Surveillance over Members' Exchange Rate Policies and of the 1977 Surveillance Decision—Statistical Appendix," SM/90/103, Suppl. 1 (May 29, 1990), p. 4.

[20]Paragraph 1 of the February 1991 guidance note to staff, accessible at http://www.imf.org/external/pubs/ft/history/2011/index.htm. During the two years that this modified procedure was in effect, three interim consultations were concluded with a Board meeting at the request of an Executive Director: the Solomon Islands in 1991 and Myanmar and Greece in 1992. "Biennial Review of the Fund's Surveillance Policy—Background Paper," SM/92/234, Suppl. 1 (January 19, 1993), p. 8n.

Figure 4.1. Coverage of Article IV Consultations, 1979–99



Source: Staff reports for biennial reviews of surveillance.

efficiency that the original bicycle had engendered. Two years later, the Board agreed to scrap the bicycle altogether and place all those countries on annual cycles.[21]

From an all-time peak of 85 percent coverage in 1985, the rate steadily declined to a trough of 50 percent in 1992 (Figure 4.1). That figure resulted in part from a Board decision to postpone the 1992 consultations for countries that were not borrowing and had no imminent prospect of borrowing from the Fund and were not large enough to have systemic importance either globally or regionally.[22] Even before that decision, though, the coverage rate had been about two-thirds or less for three years, down substantially from the peak. After 1992, as the Fund added more staff to accommodate the demands of the rising membership, the number of consultations soared from a low of 88 to a new high of 145. Coverage from 1993 through 1999 averaged close to 75 percent of the membership.

[21]Decision No. 10362-(93/67); minutes of EBM/93/67 (May 10, 1993), p. 25.

[22]Minutes of EBM/91/157 (November 22, 1991), p. 3. That decision was motivated by the need to shift large numbers of staff to work on the Soviet Union and its component states. For the list of countries affected by this decision, see "Temporary Changes in Article IV Consultation Cycles," EBD/91/311 (November 22, 1991).

Nonmember Territories

In a few cases, the Fund held regular consultation discussions with nonmember territories following voluntary agreements with members. The prototype for this activity was an agreement with the Netherlands, beginning in 1970, to conduct Article VIII consultations with the Netherlands Antilles.[23] The Antilles (then comprising Aruba, Curaçao, and four other Caribbean islands) was an integral political part of the Kingdom of the Netherlands but had a distinct and autonomous economy based largely on tourism and petroleum. It also had its own currency, which was pegged to the U.S. dollar, not to the Netherlands guilder. A local political crisis in 1969 did considerable damage to the economy and to the balance of payments. That induced the Dutch government to ask the Fund to consult with the authorities in the Antilles and offer policy advice.[24] From then on, the Fund conducted regular consultations with the Antilles, first under Article VIII and later (after the Second Amendment took effect) under Article IV.

In 1990, the Fund entered into a similar agreement with the United Kingdom for consultations with Hong Kong. The government of the United Kingdom controlled the territory through a 99-year lease from China, scheduled to expire in 1997.[25] In April 1990, the British and Chinese authorities ratified an agreement for the return of Hong Kong to China when the lease ran out. Although Hong Kong was a major hub for international finance, its status as a British territory meant that its relations with the IMF had been limited. Beginning in 1979, the Fund included some data in the WEO. From 1987, it provided technical assistance, mainly on balance of payments accounting. Two years later, the British and Chinese teams negotiating terms for the handover agreed that Hong Kong would "continue to participate in the activities of the IMF" after the change in sovereignty. That decision enabled the IMF to begin collecting data more systematically and to initiate annual consultations and other contacts.[26]

The first Article IV consultation discussions with Hong Kong took place in October 1990, led by Bruce J. Smith (Assistant Director, Asian Department). The staff report praised the authorities' impressive record of economic success, while offering some low-key advice to strengthen balance of payments statistics, watch out for spending excesses, and consider implementing a value-added tax.[27] The staff recommended

[23]Formally and legally, these consultations were a component of the consultations with the Netherlands. In practice, they were conducted separately.

[24]"Kingdom of the Netherlands—Netherlands Antilles—Staff Report for the Article VIII Consultation," SM/70/230 (November 3, 1970).

[25]After the handover, the territory became known as Hong Kong Special Administrative Region of China, or Hong Kong SAR.

[26]See the "Fund Relations" Appendix in "United Kingdom—Hong Kong—Staff Report for the 1996 Article IV Consultation Discussions," SM/97/33 (February 6, 1997).

[27]"United Kingdom—Hong Kong—Staff Report for the 1990 Article IV Consultation Discussions," SM/90/233 (December 19, 1990).

placing Hong Kong on the bicycle, but the authorities asked for—and got—annual consultations.[28]

Regional Surveillance

Another approach the staff suggested in 1990 was to make increased use of regional surveillance. For groups of countries with close trade and other economic and financial ties, and especially for those with common currency arrangements, discussing them as a group would bring two benefits. The main advantage would be to generate more meaningful analysis of policy options. In some situations, regional surveillance would also yield economies of scale for the use of time by both the staff and Executive Directors. Groupings that seemed particularly apt included the European Communities, the CFA franc zone in Africa, and the Eastern Caribbean Currency Union.[29] The Executive Board cautiously endorsed that approach, though with the proviso that it should be primarily an analytical exercise and not a substitute for bilateral surveillance with individual member countries.

As detailed in Chapter14, the Fund began this sort of regional analysis with a study of the exchange arrangements of the CFA franc zone. That study eventually contributed to the regional understanding essential for successfully managing the devaluation of the CFA franc in January 1994. Soon afterward, when war broke out in the Middle East in response to the invasion of Kuwait by Iraq, the Fund undertook a study of the likely economic effects on the region. That study helped inform an interagency effort to provide advice and financial assistance to the most severely affected countries.[30]

Subsequent instances of regional surveillance in the 1990s, with the exception of the European issues discussed below, were mostly singular discussions of regional groupings or discrete events with important regional effects. Examples included coverage of regional policy issues in the West African Economic and Monetary Union in 1998; the establishment of the Central African Economic and Monetary Community in 1999; developments in the Eastern Caribbean Currency Union in 1998–99; postmortem analysis of the Asian financial crises of 1997–98; and studies of the economic and

[28]For a detailed review of these consultations up to the 1997 handover, see Dodsworth and Mihaljek (1997). The Fund's subsequent policy advice to Hong Kong is discussed in Chapter 12 of this History.

[29]"Biennial Review of the Implementation of the Fund's Surveillance over Members' Exchange Rate Policies and of the 1977 Surveillance Decision," SM/90/103 (May 29, 1990), pp. 13–14.

[30]For an overview, see "International and Regional Implications of the Crisis in the Middle East and its Aftermath," ICMS/Doc/91/5 (April 26, 1991).

policy implications of regional trade agreements.[31] The opening of the Regional Office for Asia and the Pacific in Tokyo in 1997 also symbolized the Fund's recognition of the need for a wider focus in that region. And in September 1998, the Fund hosted a special meeting of Latin American finance ministers and central bank governors to develop a regional approach to containing the effects of the financial crises that had already spread from East Asia to the Russian Federation (see Chapter12).

One of the most important and continuing examples of regional surveillance was with regard to the monetary integration of western Europe. The *ad referendum* signing of the Maastricht Treaty in December 1991 set in motion an integration process aimed at establishing full Economic and Monetary Union (EMU) by 1999. The staff of EUR monitored developments over the next year and then prepared a study of the regional and global implications that was intended to be discussed by Executive Directors around the end of August 1992. The paper noted that the transition from national formulation and implementation of monetary policy to joint implementation by participating European countries would take several years but ultimately would have profound effects on Europe, its trading partners, and the Fund. It proposed that the Fund begin to conduct a regional "Article IV type" surveillance consultation with the new regional monetary authorities (primarily the European Monetary Institute, or EMI, which the Maastricht Treaty would establish as a transitional body to the permanent European Central Bank, or ECB).[32]

Unfortunately, the Executive Board's discussion of the EMU paper was postponed in August 1992.[33] When the exchange rate mechanism (ERM) of the European Monetary System (EMS) came under speculative pressure in September and the British and Italian currencies were forced out, the hole in Fund surveillance was glaringly obvious. Coincidentally, European finance officials were in Washington for the IMF/World Bank Annual Meetings, and some of their negotiations took place either at Fund headquarters or at the convention hotels. The Fund itself, however, was kept on the sidelines, not only by the long-standing reluctance of European officials to seek the Fund's advice, but by the lack of a clearly articulated institutional position on EMU. Only

[31]See, for example, "Regional Trading Arrangements," SM/94/193 (July 22, 1994); "Interim Assessment of the World Economic Outlook—Regional and Global Implications of the Financial Crisis in Southeast and East Asia," EBS/97/231 (December 9, 1997); "West African Economic and Monetary Union—Recent Developments and Regional Policy Issues," SM/98/83 (April 13, 1998); "Central African Economic and Monetary Community—Recent Developments and Main Regional Policy Issues," SM/99/316 (December 30, 1999); and van Beek and others (2000) on the Eastern Caribbean Currency Union.

[32]"Economic and Monetary Union in Europe—Policy Issues and Implications for Fund Surveillance," SM/92/129 (June 26, 1992).

[33]Press reports, based on leaks from one or more Executive Directors, suggested that the delay was linked to the impending referendum on the Maastricht Treaty in France. Camdessus called that link "nonsensical" but did not offer an alternative explanation; minutes of EBM/92/105 (August 26, 1992), p. 21.

after the crisis had passed, in December 1992, did the Executive Board finally hold its postponed seminar.

That seminar led to general agreements that the Fund should hold regular discussions of EMU during the transition, that the Fund broadly supported the process despite some misgivings about the wisdom of defending exchange rates between countries with different trend rates of inflation, and that formal consultations under Article IV had to be restricted to sovereign member countries.[34] Over the next year, as turmoil continued in the ERM, the WEO and the periodic WEMD sessions became the main vehicles for these discussions. Twice in 1994 and once in 1996, the Board held more formal discussions of the broader implications of European monetary integration. The staff papers for these meetings stressed the potential benefits of EMU but also highlighted the political and technical hurdles that remained to be cleared before the process could be brought to a successful conclusion.[35]

When Executive Directors met to discuss the subject in March 1996, those hurdles were daunting. Almost none of the candidate countries for EMU met the criteria spelled out in the Maastricht Treaty, and the region was in a recession that appeared to be caused or aggravated by attempts to get fiscal deficits and debt levels down to qualifying levels. A few Directors from outside the European Union (EU) found the prospects worrying, and some were skeptical of whether EMU was really feasible on the envisaged schedule. Shakour Shaalan (Egypt) kicked off the debate by pleading for a delay in the process and expressing doubts about whether a single currency was even in Europe's best interests. Daniel Kaeser (Switzerland) joined that argument by noting that "adjusting the timetable . . . [would put the] future European monetary policy, from its inception, on a more solid and thus more robust basis." Even Directors from EU member countries expressed concerns about the convergence criteria pushing up unemployment rates across the continent. The prevailing view, though, was that no matter how difficult the process turned out to be, its successful conclusion was critically important for Europe and for the rest of the world.[36]

In March 1997, as the adoption of the Stability and Growth Pact was approaching, the Fund hosted a conference at which a number of outside experts debated the benefits and costs of Europe proceeding with EMU as planned. Despite considerable

[34]Minutes of SEM/MTG/92/4 and SEM/MTG/92/5 (December 14, 1992). For that seminar, the staff produced a postcrisis update to the June 26 paper cited in footnote 32; SM/92/129, Suppl. 2 (December 1, 1992). A first supplement (June 29) provided background information on the Maastricht Treaty and related developments.

[35]See "Monetary Policy Issues Following the Widening of the ERM Bands," SM/94/14 (January 27, 1994); "European Union: Common Policies and Recent Institutional Developments," SM/94/120 (May 12, 1994); and "Progress toward EMU—Developments and Selected Issues," SM/96/41 (February 14, 1996). These papers were discussed by the Executive Board at SEM/94/1 (March 7, 1994), SEM/94/5 (June 6, 1994), and SEM/96/3 (March 6, 1996), respectively.

[36]Minutes of SEM/MTG/96/3 (March 6, 1996), pp. 3 (Shaalan), 35 (Kaeser), and 51–54 (concluding remarks by Camdessus).

doubts on the part of many speakers, the general atmosphere was supportive.[37] In April, the Interim Committee "welcomed the progress made toward establishing conditions for EMU, the creation of which is one of the most important international monetary developments in the post–Bretton Woods period." The communiqué called on the Fund to "undertake a broad program to assess the implications of EMU for the international monetary system and for the Fund."[38]

From that point on, analysis of all aspects of EMU was an integral part of Fund surveillance. The staff was meeting regularly with counterparts in the EMI. When the ECB replaced the EMI in January 1999, the Fund granted it observer status in the Fund, with the right for its representative to attend relevant meetings of the Executive Board.[39] More broadly, the Fund agreed in 1998 that once the EU adopted a common currency (the euro) in January 1999, consultations on monetary and exchange rate policies should take place at the regional level, while Article IV consultations with euro area countries "should focus on fiscal, financial, and structural policies."[40] Thus, for the first time, the Fund adopted a specific policy establishing regional surveillance as an ongoing function.

Standards for Good Policies

To be effective, surveillance has to be based on an agreed-on model, or at least a set of agreed-on principles for what constitutes good and sustainable economic policies. In the Fund's first quarter-century, the question was simply whether a country's policies would enable it to maintain its fixed exchange rate without having to take damaging countermeasures. In the 1970s, that question modulated to include the option of allowing the exchange rate to change without becoming destabilizing. By the 1980s, confidence in the stabilizing influence of exchange rate flexibility had waned. Several efforts were made—both within the IMF and by small groups of the major industrial countries with key internationalized currencies—to agree on a "global strategy" for monitoring focused on the quality of good policies. Target zones for exchange rates, monitoring zones, reference ranges, and sets of objective or quantitative indicators all had their day in the sun. None led

[37]The proceedings were published as Masson, Krueger, and Turtelboom (1997). Also see "Summary of the Conference on EMU and the International Monetary System," SM/97/91 (April 10, 1997).

[38]Interim Committee communiqué (April 28, 1997), paragraph 6.

[39]This decision limited ECB attendance to Executive Board meetings on euro area issues, the WEO and international capital markets reports, WEMD sessions, and others "recognized by the ECB and the IMF to be of mutual interest for the performance of their mandates." This rule required some time to be properly interpreted because ECB representatives tended to take a broader view of mutual interest than did the Fund. The initial ECB representative at the Fund was Robert Raymond, the former director general of the EMI.

[40]Minutes of EBM/98/101 (September 21, 1998); the quotation is from concluding remarks by the Acting Chairman (Deputy Managing Director Shigemitsu Sugisaki) on p. 53.

to a firm footing for the assessment of the sustainability, wisdom, or consistency of countries' policies.[41]

All these efforts were based on the notion of assessing consistency between a country's exchange rate and its "fundamentals." The difficulty lay both in measuring fundamentals and in modeling the relationship between them and the exchange rate. In some contexts, the fundamentals were defined as the country's monetary and fiscal policies and other variables affecting aggregate demand and supply. Assessment of consistency then amounted to evaluating whether speculative pressures were causing the exchange rate to deviate from the level that those conditions would otherwise have generated. On a deeper level, the question was whether the country's economic policies were appropriate and sustainable. If a country had a fixed or managed exchange rate, the dual question was whether that regime was consistent with other economic policies and whether those other (fundamental) policies were appropriate. As the staff summarized the problem in 1992, the goal was to find "the level of a country's exchange rate consistent with the achievement of both internal and external macroeconomic balance over the medium term."[42] That was no small challenge.

Global Standards

Establishing good medium-term goals and policies was more a political than an economic task. The staff's technical job was to assess the economic consequences of the political decisions. Consequently, after the 1992 review of surveillance, Camdessus and the Chairman of the Interim Committee (Philippe Maystadt) decided to seek the Interim Committee's support in defining standards for good policies. That led to a three-year progression of increasingly detailed declarations by the Committee that culminated in what Camdessus later liked to call the "eleven commandments."

The initial effort was the Interim Committee's "Declaration on Cooperation for Sustained Global Expansion," adopted at the April 1993 meeting in Washington.[43] This declaration called on all countries and the major multilateral institutions "to join forces in a *global cooperative effort* to bolster confidence and strengthen prospects for a durable, noninflationary world expansion." (Emphasis is in the original text.) Specifically, the declaration stressed the importance of a multilateral effort to promote free trade, including a successful conclusion to the Uruguay Round of trade negotiations; continued reform of the transition economies; improved and better-coordinated economic policies in industrial countries, including fiscal consolidation over the medium term and structural reforms to improve the functioning of markets; and an updating of IMF lending facilities,

[41]Those various efforts are chronicled in Boughton (2001), pp. 97–101 and 186–224. The "global strategy" framework was first proposed by the U.S. Treasury Secretary in 1979; Boughton (2001), p. 100.

[42]"Biennial Review of the Fund's Surveillance Policy," SM/92/234 (December 30, 1992), p. 21.

[43]The communiqué and the declaration were published in *Annual Report 1993*, pp. 159–61.

including for concessional lending to low-income countries. The declaration reaffirmed the IMF's role as "the central international monetary institution."

This statement of principles was expressed in very general terms. Limited as it was, at that time the 1993 declaration was the most concrete international commitment to promoting market-oriented structural policies, and the most ambitious attempt to define good macroeconomic policies. It thus gave a global blessing to what had become known as the "Washington Consensus."[44]

The next step was the adoption of the Madrid Declaration at the October 1994 meeting of the Interim Committee in Madrid, Spain. That document asserted that a "strategy based on steadfast implementation of strong programs of macroeconomic adjustment and structural reform" had succeeded in "many developing economies" and should be adopted more widely. To enhance the prospects for success, it called on industrial countries to improve the "global environment" by strengthening their own macroeconomic policies, opening their markets to developing-country exports, reducing the debts of low-income countries, and increasing development assistance.[45] The Madrid Declaration offered more specific guidance than did its predecessor. That guidance focused mainly on the specific issues the world economy faced at the time, such as the continued need for a gradual reduction in fiscal deficits and for ratification of the trade agreements in the Uruguay Round, but it laid the groundwork for a more comprehensive agreement to follow.

This progressive effort culminated two years later in the adoption by the Interim Committee of the document, "Partnership for Sustainable Global Growth."[46] By this time, the principles of the Washington Consensus had become so broadly accepted that they had (temporarily, as it happened) ceased to be controversial, at least among the world's finance officials. Camdessus therefore decided that the time was ripe to redefine the purposes of the Fund beyond those set out in Article I of the Articles of Agreement. He was convinced that the IMF had to promote *sustainable* economic development, through its surveillance as much as through its conditional lending. Clarification and extension of the Madrid Declaration would make a good start.

The 1996 declaration, the final text of which was hammered out by the Executive Board in two drafting sessions just before the meeting of the Interim Committee, reiterated the validity of the earlier principles and restated them as a set of action-oriented goals.[47] It added that a goal of the global strategy was to promote the "full participation

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[44]For the origin and controversies of the phrase "Washington Consensus," see Prologue, pp. lxi–lxii.

[45]*Annual Report 1995*, pp. 207–08.

[46]This document may be accessed at http://www.imf.org/external/pubs/ft/history/2011/index.htm.

[47]For the drafting process, see "Draft Interim Committee Declaration—A New Partnership for Sustainable Global Growth," EBD/96/125 (September 24, 1996); "Revised Draft Interim Committee Declaration—A Partnership for Sustainable Global Growth," EBD/96/125, Revision 1 (September 25, 1996); and minutes of IS/96/7 (September 25, 1996) and IS/96/8 (September 26, 1996).

of all economies, including the low income countries, in the global economy. . . . Because the sustainability of economic growth depends on development of human resources," the strategy had to include policies to strengthen the resources for and effectiveness of social spending and programs to protect the poor and alleviate poverty. The committee concluded the statement of 11 goals by encouraging "the Fund to continue to cooperate with other international organizations *in all relevant areas*." (Emphasis added.) To underscore the operational implications, the Interim Committee communiqué added a quotation from the Managing Director, stating that the declaration was "the distillation of Fund surveillance by the world's most representative body of finance policymakers."

The issuance of these "eleven commandments" turned out to be the apogee of Camdessus's ambitious effort to base Fund surveillance on this broad strategy. Indeed, it is difficult to discern any direct effect at all from any of these declarations on the treatment of macroeconomic or social policies in Article IV consultations with countries large or small. To a great extent, this failure reflected deep skepticism by many on the staff about whether the Fund was the right agency to promote structural reforms or that such an effort could succeed outside the framework of conditional lending. The difficulty was reinforced in the aftermath of the 1997–98 Asian financial crisis, when public, official, and academic skepticism about global trade and finance began to supplant the optimistic views of the mid-1990s. Another decade would pass before the Fund would successfully rebase its surveillance on specific but universal policy goals, and even then the scope of the reform would be greatly diminished.[48]

Codes of Good Practices

What did bear fruit in the second half of the decade was the use of IMF surveillance to examine whether countries were meeting internationally established standards on institutional development, including data dissemination, financial sector soundness, and the conduct of fiscal policies. The Fund's oversight of these specific issues is discussed later in this section. The general approach on codes of good practices evolved in response to the 1997–98 financial crisis in East Asia. While that crisis was still unfolding at the end of the summer of 1997, the Interim Committee asked the Fund to take several measures aimed at helping to prevent a recurrence. In that regard, the committee "stressed the importance of openness and accountability of economic policymaking" and asked the Fund to consider "developing a code of good practices."[49]

[48]In June 2007, the Fund replaced the 1977 decision on the principles and procedures of bilateral surveillance. The new decision specified that "the Fund will examine whether domestic policies are directed toward fostering a high rate of potential growth only in those cases where such high potential growth significantly influences prospects for domestic, and thereby external, stability"; Public Information Notice No. 07/69 (June 12, 2007); accessed at http://www.imf.org/external/np/sec/pn/2007/pn0769.htm#decision.

[49]Interim Committee communiqué (September 21, 1997), paragraph 7; *Annual Report 1998*, p. 159.

As an initial response to that request, the staff prepared a draft code of good practices on "fiscal transparency" in time for the Interim Committee's next meeting. The final version of the code reflected many modifications made by Executive Directors, who went through the draft line by line before agreeing to send it to the Interim Committee in April 1998. Agreement by consensus was nearly derailed by objections from Russia, which insisted—both in the Executive Board and in the Interim Committee—that the document should be downgraded from a prescriptive "code" to a set of suggested "principles." Eventually, Maystadt settled the issue by retaining the original title but adding "declaration on principles" as a modifier.[50] With that one change, the code was adopted and published as an attachment to the Interim Committee communiqué.[51]

Throughout 1998 and into 1999, work in this area proceeded in two directions. For one, the staff continued to develop standards for other policies for which it had a primary mandate, including on transparency in monetary and financial policies and on data dissemination.[52] In addition, the idea began to take hold that the Fund should have a central role in monitoring countries' adherence to such standards, including those that other agencies were responsible for developing.[53] In October 1998, a working party commissioned by the Group of 22 (G22, the forerunner of the G20) called on the Fund to use its Article IV consultations to prepare "transparency" reports on "the degree to which [countries meet] internationally recognized disclosure standards."[54] Shortly afterward, the G7 finance ministers endorsed that suggestion and added that the Fund, in cooperation with other agencies, should "monitor . . . the implementation of these codes and standards," publish its transparency reports, and advise member countries on how to improve compliance (Group of 22, 1998).[55]

[50]See "Draft Code of Conduct on Fiscal Transparency," SM/98/66 (March 6, 1998), which was discussed by Executive Directors at SEM/98/3 (April 1, 1998); Revision 1 of that document (April 7, 1998), discussed at EBM/98/42 (April 8, 1998); and "Draft Code of Good Practices on Fiscal Transparency," SM/98/66, Revision 2 (April 10, 1998), which was submitted to the Interim Committee as ICMS/DOC/50/98/5 (April 10, 1998). The text of the code adopted by the committee was the same as the text submitted on April 10. The code and the detailed manual that followed it were revised and updated several times beginning in 2001.

[51]This attachment was titled "Code of Good Practices on Fiscal Transparency—Declaration on Principles" and may be accessed at http://www.imf.org/external/pubs/ft/history/2011/index.htm.

[52]In September 1999, the Interim Committee endorsed a "code of good practices on transparency in monetary and financial policies," to complement the code on fiscal transparency; see http://www.imf.org/external/np/mae/mft/code/index.htm.

[53]For example, the Basel Committee on Banking Supervision and the International Organization of Securities Commissions had primary responsibility for setting regulatory standards for banks and securities markets, respectively.

[54]The working group was cochaired by Mervyn King (deputy governor of the Bank of England) and Andrew Sheng (deputy chief executive of the Hong Kong Monetary Authority). Jack Boorman (Director, PDR) represented the IMF as an observer.

[55]"Declaration of G7 Finance Ministers and Central Bank Governors" (October 30, 1998); accessed at http://www.g7.utoronto.ca/finance/fm103098.htm.

In March 1999, the Fund began preparing "transparency reports," not as a surveillance activity but as technical assistance to its member countries. It then broadened and renamed them "reports on the observance of standards and codes" (ROSCs). At the outset, there were four ROSC modules: banking supervision, data dissemination, fiscal transparency, and transparency in monetary and financial policy. Although supportive of the staff's proposals for this initiative, many Executive Directors insisted that participation had to be purely voluntary.[56] The first country to volunteer for an assessment by the IMF was the United Kingdom, for which the Fund prepared reports on all four categories in March 1999. That was followed by reports on Argentina and Australia in April, and on Hong Kong SAR and Uganda in August. The Fund then produced five ROSCs on Tunisia in September, adding a new category for regulation of the securities market. In addition, fiscal transparency ROSCs were issued on Ukraine in September and on Greece in December.[57]

Issues in Surveillance

The IMF tried to make surveillance more effective by intensifying its focus on the issues that were most important for financial stability and sustainable macroeconomic balance. In the 1990s, these issues included removal of exchange restrictions, management of capital flows, and reform of structural policies with macroeconomic effects.

Removal of Exchange Restrictions

One of the fundamental purposes of the IMF is to promote currency convertibility for current account transactions. In the original Articles of Agreement, Article XIV afforded member countries the option of maintaining exchange restrictions on current transactions for a transitional period. In the Second Amendment of the Articles (1978), the reluctance of many members to commit to convertibility was acknowledged by a subtle revision in language, from "transitional period" to "transitional arrangements." The Fund adopted a passive attitude toward this shift, and by the end of the 1980s—almost a half century after the founding of the IMF—only a minority of member countries (43 percent) had irrevocably committed themselves to accepting the convertibility obligations of Article VIII.[58]

During the 1993 review of surveillance, Camdessus persuaded the Executive Board that the Fund was not doing enough to encourage its members to terminate exchange

[56] See, for example, the discussion at EBM/99/34 (March 29, 1999).

[57] The Fund published these reports on its website, at http://www.imf.org/external/np/rosc/rosc.asp.

[58] For the history through 1989, see Boughton (2001), pp. 120–23.

restrictions and commit themselves to avoiding them in the future. The Fund then adopted a strategy to induce members to accept the obligations of Article VIII.[59] From that point on, every consultation mission to a noncomplying country was required to raise the issue with the authorities, to discuss the need for any remaining exchange restrictions, and to recommend a schedule for removing restrictions (if any remained) and moving to Article VIII status.[60]

The results of shifting from passive to active voice were dramatic. In the four years 1993–96, the number of Article VIII countries jumped from 74 to 138, or 76 percent of the membership (Figure 4.2). One major reason for this success was that about 40 countries had already removed all or most restrictions subject to Fund jurisdiction. Some may have been reluctant to commit to refrain from reimposing restrictions in the future, but the main reason for delay was probably simple inertia. As noted above, those four years were the heyday of acceptance of openness in international transactions. Making a public commitment to openness was, in most countries, not controversial. After 1996, acceptances of the Article VIII obligations continued to increase, but at a slower pace. By the end of 1999, the total stood at 149 countries (82 percent of the membership). Most of the holdouts were countries in Africa, the Middle East, and Central Asia.

From a global perspective, the most important result of this push by the IMF was not the number of countries accepting the obligations of Article VIII. Rather, it was that the list included some of the largest developing and transition countries, including the four major emerging markets that would later become known as the BRICs: India in August 1994 (one month after Pakistan), Russia in June 1996, China in December 1996, and Brazil in November 1999.[61] Brazil thus was the last major country to move to Article VIII status in the IMF. By 1996, the staff was pressing the Brazilian authorities to make the shift. In principle, they were willing to do so, but they still had a number of restrictions in place that would take some time to remove. Even in November 1999, when the government finally accepted the obligations of Article VIII, two restrictions were still in effect, but they were scheduled to be removed early in the new year.[62]

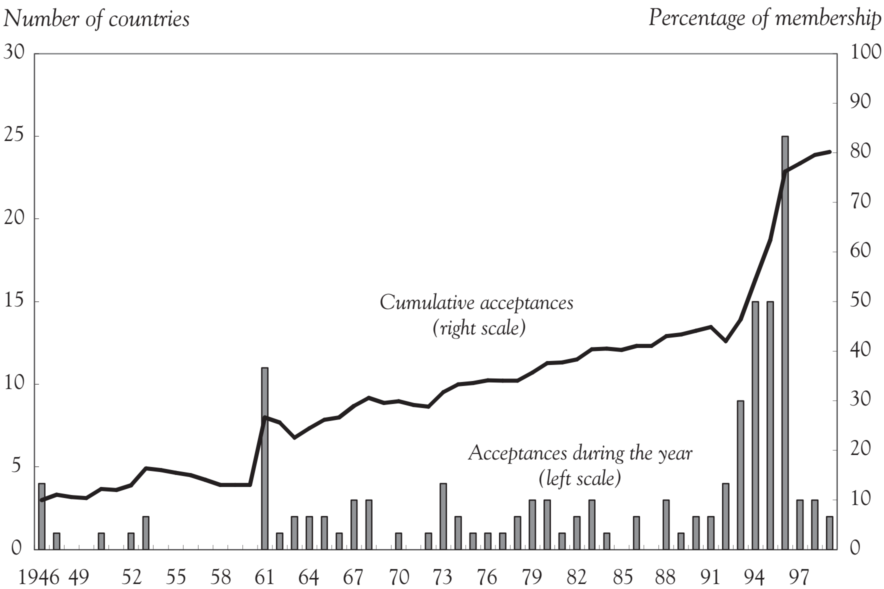
[59]For the background to this decision, see "Biennial Review of the Fund's Surveillance Policy," SM/92/234 (December 30, 1992), pp. 33 and 46–48. The decision was embodied in the Chairman's Summing Up at EBM/93/15 (January 29, 1993), p. 18.

[60]This strategy was set out in a guidance note attached to a memorandum from Boorman (Director, ETR Department) and Justin B. Zulu (Director, Monetary and Exchange Affairs Department) to Heads of Department, "Strategy for Encouraging Members to Accept the Obligations of Article VIII—Guidance Note," April 13, 1993. Also see memorandum from the Managing Director to Heads of [Area] Departments, "Encouraging Members to Accept Obligations of Article VIII," April 11, 1994. Both are in IMF archives, Historian's files.

[61]The grouping of these four leading emerging-market countries under the acronym BRICs originated in O'Neill (2001).

[62]"Brazil—Acceptance of Obligations of Article VIII, Sections 2, 3, and 4," EBD/99/140 (December 22, 1999).

Figure 4.2. Acceptance of Article VIII Status, 1946–99



Source: *Annual Reports*.

A complication in the pursuit of liberalization of international exchange arises when countries impose restrictions for what they consider to be national security reasons unrelated to trade. The IMF decided early in its history (in 1952) that it could not entirely duck the question of whether such restrictions were legitimate. It set up a procedure under which a member country could notify the Fund that it was imposing a restriction for national security, and the Executive Board would have 30 days in which it could object to that characterization. Unless the Fund objected, the restriction would then be considered to be approved.[63] Several such cases arose in the 1990s, most of which involved sanctions imposed or endorsed by the United Nations, including

- the freezing of Kuwaiti assets while the country was occupied by Iraq in 1990–91;
- sanctions imposed on the Federal Republic of Yugoslavia (Serbia and Montenegro) in 1992 in response to the war in Bosnia and Herzegovina;
- sanctions on Libya in 1993 in an escalation of pressure after the bombing of commercial airplanes in the late 1980s; and

[63]For the history of this issue before 1990, see Horsefield (1969), Vol. 2, pp. 259–60; and Boughton (2001), p. 120n116.

- sanctions on Haiti in 1994 in a UN-led effort to unseat the military dictatorship that had overthrown President Jean-Bertrand Aristide three years earlier.

In addition, in December 1997, the United States informed the Fund that it had imposed exchange restrictions on Sudan as part of a package of sanctions responding to the Sudanese government's alleged sanctioning of international terrorism, destabilizing neighboring governments, and human rights abuses. In none of these cases did the Executive Board take action to object to the representation that the restrictions were imposed for reasons related to national security.

Oversight of Capital Flows

The IMF's views on capital flows evolved during the 1990s in response to the rapid expansion of global flows and to research on the effects of such flows. Fund surveillance paid increasing attention to monitoring capital flows and to advising countries on how to manage their capital accounts. However, the extent of the Fund's mandate to oversee liberalization of capital accounts was less clear than its mandate over current account transactions. In mid-decade, momentum built up briefly for an amendment to the Articles of Agreement to clarify the Fund's role and responsibilities.

Pursuit of Orderly Liberalization

Liberalization of currency exchange for current account transactions was a widely shared goal and scarcely controversial. The same could not be said for liberalization of the capital account. When John Williamson coined the phrase "Washington Consensus" in 1990 to describe the generally accepted prescriptions for good economic policies, he pointedly omitted capital account liberalization from the list. Moreover, the Articles of Agreement did not include a mandate for the IMF to promote open capital flows. On the contrary, Article VI prohibited the Fund from lending to finance large or sustained capital outflows, and it empowered the Fund to require member countries to impose capital controls as a condition for borrowing if necessary to prevent a large or sustained outflow.

For the first quarter-century of IMF operations, private sector capital flows played a small, relatively benign, and mostly passive role in facilitating international trade and economic growth. In the 1970s, that situation began to change. The advent of generalized floating of exchange rates, combined with large-scale international wealth transfers associated with increases in oil prices, spurred rapid growth in capital flows. In a popular phrase of the day, that growth served to "recycle petrodollars." Oil-exporting countries invested earnings with large international banks that then onlent the funds to oil-importing countries, including many developing countries. Beneficially, those flows limited or delayed the negative consequences of oil price increases on economies dependent on oil imports. That benefit came at a cost, because the inflows were often

on highly liquid terms and were denominated in key currencies, not the local currency of the borrower. When short-term interest rates rose internationally in the early 1980s, bank creditors tried to withdraw liquid capital from developing countries. The resulting debt crisis nearly bankrupted sovereign borrowers and private creditors alike.

As detailed in Chapter 9, private capital began flowing back into developing countries in the early 1990s. Much as it had two decades earlier, but with more force and much greater breadth, this inflow fueled economic growth. Rather than coming only from international commercial banks in the form of loans, financial capital in the 1990s came from many different sources and in many different forms. Middle-income developing countries transformed themselves into "emerging markets" where companies could issue bonds and sell equities internationally. Adapting to these new market conditions and meeting the standards for attracting international capital became imperatives for any developing country aspiring to share in global prosperity.

The financial collapse of Mexico in December 1994 unmasked the fragility of this boom period, reminiscent of Mexico's 1982 debt crisis that brought an end to the first great wave of postwar international capital flows. Most emerging markets nonetheless continued to attract capital for the next two or three years, until the Asian and Russian financial crises forced a major and broadly based pullback.

These shifting fortunes posed a challenge for IMF surveillance.[64] If a country was failing to establish economic conditions conducive to capital inflows, it would be underperforming with regard to potential growth. If it established conditions that attracted capital at an excessive rate, it could subject itself to destabilizing inflationary pressures and risk facing a sudden cessation of inflows. Either way, the IMF had a responsibility to assess the risks and offer appropriate policy advice.

The official guidance to the staff in the early 1990s did not specifically address these issues, but the Fund was aware of the dangers of uncontrolled inflows. A 1992 staff research paper, published as Calvo, Leiderman, and Reinhart (1993), was a seminal study of the potential for "sudden stops" in capital flows and their devastating effects on emerging markets. Another (Mathieson and Rojas-Suárez, 1993) examined several countries that had experienced destabilizing real exchange rate appreciations after opening their capital accounts. The Executive Board reviewed the issue in July 1993 and concluded that finding ways to stabilize and absorb capital inflows effectively should be a priority for Fund surveillance.[65] In 1994, at the request of the Asia-Pacific Economic Cooperation (APEC) finance ministers, the staff prepared a set of papers (Khan and Reinhart, 1995) on ways APEC member countries could better manage inflows of financial capital. The initial paper for the 1995 biennial review of surveillance, largely written before the eruption of the Mexican peso crisis, noted that the

[64]Independent Evaluation Office (2005) provides a thorough analysis of the IMF's approach to capital account liberalization throughout its history.

[65]Minutes of SEM/MTG/93/3-4 (July 21, 1993). The staff paper for that meeting was published as Schadler and others (1993).

Fund had to have "clearer recognition of the extreme vulnerability of the recipients . . . to a sudden cessation or reversal of the inflows."[66]

In the aftermath of the Mexican crisis, the Fund saw clearly that it had to pay close attention to the dangers of unsustainable capital inflows. Mexico had attracted sizeable inflows throughout 1994 by selling a hybrid form of government securities called *tesobonos*, which were payable in pesos but in amounts that were effectively denominated in U.S. dollars (see Chapter 10). As the outstanding stock of these notes accumulated, the potential cost of a currency devaluation rose correspondingly. The situation was unsustainable, and it crashed at the end of the year.

When the Executive Board met in mid-February 1995 to conduct the biennial review of surveillance, Huw Evans (United Kingdom) proposed modifying the 1977 decision to include a concern about private capital flows.[67] The decision already contained a reference to "policies that provide abnormal encouragement or discouragement to capital flows" as one of the factors that could signal the need for a special consultation or other discussions with a member country. The new issue was whether, despite the pursuit of reasonable policies, a country might face circumstances in which private capital flows could become volatile or unsustainable.

After further discussion, the staff proposed, and the Board approved, revising the opening of the third paragraph of the 1977 decision to read (with the new wording in bold here), "The Fund's appraisal of a member's exchange rate policies shall be based on an evaluation of the developments in the member's balance of payments, **including the size and sustainability of capital flows**, against the background of its reserve position and its external indebtedness." In addition, Evans insisted, and the Board agreed, that the list of possible signals be extended to include "unsustainable flows of private capital."[68] With those amendments, the Fund put itself on record in favor of limiting the size and volatility of capital flows to sustainable levels.

Limiting the size of capital flows did not imply that the Fund was in favor of capital controls. Rather, the Fund was in favor of a world in which (a) emerging-market countries would pursue stable macroeconomic and financial sector policies that did not abnormally encourage capital inflows and (b) advanced economies would pursue stable policies that did not give rise to abnormal incentives for capital to flow out to the emerging markets. Direct controls on capital flows were generally discouraged, although most Fund officials recognized that controls could be helpful in some circumstances if they were well designed and applied only temporarily. The long-run goal of

[66]"Biennial Review of the Implementation of Surveillance over Members' Exchange Rate Policies and of the 1977 Surveillance Decision," SM/95/22 (January 26, 1995), p. 32.

[67]Minutes of EBM/95/17 (February 17, 1995), p. 28.

[68]"Biennial Review of the Implementation of Surveillance over Members' Exchange Rate Policies and of the 1977 Surveillance Decision—Additional Material," SM/95/22, Suppl. 2 (April 3, 1995), pp. 5–6; and minutes of EBM/95/37 (April 10, 1995), especially pp. 17–18, 29, and 35–36. Also see the full revised text of the 1977 decision, which may be accessed at http://www.imf.org/external/pubs/ft/history/2011/index.htm.

many, especially in the mid-1990s, was a system in which capital would flow freely enough to spur development and growth but would not be so unruly as to destabilize national economies in the process. Unfortunately, the Fund found it difficult to convey this nuanced position with clear policy advice to its member countries.

Pleading for the Fifth Amendment

Pursuit of a stable and orderly liberalization of capital was hampered by both the complexity of the message and the lack of a clear mandate. In 1994, the Interim Committee's Madrid Declaration expressed support for the free flow of capital, and that impelled the Fund to begin thinking seriously about the adequacy of its efforts in that direction. If each country was free to set its own course, and if the IMF acknowledged that capital inflows could have both negative and positive effects, then what advice could it sensibly give? If openness to international capital was a desirable long-term goal, how could the IMF ensure that each country was progressing adequately toward it?[69]

In July 1995, the Executive Board had a preliminary discussion of the possibility of amending the Articles of Agreement to give the IMF a clear mandate to promote capital account liberalization. The staff paper was circumspect, and the strongest push for the idea came from Karin Lissakers (United States). "We would see merit," she noted, "in an amendment to the Articles of Agreement to bring capital convertibility explicitly within the jurisdiction of the Fund and to introduce obligations regarding the staged liberalization of capital account transactions." When a number of other Directors expressed reservations, Manuel Guitián (Director, Monetary and Exchange Affairs Department) responded by pleading for action. There was, he argued "general agreement about the economic advantages of such a liberalization," but "current practice did not provide the Fund with any basis for influencing effectively what a country's plans might be for capital account liberalization."[70]

The staff overall was more skeptical than Guitián, and so were most Executive Directors—especially those from emerging markets and other developing countries. The conclusions of the Board in July 1995 were that capital flows should be liberalized gradually, at a pace reflecting each country's circumstances, and that the Fund had adequate scope under the Articles to monitor and encourage that process. The matter lay dormant for the next year, while the staff conducted more detailed research on the implications of large-scale capital inflows to developing countries. Camdessus kept the

[69]For detailed academic analyses of the effort to give the IMF jurisdiction over capital flows, see Abdelal (2007), Chapter 6; and Chwieroth (2010), Chapter 8.

[70]Minutes of EBM/95/73 (July 28, 1995), pp. 24 (Lissakers), 62 (Guitián), and 68–70 (Summing Up by the Acting Chairman, Stanley Fischer). The staff paper for the Board meeting was subsequently published, with minor revisions, as Chapter II of Quirk and Evans (1995). The identification of "we" in Lissakers' remark is unclear. On the basis of interviews with senior U.S. officials, Abdelal (2007), pp. 138–39, concludes that she was arguing for an amendment primarily on the basis of her personal views, not those of the U.S. authorities.

issue alive by asking the staff to prepare papers for the Executive Board on economic and legal issues related to "capital account convertibility and the role of the Fund."[71] The Interim Committee communiqué of September 1996 encouraged the Fund to continue working on it.

Serious consideration of amending the Articles began in February 1997. A staff paper set out the rationale and scope for such an amendment, and the Executive Board held an informal discussion of it. The Board reaffirmed the view that an "orderly and sustainable process" leading over time to "an open and liberal system of capital movements" was desirable and should be promoted by the Fund. Directors were prepared to recommend an amendment that would make capital convertibility part of the Fund's mandate, but not everyone liked the idea of a prescriptive amendment giving the Fund jurisdiction over countries' capital account policies.[72]

Several Directors from developing countries were worried about the Fund pressing them to open their financial systems before they were ready, and some from industrial countries were worried about the Fund stretching into fields in which it lacked a clear rationale for its decisions. Thomas A. Bernes (Canada) suggested that other organizations, such as the Organization for Economic Cooperation and Development or the World Trade Organization, might be better placed for "rule making and negotiating." Willy Kiekens (Belgium) expressed support for the idea that "the Fund should advise countries on issues connected with liberalizing capital movements." He noted that his authorities were "not convinced that the Fund should have jurisdiction to decide whether controls are still needed during the transition period."[73] It appeared that any amendment would have to be narrowly written to have any chance of being accepted and ratified by countries holding the requisite 85 percent of the voting power.

The Interim Committee endorsed this ongoing effort in its April 1997 communiqué and asked the Fund to come up with "key elements" for a proposed amendment by its next meeting. In September, the ministerial committee would be meeting in Hong Kong SAR, making for a special occasion and therefore an ideal time to modernize the

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[71]"Statement by the Managing Director on the Work Program of the Executive Board," BUFF/96/61 (May 16, 1996), p. 2. In addition to the papers submitted for discussion by the Executive Board, the staff prepared 10 working papers in 1996 analyzing various aspects of capital flows into developing and transition countries. In December 1995, the Research Department and the IMF Institute held a week-long seminar for senior officials from member countries on "Implications of International Capital Flows for Macroeconomic and Financial Policies." An overview of the conference and a selection of papers from it were published in the *International Journal of Economics and Finance*; see Khan and Mathieson (1996) and the associated papers.

[72]Minutes of SEM/MTG/97/2 (February 26, 1997); the quoted phrases are from p. 70. The staff paper discussed at that meeting was "Capital Account Convertibility and the Role of the Fund—Review of Experience and Consideration of a Possible Amendment of the Articles," SM/97/32 (February 5, 1997). The term "convertibility" in this context means that a country's currency is freely convertible into other currencies, including for transactions that are not within the current account under accepted international accounting standards.

[73]Minutes of SEM/MTG/97/2 (February 26, 1997), pp. 16 (Bernes) and 32 (Kiekens).

Fund's mandate. Throughout the summer, the staff, management, and Executive Directors worked to refine the technical aspects of the proposal. How, and under what circumstances, might the Fund approve capital controls? Should the Fund impose a time limit? What if a country committed itself to an open regime and then subsequently introduced a new restriction? Should all types of capital flows be treated alike, or should direct investment be treated differently? Should the Fund's jurisdiction be limited to currency convertibility, or should it extend to the underlying transactions? These questions would have to be resolved before a sensible amendment could be drafted, and the Fund devoted a fair amount of time to the task.[74]

A major outcome of these discussions was recognition that an overly narrow amendment would not have the desired effect. Making liberalization of capital flows a purpose of the Fund without simultaneously imposing obligations on all member countries and giving the Fund jurisdiction over those obligations would simply enable the Fund to justify imposing related conditions on its lending arrangements. To be effective, the amendment would have to be comprehensive and applicable to all members.[75]

At the Hong Kong SAR meetings, enthusiasm for the open-capital amendment was at an all-time high but was not unalloyed. At a seminar preceding the formal meetings of Fund and World Bank Governors, Stanley Fischer laid out a carefully reasoned case for the amendment, arguing that it would enable the Fund to guide liberalization in an orderly way, taking account of each country's circumstances and allowing for as long a transition as was appropriate.[76] The Interim Committee gave its blessing and trumpeted that it was "time to add a new chapter to the Bretton Woods agreement." It added a note of prudence, however, that the "Committee sees the Fund's proposed new mandate as bold in its vision, but cautious in implementation."[77]

In the months after the meetings in Hong Kong SAR, crises spread from Thailand to Indonesia and Korea and threatened to engulf the whole East Asian region. Although the fundamental causes derived from weaknesses in the financial sectors of the primarily affected countries, the shock and the crisis consisted of a sudden withdrawal of private capital. Belatedly, Fund staff realized that the "carry trade" in Japanese yen—in which speculators borrowed yen at extremely low interest rates and invested the proceeds in emerging markets with much higher yields—had greatly magnified the

[74]See "Capital Account Convertibility—Transitional Arrangements, Approval Policies and Financing under an Amendment," SM/97/173 (July 1, 1997); "Capital Movements under an Amendment of the Articles—The Treatment of Inward Direct Investment," SM/97/168 (June 27, 1997) and Suppl. 1 (July 11, 1997); and minutes of EBM/97/72 (July 15, 1997) and EBM/97/74 (July 18, 1997).

[75]"Report to the Interim Committee on the Liberalization of Capital Movements under an Amendment of the Articles," SM/97/230, Rev. 2 (September 10, 1997), pp. 2–3.

[76]Fischer's paper was published in Fischer and others (1998), pp. 1–10.

[77]The full text of this statement, "Liberalization of Capital Movements under an Amendment of the Articles," is reproduced at http://www.imf.org/external/pubs/ft/history/2011/index.htm.

consequences of domestic policy shortcomings in emerging-market countries.[78] In a January 1998 speech on the Asian crises, Fischer noted that

> developments in the advanced economies and global financial markets contributed significantly to the buildup of the imbalances that eventually led to the crises. . . . Large private capital flows to emerging markets, including the so-called "carry trade," were driven, to an important degree, by these phenomena and by an imprudent search for high yields by international investors without due regard to potential risks.[79]

The fear of exposure to the vagaries of international capital markets had begun to outweigh the desire to reap the uncertain benefits.

From that point on, the debate over the amendment was muddled. Camdessus and Fischer tried to project the message that their goal was to guide liberalization gradually, country by country. In their view, each country should first strengthen its economic, legal, regulatory, and other institutional policies. The longer-run goal of full convertibility would help speed up and guide that process, and the IMF was the agency best situated to monitor and lead it. They were not aiming to induce countries to open their financial systems to capital inflows before the preconditions were in place. After the financial crisis in Asia, that message got lost. Critics focused on the dubiety of both the goal and the means. Were capital controls necessarily bad? Was the IMF the right agency to promote their elimination? As discussed in Chapters 11 and 12, the Fund was mistakenly accused of having forced Asian countries to open their capital accounts prematurely, thus aggravating the crisis. That perception added to the difficulty of having a reasonable discussion of the Fund's role and mandate.[80]

The bureaucracy of the IMF continued to work on preparing an amendment, and Camdessus continued to press for a successful conclusion to what he called a "major historic opportunity." The staff organized a two-day seminar in March 1998 at which a number of senior government officials spoke alongside leading academic economists. Although most speakers and participants in the discussions agreed capital liberalization should be made a purpose of the Fund, they were much less enthusiastic about giving

[78]The first staff paper to discuss the effects of the carry trade was "Hedge Funds and Financial Market Dynamics," EBS/98/9 (January 16, 1998), which was subsequently published as Eichengreen and Mathieson (1998). As that paper noted (p. 17), the prevalence of carry trade began with capital inflows to Malaysia in 1991–92.

[79]"The Asian Crisis: A View from the IMF," address by Stanley Fischer at the Midwinter Conference of the Bankers' Association for Foreign Trade, Washington, DC (January 22, 1998); accessed at http://www.imf.org/external/np/speeches/1998/012298.htm.

[80]Even among those who clearly understood the issue, the range of arguments brought to bear on both sides of this debate was remarkable. In the volume of papers collected in Fischer and others (1998), Rudiger Dornbusch asserted that "capital mobility ought to be unrestricted" (p. 20), a conclusion that Dani Rodrik called "genuinely odd" (p. 56). Stanley Fischer concluded that the "proposed amendment . . . will serve . . . the international community well" (p. 10), while Jacques J. Polak concluded that it would be neither necessary nor effective (p. 50). For a detailed assessment of criticisms of the Fund's role in capital account liberalization, see Independent Evaluation Office (2005).

the Fund jurisdiction over it in any way comparable to the Fund's existing jurisdiction over current account restrictions.[81] Even inside the Fund, much of the steam behind the amendment effort had dissipated.

The Executive Board met on April 2, 1998, to consider a proposal from Camdessus to amend the Fund's purposes as set out in Article I and to agree in principle on "the general rule [with specific exceptions] that members are prohibited from imposing restrictions on international capital movements without Fund approval." No formal vote was taken, but enough Directors spoke out against the jurisdictional rule that it had to be shelved.[82]

For the April 1998 meeting of the Interim Committee, Camdessus therefore submitted a proposal for a possible fifth amendment that would merely revise Article I to add the "orderly" liberalization of capital flows as an additional purpose of the Fund. Specifically, the purposes of the Fund set out in Article I would read as follows, with the new language in bold here:[83]

> The purposes of the International Monetary Fund are:
>
> (i) To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems.
>
> (ii) To facilitate the expansion and balanced growth of international trade **in goods and services and an efficient international allocation of capital**, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.
>
> (iii) To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.
>
> (iv) To assist in the establishment of a multilateral system of payments in respect of current **and capital** transactions between members, **in the orderly liberalization of international capital movements**, and in the elimination of foreign exchange restrictions which hamper the growth of world trade **and investment.**
>
> (v) To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with

[81]See "Summary of the Seminar on Capital Account Liberalization," SM/98/75 (March 25, 1998). Camdessus's "historic opportunity" remark was made at EBM/98/38 (April 2, 1998), p. 6.

[82]Minutes of EBM/98/38 (April 2, 1998).

[83]See attachment to "Liberalization of Capital Movements under an Amendment to the Articles," ICMS/DOC/50/98/7 (April 10, 1998). The reference to a "fifth" amendment presumed that the Fourth Amendment, allowing for a selective allocation of SDRs, would soon be ratified; see Chapter 15.

opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.

(vi) In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.

The Interim Committee put the best possible lipstick on the proposal by endorsing this language for Article I while noting that amendments to the more operational articles would also be required as part of the package. The matter was thus back in the hands of the Executive Board, which remained reluctant to push forward. During the rest of 1998 and 1999, the Board held several meetings to discuss various aspects of capital controls and liberalization, but its only further formal discussion of a possible fifth amendment was in an inconclusive seminar in July 1999.[84] Even the uncontroversial extension of purposes quoted above was never submitted to the Board of Governors for consideration.

Monitoring the Markets

Aside from developing policies on capital flows, the IMF had to determine the best way to monitor what was going on. When international banking flows exploded in the early 1970s, the Fund began tracking the implications by holding special discussions with the monetary authorities of countries with major financial centers. In 1974, the Executive Board reviewed developments in what were then called euro-currency markets and concluded that the staff should continue to build up a knowledge base about these markets. For the next five years, market developments were reported to the Board through the WEO. Then in 1979, staff in ETR began preparing a separate annual report, initially under the name "International Capital Markets: Recent Developments and Near-Term Prospects." Whereas the 1974 report was based on meetings only with country officials, the preparatory missions in

[84]The principal meetings during the year after the failure of April 1998 were EBM/98/85 (August 3, 1998), EBM/99/31 (March 24, 1999), and EBM/99/32 (March 25, 1999). The staff papers discussed at those meetings were published as Eichengreen and Mussa (1998) and Ariyoshi and others (2000). The Legal Department then prepared a list of options for an amendment in "The Role of the Fund in the Liberalization of Capital Movements—Options for Consideration," SM/99/147 (June 23, 1999), which Executive Directors discussed in seminar format at SEM/MTG/98/4–5 on July 9 and 12, 1999. A follow-up Legal Department paper, "The Role of the Fund in the Liberalization of Capital Movements—Further Considerations on a Two-Tiered Approach," SM/99/220 (September 3, 1999), was circulated but never discussed in a Board meeting. The final meeting of the decade on this topic (EBM/99/101 [September 10, 1999]) was limited to a review of country experiences with liberalization.

1979 met with private sector bankers as well.[85] These capital markets missions and reports became an annual exercise for the Fund. The following year, the Fund began publishing the reports, the first one being Williams (1980).[86]

The debt crisis of the 1980s brought Fund staff into much more regular contact with commercial and investment bankers, foreign exchange traders, and other market participants. The acceleration and diversification of capital flows in the 1990s pulled the staff in even more deeply. For the 1999 report, staff missions traveled to 17 countries, including all of the major international financial centers as well as such emerging markets as Argentina, China, Hungary, Malaysia, and Turkey. As this work intensified, the missions and the reports were elevated to a more central role in Fund surveillance.

The growing importance of the capital markets report led to a subtle change in its subtitle in 1992, to "Developments, Prospects, *and Key Policy Issues*." (Emphasis added.) At the same time because the report was becoming more analytical in scope, primary responsibility for its preparation was shifted from ETR to RES (which was also responsible for preparation of the WEO). Throughout the 1990s, the capital markets report took its place alongside the WEO as one of the two flagship publications of the IMF.

The clearest example of the influence of the capital markets report came in 1995, when the report included a detailed and (by IMF standards) unusually blunt retrospective analysis of the Mexican peso crisis. A debate had been raging in Mexico about the role of foreign investors and speculators in precipitating the crisis. Taking sides, to the consternation of the authorities, the Fund report concluded that "the pressure on Mexico's foreign exchange reserves . . . came not from the flight of foreign investors or from speculative position-taking by these investors, but from Mexican residents."

[85]The need for direct and regular contacts with financial markets was perceived much earlier. In 1957, for example, Irving S. Friedman (Director, Exchange Restrictions Department) became concerned that the Fund did not have enough information to assess the appropriateness of exchange restrictions Argentina was introducing. Reflecting on the problem, he wrote to a colleague, "If, as it seems likely, we are to become increasingly involved in passing judgments or giving advice on current restrictive practices and in judging a country's need for financial assistance, it would seem desirable to get to know much more of what is happening in the market and what people on the private side feel about developments"; untitled memorandum (January 26, 1957); IMF archives, CF/Country files, Argentina. The matter appears not to have been pursued further, however. The subsequent consultation report made no mention of meetings with market participants; see "1956 Consultations—Argentina," SM/57/68 (August 7, 1957), p. 1.

[86]The 1979 report was circulated internally as SM/79/185 (July 10, 1979). That paper and the first four published reports, issued in the Occasional Paper series, were prepared by ETR staff teams led by Richard C. Williams. In 1984, C. Maxwell Watson took over. Beginning in December 1986, the reports were issued in the World Economic and Financial Surveys series. In 2002, the capital markets report was reconstituted as the *Global Financial Stability Report* and was prepared by the newly formed International Capital Markets Department.

The ensuing controversy eventually became an important element in the evolving understanding of how to avoid such a crisis in the future.[87]

The capital markets report was also a major channel through which the staff analyzed other crises in the 1990s, including the ERM crisis of 1992–93 and the Asian crises of 1997–98. As discussed in Chapter 11, the capital markets mission to Korea in April 1997 raised an alarm about how deep and widespread the weaknesses in the Korean financial system were, well before the crisis erupted in November. Unfortunately, that message was not absorbed by either the area department or senior management until much later. One of the critical lessons from the Asian crisis was the need for much better integration of capital markets and macroeconomic analysis, especially for vulnerable emerging markets.

New Focus on Structural Policies

The Fund's new emphasis on helping countries achieve "high-quality growth" rather than financial stability alone meant that surveillance had to cover a much wider range of policies.[88] Exchange rate and macroeconomic policies were the keys to controlling demand to ensure that external payments balances were financeable and sustainable at reasonably high employment. To exceed that goal and try to ensure that the economy was on a path of strong growth sustainable over a longer period, that offered real benefits across the spectrum of the citizenry, and that avoided degradation of the natural environment and its resources, structural policies would need attention as well. The challenge for the IMF in the 1990s was to find ways to extend its field of vision without extending its reach into areas in which it had no mandate and little expertise.

Financial Sector Soundness

Certain structural policies linked naturally to the Fund's traditional focus on macroeconomics and finance. The most important of those was the soundness of a country's banking system. Until the mid-1990s, the institutional structure of national finance was not systematically reviewed by the IMF unless a country requested technical assistance on the subject.[89] If a country had manifest problems or if it was undertaking major institutional changes, the staff would take note of it

[87]The quotation is from Folkerts-Landau and Ito (1995), p. 7. For an example of the reaction in Mexico, see Salinas (2002), pp. 1121–22. Within the Fund, the Executive Director for Mexico (Luis E. Berrizbeitia of Venezuela) took note of what the Mexican authorities regarded as "factual inaccuracies" in the report; minutes of EBM/95/51 (May 24, 1995), pp. 61–62.

[88]For the background to high-quality growth as an objective of the IMF, see Chapter 1, pp. 14–15.

[89]Perhaps the earliest example of a technical assistance request for a comprehensive look at the financial sector was from Mauritius in 1975; see "Mauritius—Technical Assistance," EBD/75/258 (November 19, 1975). A team of three economists from the Central Banking Service spent a few weeks in the country and prepared a report for the authorities. The report was not circulated further and had no discernible effect on the consultations with Mauritius, which were conducted independently by the African Department.

in its Article IV consultation reports, but the Fund did not generally attempt to uncover institutional weaknesses in anticipation of a crisis. The limitations of this approach are best illustrated by the Swedish banking crisis.

Sweden. Throughout the 1980s, Sweden carried out major structural reforms aimed at making the financial sector more competitive, both domestically and internationally. As nonbank finance companies flourished in response to these reforms, banking regulations were removed or reduced to enable banks to compete. In the second half of the decade, a number of Swedish banks merged with one another, and large international banks established offices in Sweden. These changes generated substantial capital outflows, as residents took advantage of new opportunities to invest in foreign currencies and in foreign financial institutions, but both the authorities and the Fund staff viewed this as a benign side effect of the transition to a more open and vibrant system. Assessing the situation in mid-1990, the staff "welcomed" the liberalization of the financial sector, through which the "highly regulated financial sector had been transformed into a market system."[90]

In fact, the "market system" had a fatal flaw, similar to the one that gave rise to the crisis in U.S. Savings and Loan institutions in the late 1980s and that later would fuel other financial crises such as those in Thailand in 1997 and worldwide in 2008.[91] Although interest rate and some prudential regulations had been softened, allowing financial institutions to offer high rates to attract deposits they could onlend to finance risky investments, depositors and investors generally viewed those institutions as implicitly protected by the regulatory authorities. This underpricing of risk led to excessive borrowing and hence to a bubble in asset prices, notably in commercial real estate. When the deterioration in asset quality became evident, sizeable government assistance was required to prevent a wave of insolvencies from undermining the payments system.

The imbalances in the Swedish financial sector were already evident by 1990, but IMF surveillance at that time was focused on macroeconomic data. Bank assets were growing rapidly and aggregate profits were holding up well, but the underpricing of risk meant that profit margins were being squeezed. As the staff would later acknowledge, banks were already becoming increasingly vulnerable to risks and increasingly dependent on ever more costly sources of funds.[92] Real estate prices had peaked in 1989, but the declines were not yet large enough to precipitate a crisis, and the staff saw no reason to raise an alarm.

In December 1990, the Swedish parliament authorized the government to apply for membership in the European Communities, which would soon be reconstituted as the

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[90]"Sweden—Staff Report for the 1990 Article IV Consultation," SM/90/146 (July 27, 1990), pp. 12 and 17.

[91]For an overview of the U.S. Savings and Loan crisis, see Fries (1992). On Thailand, see Chapter 11 in this History.

[92]See "Sweden—Recent Economic Developments," SM/93/169 (August 3, 1993), Appendix I.

EU. The following May, as one step toward membership, Sweden changed its exchange rate policy from a trade-weighted basket peg to a peg against the European Communities' unit of account, the European currency unit (ECU). Although that shift had the effect of hardening the currency at a time when the real economy was beginning to soften, the staff noted that it immediately produced an inflow of portfolio capital and thus led to a decline in interest rates. It was expected to bring a drop in inflation as well, and the staff accordingly fully endorsed it. The 1991 staff report also continued to praise the way the authorities were overseeing the financial sector. "Sweden has had considerable success in carrying out structural reforms," the mission wrote in August 1991. "The tax reform and the deregulation of financial markets have made important contributions."[93]

When the next staff mission went to Stockholm in May 1992, it was to conduct only a bicyclic "interim" consultation, which would be concluded without a meeting of the Executive Board. That decision implied that the Fund viewed Sweden's circumstances as benign, not posing a serious macroeconomic threat either to itself or to its neighbors. The staff mission was led by the third chief in as many years, reflecting the demands being placed on the staff by work on the large number of new European member countries.

In the course of the 1992 discussions, the authorities informed the staff they were having problems with the banking sector, notably in the form of large losses at two major banks attributable to "the steep falls in commercial property prices." Those losses were sufficiently large to require substantial government support. Most banks, however, still satisfied international capital adequacy standards, and neither the authorities nor the staff expressed much anxiety. The overall appraisal in the mission's report did not mention the issue at all.[94]

The Fund's concern about the banking situation—not only in Sweden but in the whole Nordic region—began to grow during the summer of 1992. In August, Camdessus stopped in both Finland and Sweden for some quiet discussions about steps that might be needed if more banks got into trouble. Although it was highly unlikely that either country would ask for loans from the IMF, he stressed to the authorities that the Fund was ready to help if needed.

The Fund's apprehension about financial stability in Sweden heightened considerably when the ERM crisis stuck on Black Wednesday, September 16, 1992. Although Sweden did not participate in the EMS, it pegged the krona to the ECU and thus was just as vulnerable to a speculative attack. The central bank, the Riksbank, mounted a classic and vigorous interest rate defense, briefly raising interest rates as high as

[93]Sweden—Staff Report for the 1991 Article IV Consultation," SM/91/158 (August 9, 1991), p. 15.

[94]"Sweden—Staff Report for the 1992 Interim Article IV Consultation," SM/92/124 (June 23, 1992). The quotation is from p. 8.

500 percent. When that defense failed to stem the attack, the authorities were forced to abandon the peg in November and allow the currency to float.

During this period, the Fund twice responded to invitations from the Riksbank to send staff—led by Desmond N. Lachman (Assistant Director, European I Department)—to Stockholm to advise the authorities. The first visit, in mid-September, coincided with the ERM crisis and focused on how to insulate Sweden from the attack. The Riksbank was determined to defend the exchange rate peg, but Lachman argued that the first priority should be to reduce Sweden's burgeoning fiscal deficit. Even with a "bold fiscal package," he warned that the exchange rate would still be overvalued and a float was close to inevitable. His second visit came right after the Riksbank was indeed forced to float the krona on November 19. Again the staff's main concern was the lack of political will to get the government's fiscal accounts in order.

The 1993 consultation finally provided an opportunity for the staff to respond comprehensively to the ongoing emergency, which it called Sweden's "worst economic crisis since the 1930s . . . characterized by . . . a marked decline in output and employment, a ballooning fiscal deficit, and a banking system under severe strain."[95] Moreover, the staff now acknowledged that the crisis had been brewing for several years:

> During the second half of the 1980s, in a climate of financial market deregulation, Sweden's banking sector overextended credit in an effort to gain market share, thereby contributing to an asset price boom. The subsequent slowing in the economy and puncturing of the asset price bubble resulted in substantial credit losses in the banking sector. Between 1990 and 1992, Swedish bank groups had to make provisions for bad debts totaling . . . almost 12 percent of total bank lending, while the State had to intervene directly in support of a number of important banks. In order to maintain public confidence in the banking system, the Government was obliged to provide direct budget assistance to individual banks totaling . . . almost 2 percent of GDP, in late 1991 and 1992.[96]

By then, the authorities were already well on their way to resolving the problems in the banking sector. After 1993, no further government support of the troubled banks was required, and real GDP was growing again.[97] For the rest of the decade, consultations with Sweden continued to focus primarily on deficit reduction and related fiscal policy issues. More generally, however, the main lesson for the IMF from this episode was the need to examine the health of the banking system as an integral part of bilateral surveillance. In the Swedish case, the Fund was able to assess the extent and the implications of the sectoral weakness once the problem had come to a head, but not before. Only by broadening the annual discussions so as to examine the financial sector routinely could this shortcoming be alleviated.

[95]"Sweden—Staff Report for the 1993 Article IV Consultation," SM/93/150 (July 13, 1993), p. 1.

[96]"Sweden—Staff Report for the 1993 Article IV Consultation," SM/93/150 (July 13, 1993), pp. 4 and 6. For a detailed discussion of the banking crisis as seen by the staff at that time, see "Sweden—Recent Economic Developments," SM/93/169 (August 3, 1993), pp. 43–59.

[97]For a postmortem on the banking crisis, see Ingves and Lind (1996).

Toward a systematic analysis. The Swedish banking crisis stimulated the staff to begin thinking in general terms about the potential for similar problems in other advanced economies, but it did not immediately alter the conduct of surveillance. The Fund's treatment of financial sector issues in its surveillance activities began to evolve only in 1995, in the wake of the financial crisis in Mexico. As pressures on the peso built up during 1994, one of the reasons the Mexican authorities were reluctant to raise interest rates was a fear that major banks would suffer large losses. At the time, IMF staff had no way to evaluate this threat. As the realization set in that this gap was a substantial hindrance to the effectiveness of surveillance, the Fund set out to strengthen its procedures.

In April 1995, the Interim Committee "noted the risks attached to overreliance on easily reversible capital inflows, and invited the Fund to pay more attention to members' financing policies, and the soundness of their financial sectors, in its surveillance activities."[98] The staff intensified its work in this field, mainly in the Monetary and Exchange Affairs Department (MAE), where Carl-Johan Lindgren (Chief of the Banking Supervision and Regulation Division) led a team effort. The findings in the staff report were alarming, beginning with the opening sentence: "Since 1980, over 130 countries, comprising almost three fourths of the [IMF's] member countries, have experienced significant banking sector problems" (Lindgren, Garcia, and Saal, 1996, p. 3).[99] In response, the Board decided in March 1996 that Fund surveillance should be reoriented to focus more directly on bank soundness and especially on the interactions between the banking sector and the macroeconomy.[100]

The emphasis on examining banking sectors increased further in 1997, after the staff produced two follow-up studies. In February, the Board agreed that the Fund was "uniquely placed," because of its surveillance and technical assistance roles, to alert member countries to weaknesses in their banking systems and to encourage countries to adhere to internationally accepted standards. In March, the Board asked the staff to develop a more detailed analytical framework for assessing the strength of countries' banking and financial sectors. In July, management approved a revised guidance note for the conduct of surveillance activities, which—for the first time—specifically asked that all staff reports "should include assessments of financial market developments and

[98]Interim Committee communiqué (April 26, 1995), paragraph 4; *Annual Report 1995*, p. 210. Similar language was included in the next communiqué, dated October 8, 1995.

[99]The wording of this sentence was slightly different, with a lower estimate of the number of affected countries, from the original draft discussed by the Executive Board.

[100]Minutes of EBM/96/21 (March 11, 1996).

prospects as well as problems and policy issues in the banking and financial sector where they are of macroeconomic significance."[101]

Two external developments further spurred the Fund's work on financial sector soundness. One was the issuance of a set of "core principles" by the Basel Committee on Banking Supervision. The committee—a standing body of central bank officials convened by the Group of Ten (G10) and headquartered at the Bank for International Settlements (BIS) in Basel, Switzerland—issued its recommendations in draft form in April 1997 and in final form in September, after receiving comments from the Fund and other agencies.[102] That document provided guidelines for the staff to follow in assessing the soundness of national banking systems.

The second development was the wave of financial crises that hit Thailand, Indonesia, and Korea in the second half of 1997. That shock laid bare the extent of weaknesses in financial sectors throughout the world's emerging markets and the depth of the interconnectivity between those weaknesses and macroeconomic vulnerability. It also revealed weaknesses in surveillance. The affected countries were not providing enough information for the Fund to assess the strength of their banking sectors, and the staff did not have sufficient specific expertise to uncover problems independently or to challenge the authorities' representations. The need for better and more consistent surveillance of financial systems was to be one of the crucial lessons from the Asian crises.[103]

By 1998, almost every staff report on Article IV consultations with emerging-market countries included an assessment of the country's framework for financial sector oversight. The great majority of those reports included recommendations for reform. In May 1999, the Fund and the World Bank jointly launched an additional program on a pilot basis, known as the Financial Sector Assessment Program (FSAP). On the Fund side, this program involved sending a special FSAP mission to each participating country ahead of the regular Article IV mission to prepare a Financial Sector Stability Assessment. Those assessments, prepared by a separate team of specialists rather than as a side activity by the area department's country team, provided in-depth analyses of financial soundness and oversight for review by the Fund as an integral part of its bilateral surveillance. Four FSAP missions were sent out in 1999, to Lebanon (in May), Colombia (July), Canada (October), and South Africa (October). The first reports

[101]The papers discussed in February were subsequently published in slightly revised form; see Alexander and others (1997). The staff papers discussed in March were "Toward a Framework for Sound Banking," EBS/97/38 (March 10, 1997) and three supplements; see minutes of EBM/97/12 (February 10, 1997) and EBM/97/30 (March 28, 1997). The relevant paragraphs of the 1997 staff guidance note may be accessed at http://www.imf.org/external/pubs/ft/history/2011/index.htm. The full note was circulated as "Staff Operational Guidance Note Following the 1997 Biennial Surveillance Review," SM/97/178 (July 3, 1997).

[102]The 1997 document, which was subsequently revised, may be accessed at http://www.bis.org/bcbs/history.htm.

[103]"Review of Members' Policies in the Context of Surveillance—Lessons for Surveillance from the Asian Crisis," EBS/98/44 (March 9, 1998), pp. 14–16.

were completed in 2000, and the FSAP program was made permanent later that year.[104]

Unproductive Spending

In 1988, Helmut Schmidt (chancellor of Germany, 1974–82) convened a UN-sponsored commission of distinguished officials from around the world to prepare a report on what could be done to increase aid flows to developing countries. The resulting 1989 report made several recommendations, one of the more intriguing being that donor countries should direct their scarce aid resources to countries spending less than 2 percent of GDP on the military. At the time, developing countries were spending an average of 4.7 percent of GDP on military outlays—more than four times what they were receiving in official development assistance. By cutting back on the "excess" and getting more aid as a reward, countries could make large gains in education, health, infrastructure, and other development essentials (see Schmidt, 1989).[105]

Camdessus took up this proposal as a cause for the IMF. In February 1990, a few months after the Schmidt Commission report was published, Camdessus used a speech in the Philippines to warn his audience that "countries that take their social responsibilities seriously . . . are more likely to attract international help than countries that waste money on unproductive prestige projects or excessive military display."[106] Meanwhile, the crumbling of the Soviet empire and the consequent end of the Cold War were raising the prospect that the major countries could and should sharply reduce their own military spending. The combination of the moral imperative for development and the economic benefit of the presumed "peace dividend" was pushing "unproductive spending" to the forefront of international debates.

In the first half of 1991, the Development Committee, the World Bank's *World Development Report*, and the G7 summit meeting all appealed to countries to cut back on military spending.[107] The summit leaders specifically welcomed the efforts being made by Camdessus and by Barber Conable, President of the World Bank, to call attention to "excessive military spending, in the context of reducing unproductive public expenditure."[108]

[104]For more on the origins of the program, see Chapter 3, pp. 85–86. Also see "Financial Sector Assessment Program (FSAP) – A Review: Lessons from the Pilot and Issues Going Forward," (November 27, 2000); accessed at http://www.imf.org/external/np/fsap/2001/review.htm#I.

[105]The data estimates cited here are from "Military Expenditures and the Role of the Fund," EBS/91/155 (September 10, 1991), p. 5.

[106]"Some Global Economic Issues for the 1990s; remarks before the One-Asia Assembly, Manila, February 19, 1990," MD/SP/90/2, p. 4.

[107]The Development Committee (formally, the Joint Ministerial Committee of the Boards of Governors of the Bank and Fund on the Transfer of Real Resources to Developing Countries) was established in 1974 in parallel with the Interim Committee, to advise the World Bank and the IMF on development issues.

[108]"Declaration on Conventional Arms Transfers and NBC [Nuclear, Biological and Chemical] Non-Proliferation" (July 16, 1991); accessed July 1, 2009, at http://www.g7.utoronto.ca/summit/1991london/arms.html.

In preparation for the 1991 IMF/World Bank Annual Meetings in Bangkok, the Fund responded to these various appeals by reviewing its own ability to assess members' military budgets in the context of its bilateral surveillance under Article IV. Not surprisingly, the Fund's Executive Directors were not of one mind on this controversial issue. Many countries closely guarded any information on military spending, and they were not likely to give it out to satisfy the IMF. If they expected the Fund to use the data to try to induce them to cut down, they would be even less willing to divulge it. Several African countries were fighting off armed insurrections, a particularly brutal example being the one waged by Liberia-based rebels against the government of Sierra Leone. In such circumstances, at what level could military spending be said to be excessive? Lacking a clear mandate, the Fund's options seemed limited, and its case seemed weak.

After two days of discussion, the Executive Board agreed on a minimalist policy under which the staff could request data on military spending in the course of Article IV consultation discussions but could not require the authorities to provide it. The staff was expected to respect national sensitivities and sovereignty concerns. The Board explicitly eschewed using such data to establish conditions on loans from the Fund.[109] The policy thus amounted to little more than an expression of concern that "information on [military] expenditures may be necessary to permit a full and internally consistent assessment of the member's economic position and policies."[110]

The Interim Committee, meeting in Bangkok, also took a cautious view, noting only that in the global effort to promote national saving, "an important contribution could be made by reassessing spending on defense and subsidies."[111] Camdessus was undeterred, and for the next few years he conducted a personal campaign to persuade countries to curtail military spending. He began by stopping in India and Pakistan on his way back to Washington from Bangkok. In both countries, he pressed the authorities to take advantage of more peaceful global conditions by redirecting spending from military outlays to education and health. In both countries, he made the same point in public speeches: "What a fine example it will be to the rest of the developing world, if these two great nations can each transfer substantial human and financial resources to activities that will more directly contribute to growth and to the

[109]The IMF already had a policy, adopted in September 1946, that its loans could not be used by borrowers to purchase armaments; minutes of Executive Board Meetings 70 and 71 (September 25 and 26, 1946); and Horsefield (1969), Vol. II, p. 385, and Vol. III, p. 245. That policy, however, was difficult to apply because of the fungibility of financing. For example, when India decided to purchase $3 billion in military aircraft in 1981 while it was seeking a $5.9 billion extended arrangement from the IMF, the timing raised eyebrows but did not prevent or delay approval; see Boughton (2001), p. 714.

[110]"Military Expenditures and the Role of the Fund," ICMS/DOC/91/13 (October 4, 1991). Also see the staff paper with the same title, EBS/91/155 (September 10, 1991).

[111]Interim Committee communiqué (October 14, 1991), paragraph 2; *Annual Report 1992*, p. 126.

reduction of poverty. What a prospect that could create for a better life for everyone in the subcontinent!"[112]

Staff in the Fund's Fiscal Affairs Department (FAD) were assigned to monitor the adequacy of statistics and data reporting and to undertake research on the macroeconomic effects of military spending, and the subject was raised in about 9 percent of Article IV consultation reports (none in industrial countries).[113] The Fund's involvement remained on a low flame—just bright enough to throw some light onto the most troubling cases—and it was not elevated further in the course of the 1990s. Other types of "unproductive" spending, such as the subsidies to which the 1991 Interim Committee communiqué alluded (see the preceding paragraph), were never systematically treated in a Fund policy statement but were made the subject of staff analysis in some consultations.[114]

National Governance and "Reform of the State"

As with excessive military spending, staff and management at the IMF were always concerned about corruption and weak governance in member countries but had difficulty figuring out what if anything to do about it. Until the 1990s, they were reluctant to express those concerns openly or to take any action in response. There were exceptions, usually limited to specific advice or requirements in the context of IMF lending. For example, if tax policies were routinely abused, or government spending practices were poorly documented, or banks were induced to lend to official or politically connected borrowers, the Fund might try to find ways to persuade or induce countries to limit such practices. The Fund also offered technical assistance to many countries to help strengthen fiscal and financial sector practices by making them more open and transparent.

These occasional efforts did not amount to a real policy. From the late 1970s through the 1980s, for example, the IMF lent frequently to Zaïre despite knowing that much of the proceeds were being siphoned off by President Mobutu Sese Seko and his cronies for their

[112]"Address to the India International Center, New Delhi, India, October 24, 1991," MD/SP/91/17, p. 6; and "Address to a Seminar on Structural Adjustment and Macroeconomic Policy Issues, Lahore, Pakistan, October 27, 1991," MD/SP/91/18, p. 6. Also see Camdessus's report to the Executive Board, minutes of EBM/91/145 (October 31, 1991), pp. 3–4.

[113]"Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision," SM/00/40 (February 18, 2000), p. 43. The staff also produced several working papers on military spending and its effects; see Davoodi and others (2001).

[114]In 1994, FAD prepared an analysis of various categories of public expenditure in a preliminary attempt to identify those that were relatively unproductive, including "white elephant" projects; see "Economic Implications of Unproductive Public Expenditures," EBS/94/69 (March 31, 1994). Also see Chu and others (1995); and Gupta and others (2000).

personal benefit (see Boughton, 2001, pp. 804–10). Protecting the Fund from political pressure and stopping such practices was becoming a necessity and a priority.[115]

In the 1990s, the Fund broadened its involvement in fighting corruption and in improving fiscal and financial governance and applied its concerns more consistently. It also extended this reach more regularly into its surveillance activities as well as its lending practices. To do so, it had to pull back a bit from its long-standing reluctance to inject political considerations overtly into its lending decisions and policy advice.

The drive to reduce military spending that rose to the fore in 1991 was motivated in part by a conviction that such excesses were often a symptom of official corruption. For the most part, those who spoke out on the issue stuck publicly to the theme of promoting development and increasing economic efficiency. Nearly everyone understood, however, that corruption was the heart of the problem. At the 1991 Annual Meetings in Bangkok, the point was made most clearly by Wim Kok, deputy prime minister of the Netherlands, who told the assembly that successful development policies require a "substantial investment in human resource and physical infrastructure. . . . The effectiveness of such policies depends on international economic cooperation and support, but mainly on good governance, and could often be enhanced by a cutback of disproportionate military expenditures" (IMF, 1991, p. 35).[116] Still, the time had not yet come when the IMF, or even the World Bank, had enough official support from the international community to take on corruption openly as a policy issue.[117]

In contrast to the Fund's reluctance and timidity in the 1980s, in the 1990s the institution gradually showed a willingness to address at least the most egregious cases of official corruption. As recounted in Chapter 14, the staff, the Executive Board, and Camdessus strongly criticized the Kenyan government in 1993 for the country's pervasive culture of bribery, nontransparent relations between the government and economic enterprises, and other forms of corruption. Those criticisms were made in private and did not—at that time—block approval of the financial support Kenya was asking for, but they at least served notice of unease. In the transition economies, especially those that emerged from the former Soviet Union, the Fund routinely included loan conditions aimed at reducing corruption and promoting good governance. Effective enforcement of those conditions, however, proved difficult.[118]

[115]At the 1991 IMF/World Bank Annual Meetings in Bangkok, for example, Frank Potter (Executive Director for Canada in the World Bank) was quoted as saying, "Our countries are sick of giving money to Mr. Mobutu and seeing it go into some Swiss bank account" (Stackhouse, 1991, p. B4).

[116]Kok was speaking at the plenary session on behalf of the member states of the EU.

[117]Barber Conable, President of the World Bank from 1986 to 1991, tried to take it up. For example, he wrote in 1989 that "Private sector initiatives and markets mechanisms are important, but they must go hand-in-hand with good governance—a public service that is efficient, a judicial system that is reliable, and an administration that is accountable to the public" (Conable, 1989, p. xii). But he stopped short of asserting a role for the Bank in promoting good governance.

[118]For a review, see Wolf and Gürgen (2002).

In January 1994, Camdessus decided to take his broader concerns public. Addressing a meeting of world church leaders at the Inter-American Development Bank headquarters in Washington, he asserted that "high quality growth . . . the ultimate objective of our work at the IMF . . . requires good governance. By this I mean publicly accountable and participatory government that serves the whole of society rather than sectional interests, and legal and regulatory frameworks that are transparent, fair, and limited to what is strictly necessary, so that the scope for arbitrary administrative decisions and corruption is minimized."[119] In a 1995 speech to the UN Economic and Social Council, he made a direct link to economic development: "to fight corruption . . . is a difficult task, requiring courage and perseverance. But progress must continue: it will profoundly strengthen the development process."[120]

Talking about corruption was a vital first step, but the greater challenge was to broaden support in the Executive Board sufficiently to turn that campaign into action. An opportunity arose in March 1996, when the Board was scheduled to hold an overnight retreat in the Virginia suburbs of Washington. One of the issues that Camdessus put on the table for discussion was "whether and how the Fund, in its relations with members, should address governance issues that have significant macroeconomic implications that are important to the Fund's surveillance and financial assistance."[121] As background material, Camdessus circulated a working paper by Vito Tanzi (Director, FAD) on "Corruption, Government Activities, and Markets," which set out a theory of the way corruption affected economic performance and how it might be controlled.[122]

When Camdessus made the case over dinner that Fund-supported programs were failing frequently because of corruption, Executive Directors were mostly skeptical that this was an issue that the Fund could or should tackle. As the discussion continued in the morning, however, views began to shift. Obviously, corruption could and did undermine the effectiveness of the Fund's financial support. More generally, if the Fund were to ignore corruption it knew was weakening a country's macroeconomic performance, the credibility and effectiveness of its surveillance would be damaged. At the end of the day, Directors agreed to try to develop a broad and evenhanded policy for examining corruption and other governance issues in the context of surveillance, lending, and technical assistance.[123]

The IMF was not alone in ramping up its efforts to combat corruption. In the mid-1990s, a wide variety of international organizations—the EU, the Financial Action Task

[119]"The Economic View of Growth: Evaluation of the Impact of Economic Reforms in Latin America," MD/SP/94/1 (January 13, 1994), pp. 2–3 (delivered in Spanish; official translation).

[120]"Address at the High-Level Segment of the UN Economic and Social Council, Geneva, July 6, 1995," MD/SP/95/11, p. 5 (delivered in French; official translation).

[121]"Executive Directors Retreat, March 4–5, 1996; Issues for Discussion," FO/DIS/96/8 (February 23, 1996), p. 2.

[122]A revised version was published as Tanzi (1995). The version circulated for the retreat was IMF Working Paper 94/99 (September 1, 1994).

[123]"Summary Record of Retreat Discussion on March 4–5, 1996," FO/DIS/96/22 (April 26, 1996).

Force, the Organization of American States, the Organization for Economic Cooperation and Development, the UN Development Program, the World Bank and other multilateral development banks, and the World Trade Organization—were taking actions within their own mandates to promote good governance. Several of those bodies as well as civil society organizations were actively pushing the Fund to join in the battle. In most cases, the IMF had observer status or otherwise participated in relevant discussions.

The legal basis for an IMF role was not spelled out clearly, but with a little ingenuity it could be inferred from Article IV, Section 1, of the Articles of Agreement. That section required each member country

> to endeavor to direct its economic and financial policies toward the objectives of fostering orderly economic growth with reasonable price stability, and to seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions.

On that basis, the Fund determined it had an obligation to evaluate, through its surveillance activities, whether poor governance was impinging seriously on a country's economic performance and, if so, whether its policies were in compliance with Article IV.[124]

While the debate was continuing over a possible role in addressing governance through surveillance, the Fund moved ahead in dealing with governance problems in borrowing countries. Notably, when Kenya asked for an ESAF arrangement in the fall of 1995, the Fund insisted that the authorities take specific measures to control corruption before it would approve the request. On the basis of initial signs of progress, the Executive Board gave its approval in April 1996 and allowed a first disbursement. When the government failed to follow up, and evidence of pervasive corruption persisted, the Fund cut off further lending for the next four years.[125]

The clarity of the Fund's mandate to evaluate governance was given a further boost with the adoption of the "eleven commandments" by the Interim Committee in September 1996.[126] The tenth item on the committee's list of objectives was "promoting good governance in all its aspects . . . as essential elements of a framework within which economies can prosper." The declaration concluded by encouraging "the Fund to continue to cooperate with other international organizations in all relevant areas."[127]

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[124]"The Role of the Fund in Governance Issues," EBS/96/197 (December 20, 1996), p. 7.

[125]These developments are covered in more detail in Chapter 14.

[126]Accessible at http://www.imf.org/external/pubs/ft/history/2011/index.htm.

[127]The declaration was drafted by Fund staff and then revised after two days of discussion by Executive Directors. The original text on governance was more pointed, calling on countries "to renovate the state, including by ensuring the rule of law, strengthening the judiciary, protecting the security of persons and property, improving the efficiency and accountability of the public sector, and fighting corruption and money laundering"; see "Draft Interim Committee Declaration—A New Partnership for Sustainable Global Growth," EBD/96/125 (September 24, 1996), and Supplements 1 and 2 (September 25 and 27); and minutes of IS/MTG/96/7 (September 25, 1996) and IS/MTG/96/8 (September 26, 1996).

Within days after that document was issued, Camdessus used his speech to the Governors assembled at the IMF/World Bank Annual Meetings to call for a "reform of the state," meaning that "governments must demonstrate that they have no tolerance for corruption in any form." At the same meeting, World Bank President James D. Wolfensohn made an even more explicit statement on the subject, decrying the "cancer of corruption" and promising that "the Bank Group will not tolerate corruption in the programs we support."[128] Camdessus was not yet able to make a similar promise, because the Fund still lacked a clear policy on corruption. The time had now come.

The Interim Committee declaration provided the impetus for Camdessus to ask the staff to prepare a guidance note for the Fund's role in governance issues. When the Executive Board had its first look at a draft in January 1997, the key point that emerged from the discussion was that the Fund should limit its involvement to the "economic aspects of governance" and strictly avoid getting embroiled in political issues. Everyone seemed to agree, though, that the demarcation between the two was extremely fuzzy and ill-defined.[129] The staff was sent back to refine its proposals, and it finally submitted a guidance note that the Board agreed was appropriate and within the Fund's mandate.[130] The guidance note set out a specific, though not necessarily exclusive, list of economic governance issues the staff might reasonably address, as well as any instance of corruption judged to have "significant macroeconomic implications, even if those effects are not precisely measurable" (paragraph 10). In the normal course of Article IV consultations, the staff was expected to raise such issues with the authorities and report on the discussions to the Executive Board.

During the next three years, staff reports for Article IV consultations addressed governance issues in nearly a quarter of all cases, up from 18 percent in the preceding two years. More important, the nature of the references tended to be more pointed.[131] Many of those reports, though not all, were for countries borrowing from the Fund or asking to borrow. A notable exception was the 1999 report on Nigeria, to which the Fund had not lent any money since 1992. President Olusegun Obasanjo had just taken office in the country's first democratic elections, and he wanted to get the Fund's seal of approval and restore the country's credibility in international markets. The staff

[128]A mythology later took hold that Wolfensohn's "cancer of corruption" speech was the seminal event in the governance agenda of the Bretton Woods institutions; see, for example, Mallaby (2004, p. 176), and "Ten Things You Did Not Know About the World Bank and Anti-Corruption," at http://go.worldbank.org/MR1Y8R0ZA0. In fact, as shown here, both the Bank and the Fund had already been strengthening their agendas for several years.

[129]Minutes of EBM/97/3 (January 15, 1997).

[130]Accessible at http://www.imf.org/external/pubs/ft/history/2011/index.htm.

[131]"Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision," SM/00/40 (February 18, 2000), p. 43. The record for 1994–96 is summarized in a memorandum from Il Houng Lee (Economist, Development Issues Division of PDR) to Benedicte V. Christensen (Chief, Development Issues Division), "Governance in Article IV consultation discussions" (August 2, 1996); IMF archives, Accession 2008-0251-12, PDR-DS, "Good Governance – August–October 1996."

report noted that in economic terms, Nigeria was no better off in 1999 than it had been in 1970, mainly because of long-standing and pervasive corruption, "financial malfeasance," and other forms of weak governance. The staff mission, led by Hiroyuki Hino (Senior Advisor, African Department), told the new authorities that the Fund could not approve their policies until they took concrete steps to deal with these problems. Obasanjo was already committed to doing so, and the report served to reinforce the message that the international community was behind the effort.[132]

All of the Article IV staff reports covering governance problems in the late 1990s were for developing or transition countries. Despite the repeated calls for evenhandedness, mission chiefs remained reluctant to call attention to such issues in the more advanced economies. A clear example occurred in 1997, when the Fund conducted its annual consultation with Austria. The staff mission, led by Hans M. Flickenschild (Advisor, European I Department, or EU1), held extensive discussions with the authorities in Vienna and with trade union representatives and other nongovernmental organizations on the pressing need for Austria to adopt structural reforms that would make it more competitive in an increasingly globalized marketplace. The approaching date of the introduction of the euro added to this imperative. At the time, the Austrian government still had a heavy hand in the economy, and a wide range of rigidities was hampering overall economic performance. One important factor was the role of political patronage in the appointment of senior managers in enterprises and banks. The staff was aware of and concerned about the problem, but no mention was made of it in the staff report.[133]

When the Executive Board met to conclude the consultation with Austria, Flickenschild explained the staff's concerns and noted that the issue had been omitted from the report owing to its "sensitive nature." That drew rebukes from Martin A. Brooke (Advisor, United Kingdom) and Eva Srejber (Sweden), who reminded staff of the need for evenhanded treatment of all countries. Wolf-Dieter Donecker (Alternate, Germany) defended the staff for its caution and even questioned whether "exerting political influence on major companies and banks" was really "bad governance" or was "simply a custom in many countries." Rejoining for the staff, David Burton (Senior Advisor, PDR) acknowledged that even treatment was important and that the matter "should probably have been touched upon in writing in the staff report." Even so, the Summing Up of the Board discussion made no mention of it.[134]

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[132]"Nigeria—Staff Report for the 1999 Article IV Consultation," SM/99/276 (November 17, 1999). As recounted in Chapter 14, Camdessus also went to Nigeria in 1999 to convey the anti-corruption message directly to Obasanjo. Nigeria was seeking a precautionary stand-by arrangement, on which it did not intend to draw (and did not).

[133]"Austria—Staff Report for the 1997 Article IV Consultations," SM/97/126 (May 23, 1997).

[134]Minutes of EBM/97/59 (June 13, 1997), pp. 51–52 (Flickenschild, identified in the minutes as "the staff representative from" EU1), 62 (Brooke, Donecker, Srejber, and Burton), and 65–67 (Summing Up).

Protection of the Environment

No issue illustrates the delicate balance between focus and breadth better than preservation of the natural environment. Could the IMF assess the sustainability of a country's macroeconomic policies without examining the effect of economic growth on the environment? Before the 1990s, few would have taken that question seriously. The World Bank, the UN, and civil society were much better equipped than the Fund and had much clearer responsibilities in this domain. By this decade, however, preserving the environment was becoming such a critical and universally shared goal that all able-bodied institutions were being conscripted into the cause. The IMF was no exception, but views differed strongly on how it should respond.

The prime advocate for IMF involvement in this area was the U.S. government. In 1989 and 1990, the U.S. Congress passed two laws calling on the U.S. Executive Director to encourage the IMF to consider the effects of its policies on environmental sustainability and to reduce or eliminate any negative impacts. The Fund responded by preparing a study discussed by the Executive Board in December 1990. The staff study noted that Fund-supported programs were macroeconomic rather than structural and therefore had no direct or generalized impact on the environment. It acknowledged, though, that the indirect effects could be significant and harmful. If a country had to take action to control aggregate demand or reduce imports to fix an unsustainable payments deficit, exporters might take actions such as increasing logging of old-growth forests to make up for the short-term losses. Positive responses also were possible, such as an increase in taxes on polluting activities or cuts in subsidies on chemical fertilizers. The challenge was to understand these various possibilities and possibly to guide the responses in a positive direction.[135]

Camdessus had no doubt that the environment was an appropriate concern for IMF surveillance. The U.S. authorities were asking the Fund to monitor the effect of economic policies on the environment, and he proposed establishing a small unit of two or three staff within FAD for this purpose. The existing staff was already stretched thin, and he pointed out that the Fund could not take on this task without the budget authority to hire additional specialists.[136] The Executive Board, however, was unconvinced.

Executive Directors raised two objections, one general and one more specific. The general issue was that the IMF lacked a mandate to deal with environmental issues. The Fund's General Counsel, François Gianviti, disposed of that objection in a Board seminar in March 1991. Article I of the Articles of Agreement, in his explanation, implied that "while the Fund was not concerned with the environment as such, it was

[135]"The Fund and Environmental Issues," SM/90/219 (November 16, 1990).

[136]"Statement by the Managing Director on the Fund and Environmental Issues," BUFF/90/230 (December 18, 1990).

concerned with the economic and financial consequences of environmental degradation."[137]

The second issue was more subtle. If the Fund were to hire environmental specialists, how would it use their findings? Would it deal evenhandedly with industrial and developing countries, or would it become part of a broad campaign to force environmental standards on developing countries that needed to borrow from the Fund? After two Board meetings on the subject, only six Directors, holding less than 40 percent of the voting power, were willing to support Camdessus's proposal. Of those, only one was from a developing country—Tanya Sirivedhin (Alternate, Thailand). She conditioned her support on the understanding "that Fund environmental scrutiny could be applied under Article IV consultations with any member—with or without a Fund-monitored program—if the circumstances seemed to warrant it."[138]

As soon as nongovernmental environmental organizations learned of this internal debate, they began lobbying for Fund involvement. One major group, Friends of the Earth, wrote letters to Executive Directors in early February urging a positive response, but that served only to strengthen the opposition.[139] Shortly afterward, Camdessus toned down his proposal in four ways. First, the Fund would not undertake any original research on links between macroeconomics and the environment. Instead, it would "monitor relevant research [by others] and channel information to staff members in area departments." Second, he dropped the plan to designate the specialists as a separate unit within FAD and promised that they would instead "be fully integrated within the work of that department." Third, he proposed that there be no "environmental conditionality" and that the new approach "be applied to all members in an evenhanded way." Fourth, he agreed that "the decision to devote Fund resources to environmental issues will be given minimal publicity."[140]

With these modifications, a majority of the Executive Board reluctantly agreed to go along. Several chairs that had earlier opposed any move in this direction, including Japan and Saudi Arabia, now were willing to accept it. Others, including Australia and China, remained opposed.[141] Enthusiasm, however, was notable in its absence. The combination of Camdessus's infectious promotion and U.S. pressure for action had simply worn down the opponents. The Board made no formal decision, and management issued no public announcement.

137Minutes of SEM/MTG/91/3 (March 1, 1991), p. 13.

138Minutes of EBM/91/13 (February 1, 1991), p. 21. The other chairs expressing support for the proposal were the Directors appointed by France and the United States, and the constituencies headed by Belgium, Canada, and Italy.

139Minutes of EBM/91/16 (February 8, 1991), p. 11.

140"Remarks by the Managing Director on the Fund and Environmental Issues," BUFF/91/37 (February 22, 1991). The "evenhanded" phrasing is in Camdessus's concluding remarks at SEM/MTG/91/3 (March 1, 1991), p. 24.

141Minutes of SEM/MTG/91/3 (March 1, 1991).

Once this policy was accepted, the staff began including brief summaries of environmental issues in Article IV consultation reports. To ensure that no one could accuse them of not being evenhanded, one of the early examples was the 1991 consultation with the United States.

In discussions held in Washington in May and June 1991, just two months after the Board agreed to the proposal, the staff suggested to the U.S. authorities that they should consider an increase in gasoline and other energy taxes as an environmentally helpful way to reduce the fiscal deficit. In 1992, the staff raised this issue again and noted that energy taxes aimed at reducing carbon dioxide emissions by 6–10 percent by 2000 would yield up to 1 percent of GDP in additional revenues. The environment then became a routine part of the annual discussions for a few years. In 1993, the new Clinton administration stressed its view that environmental concerns "should play an important role in economic policy considerations," subject to a cost-benefit analysis.[142] After that, coverage of the topic gradually died down. For the next five years, references to environmental policy in the U.S. reports were limited to brief explanations of administration plans with respect to balancing environmental concerns against its pursuit of bilateral and regional free trade agreements. The 1999 report included no reference at all to the environment.

Consultations with developing countries often reported favorably on governments' efforts to preserve the environment. The 1991 report on Malaysia, for example, noted that

> Malaysia's environmental policies are focused on the preservation of virgin forestry resources . . . . Malaysia has begun reducing log exports and encouraging higher value-added downstream processing through the application of quotas and fiscal incentives in the wood industry. The authorities also argued, however, that environmental issues should generally be placed in a more balanced historical and regional perspective, including the role and responsibilities of industrial countries in this respect.[143]

Similarly, in 1995 the staff praised the Dominican Republic for taking actions to deal with long-standing environmental problems:

> Regarding environmental issues, the authorities . . . explained that key . . . issues are deforestation, degradation of the urban environment, and the impact of certain unplanned population settlements in the tourist areas that seem to be negatively affecting the coastal ecosystems. A National Environmental Action Plan has been elaborated with the assistance of UNDP to address these problems as well as to improve the management and preservation of river basins. A commission headed by the Vice President of the Republic was recently created to coordinate and supervise this plan.[144]

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[142]Staff reports of the U.S. Article IV consultations, SM/91/159 (August 13, 1991), p. 21; SM/92/149 (August 3, 1992), p. 10; and SM/93/172 (August 4, 1993), p. 15.

[143]"Malaysia—Staff Report for the 1991 Article IV Consultation," SM/91/130 (June 27, 1991), p. 18.

[144]"Dominican Republic—Staff Report for the 1995 Article IV Consultation," SM/95/118 (May 24, 1995), p. 12.

Despite the intended prohibition on environmental conditionality, the Fund did follow up on negative assessments in a few cases in the second half of the decade. As was true generally, the Fund's influence in this field was bound to be more effective when a country was seeking to borrow than when it was merely consulting on the quality of its policies.

IMF advice to Cambodia in the mid-1990s illustrates the Fund's delicate balancing act between demonstrating concern for the environment and steering clear of overt environmental loan conditions. As part of the 1992 UN-brokered peace agreement in Cambodia, the transitional authorities agreed to ban log exports, partly for environmental reasons (deforestation was causing massive flooding) and partly to restrict the flow of money to military and paramilitary forces including the Khmer Rouge. When the Fund resumed normal relations with Cambodia soon afterward, the staff included this export ban among its policy concerns. It soon transpired that illegal log exports were continuing to occur and that some state-owned enterprises were simply exporting sawn timber instead of logs. The staff called attention to the problem in its 1993 report on the Article IV consultation discussions.[145]

In February 1994, the authorities submitted a Letter of Intent and an accompanying Memorandum of Economic and Financial Policies as the basis for the first tranche of a three-year ESAF arrangement. The staff team on Cambodia, led by Owen J. Evans (Advisor, Central Asia Department), was determined to make this arrangement the Fund's first "green program," and the team asked the authorities to set out their environmental policies, including on logging, as part of the documentation. Paragraphs 42 and 43 of the memorandum read as follows:

> 42. Environmental concerns are receiving increased attention from the Cambodian Government. In late 1993, the Secretariat of State for the Environment was established as a permanent government agency, with authority to supervise and develop a National Protected Areas System covering 3.3 million hectares designated for national parks, wildlife sanctuaries, protected areas, and multiple use management areas. During 1994 the Government intends to formulate a National Environmental Action Plan in consultation with the World Bank and other donors.
>
> 43. The forestry sector faces particular environmental challenges. Although Cambodia has a relatively large forest area by regional standards, logging for export timber and fuelwood is a concern for the Government. Thus far logging has been controlled largely through export restrictions, but in 1994 the Government will investigate ways to achieve its environmental goals more directly.[146]

The ESAF arrangement took note of the memorandum, but it did not include fulfillment of the plans set out in those two paragraphs in the list of specific conditions

[145]"Cambodia—Staff Report for the 1993 Article IV Consultations," SM/93/74 (April 12, 1993), p. 8.

[146]"Cambodia—Request for Three-Year Arrangement under the Enhanced Structural Adjustment Facility—Letter of Intent," EBS/94/44 (March 9, 1994), p. 13.

that could derail the scheduled disbursements under the arrangement.[147] In December 1995, Deputy Managing Director P.R. Narvekar visited Cambodia and noted that the illegal export of logs was depriving the government of "much-needed revenue," but he did not focus on the environmental consequences.[148]

This low-key approach changed in 1995, when the staff noted that forests were "Cambodia's largest and most valuable natural resource. . . . The pace of deforestation has become a prime environmental concern. Uncontrolled logging, mostly for export, has reduced forest cover from around 74 percent of land area in the early 1970s to an estimated 30–35 percent today."[149] In response, the Fund cooperated with other multilateral agencies to persuade the authorities to take stronger action. The policy memorandum for the second year of the ESAF arrangement included a more specific promise from the government:

> An area of especially great concern to the Government is to avoid an environmentally unsustainable rate of cutting of trees. To this end, the Government will begin to prepare a forest management code in 1995. . . . The Government has agreed to formulate, in consultation with the World Bank, [the International Tropical Timber Organization], and other contributors, a program and a timetable for a National Environmental Action Plan.[150]

Early in 1996, the government entered into new agreements to export logs, prompting the Fund to question the authorities' commitment to implement the agreed-on forestry policies. Specific actions were then required to be taken before the Fund would make the next disbursement under the ESAF arrangement. When the authorities failed to take those prior actions on time, the Fund interrupted and eventually canceled the arrangement. In doing so, it emphasized the fiscal rather than the environmental consequences of the failure.[151] Throughout this three-year period, the Fund prodded the authorities—first gently and then more forcefully—to limit the environmental damage from the stressed condition of the economy, all the while trying to avoid basing its advice explicitly or exclusively on this controversial issue.

The Fund adopted similar approaches in other countries where environmental concerns were paramount. Deforestation was an important issue in numerous developing and transition countries all over the world. Altogether, IMF staff reports discussed

[147] "Cambodia—Enhanced Structural Adjustment Arrangement," EBS/94/76, Suppl. 1 (May 12, 1994).

[148] Minutes of EBM/95/122 (December 21, 1995), p. 6.

[149] "Cambodia—Staff Report for the 1995 Article IV Consultations and Request for the Second Annual Arrangement under the Enhanced Structural Adjustment Facility," EBS/95/145 (August 29, 1995), p. 6.

[150] "Cambodia—Staff Report for the 1995 Article IV Consultations and Request for the Second Annual Arrangement under the Enhanced Structural Adjustment Facility," EBS/95/145 (August 29, 1995), pp. 50–51.

[151] "Forestry could yield annual budgetary revenue equivalent to 3.5 percent of 1995 GDP on a sustainable basis"; "Cambodia—Staff Report for the 1996 Article IV Consultation," SM/97/12 (January 17, 1997), p. 5n.

deforestation in 71 countries at some time in the 1990s. The Fund also raised concerns about a wide variety of other environmental issues such as unsustainable fishing yields (e.g., in Mauritania and Senegal), depletion of water resources owing to underpricing of water usage or insufficient penalties for polluting activities (e.g., in Ethiopia), and environmental degradation from inappropriate industrialization (e.g., from aluminum production in Tajikistan). In most cases, the Fund's concerns in these areas reflected those of other agencies—principally the World Bank, but also the UN and its specialized agencies—with which the Fund staff consulted in its preparatory work on each country.[152]

Transparency of the IMF

As discussed more generally in Chapter 3, a major cultural reversal occurred at the IMF in the 1990s, from confidentiality to transparency. When the Fund conducted the 1990 biennial review of surveillance, the prevailing view held, as in the past, that publishing the results of consultations with member countries would undermine the Fund's role as a confidential advisor to its members. To be effective, the staff had to feel free to express views candidly. They also had to have confidence that country officials would provide information willingly and completely. Publication of their findings could compromise those processes. If country authorities knew that what they told the staff would soon be in the public domain, they would be reluctant to share sensitive information. If the staff knew that what they wrote was intended for publication, they would feel less free to criticize a country's policies. These were serious concerns. All that the staff was willing to propose was that the Fund publish selected research studies on "some large countries with systemic influence," and to continue to use the WEO exercise, the Fund's *Annual Report*, and speeches by management as the main avenues for disseminating the Fund's analysis.[153]

The policy of not publishing conclusions or staff reports on consultations remained in place through the first half of the decade, even while the Fund began expanding its publication policies in other ways. In July 1994, the Fund adopted a policy to begin publishing most of the background papers prepared for consultations—then usually called "Recent Economic Developments"—subject to the approval of the country concerned. Even that limited step, which Camdessus called a "modest first stage in the process of gradually improving the Fund's information policy," proved to be controversial. Several Directors from developing countries feared it would lead to pressure on them to divulge more information than they might otherwise. Some also

[152]The Fund's interagency liaisons are summarized in "The Fund and the Environment," SM/93/251 (December 2, 1993).

[153]"Biennial Review of the Implementation of Surveillance over Members' Exchange Rate Policies and of the 1977 Surveillance Decision," SM/90/103 (May 29, 1990), pp. 15–17. The concurrence of the Executive Board with this view was summed up in Supplement 3 to that paper (August 23, 1990).

predicted—correctly—that it would lead eventually to a policy of publishing full staff reports. A "distinct majority," however, led most strongly by Karin Lissakers (United States), favored the proposal, which was adopted.[154]

The Fund also began quietly encouraging some countries to release the "final statements" of staff missions—that is, the staff's preliminary assessment of the country's economic conditions and policies—to local media outlets. In a few cases, mission chiefs began holding press conferences at the end of the mission to explain the staff's findings. The full staff report, however, was still treated as a confidential document.[155]

As these developments became known, the Fund came under increased public pressure to release its staff reports as a way to make the Fund more accountable. Internally, the staff and management were increasingly questioning whether the tradition of secrecy was really most effective. In addition, the rising trend for central banks to open up their own decisions and processes to public scrutiny was making the case for continuing confidentiality less compelling.

The next step came in 1997. Since 1978, it had been the policy of the IMF to conclude each Article IV consultation with a "Summing Up" by the Managing Director (as Chairman of the Executive Board) or by a Deputy Managing Director (as Acting Chairman).[156] That document summarized the views of the Executive Board, whereas the staff report obviously represented the views of the staff.[157] The Summing Up was routinely sent to the senior monetary authorities of the country concerned, normally under cover of a letter from management stressing the key messages. It often contained politically sensitive and market-sensitive information and thus was treated with great confidentiality. Starting in 1989, however, the Fund began publishing summary reports on selected Article IV consultations in the *Annual Report*, initially just for the G7 countries and then for a gradually expanded sample of others. Although not labeled as such, those summaries were adapted from the Summings Up. The question now was whether to begin publishing the full documents for individual countries soon after issuance.

In the course of the 1997 review of surveillance, the staff came up with a proposal to publish "press information notices" (PINs) shortly after the conclusion of each Article IV consultation. Each PIN would have two sections. One would provide a couple of pages of background on economic developments in the country concerned. The

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[154]Minutes of EBM/94/61 (July 11, 1994), pp. 3–26. The two quotations are from p. 25.

[155]For a summary of these developments, see "Biennial Review of the Implementation of Surveillance over Members' Exchange Rate Policies and of the 1977 Surveillance Decision," SM/97/53 (February 19, 1997), pp. 32–33.

[156]The origin of this practice is described in Boughton (2001), pp. 89–90 and 127–28.

[157]In practice, the distinction was not quite that clear. Before each Board meeting, the staff prepared a draft of the Summing Up. That first draft usually was based on the assumption that Executive Directors would agree with the staff's views, unless the staff anticipated a specific controversy. Management and staff would revise the draft during the meeting to reflect the discussion as it progressed. At the conclusion of the discussion or shortly afterward, the Chair would read out the revised draft. Directors then would have an opportunity to ask for revisions.

second would "correspond closely to the Chairman's summing up of the Board discussion." Publication would be voluntary and would require the explicit consent of the country. To prevent the PIN from being bowdlerized, Camdessus proposed that editing of the Summing Up section "be kept to a minimum, removing only highly market-sensitive information, probably limited mainly to Fund views on exchange rate and interest rate matters in selected circumstances."[158]

The Board approved the issuance of PINs in April 1997.[159] Although participation was voluntary, publication (on the website http://www.imf.org) quickly became the norm. By the end of 1999, more than 80 percent of all Article IV consultations were resulting in publication of a PIN, which by then had been rechristened as a public (rather than press) information notice. Most of those were virtually identical to the Summing Up, but about 18 percent had some sensitive information removed.[160]

Finally, in 1999, the Fund was ready to begin publishing staff reports. Because a sizeable minority of the Executive Board was still skeptical about the wisdom of it, the Board agreed only to establish a "closed-end" pilot project. That is, any member country could volunteer to participate, but the project would run for only 18 months. If fewer than 20 countries volunteered, the project would not proceed at all. Success would be evaluated after the first year or so. Unless the Board agreed then to make the policy permanent, the experiment would end.[161] It worked better than expected. Staff reports for 46 countries were published in the first year, and another 20 countries expressed a desire to participate. The public—including financial market participants, academic analysts, media outlets, and nongovernmental advocacy groups—also responded enthusiastically. The staff found very little evidence of any loss of candor in consultation discussions.[162] Most of the opposition withered away, and in January 2001 the Fund adopted a permanent policy to continue publishing staff reports on a voluntary basis.

Data Quality

The IMF had a long-standing concern, dating from the 1940s, with the quality and international standardization of macroeconomic and financial data. In the 1980s and early 1990s, statisticians in the Fund focused in particular on improving the

[158]"Biennial Review of the Implementation of Surveillance over Members' Exchange Rate Policies and of the 1977 Surveillance Decision—Additional Material," SM/97/92 (April 10, 1997), p. 4.

[159]Decision No. 11493-(97/45); minutes of EBM/97/45 (April 24, 1997).

[160]"Review of the Pilot Project for Voluntary Release of Article IV Reports and Other Issues in Fund Transparency—Background Paper," SM/00/190, Suppl. 1 (August 11, 2000), pp. 29–30.

[161]See "Transparency and Fund Policies—Further Steps," SM/99/45 (February 19, 1999); minutes of EBM/99/22 (March 5, 1999); "Transparency and Fund Policies—Further Considerations," SM/99/79 (March 26, 1999); and minutes of EBM/99/38 (April 5, 1999).

[162]See "Review of the Pilot Project for Voluntary Release of Article IV Reports and Other Issues in Fund Transparency—Background Paper," SM/00/190, Suppl. 1 (August 11, 2000).

reporting of balance of payments data, including by reducing the statistical discrepancies preventing the global balance of payments from adding to zero. The "Godeaux Report," prepared by an international working party headed by Baron Jean Godeaux and published as IMF (1992), provided guidance for subsequent work in the Fund and in other international agencies, especially the 1993 publication of the fifth edition of the Fund's *Balance of Payments Manual*. The next major challenge was to improve the reporting of these and other essential data for purposes of Fund surveillance.

The Mexican peso crisis of 1994–95 highlighted a shortcoming in surveillance that had to be corrected. Almost from the moment the crisis erupted, Fund officials realized their ability to assess precrisis conditions in Mexico and to try to forestall the crisis had been hampered by the inadequacy of available data. A few weeks after the Executive Board approved the massive stand-by arrangement for Mexico, it conducted the biennial review of surveillance. Introducing the review at the Board meeting, Camdessus suggested that the number one priority for the future was to get more "timely and comprehensive data" from countries.[163] That generated an intensive work program over the next year that culminated in a commitment by the Fund to ensure and coordinate the dissemination of adequate data, not only to the Fund but to the public as well.

The effectiveness of Fund surveillance was being hampered by three data-related shortcomings. First, many countries had inadequate data on key variables, such as fiscal obligations and external debt. Second, countries might not be providing timely and comprehensive data to the Fund. That problem was most acute with respect to foreign exchange reserves and intervention in foreign exchange markets. Third, even when data were made available, the staff might not be making full use of them, in particular by sharing sensitive data with staff working on countries that might be affected by adverse developments elsewhere. The first problem could be alleviated by stepping up technical assistance to official agencies that were collecting and producing statistical data. The third problem could be alleviated by improving internal processes.[164] Alleviating the second problem—inadequate dissemination of data—would require an expansion of Fund surveillance into new areas.

Through the spring and summer of 1995, the Board met several times to review the Fund's policies and practices vis-à-vis national statistics and to devise a more effective approach. With regard to the provision of data to the Fund, the Board readily agreed to establish a "list of 11 core data categories as the minimum set to be provided to

[163]Minutes of EBM/95/17 (February 17, 1995), p. 6.

[164]These three issues were summarized by Jack Boorman (Director, PDR) at EBM/95/18 (February 22, 1995), pp. 17–18.

the Fund on a regular and timely basis for continuous surveillance."[165] Management then directed the staff to integrate efforts to collect these data into Article IV consultations.

The more challenging task was to define the Fund's role—if any—in encouraging countries to provide adequate data to the public. Inadequate and untimely data were judged to have been a major shortcoming in Mexico in 1994. If, for example, depositors and investors had known about the decline in reserves as it happened or with minimal lag, the central bank and the government would have been forced to take remedial actions much more quickly, and the crisis might have been averted.

What became clear as the staff—in the Statistics Department and in PDR—worked on this issue was that data provision to the public was especially important for emerging-market countries seeking capital inflows from international financial markets. If those countries could be certified as meeting certain international standards for data provision, their access to financial markets would be more secure. In the fall of 1995, the staff visited nearly two dozen countries to seek their views on the appropriate standards and on their willingness to subscribe to them, and they corresponded with more than 40 other countries for the same purpose. That exercise revealed widespread enthusiasm for the project, and the Fund decided to proceed with it.[166]

The guidelines for disseminating data by market-access countries—initially called the "More Demanding Standard" and then the "Special Data Dissemination Standard" (SDDS)—were complex and detailed, but the essence may be briefly summarized. The Fund would set the standard in consultation with countries interested in subscribing to it. The standard would specify the types of data to be issued and the maximum acceptable lags for their issuance. Each participating country would agree to announce a calendar for the release of relevant data and to publish the data within the established intervals. The Fund would set up an electronic bulletin board on its website, with explanations of how the statistics are produced and disseminated by each country ("metadata") and hyperlinks to the national authorities' websites where the actual data would be posted.

The Executive Board approved establishment of the SDDS in April 1996, the system went live on the web that September, and the first hyperlinks to national data were opened in April 1997. At the outset, 33 countries participated. The list grew

[165]"Provision of Information to the Fund for Surveillance—Further Considerations and Draft Report to the Interim Committee," SM/95/229 (September 7, 1995), p. 12. The list was approved at EBM/95/32 (April 5, 1995), on the basis of proposals set out in "Strengthening Fund Surveillance—Provision of Statistical Data by Members," SM/95/59 (March 24, 1995).

[166]"Development of Standards for Dissemination of Economic and Financial Statistics to the Public by Member Countries," SM/95/321 (December 29, 1995).

gradually, and by the end of 1999 the SDDS bulletin board included 47 members.[167] Following the Asian financial crisis, the Fund and a committee of the G10 central banks jointly developed an additional template for the SDDS that provided for more information on reserve assets and on actual and potential drains on those assets.[168]

Meanwhile, the Fund was also developing a less demanding set of guidelines designed to apply to all countries, which it called the General Data Dissemination System (GDDS). The GDDS was to be a framework through which the IMF could help countries set up better statistical systems. In contrast to the SDDS, joining the general system did not require a country to meet specified standards. All that a member had to do was commit to cooperating with the Fund to improve the production and dissemination of statistical data. The Executive Board approved the GDDS in December 1997, and it gradually became a central component of the Fund's efforts to strengthen the quality and availability of national statistics.[169]

Surveillance over Major Economies

Formally, the IMF treats all countries alike when conducting Article IV consultations. The practical reality, however, is that the way countries respond to surveillance varies across groups. Developing countries with substantial financing shortfalls are more obliged to take the Fund's advice. Even if they are not active borrowers from the Fund, they are likely to depend on the Fund's "seal of approval" to get financing from other creditors and from donors. By the 1990s, most smaller advanced economies were immune from that kind of pressure, but they still were more likely to benefit from external policy advice and commendation than were their larger neighbors.

A good example of the benefits of surveillance for a small advanced economy was Belgium. In the late 1980s, Belgium was following a policy within the EMS of maintaining stability between the Belgian franc and the ECU basket. For various reasons, it was having trouble achieving the high level of credibility for this policy that was necessary if it hoped to keep interest rates close to those in Germany, the standard bearer for

[167]In its original form, the SDDS allowed countries to subscribe even if they did not fully meet all of the prescribed conditions, as long as they had adopted a "transition plan" to meet the standards by a specified date. At the end of 1999, 36 of the 47 subscribing countries were still completing their transition plans (Carson and Austin, 2008, p. 11).

[168]The Data Template on International Reserves and Foreign Currency Liquidity, which was approved at EBM/99/30 (March 23, 1999), represented a compromise between those countries favoring maximum information and those that sought to preserve more privacy. For details, see "Second Review of the Special Data Dissemination Standard," SM/99/65 (March 10, 1999), and the discussion at EBM/99/30 (March 23, 1999).

[169]For an overview of the way the dissemination standards worked over the next several years, see the papers in Alexander, Cady, and Gonzales-Garcia (2008); and see Dawson and Enoch (2009), pp. 156–64.

the region. In the 1989 consultation discussions, the IMF staff mission, led by Michael Deppler (Director, EUR), recommended shifting to an even stronger policy of tracking the deutsche mark rather than the ECU and publicly announcing that it was doing so.[170] The authorities took that advice, acted on it, and soon saw a substantial reduction in the interest rate differential. At the Executive Board meeting concluding the 1990 consultation, Belgium's long-serving Executive Director, Jacques de Groote, paid tribute to the role of the IMF in this outcome:

> Last year's Board discussion of the Article IV consultation report and the staff's convincing arguments on the desirability of the strong currency option for Belgium prepared the ground for the impending exchange rate decision. Belgium's reliance on the Fund's advice throughout the adjustment process begun in 1982 thus continues at every step.[171]

The response of the largest industrial countries tended to be more reserved. In most cases, senior officials—finance ministers and central bank governors—would meet the mission chief and listen politely to the Fund's policy advice. Heeding that advice was no better than a rare occurrence, and examples of the authorities of a major country acknowledging doing so were even rarer. For the Fund, the implicit objectives of Article IV consultations with the largest countries were to assess economic policies and conditions, offer the best advice it could, explain that advice both to the country's authorities and to the world at large, and provide a forum in which the international community could convey its collective views on these issues. Even if the advice was ignored at the time, meeting these objectives could serve a useful purpose over the longer run.

The following summaries cover consultations in the 1990s with the five largest economic powers: the United States, Japan, Germany, the United Kingdom, and France. The coverage of issues is selective rather than comprehensive, focusing on the key issues that arose in the discussions.

The United States

The biggest challenge in IMF surveillance has always been giving advice to the monetary authorities of the United States. Part of the challenge is that the U.S. economy is constantly and extremely well analyzed, in exquisite detail, by armies of official and private sector economists. How to add value is far from obvious. The other part is that the sheer dominance of the world's only superpower does not encourage its leaders to listen to outside advice. And yet, if the IMF were not to make every possible effort to try, it would justly be accused of bowing to that dominance, of yielding to its largest contributor, of an unforgivable asymmetry. Despite the frustration, Article IV consultations with the United States have to be a key feature of the surveillance landscape.

[170]"Belgium—Staff Report for the 1989 Article IV Consultation," SM/89/68 (April 14, 1989), pp. 9–10 and 12.

[171]Minutes of EBM/90/94 (June 15, 1990), p. 3.

Even when the U.S. authorities were not actively seeking the Fund's advice, both sides took the consultations seriously and engaged in discussions at the highest level. In each of the consultations in the 1990s, Camdessus personally concluded the discussions by meeting with the chairman of the Federal Reserve System, Alan Greenspan, and with the secretary of the Treasury. In most of those meetings, the Deputy (or First Deputy) Managing Director also participated, as did the U.S. Executive Director. The technical and policy discussions with Treasury, the Federal Reserve, and other officials were usually led by the Director or a Deputy Director of the Western Hemisphere Department (WHD) and lasted for several weeks. Even the second in command on these missions, an assignment that often rotated frequently for other countries, was held by just three assistant directors of WHD in the 1990s.[172]

In the preceding decade, the Fund's primary concern in its consultations with the United States had been the low level of national saving. Driven by the high fiscal deficits of that decade, the net national saving rate in the United States was one of the lowest among all industrial countries.[173] That issue gradually (and, it would turn out, temporarily) diminished in importance in the 1990s. The Omnibus Budget Reconciliation Act of November 1990, which raised several types of taxes and placed "pay as you go" limits on congressional spending decisions, initiated a decade-long improvement process that culminated in a series of annual fiscal surpluses beginning in 1997. It also ushered in a period in which discussions between the IMF and the U.S. authorities became much less confrontational.

The major issues in the U.S. consultations in the 1990s included maintaining economic growth without an acceleration of inflation; raising the level of national saving, notably by continuing to reduce the federal fiscal deficit; and strengthening the country's commitment to free trade. At the end of the decade, the possibility of a bubble in equity prices, especially in technology stocks, became a concern.

In 1990, the U.S. economy was slowing down and was falling into the first recession since 1981. By a quirk of timing, however, the recession was not a major issue in the Article IV discussions. It was not foreseen at the time of the 1990 discussions, and by the time of the next discussions, it was all but over. In June 1990, the U.S. representatives in the consultation discussions "saw few reasons to expect a recession." They nonetheless feared that aggressive action to reduce the fiscal deficit could trigger a downturn, but the staff urged them to ignore that risk and tackle the underlying

[172]Yusuke Horiguchi was in charge of work on the United States from 1987 to 1991. Jorge Márquez-Ruarte took over for the 1992–95 consultations, and Steven V. Dunaway held the post through 2001. Readers of this volume will encounter Horiguchi and Márquez-Ruarte again in Chapter 7; they were the mission chiefs on Russia in 1994–97 and 1997–99, respectively. Márquez-Ruarte also turns up later in this chapter because he was in charge of work on Japan before moving to WHD in the fall of 1991.

[173]Article IV consultations with the United States in the 1980s are covered in Boughton (2001), pp. 138–54. For an assessment of the saving rate, see Aghevli and others (1990).

problem. The staff appraisal concluded that "neither the U.S. authorities nor the staff forecast a recession."[174]

The recession started in August 1990 and lasted until March 1991, during which time real GDP in the United States contracted by about 2.25 percent.[175] By mid-1992, the unemployment rate had risen to 7.75 percent from just more than 5 percent. In the 1991 discussions, it was apparent that the recession was either already over or nearly over. With a resumption of growth in sight, the staff urged the authorities to focus on implementing the 1990 budget agreement as a way to strengthen national saving over the medium term. In 1992, the concern was that recovery from the recession was slow. On that occasion, the staff endorsed the monetary easing that the Federal Reserve had already initiated. In subsequent years, growth in the U.S. economy was strong enough not to be a real issue in the discussions.

In the early part of the decade, the staff and the U.S. authorities were both advocating strengthening the country's commitment to free trade, but some differences in nuance arose. In a nutshell, the U.S. authorities were disillusioned with the pace of global negotiations through the General Agreement on Tariffs and Trade (GATT), and they wanted to take bilateral initiatives to speed up the process. Their strategy was to develop a network of free trade agreements with individual countries or regions and gradually expand it into a generalized system. The Fund advocated the global approach, and the staff worried that regional agreements might turn out to be trade-diverting rather than trade-expanding. In the U.S. consultations, that general concern was reinforced by occasional protectionist acts by Congress or the administration.

The important developments spurring a dialogue on free trade were the Enterprise for the Americas Initiative (EAI), announced by President George H.W. Bush in 1990, and the initiation a year later of negotiations with Canada and Mexico on the North American Free Trade Agreement (NAFTA). NAFTA was intended to be the prototype for free trade agreements throughout the Americas under the broad framework established by the EAI. The IMF was skeptical. In the staff view, these "regional initiatives could signal a lessening of the commitment to multilateralism." Accordingly, the staff "wondered whether the proposed NAFTA and the various proposed agreements under the EAI were fully compatible with the Administration's objectives for freer multilateral trade."[176]

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[174]"United States—Staff Report for the 1990 Article IV Consultation," SM/90/155 (August 30, 1990), pp. 7, 11, and 24.

[175]The dates of U.S. recessions are determined by the National Bureau of Economic Research, which makes and announces its determinations only after enough data are available. The onset and conclusion of the 1990–91 recession were announced in April 1991 and December 1992, respectively; see http://www.nber.org/cycles/cyclesmain.html.

[176]"United States—Staff Report for the 1991 Article IV Consultation," SM/91/159 (August 13, 1991), p. 16. Most Executive Directors broadly agreed with these concerns; see minutes of EBM/91/126 (September 18, 1991), pp. 20–21.

The Fund repeated its concerns about trade-diverting agreements in 1992 and 1993, but it quietly abandoned the battle after NAFTA took effect in 1994 with clear trade-expanding effects. For the rest of the decade, the focus of discussions on trade in the U.S. Article IV consultations was on the authorities' continuing to resort to measures such as antidumping legislation and countervailing duties, which U.S. officials viewed as legitimate tools to pry open foreign markets but which the Fund viewed as protectionist.

Toward the end of the 1990s, a sharp rise in equity prices—more than 30 percent annual rates of return for three straight years—gave rise to a new controversy. Was it a legitimate and sustainable reflection of a "new economy" resulting from a rash of advances in information technology, or was it a bubble born of a craze over the phenomenal early success of new technology-related companies? If it was a bubble, might its eventual bursting bring a marked slowdown in the economy? The U.S. authorities' position was that it might or might not be a bubble, but in either case there was no reasonable policy option for dealing with it. Therefore, they were content to let the stock market develop without any corrective action on their part. The staff warned in 1998 that it did look like a bubble, but the mission agreed that the risk of trying to prick it might not be worthwhile. Even with no action, the staff report concluded, a "correction . . . might slow the economy momentarily, . . . [but] would not be expected to have a prolonged or pronounced effect on demand."[177]

When the rise in equity prices continued for another year, the Fund became more alarmed. In the 1999 report, the staff warned that the clearly overvalued market was the principal risk to a continuation of economic growth and that monetary policy should gradually be tightened to force an orderly correction before the bubble burst on its own. As the value (on paper) of household wealth had risen, households had taken on increasing debt burdens and had driven the national saving rate to a record low level. These imbalances were no longer sustainable. Again, however, the argument fell on deaf ears. The authorities concluded "that one could not assert with a high degree of confidence that the market was overvalued. Even if such a judgement could be made, macroeconomic policy tools could not be finely calibrated to gently deflate a bubble."[178]

[177]"United States—Staff Report for the 1998 Article IV Consultation," SM/98/179 (July 13, 1998), p. 11.

[178]"United States—Staff Report for the 1999 Article IV Consultation," SM/99/159 (July 6, 1999), p. 19. U.S. equity prices peaked in March 2000, after which the main index of technology stocks declined by more than 50 percent in a little more than a year. Prices of more established firms (as measured by the Standard & Poor's index of 500 stocks) fell by about one-sixth. The ensuing recession began in March 2001.

Japan

At the beginning of the decade, Japan—the second largest economy in the world—was in an extraordinary economic boom, fueled by an easy monetary policy that encouraged substantial lending for real estate ventures and ultimately led to a property price bubble. The seeds for the bubble had been sowed in the Plaza accord among the Group of Five countries in September 1985, under which the yen was to be allowed to appreciate against the U.S. dollar, and the Baker-Miyazawa agreement of 1986, in which Japan agreed to cut short-term interest rates (see Boughton, 2001, pp. 206–18). Fearing that yen appreciation would bring a downturn in the economy, the Japanese authorities began easing monetary policy more aggressively. While consumer price inflation remained low overall, the rise in asset prices—notably corporate equities and commercial real estate—began to accelerate dramatically. Equity prices began falling once the Bank of Japan shifted back to a policy of raising interest rates in 1989, and real estate values followed shortly. By 1992, stagnation had set in, and Japan was mired in what would become known—in an eerie echo of Latin America's woes in the 1980s—as its "lost decade."

The central issue in the IMF's response to these developments was how to use monetary and fiscal policies to stabilize the Japanese economy.[179] Both at the time and afterward, many Japanese officials concluded the Fund was taking an overly Keynesian position—trying to fine-tune aggregate demand through countercyclical policy adjustments. There was a measure of truth to that complaint, but the dispute was mainly within the Executive Board, not between the authorities and the staff.

For the first half of the decade, consultations with Japan took place against a backdrop of bickering between Japan and the United States over the appropriate course of fiscal policy.[180] The U.S. view, under the administrations of both George H.W. Bush and Bill Clinton, was that Japan needed a more expansionary fiscal policy. Japan's sluggish aggregate demand was stifling economic growth and driving up the external surplus. By stimulating demand and causing the real exchange rate to appreciate, fiscal expansion could bring down the surplus and correspondingly reduce the U.S. current account deficit. The Japanese view was that fiscal policy should be directed at longer-term issues, especially the anticipated fiscal costs associated with the aging of its population. The Fund staff team tended to side with the Japanese, and that stance led to increasingly outspoken reactions from the United States.

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[179]The appropriateness of exchange rate movements was another recurring theme, as was structural reform in the financial sector. Those and related themes are discussed in Callen and Ostry (2003).

[180]This policy dispute dated from the early 1980s; see Boughton (2001, pp. 154–64) on the effect it had on consultations with Japan in the 1980s; and Golub (1994) on the causes of the bilateral imbalance.

In the 1990 consultation discussions, the staff mission—led by P.R. Narvekar (Director, Asian Department) and seconded by Jorge Márquez-Ruarte (Division Chief)—concluded that demand-management policy in Japan was appropriately aimed primarily at containing inflationary pressures. "It is imperative that Japan's excellent record of macroeconomic stability be preserved. This will be the foundation of both continued sustainable output growth and stability in domestic financial and foreign exchange markets."[181] At the Board meeting, Thomas C. Dawson II (United States) questioned both the conclusion and the premise that latent inflation was a major risk. Most Directors agreed with the staff that the best way to deal with the external surplus was to reduce disincentives to import, but several agreed with Dawson that fiscal stimulus should also play a role.[182]

The 1991 staff report wryly took note of that disagreement among Executive Directors. ("The judgment that inflation was a serious risk was, of course, not shared universally in the Executive Board.") Narvekar and Márquez-Ruarte nonetheless stuck to their earlier assessment and called again for steady application of restraint in both monetary and fiscal policies. Again the U.S. chair, supported by a few others, disagreed and called for a more expansionary policy stance.[183]

Matters continued in that vein in 1992; neither the Japanese authorities nor the staff realized the economy was beginning to stagnate more permanently under the weight of declining asset prices. In the view of the staff team (now led by Bijan Aghevli, Deputy Director, Central Asian Department, and seconded by Ulrich Baumgartner, Assistant Director), "additional stimulus should be undertaken only if there were unmistakable signs of greater economic weakness than [is] expected now." At the Board meeting, Jacques de Groote (Belgium) took the lead in calling for a shift toward expansion. He was followed closely by Dawson, who mocked the staff position as an "Amen Chorus of Kasumigaseki," referring to the vernacular name of the Japanese government bureaucracy. The majority view in the Board, however, still favored a steady application of fiscal restraint.[184]

By 1993, the Japanese stagnation was well under way. The authorities had initiated a mild fiscal stimulus and were convinced that a recovery had begun as a result. The staff accepted that scenario and agreed that the moderately expansionary policy was appropriate. Views on the Executive Board were mixed. The prevailing view was

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[181]"Japan—Staff Report for the 1990 Article IV Consultation," SM/90/112 (June 8, 1990), p. 26.

[182]Minutes of EBM/90/107 and EBM/90/108 (July 9, 1990). Dawson's intervention is on pp. 10–15 of the first (morning) meeting, and the Summing Up of Directors' views is on pp. 10–12 of the afternoon session.

[183]"Japan—Staff Report for the 1991 Article IV Consultation," SM/91/126 (June 19, 1991), p. 17; and minutes of EBM/91/93 (July 17, 1991), p. 12.

[184]"Japan—Staff Report for the 1992 Article IV Consultation," SM/92/122 (June 17, 1992), p. 18; minutes of EBM/92/88 (July 15, 1992), pp. 10 (de Groote) and 12 (Dawson); and minutes of EBM/92/89 (July 15, 1992), pp. 26–29 (Summing Up).

supportive, but Dawson took an even more negative and contemptuous view of the matter than he had in the preceding years. He had "fundamental differences of view" with the staff analysis, which he found to be "far too optimistic" and to reflect a "misdirected preoccupation with fiscal consolidation." "More fundamentally," he continued, the U.S. "authorities have instructed me to convey their basic dissatisfaction with the orientation of these consultations with Japan. Nowhere is there the focus on international economic cooperation that ought to be at the heart of Fund surveillance of major industrial countries."[185]

Dawson's prediction that economic growth was not about to resume proved to be correct. A year later, the staff again accepted the Japanese authorities' view that growth was on the verge of recommencing. Although they expected the rebound to be anemic, they also accepted the authorities' conclusion that any further stimulus should come through monetary easing, not fiscal. Again, the U.S. Executive Director (Karin Lissakers, who had succeeded Dawson) took exception. She argued that Japanese national saving was too high and was being propped up by inappropriately tight fiscal policy.[186]

The only year in this decade when the Fund questioned the fundamental stance of macroeconomic policy in Japan was 1995. By then the evidence that the economy was in long-term stagnation was becoming overwhelming, and confidence had been further shaken by a devastating earthquake near Kobe in January and by a domestic terrorist attack using poison gas on the Tokyo subway system in March. Nonetheless, the authorities were reluctant to make more than a modest shift toward stimulus. The staff strongly urged them to implement further stimulus through both fiscal and monetary actions.[187] Most Executive Directors agreed. On this occasion, Lissakers expressed the agreement of the U.S. authorities with the "broad contours of the staff assessment" and suggested only that "the message [of further stimulus] should carry a much greater sense of urgency."[188] To convey that urgency, Stanley Fischer soon traveled to Tokyo, where he met with both the finance minister and the central bank governor to explain why the Fund believed further action was necessary.[189]

For the rest of the decade, the Fund's macroeconomic advice to Japan responded more to cyclical fluctuations than to the longer run. Unfortunately, as the Fund predicted in 1995, the recovery from the postbubble stagnation proceeded at a weak and

[185]Minutes of EBM/93/100 (July 16, 1993), p. 13. Also see "Japan—Staff Report for the 1993 Article IV Consultation," SM/93/132 (June 22, 1993).

[186]The economic logic of this argument was that excess domestic investment had been generated by the "bubble economy" of the late 1980s. Investment subsequently had fallen to a more realistic level, but saving had not followed suit. Lissakers developed this line of reasoning at EBM/94/69 (July 27, 1994); see minutes, pp. 17–20. The staff argument that Japanese saving was at or near an equilibrium level was based on an analysis using neoclassical growth theory; see Section II ("Does Japan Save Too Much?") of "Japan—Recent Economic Developments—Supplementary Material," SM/94/185, Suppl. 1 (July 22, 1994).

[187]"Japan—Staff Report for the 1995 Article IV Consultation," SM/95/160 (June 30, 1995).

[188]Minutes of EBM/95/69 (July 21, 1995), p. 16.

[189]See Fischer's report to the Executive Board at EBM/95/78 (August 23, 1995), p. 4.

unsteady pace. The Fund had trouble foreseeing the ups and downs of this feeble cycle, and its advice suffered accordingly. In 1996, the recovery seemed to be accelerating nicely, and the Fund advised Japan that the "exceptional fiscal stimulus" introduced early in the year "should be phased out in 1997 if the recovery continued as envisaged." It offered similar advice in August 1997, even though it later came to light that the economy was already back in recession and that the downturn was both aggravating and being aggravated by the burgeoning regional financial crisis.[190] At the conclusion of the 1998 consultation, the Fund acknowledged that "the performance of the Japanese economy had been much weaker than anticipated" a year earlier. In these circumstances, it was "vital for the authorities to ensure that fiscal support for the economy remains in place until the recovery takes hold." At the end of the decade, the Fund implicitly returned to its earlier stance of just supporting the main thrust of the authorities' program. Although neither the government nor the Fund had much confidence left in their ability to forecast the direction of the economy, "Directors endorsed the government's evolving strategy" in 1999 and "suggested that the present supportive fiscal stance should be sustained until a recovery in private demand takes hold."[191]

European Union

The most visible financial crisis in the first part of the decade was the one that hit the countries participating in the Exchange Rate Mechanism (ERM) of the EMS in 1992–93. Since German unification in 1990, speculative pressures had gradually built up against the fixed exchange rates within the ERM. The rejection of the Maastricht Treaty on EMU in a Danish referendum in June 1992 and an exchange crisis in the Nordic region in September brought these speculative pressures to a head. The Italian lira and the British pound sterling came under especially heavy attack, and both countries responded by pulling out of the ERM on "Black Wednesday," September 16. When generalized speculation resumed in 1993, European finance officials dramatically widened the intervention bands in the system in August, from ±2.25 percent to ±15 percent. The crisis then passed, and the long trek toward full monetary union across Europe resumed.[192]

[190]For an analysis of the financial interconnections between Japan and Asian emerging markets in the 1990s, see Sheng (2009), Chapter 2.

[191]For the 1996 assessment, see the Summing Up at EBM/96/71 (July 24, 1996), pp. 52–54. The assessments for 1997–99 were published as Public Information Notices at http://www.imf.org/external/news/default.aspx?pn.

[192]For an overview and analysis of the ERM crisis, see Buiter, Corsetti, and Pesenti (1998) and references therein. They attribute the crisis primarily to the failure of the participating countries to find a cooperative response to the new financial realities posed by monetary unification in Germany, a response that could have combined a cut in German interest rates with a realignment of parities.

Because the major western European countries did not view the IMF as a necessary or valued source of financial advice, the Fund's participation in managing the ERM crisis was never an option. The interesting historical question is whether the Fund, through its annual Article IV consultations or other means, provided adequate warnings or analysis, especially while conditions worsened from 1990 to 1993.

Germany

The largest and wealthiest country in the European Communities came under tremendous financial pressure at the beginning of the 1990s. As the physical barriers symbolized and anchored by the Berlin Wall crumbled, hundreds of thousands of people emigrated from the long-isolated and depressed German Democratic Republic (East Germany) into its much freer and richer western sibling, the Federal Republic of Germany. In May 1990, the two countries signed a treaty of economic and monetary union to make the deutsche mark (DM) the common currency of both. East German ostmarks would be exchanged for DM at parity up to a specified level per person and at a 1:2 rate for the rest. In October, the two countries merged, and East Germany ceased to exist as a separate state.

The economic and financial burden of German unification was large enough to induce the authorities to consider asking for financial assistance for East Germany from the IMF. During a March 1990 Executive Board discussion of the need for an increase in the Fund's financial resources, the German Executive Director, Guenter Grosche, noted that "his authorities had foreseen a need to draw on Fund resources to facilitate adjustment in the German Democratic Republic." Now that unification was proceeding, "while he expected that Germany would not need to enter into a Fund program in the foreseeable future, that possibility could not be totally ruled out."[193] Although Germany did not end up asking for help, it was incumbent on the Fund to respond more generally to these dramatically changed circumstances.[194]

The crucial consultation discussions with Germany, led by Manuel Guitián (Deputy Director, EUR), took place in Bonn and Frankfurt in the first part of June 1990, after the German authorities had finalized plans for unification and for the currency conversion. The German authorities were in the middle of preparations for implementing the currency conversion, and they were committed to engineering a full economic, social, and political unification as soon as possible. The staff noted that the conversion of claims, salaries, debts, and so forth into DM was going to be expensive and potentially inflationary, but they did not question the choice of conversion rates. Instead, the staff report counseled more aggressive fiscal tightening, particularly

[193]Minutes of EB/CQUOTA/MTG/90/13 (March 20, 1990), p. 11.

[194]For the Fund's initial analysis of German unification, see the papers collected in Lipschitz and McDonald (1990).

through tax increases and containment of subsidies.[195] If the entire burden of inflation control were to fall on monetary policy, interest rates could rise sharply, putting a strain on Germany's neighbors. Without price and interest rate stability in Germany, the viability of the ERM would be gravely threatened, with potentially serious adverse consequences for all of Europe. Two weeks after the conclusion of the staff mission, Camdessus went to Germany to reinforce this message in meetings with the finance minister and the president of the Bundesbank.[196]

The authorities viewed the Fund's advocacy for fiscal tightening as excessively strict. Without large subsidies, the rise in unemployment in the eastern states was likely to be devastating and was expected to perpetuate the massive labor migration to the west. Both sides agreed, however, that while a realignment of exchange rates within the ERM (effectively revaluing the DM) would help the stabilization process, that advantage was outweighed by the risk of weakening the European commitment to maintain firm parities and advance toward EMU.

The staff continued to make the case for policy adjustments in 1991 when Patrick de Fontenay (Deputy Director, EUR) led the first staff mission since unification.[197] The fiscal deficit had ballooned, making the Bundesbank's task of maintaining price stability much more difficult. As the staff report noted, "much of Europe has come to depend on the firm anchor of German monetary policy." Without greater fiscal discipline, monetary discipline would be continually threatened.[198]

The 1992 consultation discussions took place both before and after the September ERM crisis. At the time of the first mission, led by Jacques Artus (de Fontenay's successor as Deputy Director, EU1)[199] in early September, the previous missions' fears were being realized. The high interest rates that had resulted from the continuing fiscal deficit were strengthening the DM in exchange markets, and the effort to keep up with it was weakening economic activity in other countries participating in the ERM.[200]

[195]"In the view of the staff the effective conversion rate was sufficiently depreciated to absorb excess (and potentially inflationary) monetary balances in the GDR." The report noted that Bundesbank officials had argued for a 1:2 conversion rate for all ostmarks, and that the effective rate (a weighted average of 1:1 and 1:2 for different types of balances) was expected to be about 1:1.8; "Federal Republic of Germany—Staff Report for the 1990 Article IV Consultation," SM/90/153 (August 1, 1990). The sentence quoted here is in footnote 1, p. 12.

[196]Report to the Executive Board; minutes of EBM/90/106 (July 2, 1990), pp. 3–4.

[197]While the head of mission changed fairly frequently during this period (Guitián—who had led several earlier missions to Germany—had moved to another department), the second in command provided a bit more continuity. The analytical work on Germany was directed by Leslie Lipschitz (Assistant Director, EUR), who participated in missions to Germany from 1985 to 1991. For a review of pre-1990 consultations with Germany, see Boughton (2001), pp. 165–77.

[198]"Germany—Staff Report for the 1991 Article IV Consultation," SM/91/164 (August 14, 1991), p. 24.

[199]The European Department was split in 1992, with all countries outside the former Soviet Union assigned to European I (EU1).

[200]"Germany—Staff Report for the 1992 Article IV Consultation," SM/92/194 (October 30, 1992), p. 21.

Speculative pressures against the ERM parities were building up rapidly. Shortly after that mission concluded, the crisis erupted. When the dust settled, the staff returned for follow-up discussions, mainly to assess how the financial landscape had changed. The basic message on macroeconomic policy—tighten fiscal policy to relieve the pressure on monetary policy—remained the same.

The staff and the German authorities shifted roles a bit in 1993. The economy was now in recession because the earlier appreciation of the DM had taken its toll on international competitiveness. Bundesbank officials were nonetheless still focused primarily on price stability, while the staff suggested that the time had come for some easing to restore the momentum of aggregate demand. The mission—again led by Artus—was still calling for a tightening of fiscal policy, but it was more open than before to a preemptive easing on the monetary side without waiting for fiscal action.[201] By the time of the next mission, in May 1994, the ERM crisis had passed. The widening of the intervention bands had restored calm in exchange markets, and the German economy was recovering from recession.

Had the Fund given the right advice? From a macroeconomic perspective, it had. With a different mix of monetary and fiscal policies, the German authorities could have maintained the pace of aggregate demand without relying so heavily on high interest rates to preserve price stability. That approach would have relieved pressure on exchange rates and might have averted the ERM crises of 1992 and 1993. From a structural perspective, the authorities' objections to that course also made sense. The costs of unification had to be met in part by borrowing, and that required larger fiscal deficits than would otherwise have been optimal. A less aggressive response to the severe imbalance in initial conditions in the eastern and western Länder would have seriously delayed and could have derailed the successful integration of the two Germanies. The rejection of an early realignment may have been questionable, but the rationale for it was strong at the time. All the good options were hemmed in by real constraints.

The United Kingdom

On October 5, 1990, the government of the United Kingdom announced that the pound sterling was joining the ERM, though with wider bands (± 6 percent around central parities) than most other members were using (± 2.25 percent). This decision ended a multiyear period in which the British authorities had experimented—without much success—with various strategies for stabilizing the exchange rate. The "medium term financial strategy" introduced at the beginning of the 1980s, which aimed to stabilize prices by controlling the growth rate of the money stock, had led to very wide fluctuations in the exchange rate. For a year in 1987–88, the strategy had been to "shadow" the DM to prepare the way for eventual ERM

[201]"Germany—Staff Report for the 1993 Article IV Consultation," SM/93/136 (June 30, 1993), pp. 20–21.

participation. When that strategy led to unstable domestic conditions, the exchange rate was again allowed to float to a market-determined level. By 1990, a coalition of strong supporters of financial integration with Europe and others who were frustrated with the lack of a good alternative finally won the day.[202] The triumph was short-lived.

The Fund supported the authorities' intention to join the ERM. In fact, for several years, the staff had been quietly encouraging the authorities to prepare for such a step. The only questions were when and at what exchange rate. When the 1989 consultations were concluded in March 1990, every Director who addressed the subject urged an early entry, but a few—including Bernd Goos (Germany)—cautioned that Britain should first bring down its high rate of price inflation.[203] When the Board next discussed the United Kingdom, after the entry was a *fait accompli*, a few Directors were still nervous about the consequences. With British inflation roughly double that on the continent, did it really make sense to hitch the exchange rates together? However, the prevailing view by far was support for the staff's conclusion that ERM participation would enhance the credibility of the authorities' determination to reduce inflation, and that it was indeed the only hope for success.[204] In February 1992, the Executive Board again agreed with the staff that adherence to the ERM was the right strategy and that the pound should be brought into the narrow band as soon as the inflation differential could be substantially eliminated.

Even with the flexibility afforded by the wide band, the pound was vulnerable to a speculative attack against the ERM parity. That vulnerability increased with every month that prices rose more rapidly in Britain than on the continent. Because of the sheer size of the British financial system and of the foreign exchange reserves held by the Bank of England, neither the authorities nor the staff of the IMF seems to have regarded an attack as a serious threat in 1991 or 1992. By August 1992, however, the pound was trading near the floor of its trading band, while the whole ERM was coming under pressure owing to a rise in German interest rates and growing doubts about the extent of public support for EMU. Speculation turned into an attack and then into a rout in mid-September, when Italy was forced out of the ERM on September 14. After the Bank of England tried desperately to defend the pound by raising short-term interest rates sharply, it gave up on Black Wednesday, September 16. The investor and hedge fund manager George Soros soon became known as "the man who broke the Bank of England" when he revealed that he had led the attack by betting $10 billion against the pound and that he had made nearly $1 billion in profits when the Bank was forced to abandon the fight (Kaletsky, 1992, p. 1).

[202]For these and related developments, see Boughton (2001), pp. 180–83.

[203]Minutes of EBM/90/31 (March 5, 1990). Goos's remarks are on pp. 29–31.

[204]Minutes of EBM/91/17 and EBM/91/18 (February 11, 1991); the Summing Up begins on p. 38 of the latter meeting. Also see "United Kingdom—Staff Report for the 1990 Article IV Consultation," SM/91/14 (January 17, 1991); p. 20 presents the staff appraisal of the ERM decision.

Following withdrawal from the ERM, the British authorities knew they needed new rules to replace the discipline of the European system. They therefore adopted an inflation-targeting regime. They remained committed in principle to an eventual resumption of ERM membership, but only after a convergence of cyclical economic conditions vis-à-vis Germany. The staff mission that arrived in London in early December, led by Artus, endorsed the inflation-targeting regime but cautioned that fiscal policy would have to be tightened substantially for it to succeed.[205]

For the next few years, a crucial question was how to gain greater credibility for British macroeconomic policies so that robust and noninflationary growth could take hold. Inflation targeting was working reasonably well but seemed fragile. Beginning in 1994, the staff urged the authorities to enable the Bank of England to implement monetary policy independently of the Treasury, as one way to establish a more credible anti-inflationary policy regime.[206] The authorities resisted that advice until after the May 1997 parliamentary elections, which ended 18 years of rule by the Conservative Party and elevated the Labor Party's Tony Blair to the premiership. Blair's chancellor of the Exchequer, Gordon Brown, was a strong advocate of central bank independence, and he granted it to the Bank of England within a few days after taking office.

Another of Brown's first acts as chancellor was to announce a set of five tests that would have to be met before it would make sense for Britain to adhere to EMU and adopt the euro as the national currency. Because none of the tests was met at the time and the prospects were somewhat remote, this tactic enabled the government to maintain a formal commitment to EMU while postponing it indefinitely. This policy, too, was endorsed by the Fund, and the rest of the decade's consultations proceeded without major controversy.[207]

France

Meanwhile, France—the other major power in the EMS, along with Germany—was firmly committed to a policy of maintaining parity with the DM, even if that meant pushing interest rates higher than might seem desirable for domestic policy purposes.[208] Throughout the early 1990s, Article IV missions endorsed that policy

[205]"United Kingdom—Staff Report for the 1992 Article IV Consultation," SM/93/14 (January 21, 1993), pp. 18–20.

[206]"United Kingdom—Staff Report for the 1994 Article IV Consultation," SM/94/248 (September 23, 1994), p. 15.

[207]The staff appraisal in 1997 was muted on this issue, noting only that "the recent opening of a thorough national debate on where the United Kingdom's economic interests lie" with respect to EMU participation "was overdue"; "United Kingdom—Staff Report for the 1997 Article IV Consultation," SM/97/251 (October 6, 1997), p. 24. The Executive Board was a little more direct, concluding that it "welcomed the government's declaration of support in principle for participation in monetary union, subject to its meeting certain economic tests, particularly regarding cyclical convergence"; minutes of EBM/97/106 (October 27, 1997), p. 60.

[208]This "franc fort" or hard currency policy originated in 1986. That shift and the Fund's relations with France in the 1980s are covered in Boughton (2001), pp. 177–80.

and marveled at the sight of France achieving inflation rates below those of Germany. Consequently, no major policy issues arose in the discussions. Instead, the crucial meetings came after the ERM crisis, which France survived without a devaluation but with a legacy of macroeconomic imbalances that were difficult to ignore.

The Maastricht Treaty specified several "convergence criteria" for countries intending to enter into EMU in 1999, including that they must make steady progress toward a sustainable fiscal deficit of no more than 3 percent of GDP by 1997. France's deficit was close to 6 percent in 1993, only partly because the economy was in recession. The following year, the Fund began to question whether the authorities' plans to converge quickly enough to the target were based on credible assumptions. With high unemployment (judged by the Fund to result from structural rigidities in labor markets, not from inadequate demand) and the prospect of presidential elections less than a year away, the government had not yet announced the specific spending cuts that would be needed to stay on course. The staff pronounced the required cuts to be "severe," and it projected that the deficit would remain well above the convergence path. With characteristic diplomacy, however, the staff report concluded that it "welcomes the strong assurances" by the authorities that France would meet the targets.[209]

The fiscal debate intensified in 1995, when a staff mission led by Artus arrived a few weeks after the election of Jacques Chirac as president. Chirac's succession to the post held for 14 years by François Mitterrand completed a shift to the right that had begun with the parliamentary elections of 1993. The election also removed the political necessity of promoting short-term over longer-term goals for economic policy. With the fiscal deficit still clinging stubbornly to 6 percent, reducing it was becoming imperative if France hoped to meet the Maastricht target and avoid a possibly debilitating panic in foreign exchange markets. Accordingly, Artus and his team set out a detailed "adjustment scenario" for fiscal policy and urged that it be incorporated into the government's forthcoming budget.[210]

On this occasion, the staff's analysis appears to have made a difference. At the outset of the Executive Board meeting concluding the 1995 consultations, Marc-Antoine Autheman (France) averred that the points made by the staff, "which echoed the opinion of the Bank of France, were convincing." The government had planned to present a budget that was projected to bring the deficit down just to 3 percent of GDP by 1997, but now it would be more aggressive in cutting spending and more ambitious in its deficit reduction. He acknowledged that the "credibility of our fiscal policy has

[209]"France—Staff Report for the 1994 Article IV Consultation," SM/94/210 (August 9, 1994), p. 17.

[210]"France—Staff Report for the 1995 Article IV Consultation," SM/95/251 (September 21, 1995). The general policy recommendation is on p. 31, and the detailed scenario is set out on pp. 36–38.

suffered from the lack of strict implementation of past commitments." This time would be different, "because my authorities do not consider nonconvergence an option."[211]

That lack of credibility was evident in the staff's response to the budget announcement and in the responses of other Directors to Autheman's assurances. After reviewing the budget for 1996, the staff concluded, "Much more is needed and time is running short."[212] At the Board meeting, Directors piled on. J. Onno de Beaufort Wijnholds (Netherlands) suggested that meeting the government's deficit target by 1997 would "require a 'tour de force'." Stefan Schoenberg (Germany) suggested that the French social security system was in need of "radical reform." Huw Evans (United Kingdom) eruditely reminded his colleagues that the "immediate cause of the French revolution was the fiscal crisis of 1788," which he thought was not too different from that of 1995. Karin Lissakers (United States) picked up that theme by quoting the always quotable American baseball legend Yogi Berra—reading about France's fiscal problems was "déjà vu all over again." At the end of the day, Fischer summed up the Board's sense of urgency by noting that "France's task was now truly historic . . . [as] the future of European monetary integration lies largely with France. For the authorities and for the French people, fiscal convergence is a challenge that must be met."[213]

It was met. Proving the skeptics wrong, Chirac and Prime Minister Alain Juppé tackled the social security problem and took other measures to strengthen the fiscal accounts. The staff mission for the 1996 consultations—again led by Artus—found that the deficit was likely to be held to 4 percent and then keep falling. That defused much of the worry about the convergence target for 1997, and from that point on the debates were more muted. In the end, the deficit for 1997 was 3 percent, although the target was met only by a one-time transfer of privatization receipts. That year, the EU adopted a new set of more flexible and dynamic targets for EMU convergence, in the Stability and Growth Pact. France continued to meet those targets through the end of the decade.

Lessons Learned

Throughout the 1990s, the IMF repeatedly tried to hone its surveillance work to make it more effective and efficient. Some of these efforts may have been misguided, such as the various attempts to broaden bilateral surveillance consultations to cover nonfinancial issues like military spending and the natural environment. However beneficial a successful move in that direction might have been, the lack

[211]Minutes of EBM/95/100 (October 25, 1995), pp. 3–7.

[212]"France—Staff Report for the 1995 Article IV Consultation," SM/95/251, Suppl. 1 (October 18, 1995), p. 10.

[213]Minutes of EBM/95/100 (October 25, 1995), pp. 17 (Wijnholds), 21 (Schoenberg), 25 (Evans), 38 (Lissakers), and 62 (Summing Up).

of mandate, expertise, or real commitment made success elusive. Other efforts may have been quixotic, such as the various attempts to strengthen the Fund's ability to anticipate financial crises. The onset of a financial crisis is, in most cases, not foreseeable, because it depends crucially on a psychological tipping point as markets assess and act on the likelihood of their own collective responses. Still other efforts failed because of poor timing or execution. Notably, the attempt to amend the Articles of Agreement to assign the Fund a mandate to oversee a process of orderly liberalization of capital accounts collapsed because the Fund was perceived to be overreaching and trying to force countries to liberalize prematurely. The endeavors with the best chances of success were the efforts to focus surveillance on the issues critical to reducing countries' vulnerability to crisis. Those efforts did not always succeed, but they perceptibly improved the practice of surveillance by the end of the decade. The Fund also had some clear successes in ensuring that its surveillance was applied evenhandedly and in an increasingly transparent framework.

The primary vehicle for reassessing the practice of surveillance was the biennial review process. In the 1990s, those reviews led to a number of revisions and extensions to the guidance that management and the Executive Board gave to the staff. The more important of those revisions, detailed at various places in this chapter, included an increased focus on financial market developments, the provision of data to the Fund and to the public, and the orderly liberalization of capital markets. On three other occasions, the Fund looked "outside the box" to see if it could make more-fundamental changes.

The first occasion was in 1995, when Camdessus commissioned Alan Whittome to prepare a report on the failures of surveillance in the run-up to the Mexican peso crisis. As discussed in the "Consultation Procedures" section earlier in this chapter, the Whittome report recommended that the Fund endeavor to make its surveillance of vulnerable countries more nearly continuous, to obtain better and more current data, to be more critical of soothing reassurances from national authorities, to listen more to financial markets, and to report its findings more boldly and with greater clarity. Although the staff tried to improve performance in all of these areas, the most evident subsequent improvement was in the Fund's interactions with and understanding of financial markets.

The second occasion was a postmortem internal review of the effectiveness of Fund surveillance in the period before the Asian financial crises in 1997–98. That review, conducted in the first quarter of 1998, reinforced the messages of the Whittome report, especially the importance of continual monitoring of macroeconomic and financial market conditions and of the timely availability of relevant data. It also concluded that the Fund needed to pay greater attention to the spillover effects from policy errors and other problems in regionally important countries, and it needed to do more to disseminate information about emerging problems, because "policy transparency" was crucial for gaining or restoring credibility in financial markets. Finally, the review suggested

that the Fund should encourage the further development of other peer review mechanisms such as regional policy forums.[214]

Also in 1998, the Executive Board commissioned an outside panel, led by John Crow, a former governor of the Bank of Canada, to evaluate the conduct and effectiveness of Fund surveillance. The Crow report (Crow, Arriazu, and Thygesen, 1999) was the first comprehensive external review of Fund surveillance. It offered a large number of recommendations, ranging from procedural issues (e.g., establish a surveillance committee of Executive Directors, publish all Article IV staff reports) to broad issues of substance. One key recommendation was to focus surveillance much more sharply on "the core issues of exchange rate policy and directly associated macroeconomic policies, in particular the international implications of such policies" than had been done in the 1990s. The report criticized the staff for trying to optimize all aspects of countries' economic policies and thereby losing sight of what mattered most. It argued for paying more attention to systemically important countries and less to small countries whose domestic problems had little effect on their neighbors.[215]

Many of the specific recommendations of the Crow report clashed with the culture and traditions of the IMF. Both the staff and the Executive Board issued detailed rebuttals (published as part of the report), mainly pertaining to the procedural rather than the substantive proposals. On the main substantive issues, though, the three major reviews all conveyed the same message: stay focused, get and analyze as much relevant information as possible, and convey a clear message both to the authorities and to the public. That advice was gradually incorporated more fully into the practice of surveillance in the years that followed.

[214]"Review of Members' Policies in the Context of Surveillance—Lessons for Surveillance from the Asian Crisis," EBS/98/44 (March 9, 1998); and minutes of EBM/98/34 (March 26, 1998. The lessons from the review were published in *Annual Report 1998*, pp. 34–38. This review dealt only with the role of surveillance. The separate question of how well the Fund responded to the crisis through its lending, policy advice, and technical assistance was taken up in other reviews, as discussed in Chapter 12.

[215]Crow, Arriazu, and Thygesen (1999), especially Chapter 6. The quotation is from p. 63.

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5

Many Borrowers; How Many Sizes? IMF Lending and Program Design

THERE IS NO ONE-SIZE-FITS-ALL IN THIS BUSINESS. YOU HAVE TO UNDERSTAND WHAT IS going on in each individual country; otherwise, you simply end up getting it wrong.

Stefan Ingves[1]
Director, IMF Monetary and
Exchange Affairs Department
September 25, 1999

From the beginning of IMF lending in 1947, the staff understood that countries could have difficulty financing their balance of payments for two reasons: either because their economic policies were inadequate or because of circumstances beyond their control. With experience, though, the Fund realized a basic lesson. Even if the root cause of the problem was an external shock, such as a weak market for the country's exports, policies would have to be adjusted to compensate unless the shock was temporary and the gap could be covered by a repayable loan. Because few shocks could be judged reliably to be "temporary," the Fund increasingly conditioned its lending on policy adjustments. This confidence in and reliance on conditionality reached its zenith in the 1990s.

Of course, to paraphrase Leo Tolstoy, every unhappy country is unhappy in its own way. Every country that asks to borrow from the IMF faces a unique set of circumstances that requires a tailored response. The policy conditions and the mix of adjustment and financing must reflect the context. Throughout this decade, the Fund made a number of changes to its policies on conditionality, and it introduced new specialized lending windows in response to changing world conditions. This chapter reviews the overall pattern of Fund lending, policy advice, and technical assistance in the 1990s and the various changes that the Fund introduced.

[1]Opening remarks, press briefing on "Report on Financial Sector Crisis and Restructuring: Lessons from Asia" (September 25, 1999); accessed at http://www.imf.org/external/np/tr/1999/tr990925.htm.

Overview

When the IMF first began lending to its member countries in 1947, it made simple outright disbursements in response to requests.[2] Five years later, it began the practice of offering stand-by arrangements, under which it would make a standing commitment to disburse up to a specified amount during a specified period, conditional on the country maintaining acceptable exchange rate and macroeconomic policies. Both the outright credits and the stand-by arrangements were also conditional on a finding that the borrower had a "balance of payments need" for them. Starting in 1963, the Fund established a variety of "special facilities" designed to respond to specific types of balance of payments problems, such as export crop failures or weak export markets. In 1977, it introduced the practice of lending on concessional terms to low-income countries through separate trust funds. As the range of lending practices widened, lending became an increasingly important activity for the Fund. In the 1990s, 100 countries borrowed from the IMF at least once.[3]

The Ebb and Flow of Lending by the IMF

The episodic nature of IMF lending is striking (Figure 5.1). The onset of a financial crisis induces a sudden spike in lending, which then tapers off quickly once the crisis is over. Before the 1990s, the major episodes were associated with the Suez crisis of 1956 (point A in Figure 5.1), the crises of confidence in the U.K. pound sterling in the 1960s (points B and C), the collapse of the official gold market in the late 1960s (point D), the "oil shock" of 1973–74 (point E), and the Latin American debt crisis that began in 1982 (point F). This episodic pattern continued in the decade covered by this History (and in the decade that followed).

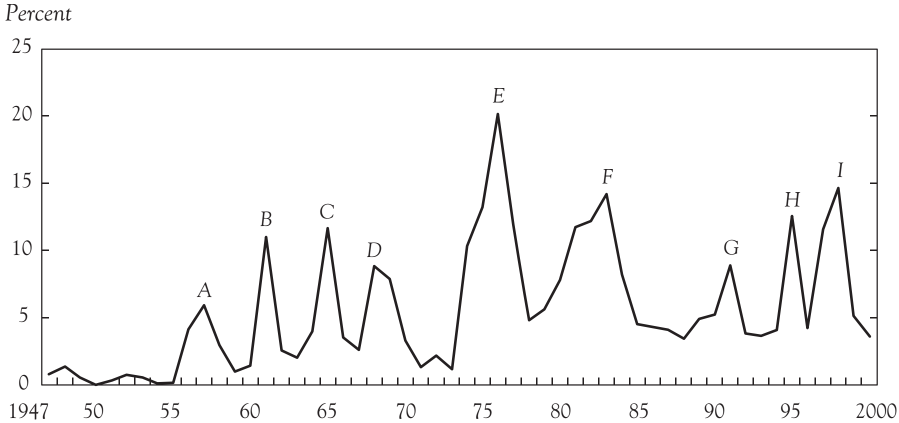
For the first half of the 1990s, the Fund was actively lending to a large number of countries. The aftermath of the 1980s debt crisis, the influx of new members with acute financial shortages, and the strengthening of the Enhanced Structural Adjustment Facility (ESAF) as a vehicle for lending to low-income countries all made for heavy demand. Nonetheless, the amounts involved were not large by historical comparison.[4] On average, annual lending from 1990 through 1994 was about $8.5 billion

[2]In technical terms, these disbursements are "purchases" of currencies by the member and are not loan disbursements. For more on terminology, see the Preface.

[3]The peak in IMF lending in proportion to world trade came in the 1960s, primarily because of large lending to the United Kingdom. The peak in the percentage of member countries that borrowed from the Fund came in the 1970s, owing to the ready availability and low conditionality of the Oil Facilities. The peak in the number of borrowing countries came in the 1990s.

[4]The small spike in 1991 (point G in Figure 5.1) is attributable partly to the Gulf War and a fiscal crisis in India, both of which raised the numerator, and partly to a delay in increasing quotas, which kept the denominator low.

Figure 5.1. IMF Lending, 1947–2000
(In percentage of Fund quotas)



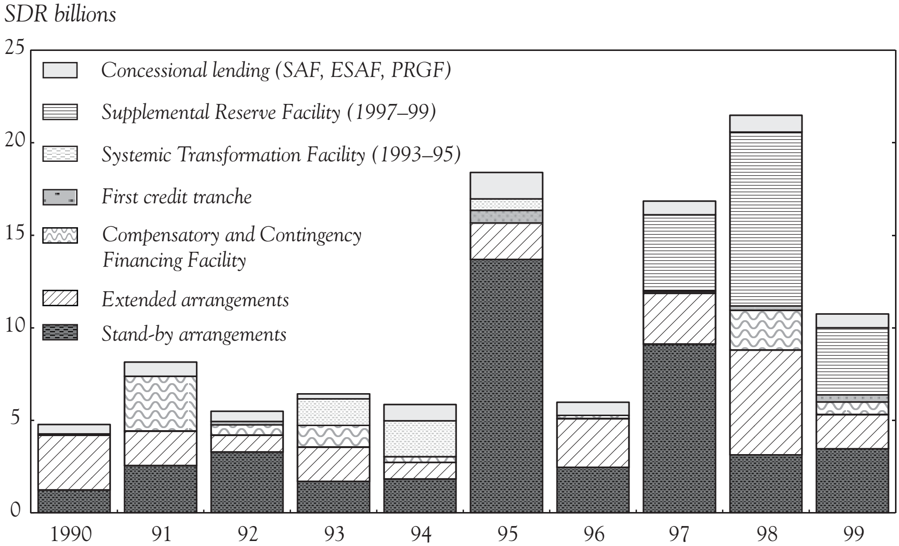
Source: IMF financial accounts.
Note: See text for meaning of labels at peaks. Figure includes all purchases except those in the reserve tranche, plus loans from administered trust funds.

(SDR 6.1 billion), with a total of 94 borrowing countries. The Mexican peso crisis at the end of 1994 (point H in Figure 5.1) ushered in a new era of much larger lending, followed as it was by the East Asian financial crisis of 1997–98, the Russian meltdown of 1998, and the Brazilian exchange crisis of 1998–99 (point I). For the second half of the decade, the Fund had just 75 active borrowers, but it lent an annual average of $20.7 billion (SDR 14.7 billion).

The mainstay of this lending was stand-by arrangements, which accounted for more than 40 percent of the total volume (Figure 5.2 and the Appendix to this chapter). Extended arrangements (longer-term and generally larger arrangements under the terms of the Extended Fund Facility, or EFF) accounted for another 22 percent. The rest was spread across several special facilities and other lending policies, which are discussed in more detail in the next section. At times, one or another of these special facilities rose to the fore owing to its suitability for the occasion. Thus, the EFF accounted for 62 percent of the volume in 1990, with the Fund using it to help emerging-market countries obtain debt relief from commercial bank creditors. The Compensatory and Contingency Financing Facility (CCFF), amended to help countries affected by the Gulf War, accounted for 36 percent of 1991 lending. The Systemic Transformation Facility (STF) accounted for a third of the volume in 1994 as a number of new Fund members used it in the early stages of transition to market economies. And the Supplemental Reserve Facility (SRF) accounted for 44 percent of lending in 1998, being the preferred way for the international community to put enough money on the table for the countries most severely affected by the systemic financial breakdown that year.

The increased incidence of prolonged borrowing also featured in this decade. Although the Fund was intended to be a purveyor of temporary financial assistance,

Figure 5.2. IMF Lending by Facility, 1990–99



Source: IMF financial accounts.
Note: SAF = Structural Adjustment Facility; ESAF = Enhanced SAF; PRGF = Poverty Reduction and Growth Facility.

prolonged usage became a fact of life in the 1980s and 1990s. During those 20 years, some 70 countries became prolonged users for a substantial portion of the time.[5] This phenomenon seems to contravene the spirit of the Articles of Agreement, which state in Article I that a purpose of the IMF is to "give confidence to members by making the general resources of the Fund *temporarily* [emphasis added] available to them under adequate safeguards."[6] In most cases, however, the Fund extended credit with an expectation on both sides that the borrower would strengthen its policies so it could repay the loan on schedule. Policy slips, adverse shocks during the life of the arrangement, and poor program design all contributed at various times to delays that required the

[5]Any definition of prolonged borrowing is somewhat arbitrary. The definition used here is the same as that used in Boughton (2001), pp. 618–19. A prolonged user at any given date has outstanding obligations to the Fund at least equal to its quota *and* has had at least five annual Fund-supported programs in the preceding 10 years. In one dimension, this definition is broader than the one used by the Fund's Independent Evaluation Office (Independent Evaluation Office, 2002), in that the IEO required a country to have seven annual programs over 10 years. It is, however, more restrictive in another dimension, specifying as it does a threshold for outstanding obligations. For this purpose, outstanding obligations exclude overdue interest charges and penalties, which normally are capitalized and included in the total. The definition of a Fund-supported program excludes programs supported only by purchases in the first credit tranche, the Compensatory Financing Facility or Compensatory and Contingency Financing Facility, the Buffer Stock Financing Facility, or emergency disaster relief.

[6]The word "temporarily" was added as part of the first amendment, in 1969, but the change was regarded as a clarification and not a change in policy.

Fund to lend repeatedly, sometimes for decades on end. In effect, this repeated lending rescheduled all or part of the original loans, conditional on the borrower agreeing to a new set of policy reforms. In almost all cases, the loans were eventually repaid in full and on the original terms. (The exceptional cases, in which arrears piled up and remained outstanding, are discussed in Chapter 16).

In all, 52 countries were prolonged users of Fund resources at some point in the 1990s, about the same number as in the 1980s (48 countries). In an important sense, though, the scope of the problem diminished in this decade. The difference between the two periods was that in the 1980s, all but 4 of the 48 countries had prolonged recourse to the Fund's General Resources Account (GRA) through repeated stand-by or extended arrangements. In the 1990s, the phenomenon was much more concentrated in the ESAF, a trust fund better designed to accommodate prolonged borrowing and not covered by the "temporarily" restriction cited above. Only 22 countries were prolonged users of GRA resources in the 1990s (Figure 5.3).

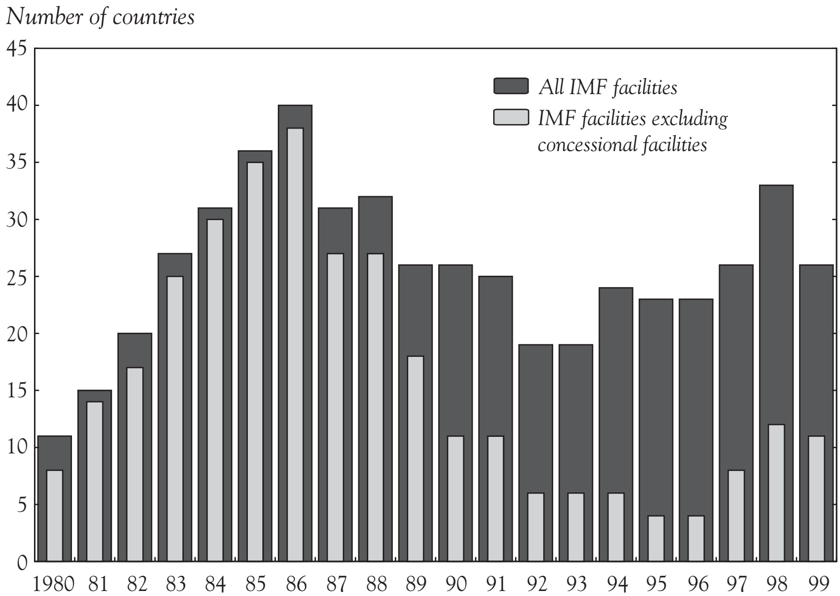
Within the group of prolonged users of the Fund's general resources were instances in which the Fund recognized at the outset that it would have to engage in repeated lending before the country would be able to graduate. Perhaps the clearest example was Bulgaria, which asked to borrow from the Fund soon after it became a member in 1990. The country's economy had been battered by decades of inefficient central planning and then by the collapse of the Soviet-based trading system (see Chapter 9). The increase in oil prices associated with the Gulf War additionally justified its borrowing from the IMF, but the most serious problems were chronic and would take several years to overcome.

A staff team headed by Anoop Singh (Advisor, European Department) made three trips to Sofia in as many months, at the end of which the team recommended a CCFF loan, to be followed almost immediately by a stand-by arrangement. In making that recommendation, Singh warned the Executive Board that the authorities were already talking about asking for a second arrangement when the time came. "Bulgaria," he concluded, "may be expected to be a prolonged user of Fund resources in the coming years."[7] That alarmed several Executive Directors, who observed that it was inappropriate for the Fund to lend to a country that lacked the capacity to repay the Fund when the loan fell due. Yet, everyone knew that Bulgaria could not recover and become a productive part of the world economy without the financial support of the IMF. The cause was too important, and the risk was worth taking.[8] The demands of the moment overwhelmed any doubts about whether the Fund was the appropriate agency to undertake that risk.

[7]"Bulgaria—Use of Fund Resources—Compensatory and Contingency Financing Facility—Request for Financing for Fluctuations in the Cost of Oil Imports," EBS/91/22, Suppl. 1 (February 14, 1991), p. 16. Also see Singh's remarks at the Executive Board meeting, minutes of EBM/91/27 (February 25, 1991), pp. 18–19.

[8]Minutes of EBM/91/27 (February 25, 1991) and EBM/91/37 (March 15, 1991). The CCFF loan was approved at the first meeting; the stand-by arrangement at the second.

Figure 5.3. Prolonged Users of Fund Resources, 1980–99



Source: IMF financial accounts and staff reports.
Note: A prolonged user is defined here as one with five or more annual programs in the preceding 10 years and with outstanding credit of at least 100 percent of quota at the end of the year indicated. Outstanding credit excludes charges on overdue obligations to the Fund.

Bulgaria did become a prolonged user of Fund resources, with six stand-by arrangements and one extended arrangement in effect almost continuously through 2004. As expected, the economic reform process was long and difficult and not without hiccups. In the end, though, it succeeded. At the close of one more stand-by arrangement that the authorities successfully treated as precautionary, Bulgaria fully repaid its borrowings with a final balloon payment in April 2007.

Jordan also borrowed through a series of almost continuous arrangements for 15 years (1989–2004). Shortly after Jordan graduated from this relationship, the Independent Evaluation Office prepared a detailed assessment.[9] That report concluded that the Fund had made "an important contribution" to Jordan's recovery from terrible initial conditions. Starting from a "severe balance of payments crisis" and "deep-rooted macroeconomic and related structural problems," Jordan made "major progress over the 15-year period of its IMF program involvement" (Independent Evaluation Office, 2005a, pp. 8, 12, and 13). The report was critical of what the Independent Evaluation Office regarded as the Fund's excessive focus on short-term issues and lack of clarity in

[9]Also see the discussion of Jordan in Chapter 16, p. 854.

its analysis of the relationship between program design and longer-run goals. Greater emphasis on technical assistance aimed at building institutions and fostering domestic ownership of reforms might have led to more effective and earlier results.

The staff did not disagree with these conclusions, but it noted the relevance of "the external and political factors influencing the Fund's decision to assist Jordan," including "the link between Fund arrangements and Jordan's requests for Paris Club agreements" to reschedule debts to official creditors (Independent Evaluation Office, 2005a, p. 84). Paris Club creditors would not reschedule a country's debt-service payments in the absence of a Fund agreement, and those creditors constituted a majority on the Fund's Executive Board. Prolonged usage, in this and other cases, may have resulted in part from external pressure to contribute to a broad international assistance effort.

The Evolution of Conditionality

Although the IMF normally lends subject to a set of conditions on the borrowing country's economic policies, nothing in the Articles of Agreement requires it to do so. Indeed, John Maynard Keynes—the British economist who was one of the IMF's two main "founding fathers"—wanted an institution that would lend almost automatically on demand. The Fund's other main founder, the American Harry Dexter White, was more skeptical of the practicality of that plan, with the result that the Articles were silent on the role of policy conditionality. Eventually, conditional lending prevailed after the Fund began lending to countries that could not resolve their payments difficulties without major changes in their policies.

In some circumstances, lending without policy conditions is clearly more appropriate. If a country faces a balance of payments deficit because of a temporary decline in the value of its exports owing to a worsening of world market conditions, it may need financial assistance to weather the downturn, but it does not necessarily need to change its policies. The Compensatory Financing Facility (CFF) was created precisely to accommodate such situations. Similarly, if deteriorating world financial markets temporarily limit a country's ability to raise funds privately, it may be appropriate for the IMF to lend quickly and without requiring a change in policies. Establishing ground rules for such lending has, however, proved to be extremely difficult, as discussed in the next section. Especially starting in the late 1970s, most IMF lending was conditioned on a specific list of economic policy adjustments by the borrowing country.[10]

The main story about conditionality in the 1990s is that the Fund gradually shed its reluctance to impose conditions on structural—as opposed to macroeconomic—policies. Throughout its first three decades of lending, the Fund eschewed structural policy

[10]For the history of conditionality through 1989, see Boughton (2001), Chapter 13, and references therein.

conditions altogether except in very unusual situations. To give force to that principle, the Executive Board adopted guidelines in 1979 that included this paragraph:

> 9. The number and content of performance criteria may vary because of the diversity of problems and institutional arrangements of members. Performance criteria will be limited to those that are necessary to evaluate implementation of the program with a view to ensuring the achievement of its objectives. Performance criteria will normally be confined to (i) macroeconomic variables, and (ii) those necessary to implement specific provisions of the Articles or policies adopted under them. Performance criteria may relate to other variables only in exceptional cases when they are essential for the effectiveness of the member's program because of their macroeconomic impact.[11]

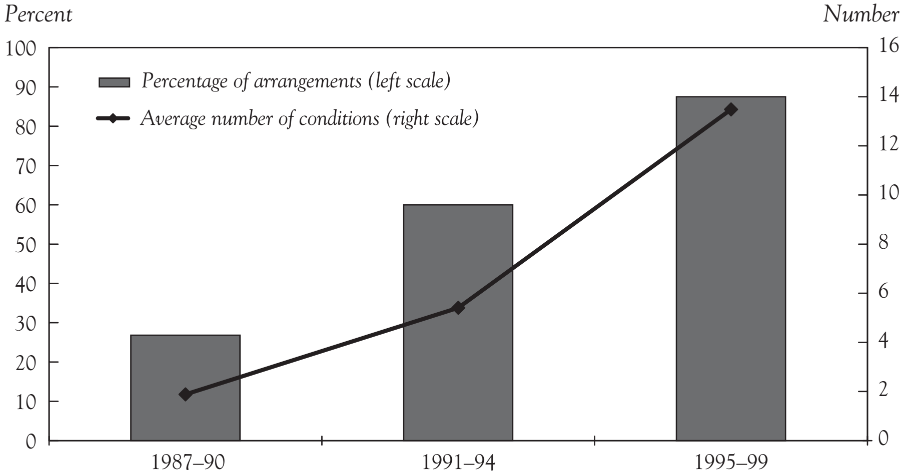
That decision was interpreted fairly strictly in the 1980s, with structural policy conditions limited to countries with central planning or heavy government intervention in the economy; and to developing countries implementing multiyear programs supported by the EFF, the Structural Adjustment Facility (SAF), or the ESAF. For most stand-by arrangements, performance criteria—the quantitative conditions on which disbursements under the arrangement depend—were limited to ceilings on credit expansion, government deficits, and borrowing; and prohibitions on current account exchange restrictions and on arrears to external creditors. Although the breach in the prohibition began to widen in the late 1980s, the practice remained unusual. Out of 41 stand-by arrangements in effect from 1987 to 1990, only 11 contained any structural policy conditions, and those averaged fewer than two such conditions per program year (Figure 5.4).

Staff, management, and Executive Directors all struggled to find the right balance on this delicate issue. If the Fund restricted its conditionality to macroeconomic variables, it ran the risk that the selection of policies—for example, what types of spending to reduce or which taxes to raise if a cut in the fiscal deficit was required—would be driven by domestic political considerations with short-run benefits but negative implications for sustainable economic growth. If the Fund imposed conditions on those structural policies, it ran the risk that it would undercut national ownership of key policy decisions and weaken the capacity of both the government and civil society to take responsibility for economic performance. Because the optimum strategy might well vary greatly across countries and over time, establishing and adhering to consistent guidelines was not easy.

The Fund did not revise its guidelines on conditionality during the 1990s, but it did revise its practices extensively. Without making a formal decision, the Fund expanded its use of four existing techniques. First, it supplemented its standard quantitative performance criteria with an increasing number of "structural performance criteria" such as ceilings on types of public sector borrowing or the extension of credit to types of borrowers. Second, it gradually added more structural "benchmarks" to stand-by and

[11]Executive Board Decision No. 6056-(79/38), adopted March 2, 1979; reproduced in Boughton (2001), pp. 629–31.

Figure 5.4. Structural Conditionality in Stand-By Arrangements



Source: IMF Monitoring of Fund Arrangements (MONA) database.
Note: Number of conditions is per year.

other arrangements. These benchmarks, such as progress indicators for ongoing reform programs, differed from performance criteria in that they often were not quantitative, and a failure to meet a benchmark did not automatically disqualify the borrower from the right to make the next drawing on the arrangement.[12]

Third, the Fund had increasing recourse to "prior actions," which the authorities would have to complete before management would take the request for an arrangement or completion of a program review to the Executive Board for approval. The use of prior actions was first introduced as a way to get essential measures taken in a timely manner when it was impractical to make them into performance criteria, the classic example being a currency devaluation. In the 1990s, the Fund increasingly imposed a range of prior action requirements to get countries to establish track records and demonstrate the ability and the political will to implement reforms.[13]

Fourth, the Fund broadened the scope of program reviews. Originally, the Fund introduced reviews into multiyear arrangements so that it could delay setting performance criteria for each year until it had at least preliminary results for the previous year. By the 1990s, the initial performance criteria often were set for less than a year, so that more frequent reviews were necessary. In addition, reviews commonly covered

[12]Failure to satisfy a performance criterion would preclude the Fund from approving a drawing unless the Executive Board explicitly granted a waiver. As a general rule, the Board granted waivers if the deviation was minor or temporary or if the authorities were taking sufficient corrective actions.

[13]For a review, see Thomas and Ramakrishnan (2006).

the authorities' success at meeting structural benchmarks as well as performance criteria.

These various extensions added flexibility and realism to Fund-supported programs, but they also removed much of the predictability of the Fund's financial commitment. Borrowers could no longer have confidence that if they met all the performance criteria, they would be entitled to borrow the next tranche of the arrangement. They would also have to meet a critical mass of the benchmarks and satisfy the Fund that the program was qualitatively on track—judgmental decisions that the Fund would make at the time of a review, not before.

Several forces combined to pull the Fund more deeply into structural conditionality in the 1990s, in ways that paralleled the expansion of surveillance concerns detailed in the preceding chapter. First, the Fund had explicitly accepted that promoting economic growth, not just financial stability, was a major goal of its lending. As the staff put it in 1987, a "powerful argument for conditionality to include growth as a direct objective is that without such an approach medium-term viability (and the revolving character of Fund resources) may be elusive."[14] Second, the Fund was becoming increasingly sensitive to the need to avoid letting the effects of financial adjustment fall disproportionately on poor people. Reducing fiscal deficits and controlling inflation could be, and should be, beneficial to the poor, but the effects depended on the structure of the adjustments. The government might want to maintain the size of its bureaucracy, defend subsidies for money-losing state enterprises, or preserve benefits for the urban upper classes. To enhance the distributional effects of adjustment in such cases, the Fund would have to insist on structural reforms. Third, many of the Fund's borrowers in the 1990s were making a difficult transition from central planning to market economies. Without structural reforms, that transition could not succeed.

The effect of these combined forces was that structural conditionality progressed from the exception to the norm. As shown in Figure 5.4, by the second half of the 1990s almost 90 percent of all stand-by arrangements had structural conditions, and those arrangements had an average of about 13 such conditions per program year. For extended arrangements and those supported by the ESAF, the numbers were even higher. Those facilities generally required borrowers to undertake structural reforms, and virtually all such arrangements in the late 1990s had structural conditions. On average, the number of conditions per program year was similar, regardless of the type of arrangement.

This expansion of conditionality posed unprecedented challenges for the Fund. The basic rationale for conditionality is that it can serve as a commitment mechanism for national authorities. Without conditionality, they might otherwise have difficulty persuading domestic interest groups to accept policies with overall benefits but net losses for those groups; or they might have difficulty getting electorates to support

[14]"External Adjustment, Financing and Growth—Issues in Conditionality," EBS/87/40 (February 25, 1987), p. 19.

policies with long-run benefits but short-run costs.[15] Conditionality is likely to be less successful when it is used to overcome the inability or unwillingness of the authorities to formulate and carry out strong policies. In practice, the difference between these two circumstances often becomes indistinct, especially when "the authorities" are not a homogeneous body.

These challenges came to a head when the Fund was called upon to help Thailand, Indonesia, and the Republic of Korea overcome a regional financial crisis in 1997 (see Chapter 11). In each of the three countries, the government in power at the time of the crisis resisted making the policy adjustments requested by the Fund as conditions for its lending. In each case, some officials, advisors, or opposition leaders were more sympathetic to the need for reform. In Indonesia, government advisors were instrumental in designing the reforms but lacked the power to get them carried out. In all three countries, domestic power struggles ensued, new governments were elected, and successful reforms were eventually implemented.

By the end of the 1990s, the need for strong domestic ownership of reforms was becoming clearer, as was the need for restraint on the part of the IMF. Structural policy conditions could be an important component of the Fund's tool kit, but only if the conditions were designed with care and focus and were negotiated in partnership with the national authorities (see Goldstein, 2001, and references therein; and IMF, 2002). With that conclusion in mind, the Fund undertook a major overhaul of its conditionality and adopted new guidelines in 2002 aimed at focusing and streamlining its practices. At the end of that decade, it seems safe to conclude that the 1990s were the high water mark for the scope of conditionality.

New Special Facilities

If the only choices available to the IMF were to lend through a stand-by arrangement with all the usual policy and other conditions or to lend in response to shocks without negotiating policy adjustments, the second choice would be open-ended and irresistible. To reduce temptation as well as to tailor lending to country circumstances, the Fund created a web of special facilities designed for specified conditions when an ordinary stand-by arrangement would be inappropriate or insufficient. Whenever a new type of potential circumstance arose, it was necessary to establish a new facility or modify an existing one. This practice had the advantage of enabling the Fund to maintain control while responding to shocks with a measure of flexibility, but it occasionally produced results that were not needed or that were ill designed for their intended purpose.

[15]For analyses of the relationships linking conditionality to ownership and program effectiveness, see Boughton (2005); Boughton and Mourmouras (2004); and Ivanova and others (2003).

Two new special facilities were created and used successfully by the Fund during the 1990s: the Systemic Transformation Facility (STF), which was created in 1993 as a temporary facility for assisting countries in transition, and the Supplemental Reserve Facility (SRF), which was created in 1997 as a means of providing large-scale financing to countries facing capital account crises. Two other innovations, the Contingent Credit Line (CCL) and the Y2K Facility, were created in 1999 but never used.[16]

The Systemic Transformation Facility

The IMF faced a major challenge at the beginning of 1993. It had taken in 22 new member countries in the preceding year. Almost all of them were undertaking a transition from state ownership and control to private enterprise, market-based pricing, and openness to international trade and finance. Most had little or no foreign exchange, little or no experience with market prices, limited administrative capacity to set and collect taxes, no national currency or experience with monetary control, and a production structure geared toward bilateral trade within a command system that no longer existed. They also faced a Catch-22—without the ability to stabilize and reform, few of them could be expected to formulate or implement a program of policies that would warrant the support of the international community on normal terms. Without that financial support, the transition would be seriously delayed and possibly aborted altogether because each country would face a collapse of output and incomes and, consequently, social unrest and backlash against reform.

At the time, the Fund's only choices for helping these countries financially were a first credit tranche drawing or a highly risky stand-by arrangement supported by an economic reform program that would almost certainly fail. As the experience with the Russian Federation and other transition countries in 1992 had shown all too clearly, neither choice would spur reform. The first choice would provide too little financing, and the second would likely result eventually in unsustainable and unredeemable debts. A new facility was needed that would support the early stages of reform: a program aimed at stemming the output losses, stabilizing the economy after the initial price adjustments, and buying enough time for the authorities to work with the Fund and other agencies to develop a comprehensive strategy and plan.

Once the need for a new facility became apparent, the Fund responded quickly. The staff put together a general proposal in March 1993, and the Executive Board considered it in April. A preliminary discussion revealed widespread support, and on that basis the staff prepared a specific proposal—the STF—which the Board approved on

[16]This review covers only the facilities for borrowing from the Fund's General Resources Account. The separate trust funds for lending on concessional terms are covered in Chapter 13.

April 23.[17] The central element was an understanding that policy conditionality would be lighter and much less detailed than under a conventional stand-by arrangement. Each applicant would be expected to submit a letter stating its policy intentions for the next year, including steps "to put in place the basic institutions of economic management in a market-oriented system." The letter would also spell out macroeconomic policy intentions and would commit the authorities to work toward a "comprehensive adjustment program that could be supported by a Fund [stand-by] arrangement."[18]

In addition to lighter policy conditions than in stand-by arrangements, the STF also offered borrowers a longer time to repay the loans (10 years instead of 5). Access limits were relatively small: each eligible country could borrow up to 50 percent of quota in two equal tranches. This borrowing would not count toward the general access limits, but it would preclude a "first credit tranche" loan with no conditionality. Interest rates were the same as for a stand-by arrangement.

The decision establishing the STF allowed for the possibility that the Fund might simultaneously—or even earlier—approve a stand-by arrangement for a country borrowing from the new facility. In that case, the Fund's goal in using the STF would be to front-load, top up, and extend the arrangement. This feature turned out to be important; nearly half of the countries using the STF had stand-by arrangements approved along with their first STF drawing (Table 5.1).

A large part of the rationale for developing the STF so quickly was the Fund's eagerness to put together a strong financing package for the Kyrgyz Republic. As discussed in Chapter 9, the Kyrgyz authorities were about to launch their own currency and back it up with a stabilization program. The Fund had previously declined to approve financing until the government had a credible monetary policy ready, and now it needed to act aggressively to ensure the success of the new currency. On May 12, 1993, just three weeks after the establishment of the STF—and just two days after the authorities introduced the som as the national currency—the Fund approved a stand-by arrangement and a simultaneous STF drawing. The combination meant that the Kyrgyz Republic could draw 40 percent of quota immediately (SDR 25.8 million, equivalent to $37 million), enough to finance the first stage of an effective reform program.

The STF as a whole was scheduled to expire in 20 months, at the end of 1994. By then, the Fund expected that the initial shock of the transition process would have worn off, and most of the eligible countries would be ready for conventional stand-by arrangements. However, heavy demand for STF loans continued, and a few eligible countries took longer than expected to put basic institutional and policy structures in

[17]Systemic Transformation Facility. Decision No. 10348-(93/61) STF, adopted April 23, 1993. This document may be accessed at http://www.imf.org/external/pubs/ft/history/2011/index.htm.

[18]Paragraph 3(a)(i) of Systemic Transformation Facility. Decision No. 10348-(93/61) STF, adopted April 23, 1993. This document may be accessed at http://www.imf.org/external/pubs/ft/history/2011/index.htm.

Table 5.1. STF Loans and Associated Arrangements, 1993–95

	First Drawing		Second Drawing		Associated Arrangement		
Country	Date	SDR (Millions)	Date	SDR (Millions)	Type	Date	SDR (Millions)
Albania	n.a.		n.a.		ESAF	Jul 1993	42.4
Armenia	Dec 1994	16.9	Jul 1995	16.9	SBA*	Jun 1995	43.9
Azerbaijan	Apr 1995	29.3	Nov 1995	29.3	SBA*	Nov 1995	58.5
Belarus	Aug 1993	70.1	Feb 1995	70.1	n.a.		
Bulgaria	Apr 1994	116.2	n.a.		SBA	Apr 1994	69.7
Cambodia	Oct 1993	6.3	n.a.		ESAF	May 1994	84.0
Croatia	Oct 1994	65.4	Apr 1995	65.4	SBA	Oct 1994	65.4
Estonia	Nov 1993	11.6	Jan 1995	11.6	SBA	Oct 1993	11.6
Georgia	Dec 1994	27.8	Jul 1995	27.8	SBA*	Jun 1995	72.2
Kazakhstan	Jul 1993	61.9	Jan 1994	61.9	SBA*	Jan 1994	123.8
Kyrgyz Republic	May 1993	16.1	Sep 1993	16.1	SBA	May 1993	27.1
Latvia	Dec 1993	22.9	Jul 1994	22.9	SBA	Dec 1993	22.9
Lithuania	Oct 1993	25.9	Apr 1994	25.9	SBA	Oct 1993	25.9
Macedonia, FYR	Feb 1994	12.4	May 1995	12.4	SBA*	May 1995	22.3
Moldova	Sep 1993	22.5	Dec 1993	22.5	SBA	Dec 1993	51.8
Mongolia	n.a.		n.a.		ESAF	Jun 1993	40.8
Romania	May 1994	188.5	n.a.		SBA	May 1994	132.0
Russian Fed.	Jul 1993	1,078.3	Apr 1994	1,078.3	n.a.		
Slovak Republic	Jul 1993	64.4	Jul 1994	64.4	SBA*	Jul 1994	115.8
Ukraine	Oct 1994	249.3	Apr 1995	249.3	SBA*	Apr 1995	997.3
Uzbekistan	Jan 1995	49.9	Dec 1995	49.9	SBA*	Dec 1995	124.7
Vietnam	Oct 1993	12.1	June 1994	12.1	SBA	Oct 1993	145.0
Total		2,147.6		1,952.8			
Cumulative total				4,100.3			

Source: IMF financial accounts.

Note: n.a. = Not applicable; ESAF = Enhanced Structural Adjustment Facility; SBA = stand-by arrangement.

*Arrangements were associated with the second STF drawing.

place.[19] In June 1994, as the deadline for making STF drawings approached, Managing Director Michel Camdessus tried to persuade the Executive Board to extend the facility, increase access from 50 percent of quota to 85 percent, and allow countries to make as many as five consecutive drawings instead of the two already allowed.[20] A number of Board members, led by Ewen Waterman (Australia), were skeptical about either increasing access or allowing multiple tranches, and those ideas were ultimately dropped. However, the Board eventually agreed to extend the deadline for a first STF drawing to end-April 1995, to extend the maximum gap between a first and a second

[19]The original proposal—"A Facility to Help Members Respond to Systemic Disruptions in Economies in Transition," EBS/93/56 (April 1, 1993)—envisaged about 15 countries borrowing up to SDR 3.5 billion. The final tally was SDR 4.1 billion by 20 countries.

[20]Minutes of EBM/94/54 (June 17, 1994), pp. 4–5. Also see "The Role of the Fund in Financing the Economies in Transition—Access and Cofinancing Trust Accounts," EBS/94/121 (June 3, 1994).

drawing from one year to 18 months, and to allow second drawings to be made up to the end of 1995.[21]

The establishment or extension of special facilities such as the STF required the approval of Executive Directors holding at least 85 percent of the voting power.[22] In April 1995, when the Board considered whether to extend the life of the STF any further, the consensus broke down. Karin Lissakers (United States) asked that the facility be extended and augmented. A majority of Directors either supported her or were willing to go along with the proposal, but others were skeptical. After some deliberation, Camdessus concluded that the facility had served its purpose well but was no longer needed. As a temporary facility, it should be allowed to expire. Several Directors then sided with the Managing Director. Hachiro Mesaki (Japan), for example, stressed the importance of strong conditionality for promoting economic reform. Prolonged reliance on the STF would weaken the effectiveness of Fund support, so the time had come "to draw the curtain and bid [the STF] a warm farewell." Most of the Board had no strong preference on the matter. Even Krzysztof Link (Alternate, Poland), whose constituency included several STF borrowers from the Caucasus region and central Asia, noted the value of the facility but concluded that its expiration "would not create great harm to any country." Support for an extension fell well short of the 85 percent threshold, and the motion failed.[23]

The last two countries to qualify for STF drawings were Uzbekistan (in January 1995) and Azerbaijan (in April). Shortly before the facility expired for good, both countries made their second drawings and simultaneously obtained their first stand-by arrangements.

In all, of the 20 countries that borrowed through the STF, 16 made two equal drawings, each one amounting to 25 percent of quota. Of the remainder, two low-income countries, Cambodia and Vietnam, shifted to concessional borrowing from the ESAF.[24] As discussed in Chapter 6, Bulgaria was out of compliance with the terms of its stand-by arrangement in 1995. Romania's financing needs were satisfied by its stand-by arrangement without the need for a top-up from the STF.

Eight of the 20 borrowers had stand-by arrangements approved along with the initial STF drawing, and eight others had stand-by arrangements approved along with the

[21]For Waterman's and others' responses, see minutes of EBM/94/54 (June 17, 1954). For the amendments to the STF, see the footnotes to "Systemic Transformation Facility, Decision No. 10348-(93/61) STF, adopted April 23, 1993," accessible at http://www.imf.org/external/pubs/ft/history/2011/index.htm. In April 1995, the Board declined to approve any further extensions; minutes of EBM/95/41 (April 19, 1995).

[22]Article XXX of the Fund's Articles of Agreement permits the Fund to exclude purchases under special facilities from the calculation of the member's reserve tranche position. To qualify, such facilities must be approved by an 85 percent majority.

[23]Lissakers made her request at EBM/95/26 (March 20, 1995), p. 76. The substantive discussion took place at EBM/95/41 (April 19, 1995). The quotations from Link and Mesaki are on pp. 39 and 42, respectively, of the minutes for the latter meeting.

[24]Vietnam's one drawing, at 5 percent, was the only one not equal to 25 percent of quota.

second drawing. Two countries—Belarus and Russia—had stand-by arrangements approved several months after the second drawing, and the remaining two—Cambodia and Vietnam—had ESAF arrangements associated with their single drawing on the STF. As shown in Table 5.1, two other low-income transition countries—Albania and Mongolia—did not draw on the STF but obtained ESAF arrangements whose amounts were later augmented to take into account the adverse effects of the transition process.

Emergency Financing and the Supplemental Reserve Facility

In 1994, as the possibility of a sudden reversal of capital inflows to developing countries emerged as an imminent threat, the Fund took a fresh look at its options for providing quick-disbursing assistance to affected countries. As detailed in Chapter 9, financial capital had been flowing freely into many emerging markets for more than four years. The longer that inflow continued, the greater the potential for imbalances, increasing the likelihood of a reversal. In response, the staff prepared a proposal for a short-term financing facility aimed at helping countries facing large and presumably temporary outflows of capital. The Fund would assess each country's policies as usual through annual Article IV consultations. If, despite satisfactory policies, the economy got hit by outflows anyway, the Fund would be prepared to lend quickly and possibly even automatically in amounts adequate to stem the speculative pressure. In support of the proposal, the staff's paper noted that the Czech Republic, Mexico, and Sweden had all faced such situations in the early 1990s and could have benefited from such a facility.[25]

Antecedents

The 1994 proposal was not the first of its type. In May 1972, as part of an initial staff proposal for systemic reform during the breakdown of the Bretton Woods par value system, Jacques J. Polak (Economic Counsellor) prepared a note for the Board on "possible Fund financing of short-term capital movements." For some countries, such capital flows were expected to be large relative to Fund quotas, provoking the fear that existing credit facilities (in the Fund or elsewhere) would be inadequate to cover the potential imbalances. Polak raised the question of "whether reserve creation by the Fund should in some way be responsive to the needs for reserves caused by the ebbs and flows of capital movements." If so, he asked, "should the facility in principle be available to all members . . . or perhaps [to] those Article VIII members that met certain additional criteria?" The first question, however, was whether the reformed system would be anchored by par values, and if not, whether fluctuations in exchange rates would absorb the pressure for large capital movements. That discussion occupied the Executive Board

[25]"Short-Term Financing Facility," EBS/94/193 (September 26, 1994).

and the Committee of Twenty for two years, by which time everyone seems simply to have forgotten the Polak proposal.[26]

In 1979, the staff considered introducing "reverse stand-by arrangements." In that scheme, if the staff team conducting Article IV discussions with a member country considered the country's economic conditions strong and its policies sound, the Managing Director could offer a stand-by arrangement as a "seal of approval" instead of waiting for countries to develop problems and then ask for a borrowing arrangement as a last resort.[27] A year later, Alexandre Kafka (Brazil) floated the idea during the Executive Board's periodic discussion of its work program, but it gained no traction and was quietly dropped.[28]

Polak tried again in January 1980, when he was serving as Advisor to the Managing Director (Jacques de Larosière). In a memorandum, he proposed establishment of a "temporary intermediation facility" that would provide low-conditionality loans quickly to countries facing sudden losses of access to international bank loans. In his view, it would be a natural extension of the Oil Facilities, in view of the similarities between the effects of the oil price increases of 1973–74 and the interest rate increases of 1979–80. De Larosière forcefully rejected the idea on the grounds that Fund lending should be backed up by policy conditionality and not extended automatically.[29]

In January 1981, the European Department toyed with the idea of providing large-scale short-term lending without a stand-by arrangement. No special facility would be created. Instead, the Board would be asked to waive the normal conditionality requirements on a case-by-case basis for countries deemed to qualify because of their track records and current policies. This proposal was floated in the context of an exchange-market crisis in Sweden. The Fund would disburse close to 150 percent of quota up-front, with an expectation of either an early repayment or a rollover into a stand-by arrangement if necessary. De Larosière rejected that proposal on essentially the same grounds as the previous one from Polak.

Only once again in the 1980s did a proposal reach the Executive Board, and then only in the most general terms. In the immediate aftermath of the Mexican debt crisis of 1982, the U.S. authorities asked for consideration of new special procedures to deal with systemic strains. In response, the staff prepared a paper assessing "the adequacy of existing arrangements to deal with major strains in the international financial system."

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[26]For a discussion, see de Vries (1985). The proposal is reproduced therein in Volume III, p. 16, and discussed in Volume I, pp. 123–34. The reference to "Article VIII members" is to countries that have accepted the obligation not to impose capital controls. The Committee of Twenty was the predecessor of the Interim Committee.

[27]Memorandum from E. Walter Robichek (Director, Western Hemisphere Department) to C. David Finch (Director, Exchange and Trade Relations Department), "'Reverse Stand-by Arrangement'," December 14, 1979; IMF archives, Historian's files. Robichek evidently envisaged Brazil as a prime example of a qualifying country.

[28]Minutes of EBM/80/161 (November 5, 1980), p. 12.

[29]On this and the next paragraph, see Boughton (2001), pp. 560–63 and 747–48.

On the role of the Fund, the paper noted that "under . . . present policies, there are no special facilities that members can use in the event of a financial emergency arising from sudden, severe, and widespread strains in the international financial system." It posed the question of whether a new facility might be warranted and whether SDR allocations could help finance it, but it did not elaborate a specific scheme.[30]

When the Executive Board met to discuss the 1982 paper, the idea became known as the "contingency fund" proposal. Directors generally agreed that it was better to prevent crises than to clean up the mess afterward, but a majority nonetheless balked at the idea of weakening conditionality. Gerhard Laske (Germany) suggested that such a scheme might be interpreted as a "safety net for the banks," which would be counterproductive and possibly destabilizing. Summing up the meeting, de Larosière noted that "a number of Directors considered that, on the whole, it might be inappropriate for the Fund to engage in short-term bridging financing in view of the risk of impairing the effectiveness of the Fund's adjustment programs."[31]

The Emergency Financing Mechanism

In sum, all these suggestions failed to win support because they were seen to be too soft on conditionality. The 1994 proposal suffered the same result when considered by the Board. Waterman opened the discussion by suggesting it was "unlikely that a country with strong fundamentals and a track record of sound policies would be cut off from borrowing from international capital markets. . . . In practice, the greatest demand could come from the countries whose economic fundamentals are not sound and whose track record is not so good." That confidence in the wisdom and rationality of capital markets and in the general need for conditionality carried the day. Ian D. Clark (Canada) expressed a liking for the idea in principle, but he seriously doubted that the Fund could outsmart the markets in assessing the quality of a country's policies and circumstances. Several speakers also worried about the Fund's ability to judge whether a shock was temporary or would persist.[32]

Camdessus cast the discussion in the best possible light ("some [Directors] were cautiously optimistic; others were skeptical but receptive") and promised to continue working to devise a viable proposal. Three weeks later, Mexico—one of the three countries the staff had singled out as a possible beneficiary of a quick-disbursing facility—exploded in a frightening financial crisis that exposed underlying weaknesses the Fund had failed to see (Chapter 10). For the time being, that crisis ended further consideration of the proposal.

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[30]"The Adequacy of Existing Arrangements to Deal with Major Strains in the International Financial System," EBS/82/194 (October 22, 1982).

[31]Minutes of EBM/82/150 (November 19, 1982), p. 13 (Laske); and EBM/82/151 (November 19, 1982), p. 29 (de Larosière).

[32]Minutes of EBM/94/104 (November 30, 1994), pp. 4–5 (Waterman), 12–13 (Clark), and 71 (Camdessus, in the next paragraph).

Notwithstanding the daunting challenges, the Fund still needed some means of reacting quickly and forcefully when a member country came under a speculative attack. The Mexican crisis showed that although the Fund might not be able to see a crisis coming, it had to—and could—respond quickly once the crisis erupted. To enhance that response, the heads of state and government of the Group of Seven (G7) countries, meeting in Halifax, Nova Scotia (Canada), for their annual summit in June 1995, proposed establishing an "Emergency Financing Mechanism involving a Fund arrangement with strong conditionality but with high up-front access and faster procedures to access Fund resources in crisis situations under the 'exceptional circumstances' clause."[33]

A staff team in the Policy Development and Review Department quickly prepared a proposal in response to the Halifax summit request, which was being pushed particularly forcefully by the United States. In the staff conception, the trigger for activating special procedures under the Emergency Financing Mechanism (EFM) would be a finding by the Fund that a country faced an exceptional crisis and was prepared to take strong policy actions to deal with it. In such "rare circumstances," the Fund would accelerate its reaction, negotiate a program as quickly as possible, prepare only a short report for the Executive Board, and at least consider granting exceptionally large access in relation to the member's quota. Additional financing from bilateral creditors and other multilateral lenders would be expected as a normal part of the international package of support.[34]

Two features made the EFM more palatable than the rejected schemes of the past. First, it did not rely on the staff's ability to foresee a crisis or to assess the quality of a country's policies in advance. Second, it did not rely on a distinction between external and internal causes of the crisis. As long as a country was willing to work with the Fund to deal with the problem, it could qualify for large and speedy assistance.

The Executive Board approved the EFM in September 1995, on the understanding that it was not a formal new lending facility but only a new set of procedures for coping with extreme financial crises. To that end, the Board issued no formal decision. The procedures, which in essence just described the way the Fund had responded to the Mexican crisis, were specified in the Chairman's Summing Up of the Board meeting.[35] The rationale for this low-key approach was that many on the Board were wary of raising expectations that the Fund would just "bail out" any country that might get into major financial trouble. Marc-Antoine Autheman (France) went so far as to argue that the EFM should not be used "more than two or three times a century." While not

[33]"The Halifax Summit Review of the International Financial Institutions: Background Document," June 16, 1995, Section 5; accessed at http://www.g8.utoronto.ca/summit/1995halifax/financial/index.html. The document was issued in the IMF as EBS/95/86 (June 20, 1995).

[34]"An Emergency Financing Mechanism," SM/95/216 (August 22, 1995).

[35]Emergency Financing Mechanism. Summing Up by the Chairman, EBM/95/85 (September 12, 1995). This document may be accessed at http://www.imf.org/external/pubs/ft/history/2011/index.htm.

everyone wanted to be that strict, almost all Directors (with the exception of Karin Lissakers of the United States) agreed that its use should be limited to "truly exceptional" and thus rare circumstances.[36]

The agreement on the EFM allowed the Fund to approve exceptionally large loans, but it did not require a link between the emergency procedures and exceptional access. In fact, the first invocation of the procedures did not involve exceptional access. In July 1997, the Philippines was hit by contagion from the financial crisis in Thailand just as it was preparing to exit from prolonged dependence on IMF financial assistance (Chapter 12). The crisis erupted on July 2; the central bank abandoned the peg between the Philippine peso and the U.S. dollar and allowed the peso to float on July 11; a staff report was issued to Executive Directors on July 14; and the Executive Board approved an augmentation and extension of the existing extended arrangement on July 18 (see Chapter 12). Although the peso continued to depreciate for some time, the panic subsided. The Philippines was thus spared a crisis of the extent and magnitude of those that engulfed much of the region that year.

Before the end of 1997, the Fund invoked the EFM procedures three more times: for Thailand in August (21 days from the authorities' request for assistance to the Fund's approval of a stand-by arrangement), for Indonesia in November (23 days), and for Korea in December (8 days). In July 1998, although the Fund did not specifically invoke the EFM as justification, the Executive Board greatly augmented Russia's extended arrangement just 10 days after the authorities asked for help. In each of these four cases, the arrangement included exceptionally large access.[37] Autheman's "two or three times a century" was already exceeded, as the world economy staggered from a series of crises that no one could have foreseen.[38]

The Supplemental Reserve Facility

As the Fund began providing large-scale financial support—loans that were well in excess of the normal quota-based ceilings—to countries facing massive outflows of private capital, attention turned again to the question of the way those arrangements should be structured. Just topping up and front-loading stand-by and extended arrangements on the same terms as their smaller cousins was not satisfactory. It failed to provide adequate safeguards to the Fund, and it raised the risk of moral hazard if vulnerable countries and their commercial creditors came to expect

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[36]Minutes of EBM/95/85 (September 12, 1995). Autheman's remark is on p. 45; the Chairman's Summing Up establishing the procedure is on pp. 53–57; and Lissakers' objection to "truly exceptional" is on p. 57.

[37]The three Asian cases are discussed in detail in Chapter 11. Russia is discussed in Chapter 7. On the exceptional access, see Chapter 15, especially Table 15.3.

[38]In the following decade, the IMF invoked the EFM eight more times: for Turkey in 2001, Georgia in 2008, and—in response to the crises of the "Great Recession"—for Armenia, Hungary, Iceland, Latvia, Pakistan, and Ukraine in 2009.

a bailout on relatively easy terms. Nonetheless, the Mexican and Asian crises showed clearly that large-scale assistance might continue to be needed.

In the wake of the 1997 crisis in Thailand, Japanese officials proposed establishing an Asian Monetary Fund, independent from the IMF, that would use regional resources and avoid the stigma many countries associated with borrowing from the IMF. As discussed in Chapter 12, that proposal did not gain much support, but it did lead to an international agreement to establish a peer-group surveillance process known as the Manila Framework. The communiqué for the meeting that set up the Manila Framework also called on the IMF to set up a mechanism to provide large-scale assistance on a more consistent and formal basis. Specifically, the finance and central bank deputies of 14 countries "urged the IMF to constructively examine the establishment of a new mechanism to provide short-term financing to augment an exceptional stand-by or extended arrangement in the light of the globalization of financial markets and the increased scale of private capital flows."[39]

The staff responded to this request with a proposal quite different from the "short-term financing facility" that was not approved in 1994. The new proposal dropped the idea of trying to sort out strong and weak economies in advance, and it dropped the idea of offering low conditionality to the strong ones. It built on the concept of the EFM by noting the importance of a rapid and large-scale response, and it added two new elements: relatively high interest rates and incentives for early repayment. Assistance would be provided through a new or existing arrangement with the same policy conditions that would apply in normal circumstances.

The driving assumption behind the 1997 proposal for what was initially called the "Manila facility" was that a country hit by a sudden loss of access to private financial capital would have both short-term and longer-term financing needs. The longer-term or "underlying" need would be associated with a balance of payments deficit similar to other situations that would lead countries to ask for loans from the Fund. That sort of demand could be met in the usual way, with the amount of the arrangement linked to the country's quota through the established access limits, as discussed in Chapter 15. The short-term need would be associated with the initial capital outflow and might be large relative to the size of the economy and thus out of proportion to the country's quota. If the Fund-supported program worked as expected, private capital inflows would eventually resume, and this additional financing could then be repaid. The Mexican crisis of 1994–95 had shown this pattern, and the staff saw that it was reappearing in Korea and was likely to develop in Thailand and Indonesia as well.[40]

While the staff was formulating its response to the request from the Manila Framework, crisis erupted in Korea. The authorities asked for help, and—as noted above—the

[39]"A New Framework for Enhanced Asian Regional Cooperation to Promote Financial Stability," Meeting of Asian Finance and Central Bank Deputies: Agreed Summary of Discussions, paragraph 7, Manila, Philippines, November 18–19, 1997; accessed at http://www.mof.go.jp/english//if/if000a.htm.

[40]"Supplemental Reserve Facility," EBS/97/225 (December 5, 1997), pp. 7–11.

Fund responded extremely quickly by activating the EFM procedures. On December 3, Camdessus flew to Seoul to complete the negotiations. He reported back to the Executive Board via videoconference, later the same day, that the authorities agreed to shift a major portion of their borrowings to a new short-term facility once the Fund was able to enact it. With that informal understanding, on December 4—just two weeks after the Manila conference—the Executive Board approved a massive stand-by arrangement equivalent to just under 20 times Korea's quota (Chapter 11). The next day, the staff hastily put the finishing touches on its proposal for a Supplemental Reserve Facility (SRF) and circulated it to Executive Directors.

The staff carefully designed the SRF to maximize the safeguards. Everyone involved understood fully the extent of the risk to the Fund of lending extremely large amounts to troubled countries without being able to take the time to negotiate a completely articulated program of economic reforms. The risk of creating a moral hazard if creditors believed that the Fund would always rescue them from bad lending or investing decisions also weighed on everyone's minds. When the Executive Board met to consider the proposal in mid-December, just when doubts about the effectiveness of the Korea program peaked, most of the discussion concerned means of making the safeguard provisions even stronger. The staff duly produced a revision, which the Board unanimously approved on December 17.[41]

The decision creating the new facility included several provisions aimed at coping with risks and minimizing moral hazard.[42] First, use of the SRF would be limited to cases posing systemic threats. Second, the borrowing country would be expected to try to persuade all creditors, "both official and private," to maintain their exposure, and the Fund and other official creditors would assist in that effort. "All options should be considered to ensure appropriate burden sharing." As discussed in Chapter 1, that feature effectively restored "private sector involvement" as an essential element in this type of rescue effort. Third, if that persuasion effort proved insufficient, the Fund could require the country to impose controls to stem capital outflows. Fourth, the borrower would be expected to repay the loan within two and a half years, compared with the five-year maturities for ordinary stand-by arrangements and ten years for extended arrangements. Fifth, to cover the additional risk and encourage prompt repayment, the interest rate charged on SRF loans would start at 3 percentage points above the standard rate and rise to as much as 5 points above once a loan was outstanding for two and a half years.

On December 18, 1997, one day after establishing the SRF, the Fund approved the second installment of the stand-by arrangement for Korea. From this point on, disbursements would be made under the terms of the SRF rather than the ordinary credit tranches. Korea borrowed approximately $2.1 billion on December 19 and a total of $13.5 billion (SDR 9.95 billion) through the SRF by the end of 1998. Korea repaid

[41]Minutes of EBM/97/121 (December 15, 1997) and EBM/97/123 (December 17, 1997).

[42]Supplemental Reserve Facility. Decision No. 11627-(97/123) SRF, adopted December 17, 1997. This document may be accessed at http://www.imf.org/external/pubs/ft/history/2011/index.htm.

those drawings in installments from December 1998 through September 1999. The initial drawings on the stand-by arrangement were repaid in 2001.

The Fund activated the SRF twice more in the 1990s. In July 1998, Russia requested and received a large augmentation to its EFF arrangement plus a CCFF drawing in its last desperate attempt to stave off a default on its government debt (Chapter 7). The package totaled $11.2 billion, of which $4.8 billion was to be made available immediately. Most of the immediately available funds were provided through the CCFF ($2.9 billion) or the EFF on normal terms ($1.0 billion). The remainder ($0.9 billion) was provided under the terms of the SRF. All of it was financed by activating the General Arrangements to Borrow.[43] Then in December 1998, the Fund approved a stand-by arrangement for Brazil that was primarily on SRF terms (Chapter 12). Brazil borrowed close to $9 billion through the SRF linked to that stand-by arrangement: $4 billion in December 1998 and $4.9 billion in April 1999.

The SRF was activated several more times in the next four years.[44] It was terminated in 2009 as part of a general restructuring of Fund facilities.

Contingent Credit Lines

Establishing the SRF as a high-conditionality facility did not mean the IMF was giving up on the idea of low-conditionality lending. When the Russian default in August 1998 began to threaten other emerging markets around the globe, decisive and coordinated action appeared to be needed to forestall that threat. As discussed in Chapter 12, Camdessus called a special meeting of finance ministers throughout the Americas, which was held at Fund headquarters at the beginning of September. That meeting produced a general agreement that many of the Latin American emerging-market countries had greatly strengthened their economic policies and conditions in recent years but still faced a serious risk of a reversal of support from international financial markets. In a communiqué summarizing the meeting, Camdessus noted that the Fund was already providing financial assistance to many of these countries, and he was "ready to recommend the strengthening and broadening of this support, if necessary." That was a veiled reference to the possibility that the Fund might make an advance commitment to a select group of countries judged to be vulnerable despite the implementation of sound economic policies.[45]

[43]Activation of the General Arrangements to Borrow is discussed further in Chapter 15. Following the debt default in August 1998, Russia did not make any further drawings on the EFF arrangement or the SRF.

[44]Brazil drew on the SRF again from 2001 to 2003. The other users were Turkey (2000–02), Argentina (2001), and Uruguay (2002).

[45]See Fischer (2000) and "Communiqué of Meeting of Economic Policy Makers in the Western Hemisphere Region," press release PR/98/37 (September 3, 1998); accessed at http://www.imf.org/external/np/sec/pr/1998/pr9837.htm.

The strongest impetus for a preemptive lending facility came from U.S. President Bill Clinton. Shortly after the ministerial conference at the Fund, in a speech to the Council on Foreign Relations in New York on September 14, 1998, Clinton called for the Fund to take more direct action to ward off crises of contagion before they could destroy otherwise healthy economies:

> We must develop policies so that countries can reap the benefits of free-flowing capital in a way that is safe and sustainable. We must adapt the IMF so that it can more effectively confront the new types of financial crises, minimizing their frequency, severity, and human cost. We need to consider ways to extend emergency financing when countries are battling crises of confidence due to world financial distress as distinct from their own errors in policy. We must find ways to tap the energy of global markets without sentencing the world to a cycle of continued extreme crises.[46]

Clinton's speech effectively put the 1994 proposal for a preemptive short-term financing facility back on the table. When the G7 finance ministers met at the beginning of October, they "agreed to explore a strengthened capacity, based in the IMF . . ., to provide more effectively contingent finance to help countries pursuing sound policies to maintain stability in the face of difficult global financial conditions." Although the tortured syntax of that sentence suggested that the ministers had argued a bit over how far to run with the idea, it was enough to convince the Interim Committee to put it on the agenda for the Fund's work program.[47]

The intended beneficiary of the proposed contingency facility was Brazil. As soon as the Russian government defaulted on part of its debt in August 1998, international financial markets concluded that Brazil was the most likely market to collapse next (Chapter 12). IMF officials were pressing Brazil to tighten fiscal policies and to allow the exchange rate to depreciate more, but they had confidence that the government would take the necessary measures. Because the Clinton administration shared that view, the prospects were good that the Fund could offer large-scale preemptive financing to Brazil on a precautionary or contingent basis. The question was not whether but how to frame the offer. A conventional stand-by arrangement, even if it was announced as precautionary, would be risky, because it would inflame the political opposition in Brazil and could further ignite the already intense speculative pressure in financial markets. In the fall of 1998, however, that was the only option available to the Fund. As negotiations started in October, Stanley Fischer (First

[46]"Global Economy," speech at the Council on Foreign Relations, September 14, 1998; accessed at http://www.cfr.org/publication/9349/global_economy.html?breadcrumb=%2Fpublication%2Fpublication_list%3Ftype%3Dtranscript%26page%3D66. Administration officials had discussed this proposal with Camdessus while the speech was in preparation, and he had encouraged them to include it. See the transcript of his press conference on October 8, 1998, at http://www.imf.org/external/np/tr/1998/TR981008.HTM.

[47]"Statement by the G7 Finance Ministers and Central Bank Governors, Washington DC, October 3, 1998," paragraph 3; accessed at http://www.g7.utoronto.ca/finance/fm100398.htm. The Interim Committee communiqué (October 4, 1998) simply reproduced the G7 sentence word for word.

Deputy Managing Director) promised Executive Directors that if the IMF created what was then being called the Contingent Reserve Facility, Fund support for Brazil would be shifted to it.[48]

On October 30, when newspapers around the world were reporting that Brazil was desperately trying to reach an agreement with the IMF, the G7 raised the ante by issuing a statement in the name of the "leaders" (heads of state or government), welcoming both Brazil's new policy commitments and the plans for new "financing arrangements to ward off destabilizing market contagion." The G7 leaders' statement included a specific description of what they wanted: "an enhanced IMF facility to provide a precautionary line of credit that could be drawn on if needed by countries pursuing strong IMF approved policies, accompanied as appropriate by bilateral finance, on a case by case basis, and with appropriate private sector involvement."[49]

The staff visualized modifying the SRF to include the possibility of making an advance commitment to select countries for a Contingent Credit Line (CCL). A public commitment from the Fund would help countries with good policies avert a financial attack, and SRF resources would serve as a backup if a crisis hit anyway and if normal quota-based resources were too small to cope with it. The first challenge, therefore, was the same one that had doomed earlier attempts. Could the Fund reliably and convincingly separate the wheat from the chaff? The staff report proposing the facility acknowledged the problem but confined its doubts to a footnote: "In practice it would be difficult to draw such a clear line. . . . Nonetheless, it would be important to confine the use of a contingent credit line to members for which . . . policy shortcomings can confidently be judged unlikely to be the trigger for the crisis."[50] The momentum coming from the G7 was too strong for more pronounced skepticism.

Executive Directors from outside the G7 were less constrained by the political winds.[51] A. Shakour Shaalan (Egypt) argued that existing facilities, notably Fund-monitored programs and precautionary stand-by arrangements, were perfectly adequate. J. Onno de Beaufort Wijnholds (Netherlands) scoffed that the CCL was "being created for a clientele which does not exist (i.e., 'innocent' countries)" and would "undermine the Fund's credibility and catalytic role." Zhixiang Zhang (China) suggested that countries with strong policies would be unlikely to ask the Fund for assistance in advance of a crisis; in any case, the "health checks" the staff was proposing to

[48]Minutes of EBM/98/108 (October 26, 1998), p. 5.

[49]"G7 Leaders Statement on the World Economy" (October 30, 1998); accessed at http://www.g7.utoronto.ca/finance/g7_103098.html. The statement was issued by the U.K. Chancellor of the Exchequer, Gordon Brown, who was then chairing the G7 finance ministers.

[50]"Review of the Supplementary Reserve Facility and Preliminary Consideration of a Contingent Credit Line," EBS/98/214 (December 9, 1998), p. 7n.

[51]G7 member countries were not uniformly enthusiastic about the proposal. As Blustein (2001, pp. 331–36) reported, Germany was particularly concerned about the moral hazard implications. After the October 1998 meetings, however, German officials focused their interventions on an effort to tighten the standards for using the facility, not preventing its adoption; see in particular the statement by Bernd Esdar at EBM/99/6 (January 13, 1999), pp. 28–31.

separate strong from weak economies were still untested. Willy Kiekens (Belgium) concluded that a positive assessment by the Fund—a "credible assurance" of sound policies and strong economic conditions—would do more good for a country than a contingent promise of future loans. Even the Russian Executive Director, Aleksei V. Mozhin, acknowledged that "the countries that have been hit by the crisis did not have spotless records, to put it mildly."[52]

In light of these controversies, the staff put three options up for consideration. First, the Fund could agree to monitor a member country's policies, with an explicit commitment to consider offering a stand-by arrangement of a specified amount if the country were hit by a contagion-fueled crisis (the "Fund-monitored program" option). Second, the Fund could approve a "low-access precautionary arrangement," with a promise to consider augmenting it with large-scale resources if needed (the "augmentation" option). Third, the Fund could approve a large-scale arrangement, with the full amount already committed and to be made available in the event of a crisis (the "commitment" option). The first two options would provide the greatest protection for the Fund but would provide relatively little assurance to the country that help would be available when needed. Only the commitment option would provide the desired assurances, but it would leave the Fund exposed to relatively high risk.[53]

Eventually, management and the staff decided on a watered-down version of the commitment option. The Fund would approve an arrangement with a commitment to the full amount the country might need in a crisis, but disbursement "would be subject to a review and decision by the Executive Board, taking into account the circumstances of the member, the member's policy response to those circumstances, and the member's track record under the program specified in consultation with the Fund." Once it was activated, the CCL would be subject to "appropriate conditionality (performance criteria and reviews)."[54]

Because an applicant would have no assured access to the resources committed under a CCL, the main advantage would be the Fund's public approval of its policies. In the final formulation, to be considered for a CCL, a member country would have to satisfy four criteria. First, the Fund would determine that the country would not need to borrow from the Fund unless it was hit by financial contagion. Second, the country would have to have a favorable assessment from the most recent Article IV consultation and a continuing positive assessment when the Board considered the request for a CCL. Third, the applicant should be "maintaining constructive relations with its private creditors" so as to limit its vulnerability and to "facilitate the appropriate involvement of the private sector" in the event of a crisis. Fourth, the country should put

[52]Minutes of EBM/99/6 (January 13, 1999), pp. 6 (Shaalan), 11 (Wijnholds), 15 (Zhang), 35 (Kiekens), and 40 (Mozhin).

[53]"Review of the Supplementary Reserve Facility and Preliminary Consideration of a Contingent Credit Line," EBS/98/214 (December 9, 1998), pp. 7–16.

[54]"Further Considerations Toward a Contingent Credit Line," SM/99/54 (February 24, 1999), p. 14.

in place a "satisfactory economic and financial program" and submit it for approval by the Fund.[55] If the Fund had any credibility with financial markets, then a country meeting these criteria should be assured of continuing support from the markets, and the CCL should serve only as a second line of defense against a widespread market meltdown.

This formulation was carefully crafted to meet two conflicting objectives: maximize the potential benefits by making large amounts of money available to stricken countries and minimize the risk by limiting access to the most-deserving countries. The discussion in the Executive Board, which took place over several days of meetings through the first four months of 1999, showed that everyone was keenly aware of the difficulty of making the new facility useful without weakening the Fund's control over the use of its financial resources. The crisis in Brazil was already essentially resolved, with the approval of a conventional stand-by arrangement in December 1998 and a successful revision of the economic program in February 1999. Which other countries might apply for and benefit from a CCL was not clear and was not openly discussed. It was thus with an apparent sense of weariness and limited enthusiasm that Executive Directors established the CCL as a separate set of procedures within the SRF,[56] just in time for the Interim Committee to welcome it at its meeting in April 1999.

From the vantage point of the IMF, the CCL was a device for certifying that certain countries had "first class" policies and no need for major adjustments. The combination of that certification and the (conditional) promise of large-scale financing if private markets pulled out was expected to play a key role in preventing crises from occurring or spreading. Fischer (2000) trumpeted it as "a watershed in the role of IMF lending" and expected "several countries" to avail themselves of it in the near future. For a time, speculation centered on Argentina as a prime candidate, but Mexico, South Africa, Korea, and other countries also were mentioned as possibilities.[57] Within the Fund, Estonia—much admired for its handling of the transition—was also considered a prime candidate.

From the vantage point of countries that the IMF encouraged to apply, the CCL looked more like a way of admitting that they might be vulnerable to a speculative attack. If only one country had a CCL, its financial markets might feel as if they had targets painted on their front doors. If two countries had approved credit lines

[55]Summing Up by the Chairman, minutes of EBM/99/48 (April 23, 1999), pp. 32–37.

[56]On April 23, 1999, the Executive Board approved an extension of the Supplemental Reserve Facility to provide for contingent credit lines. The SRF decision was amended to add a second section. The amended document may be accessed at http://www.imf.org/external/pubs/ft/history/2011/index.htm.

[57]In the course of a press conference explaining the establishment of the CCL, Jack Boorman (Director, Policy Development and Review Department) suggested that it was "no surprise . . . that Argentina's name would come up as a possible candidate," because it met the specified criteria for eligibility; see "IMF Press Briefing, 'Transparency, Standards, and CCL' " (April 26, 1999); accessed at http://www.imf.org/external/np/tr/1999/tr990426.htm. Speculation about Mexico, South Africa, and Korea, based on interviews with unnamed IMF officials, was mentioned in Phillips (1999), p. 15.

and one came under attack, the other could be dragged into the fray by association. If the Fund approved a country's application and then later decided that a weakening of the country's economic policies disqualified it, the termination could have devastating consequences for market access. The contingent nature of the Fund's commitment and the fact that activation would be accompanied by policy conditions that would be specified only at that time further weakened the incentives for applying.

Although the Fund was fully aware of these difficulties when it established the facility, the terms were as favorable as the Executive Board could tolerate in 1999. They were not favorable enough. Over the next four years, no country applied for a CCL, despite a concerted effort by the Fund to inform officials of several countries that an application would be favorably received. The CCL was terminated in November 2003 without ever having been used.[58]

Fear of the Millennium: The Y2K Facility

Anyone coming of age in the twenty-first century will find this story hard to conjure, but in the waning years of the twentieth a great many people seriously feared that the millennium would usher in a meltdown of modern technology. The origin of this concern was ridiculously plain. When the computerization of financial records began in the 1950s, the prevailing programming technology relied on instructions encoded on 80-column cardboard punch cards. Because efficient programming required stringent economizing on the use of these columns, years were universally recorded in two-digit form, that is, without the century. Even though punch cards were phased out in the 1970s, and all of the successor programming technologies were free of the need for this streamlining of numbers, the habit persisted well into the 1990s. Consequently, as the millennium approached, a massive reprogramming effort was required if computers were to be capable of recognizing that 2000 (a year dubbed "Y2K") was the successor to 1999 and not 99 years before it.

The Fund began internal preparations in 1997 to ensure that its own computer-based operations were Y2K-compliant. It completed that process without incident before May 1999, when its financial year 2000 began.[59] In the fall of 1998, the Fund turned its attention more toward member countries, out of concern that many of them—particularly those with seriously outmoded computer systems and limited capacity to replace them—might face major breakdowns when the millennium turned.

[58]For a summary review of the various efforts made to modify the CCL to make it more attractive, see "Signaling by the Fund—A Historical Review" (July 16, 2004), pp. 28–33; accessed at http://www.imf.org/external/np/pdr/signal/2004/071604.htm. After the termination of the CCL, the Fund continued to refine its thinking on the subject. That led to the establishment in 2009 of the Flexible Credit Line, which was used almost immediately by Mexico and then by others.

[59]For details, see "Addressing Year 2000 Issues in the Fund," FO/DIS/98/85 (September 11, 1998).

Most directly, it feared that some countries might not be able to carry out transactions with the Fund or with other bilateral or multilateral agencies because of technological breakdowns. Even domestic payments systems might break down if computers were unable to recognize transaction dates correctly. More generally, even if the technology was fixed, savers and investors might retain the fear of a breakdown. Savers could shift massively out of banks and into cash; large institutions might shift investments out of smaller banks; and low-income and other developing countries could face capital flight.

In September 1998, Camdessus asked the staff to raise Y2K issues in every consultation, regardless of whether the context was surveillance, lending, or technical assistance, to ensure that all countries were adequately prepared. During the next two years, almost every staff report contained at least one reference to the issue. To reach a wider and higher-level audience, the Fund held a seminar on the subject at the 1998 IMF/World Bank Annual Meetings in Washington. The word was thus put out that upgrading all technological systems before the end of 1999 was critically important. The remaining question was whether the Fund could do anything more directly to support the international effort.

A number of countries asked the Fund's technology service—the Bureau of Computing Services—to provide technical assistance on computer modernization. The Fund declined to do so on the grounds that the bureau was not equipped to assist with implementation (as opposed to system design) problems.[60] Instead, in September 1999, with encouragement from the U.S. authorities and a few other major shareholders, Camdessus proposed establishing a special lending facility for countries experiencing balance of payments difficulties as a result of Y2K-related problems. The Executive Board acted quickly to pass the measure in time for the Interim Committee to endorse it in its September 26 communiqué. Few objections were expressed, except that Gregory Taylor (Australia) complained that the staff had failed to explain the way in which a Y2K-related balance of payments problem would be distinguished from one arising from other causes. Without that, it was not clear how eligibility for the facility would be determined. Thomas Leddy (Deputy Director, Policy Development and Review Department) insisted that because the nature of the shocks that might arise was unknowable, it was necessary to stay flexible. Unsatisfied, Taylor abstained from approving the decision.[61]

The new "Year 2000 Facility" was a channel for the IMF to lend up to 50 percent of a country's quota (or more under "exceptional circumstances") as an outright

[60]"Review of Fund Technical Assistance," EBAP/99/59, Suppl. 1 (May 17, 1999), p. 152.

[61]Minutes of EBM/99/108 (September 23, 1999), pp. 44–55. Many on the staff were even more skeptical than Taylor about the wisdom of establishing a special facility for this limited purpose. Jack Boorman—who, as Director of the Policy Development and Review Department, normally would have been the staff representative at the Executive Board meeting—later recalled that he objected so strongly that he sent Leddy instead.

purchase (as opposed to a series of drawings under a stand-by arrangement).[62] The only policy condition would be a general test of cooperation with the Fund. As with the SRF, a borrower would have to pay a surcharge amounting to 3 percentage points above the basic interest rate on stand-by arrangements, and more if the drawing was outstanding for more than six months. Drawings under the Y2K Facility would not reduce a borrower's access to drawings under other Fund facilities.

January 1, 2000, arrived on a Saturday, first in the western Pacific islands and New Zealand, and then it rolled westward hour by hour as the earth spun leisurely on its axis. At IMF headquarters in Washington, a small army of technical staff stayed at their desks throughout the weekend, ready for whatever calamity might arise. Financial institutions, governments, and corporations around the world conducted similar death watches. Nothing happened. To almost everyone's amazement, three years of careful preparation in some 200 countries and countless private enterprises had squashed the "millennium bug." Everywhere, financial records remained intact, and transactions occurred smoothly.

In the end, no country requested to use the Y2K Facility. On March 31, 2000, any possible need for it having passed, it expired as scheduled.

Use and Modification of Earlier Special Facilities

Three special lending facilities existed at the beginning of the 1990s: the Compensatory and Contingency Financing Facility, the Buffer Stock Financing Facility, and the Extended Fund Facility. Each one was controversial in its own fashion.

Compensatory and Contingency Lending

The first special lending facility established in the IMF was the Compensatory Financing Facility (CFF), created in 1963. It aimed to help developing countries that were heavily dependent on exporting primary commodities, the prices of which were highly unstable in world markets. Beginning with a $60 million loan in June 1963 to compensate Brazil for a drop in the value of coffee exports, the Fund used the CFF sporadically but in important ways for about 20 years, with large bursts of lending whenever commodity prices were generally weak. The Fund then decided, in effect, that it should usually grant compensatory credit only in conjunction with a stand-by or extended arrangement. That 1983 decision substantially tightened the standards for CFF lending, and usage declined. The expansion of the facility in 1981 to include a window to compensate for the increased

[62]Year 2000 Facility. Decision No. 12058-(99/110) Y2KF, adopted September 24, 1999. This document may be accessed at http://www.imf.org/external/pubs/ft/history/2011/index.htm.

Table 5.2. CCFF Drawings, 1990–99
(Millions of SDRs)

Country	Date	Total Drawing	Export Shortfall	Cereals Imports	Oil Import Excess	External Contingency Mechanism[a]	Associated Arrangement
Trinidad and Tobago	April 1990	0				0	SBA
Papua New Guinea	May 1990	42.8	42.8				SBA
Côte d'Ivoire	September 1990	24.8	24.8				SBA
Czechoslovakia	January 1991	314.5			314.5		SBA
Hungary	January 1991	226.2			226.2	0	SBA
India	January 1991	716.9			716.9		SBA
Philippines	February 1991	277.1	105.9		171.2	0	SBA
Jamaica	February 1991	19.9			19.9		SBA
Bulgaria	February 1991	60.6			60.6		SBA
Romania	March 1991	209.4			209.4	0	SBA
Costa Rica	April 1991	33.6			33.6	0	SBA
Romania	April 1991	38.3			38.3		SBA
Poland	April 1991	162.6			162.6	0	SBA
Algeria	June 1991	0				0	SBA
Czechoslovakia	June 1991	83.5			83.5		SBA
Jamaica	July 1991	15.3	10.1		5.2		SBA
India	July 1991	166.2	124.6		41.6		SBA
Dominican Republic	September 1991	44.8	6.5		38.3		SBA
India	September 1991	468.9	468.9				SBA
Pakistan	December 1991	122.4			122.4		SAF
Czechoslovakia	January 1992	103.0			103.0		SBA
Barbados	February 1992	22 .2	22.2				SBA
Honduras	February 1992	44.1	44.1				SBA
Panama	February 1992	36.7	1.6		35.1		SBA
Bulgaria	March 1992	56.9				56.9	SBA
Hungary	March 1992	38.8			38.8	0	SBA
Israel	April 1992	178.6	178.6				
Romania	June 1992	76.8			76.8		SBA
Moldova	February 1993	13.5		13.5			
Dominican Republic	July 1993	34.6	34.6				SBA
Ghana	July 1993	47.0	47.0				
South Africa	December 1993	614.4	409.6	204.8			
Gabon	April 1994	21.5	21.5				SBA
Algeria	June 1994	274.3	219.5	54.9			SBA
Moldova	December 1994	12.2		12.2			SBA
Rwanda	November 1995	8.9	8.9				
Algeria	June 1996	174.6		174.6			EFF
Bulgaria	April 1997	107.6		107.6			SBA
Russian Federation	July 1998	2,156.6	2,156.6				EFF
Pakistan	January 1999	352.7	352.7				ESAF

Table 5.2. (continued)

Country	Date	Total Drawing	Export Shortfall	Cereals Imports	Oil Import Excess	External Contingency Mechanism[a]	Associated Arrangement
Azerbaijan	January 1999	56.3	56.3				ESAF
Jordan	April 1999	34.1	34.1				EFF
Algeria	June 1999	223.5	223.5				
Macedonia, FYR	August 1999	13.8	13.8				ESAF[b]
Totals, 1990–99		7,730.7	4,608.3	567.6	2,498.0	56.9	

Source: IMF financial accounts and staff reports.

Note: EFF = Extended Fund Facility; ESAF = Enhanced Structural Adjustment Facility; SAF = Structural Adjustment Facility; SBA = Stand-by arrangement.

[a]A zero in this column indicates that an External Contingency Mechanism loan was approved but not activated.

[b]The ESAF arrangement for FYR Macedonia was inactive at the time of the CCFF drawing.

cost of cereal imports provided some additional scope, as did the addition of a contingency element in 1988. The latter change resulted in the renaming of the facility as the Compensatory and Contingency Financing Facility (CCFF).[63]

In the 1990s, the Fund approved 42 CCFF drawings by 27 countries (Table 5.2). Almost half of those drawings (18) resulted from the temporary establishment of a window to help countries cope with the surge in oil prices after the 1991 Gulf War. After that option expired in 1992, usage dropped off sharply. The main constraint continued to be a conviction by major creditors that "in almost all cases in which members face arguably temporary [balance of payments] financing needs that are met by the CCFF, they also face pressing adjustment needs which are best met through conditional upper credit tranche support."[64] That meant that the Fund was very unlikely to approve the use of the facility for countries without a Fund-supported policy program with upper-tranche conditionality. Instead, the Fund typically approved CCFF credits to augment and accelerate disbursements under stand-by, extended, and (more rarely) SAF or ESAF arrangements.

The Paucity of Stand-Alone Loans

On just five occasions in this decade, the Fund approved requests for CCFF drawings from countries that had no new or ongoing program relationship with the Fund. The first of these occasions was the most controversial because it gave rise to a highly unusual injection of politics into the considerations.

[63]For the history of the CFF through the 1980s, see Boughton (2001), pp. 723–42, and references therein.

[64]Statement by Mark Sobel (Senior Advisor to the U.S. Executive Director) at EBM/99/56 (May 26, 1999).

In March 1992, Israel requested a $245 million (SDR 178.6 million) loan to compensate for export shortfalls related to the Gulf War. On reviewing the request, the staff concluded that the war had substantially and temporarily depleted Israel's export revenues and raised the cost of its oil imports. By the time of the request, those disruptions had passed. Meanwhile, since the end of 1989, Israel had been absorbing a massive influx of immigrants, including some 350,000 from the former Soviet Union. That influx was causing a sustained balance of payments problem and was making it difficult for Israel to meet its targets for foreign exchange reserves. The two problems together gave rise to a balance of payments need that warranted financial support from the Fund. Because Israel's macroeconomic policies were considered to be sound, a CCFF drawing seemed more appropriate than a conditional stand-by arrangement.[65]

When the Executive Board met to consider Israel's request, three Directors—from the Islamic Republic of Iran, Libya, and Saudi Arabia—strongly objected. Mohamed Finaish (Libya) led the attack, noting that the real motivation was to cope with immigration, not the war that was already over. To accommodate the new immigrants, Israel was expanding its settlements in the Occupied Territories of the West Bank and Gaza. Finaish, supported by Muhammad Al-Jasser (Saudi Arabia) and Mohamed Ali Hammoudi (Iran, Senior Advisor to Abbas Mirakhor), noted that these settlements were illegal under international law and contravened a resolution of the United Nations (UN) Security Council. Those three constituencies, which held a total of 9.8 percent of the voting power, voted to deny the request. Other Directors, however, decried this overt injection of political considerations into its deliberations. E.A. (Ted) Evans (Australia) questioned the appropriateness of using the CCFF to assist with a medium-term problem such as Israel's surge in immigration, but he dissociated himself from the comments of Finaish and others and did not oppose the loan.[66]

The next year, the Fund approved three stand-alone CCFF drawings, for Moldova, Ghana, and South Africa. In each case, the borrowing country was undertaking difficult political transitions.

Moldova—a country of the former Soviet Union—joined the Fund in August 1992 and set about to establish basic economic institutions and develop a macroeconomic policy program in consultation with the Fund and other international agencies. Even to prepare the ground for an STF loan was going to take a full year (see Chapter 8). In the meantime, as a down payment on the support that it expected to provide over time, the Fund approved a CCFF loan for $18.5 million (SDR 13.5 million) in February 1993.

Ghana had just established a multiparty democracy, and the 1992 elections had been won by the country's long-standing military ruler, Jerry John Rawlings. The previous government had successfully implemented a four-year program supported by the

[65]"Israel—Use of Fund Resources—Request for Purchase under the Compensatory and Contingency Financing Facility," EBS/92/41 (March 9, 1992). At the time of the request, Israel had no outstanding financial obligations to the Fund.

[66]Minutes of EBM/92/37 (March 27, 1992).

Fund through the ESAF (1988–92), and in 1993 the authorities were trying to maintain the same policy approach under difficult circumstances. The Fund and the authorities both considered Ghana ready to "graduate" from reliance on IMF financing. Accordingly, the Fund was monitoring performance through its "enhanced surveillance" procedures—the first time it had applied these procedures to an ESAF-eligible country—with the objective of encouraging domestic saving and other private sector financing. In the second half of 1992, Ghana suffered not only from the policy slips often associated with a transition to democracy, but also from a weak world market for cocoa (Ghana's principal export crop) and a weather-induced slump in export volume. The Fund responded by approving a $65 million (SDR 47 million) CCFF loan in July 1993 and continuing its enhanced surveillance.[67]

As discussed in Chapter 14, in 1990 South Africa began a historic transition to democratic majority rule. In 1993, as the date for elections approached, the transitional government held discussions with the IMF about financial support. The Fund was prepared to offer a stand-by arrangement, but the authorities were convinced that accepting the Fund's policy conditions was undesirable and could be politically suicidal. As a compromise, the authorities requested, and the Fund approved, a CCFF loan of $850 million (SDR 614.4 million) to compensate for the effects of a drought and a weak global market for gold.

After 1993, the Fund approved stand-alone CCFF drawings on only two occasions.[68] Again, these special cases were marked by political transitions that made normal program implementation and support difficult.

In 1995, Rwanda was emerging from one of the most horrific internecine wars of the twentieth century. As its national unity government began to formulate a recovery plan, it entered into talks with the IMF regarding a program to be supported with ESAF loans. As an early gesture toward that end, the Fund approved a $13 million (SDR 8.9 million) CCFF loan in November 1995, justified by the temporary interruption of international trade during the war (see Chapter 14).

Algeria received the final stand-alone drawing in this period. An exporter of oil and gas, Algeria had borrowed from the Fund from 1994 to 1998 through a stand-by and then an extended arrangement, both of which were completed successfully (Chapter 14). In April 1999, the appointed government attempted to move toward democracy

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[67]The program the IMF agreed to monitor is set out in "Ghana—Staff Report for the 1991 Article IV Consultation," EBS/92/34 (February 28, 1992). The background to the CCFF loan is explained in "Ghana—Staff Report for the 1993 Article IV Consultation and Request for Purchase under the Compensatory and Contingency Financing Facility," EBS/93/95 (June 16, 1993). The Fund's relations with Ghana before the 1990s are discussed in Boughton (2001), pp. 673–79. Enhanced surveillance is also explained there, pp. 429–36. Ghana resumed borrowing on a more regular basis, again by taking out ESAF and then Poverty Reduction and Growth Facility loans, in 1995.

[68]The August 1999 loan to the former Yugoslav Republic of Macedonia could also be considered to be in this category. The country had an EFF arrangement in effect, but it was not able to draw on it owing to policy slips. The authorities were discussing a replacement arrangement with the staff at the time of the loan.

through multiparty elections for president, but the effort was thwarted when six of the seven candidates withdrew to protest alleged irregularities in the process. After the election, to help the economy through a troubled period and to smooth out and prolong the repayment schedule on Algeria's outstanding obligations, the Fund approved a CCFF loan for $300 million (SDR 223.5 million). That turned out to be Algeria's last borrowing from the Fund for at least the next decade.

Oil Imports and the 1991 Gulf War

The invasion of Kuwait by Iraq in August 1990 touched off a series of events, including the Gulf War of 1991, that disrupted the world oil market and caused a major spike in oil prices. For many of the affected countries, the Fund could respond by augmenting or accelerating stand-by or other arrangements. At the time, nearly 50 countries had active borrowing arrangements with the Fund, an unusually high number by previous standards. For other countries likely to see the cost of their imports rise, Camdessus proposed modifying the CCFF by adding a window relating specifically to oil imports. This device would give the Fund the flexibility to provide low-conditionality and fast-disbursing loans to at least 30 highly vulnerable countries that would not otherwise need to borrow.[69]

Although the Interim Committee seemed to endorse the idea in its September communiqué, the Fund staff was skeptical. The staff paper circulated after the Interim Committee meeting explained how an import "element" might work but declined to recommend it. Flexibility in handling requests for regular borrowing arrangements could take care of most cases; the logic of singling out one component of the balance of payments was weak; and it would be difficult to distinguish a transitory spike in prices from a shift in the trend, as required by the CCFF rules.[70] That reluctance drew a rebuke from Thomas C. Dawson II (United States), who argued strongly for the proposal at a Board meeting on November 2. The Dean of the Board, Alexandre Kafka (Brazil), also considered the introduction of an oil-import window to be an "essential" component of "an effective Fund response" to the crisis. Although some Directors

[69]"The Managing Director's Statement on Considerations on the Role of the Fund in Current Circumstances," BUFF/90/182 (September 17, 1990). The estimate of 30 or more countries was made implicitly in "The Response of the Fund in the Wake of Recent Developments in the Middle East," EBS/90/179 (October 16, 1990), pp. 23–24. The staff computed that 65 countries might benefit from an oil-import window, but close to half of those could be assisted alternatively through modifications to existing lending arrangements.

[70]Although the CCFF was designed to assist countries facing specific types of payments problems, the calculations took into account positive changes in other items that might offset the problem. The closest precedents for the oil-import window were the Oil Facilities that the Fund established in response to the first oil price shock of the 1970s. Those facilities were in effect in 1974–76.

shared the staff's skepticism, most were at least open to the proposal, so it was kept alive by the political momentum.[71]

Because of the highly technical structure of the CCFF, detailed amendments had to be drafted to maintain consistency. For the oil-import element, that meant specifying ways for the access limits and associated policy conditions to be applied in various circumstances, computation of the excess cost of imports, recomputation of the initial loan if the cost of oil turned out to be different from projections, and so forth. In just a few weeks, the staff managed to draft an amendment to the CCFF that included 45 paragraphs and subparagraphs covering all conceivable circumstances.[72] The Executive Board approved this and other amendments on December 5, 1990. At the same time, acting under UN resolutions, the United States and other allied countries were preparing to go to war to free Kuwait from the Iraqi occupation. By the time the war began, the Fund stood ready to offer loans through these new procedures.

During the 18 months the oil window was open, 12 countries borrowed a total of $3.4 billion (SDR 2.5 billion) through it.[73] All of them had ongoing program relationships with the Fund at the time—in most cases, stand-by arrangements (Table 5.2). None of the countries the Fund had expected to be the prime beneficiaries—those that otherwise would not need to borrow—chose to use it. The temporary window may have been a useful vehicle for the countries that did use it, to the extent that it enabled the Fund to augment its lending quickly and without renegotiating underlying programs. It also may have helped calm financial markets by demonstrating the Fund's commitment to managing the crisis produced by the Gulf War. It would, however, be hard to argue that it was as successful as its advocates had hoped. Other aspects of the Fund's crisis-management strategy—temporarily suspending some access limits, rephasing disbursements under existing arrangements to bring them forward, and increasing

[71]"The Response of the Fund in the Wake of Recent Developments in the Middle East," EBS/90/179 (October 16, 1990), p. 24; minutes of EBM/90/155 (November 2, 1990), pp. 7–11 (Dawson) and 13 (Kafka); and minutes of EBM/90/156 (November 2, 1990), p. 34 (concluding remarks by Camdessus). On September 24, the Interim Committee "agreed that the Fund should respond on an expedited basis . . . through use and, as appropriate, adaptation of its existing facilities, including" the CCFF (communiqué, paragraph 5; *Annual Report 1991*, p. 121). On Kafka's role as Dean of the Executive Board, see Chapter 17.

[72]Oil Import Window in the CCFF. On December 5, 1990, the Fund amended the Compensatory and Contingency Financing Facility in several ways, including by adding a section establishing a temporary procedure for compensating countries for an increase in the cost of importing oil. This section was titled "Section V. Compensatory Financing of Fluctuations in the Cost of Oil Imports." This document, as amended, may be accessed at http://www.imf.org/external/pubs/ft/history/2011/index.htm.

[73]The decision establishing the oil window specified December 31, 1991, as the terminal date for a country to submit a request (paragraph 41) but permitted drawings to be made until June 30, 1992 (paragraph 60). The first drawing was made by Bulgaria, on February 28, 1991; the last was by Romania, on June 15, 1992.

the financing available through the ESAF—were more generally applicable and more clearly beneficial.[74]

Cereal Imports

The "cereals window" of the CFF was established in 1981 in response to international calls for a "food facility" to help developing countries cope with unusually high costs of importing food. It was designed to provide a means of compensating countries for a broader range of commodity-related balance of payments problems and to increase the access limits for countries with multiple problems. However, the requirement that it could be activated only when a country had a net shortfall in its balance of payments limited its applicability. That is, if a country had excess costs of importing cereals such as wheat or maize at the same time it had a temporary increase in the value of its exports, it normally would not be eligible to draw on the cereals window.[75]

Target countries used the cereals window only lightly during the first five years of its life, but that turned out to be its heyday. From 1981 to 1986, seven countries borrowed a total of some $560 million (just over SDR 500 million) under this decision, which was about 6 percent of total CFF drawings during that period.[76] Through the end of 1989, just two more countries availed themselves of it. Both of those drawings were made in conjunction with the activation of conditional lending arrangements.

In the 1990s, four countries—Algeria, Bulgaria, Moldova, and South Africa—drew on the cereals window, on six occasions (Table 5.2). Three of these drawings compensated for the effects of drought on domestic crop production. The other three compensated for other problems that required the country to increase its imports sharply and temporarily.

Bulgaria made the final drawing on the cereals window in April 1997, while the country was in the middle of a political and economic crisis, as discussed in Chapter 6. The Bulgarian economy was on the brink of hyperinflation, and a collapse of production was leading to severe food shortages. The Fund approved a stand-by arrangement, supplemented by a CCFF loan. The initial drawing on the stand-by arrangement was only SDR 23.2 million, but it was accompanied by a CCFF drawing of SDR 107.6 million. (The total drawing was the equivalent of approximately $180 million, or 28 percent of quota.) Those amounts helped to alleviate the immediate problems and gave the authorities time to establish momentum for their reform program.

[74]The Fund announced the full package of measures in a press release on November 15, 1990 (PR/90/57).

[75]On the origins and early use of the cereals element, see Boughton (2001), pp. 730–33 and 748–53. The rules limited its use to SITC categories 041 through 047, which included wheat, maize, rice, barley, sorghum, and millet, plus flour from those grains.

[76]"Review of the Decision on Compensatory Financing of Fluctuations in the Cost of Cereal Imports," SM/87/86 (April 8, 1987), p. 5 and Table 2.

Contingencies

In August 1988, the Fund established an External Contingency Mechanism (ECM) within the CFF and renamed the facility the CCFF. As explained in Boughton (2001, pp. 737–42), the mechanics were extremely complex, but the essential feature was a procedure to supplement or alter a stand-by or other Fund arrangement in the event of adverse shocks. Suppose, for example, that a stand-by arrangement assumed that the price of the borrower's principal export commodity would remain constant throughout the life of the arrangement. Separately from the arrangement, the Fund could approve an ECM under which the Fund would offer an additional loan if export prices weakened. Other covered situations included unanticipated increases in export volumes, import prices, or interest rates on external debt. Although such contingencies could be covered by appropriate modifications to the arrangement itself—either a contingency clause in the original arrangement or a revision after the fact—the ECM was more palatable to a majority of Executive Directors because it was thought to be less likely to lead to a profusion of requests that would be hard for the Fund to contain or manage.

The popularity of the ECM was limited. Neither the Fund nor most of its borrowers found it to be helpful, simply because approving waivers or modifying programs as circumstances warranted was much easier and offered more flexibility. From the borrower's perspective, the most troubling feature was the "symmetry provision" of the ECM, which provided that the allowable drawings under the associated arrangement could be reduced in the event of a favorable shock. From 1988 through 1992, the ECM was used in association with 11 programs, but it was activated only once (Table 5.2).[77] As the staff acknowledged at the time, the procedure had "proven to be largely unworkable in practice."[78] After 1992, it was not used at all.

Even the one activated case was odd, in a way that illustrates the frustrations of this restrictive and complicated facility. In February 1991, the Fund made its first loan to Bulgaria (which had just become a member a few months earlier) in the form of a CCFF loan to compensate for excess oil-import costs associated with the Gulf War. As discussed in Chapter 9, that loan was followed a few weeks later by a stand-by arrangement, which was fully drawn. In March 1992, as the staff completed the terms for a second stand-by arrangement, it determined that it had overestimated the size of the temporary oil excess and that Bulgaria had not been eligible for the initial CCFF loan at all.

[77]Table 5.2 begins with 1990 and thus excludes the first two cases: Trinidad and Tobago in January 1989 and the Philippines in May 1989, neither of which was activated. The account in Boughton (2001) includes a typographical error on p. 741. A sentence in the middle of the page should read as follows: "During the first 12 months of CCFF operations, the Fund negotiated and approved 29 arrangements, only 2 [not 12] of which included contingency provisions."

[78]For an analysis of the inflexibilities and other shortcomings of the ECM, see Section II of "Compensatory and Contingency Financing Facility (CCFF)—Review of Facility," EBS/92/201 (December 4, 1992). The quotation is from p. iii. Table 1 of that paper includes a detailed account of the 11 cases in which the mechanism was used, including the two that predate the period covered here.

The problem in the Bulgarian case was not that oil prices were too low. The problem was that oil prices had remained high, so the excess was not temporary enough. Under the Fund's rules, that required Bulgaria to repay the original loan. Because the country's external financing needs were huge at this early stage of the transition to a market economy, no one wanted to force such a repayment. Fortunately, the 1991 stand-by arrangement included a contingency element that committed the Fund to make a new CCFF loan in the event of a further or more sustained increase in the price of imported oil. To resolve the matter, Bulgaria repaid the original loan (SDR 60.6 million) at the same time that the Fund activated the ECM (SDR 56.9 million). The two amounts were nearly offsetting, and the new stand-by arrangement, approved in April, took care of the difference and preserved the momentum of the reform program.

The End of the CCFF

In the first quarter of 2000, the Fund made one last attempt to simplify the CCFF to make it more transparent and easier to use. The staff recommended, and the Executive Board agreed, to eliminate the ECM, which clearly was not serving its intended purpose. That move restored the name to the original Compensatory Financing Facility (CFF). The Board also accepted staff recommendations to retain the export shortfall and cereals windows but to simplify the access limits. After a lengthy debate that echoed earlier battles going back to the 1960s, the Board formalized the understanding that the CFF should be used only in association with a conditional stand-by or other Fund arrangement, except in the "rare" case in which the country's balance of payments was otherwise satisfactory.[79]

Despite all of the Fund's efforts to fine-tune the facility, no country requested to draw on it after 1999. When the Fund undertook to simplify its system of special facilities in March 2009, it eliminated the CFF altogether.

Buffer Stock Financing Facility

The second special facility created by the Fund was the Buffer Stock Financing Facility (BSFF), established in 1969. At that time, several international buffer stock agreements were in force requiring members of those agreements to purchase specified primary commodities when market prices would otherwise be cyclically depressed. For example, from 1956 to 1985, major tin exporters entered into a series of formal arrangements to maintain buffer stocks and thereby try to stabilize the world price of tin. If a country represented to the IMF that it faced difficulty financing its balance of payments owing to the financing requirements of an approved commodity agreement, the Fund could lend to it through the BSFF without the normal policy

[79]See "Review of the Compensatory and Contingency Financing Facility and Buffer Stock Financing Facility—Preliminary Considerations," EBS/99/222 (December 9, 1999); and minutes of EBM/00/5 (January 14, 2000) and EBM/00/27 (March 16, 2000).

conditions of a stand-by arrangement. From 1971 to 1984, the Fund lent in this way to 18 countries participating in buffer stock arrangements for rubber, sugar, and tin.[80]

By the 1980s, the efficacy of buffer stock agreements for stabilizing commodity prices was being called increasingly into question. Agreements on cocoa, coffee, sugar, and tin all expired in the 1980s (see Gilbert, 1996; and Cashin, Liang, and McDermott, 2000). That left only the International Natural Rubber Agreement (INRA) as a basis for IMF lending through the BSFF. In April 1990, the Fund approved the 1987 INRA as a successor to the 1979 INRA and its eligibility for buffer stock financing. The staff indicated that they did not expect any participating country to use the BSFF, but thought it helpful to retain it as a backup in case of need.

No country requested a loan from the BSFF after 1984. When the 1987 INRA expired in 1993, no eligible price stabilization schemes remained in force. A new rubber agreement took effect in 1997, and two years later its officials asked the Fund to consider approving it. The Fund declined to do so and terminated the BSFF in February 2000.[81]

The Extended Fund Facility

The Fund established the EFF in 1974 as a substitute for an ordinary stand-by arrangement for developing countries needing time and assistance to implement wide-ranging structural reform programs. The EFF offered both higher access limits, initially up to 140 percent of quota rather than 75 percent, and longer repayment terms, initially eight-year maturities rather than five. To qualify, a country had to submit a Letter of Intent specifying a policy program covering at least three years and including adequate structural reforms. These terms and relationships were revised over time to make the EFF more attractive to borrowers, for example, by extending the repayment schedule to 10 years, starting in 1979. In 1979–83, the Fund approved 24 EFF arrangements totaling nearly $25 billion (SDR 21.3 billion), which equated to more than half the total value of the stand-by and extended arrangements approved in those five years. The Fund then grew wary of making longer-term and relatively large commitments, and the facility was little used for the next five years (three arrangements totaling SDR 1.2 billion).[82]

The renaissance of the EFF began in May 1989, when the IMF agreed to support the Brady Plan to reduce the external debts of certain heavily indebted developing countries (Chapter 9). One of the requirements for a country seeking debt reduction was to

[80] This history is described in more detail in Boughton (2001), pp. 742–44.

[81] "Review of the Compensatory and Contingency Financing Facility and Buffer Stock Financing Facility—Preliminary Considerations," EBS/99/222 (December 9, 1999), pp. 20–22.

[82] The origins of the EFF are covered in de Vries (1985), pp. 361–83. For the history of the facility through 1989, see Boughton (2001), pp. 705–23.

submit a program worthy of EFF financing. The Fund then would approve an EFF arrangement that included provisions for augmenting or setting aside specified amounts for debt relief once the country had negotiated a Brady deal with its commercial bank creditors. That led quickly to three large EFF arrangements—for Mexico, the Philippines, and Venezuela—in 1989, with a total commitment (including later augmentations) of more than $10 billion (SDR 8.25 billion).

The EFF remained in place throughout the 1990s and proved to be popular both with the Fund and with its middle-income borrowers.[83] (Low-income countries had access to the ESAF on similar but much less expensive terms.) From May 1989 through end-1999, the Fund entered into 36 extended arrangements with 27 countries (Table 5.3). Several arrangements supported Brady deals, and several others assisted heavily indebted countries recovering from the 1980s debt crisis in other ways.[84]

Although a number of EFF arrangements were large, either absolutely or in proportion to the borrower's quota, size was not their defining characteristic. In most of the cases in which large-scale IMF lending was part of the solution to a major financial crisis, including Mexico in 1995; Thailand, Indonesia, and Korea in 1997; and Brazil in 1998, the Fund's support took the form of stand-by arrangements on scales made possible by invoking the exceptional circumstances clause (see Chapter 15). The rationale in those cases was that the country was coping with a liquidity crisis and had a reasonable expectation of regaining market access and repaying the Fund quickly (as in fact happened). The EFF was distinguished from other arrangements by an expectation that the country faced deep-seated structural problems that would not be resolved in a year or two, even if initially triggered by a financial crisis similar to other crises. Thus, the large arrangements for Argentina in 1992 and 1998, Russia in 1996, and Indonesia in 1998 were formulated for the EFF rather than as ordinary stand-by arrangements.

As with stand-by arrangements, EFF arrangements occasionally were conceived as "precautionary," meaning that the authorities stated their intention not to draw on the arrangement. During the 1990s, 12 EFF arrangements were treated as precautionary for at least part of the time they were in effect, but only three remained so

[83]The only major change in the facility during this period, other than changes in access limits and charges that were implemented as part of a more general revision of lending policies, was a simplification of procedures for supporting debt- and debt-service-reduction operations under the Brady Plan. The original decision, made in May 1989, segmented the amounts by which the Fund could augment arrangements according to the nature of the operations (debt buybacks, collateralization with Brady bonds, and so forth). Those segmentation rules were eliminated in January 1994; see "Modalities of Fund Support for Debt and Debt-Service Reduction," EBS/93/190 (November 30, 1993); minutes of EBM/94/1 (January 7, 1994); and "Summing Up by the Acting Chairman—Modalities of Fund Support for Debt and Debt-Service Reduction," BUFF/94/2 (January 10, 1994).

[84]See the related discussion in Chapter 9 and particularly the list in Table 9.1. Nearly half of the extended arrangements approved during this period—all three in 1989 and then 16 out of 36 in the 1990s—were for the heavily indebted countries discussed there.

Table 5.3. Extended Arrangements in Effect, 1990–99

Country	Approval	Expiration or Cancellation	Duration (Months)	SDR (Millions) Agreed Amount[a]	Amount Drawn
Algeria	May 1995	May 1998	36	1,169.28	1,169.28
Argentina	March 1992	March 1996	48	4,020.25	4,020.25
Argentina	February 1998	March 2000	25	2,080.00	0
Azerbaijan	December 1996	March 2000	39	58.50	53.24
Bulgaria	September 1998	September 2001	36	627.62	627.62
Colombia	December 1999	December 2002	36	1,957.00	0
Croatia	March 1997	March 2000	36	353.16	28.78
Egypt	September 1993	September 1996	36	400.00	0
Gabon	November 1995	March 1999	40	110.30	60.67
Hungary	February 1991	September 1993	31	1,114.00	557.23
Indonesia	August 1998	February 2000	18	5,383.10	3,797.70
Jamaica	December 1992	March 1996	39	109.13	77.75
Jordan	May 1994	February 1996	20	189.30	130.32
Jordan	February 1996	February 1999	36	238.04	202.52
Jordan	April 1999	May 2002	37	127.88	127.88
Kazakhstan	July 1996	July 1999	36	309.40	157.70
Kazakhstan	December 1999	March 2002	26	329.10	0
Lithuania	October 1994	October 1997	36	134.55	134.55
Mexico	May 1989	May 1993	48	3,729.60	3,263.40
Moldova	May 1996	May 2000	47	135.00	87.50
Pakistan	February 1994	December 1995	22	379.10	123.20
Pakistan	October 1997	October 2000	36	454.92	113.74
Panama	December 1997	June 2000	30	120.00	40.00
Peru	March 1993	March 1996	36	1,018.10	642.69
Peru	July 1996	March 1999	33	300.20	160.50
Peru	June 1999	February 2001	19	383.00	0
Philippines	May 1989	February 1991	21	660.60	235.92
Philippines	June 1994	March 1998	45	791.20	791.20
Poland	April 1991	March 1993	23	1,224.00	76.50
Russian Fed.	March 1996	March 1999	36	13,206.57	5,779.71
Tunisia	July 1988	July 1992	48	207.30	207.30
Ukraine	September 1998	September 2002	48	1,919.95	1,193.00
Venezuela	June 1989	March 1993	45	3,857.10	2,005.60
Yemen, Rep. of	October 1997	October 2001	48	72.90	46.50
Zimbabwe	January 1992	September 1992	9	343.80	71.20
Zimbabwe	September 1992	September 1995	36	114.60	86.90
Total				47,628.55	26,070.35

Source: IMF financial accounts.

[a]Final approved amount of the arrangement. In a number of cases, the original amount was subsequently augmented or reduced.

throughout their lives.[85] In 2000, the Executive Board accepted a staff recommendation to avoid the use of precautionary EFF arrangements in the future. Experience had shown that in most cases, if a country had a longer-term structural imbalance warranting an EFF commitment, it would also need to borrow to finance its balance of payments.

Of all the special lending facilities in effect for the IMF's general resources during or before the 1990s, only the EFF survived the streamlining exercise of 2009. Special policies (without formal facilities) remained for lending in certain circumstances such as postconflict situations or the aftermath of natural disasters. The evolution of those policies in the 1990s is the subject of the next section.

Other Specialized Lending Programs

In a few instances, the IMF created special lending policies without creating a formal facility. In these cases, the Fund would apply the usual rules for lending "in the credit tranches" without a stand-by arrangement, but it would establish separate criteria for the circumstances under which it would lend. At the outset of the 1990s, the only such policy in effect was lending in response to natural disasters. In the course of the decade, the Fund approved lending for two more special situations: recovery from war or other conflicts and currency stabilization following a period of high inflation.

Natural Disaster Relief

Beginning with a loan to Egypt in 1962 that responded to disastrous crop failures, the Fund occasionally bypassed its normal negotiation of policy reforms when a natural disaster hit a member country. That policy was formalized in 1982 with the adoption of guidelines specifying the range of applicable circumstances, the amounts that the Fund would generally be willing to lend, and other terms. The Fund decided that it would quickly lend small amounts (normally 25 percent of quota) when a natural disaster would otherwise result in a "serious depletion of . . .

[85]The three unambiguously successful precautionary EFF arrangements were for Colombia, Kazakhstan, and Peru, all of which were in effect from 1999 to 2002. In addition, Egypt had a precautionary arrangement in effect in 1993–96, but the program was off track during the latter part of the arrangement and no drawings would have been allowed. Argentina had a precautionary arrangement that began in 1998 and was scheduled to run through February 2001. The authorities did not draw on it, but it was canceled in March 2000 and replaced by a three-year stand-by arrangement. That arrangement was announced as precautionary, but the authorities drew on it beginning in December 2000. The other seven precautionary extended arrangements that were in effect during the 1990s—for Kazakhstan (1996–99), Mexico (1989–93), Peru (1993–96 and 1996–99), the Philippines (1994–98), Tunisia (1988–92), and the Republic of Yemen (1997–2001)—were each drawn upon at least once.

external reserves." In lieu of a negotiated policy program spelled out in a Letter of Intent, the applicant would be required only "to describe the general policies it plans to pursue, including its intention to avoid introducing or intensifying exchange and trade restrictions." These requirements reflected those that the Fund applied to requests for drawings in the first credit tranche. Rather than a new policy, it mostly clarified long-standing practice. The major new element was an understanding that these loans would normally be limited to 25 percent of quota. In four of the nine earlier cases, the Fund had lent larger amounts.[86]

Under the 1982 policy, the Fund made emergency loans on eight occasions through 1989, and then use almost stopped. From 1990 through 1997, the only such loan was to Pakistan (Table 5.4). In September 1992, the Indus River flooded, inundating a swath of southern Pakistan, forcing several hundred thousand people to evacuate their homes, and disrupting economic activity throughout the country. Pakistan had completed a SAF arrangement in December 1991 and was preparing to negotiate a larger ESAF arrangement with the Fund. As soon as the floods subsided, the Fund sent a staff team to Islamabad to assess the damage and the economic effects. Soon afterward, the authorities requested emergency assistance, which the Executive Board approved on November 25.[87]

A more widespread natural disaster also occurred in 1992, in the form of one of the most severe African droughts of the twentieth century. The worst effects were in southern Africa, but drought conditions persisted in the east as well, as far north as the Horn of Africa. Like Pakistan, most of the affected countries were eligible for concessional assistance. In contrast, however, most of them either had programs already in place or were well into the process of negotiating them. Rather than offering emergency assistance on General Resources Account (GRA) terms, the Fund accelerated, and in several cases augmented, its ESAF support to many of the affected countries.[88]

The next use of this policy came in October 1998, after a massive flood submerged three-fourths of the land area of Bangladesh. At that time, Bangladesh had not borrowed from the Fund for five years. The country's only outstanding debts were from an ESAF arrangement concluded in 1993. Elections in 1996 had brought in a new government and a period of stability that was brightening the country's economic prospects. In the summer of 1998, the authorities were engaged in discussions with the staff about a possible successor ESAF arrangement when the floods disrupted the economy and

[86]The history of the Funds' emergency disaster relief through 1989 is covered in Boughton (2001), pp. 744–47. The 1982 policy is reproduced therein on pp. 753–54.

[87]See "Pakistan—Staff Report for the 1992 Article IV Consultation and Use of Fund Resources—Emergency Assistance," EBS/92/174 (November 4, 1992); and "Pakistan—Emergency Assistance," press release PR/92/83 (November 25, 1992).

[88]See "Statement by the Managing Director on the Drought in Southern Africa," EBD/92/89 (April 15, 1992); and "Statement by the Managing Director on the Drought in Southern Africa—An Update," EBD/92/212 (September 18, 1992).

Table 5.4. Emergency Loans for Natural Disaster Relief, 1990–99

Country	Date	Disaster	Amount: Millions of SDRs	Amount: Percentage of Quota
Pakistan	November 1992	flood	189.6	25.0
Bangladesh	October 1998	flood	98.1	25.0
Dominican Republic	October 1998	hurricane	39.7	25.0
Haiti	November 1998	hurricane	15.2	25.0
Honduras	December 1998	hurricane	47.5	50.0
St. Kitts and Nevis	December 1998	hurricane	1.6	25.0
Turkey	October 1999	earthquake	361.5	37.5

Source: IMF financial accounts.

weakened the outlook considerably.[89] On October 28, the Executive Board approved an emergency loan of $138 million, or 25 percent of quota, with an expectation that this response would soon be followed by larger support through the ESAF. However, owing in part to political uncertainty and in part to the underlying challenges arising from the country's extreme poverty, policy implementation did not live up to the Fund's expectations. Bangladesh's next borrowing, in the form of a three-year Poverty Reduction and Growth Facility (PRGF) arrangement, did not occur until 2003.

Two devastating hurricanes passed through the Caribbean region in 1998. Hurricane Georges hit the Dominican Republic and Haiti on September 22 with 105-knot winds, killing more than 600 people and causing untold physical damage. In the Dominican Republic, the damage estimates ranged around 8 percent of GDP. The authorities had no other need to borrow from the Fund because foreign direct investment was covering much of the country's external financing requirements. To help with the short-term reconstruction effort, the Fund provided an emergency loan of $56 million (25 percent of quota). Haiti, where the impact was estimated to be close to 2 percent of GDP, was out of compliance with the terms of its ESAF arrangement at the time of the hurricane. Rather than granting a waiver so it could lend on concessional terms, the Fund approved emergency assistance of $21 million (25 percent of quota) through its general account.

Hurricane Mitch was even worse. One of the two or three deadliest storms of the century, it caused heavy damage to several islands before slamming into Honduras and Nicaragua on October 27 with 155-knot winds. Before it finally weakened, it killed more than 9,000 people. Two weeks later, Camdessus visited Nicaragua, Honduras, and El Salvador to discuss and assess the devastation, which he found to be "dramatic and heartbreaking."[90] Honduras, where the Managing Director was escorted by the

[89]See "Bangladesh—Staff Report for the 1998 Article IV Consultation," SM/98/232 (September 22, 1998); and "Bangladesh—Use of Fund Resources—Request for Emergency Assistance," EBS/98/175 (October 21, 1998).

[90]See his report to the Executive Board at EBM/98/123 (December 7, 1998), pp. 3–8.

Catholic archbishop of Tegucigalpa, Cardinal Oscar Rodriguez Maradiaga, was especially hard hit. Whole villages had been obliterated by mudslides, and survivors were still numbly searching for family members who might lie buried in the sludge. The Fund responded with emergency loans to Honduras ($66 million) and to St. Kitts and Nevis ($2.3 million). Reflecting the magnitude of the destruction in Honduras, that loan was exceptionally large in relation to quota, at 50 percent. Assistance to Nicaragua took the form of an augmentation of the existing ESAF arrangement and an acceleration of debt relief under the Heavily Indebted Poor Countries Initiative. El Salvador had a precautionary stand-by arrangement already in place, but the authorities chose not to draw on it, nor to request emergency assistance.

The Fund made its final loan for natural disaster relief in the 1990s to Turkey. As discussed more fully in Chapter 12, Turkey was carrying out a staff-monitored program in August 1999 when it was struck by an earthquake that measured 7.4 on the Richter magnitude scale, killed more than 15,000 people, and left hundreds of thousands homeless. The Fund responded with an emergency loan of about $500 million (37.5 percent of quota) and then accelerated its negotiations on a three-year stand-by arrangement.

Postconflict Assistance

Armed conflict, whether internal civil war or between countries, inevitably interrupted normal relations with the international community, including the IMF. Severe conflicts often left countries without basic economic, financial, and legal institutions and without the administrative capacity to carry out sustainable economic policies. Postconflict recovery required coordinated efforts among aid agencies, bilateral donors, policy advisors, and creditors. When a large number of diverse situations arose in the early 1990s, the lack of planning and coordination became all too clear. In response, the 1995 G7 summit meeting in Halifax called on "the Bretton Woods institutions and the UN to establish a new coordination procedure, supported as necessary by existing resources, to facilitate a smooth transition from the emergency to the rehabilitation phase of a crisis, and to cooperate more effectively with donor countries."[91]

It had indeed been a tumultuous few years. The collapse of the Soviet Union had given rise to conflicts among some of the newly independent countries, especially between Armenia and Azerbaijan, and to civil wars (notably in Georgia and Tajikistan). The 1991 Gulf War disrupted economic activity and trade across much of the Middle East. The 1994 civil war in Rwanda affected both that country and its neighbors in central Africa. The U.S. invasion of Panama in 1989, a 1991 military coup in Haiti, and a long-running civil war in El Salvador that ended in 1992 brought disruptions to

[91]Halifax Summit Communiqué (June 16, 1995); accessed at http://www.g7.utoronto.ca/summit/1995halifax/communique/index.html#development.

the Caribbean and Central America. The restoration of more peaceful conditions in Southeast Asia led to a need for postconflict assistance to Cambodia and Vietnam. In each case, the IMF's offers of technical assistance, policy advice, and loans had to be embedded within a broader multiagency rescue effort.

For once, the Fund rejected the central premise of the G7 request. Although it was certainly true that careful coordination was needed in each postconflict situation, the evidence did not suggest that coordination failure had been a generalized problem. In any case, it did not seem either desirable or practical "to establish a new coordination procedure." Rather, case by case, agreement on who the lead agency should be was needed.[92] For one country, it might be a bilateral donor with strong cultural and historical (usually postcolonial) ties. For another, it might be a regional development bank. Rarely if ever would logic dictate that it be the IMF. The staff concluded, and Executive Directors agreed, that the only need was for an implicit understanding that in the future, all the agencies involved in helping a postconflict country would designate one among them to take the lead, and all would coordinate their work within that framework.[93]

The Fund established a policy on emergency postconflict assistance (EPCA) in 1995, but that policy focused primarily on the Fund's provision of financial assistance rather than on strategic coordination. In most cases, the borrowing country had not been ready or able to carry out a set of economic policies that the Fund could support with a stand-by arrangement, so it had devised an ad hoc proposal each time. For transition economies such as Georgia and Vietnam, the STF had been handy while it existed, but it was expiring in 1995. For Rwanda, the CCFF was appropriate, but the range of situations in which the facility could be used was limited. That left only the first credit tranche, but only if the country had not already drawn on it and was able to submit a plan for cooperating with the Fund in solving its problems. The Fund needed a policy under which it could lend quickly on an emergency basis, without regard to the restrictive rules of these facilities and other policies.

Additional problems arose when a country had outstanding payments arrears on earlier loans from the Fund. Chapter 16 details numerous conflicts that led to arrears, only some of which were resolved in the 1990s. Many of those debts would be unpayable without external help. For example, the signing of a peace agreement in Paris in

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[92]The only new mechanism seriously considered was to have each country prepare a policy framework paper, similar to the documents that underpinned Fund and World Bank lending to low-income countries generally. Even if such documents would have been helpful, the idea was impractical for the emergency situations most likely to arise. See the minutes of EBM/95/82 (September 6, 1995), pp. 103–37. Also see the discussion of "tripartite documents" for countries of the former Soviet Union, which the Fund eventually rejected in 1992; Chapter 3, p. 84.

[93]See "Fund Involvement in Post-Conflict Countries," EBS/95/141 (August 16, 1995). The staff identified only one previous instance of serious coordination failure: El Salvador at the end of the civil war in 1992. In the Fund staff's view, the World Bank got ahead of other agencies by providing financial aid before the government was ready to implement an appropriate framework for using it; "Fund Involvement in Post-Conflict Countries," EBS/95/141 (August 16, 1995), pp. 6, 10, and 11.

October 1991 began a lengthy process by which Cambodia restored internal peace and emerged from more than 16 years of international isolation. The Fund began providing technical assistance and program monitoring soon afterward, but it could not resume financial assistance until Cambodia cleared its long-standing payments arrears. That process was completed only in October 1993. The Fund then quickly made a small conventional loan through the STF and entered into negotiations for concessional lending. The first ESAF arrangement was approved seven months later, in May 1994.

The EPCA policy the Fund established in September 1995 had two basic elements.[94] First, it acknowledged that in most cases the Fund should not be the lead agency but should work in close coordination with others. Second, it extended the Fund's policy on emergency assistance for natural disaster relief to cover postconflict emergencies, subject to certain conditions. To be eligible for EPCA, the borrowing country should have an "urgent balance of payments need." Moreover, its administrative capacity and commitment should be adequate to plan a comprehensive recovery program, but not yet adequate to carry out a program that would warrant the Fund's regular support through a stand-by or other conditional arrangement. For its part, the Fund should have an identifiable role "in catalyzing support from other official sources," and that role should be part of a coordinated and comprehensive international effort to assist the country's recovery from the effects of the conflict.

This new policy was not a fundamental change for the Fund. It did not greatly expand or modify the Fund's role or its ability to lend when necessary. The policy mainly simplified its procedures in these cases and made them more transparent. Specifically, it enabled the Fund to lend a relatively small amount (usually 25 percent of quota) quickly and without the additional justification required by the CCFF. It also established the principle that the Fund should be involved in coordinated reconstruction efforts if at all possible, notwithstanding the objections of those who might seek to preserve the "monetary character" of the IMF by limiting its financial role to situations involving countries capable of carrying out a fully fledged adjustment program. Finally, it expressed agreement that the Fund would seek bilateral subsidies to cover the interest on GRA credits for ESAF-eligible countries availing themselves of early Fund support.

Executive Directors found extending the emergency financing procedures controversial, for two reasons. First, a number of them felt that the existing policies were perfectly adequate and could be applied flexibly without adopting a new policy. More seriously, several Directors argued that postconflict assistance was primarily the province of aid agencies and multilateral development banks and that the proposed role for the Fund threatened the institution's monetary character. No formal vote was taken,

[94]On September 6, 1995, the Executive Board agreed to establish a policy on providing emergency financial assistance to countries emerging from internal or external conflicts. This Emergency Post-Conflict Assistance (EPCA) policy was set forth in the Chairman's Summing Up of EBM/95/82. This document may be accessed at http://www.imf.org/external/pubs/ft/history/2011/index.htm.

but in the course of the meeting, seven Directors, with 26 percent of the voting power on the Board, expressed opposition. Hence, the Summing Up referred to the policy being adopted by "Directors in their majority."[95]

Bosnia and Herzegovina made the first loan application to be considered under the new policy while still in the final stages of acceding to membership in the IMF (see Chapter 2). When EPCA was established, North Atlantic Treaty Organization (NATO) military forces were conducting an air campaign against Bosnian Serbs in an effort to force settlement of an ethnic war that had been raging for more than three years. Soon afterward, the UN arranged to fly representatives of several multilateral institutions into Sarajevo to begin advising Bosnian officials on reconstructing the economy once peace was restored. Remarkably, the situation was not yet *post*conflict. The UN plane had to "corkscrew" into the airport to minimize the risk of being shot down. As recounted in gripping and harrowing detail by the journalist Sebastian Mallaby, conditions on the ground were both dangerous (sniper fire was part of daily life) and lacking in basic comforts (Mallaby, 2004, Chapter 5).

The IMF was represented in this group by Scott B. Brown (Assistant to the Director of the European Department), a veteran of several earlier postconflict situations who came primarily to provide technical assistance on budget preparations and other matters.[96] While he was in Sarajevo on this first trip, multilateral peace negotiations began in Dayton, Ohio (United States), and the major powers soon asked the Fund to shift into high gear to normalize relations.

Brown returned to Bosnia and Herzegovina in mid-November with a full staff mission team while the Dayton talks were still in progress. In less than a month, the membership process and the settlement of arrears were complete.[97] On December 20—the same day the UN turned its peacekeeping operations in Bosnia and Herzegovina over to NATO—the Executive Board approved its first financial assistance to the newly independent and peaceful country—an EPCA loan for $45 million (Table 5.5). Although the World Bank and other agencies were also providing technical assistance by this time, the EPCA loan was the first financial assistance to Bosnia and Herzegovina from any external institution.

[95]Minutes of EBM/95/82 (September 6, 1995), pp. 103–37. The Directors who spoke against adopting the EPCA were Hachiro Mesaki (Japan), Oleh Havrylyshyn (Alternate to the Director for the Netherlands), Jarle Bergo (Norway), Abdulrahman Al-Tuwaijri (Alternate, Saudi Arabia), Yacoob Yusef Mohammed (Alternate, Bahrain), Aleksei V. Mozhin (Alternate, Russia), and Daniel Kaeser (Switzerland).

[96]In the course of a 22-year career at the IMF, Scott Brown frequently found himself among the first international civil servants being sent to postconflict countries where conditions were still unsettled and possibly quite dangerous. In August 2003, eight years after this assignment, Brown was seriously injured in a terrorist bombing in Baghdad that killed Sergio Vieira de Mello (chief UN envoy to Iraq) and 21 other people.

[97]The membership process for Bosnia and Herzegovina, which could not be completed until arrears were settled, is covered in Chapter 2. The settlement of arrears is covered in Chapter 16.

Table 5.5. Emergency Postconflict Assistance, 1995–99

		Amount		Subsequent Arrangement	
Country	Date	Millions of SDRs	Percentage of Quota	Date	Type
Bosnia and Herzegovina	December 1995	30.3	25.0	May 1998	SBA
Rwanda	April 1997	8.9	15.0		n.a.
Albania	November 1997	8.8	25.0	May 1998	ESAF
Rwanda	December 1997	6.0	10.0	June 1998	ESAF
Tajikistan	December 1997	7.5	12.5		n.a.
Tajikistan	April 1998	7.5	12.5	June 1998	ESAF
Republic of Congo	July 1998	7.2	12.5	December 2004	PRGF
Sierra Leone	November 1998	11.6	15.0		n.a.
Guinea-Bissau	September 1999	2.1	15.0	December 2000	PRGF
Sierra Leone	December 1999	15.6	15.0	September 2001	PRGF

Source: IMF financial accounts.

Note: ESAF = Enhanced Structural Adjustment Facility; n.a. = Not applicable; PRGF = Poverty Reduction and Growth Facility; SBA = Stand-by arrangement.

After the loan to Bosnia and Herzegovina, most EPCA loans were to African countries: Rwanda in 1997, the Republic of Congo and Sierra Leone in 1998, and Guinea-Bissau and Sierra Leone in 1999.

As noted above (p. 220), Rwanda had borrowed through the CCFF in 1995. Two years later, the government was still struggling to reconstruct its economic institutions, but it had accomplished enough to warrant a Fund-supported policy program. As negotiations for an ESAF arrangement continued, the Fund provided interim financing through two EPCA loans. (An ESAF arrangement was approved in June 1998; see Chapter 14.)

The Republic of Congo (Brazzaville) borrowed from the ESAF in 1996, but policy stability collapsed after a civil war erupted in 1997. When fighting stopped in 1998, the Fund offered an EPCA loan because a resumption of the ESAF arrangement was not yet possible. The war soon resumed, but when it ended in 1999, the country held its first multiparty elections. The Fund provided a second EPCA loan in 2000 and recommenced concessional lending with a PRGF arrangement in 2004.

From 1994 through 1997, Sierra Leone borrowed through the ESAF, even though successive governments were still fighting off a brutal insurrection (Chapter 16). The restoration to power of a civilian government in 1998 created the conditions for EPCA lending, followed by a PRGF arrangement in 2001.

Guinea-Bissau established a democracy in 1994 and joined the CFA franc zone three years later. All too soon, the people's hopes for stability were dashed when an insurrection erupted and eventually overthrew the elected government. Once new elections were scheduled in 1999, foreign assistance resumed, including an EPCA loan from the IMF in September.

Aside from these loans to African countries, EPCA loans in the 1990s were confined to transition countries. After the first such loan, to Bosnia and Herzegovina, the

Fund lent under this policy to Albania and Tajikistan. In Albania, a massive collapse of the financial system in 1997 led to civil unrest that the government was incapable of controlling. A UN peacekeeping force restored order, and the Fund helped the reconstruction effort with an EPCA loan followed by a resumption of ESAF lending (see Chapter 6). In Tajikistan, a June 1997 peace accord ended a long-running civil conflict and enabled postconflict and other support from the IMF (Chapter 8).

As it happened, all the postconflict borrowers in this period except Bosnia and Herzegovina were eligible for concessional financing. In each case, the EPCA loan served as a bridge to larger and longer-term ESAF or PRGF arrangements once the authorities were able to prepare comprehensive reform programs (see Table 5.5). The policy adopted by the Fund in 1995 envisaged that donor countries would subsidize the interest cost of EPCA loans, thus reducing the borrower's debt service to a level commensurate with the ESAF. In practice, that idea was too difficult to apply, and it never materialized. Instead, in most cases the Fund agreed to top up the subsequent arrangements to enable the borrower to repay the EPCA loan. In effect, this practice rescheduled the loans into the ESAF and later into the PRGF.

In 1998 and in subsequent reviews, the Fund considered various proposals to strengthen the provision of assistance to postconflict countries. The general conclusion, however, was that the policy was working well as long as it was applied flexibly and quickly in each applicable case. The policy continued with little change through the next decade.[98]

Support for Currency Stabilization Funds

When a democratically elected government took office in Poland in 1989, it decided to try to establish a market economy quickly—in a "big bang," as the expression went—and to stabilize conditions by anchoring expectations with a pegged exchange rate. Because Poland started with very low foreign exchange reserves, a group of 13 industrial countries agreed to establish a currency stabilization fund (CSF) by putting $1 billion at the authorities' disposal on an as-needed basis. The fund was to be administered by those countries' Executive Directors at the IMF, and its activation was to be conditioned on the successful implementation of a Fund stand-by arrangement. The experiment was a clear success. The authorities pegged the zloty to the U.S. dollar, and the existence of the CSF as a secondary line of defense against a speculative attack gave the policy the necessary credibility.

[98]The first comprehensive review was made in 1998; see "Issues Note on Providing Additional Assistance to Post-Conflict Countries," EBS/98/155 (September 1, 1998); and minutes of EBM/98/102 (September 22, 1998), pp. 3–25. In 2000, the Fund established a "special policy" on EPCA so that these loans would not count toward the standard access limits.

Poland did not have to draw on the fund, and it was allowed to expire at the end of 1992.[99]

The success of the Poland CSF inspired the Russian authorities to ask for similar support when they were joining the IMF in 1992. As explained in Chapter 7, the G7 agreed in principle to fund a $6 billion CSF for the ruble, but it never came to fruition. Subsequently, the subject occasionally arose in talks between Russia and the Fund, especially after the authorities pegged the ruble to the dollar in July 1995. Meanwhile, Ukraine also asked the Fund to sponsor or help arrange for a CSF in support of its "radical economic reform" program, launched in October 1994.[100]

The IMF responded to these requests by establishing a new lending policy.[101] Basically, the Fund would approve a stand-by or extended arrangement with sufficiently large access to accommodate a separate pool of funds within it, set aside from the rest of the arrangement. This pool (the CSF) could be drawn upon only to finance short-term intervention in exchange markets. To qualify, the country needed a credible set of financial policies designed to maintain a fixed exchange rate as an anchor for expectations. To apply this policy sensibly, the Fund would conclude that a currency peg was viable and appropriate but might not be credible to financial markets, perhaps owing to past weaknesses in policy implementation.

The staff first proposed introducing a CSF policy in December 1994, but quite a few Executive Directors reacted skeptically. The Canadian Director, Ian Clark, opened the discussion by noting that the policy could be perceived as a general and inappropriate preference by the Fund for fixed exchange rates and exchange rate–based stabilization policies. Jung-Ho Kang (Alternate, Korea) worried that it could be used to support weak programs. If policies were strong enough to warrant financial support from the IMF, why would they lack credibility to such an extent that a CSF was warranted? Marc-Antoine Autheman (France) regarded the Fund's existing policies to be sufficiently flexible. Alexandre Kafka (Brazil) suggested that a CSF would have to be quite large to be of any real use. Vicente J. Fernández (Alternate, Spain) thought that the whole idea of exchange rate–based stabilization was bad policy. Several other Directors, led by Karin Lissakers (United States), were more sympathetic and encouraging.[102]

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[99]See Annex I of "Fund Policies with Regard to Currency Stabilization Funds—Preliminary Considerations," EBS/94/230 (December 2, 1994).

[100]The program is described in Chapter 8. On the request for a CSF, see "Ukraine—Staff Report for the 1994 Article IV Consultation and Request for a Purchase under the Systemic Transformation Facility," EBS/94/203 (October 19, 1994), p. 10.

[101]On September 13, 1995, the Executive Board established a policy on the use of Fund resources to finance currency stabilization funds (CSFs). This policy was set forth in the Summing Up of the discussion at EBM/95/86 and in an attachment with specific guidelines for CSF support. This document may be accessed at http://www.imf.org/external/pubs/ft/history/2011/index.htm.

[102]Minutes of EBM/94/109 (December 14, 1994). Some years later, Stanley Fischer (2001) acknowledged that the "impetus" for this proposal and for several other revisions to lending policies in the 1990s came from the U.S. Treasury.

Seven months later, the staff came back with a revised and more specific proposal, to create a new policy but not a new facility. No country would be offered an IMF-financed CSF except as one element of a stand-by or extended arrangement. That would ensure that any CSF would be firmly linked to upper credit tranche policy conditionality, but this new proposal had the disadvantage of restricting the size of a fund to the quota-based access ceilings for the regular facilities. To ensure even more control, the proposal gave the Executive Board the right to refuse activation of a CSF if, after the initial approval of the arrangement, it deemed policies to have weakened. Most of those who expressed doubts during the first discussion remained skeptical, but a majority favored moving ahead. Accordingly, the staff prepared a final version, and the Board approved it in September 1995.[103]

Once the policy was adopted, its restrictive features proved to be overwhelming. The low level of potential access, the limited circumstances under which it could be used, and—perhaps most important—the retention by the Executive Board of discretion in approving activation of CSFs, meant that the policy was of little use to countries contemplating the introduction of an exchange rate anchor. No country applied for a CSF, and the Fund abolished the policy in April 2000.[104]

Technical Assistance, Training, and Resident Missions

The IMF formally began providing technical assistance to its member countries in 1964, when it created the Fiscal Affairs Department, the Central Banking Service, and the IMF Institute. Each of these units worked according to a sort of template, helping countries establish treasury systems and central banks and providing training on macroeconomics and finance. Over time, those activities were supplemented by technical assistance from the Legal Department and the Bureau of Statistics, each in its own area of expertise. In the late 1980s, the Fund found itself providing more than 100 staff years of assistance annually—mostly free of charge—to many developing countries. Although this activity was small scale when compared with that of some other multilateral agencies, it accounted for a significant portion of the Fund's administrative budget.[105]

[103]"Fund Policies with Regard to Currency Stabilization Funds—Further Considerations," EBS/95/109 (June 30, 1995); and minutes of EBM/95/68 (July 19, 1995) and EBM/95/86 (September 13, 1995).

[104]See "Review of Fund Facilities—Preliminary Considerations," EBS/00/37 (March 2, 2000), accessed at http://www.imf.org/external/np/pdr/fac/2000/faciliti.pdf; and the Summing Up of the discussion at EBM/00/27 (March 16, 2000), accessed at http://www.imf.org/external/np/pdr/fac/2000/sum.htm.

[105]For the history of technical assistance through 1989, see Boughton (2001), pp. 1017–18, and references therein.

In the course of the 1990s, this activity more than doubled in volume, to more than 300 staff years.[106] One obvious reason for this burst of activity was the influx of new members, especially those in transition to market economies. Many of those countries regarded the Fund's technical assistance as more valuable than its lending. The countries emerging from the former Soviet Union lacked most of the basic building blocks of a functioning economy. Monetary policy had been conducted in Moscow; revenues had been generated from state-owned enterprises rather than through taxes; international trade had been conducted on barter or bilateral settlement terms, with centralized decisions on production and the direction of trade; and bankruptcy procedures and market regulation did not exist. Officials and staff needed training and guidance on overcoming these and other daunting initial conditions.[107]

A second reason for the increase was that the Fund shifted from the template approach to one driven more by the needs of individual countries. That is, much of the increased technical assistance was provided to help countries undertake specific reforms, often in the context of Fund-supported programs. This assistance in policy design and implementation supplemented the traditional emphasis on capacity building and institutional development. Because it required knowledge of and experience in the country or region, the Fund frequently hired outside experts for this purpose—especially for work in the transition countries and new members—rather than using career staff.

In several instances in the 1990s, the Fund provided technical assistance to nonmember countries. This practice started with the Soviet Union, through the Special Association agreement signed in October 1991 (Chapter 2). For the year or so after the union was dissolved and membership negotiations proceeded, the Fund—along with numerous other agencies—provided as much assistance as it could to get institution building and other reforms started.

In November 1994, staff from the Monetary and Exchange Affairs Department (MAE), in cooperation with officials from Israel and Jordan, began providing technical assistance to the Palestinian authorities in the West Bank and Gaza Strip to help them establish a Palestinian Monetary Authority. That work, initially directed by Arne B. Peterson (Advisor, MAE) focused on developing the payments system, regulating and supervising commercial banks, and managing the foreign exchange market. Experts from the Fund's Legal and Middle Eastern Departments, the Bank of England, and the Bank of Finland also participated.[108]

[106]Comparisons over time are only suggestive because the Fund's definitions for reporting the provision of technical assistance were not consistent. Data for the 1990s are more comprehensive than those for the 1980s.

[107]For a review of the Fund's assistance to transition countries in setting up treasuries in the 1990s, see Potter and Diamond (2000).

[108]For the initial technical assistance report, see "West Bank and Gaza Strip: Issues Related to the Establishment of a Palestinian Monetary Authority," December 1994 (unnumbered).

In 1997–98, as described in Chapter 2, the Fund provided assistance to North Korea. That effort aimed to initialize a process that could lead eventually to membership, but in the end it came to nothing.

In October 1999, the UN succeeded in quelling a violent attempt by Indonesian military forces to suppress the independence movement in East Timor. As the UN prepared to establish an interim civil administration, it asked the IMF and the World Bank to provide technical assistance on establishing the rudiments of a national economy in East Timor. Immediately afterward, a Fund staff mission headed by Luis M. Valdivieso (Advisor, Asia and Pacific Department) went to East Timor to advise officials on restoring stability in the payments system, establishing a viable system of public finance, and rebuilding international trade.[109] That effort continued and broadened until the country became a member of the IMF (as the Democratic Republic of Timor-Leste) in 2002.

The biggest recipient of Fund technical assistance in the 1990s was Namibia, which joined the IMF in 1990. Namibia, the last African country to join the Fund, was emerging from nearly a quarter-century of guerilla warfare and had just become a fully independent country. The Fund responded with a massive injection of staff and expert assistance, totaling more than 47 staff years by the end of the decade (Table 5.6). Russia was the second largest recipient of these services, and the next two on the list were contiguous neighbors: Angola to the north of Namibia, and Ukraine on Russia's western flank. Overall, the IMF's technical assistance during this decade focused primarily on Africa, as it had in the 1980s.

As technical assistance began to absorb an increasing portion of the administrative budget—as much as 15 percent by the late 1990s—some Executive Directors began to worry that the effort lacked a clear purpose and focus.[110] Responding to those concerns was difficult, because assessing the benefits of technical assistance is inherently subjective and is complicated by the long gestation period before the benefits may be fully apparent. The Fund commissioned a few evaluations of aspects of its assistance programs during the 1990s. In 1999, it finally decided to undertake a comprehensive internal review. That review concluded that technical assistance was generally working well in that it was much in demand and appreciated by recipients. The report made several common-sense recommendations for improvements: develop an overall framework, integrate technical assistance with surveillance and program work, focus on those areas in which the Fund has a clear comparative advantage, and regularly reassess what works

[109]See minutes of EBM/99/118 (October 22, 1999); "East Timor—Informal Board Meeting," FO/DIS/99/165 (November 23, 1999); and "East Timor—Establishing the Foundations of Sound Macroeconomic Management," SM/00/178 (July 20, 2000).

[110]Because most recipients were low-income countries, or nearly so, the IMF was reluctant to charge for the service. In March 1990, the Fund established an administered account to receive annual grants Japan was offering to finance assistance for some of the neediest countries. That enabled the Fund to expand its technical assistance program despite the substantial squeeze on the budget at that time.

Table 5.6. Top Recipients of Fund Technical Assistance by Region, FY1990–99

(Staff years)

	Africa		Asia and Pacific		Europe		Latin America		Middle East	
1	Namibia	47.1								
2					Russian Fed.	38.7				
3	Angola	38.1								
4					Ukraine	34.2				
5									Yemen, Rep. of	32.0
6							Haiti	29.2		
7	Zambia	28.2								
8	Tanzania	27.4								
9	Lesotho	27.3								
10			Vietnam	27.1						
11	Guinea	27.1								
12			Indonesia	25.6						
13					Albania	23.4				
14			Pacific Islands	22.7						
15	Malawi	22.6								
16	Rwanda	21.3								
17							Nicaragua	21.1		
18					Georgia	20.8				
19			Lao PDR	19.4						
20	Mozambique	19.3								
21							Guyana	18.1		
22			Mongolia	17.6						
23					Bulgaria	17.3				
24									West Bank and Gaza	16.7
25	Mauritania	16.6								
26							Bolivia	16.2		
27			Tonga	15.4						
28	BEAC	15.1								
29	São Tomé and Príncipe	15.1								
30	Botswana	14.8								
Other countries		246.7		154.6		239.3		132.2		55.7
Total		566.7		282.3		373.7		216.9		104.4

Source: Staff calculations.

Note: BEAC = Bank of Central African States.

and what does not.[111] That report induced the Fund to develop, for the first time, a policy framework for the provision of technical assistance, which it published in 2001.[112] Four years later, the Independent Evaluation Office conducted a further review (Independent Evaluation Office, 2005b), which found that the Fund was continuing to make progress but with somewhat uneven results.

The Fund also expanded its training programs for country officials in the 1990s, notably by helping establish five regional training institutes through joint ventures. This process began with a November 1991 proposal by the Fund for a regional training center for officials from transition countries. After extensive discussions among multilateral organizations and officials from the transition countries and from western Europe, the Joint Vienna Institute (JVI) was established in September 1992 as a temporary training center.[113] Locating this joint venture in Vienna was felicitous, in part because of the city's convenient location for officials from countries of the former Soviet Union and the transition economies of Central and Eastern Europe, but also because Austria had always maintained good relations with many of those countries. Andrew J. Beith, who had been serving as director of the IMF's Offices in Europe, was named as the JVI's first director.

At the outset, the JVI was intended to be a temporary venture to provide training to officials of transition countries, only until more general educational and training facilities could take over the task. During its first four years, through the end of 1997, 8,300 participants from 33 countries completed training courses at the JVI. By then, it was clear that the demand for such training was going to extend much longer than the original termination date of August 1999.[114] All the sponsors agreed to extend the life of the JVI to 2004, and in 2003 they further amended the agreement to convert the JVI into a permanent institute.

In 1993, the IMF set up the Pacific Financial Technical Assistance Centre (PFTAC) in Suva, Fiji, as a joint venture with the UN Development Program (UNDP). The PFTAC was designed to provide training to officials from 15 Pacific island countries. Additional financing was provided by the aid agencies of Australia, Japan, and New Zealand; the Asian Development Bank; and the South Pacific Forum. The IMF-Singapore Regional Training Institute was established in 1998 as a joint venture with the host country. The IMF-AMF Regional Training Program in Abu Dhabi, United

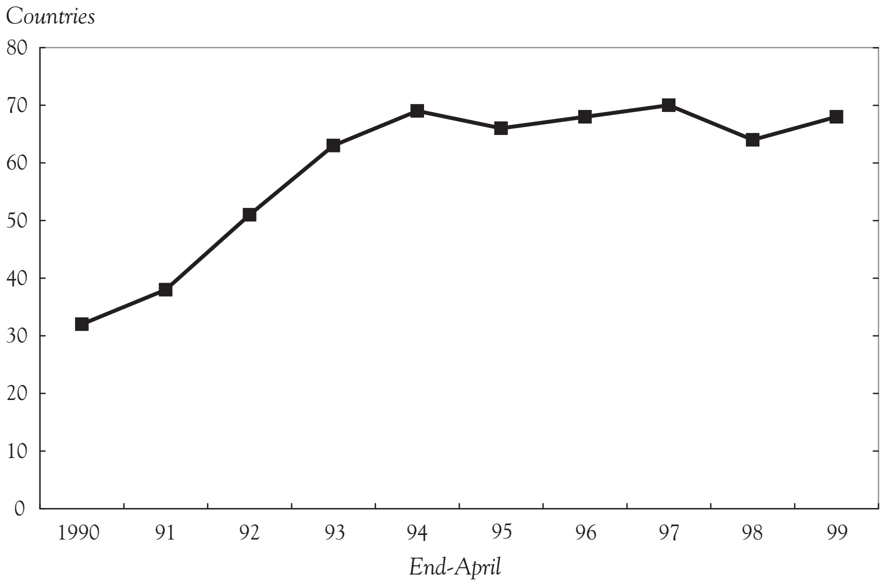
[111]"Review of Fund Technical Assistance," EBAP/99/59 and Suppl. 1 (both dated May 17, 1999).

[112]"Policy Statement on IMF Technical Assistance," April 1, 2001; accessed at http://www.imf.org/external/pubs/ft/psta/index.htm.

[113]The JVI was initially sponsored by the IMF, the Bank for International Settlements (BIS), the European Bank for Reconstruction and Development (EBRD), the Organization for Economic Cooperation and Development (OECD), the World Bank, and the Austrian central bank and finance ministry. The World Trade Organization (WTO) joined in 1998. See "A Brief History of the JVI" at http://www.jvi.org/index.php?id=168.

[114]"The Joint Vienna Institute—Recent Developments and Extension of Mandate," EBAP/98/12 (February 2, 1998); and minutes of EBM/98/21 (March 2, 1998), pp. 3–20.

Figure 5.5. Resident Representative Posts, 1990–99



Source: *Annual Reports*.

Arab Emirates, began offering courses in 1999 as a joint venture with the Arab Monetary Fund. The Joint Africa Institute was also established in 1999, as a joint venture with the World Bank and the African Development Bank. Each of these institutes accepted students from among the officials of countries in the regions in which they were located.

Finally, the Fund's Resident Representative offices served as a way for management and staff in Washington to stay abreast of developments in its borrowing countries, for the staff to provide ongoing technical assistance and policy advice to the authorities, and for the Resident Representative to explain the Fund and its functions to officials and to civil society in those countries. The practice of setting up offices in member countries began in March 1956, when the Fund assigned a staff member to work in Paraguay for six months to assist the authorities in implementing policies to control inflation following devaluation of the guarani and liberalization of the foreign exchange market.[115] Two more offices opened later that year, in Bolivia and Haiti. In 1965, when seven overseas offices were in place, the IMF formally established a policy providing for Resident Representatives of the Fund, as distinguished from resident or technical advisors with more limited responsibilities. The program gradually grew, and by the end of the 1980s the Fund had more than 30 Resident Representative (or "res

[115]See minutes of EBM/56/12 (February 27, 1956).

rep" in the common parlance of 19th Street) offices around the world. Most postings were made to help oversee implementation of Fund-supported programs, but the policy also allowed for a post to be established when the Fund had some other form of "intensive involvement," such as a staff-monitored program or ongoing negotiations.[116]

The early 1990s witnessed a sharp rise in the number of Resident Representative posts, from 32 in April 1990 to 69 four years later (Figure 5.5). This growth was unrelated to the number of active stand-by and other arrangements, which were almost flat during that period. Instead, the influx of new member countries with immense and diverse needs for technical assistance and policy advice drove the growth. Many of the new members were not yet prepared to implement fully articulated policy programs, and an important role of the Resident Representative was to assist in that preparation and to coordinate a regular flow of technical advisors and staff missions from headquarters. In several cases, starting with Poland in 1990 and then including China, India, and Russia, the Fund's local offices were staffed by more than one Resident Representative.[117] After 1994, the number of overseas offices remained roughly constant.

[116]For the history of the Resident Representative program, see "Review of the Resident Representative Program," EBAP/94/69 (September 2, 1994), pp. 1–3; and "Review of the Resident Representative Program—Selected Issues and Statistical Annex," EBS/97/137, Suppl. 1 (September 17, 1997), pp. 5–9.

[117]Traditionally, the staffing usually included only one Resident Representative, assisted by a small number of locally recruited personnel. The Moscow office was exceptional in the 1990s in that it included as many as four Resident Representatives; see "Review of the Resident Representative Program," EBAP/94/69 (September 2, 1994), p. 9. The length of an assignment for a Resident Representative in the 1990s was either two or three years, with an average length of 2.3 years; "Review of the Resident Representative Program—Selected Issues and Statistical Annex," EBS/97/137, Suppl. 1 (September 17, 1997), p. 11.

Appendix: Credits and Loans, 1990–99

(Millions of SDRs, except as noted)

Country	Stand-by and Credit Tranche Drawings[a]	Drawings under Special Facilities: EFF	CCFF	STF	SRF	Emergency Assistance: Natural Disasters	Postconflict	Total Credits	Loans (SAF, ESAF, and PRGF)	Total Credits and Loans	Maximum Outstanding	Maximum in Percentage of Quota
Albania	13.1						8.8	22.0	52.4	74.4	60.4	129.7
Algeria	610.2	1,169.3	672.4					2,451.9		2,451.9	1,661.9	181.7
Argentina	1,373.8	4,020.3						5,394.0		5,394.0	4,443.7	289.1
Armenia	13.5			33.8				47.3	109.4	156.6	148.0	200.4
Azerbaijan	58.5	53.2	56.3	58.5				226.6	81.9	308.5	303.4	195.0
Bangladesh						98.1		98.1	330.0	428.1	561.7	193.6
Barbados	14.7		22.2					36.8		36.8	36.8	108.0
Belarus	50.0			140.2				190.2		190.2	190.2	67.8
Benin								n.a.	77.6	77.6	71.0	156.7
Bolivia								n.a.	229.8	229.8	193.3	211.1
Bosnia and Herzegovina	53.3						30.3	83.6		83.6	76.0	45.0
Brazil	1,484.3				6,512.4			7,996.7		7,996.7	7,055.1	232.4
Bulgaria	971.1	313.8	225.1	116.2				1,626.3		1,626.3	910.7	172.9
Burkina Faso								n.a.	95.9	95.9	88.8	182.1
Burundi								n.a.	17.2	17.2	47.4	98.0
Cambodia				6.3				6.3	50.4	56.6	54.5	74.2
Cameroon	58.1							58.1	126.1	184.2	146.2	92.5
Central African Rep.	10.7							10.7	22.6	33.3	30.2	93.1
Chad	10.3							10.3	55.7	66.0	52.3	125.1
Comoros								n.a.	2.3	2.3	2.3	34.6
Congo, Rep. of	16.5						7.2	23.7	13.9	37.6	27.4	47.3
Costa Rica	25.6		33.6					59.3		59.3	62.3	74.1
Côte d'Ivoire	121.0		24.8					145.8	457.3	603.2	457.3	192.0
Croatia	13.1	28.8		130.8				172.7		172.7	172.7	66.0
Czechoslovakia	655.5		501.0					1,156.5		1,156.5	1,121.5	155.6
Czech Rep.	70.0							70.0		70.0	850.7	144.3
Djibouti	7.3							7.3	2.7	10.0	9.3	63.2

Appendix (continued)

(Millions of SDRs, except as noted)

Country	Stand-by and Credit Tranche Drawings[a]	Drawings under Special Facilities: EFF	CCFF	STF	SRF	Emergency Assistance: Natural Disasters	Postconflict	Total Credits	Loans (SAF, ESAF, and PRGF)	Total Credits and Loans	Maximum Outstanding	Maximum in Percentage of Quota
Dominican Rep.	56.0		79.4			39.7		175.2		175.2	135.5	85.3
Ecuador	141.0							141.0		141.0	247.9	164.5
Egypt	147.2							147.2		147.2	161.7	34.9
Equatorial Guinea								n.a.	10.1	10.1	13.8	56.8
Estonia	39.5			23.3				62.8		62.8	62.8	135.0
Ethiopia								n.a.	78.9	78.9	76.8	78.1
Gabon	49.1	60.7	21.5					131.3		131.3	109.2	149.4
Gambia, The								n.a.	14.6	14.6	31.8	186.2
Georgia	22.2			55.5				77.7	172.1	249.8	238.4	195.0
Ghana			47.0					47.0	345.8	392.8	597.2	292.0
Guinea								n.a.	101.4	101.4	92.7	114.4
Guinea-Bissau							2.1	2.1	10.5	12.6	12.6	106.4
Guyana	49.5							49.5	153.2	202.7	128.6	230.3
Haiti	18.4					15.2		33.6	15.2	48.8	40.8	72.0
Honduras	30.5		44.1			47.5		122.1	109.9	232.0	153.3	120.0
Hungary	184.1	557.2	265.0					1,006.3		1,006.3	908.3	169.7
India	2,207.9		1,352.0					3,559.9		3,559.9	3,634.9	129.8
Indonesia	3,669.1	3,797.7						7,466.8		7,466.8	7,466.8	431.1
Israel			178.6					178.6		178.6	178.6	40.0
Jamaica	125.7	86.8	35.2					247.6		247.6	299.0	205.5
Jordan	44.4	354.2	34.1					432.7		432.7	374.9	276.9
Kazakhstan	259.9	154.7		123.8				538.3		538.3	463.7	187.3
Kenya								n.a.	205.9	205.9	354.2	249.4
Korea, Rep. of	4,462.5				9,950.0			14,412.5		14,412.5	13,325.0	1,666.5
Kyrgyz Rep.	11.6			32.3				43.9	118.5	162.4	142.7	197.5
Lao People's Dem. Rep.								n.a.	49.8	49.8	52.5	134.2
Latvia	64.1			45.8				109.8		109.8	109.8	120.0
Lesotho								n.a.	21.1	21.1	28.4	120.0

Appendix (continued)

(Millions of SDRs, except as noted)

Country	Stand-by and Credit Tranche Drawings[a]	Drawings under Special Facilities: EFF	CCFF	STF	SRF	Emergency Assistance: Natural Disasters	Postconflict	Total Credits	Loans (SAF, ESAF, and PRGF)	Total Credits and Loans	Maximum Outstanding	Maximum in Percentage of Quota
Lithuania	62.1	134.6		51.8				248.4		248.4	208.2	201.2
Macedonia, FYR	22.3		13.8	24.8				60.9	27.3	88.2	79.2	150.0
Madagascar								n.a.	66.3	66.3	123.3	185.7
Malawi	12.7							12.7	90.0	102.7	87.4	234.9
Mali	5.1							5.1	163.2	168.3	144.4	195.2
Mauritania								n.a.	91.2	91.2	83.4	175.8
Mexico	9,792.4	2,773.9						12,566.3		12,566.3	10,648.1	607.3
Moldova	84.2	87.5	25.7	45.0				242.4		242.4	182.8	203.1
Mongolia	13.8							13.8	41.2	54.9	39.3	102.1
Morocco	66.4							66.4		66.4	638.8	208.4
Mozambique								n.a.	199.4	199.4	157.0	185.0
Nepal								n.a.	16.8	16.8	40.7	106.3
Nicaragua	17.0							17.0	115.2	132.2	115.2	88.6
Niger	11.1							11.1	55.0	66.1	62.9	186.7
Pakistan	382.7	236.9	475.1					1,094.7	546.8	1,641.6	1,405.6	185.4
Panama	138.9	40.0	36.7					215.6		215.6	243.2	238.0
Papua New Guinea	35.3		42.8					78.2		78.2	44.0	66.8
Peru		803.2						803.2		803.2	803.2	174.4
Philippines	879.9	791.2	277.1					1,948.2		1,948.2	1,344.5	200.9
Poland	997.8	76.5	162.6					1,236.9		1,236.9	963.3	97.4
Romania	847.7		324.5	188.5				1,360.7		1,360.7	977.1	143.5
Russian Federation	5,503.5	5,104.7	2,156.6	2,156.6	675.0			15,596.3		15,596.3	14,136.3	327.8
Rwanda			8.9				14.9	23.8	42.1	65.9	55.3	69.0
Senegal	30.9							30.9	244.6	275.5	250.7	294.6
Serbia and Montenegro	65.7							65.7		65.7	56.8	254.2
Sierra Leone							27.1	27.1	123.9	151.0	142.0	175.5
Slovak Rep.	32.2			128.7				160.9		160.9	449.1	174.5
South Africa			614.4					614.4		614.4	614.4	45.0

Appendix (concluded)

(Millions of SDRs, except as noted)

Country	Stand-by and Credit Tranche Drawings[a]	Drawings under Special Facilities: EFF	CCFF	STF	SRF	Emergency Assistance: Natural Disasters	Postconflict	Total Credits	Loans (SAF, ESAF, and PRGF)	Total Credits and Loans	Maximum Outstanding	Maximum in Percentage of Quota
Sri Lanka								n.a.	324.6	324.6	427.2	157.5
St. Kitts and Nevis						1.6		1.6		1.6	1.6	25.0
Tajikistan	15.0						15.0	30.0	47.0	77.0	77.0	117.2
Tanzania								n.a.	288.6	288.6	234.0	136.1
Thailand	2,500.0							2,500.0		2,500.0	2,500.0	400.8
Togo								n.a.	77.3	77.3	75.8	159.2
Trinidad and Tobago	113.3							113.3		113.3	269.1	158.2
Tunisia		207.3						207.3		207.3	217.2	157.1
Turkey	682.2					361.5		1,043.7		1,043.7	648.8	71.7
Uganda								n.a.	379.9	379.9	294.9	242.5
Ukraine	1,318.2	712.2		498.7				2,529.0		2,529.0	2,203.8	201.9
Uruguay	139.2							139.2		139.2	144.0	87.9
Uzbekistan	65.5			99.8				165.2		165.2	165.2	82.8
Venezuela	350.0	1,589.0						1,939.0		1,939.0	2,271.3	165.6
Vietnam	108.8			24.2				133.0	241.6	374.6	374.6	155.0
Yemen, Rep. of	132.4	40.0						172.4	150.0	322.4	316.1	135.1
Yugoslavia	65.7							65.7		65.7	327.9	53.5
Zambia	651.7							651.7	853.4	1,505.1	853.4	253.0
Zimbabwe	63.9	158.1						222.0	151.9	373.9	310.0	118.6
Total, 102 countries	42,420.6	23,351.6	7,730.6	3,984.1	17,137.4	563.6	105.5	95,293.5	7,469.3	102,762.8		

Source: IMF financial accounts.

Note: n.a. = Not applicable.

[a]Excludes emergency assistance.

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II

The IMF and the Transition from Central Planning

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6

The Death of Central Planning and the Birth of Markets

Before the period covered by this History, the IMF was often described as a "capitalist club." Few socialist or centrally planned countries were members, and the absence of the Soviet bloc and (until 1980) the People's Republic of China was a glaring feature of the membership. It was not designed to be that way. As described in Chapter 2, the U.S. government under President Franklin D. Roosevelt tried hard in 1944 to pave the way for the Soviet Union to become an original member of the IMF. That effort almost succeeded, but when relations between the United States and the Soviet Union hardened into the Cold War, financial cooperation through the IMF was a collateral casualty.

In fact, the IMF never really was a capitalist club. Its membership during the Cold War always included nonaligned countries with socialist or semisocialist economies, such as Egypt, India, and Yugoslavia. It also included at least a few Soviet allies. Relations with socialist countries, however, often became strained. Poland withdrew in 1950 under pressure from the Soviet Union, and Czechoslovakia was expelled in 1954 for failing to provide required data. Cuba withdrew from membership in 1964, five years after Fidel Castro took power and began restructuring the economy along socialist lines. All three countries had been original members from 1945. Romania joined the IMF in 1972, but relations deteriorated badly in the 1980s until the overthrow of Nicolae Ceauşescu in November 1989.[1]

In some respects, matters improved in the 1980s. Deng Xiaoping's liberalization initiative in 1979 opened the way for the People's Republic of China to assume control of China's membership at the IMF. The weakening finances of the Soviet Union, combined with the international debt crisis, made it both possible and necessary for Hungary to join in 1981 and for Poland to rejoin in 1986. Nonetheless, the economic and political wall between most of the Soviet bloc and the membership of the IMF

[1]These developments, and those mentioned in the next paragraph, are covered in more detail in Boughton (2001). On the withdrawal of Poland and Czechoslovakia, see pp. 964–65 and references therein; on Cuba, p. 758; and on Romania, pp. 321–24 and 965n5. Chapter 19 covers relations with China, Hungary, and Poland through the 1980s. Cuba is discussed further in Chapter 2 of the present work, as is North Korea (officially, the Democratic People's Republic of Korea), another nonmember with a socialist economic system.

remained insurmountable until the transformational events of 1989–91 that led to the dissolution of the Soviet Union.

This chapter introduces the strategy the IMF developed for its relationships with countries undertaking a transition to market-oriented economic policies, and it reviews how the Fund applied that strategy in the countries that had been allied with but not part of the Soviet Union. Relations with the former Soviet Union itself are taken up in the next two chapters.[2]

The Challenge and the Strategy of Transition

The Soviet system of production and trade was based on central planning, and it relied heavily on regional specialization. That policy, combined with the semi-isolation of the Soviet Union throughout the Cold War, led to a very high volume of trade among the Soviet republics and between the Soviet Union and the rest of the bloc, and thus to a high degree of economic interdependence. When Mikhail Gorbachev assumed leadership of the union in 1985, he tried to reform this system to make it more consistent with the requirements for participating in global trade. That effort implied retaining the basic structure of central planning and regional specialization while gradually opening the system to market pricing, private ownership, and international competition. This gradualist strategy failed, the reform effort was abandoned in 1990, and the system collapsed without a viable alternative in sight.

For all the weaknesses of the old regime, the short-term consequences for the entire region under Soviet control and influence were even worse when it vanished. Eventually, the exposure to competitive market forces would induce each new state to evolve toward its own comparative advantage, but that adjustment process was going to take at least a few years—in some cases, many years—to complete. At the outset, just preserving as much as possible of the existing levels of production and trade posed a major challenge. Though necessary, that initial stabilization effort may have further delayed real reforms in a number of countries.

From 1949 to 1990, international trade within the Soviet bloc—the 15 republics and 10 or so closely allied countries—was conducted bilaterally, without any provision for multilateral settlement of payments, under the auspices and direction of the Council on Mutual Economic Assistance (CMEA, also known as COMECON).[3]

[2]Relations with two other transition countries, Cambodia and Vietnam, which were long-standing member countries with low incomes and communist governments, are discussed in chapters 12 and 16.

[3]CMEA membership in 1990 comprised the Soviet Union, Bulgaria, Cuba, Czechoslovakia, the German Democratic Republic (East Germany), Hungary, Mongolia, Poland, Romania, Vietnam, and Yugoslavia (as an associate member). For a historical overview, see Shrenk (1991).

The council and its settlement system were abandoned in 1990, with the intention that trade would then occur at market prices and be settled in U.S. dollars or other convertible currencies. However, few of these countries possessed hard currencies in sufficient quantities, so this decision also made matters worse in the short run.

The Soviet bloc used two currency systems, neither of which was consistent with market equilibrium. Trade within the Soviet Union either was conducted through barter or was settled in Soviet rubles, which were not convertible into other currencies. Trade between the Soviet Union and other bloc members was handled similarly, except that the unit of account was the "transferable ruble," an artifact created solely for translating inconvertible national currencies such as Polish zlotys or Hungarian florins into rubles. Like its domestic counterpart, the transferable ruble was otherwise inconvertible.

The prices at which these exchanges took place were neither market-clearing nor intended as rationing devices, but were set administratively to serve social or political objectives. Most famously, prices of basic necessities were set at low levels even when the goods were scarce, a practice that increasingly resulted in empty shelves. The drive toward market-based structures required huge increases in such prices, which in turn made the prevention of hyperinflation or a collapse in output a massive challenge and a top priority for economic policy. Attempting to alleviate the cost to consumers by stretching out the adjustment of relative prices would only magnify the problem by piling up the output losses and allowing vested interests to become even more entrenched.

Helping new member countries manage this transition gave rise to the biggest challenge the IMF had ever faced. The complexity of the required strategy overshadowed anything the staff had ever had to contemplate. In the Fund's first few years, immediately after the Second World War, western Europe, Japan, and the Soviet Union all had to make similar transitions to rebuild their economies and restore international relations, but in those cases the IMF was either marginalized or not involved.[4] In the 1990s, the international community expected the IMF to play a material role as advisor, coordinator, and financier. Most of the countries concerned were new members, so the IMF staff initially had little expertise either on these economies or on the policy transformations they were beginning to undertake. The Fund could help readily in the effort to stabilize economies and move toward a market-clearing equilibrium. However, the Fund had much less experience to draw on for the more complex tasks of establishing sound institutions and good governance.

The knowledge that the potential cost of failure was limitless added to the challenge. A failed transition could lead to hyperinflation and a collapse in output, both horrible economic outcomes; but the political and social costs of failure would be far worse.

[4]The three largest economies—Germany, Japan, and the Soviet Union—were not IMF members. (Germany and Japan joined in 1952. The Soviet Union never did.) Other European countries relied more on the World Bank, the U.S. Marshall Plan, and intra-European arrangements than on the IMF.

The Russian Federation and several other countries of the former Soviet Union held large stocks of nuclear weapons. Demobilizing those weapons and ensuring that they would not be misused, stolen, or sold to rogue states was going to be expensive. An economic collapse would make the task more difficult and the outcome more uncertain. In addition, in many states throughout the Soviet bloc, large segments of the population had fared relatively well under communism, benefiting from the notional security of a strong and centralized welfare state. The combination of nationalism and nostalgia fostered by the collapse of the Soviet Union and its economic system made a backlash against democratic and market reform all too likely. The only way to maintain forward momentum was to stabilize the new market economies as quickly as possible, generate economic growth, and ensure that the gains from reform were widely shared. Everyone trying to help these countries, at the IMF and elsewhere, understood that the potential cost of failure was nothing less than a return to the Cold War and an increased risk of a nuclear confrontation.

The IMF took on the task of helping countries liberalize their economies and position themselves to become integrated into the world economy.[5] It had three tools: policy advice, technical assistance, and lending. Lending, particularly the policy conditions that the Fund attached to its loans, got most of the publicity. Often neglected in discussion but also important, however, was technical assistance. Because of the peculiarities of the socialist economic structures, most of the transition countries had no real central banks or treasury systems, no internationally comparable economic and financial statistics, and no experience with the requirements for market or macroeconomic equilibrium. Overall, nearly a quarter of the volume of the IMF's lending in the 1990s, and 22 percent of the staff time devoted to technical assistance, went to transition countries.

Help flooded into the region from many quarters, including from the European Bank for Reconstruction and Development, which was established in 1991 specifically to provide financing and technical assistance for the development of private sectors in transition countries. The Paris-based and long-established association of industrial countries, the Organization for Economic Cooperation and Development, expanded its activities to include providing technical assistance to transition countries on a wide range of issues for which it had cross-country expertise. The Bank for International Settlements in Basel, Switzerland, and the Commission of the European Communities also provided much-needed expertise; industrial-country governments and central banks placed advisors directly in their counterpart agencies in transition countries; and nongovernmental organizations such as the Soros Foundations helped countries establish democratic institutions. In 1992, the IMF, four other multilateral organizations, and Austria established the Joint Vienna Institute as a center to train officials from

[5]For the staff's strategy at the outset, see "The Role of the Fund in Assisting Eastern European Countries," SM/91/46 (February 28, 1991).

transition countries in economics and the functioning of the international economic system (see "Technical Assistance, Training, and Resident Missions" in Chapter 5).

The Bretton Woods institutions—the IMF and the World Bank—had a central role in the provision of technical assistance, allocating massive amounts of staff time both in the field and in Washington, conducting seminars and courses for country officials. For the 11 years through 2000, the Fund devoted 345 staff years to providing technical assistance to 29 transition countries (Table 6.1). Russia and Ukraine, the two largest economies in this group, received the most assistance, followed by smaller countries with enormous needs: Albania, Georgia, Mongolia, and Bulgaria.

The IMF's expertise was particularly relevant for developing a strategy for establishing currency convertibility. At the beginning of the decade, almost all currencies in the transition countries circulated only in the countries in which they were issued. Residents could not convert their home currencies into others, and nonresidents were legally required to convert foreign currencies at the official (and artificial) rate to visit or do business in each of these countries. As each country embarked on the transition process, the long-run goals obviously included a convertible currency. Each country had to find a way to get there without destabilizing trade and payments along the way.

In Europe, the notion took hold in 1990 that the defunct CMEA should be replaced by a new system for multilateral clearing of payments within the same region. Until the transition countries could raise their standards of production of goods to a level that could compete with the established western market economies, they would be at a severe disadvantage. That they started with little or no hard currency reserves of their own added greatly to the problem. The European Payments Union had served the transitional purpose fairly well for western Europe in the 1950s, and it seemed reasonable that the eastern bloc could benefit from something similar for the 1990s.

At the IMF, the Research and European Departments both took the "eastern payments union" idea seriously but ultimately concluded it was unlikely to help. The practical problem was that the only way such a clearing mechanism could work would be by relying heavily on support from the Soviet Union. It thus would delay, not promote, the transition to economic integration with the west. Without a payments union, the major industrial countries—or the IMF—could provide the financial assistance to advance the transition. Whether they would actually do so was not obvious. Yet, the payments union idea faded from view even before the Soviet Union collapsed in 1991.[6]

[6]The European Department's opposition to the payments union proposal was shaped primarily by Princeton University Professor Peter B. Kenen, who spent several months in 1990 as a consultant to the department. See Kenen (1991), which includes a review of proposals for an eastern European payments union. The Research Department view initially was more neutral. A staff paper discussed by the Executive Board in June 1990 concluded that "if a modern EPU [European Payments Union] were deemed to be desirable, its benefits would be greatly increased if its membership could be made as broad as possible in order to encourage the development of true multilateral trade"; minutes of Executive Board Seminar 90/1 (June 6, 1990), p. 5. Also see the discussion of the dismantling of the ruble area, in Chapter 8.

Table 6.1. Technical Assistance to Transition Countries, 1990–2000

Country	Staff Years	
Russian Federation		38.7
Baltic countries		22.8
Estonia	5.8	
Latvia	5.8	
Lithuania	11.2	
Other Central and Eastern European countries		
Former Soviet Union		61.0
Belarus	13.3	
Moldova	13.6	
Ukraine	34.2	
Pre-1990 IMF members		23.9
Hungary	3.4	
Poland	13.7	
Romania	6.7	
Yugoslavia and successors		32.1
Bosnia and Herzegovina	11.5	
Croatia	7.5	
Federal Republic of Yugoslavia (Serbia and Montenegro)	3.3	
FYR Macedonia	9.4	
Slovenia	0.4	
Other European countries		47.9
Albania	23.4	
Bulgaria	17.3	
Czechoslovakia	1.7	
Czech Republic	3.1	
Slovak Republic	2.4	
Caucasus region		45.0
Armenia	11.9	
Azerbaijan	12.3	
Georgia	20.8	
Central Asia		73.8
Kazakhstan	14.8	
Kyrgyz Republic	14.6	
Mongolia	17.6	
Tajikistan	10.3	
Turkmenistan	10.1	
Uzbekistan	6.4	
Total staff-years		345.3
Percentage of total IMF technical assistance		22.2

Source: Staff calculations.
Note: Columns may not total because of rounding.

Without an effective payments system, without good channels for exporting goods to the west, without large-scale external support, and in the wake of large price increases and a sharp drop in demand for military and other capital equipment, a short- to medium-term collapse in output, trade, incomes, and employment was unavoidable.

The challenge was to get through that collapse as quickly as possible and to minimize the impact on the poorest and most vulnerable segments of society.

At the outset of the transition, IMF Managing Director Michel Camdessus laid out the immediate tasks for the region in a pair of speeches in May 1990. In Budapest, he acknowledged that it was "humanly impossible to change everything in a short period of time." Nonetheless, the full scope of the transition should be announced right away, and each reform should be introduced as rapidly as possible. Otherwise, inefficiencies would persist, "adjustment fatigue" would set in, and the long-term costs would be all the greater. Two days after that speech, at Georgetown University in Washington, Camdessus again made the case for a comprehensive and aggressive approach to reform. The first priority for the state in a new market economy, he argued, should be "to establish an institutional framework (legal system, regulatory agencies, etc.) so that the market system can operate smoothly and unleash the growth potential that lies in private initiative." Second, the state should develop a "popular consensus" for using macroeconomic policies to stabilize the economy. Third, the state should provide "social safety nets" including "unemployment insurance, . . . job training schemes, and assistance to help the poor and vulnerable who are the least able to cope" with a rapidly changing economic environment.[7]

Each of these three elements proved difficult, both for the transition countries and for the IMF. The fundamental problem was the interaction between economic stability and institutional development and reform. To limit the downward spiral, the economy had to be stabilized quickly, but stability could not be sustained without strong institutions and infrastructure. Developing those institutions took longer and was made more difficult by economic instability. In many (but not all) transition countries, weak public institutions—undeveloped legal and regulatory systems, inadequate bankruptcy procedures, hastily contrived privatization schemes, and other ills—prevented stabilization and delayed the recovery. In addition, the social safety nets often failed because they were expensive and were inadequately supported either by national governments or by external donors.

In attempting to help countries make the transition to a market economy, the IMF had no choice but to accept the current state of institutional development as a starting point. The Fund often found itself signing off on programs that would succeed only if the authorities developed strong institutions rapidly once the financial support was already approved and was being disbursed. As the overviews in the next two sections illustrate, in most cases the authorities were not unwilling to take the necessary actions to strengthen macroeconomic policies and institutions. Although the quality of leadership varied

[7]Remarks at a conference on "Economic Reform in Central and Eastern Europe: A Challenge for All of Europe," organized by the Parliamentary Assembly of the Council of Europe, Budapest, MD/SP/90/9 (May 16, 1990); and remarks at a joint IMF–Georgetown University seminar on "Eastern Europe in the Nineties," Washington, MD/SP/90/10 (May 18, 1990).

widely across countries, the central problem in many cases was to sustain popular support for reforms in the face of extraordinarily difficult external and internal conditions.[8]

The Transition in Existing Member States

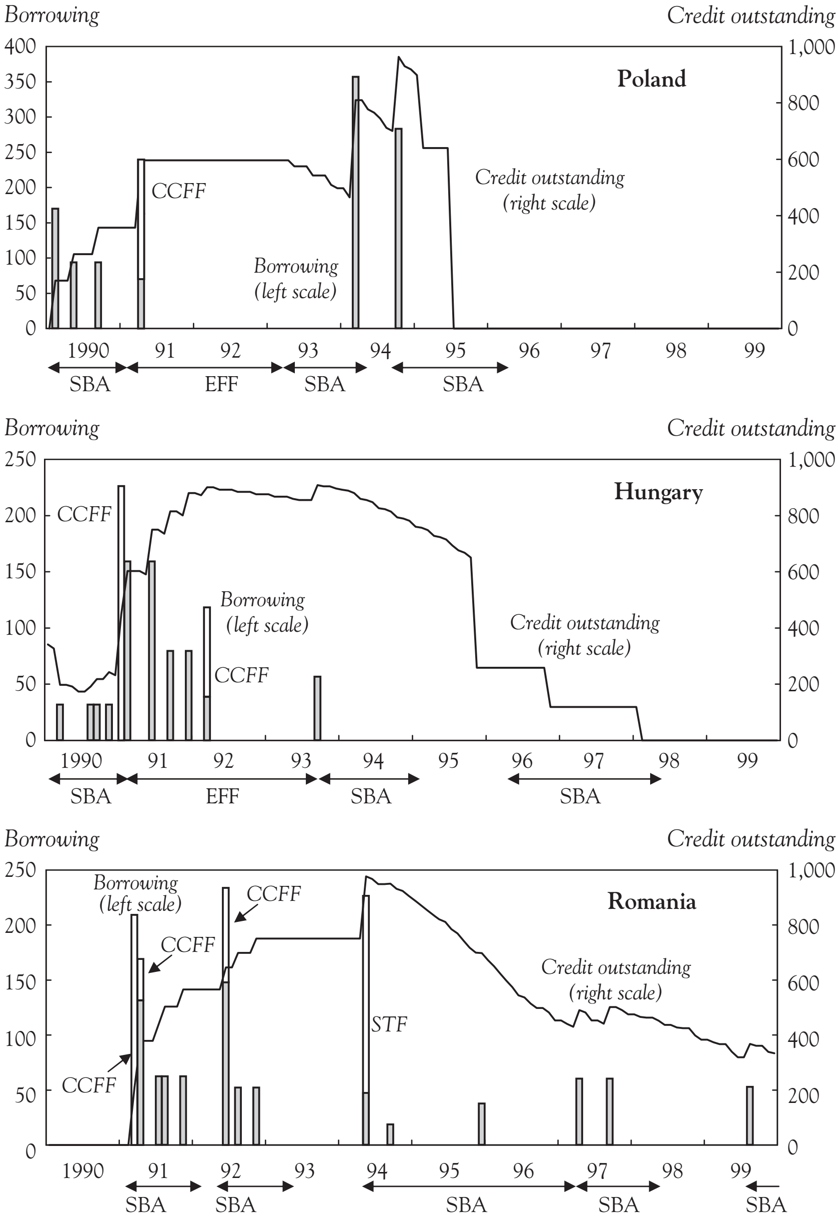
None of the three Soviet-bloc countries with IMF membership at the beginning of the 1990s had been borrowing significant amounts in the preceding five years. Poland's desire to borrow after it rejoined in 1986 had been rebuffed owing to strong opposition from the U.S. authorities. In Romania, President Nicolae Ceaușescu made the disastrous decision in 1984 to stop all external borrowing and to try to repay foreign creditors as rapidly as possible. The Romanian authorities canceled an IMF stand-by arrangement in January 1984 and completed the repayment of all outstanding obligations five years later. Hungary borrowed heavily through two stand-by arrangements from 1982 through 1985. Drawings under a third arrangement in 1988–89 were large enough only to offset repayments on the earlier loans and effectively reschedule those debts by a year. As soon as new, democratically elected governments took office in these three countries, financial assistance from the IMF quickly resumed (Figure 6.1).

Poland

Poland got off to the fastest start, with the seminal "big bang" economic reform program of January 1990. As recounted in more detail in Chapter 9, the IMF supported that program financially from February 1990 through October 1994, using three stand-by arrangements and one extended arrangement. After 1994, Poland had excellent access to private capital markets, enabling it to repay its IMF loans ahead of schedule. Over that same five-year period, the Fund provided 12 staff-years of technical assistance to the Polish authorities. The bulk of that assistance came from the Monetary and Exchange Affairs Department (MAE), which sent 14 missions to help officials at the National Bank of Poland (NBP) modernize virtually all aspects of its operations and the conduct of monetary policy. In addition, MAE coordinated numerous visits to the NBP by experts from other central banks, and for a year it provided a full-time resident advisor to the NBP president. The Fiscal Affairs Department and the Statistics Department sent a total of 10 staff missions

[8]A full examination of the reasons for different records of success across the region would be beyond the scope of this History. The initial quality of institutions, experience with the rule of law, the ability and willingness of political leaders and economic officials to design and carry out reforms, the extent to which the country's collective memory was favorable to openness and liberal economic systems—all these (and probably other) factors had a role. For a thorough analysis, see Havrylyshyn (2006).

Figure 6.1. Poland, Hungary, and Romania: Use of Fund Credit, 1990–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics.
Note: CCFF = Compensatory and Contingency Financing Facility; EFF = Extended Fund Facility; SBA = Stand-by arrangement; STF = Systemic Transformation Facility.

to government agencies during that period. At the height of this effort, in 1990–91, Poland was the third largest recipient of technical assistance from the IMF.

Hungary

The IMF provided primarily financial and catalytic support for the transition in Hungary since the country requested relatively little technical assistance. Throughout the first half of the 1990s, the Fund tried to press the authorities to take a more aggressive approach to both stabilization and reform. In response to weak conditions in Hungary's traditional export markets (the Soviet bloc and Yugoslavia) and in western Europe, the fiscal and external current accounts shifted sharply into deficit. A succession of governments in Hungary tried to cope by tightening policies and promoting development of a more vibrant private sector, but the Fund regarded the implementation of those measures as no better than halfhearted.

The first stand-by arrangement, approved in March 1990, began well enough and was soon replaced by a larger three-year extended arrangement. By the middle of 1992, however, slippages in policy implementation generated an excess fiscal deficit, which induced the Fund to suspend disbursements for the remainder of the arrangement. A smaller 15-month stand-by arrangement was approved in 1993, but the Fund allowed only the initial drawing. That turned out to be Hungary's last drawing on the Fund. Although Hungary's large outstanding external debt made it highly vulnerable to contagion from the Mexican crisis at the end of 1994, the authorities took strong and successful action to defend their financial position, including through a devaluation of the forint. They gradually regained good access to international capital markets and were able to treat their final stand-by arrangement (1996–98) as precautionary. That final arrangement was aimed primarily at reassuring private creditors that the country's policies were sound. When that arrangement expired in February 1998, Hungary finished repaying all of its outstanding obligations to the Fund.

Romania

Romania began the 1990s in disastrous economic condition but with a fresh political start. Relations with the international community, including the IMF, had deteriorated in the second half of the 1980s, as the government of Nicolae Ceaușescu tried desperately to repay all of its external debt, even if that meant deprivation and perhaps starvation at home. In the late 1980s, the authorities stopped providing so much as basic economic data to the Fund and refused to accept an Article IV consultation. By the end of the decade, Romania had nominally solved its debt problem and had repaid all of its earlier borrowings from the IMF, but its economy was devastated. Inspired by revolutions spreading throughout

eastern Europe, a popular but violent uprising overthrew Ceauşescu in December 1989.[9]

Once a new government was elected and in office, Camdessus visited Bucharest in October 1990 to reestablish communications. The IMF then began an intensive program of technical assistance and lending that lasted through the 1990s. The lending occurred mainly through a series of five stand-by arrangements, supplemented by three drawings on the Compensatory and Contingency Financing Facility and one on the Systemic Transformation Facility (STF). The bulk of the lending and technical assistance took place early in the decade. Romania's indebtedness to the Fund peaked in May 1994, at a little under $1.4 billion (SDR 977 million, or 130 percent of quota). After that, a succession of democratically elected governments continued to make economic progress, though slowly and unevenly. Romania borrowed from the Fund repeatedly through 2003 and finished repaying those loans in 2008, a year after it became a member of the European Union.[10]

The Transition in New Members

In 1990–91, three central European countries—Czechoslovakia, Bulgaria, and Albania—and one central Asian country—Mongolia—joined the IMF as part of a transition from Soviet-style to market economics. In the following year, the breakup of both Czechoslovakia and Yugoslavia further expanded the membership and broadened the IMF's work on transition economies.

Czechoslovakia and Its Successors

Reform must start with a heavy dose of restrictive macroeconomic policy. . . . the country that deliberately—without IMF pressure—and most vigorously implemented this unpopular step was undoubtedly Czechoslovakia.

Václav Klaus[11]
Prime Minister of the Czech Republic
1993

As recounted in Chapter 2, a newly democratic Czechoslovakia rejoined the IMF in September 1990 after the "velvet revolution" brought Václav Havel to power as president. As important as Havel was to the political transformation of Czechoslovakia, the leading economic reformer in the government was the minister of finance, Václav Klaus. A great admirer of the British economic reforms introduced by Margaret

[9]Relations with Romania through 1989 are covered in Boughton (2001), pp. 321–24.

[10]The other two countries in this group—Hungary and Poland—acceded to EU membership in 2004.

[11]Klaus, 1993, p. 3.

Thatcher a decade earlier, Klaus set out to stabilize and reform the Czech economy as quickly and thoroughly as possible. He began preparing a "big bang" price liberalization for January 1991, to be followed by a comprehensive privatization program. The IMF did not have to press for reform. It only had to advise on procedures for effective reform, provide some short-term financing for the early stages of the transition, and assure potential creditors and investors that the reform program was on track.

In the weeks following Czechoslovakia's admission to membership, a staff mission led by Bijan Aghevli (Senior Advisor, Research Department) visited Prague twice to conduct the initial Article IV consultation discussions and negotiate a program to be supported by a stand-by arrangement. Those talks readily succeeded, and the Executive Board approved the arrangement on January 7, 1991, just as the liberalization process was getting under way. Havel's government carried out that program and borrowed all of the $880 million (SDR 619.5 million, or 105 percent of quota) available under the 15-month arrangement. They entered into a second stand-by arrangement in April 1992 and easily met all the policy conditions. This time, though, the authorities decided not to draw on the arrangement after the initial disbursement because the balance of payments was strengthening and private capital was flowing into the country.

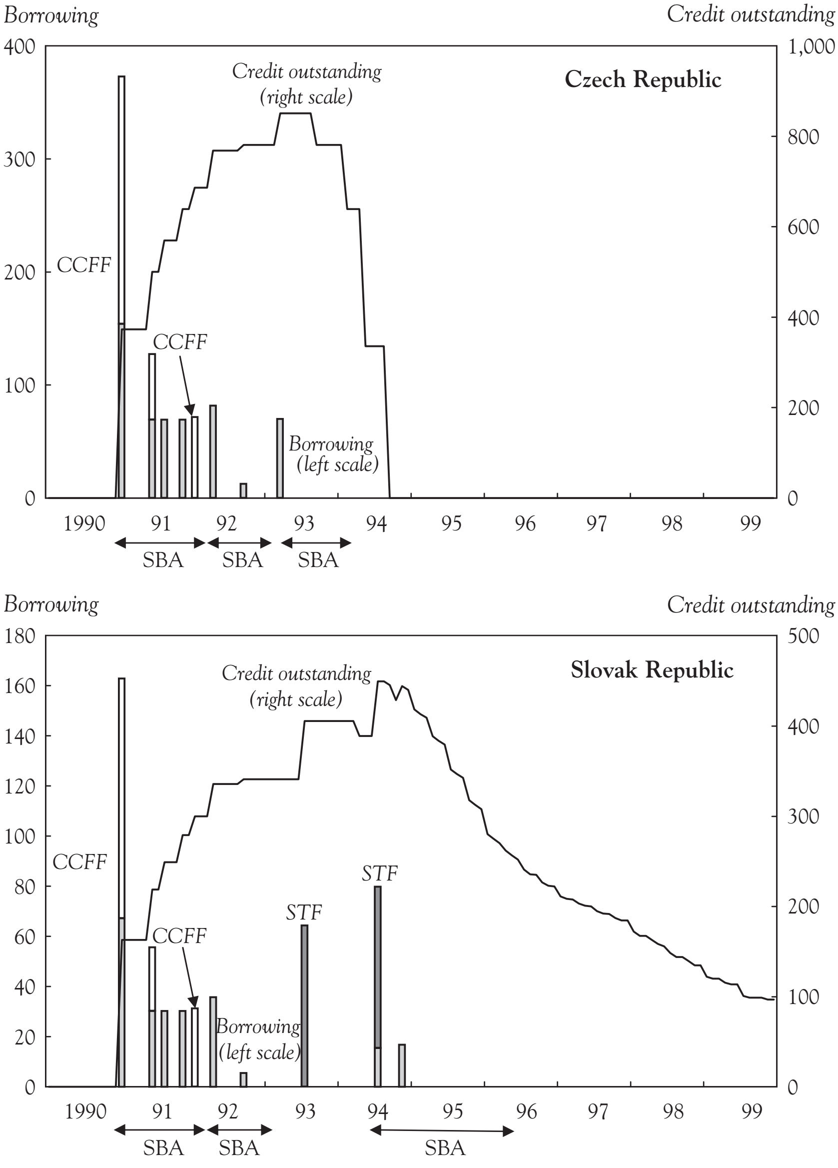
While this second stand-by arrangement was in its early stages, the Czech and Slovak federation was gripped by political separatism. After a few months of negotiations, Czechoslovakia was succeeded by two separate successor states.

Czech Republic

In anticipation of the dissolution of the federation, Czechoslovakia canceled its stand-by arrangement as of the end of 1992. The Czech authorities' intended to have no further need to borrow from the Fund, but events overtook this hope. As an interim measure, the two republics had agreed to continue using the Czechoslovakian koruna in a currency union until they could issue their own currencies in the second half of 1993. Investors proved to be leery of that plan, and both of the new states suffered large-scale capital flight throughout the first several weeks of the year. The Czech government asked the Fund for help, and the Executive Board approved a stand-by arrangement in mid-March. After the initial drawing, the capital market calmed down, and the crisis passed. The next year, the Czech Republic repaid its debts early, completing the process in September 1994 (Figure 6.2).

In 1996–97, conditions in the Czech economy deteriorated. Enticed by strong demand for investment and a five-year record of exchange stability, foreign capital was flowing into the Czech Republic in volumes sufficient to sustain a high rate of domestic investment and a growing external current account deficit. In the 1996 Article IV consultation, the staff agreed with the authorities that continuation of tight monetary

Figure 6.2. Czech and Slovak Republics: Use of Fund Credit, 1990–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics.
Note: CCFF = Compensatory and Contingency Financing Facility; SBA = Stand-by arrangement; STF = Systemic Transformation Facility. When the two countries separated, the IMF allocated 69.61 percent of Czechoslovakia's outstanding obligations to the Czech Republic and 30.39 percent to the Slovak Republic. The data for 1990–92 have been allocated using this formula.

policy and a strong exchange rate were needed to keep inflation under control. Control of inflation, in turn, was necessary so that the Czech Republic could converge to European Union (EU) levels and thus qualify for Economic and Monetary Union.[12] This policy, however, constrained the authorities' ability to manage the external deficit. In the early months of 1997, just a modicum of bad economic news reversed the inflow of financial capital and put strong pressure on the exchange rate. A currency crisis ensued, and in May events forced the authorities to let the exchange rate float.

The volatility of capital flows to and from the Czech Republic and the vulnerability of its economy to a sudden cessation of inflows in 1997 were a direct consequence of the liberalization of the capital account in October 1995. That liberalization was a requirement of the Organization for Economic Cooperation and Development for accession to membership, which was completed two months later. For its part, the IMF staff took a cautious position, concluding in 1996 that "progress toward full liberalization of the capital account will be facilitated by policies that effectively address the economic imbalances." In other words, liberalization was a worthy goal, but it should not get ahead of the economy's ability to absorb flows stably. A year later, after the crisis had abated, the staff noted the economy's continued vulnerability to capital account instability and urged the authorities to proceed more aggressively to get wage increases under control and to broaden structural reforms.[13]

Slovak Republic

The Slovak Republic's transitional adjustment needs were more acute than those of its larger partner. Throughout the communist era, the Slovak economy had been forced into specialized industrial production aimed at serving the CMEA trading region. The collapse of the CMEA and Czechoslovakia's rapid shift toward trade with the west in 1990–92 had left a largely unfinished agenda here. Personal incomes were 25 percent below those in the Czech Republic, unemployment was more than three times as high, and much of the public infrastructure remained to be built.[14]

One of the IMF's first tasks was to provide technical assistance in establishing the National Bank of Slovakia as a central bank and developing a viable strategy for

[12]"Czech Republic—Staff Report for the 1996 Article IV Consultation," SM/96/285 (November 12, 1996).

[13]"Czech Republic—Staff Report for the 1996 Article IV Consultation," SM/96/285 (November 12, 1996), p. 23, for the quotation; and "Czech Republic—Staff Report for the 1997 Article IV Consultation," SM/98/29 (January 29, 1998), p. 11, for the subsequent assessment. These staff reports, and similar cautionary statements from Executive Directors, belie the later conclusion by Václav Klaus that the crisis resulted from "idolization of the IMF" by the central bank and a slavish acceptance of its policy recommendations (Klaus, 2005, p. 81). Klaus resigned as prime minister in November 1997 and was replaced briefly by Josef Tošovský, who was head of the central bank during the crisis.

[14]For the staff's contemporaneous analysis, see "Czech Republic—Staff Report for the 1993 Article IV Consultation and Review Under Stand-By Arrangement," EBS/93/107 (July 6, 1993); and "Slovak Republic—Staff Report for the 1993 Article IV Consultation and Use of Fund Resources—Request for a Purchase Under the Systemic Transformation Facility (STF)," EBS/93/117 (July 15, 1993).

monetary policy. The staff also assisted with the initial stages of setting up tax and public expenditure systems. Because it would take some time before the authorities could present a fully fledged stabilization or reform program, the Fund agreed to provide interim financing through the STF. Over the course of 17 months in 1993–94, the Slovak Republic borrowed $230 million (SDR 160.85 million, or 62.5 percent of quota). That sum, added to the debt that the new member inherited from the former Czechoslovakia at the end of 1992, brought the country's obligations to a peak of $645 million (SDR 449 million). From that point on, the Slovak Republic had no further need to borrow, and it repaid all this debt by October 2000.

The Successors to Yugoslavia

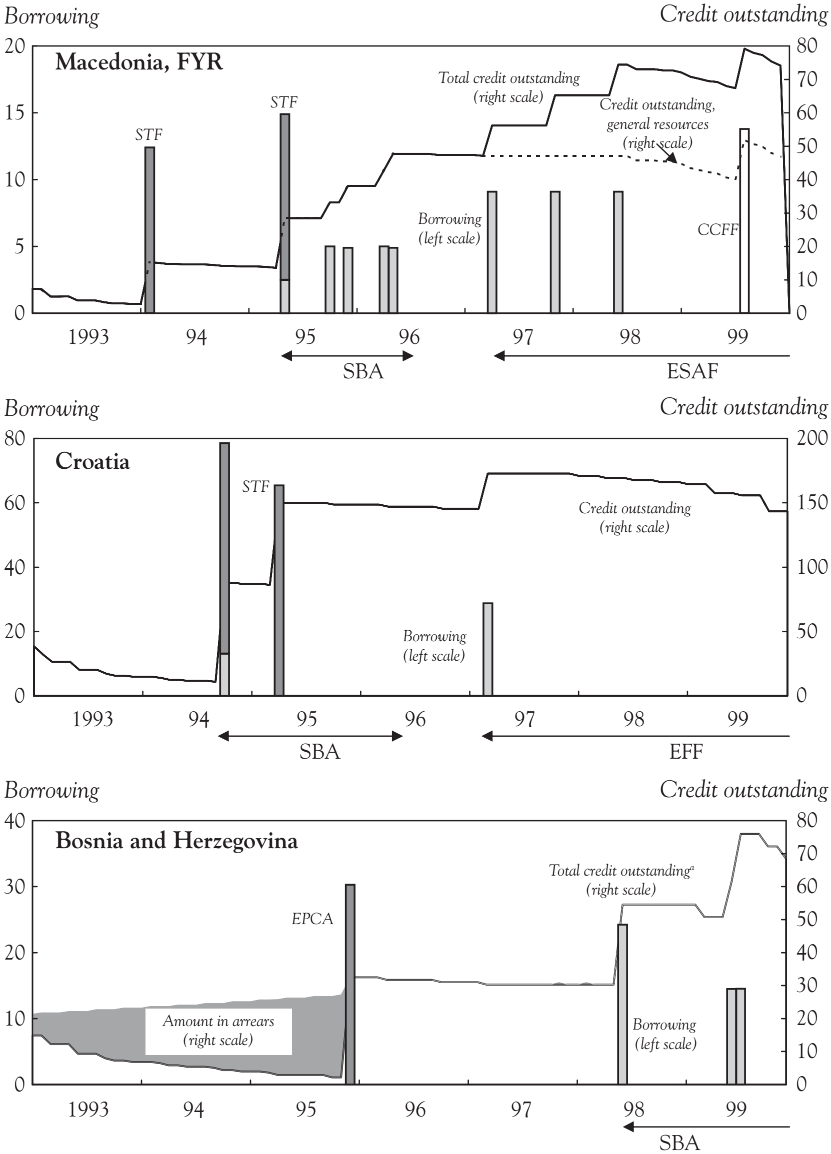
The breakup of the Socialist Federal Republic of Yugoslavia in 1992 created far more complications than did Czechoslovakia's breakup. Its unique economic system, based on a form of "market socialism" with heavy reliance on administrative controls, also encompassed a vibrant private sector of small and medium enterprises without Soviet-style central planning. For more than a decade, this system's effectiveness had been in a downward spiral, owing as much to political disarray as to intrinsic policy weaknesses. The combination of economic mismanagement and a severe breakdown of social cohesion and coordination among the republics had led to extremely high inflation, a sharp drop in industrial output, and high and rising unemployment.

The federation's disintegration resulted in five (and eventually more) disparate new countries. Each one had to find its own reform path, starting from a ruined economy and unstable social and political relations, both internal and external. Some warred with each other, while some faced bitter and violent internal conflicts. As recounted in Chapter 2, two of the new countries were subject to United Nations (UN) and other international sanctions that crippled their ability to meet the obligations of membership in the IMF and other international organizations. Once each successor state met those requirements, the Fund responded with financial and other assistance (Figure 6.3).

One task for which a new country would normally seek advice from the IMF had already been completed. As monetary disarray in Yugoslavia spiraled toward hyperinflation in 1991 and 1992, each seceding republic had to establish its own currency. In contrast to the former Soviet Union, where the various countries had a bit of time to phase out rubles while preparing the groundwork for national currencies (see Chapter 8), waiting until IMF membership was in place was not an option in Yugoslavia. The Federal Republic of Yugoslavia (Serbia and Montenegro) continued to use the dinar, but by the end of 1992 all the other republics had begun issuing their own currencies, each of which—like the Yugoslav dinar—was pegged to, or at least closely managed against, the deutsche mark (Table 6.2).

As each new country completed the membership process, the IMF provided substantial technical assistance—a total of 32 staff-years by the end of the decade (see Table 6.1). It also entered into discussions for lending. The northernmost and most economically advanced country, Slovenia, took strong action early to establish an

Figure 6.3. Successors to Yugoslavia: Use of Fund Credit, 1993–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics.
Note: CCFF = Compensatory and Contingency Financing Facility; EFF = Extended Fund Facility; ESAF = Enhanced Structural Adjustment Facility; EPCA = Emergency postconflict assistance; SBA = Stand-by arrangement; STF = Systemic Transformation Facility. "Credit outstanding, general resources" excludes ESAF loans.
[a] Total credit outstanding for Bosnia and Herzegovina includes overdue obligations (principal, interest, and charges).

Table 6.2. Introduction of New Currencies in the Former Yugoslavia

Country	Currency	Effective Date	Initial Exchange Regime
Federal Republic of Yugoslavia (Serbia and Montenegro)	Yugoslav dinar	(already in use)	pegged to deutsche mark (DM)
Slovenia	Slovenian tolar	October 1991	managed against DM
Croatia	Croatian dinar Croatian kuna	December 1991 May 1994	managed against DM
Macedonia, FYR	Macedonian denar	April 1992	pegged to DM
Bosnia and Herzegovina	Bosnia and Herzegovina dinar[a] Convertible marka	July 1992 August 1997	pegged to DM

Source: Staff reports.

[a]Operations and transactions with the IMF were conducted in DM, which also circulated alongside dinars as a domestic medium of exchange.

effective market economy and did not need financial assistance from the IMF. Slovenia repaid its inherited obligations gradually through 1997. The Federal Republic did not begin borrowing until December 2000, after it finally completed the membership process. The other three new members all took advantage of the opportunity to borrow, each in its own way.

The Former Yugoslav Republic of Macedonia

The first successor to borrow from the IMF was the former Yugoslav Republic of Macedonia (FYR Macedonia). With by far the smallest economy of the group, FYR Macedonia accepted its share of the outstanding liabilities incurred by Yugoslavia before the breakup, and it was accepted as a member in the IMF in April 1993 after a brief dispute about the name of the country (discussed in Chapter 2). As noted above, the country already had a national currency, having abandoned the Yugoslav dinar and begun issuing a local "denar" in April 1992.

The first staff mission—arriving in Skopje in May 1993, led by Poul Thomsen (Deputy Division Chief, European I Department)—had difficulty evaluating the depth of the economy's depression, owing to a lack of reliable statistics. Clearly, however, trade and other economic activity had been hit hard by developments in neighboring countries. Trade with the rest of the former Yugoslavia was suppressed by the UN sanctions against the Federal Republic, and trade with other transition countries was depleted by the collapse of the CMEA and the depressed condition of most of the region. The staff estimated that industrial production barely exceeded half the level of three years earlier. On the positive side, FYR Macedonia had inherited a decentralized

economic system with a number of well-functioning enterprises and an open system of international trade and finance.[15]

The challenge in FYR Macedonia was to create the preconditions for a normal economy rapidly so that the authorities could obtain new flows of foreign aid and put it to good use before the economy degenerated much further. That would require quickly stabilizing monetary and fiscal conditions, reforming the state's role in the economy, and clearing arrears to both public and private creditors. The IMF began providing technical assistance on statistical and fiscal reforms within a few months after the Board accepted the request for membership. In February 1994, the Fund made its first loan to FYR Macedonia, the equivalent of $17 million (SDR 12.4 million, or 25 percent of quota), through the STF. Meanwhile, the government of the Netherlands organized a donors' group to help FYR Macedonia pay off its overdue debts to a variety of creditors and thereby qualify for new loans.

Completing even the initial stages of the transition process was bound to take several years for a country as economically depressed as FYR Macedonia, but the authorities responded well to the challenge and continued to benefit from support from the IMF and other international agencies. The Fund lent regularly to the country throughout the rest of the 1990s and well into the next decade. It made FYR Macedonia eligible for loans from the Enhanced Structural Adjustment Facility (ESAF) in 1994, but recognized that the authorities would need some time before the country could meet the high standards for that concessional facility. After the successful completion of a stand-by arrangement in 1995–96, macroeconomic policies were remarkably strong, in fact, strong enough to meet the Maastricht criteria for Economic and Monetary Union within the EU. When visiting Skopje in 1997, Camdessus pronounced this achievement "miraculous" under the circumstances, but the horrendous war raging just beyond the border tempered the Managing Director's optimism. The best that he could find to say about the country's economic prospects was that "it was heartening to note . . . that the worst outcome was not necessarily the most probable."[16]

The "worst outcome" soon receded from view, though the transition would be prolonged. FYR Macedonia borrowed through the ESAF in 1997 and 1998 and through the Poverty Reduction and Growth Facility (the successor to the ESAF) in 2000. By that time, the economy was improving sufficiently that further borrow-

[15]See "Former Yugoslav Republic of Macedonia—Staff Report for the 1993 Article IV Consultation," SM/93/171 (August 4, 1993).

[16]Report to the Executive Board after a visit to the former Yugoslav Republic of Macedonia; minutes of EBM/97/49 (May 14, 1997), p. 3.

ing could be done on normal market terms.[17] Lending continued until 2005, and in 2007 the authorities repaid all the outstanding loans three years ahead of schedule.

Croatia

The IMF began providing technical assistance to Croatia in November 1992, before completion of the membership process. The Fund approved a stand-by arrangement in October 1994 and quickly disbursed two loans through the STF, bringing Croatia's total indebtedness in April 1995 to about $237 million (SDR 150.1 million, or 57 percent of quota). Despite the difficulties Croatia faced, the Fund was reasonably impressed with the adjustment and reform effort under that stand-by arrangement and with the government's prospects for sound and sustainable economic growth. By the beginning of 1997, it was prepared to approve a much larger three-year arrangement through the Extended Fund Facility (EFF), which, if fully used, would more than triple Croatia's outstanding borrowings. The Executive Board approved the arrangement in March, and the authorities made the initial drawing.

In the months that followed, Croatia met nearly all the conditions under the EFF arrangement. The staff expected that the release of the second disbursement, scheduled for July 1997, would be routine. Accordingly, the staff circulated its assessment for approval by the Executive Board on a lapse-of-time basis, with no need for a formal Board discussion. Unexpectedly, the U.S. authorities objected and called for a meeting. Barry Newman (Alternate, United States) pointed out that Croatia was not in compliance with the international agreement for ending the conflict next door in Bosnia and Herzegovina. In particular, Croatia was alleged to be declining to extradite war criminals, restricting transportation between Bosnia and Herzegovina and Serbia, and limiting the movements of refugees. In the U.S. view, "the lack of compliance with the Dayton Accords was jeopardizing regional stability and had important consequences for [Croatia's] reform efforts [that] go to the heart of its capacity to repay the Fund."[18]

Most Executive Directors viewed Newman's "capacity to repay" argument as a transparent cover for the political objective of compelling Croatia to cooperate more fully with the Dayton peace process (on which, see Chapter 2, pp. 73–74). Directors were not comfortable with the prospect of the IMF making lending decisions on the basis of political concerns. Marc-Antoine Autheman (France) spoke for many in

[17]FYR Macedonia also borrowed a small amount (SDR 13.8 million, 20 percent of quota) through the CCFF in August 1999, to compensate for the effects on exports of the war in neighboring Kosovo. In June 2003, the IMF removed FYR Macedonia, along with Bosnia and Herzegovina, from the list of countries eligible to borrow on concessional terms. By then, both countries' per capita GDP was well above the standard cutoff level.

[18]Minutes of EBM/97/69 (July 9, 1997), p. 5. For the staff assessment, see "Republic of Croatia—First Review under the Extended Arrangement," EBS/97/115 (June 25, 1997).

saying that "it is essential for the Fund to abide by its mandate and to continue to refrain from making decisions on the basis of explicitly political purposes, however legitimate they may be. . . . I think it would be improper for the Board to substitute its judgment [for] the judgment [that] should be made by the United Nations Security Council." The Director representing Croatia, J. Onno de Beaufort Wijnholds (Netherlands), reacted furiously to the U.S. effort. Supported by Willy Kiekens (Belgium), staff representatives, and others, Wijnholds stressed that Croatia had ample foreign exchange reserves to guarantee its ability to repay the Fund even if its economic performance were to fall well short of projections. Treating countries this way could "signal the beginning of a breakdown of the Fund as an institution," he concluded. When Kiekens pressed the staff for examples of cases in which the Fund had failed to complete a program review after the country had satisfied the conditions specified in the arrangement, the staff was unable to cite any such instance.[19]

Set against this concern for the Fund's independence from political pressures was a concern that the international community was united in wanting the Dayton peace process to succeed, and a recognition that the government of Croatia was not doing its part. Initially, five other Directors, representing Germany, Italy, Japan, Saudi Arabia, and the United Kingdom, supported Newman's request for an indefinite postponement. Those six Directors held just over 37 percent of the voting power. Two Directors abstained, and the others all favored either an immediate approval of the disbursement or only a brief delay. The stated purpose of having a short delay was to give Directors time to consult further with their authorities, to try to generate consensus on the Board, and to give the UN and other institutions time to pressure Croatia independently on the political issues. Stanley Fischer (First Deputy Managing Director), who was chairing the meeting, concluded that the "short delay" option reflected the majority view. He promised to bring the matter back to the Board for further consideration within three weeks (that is, by the end of July).[20]

On July 25, the Board took up the issue for a second time, only to find that positions had barely shifted. As before, the Managing Director firmly argued that the review should be completed immediately in Croatia's favor. The majority, however, concluded that the request should be further postponed until after the IMF/World Bank Annual Meetings and taken up again no later than October 10. Wijnholds tried to force a vote on an earlier decision, but he ultimately withdrew the threat. Finally, on October 9, the Board quietly completed the review on lapse of time without further discussion.[21]

[19]Minutes of EBM/97/69 (July 9, 1997), pp. 6, 12, and 17 (Wijnholds); p. 9 (Autheman); and pp. 12–13 (discussion of precedents).

[20]Minutes of EBM/97/69 (July 9, 1997), pp. 3–18.

[21]See minutes of EBM/97/77 (July 25, 1997), pp. 3–16; and minutes of EBM/97/102 (October 15, 1997), pp. 125–26.

This incident severely strained relations between Croatia and the IMF and weakened the authorities' commitment to carry out the Fund-supported policy program. The authorities declined to borrow any of the money that the Fund had made available, and over the next year policies deviated substantially from the agreement reached early in 1997. In most respects, the economy continued to perform well, but financial stability suffered in 1998, and a recession set in during 1999. The EFF arrangement formally remained in place until it expired in March 2000, but the program lapsed, and no further performance criteria were ever set.

Bosnia and Herzegovina

Circumstances in Bosnia and Herzegovina were especially dire, owing to one of the worst internal and regional conflicts in post–Second World War European history. The Fund's relations with the country began in tandem with the November 1995 conclusion of the Dayton peace accords, which aimed to end the conflict in Bosnia and Herzegovina that had given rise to the gruesome phrase "ethnic cleansing." Three major ethnic groups—Bosniaks, Croats, and Serbs—coexisted uneasily both in the new country and in neighboring regions. Security in and around the capital city, Sarajevo, was poor, and the economy was in shambles. IMF staff found that per capita GDP had fallen by 75 percent, from \$2,400 in 1990 to \$600 in 1995.[22]

Before the IMF could lend to Bosnia and Herzegovina, the country first had to start settling the arrears on debt it inherited from the breakup of Yugoslavia in 1992. Total arrears to external creditors were estimated to be about \$2 billion, including some \$37 million in overdue obligations to the IMF. The small IMF slice was solved easily through carefully coordinated transactions on or near December 20, 1995. First, the U.S. government made a short-term loan to enable Bosnia and Herzegovina to pay the reserve-asset portion of its quota subscription so that it could complete the process of becoming a member of the IMF. The Netherlands provided a similar bridging loan, which the authorities used to settle their arrears to the Fund. Then the Executive Board approved an Emergency Post-Conflict Assistance (EPCA) loan of \$45 million (SDR 30.3 million, or 25 percent of quota), part of which the authorities could use to repay the Netherlands. On balance, this sequence provided Bosnia and Herzegovina with about \$8 million in foreign exchange reserves. Finally, the authorities drew out their reserve tranche balance and used those proceeds to repay the United States.

With these initial agreements in place, the Bosnian authorities set about clearing other external arrears, including through a similar arrangement with the World Bank

[22]For the background, see "Republic of Bosnia and Herzegovina—Use of Fund Resources—Emergency Post-Conflict Assistance," EBS/95/215 (December 8, 1995), pp. 1–5. The per capita GDP figures quoted here were revised upward in the first half of 1996 from those reported in EBS/95/215. These data are from "ESAF Eligibility—Bosnia and Herzegovina," EBS/96/121 (July 29, 1996), p. 2.

and a rescheduling by the Paris Club.[23] Meanwhile, the Fund provided technical assistance on a wide range of topics and set up a Resident Representative office in Sarajevo. Both the Bank and the Fund declared Bosnia and Herzegovina to be eligible for borrowing on concessional terms, with the intention that the economy would grow out of that low-income status within a couple of years.

The Fund's EPCA loan did not require the authorities to agree to a detailed economic policy program. It required only a statement of principles aimed at leading to a fully articulated program as soon as possible. As a critical first step, the authorities agreed to establish a strict monetary policy, similar to a currency board, to ensure that they could preserve parity between the dinar and the deutsche mark. The most serious obstacle to further progress was political in origin but had undeniable economic consequences. The Dayton accords had recognized that the country was divided into two major political entities: the Federation of Bosnia and Herzegovina and the Republika Srpska. The Fund took the view that it could not undertake further lending until both divisions had functioning policies in place and were willing to cooperate with each other. "Without closer cooperation," the staff argued, "no government in Bosnia and Herzegovina will have the capacity to implement a program to address the country's balance of payments problems—even in the Federation, let alone for the whole country."[24] Overcoming deep-seated ethnic rivalries and hostilities was going to take time.

By 1998, Bosnia and Herzegovina had made adequate progress toward stabilizing the economy, controlling the budget, and establishing viable market institutions, allowing the Fund to offer new loans. Real political cohesion was still some way off, but the country had a new central bank with an IMF-appointed governor. The central bank was operating an effective currency board arrangement with a new currency (the convertible marka) that was circulating as legal tender throughout the whole territory. Other currencies were still circulating in parallel, and structural reform was still embryonic. Consequently, the Fund could not offer an ESAF arrangement, and the authorities had to settle for a smaller, shorter-term, and more expensive stand-by arrangement. Everyone hoped that this arrangement could be replaced in 1999 by a three-year ESAF arrangement. Instead, as progress continued at a slow pace, the Fund repeatedly ex-

[23]World Bank procedures for clearing arrears were simpler than those of the IMF and permitted direct consolidation of outstanding obligations, including amounts that were in arrears, into new loans. The Bank completed that process in June 1996. It also provided new financial assistance throughout 1996, starting even as the membership accession process was still under way. For a summary, see Appendix II of "Bosnia and Herzegovina—Staff Report for the 1996 Article IV Consultation," SM/96/203 (August 5, 1996).

[24]"Bosnia and Herzegovina—Staff Report for the 1996 Article IV Consultation," SM/96/203 (August 5, 1996), p. 7.

tended the stand-by arrangement until the last tranche was finally drawn in May 2001.[25]

Other New Members

Three other formerly socialist countries joined the IMF and received policy advice and financial assistance to support their transitions to a market economy: Albania, Bulgaria, and Mongolia.

Albania

Adjacent to Yugoslavia on the western edge of the Balkan Peninsula, Albania stood out as the world's most isolated and autarkic country throughout the Cold War era. Its communist dictator from 1944 to 1985, Enver Hoxha, rejected both the Soviet and the Chinese economic systems as insufficiently faithful to Marxism and Leninism. By the 1980s, Albania's political and social isolation from the rest of the world was practically complete, and its economic ties were limited to a relatively small amount of trade with European neighbors and China.[26] Disillusionment on China's part, Hoxha's death, and the collapse of the CMEA and the Soviet system put this regime in an untenable position. Estimates of per capita income were not reliable, but incomes obviously fell far short of those of any other European country, at no more than a few hundred dollars a year.[27] In the second half of the 1980s, Albania embarked on its own form of *glasnost* and *perestroika*, a journey that culminated in full democratization in 1992.

In January 1991, Albania applied to join the IMF. Discussions began on the size of the quota and other matters, and Albania became a member on October 15. By that time, popular pressure for democratization was becoming overwhelming. The communist-led coalition resigned in December, to be replaced by a democratically elected government in March 1992. These developments paved the way for the Fund to conduct its first full review of the economy and of economic policies. This initial Article IV consultation revealed more clearly the extent of Albania's devastation and poverty, but it also convinced the IMF that the new government was already implementing a

[25]Bosnia and Herzegovina never drew on the ESAF (or on its successor, the Poverty Reduction and Growth Facility) before the Fund removed the country from the list of eligible borrowers in 2003. The Fund approved a second stand-by arrangement in 2002, which was fully drawn. In 2008, the authorities completed the repayment of all their outstanding borrowings.

[26]For the IMF's initial analysis of developments up to 1991, see "Albania—Calculation of Quota," EB/CM/Albania/91/1 (September 13, 1991).

[27]In 1991, the staff estimated 1990 GDP per capita to have been $623 at the prevailing commercial exchange rate; "Albania—Calculation of Quota," EB/CM/Albania/91/1 (September 13, 1991), p. ix. A year later, it estimated the 1991 figure to be closer to $300; see "Albania—Staff Report for the 1992 Article IV Consultation and Request for Stand-By Arrangement," EBS/92/121 (August 3, 1992), p. 6a.

serious and well-designed stabilization and reform program. In August 1992, instead of starting slowly with a small STF loan as it had for several other transition economies, the Fund approved a regular stand-by arrangement for 80 percent of Albania's quota (SDR 20 million, equivalent to $29 million).

Because of the high risks of lending to a country at such an early stage of the transition, the Fund required the authorities to complete several of the key policy conditions before approval of the 1992 stand-by arrangement. The authorities did so, and they also successfully met all the performance criteria once the arrangement was in place. Within a year, the Fund escalated its commitment by approving a three-year ESAF arrangement for 120 percent of quota (SDR 42.4 million, or $59 million).[28] That, too, succeeded, as the government stabilized its finances and aggressively promoted private sector development. Economic growth averaged about 9 percent a year, and the authorities drew the first four semiannual tranches of the ESAF arrangement (Figure 6.4).

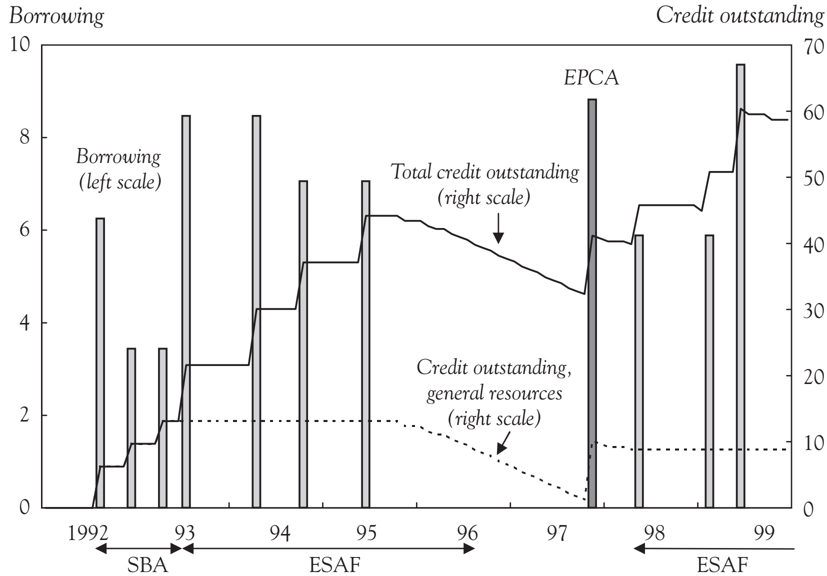
Albania's economic transformation soon got ahead of the development of sound institutions, with calamitous results. By 1996, a large number of informal investment companies running Ponzi schemes and other financial pyramids overwhelmed the banking system. As those schemes spiraled out of control, their nominal value approximated six months of GDP. When they inevitably collapsed, near the end of 1996, the ensuing panic threatened to bring down much of the economy. Inflation soared, output and government revenues fell sharply, and the value of the currency collapsed. The government was unable to contain the panic, which worsened throughout the first half of 1997. By March, the country was in a state of anarchy. Only when a UN peacekeeping force restored order and national elections led to a new government could a new beginning be made.[29]

As the size of the pyramid schemes grew in the second half of 1996, the IMF, the World Bank, and other external advisors warned the authorities of the dangers, to no avail. In November, Camdessus wrote to President Sali Berisha (whom he knew from a visit to Albania in 1992) to warn him that "there is an urgent need to tackle the rapid and uncontrolled expansion of the informal deposit market." A staff mission, led by Ranjit Teja (Deputy Division Chief, European I Department, or EU1) was in Tirana at the time, and rumors quickly spread that the IMF was trying to shut down what most people in the country still thought were legitimate businesses. Teja held a press conference during which he warned the public about the true nature of the schemes and explained that the government, not the IMF, was responsible for dealing with them:

[28]Albania's quota had been raised from SDR 25 million to SDR 35.3 million in November 1992, as the result of a general quota review.

[29]The rise and fall of the pyramid schemes is summarized in "Albania—Use of Fund Resources—Emergency Post-Conflict Assistance," EBS/97/188 (October 16, 1997). See especially Box 1, p. 6. For a detailed analysis, see Jarvis (2000). Jarvis suggests that "the IMF and the World Bank should have seen the problem in Albania coming earlier, and warned the authorities more sternly"; and that the government ultimately handled the crisis well enough (including by refusing to bail out the perpetrators of the schemes) to limit the macroeconomic effects.

Figure 6.4. Albania: Use of Fund Credit, 1992–99
(In millions of SDRs, monthly data)



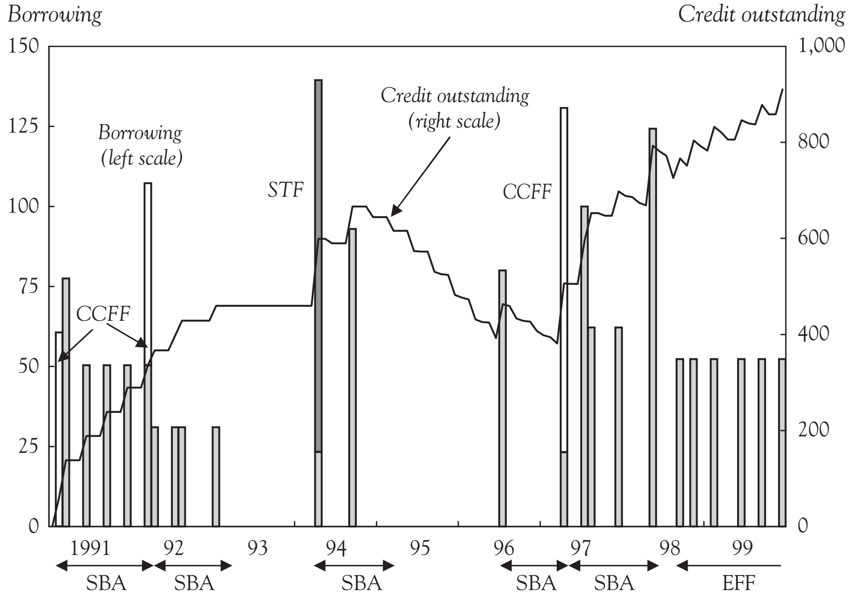
Source: International Financial Statistics.
Note: EPCA = Emergency postconflict assistance; ESAF = Enhanced Structural Adjustment Facility; SBA = Stand-by arrangement. "Credit outstanding, general resources" excludes ESAF loans.

"fraud in the informal market was indeed a concern, but . . . it was up to the authorities to investigate and take action in the public interest."[30]

Those discussions failed to lead to an agreement, either on controlling the pyramid schemes or on a resumption of IMF lending to Albania. Specifically, the staff rejected the government's policies as a basis for approving the third annual disbursement from the ESAF. The Fund thus was largely sidelined during the collapse in 1997. After order returned, the new government asked the Fund to renew its assistance. The Fund responded quickly by lending $12 million (SDR 8.8 million, or 25 percent of quota) as an EPCA loan in November 1997 and resuming ESAF lending six months later.

[30]For Camdessus's letter, see attachment to memorandum from Massimo Russo (Director, EU1) to the Managing Director, "Albania: Draft Response to Letter from President Berisha," November 15, 1996. For the mission's findings and actions, see memorandum from Teja to the Acting Managing Director, "Albania—Back to Office Report following ESAF and Article IV Consultation Discussions," (December 4, 1996). The staff became aware of the pyramid schemes and first warned the authorities to take action in August 1996. See memorandum from Teja to the Managing Director, "Albania—Back-to-Office Report," August 16, 1996. These documents are in IMF Archives, OMD-AD, Accession 1999-0270-0001, "Albania 1996."

Figure 6.5. Bulgaria: Use of Fund Credit, 1991–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics.
Note: CCFF = Compensatory and Contingency Financing Facility; EFF = Extended Fund Facility; SBA = Stand-by arrangement; STF = Systemic Transformation Facility.

Albania successfully implemented the ESAF-supported program, put the reform effort back on track, and borrowed the full available amount.[31]

Bulgaria

When Bulgaria joined the IMF in 1990, it was undertaking a complete political and economic transformation while simultaneously trying to cope with a large overhang of debt to external commercial creditors. As noted in the preceding chapter, the staff warned the Executive Board that Bulgaria was likely to be a prolonged user of Fund resources for years to come. Sadly, that prediction proved to be correct (Figure 6.5). The government managed to restructure its debt by 1994, with substantial financial and other assistance from the IMF. That story is told in Chapter 9, along with other debt-restructuring cases. The transformation of economic policy proceeded more slowly, and this gradual approach eventually led to a serious financial crisis.

[31]For an analysis of the postcrisis reforms, see Treichel (2002).

When national elections were held in December 1994, Bulgaria was out of compliance with the terms of its third stand-by arrangement with the IMF, owing mainly to lax monetary control and weak regulation of the banking system. The Bulgarian Socialist Party (the former Communist Party) won those elections and set out to take an even slower and less-committed approach to economic reform. The financial imbalances worsened throughout 1995, degenerating into a crisis in 1996. A high and rising fiscal deficit, the collapse of some prominent pyramid schemes, and rumors of bank solvency problems led to a series of bank runs. Ironically, the panic worsened after the government announced a limited deposit insurance plan, because most depositors had previously assumed the existence of an implicit government guarantee on *all* deposits. Capital inevitably took flight. In the first five months of 1996, the central bank's foreign exchange reserves and the exchange value of the currency (the lev) both fell by half.[32]

At that point, the Bulgarian government decided to try to make a clean break with the past, stabilize the economy once and for all, accelerate market reforms, and put the country on a clear path toward eventual membership in the EU. Along with the first steps in that direction, the authorities applied for a fourth stand-by arrangement.

A notable element in the reform program that the Fund was being asked to support was a restructuring of the domestic banking system. The plan included closing or taking over the weakest banks and recapitalizing others. The staff mission, led by Anne Kenny McGuirk (Division Chief, EU1), supported the plan but cautioned that "virtually all" of the Bulgarian banks were insolvent. Restoring confidence in the banking system and in the government's ability to manage the economy was going to require both a "bold and carefully structured . . . strategy" and a great deal of imagination and luck.[33] An overlapping mission from MAE, led by Charles A. Enoch (Division Chief), arrived in Sofia to provide technical assistance.

The Fund put approval of the stand-by arrangement on a fast track to quell rumors and assure the Bulgarian public that the international community supported the government's program. Fears became so acute that at the last minute, management rescheduled the Board meeting from the afternoon to the morning so that news of the approval of the stand-by arrangement could reach Sofia before financial markets closed for the day. On the Executive Board, a few Directors were every bit as skeptical as the Bulgarian public, particularly because the economic news from Sofia continued to worsen in the days leading up to the Board meeting. The previous government's track record had been poor, and the odds of sustained implementation in the future seemed

[32]These developments are reviewed in "Bulgaria—Request for Stand-By Arrangement," EBS/96/116 (July 5, 1996), pp. 2–5.

[33]"Bulgaria—Request for Stand-by Arrangement," EBS/96/116 (July 5, 1996), p. 6.

almost as poor. With full knowledge of the risks, the Board approved the arrangement unanimously on July 19, 1996.[34]

The Fund-supported program quickly failed, mainly because the public at large had no confidence in the banking system, nor in the government's ability to manage the economy. On macroeconomic policy, the authorities were doing all that they could—the primary fiscal surplus exceeded 10 percent of GDP. But every effort to strengthen the banking system was being undercut by continuing runs on deposits and continuing flight into deutsche marks and dollars. A drastic departure from this orthodox strategy was needed.

McGuirk and her staff team returned to Sofia in November 1996 to negotiate a new program. On this occasion, Michael Deppler (Deputy Director, EU1) joined them to raise the profile and the political influence of the mission. That escalation came at a critically important juncture because the staff was about to press the authorities to take a radical step that they would be loathe to take on their own. After meeting with President Zhelyu Zhelev and other senior officials, Deppler held a press conference to announce that the IMF was asking the government to establish a currency board arrangement as the basis for monetary policy. By placing a strict legislative limit on the issuance of currency, the government would tie its own hands and thus increase its credibility—at least, that was the hope. If it failed, the government would have no backup resources to stabilize the economy.

The imminent prospect of a total financial meltdown in Bulgaria compelled the timing of the Fund's proposal, but it was politically awkward. Zhelev was a lame-duck president, having been defeated in an election in late October. The national assembly would thus have to debate and enact highly controversial legislation in a politically charged environment. Although the major political parties publicly supported the currency board proposal, the government's support was understood to be shallow, and it was not shared by the leadership at the central bank. As the debate over this and other reforms proceeded, Prime Minister Zhan Videnov found his own political support waning, and he abruptly resigned on December 21. Realizing that it was now working in a political vacuum, the IMF staff had no choice but to return to Washington and wait for a new government to emerge.

On February 12, 1997, the Bulgarian National Assembly named a caretaker government led by a former opposition party, the Union of Democratic Forces (UDF). A week later, McGuirk's team returned to Sofia to resume negotiations. Once the technical

[34]See minutes of EBM/96/69 (July 19, 1996), pp. 3–31. Vicente J. Fernández (Alternate, Spain) objected to the front-loading of scheduled disbursements in the arrangement, but he did not abstain from approving it. Alassane Ouattara (Deputy Managing Director), who was chairing the meeting, took note of the "considerable reservations" that some Directors had expressed.

details were set, Deppler also returned, and an agreement was quickly finalized.[35] In the meantime, the economic collapse had become much worse. Faced with hyperinflation (prices were rising at a monthly rate of 240 percent) and Depression-era output declines, Bulgarians were ready to embrace reform and the proposal for a new Fund-supported program.

The severity of the economic downturn improved the feasibility of the proposed currency board, economically as well as politically. With the lev greatly depreciated against major currencies, the authorities could peg it to the deutsche mark with full backing for the outstanding currency issue. The staff and the authorities worked out the details over the next few months, during which time the UDF won control in parliamentary elections. Advocates of reform now had a clear mandate, and the new government established the currency board in July.

Finally, the reform effort took hold.[36] The IMF approved a fifth stand-by arrangement in April 1997 and followed that with an extended arrangement in September 1998. The authorities carried out these programs as expected, and economic performance steadily improved. The staff's initial prediction had proved correct: Bulgaria had become a prolonged user of Fund resources, with borrowing arrangements in place almost continuously from 1991 through 2004. By then, however, the market economy was well established. In April 2007, the authorities repaid all outstanding credits ahead of schedule. One month later, they acceded to membership in the EU. The currency board arrangement, established in 1997 as a last-ditch measure to stabilize an economy in crisis, remained in place as an anchor while Bulgaria moved toward formal entry into the euro area.

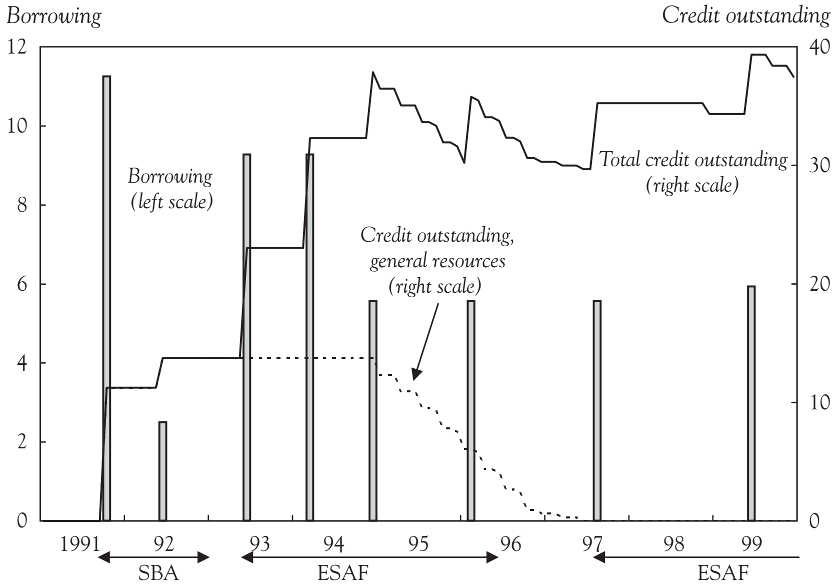
Mongolia

The Mongolian People's Republic was founded as an independent state in 1924, ending an era of Chinese rule or dominance. Political and economic ties with Mongolia's northern neighbor, the Soviet Union, were gradually strengthened over those with China, on its southern border. Throughout the Cold War period, Mongolia maintained an economic system based on central planning, similar to the Soviet model. A succession of rulers gradually managed to reduce Mongolia's international isolation. After 15 years of rejection, the UN admitted Mongolia as

[35]See "Bulgaria—Use of Fund Resources—Request for Stand-By Arrangement and Request for Purchase Under the Compensatory and Contingency Financing Facility," EBS/97/53, Suppl. 1 (April 3, 1997). For the staff's detailed proposal for the currency board arrangement, see the (unnumbered) technical assistance reports, "Bulgaria—Preparations for a Currency Board Arrangement," Volumes I and II (February 1, 1997).

[36]For an overall assessment, see "Bulgaria: Ex Post Assessment of Longer-Term Program Engagement" (May 19, 2004); accessed at http://www.imf.org/external/pubs/ft/scr/2004/cr04176.pdf.

Figure 6.6. Mongolia: Use of Fund Credit, 1991–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics.
Note: ESAF = Enhanced Structural Adjustment Facility; SBA = Stand-by arrangement. "Credit outstanding, general resources" excludes ESAF loans.

a member in 1961. Only in June 1990, however, did the government apply to join the IMF.[37]

A new constitution in May 1990 provided for multiparty elections. The ruling Communists (reconstituted as the Mongolian People's Revolutionary Party) won the elections but brought representatives of other parties into the government and initiated an economic reform program. Stabilizing the economy proved difficult because the collapse of the CMEA and upheaval in the Soviet Union severely disrupted external trade. Output, already so low as to classify Mongolia as a low-income developing country, was being further depressed by external conditions. To help the country cope, the IMF began providing technical assistance in November 1990, advising primarily on tax reforms. The IMF broadened and intensified that assistance in 1991, after Mongolia became a member of the Fund on February 14. The Fund also acted quickly to offer financial assistance, as the Executive Board approved a stand-by arrangement for $30 million (SDR 22.5 million, or 90 percent of quota) in October 1991.

[37]For a more detailed history, see Milne and others (1991), and references therein. That monograph was based on the initial staff report to the Executive Board, "Mongolia—Calculation of Quota," EB/CM/90/1 (November 29, 1990).

A change of government in 1992 derailed economic policy for a time, and Mongolia received only the first two scheduled disbursements under the stand-by arrangement. By mid-1993, however, the authorities were getting policies back under control, and they prepared a Policy Framework Paper—the essential requirement for gaining access to ESAF loans. More generally, the government was demonstrating a remarkable capacity for economic reform at a time when its institutional development was still in its infancy. Prices were being set freely in the market, private enterprise was flourishing, the floating exchange rate was unified and reasonably stable with little intervention, and inflation was low and falling. The Fund responded in June 1993 by approving a three-year ESAF arrangement for $58 million (SDR 40.8 million), thereby shifting Mongolia's borrowing into that longer-term and less-expensive facility (Figure 6.6).

The difficulty of establishing strong public and financial institutions continued to plague Mongolia. Throughout the three-year period of the ESAF arrangement, the banking system was subject to periodic runs by depositors, and weaknesses in the interbank market occasionally resulted in unstable exchange rate movements. The slowing pace of reform led the IMF to delay disbursements under the arrangement, which expired in June 1996 with a quarter of the total unused.

Elections in 1996 and 1997 brought new coalitions to power, but the focus on market-oriented reforms remained in place and gradually intensified. Fund staff regularly reviewed the government's economic program and broadly endorsed it. In July 1997, the Fund resumed lending, with a three-year ESAF arrangement for $46 million (SDR 33.4 million).

Overall, the issue for the Fund in assisting Mongolia throughout most of the 1990s was not whether the government was sufficiently committed to its program. The Fund did not have to push the Mongolian authorities. The issues were whether implementation was forceful enough to maintain momentum, and whether the right balance was being struck between stabilization of macroeconomic conditions and reform aimed at stimulating medium- and longer-term growth. The Fund's confidence in the government's course of action increased further in the late 1990s, as the only serious setback came in the wake of the regional crisis across East Asia and Russia in 1997–98. That crisis interrupted the ESAF-supported program for a time, but by 1999 it was back on track.

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7

Russia: From Rebirth to Crisis to Recovery

NOT A SINGLE REFORM EFFORT IN RUSSIA HAS EVER BEEN COMPLETED.

Boris Yeltsin
President of the Russian Federation
1994

On August 19, 1991, hard-line communist forces in the Soviet Union launched a military coup against President Mikhail Gorbachev in reaction to his efforts to give greater autonomy to the Soviet republics. In Moscow, with Gorbachev under house arrest in Crimea 1,200 kilometers to the south, Russian President Boris Yeltsin climbed atop a tank outside the parliament building to call for a general strike and for the armed forces to oppose the coup. The resulting popular fervor and military support crushed the conspiracy and restored order within two days. Although Gorbachev quickly returned to the Kremlin, Yeltsin now held the reins as the union collapsed and the Russian Federation emerged as the successor state and dominant regional power. Almost exactly seven years later, on August 16, 1998, a physically ill but still politically powerful Yeltsin faced a financial crisis that threatened to undo all the economic and perhaps even the political reforms he had brought to Russia. The Russian ruble, the strength of which was the most visible symbol of his success, verged on toppling, and Yeltsin had no choice but to agree to a default on a substantial part of his government's debt.

The path that Yeltsin and Russia took from the political crisis of 1991 to the financial crisis of 1998 was one of steep slow climbs and precipitous crevasses. The promised rewards at the end were a strong, healthy economy; a free and democratic political system; and a welcome to a seat in global councils. The potential cost of failure would be an impoverished country of nearly 150 million people; a return to communist or ultranationalist dictatorship; and political isolation from a world community fearful of Russia's massive arsenal of nuclear weapons. Helping Russia's

leaders succeed, whatever their faults might be, was the most important task and the biggest challenge facing every world leader and every international institution—none more than the IMF. At the end of the decade, Yeltsin's pessimistic observation (quoted above) remained true, with the push for democracy and economic reform still meeting resistance. Even so, economic progress was palpable, and the worst risks seemed to have been conquered.

First Steps

Once the baton of leadership passed to Yeltsin, he did not hesitate to run with it. On January 3, 1992, less than a week after becoming the undisputed sovereign head of the Russian Federation, he wrote to the Fund's Managing Director, Michel Camdessus, applying for IMF membership.[1] Standing behind Yeltsin and spearheading this move was First Deputy Prime Minister Yegor Gaidar. Gaidar had been picked to oversee the economy of one of the world's great powers, but he understood full well that the economy was virtually bankrupt.[2] At the moment that Russia emerged as the successor to the Soviet Union, it inherited responsibility for a rising stock of some $66 billion in external debt, and it possessed only a declining stock of not much more than $2 billion in net gold and foreign exchange reserves.[3] Consumer goods were extremely scarce because the Soviet production and marketing systems had effectively ceased to function. Without full cooperation from creditor countries, Russia could neither service its debts nor escape from its rapid descent into widespread deprivation and poverty. Securing that cooperation, as the Group of Seven (G7) industrial countries made clear, would require the IMF to take on a central role as policy advisor, lender, and coordinator of western assistance.

[1]"Russian Federation: Application for Membership," EBD/92/4 (January 7, 1992). Yeltsin was elected president of Russia on June 12, 1991, and shared power with Gorbachev until the dissolution of the Soviet Union.

[2]Yegor Timurovich Gaidar was one of the leading advocates of economic and political reform in Russia throughout the first two decades of the transition. Although he was in the government only intermittently in the 1990s, as described throughout this chapter, he continued to influence the reform process as a politician, as the founder and director of the Moscow-based Institute for the Economy in Transition, and as a prolific writer who authored several best-selling books. Gaidar was one of the most frequent and helpful contacts for senior IMF officials throughout the 1990s. He died in 2009, just 53 years old.

[3]Even though the Soviet Union was one of the world's largest miners of gold, its official holdings at the end of 1991 were reported at just 290 tons (then worth approximately $3.2 billion), and a substantial portion of that stock was pledged as collateral for various foreign obligations. As of end-March 1992, Russia reported its net international reserves to the Fund as $2.25 billion; see "Russian Federation—Use of Fund Resources—Request for First Credit Tranche Stand-By Arrangement" (EBS/92/119, Suppl. 3, July 24, 1992), Table 6; and Letter of Intent (EBS/92/119, July 10, 1992), p. 16.

The link between G7 assistance and Russia's cooperation with the IMF had started with the joint study of the Soviet economy in 1990 (IMF and others, 1990), had been reinforced by the Special Association agreement in July 1991, and had been cemented in a G7 accord on Soviet external debt in November.[4] Although it would take several months to complete the process of bringing Russia formally into IMF membership, these earlier agreements paved the way for the Fund staff to open discussions immediately on an economic reform program.

A Preliminary Economic Reform Program

For the Fund to negotiate and agree to monitor a program for a nonmember country was unprecedented, but so were the circumstances. The Special Association agreement provided a mandate and a framework, and the Fund eagerly seized the opportunity and the responsibility thrust upon it. The more ominous aspect of the arrangement, as would become increasingly clear in the ensuing years, was the G7's controlling role over the ostensibly independent activities and decisions of the IMF in its relations with Russia.

Gaidar's reform campaign began with a bang when the government ended controls on all but a few prices on January 2, 1992. Because most prices had been kept artificially low and because little competitive pressure acted to hold market prices down, this liberalization quickly led to a 10-fold increase in the overall price level, but it also quickly succeeded in bringing consumer goods back into shops where shelves had long been almost bare.[5] Preventing this initial and necessary adjustment from turning into ongoing and destructive inflation posed the next challenge. The Central Bank of Russia absorbed and replaced the old Gosbank, but it was still far from being a real central bank with the means, mandate, and will to stabilize the price level by limiting the banking system's access to liquidity. Two separate IMF mission teams spent most of January in Moscow trying to assess the situation, but they had to spend the greater part of their time just collecting basic data from officials who were still reluctant to release it.[6]

Russia attached the highest priority at this point to reaching an agreement with the Fund on stabilizing the economy, because that would unlock access to possibly large-scale financial assistance from the G7 and other donors. That goal was achieved fairly easily because Gaidar and John Odling-Smee (Director, European II Department, or EU2), largely saw eye-to-eye on the major policy issues. After some

[4]Relations with the Soviet Union in 1990 and 1991 are covered in Chapter 2. The settlement of Soviet debt is discussed in Chapter 8.

[5]The economic effects of the price liberalization are analyzed in Koen and Phillips (1993).

[6]Memorandum from Ernesto Hernandez-Catá to the Managing Director, "Russia—Back-to-Office Report" (January 29, 1992); and memorandum from Tobias Asser, Joseph Lang, and Orlando Roncesvalles to the Managing Director, "Russian Membership" (January 31, 1992); IMF archives, OMD-AD, "Russia 1992 – (1) Country Files," Box 22043, Accession 1996-0187-0006.

haggling over the targeted inflation rate, the staff and the Russian authorities agreed on the text of a Memorandum on Economic Policies (MEP; similar to a Letter of Intent for a conventional Fund-supported policy program) before the end of February. Camdessus understood that political support for the reforms was limited in Russia, as was the government's administrative capacity to carry out its intended policies,[7] but he had no choice other than to gamble on the authorities' ability to get the job done.

Russia's Quota

Before the Fund could lend to Russia, the Executive Board had to decide on the terms on which Russia could become a member of the Fund. Politically, Russia was sufficiently important to have a quota large enough that it could elect its own Executive Director—but not so large as to put it in the top five members with the right to appoint their Directors, nor so large as to encroach upon the G7.[8] Those considerations implied that the quota should be in the range of 2.5 percent (just above China) to 3 percent (just below Italy) of total quotas. Illustrative calculations by the staff, using the standard quota formulas but relying on data that were known to be of poor quality, suggested a similar range.[9] Within that range, the prevailing view among the sitting Directors gravitated toward setting the quota closer to the lower end to avoid upsetting the balance of power any more than necessary.[10] When this proposal was put to the Russian negotiator, Konstantin Kagalovsky, he rejected it as categorically unacceptable.[11]

In the absence of reliable data, political considerations guided the quota discussions. In the view of the Russian government, the Fund's quota calculations reflected the temporarily depressed state of its economy, not its real potential and certainly not its geopolitical importance. After all, at Bretton Woods in 1944,

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[7]Statement by the Managing Director to the Executive Board, BUFF/92/36 (February 27, 1992).

[8]The Articles of Agreement specify that the five countries with the largest quotas are to appoint their own Directors. In addition, if any other member is one of the top two creditors of the Fund, it also may appoint a Director. All others participate in a biennial election of Directors. In 1992, two members—China and Saudi Arabia—had chosen to elect Directors using only their own votes, rather than forming or joining a multicountry constituency.

[9]See "Quota Calculations for the Republics of the Former Soviet Union—Methodological Issues," EB/CW/QMethodology/92/1, February 28, 1992; and "Republics of the Former Soviet Union—Qualitative Factors and the Ratio of Actual to Calculated Quotas," EB/CW/QMethodology/92/2, March 19, 1992.

[10]See the minutes of the Committee of the Whole on Membership for the Republics of the Former U.S.S.R., EB/CWM/Former USSR/MTG/92/1 through EB/CWM/Former USSR/MTG/92/6, March 16–30, 1992.

[11]The following account is based primarily on interviews with participants in the discussions. For an external perspective, see Momani (2007).

the Soviet Union had been assigned the third largest quota (13.6 percent of the total), behind only the United States and the United Kingdom. Updating that original quota at the average rate of increase for all members and then allocating Russia its current portion of the Soviet-area economy would produce a quota share of about 6 percent (second only to the United States and slightly above Germany and Japan). The British Executive Director, David Peretz, who was looking after Russian interests in the Fund discussions, managed to convince the Russians that a quota of that magnitude was out of the question. The most they could realistically hope to get was 3 percent, the top end produced by the quota formulas.

In the first round of informal discussions among Executive Directors from the G7 countries, Peretz dutifully argued for a 4 percent share, while some others—notably Hiroo Fukui (Japan)—tried to put politics aside and offer a share below 3 percent. When Kagalovsky found that he could not even get to the 3 percent level in talks at the Fund, he took his case to the bosses of the G7 Executive Directors, the finance deputies. He met with the U.S. deputy, David C. Mulford, in Washington; traveled to London, Paris, Bonn, and Rome to talk to the European deputies; and reached the Canadian and Japanese deputies by telephone. Meanwhile, and far more important, Yeltsin took the quota case directly to U.S. President George H.W. Bush. With the White House now behind him, Kagalovsky easily lined up enough support to pressure the Fund to raise the quota offer to 3 percent. That still put Russia in ninth place, but now just below the smallest quota for a G7 country (Italy).[12]

With that dispute effectively settled, the Executive Board met on March 30 to give its informal blessing to the Russian program, as set out in the MEP. ("Directors commended the Russian authorities for having launched a bold and comprehensive economic reform program, which until a few months ago would have appeared almost inconceivable.")[13] Camdessus chaired the meeting, calling it "a most historic occasion." Kagalovsky addressed the Board in the same spirit, stressing the importance of Fund membership and of the program for the future of Russia. "Now we begin a radical economic reform," he concluded, "the target of which is to build a normal market economy and democratic society. We do not want to find unique ways for our approach. Rather, we want to use the traditional economic approach of stabilization and liberalization of the economy."[14] The reality, of course, was far more complex, but whatever foreboding those sitting in the Board room may have felt was overshadowed for the moment by the excitement of finally fulfilling the vision of the founders at Bretton Woods of the IMF as a universal institution.

[12]The eight largest quotas were held by the G7 countries plus Saudi Arabia.
[13]Minutes of EBM/92/39 (March 30, 1992), p. 76.
[14]Minutes of EBM/92/39 (March 30, 1992), p. 6.

G7 Support

The IMF's approval of the Russian program put the ball back in the G7's court. Two days later, on April 1, 1992, President Bush and German Chancellor Helmut Kohl announced that the G7 had approved a one-year financial support package for Russia totaling $24 billion. That figure, however, was just a headline number that disguised how little money was actually being offered directly by the G7 countries. Of the total, $6 billion was earmarked for a ruble stabilization fund, modeled on the fund established for Poland two years earlier, to be administered by the IMF upon satisfaction of the as-yet unspecified preconditions.[15] Another $4.5 billion was the estimated potential value of loans that might be extended by the IMF and the World Bank. A debt rescheduling approved by Paris Club creditors in January constituted another $2.5 billion.[16] The remaining $11 billion was to be offered in the form of bilateral assistance from the G7 countries, but much of that was not yet budgeted or specifically committed, and all of it depended on Russia and the IMF agreeing on a program of economic reforms.[17] In fact, the ruble stabilization fund never materialized, multilateral assistance fell well short of projections because Russia failed to meet the program conditions, and bilateral assistance took longer than expected to be disbursed.[18] The Grand Bargain envisaged in 1991—large-scale financial assistance from the west to support fundamental economic reforms in Russia (see Chapter 2)—was far from being realized.

Without any doubt, Russia desperately needed financial support. The Russian reform program was exacerbating the country's economic decline—the MEP projected an astonishing 50 percent drop in output over three years, starting from an already depressed level, before an anticipated recovery in the second half of the 1990s. The Fund staff estimated that preventing an even worse short-run decline would require external financing of some $17 billion in 1992, not including the proposed currency stabilization fund. Failure to implement the reforms would also make matters worse. In other words, Russia needed all the money in the G7's advertised package, and it needed to fully implement the policies outlined in the MEP, neither of which could be considered likely.

[15]The idea of a ruble stabilization fund was first broached by Gaidar, reportedly with support from the IMF, in December 1991 (Braithwaite, 2002, p. 308).

[16]Although the G7 announcement treated these sums as part of their package, the financing was envisaged as coming from a broader group of creditor countries. The currency stabilization fund would have been financed by activating the General Arrangements to Borrow, in which 11 countries participated. The funds for IMF and World Bank lending would have come from the 40 or so creditor countries in the membership. The debt rescheduling involved 17 official creditor members of the Paris Club.

[17]This link was made explicitly by the G7 finance ministers a few weeks later. After meeting with Gaidar in Washington on April 26, the group issued a statement to the press noting that the financing was to be provided "in the context of an agreed IMF program."

[18]For details, see Christensen (1994), Table 5 and Appendix IV; and Brau (1995).

"AIR DROP"—A 1993 Herblock Cartoon, copyright by the Herb Block Foundation

By mid-April, when the Executive Board next met to discuss Russia's requirements, the government verged on collapse owing to parliamentary[19] displeasure with liberalization generally and with Gaidar's program in particular. From a financial perspective, lending to Russia under these circumstances was very risky. From a political perspective, failing to support the government was even riskier. Peretz (United Kingdom) put the dilemma starkly: "We have no alternative but to proceed on the assumption that a reform program of some kind will survive in Russia, and we must always fervently hope that it does, because it is extremely important."[20]

[19]Throughout this chapter, the term "parliament" is used to refer to the Russian legislature. Until September 1993, legislative power was held by the Congress of People's Deputies and the Supreme Soviet. Yeltsin dissolved those bodies in September 1993. Under the new constitution ratified by referendum in December 1993, the State Duma (Russian for "assembly," previously applied to a parliamentary body created by Czar Nicholas II, 1905–17) was established as the lower house of parliament and the principal body for enacting legislation.

[20]Minutes of EBM/92/54 (April 13, 1992), p. 13. As noted, at this time Peretz was responsible for Russia's interests in the Fund as well as those of the United Kingdom, pending the election of a Russian Executive Director later in the year.

Russia's transformation was only beginning, but at least a start had been made. On June 1, 1992, the Russian Federation became the one hundred sixty-fifth member country of the IMF, with a quota of SDR 2,876 million (approximately $4 billion and 3 percent of total Fund quotas).

The Initial Transition: Support from the IMF

The Fund set out immediately to provide three types of assistance to Russia: financial support, policy advice, and technical assistance. Because of the breadth and magnitude of the structural changes under way in Russia, the least glamorous of these—technical assistance—took on unusual importance in the early stages.

Technical Assistance and Policy Advice

Technical assistance on economic and financial institutions was especially important in Russia, as in other transition economies, because the availability of even basic textbook economic analysis had been suppressed for decades under the Soviet system. Exceptionally, Yegor Gaidar reportedly had obtained a copy of Paul Samuelson's economics textbook, which he studied carefully and then shared secretly with fellow would-be reformers. Andrei Illarionov, a senior economic advisor to the Russian government, recalled in an interview for this History that as a university student in Leningrad in the 1980s, he had had no access to textbooks or other material explaining the workings of market economies. The university library did, however, subscribe to the IMF's monthly global statistical digest, *International Financial Statistics* (IFS). For several years, Illarionov quietly pored over the numbers and the explanations of their derivation and the relationship between one and another, until at last he believed he understood the structure of a market economy and the ways in which it differed from the one where he lived. Other than these "young Turk" reformers, however, most officials were picking up the study of western economics at square one.

The differences between a market economy and the economic system of Soviet Russia were enormous and pervasive. Output had been measured as "material product," not by GDP or GNP. Statistical systems had been constructed around the requirements for detailed input-output tables, which in turn were required for implementing a series of national production and distribution plans. Domestic goods prices had been set for social reasons rather than to clear markets, and international trade among the member countries of the Soviet-run Council on Mutual Economic Assistance (CMEA) had also been based on arbitrary prices and exchange rates. Moreover, the major economic agencies and institutions, including the finance ministry and the central bank, had been designed to further national

political and social goals and not to promote macroeconomic stability. For Russia to become a full participant in the global economy, virtually all of its technocratic infrastructure would have to be redesigned and rebuilt from the ground up.[21]

An army of multilateral agencies—notably the European Bank for Reconstruction and Development (EBRD), the European Union (EU), the IMF, the Organization for Economic Cooperation and Development (OECD), the United Nations (UN), and the World Bank—was prepared to help Russia reform its institutions, and many governments of countries with advanced market economies were eager to provide bilateral assistance and advice. Plenty of help was forthcoming; the challenge was to organize and coordinate it. For example, throughout the 1990s, the EBRD and the EU worked together to promote the establishment and development of private enterprises in Russia. The OECD provided extensive advice in areas such as competition policy and corporate governance. The World Bank helped Russia set up and run its privatization programs, and it provided assistance in efforts to strengthen health care, education, environmental protection, and other social and structural policies.

The IMF's role was more limited but no less important to Russia. In October 1990, Teresa Ter-Minassian (head of the interagency task force on the Soviet economy) set out the priorities for IMF technical assistance to the Soviet Union.[22] That blueprint served as a guide for the work that would intensify greatly once Russia became a member of the Fund. It set out five key areas of assistance:

- converting the Gosbank into a true central bank, with the ability to stabilize the supply of money and credit through indirect controls such as open market operations and reserve requirements;
- putting foreign exchange operations on an efficient and market-determined basis;
- strengthening administration of tax collections, reforming tax policy to make it more efficient, and modernizing the customs office;
- developing a system of statistics consistent with international standards; and
- improving economic forecasts, particularly with respect to the data required for financial programming.

The Fund began offering technical assistance even before the formal breakup of the Soviet Union, when two unusually large teams arrived in Moscow on November 11, 1991. One team of 17 people, organized by the Fund's Central Banking Department (CBD), was led by a former governor of the National Bank of Belgium, Baron Jean Godeaux. That team also included experts from four other national

[21]For an introduction to the Soviet economic system, see Nove (1986, 1989).

[22]Memorandum from L. Alan Whittome to relevant department heads, "USSR—Technical Assistance" (October 11, 1990), with attachment by Ter-Minassian; IMF archives, Accession 91/118, OMD files, "USSR Mission and Reports by Mr. Whittome," Box 4. For Whittome's and Ter-Minassian's roles in the Fund's initial analysis of the Soviet economy, see Chapter 2, pp. 59–60.

central banks, the Bank for International Settlements, the OECD, and the World Bank. The other team of 14 people, headed by John McLenaghan (Director, Statistics Department, or STA), included statistical experts from the OECD, the EU (Eurostat), the UN Statistical Office, the International Labor Organization, and the World Bank.

After the breakup, the effort to provide technical support to Russia began early in 1992, with assistance from CBD and various national central banks to the newly independent Central Bank of Russia, from the Fiscal Affairs Department to the ministry of finance and various spending agencies, and from STA to the national statistical office.

In addition to this specific technical assistance, Fund staff provided macroeconomic and related policy advice. At the outset, much of the discussion centered on how and when to initiate structural reforms such as price liberalization, and on how to get the government's fiscal accounts under control as a way of stabilizing the economy. Although most prices were freed in January 1992, the Russian government wanted to delay raising energy prices as long as possible to cushion the impact both on industry and on the poor and the elderly. The Fund was concerned about the effect on the fiscal deficit of subsidizing energy and advised Russia to free up energy prices and provide targeted subsidies as a social safety net. Prices quickly adjusted to market levels, but the government was less successful at protecting pensioners from the effects of the price increase.

Extensive discussions were held on currency reform in 1992. That work focused first on managing the issuance and use of rubles in what was expected to be a multicountry currency union involving Russia and most of the other newly established countries, and later on how to unwind the currency union as the other countries established their own currencies.[23] More generally, the Fund tried to advise Russia on managing its exchange rate to maintain stability without endangering international competitiveness. As will be seen below, devising a sustainable exchange rate policy proved to be an elusive goal until the end of the decade.

As the new central bank gradually gained experience and control over monetary policy, the Fund shifted its own role from technical assistance to policy advice on using interest rates and other indirect policy tools to stabilize the price level. By the mid-1990s, the Fund's advice to Russia also encompassed a second generation of structural reforms, particularly privatization and other building blocks of a market economy. In that sphere, the Fund kept its advice on a general level and left the details to the World Bank and others with appropriate expertise. Throughout the decade, the overriding concern and the greatest continuing challenge was always fiscal policy: controlling spending and strengthening the central government's ability to collect taxes from a population that had no tradition of paying them.

[23]Fund advice regarding the ruble area is discussed in more detail in Chapter 8.

Financial Support

With the collapse of the Grand Bargain and the refusal of most creditor countries to provide large-scale grants or loans bilaterally (despite the G7 announcement), the IMF became both the gatekeeper and the lender of first resort to Russia.

The First Stand-By Arrangement

Three days after Russia became a member of the IMF in June 1992, Odling-Smee and a small team of economists traveled to Moscow to try to negotiate a program that the Fund could support with a stand-by arrangement. On the surface, it was a typical IMF encounter. Policies had not been implemented in accordance with the MEP agreed to four months earlier—both monetary growth and the fiscal deficit were higher than promised. The Russian authorities argued that to do more would weaken the economy, while the Fund staff argued that without greater effort inflation would spiral and undermine the economy even more. Bridging the gap between the two positions by the end of this two-week mission was impossible, even though preparatory discussions had helped pave the way. If this had not been Russia at its moment of rebirth, a series of follow-up missions over the next few months might have brought the two sides gradually to a compromise. But this was not an occasion for business as usual.

On June 15, while Odling-Smee and his team were still at work in Moscow, Yeltsin elevated Gaidar to the post of acting prime minister and took him along on a state visit to Washington. Yeltsin was welcomed in the U.S. capital with the enthusiasm usually reserved for rock music stars (and for his charismatic predecessor, Gorbachev) as he got out of his armored limousine, waved a small American flag, and mingled jocularly with the crowd lining the avenues. Yeltsin's popularity and the nearness of the next G7 summit intensified the desire of U.S. officials from President Bush on down to see an agreement soon. Meanwhile, Gaidar headed down the street a few blocks to the IMF, where he met with Camdessus to make the case for more flexibility on the part of the Fund. At the conclusion of that meeting, the prime minister and the Managing Director issued a joint news release, stating that "both sides were confident that the continuing negotiations [in Moscow] would lead to an early agreement on a program that could be supported by the financial resources of the Fund."[24]

Alarmed by the pressure from these developments, Odling-Smee faxed a memorandum to the Managing Director from Moscow, outlining the outstanding issues blocking an agreement and asking him not to push for an agreement before the G7 summit meeting. This plea initially had the desired effect—Camdessus informed

[24]See "Joint Statement of Mr. Yegor Gaidar, Prime Minister of the Russian Federation, and Michel Camdessus, Managing Director of the IMF," NB/92/15 (June 18, 1992). Also see Odling-Smee and Pastor (2002), p. 20; and Gaidar (2002), p. 35n.

the Executive Board later in the day that the effort to negotiate a program was being postponed. When public pressure from the U.S. government continued, Camdessus issued another press release a week later, saying that "agreeing on an inadequate policy package just for the sake of having an agreement before the economic summit would be a disservice to Russia, to our membership, and to the world."[25]

Odling-Smee came back to headquarters on June 18 but returned to Moscow before the month ended. For a few days, negotiations plodded along with no real movement. The Russian negotiating team put a compromise proposal on the table, but Gaidar—urged on by a team of foreign advisors led by Harvard Professor Jeffrey Sachs and including a former IMF economist, David Lipton—undercut his own team by subsequently rejecting their compromise and retreating to his previous position. Gaidar then decided to bypass the IMF staff as well and take the matter to a higher level by calling a few G7 finance ministers to get their support. In response, the German deputy finance minister, Horst Köhler, telephoned Camdessus to urge him to go to Moscow and meet with Yeltsin to break the impasse. Camdessus replied cautiously, saying that he could not go without an invitation from the Russian government. Köhler then escalated it further by getting Chancellor Kohl to ask Yeltsin to invite Camdessus. Yeltsin phoned Camdessus, who agreed, despite the obvious risk of undermining his own staff's authority.

Arriving in Moscow on July 3, Camdessus told Gaidar straight away that he would have to devise a stronger program to get an agreement from the Fund. That induced Yeltsin to call a press conference on July 4 in which he accused the IMF of trying to "force us to our knees" by imposing harsh conditions including a demand that Russia fully liberalize energy prices.

At that moment, the whole process seemed to be unraveling. A private meeting between Yeltsin and Camdessus the same day, however, was more agreeable and productive. The next day, the Russian side offered to tighten fiscal policy, and the Fund took that package as an acceptable compromise (without the increase in energy prices that the staff had been demanding). Gaidar and Camdessus exchanged letters to that effect, and the Managing Director flew to Munich with an agreement on July 6—the opening day of the G7 summit.[26]

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[25]For Odling-Smee's plea from Moscow, see his memorandum to the Managing Director, "Meeting with Mr. Gaidar, June 18" (June 18, 1992); IMF archives, C/Russian Federation/1760, "Stand-by Arrangement 1992." Camdessus's statement to the Executive Board was issued as "Statement by the Managing Director on the Russian Federation," BUFF/92/103 (June 18, 1992). The two press releases were NB/92/15 (June 18, 1992) and NB/92/17 (June 25, 1992).

[26]For an overview of these developments, see memorandum from Odling-Smee to the Managing Director, "Russian Federation—Back-To-Office Report" (July 8, 1992); IMF archives, Accession 1996-0187-0006, OMD-AD, Box 9110, "Russia (3) 1992." Odling-Smee (2006, p. 164) later acknowledged that the compromise agreement essentially reflected the authorities' preferences, forced upon the Fund by the G7's demand for a presummit agreement. Also see the lead editorial in the *New York Times* for July 7, 1992, praising the Bush administration for pressuring the IMF to "take a prudent chance on the Yeltsin government."

The summit communiqué implicitly acknowledged the weakness of the economic policies the G7 had pressured the IMF to accept:

> We support the phased strategy of cooperation between the Russian Government and the IMF. This will allow the IMF to disburse a first credit tranche in support of the most urgent stabilisation measures within the next few weeks while continuing to negotiate a comprehensive reform programme with Russia. This will pave the way for the full utilisation of the $24 billion support package announced in April. Out of this, $6 billion earmarked for a rouble stabilisation fund will be released when the necessary macroeconomic conditions are in place.[27]

One month later, on August 5, 1992, the Fund approved its first lending to Russia (and the first to any country of the former Soviet Union). The amount of the stand-by arrangement was small in relation to Russia's needs: approximately $1 billion (SDR 719 million), or 25 percent of Russia's quota in the Fund. It was thus a "first-tranche" arrangement, which, under the Fund's rules, does not involve any phasing (the money is available immediately to the borrower) or performance criteria (formal policy conditions). In this case, however, it was necessary to restrict the use of the funds, given the real risk that the authorities would be frustrated in their attempts to carry out even the small reforms they had promised. The staff appraisal, while recommending approval, fell back on the linguistic and syntactical fog occasionally employed in the Fund to obscure a lack of confidence: "The delays and slippages of the past few months show how difficult it will be in practice to implement the program in full. However, if it is fully implemented, the program would represent a marked tightening of financial policies which deserves the support of the Fund."[28]

The stand-by arrangement therefore required Russia to maintain a floor on its international reserve assets so high that it effectively prevented the authorities from spending any of the proceeds. This restriction angered some in the G7. Peretz complained during the Board meeting that the do-not-spend rule was too restrictive, and in October—when no funds had yet been drawn by Russia—32 U.S. senators wrote to Camdessus complaining of "excessive conditionality" in the face of a Russian economic depression comparable to that experienced in the west in the 1930s. In response, Camdessus insisted that if Russia failed to reform its economy, the outcome would be far worse.[29]

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[27]"Economic Declaration: Working Together for Growth and a Safer World," paragraph 40; accessed at http://www.g8.utoronto.ca/summit/1992munich/communique/.

[28]"Russian Federation—Use of Fund Resources—Request for First Credit Tranche Stand-By Arrangement," EBS/92/119, Suppl. 3 (July 24, 1992), p. 37.

[29]For Peretz's complaint, see minutes of EBM/92/101 (August 5, 1992), p. 6. For the exchange with the senators, see letter from Claiborne Pell and others to Camdessus (October 5, 1992) and letter of reply from Camdessus (October 19); IMF archives, C/Russian Federation/1760, "Stand-by Arrangement 1992."

The Russian government had little incentive to draw on the Fund's money under these conditions because the interest charges it would have to pay would wipe out any income it would earn by investing the proceeds. Only in October did Gaidar and Viktor Gerashchenko (acting head of the central bank) begin inquiring about procedures for making a drawing, and by that time the reform program was already hopelessly off track. First the staff and then Camdessus tried to discourage the authorities from drawing on the arrangement, fearing that the hidden intention was to spend rather than to invest the proceeds.[30] Russia, however, ignored the warnings and borrowed the full amount in two installments, in November and December.[31]

As 1992 drew to a close, economic conditions in Russia continued to deteriorate, and Yeltsin felt his own political support being dragged down as a result. Although he had not lost faith in the reform process, he sensed that he had to change direction to regain momentum for it. He abruptly fired Gaidar as prime minister and replaced him with Viktor Chernomyrdin, a deputy prime minister (in charge of fuel and energy) and the former head of the natural gas monopoly Gazprom. Chernomyrdin had little experience with macroeconomics and was free of any association with market reforms. His appointment bought Yeltsin some time to try to get a recovery started without the political pressure that Gaidar attracted like a lightning rod (see Yeltsin, 1994, pp. 197–201).

The external political climate was also shifting, with Bill Clinton succeeding George Bush as U.S. president in January 1993. Less than a week after his inauguration, Clinton delivered a foreign policy address at American University in Washington in which he called for large-scale financial assistance to Russia, akin to the Marshall Plan sponsored by the U.S. government after the Second World War. Privately, he told his aides that they needed "to think bigger and do more" for Russia (Talbott, 2002, p. 53; and Clinton, 2004, p. 505). With Clinton's support, when G7 finance and foreign ministers met in Tokyo that April, they were able to announce an increase in the size of their nominal financial support for Russia from the previous $24 billion to $43.4 billion. No less than before, however, this headline figure included a mix of previously delivered aid, multilateral lending that depended on Russia meeting certain conditions, and bilateral aid from G7 and other countries not yet in national budgets. The main immediate effect was simply to express the G7's "determination to support the reform process in ways which complement the efforts of Russia."[32]

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[30]See, for example, letter from Camdessus to Gaidar (November 19, 1992); IMF archives, EU2 files, R-130, "Use of Fund Resources."

[31]By the end of 1992, Russia complied technically with the requirement to increase its gross and net international reserves by the amount of the drawings, but it did so by violating another commitment, which was not to increase its arrears to other creditors; see "Russian Federation—Staff Report for the 1993 Article IV Consultation," SM/93/66, Suppl. 1 (April 16, 1993), p. 8.

[32]See "G7 Chairmen's Statement on Support for Russian Reform," April 15, 1993; accessed at http://www.G8.utoronto.ca/adhoc/g7chair93.htm.

The First STF Loan

The next year, 1993, turned out to be another make-or-break year for Yeltsin and for economic and political reform in Russia. Outside the country, supporters of the reform effort showed increasing frustration. In early February, Camdessus told a reporter from *Izvestia* that the central bank had not kept its promises under the stand-by arrangement and had let the money supply expand much too rapidly in the second half of 1992.[33] A few weeks later, Canadian Minister of Finance Don Mazankowski told reporters just before a G7 ministerial meeting that the main obstacle to their providing further financial help was Russia's failure to meet the IMF's policy conditions (Ortiz, 1993). Meanwhile, inside the country, an anti-Yeltsin parliamentary majority was working to further undermine the reform effort and restore the stability that many still believed had been the hallmark of the Soviet system. Yeltsin survived an impeachment attempt in March, and in April he won a referendum supporting presidential power over the parliament.

Once again, the stakes were high when a large new IMF staff team—led by Ernesto Hernandez-Catá (Deputy Director, EU2), and comprising 11 professional staff (more than double the usual complement)—went to Moscow in May 1993 to negotiate terms for a second IMF arrangement. By this time the Fund had established a new lending window, the Systemic Transformation Facility or STF (see Chapter 5), so that it could lend quickly to countries in transition, in support of nascent rather than fully developed and rigorous policy reforms. Judged by this relaxed standard, Russia seemed to be making decent economic progress. A privatization program was under way, the government was cutting subsidies to state enterprises, and the central bank was raising interest rates in an effort to reduce the inflation rate—but this glass was only half full. Many of the new private firms were no more efficient than the old ones run by the state, and both the budget and the price level were still out of control, but the scent of progress was detectable and encouraging.

Hernandez-Catá reached an acceptable agreement after just two weeks of negotiations, and on May 22, 1993, Chernomyrdin sent Camdessus a statement setting out the economic policy program to be supported by an STF loan. This time the IMF would be offering more money than in 1992 (equivalent to $1.5 billion), available immediately and without the restrictions preventing the government from using the proceeds to help finance the budget.[34] The Executive Board approved the arrangement at the end of June and even permitted itself a little

[33]"Russia's Hyperinflation Must Be Prevented, Says Camdessus," *IMF Survey*, Vol. 23 (February 22, 1993), pp. 49–53.

[34]As with all IMF credits, the arrangement was denominated in SDRs. The total loan amount, SDR 1,087.275 million, was disbursed partly in SDRs and partly in currencies (U.S. dollars, deutsche marks, French and Swiss francs, Japanese yen, and Dutch guilders); see "Russian Federation—Purchase Transaction—Systemic Transformation Facility (STF)," EBS/93/91, Suppl. 2 (June 29, 1993). Also see Hernandez-Catá (1994), pp. 15–16.

optimism. Although Hiroo Fukui (Japan) observed with some sarcasm that parliamentary support for reform in Russia "remains uncertain, to put it positively," Thomas C. Dawson II (United States) declared himself to be "extremely encouraged" by the promises of fiscal tightening.[35]

The odds against success, however, remained high, and not only because of the ongoing domestic battle between Yeltsin and the parliament. The numbers added up, but only because the staff had to assume that Russia would receive $610 million in loans from the World Bank and $10.2 billion in assistance from G7 and other donor countries in 1993. Realization of the latter amount required that all the money being talked about by the G7 would materialize. The following week, the annual G7 summit in Tokyo concluded with a promise of only $3 billion to establish a privatization fund.[36]

The finance minister, Boris Fyodorov, and his principal deputy, Andrei Vavilov, struggled through the rest of the year to contain the budget deficit and meet the Fund's conditions.[37] The rest of the government provided less support. When Chernomyrdin went to Washington in September for meetings with U.S. Vice President Al Gore, both Camdessus and Lawrence Summers (under secretary of the U.S. Treasury) separately visited him at Blair House (the official U.S. residence for visiting dignitaries) to impress upon him the importance of meeting the Fund's conditions. Russia's economic policies, both visitors insisted, had to be adjusted to be consistent with the real discipline imposed by market economics.[38] With little progress in view, the size of the next staff mission to Moscow was scaled down and given instructions not to open discussions on additional financing until the government showed more seriousness of purpose in carrying out the existing program.[39]

In the middle of these economic discussions, the political disarray in Russia suddenly turned brutal. The parliament tried to depose Yeltsin, who responded by

[35]Minutes of EBM/93/92 (June 30, 1993), pp. 6 (Dawson) and 15 (Fukui).

[36]"Economic Declaration: A Strengthened Commitment to Jobs and Growth," paragraph 10, Tokyo, July 9, 1993; accessed at http://www.g8.utoronto.ca/summit/1993tokyo/communique/index.html. The assumption that donors and official creditors would deliver on their promises was an unavoidable standard practice in the Fund.

[37]Transliteration of Russian names into English is sometimes capricious. At the time, IMF documents spelled the finance minister's name Federov. The alternative Fyodorov later became more commonly used.

[38]"Over a small dinner at Blair House, Larry [Summers] walked Chernomyrdin through the logic of conditionality. Chernomyrdin bristled. . . . Larry persisted. The rules that governed IMF lending . . . were a reflection of the immutable principles of economics" (Talbott, 2002, p. 85). Also see Camdessus's report to the Executive Board, minutes of EBM/93/123 (September 3, 1993), pp. 3–4.

[39]See memorandums from Odling-Smee to the Deputy Managing Director, "Russian Federation—Modification to the Mission Schedule" (September 2, 1993), and to the Managing Director, "Russian Federation—Staff Visit" (September 29, 1993); IMF archives, OMD-AD, "Russia 1993 – (3) Country Files," Box 22069, Accession 1997-0067-0008.

dissolving the parliament and calling for new elections to take place in December. Street battles erupted in Moscow between supporters and opponents of Yeltsin. This constitutional crisis climaxed on October 4 with the military shelling the parliament under Yeltsin's orders. That eventually brought a nervous calm to the capital but no victory to either side. In the December 12 elections, extreme nationalists gained parliamentary strength, but Yeltsin also won approval for a new constitution bolstering the powers of the presidency. Although contemporary reports worried mostly about the ascent of the ultranationalists, the shift to a powerful presidency would prove to be one of Yeltsin's most enduring legacies.

Despite all this political turmoil, most G7 officials—including those in the U.S. Treasury—continued to stand behind the IMF's ongoing efforts to convince the Russians to strengthen their economic policies, especially by cutting the budget deficit. A faction in the Clinton administration, however, perhaps panicked by the opposition ascendancy in Moscow, started publicly blaming the IMF for being too harsh. Vice President Gore led the attack (saying with typical turgidity that the IMF had been "slow to recognize some of the hardships that are caused by some of the conditions that have been overly insisted upon in the past"), joined by Deputy Secretary of State Strobe Talbott (saying famously and more succinctly that what Russia needed now was "less shock and more therapy").[40] At the end of 1993, the prospects for economic growth and stability in Russia were scarcely clearer or more favorable than they had been at the beginning of the year.

The Second Stage: Fiscal Reform and the Strong Ruble

For a time in the early months of 1994, the Russian economy continued to deteriorate while the political pressure persisted on both the Fund and the Russian reformers. Stung by the growing chorus from Gore and others criticizing the conditions on multilateral assistance, the IMF and the World Bank issued a joint public statement in defense of their approach. Unconditional financial assistance, the note argued, could actually harm the Russian economy "by financing the retention of the status quo, increasing capital flight, and prolonging the period of reduced living standards. . . . The [IMF and World Bank] have been insisting on policy conditionality, which Russia's reformers generally welcome."[41] In mid-January, however, Yeltsin suddenly decided to reshuffle his cabinet, including by forcing out the two leading economic reformers, Gaidar and Fyodorov. That move

[40]Both quotations—from separate remarks to journalists by Gore and Talbott in September 1993—are from Talbott (2002), p. 106.

[41]"Economic Reform in Russia: Lessons from Experience," EBD/94/3 (January 5, 1994), p. 5. The note was circulated internally for the information of Executive Directors with the unusual cover note that it had been "prepared at the initiative of the World Bank and Fund management and staff."

signaled a further weakening of official commitment to reform and provided further evidence that Gore's and Talbott's remarks had resonated in the Kremlin. Fyodorov responded with a blistering attack, calling the shift "an economic coup d'état" by "Red managers" and warning: "If the International Monetary Fund bends the rules, if some people continue 'rethinking policy,' Russia is in for major trouble that will inevitably affect the whole world" (Fyodorov, 1994).

The Second STF Loan

Despite the danger signs, the IMF proceeded to negotiate a second $1.5 billion STF loan. A February mission led by Hernandez-Catá failed to reach agreement despite three weeks of talks in Moscow, after which the G7 finance ministers and central bank governors met with their Russian counterparts in Kronberg, Germany. At the conclusion of that meeting, U.S. Treasury Secretary Lloyd Bentsen told reporters that the G7 planned to get "more involved" in the effort to get Russia and the IMF to agree on terms for the STF loan.[42]

More necessary, though, was for Camdessus to increase his personal involvement in persuading the highest-level Russian officials of the need for adopting the reforms advocated by the IMF. He had already met Chernomyrdin during the prime minister's visit to Washington in September 1993. Their relationship deepened in 1994 through the intermediation of Peter Castenfelt, a Swedish businessman with close ties to Yeltsin, Chernomyrdin, and other senior Russian officials. Camdessus met privately with Castenfelt in Frankfurt before the G7 meeting in Kronberg and again a few days later in Washington, after which Castenfelt set out to smooth relations between Russian officials and the Managing Director.[43] Hernandez-Catá then returned with his staff team to Moscow. Camdessus joined them a few days later. The Managing Director arrived in time to spend the weekend hunting with Chernomyrdin, after which they traveled to Sergiev Posad, where they visited the historic monastery and met with church leaders. This bonding experience, coupled with Camdessus's infectious optimism and empathy with the Russian culture,[44] helped to force a compromise, and Camdessus and Chernomyrdin were able to announce an agreement on the main policy issues on

[42]"IMF Mission to Return to Moscow in about a Week," Reuters News, February 27, 1994; accessed at http://global.factiva.com/. The G7 did not issue a formal communiqué for this meeting.

[43]The meeting between Castenfelt and Camdessus was arranged with the assistance of Jacques de Groote (Executive Director from Belgium). News of the unusual meeting soon leaked to the press, who characterized it as a back channel in the negotiations (Miller, 1994). Castenfelt, who knew Camdessus from his days as an investment banker, later became famous for helping to broker a 1999 peace agreement in Kosovo (Lloyd, 1999).

[44]Declaring himself an optimist in a speech before the Moscow Finance Academy on March 21, Camdessus enthused, "A country with such human and natural resources as yours will overcome its temporary problems."

March 22.[45] A month later, after the government had completed several required prior actions relating primarily to raising fiscal revenues, the Fund formally approved the loan, increasing Russia's indebtedness to the IMF to approximately $4 billion.[46]

Economic policies in Russia continued to be lax and unconstrained by the agreement that supposedly underpinned the STF loan. Despite major efforts by the finance ministry and other senior officials, Russia still had little cash support from the G7 or other external creditors, no significant domestic bond market, and a parliament demanding higher levels of government spending than could be paid for under the country's weakly enforced tax system. The Russian authorities thus had little choice but to run a large fiscal deficit and finance it with money creation by the central bank. For the second half of 1994, both the fiscal deficit and central bank lending to the government were about half again as large as had been targeted in the program.[47]

As a result of this fiscal weakening, consumer price inflation accelerated sharply at the beginning of the fourth quarter of 1994. That increase brought a loss of confidence in the overall reform effort, culminating in a panic in the foreign exchange market. On a single day that became known as "Black Tuesday" in Russia (October 11, 1994), the value of the ruble dropped by 21 percent against the U.S. dollar. This financial shock, though it seemed a disaster at the time,[48] turned out to be the jolt that finally convinced Yeltsin he could not avoid pressing ahead with the reform effort. As before, his first reaction was to fire and replace his economic team, but this time the shake-up was aimed at strengthening the reformers. Notably, he elevated one of the most well-known advocates of free market economics, Anatoly Chubais, from the post of deputy prime minister in charge of privatization to first deputy prime minister in charge of the economy. He also fired Gerashchenko as head of the central bank and elevated Tatiana Paramanova from deputy to acting governor.

The Second Stand-By Arrangement

The next IMF staff mission, arriving in Moscow a week after Black Tuesday, was able to make a fresh start with a new team on the other side of the table. Moreover,

[45]For a different perspective on Camdessus's diplomacy at this time, see Stone (2002), pp. 128–31. Stone reports (based on interviews) that Hernandez-Catá wanted to delay approval of the STF loan until Russia had successfully carried out a staff-monitored reform program, but he was overruled by Camdessus.

[46]The STF loan for SDR 1,078.28 million was approved on April 20, 1994. After drawing this amount, Russia's obligations to the IMF totaled SDR 2,875.56, equivalent to 166.67 percent of Russia's quota. On the prior actions, see Camdessus's statement to the Executive Board, BUFF/94/36 (March 24, 1994).

[47]"Russian Federation—Request for a Stand-by Arrangement," EBS/95/46, Suppl. 1 (March 29, 1995), Table 1.

[48]The drop in the rate was quickly reversed, but the loss of confidence that had brought it about continued to generate volatility and uncertainty in financial markets for some time.

Stanley Fischer—who had studied the Russian economy extensively, first as chief economist for the World Bank at the time of the 1990 joint study and then as part of a U.S. team of academic advisors to Yavlinsky in 1991—had recently joined the IMF as Camdessus's principal deputy and was actively engaged in devising a new policy approach. The mission took the opportunity to put two new and controversial ideas on the table as a possible basis for what would be Russia's first full-scale stand-by arrangement.

New Program Design

First, Hernandez-Catá proposed a set of specific measures to raise taxes rather than relying primarily on spending cuts to temper fiscal imbalances. Russians were still not comfortable with the idea of paying taxes, and the whole tax system was widely known to be inefficient and corrupt. Until the government could solve this problem, it would not be able to find the revenues to pay for essential public goods and services. Nonetheless, any tax reform was bound to meet with formidable resistance, and whether Chernomyrdin's government had either the will or the means to push it through the parliament was far from clear.

Second, Hernandez-Catá suggested that Russia should abandon the floating exchange rate and peg the ruble at a new devalued rate. The authorities, unconvinced that they could or should fulfill a commitment to stabilize the value of the ruble before the economy and the state of the government's finances were stronger, resisted this idea as well.[49]

The October 1994 mission did not produce an agreement, but it did get a serious negotiation process started, and it ushered in a period unprecedented in the intensity of relations between the IMF and a borrowing country. For the next few years, the IMF sent staff missions to Moscow almost every month, often involving two or three times the standard number of economists on such trips (without even counting the sizeable number of staff resident in Moscow, who also participated in the missions). For a time, two distinct teams of economists took turns, in an effort to minimize fatigue and burnout. The mission chief throughout most of this period, Yusuke Horiguchi (Deputy Director, EU2), who joined the IMF's Russia team with the October mission, made 31 trips from Washington to Moscow in as many months.

The first task of these monthly missions was just to get an agreement on an economic program the Fund could support. That task took a total of six missions in six months, with both Fischer (in December) and Camdessus (in March 1995) traveling to Moscow to help spur the process.

Legislative resistance to tax reform posed a substantial obstacle, one that would reverberate for years to come. The Fund staff and management believed strongly

[49]Back-to-office report from Hernandez-Catá to the Managing Director (November 2, 1994); IMF archives, C/Russia/1720.

that the only way to get the fiscal deficit permanently under control was to build an effective system for levying and collecting taxes to cover the country's spending demands.[50] Chubais, however, argued that the government could not possibly get strong tax legislation approved by the parliament, and the only practical way to control the deficit was simply to sequester a large part of the spending that the parliament approved. Neither Chernomyrdin nor Yeltsin was prepared to invest considerable political capital to force a showdown with the parliament, and were content to let Chubais take the heat for imposing deep spending cuts administratively. In the end—amid fears that Russia stood on the brink of a financial, economic, and political crisis[51]—the Fund had no real choice but to go along, though with serious misgivings.

Meanwhile, the G7 was sending strong signals to Russia that the government could not expect further financial help from them until they reached agreement with the IMF. Concluding a meeting in Toronto in early February, the finance ministers of the G7 issued a statement saying that additional "debt rescheduling for Russia will depend on the introduction of a comprehensive reform program that will merit IMF support."[52] With the pressure on, Camdessus and Chernomyrdin met in Paris on March 3 and agreed that if the Fund approved the program, Russia would allow the Fund to monitor compliance monthly rather than quarterly, as was usual. Tight monitoring offended Russian pride, but the Fund viewed it as essential because the program depended so heavily on the government's continuing ability to hold spending below what the parliament was likely to approve. In addition, Chernomyrdin agreed to complete a number of actions the Fund required before formally approving the stand-by arrangement, including keeping money creation within strict limits through the end of March and rescheduling $2.5 billion in debts owed by Ukraine.[53]

From Paris, Camdessus flew to Moscow to secure Yeltsin's personal backing for the agreement. On March 10, in a Kremlin ceremony, Yeltsin signed a letter to Camdessus promising his support for the program and his commitment "to use

[50]The first major fighting in Chechnya was under way at this time, adding further to the spending requirements.

[51]On February 9, Odling-Smee warned management that "a crisis could unfold fairly quickly" in Russia, owing to the Chechnya conflict, doubts about the breadth of commitment to reform in the government, and the possibility that Russian banks could switch quickly out of rubles into dollars. Memorandum from Odling-Smee to the Surveillance Committee, February 9, 1995; IMF archives, Accession 1998-0106-0008, OMD/AD (Fischer), "Russia 1995."

[52]"Excerpts from the G7 Finance Ministers and Central Bank Governors Statement from the meeting in Toronto on February 3–4, 1995"; accessed at http://www.g8.utoronto.ca/finance/g7torfin.htm.

[53]The rescheduling agreement between Russia and Ukraine was a prerequisite for the Paris Club of official creditors to reschedule their own claims against Ukraine; see back-to-office report from Horiguchi to the Managing Director (March 14, 1995); IMF archives, Accession 1998-0106-0008, OMD/AD (Fischer), "Russia 1995."

every means available to me to ensure its success." Chernomyrdin and Paramanova then signed the agreed-on Letter of Intent, to which was attached a detailed statement of economic policies. Chernomyrdin and Camdessus signed a joint communiqué stating that the Managing Director was "prepared to recommend" approval by the Fund "after the initial elements of the program are in place" (meaning the completion of the prior actions agreed to in Paris).[54]

Successful Implementation at Last

For once the process worked—or seemed to work. The Executive Board met on April 11, 1995, six months to the day after Black Tuesday, and approved a stand-by arrangement for $6.8 billion (SDR 4,313.1 million, or 100 percent of quota). Many on the Board expressed doubts that Russia would carry out its promises, and many indicated they were supporting the Managing Director's recommendation only because the costs to Russia and to the world of not doing so would be so great. As Autheman (France) put it, "We know that Russian programs go back on track in the winter, that we reach agreement in spring, that we congratulate each other in the end of June, and that everything falls apart in summer." Without "a summer and a fall of success, . . . the conclusion of this agreement will not raise confidence in private markets."[55] Nonetheless, no one objected, and the stand-by arrangement was approved unanimously.

With only minimal delays, Russia met all the conditions in the arrangement, and drew down the entire amount in nine installments from April 1995 through February 1996. Although that brought Russia's outstanding debt to the Fund to $10.5 billion (SDR 7.2 billion), the highest of any member country except Mexico, this successful implementation enabled discussions to proceed relatively smoothly toward even larger and longer-term financing from the Fund (Figure 7.1).

The program supported by the 1995 stand-by arrangement was both strong and apparently well implemented. It soon succeeded in restoring a measure of international confidence in the economy and the Yeltsin government, and the resulting foreign investment more than reversed the weakness that had plagued the value of the ruble since the beginning of the reform era in 1992. This success, however, disguised two lurking problems that would have major adverse consequences in the next few years.

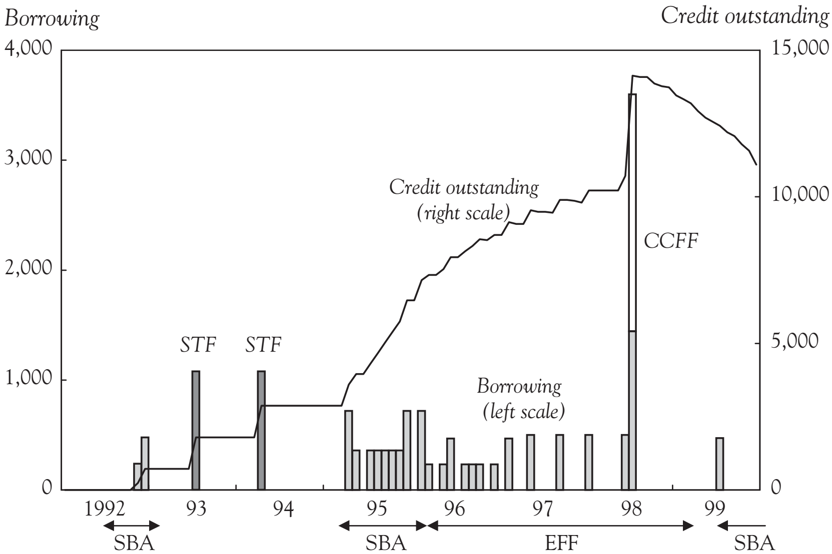
First Problem: A Flawed Privatization Scheme

The first problem, which was just emerging when the Fund approved the 1995 stand-by arrangement, was the way the government chose to privatize its major state-owned enterprises. Chubais had overseen a scheme for the first wave of

[54]These various documents are in IMF archives, Accession 1998-0106-0008, OMD/AD (Fischer), "Russia 1995."

[55]Minutes of EBM/95/38 (April 11, 1995), p. 37.

Figure 7.1. Russia: Use of Fund Credit, 1992–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics.
Note: CCFF = Compensatory and Contingency Financing Facility; EFF = Extended Fund Facility; SBA = Stand-by arrangement; STF = Systemic Transformation Facility.

privatizations in 1992–94, in which the government had sold vouchers for a nominal fee to Russian citizens. The vouchers could be used to buy shares in companies or could be sold for cash in a secondary market. That scheme had privatized some 14,000 enterprises and turned 40 million Russians into capitalists (see Chubais and Vishnevskaya, 1995; Stent and Shevtsova, 1996; and Schleifer and Treisman, 2000, Chapter 2). Unfortunately, many of these companies turned out to be no better managed than they had been under communism. Though some companies were managed successfully and well, by the time the voucher scheme ended in mid-1994, it had failed to generate much popular support. When Chubais undertook the second wave, in which some of the largest state monopolies would be sold off, he was presented with a more centralized process, which he carried out with disastrous results.

The essence of what became known as the loans-for-shares scheme was that a consortium of Russian banks would take control of a company from the state as collateral for a loan to the government. When the loan matured, and if the government chose not to repay it, the banks—which proposed this scheme to Yeltsin in March 1995—would auction the company to the highest bidder. If the government was dissatisfied with the outcome, it retained the right to buy the company back during the next year. The process turned out to be an open invitation to corruption. The banks manipulated the system by excluding all but one or a

few bidders from the auctions so that favored clients could purchase companies at prices far below true market value. The cash-strapped government was in no position to intervene or to buy back the companies after the fact. In case after case, both the bankers and the new owners—"oligarchs," as they came to be called—became fabulously wealthy and thus politically powerful. When Yeltsin decided to run for reelection as president in 1996, the oligarchs largely financed his campaign and further strengthened their grip on economic power and political influence.[56]

When the staff negotiated terms for the 1995 stand-by arrangement, the government was still considering whether to accept the banks' proposal for the loans-for-shares scheme. The Letter of Intent Chernomyrdin and Paramanova signed in March included a commitment to resume privatization in a way that would "conform to internationally accepted standards," but the details were left to be specified later.[57] At the Board meeting on April 11, Karin Lissakers (United States) expressed concerns about press reports on the emerging proposal. Horiguchi reassured her. His understanding was that the government was "not interested in proceeding with the deal," and the staff "would continue to monitor the situation and report any developments."[58]

At the first review of the program barely a month later, Horiguchi questioned the authorities in Moscow about the proposed loans-for-shares scheme. In response to his concerns that it would cede control over public property without competitive bidding, would violate the principle of arms-length transactions between banks and their customers, and could worsen the monopolistic structure of the economy, the authorities agreed and insisted that they were "approaching the issue very carefully."[59] At Executive Board meetings for this and subsequent reviews through the summer of 1995, Stefan Schoenberg (Germany) repeatedly urged the staff to monitor the proposal. Although the staff agreed that the scheme was deeply flawed, they continued to accept the authorities' assurances that it was unlikely to be implemented. Following the August mission, Horiguchi concluded that the proposal seemed to have "lessened momentum," but even before the report was circulated to the Board, Yeltsin had signed a decree enacting the scheme.[60]

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[56]For an overview of the scheme and its consequences, see Nagy (2000), pp. 88–96.

[57]"Russian Federation—Request for Stand-By Arrangement—Letter of Intent," EBS/95/46 (March 22, 1995), pp. 8–9.

[58]Minutes of EBM/95/38 (April 11, 1995), pp. 33 (Lissakers) and 50 (Horiguchi).

[59]"Russian Federation—First Monthly Review under the Stand-By Arrangement," EBS/95/84 (May 19, 1995), p. 8. Also see Odling-Smee (2006), pp. 168–69.

[60]"Russian Federation—Staff Report for the 1995 Article IV Consultation and First Quarterly Review Under the Stand-By Arrangement," EBS/95/149 (September 8, 1995), p. 14. Yeltsin signed the decree on September 1.

Even after the scheme was implemented, the staff paid little attention to it or to the corruption it was likely to feed. This acceptance resulted partly from the soothing reassurances from Moscow, and partly because the details of the way in which enterprises were privatized were considered to be the primary province of the World Bank, not the Fund. Some Executive Directors, however, continued to worry. In December, for example, Daniel Kaeser (Switzerland) noted the absence of any mention of the privatization scheme in the latest staff report. As a result, he had to rely on press reports, which had indicated that "powerful pressure groups" had secured a ban on foreign companies participating in the auctions, which was "contrary to the market-oriented philosophy of the program supported by the Fund." He asked for the Fund to impose conditionality on the process. Horiguchi expressed agreement with the general concern, but the staff did not regard it as an urgent issue for the Fund.[61]

Second Problem: An Unsustainable Exchange Rate

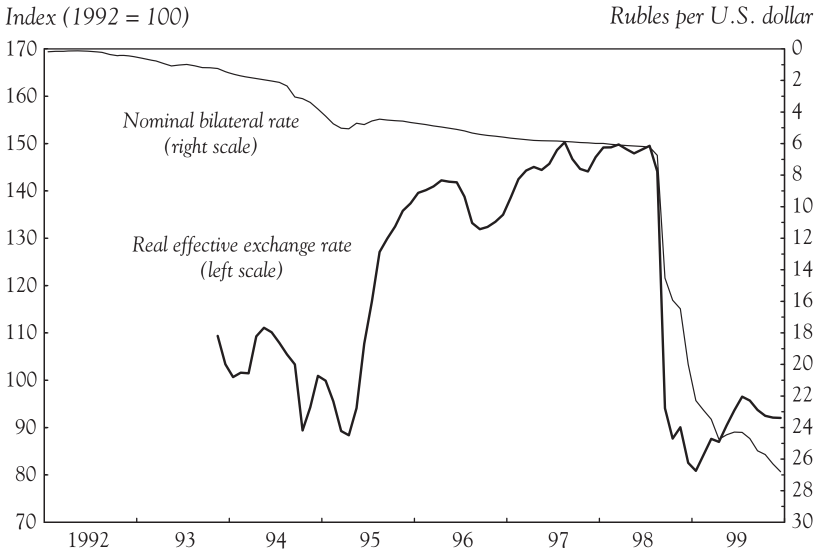
The second problem that arose in this period was that the strong ruble became an entrenched feature of Russian economic policy. As noted above, in late 1994 the authorities had rejected the staff's advice to peg the ruble on the grounds that they needed to stabilize the economy first. By June 1995, however, the roles were reversed. Chubais had decided the time to peg was right,[62] and he raised the idea with Horiguchi during the monthly mission as a proposal for solidifying the price stabilization already under way and preventing a return of inflationary pressures.[63] Horiguchi, after checking with Fischer, replied cautiously and did not encourage such a move. The exchange rate was appreciating strongly (by about 12 percent against the U.S. dollar from end-April to end-June, and by some 22 percent in real effective terms), raising the risks of both further volatility and overvaluation. The Fund was also newly wary of the dangers of trying to fix the rate, in the wake of the Mexican peso crisis that had erupted at the end of 1994 (see Chapter 10). Chubais flew to Washington with several advisors and took the case to Odling-Smee,

[61]Minutes of EBM/95/115 (December 6, 1995), pp. 90 (Kaeser) and 101 (Horiguchi); and additional information from interviews with participants. The authorities' Letter of Intent requesting the stand-by arrangement included two paragraphs describing plans for further privatization, but the arrangement did not include specific conditions related to the implementation of those plans; see "Russian Federation—Request for Stand-By Arrangement—Letter of Intent," EBS/95/46 (March 22, 1995), paragraphs 27 and 28.

[62]IMF staff were not the only advisors who had been encouraging Chubais to peg the ruble in 1994. Jeffrey Sachs, for example, had been offering this advice consistently since the beginning of reforms in 1992. At a 1994 conference attended by Chubais, Sachs argued that the failure to stabilize the exchange rate as an anchor "flew in the face of stabilization experience" in Eastern Europe and elsewhere (Sachs, 1995, p. 55).

[63]Memorandum from Fischer to Manuel Guitián and others, "Russia—Meeting on Exchange Rate Policy" (June 12, 1995); IMF archives, Accession 1998-0106-0008, Box 22082, OMD-AD (Fischer).

Figure 7.2. Russia: Exchange Rates, 1992–99



Source: International Financial Statistics.
Note: Nominal rate is normalized on the new ruble, introduced in January 1998 and equal to 1,000 old rubles.

who responded that the Fund would advise them to retain the floating rate for the time being but would go along if the authorities decided to peg the rate.[64]

The policy that emerged from these discussions and that was put in place in July 1995 was a horizontal band, or "corridor," for the exchange rate. That is, the central bank undertook to maintain a fixed dollar-ruble rate within a margin of ±6.5 percent. Despite the Fund's lack of enthusiasm about the policy shift, the staff worked closely with the authorities to help them design and prepare for it, and they soon acknowledged that the corridor had succeeded in calming the markets during a period of economic and political uncertainty.[65]

The difficulty with pegging the exchange rate did not become apparent until later. At first, the new exchange rate regime provided a stable anchor for price expectations, stimulated the government and parliament to get serious about controlling the fiscal deficit, and helped generate confidence in the ruble as the medium of exchange and value in Russia. Over time, however, as the fiscal imbalance proved more and more intractable, inflation continued to be higher than in the

[64]Memorandum from Odling-Smee to Fischer, "Russia—Exchange Rate Management and Stabilization Strategy," June 23, 1995; IMF archives, Accession 1998-0106-0008, OMD-AD (Fischer).

[65]"Russian Federation—Request for Extended Arrangement," EBS/96/31, Suppl. 3 (March 12, 1996), p. 9.

United States and western Europe, and the dollar appreciated against other major currencies, the real value of the ruble climbed steeply (Figure 7.2). Without a lasting solution to the fiscal shortages, preserving the peg was bound to become increasingly difficult and costly. The government and the Fund faced the challenge of finding a way to introduce more flexibility and realism into the exchange regime before a problem could escalate into a crisis.

The Extended Arrangement

THE REJECTION OF REFORM IS AN EASY SOLUTION, BUT IT HOLDS NO FUTURE.

Boris Yeltsin[66]
President of the Russian Federation
February 22, 1996

The successful expiration of the stand-by arrangement in February 1996 ushered in the next and more difficult stage in Russia's relationship with the IMF. After three and a half years of borrowing, the time had come for Russia to begin repaying the earliest drawings. The scheduled repayments were moderate—about $500 million, or 5 percent of outstanding debts, was due in the first year—but they were coming at a time when Russia needed *more* external financing and could not afford net outflows of hard currency. Output was estimated to have declined by more than 40 percent since 1991. Even allowing for the inherent exaggeration in such estimates, popular impatience with the length of the transition toward renewed economic growth was naturally becoming intense. The government accordingly requested a new arrangement, larger and longer term than its predecessors, to be financed under the IMF's Extended Fund Facility (EFF).

Negotiating in an Election Year

Planning for this multiyear EFF arrangement had begun earlier, in June 1995, with scarcely a pause after the start of the one-year stand-by arrangement. For eight months through February 1996, Horiguchi and two rotating teams of staff economists held almost continuous talks with Russian officials, mostly in Moscow but also in Washington, simultaneously reviewing compliance with the 1995 program and negotiating terms for the next one. As the talks progressed and the deadline for completion loomed, it became increasingly apparent to both sides that the successes of 1995 were already fading and would be difficult to repeat.

To meet the program targets each month in 1995, the ministry of finance had set up a special unit whose only job was to find ways to implement the program

[66]Letter from President Yeltsin to Michel Camdessus (February 22, 1996); in "Russian Federation—Request for Extended Arrangement—Supplementary Information," EBS/96/31, Suppl. 1 (February 27, 1996), p. 1.

and satisfy the Fund's conditions. In view of the continuing pressures on the budget, this task required ingenuity as well as perseverance, and by the end of the year the unit was nearly "out of breath."[67] The biggest difficulty was that the authorities were restraining the fiscal deficit largely by withholding or delaying essential government spending to keep it within sight of woefully inadequate tax revenues. Horiguchi now proposed to move beyond this ad hoc and transitory solution by insisting on broadening and rationalizing the tax base. The staff report supporting the authorities' request for the 1996 EFF arrangement stressed this point:

> At the heart of the revenue collection problem is the authorities' acquiescence to the perpetuation of a "culture of nonpayment." Greater exercise of political will to collect taxes due should be an integral part of a strategy directed at putting an end to this culture. . . . Significant strengthening in the technical design of the tax system and the procedures of tax administration is also required.[68]

Major political uncertainty, initiated by the growing strength of the Communist Party in parliamentary elections held in December 1995, added to these worries. Yeltsin was campaigning for reelection in July 1996, and it now appeared that his chief—and formidable—rival would be Gennady Zyuganov, the Communist Party leader. That prospect frightened not only those concerned primarily about the future of Russian democracy—G7 leaders as well as Yeltsin's supporters in Russia—but also those concerned primarily about the future of the Russian economy—notably the IMF. In an apparent panic, Yeltsin abruptly fired Chubais, the most prominent reformer in his cabinet, as first deputy prime minister in January 1996 and replaced him with Vladimir Kadannikov, known primarily as the former director of automobile manufacturing in the Soviet era. While this sop to the Communists might have enhanced Yeltsin's reelection prospects, it certainly did nothing to enhance the prospects for economic progress.

Pressure on the Fund from the G7 intensified as the anticipated expiration of the stand-by arrangement approached. U.S. President Clinton warmly received Chernomyrdin in the White House at the end of January and publicly stated his support for the proposed new IMF lending—even though negotiations were still under way.[69] Soon afterward, both German Chancellor Kohl and French President Jacques Chirac responded to personal appeals from Yeltsin by offering new bilateral

[67]The phrase is from a statement made by the Russian Executive Director, Dmitri V. Tulin, at EBM/96/27 (March 26, 1996), p. 6.

[68]"Russian Federation—Request for Extended Arrangement," EBS/96/31, Suppl. 3 (March 12, 1996), p. 12.

[69]In response to a reporter's question on January 30 about the proposed IMF loan, President Clinton replied, "As far as I know, they've worked out—they either have worked out or we are in the process of seeing worked out—the differences between them. So I believe that the loan will go through, and I believe that it should"; official transcript, U.S. Newswire (January 30, 1996). Also see Clinton (2004), p. 697. Additional information is from interviews. Also see Stone (2002), pp. 138–43.

aid and traveling to Moscow to meet with him. Within the IMF, several Executive Directors quietly conveyed their governments' desires for continuing IMF support for Russia.[70]

The effect this pressure might have had is difficult to judge. Both Camdessus and Fischer were already firmly committed to supporting Yeltsin and Russia if at all possible. Whatever weaknesses and faltering steps they might be seeing in the run-up to the presidential election were likely to be overcome once the election was over. But first Yeltsin had to win, and support from the IMF—as the embodiment of the international community—could help. Clearly, the Fund's support in these circumstances no longer depended primarily on the staff's technical assessments of economic policies and performance. As policy implementation weakened in January and February 1996, the staff saw its job as pushing as hard as possible for improvements while both sides knew that the Fund would approve whatever policies eventually emerged.

With Chubais out of office and the political atmosphere so highly charged, Horiguchi found it increasingly difficult to get the Russians to agree to any meaningful reforms. In a last-ditch effort to move the process along, Camdessus went once again to Moscow to take the case for reform directly to Yeltsin. When he insisted strongly on getting a tough program that the IMF could support on its merits, Yeltsin agreed. Following his meeting with the Managing Director, the Russian president issued a letter addressed to Camdessus, promising his support for "budgetary discipline . . . a tight credit policy . . . [and] strict compliance with the targeted plans to implement structural changes" to "permit the process of economic transformation to become truly irreversible."[71] A few days later, Chernomyrdin and Sergei Dubinin (governor of the central bank) signed off on a program that included, in addition to the usual program conditions, some 13 concrete measures to be taken prior to the start of the EFF arrangement and a long list of structural benchmarks that the Fund staff could monitor throughout the coming year.[72]

Approval of a Risky Program

Whether the government had either the will or the means to carry out this program—even if Yeltsin was reelected in July—was highly questionable.[73]

[70]In mid-February, France offered credits totaling about $800 million, and the prime minister, Alain Juppé, went to Moscow in a show of support. On March 6, the German government announced that it was providing guarantees for DM 4 billion ($2.7 billion) in loans to be provided by German banks. Chancellor Kohl traveled to Moscow in April.

[71]Letter from President Yeltsin to Michel Camdessus (February 22, 1996); in "Russian Federation—Request for Extended Arrangement—Supplementary Information," EBS/96/31, Suppl. 1 (February 27, 1996), p. 2.

[72]"Russian Federation—Request for Extended Arrangement," EBS/96/31 (February 27, 1996) and Suppl. 1 (same date).

[73]For a candid assessment of the risks, see "Russian Federation—Request for Extended Arrangement," EBS/96/31, Suppl. 3 (March 12, 1996), pp. 36–37.

Nonetheless, the combination of a strong political tailwind, a good record of implementation the previous year, and the prospect of monthly (and practically continuous) monitoring by the staff sufficed to induce the Executive Board to approve the program without dissent on March 26, 1996.[74]

The extended arrangement, designed to put Russia's external finances on a firm footing for at least the next several years, had some unique features. Even though Russia had a current account surplus and was expected to continue to maintain it, the Fund was offering a tremendous level of financial support. The arrangement would allow Russia to draw the equivalent of approximately $10 billion (SDR 6.9 billion, or 160 percent of quota) over three years. If fully drawn, and after allowing for scheduled repayments to the Fund, this new borrowing would raise Russia's indebtedness to the IMF to $15 billion (SDR 10.2 billion) by March 1999, equivalent to about a quarter of the Fund's total loan portfolio in 1996. Approving the arrangement was—along with the Mexico arrangement of the previous year—one of the riskiest financial decisions ever made by the IMF.

Economically, the most important innovation of the 1996 EFF arrangement was its requirement for an increase in tax revenues. In a departure from the previous reliance on sequestering expenditure, the arrangement included a floor that the federal government was required to maintain on tax revenue each quarter. Such a condition had not been used by the Fund before, but it was seen as appropriate for Russia's unique situation.[75] Paradoxically, however, the arrangement also required Russia to eliminate oil-export duties—a major source of revenue for the government—by mid-1996, as part of a general plan to liberalize foreign trade. New excise taxes on the *transportation* of oil ("pipeline" taxes) were supposed to compensate for the loss of revenue, but that assumption was simply unrealistic. As Autheman pointed out presciently, "in the complex world of Russian politics, . . . it is easier . . . to levy export duties than transportation fees."[76] More generally, because the parliament had to approve tax reform but was showing little inclination to do so, raising revenue was to a large extent beyond the control of Yeltsin's government. Desirable as this tax-floor condition might have seemed to the Fund staff at the time, it would eventually help undermine the program.

Once the program was approved, Yeltsin made a genuine effort to meet the Fund's fiscal targets, but he had to continue to rely on issuing decrees limiting

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[74]In addition to continuing the practice of monthly monitoring, the EFF arrangement also included an unusually broad commitment from the Russian authorities to "consult with the Fund on the adoption of any measures that may be appropriate . . . whenever the Managing Director requests consultation . . . because [he] considers that consultation on the program is desirable"; "Russian Federation—Extended Arrangement," EBS/96/31, Suppl. 6 (April 2, 1996), p. 4.

[75]"Russian Federation—Extended Arrangement," EBS/96/31, Suppl. 6 (April 2, 1996) p. 25. As noted above (pp. 306–07), the Fund's major effort to persuade Russia to strengthen tax collections began in 1994.

[76]Statement by Marc-Antoine Autheman (France), at EBM/96/27 (March 26, 1996), p. 12.

spending rather than raising revenue. The Fund staff offered extensive technical assistance on strengthening tax collections, mainly through improvements to the value-added tax and cracking down on major tax avoiders, and on other related issues.[77] These efforts would take time to implement, and when the Executive Board met in early June to review the arrangement, the pledged improvements were still just vague promises. Yeltsin's decrees had, however, kept the deficit within the target, and the Board unanimously approved the next disbursement.[78]

The Fund's approval of the extended arrangement also cleared the path for further financial support from other creditors. At the end of April, the Paris Club of official creditors reached a historic agreement, rescheduling $40 billion of Russia's Soviet-era debts to be repaid over the next 25 years. The accord—the largest rescheduling agreement in the 40-year history of the Paris Club—was made contingent on Russia's "continued and full implementation of" the IMF arrangement.[79] Up to this time, the Paris Club had reached short-term agreements each year (1993–95) to reschedule payments coming due during the period covered by the annual series of IMF-supported programs. Under the rules of the Paris Club, a longer-term agreement required the country to have a multiyear arrangement with the IMF in support of a comprehensive adjustment program. In this case, however, the main catalyst for the adjustment was political rather than economic, driven by U.S. support for the Russian desire to put an early end to the need for continuing annual debt reschedulings.[80]

After the Elections: Weak Implementation

In the weeks leading up to the first round of the presidential election, Yeltsin's standing in the polls steadily improved. He placed first in the voting, just ahead of Zyuganov, and then handily defeated him in the runoff vote on July 3. In important respects, however, including for the Russian economy, it was a Pyrrhic victory.

[77]During the first 14 months the EFF arrangement was in effect, the Fund's Fiscal Affairs Department sent nine technical assistance missions to Moscow and maintained a resident advisor in the state tax service. Five of those missions dealt with tax administration, and the others covered tax policy, customs administration, and general budget issues. During the same period, the Monetary and Exchange Affairs Department sent ten missions, held three workshops, and maintained a resident advisor in the central bank. The Statistics Department sent five missions, held two seminars for central bank officials, and maintained a resident advisor in the state statistics office. The IMF Institute conducted two courses, for officials in the central bank and the ministry of finance. See "Russian Federation—Staff Report for the 1997Article IV Consultation, Review Under the Extended Arrangement, and the 1997 Macroeconomic and Structural Program," EBS/97/78 (May 2, 1997), pp. 44–45.

[78]See minutes of EBM/96/54 (June 5, 1996).

[79]For the press release, see http://www.clubdeparis.org/sections/communication/archives-anterieures/russie.

[80]For details on the agreement, see www.clubdeparis.org. Additional information is from interviews with participants.

In the course of the campaign, Yeltsin had suffered one or more heart attacks. He had managed to keep his weakened health secret by virtually dropping out of public sight, but the Kremlin now faced a power vacuum that would persist until well after Yeltsin could recover adequately to undergo heart surgery in November.[81] In the meantime, the implementation of economic policy slipped badly.

Despite the absence of real leadership, the government had to find a way to rationalize exchange rate policy as soon as the election was over. For a full year, the horizontal corridor had prevented the rate from depreciating in line with Russian inflation, and the extent of the overvaluation was beginning to bite. In April 1996, the IMF staff began discussing options for coping with a possible crisis in the run-up to the elections and for introducing more flexibility into the system once calm was restored. Both Odling-Smee and Fischer offered the Fund's services to the authorities to help them design a workable crawling peg arrangement, but the Russians decided to proceed on their own.[82] On May 15, Dubinin announced plans to replace the corridor with a managed crawl under which the central rate would depreciate against the U.S. dollar by 1.5 percent a month. Although the Fund staff feared the depreciation rate was too slow to prevent the overvaluation from continuing to worsen, they felt they had been presented with a *fait accompli* and had little choice but to keep their reservations quiet.

No one in the IMF knew it at the time, but the situation was worse than it appeared in the official data. As revealed by an external audit demanded by the Fund in 1999, the central bank was overstating the level of its unencumbered foreign exchange reserves by not reporting a number of obligations and guarantees, and it was understating its extension of credit to the government by misclassifying certain transactions. As a result, it appeared throughout the latter part of 1996 that Russia was in compliance with IMF conditions when in fact it was not.[83] When the external audit uncovered this deception, the Executive Director for Russia, Aleksei V. Mozhin, acknowledged that it had been a "shameful story" that had occurred in "a period of extreme madness and hysteria associated with the presidential elections." The Fund concluded that the episode constituted "a fundamental lack of cooperation on the part of the authorities and a serious violation of Russia's obligations to the Fund."[84]

[81]Yeltsin publicly acknowledged his heart problems only on September 5.

[82]See memorandums from Odling-Smee to Fischer, "Russia: Exchange Rate Issues" (April 22, 1996); and Odling-Smee to the Managing Director, "Russian Federation—New Exchange Rate Band" (May 15, 1996); IMF archives, "DMD's 1996 Country Files," Accession 1999-0275-0007.

[83]For the audit report and the staff analysis of it, see "Russian Federation—Staff Report for the 1999 Article IV Consultation and Request for Stand-By Arrangement," EBS/99/124, Suppl. 1 (July 20, 1999).

[84]Minutes of EBM/99/83 (July 28, 1999), pp. 28 (Mozhin) and 97 (Summing Up by the Acting Chairman). Because the discrepancies were not discovered until 1999, the IMF's usual remedies under its misreporting guidelines did not apply. For a more detailed account of the misreporting, see Stone (2002), pp. 142–45. Also see Chapter 16 in this volume.

In the summer and fall of 1996 it was already clear that Russia had progressed little in strengthening the collection of taxes. In July and again in November, the Fund, encouraged by at least some of the reformers in Moscow, temporarily withheld approval of monthly disbursements until the authorities showed modest new signs of progress. At one critical moment, Gaidar—who had left the Yeltsin government for good and had founded his own reform party—telephoned Fischer in late November to ask him to put more pressure on Chernomyrdin and Chubais to get fiscal policy under control. With Yeltsin about to retake the reins, the government had an opportunity to act decisively. If they did not, Gaidar warned, "everything will blow up in one-and-a-half years."[85]

That very evening in November Chernomyrdin and Camdessus were holding a long meeting in Paris that continued over dinner at the Jules Verne restaurant in the Eiffel Tower and went on until the middle of the night. Eventually the prime minister seems to have convinced the Managing Director that matters were about to improve. Camdessus issued a tentative and hedged but generally positive assessment to the press before finally retiring for the night.[86] He then agreed to recommend to the Executive Board that the Fund resume lending to Russia.

When the Board met on Friday, December 13, no one was happy to be asked to support such a weak reform effort. Thomas Bernes (Canada) expressed "deep concerns"; Autheman spoke of the need for "better standards" in dealing with Russia; and Lissakers described her "disappointment" in the authorities' weak performance in carrying out the program. Although the Board granted waivers for Russia's failures to meet the program's conditions (the fiscal deficit being too large, tax collections too weak, and foreign exchange reserves too low) and unanimously approved the drawing, the tone of the meeting conveyed a clear warning to management and staff that Directors expected better evidence of progress in the coming months.[87]

1997: A "Crisis of the State"

The next year, 1997, proved to be just as challenging as the last. With no prospect in sight for closing the gap between government spending and tax revenues or for making exchange rate policy consistent with the fiscal imbalances, the question that occupied the IMF was how the government could finance the fiscal deficit. The options were not attractive. Reluctantly, Horiguchi decided not to oppose a "tax offset" scheme whereby the ministry of defense was allowed to purchase goods from

[85]See Fischer's notes on the conversation (November 27, 1996); IMF archives, "DMD's 1996 Country Files," Accession 1999-0275-0007.

[86]Report from Christian Brachet (Director, Office in Europe) to Shailendra Anjaria (Director, External Relations Department), November 29, 1996; IMF archives, "DMD's 1996 Country Files," Accession 1999-0275-0007.

[87]Minutes of EBM/96/111, pp. 66 (Bernes), 68 (Autheman), and 69–72 (Lissakers). Also see "Russian Federation—Third Quarterly Review Under the Extended Arrangement and Request for Waiver and Modification of Performance Criteria," EBS/99/189 (December 9, 1996).

suppliers and pay for them by canceling the companies' tax arrears.[88] That would help a little, but a more general and reliable source of financing had to be found.

Through 1996, foreign investors had purchased few Russian treasury bills, known by their Russian acronym GKOs, primarily discouraged by restrictions on repatriation of the proceeds.[89] By December 1996, both the Fund staff and the government became convinced that these restrictions had to be abandoned, partly because the restriction on repatriating interest income was incompatible with Russia's obligations under the IMF's Articles, but more important, because Russia needed foreign investment to finance the fiscal deficit. Eliminating the restriction on repatriating interest income (a current account restriction covered by Article VIII) would do little good without a corresponding elimination of the restriction on repatriating principal (a capital account restriction permitted under the Articles).[90] With the full concurrence of—and even encouragement from—the authorities, Horiguchi proposed, and Fischer approved, making a gradual liberalization of the GKO market a condition for continued disbursements under the EFF arrangement, beginning in January 1997.[91]

Meanwhile, the U.S. government was pushing for full acceptance of Russia as a major economic power. At a summit meeting with Yeltsin in Helsinki in March 1997, President Clinton promised to support Russian membership in the World Trade Organization, the OECD, and the Paris Club, and to reconstitute the annual G7 summits as the "Summit of the Eight" with full Russian participation. Accepting Russia as a Paris Club creditor made some sense given that Russia was an important creditor to a number of developing countries that had Fund-supported programs. The idea was nonetheless grating to some other creditors, who vividly recalled that it had been less than a year since they had agreed to reschedule Russia's obligations on its Soviet-era debt. Once again, the political imperative to

[88]Memorandum from Horiguchi to the Acting Managing Director (Fischer), "Russian Federation: Summary of Interdepartmental Meeting on Wednesday, December 4, 1996" (December 5, 1996); IMF archives, "DMD's 1996 Country Files," Accession 1999-0275-0007. For an analysis of these tax offsets in the broader context of the culture of "nonpayments" in Russia at that time, see Pinto, Drebentsov, and Morozov (2000).

[89]GKOs are short-term discount (zero-coupon) bills issued by the ministry of finance.

[90]For the different roles of current account and capital account restrictions in the IMF, see "Issues in Surveillance" in Chapter 4. Russia accepted the obligations of Article VIII in June 1996, and the IMF temporarily approved the continuation of the restriction on repatriation of interest in July. After the authorities agreed to remove the restrictions on both interest and principal gradually during 1997, the Executive Board extended its temporary approval through the end of 1997.

[91]Memorandums to the Acting Managing Director (Fischer) from Odling-Smee, "Russia: New Disbursement Schedule" (December 6, 1996); and from Horiguchi, "Russia: Back-to-Office Report" (December 30, 1996); IMF archives, "DMD's 1996 Country Files," Accession 1999-0275-0007. Also see "Russian Federation: Information Note on End-January Targets Under the Extended Arrangement," EBS/97/3 (January 13, 1997), p. 7. A mythology later took hold that the IMF had forced capital liberalization on a reluctant Russian government; see, for example, remarks by Dubinin, in Desai (2006), p. 235; Stiglitz (2002), p. 145; and Woods (2006), pp. 125–28.

draw Russia into closer economic relations with the west was running ahead of the country's economic realities.[92]

Camdessus, increasingly alarmed at Russia's inability or unwillingness to confront its tax-collection crisis, refused to be drawn into this political whirlwind. At the end of March, just 10 days after the Clinton-Yeltsin summit, he flew to Moscow for a series of meetings with Yeltsin, Chernomyrdin, and other senior officials. Toward the end of the trip, he delivered a speech at the Moscow Institute of International Affairs, publicly urging adoption of a comprehensive program of reforms. Despite an impressive list of achievements, he warned, Russia was "in a state of crisis . . . a crisis of the state."[93]

To resolve the crisis, Camdessus argued, Russia had to improve the legal, regulatory, and institutional environment for private investment. The nonpayment of taxes was close to becoming a "crisis of democracy," especially because it resulted in large part from "the exceedingly close relationship between the government and a number of large enterprises" (partly a reference to the oligarchs created by the loans-for-shares scheme, but also to companies such as Gazprom). More generally, Russia would have to root out corruption, which had become pervasive. Back in Washington a few weeks later, Camdessus went so far as to speak of "a major risk of anarchy" if the Russian government failed to stem the crisis.[94]

Yeltsin personally was receptive to this message, and sought new ways to overcome the parliamentary opposition to liberalization and reform. In mid-March he appointed or elevated several reformers in the government, notably by naming Chubais (who had been serving as his chief of staff since the July 1996 elections) to be a first deputy prime minister and minister of finance.[95]

These appointments created a dilemma for the IMF. For several months, the government had shown little resolve in implementing either fiscal policy or structural reforms, but the Fund had not cut off its financial support. Should it now continue disbursing large sums each month on the assumption that these new

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[92]At that time, the Clinton administration was pressing ahead with plans to expand the North Atlantic Treaty Organization (NATO) by admitting three Visegrad countries—Poland, Hungary, and the Czech Republic—that were former members of the Warsaw Pact. Yeltsin objected strongly to this development, but he muted his opposition after Clinton cleared the path for Russia to join the G7, the Paris Club, and the WTO and to support moves toward Russian membership in the OECD. The G7 summit became the "Summit of the Eight" in June 1997, and Russia was accepted as a creditor member of the Paris Club in September. The three Visegrad countries became NATO members in March 1999. More than a decade later, negotiations continued for Russia to become a member of the OECD and the WTO.

[93]Untitled address (April 2, 1997); accessed at http://www.imf.org/external/np/speeches/1997/mds9705.htm.

[94]Transcript of a press conference (April 24, 1997); accessed at http://www.imf.org/external/np/tr/1997/tr970424.htm.

[95]At the same time, Boris Nemtsov was made first deputy prime minister alongside Chubais, and Aleksei Kudrin became Chubais's principal deputy in the ministry of finance.

appointments signaled an improved policy climate, or should it withhold its approval until the government could produce results, especially on tax collection? Having supported a weaker government for the past year, what message would the IMF be sending if it now turned its back on the reformers?

Those questions generated a fierce internal debate, with Jack Boorman (Director, Policy Development and Review Department, or PDR) leading the case for a "pause" in the arrangement and Michael Mussa (Director, Research Department) supporting Horiguchi in making the case for showing immediate support for the newly returned reformers. In the end, Camdessus sided with Boorman and insisted on a strengthening of tax revenues before releasing any more money under the EFF arrangement.[96] Negotiations continued, and no drawings were allowed in March or April.[97]

The dilemma did not ease with time. Chubais insisted that the Fund's proposed revenue floor was too ambitious economically and was unrealistic politically. In mid-April Fischer told Horiguchi—who was about to lead the last of his 31 staff missions to Moscow—to continue pushing for higher revenues but to be flexible if he failed to make progress.[98] That broke the impasse, and negotiations concluded with a federal government revenue floor equivalent to 8.3 percent of projected GDP, down from the 10.5 percent target that the staff had been demanding. In return, the authorities accepted a somewhat lower level of borrowing: SDR 500 million every three months, down from the previously scheduled SDR 593 million. On May 16, 1997, the Executive Board accepted this compromise, and drawings resumed.

For the next few months, the Russian economy seemed to be stabilizing. Inflation and interest rates were down, output and incomes were growing, the program conditions were satisfied, and the IMF was able to keep disbursing funds under the EFF arrangement. By the time of the IMF/World Bank Annual Meetings in Hong Kong SAR in September, Chubais was even speaking openly of a "friendly divorce" from the IMF. Although Camdessus was not optimistic about such a prospect, he did express his hope that they could succeed in reaching that point.[99]

The deeper picture was less glowing, and the talk of friendly divorce was soon revealed to have been premature speculation. When the next staff mission, now led by Jorge Márquez-Ruarte (Senior Advisor, EU2), went to Moscow in late

[96]Memorandum from Owen Evans (Assistant Director, Mr. Fischer's office) to Fischer (March 21, 1997); IMF archives, Accession 2000-0117-0009, DMD-AI, Box 22267, "Russia."

[97]Through April 1997, Russia had drawn approximately $3.4 billion (SDR 2,336 million) under the EFF arrangement, which was some $680 million less than had been envisaged under the original schedule. This was equivalent to 12 monthly drawings out of 14 scheduled.

[98]File memorandum by Owen Evans (April 17, 1997); IMF archives, Accession 2000-0117-0009, DMD-AI, Box 9, "Russia."

[99]Responding to a reporter's question in Hong Kong SAR, Camdessus noted that a "divorce" would mean "that we will continue, in one way or another, living together but I will no more pay for the expenses of the household. Our love will continue to be exuberant, and I believe the lady there will be even more charming." On that risqué note, his spokesman quickly called the press conference to a close. For the transcript, see http://www.imf.org/external/np/tr/1997/tr970925.htm.

October, it found that the budget imbalances were much worse and more entrenched than had been thought throughout the summer. Within days, even before the mission finished its work, the seeds of one of the most severe financial crises of the decade were beginning to sprout.

The Crisis of 1997–98

As promised, Russia had been gradually liberalizing its treasury bill market for foreign investors throughout 1997. By October, the remaining restrictions were largely ineffective, and nonresident purchases of GKOs were rising sharply.[100] Speculative investors were lured in by a combination of high nominal yields, the ability to engage in "carry trade" by borrowing cheaply in Japanese yen and other major currencies, a stable exchange rate, and the appearance of safety associated with IMF and other official international support. This inflow enabled the government to finance its fiscal deficit without tackling the deep-seated structural and social problems that made effective tax collection and expenditure control practically impossible. Even if the inflow of foreign capital had been steady and reliable, the longer-term consequences of these issues would have been worrisome. In reality, Russian fiscal policy was now constrained by the whims of international speculation as well as by the government's inability to control taxes or spending. The interaction of these two forces was about to drive the Russian financial system into a horrendous crisis.[101]

The First Wave: October 1997

The first break in expectations came on October 28, 1997, just five weeks after the ebullience of the meetings in Hong Kong SAR. On that one day, in an attack that apparently came as a complete surprise to Russian officials, the Russian stock market lost 20 percent of its value, interest rates on GKOs rose from 19 percent to 25 percent, and the exchange rate fell to the bottom of the central bank's daily intervention limit. The timing of the attack was unrelated to any particular news about Russia. For some weeks, investors had been getting increasingly nervous about financial developments in East Asia. The Taiwan dollar, which most investors had thought to be unassailable, had been devalued in mid-October, precipitating a general pullout from emerging stock markets beginning on October 20. Over the

[100]Throughout this period, until after the 1998 crisis, the IMF staff did not have access to data on the ownership of government debt by nonresidents. As it turned out, by mid-1998 about a third of the outstanding stock of GKOs was held by nonresidents; see IMF (1998), p. 18, and Santos (2003), p. 162.

[101]For an overview of the chronology of the crisis, and an analysis of how the inconsistency between loose fiscal policies and tight exchange rate policies made the crisis inevitable, see Kharas, Pinto, and Ulatov (2001).

next four days, the Hong Kong market fell by more than 23 percent. By the next Monday, October 27, equity markets were declining sharply throughout the Americas as well, from New York to Buenos Aires. Perhaps the real surprise would have been for Russia to remain unaffected, but the magnitude of the collapse was still a major shock.

Although these losses were partially reversed in the coming days, the IMF was now on the alert and ready to shift into crisis mode. Two problems had to be solved: fiscal policy had to be brought into balance without continued reliance on short-term money from abroad, and exchange rate policy had to be managed to prevent the outflows from depleting the central bank's reserves.

Everyone who was involved at the IMF agreed that the fiscal problem was acute and a top priority. On exchange rate policy, views were less unified. At this time, the Russia team on the staff wanted the authorities to devalue the ruble immediately and then manage the crawling band with more flexibility than in the past year. Fischer discouraged that line of advice by arguing that the fiscal imbalance should be tackled first to avoid a serious loss of confidence. In the meantime, the authorities could let interest rates rise. If that approach failed to stem the pressure, then they could consider devaluation. [102]

The mission returned to Washington at the end of October without a resolution on how to strengthen policies. Fischer went to Moscow on November 9 to break the impasse. At the end of his three-day visit, he and the ministry of finance announced agreement on a package of tax and spending measures that became known formally as the Fiscal Action Plan and informally as the Kudrin-Fischer Plan.[103]

Now that the government had a strategy for controlling the budget, the question was whether it could implement the plan. Some elements, such as ending the practice of canceling tax arrears as a way of paying for government purchases, were implemented right away by getting Yeltsin to issue a presidential decree.[104] Others, such as raising domestic interest rates, could be implemented right away by the central bank. The longer-lasting elements, necessary for bringing taxes and spending into alignment and for reducing the incentives for corruption, were still impossible to implement because the government was deeply divided within itself and the measures were strongly opposed by the majority in parliament. Until some real

[102]Memorandums from Odling-Smee to the Managing Director, "Russia—Exchange Market Pressures" (November 5, 1997); and from Márquez-Ruarte to the Acting Managing Director (Fischer), "Russia: Emergency Assistance" (November 14, 1997); IMF archives, Accession 2000-0117-0009, DMD-AI, Box 9, "Russia III."

[103]For a summary of the plan, see "Russian Federation - Sixth Quarterly Review Under the Extended Arrangement," EBS/97/245 (December 24, 1997), p. 19.

[104]Yeltsin signed the decree ending the tax offsets on November 7. In recognition of the role the IMF had played in the background, Chernomyrdin signed a copy with a congratulatory note and gave it to Fischer, who proudly displayed it on his office wall for several years.

progress could be shown on that front, Fischer was not prepared to promise any more financial support from the IMF.[105]

While Fischer was still in Moscow, Dubinin announced that the central rate of the ruble would be devalued at the beginning of 1998 as part of a currency reform and that the market rate would be allowed to fluctuate within a wide horizontal band. In practice, this would allow the central bank to manage a gradual depreciation within the band. At the time, this tactic seemed sufficiently flexible, but it failed utterly to impress investors in the GKO market. By the end of November, the central bank was running dangerously low on foreign exchange reserves, the exchange rate was at the bottom end of the daily intervention band, and a further sharp increase in interest rates was not generating confidence.

For the next few weeks, the IMF tried to force specific reforms on a reluctant government while publicly dangling the prospect of renewed financial support. Camdessus, holding the toughest line, insisted that the government block access to Russia's oil-export pipelines for companies with major tax arrears. That requirement nearly backfired when Boris Berezovsky, owner of one of the delinquent companies and one of the country's most prominent oligarchs, obtained a copy of a letter to this effect from Camdessus to Chernomyrdin and promptly leaked it to parliamentary leaders. That, understandably, created the impression that the IMF was dictating economic policy to the government.[106] Nonetheless, the authorities proceeded to crack down on major tax cheaters, though the largest among them continued to avoid compliance. Despite the difficulties, Camdessus decided that the tax-collection effort was sufficiently strong to warrant resumption of lending. On January 8, 1998, the Executive Board met and approved a drawing of $672 million (SDR 500 million).

Despite this injection of cash and the vote of official confidence it represented, Russia's financial prospects continued to deteriorate. The February staff mission tried to take a tough line with the government by insisting on a high floor on federal tax collections (11 percent of GDP). The government eventually agreed to this demand, but it had no way to achieve it. The mission chief, Márquez-Ruarte, later admitted that the ambition had been unrealistic.[107]

[105]Memorandum from Fischer to the Managing Director, "Visit to Russia, November 9–11" (November 11, 1997); IMF archives, Accession 2000-0117-0009, DMD-AI, Box 9, "Russia III."

[106]Memorandum from Odling-Smee to the Managing Director, "Russian Federation: Report from the Mission" (December 9, 1997); IMF archives, Accession 2000-0117-0009, DMD-AI, Box 9, "Russia III."

[107]See memorandums of February 27 and May 26, 1998, from Márquez-Ruarte to the Managing Director, "Russia—Back-to-Office Report on Mission to Finalize 1998 Program Negotiations" (February 27, 1998) and "Russia—Back-to-Office Report for Follow-Up Staff Visit to Review Implementation of the 1998 EFF Program" (May 26, 1998); IMF archives, Accession 2001-0284, OMD-DMD [Fischer], Box 12, file "Russia (1)."

On February 17, Camdessus flew to Moscow from Seoul, where the Republic of Korea's own financial crisis was moderating but still worrisome after three months of effort (see Chapter 11). In meetings with Yeltsin and Chernomyrdin, he did his best to convince them that Russia faced many of the same preconditions for a crisis that Korea had a few months earlier. He warned that unless Russia decisively tackled its fiscal imbalances, made the oligarchs pay their taxes, and strengthened the banking system, it was heading for a disaster of similar dimensions as those that had hit countries across Asia. Camdessus also met with a group of the most powerful oligarchs—including well-known oil tycoons such as Platon Lebedev and Mikhail Khodorkovsky—and lectured them on the dangers they were foisting on the Russian economy and therefore on their own futures.[108] These warnings, however, had no discernible effect on either the government or the industrialists. Yeltsin, as he had several times before, reacted to the crisis conditions by firing the prime minister (Chernomyrdin) and his first deputy (Chubais).[109]

The change in government, predictably, made matters worse. The parliament twice rejected Yeltsin's chosen candidate for prime minister, Sergei Kiriyenko, before finally accepting him on April 24. Meanwhile, policy implementation slipped even more badly than it had previously. At the IMF, the challenge was to negotiate a realistic and viable economic program for the remainder of 1998 that would merit the continuation of Fund support through the EFF arrangement, at a time when no one—not even the U.S. officials who had long been pushing the IMF to lend in support of dubious programs—had any confidence that promises would lead to actions.[110]

The Second Wave: May 1998

Discussions between the staff and Russia's economic team continued through April with little progress. Then, on May 18, the second wave of the financial crisis began. The annualized yield on GKOs suddenly jumped from about 30 percent to more than 50 percent, and the central bank was forced to intervene heavily to

[108]On Camdessus's meetings in Moscow, see memorandums from Odling-Smee to the Managing Director, "Russia—Program for Your Visit" (February 10, 1998) and "Russia—Report to the Executive Board" (February 24); IMF archives, Accession 2001-0284, OMD-DMD [Fischer], Box 12, file "Russia (1)." Berezovsky also was on the list of participants, but he reportedly was injured and unable to attend (Blustein, 2001, p. 247). For Camdessus's views on the oligarchy and its similarities to "crony capitalism" in Asia, see his April 1998 speech to the U.S.-Russia Business Council in Washington; accessed at http://www.imf.org/external/np/speeches/1998/040198.htm. Berezovsky later went into exile to avoid prosecution, and Lebedev and Khodorkovsky were both convicted of and jailed for tax evasion and fraud.

[109]On the rationale for firing Chernomyrdin, see Yeltsin (2000), pp. 103–14.

[110]Treasury Under Secretary Summers went to Moscow in early May, and Vice President Gore in late July, to try to warn the Russians that they had to strengthen policies and meet the IMF's conditions if they wanted U.S. support.

prevent the ruble from collapsing. Although Gaidar had predicted 18 months earlier that "everything will blow up" in a year and a half (see above, p. 319), again developments in Asia more than those in Moscow dictated the timing of this wave. This time the catalyst was a political crisis in Indonesia, where rioting against the Suharto regime had left hundreds of people dead. The newly renamed "Group of Eight" summit meeting in Birmingham, England, had concluded on Sunday, May 17, with a call for "political reform" in Indonesia—widely understood to be a veiled call for President Suharto to resign. As investors began pulling money out of weak economies, Russia again was on the front lines.

By coincidence, Márquez-Ruarte and a team of IMF economists arrived in Moscow the next day to resume discussions on the 1998 program. (No drawings had been allowed since January while these talks continued.) Shortly afterward, the head of the IMF office in Moscow, Martin Gilman, told reporters that the Fund was not ready to approve Russia's policy program. That statement contributed to a further decline in financial markets, but the Fund and the government acted quickly. Camdessus publicly denied that the Russian economy was in a crisis and asserted that the financial panic was "not a major development" (Gordon and Sanger, 1998, p. A1). On Tuesday, May 26, Yeltsin announced a new package of fiscal measures. After Kiriyenko called Fischer to explain this new package, the Fund issued a news brief welcoming the progress and expressing the IMF's hope "to conclude its assessment of the 1998 program in the next few days."[111] Odling-Smee left immediately for Moscow, held further talks on the remaining fiscal shortcomings, and conducted a press conference intended to reassure financial markets.[112]

On May 28, Chubais flew to Washington, arriving at midnight, and spent all of the next day meeting with senior U.S. and international officials, including Secretary Robert E. Rubin and Summers at the Treasury and Fischer at the IMF. Though not even an official member of the Russian government at the time, Chubais (accompanied by Yeltsin's deputy chief of staff, Sergei Vasiliev) was not only pleading for an early release of the next installment of the EFF loan; he was also opening an appeal for large-scale additional financing through the Fund's new Supplemental Reserve Facility (SRF; see Chapter 5). The appeal succeeded quickly with the Americans, and two days later, President Clinton announced that he "endorses additional conditional financial support from the international financial

[111]See "IMF Management Welcomes Russian Fiscal Measures, Hopes to Conclude Program Assessment in Next Few Days," NB/98/14 (May 26, 1998); accessed at http://www.imf.org/external/np/sec/nb/1998/nb9814.htm.

[112]See "IMF Welcomes Russian Government's Statement on Fiscal Measures; Management to Recommend Completion of Review Under Russia's EFF Program," NB/98/15 (May 29, 1998); accessed at http://www.imf.org/external/np/sec/nb/1998/nb9815.htm.

institutions." Although IMF management and staff were initially skeptical, Clinton's announcement put strong pressure on them to consider the financing.[113]

Unfortunately, the latest policy announcements from Moscow impressed the financial markets even less than they had Fund officials. By June 1, GKO yields were approaching 95 percent, as the central bank tried desperately to preserve its policy of fixing the exchange rate of the ruble against the dollar. The IMF now had to sail a very narrow channel between the Scylla of financing weak policies and the Charybdis of contributing to a total collapse of the Russian economy.

Given the amount of pressure and the limited room and time for maneuver, it is perhaps not surprising that management of the crisis did not go smoothly. On June 11, the Fund announced that agreement had been reached on a program that qualified for financing via the next tranche of the EFF arrangement. "Provided that the actions to be taken in the next few days are implemented," the Board would meet on June 18 to complete the review and release the money.[114] This announcement was aimed at restoring a measure of investor confidence, but it risked backfiring if the authorities failed to complete the required actions, which included moving aggressively against tax cheaters and improving the transparency of industrial privatizations.

The backfire came on June 18, the day the Executive Board was scheduled to meet. Although most prior actions had been completed, little had been done to improve tax collections, and the Fund had to announce that the Board meeting was being postponed. As an additional misfortune, the announcement came just as the government was preparing to issue a new, long-term, dollar-denominated Eurobond. The postponement of the Board meeting confused and upset investors, and the government had to pay about 7.5 percentage points above comparable U.S. rates to sell the bond. Closing the financing gap was getting ever more out of reach.

Yeltsin then brought Chubais back into the government as his special representative to negotiate with the IMF and other official creditors. More important, both Yeltsin and Kiriyenko finally seemed to be convinced that they needed to act more decisively to fill the hole in the budget. On June 23, Yeltsin summoned legislators to a public meeting and threatened to rule by decree if they refused to pass his

[113]When news reports began circulating that IMF officials were skeptical, David Lipton, under secretary of the U.S. Treasury, telephoned the Fund's chief spokesman to insist that Clinton's expression of support not be undercut. That induced the Fund to change its official message slightly to say that additional support "was not being excluded"; see memorandum from Shailendra Anjaria to the Acting Managing Director (Fischer), "Russia—Call from Mr. David Lipton" (June 1, 1998); IMF archives, Accession 2001-0284, OMD-DMD (Fischer); Box 12, file "Russia (2)."

[114]See "Russian Authorities and IMF Reach Understandings on 1998 Economic Policy Statement," NB/98/20 (June 11, 1998); accessed at http://www.imf.org/external/np/sec/nb/1998/nb9820.htm.

proposed budget. At the same meeting, Kiriyenko stated unequivocally that the government had to assume responsibility for the crisis: "Today we are confronted with the result of our indecisiveness in carrying out reforms. . . . Russia's problems lie not in Asia, but in Russia itself" (Gordon, 1998b, p. A3).

The question at the IMF, as it had been all along, was whether brave words would be followed by convincing actions. Fischer had gone once again to Moscow on June 22 to persuade Kiriyenko and Chubais that they had to crack down much more forcefully on the largest tax evaders. By June 24, the authorities had taken actions against some offenders and had promised to act against the rest by July 1, when the next tax payments were due. That promise persuaded Fischer to schedule a Board meeting for the next day, even though neither he nor anyone else really believed the promise could be fully kept.[115]

When the Executive Board met on June 25, the atmosphere was heavy. At the outset, Fischer acknowledged that the Russians had not yet done all the Fund had asked. He recommended approval as a necessary step to prevent a total collapse of confidence, but he promised that "if the authorities do not proceed forcefully against the largest tax delinquents after July 1, that would affect the Board's consideration of any further financial support for the Russian Federation." Even though the U.S. government had been the leading advocate for going ahead with the program, Lissakers concurred with this cautious assessment. She poignantly compared the ongoing saga of apparently endless rescue attempts to the classic silent film serial, "The Perils of Pauline," in which the hapless heroine was repeatedly saved from impending death at the last possible moment. [116]

Several Directors were upset at being asked to approve a program for which both the track record and the prospects for implementation of promised reforms were so poor. Charles O'Loghlin (Alternate, Ireland) undoubtedly spoke for many of his colleagues on the Board in saying it was "with considerable reservations" that he was willing to "once again give the Russian authorities the benefit of the doubt." Yukio Yoshimura (Japan) complained that the Fund seemed to be supporting Russia only because it was, in a sense, too big to be allowed to fail. Concerns about "disruptive systemic implications for global financial stability," he warned, "should not compromise our attitude to program implementation."[117]

Despite these reservations, no one abstained or voted against completing the review. Russia drew close to $670 million (SDR 500 million), bringing the country's total indebtedness to the IMF to $14.3 billion.

[115]See memorandum from Gérard Bélanger (Deputy Director, EU2) to the Acting Managing Director, "Russia—Decision to Hold Board Meeting Tomorrow" (June 24, 1998); IMF archives, Accession 2001-0284, OMD-DMD (Fischer); Box 12, file "Russia (2)." Also see "Russian Federation—The 1998 Program and Seventh Quarterly Review Under the Extended Arrangement," EBS/98/100, Suppl. 2 (June 24, 1998).

[116]Minutes of EBM/98/68 (June 25, 1998), pp. 21 (Fischer) and 13 (Lissakers).

[117]Minutes of EBM/98/68 (June 25, 1998), pp. 23 (O'Loghlin) and 25 (Yoshimura).

The Third Wave: July 1998

Even at this late stage, the Fund staff team remained convinced that Russia could and should avoid devaluing the ruble. The staff did, however, begin developing a more detailed fallback position in case market pressure on the currency and depletion of Russia's foreign exchange reserves should become unbearable. If the government could take exceptional steps to raise tax revenue, and if it could get even more large-scale financial assistance to close its financing gap until those revenues could be realized, then a devaluation of, say, 10 or 15 percent might stabilize the foreign exchange market.[118] In view of the amount of money involved, the six-year history of setbacks and false promises, and the importance of a stable Russia to the institution and to the world, this was almost as risky a prospect as anyone could have imagined. But with the expectation that Russia's continuing failures to act would lead to a complete collapse of the currency, destroy the Russian banking system, and ultimately bring down the government, the available alternatives appeared to be even worse. No one should have been under any illusion that the Russian government could get tax policy under control. On July 3, barely a week after the Fund had renewed its support, parliament rejected several of Yeltsin's proposals to raise federal revenues and thereby effectively undermined the program (see Schleifer and Treisman, 2000, p. 149).[119] In response, the U.S. government tried to shift its pressure from the Fund to the Russians, in what President Clinton privately called a "fulcrum moment" for U.S. policy toward Russia. The administration promptly dispatched David Lipton to Moscow to tell officials the United States would not support further disbursements from the IMF unless Russia carried out the agreed-on conditions. Yeltsin responded, as he often did, by phoning Clinton and insisting that he had to get a public promise of support from the IMF *before* he could get parliament to approve the tax reforms. If not, "it will mean the end of reform and basically the end of Russia" (Talbott, 2002, p. 275).[120] This telephone diplomacy severely circumscribed the ability of the staff and management of the IMF to influence the course of economic policy in Russia.

Meanwhile, Odling-Smee arrived in Moscow the same day as Lipton and spent an intense weekend negotiating a new program to be supported by additional and much larger IMF financing. Simultaneously, Márquez-Ruarte was helping Russia's finance officials complete an offer to private creditors to

[118]See memorandums from Fischer to the Managing Director, "Russia: What Now?" (June 28, 1998) and from Odling-Smee to Fischer, "Russian Federation—Alternative Adjustment Scenarios" (July 2, 1998); IMF archives, Accession 2001-0284, OMD-DMD (Fischer); Box 28269, "Russia (2)."

[119]Also see memorandum from Odling-Smee to the Managing Director, "Russian Federation—Outlook for Negotiations" (July 6, 1998); IMF archives, Accession 2001-0284, OMD-DMD (Fischer); Box 12, file "Russia (2)."

[120]Also see Blustein (2001), pp. 254–56; and Rubin and Weisberg (2003), p. 279.

convert holdings of GKOs into longer-term bonds denominated in U.S. dollars. In Washington, Camdessus was meeting with James D. Wolfensohn, President of the World Bank, to try to secure the Bank's help with the proposed financing package despite the Bank staff's reservations about the wisdom of trying to avoid devaluation.[121] In New York, the G7 finance deputies met privately and agreed to support massive new lending by the IMF once a new program was in effect.

This flurry of activity succeeded well enough for Kiriyenko to sign a new Letter of Intent on Monday, July 13. In it, the prime minister acknowledged that the "root cause" of the financial pressures Russia faced was its "large government borrowing requirements and the uneven progress in structural reforms over the past several years." To address the problem, he promised a "radical tightening of the federal budget," to be supported by massive new financing from the IMF and voluntary restructuring of the government debt to lengthen its maturity. For its part, the IMF would augment the existing extended arrangement (approved in 1996 and scheduled to last until March 1999) by \$8.5 billion (SDR 6.3 billion, or an additional 146 percent of Russia's quota). According to the press release issued in Camdessus's name on July 13, \$5.6 billion would be disbursed immediately upon approval by the Executive Board, which was scheduled to take place just one week later, on July 20.[122] Of that \$5.6 billion, half would be an initial drawing on the augmented EFF arrangement and half would be through the Compensatory and Contingency Financing Facility (CCFF) to help Russia cover a temporary shortfall in export receipts related to the depressed level of world oil prices.[123]

As was by then customary in dealing with capital market crises, the IMF folded its announcement of additional financing into a larger package that included pledges from other official creditors. The headline figure called for total financing of \$22.6 billion for the remainder of 1998 and in 1999: \$14.1 billion from the IMF,

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[121]See file memorandum by Juan J. Fernandez-Ansola, "Russia: Debt Conversion" (July 10, 1998); memorandum from Odling-Smee to the Managing Director, "Breakfast with Mr. Wolfensohn" (July 7, 1998); and memorandum from Odling-Smee to Fischer, "Russian Federation—Recent Visit" (July 15, 1998); all in IMF archives, Accession 2001-0284, OMD-DMD (Fischer). The first two items are in Box 12, file "Russia (2)"; the third is in Box 28268, file "Russia (3)." Also see Gordon (1998a), p. A9.

[122]NB/98/24 (July 13, 1998); accessed at http://www.imf.org/external/np/sec/nb/1998/nb9824.htm. From March 1996 through June 1998, the IMF had disbursed the equivalent of \$5.8 billion of the originally committed \$9.2 billion under the EFF arrangement (both evaluated at the July 1998 SDR/\$ exchange rate). By augmenting the total arrangement to \$17.7 billion, the balance remaining to be drawn would be raised to \$11.9 billion.

[123]Crude oil prices averaged \$19.27 a barrel in 1997. In July 1998, the staff estimated that the price would average \$13.86 in 1998 and then recover; see Appendix III of "Russian Federation—Use of Fund Resources—Request for Augmentation of Extended Arrangement and Request for Purchase Under the Compensatory and Contingency Financing Facility," EBS/98/120, Suppl. 1 (July 17, 1998).

$6 billion from the World Bank, and $1.5 billion from Japan. Aside from the $5.6 billion to be disbursed at once, the availability of these amounts depended both on further negotiations and on implementation of the agreed-on program.

These large proposed drawings strained the IMF's liquidity position, especially after the commitments the Fund had recently made to Indonesia, Korea, and other members in the past year. Many in the Fund thought it high time for major official creditors to get more publicly involved in backing the Fund's support for Russia. Consequently, after consulting with Executive Directors from creditor countries, Camdessus decided to borrow the money by activating the General Arrangements to Borrow (GAB) for the first time in 20 years (see Chapter 15). That is, the whole SDR 6.3 billion augmentation of the EFF arrangement would be lent to the IMF by the 11 countries participating in the GAB.[124]

Even before the Executive Board could meet to act on this request, the program began to unravel. The debt-conversion scheme activated on July 14 failed to slow either the continuing rise in GKO yields or the downward pressure on the value of the ruble.[125] Institutional investors were willing to buy long-term dollar-denominated Russian bonds only at high spreads over low-risk western government debt and only as long as they could be confident that the IMF and other official creditors would continue to provide large-scale financial support to the Russian government. Uncertainty about the IMF's intentions, especially after the obvious lack of enthusiasm for approving the June disbursement, seemed to be further driving up the required yields and driving down the ruble.[126]

Even worse, on July 16 parliament again refused to approve the tax increases at the heart of the economic program. To rescue the program long enough to keep the basis for IMF support alive—though just barely—Yeltsin once again issued presidential decrees to modify the tax laws. Under the Russian constitution, that gave parliament 10 days to decide whether to acquiesce to the decrees: 10 days

[124]GAB participants comprised the countries in the Group of 10 (G10). For a list of participants and the amount provided by each for this purpose, see "General Arrangements to Borrow—Proposal for Future Calls for Exchange Transactions Under an Augmentation of the Current Extended Arrangement for the Russian Federation," EBS/98/123 (July 17, 1998) and Suppl. 1 (July 20, 1998). President Clinton (2004) erred in claiming that the United States "contributed almost a third of the $23 billion IMF package in July" (p. 807). The correct figure was 25 percent of the GAB financing. Even applying that percentage to the potential financing of the IMF commitment would imply a contribution of about one-sixth of the total package.

[125]The text of the debt-conversion scheme was circulated in the Fund as FO/DIS/98/64, "Russian Federation—Road Show Documentation" (July 15, 1998). For background and analysis of the scheme, see Blustein (2001), pp. 260–65; and Kharas, Pinto, and Ulatov (2001), p. 2.

[126]At the June 25, 1998, meeting of the Executive Board, Willy Kiekens (Belgium) warned that the terms of the planned conversion were excessively expensive and that Russia was "now extremely vulnerable to changes in market sentiment, and that the continuation of her present policies was not sustainable"; minutes of EBM/98/68, pp. 18–19. Also see the above discussion of the overall tone of that Board meeting.

during which the Fund would have to decide whether to advance billions of dollars to the government.[127]

The staff report was brutally frank. "Clearly the Fund is undertaking exceptional risks in Russia. Past failures to implement agreed programs, the uncertain timing of a return of market confidence, and the uncertainty of a strengthening of the economy cast some doubt on Russia meeting its payments to the Fund on time."[128] Russia's Executive Director, Aleksei Mozhin, was no less honest, telling his colleagues that their approval would be "very risky" and would be justified only because the alternative would be "even more risky."[129]

Responding to these risks, and to quell a rebellion by Executive Directors threatening to oppose the augmentation of the arrangement, Camdessus decided to scale back the magnitude of the initial drawing from $5.6 billion to $4.8 billion. That infuriated Chubais, who had come to Washington in the days leading up to the Board meeting. Chubais went to the IMF to see Fischer and warned him that the financial markets were likely to view the reduced access as a signal that the Fund lacked confidence in Russia. If so, the hoped-for catalytic effect on investor confidence could be seriously undermined. Fischer disagreed, but in any case he could not overturn the decision.

When the Board met on July 20, several Directors from creditor countries wanted to delay approval until after the Russian parliament had approved the tax reforms, but Odling-Smee reassured them that "the staff believes the Duma will acquiesce to the Presidential decrees." In the end, no one abstained or voted against the proposal, but Fischer (who chaired the meeting) acknowledged that "most Directors agreed only reluctantly to the program."[130] The Fund promptly disbursed the equivalent of $4.8 billion, bringing Russia's outstanding debt to the

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[127]The debt-conversion scheme discussed in the preceding paragraph, the rejected tax measures, and the plan to issue presidential decrees are described in EBS/98/120, Suppl. 1 (July 17, 1998), pp. 8, 10, and 16, respectively.

[128]"Russian Federation—Use of Fund Resources—Request for Augmentation of Extended Arrangement and Request for Purchase Under the Compensatory and Contingency Financing Facility," EBS/98/120, Suppl. 1 (July 17, 1998), p. 18.

[129]Minutes of EBM/98/79 (July 20, 1998), p. 29.

[130]Minutes of EBM/98/79 (July 20, 1998), pp. 29 (Mozhin), 51 (Odling-Smee), and 72 (Fischer). Those arguing for a delay were from Australia, Belgium, Canada, Italy, and Japan. Tellingly, the press release the Fund issued at the end of the day stated only that "the management of the IMF welcomes the decision of the Executive Board" and the policy actions taken by the Russian government, without stating that Executive Directors endorsed the program or the government's actions; "IMF Management Welcomes Executive Board Support for Russia," NB/98/26 (July 20, 1998); accessed at http://www.imf.org/external/np/sec/nb/1998/nb9826.htm. Later, Odling-Smee (2006) admitted the staff knew "the government was weak and could not deliver very much" on fiscal policy (pp. 170–71). Similarly, Rubin wrote in 2003 that he had believed at the time that the odds were less than even that the program would succeed, but "the risks to the United States from destabilization in Russia seemed so enormous . . . A small chance of success was worth a high risk of failure" (Rubin and Weisberg, 2003, pp. 276–77).

Fund to what would turn out to be its all-time peak of $16.2 billion (SDR 14.1 billion; see Figure 7.1).

The Russian parliament refused even to meet in August to consider Yeltsin's decrees. Kiriyenko, Boris Fyodorov (the former finance minister, now back in government in charge of tax collections), and other officials waged a public campaign to shame parliamentarians into returning from their holidays to pass measures deemed essential for restoring confidence and credibility, to no effect. With each passing day, interest rates on government debt rose, stock prices fell, and the central bank used more of its dwindling reserves to maintain the exchange rate. In just a few weeks, virtually all the $4.8 billion the IMF had lent Russia on July 20 had been spent, either directly by the treasury or to support the ruble.[131]

The Final Crisis: August 1998

Sensing that matters were worse than official pronouncements from Russia were suggesting, Fischer returned to Moscow at the end of July to try to "light a fire under" the Russians "before we hit a brick wall in September."[132] There he learned that the central bank was indeed hemorrhaging reserves and that tax collections were still weaker than expected. Drastic action would be required to save the economy, and drastic action was politically impossible. Chubais took a particularly bleak view and suggested that without new action on tax collections, the government would not only be forced to devalue, it also would have to default on at least some of its debt. If it devalued without defaulting, holders of GKOs would lose confidence and would stop rolling them over on maturity, which would then force a default. If they defaulted without devaluing, new capital inflows would dry up, and the central bank would no longer be able to maintain the exchange rate. After meeting with Chubais, Fischer tried to put a positive spin on the outlook, telling

[131]The original plan had been that the entire $4.8 billion would be added to the central bank's reserves. When Fischer went to Moscow at the end of July, Russian officials asked him to allow them to use $1 billion for budgetary support. After checking with Camdessus, he agreed; see memorandums from Odling-Smee to the Acting Managing Director [Fischer], "Russia—Latest Status of Conditions to Allow Use of $1 billion for the Budget" (August 4, 1998); and from Daniel A. Citrin (Assistant Director, EU2) to Odling-Smee and Thomas B.C. Leddy (Deputy Director, PDR), "Russian Federation: Information Note on Budgetary Financing and Recent Developments under the Extended Arrangement" (August 5, 1998); IMF archives, OMD-DMD, "Russia 1998 – (3) Country Files," Box 161971, Accession 2001-0284. The ministry of finance announced the shift publicly on August 12 in an effort to shore up public confidence; see Thornhill (1998), p. 2.

[132]Handwritten note, Fischer to Odling-Smee (July 29, 1998); IMF archives, Accession 2001-0284, Box 28268; OMD-DMD (Fischer), "Russia 1998 – (3) Country Files."

reporters in Moscow that the government had "a lot of hard work" to do to implement the program.[133]

Throughout the northern hemisphere, August is a time for holidays, and Russian legislators were not the only ones to close their offices while the economy was spinning out of control. In the second week of August, Camdessus was resting at his summer home in the south of France. Fischer was on the Aegean island of Mikonos. Rubin was fishing for salmon in Alaska, and almost all of the other senior G7 finance officials were similarly at leisure. Yeltsin, Chubais, and Dubinin were all out of Moscow. The IMF office in Moscow was open, but it was short of staff, and Gilman was distracted by the birth of his first child the week before. When the U.S. Treasury sent Lipton to Moscow to reinforce the message that Russia should not expect any more official financing, from the IMF or anyone else, he found that almost everyone of influence was gone.

On Thursday, August 13, with confidence in the Russian economy already at a nadir, the *Financial Times* published a letter from the financier George Soros lamenting that the "international financial authorities do not appreciate the urgency of the situation" in Russia. He called on the government "to introduce a currency board after a modest devaluation of 15 to 25%," and suggested that the "alternatives are default or hyper-inflation." Because Soros was famously remembered as the man who had successfully gambled billions of dollars against the British pound in 1992, financial markets—and some IMF officials—naturally assumed that Soros was similarly speculating against the ruble.[134] The only question now was whether the ruble could be devalued in an orderly manner without a default.

The financial chaos worsened dramatically the next day, as a run on Russian banks and a collapse in GKO prices forced the banks to start selling large quantities of securities they had purchased on margin. As the economist Nouriel Roubini later observed, by this time many Russian banks were acting more like hedge funds than commercial banks, with highly leveraged balance sheets, relatively little lending to real companies, and an unsustainable exposure to currency risk (Roubini and Setser, 2004, p. 60). In these circumstances, any attempt by the central bank to try to protect the payments system by serving as a lender of last resort to banks

133See memorandums from Fischer to the Managing Director, "Russian Options" and "Visit to Russia, July 31–August 1" (both dated August 2, 1998); IMF archives, OMD-DMD, "Russia 1998 – (3) Country Files," Box 28268, Accession 2001-0284. Also see Bohlen (1998a), p. 8. Additional information is from interviews with participants.

134Fischer later blamed Soros for triggering the crisis, along with the Russian authorities (for lacking policy discipline) and the G7 leaders (especially the German chancellor, Helmut Kohl) who had failed to provide enough aid as the crisis developed; see Kaps (1998), p. 17; and "IMF's Fischer Blames Kohl for Lack of G7 Russia Rescue," Dow Jones News Service, August 24, 1998; accessed at http://global.factiva.com/. At the end of August, U.S. President Clinton privately regretted to aides that his government had not provided the large-scale support that Russia needed; see Talbott (2002) pp. 283, 286.

was bound to fail. By Friday afternoon, only the weekend stood between the authorities and a complete financial meltdown.

That evening, Odling-Smee left Washington for Moscow to advise the Russians on what to expect from the Fund as the crisis unfolded. Unfortunately, his instructions were garbled. Camdessus had telephoned him that morning (Washington time) from the terrace of his vacation home in Bayonne, France. The Managing Director thought he was conveying the view—consistent with standard IMF policy—that the Fund could not accept a unilateral default, that instead the authorities should try to negotiate a debt restructuring with their external creditors. Odling-Smee, however, interpreted Camdessus as conveying a more neutral position on default. Separately, Fischer, who had rushed back to Washington from Greece to take charge of the Fund's response, sent a handwritten note to Odling-Smee by fax, stressing that the Russians should come up with their own solution to their problems; the Fund should not try to impose its views.[135] That message appeared to agree with the seeming agnosticism Odling-Smee had heard from the Managing Director. Accordingly, when Odling-Smee met with Chubais and Gaidar over dinner in Moscow on Saturday evening, he told them the IMF agreed they had no choice but to default and would support their decision. Regardless of the source of the miscommunication, it had no effect on Russia's decision to devalue, but it contributed to confusion about the broader policy package and to resentment regarding the Fund's role in the process.

On Sunday, Chubais accompanied Kiriyenko by helicopter to see Yeltsin at his country home to get his approval for a plan to default on GKOs and to allow the ruble to depreciate more rapidly while still using Russia's reserves to control the decline. The president quickly agreed that they had all "become hostages to the situation" and had no good options left (Yeltsin, 2000, p. 174). The die was now cast, and all that remained was for the government to announce the default on Monday.

Meanwhile, Camdessus rushed back to Washington over the weekend. Stopping briefly in Paris, he received phone calls from Summers and Rubin, who urged him to take a public stand in favor of default. Not knowing that Yeltsin had already decided on this course of action, Camdessus declined, saying the Fund could not be a party to a nonmarket solution. When Russia went ahead with the default on Monday, he issued a press release that was pointedly muted in its support. While noting that "it is important that the international community as a whole, both public and private sectors, show solidarity for Russia at this difficult time," the statement omitted any endorsement of the default. Instead, it suggested that

[135]Note from Fischer to Odling-Smee (August 15, 1998); IMF archives, OMD-DMD, "Russia 1998 – (3) Country Files," Box 161971, Accession 2001-0284. Also see Blustein (2001), pp. 268–69. The rest of this account is based primarily on interviews.

the Russian "authorities should . . . spare no effort to find a cooperative solution to their debt problems, in a close dialogue with Russia's creditors."[136]

The Russians immediately began negotiating with external creditors, but the two sides held widely divergent views about the sort of debt restructuring that would be feasible and appropriate. They faced an unprecedented situation in that Russia had defaulted on debts denominated in its own currency. Previous defaults on sovereign debts had always been limited to foreign-currency debt because the burden of domestic debt could more easily be reduced through inflationary policies. In this case, however, foreign financial institutions had bought large amounts of short-term, floating-rate, ruble-denominated debt, and the usual remedies would have been more costly. Negotiations dragged on for months, and a final settlement—imposing losses on creditors estimated at 50–70 percent of precrisis values (Sturzenegger and Zettelmeyer, 2005, pp. 9–18; 2008)—was not reached until March 1999.

Following the default, the IMF's dilemma was whether to continue lending to Russia. The situation the Fund faced was also unprecedented, in that the institution had lent as much as it possibly could to the country *before* the crisis hit. The usual response of lending to help the country resolve the crisis was, for the moment at least, off the table. The next drawing under the EFF arrangement was scheduled for mid-September, but the program would have to be completely renegotiated before the Fund could disburse any more money. Moreover, when Camdessus suggested that more lending might be needed, not just for Russia's sake but also for global financial stability, he met strong resistance. Finance officials from the G7 countries unanimously conveyed the message that they would provide no more loans to Russia, and would not support more IMF lending, at this time.[137]

Virtually everyone—Russian, IMF, and G7 officials alike—agreed that resolution of the crisis depended first and foremost on strengthening Russia's economic policies. Yeltsin, as always, began by firing his top officials, including the prime minister, Kiriyenko; the chief external negotiator, Chubais; and the governor of the central bank, Dubinin. To replace Dubinin, he brought Gerashchenko back in after a four-year hiatus. For prime minister, he nominated Chernomyrdin to return after a gap of less than six months. Chernomyrdin quickly interrupted his vacation and promised an antiliberalization government that parliament could support, with no "Chubaises, Gaidars, or Nemtsovs in the government" (Yeltsin, 2004, p. 181).[138]

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[136]"Camdessus Comments on Russian Actions," NB/98/30 (August 17, 1998); accessed at http://www.imf.org/external/np/sec/nb/1998/nb9830.htm.

[137]The strength of opposition varied somewhat within the G7, with some U.S. officials—especially in the State Department—more sympathetic than others (Talbott, 2002, pp. 283–90).

[138]Boris Nemtsov (see footnote 95) was a first deputy prime minister from March 1997 until the dismissal of the Kiriyenko government in August 1998.

Despite Chernomyrdin's stated antipathy to the reformers, he had developed a close personal relationship with Camdessus over the course of his previous five years as prime minister, and Camdessus viewed him as a man with whom he could work to rebuild the Russian economy. A week after the default, and two days after Yeltsin's nomination of Chernomyrdin, Camdessus flew to Paris and then traveled by Russian government plane to the Crimean peninsula in Ukraine. There, at the dacha where Gorbachev had been held under house arrest in 1991, Camdessus met tête-à-tête with Chernomyrdin. In yet another meeting that lasted well into the night, he urged the acting prime minister to press ahead with fiscal and structural reforms. He also suggested that a currency board arrangement might help to reestablish credibility for a stable exchange rate. Chernomyrdin was skeptical of the currency board idea, but he regarded the situation as "tragic but not hopeless" and was determined to press ahead with reforms.[139]

The Russian authorities, along with everyone else, had a hard time figuring out what to do next, especially with regard to trying to stabilize the currency. From August 17 (the date of default) to August 25 (when Camdessus and Chernomyrdin met in Crimea), the ruble depreciated by 19 percent, despite the central bank's continued intervention. At the IMF, even as the Managing Director was advising Russia to set up a currency board, the staff was advising the authorities to stop intervening and allow the exchange rate to float.[140] At the beginning of September, Russia shifted to a floating rate while Chernomyrdin and Fyodorov began advocating a currency board and Gerashchenko argued for imposing exchange controls. Meanwhile, although Clinton flew to Moscow on September 1 to meet with Yeltsin about the crisis, the prevailing U.S. view held that Russia had no economic leadership and no effective strategy. Until it developed both, no financial support could be expected from the United States, the G7, or the IMF.[141]

As the Russian economy continued to stagnate, parliament refused to confirm Chernomyrdin as prime minister. On September 10, Yeltsin withdrew the nomination and elevated the foreign minister, Yevgeny Primakov, instead. Primakov was quickly confirmed, and he signaled his intention to implement policies the IMF could support. After Odling-Smee met with Primakov in Moscow on September 15, he sent Márquez-Ruarte back to Moscow with a staff mission to try to negotiate a

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[139]The phrase is from a press conference on August 28, 1998, in which Camdessus reported on his meetings in Crimea; see http://www.imf.org/external/np/tr/1998/tr980828.htm. Also see Camdessus's report to the Executive Board earlier that day; minutes of EBM/98/90 (p. 3). The details of the trip are from interviews with participants.

[140]See memorandum from Márquez-Ruarte to the Managing Director, "Russia—Exchange Rate Policy" (August 25, 1998); IMF archives, OMD-DMD, "Russia 1998 – (3) Country Files," Box 161971, Accession 2001-0284.

[141]On Clinton's trip and the U.S. reluctance to provide aid without more effective reforms, see Clinton (2004), p. 807; and Talbott (2002), pp. 278, 290. Also see remarks by Summers, in Erlanger (1998).

program for the coming year. That effort failed, largely as a result of the government's internal uncertainty about what policies to implement. After a week of negotiations, the main interlocutor on the Russian side, Deputy Prime Minister Aleksander Shokhin, publicly threatened to default on more of the country's debt if the IMF would not agree to accept Russia's policies as the basis for renewed support. IMF officials let it be known that they viewed this threat as unacceptable blackmail, and Shokhin resigned the next day. Once again, a leadership vacuum blocked progress.[142]

Even as these negotiations were breaking down, a new controversy erupted. On September 21, Venyamin Sokolov, the Russian government's chief auditor, accused the central bank of wasting billions of dollars defending the ruble, and he asserted that some unspecified portion of the money borrowed from the IMF had been stolen. At first, the IMF refused to take this story seriously, but when the rumor persisted the Fund insisted that the Russian central bank commission an external audit. That audit, completed by the firm PricewaterhouseCoopers in the summer of 1999, found no evidence of theft. The $4.8 billion the IMF lent to Russia in July 1998 was arguably wasted because it was used to try to defend an exchange rate that could not be defended, but it was used legitimately for that purpose.[143]

Negotiations between the IMF and Russia continued intermittently for several months, through missions in October and November 1998 and in April 1999, interspersed by visits to Moscow by Camdessus in December 1998 and in March and June 1999. The low point came at the end of the November mission, when negotiations broke down and Primakov complained that the IMF was trying to dictate policies to Russia.[144] The prime minister called Camdessus and asked him to come to Moscow to try to work out a new strategy. The Managing Director was in Madrid at the time, to deliver a speech in which he pledged that the IMF "will not abandon Russia. . . . But Russia must first be willing to help itself."[145] From there he

[142]See memorandum from Odling-Smee to the Managing Director, "Russian Federation—Visit to London and Moscow" (September 16, 1998); IMF archives, Accession 2001-0284, OMD-DMD (Fischer), "Russia 1998 – (3) Country Files," Box 28268. Also see report by Márquez-Ruarte, minutes of EBM/98/105 (September 30, 1998), pp. 13–16. On Shokhin's threat, see Bohlen (1998b).

[143]The PricewaterhouseCoopers audit of the 1998 transactions was one of two prepared in 1999, the other being the report on the 1996 misreporting episode (see above, p. 318). For both reports and a staff analysis, see "Russian Federation—Staff Report for the 1999 Article IV Consultation and Request for Stand-By Arrangement," EBS/99/124, Suppl. 1 (July 20, 1999).

[144]Memorandum from Márquez-Ruarte to the Managing Director, "Russia—Back-to-Office Report" (December 2, 1998); IMF archives, OMD-DMD, "Russia 1998 – (5) Country Files," Box 16197, Accession 2001-0284.

[145]"The Global Economy: Still in Crisis?" delivered at the International Financial Congress: Finantia '98, in Madrid, Spain (November 25, 1998); accessed at http://www.imf.org/external/np/speeches/1998/112598.htm.

flew to Moscow, where he and Primakov agreed on the outlines of a homegrown program for 1999 that Primakov believed would generate domestic "ownership" and that Camdessus agreed would be strong enough to justify both new financing from the IMF and debt relief from Paris Club (official) and London Club (commercial bank) creditors.[146]Adding to the urgency of these talks was a looming deadline for Russia to begin repaying the large loans that the IMF had advanced in 1996, when it first approved the EFF arrangement, on top of the ongoing repayments from earlier credits. In total, more than $4 billion would be due in 1999, including some $830 million in July alone. New lending would soften this blow by extending and smoothing out the repayment schedule, but as Camdessus had stressed in Madrid, Russia first had to prove it was serious about carrying out its promises, especially on tax collections. When, in March 1999, parliament again refused to approve revenue measures the government had agreed on with the Fund, the mission chief reported wryly that the rejection did "not suggest much ownership."[147] Throughout this brief period, the IMF's firm insistence on the strengthening of macroeconomic policies and on more-serious structural reforms for once had strong support from the U.S. government and other official creditors.[148]

By this time, Russia had received no external financing for eight months, and none was in sight. Could a new financial crisis still be avoided? Primakov was due to go to Washington the week after the failure of the March mission, and he and Camdessus made plans to meet there with the aim of quickly restarting talks on a new stand-by arrangement. That plan was abruptly shelved when a political crisis intervened. On March 24, North Atlantic Treaty Organization (NATO) airplanes began bombing Belgrade in an effort to stop Serbian atrocities in Kosovo. Primakov, who opposed NATO's military involvement in Yugoslavia, learned of the imminent campaign while en route to the United States, and he ordered his pilot to turn the plane around and return to Moscow. He then telephoned Camdessus and informed him of the situation. Not wanting to miss this opportunity, Camdessus offered on the spot to come to Russia instead. Primakov accepted, and Camdessus—along with

[146]See Camdessus's report to the Executive Board at an informal meeting on December 4, 1998; BUFF/98/111 (December 7, 1998). Also see memorandum for files by Gilman, "Managing Director's Discussions with Primakov" (December 3, 1998); IMF archives, OMD-DMD, "Russia 1998 – (5) Country Files," Box 161971, Accession 2001-0284.

[147]Memorandum from Gerard Bélanger (Deputy Director, EU2) to the Managing Director, "Russia—Back-to-Office" (March 22, 1999); IMF archives, DMD-AI, "Russia 1998 – (4) Country Files," Box 177888, Accession 2002-0149.

[148]On the U.S. position, see memorandum from Mark Sobel (Advisor to the U.S. Executive Director) to Odling-Smee and Citrin, "Russia—Economic Crisis" (November 19, 1998); memorandum from Fischer to the Managing Director, "Russia: Meeting between Prime Minister Primakov and Vice President Gore in Kuala Lumpur" (November 19, 1998); and memorandum from Odling-Smee to the Acting Managing Director, "Russia—Report from the Mission" (November 20, 1998); all in IMF archives, OMD-DMD, "Russia 1998 – (4) Country Files," Box 161971, Accession 2001-0284.

a documentary film crew from the French company ARTE that had been following his every move for several months—flew to Moscow the next day.

Camdessus's rush to Moscow came at some personal cost. After 12 years as the head of the IMF without missing a day of work to sickness, he developed severe back pain while flying to Europe, which turned out to be a case of shingles that would keep him confined to his bed and under medical care for much of the trip. He nonetheless managed to meet with Primakov, Finance Minister Mikhail Zadornov, and other officials—and to add considerable spice to the ARTE documentary film.[149]

Camdessus's trip closed much of the gap between Russia and the Fund on the requirements for raising tax revenue. That progress set the stage for a follow-up mission in April, which reached tentative agreement on an economic program, subject to several prior actions that would have to be completed before the Executive Board would consider it. Unfortunately, a domestic political crisis erupted. Yeltsin—facing yet another impeachment attempt in parliament—abruptly fired Primakov and asked the interior minister, Sergei Stepashin, to form a new government. The impeachment drive ultimately fell short, but the damage was done. No one believed Yeltsin and Stepashin had the political clout to carry out the economic program Primakov had started, but the IMF had little choice other than to approve at least enough new lending to offset the large repayment due in July. Failure to do so would threaten more than the stability of the Russian economy because Russia's debt to the Fund now accounted for more than 20 percent of the Fund's total credits outstanding.

On July 28, the Executive Board approved a new stand-by arrangement, committing $4.5 billion (SDR 3.3 billion, or 55 percent of quota) through the end of 2000. Directors did not disguise their reservations about approving what the U.S. Treasury regarded as a "virtual welfare payment" (Talbott, 2002, p. 291), but they all knew how much was at stake. Russia promptly made the initial drawing,[150] which would turn out to be the country's last drawing on the IMF (as of 2010).[151]

In August, Yeltsin sacked Stepashin and named Vladimir Putin to be prime minister and the heir apparent to the Russian presidency. Amid growing concerns about corruption, the renewal of hostilities in Chechnya, and continuing weaknesses in economic policies, political support from G7 leaders was waning, and the

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[149]*Le Pouvoir FMI* (The Power of the IMF, 1999), directed by Pascal Vasselin, a coproduction of La Sept ARTE and Tétra Media.

[150]As an extra precaution to ensure that the money would not be misused, the arrangement specified that the drawing would be provided entirely in SDRs and would be held in Russia's account in the SDR Department of the IMF; see "Russian Federation—Staff Report for the 1999 Article IV Consultation and Request for Stand-By Arrangement," EBS/99/124, Suppl. 3 (July 26, 1999).

[151]Three days later, the Paris Club agreed to reschedule Russian debts one more time—the only time in the history of the group it had rescheduled the debts of a "creditor" member.

IMF was able to withhold further lending to Russia. A decade of close relationships, turbulence, and drama thus ended weakly. For the IMF and for the reformers within the Russian government, the satisfaction of seeing the country still on the road to integration with the world economy was mixed with disappointment that progress on that road was still slow and that success was far from assured.

This mixed and troubled story eventually had a happy ending. Thanks to a combination of factors—the structural reforms of the 1990s, the 1998 devaluation, later improvements in macroeconomic policies, and a resurgence of world oil prices that greatly boosted the value of Russia's exports—the Russian economy grew at an average annual rate of 6.75 percent from 1999 through 2004.[152] Throughout this period, the balance of payments was in substantial surplus, the exchange rate was stable, and the central bank steadily accumulated foreign exchange reserves. By the time the stand-by arrangement expired in December 2000, Russia had no further need for loans from the IMF or other official creditors. In January 2005, the government repaid all outstanding IMF obligations before they were due, and the IMF then added the Russian ruble to its list of currencies that are usable in lending operations. In a remarkable 14 years after emerging from the ashes of the Soviet Union as a heavily indebted country without a functioning economy, the Russian Federation had become a creditor country in the international community.

Lessons from History

Throughout the 1990s, the IMF confronted difficult choices on how best to help Russia, as did western governments and Russian officials. The country was undergoing a historic transformation—economically, politically, and socially, all at the same time—that made success a relative and elusive concept. To a degree, the transformation succeeded, and to some extent the IMF can justly take credit for having helped, as midwife and handmaiden as much as financier. In broad perspective, the IMF made two key decisions on Russia. First, it accepted responsibility for assisting with the transition from central planning to a market economy (especially in the extended arrangement approved in 1996), rather than focusing more narrowly on financial stability and the external payments balance. Second, it agreed to provide a large portion of Russia's external financing needs, rather than providing modest seed money and a seal of approval as a catalyst for large-scale financing from official creditors and private financial markets. Necessity drove both of these decisions because the Fund was the only institution that could coordinate and lead the more piecemeal assistance being provided from a large number of diverse sources. Together, these two paths of action kept the Russian economy

[152]For an overview of the postcrisis recovery, see Owen and Robinson (2003).

and the nascent move to democracy alive—on life support, perhaps, but alive. The mixed success of these decisions carried major consequences for Russia and the IMF.

More specifically, eight critical crossroads, from the beginning of the transition to the aftermath of the 1998 financial crisis, can be identified.

First, when Gorbachev asked the G7 in 1990 to engage in a dialogue on integrating the Soviet Union into the world economy, Camdessus took the initiative to prepare a detailed study of the Soviet economy. Although several other agencies participated in the project and brought much essential specific experience and knowledge to the table, the IMF became the lead agency on the project and ensured completion of the report in just a few months of intensive work. That effort positioned the Fund to continue to advise on a variety of policy issues with which it had limited expertise and experience, such as the sequencing of reforms and privatization of industry, as well as on those where it had a clearer advantage. Throughout the rest of the decade, the Fund staff struggled—not always successfully—to find the right balance between adhering to the institution's narrow mandate on financial and macroeconomic issues and meeting the broader challenges of helping Russia undertake a massive structural transformation.

Second, when the Soviet Union dissolved at the end of 1991, the Fund accelerated the handling of Russia's application for membership (completing the process within six months), granted Russia a quota a bit larger than that warranted by the staff's technical calculations, and began providing financial assistance immediately without the usual level of conditionality. Although understandable and even necessary in view of the magnitude of the issues and problems at hand, this rapid and positive response clearly reflected political pressure from the G7 and reinforced the image that the IMF was becoming deeply involved in Russia's transition.

Third, when the G7 countries decided in 1992 and later to provide very little bilateral cash assistance to Russia—the rejection of the Grand Bargain (Chapter 2) despite the announcement of large support "packages"—the IMF did not attempt to pressure or persuade them to provide large-scale support. The resulting situation not only required the IMF to shoulder a large portion of the financial burden, it also further reinforced the Fund's role as lead agency in the transition process. More important, because the Fund's own financial resources were limited, Russia was left strapped for cash in the early stages of the transition, magnifying the economic and social consequences of the country's fiscal imbalances. Whether pressure from the IMF on the G7 would have alleviated the shortfall is, however, far from obvious.

Fourth, when Russia's economic policies weakened in 1993 and 1994 and the prospects for implementing an agreed-on program were poor, the IMF continued to provide financial support rather than use its leverage to force an improvement. In addition to the Fund's usual leverage, Russia had a surplus in its current account throughout the 1990s. Thus, even though the government desperately

needed budgetary support, it did not unambiguously qualify for balance of payments assistance. The IMF justified its lending to Russia on the grounds that the country had a shortage of foreign exchange reserves and that the external balance probably would have turned negative if the economy had grown rapidly enough to reach its estimated potential. That lending, though, enabled the government to meet its fiscal spending requirements without making the difficult political decisions to increase revenues from taxes. As Odling-Smee (1998) later wrote, "the ready availability of international financial support was only partly effective in encouraging the reform process in Russia. Regrettably, it also permitted the postponement of some of the tough measures necessary to plug fiscal gaps."

Fifth, in March 1996, during Yeltsin's tight race for reelection against communist and ultranationalist opponents, the Fund approved its largest and longest-term lending arrangement to Russia up to that time. Although the basis for the increased lending was an improvement in policy implementation in the previous year, undeniably, the political situation made approval practically irresistible. The timing did little to enhance the credibility of the Fund's support as a signal that the country was implementing good policies.

Sixth, the Fund tried to respond flexibly to changing circumstances in its advice to Russia on exchange rate policy. Rather than enhancing its effectiveness, that flexibility came across as inconsistency and uncertainty and thus had little effect on Russian policy. In 1992, the staff advised maintaining a currency union with at least some of the former Soviet republics in a "ruble area"; in 1993, it took a more neutral position on that issue. It advised pegging the ruble exchange rate in 1994, and reversed that position the following year. As the exchange rate became increasingly difficult to sustain in 1997 and 1998, the Fund officially stood behind the strong-ruble policy, despite occasional misgivings by the staff, until the ruble collapsed in the crisis of August 1998. Management and staff then gave conflicting advice on whether to let the ruble float or to try to stabilize it through a currency board arrangement. These shifting views reflected and responded to shifting conditions and were to some extent influenced by Russia's own independent policy decisions. If the Fund had held to a fixed position on exchange rate policy from beginning to end, it doubtless would have been subjected to even more criticism. In retrospect, it nonetheless seems that the Fund lacked a clear view and thus missed several opportunities to provide more helpful advice on a core policy issue.

Seventh, having provided substantial loans to Russia over a period of several years, the Fund began to appear reluctant in mid-1998, at the very moment when confidence among external investors was most in need of revival. A one-week delay in June 1998 and a 14 percent reduction in the size of the July disbursement may have seemed, to the Fund and to creditor-country officials, to be minor and necessary technical adjustments, but to many investors they seemed more like admissions that Russia was achieving too little to warrant full-hearted support.

Of course, at the time Russia *was* achieving too little, and investors may well have reached the same conclusion even if the Fund had put on a braver face.

Finally, after the default and devaluation of August 1998, the Fund was unable to provide the financial assistance Russia needed to manage and recover from the crisis. That constraint did not arise from an internal failing at the Fund. Rather, it resulted from a combination of political paralysis within the Russian government that prevented effective policy formation and from newly firmed-up resistance by creditor countries to bailing Russia out of a quagmire of its own making.

The controlling influence over the IMF's work on Russia throughout the 1990s was Russia's strategic importance. Preventing a communist backlash, preventing an ultranationalist electoral triumph driven by populist sentiment, and preventing a serious economic decline that might threaten the security of Russia's vast nuclear arsenal were the driving concerns of the world community and of every Executive Director and senior official at the IMF. Staff and management strove to give their best professional advice, and the depth and breadth of the Fund's technical assistance throughout the decade contributed greatly to the ultimate success of the transition. Viewing only the effect of the IMF's conditional lending on economic progress in Russia might lead to the conclusion that the Fund had failed. That narrow focus, however, was never the most relevant consideration, either at the time or afterward.

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8

After the Fall: Building Nations out of the Soviet Union

The Russian Federation, covered in the preceding chapter, was the largest but not the only country to emerge from the Soviet Union as an independent state. In a span of 12 months starting in May 1992, all 12 of the former Soviet Socialist Republics that had constituted the core of the Soviet Union, and the three Baltic states that had been forcibly annexed in 1940, joined the IMF. This influx of new members created new challenges for the Fund and put unprecedented pressures on its staff and its ability to cope. To some extent, the challenges were regional—maintaining economic activity and trade after the collapse of the Soviet-bloc trading arrangements, dividing up the assets and liabilities of the union among the newly independent states, and conducting international finance without the Soviet ruble as a regional currency. Once those broad issues were settled, attention could turn more fully to the needs of the separate states as they began making the transition from central planning to market economics.

The transition proved to be brutal throughout the region, though some countries handled their trials better than others. At one extreme, estimated real output per capita in Tajikistan fell by more than two-thirds from 1991 to 1996. The level averaged less than $150 a year for much of the decade, and incomes recovered only slightly by the end of the 1990s (Table 8.1). Even allowing for the probable bias toward overestimation, the decline was dramatic and brought on severe economic hardships.[1] At the other extreme—geographically as well as economically—Estonia's real output per capita recovered quickly after an initial drop of 22 percent in the first two years of independence. By the end of the decade, output in Estonia exceeded $4,000 per capita, far above its preindependence level. Between the two is found a great variety of experiences in countries bound together by a shared history that, for a time, forced them to cope together with regional issues.

[1]These data are subject to very large measurement errors, but the general pattern is well established. For analyses, see De Broeck and Koen (2000); and Havrylyshyn (2001).

Table 8.1. Per Capita GDP in the Baltic Countries, the Russian Federation, and Other Countries of the Former Soviet Union, 1991–2000

Country	Annual Average 1991–2000 (Dollars)	Maximum Real Decline from 1991 (Percent)	Year of Lowest GDP	1991–2000, Percentage Change
Russian Federation	1,789	39	1998	−28
The Baltic countries				
Estonia	2,764	22	1993	14
Latvia	2,093	34	1993	−3
Lithuania	2,065	40	1994	−20
Other middle-income countries				
Belarus	1,007	34	1995	−9
Kazakhstan	988	28	1995	−14
Turkmenistan	852	53	1997	−33
Ukraine	707	53	1998	−50
Low-income countries				
Moldova	368	56	1999	−55
The Caucasus region				
Armenia	346	45	1993	−12
Azerbaijan	404	60	1995	−46
Georgia	785	63	1994	−45
Central Asia				
Kyrgyz Republic	286	46	1995	−34
Tajikistan	148	68	1996	−64
Uzbekistan	474	25	1996	−16

Source: World Development Indicators (World Bank).

Regional Issues

As recounted in Chapter 6, the overarching economic challenge for the countries that emerged from the Soviet Union was to shift production and trade from the artificial and arbitrary practices of the past several decades to a more efficient market system that would be compatible with the world economy. That effort would take several years. Until sufficient progress could be made to enable these countries to integrate economically with western Europe and other market economies, conventional wisdom held that it was necessary to try to preserve trade among the former republics. If continuation of regional trade failed, even more precipitous drops in output and employment were feared.

In December 1991, the three republics that had first banded together in 1922 to form the Soviet Union—Russia, Ukraine, and Byelorussia (Belarus)—met outside Minsk to proclaim the death of the political union and to replace it with a new and looser entity, the Commonwealth of Independent States (CIS). Most of the other republics, with the exception of the Baltic countries, joined the CIS before the end of 1991, a step that declared both their political sovereignty and their intention to retain close economic and other ties. With a few changes in membership, the CIS remained

in effect throughout the rest of the decade and served as an umbrella organization (headquartered in Minsk) for promoting cooperation on a wide range of economic and political issues.[2]

The primary external advisors and providers of financial assistance for restructuring production and the direction of trade and for related structural issues such as the privatization of state-owned enterprises and other property were the World Bank, the newly established European Bank for Reconstruction and Development (EBRD), and western European and other bilateral donors. Although the Fund was inexorably drawn into dealing with nonfinancial structural issues, its main responsibility in this region—as elsewhere—was to help each country achieve macroeconomic and financial stability. As a prerequisite, two regional financial problems had to be resolved quickly. First, some means had to be found for allocating and servicing the external debt incurred by the Soviet government. Second, each country had to decide whether to continue using the ruble (the common currency of all the Soviet republics) or establish its own national currency, and then a structure had to be set up for managing whatever common currency area (the "ruble area") remained. For these tasks, the IMF embarked on playing an important—though often controversial—advisory role.

Settling the Soviet Debt

As the Soviet Union unraveled throughout 1991, its economic system crumbled with it. The region badly needed financial assistance from international agencies and from major creditor countries, and that assistance depended first on finding a way for Russia and the other republics that were assuming at least partial sovereignty to continue to service and ultimately repay the Soviet debt. Until the republics reached debt-servicing agreements with official creditors, they would not be able to undertake new borrowing from the IMF or others.

As the first step in this process, the finance officials of the Group of Seven (G7) countries acted as a kind of steering committee for discussing with the Soviet Union and its republics by what method responsibility for Soviet external debts should be apportioned. In October and November 1991, the deputies to the G7 finance ministers, chaired by Nigel Wicks of the United Kingdom, met with Soviet officials in Moscow in two series of meetings to try to forge an agreement on how the separate republics were going to service the Soviet debts, and the extent of debt relief and other financial assistance the creditors might be willing to grant. John Odling-Smee (Deputy Director, European Department) and Benedicte Christensen (Assistant to the Director

[2]In addition to the three founding states, Armenia, Kazakhstan, the Kyrgyz Republic, Moldova, Tajikistan, Turkmenistan, and Uzbekistan signed the CIS protocol in December 1991. Azerbaijan and Georgia joined in 1993. For a detailed reference on the origins, structure, and early history of the CIS, see Brzezinski and Sullivan (1997).

of the Exchange and Trade Relations Department, or ETR) represented the Fund as observers and helped to clarify the facts.

The difficulty in establishing responsibility was that official creditors worried that some republics would simply repudiate their share of Soviet debt. The matter appeared to be resolved once the Russian government suggested that all the republics be jointly responsible for all of the debt. The G7 deputies readily embraced this idea, which was encapsulated in an expression borrowed from English law: each republic would be "jointly and severally" responsible for servicing the debts. As a practical matter, this language had little meaning because none of the smaller republics could conceivably have taken up the slack if Russia or even Ukraine (the second largest of the new states) had defaulted. Within months, Russia would accept full responsibility in exchange for laying claim to overseas assets, including both financial assets such as gold and foreign exchange reserves and real assets such as Soviet embassies (a solution that became known as the "zero-option" agreement).[3] At the time, however, the concern was just to establish and agree on an equitable formula.

A second and related issue—debt relief from official creditors—proved more difficult, because the G7 members had conflicting interests. At one end of the spectrum, the United States, represented in the finance deputies' group by David Mulford, pushed the group to forgive a large part of the debt, the lion's share of which was held by German banks. At the other end, the German government, represented by Horst Köhler, was understandably less enthusiastic about that proposal. Meeting in Bangkok in mid-October in the margins of the IMF/World Bank Annual Meetings, the G7 apparently reached agreement on basic principles, notably that they would not forgive the debt and that they wanted to have a single party held responsible for servicing it—not 15 individual states—if the union continued to break up.

Discussions with Soviet officials continued in Moscow. Finally, at a meeting in the middle of the night in a swelteringly hot room in the basement of the British embassy, the deputies reached an understanding that the G7 would support a generous rescheduling—but not forgiveness—of the Soviet debt, contingent upon Russia (or the Soviet Union, if it survived) agreeing to implement an economic reform program to be worked out with the IMF.[4] Commercial bank creditors, meeting as the London Club under the chairmanship of Deutsche Bank in Frankfurt, agreed in mid-December to

[3]For background and details on these agreements, see Christensen (1994), pp. 21–25.

[4]The G7 deputies and their Soviet counterparts agreed on these points in principle in Moscow on October 28, but some on the Soviet side then began to question the financial arrangements. The G7 deputies met among themselves in Paris in early November and with the Soviets back in Moscow, November 18–21. The agreement was signed at the end of those meetings; see "Report on the Agreement on the Deferral of the Debt of the U.S.S.R. and its Successors to Foreign Official Creditors," SM/92/5 (January 9, 1992); and the minutes of EBM/92/3 (January 10, 1992). For further details, see memorandums from Odling-Smee to the Managing Director, "USSR—G7 Meetings in Moscow" (October 30, 1991) and "USSR—G7 Meeting" (November 19, 1991); IMF archives, "Russia 1991-(2) Country Files," Box 21980, Accession 1995-0180-0007. Also see Braithwaite (2002), pp. 259–60, for a memoir by the British ambassador.

reschedule their loans. The final step was a rescheduling agreement by official Paris Club creditors (17 countries) on January 4, 1992, following closely on the heels of the official dissolution of the Soviet Union in December.

Dissolving the Ruble Area

Upon the dissolution of the Soviet Union and its replacement by 15 independent countries at the end of 1991, the Soviet State Bank, or Gosbank, was similarly replaced by 15 independent central banks, each of which had the power to issue its own monetary liabilities. Initially, the entire region used just one currency, the ruble. The Central Bank of Russia (CBR, the successor to the Gosbank in Moscow) continued to supply rubles to the other central banks to finance bilateral payments imbalances. As a transitional measure, this practice was intended to help sustain trade and financial relationships across the former Soviet region, but it also enabled each country to pursue policies leading to unrestrained inflation. The CBR's attempt to tighten monetary policy in mid-1992 was overwhelmed by transfers to the other ruble-emitting countries. These transfers were estimated to approach 10 percent of Russian GDP (Gaidar, 2002, p. 33).

IMF officials recognized from the outset that whether, how, and when the newly independent countries should establish their own currencies would be crucial decisions in the post-Soviet transition and that those decisions would depend on political as well as technical considerations. Even before the dissolution of the union, IMF Executive Directors questioned Managing Director Michel Camdessus as to what the Fund's view should be on retaining the region's common currency. The Managing Director (himself a former central bank chief) replied that although the Fund could provide good technical advice, "the Fund's theoretical views about the optimal size of a monetary union or economic space would not be a predominant consideration in the solution which ultimately prevailed. The Fund could make available to the USSR the judgments which came from its rich experience, but whatever the quality of the judgments, the final decisions will probably be taken for reasons unrelated to them." Six months later, he made the point even more forcefully. "The Fund's position should be absolutely pragmatic, if not agnostic," he told the Board. "The choice of a currency is a sovereign choice. Although from an economic standpoint, choosing to introduce a national currency might not be the best solution, economic rationale cannot operate independently of a given national tradition."[5]

As the Fund geared up to provide policy advice to the emerging countries, the staff took what it considered to be the pragmatic view, that for the early part of the transition preserving the ruble area would be in the interests of the countries of the former Soviet Union outside of the Baltic states and Russia. The proposed work program for the region, as set out in November 1991, recommended

[5]Minutes of EBM/91/147 (November 6, 1991), p. 8; and EBM/92/49 (April 9, 1992), p. 16.

> maintaining the ruble monetary union in 1992—not because we are opposed to national currencies, but on the pragmatic grounds that satisfying the preconditions for the credible introduction of such currencies will take time. . . . Even though republics may resent a Russian dominated monetary authority, it would be in their own interests to cooperate with it in the short term, as long as it pursued anti-inflationary policies.[6]

The situation evolved rapidly and often chaotically, and the Fund's views evolved, too. The first opportunity to present a general overview to the monetary authorities in the region came at a conference in Brussels in February 1992. Ernesto Hernandez-Catá (Deputy Director of the newly formed European II Department, or EU2) represented the Fund and presented its policy advice. In written remarks for the meeting, he explained the steps and preconditions that would be needed if a country wanted to establish its own currency. That avenue would make sense only if the country's monetary authority could do a better job than the central authority (the CBR) at maintaining price stability. In sum, "new currencies should not be introduced hastily, and certainly not before conditions have been established domestically to ensure the stability of the currency."[7]

At the end of March 1992, seven CIS member states signed a protocol in Minsk, Belarus, establishing the Interbank Coordinating Council of the Heads of National Banks (ICC). The other emerging states soon joined or affiliated themselves with the ICC. On May 20, representatives of all 15 central banks gathered in Tashkent, Uzbekistan, along with a delegation of IMF staff led by Odling-Smee (now Director of EU2) and Hernandez-Catá, to develop a plan for coordinating monetary policies in those countries still within the ruble area. At that time, all 15 countries still used the ruble. Five of them—Estonia, Latvia, Lithuania, Moldova, and Ukraine—had announced their intentions to establish their own separate currencies in the near future,

[6]Memorandum from Odling-Smee to the Managing Director, "USSR—Program Work in the Republics" (November 22, 1991); IMF archives, DMD, Accession 1995-0180-0007, B7632, "USSR (3) 1991."

[7]Attachment to memorandum from Hernandez-Catá to Mussa and others, "Paper on New Currencies," February 10, 1992, p. 3; IMF archives, Russia Country Files, RES/AI, Accession 2006-0156-19. A revised version of the paper was published as Hernandez-Catá (1992); in that version, the quotation appears on p. 64. The paper expressed the views of the author rather than the Fund, but a preliminary draft was reviewed by the Research, ETR, and Central Banking Departments. At least three readers provided comments critical of parts of the argument, but none questioned the assessment quoted here. Because some IMF staff were more disposed to favor the establishment of new currencies, Jack Boorman (Director, ETR) cautioned EU2 "to avoid giving the impression that the Fund is pushing for the introduction of national currencies while others are working toward the preservation of the ruble zone and inter-republican trade"; memorandum from Boorman to Odling-Smee, "Paper on the Introduction of a National Currency for the Forthcoming Conference in Brussels" (January 22, 1992); Historian's files. In a later review, Odling-Smee and Pastor (2002) pp. 14–16, asserted that the staff position at the Brussels conference was neutral and was limited to advising countries on how to implement policies, regardless of whether they chose to remain in the ruble area or to introduce a national currency.

but the understanding of the IMF staff was that most of the others had "indicated that they intend to remain in the ruble area, at least for some time."[8]

One option G7 officials were considering as a way to preserve the viability of the ruble area was for participating countries to set up currency board arrangements similar to those used by Argentina, Hong Kong, and a few other countries. In May 1992, right after the Tashkent meeting, Thomas C. Dawson II (Executive Director, United States) informed Camdessus that British officials were proposing such a scheme, apparently with the support of the U.S. Treasury.[9] As events unfolded, however, nothing more came of the idea.

While preparing for the Tashkent meeting, the IMF staff broke into something close to bureaucratic warfare over their differing assessments of the viability of the ruble area. Research Department staff, led by David Folkerts-Landau (Chief, Capital Markets and Financial Studies Division), circulated a draft paper that assumed the common currency area was about to collapse. In a covering memorandum to other departments, the Director of Research, Michael Mussa, observed that the "sufficient conditions for the breakup of the ruble zone—high inflation in the common currency and perceived inequities in the sharing of seigniorage—are satisfied." That provoked an angry reaction from Hernandez-Catá, who reportedly attacked the paper as "flying in the face of G7 and Fund policy."[10] The paper was never finalized or circulated more widely, but the episode revealed a deep rift that contributed to ambiguities in, and misunderstandings about, the Fund's views on this delicate issue.

The IMF's objectives for the Tashkent meeting were to help the countries find a way to make the ruble area work and to promote and assist cooperative policies even for those countries about to strike out on their own. On the eve of the meeting, Odling-Smee and Hernandez-Catá met with Georgi Matyukhin, the head of the CBR. When Matyukhin explained that his concern was to ensure that Russia could control the issuance of money throughout the area, Odling-Smee replied that insistence on this point would doom the system. Cooperation, not unilateral decision making, was essential.[11] The Russians were unconvinced, and—for the reason that Odling-Smee

[8]Draft paper by Hernandez-Catá, "The Coordination of Monetary Policy in the Ruble Area," April 27, 1992; IMF archives, Russia Country Files, RES/AI, Accession 2006-0156-19.

[9]Memorandum from Dawson to the Managing Director, "Currency Boards," May 22, 1992; IMF archives, Russia Country Files, RES/AI, Accession 2006-0156-19.

[10]Memorandum from Mussa to John T. Boorman and others, "Currency Reform Paper," May 8, 1992, covering a preliminary draft of the paper, "The Economics of Currency Reform in the CIS"; and memorandum for files by Folkerts-Landau, "Mr. Hernandez-Catá's Informal Remarks about the Currency Reform Paper," May 22, 1992. Also see memorandum from Mussa to Boorman and others, "Comments on 'The Economics of Currency Reform'," June 9, 1992; IMF archives, Russia Country Files, RES/AI, Accession 2006-0156-19. Parts of the paper dealing with historical precedents were issued as an IMF working paper and later were published externally (Garber and Spencer) 1994.

[11]Memorandum from Hernandez-Catá to the Managing Director, "Meetings with Central Bank of Russia Officials on Monetary Policy in the Ruble Area," May 26, 1992; IMF archives, Russia Country Files, RES/AI, Accession 2006-0156-19.

foresaw—the conference failed. In principle, the ICC accepted the Fund's guidelines for a rules-based system for coordinating monetary policy, but several delegations refused to sign the draft communiqué, which was not formally issued.

Two weeks later, at a follow-up meeting in Tallinn, Estonia, Russia's insistence on centralized control came out even more clearly, effectively burying the Fund's proposed guidelines.[12] Camdessus then had a testy meeting with Konstantin Kagalovsky, Russia's representative at the IMF, in which he asked him to explain the variance between the Tashkent communiqué and Russia's subsequent position that the ruble area was no longer workable and should be dissolved as quickly as possible. Kagalovsky reportedly replied that "Russia was not willing to sacrifice its own reforms for the sake of foreign countries." The Managing Director pleaded in vain for Russia to cooperate in promoting "a good monetary policy . . . throughout the ruble area" and an orderly transition period for those countries that wanted to leave the area.[13]

For the most part, after Tashkent the IMF just tried to advise the CIS countries on how to run the ruble area effectively, *if they chose to try to preserve the area*. Despite the staff's skepticism about the institutional capacity of many of these countries—other than the Baltic states—to issue their own stable currencies, the Fund recognized the difficulties of maintaining the status quo and in most cases did not actively discourage countries from trying to extract themselves from the ruble. The Tashkent guidelines implied that if countries continued to use the ruble, their adherence to the guidelines would be a condition for financial assistance from the IMF. The Fund also stressed to the Russian authorities that they would have to "put in place a system of monetary policy cooperation [with the countries in the ruble area] before an arrangement can be agreed with the Fund."[14] The policy requirements for countries leaving the area were to be discussed later on a case-by-case basis.

The three Baltic countries were the first to leave the ruble area. Of all those involved, they had the best institutional structures in place for managing their own currencies. They also had the keenest desire to establish separate currencies, as a matter of national pride and as a way of stating boldly that they were fully independent from the country that had controlled them for half a century. Estonia led the exodus,

[12]See "Statement by the Managing Director on Monetary Policy Cooperation in the Ruble Area, Executive Board Meeting 92/72, June 12, 1992," BUFF/92/99 (June 12, 1992); and "Monetary Policy in the Ruble Area," EBD/92/117 (June 12, 1992). The latter document contains the Fund's guidelines. Also see memorandum from Malcolm D. Knight (Assistant Director, Research Department)—one of the eight members of the IMF delegation in Tashkent—to Mussa, "Tashkent Meetings on Monetary Cooperation in the Ruble Area," May 26, 1992; IMF archives, Russia Country Files, RES/AI, Accession 2006-0156-19. The draft communiqué is attached to Knight's report. The guidelines and the communiqué were drafted primarily by Hernandez-Catá.

[13]File memorandum by Vincent R. Koen (Economist, EU2), "Meeting of Mr. Kagalovsky with Management, June 2, 1992," June 4, 1992; IMF archives, Russia Country Files, EU2, Accession 96/194.

[14]"Statement by the Managing Director on Monetary Policy Cooperation in the Ruble Area, Executive Board Meeting 92/72, June 12, 1992," BUFF/92/99 (June 12, 1992).

introducing the kroon in June 1992, just a few weeks after the ICC meeting in Tashkent. Latvia followed with its own ruble in July, and Lithuania introduced the talonas in October. Ukraine and the Kyrgyz Republic soon followed suit, but the biggest catalyst came in July 1993. That month, the Russian government suddenly announced—without any prior consultation with the IMF and after almost no notice to the other states using the ruble—that it was issuing a new ruble to replace the Soviet-era notes (which still featured Vladimir Lenin's picture). It allowed Russian residents just a brief period to make the exchange.[15] Although the conversion rules were quickly relaxed, the potential still existed for Russian residents to try to dump their old rubles by spending them in neighboring countries where they were still in circulation. Even worse, in the short run those countries had no assured official supply of new rubles. Suddenly, even those countries that had planned to remain in the ruble area realized the currency union was no longer viable. By the end of 1993, all but Tajikistan had introduced national currencies either to replace or to supplement the Russian ruble in domestic exchange (Table 8.2)[16]

The views of the Fund staff working on these countries evolved throughout 1992, from mild opposition to the early introduction of national currencies toward cautious support. By July, the staff realized its technical advice on whether and when to leave the ruble area was of secondary importance, because each country was making its decision primarily on political grounds or in reaction to the breakdown of policy coordination across the whole region.[17] The failure of a CIS summit meeting in Bishkek, Kyrgyz Republic, to establish credible limits on credit expansion made the outlook for the area even gloomier. In a letter sent to all regional central banks in November, Odling-Smee argued that the region's strategy of trying to coordinate monetary policy among countries had failed. Every country now had to decide whether "to remain in a single currency area with a common monetary policy or . . . to introduce a separate, national currency. There are no other viable alternatives."[18]

[15]See "Russian Federation—Recent Economic Developments and Policy Outlook," EBS/93/161 (September 24, 1993), p. 4, which notes that the announcement caused "considerable chaos and a political outcry." Also see a statement by Richard D. Erb (Deputy Managing Director) to the Executive Board, regretting the lack of consultation and planning and the "unnecessary degree of uncertainty" that it caused, "both within Russia and in a number of other . . . states" in the ruble area; minutes of EBM/93/107 (July 28, 1993), pp. 5–7. Russian President Boris Yeltsin later acknowledged that the ruble conversion was mishandled, but he shifted the blame to Matyukhin's successor as central bank governor, Viktor Gerashchenko, for managing it badly; see Yeltsin (1994), pp. 217–24.

[16]For further background, see Odling-Smee (1994) and Wolf (1994).

[17]Report by the Deputy Managing Director, Richard D. Erb, at EBM/92/94 (July 24, 1992), pp. 5–6.

[18]The letter to Gerashchenko was reproduced in Odling-Smee and Pastor (2001), pp. 42–44. Similar letters were sent to the central bank governors in all countries still using the ruble. Earlier, in October, Camdessus made the same point in meetings with the presidents of Kazakhstan and the Kyrgyz Republic; see his report to the Executive Board at EBM/92/127 (October 21, 1992), p. 3.

Table 8.2. Dissolution of the Ruble Area, 1992–95

Country	Currency	Introduction of Parallel Currency	Introduction of National Currency	Initial Exchange Regime
Armenia	dram	n.a.	November 1993	float
Azerbaijan	manat	August 1992	January 1994	peg to U.S. dollar[a]
Belarus	rubel	May 1992	September 1993[b]	managed float
Estonia	kroon	n.a.	June 1992	currency board, pegged to deutsche mark
Georgia	coupon[c]	April 1993	August 1993	managed float
Kazakhstan	tenge	n.a.	November 1993	float
Kyrgyz Republic	som	n.a.	May 1993	managed float
Latvia	ruble[d]	May 1992	July 1992	float[e]
Lithuania	talonas[f]	May 1992	October 1992	float[g]
Moldova	leu	June 1992	November 1993	float
Russian Fed.	ruble	n.a.	July 1993[h]	float
Tajikistan	Tajik ruble[i]	n.a.	May 1995	float
Turkmenistan	manat	n.a.	November 1993	de facto peg to U.S. dollar[j]
Ukraine	karbovanets[k]	January 1992	November 1992	float
Uzbekistan	sum[l]	November 1993	January 1994	managed float

Source: IMF staff reports. Some previously published tables, including those in Odling-Smee and Pastor (2002) and Pomfret (2002), give different dates from those in this table. Where they differ, the IMF staff-report sources for this table are as follows: For the absence of a parallel currency to the ruble in Armenia before the introduction of the dram, see the unnumbered technical assistance report, "Armenia: Management of an Independent Currency," December 31, 1993, pp. 2–3. For January 1, 1994, as the effective date that the manat became the sole legal tender in Azerbaijan, see "Azerbaijan Republic—Staff Report for the 1994 Article IV Consultation," SM/94/116 (May 11, 1994), p. 5. For January 1994 as the date that rubles ceased being legal tender in Uzbekistan, see "Republic of Uzbekistan—Staff Report for the 1993 Article IV Consultation," SM/93/259 (December 20, 1993), p. 7. For June 28, 1993, as the date that the lats replaced the Latvian ruble, see "Latvia—Representative Rate for the Lats," EBD/93/127 (July 23, 1993), p. 1.

Note: n.a. = Not applicable.

[a]Azerbaijan abandoned the dollar peg in March 1994, pegged briefly to the Russian ruble, and floated the manat at the end of May 1994.

[b]Convertibility into rubles was suspended at this time; the rubel officially became the sole legal tender in May 1994.

[c]The coupon (introduced as a temporary currency) was replaced by the lari in October 1995.

[d]The Latvian ruble was replaced by the lats in June 1993.

[e]Latvia pegged the lats to the SDR in February 1994.

[f]The talonas was replaced by the litas in June 1993.

[g]Lithuania established a currency board and pegged to the U.S. dollar in April 1994.

[h]Soviet-era rubles were replaced by new Russian ruble notes.

[i]The Tajik ruble was replaced by the somoni in October 2000.

[j]Officially classified as a managed float.

[k]The coupon was introduced as a parallel currency in January 1992. The karbovanets was introduced in November 1992 and was replaced by the hryvnia in September 1996.

[l]The sum was first introduced as a coupon and was converted to a regular currency in July 1994.

In the field, staff missions were making this argument country by country.[19] Which option to choose was up to the country authorities, but the Fund was not prepared to do any more than minimal lending until that decision was made. Those discussions are summarized below, in the context of the Fund's overall policy advice to each country.

Much of what has been written about the IMF's policy advice on the ruble area, even by those who were closely involved in the discussions, is at least partially contradicted by the archival record. Contentions range from those that claim the Fund actively opposed and effectively obstructed the dissolution of the area to those that assert the Fund never discouraged countries from leaving it.[20]

An early report written for the Bank of Finland got the story almost right. The authors noted that, "While the IMF recommended careful consideration to the Baltic countries in early 1992, the Fund was already by early 1993 understood to be pushing such unwilling former Soviet republics as Belarus and Kazakhstan towards the introduction of national currencies as a condition for full-scale financial support" (Lainela and Sutela, 1994, p. 37). This description of the timing of the evolution is accurate, but it overstates the point. As discussed below (pp. 379–80, and 384), the IMF did not "push" these countries, and it did not make a specific outcome a condition for any of its lending. Rather, it insisted that each country had to decide whether to introduce its own currency or to find a viable way to manage monetary policy within the area.

In retrospect, the Fund's ambivalence toward the ruble area and its sharp internal divisions on the general policy issue and on advice to individual countries had limited practical consequences. More active support for the establishment of new currencies might have hastened and abetted the process, but probably not substantially. For the most part, as Camdessus had predicted, these countries paid little attention to the Fund's advice on whether to stay in or jump out and were guided primarily by domestic political considerations and by Russia's reluctance to engage in a cooperative system. They did, however, call on the Fund for technical assistance and advice on managing whatever monetary systems they chose.

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[19]Toward the end of 1992, an overview report to the Executive Board noted that "the staff has recently been recommending that, while making every effort to make the ruble area work effectively, the case for and against the separate currency option should be examined objectively, and preparations to introduce a new currency should be made, at least on a contingency basis"; "Interstate Monetary and Payments Arrangements in the Former Soviet Union," EBS/92/205 (December 8, 1992), p. ii.

[20]For examples of the former, see Granville (1995) and Åslund (1995), pp. 111–19. Åslund's assertion (p. 118) that the Fund "resisted every currency reform until each had already been initiated" is particularly wide of the mark. For the opposite view, see Hernandez-Catá (1993), p. 54n, and (1994), p. 7n; and Odling-Smee and Pastor (2002). The 2002 paper by Odling-Smee and Pastor, originally circulated as an IMF Working Paper a year earlier, claimed that the Fund's position was neutral and was limited to explaining the pros and cons of leaving the area. That provoked Åslund (2002) and several other critical responses that were published along with it. Also see footnote 31, below.

Even if the IMF's advice on this issue was not decisive, whether the IMF's analysis of the ruble area was sound remains an important question. The staff certainly got it right in insisting a country needed to develop the ability and the will to manage its own currency better than the central authority before it broke away. The chief difficulty in that regard lay in guessing at Russia's level of success at stabilizing its own policies.[21] In hindsight, it appears that those who argued initially for delay underestimated three risks: the risk that preserving the ruble area would weaken the incentive for countries to reform their economies and move forward, the risk that the absence of a regional fiscal authority would undermine monetary stability and lead to rampant inflation, and the risk that Russia would refuse to support a cooperative federal system for controlling the currency supply. Nonetheless, even if everyone understood that relying on Russia to anchor regional monetary policy was not ideal, it was reasonable to conclude at the time that monetary independence at the outset of an arduous transition process would be dangerously risky for many of these newly emerging countries.

The Managing Director certainly got it right in his assessment that political rather than financial concerns would likely predominate in the decision process. Here, the difficulty lay in guessing at the extent of Russia's willingness to serve regional interests when doing so would be expensive. And the biggest difficulty may have arisen because the staff judged correctly that the issues were multifaceted, that either option was risky and success was uncertain, and that the balance of risks was different for each country. Consequently, the Fund conveyed a complex message that convinced many of the authorities the Fund did not want them to strike out on their own.

What destroyed the ruble area? The failure had many fathers. Three distinct factors stand out.[22] First, as discussed in Chapter 7, Russian monetary policy in 1992 was poorly managed. Without a clearly communicated and effectively implemented policy by the dominant central bank, the other countries quickly lost confidence in the system. Second, several countries took advantage of the lack of central control to draw excessively on the CBR to finance their own inflationary policies. As noted above, this inflationary bias imposed very heavy costs on Russia, whose government soon wearied of supporting its neighbors in such an unproductive way. Third, and most crucial, Russia's unilateral decision to introduce a new ruble in 1993 manifested its final refusal to share control with the other countries in the area. The technical shortcomings of the ruble area have been well documented in the

[21]An influential paper by Rudiger Dornbusch, first delivered as a lecture in June 1992, examined the lessons from the breakup of the Austro-Hungarian empire for the future of the ruble area. Dornbusch concluded that it "is a quite awful idea to maintain a currency area between sovereign nations based on an *un*stable center currency. . . . A clean break is far better and the sooner it is done, the better" (Dornbusch, 1992, p. 419); the emphasis on "unstable" is in the original.

[22]For more detailed discussions, see Wolf (1994); Åslund (1995, Chapter 4); and the symposium published in conjunction with Odling-Smee and Pastor (2002).

literature, but the overriding problem was a lack of political commitment to devise an equitable and effective system based on federal principles rather than central control.

The IMF did not in any sense lead or guide the dissolution of the common currency area, but as the area's weaknesses became apparent, the Fund's policy shifted accordingly. In December 1992, the staff concluded that the "present system cannot continue."[23] From that point on, the Fund's efforts focused on helping countries establish their own currencies, although the specific advice varied depending on the country's progress toward meeting the preconditions.[24]

The Baltic Countries

The three small countries stacked up on the eastern shore of the Baltic Sea—Estonia to the north, then Latvia and Lithuania—were different from the rest of the Soviet Union for two reasons. First, they had been forcibly annexed into the USSR in 1940 after being occupied by Soviet troops. Much of the international community had never recognized this annexation and had regarded it as illegal. By 1989, even the Soviet government in Moscow was taking steps to grant the region more autonomy. Second, this region had a deeper tradition of democracy and market economics than most of the Soviet Union. Popular sentiment in the Baltic countries strongly favored establishing economic and political ties with western Europe. Inevitably, reforms would take place more quickly and more forcefully here, and these three countries would be a crucible for testing the changes that would come more gradually to the south and east.

In 1992, all three joined the IMF, began borrowing from it and making extensive use of its technical assistance and policy advice, and introduced their own national currencies. Just 12 years later, these three small countries had repaid almost all of their IMF debts and had become fully integrated with the west by joining the European Union (EU) as part of its expansion of May 1, 2004.[25]

[23]"Interstate Monetary and Payments Arrangements in the Former Soviet Union," EBS/92/205 (December 8, 1992), p. ii.

[24]See, for example, Abrams and Cortés-Douglas (1993), which was "designed as a working document for those involved with currency reforms to help ensure that all the necessary steps are taken before, during, and immediately after a new currency is introduced" (p. iv). Also see Bredenkamp (1993), the aim of which was to "consider the options that might . . . face an FSU country . . . which elects to introduce its own independent currency" (p. 1); and Hernandez-Catá (1993), which sets out the various practical options. In November 1993, after Kazakhstan introduced its own currency, Camdessus issued a news brief that "reiterated" the IMF's support for the practice across the region provided that it was underpinned by appropriate economic policies; see "Camdessus says IMF Supports Introduction of New Currencies in the Former Soviet Union," NB/93/16, November 15, 1993.

[25]For an overview, see Knöbl and Haas (2003).

The Baltic countries suffered enormous losses of trade and production during their first years of independence, but by 1994 they all were growing again. The issuance of national currencies and the corresponding achievement of financial stability played an important role in this turnaround. Immediately after regaining its independence, Estonia established a currency board arrangement to stabilize its currency. Latvia and Lithuania soon set up similar systems. Advising the authorities and assisting with this process became a key element in the IMF's work in the region.

Estonia

The IMF and Estonia had an unusual but generally positive relationship in the first few years of the country's membership. Instead of encouraging or pushing the authorities to stabilize and reform the economy, the Fund found itself trying to caution them not to move too quickly and to temper their enthusiasm for unfettered markets. The authorities rejected that advice, but the Fund soon came to play a valuable supporting role in one of the world's most radical free-market reform programs.

The economic reform movement in Estonia began in 1987, when a group of economists led by Siim Kallas (then working as a journalist; later to become a senior official and eventually prime minister) published a proposal calling for full economic autonomy from the Soviet Union. When the Soviet Union granted economic sovereignty to the Baltic states in November 1989, Estonia already had done much of the planning and could move rapidly to hold legislative elections, reestablish a central bank, and put the country on a path to independence. Plans to introduce a national currency were set in motion in March 1991. Six months later Estonia gained its political independence with the concurrence of the central government in Moscow.[26] Before the end of September 1991, Estonia had become a member of the United Nations, had applied for membership in the Fund, and had received a promise of financial aid from the United States.

The IMF responded quickly to these developments. In the last week of September 1991, the Deputy Managing Director, Richard D. Erb, met with the prime minister, Edgar Savisaar, in Tallinn. A staff visit followed in November, then a full-scale membership mission occurred in January 1992, led by Adalbert Knöbl (Chief of the Baltic Division, EU2). The membership mission coincided with the declaration of an economic emergency—the sudden liberalization of prices in Russia at the beginning of January had immediately destabilized prices in Estonia. That situation brought down the Savisaar government, which was replaced by a transitional coalition government headed by Tiit Vähi. Although it was essentially a caretaker until new elections could be held and a constitution drafted, and although it was to some extent sympathetic to the old central-planning model, Vähi's government pushed ahead with economic

[26]For more on these developments, see Kukk (1997) and Laar (2002).

reforms. Simultaneously, the IMF proceeded with the formalities of the membership process. Estonia became a member of the IMF on May 26, 1992.

As with the other new states, the newly independent Estonia took control of its own finances as one of its first tasks. The long-standing dream of establishing a national currency would have to be a high priority for whatever government was in power. The IMF initially was cool to that idea, as were the governments of the neighboring Nordic countries, particularly because of the highly unstable state of Estonia's finances while the economy was being buffeted by the uncertainty of developments in Russia. During the January 1992 membership mission, Knöbl strongly advised the authorities to proceed slowly on currency reform until they could make substantial progress on fiscal control, develop a strategy for sustaining trade with the other newly emerging countries, and devise a viable exchange regime.[27] As late as May of that year, when Kallas (who had become the central bank governor) was in Washington to sign the Articles of Agreement on behalf of the new member, Camdessus tried to talk him out of taking the risky step of issuing a national currency too early.[28] The Fund's economic arguments, however, clashed with Estonia's political ambitions and fell on deaf ears.

To the authorities, the only real issue was the type of currency regime to establish, with the aim of stabilizing the price level as rapidly and as firmly as possible. Because Estonia had set about recovering substantial gold reserves that had been held abroad during the Soviet era, Kallas proposed adhering to the gold standard.[29] That idea would have been in conflict with Article IV of the IMF charter, and all the outside experts advising the authorities counseled against it. The IMF staff suggested allowing the new currency, to be known as the kroon, to float long enough to reach an equilibrium level and then pegging the rate. Kallas thought the scheme too complicated to be understood by the populace, and rejected the idea.

In April 1992, as debate about these options continued, Harvard Professor Jeffrey Sachs and his colleague Ardo Hansson arrived in Tallinn to offer independent advice. (Hansson was an American whose parents were Estonian. He had studied under Sachs at Harvard and later would become an advisor to the prime minister.) Drawing on the initial success of the contemporaneous Argentine stabilization program (Chapter 9),

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[27]See memorandum from David Burton (Advisor, Exchange and Trade Relations Department) and Adalbert Knöbl to the Managing Director, "Estonia—Meeting of the Monetary Reform Committee," January 13, 1992; IMF archives, OMD-AD, Accession 1996-0187-0002. Also see Knöbl, Sutt, and Zavoico (2002), p. 8.

[28]Memorandum from Eduard Brau (Deputy Director, EU2) to the Managing Director, "Estonia—Lunch with Governor Kallas: May 26," May 21, 1992. Also see letter from Richard D. Erb (as Acting Managing Director) to Prime Minister Vähi, May 7, 1992. Both items are in IMF archives, OMD-AD, Accession 1996-0187-0002. Additional details are from interviews.

[29]On the sources of the gold reserves, see Bennett (1993), p. 462.

they recommended that Estonia set up a currency board.[30] Kallas liked that idea because it was closely akin to his preference for a gold standard. A currency board would insulate monetary policy from pressures to help finance government spending, ensure stability against the key western European currencies, and be easy to explain publicly. Knöbl, in Tallinn at the time with a staff team, told Kallas the IMF could support this proposal, though he warned it could work only if the government got fiscal policy under control.[31]

Kallas decided to adopt the basic thrust of the currency board proposal without abandoning the traditional role of a central bank in overseeing the currency and the banking system. That setup made the regime more like a conventional exchange rate peg, though with a stronger commitment mechanism. (The exchange rate could be changed only by an act of parliament.) In this respect, it was quite similar to the Argentine system. The critical element, though, was that the central bank would be required formally to limit the monetary base to the size of the official foreign exchange and gold reserves.[32] Kallas also accepted the advice of the IMF to delay the reform by a month, to allow time for implementation of supporting policies.

On June 20, 1992, less than four weeks after joining the IMF and not even nine months after gaining independence, Estonia began withdrawing rubles from circulation and replacing them with krooni, the first national currency to be established in a country of the former Soviet Union. Residents could obtain currency at a fixed rate of 1 kroon

[30]Several months earlier, Lars Jonung (professor of economics at the University of Stockholm) had proposed that Estonia establish a currency board jointly with the Swedish government. Under that scheme, which was quite different from the one finally adopted, Sweden would have donated a sum of its own currency to serve as Estonia's stock of reserves and as backing for the monetary base. The kroon would have been pegged to the Swedish krona, and Russian rubles would have circulated alongside the kroon as a parallel currency with a floating exchange rate; see Hanke, Jonung, and Schuler (1992).

[31]Hansson and Sachs (1992) noted correctly that the IMF "tried at first to delay the introduction of" the kroon, but they exaggerated in asserting that the Fund argued "that the currency should be introduced late in 1992, or in 1993" (p. 2). In response, Odling-Smee (1992) called that description a "travesty" and implied that the Fund had not tried to delay the reform. His characterization was that the staff had "explained what was involved and that certain key elements would need to be in place to improve the chances for success" (p. 9). In fact, the April 1992 staff mission told the authorities that the Fund would not support the reform except as one component of a "broader stabilization program," that Kallas's proposal to introduce the currency in the second half of May was not feasible from that perspective, and that the earliest the Fund could offer its support would be late in June; memorandum from Knöbl to the Managing Director, "Estonia: Preliminary Policy Discussions—Back-to-Office Report," April 16, 1992; IMF archives, OMD-AD, Accession 1996-0187-0002. Also see Hansson (1993); and Knöbl, Sutt, and Zavoico (2002), pp. 11–12.

[32]Because it would take some time to repatriate reserve assets from the various countries holding them, the government took the unorthodox step of transferring control of certain parts of the national forests temporarily to the Bank of Estonia. For the next few years, the commercial value of those timber resources thus supplemented the central bank's reserves and helped build confidence in the stability of the currency. Fortunately, the efficacy of this unique "timber standard" was never tested, and in 1997 full control over the forests returned to the government.

per 10 rubles, and the kroon could be exchanged freely for other currencies at a fixed rate of 8 krooni per deutsche mark. These ratios corresponded roughly to the prevailing market rate (about 80 rubles to the mark) and satisfied Kallas's penchant for simplicity.

To this point, the IMF had played a mostly reactive supporting role on the currency issue. The authorities had followed their own course rather than taking much of the Fund's advice. Now they had to get the economy onto a path of sustainable growth. In this task, too, they would find themselves out in front of the Fund with regard to their determination to implement strong and sustainable macroeconomic policies and to reform the economy.

When currency speculation by domestic banks led to a crisis that wiped out some 40 percent of the money supply in December 1992, the government—now led by Mart Laar, as firm an advocate of free markets as could be found anywhere in the world—rejected advice to bail out the banks and their depositors. Instead, the government simply let the banks fail. A few months later, it instituted a flat tax on individual and corporate incomes, rejecting advice that the system would generate insufficient revenues. As soon as the Fund staff saw that these policies were working, they got in step and provided technical assistance on implementation. On other policies, such as the critical decision to open up trade and finance fully to international competition, the staff and the authorities were more in tune from the beginning.

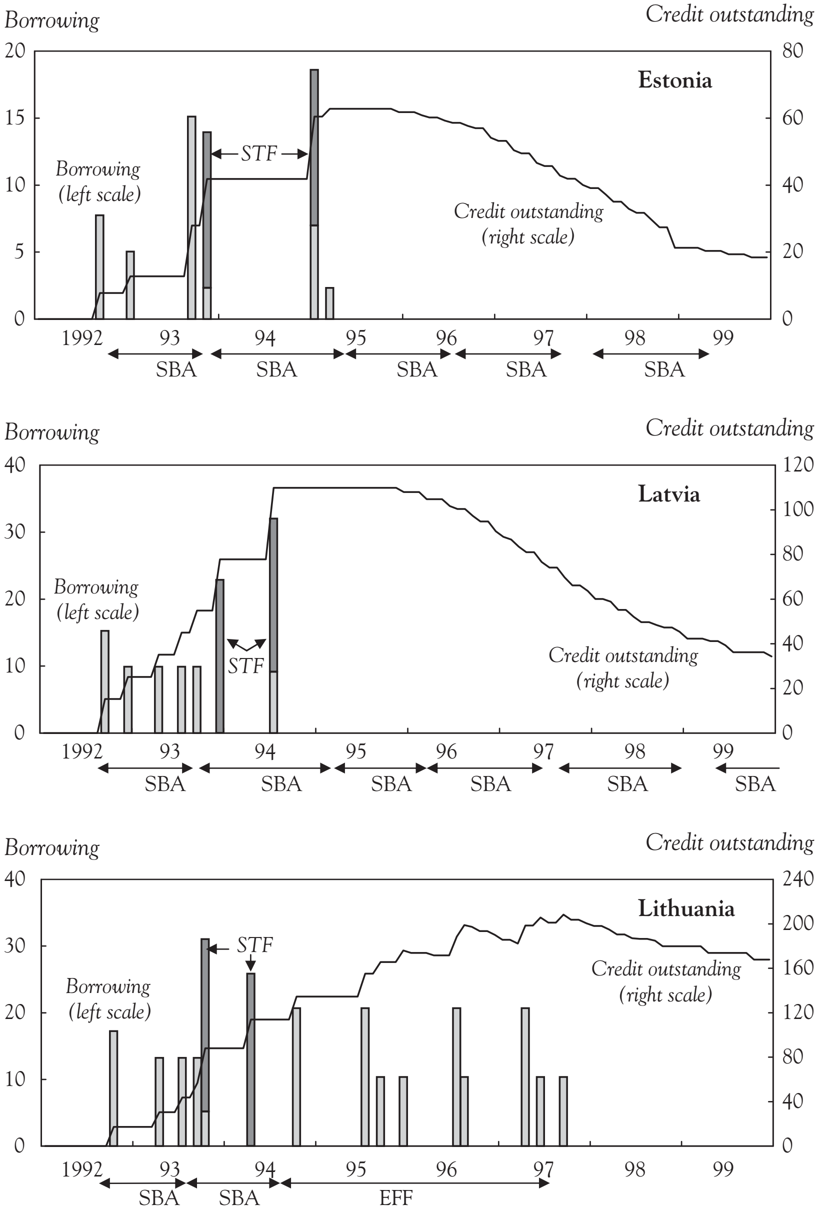
Throughout the decade, Estonia needed the Fund primarily for its seal of approval for the actions the authorities decided to take. Over a period of two and a half years beginning in September 1992, Estonia borrowed about $90 million from the IMF (SDR 62.8 million, or 135 percent of quota), through two stand-by arrangements and two drawings on the Systemic Transformation Facility (STF) (Figure 8.1). Estonia used that money only to bolster its reserves. The authorities ran the currency board arrangement skillfully and even managed to balance the government budget while restoring growth in real GDP. After those initial arrangements expired, Estonia had no further need to borrow, but it did request and obtain four more stand-by arrangements on a precautionary basis, which the Fund readily approved. The Fund's continuing support helped Estonia weather a stock market bubble that burst in the last quarter of 1997 and the Russian financial crisis that hit a few months later.

Latvia

Beginning in 1987, Latvia developed an even more aggressive pro-independence movement than that in Estonia. On May 4, 1990, the newly elected parliament unilaterally declared the country's independence from the Soviet Union. The United Nations admitted Latvia as a member on September 19, 1991, and the government applied for IMF membership the same day.

From the outset, the Fund approved Latvia's plan to introduce a national currency, but the staff advised the authorities first to establish a proper central bank and a functioning system of private banks. The need to cope with a severe shortage of ruble banknotes from Russia soon overtook this cautious approach. A real central bank

Figure 8.1. Baltic Countries: Use of Fund Credit, 1992–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics.
Note: EFF = Extended Fund Facility; SBA = Stand-by arrangement; STF = Systemic Transformation Facility.

quickly took form, led by Einars Repše—a 30-year-old physics graduate who had taught himself economics by reading Paul Samuelson's elementary textbook. With the conviction of the revolutionary, Repše decided that this was all the economics he needed to convert Latvia to a western monetary system. By the time the country joined the IMF in May 1992, the new and independent Bank of Latvia had already taken the risky and potentially calamitous step of circulating Latvian rubles in parallel with those from Russia (freely exchangeable at par).

The gamble paid off, owing to two supporting measures. First, with technical assistance and policy advice from the IMF, the government maintained fiscal discipline and established a tax system capable of generating adequate revenues. Second, the repatriation of gold that had been held by western central banks provided Repše with enough reserves to completely back the currency he was putting into circulation. Although not formally a currency board arrangement, it was based on the same level of discipline. Against all expectations, the Latvian ruble was rapidly accepted throughout the country, and foreign exchange reserves increased further.

Two months later, the authorities abandoned the peg against the Russian ruble, declared the Latvian ruble to be the sole legal tender, and let the exchange rate float. Though still worried about the infant central bank's capacity to run a stable monetary policy, the IMF endorsed these actions and viewed them as key steps toward establishing a market economy.[33]

Latvia entered into six stand-by arrangements with the IMF in the 1990s, but all of its borrowing occurred in the first two years (Figure 8.1). The first arrangement, approved in September 1992, came at a time when output was falling sharply. Latvia was suffering severely from the disruptions caused by the collapse of both the ruble area and the Soviet-era trade arrangements, known as the Council for Mutual Economic Assistance (CMEA). That first stand-by arrangement, for $80 million (SDR 54.9 million, or 90 percent of quota), was fully used to help build the central bank's foreign exchange reserves. The Fund approved a second stand-by arrangement in December 1993, for $32 million (SDR 22.9 million, or 25 percent of quota), along with an STF drawing of the same amount. As domestic output continued to fall, Latvia made the first two drawings on the stand-by arrangement plus a second STF drawing. By then the economy was beginning to grow and foreign capital was beginning to return.

[33]The March 1992 premembership economic report noted that although "monetary policy will have to be coordinated with that of the ruble zone in the immediate future, it would become a key element in macroeconomic policy in 1992 if the authorities were to introduce a Latvian currency." Five months later, when Latvia requested its first loan from the Fund, the staff concluded approvingly that the introduction of a national currency had "created the necessary conditions for the pursuit of an independent monetary policy," but it warned of "considerable uncertainty concerning the proper stance of monetary policy in the current circumstances." See "Latvia—Pre-Membership Economic Review," SM/92/46 (March 6, 1992), p. 9; and "Latvia—Request for Stand-By Arrangement," EBS/92/131, Suppl. 1 (August 24, 1992), p. 19.

To preserve the country's credibility with foreign investors, the authorities obtained four more stand-by arrangements throughout the rest of the decade, announcing in each case that they intended not to borrow any of the money. As the economy continued to grow and the lats (the successor to the Latvian ruble) continued to appreciate, the authorities were able to stabilize further by pegging the currency to the SDR in 1994 and then to the euro in 2005. Latvia repaid its IMF loans on schedule, completing the cycle in 2004, the same year that it joined the EU.

Lithuania

Lithuania began openly seeking independence in June 1988, and it declared its sovereignty unilaterally in March 1990. The Soviet Union objected and imposed an economic blockade, which forced the government to back off and enter into negotiations. As with the other two Baltic countries, the real dawn came in the wake of the aborted coup against Gorbachev in August 1991, which induced the weakened government in Moscow to grant independence. Lithuania became a member of the UN in September and immediately applied for IMF membership.

The staff (led by Knöbl) held intensive policy discussions with the Lithuanian authorities in February 1992, covering a wide range of issues on the transition to a market economy: procedures for privatizing enterprises and housing, liberalization of the few remaining controlled prices, using incomes policies to stop the wage-price spiral the initial liberalization had started, loosening fiscal policy in reaction to the sharp decline in output and employment, determining when to introduce a national currency, preserving trade with the other republics, and retaining a social safety net while eliminating wasteful subsidies.[34] Separately, several staff missions spent considerable time in Vilnius providing technical assistance on central banking, fiscal, statistical, and general macroeconomic issues. All of this early advice from the IMF was given in the context of an extremely bleak economic situation, in which trade and output were collapsing while prices were rising rapidly in response to the end of central controls.

Even before they applied to join the IMF, the Lithuanian authorities had committed themselves to leaving the ruble area as quickly as possible. By the time the first IMF staff mission arrived in Vilnius in November 1991, the central bank was already taking delivery of new banknotes that had been printed in the United States. Knöbl nonetheless urged them to go slowly down this road. While the Lithuanians were worried about importing monetary instability from Russia, the Fund was more concerned about whether Lithuania had the technical expertise it would need to stabilize on its own. When Knöbl and his team arrived in February 1992, the authorities agreed to wait until they could devise a stabilization program the Fund could support. A month later, the Executive Board reinforced this advice, concluding "that the introduction of a

[34]For a detailed report on the Fund's advice on these issues, see "Lithuania—Pre-Membership Economic Review," SM/92/60 (March 13, 1992), pp. 9–15.

separate currency without adequate preparation to exercise financial control would be premature and would not by itself stabilize prices and the economy."[35]

As soon as negotiations began on the terms for IMF financial support, the emphasis shifted toward creating the necessary conditions for successful introduction of the new currency. On May 1, 1992, the authorities began issuing coupons, known as the talonas, to circulate as legal tender alongside the ruble. That gave the central bank some experience at managing currency, while the Fund sent a team of specialists to offer technical assistance. When rubles began to pour into the country from Ukraine and elsewhere, the authorities reacted forcefully by declaring on September 23 that the ruble would cease to be legal tender in Lithuania as of October 1. The Fund supported that move, and on October 21 the Executive Board approved Lithuania's first use of Fund resources.

Lithuania borrowed steadily from the IMF for the next five years, with peak indebtedness of $295 million (SDR 208.2 million, or 201 percent of quota) reached in September 1997 (Figure 8.1). Although the Fund interrupted disbursements for a time in 1994 owing to fiscal excesses, it generally pronounced itself satisfied with the implementation of policies. A key early development in the stabilization of the Lithuanian economy was the April 1993 decision by Adolfas Šleževicius—newly appointed as prime minister—to limit wage increases to a rate below that of price inflation. Knöbl's mission team had just arrived in Vilnius when the prime minister announced his intention to allow a 40 percent increase. After discussions with the mission, he scaled the increase back to 15 percent. That decision kept the program on track and quickly reduced the rate of consumer price inflation.[36]

The first stand-by arrangement was fully drawn on schedule, enabling the economy to stabilize enough for the authorities to introduce a national currency, the litas, in June 1993. Soon afterward, however, the government was besieged by opposition pressures to ease up on monetary policy. To counter that pressure, the authorities decided to switch from a floating exchange rate to a currency board arrangement and use it to peg the value of the litas firmly to the U.S. dollar. The staff strongly supported this move, calling it "a momentous step toward achieving lasting financial stability."[37]

The currency board took effect in April 1994, after which confidence returned and the economy stabilized and began to grow. That fall, the Fund replaced the stand-by arrangement with a larger three-year extended arrangement, which was well implemented and fully used despite the setbacks from a major banking crisis at the end of 1995. The expiration of that arrangement in 1997 brought Lithuania's borrowing to a close, but the IMF continued to provide a large and varied amount of technical assistance.[38] From 1992 through the end of the decade, the Fund sent a stream of staff

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[35]Minutes of EBM/92/41, p. 14.

[36]See "Lithuania—Review Under the Stand-By Arrangement," EBS/93/86 (June 7, 1993).

[37]EBS/94/60 (March 23, 1994), p. 18.

[38]Lithuania had two subsequent stand-by arrangements, approved in 2000 and 2001, but those arrangements were precautionary, and no drawings were made on them.

missions to advise on central banking, fiscal administration, and statistics. In addition, the Fund helped train a great many officials through courses offered in Washington and Vienna, and it temporarily placed resident advisors at the Bank of Lithuania and the ministry of finance.

Like its two northern neighbors on the Baltic Sea, Lithuania enjoyed good economic performance throughout much of the second half of the 1990s, interrupted by the effects of the Russian crisis of 1998. That setback, however, did not force Lithuania to resume borrowing from the IMF, and the economy soon got back on its growth path.

Other Middle-Income Countries

Four other countries that emerged from the breakup of the Soviet Union were classified as middle income: Belarus, Kazakhstan, Turkmenistan, and Ukraine. Turkmenistan had no need for IMF financing, but each of the other three had at least one stand-by arrangement in the first few years of their membership in the IMF. Ukraine—easily the largest economy in the region aside from Russia—borrowed almost continuously from 1994 through 2002.

Ukraine

In important respects, Ukraine embarked upon independence in the most precarious situation of all the countries of the former Soviet Union. It had been pressured to accept the "zero-option" agreement, under which Russia assumed responsibility for all Soviet debt and took ownership of all external assets. That left Ukraine largely free of debt but with no liquid reserves. Ukraine had none of the essential institutional structure for running a market economy, nor any relevant national history upon which it could draw. Under the Soviet system, Ukraine's industry had been developed with the primary aim of exporting industrial and military goods to Russia. Agriculture was totally collectivized, and all land was owned by the state. As for finance, monetary control had been centralized in Moscow. A splendid building in central Kyiv housed the Ukraine's branch of the Soviet Gosbank, but its staff had no responsibility for, nor training in, the policy functions of a central bank.

In addition to having no resources and no usable training, Ukraine had few friends willing and able to help it. To the east, Russians were not ready to forgive Ukraine for its strong and early insistence on independence, and their resentments and suspicions drew on a long history of disputed borders and strained relations. In practical terms, the economic size and political importance of Ukraine—independent and possessing nuclear weapons—posed challenges that Russia could not afford to ignore. To the west, the U.S. government had made no secret of its preference for a modernized and less centralized Soviet Union rather than full dissolution into a balkanized region. In the

midst of Ukraine's drive for independence in August 1991, President George H.W. Bush went to Kyiv to address the Ukrainian parliament. Implicitly, he urged them to reconsider the course on which they had embarked. Better, he suggested, to continue to develop democracy gradually within a less centralized Soviet Union than to insist upon independence for its own sake.[39] Three weeks later, the attempted coup in Moscow rendered that option moot, but the memory of the *defí americain* persisted.

Into the IMF, Out of the Ruble

Despite the obstacles, Ukrainians were determined to chart their own course. The parliament first declared the country's sovereignty in July 1990. Ukraine then continued as a Soviet republic, but on August 24, 1991, it unilaterally declared independence. One of its first acts as an independent state (though it was not yet recognized as such) was to enter into a secret arrangement with a Canadian firm to print banknotes for a Ukrainian currency, to be known as the hryvnia. The authorities in Moscow learned of it quickly, but they were powerless to stop Ukraine from having the new notes printed in 1992 and shipped to Kyiv. The currency was hidden away until such time as the government would feel ready to put it into circulation. In the euphoria of independence, replacing the ruble with the hryvnia would provide a powerful symbol of statehood.

Although the staff knew about the banknotes,[40] the Fund's official position was that Ukraine should continue to use the ruble as its currency until it had established a well-functioning financial system backed up by stable macroeconomic policies. A "prediagnostic" mission in November 1991, led by Jean Godeaux (a former governor of the National Bank of Belgium) and staffed by the Fund's Central Banking and Legal Departments and by western central banks and the World Bank, concluded that "the sharing of a common currency is desirable at least during a transitional period."[41] A few weeks later, Deputy Managing Director Erb was in Kyiv, where he met with the newly elected president, Leonid Kravchuk, and other senior officials. When told that Ukraine intended to issue the hryvnia as soon as the Canadians could finish printing the banknotes, Erb expressed skepticism and tried to dissuade them.[42]

Kravchuk soon submitted an application for membership, and the IMF sent a staff mission—led by Peter C. Hole (Assistant Director, European Department)—to gather

[39]"Remarks to the Supreme Soviet of the Republic of Ukraine in Kiev, Soviet Union," August 1, 1981; Public Papers, George Bush Presidential Library and Museum; accessed at http://bushlibrary.tamu.edu/research/public_papers.php?id=3267&year=1991&month=8.

[40]In September 1991, Thomas Dawson (United States) learned about the Canadian printing contract while on a visit to the Soviet Union with the secretary of the U.S. Treasury. He reported the information to the Executive Board on his return; see minutes of EBM/91/132 (September 25, 1991), p. 17.

[41]Unnumbered technical assistance report, "Ukraine – Monetary and Supporting Central Banking Reforms: Preliminary Findings and Recommendations, and Future Technical Assistance – Aide Memoire," December 1991.

[42]Minutes of EBM/91/171 (December 20, 1991), pp. 4 and 7.

information and hold preliminary policy discussions. Hole was dismayed to find a largely dysfunctional economy, with no real data and no officials with any understanding of market economics. The government did not yet have its new banknotes, and it was facing a severe shortage of cash rubles. It was issuing coupons as a kind of scrip, which served as legal tender alongside rubles. The staff worried that this practice would just free up hoarded rubles to flood the neighboring ruble-area countries. Although the parallel-currency scheme was "badly flawed," Hole recommended that it be continued for the time being but with strict limits on supply.[43] That was followed almost immediately by a mission from the Central Banking Department, which concluded that the authorities had a "formidable task" ahead to convert its branch of the Gosbank into a true central bank. That transformation would be "an essential precondition for a successful currency issue and monetary reform."[44] (Emphasis in the original.)

Events soon overtook this analytical model. In Moscow, the Russian parliament voted on March 24, 1992, to force Ukraine out of the ruble area. Russia's concern was that Ukraine was abusing the system by drawing excessively on Gosbank credits and flooding itself and its neighbors with rubles. Although Russia's preemptive act was in accord with Ukraine's own desire for monetary independence, it forced the government's hand when the newly established National Bank of Ukraine (NBU) was still completely unprepared to take over responsibility for monetary control.

After several months of trying to cope with the temporary ruble-plus-coupon system, Ukraine formally abandoned the ruble in November 1992. Although the government had already stockpiled its new banknotes, it decided to keep them in storage until the NBU had gained more experience managing a monetary system. Instead, it issued an interim currency, called the karbovanets (the term commonly used for the ruble in Ukrainian). This move gave Ukraine a measure of financial independence, but the effort foundered because the authorities failed to take action to stabilize the currency with sound macroeconomic policies. As one official described the situation in an interview for this book, "we made all possible mistakes." As a result, inflation became rampant, reaching 10,000 percent in 1993. Tax evasion, expenditure overruns, and monetary financing prevailed. Two years passed before policies and the economy stabilized enough for the Fund to start lending. In that time, output in Ukraine fell to a level not much above half of the estimated preindependence level.[45]

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[43]"Ukraine—Pre-Membership Economic Review," SM/92/40 (February 28, 1992), pp. 24 and 30. For a description of how the coupon system worked in this initial stage, see SM/92/40, Suppl. 1 (March 5, 1992), pp. 14–15.

[44]Unnumbered technical assistance report, "Ukraine – National Bank of Ukraine: Preparation for Currency Issue / Monetary Reform and Related Institution Building," April 1992.

[45]These inflation and output figures are IMF staff estimates; see "Ukraine—Staff Report for the 1994 Article IV Consultation and Request for a Purchase Under the Systemic Transformation Facility," EBS/94/203 (October 19, 1994), p. 24.

First Steps Toward Reform

By mid-1994, Ukraine's economic decline was so deep that the Kravchuk government could no longer survive. To drive home the importance of policy reform with a sizeable carrot, the communiqué of the G7 summit in Naples, Italy—issued just 10 days before elections were scheduled to take place in Ukraine—offered financial assistance of up to $4 billion via the IMF, the World Bank, and the EBRD, but only "following the commencement of genuine reforms." In short order, Kravchuk lost the July 19 election to Leonid Kuchma, who had served as prime minister since 1992. Before the month was over, Camdessus responded to an invitation from Kuchma by going to Kyiv to meet with him.[46] Over dinner with the president, Camdessus stressed the need for specific economic reforms and offered the Fund's help in designing and financing them.

Kuchma was determined to make a real break with the economic mismanagement of the preceding regime. Camdessus, impressed by Kuchma's resolve, sent a staff mission, again led by Hole, to Kyiv in mid-August to negotiate terms for an STF loan. The team stayed for nearly six weeks and negotiated an unusually detailed and comprehensive program for an STF arrangement. The STF had been designed to accommodate countries in the early stages of economic transformation. The staff report for Ukraine acknowledged that the program, while impressively "comprehensive, coherent, and strong," was probably overly ambitious. The government was unlikely to be able to carry it out in full. Nonetheless, the staff recognized a genuine commitment by the government that merited support from the IMF.[47]

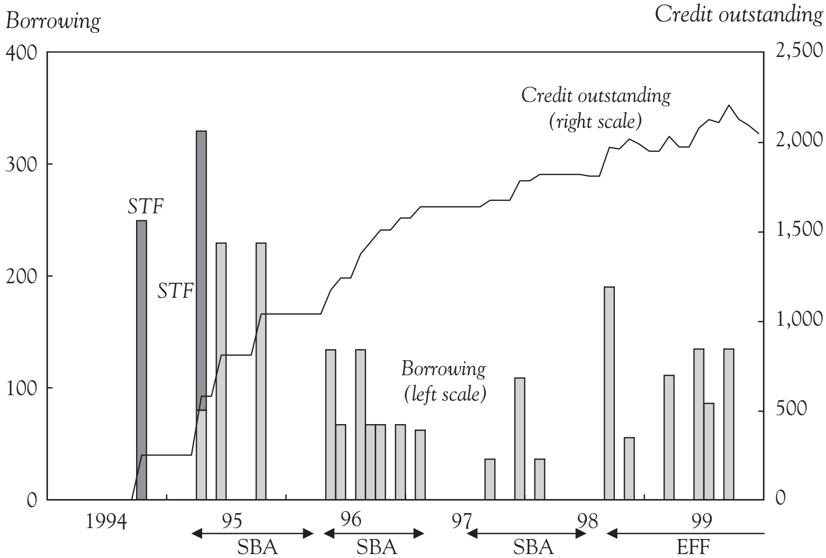
On October 11, 1994, Kuchma launched the program with a speech to parliament that outlined a path toward "radical economic reform." Parliament approved the key points the next day, and international support followed quickly. Fischer hosted a meeting of bilateral donors at the IMF on October 18, which generated enough financing assurances to enable the Fund to approve immediate disbursement of an STF loan for $365 million (SDR 249.3 million, or 25 percent of quota).

The Fund's confidence in the government was justified. The authorities met almost all of their commitments over the next several months. Macroeconomic performance, however, responded very little in the short run. Ukraine still had only the merest rudiments of a market economy, and both the authorities and the staff recognized that much work remained. The IMF approved a second STF drawing in April 1995, along with a full stand-by arrangement. That combination enabled Ukraine to borrow just over $1.2 billion (SDR 788 million, or 79 percent of quota) in 1995 (Figure 8.2). By the end of the year, inflation had fallen sharply, but it remained high, and output was

[46]Åslund (2009) pp. 88–89, notes that Camdessus was the first "major international visitor" to Ukraine after Kuchma's election, followed soon afterward by U.S. Vice President Al Gore.

[47]"Ukraine—Staff Report for the 1994 Article IV Consultation and Request for a Purchase Under the Systemic Transformation Facility," EBS/94/203 (October 19, 1994), pp. 17–19.

Figure 8.2. Ukraine: Use of Fund Credit, 1994–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics.
Note: EFF = Extended Fund Facility; SBA = Stand-by arrangement; STF = Systemic Transformation Facility.

continuing to fall. Inevitably, adjustment fatigue was settling in, and program implementation soon faltered.

Reforming the structure of an economy as complex as Ukraine's, and as misdirected as it had been, was testing the abilities of everyone concerned. Reforms that seemed well designed sometimes just did not work in this context. For example, in 1996, the government accepted a staff recommendation to abolish a complicated system of quotas and licenses for exporting grain, despite misgivings that a surge in grain exports could lead to shortages for domestic consumption. As it happened, many farmers preferred to continue selling grain to the state at relatively low prices rather than to take their chances on an open market they did not understand. This and many other inefficiencies endured throughout the 1990s, delaying the return of economic growth.[48]

Events in 1996 brought some relief. A second IMF stand-by arrangement, approved in May, provided both more reserves (some $864 million, fully drawn over nine months) and renewed credibility to the reform program. Prices finally stabilized enough that the government could dust off the banknotes it had stored away in 1992 and retire the karbovanets. In September, the NBU introduced the hryvnia as the national

[48]For a detailed examination of this period, see "Kuchma's Stagnation, 1996–99," Chapter 4 of Åslund (2009).

currency, replacing the karbovanets at a rate of 1 hryvnia per 100,000 karbovanets. The new currency traded initially at 1.76 per U.S. dollar, with the NBU intervening to keep the rate within a narrow band. At the same time, most current account exchange controls were abolished, and Ukraine formally accepted the obligations of the Fund's Article VIII. In November, negotiations began on a more comprehensive program for 1997 designed to qualify for EFF support.

This benign period continued through most of 1997, though with no respite from stagnation in output. Despite some slips in fiscal policy, macroeconomic conditions were reasonably stable, but the Fund was not yet satisfied with the government's ability to implement a wide range of structural reforms. In particular, the continued dominance of large and inefficient state-owned enterprises was seen as a substantial barrier to progress. After several months of negotiations in both Kyiv and Washington, the two sides temporarily gave up on formulating a program for EFF support and agreed to enter into another relatively small stand-by arrangement instead. The Executive Board approved that outcome in August, after which talks resumed on a broader structural package.

The Crisis of 1998

The real trouble in Ukraine began late in 1997, when investors began reducing exposure in emerging markets in response to the financial crises in East Asia. At the same time, the Ukrainian government was trying to shore up support at home as the March date for parliamentary elections approached. Implementation of the Fund-supported program lapsed, negotiations stalled, and the staff became increasingly disillusioned. By this time, according to a later staff summary, Ukraine was "stuck in an under-reform trap, with constrained growth dynamics, an expanding shadow economy, and a pervasive non-payment culture."[49]

A window of opportunity opened in April 1998. As soon as the elections concluded, Kuchma signaled his commitment to get the reform program back on track. A staff mission, led by Mohammad Shadman-Valavi (Assistant Director, EU2), succeeded in getting agreement on "most elements" of a program sufficiently strong to warrant sizeable EFF support from the Fund.[50] News of this progress, which persuaded major private creditors to put aside their fears of an economic collapse, temporarily reduced the external pressure on the exchange rate.[51]

[49]"Ukraine—Ex Post Assessment of Longer-Term Program Engagement," October 18, 1995, p. 4; accessed at http://www.imf.org/external/pubs/cat/longres.cfm?sk=18717.0.

[50]Memorandum from Odling-Smee to the Managing Director, "Ukraine—Outcome of the Mission," April 21, 1998; IMF archives, OMD-ND, Accession 2001-0206-0001, Box 22107.

[51]In May, the G7 issued an ambiguously cautious communiqué stating that the summit leaders "look forward to the Ukrainian government and parliament taking the steps necessary to agree on an [EFF arrangement] with the IMF"; "G7 Chairman's Statement," released at the Birmingham G8 summit, May 15, 1998; accessed at http://www.g8.utoronto.ca/summit/1998birmingham/chair.htm. Around this time, creditors reportedly began referring to Ukraine as a possible "moral hazard play," meaning that one could take large risks in the expectation that the Fund or G7 governments would bail them out; see Blustein (2001), pp. 246–47.

Three difficulties stood in the way of early approval of the proposed loan. First, parliament was reluctant to enact the more than 40 proposed laws giving force to the fiscal and structural changes the president and his ministers had approved. As in Russia, the Ukrainian constitution gave the president the right to issue decrees, but parliament had the right to review and possibly overturn them. Kuchma fully supported the program and was already issuing the necessary decrees, but the Fund had no assurance that they would hold for longer than the 30-day parliamentary review period. Not until late July did the staff receive confidential written assurances that the decrees were legal and that parliament would not object to them.[52]

Second, the central bank, in trying to hold the exchange rate within the announced band against the U.S. dollar, was beginning to run short of reserves. Fischer was sympathetic to the notion that a devaluation or a free float would ruin many of Ukraine's banks, but by August it was getting harder to stave off the inevitable. The more widely held view on the staff was that the NBU should stop intervening altogether, but the authorities insisted on hanging on as long as possible.[53]

Third, the Fund needed assurances that private foreign creditors would not take advantage of an influx of official financing as an opportunity to take their profits and pull out their own money. Three large investment banks, two based in the United States and one in Japan, held the majority of Ukraine's official debts to nonresidents. Ukraine's intensive talks with all three, some involving IMF officials, continued throughout July and early August with little progress. Surmounting this stalemate was especially important because the Fund had specified the financing assurances as required prior actions before the Managing Director would schedule a Board meeting to consider the arrangement. By the second week in August, when the authorities submitted a Letter of Intent to the Fund, the staff was optimistic enough about cooperation from creditors that management set and announced a tentative Board date of August 26.[54]

The Russian default on August 17 (see Chapter 7) upended this timetable and created a financial crisis. Pressure on the hryvnia intensified immediately, leaving the authorities with very little time to secure official support to stave off a ruinous currency collapse. Fortunately, by that time Kuchma's decrees had found solid legal footing and

[52]The gist of these letters was explained to the Executive Board by Shadman-Valavi at EBM/98/94 (September 4, 1998), p. 96.

[53]For an internal exchange of views on exchange rate policy, see memorandum from Odling-Smee to the Acting Managing Director (Fischer), "Ukraine—Draft Briefing Memorandum for Staff Visit," July 16, 1998, with Fischer's handwritten reply dated July 21; and memorandum from Jorge Márquez-Ruarte (Deputy Director, EU2) to the Acting Managing Director, "Ukraine—Towards an Early Resolution and Other Matters," July 22, 1998; IMF archives, OMD-ND, Accession 2001-0206-0001, Box 22107.

[54]With the consent of the authorities, the Fund published the detailed program on its website, and it ran an upbeat story in its biweekly newsletter; see "Ukraine: Memorandum of Economic Policies," at http://www.imf.org/external/np/loi/081198.htm; and "IMF Mission Reaches Tentative Agreement on Stabilization, Structural Program for Ukraine," *IMF Survey*, Vol. 27, No. 16 (August 17, 1998), p. 253.

were succeeding in stabilizing the government's own finances. Unfortunately, the willingness of the three main private creditor banks to agree to a voluntary rollover or to new lending had plummeted. In the aftermath of the Russian default, G7 finance officials adamantly insisted that the Fund not resume lending to Ukraine without firm commitments from those creditors. Although arguably a necessary precaution, that position effectively put the Fund and the authorities at the mercy of the banks.

The August 26 Board meeting was no longer possible. Discussions were deadlocked throughout the second half of August, by which time Ukraine's financial situation was truly desperate. Camdessus was as fully engaged as he could be while simultaneously trying to contain the crisis in Russia and the spread of contagion elsewhere. He met with Kuchma in Crimea on August 26 in the margins of his meeting with the Russian leader, Viktor Chernomyrdin (Chapter 7, p. 338), and the two spoke several times by telephone over the next few days, but he was not yet willing to ask the Board to approve the EFF arrangement without financing commitments from the banks. Success on that front depended in turn on what happened next in Russia. If Russia descended into "chaos," which was still a real possibility in late August, then Ukraine had no hope of restoring financial stability.[55]

The rapid dwindling of Ukraine's foreign exchange reserves became the prevailing issue. The central bank governor (and future president), Victor Yushchenko, signaled his willingness to devalue and widen the band on the exchange rate, but not before IMF approval of the arrangement. Otherwise, he feared, investor panic would quickly ensue. If the Executive Board did not meet by Friday, September 4, this plan would collapse for lack of reserves. The Fund's major shareholders, however, were unwilling to go along. As late as September 1, the internal debate still raged at the Fund on whether to act quickly or wait for support to gel.

Intervention by the French president, Jacques Chirac, finally broke the impasse. When Chirac went to Kyiv on September 2 to discuss plans for nuclear cooperation, Kuchma took the opportunity to plead with him to intervene with Camdessus for a quick decision on the EFF arrangement. Chirac reportedly called Camdessus right away.[56] Whether that call swayed Camdessus is impossible to judge, but at the very least it signaled a split among creditor countries that made a request to the Executive Board more likely to succeed.

In a highly unusual acceleration of normal procedures, Camdessus agreed on Thursday September 3 to schedule the Board meeting for the next day. In Kyiv, also on the third, Shadman-Valavi and the authorities agreed on revisions to the program, including a plan to try to stabilize the exchange rate by devaluing and widening the band.

[55]See the Managing Director's report to the Executive Board at EBM/98/90 (August 28, 1998), p. 5.

[56]Upon arriving in Moldova on September 4, Chirac told reporters that he had spoken with Camdessus by telephone to argue the case for early approval of Ukraine's program; see "French President Chirac given warm welcome in Moldova," Agence France-Presse, September 4, 1998; accessed at http://global.factiva.com.

If the exchange rate failed to steady, they agreed, then it would be allowed to float after a few weeks. Within hours, the revised documents were cleared by Fischer in Washington and were circulated to Executive Directors for the Friday meeting.

Although negotiations with two of the main creditor banks had not yet concluded,[57] the EFF arrangement was written so as not to allow any leeway in those talks. Any repayment of principal would constitute a violation of the arrangement that could prevent Ukraine from drawing on it after the initial disbursement. That provision satisfied most Directors, although many of them still viewed approval as a highly risky gamble, one that Jean-Claude Milleron (France) frankly called "kind of a bet," but "a bet worth making." Roberto F. Cippà (Switzerland) abstained from voting because the Swiss authorities (though not Poland, the other large country in his constituency) objected to lending without solid financing assurances, especially in the absence of broad political support within the borrowing country. The Swiss judgment was that "the chances of success . . . are too small to risk another blow to the credibility" of the IMF. With that one exception, the Board approved the request.[58]

The extended arrangement immediately added $260 million (SDR 190 million) to the foreign exchange the NBU had at its disposal, and it committed a total of $2.25 billion (SDR 1,645.55 million, or 165 percent of quota) over the next three years. Drawings on it would be contingent on obtaining the assurances of external financing discussed above, and also on the authorities' ability to carry out an extensive reform program.[59]

The EFF-supported program in Ukraine was in some respects even more complex than the much-criticized one that Indonesia had undertaken earlier in the year (see Chapter 11). Ukraine's program included 88 separate measures to be taken by the authorities, with some 150 "sub-measures" serving as additional benchmarks. Completing the program fully in three years would probably have been beyond the capacity of any government, let alone one still at an early stage of administrative and political development and contending with substantial domestic opposition. Some highly specific measures, such as a requirement to eliminate an export tax on sunflower seeds

[57]By this time, the government had repaid the balance due to one of the three major creditors, Nomura, because Nomura was refusing to negotiate. The other two creditors, Merrill Lynch and Chase Manhattan, were unwilling to commit to a rollover but were still discussing the possibility and negotiating terms; see "Ukraine—Request for Extended Arrangement," EBS/98/144, Suppl. 1 (September 3, 1998), pp. 1 and 5.

[58]Minutes of EBM/98//94 (September 4, 1998), pp. 90–122. Milleron's remark is on p. 99; Cippà's statement is on pp. 102–04.

[59]Agreements with Merrill Lynch and Chase Manhattan were concluded in October 1998; see "Ukraine—Extended Arrangement—Financing Assurances Review, and Request for Waivers and Modification of Performance Criteria," EBS/98/176 (October 22, 1998) and Suppl. 1 (October 27, 1998). For an analysis of Ukraine's rescheduling agreements, see Sturzenegger and Zettelmeyer (2006), pp. 115–33.

(reminiscent of the demand that Indonesia dismantle its monopoly on clove exports), were widely ridiculed and were subsequently dropped from the program.[60]

Nonetheless, Kuchma's government did a reasonable job of maintaining forward progress. The Fund delayed some disbursements, and the arrangement was extended to four years to give the authorities more time, but much of the job was eventually completed. When the arrangement expired in 2002, Ukraine had used it to borrow nearly $1.6 billion (SDR 1,193 million), which they repaid gradually over the next several years, once reform finally began bearing the fruits of strong growth.[61]

Belarus

Belarus—the third largest economy in the region and one of the wealthiest—had been an industrial center within the Soviet Union, producing a wide range of consumer, industrial, and military goods using raw materials imported primarily from Russia. The breakdown of the union left this specialization in shambles, reduced access to formerly captive export markets, and sharply raised the cost of importing energy and materials. The newly elected government feared that rapid economic liberalization would exacerbate these already severe problems and result in massive unemployment. From this vantage point, maintaining close relations with Russia and preserving as much of the old system as possible during a steady but gradual transition would offer the country the best hope for avoiding a total economic and political breakdown. The Fund, in contrast, feared that this strategy would merely perpetuate stagnation and would seriously delay the country's integration into the world economy. It urged the authorities to move much more quickly to establish a market-oriented system. Tension set in that persisted throughout the rest of the decade.

On gaining independence and joining the IMF, Belarus informed the Fund that it preferred to remain in the ruble area, "but not at any cost." Staying in would enable Belarus to continue buying oil, gas, and other inputs at highly subsidized ruble prices. If they had to go onto the open market and pay in a hard currency, they would face a massive external deficit with no realistic way to finance it. The authorities worried, however, that instability in neighboring countries might lead to a flood of rubles into Belarus as people sought to buy scarce goods, and they were distressed that Russia insisted on having sole control over the issuance of currency.[62] As a precaution, they

[60] For a staff analysis, see "Ukraine—Ex Post Assessment of Longer-Term Program Engagement," October 18, 1995; accessed at http://www.imf.org/external/pubs/cat/longres.cfm?sk=18717.0. For a subsequent independent evaluation, see Independent Evaluation Office (2009), pp. 170–79.

[61] The global financial crisis of 2008 interrupted this progress and induced the government to obtain a new stand-by arrangement from the Fund.

[62] See memorandum from the mission chief, Peter C. Hole (Assistant Director, EU2), to the Managing Director, "Belarus—Staff Visit," August 3, 1992; IMF archives, OMD-AI, Accession 1994-0070-0001, Box 6276.

introduced the Belarusian rubel as a parallel currency with a fixed conversion rate into the ruble. A year later, after Russia demonetized the old rubles, Belarus stopped allowing conversion into rubels. With the ruble area collapsing all around them, the authorities entered into negotiations with Russia to try to establish a monetary union of the two countries, with monetary control to be shared between their central banks. Russia signaled its willingness to share a currency, but only if the CBR had exclusive control over monetary policy. Negotiations broke down, and in May 1994 Belarus declared the rubel to be the sole legal tender within its borders.[63]

This evolution coincided approximately with the Fund's own growing disillusionment with the ruble area. Throughout the second half of 1992, the staff responded to inquiries from the authorities by stating that the choice of whether and when to introduce a national currency was a "sovereign decision" and that the Fund's lending conditions would be "much the same" in either case. The Fund only wanted a "clear decision" for one option or the other.[64] By March 1993, the Fund had accepted that the ruble area might be too unstable to survive, and the staff was concerned about the sluggish pace of reforms in Belarus. Consequently, the staff began urging the authorities to move more rapidly to introduce a national currency, but still agreed that either option was acceptable.[65] As late as June 1993, management approved a mission brief that advised that "Belarus will be encouraged to move quickly to either a separate national currency or a full reintegration in the ruble area. Staff will continue to prefer the first of these two alternatives." Nonetheless, the economic program the staff discussed with the authorities assumed Belarus would continue to use the ruble.[66] Russia's demonetization of rubles a few weeks later made that option untenable. For the most part, throughout this period the Fund had maintained a neutral stance and had restricted its advice mostly to the technical issues of managing whichever monetary system prevailed.

Lending decisions were more controversial. Belarus asked for a stand-by arrangement immediately after joining the IMF in July 1992, but the Fund responded cautiously and continually pressed the authorities to stabilize and reform the economy

[63]Discussions between Belarus and Russia on reestablishing a common currency area resumed in the later 1990s; see Gulde, Jafarov, and Prokopenko (2004).

[64]For "sovereign decision," see memorandum from Odling-Smee to the Managing Director, "Belarus—Briefing Paper," October 26, 1992. For "much the same," see memorandum from Peter J. Quirk (Division Chief, Monetary and Exchange Affairs Department) to the Acting Managing Director, "Belarus: Monetary and Exchange Reforms," August 20, 1992. For "clear decision," see memorandum from Hole to the Managing Director, "Belarus—Staff Visit," November 24, 1992. All three documents are in IMF archives, OMD-AI, Accession 1994-0070-0001, Box 6276.

[65]Memorandum from Grant Spencer (Consultant in EU2) to the Managing Director, "Belarus: Back-to-Office Report, Article IV Mission," March 23, 1993; IMF archives, OMD-AI, Accession 1996-0129-0001, Box 8701, file "Byelarus."

[66]See attachment to memorandum from Eduard Brau (Deputy Director, EU2) to the Managing Director, "Belarus—Briefing Paper for STF Negotiations," June 4, 1993; and memorandum from Spencer to the Acting Managing Director, "Belarus—Back to Office Report," June 28, 1993; IMF archives, OMD-AI, Accession 1996-0129-0001, Box 8701, file "Byelarus."

more aggressively. In the summer of 1993, a staff mission headed by Henri R. Lorie (Advisor, EU2) negotiated a 12-month program to be supported by a drawing under the STF. That drawing, for 25 percent of quota (SDR 70.1 million, equivalent to $98 million), occurred in August. Subsequently, however, the authorities fell short of carrying out the program, especially the structural reforms aimed at shifting from state control to open markets. Lorie and his team returned to Minsk in the spring of 1994 to try to get an agreement on accelerating reform efforts, with only partial success.[67] Reviewing the situation in July, the Executive Board expressed "deep concern [over] the deterioration in Belarus's economic performance," which it attributed primarily to the government's "wavering commitment to systemic market reforms." Although the Board acknowledged that Belarus needed help coping with difficult external circumstances, it insisted that further financial assistance be put on hold until the authorities strengthened economic policy.[68]

To this point, Belarus had been governed by a Supreme Soviet elected in 1990 and dominated by the Communist Party. A week before the July 1994 Board meeting, Alexander Lukashenko was elected president by a strong majority, reflecting popular disenchantment with economic performance under the transition government. Two years later, Lukashenko would push through legal reforms giving him authoritarian powers and ultimately allowing him to override the original constitutional limits on the presidential term of office. By the end of the decade, he would become a symbol in western Europe of Belarus's nostalgia for central control and of its resistance to economic and political integration with the world economy. In July 1994, however, he was viewed as a refreshing replacement for the previous government, and a likely economic reformer. The Executive Director representing Belarus, Willy Kiekens (Belgium), told his colleagues that Lukashenko and his government "were fully aware that further delay in implementing a strong program would be only a recipe for disaster." Speaking for the staff, Lorie concurred, observing that Lukashenko "appeared to have an open mind on the future course of economic policies [and] had indicated a willingness to continue working with the Fund and to rely on Fund technical and financial assistance."[69]

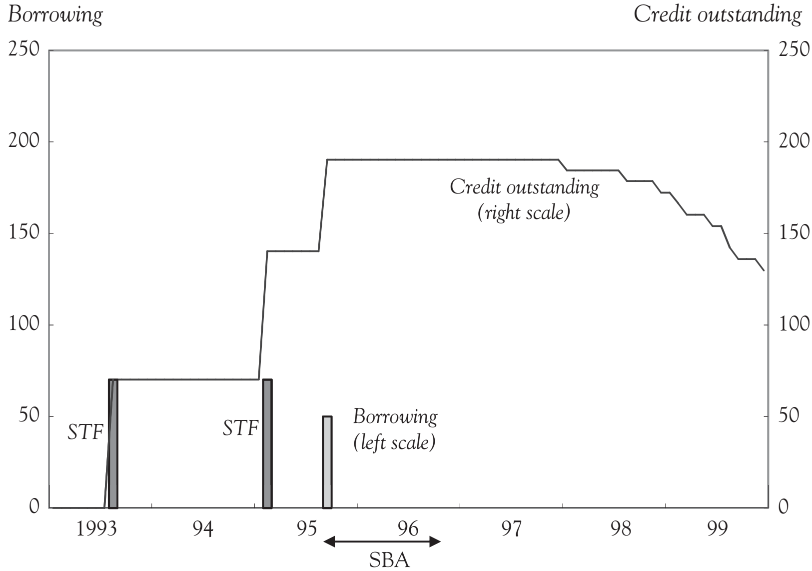
The Lukashenko government and the Fund tried to work together, and an economic program for 1995 was negotiated and signed in December 1994. At that time, the Fund expected to support the program with a stand-by arrangement plus a second STF drawing. To finance the program fully, however, Belarus also needed substantial bilateral support from donor countries. The Fund convened a creditors' meeting in Washington on December 15. Although everyone who attended expressed admiration for what Belarus had achieved, the meeting generated only about a third of the

[67]These developments are summarized in "Republic of Belarus—Staff Report for the 1994 Article IV Consultation," SM/94/157 (June 24, 1994). Note that an STF-supported program gives the Fund relatively little leverage to induce the authorities to carry out their policy intentions, given that the loan is disbursed entirely at the outset.

[68]Minutes of EBM/94/64 (July 18, 1994), pp. 116–18.

[69]Minutes of EBM/94/64 (July 18, 1994), pp. 107 (Lorie) and 116 (Kiekens).

Figure 8.3. Belarus: Use of Fund Credit, 1993–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics.
Note: SBA = Stand-by arrangement; STF = Systemic Transformation Facility.

required amount of pledges. The Fund's management then had no choice but to pull the proposal from the agenda.[70]

The situation did not improve. Lukashenko's drift into authoritarian rule and his increasingly evident aversion to economic reform cost him both international political support and policy credibility. Nonetheless, the Fund continued to offer its technical and financial assistance throughout 1995. The staff provided technical advice on foreign exchange management and central bank operations, and the Board approved a second STF drawing on January 30 (just a week before the facility was due to expire) and a stand-by arrangement on September 12. By the latter date, Belarus had tightened policies considerably and had managed to cover the expected financing gap without recourse to the extensive rescheduling agreements that had earlier been thought necessary. Although many in the IMF still harbored doubts about the authorities'

[70]Minutes of EBM/94/112 (December 19, 1994), pp. 39–40. Before the December 15 meeting, the staff calculated that the 1995 program was underfinanced by $460 million. The meeting yielded only $150 million in pledges, with the European Union and Japan being the main holdouts.

commitment to economic liberalization, the very real macroeconomic successes of 1995 were clearly sufficient to merit the Fund's support.[71]

The September 1995 drawing raised Belarus's debt to the Fund to $282 million (SDR 190.2 million, or 68 percent of quota; see Figure 8.3). That turned out to be the peak because the authorities were unable to implement the program. Along with most other official creditors, the Fund ceased lending to Belarus. For a while, the government was able to sustain economic growth by rebuilding trade relations with Russia and by pursuing inflationary macroeconomic policies, but the growth strategy soon led to balance of payments pressures and bottlenecks. Adverse weather for crop production in 1998, followed closely by the Russian financial crisis, badly weakened the economy and brought the authorities back into negotiations for financial help from the IMF. With policy implementation still below standard, those discussions broke down, and the decade closed without further progress.[72] Nonetheless, Belarus repaid its IMF loans on time, completing the process in February 2005.

Kazakhstan

Three time zones east of Moscow, Kazakhstan dominated the southern side of the former Soviet Union. Roughly the size of western Europe, it was the second largest territory among the republics, third in value of output, and fourth in population. When Kazakhstan became a member of the IMF in July 1992, Camdessus regarded it as the linchpin to stability in central Asia.

In Nursultan Nazarbayev, Kazakhstan had a president who was prepared to try to lead the country into the world economy, a man with whom the IMF could work effectively. Nazarbayev had assumed the chairmanship of the Supreme Soviet in Kazakhstan in 1990, had campaigned actively for independence and the breakup of the Soviet Union, and had won the presidency of the newly independent state in December 1991. Allied with Boris Yeltsin by this time, he launched a privatization program in the summer of 1991 and began 1992 by liberalizing prices and implementing other market-oriented economic reforms in parallel with Moscow. He urged economic reformers in the government to develop market institutions, and he encouraged foreign direct investment from the west. Over time, the IMF became increasingly concerned about the pervasive culture of corruption in Kazakhstan, but it did not view the problem as

[71]Approval of the stand-by arrangement was nearly derailed in late August 1995, owing to excessive monetary creation in the previous months. The Board meeting was delayed by three weeks to give the authorities time to correct the overrun, and the Acting Managing Director (Stanley Fischer) issued a reassuring news bulletin designed to negate the fears that might otherwise have resulted from the delay. By September 12, the monetary base was comfortably on target; see NB/95/14, "IMF Praises Belarus Economic Policy, Sees September Stand-By," August 24, 1995; and minutes of EBM/95/85 (September 12, 1995).

[72]For an overview of the last two years of the decade, see "Republic of Belarus—Staff Report for the 1999 Article IV Consultation," SM/99/169 (July 12, 1999).

outweighing the strengths of the government's economic management, nor as undermining the effectiveness of structural reforms.[73]

At the outset, Nazarbayev worked to preserve the ruble area within the CIS as a means of maintaining good relations with Moscow and limiting the breakdown of trade and finance in the former Soviet Union. Although Kazakhstan had huge oil and gas reserves, good agricultural output, and a wide range of heavy industry, it had no effective or economical means of exporting its output except within the Soviet region. The key to preserving that system and its advantages to Kazakhstan was to develop a stable interstate monetary system, which in 1992 meant building a cooperative system for controlling the issuance of ruble notes and credits. Nazarbayev thus lobbied the Russian authorities for a ruble-area central bank in which each member country would have an equal vote. That proposal was anathema in Moscow, and it failed to gain any traction in regional discussions.

As noted above, in the first half of 1992 the IMF staff urged many of the countries emerging from the former Soviet Union to continue using the ruble as a common currency for the region until they were capable of managing their own currencies. In January, the Kazakh authorities told the staff they wanted to stay in the ruble area "for the foreseeable future" but were concerned about the "lack of adequate consultation and co-ordination within the monetary union" and the risk that some member states would fail to exercise "fiscal prudence and monetary restraint." Nonetheless, and despite their "marked preference for remaining in the ruble zone and maintaining a common economic space with other republics" in the CIS, the authorities were concerned enough about the weaknesses in the system "to begin preparing the ground should it becoming necessary" to establish a separate national currency. The Fund's premembership staff mission, led by Ishan Kapur (Division Chief, EU2) advised against "precipitate" action to leave the ruble area, and stressed "that adequate institutional and policy mechanisms must be in place" before taking such action.[74]

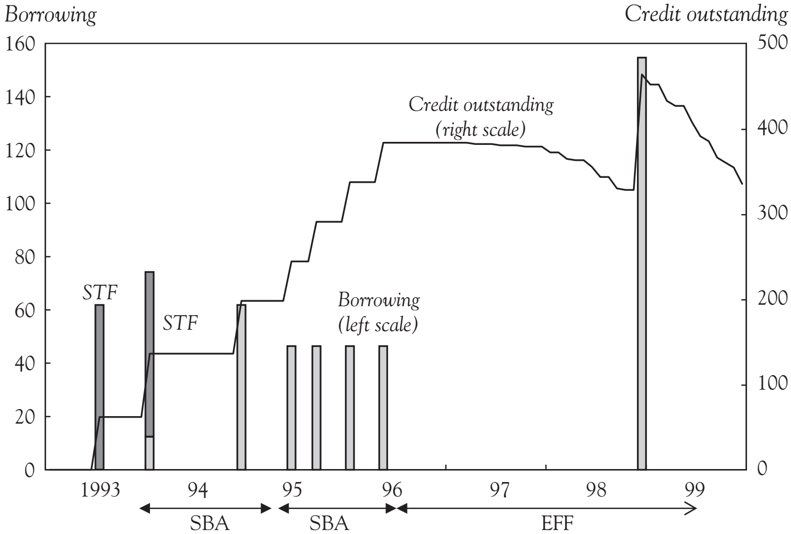
As 1992 progressed and the systemic weaknesses in the ruble area became increasingly apparent, the IMF staff gradually lost its enthusiasm for the ruble, but the Kazakh authorities hung on for a while longer. Camdessus met with Nazarbayev in Almaty in October, in the middle of negotiations on a possible Fund-supported economic program. In the course of several meetings, Camdessus told the president that "workable monetary arrangements would need to be in place, whether [Kazakhstan] stayed in the ruble area or introduced a separate currency, before the Executive Board would be prepared to approve a program."[75] Because the ruble-based system was not working,

[73]Wolf and Gürgen (2002) reported that, in a group of 23 transition countries, Kazakhstan had one of the highest levels of corruption but was right in the middle with regard to the extent to which each country had implemented market-oriented economic reforms.

[74]"Kazakhstan—Pre-Membership Economic Review," SM/92/41 (February 28, 1992), pp. 19 and 23.

[75]Managing Director's report to the Executive Board; minutes of EBM/92/127 (October 21, 1992), p. 4. Program negotiations had begun in April 1992, and in July Erb had told the Board that "we foresee a realistic possibility of reaching agreement on a program within the next few months"; minutes of EBM/92/94 (July 24, 1992), pp. 6–7. Also see "Kazakhstan—Staff Report for the 1993 Article IV Consultation," SM/93/60 (March 23, 1993), p. 1n.

Figure 8.4. Kazakhstan: Use of Fund Credit, 1993–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics.
Note: EFF = Extended Fund Facility; SBA = Stand-by arrangement; STF = Systemic Transformation Facility.

and because the authorities were not yet ready to introduce their own currency, further discussion of IMF lending was put on hold.

Meanwhile, the IMF continued providing a regular flow of technical assistance on statistical, monetary, and fiscal systems and policies, and it set up a full-time office in Almaty. In January 1993, Kapur and a team of EU2 economists returned to Almaty to hold discussions for Kazakhstan's first Article IV consultation with the Fund. By the middle of 1993, even though Kazakhstan still had not met the "either this or that" condition on its currency, the Fund was satisfied that economic policies and conditions overall were moving in the right direction and offered an initial STF loan, for $86 million (SDR 61.9 million, or 25 percent of quota). At that time, the government still planned to remain in the ruble area "for the immediate future," but it was making contingency plans to roll out a new currency within a few months if rampant inflation continued in the area as a whole.[76] As it turned out, inflation did continue, and Russia forced the issue by demonetizing old rubles. Kazakhstan introduced its national currency, the tenge, in November.

From that point through the end of the decade, Kazakhstan had a regular program relationship with the IMF, though with a declining need for the Fund's money (Figure 8.4). Shortly after the rollout of the tenge, the Fund approved a second STF

[76]"Kazakhstan—Use of Fund Resources—Request for Purchase Under the Systemic Transformation Facility (STF)," EBS/93/113 (July 12, 1993), p. 9.

loan and a stand-by arrangement, together totaling $255 million (SDR 185.6 million, or 75 percent of quota). Both budgetary and monetary policies suffered poor implementation in the first half of 1994, but the authorities made great efforts to get matters under control later in the year. The Fund granted a second disbursement under the stand-by arrangement in December, after which economic performance gradually strengthened for the rest of the decade.

A second stand-by arrangement, again for 75 percent of quota, was approved in June 1995 and was fully drawn. In July 1996, the Fund approved an extended arrangement, but by this time Kazakhstan was enjoying strong capital inflows on its own and no longer needed to draw on Fund resources. For the next year, it treated the arrangement as precautionary, made no drawings on it, and used it primarily as a signal of official international support.

The Russian financial crisis of August 1998 interrupted the country's progress, but only briefly. Exports to Russia and other affected countries fell sharply for a time, and capital inflows dwindled. Fortunately, Kazakhstan had built up a cushion by not drawing on the EFF arrangement and by pursuing prudent macroeconomic policies for three solid years. In December, the Fund renewed its endorsement of the policy program, and Kazakhstan drew down half of the total amount available all at once.[77] As oil production and prices recovered, that turned out to be Kazakhstan's last use of Fund resources. The authorities undertook one more precautionary three-year arrangement, beginning in December 1999, and repaid all outstanding obligations to the Fund by the following August.

Turkmenistan

When Turkmenistan gained independence in 1991, the authorities intended to remain in the ruble area. Within a year, they began having second thoughts. While attempting to implement stabilizing macroeconomic policies, they found they were importing inflationary and destabilizing pressures from the rest of the area. Throughout this period, the staff took a neutral stance and merely advised the authorities to focus primarily on having strong supporting policies. In the staff view, "irrespective of the monetary arrangements to be used, sound financial policies had to be in place to ensure that stabilization was achieved and the full benefits of the reform effort realized."[78] When Russia demonetized the old ruble in July 1993, Turkmenistan had already done much of the necessary contingency planning, and it was able to introduce its new currency, the manat, on November 1

[77]For the background to this activation of the arrangement, see "Republic of Kazakhstan—Fifth Review Under the Extended Arrangement, and Request for Waiver of Performance Criteria," EBS/98/212 (December 7, 1998); minutes of EBM/98/127 (December 15, 1998); and "IMF Executive Board Completes Fifth Review of Kazakhstan's Economic Program—Next Loan Tranche Approved," NB/98/53 (December 15, 1998); accessed at http://www.imf.org/external/np/sec/nb/1998/nb9853.htm.

[78]"Turkmenistan—Pre-Membership Economic Review," SM/92/77 (March 29, 1992), p. 21.

without much difficulty. A few weeks later, Camdessus went to Ashgabat to express his support both to the authorities and in public.

Of the 15 countries that succeeded the Soviet Union, only Turkmenistan did not borrow from the IMF in the 1990s. On the surface, the main reason was that Turkmenistan—a large but sparsely populated and mostly desert country—had a wealth of natural gas and other resources. That advantage, however, is notoriously difficult for any country to exploit and benefit from, and Turkmenistan was no exception. Within the Soviet Union, Turkmenistan's natural gas had been sold to other republics at artificially low prices, and the forced regional specialization had limited the development of domestic industrial production. When the newly independent government raised export prices to world market levels (despite warnings from the IMF), its traditional buyers—notably Ukraine and other neighboring countries within the former Soviet area—were unable to pay.[79] By 1994, payments arrears on gas exports were equivalent to nearly three-quarters of Turkmenistan's GDP. On paper, the country was relatively wealthy, but the government would not begin to reap the benefits until it developed the pipeline capacity to ship natural gas in new directions or until its close neighbors made enough economic progress to settle their arrears.[80]

The second reason for Turkmenistan's relative success was that the authorities realized early on that they had to create a market economy. For the first few years of independence—despite the reluctance of the eccentric and erratic president, Saparmurat Niyazov (self-named Turkmenbashi)—they appeared to pursue reasonably sound fiscal policies. Aided by a serendipitous rise in the price of natural gas, they succeeded in generating surpluses in the balance of payments that they used to build up their foreign exchange reserves. When the payments arrears on natural gas exports led to serious financial difficulties in 1994, the government was able to borrow from private creditors—mostly German and U.S. banks—and avoid asking the IMF for assistance.[81] The country's severe structural problems, of which the reliance on selling natural gas to bankrupt customers was only the most glaring, gradually undermined the government's early commitment to implement stabilizing reforms. In the second half of the 1990s, those structural problems led to an unfortunate focus on short-term solutions that

[79]The staff expressed skepticism about the efficacy of market pricing during the 1993 Article IV consultation and warned the authorities that their major trading partners were already experiencing difficulty paying the lower price (which was about half the world market price) and would probably have to cut import volumes, run up arrears, or both; see "Republic of Turkmenistan—Staff Report for the 1993 Article IV Consultation," SM/93/247 (November 24, 1993), p. 19. The Fund, however, acknowledged the complexity of the problem and did not advise the country to continue selling gas at highly subsidized prices; see minutes of EBM/93/172 (December 17, 1993), pp. 3–36.

[80]A pipeline to the Islamic Republic of Iran became operational in 1998.

[81]In 1993, the authorities and the staff discussed the possibility of entering into a precautionary stand-by arrangement as a way of encouraging private capital inflows, but those talks broke down when the staff insisted on a more comprehensive liberalization policy than the authorities were willing to try; see "Republic of Turkmenistan—Staff Report for the 1993 Article IV Consultation," SM/93/247 (November 24, 1993), p. 1.

further weakened the economy and lengthened the transition. External creditors nonetheless continued to support the regime.

The IMF provided substantial technical assistance to Turkmenistan, as it did to the other new members in the region. In addition, it helped contain the accumulation of overdue payments for natural gas by conditioning financial assistance from the Fund to Armenia, Georgia, Ukraine, and others on their promises not to incur any new external arrears. But the Fund was critical throughout the 1990s of Turkmenistan's gradualist approach to market openness and of its accumulation of external debt.[82] By the late 1990s, external debt service was absorbing more than half of all export revenues, and extremely high inflation had forced the exchange rate to depreciate from 2 manat per U.S. dollar when the currency was introduced in November 1993 to a peak of 19,000 per dollar in April 1999. The situation certainly appeared to be unsustainable, yet the government sustained it well enough to avoid having to ask for a Fund-supported program.[83]

At the end of the 1990s, progress on reforming the Turkmen economy remained limited. On two occasions, the authorities temporarily cut off export shipments of natural gas in a futile attempt to force customers to pay their bills; the 1998 financial crisis in Russia weakened confidence and caused the exchange rate to depreciate sharply; and domestic political disputes weakened the reformers' ability to ease restrictions on economic transactions. The Fund repeatedly urged the authorities to shift from reliance on administrative controls and to diversify and open up the economy more aggressively, but as long as other creditors were available, the government saw little reason to heed the Fund's advice.

Low-Income Countries

Nearly half of the newly independent states faced overwhelming problems of poverty and underdevelopment simultaneously with embarking on a transition toward market economics. In the first few years of their membership, the IMF assisted these countries with the same set of tools—technical assistance in areas of Fund expertise, advice on implementing sustainable macroeconomic and financial policies, and lending through stand-by and similar arrangements—that it used for the middle-income countries discussed above. As the transition progressed, the problems of underdevelopment rose to the fore, and the Fund adapted its approach accordingly. By the end of the 1990s, the IMF and other multilateral agencies were focusing on the common development problems and debt burdens of this group of countries in what came to be known as the "CIS-7" initiative. In the initial years

[82]The staff criticism of external debt accumulation is detailed in "Turkmenistan—Staff Report for the 1994 Article IV Consultation," SM/95/14 (January 20, 1995), pp. 5, 9–10, and 12.

[83]As of 2009, Turkmenistan had had no financial transactions with the IMF since it joined in 1992.

of the decade, however, the focus was more on how each country could best make the transition within the constraints of its own background.

Much as the Soviet Union as a whole had been, the CIS-7 countries were scattered across a vast geographic area. They included Moldova to the west; Armenia, Azerbaijan, and Georgia in the southern Caucasus; and the Kyrgyz Republic, Tajikistan, and Uzbekistan in central Asia.

Moldova

When the first IMF mission arrived in Chisinau in February 1992 to discuss the terms on which Moldova would join the institution, the authorities had already decided to replace the ruble with their own national currency. Although they knew it would not be easy and that they lacked the experience to do it smoothly, they feared that not doing so would be even riskier. The Trans-Dniester region (also known as Transnistria) bordering Ukraine was occupied by a large contingent of Russian troops and was in armed rebellion against the Moldovan central government. Consequently, the Moldovan economy risked being swamped with a flood of rubles from the region. In response, the staff "recognized the very real concerns of the Moldovan authorities in current circumstances, but pointed out that the considerable costs involved [in establishing a national currency] should be carefully weighed."[84] When the Executive Board met to discuss the matter in early April, the Fund expressed this cautionary message more directly:

> With regard to the question of the possible introduction of a national currency, in view of the sizable cost and risks involved, Directors cautioned against precipitous action: it was essential to have in place the institutions and the instruments, and above all, to demonstrate the firm resolve to implement tight fiscal and monetary policies in order to protect the internal and external value of the currency. Directors also stressed the importance of coordinating monetary and interest rate policies with other members of the ruble area until Moldova introduced its own currency.[85]

Over the next few months, the authorities reconsidered and decided instead to begin issuing coupons to circulate in parallel with the ruble. Although still committed to replacing the ruble, they were prepared to proceed slowly unless circumstances forced them to act more quickly. The Fund's advice also evolved. In August 1992, a different team of Fund experts (from the Monetary and Exchange Affairs Department, or MAE) went to Chisinau to advise the Moldovan authorities on issues involved in introducing and managing their own currency, to be called the leu. This staff team broadly supported the authorities' decisions and encouraged them to introduce a national currency as soon as they were ready: "A cautious approach to the introduction of the new currency seems appropriate; however, it is important to continue preparations in earnest, to maintain freedom of action in case circumstances indicate a faster introduction of

[84]"Moldova—Pre-Membership Economic Review," SM/92/44 (March 6, 1992), p. 14.
[85]Minutes of EBM/92/43 (April 2, 1992), p. 14.

the leu."[86] Moreover, the staff clearly acknowledged the shortcomings of a Russian-dominated ruble area:

> A serious difficulty with present ruble area arrangements is the absence of workable operational arrangements that would give member states confidence on the soundness of monetary policy in the area. In the absence of those arrangements, individual member states, such as Moldova, have little influence over monetary policy. Moreover, such absence can encourage individual members to run excessively expansionary policies. A special responsibility falls on the Central Bank of Russia, given its particular position as the sole issuer of ruble banknotes: the amount of ruble banknotes that it puts in circulation and the size of the correspondent account overdrafts that it allows other members to run are key factors in monetary developments and in the distribution of seigniorage among central banks in the area. The potential exists, therefore, for ruble area conditions to become so unstable to thwart efforts from individual countries to stabilize their economies. In those circumstances, issuing the leu could become a prerequisite for implementing a successful stabilization program in Moldova.[87]

By mid-1993, as Moldova faced increasing difficulty obtaining sufficient ruble notes from Russia, some 80 percent of the currency in circulation consisted of locally printed coupons. When Russia suddenly removed the old rubles from circulation on July 24, Moldova had no choice but to take the "precipitous action" that it and the IMF had sought to avoid. The National Bank of Moldova (NBM) withdrew all rubles from circulation in exchange for coupons and declared them no longer to be legal tender. The exchange rate of the coupon—renamed the Moldovan ruble—was allowed to float against the Russian ruble, which effectively committed the NBM to establishing its own monetary policy. The IMF staff fully supported this reaction: "Moldova can and should insulate itself from the effect of expansionary financial policies elsewhere in the ruble area by adhering strictly to the monetary program and by proceeding in parallel with the plans to introduce the leu."[88]

From that point on, the challenges for Moldova were to master the technical conversion to a regular currency and simultaneously to stabilize monetary and fiscal policy. (Inflation, at about 20 percent a month, was higher than that in Russia.) The Fund's MAE Department continued to provide technical advice throughout 1993, while EU2 staff helped the authorities devise a stabilization program the Fund could support with financial assistance. Moldova finally rolled out the leu to replace the ruble coupons on November 29, 1993, with the "full support" of the IMF—both in words (through a press release[89]) and in deed (through a stand-by arrangement approved in mid-December).

[86]"Moldova—Issues Related to the Introduction of a New Currency and Institution Building at the National Bank of Moldova" (unnumbered technical assistance report), September 30, 1992, p. 1.

[87]"Moldova—Issues Related to the Introduction of a New Currency and Institution Building at the National Bank of Moldova" (unnumbered technical assistance report), September 30, 1992, p. 2.

[88]See "Republic of Moldova—Use of Fund Resources—Request for Purchase Under Systemic Transformation Facility," EBS/93/149 (September 1, 1993), pp. 4–5 and 19.

[89]See "IMF Supports the Introduction of Moldova's New Currency," NB/93/17 (November 28, 1993).

Moldova began borrowing from the Fund in February 1993 and continued to do so throughout the rest of the decade. Its first loan was through the Compensatory and Contingency Financing Facility (CCFF), so the Fund could help the government cope with a disastrous crop failure, the result of the country's worst drought since 1946.[90] This loan was for $18.5 million (SDR 13.5 million, or 22.5 percent of quota). At the time, the government of Moldova was not yet ready to implement a viable macroeconomic stabilization program, and the CCFF provided a means for the Fund to offer at least some small financial help quickly.

That initial loan was followed in September 1993 by a somewhat larger one (SDR 22.5 million; roughly $32 million) through the STF, which helped bolster the NBM's foreign exchange reserves as it prepared to begin issuing its own currency. In December, following the introduction of the leu as the national currency and the corresponding adoption of a comprehensive program of macroeconomic policies, the Fund approved a 15-month stand-by arrangement for $72 million (SDR 51.75 million, or 58 percent of the newly increased quota). The authorities successfully carried out the agreed-on stabilization program and drew out the full amount of the arrangement. They also borrowed a second time through the CCFF, in response to yet another drought-induced crop failure in 1994.

By 1996, Moldova was beginning to make progress toward establishing a market-based economy, although barter and other nontransparent transactions remained commonplace. In May, the Fund agreed to support the reform effort more substantially, through a three-year EFF arrangement for $195 million (SDR 135 million, or 150 percent of quota). The reform program supported by that arrangement began well, but political paralysis set in after the December 1996 elections. The fiscal deficit failed to decline as programmed, and in the latter part of 1997 the Fund decided to stop disbursing (Figure 8.5) until the new government could establish a track record of fiscal control.

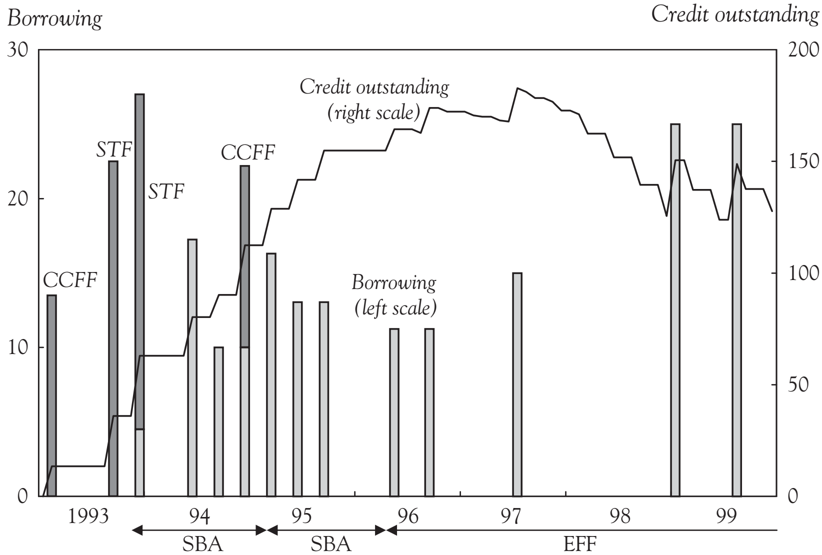
Moldova suffered a further setback in the summer of 1998 as a result of the financial crisis in its largest export market, Russia. Export receipts quickly dried up, and the government was driven to the brink of default on its outstanding debts. The NBM managed to bail out the government through extensive monetary financing, but its foreign exchange reserves dropped precipitously as it tried to resist a depreciation of the currency. That effort was abandoned in November, after which the exchange value of the leu plummeted. For the year, real GDP fell by 8.5 percent.[91]

The long-run picture was not much brighter. Per capita GDP in 1998 was estimated at just more than $500 and had been essentially flat throughout much of the decade.

[90]"Moldova—Use of Fund Resources—Request for Purchase Under Compensatory and Contingency Financing Facility," EBS/93/8 (January 15, 1993).

[91]See "Republic of Moldova: Recent Economic Developments," IMF Staff Country Report No. 99/110, September 1999, pp. 18–21; accessed at http://www.imf.org/external/pubs/cat/longres.cfm?sk=3232.0.

Figure 8.5. Moldova: Use of Fund Credit, 1993–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics.
Note: CCFF = Compensatory and Contingency Financing Facility; EFF = Extended Fund Facility; SBA = Stand-by arrangement; STF = Systemic Transformation Facility.

The lack of progress was partly due to the country's fractured political condition and the persistence of domestic opposition to market reforms, and partly to the sheer magnitude of the economic and political transformation being undertaken. The government signaled its continuing commitment by successfully implementing a set of prior actions specified by the IMF, and the Fund responded by resuming lending in January 1999 and extending the EFF arrangement to a fourth year (through May 2000).

Despite seven years of trying to put the economy on a forward course, supported by the IMF through nearly continuous lending and extensive policy advice, Moldova was still mired at the end of the decade. Recognizing that a more generous and longer-term approach was needed, the IMF agreed in March 1999 to add Moldova to the list of low-income countries eligible for concessional loans.[92] Moldova made one more drawing on the EFF arrangement, in August 1999. In the succeeding years, it needed to continue to borrow from the Fund, but at least it had recourse to the less expensive loans of the Poverty Reduction and Growth Facility.

[92]Early in the decade, the World Bank estimate of Moldova's per capita GDP—the primary datum used by the IMF for determining eligibility for concessional loans—was well above the threshold. That initial estimate turned out to be overly optimistic. By 1999, it was apparent that Moldova had started its independent life at a lower income level and then had declined greatly from there; see "Republic of Moldova—ESAF Eligibility," EBS/99/43 (March 17, 1999). The criteria for and experience with ESAF eligibility is discussed more generally in Chapter 13.

The Caucasus Region

Three of the poorest countries were crowded together in a conflict- and earthquake-prone belt on the southern edge of the Caucasus Mountains, between the Black and Caspian Seas, and bordered by Turkey and the Islamic Republic of Iran to the south and by Chechnya and other restless regions of the Russian Federation to the north. In the 1990s, the IMF assisted these countries with a steady flow of technical assistance and policy advice, particularly on introducing national currencies and establishing effective central banks, fiscal agencies, and statistical systems. The Fund also lent steadily to all three countries, first through its regular credit facilities and then through the Enhanced Structural Adjustment Facility (ESAF) (Figure 8.6).

Armenia

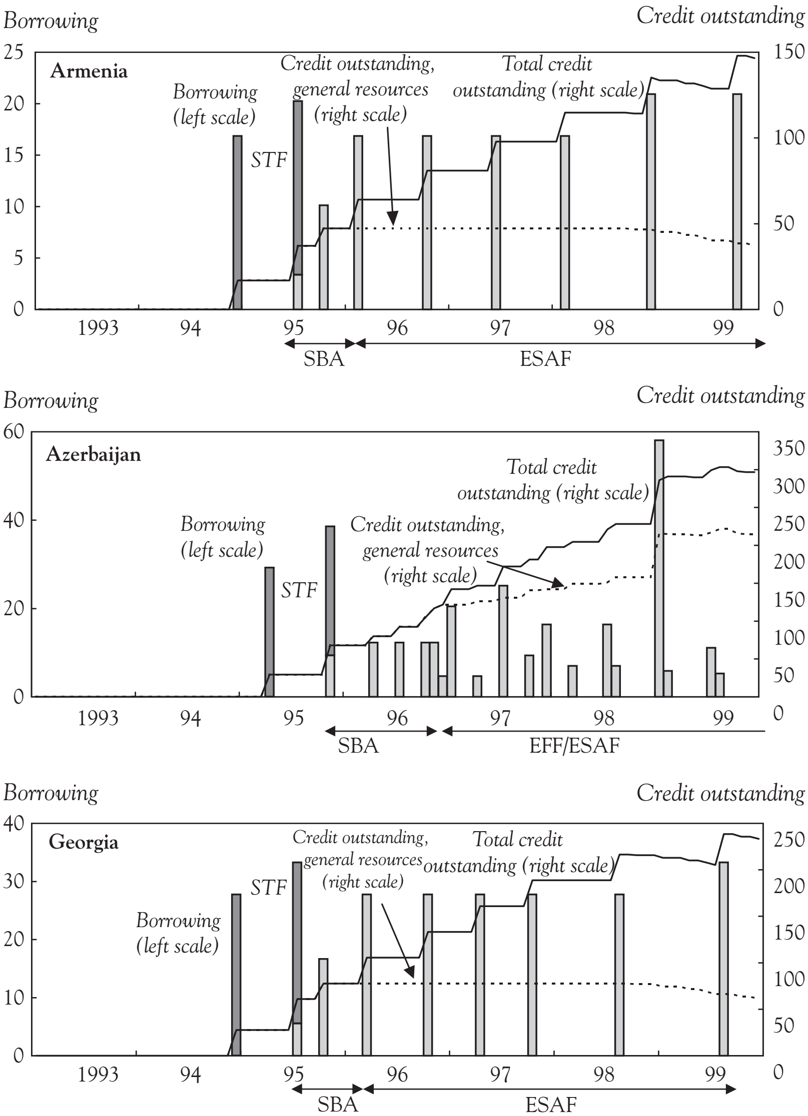
Armenia joined the IMF in May 1992, saddled with a host of ills in addition to the baggage of its history in the Soviet system. A deadly earthquake had hit in December 1988, displacing more than a half million people and leaving much of the country's infrastructure in tatters. The dissolution of the Soviet Union allowed a long-simmering conflict with Azerbaijan over control of the Nagorno-Karabakh region to re-erupt. That area had been a self-governing part of the Soviet republic of Azerbaijan for more than a half century, but it was populated largely by ethnic Armenians. Turkey, in support of Azerbaijani interests, imposed a trade embargo on Armenia, which remained in effect throughout the rest of the decade. By the time a temporary cease-fire was signed in 1994, an estimated 1 million people had been displaced and had become refugees, mostly on the Azeri side of the border. To the north, civil conflicts in Georgia further destabilized the region.

Armenia suffered devastating economic effects. In 1991–92 alone, output was estimated to have fallen by half. Inflation soared, and food shortages occurred throughout the country. The government's efforts to establish a market-based economy with assistance from the IMF and other agencies were totally overwhelmed by circumstances. In December 1992, President Levon Ter-Petrossian declared a state of "national disaster" and appealed to world leaders for help.[93]

This situation placed Armenia in a somewhat different position vis-à-vis the ruble area from that of the larger middle-income countries. Although it was true, as elsewhere, that the authorities could not contain inflation so long as they remained in the unstable system, it was also true that Armenia could at least try to use an influx of ruble credits to finance its external deficit and alleviate its development needs. As a small and very poor country, its reliance on the ruble posed no real systemic problems for Russia or the other large members of the area. On balance, therefore, the authorities

[93]For an overview, see "Armenia—Staff Report for the 1992 Article IV Consultation," SM/93/15 (January 22, 1993).

Figure 8.6. Low-Income Countries in the Caucusus Region: Use of Fund Credit,1993–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics.
Note: EFF = Extended Fund Facility; ESAF = Enhanced Structural Adjustment Facility; SBA = Stand-by arrangement; STF = Systemic Transformation Facility.
"Credit outstanding, general resources" excludes ESAF loans.

preferred to stick with the ruble for the time being, and the Fund staff signaled its support for whichever choice they might make.[94]

Russia's decision in mid-1993 to stop accepting Soviet-era ruble notes forced the hand of the Armenian authorities. They could not obtain enough cash in new rubles to sustain the economy, but by continuing to accept old notes they opened themselves to inflows from neighboring states. In the fall of 1993, those inflows turned into a flood that sparked higher inflation and further shortages. In November, the still-unprepared government had no choice but to introduce its own national currency, the dram, and withdraw from the ruble area. An IMF mission had just spent two weeks in Yerevan advising officials in the central bank on a plan to use coupons during a transition period until adequate preparations could be made, but that plan had to be scrapped in favor of an immediate withdrawal of rubles from circulation.[95]

The collapse in Armenia's output in 1991 and 1992 pushed it below the threshold that the World Bank used for determining eligibility for concessional loans from the International Development Association (IDA), but not so far as to qualify it for "IDA-only" borrowing. That is, in 1993 the Bank placed Armenia in a category eligible for a blend of IDA credits and nonconcessional loans from the main World Bank lending agency, the International Bank for Reconstruction and Development (IBRD). The IMF responded accordingly by making Armenia eligible for ESAF loans but with the intention of possibly lending to it from its general resources as well.[96]

For the first three years of Armenia's independence, the IMF helped primarily by providing intensive technical assistance: 26 separate missions, seminars, or courses in 1992–94, involving staff from four departments and assisted by outside experts. IMF lending to Armenia began in December 1994, once the new currency was successfully in circulation and a measure of fiscal and monetary discipline had been established. After three years of sharp declines, output began growing in 1994 and continued throughout the rest of the decade.

Although Armenia was eligible to borrow on concessional terms, doing so required agreement on a comprehensive three-year structural adjustment program.[97] The authorities were not yet able to formulate such a program, so the Fund began with a simple STF drawing for 25 percent of Armenia's quota (SDR 16.875 million, or $24.5 million). This amount was small in relation to Armenia's financing needs, but it helped catalyze larger support from other agencies and governments, including an

[94]"Armenia—Staff Report for the 1992 Article IV Consultation," SM/93/15 (January 22, 1993), pp. 7–9.

[95]"Armenia: Management of an Independent Currency," unnumbered technical assistance document (December 31, 1993).

[96]See "ESAF Successor—Operational Modalities and Program Design Issues," EBS/93/178 (November 16, 1993), pp. 2–4.

[97]Technically, two facilities—the SAF and the ESAF—were available, and only the ESAF required a comprehensive three-year program. By December 1994, however, all the funds remaining in the SAF were committed to other countries; see Chapter 13, p. 641.

agreement by a group of donor countries to provide additional bilateral financial assistance totaling at least $140 million.[98]

Development of a comprehensive program took another 14 months. In the interim, the Fund approved a one-year stand-by arrangement, supplemented by a second STF drawing, in June 1995. The authorities carried out that program successfully, and it was replaced by a three-year ESAF arrangement in February 1996 (see Figure 8.6). Despite a serious financial setback after the 1998 Russian crisis, the three-year program also was completed successfully, and the arrangement was fully drawn just months behind the original schedule.[99]

Azerbaijan

When Azerbaijan joined the IMF in September 1992, it was well endowed with natural resources, including fertile agricultural land and mammoth oil and gas reserves. However, internal conflicts and the usual post-Soviet administrative weaknesses and corruption held it back from realizing its potential. The civil war in the Nagorno-Karabakh region, which was also destabilizing conditions in Armenia (see above), posed the biggest single problem. For this and other reasons, the World Bank estimated that per capita GDP in Azerbaijan fell by about 60 percent from 1989 to 1995. Though much less steep than the income decline in Armenia, the cumulative effect was greater. The Fund initially (in 1993) declined to make Azerbaijan eligible for concessional assistance through the ESAF, but it agreed to keep the issue under review. When incomes continued to fall, it declared the country to be ESAF-eligible in May 1995.[100]

Shortly before joining the IMF, Azerbaijan introduced a national currency, the manat, to circulate alongside the ruble. When Russia stopped redeeming old rubles in July 1993, Azerbaijan began withdrawing them from circulation. In November, the authorities tried to stabilize prices by pegging the manat to the U.S. dollar, and in January 1994 they declared the manat to be the country's sole legal tender. The Fund staff supported the introduction of the currency, but it advised against pegging it to a hard currency at that time. The manat simply was not strong enough to sustain the peg, and it was trading at a huge discount on the black market. The authorities accepted the Fund's advice, and in March 1994 they went back to pegging the manat to the ruble.

[98]For details, see "Republic of Armenia—Use of Fund Resources—Request for a Purchase Under the Systemic Transformation Facility," EBS/94/218, Suppl. 2 (December 12, 1994).

[99]All obligations to the Fund's general account arising from the STF and stand-by drawings were repaid by 2005. Armenia continued to borrow from the IMF on concessional terms for several more years, through two fully utilized PRGF arrangements, 2001–04 and 2005–08, and a third PRGF arrangement in 2008–09. In March 2009, Armenia resumed borrowing from the general account through a stand-by arrangement.

[100]The background to Azerbaijan's ESAF eligibility is explained in "ESAF Eligibility—Azerbaijan Republic and the Republic of Congo," EBS/95/86 (May 24, 1995).

Two months later, they let the exchange rate float until it reached a new—greatly depreciated—level, and then they repegged successfully to the dollar.[101]

IMF lending to Azerbaijan started only in April 1995, through an STF loan, but it then continued with frequent disbursements through the rest of the decade (Figure 8.6). Until the authorities could formulate a comprehensive medium-term program, lending had to be done on nonconcessional terms. A one-year stand-by arrangement approved in November 1995, along with a second STF loan, was fully drawn. A three-year ESAF arrangement, approved in December 1996, was almost fully drawn after a brief extension. In this case, however, the Fund decided to limit the amount of concessional lending and supplement the ESAF arrangement with a concurrent (1996–99) EFF arrangement financed with the Fund's general resources. Although Azerbaijan had a very low level of per capita income, its growth prospects—deriving largely from its petroleum reserves—were considered quite good. Once that growth was realized, the government would be able to afford to pay a market interest rate on at least part of its debts.[102]

Georgia

When Georgia became a member of the IMF in May 1992, the Fund had high hopes for reform and economic progress in this small, poor country. The main basis for optimism was what the staff came to call the "Shevardnadze effect." Eduard Shevardnadze had acted as a strong force for political reform in the Soviet Union while serving as foreign minister under Mikhail Gorbachev (1985–90 and briefly again in 1991). After the breakup of the Soviet Union, a military coup against the initial government in Georgia created an opening for Shevardnadze. He became head of government in 1992, eventually winning the presidency once a new constitution was adopted in 1995. He held that post until he was forced to resign in 2003 amid allegations of election irregularities and other corruption charges. Throughout the 1990s, however, he maintained wide respect as a reformist leader with whom the international community was eager to work.

At the outset, Georgia's immediate prospects for either stability or growth appeared dim. A simmering civil war and a major earthquake in 1991 added to the devastating effects on output and trade from the collapse of the CMEA. Before joining the IMF, the authorities decided to remain in the ruble area for the time being but—owing to political tensions with Russia—not to join the CIS. By the time of the first Article IV consultation discussions in January 1993, however, the Shevardnadze government had already decided that leaving the ruble area and establishing a national currency was

[101]See "Azerbaijan Republic—Staff Report for the 1994 Article IV Consultation," SM/94/116 (May 11, 1994), and Suppl. 1 (June 6, 1994).

[102]A boom period, fueled by oil exports, materialized in the following decade. Azerbaijan completed a PRGF arrangement in 2005 and then did not borrow during the next few years.

"desirable and inevitable." The only question was how soon the country would be ready.[103]

The staff mission, led by Donal Donovan (Assistant Director, EU2), took a neutral position on whether and when Georgia should strike out on its own financial path. It emphasized, however, that the economy could not continue on the course it had taken in the first year of independence. The instability of the ruble area, combined with Georgia's excessive fiscal deficit, made the status quo unsustainable. Donovan recommended introducing coupons alongside the ruble "as a transitory step" until the authorities could get reforms in place and could see a level of financial stability sufficient to make a new national currency credible.[104]

Georgia began issuing coupons in April 1993, to circulate alongside rubles. Rubles by then were already in short supply, and they became much more so three months later when Russia stopped redeeming them. For the next two years, the coupon was the only legal tender in Georgia, but the government's inability to discipline itself in issuing them as a means of financing its own spending soon made them virtually worthless. The ruble reasserted itself as the principal medium of exchange, and hyperinflation followed inevitably.[105]

When Georgia approached the IMF for an initial STF loan in 1994, its economy was in shambles. The authorities acknowledged that they would have to make a complete turnaround in economic policies if they were to have any hope of securing international assistance and gaining control over their economic fortunes. As one indication of how unrealistic prices had become, and therefore of how massively the practically bankrupt government was subsidizing basic commodities, in September 1994 the government raised the price of bread from 700 coupons per kilogram to 200,000 coupons! Many other subsidies were similarly cut and replaced by a much more limited social safety net targeted at the poor and the elderly. Those encouraging moves persuaded the Fund to approve an STF loan of about $40 million (SDR 27.75 million, or 25 percent of quota) in December. More important, a tightening of monetary policy, the rationalization of basic commodity prices, and a program to begin privatizing agriculture quickly ended the hyperinflation and offered some hope for the future.[106]

In-depth economic and political reform began in 1995, culminating in adoption of a new constitution in August and the rollout of a new national currency (the lari, exchanged for coupons at a rate of 1 million to 1) in September. The introduction of the lari was a watershed moment for the Georgian economy, suddenly halting and reversing the public's preference for using U.S. dollars and deutsche marks instead of domestic currency. Some $100 million in foreign exchange soon flooded into the

[103]"Georgia—Staff Report for the 1993 Article IV Consultation," SM/93/76 (April 12, 1993), p. 10.

[104]"Georgia—Staff Report for the 1993 Article IV Consultation," SM/93/76 (April 12, 1993), p. 10.

[105]Monetary developments in 1993 and the first part of 1994 are reviewed in "Republic of Georgia—Staff Report for the 1994 Article IV Consultation," SM/94/143 (June 8, 1994), pp. 7–10.

[106]For an analysis of the hyperinflation and the subsequent stabilization, see Wang (1999).

central bank, tripling the size of Georgia's foreign exchange reserves and raising them to a comfortable level. IMF staff and consultants provided technical assistance on the rollout and even arranged for an airplane to fly the cash to Germany, where it could be held in secure reserve deposits.[107]

The Fund responded financially to these developments in June 1995 with a stand-by arrangement, designed to serve as a bridge to larger and less expensive ESAF lending as soon as the authorities could formulate a comprehensive three-year program. That promise was fulfilled in February 1996 (see Figure 8.6). The authorities succeeded in carrying out the three-year program, and the Fund disbursed the full amount of the ESAF arrangement. Output, which began growing in 1995, continued to grow throughout the rest of the decade, although growth slowed sharply for a time after the Russian financial crisis of 1998. By the end of the 1990s, Georgia still faced formidable challenges but appeared to be on the right track toward strengthening its economy and its ties with the international community.

Central Asia

Of the five central Asian nations to emerge from the Soviet Union, two—Kazakhstan and Turkmenistan—benefited from a wealth of natural gas and other mineral resources. The Kyrgyz Republic, Tajikistan, and Uzbekistan were much poorer and faced much greater obstacles to their ability to mature as independent economies. Working with each of these countries, the IMF first helped them develop market institutions and establish their own national currencies and then provided at least small amounts of financial assistance. The degree of success varied, owing foremost to the different political choices and the different external and internal disturbances faced by each country.

Kyrgyz Republic

The Kyrgyz Republic[108] started its history as an independent post-Soviet country with great promise. Its president, Askar Akayev, was a highly respected academic physicist. He was also known as a reformer, and his government quickly established an open and apparently democratic system. The IMF responded by providing substantial technical assistance, notably to modernize the central bank, and by providing a series of loans starting in 1993.

During membership discussions with IMF staff early in 1992, the authorities indicated that they intended to continue to use the ruble as the Kyrgyz currency. Much of the technical discussion with the staff concerned the best way to coordinate monetary policy and credit creation with other countries in the ruble area. Soon after joining the

[107]See "Georgia—Recent Economic Developments," SM/96/231 (September 9, 1996), pp. 26–27. Additional information is from interviews with staff.

[108]For the history of the name of this country, see the Appendix to Chapter 2.

IMF in May 1992, however, the authorities grew disillusioned with that arrangement, finding it difficult to develop satisfactory relations with Russia for managing monetary policy, and Russia's own monetary management was being increasingly called into question. Even if they lacked the administrative capacity to issue and manage their own national currency, the authorities realized that sticking with a currency and a system as unstable and inflationary as the ruble area had become was not sustainable.[109]

Staff views evolved in parallel with those of the authorities. After initially accepting the decision to continue using the ruble, the staff soon had second thoughts. In this case, the staff missions, led by Peter M. Keller (Advisor, EU2), took a relatively proactive stance, urging the country to leave the ruble area and establish its own currency. When the authorities requested a stand-by arrangement in the summer of 1992, the staff responded by warning them that in the then-current conditions of instability, "it would be difficult for the Fund to agree to a program with a member of the ruble area."[110]

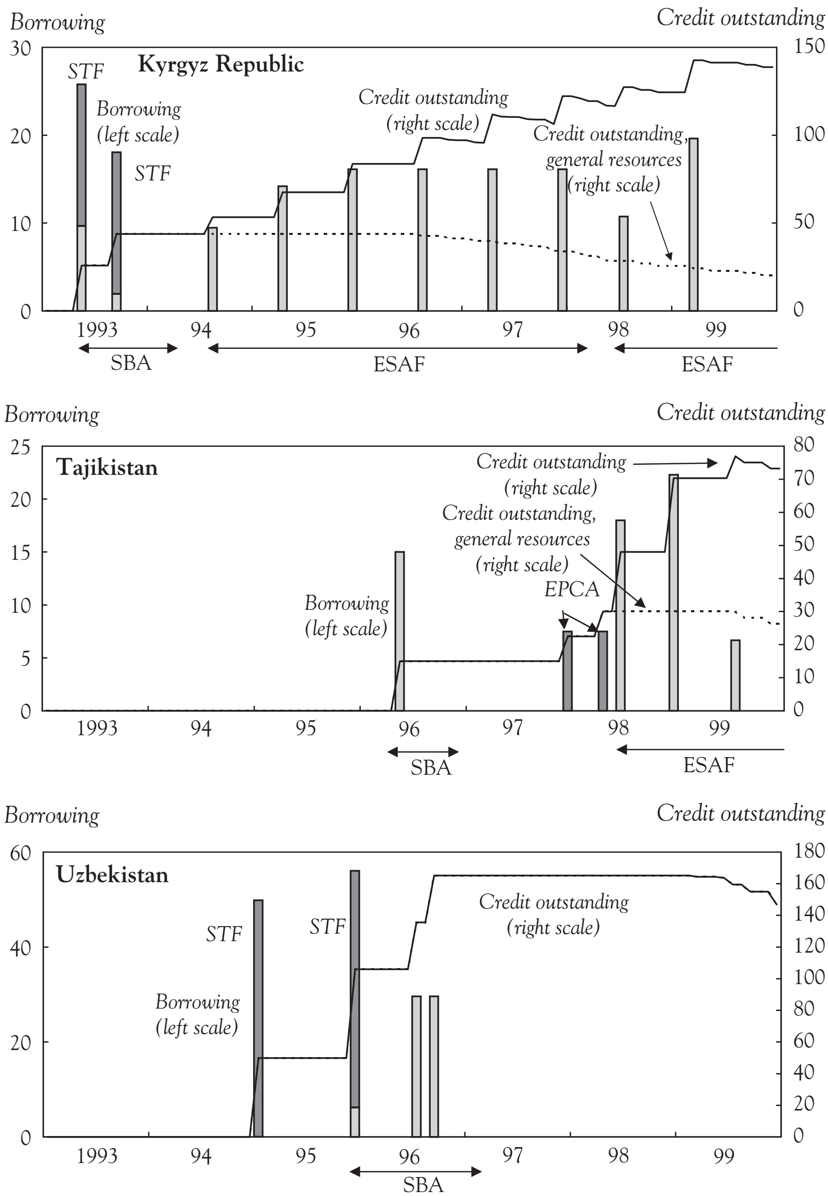
Akayev was reluctant to take quick action to abandon the ruble, primarily because of concern that Russia would respond with hostility (as it had when the Baltic countries left the ruble area). After high-level consultations with Russia and technical discussions with officials from the Baltic countries, the president and his government were satisfied that they could convert successfully to a new currency. By March 1993, they had formulated a comprehensive economic program and were making plans to launch the currency, the som. With that plan on the table, negotiations were completed for IMF support. Issuance of the currency began on May 10, and two days later the Executive Board approved an 11-month stand-by arrangement and an initial STF loan, which was the first use of the newly established facility by any country (see Chapter 5).

For the rest of the decade, the Fund extended loans annually to the Kyrgyz Republic, with only minor delays (Figure 8.7). Implementation of the policy program flagged in the second half of 1993 but then resumed sufficiently for the IMF to approve a three-year ESAF arrangement in June 1994. From that point on, the Fund supported the country exclusively through loans on concessional terms from its administered accounts, which continued at least through the next decade. Economic performance deteriorated in the late 1990s, partly because of governance problems, but also because of external problems beyond the authorities' control. Chief among the external shocks was the Russian financial meltdown in 1998, which caused capital flows to the Kyrgyz Republic to dry up, severely reduced exports to Russia and other neighboring countries,

[109]The authorities' evolving views are reported in "Kyrghyzsta—Pre-Membership Economic Review," SM/92/64 (March 18, 1992) and "Kyrgyzstan—Request for Stand-By Arrangement," EBS/93/54, Suppl. 1 (April 16, 1993).

[110]Memorandum from Odling-Smee to the Managing Director, "Staff Visit to Kyrgyzstan, September 1–11, 1992," September 16, 1992; IMF archives, Accession No. 1996-0187-0004, OMD-AD, B9108, "Kyrgyzstan 1992."

Figure 8.7. Low-Income Countries in Central Asia: Use of Fund Credit, 1993–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics.
Note: EFF = Extended Fund Facility; EPCA = Emergency Postconflict Assistance; ESAF = Enhanced Structural Adjustment Facility; SBA = Stand-by arrangement; STF = Systemic Transformation Facility.

and precipitated a crisis in the Kyrgyz banking system. Even so, output continued to grow, albeit slowly, and the overall economic record remained modestly positive.

Tajikistan

Tajikistan declared its independence in September 1991, joined the CIS when the group was formed in December, and applied to join the IMF in February 1992. Its economic prospects, never very bright, dimmed considerably when civil war erupted. As noted in Chapter 2, Fund membership was delayed until April 1993, and the first Article IV consultation with Tajikistan did not take place until mid-1994.

Reforming the economy in the absence of the structure and support the Soviet Union had provided for more than six decades was a daunting task for all these countries, and it was one for which the Tajik authorities were especially unprepared. They presided over an extremely poor country, with the lowest per capita income in the region. Landlocked and mountainous with very little arable land or modern infrastructure, Tajikistan began with practically none of the attributes of a functioning national economy.[111]

For the first year of Tajikistan's membership, the staff focused mainly on providing technical assistance, particularly on transforming the National Bank of Tajikistan into a modern central bank. When the first Article IV mission arrived in Dushanbe in May 1994, the civil war was still ongoing, but the government—with support from Russia—had gained control over most of the country. Financially, the most significant issue, as in other countries of the former Soviet Union, was how to remonetize the economy after the ruble area crumbled. In this case, the authorities were negotiating with Russia to establish a formal monetary union. As an interim policy, Tajikistan officially was using the Russian ruble (the new one, which supplanted the old Lenin notes in 1993). Instead of supplying the central bank with Russian banknotes, however, Russia was printing specially marked ruble notes for use only in Tajikistan.

The 1994 staff mission was led by Peter Keller, who was also handling the Kyrgyz Republic. Accommodating the authorities' preferences, Keller took a more neutral position on the currency issue than he had in the neighboring country. For Tajikistan, the Fund advised that a successful ruble-based system would require a formal agreement with Russia covering the supply of money and the conduct of monetary policy. If that was not possible, then Tajikistan would be well advised to change course and issue its own national currency. The authorities informed Keller that they wanted financial

[111]For the staff's overview, see "Tajikistan—Pre-Membership Economic Review," SM/92/70 (March 23, 1992).

assistance, but he responded that they would first have to settle the currency issue and strengthen their finances.[112]

Before long, negotiations on a monetary union with Russia broke down, and at the end of 1994 Russia stopped shipments of rubles to Tajikistan altogether. That forced Tajikistan to introduce its own currency and left precious little time for proper planning. The IMF sent a staff mission to Dushanbe in January 1995 to advise on both the technical aspects of currency conversion and on the design of supporting policies. The crucial elements of the latter were to be a liberalization of consumer prices and a six-month freeze on credit extension by the central bank, to prevent the liberalization from leading to an inflationary spiral. A second mission went in April and May to oversee the rollout of the new currency, the Tajik ruble.[113] With that launch, all the countries emerging from the former Soviet Union had their own separate national currencies.

Relations between the IMF and Tajikistan in the second half of the decade turned to financial assistance (see Figure 8.7). By this time, the STF had expired, but the Fund could still provide an initial loan on similar terms simply by granting a "first-tranche" stand-by arrangement for 25 percent of quota and disbursing the full amount immediately. Tajikistan requested such an arrangement in 1995, but discussions did not go well. The tight monetary and fiscal policies advised by the IMF proved to be far too draconian for the authorities, who had to cope with falling output and soaring price pressures while containing civil unrest that had continued for more than four years. (By this time, an estimated 600,000 people—more than 10 percent of the population—had been displaced by the conflict.) The credit freeze was quickly abandoned, and a staff-monitored program that began in September 1995 failed almost instantly. After the installation of a new prime minister in February 1996, negotiations took a more positive turn, and the Executive Board finally approved a first-tranche stand-by arrangement in May 1996.[114]

Policy implementation flagged again over the next year, but matters took a distinct turn for the better upon the signing of a peace accord in June 1997. The Fund then disbursed postconflict assistance in two tranches totaling 25 percent of quota, and then set about to help the authorities develop a longer-term program suitable for ESAF support. The Fund approved a three-year ESAF arrangement in June 1998, after which economic growth and the pace of structural reform both gradually increased. The Fund

[112]"Republic of Tajikistan—Staff Report for the 1994 Article IV Consultation," SM/94/204 (August 2, 1994). In September, the Executive Board concurred with the staff's advice, though tilted more toward encouraging the authorities to strike out on their own; see minutes of EBM/94/84 (September 14, 1994), pp. 51–62.

[113]"Republic of Tajikistan—Introduction of a National Currency," SM/95/141 (June 8, 1995).

[114]These various developments are described in "Republic of Tajikistan—Staff Report for the 1996 Article IV Consultation and Request for First Credit Tranche Stand-By Arrangement," EBS/96/65 (April 23, 1996).

continued to support Tajikistan with loans on concessional terms for the next several years.

Uzbekistan

Much like its two close neighbors, when Uzbekistan first began discussions on joining the IMF, the authorities expressed a preference for continuing to use the ruble as part of a common currency area with Russia and other newly independent states. The authorities recognized, however, that the system might collapse and that they would have to prepare for the contingency of going it alone. The IMF staff, led by Ishan Kapur (who was also leading missions to Kazakhstan), cautioned that such a step "would need to be preceded by careful technical preparation." In any event, the staff view was that Uzbekistan's primary and immediate challenges were "strong macroeconomic discipline and fundamental structural reforms."[115]

Soon after Uzbekistan joined the IMF in September 1992, the difficulty of establishing cooperative payments arrangements within the ruble area forced the authorities to consider alternatives. The Fund responded in December by sending a team of experts from MAE. They supported the authorities' intention to consider ways to respond if Uzbekistan was forced to withdraw from the ruble area, and provided detailed technical assistance on the necessary steps to take if the occasion arose.

The trigger, as for several other states, was Russia's decision in July 1993 to stop accepting the old rubles. As cash became increasingly scarce, the Uzbek authorities started issuing coupons in November 1993 to circulate alongside both old and new rubles as means of payment. Two months later, the ruble was dropped as legal tender. Finally, in July 1994, a new currency, the sum, replaced the coupons.[116]

Relations between Uzbekistan and the IMF were uneasy throughout the 1990s. The government, led by the former Communist Party chief, Islam Abduganievich Karimov, opted to retain much of the Soviet-era economic structure and many of its political institutions. It resisted much of the Fund's advice on market-oriented structural reforms and was unable to stabilize macroeconomic policies. In the first few months after the launch of the sum as a national currency, rapid monetary expansion induced a depreciation of the exchange rate from 7 sum per U.S. dollar in July 1994 to about 30 in November. By that time, the authorities were ready to try to stabilize the currency and begin a reform program.

In 1995, the IMF agreed to begin lending to Uzbekistan on a small scale. The Executive Board approved a first STF loan in January, after which negotiations started on a stand-by arrangement. Three staff missions spent a total of six weeks meeting with the authorities in Tashkent, and Camdessus met with Karimov and other senior officials there in May. In the end, the Fund was convinced that the government was

[115]"Uzbekistan - Pre-Membership Economic Review," SM/92/80 (April 3, 1992), p. 17.

[116]Coupons, which also were known as the sum, were exchanged for the new currency at a rate of 1,000:1.

committed to carrying out its stabilization program. The structural reform agenda was not very ambitious, but the staff (now led by Leif Hansen, Division Chief, EU2) accepted "the judgment of the authorities that the envisaged program represents the pace of adjustment best suited to maintaining political and social stability in the country."[117] The Executive Board concurred, and the stand-by arrangement—along with a second STF loan—took effect in December 1995.

Midway through the 15-month stand-by arrangement, in the fall of 1996, the government abruptly changed course. The imposition of exchange and trade controls and a surge in government expenditure violated the terms of the arrangement with the IMF, which eventually expired with no more drawings being allowed. Discussions with the staff led nowhere until Fischer went to Tashkent in May 1997 in response to a personal invitation from Karimov. After a tense three-hour meeting, the president finally committed himself to "the unconditional fulfillment of outstanding commitments under the stand-by arrangement." Fischer agreed that once that condition had been met, including the elimination of exchange controls, the Fund would consider new lending, possibly on a larger scale than before.[118] For the rest of the decade, however, policies remained on a course that the staff considered insufficiently strong to warrant Fund support.[119]

In the background throughout all the discussions of IMF financial support for Uzbekistan was the Fund's decision not to make the country eligible for concessional loans. The issue first arose in November 1993, in the context of a review of the ESAF in which seven other countries were added to the eligibility list. The staff acknowledged that both Uzbekistan and Azerbaijan had per capita incomes estimated to be in the same range as the other countries being added, but they drew the rather strained distinction that for these two countries, income was not on a "declining trend."[120] Two months later, in the context of the first Article IV consultation, the Executive Board noted that Uzbekistan's status as a major producer of two valuable commodities—cotton and gold—gave it "considerable . . . economic potential, . . . provided that reforms necessary for rapid economic transformation were actively pursued."[121]

The denial of access to concessional loans stood until 2003, when Uzbekistan finally was made eligible. In the meantime, the economy did not perform too badly, at least relative to other countries in the region (see Table 8.1). The Fund continued to push for deeper reforms, on the grounds that Uzbekistan's relative success was attributable to its natural resources and could be greatly strengthened with better policies.[122]

[117]"Republic of Uzbekistan—Requests for a Stand-By Arrangement and for a Second Purchase Under the Systemic Transformation Facility," EBS/95/191 (November 27, 1995), p. 17.

[118]Report by Fischer at EBM/97/47 (May 7, 1997), pp. 3–4.

[119]Uzbekistan repaid its financial obligations to the IMF, all of which stemmed from the two STF loans and the 1995–97 stand-by arrangement, by 2006.

[120]Statement by Jack Boorman at EBM/93/162 (November 29, 1993), pp. 53–54.

[121]Chairman's Summing Up, minutes of EBM/94/4 (January 21, 1994), p. 56.

[122]For an analysis, see Zettelmeyer (1999).

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III

The IMF and Emerging Markets

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9

Five Fat Years: Recovery from the Debt Crisis, 1990–94

BEHOLD, THERE COME SEVEN YEARS OF GREAT PLENTY THROUGHOUT ALL THE LAND OF Egypt. And there shall arise after them seven years of famine; and all the plenty shall be forgotten.

Genesis 41:29–30

The debt crisis of the 1980s engulfed whole regions of the developing world: Latin America most broadly and painfully, but also Eastern Europe and Africa. In all, it directly affected at least 20 countries, with more than 30 distinct crisis episodes.[1] This trouble lasted the whole of the decade, and the withdrawal of bank loans forced the most heavily indebted countries to cut spending and revert to borrowing from the IMF and other official creditors. Latin America experienced a "lost decade," and incomes at the end of the period were lower than at the beginning. The debt crisis finally ended in 1989, when a drop in world interest rates, official acceptance of the need for negotiated debt reductions, and the cumulative effect of several years of economic reforms made the burden of developing-country debt more tolerable.

The Brady Plan of 1989, named after U.S. Treasury Secretary Nicholas F. Brady, formed the keystone of the debt-reduction strategy that ended the crisis. Brady's deputy, David C. Mulford, developed the plan in 1988 and the first months of 1989 with the involvement of his Japanese counterpart, Makoto Utsumi, and of IMF staff and the Fund's Managing Director, Michel Camdessus. The plan called for commercial bank creditors to waive the usual negative pledge clauses in their sovereign loan contracts so that the dominant creditors could renegotiate their claims without getting tied up by small banks or vulture funds vying for advantaged settlements.[2] Creditor-country governments would adapt the

[1]For an overview, see Boughton (2001), Chapter 6. This description relates only to commercial-debt crises in emerging-market countries, not to the burden of debt to official creditors by low-income countries, which was a separate problem and a crisis of a different nature.

[2]Negative pledge clauses require borrowers to treat all creditors equally in any settlement and thus prohibit repaying one loan in full while going into arrears on others. A "vulture fund" purchases distressed debt in a secondary market and then takes (or threatens to take) legal action to force the debtor into a settlement.

application of their bank regulations to promote a flexible menu of options for banks to renegotiate their loans to sovereign borrowers, and multilateral creditors would provide additional credits to heavily indebted countries to help finance those settlements.

The IMF's role in the Brady Plan was to negotiate stand-by arrangements (usually extended arrangements) that provided for the Fund to set aside part of its own loans to help the borrower restructure its commercial debt with reduced debt stock and reduced debt service, and to augment the size of the arrangement for the same purpose once the borrower had reached a settlement with its commercial bank creditors.[3] The U.S. Treasury further supported this process by issuing special zero-coupon bonds that the heavily indebted developing countries could purchase and use as collateral for new securities ("Brady bonds") that they might issue to replace their bank loans.[4]

With the Brady Plan in place and world economic conditions coincidentally improving, the heavily indebted emerging-market countries benefited in two ways. First, they had a clear path in front of them for getting out from under the debt overhang that had stifled investment and growth throughout the 1980s. This prospect led to a wave of new IMF lending arrangements as a precondition for these countries to take full advantage of the Brady Plan. Second, once bank creditors and global investors realized that the prospects for growth had returned, private capital began flowing back to developing countries in huge and unprecedented volumes.

Latin America in particular attracted capital like a magnet. Mexico took in an average of more than $23 billion a year in net private flows, 1990–94, after suffering net outflows in most of the preceding eight years. Argentina, Brazil, and Chile also showed sizeable net inflows for the first time in a long while. Outside Latin America, private capital was flowing into a diverse group of countries such as Côte d'Ivoire, Hungary, the Philippines, and Romania. With the notable exception of countries making the difficult transition from central planning to market economics, most of the middle-income countries that started the 1990s with heavy external debts succeeded in using these inflows to fuel sustained increases in output growth, at least for the first half of the decade.

This chapter recounts the effects of these developments on the IMF and on the affected member countries. For both, but especially for many of the countries that had suffered through the 1980s, the short-term effect was a five-year period of mostly favorable conditions. The improvements, however, did not materialize all at once or uniformly across countries.

Resolution of the Debt Crisis

Implementation of debt reduction under the Brady Plan—the most important single factor in resolving the debt crisis of the 1980s—had to be tailored to the circumstances of each indebted country. In 1990, Mexico became the first to reach

[3]The development of the IMF role in the Brady Plan is described in Boughton (2001), pp. 491–98.
[4]For an overview of the issuance of Brady bonds, see Izvorski (1998).

a debt-reduction agreement with its commercial bank creditors and exchange its discounted bank loans for Brady bonds. As shown in Table 9.1, Costa Rica, Morocco, the Philippines, and Venezuela followed suit before the end of 1990, but for other countries these negotiations took years to complete.

All but two of the most affected countries borrowed from the IMF under at least one conditional arrangement in the 1990s as part of their recovery efforts. Exceptionally, neither Colombia nor Nigeria borrowed from the IMF in the 1980s or the 1990s, although both were classified as heavily indebted. In 1985, at Colombia's request, the Fund gave its "seal of approval" to the country's economic policies, but Colombia did not request a stand-by arrangement. In 1999, the Fund approved an Extended Fund Facility (EFF) arrangement, on which Colombia chose not to draw. Nigeria entered into three stand-by arrangements with the IMF during this period (in 1987, 1989, and 1991), all of which the authorities treated as precautionary.

Relaxation of the Fund's policy on "lending into arrears" enabled its wave of early-1990s lending to countries with heavy debt burdens to foreign commercial banks. Before 1989, the policy had been to require countries in arrears on sovereign debts to clear those arrears before the Fund would lend to them. Beginning in 1987, the Fund began making exceptions to that rule if a country's commercial bank creditors were being recalcitrant in negotiations. Otherwise, the creditors could have continued to use the Fund's policy as leverage to exact sovereign debtors' agreement to harsh terms.

In May 1989, the Executive Board agreed to relax its policy on lending into arrears more generally and formally. From that point on, it was agreed that in deciding whether to approve a stand-by arrangement, "an accumulation of arrears to banks may have to be tolerated where negotiations continue and the country's financing situation does not allow them to be avoided. Directors emphasized that appropriate safeguards would need to be incorporated into the monitoring procedures of the Fund arrangement. The Fund's policy of non-toleration of arrears to official creditors remains unchanged."[5]

The "Big Three" of Latin America

All three of the major Latin American debt-crisis countries—Argentina, Brazil, and Mexico—underwent remarkable economic transformations in the 1990s that enabled them to recover strongly and put the 1980s behind them. All three eventually stumbled and experienced new financial shocks, but only after experiencing several years of good growth sustained by sound policies.

[5]Minutes of EBM/89/61 (May 23, 1989), p. 30. For the background to this change, see Boughton (2001), pp. 481–83 and 492–98. In 1998, the Fund extended the toleration policy to cover debts to bondholders and other nonbank creditors. The following year, it relaxed the policy further by extending it to cases in which no negotiations with creditors were taking place but the country was making a good faith effort to do so. For a review, see "Fund Policy on Lending into Arrears to Private Creditors—Further Consideration of the Good Faith Criterion" (July 30, 2002); accessed at http://www.imf.org/external/pubs/ft/privcred/073002.htm.

Table 9.1. IMF Assistance to Selected Heavily Indebted Countries, 1980s and 1990s

	1981–89				1990–99				
		IMF Assistance[a] (number of arrangements)					IMF Assistance[a] (approval dates)		
	Initial Crisis	SBAs	EFFs	SAF/ ESAF	Debt-Reduction Agreement	Brady Bonds	SBA	EFF	ESAF
Baker 15 countries[b]									
Latin America									
Argentina	1982	4			1993	1993	1991, 1996	1992, 1998	
Bolivia[c]		1		2					1992, 1994, 1998
Brazil	1982	1	1		1994	1994	1992, 1998		
Chile	1983	2	1						
Colombia	1985							1999	
Ecuador	1983	5			1995	1995	1991, 1994		
Mexico	1982	1			1989	1990	1995, 1999		
Peru	1984	1	1		1997	1997		1993, 1996, 1993	
Uruguay	1983	2			1991	1991	1990, 1992, 1996, 1997, 1999		
Venezuela	1984		1		1989	1990	1996		
Other regions									
Côte d'Ivoire[c]	1984	5	1		1997	1998	1991		1994, 1998
Morocco	1982	5	1		1990	1990	1990, 1992		
Nigeria	1982	2			1991	1992	1991		
Philippines	1983	3	1		1989	1990	1991, 1998	1994	
Yugoslavia	1981, 1985	4					1990		
Croatia					1996	1996	1994	1997	
Slovenia					1996	1996			

Table 9.1. (continued)

	1981–89				1990–99				
		IMF Assistance[a] (number of arrangements)					IMF Assistance[a] (approval dates)		
	Initial Crisis	SBAs	EFFs	SAF/ ESAF	Debt-Reduction Agreement	Brady Bonds	SBA	EFF	ESAF
Other debt-crisis countries									
Costa Rica	1981	4	1		1989	1990	1991, 1993, 1995		
Hungary	1982	3					1990, 1993, 1996	1991	
Jamaica	1984	4	1				1990, 1991	1992	
Jordan	1988	1			1993	1993	1992	1994, 1996, 1999	
Poland[d]	1981				1994	1994	1990, 1993, 1994	1991	
Romania	1982	1					1991, 1992, 1994, 1997, 1999		
Other heavily indebted middle-income countries									
Bulgaria[e]					1994	1994	1991, 1992, 1994, 1996, 1997	1998	
Dominican Republic[f]		1	1		1994	1994	1991, 1993		
Panama		3			1996	1996	1992, 1995	1997	

Source: International Financial Statistics and author's calculations.

Note: EFF = Extended Fund Facility; ESAF = Enhanced Structural Adjustment Facility; SAF = Structural Adjustment Facility; SBA = Stand-by arrangement. Except for two "Baker 15" countries (Bolivia and Côte d'Ivoire), this table excludes low-income countries, which are discussed in Chapter 13.

[a]For financial assistance other than through SBA, EFF, ESAF, and SAF, see notes on individual countries.

[b]The Baker 15 was a list of countries proposed by U.S. Treasury Secretary James Baker in 1985 as the most heavily indebted to foreign commercial banks and eligible for special consideration under the Baker Plan.

[c]Bolivia and Côte d'Ivoire also received debt relief through the Heavily Indebted Poor Countries Initiative in 1998.

[d]Poland became a member of the IMF in 1986.

[e]Bulgaria became a member of the IMF in 1990.

[f]The Dominican Republic also received emergency assistance for natural disaster relief in 1998.

Argentina

The most dramatic economic turnaround among emerging markets in the early 1990s, in both policies and performance, occurred in Argentina. The country started the decade with extremely poor economic conditions, a failed series of IMF lending arrangements, and protracted arrears to Paris Club official creditors and to commercial bank creditors.[6] With consumer prices more than doubling every month, all efforts at fiscal prudence being undermined by resistance from provincial governments, and the central government close to bankruptcy, Carlos Menem, inaugurated as president in July 1989, set out to get the economy under control.

The successes enjoyed by Argentina in the 1990s, described below, were followed by a total collapse in 2001–02. Ultimately, the tension between lax fiscal policies and a strong currency brought on a financial crisis that forced the government to default on much of its debt, after which the currency lost three-fourths of its value in foreign exchange, and the government fell. Analysts later generally treated the collapse as the inevitable consequence of the policies of the 1990s, abetted by the misguided support of the IMF, and wrote about it as the chronicle of a death foretold.[7] That is not the approach taken in this History. Here, the goal is neither to cast blame nor to excuse or paper over mistakes. The goal is to recount the interaction between Argentina and the IMF as it transpired at the time, without reinterpreting it in the glaring light of the tragedy that followed.

Practically everyone agreed at the beginning of the 1990s that Argentina's policies of the previous decade could not continue. The ideological divide between Argentine and IMF officials, and between those who rejected and those who embraced openness to international trade and finance, had become much narrower. Seeking financial stability as a path toward sustainable growth had become a common cause. The question was how best to find that path. When the government took its first decisive steps, some analysts—in Argentina, at the IMF, and in financial markets—were skeptical that the experiment would succeed. Others had more confidence. The outcome, whether the break with the past would finally succeed or fail, was not inevitable.

The probability of long-run success fluctuated greatly over the next several years. In view of the record of failure in the 1980s, that probability looked fairly low at the outset. As Chapter 10 shows, prospects improved greatly in the mid-1990s after the government took strong measures to weather the contagion effects of the financial crisis in Mexico. Subsequently, as discussed in Chapter 12, new shocks combined with flagging efforts weakened the outlook again. Both the authorities and the IMF made some good decisions along the way, and some bad. In the end, the skeptics had their

[6]Relations between the IMF and Argentina in the 1980s are covered in Boughton (2001), pp. 327–36 (on the initial crisis in 1982), pp. 385–401 (on the effort to contain the crisis in 1983–85), pp. 461–75 (on the subsequent efforts of 1986–87), and pp. 520–26 (on the last program of the 1980s, approved in 1989).

[7]See, for example, Mussa (2002); Independent Evaluation Office (2004); and Blustein (2005).

day. But the shocks and shifting fortunes could not be foreseen at the dawn of the decade, which is where this story begins.

In November 1989, in a tribute to the power of hope to overcome bitter experience, the IMF approved a stand-by arrangement for Argentina: the thirteenth arrangement in Argentina's 33 years of membership. Financial markets remained highly skeptical of the government's ability to stabilize its own financial position, and capital flight and price inflation persisted. Unless the IMF was willing to take a substantial risk by resuming lending, Argentina had little hope of renegotiating its debts and thus little hope of escaping the crisis without another default. As soon as the Executive Board approved the arrangement, Argentina borrowed $234 million of the total 17-month commitment of $1.4 billion (SDR 1,104 million).

To build on this show of confidence, Menem's government tried to slow inflation by forcibly mopping up liquidity. In January 1990, they introduced the "Plan Bonex," which froze time deposits in Argentine banks and replaced those deposits with less-liquid bonds denominated in U.S. dollars. The effect was the opposite of what was intended: capital flight intensified, the exchange rate depreciated sharply, and the fiscal overruns that had already undermined the Fund-supported program increased further. The Fund sent a staff mission to Buenos Aires to try to rescue the program, and it had some success as the government itself was trying desperately to find some way to restore equilibrium. On March 5, Menem announced a generalization of the country's value-added tax. The additional tax revenue went some distance toward balancing the budget—but not enough to finance the external deficit or to stop the accumulation of arrears to foreign creditors. The Fund took the unusual step of canceling (not just postponing) the second drawing on the stand-by arrangement and reducing the size of the arrangement to $1.2 billion.[8]

For the rest of 1990 and the first two months of 1991, Menem continued to make progress in fits and starts. The government resumed partial payments on its foreign debts, privatized some major enterprises including the telephone company and the national airline, and prohibited the indexation of austral-denominated contracts, including wage agreements. The IMF provided extensive technical assistance throughout this period on the restructuring of tax policy and tax administration, reorganizing the central bank to make it independent of the government, and strengthening the accounting and statistical systems of the central bank.[9] Argentina made two more drawings on the stand-by arrangement, in June and December 1990, but the Fund canceled another drawing in November and again reduced the total amount of the arrangement.[10]

[8]See minutes of EBM/90/82 (May 25, 1990).

[9]For an overview of this technical assistance, see "Argentina—Request for Stand-By Arrangements," EBS/91/107 (July 26, 1991), Suppl. 1, p. 39.

[10]When the stand-by arrangement expired on March 31, 1991, Argentina had drawn SDR 506 million, out of an initial approved amount of SDR 1,104 million. The Fund had canceled two drawings totaling SDR 368 million, and SDR 230 million remained undrawn.

To give more impetus to the reform effort, Menem made two major personnel changes at the end of January 1991. First, he moved Domingo Felipe Cavallo from the post of minister of foreign affairs to that of minister of the economy. Cavallo had a Ph.D. in economics from Harvard University and had been governor of the central bank in the early 1980s. He now wanted to build on that experience to try a bold new approach to macroeconomic policy. Second, Menem named Roque Benjamin Fernandez—an economics Ph.D. from the University of Chicago and a highly respected university professor in Buenos Aires—to lead the central bank. The combination of Cavallo's boldness and Fernandez's conservative Chicago credentials pointed to a new era in which the legacy of hyperinflation might finally be conquered in Argentina.

The decisive break with the past came on March 27, 1991, when the Argentine Congress approved adoption of the Convertibility Law. Similar to a currency board arrangement, this law required the central bank to hold liquid foreign exchange at least equal to the monetary base. Designed to force domestic inflation to fall immediately to international levels, the convertibility scheme was effectively equivalent to a currency board arrangement pegging the Argentine austral to the U.S. dollar at a rate of 10,000 to 1.[11] This plan, designed primarily by Cavallo, distressed the Fund staff and management, who feared that it would lock in an overvalued currency, force the government to tighten fiscal policy by much more than was politically feasible, and seriously weaken the real economy.

The primary challenge for the convertibility plan was to get fiscal policy under control. The government had a large stock of debt to foreign creditors, much of which was in arrears, and it needed to generate a steady stream of net revenues to service that debt. Until this point, it had been able to supplement its small primary surplus with seigniorage revenues, at the expense of generating extremely high inflation. An abrupt end to inflation would wipe out that cushion. To avoid default, the government now would have to raise tax revenues or cut spending to generate a large primary surplus, and it would have to sustain that effort for a few years. The Fund staff was highly skeptical. The day after Cavallo announced the plan, the head of the Western Hemisphere Department (WHD), Sterie T. Beza, explained the scheme to Camdessus and noted with incredulity, "Surprisingly, the initial reaction to the Minister's statement in financial markets in Buenos Aires has been positive!"[12]

This scheme worked as intended. The plan, which took effect on April 1, 1991, quickly restored investor confidence; liquid capital flowed back into the banking system; and the central bank was able to buy large amounts of foreign exchange to rebuild

[11]The spread of currency board arrangements in the 1990s is discussed in Chapter 1. For the text of Argentina's Convertibility Law, see Cavallo (2001), Appendix II.

[12]Memorandum from Beza to the Managing Director, "Argentina—Back-to-Office Report," March 21, 1991; IMF archives, Argentina 1991 Country Files, OMD-AD, Box 7626, Accession 1995-0180-0001. The staff skepticism about the plan is spelled out in more detail in a separate memorandum from the mission chief, Armando Linde (Assistant Director, WHD), attached to Beza's.

its reserves. The following January, the government replaced the austral with a new Argentine peso worth 10,000 australs, equivalent in value to the U.S. dollar. Much of the Argentine economy was already largely dollarized, so this conversion had the psychological effect of restoring widespread confidence in the stability of the currency and in the government's ability to manage the economy.

Despite its initial skepticism, the Fund responded positively to the convertibility plan once it was in operation. In July, the Executive Board approved a new stand-by arrangement, for $1 billion (SDR 780 million, or 70 percent of Argentina's quota). Of that total, $193 million was available for Argentina to draw immediately, and another $64 million was set aside in accordance with the Brady Plan for Argentina to use to finance a debt-reduction agreement with private creditors once an agreement could be reached. The country's poor record of policy implementation during the past decade made a number of Directors nervous about the size of the arrangement, but no one refrained from approving it.[13] To everyone's relief, the government implemented the program as planned and met most of the conditions specified in the arrangement.[14]

By March 1992, the Menem government had established an adequate track record and was having enough economic success that the Fund was ready to offer more-substantial and longer-term loans. That month, the Board approved a three-year extended arrangement for $2.9 billion (SDR 2,149.5 million) to replace the stand-by arrangement, which would have expired in a few months. The money set aside for the Brady Plan had not yet been used because Argentina was still negotiating with its creditor banks. The Fund agreed to carry the set-aside provision forward into the new loan agreement, and it added a promise to augment the arrangement as a further incentive for the two parties to settle.

From that point on, the settlement of Argentina's arrears and the reduction of its external debt burden proceeded smoothly. The authorities reached an agreement in principle with their bank creditors in April 1992, signing a final deal on December 6. The agreement enabled Argentina to reschedule its interest arrears and reduce the net present value of its debt by replacing loans with Brady bonds. Bank creditors could choose whether to exchange their loans for discount bonds (bonds with a market interest rate but a reduced face value) or par bonds (full-value bonds with a reduced interest rate). The two options were priced to have the same market value, and the whole operation was calculated to be equivalent to a buyback of existing debt at 38 percent

[13]Minutes of EBM/91/102-03 (July 29, 1991).

[14]The December 1991 drawing was allowed despite Argentina's failure to adhere to the end-September limits on the fiscal deficit specified in the stand-by arrangement. The staff determined that fiscal policy was broadly consistent with the requirements of the program and that the recorded excesses were not an impediment to meeting future targets; see "Argentina—Review and Modification of Stand-By Arrangement," EBS/91/209 (December 10, 1991). The end-December targets were all met. Altogether, the three drawings on the 1991–92 stand-by arrangement totaled $600 million (SDR 438.8 million), and another $200 million was set aside to help finance a future debt-reduction agreement with commercial creditors.

of face value, approximately equal to the prevailing secondary market price at the time of the preliminary agreement. The cost for Argentina to make an initial payment of past-due interest and to provide guarantees on future payments of principal and interest was estimated at $3.7 billion, of which approximately $1 billion was to be covered by drawing on the IMF. The World Bank, the Inter-American Development Bank (IDB), the Japanese Export-Import Bank, and Argentina's own resources were to cover the rest.[15]

On December 30, 1992, less than a month after the signing of the Brady deal with the banks, the IMF Executive Board approved an augmentation of the extended arrangement. The main concern at the IMF at this time was the same one that had made the staff skeptical at the outset of the convertibility plan: although inflation in Argentina had been dramatically reduced, it was still well above the U.S. rate. With the peso firmly pegged to the U.S. dollar, international competitiveness was being steadily eroded. The current account deficit was becoming wider, threatening the long-term viability of the exchange regime. That concern, however, was offset by the impressive way that the government was reforming the Argentine economy to make it more vigorous and efficient. Thomas C. Dawson II (United States) concluded his observations enthusiastically: "We believe that the sweeping market-oriented economic reforms that are being implemented are exactly the sort of policies we had in mind when the international financial community endorsed Secretary Brady's proposals for debt and debt-service reduction."[16]

The Board's approval enabled Argentina to draw $1.2 billion (SDR 862.9 million) right away, on the understanding that the authorities would use most of the money to help finance the debt restructuring.[17] The other official creditors quickly followed suit. With this financing secured, the government floated the Brady bonds in March 1993, effectively bringing its debt crisis to a successful conclusion.

The Argentine economy continued to improve dramatically throughout this period, fueled by large capital inflows and a resurgence of domestic activity spurred by privatization, deregulation, and other market-oriented reforms. Gradually, inflation virtually disappeared, falling from nearly 5,000 percent in 1989 to less than 4 percent in 1994. GDP growth averaged more than 7 percent a year, 1991–94. The current account remained in deficit, partly owing to the high valuation of the exchange rate but also as a reflection of the rapid return of private capital. The fiscal accounts were balanced, and the country's external debt fell substantially in relation to output. After the nightmare of the 1980s, these achievements were invigorating and transformational.

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[15]"Argentina—Extended Arrangement—Review and Second Year Program," EBS/92/210 (December 15, 1992), pp. 7–8 and Table 4.

[16]Minutes of EBM/92/157 (December 30, 1992), p. 27.

[17]The scheduled drawing for December 1992 was SDR 146.2 million, excluding the scheduled set-aside. The augmentation amounted to SDR 333.9 million, and the sum of previous and planned set-asides was SDR 382.7 million. All of these amounts were made immediately available.

Although the central government under Menem was firmly committed to fiscal probity, it found its ability to control overall government spending limited by popular opinion in much of the country and by the powers granted to provincial governments under the Argentine constitution. As long as the economy was rebounding strongly and investor confidence remained high, the external deficit could easily be financed and opposition to fiscal tightening could be held in check. As a result, the authorities were able to satisfy the Fund's conditionality and continue to draw regularly on the EFF arrangement throughout 1993 and most of 1994.[18] By then, however, domestic pressures on fiscal policy were beginning to build, and investors' worries about the viability of the policy regime were growing. As shown in the next chapter, the Argentine economy and the Fund-supported policy program were again in fragile condition when the Mexican crisis hit at the end of 1994.

Brazil

Much like Argentina, Brazil opened the 1990s in a morass of economic and financial difficulties but with new leadership committed to stabilizing the economy.

The IMF had approved a stand-by arrangement for Brazil in August 1988 in the middle of newly minted optimism about the country's prospects for economic stability. The program unfortunately foundered when the central government failed to control the general government deficit or prevent an upward spiral of inflation. The stand-by arrangement went largely unused, and Camdessus concluded the Fund's last discussion of Brazil in the 1980s by warning the authorities that "the time for gradualism had clearly run out."[19]

In December 1989, the Brazilian people, also disillusioned with the country's legacy of failed economic policies, elected a new president, Fernando Affonso Collor de Mello, who promised to make a fresh start. When Collor took office the following March, he immediately announced a new economic program with an ambitious menu of liberalizing structural reforms and a floating exchange rate but also with such heterodox elements as a temporary freeze on price increases.

This New Brazil Plan (or "Collor Plan," as it was often called) was not a great success. Policy implementation continued to be hampered by political disputes and undermined by the crushing weight of the country's deeply entrenched inflationary pressures. Interest payments on external government debt were in arrears to both commercial and official bilateral creditors, and the secondary market price of Brazil's sovereign debt was hovering around 25 percent of face value. The authorities had no desire for the

[18]Argentina made all the EFF drawings on schedule through September 1994, at which time it had drawn all but SDR 278.1 million of the augmented total amount of SDR 2,483.2 million. The last two drawings were not allowed.

[19]Minutes of EBM/89/137/R-1 (October 27, 1989), p. 56. The history of the IMF's relations with Brazil in the 1980s is covered in Boughton (2001), pp. 336–45 (on the initial crisis in 1982), pp. 372–84 (on the effort to contain the crisis in 1983–85), pp. 453–61 (on the subsequent efforts of 1986–87), and pp. 526–31 (on the final stand-by arrangement in 1988–89).

Fund staff to visit Brazil while these disputes and problems were raging, out of fear that the presence of an international agency would simply inflame the opposition. Nonetheless, they needed international support to regularize relations with creditors and put the economy on a sustainable growth path. After a few months' hesitation, they invited the IMF to send a staff mission to negotiate terms for a stand-by arrangement.

Thomas Reichmann, who had worked on Brazil through much of the 1980s and was now an Assistant Director of WHD, spent all of August 1990 in Brasilia with a staff team and brought home at the end of the month an agreement on an acceptable policy program for the next year and a half. Brazil's central bank governor, Ibrahim Eris, went to Washington the next week to put the final touches on a draft Letter of Intent. On September 7, Camdessus informed the Executive Board that everything was set, and that Brazil's request for an arrangement would be submitted to them by the middle of the month.[20]

It was not to be. The Brazilian authorities needed to take the next crucial step toward recovery: reaching agreement with commercial bank creditors on a debt- and debt-service-reduction deal consistent with the Brady Plan. That required both sides to agree on terms that reflected the market evaluation of Brazil's huge stock of outstanding debts. The Brazilian team would be led by an experienced diplomat, Ambassador Jorio Dauster, and the banks' advisory committee would be led by William R. Rhodes, Vice Chairman of Citibank and the world's most experienced debt negotiator. Despite these credentials, the discussions started badly and then stumbled downhill.

At a meeting in New York on October 10, with Reichmann on hand to help explain the policy program, Dauster tabled a proposal that the banks flatly rejected on the grounds that it was far below market value. The Fund also considered it unacceptable, especially because it seemed inconsistent with what Dauster and Eris had promised to Camdessus in early September. Several follow-up meetings were held, including one in which Rhodes and his boss at Citibank, John S. Reed, went to Washington to try to persuade Camdessus to lean harder on the Brazilians. Those efforts failed, and at the end of November, Rhodes abandoned the effort.[21]

With no prospect for a bank deal, the program the IMF had intended to support could not be financed. Camdessus had no choice but to drop his plan to take Brazil's

[20]See memorandums from Beza to the Managing Director, "Mission to Brazil," September 4, 1990; and "Brazil—Meeting with the President of the Central Bank," September 6, 1990; both in IMF archives, OMD-AD, Accession 1994-0289-0001, Box B6908. For the Managing Director's report to the Executive Board, see minutes of EBM/90/137 (September 7, 1990), p. 3.

[21]See memorandums from Beza to the Managing Director, "Report of Staff on First Round of Negotiations between Brazil and the Commercial Banks," October 12, 1990; "Brazil—Meeting with the President of the Central Bank," October 23, 1990; "Meeting with Mr. Reed and Mr. Rhodes," October 24, 1990; and "Brazil—Negotiations with Banks," November 7, 1990. On the adjournment of the meetings, see cable from the banks' advisory committee, December 7, 1990. All these documents are in IMF archives, OMD-AD, Accession 1994-0289-0001, Box B6908.

request to the Board for approval.[22] At the end of 1990, Collor's first attempt at reviving the Brazilian economy had come to nothing.

Collor and his economic team made a second attempt in January 1991, announcing a new program that the press called "Collor II." Like its predecessor, it relied heavily on controls to stifle price and wage inflation, combined on this occasion with substantial increases in gasoline prices and other public sector tariffs on basic consumer goods and services. The new plan worked adequately for a few months, while Dauster resumed negotiating with the banks' advisory committee. Those negotiations led to a settlement of a portion of Brazil's interest arrears to foreign banks in early April, at which point the authorities renewed their request for a stand-by arrangement with the IMF. Camdessus responded by sending Reichmann back to Brasilia to assess the new program, but in the middle of those meetings Collor's economic team abruptly resigned. Reichmann and his team returned to Washington to wait for the new finance minister, Marcílio Marques Moreira, to get settled.

Although the resignations had been triggered primarily by personal rather than policy issues, the appointment of Moreira—who had worked at the IMF 30 years earlier—turned out to be pivotal in Brazil's efforts to resolve its debt crisis. For the first time in Brazil's modern history, the government decided to try to stabilize the economy by using conventional ("orthodox") macroeconomic policies rather than by relying on controls and other heterodox measures. Just as important, the new finance team decided to emphasize negotiation over confrontation in its international discussions. From then on, negotiations with creditors—now led by Pedro Sampaio Malan, who had spent the preceding five years in Washington as Brazil's Executive Director at the World Bank and then the IDB—proceeded apace.

When the IMF Executive Board finally concluded the Article IV consultation in October 1991 (the first Board meeting on Brazil in two years), discussions aiming at a Fund-supported program were nearly complete. The authorities needed only to flesh out the draft Letter of Intent and to get the Brazilian Congress to enact several fiscal measures considered critical for macroeconomic stability. The real obstacle to the IMF's agreement, however, was the government's weak international credibility, the legacy of a decade of disappointment.

Personally skeptical and facing the possibility of a rebellion by Executive Directors, Camdessus flew to Brasilia in late November 1991 to assess the strength of Collor's commitment to the program and of his ability to get it adopted by congress. The trip nearly turned into farce when Camdessus arrived in the capital only to find that the president had just left for a summit meeting of Latin American heads of state in Cartagena, Colombia. Government officials in Brasilia quickly realized the importance of rearranging the meeting, and they saved the day by putting an official plane at the

[22]The requirement for approval, under the Brady Plan and the IMF's general policy on financing assurances, was that discussions with creditors be "firmly launched with a good prospect of a satisfactory conclusion"; see "Brazil—Financing Assurances," EBS/90/163, Suppl. 1 (September 21, 1990).

Managing Director's disposal and flying him directly to Cartagena. There, he met with Collor, who made a convincing case for proceeding. In a press conference after the meeting, and again in remarks at the IDB in Washington a few days later, Camdessus praised Collor and expressed confidence that the program would succeed.

The Executive Board approved the stand-by arrangement on January 29, 1992, but only after several Directors from creditor countries expressed deep misgivings about the strength of Brazil's economic program and about the Managing Director's public discussions of it ahead of the Board meeting. Feeling that they had been presented with a *fait accompli*, all Directors approved the request, but they strongly put management on notice that subsequent drawings and any future request for a larger or extended arrangement would be subjected to a higher standard.[23]

Directors' worries and misgivings were well placed, despite Collor's best efforts to implement the program as promised and the best efforts of the international community to provide support. The Paris Club of official creditors agreed in February 1992 to reschedule Brazil's debts and to accept a plan to settle outstanding interest arrears. In July, the authorities also reached an agreement in principle with the banks' advisory committee on a comprehensive reduction in debt and debt service. By then, however, Collor was bogged down in a political scandal that would soon lead to his impeachment and removal from office. With the government unable to formulate a credible fiscal policy for 1993, the IMF had no basis for continuing to lend. As with the 1988 stand-by arrangement, Brazil made only the initial drawing and then fell out of compliance.[24]

In May 1993, Collor's successor as president, Itamar Franco, picked Fernando Henrique Cardoso to be his fourth finance minister in the space of six months. Cardoso immediately set out to strengthen Brazil's economic and financial policies, but it took him some time to convince skeptical investors of his ability to make a real break with the failed policies of the previous decade. IMF officials were equally skeptical. When the authorities requested a new stand-by arrangement in July, Beza told them that the request "would be very difficult to support in view of experience." He suggested that they would need to show more of a track record on fiscal policy and inflation control.[25]

Cardoso responded to the Fund's rebuff by pushing ahead on his own. The terms of the July 1992 agreement with Brazil's bank creditors posed the chief obstacle, by

[23]Minutes of EBM/92/9 and EBM/92/10 (January 29, 1992). Although the Board meeting was conducted in restricted session, a detailed and accurate account of it was leaked immediately afterward to a Washington-based reporter from a Brazilian newspaper; see Sotero (1992). For the Sotero article, an English translation, and related internal correspondence, see attachments to a February 13, 1992, note to the Acting Managing Director from Leo Van Houtven (Secretary of the Fund); IMF archives, OMD-AD, Accession 1996-0187-0001, Box B9105. The source of the leak was never uncovered.

[24]The arrangement was for $2.1 billion (SDR 1.5 billion). On approval, Brazil drew the equivalent of $180 million, and the Fund set aside $60 million to help finance a future Brady deal between Brazil and its bank creditors. The rest of the commitment was unused when the arrangement expired in August 1993.

[25]Memorandum from Beza to the Managing Director, "Meeting with Brazilian Officials," July 27, 1993; IMF archives, OMD-AD, Accession 1997-0067-0001, Box B9955.

requiring the government to collateralize its rescheduled debts with zero-coupon bonds to be issued by the U.S. Treasury in accordance with the Brady Plan. The Treasury would not issue the bonds in the absence of an IMF-supported economic program, and the normal practice in other Brady Plan countries had been to use part of the money borrowed from the Fund to finance the purchase of those bonds. To circumvent this roadblock, the central bank—led by Malan, appointed as governor in September 1993—began quietly (through a leading U.S.-based investment bank) purchasing existing U.S. Treasury zero-coupon bonds in the secondary market using its own dollar reserves.

The agreement with the banks' advisory committee was to become effective once negotiations on specific terms were concluded successfully with at least 95 percent of Brazil's several hundred commercial bank creditors. The agreement offered creditors a complex array of options for restructuring a total of $46.6 billion of debts, and it gave them a year to complete the deal. The deadline was repeatedly extended, and the critical mass of approvals was finally reached. The comprehensive agreement—restructuring all eligible debt with a new value of about 38 percent of the original level—was signed at a ceremony in Toronto, Ontario (Canada), on November 29, 1993. The primary remaining obstacles were for the authorities to acquire the necessary collateral and for the IMF to approve a stand-by arrangement to ensure implementation of the supporting policies.

In March 1994, bank creditors agreed to waive the requirement for a Fund-supported program, in effect agreeing to place more trust in President Franco, Finance Minister Cardoso, and Central Bank Governor Malan than the IMF was yet willing to do. This extraordinary reversal negated the IMF's conventional role of providing financial support backed up by policy conditionality when private creditors were not yet ready to lend or invest. From the banks' perspective, even if the IMF was right and the fiscal policy stance turned out to be inconsistent with inflation control, Brazil was strong enough financially to service its external debts once a debt-reduction deal was in place (see Malan, 2004, pp. 165–66).

On April 15, 1994, Brazil deposited $2.8 billion in zero-coupon U.S. Treasury bonds in an escrow account at the Bank for International Settlements (BIS) in Basel, Switzerland. Brazil's Brady deal was complete, and its relations with its bank creditors were back on normal footing.[26]

Restructuring and reducing external debt was an important step in Brazil's recovery from the debt crisis, but the bigger and more crucial challenge was to restructure economic policies to prevent another debt crisis. On this front, too, the IMF's own reluctance to resume lending in the absence of a solid and sustained move toward a sustainable fiscal balance relegated it to the sidelines. In the last quarter of 1993, Cardoso and Malan began to develop a new and truly ambitious plan to wring the

[26]For a detailed description of the agreement, see "Brazil—Recent Economic Developments," SM/94/182 (July 14, 1994), pp. 18–23.

inertial force of high inflation out of the economy. They discussed this proposal with a Fund mission, led by José Fajgenbaum (Assistant Director, WHD), in November and announced the outlines of the plan at the end of that month.

The basis for the Cardoso plan was recognition that extremely high inertial inflation had created such a large fiscal deficit that the hole could not realistically be filled simply by the conventional means of cutting expenditures or raising taxes. The first step had to be to change market expectations and contract-writing practices so that inflation could be reduced quickly without wrecking the economy. For that purpose, the government would begin by introducing a new indexation mechanism linked to the U.S. dollar, which it hoped would be taken up by the private sector as superior to the backward-looking indexing to inflation that was then the almost universal practice. Once the new indexation scheme was established, the original plan called for the government to replace the cruzeiro with a new currency pegged to the dollar, perhaps by introducing a currency board. The new exchange regime would be reinforced by new procedures for setting public sector wages, tax rates, and other key variables.[27]

The staff reacted cautiously to this scheme, just as it had to the convertibility plan in Argentina two years earlier—and for essentially the same reason. Unless the government could tighten fiscal and monetary policies substantially and quickly, and maintain that stance for as long as it took to break fully the momentum of inflation, the plan would almost certainly fail. Specifically, the staff calculated that the public sector would have to achieve a primary budget surplus (the fiscal balance excluding interest payments on government debt) on the order of 1 percent of GDP in 1994 to avoid a financial meltdown. No surplus was then being contemplated, and achieving one seemed unlikely. Cardoso and his economic advisors were, however, determined to push ahead with or without IMF support.

The Fund tried to help, though without committing any money and without formally endorsing the policy program. The staff agreed to monitor the economic program for 1994 and to continue the frequent missions that had become the norm for Latin America's largest economy. Twice in February 1994 Fajgenbaum and his team returned to Brasilia to conduct Article IV consultation discussions, with the ancillary intent of helping the authorities hammer out the details of the new policies. In the middle of the second mission, on February 28, the authorities announced what came to be known as the Plano Real, named after the new index: the Unidade Real de Valor. The indexation mechanism would be introduced immediately, and once it was fully operational in the middle of the year, a new currency—the Brazilian *real*, a name selected to invoke both a royal heritage and a solid real value—would be issued to replace the cruzeiro. No currency board would be established because the indexation scheme itself was expected to serve as an anchor for expectations and for monetary policy.

[27]For an inside account of the origins of the scheme, see Cardoso (2006), pp. 179–88.

When the *real* was introduced on July 1, 1994, it was allowed to float against the U.S. dollar, subject to a commitment by the government to prevent the currency from depreciating below parity with the dollar. For the rest of the year, the new currency appreciated against the dollar, and the central bank continued rebuilding its stock of foreign exchange reserves.

The Fund staff remained skeptical about the sustainability of the Plano Real. Until the government could take the steps necessary to achieve a primary fiscal surplus, the staff view was that Brazil would be at risk of a ruinous resumption of inflation. The Fund admired the "considerable skill" with which the authorities phased in the new currency and their "initial success" in reducing inflation, but it also "cautioned . . . that a lasting reduction . . . had not yet been secured."[28] Management and the Board were willing to consider new lending, but only after Brazil showed more lasting success in carrying out the program.

The economy performed better than expected, owing primarily to a resurgence of confidence by domestic and foreign investors. Except for a few months after the Mexican crisis (see Chapter 10), private capital flowed into Brazil. Price inflation fell sharply and persistently, from a monthly rate of 47 percent in June 1994 to just over 1 percent eight months later. Even with the tightening of macroeconomic policies that accompanied the Plano Real, real GDP grew strongly, by 5.7 percent for 1994 as a whole. The rebound in economic activity produced a primary fiscal surplus that exceeded what the Fund had insisted upon (and that even the authorities had thought was not practical). Despite the trauma induced by the Mexican crisis at the end of the year—stock prices on the São Paulo exchange fell by 40 percent in three months—the contagion effect from the peso crisis was soon contained, and Brazil had no further need for IMF financing until a new financial crisis hit in the fall of 1998 (see Chapter 12).

Mexico

The transformation of the Mexican economy seemed less dramatic than those of Argentina and Brazil because it took place more gradually and in several stages. Although faced with a severe debt crisis, Mexico avoided defaulting throughout the 1980s. It liberalized its trade regime and joined the General Agreement on Tariffs and Trade (the forerunner of the World Trade Organization) in 1986. In 1989, it became the first country to complete a Brady deal with its commercial bank creditors, a deal supported by the IMF with an exceptionally large extended arrangement using the

[28]See the staff appraisal in "Brazil—Staff Report for the 1994 Article IV Consultation," EBS/94/204 (October 21, 1994), pp. 18–21; and "The Chairman's Summing Up at the Conclusion of the 1994 Article IV Consultation with Brazil, Executive Board Meeting 94/100 – November 16, 1994," SUR/94/132 (November 29, 1994). Stanley Fischer, who joined the IMF as First Deputy Managing Director that fall, took a more sanguine view of Brazil's prospects and subsequently played a key role in shifting the Fund's stance.

EFF.[29] For the next four years, the government continued to pursue sound macroeconomic policies and to loosen regulations and promote private sector economic activity. Foreign capital flowed back into the country after a virtual absence of more than seven years. As the capstone of this transformation, Mexico entered into a major free trade agreement with the United States and Canada—the North American Free Trade Agreement (NAFTA)—at the beginning of 1994. A few months later, it was granted membership in the Paris-based Organization for Economic Cooperation and Development (OECD)—the "club" of advanced industrial countries.

Although this transformation may have been relatively gradual, its effects on the Mexican economy were revolutionary. Inflation fell from almost 30 percent in 1990 to 7 percent in 1994, while output growth resumed and averaged 3 percent a year. For three years, Mexico continued to draw on the EFF arrangement without major difficulty. In May 1992, the IMF extended the arrangement for a fourth year as a signal of its continuing support, but Mexico announced that it no longer intended to draw on it. By the time the arrangement expired a year later, Mexico was repaying its earlier drawings and appeared to have graduated decisively from dependence on official creditors. "Nevertheless," averred Thomas Dawson (United States), "we still have some nagging fear that, with everything looking so right, something might yet be wrong."[30]

Other Major Brady Agreements

Argentina, Brazil, and Mexico in the early 1990s provide outstanding examples of how troubled and debt-ridden economies can be turned around through a combination of strong domestic economic policies and international support. The economies of other countries in the so-called Baker 15 (see Table 9.1, note b) changed less radically in these years, but several benefited from the Brady Plan, and almost all enjoyed better performance in the early 1990s than they had in the preceding years. Two of these countries, the Philippines and Venezuela, completed Brady deals early in the decade. Two others—Ecuador and Peru—completed the process later in the decade.

The Philippines

Economic recovery in the Philippines responded to the country's major political changes. The election of Corazon C. Aquino as president in 1986 marked the beginning of democratization and a new era of cooperation with the international community. The IMF had provided financial assistance to the government of Aquino's autocratic predecessor, Ferdinand Marcos, for a long time, but the country

[29] The history of the IMF's relations with Mexico in the 1980s is covered in Boughton (2001), pp. 281–318 (on the initial crisis in 1982), pp. 359–72 (on the effort to contain the crisis in 1983–85), pp. 437–53 (on the subsequent efforts of 1986–87), and pp. 510–15 (on the EFF arrangement and Brady agreement in 1989).

[30] Minutes of EBM/92/64 (May 20, 1992), p. 16. The realization of that fear is discussed in Chapter 10.

in the first half of the 1980s had been troubled by inconsistent economic policies, financial corruption, and increasingly widespread political opposition to Marcos's rule. The Aquino government successfully restored a measure of economic stability to the Philippines, and the IMF supported that effort with a stand-by arrangement (1986–88) and an extended arrangement approved in May 1989.[31]

Performance under the EFF arrangement started off well, and in January 1990 the government used part of the proceeds to buy back a small part of its external debt at a 50 percent discount, under the terms of the Brady Plan. Completing the debt-reduction plan, however, proved to be more difficult.

A series of shocks hit the economy in 1990, including a drought, an earthquake, a major typhoon, and the sharp run-up in oil prices after Iraq's invasion of Kuwait. The government responded by easing macroeconomic policies, but that move put them out of compliance with the EFF arrangement, and the Fund suspended disbursements throughout 1990. In February 1991, the Fund canceled that arrangement and replaced it with a smaller and shorter-term stand-by arrangement, supplemented by a sizeable drawing under the terms of the Compensatory and Contingency Financing Facility (CCFF), as a way of restarting the adjustment program and catalyzing an agreement with bank creditors. The latter process took more than another year to complete, but the Philippines finally reduced its debt service to a sustainable level through a comprehensive Brady deal in July 1992.[32]

Before the debt-reduction agreement, the burden on the economy had reached such a point that the IMF found it necessary (in April 1992) to declare the Philippines eligible for loans on concessional terms through the Enhanced Structural Adjustment Facility (ESAF). Following the debt-reduction agreement, the Philippines made a remarkable, though still gradual, recovery. President Aquino declined to run for reelection, and in June 1992 this young democracy recorded a smooth electoral transition to a new president, Fidel V. Ramos. Meanwhile, the Fund extended the stand-by arrangement twice, to March 1993, and the government met the conditions and drew on it regularly. A new extended arrangement was approved in 1994, but by then the Philippines was enjoying good access to private capital on favorable market terms. After the initial drawing, the authorities decided to treat the arrangement as precautionary and to borrow no more against it. In December 1995, the Fund removed the Philippines from the list of countries eligible to borrow from the ESAF, a privilege that the country had chosen not to use.

[31]The history of the IMF's relations with the Philippines through 1989 is covered in Boughton (2001), pp. 508–10 (on the 1989 EFF arrangement) and 619–29 (on the prolonged use of Fund resources from 1962 to 1989).

[32]For the background to the 1991 arrangement, see "Philippines—Staff Report for the 1990 Article IV Consultation and Request for Stand-By Arrangement and Purchase Under the Compensatory and Contingency Financing Facility," EBS/91/17 (February 6, 1991). The 1992 Brady agreement is described in "Malawi—Request for a Fourth Annual Arrangement Under the Enhanced Structural Adjustment Facility," EBS/92/153 (September 16, 1992), pp. 44–45.

Venezuela

Another country in the Baker 15—Venezuela—got off to a fast start toward recovery from the debt crisis, but it was unable to sustain the momentum. In June 1989, in a strong signal of support for the macroeconomic policies being implemented by the newly elected president, Carlos Andres Pérez, the IMF approved an EFF arrangement for Venezuela with a potential total of $5.3 billion, or just over three times the member's quota.[33] Bank creditors still balked at agreeing to reduce Venezuela's debt because they believed that this oil-exporting country had the resources to service its debts in full. After a few months, however, they relented, and the two parties reached a Brady-type settlement in June 1990.

Venezuela drew regularly on its extended arrangement through 1991, but then ran into difficulties. Despite high oil prices in the months surrounding the Gulf War, it was politically difficult for Pérez to get the Venezuelan Congress to put fiscal policy on a solid footing, either by cutting expenditure or by enacting a value-added tax. As oil prices began to fall again, the government found itself in a fiscal dilemma, and the end-1991 performance criteria were breached. The authorities and the Fund never could reach agreement on a plan to restore fiscal balance. Two attempted military coups during 1992 did not help matters, and the arrangement expired in March 1993 with almost $2.6 billion (SDR 1.85 billion) unused.

The Pérez government collapsed in 1993 in a financial corruption scandal that led to a banking crisis in 1994. Pérez's eventual successor, Rafael Caldera, was unable to restore stability, and the economy stagnated for several years until oil prices again spiraled upward in the late 1990s. Venezuela's last IMF borrowing of the decade occurred in 1996, when the government made a promising start on a fiscal retrenchment program, and the Fund responded by approving a one-year stand-by arrangement. Implementation of that program also fell short of expectations. The government made only the initial drawing, and its request for a follow-up EFF arrangement had to be abandoned.

Ecuador

Ecuador, like Venezuela, benefited from high world prices for its oil exports in the early 1990s. The government also tried to take more lasting measures to limit its fiscal deficit. In anticipation of a Brady agreement with bank creditors, the IMF approved a stand-by arrangement in December 1991 with a provision for setting aside part of each drawing to finance future debt reduction. Unfortunately, the country's fiscal effort soon faltered, no drawings were made after the initial one, and Ecuador's negotiations with bank creditors made little progress. By 1994,

[33]The amount approved at that time was the equivalent of $4.6 billion (SDR 3.7 billion). The decision also provided for a possible augmentation by 40 percent of quota once agreement was reached with bank creditors. The Fund eventually augmented it by a much smaller amount (11 percent of quota) in December 1990; see Boughton (2001), pp. 515–19.

a new government was having more economic success, and the Fund made a second effort to help rid Ecuador of its commercial debt overhang.

Once the government had achieved some early successes in reducing inflation, removing inefficient subsidies, and stabilizing its fiscal accounts, the Fund approved a 22-month stand-by arrangement in May 1994. Ecuador did not immediately draw on it, but the Fund's approval enabled both the Paris Club and commercial bank creditors to reschedule Ecuador's debts. In November, the Fund reinforced its support by releasing the set-asides and augmenting the size of the arrangement to help finance the conversion of bank debt into Brady bonds and other debt- and debt-service-reduction operations. Ecuador then made a single drawing of about $146 million (SDR 98.9 million). As 1994 drew to a close, Ecuador appeared to be progressing steadily on a path of sustainable economic growth.

This period ended suddenly in January 1995, when a long-simmering border dispute with Peru erupted into open warfare. The cost of the conflict and its disruptions to normal activity halted the economic program. The Fund provided nonfinancial assistance by having the staff monitor the government's economic program for 1995–96, but stability remained out of reach.[34]

Peru

Next door to Ecuador, Peru was among the last countries to issue Brady bonds. At the beginning of the decade, Peru had protracted arrears to the Fund and other creditors, and it had been ineligible to borrow from the Fund since 1986. The outlook brightened considerably in June 1990, when Alberto Fujimori won the election to succeed Alan García as president. García had initiated Peru's payments arrears by decreeing that the government would use no more than 10 percent of its export receipts to service its external debts. Fujimori pledged to take a more cooperative approach and to adjust economic policies in an effort to strengthen the country's finances and restart economic growth.

The IMF responded quickly to Fujimori's initiative. As discussed in Chapter 16, it accepted Peru into the first group of countries that were eligible to undertake a Rights Accumulation Program to settle arrears by establishing track records of good economic policies. Peru successfully completed the program in March 1993, leading the Fund to approve an EFF arrangement for $1.4 billion (SDR 1,018 million, or 218 percent of quota). That arrangement provided for 25 percent of each scheduled drawing to be set aside to finance an anticipated debt-reduction agreement with commercial creditors.

After making the March 1993 drawing from the Fund, Peru recorded a remarkable turnaround in economic performance. Thanks in part to a major privatization effort and liberalization of international trade, private capital began flowing into Peru in steadily increasing amounts. Growth accelerated, the exchange rate appreciated, and inflation fell to internationally comparable levels. Not even the 1995 military conflict with

[34]Subsequent developments are discussed in Chapter 12.

Ecuador could throw this improvement substantially off track. The government met all the conditions in the EFF arrangement, but it chose not to borrow any of the money after the initial drawing, instead treating the arrangement as precautionary and as a continuing signal of international support. Ironically, this strong performance made reaching a debt-reduction settlement with commercial creditors more difficult, and those negotiations continued throughout the three years the arrangement was in effect.

The final stage in Peru's resolution of its debt overhang came in 1996–97. Peru reached an agreement in principle with its commercial creditors in June 1996, and the Fund approved another three-year EFF arrangement the following month. On that basis, and with an additional commitment from the Fund and Peru to maintain enhanced surveillance for three years after the arrangement expired, the Paris Club granted Peru a multiyear rescheduling agreement. Peru successfully carried out the economic program and completed the debt-reduction operations in February 1997. Peru drew on the arrangement primarily to help finance the issuance of Brady bonds and the repurchase of some of its bank debt.

The Rest of the Baker 15

In the first half of the 1990s, most of the other countries in the Baker 15 enjoyed achievements comparable to those discussed above. **Yugoslavia**, which had an IMF stand-by arrangement in 1990, posed the most problems upon its descent into civil war. The federation dissolved in 1992 and was replaced by five successor states, each of which accepted responsibility for a share of the outstanding debts. As hostilities continued, those successors had varying degrees of economic success and varying access to IMF support for the rest of the decade (see Chapters 2 and 5).

At the other extreme, **Chile** recovered on its own. After Augusto Pinochet stepped down as president in 1989 and allowed free elections to resume, private capital began flowing into Chile in such quantities that the government felt it prudent to impose selective controls on inflows. These "speed limits" (differential reserve requirements on short-term inflows) generally worked well and became a model for applying capital controls effectively, so long as they are limited in scope and duration and applied in an economy with a sound financial system.[35] Chile had no need for official financial support in the 1990s.

The two low-income countries in this group—Bolivia and Côte d'Ivoire—reached debt-reduction agreements with commercial creditors in which they bought back their debts at a deep discount using funds provided by the World Bank. In August 1989, the Bank established a Debt Reduction Facility for the lowest-income ("IDA-only")

[35]For an analysis of how Chile's controls worked, see Cowan and de Gregorio (2007). For a review of the IMF's reaction to the controls, which began positively, turned negative after the first few years, and then again became more favorable, see Independent Evaluation Office (2005), p. 28. Chile abolished its controls in September 1998.

countries, funded by IBRD net income and by cofinancing from donor countries.[36] **Bolivia** bought back $170 million of commercial debt in 1991–93 for 16 percent of its face value. **Côte d'Ivoire** drew on the facility to buy back $724.5 million at 24 percent of its face value through 1998. The IMF's role in these two cases was to provide financing, mostly through its own concessional facility, the ESAF,[37] to support the countries' macroeconomic stabilization and structural reform programs; and to provide debt relief through the Heavily Indebted Poor Countries Initiative (see Chapter 13). IMF support also was a precondition for the participation of most donors in debt relief.

As noted above, **Colombia** and **Nigeria** took advantage of the IMF's seal of approval but did not request any loans during this period. Nigeria obtained a Brady agreement in 1991 while implementing a program supported by a precautionary stand-by arrangement from the IMF. **Morocco** issued Brady bonds as part of a 1990 rescheduling agreement with bank creditors. The IMF supported that process with two stand-by arrangements, in 1990 and 1992. **Uruguay** began issuing Brady bonds in 1991, financed mostly with its own money and loans from the World Bank and the IDB, but also in small part by set-asides from a Fund stand-by arrangement. Uruguay also made a strong effort to liberalize its economy, with good results on both growth and price stability. A successor stand-by arrangement in 1992 was mainly for precautionary and signaling purposes.

Other Debt-Reduction Agreements

Those classified as the Baker 15 in 1985 were not the only developing countries to begin the 1990s with an unsustainable overhang of debt to foreign commercial creditors. A brief review of the others illustrates just how widespread and diverse the circumstances were, and the extent to which the IMF had to adapt its responses to those circumstances.

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[36]Within the World Bank Group, the International Bank for Reconstruction and Development (IBRD) lends to middle-income developing countries on market terms, and the International Development Association (IDA) lends to low-income countries on concessional terms. Near the margin, some member countries (known as "blend" countries) are eligible for a mix of loans from both agencies. Those that receive loans only from the IDA are referred to as IDA-only countries. For an explanation of how the Bank's facility operated, see the World Bank website, at http://go.worldbank.org/2CRHS4N500.

[37]In the 1980s, the Fund lent regularly to Côte d'Ivoire on market terms, through an extended arrangement, five ordinary stand-by arrangements, and drawings on the Compensatory Financing Facility (CFF) and the Buffer Stock Financing Facility (BSFF). After one more stand-by arrangement in 1991–92, the Fund shifted to concessional financing for Côte d'Ivoire and approved two ESAF arrangements (1994–97 and 1998–2001). The latter arrangement included an augmentation of access by $70 million (SDR 51 million) to help cover the upfront costs of restructuring commercial debt; see "Côte d'Ivoire—Staff Report for the 1998 Article IV Consultation and Request for Arrangements under the Enhanced Structural Adjustment Facility," EBS/98/36 (March 4, 1998), pp. 7 and 20. As noted in Chapter 13, that augmentation was the only instance in which ESAF resources were approved for use in a commercial debt–reduction operation.

The Dominican Republic

The Dominican Republic began the decade with a record of deteriorating macroeconomic performance and policies. After three years with a growing fiscal deficit financed by inflationary domestic policies and heavy borrowing abroad, in mid-1989 the government could no longer service its outstanding debts. Already in arrears to commercial and official creditors, in August 1989 the country also fell into arrears on its obligations to the IMF.[38]

In the summer of 1990, the authorities embarked on a serious effort to get their fiscal accounts on a more sustainable footing, then entered into extended discussions with the Fund staff aimed at settling arrears and obtaining new financial and other assistance. They settled their arrears to the Fund in April 1991 (see Chapter 16), and in August the Fund approved a stand-by arrangement and a CCFF drawing. In view of the country's large outstanding debts, the stand-by arrangement was small ($52 million, equivalent to 35 percent of quota).[39] Its primary purpose was to send a signal of confidence that would catalyze both a debt rescheduling by official Paris Club creditors and a debt-reduction agreement with commercial creditors.

The signaling strategy worked. The Paris Club agreed to reschedule the Dominican Republic's debts in November 1991, and negotiations with an advisory committee of commercial bank creditors began shortly afterward but proceeded slowly. Economic conditions continued to improve through most of 1992, and the authorities chose not to draw on the stand-by arrangement until December.[40] Ironically, that choice seems to have made negotiations with bank creditors more difficult, because it led the banks to believe the country had the capacity to repay its existing debts. The Fund staff, however, judged that the country's external balance was still fragile and that the country still deserved a Brady deal. Agreement in principle with the banks was finally reached in April 1993, and the authorities resumed making partial interest payments to banks in May.

The Fund provided further assistance in the second half of 1993 in the form of a new stand-by arrangement and another drawing under the CCFF. Although the country's economic performance deteriorated somewhat in 1994, the economy had recovered enough that the authorities could sign a final debt-reduction agreement with its bank creditors in February. Over the next several months, the authorities bought back part of the debt at a deep discount and issued Brady bonds to cover much of the rest. They

[38]For an overview of that period, see "Dominican Republic—Staff Report for the 1989 Article IV Consultation," SM/89/265 (December 13, 1989).

[39]The CCFF drawing was for $60 million (40 percent of quota) and was intended to compensate for a drop in revenues from ferronickel and other exports and the increased cost of oil imports in the wake of the Gulf War.

[40]Following completion of the second review of the program by the Executive Board in November 1992, the authorities drew all but a small portion of the stand-by arrangement in December. They drew the remaining balance in February 1993, and the arrangement expired in March.

also reached a series of agreements with official creditors. By the end of 1994, the Dominican Republic had fully resolved its debt crisis, and it had no further need to borrow from the IMF until a devastating hurricane hit the island in 1998 (see Chapter 5).

Bulgaria

Bulgaria's debt crisis was the least of its problems. One of the Soviet Union's closest allies, Bulgaria was not a member of the IMF and was heavily dependent on its trading and financial links within the Soviet bloc. As the Soviet economy crumbled in the second half of the 1980s, Bulgaria's foreign trade declined along with it. The government tried to adapt by gradually replacing the centralized command structure with a somewhat more liberal system (for example, by legalizing some forms of private ownership). Similarly to the Soviet system under Gorbachev, this partial relaxation left the economy in limbo, neither controlled sufficiently to function in the old way nor sufficiently free to function through market activity. The government forestalled collapse for a time by borrowing increasingly (and at increasingly shorter maturities) from commercial banks in western Europe and Japan, but by the end of the 1980s the burden of that debt was becoming unmanageable. Meanwhile, a popular uprising in November 1989 forced out Bulgaria's longstanding communist leader and Soviet loyalist, Todor Khristov Zhivkov. In March 1990, when Bulgaria stopped servicing its debt to foreign banks, the default was but one manifestation of general economic and political disintegration.

With Zhivkov out of the way, the Bulgarian Communist Party moved quickly in 1990 to reform itself and to begin to reorient the country away from the Soviet sphere. In February, the government applied for membership in the IMF. In May, it signed an agreement on economic cooperation with the European Communities. It held elections in June, which it won narrowly under its new banner of the Bulgarian Socialist Party. Two months later, a new coalition government was formed in which the Socialists shared power with the opposition Union of Democratic Forces. In the meantime, the economic downturn continued, not only because of doubts about the government's ability to manage the economy but also because of external shocks: the disintegration of the Soviet-led trading bloc (the Council on Mutual Economic Assistance, or CMEA) and the invasion of Kuwait and the impending outbreak of the Gulf War. The Fund staff later estimated that these shocks, by squeezing export markets and worsening the terms of trade, worsened Bulgaria's balance of payments by $3.5 billion, equivalent to 17 percent of GDP.[41] Notwithstanding these setbacks, the coalition government was unified in its desire to reform the economy and ultimately to integrate it with western Europe.

The IMF responded positively to the request for membership. Bulgaria formally joined during the IMF/World Bank Annual Meetings in Washington in September

[41]"Bulgaria—Staff Report for the 1992 Article IV Consultation and Request for Stand-By Arrangement," EBS/92/55 (March 20, 1992), p. 2.

1990 (see Chapter 2). Bulgaria's commercial bank creditors also responded positively, by forming an advisory committee chaired by the principal creditor, Deutsche Bank. The committee accepted a temporary standstill on outstanding loans and agreed to consider a debt-reduction deal under the terms of the Brady Plan.[42] Thus, by the fourth quarter of 1990, Bulgaria had at least made a start at normalizing its economic and financial relationships with the international community.

Before the government could implement its reform agenda, it needed to develop administrative capacity throughout all departments. During the first two years of Bulgaria's membership, the Fund sent about 20 technical assistance missions to Bulgaria, covering a wide range of issues including fiscal and central bank operations, bank supervision, foreign exchange management, national accounts, price statistics, and the legal system.[43] In addition, the IMF Institute held three training seminars in Sofia for Bulgarian officials, and the Fund opened a resident office in the city. These technical and training services continued throughout the decade.

As the Fund prepared to begin lending to Bulgaria, the staff saw clearly that the country's financial needs were so severe that it was likely to be dependent on official credits, including from the Fund, for a prolonged period (see Chapter 5). In this case, the Fund would have to do both what it had always done best—acting quickly to manage a crisis situation—and what it was usually reluctant to be drawn into—lending steadily to a country for many years. Eventually, however, normalization with commercial creditors and resumption of economic growth enabled the Fund to withdraw to the sidelines.

IMF lending to Bulgaria began in February 1991, with a loan of $87 million (SDR 60.6 million) to help cover the increased cost of importing oil resulting from the Gulf War. This CCFF drawing was followed quickly by a stand-by arrangement for $385 million (SDR 279 million) and a promise to increase the arrangement by up to $107 million if the price of oil continued to rise substantially. Bulgaria successfully carried out its policy commitments and borrowed almost all of the money over the next year. These sums, however, were minor relative to the country's financing needs, and a sizeable gap remained.[44]

Upon completion of the first stand-by arrangement, the Fund quickly agreed to provide another. This second arrangement, approved in April 1992, was predicated on the assumption that the Bulgarian authorities would continue to negotiate with their commercial creditors but would not reach a final agreement during the 12-month life of the Fund's commitment. The Fund would lend up to $212 million (SDR 155 million) over the coming year, without the set-aside or augmentation provisions that

[42]"Bulgaria—Calculation of Quota," EB/CM/Bulgaria/90/1 (August 6, 1990), pp. 11 and 69.

[43]See "Bulgaria—Staff Report for the 1992 Article IV Consultation and Request for Stand-By Arrangement," EBS/92/55 (March 20, 1992), Appendix I.

[44]The oil-price contingency was offered under the terms of the External Contingency Mechanism that the Fund enacted in 1988 by converting the CFF into the CCFF (see Chapter 5).

would normally have been included when a Brady deal was pending. It was understood, however, that the only way that Bulgaria would be able to repay these and earlier loans from the Fund would be by reaching an agreement on debt reduction with its other creditors.[45]

The coalition government ran into increasing difficulty maintaining broad support for its reform program, and in October 1992 it lost a parliamentary confidence vote and had to resign. Its successors were less committed to the reform process and for the next four years achieved little economic progress. When Bulgaria failed to meet the monetary targets in the Fund-supported program, the final drawing under the stand-by arrangement was not allowed.[46] Despite these setbacks, the Paris Club of official creditors rescheduled Bulgaria's outstanding debts in December, and negotiations continued with the committee of commercial creditors.

Bulgaria managed for a year without IMF financial assistance, but lending resumed in April 1994. At that time, the Fund approved a small stand-by arrangement (Bulgaria's third), for $98 million (SDR 69.7 million, or just 15 percent of quota), plus an immediately available $163 million (SDR 116.2 million) through the Systemic Transformation Facility. By this time, Bulgaria had reached agreement in principle with its commercial bank creditors, and was progressing rapidly toward final resolution of the debt crisis that had begun four years earlier. To help finance the resolution, the Fund also promised to consider augmenting the stand-by arrangement once a final agreement was reached.[47]

On July 28, 1994, Bulgaria completed its debt-reduction deal, spending $716 million of its own reserves to buy the necessary Brady bonds for collateral, buy back some of the outstanding loans at a discount, and pay other costs (Houben, 1995). It could make those payments largely because earlier loans from the Fund, the World Bank, and other official lenders had enabled the central bank gradually to build up a reserve cushion, but now it needed to rebuild its reserves fairly quickly. On September 12 the Fund doubled the size of the stand-by arrangement and made the additional amount ($102 million) available immediately. With additional support from the World Bank, the Japanese Export-Import Bank, and the Group of 24 (G24), Bulgaria replenished its reserves and fully financed its balance of payments for the rest of the year.[48]

Although Bulgaria resolved its debt crisis by 1994, the country's economic potential remained unrealized, primarily because of weak political will to make the transition

[45]See "Bulgaria—Staff Report for the 1992 Article IV Consultation and Request for Stand-By Arrangement," EBS/92/55 (March 20, 1992), pp. 17–19.

[46]The arrangement provided for SDR 155 million to be drawn in five equal installments of SDR 31 million. The first four were made on schedule, but the fifth was not.

[47]See "Bulgaria—Request for Stand-By Arrangement and Purchase Under Systemic Transformation Facility," EBS/94/52 (March 14, 1994), and minutes of EBM/94/33 (April 11, 1994).

[48]These developments are detailed in "Bulgaria—Augmentation of Stand-By Arrangement, Waiver of Performance Criteria, Financing Assurances Review, and Consultation Under Article XIV," EBS/94/160 (August 16, 1994).

from central planning to reliance on market forces. When the Socialist Party regained power in January 1995, the conditions were already ripe for a new financial crisis (see Chapter 6).

Poland

Poland's circumstances at the beginning of the decade superficially resembled those in Bulgaria. A communist dictatorship had been forced out of power, and a new democracy was being established. Four decades of central planning were being scrapped to make room for a market economy. A decade of poor economic performance and partial isolation had left the government with an unsustainable overhang of external debt that would take at least four years to clear. There the similarities ended.

The government that won Poland's first modern free elections in June 1989 moved with extraordinary boldness and speed to allow prices to rise to market-clearing levels, remove impediments to private enterprise, and stabilize macroeconomic policies. After lengthy discussions with the IMF staff and other external advisors, the architect of this "big bang" strategy—Leszek Balcerowicz, the newly installed finance minister and deputy prime minister—decided to peg the exchange rate to the U.S. dollar. The peg would provide a nominal anchor for policies and expectations, and the rate Balcerowicz selected was amply depreciated to ensure that Polish exports would be competitive in world markets for at least the first year.[49] Unfazed by widespread skepticism about the viability of this plan, Balcerowicz had the key elements in place by the end of the year.[50] The transition would be far from easy or smooth, but over the next several years Poland was to record a growth rate and a record of financial stability that easily outstripped those of its neighboring transition economies.

The IMF began lending to Poland in February 1990, with the approval of a stand-by arrangement for $723 million (SDR 545 million, or 80 percent of quota). A central goal of the program was to prevent the necessary sharp increase in consumer prices from spiraling into sustained inflation. Price inflation was running at a frightening pace of nearly 80 percent a month, but the government was trying to restrict both credit expansion and government outlays to stop the process as quickly as possible. A group of bilateral donors had assembled a $1 billion currency stabilization fund for Poland, and the Fund's stand-by arrangement was intended to help rebuild the central bank's foreign exchange reserves and instill confidence in the government's shock program.

This strategy soon ran into trouble when output and employment fell much more than anticipated. In the second half of 1990, the government reacted by easing policies

[49]In May 1991, the zloty was devalued by 14 percent and pegged to a basket of currencies instead of just to the dollar.

[50]For the background to Poland's membership in the Fund (which was restored in 1986 after a hiatus of 36 years) and the initiation of the transition in 1989–90, see Boughton (2001), pp. 986–92. For inside accounts of the negotiation and functioning of the initial program, see Lane, Ossowski, and Russo (2009) and, in the same volume, the comment on that article by Balcerowicz.

and granting some large wage increases, but those moves brought little relief. Doubts began to settle in, both domestically and abroad. Poland made the first three drawings under the 1990 stand-by arrangement, but it then went out of compliance and did not make the last two.[51]

By November the government was ready to make a renewed stabilization effort, and it entered into a new round of negotiations with the Fund. Peter Hole (Assistant Director, European Department), who had helped negotiate the first arrangement, took charge of these negotiations, assisted by Mark Allen, who had moved to Warsaw as Senior Resident Representative, and a team of five Fund economists. Their first discussions, however, could only be preliminary, because the mission team arrived at a critical moment in Poland's political history. Lech Wałęsa, the former electrician at the Gdansk shipyards who spearheaded the labor movement in the 1980s and made *Solidarność* into a household name around the world, became the country's first democratically elected president in December 1990. Balcerowicz remained as finance minister, but the new government would have to reassess just how far and how fast to push the liberalization of the economy.

The authorities understood that exiting successfully from the dismal trade-off it faced between financial stability and economic growth required the country to shed a substantial part of the debt to foreign creditors it had inherited from the failed regime of the 1980s. More than 70 percent of that debt ($33 billion) was owed to Paris Club creditors. Commercial banks held 25 percent ($10 billion), and the rest ($2 billion) was owed to Russia and other former members of the CMEA. Poland needed to begin by negotiating a new program with the IMF. That would unlock the Paris Club, which in turn would open the door to agreements with commercial and other creditors.

The first critical stage was completed in late February 1991, after nearly five weeks of negotiations in Warsaw between the two teams led by Balcerowicz and Hole. The government now had a viable program for the next three years, which the Fund was ready to support with a sizeable extended arrangement.

The Paris Club met in mid-March, with Jean-Claude Trichet (director of the French Treasury) in the chair. This meeting was to be decisively important, both for Poland and for the Paris Club. For the first time, official creditors agreed (provisionally) to reduce the stock of a debtor's outstanding principle. The agreement did not come easily. Poland was asking for a 75 percent reduction in the present value of its debt. In preliminary discussions, most official creditors expressed willingness to accept some reduction, but none was prepared to cut that deeply. Most of them wanted to cap the reduction at less than 50 percent, but the IMF—eager to ensure that Poland would be able to finance its adjustment program—was quietly lobbying for an agreement

[51]"Republic of Poland—Staff Report for the 1991 Article IV Consultation, Request for an Extended Arrangement and External Contingency Mechanism, and Purchase Under the Oil Element of the Compensatory and Contingency Financing Facility," EBS/91/60 (April 4, 1991), p. 9.

close to Poland's request. Trichet proposed 50 percent as a reasonable compromise, and that target was eventually accepted.[52]

The Paris Club offer became part of a comprehensive debt-restructuring plan unprecedented in its scope and generosity. As soon as the Fund formally approved the EFF arrangement, official creditors would take actions to reduce the net present value of Poland's debt by 30 percent. If Poland successfully carried out its commitments under the three-year Fund-supported program, official creditors would reduce those debts by another 20 percent of their initial value, for a total reduction of 50 percent.[53]

The IMF approved the EFF arrangement on April 18, 1991. The financing package offered by the Fund totaled about $2.6 billion over three years, of which $325 million would be available at once. The rest would be contingent on performance and on external developments and would be phased in over the next three years.[54] The Paris Club met again on April 21 and finalized the terms of its debt-reduction agreement.

When the IMF approved the EFF arrangement, the staff expected Poland would soon reach a debt-reduction agreement with its commercial creditors and private capital would gradually start flowing into Poland to restore longer-term viability to the balance of payments. Those assumptions were an important piece of the expected financing of the balance of payments, but they turned out to be overly optimistic.

A large part of the problem in the negotiations with commercial creditors was a sharp difference in view on how much debt reduction was consistent with market conditions. Before the Paris Club made its exceptional offer, Poland's commercial debt was trading in the secondary market at prices close to 20 percent of face value. As soon as Trichet announced the breakthrough in March 1991, the market price rose to 30 percent. As far as the banks were concerned, that higher level was now the minimum price at which a settlement could be reached. The Fund, however, supported the government in arguing that the benefit of the Paris Club offer should go to Poland, not to

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[52]See handwritten and untitled memorandum dated March 12, 1991, from Thomas Leddy (Deputy Director, ETR) to Richard D. Erb (Deputy Managing Director), and memorandum from Hole to the Managing Director, "Poland—Paris Club" (March 15, 1991); IMF archives, Poland 1991 Country Files, OMD-AD, Box 7630, Accession 1995-0180-0005.

[53]"Republic of Poland—Report on External Debt Negotiation," SM/91/103 (May 17, 1991).

[54]The main element in the package was the EFF arrangement, for $1.7 billion (SDR 1,224 million, or 180 percent of quota). One-fourth of each scheduled disbursement was to be set aside and released later if needed to help finance a Brady-type debt- and debt-service-reduction agreement. In addition, the Fund committed up to $600 million as a contingency provision under the CCFF, to be made available to Poland if oil or natural gas prices were to rise by more than anticipated and were to put pressure on the balance of payments. The third component, also under the terms of the CCFF, was intended to compensate for the temporary increase in the cost of fuel imports associated with the Gulf War. That component provided an immediate disbursement of $221 million (SDR 162.6 million) and a possible $119 million more (SDR 87.6 million) once more complete data were in and assuming the conditions for it were met. For a detailed description, see "Republic of Poland—Staff Report for the 1991 Article IV Consultation, Request for an Extended Arrangement and External Contingency Mechanism, and Purchase Under the Oil Element of the Compensatory and Contingency Financing Facility," EBS/91/60 (April 4, 1991).

the foreign bank creditors. That position implied that Poland should be able to buy back or restructure its commercial debt at a cost approximating 20 cents to the dollar. The banks balked, and the ensuing dispute took three years to resolve.

The Polish economy survived during those three years through a combination of reasonably stable and well-implemented macroeconomic policies, surprisingly strong performance by state-owned industries now operating under hard budget constraints and market discipline, and continuing support from the Fund and other official creditors. Once investors recognized the country's pent-up potential, private capital also began to flow into the economy.

Poland satisfied the policy conditions in the EFF arrangement, but the authorities chose not to make any further drawings. As the financing gap shrank, the Fund canceled the arrangement in March 1993 and replaced it with a smaller one-year stand-by arrangement on which the authorities initially chose not to draw. Finally, in March 1994, just as a debt-reduction agreement with commercial creditors was finally being reached, Poland borrowed $500 million (SDR 357 million), or two-thirds of the total available under the arrangement.[55]

By 1994, the Polish economy was shifting into high gear, with real GDP growing by 4.5 percent a year. Inflation was still a worry, as was the persistence of large income inequalities that had arisen when the old socialist support system was withdrawn. Tellingly, in discussions with the IMF, the authorities worried about these sticking points more than the staff did. The Fund perceived that the government clearly had the capacity and the will to overcome the difficulties, though it would take time.[56] In August, the Executive Board approved one last loan to Poland, a two-year stand-by arrangement for slightly less than $800 million (SDR 545 million, or 55 percent of quota). Two months later, the Brady debt-reduction agreement with commercial bank creditors was finally activated, enabling Poland to restructure $14.4 billion of debt at an upfront cost of $1.9 billion. The market-equivalent value of the restructured debt was estimated to be 27 cents on the dollar, comfortably near the range of secondary market prices around the time of the 1991 Paris Club offer and well below the secondary market price in effect when the agreement in principle was signed in March 1994 (39 cents).[57]

On October 26, 1994, just one day before the signing ceremony for the Brady deal, the Executive Board approved a disbursement of $423 million (SDR 283 million) to help finance that deal. Poland's indebtedness thus reached an all-time peak of just 90 percent of quota, and after that Poland had no further need for IMF borrowing.[58]

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[55]The Fund's approval of the March 1994 disbursement also enabled completion of the second stage of the Paris Club debt-reduction agreement.

[56]"Republic of Poland—Staff Report for the 1994 Article IV Consultation and Review Under the Stand-By Arrangement and Review on Financing of the Program," EBS/94/48, (March 11, 1994).

[57]"Republic of Poland—Request for Financial Support for a Debt and Debt Service Reduction Operation," EBS/94/195 (October 12, 1994).

[58]For more on Poland's recovery in the early 1990s, including a figure showing its indebtedness to the IMF, see Chapter 6.

Poland's economic transformation continued at a remarkable pace. The country accepted the currency-convertibility obligations of Article VIII in June 1995, repaid all of its IMF debts a month later, and joined the OECD in November 1996. Within a few years, Poland would be a creditor country in the IMF and would be well on its way to joining the European Union in 2004.

Costa Rica

Costa Rica got an early start at recovering from its decade-long debt crisis by becoming the first country to benefit from the Brady Plan, in May 1989. That fast takeoff, however, masked underlying weaknesses preventing the country from taking full advantage of its debt reduction.

The 12-month stand-by arrangement the Executive Board approved in 1989 covered too short a time to provide the confidence bank creditors needed before they would agree to reduce Costa Rica's outstanding debts. The Fund was not willing to commit its own resources for a longer period because Costa Rica's highly respected president—Oscar Arias Sanchez, the winner of the Nobel Peace Prize in 1987—would be stepping down in 1990, and his successor was not yet known. This political uncertainty led to a vicious circle. As negotiations with bank creditors dragged on, the authorities were unable to meet their program targets. That meant they were unable to draw on the stand-by arrangement, which made the debt settlement more difficult, further worsening the fiscal outlook. Fortunately, the U.S. government and other official creditors recognized the problem and stepped in with bilateral financing for a special Voluntary Contribution Account established and administered by the IMF.[59] Bank creditors then quickly agreed to a debt-reduction deal in May 1990 that included buybacks and negotiable bonds, though not collateralized Brady bonds.[60]

Following that agreement, Costa Rica continued to seek and obtain the support of the IMF throughout most of the 1990s, though without borrowing large amounts of money. This effort had only mixed success through the decade. In April 1991, the Fund approved a one-year financing package totaling $119 million (SDR 88.3 million, or 105 percent of quota). Of that, $74 million was disbursed immediately. The rest was contingent on conditions and on the strength of economic policies. A few months later, the government ran into difficulty servicing its debts to other external creditors, and most of the conditional and contingent financing went unused.[61]

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[59]Decision No. 9420-(90/65), April 25, 1990. Also see PR/90/19 (May 2, 1990).

[60]For the background to Costa Rica's debt crisis and the 1989–90 settlement, see Boughton (2001), pp. 499–508.

[61]The initial disbursement in April 1991 included a $45 million drawing under the CCFF to compensate for the high price of oil imports and a $29 million drawing on the stand-by arrangement. That left a $16 million balance on the stand-by arrangement to be disbursed later if the conditions were met, and a possible $28 million disbursement to be released under the contingency window of the CCFF in the event of adverse external developments. The contingency element was not activated, and the only further drawing on the stand-by arrangement was $5.5 million in April 1992.

By 1993, Costa Rica's financing needs eased somewhat but were still too high for comfort. The authorities requested another stand-by arrangement, but this time they indicated they just wanted the Fund's seal of approval; they intended to treat the arrangement as precautionary and not draw on it if they could avoid doing so. The Fund approved a 10-month arrangement, but again the program went off track after a few months, and the midyear review was not completed.

The country's final stand-by arrangement of the decade, approved in November 1995, provided for six drawings over 15 months, totaling $78 million (SDR 52 million, 62 percent of quota). Again, the authorities treated the arrangement as precautionary, and again they were unable to meet the program conditions for more than a few months. Even so, they continued to repay their earlier borrowings, and in March 1997 they made the last scheduled payment. That November, the Fund agreed to a staff-monitored program that stayed in effect until a newly elected government could take office in May 1998. By that time, the Costa Rican economy was on a more sustainable path, and the government was able to exit fully from dependence on IMF support.

Other Heavily Indebted Countries

The only other middle-income country to reach a debt-reduction agreement with commercial creditors was **Panama**. The circumstances were a little unusual, in that Panama started the decade in arrears to the IMF and had been declared ineligible to borrow. That situation had arisen out of a dispute with the United States that blocked Panama from getting access to its foreign exchange reserves and thus from repaying its outstanding IMF loans.[62] Following settlement of that dispute in 1990, Panama successfully carried out a Fund-monitored program that helped to restore economic growth and financial stability. That program enabled the government to obtain financial support from the United States and other creditor countries that it could use to settle its arrears to the IMF in 1991 (see Chapter 16). Panama then had two stand-by arrangements with the Fund, in 1992–94 and 1995–97, and turned its attention to regularizing relations with other creditors. The second stand-by arrangement included set-aside and augmentation provisions in anticipation of a Brady agreement with commercial bank creditors. Those provisions were activated when an agreement was concluded in 1996. Panama had one last borrowing arrangement, a three-year EFF arrangement approved in December 1997.[63]

As the experiences of Bolivia and Côte d'Ivoire (both low-income members of the Baker 15) illustrate, the burden of excessive indebtedness to international commercial

[62]For the history of that dispute, which culminated in a U.S. invasion and the arrest of Panama's military ruler, see Boughton (2001), pp. 799–802.

[63]Disbursements under the EFF arrangement stopped in 1998, owing to fiscal overruns. After presidential elections in 1999 and the transfer of the Panama Canal from U.S. to local ownership at the end of 1999, a new government entered into a stand-by arrangement with the Fund, but it treated the arrangement as precautionary and did not draw on it. Panama repaid all the principal on its outstanding obligations to the Fund by 2008.

banks was not limited to middle-income countries. By the end of the 1990s, the World Bank's Debt Reduction Facility for IDA-Only Countries had financed or was preparing to finance reductions in commercial debt for more than 20 low-income countries (see footnote 36). As discussed in Chapter 13, the IMF provided related financial assistance on concessional terms to all those countries.

Finally, two other middle-income countries experienced debt crises in the 1980s: Hungary and Jamaica.[64] Neither was included in the Baker 15, and neither one had a debt-reduction agreement in the 1990s. They did, however, benefit from stand-by arrangements in the early 1990s to help them grow out of and resolve their debt difficulties. In both countries, the problem stemmed from the debt crises that were spreading around the developing world in the early 1980s.

Hungary joined the IMF in 1982, after its bank debt had already become unsustainable. Extensive borrowing from the Fund throughout the rest of the 1980s did little good, largely because the government failed to meet the program conditions and justified its loan requests with inaccurate data (Boughton, 2001, pp. 980–86). Only after the country's first democratic elections brought in a new government was Hungary able to normalize relations with creditors and resolve its debt problems. Hungary borrowed steadily through 1993 but repaid all those loans by 1998.

Jamaica was a prolonged user of IMF financing, with six stand-by and three extended arrangements from 1973 through the end of the 1980s, plus drawings on the CFF and the Oil Facilities. Jamaica's debt to the IMF peaked in June 1985, following the successful completion of a stand-by arrangement. At that time, Jamaica was struggling to stay current on its interest payments to commercial creditors and was staying afloat only by rescheduling the repayment of principal and occasionally of interest. Subsequent financing from the IMF was designed to catalyze rescheduling agreements with commercial and official creditors and to provide for a gradual unwinding of Jamaica's outstanding debts to the Fund. In 1986 and 1987, Jamaica fell behind in its payments to the Fund, but not so badly as to trigger a declaration of ineligibility to keep borrowing. The government's difficulties in managing its external debt continued throughout the rest of the decade and into the 1990s.

By 1990, Jamaica's economy and its finances had strengthened, putting it on the verge of regularizing its relations with external creditors. In June of that year, soon after the IMF approved a 14-month stand-by arrangement, commercial bank creditors extended new terms for a multiyear rescheduling agreement that had originated in 1987. That turned out to be the last debt relief Jamaica would need from its commercial creditors. The Fund continued to roll over its own financing, with another stand-by arrangement in 1991–92 and an EFF arrangement in December 1992 that eventually stretched to March 1996. With additional relief from the Paris Club, new lending on

[64]A third country in this group, Romania, had resolved its debt crisis before 1990 but was mired in an even worse economic and political crisis. That case is covered in Chapter 6.

favorable terms from various official creditors, and a gradual resumption of foreign direct investment and other private capital inflows, Jamaica graduated from IMF borrowing.[65]

Crisis and Transformation in India

Resolution of the major debt crises was just the tip of the globalization iceberg, as many other countries turned toward more open and market-oriented policy regimes to promote stable economic growth.

India provides one of the most remarkable examples of the "silent revolution" in economic policy in the developing world. The starting point was not auspicious. Not only a longtime adherent of dirigiste policies and state-driven development, India was a major intellectual and cultural inspiration for countries following similar strategies. Moreover, 40-some years of independence from Britain had not diminished the massive and pervasive bureaucracy that India had inherited. Both Indira Gandhi and her son Rajiv—the country's two dominant political leaders of the 1980s—had tended toward reforming and liberalizing the economy, but only in tentative half-steps that improved economic performance compared with previous decades but did not fundamentally alter ways of doing business or of interacting with the rest of the world.[66] That approach was about to change.

The IMF supported the initial reforms of the 1980s through a three-year EFF arrangement (1981–84) for \$5.8 billion (SDR 5 billion), the largest loan commitment ever made by the Fund through the 1980s (see Boughton, 2001, pp. 709–16). Partly because of an easing of trade restrictions (an element of the program under the IMF arrangement), but more because of a major infrastructure investment program and the serendipitous development of a major oil field, the economy recovered and grew. Two years into the program, the government announced that it no longer needed the Fund's money, and it canceled the final year of the arrangement.

This gradual liberalization continued for a few more years, but when Rajiv Gandhi's government got bogged down in scandals in 1987, the effort lost much of its momentum. Economic growth continued, but the basic inefficiency of the economic system was again showing through the cracks in the surface. By 1989, the government could finance its burgeoning fiscal deficit only through increasing reliance on short-term borrowing from foreign banks.

[65]The last disbursement to Jamaica in this period was in December 1995. Jamaica repaid all of its borrowings by March 2007 and then resumed borrowing in 2010.

[66]Indira Gandhi, who had served as prime minister from 1966 to 1977, was elected to that post again in 1980 and served until she was assassinated in 1984. Rajiv Gandhi succeeded her and served until his party was defeated in the election of 1989. For an overview of the economic reforms of the 1980s, see Joshi and Little (1994).

The Indian economy might have trundled along in this manner for some time, but a political crisis intervened. Although Rajiv Gandhi had lost much of his popular support, the Congress Party that he chaired was widely expected to retain its long-standing hold on the reins of government in the parliamentary elections of November 1989. However, Rajiv's former finance and defense minister, V.P. Singh, managed to form a non-Congress coalition government that was united only in its opposition to the old ruling party. Governing effectively turned out to be impossible, and confidence in the economy was badly damaged both at home and abroad. The coalition collapsed less than a year later, and its successor was just as ineffective.

The next push down this slope came from the threat of war in the Middle East after Iraq invaded Kuwait in August 1990. The price of India's oil imports rose sharply; the flow of remittances from Indian workers in the region slowed; and the government had to expend substantial sums repatriating many of those workers. As if that were not enough, one of India's major trading partners, the Soviet Union, began falling to pieces. Suddenly, a mudslide had become an avalanche, diminishing India's foreign exchange reserves more and more rapidly.

As a first stop-gap measure to stabilize the economy, the authorities began withdrawing India's reserve-tranche balance at the IMF in July 1990. That action covered the repayments falling due to the IMF from the 1981 extended arrangement and thus helped stabilize the country's foreign exchange reserves for a few months.[67] The authorities knew, however, that they soon would need much more. Within weeks after the invasion of Kuwait, V.P. Singh authorized his officials to ask the Fund for a loan, the first such request in a decade.

The politics of borrowing from the IMF is always complex, but in India it was especially so. On the one hand, Indian politicians had long viewed IMF conditionality with some disdain. As soon as it became known that the government was applying for a stand-by arrangement, its leaders would be attacked in parliament and in the press for subjugating the country's interests to foreign domination. On the other hand, most of the country's economic and financial officials had good relations with the IMF, and an unusually high degree of trust had developed on both sides over the years.

India was an original member of the Fund, and its delegation had played an important part in the negotiations to create the institution at the 1944 Bretton Woods conference. Although not yet independent from Great Britain, India was awarded the fifth largest quota among the 40 original members and thus was entitled to appoint its own Executive Director.[68] Although it lost that privilege in 1972 after Japan was

[67]In most cases, before a country borrows from the IMF, it withdraws its reserve-tranche credit balance. It is not required to do so, however, and India had elected to maintain a reserve position while drawing on the CFF and the EFF in the 1980s.

[68]The members with the five largest quotas are entitled to appoint an Executive Director, while those with smaller quotas generally participate in a biennial election. India's quota in the Bretton Woods list was the sixth largest, but the Soviet Union (third on the list) declined to join. For the history of India's role in the design of the Fund, see Simha (1996), Chapter 2.

awarded a larger quota, India then formed a small regional constituency and was able to elect a Director and maintain a continuous presence on the Executive Board. Because of this history and India's position of leadership in various groups of developing countries, its Executive Director often took an active role in broader policy debates in the Fund. Thus, in 1990, despite the fragile condition of India's fiscal and external finances, both the Indian government and IMF management perceived their relationship to be founded on a long record of mutual respect.

To balance these two considerations, V.P. Singh's government decided initially to limit its request to whatever it could borrow from the Fund without making specific forward-looking policy commitments. A stand-by arrangement for the first credit tranche (25 percent of quota) and a CCFF drawing to compensate for the effects of the Iraq-Kuwait war on the cost of oil imports would provide about $1.8 billion, all of which would be available immediately without further conditions.[69] India's projected financing gap exceeded that, and as soon as the new government took office following V.P. Singh's defeat in November, the authorities informed the Fund that they planned to ask for larger loans in the near future. The priority at the moment was just to make a fast start. The Executive Board met on January 18, 1991, and readily approved the arrangement.[70]

The day before the Board meeting, the Gulf War began, as U.S.-led coalition forces attacked Iraqi positions from the air. Over the next few weeks, the Indian government struggled to maintain a neutral stance amid strong domestic opposition to the refueling of U.S. military airplanes at Indian bases. Prime Minister Chandra Shekhar found it increasingly difficult to govern in these circumstances, and he was unable to present a budget to parliament. That effectively put discussions with the IMF on hold. With no prospect in sight for resolution of the political stalemate, Shekhar resigned on March 6 but agreed to lead a caretaker government for a few months until elections could be held.

As negotiations continued with the Fund on terms for a larger stand-by arrangement, Rajiv Gandhi and the Congress Party he chaired appeared headed for a return to power. That possibility tragically and brutally vanished on May 21 when Gandhi was assassinated while campaigning. Confidence crumbled, and suddenly the country's financial outlook was even worse. As an emergency measure, the government quickly sold 20 tons of gold with a six-month repurchase option, in effect borrowing

[69]The first-tranche stand-by arrangement was worth $785 million, and the CCFF drawing $1,020 million (SDR 552 million and SDR 717 million, respectively). IMF policies limit the phasing of stand-by drawings and the application of performance criteria to arrangements that extend into the upper credit tranches. First-tranche drawings require only a finding that the member country is cooperating with the Fund and has a balance of payments need for the drawing. Cooperation usually requires implementation of a number of policy actions prior to Board approval of the arrangement and the formulation of a set of macroeconomic policies that will enable the member to resolve its payments problem and repay the loan.

[70]See minutes of EBM/91/7 (January 18, 1991). For the government's economic program and the staff's appraisal of it, see "India – Use of Fund Resources – Request for Stand-By Arrangement and for a Purchase Under the Compensatory and Contingency Financing Facility," EBS/91/4 (January 7, 1991).

$200 million from a consortium of foreign banks at the London interbank offered rate (LIBOR). For a country that for centuries has viewed gold as an almost mythical store and symbol of value, the sight of so much gold being physically shipped to Zurich for safekeeping came as a shameful shock, but under the circumstances it had to be accepted as necessary. The government also obtained a commitment from Japan for up to $300 million in loans on concessional terms.

The election was postponed for a few weeks, and on June 21 the Congress Party regained power and named P.V. Narasimha Rao to the premiership. India now had an effective government, but a year of turmoil had brought it to the brink of default. With about $4 billion in external debt falling due in the near term, India had less than $2 billion in official foreign exchange reserves. A lot of loose talk about the country being "bankrupt" occurred, but the government and the Reserve Bank of India (RBI) still owned another 380 metric tons of gold, at least part of which could be sold or pledged if need be. At the very least, Rao was facing the most severe liquidity crisis in India since 1966. Even the IMF was losing confidence and was close to a decision to ship its own gold out of the country to safer shores.

In what would turn out to be a decisive moment for the future of the Indian economy, Rao immediately named Manmohan Singh to be his minister of finance. Singh was already well known in financial circles in India, having been governor of the RBI (1982–85) and head (deputy chairman) of the Planning Commission (1985–87). More recently, he had directed the Geneva-based intergovernmental agency, the South Commission (1987–90), and had served as advisor to the prime minister on economic affairs during the few months of Chandra Shekhar's coalition government (1990–91). Armed with a doctorate in economics from Nuffield College, Oxford, he had built a reputation as a soft-spoken intellectual who could work within the political system without being tainted by its demands. His real achievements, however, were still ahead of him: five years as finance minister (1991–96) and eventual election as prime minister in 2004.

Manmohan Singh initiated several policy changes in his first few weeks in office, aimed at closing the financing gap as quickly as possible. First, he devalued the rupee relative to the U.S. dollar by nearly 19 percent in two steps in early July.[71] Second, he arranged to borrow $400 million from the Bank of England and the Bank of Japan, using gold from the official reserves of the RBI as collateral. As before, owing to the dire state of India's finances, the gold had to be shipped out of the country—this time to the Bank of England—to be acceptable collateral. Third, he asked for and received a public statement of support from Camdessus on behalf of the IMF and then borrowed another $800 million (SDR 635 million) through the CCFF.[72] Fourth, he asked the

[71]For an analysis of the pressures on the exchange rate at this time, see Cerra and Saxena (2002).

[72]Camdessus's statement of support was issued to the press on July 4, 1991, the day after the devaluation of the rupee was completed. In it, he noted that the Fund was "in close contact with the Indian Government" and stood "ready to support India's adjustment policy"; see "Camdessus Says IMF in Close Contact with Indian Government," NB/91/9 (July 4, 1991).

Fund to provide larger loans: first with an upper-tranche stand-by arrangement and later—when he had had time to devise a more comprehensive reform program—with an extended arrangement.

Throughout this time, the Fund staff kept in almost continuous contact with the Indian authorities. The working relationship was a little unusual, in that the authorities knew full well what they needed to do to qualify for the Fund's seal of approval and financial support. The decision to devalue, for example, was not made at the insistence of the Fund, but on the understanding that the Fund would approve it and that both sides believed it was necessary and was in India's interest. As had been true for the 1981 negotiations, these discussions were amicable and collegial.[73]

The main negotiations took place in Bombay and Delhi in August 1991, with the Fund mission led by Hubert Neiss (Deputy Director, Asian Department). Manmohan Singh signed a Letter of Intent on August 27, and after some delay, the Executive Board met on October 31 to consider India's request for a 20-month arrangement totaling \$2.3 billion (SDR 1,656 million, equivalent to 75 percent of India's quota). As the date of the meeting approached, the only significant uncertainty was whether the United States would raise any objections. As noted above, India's reluctance to allow military jets to refuel during the Gulf War earlier in the year had not endeared the country to the United States. Separately, the U.S. Treasury was keen to press India to move rapidly to open and liberalize its economy. However, the U.S. Executive Director, Thomas Dawson, praised the "sea change in India's economic orientation." Although the U.S. view was that India needed "a far more radical reform" of the economic role of the government, Dawson concluded that India had already "earned the support of the international community." The stand-by arrangement was thus approved without dissent.[74]

By October, the Indian government was embarked on a major drive, not just to stabilize the economy and resolve the liquidity crisis, but more important, to liberalize the economy as much and as quickly as possible. As Singh put it in a supplement to his August 27 letter to Camdessus, the goal was to "impart a new element of dynamism . . . in the economy." To that end, the government intended "to increase the efficiency and international competitiveness of industrial production, to utilize foreign investment and technology to a much greater degree than in the past, to improve the performance and rationalize the scope of the public sector, and to reform and modernize the

[73]The chief contrast between the two episodes was not in the relations between the Asian Department staff and the authorities, but rather in the internal discussions within the Fund. On the earlier occasion, the idea of supporting a "homegrown" program was less easily accepted, and doubts were expressed—by some senior staff and by the U.S. authorities—as to whether India really had a balance of payments need for the loan.

[74]See minutes of EBM/91/145 (October 31, 1991). Dawson's statement is on pp. 15–18.

financial sector."[75] It was a bold agenda, and it would be strongly resisted by entrenched interests within India.

Over time, it became clear that the government would carry out these reforms in a heterodox way and on its own terms. For example, in March 1992, the authorities temporarily introduced a dual exchange rate scheme as a way to finance subsidies to imports of essential goods (notably petroleum products and fertilizer) while shifting to a market-determined rate for most transactions. As a multiple currency practice, the dual rate violated the terms of the stand-by arrangement. The staff, however, chose not to object to it, and the Fund readily granted a waiver so that India could continue to draw on the arrangement.[76] The underlying premise throughout this time was that no one seriously doubted the government's commitment to the ultimate objective of liberalizing the economy, especially foreign trade and payments.

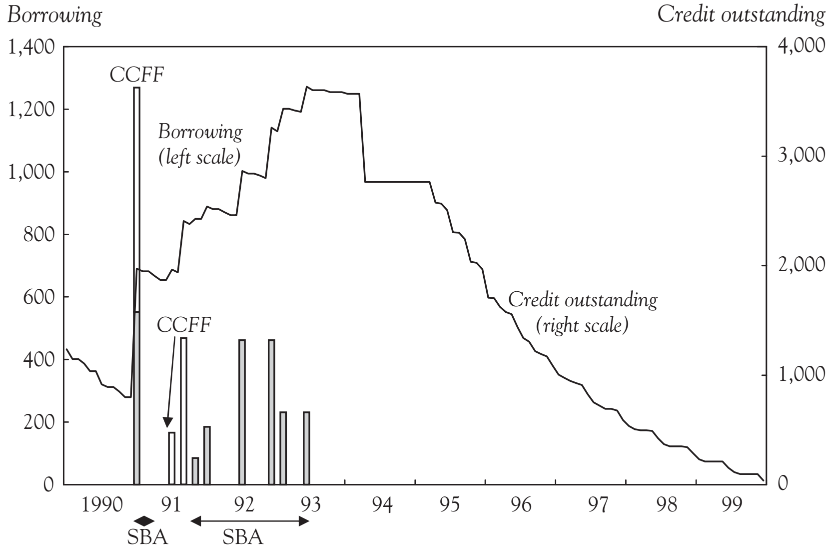
Despite the complexity of the structural reform program and the centrality of those reforms to the program's success, the stand-by arrangement with the Fund was deliberately kept simple and uncluttered. The availability of disbursements after the initial drawing would depend on a standard set of performance criteria: ceilings on overall borrowing by the central ("Union") government, on the net domestic assets of the RBI, and on net credit to the Union government from the RBI; a floor on net international reserves; and boilerplate prohibitions on introducing exchange restrictions, multiple currency practices, bilateral payments agreements, or import restrictions for balance of payments purposes. The program also included a list of 16 "structural benchmarks" that the Fund would review after a few months, but only two of those were considered critical.[77] The Fund was prepared to give the government free rein in carrying out its reform agenda. If the effort faltered, the subsequent negotiations on an extended arrangement would provide an opportunity to take a more proactive stance.

[75]"India – Request for Stand-By Arrangement – Letter of Intent and Memorandum on Economic Policies," EBS/91/143 (August 27, 1991), p. 3.

[76]Before the initiation of the reform program, the government banned the importation of most consumer goods. Beginning in August 1991, that practice was phased out in favor of a system in which exporters received "EXIM scrip" as a portion of their export receipts, which could be used to purchase imported goods or could be traded in an open market; see "India – Recent Economic Developments," SM/91/207 (October 18, 1991), Appendix IV. The dual exchange rate, which was in effect only until March 1993, replaced the scrip scheme as the next stage of the transition to an open market system. For the staff's assessment, see "India – Review under Stand-By Arrangement," EBS/92/96 (June 3, 1992).

[77]The distinction between a "performance criterion" (PC) and a "benchmark" is subtle. Both are conditions for the Fund's approval of each disbursement under a stand-by arrangement. If a PC is not met, the Executive Board has to make a formal decision to grant a waiver or the disbursement must be disallowed. If the borrower fails to meet a benchmark, the Board can choose to complete the review anyway, and no formal waiver is required. The more substantive distinction is that the Fund generally expects only that the authorities will make a serious effort to meet the benchmarks and will carry out the spirit of its commitments. If an arrangement includes a large number of benchmarks, the expectation is that many, though probably not all, will be met, whereas the expectation is always that all PCs will be met.

Figure 9.1. India: Use of Fund Credit, 1990–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics.
Note: CCFF = Compensatory and Contingency Financing Facility; SBA = Stand-by arrangement.

India emerged from its fiscal crisis with amazing alacrity. The Fund's first review of the stand-by arrangement was delayed while the government prepared its budget for the 1992/93 fiscal year, but all performance criteria were met, and all of the stand-by arrangement was eventually disbursed. By the time the arrangement expired in mid-1993, India's economy was thriving and private capital was flowing in so steadily that the country had no further need to borrow from the IMF. The government began repaying the Fund early in 1994 (Figure 9.1), and it quietly dropped the idea of asking for an extended arrangement.

Even in the initial year after the crisis, India's real GDP did not decline, and for the next three years growth averaged more than 5 percent a year. Net international reserves, virtually zero in mid-1991, surpassed $17.5 billion four years later. Even more impressive, the reform program led to spectacular economic growth rates throughout the rest of the decade without threatening financial stability.[78]

[78]This view of the importance of the 1991 reform agenda for subsequent economic performance is widely but not universally accepted. For detailed explanations of the pro-reform argument, see Joshi (1998) and Srinivasan and Tendulkar (2003). An alternative view, that growth in the 1990s was primarily a continuation of a pattern that began with the less comprehensive reforms of the 1980s, has been advanced by DeLong (2003) and by Rodrik and Subramanian (2005). The central issue dividing these camps is the extent to which the 1991 crisis resulted from the failings of the reforms of the 1980s; see Panagariya (2005).

The 1991–93 stand-by arrangement with India proved to be an outstanding success story, both for the Indian government and for the IMF. Faced with a dangerous fiscal and political crisis, Rao's government seized the opportunity to begin a reform program that irreversibly altered the very nature of the Indian economy. Although by all accounts the reform agenda was still far from being completed, it continued throughout the decade, and it enabled the Indian economy to weather the turbulence in the world financial system in the late 1990s. In 2003 India became a creditor of the Fund. Through the end of that decade, it did not have to borrow.

The IMF played two roles in assisting the process in India. First, it provided substantial financial support at a critical juncture, enabling the authorities to take default off the list of options for dealing with the crisis. Second, it gave its full and very public support to the government's reform program and forbore from piling on additional conditions to its lending commitment. The Fund could show such restraint because it understood that the government, though newly elected and untested in its ability to deliver on its promises, was deeply committed to the reform process. These circumstances may have been unique, but the lessons for the Fund and for other countries in crisis—the importance of domestic ownership and of mutual confidence, trust, and restraint—are universal.

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10

Tequila Hangover: The Mexican Peso Crisis and Its Aftermath

It was midnight in Madrid, and Pedro Aspe was not even the last speaker on the program. But with his regal bearing, his smooth and practiced delivery, and—above all—his compelling story, the Mexican finance minister had his audience in thrall. Mexico, he asserted convincingly, had been a "pioneer" in transforming its economy from one that was closed to competition, highly controlled and regulated, and wracked by high debt and inflation, into a modern, open, and efficient economic system based on market principles. With substantial help from the IMF and the World Bank, Mexico had carried out a "profound reform of the State" that had put its troubled economic past on the shelf and positioned it well for a stable and growing future.

Aspe was delivering this message to a distinguished audience of the world's finance ministers and central bank governors, their spouses, and other guests who had gathered at the historic Castillo de Viñuelas in Spain on a lovely, warm late September night in 1994 to commemorate the fiftieth anniversary of the founding of the IMF and the World Bank at Bretton Woods. Other speakers that evening included Michel Camdessus and Lewis Preston, the heads of the two institutions; Wim Duisenberg, the head of the Netherlands central bank and of the governors of the Bank for International Settlements (BIS); and Jacques Polak, who spoke on behalf of his fellow veterans of the Bretton Woods conference, several of whom were also present. Aspe, however, was clearly the star of the evening, introduced by Duisenberg as the "personification of stability . . . based on sound fundamentals."[1]

One member of the audience knew Aspe particularly well, having been one of his teachers when Aspe was studying for a doctorate in economics at the Massachusetts Institute of Technology (MIT). Stanley Fischer had just moved from MIT to the IMF that month to become the First Deputy Managing Director (FDMD), and he had every reason to believe that Mexico, under the financial direction of his former star student, had, in turn, fairly earned its global reputation as a star student of the IMF. In less than three months, the report card would have to be dramatically rewritten.

[1]Aspe's and Duisenberg's remarks are reproduced in the proceedings of the anniversary conference (Boughton and Lateef, 1995, pp. 123–38).

The foreign exchange crisis that hit Mexico at the end of 1994 was a classic example of a country's stubborn adherence to a "strong" currency. Its origins were deeply rooted in the history of an economy that had experienced election-year excesses and instability for decades. Nonetheless, for Mexico, for its major trading partners from Canada to Argentina, and for the IMF, the crisis also had new and unique facets that justified its being dubbed "the first financial crisis of the twenty-first century."[2] At the IMF, the onset and the management of the crisis induced a great deal of soul-searching. Was the Fund blinded by its admiration for a country that had emerged successfully from earlier Fund-supported programs? How could the Fund have played a more effective role in preventing the crisis? Could (and should) the Fund have avoided being drawn in so deeply in financing its eventual resolution?

Mexico as Star Student

By December 1994, Stanley Fischer had already earned a reputation as one of the hardest-working people at the IMF. Late-night phone calls and early-morning e-mails from the FDMD formed part of his legend and quickly became the expected norm. Aside from long-standing personal habits, this diligence was Fischer's response to what he had found to be a surprising lack of hard information in the Fund about events and trends in the world economy. So it was not unusual that he was on the phone at 11:00 at night on December 19, talking to Jeffrey R. Shafer (assistant secretary for international affairs at the U.S. Treasury) about financial developments in the Middle East. What was unusual was the bombshell that Shafer was about to drop. By the way, Shafer injected, you know that Mexico is going to

[2]The origin of this oft-quoted phrase is not clear, but it most likely originated with Camdessus. Rubin and Weisberg (2003) pp. 16–17, credits it to the Speaker of the U.S. House of Representatives, Newt Gingrich, but hedges by noting that Michel Camdessus used the same phrase around the same time and that Gingrich "may not have been the first" to say it. The Mexican finance minister, Guillermo Ortiz Martinez (1998), credited it to Camdessus, as have many others, including Fischer (2001) and this author (Boughton, 2001a) p. 443. To my knowledge, Camdessus's first documented statement of it came at a retreat of the Executive Board on January 26, 1995 (which, if Robert Rubin's recollection is correct, would postdate Gingrich's remark). At the retreat, Camdessus was frustrated by the need to delay consideration of Mexico's request for financial assistance until the staff report could be sent by telex or fax to capitals around the world for consideration by national authorities. In response, he remarked that the Fund was dealing with the first financial crisis of the twenty-first century using the techniques of the nineteenth. Six days later, the U.S. Executive Director, Karin Lissakers (who had been present at the retreat), remarked during a Board meeting that "I think it is not over dramatizing the situation to say that we may in fact be facing, grappling now with the first financial crisis of the twenty-first century." (These two quotations were transcribed by participants in the meetings; they do not appear in official minutes.) In October of that year, Camdessus stated in a speech that the "crisis in Mexico has been described, *by I don't know whom*, as the first financial crisis of the 21st century, meaning the first major crisis to hit an emerging market economy in our new world of globalized financial markets" (emphasis added); see http://www.imf.org/external/np/sec/mds/1995/mds9513.htm.

Mexican Finance Minister Pedro Aspe speaking in Madrid, September 1994. (IMF photo)

devalue and float the peso tomorrow. Fischer did not know, and therein hangs the tale.[3]

The most recent consultation with Mexico had been concluded nearly 10 months earlier, on February 28, on the basis of discussions between the IMF staff and the authorities in Mexico City in early December, 1993. At that time, the Mexican economy had been humming along with no major difficulties after four years of good economic growth fueled by large and apparently reliable capital inflows (see Chapter 9). An uprising in the southern state of Chiapas was causing domestic political problems but did not yet pose a threat to economic or financial stability. Indeed, the authorities had been trying

[3]Throughout this chapter, statements not specifically attributed to documents or publications are based on classified internal Fund documents or on interviews with participants in these events. As described in the Preface, those interviews were conducted on a background basis. Most interviews on this issue with IMF staff and management were conducted during or shortly after the crisis in 1995. Interviews with Mexican, U.S., and European officials were conducted several years later as part of the research for this book.

to discourage speculative inflows by allowing the exchange rate to fluctuate freely within a crawling band and thus create some uncertainty about future movements. Although the 1989 Extended Fund Facility arrangement had been extended to a fourth year in May 1992, Mexico had decided not to draw on it after that date, and the authorities were now in the process of repaying earlier drawings.[4] Uncertainty about whether the U.S. Congress would ratify the North American Free Trade Agreement (NAFTA) had limited investors' interest in Mexico and thus depressed the growth rate in 1993, but since NAFTA had come into effect at the beginning of 1994, Mexico's growth prospects looked much brighter. The Executive Board accordingly expressed mostly positive views, echoing the staff's conclusion that "Mexico's medium-term prospects remain favorable."[5]

The IMF was not completely insouciant about the current account deficit or the exchange rate, even at this early date, but the optimists greatly outnumbered the worriers. Camdessus first expressed concerns to Aspe during a breakfast meeting in July 1993, and he repeated those concerns to the central bank governor, Miguel Mancera, in October. On both occasions, and in the Article IV discussions, the authorities pointed to continued strong growth in Mexico's exports as evidence that the exchange rate was not overvalued. Moreover, they believed that the crawling band policy already gave them sufficient leeway to deal with any pressures that might arise.[6] The staff accepted those arguments, as did most members of the Executive Board. At the meeting to conclude the Article IV consultations in February 1994, Karin Lissakers (United States) urged Mexico to depreciate the peso, and Douglas Smee (Canada) argued more generally for greater flexibility in exchange rate policy. In contrast, Giulio Lanciotti (Italy) embodied the majority in concluding that "the conditions seem to be in place now for a successful hardening of the exchange rate commitment."[7]

Barely three weeks after the Board meeting, Mexico's short-term stability came under threat following the March 23 assassination of Luis Donaldo Colosio, the leading candidate to replace Carlos Salinas de Gortari as president in the August elections. The Bank of Mexico suddenly began to lose foreign exchange reserves at a rapid rate, prompting Camdessus to use a previously scheduled press conference to reassure investors that Mexico's economic policies were "fundamentally sound" and that the "signs of nervousness in the financial markets . . . will be short-lived."[8] More concretely,

[4]For a review of the 1989 EFF arrangement with Mexico, see Boughton (2001b), pp. 510–15. Mexico's peak indebtedness to the Fund in this period was $6.6 billion in May 1992 (SDR 4.77 billion, or 409 percent of quota). Repayments through end-1994 reduced the balance outstanding to $3.8 billion (SDR 2.6 billion, or 149 percent of the increased quota).

[5]"Mexico—Staff Report for the 1993 Article IV Consultation" (February 1, 1994), p. 13; and the Chairman's Summing Up, minutes of EBM/94/16 (February 28, 1994), p. 53. The staff and Executive Board conclusions were identical except that the latter added "particularly" before "favorable."

[6]Minutes of EBM/95/33 (April 4, 1995), pp. 1–2.

[7]Minutes of EBM/94/16 (February 28, 1994), pp. 11 (Lissakers), 13 (Smee), and 27 (Lanciotti).

[8]Transcript of press conference of Michel Camdessus, March 24, 1994; IMF archives, OMD/AI, "Surveillance of Mexico" Box 1, Accession 2007-043.

the U.S. Treasury and the U.S. Federal Reserve System responded immediately by establishing a temporary $6 billion swap line that could be activated only if the IMF Managing Director submitted a "comfort letter" supporting Mexico's economic and financial policies, which he promptly did.[9] This swap line was made permanent the following month, but by then the capital outflow had ebbed, and Mexico did not draw on it for the rest of the year. Both the U.S. authorities and the IMF staff soon concluded that the financial effect of the Colosio assassination was nothing more than a liquidity crisis that had quickly passed. Although pressures could arise again in connection with election-year uncertainties, everyone seemed confident that the Mexican authorities could manage the situation.[10]

Mexico got a much-needed confidence boost in mid-May, when it became the first new member of the Organization for Economic Cooperation and Development (OECD) since New Zealand in 1973. Now Mexico could—and did—consider itself to be no longer a developing country. It had joined the club of rich industrial nations, and it fully expected to leave its troubled financial past in the dust of its economic progress.

Not everyone, however, was impressed. Many outside commentators were becoming increasingly vocal in calling for a devaluation to correct what they saw as a substantial overvaluation of the peso, which was depressing growth and threatening to stall Mexico's economic development. Rudiger Dornbusch, the highly respected and knowledgeable MIT economist, led the choir, repeatedly articulating a detailed case in the spring and summer of 1994 that the peso was overvalued by about 20 percent. He concluded that "great damage . . . lies ahead unless the currency is devalued" (Dornbusch and Werner, 1994, p. 287). Discussing that paper in early April, Stanley Fischer (then a colleague of Dornbusch at MIT), among others, agreed with this diagnosis (Dornbusch and Werner, 1994, p. 307). In July, the *Economist* reported that "a growing chorus of financial pundits reckon a devaluation of some sort is likely just after the [August presidential] election, if not before" (July 23, 1994, p. 76).

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[9]The letter was sent to Lloyd Bentsen (secretary of the U.S. Treasury) and Alan Greenspan (chairman of the U.S. Federal Reserve System) on March 24; IMF archives, OMD-AD (Mr. Fischer's files), Box 11508, Accession 1998-0105-0005, "Mexico Operational File 1994."

[10]See "Foreign Exchange and Financial Markets in April 1994," EBD/94/84 (May 17, 1994); and memorandum from Ewart Williams to the Managing Director, "Mexico—Back-to-Office Report" (June 16, 1994); IMF archives, OMD-AD (Mr. Fischer's files), Box 11508, Accession 1998-0105-0005, "Mexico Operational File 1994." Also see Lustig (1997). The IMF staff assessment was based on a staff visit to Mexico near the end of May, during which the authorities assured them that they had tightened macroeconomic policies since the assassination and were prepared to float the exchange rate temporarily if necessary; see memorandum from Sterie T. Beza (Director, Western Hemisphere Department) to the Managing Director, "Mexico—Supplement to Back-to-Office Report" (June 16, 1994); IMF archives, OMD-AD (Mr. Fischer's files), Box 11508, Accession 1998-0105-0005, "Mexico Operational File 1994." After further informal discussions between the staff and the authorities, Camdessus sent a comfort letter to the BIS on July 21 in support of a proposal by major central banks to renew their "secondary line of reserves" (swap lines) to Mexico. That letter is in IMF archives, OMD/AI, "Surveillance of Mexico" Box 2, Accession 2007-043.

The proximate source of this worry was the external current account, which was in deficit by about 7 percent of GDP.[11] Although the government was running a small surplus in its own accounts, it had to keep rolling over a large stock of short-term securities, a rising portion of which was held by nonresidents. After the Colosio assassination, investors—both domestic and foreign—became wary of holding peso assets. The government countered by increasingly replacing peso-denominated treasury bills (*cetes*) with bills that were payable in pesos but denominated in U.S. dollars (*tesobonos*). Because holders of tesobonos were protected against a devaluation, these bills could be sold at a lower interest rate than cetes. The interest rate spread between the two instruments doubled (to 8.7 percentage points) after the Colosio assassination. In response, from end-February to end-November 1994, the government raised the portion of tesobonos in outstanding debt from 6 percent to 50 percent.[12] Although this shift dramatically lowered the government's borrowing cost, it created a large unhedged foreign currency position for the government and thereby raised the potential cost of a devaluation.

A window of opportunity to avoid an exchange crisis opened in August, when Ernesto Zedillo Ponce de León (Colosio's replacement on the ballot) won the presidential election, widely regarded as the cleanest and fairest in Mexican history. Financial markets responded favorably to the prospect of a Zedillo presidency, and the Salinas government could have taken advantage of the calm to engineer a devaluation by adjusting the crawling band. The main advocate for devaluation within the administration was the deputy finance minister, Guillermo Ortiz Martinez, but several other senior officials and some of Zedillo's top advisors were opposed. Ortiz's view was bolstered by an independent study of Mexico's exchange rate policy that had been commissioned secretly by Colosio and then submitted to Zedillo. The paper, prepared by two foreign economists—Sweder van Wijnbergen and Nissan Liviatan—and completed in September, supported the view that the currency needed to be depreciated, preferably by floating the peso. Aspe, Mancera, and ultimately Zedillo all rejected the argument or at least indicated that they preferred to wait until after the new government took office on December 1. They viewed a stable exchange rate as an essential

[11]For the IMF staff's analysis of the causes of the crisis and the role of the external current account deficit, see Savastano, Roldós, and Santaella (1995). For academic views, see Calvo and Mendoza (1996) and Lustig (1995). For a contrasting analysis by senior officials of the Bank of Mexico, see Gil-Díaz and Carstens (1996), which emphasizes the role of political shocks in addition to financial factors as contributors to the crisis.

[12]Mexico began issuing tesobonos in July 1989, but the amounts outstanding remained small until after the Colosio assassination. On Mexico's debt restructuring in 1994, see Folkerts-Landau and Ito (1995), pp. 55–56.

anchor for the health of the economy, and they believed that their macroeconomic policies were strong enough to sustain it.[13]

The postelection calm was shattered on September 28, with the assassination of José Francisco Ruiz Massieu, the secretary general of the Partido Revolucionario Institucional (PRI), the political party of both Salinas and Zedillo. Remarkably, this second political killing of the year came just one day before Aspe's triumphal speech in Madrid, described in the introduction to this chapter. A few days later, the IMF staff met with the Mexican delegation to the IMF/World Bank Annual Meetings in Madrid and again accepted the glowing official account of economic developments. In a move that Camdessus would later realize was a major mistake for the IMF, both sides agreed that the next Article IV discussions, previously scheduled for December, could safely be postponed by a month or two to give the Zedillo administration time to settle into the job.[14]

By mid-November, allegations that Raul Salinas, brother of the president, was responsible for the killing of Ruíz were gaining enough traction to induce deeper worries about Mexico's political and economic stability.[15] When the U.S. Federal Open Market Committee continued to raise short-term interest rates, capital outflows from Mexico rose sharply. In response, Salinas, Zedillo, and their top economic advisors gathered at Salinas's home on the weekend of November 19–20 to consider—for one last time before the hand over of presidential power—whether to devalue the peso. By this time, Zedillo realized that devaluation was inevitable, and Salinas indicated he was prepared to take responsibility for it if it occurred right away. After many hours of discussion, however, Aspe's firm opposition still prevailed. No action was taken, but Zedillo issued a public statement of support for Salinas's and Aspe's policies, which induced a strengthening of the currency during the last 10 days of the Salinas regime.[16]

Throughout this period of financial turmoil, the IMF had no current information on Mexico's foreign exchange reserves and had to rely on the most recent published

[13]For an indirect reference to the secret Wijnbergen-Liviatan study, see Salinas (2002), p. 1116. The internal rift on this issue was described contemporaneously in the *Financial Times* (September 13, 1994, p. 4): "The possibility of a change in exchange rate policy has been heightened by a reported division between . . . Aspe . . . and the central bank [i.e., Mancera], on the one hand, and . . . Ortiz on the other. The former are believed to support a strong currency . . .; Mr. Ortiz is said to back a faster devaluation of the currency."

[14]Minutes of meeting of Beza and other IMF staff with Aspe and other Mexican officials on October 5, 1994; IMF archives, "L.A.W. Mexico Project 1995," Accession AR 2007-043, Box 2. For Camdessus's reassessment of the postponement decision (which he misremembered as having been made in mid-November, not early October), see minutes of EBM/95/33 (April 4, 1995), p. 3.

[15]In 1999, Raul Salinas was found guilty of ordering the killing of Ruíz. His conviction was overturned on appeal in 2005.

[16]Aspe's account of this meeting was published in the *Wall Street Journal* (July 14, 1995), p. A13. For Salinas's account, see Salinas (2002), pp. 1091–93.

data.[17] Those figures, for mid-October, showed no significant worsening since April. The staff knew that the Mexican government was relying increasingly on issuing tesobonos, but its information on the magnitude was based primarily on published accounts and thus was a few months out of date. In any case, despite the obvious risks, selling tesobonos seemed to be a rational financial strategy as long as the reserve position was comfortable. Neither the staff nor the Executive Board saw any particular reason to raise alarms about Mexico's financial prospects.

On November 30, it happened that the Executive Board met to discuss a proposal to establish a new lending facility. This "short-term financing facility" would have offered quick-disbursing loans to countries with strong economic policies that were facing adverse conditions for reasons outside their control. To most everyone involved, Mexico seemed to be the shining example of a qualifying country. Even those Directors who opposed creating the new facility expressed admiration for Mexico's economic management. As Willy Kiekens (Belgium) noted at this meeting, "of the three cases presented by the staff, only the Mexican case is a strong one." Stefan Schoenberg (Germany) observed that "the balance of payments pressures" on Mexico (and on two other countries) had "subsided quickly once policy adjustments were made."[18]

The conclusion that the IMF was unaware of the precarious position of Mexico's finances in the weeks and months preceding the crisis is hard to avoid.[19] Several reasons have been advanced for this display of innocence, some unique to the particular case and some deriving more generally from the culture of the institution. Certainly the Mexican authorities had star quality and had all the confidence-instilling appearance of being in firm control. Thus, they could provide limited information about their foreign exchange reserves without being subject to strong criticism. As a new member of NAFTA and the OECD, they were more inclined to share information with the U.S. Treasury than with the IMF. More generally, Fund surveillance suffered at the time from being intermittent. The last full-scale staff mission to Mexico had occurred in December 1993. A small staff visit in May 1994, a brief meeting in Madrid in October, and occasional telephone conversations were not sufficient to keep the staff

[17]The staff raised concerns about the quality of Mexico's monetary statistics in the course of the December 1993 Article IV discussions. The initial draft of the staff report for that mission noted that although Mexico's monetary data were "generally satisfactory," their "quality and timeliness . . . seem to have deteriorated somewhat." When the authorities objected to this description, the latter phrase was deleted; "Mexico—Staff Report for the 1993 Article IV Consultation," EBS/94/31 (February 1, 1994), p. 10; and EBS/94/31, Correction 1 (February 22, 1994). The May 1994 staff visit did not raise any questions in this area.

[18]See "Short-Term Financing Facility," EBS/94/193 (September 26, 1994), and minutes of EBM/94/104 (November 30, 1994). The quotations are from the minutes, pp. 21 (Kiekens) and 30 (Schoenberg). The other two countries cited in the staff report as possible candidates were Sweden and the Czech Republic. For more on this proposal, see "Emergency Financing and the Supplemental Reserve Facility" in Chapter 5 of this volume.

[19]Several years later, Fischer (2001) admitted that the "IMF and investors simply did not know what was happening to Mexico's reserves in the lead-up to the crisis."

well informed. A great deal of information could be gleaned from the actions and writings of private investors and analysts, but that information was not systematically scrutinized by the staff working on Mexico. Eventually, the Fund absorbed the lessons from these failings, but not in time to help with this case, the first crisis of its kind.[20]

The Peso Crisis Hits

The crisis began not with a financial shock, but with an outbreak of political chaos. On Monday, December 19, 1994, the Zapatista National Liberation Army came out of hiding in Chiapas and exerted temporary control over a number of towns throughout the state. The Zapatista movement had been building up steam since its original attacks in January, and this sudden success—brief though it would turn out to be—caused both domestic and international investors to reconsider the risk that the new government in Mexico City would be unable to control the economy while fighting an insurgency in the south. Stock and bond prices fell sharply, and the exchange rate (then 3.46 pesos per U.S. dollar) looked more vulnerable than ever. The effects of the Chiapas uprising alone could have been contained, but this shock climaxed a year of growing unrest and assassinations that had already made the financial situation in Mexico precarious.

The only viable option left to the government was to allow the peso to depreciate more rapidly, either in a free float or through an immediate devaluation and a widening of the band. Unfortunately, the government's ability to act was constrained by its commitments under the Pacto de Solidaridad Económica, generally known simply as the Pacto. This arrangement came about in December 1987, when the government formally agreed with business and labor leaders to devalue the peso, establish a de facto crawling peg against the dollar, and support the new exchange regime with a package of fiscal and other policies aimed at sharply reducing price and wage inflation and stabilizing the economy.[21] The Pacto participants renegotiated the specific policy agreements annually, but a consistent feature of the Pacto was that the government promised not to alter the exchange regime without first consulting its business and labor partners. In normal circumstances, this commitment helped maintain labor peace, but in the circumstances of December 1994 it proved to be a disastrous constraint.

Zedillo's finance minister, Jaime Serra Puche, had been in office for only a few weeks, and his previous experience had been primarily in trade rather than finance. (As Salinas's secretary of trade and industry, Serra had presided over the NAFTA

[20]For a detailed examination of the shortcomings in the run-up to the peso crisis, see "Mexico—Report on Fund Surveillance, 1993–94," EBS/95/48 (March 23, 1995).

[21]For a brief summary of the origins of the Pacto in the context of the debt crisis of the 1980s, see Boughton (2001b), pp. 451–52. For overviews of the evolution of the agreement, see Aspe (1993) and Dornbusch and Werner (1994), Appendix A.

negotiations.) Nonetheless, he responded immediately to the financial pressure on December 19 by calling a meeting of the Pacto principals for that evening. When the business and labor officials gathered at the headquarters of the labor ministry in Mexico City, Serra boldly proposed allowing the peso to float, but both groups flatly refused. Eventually, those gathered reached a compromise under which the peso would be devalued by 15 percent the next morning, but everyone present realized that this action might not be enough (see Salinas, 2002, pp. 1102–03).[22]

Although no one in the Mexican government seems to have thought it necessary to tell the IMF, their economic team spoke frequently with Shafer and others in the U.S. Treasury and kept them informed as these plans developed. That led to the stunning situation late that night, in which the IMF first learned of the impending devaluation through a casual comment by Shafer to Fischer during a routine telephone conversation (see above, pp. 456–57).

The next morning, Lawrence H. Summers (under secretary for international affairs at the U.S. Treasury) telephoned Fischer and asked him to issue a statement of support for the devaluation. Fischer readily agreed because he believed that Mexico's policies were basically sound except for the obvious need to correct the overvaluation. He telephoned Camdessus, who was vacationing at his family home in the south of France. Fischer then intended to issue a press release, but new developments intervened.

For two days, the Mexican authorities tried desperately to keep the peso within 15 percent of its old level, but they fought a losing battle. Despite a rise in short-term interest rates to 32 percent from 15 percent, the Bank of Mexico continued to lose reserves. (In one week, the loss totaled $6.4 billion.) Much of the capital outflow apparently derived from Mexican residents sending their money abroad, in all probability led by those who had received early warning of the magnitude of the situation at the Pacto meeting Monday night. By Wednesday afternoon, December 21, Zedillo and Serra had concluded that they would have to float the peso after all. Serra held a second Pacto meeting that evening, and this time no one was able to veto the change.[23]

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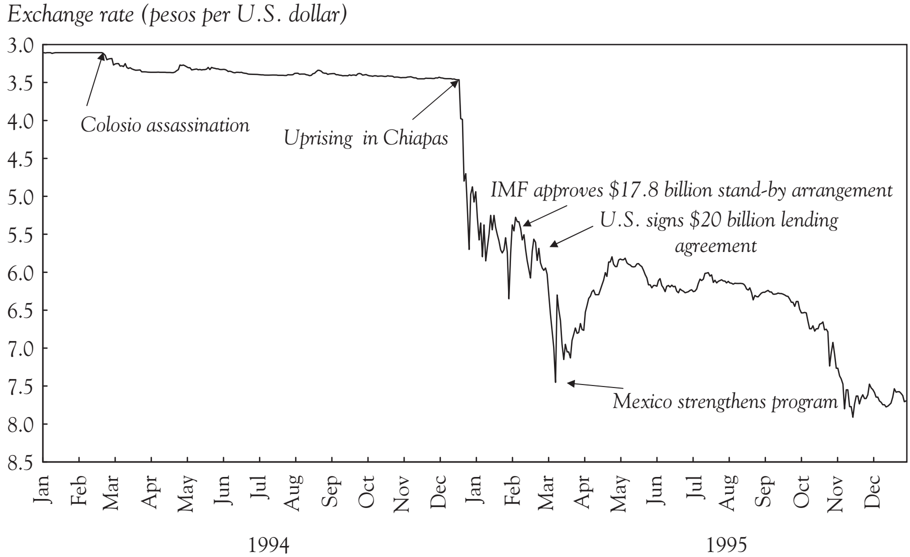
[22]The specific decision was to lower the floor of the exchange rate band (the depreciation limit) by 15 percent (to 4.0016 pesos per U.S. dollar) and to leave the daily rate of crawl for the widened band unchanged. Because the exchange rate was already at the floor, this action effectively devalued the currency by 15 percent. In addition, the Pacto agreement reached that night included fiscal and credit restraints to be implemented in the coming weeks. The Mexican press communiqué announcing the change was circulated within the Fund as EBD/94/200 (December 21, 1994). For the immediate staff reaction, see memorandum from Claudio Loser to the Acting Managing Director (Fischer), "Mexico—Recent Developments" (Revised), December 20, 1994; IMF archives, OMD-AD (Mr. Fischer's files), Box 11508, Accession 1998-0105-0005, "Mexico Operational File 1994."

[23]On the extent and nature of capital outflows, see Folkerts-Landau and Ito (1995), pp. 57–62. On the Pacto meeting, see Salinas (2002), p. 1106. Also see memorandum from Javier Guzmán-Calafell (Advisor to the Executive Director for Mexico) to the Managing Director, "Mexico—Exchange Arrangements," December 22, 1994; IMF archives, OMD-AD (Mr. Fischer's files), Box 11508, Accession 1998-0105-0005, "Mexico Operational File 1994."

Figure 10.1. Mexico: Exchange Rate, 1994–95



Sources: Bloomberg L.P. and author's notations.

The next day, the peso shot up to 4.8 per dollar, a depreciation of 28 percent from the precrisis level (Figure 10.1).[24]

Fischer called an emergency meeting of the most senior staff for 7:30 Thursday morning to devise a response strategy. To buttress the new policy and to try to prevent a complete collapse of the peso, Mexico was asking the U.S. and Canadian central banks to activate their established swap lines. A normal requirement for doing so would be for the IMF to issue a statement attesting to the soundness of Mexico's economic policies and prospects. Reached again by telephone, Camdessus insisted the Fund could not make such a statement without at least a request from Mexico for a staff visit to assess the situation.

After some initial resistance, the authorities finally agreed to receive a staff visit. Fischer and the staff drafted a statement to be issued immediately and publicly. It took note of Mexico's shift to a "flexible exchange rate regime" and stated that the "actions being adopted by the authorities represent an appropriate policy response to recent market developments" that "will help reinforce the economic recovery that has been

[24]These depreciation percentages are presented in the standard IMF style, as the percentage loss in the value of the domestic currency, measured by the amount of foreign exchange (U.S. dollars) the currency will buy. By this measure, the peso depreciated by 12.8 percent on December 20 and by a cumulative 27.8 percent through December 22. The Mexican authorities used the reciprocal: the percentage increase in the cost of buying foreign exchange. By that measure, the depreciation rates were 14.7 percent and 38.5 percent, respectively.

evident since early 1994 and secure the viability of Mexico's external position."[25] Because Mexico had not asked for any financial help from the IMF, and because the U.S. Treasury seemed willing to take responsibility for whatever help Mexico might need, the IMF—for the moment—could do little more.

In the first two days of the crisis, the Mexican authorities had communicated their intentions only to U.S. Treasury officials, but now they were beginning to reach out to the IMF and to commercial bank creditors. Mancera called Fischer twice on Thursday to ask for the statement of support, while Serra flew to New York to try to calm down bank creditors. The latter effort initially seemed to work, as the peso recovered somewhat on Friday, but the calm did not last.

On Saturday, Christmas Eve, Fischer—who had undergone a long-scheduled surgery on Friday—met again with key staff members at his home to make final plans for the staff visit to Mexico. Claudio M. Loser (Director, Western Hemisphere Department) and a couple of other staff were scheduled to leave for Mexico City for one day of meetings right after Christmas, but in the meantime, Serra and Mancera had both suddenly decided to come to Washington on December 26. That would require postponing Loser's departure by a day or two, but it would give Fischer a chance to clarify in direct talks with the authorities the Fund's expected role.

On Monday, the day after Christmas, normally one of the quietest days of the year in Washington offices, Serra and Mancera spent a long and exhausting day at the Treasury and the Federal Reserve Board explaining their plans and asking for help. U.S. officials were reluctant to make any firm commitments in the absence of a substantial increase in Mexican interest rates to discourage capital outflows, but Mexican officials feared that increasing interest rates would have disastrous effects on the economy. This classic dilemma could not be resolved in a day. The Mexican team finally got to the IMF about 9:30 that evening, where Fischer, Loser, and other staff were waiting. Fischer's entreaties for a stand-by arrangement fell on deaf ears because the Mexican authorities were firmly convinced that they should and could handle the problem bilaterally with the United States. Being forced by circumstance to seek conditional assistance from the IMF was an uncomfortable and embarrassing situation for any government. More specifically, Mexico was a NAFTA participant and a member of the OECD. Having to borrow from the IMF would be a major setback to its reputation as the newest member of the world's advanced economies.

However, Mexico needed to borrow sufficient money from other (non-IMF) sources quickly to stop the free fall of the peso, which on that Boxing Day was trading at about 5.15 pesos to the dollar, down 33 percent from a week earlier. Serra seemed to think it possible, after his meetings with U.S. officials, to cobble together a package of about \$40 billion. Of that, perhaps \$20 billion would come from the United States and Canada in the form of a currency stabilization fund, \$6 billion each from the BIS and from commercial banks, and up to \$2 billion from other

[25]"IMF Supports Mexico's Exchange Rate Action," NB/94/18 (December 22, 1994).

official creditors. From the Mexican perspective, the IMF needed only to endorse their economic policies.

Fischer had no objection at all to endorsing Mexico's policy program, which looked strong on paper and was backed up by a good track record over the past several years. He was less confident about the country's prospects for getting $40 billion in official credits without direct financial participation by the IMF. Accordingly, he tried—but failed for the moment—to persuade the officials to ask for a stand-by arrangement. The officials did agree to allow Loser to lead a mission to Mexico—not just an informal staff visit, but a small though full-scale mission—right away, but only on condition that it be kept strictly secret and that it not enter into program negotiations.[26]

When Loser arrived in Mexico City on December 28, he did not feel welcome, and he was uncomfortable with the high level of secrecy surrounding his mission. The authorities made it quite clear that they did not want to discuss policies with the Fund and had no interest in seeking a stand-by arrangement. They rejected a further plea from Fischer to announce that talks were under way. Fischer thought that Mexico would gain credibility by inviting the IMF in, but Mexican officials feared the possibility of a domestic political backlash.

Reinforcing the Mexicans' conviction that they did not need help from the Fund was Summers's continuing view that Mexico was facing a temporary liquidity problem that the United States could handle bilaterally by activating existing swap lines. Summers, who was effectively in charge of international policy at the U.S. Treasury at this time,[27] issued a public statement of support to Mexico on December 29, which gave a brief uptick to the peso and further weakened the case for IMF involvement. Behind the scenes, Andrew Crockett, general manager of the BIS, began soliciting the participation of major central banks in a $5 billion short-term loan to Mexico to serve as part of an international support package.[28]

The first hint that the stalemate on IMF involvement might be broken came later that day, when Zedillo suddenly named a replacement for Serra as finance minister.

[26]In general, the mandate of a "staff visit" is simply to gather information. A "mission" is intended more as a two-way dialogue in which the staff also may offer policy advice on behalf of the Fund.

[27]Robert E. Rubin had been nominated to replace Lloyd Bentsen as secretary of the Treasury, but he had not yet been confirmed by the U.S. Senate. In the meantime, he had gone on holiday to the Virgin Islands, and Summers was in charge of international affairs; see Rubin and Weisberg (2003), pp. 5–6.

[28]The BIS request was addressed to the central banks of the member countries of the Group of Ten (G10), except for the United States and Canada because those two central banks were providing financial support bilaterally, plus Spain. Although Mexico had not yet asked for a stand-by arrangement with the IMF, Crockett's proposal was contingent on the successful negotiation of such an arrangement, and the BIS loan was intended primarily to serve as a bridge to IMF financing; see letter from Crockett to William J. McDonough (president of the Federal Reserve Bank of New York), December 30, 1994; IMF archives, OMD-AD (Mr. Fischer's files), Box 11508, Accession 1998-0105-0005, "Mexico Operational File 1994."

In his stead, he chose Ortiz, who—as a former member of the IMF Executive Board (1984–88)—was more open to the idea of IMF financial support than his predecessors had been. Just three days later, on New Year's Day, Ortiz called Loser in Washington to say that he had discussed with Zedillo the possibility of having a Fund-supported program. They had agreed to consider it if the Fund was willing to accept the policies that Zedillo was about to announce and not require them to take additional measures. Zedillo would be making a speech the next day (Monday, January 2) announcing the new policies. It would then be up to the Fund to decide whether to concur.

Another day was lost while Zedillo's team negotiated details of their adjustment program with their Pacto partners. The president then announced the new program on television on January 3, but with no mention of any request for IMF assistance.[29] Fischer then came under pressure from both the U.S. and the Mexican authorities to give the Fund's blessing to the Zedillo speech, even though he still had no firm indication of what role the Fund might be asked to play. To cover all possibilities, Fischer issued a press release that ended with some convoluted and ambiguous prose. After describing the program that Zedillo had just announced, based on a significant tightening of monetary and fiscal policies, he concluded: "These policies provide a solid basis for discussions on an agreement that could be supported by the use of IMF resources, at the request of the Mexican authorities."[30] No such request had been made, but Fischer had inferred from conversations with Ortiz and from Loser's mission report that one might be imminent. Ortiz also hoped that the public show of support from Fischer might improve investor sentiment and obviate the need for the Fund's financial assistance.

The IMF now entered full crisis mode. It was far from clear that Mexico would have either strong enough economic policies or sufficient external financing to avoid a default or the imposition of exchange controls, either of which could have disastrous consequences that would reach far beyond the country's borders. Camdessus returned from vacation on January 4 and met informally with Executive Directors. He also spoke by telephone with Ortiz, using what he would later describe as "very strong language" to explain to him why he should seek help from the Fund to stabilize the currency and the economy. From this point on, high-level meetings on Mexico would take place at the Fund almost daily until well into February.

Ortiz flew to New York on January 5, where he met with several hundred bank creditors, investors, and rating agency representatives in the ballroom of the Pierre

[29]The only new element of external financing was the creation of an $18 billion exchange stabilization fund, to be financed by activating and enlarging (from $6 billion to $10 billion) the swap lines with the U.S. and Canadian monetary authorities under the terms of the April 1994 North American Framework Agreement, by drawing on the anticipated $5 billion loan from the BIS, and by borrowing $3 billion from a syndicate of commercial banks. (The last element did not materialize.)

[30]"IMF Management Welcomes Mexico's Comprehensive Economic Program," NB/95/2 (January 3, 1995).

Hotel. After he explained the steps the government was taking to reduce the external deficit, he found the atmosphere in the room was one of calm acceptance. More important, he was relieved to see the peso rising in value in the hours after the meeting. The next morning, however, while Ortiz and his aides were en route home in a Mexican Air Force plane, he learned the peso was falling again. Fearing that the currency was still under attack, he ordered the pilot to take him to Washington instead. There, he met with Camdessus over lunch, and they announced finally that Mexico was seeking financial assistance from the IMF. More than two weeks had passed since the onset of the crisis, during which the peso had depreciated by 40 percent against the dollar and the flight from tesobonos and other Mexican securities had continued unabated. The fear of a unilateral restructuring and the resulting outflows had not yet subsided, but at least a plan was in place for coping with the crisis.

What Role for the IMF?

On a first reading, the story up to this point may suggest that the IMF's senior management team was seeking to inject the Fund into the crisis resolution process to give themselves and the institution an important role. The essence of the matter went much deeper. They believed that IMF participation was vital for the workout to succeed, and in retrospect they were correct. Three reasons stand out.

First, no official creditor—including the United States—was willing to advance its own money bilaterally without the IMF's written assurance that Mexico was implementing a sound economic policy program. Camdessus had been providing "comfort letters" to U.S. and other official agencies throughout 1994, but once the crisis erupted in December, he could not continue to do so in good faith without the Fund's direct participation. In practice, that meant that Mexico had to enter into a stand-by arrangement, with all the attendant conditionality.

Second, even with the Fund's seal of approval for Mexico's policies, the amount of money that might be needed to stop a speculative attack on the peso likely exceeded the means of bilateral creditors, or of the IMF and other multilateral agencies acting as a group. By the time Ortiz arrived in Washington on January 6, his staff had calculated that US$40 billion to US$50 billion in external debt was coming due in the near term. Because the net foreign exchange reserves of the Bank of Mexico were close to zero, most of the debt would have to be rolled over voluntarily (which was very unlikely), or official creditors would have to guarantee the debt or supplement Mexico's reserves (which would require a very large commitment), or Mexico would have to default on its debt (which everyone involved considered highly undesirable). Concerted multilateral action—which would be difficult or impossible without coordination by the IMF—was the only viable course.

Third, in addition to these concrete issues, the IMF also provided a calming influence. The fear that this situation would spin out of control and end in a Mexican default

despite all best efforts had thrown both Mexican and U.S. officials into a serious panic. Rubin, who took over as secretary of the U.S. Treasury on January 10, has written of his fear of a "meltdown" that "could deal an enormous setback to the spread of market-based economic reforms and globalization" throughout the world. In meetings with Rubin, Ortiz looked "ashen and exhausted." At the U.S. Treasury, Rubin, Summers, and Shafer all felt "distressed," "worried," and under enormous pressure. Before the crisis ended, Summers offered his resignation if the rescue should fail (Rubin and Weisberg, 2003, pp. 5 and 26–31). Camdessus later recalled hearing a trembling in Rubin's voice during some of their frequent telephone conversations about Mexico. In contrast, Camdessus had an incurable confidence that the recovery effort could not possibly fail, and his optimism was infectious.

For all these reasons, by the time of Ortiz's stopover in Washington on Friday, January 6, both he and Summers had determined independently to turn to the IMF for help. That weekend, Fischer and Summers met and decided that an official package of loans totaling just $25 billion (about half of the amount that would soon be falling due) should instill sufficient confidence to get private creditors to roll over the rest voluntarily. For the next few days, this figure became the target for the financing package being assembled. The seed money, but only the seeds, would come from the IMF. It looked unlikely that the Fund could lend Mexico more than 100 percent of its quota (about $2.5 billion) in 1995, and no other country was expected to offer very much, so the bulk of the $25 billion would have to come from elsewhere.

The next step was for Loser and a larger staff team to return to Mexico City to negotiate terms for a stand-by arrangement. They arrived on January 10, hoping to complete the talks in no more than a week. After all, Mexico had already floated the currency and had announced a program that went a long way toward correcting the problems that had led to the crisis. The main issue to be resolved concerned fiscal policy. Although lax fiscal policy was not a problem in Mexico, the staff believed that a temporary further tightening was needed to offset the loss of external financing and to restore confidence. Loser's brief called for him to ask for additional fiscal measures totaling 2 percent of GDP. The authorities were certain to resist this request, but Loser had to try to get as much as he could.[31]

On the same day the mission started, Fischer spoke by telephone with Zedillo's chief of staff, Luis Téllez (another of Fischer's former MIT students). Fischer was concerned that none of the principal participants in the mission discussions—himself included—had ever handled this kind of international crisis before. He also sensed that the Mexican authorities were in a panic and unsure of what to do. It would be beneficial, he suggested, if Camdessus—who had helped manage any number of financial crises,

[31]Memorandum from Loser to the Managing Director, "Mexico—Briefing for Mission" (January 10, 1995); IMF archives, OMD-AD (Mr. Narvekar's files), "Mexico Correspondence Jan. 1995," Box 9489, Accession 1996-0266-0001.

both as a French official and as Managing Director—got more personally involved. Téllez agreed, and the next morning (January 11) a Mexican presidential jet picked up Camdessus in Washington and flew him to Mexico City to meet with Zedillo. To avoid generating rumors, the mission was kept strictly secret, even from IMF staff at headquarters, and Camdessus returned home late that same night without having been seen.

In his meeting with Zedillo, Camdessus stressed that a successful resolution to the crisis was essential both for Mexico and for the international community. Mexico would have to make an extra effort to strengthen its own finances. If the authorities did, he was prepared to make an "extraordinary effort" to get additional financing, both in the form of higher access to IMF money (possibly going well beyond the $2.5 billion that was currently being discussed) and more widely.[32] Despite this promising start, and even with Camdessus putting his personal prestige on the line, negotiations between Loser and Ortiz would drag on for more than two weeks.

One reason for the lengthy meetings was simply the difficulty of finding a compromise policy program on which both sides could agree. Ortiz not only wanted to slow down and reduce the magnitude of the required fiscal adjustment, he also wanted some flexibility to handle developments beyond his control. Mexico had pioneered the use of contingency clauses in a Fund arrangement in 1986,[33] and he insisted on repeating the success of that experiment. An announcement by the U.S. Treasury that it would ask the U.S. Congress to authorize a large-scale program of loan guarantees for Mexico strengthened his position. On January 17, Ortiz went again to Washington, where he secured from Camdessus a promise for more flexibility. In the end, the Fund agreed that the base level of fiscal policy could be relatively accommodative, and the authorities agreed to tighten further if demand pressures worsened.

A second reason for the delay was that it was not immediately certain that Camdessus could deliver on his promise of exceptional access to IMF resources. To make the case to the Fund's Executive Directors, he had to convince them that resolving the Mexican crisis was important not just for Mexico (and for the United States) but for the international financial system and for the world economy. Fischer first expressed concerns about contagion on January 3, when he asked the staff to prepare a study of the risks to other developing countries. The following week, Jack Boorman (Director, Policy Development and Review Department, or PDR) supported this view in stark terms, writing privately to the Managing Director that the "risk of contagion from self-fulfilling investor pessimism constitutes a systemic risk that underlines the need for

[32]Camdessus informed the Executive Board on January 12, in restricted session. On February 2, during an interview on U.S. television, he revealed publicly that he had made this trip.

[33]That episode is described in Boughton (2001b), pp. 440–53.

extraordinary responses from the Mexican authorities, from the Fund, and from the international financial community more generally."[34]

Camdessus acted on this advice and made a strong case based on three risks. First, the pullout of investment funds from Mexico could spread to other countries, in what Boorman had called "self-fulfilling investor pessimism." That pullout could be aggravated by sympathetic declines in stock markets around the world. Second, because Mexico had been extolled as the star performer in profiting from an open and liberal policy regime, its economic collapse could discredit the whole silent revolution in development policy and set back the course of financial globalization. Third, even beyond the developing countries, world economic growth could decline as a result of falling production and shrinking markets.[35]

Camdessus's arguments left the Fund's European Executive Directors distinctly unimpressed. When he first made his case to the Board in an informal and restricted meeting on January 12, the Europeans offered two counterarguments. First, most of them were skeptical about the risk of contagion. Even if some investors pulled out of other countries in the region, they reasoned, the aggregate effect was likely to be small. In this view, they drew some support from the Fund's research staff, who calculated at the time that the effects of the Mexican crisis on economic growth in the United States and in Latin America generally (with the notable exception of Argentina) were likely to be modest and fairly quickly reversed (see IMF, 1995, pp. 11 and 36–37). Second, some Directors, led by Stefan Schoenberg (Germany), argued that it was not proper for the IMF to lend to one country to avoid an adverse effect on another. If there was a risk to, say, Argentina, then the Fund should be lending to Argentina, not Mexico. On that point, most of the senior staff strongly disagreed. Faced with a risk to the international financial system, they reasoned, the IMF should do whatever it could to minimize that risk. In one staff meeting on the crisis, a senior department head scoffed that the German authorities would not acknowledge a systemic risk unless an asteroid was heading toward earth with the potential to wipe out two-thirds of mankind. Clearly, nerves were on edge.

Both of these issues were tentatively resolved on January 26. Although several Executive Directors still opposed granting Mexico exceptional access, Camdessus gave Loser the go-ahead to finalize a request from Mexico for an 18-month stand-by arrangement for 300 percent of quota (SDR 5.3 billion, or about $7.8 billion). Ortiz and Mancera then signed a Letter of Intent that included the contingency provisions requested by Mexico. A Board meeting was scheduled for February 1 to consider the request.

[34]Memorandum from Boorman to the Managing Director, "Mexico" (January 12, 1995); IMF archives, OMD-AD (Mr. Narvekar's files), Box 9489, Accession 1996-0266-0001,"Mexico Correspondence Jan. 1995."

[35]Memorandum from Alexander Mountford (Advisor in the Secretary's Department) to Leo Van Houtven (Secretary of the Fund), "Mexico: Some Developments" (January 13, 1995); IMF archives, Historian's files.

How Much to Lend?

Meanwhile, with capital markets still showing no eagerness to keep their money in Mexico, the early-January target of a $25 billion financing package was looking much less adequate. In fact, as early as January 12, U.S. Senator Alfonse M. D'Amato (chairman of the Senate Committee on Banking, Housing, and Urban Affairs) suggested that a package of $40 billion (approximately the amount of Mexico's external very short-term debt) would be much more effective at discouraging a speculative attack (see Rubin and Weisberg, 2003, p. 14).[36] Once that figure entered into the public discourse, it became a minimum from which no retreat was possible. In Alan Greenspan's words, U.S. intervention had to be "massive and fast." Summers likened it to the Colin Powell doctrine of using overwhelming force from the outset of a military engagement.[37] Any retreat from an announced figure would raise doubts about the commitment to succeed.

The problem with providing $40 billion to bolster Mexico's reserves was that if the move failed to restore confidence swiftly, it would enable all holders of tesobonos to get repaid in full at the undepreciated peso-dollar exchange rate. That could create huge moral hazard problems later on, but the alternative—a default on the debt, possibly accompanied by an economic meltdown—could create much greater problems far more quickly. Regardless of the longer-term consequences, most of the official participants (aside from a large portion of European monetary authorities) decided to focus on solving the crisis at hand.

For much of the second half of January, it looked as if official support for Mexico might total as much as $55 billion. In addition to the proposed $7.8 billion IMF stand-by arrangement, the Bank of Canada was offering $1.2 billion in short-term financing through a swap arrangement under the terms of the April 1994 North American Framework Agreement, the BIS was prepared to lend $5 billion to the Bank of Mexico, and the World Bank (specifically, the International Bank for Reconstruction and Development, or IBRD) and the Inter-American Development Bank (IDB) were expected to lend amounts that might total about $1 billion. The centerpiece, however, was to be the provision of $40 billion in loan guarantees from the U.S. government. As announced by the U.S. Treasury on January 12, the United States would guarantee the principal on that amount of private sector loans to the Mexican government, in return for which Mexico would pay substantial fees: so large as to cover the anticipated costs and to give Mexico an incentive to exit from the program as early as possible.

[36]Senator D'Amato later became an outspoken critic of the U.S. rescue effort, writing in March 1995 that "this bailout will go down as one of the President's biggest blunders. . . . We should not bail out a mismanaged foreign government" (D'Amato, 1995, p. 24).

[37]Greenspan (2007), pp. 156–60, provides an account of the U.S. response to the Mexican crisis. Summers frequently used the "Powell doctrine" analogy in remarks on the Treasury's response.

The Clinton administration was optimistic that Congress would approve the guarantees, because the congressional leadership team—though dominated by the opposition Republican Party—unanimously supported the proposal. On January 25, however, a hearing by the House Banking Committee went badly when several committee members strongly attacked Rubin for, in their view, trying to bail out Wall Street investors with taxpayers' money. The guarantee plan quickly unraveled at the same time that the IMF was preparing to consider Mexico's request for a stand-by arrangement.

On Saturday (January 28), Ortiz met with Rubin at the Treasury building in Washington and told him that Mexico's financial situation was continuing to deteriorate. The Mexican government would be unable to meet the payments coming due in the next week unless it got immediate help from the United States. President Clinton, Rubin, and other senior U.S. officials then met at the White House to consider alternatives if Congress were to reject the guarantee proposal. The most viable alternative appeared to be for the U.S. Treasury to lend directly to the Mexican government using the resources of the Exchange Stabilization Fund (ESF).[38] That scheme, which would not require congressional approval, had been suggested earlier in the month by Robert Bennett, a Republican Senator with close ties to the Senate leadership, so it was reasonable for the administration to think that it would be well received.[39]

On Sunday, Summers met with his Group of Seven (G7) finance deputy colleagues in Paris. He told them vaguely that alternatives were under consideration, and he was understood to have promised to consult with them before deciding on one. When events quickly moved ahead of him the next day, the lack of consultation would become a major source of irritation to the European deputies.

Throughout the day on Monday, January 30, as the peso fell to 6.35 against the dollar (a 45 percent depreciation since the start of the crisis), the possible collapse of U.S. financing for Mexico dominated discussion at the IMF. In a series of meetings with staff and with Executive Directors from creditor countries, Camdessus explored ways of getting other countries to contribute bilateral financing. Lissakers assured him she was confident the U.S. Congress would approve the $40 billion in guarantees, but Fischer—who returned to Washington in the afternoon from the World Economic Forum in Davos, Switzerland—reported that congressmen attending the Davos meetings had told him the plan was almost certain to die. By the end of the day, however, none of this discussion had produced any concrete proposals.

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[38]The United States had previously lent ESF monies to Mexico on several occasions, beginning in 1936 and including a loan that was part of the initial package to deal with the 1982 debt crisis; see Bordo and Schwartz (2001) and Boughton (2001b), pp. 292–93. For the history of the ESF, see Schwartz (1997) and Henning (1999).

[39]Ortiz's plea is described in Rubin and Weisberg (2003), p. 22; and Clinton (2004), p. 643. For an account of the meetings at the White House and in Paris (see next paragraph), see Graham and others (1995), p. 4. Clinton (2004) attributes the idea of using the ESF to Rubin and Summers, and Greenspan (2007) p. 159, attributes it to Rubin; but Rubin and Weisberg (2003) p. 21, credit Bennett.

That evening, the U.S. government was forced to abandon the guarantee plan when the Speaker of the House of Representatives, Newt Gingrich (Republican of Georgia), telephoned the White House to say that he was pulling the proposal rather than face certain defeat in a floor vote. Clinton's economic team—including Summers, who had rushed back from Paris—met throughout the evening to come up with a single viable alternative. The president himself joined them about 11:00 p.m., and around midnight he accepted their proposal to lend Mexico $20 billion through the U.S. ESF. That was only half the size of the previously announced plan, and it was unlikely to cover Mexico's needs for long, but it was all that could safely be spared from the Treasury's funds.

Now it was up to the IMF to react. At one o'clock Tuesday morning (January 31), Summers telephoned his jet-lagged friend Fischer (who had also just returned from Europe that day) to tell him the bad news. The administration, he reported, planned to announce the ESF plan at 9:00 that morning. Once he fully woke up, Fischer tried to convince him to delay the announcement until they could beef up the package, because the financial markets—already in turmoil on Monday—would certainly attack the peso again as soon as traders knew of the drastic cuts in official support. Summers, however, felt that nothing more could be done. The New York financial markets would open at 9:30 in the morning, and Rubin was scheduled to testify before a congressional committee at 10:00. Delay seemed impossible.

Fischer now was deeply worried that before the day was over, Mexico would be forced to default and impose strict exchange controls, with devastating consequences for the world economy. As he later admitted, he feared that "Western civilization as we knew it was coming to an end" (Blanchard, 2005, p. 253). Even so, he was loathe to wake his boss at that hour. After a mostly sleepless night, he finally called Camdessus a few minutes before 6:00 a.m. As usual, Camdessus reacted calmly. We are now in a real crisis, he told Fischer, and in a crisis the first rule is not to panic. Camdessus then called his personal assistant, Ruth Saunders, and asked her to call his top advisors immediately for a meeting in his office at 7:30.

By the time Camdessus and Fischer arrived at the Fund, shortly before 7:00 a.m., the Managing Director had devised a bold plan to restore the package close to the $50 billion magnitude that financial markets had come to expect. First, he would ask the Executive Board to increase the size of the stand-by arrangement from $7.8 billion to $17.8 billion. A financial commitment of this magnitude would be completely without precedent and far beyond any operation previously attempted by the IMF, but Camdessus was convinced that the circumstances warranted it.[40] Second, he would ask the Board to approve disbursing all the original $7.8 billion immediately, rather than in the usual tranches over the life of the arrangement. Separately, Edwin M. Truman (director of the international finance division at the U.S. Federal Reserve Board) had already (around

[40]The largest commitment by the IMF up to this time was the 1981 extended arrangement with India, totaling $5.8 billion (SDR 5.0 billion).

1:00 a.m.) called Andrew Crockett (managing director of the BIS) to ask him to double the BIS commitment from $5 billion to $10 billion. Together with the commitments from Canada and the United States, that would enable Camdessus and Clinton to announce a new package that morning that was not much smaller than the old one.

At 7:00 a.m., Camdessus was on the telephone with Rubin, with Fischer and Summers listening in. Camdessus, in what Rubin would later describe as "a moment of daring unusual even for him" (Rubin and Weisberg, 2003, p. 23), explained that he planned to ask the Board to approve the much larger amount later in the morning. When Rubin asked him incredulously if he could really deliver that large a loan, Camdessus replied that the Board would have to approve it if they wanted him to stay as Managing Director. All that he asked was that any lending agreement between the U.S. Treasury and Mexico be written so as to not to conflict with IMF conditionality and so as to respect the Fund's implicit preferred-creditor status.

Next, Camdessus met with his deputies and a few key department heads at 7:30. To get the additional $10 billion without straining the Fund's own liquid assets excessively, Camdessus tabled an unusual and seemingly bizarre proposal that became known as "$10 billion − X."[41] He would personally try to persuade countries that were not members of the G10 (because the G10 members were already contributing through their participation in the BIS) to lend Mexico up to $10 billion to fund its exchange stabilization fund. The IMF would still—in principle—augment its own arrangement by $10 billion, but only to the extent that the solicitation effort fell short.

Boorman and Fischer tried to argue that it would be better to present the request as a positive challenge, in which the IMF would raise its commitment by $5 billion only if non-G10 countries would also contribute $5 billion, but Camdessus insisted on his 10 − X proposal. Part of his reasoning was that he believed Mexico did not need an extra $10 billion for the three years before they would have to start repaying the loan from the IMF. All they needed was to have a large pile of money available for a short period until the crisis passed. The 5 + 5 alternative would take some time to complete and thus would not satisfy Mexico's immediate needs.

The sun was up now, and time was running out before the New York financial markets would open for the day. Normally the Executive Board meets at 10:00 a.m. and only on Monday, Wednesday, and Friday each week, but for this emergency Camdessus asked Directors to meet at 9:00 on this Tuesday morning in restricted session. When he sketched out his request, some Directors reacted bitterly, led by Huw Evans (United Kingdom) and Schoenberg. It appeared to them that the Managing Director had effectively committed the Fund to this course of action after discussions with the U.S. authorities but without any consultation with the rest of the Executive Board. In reply,

[41]Camdessus also briefly considered asking the G10 member countries to approve activation of the General Arrangements to Borrow (GAB), but that idea was rejected during this meeting on the grounds that it would require lengthy negotiations and that European skepticism made the outcome uncertain.

Camdessus asked if anyone thought he had any real choice, and he stressed he had made no promises either to Mexico or to the United States, except to bring this request to the Board for consideration. With that, no one objected further to Camdessus's intention to make a public announcement at once, subject to formal consideration of the stand-by arrangement by the Board at their regular meeting the next day.[42]

While this meeting was under way, Clinton was meeting with the congressional leadership team at the White House to secure their support for the revised plan. Rubin managed to get his congressional testimony delayed so that Clinton could announce the new plan himself at 11:15. The IMF Board meeting was adjourned a few minutes after 10:00, and in an extraordinary bit of synchrony, the U.S. president and the IMF issued their announcements at the same time.[43] Unfortunately, the wording of Clinton's statement seemed to suggest that he had asked the IMF to augment its lending to offset the diminishment of the U.S. contribution. ("I have worked with other countries to prepare a new package. As proposed now, it will consist of a $20 billion share from the [ESF] . . .; $17.5 billion [sic] from the International Monetary Fund; and . . . $10 billion from the [BIS].")[44] This misleading implication that the increase in IMF lending was a U.S. initiative served only to heighten the already simmering resentments in European capitals.

The IMF Executive Board approved the arrangement the next day, February 1, but only after a very long and contentious series of meetings. To give Directors time to seek advice from their national authorities, Camdessus scheduled the Board meeting for the afternoon. When the revised staff report was finally circulated to Directors only at midday, he was forced to postpone the meeting to the evening. (Normally the Board requires a three-week circulation period for such papers.) He spent the day trying to shore up support, while the staff worked to define the terms on which they could ask non-G10 countries to participate in the financing.

The only opposition to the proposed arrangement was coming from western Europe. The hostility of many European officials arose partly because they thought the financial package was excessively large and had the potential to weaken the security of the Fund's financial resources, and partly because they thought it posed a serious moral hazard for private sector creditors. More viscerally, it arose because they felt the deal had been cooked up between the Managing Director and the U.S. authorities without

[42]See minutes of EBM/95/10 (January 31, 1995); additional information is from interviews.

[43]The BIS did not issue a press release at this time. Its announcement was not made until February 13, following the formal approval of the facilities by the BIS's governing board.

[44]Speech to the National Governors' Association at the J.W. Marriott Hotel in Washington, DC (January 31, 1995). The misimpression was compounded that afternoon, when Rubin told a press conference that "through the extraordinary good work of Under Secretary Larry Summers last night, the IMF increased its participation." For the transcripts, see the website of the William J. Clinton Presidential Library (http://www.clintonlibrary.gov/). The IMF announcement was released with the headline "Camdessus to Recommend that IMF Commit an Additional $10 Billion for Mexico, Raising its Total Commitment to $17.8 Billion," NB/95/5 (January 31, 1995); accessed at http://www.imf.org/external/np/sec/nb/1995/nb9505.htm.

The Mexican rescue team at the IMF, 7:30 a.m., January 31: (from left) Jack Boorman, Claudio Loser, Stanley Fischer, Michel Camdessus, Shailendra Anjaria (Director, External Relations Department), Hernan Puentes (Chief Information Officer), and Ruth Saunders. (IMF photo)

broader consultation. Although in fact Camdessus had devised the initiative on his own with no prior consultation with anyone in the U.S. administration, it looked otherwise to many observers, and Camdessus never was able to convince some European officials to the contrary. The German authorities were especially upset, and not only at the Managing Director. They also believed that Summers should have consulted with them before abandoning the $40 billion guarantee plan and thus effectively forcing the IMF to take up the slack. They instructed Schoenberg to abstain in protest. That got Summers worried because he feared that a split within the G7 might upset the financial markets and undo the benefits of the IMF's support. The G7 finance deputies conferred through a protracted conference call while the Executive Board was in session, but they failed to reach a consensus.

When the Board meeting finally adjourned at 11:30 p.m., seven European chairs—representing approximately 32 percent of the voting power—appeared to be opposed to the stand-by arrangement. Subsequently, five of those asked to be recorded formally as abstaining from the Board decision. Because approval required only a simple majority of votes cast, this protest had no effect on the outcome.[45] It did, however, put the

[45]While the meeting was in progress, confusion arose as to whether approval of the exceptional financing—which also in this case required amending the Fund's currency budget—might require a 70 percent majority of the voting power. It did not, but the possibility added to the tension as the long night progressed.

Managing Director on notice that a sizeable group of shareholders wanted to keep him on a short leash and wanted to ensure that proper procedures were followed if another such crisis should occur. Camdessus, furious at what he considered to be pointless and even hypocritical objections, called the rebels to his office the next day for a meeting. One participant recalled afterward that Camdessus appeared "to have adrenalin coming out of his ears," but he failed to convince anyone to withdraw the abstention.[46]

The European protest in the Executive Board was directed primarily at the unorthodox procedure by which the arrangement was being increased rather than at the outcome. On Saturday, February 4, the G7 finance ministers and central bank governors, meeting in Toronto, Canada, issued a communiqué fully and unanimously endorsing the IMF agreement.[47]

The package of official financial support for Mexico now totaled $40 billion, but it appeared to most participants in the discussions to total $50 billion, and that was the figure that the IMF and the U.S. administration publicly announced. The largest share was provided by the U.S. Treasury, which would lend $20 billion through the ESF, pending further negotiations on terms, to be made available in early March. The second largest share was provided by the IMF, which would lend the equivalent of $7.8 billion in a cocktail of currencies, available the next Monday, February 6.[48] The stand-by arrangement approved on February 1 also provided that a review would take place by end-June, after which it could be augmented by $10 billion. In any case, the sum of any additional loans from governments or central banks and the augmentation of the stand-by arrangement would total $10 billion.[49] As noted above, the Bank of Canada was activating the

[46]The five abstaining Directors were Jarle Bergo (Norway), Huw Evans (United Kingdom), Oleh Havrylyshyn (Alternate to J. de Beaufort Wijnholds, Netherlands), Krzysztof Link (Alternate to Daniel Kaeser, Switzerland), and Stefan Schoenberg (Germany). During the meeting, Michel Sirat (Alternate to Marc-Antoine Autheman, France) and Johann Prader (Alternate to Willy Kiekens, Belgium) also expressed strong reservations about the proposal; see minutes of EBM/95/11 (February 1, 1995). Sirat had been instructed by the French authorities to convey their concerns but not to object formally. At the end, Prader asked to be recorded as abstaining, but he later withdrew that request on instructions from the Belgian finance minister (and Interim Committee Chairman), Philippe Maystadt. The final decision on recording abstentions was made on the following day, February 3; see minutes of EBM/95/12.

[47]See "Excerpts from the G-7 Finance Ministers and Central Bank Governors Statement from the meeting in Toronto on February 3–4, 1995"; accessed at http://www.g7.utoronto.ca/finance/g7torfin.htm.

[48]This drawing was financed in part by selling $3.7 billion of the Fund's holdings of SDRs to a group of creditor countries. The rest came from currencies in the Fund's operational budget, supplied directly by the issuing countries. In all, 15 creditor countries participated in the financing operation.

[49]"Mexico—Stand-By Arrangement," EBS/95/14, Suppl. 3 (February 2, 1995). In a last-minute amendment, the reference to "non G10 countries" in the draft arrangement was changed to "countries wishing to support Bank of Mexico's exchange stabilization fund." At a press conference on February 2, Camdessus stated that if the effort to solicit loans from such members was successful, those funds could be available to Mexico as early as April (following the Fund's completion of the first scheduled review of the program).

equivalent of $1.2 billion (CA$1.5 billion) in swap lines with the Bank of Mexico, and the rest ($1 billion) was anticipated to be lent by the IBRD and the IDB. The $10 billion being lent by the BIS was then added to this total to suggest a $50 billion package. As will be seen below, however, this BIS slice was not really countable.

The Crisis Is Resolved

The immediate financial crisis was now resolved, or at least postponed. The upfront proceeds and the promise of more allowed Mexico to roll over some outstanding credits and repay the rest for the time being. For the IMF, the next step was to try to secure additional financing to cover the next $10 billion. Starting on February 2, Camdessus sent letters to 32 governors of central banks that were not members of the G10 and that had relatively strong reserve positions, asking them to lend to an account to be administered by the IMF, "on terms and conditions comparable to those being developed by the BIS." The quest, however, proved to be more daunting than had been expected, not least because of weak support from within the G10.

On February 11, Camdessus went to Basel, Switzerland, to discuss the Mexican arrangements with the G10 central bank governors, who were holding their monthly meeting at the BIS. The trip was not a success. Several of the European governors, led by Hans Tietmeyer, president of the Deutsche Bundesbank, strongly attacked Camdessus for overstepping the bounds of good practice. The atmosphere was so poisonous that for several months afterward, Camdessus—a former governor of the Banque de France and G10 chairman as well as the head of the IMF—was told that he was no longer welcome to attend these monthly gatherings. (The freeze ended after Camdessus simply invited himself back in July and, over dinner, explained his view of the systemic nature of the Mexican crisis.)

The greatest hurdle was not European opposition but the very nature of the G10 lending. The $10 billion short-term loan was to be paid into an account at the BIS, and the Bank of Mexico was required to provide liquid collateral for the full amount (in effect, blocking any use of the funds). Because the funds could not be drawn upon, technically they were not even countable as official international reserves. That implied not only that the real value of the official package approved on February 1 was only $40 billion, but also that any additional lending by other countries on comparable terms would be of no real use to Mexico. Either the non-G10 countries would have to lend on more generous terms than the G10, or the whole solicitation effort would come to naught.

These implications became known only gradually.[50] Not until the British newspaper *Financial Times* published a lengthy report on the Mexican rescue on February 16 did

[50]When Tietmeyer announced the BIS offer of $10 billion in loans on February 13, he declined to provide any details on the confidential agreement; see "BIS Agrees Mexico Package, Tietmeyer Says," Reuters News, February 13, 1995; accessed at http://global.factiva.com.

officials at the Fund realize fully what they were up against. By that time, only a few non-G10 central banks had replied to Camdessus's appeal, and no reply had yet been positive.[51] Now that it was known that the G10 central banks were not putting up any usable money, and that no other country appeared willing to lend on terms more generous than those of the G10, Camdessus's already quixotic quest to raise $10 billion outside the G10 was almost surely doomed to fail.

Meanwhile, the Mexican authorities turned their attention to negotiating the terms for the $20 billion loan from the U.S. Treasury. Ortiz, Mancera, and Téllez all made frequent trips to Washington during the next three weeks, and Ortiz's deputy, Martin Werner, stayed in Washington for daily meetings at the Treasury. The essence of the final deal was that the United States would lend $3 billion to Mexico immediately and would commit to lending another $7 billion by end-June 1995 and the remaining $10 billion "as needed and in stages" thereafter. Disbursements would be subject primarily to Mexico staying in compliance with the IMF-supported policy program and holding sufficient receipts from petroleum exports as collateral in an escrow account at the Federal Reserve Bank of New York. The agreement specified additional policy measures, including a requirement to strengthen reporting of the international reserve position of the Bank of Mexico.[52]

The financial package nearly collapsed at the last moment, owing to a difference in understanding between Camdessus and Rubin. Rubin was convinced Mexico needed medium-term support, and his understanding was that the IMF was fully committed to entering into an 18-month stand-by arrangement with Mexico for $17.8 billion. The only issue was whether countries outside the G10 would provide additional financing. Camdessus, in contrast, was convinced that Mexico's medium-term finances were sound, and that the main challenge for the international community was to provide financing for a short period as quickly and as forcefully as possible. His understanding was that he would first try to obtain liquid financing from the non-G10 countries on terms similar to those provided by the G10 through the BIS, and that he would later ask the Executive Board to augment the stand-by arrangement to make up any shortfall (the 10 – X proposal). In that view, the portion of the remaining $10 billion that would be short-term or medium-term financing, and the terms on which Mexico could use the money, would depend entirely on the extent of Camdessus's success in persuading central banks to lend.

Rubin regarded Camdessus's position as insufficient, and on the morning of February 21—with the signing ceremony just hours away—he called Camdessus and

[51]Copies of this correspondence may be found in the IMF archives, OMD-AD (Mr. Narvekar's files), "Mexico – MD's letters Feb 2 – Mar 3/95 and replies," Box 9490, Accession 1996-0266-0002.

[52]For a summary of what was announced publicly, see "Statement by the United States Treasury Secretary," EBD/95/23 (February 21, 1995).

threatened to cancel the U.S. agreement with Mexico unless Camdessus promised to go ahead with the full $17.8 billion IMF arrangement. Rubin understood Camdessus to promise to go along, but he nonetheless decided to apply further pressure on him and the IMF by going public with the dispute. His official statement at the signing ceremony included this warning:

> The IMF recently advised us that it is seeking additional short-term credit from non-G10 countries as part of the $10 billion portion of the IMF stand-by arrangement. Since the short-term funds from the BIS are considered adequate, we do not believe additional short-term funds are useful. Of course, medium-term participation in the IMF financing facility would be valuable.
>
> Based on our conversations with a number of countries, we fully expect that little or no short-term monies will be forthcoming. Under these circumstances, we also fully expect the additional $10 billion of medium-term money previously authorized by the IMF will be provided.[53]

With the United States and much of western Europe now lined up against his strategy, with no outside money in prospect, and with considerable questions being raised about the implications of the U.S. agreement for the IMF's preferred-creditor status, Camdessus had no choice but to review the matter again with the Executive Board. In response to a last-minute request by Daniel Kaeser (Switzerland), Camdessus reported on Mexican developments at the beginning of the regularly scheduled Board meeting on February 22.

At the outset of the meeting, Camdessus noted that the Fund had three options: prepare to provide the full $17.8 billion out of the Fund's own resources; redouble the effort to secure outside financing, perhaps including a new request for medium-term loans; or retract the commitment to provide the extra $10 billion on the grounds that the related financing was not in place (in effect, calling Rubin's bluff). This drama caused a fair bit of panic around the table. After some discussion, the Board agreed to try to reach a definitive decision at the next meeting, two days later, to give themselves time to consult with their capitals. In the end, the original decision—including the intention to augment the stand-by arrangement by up to $10 billion at the end of June—was allowed to stand. The Board also agreed that Camdessus would persevere with the effort to secure external financing and would broaden the request to include the option of medium-term lending in tandem with the Fund stand-by arrangement. As initially agreed, the augmentation would be reduced by any contributions from others, regardless of whether the outside financing was short or longer term. Even so, most

[53]"Statement by the United States Treasury Secretary," EBD/95/23 (February 21, 1995). Also see Rubin and Weisberg (2003), pp. 30–31.

people around the table understood that raising money this way was nearly hopeless and that the Fund's share of "10 − X" was going to be pretty close to $10 billion.[54]

The announcement of the U.S. agreement and the IMF's reaffirmation of its commitment did not stop the capital outflow from Mexico or the continuing slide of the peso (Figure 10.1). For the next two weeks, Rubin and Summers were convinced that the rescue operation was going to fail. Summers offered to resign, and Rubin considered whether to renege on the U.S. agreement, but White House officials decided to stay in and hope for the best (see Rubin and Weisberg, 2003, pp. 31–32).

A decision by the Mexican government to strengthen the program finally turned around the situation. The original policy program had been predicated on the assumption that the peso exchange rate would stabilize near early-January levels and that GDP would grow by 4 percent in 1995. Early in March, Ortiz realized that neither assumption was remotely likely to hold, and he informed the IMF he was putting together a new package of tax increases and spending cuts. Loser and a staff team returned to Mexico City for a week to consult on these measures, which Ortiz announced publicly in the evening of March 9. The next day, Fischer issued a public statement welcoming the shift, and within a few days the U.S. Treasury disbursed the first installment ($3 billion) of its $20 billion loan.[55] Financial markets reacted enthusiastically: the peso appreciated by 18 percent against the dollar on March 10 and, after a brief reversal, continued to strengthen for the next two months.

Throughout the second quarter of 1995, a degree of calm returned. In mid-April, as Mexico gradually began to return to the international capital market for its external financing, Camdessus called off his effort to raise official money from central banks. Ortiz briefly considered reestablishing a crawling peg for the exchange rate, but the Fund staff discouraged him. At a breakfast meeting in the margins of the spring meeting of the Interim Committee in Washington, Greenspan convinced him that the peso should continue to float. (Some 15 years later, the floating rate regime was still in place.) Although output and employment continued to fall, the authorities allowed themselves to believe—correctly, as it turned out—that a recovery would begin later in the year.

As the end of the quarter approached, the Fund had to decide on a plan for augmenting the stand-by arrangement: on what terms would the promised $10 billion be

[54]The minutes of the February 22 session (EBM/95/18) state only that the "Managing Director reported on the financial agreement concluded between the United States and Mexico and the statement by the U.S. Treasury Secretary" (p. 3). The minutes for February 24 (EBM/95/19) state only that "Executive Directors met in restricted session to discuss certain issues related to the stand-by arrangement for Mexico" (p. 3). For Camdessus's concluding remarks at the latter meeting, see memorandum from the Secretary to Executive Directors, "EBM/95/19—Restricted Session—Concluding Remarks," (February 24, 1995); IMF archives, OMD-AD (Mr. Narvekar's files), "Mexico Correspondence Feb. 1995," Box 9489, Accession 1996-0266-0001. For Kaeser's request, see his memorandum to the Secretary, "Mexican Rescue Package" (February 22, 1995), in the same file.

[55]See "Mexico—Program Tables," EBS/95/31 (March 10, 1995); and "IMF Welcomes New Mexican Economic Measures," NB/95/8 (March 10, 1995).

made available to Mexico? The U.S. authorities, who had disbursed $8 billion of their $20 billion ESF commitment plus a net $2 billion in central bank currency swaps, faced a similar decision on disbursing the remainder of the ESF. Neither the Fund nor the U.S. Treasury wanted to lend much more than the other, to share the risk fairly evenly. That led to some jockeying for position and some continuing unpleasantness until Camdessus and Summers sat down tête-à-tête over lunch at the Fund in early June and agreed informally on a schedule. The IMF, they decided, would disburse $2 billion in early July and another $1.6 billion in August, assuming that Mexico continued to satisfy the Executive Board that it was in compliance with the program conditions. On similar conditions, the United States would disburse $2 billion to $3 billion in July, and—in Summers' terms—would keep "the remainder of our $20 billion commitment available for possible use later in the year if needed."[56]

With this understanding, the staff proposed to disburse the $10 billion in six installments, with the first two taking place at end-June and in mid-August (for $2 billion and $1.7 billion, respectively). This plan once again upset the European Executive Directors in the Fund because it appeared the Fund was making a firmer financial commitment to Mexico than was the U.S. government. On June 28, two days before the Board was to consider the request, the European Executive Directors sent an unusual joint memorandum to the staff asking them to leave the post-August disbursement schedule unspecified and to indicate "a presumption that, beyond the August purchase, the arrangement will be of a precautionary nature."[57]

When the Board met on June 30, other Directors did not support the European proposal, fearing that any vagueness about the availability of IMF money would weaken the still-fragile confidence of private investors. They did agree, though, to encourage Mexico not to draw more than was absolutely necessary. Camdessus's Summing Up of the meeting therefore included this paragraph:

> Directors generally believed that with the continuation of appropriately tight policies, confidence should be sustained and normal access to international capital markets could be restored. In this context, Executive Directors considered that if the balance of payments and international reserves improved as projected under the program, the authorities would be able to treat the arrangement as precautionary beyond August. Accordingly, Directors welcomed the reiteration by the authorities of their intention to forgo some purchases from the Fund if the economic situation stabilizes and to make early repurchases from the Fund if reserves permit.[58]

[56]Letter from Summers to Camdessus, June 9, 1995; IMF archives, OMD-AD (Mr. Fischer's files), Box 11518, Accession 1998-0106-0006, "Mexico 1995."

[57]Memorandum from Autheman, Evans, Kaeser, Kiekens, Lanciotti, Schoenberg, Eva Srejber (Sweden), and Wijnholds to Loser and Boorman, "Mexico—Second Review under the stand-by arrangement," June 28, 1995; IMF archives, OMD-AD (Mr. Narvekar's files), "Mexico – Correspondence June-August 1995," Box 9490, Accession 1996-0266-0002.

[58]Minutes of EBM/95/64 (June 30, 1995), p. 63.

Economic conditions in Mexico continued to improve slowly, and the authorities indicated in August that they intended not to make further drawings. Unfortunately, within two months, conditions worsened anew, as investors became concerned once again about economic and political stability. Might Zedillo abandon the Fund-supported program and embark on a federal spending spree to pull the economy out of its slump? Investors could not be sure, and a renewal of capital outflows weakened the exchange rate in October and November. When Loser and his team returned to Mexico City at the end of October, they found the authorities receptive to considering fresh ways to bolster confidence. Fischer joined the discussions for two days in mid-November, after which Ortiz decided to request a fourth drawing, primarily to demonstrate to the markets that the Fund was fully behind his policies.

On December 15, 1995, nearly one year after the peso crisis first erupted, the Executive Board approved a fourth drawing, for $1.7 billion. That disbursement—which would be the last under this stand-by arrangement—brought Mexico's total IMF borrowings for the year to $12.9 billion, nearly three-quarters of the Fund's $17.8 billion commitment. Mexico's total borrowing from all official sources in 1995 amounted to about $28 billion.[59]

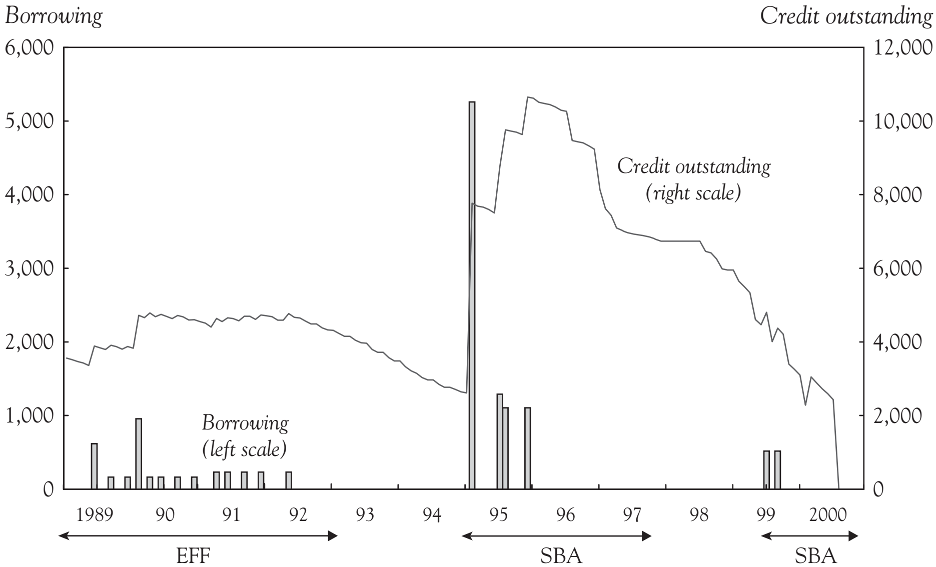
At the end of 1995, Mexico's outstanding obligations to the Fund were at an all-time peak—for any country up to this time—of $15.8 billion (SDR 10,648 million), which was more than six times Mexico's quota (Figure 10.2). But by then the tide was beginning to turn.

As terrible as this year had been for Mexico, and as traumatic as it had been for the IMF, the "first financial crisis of the twenty-first century" had a happy ending. Mexico's finances continued to strengthen in 1996, and economic growth gradually resumed. The unemployment rate, after peaking in August 1995 at 8 percent, declined to 3 percent by the end of 1997, while GDP growth averaged 6 percent a year. Although Mexico's finances were adversely affected in 1997–98 by the crises in East Asia, the Russian Federation, and Brazil, its economy weathered those storms better than did most other emerging markets.

In July 1999, to help Mexico "alleviate potential market concerns . . . in the run-up to the presidential elections" in July 2000, and to help smooth the timing of Mexico's repayments, the Fund approved a new stand-by arrangement in the amount of $4.2 billion (SDR 3,103 million, or 120 percent of quota). Mexico drew about two-thirds of that sum in three installments through March 2000, while continuing to

[59]Through September 1995, Mexico borrowed $12.5 billion from the U.S. monetary authorities and $237 million from the Bank of Canada. It then began repaying those loans. In June 1995, the World Bank approved $1.5 billion in loans to Mexico, and the IDB approved $1.25 billion.

Figure 10.2. Mexico: Use of Fund Credit, 1989–2000
(In millions of SDRs, monthly data)



Source: International Financial Statistics.
Note: EFF = Extended Fund Facility; SBA = Stand-by arrangement.

repay earlier drawings. In August 2000, Mexico repaid all of its remaining obligations to the IMF well ahead of schedule, bringing the crisis to a successful conclusion.[60]

Quarantining the Crisis

In addition to helping Mexico resolve the "tequila" crisis (as it quickly became known), the IMF took steps to try to prevent it from spreading to other emerging markets and to strengthen its own ability to foresee and forestall future crises. The first issue—contagion—was controversial from the outset, and the second—crisis prevention—proved difficult to achieve.

[60]If Mexico had drawn the full amount of the 1999 stand-by arrangement and had then repaid those and earlier drawings on time, it would not have cleared its obligations until 2005. Instead, by 2001 Mexico had become a creditor of the IMF. Mexico also repaid its obligations to the United States ahead of time, completing the process in January 1997, motivated by the high cost of those loans and the necessity of keeping oil revenues in escrow as collateral. Greenspan (2007) p. 159, reports that "the United States actually profited $500 million on the deal."

Limiting Contagion

On that memorable day [January 31, 1995], we had to put huge amounts of money on the table to avoid the financial collapse of Mexico and the spill-over effects that in a few hours or days could have forced many Latin American and other countries to resort to exchange controls and debt moratoria and could have caused a dramatic disruption in private capital flows to developing countries.

Michel Camdessus[61]
Managing Director of the IMF
November, 28 1995

Why the concern about contagion? Why did IMF officials fear that a crisis in Mexico would lead to problems for other countries? The most direct potential effects, though not necessarily the most important, would work through trade links because a downturn in spending in Mexico would depress export demand elsewhere. Although Mexico was an important trading partner for the United States, IMF staff estimates at the time put a ceiling on the negative effect on U.S. economic growth at one-quarter of 1 percent of GDP. For most other countries, the effects would have been even smaller. Empirical estimates, however, are necessarily based on past observed associations. The Fund's most senior officials—notably Camdessus and Fischer, but also Boorman and others—were worried about possible changes in those associations that could lead to negative indirect effects around the world.

Potential contagion through financial markets caused the most immediate fear. If the Mexican crisis made investors reevaluate the risks of disturbances in other emerging markets, then other vulnerable countries—those that otherwise might well have muddled through with little difficulty while relying on a continuing inflow of foreign capital—might be subject to crises as well. A host of speculators, particularly those specializing in Latin American securities, were likely to pounce at the first signs of vulnerability. The first indicators of this type of contagion would be falling prices in equity and bond markets, possibly combined with pressures on the exchange rate manifested by a sharp depreciation or a fall in the country's foreign exchange reserves. Whether this financial contagion was a remote possibility or a serious risk at the end of 1994 depended on investor psychology—"animal spirits," as John Maynard Keynes famously phrased it—and not on measurable economic models. The fact that an active secondary market in the sovereign debt of emerging-market countries was still new and growing made the assessment of risks all the more difficult.

A second fear was of what Fischer sometimes called "intellectual contagion." If Mexico was thought to have been a "star pupil" of IMF policy advice and an adherent

[61]"Africa and the World," Introductory Remarks by Michel Camdessus, Managing Director of the International Monetary Fund at the Global Coalition for Africa Plenary Conference on Africa's Future and the World, Maastricht, the Netherlands, November 28, 1995; accessed at http://www.imf.org/external/np/sec/mds/1995/mds9519.htm.

to free markets and openness, what effect would its crisis have on policymakers and public opinion across Latin America and the developing world? If Mexico was forced to impose exchange controls to protect itself against the vagaries of international trade and capital markets, the backlash against free trade, outward-looking growth strategies, and the role of IMF policy advice could be severe.

Not everyone at the Fund was convinced that these threats were real or that the risks would be greatly aggravated by the crisis in Mexico. Initially, almost the only person in the building who took the contagion threat seriously was Fischer. (Camdessus, who later was equally concerned, was away for the holiday season.) As soon as the crisis started, Fischer worried that it would spread to other emerging markets, especially but not only in Latin America.

On December 21, 1994, the day after the initial peso devaluation, stock market indexes in Buenos Aires and São Paulo dropped by some 6 percent. Fischer immediately called for a senior staff meeting to consider the extent of the threat of contagion to these and other markets. The area department heads who participated in that meeting downplayed the threat, but Fischer was not convinced. He saw a strong parallel between this crisis and the one that had hit Mexico in 1982 and then had spread throughout Latin America, giving rise to a "lost decade" for much of the continent. Even if his colleagues were skeptical, he asked them to pursue the matter further.[62]

Two weeks later, in early January 1995, net capital inflows to Argentina and Brazil clearly were continuing to drop, most probably because of investor concerns stemming from the crisis in Mexico. A staff report prepared for Fischer at that time suggested that a few other countries, notably Hungary and Egypt, were "potentially vulnerable" owing to weak initial conditions, while emerging markets in Asia seemed to be relatively unscathed. Within days, however, equity markets and the secondary markets for Brady bonds and other sovereign debt were declining more widely. In addition to Argentina and Brazil, Chile and Peru were now seeing adverse effects. Before the Fund announced the stand-by arrangement with Mexico at the end of January, several countries outside the region seemed directly vulnerable. Hungary and Turkey were experiencing weaknesses in financial markets, and the central banks of Indonesia, Malaysia, and Thailand were all intervening in substantial amounts to stabilize their currencies. The Philippines was also considered to be at risk of contagion.[63]

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[62]See materials for the December 22 meeting, in IMF archives, OMD-AD (Mr. Fischer's files), Box 11508, Accession 1998-0105-0005, "Mexico Operational File 1994"; and Fischer's report on the meeting to Camdessus, same date, in IMF archives, OMD-AD (Mr. Narvekar's files), Box 9489, Accession 1996-0266-0001.

[63]See memorandum from Mark Allen and Steven V. Dunaway (Deputy Director and Division Chief, respectively, in PDR) to the Managing Director, "Contagion Effects from Mexico" (January 4, 1995); memorandum from Boorman to the Managing Director, "Mexico—Systemic Impact of Crisis" (January 12, 1995); untitled note from Narvekar to the Managing Director (February 3, 1995); and memorandum from Kunio Saito (Director, Southeast Asia and Pacific Department) to Mussa and others, "Countries at Risk Post Mexico" (February 7, 1995); all in IMF archives, OMD-AD (Mr. Narvekar's files), "Mexico Correspondence Feb. 1995," Box 9489, Accession 1996-0266-0001.

Most of those effects and risks turned out to be temporary, but it was difficult to say with certainty whether contagion from Mexico was just a sniffle or whether a potential pandemic had been averted by the rapid containment of the immediate crisis. Fischer was strongly inclined toward the latter view. In February, he wrote to a sympathetic member of the U.S. Congress, "There can be little doubt that several countries, among them Argentina and Brazil, and some on other continents including Hungary and Turkey, would have been in extreme difficulty today if the financial package had not been assembled."[64]

Beyond any doubt, Argentina and Brazil faced the most risk of contagion from Mexico. Within a few months, the resolution of the Mexican crisis certainly helped them, as Fischer stated, but they also helped themselves by adjusting their own economic policies. The role of the IMF differed between the two cases.

Argentina

Argentina was on the front line of the battle to contain contagion—because of its unstable economic history, its weak fiscal accounts and controls, and particularly the fragility of its de facto currency board arrangement. The central bank was obliged to hold reserve assets at least equal to the monetary base, and by December 1994 it had only a small margin. Capital flight or the withdrawal of foreign deposits would force a monetary contraction that could destabilize the economy and force the authorities to abandon the policies that had worked so well for the previous four years.

Indeed, as soon as the Mexican crisis hit, Argentina faced a sudden large outflow of private capital, including withdrawals of nonresident bank deposits, and a corresponding decline in official reserves. Domestic activity began to contract, and the authorities requested an extension of the country's Extended Fund Facility (EFF) arrangement, which they had been implementing successfully since its approval in March 1992. The Fund responded positively, and a mission led by Martin Hardy (Assistant Director, Western Hemisphere Department) arrived in Buenos Aires on January 29, just as the Fund's Executive Board was about to consider Mexico's request for a stand-by arrangement.

The first round of negotiations did not go well. After three weeks, the mission had not convinced the authorities to agree to take what the Fund staff regarded as the essential measures to tighten fiscal policy sufficiently to stop the capital outflow. Hardy returned to Washington empty-handed on February 23.

Early in March, with the Mexican crisis not yet resolved and Argentina still facing a continuing run on domestic bank deposits and large-scale capital flight, Fischer called the Argentine finance minister, Domingo Cavallo, and warned him that he was taking a large risk by not acting to shore up Argentina's finances.[65] If Cavallo would

[64]Letter from Fischer to Howard L. Berman (Democrat, California), February 23, 1995; IMF archives, OMD-AD (Mr. Fischer's files), Box 11518, Accession 1998-0106-0006, "Mexico 1995."
[65]Cavallo, like several of Mexico's top finance officials, was a former student of Fischer's.

agree to raise taxes by the equivalent of 2 percent of GDP, then Fischer would recommend a resumption of financial support for Argentina from the IMF. With presidential elections scheduled for just three months later, and with strong resistance to fiscal discipline from provincial governments, raising tax revenues would not be easy. Nonetheless, after a day's reflection, Cavallo agreed to Fischer's proposal. Fischer then sent Hardy and his mission team back to Buenos Aires, where they arrived on Saturday morning, March 11.[66]

This second mission succeeded quickly, after just a weekend of intensive meetings. On Monday evening, the Fund issued a press release announcing a breakthrough and praising Argentina's willingness to strengthen policies "in the context of unsettled international financial markets."[67] Finalizing the detailed program and drafting the Letter of Intent took another couple of weeks. The Executive Board approved a fourth-year extension and further augmentation of the EFF arrangement on April 6. Several Directors worried aloud about the risks of sticking to a currency board regime without a viable exit strategy, but everyone recognized that abandoning the system in the middle of a crisis could make matters far worse. Argentina's willingness to tighten fiscal policy in very difficult conditions impressed even the Europeans who had objected so strongly to the Mexican rescue two months earlier.

The Fund's support helped Argentina stop the outflow, even though the major vulnerabilities remained in place.[68] Although output in Argentina declined substantially in 1995, its economy—like Mexico's—began to grow again in 1996. Argentina adhered to its tight policies, but it slipped out of technical compliance with the conditions in the EFF program, owing to the effect of the recession on the fiscal deficit. The Fund granted waivers for those slippages, and Argentina made all the scheduled drawings in the fourth and final year of the EFF arrangement. That arrangement expired at the end of March 1996 and was succeeded a week later by a 21-month stand-by arrangement. That arrangement was also broadly successful, until the fall of 1997.

Throughout the 1990s, Argentina had a nearly continuous series of stand-by and extended arrangements (Figure 10.3). Following only intermittent drawings on the compliance-plagued stand-by arrangements of 1989–91 and 1991–92, it drew the full amount of the 1992–96 EFF arrangement (just over SDR 4 billion, equivalent to approximately $5.8 billion at the average exchange rate) and 85 percent of the 1996–98 stand-by arrangement (SDR 613 million, or $860 million). In September 1997,

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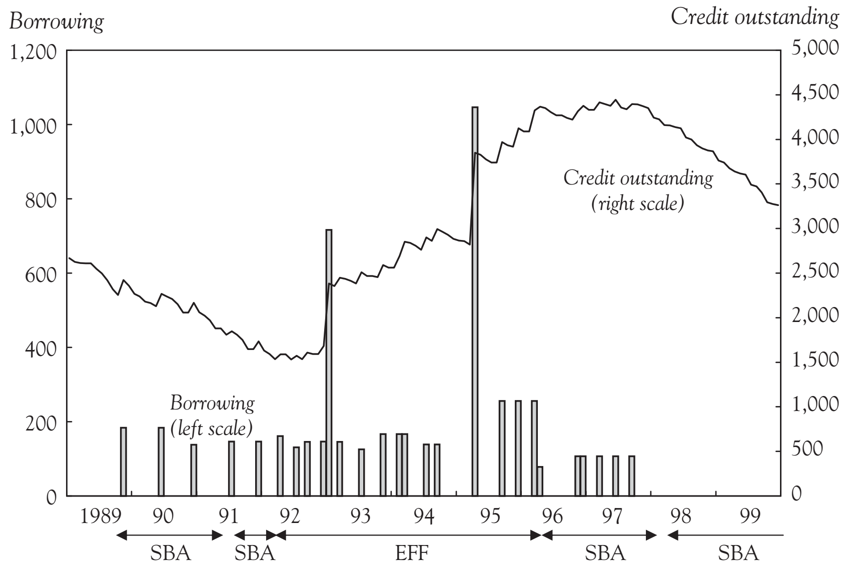
[66]For an overview of these missions, see "Argentina—Ninth Review Under the Extended Arrangement, Request for Waiver of Performance Criteria, and Request for Fourth-Year Extension of the Extended Fund Facility," EBS/95/51, Suppl. 1 (March 29, 1995). Also see Cavallo (1997), pp. 224–25. Additional details are from interviews.

[67]"IMF Praises Argentine Measures, Sees US$2b Loan Increase," NB/95/9 (March 13, 1995).

[68]See Daseking and others (2004), Chapter 2, for a review of the "buildup of vulnerabilities" in Argentina in the middle years of the decade. That review concluded (p. 22) that the weaknesses "were not sufficiently addressed in IMF-supported programs during this time" and contributed importantly to the subsequent crisis.

Figure 10.3. Argentina: Use of Fund Credit, 1989–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics.
Note: EFF = Extended Fund Facility; SBA = Stand-by arrangement.

Argentina's indebtedness to the Fund peaked at $6.4 billion (SDR 4.7 billion). By then, fresh turbulence in international markets and weakening domestic support for the government raised a new threat of contagion for Argentina, requiring yet another EFF arrangement (Chapter 12).

Brazil

Brazil, like Argentina, had a long history of macroeconomic instability and was in the early stages of a bold plan to put the economy on a sustainable growth path. Like Argentina, financial contagion from the Mexican crisis hit it hard. In contrast to Argentina, however, Brazil managed to get through without direct financial assistance from the IMF.

Throughout most of 1994, as described in Chapter 9, Brazil's economic policies and performance strengthened remarkably. In February of that year, after consultation with the IMF staff, the government announced a bold scheme, the Plano Real, to wring inflation out of the economy. In April, Brazil reduced and restructured its outstanding external debt through a Brady Plan agreement, and it thereby restored normal relations with its external creditors. The government introduced a new currency, the *real*, in July 1994. Inflation then fell sharply, from nearly 50 percent in June (monthly rate) to less than 2 percent a month in the fourth quarter of the year, and private capital began to flow back into the country.

Preventing the resurgence of capital inflows from importing inflationary pressures and limiting the real appreciation of the *real* presented the two economic policy challenges for Brazil in the second half of 1994. Accordingly, the authorities loosened restrictions on imports of thousands of individual goods and imposed additional restrictions on capital inflows. They also strengthened the package of structural reforms initiated earlier in the year, aimed at promoting the development of private sector activity. The Fund's Executive Board concluded the Article IV consultations in mid-November with words of praise for what Brazil had achieved, tempered with caution about the need for additional stabilizing measures.[69]

The onset of the Mexican peso crisis in December 1994 upset Brazil's uneasy economic balance as capital inflows dried up throughout Latin America. Equity prices fell sharply, and the market price of Brazil's Brady bonds plummeted. In response, the authorities reversed some of the policy changes they had introduced just a few months earlier, retightening import controls and easing controls on capital inflows. Despite heavy intervention, the exchange rate depreciated in the first two months of 1995. On March 6, the authorities announced they were establishing an adjustable band on the exchange rate against the U.S. dollar, designed to allow a small further depreciation. Speculators immediately attacked, forcing the central bank to devalue the currency four days later by adjusting the band. A Fund staff mission led by José Fajgenbaum (Assistant Director, Western Hemisphere Department) arrived later that month and urged the authorities to be more willing to allow the exchange rate to depreciate if speculative pressures continued. The authorities rejected that advice, preferring to hold the line against inflation and other destabilizing pressures. Instead, they raised short-term interest rates, continued to intervene in the exchange market, and accelerated the structural reform program. By May, confidence began to return, and the crisis passed.[70]

In the middle of the crisis in early 1995, Brazil asked the staff to continue to monitor its economic program and agreed to have intensified contacts, with more frequent monitoring of conditions and policy advice. In 1995, the Executive Board met twice to discuss Brazil, in June to review the staff monitoring of Brazil's economic program, and in December to complete the annual Article IV consultation. But Brazil did not ask for financial assistance or even a precautionary stand-by arrangement. In 1996, relations reverted to the standard 12-month consultation cycle.

Strengthening Crisis Prevention and Resolution

Once the Fund's response to the immediate crisis in Mexico was in place, avoiding and minimizing future crises became a high priority. The Fund obviously had done an

[69]Minutes of EBM/94/100 (November 16, 1994).

[70]These developments are reviewed in "Brazil—Staff Report for Monitoring of Economic Program," EBS/95/92 (June 1, 1995).

inadequate job of foreseeing—much less forestalling—the peso crisis. Whether it was possible to improve on that performance, and how best to try, were less clear. Over the next several months, the Fund took three steps in that direction: more intensive monitoring of major lending arrangements, a comprehensive postmortem of the Mexican crisis, and establishment of a formal rapid-response procedure.

Intensive Monitoring

Because the Fund's lending to Mexico had to be so heavily front-loaded to restore confidence quickly, the usual safeguard of reviewing policies and performance carefully before each quarterly disbursement was not effective in this case. Instead, the Fund decided to try to monitor developments more or less continuously, so as to be ready to react with fresh policy advice or lending conditions if the need arose. From the time of the stand-by arrangement's approval in February 1995, the staff provided senior management with detailed weekly assessments of economic and financial conditions in Mexico. Initially, those reports were based on frequent staff visits, discussions with the Mexican authorities in Washington, and other ad hoc contacts. Simultaneously, Camdessus and Fischer pressed Ortiz to let the Fund open a resident office in Mexico City. He eventually agreed, and from May 1995 Jan van Houten (formerly Assistant Director, PDR) was posted there as Resident Representative of the IMF.

Intensive monitoring in the field became common practice in other very large lending arrangements in the second half of the 1990s. The most prominent example was Russia, where the Fund maintained an unusually large resident office, sent missions from headquarters every month for three years, and conducted formal monthly reviews in the Executive Board (see Chapter 7). Others included Indonesia and the Republic of Korea beginning about the end of 1997, where frequent missions supplemented the work of Resident Representatives for several months (Chapter 11).

Strengthening Surveillance

Camdessus quickly realized not only that the Fund had been embarrassed by being caught flat-footed, but also that the problem might not be confined to Mexico. On February 3, 1995, just two days after the Board approved the stand-by arrangement with Mexico, he asked L. Alan Whittome to conduct an in-depth postmortem of the Fund's surveillance over Mexico with the aim of identifying ways to avoid a repeat of the evident failings. As discussed in Chapter 4, the Whittome report made several recommendations for strengthening the Fund's ability to detect the preconditions for financial crises.[71] The Mexican crisis had demonstrated that the standard annual consultation cycle was insufficient in any situation in which major problems might be accumulating. Surveillance had to be continuous. It had to be based on comprehensive and timely data. The staff had to develop better contacts with financial markets and other nongovernmental analysts. The staff should be less deferential to the authorities when it had

[71]"Mexico—Report on Fund Surveillance, 1993–94," EBS/95/48 (March 23, 1995).

reason to doubt the quality of the official analysis. And the staff should write its reports more clearly and forcefully so that its messages could have the right impact.

The Whittome report was a powerful wake-up call to the Fund, garnering a favorable initial internal response.[72] Nonetheless, because many of the problems highlighted in the report seemed to be unique to Mexico and because management insisted on keeping the report's findings secret, it failed to have the lasting impact it deserved. As Chapter 11 shows, many of these shortcomings appeared again in 1997 when the Asian crisis erupted. Only then did the systemic nature of the problem become sufficiently evident.

Responding More Effectively

The Fund's response to the Mexican crisis had to be cobbled together under immense pressure, with little precedent for deciding how to design an effective adjustment program in a few weeks, how to interact with other official creditors, or how to reinstill investor confidence or otherwise induce private creditors to invest in the afflicted country. In addition to devising a plan for managing that case going forward and avoiding repetition elsewhere, the Fund had to develop rules and procedures for responding more systematically if such a crisis should occur in the future.

One aspect of crisis response not examined systematically after the peso crisis was the possibility of involving private sector creditors through official persuasion or requirement. Private sector involvement (PSI) had been a central part of the Fund's handling of the Latin American debt crisis in the 1980s, first through "concerted lending" and later through a menu of debt- and debt-service-reduction schemes (see Boughton, 2001b, Part II). When this new crisis hit, the assumption was that PSI would be neither effective nor desirable. The goal was to restore confidence among bondholders, who had become the main creditors in place of the large international commercial banks that had provided most capital inflows in the previous decade. The option of restructuring the outstanding tesobonos, perhaps by repaying at a depreciated exchange rate, was considered to be too risky because it could have weakened Mexico's ability to attract future inflows on favorable terms. As shown in Chapter 11, not until the Korean crisis struck three years later did the Fund and the major creditor countries develop a strategy for restoring PSI to the response arsenal.

In the immediate aftermath of the Mexican crisis, the strongest impetus for a new set of procedures came from the summit meeting of the heads of state and government of the G7, held in Halifax, Nova Scotia, in mid-June 1995. The G7 leaders asked the IMF to devise an "Emergency Financing Mechanism [EFM] . . . with strong conditionality but with high up-front access and faster procedures to access Fund resources in crisis situations under the 'exceptional circumstances' clause."[73] The Executive Board

[72]See minutes of EBM/95/33 (April 4, 1995).

[73]"The Halifax Summit Review of the International Financial Institutions: Background Document," Section 5; accessed at http://www.g7.utoronto.ca/summit/1995halifax/financial/index.html.

approved an EFM in September, not as a new facility but just as a policy statement formalizing how the Fund could react similarly to the way it handled the Mexican crisis if another such emergency were to occur. (The establishment of the EFM is described in Chapter 5.)

Although the Fund established the EFM with the expectation that it would be used rarely, it turned out to be an essential tool for the next several years. As the East Asian crisis unfolded in 1997–98, the Fund invoked its emergency procedures repeatedly. In the following decade, the EFM saw even greater usage, especially in the global crisis of 2008–09. The twenty-first century had indeed arrived a few years early, and Mexico once again proved to be the crucible for developing and testing the crisis responses of the IMF and the international community.

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11

Asian Flu: Financial Crisis in the Pacific

Gonville and Caius College (known fondly to students and faculty alike as "Keys") was founded in 1348 as part of the University of Cambridge. It sits in the very heart of that even more ancient English city, where John Milton studied; Erasmus and Isaac Newton wrote their major treatises; and John Maynard Keynes grew up, studied, and taught. Naturally, then, an international group of economists who gathered there toward the end of the twentieth century reflected more on the past than on current events.

The occasion was a conference on "The Origins and Management of Financial Crises," and the recent past had plenty to offer: the debt crises that engulfed Latin America throughout the 1980s; the speculative attacks on the French franc and the pound sterling in 1992 and 1993; and the collapse of the Mexican peso in 1994–95. The present, too, pressed in on the ivied walls of the lecture hall. It was early July 1997, and Thailand had just been forced to sharply devalue its currency, the baht. To most of the experts in the hall, the events happening in Thailand seemed to be a curious and interesting episode in a small country on the other side of the earth. Thailand was not the United Kingdom, and it was not even Mexico. The collapse of the baht was a national problem, perhaps even a national disaster, but not a cause for international panic.

However, these events worried Stanley Fischer. The First Deputy Managing Director of the IMF had played a key role in managing the Mexican peso crisis, and he recognized the warning signs of another collapse that could spread to neighboring countries and perhaps farther. As it happened, he had come to Cambridge to discuss a paper on "Contagious Currency Crises" (Eichengreen, Rose, and Wyplosz, 1997), in which the authors argued that trade links, not similarities in macroeconomic conditions, caused crises to spread to other countries. In his remarks, and to anyone who would listen over lunch or coffee, Fischer conveyed that the danger was broader and more serious than that. The repercussions of the events of the moment could reverberate long and widely, simply because Thailand was only one of many vulnerable countries. It was not a Thai crisis, he argued; it was a Southeast Asian crisis. Before long, even that description would prove to be far too narrow.[1]

[1]For a summary of the conference, see *IMF Survey*, Vol. 26, No. 16 (August 18, 1997), pp. 260–62. Fischer described his reactions to the conference at EBM/97/72 (July 15, 1997), p. 3. The description here is based primarily on this author's own recollections.

Onset of the Crisis: Thailand in July

Any ordinary person in early 1997 could have easily seen that it was impossible to protect the currency peg system.

Nukul Commission[2]
1998

Before the Crisis: Two Years to Boil

Thailand—strategically located in the heart of Southeast Asia—joined the IMF in May 1949 as one important step in regaining international acceptance after a break engendered by the Second World War. Bolstered by large-scale aid from the United States, its economy grew rapidly in the 1950s and 1960s, and Thailand had no need for financial assistance from the IMF. Political instability in the 1970s and 1980s temporarily slowed this economic progress, and Thailand had recourse to IMF lending on several occasions.[3] In the 1990s, however, Thailand's economy strengthened further, and the country became one of the leading "Asian tigers" and a creditor of the Fund. When Bangkok hosted the IMF/World Bank Annual Meetings in September 1991, the contrasts between the traditional and the modern cultures were stark, but Thailand seemed to be finding a sustainable path to development.

For the next few years, discussions between the Fund and the Thai government were low-key, mostly congratulatory annual affairs. In the 1992 "interim" Article IV consultation, the staff highlighted the need for more investment in public sector infrastructure, including transportation, telecommunications, and water supply. In 1993, the Executive Board offered further encouragement for such investments and congratulated the authorities for their "outward-oriented growth strategy and commitment to a liberal external trade environment." In 1994, the Board noted with satisfaction the progress being made in developing infrastructure and again expressed admiration for the "remarkable performance" of the economy, but expressed some concern about overheating economic demand.[4]

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[2]Nukul Commission (1998), p. 121.

[3]Thailand's first use of Fund financing came in 1972, when it drew on the Buffer Stock Financing Facility to finance its participation in the Fourth International Tin Agreement. The IMF provided a Compensatory Financing Facility drawing for export shortfalls in 1976 and four stand-by arrangements from 1978 through 1985. All of those loans were repaid by May 1990. The staff provided a generally upbeat analysis of Thailand's economic performance in the 1980s in Robinson, Byeon, and Teja (1991).

[4]At that time, interim consultations—in which the staff would issue a report based upon discussions with the authorities and the Executive Board would take note of the report without discussing it—were used biennially for countries without major problems or systemic implications (Chapter 4, pp. 117–18). See "Thailand—Staff Report for the 1992 Interim Article IV Consultation" (SM/92/90, April 29, 1992); and the Summings Up by the chair of EBM/93/74 (May 21, 1993) and EBM/94/60 (July 8, 1994).

The intensity of the Fund's concern strengthened in 1995, in the wake of the financial crisis in Mexico. Though half a world distant from Bangkok, the collapse of the peso immediately forced global investors to reexamine their love affairs with emerging-market assets. If maintaining a stable exchange rate was risky while foreign capital was steadily and eagerly flowing in, it was likely to become disastrous once the inflow became unsteady and unreliable. Predicting disaster is always precarious, and it is not a tactic that the inherently cautious Fund willingly undertook. In this case, however, the Fund conveyed increasingly strong and ultimately desperate messages to the Thai authorities for more than two years leading up to the crisis of July 1997.[5] The Fund's warnings failed to avert the crisis, partly because the authorities rejected some of the analysis and partly because the messages were not always clearly focused nor well delivered.

The Fund's effort to convince the authorities to alter their policies began in earnest with a visit by P.R. Narvekar (Deputy Managing Director) in June 1995. He questioned the consistency of the exchange regime (pegging the value of the baht to a basket of currencies with a heavy weight on the U.S. dollar) with the inflationary stance of monetary and fiscal policies, aggravated by the capital inflows being encouraged in part by the fixed exchange rate. This argument failed to impress the Thais with the need to change the policy stance. They viewed the exchange rate peg as an important anchor for business expectations and as a politically sensitive issue, and they thought they could contain inflationary pressures gradually by encouraging domestic saving. Narvekar returned to Bangkok in December to plead again for moderation and flexibility, but he again met polite resistance.[6]

In those meetings and in the Article IV consultations through 1996,[7] the perceived macroeconomic dangers received most of the IMF's focus, almost to the exclusion of the more important structural financial problems that would later bring economic growth to a crashing halt. Two such problems were then simmering. One was a growing volume of nonperforming loans at major banks and finance companies, resulting from the often close ties between those institutions and the companies to which they were lending. The other was a booming market in commercial property that was evolving into a speculative bubble. As an internal review noted early in 1997, the staff had

[5]For overviews of the crisis and its resolution, see Blustein (2001) and Nukul Commission (1998). The latter is the official report prepared for the government of Thailand by a commission chaired by Nukul Prachuabmoh, a former governor of the Bank of Thailand.

[6]See Narvekar's reports to the Executive Board at EBM/95/61 (June 23, 1995), p. 4, and EBM/95/122 (December 21, 1995), p. 5.

[7]After the interim consultation of 1992, the Fund held full Article IV consultations with Thailand every year.

"identified these risks" but "not . . . with a clear sense of urgency or concern that might now seem appropriate."[8]

The staff mission to conduct the 1996 Article IV discussions took place in late March, at which time the staff had little information on these financial imbalances. Six weeks later, in mid-May, the evidence became much clearer when the finance ministry had to take over one of the country's largest banks, the Bangkok Bank of Commerce, to save it from bankruptcy. Even so, when the Executive Board met in mid-July to discuss the staff report, macroeconomic overheating and the vulnerability of the pegged exchange rate were the only real concerns, and even those were overshadowed by Thailand's impressive and continuing record of economic growth. As Karin Lissakers (United States) noted during the meeting, Thailand was still "a rather extraordinary success story."[9] Nonetheless, the Fund's Managing Director, Michel Camdessus, followed up by writing to the finance minister, Bodi Chunnananda, conveying the Fund's macroeconomic advice in strong terms. He wrote about "a broad consensus among Directors that the time was now ripe to permit greater exchange rate flexibility." More specifically, he recommended changing the composition of the currency basket (to reduce the high weight given to the U.S. dollar), substantially widening the band within which the rate was permitted to fluctuate, and tightening fiscal policy.[10]

Private financial markets reacted more negatively to the increasingly bad news about Thailand's financial problems. In September 1996, Moody's Investors Service, a leading credit rating agency, downgraded its rating on Thailand's short-term external debt. That action generated a sizeable outflow of private capital, both from foreign investors and from companies and banks based in Thailand (Nukul Commission, 1998, p. 43). No longer would it be possible for Thailand to finance its current account deficit with foreign direct investment inflows at the fixed exchange rate. Nonetheless, in an apparent continuation of the "East Asian miracle," economic growth slowed only slightly in 1996 from the rapid pace of the early 1990s.[11]

Although the staff still had limited information on the worsening condition of the financial system, it realized that the authorities would have to act quickly to avoid an exchange rate crisis. Toward the end of 1996, the Fund also began focusing more on the underlying structural issues.

[8]"Biennial Review of the Implementation of Surveillance over Members' Exchange Rate Policies and of the 1977 Surveillance Decision," SM/97/53 (February 19, 1997), p. 71, "Box 2: Banking Issues in Thailand."

[9]Minutes of EBM/96/68 (July 17, 1996), p. 33.

[10]Letter from Michel Camdessus to Bodi Chunnananda (July 25, 1996); IMF archives, Box 22096, Accession 1999-0275-0008, OMD-AD (Fischer), "Thailand 1996."

[11]In real terms, Thailand's GDP grew by 5.9 percent in 1996, compared with an annual average of 8.8 percent in 1993–95. For the 1992 Article IV consultation, the Fund staff had projected total growth for the next four years of 34 percent. Actual growth totaled 36 percent.

In December 1996, Camdessus made a hastily arranged stop in Bangkok at the end of a trip to Australia, Papua New Guinea, and Singapore. He agreed with the new finance minister, Amnuay Viravan, and the governor of the Bank of Thailand, Rerngchai Marakanond, that this was probably not the best moment to change the exchange regime. As long as they were facing a large outflow of capital, widening the exchange rate band would just transfer the pressure from the central bank's exchange reserves to the exchange rate and force them into a depreciation spiral. Instead, he argued, they should immediately attack the fundamental problems by taking "early action to create a more sustainable debt structure and to strengthen the banking system."[12]

The key to understanding the Fund's advice at the end of 1996 and the beginning of 1997 is to note its subtlety of timing. A letter from Camdessus to Amnuay in late January made the clearest statement. The Managing Director began by noting that "the situation remains very unsettled, and . . . market confidence remains weak." He recommended tightening both monetary and fiscal policies and moving "rapidly and convincingly" to reform the financial sector. Then came the crucial passage: "In present circumstances, provided that policies succeed in calming markets in coming days, I would not recommend an *immediate* change in exchange rate policy. Thereafter, however, I would urge you to move quickly and decisively to reform the present system, taking into account the need for greater flexibility" (emphasis added).[13] The authorities in Bangkok seem to have understood this to mean most clearly that the Fund was agreeing with them that they should not change the exchange rate.

A few days later, the property market bubble began to deflate when a major developer, Somprasong Land PLC, defaulted on its external debts. As foreign and domestic investors grew more wary, currency speculators began to attack the baht. The window of opportunity for the authorities to deal with the underlying problems and avoid a currency crisis was now at the shattering point, but still no policy changes were evident. On February 7, two days after the Somprasong default, the Fund abandoned its two-stage advice and strongly urged the authorities to devalue at once. This time the letter came from Fischer, hand delivered to Amnuay and Rerngchai in Bangkok by Bijan Aghevli (Deputy Director, Asia and Pacific Department, or APD). Avoiding a devaluation, Fischer warned, "will require not only maintaining high real interest rates for the foreseeable future (with serious effects on the banking system) but also entails the risk of a rapid rundown in reserves." Fischer also offered financial support from the

[12]Camdessus's report to the Executive Board at EBM/96/111 (December 13, 1996), pp. 3–4. Additional information is from interviews with participants.

[13]Letter from Camdessus to Amnuay (January 31, 1997); IMF archives, Box 22190, Accession 2000-01117-0011, DMD-AI (Fischer), "Thailand 1997 I."

Fund if the authorities were ready to act. Both the policy advice and the offer of support were firmly rejected.[14]

As the financial picture continued to worsen—Moody's issued another warning in mid-February—the IMF persisted in pressing the authorities to undertake financial reforms including a devaluation, but Camdessus also tried to reassure the markets with soothing public statements so as not to aggravate the speculative pressure on the baht. At the beginning of March, he met with Amnuay in the beach resort of Phuket, in the margins of a meeting of the finance ministers of the Association of South-East Asian Nations (ASEAN). Although he received no firm assurances in response to his plea for "quick action," he told reporters afterward that the Thais "are doing exactly what you must do to avoid a recurrence of a Mexico-like crisis. . . . I don't see any reason for this crisis to develop further." Even privately to the Executive Board, he reported that "there is certainly no reason for panic in Thailand."[15]

With the clarity of hindsight, a crisis was already close to inevitable, and even a large devaluation or a free float of the baht could not have prevented it. The fundamental imbalance arose from the business practices of the main financiers of property speculation, known in Thailand as finance companies, and of the Bangkok International Banking Facilities (BIBFs). Unlike commercial banks, these finance companies were not primarily deposit-taking institutions. Instead, they borrowed in domestic and international capital markets and then on-lent the funds to domestic companies. Their debts were partly short-term obligations, and the BIBFs and some of the larger finance companies borrowed significant amounts denominated in U.S. dollars or other foreign currencies. Their claims, for the most part, were longer-term obligations denominated in baht. Almost any sizeable deviation from a benign growth path, regardless of whether it was an increase in interest rates aimed at cooling down the economy, a puncturing of the property bubble, or a depreciation of the currency, would render a number of financial institutions insolvent. This combination of currency and maturity mismatches had been building up through years of insufficient regulation and oversight,

[14]Letter from Fischer to Amnuay (and copied to Rerngchai), dated February 7, 1997, and delivered on February 11; IMF archives, DMD-AI, Accession 2000-0117-0011, B22190, "Thailand 1997 I"; and memorandum from Aghevli to the Managing Director, "Thailand—Delivery of Mr. Fischer's Memo" (February 13, 1997); IMF archives, DMD-AI, Accession 2000-0117-0011, B22269, "Thailand – 1997." Also see Nukul Commission (1998), pp. 46–47.

[15]*Financial Times* (March 11, 1997), p. 4; and minutes of EBM/97/23 (March 12, 1997), p. 65. Also see Nukul Commission (1998), pp. 63–65.

and the only solution for it at this point would have been a vastly expensive takeover by the government.[16]

Just two days after Camdessus's meetings in Phuket, the government had to rescue the leading finance company, Finance One, by merging it with a commercial bank. That takeover further exposed the weaknesses in the financial system, but the Fund staff was more concerned with convincing the central bank to correct what the Fund regarded as a seriously overvalued exchange rate. As it happened, a staff team was preparing to go to Bangkok in mid-March to conduct the first full-scale investigation of the economic situation since 12 months earlier.[17] Internally, the staff was divided in its views on what the Thai authorities should do about the exchange rate. Should they devalue the rate by a large percentage and then let it float, or should they just widen the band and reduce the weight of the U.S. dollar in the basket? The Thais had already told Fund officials that they had no intention of devaluing, but the alternative strategy might not suffice and might even make the speculative pressure worse.

Fischer resolved this debate by asking the mission chief—David J. Robinson (Division Chief, APD)—to recommend devaluation, but only through a secret letter to the finance minister so that the advice would not become public and add to the speculative pressure. The usual "final statement" that Robinson presented to Amnuay and other senior officials on March 28 warned strongly of the dangers of not changing policy, and it recommended widening the band and revising the weights in the basket. Separately, however, Robinson sent a private letter to Amnuay urging him to take the even stronger action of devaluing immediately by 10 to 15 percent.[18]

The authorities still believed that the country's continued economic success required a stable exchange rate. They rejected both the mild and the strong versions

[16]For a review of the buildup of mismatched portfolios, see "Thailand—Recent Economic Developments," SM/97/141 (June 3, 1997). The similarities and differences between this situation and earlier crises that undermined the Savings and Loan sector in the United States in the mid-1980s and Nordic banking systems in the early 1990s are instructive. Each of these crises was initiated by the willingness of asset holders to invest in institutions offering above-market yields, without due regard for the inherent risk, apparently on the assumption that the institutions would be bailed out in the event of failure. Insufficient and poorly understood regulations played a major role in each case. The primary differences were that the bad investments in Thailand were far larger in relation to the size of the economy and were doubly vulnerable because they involved exchange risk as well as credit risk. For a systematic analysis of the similarities in financial crises over several centuries, see Reinhart and Rogoff (2009).

[17]Because Thailand had borrowed only intermittently from the Fund, and had not borrowed at all for several years, the Fund had never opened a resident mission in Bangkok.

[18]See memorandums from Fischer to Hubert Neiss (Director, APD), "Thailand—Article IV Briefing Paper" (March 11, 1997); from Bijan Aghevli to the Acting Managing Director (Fischer), "Thailand—Briefing Paper for the 1997 Article IV Consultation" (March 6, 1997); from Fischer to Neiss, "Thailand—Article IV Briefing Paper" (March 11, 1997); and from Aghevli to Fischer (April 2, 1997); all in IMF archives, DMD-AI, Accession 2000-0117-0011, B22269, "Thailand–1997."

of the Fund's advice and refused to modify the exchange rate band or the basket.[19] Instead, the central bank continued to deplete its foreign exchange reserves in a last-ditch effort to ride out the large and growing speculative attacks. Increasingly, it did so by engaging in forward swaps of foreign currencies for baht rather than through outright purchases of baht, which left the reported stock of reserves intact. Because the Bank of Thailand (like many other central banks) did not publish those forward transactions—or even divulge them to the IMF—this practice effectively disguised the extent of the real loss.

Without knowledge of the sharp and ongoing drop in net reserves, Fund officials soon concluded that the crisis had passed. When Amnuay and Rerngchai went to Washington in April for the spring meeting of the Interim Committee, they met with Fischer, who did not press them anew to devalue. Publicly, Camdessus was upbeat, though more cautious than he had been a month earlier. Responding to a question at his press conference before the meetings, the Managing Director reassured reporters:

> We are also closely monitoring what the Thai authorities are doing. They have already taken a few significant steps. They continue working on strengthening their financial sector and on reducing demand pressure in order to bring their current account deficit into a more acceptable range. We are pressing them to take additional steps, and they are considering doing that. We are hopeful that they will continue acting this way.[20]

Financial markets were not impressed, either by developments in Bangkok or by reassurances from outsiders. Speculation against the baht intensified further in early May, and the central bank staved off devaluation only with massive forward intervention (selling more than $6 billion in one day) that brought net reserves close to zero. The monetary authorities of Hong Kong and Singapore intervened in support of the baht in mid-May. In addition, the Bank of Thailand—convinced that foreign hedge funds were causing the problem—issued a control on capital outflows, prohibiting Thai banks from lending to foreign financial institutions except to finance trade (Nukul Commission, 1998, pp. 77–82). Following the May 9 attack, Camdessus wrote increasingly pointed letters to the authorities—including to Prime Minister Chavalit Yongchaiyudh—calling for devaluation. On May 22, Fischer made a long detour to Bangkok, from a trip to Japan, to deliver the message personally.[21] Even though Fischer reminded

[19]It is not clearly established that Amnuay even saw the letter recommending devaluation. The Nukul Commission report made no mention of it, and in an interview for this book in 2006, Amnuay had no recollection or record of it.

[20]Transcript of the press conference (April 24, 1997); accessed at http://www.imf.org/external/np/tr/1997/tr970424.htm.

[21]Chavalit refused to see Fischer in person, citing concerns about negative publicity if he were seen receiving an emissary from the IMF. Fischer hand delivered Camdessus's letter to Amnuay, who passed it on to Chavalit. Fischer also spoke directly with the prime minister by telephone. Years later, Fischer would recall the memory of "being driven through Bangkok in a van with darkened windows on [this] secret visit"; see the transcript of Fischer's farewell speech on his departure from the Fund (August 29, 2001); accessed at http://www.imf.org/external/np/speeches/2001/082901a.htm.

the authorities that Mexico had faced disaster two years earlier after failing to devalue soon enough, and even though he offered large-scale lending from the IMF if the Thai authorities did act, none of his or Camdessus's urging had any discernible effect on economic policies. Chavalit had stated publicly that he would never devalue the baht, and that—for the moment—was the end of the matter.

Fischer also tried and failed to obtain data on the size of the outstanding forward swaps. By May, the Fund staff strongly suspected that the Bank of Thailand must have made sizeable forward commitments—it was obvious that they had to be intervening heavily in the market while gross reserves did not seem to be declining. Fischer was the logical choice to try to obtain the data because he was well known and respected at the Bank of Thailand. (The deputy governor, Chaiyawat Wibulswasdi, had earned a Ph.D. in economics in 1974 at MIT, where Fischer later chaired the department.) Bank of Thailand officials, however, treated even gross reserves as secret and reluctantly told Fischer the total only on the condition that he not reveal it to anyone else. Even in Bangkok, no one outside a small group in the central bank seems to have realized how appalling the situation was.

The Fund's Executive Board met in restricted session on June 13 to conclude the Article IV consultation. The meeting gave Directors an opportunity to urge Thailand to adopt a more flexible exchange rate regime, strengthen its economic and financial sector policies, and provide more comprehensive and timely data. In yet one more effort to avoid fanning the flames, no Public Information Notice was issued on this occasion, and even the Summing Up of the meeting was classified as strictly confidential. Within a few days, however, wire services were reporting that the Fund was unhappy with Thailand's pegged exchange rate.[22]

On June 19, Amnuay resigned from the government, frustrated by his inability to navigate a reasonable course between a prime minister adamantly and publicly committed to maintaining a fixed exchange rate and a central bank governor who would not even keep the government informed about the extraordinary risks the bank continued to take to maintain that rate. His successor, Thanong Bidaya, quickly realized he was in a crisis and had to force a decision at once. Ruling out a default on external debt, he gave Rerngchai, the central bank governor, a few days to choose between devaluation and a floating rate. On Friday, June 27, the ministry of finance and the central bank jointly announced they were shutting down or taking over 16 of the largest finance companies. On Sunday, Chavalit, Thanong, and Rerngchai met and agreed to devalue.

[22]On June 17, the Knight Ridder news agency circulated a story quoting anonymous sources within the IMF as saying that the Fund had recommended a more flexible exchange rate policy. The story also quoted Camdessus as telling reporters that he was encouraging the authorities to move in that direction and to strengthen their fiscal position and the financial system; see memorandum from Neiss to the Acting Managing Director, "Thailand" (June 18, 1997); IMF archives, Box 22190, Accession 2000-01117-0011, DMD-AI (Fischer), "Thailand 1997 I."

On Thursday, July 2, the Bank of Thailand announced it was allowing the baht to float. The baht closed the day down by nearly 17 percent against the U.S. dollar in offshore trading, and the Asian financial crisis had begun in earnest.

After the Crisis: Enter the IMF

The decision to allow the baht to float did not involve the IMF, and the authorities informed the Fund only after the fact. Nonetheless, Fischer responded quickly and positively by issuing a press release "welcoming" the policy changes and promising "technical assistance . . . for the effective implementation of these measures."[23]

Conspicuously absent from the Fund's initial response was any promise of financial assistance, simply because Thailand had not asked for it. All hoped that the effective devaluation—which was essentially what the Fund had been advising for the past four months—would stop the capital outflow and restore stability without any need for official money from outside the country. For several days, that strategy appeared to be working: the baht stabilized and even appreciated, and prices rose in the Bangkok stock market. By mid-July, however, the financial markets were shifting to a more negative view.

The Fund sent a staff mission to Bangkok immediately after the fall of the baht, led by Aghevli, who was already nearby in Manila. Staff from the Monetary and Exchange Affairs Department also flew in to advise on monetary management and financial sector reform. The Reserve Bank of Australia sent an expert to advise on managing a floating exchange rate, and the Japanese ministry of finance sent a top official to discuss options for bilateral financial assistance. In mid-July, Thanong flew to Tokyo to follow up on those discussions while other Thai officials went to Beijing to see if China could offer a loan. No country, however, was prepared to lend to Thailand in the middle of a crisis without an IMF-supported policy program in place, as quickly became apparent.

The prospects for IMF support did not look promising. Not only was the government loathe to make such a request, but the Bank of Thailand was still refusing to provide comprehensive data on its foreign exchange reserves. Two weeks after the crisis began, the latest reserve data the Fund staff had seen were for mid-May, and the staff still had no data at all on the forward transactions that had effectively wiped out net reserves. Fischer felt frustrated both by the delay—which was frightening the financial markets more every day and leaving the Thai authorities with no options—and by the low level of cooperation. He sensed, however, that a call for help had to be coming soon, and on the last weekend in July he took the highly unusual action of sending

[23]NB/97/12 (July 2, 1997).

Hubert Neiss (Director, APD), Anoop Singh (Deputy Director, APD), and several other staff to Thailand in anticipation of such a request.[24]

By the time Neiss and the other staff landed at Bangkok International Airport on July 28, the government had decided to ask for a stand-by arrangement, and both the finance minister and the central bank governor had resigned. The Fund was prepared to consider the request on an expedited basis, using the accelerated procedures of the Emergency Financing Mechanism (EFM) it had adopted in September 1995. The two sides began negotiating terms as soon as new finance officials were in place. Once started, negotiations took only two weeks despite the difficult issues that had to be resolved. In addition to the usual disputes over the level of austerity needed to stabilize the country's finances, the major points of contention concerned the still-secret reserve data and the restructuring of the finance companies.

On financial restructuring, the central bank initially argued that by closing 16 companies at the beginning of July, they had solved the problem. The Fund staff concluded that as many as 50 more finance companies, accounting for some 10 percent of the total assets of Thailand's financial system, had balance sheets so shaky that the firms should be shuttered. In the authorities' view, that would be so disruptive as to lead to a political upheaval. Within a few days, however, they agreed to close 42 finance companies (in addition to the 16 closed earlier) and to offer a comprehensive guarantee to commercial bank depositors and creditors.[25]

The agreement on the guarantee came only after a bitter and emotional dispute among the Fund staff, between those who saw it as necessary to prevent the shutdowns from leading to a massive run on commercial banks and those who saw it as an inappropriate bailout of risky and speculative investments.[26] The issue was resolved internally only because the U.S. Treasury expressed a strong view in favor of a guarantee. As it happened, both Timothy F. Geithner from the U.S. Treasury and Edwin M. Truman from the U.S. Federal Reserve Board were traveling in the region and went to Bangkok soon after the Fund mission arrived.[27] In meetings with Neiss and other Fund officials,

[24]Singh was designated to be the mission chief. Neiss had plans to take home leave to Austria, but he rearranged his schedule to stop in Thailand on the way. On arrival in Bangkok, he discovered the dimensions of the situation, abandoned his leave plans, and effectively took charge of the negotiations.

[25]The Fund's public announcement welcoming the agreement was couched in fairly general terms, referring favorably to the "comprehensive restructuring of troubled financial institutions . . . [as] essential . . . to set the stage for effective recovery"; see "Camdessus Welcomes Thailand's Policy Package," NB/97/16 (August 5, 1997); accessed at https://www.imf.org/external/np/sec/nb/1997/nb9716.htm.

[26]For an example of the case against the deposit guarantee, see memorandum from Joaquin Ferrán (Deputy Director, Policy Development and Review Department) to Neiss, "Thailand—LOI" (August 4, 1997); IMF archives, Historian's files.

[27]In August 1997, Geithner was senior deputy assistant secretary for international affairs at the U.S. Treasury, and Truman was director of the division of international finance at the Board of Governors of the U.S. Federal Reserve System.

they argued that the first priority was to prevent a financial collapse. That view eventually outweighed the concerns held by Fund officials at headquarters about the deposit guarantees.

The Hole in Reserves

Early in the negotiations, the central bank finally provided data to the Fund mission revealing the extent of the forward swaps against the foreign exchange reserves. That information raised two additional and closely related issues that would have to be resolved before the Fund could agree to finance the program: Should the "hole in reserves," as it came to be called, be made public? And how much money would have to be advanced to Thailand to convince investors that the risk was covered?

The Fund staff and management were virtually unanimous in fearing that it would be dangerous for the authorities to announce that all of their reserves were committed to cover forward swaps. The only serious question was whether it would be even more dangerous not to announce it and leave the matter to rumor. Because the authorities were dead set against a public announcement, the Fund would not have forced the issue on its own. But U.S. officials had other ideas, and they did not hesitate to assert them. In discussions with Fischer, Lawrence H. Summers (deputy secretary of the U.S. Treasury) argued that the financial markets already had a fair idea of the proportions of the reserve situation and that revealing the numbers was more likely to calm them than to frighten them further. His insistence on this point implied that U.S. support for the stand-by arrangement would depend on the numbers' being publicized. Fischer reluctantly went along, and Thailand's willingness to publish the size of the forward position was made a condition for the Fund's support.[28]

A financing package then needed to be assembled. The IMF was prepared to approve a stand-by arrangement for close to $4 billion (SDR 2.9 billion, or roughly five times Thailand's quota in the Fund), to be disbursed over 34 months. No one believed that this amount alone would suffice. Even before Neiss finished negotiations in Bangkok, efforts were under way to secure additional financing.

A major difficulty arose immediately. The Clinton administration in the United States—despite its strong interest in a satisfactory resolution of the crisis—was not prepared to expend the considerable political capital necessary to try to persuade the U.S. Congress to approve a financial package for Thailand. It could not provide significant emergency financing without that approval because the Congress had imposed restrictions on the use of the Treasury's own funds in response to what it considered to be an inappropriate "bailout" of Mexico in 1995. The "D'Amato restrictions," as they were commonly known, would soon expire, but not soon enough to help Thailand.

As discussed in Chapter 10, when the U.S. Congress refused to approve President Clinton's request for emergency loans to Mexico in January 1995, the president approved the use of the Treasury's Exchange Stabilization Fund (ESF) instead. A few

[28]EBS/97/148 (August 14, 1997), p. 9.

weeks later, New York Senator Alfonse D'Amato responded by introducing legislation limiting the use of the ESF for such purposes. The legislation, as enacted in August 1995, prohibited the use of more than $1 billion in ESF monies for lending to a foreign country for more than 60 days without congressional approval, unless the president certified "in writing to the Congress that a financial crisis in that foreign country poses a threat to vital United States economic interests or to the stability of the international financial system."[29] That limitation expired at the end of September 1997. The decision not to submit such a certification regarding the crisis in Thailand or to press Congress for approval took into account that the president's party (the Democratic Party) did not control either the House or the Senate and that the administration did not want to endanger passage of pending legislation approving an IMF quota increase and establishing the New Arrangements to Borrow. Nonetheless, President Clinton later acknowledged that he "regretted not making at least a modest contribution to the Thai package. . . . [Treasury Secretary Robert E.] Rubin and I didn't make too many policy errors. I believe this was one of them" (Clinton, 2004, pp. 806–07).

Other countries responded more positively, with encouragement from the U.S. government. On August 11, the IMF and the Japanese finance ministry jointly hosted a meeting of the "Friends of Thailand" at the Imperial Hotel in Tokyo.[30] Delegates from East Asia, Australia, North America, the Asian Development Bank (AsDB), the World Bank, and the IMF attended the one-day meeting. Japan initiated a wave of bilateral contributions by promising to match the IMF by lending $4 billion to Thailand through Japan's export-import bank. Six central banks in the region—the Reserve Bank of Australia, the Hong Kong Monetary Authority, Bank Indonesia, the Bank of Korea, Bank Negara Malaysia, and the Monetary Authority of Singapore—pledged financial support totaling $5 billion, and China, the AsDB, and the World Bank promised assistance estimated to total about $3 billion.[31] Although the nature and firmness of these pledges varied, it was a successful day by any standard. That evening, the head of the IMF delegation, Deputy Managing Director Shigemitsu Sugisaki, announced that the total package—including the Fund's own $4 billion contribution—would amount to at least $16 billion.[32]

[29]Sec. 632, Treasury, Postal Service, and General Government Appropriations Act, 1996, Pub. L. No. 104-52, 109 Stat. 468 (1996).

[30]The meeting was convened by the IMF on an emergency basis just four days beforehand; see "IMF Calls Tokyo Meeting to Discuss Thai Financing Package," NB/97/17 (August 7, 1997); accessed at https://www.imf.org/external/np/sec/nb/1997/nb9717.htm.

[31]For a first-hand account of this meeting and of the pledges that were offered, see Sakakibara (2000). For an official list of pledges, see EBS/97/148 (August 14, 1997), p. 42.

[32]The bilateral financing from regional central banks, including from the People's Bank of China, was finalized at a meeting in Bangkok on August 20. For details, see memorandum from Thomas Leddy (Deputy Director, Policy Development and Review Department) to the Managing Director, "Thailand—August 20 Meeting in Bangkok on the Bilateral Element of the Financing Package" (August 22, 1997); IMF archives, Box 22190, Accession 2000-01117-0011, DMD-AI (Fischer), "Thailand 1997 III."

How much of this "headline" figure would be needed, and how much would really be available if it were needed, could not be known in August 1997.[33] The crucial assumption that convinced the Fund the amount was sufficient was that the Fund-supported policy package (tightening monetary policy, aiming for a surplus in the government budget, and continuing to restructure the financial system) would quickly restore confidence among both domestic and foreign investors so that a large portion of the country's short-term external debt and of the central bank's forward obligations would be rolled over voluntarily.[34] When asked by reporters whether he thought $16 billion would suffice, Sugisaki replied that he thought it would, *if* the government fully implemented the program.

The next day, the Thai authorities met with a group of Japanese banks and secured promises that the banks would maintain their credit lines. Because the Japanese banks were Thailand's largest external creditors, this agreement went a long way toward ensuring that official support would not just finance an outflow of private capital as creditors raced for the exits.[35]

The following week, on August 20, the Executive Board approved the stand-by arrangement without dissent.

Limited Options

Before turning to the issue of the effectiveness of the program, it is appropriate to consider what options were available for getting through the crisis. In short, in the face of massive balance sheet weaknesses throughout the financial sector, the authorities—and the Fund—had no good choices and had to do as well as possible with limited tools.

The keys to resolving the crisis in Thailand were to restore confidence among domestic and international investors sufficiently to enable the country to finance its external deficit, to stabilize and strengthen macroeconomic policies to get the economy on a sustainable course, and to restructure the financial system to eliminate the weaknesses that caused the crisis in the first place. A start could be made right away in all three domains, but the only tools that would bring much immediate relief were monetary and exchange rate policies.

To eliminate the incentive for capital flight by domestic institutions, monetary policy would have to be adjusted to set the interest rate at a competitive level; the

[33]The commitments from Japan and the regional central banks were firm and were to be disbursed in tandem with the IMF, but the other commitments were either conditional or were pending final agreements.

[34]In addition, Bank of Thailand officials argued that they could exercise substantial leverage over the holders of the forward swaps to induce them to roll them over. The banks that held the swaps would have to obtain an equivalent amount of baht if they wanted to close them out, and the Bank of Thailand could in principle refuse to supply it in sufficient quantities.

[35]See EBS/97/148 (August 14, 1997). Additional information is from contemporaneous press reports and from interviews for this book.

central bank would have to maintain adequate foreign exchange reserves to reassure the markets it could meet its obligations and smooth financial disturbances; and the exchange rate would have to be maintained at a level that would minimize the risk of a further depreciation. The qualitative requirements for attracting *foreign* investment were more difficult to determine, because that lending was done in foreign currency at a markup over London or New York interest rates. Domestic interest rates and the exchange rate affected expected returns on those investments only indirectly, through their effects on the country's economic performance.

Tightening fiscal policy and restructuring the banks and finance companies (closing insolvent institutions and taking over or merging others that were in trouble) would also play an essential role but would take longer to implement and to be effective. In the meantime, relying heavily on depreciation of the currency would run the risks of worsening the panic and igniting an inflationary spiral. Relying too heavily on monetary tightening would run the risk of bankrupting companies with large outstanding debts and causing a severe and possibly prolonged economic downturn.[36]

The IMF's preferred strategy for responding to the financial crisis in Thailand was to begin by insisting on a restoration of financial stability through a combination of fiscal and monetary tightening that would support the initial exchange rate depreciation without destabilizing the economy. Extraordinary luck as well as skill would be needed for the staff to guess the optimal combination of policy adjustments correctly on the first try. It would be extraordinary if the authorities were to implement the agreed program exactly as planned. It would be extraordinary if domestic and foreign investors were to respond as positively as was hoped. More likely, management of this crisis would become a continuing cycle of reaction and refinement until a genuine economic recovery was confidently under way.

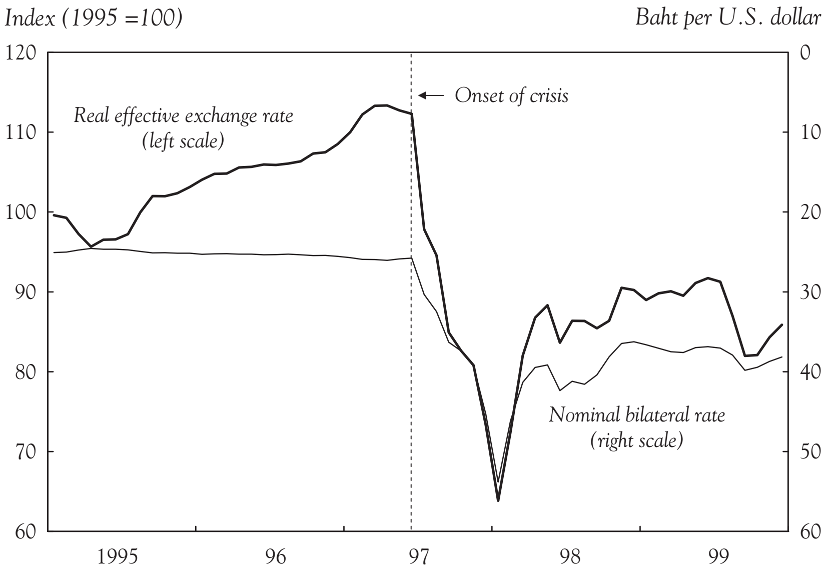
Difficulties Emerge

The first difficulty to emerge was that financial markets remained skeptical about the benefits of investing in Thailand, and the baht continued to decline in value after the IMF support was announced (Figure 11.1). Part of the problem was that the announcement of the net reserve position on August 21 was badly received. As many in Thailand and in the Fund had feared, the data made it obvious that the official financial package—though it had grown to a little more than $17 billion—was smaller than the size of the Bank of Thailand's forward commitments against its reserves ($23.4 billion).

The amount of the package had been negotiated when both the Fund staff and the authorities believed that the size of the net reserve position would not be made public. Once the latter figure was announced, the package was no longer adequate. Even if the

[36]This trade-off between raising interest rates and depreciating the currency became the subject of heated public debate with regard to the IMF's management of the Asian financial crises. For a summary and analysis, see Boughton (2006).

Figure 11.1. Thailand: Exchange Rates, 1995–99



Sources: Information Notice System and International Financial Statistics.

whole package eventually was made available, it looked as if the central bank might have difficulty meeting all of its existing commitments. Even though it was highly doubtful that an attempt to disguise the situation could have succeeded, and even though larger official financing was neither feasible nor desirable, clearly the decision to proceed in this way was not succeeding either.

Second, the political situation in Thailand became highly uncertain. Prime Minister Chavalit was being blamed for the onset and continuation of the crisis, and speculation was rising that he would soon be forced to resign. Even though the authorities were carrying out their commitments under the program adequately, and both Camdessus and Rubin issued public statements of support in September,[37] investors' lack of confidence was deepening both the financial and the political crises. The Chavalit government found itself in a downward spiral that made effective governance impossible. Thanong resigned as finance minister on October 24,

[37]These public statements were positive but muted. In the course of a press conference in Hong Kong SAR on September 18, Camdessus stated that the Thai authorities were "complying pretty well with all the macroeconomic elements of the program," but were having more difficulty restructuring the financial sector. Four days later, also in Hong Kong SAR, Rubin met with Thanong and Chaiyawat (Chaiyawat having become central bank governor in the end-July shake-up). Afterward, he told reporters he believed that the Thais were prepared to implement the necessary reforms (Wagner, 1997). The transcript of Camdessus's press conference is at http://www.imf.org/external/np/tr/1997/tr970918.htm.

and two weeks later Chavalit offered his own resignation and dissolved the government. By this time the value of the baht vis-à-vis the U.S. dollar was down by some 16 percent since the announcement of the Fund's financial support and by 36 percent since July 1.

The formation of a new government led by Chuan Leekpai in mid-November had a brief calming effect on financial markets once Chuan signaled his intention to maintain the tight macroeconomic policies required by the stand-by arrangement with the IMF. Paradoxically, that led to the third difficulty with the program: The fiscal requirement—shifting the fiscal balance from a deficit of about 1.5 percent of GDP in the 1997 fiscal year to a surplus of 1 percent in 1998 at a time when incomes were also being depressed by the declining value of the currency and the withdrawal of external capital—was so rigorous that it might throw the economy into a severe recession. To a population that still faced major development needs even as it had become accustomed to steady economic growth rates of 6 percent or more each year, this prospect was grim indeed. To avoid the political fate that had befallen Chavalit, Chuan realized he would have to convince the IMF to let him ease up a bit.

Meanwhile, a fourth difficulty was brewing, in the form of financial crises in nearby countries. The crisis that hit Thailand in July, having made manifest the extent of the weaknesses in its financial sector, had made investors nervous about the possibility that conditions might be similarly poor in other countries in the region. As discussed below, by mid-November, contagion from Thailand had spread south to Indonesia and north to the Republic of Korea, both of which had internal financial weaknesses that made them especially vulnerable. Pressure on the Indonesian rupiah and the Korean won then fed back onto the baht, which continued to fall against the U.S. dollar throughout the first month of the Chuan government's tenure. Even worse, trade credit was drying up, and the need for cash to finance imports was further depressing economic activity.

To get a better sense of these developments, the IMF opened a resident mission in Bangkok, directed by Reza Moghadam (Senior Economist, APD).[38] In addition, Camdessus made two more visits to Bangkok, where he met with the new prime minister and other senior officials. By the time the Executive Board next met (on December 8, 1997, again in restricted session) to review the stand-by arrangement, it was evident that the program targets should be eased to prevent the economy from completely collapsing, but the staff was worried that a premature relaxation of fiscal policy could further damage confidence and would make it more difficult to finance what had become a very expensive restructuring of the banking system. Fischer concluded that some easing of fiscal policy might be appropriate once the economy had stabilized.

[38]For a firsthand account of the opening of this office in the middle of the crisis, see Moghadam (2007).

Turning the Corner

The critical corner was turned in mid-January 1998. On January 5, Chuan announced publicly that he would ask the IMF to release the government from its commitment to aim for a budgetary surplus for the year. For a few days more, the baht continued to depreciate, and on January 12 it closed at its all-time low, 55.5 to the dollar. The baht had depreciated by 42 percent since the Fund approved the program in August and by 56 percent since the crisis erupted at the beginning of July. But then the Fund began to signal its agreement that the program was too tight and could safely be relaxed. On January 16, Camdessus held a press conference in Kuala Lumpur, Malaysia, during which he explained that the fiscal requirement in Thailand was being reassessed and the program was being adapted to "changing circumstances" in preparation for the next review. By this time, the exchange rate had finally begun to appreciate. Five months of tight policy may have seemed excessive, but it had succeeded in creating the conditions for a sustainable recovery.

In early February, Neiss and Singh went back to Bangkok with a staff team to hammer out an agreement on how the program should be relaxed and by how much. The most significant modification that emerged from these meetings was a relaxation of the fiscal target from a surplus of 1 percent of GDP in 1998 to a deficit of 2 percent. As soon as that agreement was reached, Neiss went on Thai television to announce it, stressing that the Fund and the authorities both felt the looser target was warranted. "I think that in asking for more flexibility, the Thai government has pushed on an open door," he explained.[39] With investor confidence still fragile, it was important not to leave the impression that the program was being weakened under pressure.

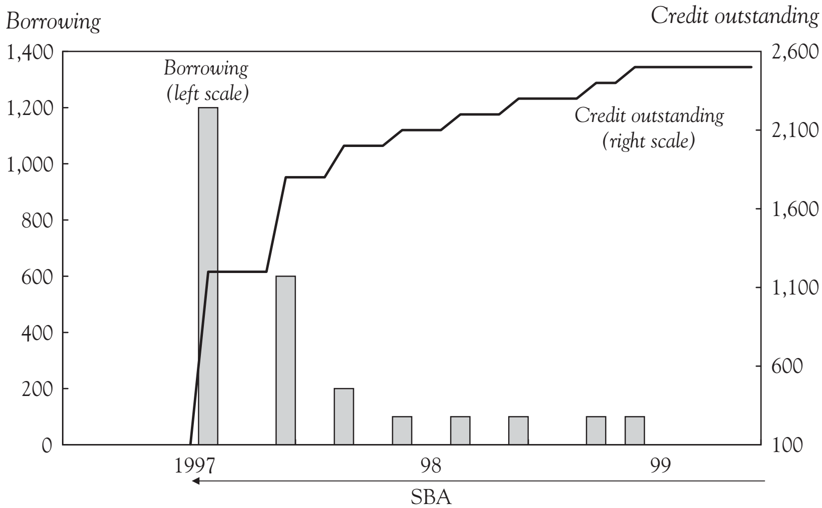
The Thai cabinet ratified the new Letter of Intent on February 24, clearing the way for the IMF Executive Board to approve the proposed changes to the program. At the conclusion of the Board meeting on March 4, Camdessus further reinforced the positive message by announcing that the fiscal requirement had been eased "in recognition of the adverse effect of the recession on revenues and the need to raise spending on the social safety net."[40] It would take a few more months before the economy would show solid signs of recovery, but the crisis could now be said to have been resolved.

The stand-by arrangement remained in effect until June 2000, but after June 1999 Thailand no longer requested to draw on it (Figure 11.2). By that time, it had drawn $3.4 billion under the arrangement (SDR 2.5 billion, out of an approved total of SDR 2.9 billion). It had also borrowed $14.3 billion from the creditors participating in the $17.2 billion package of supplementary financing, as the pledges made in Tokyo turned out to be firmer than many observers had initially feared. The Thai economy was

[39]Quoted by Agence France-Press (February 12, 1998) from an interview on Independent Television.

[40]"IMF Executive Board Completes Second Review of Thailand's Economic Program," NB/98/5 (March 4, 1998); accessed at https://www.imf.org/external/np/sec/nb/1998/nb9805.htm. The Board meeting was held in restricted session, and no minutes of the discussion are available.

Figure 11.2. Thailand: Use of Fund Credit, 1997–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics.
Note: SBA = Stand-by arrangement.

growing again (by 4.5 percent in 1999 and 4.75 percent in 2000), and the authorities were able to repay all of these credits in full and on or ahead of time.

The Crisis Spreads to Indonesia

UNDOUBTEDLY, IN THE END, OUR FATE LIES IN OUR HANDS.

President Suharto[41]
March 1, 1998

The first country to be affected by contagion from the crisis in Thailand was Indonesia: one of the most populous countries and for more than two decades one of the most successful economies in the region.

Indonesia joined the IMF in 1954 and borrowed occasionally from 1956 through 1972.[42] After the first major increase in oil prices in 1973, this oil-exporting country

[41]Speech to the People's Consultative Assembly, as quoted on www.cnn.com.

[42]In January 1965, President Sukarno pulled Indonesia out of the United Nations to protest the seating of Malaysia on the Security Council. In August of that year, the country withdrew from the IMF as well. Indonesia rejoined the IMF in February 1967 after the transfer of power to Suharto. For the next three years, Indonesia drew on a series of stand-by arrangements; see de Vries (1976), Vol. 1, pp. 359–60.

no longer had any need to borrow from the Fund. In 1975, the government managed to overcome the disastrous collapse of Pertamina, the country's monopoly oil and gas company, without financial assistance from the IMF. Indonesia soon became a Fund creditor except for two brief periods in the 1980s when world oil prices slumped. Even then, Indonesia drew only on the Buffer Stock Financing Facility to finance its commitments under the international rubber and tin agreements and on the Compensatory Financing Facility for shortfalls in oil revenues and other exports. Throughout this middle period, Indonesia had no need for either a stand-by arrangement or debt rescheduling from other creditors.[43]

From the beginning of the Suharto era in the late 1960s, Indonesia maintained good and close relations with the IMF. Policy advice and technical assistance from the IMF, other multilateral agencies, and private sector supporters such as the Harvard Institute for International Development played an instrumental role in Indonesia's initial development of professional expertise and management capability.[44] Even long after Indonesia stopped borrowing, the Fund maintained a Resident Representative office in the central bank and enjoyed ready access to senior officials and advisors to the president. Many of those officials had earned graduate degrees at U.S. universities (the "Berkeley mafia" was a popular sobriquet for the group, although Boston University was an even more common training ground) and broadly shared the liberal economic and political perspective of the typical Fund economist. In sum, Indonesia was long regarded as a strong performer and a willing adherent to the economic principles advocated by the Fund.

The IMF's role as a valued advisor to the Suharto regime endured well into the 1980s. Gradually, however, the importance of that role diminished as the apparent likelihood of Indonesia ever borrowing again from the Fund steadily fell. Coincidentally, by the early 1990s, when Suharto had been president for some 25 years, the concentration of power and wealth in the hands of his family and associates began to weigh heavily on his ability—and that of his still reform-minded advisors—to sustain the country's economic progress. A small set of individuals close to the president now owned or controlled many of the key sectors in the economy, from major industries to agricultural marketing to banking. The death of Suharto's wife in April 1996 seems to have further weakened his ability to hold the reins, particularly against the greed and power of his now-adult children. The Indonesian economy continued to grow at a good pace, but the underpinnings of that growth were gradually becoming less secure.

[43]For background on these developments, see Boughton (2001), pp. 273, 737, and 743.

[44]In 1971, the Fund's Central Banking Service established a training institute in Jakarta for both central bank staff and private bankers. For an overview of technical assistance in that period, see de Vries (1976), Vol. 1, pp. 581–85.

Before the Crisis: Unheeded Advice

In January 1994, the Fund again began providing regular technical assistance to Indonesia, mostly on issues related to coping with banks that had large amounts of nonperforming loans (particularly to companies with powerful political connections) or with other financial difficulties. Over the next four years, including in the aftermath of the country's financial crisis, the Fund sent 15 technical assistance missions to Jakarta: 10 on banking problems, 4 on strengthening national statistics, and 1 on improving tax administration and broadening the tax base.

By 1995, the Fund also began expressing increasingly urgent concerns about overheating in the Indonesian economy, through the annual Article IV consultations and management visits to Jakarta. When Stanley Fischer made his first visit to Indonesia in May 1996, he publicly called on the government to grant independence to the central bank. Privately, he gave Suharto an *aide-mémoire* urging him to tighten fiscal policy so as to reduce the current account deficit and the inflation rate; to eliminate off-budget spending and other nontransparent fiscal actions; and to authorize the central bank, Bank Indonesia, "to take all necessary actions" to clean up the problem banks. On his return to Washington, Fischer reported back to Camdessus that he was quite worried about the level of corruption in the government and the lack of transparency in government accounting, which he feared was covering up a "multitude of sins." To the Executive Board, however, Fischer was more sanguine, concluding that Indonesia's problems were "not of serious concern, in the sense of a looming crisis."[45]

In November 1996, Camdessus met with Suharto in Jakarta, where the Managing Director was to give the keynote address at a regional conference. In addition to repeating the broad warnings about overheating and weak banks, Camdessus urged the president to begin dismantling the agricultural monopolies that were strangling economic progress in the country and to cut the country's large military expenditures as one especially effective way to reduce overheating.[46] Suharto responded with general agreement and vague assurances, as he had with Fischer earlier in the year, but took no effective actions to implement the recommendations.

The Fund continued to press for reform in this low-key manner throughout the first half of 1997, through staff visits; the annual Article IV consultation mission at the end of March; and direct meetings between Camdessus and the minister of finance, Mar'ie

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[45]See memorandum from Fischer to the Managing Director, "Visit to Indonesia, May 20–25" (May 29, 1996); IMF archives, OMD (Fischer), Accession 1999-0275-0003, "Indonesia – 1996." Also see minutes of EBM/96/51 (May 29, 1996), p. 3; and *Jakarta Post*, "IMF Executive Calls for Independent Central Bank" (May 23, 1996). In July, the Executive Board endorsed management's recommendations for tighter policies and a strengthening of public control over the banking system; see minutes of EBM/96/72 (July 26, 1996), pp. 56–57.

[46]Memorandum for files by Kadhim A. Al-Eyd, "Indonesia—Managing Director's Meeting with President Soeharto" (November 14, 1996); IMF archives, OMD (Fischer), Accession 1999-0275-0003, "Indonesia – 1996."

Muhammad, in Phuket, Thailand, and with the central bank governor, Soedradjad Djiwandono, in Washington. Although these officials and others did not dispute the need for reform, the Fund's advice was not taken seriously. After a quarter-century of economic progress without an IMF-supported program, most Indonesian officials no longer regarded the agency as the important force it once had been.

The Crisis Hits

The forced devaluation of the Thai baht at the beginning of July 1997 did not immediately disturb the sense of economic tranquility in Indonesia. Initially, most observers and the Fund thought the Indonesian economy had largely escaped being thrown off course by the crisis in Thailand. As it happened, the Executive Board met to conclude the 1997 Article IV consultation with Indonesia just one week after the devaluation of the baht. For the moment, the rupiah—which was being managed within a crawling band against the U.S. dollar—was fairly stable, and Directors generally expressed relief that the crisis did not seem to have spread across the South China Sea.[47] Nonetheless, Bank Indonesia took the prudent step on July 11 of widening the exchange rate band: a step that on previous occasions had resulted in a welcome appreciation of the rupiah.[48]

As the summer progressed, pressure gradually developed on the rupiah, partly because of regional contagion and partly because Indonesian companies were facing a liquidity squeeze from the large amount of external debt falling due. Suharto personally decided in mid-August that the central bank should stop intervening to support the exchange rate. In a move welcomed but not initiated by the IMF, Bank Indonesia floated the rupiah on August 14 and tightened monetary policy so as to restrict the growth of bank liquidity and thus reduce the pressure on the exchange rate (Soedradjad, 2005, p. 44).[49] Unfortunately, both actions *increased* pressure on the balance sheets of the major banks, pressure that few of them could readily withstand. Of the 238 banks in the country, perhaps 1 in 10 was insolvent even before the Thai crisis, but these banks were able to keep operating thanks to continuing infusions of cash from Bank

[47]Minutes of EBM/97/69 (July 9, 1997). The following day, World Bank staff gave a similarly reassuring report to the Bank's Executive Board; see Blustein (2001), p. 96, and Mallaby (2004), p. 184. A few days later, bilateral donors meeting as the Consultative Group on Indonesia met in Tokyo and expressed relief and congratulations to the government for responding well to the crisis.

[48]The widening of the band from ±4 percent around the central rate to ±6 percent was the eighth such shift in five years and represented the culmination of a strategy to manage the crawl more flexibly. For an account of the widening, and background on the exchange rate policy, see Soedradjad (2005), pp. 37–42.

[49]In response to the float, Aghevli informed Camdessus that the policy was "appropriate and in line with our advice." See his memorandum to the Managing Director, "Indonesia: Exchange Rate Float" (August 14, 1997); IMF archives, OMD (Mr. Fischer's files), Accession 1999-0275-0003, "Indonesia (1) – 1997."

Indonesia. The floating of the rupiah in August and the accompanying withdrawal of liquidity support from the central bank rendered this practice unviable, owing to the widespread acceptance of open currency positions, maturity mismatches, and other high-risk balance sheet positions. Within weeks, the whole banking system was either insolvent or nearly so.[50]

In retrospect, by mid-August Indonesia had already passed the point at which the government could avoid a crisis. Trying to maintain a strong exchange rate and simultaneously provide enough liquidity to keep the banks afloat would surely and steadily have worsened speculative pressures and depleted the country's reserves. Applying capital controls almost certainly would have been ineffective and would have led to an even greater speculative panic. But allowing the exchange rate to float and tightening liquidity—the course that Suharto and his advisors chose and that the Fund eventually supported—was bound to undermine the viability of the country's already fragile financial system. A year of ignoring the warning signs in the economy and from the IMF had left the authorities with no good options.

Indonesia's crisis, more than any other the IMF helped manage in the 1990s, was deeply rooted in domestic systemic failures that had long lain dormant but that, in the end, had to be corrected before the crisis could be resolved. Furthermore, steadily escalating competition between two very different groups of advisors to the president compounded the difficulty of fixing these underlying problems.

One group close to Suharto was the "Berkeley mafia" mentioned above: the generally reform-minded economic team, including those with formal official duties such as the minister of finance and the central bank governor, but also a group of informal advisors led by the legendary intellectual Widjojo Nitisastro. The second competing group comprised family and associates of Suharto, who owned or controlled many of the banks, major industries and utilities, and agricultural monopolies in Indonesia and thus benefited from enormous economic rents. This group, often called the "cronies," opposed all serious efforts at reform.

Generating support for reform required working through the economic team, but outsiders found it difficult to determine how best to evaluate and—if possible—to bolster the influence of that group relative to the cronies. To some extent, the IMF and its external allies had direct access to Suharto, but the impact of that access was ephemeral in the absence of more consistent and dominant influence on the part of the economic team. Hence, the key to success or failure turned out to be the waxing and waning of the relative clout of the two competing groups of domestic advisors.

Before the crisis, the two groups enjoyed an uneasy standoff in which each had enough influence with Suharto to further its own agenda. The economic team had a

[50]The extent and depth of the problems in the banking sector before the crisis are difficult to assess because various indicators point in different directions. For a relatively upbeat assessment, see Hill (1999), pp. 61–67. Grenville (2006, p. 107) describes the mid-August withdrawal of bank liquidity as a "key mistake" in the handling of the crisis.

measure of independence in maintaining macroeconomic growth and stability, and the resulting high growth in the economy year after year produced an expanding economic pie. In these circumstances, the cronies could cut ever-larger slices for themselves without destroying the prosperity of others. In fact, Indonesia gradually managed to reduce extreme poverty to very low levels and to promote the interests of a growing middle class. Dissatisfaction with and rebellion against the great privileges of the few were never far from the surface, but political instability was broadly containable as long as the economy was progressing reasonably well.

The onset of the financial crisis initially emboldened and strengthened the hand of the reformers, but it then led to a "war of attrition" between the two groups.[51] The Fund soon found itself drawn into the maw of this vortex.

In the wake of the mid-August decision to float the rupiah, both the Indonesian reformers and the IMF team thought the only hope for avoiding a full-blown financial crisis was for Suharto to agree to implement a comprehensive set of reforms centered on macroeconomic stability and banking reform. In response to a request from Mar'ie, Fischer decided to stop in Jakarta in mid-September. There, Mar'ie and Widjojo alerted him that slow progress on banking reform was still a major obstacle. Fischer then met with Suharto, praising him for acting expeditiously to ward off speculative pressures but also warning him again of the dangers of not dealing with the many problem banks. This time, Suharto seemed to get the message, promising Fischer that some banks would soon be closed or merged.[52] At this time, neither Fischer nor the economic officials in Jakarta thought macroeconomic conditions in the country were a problem or that Indonesia might need financial support from the IMF.

As soon as Fischer returned to Washington at the end of September, he wrote to Suharto and other officials, offering to send a staff mission to Jakarta to negotiate a precautionary stand-by arrangement. The Fund would make a specified sum of money available to the authorities as a stand-by line of credit, on the understanding that the money would not be drawn unless circumstances worsened unexpectedly. In return, the authorities would commit themselves to implementing a reform program, which in this case was expected to be limited primarily to tightening fiscal policy and restructuring the financial sector.[53]

[51]The phrase is from a model developed by Alesina and Drazen (1991) that explains delays in essential economic reforms when interest groups compete for control.

[52]Memorandum from Fischer to the Managing Director, "Visit to Indonesia, September 16–17" (September 23, 1997); IMF archives, OMD (Mr. Fischer's files), Accession 1999-0275-0003, "Indonesia (1) – 1997."

[53]For the letters to Soedradjad and Mar'ie (dated October 1, 1997), see IMF archives, OMD (Fischer), Accession 1999-0275-0003, "Indonesia (1) – 1997." On the expected content of the program to be negotiated, see memorandum from Neiss to Fischer, "Indonesia" (October 3, 1997), in the same file. For a September 30 draft of the letter to Suharto, see attachments to a note from Margaret Kelly to Fischer, "Indonesia—Draft Letters" (October 1, 1997); IMF archives, APD/AI, Neiss collection, Box 19, file 4.

During the next week, as the Fund prepared to send a small staff team to Jakarta for these discussions, speculative pressure against the rupiah began to worsen, for reasons that everyone involved found hard to understand or to relate to Indonesia's economic circumstances. Although Bank Indonesia had resumed intervening to try to stabilize the rate, by October 8 the rupiah had lost more than a third of its value against the U.S. dollar since the initiation of floating less than two months earlier—including some 10 percent in the previous two days (Figure 11.3). Fund officials still believed the drop was excessive and that it was mainly fallout from the ongoing crisis in Thailand.[54] Nonetheless, they quickly escalated the urgency of the mission. Whatever the cause, Indonesia now needed not just advice and moral support, but a lot of money as well.

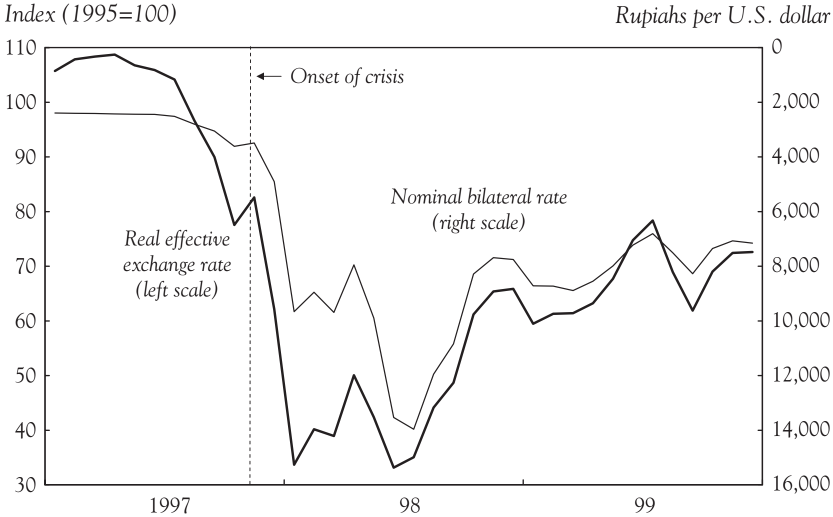
Officials in Jakarta were just as convinced as the Fund staff that they faced an increasingly dire situation. They still had $27 billion in foreign exchange reserves, but unless they could convince investors that it was safe to hold rupiah assets, either they would have to spend all of that and more in a short period or they would have to let the value of the currency plummet even further. That same day (October 8), Suharto announced to the public that he was seeking financial support from the IMF, and also from the World Bank and the AsDB. The announcement by itself came as a positive shock to the financial markets, and for several days the situation calmed down as the IMF staff team rushed to Jakarta and began meeting practically around the clock to get an agreement on paper before the next shock wave could hit.

The Fund negotiating team for this first mission had an unusual structure, owing to the range of issues involved and the shortage of detailed knowledge of Indonesia among the available senior staff. The senior official in APD with regular oversight of the department's work on Indonesia was Margaret Kelly (Senior Advisor). Given the magnitude of the problem at hand, two even more senior officials in the department would also have to be closely involved: Bijan Aghevli (Deputy Director), who was already in charge of the program with Thailand, and the director of the department, Hubert Neiss. For obscure bureaucratic reasons, Aghevli and Kelly were designated as joint chiefs of the mission, but everyone involved understood that Aghevli was really in charge. When Neiss arrived for a few days in the middle of the negotiations, he supplanted both of the nominal chiefs.

Normally, the personalities of Fund officials at this level can be largely ignored for purposes of understanding interaction between the institution and the national authorities or the reasons for success or failure of Fund-supported programs. No individual is a mere cog in a wheel, but the intellectual discipline that the IMF imposes on its staff usually dominates ego and persona. That rule did not hold in the Indonesia crisis, owing to the intense public interest in the proceedings. Bijan Aghevli was an Iranian national who had left the Middle East in the early 1960s to study in the United States. After earning a Ph.D. in economics at Brown University, he joined the IMF staff in 1972 and rose rapidly through the ranks, mostly in the Asian Department. As a

[54]Minutes of EBM/97/100 (October 8, 1997), pp. 4–6.

Figure 11.3. Indonesia: Exchange Rates, 1997–99



Sources: Information Notice System and International Financial Statistics.

negotiator, he came across as supremely self-confident and tough-minded, a trait that struck many Indonesians as akin to arrogance. Aghevli was nonetheless highly respected on both sides of the table. His style did not delay agreement on the program, though it does seem to have added to the tension in the early stages.

In appearance, Neiss was even more of a bulldog than Aghevli. Contemporary news accounts and subsequent literature often commented prominently on his trademark hairstyle, a kind of 1950s-era crisp flattop.[55] An Austrian national with a doctorate in economics from the Hochschule für Welthandel in Vienna, Neiss joined the IMF staff in 1967, spent two years in Jakarta (1974–76) as the Fund's Resident Representative, and was named Director of the Central Asian Department (a forerunner of APD) in 1991. By 1997, he had accumulated a wealth of experience as a negotiator in Asia, including on the initial stand-by arrangement with China in 1981, relations with the Philippines during the last years of Ferdinand Marcos's regime and the transition to democracy, the 1991 arrangement with India, and the Thai crisis in the summer of 1997. Almost from the moment he returned to Jakarta in the autumn, he became the public face of the IMF. Many Indonesians saw Neiss, in contrast to their view of Aghevli, as a listener. He met often with groups other than the negotiating team, including the press, parliamentarians, and students; and he clearly and patiently explained the issues as he saw them. He liked to go jogging in the parks of Jakarta and to

[55]"With his distinctive shock of close-cropped vertical hair . . . he became the face of a faceless IMF" (*International Herald Tribune*); "distinctive spiky blonde [sic] hair" (Dow Jones International News); ". . . an economic disciplinarian for troubled countries, and with his flattop haircut and sober demeanor, he looked every bit the part" (Blustein, 2001, p. 1).

stop by the local markets to get a clear picture of economic conditions. He was widely recognized wherever he went, and he eventually came to be seen by many almost as a local hero: a positive and refreshing antidote to the increasingly corrupt and declining forces surrounding the Suharto regime.[56]

Many other Fund officials also played prominent roles, including several staff from the Monetary and Exchange Affairs Department (MAE) as well as both Fischer and Camdessus. The MAE staff often worked concurrently with the main APD mission in Jakarta but functioned independently, primarily to advise on the restructuring of the financial system. Fischer was involved mostly in Washington, guiding and reviewing the staff work and speaking frequently by telephone with government and central bank officials in Jakarta. Jack Boorman (Director of PDR and a key advisor to management) had served as the Fund's Resident Representative in Jakarta in the mid-1970s, had visited the country regularly ever since, and knew many of the country's senior officials well. He was involved in nearly every management meeting throughout the crisis. Camdessus's participation was more episodic but no less crucial, especially his three meetings with Suharto (in November 1996, November 1997, and January 1998). As discussed below, the last of those meetings turned out to be a notable negative turning point for the program, the government, and the lasting impression of the IMF in Indonesia.

The initial negotiating mission worked in Jakarta from October 13 to the end of the month. Reaching agreement was not easy, in large part because Fischer and others at the IMF had become convinced that broader structural reform was not only possible but had become an essential part of the solution to the crisis. Even on the core element of reform—closing or merging the insolvent banks—the two sides were some distance apart on how extensive the required solution had to be. How many banks should be closed, and how much compensation should be given to "bail out" the owners (who included Suharto's children)? Less central proposals, such as that the government scrap plans to produce and market automobiles (generally known as the "national car project") and that the major agricultural monopolies be broken up, provoked even more contention and were set aside temporarily. Of more immediate concern, the Fund was insisting that Bank Indonesia sharply raise short-term interest rates, a move that Soedradjad and others feared would destroy the country's fragile banking system.

The IMF did not initiate the bulk of the structural reform agenda. Much of the drive for deep reform and many of the specific ideas about what had to be reformed came from the Indonesian reformers with whom the IMF team was in regular contact, both in Jakarta and in Washington. Once the Fund's senior management became convinced that the Indonesians themselves wanted strong action, the role of the Fund staff was to press for the reforms as part of the conditionality for the stand-by arrangement.

[56]This positive impression did not extend to all Asian countries where Neiss led program negotiations. In some cases he was seen as the recognizable face of a much disliked foreign agency.

Within days of the start of the October mission, it became apparent that support for structural change was held only narrowly within the government and that no agreement would be reached unless Suharto himself could be persuaded to endorse it. That induced Neiss to join the fray for the first time, and he flew to Jakarta for a direct meeting with Suharto on October 21. Neiss reported back that the meeting with the president had been friendly, but that it might be necessary for Camdessus to get involved as well. The Managing Director did not do so directly at this time, but a telephone call to Mar'ie from Lawrence Summers (then under secretary of the U.S. Treasury) that seemed to imply a promise of substantial backup financial support from the United States helped to generate new forward momentum.[57]

As October drew to a close, the structural agenda to be implemented right away was narrowed to the banking sector. On October 29, Aghevli agreed to the authorities' counterproposal to close just 16 banks immediately, including two that were prominently linked to members of Suharto's family. The 10 others identified as insolvent would remain open for the time being but would receive only limited short-term liquidity support from the central bank. Fischer agreed, and the next day Mar'ie and Soedradjad signed a Letter of Intent spelling out the program—including the bank closings, a tightening of fiscal policy, a phased-in liberalization of foreign trade and payments, and the maintenance for the time being of high interest rates—to be implemented with support from the IMF.[58]

Camdessus quickly issued a public statement of praise and support that spelled out both the "impressive," "strong," and "ambitious" policy measures to be taken and the "substantial" financial assistance being offered in exchange by the international community. The headline figure for the total financial package was "a first line of financing of the order of US$23 billion,"[59] but the makeup and availability of its components were remarkably varied and in fact amounted to rather less than the headline suggested:

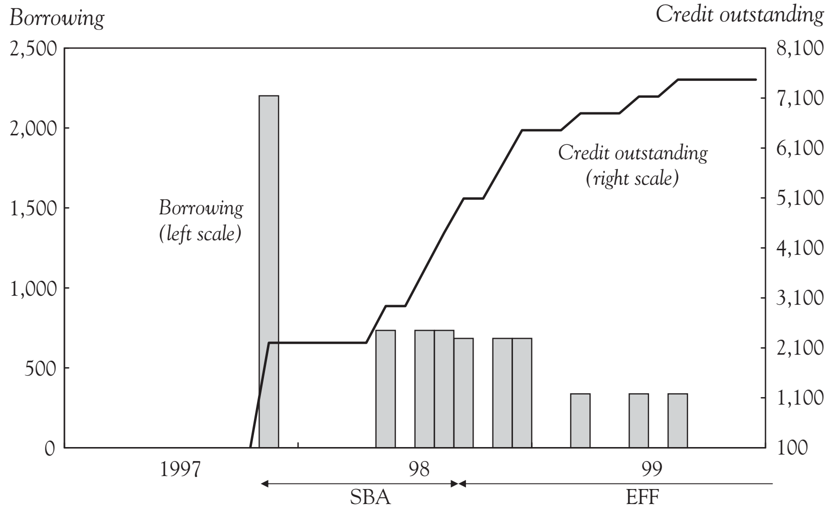
- The IMF was providing a three-year stand-by arrangement in the amount of $10 billion (SDR 7.3 billion, or 490 percent of Indonesia's quota), of which $3 billion would be available as soon as the Executive Board approved the arrangement a few days later (Figure 11.4). Some $4 billion more could be disbursed during 1998 if the program was implemented as planned, and the rest would become available in 1999–2000.
- The World Bank and the AsDB had indicated their intention to provide $4.5 and $3.5 billion, respectively, in loans and related assistance. The terms for this assistance were still being discussed.

[57]See notes by Fischer on a telephone call with Mar'ie (October 27, 1997); IMF archives, Accession No. 2000-0117-0005, B22263, DMD-AI (Fischer), "Indonesia (II)."

[58]"Indonesia—Request for Stand-By Arrangement," EBS/97/195, Suppl. 1 (November 1, 1997).

[59]"Camdessus Commends Indonesian Actions," NB/97/22 (October 31, 1997); accessed at http://www.imf.org/external/np/sec/nb/1997/nb9722.htm.

Figure 11.4. Indonesia: Use of Fund Credit, 1997–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics.
Note: EFF = Extended Fund Facility; SBA = Stand-by arrangement.

- The sources for the remaining $5 billion were unspecified, except for "the use of part of Indonesia's own substantial external assets." That phrase meant that the terms of the stand-by arrangement with the IMF allowed Indonesia to draw down its foreign exchange reserves by approximately that amount if necessary.[60]

Through 1998, then, the total specified "first line" of external assistance was about $15 billion, subject to further negotiation and implementation. In addition, several countries and monetary authorities—Australia, China, Hong Kong SAR, Japan, Malaysia, Singapore, and the United States—agreed in principle to provide a *second* line of defense "in the event of unanticipated adverse external circumstances." Although none of that second line was ever provided in the form of medium- or longer-term financing, the agreement for it was followed quickly by coordinated large-scale intervention by Bank Indonesia, the Bank of Japan, and the Monetary Authority of Singapore to support the rupiah in the early days of the program.

[60]Soedradjad (2005) pp. 85–88, explains that the basis for this unusual specification was that Bank Indonesia used a more conservative accounting method than the IMF for computing its reserve holdings. By converting to the standard international accounting, Bank Indonesia could spend up to $5 billion from its own holdings without reducing its reported reserves. As head of the central bank, Soedradjad preferred to adhere to the conservative accounting principle, and he found the Fund's advice on this point to be "strange, to say the least" (pp. 85–86).

Even before the Executive Board met on November 5 to ratify the stand-by arrangement, the weaknesses of the program began to emerge. The fundamental problem was that the bank restructuring plan was not going to restore confidence in the banking system. Deposits in the 16 banks being closed were mostly uninsured, and the plan offered a guarantee for repayment only up to 20 million rupiah (then worth about $5,000). Everyone with deposits in the domestic banks remaining open had to reassess the risk of losing those deposits. Moreover, it was obvious that a significant number of the still-open banks were not very far from meeting the same fate. The classic conditions for a run on the banking system were building rapidly.

Why did the program not incorporate a comprehensive guarantee on bank deposits, along the lines of the agreement in Thailand just two months earlier? As noted above (p. 507), the highly controversial idea had been agreed to for Thailand only after a lengthy internal debate that had never been fully settled. This time, the case for using scarce government money to bail out people who had deposited large sums in banks with political connections and unsound balance sheets seemed even less persuasive, and those who saw it as giving rise to moral hazard were able to carry the day. The case for a guarantee was also weakened by the government's willingness to close the worst banks right away, in the hope that bold action to take the bad apples out of the basket would prevent the others from catching the rot. Because the closed banks accounted for only about 3 percent of total deposits, the Fund mission concluded that a systemic run was unlikely. Regardless of the merits these arguments may have had at the time, the negative effects of the decision on confidence soon became apparent.

The decision not to offer a more general guarantee attracted extensive analysis and substantial criticism in the aftermath of the crisis. In an internal confidential report, the Fund staff acknowledged at the beginning of January 1998 that the determination to close 16 banks without a guarantee on deposits in other banks had led to a "flight to safety," not only into state banks where many believed an implicit guarantee from the government would protect them, but also out of the banking system altogether. As a consequence, the government was already considering additional guarantees (above the 20 million rupiah limit) as a way to "improve confidence in the banking system." That internal report was leaked to the press almost immediately, and a front-page story on it in the *New York Times* generated further consternation both in Jakarta and abroad.[61] Subsequently, Radelet and Sachs (1998, pp. 62–63) called the decision "egregious" because it left large depositors "unprotected." Grenville (2004, p. 82) argued that the limited guarantee "was no help in limiting runs on banks that remained open."

The IMF's Independent Evaluation Office took a more nuanced position, noting that "the concept of a partial guarantee was entirely reasonable in a corrupt banking system" and concluding that "the most damaging aspect . . . was not the nature of the guarantee itself, but the lack [of] a well-communicated, comprehensive strategy to deal

[61]"Indonesia—Stand-By Arrangement—Review under the Emergency Financing Procedures," EBS/98/2 (January 7, 1998), pp. 12–15; and Sanger (1998).

with problem banks" (Independent Evaluation Office, 2003, p. 85). Soedradjad (2005, pp. 117–25) provided a detailed defense of the handling of guarantees, and McLeod (2004) argued that it was appropriate to force bank depositors, not taxpayers, to bear the brunt of the cost of systemic failures. In any event, the requirements for restoring investor confidence in the middle of a financial crisis lie well outside the bounds of economics and may be impossible to judge correctly in advance (see Boughton, 2006).

Indonesia's implementation of the program was spotty and confused, especially on monetary policy. Interest rates rose sharply in early November, at least partly as a result of foreign exchange intervention and the withdrawal of liquidity through the bank closings rather than a deliberate move to tighten policy. On November 12, Camdessus stopped in Jakarta as part of a regional trip and met privately with Suharto. For Camdessus, the key outcome of the meeting was an assurance by the president that he remained willing to undertake difficult structural reforms even if they adversely affected members of his own family. For Suharto, the main outcome seems to have been a perception that the IMF would not object if interest rates were allowed to drop to reverse the recent increases. Almost immediately after this meeting, Suharto met with his cabinet and instructed Soedradjad to lower interest rates by five percentage points across the board.[62] A week later, however, under renewed pressure from the Fund, Bank Indonesia again raised rates fairly sharply.[63]

In the middle of this confusion, which had completely undone the initial strengthening of the rupiah that followed announcement of IMF support, Suharto tried to calm financial markets by announcing that no more banks would be closed. He then left the country to attend the annual summit meeting of the Asia-Pacific Economic Cooperation forum in Vancouver, Canada, where U.S. President Bill Clinton urged him to implement the IMF-supported program fully. Separately, Summers met with Widjojo in Vancouver and expressed concern about the easing of monetary conditions. Shortly after they returned to Jakarta, however, the technical issues were overshadowed by rumors that Suharto had suffered a heart attack or a stroke. Certainly the president was taken seriously ill, and he did not appear in public for the next two weeks, during which time the rupiah lost about a third of its value against the U.S. dollar. Suharto had been a strong and dominant political force for more than two decades, enabling him to preserve a kind of truce between the indigenous Javanese populace and the ethnic Chinese community that figured prominently in business affairs in Jakarta.

[62]Memorandum from Aghevli to the Managing Director, "Indonesia—Progress in Program Implementation" (November 25, 1997); IMF archives, Accession No. 2000-0117-0005, DMD-AI (Fischer), B22263, "Indonesia (III)." Also see Soedradjad (2001), p. 9.

[63]The staff was divided on the critical issue of what advice to give Indonesia on interest rate policy. In discussions with the authorities, Aghevli was a consistent and forceful advocate of reversing the mid-November rate cut, but only because he was pressured in that direction by Fund management and the U.S. authorities. On this point, the account in Blustein (2001) p. 114, is corroborated by senior staff who were involved in these deliberations.

If Suharto was gravely ill, many feared this calm could be shattered and they began transferring liquid assets out of the country.[64]

By this time (mid-December), the Indonesian policy apparatus was immobilized and in complete disarray. The massive capital flight driving down the rupiah was just the most obvious bellwether for a situation that was rapidly escalating from a financial crisis into one with broad economic and political consequences. The benign assumptions about the rupiah's value and economic activity that had underpinned the program in October no longer applied, and the likelihood that the policies in the lending program would be implemented were minimal. To resolve the crisis would require a fresh start in the new year.

Rush to Resume: January 1998

To restart the program and revive investors' confidence in the government's ability to manage the economy, Camdessus agreed to send a staff mission back to Jakarta in early January and to go there himself to meet directly with Suharto. Karin Lissakers (United States) then asked for a formal discussion by the Executive Board so that staff and management would have the unambiguous and full backing of the Board behind them as they tried to persuade Suharto to strengthen and carry out the reform program. A Board discussion was hastily arranged for January 8 in restricted session. Camdessus informed Directors that he would insist—as a condition for continuing support from the IMF and other official creditors—on an unusually strong and comprehensive set of actions led personally by the president. The Board agreed to this approach, and that evening the Fund issued a press release announcing that a mission would soon be on its way.[65]

Aghevli and his team arrived in Jakarta on January 11, formally to conduct the first review of the stand-by arrangement. His task—convincing a proud but declining president to act forcefully in the long-run interests of his country and against strong resistance from his own family and close associates—was daunting, but he was not alone in attempting it. Fischer joined Aghevli for the first few days, and Camdessus was scheduled to arrive on the fourteenth. In the days surrounding the arrival of the Fund mission, Suharto also received urgent telephone calls from Clinton, German Chancellor Helmut Kohl, Japanese Prime Minister Ryutaro Hashimoto, and other world leaders, urging him to reach an early agreement with the IMF on the reform agenda (Blustein,

[64]For a statistical analysis of the effect of rumors about Suharto's health on financial markets in Indonesia, see Fisman (2001).

[65]"IMF Team to Visit Indonesia to Assess Developments," NB/98/1 (January 8, 1998); accessed at https://www.imf.org/external/np/sec/nb/1998/nb9801.htm.

2001, pp. 207–09; and Rubin and Weisberg, 2003, p. 245).[66] Paul Volcker, the former chairman of the U.S. Federal Reserve System, flew to Jakarta and met with Suharto on the same day that Aghevli and Fischer arrived. Those efforts were followed in close order by visits from Summers (who delivered a personal message from Clinton to Suharto); from the principal finance deputies from most of the other Group of Seven (G7) countries; from Horst Köhler (formerly Germany's finance deputy, then the president of the German Savings Bank Association) as a special envoy from Kohl; and from the prime minister of Singapore, Goh Chok Tong.

The extraordinary outcome of all of this external pressure was that Suharto decided he could no longer trust his economic team to negotiate with the IMF, and he effectively took personal charge of the process. If agreement was to be reached, it would be the president who would decide. Instead of the outcome being the usual Letter of Intent (LOI) signed by the minister of finance and the central bank governor (Mar'ie and Soedradjad), Suharto would take full responsibility and sign it himself.

On Monday morning, January 12, the Fund mission was informed that Suharto wanted to see a draft LOI by midday on Tuesday. That generated some hope but also not a little panic given that no such draft yet existed. The staff stayed up all night working in their hotel rooms and managed to produce a 25-page document spelling out the full proposed reform agenda in detail.[67] It called for a balanced government budget at an assumed exchange rate of 5,000 rupiah to the dollar (the rate was then about 7,200, but everyone involved believed it was undervalued owing to market overreactions). More fundamentally, it called for several major monopolies, including the marketing boards for cloves and vanilla, to be dismantled by February 1. That requirement constituted an atypical level of micromanagement by the IMF, but Indonesian technocrats were pushing for it, and Fischer and others in the Fund believed it was necessary if the authorities were to demonstrate a commitment to strengthening economic governance. The structural reform program, much of which was formulated by the World Bank staff in Jakarta, also included a long list of detailed policy changes such as increases in fuel and electricity prices, increases in sales and excise taxes, a broadening of the base for value-added taxes, cancellations of the development of the national

[66]After the United States, Japan was the most intensively interested and involved country. The Japanese government disagreed with much of the structure of the Fund-supported program, including the initial decision to close commercial banks and the later decision to dismantle monopolies, but it still supported the Fund's role in resolving the crisis.

[67]The LOI itself—the document to be signed by the president—was just a short four-paragraph letter addressed to the Managing Director. The detailed program was described in a 51-paragraph attachment to the LOI, the Memorandum of Economic and Financial Policies (MEFP). For simplicity, and following standard usage, the letter and the memorandum together are referred to here as the LOI.

car project and several major infrastructure projects, strengthening of the social safety net to protect the poor, and an intensification of environmental regulations.[68]

Fischer sent the draft LOI to Suharto at 2:00 p.m. on Tuesday, and he then met the president at his home for 90 minutes that evening to go through the draft page by page. Suharto agreed to the full agenda, but Fischer left with the impression that the president did not fully grasp the extent of what the Fund was asking. In any case, the next step was to refine the LOI and have it in final form to hand to Camdessus when the Managing Director arrived in Jakarta Thursday morning. Separately, Fischer now proposed that the Fund reverse course on the issue of guaranteeing bank deposits.[69] As part of a comprehensive restructuring of the banking system, Indonesia should offer a full guarantee on deposits, which now appeared to be the only way to stop the ongoing run on the banks that were still open. Formulating the guarantee would take some time, so it was not part of the formal conditionality associated with the January review, but the process was now in motion.

Camdessus arrived on schedule on Thursday, January 14. That evening he and Suharto met privately for more than two hours and reviewed the final LOI item by item in all its detail. Suharto not only agreed to the program—he informed Camdessus that his family had also reviewed it and did not object. Camdessus already knew the economic team was strongly behind the reform plans. There now seemed to be no serious impediment to full national ownership of the program.

The next morning, Suharto and Camdessus met again at 7:30 to go over the LOI one more time before the public signing ceremony. The president reaffirmed his support, and at 10:00 a.m. the two appeared together before the television cameras at the presidential palace. Suharto took his seat alone at the table, while Camdessus moved over to one side where he had no choice but to stand awkwardly and watch Suharto sign the document setting out the government's program. For the moment, it seemed like a diplomatic triumph and a decisive step toward resolving the Indonesian crisis.

Almost immediately, the whole effort unraveled. Throughout the week leading up to the signing ceremony, newspapers in Indonesia and around the world had been replete with stories about the discontent of world political leaders with Suharto's reluctance to follow the IMF's policy advice. Now that Suharto had seemingly reversed course, the general reaction was that he had done so under duress rather than willingly, and his insistence on signing the LOI personally and publicly had only reinforced that impression. In the press reports on the ceremony, the dominant image was of Camdessus standing with his arms folded while Suharto bent closely over his desk to sign a

[68]See memorandum sent by fax from Aghevli (in Jakarta) to Fischer (in Washington), "Indonesia: Letter of Intent and MEFP" (January 15, 1998); and e-mail from Josh Felman (also in Jakarta) to Fischer, "Indonesia" (January 15, 1998); both in IMF archives, Accession No. 2001-0284, Box 6, OMD/DMD (Fischer). For the signed LOI (in Bahasa Indonesia, with an English translation), see IMF archives, APD/AI, Neiss collection, Accession 2005-0681-03.

[69]Memorandum from Fischer to Aghevli, "Indonesia—Options for Restoring Banking Sector Stability" (January 16, 1998); IMF archives, OMD (Fischer), Accession 2001-0284, Box 6, "Indonesia (1) – 1998."

document that had essentially been dictated by the IMF. For months and even years afterward, these photographs were reprinted or described with Camdessus characterized variously as "smug," "grinning," "imperious," "triumphalist," a "schoolmaster," and even an "angry father," watching over a "humble" and even "desperate" Suharto. Indonesia's centuries under colonial rule had ended more than half a century earlier, but memories ran deep, and a news photograph is a powerful image.

Perhaps in response to being perceived almost as a lackey of the IMF, perhaps in response to pressure from within his inner circle, perhaps because the rupiah continued to depreciate after the signing ceremony, or perhaps because he never intended to carry out the program—for reasons known only to himself—Suharto almost immediately undercut the implementation of the promises in the LOI. Privately, he informed his cabinet and other aides that it was not necessary to implement the program fully, and he likened his apparent approval of it to the guerrilla warfare he had practiced against the Dutch many years earlier. When Clinton and other world leaders called to press him to carry out the program, he told them bluntly that the IMF's advice was not working and that he wanted to find an alternative plan. Publicly, he let it be known that he intended to select Bucharuddin Jusuf Habibie to be his vice president following elections in March. Because Habibie was widely regarded as opposed to economic reform, this tactic further undermined confidence and engendered an even further decline in the exchange value of the rupiah.[70]

Meanwhile, the IMF financial experts in Jakarta, led by Charles Enoch (Division Chief, MAE), were hard at work devising a plan to restructure the banking system and implement the comprehensive guarantee on bank deposits. An essential element in that plan was the establishment of the Indonesian Bank Restructuring Agency (IBRA), which was to take control of the troubled banks and sell them to new investors with the means to revive them. Other Fund staff were devising a plan for restructuring corporate foreign debt, which involved first getting corporations and their external creditors to agree on debt relief, and then having the government subsidize the repayments. Despite these efforts, with the exchange rate approaching 13,000 rupiahs per dollar in late January—an 80 percent depreciation from the precrisis level—the prospects for escaping the crisis were growing dimmer by the day.

In desperation, Suharto decided to try the economic equivalent of alternative medicine. In late January, he allowed one of his daughters to invite Professor Steve H. Hanke of Johns Hopkins University (Baltimore, Maryland, United States) to Jakarta to discuss Hanke's proposal for establishing a currency board as a way to stabilize the rupiah.[71] Hanke met with Suharto in early February and then presented his proposal

[70]On these developments, see Kenward (2002), pp. 67–68; and Soedradjad (2005), p. 163.

[71]A currency board is "a monetary regime based on an explicit legislative commitment to exchange domestic currency [for foreign currency] at a fixed exchange rate, combined with restrictions on the issuing authority—the currency board—to ensure the fulfillment of its legal obligation" (Baliño and Enoch, 1997, pp. 1–2). For an overview of the history of currency boards and the IMF's views on them, see Chapter 1, pp. 26–27.

President Suharto (right) greets Camdessus at his home in Jakarta, January 14, 1998. (Reuters photo)

to government and central bank officials. Although few if any of those officials were impressed by the plan,[72] Suharto's inner circle of family and close associates continued to press for it. Initially, the IMF staff declined to take the currency board proposal seriously, but once they realized it might be taken up by the Suharto family they took a closer look and concluded it would quickly lead to disaster.

The program signed by Suharto on January 15 assumed that a restoration of investor confidence would stabilize the rupiah fairly quickly. Although the rate at which it might stabilize was not spelled out, the staff projections were predicated on a restoration of the rate to what was then considered to be a more normal level. The rupiah had traded at a rate of about 5,000 to the dollar for a while in late December, but the

[72]Soedradjad (2001) dismissed the proposal as having come from a "shady professor." In interviews for this book, no Indonesian official acknowledged having taken the idea seriously at the time. For an internal account of the debate, see Soedradjad (2005), pp. 187–96. Within the IMF, the only senior official to argue in favor of a currency board for Indonesia was Michael Deppler (Director, European I Department), who had been impressed by the success of a similar policy in Bulgaria earlier in the year (see Chapter 6). Kenward (2002) pp. 75–78, discusses the issue from the perspective of a staff member in the World Bank's Jakarta office at the time. Also see Radelet (2000), pp. 57–58. For Hanke's own account, see Culp, Hanke, and Miller (1999).

Camdessus (left) observes Suharto signing the Letter of Intent, January 15, 1998. (Reuters photo)

assumption that it might return to that range had become increasingly unrealistic as the traumas of January unfolded.

The continuing depreciation of the rupiah posed a real dilemma for the proposed currency board. To be effective, the board would have to back up the monetary base (currency and bank reserves) with an equivalent amount of foreign exchange reserves. The ratio of domestic money to reserves depends on the exchange rate. Bank Indonesia's foreign exchange reserves were barely adequate to cover base money at an exchange rate near 5,000, and that would have left nothing to cope with the projected deficit in the balance of payments or the large amount of external debt that was falling due in 1998.[73] If establishment of a currency board quickly restored credibility and confidence, then tying up the whole stock of reserves in this manner might not be a problem, but the prospects for that degree of success looked dim in the chaos that gripped Indonesia in February 1998. The observation that wealthy and powerful members of Suharto's own family had been among those most eager to move their money

[73]On February 9, according to a report in the next day's *Wall Street Journal*, Suharto announced his intention to peg the exchange rate at 5,500 per U.S. dollar. Also see Blustein (2001) p. 222, based on the same report. The staff then calculated that a currency board would require more than $40 billion in reserves to sustain that exchange rate, given the other expected demands on reserves. At that time, Bank Indonesia held $14.5 billion in reserves; see unsigned note in IMF archives; Accession 2001-0284, Box 6, OMD-DMD (Fischer), "Indonesia 1998 (1),"

out of the country and were also the strongest proponents of the currency board did little to instill confidence that the proposal made any sense.

Camdessus was distressed at the possibility that Suharto might proceed unilaterally to establish a currency board and completely undermine any possibility of restoring stability or reviving the Fund-supported program. On February 11, he gambled that he could dissuade the president from that course by sending him a personal letter implying that a resumption of IMF support depended on his abandoning the currency board proposal. "I believe strongly," he wrote, "that such a move is inappropriate in Indonesia's current circumstances." The same day, Aghevli circulated a note to the authorities setting out the IMF staff's objections in more detail, and two days later P.R. Narvekar, a former Deputy Managing Director of the IMF who had just arrived in Jakarta to serve as a liaison between Camdessus and the president, met with Suharto to try to work out an acceptable forward course.[74] To help resolve the impasse, in public the Fund maintained a generally neutral stance on the currency board issue.[75]

Clinton also called Suharto again to urge him to implement the program he had signed in January, but Suharto reportedly told him that the IMF-supported program had failed and that if the U.S. government did not like the currency board plan, it should propose an alternative. Shortly afterward, Gordon Brown, the British chancellor of the exchequer, issued a statement on behalf of the finance ministers of the European Union, saying that the currency board proposal was "premature."[76] In early March, Clinton sent former U.S. Vice President Walter F. Mondale to Jakarta to tell Suharto once again that the currency board proposal was a bad idea in Indonesia's current circumstances.

Indeed, with the collapse of the rupiah rendering both the IMF-supported program and the currency board proposal unworkable, the complete disintegration of the Indonesian economy appeared to be inescapable. Under more normal circumstances, the January 15 LOI would have been submitted to the Fund's Executive Board as the basis for releasing another $3 billion under the stand-by arrangement in the middle of March. Instead, it was held back and ultimately was never circulated. The fanfare and high hopes of January were but a faded memory.

[74]For the letter and the staff note, see IMF archives, Accession 2001-0284, Box 6, OMD-DMD (Fischer), "Indonesia 1998 (1)."

[75]At a news conference on another matter in Washington on March 10, reporters asked Fischer repeatedly about the consequences if Indonesia should adopt a currency board regime. After trying to duck the question a few times, Fischer replied, "We haven't changed our view that if preconditions were met, a currency board could work in Indonesia"; transcript, UNDOC/98/54 (March 12, 1998), p. 6.

[76]In response to a request from Suharto, Narvekar spent several weeks in Jakarta, with the title Special Advisor to the President of Indonesia and Senior Consultant to the Managing Director of the IMF. On Clinton's telephone call and Brown's press release, see Blustein and Richburg (1998), p. D1.

The End of the Indonesian Crisis: April to June 1998

As a first step toward reviving the program, Fischer and Neiss privately urged the U.S. government to take the lead in providing stronger political and financial backing to Indonesia. In their view, that would restore credibility to Suharto and enable him to regain the domestic support he would need to carry out the program.[77] Unfortunately, Suharto was still flailing around in search of a quick fix. He soon abandoned the currency board idea, but he decided on his own to fully compensate all creditors of the 16 banks that had been closed in November; he abruptly replaced the governor of Bank Indonesia; and he toyed with imposing a multiple currency scheme that would have placed Indonesia in violation of the IMF Articles of Agreement.

In these circumstances, the United States was not about to offer money to Indonesia, nor to support lending by the IMF. U.S. Treasury officials were becoming convinced that Suharto would not reform economic policy and that a recovery now depended on his removing himself from office. That alarmed the Australian government, which had much closer links to Indonesia than the United States did and which already believed the IMF program would "tear apart the social fabric" of Indonesia by insisting on far-reaching economic reforms.[78] Over the next few weeks, the Australian foreign minister, treasurer, and governor of the central bank all went to Washington to try to persuade their U.S. counterparts that Suharto still deserved their support and that of the IMF, to no avail. They also tried to persuade Camdessus that the IMF was insisting on excessive austerity and excessive structural reform as conditions for reviving the program, also to no avail.[79]

On March 10, the People's Consultative Assembly of Indonesia reelected Suharto to a seventh five-year term as president. Suharto then appointed a new cabinet that excluded most of the reformers and replaced them with several of his own associates who were generally regarded as presidential cronies. He nonetheless renewed his commitment to working with the IMF, apparently deciding to give the conventional approach one more try. To that end, he elevated the highly respected planning minister, Ginandjar Kartasasmita, to the top economics position in the cabinet, the state coordinating minister for finance, industry, and development.

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[77]Memorandums from Fischer to the Managing Director, "Developments in your absence—mainly Indonesia," (February 11, 1998); and from Neiss to the Managing Director, "Indonesia" (February 16, 1998); both in IMF archives, Accession 2001-0284, Box 28263, OMD-DMD (Fischer), "Indonesia 1998 (1)."

[78]Remarks to news reporters by the Australian foreign minister, Alexander Downer; quoted in Taylor (1998).

[79]Blustein (2001) pp. 227–30, discusses the shift away from Suharto within the U.S. government. Information on the Australian effort is from interviews for this book and contemporaneous news reports. For an overview of the Australian objections to the IMF program for Indonesia, see Grenville (2004).

Though Fischer acknowledged privately that he was hoping for a miracle, he sent Neiss and three separate mission teams (from APD, MAE, and the Legal Department) back to Jakarta to resume negotiations on March 16. At the same time, three senior G7 finance officials—David Lipton (United States), Eisuke Sakakibara (Japan), and Klaus Regling (Germany)—arrived simultaneously to oversee the process.[80] Working as a team (the local press dubbed them the "three musketeers"), they quickly convinced the government to raise interest rates, in part by promising that the World Bank would help protect small enterprises from the worst effects.

Neiss's mission succeeded in negotiating a new program, and Ginandjar signed a new LOI on April 10.[81] The revised program reflected the serious deterioration in economic conditions since mid-January and called accordingly for a larger fiscal deficit to be financed by larger official financing from the AsDB, the World Bank, and creditor countries. In return, the IMF insisted on completion of 20 steps before it would release any more financing, covering a range of actions from standard macroeconomics to detailed structural policies (e.g., "provide historical data on the accounts of the Reforestation Fund"). The Fund also decided to switch from the usual quarterly monitoring and disbursing schedule to monthly reviews, as it was already doing with Russia (Chapter 7, p. 307). Prior actions were duly completed, and the Executive Board meeting was set for May 4.

The policy program, on which billions of dollars of external financing from the IMF and other official creditors would depend, was daunting. The program included the standard quantitative performance criteria that set maximum values for the net domestic assets of Bank Indonesia and the fiscal deficit of the central government, a floor on net international reserves, indicative ceilings on the growth of base money and the amount of liquidity support that Bank Indonesia could offer to banks, and ceilings on the contracting or guaranteeing of new external debt with a subceiling on the stock of short-term debt. In addition, the LOI included the 20 prior actions mentioned above and a seven-page table listing 114 "structural policy commitments" to be carried out during the life of the program. Completion of these commitments would constitute nothing less than a revolution and would transform the Indonesian economy from one based on monopolies, personal relationships, and rent-seeking to one of open markets and transparent policy making.

One measure that the Fund had intended to be a prior action was a sharp increase in fuel and electricity prices, a step essential for getting the budget deficit under control. Ginandjar agreed that the increases were necessary, but he pleaded successfully

[80]In the same vein, two days before the arrival of the IMF mission, Japanese Prime Minister Hashimoto went to Jakarta for a two-and-a-half-hour meeting with Suharto, during which he urged Suharto to adhere to the Fund-supported program; see "Press Conference by the Press Secretary March 17 1998," accessed on the website of the Japanese ministry of finance, http://www.mofa.go.jp/announce/press/1998/3/317.html#C.

[81]"Indonesia—First Review under the Stand-by Arrangement—Letter of Intent," EBS/98/73 (April 10, 1998).

with Neiss that they should wait until schools and universities were in recess and the inevitable protests would be dissipated. Consequently, the price increases were reformulated as an end-June performance criterion on which the next disbursement would depend.[82]

Inexplicably, Suharto personally decided to announce the unpopular price increases early, the day before the Executive Board was to meet to complete the program review.[83] Either he underestimated the outcry that would follow, or he assumed that by linking the announcement to the timing of the Board meeting he could redirect the public's anger from himself to the IMF. Either way, it was a disastrous misjudgment. Throughout the next week, protests by students and their supporters in Jakarta were directed squarely at Suharto and the corruption that surrounded him. The riots increased in size and intensity until police opened fire on May 12 and killed several protesters. Most of Suharto's key ministers resigned. As the riots and the recriminations continued, the IMF staff were forced to evacuate their offices at Bank Indonesia and leave the country in a specially chartered plane for Singapore. By May 20, Suharto had mobilized 150,000 troops to quell the demonstrations, but the unrest persisted. That evening, Madeleine Albright, the U.S. secretary of state, publicly called on Suharto to "preserve his legacy" by undertaking an "historic act of statesmanship" and resigning. The next day he did so, turning over the presidency to Habibie.

As this drama was beginning to unfold, the Executive Board met as scheduled on May 4 and approved the immediate disbursement of nearly $1 billion (SDR 773.8 million) to Indonesia. Although no one abstained or voted against the request, Directors were severely divided between those from developing countries who thought the Fund was injecting itself much too deeply into micromanaging Indonesia's structural policies and those from the main creditor countries who were highly skeptical of the government's willingness or ability to reform and carry out the program. Lissakers was particularly outspoken. She called on the staff to ensure that by the next monthly review, they would see "progress on establishing a review committee" for the bank restructuring agency; and "unambiguous evidence" that the monopolies on marketing cloves, palm oil, and other commodities were being dismantled and that these markets were being opened to foreign investors. She also decried "Indonesia's . . . lack of respect . . . for human rights," which "weakens support for the program and reduces the likelihood of success. . . . Attempts to bottle up the growing aspirations of the Indonesian people for political reform could well produce an explosion that would demolish the economic program."[84]

[82]"Indonesia—First Review under the Stand-by Arrangement—Letter of Intent," EBS/98/73 (April 10, 1998), p. 20.

[83]On the calendar, Suharto's announcement in Jakarta and the Board meeting in Washington both took place on May 4. On Washington time, the announcement came a day earlier.

[84]Minutes of EBM/98/51 (May 4, 1998), pp. 19–21.

The IMF made no secret of the fact that it was supporting Suharto with great reluctance. In a press briefing right after the Board meeting, Fischer was asked how the IMF might respond if there were a "brutal crackdown on demonstrations." Fischer declined to speculate, but he noted that "there are cases where governments [IMF members] will decide, as they have in this one, that they would rather try to work with the government concerned to change the way it behaves." Some two and a half years later, on the day that Camdessus announced that he was resigning as Managing Director, he admitted to an interviewer that the IMF had "created the conditions that obliged President Suharto to leave his job," although "that was not our intention."[85]

Suharto's resignation did not end the political uncertainty or the economic chaos that had paralyzed policymaking for half a year, but neither did it derail the Fund-supported program. The staff continued to work closely with Ginandjar and the economic team, who continued in office under Habibie, to restructure the external debt of the corporate sector; revitalize the banking system; secure additional external official financing and a rescheduling of debt to Paris Club creditors; and provide technical assistance on tax reform, monetary and balance of payments statistics, and other issues.

In mid-June, the rupiah finally hit bottom, at an exchange rate of 16,650 to the dollar—an almost unimaginable 85 percent depreciation since a year earlier. From that point on, matters gradually improved on most fronts. The IMF disbursed another $1 billion in July and raised the total commitment under the stand-by arrangement by about $1.3 billion (SDR 1 billion, to a total of SDR 8.3 billion). In August, it disbursed another $1 billion and replaced the stand-by with an extended arrangement for the remaining balance so that Indonesia could repay the loans over a longer period.

The financial crisis was at an end. Indonesia continued to experience both political and economic setbacks, but by the end of 1998 the rupiah had recovered to about 8,000 to the dollar, and in 1999 output began to recover despite a major banking scandal and a violent conflict over independence in East Timor. The situation in East Timor led to a temporary suspension of IMF support under pressure from the United States and other concerned countries.[86] The conflict was eventually resolved, and by

[85]For Fischer's remarks, see *IMF Survey*, Vol. 27, No. 9 (May 11, 1998), p. 143; accessed at http://www.imf.org/external/pubs/ft/survey/pdf/051198.pdf. For Camdessus's remark, see Sanger (1999), p. A1.

[86]On September 10, 1999, the British Broadcasting Corporation quoted Neiss as saying that discussions with the Indonesian authorities were on hold pending a resolution of the crisis in East Timor. "The events in East Timor are first of all a large human tragedy, and the international community including the IMF cannot be indifferent to that . . . . An IMF program can only be successful if there is the necessary internal as well as external support to the efforts"; see "IMF Suspends Talks with Indonesia"; accessed at http://news.bbc.co.uk/1/hi/business/the_economy/442969.stm. Clinton (2004) p. 869, refers obliquely to the U.S. pressure, noting that "At first the Indonesians were opposed to" an Australian plan to lead an international peacekeeping force in East Timor, "but soon they would be forced to relent." Specifically, Clinton privately told Ginandjar that a resolution of the East Timor crisis was a precondition for a resumption of talks with the IMF.

the time the program ended in October 2000, Indonesia had borrowed just more than $10 billion from the Fund (SDR 7.5 billion, or 90 percent of the augmented and extended arrangement and 359 percent of Indonesia's quota; see Figure 11.4). It began repaying the loans the following year, and the IMF approved a new EFF arrangement that enabled the country to smoothen and stretch out the amortization schedule. The economy continued to improve, and by 2006 Bank Indonesia had accumulated reserves sufficient to repay the remaining balance ahead of schedule.

The Debt Also Rises: The Republic of Korea

THE FUND HAS BEEN CALLED FOR A RESCUE BECAUSE WE HAVE FAILED TO DO OUR JOB TO take care of our own economy.

Kim Dae-Jung[87]
President of the Republic of Korea
December 18, 1997

GOOD MEDICINE TASTES BITTER.

old Korean saying[88]

Even more than Indonesia, Korea seemed—and should have been—a highly unlikely candidate for a financial crisis. Since 1980, when the government initiated a major economic adjustment program with help from the IMF, the annual growth of output per capita had averaged 7 percent, and any macroeconomic or structural imbalances had appeared to be moderate and under control. Korea hosted the IMF/World Bank Annual Meetings in 1985 and the Olympic Games in 1988. The government eliminated current account exchange restrictions in the late 1980s and increasingly allowed the exchange value of the won to be determined by market forces.[89] In the wake of this liberalization, economic performance strengthened even further, while inflation averaged just 5 percent a year. The central government budget was balanced or in surplus, the current account deficit was small and easily financed, and the exchange rate was stable.[90]

Recognizing these achievements, in 1995 the World Bank "graduated" Korea from the status of a borrower. In the same year, Korea became an original member of the

[87]Speech to the nation following his election as president on December 18, 1997; quoted in minutes of EBM/97/125 (December 19, 1997).

[88]Quoted by Okyu Kwon (Alternate, Korea) at the Executive Board meeting of December 4, 1997.

[89]For developments through the 1980s, see Boughton (2001), pp. 113–19.

[90]For an overview of the Korean economy throughout the 1990s, including the crisis and recovery periods, see Chopra and others (2002) and Chung and Eichengreen (2004). For detailed accounts of the crisis by journalists who covered it, see Kirk (2000) and Blustein (2001).

World Trade Organization,[91] and the government applied for membership in the Organization for Economic Cooperation and Development (OECD), which was granted a year later along with membership in the Bank for International Settlements. No longer just a developing country, Korea was reclassified by the IMF as an "advanced economy."[92] By 1997, Korea was the quintessential "Asian tiger" and the principal inspiration for the phenomenon the World Bank staff and others had called the "East Asian miracle."

In this environment, the annual Article IV discussions with Korea were relaxed and positive in tone. The 1990 and 1991 missions found that macroeconomic policies were a bit lax and warned of the risk that the economy could be overheating. The authorities did not disagree, and by the time of the 1991 consultations, they were already tightening fiscal and monetary policy both. Subsequent missions continued to urge further fiscal restraint and advised the authorities to let the exchange rate appreciate more rapidly to help contain inflationary pressures. Nonetheless, even when the external current account began to shift back into deficit in 1996, neither the Fund nor the government was particularly concerned about macroeconomic stability.

Structural policies were more of an issue. Throughout the early 1990s, the IMF regularly urged the government to adopt a more market-oriented stance by reducing the government's role in the economy and opening up the financial and external sectors. Although Korea was moving in that direction in small steps, the Fund was concerned that the approach was slow and piecemeal and thus much less effective than it should be. The authorities implicitly rejected this advice, partly because they felt the economy was doing better under its regime than it would under a more liberal approach, and partly because many other observers—including the World Bank—were praising their approach as a "miracle" that contrasted favorably both with pure market approaches and with traditional socialist regimes.[93]

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[91]Korea acceded to membership in the General Agreement on Tariffs and Trade in March 1967 and became a member of the WTO upon the organization's establishment in January 1995.

[92]In the spring of 1997, the IMF changed its classification of countries by replacing the "industrial country" group (23 countries) with an expanded group called "advanced economies." Korea—formerly treated as a "newly industrializing" developing country—was placed in this new group along with Israel, Hong Kong (later Hong Kong SAR), Singapore, and Taiwan Province of China. This reclassification recognized these economies' "relatively high income levels . . ., well-developed financial markets and high degrees of financial intermediation, and diversified economic structures with rapidly growing service sectors" (IMF, 1997, p. 118).

[93]For the World Bank view, see World Bank (1993) and Stiglitz (1996). At the IMF, Stanley Fischer, among others, broadly endorsed this view (Fischer, 1996). Among independent analysts, Kim and Lau (1994), Krugman (1994), and Young (1995) explicitly or implicitly rejected the Bank's (and others') argument that well-directed government intervention was behind the high rate of growth in Asian countries. They argued instead that Asian growth rates fundamentally reflected those countries' work ethics, rising education levels, and high national saving rates. Precrisis debate within Korea tended to be more nuanced than the external debate, with most analysts seeing a mix of benefits and costs to the high level of government intervention in financial markets. See, for example, the papers by Won-Am Park and Sang-Woo Nam in Ito and Krueger (1996).

Two crucial structural issues during this benign period concerned liberalizing capital flows and the financial sector. Although much had been done in recent years, the staff concluded in 1996 that "Korea's financial sector and capital account transactions remain subject to many regulations and government interventions, and further liberalization continues to be a key challenge for structural policies."[94] In light of the nature of the subsequent crisis, the staff's lack of focus in 1996 on prudential issues such as the level of nonperforming bank loans or currency and maturity mismatches—which the authorities were reporting to be under control—is striking. The emphasis rather was on the heavy regulation of interest rates, which was seen as producing an inflexible rate structure and inappropriately low rates.

On the capital account, the staff raised the point that the government had eased regulations on outflows of capital (allowing Korean residents and firms to buy foreign securities) by "far more" than on inflows (limiting the ability of nonresidents to buy Korean assets). Consequently, when the terms of trade moved against Korea in the mid-1990s in response to a large drop in semiconductor prices, the won was seen to be depreciating by more and for a longer period than the Fund staff thought healthy. The Fund accordingly advised Korea to accelerate the liberalization of capital inflows. None of these problems, however, received serious attention in Seoul or in Washington.[95]

Before the Crisis: Secrets in Seoul

Korea's economic performance deteriorated badly in the early months of 1997. A seminal event came on January 23, when Hanbo Steel Industry, Korea's second largest producer of steel, declared bankruptcy. When investigations uncovered evidence of bribery and political pressures in connection with large bank loans that were intended to keep the company operating, confidence in the government's economic management began to erode. A small staff team, led by Charles Adams (Division Chief, APD), arrived a few days after the Hanbo bankruptcy and initiated discussions on restructuring the financial sector. At this stage, however, few observers foresaw a systemic crisis in the banking system.[96]

The staff began to take the problems in the banking sector more seriously in the course of an April mission from the Research Department, led by David Folkerts-Landau (Assistant Director of the department), as part of the standard preparation of the Fund's annual report on developments in world capital markets. At this time, while

[94]"Korea—Staff Report for the 1996 Article IV Consultation," SM/96/262 (October 22, 1996), p. 18.

[95]The main push to encourage Korea to liberalize capital flows came from the OECD, which required the country to comply with its Code of Liberalization of Capital Movements as a condition of membership; see OECD (2002) and Abdelal (2007), pp. 117–21.

[96]See memorandum from Neiss to the Managing Director, "Korea—Staff Visit January 29–31, 1997" (February 3, 1997); IMF archives, DMD-AI (Fischer), Accession 2000-0117-0007, "Korea I."

the government was reporting that banks' nonperforming loans comprised only about 1 percent of total loans, market participants believed that the real figure was about 20 percent and that the government was implicitly guaranteeing the bad loans as a way of bailing out weak companies off-budget.[97] Meeting with hedge fund managers in New York in February, Folkerts-Landau and his staff had learned that market participants were convinced that the won and the Korean equities market were overvalued, and that New York–based investors were worried about the solvency of potential counterparties in Korea.[98] The mission was instructed not to press the authorities on the sensitive issue of nonperforming bank loans, but Folkerts-Landau nonetheless concluded that the banking system was "experiencing a serious deterioration in its balance sheet." Although the problems were still manageable, the situation required a substantial and quick improvement in oversight and regulation that did not seem likely.[99]

Overall, the staff continued to express confidence in Korea's economic management and prospects. When newspapers began reporting in May that foreign bankers were getting worried that Korea's growing external debt might lead to a crisis similar to that in Mexico two and a half years earlier, Anoop Singh informed the Managing Director that "we continue to believe that such fears are exaggerated."[100] Even after the crisis in Thailand put additional pressure on the won, Hubert Neiss argued that while the staff was concerned about "domestic events" such as the fallout from the Hanbo Steel bankruptcy, it was not worried about external pressures.[101] A month later, he elaborated that "we . . . assign a low probability of a major Thai-type external crisis."[102]

These reassuring assessments reflected the positive information being provided to the staff by the authorities. Much of the most critical data, including up-to-date intervention figures and external borrowing by overseas branches of Korean banks, were not

[97]For an insider account of how these links worked, see Kang (2003).

[98]Notes on the February mission to New York are in the archived files of Folkerts-Landau's Deputy Division Chief, Garry Schinasi; IMF archives, FIN-AI, Accession 2006-0059-01.

[99]See memorandum from Folkerts-Landau to the Managing Director, "Capital Markets Surveillance Mission to Asia" (April 30, 1997); IMF archives, DMD-AI (Fischer), Accession 2000-0117-0007, "Korea I." The quotation is from p. 12.

[100]Memorandum to the Acting Managing Director (Fischer), "Korea—*Financial Times* Article on Debt Surge" (May 8, 1997), covering a reprint of John Burton and Peter Montagnon, "Debt Surge Raises Fears over Korea," *Financial Times* (May 7, 1997); IMF archives, DMD-AI (Fischer), Accession 2000-0117-0007, "Korea I."

[101]Memorandum from Neiss to the Acting Managing Director (Fischer), "Korean Developments" (July 16, 1997); IMF archives, DMD-AI (Fischer), Accession 2000-0117-0007, "Korea I."

[102]Memorandum from Neiss to the Managing Director, "Korea" (August 22, 1997); IMF archives, DMD-AI (Fischer), Accession 2000-0117-0007, "Korea I."

yet available to the Fund or other analysts.[103] All that the staff could do at this time was to infer from market behavior and from the government's reactions to events what might be happening below the surface.[104] One such inference came in late August, when the government announced it would guarantee up to $20 billion of the external debts of Korean banks. The staff found this "troubling," because it suggested that the continuing wave of corporate bankruptcies was weakening the banking system more than the official data indicated.[105] Only much later, in December 1997, did it become clear that the announced guarantee was just window dressing, given that it had no legal standing without parliamentary approval (which was never granted) and the central bank was running out of foreign exchange reserves to cover the guarantee.

In October, Adams returned to Seoul with a staff mission to conduct the first full-scale consultation discussions since August 1996.[106] By this time, the problems in the banking system were reasonably well understood,[107] but Adams and most others on the staff still regarded them as manageable. Moreover, the most serious weakness, the one that would trigger the crisis within a few weeks, remained a closely guarded secret even in Seoul. A large portion of the central bank's foreign exchange reserves consisted of deposits in overseas branches of Korean banks, and those banks had committed the money to cover their own external debts. The IMF had never encountered such a situation before, and the staff did not even know what questions to ask to uncover it.

[103]Short-term borrowing in foreign currencies by overseas branches did not show up in the official balance of payments data, because the borrower was considered nonresident. The discrepancy between residency-based and ownership-based external debt did appear in data collected and reported by the BIS, but the IMF staff did not pursue the issue before the financial crisis. The OECD took an equally benign view of Korea's prospects. The June 1997 *OECD Economic Outlook* projected that "real GDP growth may decelerate further to around 5½ percent in 1997 [from 7 percent in 1996], with some pick-up in growth likely in 1998" (p. 95). A positive shift in the external trade balance was expected to contribute to this turnaround. Like the Fund staff, the OECD staff considered the main risk to be "the possibility of further business failures," which "would further weaken the banks" (OECD, 1997, p. 96).

[104]Anne O. Krueger, who was professor of economics at Stanford University in 1997, later recalled that Korean "economic policy makers" had conveyed a sense of "deep gloom" at a conference in August of that year "about the chaebol [large business conglomerates], the state of the financial system, and the potential for reforms of economic policy" (Krueger and Yoo, 2002, p. 169n21).

[105]Memorandum from Bijan Aghevli to the Managing Director, "Korea—Bank Support Package" (August 28, 1997); IMF archives, Historian's files.

[106]Although Adams led both the 1996 and the 1997 missions, during the intervening months he was assigned to work on China and particularly on the transfer of sovereignty over Hong Kong from the United Kingdom to China. He returned to work on Korea only in August 1997 and had to bring himself up to date quickly.

[107]At the IMF/World Bank Annual Meetings in Hong Kong SAR in September, the Korean finance minister had acknowledged publicly that the corporate insolvencies of 1997 were "symptomatic of the Korean economy's structural imbalances" and had induced the government to restructure the financial system and to undertake a "complete overhaul of Korea's central banking and financial supervisory systems"; (statement by the Hon. Kyong Shik Kang at the Joint Annual Discussion, 1997 Annual Meetings, September 23–25, 1997, Press Release No. 42).

The mission's report to management did not foresee a crisis; instead, it focused on the longer-term and still-simmering financial sector problems:

> A string of bankruptcies among Korea's major conglomerates . . . has led to a sharp increase in nonperforming loans and spilled over into higher spreads and increased difficulty borrowing abroad. Korea has been relatively unaffected by contagion from Southeast Asia but confidence is extremely weak and the stock market has been depressed. . . . Attracting private capital—from domestic or foreign sources—is not likely to be easy until comprehensive reforms are introduced to improve the safety and soundness of the financial system and raise expected profitability. . . . The staff's judgment is that the authorities are relatively well equipped to deal with moderate additional external pressures on account of the continued relatively strong macroeconomic situation.[108]

Publicly, Adams was even more upbeat, telling reporters at a press conference marking the close of the mission that although the economy was in a cyclical downturn, "the long-term outlook for the Korean economy is very bright" (Veale, 1997). That statement was certainly true, but it unfortunately proved the worth of John Maynard Keynes's famous dictum that economists must focus as much on the short term as on the long, "for in the long run we are all dead."

Onset of the Crisis: Disappearing Reserves

Korea's financial problems worsened in the second half of October, right after the conclusion of Adams's mission. The floating of the Taiwan dollar on October 17 and a sharp sell-off in the Hong Kong stock market on October 23 aggravated the decline in confidence in the already weakening Korean markets. Continuing collapses of large corporations (so far that year, 6 of the 30 largest conglomerates, or *chaebol*, had declared bankruptcy), and the consequent pressures on the banking system and on the potential bailout costs to the government, led the rating agency Standard & Poor's to downgrade its assessment of Korea's sovereign debt on October 24. At the same time, the agency warned that the outlook was poor and that further downgrades were possible in coming months.[109] By the end of October, the main index of Korean equities was down nearly 40 percent from its early August level, and the won was falling against the U.S. dollar. Although the staff still believed that the authorities had the foreign exchange reserves and the policy

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[108]Memorandum from Charles Adams to the Managing Director, "Korea—Back-to-Office Report for the 1997 Article IV Consultation Discussions" (October 21, 1997); IMF archives, DMD-AI (Fischer), Accession 2000-0117-0007, "Korea I." The staff report for this mission was overtaken by events and never completed.

[109]The one-level downgrade affected both short- and long-term debt, and domestic-currency as well as foreign-currency debt. The lowest rating, as before, applied to short-term debt denominated in foreign currencies (lowered from A+ to A). See "Standard & Poor's Cuts Korea and Entities' Foreign Currency Ratings to A+; Outlook Negative," PR Newswire (October 24, 1997); accessed at http://www.thefreelibrary.com/Standard+%26+Poor's+Cuts+Korea+and+Entities+Foreign+Currency+Ratings+to...-a019913205.

flexibility to handle these pressures, Neiss and Adams warned management that the "risk of a foreign exchange crisis . . . is increasing significantly and the authorities could be overwhelmed if the current pressures continue."[110]

In fact, the crisis was already at hand. Korean financial institutions owed an estimated $30 billion on very short-term external borrowings in foreign currencies, which they were using to fund longer-term won-denominated loans to domestic corporations. External lenders were showing increasing reluctance to roll over those claims on maturity.[111] Although practically no one outside the central bank knew it at the time, the country's official reserves were woefully inadequate to cover those claims, as were the domestic banks' own reserves.

Even the little that was known was enough to alert Stanley Fischer to the potential for a developing crisis. He began to lay the groundwork for IMF assistance in the first week of November. Through several telephone calls with Korean officials, he tried to persuade them to accept a staff mission from the Monetary and Exchange Affairs Department (MAE) to conduct a more in-depth analysis of the banking system in anticipation of a possible "Indonesian style program." Those officials, however, were not yet ready. With a lame duck president in office and a presidential election campaign in progress, the government was effectively paralyzed and unable to make difficult decisions. Moreover, much like the initial Mexican reaction in December 1994, Korean officials believed that their new status as a member of the OECD made borrowing from the IMF both inappropriate and unnecessary. Fischer told them bluntly that this attitude was "stupid" and could "cost them dearly."[112] He then asked the staff to prepare a draft briefing paper for a negotiating mission in case the Koreans changed their minds.

Korea's finance officials knew they were in trouble and needed help. They just wanted to avoid getting it from the IMF if possible. The U.S. government was not prepared to step in, as it had tried to do for Mexico, partly because of the political trauma the earlier effort had engendered and partly because the case for bailing out a country whose industries were aggressively and successfully competing against

[110]Memorandum from Neiss to the Managing Director (drafted by Adams), "Korea: Severe External Pressures" (October 31, 1997); IMF archives, DMD-AI (Fischer), Accession 2000-0117-0007, "Korea I."

[111]For an analysis of Korea's external debt problem, see Yanagita (2000).

[112]Memorandum from Fischer to the Managing Director, "Brazil, Korea, Russia" (November 8, 1997), and Fischer's handwritten notes on a telephone conversation of the previous day; IMF archives, DMD-AI (Fischer), Accession 2000-0117-0007, "Korea I." More than a year earlier, Fischer had publicly rejected this "OECD syndrome" in Korea, telling a conference at the Brookings Institution in Washington that the IMF "will help again, if needed" (Fischer, 1996, p. 347).

U.S. firms would be even harder to sell domestically.[113] That left Japan as the most viable alternative.

Korea had helped its wealthier neighbor finance the rescue of Thailand in August, so the prospects for assistance from Japan seemed good. That avenue, however, was also blocked. The Japanese authorities had already refused an appeal to dissuade Japanese banks from withdrawing funds from Korea, and they had informed the Korean central bank governor, Kyung Shik Lee, that they would not establish a bilateral swap line without an IMF-supported program in effect. In a last-ditch effort, the Korean finance minister, Kyong Shik Kang, sent an assistant minister to Tokyo on November 11 to ask for official bilateral financing. When that effort failed, the IMF became the lender of last resort.[114]

Kyong Shik Kang knew that if he approached the IMF openly, financial markets would panic, instigating a crisis. In the course of a telephone call with Fischer, he learned that Camdessus was already in East Asia for a series of one- to two-day stops in Kuala Lumpur, Jakarta, Singapore, Bangkok, and Manila. As it happened, ambassador-at-large Kihwan Kim was in Bangkok to give a speech, so Kang asked him to find Camdessus and persuade him to come to Seoul for an emergency, top-secret meeting with the senior finance officials. After some searching, Kim finally caught up with Camdessus on Friday evening, just as the Managing Director was in the middle of an official dinner at the Bank of Thailand. To Kim's surprise, after he quickly explained the situation to Camdessus in a corridor outside the dining room, Camdessus immediately agreed to extend his trip. He had to go to Manila on Saturday, but he would then divert to Seoul instead of returning directly to Washington.

Camdessus, accompanied by Hubert Neiss, arrived at Gimpo Airport near Seoul on Sunday evening, November 16. From there, they were driven in an unmarked car to the Intercontinental Hotel, where they were registered under assumed names and could meet in secrecy with Finance Minister Kang and Governor Lee. Camdessus's intention at this meeting was to try to convince the Koreans that they would need an IMF-supported program. By this time, however, Kang and Lee had already persuaded President Young Sam Kim that they would have to ask for IMF support.[115] The only relevant questions concerned what policies they would have to agree to change and how much money the IMF was prepared to lend.

[113]The legislative restrictions that had prevented the U.S. government from helping Thailand in July (see above, pp. 508–09) expired in September. As regards Korea, the political constraint on U.S. action in November was less formal but no less important. In addition, at this time most U.S. finance officials believed that Korea—as an OECD member country—could handle its own economic troubles and that bailing them out could create a serious moral hazard.

[114]On Kang's final attempt to get support from Japan, see Blustein (2001), p. 128; additional information is from interviews for this book.

[115]The crucial meeting with the president took place at the Blue House on the morning of November 14; see Kang (1999), pp. 332–34.

Camdessus first wanted to know how much Korea really had in usable foreign exchange reserves. What he learned was alarming, but it was still not the full story. Kang and Lee told him they had about $25 billion in reserves and some $6 billion in forward commitments against that balance.[116] They estimated that perhaps $10 billion to $15 billion in short-term external debt would not be rolled over, implying they might have to use more than half of their uncommitted reserves to help the banks meet their commitments for the next couple of months. On that basis, Camdessus concluded that Korea could run out of reserves by the end of December. He still did not know that much of the nominal stock of reserves consisted of deposits in overseas branches of commercial banks that had committed the money to repay their own debts. Although the Bank of Korea was not legally obligated to use its reserves to cover those commercial debts, refusing to do so would bankrupt much of the country's financial system. Even without taking that implicit obligation into account, the Korean authorities were suggesting they needed $30 billion in official financing, which the IMF would be hard-pressed to provide on its own.[117]

The First Program: December 4, 1997

The ball was now rolling inexorably toward a negotiated program. By the time Camdessus returned from Seoul, the staff had prepared a briefing paper that envisaged a two-year stand-by arrangement for an unspecified but large amount: large enough to require exceptional access in relation to Korea's unusually small quota. In view of Korea's regional importance, the staff anticipated that additional official lending would be forthcoming from the United States, China, Japan, and other countries. The briefing paper noted the contagion effects from adverse developments elsewhere in Asia, but it also stressed the importance of "weaknesses . . . in Korea's corporate and financial sectors and the inability of the authorities to address the situation."[118]

Despite the acknowledged good record of macroeconomic policymaking in Korea, the staff proposed tightening policies, noting that the program would "build upon the authorities' current macroeconomic policy framework (updated to take into account the implications of the recent deterioration in the external situation)." The proposed

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[116]These figures are what Camdessus reported to the Executive Board on his return to Washington. Kang (1999, p. 338) reported that Lee told Camdessus that gross reserves were only $17 billion.

[117]See the report by Camdessus and Neiss (who accompanied Camdessus to the meetings in Seoul) to the Executive Board at EBM/97/112 (November 21, 1997), pp. 5–10. Also see memorandum from Neiss to the Managing Director, "Korea—Briefing Paper for Negotiation of a Stand-By Arrangement" (November 21, 1997); IMF archives, DMD-AI (Fischer), Accession 2000-0117-0007, "Korea I."

[118]Memorandum from Wanda Tseng (Deputy Director, APD) to Michael Mussa and other concerned department heads, "Korea Briefing Paper" (November 18, 1997); IMF archives, DMD-AI (Mr. Fischer's files), Accession 2000-0117-0007, "Korea I."

measures included tightening fiscal policy by 1.5 percent of GDP to offset the expected cost of financial restructuring and to promote investor confidence, and tightening monetary policy to prevent “a significant further weakening of the currency.”[119]

While Camdessus was returning from Seoul, Fischer was on his way to Manila for an ad hoc international meeting of finance officials to set up what would become known as the Manila Framework (Chapter 12). From there Fischer planned to go on to Seoul in response to an invitation from the finance ministry. On the day of the meeting—November 19—the Korean delegation withdrew the invitation. President Young Sam Kim had just dismissed Kyong Shik Kang from his posts as finance minister and deputy prime minister, and the government now seemed to be pulling back from the brink of asking the IMF for help. Fischer, however, was determined, and he informed the delegation that he intended to go to Seoul anyway, even if it meant that he would have to sit alone in a hotel room.[120]

By the time Fischer got to Seoul on November 20, the president had installed a new finance minister, Chang-Yuel Lim, a former Alternate Executive Director at the IMF (1986–89). Lim had already announced a financial restructuring and had widened the band within which the exchange rate was allowed to fluctuate. It was a promising beginning, and he and Fischer had a productive meeting over dinner that evening. Although Fischer’s trip—like Camdessus’s a few days earlier—was supposed to be a secret, the press discovered he was in town, and he was followed by paparazzi for the rest of his visit except when he “barricaded” himself in his hotel room (Fischer, 2001).

The next morning, while Fischer delayed his scheduled departure for Washington, Lim went to see the president to get his final approval for seeking financial assistance from the IMF. Young Sam Kim gave his approval, conditional on getting a public statement of support from each of the three main candidates for the presidential elections to be held on December 18. That support was in everyone’s interest: the outgoing president did not want to take all the blame for accepting a painful adjustment process, and the IMF had to be sure that the incoming leader would continue to implement the program. Fischer agreed, although he was worried about whether the government was really prepared to take the tough steps required to restore confidence. “This is going to be a very difficult negotiation,” he reported back to Camdessus.[121]

From this point on, the process picked up momentum. Within hours, the government announced to the Korean people that it was seeking an arrangement with the

[119]Memorandum from Wanda Tseng (Deputy Director, APD) to Michael Mussa and other concerned department heads, “Korea Briefing Paper” (November 18, 1997); IMF archives, DMD-AI (Mr. Fischer’s files), Accession 2000-0117-0007, “Korea I.”

[120]Memorandum from Fischer to the Managing Director, “Visits to Qatar, Manila, and Seoul, November 16–21” (November 21, 1997); IMF archives, DMD-AI (Fischer), Accession 2000-0117-0007, “Korea I.”

[121]Memorandum from Fischer to the Managing Director, “Visits to Qatar, Manila, and Seoul, November 16–21” (November 21, 1997); IMF archives, DMD-AI (Fischer), Accession 2000-0117-0007, “Korea I.”

Fischer and Chang-Yuel Lim photographed during Fischer's "secret" trip to Seoul. (Associated Press file photo)

IMF. Camdessus spoke to the president, the prime minister, and the finance minister by telephone to express his support and explain the way in which the Fund would proceed. He also made plans to go to Korea himself as soon as possible. The previously planned MAE mission arrived in Seoul that evening, headed by Tomas Baliño

(Assistant Director, MAE), and the negotiating mission from APD was preparing to leave Washington in a day or two.

When the Executive Board met the next day, November 21, to hear Camdessus's report on Korea, the two issues that would dominate the debate—not only in the coming weeks but for years afterward—were already in the air.

First, was it desirable and necessary for Korea to raise interest rates? Doing so, as Okyu Kwon (Alternate, Korea) pointed out, would further weaken the profitability of many businesses and lead to even more bankruptcies. Failing to do so, as Lissakers (United States) and Gus O'Donnell (United Kingdom) argued, would perpetuate the capital flight already under way and would either dissipate the country's official reserves or lead to a collapse in the exchange rate, or both. A middle ground would have to be located.

Second, was it feasible and desirable to induce the external creditors of Korean banks to take losses or increase their exposure, or should the program aim to restore confidence quickly, thus convincing foreign banks to stay in the game voluntarily? Bernd Esdar (Germany) argued that creditors should be compelled to make their "fair share" of loans to Korea, to which Lissakers responded that for creditors to reduce exposure in the current circumstances was a sensible and prudent business decision with which the Fund should not try to interfere.[122]

Both problems were acute, and the two were linked. Short-term interest rates were hovering around 15 percent, which was adequately high in relation to the inflation rate but very low in relation to the expected depreciation in the exchange rate. The incentive for capital flight was therefore quite high. Understandably, creditors were equally reluctant to roll over their maturing loans. That evening, Camdessus telephoned Lim to try (unsuccessfully) to persuade him to raise interest rates immediately, in a preemptive strike aimed at avoiding a much larger increase later.

The Fund was, from the outset, less concerned about fiscal than about monetary policy. The staff mission team recognized that restructuring the banking system and keeping both the banks and their business customers operating was going to drain the public treasury. They therefore believed that some offsetting measures would be needed to cover the cost. They also were no doubt influenced by the Fund's experience in Mexico and in other crisis situations in which a combined tightening of fiscal and monetary policies had been a central component of restoring credibility and stability. Still, they also realized that the government had some room to maneuver as a result of several years of fiscal prudence before the crisis. The tightening proposed in the draft briefing paper—1.5 percent of GDP—was fairly modest, but when Fischer reviewed the paper on November 24, he approved it only after lowering the recommendation to a mere 0.5 percent.[123]

[122]See minutes of EBM/97/112 (November 21, 1997), pp. 5–10. Additional information is from interviews with participants.

[123]Memorandum from Neiss to the Managing Director, "Korea—Briefing Paper for Negotiation of a Stand-By Arrangement" (November 21, 1997), with handwritten notations by Fischer (November 24, 1997); IMF archives, DMD-AI (Fischer), Accession 2000-0117-0007, "Korea I."

On November 26, the negotiating mission arrived in Seoul and immediately went to work.[124] That evening, Neiss, the mission chief, faxed a handwritten note back to Fund headquarters with a frightening message. On arrival, the staff had finally discovered the full extent of the weakness in Korea's foreign exchange position. No more than $9 billion of Korea's $24 billion in official reserves was usable, and $15 billion in external debt would fall due before the end of December. Given that no more than 30 percent of that debt was being rolled over, the Bank of Korea was likely to run out of reserves completely before the tentatively scheduled meeting of the Executive Board to approve a stand-by arrangement (December 18). Neiss urgently advised the Managing Director to try to arrange for supplementary financing or a standstill on redemption of private credits.[125]

The Fund's decisions and actions on Korea would not be made in a vacuum. The major creditor countries not only had to approve the stand-by arrangement at the Executive Board, but it appeared that they also would have to provide supplementary credits if the overall financing was to be sufficient. Time was short, and a long holiday weekend was approaching in the United States. (Thanksgiving Day was on Thursday, November 27.) In a hastily arranged meeting at Camdessus's request, the G7 finance deputies assembled in the Air France Concorde lounge at John F. Kennedy Airport in New York City on November 26 to decide how to proceed. Camdessus, who was starting his second trip around the world in as many months, met them there along with his Economic Counsellor, Michael Mussa. Camdessus reported that his initial discussions in Seoul had been extremely difficult, and that it was by no means clear that the Korean authorities realized the precarious state of their financial situation. The Fund would insist on tough conditions, which Korea might or might not accept. If negotiations broke down, Korea inevitably would default on its external debts.

Although the G7 deputies and their ministers were considerably worried about the prospects for a default, they were prepared to leave the financial solution in the hands of the IMF for the time being. They rejected the idea of providing a bridging loan if negotiations dragged on; they rejected the idea of offering a "second line of defense" to supplement an IMF loan; and they rejected the idea of taking coordinated action to persuade private creditors to maintain credit lines. One or more deputies were in favor of each proposal, but others were strongly opposed.[126]

Later that day, Acting Managing Director Alassane Ouattara held an emergency meeting with a few senior staff to decide how to proceed in the absence of a backup

[124]For an inside account of the work of the staff missions, see Neiss, Tseng, and Gordon (2009).

[125]Handwritten memorandum from Neiss to the Managing Director, "Korea—Foreign Exchange Situation" (November 26, 1997); IMF archives, DMD-AI (Fischer), Accession 2000-0117-0007, box B22265, "Korea I."

[126]This account is based on interviews with participants. Also see Rubin and Weisberg (2003), pp. 229–30.

plan from the G7.[127] The staff concurred on the one hand that avoiding a default, which "would run a substantial risk of precipitating a serious financial crisis in the region and elsewhere," was critically important. On the other hand, persuading the Koreans to raise interest rates "up-front" was also critically important. Otherwise, the crisis was likely to continue. Somehow, the staff would have to reach an agreement with the authorities on this issue before Camdessus arrived in Seoul to wrap up negotiations in early December.[128] If they succeeded, then the Board meeting could be advanced from mid- to early December, tentatively as early as December 4. Because the central bank was losing reserves much more quickly than the staff had thought before the mission arrived, if Korea did not get at least a few billion dollars from the Fund by early December, it would have to begin defaulting on its external debt.

The level of interest rates was only one of several points making these negotiations extremely difficult. More generally, the U.S. government was pushing hard for a broad agenda of structural reforms in Korea, including liberalization of capital inflows and deep reform of the financial system.[129] This push came partly out of conviction that reforms were needed and partly in reaction to lobbying by U.S. industries competing with those in Korea. On Thanksgiving Day, President Clinton telephoned President Young Sam Kim "to strongly urge reforms," and the treasury secretary, Robert Rubin, decided to send an aide, David A. Lipton, to Seoul immediately "to get an independent assessment of the situation as well as to reinforce the importance of strong reform measures." Lipton—who had once worked for Neiss at the IMF—promptly checked into the Seoul Hilton, where Neiss and the rest of the Fund team were staying. He spent several days meeting both with the Korean authorities (separately from the Fund mission's meetings) and with Neiss (Blustein, 2001, pp. 6 and 143–44; and Rubin and Weisberg, 2003, pp. 233–34).[130] In effect, Neiss had to negotiate with both the Korean and the U.S. authorities to arrive at a program that the one would implement and the other would support.

After some 72 hours of all-day meetings and all-night preparations, Neiss sent a first draft of a Letter of Intent (LOI) back to headquarters on Saturday, November 29. Based on what he thought Korea was willing to accept, the draft called for a small rise in interest rates and a fairly modest beginning to a reform agenda. Several department heads read it that day, and they all rejected it as too vague and too weak. Mussa was especially strident. The draft program, he wrote, "appears to be a massive and

[127]At this time, Camdessus was in Europe, en route to Korea, and Fischer was in the Middle East.

[128]Memorandum for files by Aghevli, "Korea—Options for Dealing with the Crisis" (November 26, 1997); IMF archives, DMD-AI (Fischer), Accession 2000-0117-0007, "Korea I."

[129]Most restrictions on capital outflows had already been liberalized, either as part of the general opening of the economy in the 1980s and early 1990s or as a requirement for Korea's accession to OECD membership in 1996; see OECD (2002), especially pp. 97–105.

[130]In addition, Rubin occasionally telephoned Camdessus to convey U.S. views, and both Summers and Lipton would call Fischer.

unjustified bailout without adequate conditionality, which will set a terrible precedent for the future."[131]

On Sunday afternoon, a broader group of senior staff met with Deputy Managing Director Shigemitsu Sugisaki and reached the same conclusion. The draft LOI was too weak and would fail to restore investor confidence. For the program to succeed, they felt it would have to include a "strong explicit commitment on how far the authorities would be willing to raise interest rates" and a set of prior actions to be completed even before the Managing Director would agree to support the program.[132] That evening, Fischer—who had just returned to Washington during the day—informed Executive Directors that negotiations were at this critical stage. All of the Directors from major creditor countries apparently agreed that their support would depend on the strength of the program.[133] For better or worse, the Fund was preparing to stiffen its collective backbone.

In addition to the program conditions, the Fund had to figure out how to make the numbers tally. With very little of the existing private sector credits being rolled over and the central bank losing reserves at the rate of $700 million a day, official creditors would have to commit much more money than the IMF could possibly provide. This gap had two dimensions: the amount of money needed to restore investor confidence, and the amount needed to keep the central bank from running out of reserves.

The first problem—restoring confidence—was psychological. Having seen the effect on markets of the $40 billion package assembled for Mexico in 1995, Fischer concluded that Korea would need a similar commitment and probably a bit more. He envisaged a $50 billion package, even if a fair bit of it consisted of vague and conditional commitments. Fortunately, by Tuesday, December 2, creditor countries had realized they would have to provide supplementary bilateral financing after all, at least on a contingent basis. Assuming commitments to this second line of defense would total about $20 billion and the World Bank and the AsDB could be persuaded to lend Korea another $10 billion, then a credible package totaling $50 billion would be within reach if the IMF was prepared to approve a record-setting $20 billion stand-by arrangement.

The second problem—keeping the Bank of Korea from running out of cash—was both more immediate and, in principle, more firmly grounded. Now that the staff had a reasonably accurate count of Korea's usable reserves and of the stock and duration of short-term external debt, the essential question was what portion of the debt would be renewed. As the impossibly tight deadline for completing negotiations approached,

[131]See attachments to a memorandum from Aghevli to Jack Boorman, Manuel Guitián, and Mussa, "Korea: Program Documents" (November 30, 1997); IMF archives, DMD-AI (Fischer), Accession 2000-0117-0007, "Korea I."

[132]Memorandum from Fischer to the Managing Director, "Korea" (November 30, 1997); IMF archives, DMD-AI (Fischer), Accession 2000-0117-0007, "Korea I."

[133]Memorandum from Fischer to the Managing Director, "Board meeting, etc." (November 30, 1997); IMF archives, DMD-AI (Fischer), Accession 2000-0117-0007, "Korea I."

the mission team had no choice but to assume that private creditors would roll over whatever was necessary to stabilize the reserve balance. At a time when a 30 percent renewal rate would have been a very favorable outcome, the staff assumed heroically that the forthcoming announcement of an agreement with the Fund would quickly restore confidence and lead to a 90 percent renewal rate. The mission team knew this assumption was unrealistic. In essence, the Fund was internalizing the backup official financing (the second line of defense) as if it were private credit.

Camdessus arrived in Seoul early Wednesday morning, December 3 (Tuesday afternoon in Washington, where discussions were also continuing among the staff), after an overnight flight from Bangkok. Despite the early hour, his plane was met by a large contingent of journalists taking photographs and shouting questions to him. Ignoring them, he was taken by official car to the presidential residence, the Blue House, where he met with President Young Sam Kim. Through a day of discussion, the two leaders ironed out the few remaining differences on terms for the proposed stand-by arrangement. By this time, Korea had already implemented the required prior actions, including an initial increase in interest rates, measures to raise tax revenues, and commitments to shut down several insolvent banks and to allow foreign financial institutions to acquire Korean banks.[134]

All that remained was for Young Sam Kim to secure the support of each of the candidates who might succeed him after the December 18 presidential election. With time running out, he sent emissaries by helicopter to obtain the letters of support the Fund was requiring. Within hours, all three leading contenders had submitted letters addressed to Kim stating that if elected, they would implement the economic program. Ominously, one of the three—the eventual winner, Kim Dae-Jung—carefully hedged his support:

> If I am elected president, I will fulfill, in principle, the content of the agreement with the IMF. . . . However, in concretely carrying out the terms of the agreement, we should, through continuous discussions and negotiations concerning the details, reduce to a minimum the suffering of the people resulting from mass nonpayment and mass unemployment accompanying the sudden economic recession.[135]

Normally, the staff would have several weeks after a mission to prepare a detailed staff report, which would be circulated to Executive Directors along with the LOI and other relevant documents at least three weeks before the Board meeting at which the

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[134]The publicly announced actions were described in a letter from Finance Minister Chang-Yuel Lim to Camdessus (December 4, 1997); IMF archives, DMD-AI (Fischer), Accession 2000-0117-0007, "Korea I."

[135]Memorandum from The Secretary to Members of the Executive Board, "Republic of Korea—Letters," FO/DIS/97/104 (December 10, 1997), conveying copies of the letters in the original Korean language and in English translation. The Speaker of the National Assembly, Su-han Kim, also submitted a letter promising the president that he would "actively cooperate to ensure that prompt legislative measures are enacted." The other two candidates promised simply to "execute the content of the agreement as it was mutually agreed upon."

proposed arrangement would be considered. Directors would use the three-week interval to circulate the papers to their national capitals for consideration and comments. In this case, Korea's financial crisis was imminent and no delay was possible. The Fund therefore invoked its Emergency Financing Mechanism, an accelerated procedure adopted in 1995 in the wake of the Mexican crisis (see Chapter 10). After Camdessus's meeting with Young Sam Kim, the mission team stayed up all night drafting the staff report. Neiss faxed it to headquarters, and it was circulated to Executive Directors the same day (the production being aided by the 14-hour time difference between Washington and Seoul). Camdessus flew from Seoul to Tokyo, where he was to deliver a long-scheduled speech and where he could take advantage of videoconferencing facilities to brief Executive Directors without having to wait until he could return to Washington. This was the first time the IMF Executive Board ever met via videoconference. The regular Board meeting was then scheduled for the next day, December 4, to be chaired by Fischer.

The Board meeting was held in restricted session, and the associated documents—the LOI and the staff report—were classified "strictly confidential." The authorities, under pressure from Executive Directors from creditor countries, soon agreed to publish the LOI. Publishing the staff report was a more delicate matter because it contained critical statements about economic policies that could further damage confidence. That issue was set aside for a few days, but when the newspaper *Chosun Ilbo* obtained a copy (apparently from a source in the government) and published it, the ministry of finance had no choice but to release it officially.

Despite nearly universal skepticism about whether the program would succeed, the Board approved Korea's request for a three-year stand-by arrangement totaling $21 billion (SDR 15.5 billion). This was not only the largest arrangement the Fund had ever approved; it also was the largest by far in relation to the member's quota (1,938 percent).[136] Of that, Korea was able to draw about $5.6 billion (SDR 4.1 billion) without delay. To cobble together that much money to transfer to Korea, the Board immediately followed its consideration of the stand-by arrangement with a brief discussion of the operational budget. As soon as the Board formally agreed to increase the amounts of several currencies

[136]The previous records were held by the stand-by arrangement for Mexico in 1995, both in absolute amount (SDR 12.07 billion) and in percentage of quota (688 percent). The large ratio for Korea was justified by the country's extremely low quota and was made possible by invocation of the long-standing "exceptional circumstances clause." On the background for the low quota, see Boughton (2007). On the exceptional circumstances clause, see Boughton (2001), pp. 878–79. The absolute and relative sizes of the Korea arrangement were surpassed in May 2010, when the Fund approved a stand-by arrangement for Greece totaling SDR 26,432.9 million (€30 billion, or $33.8 billion), more than 32 times Greece's quota.

the Fund could use, the Treasurer, David Williams, signaled his staff to begin the transfers.[137] For the moment, Korea's central bank was saved from bankruptcy.

As noted above, the broader objective of convincing private creditors to roll over their loans voluntarily required assembling a large package of official commitments. Although the World Bank had just graduated Korea from its list of eligible borrowers, and even though the Bank's President, James Wolfensohn, complained privately to the Fund about not being consulted while the program was being negotiated, the Bank now announced it was prepared to lend Korea up to $10 billion, pending negotiation of specific terms. The AsDB indicated its willingness to lend up to $4 billion, and a group of 12 industrial countries announced a $20 billion contingent package, or second line of defense. Altogether, including the Fund arrangement, by the end of the day on December 4 Camdessus was able to announce that the international community was prepared to place up to $55 billion at Korea's disposal.[138]

The First Review: December 18, 1997

Despite all the bold talk of a $55 billion package, the Bank of Korea had at its disposal when it opened for business on December 5 just the initial disbursement from the IMF ($5.6 billion) and its own dwindling reserves. These resources would suffice only if the rollover rate on private credits rose from 30 percent to a rate close to the assumed 90 percent, and everyone involved knew that was a long shot. Further lowering the likelihood, four factors combined to undermine investors' confidence that the authorities and the IMF had the situation under control.

The first problem was that the delay in publishing the staff report created fertile ground for leaks and for rumors about the depth of the crisis and the level of austerity being forced upon the government. Then, when the finance ministry finally released the document on December 9, news reports typically focused on the IMF staff's assessment that the government's attempts to avert the crisis had been piecemeal and insufficient and that usable reserves were far below what had been announced earlier

[137]See "Enlargement of the Operational Budget for November 1997 – February 1998," EBS/97/221 (December 3, 1997), and minutes of EBM/97/116 (December 4, 1997). Korea drew the $5.6 billion in seven currencies, with the U.S. dollar and the Japanese yen each accounting for about 36 percent of the total. The rest was transferred in deutsche marks, Italian lire, Swiss francs, pounds sterling, and Canadian dollars. Four years later, when Fischer was about to retire from the IMF, he vividly recalled the memory of Williams "standing at the door of the Board room, waiting for the vote, to give the signal to send the money"; see http://www.imf.org/external/np/speeches/2001/082901a.htm.

[138]See "IMF Approves SDR 15.5 Billion Stand-by Credit for Korea," PR/97/55 (December 4, 1997); accessed at http://www.imf.org/external/np/sec/pr/1997/pr9755.htm. On Wolfensohn's displeasure, see memorandum from Fischer to the Managing Director, "Korean Loan" (December 2, 1997); IMF archives, DMD-AI (Fischer), Accession 2000-0117-0007, "Korea I." The World Bank disbursed the first tranche of its $10 billion Economic Reconstruction Loan on December 23, 1997.

(see, for example, Bulman, 1997). The knowledge that publication had come grudgingly and only after the document had been leaked to the press no doubt added to the generally poor reaction.

Second, in a televised debate among presidential candidates on Sunday, December 7, two of the leading candidates—Kim Dae-Jung and In-Je Rhee—pledged to try to revise the terms of the Fund arrangement if they were elected. In Kim's case, the pledge merely reiterated the contents of his letter to Young Sam Kim four days earlier, but the broadcast likely heightened investors' fears that the government was not really committed to carrying out the program. In an effort to rectify this problem, Kim Dae-Jung wrote to Camdessus on December 11 expressing his support for the program, though he still insisted it had "shortcomings" that should be fixed. After Camdessus replied by asking him to make that support public, he did so on December 13 by stating unequivocally, "I will fully support the agreement made between the government and the IMF."[139]

Third, the countries that had committed to provide $20 billion in a second line of defense expressed reluctance to make any of that money available. For the first two weeks into the program, their prevailing view was that they had agreed only to consider providing bilateral support in the event of unexpected adverse shocks. Until that circumstance arose, they were not prepared to make a more specific commitment.[140] First the staff and then the Managing Director pleaded with the potential creditors to firm up their pledges and put the money on the table, but that effort did not bear fruit until December 18. In the meantime, the sense that official creditors were holding back made private creditors even less willing to roll over their own investments.

Fourth, the authorities were disinclined to raise interest rates by as much as was needed to stabilize the exchange rate. Doing so would risk bankrupting many of Korea's highly leveraged corporations and affect the impending presidential election. The LOI did not specify a target for short-term interest rates, other than to state that these rates would be "allowed to rise sufficiently" and would be "maintained at that level or higher as needed to stabilize [financial] markets."[141] Unbeknownst to the IMF staff during negotiations, the authorities had a legal obligation (under the Interest Rate Limitation Law) to establish a ceiling of 25 percent on short-term interest rates. The Bank of Korea continued to apply that ceiling after the program was put in place. To monitor developments and to try to reach firmer understandings on policy commitments, several members of the staff mission stayed in Seoul after the preliminary agreement had

[139]For the exchange of letters, see memorandum from The Secretary to Members of the Executive Board, "Republic of Korea—Letters," FO/DIS/97/105 (December 12, 1997).

[140]See memorandum for files by Boorman, "Meeting with Executive Directors" (December 9, 1997); IMF archives, Accession 2000-0117-0006, DMD-AI (Fischer), "Korea II."

[141]"Republic of Korea—Request for Stand-By Arrangement," EBS/97/222 (December 3, 1997), p. 39. The LOI did specify that the interest rate charged by the Bank of Korea on "foreign exchange injections to Korean commercial banks or their overseas branches" would be set at least 4 percentage points above the London interbank offer rate (LIBOR).

been reached on December 3. Neiss returned to Washington, but Wanda Tseng (Deputy Director, APD) took over as mission chief. She was advising the authorities to raise the ceiling to 40 percent, on the grounds that the constraint on rate increases, in combination with a 10 percent band on daily exchange rate movements, had "paralyzed" the exchange market.[142]

Tseng was also concerned, however, that if interest rates actually rose by that much, the consequences for the economy could be horrendous. Even at 25 percent, the pace at which companies and banks were being driven out of business was rising sharply. Although the high rates seemed necessary at that moment so that Korean banks could continue to service their short-term debts, a continuation ran the risk of bringing on "an enormous, and perhaps unsustainable, cost to the economy."[143] The most realistic escape from this dilemma was via an organized standstill on debt redemptions, but creditor governments were not yet ready to try that approach.

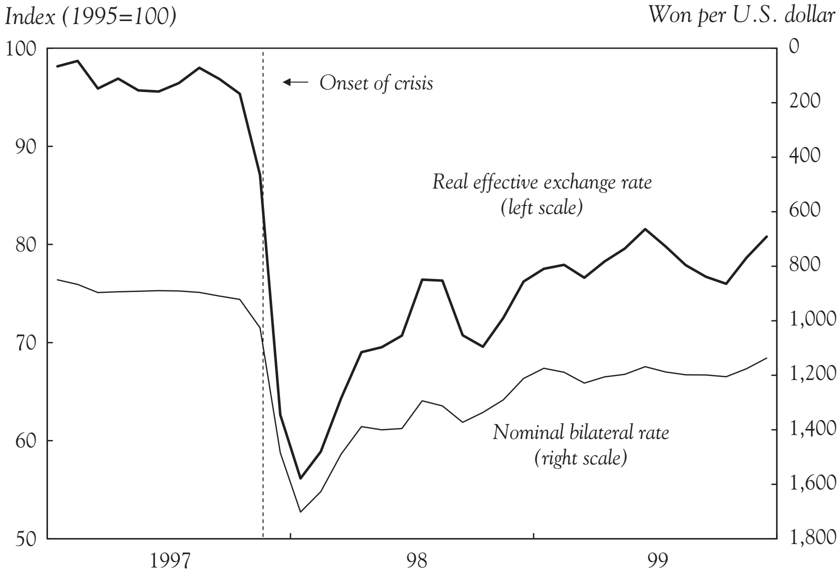
Much of the criticism of the IMF's handling of the Korean crisis that welled up in December and festered for years afterward started from the premise that the Fund was imposing excessive austerity on a country that already had established a record of sound macroeconomic policies. That premise was flawed, for three reasons. First, even if policies are sound before a crisis, the withdrawal of a major source of financing (foreign bank loans) may require a substantial policy adjustment. Second, the program was not designed to tighten fiscal policy or even to offset fully the effects of the anticipated recession on the budget. The required fiscal adjustment was intended only to offset the budgetary costs of managing the crisis. Without that adjustment, the rise in interest rates would have had to be even higher to enable the government to cover its borrowing requirement without resorting to massive inflationary financing. Third, to a large extent the monetary tightening was made necessary by the desire—shared by all—to avoid a default and by the decision—less widely shared—not to try to engineer a collective standstill on debt redemptions. The appropriate criticism is not that the program was too tight, at least not ex ante. If there was a major flaw in the design of the program, it was that a serious consideration of a standstill came only quite late in the process.

The IMF reacted particularly strongly to suggestions from Harvard Professor of Economics Jeffrey Sachs and World Bank Chief Economist Joseph Stiglitz that the program should have allowed interest rates to stay low even if it meant a collapse of the exchange rate. Fischer wrote an article for the *Financial Times* ("IMF—The Right Stuff") responding to that criticism, and Shailendra Anjaria (Director, External Relations Department) published a letter in the same newspaper asserting that Sachs's attack was "facile and distorted . . . on the basis of analysis that he must know to be

[142]Memorandum from Tseng to Neiss, "Korea—Foreign Exchange Market" (December 11, 1997); IMF archives, Accession 2000-0117-0006, DMD-AI (Fischer), "Korea II."

[143]Memorandum from Tseng to the Managing Director, "Korea: Program Issues and Strategy" (December 14, 1997); IMF archives, Accession 2000-0117-0006, DMD-AI (Fischer), "Korea II."

Figure 11.5. The Republic of Korea: Exchange Rates, 1997–99



Sources: Information Notice System and International Financial Statistics.

half-true or untrue." As would soon become clear, instead of an easier monetary policy Korea urgently needed a restructuring of its external debt to slow or halt the redemptions that were bankrupting the central bank.[144]

The Executive Board met to review the program on December 18, right after the presidential election won by Kim Dae-Jung.[145] Confidence in the Korean economy had not recovered; in fact, it was continuing to worsen. In the two weeks since the stand-by arrangement had been activated, the stock market in Seoul had fallen by 20 percent, and the won had fallen by 45 percent against the U.S. dollar (Figure 11.5). The authorities had agreed to raise the interest rate ceiling to 40 percent, but for the moment they were continuing to inject enough liquidity into the banking system to keep actual short-term rates at about 25 percent. Banks were afraid to lend, and their customers were frantically withdrawing their deposits. At this time, two weeks into the Fund-supported program, the central bank was still privately calculating that it was likely to completely deplete its reserves by the end of the month (Kim, 2006, p. 10). In the Fund's view, reserves were already fully depleted or committed.

[144]See Sachs (1997) p. 21, and the articles by Fischer and Anjaria in the *Financial Times* (December 17, 1997), p. 16. The *Financial Times* articles were circulated in the IMF as Prep/97/17 (December 18, 1997). The argument for a debt restructuring to lengthen maturities was presented cogently in Yanagita (2000). For a fuller discussion of the general criticisms and of the rationale for tightening policy to restore external balance, see Boughton (2006).

[145]The news that Kim Dae-Jung had won the presidency arrived during the Board meeting but had no discernible effect on the discussion.

The public's fears did not result primarily from doubts about the program or the government's willingness to implement it. Aside from the hesitation about raising interest rates, everyone in power now seemed committed, and they were implementing the program more or less on schedule. The central problem was that it would take months or even years to complete the financial reforms at its heart. In the meantime, both foreign creditors and domestic depositors were reluctant to accept the risk of lending to or investing in Korean banks. Not even a $55 billion package of official financing could sufficiently diminish that risk.

By this time, the staff was assuming only a 30 percent rollover rate on existing short-term debt, but even that rate looked increasingly optimistic. The election of a new government should have removed a source of substantial uncertainty, but investors were jittery about earlier statements by the president-elect suggesting he might undercut the reform program. In these conditions, the Fund could do little to turn the situation around except to continue its own financing and try to reassure markets that the government was carrying out the program. Accordingly, the Executive Board approved the completion of the first biweekly review of the stand-by arrangement and released an additional $3.5 billion (SDR 2.6 billion), for a cumulative disbursement of $9 billion (SDR 6.7 billion) so far in December. This second tranche, as anticipated from the outset, was made at a higher interest rate and a shorter maturity than the first, under the terms of the new Supplemental Reserve Facility (SRF) that the Board had approved only the day before (see Chapter 5).

To reinforce the positive signal from the completion of the review, Camdessus issued a clear statement of support:

> The Korean authorities are moving swiftly to implement the economic program approved by the IMF on December 4, 1997. The interest rate ceiling is being raised, the won is now freely floating, and important actions have been taken on the fiscal front. Action plans for restructuring the financial sector, constituting the cornerstone of the program, are also proceeding, and the IMF looks forward to continued close cooperation with the authorities in this critical area.[146]

Privately, however, the staff remained worried that if the rollover rate continued to fall, the Bank of Korea could still run out of usable foreign exchange reserves by the end of December, even after the addition of $9 billion from the IMF. The Fund had no plan to deal with that possibility.

[146]"IMF Executive Board Completes 1st Review of Korean Program: Activates Supplemental Reserve Facility," NB/97/30 (December 18, 1997); accessed at http://www.imf.org/external/np/sec/nb/1997/nb9730.htm.

The Revised Program: December 30, 1997

CHRISTMAS DAY 1997 . . . WAS THE WORST EXPERIENCE I HAVE EVER HAD IN POLITICS . . . I will never forget . . . what I have called . . . "white knuckle time."

Peter Costello[147]
Treasurer of Australia
December 20, 2005

If Korea's bank creditors were unwilling to continue lending, if the international community of finance officials was unable or unwilling to force or persuade them to keep lending, and if the money that the international community was willing to commit to Korea was still not enough to cover all of the repayments falling due, then Korea's only remaining option was to default. By the time the Fund-supported program had been in effect for just a few days, the IMF had to confront that prospect as a real possibility. On December 9, Thomas Leddy (Deputy Director, Policy Development and Review Department, or PDR) warned the Managing Director "that, in the worst case scenario, Korea would have to declare a debt moratorium, impose exchange controls limiting the private sector's ability to service short-term loans, and seek to restructure the debt."[148]

This alarm induced Camdessus and Fischer to use one of their periodic informal lunches with Executive Directors, on December 11, to quietly raise the question of whether they should begin trying to push Korea's creditors somehow to maintain their loan exposures. Some Directors, including those from Japan, Germany, and a few other European countries, spoke in favor of the idea, but they were a small minority.[149]

Not only in the IMF but in world capitals, enthusiasm for a negotiated debt moratorium (a standstill on repayments) was muted, for various reasons. Some people were opposed because they thought that markets should find their own way without official guidance or intervention; some because they still thought (or hoped) that the announcement of official support would quickly restore confidence (as it had in Mexico); and some because they did not believe that a standstill would work. In contrast to the 1980s, when debt crises primarily involved syndicated bank loans to sovereign governments, capital flows in the 1990s were much more diverse. Flows into Korea, more than for other Asian countries, took the form of bank loans, but the number of creditors was large, their geographic range was wide, and their loans were mostly to Korean banks, not to the government. Quite apart from ideology, organizing a standstill would be a complex operation involving creditor institutions in many countries. More and more, however, it was becoming clear that such an operation would have to be tried.

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[147]Interview with Stephen Mayne of ABC Radio (Australia) (December 20, 2005); accessed at http://www.treasurer.gov.au/tsr/content/transcripts/2005/172.asp.

[148]Memorandum by Leddy to the Managing Director, "Korea—Contingency Planning" (December 9, 1997); IMF archives, Accession 2000-0117-0006, DMD-AI (Fischer), "Korea II."

[149]Information provided by participants.

The next day, December 12, Boorman circulated a note to the Managing Director setting out options for restructuring the external debt of Korean banks involuntarily. At this stage, these options were considered just a contingency plan.[150] Four days later, he circulated a more detailed proposal, which he characterized as "Plan B." One of the challenges for Korea if it was forced to default was that the external debt was owed by private financial institutions, not by the sovereign government. If the country had to declare a standstill unilaterally, the IMF staff was recommending that the authorities should impose exchange controls preventing banks from repaying principal on their debts, and they should declare a bank holiday while the controls took effect. For their part, the banks should continue paying interest so as not to go formally into default.[151]

Plan B was received coldly. The U.S. authorities—in particular, both Rubin and Alan Greenspan (chairman of the U.S. Federal Reserve System)—were opposed on the grounds that a standstill could make banks less willing to lend to other emerging-market countries (Rubin and Weisberg, 2003, pp. 236–38). That opposition made the internal Fund debate moot, and most of the key personnel already agreed with the Americans. Manuel Guitián (Director, MAE) and his top aides were opposed to Plan B on the grounds that a unilateral standstill could "trigger a massive capital flight" unless it was backed up by extremely comprehensive and effective capital controls. Neiss was also concerned, fearing that Korea could lose access to international capital markets for an extended period and suffer a serious and prolonged recession as a result.[152] Fischer was determined to get a voluntary and cooperative agreement if at all possible.

These concerns were based partly on experience and partly on a strong preference for market-based policies. As the rollover rate continued to decline, however, the need for a fresh approach would become more compelling. The moment was rapidly approaching when the only choice would be between a negotiated standstill and a unilateral one (i.e., a default).

Once the presidential election and the December 18 Board meeting were over, the major creditors knew they had to act. The critical decisions in this regard had to come from the U.S. authorities because they were both the dominant official creditor and the one that had been most opposed to the idea of a standstill. On December 19,

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[150]Memorandum from Boorman to the Managing Director, "Korea—Restructuring Short-Term Debt" (December 12, 1997); IMF archives, Accession 2000-0117-0006, DMD-AI (Fischer), "Korea II." Also see Blustein (2001), p. 185, where the authorship of the memorandum was (correctly) attributed to Matthew Fisher (Division Chief, PDR).

[151]Memorandum from Boorman to the Managing Director, "Korea: Plan B" (December 16, 1997); IMF archives, Accession 2000-0117-0006, DMD-AI (Fischer), "Korea II."

[152]See memorandums from Guitián to Boorman (December 16, 1997), from Boorman to Guitián (December 18, 1997), and from Patrick T. Downes (Assistant Director, MAE) to Boorman (December 22, 1997), all titled "Korea: Plan B"; and Neiss and David J. Goldsbrough (Senior Advisor, APD) to the Managing Director, "Korea—Cash Flow and Financing Strategy" (December 16, 1997); IMF archives, Accession 2000-0117-0006, DMD-AI (Fischer), "Korea II."

Kihwan Kim met with Summers at the U.S. Treasury in Washington and offered to strengthen Korea's reform agenda well beyond the requirements of the IMF—an idea that Kim called an "IMF-plus" program—if the United States would help persuade creditor banks to roll over their loans to Korea. The additional reforms could include increased flexibility in labor markets, so that firms could fire unproductive workers more easily, and increased access to some Korean markets for foreign firms. Summers made no promises, but the next day the Treasury sent David Lipton to Seoul to meet with Kim Dae-Jung and confirm that the president-elect was committed to carrying out and even going beyond the IMF-supported program. They met on December 22, and Kim Dae-Jung assured Lipton he understood the need for structural reform and would do whatever it took to resolve the crisis and put the country onto a strong and sustainable path of economic growth. Rubin then initiated a broad effort among finance officials and central bankers from the major creditor countries to try to persuade (not force) their banks to roll over their loans to Korean borrowers (Blustein, 2001, pp. 193–96; Rubin and Weisberg, 2003, pp. 238–41; and interviews for this book). By this time, that effort was very likely to succeed because Korea's large bank creditors had already assured the staff they would welcome an organized solution.

Meanwhile, Neiss returned to Seoul to renegotiate the macroeconomic program. It was now almost inevitable that Korea would run out of reserves within a week unless it got even more new injections from official creditors. Korea still had $5 billion in usable reserves, and it was due to receive $4 billion in loans from the World Bank and the AsDB in the next few days. But the rollover rate was now only 15 percent and still falling, which implied that more than $7 billion out of a total of about $9 billion in outstanding principal would have to be repaid before the end of December. In addition, $2 billion in overnight deposits was unlikely to be renewed, and that would completely exhaust the resources of the central bank. As a first step toward regaining credibility and reinstilling confidence, the authorities signed a new LOI on December 23, after just three days of discussions with Neiss and his team. The new LOI offered more explicit commitments than the first one, including a promise to raise short-term interest rates to 30 percent.[153]

That evening, Fischer joined a conference telephone call among the G7 finance deputies that turned out to be pivotal in Korea's recovery from the crisis. It was already the predawn hours of Christmas Eve in Europe, where four of the deputies were sitting, and late morning in Japan. As important as the holiday was to most of them, this year it would have to wait. They all knew how desperate Korea's financial situation was and how serious the consequences could be if Korean banks began to default on billions of dollars in foreign debts. The deputies now all agreed that a standstill would have to be tried, and they devised a plan along the following lines: First, the finance ministries of each country—not the central banks, which would have to preserve some

[153]The draft LOI and a table showing the reserve situation was sent by fax from Neiss to Fischer on December 23; IMF archives, Accession 2000-0117-0006, DMD-AI (Fischer), "Korea III."

distance from the operation because of their role as bank regulators—would try to persuade their banks to maintain their loan exposures in Korea.[154] Second, the IMF would work with the Bank of Korea to collect and disseminate data on the success of that operation. Third, the central banks would coordinate the debt rollovers internationally and make sure that aggregate exposure was being maintained.[155]

The next morning, to prepare the ground for the standstill by putting their own money on the line, official creditors announced newly concrete commitments. The G7 finance ministers and central bank governors issued a statement welcoming the strengthening of the program in the new LOI and promising to begin disbursing funds from the second line of defense. Later in the day, the group of 13 countries participating in the second line issued a public statement promising specifically to lend Korea $8 billion (out of total potential commitments of $20 billion) "by early January."[156]

Now it was indeed "white knuckle time." Would enough commercial banks go along with the plan? Could they even be reached during the long holiday weekend that had already begun? When Jean Lemierre, the French finance deputy, telephoned one banker at home, he was told that he would have to call back after the holiday, because the banker was busy shucking oysters for his Christmas dinner. Lemierre refused to take that for an answer, and he eventually persuaded the banker to help. One by one, over the next few days, most of the major banks in North America, Europe, Japan, and Australia were gradually brought into the fold. Although cooperation was less than complete—Russian banks, for example, were reportedly reluctant to participate in the standstill—Korea's external debt was successfully stabilized within a few weeks.

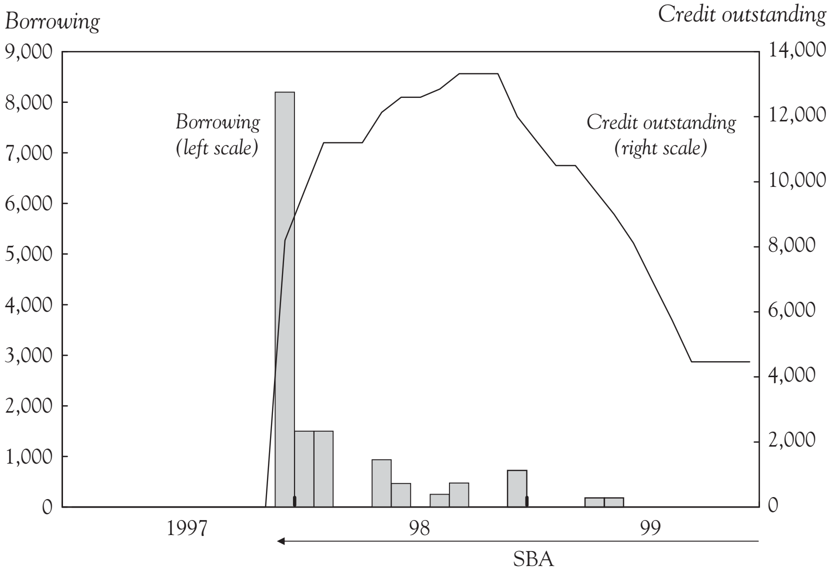
The IMF's role in the standstill was to help the Bank of Korea monitor the amount of debt being rolled over, broken down by individual creditor. This operation required getting each Korean bank, including overseas branches, to report their detailed outstanding obligations every day. Once these data were tabulated, the Fund conveyed the information to creditor-country central banks through confidential reports and a daily conference call. Each central bank got figures for banks in its own country and aggregate data for other countries. If the banks in one country were failing to roll over their

[154]As regulators, central bankers had to ensure that commercial banks did not make imprudent investments, but they also had a responsibility to help prevent the instability and even panic that could have resulted from a default on banks' existing claims. In this instance, the most common way that this conflict was resolved was by allowing treasury officials to hold meetings with bankers in the offices of the central bank, thus hinting that the operation had the regulators' support, but without the direct participation of the central bankers themselves.

[155]See handwritten notes made by Fischer during the telephone call on December 23, 1997; IMF archives, Accession 2000-0117-0006, DMD-AI (Fischer), "Korea III." Additional information is from interviews with participants.

[156]See "G7 Statement on the Korean Situation" (December 24, 1997), released by Finance Minister Paul Martin of Canada; accessed at http://www.g7.utoronto.ca/finance/fin_dec2497.htm. Since the initial agreement on the second line of defense, the number of participating countries had risen from 12 to 13 with the addition of New Zealand. The statement by the 13 participants was circulated in the IMF as EBD/97/140 (December 24, 1997).

Figure 11.6. The Republic of Korea: Use of Fund Credit, 1997–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics.
Note: SBA = Stand-by arrangement.

loans, that country's officials would apply additional persuasion. It was an immensely complex process involving Fund staff in Seoul and in Washington, a massive command center set up and run by the Bank of Korea in Seoul, and central and private bankers in at least two dozen countries around the world. It had never been tried before, and it had to be handled delicately to avoid crossing the line between persuasion and compulsion. With evident satisfaction and relief, one deputy happily recalled—in an interview for this book—that success was achieved "more or less voluntarily" by the major bank creditors.

To complete the renewal of the program, the Executive Board met on December 30 and agreed to accelerate the disbursement of funds under the stand-by arrangement. The Korean authorities had agreed to strengthen their own efforts, in particular by greatly increasing the penalty rates the Bank of Korea was charging Korean banks for liquidity support. In return, the Fund brought forward a $2 billion drawing that had been scheduled for January 8 and disbursed it on December 30 instead, bringing total disbursements for the month to a staggering $11 billion (SDR 8.2 billion, see Figure 11.6, more than 10 times Korea's quota).[157]

By eight p.m. on New Year's Eve, only a few lights were still on at IMF headquarters in Washington, for staff in Fischer's office and that of the U.S Executive Director.

[157]See "Republic of Korea—Request for Modification of Schedule of Purchases—Letter of Intent," EBS/97/246 (December 24, 1997) and Suppl. 1 (December 28, 1997).

The staff mission was finally home after more than five weeks in Seoul (though it had already been replaced by another team). The most dramatic year in IMF history was finished, and no one yet knew that another such year was about to begin. They did know, however, that the Korean crisis was still not resolved. Most of the staff finally had a weekend off, but only a weekend.

The Korean Financial Crisis Resolved: January 1998

The two remaining tasks, in broad terms, were to devise a more permanent plan for restoring and stabilizing Korea's financial strength and to reverse the horrendous collapse in the Korean economy. Only the first task could be tackled quickly.

Once the coordinated persuasion by country officials began in the last week of December, the precipitous decline in loan exposure by bank creditors slowed and then reversed. By late January 1998, the rollover rate had risen from a low of 10 percent just before Christmas to nearly 80 percent. That bought enough time for a group of the largest banks to organize a longer-term debt restructuring deal. Led by William R. Rhodes, the manager of many a concerted lending operation in the 1980s, a bank advisory committee met with a group of Korean representatives at Citibank headquarters in New York on January 8 and heard a telephone briefing by Fischer on the economic situation.[158] That meeting initiated a process that resulted in a January 28 agreement to restructure $24 billion in short-term bank debts into longer-term loans secured by the Korean government.

The most remarkable component of Korea's crisis recovery was the spontaneous outpouring of support from families throughout the country. The centerpiece of that support was the voluntary sale—not organized by any government agency—of massive amounts of privately held gold jewelry and similar personal treasures. Individuals, mostly women, sold their gold to corporations in exchange for won, and the companies then sold the gold for foreign exchange that they could use to repay debts to foreign creditors. This activity generated more than $2 billion that otherwise would have further drained the scarce foreign exchange reserves of the central bank. The psychological benefit to a people whose self-confidence had been badly damaged by the crisis was incalculable.

With these developments, the financial aspects of the crisis were largely resolved by the end of January. The Korean banking system was still fragile, and the Fund's financial markets experts—alongside experts from the World Bank and the AsDB—would spend several more months in Seoul advising the authorities on a restructuring

[158]While Fischer took charge of the Fund's role in the rescheduling operation, David Burton (Senior Advisor, PDR) represented the IMF staff at the January 8 meeting; see Burton's memorandum for files (January 9, 1998); IMF/RD, Accession 2001-0284, OMD-DMD (Fischer), Box 8, "Korea – 1998 (1)." At this time, Rhodes was vice chairman of Citibank. On his role in the 1980s, see Boughton (2001), Chapters 7–10.

plan. The plan that emerged involved fully protecting bank depositors through a comprehensive deposit insurance scheme, closing the weakest institutions, recapitalizing others by buying distressed assets, and strengthening supervision so as to enhance competition and market discipline. To further promote competition and inject fresh capital, foreign financial institutions were allowed to purchase domestic banks.[159] The international monitoring of debt rollovers also would continue for a few more months, but the rollover rate continued to rise, and more and more Korean banks were able to repay the expensive liquidity support they had obtained from the Bank of Korea during the crisis. By the middle of 1998, the central bank had rebuilt its reserves to a comfortable level (equivalent to four months of imports), and the exchange rate was steadily appreciating. Confidence in Korea had returned.

The real economic picture in Korea was not so benign. As a result of more than 30,000 bankruptcies of firms in the past year, Korea was in an economic depression, with sagging output, rising unemployment, continuing corporate bankruptcies, and severe hardships for a large part of the population. From the outset, the IMF staff had seriously underestimated the magnitude of the negative shock to the economy that would result from the combination of the massive bankruptcies throughout 1997, the loss of external financing in the last two months of the year, and the tightening of macroeconomic policies starting in December. Once the extent of the downturn became clear, and the financial crisis faded into the background, the focus had to shift to restoring economic growth.

To a large extent, the underestimation of the downturn may have been an unavoidable consequence of the implicit constraint against devising a reform program that was expected to leave the economy in a recession. Certainly the staff in the field understood that the poor circumstances in Korea could engender a serious risk of a decline in output from 1997 to 1998. That prospect, however, was unthinkable for the Korean government or the Korean people, who had just enjoyed a heady decade of rapid growth and expected their success to continue. The staff report for the original program in early December 1997 therefore envisaged real GDP growth for 1998 of 2.5 percent, a figure that was as low as was politically acceptable in Korea.[160]

By the time the Fund held the first quarterly review of the stand-by arrangement in February 1998, the staff's growth projection for 1998 had been reduced to 1 percent, with the caveat that the yearly growth rate could even be negative. At the second quarterly review, in May, the staff acknowledged that output was likely to decline by 2 percent for the year, and the report added that "a larger contraction is possible." Output continued to weaken, and the outcome for 1998 was a massive contraction of 6.7 percent. But the economy then recovered even more sharply and surprisingly, with

[159]For an overview, see EBS/98/20, Suppl. 1, pp. 8–11.

[160]Throughout the crisis, the Korean authorities conveyed strong concerns to the staff and urged that the IMF not publish projections that were much less optimistic than the official forecasts.

real growth in 1999 reaching 10.7 percent.[161] For the two years together, growth thus averaged 3.3 percent, which most independent observers in late 1997 probably would have thought to be a reasonably satisfactory result, given the severity of the initial conditions.

As Korea's financial outlook improved, the government increasingly was able to resume control over economic policy instead of being constrained by the policy conditions of the IMF stand-by arrangement. This control would be especially strong once Kim Dae-Jung took office at the end of February, but it was evident even earlier. Notably, by the end of 1997 the authorities became firmly convinced that they could not afford to propose a fiscal deficit without triggering a backlash in the form of renewed pressure on the exchange rate. They therefore decided on their own to raise taxes to preserve fiscal balance. In February, the government reached a "tripartite accord" with business and labor groups on a social compact and safety net to protect the poor and preserve employment. By stating publicly that the unpopular elements of these reforms were needed to meet the conditions imposed by the IMF, Kim Dae-Jung was able to defuse much of the domestic political opposition.

An unfortunate side effect of this strategy was that the IMF took an inordinate portion of the blame for the suffering that resulted from "the IMF crisis." In Seoul, a cheap meal became an "IMF lunch," and people joked that IMF stood for "I'm fired." These phrases stayed in the popular imagination for years. In truth, the president's personal commitment was the critical ingredient in getting economic policies and labor and other markets to change fundamentally, from heavy regulation and dependence on the government to a much more market-friendly environment.[162]

By the spring of 1998, as confidence began to improve, the government began easing fiscal policies and further improving the social safety net. The Fund did not initiate that shift either, though it fully supported it once it was under way. In what may have been an excess of caution, both the government and the IMF staff were reluctant to see an aggressive easing of monetary policy until it was abundantly clear that confidence was fully restored. Consequently, although interest rates began retreating from peak levels in February 1998, they did not return to precrisis levels until late in the year.

Throughout the three years that the stand-by arrangement was in effect, Korea consistently met and often exceeded the program targets set by the Fund. Korea continued to draw on the stand-by arrangement through May 1999, after which it had no further need for official financing. Altogether, the country borrowed $19.6 billion out of the $21 billion arrangement, all of which it repaid by 2001. That same year, Korea

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[161] See EBS/97/222 (December 3, 1997), Table 3; EBS/98/20, Suppl. 1 (February 13, 1998), p. 4 and Table 1; EBS/98/86 (May 19, 1998), p. 18 and Table 2; and EBS/00/137, Suppl. 1 (August 21, 2000), Table 2.

[162] With respect to labor market issues, the Fund staff generally avoided getting involved; see Neiss, Tseng, and Gordon (2009), p. 26.

again became a creditor country, with a currency strong enough for the IMF to use in its lending to other countries.[163]

Of all the emerging-market countries hit by financial crisis in the 1990s, Korea made the fastest and most sustained recovery. The downturn in 1997–98 was severe and painful, but at least it was short-lived, owing primarily to the extraordinarily strong and unified response eventually made by the government and the Korean people.

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[163]The stand-by arrangement expired in December 2000. Although Korea still had outstanding debts to the Fund, its strong reserve position and its stated intention to repay all of its borrowings ahead of schedule in the coming months induced the IMF to add the Korean won to the list of currencies usable for lending.

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12

Boats Against the Current: Coping with a Global Tide

So we beat on, boats against the current, borne back ceaselessly into the past.

F. Scott Fitzgerald
The Great Gatsby
1925

The East Asian crisis of 1997–98 was the apex of a wave of financial breakdowns extending from Mexico in 1994 to Argentina in 2002. The spillover or contagion effects from the "tequila" crisis were significant around the world but had major macroeconomic impacts in only a few countries in Latin America. The East Asian crisis was different, striking in multiple countries thought not to be particularly vulnerable, then spreading quickly throughout the region. Within a few months of its outbreak, analysts and investors began to reassess the risk of placing financial capital in emerging markets, regardless of geographic proximity to the crisis epicenter. The undercurrent from the withdrawal of capital threatened to undo the economic achievements of developing countries everywhere.

East Asia

The Asian crisis was not limited to the three countries—Thailand, Indonesia, and the Republic of Korea—discussed in Chapter 11. The major financial centers in Asia, including Tokyo, Hong Kong SAR, and Singapore, felt the effects but had ample resources to manage the challenges and ride out the downturn. Financial contagion hit two other developing countries—the Philippines and Malaysia—particularly hard, and the low-income countries in Indochina suffered from the regional slowdown in aggregate demand. From the broad perspective of the IMF, the key to limiting these effects and keeping the downturn from getting out of control was to ensure stability in China, the largest emerging market of all.

China

Developments in China had substantial effects, not only on its Asian neighbors but on the global impact of the Asian crisis. By not devaluing the yuan in response to the depreciations of other Asian currencies, the Chinese authorities helped prevent the financial crisis from exploding into a generalized currency meltdown. A decade later, China's adherence to a tightly managed exchange rate would come to be seen by the U.S. authorities and many external analysts as a destabilizing contributor to global payments imbalances. In the late 1990s, it was rightly viewed as a calming source of stability.

Officially, China had a managed-float regime for its exchange rate. In practice, from the beginning of 1995 the authorities had managed the rate tightly to maintain it close to 8.3 yuan per U.S. dollar.[1] Because the country's economic growth depended heavily on exports, IMF officials and other external analysts feared that China would try to prevent a real effective appreciation by allowing the rate to move in response to the depreciations taking place elsewhere in the region. Whether the Chinese authorities ever seriously contemplated devaluing the renminbi is difficult to know. The renminbi had depreciated substantially in nominal and real terms in the early 1990s until the authorities unified the foreign exchange market and started managing the rate against the dollar at the beginning of 1994. Since that time, the fixed nominal rate had produced a steady appreciation in real effective terms, but the real rate remained well below its early 1990s levels.[2]

On several occasions in the second half of 1997 and the first few months of 1998, the Fund's Managing Director, Michel Camdessus, met with the Chinese authorities to urge them to hold the exchange rate steady. On each occasion, they assured him they understood the importance of stability and intended not to alter their policy. During the same period, U.S. officials including President Bill Clinton made similar direct appeals to their Chinese counterparts. They also received reassuring responses.[3] Even if the Chinese intended all along to keep the rate where it was, this quiet but public diplomacy helped to preserve a measure of calm in otherwise very nervous financial markets.

The other currency-related issue for China was the strength of the Hong Kong dollar. At the same moment that Thailand was preparing to devalue the baht at the

[1]The Chinese currency is the renminbi. The basic unit of value is the yuan.

[2]See "People's Republic of China—Staff Report for the 1997 Article IV Consultation," SM/97/137 (June 3, 1997).

[3]After meetings in Beijing in January 1998, Camdessus held a press conference in Kuala Lumpur, Malaysia, during which he reported that the Chinese authorities "rightly intend to maintain the present value of the renminbi." For the transcript, see http://www.imf.org/external/np/tr/1998/tr980116.htm. Later, U.S. Treasury Secretary Robert E. Rubin took pride in having helped to avoid trouble. "Several times, in meetings with President Clinton, with others in the administration, or with me, President Jiang Zemin and Premier Zhu Rongji underscored the firmness of their commitment not to devalue the Chinese currency. And they never did" (Rubin and Weisberg, 2003, p. 227).

beginning of July 1997, the United Kingdom was formally handing over control of Hong Kong to China, at which time the territory would become Hong Kong Special Administrative Region of China, or Hong Kong SAR. The Hong Kong Monetary Authority (HKMA) had been operating as a currency board since 1983, maintaining the exchange rate at HK$7.8 per U.S. dollar. Adhering to this fixed rate through the market uncertainty associated with the hand over and the tumult of the regional financial crisis was going to be a major challenge. The Hong Kong authorities expressed their determination to persevere, and the Chinese authorities expressed their support and their commitment not to interfere.[4]

The Hong Kong dollar came under speculative attack, first in July and August 1997 and then again in October. In each case, the authorities drew on their ample stock of foreign exchange reserves to intervene in support of the currency. They also raised interest rates and mopped up excess liquidity in the economy. The defense succeeded, but at the expense of a sharp downturn in economic activity and a rise in unemployment. Real GDP declined by more than 5 percent in 1998 before beginning to recover in 1999; the unemployment rate rose from 2.2 percent in 1997 to 4.7 percent in 1998 and 6.3 percent in 1999.

The IMF strongly endorsed the Hong Kong authorities' commitment to pursuing tight monetary and fiscal policies while persisting with the fixed exchange rate. The staff noted that the currency board was well run and that it provided a solid anchor for expectations. In the immediate aftermath of the hand over, the currency board provided assurance that Hong Kong SAR would continue to run economic policies independently from Beijing. In the middle of the regional financial crisis, it provided assurance that Hong Kong would preserve its financial strength and stability.[5]

The real test for the HKMA came in August 1998, when a collapse of confidence severely depressed equity prices just as the Russian financial crisis was exploding. Concluding that the problem was a speculative attack rather than weak economic fundamentals, the HKMA made the unusual decision to buy equities and futures contracts for its own account. That move stabilized market conditions somewhat, but it also highlighted the vulnerability that resulted inevitably from the small size of Hong Kong SAR's completely open equity and foreign exchange markets. If a few well-capitalized hedge funds could easily attack these markets, would it not be better to adopt a more flexible policy with respect to the exchange rate? That question was hotly debated in Hong Kong SAR after August 1998, but in the end the authorities prevailed and maintained the unchanged exchange rate peg.

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[4]See, for example, "Monetary Relations between the Mainland of China and Hong Kong," speech by Chen Yuan (deputy governor of the People's Bank of China) at the Federal Reserve Bank of New York, February 14, 1997; circulated in the IMF as EBD/97/17 (February 20, 1997).

[5]"People's Republic of China—Staff Report for the Article IV Consultation Discussions Held in 1997 in Respect of the Hong Kong Special Administrative Region," SM/97/295 (December 29, 1997), pp. 20–21.

The staff unreservedly supported this decision.[6] So, for the most part, did the Executive Board, although several Directors suggested that the authorities should be developing a strategy to exit from the exchange rate peg at an appropriate time.[7] Soon afterward, however, economic growth resumed in Hong Kong SAR, and the peg survived.

The Philippines

In 1997, the Philippines was reaching the end of a 35-year stretch in which it had been a nearly continuous debtor to the IMF. Since the fall of 1994, the authorities had been successfully reforming the economy through a program supported by the Extended Fund Facility (EFF). Even more impressive, they had been able to treat the EFF arrangement as precautionary and had financed their balance of payments without further financial help from the Fund.[8] By June 1997, they had repaid nearly all of their earlier loans (Figure 12.1), and their remaining obligations totaled just 18 percent of quota, the lowest percentage since 1974. The Thai crisis interrupted this march to the exits, but—thanks to timely action by the authorities—it did not bring it to a halt.

In February 1997, a staff mission reached agreement with the authorities on economic policies for the rest of the year. At that time, the staff expected the extended arrangement would remain in effect until it expired on schedule in June and that the authorities would continue to treat it as precautionary and then end their era as a borrowing country. That continued to be the Fund's view until the Thai baht came under speculative attack in the middle of May. As investors began to reassess the strength of other currencies in the region, the Philippine peso was among the first to be downgraded.

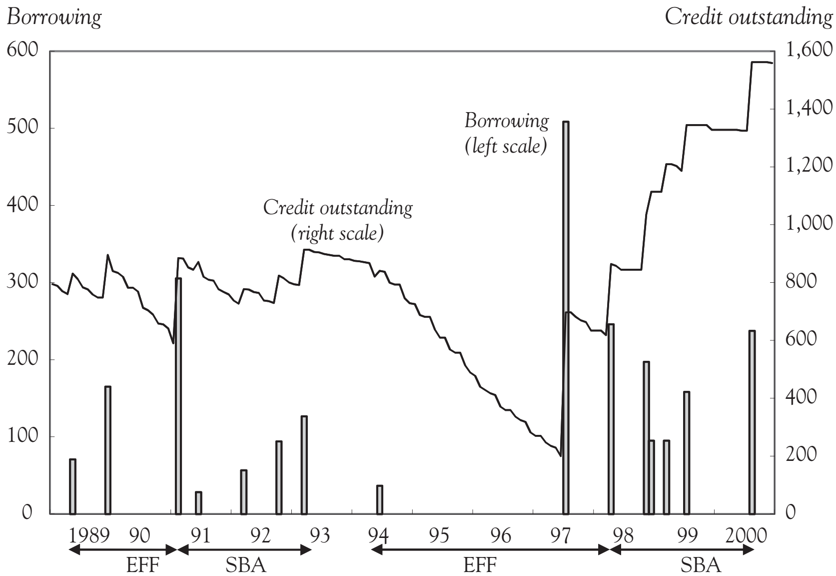
The Philippine authorities reacted swiftly to this contagion by raising overnight interest rates. The IMF's Executive Board was about to complete the final review of the 1994–97 arrangement, but put it on hold until the extent of this new difficulty could be clarified. When the initial interest rate response proved inadequate, the governor of the central bank, Gabriel Singson, called Camdessus and asked for additional support. The Managing Director immediately sent a mission to Manila, led by

[6]The December 1997 staff report (cited in the preceding footnote) noted that the "staff continues to endorse the authorities' commitment to the linked exchange rate system" (p. 20). A year later, while noting that "some have argued . . . [for a shift] to a more flexible exchange rate regime, the staff . . . remains strongly of the view that the linked exchange rate system should be maintained"; "People's Republic of China—Hong Kong Special Administrative Region—Staff Report for the 1998 Article IV Consultation Discussions," SM/99/4 (January 8, 1999), p. 36.

[7]See minutes of EBM/99/12 (January 29, 1999), pp. 7–46.

[8]For the earlier period, see Chapter 9. For a more detailed discussion of the reform of the economy, see Rodlauer and others (2000) and Balisacan and Hill (2003).

Figure 12.1. The Philippines: Use of Fund Credit, 1989–2000
(In millions of SDRs, monthly data)



Source: International Financial Statistics.
Note: EFF = Extended Fund Facility; SBA = Stand-by arrangement.

John E. Hicklin (Assistant Director, Asia and Pacific Department, or APD), to negotiate terms for an extension of the existing arrangement.[9]

The staff determined that the key to avoiding a financial crisis was exchange rate policy. The government had recently implemented a number of difficult measures to strengthen both the banking system and its own finances. The success of these measures had not yet been tested, and many domestic banks had large short-term liabilities in foreign currencies, making the currency vulnerable to a speculative attack. For a year and a half, the authorities had been managing the exchange rate tightly, in a de facto peg to the U.S. dollar. In the middle of 1997, they believed they were managing well enough to continue pegging, but Hicklin and others in the IMF quickly concluded this was going to be impossible.

For the IMF, preserving the fragile gains the Philippines had made in the mid-1990s was an important goal. It was crucial not only for the future of the Philippine economy but also for stability throughout the Pacific region in the wake of the crisis engulfing

[9]As an interim step, the Fund extended the arrangement for one month while talks proceeded on a longer extension and corresponding revisions to economic policies; see "Philippines—Extended Arrangement—Request for Extension of Period," EBS/97/111 (June 18, 1997). That extension was approved and took effect on June 23, the date that the three-year arrangement was scheduled to expire.

Thailand. It was also an important test of whether the Fund really could help a country with long-standing financial and developmental weaknesses to get on its feet and graduate from dependence on multilateral assistance.

Camdessus realized that convincing the authorities to let the value of the peso float relative to the dollar was going to be a tough sell. To reinforce the message, he asked Bijan Aghevli (Deputy Director, APD) to join Hicklin's mission in Manila and impress upon the authorities the importance of abandoning or at least loosening the peg. He also asked Shigemitsu Sugisaki (Deputy Managing Director) to deliver that message directly to Singson. Sugisaki and the governor were both scheduled to go to Hong Kong at the end of June for the ceremonial handover of sovereignty from the United Kingdom to China. There, they could meet quietly and discuss what to do next.

As expected, Singson was reluctant to let the exchange rate float because he feared that speculation would get out of control and produce a ruinous overshooting. Sugisaki persisted, and after the ceremonies in Hong Kong the two traveled together to Manila for further discussions as part of the mission already in progress.

At 9:00 a.m. on Wednesday, July 2, Sugisaki, Aghevli, and Hicklin were meeting with Singson in the governor's office in Manila when they received word that the Bank of Thailand had just announced it was no longer defending the value of the baht. Everyone in the room understood immediately that the Philippine central bank would have to follow suit. If they tried to maintain the existing rate against the dollar, speculators would quickly acquire all of the country's foreign exchange reserves. Singson could not make such a decision on his own. As soon as they could, he and Sugisaki went across town to inform the president, Fidel V. Ramos, of this turn of events.

The market reaction was not immediate, but it did come. After a long weekend of hesitation, the government decided to allow some depreciation of the peso while trying to control the rate of change by continuing to intervene in the foreign exchange market. Predictably, that led to even more intense speculative pressure. On July 9, a full week after the onset of the crisis, Camdessus picked up the telephone himself and called Singson. By then the governor was ready to accept the Fund's advice. The next day Singson met again with Ramos and got approval to act. On Friday, July 11, the peso was allowed to float.[10]

The staff mission wrapped up its work on July 11 and returned to Washington. In the end, the Fund agreed not just to extend the EFF arrangement but to augment the amount. The Fund was able to act quickly in this case by invoking—for the first time—the Emergency Financing Mechanism it had adopted in 1995 for coping with financial crises (Chapter 5). In mid-July, the Philippines borrowed $700 million from the IMF (SDR 508.75 million, or 80 percent of quota). This bold move did not completely stop

[10]This sequence of events was conveyed to the Executive Board by Aghevli at EBM/97/74 (July 18, 1997); see minutes, p. 11. Also see "Philippines—Fourth Review Under the Extended Arrangement and Request for Extension, Rephasing, and Augmentation," EBS/97/70, Suppl. 1 (July 14, 1997). Additional detail is from interviews with participants.

the speculative pressure, and the peso's value continued to fall, but at least the pace of depreciation now seemed manageable.

The onset of the regional crisis emanating from Indonesia and Korea in November 1997 worsened the outlook considerably. The peso tumbled sharply against the U.S. dollar. By early January, it was selling for less than 60 percent of its precrisis level. That, fortunately, turned out to be its low point. By the time a new program was negotiated with Fund staff in February, the authorities were already tightening monetary policy, confidence was beginning to be restored, and the peso was recovering. In April, the Fund approved a two-year stand-by arrangement to succeed the extended arrangement that had finally expired.[11]

In contrast to Thailand, the Philippines successfully protected itself from a major financial crisis by abandoning the fixed exchange rate while the central bank still had ample foreign exchange reserves. In contrast to Thailand and Korea, the authorities shared vital information with the IMF at an early stage and thus enabled the Fund to provide informed and timely policy advice. In contrast to Indonesia, early action to strengthen the financial system limited the extent of depreciation after the rate was allowed to find its own level. Contagion from the crises in those countries was a serious shock to the Philippine economy, but the outcome was manageable with only a continuation of routine lending by the IMF. The Philippines made several drawings on the 1998–2000 stand-by arrangement, at the end of which its debit position in the Fund peaked at just over $2 billion (SDR 1.56 billion, or 178 percent of quota). By then, the worst was truly over, and the country was able to repay all of that debt on time, completing the process in 2006.

Malaysia

Malaysia was the only IMF creditor country to be hit by market contagion from the East Asian crises. Even at the height of speculative pressure against the currency, Malaysia had no need to borrow from the Fund. Nonetheless, an ugly and very public dispute flared up over the Fund's policy advice and Malaysia's decision to impose capital controls in 1998 as part of its response to the crisis.

From the time it joined the IMF in 1958, the newly independent Federation of Malaya (expanded and renamed Malaysia in 1963) generally maintained a creditor position in the Fund. On a few occasions from 1977 to 1983, it drew on special facilities (the Compensatory Financing Facility and the Buffer Stock Financing Facility) to cope with low export prices. It repaid all of its loans on schedule by 1985. Throughout

[11]In all, the Fund extended the EFF arrangement four times from the original expiration date in June 1997, ultimately to March 1998. After augmentation in July 1997, the IMF's total commitment under the arrangement was SDR 791.2 million. The authorities borrowed the full available amount in three tranches: the initial drawing in June 1994, the large one on augmentation, and a final one just before expiration in April 1998.

this period, Malaysia experienced strong economic growth and a remarkable reduction in the incidence of poverty.

Progress accelerated further in the late 1980s, when Prime Minister Mahathir Mohamad set the economy on a path of rapid industrialization. In 1991, he initiated an export-led growth strategy known as the New Development Plan and appointed a new economic team, led by Anwar Ibrahim as minister of finance. Two years later, he elevated Anwar to deputy prime minister. The export-led growth strategy was introduced at a propitious time, when international capital was beginning to flow freely to emerging markets after several years of net outflows. As one of the new "Asian tigers," Malaysia quickly became a major recipient of these inflows, which fueled an investment boom that turned the country into a major center of production for export and transformed Kuala Lumpur into a showcase for modern Asian architecture. From 1988 through 1997, annual real output growth averaged more than 9 percent.

IMF staff reports broadly supported Malaysia's aggressive growth strategy, but from 1991 on the staff quietly urged the authorities to be cognizant of the potential for the economy to overheat. By 1994, the inflow of financial capital was becoming difficult to manage. Inflation pressures were building up, and the first signs were emerging of a bubble in the property market. To contain the pressure, the authorities temporarily introduced controls on capital inflows.[12] IMF officials expressed skepticism about this move but recognized they had no power, nor even a mandate, to stop it. Accordingly, the Fund's response was muted and referred only to the desirability of ending the controls as soon as possible. Specifically, the 1994 Article IV mission report noted that "as such measures introduced distortions, they were not desirable in the longer term." The authorities agreed, and they terminated the controls in August.[13]

Throughout the early and mid-1990s, the IMF had excellent relations with the Malaysian authorities. Staff reports generally called for a tightening of monetary and fiscal policies to counter inflationary pressures, but the overall message was always based on admiration for skillful economic management and the strong performance of the economy. Camdessus had a particularly high regard for Malaysia's achievements, reinforced by his respect for, and personal friendship with, Anwar Ibrahim. The two men had similar views on economic policy, a shared sense of the universality of

[12]The 1994 control was a ceiling on the external liabilities of domestic banks, excluding borrowing to finance current account transactions or foreign direct investment. For analyses of Malaysia's capital controls, see Athukorala (2001) and Tamirisa (2001). Table 5.1 of the latter provides a detailed chronology of controls from 1994 to 2001. The Fund staff later noted that the upward speculative pressure on the ringgit in 1991–92 resulted in large part from the advent of large-scale carry trade at that time (Eichengreen and Mathieson, 1998, p. 17).

[13]"Malaysia—Staff Report for the 1994 Article IV Consultation," SM/94/239 (September 1, 1994), p. 11. The general agreement between the Malaysian authorities and the IMF staff was expressed directly in the following year's report: "The staff agrees with the authorities that restrictions on capital flows should be used only as a last resort, as they can lead to market distortions and an inefficient allocation of resources"; "Malaysia—Staff Report for the 1995 Article IV Consultation," SM/95/200 (August 16, 1995), p. 25.

religious experience, and an urbane and philosophical approach to policymaking and diplomacy. In 1996, Camdessus twice visited Malaysia in response to invitations from Anwar, who introduced his friend to Mahathir. Both in Kuala Lumpur and on his return to headquarters, Camdessus was effusive in his praise for Malaysia's record of harmonious ethnic relations, commitment to reducing poverty, and strong economic growth.[14] In his public address, he praised Malaysia as "exceptionally successful" and promised to "support your efforts" to achieve the status of an industrial country "with every means at our disposal."[15]

The IMF staff working on Malaysia also were generally upbeat. Their concerns about overheating and the risk of a real estate bubble were tempered by a respect for the high rate of domestic saving and the boom in productive investment fueling the economy's growth. The banking sector was generally free of the weaknesses plaguing other countries in the region. External debt was largely long term and did not appear to pose any problems.[16] Of all the emerging markets in East Asia, Malaysia was one of the least likely to get into financial trouble.

Trouble came, however, in the wake of the crisis in Thailand, beginning when the Thai baht came under speculative attack in May 1997. The central bank (Bank Negara Malaysia) raised interest rates and intervened in the foreign exchange market in a rapid response to limit contagion. A week later, an IMF staff mission led by David J. Robinson (Division Chief, APD) arrived to conduct the already scheduled Article IV discussions. Robinson urged the authorities to take more aggressive action to tighten policies, not because the stance of monetary policy was particularly loose but because of the elevated risk of a catastrophic loss of investor confidence resulting from the situation in Thailand. The Malaysian authorities decided that further action was unnecessary.[17]

The investment climate worsened further after Thailand devalued the baht at the beginning of July. Domestic banks and other local institutions in Malaysia began shifting assets out of the ringgit, and the resulting pressure on the exchange rate caused foreign investors to speculate against the currency as well. Bank Negara again reacted swiftly, raising interest rates sharply for about two weeks. By then the authorities realized circumstances in the region were deteriorating more fundamentally. They lowered interest rates and allowed the exchange rate to depreciate in value by more than a

[14]Minutes of EBM/96/69 (July 19, 1996), pp. 47–48.

[15]"Challenges Facing the IMF and Malaysia," address by Michel Camdessus at a meeting of financial and business leaders, Kuala Lumpur, July 15, 1996; accessed at http://www.imf.org/external/np/sec/mds/1996/mds9615.htm. Mahathir had announced a goal of completing the transformation of Malaysia into an industrial country by 2020.

[16]For the official staff view, see "Malaysia—Staff Report for the 1996 Article IV Consultation," SM/96/217 (August 15, 1996). Also see Milesi-Ferretti and Razin (1999) and Ostry (1997), both of which found that Malaysia's external deficits were relatively manageable because of strong investment inflows.

[17]See "Malaysia—Staff Report for the 1997 Article IV Consultation," SM/97/197 (July 31, 1997).

third, from about 2.5 ringgit to the dollar—the level that had prevailed for more than five years—to nearly 3.9 by the end of 1997.

As the exchange value of the ringgit fell, Mahathir embarked on a public rampage against "billionaire . . . currency traders," whose activities were "unnecessary, unproductive and immoral." In various forums, including during the IMF/World Bank Annual Meetings in Hong Kong SAR in mid-September, Mahathir singled out George Soros for particular scorn, even though Soros denied that his hedge funds had been selling ringgit. Mahathir criticized the IMF for tolerating such practices. He made a broad attack on Jews, accusing them of deliberately trying to undermine the Malaysian currency.[18] The tone of these various remarks doubtless made many investors nervous and more reluctant to keep their money in Malaysia.

In counterpoint to Mahathir's attack, Anwar made a conciliatory speech at the Annual Meetings in Hong Kong SAR and generally did his best to try to present a calmer and more positive image to international investors. The IMF also tried to restore calm. From November 1997 through January 1998, Camdessus made three more trips to Kuala Lumpur. He met with the prime minister and explained the IMF's view that hedge funds were not the major culprit in currency markets and that suppressing speculation would do more harm than good.[19] These efforts seem to have helped. The 1998 Article IV mission was advanced to January, and those discussions produced agreement on a modest tightening of macroeconomic policies that the Fund was willing to endorse informally.[20] On January 16, Camdessus held a press conference in Kuala Lumpur in which he applauded the actions already taken and offered the Fund's technical assistance and advice in formulating a more comprehensive package.[21]

Although the IMF and the authorities still enjoyed a productive working relationship in January 1998, the public perception of the Fund in Malaysia was deteriorating almost irretrievably. Fund-supported programs in Thailand, Indonesia, and Korea were viewed as disastrous failures. The Fund was thought to be forcing countries throughout the region into inappropriate and even ruinously restrictive policy changes. "One size fits all" was being bandied around as a pejorative description of the austerity many observers thought the Fund was imposing across East Asia and was now trying to import into Malaysia. When the infamous photograph of Camdessus apparently lording his authority over Indonesian President Suharto (see Chapter 11) splashed across the front pages of newspapers everywhere on January 16, 1998—the same day that Camdessus was arriving in Kuala Lumpur to express the IMF's support for Malaysian

[18]The quoted phrases are from remarks made by Mahathir at a forum during the IMF/World Bank Annual Meetings in Hong Kong SAR on September 20, 1997. The text was published in *Executive Intelligence Review* (LaRouche Publications) of October 3, 1997. Also see "Mahathir's Roasting," *Economist* (London), September 27, 1997, p. 39; and Mydans (1997).

[19]Letter from Camdessus to Mahathir, February 12, 1998; IMF archives, Accession No. 2001-0284-0009, OMD-DMD, B28266, "Malaysia 1998."

[20]"Malaysia—Staff Report for the 1998 Article IV Consultation," SM/98/79 (March 27, 1998).

[21]The transcript is available at http://www.imf.org/external/np/tr/1998/tr980116.htm.

policies—it solidified the perception that the Fund posed a serious threat to Malaysia's sovereignty as well.

Notwithstanding these setbacks, quiet efforts at cooperation continued throughout the first half of 1998. At no time did the Malaysian authorities ask for financial assistance from the IMF. Nor did the IMF suggest to them that they should. Rather, the authorities wanted a positive assessment from the Fund so they could borrow more readily from other agencies, including the World Bank and the Asian Development Bank, and bilaterally from Japan. Before offering such an assessment, the Fund was asking for more policy actions.

Both Camdessus and the First Deputy Managing Director, Stanley Fischer, made further trips to Malaysia, and Fischer met again with Mahathir during a conference in Tokyo in June. Throughout this time, the Fund's message to the authorities was that the steps taken so far to tighten policies in response to capital outflows were not going to be sufficient to stabilize the economy. As long as the East Asian region was in financial turmoil, Malaysia was going to suffer contagion effects in its financial markets until it protected itself with a sustainable and comprehensive package of economic policies. Mahathir rejected that message and argued instead that the fundamental problem was external: the power of unregulated financial market players to destabilize emerging-market economies. In July and August he began shifting policies in the opposite direction from that which the IMF was advising.[22]

Independently from any discussions with the IMF, the government developed a new plan during the summer of 1998 that aimed to impose a wide range of capital controls. Those controls would create some scope for monetary policy by insulating Malaysia's financial markets from external pressures and thereby enable a shift toward more growth-oriented policies without suffering even further outflows. At the southern tip of the Malaya peninsula, international banks operating in Singapore were offering high interest rates for ringgit deposits. Some Malaysian officials were determined to shut that market down and stop the ringgit from becoming an international currency. Others, including both Anwar and the governor of Bank Negara, Ahmad Mohd Don, worried that doing so would also shut down foreign investment and seriously damage the economy. When it became clear that Mahathir supported the plan, Ahmad Don resigned.

On September 1, 1998, Ahmad Don's successor at the helm of Bank Negara, Acting Governor Zeti Akhtar Aziz, announced the imposition of controls, but only after she had persuaded the prime minister to scale down the complexity and coverage of the original scheme. The principal new rules comprised a requirement that offshore ringgit accounts had to be repatriated within 30 days and a one-year holding period on ringgit-denominated nonresident accounts. With channels for outflows drying up, the exchange value of the ringgit jumped the next day. That increase enabled Bank Negara

[22]For the prime minister's own account of the crisis and his reactions to it, see Mahathir (2000).

to peg the exchange rate at 3.8 ringgit per U.S. dollar, which was close to the market but was thought to undervalue the ringgit somewhat.[23]

These acts by themselves would not necessarily have been a problem from the IMF's perspective, although Fund officials did not think them wise or appropriate under the circumstances. The Fund's general policy on capital controls at this time (see Chapter 4, "Oversight of Capital Controls") discouraged their use but accepted that they could be helpful in certain circumstances. The suitability of controls for Malaysia in 1998 could be disputed, but that dispute by itself should not have given rise to an acrimonious rupture.[24]

The situation became more worrying the next day when Mahathir dismissed Anwar from his posts and placed him under a form of house arrest. Anwar had objected to the controls, both because he believed controls in general to be unnecessary and counterproductive and because he concluded that this particular act was designed to benefit firms that were well connected politically.[25] Up to this time Anwar had been widely expected to succeed Mahathir eventually as prime minister. His opposition to a major policy initiative could not be tolerated within the government. However, much of the international reaction interpreted his arrest as a signal that conditions and policies in Malaysia were about to deteriorate more fundamentally. Whether that reaction was justified is also a matter for debate, but the tension that arose between the IMF and the Malaysian authorities over the imposition of capital controls is difficult to explain without reference to the treatment of Anwar, which continued to worsen.[26]

The difficulty for Malaysia was that without an endorsement of the policy regime from the IMF, neither private nor official capital would be easy to attract. World Bank

[23]For an overview of these developments, see "Malaysia—Staff Report for the 1999 Article IV Consultation," SM/99/141 (June 16, 1999).

[24]An internal Fund report prepared immediately after the imposition of controls took note of the potential for long-term harm but did not propose objecting to them; memorandum from Bijan Aghevli and Anoop Singh (both Deputy Directors, APD) to the Managing Director, "Malaysia: Update and Preliminary Assessment," September 9, 1998; IMF archives, Accession No. 2001-0284-0009, OMD-DMD, B28266, "Malaysia 1998." A staff team, led by Kalpana Kochhar (Deputy Division Chief, APD), then visited Kuala Lumpur to assess the specific impacts. Kochhar thought the authorities were being secretive about the rationale for imposing controls and were unwilling to share information fully with the Fund. Nonetheless, she reported that the controls were not inconsistent with Malaysia's obligations under the Articles of Agreement and that there was no basis for the Fund to object to them; see memorandum from Hubert Neiss (Director, APD) to the Managing Director, "Malaysia—Staff Visit, September 21–25," September 30, 1998; IMF archives, Accession No. 2001-0284-0009, OMD-DMD, B28266, "Malaysia 1998"; and "Malaysia—Inquiry Under Article VIII, Section 2(b)," EBD/99/33 (February 23, 1999).

[25]Johnson and Mitton (2003) found empirical evidence that the controls benefited politically connected corporations.

[26]After being sacked from his post, Anwar spoke out publicly against the policy changes of September 1. He was then jailed on corruption and other charges widely thought to be unjustified and imposed for political reasons. Anwar would spend the next six years in prison, after which the charges against him were dismissed.

officials were equally concerned and were even more outspoken than the Fund. The Japanese government sided with Malaysia and offered new loans, but the U.S. and other governments either stayed on the sidelines or called openly for change.[27] IMF officials avoided speaking in public about the treatment of Anwar and generally limited their comments on capital controls to pointing out the long-run dangers. At the Annual Meetings, for example, Fischer told reporters that "the reimposition of controls—the attempt that seems to be being made to cut the country off, cut the domestic financial system off from the international system—is not one that will do very much for Malaysia . . . over any sustained period."[28] Both publicly and privately, Fund management and staff persistently urged the authorities to phase out the controls and allow some flexibility in the exchange rate as quickly as possible.

Despite the public contretemps, the authorities heeded this advice. In February 1999, they replaced the ban on repatriation of financial capital with a tax on short-term outflows. They also accelerated banking sector reforms and kept the stimulative monetary and fiscal policies within the generous bounds determined by their relatively favorable initial conditions. Export growth, and output growth more generally, rebounded in the early months of 1999. As confidence returned, the economic recovery in Malaysia proved to be as strong and as durable as that being experienced elsewhere in the region.[29]

In July 1999, the Executive Board reviewed the Malaysian economy for the first time since the imposition of controls. Most Directors acknowledged that the Fund (along with "many observers") had overreacted in its initial response. The staff also pulled back a bit and implicitly blamed the first reaction on the views of an amorphous "international community." The Summing Up of the Board discussion concluded by noting the earlier error and adopting a more balanced view on the way policy should evolve in the future:

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[27]In the course of a press conference preceding the Annual Meetings, World Bank President James D. Wolfensohn remarked that Anwar was "a friend of mine. When I see him with a black eye and bruises [as a result of abuse while in prison], it troubles me." U.S. Treasury Secretary Robert Rubin told a public conference that the reported abusive treatment of Anwar was "deeply, deeply, deeply troubling"; see Pura and Phillips (1998). Later, at a summit meeting of the Asia-Pacific Economic Cooperation (APEC) forum in Kuala Lumpur on November 16, 1998, U.S. Vice President Al Gore made a veiled but undiplomatic attack on Mahathir by crediting the "brave people of Malaysia" who were calling for "reformasi" (the rallying cry of Anwar's supporters). For the transcript, see http://clinton4.nara.gov/WH/EOP/OVP/speeches/apec.html. Japan, in contrast, launched the New Miyazawa Initiative in early October. The initiative offered loans to countries throughout the East Asia region, but the timing of its launch aimed to provide support to Malaysia when few others were willing to do so. For the text of the announcement, see http://www.mof.go.jp/english/if/e1e042.htm.

[28]For the full transcript, including Fischer's elaboration of the long-run costs of maintaining controls on capital flows, see http://www.imf.org/external/np/tr/1998/tr980911.htm. The Fund's *World Economic Outlook* report published in October 1998 included a similar caution (IMF, 1998, p. 4).

[29]The staff's first detailed postcrisis analysis—following a staff mission to Kuala Lumpur in April 1999—was set out in "Malaysia—Staff Report for the 1999 Article IV Consultation," SM/99/141 (June 16, 1999).

> Directors broadly agreed that the regime of capital controls—which was intended by the authorities to be temporary—had produced more positive results than many observers had initially expected. They welcomed the pragmatic and flexible way in which Malaysia had implemented and adjusted the controls, notably by replacing the quantitative restrictions on the repatriation of portfolio investments by an exit levy in February 1999. A number of Directors expressed support for the authorities' intention to maintain the control measures while preparing for an orderly exit from these controls. A number of other Directors, however, were more skeptical about the decision to impose capital controls, as they felt that the costs, in terms of an adverse impact on the prospects for recovery, may become more visible in the future. They therefore recommended that the authorities remove the exit levy applied to profits on portfolio investments. These Directors also considered that, since Malaysia is in a position of strength, an early exit would help to boost investor confidence in Malaysia and attract long-term capital.[30]

Perhaps this moderation could have ended the dispute, but it did not. For some years afterward, staff and management continued to argue that the controls had not been helpful, and the authorities continued to defend their actions. The perception of the Fund by the Malaysian public and by some officials as an overbearing institution that had offered totally wrong policy advice prevailed for years. Everyone concerned viewed the whole episode as an embarrassing dispute that seriously damaged the earlier positive and productive working relationship between the Fund and Malaysia.

Indochina

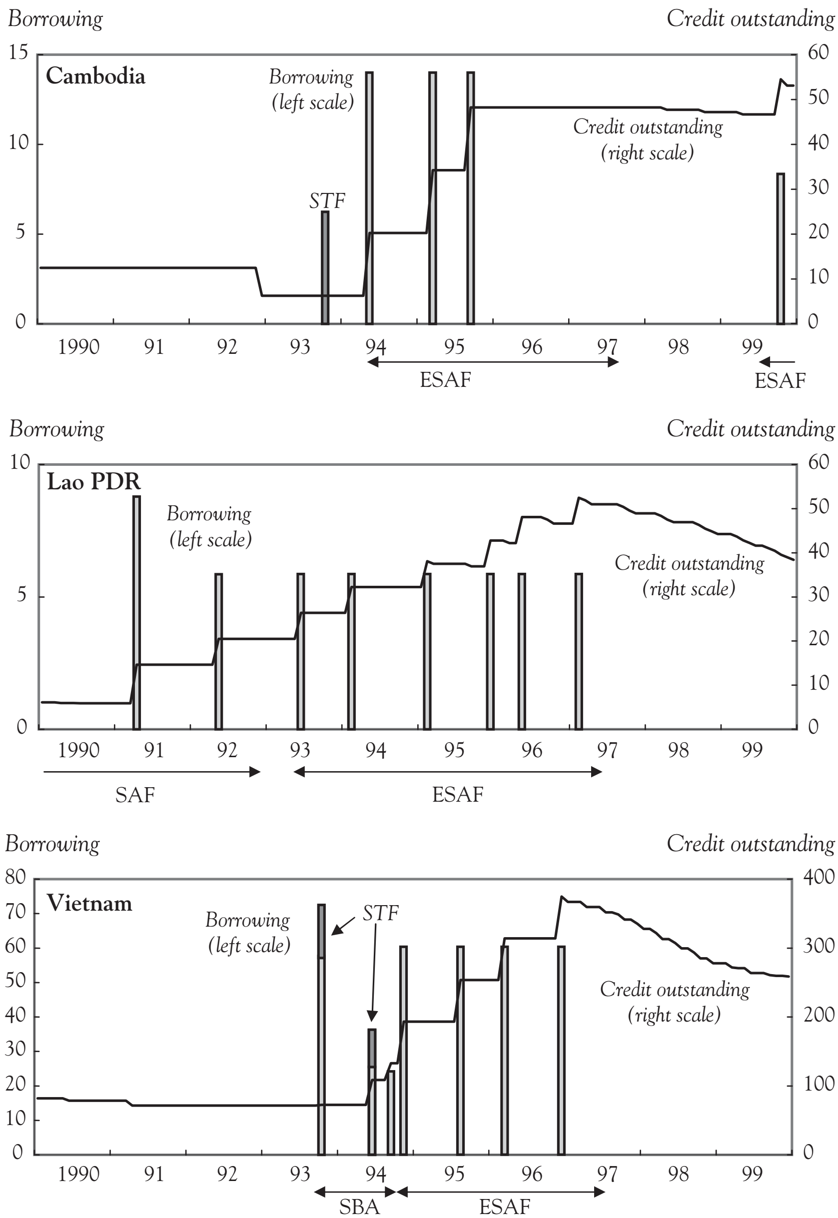
The three low-income neighbors of Thailand known collectively as Indochina—Cambodia, the Lao People's Democratic Republic (Lao PDR), and Vietnam—had all been borrowing from the IMF through the Enhanced Structural Adjustment Facility (ESAF) in the period leading up to the regional financial crisis. All three suffered from the crisis, mainly because it aggravated the economic effects of preexisting political problems. In its efforts to help these countries, the IMF focused more on the long-term objective of removing structural impediments to growth than on the short-term financial difficulties. Consequently, lending was slow to resume (Figure 12.2).

Cambodia

Cambodia resumed borrowing from the IMF in 1993 after two decades of devastating internal and regional conflicts (see Chapter 16). As with other transition countries, the Fund initiated its lending to Cambodia with a fast-disbursing loan through the Systemic Transformation Facility, in October 1993. It then shifted to concessional lending and approved a three-year ESAF arrangement in May 1994. Midway into the arrangement, however, it suspended disbursements because of a controversy over forestry management. As discussed in Chapter 4, the international community generally regarded Cambodia's logging practices as

[30]Minutes of EBM/99/74 (July 7, 1999), pp. 128–29.

Figure 12.2. Cambodia, Lao PDR, and Vietnam: Use of Fund Credit, 1990–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics.
Note: ESAF = Enhanced Structural Adjustment Facility; SAF = Structural Adjustment Facility; SBA = Stand-by arrangement; STF = Systemic Transformation Facility.

environmentally unacceptable, and the IMF also regarded them as undermining long-term fiscal viability. The Executive Board repeatedly extended the arrangement while efforts to resolve the dispute continued. Then in July 1997, just a few days after the devaluation of the Thai baht initiated the regional financial crisis, former Prime Minister Hun Sen led a coup d'état and resumed power. The ensuing political uncertainty and international isolation compounded the economic setback. The economy continued to weaken for the next year, until new elections in July 1998 restored a measure of political stability. The Fund then approved a successor ESAF arrangement in October 1999, which eventually was fully drawn.

The Lao PDR

The Lao PDR successfully completed an ESAF arrangement in the spring of 1997, after which the attack on the Thai baht and the subsequent regional slowdown caused a serious reversal of fortune. Thailand was the major market for Lao exports, and when the Lao government tried to counter the spillover effect by pursuing expansionary policies, the currency (the kip) depreciated by even more than the baht. As inflation accelerated, the authorities requested a successor arrangement with the Fund and began formulating a new program as the basis for it, but conditions were too difficult.[31] Discussions continued at the staff level, but the IMF did not resume lending to the country until 2001.

Vietnam

Vietnam began borrowing from the ESAF in November 1994, with a three-year arrangement scheduled to expire in November 1997. Throughout the third year of the arrangement, the Fund declined to approve the government's policies, primarily because of dissatisfaction with the pace of structural reforms to privatize state-owned enterprises, restructure state-owned banks, and eliminate nontariff trade barriers. As the arrangement was about to expire, the regional crisis weakened demand for Vietnam's exports and ushered in a slowdown of foreign direct investment. Economic growth slowed sharply, prompting the authorities to request a new ESAF arrangement. Despite the external shock, the Fund did not back away from its insistence on an acceleration of structural reforms. Only after more than three years of negotiations did it approve a successor arrangement, in April 2001.

Europe

The greatest influence of the Asian crisis on European economies was felt in the Russian Federation. As recounted in Chapter 7, while several countries in East Asia were

[31]For a review of the effects of the Thai crisis on the Lao economy, see "Lao People's Democratic Republic—Staff Report of the 1998 Article IV Consultation," SM/98/118 (May 28, 1998).

still embroiled in crisis management, the IMF and others warned the authorities in Russia that they were vulnerable to the same kind of market pressures. In view of Russia's severe and persistent weaknesses, both in fiscal policy and in oversight of the banking system, throughout the first half of 1998 the economy was clearly at the edge of a precipice. As the collapse of confidence in the economies of Thailand, Indonesia, and Korea gradually infected other emerging markets with similar problems, Russia faced a massive withdrawal of short-term financial capital. When the Russian financial system collapsed in August, many of its neighbors were increasingly at risk as well.

Central and Eastern Europe

The Baltic states and the other European countries of the former Soviet Union were adversely affected in three ways. First, many of them still had sizeable exports to Russia. The drop in demand directly worsened their trade balances and forced cuts in output. Second, investors generally feared that these countries were still at such an early stage of development and transition to a full market economy that they might have to resort to the same drastic measures (default and a large devaluation) as in Russia. Financial contagion thus aggravated the direct effect working through the trade accounts. Third, many of these countries still had fragile political coalitions set against nationalist or nostalgic-socialist oppositions. The risk of reversal of the political momentum for reform only made matters worse.

Chapter 8 discusses the progression of this crisis, country by country throughout the former Soviet region, and the IMF's response to it. Ukraine suffered most severely from the financial contagion. The country, after Russia the second largest economy in the former Soviet Union, had enjoyed initial success in attracting foreign capital but—unlike the Baltic states—had not yet solidified its reputation as a western-oriented market economy. The rest of the region to the south and east was affected more by trade links to Russia. Even the low-income countries (the "CIS-7"[32]), which depended on official financing rather than on private capital markets, suffered large current account and output effects owing to the direct decline in exports to Russia, Ukraine, and others. For that group of mostly smaller countries, the IMF responded on a regional level by encouraging donor countries to help cover the estimated losses. Notably, on December 11, 1998, the Fund and the World Bank cohosted a donors' meeting that raised $200 million for six of the CIS-7 countries, an amount estimated to compensate for half of the financing gap caused by the Russian crisis.[33]

Elsewhere in central and eastern Europe, ongoing transitions left several countries financially vulnerable (see Chapter 5). In the first half of the 1990s, 10 or so countries

[32]The CIS-7 comprised the seven low-income countries in the Commonwealth of Independent States (CIS): Armenia, Azerbaijan, Georgia, the Kyrgyz Republic, Moldova, Tajikistan, and Uzbekistan.

[33]See "New Financial Support for Poorest Countries Neighboring Russia," IMF NB/98/51, December 11, 1998. Uzbekistan, where the reform process was less advanced than in the other CIS-7 countries, and which had not been approved as eligible for concessional loans, was excluded from the support effort.

Table 12.1. IMF Lending to European Countries Other Than the Former Soviet Union, 1990–99

Country	Type of Loan or Arrangement	Date	Size of Loan or Arrangement[a] (Millions of SDRs)	Amount Drawn through end-1999 (Millions of SDRs)
Albania	SBA	1992–93	20.00	13.12
	ESAF	1993–96	42.36	31.06
	EPCA	1997	8.83	8.83
	ESAF	1998–2001	45.04	31.06
Bulgaria	CCFF/oil	1991	60.60	60.60
	SBA	1991–92	279.00	279.00
	ECM	1991	77.50	56.90
	SBA	1992–93	155.00	124.00
	SBA	1994–95	139.48	116.24
	STF	1994	116.22	116.22
	SBA	1996–97	400.00	80.00
	SBA	1997–98	371.90	371.90
	CCFF/cereal	1997	107.60	107.60
	EFF	1998–2001	627.62	313.80
Czechoslovakia	SBA	1991–92	619.50	619.50
	CCFF/oil	1991	314.47	314.47
	CCFF/oil	1991	83.53	83.53
	SBA	1992	236.00	36.00
	CCFF/oil	1992	103.00	103.00
Czech Republic	SBA	1993–94	177.00	70.00
Slovak Republic	STF	1993	64.35	64.35
	SBA	1994–96	115.80	32.15
	STF	1994	64.35	64.35
Hungary	SBA	1990–91	159.21	127.37
	CCFF/oil	1991	226.20	226.20
	EFF	1991–93	1,114.00	557.23
	CCFF/oil	1991	299.45	0
	CCFF/oil	1992	38.80	38.80
	SBA	1993–94	340.00	127.37
	SBA	1996–98	264.18	56.7
Poland	SBA	1990–91	545.00	357.50
	EFF	1991–93	1,224.00	76.50
	CCFF/oil	1991	442.00	162.60
	SBA	1993–94	476.00	357.00
	SBA	1994–96	333.30	283.30
Romania	CCFF/oil	1991	209.36	209.36
	SBA	1991–92	380.50	319.10
	ECM/oil	1991	131.00	0
	CCFF/oil	1991	38.34	38.34
	SBA	1992–93	314.04	261.70
	CCFF/oil	1992	76.80	76.80
	SBA	1994–97	320.50	94.27
	STF	1994	188.53	188.53
	SBA	1997–98	301.50	120.60
	SBA	1999–2001	400.00	53.00

Table 12.1. (continued)

Country	Type of Loan or Arrangement	Date	Size of Loan or Arrangement[a] (Millions of SDRs)	Amount Drawn through end-1999 (Millions of SDRs)
Turkey	SBA	1994–96	610.50	460.50
	ENDA	1999	361.50	361.50
	SBA	1999–02	2,892.00	221.72
Yugoslavia	SBA	1990–91	460.00	65.70
Bosnia and Herzegovina	EPCA	1995	30.30	30.30
	SBA	1998–2001	77.51	53.27
Croatia	SBA	1994–96	65.40	13.08
	STF	1994	65.40	65.40
	STF	1995	65.40	65.40
	EFF	1997–2000	353.16	28.78
Macedonia, FYR	STF	1994	12.40	12.40
	SBA	1995–96	22.30	22.30
	STF	1995	12.40	12.40
	ESAF	1997–2000	54.56	27.28
	CCFF/export	1999	13.78	13.78

Source: International Financial Statistics.

Note: CCFF = Compensatory and Contingency Financing Facility; ECM = External Contingency Mechanism; ENDA = Emergency Assistance for Natural Disasters; EPCA = Emergency Postconflict Assistance; ESAF = Enhanced Structural Adjustment Facility; EFF = Extended Fund Facility; SBA = Stand-by arrangement; STF = Systemic Transformation Facility.

[a]Amount includes augmentations through December 31, 1999.

in this region had borrowed from the IMF (Table 12.1).[34] Some were new members, borrowing for the first time: Bulgaria beginning in 1991, followed by Albania (1992), the Czech and Slovak Republics (1993), the former Yugoslav Republic of Macedonia (1994), Croatia (1994), and Bosnia and Herzegovina (1995). Others were borrowing to help stabilize their economies during the early stages of a transition away from the Soviet system: Hungary (1990–93), Poland (1990–94), and Romania (from 1991 through the rest of the decade). After several years in which the IMF had done very little lending to European countries, Europe had again become a continent with substantial financial needs.[35]

Several European countries continued to borrow in the late 1990s, but mostly for reasons unrelated to global financial contagion. Two countries—Albania and the

[34]Counting countries is somewhat arbitrary because of the breakup of both Czechoslovakia and Yugoslavia in 1992. Those two members borrowed from the Fund before their dissolution, and afterward most of their successor states did so, too. Of the immediate successors to Yugoslavia, neither Slovenia nor Serbia borrowed in the 1990s.

[35]In the second half of the 1980s, the only European borrowers were Hungary and Yugoslavia.

former Yugoslav Republic of Macedonia—were low-income members that shifted their borrowing from the Fund's general resources to the less expensive and longer-term ESAF in the course of the decade. Two others—Bulgaria and Romania—were undertaking very difficult transitions and borrowed almost continuously throughout the 1990s. Bosnia and Herzegovina began borrowing in December 1995 following the signing of the Dayton peace accords that ended the regional war. A first stand-by arrangement was approved in 1998. Croatia ended its borrowing in 1997.

Turkey

One European borrower did not fit this general transitional pattern. Turkey, like Russia, straddles Europe and Asia and is treated by the IMF as European. A member since 1947, Turkey began borrowing from the Fund in 1953. It entered into 10 stand-by arrangements in as many years starting in 1961 and continued borrowing through various facilities through 1984. By that time, Turkey had achieved a good measure of financial stability and independence and was able to manage its external debts on its own. It steadily repaid its debts to the IMF and did not borrow again over the next decade.

In the early 1990s, the Turkish authorities gradually loosened their grip on monetary and fiscal policies. The rate of inflation rose, and the balance of payments progressively worsened. The tipping point came in the first quarter of 1994, when investors fled the Turkish market and the value of the currency fell by half against the U.S. dollar in three months. In April, the government announced a new policy program aimed at stabilizing the economy quickly, and the authorities asked the IMF for financial and program assistance. In July, the Executive Board approved a 14-month stand-by arrangement for $740 million (SDR 509.3 million, or 85 percent of quota). That program and lending arrangement worked well through the following summer, after which political instability in Turkey paralyzed policymaking.[36]

A succession of short-lived Turkish governments tried repeatedly to get inflation under control and stabilize the economy. Beginning in mid-1997, the authorities and the IMF staff engaged in protracted discussions on a policy program that the staff could monitor while the authorities established a track record of good implementation. That effort finally succeeded in mid-1998, at which time Güneş Taner (minister of state for the economy) and Gazi Erçel (governor of the central bank) signed and published a 10-page memorandum of economic policies as the basis for a staff-monitored program covering the period through the end of 1999.[37]

[36]In the course of 1995, the Fund augmented and extended the stand-by arrangement, but policy disputes prevented the authorities from drawing on it after September. The arrangement expired in March 1996 with SDR 150 million undrawn.

[37]"Turkey—Memorandum of Economic Policies," EBD/98/72 (July 2, 1998).

Carrying out this ambitious program proved to be impossible. The lingering effects of the government's lack of a credible track record on economic policy interacted with a series of external and domestic shocks. Just as the stabilization effort was beginning, Russia's bond default induced a large outflow of capital from Turkey and a sharp slowdown in international trade. As recession took hold, the governing coalition collapsed in November 1998. By the first quarter of 1999, real output was down by more than 8 percent from a year earlier. A new government took office in June and began discussing a modified policy regime with the Fund, but then disaster struck. On August 17, a massive earthquake killed more than 15,000 people, left a half million people homeless, and caused extensive disruption to economic activity. Even by the standards of this highly earthquake-prone region, it was one of the worst natural disasters of the twentieth century.[38]

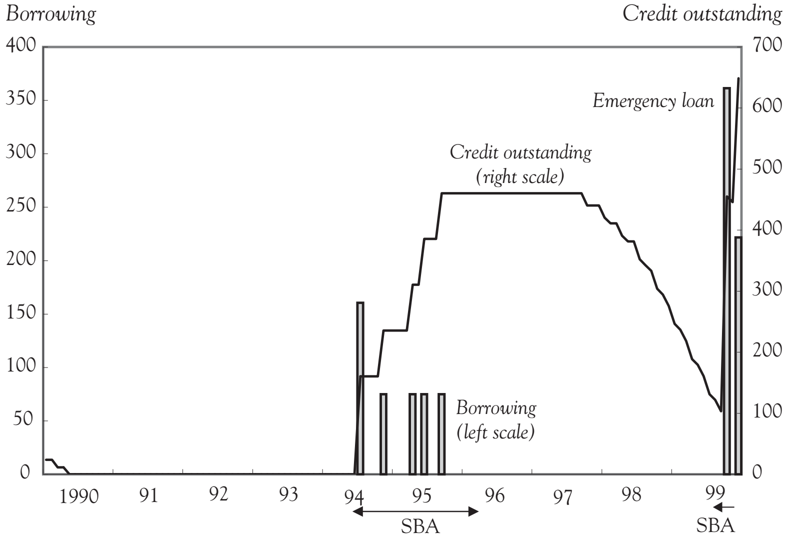
The IMF reacted swiftly by providing an emergency loan of $500 million (SDR 361.5 million, or 37.5 percent of quota) in October 1999. That loan was followed by approval of a rare three-year stand-by arrangement for $4 billion (SDR 2,892 million, or 300 percent of quota) in December, on which Turkey immediately drew about $300 million (SDR 221.7 million) (Figure 12.3). That extraordinary level of support—the maximum that the Fund could provide without invoking its "exceptional circumstances" provisions—responded to a strong commitment by the Turkish authorities to tighten financial policies sufficiently to get inflation under control, firm up exchange rate policy to anchor expectations until confidence could be fully restored, and undertake numerous structural reforms affecting almost every sector of the economy. The Fund required many of those reforms to be completed even before it approved the stand-by arrangement, and the government rose to the task.

The explicit goal of the IMF's large financial commitment to Turkey in 1999 was not to cover an actual shortage of international reserves. Those balances were still at a comfortable level. Rather, the goal was to ensure debt sustainability through a rapid and continuing reduction in inflation and interest rates. More immediately, the goal was to convince financial markets that the international community stood ready to provide whatever financial support the authorities might need in the event of a speculative attack. However, that tactic worked only briefly: full restoration of investor confidence was a long way off, and Turkey would undergo a serious financial crisis in 2000–01 and would depend on large-scale IMF loans for years to come.[39]

[38]See "Turkey—Use of Fund Resources—Request for Emergency Assistance," EBS/99/191 (October 5, 1999). A staff mission had been in Ankara and Istanbul throughout the second half of June, but shortly after the mission left the economy minister who had been leading the discussions for the authorities (Hikmet Uluğbay) attempted suicide and then resigned from office. The earthquake hit before discussions with the new Turkish team could begin.

[39]The crisis and the role of the IMF are analyzed in Öniş and Rubin (2003). For the aftermath and consequences, see Moghadam (2005).

Figure 12.3. Turkey: Use of Fund Credit, 1990–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics.
Note: SBA = Stand-by arrangement.

Latin America

After the Russian bond default of August 1998, IMF officials realized that emerging markets all over the world might be vulnerable to a sudden withdrawal of financial capital. Latin America seemed most clearly ripe for the next speculative attack.

In late August, just a few days after the Russian default, Camdessus invited the finance ministers and central bank governors from all of the major financial markets in the Americas to come to the IMF to discuss how to respond to the market pressures already facing many of them. For the IMF to convene such a regional meeting on this scale was unprecedented, and to succeed the meeting would have to occur extremely quickly. Before the end of the month, the ministers and governors from 11 countries[40] had accepted Camdessus's invitation and were making plans to go to Washington for what was to become the first major effort at "regional surveillance" by the IMF.[41]

[40]Argentina, Brazil, Canada, Chile, Colombia, Ecuador, Mexico, Peru, the United States, Uruguay, and Venezuela participated in the meeting.

[41]In opening remarks at the meeting, Camdessus explicitly noted that it was intended to be a prototype for regional surveillance; see memorandum from Claudio Loser (Director, Western Hemisphere Department, or WHD) to the Managing Director, "MD's Speech for Western Hemisphere Countries Conference," September 3, 1998; IMF archives, "Meeting of Economic Policy Makers August-September 1998," OMD-AI, Accession No. 2007-0131-01. The closest precedents had involved IMF participation in regional or other affinity-group meetings organized and run by the country groups (e.g., the G7 or ASEAN countries) rather than by the Fund.

The meeting was held on September 3–4, 1998, in the conference hall at IMF headquarters where the Interim Committee met twice each year. Fund officials made presentations on the likely impacts of ongoing developments in the world economy, and country officials discussed their strategies for coping with those developments. The Presidents of the World Bank and the Inter-American Development Bank (James D. Wolfensohn and Enrique V. Iglesias, respectively) also participated. At its conclusion, Camdessus, Wolfensohn, and Iglesias held a press conference and summarized the outcome of the meeting.[42]

Formally, the main result was a set of commitments by participating countries to strengthen fiscal and monetary policies in response to the Russian crisis, the subsequent turmoil in world financial markets, and other adverse external shocks. Perhaps the greater benefit, though, was that finance officials at the highest level had seized the opportunity to come together and hear from each other and from the leading multilateral agencies about measures being taken and measures still needed. Although each country had to take its own actions in light of its own circumstances, knowing what one's neighbors were doing had the potential to improve the outcome considerably.

Of the large countries in Latin America, the two most vulnerable to contagion in 1998 were Brazil and Argentina. Among the smaller countries, Ecuador was especially vulnerable. In each case, the IMF followed up the regional surveillance effort with intensive staff work in the country.

Brazil

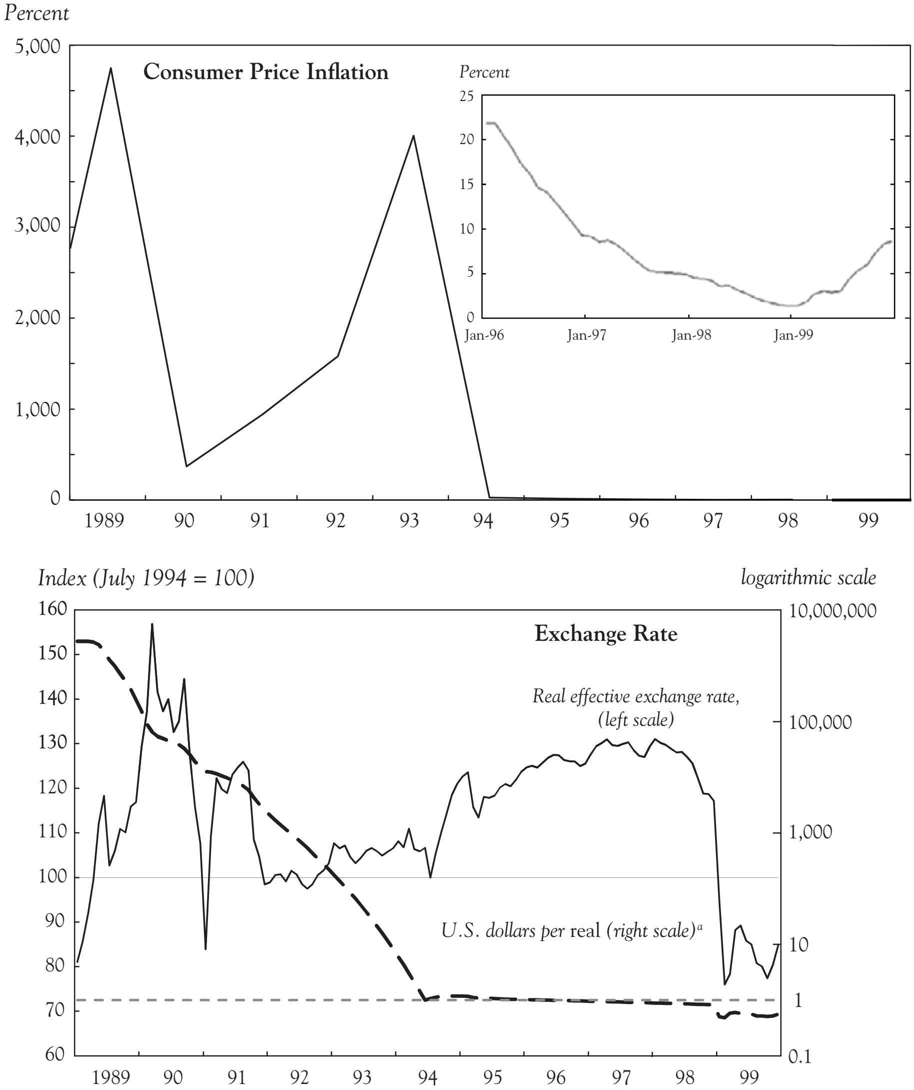
Following the shock from the Mexican crisis of 1995 (see Chapter 10), the Brazilian monetary authorities focused on solidifying the underpinnings of the Plano Real. Although inflation fell quickly and sharply after the introduction of the new currency, the *real*, in mid-1994, and even though the plan initially allowed the exchange rate to float until it found a competitive level, the rate appreciated slightly in nominal terms and substantially in real effective terms (Figure 12.4). That damaged Brazil's international competitiveness, with effects that would gradually become more severe. In addition, the loss of "inflation tax" revenues as prices stabilized severely affected both government finances and the banking system.

By 1996, Brazil was facing a potentially calamitous banking sector crisis, but the central bank managed to contain it through a combination of takeovers, bailouts, and privatizations.[43] The government also took measures in this period to strengthen the independence of the central bank and increase the transparency of its policy decisions. Fiscal policy proved to be more difficult to control, partly because of the familiar

[42]At the end of the first day, the Fund issued a statement to the press; see "Communiqué of Meeting of Economic Policy Makers in the Western Hemisphere Region," PR/98/37 (September 3, 1998); accessed at http://www.imf.org/external/np/sec/pr/1998/pr9837.htm.

[43]"Brazil—Recent Economic Developments," SM/97/44 (February 13, 1997), pp. 70–81.

Figure 12.4. Brazil: Inflation and Exchange Rates, 1989–99



Sources: International Financial Statistics and Information Notice System.
[a]Data prior to July 1994 are the equivalent in *reais* of then-prevailing currency units.

political pressures but also because the revenue losses from the end of high inflation coincided with the costs of rescuing the banking system.

The Asian financial crisis brought these simmering stresses to a boil. Since March 1995, the central bank had been managing the exchange rate within an adjustable band vis-à-vis the U.S. dollar. During the November 1996 Article IV consultation

discussions in Brasilia, the staff and the authorities agreed the currency was overvalued and the band should be adjusted gradually over a two-year period to correct the problem.[44] A year later, when speculative pressures on the exchange rate picked up in response to the Asian crisis, the government announced a sizeable package of fiscal measures. Although the staff and management of the Fund were privately urging the authorities to shift the exchange rate more aggressively as well, Camdessus publicly praised the fiscal measures, which calmed financial markets, allowing Brazil to ride out the crisis without a change in exchange rate policy.[45] Implementation of fiscal policy flagged in 1998, however, and the underlying problems—a large fiscal deficit and an overvalued currency—remained.

The Russian default in August 1998 dealt an even bigger blow. Among emerging markets, Brazil was particularly vulnerable. It was viewed as having a debt structure and a potential exchange rate problem similar to Russia's, and it was in the heat of a presidential election campaign. Although the central bank had ample foreign exchange reserves, preserving the adjustable-band exchange arrangement had the potential to become expensive if foreign creditors stopped rolling over their loans or domestic residents shifted liquid assets into dollars in large quantities. In that event, would Brazil be forced into the same default strategy employed by the Russians? International financial conditions were more hostile generally in 1998 than they had been in 1995 or 1997, and skeptical international investors were focusing their sights increasingly on Brazil. Many analysts thought Brazil's circumstances were so dire, and policies so weak, that international financial support would be futile. The MIT economist Rudiger Dornbusch famously advised the IMF that "when they call 1-800-BAILOUT, just let it ring. Say our operators are busy."[46]

Among the first to sound the alarm was David Folkerts-Landau, head of global emerging-markets research at the investment bank Deutsche Morgan Grenfell. The bank had taken large losses in the Russian default, and Folkerts-Landau—who had worked in the IMF's Research Department from 1979 to 1997—was both highly critical of the IMF's policy advice to Russia and apprehensive of a repeat performance in other weak economies. In a conference call with clients on August 26, Folkerts-Landau warned that Brazil was the country most vulnerable to contagion and that the risk of

[44]"Brazil—Staff Report for the 1996 Article IV Consultation," EBS/97/11 (January 30, 1997), p. 23.

[45]In Brazil's adjustable-peg regime, the central bank announced a wide band, or "maxiband," on an annual basis and then intervened to keep the rate within a narrow "miniband" that they changed much more frequently. The policy in effect at that time, consistent with the outcome of the 1996 consultation, was to adjust the maxiband each year to effect a depreciation of about 7.5 percent over the year. In January 1998, the central bank announced an adjustment of that magnitude. For the Managing Director's reaction to the fiscal adjustment, see NB/97/24, "IMF's Camdessus Welcomes Brazilian Fiscal Policy Package," November 10, 1997; accessed at http://www.imf.org/external/np/sec/nb/1997/nb9724.htm.

[46]Quoted in Dornbusch's obituary in *MIT News* (July 26, 2002); accessed at http://web.mit.edu/newsoffice/2002/dornbusch.html.

investing there was now much higher.[47] Financial markets immediately panicked, apparently fearing Brazil would soon be forced to ask the IMF for help and the IMF would advise them to default in much the way Russia had. Stocks on the São Paulo stock market fell sharply the next day in chaotic trading conditions.[48] Although the declines were soon partially reversed, confidence was badly shaken.

When the stock market again fell sharply on September 10 as part of a broad sell-off across Latin American markets, the government decided it was time to act. The authorities' immediate response was to raise short-term interest rates to nearly 50 percent to curb speculative pressures. The finance minister, Pedro Sampaio Malan, then called Fischer the next morning to discuss policy options and to gauge international support. Fischer stressed the importance of reducing the fiscal deficit. He then participated in a conference call among the finance deputies of the Group of Seven (G7) countries. That group reinforced the fiscal message, saying they would not issue a statement of support for Brazil until the government committed to a strong fiscal policy for the next three years.[49]

By this time, the Fund staff was convinced that the *real* was so overvalued that the policy of depreciating it gradually was no longer sufficient. Once confidence weakened, the question was whether the central bank could continue to defend the announced band without depleting its reserves. If not, could a devaluation be made to stick long enough to allow the government to tighten monetary and fiscal policies without getting hit by a financial crisis? With the presidential election just three weeks away, the staff advised Fischer to press Brazil to devalue as soon as the election was decided.[50]

President—and former Finance Minister—Fernando Henrique Cardoso decided not to wait to get fiscal policy under control. On September 22, he made a dramatic televised speech to the nation in which he stated unequivocally that "the state has not been able to live within its own means. . . . This cannot continue."[51] Brazil could not expect to sustain economic growth unless the government restored fiscal balance quickly, and Cardoso promised to do so. The next day, Camdessus issued an enthusiastic

[47]"Verärgerung über den IMF" ["Anger over the IMF"], *Neue Zürcher Zeitung* (August 27, 1998); accessed on http://global.factiva.com. For a more detailed account based on a transcript of the conference call and an interview with Folkerts-Landau, see Blustein (2001), pp. 274–77.

[48]See memorandum from Teresa Ter-Minassian (Deputy Director, WHD) to Fischer, "Possible Talking Points for a Telephone Call to Minister Malan" (August 27, 1998); IMF archives, OMD-DMD (Mr. Fischer's files), Accession 2001-0284, "Brazil-1998."

[49]See memorandum from Fischer to the Managing Director, "Phone calls this morning," September 11, 1998; IMF archives, OMD-DMD (Mr. Fischer's files), Accession 2001-0284, "Brazil-1998."

[50]Memorandum from Claudio Loser (Director, WHD) to Fischer, "Brazil—Exchange Rate Policy" (September 14, 1998); IMF archives, OMD-DMD (Mr. Fischer's files), Accession 2001-0284, "Brazil-1998"

[51]Translation of the speech, forwarded to the Managing Director by Claudio Loser (September 23, 1998); IMF archives, OMD-DMD (Mr. Fischer's files), Accession 2001-0284, "Brazil-1998."

statement of support on behalf of the IMF,[52] and officials of major creditor countries—notably U.S. Treasury Secretary Robert Rubin—soon followed suit.

Cardoso won reelection on Sunday, October 4, just as the IMF/World Bank Annual Meetings were getting under way. Malan and the central bank governor, Gustavo Henrique de Barroso Franco, were in Washington for the meetings, and they took advantage of the occasion to ask Fischer for advice over dinner on the Friday before the elections. Fischer repeated his warning about the importance of a fiscal retrenchment, but he also calculated that Brazil was going to need substantial financial assistance from official creditors until the private sector regained confidence and resumed lending. To anchor that support and hasten the country's return to the financial market, he suggested that Brazil needed a Fund-supported program.[53] Malan and Franco took that advice back to Cardoso, and within days the government was preparing to enter into discussions leading to a new stand-by arrangement with the IMF.

To defuse the domestic political ramifications of calling in the IMF for help, Malan declined to invite a staff mission to come to Brasilia. Instead, he sent a deputy, Pedro Parente, to Washington to begin negotiating with the IMF on October 17.[54] The talks proceeded quickly and fruitfully, primarily because the two sides agreed completely on the need for a large and rapid change in fiscal policy. Two other issues were more divisive: exchange rate policy and the strategy for regaining access to financial markets.

On exchange rate policy, the Fund staff pressed their view that Brazil should increase the rate of crawl to get real effective depreciation of at least 10 percent a year. The authorities resisted and argued that any change in policy would have a devastatingly destabilizing effect on expectations. Quickly but reluctantly, the Fund relented on this issue.

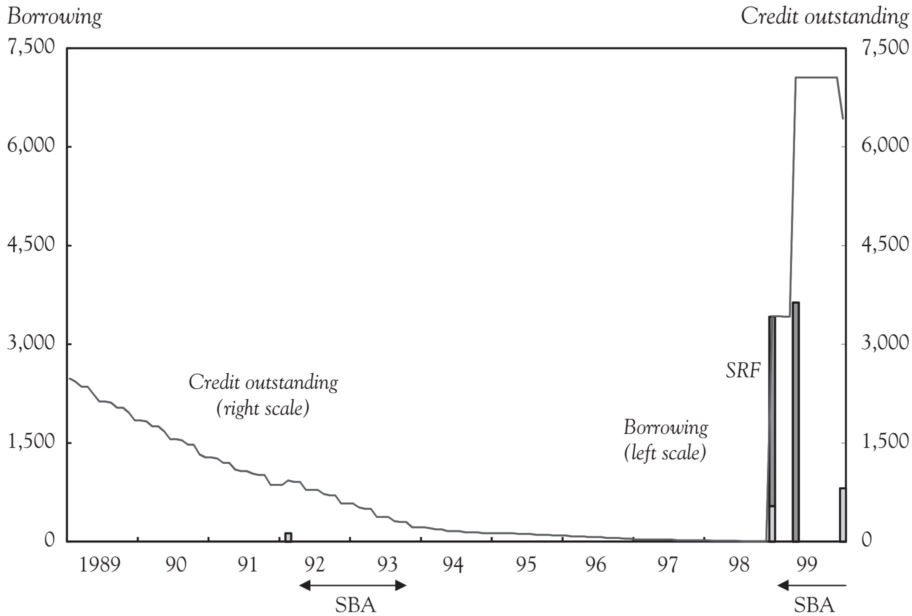
On private sector involvement, the Fund was more insistent, for three reasons. First, lending official money to Brazil while private creditors pulled their money out would do little to stabilize the economy or lay the groundwork for future growth. Somehow, the participation of financial markets had to be secured, and the only real issue was the best way to achieve that objective. Second, the memory of the initial failure of the Korean program in December 1997 was still fresh in the minds of the IMF management team. Only when major central banks began encouraging their countries' commercial banks to maintain loan exposure to Korea was the crisis resolved (see Chapter 11). Third, in the case of Brazil, European central banks were insisting that some form of officially organized involvement of private creditors was the *sine qua non* for their participation in the rescue.

[52]See "Statement by IMF Managing Director on Brazil," NB/98/34 (September 23, 1998); accessed at http://www.imf.org/external/np/sec/nb/1998/nb9834.htm.

[53]See memorandum from Ter-Minassian to the Managing Director, "Brazil—State of Discussions" (October 3, 1998); IMF archives, OMD-DMD (Mr. Fischer's files), Accession 2001-0284, "Brazil-1998."

[54]Fischer made a quick trip to Brazil on October 23 to take up the key issues directly with Malan and other senior officials; see minutes of EBM/98/108 (October 26, 1998), pp. 3–6.

Figure 12.5. Brazil: Use of Fund Credit, 1989–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics.
Note: SBA = Stand-by arrangement; SRF = Supplemental Reserve Facility.

The Brazilian negotiators resisted that approach out of concern that they would come to be regarded as in the same boat as other emerging-market countries suffering from financial crises. In their view, Brazil had a much stronger economy and a much more solid financial footing than Korea, Mexico, or Russia, and they were determined to find a market-friendly solution to their current problems. Faced, however, with continuing capital outflows and the need for an agreement with the IMF, they eventually agreed to try an intermediate approach in which interbank credits would be monitored, and the Fund would coordinate an effort to encourage foreign bank creditors to maintain their exposures. To soften the risk of a negative market reaction, they suggested that the stand-by arrangement with the Fund should be purely precautionary. The Fund would put a large sum of money at Brazil's disposal, but the government would announce its intention not to draw on it.

Ever since the Mexican rescue of January 1995, the usual strategy in devising official financing packages for emerging-market countries facing capital market crises had been to assemble a large pile of money to convince speculators that the country could defend its exchange rate. What was being defended, however, differed greatly from one case to the next. In Mexico and Thailand, financial support was announced after a sizeable devaluation had already occurred, and the object was to restore confidence. In Korea, the authorities had begun allowing more flexibility in the exchange rate, and

part of the objective was to limit the extent of the fall. In Russia, the Fund had made a large financial commitment without a devaluation, with the hope of preventing a collapse of the banking system and gaining time for the government to shore up its finances and stabilize exchange markets.

In Brazil, the objective was similar to the Russian case, but with three major differences that added greatly to the credibility of the program. First, Brazil had not borrowed from the IMF since 1992, and it had repaid all of its outstanding loans (Figure 12.5). Second, the authorities were gradually depreciating the exchange rate along a controlled path. The need for a real effective depreciation was not in dispute. The only question was whether to get there gradually or more quickly. Third, Cardoso had just been reelected on a platform that included a major and sustained tightening of fiscal policy, and his party had a solid majority in congress. All he needed, it seemed, was time to carry out his program.

Negotiations on emergency financial support for Brazil took place on multiple fronts throughout the first two weeks of November 1998. The largest single share would come from the IMF, in the form of a three-year stand-by arrangement totaling more than $18 billion (SDR 13 billion, or six times Brazil's quota). Although this was the second largest financial commitment in IMF history (after the 1997 Korea arrangement), agreement on the accompanying economic program was reached readily in a series of meetings at Fund headquarters. On the other side of the Atlantic, a meeting of central bankers at the Bank for International Settlements (BIS) produced pledges from industrial countries totaling $14.5 billion for a credit facility for Brazil. A separate bilateral loan from Japan and loan commitments from multilateral development banks brought the total to $42 billion.

The multilateral financial package was announced with great fanfare on November 13, at which time the IMF's portion was just being submitted to the Executive Board for consideration. Formal approval of the stand-by arrangement did not come until December 2. At the Board meeting, the dominant issue was the wisdom of lending to Brazil without demanding a devaluation. The head of the staff team on Brazil, Teresa Ter-Minassian (Deputy Director, Western Hemisphere Department, or WHD), defended the program on practical grounds. Experience in Asia had shown that changing exchange rate policy in the middle of a financial crisis was likely to lead to overshooting and unpredictability. For four years, Brazil had been using exchange rate stability as an anchor for expectations, and that strategy had succeeded in stabilizing prices in a country that had previously suffered through hyperinflation. In the staff's view, the fundamental cause of the external deficit and the loss of confidence by the markets was the government's inability to get the fiscal deficit under control. Eliminating that problem was the goal. If the authorities failed to solve the fiscal imbalance, they would have to devalue later. But not now, not in a crisis.[55]

[55]Minutes of EBM/98/189 (December 2, 1998), pp. 76–77. For an analysis of the program, including the Fund's willingness to lend to Brazil without a devaluation, see Independent Evaluation Office (2003), Annex 3.

The stand-by arrangement, which was approved unanimously, had three special features. First, like the Korean and Russian arrangements made in the preceding 12 months, a major portion (70 percent in this case) was being made available under the terms of the Supplemental Reserve Facility (SRF). Using the SRF meant that disbursements could be heavily front-loaded, but also that the country would be expected to repay them relatively quickly as economic conditions improved. Moreover, the interest rate the Fund charged on outstanding SRF balances was much higher than the standard rate of charge. Second, the IMF was borrowing the funds for the SRF portion of the arrangement by activating the New Arrangements to Borrow (NAB) for the first time. Third, as noted above, the authorities stated they viewed it as precautionary. The whole $42 billion package was a crucially important signal of confidence from the international community, but the government was convinced it could continue to manage the exchange rate primarily with its own reserves.[56]

Serious problems arose almost immediately, not because of any inherent design flaw in the program or because of a failure by the government to implement it, but because of an unexpected flare-up of domestic political opposition. Despite Cardoso's personal popularity and his party's majority, in December the Brazilian Senate rejected key elements of his proposal to strengthen the budget. That action destroyed the authorities' plan to treat the stand-by arrangement as precautionary. On December 15, two weeks after the arrangement was approved, Brazil made an initial drawing of some $4.8 billion (SDR 3,419 million) to rebuild its foreign exchange reserves.[57] On January 6, 1999, Itamar Franco—Cardoso's predecessor as president and at that time the governor of the state of Minas Gerais—declared that his state was defaulting on more than $15 billion of debts to the federal government. Although this declaration was largely political bluster (because the federal government had access to financial assets it could seize to collect the debts), the effect on investor confidence was immediate and devastating. From that moment, the IMF-supported program was effectively dead.

The next 10 days were chaotic and disastrous. As Ter-Minassian had foretold, Brazil now had no choice but to act aggressively to depreciate the currency to a level that would restore confidence. The central bank governor, Gustavo Franco, adamantly opposed any change in foreign exchange policy, fearing such action would destroy the Plano Real that had underpinned the country's economic success for the past four years. Cardoso decided he had to replace Franco to restore viability to his program, and he eventually found a plan that looked to be worth trying.

On January 12, Malan called Fischer to inform him that Cardoso was replacing Franco with Francisco Lopes, the director of monetary policy at the central bank.

[56]See statement by Murilo Portugal (Executive Director for Brazil) at EBM/98/122 (December 2, 1998), p. 9. For the background to the NAB and the SRF, see Chapters 15 and 5, respectively.

[57]Of that amount, SDR 2,876 million was in the form of an SRF loan with a higher interest rate and an expectation of early repayment, and was financed by activating the NAB. The rest (SDR 543 million) was a conventional credit-tranche purchase. The total was equivalent to 157 percent of Brazil's quota, or 113 percent of the enlarged quota that was to take effect in January 1999.

Lopes had developed his own plan for preserving the exchange rate's stability by restructuring the crawling band regime into a "diagonal endogenous exchange rate band," and he had personally convinced the president to give it a try. Fischer was appalled because he saw clearly that the scheme had virtually no chance of success. In a series of telephone calls throughout that night, he tried to convince Lopes to abandon the idea, close the exchange market for a day or two to give markets time to calm down, and then allow the exchange rate to float. That effort at persuasion failed, and the next morning the central bank announced the new band.[58]

Fischer was right. Speculators immediately attacked the *real*, and the central bank was unable to defend the "endogenous band." At a meeting early Friday morning, January 15, Malan insisted that Lopes abandon the two-day-old regime and allow the exchange rate to find its own market level. The rate depreciated by about 10 percent by the end of the day, but the worst had ended. That night, knowing the weekend would give them a brief reprieve, Malan and Lopes flew to Washington for an intense (and tense) two days of consultations.

IMF officials were decidedly unhappy, both with the change in regime and the way it had occurred suddenly and without prior consultation (as was required under the terms of the stand-by arrangement).[59] Camdessus felt compelled to issue a public statement of support, but he made sure it was as neutral and ambiguous as it could be. The authorities, he wrote, have "informed the IMF of the modifications of the exchange rate system adopted today" and have "reaffirmed to the IMF their strong determination to put in place . . . the full fiscal adjustment program announced in November 1998." He concluded simply, "I welcome these assurances."[60] The weekend was not going to be much fun.

At that moment, IMF officials had no clearer an idea of the way to move forward than did the Brazilians. When a large contingent of staff met with Malan and Lopes in the Managing Director's office on Saturday, January 16, the first suggestion from the

[58]Blustein (2001) pp. 355–69, gives a detailed account of this episode. Lopes (2003) describes the specific technical strategy for trying to avoid floating the currency. Fischer's advice to float seems to have become muddled, as Lopes interpreted the message quite differently.

[59]The Letter of Intent signed by Malan and Gustavo Franco in November 1998 concluded with the standard boilerplate commitment: "During the period of the arrangement, the authorities of Brazil will maintain close relations with the Fund, and will consult on the adoption of policy measures that may be needed, in accordance with existing practices." The text of the stand-by arrangement approved by the Fund in December specified that in accordance with that letter, "Brazil will consult with the Fund on the adoption of any measures that may be appropriate at the initiative of the government or whenever the Managing Director requests consultation because any of the [performance] criteria . . . have not been observed or because the Managing Director considers that consultation on the program is desirable"; "Brazil—Request for Stand-By Arrangement—Letter of Intent," EBS/98/189 (November 12, 1998); and "Brazil—Stand-By Arrangement," EBS/98/189, Suppl. 2 (December 4, 1998), paragraph 10.

[60]"IMF's Managing Director's Statement on Brazil," NB/99/2 (January 13, 1999); accessed at http://www.imf.org/external/np/sec/nb/1999/nb9902.htm.

IMF came from Camdessus. Why not try a currency board, he asked. It was working for Argentina, and the conditions seemed right for it to work in Brazil. Following the depreciation of the previous day, the currency was no longer obviously overvalued, and—in contrast to Indonesia, where Camdessus had forcefully rejected a proposed currency board the year before—the central bank had adequate reserves to back up the monetary base.[61] Neither Malan nor Lopes had any interest in trying it. In their view, the structure of the Brazilian financial system—including a low rate of dollarization and large quantities of very liquid securities outstanding, which served as close substitutes for money—would render a currency board ineffective.

Fischer and many on the staff thought a floating exchange rate would have a better chance of success. The danger was that the value of the *real* could plummet further, plunging the economy into chaos (as had happened in Indonesia). The fiscal adjustment Brazil was already making would reduce that risk, and a sound, complementary strategy for monetary policy could anchor expectations firmly. The crucial point from the IMF side of the table, though, was not the specific proposal. The key was to move decisively to a "corner solution": either a resolutely fixed exchange rate or a clear commitment not to intervene at all. Any policy that was less clear, they believed, would quickly be undermined by speculation.[62]

For the rest of January, Brazil muddled through the crisis as best it could, while continuing to allow the exchange rate to find its own level. The *real* depreciated further against the dollar, and the central bank responded by raising interest rates, though not by enough to satisfy the IMF. At the end of the month, Ter-Minassian returned to Brasilia to renegotiate the program. She happened to arrive on the same day that Cardoso decided to replace Lopes with a new central bank chief, Arminio Fraga.

Although Fraga had spent the past six years in New York running a hedge fund for George Soros, he was a former director of the Central Bank of Brazil and was well known and respected both in the country and in Washington. He was also a keen advocate of a floating exchange rate, which he proposed to anchor by targeting the inflation rate. Immediately after his appointment, he consulted with Fischer and with Lawrence Summers (deputy secretary of the U.S. Treasury) on how to set up an inflation-targeting regime for monetary policy. He also sought technical assistance from the Fund's Monetary and Exchange Affairs Department. Using such a regime to bring Brazilian inflation down steadily to internationally comparable levels would not be

[61]For the IMF staff view in favor of a currency board, see memorandum from Adam Bennett (Chief of the Stand-By Operations Division in the Policy Development and Review Department) to Fischer, "Brazil—Considerations towards a Currency Board Arrangement," January 22, 1999; IMF archives, DMD-AI, Accession 2002-0149, box B30552. (The staff team in the WHD were less convinced that a currency board was appropriate for Brazil.)

[62]Fischer's advocacy of corner solutions to exchange rate policy is discussed in Chapter 1, pp. 23–24.

easy, but it was a strategy he believed would work and the IMF was willing to support fully.[63]

To solidify the Fund's support for the revised program, Fischer made a 6,000 mile detour to Brasilia on his way back to Washington from the World Economic Forum in Davos, Switzerland. After meeting with Cardoso, Malan, and Fraga, he signed off on a press release announcing agreement on all the key issues. On this occasion, the Fund was unreserved in its endorsement of Brazil's program:

> The authorities and the IMF team are confident that the decisive implementation of appropriate economic and structural policies, with the support of the international financial community, will be instrumental in promoting in the course of 1999 a progressive rebuilding of confidence, a substantial improvement of the current account of the balance of payments, a gradual reflow of private capital to Brazil, and a strengthening of the exchange rate.[64]

With the Fund's approval secured, the last critical element in Brazil's recovery from the crisis was to stabilize private capital flows and rebuild investor confidence. Folkerts-Landau and his colleagues at Deutsche Bank were still extremely skeptical that the government could carry out its intended policies, and many other bankers were similarly skittish. A temporary intensification and broadening of the effort to encourage creditors to maintain their loan exposure was needed. Although reluctant to do anything that might look like arm-twisting, the authorities agreed to do a series of "road shows" around the world to present the program to bank creditors and ask them to roll over loans as they came due. IMF staff participated in each of those meetings and helped explain the program and the economic outlook. The major creditor countries also helped by hosting the meetings, usually on the premises of their national central banks. As with the similar operation carried out for Korea the year before, Fund staff also coordinated and monitored the rollover process. Each creditor bank thus

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[63]See Fraga (1999) and Research Department, Central Bank of Brazil (2000). In May 1999, the IMF organized a seminar on inflation targeting in Rio de Janeiro, at which central bankers from around the world made presentations on their experience with inflation-targeting regimes; see http://www.imf.org/external/pubs/ft/seminar/2000/targets/stratop.htm. A key issue for the IMF was how to adapt the policy conditions in the stand-by arrangement, which had been designed in the context of a fixed exchange rate, to the new regime. The technical requirements are discussed in "IMF Conditionality in the Context of Inflation Targeting—The Case of Brazil," SM/99/296, Suppl. 1 (December 16, 1999), and in Blejer and others (2001).

[64]"Joint Statement of the Ministry of Finance of Brazil and the IMF Team," NB/99/5 (February 4, 1999); accessed at http://www.imf.org/external/np/sec/nb/1999/nb9905.htm. For Fischer, this detour to Brazil was one of the most memorable experiences of his seven years at the IMF. On leaving the Fund in 2001, he recalled "leaving for Brazil from Davos at 4 a.m., driving through the beautiful snow-covered moonlit mountains, worrying that this could become a disaster. But thanks to the steadfastness of President Cardoso, and the skill of Pedro Malan and Arminio Fraga, helped by the outstanding work of the Fund team led by Teresa Ter-Minassian, disaster was avoided"; farewell dinner speech, August 29, 2001; accessed at http://www.imf.org/external/np/speeches/2001/082901a.htm.

could be assured that others were maintaining their exposures, and no one had to worry about losing a race for the exits.[65]

For the next two years, the program succeeded remarkably well.[66] Despite the depreciation of the currency, the inflation-targeting regime ushered in a steady reduction in price inflation, and economic growth remained positive. At the end of March 1999, the Executive Board reviewed the program favorably and approved disbursal of a second tranche of the stand-by arrangement, in the form of an SRF loan of nearly $5 billion (SDR 3,636 million). By August, international investors were once again eager to lend to Brazil, a turnaround that inspired the British magazine *Euromoney* to give its coveted "central banker of the year" award to Brazil for the second straight year (Franco in 1998 and Fraga in 1999). In December, Brazil began repaying the SRF loans, and the crisis was past.[67]

Argentina

Before, during, and after the East Asian crisis, Argentina was the darling of international investors. The skepticism that had prevailed in the early 1990s—could Argentina really overcome the failures of the 1980s and achieve sustainable, noninflationary growth?—dissipated after the economy successfully weathered the tequila crisis. The willingness and the political ability of the government to raise taxes in the middle of President Carlos Menem's campaign for reelection in 1995 greatly impressed the IMF and led to a resumption of lending that was still continuing when the Asian crisis hit two years later. Private capital markets responded even more enthusiastically, and the resulting inflow of capital enabled Argentina to end—temporarily—its reliance on official financing.

The central financial issue for Argentina at this time was the development of exchange rate policy. The rate between the peso and the U.S. dollar had been fixed at parity since the enactment of the Convertibility Law in 1991. This stability and the commitment underpinning it functioned as the very foundation of Argentina's economic recovery, but almost everyone understood that sooner or later the rate would come under market pressure and the government's commitment would be severely tested. Before much longer, the government would have to find a way either to

[65]"Brazil—First and Second Reviews Under the Stand-By Arrangement," EBS/99/30, Suppl. 2 (March 25, 1999), p. 15. These meetings took place in mid-March 1999, in New York, Tokyo, Frankfurt, Lisbon, London, Madrid, Paris, and Rome. Malan (2004) p. 167, includes a memoir of the road show.

[66]For a review, see Pérez and Gerson (2009).

[67]Brazil did not draw on the stand-by arrangement in 2000, and it made just one small drawing in 2001 before the onset of a new crisis led to negotiation of more loans. In all, Brazil borrowed about two-thirds of the $18.3 billion committed by the Fund for the 1998–2001 arrangement. All of the SRF portion was repaid by April 2000. Even after large borrowings in 2001–05, Brazil repaid all of its outstanding obligations to the IMF by February 2006.

introduce more flexibility into its management of the rate or to make its commitment even more irrevocable.

Although the IMF never tried seriously to induce Argentina to abandon the de facto currency board, it understood the problem. When the Executive Board met in April 1995 to review performance under the EFF arrangement, Stefan Schoenberg (Germany) characterized the issue as the "Hotel California dilemma": "You can check out any time you like, but you can never leave."[68] Once confidence begins to wane, either adhering to the regime or abandoning it is likely to damage confidence even further. At the same meeting, both Karin Lissakers (United States) and Camdessus expressed "skepticism about the long-term viability of a currency board," because of the absence of a lender of last resort in such a scheme. Marc-Antoine Autheman (France) identified the key issue, which would bring down the Argentine regime in 2001: the program was "very risky" because it was "unusually strong" and thus "very difficult to sustain." In sum, "the risk of failure . . . is related to a central issue, the political sustainability of the very tight monetary and fiscal policy implied by this program."[69] Nonetheless, the Board approved a fourth year and an augmentation of the arrangement.

The convertibility plan was the brainchild of Domingo Cavallo, whom Menem had installed as economy minister in 1991. Five years later, political tension between Menem and Cavallo led to Cavallo's resignation in July 1996. His departure left a gap that temporarily frightened investors, but the disturbance quickly passed. Roque Fernandez, his replacement, was a scholarly economist with a Ph.D. from the University of Chicago who had worked at the IMF in the 1970s and had served as president of the central bank while Cavallo was in charge of economic policy. As his principal deputy (secretary of finance), he brought in Pablo Guidotti, an IMF veteran from the 1980s who had served under Fernandez at the central bank. This good team, well known and respected in Washington and in financial markets, would have to try to find a viable exit strategy.

The economic case for floating the Argentine peso was fairly strong in 1997, but neither the authorities nor the IMF staff were pushing in that direction. The U.S. dollar was strengthening in foreign exchange markets, raising the value of the peso against other currencies and weakening Argentina's international competitiveness. With private capital shifting to Argentina from other emerging markets, the biggest short-term risk was that the rate would appreciate further if left alone to find its own level. On economic grounds, the likelihood of a large movement in either direction seemed small. The benign financial conditions of 1997 offered a golden opportunity to achieve a long-term goal of establishing stable and independent monetary and fiscal policies with a market-determined exchange rate.

[68]Minutes of EBM/95/35 (April 6, 1995), p. 9. The reference was to the 1977 popular song "Hotel California," written and recorded by the Eagles.

[69]Minutes of EBM/95/35 (April 6, 1995), pp. 28 (Lissakers), 29 (Camdessus), and 37 (Autheman). The "skepticism" quotation is from Camdessus.

The real risk was political. The fixed rate, enshrined in law, was extremely popular across the political spectrum in Argentina. Memories of the disastrous effects of previous governments' inability to control budgets or inflation were painfully acute. After just six years of stability, six years that had raised the international esteem of Argentina beyond the dreams of those who had lived through the 1980s, would a shift in policy toward flexibility be credible? Would it be undercut by renewed budgetary battles? Would international investors flee Argentina, as they were already fleeing Indonesia and Korea? No one in power in 1997 was prepared to take that test. No one in the IMF was willing to risk destabilizing the country by publicly challenging the convertibility regime.

Throughout Menem's last three years as president (economically, the post-Cavallo years, 1996–99), the goal for exchange rate policy was to move toward discarding the peso altogether and making the U.S. dollar the official currency of Argentina. Until 1999, that goal was pursued quietly because the public face of policy was preservation of the convertibility plan at the fixed exchange rate. Increasingly, however, Argentine residents were denominating contracts, including long-term home mortgages, in U.S. dollars. Because the dollar became the dominant store of value while the peso remained the dominant means of payment, the potential cost of ever devaluing the peso or allowing it to float was becoming unbearable.

In January 1999, Menem publicly announced that he wanted ultimately to dollarize the economy. To follow up, the finance authorities entered into negotiations with their counterparts at the U.S. Treasury and Federal Reserve Board to develop a cooperative agreement on dollarization that they hoped would lead ultimately to a "monetary association treaty."[70]

These negotiations concentrated on the central issues of seigniorage and oversight of the banking system. At the time, the Argentine government was receiving about $750 million a year from the U.S. Treasury in interest on the securities the Treasury held as backing for the peso. Dollarization would involve converting those securities into cash, which would give rise to a seigniorage windfall for the United States at Argentina's expense. Some means would have to be found to share that windfall more equitably. The deeper problem was that the central bank would surrender its ability to act as a lender of last resort in the event of a banking crisis. U.S. officials made it quite clear, first privately and then publicly, that they would take no heed of any dollarized country's monetary policy needs, nor any responsibility for the soundness of banks in dollarized economies. That sobering conclusion did not overly discourage the

[70]Menem's announcement was made in an interview with a television reporter in Buenos Aires; see "Argentine President Wants Study 'Quickly' on Switch to Dollars," Dow Jones International News, January 15, 1999. The announcement that Argentina was seeking a treaty with the United States was made by the central bank governor, Pedro Pou, the following week; see "Argentine Central Bank Proposes Money Link with U.S.," Reuters News, January 21, 1999. Both stories were accessed at http://global.factiva.com.

Argentine authorities, who continued discussing the possibility of dollarization until they left office after the presidential elections of October 1999.[71]

Most IMF staff throughout this period accepted this very strong commitment to the fixed exchange rate as a fact of life, and in any case did not generally disagree with it.

An IMF staff mission, led by Ter-Minassian (who was also covering Brazil), went to Buenos Aires in May 1997 to review the 1996–98 stand-by arrangement. She found the trade deficit worsening, owing to a surge in imports. The authorities were not particularly worried; they were counting on productivity gains and low domestic inflation to preserve international competitiveness and eventually to moderate the imbalance in trade. The mission report warned them to be "vigilant," not in thinking about exchange rate flexibility, but rather of the need to tighten fiscal policy if the current account were to weaken substantially.[72] A few weeks later, Camdessus met with Menem, other officials, and leaders of civil groups in Buenos Aires. While sympathizing with concerns of nongovernmental groups about rising unemployment and poverty, he "expressed confidence that high unemployment could be dealt with effectively through maintaining the present course of economic policy and through deepening the [structural] reforms."[73]

The staff issued a favorable review of program implementation, and the Executive Board approved the release of two more tranches of the stand-by arrangement in June and September 1997. Those two drawings turned out to be the last by Argentina in this decade, first because of fiscal slippages and later because the government no longer needed official financing.[74]

The outbreak of the Asian financial crisis in the second half of 1997 coincided with weakening political support for the government. Menem's party, the Justicialist Party, lost its parliamentary majority in the October elections, after which the government's ability to control fiscal policy weakened. A sell-off of equities in the Hong Kong SAR market later that month caused a brief bout of contagion to Argentina, but private

[71]This account is based primarily on interviews with participants. In April 1999, U.S. Treasury Secretary Robert Rubin addressed the issue in remarks at the Johns Hopkins University campus in Washington. Without ever mentioning Argentina, he observed that "some countries" were considering dollarizing. He then noted, "We do not have an a priori view as to our reaction to the concept of dollarization. We would also observe that there are a variety of possible ways for a country to dollarize. But it would not, in our judgment, be appropriate for United States authorities to extend the net of bank supervision, to provide access to the Federal Reserve discount window, or to adjust bank supervisory responsibilities or the procedures or orientation of U.S. monetary policy in light of another country's decision to dollarize its monetary system"; see "Treasury Secretary Robert E. Rubin Remarks on Reform of the International Financial Architecture to the School of Advanced International Studies," U.S. Treasury press release RR-3093 (April 21, 1999); accessed at http://replay.waybackmachine.org/20021219000202/http:/www.ustreas.gov/press/releases/rr3093.htm.

[72]"Argentina—Third Review under the Stand-By Arrangement," EBS/97/133 (July 16, 1997), p. 13.

[73]Minutes of EBM/97/54 (May 28, 1997), p. 3.

[74]The pattern of Argentina's borrowing from the IMF in the 1990s is shown in Chapter 10 (Figure 10.3).

capital inflows soon resumed. At that point, the authorities decided to secure the IMF's seal of approval as a precautionary bulwark against a potential reversal of financial fortune.

Argentina's request for a precautionary EFF arrangement put the IMF in a quandary. Excessive spending by the central government had violated the terms of the stand-by arrangement that was about to expire. The authorities had not requested a waiver and had decided to forgo the last scheduled drawing. IMF staff and management urged the authorities to tighten fiscal policy, but their leverage was poor as long as Argentina was asking only for a vote of confidence, not a loan. The Fund could have denied the precautionary arrangement, but at the outset of 1998 Argentina's policies were not so bad as to warrant such a drastic step. Looking forward, the staff concluded that "the authorities' program is consistent with maintaining financial stability, while promoting growth and advancing the structural reforms needed to provide lasting support to Argentina's monetary and exchange arrangements."[75] The Executive Board concurred and approved a three-year arrangement for $2.8 billion (SDR 2.08 billion, or 135 percent of quota) in February 1998.

By mid-year, when Ter-Minassian returned to Buenos Aires to review the program, the economy was weakening. The assumption of 5 percent growth on which the program was based was now seen clearly to have been overly optimistic. Lower growth rates meant tax revenues would fall short, and the fiscal deficit would exceed the program target. After the Russian default in August and the collapse of the Long-Term Capital Management hedge fund in September, the problem worsened as the inflow of private capital began to falter. The main stock market index for Argentina fell by about 40 percent.

The IMF was at a crossroads. It could insist, as a condition for continuing its seal of approval, on a tightening of fiscal policy or a deepening of structural reforms to correct the financial problem. A fiscal tightening, though, would worsen the economic downturn and could lead to panic. Alternatively, the Fund could treat the situation as a temporary setback for which automatic fiscal stabilizers were the correct response. Because the policy stance was basically sound, this second option was preferred at that time.

The Executive Board approved the program review on September 23, 1998. To reinforce the message that the Fund (and the United States) strongly supported Argentina's policy stance, Menem made a well-publicized trip to Washington two weeks later. In a highly unusual maneuver, he was invited to address the opening plenary session of the IMF/World Bank Annual Meetings, immediately following the traditional address by the head of state of the host country (U.S. President Bill Clinton). Defending that decision, Camdessus praised Menem's economic policies and told the press

[75]"Argentina—Staff Report for the 1997 Article IV Consultation and Request for Extended Arrangement," EBS/98/6 (January 14, 1998), p. 22.

that "Argentina has a story to tell the world."[76] Many on the staff were less impressed by the authorities' ability to rein in fiscal pressures as political support for them waned, but the Fund's public stance was united in support.[77]

Throughout 1999 and beyond, the IMF continued to support Argentina by approving the EFF-supported economic program. The $2.8 billion loan commitment remained in force, while inflows of private capital enabled the authorities to continue to forgo drawing on it. As the presidential campaign heated up, Fischer met with senior Argentine officials at a conference in Chile, after which he privately told the Fund's Executive Directors that "we could be in for a fairly difficult time in the months to come."[78] However, the program worked reasonably well for another two years, before pressures finally built up and exploded in the massive crisis of 2001–02.[79]

Ecuador

Ecuador faced extraordinarily difficult economic circumstances in the late 1990s, brought on by natural disasters (drought followed by floods, then the decimation of the fishing harvest caused by "El Niño" tides), border warfare with Peru, extremely low prices for oil exports, and political instability (four presidents in quick succession). Macroeconomic policy implementation was lax, owing in large measure to the inability of the government to secure parliamentary support. Weaknesses in the banking system erupted into crisis in 1998 after the Asian meltdown aggravated weakening capital inflows. A major financial and economic crisis ensued a year later.[80]

As long as the border conflict and the domestic political quarrels occupied the government's attention, the IMF could do little to help. The staff monitored policy implementation in 1995–96, but the government's performance (in the staff's cautious terms) "fell well short of expectations."[81] After the short-lived presidency of Abdalá Bucaram ended in his impeachment, the staff entered into program negotiations with the interim president, Fabián Alarcón, and then (from August 1998) with his newly elected successor, Jamil Mahuad. Mahuad's election, closely followed by the settlement of the border dispute with Peru in October, created an opportunity to stabilize the economy and regain the support of the IMF, but circumstances remained difficult.

[76]Transcript of press conference, October 1, 1998; accessed at http://www.imf.org/external/np/tr/1998/tr981001.htm. The text of Menem's October 6 speech is available at www.imf.org/external/am/1998/speeches/pr05e.pdf.

[77]For a strikingly frank criticism of Camdessus's position by a senior official of the Fund, see Tanzi (2007), pp. 117–18.

[78]Minutes of EBM/99/53 (May 12, 1999), p. 4.

[79]For critiques of the IMF's relations with Argentina in the lead-up to the 2002 crisis, see Internal Evaluation Office (2004) and Mussa (2002). For a detailed analysis of the conditions that led to the crisis, see Daseking and others (2004).

[80]For an analysis of the crisis, see Jácome (2004).

[81]"Ecuador—Staff Report for the 1997 Article IV Consultations," EBS/97/212 (August 19, 1997), p. 6. Relations with Ecuador before the staff-monitored program are covered in Chapter 9.

In 1999, continued inaction by the authorities in the face of unrelenting negative circumstances turned the domestic banking collapse into a currency crisis that threatened the country's whole economy. As more and more of its dwindling export revenues were siphoned off to service external debts, defaulting on that debt became a serious option, both for the authorities and for the IMF staff. In April, as a staff mission prepared to go to Quito to negotiate terms for a stand-by arrangement, officials in the Policy Development and Review Department (PDR) who were overseeing the Fund's policy advice to Ecuador felt the need to issue a warning to the area department staff. "Ecuador should pursue a *cooperative* approach with its creditors and do all that it can to avoid the need for unilateral action," they wrote, and urged that the IMF should not take a position on Ecuador's evident desire for a rescheduling of its external debt.[82] That became the institution's official position, but the tension between preserving market-based relations with creditors and keeping the economy running was only going to get worse.

The May 1999 mission, led by John Thornton (Deputy Division Chief, WHD) and reinforced at the outset by a brief visit by Fischer and Loser, concluded that the government needed to take further action to get its own finances under control, but also that weak domestic political support hampered its ability to do so. In addition to that adjustment effort, Thornton urged the authorities to try to reach three types of agreements with creditors. To regularize relations with external creditors and avoid default, they needed a rescheduling agreement with official creditors through the Paris Club; a similar agreement with private bank creditors through the London Club; and a new syndicated bank loan to cover the interest falling due on the country's foreign-currency bonds, which were predominantly in the form of nearly $6 billion in Brady bonds. Because many of those bonds were held by large foreign banks, the best prospect for a new loan would be an agreement with a consortium of those creditors. Once those agreements were in place, the Fund could provide additional financing through a stand-by arrangement.[83]

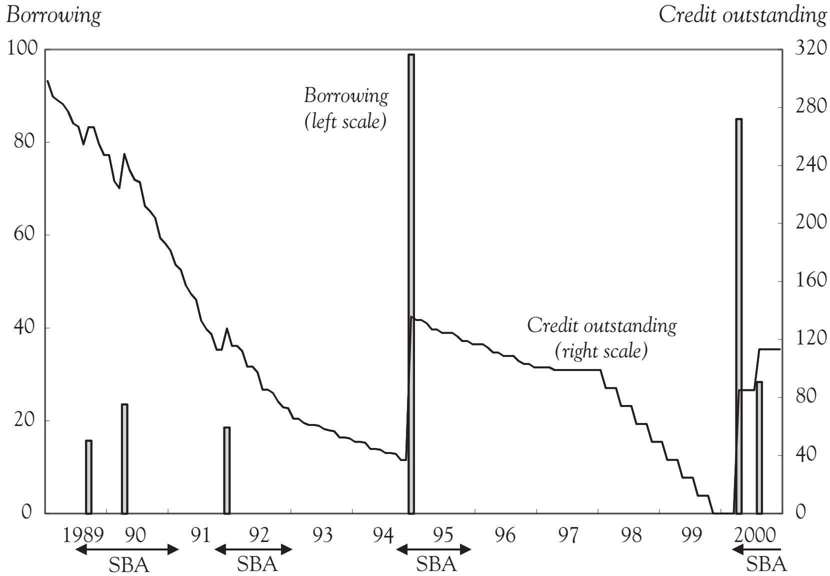
Fischer repeated that message in a meeting with Mahuad. At this time, Fund management was trying to put in place a plan for "private sector involvement" in debt workouts as advocated by the G7.[84] Paris Club creditors were signaling that they would not reschedule debts without assurance that private creditors would maintain their exposure. Private creditor participation thus was essential if a heavily indebted country hoped to finance its balance of payments. In Ecuador, Fischer explained, the key point

[82]The emphasis is in the original. Memorandum from Jesus Seade (Assistant Director, PDR) to Claudio Loser (Director, WHD), "Ecuador—Strategy for Dealing with External Debt Problems," April 6, 1999; IMF archives, Historian's files.

[83]Memorandum for files by Thornton and Robert Kahn (Deputy Division Chief, PDR), "Meeting with Ecuadoran Debt Policy Team and Their Legal/Financial Advisors" (May 18, 1999); IMF archives, Historian's files.

[84]See Chapter 1, pp. 31–32. On the application of the G7 strategy to the Ecuador case, see Rieffel (2003), pp. 239–42.

Figure 12.6. Ecuador: Use of Fund Credit, 1989–2000
(In millions of SDRs, monthly data)



Source: International Financial Statistics.
Note: SBA = Stand-by arrangement.

was that "the private sector [collectively, the holders of Ecuador's Brady bonds] would have to contribute by maintaining its exposure to the country. We [the IMF] did not mind how they did it, but it had to be done, and it was up to the country to start the negotiations and we would be willing to assist."[85]

For each of these targeted agreements, creditors would normally expect the government to reach a prior agreement with the IMF on a stand-by arrangement. That agreement, in turn, would require the Fund to have a solid assurance that Ecuador could finance its external payments. This circle could be squared if all of the main parties could reach tentative agreements, conditional on the others, so that the IMF could coordinate the complex package and bring all the negotiations to a conclusion. Any slippage could be fatal.

Although Ecuador had not borrowed from the IMF since 1994, the Fund was still a creditor to Ecuador as well as a policy advisor and an assessor of its policies and economic prospects. Ecuador's staying current on those IMF loans was understood to be a prerequisite for an orderly settlement of its other loans. In 1998 and 1999, Ecuador made eight quarterly loan repayments to the IMF totaling about $135 million (SDR 98.8 million). That completed the timely repayment of all of Ecuador's outstanding obligations to the Fund (Figure 12.6).

[85]Report by Fischer to the Executive Board; minutes of EBM/99/53 (May 12, 1999), p. 4.

Over the summer of 1999, Thornton monitored progress closely from Washington and returned to Quito every few weeks to consult further with the authorities. Gradually, it became clear that private creditors had little interest either in negotiating a reduction in Ecuador's debt or in offering new loans to cover bond interest. Ecuador had a poor track record for economic management and thus little credibility in financial markets. The options for a market-based solution to the impasse were rapidly dwindling.

Matters came to a head late in the summer. On August 28, the government of Ecuador was scheduled to pay $96 million in interest on its Brady bonds, most of which were held by major international banks. It could not make that payment on time without taking draconian measures that would be politically costly and could be economically ruinous. The authorities were pressing the IMF to approve the lending arrangement in time to enable this payment. Fund management, however, was reluctant to lend to Ecuador for the purpose of repaying private creditors.

On August 18, the minister of finance, Ana Lucia Armijos, traveled to Washington to meet with Camdessus and others at the IMF. In the course of the meeting, Camdessus informed her that he could not propose approval of the arrangement without adequate assurance that the country's economic program would be fully financed. That meant, in the first instance, that Ecuador could not make the August 28 interest payment.[86]

When the IMF's insistence on this point leaked out, the Fund appeared to be forcing Ecuador to default on its Brady bonds. No country, to this point, had ever defaulted on Brady Plan debt. For Ecuador to do so could raise risk premiums for all other countries with such debts. That was not the intended outcome. Ecuador's bonds allowed for a 30-day grace period. If Ecuador deferred its interest payment, those 30 days could be used to bring both sides to the table for more serious negotiations on rescheduling and reducing Ecuador's debt burden. Realistic or not, that was the intention and the hope.

This tactic failed. President Mahuad announced the deferment on August 25 and indicated that the IMF had already approved it (Cisternas, 1999). That angered and raised the suspicions of creditors, while it simultaneously emboldened the authorities. The Fund moved quickly to contain the damage, by announcing a successful conclusion to program negotiations on August 31.[87] That also backfired. Although the press release cautioned that approval of a stand-by arrangement still

[86]Memorandum for files by Mariano Cortés (Economist, WHD), "Ecuador—Authorities' Meeting with Management," August 24, 1999; IMF archives, DMD-AI (Mr. Fischer's files), "Ecuador – 1999 (1)," Accession No. 2002-0149.

[87]"IMF Announces Conclusion of Staff Negotiations with Ecuador," NB/99/53 (August 31, 1999); accessed at http://www.imf.org/external/np/sec/nb/1999/nb9953.htm. This announcement was issued only after Mahuad assured the IMF that he was personally committed to implementing the agreed-on terms of the program; see memorandum from Loser to the Managing Director, "Ecuador—Letter from President Mahuad," August 31, 1999; IMF archives, DMD-AI (Mr. Fischer's files), "Ecuador – 1999 (1)," Accession No. 2002-0149.

depended on completion of a number of policy actions and "the receipt of adequate financing assurances," the message was widely interpreted as an implicit approval of default.

IMF officials were hoping for one of two favorable outcomes. Either the combination of Ecuador's unilateral deferral and the Fund's announcement of its approval of the policy program would lead quickly to a negotiated settlement with creditors, or the authorities would find a way to make the interest payment in September and then enter into negotiations for a more comprehensive debt restructuring.[88] With encouragement from external advisors, however, Mahuad was leaning increasingly toward defaulting as a way to force creditors to be more flexible in negotiations. On September 23, 1999, a reporter asked Camdessus if the Fund was encouraging Ecuador to default on its Brady debt. Camdessus denied it and replied that the Fund was encouraging the authorities to use the 30-day grace period to "narrow the gap" with its creditors.[89] Although the staff still believed Ecuador would pay in time to avoid default, the prospects for narrowing the gap were already dim.

Just four days later, as the grace period approached expiration, Camdessus had to issue another news brief, stating that he "regrets that to date Ecuador appears not to have found it possible to enter into negotiations with its creditors, with a view to reaching a comprehensive resolution of these difficulties in a collaborative manner." His recommendation for approval of the stand-by arrangement was still contingent upon Ecuador being "judged to be making good faith efforts to reach a collaborative agreement with its creditors."[90] In the view of both private creditors and the IMF, those good-faith efforts were not yet evident.

As of September 30, Ecuador was formally in default.[91] The IMF nonetheless accepted the authorities' Letter of Intent setting out the policies it intended to follow to get the economy back on course. The authorities then needed to engage in meaningful and cooperative negotiations with creditors and to begin implementing the fiscal, monetary, and other policies in the program. Negotiations did get under way soon afterward, but the government failed to carry out the policy program. By end-October, the Fund abandoned the plan to approve the stand-by arrangement, and negotiations with creditors suffered a setback. The impasse continued through the rest of 1999, and

[88]For a more detailed description of the available options, see memorandum from Jack Boorman (Director, PDR) and François Gianviti (General Counsel) to the Managing Director, "Ecuador: Debt Strategy Options" (September 21, 1999); IMF archives, DMD-AI (Mr. Fischer's files), "Ecuador – 1999 (1)," Accession No. 2002-0149.

[89]See transcript of press conference at http://www.imf.org/external/np/tr/1999/tr990923.htm.

[90]"IMF Urges Collaboration Between Ecuador and Its Creditors," NB/99/61 (September 27, 1999); accessed at http://www.imf.org/external/np/sec/nb/1999/nb9961.htm.

[91]For an analysis of the default and its implications, see Sturzenegger and Zettelmeyer (2006), pp. 147–64.

economic conditions continued to worsen, contributing to the fall of yet another Ecuadoran government but ultimately forcing a solution to the crisis.

In a last-ditch but ultimately successful effort to generate an economic recovery, Mahuad decided to take the bold step of replacing the national currency, the sucre, with the U.S. dollar. Although he was driven from office early in 2000 in a coup d'état, the new government continued with the dollarization scheme. The staff renegotiated the program accordingly, and in April 2000 the IMF finally approved a stand-by arrangement for just over $300 million (SDR 226.7 million, or 75 percent of quota). The arrangement enabled Ecuador to reach a debt-exchange agreement with creditors in July, and the crisis was brought to an end.

Lessons Learned

The Asian crisis was a transformational event for the IMF. The intensity and severity of the economic, political, and social consequences were so great; the consequences were felt so widely around the world; and the subsequent criticism of the Fund for allegedly failing to foresee or forestall it and for allegedly mismanaging it was so vitriolic that staff, management, and the affected countries all had to examine every aspect of it in search of lessons to apply in the future.

Reactions at the IMF

We have learned many lessons from the Asian experience, and there are many yet to learn. . . . we must demonstrate to the world that we are responding effectively.

Michel Camdessus[92]
Managing Director of the IMF
April 1998

A staff study conducted shortly after the Asian crisis (Lane and others, 1999) found that the primary failing was the limited ability of Fund-supported programs to restore confidence among private investors following a major collapse of capital inflows. Several more-detailed studies examined the reasons for this failing in specific cases and suggested a wide variety of explanations. Possible culprits included the inapplicability of standard macroeconomic models to capital account crises; the need for a more country-specific focus in program design; the absence of a true lender of last resort in international finance; recurring policy failings in borrowing countries, including rigid and overvalued exchange rates and weak oversight of financial systems; and excessive speculative behavior in international capital markets, perhaps buoyed by the moral hazard

[92]Minutes of EBM/98/38 (April 2, 1998), p. 6.

resulting from the possibility of an official rescue.[93] Some broad lessons were drawn fairly quickly, but a more complete reassessment was still ongoing a decade later.[94]

A common thread running through all of the financial crises of the 1990s was an increasing reliance on short-term foreign-currency borrowing in the months before the outbreak. The details were country-specific—*tesobonos* in Mexico, GKOs in Russia, corporate debt in Korea, finance-company debt in Thailand, bank debts in Indonesia—but the results were always the same. Because the country's external obligations were denominated in foreign currency, any sizeable depreciation of the home currency would risk bankrupting a substantial part of the economy. Because the obligations were highly liquid, any shift in investor sentiment would also risk driving up interest rates quickly and undermining the foundations of the country's economic growth and stability. Many emerging-market countries had little choice but to fall prey to these risks, because the cost of borrowing at longer maturities or in domestic currency was simply too high to absorb. Only short-term credit—financed in part through "carry trade" (see Chapter 4, pp. 136–37)—was readily available on affordable terms.

The analytical tools available to the IMF in the mid-1990s took inadequate account of these balance sheet vulnerabilities. Standard macroeconomic models indicated that a temporary resort to "austerity"—a tightening of fiscal and monetary policies—would close a financing gap caused either by an initial fiscal or monetary excess or by a shortage of net private saving. Once balance was restored, confidence would return and a recovery could begin. Those models did not show that a country—especially an emerging market—could maintain an equilibrium by importing capital from abroad only so long as its "debt dynamics" were perceived to be sustainable. The sustainable level of net capital inflows was not an endogenous variable determined by the quality of the country's macroeconomic policies and net national saving. It was an exogenous variable determined by the psychology of financial markets. Capital could disappear overnight, especially when it was a speculative flow financed by carry trade. Any economy dependent on short-term capital was vulnerable.[95]

The emergence of a theoretical literature on the links between balance sheet vulnerabilities and financial crises (for example, Kaminsky and Reinhart, 1999; and

[93]Major cross-country studies by the staff included—in addition to the seminal paper by Lane and others (1999)—Boorman and others (2000), Lindgren and others (2000), and Ghosh and others (2002). Also see Independent Evaluation Office (2003). For an introduction to the voluminous external analysis of the Fund's role in the management of late-1990s financial crises, see Stiglitz (2002), Feldstein (2003), and Williamson (2004).

[94]This review does not attempt to cover all the issues raised regarding how to anticipate and manage financial crises. Instead, it summarizes the main themes that were motivated by the Fund's handling of the crises of 1997–98. For a discussion of the effort to improve crisis prediction, see "Strengthening Crisis Prevention and Resolution" in Chapter 10.

[95]For overviews of the balance sheet and microeconomic analyses that developed in the wake of the 1990s financial crises, see Calvo (2005) and Eichengreen and Hausmann (2005). The former spotlights the role of "sudden stops" in capital inflows; the latter, the "original sin" of borrowing short-term in foreign currencies. Under both approaches, the possibility of multiple equilibria makes it impossible for a conventional model to predict whether a good or a bad outcome will prevail.

This cartoon from the *Economist* in 1998 was a typical reaction to the Fund's handling of the Asian crisis. (The theme was common in the 1990s; see Chapter 7, p. 293.) Copyright 1998 KALtoons

Krugman, 1999) had a substantial impact on crisis analysis at the IMF. In September 1999, the staff acknowledged that "recent crises have demonstrated that few observers fully understood countries' vulnerabilities to capital market shocks."[96] Under prodding by the Group of Ten (G10) industrial countries, the staff set out to intensify its analysis of countries' liquidity management and risk assessments as part of the regular Article IV consultation process. Separately, the staff conducted extensive research into the theoretical and empirical dimensions of the interaction between balance sheet vulnerabilities and financial crises.[97]

[96]"The Management of External Debt and Reserves in Emerging Markets," FO/DIS/99/124 (September 9, 1999), p. 1.

[97]For a review and overview, see Mulder, Perrelli, and Rocha (2011).

Although these research initiatives deepened the profession's and the staff's understanding of the nature and origins of financial crises, the policy implications remained controversial. Was the key to reducing vulnerability an improvement in economic policymaking in the emerging markets, including better management of debt and liquidity, or was it a strengthening of oversight of capital markets and other elements of the international financial system? These ideas were not mutually exclusive; what mattered was emphasis and priority.

In the IMF, a first lesson drawn from the Asian crisis was that the structural and institutional prerequisites for successfully opening up to capital inflows were more stringent and daunting than previously thought. Before the crisis, Fund management and staff had always been careful to note that sound financial institutions and a stable monetary system were essential for a country to take advantage of the opportunities afforded by an open capital market. For the most part, however, they did not view that cautionary message as an impediment for the major emerging markets in Asia. Their financial systems had problems, but few people thought those problems serious enough to undermine the advantages of capital openness.[98] By 1999, the balance of concerns had shifted, and the Fund's advice on the importance of strengthening financial sectors was becoming more pointed.

A second lesson for the IMF was that crisis management requires careful, case-by-case attention to the behavior of private capital markets. The debt crisis in Latin America in the 1980s had been handled with the aid of several ad hoc tactics to ensure that private sector creditors—particularly international commercial banks—maintained their loan exposures until the indebted countries could regain normal access to capital markets. By the time the Mexican peso crisis hit at the end of 1994, those tactics were no longer applicable because bank creditors were less heavily exposed, bond financing had become a major supplement to bank loans, and a flourishing secondary market in emerging-market debt provided an additional safety valve for creditors wishing to reduce their exposures. Consequently, the Fund's handling of the peso crisis raised serious concerns about moral hazard for creditors, given that the holders of Mexican tesobonos were mostly repaid in full despite the high risk inherent in holding those securities.

The management of the Asian crisis—and even more so, the Russian default that followed it—alleviated those moral-hazard concerns because most investors incurred large losses. In turn, those losses aggravated the difficulty of restoring creditor and investor confidence. Korea's continuing reserve outflow throughout December 1997 and the almost total collapse of the Indonesian rupiah in the first few months of 1998 were

[98]An academic literature on the implications of financial sector weakness for macroeconomic vulnerabilities existed before the Asian crisis, but it focused primarily on Latin America. Only a few prescient analysts foresaw the similarities in East Asia; see, for example, Kaminsky and Reinhart (1999), which is a revised version of a 1996 working paper. For a thoughtful postcrisis analysis of the financial sector weaknesses in East Asia, see the papers in Chow and Gill (2000).

shocking setbacks that forced the authorities, the IMF, and the major creditor countries to reconsider their passive stances regarding private capital flows to and from those markets. Improving domestic macroeconomic policies was necessary, but it would never be sufficient without some limitation on speculative international financial flows.

The remaining challenge was to find a more productive strategy. Was the solution for the country to impose new regulations on capital movements; for creditor-country monetary authorities to use regulations or persuasion to limit speculative investments and induce "private sector involvement" in any workout; for the international community more broadly to develop something akin to a sovereign bankruptcy procedure to force a collective response from creditors; or simply for the IMF and the authorities to redesign the policy reform program so as to try to "bail in" private creditors voluntarily? In the years that followed the Asian crisis, that question remained controversial and was never fully resolved. Plainly, though, the right answer would change over time and would depend on the specific conditions in each case.

A third lesson, even more difficult to apply, concerned the central role of political leadership in the successful management of a major financial crisis. All three of the main crises in East Asia occurred in countries in which government oversight of the economy had once been strong but had dissipated in the precrisis period. Once the economy collapsed, the policy regime could not be corrected without a change of government at the highest level. In Thailand, a new constitution was adopted in October 1997. A new government took office the following month, after which a real recovery began. In Korea, the December 1997 election of Kim Dae-Jung was the critical turning point for domestic support for a new beginning. In Indonesia, President Suharto's resignation in May 1998 made room for a new team that could deal decisively with the corruption that had undermined the economy. Any effort to manage a crisis by correcting macroeconomic or structural imbalances was likely to run aground until the underlying political weaknesses could be overcome.[99]

A fourth lesson was that the international financial "architecture" was riddled with structural deficiencies. Regulation of market behavior was essentially a national undertaking; international cooperation on structural policies was piecemeal and sporadic; and compliance with international standards and codes was mostly voluntary. Recognition of these weaknesses led to a diversified and only partially successful effort to shore up the system by institutionalizing standards, monitoring compliance, broadening the major country caucuses to include emerging markets in new groups such as the Asia-Pacific Economic Cooperation (APEC) forum and the Group of 20, and attempting (unsuccessfully) to replace the Fund's Interim Committee with a more formal Council.

[99]Boorman (Director, PDR) characterized this problem as the "two-try thesis." Typically, the authorities would initially deny that they had a problem. Only when their first attempts to muddle through proved insufficient would someone take charge and deal with the problems more seriously (Boorman, 1999).

Most directly relevant for the work of the IMF, the fifth lesson was that policy conditions on Fund lending had to focus on correcting the problems most critically important for resolving the issues that had generated the crisis. The temptation to try to fix other, perhaps insidious and entrenched, problems at the same time had to be resisted. That conviction led eventually to the adoption of new conditionality guidelines in 2002 that required policy conditions to be applied "parsimoniously" and only when they were "of critical importance" for specified purposes.[100]

Reactions Elsewhere

THE ASIAN CRISIS . . . HAS LEFT A SCAR ON THE MINDS OF ASIAN POLICYMAKERS. BUT THE recovery . . . has . . . been robust.

Tharman Shanmugaratnam[101]
Minister for Education,
Second Minister for Finance,
Singapore
September 17, 2006

In contrast to the responses by the IMF, in Asia the view took hold that the primary challenge was to strengthen oversight and regulation of the international financial system. Because macroeconomic policies had not been especially worse in this region than elsewhere, the IMF's focus on austerity, even as a temporary response to crisis, did not seem appropriate. Within the Fund, M.R. Sivaraman (India) gave voice to this view during a March 1998 review of the crisis. The financial institutions that displayed rent-seeking behavior and that underpriced the risks of lending to Asian emerging markets were, in his view, "to be equally blamed for the crisis . . . as much as the lax policies and weak financial sectors in these countries."[102]

One proposed alternative, exemplified by Malaysian Prime Minister Mahathir's speeches, was simply to prohibit speculation in foreign exchange markets. More practically, limited controls on capital flows were accepted fairly generally as a possible element in a broad strategy to minimize the likelihood of a sudden pullout. The IMF's general skepticism and sometimes hostility toward such controls created tensions between the agency and its Asian members.

The Asian Monetary Fund

A second arrow in the Asian quiver—in addition to controls—was to build up and pool ample foreign exchange reserves to enable participants to defend themselves against a speculative attack or a temporary payments deficit without

[100]"Guidelines on Conditionality," Executive Board Decision No. 12864-(02/102), adopted September 25, 2002; available at http://www.imf.org/External/np/pdr/cond/2002/eng/guid/092302.htm.

[101]Tharman (2006), p. 4.

[102]Minutes of EBM/98/44 (March 26, 1998), p. 3.

having to borrow from the IMF and thus subject themselves to what they saw as inappropriately austere policy conditions. That desire led to a 1997 proposal known as the Asian Monetary Fund (AMF). Although the AMF was not adopted at that time, the principle resurfaced in various forms over the next few years.

The idea of a regional financing mechanism for Asia first arose in this context at a November 1996 meeting of the finance ministers and central bank governors of the Association of South-East Asian Nations (ASEAN) in Jakarta, Indonesia. The G10 had served as a peer group for reviewing industrial countries' economic policies and conditions since the early 1960s. The Monetary Committee of the European Union and its predecessor committees had served a similar purpose since the 1950s. Why not set up a similar peer mechanism in Asia?

Camdessus was participating in the Jakarta meeting, and he offered a positive assessment at a private dinner he hosted for the ministers and governors.[103] If they were to meet regularly to share information and establish standards for good policies, they could help each other avoid getting into a financial crisis. As director of the French treasury, Camdessus had chaired the European Monetary Committee in the early 1980s, and he was enthusiastic about the benefits of a peer review process. The goal, as he saw it, was for countries to act early and together in advance of a crisis.

Some of the Managing Director's dinner guests interpreted his remarks a little differently. An integral feature of both the G10 and the European Union was a short-term financing mechanism in the form of swap lines or pooled reserves. In both systems, the availability of financing from within the group had helped take those countries out of the IMF sphere of influence by obviating the need to borrow. Peer review might help a little, but peer financing would do much more. Regardless of whether Camdessus intended the one to encompass the other, the extension seemed logical to at least some of the officials around the table.

ASEAN officials resumed discussion of the idea at their next meeting, in Phuket, Thailand, in March 1997. Again, Camdessus was invited to participate. Presciently—the crisis was still a few months in the future—the finance ministers engaged the Managing Director in a dialogue about the IMF's potential response in the event of a "Mexican-style" financial crisis. Some among them worried that the Fund might be less engaged in their region than it had been in rescuing a large country next door to the United States. Camdessus assured them that the Fund's assistance was universally available. He then went on to say, "Just as the Fund's role in the case of Mexico had been decisive because of the support of other creditors, so the Fund's role could be

[103]This account of the conference is based primarily on interviews with participants. The official proceedings were published as Hicklin, Robinson, and Singh (1997), but the discussions of interest here took place outside the formal structure.

stronger in the event of an Asian crisis if Asian nations provided complementary financial support to each other."[104]

To Camdessus, the critical word in that advice was "complementary," meaning that intraregional financial assistance should help support a program that was primarily supported by the IMF and subject to policy conditionality. If, for example, Thailand were to request a stand-by arrangement from the IMF, the program would be more likely to succeed if Japan, Korea, and other developed countries could provide supplementary financing, much as the United States and other countries had done through joint participation in the workout of the Mexican crisis in 1995. The implicit primacy of the IMF in such a process no doubt came more naturally to the Managing Director than it did to the Asian officials in Phuket.

The urgency of a regional process intensified dramatically after the outbreak of the crisis in Thailand in July 1997. As described in Chapter 11, p. 509, the IMF and the Japanese finance ministry cohosted a "Friends of Thailand" meeting in Tokyo on August 11, at which eight central banks or national government agencies and three multilateral institutions assembled a support package totaling $16 billion. Although the IMF provided a quarter of that total, it was now abundantly clear to all that if any East Asian country needed financial assistance, they would have to band together to provide the bulk of the money jointly.

From that moment, Eisuke Sakakibara, Japan's vice minister of finance, embarked on a quest to establish the AMF, not necessarily as a supplement to IMF money but as a possible substitute for it. That twist would mean that the regional fund would not just ensure adequate financial support but also that the IMF's policy conditions might be avoided.[105] The staff at the finance ministry hastily drafted a proposal, which Sakakibara then shopped to his counterparts around Asia, to the U.S. Treasury, and to the IMF during the rest of August and September. This effort culminated in meetings of Asian ministers and governors during the IMF/World Bank Annual Meetings in Hong Kong SAR in the third week of September. At each stop along the way, Sakakibara received a polite reception, encouraging him that the proposal would eventually carry the day. Initially, he believed—incorrectly—that both Camdessus and Lawrence Summers were on board. In fact, both were strongly opposed. Even among Asian officials, support was both shallow and thin. By the time the Hong Kong SAR meetings ended, the effort to establish the AMF was effectively dead.[106]

[104]Report by Camdessus to the Executive Board; minutes of EBM/97/23 (March 12, 1997), p. 62.

[105]Sakakibara later made this point explicitly: "I well understand the criticism that IMF conditionality is too heavily involved. After all, it was the desire to create a policy alternative to the IMF prescription that motivated the proposal to create the AMF" (Sakakibara, 2001). For his complete memoir of the episode, see Sakakibara (2000). For a detailed outside account, see Lee (2006). Lee notes that Japanese officials tended to view excluding the IMF from the arrangement as equivalent to excluding the United States.

[106]For an account of the reaction of Asian creditor countries, see Sheng (2009), Chapter 1. Sheng notes that Sakakibara continued to try to generate support for his proposal until the Manila meeting, which this chapter addresses next.

The Manila Framework Group

Except for a few potential borrowers, most national officials saw independence from the IMF as the poison pill in the AMF proposal. They were attracted to the idea by the goal of establishing an ongoing peer review group, with or without financing. U.S. officials warmed to that design, though only on the understanding that they would be invited to participate. After the failure of the AMF, most everyone thought strongly that the IMF should take the initiative to bring potential creditors and borrowers together to work out a specific alternative plan.

Shortly after Stanley Fischer returned home from the Annual Meetings in Hong Kong SAR, he wrote to Roberto F. de Ocampo, the secretary of finance of the Philippines, to propose establishment of a "regional surveillance group." In this scheme, the IMF would provide a secretariat through its Tokyo office and would participate at a high level. Moreover, Fischer suggested, "it would be desirable" for this new group "to adopt a cooperative financing initiative" on which a participating country with an IMF-supported program could draw to supplement the Fund's own resources when needed.[107]

De Ocampo responded by convening a meeting in Manila, to be attended by finance deputies from the East Asia and Pacific region plus representatives from North America, major European countries, the IMF, the Asian Development Bank, and the World Bank. By the time the meeting was held, on November 18–19, 1997, the deputies from Japan and the United States had already agreed bilaterally on a draft communiqué. After two days of talks, the delegates endorsed that draft with minor changes. The outcome was the establishment of the Manila Framework Group (MFG) with 14 member countries from both sides of the Pacific Ocean but no permanent secretariat. The communiqué endorsed the idea of a supplemental financing mechanism, though without any specific proposals for creating one.[108]

The MFG met semiannually for the next seven years to discuss regional financial issues. The need for regional financing did not arise during this period. Eventually, the group proved to be too unwieldy to have much relevance, and it disbanded in 2004.

The stillborn AMF and the ill-fated MFG were but two of several efforts by East Asian countries to establish an effective mechanism for regional economic and financial cooperation. ASEAN, the long-standing forum for finance officials of Southeast

[107]"Philippines—Communication from the First Deputy Managing Director," EBD/97/126 (November 5, 1997).

[108]"A New Framework for Enhanced Asian Regional Cooperation to Promote Financial Stability," Meeting of Asian Finance and Central Bank Deputies: Agreed Summary of Discussions, Manila, Philippines, November 18–19, 1997; accessed at http://www.mof.go.jp/english//if/if000a.htm. An abridged version of the communiqué was published in *IMF Survey*, Vol. 26 (December 1, 1997), p. 371. The members of the MFG were Australia, Brunei Darussalam, Canada, China, Hong Kong SAR, Indonesia, Japan, Korea, Malaysia, New Zealand, the Philippines, Singapore, Thailand, and the United States.

Asian countries, expanded its membership and included other Asian countries by meeting as "ASEAN Plus." By the late 1990s, senior officials of 11 central banks were also meeting regularly as the Executives' Meeting of East Asia-Pacific Central Banks. The APEC forum provided a summit framework at a broader regional level. After the end of the 1990s, these efforts intensified, notably with the establishment of regional swap lines through the Chiang Mai Initiative (Henning, 2002).

Despite all these initiatives, and despite many East Asian leaders' continuing disaffection with the IMF as a crisis manager and general policy advisor, no viable alternative emerged to replace the IMF in these roles. Instead, vulnerable countries set out to accumulate foreign exchange reserves in unprecedented and costly amounts in an effort to avoid ever having to borrow from the Fund again. More than a decade after the Asian crisis ended, the legacy of fear and uncertainty it engendered was scarcely diminished.

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IV

The IMF and Low-Income Countries

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13

Policies for Development: From Structural Adjustment to Poverty Reduction and Growth

A WORLD WHERE SOME LIVE IN COMFORT AND PLENTY, WHILE HALF OF THE HUMAN RACE lives on less than $2 a day, is neither just nor stable. Including all of the world's poor in an expanding circle of development—and opportunity—is a moral imperative.

George W. Bush
President of the United States
September, 2002

I SEE THE THRUST OF THE IMF'S ROLE IN TWO MAJOR DIRECTIONS; FIRST TO ENSURE THE smooth functioning of the international financial system and avoid financial crises, and second, assist low-income countries in fighting poverty and in integrating into the world economy. In this regard, I welcome the many initiatives that are underway.

Trevor A. Manuel[1]
Finance Minister of South Africa
September 26, 1999

The IMF was not designed as a development agency, nor does its mandate include the provision of development assistance. The Fund does, however, have as one of its purposes to "facilitate the expansion and balanced growth of international trade, and contribute thereby . . . to the development of the productive resources of all members."[2] From the beginning of its work with its member countries in 1946, the Fund has had to find the right balance between limiting its focus to macroeconomics and international finance and ensuring that this focus contributes to economic growth and sustainable development.

This balance is nowhere more delicately poised than in the Fund's relations with low-income countries. They primarily need external financial support for development in the form of grants or heavily subsidized long-term loans. Such support typically

[1]Statement to the Interim Committee (September 26, 1999); accessed at http://www.imf.org/external/am/1999/icstate/zaf.htm.

[2]IMF Articles of Agreement I(ii).

comes from the development agencies of wealthy countries ("bilateral" aid) and from multilateral agencies such as the World Bank and regional development banks. The IMF's role is to assist recipient countries to establish economic conditions that will optimize their ability to put development aid to good use and increase their ability to develop economically. In that context, a clean division between sound finance, a stable macroeconomy, and a sustainable international payments position on the one hand, and sustainable economic development and poverty reduction on the other, is neither logical nor possible. Poor countries cannot grow without stable economic foundations, and they cannot stabilize their economies for long without the means to develop.

At the outset, the Fund took the view that countries should borrow from it only to satisfy an immediate and very short-term balance of payments need arising from a shortage of the currency being borrowed. When Ethiopia—one of the world's least-developed countries—made the first request by any member to borrow from the Fund, in April 1947, the Executive Board reacted skeptically. Several Directors suspected that Ethiopia's need for dollars was neither immediate nor so temporary as to qualify for an IMF loan. The Board tabled the request pending further justification, and the matter lapsed.[3]

In the 1960s and 1970s, the number of low-income member countries in the IMF grew rapidly as a consequence of the end of the era of colonial rule. In response, the Fund established a number of special facilities open to all members but designed primarily to assist low-income and other developing countries. These innovations included the Compensatory Financing Facility in 1963, the Buffer Stock Financing Facility in 1969, the Extended Fund Facility (EFF) in 1974, the Oil Facility Subsidy Account in 1975, and the Trust Fund in 1976. These facilities were tailored to the needs of the poor—in some cases, by providing longer-term, less expensive loans; in others, by helping to cover the costs of the kinds of temporary shocks that hit poor countries the hardest. Although they certainly helped within their own narrow confines, the total impact of these facilities on financial stabilization, not to mention economic development, was limited.

In the 1980s, the IMF made a more concentrated and sustained effort to direct its work toward the needs of its low-income members, which by then totaled about 80 countries, or more than 40 percent of the membership. At first, this effort included softening the policy conditions on loans to countries that lacked the ability to carry out fully articulated reform programs. By the middle of the decade, this easing, which had been at least partly unintentional, was clearly only prolonging the structural adjustments these countries needed to undertake. More fundamentally, many low-income countries found themselves excessively burdened with external debt. Loans from the Fund were, in most cases, a very small part of the total, but lending to the poor on the same financial terms as to middle-income countries no longer seemed reasonable. Beginning in 1986, the Fund commenced lending through a new program, the Structural

[3]Minutes of Executive Board meetings 162 and 163 (April 23 and 24, 1947). Also see Horsefield (1969), pp. 189–90.

Adjustment Facility (SAF). In 1987, the SAF was supplemented by the Enhanced SAF, or ESAF. These new facilities not only made long-term, low-interest loans—they also were designed to support structural reform agendas suited to the needs of the poor.[4]

By 1990, the IMF's commitment to deep and broad engagement with low-income countries and to reducing poverty throughout the world was well established. In a report to the Development Committee that year, the staff elevated this commitment to a central principle:

> The primary role of the Fund is to promote, through its bilateral and multilateral surveillance, technical assistance, and financial support, sustainable growth of output and employment in its member countries and an open system of international trade and payments, thus helping create the conditions for lasting poverty reduction.[5]

To achieve that objective, the report pledged the institution to address the causes of poverty, including by

> efforts to . . . encourage member countries to . . . introduce targeted expenditures and social safety nets where necessary; . . . and, in consultation with the [World] Bank, catalyze external financial assistance for economic programs, in particular, for well-designed measures to mitigate any short-run adverse impact of such programs on the poor.[6]

For the next several years, the Fund devoted considerable effort to ensuring that Fund-supported programs included such mitigation measures wherever possible, although its ability to do so was circumscribed by its mandate and expertise in this area. If the authorities resisted targeting the poor in their expenditure choices, the Fund had little authority to force the issue. Moreover, the World Bank clearly had the lead role in advising countries on poverty-related structural policies. Within those limits, the Fund continued to press governments to take the issue seriously, and by mid-decade the staff believed it was making major progress.[7]

Meanwhile, hard questions were being raised, both inside and outside the institution, about the effectiveness of the SAF and the ESAF. Were they large enough and properly designed to serve their intended clientele? Were the policy conditions, with a heavy emphasis on a kind of structural adjustment perceived as emanating from Washington more than from the developing world, appropriate for this purpose? Was

[4]These developments in the 1980s are covered in Boughton (2001), Chapter 14. A major part of the rationale for lending to low-income countries through special trust funds such as the ESAF was that the IMF's Articles of Agreement do not permit differential pricing for the use of the Fund's general resources based on a country's income level.

[5]"Strategies for the Effective Reduction of Poverty in the 1990s," EB/CW/DC/90/9 (August 10, 1990), p. 7.

[6]"Strategies for the Effective Reduction of Poverty in the 1990s," EB/CW/DC/90/9 (August 10, 1990), p. 8.

[7]See "Social Safety Nets in Economic Reform," EBS/93/34 (March 4, 1993); minutes of EBM/93/79 (June 2, 1993), at which that paper was discussed; and "Social Dimensions of the IMF's Policy Dialogue," SM/95/13 (January 19, 1995). For a longer-term analysis of the early evolution of the Fund's work on poverty issues, see Bernstein and Boughton (1993); and Boughton (2001), pp. 687–701.

the IMF the right agency to be operating these facilities? As the decade progressed, the Fund responded in ways that deepened and broadened its involvement still further. By 1999, although the questions and the attacks continued, not least from a host of non-governmental organizations (NGOs) working in low-income countries, it did not seem so unusual for the finance minister of South Africa to state that to "assist low-income countries in fighting poverty and in integrating into the world economy" was a fundamental function for the IMF.

This chapter recounts the ways in which the IMF's role expanded in the 1990s, focusing on four dimensions in particular. First, the ESAF was transformed from a modestly sized temporary lending window into a permanent and much larger fund. Second, the goal of ESAF lending was expanded to make sustained economic development and the reduction of poverty a more explicit and central target. Third, at mid-decade the IMF accepted that it should participate actively in a coordinated effort to reduce the debt burdens of the most heavily indebted poor countries. Fourth, the Fund engaged in innovative techniques to raise funds for these activities at a time when major creditor countries were reluctant to tap their own national budgets. In addition to these programs directed specifically at low-income countries, the Fund introduced or expanded other programs that benefited these countries principally though not exclusively. Those programs, including postconflict assistance and natural disaster relief, are discussed in Chapter 5.

Evolution of Concessional Lending

As a lending institution, the IMF was designed to enable it to charge interest rates that would cover its expenses, including both its cost of funds and its administrative budget. Although not subsidized, those rates typically were below market rates for most borrowers, because the IMF was not a profit-seeking institution and because its central role in the international financial system conferred a low risk of incurring losses. Even so, for many low-income countries, the Fund's standard rate of charge was still so high that their debt-service obligations could severely squeeze government budgets. Moreover, a basic sense of fairness dictated that the poorest countries should not be expected to pay as much as those with more advanced economies. Consequently, in the mid-1970s the IMF began looking for ways to reduce interest charges and other terms for its poorest members to very low ("concessional") levels.[8]

[8]In general, "concessional" refers to any loan on terms more favorable than commercial terms. In the IMF context, it refers to lending on terms (interest rate, maturity, and grace period on repayments) that are more favorable than those available to all members. In analyses of official development assistance, lending is considered concessional only if it is more favorable by a specified margin, which in the period covered here was generally 35 percent. That margin is often referred to as a "grant element"; that is, any concessional loan is equivalent to a weighted average of a grant and a loan on commercial terms. As long as the weight on the imputed grant element is at least 35 percent, then the loan qualifies as concessional.

By selling a portion of its gold holdings and soliciting contributions from donor countries, the IMF established pools of resources that could be lent to low-income countries on concessional terms or used to subsidize the interest charges on conventional loans. That shift began with the creation of a subsidy account for the Oil Facility in 1975 and continued on a much larger scale with the establishment of the Trust Fund, through which the IMF made concessional loans from 1977 through 1981. Both of those facilities entailed relatively light conditionality as well as low cost.

The IMF reinvested reflows from Trust Fund loans in a new account that funded the SAF, which began operations in 1986. When Michel Camdessus became Managing Director in 1987, he initiated a drive to raise more funds for this purpose from donors and creditors. Those funds effectively tripled the resources available for concessional lending and enabled the Fund to establish the ESAF later that year.[9] The SAF continued the low-cost structure of the Trust Fund, but it reintroduced policy conditionality similar to but less formal than that of arrangements financed through the IMF's General Resources Account (GRA). ESAF conditionality was similar to that for EFF arrangements.

When the ESAF began operations in 1988, 62 countries were deemed eligible to borrow from it. Of those, the two largest—China and India, together accounting for more than half of the total quota of the group—indicated from the outset that they did not intend to draw on the facility because they wanted to leave enough money for the rest. In the early 1990s, the Fund decided it could expand the pool of eligible countries without spreading the available funds too thinly.

The primary criterion for ESAF eligibility was the World Bank's determination that the country's per capita income and lack of access to other sources of external finance made it eligible for concessional loans from the International Development Association (IDA) of the World Bank Group. The IMF Executive Board, however, retained the right to depart from the Bank's list at any time. Over time, the Fund's list grew to 80 (Table 13.1), including several countries not eligible for purely concessional World Bank loans. About half of the countries on the list were in Africa, but the geographic diversity of the rest illustrates the continued ubiquity of extreme poverty at the end of the second millennium.

The big push to lengthen the list came in 1992, when the Fund added 11 countries. Two of those (Albania and Mongolia) were new members of the Fund. The others were granted eligibility as part of a general effort by the Fund to include countries that had been near the borderline in the 1980s and whose economic conditions were similar to countries already on the list.[10] A second group of new members, all from the former Soviet Union, was added in December 1993. A few more countries were added in the next three years. Cameroon and the Republic of Congo were made eligible after the devaluation of the CFA franc (see Chapter 14). Near the end of the decade, the Fund

[9]These developments are described in more detail in Boughton (2001), Chapter 14.

[10]See "Expansion of SAF/ESAF Eligibility," EBS/92/22 (February 11, 1992).

Table 13.1. Low-Income Countries: Members Eligible for ESAF Loans in the 1990s

Country	Added	Country	Added
Africa (42 countries)		Middle East and Central Asia (8 countries)	
Angola	4/7/1992	*Afghanistan*	
Benin		**Armenia**	12/15/1993
Burkina Faso		**Azerbaijan**	5/30/1995
Burundi		**Georgia**	12/15/1993
Cameroon	2/23/1994	**Kyrgyz Republic**	12/15/1993
Cape Verde		Pakistan	
Central African Rep.		**Tajikistan**	12/15/1993
Chad		Yemen, Rep. of	
Comoros		Other Asia (18 countries)	
Congo, Dem. Rep. of		Bangladesh	
Congo, Rep. of	5/30/1995	*Bhutan*	
Côte d'Ivoire	4/7/1992	Cambodia	
Djibouti		*China*[b]	
Egypt	4/7/1992	*India*[b]	
Equatorial Guinea		*Kiribati*	
Eritrea	1/5/1995	Lao PDR	
Ethiopia		*Maldives*	
Gambia, The		**Mongolia**	4/7/1992
Ghana		*Myanmar*	
Guinea		Nepal	
Guinea-Bissau		Philippines[c]	4/7/1992
Kenya		*Samoa*	
Lesotho		*Solomon Islands*	
Liberia[a]		Sri Lanka	
Madagascar		*Tonga*	
Malawi		*Vanuatu*	
Mali		Vietnam	
Mauritania		Europe (4 countries)	
Mozambique		**Albania**	4/7/1992
Niger		***Bosnia and Herzegovina***	8/19/1996
Nigeria	4/7/1992	**Macedonia, FYR**	2/23/1994
Rwanda		**Moldova**	3/23/1999
São Tomé and Príncipe		Western Hemisphere (11 countries)	
Senegal		Bolivia	
Sierra Leone		Dominica	
Somalia		*Dominican Republic*[c]	4/7/1992
Sudan[a]		Grenada	
Tanzania		Guyana	
Togo		Haiti	
Uganda		Honduras	4/7/1992
Zambia		Nicaragua	4/7/1992
Zimbabwe	4/7/1992	*St. Kitts and Nevis*[c]	
		St. Lucia	
		St. Vincent and the Grenadines	

Source: IMF staff reports.

Note: Countries listed in bold type were new members in the 1990s. Those shown in italics did not have a SAF or ESAF arrangement in the period through 1999.

[a]Ineligible owing to arrears to the IMF.

[b]Volunteered to forgo borrowing.

[c]Removed on December 26, 1995, after recording increases in per capita incomes.

added Moldova to the list after a sizeable downward adjustment in the estimate of its per capita income.

The good economic growth of a few countries prompted the Fund to remove them from the ESAF eligibility list. The Philippines was added in February 1992, even though it was already strengthening its economy and regaining market access (see Chapter 12). At the time, it was borrowing through the GRA under a stand-by arrangement, which expired in March 1993. In 1994, although it could have borrowed from the ESAF, it chose to request an EFF arrangement and borrow on nonconcessional terms. Similarly, not long after the Dominican Republic was added in 1992, it underwent a strong economic recovery driven by the completion of a debt-restructuring agreement with commercial bank creditors and implementation of a GRA-supported adjustment program. Per capita income increased sufficiently to put it well above the threshold again. In December 1995, the Fund graduated those two countries and the small island country of St. Kitts and Nevis, none of which had ever borrowed from the SAF or the ESAF.[11]

The Original Temporary ESAF, 1987–93

In the late 1980s, the structural adjustment facilities got off to a slow start. The SAF, although popular with borrowers because of the relatively light policy conditions attached to its use, had limited resources. The ESAF offered larger loans, but it imposed more daunting hurdles in that countries had to meet upper-credit-tranche conditionality similar to that in the nonconcessional EFF. The staff was reluctant to recommend approval of weak programs, while countries were reluctant to subject themselves to the tough conditions. Moreover, other official creditors that linked their approval to implementation of an IMF-supported program, including the World Bank and the Paris Club, were usually satisfied if a country had a SAF-supported program. Given that qualifying for ESAF assistance seemed unlikely to catalyze any more outside financial support than the less stringent SAF, the authorities in many eligible countries considered the extra effort scarcely worthwhile.[12]

For a time, it looked as if the extra effort really was not worthwhile. A 1990 staff review of the SAF and ESAF found that many of the countries that had completed SAF-supported programs had fallen short of program targets for inflation control and external balance. Those same countries, however, had shown somewhat larger increases in economic growth than other low-income countries. If an economy could grow well with a relatively weak effort, why should the authorities subject themselves

[11]See "ESAF Eligibility—Dominican Republic, Philippines, and St. Kitts and Nevis," EBS/95/207 (December 5, 1995); and Decision No. 11181-(96/1) SAF, adopted December 26, 1995.

[12]"Structural Adjustment Facility (SAF) and Enhanced Structural Adjustment Facility (ESAF)—Review of Operations," EBS/90/106 (June 12, 1990), pp. 3 and 6.

to more stringent conditions? The staff view was that this good growth performance, which covered just a few years, would not be sustained without a stepped-up commitment to sound policies and the more intensive monitoring embodied in the ESAF.[13]

The IMF thus faced three interrelated challenges at the beginning of the 1990s for making its lending to low-income countries more effective. First, more countries needed to have strong enough policies to qualify for ESAF rather than just SAF support. That would make larger loans available to them—but first they would have to strengthen their economic policy programs. Second, the staff was looking for ways to reduce the qualification hurdles by making the facility more flexible and accessible. Third, the Fund had to attract more contributions to the ESAF so that countries qualifying for support from the facility could get greater access over a longer period.

The original intent of the ESAF was that it would be a temporary facility through which an eligible country could borrow under one three-year program and the Fund would complete all of its commitments within two years of the establishment of the trust. The access limit was set rather low in relation to each country's quota, on the assumption that most eligible countries would draw on the facility and the available money would therefore have to be stretched over a large number of borrowers. Repeat arrangements would be impractical, not only because the IMF had never had a mandate to provide continuing long-term financing but also because much of the donor financing for the ESAF was provided only for a fixed period. As a result, and even though the sunset clause had already been extended by a year, in 1990 management was trying to get approval for as many arrangements as possible before the November deadline. When it became apparent that the difficulty of getting agreements on programs to be supported by the ESAF was making this deadline unrealistic, the Executive Board extended the cutoff date repeatedly, first to November 1992, then for another two years,[14] until ultimately the ESAF could be converted into a permanent ("self-sustaining") facility.[15]

The first country to get an extension beyond the original three-year commitment was Bolivia. Its ESAF arrangement was approved in July 1988 and was later extended from its original expiration of July 1991, initially to mid-1992.[16] That extension, though, was not a fourth annual arrangement, just a delay in completion of the third year's program. On June 12, 1992, the Executive Board agreed in principle to consider

[13]"Structural Adjustment Facility (SAF) and Enhanced Structural Adjustment Facility (ESAF)—Review of Operations." EBS/90/106 (June 12, 1990), pp. 9–12.

[14]The cutoff dates refer to the deadline for the IMF's approval of an ESAF arrangement. For an arrangement approved on November 30, 1989 (the original cutoff date), disbursements could be made up to November 30, 1992. The principal outstanding would be amortized over a 10-year maturity, or potentially through November 2002.

[15]Self-sustaining meant that the ESAF Trust would have sufficient resources to lend a specified amount of money on a continuing basis, based on the availability of committed funds and assuming full and timely repayments from borrowers.

[16]For the history of relations with Bolivia in the 1980s, see Boughton (2001), pp. 484–90.

a fourth annual arrangement, which was approved on September 11, 1992, extending the arrangement to September 1993.[17] When it was about to expire, the Board extended the "fourth year" to May 1994, nearly six years after the arrangement's initial approval. A new ESAF arrangement succeeded it in December 1994. That arrangement also was extended until finally expiring in September 1998. Bolivia was granted a third arrangement, scheduled to run from September 1998 through September 2001 but later extended to June 2002. Finally, a fourth consecutive arrangement ran from April 2003 to March 2006, the only one in the series that was completed successfully and on time.

In all, Bolivia had virtually continuous ESAF support for 18 years. Although longer than for most other countries, this experience illustrates the difficulty many low-income countries faced in achieving a sustainable payments position.[18] In 1992, however, the Fund was still hoping to phase out its practice of offering long-term loans on concessional terms.

The Successor ESAF, 1994–96

When the major donor countries realized that many low-income countries were going to need both concessional support and externally monitored adjustment and reform programs for extended periods, they asked the Fund to explore ways to extend the life of the ESAF substantially.[19] Most people working on the issue in the Fund did not yet think that a permanent ESAF was either appropriate or necessary. Although financial viability remained a distant dream for many of the poorest countries, the staff calculated in 1993 that a multiyear extension of the ESAF could eventually make that dream a reality for most, after which the facility could be shut down and lenders to the trust could be repaid.[20]

Consideration of whether to keep extending the life of the ESAF hinged on two key questions. Was the facility working well and achieving its objectives? And was it

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[17]In the terminology used by the Fund, an ESAF "arrangement" referred both to the overall (normally three-year) commitment to provide loans, conditional on the country satisfying the specified terms, and to each annual commitment and its associated conditions.

[18]The longest-running series of ESAF arrangements was for Mauritania, which had its first arrangement approved in May 1989 and then had nearly continuous arrangements running through 2009.

[19]"We call for an early decision by the IMF on the extension for one year of the Enhanced Structural Adjustment Facility and for the full examination of options for the subsequent period, including a renewal of the facility"; Economic Declaration of the G7 Summit at Munich (July 6–8, 1992), paragraph 20; accessed at http://www.g7.utoronto.ca/summit/1992munich/communique/index.html.

[20]The language chosen by the staff to express this hope was circumspect, but the meaning was plain: "There is, thus, a real need and opportunity to continue and accelerate the process of structural reform and macroeconomic adjustment which, together with continued concessional assistance and related debt relief, could be expected to accelerate countries' progress toward external viability"; "Operational Modalities and Funding Alternatives for an ESAF Successor—Preliminary Considerations," EBS/93/32 (February 26, 1993), p. 11.

appropriate for the IMF to lend repeatedly to countries that were far from being able to manage on their own, effectively turning the Fund into a provider of financing for development purposes?

The staff's own review of the ESAF in 1993 showed that the facility was working—most countries with ESAF-supported programs were seeing higher growth in exports and output with less price inflation than were other low-income countries. On the whole, they were receiving above-average increases in official development aid and were showing progress in liberalizing economic policies. About half of the 19 ESAF-supported countries were making headway toward achieving external financial viability, although none had yet met that goal (Schadler and others, 1993, pp. 22–29). These achievements, though modest, were nonetheless impressive because of the daunting initial conditions. These countries were among the least developed in the world, and global market conditions had worsened substantially during the period being reviewed by the staff.

This distinction between making progress toward external viability and actually achieving it differentiated the ESAF from the IMF's other longer-term facility, the EFF. The latter, funded by the IMF's general resources, was available to all members and did not make concessional loans, but the conditions on its use were otherwise similar to those of the ESAF. The distinction was that most countries eligible for concessional loans were heavily in debt; had very high external debt-service obligations in relation to export revenues; and were able to avoid default only by having recurring recourse to "exceptional financing," such as debt cancellations or rescheduling agreements. Even if they faithfully carried out an adjustment and reform program equal to one typically expected of a middle-income borrower, expecting them to stabilize the debt burden and escape from reliance on exceptional financing within the three-year term of a Fund-supported arrangement was not realistic. Hence the ESAF, in contrast to the EFF, required only that the applicant's program be designed to result in an expectation of progress toward viability.[21]

Although the second question—whether an ongoing ESAF was an appropriate activity for the IMF—was handled primarily as a normative and political issue, the inherent contradictions in the original design of the facility complicated the issue. If the eligible countries were not expected to achieve external viability by the end of a three-year arrangement, then the Fund could not reasonably expect to cut them off from ESAF support after one arrangement. Logic dictated the need for a quasi-permanent facility, but two obstacles intervened. First, donors and lenders to the ESAF Trust were not yet prepared to provide enough resources to fund it on an ongoing basis. Second, some major creditor countries were skeptical that the IMF—rather than an aid agency such as the World Bank—was the right organization to host such a facility.

[21]See remarks by Jack Boorman (Director, Policy Development and Review Department) at EBM/93/46 (April 2, 1993), p. 7.

Notwithstanding these concerns, by the time the Executive Board began to debate whether and how to establish a successor facility, the idea already had a strong political tailwind. The endorsement of a continuation by the Group of Seven (G7) summit in 1992 (see above, footnote 19) was accepted by most Directors as an *obiter dictum*. Although one G7 Director (Bernd Esdar, Alternate for Germany) stated in March 1993 that his authorities had "not yet come to a final conclusion," other skeptical Directors acknowledged that "the political decisions on having an ESAF successor have already been taken" (Godert A. Posthumus, the Netherlands).[22]

The real issue, then, was not whether to continue ESAF lending, but the way in which it should be structured and financed. After some debate, the Board decided to rely mostly on a new appeal to donors to contribute larger amounts of money and for an extended period. In addition, agreement was reached that the Fund would end the practice of supplementing ESAF arrangements with SAF arrangements. Instead, part of the balance in the account funding the SAF would be transferred to the ESAF Trust. A residual had to be retained to enable SAF loans to two countries—Sierra Leone and Zambia—that would be eligible once they completed Rights Accumulation Programs and cleared their arrears to the Fund (see Chapter 16). In the long run, all SAF resources were to be transferred to the ESAF Trust.[23] With this change, the Fund quietly ended the practice of having a relatively lightly conditioned facility to accommodate the needs of countries that could not yet qualify for ESAF support.

The successor ESAF took effect on February 23, 1994. With about $6.4 billion (SDR 4.5 billion) in assets, it was roughly 40 percent larger than the original ESAF. It would make loans on exactly the same terms, and it remained a temporary facility. The decision establishing it set a deadline of end-1996 for loan commitments and end-1999 for disbursements. The decision also implicitly enabled the Fund to approve a second three-year ESAF arrangement for any country that had already completed one under the original facility, but the intention remained that each country would have no more than one such arrangement under the successor.[24] Within a year, however, Camdessus had the staff exploring ways to create a permanent ESAF.

The "Permanent" ESAF, 1996–99

Initially, both the staff and the Executive Board balked at the Managing Director's suggestion to make the ESAF permanent. A February 1995 staff paper on the debt

[22]Minutes of EBM/93/33 (March 12, 1993), pp. 8 (Esdar) and 46 (Posthumus).

[23]See "ESAF Successor—Modalities and Proposed Decisions for Extension and Enlargement of the ESAF Trust," EBS/93/183 (November 19, 1993); and minutes of EBM/93/162 (November 29, 1993). The main decisions were made at EBM/93/170 (December 15, 1993), conditional on the completion of financing arrangements and approval by ESAF creditors.

[24]The first country to be granted a second full ESAF arrangement was Guyana. Its first arrangement was approved in July 1990 and completed in December 1993 after a brief extension. A new three-year arrangement under the successor facility was approved in July 1994.

service prospects for heavily indebted poor countries concluded that IMF financing on concessional terms "will continue to be required, though, as in the past, the Fund should not be expected to provide such financing on a continuous basis for individual countries or the group as a whole." The staff acknowledged that most of these countries would need further recourse to ESAF loans, but probably not beyond the end of the decade.[25]

The argument that led to this optimistic conclusion was constructed with some weak materials. One was an assumption that the generosity of bilateral assistance to low-income countries would not diminish and that bilateral debt forgiveness would be available on Naples terms (67 percent reduction in net present value). Another was that a favorable combination of economic policies and external market conditions would permit a steady rise in export revenues for low-income countries. When the Executive Board discussed the staff paper, many donor countries cited their own budget problems, indicating they would be hard-pressed to avoid shortfalls in development assistance. Directors also expressed skepticism about the projected growth in exports by low-income countries. At the outset of the Board meeting, Huw Evans (United Kingdom) set the tone by declaring, "It is not prudent to base policy upon such a combination of favorable outcomes. My conclusion is that, for this group of heavily indebted poor countries, there is significant evidence of difficulty in servicing multilateral debts; and that policies need to be developed to alleviate these difficulties."[26]

Evans and several other Directors favored making the ESAF permanent, but the Board as a whole was not yet prepared to take such a step. The majority view was that "it remained appropriate for the Fund to extend [loans on ESAF terms], while respecting the revolving character of our resources and the monetary character of our institution."[27] In other words, the Fund was prepared to extend the ESAF by a few more years, but it still expected that most eligible borrowers would be able to graduate from dependence on it early in the next decade.

As discussed in the "Heavily Indebted Poor Countries Initiative" section of this chapter, the credibility of this optimistic view and the wisdom of the Fund's silo approach to its own role—its insistence on protecting its "monetary character"—came under increasingly severe attack in the course of 1995, especially from NGOs. By the time of the IMF/World Bank Annual Meetings in the fall, the Fund had come to accept that it should participate in an initiative to reduce the debt burdens of those heavily indebted poor countries that were demonstrating willingness and an ability to carry out strong economic policies over a multiyear period. To make that participation feasible, the Fund would have to keep the ESAF operating into the foreseeable future.

[25]"Issues and Developments in Multilateral Debt and Financing for the Heavily Indebted Poor Countries – Preliminary Considerations," SM/95/29 (February 7, 1995). The quotation is from p. 17.
[26]Minutes of EBM/95/19 (February 24, 1995), p. 10.
[27]Summing Up by the Chairman, EBM/95/19 (February 24, 1995), p. 62.

After a year of debate focusing primarily on ways to finance the Fund's involvement, Camdessus sketched out a proposal under which ESAF lending would continue at least through 2004, financed mostly by bilateral contributions to the ESAF Trust Subsidy Account. With this compromise, the sunset clause would be extended by several years but would not be eliminated. If, by 2004, most eligible countries could be judged not to need ESAF financing any longer, the facility could be allowed to lapse. If not, the staff calculated that the total projected assets in the trust, including repayments of earlier loans, should enable the Fund to establish a permanent, self-sustaining ESAF at that time.[28]

From the ESAF to the Poverty Reduction and Growth Facility, 1999

As soon as the quasi-permanent ESAF was in place, the Fund undertook to evaluate more thoroughly the facility's achievements. Was it helping countries gain financial independence and sustainable growth? How could it be improved? The staff completed an internal study in 1997, and an external panel conducted an intensive independent analysis. The Executive Board discussed both reports, after which the staff prepared a distillation of the major findings and made recommendations for change.[29]

In addition to several recommendations to improve the Fund's policy advice and conditionality in ESAF-supported programs, these reviews highlighted a general weakness in program ownership and commitment by national authorities. The internal review reported that 28 out of 36 countries that had undertaken ESAF-supported reform programs had failed to complete the process within or close to the originally scheduled three-year period. It attributed these "significant interruptions" mainly to "factors outside the IMF's control—that is, major political upheavals . . . and flagging commitment" by the authorities (Schadler, 1997, p. 45). The subsequent external review, however, found that a major part of the problem arose from the way the staff was interacting with national authorities in low-income countries.

In principle, policy strategies were supposed to be devised jointly and cooperatively by the authorities of the country and the staffs of the IMF and the World Bank. In practice, in the belief that it was the only way to get agreement on a viable program,

[28]Minutes of EBM/96/58 (June 19, 1996), and "Financing a Continuation of the ESAF and the Fund's Participation in the HIPC Initiative," EBS/96/133 (August 23, 1996). On December 9, 1996, the Executive Board formally adopted a slightly modified proposal to extend the commitment period through 2000, so that ESAF lending could continue through 2003; see "Enhanced Structural Adjustment Facility Trust—Extension of Commitment Period," EBS/96/180 (November 26, 1996), and minutes of EBM/96/110 (December 11, 1996), pp. 3–4.

[29]For the published versions of the evaluation studies, see Schadler (1997) and IMF (1998). The head of the external review committee that prepared the core of the latter report was Kwesi Botchwey (former finance minister of Ghana). Also see "Distilling the Lessons from the ESAF Reviews" (July 1998); accessed at http://www.imf.org/external/pubs/ft/distill/index.HTM.

the IMF staff often took the heavy-handed tactic of preparing a draft program in Washington and then discussing possible modifications with the authorities. The resulting strategy was embodied in a Policy Framework Paper (PFP) intended to present the country's own views. ESAF lending by the Fund and associated concessional lending by the World Bank were supposed to serve the country's goals expressed in the PFP. The external review found, however, that officials in low-income countries had become thoroughly disillusioned with a process that had been initiated with such promise a decade earlier:

> The predominant view is that . . . [preparation of] the PFP . . . has become a rather routine process whereby the Fund brings uniform drafts (with spaces to be filled in) from Washington, in which even matters of language and form are cast in colorless stone. . . . Many interviewees . . . found this atrophying of the PFP process to be particularly regrettable. (IMF, 1998, p. 36)

The most serious implication of this deterioration was that it tended to undermine the domestic political process through which policies should normally be formulated. To the extent that the government was agreeing to do whatever was necessary to satisfy the IMF's requirements for approving the ESAF arrangement, domestic political support for taking difficult measures was unlikely to be forthcoming, and the government was unlikely to have any real commitment to work on the task. Generating effective development strategies in ways that would lead national authorities and citizens to own them and take responsibility for them thus became a central theme of the effort to improve the track record of the ESAF.

Meanwhile, the World Bank was moving in the same direction. The President of the Bank Group, James D. Wolfensohn, averred in his Annual Meetings speech in 1998 that "we need a new development framework . . . that is not imposed by us on our clients but developed by them with our help."[30] To that end, the Bank committed itself to assisting each of its borrowing countries to prepare a Comprehensive Development Framework to define the country's development goals and the broad strategy it intended to adopt to achieve those goals.

These deliberations in the Fund and the Bank resulted in a decision to scrap PFPs altogether and to replace them with Poverty Reduction Strategy Papers (PRSPs). Whereas PFPs had been closely linked to the design of ESAF-supported programs, PRSPs would be broader, more comprehensive, and more linked to countries' development plans. The Executive Boards of both institutions would review each PRSP as an essential step preceding approval of loans on concessional terms. In proposing this initiative, the staffs of the Fund and the Bank stressed that each PRSP

> must be produced in a way that includes transparency and broad-based participation in the choice of goals, the formulation of policies and the monitoring of

[30]"The Other Crisis," address to the Board of Governors, Washington, DC, October 6, 1998; accessed at http://go.worldbank.org/UW7XZSD3K0.

> implementation—with ultimate ownership by the government. . . . Governments would be expected to take the lead both in drawing up a PRSP and in conducting consultations with civil society and other stakeholders.[31]

The decision to replace the PFP with the PRSP was more momentous than it might at first appear in that it accelerated an ongoing process of institutional evolution. For several years, the IMF had been taking small but decisive steps toward opening itself up to the outside world. Staff consultation missions were now meeting routinely with a wide array of government agencies and civil society, not just with finance officials. As discussed in Chapter 4, the Fund's archives were now open to outside researchers, and its website was becoming its most prominent means of disseminating information as widely as possible. To insist that low-income countries applying for loans must take the lead in preparing their own policy strategies and that they must do so through a participatory process with their own citizens was a natural but much greater next step. If pursued diligently and aggressively, it would mark a real break with the old ways of interaction between the Fund and its less-developed members.[32]

Improving the ESAF would do little good unless enough money could be raised from donor and creditor countries to finance a continuation of operations. The facility was still expected to begin running out of money near the end of the decade. As that date approached, staff and management intensified their efforts to raise additional funds. As discussed below, that endeavor required some fancy financial engineering as well as lobbying, but it eventually succeeded. By the fall of 1999, the IMF finally had—for the first time in its history—a permanent, self-sustaining facility offering concessional loans and grants to low-income countries.[33]

Endorsing the establishment of a permanent facility, the Interim Committee stressed that it did not want business as usual. Going forward, Fund-supported programs in low-income countries were to aim to promote economic and social development much more proactively than in the past:

> The cornerstones of the new approach, which should continue to be based on sound macroeconomic policies, are as follows:
>
> - A comprehensive Poverty Reduction Strategy Paper (PRSP) will be prepared by each country, with assistance from the World Bank and the IMF, and with strong country ownership based on public partnership, to guide the design of programs; the PRSP will need the approval of both Bank and Fund Boards.

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[31]"HIPC Initiative—Strengthening the Link Between Debt Relief and Poverty Reduction," EBS/99/168 (August 26, 1999), p. 30.

[32]For an early assessment of the way this interaction process worked, see Robb and Scott (2001).

[33]Loans were provided through the ESAF; grants, through the HIPC Initiative. Whether the facility would really be self-sustaining would depend on the demand for loans. As envisaged in 1999, in the long run the trust would be able to lend about SDR 800 million a year. Larger operations would require additional resources; see "Update on Steps to Secure the Financing for the Continuation of the ESAF and the HIPC Initiative," EBS/99/143 (August 2, 1999), pp. 7–8.

- Social and sectoral programs aimed at poverty reduction will be taken fully into account in the design of economic policies for promoting faster sustainable growth.
- Greater emphasis will be accorded to good governance, in particular in all government activities, through greater transparency, effective monitoring procedures, anti-corruption initiatives, accountability, and the involvement of all sectors of society.
- High priority will be accorded to key reform measures critical to achieving governments' social goals.[34]

Through September 1999, discussions for this permanent facility used the same title as for the previous 12 years: the Enhanced Structural Adjustment Facility. In the course of trying to drum up contributions, however, Camdessus learned that a number of potential donors felt that the emphasis on "structural adjustment" was a political liability, making it difficult for them to support it. Consequently, he asked the Executive Board not only to expand the explicit purposes of the facility to include the reduction of poverty, but also to rename it accordingly. With uncharacteristic alacrity for a major policy change, the Fund acted on that proposal in less than two weeks. Securing the written approval of all creditors took another month, and on November 22, 1999, the ESAF vanished and was replaced by the Poverty Reduction and Growth Facility (PRGF).

The 1987 decision establishing the ESAF specified that loans from the trust were intended "to support programs to strengthen substantially and in a sustainable manner [low-income developing members'] balance of payments position and to foster growth." The 1999 amendment extended the final phrase to read, "and to foster durable growth, leading to higher living standards and a reduction in poverty." Although the extent to which the design of PRGF-supported programs differed from earlier ESAF-supported programs was hard to measure and was the subject of much dispute, the name change in combination with the advent of the PRSP process marked a turning point in the Fund's relationships with its poorest and least-developed members.[35]

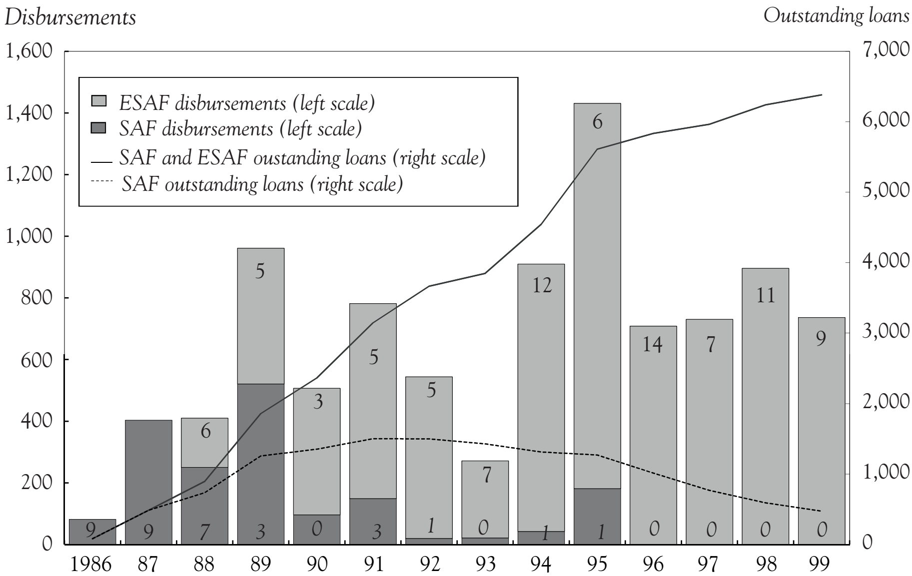
Concessional Lending in the 1990s

As a consequence of the expansion of the ESAF, concessional lending became a more substantial part of the IMF's financial activities in the 1990s (Figure 13.1). From 1986, when SAF lending began, through 1999, 57 countries availed themselves of one or more of the IMF's concessional lending facilities. Of those, 40 had two or more three-year arrangements. From 1997 on, more than half of all IMF lending arrangements in effect were ESAF arrangements. The amounts, however,

[34]Interim Committee communiqué (September 26, 1999), paragraph 5.

[35]The first PRGF loan was to Chad, approved by the Executive Board on January 7, 2000. For an evaluation of the PRGF, see Independent Evaluation Office (2004).

Figure 13.1. Total SAF and ESAF Lending
(In millions of SDRs)



Source: IMF financial accounts.
Note: Numbers at bottom of bars are the number of SAF arrangements approved each year. Numbers at top of bars, if any, are the number of ESAF arrangements approved each year.

remained small relative to the large loans the IMF was making to middle-income, emerging-market countries. At the end of financial year 1999, SAF and ESAF loans outstanding totaled the equivalent of $8.7 billion (SDR 6.4 billion), far below the $82.2 billion (SDR 60.7 billion) in outstanding loans made through stand-by arrangements and other GRA facilities.

Although the majority of ESAF-eligible countries were in sub-Saharan Africa, loans were distributed widely around the world. Of the top ten borrowers in the 1990s (Table 13.2), three were in East Africa (Kenya, Tanzania, and Uganda), two in West Africa (Côte d'Ivoire and Ghana), and one in southern Africa (Zambia). Three were in South Asia (Bangladesh, Sri Lanka, and Pakistan), and one in East Asia (Vietnam). One of the longest program engagements supported by SAF, ESAF, and PRGF lending—continuously from 1986 through 2002—was with Bolivia, in South America.[36]

The largest borrower was Zambia, which drew heavily on both the SAF and the ESAF after it settled its arrears in 1995. Those operations basically replaced Zambia's previous debts to the GRA with longer-term and less expensive obligations (see Chapter 16).

[36]See above, pp. 638–39.

Table 13.2. Top 10 SAF and ESAF Borrowers

Country	Maximum Indebtedness: Millions of SDRs	Maximum Indebtedness: Equivalent Millions of U.S. Dollars	Date Maximum Reached
Zambia	853.4	1,162.9	March 1999
Pakistan	604.5	811.9	April 1998
Bangladesh	534.8	738.2	March 1993
Côte d'Ivoire	457.3	641.2	December 1998
Ghana	429.5	594.7	November 1991
Sri Lanka	427.3	600.0	April 1994
Uganda	294.9	396.1	April 1998
Kenya	277.3	407.9	November 1994
Vietnam	241.6	347.5	December 1996
Tanzania	234.0	319.2	August 1999

Source: IMF financial accounts.

Pakistan borrowed the next largest amount. Throughout the late 1980s and the 1990s, Pakistan was a regular borrower from both the general department and the concessional facilities of the IMF.[37] The Fund's support to the country rose further in 1997 after the election of a new government—led by the Muslim League under Prime Minister Nawaz Sharif—apparently ended a long-simmering political stalemate. That October, the Fund approved an arrangement to support a three-year program of macroeconomic stabilization and comprehensive structural reforms.[38] Despite doubts about the government's ability to carry out the program, the Fund committed more than $1.5 billion (SDR 1,137.3 million) to support it, of which 60 percent was to come from the ESAF Trust. Pakistan's ESAF debt peaked in April 1998 at the end of the first year of that arrangement. Lending was then interrupted for several months as a result of international sanctions responding to a series of test detonations of nuclear devices in May. In addition, the Fund objected to the authorities' insistence on containing capital outflows through exchange controls and a suspension of debt service to external bilateral and commercial creditors. Disbursements resumed in January 1999, but at a lower level, and much of the arrangement was left unused when it expired in October 2000.[39]

[37]For the background to lending to Pakistan in 1988–91, see Boughton (2001), pp. 655–59.

[38]See "Pakistan—Staff Report for the 1997 Article IV Consultation and Request for Arrangements Under the Enhanced Structural Adjustment Facility and the Extended Fund Facility," EBS/97/185 (October 3, 1997); and minutes of EBM/97/104 (October 20, 1997).

[39]On the resumption of lending, see "Pakistan—Staff Report for the 1998 Article IV Consultation, Second Review Under the Extended Arrangement and Request for Waiver of Performance Criteria, Request for the Second Annual Arrangement Under the Enhanced Structural Adjustment Facility, Use of Fund Resources—Request for Purchase Under the Compensatory and Contingency Financing Facility, and Exchange System," EBS/98/231 (December 29, 1998). Pakistan's total indebtedness under the combined arrangement, including both GRA and ESAF obligations, peaked in January 1999 at a level slightly less than $2 billion (SDR 1,405.6 million; 191 percent of the quota that was to take effect the next month). At that time, Pakistan was also completing negotiations for debt-relief agreements with official and commercial creditors (Sturzenegger and Zettelmeyer, 2006, pp. 135–46).

Heavily Indebted Poor Countries Initiative

Debt reduction for heavily indebted developing countries became widely accepted in the late 1980s. At the IMF, as elsewhere, the idea that such countries could grow rapidly enough to service and repay their debts fully had been discredited by 1987. Achieving and sustaining solid growth was not only inherently difficult and time-consuming—time during which the debt continued to accumulate—but if the debt was large enough, its very existence seriously impeded growth. This "debt overhang" discouraged investment and distorted economic incentives. A negotiated reduction in debt was therefore recognized as an integral and unavoidable component of the international debt-management strategy.

From Controversy to Acceptance

The G7 took the first modest step down the path toward debt relief at its summit meeting in Toronto in June 1988, when it agreed to consider debt-service-reduction operations through the Paris Club. Over the next three years, Paris Club creditors used these "Toronto terms" to cancel some $600 million in debt service payments owed by 20 low-income countries.[40]

When the gross insufficiency of the Toronto terms to relieve the excessive debt burdens of the most heavily indebted poor countries (which became known as HIPCs)[41] became clear, the G7 agreed in 1991, at its summit meeting in London, to offer more-generous terms aimed at cutting the net present value of debt repayments by half for qualifying countries. The Paris Club began offering "London terms" to HIPCs that December. When that plan also proved inadequate, the G7 agreed in 1994, at its summit meeting in Naples, to increase the concessionality to 67 percent from 50 percent. Two years later, the target was raised to 80 percent under what became known as the "Lyon terms."[42]

[40]This figure is the reduction in net present value of approximately $6 billion in scheduled debt service payments owed by the 20 countries; see *Annual Report 1992*, p. 41.

[41]The first official use of the acronym HIPC in the Fund was in a joint report by the Fund and the World Bank to the Development Committee in September 1995. The full phrase, "heavily indebted poor countries," was first used in this context by a former Executive Director, Jon Sigurdsson (minister of commerce and industry for Iceland), in a statement to the Interim Committee in April 1993; see minutes of ICMS/MTG/40/93/1 (April 30, 1993), p. 72; and "Progress Report on Multilateral Debt: A Joint Bank/Fund Background Note for the Development Committee," FO/DIS/95/42 (September 27, 1995).

[42]The British government pressed particularly forcefully for improvements on the Toronto terms and its successors throughout the 1990s, beginning with a 1990 proposal for a 67 percent reduction in present values (known as the "Trinidad terms," but not adopted at that time). For more detailed reviews of these developments, see Daseking and Powell (1999); and Rieffel (2003), Chapter 5.

The increasingly generous approach to forgiving bilateral official debt made a substantial difference to the indebted countries, but positive results still depended on improvements in economic performance beyond the reach of many of the world's poorest. Moreover, many of the countries that were beginning to develop more rapidly still faced major problems because they owed a large portion of their external debt to multilateral development banks and to the IMF, not to Paris Club creditors. Until the mid-1990s, multilateral debt was considered "off the table" in discussions of ways to help the HIPCs. No matter how much of their bilateral debt was written off, they were still saddled with more debt than they could afford to repay.

Four reasons were advanced for not considering forgiveness of debts to the IMF:

- First, the multilateral lenders, and the IMF in particular, are de facto preferred creditors. Official bilateral lenders rely on the IMF, with support from the World Bank and regional development banks, to provide primary financial assistance and to ensure that borrowers are using official credits effectively to promote growth and development. Recognizing the importance of this catalytic function, they generally agree to subordinate their own claims. If the IMF were to consider forgiving its own loans, it had to have assurances that its preferred creditor status would be preserved. Forgiving debt to the IMF to enable repayments to bilateral creditors would do little to help the indebted country.
- Second, the financial structure of the IMF generally requires burden sharing between creditor and debtor countries. Unless some means could be found to circumvent that requirement, roughly half of the cost of reducing obligations of low-income countries to the IMF would be borne by other borrowers, many of them nearly as poor as the most heavily indebted.
- Third, the financial assets of the IMF are a revolving fund. Unless the value of the forgiven debt was replenished by contributions from creditor countries, less money would be available for future lending, and the financial integrity of the institution would be threatened.
- Fourth, and most generally, the IMF's greatest concern was that sufficient real resources would flow from rich to poor countries on a continuing basis. If a campaign to forgive debts merely substituted for budgeted new aid funds, then it would have little or no long-run benefits.

The adoption of the Naples terms in 1994 alleviated the first of these objections. If the IMF and the Paris Club could work in tandem to reduce multilateral and bilateral debts, they could ensure that the HIPCs would get the direct benefits, and the Fund's status as a preferred creditor would not be compromised. The problem remained that budgeted bilateral aid—official development assistance (ODA)—was on a declining trend. If creditor countries took advantage of multilateral debt relief by further reducing ODA, the net benefit to the indebted countries could still be nullified. Overcoming that difficulty along with the second and third objections listed above would take a fair bit of ingenuity. Nonetheless, by 1995 the political momentum was shifting favorably because the economic and social imperative of relieving these debts could no longer be overridden.

Throughout the first half of 1995, a massive and widespread public campaign developed to pressure international financial institutions to forgive or at least reduce their claims on poor countries. British NGOs, including Oxfam and Christian Aid, wielded particular influence. Coalitions of northern-hemisphere NGOs formed to lobby for multilateral debt reduction under such banners as the Debt Crisis Network and the Jubilee 2000 Campaign. World religious leaders frequently spoke out about the social evils deriving from excessive debts owed by the very poor. The cumulative effect of this campaign was a heightened awareness of the issue in national legislatures and parliaments, which in turn applied political pressure on countries' representatives in the IMF and other multilateral agencies.

Initially, the staff resisted this pressure because it concluded that only a "very few" HIPCs faced unmanageable multilateral debt burdens. A staff study circulated in February 1995 found that "for all but a very few heavily indebted poor countries, multilateral debt service burdens should be manageable provided new multilateral lending is on appropriately concessional terms and supports, through strong conditionality, a policy framework which generates at least moderate real export growth."[43] Although many on the Executive Board took a dubious view of this optimism, no one disputed the conclusion of Eva Srejber (Sweden): "Any idea of debt forgiveness on behalf of the Fund should be quickly put to rest."[44] As discussed above (p. 642), the Board's focus at that time was on continuing to provide loans on concessional terms, not on forgiving the loans the Fund had already made.

Shortly after that Board meeting, the World Summit for Social Development, held in Copenhagen in March 1995 through the auspices of the United Nations, invited "the international financial institutions to examine innovative approaches to assist low-income countries with a high proportion of multilateral debt, with a view to alleviating their debt burdens."[45] Nonetheless, the Managing Director's April report to the Interim Committee on the ESAF and the HIPC Initiative gave no quarter on multilateral debt relief. Instead, it noted that the Executive Board had concluded the Fund "could best assist [HIPCs] through the continued availability of ESAF resources

[43]"Issues and Developments in Multilateral Debt and Financing for the Heavily Indebted Poor Countries – Preliminary Considerations," SM/95/29 (February 7, 1995), p. 4. The background paper for that conclusion, prepared jointly with World Bank staff, examined the debt burdens of 34 HIPCs in detail. Of those, only eight were projected to have unmanageable debt burdens, and the staffs concluded that even those could be made manageable by shifting some portion of development assistance from concessional multilateral loans to bilateral grants; see "Multilateral Debt of the Heavily Indebted Poor Countries," SM/95/30 (February 9, 1995).

[44]Minutes of EBM/95/19 (February 24, 1995), p. 28.

[45]"Report of the World Summit for Social Development (Copenhagen 6–12 March 1995)," p. 21; accessed at http://www.un.org/documents/ga/conf166/aconf166-9.htm.

on present terms. . . . A few Directors felt that . . . further consideration should be given to the possibility of an extension of maturities."[46]

On a personal level, Camdessus held deep sympathy for the plight of the poor, but he also was determined to preserve the financial strength of the IMF and to continue with the basic strategy of tying financial assistance to improvements in economic policymaking. At the April 1995 meeting of the Development Committee, he implicitly responded to the swelling chorus by asserting that the strategy already in place was sufficient and needed only to be pursued faithfully. For the HIPCs, he stated, "emphasis must be kept on helping them to deal with external debt burdens to the fullest extent possible through attracting foreign direct investment—although this might take time—and through continuation of concessional support in various forms from bilateral and multilateral donors and creditors."[47]

The political balance shifted further in the run-up to the June 1995 summit meeting of G7 countries held in Halifax, Nova Scotia (Canada). The G7 summit concluded that

> measures have to be taken to ensure that the burden of multilateral debt does not impede the growth prospects for the poorest countries. Exit strategies need to be found for countries with particularly high levels of multilateral debt, but with good track records. The IMF and World Bank should take the lead in developing a comprehensive multilateral approach to assist countries with multilateral debt and debt-service ratios above prudent levels in addressing their debt burdens, through the flexible implementation of existing instruments, *and new mechanisms where necessary* [emphasis added].[48]

The initial reaction to that dictum, in both the IMF and the World Bank, was still decidedly negative. Senior officials on both sides of 19th Street believed existing instruments could deal adequately with even the most severely indebted and poorest countries. Moreover, they saw multilateral debt relief as a raid on the institutions' resources by cash-strapped bilateral donors. Such a raid, they believed, would not provide much additional assistance to the poorest countries and would weaken the ability of both institutions to provide ongoing assistance to other developing countries. Soon, however, internal opposition began to soften and then to crumble.

The World Bank's position on multilateral debt relief shifted first, though only a little, not long after Wolfensohn assumed the presidency in June 1995. One of his first acts as President was to travel to Africa, where he met with officials and citizens of five

[46]"Report of the Managing Director to the Interim Committee on Strengthening the Financial Resources of the Fund," ICMS/Doc/44/95/6 (April 21, 1995), p. 12. That section of the report reproduced the Chairman's Summing Up of a Board meeting on the subject held on March 12, the same day the UN summit issued its communiqué.

[47]"Record of Discussion of the Fiftieth Meeting of the Development Committee," DC/95-9 (June 2, 1995), p. 3.

[48]"The Halifax Summit Review of the International Financial Institutions: Background Document," June 16, 1995; accessed at http://www.g7.utoronto.ca/summit/1995halifax/financial/index.html.

countries around the continent. The experience seems to have affected the former investment banker profoundly (Mallaby, 2004). He now believed that multilateral debt relief was essential for at least a dozen of the most affected countries, and he instructed his staff to look for ways to offer that relief. He still insisted, however, that relief should be provided without compromising the Bank's financial principles. In other words, the goal was to provide debt reduction or debt-service reduction (or both) on the Bank's claims without overtly writing down or even rescheduling those claims. To square that circle, the World Bank staff began exploring ways to set up a debt-relief facility for HIPCs outside the Bank, to be funded partly by the Bank and partly by bilateral contributions.[49]

Once Camdessus sensed that the major donor countries could be persuaded to accept the idea, he asked Boorman, as head of the Policy Development and Review Department (PDR), to devise a multilateral debt-relief plan that could be implemented consistently with the Fund's mandate and financial constraints. That reference to the Fund's mandate implied that any such plan would have to have three essential features: First, relief would be conditional on countries' willingness and ability to adopt strong economic policies. Second, relief should be granted only gradually over a period of several years, in response to the strengthening of policies. Third, the proposed debt-relief facility, like the ESAF, could be established within the IMF but would have to be funded primarily by donations and not by the Fund's own resources.

That sketch became the basis for the model that the staffs of the IMF and the World Bank would work out together over the next several months. Throughout the summer, however, Boorman and his staff remained skeptical that the scheme would succeed. As late as September 25, a working draft approved by the Fund team still emphasized the obstacles more than the possibilities. "Bank staff have examined a debt reduction fund that could provide a solution" to the debt overhang problem, it noted. "This proposal, however, raises potential problems including those of moral hazard and the effect on multilateral development banks' balance sheets."[50] Still, both Camdessus and

[49]See memorandum from Boorman to the Managing Director, "Multilateral Debt," July 19, 1995; IMF archives, PDR/AI (Mr. Boorman's files), Accession 1996-0233, B9351. In response to a September 14, 1995, article in the *Financial Times* reporting on a leaked internal discussion paper, the Bank's External Affairs Department informed the Bank staff that Bank management had asked them "to explore alternative options which would . . . provide an exit strategy for poor countries facing an unsustainable debt situation . . . and not undermine the existing financial policies of the international financial institutions, including the Bank's policy not to reschedule or write off debt"; attachment to a note from Boorman to the Managing Director, "Multilateral Debt," September 14, 1995; IMF archives, PDR/AI, Accession 1999-0347.

[50]Attachment to memorandum from Boorman to Masood Ahmed (Director, International Economics Department at the World Bank), "Issues Note on Multilateral Debt," September 25, 1995; IMF archives, PDR/AI, Accession 1999-0347.

Wolfensohn fully supported the proposal.[51] On October 5, they submitted a more upbeat joint report to the Development Committee that countenanced multilateral debt relief, albeit still in quite cautious tones, especially as regards the IMF.

> The work now underway explores whether there is a case for a wider range of approaches and instruments than previously considered that could be developed within these institutional constraints. The work looks to ways to help pay part of the obligations owed to multilateral creditors, for those countries where action by commercial and bilateral creditors is not sufficient to restore debt sustainability. In the case of the IMF, such measures should be consistent with the Fund's Articles of Agreement and its monetary character.[52]

The Managing Director's public remarks to the plenary session of the IMF/World Bank Annual Meetings a few days later conveyed an even stronger commitment that the Fund was prepared to participate in the process.

> The implementation by the Paris Club of the Naples terms for debt reduction is an important contribution to easing the burden of bilateral official debt. We also need to consider very seriously the treatment of the multilateral debt of a small number of highly indebted poor countries. In this regard, you can count on our joint commitment to implement vigorously the important work program that Jim Wolfensohn and I have submitted to the Development Committee.[53]

Next, the initiative needed approval by the Executive Board, several members of which were not yet persuaded of the wisdom or the necessity of forgiving multilateral debt. When the Board first considered a specific proposal, in February 1996, the major donor countries were split. The United Kingdom, the United States, Canada, the Netherlands, and most developing countries were open to the idea, but Germany, Japan, and the Nordic-Baltic group were skeptical. Two key issues emerged.

First, did HIPCs (other than the few most desperate cases) really need multilateral debt relief? Was it reasonable to assume that, in the absence of such relief, heavily indebted and very poor countries could successfully implement the kinds of economic policies needed to restore and maintain good economic growth? The Dean of the Board, Alexandre Kafka (Brazil), summed up the view of many Directors by saying that "no debt relief is useful without strong adjustment policies. But also, no strong adjustment is likely, without debt relief for HIPCs." On the other side, Bernd Esdar (Alternate, Germany) concluded that "the current already very generous set of debt

[51]Perhaps because of the Fund staff's reluctance, the mythology took hold that the initiative came primarily from Wolfensohn, with Camdessus and the IMF as reluctant partners (Mallaby, 2004, pp. 114–15). Internally, senior staff of both institutions came to believe that each of their own groups had originally been in the lead.

[52]"Progress Report on Multilateral Debt," DC/95/16 (October 5, 1995), p. 2.

[53]Address to the Board of Governors (October 10, 1995); accessed at http://www.imf.org/external/np/sec/mds/1995/mds9514.htm.

instruments are fully able to cover the debt problems of highly indebted poor countries."[54]

Second, even if HIPCs were saddled with debilitating debt overhangs, was it appropriate for the IMF to get into the business of debt forgiveness? Srejber adhered to the strong opposition she had expressed earlier (see above, p. 651) and now went even further, arguing that the ESAF should be phased out: "further concessional lending or even debt forgiveness on behalf of the Fund is not in line with the monetary character of the Fund," she concluded. Hachiro Mesaki (Japan) added "that we should avoid any measures that could undermine the creditworthiness of the Fund as a monetary institution."[55]

Despite these misgivings, the political momentum for action continued to build, and Camdessus and Wolfensohn continued to spur their staffs to work together to devise a feasible plan. By September, the plan was close to its final form, and the Interim Committee endorsed it under the provisional title of the "Joint Program of Action."

A key element—probably *the* key element that forged the compromise everyone could accept—was that each eligible country would have to establish a six-year track record of good policy implementation before the Fund and the World Bank would grant full and final debt relief. In practical terms, that meant that an HIPC would be expected to carry out an ESAF-supported program for three years, after which it would reach a "decision point" and be granted interim relief. After the country completed a second three-year arrangement, it would reach the "completion point" and be granted the full amount of available relief. The length and difficulty of this process would turn out to be the most controversial feature of the plan because it meant that for a very long time the debt-relief results would be negligible and would be confined to very few countries. In the middle of 1996, however, this element was thought to be necessary, and in any event it was all that could be achieved politically.

A second key element was that the IMF would not directly forgive any outstanding debt. Instead, it would establish a separate trust account that would make grants to qualifying HIPCs in association with the concessional loans being made through the ESAF. Those grants would be placed in escrow until the country reached the decision and completion points, at which time the funds would be used to repay a portion of the country's outstanding debts. As discussed in the next section, the way in which this trust was to be funded remained to be decided.

Finally, on February 4, 1997, the Executive Board approved the HIPC Initiative (as the joint program was to be called) and established the ESAF-HIPC Trust. Informally, this account was usually just called the HIPC Trust. Formally, it was the "Trust for Special ESAF Operations for the Heavily Indebted Poor Countries and Interim ESAF

[54]Minutes of EBM/96/13 (February 20, 1996), pp. 13 (Kafka) and 17 (Esdar).

[55]Minutes of EBM/96/13 (February 20, 1996), pp. 20 (Mesaki) and 25 (Srejber).

Subsidy Operations."[56] The formal name of the HIPC Trust was changed in 1999 to reflect the conversion of the ESAF into the PRGF.

On a related issue, the Fund also agreed in 1997 that ESAF resources could be used by eligible borrowers to help cover the up-front costs of Brady-type debt- and debt-service-reduction agreements with commercial creditors. The World Bank's Debt Reduction Facility (see Chapter 9) was large enough to handle most countries' needs in that regard, but Côte d'Ivoire was looming as an exception. With that case in mind, the Executive Board approved an enabling decision in July.[57]

Operations

Who were the HIPCs? The joint staff papers of 1995 identified 41 countries with low per capita incomes (approximately equivalent to eligibility for IDA loans) and with debt and debt-service burdens above thresholds that had been set more or less arbitrarily.[58] The debate in the Executive Board mostly concerned the extent to which that list should be shortened. At one extreme, Directors from some of the countries on the list argued that all should be eligible. At the other, a few Directors argued that only four to eight countries really qualified. The others, they suggested, could repay their debts if they tried hard enough. In the end, the Board decided that all countries that met the specified criteria would be eligible to be considered for support, but it set a time limit on qualification. In addition to being ESAF-eligible and having at least a "borderline" unsustainable debt burden, a country would have to be receiving at least Naples-terms relief on its bilateral debt and be

[56]The text of the original trust document may be accessed at http://www.imf.org/external/pubs/ft/history/2011/index.htm.

[57]The proposal proved to be controversial, owing to issues of concessionality, additionality, and burden sharing, but a consensus was soon reached; see "Use of ESAF Resources for Commercial Debt and Debt Service Reduction Operations," EBS/97/42 (March 11, 1997); "Use of ESAF Resources for Commercial Debt and Debt Service Reduction Operations—Further Considerations," EBS/97/94 (June 4, 1997) and Suppl. 1 (June 30, 1997); and minutes of EBM/97/64 (June 25, 1997), pp. 4–46, and EBM/97/67 (July 2, 1997), pp. 8–24. The procedure was applied only to Côte d'Ivoire, in March 1998; see Chapters 9 and 14.

[58]The initial analytical thresholds were specified as ranges, to be applied judgmentally case by case. In general, a country would be judged to have an unsustainable debt burden if its annual debt-service obligations exceeded 20 to 25 percent of its export revenues and the net present value of its external debt exceeded 200 to 250 percent of its export revenues. Countries would be considered to be "possibly stressed" if their ratios were in an intermediate range. The staff acknowledged that the "empirical support for the particular threshold ranges used is weak, and these are therefore somewhat arbitrary"; see "Debt Sustainability Analysis for the Heavily Indebted Poor Countries," SM/96/22 (January 31, 1996), p. iii. For more background, see "Analytical Aspects of the Debt Problems of Heavily Indebted Poor Countries," SM/96/23 (January 31, 1996).

carrying out an IMF-supported adjustment and reform program no later than October 1998.[59]

These requirements were daunting. In a preliminary analysis aimed at estimating the initiative's potential cost, the staff determined that nearly half of the HIPCs (18 out of 41) had "sustainable" debt burdens and thus were not expected to qualify. Another four were likely to be ineligible because of outstanding arrears or because they were eligible for nonconcessional loans from the World Bank. That left a pool of 19 potential beneficiaries.[60] To qualify to be put on a track toward debt relief, each one would have to complete a three-year IMF-supported program (normally through the ESAF). By the end of the 1990s, seven countries reached that decision point and had funds set aside for future relief (Table 13.3).

Of the eight countries initially judged to have unsustainable debt burdens, only one (Mozambique) reached the decision point during the first three years of the initiative. The others all were judged not to be making satisfactory progress toward getting economic policies on a sustainable path. Two countries, the Democratic Republic of the Congo and Sudan, first had to settle their arrears to the IMF. Two others, Burundi and Guinea-Bissau, were bogged down in internal conflicts. The other three—Nicaragua, São Tomé and Príncipe, and Zambia—were making some progress toward viability, but not yet enough for the Fund to approve them for HIPC relief.

The one country in this group that reached the decision point was also put on a fast track to complete the process. As discussed in the next chapter, Mozambique was implementing courageously strong economic policies in the face of horrific environmental and social conditions. Its economy was growing well as a result, but the Fund and other agencies all recognized that Mozambique's performance inevitably would falter without multilateral debt relief. When the country completed its second three-year ESAF arrangement in June 1999, it reached the completion point and obtained approximately $1.7 billion in debt relief, of which $125 million was from the IMF.[61]

The Mozambique relief operation was the largest in this period. Four of the other six operations were for countries that initially had been considered borderline qualifiers. Relief operations for two of those, Côte d'Ivoire and Uganda, are discussed in the next chapter. The other two "possibly stressed" countries, Bolivia and Guyana, were in South America. Bolivia reached its completion point in September 1998 with the successful conclusion of its second ESAF-supported program. Guyana encountered more

[59]See Section III, paragraph 1, of the trust instrument, accessible at http://www.imf.org/external/pubs/ft/history/2011/index.htm.

[60]"Technical Note on Preliminary Costing of the Proposed Framework for Resolving the Debt Problems of the Heavily Indebted Poor Countries," SM/96/127 (June 4, 1996), pp. 3–5.

[61]These figures are in net present value terms. The "headline" figure—the estimated relief to be doled out over a period of years—was much larger. For details, see "Mozambique to Receive US$3.7 Billion in Debt Relief Through the HIPC Initiative," NB/99/35 (June 30, 1999); accessed at http://www.imf.org/external/np/sec/nb/1999/nb9935.htm.

Table 13.3. Debt Relief for Heavily Indebted Poor Countries, 1996–99

Country	Initial Assessment of Debt Sustainability	Decision Point	Completion Point	Relief from IMF (Millions of dollars) Committed	Granted
Africa					
Angola	Sustainable (prelim.)				
Benin	Sustainable				
Burkina Faso	Sustainable	September 1997		10	
Burundi	Unsustainable (prelim.)				
Cameroon	Possibly stressed				
Central African Rep.	Sustainable (prelim.)				
Chad	Sustainable				
Congo, Dem. Rep. of	Unsustainable				
Congo, Rep. of	Possibly stressed (prelim.)				
Côte d'Ivoire	Possibly stressed	March 1998		23	
Equatorial Guinea	Sustainable				
Ethiopia	Possibly stressed				
Ghana	Sustainable (prelim.)				
Guinea	Sustainable				
Guinea-Bissau	Unsustainable				
Kenya	Sustainable				
Liberia	Undetermined				
Madagascar	Possibly stressed				
Mali	Sustainable	September 1998		14	
Mauritania	Sustainable				
Mozambique	Unsustainable	April 1998	June 1999	125	125
Niger	Possibly stressed				
Nigeria	Undetermined				
Rwanda	Possibly stressed (prelim.)				
São Tomé and Príncipe	Unsustainable (prelim.)				
Senegal	Sustainable				
Sierra Leone	Sustainable				
Somalia	Undetermined				
Sudan	Unsustainable				
Tanzania	Possibly stressed				
Togo	Sustainable				
Uganda	Possibly stressed	April 1997	April 1998	69	69
Zambia	Unsustainable				
Asia					
Lao PDR	Sustainable				
Myanmar	Possibly stressed (prelim.)				
Vietnam	Sustainable				
Latin America					
Bolivia	Possibly stressed	September 1997	September 1998	29	29
Guyana	Possibly stressed	December 1997	May 1999	35	35
Honduras	Sustainable				
Nicaragua	Unsustainable				

Table 13.3. (continued)

Country	Initial Assessment of Debt Sustainability	Decision Point	Completion Point	Relief from IMF (Millions of dollars) Committed	Granted
Middle East					
Yemen, Rep. of	Sustainable				
Total				305	258

Sources: Initial assessment of debt sustainability: "Technical Note on Preliminary Costing of the Proposed Framework for Resolving the Debt Problems of the Heavily Indebted Poor Countries," SM/96/127 (June 4, 1996), Table 1; Debt relief: *Annual Report 2000*, Table 5.2.

Note: "Prelim." means that the staff made only a preliminary assessment because data were not sufficient for a detailed assessment of debt sustainability.

difficulties and reached the completion point only after making a good start on its third ESAF arrangement, in May 1999.

The Fund's other debt-relief operations in the 1990s assisted two countries in the CFA franc zone that initially had been judged to have sustainable debt burdens: Burkina Faso and Mali.

In March 1997, the staff completed a more detailed debt-sustainability analysis for Burkina Faso. Most of the country's external debt was on concessional terms, so its ratio of scheduled debt-service payments to projected export revenues appeared sustainable. Nonetheless, the staffs of the Bank and the Fund concluded that Burkina Faso—one of the poorest countries in Africa and with an unusually high ratio of debt to exports—should be eligible for debt relief. Moreover, the authorities had already established a five-year track record of good policy implementation, and the 1994 devaluation of the CFA franc had led to an acceleration of economic growth. On those grounds, the staff recommended making Burkina Faso eligible for HIPC debt relief and bringing the target completion date forward by one year, to September 1999.[62]

When the Executive Board took up the staff proposal, everyone agreed that Burkina Faso should qualify for relief. The only point of contention was whether the interval to the completion point should be accelerated from three years to two. Karin Lissakers (United States), with support from several other Directors, objected that the strict requirements of the initiative were being watered down inappropriately. After some discussion, the Board agreed on a compromise of two and a half years, which put the completion point in April 2000. Burkina Faso thus reached the decision point, and the Fund (acting as trustee for the HIPC Trust) committed $10.4 million to be disbursed at the completion point.[63]

[62]"Burkina Faso—Preliminary Document on the Initiative for Heavily Indebted Poor Countries (HIPC)," EBS/97/51 (March 26, 1997); and "Burkina Faso—Final Document on the Initiative for Heavily Indebted Poor Countries (HIPC)," EBS/97/155 (August 19, 1997).

[63]Minutes of EBM/97/93 (September 8, 1997), pp. 11–45. As a sweetener, the compromise also involved lowering the target debt ratio from 210 percent of annual exports to 205 percent. That shift implied that the present value of the relief would be roughly unchanged. Burkina Faso actually reached the completion point a few months later than anticipated, in July 2000.

Mali's situation was similar to Burkina Faso's. Its ratio of debt-service payments to exports was well below the 20 percent threshold considered to be potentially unsustainable. Its debt stock, however, was high in relation to exports; its income level was extremely low; and its export revenues were vulnerable to a variety of adverse shocks such as drought or weak external markets. After reassessing debt sustainability in 1997, the staff recommended, and the Executive Board accepted, that Mali should be eligible for HIPC debt relief. In September 1998, the Board approved the decision point for Mali and set an accelerated target for reaching the completion point in December 1999. By that time, the schedule called for Mali to have completed the current ESAF arrangement and to have embarked successfully on the next one. On that understanding, the Fund (as trustee) set aside $14 million for servicing Mali's outstanding obligations at the completion point.[64]

Altogether, as listed in Table 13.3, the IMF committed $305 million from the resources of the HIPC Trust to help cover future debt-service obligations of these seven countries. By the end of 1999, 85 percent of that commitment ($258 million) had been delivered in the form of grants to the four countries that had reached the completion point. Under the terms of the trust, those grants were paid into an escrow account known as the "umbrella account for HIPC operations." The balance in that account was used to cover a specified portion of scheduled debt service falling due over the next several years.

Enhancement

IN THE YEAR OF THIS JUBILEE YE SHALL RETURN EVERY MAN UNTO HIS POSSESSION.

Leviticus 25:13

After the first two years of HIPC debt-relief operations, it was abundantly clear that a sizeable number of countries needed such relief and that the requirement of a six-year track record before delivery of real relief was a major bottleneck. Political pressure associated with the looming approach of the millennium reinforced that simple logic. In 1999, a nearly universal desire to intensify and accelerate assistance to poverty-stricken countries as a way to commemorate the arrival of the twenty-first century elevated the enhancement of the HIPC Initiative into an ethical necessity.

In essence, 1999 brought a resumption of the outrage against unpayable debts that had flared up so strongly four years earlier. The Jubilee 2000 Coalition, Oxfam, Christian Aid, the Catholic Fund for Overseas Development, and the European Network for Debt and Development were especially influential in stoking a campaign throughout

[64]Minutes of EBM/98/99 (September 15, 1998). Also see "Mali—Preliminary Document on the Initiative for Heavily Indebted Poor Countries (HIPC)," EBS/98/28 (February 9, 1998); and "Mali—Final Decision Point Document on the Initiative for Heavily Indebted Poor Countries," EBS/98/150 (August 24, 1998). Mali reached the completion point in September 2000.

Europe and North America for deeper and faster debt relief for the poorest countries. The IMF staff took that movement to heart and also conducted its own outreach exercise. That outreach included a series of eight consultation meetings with civil society in Africa, Europe, and Central and North America and solicitation of public input through the IMF website. Meanwhile, finance officials in the major industrial countries were developing their own proposals for change.[65]

By the time of the April 1999 meeting of the Interim Committee, the only question was how, not whether, to strengthen the HIPC Initiative. The committee's communiqué asked the Fund to devise a specific proposal by September that would "provide a clear exit from unsustainable debt burdens" for qualifying countries and that would "enhance the link between HIPC Initiative assistance and poverty reduction."[66]

As a measure of the growing political importance of the issue, the major industrial countries preferred not to leave the preparation of this proposal to the staff of the Bretton Woods institutions. Instead, the finance ministers of the G7 countries quickly sketched out the "Köln Debt Initiative," which they presented to the G8 heads of state and government (comprising the G7 plus the Russian Federation) for the summit meeting to be held in Cologne, Germany, in June. Part of that proposal was to deepen Paris Club debt reductions even further. In what would become known as the Cologne terms, starting in November 1999 bilateral creditors were to forgive HIPC debts by up to 90 percent, compared with the previous ceiling of 80 percent. The main thrust of the proposal, though, was to enhance the multilateral HIPC Initiative.[67]

After the summit leaders endorsed the G7 proposal, the Fund and Bank staffs worked out the details for its implementation. The Fund's Executive Board approved most of the changes in principle in August, after which attention turned to the task of raising enough money to pay for them. Final approval for the enhancements came in January 2000, after the fundraising effort concluded.[68]

The enhancement of the HIPC Initiative introduced three critical changes to the way the IMF would compute and deliver debt relief.

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[65]For an overview of these various developments, see "HIPC Initiative—Perspectives on the Current Framework and Options for Change," EBS/99/52 (April 2, 1999). For an introduction to the ethical issues, see Donnelly (2007).

[66]Paragraph 4 of the Interim Committee communiqué (April 27, 1999); reproduced in *Annual Report 1999*, p. 188.

[67]See "Report of G7 Finance Ministers on the Köln Debt Initiative to the Köln Economic Summit," Cologne, Germany, June 19–20, 1999; accessed at http://www.g8.utoronto.ca/finance/fm061899.htm. (Cologne is the French name for Köln and is the commonly used name in English.)

[68]The joint IMF–World Bank staff response to the G7 proposal was "Modifications to the Heavily Indebted Poor Countries (HIPC) Initiative," EBS/99/138 (July 23, 1999). That paper was discussed by the Fund's Executive Board on August 5, 1999, at which time Directors gave preliminary approval to the proposed enhancements; see minutes of EBM/99/89 (August 5, 1999), pp. 3–57. The paper and the Summing Up of the Board meeting are available at http://www.imf.org/external/np/hipc/modify/hipc.htm. The formal decision to amend the trust so as to incorporate these changes was adopted on a lapse-of-time basis on January 27, 2000; see Decision No. 12132-(00/9) PRGF.

First, it compressed the timetable for countries with good policy track records. In particular, the gap between the decision point and the completion point would no longer require the country to complete a second three-year policy program. Instead, the gap would be closed "when a member has satisfactorily implemented a set of pre-defined key policy reforms, has a stable macroeconomic position, and has kept on track with its Fund-supported program. In addition, the member shall have prepared a PRSP and implemented this strategy for at least a year by the completion point."[69] This compression from three years to as little as one was characterized as a "floating completion point."

Second, the standard for assessing the sustainability of a country's debt burden was made more ambitious. Notably, instead of regarding a ratio of debt to export revenues as high as 250 percent to be sustainable, the Fund would now regard anything greater than 150 percent as unsustainable. As before, the standard could be set lower than this threshold under extenuating circumstances.[70]

Third, instead of waiting until the completion point to award grants to qualifying countries, the Fund and the World Bank could begin providing relief grants at the decision point. To qualify, a country would have to be judged to have a satisfactory record of "adjustment and reform efforts and overall progress in poverty reduction."[71]

These changes meant that many more countries would qualify and that the Fund would be making grants much earlier than had been expected under the original terms. The enhancements would be expensive and could be adopted only if donor countries would sharply increase their contributions or if the IMF could mobilize more of its own resources, or both. The staff estimated that existing commitments would have to be almost tripled in size—and quickly—for the enhancements to be fully funded.[72]

As discussed below, raising the funds took some creativity, but the task was completed before the end of 1999. The Enhanced HIPC Initiative took effect in January 2000, and it led quickly to a sharp acceleration in grants to HIPCs. After an initial three years (1997–99) in which the original HIPC Trust awarded grants totaling \$258 million to four countries, the pace quickened. Over the first three years of the enhanced initiative, the trust disbursed close to \$1 billion in grants to 25 countries. From all participating creditors, the reduction in the net present value of HIPC debts

[69]Decision No. 12132-(00/9) PRGF (January 27, 2000), paragraph xiii.

[70]In 2002, the Fund greatly refined its analysis of debt sustainability by replacing these mechanical ratios with forward-looking analyses tailored to each country's circumstances. For a review, see Barkbu, Beddies, and Le Manchec (2008).

[71]Decision No. 12132-(00/9) PRGF (January 27, 2000), paragraph xiv.

[72]See "Update and Steps to Secure the Financing for the Continuation of the ESAF and the HIPC Initiative," EBS/99/143 (August 2, 1999). For an overview of the 1999 enhancements, see Andrews and others (1999).

amounted to $3.5 billion under the original initiative and a further $21.7 billion under the first three years of the enhanced initiative.[73]

Financing the Facilities

Raising money to lend to poor countries, or to provide grants, was a constant challenge. The IMF could not use its general resources for this purpose because the Articles of Agreement require that those resources be available for all member countries on an equitable basis. The "seed money" for concessional lending came from the sale of a portion of the Fund's stock of gold in the 1970s. The market price of gold was much higher than the official price at which the Fund had valued its holdings, so the auctions generated profits that could be retained and used to establish the original Trust Fund. When Trust Fund loans were repaid, those proceeds were recycled into the SAF and eventually into the ESAF. Additional loans and grants from member countries and central banks to the ESAF Trust increased the pool of available funds.[74] The challenge in the 1990s was to replenish and augment those resources so that the ESAF (and its successor, the PRGF) could be converted into a permanent lending facility with sufficient funds to be a real help and also to finance the IMF's contributions to the HIPC Initiative. Because the continuation of ESAF lending and the ability to provide associated grants through the HIPC Initiative were so closely linked, the financing discussions gravitated toward a joint proposal for funding the two operations together.

This fundraising campaign began with the move to create a successor to the original temporary ESAF. Throughout 1993 and into 1994, staff, management, and Executive Directors made an intensive effort to persuade as many member countries as possible to help finance an enlargement of the facility. By February 1994, when the original ESAF finally was allowed to expire, some 43 members—half of them developing countries—had agreed to lend a total of some $6.4 billion (SDR 4.6 billion) to the expanded trust and to contribute $1.8 billion (SDR 1.6 billion) to enlarge the subsidy account to cover the difference between the trust's lending rate and the rates at which it was borrowing. These contributions were expected to enable close to $7 billion (SDR 5 billion) in new ESAF lending, about equal to the amount the original ESAF had lent during its six-year life.

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[73]"Heavily Indebted Poor Countries (HIPC) Initiative—Statistical Update," (March 10, 2003), Tables 2 and 7A; accessed at http://www.imf.org/external/np/hipc/2003/update/031003.htm. In all, 26 countries received relief under the enhanced initiative through 2003. One country—São Tomé and Príncipe—had no outstanding obligations to the IMF and so received relief only from other creditors.

[74]These developments are covered in de Vries (1985), Chapters 33 and 34; and Boughton (2001), Chapter 14.

Once the successor ESAF was in place, a new campaign was required so that lending could continue beyond the end of the decade. Throughout 1995 and much of 1996, staff and management devoted considerable energy to persuading ESAF creditors to renew and enlarge their commitments. Because so many of the creditors had to cope with their own domestic budgetary problems and political opposition, several of them insisted that the Fund should find a way to help finance the continuation of ESAF lending from its own assets. In particular, the United States, the United Kingdom, several other countries, and eventually the Managing Director argued that the time had come for the Fund to sell a further portion of its gold stock and use the proceeds in some fashion to finance ESAF lending.[75] As Lissakers (United States) argued, "the Fund and its members can ill afford to allow a valuable asset to lie fallow." A sizeable minority, led by Stefan Schoenberg (Germany), insisted there was "no reason for the Fund at present to sell gold in any amount." Any decision to sell gold required the approval of members holding 85 percent of the voting power, and in 1995, seven Directors with about 30 percent of the vote expressed opposition.[76]

The pressure for the IMF to sell gold did not arise from an immediate shortfall of ESAF resources. Its sale was thought to be necessary to ensure that the Fund could continue lending during 2001–04, when it would be fulfilling commitments made through 2000. After that time, as discussed above, the intention was still to phase out the concessional lending facility. Specifically, lending projections made in 1995 showed that the funds already in the trust or being raised in 1996 would enable lending to continue through 2000, and additional funds would have to be raised by then to finance an interim facility for the period 2001–04.

For that purpose, Camdessus devised a proposal under which the IMF would stand ready to sell up to 5 million ounces (4.8 percent) of its gold, but only if bilateral contributions to the trust fell short of what was needed. All of the profits from the gold sales (referred to as the "corpus") would be retained by the IMF but would be invested in interest-bearing securities. The interest income would be used to top up the ESAF Trust as needed to sustain its lending operations.

The Executive Board accepted that general proposal in September 1996. The provision for gold sales, however, was never formalized in a Board decision, because at this time it was only a contingency plan and was still opposed by a few Directors. The German government was most strongly opposed to gold sales, even to the idea of the Fund being open to them on a contingency basis. As pointed out by Bernd Esdar, who had succeeded Schoenberg as Executive Director for Germany, the existence of such an option would create a free-rider problem—a disincentive for countries to offer bilateral

[75]As noted, the original funding for the IMF's concessional lending came from the sale of gold in the 1970s. In 1993, the Fund pledged 3 million ounces of gold to be sold if needed to cover potential losses in the ESAF Trust, but that pledge was never activated (see Chapter 16).

[76]For the initial positions of the staff and the major creditor countries in these discussions, see "Gold in the Fund," SM/95/69 (April 21, 1995); and minutes of EBM/95/54 (June 2, 1995). The quotations are from the minutes, pp. 8 (Lissakers) and 18 (Schoenberg).

contributions to the ESAF or the HIPC Trust.[77] Nonetheless, the Executive Board accepted without objection the Managing Director's proposal that a decision should be made at an appropriate time, "only after all efforts have been made to secure the maximum feasible bilateral contributions, being understood that we only talk here about the exclusive use of the interest income on the investment of profits generated through such sales" of gold. The ambiguity of this implicit agreement—the absence of a formal decision or a binding commitment—would haunt the Fund for years to come.[78]

The issue of selling gold lay dormant for the next three years but arose anew at the G8 summit meeting in Cologne, Germany, in June 1999. By that time, the purpose was not primarily to help finance ESAF lending, but rather to help strengthen and deepen the IMF's contribution to multilateral debt relief through the HIPC Initiative. To get deeper debt reduction for low-income countries, the summit asked the Fund to consider the "use of interest on the proceeds of a limited and cautiously-phased sale of up to 10 million ounces of the IMF's gold reserves." The staff, however, remained worried that once the gold was gone, the temptation for creditor governments to press the Fund to spend the proceeds would be too great to resist. In addition, and more important from a practical perspective, governments in gold-producing countries feared the depressing effect on the market price if the Fund were even to announce that it was considering putting millions of ounces up for sale.

The pressure to mobilize gold could not be ignored without eviscerating the ESAF Trust and undermining the HIPC Initiative. At the time of the Cologne summit, the IMF and its major creditor countries were committed to "enhancing" the HIPC Initiative by scaling down the hurdles that countries had to clear to qualify for debt relief. Enhancing debt relief, in turn, would require more money, while at the same time a serious move was under way to convert the ESAF into the PRGF as a permanent lending facility.

Some means had to be found to mobilize gold over the objections of those countries that opposed selling any. After some brainstorming, the staff came up with

[77]Minutes of EBM/96/87 (September 13, 1996), p. 12. The German and other European Directors had made a similar objection in 1995 when Camdessus had proposed using the Fund's general resources to finance an increase in the stand-by arrangement for Mexico, as a contingency plan if bilateral support fell short of target. In that case (see Chapter 10), the objection proved to be correct. Bilateral support did not materialize, and the Fund was obliged to finance the increase with its own resources.

[78]Minutes of EBM/96/89 (September 18, 1996), p. 16. The intended restriction on the use of the proceeds from gold sales was stated a little more plainly in the IMF Annual Report, albeit in the passive voice. Summarizing the Board discussion, the report concluded, "It was also understood that it would be only the proceeds from the investment of the profits from the sale of such gold that might be used to contribute to the financing" (*Annual Report 1997*, p. 121; accessed at http://www.imf.org/external/pubs/ft/ar/97/pdf/file09.pdf). A decade later, when a decline in lending income forced the Fund to look for new income sources, proposals to sell gold and use the corpus of profits to cover current expenditures were more difficult to resist than they would have been had a formal decision to the contrary been made earlier.

an alternative proposal under which the Fund would sell the gold off-market to the central bank of a member country and then buy it back. Even though both transactions would be made at the same price, they would generate a "profit" that the Fund could invest. The explanation for this apparently magical result is that the Fund is required by its Articles of Agreement to value its gold at the price at which it acquired it ("historical cost"). Before the swap, it would value the gold at SDR 35 per ounce. After selling the gold at the market price and then buying it back, it would value that portion at the higher price. On the liability side of the IMF balance sheet, the counterpart to the increase in gold valuation would be an entry for the resources of the Special Disbursement Account (SDA). The Fund could then swap an equivalent amount of its currency holdings for interest-bearing government securities, which would be held in the SDA rather than in the General Resources Account (GRA). The income on that investment could in due course be transferred to the ESAF Trust.

When this gold-swap proposal was floated internally in August 1999, it was shot down by the Legal Department because the 1978 amendment of the Articles of Agreement had terminated the right of the IMF to purchase gold.[79] Camdessus then asked the lawyers to suggest other options, which they did. Instead of selling and repurchasing the gold, the Fund could sell gold to a member country that had a repayment due on an outstanding loan. The member could then use the gold to repay the loan, and the effect on the balance sheet would be identical to that of a sale and repurchase.

The Executive Board reacted negatively when it first discussed this proposal at the end of August. Several Directors felt that doing off-market swaps instead of outright sales of gold would be confusing and opaque and would do nothing to rationalize the Fund's asset portfolio. Others argued that it would be better to spend the profit rather than investing it and just using the flow of income for ESAF financing. Camdessus managed to deflect that argument by reminding the Board that it had agreed in 1996 to retain the corpus in the Fund, but the absence of a formal decision at that time complicated the case and left some Directors unsatisfied. More generally, no one viewed the proposal as anything better than an "eighth-best solution," as characterized by Riccardo Faini (Italy).[80]

Despite the widespread distaste for what many saw as a clever gimmick, the absence of a better option gave the proposal momentum. The staff calculated potential demands on the ESAF Trust at nearly SDR 4 billion, of which less than a third was on hand or pledged (Table 13.4, Part A). The reluctance of major donors to raise their contributions reflected not only domestic political pressures against foreign aid, but

[79]Neither the proposal nor its rejection was new. In 1990, the U.S. authorities had proposed that "gold swaps at par might be undertaken as a means of generating income-producing resources." The staff responded then that the IMF "has no authority to enter into gold 'swaps' (sale and repurchase)"; see "Statement by [Thomas C. Dawson II, the U.S. Executive Director] on the IMF Arrears Strategy," BUFF/90/24 (January 30, 1990), p. 6; and "Statement by the Staff Representative at Executive Board Informal Session 90/6," BUFF/90/30 (February 1, 1990), p. 1.

[80]Minutes of EBM/99/95 (August 30, 1999), p. 61.

Table 13.4. Financing of the PRGF-HIPC (formerly ESAF-HIPC) Trust, 1999
(Millions of SDRs, on an "as-needed" basis)

A. Financing options, August 1999		
Total anticipated financing requirement		3,940
Amounts already on hand or pledged		1,190
Confirmed bilateral pledges	800	
Contributions by the IMF[a]	390	
Amounts anticipated or under discussion		2,010
Indications made for additional bilateral contributions	500	
Further IMF contribution by terminating the practice of reimbursing the GRA for the cost of administering the trust	250	
Investment income from the profits on off-market gold transactions totaling 10 million ounces	1,260	
Subtotal		3,200
Shortfall to be filled by additional contributions		740
B. Financing secured, September 1999		
Total financing requirement		3,940
Bilateral contributions and pledges		1,500
IMF contributions		2,440
Investment income from the profits on off-market gold transactions totaling 14 million ounces	1,800	
Other transfers to the trust	640	

Sources: Part A: Minutes of EBM/99/95 (August 30, 1999), pp. 68–69; Part B: BUFF/99/126 (September 28, 1999).

Note: The amounts in this table are computed on an "as-needed" basis, meaning that they are not deflated to present values. If, for example, one country was expected to be granted relief in 1999 and another in 2002, the two amounts would be added together without any adjustment for the difference in timing.

[a]Transfers from the Reserve Account and transfers of income from the Supplemental Reserve Facility.

also a genuine concern that donating money to the ESAF would result in shortchanging financing for the International Development Association, the World Bank's concessional lending agency. The staff proposal, while retaining the corpus as an investment account, would cover half of the unfunded balance. Without it, the Fund had virtually no chance of fully financing the facility.

In the fall of 1999, in contrast to 1996, a real decision on gold had to be made quickly. The financing shortfall had to be filled because the Interim Committee was scheduled to meet on September 26 and its members were insistent on making the resolution of this matter the centerpiece of their agenda. Throughout the first three weeks of September, Camdessus, the staff, and the Executive Directors made a rigorous effort to secure additional bilateral support from a large number of countries. They succeeded to a great extent, but it also became evident that the mobilization of 10 million ounces of gold was not going to suffice to close the gap between the target number and bilateral contributions. Accordingly, the ceiling was raised to 14 million ounces. Even so, on Friday, September 24, two days before the ministerial meeting, a gap of almost SDR 200 million remained, mainly because several of the largest shareholders were balking at raising their commitments proportionately to those of many of the smaller countries. Camdessus applied as much verbal pressure as he could, at one

point singling out France and the United Kingdom for shame and telling the Executive Board that "if this effort failed, and the financing package could not be put in place, the failure would have to be traced to the lack of contribution among key G–7 players."[81]

The effort went right to the wire, concluding with a rare Saturday night meeting of the Executive Board, starting at 10:00 p.m. on the eve of the Interim Committee meeting. By then, it had become a battle of wills between the British authorities, who wanted a greater portion of the trust enlargement to be financed by gold transactions, and Camdessus, who was insisting that the British shortfall (in relation to its IMF quota) was giving other countries an excuse to withhold their own contributions. Because the British were among the most ardent advocates of the enlargement, and their chancellor of the exchequer, Gordon Brown, was Chairman of the Interim Committee, they were widely viewed as the linchpin of the package.

In the end, the British relented. On the day of the Interim Committee meeting, Development Secretary Clare Short announced that the United Kingdom would contribute an additional $50 million to the HIPC Initiative. That triggered contributions from several other countries, and two days later Camdessus announced the essential completion of the financing package.[82] Support continued to trickle in from around the world, and by the end of the financial year, a remarkable tally of 93 countries, including nearly 60 developing and 10 transition countries, had made bilateral contributions in some form. The total amounts, however, were disappointingly small. Camdessus's plan to keep gold sales as a contingency plan in case bilateral contributions fell short may indeed have backfired, as the German Director had warned three years earlier. Of the total $5.4 billion (SDR 3.94 billion) in the package, only 38 percent came from bilateral donors and lenders.[83] The off-market gold transactions would cover almost half of the total, and the IMF would cover the rest through transfers from other operations (Table 13.4, Part B).

Bilateral contributions to the PRGF Trust and the PRGF-HIPC Trust were to be made in a wide variety of forms, ranging from simple outright grants to loans at market interest rates. Much of the grant money was to be placed in a subsidy account within the PRGF Trust to cover the difference between the low interest rate on loans and the rate the Fund had to pay to borrow the money.

The most common source of grants was countries relinquishing their claims on the IMF's second Special Contingent Account (SCA-2). That account was established in 1990 to accumulate SDR 1 billion to cover potential losses on loans in arrears (see Chapter 16). The SCA-2 was funded through 1997 by contributions from creditors via a decrease in remuneration on reserve-tranche balances, and by indebted countries via an increase in the interest rate charged on outstanding balances. The SCA-2 was

[81] Minutes of EBM/99/109 (September 24, 1999), p. 7.

[82] See BUFF/99/126, revised September 30, 1999.

[83] For a complete schedule of sources of financing for the trusts through April 2000, see *Annual Report 2000*, Appendix IX; accessed at http://www.imf.org/external/pubs/ft/ar/2000/eng/index.htm.

established as a temporary account, with the proviso that any money remaining in the account after the settlement of outstanding arrears was to be returned to the contributing countries. By 1999, the Executive Board determined that this money was no longer needed. On December 8, the Board terminated the account and agreed to pay out the balance to contributors, many of whom had already agreed to transfer their share back to the HIPC Trust. Over the next few months, this plan generated close to $800 million in voluntary transfers.

Aside from these transfers, the Fund raised direct bilateral contributions for the PRGF Trust (Table 13.5) from 42 countries plus the Organization for Petroleum Exporting Countries (OPEC) Fund for International Development, and for the PRGF-HIPC Trust (Table 13.6) from 34 countries (for a combined total of 58 contributors to one or both). Including transfers of funds raised by terminating the SCA-2 account, 93 countries helped fund the PRGF-HIPC Trust.[84] That list was especially remarkable in that it included 10 African and 45 other developing countries. The bulk of the money still came from the major creditors, but fulfilling the international commitment to reduce the debt burdens of the poorest countries really had become a nearly universal effort.

Next, the gold transactions needed to be carried out to effect the Fund's contribution. That move required a formal decision by the Executive Board, enacted with a majority of 85 percent of the voting power. To clarify the context and put some political weight behind this unusual operation, the Interim Committee decided to pave the way by asking the Board of Governors to adopt a resolution supporting it. Accordingly, on September 30, 1999, the Governors adopted Resolution 54-10, endorsing the transactions as "a one-time operation of a highly exceptional nature."[85] The resolution also implied that all of the proceeds would be retained in the IMF: the original book value in the GRA and "the balance in the Special Disbursement Account *for investments* for the benefit of the ESAF-HIPC Trust" (emphasis added).

In December, the time for action arrived. Two countries—Brazil and Mexico—had large repayments falling due. On December 8, the Executive Board gave its final approval to the technical decisions needed to carry out the off-market transactions.[86]

[84]For the full list of HIPC contributors, see *Annual Report 2000*, Appendix Table II.11, p. 127.

[85]See http://www.imf.org/external/pubs/ft/sd/index.asp?decision=54-10.

[86]See "Off-Market Gold Sales, Acceptance of Gold in Payment of Repurchase Obligations and Use of Proceeds of Gold Sales Placed in Special Disbursement Account," Decision No. 12063-(99-130), December 8, 1999; *Annual Report 2000*, p. 148; accessed at http://www.imf.org/external/pubs/ft/ar/2000/eng/pdf/file5.pdf. The Board made several related decisions at the same time or shortly afterward, aimed at shifting part of the burden of the cost of the operations away from developing countries. In the absence of offsetting action, the cost of the increased remuneration to creditors resulting from the reduction in GRA currency holdings after the off-market gold transactions (see text) would be borne in large part by developing countries with outstanding debts to the Fund. To mitigate that effect, the Executive Board agreed to place a ceiling on the ratio of the rate of charge to the SDR interest rate, reduce the amount of net income that would be set aside to cover potential loan losses, and devote a portion of interest income from the Supplemental Reserve Facility to cover the expenses of the trust. For a discussion, see minutes of EBM/99/130 (December 8, 1999). All of these policy decisions were published in *Annual Report 2000*, pp. 144–49.

Table 13.5. Contributions to the PRGF Trust (as of April 30, 2000)

	Millions of SDRs			Millions of U.S. Dollar Equivalent		
		Loans[b]			Loans[b]	
Contributor	Subsidies[a]	Prior to Enlargement	For Enlargement	Subsidies	Prior to Enlargement	For Enlargement
Argentina	13.6			18.2		
Australia	2.3			3.1		
Austria[c]	34.7			46.5		
Bangladesh	0.3			0.4		
Belgium[c]	73.3		200.0	98.1		267.8
Botswana[c]	0.9			1.2		
Canada	128.6	300.0	400.0	172.2	401.7	535.7
Chile[c]	2.9			3.9		
China	5.7		100.0	7.6		133.9
Czech Republic	6.0			8.0		
Denmark	38.3			51.3		
Egypt	6.0		100.0	8.0		133.9
Finland	22.7			30.4		
France		800.0	1,100.0		1,071.3	1,473.1
Germany	120.3	700.0	700.0	161.0	937.4	937.4
Greece[c]	22.3			29.9		
Iceland	2.6			3.5		
India	4.2			5.6		
Indonesia[c]	2.4			3.3		
Iran, Islamic Rep. of[c]	0.6			0.9		
Ireland	2.4			3.3		
Italy	135.2	370.0	460.0	181.1	495.5	616.0
Japan	468.4	2,200.0	2,150.0	627.2	2,946.1	2,879.2
Korea, Rep. of	29.9	65.0	27.7	40.0	87.0	37.1
Luxembourg	5.2			7.0		
Malaysia[d]		40.0	40.0		53.6	53.6
Malta[d]		1.4	1.4		1.8	1.8
Morocco	4.2			5.7		
Netherlands	77.8		250.0	104.1		334.8
Norway	28.1	90.0	60.0	37.6	120.5	80.3
OPEC Fund for International Development			37.9			50.8
Pakistan[d]			10.0			13.4
Portugal[c]	1.6			2.2		
Singapore[d]		40.0	40.0		53.6	53.6
Spain		220.0	192.0		294.6	257.1
Sweden	110.9			148.5		
Switzerland	20.6	200.0	151.7	27.6	267.8	203.1

Table 13.5. (continued)

	Millions of SDRs			Millions of U.S. Dollar Equivalent		
		Loans[b]			Loans[b]	
Contributor	Subsidies[a]	Prior to Enlargement	For Enlargement	Subsidies	Prior to Enlargement	For Enlargement
Thailand[d]		20.0	40.0		26.8	53.6
Tunisia[d]			3.6			4.8
Turkey	2.0			2.7		
United Kingdom	285.2			381.9		
United States	106.1			142.1		
Uruguay[d]			7.2			9.6
Total[e]	1,765.4	5,046.4	6,071.4	2,364.1	6,757.8	8,130.5

Source: *Annual Report 2000*, pp. 212–13.
[a]Direct contributions to the subsidy account (unless otherwise indicated).
[b]Loan account includes loans prior to and for enlargement of the PRGF.
[c]Net income transferred from administered accounts.
[d]Borrowing agreements with the subsidy account.
[e]Columns may not add to total because of rounding.

Six days later, the process was under way. Brazil made a repayment to the IMF of $1.98 billion for principal due on its SRF loan of December 1998 (see Chapter 12). By channeling the repayment through the off-market gold entries, this transaction enabled the Fund to transfer about $1.6 billion (SDR 1.19 billion) from the GRA to the SDA to be invested in interest-bearing government securities.[87] Over the next four months, the Fund engaged in a series of similar transactions with Mexico to bring the total amount transferred to $3 billion, or SDR 2.2 billion (Table 13.7).[88]

As important as this series of transactions was for financing the HIPC Initiative, the "profit" that it generated was a misnomer. As noted above, the resources transferred to the trust resulted not from the revaluation of the gold stock, which was only a bookkeeping entry, but rather from the exchange of currencies for interest-bearing securities. The reduction in currency holdings, however, increased the remunerable reserve tranche positions of creditor countries. The gain came from the difference between the rate of return on the investment account and the rate at which remuneration was paid on reserve tranche positions. That net return was small relative to the nominal profit on the gold transactions, although it could be bolstered by investing in medium-term and thus higher-yielding assets than the short-term securities on which the

[87]The currencies transferred to the SDA were placed in the IMF's account at the Bank for International Settlements, which then invested the balance in behalf of the Fund.

[88]Because the price of gold rose when these transactions were taking place, the total amount of gold mobilized for this purpose was just 12.9 million ounces, not the full 14 million that had been approved as the maximum allowable amount.

Table 13.6. PRGF-HIPC Trust: Cumulative Contributions (as of April 30, 2000)

Contributor	Thousands of SDRs	Thousands of U.S. Dollar Equivalent
Australia	91.90	123.10
Bangladesh	11.60	15.60
Barbados	2.50	3.30
Belize	0.40	0.50
Cambodia	0.30	0.40
Canada	329.30	441.00
China	131.30	175.90
Cyprus	5.40	7.30
Denmark	61.20	82.00
Finland	22.50	30.10
France	387.00	518.20
Greece	22.00	29.50
Iceland	0.90	1.20
Ireland	39.40	52.70
Israel	11.90	15.90
Jamaica	18.00	24.10
Japan	665.60	891.30
Korea, Republic of	106.30	142.30
Luxembourg	4.90	6.50
Malta	7.10	9.50
Mauritius	0.40	0.50
Netherlands	69.50	93.00
Nigeria	11.00	14.80
Norway	72.50	97.10
Philippines	45.00	60.30
Portugal	44.30	59.30
Samoa	0.03	0.04
San Marino, Republic of	0.30	0.40
Slovak Republic	26.70	35.70
Slovenia, Republic of	3.10	4.20
South Africa	9.00	12.00
Swaziland	0.20	0.30
United Kingdom	235.50	315.40
United States	2,219.30	2,972.00
Total[a]	4,656.20	6,235.30

Source: *Annual Report 2000*, p. 225.
Note: This table excludes transfers from Fund accounts, which are included separately in the source table.
[a]Columns may not add to totals because of rounding.

remuneration rate was based.[89] The real benefit was that the securities income (the gross return on the "profit") could be transferred to the trust, while the remuneration expense was borne by the GRA.

[89]The staff presentation to Executive Directors in August 1999 estimated the profit on transactions in 10 million ounces of gold to be SDR 1,550 million. The estimated annual net income, however, was just SDR 26 million (the difference between investment income of 78 million and increased remuneration expense of 52 million), a net return of 1.7 percent; minutes of EBM/99/95 (August 30, 1999), p. 6. The net return turned out to be a bit larger (2.4 percent in financial year 2001).

Table 13.7. Off-Market Gold Transactions, December 1999–April 2000

	Brazil	Mexico	Mexico	Total
Date of transaction	December 14, 1999	December 17, 1999	February to April, 2000	
A. Ounces of gold	7,074,317	655,578	5,214,357	12,944,253
B. Historic cost (A × 35 SDR)	247,601,107	22,945,237	182,502,502	453,048,846
C. Market price per ounce (US$)	279.60	280.30	285.89	282.17
D. Market value, in dollars (A × C)	1,977,979,130	183,758,566	1,490,751,263	3,652,488,960
E. Exchange rate (SDR per U.S. dollar)	0.727	0.731	0.743	0.734
F. SDR value (D × E)	1,438,155,000	134,257,500	1,107,609,997	2,680,022,497
G. "Profit" transferred to investment account, in SDR (F − B)	1,190,553,893	111,312,263	925,107,495	2,226,973,651

Source: "Off-Market Gold Sales—Mexico," EBS/00/69 (April 7, 2000).

Table 13.8. PRGF Trust and SDA: Combined Balance Sheet (as of April 30, 2000)

	Thousands of SDRs	Equivalent Thousands of U.S. Dollars
Assets	**10,596,104**	**14,189,773**
Cash and equivalents	346,144	463,539
Investments	4,463,020	5,976,653
Loans receivable	5,769,166	7,725,779
Interest receivable	17,774	23,802
Liabilities and resources	**10,596,104**	**14,189,773**
Resources	4,305,726	5,766,013
Balance, beginning of the year	4,098,988	5,489,160
Contributions	115,809	155,086
Transfers from the SDA	168,572	225,743
Transfers through the SDA to the PRGF-HIPC Trust	−69,267	−92,759
Operational income	−8,376	−11,217
Investment income	162,189	217,195
Interest on loans	29,080	38,942
Interest expense	−199,452	−267,096
Other expense	−193	−258
Borrowings	6,223,794	8,334,594
Interest payable	66,391	88,908
Other liabilities	193	258

Source: *Annual Report 2000*, pp. 207, 210.

Note: The combined balance sheet includes the Loan Account, Reserve Account, and Subsidy Account.

Table 13.9. PRGF-HIPC Trust and Related Accounts: Combined Balance Sheet (as of April 30, 2000)

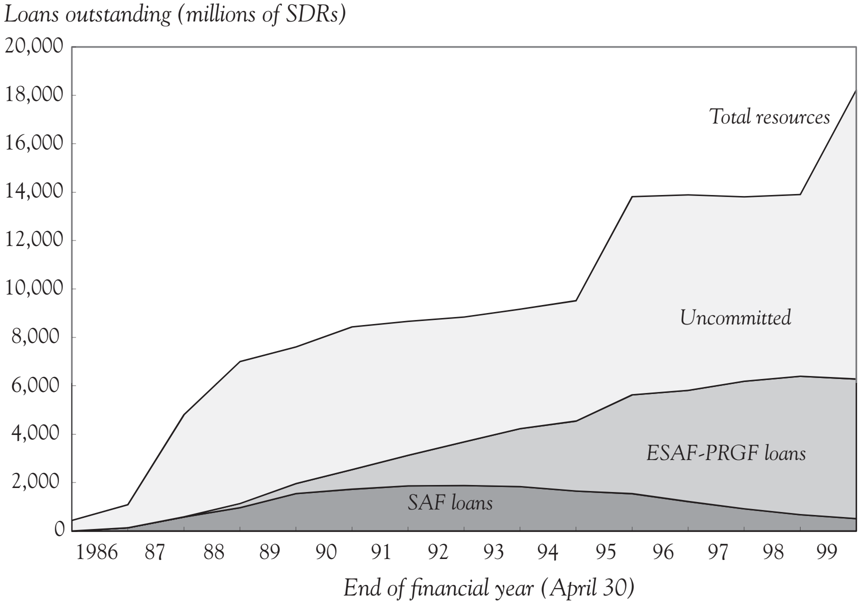
	Thousands of SDRs	Equivalent Thousands of U.S. Dollars
Assets	**834,865**	**1,118,009**
Cash and equivalents	600,736	804,476
Investments	221,135	296,133
Loans receivable	10,757	14,405
Interest receivable	2,237	2,996
Liabilities and resources	**834,865**	**1,118,009**
Resources	511,051	684,374
Balance, beginning of the year	99,651	133,448
Contributions	412,333	552,176
Grants	−139,986	−187,462
Disbursements	0	0
Transfers	128,437	171,996
Operational income	10,616	14,216
Investment income	11,734	15,714
Interest expense	−1,078	−1,444
Other expense	−40	−54
Borrowings	323,175	432,780
Interest payable	626	838
Other liabilities	13	17

Source: *Annual Report 2000*, pp. 219, 222, 223.

Note: The combined balance sheet includes the PRGF-HIPC Trust subaccount, PRGF subaccount, and HIPC subaccount.

At the end of this process (as of end-April 2000), the PRGF Trust had $14.2 billion in assets, of which about $6.5 billion was available for future lending (investments plus cash and equivalents, as shown in Table 13.8). In addition, the PRGF-HIPC Trust (Table 13.9) held $1.1 billion in assets, not including commitments by donors to provide further grants or loans as needed. Adding in undrawn commitments to the PRGF Trust and the resources of the SDA, total available resources for assistance to low-income countries amounted to more than $24 billion (SDR 18.2 billion). Two-thirds of that amount was still uncommitted (Figure 13.2). Accumulating these resources had taken several years, but the IMF now had the means to take on the dual task of providing concessional loans and grants to the world's poorest countries for the foreseeable future.

Figure 13.2. SAF, ESAF, PRGF, and HIPC Resources and Loans Outstanding



Source: IMF financial accounts.
Note: Total resources include assets in the Special Disbursement Account and the ESAF, PRGF, and HIPC Trusts plus undrawn borrowing arrangements.

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14

Looking to the Future: The IMF in Africa

IT IS IN AFRICA THAT THE FUTURE OF THE WORLD IS BEING PLAYED OUT, BECAUSE IT IS IN Africa in particular where the . . . forces that have yet to make their contribution are found: wealth in economic terms, and wealth in human terms.

Michel Camdessus
Managing Director of the IMF
January 19, 2000

At the IMF's creation in the 1940s, no one expected Africa to be an important part of the Fund's membership or a major focus of its work. Of the 40 original members, only 3—Egypt, Ethiopia, and South Africa—were in Africa, and they were scarcely representative.[1] Egypt was, and remains, more closely associated with the Middle East; and South Africa was under white minority rule. Between the Sahara and the Transvaal, Ethiopia was almost alone as an independent postcolonial country.[2] That situation began to evolve in 1957, when the newly independent countries Ghana and Sudan became IMF members. Applications soon flooded in, and by 1969 more than a third of the membership (44 of 115 countries) was African. The number, though not the percentage, continued to grow, and when Namibia joined in 1990, the IMF included all of Africa's 52 countries.[3]

Despite their large numbers, African members generally continued to play a relatively minor role in the Fund owing to their small size, generally low incomes, and

[1]In this History, Africa is defined to include all countries on the African continent and its offshore islands. The IMF's African Department, which was added to the organization chart in 1961, was responsible for relations with most, but not all, of these countries. For example, relations with Egypt were assigned to the Middle Eastern Department when that department was created in 1953, and work on several other countries in northern Africa—Algeria, Djibouti, Mauritania, Morocco, Somalia, and Tunisia—was assigned to the Middle Eastern Department in January 1993.

[2]Liberia, the only other independent country in the region at that time, participated in the 1944 Bretton Woods conference and was invited to become an original member of the IMF. The government, however, declined to join until 1962.

[3]In 1994, Eritrea separated from Ethiopia and became the fifty-third African member.

limited international trade. Even in the 1990s, they held less than 9 percent of the voting power and held only 3 of the 22 or 24 seats on the Executive Board.[4] They did, however, gradually begin borrowing in large numbers, albeit mostly in small amounts. Exceptionally, Ethiopia took out loans in 1948–49. Regular borrowing by African countries started in the late 1950s after Egypt used Fund resources to help cope with the effects of the 1956–57 Suez crisis. By 1975, the Fund had credits outstanding to 19 African countries: a third of the borrowers, but totaling just 8.4 percent of the total portfolio.

Lending to Africa increased dramatically in the late 1970s (Figure 14.1). From 1975 to 1982, the percentage of outstanding credits owed by African countries more than tripled, to 28.6 percent. This surge resulted from three separate developments.

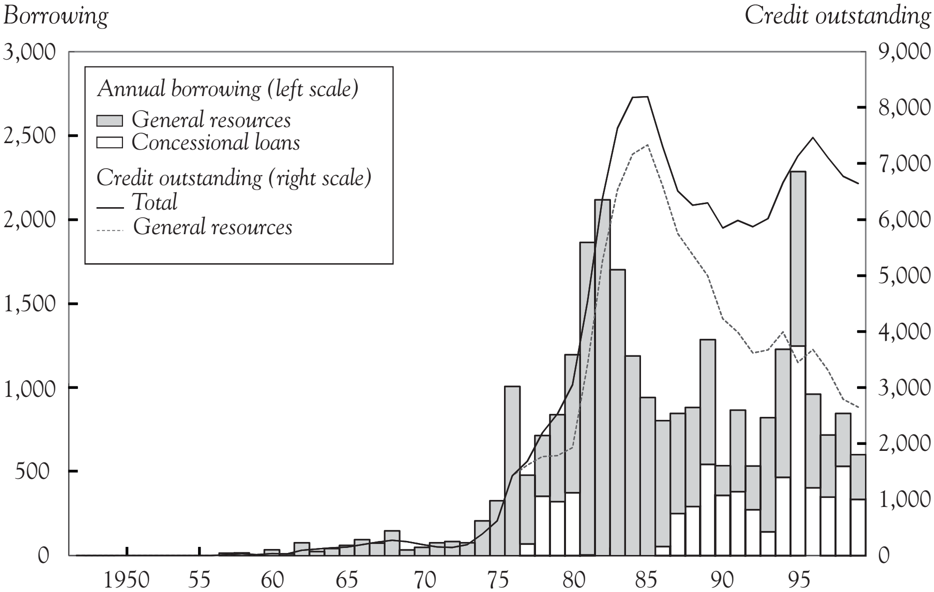
First, much of the growing African membership faced brutally adverse circumstances. Many of the newly independent countries suffered from extreme and entrenched poverty, with little access to safe drinking water, sanitation, health care, or even basic education. No one from a developed country who visited the region and saw these conditions first-hand could have failed to be moved by the need for development support, including financial aid, other material assistance, and policy advice. Even if the solutions lay beyond the boundaries of the IMF's institutional mandate, the problems could not be ignored. In the 1970s, sharply higher prices for imported oil, stagnant export markets, and (in the latter part of the decade) declining prices for a wide variety of Africa's primary-commodity exports added to the misery. Consequently, the region desperately needed stabilization financing on top of its persistent need for development assistance.

Second, the IMF was introducing new lending instruments for (though not limited to) meeting the needs of low-income countries and commodity exporters. The first of these specialized facilities, the Compensatory Financing Facility (CFF), created in 1963, aimed at providing quick-disbursing and low-conditionality loans to countries facing temporary losses of commodity export revenues. After Brazil—the first CFF borrower in June 1963—Egypt and Sudan were the next to use the new facility, which was renamed the CCFF in 1988 with the addition of a contingency element (Chapter 5). Three new facilities introduced in the 1970s were also designed in part to benefit African countries:

- In 1974, the Fund created a temporary "Oil Facility" to help oil-importing countries cope with the doubling of world oil prices that had just taken place. Much like the CFF, the Oil Facility dispensed with the usual policy conditions on Fund lending. Moreover, the Fund administered a separate subsidy account, funded by donor countries, that covered a portion of interest charges

[4]In addition to two Executive Directors from sub-Saharan Africa, a group of countries from the Middle East and North Africa has—except for two years in the mid-1970s—been represented by an Executive Director from Egypt or Libya.

Figure 14.1. Africa: Use of Fund Credit, 1950–99
(In millions of SDRs, annual data)



Source: International Financial Statistics.

for qualifying low-income countries. Of the 55 countries that borrowed from the Oil Facility during its brief life (1974–76), 21 were African.

- In 1975, the Extended Fund Facility (EFF) was established with the aim of enabling the Fund to support longer-term adjustment programs with loans that could be repaid over a longer period (10 years instead of 5). Starting with Kenya in July 1975, nine African countries availed themselves of the EFF through 1982.
- Most important for both the late-1970s surge and the longer-term growth of IMF lending to Africa, the Trust Fund was established in 1976 as an Administered Account for lending to low-income countries on concessional terms. Funded with the profits from sales of a portion of the Fund's stock of gold, the Trust Fund lent to 35 African countries (out of 55 total borrowers) through 1981, at which time its resources were fully exhausted.

Third, throughout the late 1970s, the governments of most of the large industrial countries—guided by such leaders as Jimmy Carter (United States), Valerie Giscard d'Estaing (France), Helmut Schmidt (Germany), and James Callaghan (United Kingdom)—were sympathetic to the needs of Africa and were willing to provide financing. Because analysts at the time thought most African countries were facing temporary liquidity problems from the oil shocks and other world developments, the IMF was seen as a natural instrument for this purpose. Inside the Fund, the Managing

Directors—H. Johannes Witteveen until 1978 and then Jacques de Larosière—shared this vision and made extensive efforts to broaden and deepen the Fund's role.

The surge, it must be said, did not succeed. The adverse external conditions of the 1970s did not go away, and "temporary" financing needs became permanent. Serious shortcomings in governance and institutional development in Africa, largely overlooked in the 1970s, proved to be close to intractable. Structural rigidities and market weaknesses prevented many countries from correcting their external imbalances, and prolonged liquidity shortages could not be reversed. The lending surge tapered off after 1982, when it became widely accepted that the combination of large and widespread lending and low policy conditionality had been a mistake. The consequences—long-term dependence on Fund lending and official development aid by countries throughout the continent, increasing involvement of the Fund with structural as well as macroeconomic policies, and payments arrears by countries unable to service their debts—dogged the continent and the international community for many years afterward.

IMF credit outstanding to African countries hit an all-time peak at the end of 1985, at $9 billion (SDR 8.2 billion), owed by 38 countries. Lending continued unabated, and nearly half of the countries in Africa were prolonged users of Fund resources for at least part of the 1990s. On average, however, the later loans were smaller. For the decade as a whole, the extension of credit to Africa averaged just 9 percent of total Fund lending.[5]

One reason the volume declined was the Fund's concern that many African countries were accumulating dangerously high levels of debt. The Fund's role gradually began to shift from that of primary provider of loans to one of policy advisor and certifier of the quality of countries' policy regimes and economic conditions. IMF lending generally covered a small portion of each country's financial needs, with donor countries and multilateral development agencies (mainly the World Bank and the African Development Bank) expected to cover most of the balance.

A second, and related, reason for the decline was that the Fund gradually shifted its lending to Africa out of its general resources and into special accounts—the Structural Adjustment Facility (SAF) from 1986 and the Enhanced SAF (ESAF) from 1987—whose funds could be lent at subsidized interest rates. That shift made the loans much more affordable, but the size of these donor-funded facilities was severely limited. In 1990, the combined resources for SAF and ESAF loans totaled just $4.7 billion, of which $2.6 billion was already lent to 33 low-income countries. Repayments of those loans would not begin for several more years. In the meantime, the remaining

[5]As shown in Figure 14.1, an exceptional spike occurred in 1995, when the Fund lent nearly SDR 2.3 billion ($3.5 billion) to African countries. Close to two-thirds of that total was to Zambia, following the settlement of its arrears to the Fund; see Chapter 16.

$2.1 billion would have to be spread thinly among the remaining eligible countries, many of which were among the neediest in Africa.[6]

A third reason for the lower volume was that relations between the IMF and many African countries became strained for a time. Tensions arose because of resentment over the Fund's emphasis on "structural adjustment" as the basis for its lending arrangements with low-income countries and with the increased use of detailed structural policy conditions in Fund-supported programs. The Fund's concern about corruption and other structural impediments to growth also delayed agreements in some cases.

Despite the difficulties, as the 1990s began, Africa was no longer of minor importance to the IMF. Nearly half of the countries with outstanding loans from the Fund were in Africa, and many of those had multiyear borrowing arrangements subject to extensive conditions on a wide range of economic policies. Several were in arrears, and many had little hope of repaying their loans without continuing assistance from the Fund and other agencies. By the end of the decade, glimmers of hope and pockets of progress across the continent were beginning to brighten prospects for economic growth. As middle-income developing countries began to mature into emerging markets, the challenge of helping lower-income African countries to achieve a comparable level of progress became more central to the Fund's work and to its focus.

The rest of this chapter explains the efforts the Fund made to improve economic stability and growth throughout Africa in the 1990s, assesses why the task initially proved to be so difficult, and reviews the achievements that materialized as the decade progressed. By the end of the 1990s, as the quotation from the Managing Director at the head of this chapter suggests, this assistance to Africa was becoming a major part of the future of the Fund's role.

A Growth Strategy for Africa?

The 1990s were not a great decade for Africa, but conditions improved distinctly in the second half. Although overall world economic growth averaged about 3.25 percent annually in both the 1980s and the 1990s, output growth in Africa fell to 1.9 percent from 2.3 percent. The contrast was even greater in per capita terms—world growth held steady at just over 2 percent while per capita incomes in Africa *declined* at a 1.1 percent annual rate in the 1980s and by 1.6 percent a year in the 1990s. Beginning in 1995, however, per capita income growth in Africa turned positive, averaging 1.2 percent a year for the rest of the decade.[7] This turnaround

[6]All but 5 of the 33 countries that had borrowed from these facilities through the end of 1989 were in Africa, but only 9 African countries had borrowed from the ESAF. That left 26 eligible African countries with potential demands on one or both facilities at the beginning of the 1990s.

[7]For an in-depth examination, see "The Great Sub-Saharan Africa Growth Takeoff: Lessons and Prospects," Chapter II in IMF (2008).

came at a time of extensive IMF lending across the continent, a substantial shift in lending from the General Resources Account (GRA) to less expensive concessional facilities, and the first steps toward comprehensive debt relief for the poorest countries.

Nearly as many African countries borrowed from the IMF in the 1990s (41) as in the preceding decade (46).[8] Of those that borrowed, 35 used the GRA in the 1980s, but only 21 did so in the 1990s. This shift into concessional facilities led to a drop in the overall volume of lending. In total, the Fund lent an average of $1.5 billion (SDR 1,283 million) a year to African countries in the 1980s, and $1.3 billion (SDR 940 million) a year in the 1990s. But because a much higher percentage of lending in the 1990s was through longer-term facilities, total Fund credit outstanding to Africa rose by close to 5 percent during the 1990s (and by more than 9 percent in U.S. dollars) despite the drop-off in average annual new lending.

This broad portrait of stagnation and debt accumulation does not show the full picture. Africa is a large continent with immense economic, political, and cultural diversity. A few countries, such as Ghana, Malawi, Tanzania, and Uganda, made significant and sustained progress throughout a good portion of the 1990s, though not without setbacks. Many of the 14 countries that use the CFA franc as their currency showed considerable improvement in economic performance after the devaluation of January 1994. The change in political regime that brought majority rule to South Africa also brought marked improvements in economic performance, although those improvements were uneven and difficult to sustain. Several other countries, including Algeria, Botswana, Kenya, Madagascar, Mozambique, Nigeria, and Tunisia, experienced at least a few years of strong policy implementation and economic progress despite adverse conditions such as repeatedly bad weather, the AIDS epidemic and other health disasters, and weak or protected markets for principal export commodities. However, civil conflict, lax internal security, and other governance problems impeded development more seriously in a number of African countries including the Democratic Republic of the Congo (known as Zaïre until mid-1997), Liberia, Rwanda, Somalia, Sudan, and Zimbabwe.

Multiparty democracy began to spread in the 1990s as more of the autocratic rulers who dominated the first generation in independent Africa left the stage. Among francophone countries, Benin, Burundi, Mali, Niger, and the Republic of Congo all elected new governments in 1991–93. Democracy (or partial democracy) was also established in Mozambique and in the newly independent Namibia in 1990; in Mauritania and Zambia in 1991; in Ghana and Kenya in 1992; in Malawi in 1993; in Algeria,

[8]The drop-off is explained primarily by four countries with arrears to the IMF—the Democratic Republic of the Congo, Liberia, Sudan, and Somalia—being ineligible to borrow throughout the 1990s. See Chapter 16 for a discussion of those cases.

Guinea-Bissau, and South Africa in 1994; and in Nigeria in 1999.[9] These transitions were not easy to undertake, and in most cases the political and economic instability that marked the early stages precluded adoption of forward-looking reform programs. This instability inevitably pushed the IMF to the sidelines until calm was restored, but lending usually resumed quickly.

What, overall, did the IMF do in the 1990s to try to improve economic conditions in Africa? Perhaps the most important charge was to take the task seriously and to devote sufficient time and resources to it. Undeniably, the influx of new European and Asian members after the collapse of the Soviet Union and the wave of emerging-market financial crises that began in 1994 sucked many of the best staff and much of the institutional energy away from simmering and entrenched problems and thus away from work on Africa. But just as undeniably, Michel Camdessus was personally committed to keeping help for Africa on the Fund's active agenda. He traveled to the continent frequently throughout the 1990s, making more than a dozen trips in all, to at least 30 different countries. In most cases, he met with the head of state as well as the country's senior finance officials, and also with civil and religious leaders and other influential people. Usually accompanied by his wife, Brigitte, he traveled to some of the poorest regions, where he was able to gauge the conditions of extreme poverty that dominated much of the continent, and where he gained a deeply personal sense of the desperate need for outside help.

Camdessus appointed two senior African officials to run the Fund's African Department: Mamoudou Touré (a former finance minister of Senegal) in 1988 and Goodall E. Gondwe (a future finance minister of Malawi) 10 years later.[10] In 1994, he appointed Alassane Ouattara, the highly respected former prime minister (and future president) of Côte d'Ivoire, to be one of his three deputies. Under Camdessus's tenure, Africa received more technical assistance from the IMF than did any other region—even more than the countries that emerged from the Soviet Union. He also undertook a major effort to increase the number of African nationals working throughout the Fund

[9]This list is not intended to be exhaustive, nor is it—nor is any such list—without controversy. In a number of countries, formal democratic systems were adopted, but opposition parties were effectively repressed.

[10]Much of the Fund's work on Africa was divided on a linguistic line, reflecting the predominance of English or French as the working language in most of the continent. The anglophone and francophone countries grouped themselves into separate constituencies on the Executive Board, and the African Department included divisions that worked primarily on the countries of one or the other of these linguistic groups. While the francophone Touré was the department head, two Deputy Directors led the work on these two groups: Gondwe on the anglophone countries and Evangelos A. Calamitsis (a Greek national, fluent in French) on the rest. Touré retired in 1994 and was succeeded by Calamitsis, who in turn was succeeded by Gondwe when he retired four years later.

and to bring a regular flow of African scholars to the Fund's Research Department for several weeks at a time.[11]

Energy, commitment, and resources alone are not sufficient to solve great problems. An effective strategy is also needed. On the most general level, the Fund's strategy for Africa differed from its approach in the rest of the world only in degree: provide temporary but medium-term financing, conditional on both macroeconomic stabilization and structural reform.

Most African countries (42 out of 53 by the end of the decade) were eligible for loans on concessional terms through the SAF and ESAF. For those countries, the Fund's lending was in support of a policy framework that (in principle) was developed by each country with assistance from the staffs of the IMF and the World Bank. In most cases (and again, in principle), the Fund's input into the policy framework was limited to macroeconomic and exchange rate policies and the fiscal and monetary aspects of structural reforms. Because the Fund's mandate and therefore its expertise were circumscribed, and because the Fund's financing was limited and temporary, the intention was that its inputs would constitute one element in a broader international strategy aimed at promoting sustainable development in each country and throughout the region.

The chief limitations of this strategy were architectural and much larger in scope than the IMF:

- First, no structure or even a design for one existed to ensure that the Fund's macroeconomic contributions were coordinated with the development aid and policy advice of other multilateral agencies or bilateral donors. Instead, the Fund and the others had to work out ad hoc cooperation tactics case by case. Because the Fund's contributions normally came first and well ahead of the others, the Fund had to assume that the additional financing and structural reforms would eventually materialize. This lack of coordination caused tensions between the Fund and the World Bank, weakened the ability of country officials to implement needed reforms, and left everyone uncertain about the availability of needed financing.
- Second, no model existed for placing countries' policy frameworks within a broad strategy to reduce poverty and promote economic and human development. The frameworks were aimed primarily at ensuring that the Fund- and World Bank–supported adjustment programs were comprehensive and internally consistent. For that reason, they were usually drafted initially in Washington and then modified as needed after discussions with the authorities.

[11]The effort to raise the African presence on the staff was acknowledged to have had only limited success. From 1989 to 1999, the number of African nationals on the IMF staff rose from 92 (5.3 percent of the total) to 144 (6.3 percent), but most of the increase was in the nonprofessional ranks. As for managerial positions, the number rose from 11 (4.7 percent) to 13 (4.0 percent); see "Staff Retention and Recruitment Experience in 1999," EBAP/00/40 (April 11, 2000). The visiting scholar program was initiated in 1994, with participants selected jointly by the IMF and the Nairobi-based African Economic Research Consortium.

All too often, the frameworks lacked domestic political ownership, and the authorities had great difficulty implementing them throughout the three-year lives of the programs.

- Third, no accepted framework existed yet to determine whether low-income countries could afford the levels of debt they were accumulating. As part of the Heavily Indebted Poor Countries (HIPC) Initiative in 1996, the Fund and the World Bank had established threshold ratios beyond which debt and debt service would be considered unsustainable. In the years that followed, it became increasingly clear that a more sophisticated analysis was required, and that it should be applied to all low-income countries, not just to those being considered for multilateral debt relief. In the meantime, many low-income countries in Africa and elsewhere faced recurring difficulties managing their external debts, even when those debts had been contracted on highly concessional terms.

In view of these systemic shortcomings, the Fund responded to each country case by case, trying to provide policy advice on as much of the structural reform agenda as possible within the constraints imposed by the need for financial discipline and macroeconomic stability. Unable to generate aid increases on its own, the Fund designed programs in low-income countries on the assumption that existing aid commitments would be realized, but no more. Unable to design or impose a comprehensive development strategy for each country, the Fund generally took most of the real (as opposed to financial) structure of the economy as a given, attempted to improve it at the margins, and hoped that agencies with more specialized expertise and mandates would gradually help fill in the rest.

By the end of the 1990s, the systemic architecture began to overcome these limitations. Replacing the ESAF with the Poverty Reduction and Growth Facility (PRGF) also meant scrapping the Washington-based policy framework methodology and replacing it with a more country-based process aimed specifically at reducing poverty and achieving and sustaining good economic growth. This new "poverty reduction strategy" was designed to be more homegrown in each country, based on extensive public discussion and participation, and thus more likely to be implemented. The summit-level adoption of the Millennium Development Goals by the United Nations in 2000, reinforced in 2002 by the implementation strategy known as the Monterrey Consensus, provided a clear road map for each agent's role (including the Fund's) and for coordination among the major players. In 2004, the IMF adopted an analytical framework for assessing debt sustainability in low-income countries. In the period covered here, however, these improvements were still being devised.

The effectiveness of the 1990s-era strategy was also limited by the difficulty of applying the Fund's general macroeconomic policy model to African economies. In particular, even though many of those countries had seriously overvalued real effective exchange rates, whether devaluation would improve economic performance in all such cases was far from clear. Except in cases of extreme overvaluation, currency

devaluation was unlikely to generate much of a supply response on the production of primary commodities for export. Moreover, if most imports were of inputs to production rather than consumer goods, driving up the costs of those imports through devaluation would have perverse effects on output. Worst of all, in small landlocked countries such as Malawi or Rwanda, where a large portion of the federal budget went into fuel and other transportation costs, devaluation could even aggravate the fiscal deficit. None of these difficulties justified the continuation of overvalued exchange rates, but for many countries they made the correction of the problem markedly painful.

Of the 42 African countries eligible for ESAF loans, all but 9 borrowed from the Fund at least once during the 1990s. Four of the exceptions were ineligible to borrow throughout the decade, owing to prolonged arrears to the Fund dating from the 1980s. Those countries—the Democratic Republic of the Congo, Liberia, Somalia, and Sudan—are discussed in Chapter 16. The other five nonborrowers reflected a variety of circumstances.

The most important of these nonborrowers was Nigeria, the second largest economy (after South Africa) in sub-Saharan Africa. Nigeria joined the IMF in March 1960, shortly after gaining independence from Britain. A major oil exporter with good access to international capital markets, Nigeria was a Fund creditor for most of the period from the first oil shock in 1973 to 1982. Falling oil prices, rising debt, deteriorating economic management, and political instability then combined to throw Nigeria into a debt crisis. It became one of only two African nations in the "Baker 15" countries with unmanageable debts to foreign private creditors.[12]

In June 1986, the Nigerian government adopted a "comprehensive and radical" program of structural adjustment.[13] Within a few months, that shift led to approval of what could have been Nigeria's first-ever use of Fund resources, a 12-month stand-by arrangement for $813 million (SDR 650 million, or just over 75 percent of quota). That approval unlocked debt-restructuring agreements with Paris Club official creditors and London Club bank creditors.[14] In requesting the arrangement, however, the authorities signaled their intention not to draw on it, and they did not. Two subsequent stand-by arrangements, approved in February 1989 and January 1991, were similarly and successfully treated as precautionary.

The Fund declared Nigeria eligible for ESAF borrowing in April 1992. For the next several years, that prospect was clouded by severe governance problems after the military government voided the democratic presidential elections of 1993. The Fund continued to monitor the economy through regular Article IV consultations, but discussions of financial support only resumed following the election of Olusegun Obasanjo

[12]Côte d'Ivoire was the other. The Baker 15 was a list of 15 countries singled out for special attention when U.S. Secretary of the Treasury James A. Baker III announced his plan for resolving the international debt crisis in 1985; see Boughton (2001), pp. 417–29.

[13]"Nigeria—Staff Report for the 1987 Article IV Consultation", SM/87/280 (November 25, 1987), p. 3.

[14]Biersteker (1993) reviews the evolution of Nigeria's debt crisis.

as president in February 1999. Within weeks, Camdessus went to Abuja to meet with Obasanjo (whom he already knew well) and to offer the Fund's help in pulling Nigeria out of the morass. On his return, he reported to the Executive Board that Nigeria was "truly at quite a juncture in history," but also that the new president faced incredibly daunting circumstances. On top of the long-standing problems—three decades of falling incomes, driven down by pervasive corruption—the market for Nigeria's oil exports was seriously depressed. Nonetheless, agreement had already been reached on a staff-monitored program, and the Managing Director put on a good display of his characteristic optimism. Nigeria, he noted, faced "tremendous hardship" but also a "window of opportunity, possibly the first true one for democracy and development for many years."[15] Indeed, from that point on, Nigeria began to stabilize the economy and restore growth. The Fund helped with a fourth precautionary stand-by arrangement in August 2000 and continued to provide both advice and its seal of approval in the years that followed.

On the other side of the equator, 1,200 miles south of Nigeria, Angola was mired in civil war throughout most of the decade and was able to open serious discussions with the IMF staff only in 1998. Understandings were reached on a staff-monitored program in May 2000, after which Angola began to achieve strong economic performance, and its growing oil exports enabled the government to forgo borrowing from the Fund.

The tiny island country of Cape Verde suffered from a lack of natural resources and an undiversified economy, but it obtained enough assistance from donor countries to manage its debts while generating moderate economic growth in the 1990s. The Fund provided substantial technical advice, and it approved two stand-by arrangements for Cape Verde, in 1998 and 1999. The government treated both arrangements as precautionary, to serve mainly as a basis for donor support. Beginning in 2002, the Fund lent to Cape Verde through the PRGF in support of the government's poverty reduction strategy.

São Tomé and Príncipe, an even smaller island country, also relied heavily on donor support. It took out one small SAF loan in 1989, which it repaid on schedule in 1994–99. Weak economic policies led to stagnation through much of the decade, but the government set out to strengthen policies in 1998. The Fund agreed to a staff-monitored program the following year, and PRGF lending began in 2000.

Eritrea became independent from Ethiopia in May 1993, joined the IMF in July 1994, and was declared eligible for the ESAF in January 1995. Recurring conflicts with neighboring countries and weak macroeconomic and structural policies undermined donor support and impeded progress toward agreement on conditions for IMF lending.

Not all of Africa suffered the ills of chronic underdevelopment. In the 1990s, 11 African countries achieved sufficient economic development to make them ineligible for concessional loans. The Fund's strategy for relations with these countries was

[15]Report at EBM/99/31 (March 24, 1999), pp. 5–6.

basically the same as for other developing countries, although it varied considerably depending on the country's unique circumstances. Botswana and Libya had taken good advantage of the income from diamonds and oil, respectively, and were creditors of the Fund. Neither had ever borrowed from the IMF. Four others—Mauritius, Namibia, Seychelles, and Swaziland—did not borrow in the 1990s. For those six countries, the principal interaction with the Fund was through the annual Article IV consultation. The remaining five middle-income African countries—Algeria, Gabon, Morocco, South Africa, and Tunisia—borrowed occasionally, and all but South Africa had at least one upper-tranche arrangement.

Large-Scale Lending

More than half of the IMF's gross lending to Africa in the 1990s ($7.3 billion out of a total of $13.2 billion) went to four countries (out of 38 borrowers): Algeria, Zambia, South Africa, and Côte d'Ivoire. Their circumstances varied, reflecting the range of experiences across Africa in the 1990s. Algeria was a mineral-rich country in need of structural reform. Zambia, a commodities exporter, faced worsening market conditions and an unsustainable debt burden. South Africa was a more industrial economy making an extraordinary transition to democracy. And Côte d'Ivoire was the dominant member of a monetary union undertaking a major devaluation of its currency. Three of these four cases are reviewed here. Zambia—which drew heavily on the Fund after settling its overdue obligations in 1995—is discussed along with other arrears cases in Chapter 16.

Algeria

Algeria—the second largest country in Africa and the geographic heart of the Maghreb—was the largest African borrower from the IMF in the 1990s, drawing nearly $3.5 billion (SDR 2,452 million) on the Fund's general (nonconcessional) resources. This record was especially remarkable because for most of its independent history, this oil-exporting country had little need for external financial assistance.

Algeria became independent from France in 1962 and joined the Fund in 1963, but it did not borrow from the Fund until 1989. For much of that time, with substantial revenues from exporting natural gas and petroleum, the government invested heavily in state-owned domestic industrialization projects without excessive recourse to foreign capital. The collapse of world oil prices in the mid-1980s exposed the inefficiencies in Algeria's socialist development model, left the real exchange rate at an overvalued level, and added to the burden of external debt. These circumstances forced the authorities to focus on macroeconomic stabilization and the need for a more

market-oriented strategy.[16] In June 1989, the Fund approved a combination stand-by arrangement and CCFF drawing (for export shortfalls and excess cereal imports), and the authorities drew the entire approved amount up front.

The 1989 and 1991 stand-by arrangements aimed primarily to support Algeria's effort to stabilize the economy while carrying out a limited structural reform agenda. That effort mostly failed, owing in part to the absence of a comprehensive policy framework. Notably, the large exchange rate depreciation that seemed necessary to make Algeria's export industries competitive ended up squeezing profits because those industries depended heavily on imported inputs. In addition, Algeria was saddled with expensive external debt to both official and private creditors, with debt-service payments equivalent to more than 80 percent of export revenues. At the same time, violent political conflicts between aspirant Islamic political parties and the single-party socialist government were undermining the social order. In 1994, the government was reorganized. It began a series of partial liberalizing steps that led to secularist multiparty elections in 1995 and then to the adoption of a new constitution.

Substantial IMF support for structural reforms also began in 1994. In February, a few weeks after a retired army general, Liamine Zéroual, was appointed president of the country, Camdessus decided to detour to Algiers to meet with Zéroual on his way to a Group of Seven (G7) summit meeting in Frankfurt. Afterward, Camdessus promised that the Fund would not "spare any effort in trying to help Algeria at such a difficult juncture."[17] At the same time, a team of Algerian officials was in Washington negotiating terms for a reform program to be supported by an IMF stand-by arrangement. The major elements of the government's program would be reduction in bureaucratic control and the subsidizing of economic activity, liberalization of prices and exchange markets, a sharp reduction in the fiscal deficit to be achieved primarily by creating new opportunities for private sector employment, and tightening of credit policies.[18] Agreement on terms was reached quickly, and in May the Executive Board approved a little more than $1 billion in loans: a 12-month stand-by arrangement for $647 million, supplemented by an immediately available $388 million CCFF drawing (SDR 457.2 million and SDR 274.3 million, respectively). That approval unlocked debt-relief agreements with the Paris Club and the London Club.

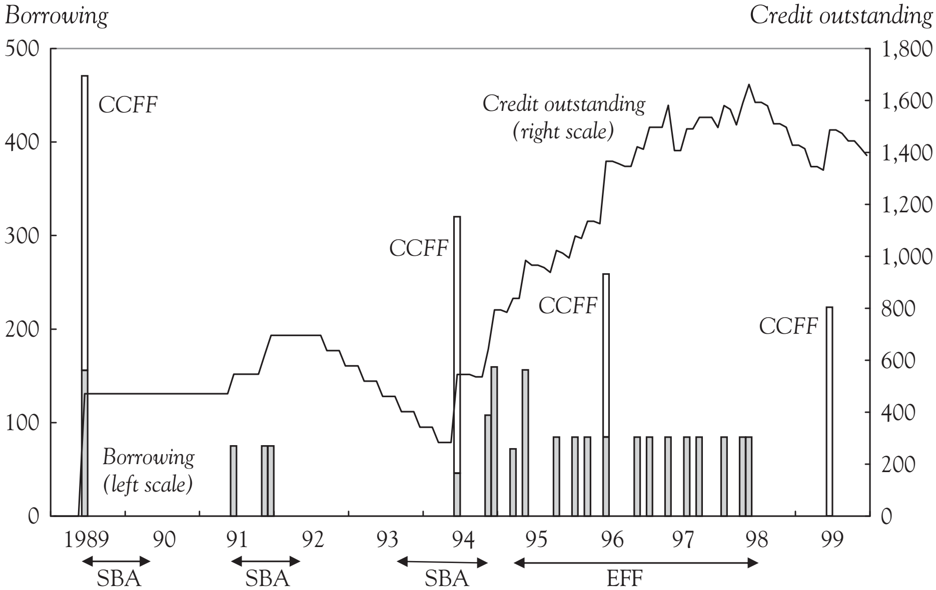
For the rest of the decade, the Fund provided regular financial assistance to Algeria in support of an ongoing economic stabilization and reform program. Despite the persistence of terrorist acts and guerrilla warfare, the government attained a strong economic progress record. Following the successful completion of the 1994–95 stand-by arrangement, the Fund approved an EFF arrangement in May 1996, which was fully drawn, and

[16]For an overview of Algeria's political and economic history and its relations with the IMF through 1997, see Nashashibi and others (1998).

[17]Report to the Executive Board at EBM/94/18 (March 4, 1994), p. 4.

[18]Report by the Managing Director to the Executive Board, minutes of EBM/94/18 (March 4, 1994), pp. 3–4.

Figure 14.2. Algeria: Use of Fund Credit, 1989–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics.
Note: CCFF = Contingency and Compensatory Financing Facility; EFF = Extended Fund Facility; SBA = Stand-by arrangement.

a CCFF loan in June 1999 to compensate for low world prices of Algeria's predominant exports, oil and gas. Algeria's indebtedness to the Fund peaked in May 1998 (Figure 14.2) at $2.2 billion (SDR 1.66 billion, or 182 percent of quota). The government repaid all of these loans either on time or early, with a final repayment in February 2006.

South Africa

MANY PEOPLE SEEM TO BELIEVE THAT A POPULARLY ELECTED BLACK GOVERNMENT CAN BE ESTABlished peacefully and would be able to maintain political freedoms, civil liberties and some kind of economic rights for its citizens, including the minority whites. . . . [That] event would perhaps be the greatest political accomplishment in human history. To put it another way, it is not going to happen.

Robert J. Barro
Wall Street Journal
December 14, 1993

South Africa, one of the four African countries that participated in the Bretton Woods conference, joined the IMF as an original member in 1945. As a major gold producer and exporter, the country had little need for official financial assistance, and

for a few years in the late 1960s it was a creditor country in the IMF. Its economic fortunes worsened considerably in the mid-1970s as the social and economic implications of apartheid surfaced and led to domestic upheavals and international isolation.[19] The IMF provided stand-by arrangements and CFF drawings in 1976–77 and again in 1982–83, after which the spread of international sanctions cut off further support until the apartheid system was renounced.[20]

In 1990, the minority government led by F.W. de Klerk announced that the long-banned African National Congress (ANC) would be legalized, along with other parties that had been outlawed because of their opposition to apartheid. That step set off an irreversible chain of events that led to the election of a Government of National Unity in 1994. Throughout this transition, the ANC, many of whose leaders—including the future president, Nelson Mandela—had been languishing in South Africa's prisons when the Fund last lent to the country a decade earlier, regarded the IMF with suspicion. Nonetheless, they did not object in 1991 when de Klerk invited Camdessus to discuss steps toward reestablishing normal relations. That diplomatic opening led to a resumption of lending two years later.

No one expected the transition to democracy to be smooth. Whether it could be completed without first passing through a period of massive bloodshed or a descent into total economic, political, and social chaos remained to be seen. Financially, this fear was manifested by capital flight and by the virtual absence of foreign inflows. Officials in the treasury and the central bank desperately wanted to draw on the IMF to bolster their foreign exchange reserves and thus allow foreign trade to continue normally, but they faced two severe obstacles. First, domestic policymaking in the South African government was nearly paralyzed because any major decision required the approval of both the de Klerk government and the transitional committee that comprised representatives of all of the newly legalized political parties.[21] Second, the major creditor countries were reluctant to allow a resumption of lending until the

[19]From 1948 to 1974, South Africa was a member of the Executive Board constituency headed by Australia. When the Australian government informed the South African authorities that they were no longer welcome in that group, South Africa ceased to participate in elections of Executive Directors. For the next two decades, the government was represented by an official who maintained an office near the IMF in Washington and who received documents and was invited to attend relevant Board meetings. Article IV consultations continued annually, the Fund continued to provide technical assistance and training, and it remained willing to lend until the mid-1980s; see Boughton (2001), pp. 590–95. South Africa repaid the 1982–83 borrowings by 1987 and had no further outstanding obligations until 1993.

[20]Formally, the sanctions imposed by many countries did not constitute a barrier to IMF lending, but they were symptomatic of broad antipathy that led the Managing Director to conclude that the Executive Board would not approve a borrowing request from South Africa. Staff Article IV missions repeatedly conveyed that message to the authorities, who accepted that such a request would be futile.

[21]The ANC and de Klerk's National Party were the dominant political forces, but several other parties were vying for influence and were participating at least intermittently in the transition negotiations. Beginning with the 1991 IMF/World Bank Annual Meetings in Bangkok, representatives of the ANC were invited to attend.

outcome of the transition was more clearly in focus. In practice, the critical steps were the establishment of a multiparty framework known as the Transitional Executive Council (TEC) and a request by the ANC leadership for the international sanctions to be lifted. Those steps were not taken until December 1993. In the meantime, entering into a stand-by arrangement with the IMF, with all of the attendant policy conditions, would have been unthinkable for the authorities as well as for the IMF.

Despite the authorities' aversion to conditional borrowing, they recognized that they needed foreign exchange. The economy was in a prolonged and deepening recession, most foreign investors were put off by the political uncertainty and were unwilling to gamble on a successful turnaround, and the central bank's reserves were dangerously low and falling. Major creditor countries recognized the global political importance of aiding the transition to democracy, but they also knew they had to have some assurance that committing money to the country would help and would not be wasted. The IMF, with its technical expertise and its regular dialogue with the authorities, was the natural conduit for determining when and how the international community could safely resume lending to South Africa.

IMF management was eager to develop a strong working relationship with the ANC and other likely participants in a democratic government, and the Fund was prepared to lend if a way around the obstacles could be found. As it happened, in 1992 and 1993 agricultural production in southern Africa was suffering from a severe drought. In addition, South Africa's export income was being hit by a drop in the world price of gold. The Fund staff agreed that these shocks appeared to be temporary and that the country thus qualified for a quick-disbursing, low-conditionality compensatory loan through the CCFF. More important, the CCFF option provided a way to lend to South Africa while minimizing the political risks for both sides. A staff team, led by Leslie Lipschitz (Assistant Director, African Department), went to Pretoria in April 1993 to begin discussions, but the team found that the ANC was still opposed to any borrowing until after the election of a democratic government.[22]

A date for elections had not yet been set, but it was obvious they could not be held until sometime in 1994. Under the rules governing access to the CCFF, a loan would have to be approved within six months of the end of the "temporary shortfall" in export revenues, which in this case was calculated to be in the middle of 1993.[23]

[22]Memorandum from Lipschitz to the Acting Managing Director, "South Africa—Staff Visit," May 4, 1993; IMF archives, Accession No. 1997-0067-0006, OMD-AD, B9960, "South Africa 1993." This staff visit was the first one to South Africa under the auspices of the African Department. Previously, relations with South Africa had been handled by the European Department.

[23]Because a large part of the shortfall had occurred in 1992, the staff calculated that any delay resulting in that period being excluded would sharply reduce the amount the Fund could lend; see memorandum from Touré to the Managing Director, "South Africa: Briefing Memorandum for Staff Visit," August 30, 1993; IMF archives, Accession No. 1997-0067-0006, OMD-AD, B9960, "South Africa 1993."

Nelson Mandela greets Michel Camdessus in Washington, September 1993.
(Newscom/AFP photo by Paul J. Roberts)

With reserves continuing to be drawn down by the outflow of capital, either the ANC would have to soften its opposition, or defaults would occur imminently.

The first breakthrough came at the beginning of July 1993, when a long and rancorous negotiating process among the political parties reached a successful conclusion. Elections were then scheduled to be held the following April, which provided justification for the ANC to relax its opposition to a CCFF loan. Lipschitz and his staff team returned to Pretoria in early September to resume discussions.

Agreement on terms, however, was not to be reached easily. Access to the CCFF did not normally depend on specific policy conditions. The formal requirement was merely that the country be cooperating with the Fund to find a solution to its balance of payments difficulties, and the Executive Board had explicitly rejected proposals to define that standard more rigidly (Boughton, 2001, p. 729). In this instance, the staff and management agreed that the substantial uncertainty about the future course of economic policies in South Africa called for a tight interpretation. Accordingly, the Fund required the authorities to agree to a memorandum of understanding on policies to be followed in 1994. Moreover, the cover letter—in effect, a Letter of Intent—would have to be signed both by the finance minister on behalf of the government and

by representatives of the TEC. The latter body did not yet exist because parliament had not yet passed the enabling legislation, but everyone involved hoped that it would be formed in the fall of 1993, in time for the Executive Board to consider the loan request before the end of the year.

A second breakthrough came shortly after the September mission, when Mandela passed through Washington on his way to address the UN General Assembly in New York. At the IMF, he had breakfast with Camdessus, during which they agreed that the pending loan from the Fund should be quickly approved. Afterward, Camdessus issued a press release stating that he was "full of admiration for the courageous steps that are being taken by South African statesmen to build a new South Africa."[24] After further encouraging talks with the authorities in the margins of the Annual Meetings in Washington, Lipschitz again went to South Africa to conclude the negotiations and finish drafting the memorandum of understanding on policies.[25] The day after he arrived, the UN lifted its sanctions, removing the penultimate barrier to a resumption of lending.

The final breakthrough came only in early December, when the TEC at last became operational. When the group held its initial meeting on December 7, 1993, its first agenda item was to approve the statement of policies contained in the memorandum of understanding that had been drafted during the October mission. That cleared the way for all of the leading participants to sign the cover letter: the finance minister, Derek Keys, on behalf of the transitional government; Dawie de Villiers, cochair of the TEC for de Klerk's National Party; and Pravin Gordhan, cochair of the TEC for the Natal Indian Congress.[26]

With all of these hurdles overcome, the Executive Board met on December 22 to approve a loan of $850 million (SDR 614.4 million) to South Africa. Although only 45 percent of South Africa's quota, it would be one of the largest loans of the decade to any African country. The Board enthusiastically and unanimously approved the request, and the discussion focused principally on the challenges that South Africa would face once a new government was in place.

Demands by a long-repressed majority population to share in the country's wealth would be strong and well justified, but any attempt by the government to satisfy those demands within a few years was likely to ruin the economy. The October staff mission had calculated that "to equalize government spending on social services for all race groups at the level enjoyed by whites would require a budget increase of 11 percent of

[24]"Statement by Michel Camdessus: 'The IMF is Helping South Africa Through the Transition'," NB/93/13 (September 24, 1993).

[25]Memorandum from Lipschitz to the Managing Director, "South Africa: Discussions on the CCFF and the Article IV Consultation," October 21, 1993; IMF archives, Accession No. 1997-0067-0006, OMD-AD, B9960, "South Africa 1993."

[26]"South Africa—Staff Report for the 1993 Article IV Consultation and Request for Purchase Under the Compensatory and Contingency Financing Facility," EBS/93/192, Suppl. 1 (December 14, 1993).

GDP. Clearly, this would be impossible to finance."[27] The Fund's Executive Board concurred and concluded that fiscal policy was constrained by the already large deficit, while monetary policy was constrained by the weakening exchange rate and the need to overcome investors' doubts about macroeconomic stability.[28] Although not an atypical IMF message to a borrowing country, it was a strikingly firm piece of advice to a country so greatly in need of economic growth and social and structural reform.

On the Board, the chief dissenter from this taut conclusion was Douglas E. Smee (Canada), who argued that South Africa's "social backlogs . . . cannot be ignored" and that the best choice in these difficult circumstances was "to ease monetary policy and . . . let the exchange rate depreciate, in return for frozen prices and wages for some agreed period." Karin Lissakers (United States) partially supported that argument, suggesting the authorities might have "more room in which to maintain a tight fiscal policy if there was some easing on the exchange rate and interest rates." Jarle Bergo (Norway) and Ewen L. Waterman (Australia) also expressed some support, but Godert A. Posthumus (Netherlands) neatly summarized the majority view when he asserted that "competitive exchange rate policy experiments, as advocated by Mr. Smee, are dangerous and, in the end, unproductive."[29]

Financial markets had difficulty believing that a South African government would embrace the IMF's policy advice. History did not provide much basis for hope that a democratically elected government in Africa would take a long-term view and give precedence to financial stability and policy sustainability. A social explosion would surely result if it tried.

In these difficult circumstances, a Government of National Unity, with the ANC as the leading party, was elected in April 1994, and Nelson Mandela was elected president. By then Camdessus was even more convinced that South Africa was going to need large-scale financial assistance. When the new government showed no inclination to seek the Fund's help, he sent Alassane Ouattara (Deputy Managing Director) to Cape Town in February 1995 to discuss the matter with Mandela and other officials, but Ouattara found that much of the leadership was still hostile to the IMF. A visit by First Deputy Managing Director Stanley Fischer in December was no more productive. Bitter memories persisted of the Fund's past support to the minority government, and many political leaders believed that IMF lending would come with unacceptable restraints on economic policies and would threaten the country's sovereignty.[30]

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[27]Memorandum from Lipschitz to the Managing Director, "South Africa: Discussions on the CCFF and the Article IV Consultation," October 21, 1993; IMF archives, Accession No. 1997-0067-0006, OMD-AD, B9960, "South Africa 1993."

[28]Minutes of EBM/93/177 (December 22, 1993), Summing Up by the Acting Chairman, pp. 5–7.

[29]Minutes of EBM/93/176 (December 22, 1993), pp. 9–11 (Smee), 36–37 (Lissakers), and 50–53 (Bergo, Waterman, and Posthumus).

[30]Report by Ouattara to the Executive Board at EBM/95/18 (February 22, 1995), pp. 3–4; and report by Fischer at EBM/95/123 (December 22, 1995), pp. 3–4.

The last real opportunity for South Africa to avail itself of the Fund's financial resources occurred in 1996. The rand came under attack in February, initially as a result of unfounded rumors that Mandela was in ill health. At the end of March, Mandela shuffled his cabinet and moved Trevor A. Manuel to the finance ministry. Manuel—like Mandela, a former prisoner of the *ancien régime*—had chaired the ANC's economic planning committee during the transition and had then served as minister of trade and industry. Like much of the ANC leadership—indeed, like most of South Africa's new economic officials—Manuel strongly believed in fiscal discipline and financial stability as the foundation for sustainable economic progress.[31] Eventually, he would be widely acknowledged as one of the outstanding finance officials in the developing world, but in 1996 his resolve had not yet been tested. When he publicly bristled at the notion that economic policy should aim to satisfy the markets, the doubts intensified.[32] From February to October, the rand depreciated by 20 percent against the U.S. dollar, and the central bank's foreign exchange reserves fell to a dangerously low level.

Camdessus made an extraordinary effort to help. In April 1996, he went to Johannesburg to attend an UNCTAD meeting. At a joint press conference with Manuel, he stated how impressed he was by the government's "fantastic achievement" of maintaining fiscal prudence while restoring economic growth. It was "an extraordinary success story," he concluded, and any speculator who bet against it was sure to lose.[33] That vote of confidence helped a bit to reduce the pressure, but the weakness of the rand and the outflow of foreign exchange continued through the summer.

In June, Manuel introduced a comprehensive growth-oriented stabilization plan, under the heading Growth, Employment, and Redistribution (GEAR) strategy. The strategy called for tightening fiscal policy, stabilizing the real exchange rate, and liberalizing the economy to promote investment and employment opportunities. Although the plan received praise from both inside and outside South Africa, investors continued to wait for concrete evidence of progress, and the rand continued to weaken. By late summer, South Africa was in financial crisis, and the country's leadership was becoming convinced they would need help from the IMF to bolster their reserves. Either Manuel or the central bank governor, Christian L. Stals, was on the telephone with

[31]For an analysis of the political economy of South Africa in this period, see Hirsch (2005). The economic results are analyzed in Nowak and Ricci (2005).

[32]Told by a reporter in March 1996 that "the markets" wanted to know whether he was going to remove South Africa's exchange controls, Manuel replied, "What is this market? What is this amorphous entity which sent you here, huh? Who sent you here? On whose behalf do you speak about these issues?" For at least a decade, press coverage of Manuel's performance as finance minister frequently referred to a supposed "amorphous markets" speech that he was thought to have made. See Pippa Green, "The Outsider Who Has Measured Vision Against Reality," in the online edition of *Business Report* (February 16, 2006); accessed at http://www.busrep.co.za/index.php?fArticleId=3115326.

[33]See Reuters News, "IMF Backs South Africa Government, Upbeat on Economy Outlook" (April 27, 1996); accessed at http://global.factiva.com.

Fischer at least once every few days, quietly seeking advice on regaining investors' confidence.

As South Africa's finances weakened, the IMF staff began preparing a proposal for an adjustment program that could be supported by a stand-by arrangement if the authorities decided to request one. The African Department was satisfied that the GEAR strategy could serve as the basis for a Fund-supported program, but they wanted to push the authorities toward further monetary tightening and deeper structural reforms as a condition for the Fund's support. Fischer, who had told Manuel that the GEAR was an "excellent" plan and who understood well the political constraints Manuel was facing, squashed that idea and insisted the Fund should offer to support the government's own program, beefing it up only by making it more specific. "We have in some way to take account of their political problems in accepting a Fund program," he told the staff.[34]

In October 1996, Camdessus returned to Johannesburg, where he again had breakfast with Mandela, this time at the president's home. By this time, official reserves were down to the equivalent of just a few weeks of imports, and pressures on the government to increase social spending were rising. In conversation with the president, Camdessus suggested the Fund could provide a multibillion dollar extended arrangement, conditional on implementation of economic policies that were essentially the same as the government was already putting in place. Mandela agreed in principle, subject to the approval of his government.

Mandela and Camdessus went outside into the sunshine to meet with the press in Mandela's garden. The president praised the IMF, welcomed its support, and stressed the importance to the country of carrying out a bold set of economic reforms—not because the IMF insisted on it, but for their own sake. "If we want IMF assistance, the IMF must be convinced that the way that we are handling our monetary policy is consistent with the guidelines it has set. I am personally convinced that the guidelines . . . are very good—without any country allowing the IMF to undermine its sovereignty . . . What is important is that we want financial assistance from the IMF."[35]

Mandela's acceptance of the Managing Director's offer turned out to be premature. While the press conference was taking place, government and ANC officials were meeting to put the finishing touches on an official announcement, which was

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[34]The pro forma program was set out in a memorandum for files by Peter Doyle (Economist, African Department), August 28, 1996. The quotation from Fischer is from his handwritten notation on the covering note, dated September 3 and addressed to Calamitsis; IMF archives, DMD-AD, Accession 1999-0275-0008.

[35]Statement by Mandela at press conference of October 18, 1996. For the complete transcript, see memorandum from S.J. Anjaria to the Managing Director, "Press Conference of President Mandela and the Managing Director," October 29, 1996; IMF archives, DMD-AD, Accession 1999-0275-0008. The quoted remarks were published in "Mandela and Camdessus Discuss South African Prospects," *IMF Survey*, Vol. 25 (November 11, 1996), p. 376.

scheduled to be made in the early afternoon. By the end of the day, however, no announcement was made, nor would one be. That evening, Manuel went to see Camdessus and informed him that the ANC had vetoed the proposal. Although program discussions between Fund management and senior officials would continue at a general level for a few more months, and although the country's social and financial needs would continue for years, South Africa would forgo all further borrowing from the IMF.

Côte d'Ivoire and the CFA Franc Zone

The fourth largest African borrower in the 1990s was Côte d'Ivoire, more familiarly known in English-speaking countries as Ivory Coast. As recounted in Boughton (2001, pp. 578–85), economic conditions in Côte d'Ivoire deteriorated seriously in the late 1980s and early 1990s. A sustained decline in world prices for the country's two major exports—coffee and cocoa—lowered Côte d'Ivoire's terms of trade by 45 percent from 1985 to 1993. Currency devaluation as a response was ruled out as a practical matter by Côte d'Ivoire's participation in the monetary union known as the CFA franc zone. Instead, the government tried a variety of policy adjustments, including a freeze on public sector wages, cuts in prices paid to farmers, and tax increases. The IMF and other official creditors tried to help by providing new loans, but none of these measures was sufficient to prevent the fiscal and external deficits from rising beyond control. By the end of 1990, the economy was in shambles. The president, Félix Houphouët-Boigny, put a former Director of the IMF's African Department, Alassane Ouattara, in charge of economic recovery and named him to the newly created post of prime minister. Although the IMF management team had the highest respect and admiration for Ouattara, the Fund suspended its lending to Côte d'Ivoire until it could see concrete evidence that the government was capable of stabilizing the economy.

The constraint on exchange rate adjustment in Côte d'Ivoire had a long history, a legacy of French colonial role. In the 1930s, the French government began stabilizing the currencies being used in many of its overseas colonies by pegging them to the French franc. At the conclusion of the Second World War, the currencies of most of France's African colonies were consolidated into a single unit called the "franc des Colonies Françaises d'Afrique" or CFA franc. An agency of the French government issued the currency, and the French treasury guaranteed convertibility of the CFA franc into the French franc by establishing "operations accounts" for each colonial central bank. Those central banks pooled most of their foreign exchange reserves through these operations accounts. In return, they enjoyed overdraft privileges, subject to rules limiting the amount of credit they could extend.

In October 1948, the rate of exchange was fixed at one CFA franc to two French francs. The number of participating countries fluctuated a bit over the years, and the nominal ratio changed from 1:2 to 50:1 with the French currency reform of 1960, but the astounding and unique fact was that for more than 40 years, through many political

and economic upheavals, the rate of exchange was unaltered between the CFA and French francs.[36]

This longevity did not result from the coherence of the zone as an optimal currency area. The inadequate transportation infrastructure across this vast area and the heavy reliance on exporting primary commodities to industrial countries meant that intraregional trade was limited. Instead, the benefits of the zone derived from the links to France and the stability that came from having a strong currency. Trade with France and other European countries became the chief engine for economic growth throughout the region, and the French government provided a large and increasing amount of financial support through the operations accounts. Moreover, the link to the French franc forced a measure of fiscal discipline. That link also provided an anchor for price expectations, producing far more stable consumer prices than those in neighboring African countries. After the terms of trade for most commodity-exporting African countries weakened in the late 1980s, the downturn in growth was similar inside and outside the franc zone.[37]

Preparing for Devaluation

Despite these advantages, the overvaluation of the CFA franc that followed the terms-of-trade shock put unbearable pressure on the exchange rate, not least because the French authorities became concerned about the cost of maintaining it. By the early 1990s, the IMF also recognized the need for a devaluation. Together, French treasury officials and the Fund's management team worked quietly for two years to persuade the African leaders that they would have to devalue and to prepare for the consequences. That diplomatic effort was both reinforced and complicated by pressure from officials in other industrial countries and in the World Bank, many of whom were convinced that the system was giving France an unfair competitive advantage in securing trade with franc-zone countries.[38]

[36]The original African participants, with their current names, were Benin, Burkina Faso, Cameroon, the Central African Republic, Chad, Comoros, the Republic of Congo, Côte d'Ivoire, Djibouti, Gabon, Mali, Mauritania, Niger, Réunion, Senegal, and Togo. Djibouti left the zone in 1949. Mali left temporarily in 1962. Madagascar established its own currency in 1963, and Mauritania did so in 1973. Réunion, an overseas *département* of France that did not become an independent country, switched from CFA to French francs in 1975. Comoros left in 1981. After that, the trend toward the exit reversed, with the return of Mali (1984) followed by the addition of new members Equatorial Guinea (1985) and Guinea-Bissau (1997). For a more complete history, see Boughton (1993a) and references therein.

[37]These points are discussed more fully in Boughton (1993a, 1993b).

[38]Much of the World Bank staff (but not its senior management) was deeply suspicious and resentful of what they believed to be a joint effort by the French and the IMF to prevent devaluation, while the French and the IMF were equally upset by what they perceived to be World Bank meddling in a delicate diplomatic effort that lay outside the Bank's mandate. For the Bank's perspective, see Kapur, Lewis, and Webb (1997), pp. 769–82.

Concerns about the exchange rate had surfaced at the IMF as early as 1980. In that year's Article IV consultation with Senegal, the staff took the unusual position of advocating a tax on imports and subsidies on exports as an alternative to currency depreciation. That struck a nerve with a few Executive Directors, who suggested that devaluation should be put on the table, even if it meant dropping out of the currency union. The U.S. and Dutch Directors asked for "an analytical study looking not only at the costs and benefits to the members of their participation in the Union, but also at the effects on nonmembers."[39] The Managing Director, Jacques de Larosière, agreed, but it seems that he (or the staff) did not assign it a high priority. Preparation of the study (Bhatia, 1985) took five years, during which time the economic performance of the zone generally benefited from depreciation of the French franc against other major currencies. The study concluded (pp. 42–45) that the balance of payments problems of franc-zone countries resulted primarily from lax fiscal policies and weak export prices, not from the constraint on the exchange rate.

The empirical basis for this relaxed attitude was gradually undermined in the second half of the 1980s, and not only because of worsening market conditions for African exports. Reinforcing the deleterious effect of those conditions, the French authorities adopted a tougher attitude toward strengthening their own currency and avoiding further devaluations against the deutsche mark, a shift that became known as the "franc fort" policy. Consequently, when the Fund conducted its annual reviews of the economies of Côte d'Ivoire and Senegal (the two largest CFA franc countries) in 1987, discussion of the lack of exchange rate adjustment became quite pointed. The U.S. Director, Charles Dallara, insisted that the "exchange rate was a powerful instrument of adjustment, and it should not be ruled out." The staff was divided. The mission chiefs for both the Senegal and the Côte d'Ivoire discussions concluded that the case for devaluation was offset by the case for preserving price stability, while the reviewing officers from the Exchange and Trade Relations Department expressed concern that cost-cutting alone was not likely to work unless it was backed up by devaluation.[40]

In November 1990, the Executive Board held its first general discussion of the CFA franc zone, in the form of an informal seminar. The meeting was requested by David Peretz (United Kingdom), who expressed concern that the Fund was not giving enough consideration to the policy implications of adhering to a currency union when the economies of the CFA franc countries were coming under severe stress. Staff in the Research and African Departments prepared an analysis that maintained a neutral view while warning that future economic progress without a realignment might prove difficult:

> In general, the Fund has been sympathetic with the aim of the CFA franc countries to maintain exchange rate stability in the context of their regional monetary arrangements based on strong ties of solidarity. However, if the present approach of improving external

[39]Minutes of EBM/80/87 (June 9, 1980), pp. 9 and 11.

[40]See minutes of EBM/87/148 (October 26, 1987), on Senegal; and EBM/87/172 (December 15, 1987), on Côte d'Ivoire.

competitiveness through downward adjustment of nominal costs and prices were to prove unworkable, alternative adjustment measures would have to be considered.[41]

At the seminar, both of the Directors speaking for the zone (Corentino V. Santos, Cape Verde; and Jean-Pierre Landau, France) insisted that the basic economic problem was fiscal, not monetary, and that it should be corrected over time through fiscal discipline, aided by a continuation of the existing exchange arrangements. Several others supported that view, one even going so far as to compare the 42-year persistence of the fixed CFA franc parity to that of Texas maintaining a fixed rate against New York over the same period. Other Directors challenged this view, either because they believed that cost-cutting alone was too drastic and not politically feasible, or because they were confident that a devaluation could be made to stick in real terms because of the region's strong record of maintaining price stability. Camdessus managed to sum up this remarkably frank but inconclusive discussion by noting the need for further reflection and for greater focus on regional surveillance.[42]

As pressure for devaluation continued to build, the practical problem remained that any change in exchange rate parity required the unanimous consent of all 13 participating African countries and of the French government.[43] The French finance minister (and later prime minister), Pierre Bérégovoy, was an architect of the "franc fort" policy and an opponent of devaluation as a policy tool. Camdessus was personally convinced that the CFA franc should be devalued, but he was reluctant to take a public stand on the issue, and he was unable to convince Bérégovoy privately. Nonetheless, by 1992 Camdessus believed he had convinced the French president, François Mitterrand, and on that basis he tried to generate consensus among the African leaders.[44]

In July 1992, Camdessus toured the CFA region and met with six heads of government who were known to be reluctant to devalue. He explained to them that maintaining the franc zone did not preclude a one-off devaluation. He argued that if a

[41]"A Review of the CFA Franc Arrangements," SM/90/136 (July 9, 1990), p. 40.

[42]Minutes of SEM/MTG/90/6 (November 5, 1990).

[43]The colonial structure of the system weakened gradually beginning in the 1960s, as the African countries gained independence. In the 1970s, the colonial franc was replaced by two separate currencies issued by two regional central banks. The seven member countries of the West African Monetary Union adopted the "franc de la Communauté financiére d'Afrique," issued by the Banque centrale des Etats de l'Afrique de l'Ouest (BCEAO). Six others adopted the "franc de la Coopération financière en Afrique centrale," issued by the Banque des Etats de l'Afrique centrale (BEAC). Technically, action could have been taken by either of the two central banks with the cooperation of the French government, but as a practical matter all participants agreed that any parity change would require unanimous consent. The French government participated through its membership on the boards of directors of the central banks. A fourteenth African country, the Comoros, was a former member of the CFA franc zone and was still in the wider franc zone. It pegged the Comorian franc to the French franc in sync with the CFA countries and participated in some deliberations.

[44]See Independent Evaluation Office (2007, p. 46) for an overview of the important role played by the IMF, and the critical importance of Camdessus's personal involvement.

change in parity were combined with tight macroeconomic policies, their economies could become more stable, more competitive, and ultimately more prosperous. Without a devaluation to correct the overvaluation of the currency, agricultural output, employment, and economic growth throughout the region would continue to be stifled. Some of the presidents were convinced, but others were not. Although the rural sectors might benefit, the income losses in the cities could be devastating. Whatever might be done to try to stabilize the economy afterward, a change of the magnitude that the Fund and others were advocating would be a massive shock and a huge risk for any government to undertake.

By the end of his trip, Camdessus felt he had come close to winning many of the leaders over, but he had fallen short of securing the unanimity required for any change in parity against the French franc.[45] To keep up the momentum, he convened a top-secret staff committee to oversee preparations for devaluation and to meet with reluctant officials to try to persuade them of the benefits.

In France, the official view on CFA franc devaluation shifted from opposition to neutrality by 1992 and then to strong support in 1993. The balance was finally tipped not so much by a growing concern for the plight of stagnating African economies but by a growing concern for the cost to France of preserving the status quo. Parliamentary elections in March 1993 led to the transfer of power from Bérégovoy's Socialist Party to the Gaullist coalition led by Édouard Balladur. After meeting with Camdessus, the new prime minister decreed that France would provide no further aid to the franc-zone countries unless they had IMF-supported reform programs in place.[46] Although the Fund was still supporting a few programs in the region, French officials understood well that the countries resisting devaluation would be forced either to give in or to forgo French and IMF financial aid.

From that point on, devaluation was inevitable, but much work remained before it could be judged likely to succeed. Without a comprehensive plan to stabilize macroeconomic policies, the gains could be quickly dissipated through wage and price inflation. As the Fund staff formulated the problem in working with African officials, national plans would have to be built on three main elements: preventing wages from spiraling upward, ensuring that the gains would directly benefit farmers and spread through the depressed rural sectors, and setting up or strengthening "safety nets" for the poor.

Further complicating the matter, market speculation of an impending devaluation intensified greatly after the change in the French government. In July 1993, the French franc came under heavy speculative pressure as European markets tested whether the September 1992 parity adjustments within the European Monetary System (EMS) were sufficient. On August 2, 1993, EMS finance ministers widened the intervention bands in their exchange rate mechanism to 15 percent but did not devalue the franc.

[45] Report by the Managing Director at EBM/92/100 (August 3, 1992), pp. 50–52.

[46] See "Côte d'Ivoire after Houphouët-Boigny," *Economist*, Vol. 329 (December 11, 1993), pp. 45–46. Additional details are from interviews with officials.

On the same day, in an effort to stem capital flight, the BEAC and the BCEAO permanently suspended the repurchase of CFA franc banknotes held outside the zone.[47]

As market pressures continued to mount and economic conditions in Côte d'Ivoire and other countries in the currency union continued to deteriorate, the staff and management undertook further detailed secret negotiations with several countries to try to reach agreement on the policy changes that would be needed after a devaluation for the countries to qualify for the Fund's financial support. From November 1993 through the first week of January 1994, the African Department sent staff missions for this purpose to at least seven participating countries, and it made preparations to send staff to all of the others immediately after devaluation, if it should occur. Camdessus also continued his personal diplomacy, staying in frequent contact, along with senior officials in the African Department, with the African leaders and finance officials until they all seemed to be convinced.

The right moment finally arrived in January 1994. All of the heads of government or state of the countries in the franc zone were scheduled to meet in Dakar, Senegal, in their capacity as Board members of the regional airline, Air Afrique. The leaders of the western African countries (the seven countries for which the BCEAO was the central bank) were also meeting separately to ratify a treaty establishing the West African Economic and Monetary Union as a trading bloc. These meetings would provide some cover for a secret discussion among them of the exchange rate, but as it turned out, not very much cover. As the date of the meeting approached, rumors of impending action were widely discussed in the financial press. Miraculously, no run on the currency ensued from these rumors, to the amazement of those in the Fund who had seen well-laid plans go far astray in the past.

Camdessus was invited to participate in the meeting in Dakar, and he went to great lengths to keep his presence secret. He left Washington on December 17 on a trip that took him to Turkmenistan and Kazakhstan and then to Paris where he was to meet with senior officials before taking some time off for the year-end holidays. His announced itinerary called for a return to Washington on January 4, but on January 3, a supplement was circulated in the Fund stating that the Managing Director's travel was being extended through January 10 "for further discussions with authorities of several member countries." On January 10, the return date was further extended to the evening of January 12.[48] Only those few staff and Executive Directors who needed to know were let in on the real purpose of the trip.

By the time of the summit meeting, the only real questions were whether one or two countries might continue to hold out and, if not, how large a devaluation would be

[47]On the devaluation rumors and the attendant capital flight, see Balls (1993), p. 4. On the imposition of the capital control, see "Modification of Exchange Rate Regulations in the West African Monetary Union," EBS/93/168 (October 20, 1993).

[48]"Absence of the Managing Director," EBAP/93/84 and supplements 1 (January 3, 1994) and 2 (January 10, 1994).

undertaken. The two issues were closely linked because the extent of the estimated overvaluation varied substantially across the region. From 1985 to 1993, the deterioration in the terms of trade—the primary source of the overvaluation—ranged from virtually nil in Chad and Senegal to 50 percent or more in Benin, Cameroon, the Republic of Congo, and Gabon. Taking that and other factors into account, the staff estimated the real effective overvaluation to be close to 30 percent for the region as a whole, while estimates for individual countries ranged from 11 percent (Gabon) to 52 percent (Niger).[49] All 13 countries would have to act together, but the consequences would vary. If a country devalued by too much, it risked losing control of price and wage stability; if it devalued by too little, it risked remaining uncompetitive and being forced to devalue again.

The Fund's advice was to find a number that would bring large enough benefits to all of the participating countries to convince financial markets that the new exchange rate would stick for many years to come. This had to be a one-time devaluation, not a repeating event. The inflationary consequences could be contained through policy adjustments tailored to each country. The negative real effects from those adjustments, including the effects on the poorer segments of society, could be contained through the injection of cash from the IMF, France, and other supporters, and by incorporating funding for social safety nets directly into the postdevaluation programs.

On January 11, 1994, after a long and occasionally bitter meeting, the 13 national leaders unanimously agreed to devalue the CFA franc by a big round number designed to impress financial markets and eliminate any one-way bets against the currency: 50 percent relative to the French franc. Parity shifted from 50:1 to 100:1, effective immediately.[50] President Said Mohamed Djohar of the Comoros also attended the meeting because the Comorian franc had been pegged at parity with the CFA franc ever since the Comoros officially left the zone in 1981. However, the Comoros, not formally a member of the CFA franc zone, had not participated in the discussions leading up to the devaluation. Djohar was reluctant to agree to the 50 percent devaluation, but he did agree to devalue concurrently by a smaller amount, to 75:1.

Eventually, if wages and other domestic costs could be restrained, these dramatic moves would make the franc zone's exports competitive again in world markets. The immediate effect, however, was simply to make imported goods in the CFA franc zone twice as expensive as they had been. Preventing chaos was not going to be easy.

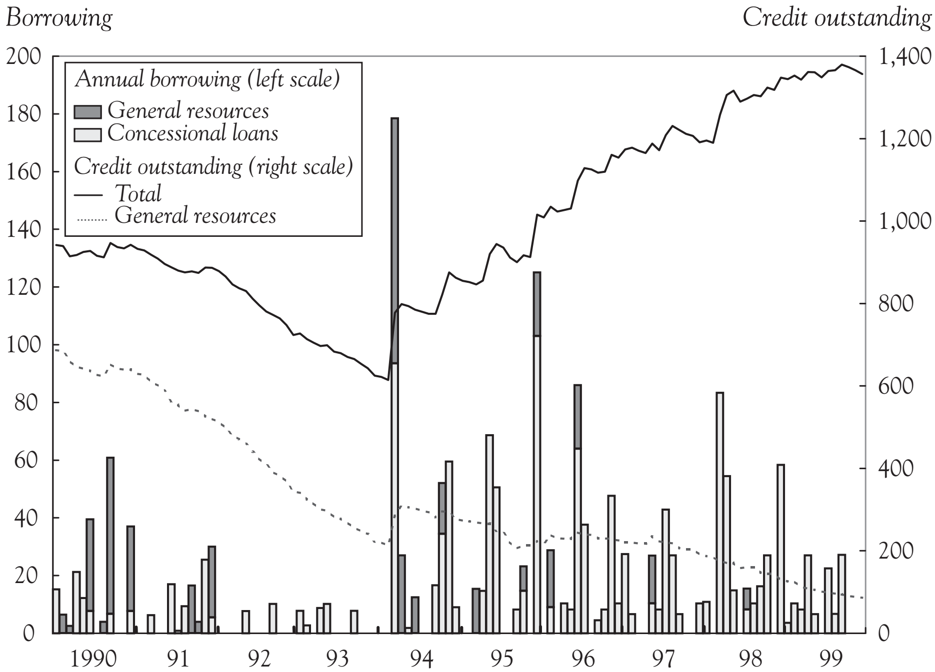
Postdevaluation Lending

Within 10 days of the announcement, IMF staff teams had arrived in the capitals of 13 of the 14 countries, and discussions were taking place in Washington with

[49]"CFA Franc Countries—Recent Adjustment Experience and Policy Issues," SM/95/261 (October 11, 1995), Appendix I, Table 3.

[50]This shift was sometimes described as a 100 percent devaluation. The value of the CFA franc fell by 50 percent against the French franc. The cost of acquiring French francs rose by 100 percent.

Figure 14.3. CFA Franc Zone: Use of Fund Credit, 1990–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics.

the authorities of the other one, the Republic of Congo (owing to an unstable security situation in Brazzaville). At some point in the four years before the devaluation (1990–93), the Fund had lending arrangements in effect with all of the franc-zone countries (Figure 14.3 and Table 14.1), so the mission chiefs were all familiar with the countries' circumstances. By the end of 1993, however, all but four of those arrangements had expired. No CFA country was borrowing from the Fund's general resources. Benin, Burkina Faso, Equatorial Guinea, and Mali had ESAF arrangements in effect, and the Comoros had a SAF arrangement. All except Benin were out of compliance. The task now was to resume lending quickly, before popular resistance to the higher postdevaluation prices could take hold.

The most straightforward task was to resume lending to the four countries with which arrangements were already in effect. The programs had to be adjusted to account for the effects of the devaluation, and the authorities had to commit to reversing the policy slippages that had marred performance in 1993, but the requirements for success were fairly well understood. In Benin, the ESAF-supported program was remarkably well on track, especially considering that the economy had suffered the largest terms-of-trade

Table 14.1. CFA Franc Zone: Lending Arrangements, 1990–99

				Amount		Maximum Amount Owed	
Country	Type of Arrangement	Beginning Date	Duration (Months)[a]	Agreed[a] (Millions of SDRs)	Used (Millions of SDRs)	Millions of SDRs	Percentage of quota[b]
Benin						70.97	156.7
	SAF	Jun 1989	36	21.91	15.65		
	ESAF	Jan 1993	40	51.89	51.89		
	ESAF	Aug 1996	48	27.18	16.31		
Burkina Faso						88.81	147.5
	SAF	Mar 1991	24	22.12	6.32		
	ESAF	Mar 1993	38	53.04	44.20		
	ESAF	Jun 1996	44	39.78	39.78		
	ESAF	Sep 1999	39	39.12	39.12		
Cameroon						146.18	78.7
	SBA	Sep 1988	21	61.80	38.63		
	SBA	Dec 1991	9	28.00	8.00		
	SBA	Mar 1994	19	81.06	21.91		
	SBA	Sep 1995	12	67.60	28.20		
	ESAF	Aug 1997	40	162.12	162.12		
Central African Republic						30.17	73.2
	SAF	Jun 1987	36	21.28	15.20		
	SBA	Mar 1994	12	16.48	10.71		
	ESAF	Jul 1998	41	49.44	24.48		
Chad						52.31	93.4
	SAF	Oct 1987	36	21.42	21.42		
	SBA	Mar 1994	12	16.52	10.32		
	ESAF	Sep 1995	43	49.56	49.56		
Comoros							
	SAF	Jun 1991	36	3.15	2.25	2.25	34.6
Congo, Republic of						27.39	47.3
	SBA	Aug 1990	21	27.98	4.00		
	SBA	May 1994	12	23.16	12.50		
	ESAF	Jun 1996	36	69.48	13.90		
Côte d'Ivoire						457.34	192.0
	SBA	Nov 1989	10	146.50	117.20		
	SBA	Sep 1991	12	82.75	33.10		
	ESAF	Mar 1994	39	333.48	333.48		
	ESAF	Mar 1998	36	285.84	123.86		
Equatorial Guinea						13.80	56.8
	SAF	Dec 1988	36	12.88	9.20		
	ESAF	Feb 1993	36	12.88	4.60		
Gabon						109.19	149.4
	SBA	Sep 1989	18	43.00	10.50		
	SBA	Sep 1991	18	28.00	4.00		
	SBA	Mar 1994	12	38.60	38.60		
	EFF	Nov 1995	40	110.30	60.67		

Table 14.1. (continued)

Country	Type of Arrangement	Beginning Date	Duration (Months)[a]	Amount: Agreed[a] (Millions of SDRs)	Amount: Used (Millions of SDRs)	Maximum Amount Owed: Millions of SDRs	Maximum Amount Owed: Percentage of quota[b]
Mali						144.44	154.8
	SBA	Aug 1988	22	12.70	12.70		
	SAF	Aug 1988	36	35.56	25.40		
	ESAF	Aug 1992	44	79.24	79.24		
	ESAF	Apr 1996	40	62.01	62.01		
	ESAF	Aug 1999	48	51.32	51.32		
Niger						62.91	186.7
	ESAF	Dec 1988	36	47.18	23.59		
	SBA	Mar 1994	12	18.60	11.11		
	ESAF	Jun 1996	38	57.96	48.30		
Senegal						250.68	294.6
	ESAF	Nov 1988	42	144.67	144.67		
	SBA	Mar 1994	5	47.56	30.91		
	ESAF	Aug 1994	41	130.79	130.79		
	ESAF	Apr 1998	48	107.01	96.47		
Togo						75.80	139.6
	ESAF	May 1989	48	46.08	38.40		
	ESAF	Sep 1994	45	65.16	54.30		

Source: IMF financial accounts.

Note: ESAF = Enhanced Structural Adjustment Facility; SAF = Structural Adjustment Facility; SBA = Stand-by arrangement.

[a]The duration and amounts are the final figures. Some arrangements were shortened or lengthened and/or reduced or augmented in size, after the initial approval.

[b]The percentage of quota is calculated as the maximum amount owed as a percentage of the quota in effect at that time. In some cases, the maximum percentage was reached at a different time, owing to a change in quota.

loss in the region. In March 1994, the Fund augmented the size of the arrangement and disbursed the third installment of available funds. Disbursements in ESAF arrangements with Burkina Faso, Equatorial Guinea, and Mali had been suspended in the second half of 1993, but new agreements were quickly reached in each case. Lending to Burkina Faso and Mali resumed in March, and to Equatorial Guinea in May.

Most of the other countries in the CFA franc zone were eligible for ESAF loans, but they faced two hurdles. First, as a formal requirement for access to ESAF resources, each country had to prepare a Policy Framework Paper (PFP) setting out the multiyear program for which the country was asking support, and the Executive Boards of both the IMF and the World Bank had to approve those PFPs. Second, the ESAF Trust was almost out of cash. The Fund was in the middle of a campaign to raise additional funds, but that effort would take time.

As a temporizing measure while these obstacles were being addressed, the staff set out to negotiate shorter-term adjustment programs the Fund could support with

ordinary stand-by arrangements. In the course of 1994, such lending arrangements were approved for seven CFA franc countries. In six of those cases—Cameroon, the Central African Republic, Chad, the Republic of Congo, Niger, and Senegal—the stand-by arrangements were eventually succeeded by ESAF loans. The exception was Gabon, which had the highest per capita income in the region owing to its oil exports and was ineligible for concessional loans.

The Fund approved two new ESAF arrangements in 1994, for Côte d'Ivoire and Togo. The latter had already completed one ESAF arrangement, from 1989 to 1993, but it had been mostly out of compliance after the first two years owing primarily to political instability.[51] A replacement arrangement was negotiated over the course of three missions from November 1993 through the following June. The arrangement was approved and took effect in September 1994.

Côte d'Ivoire previously had borrowed from the Fund's general resources through a series of stand-by arrangements. Since the mid-1980s, each program had run into difficulties, and the Fund had disbursed only a portion of the initially agreed-on amount. No disbursements had been allowed since December 1991. The problem was not lax policies, given that the government had reduced the primary fiscal deficit from 7.5 percent of GDP in 1989 to 0.1 percent in 1992. The chief problem was that regardless of the measures the authorities implemented, they were swamped by a continual weakening of the world markets for coffee and cocoa. Even in the face of these challenges, the authorities had continued to repay earlier loans on schedule. By the time of the devaluation, outstanding obligations to the Fund had fallen to $158 million, from a peak of $681 million in 1984.[52]

In these difficult and politically chaotic circumstances, a staff team, directed by Christian François (Senior Advisor, African Department), arrived in Abidjan on December 6, 1993, to begin discussions on a policy program. That plan had to be discarded almost immediately because President Houphouët—who had led the country since independence in 1960—died the next day. The mission continued to work for two weeks in the middle of national mourning and political uncertainty while the government was reorganized, but serious negotiations had to be delayed.

Ouattara, the prime minister, expected to succeed Houphouët as president, but the constitution—written before the office of prime minister had been created—specified that the succession should go to the Speaker of the National Assembly. On December 9, the Speaker, Henri Konan Bédié, declared himself president, and Ouattara resigned. At that point, the only government official who was fully briefed and had been fully involved in the devaluation negotiations was the minister of finance, Daniel Kablan Duncan. Fortunately for the negotiations, Bédié soon appointed Duncan to succeed

[51]See "Togo—Staff Report for the 1994 Article IV Consultations and Request for Arrangements Under the Enhanced Structural Adjustment Facility," EBS/94/169 (August 24, 1994).

[52]Côte d'Ivoire repaid all of its obligations to the Fund's General Resources Account (GRA) by the end of 1997. All outstanding loans after that date were to the ESAF (later PRGF) Trust.

Ouattara as prime minister, and Duncan—who had served as chairman of the Development Committee in 1974–76 and had later worked for the World Bank Group—promised to continue the policies that Ouattara had begun. After a short break, François and his team returned on January 13, two days after the announcement of the devaluation, and concluded the program negotiations before the end of the month.

The Executive Board approved an ESAF arrangement for Côte d'Ivoire on March 11, 1994, and disbursed $84 million (SDR 59.6 million) as the first installment of a total commitment of $468 million (SDR 333.5 million, 140 percent of quota). Although some Directors were apprehensive about the government's ability to implement its ambitious adjustment and reform program, the tone of the meeting was primarily one of relief, gratitude, and hope.[53] Over the next three years, the government faithfully carried out its policies, and it borrowed the full amount of the arrangement.

This remarkable confluence of actions—a coordinated exchange rate adjustment by 14 countries; concerted action to strengthen policies in the wake of the devaluation; rapid action by the IMF and other multilateral institutions to resume lending in support of countries' programs; and a sharp increase in donor support, especially from France—had a notable effect on economic performance. In Côte d'Ivoire, economic growth accelerated from negative figures in 1990–93 to 6.5 percent in 1995–97. Consumer prices rose by more than 30 percent in 1994, but within two years inflation reverted to the low single digits. Other countries in the zone also generally showed marked improvements.[54] Donor support and the competitive benefits of the large devaluation provided a window of opportunity to liberalize and reform economic policies. In addition, in the years following the adjustment, most of these countries borrowed almost exclusively on concessional terms and received the most favorable terms on rescheduling older debts.

Sustaining these improvements was a challenge. The extremely weak initial conditions throughout the region—external market conditions, domestic fiscal and other imbalances, and political fragility in several countries—contributed to the difficulty of maintaining momentum without setbacks. By the end of the 1990s, some countries were embarking on a second wave of reforms while others were struggling to maintain their early progress. Nonetheless, by any standard, devaluation had proved to be the right decision.

Côte d'Ivoire faced particularly difficult problems because the government was trying to put the economy on a sustainable course while maintaining political stability in the absence of social cohesion or consensus. Nonetheless, for nearly five years after the devaluation, economic progress was strong and was buttressed by international support, including debt relief.

Much of Côte d'Ivoire's substantial debt to foreign commercial banks was in default from 1987 until a restructuring agreement was reached with the London Club in May

[53]Minutes of EBM/94/20 (March 11, 1994), pp. 3–51.

[54]For an overall review, see Clément (1996).

1997. Recognizing the need for further relief, in March 1998 the Fund approved a new ESAF arrangement that helped finance the up-front cost of the London Club agreement (see Chapter 9) and agreed that Côte d'Ivoire qualified for debt relief through the HIPC Initiative. By that time, however, the country's social structure was crumbling, and government corruption was increasingly thwarting economic progress. In 1999, the Fund and the authorities were never able to achieve agreement on the policy reforms necessary to continue the lending arrangement or to reach the HIPC completion point. That December, Bédié was overthrown in a coup d'état, and further international assistance was put on hold until the long-delayed presidential election of 2010 (won by Ouattara) restored a measure of order and credibility to the country.

The East African Community

Throughout most of the twentieth century, the region that now comprises Kenya, Tanzania, and Uganda was engaged in an effort to strengthen its economic relations and coherence. That endeavor began in 1917 with a customs union between Kenya and Uganda and peaked in 1967 with the formation of the three-nation East African Community (EAC). The EAC disbanded in 1977 as tensions arose between Idi Amin's Uganda and the other two members. Relations improved in the 1980s, and in November 1999 the three countries signed a treaty to reestablish the EAC.[55]

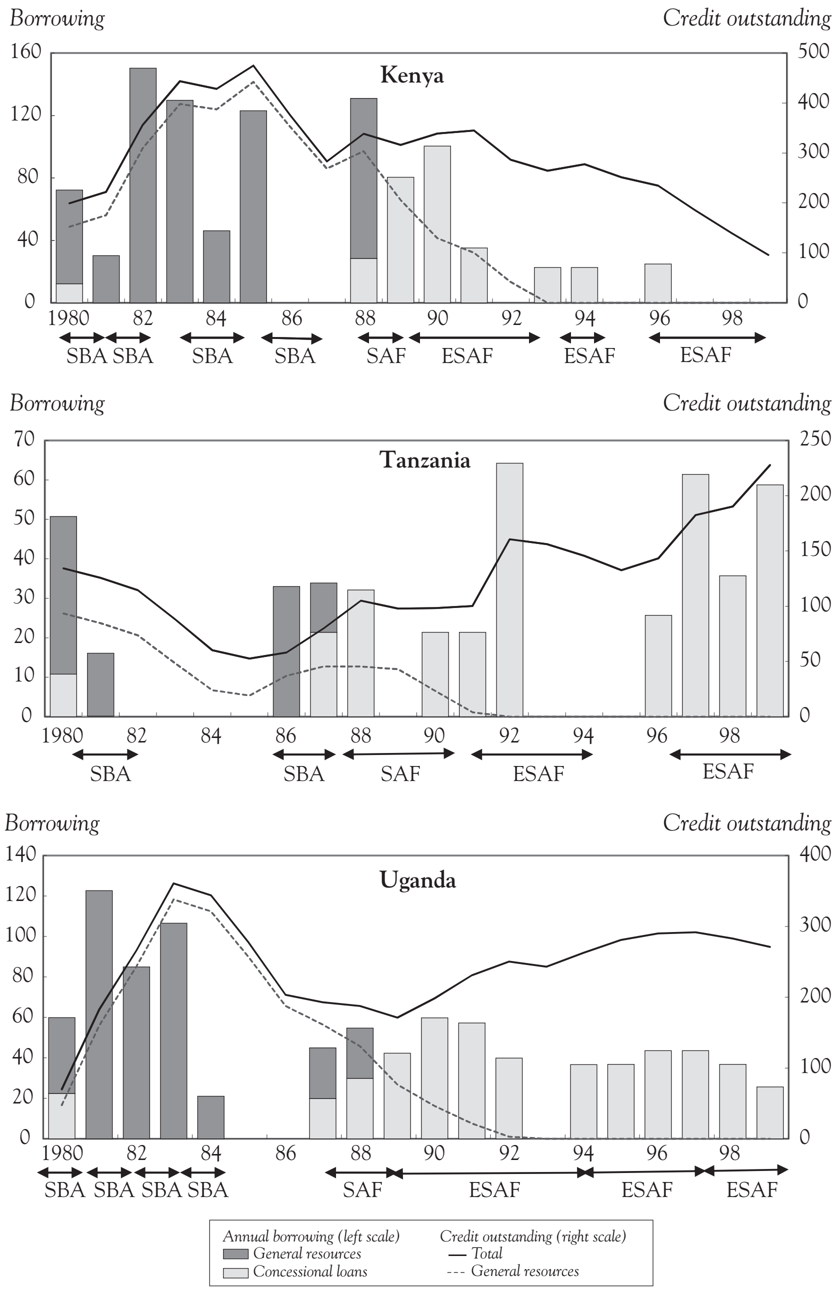
The IMF provided a regular flow of technical assistance and policy advice to all three countries throughout the 1990s. It also lent substantial sums to each country, exclusively on concessional terms, but the pattern of lending varied between countries (Figure 14.4). Lending to Kenya tapered off after 1990 and ceased after 1996, owing to concerns about economic mismanagement and pervasive corruption. Lending to Tanzania was substantial in the early 1990s but was particularly important in the second half of the decade after a new government initiated a major stabilization and development program. Lending to Uganda was fairly steady throughout the decade, in amounts that covered repayments on older loans and allowed for a moderate inflow of new money. In all three cases, the countries were able to repay all of the nonconcessional loans they had taken out earlier. By the end of the decade, all outstanding debts were to the ESAF Trust, with interest payable at 0.5 percent and with relatively long maturities. Uganda also received debt relief under the HIPC Initiative, and Tanzania was on track to begin getting relief in 2001.

Kenya

Throughout the 1970s and 1980s, Kenya had the best economic record in east Africa, and one of the best in sub-Saharan Africa. It achieved this performance

[55]The new EAC entered into force in July 2000. Burundi and Rwanda joined in 2007.

Figure 14.4. East Africa: Use of Fund Credit, 1980–99
(In millions of SDRs, annual data)



Source: IMF financial accounts.
Note: ESAF = Enhanced Structural Adjustment Facility; SAF = Structural Adjustment Facility; SBA = Stand-by arrangement.

largely on the strength of relatively modern infrastructure and a stable political system that welcomed foreign capital and expertise. Over time, as comfort with the status quo took hold, economic and political progress began to wane. Kenya enjoyed strong and regular financial and technical support from bilateral donors and from both the IMF and the World Bank, which kept the economy humming but provided little impetus or incentive for reform of an increasingly bloated, inefficient, and corrupt civil service.[56]

Donor countries' worries about corruption in Kenya burst into the open in 1986 when a European diplomat in Nairobi reported that a contract to construct the Turkwell Gorge Dam had been awarded uncompetitively and at high cost to a French company in exchange for kickbacks to senior government officials (Harden, 1990, pp. 185–88 and 213). Bilateral aid then declined, but the IMF and other multilateral lenders ignored the problem for several years and continued lending as long as macroeconomic policies remained sound. Corruption was not endemic to Kenya, and the central issue for multilateral institutions was that their assistance convey sufficient net benefits to the country.

Through the 1980s, the Fund lent to Kenya using a mix of concessional and nonconcessional arrangements. The last nonconcessional lending was in 1988, through a stand-by arrangement and a CFF drawing that supplemented a SAF arrangement. The Fund approved those higher-cost loans because the government insisted that it qualified for them, but the Fund did so reluctantly because management was worried that Kenya was taking on more debt than it could afford. The following May, those arrangements were canceled and replaced by an ESAF arrangement for a larger amount (but on more affordable terms): $306 million over three years (SDR 241.4 million, or 170 percent of quota).

The Fund suspended disbursements under the ESAF arrangement in 1991 following a weakening of policy implementation. The policy reversal had been a response to deteriorating economic conditions (poor rainfall, weak export markets, and influxes of refugees from neighboring countries) and to social unrest in the period leading up to the country's first multiparty elections. Although some major donor countries were concerned about the strength of the government's commitment to democratization, the Fund remained eager to help Kenya through these setbacks, at least by providing policy advice and working toward a resumption of lending.

The downward economic slide that began in the last quarter of 1991 culminated in a financial crisis in the spring of 1993. With most bilateral donors no longer willing to support the government of President Daniel arap Moi, the economy was squeezed by a severe shortage of foreign exchange. Initially, Moi reacted by ranting against the international community, accusing the IMF and the World Bank of making "dictatorial"

[56]The Fund's relations with Kenya in the 1980s are covered in Boughton (2001), pp. 595–97.

demands on his country.[57] He also imposed exchange controls, reversing a long-standing policy of gradual liberalization. Within a few weeks, however, the newly appointed finance minister, Musalia Mudavadi, managed to reverse course again and embark on a major liberalization and reform program. The government also devalued the shilling to correct an estimated overvaluation and tightened monetary and fiscal policies. The Fund responded positively and agreed to monitor the program while working toward a new ESAF arrangement.

Although the Fund was fairly satisfied with Kenya's macroeconomic policies in the second half of 1993, it now—for the first time—turned its attention to the corruption problem. Ironically, the government was already taking steps to deal with corruption, including by setting up special units in the police force to investigate economic crimes. Bilateral donors were sufficiently impressed to begin to resume financial aid. Even so, oversight of state-owned enterprises was still lax and was leading to inefficiency and probably to larceny. The Fund insisted on adoption of legislation ensuring that future relations between the government and its enterprises would be transparent and at arm's length. The PFP that underpinned Kenya's request for an ESAF arrangement included a clause to that effect, and the staff drew attention to it in its report on the program negotiations. More generally, several Executive Directors expressed great concern about the extent of the government's commitment to clean government and its ability to control the problem.[58]

The conditions for the one-year ESAF arrangement approved in December 1993 did not include anticorruption measures. The authorities carried out the macroeconomic and reform policies in the program, and they borrowed the full available amount, $63 million (SDR 45.2 million, or 23 percent of quota). When that unusually short arrangement expired, negotiations on a successor arrangement focused more intently on the need for strong and comprehensive efforts to root out corrupt practices, which were judged to be still pervasive. In November 1995, as those negotiations continued, the Executive Board sent a signal to the authorities that "as a prerequisite for an ESAF arrangement, the authorities should provide greater assurances that the budget and the macroeconomic balances would not be undermined by corruption."

[57]Kenya's state-run radio initially quoted Moi's remarks on March 19, 1993, which were then widely reprinted internationally, albeit with variations in wording. According to the BBC Monitoring Service, Moi complained that conditions set by the IMF and the World Bank were "harsh, unilateral, and dictatorial." Also see Ozanne (1993), quoting Moi saying that the policy conditions were "economically suicidal." Both sources were accessed at http://global.factiva.com.

[58]See "Kenya—Enhanced Structural Adjustment Facility – Policy Framework Paper for 1994–96," EBD/93/176 (November 17, 1993); "Kenya—Staff Report for the 1993 Article IV Consultation and Request for a One-Year Arrangement Under the Enhanced Structural Adjustment Facility," EBS/93/191 (November 30, 1993); and minutes of EBM/93/177 (December 22, 1993). No previous Fund documents on Kenya included the words "governance" or "corruption." At the Board meeting, speakers voicing concern about corruption included Niels Peter Hahnemann (Denmark), Karin Lissakers (United States), Roderick Rainford (Jamaica, Temporary Alternate to the Director for Canada), and Stefan Schoenberg (Germany).

Directors placed particular importance on "strict enforcement of the code of conduct in the civil service, full transparency of public finances . . ., and additional efforts to recover misused public funds."[59]

The Fund took an unusually tough line on the conditionality for the ESAF arrangement Kenya requested in 1996. First, the government had to complete or show progress on 11 actions prior to approval of the program, ranging from standard measures to tighten monetary and fiscal policies to detailed structural actions such as "agreement in principle on contracting out the management of the container terminal at the Mombasa port; and appointment of a qualified person for the position of Executive Chairman of the Kenya Ports Authority." The anticorruption drive was represented on this list by an injunction to commence "strict enforcement of the civil service Code of Conduct." The program also required a large reduction in the size of the civil service, privatization of 40 public enterprises by the end of 1996, and other major structural changes. To make any drawings after the initial one, the government also would have to take unspecified "measures to prevent the recurrence of misuse of public funds."[60]

The government made a decent start at meeting these requirements, and in April 1996 the Fund approved a three-year ESAF arrangement for $217 million (SDR 149.6 million, or 75 percent of quota). Unfortunately, that turned out to be the last sign of real progress. The week after the Board meeting, Camdessus went to Nairobi and delivered a blunt message to President Moi. The Fund's approval of fresh lending had opened a window of opportunity that the government should "seize . . . by implementing fully the ESAF-supported program, especially the commitment to fight corruption, improve financial accountability and transparency, and strengthen the judicial system." Moi reportedly expressed his commitment to do so, but the extent of that commitment was yet to be tested.[61]

After the initial tranche of $36 million, Kenya made no further drawings on the ESAF loan. The staff judged the implementation of financial policies and progress on structural reforms to be satisfactory, but the perception of financial irregularities and a general atmosphere of corruption persisted.[62] Even at the end of the decade, the Fund regarded Moi's clean-up efforts as "formalistic," and it refused to open discussions on a renewal of lending.[63]

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[59]Minutes of EBM/95/106 (November 10, 1995), p. 48.

[60]"Request for Arrangement Under the Enhance Structural Adjustment Facility," EBS/96/62 (April 12, 1996), pp. 17–19.

[61]See report by Camdessus at EBM/96/46 (May 15, 1996), p. 3.

[62]"Kenya—Staff Report for the 1996 Article IV Consultation," SM/97/70 (February 28, 1997), p. 7.

[63]"Kenya—Staff Report for the 1999 Article IV Consultation," SM/99/281 (November 24, 1999). The Fund resumed lending in August 2000, under a PRGF arrangement.

Tanzania

Relations between the IMF and Tanzania were not always smooth. When the authorities requested a stand-by arrangement in 1979, the Fund informed them that approval would require important changes in economic policy, including both a substantial devaluation of the exchange rate and a major shift away from state control of economic activity. President Julius Nyerere angrily refused, ordered the staff mission to leave the country, and publicly attacked the IMF for trying to impose its own "ideology" on Tanzania and other poor countries. A stand-by arrangement was approved in 1980, but its conditions were not met, and relations remained tense for the next five years.[64]

Nyerere, who had led Tanzania since it gained independence from Great Britain (as Tanganyika) in 1961, retired from the presidency in 1985. His successor, Ali Hassan Mwinyi, continued the basic thrust of Nyerere's socialist economic model but allowed his officials to apply it more flexibly. That change opened the door for renewal of IMF support and for the beginning of a substantive reform program. The Fund provided a new stand-by arrangement in 1986 and began lending to Tanzania through the less expensive SAF in 1987 (Figure 14.4). The three-year SAF arrangement was fully drawn and successfully completed in October 1990.

In the rest of the 1990s, the Fund assisted Tanzania through two multiyear ESAF arrangements. The first, approved in July 1991, came when the government was beginning to pursue more-aggressive liberalization reforms, notably by opening up the financial sector to private domestic and foreign banks and exchange offices.[65] The Fund welcomed those changes, and it urged the authorities to adopt a similarly forceful attitude toward the country's notoriously inefficient system of parastatal industries. The program started well, but by 1993 the government's resolve began to waver as its attention shifted to political demands in anticipation of Tanzania's first multiparty elections. For the next two years, the Fund stopped lending. Most donor countries also became disillusioned and reduced their development assistance.

The real breakthrough for Tanzania came in November 1995, with the successful establishment of multiparty democracy and the election of Benjamin W. Mkapa as the country's third president. By this time, the rigid form of state-directed socialism that Nyerere had once championed had been widely rejected, including by Nyerere himself. The crucial question was whether the government had the will and the ability to implement the changes it was now espousing.

[64]The history of the IMF's relations with Tanzania through 1989 is covered in Boughton (2001), pp. 597–602.

[65]These reforms were mostly homegrown, not implemented under outside pressure. Economically, the driving event was the adoption of the Zanzibar Declaration by the ruling party in February 1991, which effectively overturned the socialist doctrine embodied in the 1967 Arusha Declaration. Politically, the major step was the constitutional amendment of May 1992 that provided for multiparty elections.

Mkapa quickly established economic stability and recovery as his top priority. The monetary and fiscal authorities had already used the 1995 Article IV discussions with the IMF staff (led by African Department Deputy Director Goodall Gondwe) to begin talks on a program to qualify for renewed financial support. Donor countries, however, were not quite ready. When the Executive Board met a few days after Mkapa's inauguration to conclude the consultations, Directors from some of the main creditor countries expressed reluctance to consent to resume lending until the untested government could establish a track record of improved economic policies. The Board agreed to consider a new ESAF arrangement only after completion of a six-month staff-monitored program for the first half of 1996.[66]

Tanzania implemented the staff-monitored program successfully. Gondwe and his staff team returned to Dar es Salaam in August 1996 to negotiate a three-year ESAF arrangement. Technical negotiations were concluded in Washington during the IMF/World Bank Annual Meetings in early October, and Mkapa met with Fischer and Ouattara while on an official visit to Washington a few days later. By then, confidence in the government's commitment to reform was fully restored, and in November the Executive Board approved an ESAF arrangement for $234 million (SDR 161.6 million, or 110 percent of quota).

For the rest of the decade, Tanzania recorded impressive economic performance.[67] Growth accelerated enough that per capita income finally began to rise. Inflation subsided to single digits, fiscal and monetary policies remained restrained, and the government carried out a steady stream of wide-ranging structural reforms. By the time the ESAF arrangement expired, both the government and the IMF were satisfied that macroeconomic stability had been achieved and that attention could be focused more intensively on the deeper reforms needed to reduce poverty, develop infrastructure, and strengthen social indicators on health and education.

Based on the government's poverty reduction strategy, in 2000 the Fund approved a PRGF arrangement and began providing interim debt relief under the terms of the enhanced HIPC Initiative. That November, the Executive Director for Tanzania, Cyrus Rustomjee (South Africa), conveyed the authorities' thanks to the Fund for its support throughout Tanzania's "difficult and long journey [through] the adjustment process." Remarkable for a country that had once been so strongly at odds with the views of the Fund, the authorities now accepted that their "recent efforts at addressing poverty and enhancing human development could not have been successful without this support."[68]

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[66]Minutes of EBM/95/111, November 27, 1995, pp. 35–79. The suggestion to require a staff-monitored program was made by Huw Evans (United Kingdom) and was supported explicitly by Barry S. Newman (Alternate, United States) and Bernd Esdar (Alternate, Germany).

[67]For analyses, see Treichel (2005) and Sharer (2009).

[68]BUFF/ED/00/174, November 29, 2000.

Uganda

The IMF lent occasionally to Uganda in the 1970s and early 1980s, but financial support intensified in response to the ascension to power by President Yoweri K. Museveni in 1986. Museveni's overthrow of Milton Obote raised expectations of political stability sufficiently to draw foreign capital back into the country and thus lay the groundwork for sustainable economic progress. The IMF responded with a SAF arrangement in 1987 and provided nearly continuous loans on concessional terms until 2006.[69]

The IMF used the ESAF as its primary conduit for lending to Uganda in the 1990s. The Fund approved three consecutive multiyear arrangements, running from April 1989 through June 1994, September 1994 through November 1997, and November 1997 through March 2001. All of these arrangements were fully drawn, and only minor policy slippages occurred. As official development aid and private capital inflows both increased in response to the improved economic picture in Uganda, the IMF gradually reduced the scale of its own lending. Repayments of earlier loans nearly equaled new lending, so that Uganda's indebtedness to the Fund increased only marginally over the decade (Figure 14.4).

Museveni remained committed to a liberal economic policy regime throughout the 1990s, with dramatic results for economic performance. Per capita income, which had declined tragically under the misrule of Idi Amin (1971–79) and Obote (1980–85), rose from $158 in 1986 to $244 in 2000, while the poverty rate fell by a third.[70] Consumer price inflation fell from triple digits in the late 1980s to single digits by the mid-1990s. The exchange rate stabilized early in the decade and then began appreciating in response to fresh inflows of capital. As in Tanzania, the government was able to declare at least a temporary victory over macroeconomic instability and move on to the more difficult challenges of economic and social development.

By the time Uganda embarked on its second ESAF-supported program in 1994, donor countries considered it to be one of the few good role models for other low-income countries. It had achieved nearly eight years of economic progress and had demonstrated a solid record of cooperation with the IMF and other multilateral agencies. It was nonetheless still mired in poverty because of its heavy dependence on a single export crop—coffee—and its greatly underdeveloped infrastructure for health,

[69]The history of the IMF's relations with Uganda through 1989 is covered in Boughton (2001), pp. 679–84. For an overview of subsequent relations, including an assessment of deteriorating performance after 2000, see "Uganda: Ex Post Assessment of Performance Under Fund-Supported Programs and Public Information Notice on the Executive Board Discussion," Country Report No. 06/24 (January 2006); accessed at http://imf.org/external/pubs/cat/longres.aspx?sk=18827.0. Uganda's last stand-by arrangement expired in 1984, and its last use of the GRA was a pair of CFF drawings in 1987 and 1988 to supplement the SAF arrangement. As shown in Figure 14.4, Uganda repaid all of its GRA loans by 1993.

[70]These income data are for per capita GDP measured in constant U.S. dollars normalized on the year 2000 (World Bank, World Development Indicators).

education, sanitation, transportation, and other services. Much of its initial success had been financed by loans rather than grants, saddling the government with a heavy burden of external debt. Even though two-thirds of its debt was owed to multilateral institutions and thus carried relatively low interest rates and long maturities, Uganda's debt service in 1994 equaled nearly 40 percent of its export revenues. Many African countries were in worse straits regarding debt service, but the combination of high burden and strong performance put Uganda at the head of the list of countries considered eligible for debt relief.

Paris Club creditors kicked off the major debt-reduction process for Uganda in February 1995 by granting relief under the terms the G7 had advanced at the summit meeting in Naples the previous summer. Uganda was the first country to be accorded Naples terms relief, which reduced the net present value of eligible debt by two-thirds. The Paris Club decision directly reduced scheduled debt-service payments (interest and principal) by $12 million for the first year, and similar action by other bilateral official and private creditors was expected to provide an additional $26 million in annual relief. Those actions would enable Uganda to eliminate most of its outstanding payments arrears, but it was less clear whether it would put the country's debt on a sustainable path in the future.[71]

Once the Interim and Development Committees approved the HIPC Initiative in September 1996 (see Chapter 13), the staff set about examining the case for declaring Uganda eligible for multilateral debt reduction and for putting it on a fast track toward getting that relief. A staff mission, led by Naheed Kirmani (Assistant Director, African Department), traveled to Kampala in September to discuss terms for the third year of support under the ESAF arrangement. The staff and the authorities worked together to prepare a debt sustainability analysis (DSA) as a standard input into the request for ESAF financing. Fortunately for the ESAF request but unfortunately for HIPC eligibility, the DSA suggested that Uganda's debt profile appeared to be sustainable over the medium term, with debt-service payments falling below 20 percent of export revenues by the end of the decade.[72] The Fund could lend with confidence that the government would have the financial capacity to repay the loans, but the case for offering debt relief did not appear strong.

The critical issue for the assessment of Uganda's eligibility for relief under the HIPC Initiative was not the central scenario in the DSA. It was the economy's vulnerability to adverse shocks. With two-thirds of export revenues derived from coffee, a drop in the world price—possibly resulting from a remote event such as a bumper crop in Brazil—could greatly worsen Uganda's debt and debt-service ratios. The scenario also could

[71]See "Uganda—Staff Report for the 1995 Article IV Consultation and Mid-Term Review of the First Annual Arrangement Under the Enhanced Structural Adjustment Facility," EBS/95/62, April 5, 1995.

[72]"Uganda—Request for the Third Annual Arrangement Under the Enhanced Structural Adjustment Facility," EBS/96/170, November 4, 1996, pp. 14–17.

be thrown off course by worsening of the terms on which the government could borrow, by a higher than expected rise in imports in response to growth in aggregate demand, or by a shortfall in transfers from emigrants (workers' remittances). On that basis, the staff recommended declaring Uganda to be the first country eligible for HIPC debt relief.

The Executive Board accepted that recommendation in March 1997, although a few Directors from creditor countries grumbled that the case was borderline and therefore should not constitute a precedent that would let a flood of other countries in through an open door. More contentious was the question of when to set the decision and completion points as defined in the HIPC Initiative. To reach the decision point, an eligible country had to have completed a three-year program of strong implementation of macroeconomic policies and structural and social policy reforms. If that requirement was applied retroactively, then Uganda's successful completion of the ESAF arrangement in the fall of 1997 would satisfy it. The political pressure on the Fund to get the first debt-reduction case under way before the spring meeting of the Interim Committee was intense,[73] so the Executive Board agreed to set the decision point for Uganda in April and to begin providing interim relief at that time.[74]

Setting the completion point posed harder problems. Everyone agreed that Uganda's long record of adjustment and reform justified some shortening of the three-year interval between decision and completion points that was intended to be the norm. Most of the G7 countries expressed a preference for a two-year interval, which would allow time for the Fund to assess the remaining structural reform agenda and to see whether the interim debt relief was sufficient. Thomas Bernes (Canada), however, argued "strongly" for a completion point "no later than April 1998," and Huw Evans (United Kingdom) supported the appeal of many other Directors for a completion point in September 1997. This split among the major creditors opened the door for compromise, which Camdessus used to generate a consensus in favor of April 1998. The HIPC Initiative was thus launched, with Uganda to be accorded full debt relief in just 12 months but with a caveat attached: the decision was "truly exceptional" and was not to create similar expectations for any of Uganda's neighbors.[75]

On April 8, 1998, Uganda became the first country to reach the completion point under the HIPC Initiative. That achievement released $650 million to relieve

[73]Though couched in diplomatic politeness, the Interim Committee communiqué of September 1996 had strongly advised the IMF to approve at least one country by this time: "The Committee requested the Executive Board to proceed quickly with implementation and to report on progress to the Committee in spring 1997." As noted in Chapter 13, Interim Committee members were themselves being subjected to intense political pressure. As the Canadian Director remarked at the March 12 Board meeting, approving Uganda's request was "crucial if we are to demonstrate to an increasingly skeptical public the commitment of the Fund and World Bank to proceed with this Initiative"; minutes of EBM/97/23, March 12, 1997, p. 7.

[74]Minutes of EBM/97/23, March 12, 1997; Chairman's Summing Up, pp. 60–62.

[75]The "truly exceptional" phrase was suggested by Bernes in his statement at EBM/97/23. It was then picked up by five other Directors, and Camdessus included it in his Summing Up of the discussion.

Uganda's debt burden, to be delivered over a period of several years by both bilateral and multilateral creditors.[76] The IMF's portion was $69 million, in the form of a grant from the ESAF-HIPC Trust. That amount was transferred to an escrow account within the trust, to be used to meet a portion of Uganda's debt-service payments to the Fund as they fell due. In all, this HIPC debt relief was calculated to reduce the net present value of Uganda's external debt by 20 percent.[77]

Other Lending to Low-Income Countries

A close look at IMF lending to low-income countries in Africa reveals the full extent of the difficult and multivariate challenge the Fund was trying to meet, and the infrequency with which the Fund found lasting success. Nonetheless, the successes it achieved were far from trivial or ephemeral. This section reviews four countries to illustrate the variety of this experience.

Ethiopia and Rwanda had been making extremely limited and uneven economic progress, constrained in large part by the burdens of internal and external armed conflicts. The Fund lent to them sporadically during relatively peaceful periods, but found difficulty getting sustained reform processes under way. In contrast, Malawi and Mozambique borrowed more steadily for long periods at a stretch. Success in Ethiopia and in Malawi may also have been undercut by the Fund's attempts to get the authorities to make great changes quickly. In contrast, Mozambique succeeded in making great changes quickly, aided by a deep sense of national ownership of the reforms.

Ethiopia

Ethiopia was the first country to ask for a loan from the IMF, in April 1947. The Fund denied the request on the grounds that Ethiopia did not seem to have a large enough "balance of payments need" to justify the amount being requested, but it made two smaller loans to the country, in 1948 and 1949. Ethiopia did not borrow again for nearly three decades (Horsefield, 1969, pp. 189–90).[78]

[76]In present value terms, the amount of relief was calculated to be $350 million. For details, see "Uganda to Receive US$650 Million in Debt Relief," PR/98/13 (April 8, 1998); accessed at http://www.imf.org/external/np/sec/pr/1998/pr9813.htm.

[77]"Initiative for Heavily Indebted Poor Countries—Completion Point Document," EBS/98/55 (March 20, 1998). For a summary of the result, see "Uganda to Receive $650 Million in Debt Relief," PR/98/13 (April 8, 1998). Additional assistance was approved in February 2000, bringing total HIPC Initiative relief for Uganda to $2 billion.

[78]Ethiopia made one further request to borrow, in 1951, but it withdrew the application before the Fund could act on it (Horsefield, 1969, p. 325). From 1978 to 1982, Ethiopia borrowed from the Trust Fund and from the Fund's general resources, the latter comprising a stand-by arrangement and two drawings through the CFF. The country's last use of general (nonconcessional) resources was in June 1982.

As the 1990s dawned, Ethiopia had not borrowed for several years, and in 1991 it finished repaying all of its earlier loans. From 1987 through the early months of 1991, a military dictatorship led by Mengistu Haile Mariam and allied with the Soviet Union ruled the country. Rebel forces overthrew Mengistu in May 1991, and a new government took power, headed by Meles Zenawi. Meles set out to reform the economy in a more liberal direction, albeit without fundamentally reducing the economic role of the state. This new policy orientation encouraged the IMF and other international lenders and donors to reenter Ethiopia.

In October 1992, the Fund approved a SAF arrangement for $71 million (SDR 49.4 million, or 50 percent of quota). The authorities implemented both the stabilization and the reform elements of the program fully, and they drew the full amount of the available funds over a period of three years. They then applied for and received a three-year ESAF arrangement for $127 million (SDR 88.5 million), beginning in October 1996. That program soon went awry, leading to an unfortunate and ultimately unnecessary impasse with the IMF.

Neither a spending spree nor any other inflationary binge caused the problem. That type of slippage might have been forgivable in a country with a per capita income of less than US 50 cents a day and development needs markedly in excess of the amounts the country was receiving in international assistance. The fiscal deficit and the inflation rate were both better than forecast in the first year of the arrangement. The staff, however, became convinced that the authorities were not sufficiently committed to economic liberalization, which the Fund believed to be necessary for Ethiopia to achieve and sustain good growth and reduction of its extreme poverty.

The staff's disaffection with the Meles government began when it learned only gradually and well after the fact about a series of unusual financial transactions involving the national power company and Ethiopian Airlines. At the beginning of June 1996, three months before the Executive Board approved the ESAF arrangement, the government contributed the equivalent of about 2.75 percent of GDP to the capital of the electric power company, to be invested over time in energy development. The money for this investment (denominated in birr, the local currency) was placed in a "sinking fund" account at the central bank. In late August, the central bank lent a similar amount, in U.S. dollars, to the national airline to repay a foreign commercial bank loan that had been secured by liens on four airplanes and guaranteed by the government. The central bank loan reduced foreign exchange reserves by about 20 percent. Neither of these transactions was disclosed to the Fund until after the first ESAF disbursement.

At the end of February 1997, Ethiopian Airlines issued birr-denominated bonds, which were purchased by the power company using its balance in the sinking fund at the central bank. The net effect was that money intended for energy development was diverted (temporarily, but with an eight-year maturity) to pay off the airline loan, with local currency converted to dollars using the reserves of the central bank. As independent critics later pointed out, the transaction made commercial sense because the lost

interest on the reserves was much smaller than the interest saved by repaying the foreign bank loan (Wade, 2001, pp. 70–71; and Stiglitz, 2002, pp. 25–32).[79] The cost that those critics failed to acknowledge was that the transaction also sharply reduced the country's liquidity for balancing international payments. Protecting and enhancing that liquidity was a major purpose of the Fund's lending, and the government's failure to make a timely disclosure of its actions was seen in Washington as a serious breach of trust that called into question the authorities' commitment to the reform agenda.

The shortfall in foreign exchange reserves and associated changes in other monetary accounts put Ethiopia out of compliance with the terms of the ESAF arrangement. The Fund could simply have refused to grant a waiver and suspended disbursements until the accounts were back under control. Instead, both the staff and the Executive Board decided to make an issue of an unrelated problem, the government's reluctance to move ahead quickly with a planned liberalization of the financial system and the foreign exchange regime. In September 1997, the staff informed the authorities and Fund management that it could not recommend completing the review of the program (a required step before the next disbursement could be made) owing to the lack of progress on these structural reforms.

Normally, when negotiations break down in this way, the Executive Board does not get involved beyond being informed by the Managing Director. On this occasion, management decided to send "a clear, unequivocal signal from the Fund" in the form of a letter to the prime minister, backed up by a consensus of the Executive Directors. At an informal meeting of the Board on October 8, 1997, five Directors—Bernd Esdar (Germany), Karin Lissakers (United States), Jon Shields (Alternate, United Kingdom), M.R. Sivaraman (India), and Eva Srejber (Sweden)—spoke in favor of letting the program lapse and insisting that liberalizing reforms be implemented before any resumption of lending. Dinah Z. Guti (Zimbabwe), whose constituency included Ethiopia, defended the authorities' views, and both Marc-Antoine Autheman (France) and Alexandre Kafka (Brazil) called for a cautious approach, but no other Directors spoke in favor of an immediate resumption of lending.[80]

A letter from Ouattara (Deputy Managing Director) to Meles on October 15 conveyed to the authorities the basis for the Fund's decision to suspend lending. The letter singled out liberalization of the auction market for treasury bills and of the foreign

[79]Both attacks contain substantive errors in their description of the events, but they are correct in stating that the Fund's objections to the way the transactions were carried out by the government contributed to the suspension of lending under the ESAF arrangement. For the IMF staff analysis, see "Ethiopia—Staff Report for the 1997 Article IV Consultation," SM/97/267 (November 7, 1997), pp. 9–10. A more detailed chronology and assessment is attached to a memorandum from Eduard Brau (Director, Office of Internal Audit) to the Managing Director, "Ethiopia—Internal Review," October 24, 1997; IMF archives, DMD-AI, Accession 2000-0117-0003, B2261.

[80]Minutes of IS/MTG/97/5 (October 8, 1997).

exchange market as the reforms on which a resumption of discussions would depend.[81]

In retrospect, the Fund's insistence on liberalization appears to have been excessively rigid, especially as regards the external capital account. Anupam Basu (Deputy Director, African Department) had been actively involved in the discussions in Ethiopia through 1997, and summarized the dispute succinctly:

> The authorities feared that the adoption of a liberalized exchange system might lead to disruptive capital outflows which could not be easily checked. The staff had argued the opposite: in an open exchange system, with broadened financial markets and more attractive domestic financial assets underpinned by appropriate interest rates and sound policies, capital inflows were more likely to materialize than outflows. Unfortunately, the authorities remained unconvinced, partly because they had been receiving a conflicting message from other sources.[82]

At the time—the financial crisis in East Asia was still building steam—the staff's confidence in its view on capital account liberalization was at a historic high. The policies and conditions that Basu described as necessary for openness to lead to capital inflows were assumed to be achievable, even in a country as severely underdeveloped as Ethiopia. Guti noted that "the authorities did not disagree with the staff on the objectives. However, they preferred to move forward more cautiously in order to avoid disruption to the economic system."[83] A few years later, perhaps, this gap could have been bridged.[84]

This suspension of lending did not last long, but other problems ensued as a result of the outbreak of a violent border conflict with Eritrea in May 1998. A two-year war upset the government's plans to stabilize the country's finances. Despite the uncertainties, the

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[81]IMF archives, AFR-AI, Accession No. 2001-0185.

[82]Minutes of IS/MTG/97/5 (October 8, 1997), p. 6. The reference to a "conflicting message from other sources" reflected the staff's frustration with World Bank staff (including Joseph Stiglitz, the Bank's chief economist) who were telling the authorities that the Fund was wrong on this issue. The staff argument in favor of liberalizing the foreign exchange market was set out in more detail in "Ethiopia—Staff Report for the 1997 Article IV Consultation," SM/97/267 (November 7, 1997), p. 21.

[83]Minutes of IS/MTG/97/5 (October 8, 1997), p. 6. The staff was not insisting on an open capital account, but it was asking for actions that would allow residents to transfer balances more freely between domestic and foreign currencies. The sticking points concerned the authorities' unwillingness to allow recipients of foreign exchange to retain it in interest-bearing accounts and use it freely for current transactions, or to allow foreign exchange offices to make payments for cash transfers. It should be noted that the staff position was not universally held. Owen Evans (Assistant Director, Fischer's office) noted that "Reluctance by a small developing country to liberalize payments for current transfers because of the risk of disguised capital flight is common. Fund staff do not usually take such a dogmatic view. . . . Overall, these . . . issues do not seem to me to provide a sufficiently strong basis for failing to move ahead"; memorandum from Evans to Fischer, "Ethiopia—Quick Initial View," October 3, 1997; IMF archives, DMD-AI, Accession 2000-0117-0003, B2261.

[84]In October 1998, when Ethiopia's next request to borrow was being considered, Sivaraman (India) opined that the Board's 1997 decision had been "a bit hasty"; minutes of EBM/98/107 (October 23, 1998), p. 21.

staff and the authorities reached agreement in July 1998 on a program that the Fund could support by resuming lending under the ESAF arrangement. In recommending approval, the staff cautioned that "the integrity of Ethiopia's economic program ultimately hinges on a timely and peaceful resolution of the border dispute with Eritrea."[85] A few Executive Directors, led by Roberto F. Cippà (Switzerland), would have preferred to wait for peace before resuming lending, but the Board as a whole agreed that Ethiopia was making a strong enough effort to warrant the risk the Fund was taking.[86]

In the 1998–99 program, the authorities agreed to most elements of the requested financial liberalization. The authorities, not the staff, formulated other important elements of the program and the government assumed ownership of the overall reform strategy. With goodwill restored, the Fund not only approved a second disbursement under the ESAF arrangement, it also agreed that Ethiopia—with one of the heaviest debt burdens relative to incomes and export revenues of any low-income country—was eligible for the HIPC Initiative. That put Ethiopia on a path toward the decision point, after which it could begin receiving interim debt relief.

Unfortunately, the persistence of the border conflict with Eritrea destabilized the economy, and discussions on further lending were inconclusive throughout 1999. When the ESAF arrangement expired that October, Ethiopia had been allowed to borrow only a third of the total commitment. More sustained progress would have to wait for peace.[87]

Rwanda

Rwanda became a member of the IMF in 1963, a year after gaining independence from Belgium. The years immediately before independence had been marred by violent conflicts between the two main ethnic groups, Hutus and Tutsis, as a result of which some 150,000 Tutsis fled to become long-term refugees in neighboring countries. The government of the new member country was controlled by Hutus, who were also a large majority of the population. From 1966 through 1969, the government borrowed from the Fund steadily but in small amounts, through a

[85]"Ethiopia—Request for the Second Annual Arrangement Under the Enhanced Structural Adjustment Facility," EBS/98/169 (September 28, 1998), p. 26.

[86]Cippà abstained from approving the decision. Wolf-Dieter Donecker (Alternate, Germany), Alessandro Giustiniani (Temporary Alternate, Italy), and Kai Aaen Hansen (Denmark) expressed support for Cippà's view but approved the decision; minutes of EBM/98/107 (October 23, 1998.)

[87]A final peace accord was signed in December 2000. A three-year PRGF arrangement was approved in March 2001 and fully drawn; interim debt relief began when the HIPC decision point was reached in November 2001; and the completion point for full debt relief was reached in April 2004. For reviews of this period, see "The Federal Democratic Republic of Ethiopia: Ex Post Assessment of Long-Term Fund Engagement," Country Report No. 05/26 (January 28, 2005); accessed at http://www.imf.org/external/pubs/cat/longres.cfm?sk=18010.0. Also see Mahone (2007).

series of four stand-by arrangements. It did no more conditional borrowing for the next 30 years.[88]

Throughout the 1980s, Rwanda enjoyed relative political calm, but its economic fortunes worsened under the burden of weak export markets, a small and underdeveloped internal market hampered by a limited transportation network and the long overland distance through Tanzania and Kenya to the nearest port facilities, and an increasingly overvalued exchange rate. The Rwanda franc was pegged to the U.S. dollar until 1983, when the authorities switched to a peg to the SDR. Although the government pursued sound financial policies and kept price inflation in line with the major industrial countries, the strength of the U.S. dollar throughout much of the decade forced an effective appreciation of the franc in both nominal and real terms.

As these economic woes spilled over into political dissatisfaction in 1990, President Juvenal Habyarimana—who had ruled Rwanda since taking power in a coup in 1973—announced his intention to prepare a new constitution based on multiparty democracy. He also opened discussions with the IMF on an economic program to be supported by the SAF. Those discussions concluded satisfactorily in September 1990, but a few weeks later a rebel force led by Tutsi refugees invaded from bases in Uganda, once again dragging Rwanda into ethnic violence.

Throughout this two-year civil war, the Habyarimana government did its best to carry on with its planned economic reforms. Drawing largely on the Fund's policy advice and technical assistance, the authorities devalued the franc by 40 percent in November 1990, took steps to liberalize the foreign exchange regime, and introduced important fiscal reforms. The Fund renegotiated the 1991 program to take account of the fiscal pressure of the war, and in April 1991 it approved a three-year SAF arrangement totaling close to $30 million (SDR 21.9 million, or 50 percent of quota). The Fund made the first of the three scheduled disbursements right away, but by the time the second and third were due, the war had badly derailed the economic program.

Up to this point, the story evolved much like those of many other countries in the region, with the government of a desperately poor country struggling to cope with immense economic and political adversity. It then got much worse. On April 6, 1994, the president's airplane was shot down as it approached the airport at Kigali. Habyarimana's death triggered an unimaginable genocidal slaughter in which at least 800,000 people—a tenth of the total population—were systematically murdered in the course of just three months. As many as 2 million others fled to refugee camps in neighboring countries. Although the war ended almost as suddenly as it began, it left social, political, and economic scars that would take many years to heal.

[88]Rwanda's maximum indebtedness to the Fund in the 1960s was $7 million, slightly more than 50 percent of quota. It repaid all of those loans by 1971, and from 1976 until 1995 it maintained a positive reserve-tranche credit position. In 1979–81, it took out $13 million (SDR 10.7 million) in unconditional Trust Fund loans, but much of that balance was offset by its credit position in the Fund's general accounts.

In January 1995, when some semblance of security had been restored in Kigali, the Fund sent a mission led by Sadikiel N. Kimaro (Deputy Division Chief, African Department) to find out how the institution could best help rebuild Rwanda's finances. Because the preparatory work for a policy program qualifying for ESAF support was going to take many months of hard work, the Fund decided to temporize by making a CCFF loan to compensate for the disruption of international trade in 1994. The Board approved and disbursed that relatively small loan, for $13 million (SDR 8.9 million, or 15 percent of quota), in November 1995.[89]

Rwanda's financial needs were great, and the IMF's role in meeting those needs would be more symbolic than substantive. At a "round table" conference held in Geneva in January 1995, donor countries pledged $1.5 billion in aid, mostly in the form of grants. The IMF's $13 million loan was tiny in comparison, but it provided a clear signal of international support.

More important for the future of Rwanda's economy, the Fund quickly resumed its extensive technical assistance program. Rwanda had been one of the top 10 recipients of IMF technical assistance in the 1980s and early 1990s, and now the government and central bank—depleted of experienced and skilled personnel—needed it more than ever. In the course of 1995–96, the Fund sent advisory missions from all three technical assistance departments to help with monetary and balance of payments statistics and accounting, a wide variety of fiscal issues, and management of the foreign exchange market. The Fund also provided expert advisors to the treasury and the central bank on longer-term assignments.

As the economy began to return to normal in 1996 (real GDP rose by 13 percent that year), the Fund provided a continual flow of macroeconomic policy advice in the context of a staff-monitored program, while the staffs of the Fund and the World Bank worked together to help the authorities prepare a comprehensive development strategy. In 1997, the Fund resumed small-scale lending in the form of emergency post-conflict assistance totaling $21 million (SDR 14.9 million, or 25 percent of quota).

Finally, in 1998 Rwanda had recovered sufficient administrative capacity to present a full policy framework as the basis for a three-year ESAF arrangement. The Fund approved that request in June 1998, making $95 million potentially available on concessional terms. The arrangement was unusually large in relation to quota (120 percent) and was sufficiently large to make a financial difference to Rwanda, but its real

[89]The maximum loan that the Fund could offer through the CCFF was limited to 15 percent of quota by the access limits specified in paragraph 12 of the CCFF decision, as amended. A larger loan would have had to be accompanied by an arrangement in the upper credit tranches. Because CCFF loans were made from the Fund's general resources, the standard interest charge (then about 4.6 percent) applied rather than the 0.5 percent rate charged on concessional loans. In this case, the Fund established a special escrow account to receive the equivalent of about $2.2 million in donations from the Netherlands, Sweden, and the United States to reduce Rwanda's interest payments to the concessional rate; see "Rwanda—Establishment of an Administered Account at the Request of The Netherlands, Sweden, and the United States of America," EBS/95/167 (October 12, 1995).

importance was to enable the Paris Club to agree to generous terms for relieving Rwanda's burden of debt to bilateral creditors. It also put Rwanda on a path toward receiving multilateral debt relief under the HIPC Initiative.[90]

Malawi

The British colony known as Nyasaland, a small landlocked territory in southeastern Africa, became independent in 1964 under the new name of Malawi. It joined the IMF a year later and began borrowing in 1975 after the oil price increases of 1973–74 severely squeezed its balance of payments. Malawi borrowed continuously for the next 10 years.[91] Credit outstanding peaked in 1985 (Figure 14.5), after which the authorities had increasing difficulty carrying out the EFF-supported program. No further disbursements were made for two years. Lending resumed in 1988, but at a lower level that approximately compensated for repayments on the earlier loans. Because the new lending was mostly through the ESAF, it effectively rescheduled Malawi's debt to the Fund on more favorable financial terms (lower interest rates and longer repayment periods).

A second break in lending came in 1992, in the wake of growing political instability. Since the early 1960s, Malawi had been under single-party rule. Hastings Kamuzu Banda, who had been declared "President for Life" in 1971, led the country. Opposition to his rule and pressure for democratization boiled over in the early 1990s, forcing Banda to agree to a referendum. During the transition, economic policy was paralyzed, and international donor financing ceased. Nominally, the ESAF arrangement approved in 1988 remained in effect until 1994, but disbursements stopped in 1991. The referendum, held in June 1993, led to multiparty elections in May 1994 and to Banda's defeat. His loss cleared the way for a new constitution and renewal of international support.

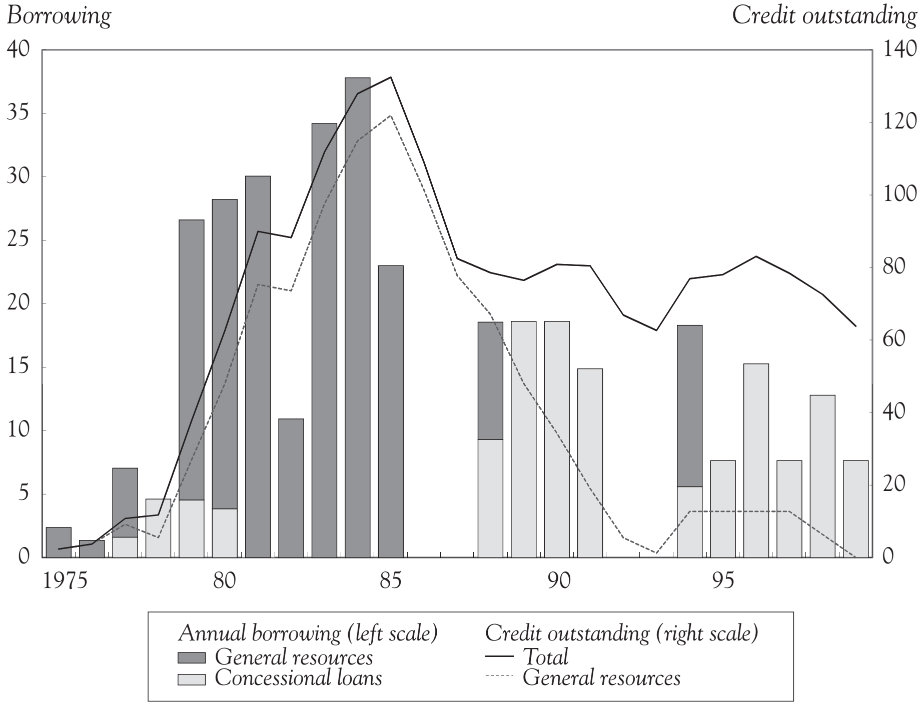
To offer a quick response to this "smooth and successful historic transition to multiparty democracy," as the staff phrased it,[92] the Fund approved an eight-month stand-by arrangement in November 1994. This decision was a departure from then-current

[90]Rwanda borrowed most of the money available under the ESAF arrangement despite increased tensions with the international community resulting from the government's involvement in a civil war in the Democratic Republic of the Congo, beginning shortly after the arrangement went into effect. Rwanda reached the completion point for HIPC relief in April 2005.

[91]The first loan to Malawi, in December 1975, was through the Oil Facility, to compensate for the effects of the 1973–74 increase in world oil prices. In 1977–80, Malawi borrowed from the Trust Fund, and in August 1979 it made a drawing under the CFF to compensate for a temporary drop in sugar and groundnut exports. The first stand-by arrangement was approved in October 1979. From that time on, Malawi had nearly continuous program engagement with the Fund, at least through 2009. For a review of Malawi's prolonged use of Fund resources, see "Malawi: Ex Post Assessment of Longer-Term Program Engagement," Country Report No. 04/389 (December 6, 2004); accessed at http://www.imf.org/external/pubs/cat/longres.cfm?sk=17885.0.

[92]"Malawi—Request for the Stand-By Arrangement and 1994 Article XIV Consultation," EBS/94/207 (October 26, 1994), p. 1.

Figure 14.5. Malawi: Use of Fund Credit, 1975–99
(In millions of SDRs, annual data)



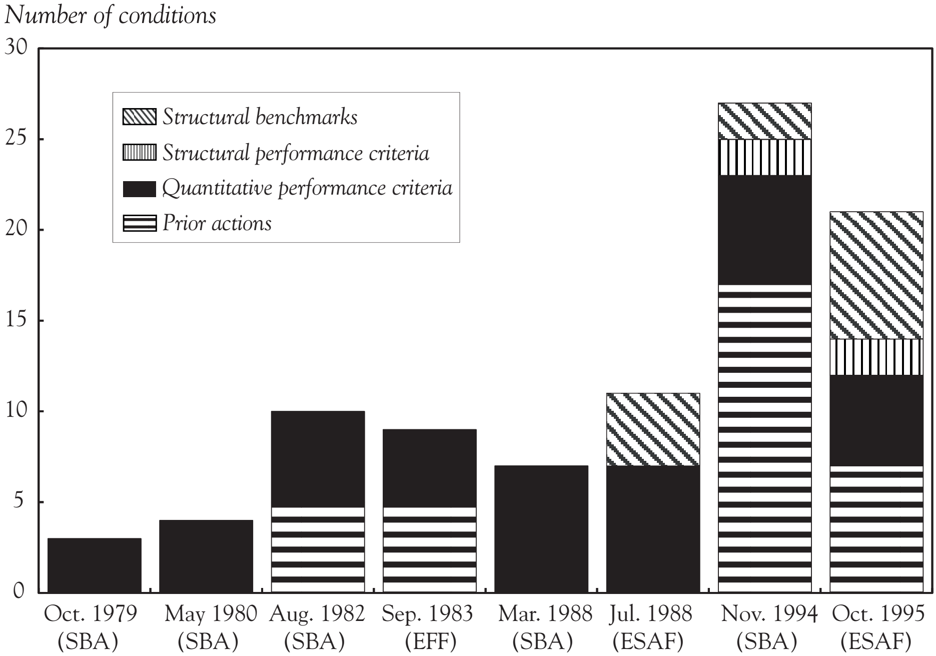
Source: IMF financial accounts.

standard practice in lending to low-income countries in that the arrangement was short term and nonconcessional. It was aimed specifically at providing quick support for the newly elected government; enabling a renewal of donor and multilateral financing from the World Bank, the European Union, and others; and laying the groundwork for a three-year ESAF arrangement as soon as the government could formulate and begin to carry out a comprehensive economic policy.[93]

Because the government was new and untested, the Fund required an unusually lengthy list of 17 actions to be completed prior to the Board discussion. Several of these actions, which the authorities carried out between June and November, were needed to initiate a shift to more-open financial policies and were fairly conventional IMF macroeconomic policy prescriptions. For example, the government eliminated requirements that exporters surrender a portion of foreign exchange receipts, tightened

[93]As noted in the discussion of lending to members of the CFA franc zone (p. 707), in 1994 the ESAF Trust had little money left for new lending.

Figure 14.6. Malawi: Conditions on IMF-Supported Programs, 1979–95



Source: IMF financial accounts.
Note: EFF = Extended Fund Facility; ESAF = Enhanced Structural Adjustment Facility; SBA = Stand-by arrangement. Counting conditions is partially arbitrary, and the guidelines and documentation have evolved over time. The numbers in this figure are broadly indicative.

monetary policy, and set up a more open system for issuing treasury bills. The list also included more-detailed structural measures, including issuing a "public notice about the removal of the export licensing requirement for groundnuts and beans" and establishing a "task force against customs fraud."[94]

From this point on, the Fund's conditions on lending to Malawi focused increasingly on structural reforms, though without lessening the importance attached to macroeconomic stabilization (Figure 14.6). Malawi had succeeded intermittently in getting the economy on a sound course, with sustainable fiscal and monetary policies, but it kept getting blown off that course by a combination of external shocks and weak public administration. The Fund concluded that reforming administrative practices sufficiently to enable the economy to withstand the shocks was the right path.[95] The new

[94]"Malawi—Request for the Stand-By Arrangement and 1994 Article XIV Consultation," EBS/94/207 (October 26, 1994), p. 37.

[95]See "Malawi: Medium-Term Country Strategy Brief," attachment to memorandum from Pierre Dhonte (Senior Advisor, African Department) to the Acting Managing Director (September 1, 1995); IMF archives, Accession No. 1998-0106-0006, OMD-AD, B11518, "Malawi 1995."

government shared that objective in general terms, but it found that carrying out that challenge was still beyond its capabilities.

The 1994–95 stand-by arrangement helped for several months, but the authorities had trouble sustaining the policy adjustments. The fiscal deficit and price inflation spun out of control in 1995, and the last drawing was not allowed. Again, the government made a great effort, and in 1996—the first year of a three-year ESAF arrangement—the inflation rate fell from 75 percent to less than 7 percent. Again, however, and notwithstanding significant progress in structural reforms, discipline soon weakened, inflationary financing of the fiscal deficit resumed, and the second half of the arrangement was a failure.

Why was the reform program in Malawi so troubled, and the effort so intermittent? The IMF's own assessment in large part blamed a lack of national ownership or commitment to good governance, especially at the highest political levels, and weak administrative capacity. However, the assessment also acknowledged that the programs of the 1990s may have been overly ambitious. Overcoming pervasive and systemic weaknesses in the way the authorities were trying to guide and control economic activity may have been the right long-run strategy, but it was unrealistic to expect a fledgling government to change the system wholesale in the span of a few years. The 2004 assessment concluded that any future program with Malawi "should focus on macroeconomic stabilization and structural measures directly related to it. Once the stabilization gains have been consolidated, the broader reform agenda can be tackled."[96]

Mozambique

Mozambique joined the IMF in 1984 while still suffering from internal and external conflicts that had devastated the country for two decades. A protracted war for independence from Portugal had ended successfully in 1975, but an even more devastating civil war had ensued. The one-party independent state had allied itself with the Soviet Union and adopted a socialist model with control of economic activity concentrated in the central government. In 1983, President Samora Machel renounced that model and initiated a reform movement that included IMF membership as part of an opening to the West. The Fund responded with a series of SAF loans from 1987 to 1990. During those years, despite the ongoing civil war, output growth averaged 7.5 percent while price inflation fell from an annual rate of 164 percent to 44 percent.

By 1990, the international community recognized that Mozambique still needed an exceptional degree of external support. Even after the rapid economic growth of the late 1980s, it remained one of the poorest and least-developed countries in the world, and it was saddled with a clearly unsustainable external debt burden. For the

[96]"Malawi: Ex Post Assessment of Longer-Term Program Engagement," Country Report No. 04/389 (December 6, 2004), pp. 29–33.

government's reform effort to have any chance of succeeding, donors and multilateral agencies would have to step up their assistance.

In June 1990, the Fund approved a three-year ESAF arrangement to succeed the much smaller and expiring SAF arrangement.[97] Two weeks later, the Paris Club agreed to reschedule most of Mozambique's debts to official bilateral creditors, to include long grace periods and maturities of up to 25 years.[98] Everyone involved knew these actions were only the beginning and much more assistance would be needed, but they also knew the government had to do its part, including by establishing peace.

The reform effort got off to a good beginning. In November 1990, in a highly symbolic recognition of its reorientation toward democracy and market economics, Mozambique adopted a new constitution and changed its official name from the "People's Republic" to the "Republic" of Mozambique. The new constitution put the country on a path toward multiparty elections, which would be held in 1994. Three months later, in February 1991, Camdessus paid a visit that included a meeting with the president, Joaquim Chissano. Although the civil war was still on, a partial peace accord had been signed, and the Managing Director was satisfied that the president and his government were committed to continuing the reform effort. Despite the problems, the ESAF-supported program was on course.

The 1990 Paris Club accord had made only a dent in Mozambique's external debt overhang, but it and the Fund's ESAF financing provided a catalyst for additional relief from others. Although the bulk of its debt was owed to official creditors and was contracted on concessional terms, the government also had more than $300 million in outstanding debts to commercial banks, including interest arrears. In December 1991, it was able to buy back 64 percent of that debt ($204 million) at a 94 percent discount, using funds provided by the World Bank's International Development Association special debt-reduction facility and bilateral contributions from four donor countries.[99]

Steady progress was not going to be achieved without great effort. Mozambique's economy depended heavily on agriculture, but the land was vulnerable to recurring droughts and floods. A severe drought hit southern Africa in the early 1990s, with devastating effects. By March 1992, the Fund staff estimated that 40 percent of the population of Mozambique was at risk of extreme dehydration or starvation.

[97]The SAF arrangement approved in 1987 totaled $37 million. It was gradually increased to $56 million, all of which was disbursed before the arrangement expired in June 1990. The successor arrangement totaled $112 million, later augmented to $186 million (SDR 130.5 million, or 155 percent of quota).

[98]"People's Republic of Mozambique—Report on External Debt Renegotiation," EBS/90/135 (July 20, 1990).

[99]For details, see "Republic of Mozambique—Staff Report for the Article IV Consultation and Mid-Term Review of the Second Annual Arrangement Under the Enhanced Structural Adjustment Facility," EBS/92/81 (May 7, 1992), p. 19; and "Cost of Fund Credit—Principles of Burden Sharing—Concessionality in Fund Operations and Related Matters," SM/92/108 (June 1, 1992), pp. 76–77.

The Executive Board responded by approving an augmentation of the ESAF arrangement and by encouraging other official creditors to step up humanitarian and other assistance.[100]

The authorities succeeded remarkably well in carrying out their stabilization and reform program during a period when they were also coping with the drought, negotiating a peace accord and then demobilizing a large part of the army, and preparing for the country's first free elections. They lost control of the fiscal balance in 1994 and 1995 owing to these pressures, even though they made substantial cuts in nonessential spending. That left a large unfinanced payments gap, and the Fund temporarily stopped disbursing loans (Figure 14.7).[101]

The Fund continued to provide technical assistance to Mozambique throughout this difficult adjustment period in the mid-1990s. From 1993 through 1997, it sent six staff missions to help improve the national monetary and balance of payments statistics, seven missions of fiscal experts to advise on the customs and tax systems, and several consultation visits on strengthening the banking system and foreign exchange management. In addition, the IMF Institute conducted a financial programming course in the capital, Maputo, for local officials.[102]

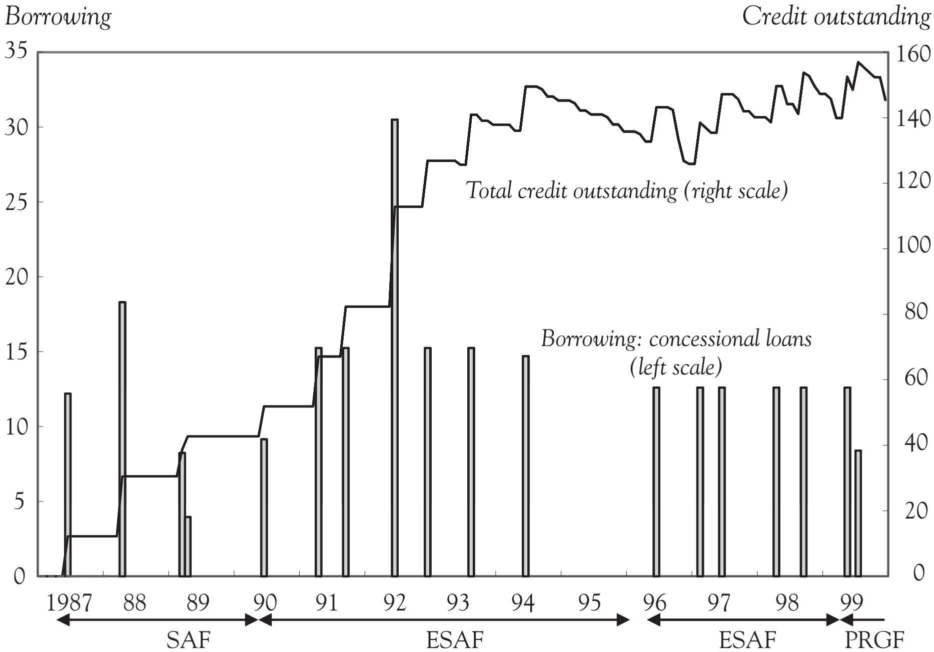
When Mozambique applied for a successor ESAF arrangement in 1996, its need for official assistance was undiminished. The drought of the early 1990s had been followed by widespread flooding caused by unusually heavy rainfall. With cropland and much of the transportation network under water, Mozambique was again unable to produce or market its output at normal levels. Moreover, the staff assessment of the situation acknowledged that the country still faced an unsustainable debt burden into the foreseeable future. Existing procedures, such as the Naples terms, then being applied by the Paris Club were grossly insufficient for this case—a poverty-stricken country that, even after relief from the Paris Club, would have to pay out 40 percent of its export receipts just to service its external debts. Because the HIPC Initiative was still pending, all the Fund could do directly to alleviate the debt burden was set a ceiling on nonconcessional borrowing as a condition for the ESAF arrangement, which was approved in June 1996. The staff report also called on the donor community to provide additional

[100]The augmentation was equivalent to 25 percent of quota, which was the standard amount that the Fund lent as quick-disbursing emergency disaster assistance at that time. Because the Fund was lending to Mozambique purely on concessional terms, the loan was treated as an augmentation of the existing arrangement rather than as a separate disaster-relief loan; see "Republic of Mozambique—Staff Report for the Article IV Consultation and Mid-Term Review of the Second Annual Arrangement Under the Enhanced Structural Adjustment Facility," EBS/92/81, Suppl. 1 (May 29, 1992).

[101]To give the authorities time to correct the fiscal overruns, the Fund extended the 1990 ESAF arrangement from its original expiration date of end-May 1993 to the end of 1995. The last disbursement, however, was made in June 1994. The arrangement expired with just one scheduled disbursement for $22 million (SDR 14.7 million; 11 percent of the total commitment) not made.

[102]"Republic of Mozambique—Request for Arrangements Under the Enhanced Structural Adjustment Facility," EBS/96/80 (May 20, 1996), p. 53.

Figure 14.7. Mozambique: Use of Fund Credit, 1987–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics.
Note: ESAF = Enhanced Structural Adjustment Facility; PRGF = Poverty Reduction and Growth Facility; SAF = Structural Adjustment Facility.

debt relief, noting that Mozambique would be a "prime candidate" for multilateral debt reduction once a system was in place.[103]

Mozambique implemented the 1996–99 ESAF-supported program effectively, and the economy turned in its best performance yet: output growth averaged more than 10 percent a year, while inflation fell from 48 percent in 1996 to 7 percent in 1997 and to 2 percent for the next two years. For the decade as a whole, Mozambique had one of the highest rates of economic growth in all of sub-Saharan Africa.

The major drag on the economy continued to be the debt overhang, which was increasingly concentrated in obligations to official multilateral institutions. In 1999, the Fund approved a third ESAF arrangement in association with the completion point for debt relief under the HIPC Initiative, as discussed in Chapter 13.

[103]The debt-service calculation was an average for the period 1996–2005; see "Republic of Mozambique—Request for Arrangements Under the Enhanced Structural Adjustment Facility," EBS/96/80 (May 20, 1996) pp. 9–10.

Mozambique thus became the fourth country to reach the HIPC completion point and begin receiving permanent relief from its multilateral debt.[104]

Postscript

In January 2000, Michel Camdessus was preparing to leave the IMF after 13 years as Managing Director. One of his first achievements in the job, in 1987, had been to convince donor countries to triple the IMF's resources for subsidized lending to low-income countries and create the Enhanced Structural Adjustment Facility. One of his last, in 1999, had been to replace that temporary lending window with a permanent Poverty Reduction and Growth Facility. Both of these initiatives had been aimed squarely at Africa in the hope of pulling its diverse economies more fully into the world of global trade and finance.

Many people, inside and outside the Fund, were disappointed that the world's premier monetary institution was devoting so much time, energy, and money to trying to help stabilize the economies of poor countries by giving them long-term loans on concessional terms. That the IMF should get out of the business of "development lending" had become a mantra for critics throughout the industrial world. Other critics, including many in Africa, were outraged that the Fund's lending had come with so many strings attached; that its insistence on financial and macroeconomic stability as a precondition for sustainable growth had, in their view, left these countries with too few resources to meet their needs for health, education, and the development of public infrastructure.

Camdessus rejected these criticisms. As expressed in the quotation at the head of this chapter, he believed that "the future of the world" lay in Africa. More to the point, he believed many of the problems keeping Africa from reaching its potential—monetary instability, fiscal excesses, lack of administrative capacity to design and carry out economic policies, and inefficient and corrupt financial oversight—were ones the IMF could and must help solve. Its attempts to do so had often failed, but as the 1990s became part of history, he could point to an increasing number of successes scattered around the continent.

Ever the optimist, Camdessus saw a half-full glass slowly being filled. The PRGF, he believed, was not just a slightly improved ESAF. It was a vehicle with which the IMF and its poorer members could work together to reduce the devastating poverty that so pervaded Africa. The HIPC Initiative, which had just been enhanced, was only one more step toward eliminating Africa's crushing burden of external debt, but it was keeping the process moving in the right direction. For the continent as a whole, per capita incomes had fallen slightly in the 1990s, as they had a decade earlier, but about

[104]For an analysis of Mozambique's reform agenda in the late 1990s and the early part of the following decade, see Clément and Peiris (2008).

half of the countries in Africa had achieved positive growth per capita, and more than half had better growth than in the 1980s. To be sure, the policy agenda was incomplete, and lasting results would take longer to materialize, but reasons for optimism could be found by those who were willing to look.

One group that shared Camdessus's optimism to a surprising degree, and that had come to respect his dedication to the cause of African economic growth, was the political leadership of Africa. More than the nongovernmental activists, they had seen firsthand the fruits of working with the IMF, and many of them had come to see Camdessus almost as "one of them," a man who could be trusted to share their goals and aspirations even as he pushed them onto new paths for reaching these goals. To cement both that personal relationship and that between the IMF and Africa, Camdessus decided to make one last trip to Africa as Managing Director. At his request, President Omar Bongo of Gabon invited heads of state and government from throughout Africa to attend a special summit meeting in Libreville. The primary purpose of the summit meeting was for Camdessus and his IMF colleagues to explain the significance for Africa of the new HIPC and PRGF facilities, but it was also intended as a way for Camdessus to say farewell and for the African leaders to express their appreciation. Senior officials from more than 30 countries, including nearly two dozen presidents and prime ministers, accepted Bongo's invitation to attend the meeting on January 18–19, 2000.

In an unusual move to raise the profile of the Fund's presence, the Managing Director was accompanied by two of his three deputies (Fischer and Eduardo Aninat) as well as Gondwe, Jack Boorman (Director, Policy Development and Review Department), and other senior staff. The occasion was nonetheless Camdessus's show. He used it to convey a relentlessly upbeat message about Africa—which was on the verge of a "renaissance"—and the role that the Fund was prepared to play, based on the summit's communiqué, which he promised would be "the bible for action for the IMF and the World Bank in the years to come."[105]

The African leaders at the summit were not quite that upbeat. In their communiqué, they focused more on the ills that still plagued the continent, from unemployment and illiteracy to the AIDS epidemic, and on the great need for more external assistance. At the close, they "paid high homage to Michel Camdessus, a great friend of Africa who has never yielded to Afro-pessimism, for his unwavering fight for African debt relief and poverty reduction."[106] In January 2000, whether that personal battle would continue on a broad institutional level under new IMF leadership and in a new century remained to be seen.

[105]"At economic summit, African leaders sign joint declaration pledging to fight poverty," *IMF Survey*, Vol. 29 (January 24, 2000), pp. 17–19. Also see Camdessus (2000).

[106]"At economic summit, African leaders sign joint declaration pledging to fight poverty," *IMF Survey*, Vol. 29 (January 24, 2000), p. 19.

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V
Institutional Evolution

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15

Money Has to Grow: How the Fund Was Financed

As an official multilateral lending agency, the IMF has a daunting task to keep its finances in balance. Its mandate requires it to lend to countries in difficult financial straits after private sector lenders have pulled out and official bilateral lenders have become wary of the risks. In the 1990s, the rapid growth and increasing complexity and instability of international trade and capital flows raised the stakes immensely. The value of world trade more than doubled from the 1980s to the 1990s. The aggregate current account deficit of all deficit countries rose from $223 billion a year in the 1980s to $366 billion in the 1990s. The size and volatility of international financial flows grew much more rapidly. In response, IMF credit outstanding rose from $28 billion to $41 billion. Despite the size of new lending, the Fund was covering a smaller portion of its members' financial needs. Raising the capital to keep this contribution from shrinking further provided a constant challenge throughout the decade.

The Financial Evolution of the IMF

The IMF began life in 1946 as a single fund: a pool of financial resources deposited by its member countries, mostly in the form of gold, U.S. dollars, and countries' own currencies. Those nondollar currency balances were a major part of the IMF's assets, even though they were—at the time—not traded or convertible internationally and therefore not usable for IMF lending. Over time, the number of "usable currencies" gradually grew. The financial assets of what eventually became the General Department of the IMF comprised gold, usable currencies, and other currencies. The First Amendment of the Articles of Agreement, adopted in 1969, enabled the IMF to allocate (i.e., issue) special drawing rights (SDRs) through a separate SDR Department, which then had its own balance sheet.[1] Beginning in 1976, the IMF

[1]The division of the IMF's accounts into separate "departments" (General and SDR) should not be confused with the organizational division into area and functional departments such as the African Department and the Fiscal Affairs Department. The two concepts are completely independent.

administered a series of trust funds to make loans to specified groups of countries, mostly low-income. The IMF sold a portion of its gold stock to finance those trust funds initially, and later borrowed from member countries, central banks, and other official bodies. By the 1990s, the IMF was no longer a single fund but a complex set of financial funds, each with its own balance sheet and operations.[2]

General Department

The IMF's main balance sheet—that of its General Department, summarized in Table 15.1—has an unusual structure in that a portion of its assets consists of currencies that are not usable for operations. Each member country is required to deposit approximately a quarter of its assigned quota in the form of usable currencies or SDRs and the remainder in its own currency. Every three months, the IMF assesses the strength of the member's balance of payments and of its reserves and determines on that basis whether to include the member's currency in the Fund's financial transactions plan, which determines the maximum amount of each currency that can be used in lending operations.[3] Thus, the operational value of the Fund's assets fluctuates with economic conditions.

Resources

At the beginning of the 1990s, the IMF held a total of $53.2 billion (SDR 40.9 billion) in 32 different currencies deemed usable for lending operations (Table 15.2), plus small amounts of 9 other currencies that were eligible to be received by the Fund from members in receipt of financial obligations.[4] In volume, these currencies ranged from U.S. dollars ($14.4 billion) down to Botswana pula ($3.8 million). In addition, the General Department held $1.2 billion in SDRs that it could lend to members. Within the General Department, the Special Disbursement Account (SDA) held about $1.1 billion in short-term SDR-denominated securities, pending

[2]The operations of the trust funds, or administered accounts—chiefly the Enhanced Structural Adjustment Facility, the Poverty Reduction and Growth Facility, and the Heavily Indebted Poor Countries Trusts—are covered in Chapter 13.

[3]The term in use through the 1990s was "operational budget." That ill-fitting term was replaced by "financial transactions plan" in 2000.

[4]Eligibility for receipts-only usage meant only that the country had a sizeable reserve tranche position in the IMF. That is, if a country had a sufficiently large reserve position in the Fund but a weak balance of payments, its currency could be used in receipts but not in lending operations; see "Principles for Calculating Amounts of Currencies under the Fund's Operational Budgets," EBS/89/201 (October 17, 1989). At the end of 1989, most of those countries were so small that the Fund decided to exclude them from the operational budget and not use their currencies for receipts. Only Bahrain and Paraguay were included as receipts-only countries. Mauritius and Thailand were excluded from the currency list for lending operations because they had outstanding obligations to the Fund; see "Operational Budget for December 1989–February 1990," EBS/89/227 (November 29, 1989); and Suppl. 2 (December 15, 1989).

Table 15.1. Balance Sheet of the General Department
(Billions of SDRs)

	December 31, 1989		December 31, 1999		Change	
ASSETS						
Liquid cash assets		42.6		96.2		53.6
Usable currencies	40.9		92.4		51.6	
SDR holdings	0.9		2.5		1.5	
SDA investments	0.8		1.3		0.5	
Loans and credits		51.0		114.6		63.6
GRA credits	22.3		51.1		28.7	
Other currency holdings	27.1		63.0		35.9	
SAF loans	1.5		0.5		(1.0)	
Receivables		1.5		1.5		(0.0)
Gold (book value)		3.6		4.9		1.3
Other assets		0.0		0.3		0.3
Total assets		98.7		217.5		118.8
LIABILITIES AND NET WORTH						
Liquid liabilities		25.5		54.8		29.3
Reserve tranche positions	22.0		54.8		32.8	
Borrowings (General Department)	3.5		0.0		(3.5)	
Balance of quota subscriptions		68.1		155.5		87.3
SDA resources		2.3		1.8		(0.4)
Other liabilities		0.4		0.5		0.2
Reserves, etc.		2.4		4.9		2.4
Ordinary reserves	1.4		2.8		1.4	
SCA	0.2		1.1		0.9	
Deferred charges	0.9		1.0		0.1	
Total liabilities and net worth		98.7		217.5		118.8
Memorandum:						
Gold at market price		31.6		21.3		(10.3)

Sources: IMF financial accounts and staff calculations.
Note: SAF = Structural Adjustment Facility; SCA = Special Contingent Account; SDA = Special Disbursement Account. Details may not sum to totals, owing to rounding.

the approval and disbursement of loans to low-income member countries through the Structural Adjustment Facility (SAF). Altogether, these liquid cash assets—resources that could readily be lent out—amounted to $55.6 billion (Table 15.1).[5]

During the 1990s, the size of the Fund's General Department more than doubled, as did the size of the resources in the financial transactions plan. By the end of the decade,

[5]The data cited here are in U.S. dollars. Those shown in Table 15.1 are in the IMF's unit of account, the SDR. The official data have been converted to dollars at the average monthly exchange rate ($1.302 per SDR in December 1989; $1.373 in December 1999).

Table 15.2. Countries with Currencies in the Financial Transactions Plan, 1989 and 1999

December 31, 1989				December 31, 1999			
Country	Holdings (Millions of SDRs)	Percentage of Quota	Percentage of Total Holdings	Country	Holdings (Millions of SDRs)	Percentage of Quota	Percentage of Total Holdings
				Australia	2,047	63	2.21
Austria	505	65	1.24	Austria	1,174	63	1.27
Belgium	1,739	84	4.25	Belgium	2,937	64	3.18
Botswana	3	13	0.01	Botswana	40	64	0.04
				Brunei Darussalam	115	76	0.12
Canada	2,539	86	6.21	Canada	4,061	64	4.39
				Chile	557	65	0.60
				China	3,002	64	3.25
Cyprus	52	74	0.13				
Denmark	456	64	1.12	Denmark	1,061	65	1.15
Finland	396	69	0.97	Finland	800	63	0.86
France	3,407	76	8.33	France	6,789	63	7.34
Germany	3,089	57	7.56	Germany	8,332	64	9.01
Greece	311	78	0.76	Greece	538	65	0.58
				Hungary	862	83	0.93
Ireland	218	63	0.53	Ireland	535	64	0.58
				Israel	863	93	0.93
Italy	1,811	62	4.43	Italy	4,472	63	4.84
Japan	1,681	40	4.11	Japan	8,539	64	9.24
Korea, Rep. of	285	61	0.70				
Kuwait	501	79	1.23	Kuwait	1,013	73	1.10
				Luxembourg	225	81	0.24
Malaysia	381	69	0.93				
Malta	22	48	0.05				
Mauritius	101	189	0.25				
Netherlands	1,733	77	4.24	Netherlands	3,283	64	3.55
New Zealand	422	91	1.03	New Zealand	586	66	0.63
Norway	257	37	0.63	Norway	1,051	63	1.14
Oman	35	56	0.09				

Table 15.2. (continued)

December 31, 1989				December 31, 1999			
Country	Holdings (Millions of SDRs)	Percentage of Quota	Percentage of Total Holdings	Country	Holdings (Millions of SDRs)	Percentage of Quota	Percentage of Total Holdings
				Poland	1,197	87	1.29
Portugal	282	75	0.69	Portugal	592	68	0.64
Qatar	95	83	0.23				
Saudi Arabia	2,739	86	6.70				
Singapore	12	13	0.03	Singapore	559	65	0.60
				Slovenia	153	66	0.17
Spain	356	28	0.87	Spain	1,938	64	2.10
Sweden	811	76	1.98	Sweden	1,533	64	1.66
				Switzerland	2,240	65	2.42
Thailand	561	145	1.37				
United Arab Emirates	64	32	0.16	United Arab Emirates	399	65	0.43
United Kingdom	4,948	80	12.10	United Kingdom	6,892	64	7.46
United States	11,072	62	27.08	United States	24,056	65	26.02
Total holdings	40,882				92,439		
Number of countries	32				33		

Sources: *Annual Reports* and International Financial Statistics.

Note: Countries shown in italics joined the IMF during the 1990s. Details may not sum to totals, owing to rounding.

liquid cash assets exceeded $132 billion. The number of usable currencies, however, was virtually unchanged. Although more than 40 countries qualified at some time during the decade, the list of eligible currencies never rose to more than 33. At a first approximation, therefore, the usable resources available to the Fund rose in parallel with the rise in Fund quotas, which remained the primary funding source for the department.

On a net basis, the Fund's usable and uncommitted resources did not rise commensurately with gross resources until some of the major borrowers began repaying earlier loans in 1999 (Figure 15.1).[6] Two causes stand out for the increased pressure on the balance sheet. First, the series of financial crises that engulfed much of the developing world from 1994 through the end of the decade led to sharp increases in Fund lending and a corresponding reduction in uncommitted funds. Second, the increase in IMF membership in the 1990s, to 182 countries from 152, applied further pressure, because most of those new members soon became borrowers. Brunei Darussalam, Slovenia, and Switzerland were creditor countries and contributed to the Fund's usable resources, but almost all of the other new members were net debtors throughout much of the decade.

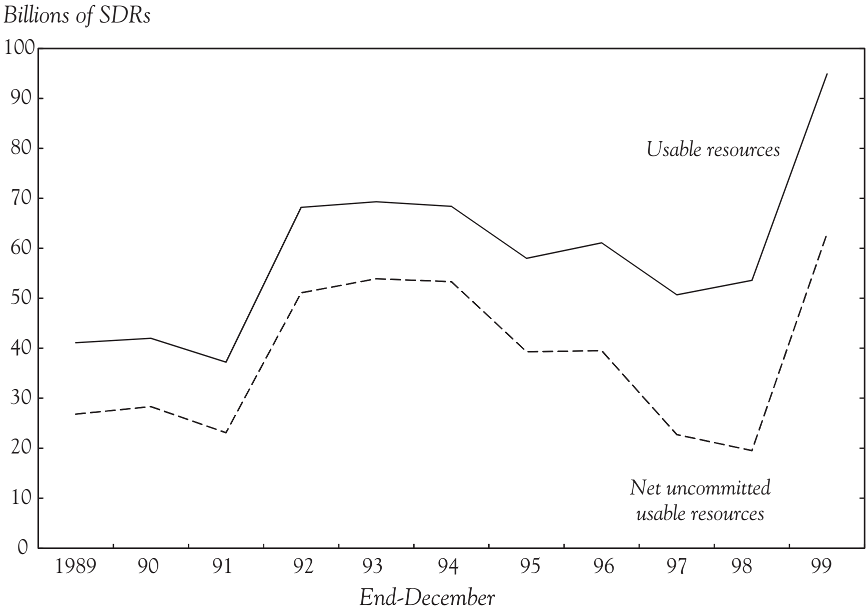
Lending peaked in July 1998, right after the IMF made a large disbursement to the Russian Federation as part of an extended arrangement. The new members had an aggregate outstanding indebtedness of SDR 18.8 billion and a combined reserve tranche (creditor) position of just SDR 2.0 billion. At that point, the Fund's net uncommitted usable resources totaled less than SDR 20 billion, well below the level at the start of the decade. The expansion of membership thus put substantial stress on the balance sheet. As discussed below, the IMF resorted to borrowing for the first time in several years. The 1999 quota increase and the first large repayments of earlier drawings then raised liquid resources sharply, to an all-time high at the end of 1999.

Gold

In addition to its currencies and SDRs, the IMF held more than 103 million ounces of gold in the 1990s—the third largest stock in the world after those of the United States and Germany. The Fund's gold stock decreased 50 million ounces from its peak following the sale of 25 million ounces to member countries in the 1970s to finance the original Trust Fund and the restitution of another 25 million ounces to member countries at the same time. During the 1990s, as recounted in Chapter 13, much political discussion and internal debate took place over the possible sale of gold to help finance the Fund's participation in the Heavily Indebted Poor Countries (HIPC) Initiative to help provide debt relief to poor countries. Surprisingly, in the end, the IMF did not sell any gold, and the physical stock

[6]The data series "net uncommitted usable resources" was constructed by the Treasurer's Department by subtracting from usable resources an estimate of commitments under existing arrangements that were likely to be used and a portion of members' reserve tranche positions that was set as an estimate of minimum working balances. This data series was replaced in 2002 by a slightly different concept, the Fund's "one-year forward commitment capacity."

Figure 15.1. IMF Usable Resources, 1989–99



Source: "Methodology Used in Reviews of the Fund's Liquidity and Financing Needs," EBS/97/60 (April 2, 1997), Table 2; "IMF's Financial Resources and Liquidity Position 2000," accessed at http://www.imf.org/external/np/tre/liquid/2000/liq00ind.htm; and staff calculations.

remained constant from beginning to end (Figure 15.2). The Fund did, however, put some of this gold to use in the 1990s:

- In 1992, the Fund "sold" a small amount of gold (21,396 ounces) to Cambodia and simultaneously accepted it back in partial settlement of the country's overdue obligations to the General Department (Chapter 16).
- In 1993, the IMF pledged to sell 3 million ounces of gold if needed to cover potential losses to creditor countries on loans from the Enhanced Structural Adjustment Facility (ESAF) Trust (also covered in Chapter 16). The need did not arise, and no gold was sold.
- In 1996, the Fund agreed to sell up to 5 million ounces if needed to finance ESAF lending (Chapter 13). As before, the need did not arise, and no gold was sold.
- The Fund "sold" 12.9 million ounces to Brazil and Mexico in a series of transactions from December 1999 through April 2000 and immediately accepted it back in repayment of outstanding obligations falling due. As explained in Chapter 13, these transactions—like the earlier one with Cambodia—raised the valuation of gold on the IMF's balance sheet but did not affect the physical

stock.[7] In this case, the revaluation also restructured the Fund's balance sheet to help finance the Poverty Reduction and Growth Facility–Heavily Indebted Poor Countries (PRGF-HIPC) Trust for the benefit of low-income countries.[8]

The market price of gold moved in a narrow range throughout most of the 1990s, usually between $330 and $400 per ounce from 1990 through 1997, and then fell to a low of $256 in 1999. That late decline meant the market value of the Fund's holdings declined by about 25 percent from the beginning to the end of the decade. The book value in SDRs, however, remained stable until the increase at the end that resulted from the revaluations described above (see Figure 15.2).

Access Limits

The original text of the IMF Articles of Agreement specified that no member was to borrow more than its quota unless the Executive Board agreed to waive the limit in a particular case. Moreover, with the same exception, no member was to borrow more than 25 percent of its quota in any 12-month period.[9] These access limits were intended to preserve the IMF's resources to ensure that funds would be available to all countries that needed them and to ensure that no country would borrow more than it needed or could afford. The limits had an apparent numerical logic, but they were inherently arbitrary. No one knew at the time what the demands on Fund resources would be, nor how quotas would relate to each member's financing requirements. By the 1960s, waivers were becoming routine. In the 1970s, the Fund began setting higher access limits based on experience, with the aim of offering adequate but sustainable amounts of financing to its member countries.[10]

At the outset of the 1990s, the IMF was applying a complex set of access limits that allowed countries to borrow up to a theoretical maximum of 590 percent of quota. Under the policy on "enlarged access to the Fund's resources" (EAR) established in 1981 and last modified in 1985, the cumulative debt limit under the Fund's tranche policies (stand-by and extended arrangements and outright purchases) was set at 440 percent of quota. In addition, the Fund had two "floating" facilities, which meant that drawings under those facilities did not count toward the general access limits. In principle, a country could borrow up to 105 percent of quota through the Compensatory

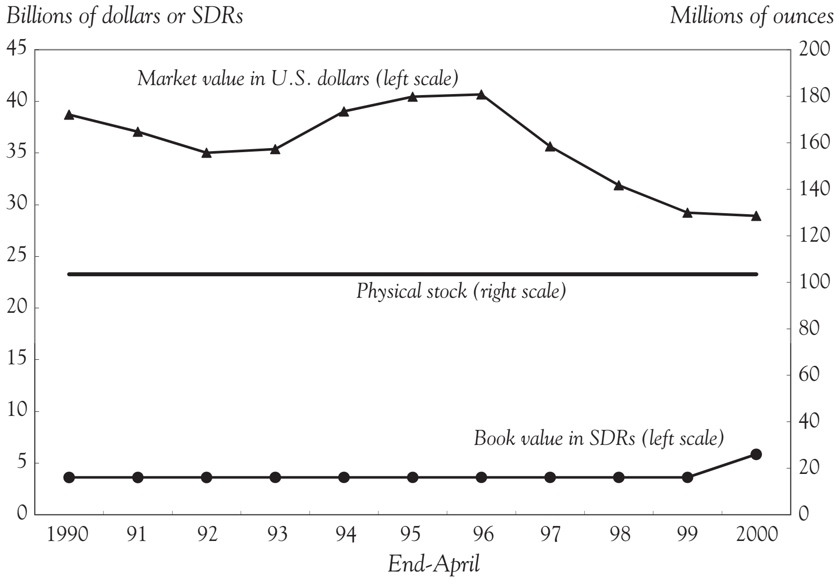
[7]The IMF values the gold on its balance sheet at the price at which the gold was acquired (historical cost). Most of the gold stock was acquired before the Second Amendment of the Articles of Agreement took effect in 1978 and was valued at the then-official price of SDR 35 an ounce. Also see Chapter 13, p. 663.

[8]This transfer mechanism is explained further in Chapter 13, pp. 669–71.

[9]Article V, Section 3(a)(iii), in the original Articles adopted at Bretton Woods in 1944 (Horsefield, 1969, Vol. III, p. 191). In the 1978 amendment to the Articles, this provision was renumbered Section 3(b)(iii), and the annual limit (25 percent of quota) was dropped. In the language of the Articles, indebtedness of 100 percent of quota is described as the Fund holding 200 percent of quota of the member's currency.

[10]For a brief history of access policies through 1989, see Boughton (2001), pp. 875–84.

Figure 15.2. IMF Gold Stock, 1990–2000



Sources: IMF financial statements in *Annual Reports;* gold price from International Financial Statistics.

and Contingency Financing Facility (CCFF) and another 45 percent through the Buffer Stock Financing Facility (BSFF) without reducing its access to other facilities.

The high ceilings fixed in the 1980s were intended to be temporary. They were set to recognize that quotas were unduly low and that countries had to borrow from official creditors to supplement quota-based resources.

The significance of the floating facilities was not just that use of the CCFF or the BSFF could raise potential access to Fund resources. A country borrowing through one or both of those windows could also borrow 25 percent of quota as a "first credit tranche" loan without having to submit to the Fund's policy conditions. Because both of these floating facilities were designed to help countries cope with adverse circumstances beyond their control and thought to be temporary, this feature had a certain logical appeal. By the early 1990s, however, major creditors and Fund management firmly believed that borrowing countries needed strong policy conditionality to improve their prospects for economic growth and stability. Termination of floating was a long-suppressed but now openly espoused goal of several of the Fund's main creditors.

When a general quota increase took effect in November 1992 (see below, under the Ninth Review), the Fund simultaneously reduced access limits in percentage terms. It eliminated the EAR and set new limits calculated so that the absolute amount a country could borrow would be the same as before the quota increase took effect; that is, the Fund replaced the temporary policy of lending borrowed money with a more sustainable regime of lending only its own resources. In percentage terms, the new limits became

300 percent of quota cumulatively and 68 percent in any 12-month period. At the same time, the Board modified the "floating" rule for the CCFF and the BSFF, so that those drawings would count the same as a first credit tranche loan for purposes of triggering upper-tranche conditionality. They remained separate, however, with respect to access limits.

The decision not to raise absolute access when the quota increase took effect may seem controversial and even odd. The principle, however, gained wide acceptance by Executive Directors, by borrowers as well as creditors. Everyone understood that the policy of enlarged access, financed by large-scale borrowing, could not be continued for long. The debate in the Fund in October 1992 was limited to the size of the cut in access limits and whether to discontinue the floating character of the special facilities.

At one extreme, G.A. Posthumus (the Netherlands) and Bernd Goos (Germany) proposed protecting the Fund's liquidity by setting the annual access limit at 60 percent of quota and the cumulative limit at a level Posthumus called "the traditional long-term average" of 250 percent. That level would have reduced absolute access for many countries, and it therefore received little support from other Directors. Even among the major creditor countries, Muhammad Al-Jasser (Saudi Arabia) and Jean-Pierre Landau (France) called for limits of 70 and 300 percent to convey a stronger signal of support for countries with substantial financing needs. At the other extreme, a few Directors from developing countries argued for ceilings of 83 and 333 percent—levels calculated by the staff as ensuring that *no* member would suffer a decline in access.

The Board was badly split. A plurality, with 40 percent of the voting power, wanted limits in the higher range—at least 70 percent annually and 300 percent cumulatively. Those with about a third of the votes favored low limits close to those proposed by the Netherlands and Germany (60 percent and 250 percent). The rest were prepared to go along with the staff proposal for ceilings of 60 and 290 percent of quota. The Managing Director, Michel Camdessus, realized that reaching a consensus on a compromise was going to require bargaining with the other element under discussion, the floating character of the special facilities. He proposed a package in which floating would be eliminated (thus giving something to the hawks) and the access limits would be set at 68 percent annually and 300 percent cumulatively (thus coming close but not quite up to the ceilings preferred by the doves).

Camdessus's proposal was met with strong resistance by the leading hawks, but it managed to pull a few Directors into a majority. After more discussion and a lunch break, the Secretary determined that the proposal carried with just 55 percent support. Consensus was obviously out of reach, so Camdessus closed the discussion and declared the package to be adopted.[11]

[11]See minutes of EBM/92/128 and EBM/92/129, October 28, 1992. At the next meeting, on October 30, Posthumus and Goos tried to amend the proposed decision by inserting language to the effect that the Executive Board expected to lower the access limits in future annual reviews. When that last-ditch effort failed, the decisions on access limits and termination of floating were adopted without further discussion, effective November 4.

Experience with the new access limits was generally positive. The Fund was able to meet most countries' financing demands through a combination of its own lending and the catalytic effect of mobilizing support from other official creditors. The main drawback was that many of the transition countries in Europe and Asia had such large financial needs associated with their efforts to establish market economies that the Fund's self-imposed ceilings became a serious constraint. In April 1994, the Interim Committee noted this constraint with some alarm. "The transition to market economies by a large group of countries," the communiqué warned, "is a task of historic proportions deserving full and concerted support of the international community." The ministerial committee urged the IMF "to continue to play a central role in this process, including if needed through increased access to its own resources."[12]

The Fund tried to respond to this call with new policies targeted specifically at the transition countries. For a time in 1994, it explored the idea of "cofinancing trust accounts," which would link IMF support to trusts funded by donors and administered by the Fund. By late summer, though, management and the staff focused more on getting approval for a selective SDR allocation for countries that had joined the IMF following the last allocation, in 1981. In combination with an expansion of the Systemic Transformation Facility (STF) and perhaps a modest increase in access limits, selective SDR allocations would have gone a long way toward closing the anticipated financing gaps of most transition countries. As explained below, the selective allocation failed to garner enough support in the Interim Committee, and it was dropped for the time being. The STF was extended by several months, but without the proposed increase in access (see Chapter 5). As a fallback position, the committee recommended "a temporary increase in annual access limits from 68 percent to at least 85 percent of quota."[13]

The Executive Board reacted with unusual alacrity to this request, acting on it just three weeks later. Even more remarkably, the hawk-dove split that had blocked consensus two years earlier was nowhere to be found. Early in the discussion, Stefan Schoenberg (Germany) stressed that "members should have confidence that the Fund would be in a position to respond on an appropriate scale in support of strong policies. We are prepared, therefore, to go substantially beyond 85 percent of quota in terms of the annual access limits; that is, we would consider appropriate an increase to 100 percent of quota." The U.S. Director, Karin Lissakers, quickly supported that suggestion "on a temporary basis." The Dutch Director, Posthumus, was still unhappy about the situation and noted correctly that the appeal to raise access limits "was a reflection more than anything else of the fact that donor countries were unprepared to provide substantial financing for the countries in transition." Even he, however, was willing to

[12]Interim Committee communiqué (April 25, 1994), paragraph 7 (*Annual Report 1994*, p. 201).
[13]Interim Committee communiqué (October 2, 1994), paragraph 3 (*Annual Report 1995*, p. 207).

go along with the emerging consensus. After a relatively brief discussion, the Board approved an increase to 100 percent, with only Saudi Arabia's Al-Jasser abstaining.[14]

The access limits set in October 1994—100 percent of quota annually and 300 percent cumulatively—proved to be sustainable. Instead of treating them as temporary, the Fund kept those limits in effect throughout the rest of the decade, through the next quota increase, and until the doubling of the limits (to 200 percent annually and 600 percent cumulatively) in 2009.

Exceptional Circumstances

As frequently stressed at every review of access limits, these limits were just that: they were ceilings, not expectations of actual or average access. Throughout the 1990s, actual annual access in nonexceptional stand-by and extended arrangements averaged about 44 percent of quota, with little trend from beginning to end. The dramatic change in Fund actions after the October 1994 review was a shift toward more frequent invocation of "exceptional circumstances" to justify breaching the ceilings.

When the IMF established the Supplementary Financing Facility (SFF) in February 1979 as its first effort to supplement its own resources with borrowings for regular lending arrangements, it included a provision that became known as the "exceptional circumstances clause." That clause allowed the Executive Board to approve arrangements and allow total cumulative indebtedness in excess of the established access limits. During the next 16 years, the Board invoked the exceptional circumstances clause only three times: in stand-by arrangements for Turkey and Zambia in 1978 and in an Extended Fund Facility (EFF) arrangement for Mexico in 1989.[15] Then in February 1995, to enlarge the stand-by arrangement for Mexico after the U.S. authorities were unable to provide the anticipated amount of cofinancing (see Chapter 10), the Board again declared the circumstances exceptional. From that instance through December 1999, the Board coped with a wave of financial crises by invoking the clause 11 times for seven countries (Table 15.3). This extraordinary practice hit its peak in December 1997, with a stand-by arrangement for the Republic of Korea totaling almost 20 times the size of Korea's quota. (On that occasion, the motivation was not only that Korea faced exceptionally dire circumstances, but also that its quota was unusually low for historical reasons.)

The Source of Reserves: Income over Expenses

Despite the decade's many challenges, the IMF managed to generate a steady flow of net income in the 1990s (Table 15.4). That income enabled the institution to build up its reserves as a cushion against the risks posed by its loan portfolio, which was heavily concentrated in large loans to a few countries with spotty economic and financial track records.

[14]Minutes of EBM/94/95 (October 25, 1994), pp. 14 (Schoenberg), 15–16 (Lissakers), 25 (Posthumus), and 30 (Al-Jasser). The decision is on p. 31.

[15]See Boughton (2001), pp. 878–79.

Table 15.3. Exceptional Access Under Fund Arrangements, 1990–99

Country	Approved	Duration (Months)	Facilities	Approved Access: Millions of SDRs	Approved Access: Percentage of Quota	Amount Drawn
Mexico	February 1, 1995	18	SBA	12,070	688	8,758
Russian Fed.	March 26, 1996	36	EFF	6,901	160[a]	
	July 20, 1998[b]	20	EFF/CCFF	15,363	356	8,344
Thailand	August 20, 1997	34	SBA	2,900	505	2,500
Indonesia	November 5, 1997	36	SBA	7,338	490	
	July 15, 1998[c]	28	SBA	8,338	557	
	August 25, 1998[d]	26	EFF	4,669	312	
	March 25, 1999[c]	19	EFF	5,383	259	7,555[e]
Korea, Rep. of	December 4, 1997	36	SBA/SRF	15,500	1,938	14,413
Brazil	December 2, 1998	36	SBA/SRF	13,025	600	10,474
Turkey	December 22, 1999	36	SBA	2,892	300	11,739[f]

Sources: "Review of Access Policy in the Credit Tranches and under the Extended Fund Facility—Background Paper," EBS/01/134 (August 9, 2001), Table 13, accessed at http://www.imf.org/external/np/tre/access/2001/080901.htm; and IMF financial accounts.

Note: CCFF = Compensatory and Contingency Financing Facility; EFF = Extended Fund Facility; SBA = Stand-by arrangement; SRF = Supplemental Reserve Facility.

[a]Exceptional access was required only for the annual limit.

[b]Augmentation and extension of the existing arrangement.

[c]Augmentation.

[d]New arrangement to replace the existing one.

[e]Cumulative amount drawn under the SBA and EFF.

[f]The arrangement was augmented in December 2000 and again in May 2001, for a total approved amount of SDR 15,038 million. (A portion of the augmentation was under the SRF.) It was canceled in February 2002 and replaced by a new arrangement.

The basic income model in place throughout the 1990s relied heavily but not exclusively on steady income from outstanding loans. For each financial year, the IMF aimed to generate net income by setting the interest rate it charged on loans at a level calculated to produce a target income, based on projected demand for loans. The Fund adjusted the rate of charge periodically during the year to stay on target. The target was set to keep the reserves of the General Department rising at a rate deemed sufficient to safeguard the Fund's resources. Throughout the decade, the annual target income level was fixed at 5 percent of initial reserves. In addition, under the "burden sharing" mechanism the Fund devised to cover the risk associated with payments arrears (see Chapter 16), the rate of charge was set at a margin above the "basic rate" each year to fund a pair of Special Contingent Accounts (SCAs).

Through financial year 1993 (FY93),[16] the Fund kept the basic rate of charge—the interest rate on most loans from the General Resources Account (GRA), before

[16]The IMF's financial year runs from May 1 through April 30. FY93 refers to the financial year ending on April 30, 1993.

Table 15.4. Income Statement of the IMF General Department, Financial Years 1991–2000

(Millions of SDRs, except as noted)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	Average, 1991–2000[a]	
											SDRs	Millions of US$
Operational Income												
Interest and charges on GRA lending[b]	1,858.7	1,765.7	1,607.2	1,321.0	1,361.4	1,771.3	1,605.9	1,983.4	2,787.6	2,548.2	1,861.0	2,614
Interest on SDR holdings	70.9	56.9	217.4	299.5	216.4	40.3	57.6	37.4	69.5	123.3	118.9	167
Interest on SAF loans	8.1	8.2	8.5	8.7	8.1	7.5	6.1	4.5	3.2	2.2	6.5	9
Income on SDA investments	74.7	62.5	39.7	23.9	9.1	4.9	0	0	0	30.1	24.5	34
SDA "profit" on gold transactions	–	–	–	–	–	–	–	–	–	2,226.0		
Net effect of change in accounting method for pension liabilities	–	–	–	–	–	–	–	–	–	268.3		
Gross Income	2,012.5	1,893.4	1,872.8	1,653.1	1,595.0	1,824.0	1,669.6	2,025.3	2,860.3	5,198.0	2,025.5	2,845
Operational Expenses												
Net remuneration to creditor countries	1,140.5	984.2	1,013.4	838.5	861.4	1,095.4	1,101.0	1,390.0	1,843.9	1,768.0	1,203.6	1,691
Interest paid on borrowings	317.9	286.6	222.1	147.2	127.6	62.0	0	0	78.8	59.0	162.6	228
Allocation to the SCA	212.1	229.7	255.3	242.6	215.4	263.5	151.9	98.5	106.7	128.5	90.4	67

Table 15.4. (continued)

(Millions of SDRs, except as noted)

											Average, 1991–2000[a]	
	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	SDRs	Millions of US$
Administrative Expenses												
Personnel	140.4	172.4	189.6	239.4	217.5	233.1	246.9	243.5	259.4	300.0	24.2	15
Travel	28.8	39.1	47.4	48.6	48.0	44.5	46.6	54.6	54.6	62.3	7.4	67
Other administrative expenses	32.1	36.1	42.8	49.3	45.3	47.4	54.0	70.4	78.1	86.1	54.2	76
Total Expenses	1,871.9	1,748.0	1,770.5	1,565.5	1,515.2	1,745.9	1,600.4	1,857.0	2,421.5	2,403.9	1,850.0	2,598
Net Income	140.6	145.4	102.3	87.6	79.7	78.0	69.2	168.4	438.8	2,794.2	175.5	247

Source: *Annual Reports*.

Note: – = Not applicable.

[a]Excludes gold transactions and accounting changes in financial year 2000.

[b]Includes a small amount of miscellaneous income.

adjustments for burden sharing—slightly below the SDR interest rate (a weighted average of yields on top-quality short-term securities in the five countries with currencies in the SDR basket). In June 1993, as the Executive Board considered its policies for FY94, it confronted three forces that affected the Fund's income adversely: a decline in the SDR interest rate, a troubling persistence in overdue financial obligations by several members, and a worsening risk profile associated with the prospect of large lending to a few countries. For the sake of prudence, the Board agreed to raise the basic rate of charge to about 111 percent of the SDR rate. The relationship between the two rates stayed near that level for the rest of the decade (Figure 15.3).

Aside from small amounts of income from the SDR holdings of the GRA and investments in the SDA (pending the use of those funds for SAF loans), in most years the accrual of charges on GRA lending was the only major item on the income side of the ledger. The exception was FY2000, when the Fund had a large bookkeeping entry for the indirect transfer of gold from the GRA to the SDA, as described in Chapter 13, and an entry for a change in the method of accounting for future payout of pensions to retired staff.

The contribution of creditor countries to IMF net income came from the difference between (a) the interest that would have accrued at the SDR interest rate on the full amount of each creditor's reserve position in the Fund and (b) the actual net remuneration paid by the Fund. That difference had two components.

First, a portion of each creditor's reserve position was set aside as "unremunerated." For each member country in the IMF in April 1978—when the Second Amendment took effect—the unremunerated position was equal to 25 percent of the quota in effect at that time. Because quotas were raised periodically after that date, this fixed amount correspondingly shrank as a percentage of current quotas.[17] On average at the end of the 1990s, after the Eleventh General Review took effect, the unremunerated portion was just 3.8 percent of quota.[18]

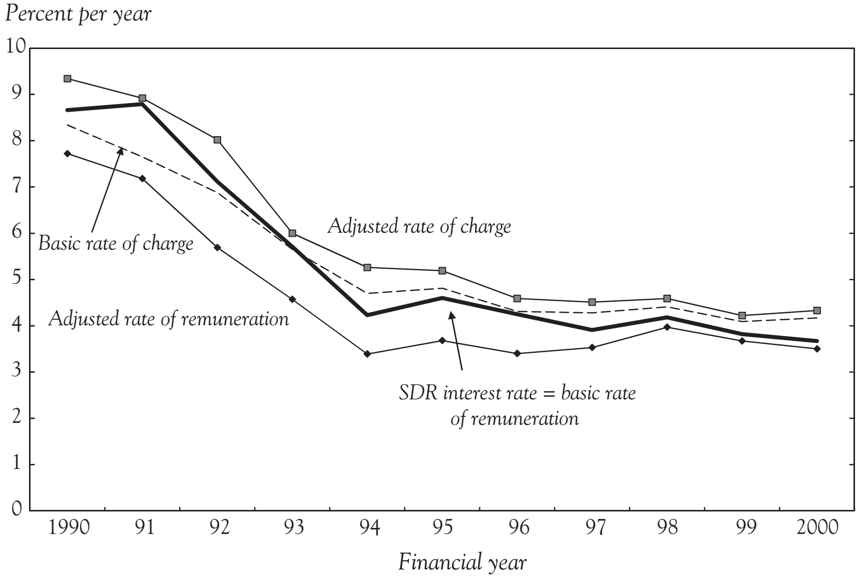
Second, the adjusted rate of remuneration was set below the SDR interest rate. Throughout the 1990s, the basic remuneration rate was equal to the SDR interest rate. As with the rate of charge, however, the actual remuneration rate was adjusted (reduced) each year to fund the two SCAs as protection against potential losses (including both principal and interest charges) on nonperforming loans (see Figure 15.3).

For an illustration of these relationships, consider FY99, the penultimate year shown in Table 15.4. Borrowers from the various facilities of the General Department paid a total of SDR 2,791 million ($3.8 billion) in interest and fees. On the expense side, the Fund paid SDR 1,844 million ($2.5 billion) in remuneration to creditors. If the Fund had

[17]For countries that joined the Fund after April 1, 1978, the "norm" for remuneration (the maximum percentage of the reserve tranche on which remuneration would be paid) was set equal to the average norm for existing members on the date that the new member joined.

[18]"'Norm' for Remuneration," EBD/99/76 (June 22, 1999). Before the 1999 quota increase, the unremunerated portion averaged 5.5 percent of quota.

Figure 15.3. SDR Interest Rate and Rates of Charge and Remuneration, 1990–2000



Sources: *Annual Reports* and staff calculations.

paid remuneration at the SDR interest rate on 100 percent of reserve positions, remuneration would have amounted to approximately SDR 2,156 million ($2.9 billion). The net implicit contribution from creditors therefore was about SDR 312 million ($0.4 billion), or just 11 percent of the direct payments from indebted countries.

The anomaly of this situation was readily apparent. Although every country benefited from the existence of an institution that helped to stabilize and provide analytical information about the international financial system, borrowing countries, most of which were less economically developed than the creditor countries, covered the great bulk of the expense.

The original conception of the IMF as a financial institution was that each member would contribute to the cost of running it in proportion to the member's quota. This equitable distribution applied automatically at the outset because no remuneration was paid on the Fund's holdings of currencies or gold, and every member was required to replenish its gold tranche contribution frequently (that is, repay any drawings on the gold tranche, which was the predecessor of the reserve tranche). By lending or investing these currencies, the Fund would generate income to cover its administrative expenses.[19] Although the actual distribution of the burden differed from the distribution of quotas

[19]The IMF began investing in interest-bearing securities in 1957 to supplement income from lending and build up a cushion of reserves. It ended that practice in 1972 because reserves were then adequate for the foreseeable future (Boughton, 2001, p. 899n131).

because the costs differed between debtors and creditors, the discrepancies were not usually large enough nor persistent enough to violate the underlying philosophy.

After the 1978 amendments, these principles no longer applied. Because countries were not required to repay reserve tranche drawings, a member could escape all costs by following Polonius's dictum to "neither a borrower nor a lender be." As long as the Fund held a currency in an amount exactly equal to the member's quota, the member would incur no borrowing cost. With no reserve position, it also would have no unremunerated balance.[20] Moreover, with remuneration paid on the lion's share of reserve positions, creditor countries would pay a relatively small share of the cost. The IMF had become uncomfortably similar to a commercial bank, in that it depended on interest income from its loans to cover its costs.

When the Executive Board began considering alternative financing structures in 1994, it focused particularly on an idea awkwardly named the "uniform adjustable norm."[21] Under this proposal, every member country, including those with outstanding drawings, would be required to maintain a reserve tranche position at least equal to a specified percentage of quota, on which remuneration would not be paid. That percentage "norm" would be equal ("uniform") for all members. With all members sharing this burden in proportion to quota, the role of interest charges in covering operating expenses could be reduced.

After a round of preliminary discussions in the Executive Board, the Interim Committee endorsed the general direction of the financial reform effort and asked the Fund to "accelerate its consideration" of the issue "with a view to ensuring a more effective and equitable mechanism" for financing its operations. The Executive Board held a second series of meetings, which resulted in a consensus view that the Fund's operating expenses should be covered by the membership in proportion to quota. The "uniform adjustable norm" proposal also could have simplified the whole system of charges and remuneration by setting both interest rates permanently equal to the SDR interest rate. Unfortunately, doing so would require an amendment to the Articles of Agreement so that the Executive Board could specify an unremunerated percentage of each member's quota instead of an unremunerated percentage of its reserve tranche position.[22]

[20]In the 1990s, an average of 37 countries—mostly, but not exclusively, low-income or very small countries—had financial positions in the GRA within 1 percent of being balanced. In most cases, that meant that the country had withdrawn all of its reserve tranche and had no outstanding debts.

[21]In the initial discussions, this concept went by an even less clear name, the "variable uniform norm." The concept was introduced in "The Cost of Financing the Fund and its Distribution—Review of Burden Sharing," EBS/94/28 (February 18, 1994), pp. 23–24. It was fleshed out in "Reforming the Financial Structure of the Fund—The Role of the Variable Uniform Norm," EBS/94/139 (July 1, 1994).

[22]Article V, Section 9(a), specified that the "Fund shall pay remuneration on the amount by which the percentage of quota prescribed . . . below [as the unremunerated portion] exceeds the Fund's average daily balances of a member's currency held in the [GRA]," subject to certain exceptions. For a discussion of the required amendment, see "Reforming the Financing of the Fund's Operations," EBS/94/235 (December 6, 1994), p. 12.

This reform proposal was broadly accepted by Executive Directors as a principle for further discussion.[23] Within a few weeks, however, the approval of an extraordinarily large stand-by arrangement for Mexico upset the consensus. Over the next several months, the focus of the Board's deliberations shifted to the question of whether the Fund should impose a surcharge on large-scale borrowing. That idea, suggested by the U.S. authorities and supported by some other creditor countries, met with strong resistance from other members.[24] In the process, the competing idea of shifting the burden more equitably to all members quietly disappeared. The lending-dependent income model stayed in place until a temporary but quite precipitous drop in demand for Fund loans in 2005–08 finally forced revisions in it.

Administrative expenses more than doubled in the course of the 1990s, in two stages. In the early part of the decade, the IMF absorbed a rapid influx of new members, many of which had large borrowing requirements and major complex structural issues to be analyzed. Responding to those demands required a sizeable increase in the staff and in the amount of staff travel. Then toward the end of the decade, the Fund was asked by its members to take on several new tasks: assisting in the development of poverty-reduction strategies for low-income countries, devising debt-reduction programs for heavily indebted poor countries (the HIPC Initiative), and undertaking new surveillance activities such as the Financial Sector Assessment Program and the preparation of reports on countries' observance of internationally recognized standards and codes. These activities gave rise to a second large increase in administrative expenses in 1998–99.

For the first few years in this decade, the IMF was incurring significant costs in the form of interest payments on earlier borrowing. Through FY92, the Fund offset much of that cost by charging higher interest rates on the high-access arrangements that were partially financed with borrowed money. After the quota increases under the Ninth General Review took effect, the Fund ended that practice and finished repaying the loans from the 1980s. For two financial years (FY97 and FY98), the Fund was debt free. The activation of the General Arrangements to Borrow for lending to Russia in July 1998 marked the temporary resumption of borrowing by the Fund.

SDR Department

EACH PARTICIPANT [IN THE SDR DEPARTMENT] UNDERTAKES TO COLLABORATE with the Fund and with other participants . . . with the objective of making the special drawing right the principal reserve asset in the international monetary system.

Article XXII of the IMF Articles of Agreement
Adopted April 1, 1978

[23]See minutes of EBM/95/1 (January 6, 1995) and EBM/95/2 (January 9, 1995).

[24]See "Charges on Large-Scale Use of the Fund's Resources," EBS/96/57 (April 2, 1996), and references therein. The proposal was later embodied in the terms of the Supplemental Reserve Facility, adopted in 1997.

By the end of the 1980s, it seemed that the SDR was an asset whose time had passed.[25] Designed in the late 1960s when a global shortage of reserve assets was a major concern, the role of the special drawing right was no longer so obvious in a world of multiple reserve currencies, floating exchange rates, and cooperative swap arrangements among central banks. If the major countries could create liquidity at will, and if the dominant concern therefore was inflation rather than a shortage of liquid assets, then of what use was the SDR? Reflecting this view, the international community declined to create any additional SDRs after 1981. Over the next two decades, the share of SDRs in world nongold official reserves fell from 6.5 to 1.25 percent.[26] The objective—enshrined in the Articles of Agreement in 1978—of making the SDR the principal reserve asset was effectively abandoned.

The Balance Sheet

The declining aggregate role of the SDR did not mean that it was of small importance. For many countries, the availability of SDRs as a supplement to foreign exchange served as a lifeline to international markets for goods and services. Receiving an SDR allocation gave them reserve balances that they could either hold as insurance against future deficits or draw upon to meet excess demand for imports or other payments needs. SDR holdings also helped countries pay quota increases or meet other obligations to the IMF. At one time or another during the 1990s, nearly three-quarters (132 out of 182) of the Fund's member countries were net users (i.e., net borrowers) of the SDRs that had been allocated to them.

Table 15.5 summarizes the balance sheet of the Fund's SDR Department around the beginning and end of the 1990s.[27] No SDRs were allocated during this decade, so the total stock outstanding was constant at SDR 21,433.33 million. The main asset of the department was the stock of outstanding claims on net users of SDRs, which rose from SDR 6.5 billion at the end of FY90 to SDR 9.3 billion 10 years later. Most of that increase resulted from the payment of quota subscriptions in 1999 when the increases under the Eleventh General Review took effect. Consequently, the main counterpart to that increase on the liability side was an increase in SDR holdings by the GRA.[28]

[25]For a primer on the nature of the SDR, see the Appendix to this chapter.

[26]The peak for this ratio was 8.4 percent, at the end of the first round of allocations in 1972.

[27]Because SDR obligations are settled quarterly on a financial-year basis, these accounts are presented in Table 15.5 at the end of the financial years 1990 and 2000.

[28]By construction, the net income of the SDR Department equals zero each year. Interest received on net uses and interest paid on net holdings are both assessed at the SDR interest rate and are exactly offsetting. Separately, the Fund levies an assessment on each member country at the end of each financial year, in proportion to the country's SDR allocation. Those assessments are charged at a rate that is calculated exactly to offset the administrative expense of running the department. Arrears on interest or assessments are offset on the liability side by a temporary increase in GRA holdings.

Table 15.5. Balance Sheet of the SDR Department
(Millions of SDRs)

	April 30, 1990	April 30, 2000
Assets		
Net usage of SDRs (allocations minus holdings, for net users)	6,494.1	9,344.3
Charges receivable	481.5	221.2
Overdue assessments and charges	43.1	105.6
Total assets	7,018.7	9,671.1
Liabilities		
Holdings by participants in excess of allocations	5,891.0	6,052.3
Holdings by the IMF General Resources Account	628.5	2,723.9
Holdings by prescribed holders	19.3	673.2
Interest payable	479.9	221.8
Total liabilities	7,018.7	9,671.1

Source: *Annual Reports*.
Note: Details may not add to totals, owing to rounding.

Evolution of the SDR as a Financial Asset

Since 1974, the SDR has been defined as an asset equivalent in value to a basket of currencies. The initial basket comprised currencies of the 16 countries that accounted for at least 1 percent of world trade. When that proved unwieldy, the basket was simplified in 1981 to include only the five currencies in widest international use: the U.S. dollar, the deutsche mark, the French franc, the Japanese yen, and the pound sterling. From that point on, the Fund agreed to examine and, if desired, revise the composition of the SDR at five-year intervals. Effective January 1, 1986, 1991, and 1996, the selection of currencies was left alone, but the amounts of each currency in the basket were revised to keep the weights in line with each one's importance in world trade and in monetary reserves (Table 15.6). The creation of the euro in 1999, replacing the mark and the franc and several other European currencies, occasioned a further revision in weights and a reduction to four currencies.[29]

A little-understood characteristic of the SDR is that it is a variable-weight basket. That is, it is the sum of fixed amounts of each of its component currencies. As exchange rates change over time, the weights in the current valuation of the SDR also

[29]Technically, the basket continued to comprise five currencies, including the euro as the currency of both France and Germany, until January 1, 2001. See "EMU and the Fund—Valuation of the SDR and the SDR Interest Rate," SM/98/221 (September 1, 1998). Also see Decisions 11801-(98/101) G/S and 11802-(98/102) G/S, both dated September 21, 1998; in *Annual Report 1999*, p. 172. The 0.3519 euro component in the 1999 basket was the sum of 0.228 euro (Germany) and 0.1239 euro (France); see "IMF Incorporates the Euro into the SDR Valuation and Interest Rate Baskets," PR/98/67 (December 31, 1998). The principal effect of this five-currency treatment was to link the basket to the five separate national securities used to compute the SDR interest rate.

Table 15.6. Composition of the SDR, 1969–2000
(Local Currency Units)

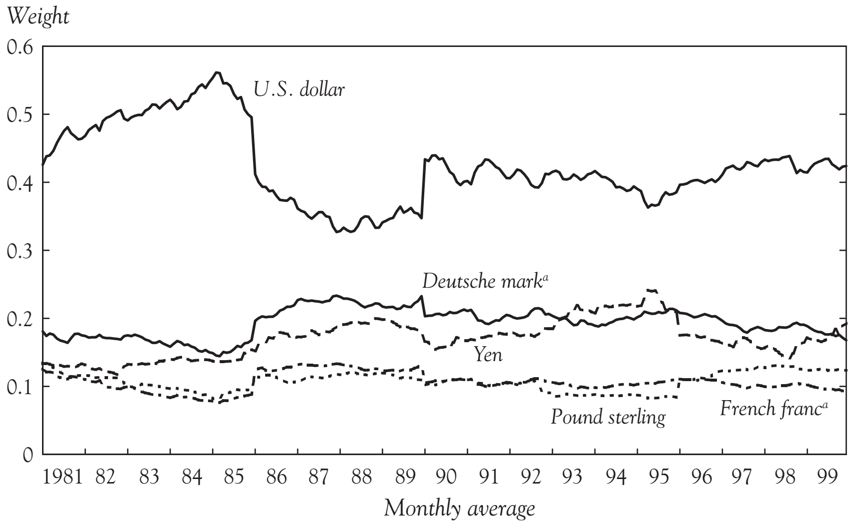
	July 1969–June 1974	July 1974–June 1978		July 1978–December 1980		1981–85		1986–90		1991–95		1996–98		1999–2000	
		Initial Weight	Amount of Currency	Initial Weight	Amount of Currency	Initial Weight	Amount of Currency	Initial Weight	Amount of Currency	Initial Weight	Amount of Currency	Initial Weight	Amount of Currency	Initial Weight	Amount of Currency
Gold (grams)	0.888671														
U.S. dollars		0.330	0.4000	0.330	0.400	0.42	0.540	0.42	0.4520	0.40	0.5720	0.39	0.5820	0.39	0.5821
Deutsche marks		0.125	0.3800	0.125	0.320	0.19	0.460	0.19	0.5270	0.21	0.4530	0.21	0.4460		
Japanese yen		0.075	26.0000	0.075	21.000	0.13	34.000	0.15	33.4000	0.17	31.8000	0.18	27.2000	0.18	27.2000
French francs		0.075	0.4400	0.075	0.420	0.13	0.740	0.12	1.0200	0.11	0.8000	0.11	0.8130		
Pounds sterling		0.090	0.0450	0.075	0.050	0.13	0.071	0.12	0.0893	0.11	0.0812	0.11	0.1050	0.11	0.1050
Euros														0.32	0.3519
Canadian dollars		0.060	0.0710	0.050	0.070										
Italian lire		0.060	47.0000	0.050	52.000										
Netherlands guilders		0.045	0.1400	0.050	0.140										
Belgian francs		0.035	1.6000	0.040	1.600										
Swedish kronor		0.025	0.1300	0.020	0.110										
Australian dollars		0.015	0.0120	0.015	0.017										
Danish kroner		0.015	0.1100												
Norwegian kroner		0.015	0.0990	0.015	0.100										

Table 15.6. (continued)
(Local Currency Units)

	July 1969–June 1974	July 1974–June 1978		July 1978–December 1980		1981–85		1986–90		1991–95		1996–98		1999–2000	
		Initial Weight	Amount of Currency	Initial Weight	Amount of Currency	Initial Weight	Amount of Currency	Initial Weight	Amount of Currency	Initial Weight	Amount of Currency	Initial Weight	Amount of Currency	Initial Weight	Amount of Currency
Spanish pesetas		0.015	1.1000	0.015	1.500										
Austrian shillings		0.010	0.2200	0.015	0.280										
South African rand		0.010	0.0082												
Saudi Arabian riyals				0.030	0.130										
Iranian rials				0.020	1.700										

Source: International Financial Statistics.

Figure 15.4. Weights in the Valuation of the SDR, 1981–99
(Valued at monthly average exchange rates)



Sources: Table 15.6 for currency composition of the SDR; International Financial Statistics for exchange rates; and author's calculations.
[a]In 1999, the deutsche mark and French franc were replaced by the euro.

change. During the 1990s, for example, the weight of the Japanese yen ranged from a high of 24.1 percent in April 1995, when the yen was at its strongest, to a low of 14.2 percent in August 1998 (Figure 15.4). The SDR thus has a built-in "strong currency" bias because the weight of any appreciating currency automatically rises.

Would There Be a Future for the SDR?

Although every proposal for allocating SDRs proved controversial, most countries found their allocations useful for one or more reasons. For low-income and other developing countries, SDRs were a relatively inexpensive source of official reserves and an inexpensive and reliable way to borrow foreign exchange (by drawing down their allocated balance). For the more advanced economies, having a stock of SDRs provided a buffer for the efficient management of reserves.[30] By settling official obligations in SDRs, those countries were able to retain foreign exchange and manage the timing of its eventual disposition. By accepting SDRs in settlements from trading partners, large industrial countries were able to accumulate reserves in a stable and

[30]Major countries also occasionally drew on their allocations to supplement their use of foreign exchange reserves in settling payments deficits. Notably, in November 1978 the United States used SDR 1.1 billion (48 percent of its allocation) as one element in a package of measures to support the value of the U.S. dollar in exchange markets.

balanced form that was less subject to exchange rate fluctuations than any individual currency. Consequently, throughout the 1990s both the dominant holders and the main net users of SDRs included the major industrial countries (Table 15.7).[31]

Controversy over proposals for new allocations arose for two reasons. First, if countries with ample foreign exchange reserves received an additional allocation, the temptation to borrow against the allocation or reduce other forms of reserves could add to aggregate demand and to inflationary pressures. That argument was the reason most often advanced by opponents. Advocates of allocations typically responded that the proposed stock of SDRs would be so small relative to total outstanding reserves that any such effects would be practically unnoticeable.[32] The second issue, usually expressed less directly, was a concern about the unconditional extension of liquidity. Although the advanced economies no longer needed a supplementary reserve asset, for many developing and transition countries the acquisition of adequate reserves remained expensive. They could attempt to accumulate reserves by running external payments surpluses, but that strategy would run counter to their development needs. Alternatively, they could borrow from the IMF, conditional on the implementation of acceptable economic policies. An SDR allocation would open up a third avenue, without the conditionality and without the need to repay or periodically renegotiate the loan. The prevailing view among major creditor countries in the 1990s was that conditional lending by the IMF was preferred over the indiscriminate extension of credit lines to all members.[33]

Even though only a relatively small number of countries held these concerns, they held them strongly enough that no realistic possibility of a general allocation existed in this period. A general allocation could be undertaken only with the support of 85 percent of the voting power in the Board of Governors, but that did not deter Michel Camdessus from trying.

In April 1993, having been rebuffed repeatedly in previous efforts, the Managing Director made as strong a case as he could muster for a general allocation. He pointed out that more than 40 percent of IMF member countries (67 out of 162) held foreign exchange reserves in amounts below the customary notion of a minimum acceptable

[31]The accumulation of SDR holdings above any country's allocation was entirely voluntary in the 1990s. Article XIX of the Articles of Agreement permits the IMF to designate a country to provide a usable currency in exchange for SDRs, but this designation mechanism was not used after 1987. Each financial year in the 1990s, the Fund prepared a quarterly series of "designation plans" that listed the countries eligible to be designated in this way, but the lists were purely precautionary.

[32]See, for example, "The Rationale for SDR Allocation Under the Present Articles of Agreement of the International Monetary Fund" by Michael Mussa (the IMF's Economic Counsellor and Director of Research) in Mussa, Boughton, and Isard (1996), pp. 57–87.

[33]For a cogent argument against the use of SDRs to extend unconditional liquidity, see Wijnholds and Kapteyn (2002), pp. 120–24. In contrast, Clark and Polak (2004) argued that the savings in resource costs from an SDR allocation would bring efficiency gains for the world economy. Lissakers (2006) made a case for the SDR as a stabilizing force in reserve management, especially to protect against a disorderly decline in official demand for U.S. dollar reserves.

Table 15.7. Leading Holders and Users of SDRs, 1990–99
(Decade Averages)

	Amount Held (Millions of SDRs)	Amount Held (Percentage of Allocation)	Percentage of Total Stock	Cumulative Percentage
A. Leading holders (holding at least 1 percent of total stock)				
1. United States	7,261.9	148.2	33.9	33.9
2. Japan	1,689.9	189.5	7.9	41.8
3. *Germany*	1,169.1	96.6	5.5	47.2
4. Canada	831.2	106.7	3.9	51.1
5. *France*	593.7	55.0	2.8	53.9
6. Netherlands	549.9	103.7	2.6	56.4
7. *United Kingdom*	470.9	24.6	2.2	58.6
8. China	411.0	173.6	1.9	60.5
9. Mexico	385.0	132.7	1.8	62.3
10. Saudi Arabia	338.0	172.9	1.6	63.9
11. Libya	335.1	570.2	1.6	65.5
12. Spain	303.4	101.5	1.4	66.9
13. *Belgium*	297.7	61.4	1.4	68.3
14. Norway	280.0	166.9	1.3	69.6
15. *Italy*	258.6	36.8	1.2	70.8
16. *Argentina*	216.7	68.1	1.0	71.8
B. Leading users (using at least 1 percent of total usage)				
1. United Kingdom	1,482.0	77.5	18.4	18.4
2. India	618.2	90.8	7.7	26.1
3. France	527.9	48.9	6.6	32.7
4. Italy	496.6	70.7	6.2	38.9
5. Australia	396.4	84.3	4.9	43.8
6. Brazil	355.7	99.2	4.4	48.2
7. Indonesia	192.1	80.4	2.4	50.6
8. Belgium	200.1	41.2	2.5	53.1
9. South Africa	183.9	83.5	2.3	55.4
10. Pakistan	166.5	98.0	2.1	57.5
11. Venezuela	141.1	44.5	1.8	59.2
12. Germany	155.7	12.9	1.9	61.2
13. New Zealand	140.5	99.4	1.7	62.9
14. Nigeria	125.4	79.8	1.6	64.5
15. Algeria	125.5	97.5	1.6	66.0
16. Chile	119.2	97.8	1.5	67.5
17. Argentina	92.3	29.0	1.1	68.7
18. Philippines	112.3	96.3	1.4	70.1
19. Israel	106.1	99.7	1.3	71.4
20. Greece	103.0	99.5	1.3	72.7
21. Turkey	100.5	89.5	1.2	73.9
22. Iran, Islamic Rep. of	109.4	44.8	1.4	75.3
23. Egypt	82.3	60.5	1.0	76.3

Source: IMF financial accounts.
Note: Countries shown in italics in Part A were net users, on average.

level (the equivalent of 10 weeks' worth of imports). No SDRs had ever been allocated to the 37 countries that had joined the Fund after the last allocation in January 1981. The transition countries that had recently joined the Fund faced the particularly daunting task of trying to build reserves from scratch at the same time that they were trying to recover from devastating declines in output.

Camdessus calculated that an allocation of SDR 36 billion would be required just to restore the stock of SDRs to its average level in relation to global reserves over the preceding 20 years. "What meaningful interpretation," he asked, "could be given to the obligation accepted by the Fund's member countries, of making the SDR the principal reserve asset of the international monetary system, if we were not prepared to take a step in that direction in such pressing circumstances?"[34]

To strengthen the pertinence of his proposal to current circumstances, Camdessus revived a proposition, made on several occasions in the preceding decade, to redistribute part of the newly allocated SDRs from industrial to developing countries. In Camdessus's formulation, the IMF would establish a new administered account. Countries with no need for additional SDRs could transfer them to this account, and the Fund could lend them as a supplement to stand-by or similar conditional arrangements. He suggested that the donors to this scheme should accept the risk associated with this lending: "the risk they encourage the Fund to take."[35]

The Managing Director's statement was an unusually direct challenge to the IMF's major shareholders, several of whom he knew would be hostile to it. Indeed, almost at the outset of the Executive Board's discussion of the proposal, Thomas C. Dawson II (United States) averred that he "remained unconvinced that there was a global need for additional liquidity at the present stage." The United States had more than enough voting power to block any SDR allocation, essentially dooming the plan, at least for the moment. Within the Group of Seven (G7) major industrial countries, France, Italy, and Japan were open to the Managing Director's proposal, but the others—Canada, Germany, and the United Kingdom, in addition to the United States—were not.[36]

With the G7 split, Camdessus pressed ahead. Shortly after the April 1993 Board meeting, the Interim Committee asked for further work on the rationale for, and im-

[34]"Statement by the Managing Director on the Need for and Modalities of an SDR Allocation," BUFF/93/16 (April 12, 1993), p. 8.

[35]"Statement by the Managing Director on the Need for and Modalities of an SDR Allocation," BUFF/93/16 (April 12, 1993), p. 7. The initial redistribution proposal in the Executive Board was made by Jacques de Groote (Belgium) in 1983. Similar suggestions, with varying details, were made by Bruno de Maulde (France) in 1984 and by Arjun K. Sengupta (India) in 1987. For a review of those three overtures, see "Proposals for Post-Allocation Adjustment in the Distribution of SDRs," SM/86/154 (June 27, 1986). The Japanese authorities proposed a similar scheme at the April 1991 meeting of the Interim Committee. That formulation was similar to Camdessus's 1993 suggestion, except that industrial countries would have made voluntary transfers to the GRA instead of to a special administered account. The GRA then would have absorbed the risk associated with additional lending. For a summary, see statement by Hiroo Fukui (Japan) at EBM/93/58 (April 19, 1993), p. 14.

[36]Minutes of EBM/93/58 (April 19, 1993).

plications of, an allocation of SDRs. Despite the reluctance of some to reanimate the SDR, the idea was not going to die. A pair of linked and disturbing facts—that Russia and other transition countries faced a severe shortage of foreign exchange reserves and that these countries had never received an allocation of SDRs, which could readily alleviate the problem—continued to haunt the corridors of the IMF.

Over the next year, the old redistribution scheme gave way to a new idea, that the Fund might allocate SDRs selectively, to help the recent member countries catch up. Dawson raised this possibility in April 1993 and asked the staff to try "to discover a mechanism compatible with the Articles [of Agreement] that would allow for a special purpose or separate allocation of SDRs to those countries that did not benefit from the allocation[s] earlier." Unfortunately, the Articles did not allow for such a mechanism. Allocating SDRs selectively would require an amendment, and that would take both time and political capital.[37]

The resolution of this issue was supposed to be realized at the IMF/World Bank Annual Meetings in Madrid, Spain, in October 1994. These meetings were held somewhere other than Washington only once every three years, and the occasion usually raised expectations for the emergence of major agreements. The Madrid meetings were especially notable because they would be used to commemorate the fiftieth anniversary of the Bretton Woods conference at which the two institutions—and the postwar international financial system—were founded. Everyone wanted an agreement on allocating SDRs as the centerpiece of the celebration.

The staff, management, and the Executive Board labored for months to craft a proposal that would make a meaningful dent in the reserve shortages in the new member countries and preserve the role of the SDR as a stabilizing influence in the system. An acceptable compromise proved hard to devise. Developing countries and their allies insisted that a "global need to supplement existing reserve assets" existed and should be met by a general allocation of SDRs for all member countries. A blocking minority of major creditors insisted that any allocation should be targeted at the post-1981 members and should be based on an amendment to the Articles without any finding of global need. As the date of the Madrid meetings approached, the gulf between these two positions had not been bridged.

In the end, the report of the Executive Board to the Interim Committee presented four distinct proposals and asked the Governors on the committee to choose among them.[38] The Managing Director proposed an allocation of SDR 36 billion, the same figure he had called for a year and a half earlier. As a compromise, Camdessus was asking for an initial allocation of SDR 20 billion based on a finding of global need, to be

[37]Minutes of EBM/93/58 (April 19, 1993), pp. 21–22.

[38]The draft report discussed by Executive Directors (see the next footnote) stated that the principles underlying at least a selective allocation were supported "by all Directors, except one," referring obliquely to strong opposition by Stefan Schoenberg (Germany). The final text stated more diplomatically that there was "nearly unanimous support."

followed by an amendment allowing for selective allocation of SDR 16 billion. As a further concession to creditors, he proposed reintroducing the "reconstitution" requirement, which had been dropped in 1981. That provision required each country that drew on its SDR allocation to restore ("reconstitute") its balance to a specified level within five years. The elimination ("abrogation") of that requirement had enabled many countries to use all or most of their allocations as a permanent source of financing for international payments.[39] Reintroducing the requirement would help restore the original concept of the SDR as a source of official reserve holdings.

Huw Evans (United Kingdom) and Karin Lissakers (United States) tabled a second proposal. Their proposal eschewed any general allocation on the grounds that "a consensus does not exist" for a declaration of global need. Instead, it called only for a "special one-time allocation" of no more than SDR 16 billion based on an amendment of the Articles. As a third proposal, two Directors—Marc-Antoine Autheman (France) and Jarle Bergo (Norway)—agreed with the Evans-Lissakers conception but conditioned their support on the allocation being at least SDR 22 billion. The fourth proposal—presented by the developing-country Directors who constituted the informal "Group of Eleven" on the Board—aimed to close the gap between the Managing Director and the leading shareholders. It called for a general allocation of SDR 14.5 billion, followed by a selective post-amendment allocation of 16 billion. The Group of Eleven also signaled their willingness to accept a reintroduction of the reconstitution requirement.

Hopes for a compromise dimmed in the run-up to the Madrid meetings. Officials from the G7, including Hans Tietmeyer (Germany's central bank governor), Lloyd Bentsen (secretary of the U.S. Treasury), and Kenneth Clarke (chancellor of the exchequer in the United Kingdom), met with reporters to say they saw no need for a general allocation. Developing-country officials, mostly under the cover of anonymity, responded that they wanted a general allocation and predicted a "battle royal" in the Interim Committee. Meanwhile, Camdessus continued to go public with the case for a two-stage allocation of SDR 36 billion, effectively siding with developing countries in the prefight sparring.

On Saturday, October 1, 1994, the G7 finance ministers and central bank governors met, as was their custom on the day before the meeting of the full Interim Committee. Although they did not issue a formal communiqué afterward, they took a strong public stand against the proposals backed by Camdessus and the developing countries. Addressing reporters after the meeting, Bentsen stated flatly, "We will not accept a general

[39]On the abrogation of the reconstitution requirement, see Boughton (2001), p. 933. On the four proposals submitted to the Interim Committee in 1994, see "Report to the Interim Committee on Access to Fund Resources and an Allocation of Special Drawing Rights," ICMS/Doc/43/94/10 (September 26, 1994). The evolution of the debate may be traced through the six versions of the draft report, SM/94/205, from August 25 through September 23, 1994; and the minutes of Executive Board meetings from EBM/94/83 on September 12 through EBM/94/90 on September 23.

allocation of SDRs."[40] Even so, the matter remained unsettled. The G7 had a keen interest in getting approval for an amendment that would enable the Fund to supply reserves to the transition countries. Without the Fund's financial support, pressure would grow on G7 countries to fund the transition process themselves. Whether they would back away from the line they had drawn in the sand remained to be seen.

The debate at the Interim Committee meeting on Sunday turned out to be as acrimonious as had been predicted and feared.[41] Formidable figures led the two sides: Manmohan Singh, finance minister (and later prime minister) for India, the chief advocate for a general allocation; and Tietmeyer, joined by Bentsen and Clarke, speaking forcefully against and trying to get the committee to endorse the G7 position. Although everyone was prepared to accept a selective allocation following the requisite amendment of the Articles, neither side would agree to it except as part of a package that included acceptance of their position on general allocations. Those positions were irreconcilable. Moreover, neither Singh nor Camdessus would consent to allowing the G7 to dictate terms on an issue this crucial for developing countries and for the Fund. For their part, G7 officials refused to believe that the usually fractious and fragmented developing countries could subvert their collective will.

The usual press conference by the Managing Director and the chairman of the Interim Committee (Philippe Maystadt, the Belgian finance minister) was scheduled to take place in late afternoon, when the committee meeting should have ended. Instead, the committee continued to meet through the evening in an effort to break the deadlock. Only as the hour hand clicked toward midnight did Maystadt finally concede that no compromise was possible. The meeting adjourned, but it was already October 3 when the exhausted pair, Camdessus and Maystadt, dragged themselves onto the podium before an impatient press corps.

The questions at the midnight press conference ranged from incredulous to openly hostile. Because Camdessus had not embraced the G7 proposal, the first questioner wanted to know, "whom do you think you represent as Managing Director?" Another noted that some G7 officials were accusing Camdessus of "wildly exceeding [his] mandate as Fund Managing Director and engaging in a partisan effort on behalf of developing countries." A third reporter wanted to know if Camdessus was going to resign as a result of the impasse. Camdessus gave the only answer that he sensibly could: "I am not here to support a given majority. I am here to serve the Fund." And he vowed to keep fighting for a general allocation.[42]

[40]"G7 Countries to Call for 'Special' Allocation of 16 Billion SDRs," Agence France-Presse, October 1, 1994. Instead of a communiqué, the G7 issued a set of notes under the heading of "media guidance." That document endorsed the U.S.-U.K. proposal as the basis for agreement on a selective allocation; see "Texts of G7 Briefing Notes," Reuters News, October 1, 1994. Both documents accessed at www.factiva.com.

[41]This account is based on interviews with participants.

[42]Transcript of the press conference, UNDOC/94/223 (October 6, 1994).

Managing Director Michel Camdessus and Interim Committee Chairman Philippe Maystadt meet the press after the committee failed to agree on a special allocation of SDRs, October 2, 1994. (IMF photo)

The Fourth Amendment to the Articles of Agreement

Camdessus kept fighting in virtually a one-man crusade to restore the systemic role of the SDR. In March 1995, as part of a broad strategy to raise resources following the unprecedented size of the $17.8 billion stand-by arrangement with Mexico, he asked Executive Directors to reconsider the issue of a sizeable SDR allocation. Elaborating on that request a few weeks later, he noted that the Mexican peso crisis was resulting in a loss of access to international capital markets by many developing countries. A fresh allocation of SDRs would help ameliorate the effects.[43]

Although the Executive Directors' positions endured essentially unchanged from a year earlier, the staff circulated a draft amendment to the Articles for consideration by the Board. Maystadt, however, decided to put the matter on the back burner after he determined that none of the active proposals had any chance of acceptance by the requisite 85 percent majority of the voting power. Preparing for the April 1995 meeting of the Interim Committee, he suggested that "we reconsider the SDR issue in the context of a wider review of its role in the international monetary system."[44]

[43]Minutes of EBM/95/28 and EBM/95/29 (March 27, 1995) and EBM/95/39 (April 12, 1995).
[44]"Interim Committee Meeting—Message from the Chairman," EBD/95/46 (March 24, 1995).

That suggestion led eventually to a high-level conference on "the future of the SDR," held at IMF headquarters in March 1996 (Mussa, Boughton, and Isard, 1996). Although the conference brought together many of the world's leading experts on reserve assets, and although it helped clarify a number of vital issues, it did little to resolve the profound differences of view on the wisdom of SDR allocations.

Despite the continuing political impasse, almost everyone wanted to find some way to solve the "equity issue" so that the post-1981 members of the IMF could enjoy the fruits of the SDR system. In June 1995, the G7 heads of state and government, meeting in Halifax, Nova Scotia (Canada), issued a summit communiqué endorsing "a one-time special allocation" for this purpose. In 1996, meeting in Lyon, France, they reiterated the call and noted that they "continue to hope for progress." The persistent challenge was to sweeten the proposal for a selective allocation sufficiently to satisfy developing countries that their economic interests were not being threatened, without sweetening it so much that the anti-SDR industrial countries would withdraw their support.

Finally, in September 1996, a delicate compromise was devised to meet this challenge. It had three critical elements. First, the Articles would be amended to call for a special one-time allocation that would result in *all* member countries having equal total cumulative allocations in proportion to their quotas. Second, the special allocation would be large enough that *all* members would receive at least a small allocation. Third, the Interim Committee would issue a statement to the effect that the existing purposes and procedures for allocating SDRs, based on a finding of long-term global need, would remain in place. No general allocation would take place at this time, but the special allocation would not prejudice the future.[45]

Completing the process took another year, owing to technical disputes over the wording of the proposed amendment, an argument about whether countries in arrears to the Fund should get an allocation, and a lengthy battle over the size of the special allocation. An agreement that any special allocation to a country in arrears would be held in escrow until the arrears were settled resolved that question. Getting an agreement on the overall magnitude was harder. By September 1996, Camdessus had lowered to SDR 26.6 billion his 1994 proposal calling for SDR 36 billion. The developing-country caucus was insisting on 30.8 billion and some of the G7 countries, chiefly Germany, were holding to a ceiling of 16 billion. As late as April 1997, the main players were still separated by several billion SDRs.[46]

The winning formula, adopted by the Executive Board in September 1997, called for doubling the total stock of SDRs, from SDR 21.4 billion to 42.8 billion.[47]

[45]"The Committee emphasized that such an amendment of the Articles would not in any way affect the Fund's existing power to allocate SDRs on the basis of a finding of long-term global need to supplement reserves as and when that need arises"; Interim Committee communiqué, PR/96/49 (September 29, 1996). Also see minutes of EBM/96/86 (September 12, 1996).

[46]Minutes of EBM/96/86 (September 12, 1996) and EBM/97/44 (April 23, 1997).

[47]This compromise was accepted by Executive Directors at EBM/97/91 (September 3, 1997), after numerous informal discussions with the Managing Director.

An allocation of that magnitude, appropriately distributed to equalize cumulative shares, would leave each participant with a stock equal to 29.3 percent of quota. Once that figure was accepted by consensus in the Executive Board, it was endorsed by the Interim Committee on September 21 at its meeting in Hong Kong SAR. Just two days later, the full Board of Governors adopted Resolution 52-4, approving the Fourth Amendment of the Articles of Agreement.[48] The remaining task was for national parliaments and legislatures to ratify the amendment.

Ratification—which required approval by 60 percent of member countries, holding 85 percent of the total voting power—turned out to be even more difficult than the struggle to produce the amendment. Almost two years after approval by the Board of Governors, only 60 countries, with 37 percent of the voting power, had ratified the amendment. It took another two years (to November 2001) to get to the required 110 countries, at which point the only remaining hurdle was ratification by the U.S. Congress. By that time, the special allocation was no longer a priority for the U.S. government, and it appeared that Camdessus's long campaign had come to naught. It was revived, at long last, by the global financial crisis of 2008, which induced a fresh look at all avenues for raising the resources available to the IMF. In June 2009, the U.S. Congress approved the necessary legislation for U.S. acceptance. The Fourth Amendment took effect in August 2009, and the special allocation was made in September.

Members' Quotas

Quota subscriptions from member countries are the main source of lendable resources for the IMF. The size of those subscriptions can be increased only with the consent of 85 percent of the Fund's total voting power. As a result, keeping pace with the rapid growth of the world economy that began in the 1950s was a recurring struggle. In addition, quota size has a major bearing on each country's voting power and the amount it can borrow from the Fund. Because countries grew at different rates, negotiations to adjust the distribution of quotas became more and more contentious.

The Size of the Fund

As every child is supposed to learn in school, a small difference in percentage growth rates eventually accumulates into a large difference in sums. From 1946, when the first quotas took effect for the 40 original members of the IMF, until 1999, total world trade (measured by total imports) grew at a remarkable average rate of 8.6 percent a year. IMF quotas, adjusted for the increase in the Fund's membership, grew by

[48]Resolution 52-4 of the Board of Governors may be accessed at http://www.imf.org/external/pubs/ft/history/2011/index.htm.

5.6 percent a year. Although the growth in quotas also seems impressive, the difference meant that quotas declined from the equivalent of 43 days of world imports at the outset to just 15 days at the end of the century (Table 15.8).

Virtually the entire decline occurred in the late 1960s and the 1970s, when three increases in quotas fell far short of keeping pace with growth in international trade. From the equivalent of 41 days of imports in 1965, aggregate quotas settled at 14 days following the increase that took effect in 1980. After 1980, the relationship rose a bit and then fell again.

In principle, general reviews of the size of the Fund were to be held at least once every five years. The first two reviews, completed in 1950 and 1955, resulted in no agreement to raise quotas. The next six reviews occurred at roughly quinquennial intervals, and each one was concluded with an increase of at least 30 percent (an annual rate of 5.5 percent). Work on the Ninth Review, scheduled to be completed in 1988, was still under way as the 1990s began.

Ninth Review

Preparation of the Ninth Review began in 1987, four years after the Eighth took effect. As explained more fully in Boughton (2001, pp. 870–72), the staff initially calculated that growth in trade and other relevant variables since 1983 justified a quota increase on the order of 57 percent. Most Executive Directors favored a doubling of quotas to allow for the further growth that would occur before any quota increase was likely to take effect. Three Directors with a total of 29 percent of the voting power—representing the United States, the United Kingdom, and Saudi Arabia—strongly resisted any such move, and discussions dragged on inconclusively for more than two years.[49]

The fall of the Berlin Wall and the other revolutionary developments in Central and Eastern Europe shook up these entrenched positions by raising the prospect that the IMF would soon be called upon to undertake large-scale lending to new member countries. By the end of 1989, U.S. opposition to a quota increase was crumbling. In March 1990, Dawson (United States) informed his colleagues on the Board that his authorities were prepared to support a 50 percent increase but would not go higher. Dawson conditioned this support, however, on an agreement that the next quota review be extended by two years from its scheduled 1993 completion date.[50] That proposal was resisted successfully via the tactic of throwing the matter to the Interim Committee to decide. When the committee met on May 7–8, 1990, it agreed that

[49]To meet the legal requirement of the five-year deadline, the Board of Governors adopted a resolution in April 1988 asking the Board to continue its work.

[50]Minutes of EB/CQuota/90/13 and EB/CQuota/90/14 (March 19, 1990). Earlier, at EBM/89/154 (November 28, 1989), Dawson had indicated that the U.S. authorities "believe that a quota increase of 35 percent would be sufficient" (p. 3). Before that meeting, the U.S. Director had declined to commit to a position on whether an increase was warranted. On December 20, 1989, Dawson issued a further statement (BUFF/89/236) indicating a willingness to go to 40 percent or "slightly higher if the right conditions are met."

Table 15.8. General Reviews of Quotas, 1950–99

Review	Originally Scheduled	Effective	Agreed Increase (Percent)	Number of Members	Stock[a] (Billions of SDRs)	World Imports[b] (Billions of SDRs)	Ratio (Days)
		1946		40	7.5	63.6	43
First	1950	1950	0	49	8.0	63.8	46
Second	1955	1955	0	58	8.8	95.9	34
Third	1960	1959	60.7	69	14.6	132.5	40
Fourth	1965	1966	30.7	102	20.9	187.6	41
Fifth	1970	1970	35.4	116	28.8	316.4	33
Sixth	1975	1978	33.6	133	39.0	721.9	20
Seventh	1980	1980	50.9	141	59.6	1,555.3	14
Eighth	1985	1983	47.5	146	89.2	1,953.0	17
Ninth	1990	1992	50.0	175	141.4	2,617.0	20
Tenth	1995	1994	0	179	145.0	3,436.9	15
Eleventh	2000	1999	45.0	182	210.7	4,982.6	15
Average annual increase (percent)			5.6		6.5	8.6	

Sources: IMF Treasurer's Department (2001), Tables II.3 and II.4; International Financial Statistics; and author's calculations.

Note: This table updates Table 17.2 in Boughton (2001), p. 854.

[a]Stocks are calculated as the sum of quotas for countries that were members when the quota review took effect. These figures differ in some cases from those in the text, which refer to the stock at a particular date.

[b]Imports are at five-year intervals, except that the initial datum is for 1948.

quotas should be increased by 50 percent under the Ninth Review and that the Tenth should be completed on schedule.[51]

Acceptance of the quota increase by the United States was also conditional on a strengthening of the IMF's procedures for sanctioning countries in arrears on their payments to the Fund. As explained in Chapter 16, the U.S. authorities wanted the Fund to be able to strip noncooperating countries of their voting rights as an intermediate step leading to the unlikely eventuality of forcing the offender to withdraw from membership. That would require an amendment to the Articles, and the United States lacked the votes to get it approved on its own merits. In April 1990, as the date of the Interim Committee meeting approached, Dawson insisted that his authorities would not approve the quota increase unless the resolution to the Board of Governors included a provision linking the effectiveness of the increase to the approval of such an amendment. The Executive Board and then the Interim Committee reluctantly went along because they had no real choice in the matter.

The Executive Board approved the resolutions for a 50 percent quota increase and for the Third Amendment on May 21, 1990. The Board of Governors completed the approval on June 28. That step initiated what would turn out to be a lengthy consent process. Because no increases could take effect until adoption of the unpopular Third

[51]Interim Committee communiqué, paragraph 7; *Annual Report 1990*, p. 113.

Amendment, many countries were in no hurry to give their formal consent to an increase in their quotas. Moreover, the resolutions implied that no increase could take effect before the end of 1991 unless the United States had given its consent, and that seemed unlikely owing to anticipated opposition within the U.S. Congress.[52]

The agreement to give the United States a second but temporary veto over quota increases in 1990–91 resulted from an Executive Board decision on the "participation requirement." To ensure that most countries' quota increases take place about the same time, the Fund traditionally had set a requirement that no increase would take effect until member governments with at least a fixed percentage of existing quotas had given their consent. In most quota reviews through the Eighth, the Executive Board set the floor in a range from two-thirds to three-quarters of total quotas. For the Ninth Review, the staff recommended setting the floor near the middle of that range, at 70 percent.[53] At the request of the United States, a two-tier requirement was eventually adopted: 85 percent until the end of 1991 and 70 percent thereafter.[54] Practically, however, this odd decision was of little consequence, because the linkage to adoption of the Third Amendment already implied that an 85 percent approval would be needed.

By the end of 1991, 18 months after the adoption of the quota resolution by the Board of Governors, 103 countries with 66.7 percent of existing quotas had consented to the proposed increases. By the same date, just 69 countries with 56.3 percent of the total voting power had accepted the proposed Third Amendment. The 70 percent participation requirement was satisfied in January 1992 with the addition of 13 more consenting countries, but ratification of the amendment was still making little headway. At this stage, all that really mattered was when the U.S. Congress would act. The United States finally ratified the amendment and consented to its quota increase in October 1992, and the increases took effect the following month. That raised total quotas—the "size of the Fund"—from SDR 96.2 billion to SDR 141.4 billion.[55]

Tenth Review

The requirement in the Articles of Agreement that the Fund must conduct a general review of quotas at least every five years gave rise to a timing anomaly that eventually squeezed out the Tenth Review. Because the Eighth Review was completed in 1983, the five-year period allowed for the Tenth began in 1988 even though the Ninth was still in progress. In 1990, as noted above, the Interim Committee refused to extend the completion date for the Ninth beyond 1993. As that

[52]At the time, the U.S. president—George H.W. Bush—was a Republican, while the Democratic Party controlled both houses of Congress.

[53]"Ninth General Review of Quotas—Consent and Participation Requirement," EB/CQuota/89/10 (November 8, 1989).

[54]"Ninth General Review of Quotas—Report and Proposed Resolution," EBD/90/91, Revision 5 (May 23, 1990).

[55]For a complete list of quotas by country before and after the Ninth Review, see the quota table at http://www.imf.org/external/pubs/ft/history/2011/index.htm.

date approached, however, an extension seemed inevitable because no further substantive work on the review had been completed. Accordingly, the Board of Governors approved a continuation of the review in April 1993 and asked the Executive Board to submit a report by the end of 1994.[56]

Demand for loans from the Fund remained moderate in 1994, and the Fund had adequate resources to meet that demand. Instead of focusing on the amount by which aggregate quotas should be increased, the work program for the Tenth Review in 1993–94 focused on the way the formulas for distributing quotas should be revised. As explained below, that work was inconclusive, and the final report on the Tenth Review suggested only that the next review aim to make further adjustments. In January 1995, the Board of Governors approved the completion of the Tenth Review without any changes in quotas.[57]

Eleventh Review

The extension of the Tenth Review beyond the scheduled five-year limit did not affect the timing of the Eleventh Review. It started officially in April 1993 and was scheduled to be completed by the end of March 1998. In a "business as usual" world, that would have meant starting work in the spring of 1997. But no sooner had the Fund disposed of the Tenth Review than the Mexican peso crisis applied new pressure to the Fund's resources and forced an early start to the Eleventh.

The initial staff paper for the Eleventh Review, circulated in August 1995, calculated that aggregate quotas should be raised by at least 60 percent to restore the relationship between quotas and world output that had prevailed when the Eighth Review was completed in 1983.[58] Allowing for the time that would elapse before completion of the review, a case clearly could be made for a doubling of quotas in 1998. The Board's report to the Interim Committee raised that possibility and concluded that "a large increase in quotas is needed to support the activities of the Fund in the years ahead."[59]

Work on the Eleventh Review dragged on for two more years. Differences in view on whether the Fund needed more quota-based resources were large but were overshadowed by disputes on how to adjust the distribution of quotas. In September 1996, after a year of such debates, the Board reported that "we have not reached firm positions on either of the issues." As late as June 1997, Camdessus was pressing for an increase of 55–65 percent, a range that Lissakers (United States), considered too large.

[56]The text of the resolution is in "Tenth General Review of Quotas—Report to Board of Governors and Proposed Resolution," EBD/93/35 (February 26, 1993). It was approved by the Executive Board on March 12 and by Governors on April 14.

[57]For the report of the Executive Board, see "Tenth General Review of Quotas—Report to Board of Governors and Proposed Resolution," EBD/94/186, Suppl. 1 (December 14, 1994).

[58]"Eleventh General Review of Quotas—Preliminary Quota Calculations," EB/CQuota/95/1 (August 10, 1995), p. 39.

[59]"Fund Policies—Fund Financial Resources and Assistance—Eleventh General Review of Quotas," ICMS/DOC/45/95/12 (September 21, 1995), p. 7.

She responded by calling it "not credible in light of the Fund's current and prospective financial position."[60]

The outbreak of the financial crisis in Thailand in July 1997 finally focused all energy on reaching a consensus and concluding the review. The direct effect of the crisis on the Fund's liquidity position and the prospect that several other countries might soon need financial help erased all doubt about the need for a sizeable increase. The main creditor countries, however, remained unconvinced that the increase should be as large as Camdessus was seeking. In August, Lissakers hinted that the United States was prepared to accept a 45 percent increase, but she insisted that "even looking at the effect of the Thailand program on liquidity, a number starting with 3 seems to us more defensible." A month later, however, when the Executive Board convened in Hong Kong SAR just ahead of the IMF/World Bank Annual Meetings there, she proposed a 45 percent increase as a compromise. That figure was readily accepted, and the Interim Committee approved it the following day.[61]

The staff proposed that quota increases under the Eleventh Review should take effect as soon as countries with 70 percent of existing quotas had consented to their proposed increases. In general terms, that participation requirement would have been consistent with practice in most previous reviews, although the Ninth Review had employed a two-stage requirement in which 85 percent participation was required for the first 12 months. On the occasion of the Eleventh, Barry S. Newman (Alternate, United States), insisted on a straightforward 85 percent requirement, so that no increases could take effect without the participation of the United States.[62]

The situation in 1998 differed from that earlier circumstance in that the United States faced the possibility of losing its veto power over major decisions by the IMF. The Articles of Agreement specified certain types of decisions, including amendments to the Articles, quota increases, and allocations or cancellations of SDRs, that could be enacted only with the support of 85 percent of the total voting power. At the outset, in 1946, the United States held 36.2 percent of the vote; but by 1998, after several quota increases and a large increase in membership, the U.S. share was down to 17.8 percent. If every country except the United States consented to the quota increases proposed under the Eleventh Review, the U.S. voting weight would have declined to less than 13 percent. Newman, though, made two other arguments in favor of requiring U.S. participation.

[60]"Eleventh General Review of Quotas—Further Considerations," EB/CQuota/97/2 (June 10, 1997), p. 2; and minutes of EB/CQuota/MTG/97/1, p. 17.

[61]Minutes of EB/CQuota/MTG/97/2 (August 22, 1997), p. 8; minutes of EBM/97/97 (September 20, 1997), pp. 3, 12, and 13; Interim Committee communiqué (September 21, 1997), paragraph 8 (*Annual Report 1998*, p. 159). In December 1997, following the spread of the crisis to Indonesia and Korea, Camdessus proposed that the size of the increase be raised to at least 70 percent. That suggestion was strongly opposed by the United States and other major creditors, and Camdessus withdrew it even before it could be discussed by the full Executive Board; see "Statement by the Managing Director," BUFF/97/118 (December 10, 1997) and minutes of EB/CQuota/MTG/97/5 (December 18, 1997).

[62]Minutes of EB/CQuota/MTG/97/4 (December 5, 1997), p. 11.

First, it would help pressure the U.S. Congress to act favorably on the proposal. Second, it would ensure that the quota increase would have the desired effect on Fund liquidity—otherwise it would not add many U.S. dollars to the Fund's resources.

A slight majority of the Board, holding 60 percent of the vote, opposed Newman's proposal and preferred to accept the staff recommendation for a 70 percent participation requirement.[63] That raised the prospect that the Executive Board would adopt a resolution that would not be accepted by the 85 percent majority vote required in the Board of Governors. The First Deputy Managing Director, Stanley Fischer, who was chairing the meeting, decided to postpone a decision for the time being. At the next meeting, three weeks later, Camdessus reiterated his preference for 70 percent but asked the Board to accept the U.S. request in "a spirit of a consensus. . . . There were solid grounds," he averred, "for giving the United States the benefit of the doubt, and for being confident that the United States would not be the last member to agree to its quota increase."[64]

The Board of Governors approved the proposal for a 45 percent increase on January 30, 1998. After that vote, the only remaining hurdle of consequence was the consent of the U.S. Congress. Five days later, Camdessus made a rare trip to Capitol Hill to testify to an executive session of the Senate Budget Committee and urge passage of the necessary legislation. President Bill Clinton's administration also made a strong appeal for approval, but it faced sharp opposition from a legislature controlled by the other major party. Curiously, this situation was the same as—but also the opposite of—that of 1992, when a Republican administration supported the quota increase and a Democratic legislature opposed it. In each case, the lack of a solid domestic constituency in favor of funding for international institutions was reinforced by the inevitable political battles resulting from two-party coexistence.[65]

Opposition crumbled in the autumn of 1998, in the middle of the Russian financial meltdown, the near collapse of the Long-Term Capital Management hedge fund, and growing concerns about financial stability in Argentina and Brazil. Republican leaders in the House of Representatives joined those in the Senate in supporting funding for the IMF, and both houses passed the enabling legislation for the quota increase in October. Other countries that had been waiting for the United States to act first began taking their own legislative actions. The 85 percent participation requirement was finally reached, and the quota increases began taking effect on January 21, 1999—almost a full year after approval by the Board of Governors, but still much faster than the 28-month completion process for the Ninth Review in 1990–92.

[63]Two compromises were also considered. Thomas A. Bernes (Canada) suggested that the participation requirement be set at 85 percent only for a limited time, as had been done in the Ninth Review. Jon Shields (Alternate, United Kingdom) suggested that the requirement could be defined as 70 percent *and* participation by the largest shareholder. Those proposals gained some support but were eventually discarded; minutes of EB/CQuota/MTG/97/4 (December 5, 1997), pp. 32–34.

[64]Minutes of EB/CQuota/MTG/97/5 (December 18, 1997), pp. 19–20.

[65]For an analysis of the congressional debates, see Locke (2000).

With the effectiveness of the Eleventh Review, quotas totaled SDR 210.2 billion at the end of 1999, an increase of 45 percent and more than double the size of the Fund at the start of the decade.

The Distribution of Quotas

The starting point for any discussion of the appropriate distribution of quotas among member countries is a set of equations known as the "Bretton Woods formula" and its variants. The U.S. team at Bretton Woods in 1944 constructed the original equation to produce a list of quotas that would be broadly acceptable to the potential membership of the IMF. The equation's arguments included estimates of each country's national income, international trade, and official reserves; and its coefficients were determined heuristically (not by statistical techniques) to generate a desired set of results. Subsequent modifications to, and variations on, the Bretton Woods formula were negotiated by the Executive Board with the aim of updating the distribution through the periodic general reviews. In a typical round of discussions, the staff would compute a list of quotas based on updated data, Executive Directors would complain about the implications for their countries, and the staff would modify the equations to tweak the results until a consensus developed that the outcome was acceptable.[66]

Redistribution in the Ninth General Review

As work developed on the Eighth Review in the early 1980s, a political consensus emerged in the Interim Committee that the allocation of quotas should be brought up to date more aggressively than had been the case in previous reviews. The end result was that 60 percent of the increase in quotas was distributed according to the formula calculations and just 40 percent according to the existing distribution. As work proceeded on the Ninth Review in the late 1980s, this redistribution commitment continued, though with a smaller portion of the total (40 percent) dedicated to it.

Japan and the G7. One especially glaring misalignment was Japan's low quota. Upon joining the IMF in 1952, Japan was assigned the ninth largest quota, just below the Netherlands and above Belgium. It gained a seat on the Executive Board by forming a constituency with a few other Asian countries—Burma, Ceylon, Thailand, and later Nepal. The Japanese economy's growth then accelerated rapidly over an extended period, and the Fund responded by increasing Japan's quota at above-average rates. Japan moved up to seventh place (tied with Italy) in 1959, surpassed Italy in 1966, and moved up again to fifth place (between France and Canada) in 1970.

[66]Developments through 1989 are discussed in Boughton (2001), pp. 859–64 and 915–17.

With that leap in 1970, Japan replaced India as one of the five countries entitled (and required) to appoint its own Executive Director instead of participating in the biennial constituency elections. Japan's quota (and voting share) remained in fifth place for the next two decades despite a sustained growth rate among the highest in the world and higher than that of any of the countries with larger quotas.

Table 15.9 shows the actual and calculated quota shares for the five leading countries as of December 1987. The only major country with an outsized shortfall was Japan, which by then had the second largest economy in the world. Also reflective of the inertia in the adjustment of quotas, the relatively slow-growing United Kingdom had the only sizeable overage.

In the second half of the 1980s, the Japanese government decided it should play a larger and more active role in international affairs, including through multilateral institutions. The minister of finance, Kiichi Miyazawa, and his deputy, Makoto Utsumi, were particularly active in strengthening Japan's role in the IMF. As a result, Japan became the leading bilateral lender to the IMF, a major contributor to the ESAF, and an important provider of funding for technical assistance and other support for low-income countries.

By 1987, when the Fund began work on the Ninth Review, Japan had a formidable case for being recognized through a substantial increase in its share in IMF governance. The Executive Director from Japan, Koji Yamazaki, made such a case repeatedly, based both on the calculated quota shortfall and Japan's increased global role. As he stressed in March 1988,

> the present situation of Japan's quota is so incommensurate with economic reality that our authorities are put in quite an awkward position in their relationship with the Diet [the Japanese parliament] whenever the promotion of cooperation with the Fund, such as the contribution to the [ESAF], is called for. Proper rectification is by all means essential.[67]

Although no one disputed Japan's claim, the proposed adjustment would be large enough to have a major negative impact on quota shares for many other countries. The French authorities specifically objected to the suggestion that their quota share should be reduced from fourth to fifth place. The British authorities were willing from the outset to see their rank decline from second to fourth, but they also objected to the idea of falling all the way to fifth. Although the French economy was the larger of the two, both the British role at Bretton Woods and centuries of tense history between the two neighboring countries made this issue more diplomatically stressful than would have made sense otherwise.

More generally, Executive Directors agreed that the shares of developing countries should not be reduced as a side effect of the proposed rebalancing at the top. Extensive discussions made it clear that any effort to rebalance the largest quotas within the

[67]Minutes of EB/CQuota/MTG/88/3 (March 14, 1988), pp. 9–10.

Table 15.9. Actual and Calculated Quota Shares of the Five Largest Economies in 1987

Country	Actual Quota Share	Calculated Share	Gap
United States	19.9	20.2	−0.3
United Kingdom	6.9	5.2	+1.7
Germany	6.0	7.0	−1.0
France	5.0	5.1	−0.1
Japan	4.7	8.0	−3.3

Source: "Ninth General Review of Quotas—Revised Quota Calculations," EB/CQuota/87/5 (December 22, 1987), Table 1.

constraints of the accepted formulas would lead to anomalous and unacceptable results for other countries. At that point, Frank Cassell (United Kingdom) and Miguel A. Fernández Ordóñez (Spain) independently suggested that the Executive Board should just leave the matter to the G7 to decide. That is, the Board would set an aggregate quota share for the G7 countries and let the G7 allocate that share among themselves. E.A. Evans (Australia) objected on principle, but most Directors seemed happy to be offered a solution that relieved them of having to slice such an awkwardly shaped pie.[68]

As the scene shifted to the G7, the solution seemed to slip out of sight once more. Finance officials argued for months about how to share the burden of the Japanese increase between Britain and France, both of which insisted on holding the fourth largest quota. (Germany qualified for third place by a clear margin and stayed out of the fight.) At the end of March 1990—the deadline that had been set for completing the review—the matter remained unresolved. The group's finance ministers scheduled a meeting for April 7 in Paris to be hosted by the French minister, Pierre Bérégovoy, who was publicly and adamantly insistent on maintaining France's rank in the hierarchy. When that meeting failed to produce an agreement, the next opportunity was the regularly scheduled G7 ministerial meeting in advance of the Interim Committee meeting, in Washington on May 6.

Two days after the G7 meeting in Paris, a larger group of 40 countries meeting in the same city concluded an agreement to establish the European Bank for Reconstruction and Development. That opened a new battleground on which several European countries would vie to have the new multilateral agency located in their capital city while France and the Netherlands would press to have one of their own officials named as the bank's first president. For the next month, those contests played out in a series of negotiations while the international press enjoyed the spectacle. By late April, the choice of a headquarters location had narrowed to London or Paris, capital cities of the same two countries squabbling over the ranking of their IMF quotas. In the first week of May, the United Kingdom and France struck a bargain that resolved all of the issues

[68]Minutes of EB/CQuota/MTG/90/4 (January 10, 1990). Agreement on this approach was reached at the next meeting; see "Concluding Remarks by the Chairman," BUFF/90/14 (January 12, 1990).

in dispute. The European Bank for Reconstruction and Development would build its headquarters in London; Jacques Attali—special advisor to French President François Mitterrand, who had initially proposed establishing the bank—would become its president; and France and the United Kingdom would share fourth place in the IMF with identical quotas. Because Germany was about to expand via a merger of East and West Germany, the G7 ministers also decided that Germany (then in the third slot) should share the number two position with Japan. The Interim Committee ratified the quota agreement a few days later, generating a collective sigh of relief.

The final agreement provided for an increase in the G7 share from 48.9 percent of total quotas to 49.4 percent. Japan's share rose from 4.7 to 6.1 percent; the British share fell from 6.9 to 5.5 percent; France's share rose from 5.0 to 5.5 percent; and the other shifts were marginal.[69]

Other adjustments. The more general effort in the Ninth Review was to continue to adjust the distribution of quotas by giving fast-growing and more-open economies relatively larger percentage increases. For the great majority of member countries, the decision to devote 40 percent of the total increase according to calculated rather than actual quotas resulted in increases ranging from 32 to 70 percent. The only outlier on the low side was the United Kingdom, which received only a 19.7 percent increase for the reasons described previously.

Increases in excess of 70 percent were received by 11 countries (Table 15.10). Three (Bhutan, Maldives, and Seychelles) were very small countries with low quotas, for which the Fund agreed to round the results upward to ensure them a meaningful share in the governance structure. In addition to Japan, a few others—ranging from Singapore (287 percent) to Korea (72.8 percent)—received above-average increases in recognition of their rapid growth. The Korean authorities asked for a larger ad hoc adjustment to correct a ridiculously large gap between their actual and calculated quotas. They almost certainly would have succeeded, except that the Islamic Republic of Iran was asking for similar treatment. The Fund had not held a consultation with Iran for more than a decade, owing to tensions with the international community dating to the time of the country's 1979 revolution and the year-long hostage taking and occupation of the U.S. embassy in Tehran. Agreeing to the Korean request while rejecting Iran's would have made an awkward impression of political partiality. Both requests were dropped before the final report was prepared in 1990.

The Executive Board held extensive discussions on the treatment of countries with arrears to the Fund. The final decision was to award increases to them, with the proviso

[69]"Ninth General Review of Quotas—Calculation of Proposed Quotas," EBD/90/91, Revision 4, Suppl. 1 (May 17, 1990). When the quota increases finally went into effect in December 1992, these shares were all lower, owing to the accretion of new members in the interim. Incidentally, the G7 did not hold the seven largest quotas, either before or after the Ninth Review. Saudi Arabia was in sixth place, with a share of 3.6 percent before the increases and 3.8 percent afterward.

Table 15.10. Largest Percentage Quota Increases, 1992 and 1999

Ninth General Review (1992)		Eleventh General Review (1999)	
Singapore	287.0	Singapore	141.2
Maldives	175.0	Iraq	135.8
Cambodia	160.0	Luxembourg	106.0
Seychelles	100.0	Korea, Rep. of	104.3
Japan	95.1	Thailand	88.5
United Arab Emirates	93.5	Congo, Democratic Rep. of	83.2
Oman	89.2	Malaysia	78.5
Lebanon	85.5	Botswana	72.1
Bhutan	80.0	San Marino	70.0
Luxembourg	76.0		
Korea, Rep. of	72.8		
Memo: Average increase	50.0		45.0

Source: International Financial Statistics.

that no country could consent to its increase as long as it had outstanding arrears to the GRA.[70] That prevented five countries—the Democratic Republic of the Congo, Liberia, Somalia, Sudan, and (until 1995) Zambia—from receiving any increase. Cambodia got a 160 percent increase in its quota in 1994 after it settled its arrears. That large increase was calculated to make up for Cambodia having had no increase in the preceding three reviews, when relations with the Fund were completely interrupted (see Chapter 16).

Quotas for New Members

Between the Executive Board's approval of the Ninth Review in May 1990 and effectiveness of the increases in November 1992, 22 countries became members of the IMF. In a few cases, the Fund could set initial quotas in a straightforward manner by examining the data, comparing the economy with those of similar member countries, and slotting them in accordingly. For others, unique problems intervened.

The former Soviet Union. Fifteen of the new members emerged from the former Soviet Union. No reliable data existed on their national income, international trade, or reserves. As explained in Chapter 7, the best the Fund staff could do was collect aggregate data for the Soviet Union, convert it roughly from socialist to market concepts, and then develop some rules of thumb on the relative size of each of the 15 component economies. The depressed state of the Soviet economy in the late 1980s caused the staff's calculations to produce results that Russian negotiators and officials considered unacceptably low. After further negotiation and some high-level political intervention, the Executive Board agreed to award Russia a quota share of 3 percent (just below Canada). Quotas for the other 14 newly independent countries were set in

[70]The Fund did not have the legal power to prevent countries with arrears to other parts of the IMF (the SDR Department or administered accounts such as the ESAF Trust) from consenting to quota increases; see statement by François Gianviti (General Counsel) at EB/CQuota/MTG/97/5 (December 18, 1997), pp. 3–7.

relation to Russia and ranged from 0.69 percent for Ukraine to 0.03 percent for Estonia and Turkmenistan. The aggregate quota share for Russia, the Baltic countries, and other countries of the former Soviet Union was set at 4.76 percent.[71]

Switzerland. Switzerland, which applied for membership in the IMF in May 1990, posed the other challenging case. C. Scott Clark (Canada) was selected to chair the membership committee (a subset of Executive Directors charged with recommending the terms on which membership would be offered to an applicant, including the quota). Jean-Pierre Landau (France) agreed to represent the interests of Switzerland on the committee. Normally, such committees completed the task fairly quickly by basing their deliberations on a staff background paper. The staff would make a series of calculations using available economic data for the country and typically would conclude with a recommended narrow range for the new member's quota. In this case, that process got short-circuited.

Conflicting views on the relative size and importance of Switzerland's economy confronted the exploratory staff mission, led by Harilaos Vittas (Assistant Director, European Department), sent to collect data and exchange information with the Swiss authorities. Total output, as measured by GDP, was smaller than that of any G10 country and was closer in magnitude to the larger developing countries (smaller than Saudi Arabia but larger than Nigeria). Switzerland, however, was a major player in international finance. Its official reserves of gold and foreign exchange, for example, were estimated to be the eighth largest in the world.[72] The fact that Switzerland was potentially among the largest creditors to the IMF could scarcely be ignored.

Using standard data sets, equations, and procedures, the staff calculated several possible quotas for Switzerland, most of which were in a range between SDR 1.35 billion and SDR 1.45 billion. The staff report acknowledged that if financial variables were taken into account more directly, a higher figure would result. One outlier in the computations was a comparison with the United Kingdom, which also was a major financial center and which (as discussed above) still enjoyed an unusually large quota as a legacy from its role in the origins of the IMF. To be comparable to the British quota, Switzerland's would have to be as high as SDR 1.79 billion. Anticipating pushback, the staff declined to suggest a specific range. Instead, the report merely suggested that these

[71]For the Eleventh Review, the staff used data from each individual country to make its calculations. Because of the limited scope for realignments of quotas in that review, the distribution of quotas within the region changed relatively little. Russia's and Ukraine's shares rose the most, and those of Kazakhstan and Turkmenistan fell correspondingly.

[72]The staff's initial calculations and analysis were presented in "Switzerland—Calculation of Quota," EB/CM/Switzerland/90/1 (August 10, 1990). The staff acknowledged that the calculations understated the relative size of Switzerland's reserves because they valued gold at the official price used in the Fund rather than the much higher market prices. Switzerland's gold reserves were a larger portion of the total than in most other major countries.

figures "may be considered as useful indicators by the Committee in making its recommendation of an appropriate quota for Switzerland."[73]

The Swiss authorities reacted negatively to these estimates.[74] The government asked to be represented directly at the initial meeting of the membership committee by the Swiss ambassador to the United States, Edouard Brunner. The committee agreed, and Brunner delivered a statement at the meeting rejecting the staff estimates out of hand. "My authorities expect," he averred, "a quota of SDR 2.1 billion, which is commensurate with Switzerland's financial, monetary, and economic importance in the world."[75] That approach did not go down well with some on the committee, who insisted that the Fund had to apply its own rules and logic, not those of the applicant, and who thought SDR 2.1 billion grossly unrealistic. A few committee members, including Thomas Dawson (United States), were willing to consider numbers between those of the staff and the high figure requested by the Swiss but supported only by Landau. A "very strong majority," however, wanted to set the quota no higher than SDR 1.5 billion, according to the committee's chairman.[76]

Without a staff recommendation as a clear guidepost, committee members were left to haggle among themselves. In a series of five meetings over six months, they debated detailed and obscure technical issues such as the treatment and measurement of income from international banking activities and the role and valuation of nonmonetary gold transactions. The real issues, though, were political and were serious matters for the IMF—Switzerland's ranking in the hierarchy, especially relative to other European countries, and the potential effect on the composition of the Executive Board.

The challenge in placing Switzerland into the ranking of quotas is best illustrated by reference to Spain, a European country with a GDP more than twice that of Switzerland. Spain's relatively low quota dated from its entry into the IMF in 1958, when still under the dictatorship of Francisco Franco. In 1990, Spain's quota (SDR 1.29 billion) was ranked eighteenth among existing members, between Venezuela and Mexico, and the Spanish authorities were waging a largely unsuccessful campaign to move up the ladder. Swiss membership with any of the quota numbers being discussed would

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[73]"Switzerland—Calculation of Quota," EB/CM/Switzerland/90/1 (August 10, 1990), p. 40. For specific comparisons with comparator countries, see Table VI.3, p. 45 in that document. In general, the comparisons were derived by computing "calculated quotas" from the standard formulas for each country and then applying the ratio of actual to calculated quota for a country or group of countries to obtain an actual quota for Switzerland.

[74]For a detailed analysis from inside the Swiss delegation, see Kaeser (2004). For an external academic analysis, see Momani (2009).

[75]Minutes of EB/CM/Switzerland/MTG/90/1 (September 11, 1990), p. 2.

[76]At EB/CM/Switzerland/MTG/90/2 (October 4, 1990), Dawson concluded that the quota "should be significantly larger than the SDR 1.45 billion implicit in the initial staff calculations. At the same time, however, a quota as large as SDR 2.1 billion appears to us excessive"; minutes, p. 6. Clark's "very strong majority" conclusion for the smaller number is on p. 23.

reduce Spain's position to nineteenth, but a much larger quota would add insult to injury.[77]

Speaking for the Spanish authorities, Miguel A. Fernández Ordóñez (Alternate, Spain) came close to threatening a withdrawal of his country's support for the institution if Switzerland got a larger quota than was justified by the staff's calculations. Spain would not "withdraw" the financial contributions it had already made, he promised. "Nevertheless, it would be very naïve to think that a decision to worsen the situation of a current member could have no consequences at all. Certainly a decision to alter the ranking that is obvious in the real world, and consistent with the calculations made by the staff, would certainly affect relations with the institution and in the long run could be costly for other members."[78]

As for the second underlying issue, the membership committee did not have a mandate to discuss the effect of the quota decision on the composition of the Executive Board. That issue would be taken up by the full board at the time of the next election of Executive Directors, as discussed in Chapter 17. Nonetheless, granting a large quota to Switzerland had the potential to squeeze out the constituency with the smallest aggregate voting power. That constituency comprised the group of 24 francophone countries in sub-Saharan Africa. Everyone understood that preserving a seat for that group was essential, but the Executive Director for the group did not want to be placed in the awkward position of having to negotiate a solution. When it became clear that most developing countries were going to resist Switzerland's request for a larger quota, the Swiss finance minister, Otto Stich, wrote to a number of Fund Governors to reassure them. His letter to S.M.H. Adeli, governor of the central bank of Iran and chairman of the Group of Twenty-Four (G24) developing countries, assured him that Switzerland "does not intend to claim a seat to the detriment of the developing countries."[79] Vague as that promise was, it helped to minimize the rebellion before it became too entrenched.

After four committee meetings failed to produce a consensus, Clark met bilaterally with each member to try to narrow the range of differences. At the outset of the fifth meeting, on March 4, 1991, he suggested that the range under consideration be narrowed to SDR 1.55 to 1.75 billion. In a spirit of weary compromise, 9 of the 12 committee members acquiesced to a quota of SDR 1.7 billion. Three others—Grant H. Spencer (Alternate, New Zealand), G.A. Posthumus (the Netherlands), and Corentino V. Santos (Cape Verde, speaking for francophone Africa)—dissented and asked for a quota no higher than 1.55 billion.[80] The full Executive Board approved the compromise later that month, and the Board of Governors approved it as part of the offer

[77]For an account of this contentious exercise from the Swiss perspective, see Kaeser (2004), pp. 88–94.

[78]Minutes of EB/CM/Switzerland/MTG/90/2 (October 4, 1990), p. 10.

[79]Letter dated November 26, 1990, attached as an Annex to minutes of EB/CM/Switzerland/MTG/91/2 (March 4, 1991), p. 8.

[80]Minutes of EB/CM/Switzerland/MTG/91/2 (March 4, 1991).

of membership to Switzerland on April 24. After another long delay, Switzerland finally entered the Fund on May 29, 1992, with a quota of SDR 1.7 billion: the fourteenth largest in the Fund, between Belgium and Australia and four places above Spain.[81]

Redistribution in the Eleventh General Review

In the Eleventh Review, the Board continued the policy of making modest adjustments by dedicating a portion of the overall increase to redistribution in favor of countries that had experienced relatively rapid economic growth. On this occasion, the distribution component was further reduced, to one-fourth of the total 45 percent increase. All but eight countries got increases ranging from 34 to 63 percent. The outliers all got larger increases, led again by Singapore (see Table 15.10). Two countries—the Democratic Republic of the Congo and Iraq—got catch-up increases for having missed out in the previous round. The Congo had been prevented from consenting to its earlier increase because it had arrears to the Fund. Iraq had not consented to its increase because it was subject to international sanctions after the 1991 war.

The lack of major realignment during the Eleventh Review reflected what Camdessus called "the tradition of the Fund to allow any realignment of the rankings of countries to occur only with the utmost gentleness and care."[82] That tradition injected a high degree of inertia into the distribution of quotas, and the resulting inflexibility was becoming a growing problem by the late 1990s. Although no one wanted to scrap this tradition and attempt a zero-based, all-new quota calculation in the context of this review, a consensus was emerging that sooner or later the IMF would have to do just that. Accordingly, in April 1997 the Interim Committee asked the Executive Board "to review the quota formulae promptly after the completion of " the Eleventh Review.[83]

In June 1999, Camdessus appointed a committee of external experts, chaired by Harvard economics professor Richard N. Cooper. The terms of reference for the Cooper Committee called for it to review the adequacy of the quota formulas "to help determine members' quotas in the Fund in a manner that reasonably reflects members' relative need for and contributions to the Fund's financial resources, taking into account changes in the functioning of the world economy and the international financial

[81]At the decisive March 1991 committee meeting, Angel Torres, who in the meantime had succeeded Fernández Ordóñez and become Executive Director for Spain, expressed a preference for SDR 1.55 billion but agreed to go along with the consensus. Kaeser (2004) p. 94, suggests a link between this acquiescence and a promise by France, Italy, and Switzerland to support Spain's campaign to join the G10. That did not bear fruit, but the Spanish case for enlargement of its own IMF quota eventually was more positively received. Spain got above-average increases in both the Ninth and the Eleventh Reviews. At the end of the 1990s, Switzerland and Spain were ranked fourteenth and sixteenth, respectively.

[82]Minutes of EBM/97/97 (September 20, 1997), p. 3.

[83]Interim Committee communiqué (April 28, 1997), paragraph 8; *Annual Report 1997*, p. 211.

system and in light of the increasing globalization of markets."[84] The committee responded with a report heavily in favor of a formulation that was "simple and transparent" and that would "have a sound economic basis and reflect the relevant changes in the world economy." Although the committee's terms of reference asked it to consider including population as one variable determining quotas, a majority of the committee's members decided against it. Instead, they recommended adopting a simple linear function of a country's output (GDP) and "external vulnerability."[85]

The results pleased almost no one, even though it would have modernized the quota system. Although some countries would have benefited by getting well-deserved increases, the shifts overall would have reinforced the initial perceptions of dominance by the few. The United States and most other major industrial countries would have received increased quota shares, as would rapidly growing emerging-market countries such as Brazil, Korea, and Mexico. Shares for China, India, Saudi Arabia, and South Africa would have declined, along with those of slowly growing European countries, including France, the Netherlands, and the United Kingdom. The aggregate share of the least-developed countries would have declined from 3.6 to 2.1 percent.[86] No action was taken on the report, and substantive reform of quota distribution was again put on hold.

Borrowing by the IMF

The IMF has borrowed episodically over much of its history, whenever its quota-based resources have become insufficient to meet its members' financing demands.[87] In 1962, the Fund entered into an agreement with a group of major industrial countries to establish the General Arrangements to Borrow (GAB). That agreement created a standing line of credit to the Fund that could be activated to meet large, systemically important demands for Fund financing from the GAB creditors themselves. On four occasions before 1990, the Fund also borrowed bilaterally from national monetary authorities or governments: from Italy in 1966, from the Swiss National Bank in 1977, from Saudi Arabia in 1981–82, and from Japan in 1987–91.

[84]"Review of Quota Formulas—Establishment of Committee and Terms of Reference," EBAP/99/63 (May 26, 1999), p. 3.

[85]"Report to the IMF Executive Board of the Quota Formula Review Group," EBAP/00/52 (May 1, 2000). Accessed at http://www.imf.org/external/np/tre/quota/2000/eng/qfrg/report/dload/EBAP52.pdf. The reason given for rejecting population, which would have increased the shares of developing countries, was that "population does not bear directly on international monetary issues, and of course a country's relative size (including population) is already captured by GDP" (p. 61).

[86]Statistical Appendix to the committee report, Part B, Table III.1; accessed at http://www.imf.org/external/np/tre/quota/2000/eng/qfrg/appb/index.htm.

[87]This review covers borrowing by the Fund's General Department. In addition, as described in Chapter 13, the Fund has administered a number of trust funds, such as the ESAF Trust, financed in part by borrowing. For a comprehensive review of borrowing through the mid-1990s, see "Borrowing by the Fund—A Chronological Review," EBS/95/122 (July 25, 1995).

In addition, on three occasions, the Fund borrowed from ad hoc groups of countries and monetary authorities: in 1974–75 to finance the oil facilities, in 1979–84 to finance the Supplementary Financing Facility (SFF), and in 1981–86 to finance the policy on enlarged access to the Fund's resources (EAR). By the end of the 1980s, only the GAB and the bilateral arrangement with Japan were still active, although some of the SFF and EAR obligations were also outstanding. Total outstanding obligations in April 1990 amounted to $4.6 billion, or 4 percent of total Fund quotas, down from peaks of $16.7 billion in April 1986 and 26 percent of quotas in April 1977.

The 1992 increase in quotas provided the resources the IMF needed for the next several years. The Fund undertook no new borrowing until 1998, when it activated both the GAB and, for the first time, the New Arrangements to Borrow (NAB), as discussed below.

General Arrangements to Borrow

Unlike the ad hoc borrowing arrangements the IMF undertook from time to time, the GAB and associated agreements provided a standing commitment by a group of 12 countries and monetary authorities to lend up to SDR 18.5 billion to the Fund on an as-needed basis.[88] Its purposes, however, were limited. Originally it could be activated only for loans to a member country of the Group of Ten (G10), which was composed of the GAB creditors which—at the time—were considered to be the only systemically important countries. That restriction was dropped in 1983 so that the Fund could activate the GAB if necessary to manage the Latin American debt crisis. It was not activated then, but it remained in reserve in case "supplementary resources are needed to forestall or cope with an impairment of the international monetary system."[89]

The Fund considered borrowing from the GAB on a few occasions in the 1990s, but it only activated the arrangements in 1998. In 1992, the G7 countries were looking for ways to provide financial support to the newly independent Russian Federation.

[88]Formally, the GAB creditors comprised eight governments—Belgium, Canada, France, Italy, Japan, the Netherlands, the United Kingdom, and the United States—and the central banks of Germany, Sweden, and Switzerland. Initially, the participation of the Swiss National Bank was through an associated agreement. That arrangement was replaced in 1983 by an amendment to the GAB that formally incorporated the bank (the central bank of a country that was still not a member of the IMF) into the GAB as a creditor. The GAB agreement by itself provided a credit line of a little less than SDR 7 billion up to 1983 and SDR 17 billion thereafter. A separate but parallel agreement was signed with the government of Saudi Arabia in 1983 for the Fund to borrow up to SDR 1.5 billion "for the same purposes and in the same circumstances as are prescribed in the GAB." For the text of the Saudi agreement, see *Annual Report 1983*, pp. 154–57. For more on the 1983 amendments to the GAB, see Boughton (2001), pp. 894–99.

[89]Preamble of the GAB. For the full original text of the GAB, see Horsefield (1969), Vol. 3, pp. 246–52. For the 1983 revision, see *Annual Report 1983*, pp. 146–53. Also see "The General Arrangements to Borrow—A Review," EBS/95/117 (July 14, 1995).

Camdessus proposed activating the GAB to finance a $6 billion fund to stabilize the exchange value of the ruble. The G7 liked the idea, but the currency stabilization fund was never established (Chapter 7). Two years later, when the Mexican peso crisis erupted, it became clear that the IMF would be called upon to lend a large sum of money to Mexico. In the view of Fund and U.S. officials, the crisis was a threat to the international monetary system. As recounted in Chapter 10, Camdessus considered asking the G10 to activate the GAB for this purpose, but the staff talked him out of it because some European members of the G10 were unlikely to support the request without a battle. During the East Asian crises in 1997, the Fund did not need the GAB to finance its lending to Thailand, Indonesia, or Korea, although the surge in Fund lending did spark discussions on the need for new borrowing arrangements, as described below. In 1998, the impending collapse of the Russian banking system necessitated emergency loans that were large enough and systemically important enough that activating the GAB was both necessary and widely supported.

In July 1998, the Fund determined it should augment its existing Extended Fund Facility (EFF) arrangement with Russia by the equivalent of $8.4 billion (SDR 6.3 billion). By this time the Fund's liquidity had already been squeezed by its lending in East Asia, so Camdessus decided the augmentation should be financed entirely by borrowing from the GAB. After preliminary discussions with GAB participants, the Acting Managing Director, Alassane D. Ouattara, wrote to each participant on July 14 to seek approval of the request. The Fund received acceptances from all 11 participants over the next few days, in time for the Executive Board to approve activation as part of its augmentation of the commitment to Russia on July 20.[90] The first tranche of the borrowing took place immediately, for $1.9 billion (SDR 1.4 billion). Two future calls were anticipated to take place in September and December 1998, but Russia's debt default in August put those plans in abeyance. The September tranche thus was the only call on the GAB in this decade.

At the insistence of the Executive Director for Germany, Bernd Esdar, who was supported by Directors from several other GAB participants, the Fund agreed to repay the loans from the GAB early, as soon as the quota increases under the Eleventh General Review took effect.[91] In March 1999, the Fund repaid the loans in full.[92]

New Arrangements to Borrow

After the Mexican crisis in 1995, the limitations on the use of the GAB and its narrow base of creditors led to consideration of new borrowing arrangements. The idea

[90]"General Arrangements to Borrow—Proposal for Future Calls for Exchange Transactions Under an Augmentation of the Current Extended Arrangement for the Russian Federation," EBS/98/123 (July 17, 1998) and Suppl. 1 (July 20).

[91]Minutes of EBM/98/79 (July 20, 1998), pp. 74–75.

[92]Russia completed the repayment of the EFF drawing in January 2005.

of creating a parallel system to attract lenders from among the smaller advanced economies and the emerging-market economies in the developing world originated within the G7 as officials prepared for the group's annual summit meeting in 1995.[93] As expressed in the summit report, the proposal was to create a new "emergency financing mechanism" within the IMF and to finance it by doubling the size of the GAB with resources to be lent by "the G10 and other countries with the capacity to support the system."[94] The IMF embraced both suggestions but demurred at the link between them. If the Fund needed to supplement its own quota-based resources, it should do so independently of the need for a new lending facility. Moreover, the staff pushed for a broader approach that would create a new facility open to all creditors, not just those approved by the existing participants in the GAB.[95]

To carry the expansion idea forward, the G7 appointed a working group, chaired by the assistant deputy minister of finance of Canada, Thomas A. Bernes (later Canada's Executive Director in the Fund). That group prepared a report that was discussed first by the finance deputies of the G7 at a meeting in Rome in September 1995 in which the Fund's Treasurer, David Williams, and its Economic Counsellor, Michael Mussa, participated. The deputies decided against trying to expand the GAB, which could have effectively spelled the end of the G10 by inviting a host of other countries to share in one of the group's flagship functions. Instead, they devised a scheme more in keeping with the Fund's preferences. Under this plan, the availability of borrowed resources to the IMF would be doubled by creating a new arrangement open both to the original participants and to others, while retaining the GAB in its existing form.[96]

This two-arrangements scheme was fleshed out progressively over the next year. The discussions gradually expanded to include all of the countries and institutions qualified and willing to participate in the New Arrangements to Borrow (NAB). The participants agreed on the text of a draft instrument at a meeting in Brussels in July 1996, and the IMF Executive Board formally approved the NAB on January 27, 1997.[97]

The essence of the NAB agreement was to nearly double the size of the pool of funds the IMF could borrow under a standing arrangement, to increase the number of potential lenders from 12 to 25, and to inject more flexibility into the procedures of

[93]The Interim Committee communiqué of April 1995 (paragraph 5) gave impetus to this move by noting the "need to examine the issues related to borrowing by the Fund from members and, in particular, the role of the [GAB]"; *Annual Report 1995*, p. 210.

[94]"The Halifax Summit Review of the International Financial Institutions: Background Document," released by the G7 summit, June 16, 1995; accessed at http://www.g7.utoronto.ca/summit/1995halifax/financial/index.html.

[95]See minutes of EBM/95/72 (July 27, 1995), and "Establishment of Supplementary Lines of Credit for the Fund," EBS/95/129 (August 2, 1995).

[96]See Williams's report to the Executive Board; minutes of EBM/95/92 (September 25, 1995), pp. 3–7.

[97]See report by Camdessus to the Executive Board in minutes of EBM/96/72 (July 26, 1996), pp. 3–4; "New Arrangements to Borrow—Proposed Decisions," SM/96/307 (December 31, 1996); and minutes of EBM/97/6 (January 27, 1997).

the borrowing arrangements. Whereas activation of the GAB required agreement by all GAB participants, the NAB could be activated with an 80 percent majority.[98]

Most of the NAB creditors—21 out of 25—were member countries of the IMF (Table 15.11). Three others were the central banks of IMF members Germany, Sweden, and Switzerland. Inclusion of the remaining participant, the Hong Kong Monetary Authority (HKMA), posed special technical problems for two reasons. First, it was not the central bank of a Fund member or even of a country as that term was normally understood. While the negotiations for the NAB were occurring, Hong Kong was a territory of the United Kingdom, but preparations were under way for sovereignty to be transferred to China on June 30, 1997. The HKMA operated independently and would continue to do so after the hand over, but for purposes of the NAB it was considered to be an official institution of the member whose territory included Hong Kong. The NAB agreement, therefore, specified that the consent of the United Kingdom or China (as appropriate) would be required before the HKMA could participate in a call on the arrangements. Second, the Hong Kong dollar was not a usable currency for IMF operations. In all other cases, each participant was expected to lend to the IMF in its own currency. Loans from the HKMA to the IMF would have to be made in another currency, normally the U.S. dollar. In all cases, however, the loans would be denominated in SDRs.

An innovative feature of the NAB agreement was that it included a cap on total borrowing by the IMF from the two arrangements plus the associated agreement with Saudi Arabia. That cap was set at SDR 34 billion, which was also the size of the NAB.[99] The new total was twice the amount available under the GAB, but slightly less than that ratio when the associated agreement with Saudi Arabia was taken into account. That is, the maximum amount the Fund could borrow increased to SDR 34 billion from SDR 18.5 billion.[100] The intention was that the NAB would be the "facility of first and principal recourse" relative to the GAB for Fund borrowing. The only exceptions would arise if a call on the arrangements was for the purpose of financing a loan to a GAB participant or if NAB participants refused to accept a proposed call.

Ratification of the NAB by participants took close to two years. Like the quota increase under the Eleventh Review, U.S. participation in the NAB had to be approved by the U.S. Congress. That body got entangled in domestic political disputes for some

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[98]For the text of the NAB agreement, see http://www.imf.org/external/pubs/ft/history/2011/index.htm.

[99]Under the new arrangements, each GAB participant committed to lend up to a specified sum through the NAB. It also continued to commit to lend up to a smaller amount through the GAB, but its total commitment was equal to its NAB commitment. When the Fund activated the GAB, as it did for Russia, calls were proportional to and limited by the GAB commitments. When the Fund activated the NAB, as for Brazil, then calls were limited by the NAB commitments. The two commitments were not additive.

[100]The GAB-associated agreement with Saudi Arabia remained in force, and the cap could be changed without an amendment to the NAB agreement. These features are set out in paragraph 21 of the NAB agreement.

Table 15.11. Borrowing Arrangements in Effect, 1998–99
(Millions of SDRs, except as noted)

	Commitments		Disbursements		
Participant	Total (= NAB)	GAB	Russia (GAB)	Brazil (NAB)	Total
Australia	810			74.7	74.7
Austria	412			38.0	38.0
Belgium	967	595.0	50.5	89.1	139.7
Canada	1,396	892.5	75.8	128.7	204.5
Denmark	371			34.2	34.2
Deutsche Bundesbank (central bank of Germany)	3,557	2,380.0	202.1	327.9	530.0
Finland	340			31.3	31.3
France	2,577	1,700.0	144.3	237.6	381.9
Hong Kong Monetary Authority	340			31.3	31.3
Italy	1,772	1,105.0	93.8	163.4	257.2
Japan	3,557	2,125.0	180.4	327.9	508.3
Korea, Rep. of	340				0
Kuwait	345			31.8	31.8
Luxembourg	340			31.3	31.3
Malaysia	340				0.0
Netherlands	1,316	850.0	72.2	121.3	193.5
Norway	383			35.3	35.3
Saudi Arabia	1,780	1,500.0[a]			0
Singapore	340			31.3	31.3
Spain	672			62.0	62.0
Sveriges Riksbank (central bank of Sweden)	859	382.5	32.5	79.2	111.7
Swiss National Bank (central bank of Switzerland)	1,557	1,020.0	86.6	143.5	230.1
Thailand	340				0
United Kingdom	2,577	1,700.0	144.3	237.6	381.9
United States	6,712	4,250.0	360.9	618.8	979.6
Total	34,000	18,500.0[b]	1,443.5	2,876.3	4,319.8
Total in U.S. dollars[c]	46,122	25,096	1,958	3,902	5,860

Source: *Annual Reports*.
Note: Details may not sum to totals, owing to rounding.
[a]Associated Agreement.
[b]Includes the Associated Agreement with Saudi Arabia.
[c]At average 1998 exchange rate.

months, but finally adopted the required legislation on November 17, 1998. In Germany, the Deutsche Bundesbank approved its participation on the same day, and the NAB was in business.

The delay in ratification meant that the NAB was not available to help finance the Fund's management of the major financial crises that afflicted East Asia and Russia in 1997 and 1998. The agreement came into effect just in time for the next shock: the

collapse of financial stability in Brazil, which struck in December 1998. The IMF borrowed SDR 2.9 billion ($3.9 billion) to finance the initial disbursement under a new stand-by arrangement with Brazil. As with the activation of the GAB for lending to Russia earlier that year, the Fund repaid the loans in March 1999 when it obtained an augmentation of its own resources through the general quota increase.

These various borrowing arrangements and their activations in 1998 are summarized in Table 15.11. The activation of the GAB for the Russian EFF arrangement was supported by calls on all 11 GAB participants in proportion to their standing commitments. A larger group of 21 NAB participants, again in proportion to their commitments, shared in the lending in support of Brazil. On that occasion, four countries—Korea, Malaysia, Thailand, and Saudi Arabia—opted not to participate. The first three were still recovering from their own financial crises, and Saudi Arabia had a weakened external payments position as a result of the low level of world oil prices. Once the GAB and NAB loans were repaid in March 1999, the Fund's General Department had no outstanding debts for the rest of the year.

Appendix: A Primer on the SDR

In the second half of the 1960s, the U.S. dollar was the only reserve currency in widespread usage. With almost all currencies fixed in value against the dollar, and the dollar in turn pegged to gold, the continual growth in world trade and finance required a commensurate increase in dollars to be added to reserves. The unsustainability of this relationship (known as the "Triffin dilemma") led to discussions about the creation of an additional reserve asset. In 1969, the IMF's member countries adopted the First Amendment to the Articles of Agreement, establishing the special drawing right (SDR) for this purpose. As the unit of account for the IMF, the SDR had a value fixed at the gold content of the U.S. dollar at that time (0.888671 grams, that being the equivalent of the official gold price of $35 an ounce). As a medium of exchange, the SDR could be held or traded only by the IMF, those member countries that elected to participate in the newly created SDR Department of the Fund, and multilateral institutions such as development banks that would be accepted by the IMF as "prescribed holders." As a financial asset, SDRs would be created—"allocated" was the official terminology—upon approval by the Board of Governors, with an 85 percent majority vote being required.

In three annual installments, 1970–72, the IMF allocated SDR 9.3 billion (equal to $9.3 billion) to the 105 participating member countries, in proportion to each country's quota in the Fund. Coincidentally, by the end of that sequence, the dollar was no longer convertible into gold, and exchange rates were floating between the dollar and other key currencies. In response, the valuation of the SDR was changed in 1974 to a basket of 16 currencies, with fixed amounts of each currency in the basket. To simplify the calculation, the Fund reduced the basket to five currencies in 1981. Meanwhile,

the Fund conducted a second series of annual allocations in 1979–81, bringing the total stock to SDR 21.4 billion (then worth about $27 billion, reflecting the dollar's depreciation during the 1970s).[101]

The primary financial role of the SDR is as a de facto line of credit between authorized holders. When a participant in the SDR Department (which since 1980 has included all IMF member countries) receives an allocation, it treats its SDR holdings as part of its official reserves, offset by a corresponding long-term liability (the allocation). It receives interest on its holdings and pays interest on its allocation. For both purposes, the SDR interest rate is a weighted average of top-quality short-term security rates in each of the five component countries. An allocation thus is costless. The country has the option of using some or all of its allocation to settle obligations with another participant, the Fund, or a prescribed holder. As its holdings fall below its allocation, the country pays net interest to the SDR Department. As other countries receive those SDRs, they earn net interest. Until 1981, net users were required to "reconstitute" their holdings periodically by repaying these loans. The reconstitution requirement was then abrogated so that participants could become permanent net users, in effect borrowing up to the amount of their allocation from other participants at the short-term (floating) SDR interest rate.

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[101]For more-detailed histories and explanations of the SDR, see de Vries (1976, 1985); Chapter 18 of Boughton (2001); and the two Appendixes in Mussa, Boughton, and Isard (1996).

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16

Carrots and Sticks: Safeguarding the Fund's Resources

The IMF is a cooperative membership institution with a fixed amount of money to lend. It is not a development bank with a regularly replenished pool of resources to distribute through grants or very long-term subsidized loans. The IMF lends to its members on the basis of information each country provides, and it relies on each country to pay interest and to repay principal on schedule without the possibility of recourse to bankruptcy or other judicial proceedings. Any breakdown of trust and cooperation threatens the viability of the Fund as a multilateral agency and imposes potentially large costs on all members. If one country fails to repay loans from the Fund, less money will be available for others to borrow. If a country borrows under false pretenses, the value that Fund lending adds to the global welfare could be seriously diminished. For these reasons, safeguarding the IMF's financial resources has always been a major concern.

In the 1990s, the sanctity of the Fund's finances suffered two threats.

First, a substantial number of borrowers failed to service their debts properly. At one time or another, 18 countries had protracted arrears—financial obligations six months or more behind schedule—to the Fund. The Fund devoted considerable energies to whittling away at those arrears, adopting more-flexible and more-effective policies and applying them case by case. Some of the new policies took the form of "carrots": positive incentives to cooperate in resolving the problem. Others took the form of "sticks": increased penalties for failing to cooperate. This potent combination, even though taking a while to work in the most difficult situations, succeeded in clearing all but two arrears cases by 2008.

Second, several countries borrowed from the Fund on the basis of false information, either deliberately or through negligence. This "misreporting" problem had never been a serious issue until this decade, so the Fund had to develop new policies and procedures to deal with it. Full resolution of this problem would take much longer than had the arrears problem.

Payments Arrears to the Fund: Containing the Problem

At the dawn of the 1990s, the IMF was struggling to contain the spreading effects of a backlog of outstanding arrears on loans it had made in the first half of the preceding decade. Several countries had fallen behind temporarily and had managed to get current again, but none of the large or persistent cases had yet been resolved. Eleven countries had fallen behind in their obligations by at least 15 months, and all of them were still in arrears at the end of the 1980s. After nearly 40 years without any significant repayment problems, more than 14 percent of the Fund's total credit and loans outstanding were now effectively in nonperforming status (Figure 16.1). Arrears continued to accumulate, and the Fund clearly needed a new strategy if it hoped to solve the problem.

The first challenge for the IMF in its quest to cope with arrears was to assess why the problem arose in the first place. Why did some countries fail to repay loans, when others—many of them just as poor and facing problems just as great—stayed current? In several cases, the Fund had entered into arrangements in the belief that the borrowing country simply faced a temporary balance of payments need, but the shortfall later proved to be more permanent. In some cases, political shifts in the country induced the new leaders to reject responsibility for earlier debts or to seek to limit debt service to a manageable portion of export revenues. In a few cases, disputes between the indebted country and one or more large creditor countries made it difficult for the debtor to obtain foreign exchange. In other cases, a breakdown of governance and civil order temporarily severed relations between the country and the international community, including the IMF.[1]

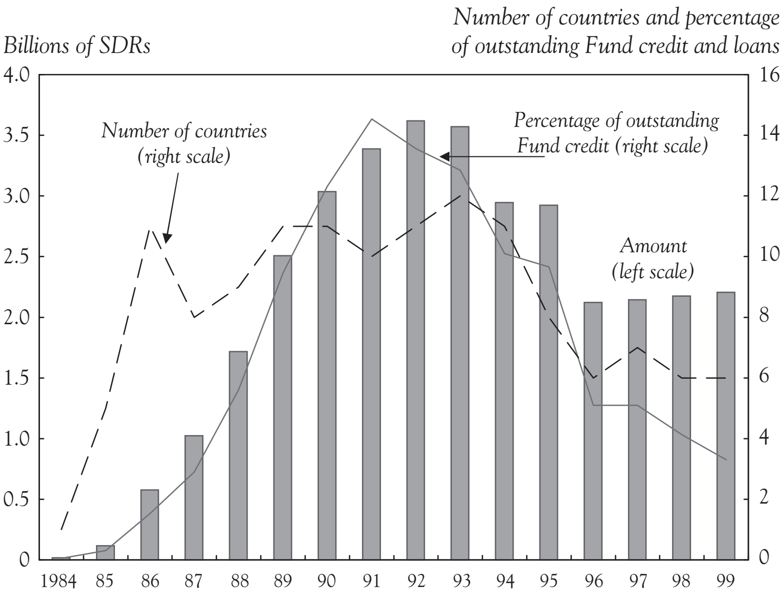
The Fund's initial response when the problem arose in the 1980s was to insist that countries eliminate their arrears as a precondition for discussions of new lending or even of policy advice. The fear was that a softer approach would give rise to moral hazard and discourage countries from servicing their debts. After a few years, it became clear that the reasons for going into and staying in arrears varied greatly from one country to another and that political instability was usually an important contributing factor. In response, the Fund gradually shifted to a case-by-case strategy that encompassed a wide range of incentives, including encouragement for cooperation wherever possible.

Policy Changes: Developing a Collaborative Solution

Almost from the onset of the arrears problem in 1985, the staff and the Executive Board struggled to develop a solution that would induce countries to repay loans on time without offering incentives that would give rise to moral hazard for other

[1]These issues are covered in Boughton (2001), Chapter 16.

Figure 16.1. Protracted Arrears to the Fund, 1984–99



Source: International Financial Statistics.

members. The Fund also began setting aside reserves to rebuild capital in view of the low quality of its loan portfolio.

In 1985, the Fund adopted a blanket prohibition against new borrowing through stand-by or extended arrangements by any country with overdue obligations. With the 1985 *Annual Report*, it began publishing its declarations that specific countries with protracted arrears were ineligible to borrow. In December 1985, it began imposing surcharges ("special charges") on the interest rate on overdue balances. In July 1986, it introduced a "burden sharing" procedure that lowered remuneration to creditors and raised interest rates paid by all borrowers so all member countries would share the risk that some loans might eventually have to be written off. A year later it established a reserve fund—the Special Contingent Account (SCA)—to provision against possible loan losses.[2]

The effort to develop a more flexible and cooperative approach to dealing with countries in arrears began in earnest in 1988. That spring, the Managing Director (Michel Camdessus) and the Chairman of the Interim Committee (Onno Ruding, finance minister in the Netherlands) agreed that the policy of refusing to provide policy advice to, or negotiate programs with, countries in arrears was proving to be counterproductive. The "sticks" of remedial measures to punish those countries were

[2]These Executive Board decisions are reproduced in the Appendix to Chapter 16 of Boughton (2001), pp. 826–32. Costs covered by the SCA included unpaid interest charges by borrowers.

still needed, but they had to be balanced with "carrots" to provide incentives for debtors to make sacrifices and get current on their repayments. In September 1988, the Interim Committee endorsed the outlines of a comprehensive three-pronged strategy to ensure all member countries would treat the IMF as a preferred creditor and make a full effort to settle and avoid arrears.

The first prong in this strategy was a renewed commitment by the staff to assess the ability of countries to implement sound policies and service their debts, and thus to try to prevent situations that would lead to arrears. The second was an intensification of deterrent measures, such as publicizing cases more extensively, withholding technical assistance, and prohibiting countries from getting quota increases. The third—which represented a real cultural shift in the Fund—was a new determination to work with the indebted countries to help them find ways to escape from and move beyond the arrears vortex.

While this "intensified collaborative approach" was still being fleshed out, arrears continued to accumulate. As shown in Figure 16.1, the total amount outstanding did not peak until 1992. The problem then diminished. By 1992, every country with protracted arrears was making at least some payments to the IMF. In five and a half years from mid-1990 to end-1995, 8 of the 11 outstanding cases from the 1980s were resolved (Table 16.1), and the total outstanding was reduced from a peak of $5.1 billion (SDR 3.6 billion) to $3.2 billion (SDR 2.1 billion). Four new cases arose and were already resolved. The remaining outstanding arrears were mostly associated with severe and seemingly intractable political and economic problems in four African countries—the Democratic Republic of the Congo (then known as Zaïre), Liberia, Somalia, and Sudan—that lay far beyond the ability of IMF assistance or pressure to alleviate.

The two main innovations in Fund policies on arrears in the 1990s were the establishment of the "rights approach" in 1990 and the adoption of the Third Amendment of the Articles of Agreement in 1993.

Rights Accumulation Programs

One bottleneck apparent by 1989 was that the largest outstanding arrears could be settled only with substantial grants from donor countries friendly to the debtors. Donors were reluctant to take on that burden by themselves, especially because the immediate direct benefit would be repayment to the IMF, not an increase in social spending in the indebted country. To break the bottleneck, the Fund needed some means to make its own financial contribution to the settlement of arrears. The most obvious and straightforward solution—rescheduling the loans similarly to the way the Paris Club dealt with nonperforming bilateral loans—was precluded by the Fund's policies and was anathema to most of the Fund's creditor members.

Informal discussions among the staff, management, and Executive Directors led to the emergence of the "rights approach" in January 1990. The basic idea, as developed by the Deputy Managing Director, Richard D. Erb, was relatively simple. If a country had arrears to the Fund and was ineligible to borrow, and if the country wanted to

cooperate with the Fund to work its way out of the problem, the Fund could agree to monitor policy implementation for a few years. It could also agree to make a provisional commitment to lend to the country at the end of that period, by allowing the country to accumulate "rights" up to the approximate level of the country's outstanding arrears. During that time, a "support group" of donor countries would help finance the country's balance of payments and development needs. The country would be expected to make regular payments to the Fund to keep its arrears from rising. Once the country had accumulated enough rights to settle its arrears, the Fund would approve a new stand-by or similar arrangement and immediately apply the rights in settlement of the old obligations and as an upfront disbursement under the new arrangement. These transactions would effectively reschedule the debts to the IMF and begin a fresh lending arrangement on normal terms.

The Executive Board discussed this proposal extensively in a series of meetings from late January through April 1990. The approach survived essentially intact, but with two major changes from the original proposal.

The first change was to introduce an intermediate step to separate the new arrangement from the previous one. This step obscured the fact that the Fund was engaging in a de facto rescheduling. At the end of the rights accumulation period, the donor support group would be expected to provide a very short-term bridge loan enabling the country to repay its outstanding obligations. Only after the country had applied the proceeds to settle its arrears would the Fund approve the new lending. The borrower could then use the initial disbursement from the Fund to repay the bridge loan, at which point all of the old balances would be fully cleared. These transactions would normally take place within a day or two, but the sequencing was viewed as essential to preserve the principle that the new arrangement was independent of the old.

The second stumbling block concerned the risk that the Fund might tie up sizeable amounts of its scarce financial resources for years while countries completed their Rights Accumulation Programs (RAPs) and that it then would disburse large sums up front to countries that might still face uncertain economic and political prospects. Approval of the program therefore became closely linked to approval of other elements of the strengthened strategy, as discussed below.

The Interim Committee endorsed the rights approach in May 1990, and the Executive Board agreed on the way in which to implement it in a series of meetings in June. The final agreement on "modalities" was adopted on June 20, 1990, not in the form of a formal decision but rather through a Summing Up of the discussion by the Managing Director.[3]

A central feature of the rights approach was that it was limited to the 11 countries with protracted outstanding arrears when the approach was initiated, and it was available only for a limited time. These limitations were imposed to avoid moral hazard opportunities for countries that might stop repaying the Fund in the future or that

[3]This Summing Up is available at http://www.imf.org/external/pubs/ft/history/2011/index.htm.

Table 16.1. Countries with Protracted Arrears to the IMF, 1990–99
(Millions of SDRs)

Country	Level of Remedial Action[a]	Date of Complaint[b]	Date of Ineligibility	Ending Date	Outstanding End-1989	Amount of Settlement[c]	Outstanding End-1999	Amount Outstanding or Settled (Percentage of Quota)
A. Cases from the 1980s resolved in the 1990s								
Guyana	7	4/4/1984	5/15/1985	6/20/1990	98.7	107.1	…	218
Honduras	7	1/30/1989	11/30/1989	6/28/1990	20.6	27.5	…	41
Panama	7	3/3/1988	6/30/1989	2/5/1992	165.7	180.9	…	177
Peru	7	12/13/1985	8/15/1986	3/18/1993	626.6	621.0	…	133
Cambodia	5	11/17/1978	…	10/1/1993	29.3	36.9	…	65
Vietnam	7	7/25/1984	1/15/1985	10/5/1993	102.5	100.2	…	41
Sierra Leone	7	3/17/1987	4/25/1988	3/28/1994	69.4	85.5	…	111
Zambia	7	7/18/1986	9/30/1987	12/6/1995	764.9	830.2	…	318
B. Cases from the 1980s that remained unresolved								
Sudan	10	12/12/1984	2/3/1986	…	847.5	…	1,132.0	667
Liberia	7	4/4/1985	1/24/1986	3/14/2008	290.6	…	470.0	659
Somalia	8	9/8/1987	5/6/1988	…	90.4	…	202.2	457
C. New cases resolved during the 1990s								
Dominican Republic	5	11/21/1990	…	4/23/1991	…	24.3	…	22
Haiti	5	1/21/1992	…	12/19/1994	…	24.8	…	41
Bosnia and Herzegovina	n.a.	10/23/1992	…	12/20/1995	…	25.1	…	21
Central African Republic	5	8/6/1993	…	3/3/1994	…	1.6	…	4

Table 16.1. (continued)

Country	Level of Remedial Action[a]	Date of Complaint[b]	Date of Ineligibility	Ending Date	Outstanding End-1989	Amount of Settlement[c]	Outstanding End-1999	Amount Outstanding or Settled (Percentage of Quota)
D. New cases that remained unresolved in the 1990s								
Serbia and Montenegro	n.a.	10/23/1992	…	12/20/2000	…	…	94.9	42
Congo, Dem. Rep. of (Zaïre)	9	1/29/1991	9/6/1991	6/12/2002	…	…	375.9	129
Iraq	5	1/29/1991	…	9/22/2004	…	…	39.9	8
Afghanistan, Islamic State of	5	2/26/1996	…	2/26/2003	…	…	4.5	4
Total					3,106.2	2,065.1	2,319.4	

Sources: IMF financial accounts and staff reports.

Note: n.a. = Not applicable. Dates are in the form of month/day/year.

[a]Most severe action taken by the IMF through 1999, according to the 11-step timetable listed on pp. 808–09.

[b]With two exceptions, this is the date on which the Managing Director issued a formal complaint to Executive Directors regarding overdue obligations by the member. For Bosnia and Herzegovina and for Serbia and Montenegro, it is the date on which the Managing Director notified Executive Directors that the predecessor state, the Socialist Federal Republic of Yugoslavia, had incurred overdue obligations.

[c]Includes only full settlements completed by December 31, 1999. In some cases, partial payments were made before the final settlement.

might delay agreeing to a new Fund-approved policy program. Moreover, the Fund did not expect all of the eligible countries to take advantage of the plan. Guyana and Honduras were on the verge of settling their arrears and would have no need for the new program. Others were not expected to qualify in time.

Within two years, three countries—Peru, Sierra Leone, and Zambia—had embarked successfully on RAPs. As discussed more thoroughly in the next section, all three completed the process successfully, cleared their arrears by 1995 at the latest, resumed borrowing from the Fund on good terms, and serviced the new debts without further difficulty. Five other eligible countries—Cambodia, Guyana, Honduras, Panama, and Vietnam—cleared arrears in that same period without recourse to the rights approach. That left just 3 of the original 11 countries—Liberia, Somalia, and Sudan—all with long-standing domestic political problems that kept them far from qualifying for a RAP. Nonetheless, the Board held out hope by repeatedly extending the deadline for qualification. At the end of the 1990s, the rights approach was still in place, awaiting the opportunity for renewed cooperation from those three countries.[4]

Remedial Actions and the Third Amendment

Until 1989, the IMF had few options for ratcheting up pressure on a country to settle its arrears. It could issue public declarations that the member was ineligible to borrow, but the next step would have been to expel the miscreant from membership. Because that step would usually be counterproductive and make it nearly impossible to collect the outstanding debt, the declaration of ineligibility was, for all practical purposes, the last arrow in the quiver.

In 1986, Yusuf A. Nimatallah, the Executive Director for Saudi Arabia, called for an amendment to the Articles of Agreement to allow the Fund to suspend a member's voting privileges and its right to accept quota increases. That suggestion was strongly opposed by Directors from developing countries—including the Dean of the Board, Alexandre Kafka (Brazil)—and it was quietly dropped.[5]

As an intermediate step, a deeply divided Executive Board approved a policy of public censure in 1989. Under this new "naming and shaming" procedure, the Fund could publicly declare a country to be failing to cooperate in efforts to resolve its problems, and the Managing Director could write directly to Governors from other interested countries and to the heads of other multilateral institutions, informing them of a country's failings.[6] No one expected these decisions to do much to reduce outstanding arrears. The outcome left the hawks on the Executive Board dissatisfied because too

[4]Liberia settled its arrears in 2008 without recourse to a RAP. Two years later, the rights approach was still in effect, pending resolution of the other two cases.

[5]Minutes of EBM/86/92 (June 6, 1986), pp. 8–11. The staff subsequently prepared two papers explaining the legal objections to suspending countries' membership rights under the Articles of Agreement; see "Suspension of Membership in the Fund—Legal Aspects," SM/87/229 (August 25, 1987); and "The Issue of Suspension of Membership," SM/89/127 (June 28, 1989).

[6]For the background to this decision, see Boughton (2001), pp. 815–17.

little was being achieved, and it left the doves frustrated because the emphasis was on punishment rather than assistance.

The United States revived the idea of suspending membership rights in 1990 and devised an effective strategy for getting it adopted. Amendments to the Articles of Agreement require the support of 60 percent of the membership holding 85 percent of the voting power. Therefore, amendments cannot be enacted without broad support from both industrial and developing countries. Those requirements posed a large challenge, but the U.S. authorities saw the goal as at least symbolically important. According to their Executive Director in the Fund, Thomas C. Dawson II, they

> believe . . . that a country which does not live up to the obligations of membership should not be allowed to enjoy the rights and privileges associated with membership. A voice and vote in the affairs of the IMF are among the most basic rights of membership in the institution. Therefore, a strengthening of the remedial measures [on a country in arrears] should include suspension of the country's voting rights and representation on the Board of Governors, Interim Committee, and Executive Board.[7]

The Board debated this proposal extensively in several long days of meetings in February 1990. Although the membership was still split, with some opponents calling it unacceptable, support for it by several creditor countries was sufficiently strong to compel the staff to draft an amendment to the Articles. The Fund's Legal Department promptly did so, despite the amendment having no chance of being ratified on its own. At that point, the U.S. authorities found an irresistible linkage. After eight years of heavy lending activity in response to the debt crises of the 1980s, the IMF badly needed a replenishment of its resources through a general increase in quotas. The United States was prepared to support an increase, but now it made its support conditional. When the Executive Board discussed the draft amendment in April, Dawson informed his colleagues that the U.S. authorities would insist "that the quota resolution should provide that any quota increase will become effective only when the amendment of the Articles of Agreement providing for suspension [of voting rights] has been ratified and adopted by the necessary 85 percent majority vote."[8]

Few Directors embraced the U.S. linkage proposal, but they all understood that neither the quota increase (which almost everyone favored) nor the amendment could pass without U.S. support.[9] Even if the U.S. authorities were bluffing, the danger remained that the U.S. Congress would refuse to ratify the increase without the amendment. A narrow majority—all from creditor countries—favored amending the Articles, and now they had the leverage to force the issue.

[7]"Statement by Mr. Dawson on the IMF Arrears Strategy," BUFF/90/24 (January 30, 1990), p. 4.

[8]Minutes of EBM/90/59 (April 16, 1990), p. 17.

[9]At the April 16 Board meeting, 9 of the Fund's 22 Executive Directors indicated a preference for amending the Articles, and 3 others said that they were open to the idea, but 5 of those 12 expressed doubts about making the quota increase dependent on approval of the amendment.

The Interim Committee endorsed the amendment in May 1990, and the Board of Governors approved it a month later. Only 61 percent of the membership, with 79 percent of the voting power, voted in favor, but that was enough to adopt the resolution and initiate the ratification process.[10] Remarkably, it had taken just five months to draft, debate, and approve a complex and highly controversial amendment.

The most arduous leg of this journey was the last. The bitterness produced by the strong-arm tactics of the majority did not quickly dissipate, and the first few months of attempts at ratification made it clear that reaching the 85 percent threshold would not be easy. Raising the rhetorical ante, Camdessus told Executive Directors in September 1990 that "what is now at stake is the life and future and the credibility of the institution."[11] If the quota increase did not take effect by the end of 1991, the resolution was scheduled to lapse. Most likely, the Fund would be left without the resources to meet members' requests for loans even earlier.

The ratification process dragged on throughout 1991, at the end of which the Executive Board reluctantly agreed to extend the deadline to June 30, 1992. By April of that year, 112 members with more than two-thirds of the voting power had ratified the amendment. The main but not the only holdout was the United States, owing both to the cumbersome legislative procedures for getting all elements of the required legislation adopted on identical terms by the Senate and the House of Representatives and to the delicacy of domestic politics in a presidential election year. Finally, in the last week of October and just days before the election, the United States completed those steps and ratified the amendment.

The Third Amendment entered into force on November 11, 1992.[12] With this amendment, the "remedial" strategy for escalating pressure on countries in arrears was complete. It encompassed the following steps, to be taken in order:[13]

1. The staff sends a reminder to the authorities as soon as the payment becomes overdue. This action automatically puts any further borrowing on hold.
2. At two weeks, the Managing Director writes to the Governor for the member.
3. At one month, the Managing Director notifies the Executive Board.

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[10]For the full results, see "Proposed Third Amendment of the Articles of Agreement—Voting Results on Board of Governors' Resolution," SM/90/101, Revision 3, Suppl. 1 (June 29, 1990).

[11]Minutes of EBM/90/134 (September 5, 1990), p. 4.

[12]The text of the Third Amendment is available at http://www.imf.org/external/pubs/ft/history/2011/index.htm.

[13]The timetable was indicative and could be varied according to specific circumstances. These procedures applied if the arrears were to the General Department of the Fund. Slightly different procedures applied for arrears to the SDR Department or to the Fund's concessional lending facilities such as the Enhanced Structural Adjustment Facility. The original Board decisions detailing these steps are reproduced in Boughton (2001), pp. 837–43. Most of the timetable summarized here was adopted in March 1990, with some shorter intervals than in the initial policy; see "Statement by the Managing Director on the Strengthened Cooperative Strategy on Overdue Financial Obligations to the Fund," BUFF/90/58 (March 15, 1990), pp. 13–14. The adoption of the Third Amendment further refined the timetable.

4. At six weeks, the Managing Director notifies the authorities that a formal complaint will soon be issued. At this time, but only after consulting with Executive Directors, the Managing Director might also write to some or all Governors asking for their help in resolving the matter.
5. At two months, the Managing Director issues a complaint under Rule K-1.
6. At three months, the Executive Board reviews the complaint and may formally suspend the member's right to draw on the Fund's resources until the arrears are settled in full.
7. Not more than 12 months after the emergence of arrears, the Executive Board declares the member ineligible to use Fund resources until the ban is lifted by the Board.
8. After another seven months, the Executive Board considers issuing a declaration of noncooperation.[14]
9. After a further "reasonable period" of noncooperation, the Executive Board—by a 70 percent majority of total voting power—may suspend the member's voting rights until such time as the Board restores those rights by the same majority.
10. Only after "all other possible avenues to redress the problem" have been exhausted, the Fund may initiate procedures leading to compulsory withdrawal.
11. Eventually, the Board of Governors—by an 85 percent majority of total voting power—may expel the member from the IMF ("require the member to withdraw").

The Fund recognized that in some cases, it might be necessary to reverse some of these steps to encourage countries to strengthen their efforts to settle arrears. In April 1992, the Executive Board agreed that a declaration of noncooperation could be withdrawn while arrears remained outstanding if the Fund determined the member was cooperating in trying to resolve the matter. In July 1999, the Board adopted more comprehensive de-escalation policies, though the policies were limited to the lifting of declarations of noncooperation and suspensions of voting rights.[15]

Other Policy Changes

As the Fund gained experience with the intensified collaborative approach, it continued to tweak its policies. A series of mostly minor changes in the early 1990s had the combined effect of guarding against new arrears, reducing obstacles to the settlement of old arrears, and shoring up the Fund's finances if some large balances remained outstanding for a long period.

[14]Consideration of a declaration of noncooperation was to be preceded by a communication sent to "all Fund governors and the heads of selected international financial institutions" within three months after step seven; see BUFF/90/58 (March 15, 1990), p. 5.

[15]See minutes of EBM/92/58 (April 17, 1992), p. 4; and "The Acting Chairman's Summing Up—Overdue Financial Obligations—De-Escalation of Remedial Measures under the Strengthened Cooperative Strategy—Further Considerations, Executive Board Meeting 99/79—July 22, 1999," BUFF/99/90 (July 27, 1999).

Preventive measures. To help prevent new problems from arising, the staff set out to strengthen its ability to analyze countries' financial capacity to service external debts and ultimately repay the Fund. Previously, the IMF had acted on the assumption that if a borrowing country strengthened its macroeconomic policies and met the conditions set out in a stand-by arrangement, it would have the capacity to repay the loan. After all, the fundamental characteristic of the Fund's "financial programming" exercise underpinning its loan conditions was a quantitative analysis of the links between macroeconomic policies and the balance of payments. The failure of several countries to service debts to the Fund in the 1980s forced the staff to consider new paradigms in which "capacity to repay" could be analyzed more directly.

Beginning in mid-1990, the policy became that every staff mission in response to a member's request to borrow should discuss the country's debt-servicing capacity with the authorities, and each staff report should include an explicit assessment of the country's capacity to repay the Fund. It also should include an assessment of possible risks that could throw the economy off track, including in the period after the Fund-supported program ended but the loan was still outstanding, and of contingency plans to deal with adverse shocks. More subtly, the staff was also asked to examine the country's record of servicing its external debts to the Fund, multilateral development banks, and other creditors. Any danger signs in this record were to be noted. In retrospect, this type of risk analysis seems quite basic, and no more than what any auditor would expect to see from a well-run financial institution. At the time, it was a notable cultural departure from the IMF's history as a membership organization in which every country was given the benefit of the doubt until a problem materialized.

One way the Fund had always tried to ensure borrowers would have the resources to repay their loans was to require borrowing countries to maintain minimum levels of official international reserves. In practice, this often meant Fund resources would simply be added to the borrower's foreign exchange reserves. Such loans were not intended to facilitate government spending directly, but rather to shore up the balance sheet so external trade could be financed more smoothly. If the country's reliability in managing its reserves was open to doubt, the Fund could ask it to accept disbursements in SDRs rather than in U.S. dollars or other convertible currencies and to hold the SDRs in the member's account at the Fund. As part of the strengthened arrears strategy in 1990, the Fund began to employ this latter tactic more widely.[16]

Financial policies. A major consequence—perhaps *the* major consequence—of the failure of some countries to service and repay their debts was the financial burden it placed on all other countries, including the poorest. The IMF responded in two ways. First, it had to increase its own reserves to cover the possibility that some loans might

[16]In 1990, such arrangements were made for several countries, including Guyana, Panama, Uganda, and Zambia; see "Six-Monthly Report on Overdue Financial Obligations to the Fund—Progress under the Strengthened Cooperative Strategy," EBS/91/41 (March 12, 1991), p. 6.

never be repaid. Second, it decided to impose what amounted to (but pointedly were not called) penalty rates of interest on overdue obligations.

As recounted in the previous History, the Fund established procedures beginning in 1986 to ensure it had adequate reserves to cover potential losses on overdue obligations. Because the Fund was created as a cooperative institution with no allowance in its Articles for writing off bad debts, and because the Fund's outstanding credits are legally distinct from loan contracts, the Executive Board did not establish an account that explicitly contained provisions for loan losses. Instead, it agreed to set up an account—the Special Contingent Account (SCA)—linked more generally to the amount of outstanding balances in protracted arrears. The SCA was funded by transferring excess net income each year (i.e., income in excess of a target level set by the Board at the start of the year). That excess income would be generated by temporarily reducing remuneration paid to creditor countries and raising interest charges to debtor countries under the Fund's "burden sharing" policies. The terms of the SCA provided that it would eventually be terminated and distributed proportionally to those same creditor and debtor countries once the extra reserve was no longer needed.[17] In addition, the Board gradually increased the target level for net income, which was added to the Fund's general reserves. By April 1990, these actions had raised the ratio of reserves to arrears-related credits (credit outstanding to countries with arrears) from a counterfactual 48 percent (what it would have been in the absence of the policy changes) to 63 percent: an improvement, but not sufficient for comfort.

A potential constraint on the size of the SCA was a provision that the remuneration rate to creditors could not be reduced below 85 percent of the SDR interest rate. The Board had agreed on this floor when it established the burden sharing mechanism in 1986. The Articles of Agreement allowed for a looser restriction, setting the floor at 80 percent. In 1990, Dawson (United States) offered to accept the 80 percent floor if the Board would agree to sell or otherwise mobilize a small portion of the IMF's gold stock as an additional way to shore up the Fund's financial protection against a loan default.[18]

Camdessus responded to Dawson's initiative by proposing to create a second SCA aimed at generating an additional SDR 750 million in reserves, with more of the burden shifted to creditor countries. To apply a comparable increase in charges to borrowers, he argued, would raise serious issues of risk. In contrast to the original SCA with its equal burdens, this new "SCA-2" would be funded two-thirds by creditors and one-third by debtors. After some discussion, the Board agreed to this proposal, with the modifications that the SCA-2 should generate SDR 1 billion in reserves and that

[17]See Boughton (2001), pp. 813–16 and 831–32.

[18]On the 1986 decision, see minutes of EBM/86/122 (July 25, 1986). The initial proposal and discussion of the 85 percent floor was made at an earlier informal Board meeting, at which no minutes were recorded. Dawson's new proposal was also made at an informal session; see minutes of IS/MTG/90/5 (January 31, 1990), p. 9.

creditors should bear 75 percent of the burden, subject to the 80 percent floor on the rate of remuneration.[19]

The Managing Director could have justified this "extended burden sharing" and the establishment of SCA-2 as a necessary and prudent action to cover the risks arising from overall arrears cases. Instead, he proposed it as also necessary to provide "backing" for the RAPs the Fund was preparing to approve. That generated a bit of an uproar. Several Directors from developing countries wanted to know: If a country settled its arrears, successfully completed a period of policy implementation under the Fund's watchful eye, and then began borrowing anew, why would the Fund need extra backing for these new commitments? The short answer was that the SCA-2 was needed to provide comfort to creditor countries and therefore was a *sine qua non* for their support for the rights approach. In addition, even without the link to the RAPs, it might be needed for the broader purposes of financial prudence.[20] These differing perspectives delayed approval of the SCA-2 for a few months, but it was eventually approved in June 1990.

Over the next seven years, the Fund accumulated the SDR 1 billion in the SCA-2. Overall, the Fund's precautionary reserves more than doubled, from SDR 1.61 billion in April 1990 to SDR 3.76 billion seven years later. Nearly three-fourths of the increase took the form of transfers to the two SCAs. The rest accrued through the normal retention of net income. At the same time, the settlement of several outstanding arrears cases lowered the outstanding balance that was notionally measured against this reserve from SDR 2.57 billion to SDR 1.86 billion.[21] The IMF had sufficient cover for any potential defaults, and the financial concerns gradually faded away.[22]

The second part of the U.S. initiative—mobilizing gold—took much longer, although the process got under way quickly. In April 1990, Dawson clarified that the United States wanted a commitment by the IMF to use a portion of its gold stock "to backstop resources of the Enhanced Structural Adjustment Facility [ESAF] to finance

[19]Specifically, to fund the new account, "(a) the rate of charge shall be increased by 0.35 percentage point and, subject to the limitation in (b), an amount equivalent to three times the proceeds of that adjustment during an adjustment period shall be generated through reduction in the rate of remuneration during the same period. (b) No adjustment in the rate of remuneration under this paragraph shall be carried to the point where the average remuneration coefficient would be reduced below 80 percent for an adjustment period"; Executive Board Decision No. 9471-(90/98), adopted June 20, 1990.

[20]For Camdessus's original proposal, see minutes of EBM/90/20 (February 20, 1990), pp. 3–15. For the Board's detailed discussion of the revised proposal under the rubric of "extended burden sharing," see minutes of EBM/90/71 (May 2, 1990).

[21]These amounts are the total General Resources Account (GRA) credit outstanding to countries in protracted arrears, including balances not yet due and payable, plus outstanding overdue charges and interest.

[22]As discussed in Chapter 13, p. 669, the SCA-2 was liquidated in 1999, and most countries donated their balances back to the IMF to help fund the enhanced Heavily Indebted Poor Countries Initiative.

purchases under the rights program."[23] On that understanding, the staff hurriedly prepared a specific proposal, which the Executive Board discussed and approved in principle in early May.[24] The Interim Committee endorsed it in its communiqué the following week:

> The Committee concurred with the proposal that the Fund pledge use of up to 3 million ounces of gold, if needed, as additional security for use of the resources of the [ESAF] in connection with the financing of the [RAPs]. It urged that members approve the decisions necessary to establish such a pledge as soon as possible.[25]

The difficulty at that point was that any commitment to sell gold had to be approved with an 85 percent majority before it could be implemented.[26] Although the United States had requested the pledge, the U.S. Executive Director could not vote for it under U.S. law until he was authorized by Congress to do so. The government submitted the necessary legislation, but it worked its way slowly through the system and did not become law until the fall of 1992. Only then could the Executive Board sensibly return to the issue and adopt the proposed decision.[27] The Board finally did so in February 1993, without dissent.[28]

Although the gold pledge remained in place throughout the decade and beyond, it was never activated. Both Sierra Leone and Zambia encashed their rights to draw on the ESAF Trust, but they serviced those debts on time and in full. Hence, the trust suffered no losses, and the Fund had no reason to sell any gold.

The cumulative effect of "special charges" on overdue obligations posed another financial obstacle to the settlement of arrears. One of the Fund's first acts to control the problem, taken in December 1985, was to raise the interest rate on overdue obligations above the standard rate of charge. The intention was to shift the burden onto the countries with arrears rather than forcing all borrowers to pay higher rates to cover the institution's costs (Boughton, 2001, pp. 811–12). Over the next five years, through January 1991, the Fund imposed a total of about $312 million in special charges on

[23]Minutes of EBM/90/59 (April 16, 1990), p. 17.

[24]The staff presented its proposal at EBM/90/69 (April 30, 1990). The Executive Board discussed it at that meeting and at the next two and agreed on May 2 to send a recommendation to the Interim Committee. The committee communiqué was issued on May 8.

[25]*Annual Report 1990*, p. 113.

[26]Specifically, Article V, Section 12, of the Articles of Agreement permits the IMF to sell gold at market prices, deposit the original purchase value in the GRA, and deposit the excess in the Special Disbursement Account (SDA). Any such sale must be approved by 85 percent of the total voting power in the Executive Board. If the excess proceeds are to be used for any valid purpose other than general operations within the GRA (such as protecting the ESAF Trust), approval of that use also requires an 85 percent majority of the total voting power. Use of the excess proceeds for general GRA operations requires only 70 percent approval.

[27]The text of the 1993 gold pledge to protect the ESAF Trust is available at http://www.imf.org /external/pubs/ft/history/2011/index.htm.

[28]Minutes of EBM/93/23 (February 22, 1993). Also see "Modalities of a Gold Pledge for Use of ESAF Trust Resources under the Rights Approach," EBS/93/10 (January 25, 1993).

38 countries. Of that total, only about $55 million was collected. The rest was added to the balance in arrears.[29]

Most (89 percent) of the outstanding balance of accrued special charges was owed by four countries: Liberia, Peru, Sudan, and Zambia. Six other countries had smaller absolute amounts outstanding, but the charges were piling up and were becoming a significant factor causing each country's arrears to rise rapidly. With the advent of the rights approach, this accumulation was becoming a potential bottleneck. For a country undertaking a RAP, a donor support group would be expected eventually to help the country settle its arrears so it could encash its rights and normalize its relationships with the Fund and other creditors. If donors had to cover the cost of repaying special charges on top of other arrears, the budgetary consequences could be substantial. Moreover, the burden sharing mechanisms for deferred charges (introduced after the system of special charges) already helped greatly to spread the burden across the whole membership.

In March 1991, the staff proposed suspending the imposition of special charges on any country implementing a RAP. Executive Directors generally liked the idea but thought it failed to go far enough. Tanya Sirivedhin (Alternate, Thailand) suggested abolishing the system of special charges altogether. Several other chairs supported her, but the winning idea came from Dawson, who noted the possibility of suspending special charges "could be used as a strong incentive for countries showing a high level of cooperation."[30] The staff prepared a slightly broader proposal, under which special charges would be suspended for any country currently in protracted arrears, if it was implementing a RAP or other Fund-monitored program or if it was cooperating with the Fund and was making enough payments to keep its arrears from rising.[31]

Of the nine countries with protracted arrears in April 1991, five soon qualified under this broad policy. By April 1992, the Fund had suspended special charges for Panama, Peru, Sierra Leone, Vietnam, and Zambia. The difficulty remained, however, that the most intractable cases were continuing to be aggravated by the accumulation of high interest charges. As it became ever clearer that no one was gaining from this practice, the Fund took advantage of the next annual review of special charges to suspend them altogether for all outstanding cases. To retain their deterrent effect, they

[29]"Six-Monthly Report on Overdue Financial Obligations to the Fund—Progress Under the Strengthened Cooperative Strategy," EBS/91/41 (March 12, 1991). The large number of countries, relative to the smaller number of countries with protracted arrears, reflected the policy of applying special charges as soon as a payment was overdue by 10 business days.

[30]Minutes of EBM/91/42 (March 25, 1991), pp. 5 (Sirivedhin) and 11 (Dawson).

[31]Minutes of EBM/91/63 (April 24, 1991), pp. 49–51. The decision limited the option of suspension of charges only to the nine countries that had protracted arrears as of that date (Cambodia, Liberia, Panama, Peru, Sierra Leone, Somalia, Sudan, Vietnam, and Zambia).

would still apply to any new cases, but for most practical purposes, the role of special charges in the Fund was brought to a close.[32]

Successful Cases

Of the 11 countries with outstanding overdue obligations to the IMF at the end of the 1980s, 8 cleared their arrears in the course of the next few years. All of these successes resulted in some fashion from the new cooperative strategies and policies the Fund and major donors adopted in the late 1980s and early 1990s. In each case, a combination of strengthened economic policies; improved relations with the international community; policy advice and monitoring from the IMF; and financial support from the Fund, other multilateral agencies, and bilateral donors was essential to resolving the problem.

Guyana

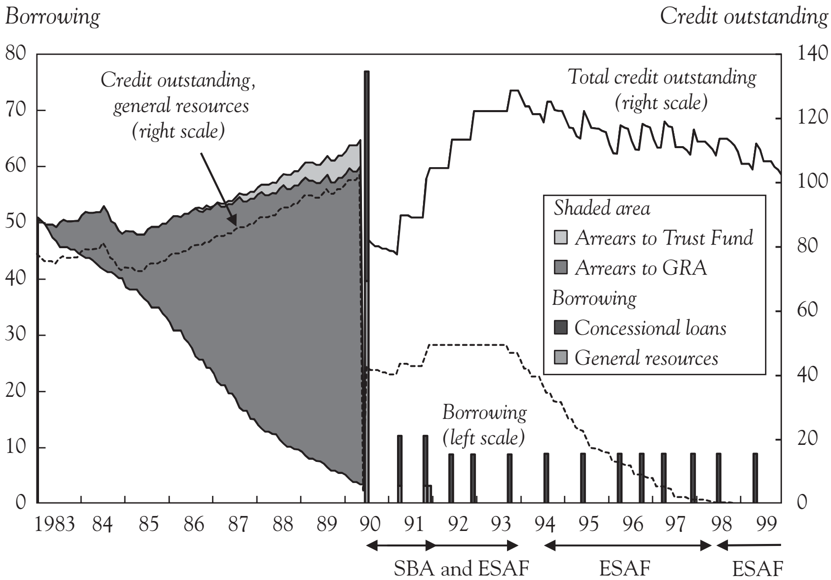
The first country to benefit from the Fund's new flexibility in the 1990s was the South American republic of Guyana. An IMF member since 1966, Guyana borrowed regularly from the Fund in the late 1970s and early 1980s in response to a weakening international market for sugar, its principal export crop. Low prices persisted for years, and from 1980 on, policy implementation and economic conditions deteriorated badly. That led the Fund to cancel an extended arrangement in 1982 and put further lending on hold. A year later, Guyana fell behind in its repayments, and its arrears accumulated for the next seven years (Figure 16.2).[33]

From the middle of 1988 through the first half of 1990, discussions between Guyana and the international community took place on two fronts. In Georgetown, the capital city, a staff team led by Carlos G. Muñiz (Advisor, Western Hemisphere Department) helped the authorities develop a comprehensive program of economic policies aimed at restoring financial viability under realistic assumptions about the future of the sugar market. Although the ultimate success of that program would require external financial support and therefore would require prior settlement of arrears, the intention was simply to establish a credible plan to be implemented more fully once the books were

[32]Very small amounts continued to accrue for a few countries through the rest of the 1990s. Although the revenues did not even cover the cost of administering the system, some Directors argued in 1999 that it should be retained to send appropriate signals about the Fund's resistance to arrears. A majority favored abolition, but the vote failed to reach the 70 percent threshold required under the Articles; see minutes of EBM/99/49 (April 30, 1999).

[33]These developments are covered in more detail in Boughton (2001), pp. 770–74. As Figure 16.2 indicates, most of Guyana's arrears were owed to the GRA, resulting from a stand-by arrangement in 1976–77, the extended arrangement of 1979–82, and a few drawings on the Compensatory Financing Facility. Guyana also had about SDR 7 million overdue to the Trust Fund, in repayment of concessional loans taken out in 1981. For further information, see Attachment II in "Guyana—Overdue Financial Obligations to the Fund—Further Review Following Declaration of Ineligibility," EBS/90/6 (January 10, 1990).

Figure 16.2. Guyana: Use of Fund Credit, 1983–99
(In millions of SDRs, monthly data)



Source: The source for data presented in this and similar figures in this chapter is the IMF's International Financial Statistics (IFS) database. "Total credit outstanding" includes purchases from the General Resources Account (GRA), except for reserve tranche purchases; loans from the Structural Adjustment Facility (SAF); loans from administered accounts, including the Trust Fund and the ESAF Trust; and any overdue obligations, including charges, interest, and fees. That last category includes overdue obligations to the SDR Department. This coverage is broader than "credit and loans outstanding" in IFS, which excludes charges, interest, fees, and all transactions in the SDR Department. Other labels in the figures refer to the facilities through which the loans were made.
Note: ESAF = Enhanced Structural Adjustment Facility; GRA = General Resources Account; SBA = Stand-by arrangement.

cleared. Separately, a group of friendly countries, led by Canada, formed a support group—chaired by Canada's Executive Director in the IMF—to help Guyana clear its arrears once the authorities had made satisfactory initial progress on stabilizing their economic policies.

In April 1989, in the first application of the Fund's new intensified collaborative approach, the Executive Board approved Guyana's program as meeting the standards for financial support in the upper credit tranches. It also agreed to monitor implementation for a year, without making any financial commitment, to give the authorities time to reestablish credibility and restore some semblance of stability to the economy. At the same time, the Board endorsed the intention of the Managing Director to approve new loans to Guyana once the Fund-monitored program was completed.[34]

[34]Minutes of EBM/89/48 (April 28, 1989), pp. 45–47.

Guyana completed the program successfully, and all the remaining elements came together quickly in the second quarter of 1990. The next crucial step was to pull together the money to repay the $140 million (SDR 107.1 million, or 218 percent of quota) Guyana owed to the IMF. Guyana itself had almost no resources it could afford to use for this purpose. The support group provided grants totaling $49.3 million, and the Bank for International Settlements and its member central banks provided a 90-day bridge loan of $178 million to help cover settlement of debts to the Fund and other multilateral lenders.[35] As a token gesture of good faith, Guyana used $600,000 of its own reserves to complete the repayment. On June 20, 1990, on the same day arrears were cleared, the Fund allowed a drawing of $53 million (SDR 39.7 million) on a new stand-by arrangement—which Guyana needed to help it repay the bridge loan—and disbursed an ESAF loan of $50 million (SDR 37.2 million).

For the next several years, Guyana continued to borrow—mostly on concessional terms through the ESAF—while its economy grew rapidly, and the government remained within its means to service these new debts. Beginning in 1998, economic performance slackened once more, but Guyana managed to avoid falling again into arrears.

Honduras

As in Guyana, world prices for Honduras's export crops (coffee and bananas) remained weak throughout much of the 1980s. After 1983, however, Honduras managed to cover its financing needs elsewhere, while gradually repaying its earlier loans from the IMF. From October 1987, those payments to the Fund slowed, and overdue obligations began to accumulate (Figure 16.3). As long as the authorities continued to reduce the total amount outstanding, the Fund was reluctant to take any punitive action, but the situation worsened toward the end of 1988. As the date for presidential elections approached, President José Azcona's government devoted its energies to domestic spending and adopted a populist stance opposing the repayment of foreign debts. With Honduras's external arrears accumulating rapidly and no payments being made, in August 1989 the Fund declared Honduras to be ineligible to borrow (effective November 1).[36] In response, a defiant Azcona reportedly concluded, "What makes me sad is not to have stopped paying the [IMF] three years ago."[37]

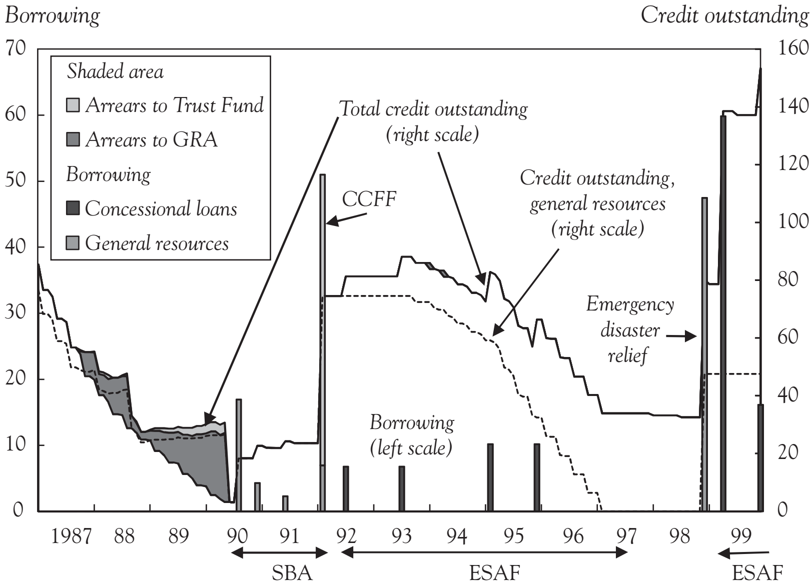
The problem did not last long. A new government took office in January 1990 and negotiated a new program with the Fund. On June 28, 1990, after obtaining a bridge loan from a support group led by the U.S. government, Honduras settled all of its

[35]For details of the bridge loan, see BIS Annual Report 1991, pp. 206–07; accessed at http://www.bis.org/publ/arpdf/archive/ar1991_en.pdf. The loan was designed to help Guyana settle arrears to the IMF, the World Bank, and the Caribbean Development Bank.

[36]For more on Honduras in the 1980s, see Boughton (2001), pp. 802–04.

[37]Reuters News, November 21, 1989, "IMF to Declare Honduras Ineligible for Loans"; accessed at http://global.factiva.com/.

Figure 16.3. Honduras: Use of Fund Credit, 1987–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics; see Figure 16.2 for further explanation.
Note: CCFF = Compensatory and Contingency Financing Facility; ESAF = Enhanced Structural Adjustment Facility; GRA = General Resources Account; SBA = Stand-by arrangement.

overdue obligations to the Fund (approximately $36 million, which was less than 4 percent of annual exports). One month later, the Fund approved a 12-month stand-by arrangement for $41 million (SDR 30.5 million, or 45 percent of quota).

From that point on, Honduras stayed current with the IMF, though it continued to have trouble servicing its other debts to official as well as commercial creditors.[38] The 1990 stand-by arrangement was followed by a sizeable ($57 million) Compensatory Financing Facility drawing in February 1992 to cover a temporary shortfall in export volumes, and then by an ESAF arrangement that stretched eventually to five years, 1992–97. In response to Hurricane Mitch, which destroyed much of the country's economy and killed thousands of people in October 1998, the Fund provided emergency disaster relief (see Chapter 5) and then approved a larger ESAF arrangement the following March.

[38]On two occasions in 1994, Honduras fell slightly behind in repaying the IMF, but each time it caught up in the following month.

Panama

The most overtly political case of arrears to the IMF in the 1980s was Panama's. In 1987, the U.S. government began investigating the chief of Panama's armed forces (and de facto political ruler), General Manuel Noriega, on a variety of criminal charges. That investigation, which was intensified in April 1988 with the imposition of financial sanctions, severely disrupted the country's economic and financial activity. Panama, unable to access its dollar reserves, could not meet its payments to the Fund, and arrears accumulated rapidly (Figure 16.4). U.S. military forces invaded Panama in December 1989 and arrested Noriega, after which the previously elected president, Guillermo Endara Galimany, was restored to his position.[39]

Panama's international relations normalized fairly rapidly after this upheaval. In 1990, the new government began strengthening its economic policies in the framework of a staff-monitored program, while the U.S. government began organizing a support group of donor countries to help Panama clear its arrears to the Fund and other multilateral institutions. In September, the Executive Board approved the continuation of the economic program as a Fund-monitored (as opposed to staff-monitored) program, meaning satisfactory progress was being made and the program met the standards for Fund support in the upper credit tranches. At that time, the authorities in both Panama and the United States expected arrears to be cleared by the end of the year.[40] However, Panama took much longer to raise the money, and it cleared all of its arrears to the Fund and other official creditors only in February 1992.[41] The Fund then resumed lending and approved both a 22-month stand-by arrangement and a CCFF drawing. This lending continued through the rest of the decade.

Peru

Peru's arrears to the Fund dated from September 1985, when President Alan García unilaterally declared a ceiling on payments on all external debts equivalent to 10 percent of the country's earnings of foreign exchange. Because Peru had the resources to service its debts to the IMF but chose instead to limit its payments, the Fund reacted quickly by issuing a formal declaration in August 1986 that Peru was no longer eligible to use Fund resources.[42]

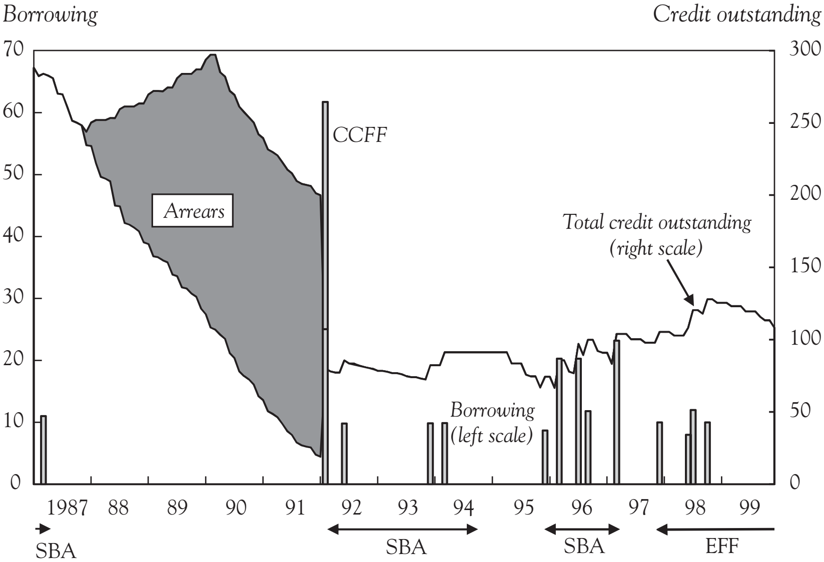
[39]These developments are covered in Boughton (2001), pp. 799–802.

[40]See minutes of EBM/90/141 (September 12, 1990).

[41]The complication in this case was that some donors insisted that Panama normalize its relations with the World Bank and the Inter-American Development Bank as well as with the IMF before allowing any grants to be released. Eventually, the Fund agreed to establish an administered account to receive donations for Panama and hold them in escrow until they could be used to settle arrears with all three of those institutions plus the International Fund for Agricultural Development; see "Panama—Establishment of an Administered Account," EBS/92/12 (January 23, 1992). The account was established on January 28, and Panama cleared its arrears on February 5.

[42]The onset of Peru's arrears in the 1980s is covered in Boughton (2001), pp. 783–86.

Figure 16.4. Panama: Use of Fund Credit, 1987–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics; see Figure 16.2 for further explanation.
Note: CCFF = Compensatory and Contingency Financing Facility; EFF = Extended Fund Facility; SBA = Stand-by arrangement.

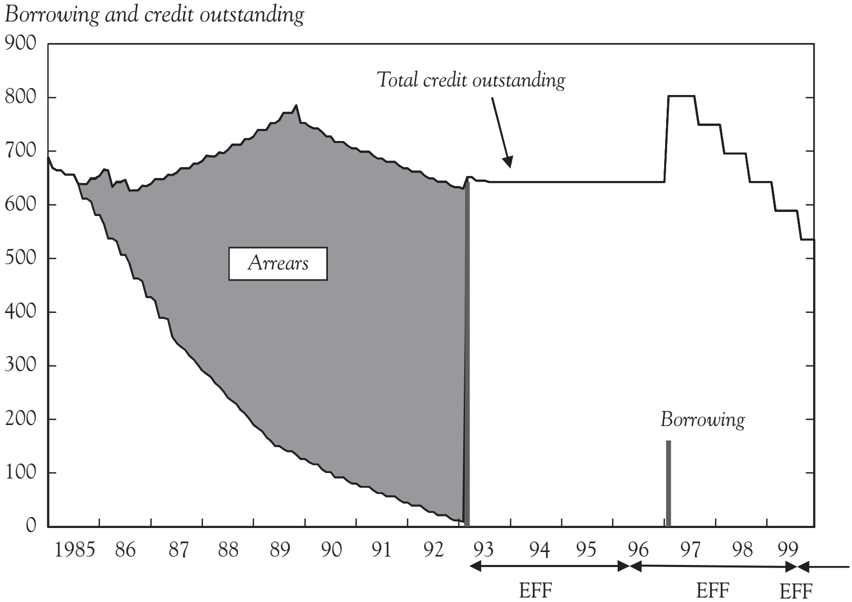
The next three years were a standoff, during which Peru made only modest occasional payments to the Fund, while continuing to repay other creditors more inclined to promise new loans. As arrears accumulated (Figure 16.5), the Fund repeatedly declared Peru to be failing to meet its obligations under the Articles. Toward the end of 1989, however, the first signs of *détente* began to appear. The Fund by then had initiated its intensified collaborative approach to dealing with arrears cases. In Peru, the next presidential election—effectively a referendum on García's policies—was rapidly approaching. Both sides thus had reason to show new flexibility.

In December 1989, Peru made a payment of some $43 million (SDR 32.8 million), which reduced its overdue obligations to the level outstanding at the end of August. The authorities also signaled they would now make regular payments to cover all amounts coming due. In other words, arrears would be held constant, and total outstanding obligations would gradually decline. In addition, they agreed to receive an IMF staff mission to hold Article IV consultation discussions and help them design a multiyear economic policy program.[43]

The Fund responded positively to these modest but politically significant gestures by taking two similarly modest but significant actions. First, it postponed further

[43]"Peru—Overdue Financial Obligations to the Fund—Further Review Following Declaration of Ineligibility," EBS/90/30 (February 21, 1990), p. 2.

Figure 16.5. Peru: Use of Fund Credit, 1985–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics; see Figure 16.2 for further explanation.
Note: EFF = Extended Fund Facility.

consideration of issuing a declaration of noncooperation. Second, it agreed to provide technical assistance the government had requested to help it stabilize its finances.[44]

In June 1990, voters elected Alberto Fujimori to succeed García as president of Peru. As part of a broad effort to stabilize the economy and resume economic growth, Fujimori set out to continue and accelerate the move, initiated by his predecessor, to normalize creditor relations. The international community responded enthusiastically. Japan and the United States convened a broad support group of donors that included nine European countries and Canada. Separately, four Latin American countries—Chile, Colombia, Mexico, and Venezuela—offered short-term bridging loans.[45] Once those pledges were in place, the IMF and other multilateral institutions arranged for Peru to settle its arrears and obtain new financing.

[44]The Managing Director had scheduled a meeting of the Executive Board for February 23, 1990, to consider issuing a declaration that Peru was failing to cooperate with the Fund in finding a means to clear its arrears. The government sent three senior officials, led by its chief debt negotiator, Abel Salinas, to participate in the Board meeting as an expression of conciliation; minutes of EBM/90/25 (February 23, 1990), pp. 11–28.

[45]These pledges are summarized in a statement by Dawson (United States) at EBM/91/121 (September 12, 1991), p. 41. For Peru's simultaneous efforts to settle arrears and reschedule debts with commercial creditors, see Chapter 9.

In March 1991, the Fund expressed its approval of the Fujimori government's policies and declared they "could serve as the basis for a two-year Fund-monitored rights accumulation program for Peru, provided that the necessary financing assurances would be available."[46] The reference to "financing assurances" meant that the support group would have to make its commitments first, and then the Fund would formally approve the onset of rights accumulation. That step was completed in September, and Peru became the second country (after Zambia; see below) to embark on a RAP.

Peru offers a clear picture of the way in which the RAP served to mobilize both policy reforms and international donor support and culminate in an effective rescheduling of outstanding obligations. When the Executive Board approved the arrangement, Peru had outstanding arrears totaling about $840 million (SDR 623 million). The two-year arrangement called for the Fund to make a conditional commitment to lend up to that amount to Peru. The actual disbursement would be made through a successor Extended Fund Facility arrangement commencing after the successful completion of the two-year program, but it would be heavily front-loaded so the initial disbursement would be roughly equivalent to the outstanding arrears. Meanwhile, the support group and possibly other donors would help finance the program throughout the period the RAP was in effect, and Peru would be expected to avoid any further accumulation of arrears.

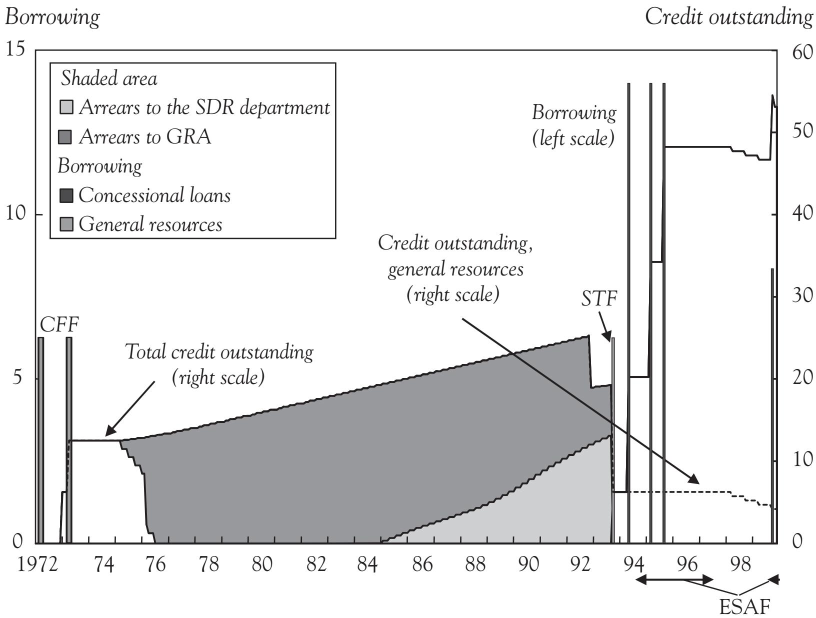
In Peru's case, the plan worked as expected, despite setbacks in donor support owing to concerns about political stability and the government's worsening record on human rights.[47] Peru completed the RAP in March 1993, by which time it had accumulated the full amount of the Fund's commitment. At that time, Japan and the United States advanced bridge loans so Peru could settle its arrears. Immediately afterward, the Executive Board approved a three-year Extended Fund Facility arrangement totaling $1.4 billion (SDR 1,018.1 million, or 218 percent of Peru's quota). Almost $890 million (SDR 642.7 million) was disbursed right away, so Peru's outstanding indebtedness was nearly constant (see Figure 16.5) but was made current with a new seven- to ten-year repayment schedule. The combination of strong economic policies and new official and commercial financing enabled Peru to forgo any further drawing on the Fund arrangement through 1996.[48]

[46]Decision No. 9678-(91/38); minutes of EBM/91/38 (March 15, 1991), p. 36.

[47]In April 1992, international condemnation was widespread after Fujimori dissolved the Congress in what became known as the *autogolpe* (auto-coup). New elections were held in November, but a further delay in the arrangement with the IMF resulted when the new U.S. administration under President Bill Clinton raised objections to human rights abuses in Peru.

[48]After making one last drawing on a new extended arrangement in 1997, Peru had no further recourse to loans from the IMF during the next decade. It completed the timely repayment of these loans in 2007.

Figure 16.6. Cambodia: Use of Fund Credit, 1972–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics; see Figure 16.2 for further explanation.
Note: CFF = Compensatory Financing Facility; ESAF = Enhanced Structural Adjustment Facility; GRA = General Resources Account; STF = Systemic Transformation Facility.

Cambodia

At the start of the 1990s, Cambodia had been in arrears on its payments to the IMF far longer than any other member country—ever since the Khmer Rouge temporarily took control of the country in April 1975 (Figure 16.6). Throughout the horrors and upheavals of the next 15 years, including 10 years of Vietnamese occupation, Cambodia lacked an internationally recognized government, and the IMF lacked any channel for official communication with the member.

The withdrawal of Vietnamese forces in 1989 did not immediately open an acceptable line of communication, but it did create an opportunity for incremental progress. The government-in-exile, then based in Thailand, was led by Prince Norodom Sihanouk, the former king who had ruled Cambodia for nearly three decades from 1941 to 1970. At this time, Sihanouk was receiving some support from the United States and was widely seen as the best hope for a return to normalcy. In June 1991, Sihanouk wrote to Camdessus to request the "readmission" of Cambodia into the IMF "as soon as possible." Camdessus welcomed the initiative, but he responded noncommittally: "We are watching events in your country with great interest, and welcome the significant progress being made towards peace. We look forward to the emergence of a

representative, national government and the normalization of relations with the Fund."[49]

The critical event enabling this normalization was the signing of a comprehensive peace treaty by all of the involved parties in Paris in October 1991, after which Sihanouk returned to Cambodia as head of state. Beginning in November, the United Nations (UN) and the Asian Development Bank organized a series of missions to Phnom Penh, in which Fund staff participated, to gather information about economic and political developments and offer technical assistance. Through this time, however, the Fund remained wary of dealing with a government that might not have the ability to control the economy.

The political balance in Cambodia in 1992 was delicately poised. The nominal government in Cambodia was still led by Hun Sen, who had been placed in office during the Vietnamese occupation. This government was not accepted internationally as legitimate, and under the terms of the Paris peace treaty it was under the control of the UN. The Supreme National Council (SNC), led by Sihanouk but also including representatives of the Khmer Rouge, was recognized but had no administrative control over the country. The SNC had authorized the Hun Sen government to act on its behalf as its "executive arm." It was with this fragile structure that the international community was trying to work. Only after the IMF received written assurances on the viability of the government's structure from the SNC and the UN Transitional Authority in Cambodia did the Fund agree to reestablish formal communications and take steps toward normalization and the settlement of arrears. That development occurred in October 1992.[50]

After several fact-finding missions and the formal decision to normalize relations, a Fund team led by John R. Dodsworth (Division Chief, Central Asia Department) negotiated a reform and stabilization program to be monitored informally by the staff through 1993.[51] That opened a pathway for the clearance of arrears. As the first step on that path, the IMF undertook a unique set of transactions made possible by the peculiar features of the long interlude in relations from 1975 to 1992. In the late 1970s, the Fund had restituted 25 million ounces of gold to its member countries and had sold another 25 million ounces at market prices to finance the original Trust Fund for lending to low-income countries on concessional terms. Because of the absence of a line of communication, the Fund had held Cambodia's share of the proceeds on the member's behalf, pending settlement of arrears. Now, in December 1992, the Fund and Cambodia agreed the Fund would restitute the gold to the country, simultaneously buy it back at the current market price, and apply the proceeds to the outstanding arrears.

[49]"Cambodia—Relations with the Fund," EBD/91/235 (July 31, 1991); official translation from the original French.

[50]"Statement by the Staff Representative on Cambodia," EBD/92/213 (September 17, 1992); and minutes of EBM/92/127 (October 21, 1992), p. 9.

[51]"Cambodia—Overdue Financial Obligations to the Fund—Review of Decisions to Limit Use of the Fund's General Resources and Suspend Use of SDRs," EBS/92/188 (November 24, 1992).

In addition, the profits from the earlier gold sales would be applied to the partial settlement. Together, those transactions reduced Cambodia's overdue obligations to $43 million from $52 million (to SDR 31.0 million from SDR 37.3 million).[52]

To cover the rest of Cambodia's arrears settlement, France and Japan assembled a support group of six countries willing to offer grants for this purpose. Once those grants were in hand and Cambodia had made sufficient progress in establishing control over its own finances, the authorities settled their arrears in total on October 1, 1993. Three days later, the Fund lifted the restrictions on Cambodia's use of its resources and approved a $9 million (SDR 6.25 million) drawing under the terms of the STF. Subsequent drawings, as discussed in Chapter 12, were all on concessional terms, through the ESAF Trust.

Vietnam

Politics also played a major role in the rise and fall of Vietnam's payments arrears to the IMF. The problem began in 1984, when the authorities grew frustrated with the Fund's refusal to agree to provide new loans through a stand-by arrangement. Repayments were coming due on earlier loans the IMF had made from the Trust Fund and the General Resources Account (GRA). The authorities were anxious to reschedule those debts, but the Fund was unimpressed by their proposed economic policies. In addition, Vietnam's occupation of Cambodia, in effect since 1978, was not conducive to good relations with the international community. Although Vietnam had sufficient gold reserves to continue servicing its obligations to the Fund, beginning in April 1984 the authorities decided it was no longer worthwhile to do so.[53]

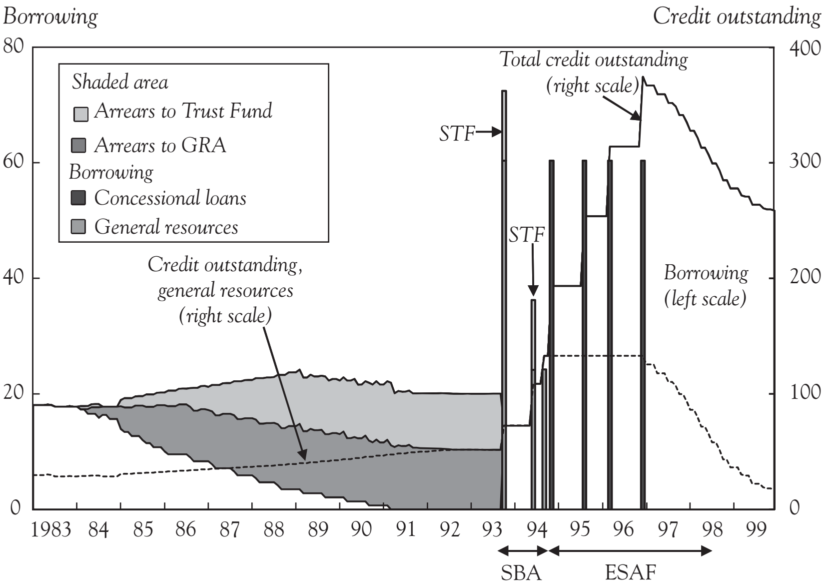
In the second half of the 1980s, Vietnam began to strengthen its economic policies, with remarkable success. As the Fund staff noted in 1991, this success was "all the more remarkable since it [was] achieved without the financial support from industrial countries and international organizations, in the face of the existence of [trade] embargoes, and despite the loss of substantial aid from" the rapidly disintegrating Soviet Union.[54] Indeed, cooperation with the Fund and the international community remained patchy. The authorities made occasional partial payments to the IMF, but arrears continued to

[52]These figures, and the data plotted in Figure 16.6, exclude SDR 6.24 million outstanding from a gold tranche purchase in September 1971 that was technically overdue but was not part of Fund credit outstanding. Before the Second Amendment to the Articles took effect in April 1978, members were obligated to repurchase such drawings on an agreed-on schedule if they had the means to do so. In 1975, the Fund established a schedule calling for the repurchase to be completed by August 1976, but by that time the Fund and Cambodia were no longer in communication. Under the Second Amendment, the gold tranche was renamed the reserve tranche, and the repurchase obligation was eliminated. As part of a general settlement of arrears, Cambodia could have repaid the gold tranche drawing and immediately taken out a reserve tranche drawing in the same amount.

[53]For more on these developments, see Boughton (2001), pp. 766–70.

[54]"Viet Nam—Staff Report for the 1991 Article IV Consultation," SM/91/225 (November 25, 1991), p. 19. For a detailed assessment of the economic progress, see Dodsworth and others (1996).

Figure 16.7. Vietnam: Use of Fund Credit, 1983–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics; see Figure 16.2 for further explanation.
Note: ESAF = Enhanced Structural Adjustment Facility; GRA = General Resources Account; SBA = Stand-by arrangement; STF = Systemic Transformation Facility.

accumulate (Figure 16.7). Despite the withdrawal of Vietnamese forces from Cambodia in 1989, the United States persisted with the trade embargo it had imposed during the war that had ended in 1975. By this time, the U.S. goal—driven by domestic politics—was primarily to force cooperation on efforts to identify the remains of missing U.S. personnel and to ensure Vietnam no longer held any prisoners of war. Other major countries, notably France and Japan, took a more positive view of economic and political developments in Vietnam, but U.S. opposition was strong enough to block a settlement.

When the Executive Board met in December 1991 to conclude the Article IV consultation with Vietnam for that year, most Directors were eager to resolve the impasse.

The French and Japanese governments had assembled a group of donors prepared to finance the settlement of Vietnam's arrears, and almost everyone agreed the country's economic progress deserved international support. No one was prepared to move, however, until U.S. opposition softened.[55] At the Board meeting, while other Directors expressed at least lukewarm support, Quincy M. Krosby (Alternate, United States)

[55]Miyashita (2003), Chapter 5, provides a thorough analysis of the influence of U.S. pressure on Japan in delaying the restoration of diplomatic relations with and financial support for Vietnam.

complained about Vietnam's "misplaced ambivalence about the virtues of market mechanisms and a lingering attachment to centralized control." E.A. (Ted) Evans (Australia) showed his exasperation with that view by calling it "poorly informed." In his view, Vietnam's difficulties resulted "not because of a lack of effort on the part of the Vietnamese authorities, but because of the decision of the international community not to provide the financing that would allow Vietnam to adopt a comprehensive program." In the end, Camdessus observed that there was "very broad—though not as yet unanimous—support to move forward in the normalization of Vietnam's international financial relations," and he promised the Vietnamese and the Board they could "count on my personal effort to this end."[56]

The change of U.S. administration that occurred in January 1993 allowed relations to improve. The Vietnamese government responded with a more welcoming attitude toward American efforts to find and identify the remains of missing personnel. Before the year was out, on October 5, 1993, Vietnam settled all of its arrears, and the IMF prepared to resume lending.[57]

Vietnam's arrears—to the GRA, the Trust Fund, and the SDR Department—totaled about $142 million (SDR 100.2 million). The nine countries in the support group provided grants totaling $55 million, and the rest was made possible by a bridge loan syndicated by agencies in France and Japan. On October 6, the IMF disbursed a $17 million (SDR 12.1 million) loan through the Systemic Transformation Facility (STF) and an $85 million initial drawing on a new stand-by arrangement. Those sums enabled Vietnam to repay the bridge loan.

The nearly simultaneous settlement of long-standing overdue obligations by both Cambodia and Vietnam in the first week of October 1993 signaled major progress in fulfillment of the IMF's commitment to resolve the arrears crisis of the 1980s. To mark the occasion, Camdessus made his first-ever trip to the region, with stops in Phnom Penh, Hanoi, and Ho Chi Minh City. Both in private meetings with senior political leaders and in public forums, he hailed these developments not only for marking the normalization of international relations for the two neighboring countries but also for potentially enabling the beginning of a new era of prosperity.

For the next year, the Fund lent to Vietnam through the stand-by arrangement and a second STF loan. Lending then switched to the less costly ESAF. Total indebtedness peaked at the end of 1996, after which Vietnam was able to obtain sufficient financial assistance from Japan and other development aid sources and gradually repay the Fund.

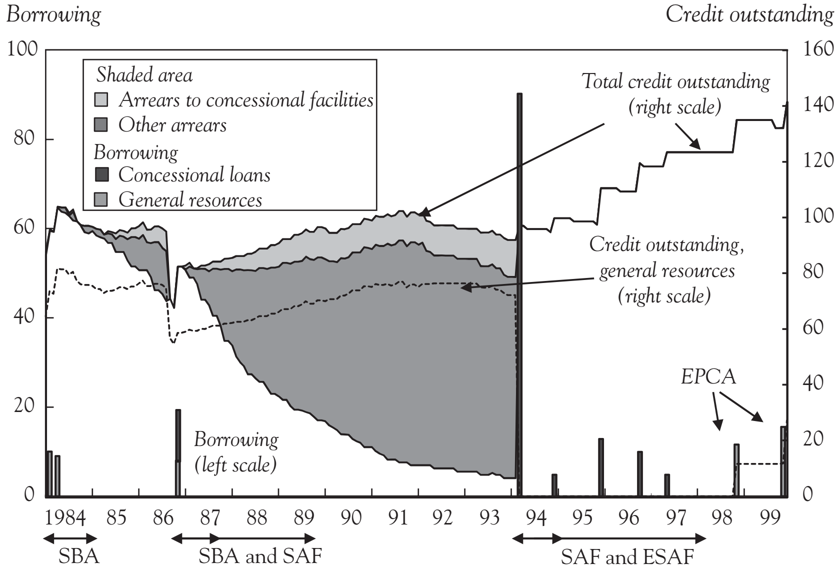
Sierra Leone

Throughout much of the 1980s, Sierra Leone struggled to implement sound economic policies and stay current on its external debts. Those efforts faltered,

[56]Minutes of EBM/91/170 (December 18, 1991), pp. 15 (Krosby), 22 (Evans), and 29 (Camdessus).

[57]The United States ended its trade embargo against Vietnam in February 1994. Formal diplomatic relations were established in July 1995.

Figure 16.8. Sierra Leone: Use of Fund Credit, 1984–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics; see Figure 16.2 for further explanation.
Note: EPCA = Emergency Postconflict Assistance; ESAF = Enhanced Structural Adjustment Facility; SAF = Structural Adjustment Facility; SBA = Stand-by arrangement.

however, and arrears continued to accumulate; the IMF declared the country ineligible for further borrowing in April 1988.[58] In the second half of 1989, Sierra Leone resumed making small payments, though not enough to keep arrears from rising (Figure 16.8). The authorities also entered into discussions with Fund staff with the aim of further strengthening policies. Although a few creditor countries, especially the United States, were skeptical of these moves, the Executive Board adopted a relatively relaxed posture aimed at encouraging the reformers within the government.[59]

The staff and the authorities met frequently in 1990 and 1991 to develop a program for the Fund to endorse and for donor countries to support. That effort culminated on April 3, 1992, when the Executive Board approved Sierra Leone as the third country (after Zambia and Peru) to have a RAP. The World Bank organized an informal support group of donor countries to coordinate financial assistance while Sierra Leone tried to carry out the Fund-monitored program. Unfortunately, during this same period

[58]See Boughton (2001), pp. 792–95.

[59]See in particular the minutes of EBM/90/51 (April 2, 1990), where Directors reluctantly accepted a U.S. proposal to add language to its conclusions noting that the Fund "regrets the recent policy slippages," but declined to accept other amendments that would have threatened further punitive actions.

the country was descending into a social and political abyss. A rebel group based in neighboring Liberia began an armed insurrection in March 1991, gradually taking control of more and more territory. As the government's grip on power started to slip, a military coup overthrew the government in April 1992, just weeks after the IMF's approval of the RAP.

The military government, constituted as the National Provisional Ruling Council, continued the civilian government's policy of cooperating with the Fund and implementing the RAP. Despite the ongoing insurrection—linked to the Liberian outlaw, Charles Taylor, and employing increasingly brutal acts of terrorism—the authorities successfully completed the program in less than two years. With help from bridge loans provided by France, Norway, and the United States, Sierra Leone settled its arrears on March 28, 1994.

The $120 million Sierra Leone repaid in 1994 was mostly the principal and interest on stand-by arrangements from the 1980s, plus a relatively small amount from a 1986 Structural Adjustment Facility (SAF) loan. The imperative now was to switch to loans on concessional terms that would be less likely to drive the country back into an unsustainable debt burden. On the same day that Sierra Leone repaid its old loans, the Executive Board approved new loans through the SAF ($38 million available immediately) and the ESAF ($125million, of which $89 million was available immediately).

Much of the initial disbursement of these heavily front-loaded arrangements was used to repay the bridge loans. As is evident in Figure 16.8, this series of actions left Sierra Leone's indebtedness virtually unchanged. The benefits were to reschedule the debt into a lower-cost and longer-maturity form, to put economic policies on a sustainable and positive path, and to establish the preconditions for a resumption of donor support.

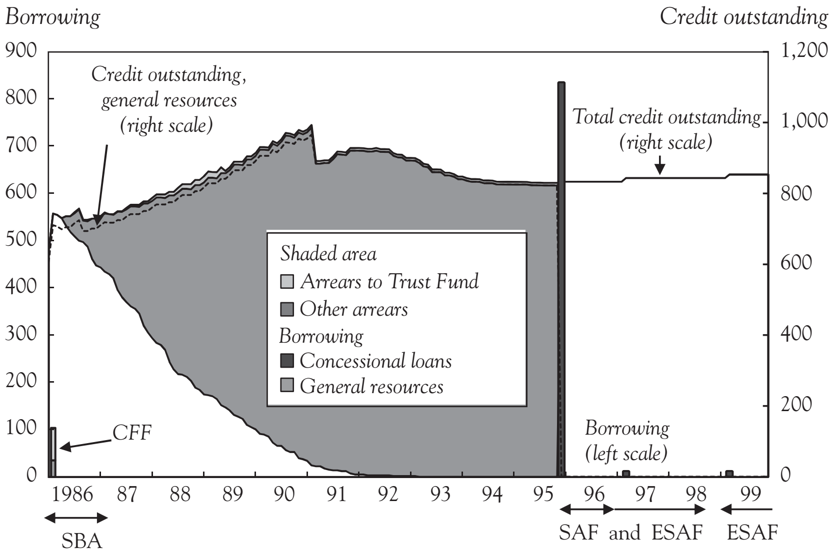
For the rest of the 1990s, relations between Sierra Leone and the IMF proceeded smoothly, notwithstanding the horrors of the ongoing insurrection with which a series of governments had to cope.[60] The policies the Fund supported with a four-year ESAF arrangement were carried out successfully. In November 1998, as the insurrection finally was being brought under control, the Fund began providing emergency post-conflict assistance from its general resources. Those loans were repaid on schedule, and the Fund continued to assist the country through the Poverty Reduction and Growth Facility (the ESAF successor) in the following decade.

Zambia

The first country to be approved for a RAP, but the third and final one to complete the program in the 1990s, was Zambia. A collapse in the world copper market in

[60]The first multiparty elections were held in 1996. That government was overthrown in 1997, and a military junta ruled for some 10 months until a multilateral force led by Nigerian troops reinstated the elected officials. The 1997 coup led to attacks on the IMF's Resident Representative and his family, who had to be rescued and evacuated; see Chapter 17, p. 894.

Figure 16.9. Zambia: Use of Fund Credit, 1986–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics; see Figure 16.2 for further explanation.
Note: CFF = Compensatory Financing Facility; ESAF = Enhanced Structural Adjustment Facility; SAF = Structural Adjustment Facility; SBA = Stand-by arrangement.

the 1980s hit this copper-exporting country hard, and the government tried but ultimately failed to put in place a program of sustainable economic policies. As payments arrears accumulated, the Fund reluctantly but unavoidably declared Zambia ineligible for further borrowing in September 1987.[61]

After the declaration of ineligibility, Zambia shifted to more stringent policies, but decided initially to rely heavily on trade and exchange restrictions to strengthen the balance of payments. By late 1988, these controls were leading to widespread smuggling and other underground activity. Inflation rose sharply, as did the fiscal deficit. Zambia's long-serving president, Kenneth Kaunda, then shifted gears again, aiming to promote stability and growth through more conventional means even if it meant taking draconian measures with major social consequences. In the first half of 1989, he tripled the price of maize (a diet staple that was in short domestic supply), introduced rationing coupons, cut the foreign exchange value of the currency in half, and lifted price controls on a wide range of consumer goods. The government negotiated a Policy Framework Paper with the Fund and the World Bank, which the institutions approved in September 1989 as a basis for new lending on concessional terms once arrears were

[61]These developments, through 1987, are covered in Boughton (2001), pp. 787–91.

cleared.[62] In the meantime, however, Zambia's arrears were continuing to pile up (Figure 16.9).

By the beginning of 1990, the staff (led by K. Burke Dillon, Assistant Director, African Department) and the authorities agreed on all of the policy elements for a Fund-monitored program. Potential donor countries formed a Consultative Group, and the Paris Club agreed to consider rescheduling some bilateral debts. Despite the continuation of arrears, the IMF resumed providing technical assistance, and it reopened the Resident Representative office in Lusaka, which had been vacant since 1987. In the absence of new external finance, however, domestic opposition to Kaunda's policy initiatives began to swell. Deadly riots broke out in June 1990, sparked mainly by the sharp increases in food prices.

Progress continued, but in fits and starts. Almost immediately after the Executive Board approved the operational terms of the rights approach, it agreed in principle to accept Zambia as the first country to qualify for a RAP. The policy framework was already in place, and the formation of the Consultative Group gave some assurance that the program could be adequately financed without an injection of cash from the IMF. Formal approval of the RAP, however, was delayed until April 1991, shortly after Zambia cleared its arrears with the World Bank. That settlement made Zambia eligible for financial assistance both from donors and from the World Bank's Special Program of Assistance for Africa. That financing assurance made it possible, in turn, for the Fund to make its own forward commitment through the RAP.[63]

As the economy continued to weaken under the weight of a severe drought that decimated maize output, domestic unrest continued to build against the government. In response, Kaunda—Zambia's only president since independence in 1964—decided to restore multiparty democracy and open discussions that would produce a new constitution. Unfortunately for him, he and his party lost the elections, and a new government under Frederick Chiluba took office in November 1991. In the meantime, policy implementation slipped badly during the election season, and Zambia's payments to the Fund fell short of the targets required under the RAP. In October 1991—four weeks before the elections—the Executive Board expressed its "deep regrets" and disappointment at the slippages and declined to approve any accumulation of rights.[64]

Once Chiluba was in office and had put new policies in place, the authorities and the IMF agreed to scrap the original RAP and replace it with a new program that would run through 1995. From that point on, progress was steadier and more evident, though still slow. The Fund granted a number of waivers in 1993 and 1994 and extended the time limit on several occasions in 1995 to keep the program alive and allow Zambia to

[62]See "Zambia—Staff Report on Economic and Financial Program for 1990," EBS/90/21 (February 13, 1990).

[63]See "Zambia—Staff Report for the 1991 Article IV Consultation and Request for Accumulation of Rights," EBS/91/59 (April 3, 1991); minutes of EBM/91/55 and EBM/91/56 (April 17, 1991); and PR/91/20 (April 17, 1991).

[64]Minutes of EBM/91/137 (October 2, 1991).

keep accumulating rights. Finally, in December 1995, all elements came together and Zambia successfully completed the program.

On December 6, 1995, the Executive Board made several decisions that helped normalize relations. It took note of Zambia's repayment of all overdue obligations, totaling more than $1.2 billion (SDR 830.2 million), which had been temporarily financed by single-day bridge loans from 11 donor countries. It lifted the ban on new loans to Zambia. It approved a one-year SAF arrangement and a three-year ESAF arrangement, and it approved immediate disbursement of almost all of that commitment as a way of encashing the rights Zambia had accumulated since 1992. At the end of the day, Zambia had no remaining obligations to the Fund's general resources,[65] it was able to repay all of the bridge loans, and its new loans from the Fund (totaling SDR 833.4 million) were all on concessional terms and would not fall due for several more years.[66]

These large up-front transactions—the largest single use of the IMF's concessional resources in the 1990s—made some donors to the ESAF Trust nervous. At the Board meeting to complete the RAP, Hachiro Mesaki (Japan) worried about Zambia's "unsatisfactory track record" and the consequent "extremely high" risk being shouldered by the creditors of the ESAF Trust. The Fund had pledged the use of up to 3 million ounces of gold (worth about $400 million at then-current prices) to cover that risk, but Mesaki found it "questionable whether 3 million ounces is sufficient to cover the increased risk." A few other creditors supported him, but the Board as a whole was willing to set those concerns aside, give Zambia the benefit of the doubt, and declare the strengthened arrears strategy to be a success.[67]

Setbacks: Unresolved Cases from the 1980s

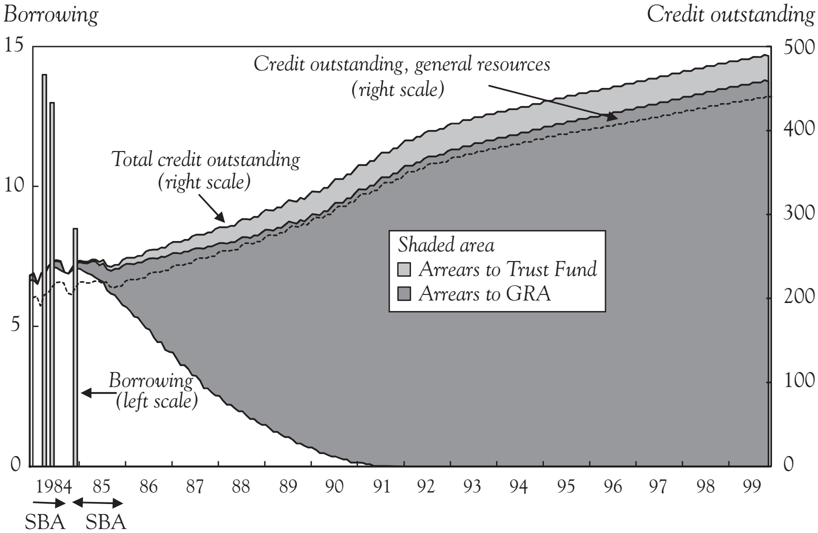
Although most of the countries with outstanding arrears at the onset of the 1990s cleared them within a few years, three major cases proved to be much more difficult. All three—Liberia, Somalia, and Sudan—resumed making some payments, but arrears continued to accumulate. In each case, political instability and a breakdown of civil order underlay the country's economic and financial shortcomings.

[65]On December 6, for technical reasons, the Fund allowed Zambia to make an outright purchase from the GRA. That purchase was repaid as soon as an equivalent disbursement was made on the ESAF arrangement.

[66]The reason for including the SAF instead of making all of the new loans through the ESAF was that the SAF still had a balance of SDR 181.75 million available to lend. That full amount was lent to Zambia, and the facility was then terminated. For more details, see Chapter 13.

[67]Minutes of EBM/95/114 (December 4, 1995). Mesaki's statement is on pp. 26–28. Zambia continued to draw on ESAF and Poverty Reduction and Growth Facility resources over the next decade and more, but it did not again go into arrears.

Figure 16.10. Liberia: Use of Fund Credit, 1984–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics; see Figure 16.2 for further explanation.
Note: GRA = General Resources Account; SBA = Stand-by arrangement.

Liberia

The IMF lent heavily to Liberia in 1980–84, as the United States and other major creditors eagerly supported the government's attempts to recover from the social and economic instability of the previous decade. Disillusionment set in on all sides at the end of that period. Liberia stopped paying the Fund right after the Executive Board approved a new stand-by arrangement; the United States canceled a planned grant to the government; and the Fund stopped disbursing on the arrangement.[68] For the next several years, until 1990, Liberia made a number of small payments, but far less than the amounts coming due. By 1990, almost all of Liberia's debt to the Fund was overdue (Figure 16.10), and prospects for servicing it were being threatened by a civil conflict that would continue throughout the rest of the decade and beyond.

An insurrection against the Liberian government began in December 1989, led by Charles Taylor, a vagabond warrior who was a fugitive from U.S. justice and was under Libyan patronage. Taylor's forces quickly took control of most of the country except for the capital, Monrovia. While this assault was under way, an IMF mission tried to carry on discussions as usual in Monrovia. The result bordered on the surreal, as the staff

[68]The deterioration that led the Fund to declare Liberia ineligible to borrow is covered in Boughton (2001), pp. 774–77.

reported to headquarters that "ongoing rebel activity in the north of the country . . . had reportedly distracted senior officials from focusing on economic policy matters." The staff also complained that the government had just purchased a jet airplane it could ill afford, and it was negotiating to settle arrears with the African Development Bank while making only token payments to the Fund. For those and other reasons, the staff concluded, "Liberia cannot be considered as actively cooperating with the Fund toward resolving the problem of its arrears to the Fund."[69]

From the Fund's perspective, the salient point was not that the authorities were unable to act in the middle of a political and military crisis, but rather that they had failed to act responsibly for more than five years. The March 1990 review was the tenth consecutive semiannual review of Liberia's arrears, and the Executive Board had little patience left. At the Board meeting, the decision to issue the Fund's first-ever "declaration of noncooperation" was a foregone conclusion. The only real controversy was its wording. The staff proposed stressing that the declaration was but one stage in an escalating series of measures the Fund might take. Specifically, the final paragraph of the draft decision noted that the Board would hold another review by the end of August 1990. "In the event that Liberia has not resumed active cooperation with the Fund . . ., the Fund will give consideration at that time to the initiation of procedures leading to the compulsory withdrawal of Liberia from the Fund."[70]

A few Directors were squeamish about making this threat in a public declaration. As a message to the authorities, its purpose was clear enough. Whether the threat should be made public was another matter. On that reasoning, Markus Fogelholm (Finland) proposed deleting from the public declaration any reference to compulsory withdrawal. Ultimately, however, a majority of the Board preferred to adhere to the staff proposal.[71]

Before the Fund could conduct a further review and initiate procedures leading to expulsion, the security situation in Liberia worsened dramatically. Taylor's rebel forces soon reached Monrovia, at which point they captured, tortured, and assassinated President Samuel Doe. A breakaway rebel faction then challenged Taylor, and the two forces settled into a devastating civil war that left Liberia in anarchy for several years. In those circumstances, the Fund had no choice but to put consideration of further

[69]"Liberia—Overdue Financial Obligations to the Fund—Further Review Following Declaration of Ineligibility," EBS/90/51 (March 19, 1990), pp. 7, 8, and 11.

[70]"Liberia—Overdue Financial Obligations to the Fund—Further Review Following Declaration of Ineligibility," EBS/90/51 (March 19, 1990), p. 13.

[71]Minutes of EBM/90/49 and EBM/90/50 (March 30, 1990).

measures on hold until a government could be formed and establish relations with the international community.[72]

Sudan

Sudan fell behind in its repayments to the IMF in 1984, continued to pile up overdue obligations for another decade, and stayed in arrears for more than a quarter-century. The origins of the problem, as detailed in Boughton (2001, pp. 777–83), were economic, but the perpetuation was political. Throughout much of the 1970s, Sudan enjoyed ready access to loans from major international banks eager to help finance cotton exports and the exploitation of major petroleum reserves. As the cotton sector weakened in response to a sustained drop in world prices and domestic inefficiency, banks began pulling out their investments. The IMF stepped in with a series of loan programs from 1978 through 1984. That rescue effort appeared to be working until civil war erupted in 1984 and culminated in a coup d'état the following year. Attempts by IMF management and donor countries to negotiate a solution to the arrears problems with the new government eventually broke down, and in February 1986 the Executive Board declared Sudan ineligible to use Fund resources.

No progress was made over the next three years, despite occasional agreements on policy adjustments. The Fund maintained a resident office in Khartoum and regularly sent staff missions, but agreement on policies was elusive. Sudan made occasional payments to the Fund that were just a small percentage of amounts falling due, while it continued to service obligations fully to the World Bank and other creditors. The authorities insisted they were trying to cooperate while confronting terrible economic circumstances. Their payments to other creditors were necessary to preserve a flow of food and other essential imports. The World Bank, they noted, was providing net new loans in exchange for the repayment of earlier credits, while the Fund was making no such promises.[73] Although most of the Fund's Executive Directors empathized with the immense challenges Sudan faced, including prolonged droughts and a devastating civil war, they concluded that the fundamental problem was still the government's failure to carry out adequate economic policy reforms.

[72]Matters continued to deteriorate for several more years, and in March 2003, the Fund suspended Liberia's voting rights. The civil war ended a few months later, after which a spirit of cooperation returned. By then, the Liberian economy was in desperate condition, but the government resumed making small repayments on its long-overdue loans. In 2006, following the democratic election of Ellen Johnson-Sirleaf as president, the Fund agreed to a staff-monitored program, and it began to unwind the remedial measures taken earlier. Liberia repaid its arrears in March 2008 with help from bilateral donors, and the Fund responded by fully restoring Liberia's rights.

[73]The staff analysis of the impasse was summarized in "Sudan—Overdue Financial Obligations to the Fund—Further Review Following Declaration of Ineligibility," EBS/90/133 (July 16, 1990). The Sudanese authorities' views were conveyed to the Fund by their Executive Director, El Tayeb El Kogali, at EBM/90/119 (July 23, 1990).

The strengthened arrears strategy adopted in July 1989 gave the Fund new leverage with which to try to pull or push the authorities into a more productive and cooperative stance. The policy dialogue and the promise of technical assistance were the carrots. If they failed to induce the desired response, the remedial sticks would come into play. By mid-1990, the Fund was convinced Sudan was not responding adequately, and it prepared to take further action against the country.

In July 1990, Camdessus proposed that the Fund should declare publicly that Sudan was not cooperating. As described above, the Fund had made such a declaration only once before, with regard to Liberia. In this case, the Executive Board was hesitant to act because many Directors thought Sudan was genuinely trying but lacked the resources to do more. After several hours of debate, the Board agreed to give the authorities two more months to improve policies and increase the flow of payments to the Fund. In September, after a further staff mission concluded the situation was not going to improve, the Fund issued its second declaration of noncooperation. In contrast to the declaration on Liberia, however, the Board softened the message a bit by pointedly omitting any reference to this being a step toward compulsory withdrawal. Instead, the declaration noted only that if Sudan did not resume "active cooperation . . ., the Fund will give consideration to the initiation of further procedures in accordance with the strengthened arrears strategy within nine months of the date of this decision."[74]

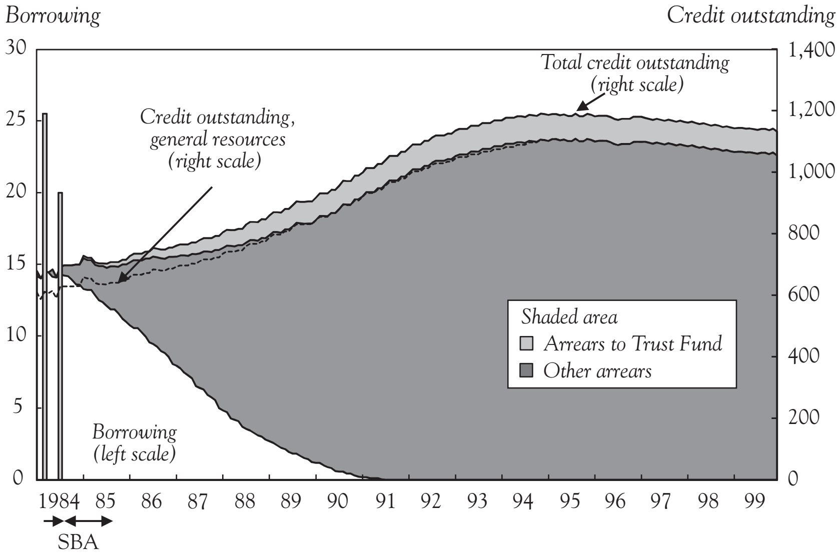
During the next two years, relations between Sudan and the Fund gradually improved. By the middle of 1992, economic conditions were on much more solid footing (good output growth driven by favorable agricultural conditions; moderate price inflation), and macroeconomic policies appeared to be sustainable. In response, the Fund was monitoring policy implementation and was open to considering a RAP if Sudan would agree to avoid any further accumulation of arrears.[75] That requirement, though, was becoming much harder to meet. Sudan now owed the Fund more than $1.5 billion, all of which was in arrears (Figure 16.11). Annual interest and related charges were expected to total more than $60 million a year, or about 20 percent of Sudan's total export earnings. Moreover, Sudan had about $11 billion in other external debt also in arrears. Sudan simply could not service these debts and avoid further accumulation of arrears without substantial and continuing aid from donor countries.

Donors were totally disillusioned with Sudan. The military government in Khartoum, led by General Umar al-Bashir, was employing increasingly harsh tactics to try to win the civil war and impose control over the whole country. Bashir's stated support for Iraq's invasion of Kuwait in 1990 further alienated the regime from the international community. As a result, one country after another sharply reduced aid, and by

[74]The decision was adopted on July 23, 1990, and it took effect without further deliberation by the Executive Board on September 14; see minutes of EBM/90/120 (July 23, 1990), pp. 8–9; and EBM/90/142 (September 14, 1990), p. 3.

[75]See "Sudan—Overdue Financial Obligations to the Fund—Further Review Following Declaration of Ineligibility," EBS/92/195 (November 30, 1992).

Figure 16.11. Sudan: Use of Fund Credit, 1984–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics; see Figure 16.2 for further explanation.
Note: SBA = Stand-by arrangement.

late 1992 Sudan was receiving only enough assistance to cover the population's most basic food requirements. Until a measure of political respectability could be restored, no resumption of donor support could be expected. Without donor support, Sudan had no hope of normalizing its relations with the IMF.

In the first half of 1993, Sudan's payments to the Fund slowed to a trickle, and implementation of economic policies worsened. As the staff-monitored program lapsed, management began considering further actions. The adoption of the Third Amendment in November 1992 made it possible to take some additional intermediate steps without rushing too rapidly toward the ultimate step of expelling the country from Fund membership. In particular, the member's voting rights could be suspended if the Fund determined the authorities had been failing to cooperate over an extended period. The Managing Director issued a complaint to that effect in June 1993, and in August the Board took the strongest action it had yet taken in a case of protracted arrears.

The Board meeting of August 6, 1993, was an extraordinary occasion. Both the minister of finance and the central bank governor came from Sudan to plead for sympathy and understanding and to state unequivocally their desire to cooperate and remain in good standing with the Fund. Directors were moved by the suffering of the Sudanese people, but most were convinced the solution rested with the authorities in Khartoum, not with the international community. The decision to suspend Sudan's

voting rights did not, however, come easily. Several chairs expressed their reluctance and regret, and some noted dissent within their own constituencies. Four chairs—the constituencies led by Egypt and the Islamic Republic of Iran, and both of the sub-Saharan African groups—voted against the proposed decision, and three others—China, France, and the Russian Federation—abstained. Suspension required approval of 70 percent of the voting power, and passage hung in the balance until the very end of the meeting. The Executive Director for India, K.P. Geethakrishnan, tried to muster a simple majority for postponing a decision until another staff mission could reassess prospects for an improvement. When that effort failed, he "very reluctantly supported the proposed decision." With that, the proposal was adopted with 71.6 percent in favor.[76]

For the next several months, little progress was evident. In April 1994, the Managing Director issued a further complaint that Sudan had "persisted in its failure to fulfill its obligations under the Articles of Agreement." As the Board prepared to consider that complaint and initiate procedures that would lead eventually to the expulsion of Sudan, the Bashir government committed itself to do whatever was required to truncate that process. At the end of April, at the request of the authorities, the Fund sent Paul Chabrier (Director, Middle Eastern Department) and a few other staff to Khartoum. That visit led to an agreement by the authorities to increase their payments to the Fund substantially, to stabilize and begin to reduce the total balance outstanding.[77] Doing so took several more months, but Sudan's arrears finally peaked in November, after which they declined very slowly (see Figure 16.11). In January 1995, as a gesture of *détente*, the Fund resumed providing technical assistance to Sudan.

Despite this renewed cooperation, the Fund applied further pressure in 1996. Although Sudan had continued making payments, the timing had become sporadic. Policy implementation was similarly spotty. The best that could be expected at this point was for the stock of outstanding obligations to creep down very gradually. Accordingly, the staff concluded Sudan "has not strengthened cooperation with the Fund in seeking a solution to the problem of its overdue financial obligations to the Fund," and the Managing Director asked the Executive Board to consider compelling the member to withdraw.

The Board discussed the matter in February 1996, but Directors were deeply divided between those who wanted to give a positive response to Sudan's modest but encouraging efforts and those who wanted to send a strong signal that protracted arrears would not be tolerated. Stanley Fischer (First Deputy Managing Director), who was chairing the meeting, reminded the Board its options were actually limited. If the Board recommended expelling Sudan but the Board of Governors failed to approve it by the required 85 percent majority, the Fund's credibility and effectiveness could suffer.

[76]Minutes of EBM/93/142 (August 6, 1993).

[77]See "Complaint under Article XXVI, Section 2(c) with Respect to Compulsory Withdrawal of Sudan from the Fund," EBS/94/77 (April 8, 1994); and minutes of EBM/94/43 (May 16, 1994), p. 23.

Moreover, if the Fund did expel Sudan, it would lose any chance of recovering the outstanding balances, and the whole membership would pay a heavy price. After much debate, the Board agreed unanimously to state "that it would expect to recommend that . . . the Board of Governors require Sudan to withdraw from the Fund unless the Executive Board determines by August 2, 1996 that Sudan has strengthened its cooperation with the Fund." Thus, the Fund put Sudan on notice that it had just six months to make substantial progress.[78]

Sudan made considerable efforts to improve its economic performance and whittle away at the arrears. Beginning in 1997, the Fund responded by providing technical assistance and monitoring policy implementation. After two years during which Sudan managed to reduce its outstanding arrears slowly but steadily, the Fund agreed to begin de-escalating its remedial measures. The United States objected strongly because it considered Sudan's economic policies inadequate and its record of payments to the Fund weak. De-escalation, in the view of the U.S. chair, was "ill-advised." The United States therefore voted against easing up on Sudan, but it received no support from other Executive Directors. As Stephen Collins (Alternate, United Kingdom) remarked, "this cooperative strategy is sort of a carrot and stick, and I think more of the carrot is appropriate in this case, within limits."[79]

Eliminating Sudan's huge arrears was impossible as long as Sudan remained politically isolated from the international community, but the Fund recognized the need to reward the authorities' efforts to cooperate. On August 27, 1999, the Board terminated the declaration of noncooperation and established a plan to restore the country's voting rights the following year.

Somalia

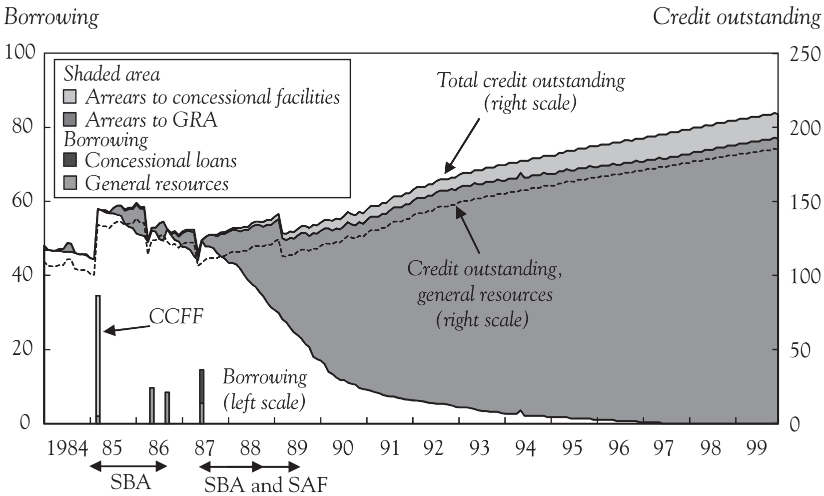
The IMF lent heavily to Somalia in the early 1980s. The country's policies were reasonably sound then, but external shocks were battering its economy. Even though the authorities fell behind in servicing their debts several times through the middle of the decade, the Fund kept lending until 1987 out of a conviction the government—besieged by an insurgency as well as by economic shocks—deserved international support. Performance then deteriorated rapidly, and from July 1987 Somalia was no longer able to keep up with the repayment schedule. In May 1988, the Fund declared Somalia ineligible for further borrowing (Boughton, 2001, pp. 795–98).

For the next two years, the authorities worked diligently with the staffs of the IMF and the World Bank to prepare a Policy Framework Paper. That effort succeeded and

[78]Minutes of EBM/96/10 (February 13, 1996). Fischer's warning is on p. 38. The formal decision is on pp. 41–42.

[79]Minutes of EBM/99/94 (August 27, 1999), pp. 108–50. The U.S. statement, delivered by S.P. Donovan (Advisor to the Executive Director), is on pp. 135–37. Collins's remarks immediately follow Donovan's. The de-escalation decision, with the United States voting no, is at the end.

Figure 16.12. Somalia: Use of Fund Credit, 1984–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics; see Figure 16.2 for further explanation.
Note: CCFF = Compensatory and Contingency Financing Facility; GRA = General Resources Account; SAF = Structural Adjustment Facility; SBA = Stand-by arrangement.

put Somalia in position for new loans if it could obtain the resources to settle its arrears. The Italian government formed a donors' support group, and for a brief moment Somalia's prospects seemed to be brightening. Tragically, by 1990 the country's persistent economic stagnation was resulting in political chaos as a variety of warlords began staking claim to territories around the country. When the IMF Executive Board met in October 1990 to review Somalia's overdue obligations, the government was rapidly losing control. Although Somalia had—almost miraculously, considering the circumstances—paid $1.35 million to the Fund since the previous review, that amount was not nearly enough to stabilize arrears (Figure 16.12). Because the authorities were making an effort but were unable to deliver either on payments to the Fund or on policy implementation, the Fund sought to find an appropriate middle ground in its response. The Board decision referred to "the absence of Somalia's active cooperation with the Fund," but it postponed a decision on issuing a formal declaration of noncooperation.[80]

That was the last review of Somalia's arrears for many years. Rebel forces overthrew the government in January 1991 but were unable to establish an effective replacement.

[80]Minutes of EBM/90/154 (October 26, 1990), pp. 51–52.

From that point on, Somalia had no recognized authority with whom the IMF could communicate.[81] All further remedial actions were put on hold.

More Setbacks: New Cases of Arrears

In addition to the difficulty of resolving old cases of arrears, the Fund had to cope with several fresh developments. Most of the new cases arose as a result of severe internal political and security problems. All of these new arrears were settled, either within the decade or shortly thereafter.[82]

The Dominican Republic

As discussed in Chapter 9, the Dominican Republic suffered a debt crisis in 1989 that led it to suspend payments to the IMF and other creditors. The authorities continued to work with Fund staff to try to resolve the problem, so neither management nor the Executive Board wanted to force the issue by taking a strong position. This cooperation resulted in a settlement of overdue obligations in August 1990, but the country missed the next payment and began rebuilding arrears (Figure 16.13).

By any reasonable standard, the Dominican Republic—a small island economy, vulnerable to external shocks, and with an income level on the border between low- and middle-income classification—was making a strong effort to stay current on its debt service. Its payments to the Fund were steadily reducing the total outstanding, though not adequately to keep up with the required schedule. The authorities were working with the staff, led by Claudio Loser (Deputy Director, Western Hemisphere Department), to develop an acceptable policy program for the coming year. Nonetheless, the prospect of a new wave of arrears cases worried many of the Fund's major creditor countries, and they were determined to take a firm stand to bring early closure to this one.

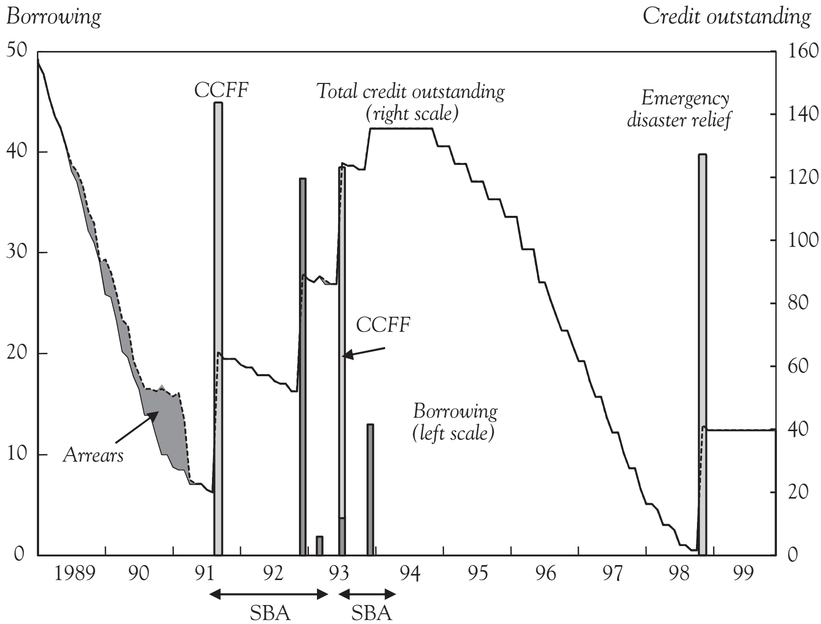
Camdessus preferred to focus on the positive steps the Dominican Republic was taking, to make it easier for the authorities to maintain domestic political support for servicing external debt. He issued a standard complaint to the Executive Board under the Fund's Rule K-1, which would lead to a Fund decision formally suspending disbursements until the country was current on its repayments. He declined, however, to initiate a move to declare the country ineligible to use Fund resources.[83] He also

[81]In September 1992, the Chairman of the Annual Meetings received notices of delegations from two competing groups claiming to be the government of Somalia. He decided not to seat either delegation. The Executive Board then decided not to recognize a Governor for the member; see "Certain Aspects of the Fund's Relations with Haiti, Somalia, and Yugoslavia," EBS/92/242 (October 9, 1992).

[82]This review omits several countries that experienced slight temporary delays in meeting financial obligations.

[83]These measures were largely symbolic; all countries with arrears were automatically prohibited from further borrowing.

Figure 16.13. Dominican Republic: Use of Fund Credit, 1989–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics; see Figure 16.2 for further explanation.
Note: CCFF = Compensatory and Contingency Financing Facility; SBA = Stand-by arrangement.

advised against sending a letter to IMF Governors alerting them to these developments. Just a few months earlier, the Fund had adopted a new policy to send such letters (see above, p. 806). However, the Managing Director concluded in this case that the letter could create a "negative perception" of the Dominican Republic among potential donors and that it could undermine the "good prospects for an agreement" to settle arrears, strengthen economic policies, and lay the groundwork for new lending by the IMF.[84]

The Executive Board overruled Camdessus and insisted he write to Governors and inform them of the Dominican Republic's arrears to the Fund. Seven chairs, representing all of the Group of Seven (G7) countries except France, plus the Netherlands, spoke in favor of taking this action. The Dean of the Executive Board, Alexandre Kafka (Brazil), supported the Managing Director, as did the French and Mexican chairs. Other Directors were silent, and the Secretary declared the creditor group to

[84]Minutes of EBM/90/177 (December 19, 1990), p. 29. The K-1 complaint was issued on November 21, 1990, and the Board approved the suspension of access to Fund resources on December 19.

have the majority.[85] Camdessus promptly sent the required letter, couched in the mildest possible terms, to a select group of potential donors or supporters. It read, in part,

> While the Executive Board recognizes the Dominican Republic's recent efforts, it views with concern this emergence of a new case of arrears to the Fund. Executive Directors stressed that further actions by the Dominican Republic are necessary to adopt appropriate policies and to settle the overdue obligations to the Fund. They also emphasized that the international community should stand ready to provide support for such efforts. In that spirit, I would greatly appreciate any assistance [your country] . . . may be able to provide in encouraging and facilitating the efforts of the Dominican Republic to adopt a suitable adjustment program and to effect full and prompt settlement of its overdue financial obligations to the Fund. I have no doubt that your Government will support the Dominican Republic in its efforts in these respects.[86]

For the next few months, the authorities and the Fund staff continued to negotiate a new policy program the Fund could support. Along with other multilateral agencies, they also tried to solicit financial support from donor countries to help settle arrears. Although the program negotiations eventually succeeded, the fundraising effort largely failed. In February 1991, the European Commission released a previously scheduled grant of approximately $120 million for budgetary support, but no country came forward with an offer to help settle arrears to the Fund. Despite this cold shoulder, the Dominican Republic used its own available resources to settle its $33 million in arrears in March and April. The Fund then approved new loans, which were drawn and repaid on schedule.

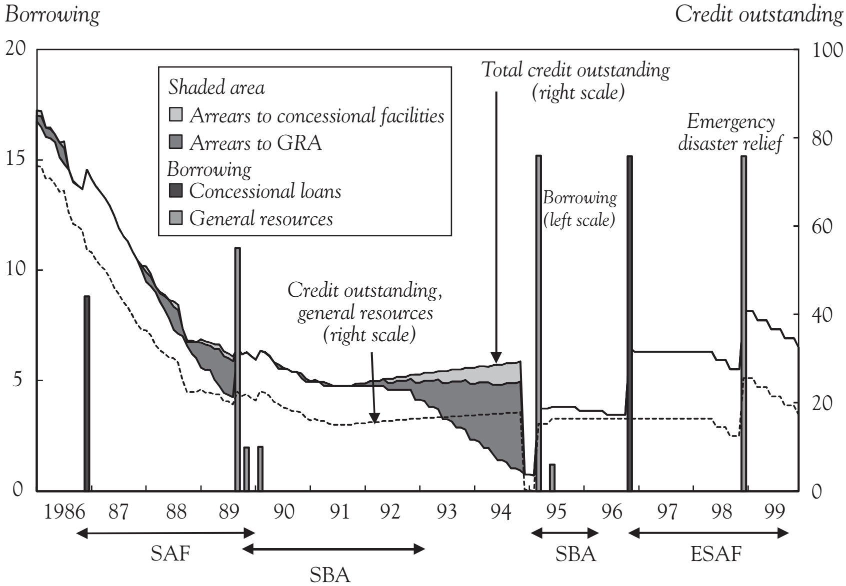
Haiti

Haiti—the poorest country in the western hemisphere, sharing the island of Hispaniola with the Dominican Republic—suffered a series of political upheavals in the 1980s and 1990s that dragged its economy down even further. From 1957 to 1986, the country was ruled by a dictatorial regime led first by François Duvalier and then by his son, Jean-Claude Duvalier ("Papa Doc" and "Baby Doc" in the popular press). Throughout that time, the IMF provided relatively small but regular financial support: 20 annual stand-by arrangements and one three-year extended arrangement, plus a series of Trust Fund loans and Compensatory Financing Facility drawings. The amounts outstanding were always manageable, peaking in 1984 at $109 million (SDR 103.3 million, or 248 percent of quota), and were repaid on time. The popular overthrow of Jean-Claude Duvalier in February 1986, brought on by the regime's increasingly brutal suppression of human rights and its inability to manage the economy, ended this fragile equilibrium.

[85]Minutes of EBM/90/177 (December 19, 1990), pp. 28–35. The seven constituencies in favor held 49.6 percent of the voting power on the Executive Board.

[86]"Dominican Republic—Communications from the Fund Regarding Overdue Financial Obligations," EBS/90/199, Suppl. 3 (December 27, 1990), p. 3.

Figure 16.14. Haiti: Use of Fund Credit, 1986–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics; see Figure 16.2 for further explanation.
Note: ESAF = Enhanced Structural Adjustment Facility; GRA = General Resources Account; SAF = Structural Adjustment Facility; SBA = Stand-by arrangement.

Initially, the IMF responded positively to Haiti's attempts to establish democracy and restart economic growth. The Executive Board approved a $25 million SAF arrangement in December 1986 and disbursed $10.6 million immediately. Over the next few years, however, the provisional governments that succeeded to power struggled to maintain enough international support to preserve fiscal balance while providing a minimum of social services to the people. They also struggled to keep up with the schedule for servicing their outstanding debts to the IMF and other creditors. In July 1988, the Managing Director notified Directors that a "curtailment of external aid flows" against "a background of political uncertainty" had made it difficult for Haiti to meet its financial obligations. Until recently, the authorities had been able to keep the delay in paying the Fund to less than a month, but now the slippage was increasing. The Board was generally sympathetic, and the Fund postponed taking any action. Haiti settled its arrears in October, and the Managing Director withdrew the complaint.[87]

[87]"Haiti—Overdue Financial Obligations to the Fund—Report and Complaint under Rule K1 and Rule S1," EBS/88/134 (July 11, 1988), p. 2; and "Haiti—Settlement of Overdue Financial Obligations to the Fund, and Withdrawal of Complaint under Rule K-1," EBS/88/173, Suppl. 3 (October 26, 1988).

Progress was short-lived. Haiti immediately missed the next payment and was in arrears for the next year. Once again, however, the government settled its accounts. In September 1989, the Fund approved a $26 million stand-by arrangement (SDR 21 million, or 47 percent of quota) and disbursed more than half of that amount at once. Haiti thus did not have to make any net payment to the Fund (Figure 16.14).

Delays began again in 1990. Meanwhile, Haiti moved toward democratic reform, holding its first free elections that year. Jean-Bertrand Aristide was elected president. He took office in February 1991 but was overthrown in a military coup in September. Political and economic chaos then overtook Haiti. In an effort to force the military to return power to the democratically elected government, the Organization of American States (OAS) imposed a trade embargo and blocked the transfer of Haitian financial assets held abroad (mostly in the United States). Although the military government told the IMF it was willing to service its debts, it obviously could not do so without first regaining access to its foreign exchange reserves. The next payments to the Fund were due in November 1991. Those payments were not made, nor were the ones that should have followed. The Managing Director responded in January 1992 by issuing a second formal complaint.[88]

Although the horrendous economic and social conditions in Haiti would have been enough justification for the country's external debt crisis, a more fundamentally political problem arose in 1991. The international community, working through the UN as well as the OAS, was determined to apply pressure on several fronts to resolve the political crisis, which meant restoring Aristide to power. As Dawson (United States) put it in September 1992, it "was the strong view of [the U.S.] authorities, and of the authorities of most countries represented in the Executive Board, that the Aristide Government was, indeed, the legitimate Government of Haiti."[89] At that time, in anticipation of the IMF/World Bank Annual Meetings, both the military government in Port au Prince and the Aristide government-in-exile had submitted credentials and requested to be represented at the meetings. The agencies referred the matter to the Annual Meetings Chairman, who in turn referred it to the Joint Procedures Committee, a broadly representative group of Governors that convenes as necessary to advise the Chairman. The committee recommended, and the Chairman agreed, not to seat the delegation nominated by the military government and instead to seat the delegation representing the government-in-exile headed by Aristide. Shortly afterward, the Executive Board also decided to deal only with the Aristide government.[90] That government, as everyone clearly understood, had no resources of its own to service the country's debts.

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[88]"Haiti—Overdue Financial Obligations to the Fund—Report and Complaint under Rule K1 and Rule S1," EBS/92/9 (January 21, 1992).

[89]Minutes of EBM/92/119 (September 16, 1992), p. 50. The Executive Director for Haiti, Alexandre Kafka (Brazil), was not present at that meeting.

[90]"Certain Aspects of the Fund's Relations with Haiti, Somalia, and Yugoslavia," EBD/92/242 (October 9, 1992), p. 2.

With these peculiar circumstances in mind, the Fund declined to take further remedial actions against Haiti. Instead, it simply waited until the political stalemate could be resolved. In September 1994, a multinational military force, led by U.S. troops and acting on a resolution of the UN Security Council, entered Haiti to restore order and return Aristide to power. With that step completed, the settlement of arrears to the Fund and other external creditors proceeded apace. The U.S. government formed a support group of nine major donor countries that provided grants totaling $643 million to enable Aristide to put the country's external accounts in order. That settlement included a payment of $36 million to the Fund, which cleared all overdue obligations.

Political instability and economic stagnation soon returned. The Fund approved a front-loaded stand-by arrangement (the twenty-second for Haiti) in February 1995 but allowed only the initial drawing and one more. An ESAF arrangement followed in 1996 but again only the first disbursement was allowed owing to a weakening of policies and a shortfall in bilateral aid inflows. The only other Fund lending in the 1990s occurred in December 1998, in the form of emergency disaster relief following a major hurricane. Nonetheless, Haiti managed to meet its repayment obligations on time.

Yugoslavia

The Socialist Federal Republic of Yugoslavia disintegrated in 1990–92, as long-standing economic weaknesses led to and were in turn reinforced by political division. The IMF, which had lent regularly to Yugoslavia throughout the 1980s, made one last attempt to support the government's stabilization efforts by approving a stand-by arrangement in March 1990. The initial drawing on that arrangement raised Yugoslavia's indebtedness to the Fund to some $686 million (SDR 527.6 million, or 86 percent of quota). As the economic and social fabric of the country began to dissolve, the Fund put further disbursements on hold. In September 1992, as the last vestiges of political cohesion were vanishing, Yugoslavia began to accumulate arrears to the Fund.

The five initial successor states—Bosnia and Herzegovina, Croatia, the Federal Republic of Yugoslavia (Serbia and Montenegro), the former Yugoslav Republic (FYR) of Macedonia, and Slovenia—each inherited a share of the federation's quota, assets, and liabilities in the IMF, including the outstanding obligations in arrears. At the end of 1992, Yugoslavia's indebtedness to the Fund amounted to about $215 million, of which some $65 million was in arrears.

As explained in Chapter 2, the Fund responded to the uniqueness of this situation by making several ad hoc decisions regarding the conditions for the successor states to accede to Fund membership. In particular, each state had to settle its share of Yugoslavia's arrears before it could become a member. Once it completed that step and the other requirements, it would be considered to have been a member without interruption since December 14, 1992, and to have continued, for its share, the membership of Yugoslavia in the Fund. That legal formality ensured that Yugoslavia's assets and liabilities in the Fund would have clear and continuous ownership.

Three of the successor states—Croatia, FYR Macedonia, and Slovenia—cleared arrears and succeeded to their shares of the Yugoslav membership within a few months. The other two—Bosnia and Herzegovina, and Serbia and Montenegro—were embroiled in conflicts and were placed under international sanctions. They therefore were not able to clear their arrears to the Fund until much later. Bosnia and Herzegovina cleared its arrears in December 1995 with the help of a bridging loan from the Netherlands Central Bank, shortly after the Dayton peace accords ended the interethnic war in the country (see Figure 6.3). Serbia and Montenegro completed the settlement of the former federation's arrears five years later, using the proceeds of bridge loans from Norway and Switzerland.

The Central African Republic

As discussed in Chapter 14, the CFA franc zone in central and west Africa experienced extensive economic setbacks throughout the late 1980s and early 1990s. The international effort to help resolve those difficulties culminated in a devaluation of the common currency in January 1994, accompanied by the adoption of comprehensive economic stabilization and reform plans in each of the participating countries. The IMF supported that effort with technical assistance and new lending. Several countries in the franc zone experienced temporary delays in meeting their financial obligations to the Fund, both before and after the 1994 devaluation, but only the Central African Republic developed protracted arrears.

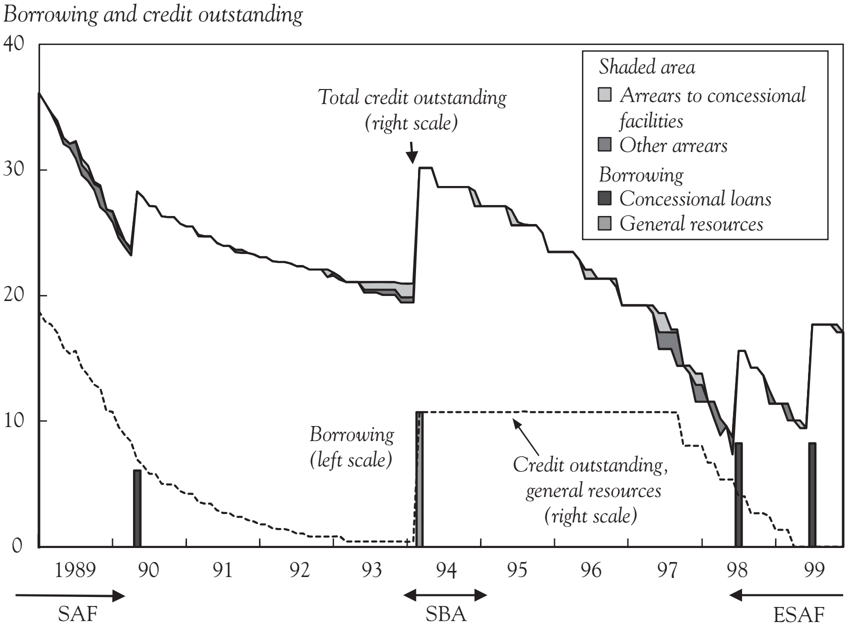
As is evident in Figure 16.15, the Central African Republic's arrears were small in relation to total credit outstanding, but they recurred frequently. From 1989 to 1998, the authorities fell behind in their payments on eight separate occasions, but they were able to get caught up in less than six months with just one exception. The Managing Director issued a complaint in 1989 and again in 1993. Only in 1993–94 did the problem threaten to get out of hand. In that case, however, by the time the six-month threshold was reached, the Fund was on the verge of negotiating the devaluation that would trigger large-scale donor support as well as new lending by the Fund and other multilateral agencies. In a December 1993 review, the Executive Board decided to postpone further action for three months, by which time the country cleared its arrears.

Finally, two cases of arrears arose in the 1990s, remained outstanding at the end of the decade, and were settled a few years later.

The Democratic Republic of the Congo

The history of relations between the IMF and the Democratic Republic of the Congo is an unhappy one and has been so throughout an unusually long period. From the mid-1970s through the 1980s, the Fund lent regularly to Zaïre, as the country was then known, despite realizing that the country's people were likely to benefit little from the proceeds. President Mobutu Sese Seko and his associates were notoriously corrupt, but the Fund tried to avoid being drawn into political judgments regarding a government that enjoyed widespread international support.

Figure 16.15. Central African Republic: Use of Fund Credit, 1989–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics; see Figure 16.2 for further explanation.
Note: ESAF = Enhanced Structural Adjustment Facility; SAF = Structural Adjustment Facility; SBA = Stand-by arrangement.

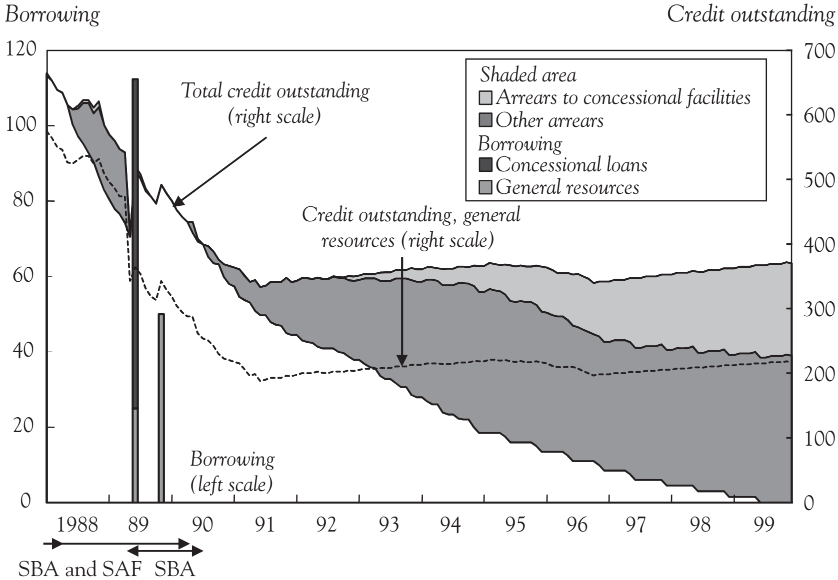
Occasional efforts by management and the staff to limit the damage were unsuccessful. Zaïre's indebtedness to the Fund rose to a peak of some $875 million in 1986 before tapering off. By 1988, Mobutu came to resent that he had to make net repayments to the Fund, especially because he was under pressure at home to keep up a semblance of economic growth in the face of massive inefficiency in the management of the economy. For about a year, Zaïre deliberately fell behind in those repayments, before settling up in May 1989 (Figure 16.16).[91]

In November 1990, Zaïre again went into arrears to the Fund, and this time no imminent repayment was in sight. Mobutu's grip on power was slipping because he was less and less able to keep up the system of patronage that had made that power possible. His international support was also waning, partly because of the breakdown in social order caused by the government's inability even to pay wages regularly and partly because the end of the Cold War rendered him less useful to European and American patrons. Mobutu's incentive to meet his external financial obligations simply disappeared.

The Fund responded forcefully to Zaïre's unwillingness to repay its loans. In September 1991, the Executive Board declared Zaïre to be ineligible to use Fund resources.

[91]These developments are covered in Boughton (2001), pp. 804–10.

Figure 16.16. Democratic Republic of the Congo: Use of Fund Credit, 1988–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics; see Figure 16.2 for further explanation.
Note: SAF = Structural Adjustment Facility; SBA = Stand-by arrangement.

Five months later, it issued a public declaration of noncooperation. At the time, an international coalition led by Belgium, France, and the United States was pressing Mobutu to resolve the domestic political stalemate and form a broadly based coalition government. In the absence of such a solution, the economy was no longer functioning. At the Executive Board meeting, only the French Director (Jean-Pierre Landau) and the two Directors from sub-Saharan Africa (L.B. Monyake, from Lesotho, and Corentino V. Santos, from Cape Verde) argued for a delay in declaring Zaïre not to be cooperating, to give the democratization process more time to succeed. Even the Belgian chair supported the staff proposal. Mobutu had few friends left in the world.[92]

For the next several years, the IMF's response to initiatives from Zaïre continued to be driven largely by political developments. After two years of stalemate in which rival governments vied for power in Zaïre and the authorities made only token payments on their arrears, the Fund suspended the member's voting rights. The formation of a new government in 1994, with Léon Kengo wa Dondo serving as prime minister and Mobutu remaining in power as head of state, led to a renewed effort to stabilize the economy. Zaïre stepped up its payments, roughly stabilizing total arrears for a brief

[92]Minutes of EBM/92/17 (February 14, 1992). The Executive Director for Belgium, Jacques de Groote, did not participate in the meeting. He was represented by his long-time Advisor, Frank Moss (also from Belgium).

period. The Fund responded by resuming technical assistance and postponing consideration of steps leading to compulsory withdrawal.

In May 1997, rebel forces led by Laurent-Désiré Kabila overthrew Mobutu, who fled to exile in Togo. Kabila revived the previous name of the country, the Democratic Republic of the Congo. Within a year, the new authorities promised to stabilize arrears again, but they failed to make good on that promise. A new civil war ensued, and the Fund continued to postpone further action until the military and political situation could stabilize. Only after the assassination of Kabila and the assumption of power by his son, Joseph Kabila, were the authorities able to make a serious effort to restart economic activity and normalize relations with external creditors. The Democratic Republic of the Congo settled its arrears in June 2002, and the Fund began lending to it through the Poverty Reduction and Growth Facility.

Iraq and Afghanistan

Similarly to Haiti, Iraq was forced into arrears as a result of sanctions imposed by the international community. The sanctions were a response to Iraq's invasion of Kuwait in August 1990, which touched off the Gulf War of 1991. Under a UN resolution, Iraq had no access to its assets held abroad, and the authorities insisted they could not make any payments to the IMF except by using those assets. Fund officials were singularly unimpressed by this argument, especially because the outstanding balance was small. Iraq had no outstanding debts to the GRA, but for several years it had drawn its holdings of SDRs down to zero. It therefore had to use its own resources to pay the interest due on the difference between its actual holdings (zero) and its allocation (SDR 68.5 million). For 1990, that amounted to about $2.2 million, or 0.3 percent of Iraq's quota in the Fund.[93] A stalemate followed, in which arrears to the SDR Department continued to accumulate while the Fund took no further action to try to collect. Eventually, following the U.S.-led military overthrow of Saddam Hussein, the new government settled Iraq's accounts in September 2004 by paying accumulated interest of some $81 million.

Afghanistan, which also had no general obligations outstanding, ran out of SDR holdings in November 1995. For several years before then, the country had been in a state of civil war, waged in the near vacuum of governance created by the departure of Soviet troops in 1989. From 1993 on, the Fund had no reliable means of communicating with the authorities. As civil war raged, various parties tried to withdraw the $7 million (SDR 4.9 million) balance in the reserve tranche, but the Fund demurred on the grounds it could not authenticate the validity of the requests.[94]

[93]"Iraq—Overdue Financial Obligation to the Fund—Report and Complaint under Rule S1," (EBS/91/13).

[94]See "Afghanistan—Overdue Financial Obligations to the Fund—Report and Complaint under Rule S1," EBS/96/28 (February 27, 1996), p. 2.

The accession to power by the Taliban further isolated Afghanistan from the world economy. The member's SDR holdings were fully depleted (through periodic charges to cover the interest due) shortly thereafter. As with Iraq, the Managing Director issued a complaint under Rule S1, and the Fund just waited until the political situation improved. In October 2001, a U.S.-led military force attacked Afghanistan to dislodge the Taliban in retaliation for its role in enabling the terrorist attacks of September 11 that year. The success of that campaign led to a new government, which settled its arrears with the Fund soon thereafter.

Conclusions

The potential cost to the IMF of the accumulation of arrears in the 1980s and 1990s, and the risks to the Fund while the problem persisted, were both immense. For the cases resolved successfully, however, the final cost to the institution was small. As long as each country eventually repays the Fund, in full and including overdue interest, the long-run cost to the Fund is just the administrative cost of developing and administering policies and of helping the country resolve the problem. The broader cost to the Fund's membership is more complicated to assess.

In most of the cases resolved in the 1990s, the indebted country obtained bridge loans from a group of donor countries to repay the Fund. The clearance of arrears was usually completed in tandem and in cooperation with the World Bank and other multilateral institutions. New lending from the Fund and others enabled the country to repay those bridge loans, usually within a few days. A renewal of arrears never followed a successful resolution. In several cases, including Cambodia, Guyana, Sierra Leone, and Vietnam, the indebted country also obtained grants from donors, either tied directly to the clearance of arrears or to provide fresh budgetary support for a new Fund-supported program. Whether those grants would have been smaller in the absence of the prior arrears is hard to judge. None of these countries obtained debt relief through the Heavily Indebted Poor Countries Initiative in the 1990s. Creditor and debtor countries helped cover the risks to the Fund through burden sharing contributions, but those contributions are repayable when all arrears are settled, or possibly earlier. On balance, therefore, even the secondary costs to donor countries do not appear to have been large in most cases.

The remaining issue, 10 years later, is whether the last two arrears cases from this era—Somalia and Sudan—will ultimately be resolved as successfully. History shows that the prerequisite is a return to political stability. Only then can the Fund work together with the authorities to begin a new and more positive relationship.

Other Policies to Safeguard IMF Resources

As a cooperative multilateral agency, the IMF depends heavily on data provided by its member countries. Accurate data are crucially important both for

surveillance, through which the Fund is trying to assess the appropriateness of members' policies, and for lending operations, through which the Fund is trying to assess whether a country needs financial assistance and whether it is using the Fund's financing properly to resolve its underlying economic problems. For these purposes, although the staff itself does extensive data collection during missions to each country, the Fund generally trusts that its members have provided accurate data unless it has good reason to question that data. Without accurate data from borrowers, the Fund cannot be assured that its financing is being used for the intended purposes. In the 1990s, misreporting became an issue for the first time, and the Fund had to develop new policies to deal with the problem.[95]

The first major case in which the Fund lent to a country based on data the country's officials had deliberately distorted was a stand-by arrangement with Hungary. The Hungarian government in the 1980s regularly reported one set of data to western creditors, including the Fund, and maintained a second and more accurate set of accounts for internal use. The reported data understated fiscal deficits and the resulting debt burden, and correspondingly overstated the central bank's foreign exchange reserves. As the date for Hungary's first modern democratic elections approached in 1989, central bank officials realized they would soon have to reveal the true state of the country's finances. When they informed the Fund, the staff discovered Hungary would not have been eligible to make three of the drawings of the preceding years if accurate data had been used. The Fund required Hungary to repay those loans before it would approve any new arrangements. The government agreed, and the matter was resolved even before the newly elected government took office.[96]

Through the rest of the 1990s, the Fund encountered 10 other cases of misreporting, involving nine countries (Table 16.2). Only four instances—misreporting by Ethiopia, Jordan, Russia, and Ukraine—were determined to have been most likely deliberate. In three other cases—Pakistan, the Philippines, and Tajikistan—the discrepancies appeared to have resulted from weaknesses in the authorities' administrative capacity. The origins of the remainder—misreporting by the Kyrgyz Republic and Romania—were unclear. The Fund's official guidelines for handling such problems did not distinguish between intentional and accidental misreporting, because the causes can be murky and the economic consequences are the same either way. As a practical matter,

[95]In 1984, the Fund adopted specific guidelines for dealing with misreporting of data. The first instances of data misreported by borrowing countries came to light in the second half of the 1980s, but in each case—involving Zaïre and Mauritius in 1985, Senegal in 1986, and Mauritania in 1988—the Executive Board decided that the problem was minor, and it granted a waiver. For details, see "Misreporting of Information to the Fund—Policies, Procedures, and Remedies—Preliminary Considerations," EBS/00/12 (February 2, 2000).

[96]See Boughton (2001), pp. 985–86; and "Misreporting of Information to the Fund—Policies, Procedures, and Remedies—Preliminary Considerations," EBS/00/12 (February 2, 2000), pp. 30–31.

Table 16.2. Misreporting of Data by Member Countries, 1990–99

Country	Dates	Date Considered by Fund	Covered by Guidelines?	Action Taken
Hungary	1982–89	February 21, 1990	yes	repayment required
Philippines	1989	April 9, 1990	yes	waiver
Ukraine	1995	December 13, 1995	yes	waiver
Romania	1995–96	May 8, 1996	no	none
Ethiopia	1996–97	October 8, 1997	no	suspension of lending
Ukraine	1998	September 4, 1998	no	closer monitoring of next arrangement
Tajikistan	1998	July 2, 1999	yes	waiver
Russian Fed.	1996	July 28, 1999	no	closer monitoring of next arrangement
Pakistan	1999	September 3, 1999	yes	waiver
Jordan	1996–97	October 5, 1999	no	suspension of lending; voluntary repayment
Kyrgyz Republic	1996–98	February 9, 2000	no	none

Sources: See text.

however, the Fund was more likely to grant a waiver if it determined the discrepancy was unintentional.[97]

Of the four most serious cases, two have been described in earlier chapters—Russia in Chapter 7 and Ethiopia in Chapter 14—and they are summarized briefly here.[98]

In 1996, the Central Bank of **Russia** overstated its net international reserves, for example, by neglecting to report it had issued guarantees to cover risky transactions of certain commercial banks. An external audit in 1999 uncovered the discrepancy, by which point it was too late for the Fund to apply remedies under its misreporting guidelines. Nonetheless, when the Executive Board reviewed the matter, it required the minister of finance, Mikhail M. Kasianov, to sign a letter promising to retain the proceeds of the next Fund arrangement in Russia's account in the SDR Department. More strikingly, it took the unusual and frankly humiliating step of noting, in its decision approving the arrangement, that in "deciding whether to complete each review under the arrangement, the Fund will take into account the adherence of the Russian

[97]In the four cases in the 1990s for which the Fund granted a waiver, the justifications included that the misreporting had resulted from "a lapse in debt management procedures" (Pakistan), a lack of familiarity "with Fund procedures" (Tajikistan), and an "administrative lapse" (the Philippines). For Ukraine, the Fund granted a waiver in view of "the minor nature of the misreporting and the corrective action taken"; see "Misreporting of Information to the Fund—Policies, Procedures, and Remedies—Preliminary Considerations," EBS/00/12 (February 2, 2000), pp. 24–27.

[98]Note that misreporting applies only to data a member country is required to report to the Fund. In some of the major crisis cases discussed in earlier chapters (notably Mexico, Thailand, and Korea), data inadequacies made it difficult for the Fund to assess the seriousness of the problems until the crisis erupted. Those shortcomings, however, were not subject to specific reporting requirements, and no sanctions applied.

Federation to the intention communicated in the letter of the Minister of Finance."[99] In effect, the Fund was putting Russia on probation until it proved it would abide by the rules and by its own commitments.

In 1997, **Ethiopia** failed to disclose a series of transactions in which central bank reserves were diverted to repay a commercial loan. The discovery of those transactions contributed to a decision by the Fund to suspend lending under the existing ESAF arrangement. Again, however, it took no formal disciplinary action.

Jordan had an extended arrangement with the IMF in 1996–98 for $294 million (SDR 200.8 million, or 165 percent of quota). While the arrangement was in effect, the authorities reported positive results to the Fund, indicating the fiscal accounts were stabilizing and economic growth was robust. Toward the end of the program period, in 1998, the staff learned those reports were exaggerated and the program had been much less successful than it had appeared. On that basis, the Fund declined to complete the next review and did not disburse the last $48 million available under the arrangement.

Management called for a thorough review, carried out in 1999 by John McLenaghan, the former Director of the Statistics Department. The Executive Board considered the report in October.[100] The Board took no formal action against Jordan, but the authorities voluntarily made an early repayment of the last drawing they had made in 1998. Some years later, the Fund's Independent Evaluation Office conducted a further review (Independent Evaluation Office, 2005) and concluded the staff had been negligent in not monitoring the program adequately (including by ignoring conflicting information readily available to the general public).

Ukraine was responsible for two episodes of misreporting. In 1995, the authorities told the staff they had fulfilled the prior actions required by the Fund before it would complete the second review under the stand-by arrangement. One of those actions was the clearance of arrears to external creditors. The staff subsequently learned Ukraine had accumulated new arrears to western creditors that it had not revealed at the time. The drawing was ruled to have been "noncomplying" with the terms of the arrangement. However, the Executive Board granted a waiver on the grounds that the amount of arrears was not large and had been cleared before the date of the Board meeting.

In the second episode, Ukraine was found to have tied up $645 million in foreign exchange reserves in blocked accounts or other commitments. The staff was aware of less than half of those commitments. After further investigation, the staff found the authorities had "consistently" been double counting and otherwise inflating reserves. Although the discrepancies were cleared up before approval of the Extended Fund

[99]Minutes of EBM/99/83 (July 28, 1999), p. 99. For the text of the letter from Kasianov to Camdessus, see "Russian Federation—Staff Report for the 1999 Article IV Consultation and Request for Stand-By Arrangement," EBS/99/124, Suppl. 3 (July 26, 1999).

[100]See "Jordan—Data Revisions and Information Reporting Issues," EBS/99/189 (October 1, 1999); and minutes of EBM/99/111 (October 5, 1999).

Facility arrangement in September 1998, the Executive Board took a dim view of both the authorities' "cavalier attitude" and the staff's "willingness to cut corners." The Fund took no formal action, but it did tighten control over the next arrangement.[101]

Ukraine's misreporting became a *cause célèbre* in January 2000, when the British newspaper *Financial Times* reported accusations that the government had been diverting money borrowed from the IMF, using it to speculate in bond markets, and siphoning off profits to personal accounts. The IMF initially denied having any knowledge of these allegations, but it subsequently released details from an external audit, similarly to its response to the Russian case (Catan, 2000).[102]

More generally, by 1999 the staff realized the misreporting problem was serious and growing. Executive Directors and other country officials were increasingly concerned that the Fund lacked the tools to oversee the use of its loans adequately. The requirement in the Articles of Agreement that Fund lending must be conducted under "adequate safeguards" was not being met. In September 1999, the Interim Committee called on the Fund "to perform an authoritative review of its procedures and controls to identify ways to strengthen safeguards on the use of its funds and to report at its next meeting."[103] The staff prepared a set of proposals that were then assessed by an independent panel of experts chaired by Michele Caparello, the director of internal audit at the European Central Bank.[104]

In March 2000, the Executive Board agreed to implement a number of policy changes. Notably, in future whenever the Fund was considering a request for a lending arrangement, the staff would collect information from the country's central bank to assess whether the bank had adequate "control, reporting, and auditing mechanisms" in place. If not, the Fund would conduct its own safeguards assessments. If misreporting

[101]See "Misreporting of Information to the Fund—Policies, Procedures, and Remedies—Preliminary Considerations," EBS/00/12 (February 2, 2000), p. 26n; and Box 1 in "Ukraine—Ex Post Assessment of Longer-Term Program Engagement," SM/05/379 (October 18, 2005); accessed at http://www.imf.org/external/pubs/ft/scr/2005/cr05415.pdf.

[102]The news story quoted an "IMF spokesman" as saying, "I am not aware of any (allegations) regarding Ukraine." Several weeks later, the Fund issued a statement acknowledging that the staff was aware of misreporting as early as August 1998; see "Allegations about the Use of Ukraine's International reserves," NB/00/15, March 14, 2000, p. 4; accessed at http://www.imf.org/external/np/sec/nb/2000/nb0015.htm. After a full investigation, the Fund issued an extensive report, "IMF Finds Ukraine National Bank Misreported International Reserves, Considers Circumstances, and Proposes Measures to Prevent Recurrences," NB/00/77, September 6, 2000; accessed at http://imf.org/external/np/sec/nb/2000/nb0077.htm. The allegation that profits were skimmed off for personal use by senior government officials was made by a former prime minister, Pavlo Lazarenko, who was himself under investigation (and was later convicted in the United States) for money laundering and related offenses.

[103]Paragraph 13 of the Interim Committee communiqué, September 26, 1999; accessed at http://www.imf.org/external/np/cm/1999/092699A.HTM.

[104]"Strengthening Safeguards on the Use of Fund Resources," EBS/00/29 (February 24, 2000); and "Strengthening Safeguards on the Use of Fund Resources—Independent Review of IMF Staff Proposals," EBS/00/30 (February 24, 2000).

occurred despite these precautions, the Board agreed the Fund would apply remedial actions more thoroughly and rigorously. Initially, these new procedures were applied experimentally. They were made permanent in 2002.[105]

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[105]The Summing Up of the March 23, 2000, meeting was published as Public Information Notice No. 00/28 (April 4, 2000); accessed at http://www.imf.org/external/np/sec/pn/2000/pn0028.htm. For the 2002 revisions, see PR/02/19 (April 5, 2002); accessed at http://www.imf.org/external/np/sec/pr/2002/pr0219.htm.

17

Coping with Stress: How the Fund Was Run

The IMF, though small, is a complex organization with both technical and political dimensions. Its chief executive officer is the Managing Director, who is selected by the Executive Board. The Executive Directors who make up the Board are either appointed or elected by the governments of the Fund's member countries, but they function as officers of the Fund and are not just political representatives. The extent to which Executive Directors act independently of their national authorities varies greatly between chairs and over time. Although the Executive Directors select the Managing Director (after consulting with their authorities), the MD—as that person is nearly always referenced within the Fund—is the Chairman of the Executive Board. The MD is also the head of the staff, who are expected to work independently as apolitical professionals while taking account of the constraints set by the political requirements of the Board.

This balancing act is overseen by the Board of Governors, consisting of central bank governors or finance ministers of every member country, and by a representative committee of Governors, known as the Interim Committee through most of the 1990s. The voting shares of Executive Directors and Governors are determined mainly by the relative sizes of national economies and trading volumes, but most decisions are made by consensus and thus incorporate, to some extent, the preferences of large and small countries, rich and poor. The tensions inherent in these complex relationships were evident in many of the internal battles depicted in earlier chapters. This final chapter describes the underlying structures in more detail.

The Institution

The membership enlargement in the 1990s forced many changes to take place at the IMF. As noted below, the Fund responded by increasing the size of the staff by more than 30 percent. Despite the sharp increase, and despite the benefits from a much greater use of computers, networks, and Internet resources, the hours that many staff worked also increased as pressures intensified. These changes happened

to come when many of the Fund's long-serving senior staff were reaching retirement age (mandatory at age 65). The changes took place gradually but resulted in a substantial cumulative effect on the structure of the institution and on the staff. At the end of the 1990s, the institution was markedly different from the "old" Fund of the 1980s.

Organization of the IMF

The expansion of the IMF workload in the 1990s required several changes in its organizational structure. For a complete list, see Appendix I at the end of this chapter.

Area Departments

One type of organizational change was to split departments in two when their workloads increased so much that they threatened to become unmanageable. In 1991–92, the influx of new member countries from the former Soviet Union and from the Soviet sphere of influence in Central and Eastern Europe overwhelmed the European Department. At the same time, the department was coping with the effects of German reunification and the first moves to establish full Economic and Monetary Union across the region. In response, management decided to create a new department to handle all of the work related to the Russian Federation, the Baltic countries, and other countries of the former Soviet Union. Knowing that any of the obvious and logical choices of a name for the new department would offend officials of one or more of the countries concerned, the Fund settled on the inoffensive but geographically ill-placed designation "European II" (EU2).[1] The original European Department was given the retronym "European I" (EU1).

The other major departmental split was for work on Asian countries that, since 1953, had been handled by the Asian Department.[2] Within that region, for historical and cultural reasons, Australia and New Zealand had been handled by the European Department, an arrangement no longer considered appropriate. The addition of several Pacific island countries as new members in the 1980s, then Mongolia in 1991,

[1]"Organizational Changes and Staff Appointments," EBAP/91/300 (December 17, 1991). Eight of the 15 countries that were covered by EU2 are in Asia, and one (Russia) spans Europe and Asia. The department title was intended to be temporary, but no agreement was ever reached on a better alternative. (The obvious solution, "Eurasian," was rejected because of its earlier negative associations with colonial regimes.) EU2 was disbanded in 2003, and its country responsibilities were divided between the reestablished European Department and the newly established Middle East and Central Asia Department.

[2]From 1946 to 1950, the Research Department had responsibility for country analysis and relations as well as for research more narrowly defined. From 1950 to 1953, country work was allocated to two area departments: the European and North American Department and the Far Eastern, Middle Eastern, and Latin American Department. That grouping was subdivided into four departments in 1953: Asian, European, Middle Eastern, and Western Hemisphere. The African Department was added in 1961. That lineup of area departments remained unchanged until 1991.

and the intensification of work in the Indochina region gave the Asian Department a diverse workload that was difficult to manage. Accordingly, in July 1991 the Managing Director (Michel Camdessus) decided to split the work between two new departments. The Central Asia Department (CTA)—another geographic misnomer—would work on China, India, Japan, the Republic of Korea, and nine smaller economies. The Southeast Asia and Pacific Department (SEA) would have Australia, Indonesia, New Zealand, the Philippines, Thailand, and 12 smaller economies.

The alignment of CTA and SEA did not work out well. In contrast to the relationship between the former Soviet Union and western Europe, Asia did not have a natural economic or political fault line running through it. Countries with close economic ties were split between the two departments, and the advantages of managing the two groups separately never materialized. Consequently, in November 1996, Camdessus merged the two back into a single department. In effect, SEA was merged into CTA, with Hubert Neiss—Director of CTA throughout its five years of existence—remaining as its head. In recognition of the inclusion of Australia and numerous island states, the combined department was given a new name, the Asia and Pacific Department.

The 1997 establishment of the Regional Office for Asia and the Pacific occurred in recognition of the growing importance of Asia in the IMF. When Camdessus informed Executive Directors of his intention to open an office in Asia, the announcement triggered a competition in which Hong Kong, Kuala Lumpur, Singapore, and Tokyo all vied for the honor of hosting it.[3] Each city had strong merits, and Hong Kong had the strong support of both the United Kingdom (which controlled it at the time) and China (which was about to take it over).[4] Japan, however, played the dominant role in the Fund among Asian countries. The Japanese authorities made a strong plea and an attractive offer to support the office if it were located in Tokyo. That proposal carried the day, and the Tokyo office opened in December 1997. Kunio Saito, who had directed SEA for its five-year existence, was named to head this new regional office.

Functional Departments

Two functional departments were reorganized and renamed in 1992.[5] Also during this period, the statistics and training functions were expanded and upgraded.

[3]Cambodian officials also made a request for Phnom Penh to be considered, but Camdessus concluded that “in spite of the particular charm of this city, [it] could not be seen as on a par with the other [four] cities”; minutes of EBM/97/26 (March 21, 1997), p. 3.

[4]Initially, Singapore appeared to have the inside track, particularly after Camdessus visited the city-state to participate in the inaugural ministerial conference of the World Trade Organization and met with the prime minister and other senior officials; see minutes of EBM/96/111 (December 13, 1996), p. 4. Intense lobbying by other governments soon erased that advantage.

[5]See “Organizational Changes,” EBAP/92/117 (June 23, 1992).

The Central Banking Department (CBD) had long served primarily to provide technical assistance to countries setting up or strengthening their central banks.[6] By the early 1990s, member demand was rising for a broader range of services focused on the techniques of monetary policy and oversight of banks and other financial institutions. Those areas also were becoming an important subject for Fund surveillance and program design. The Fund responded by shifting one of its leading monetary experts, Manuel Guitián, into the department as Associate Director (a position at the same hierarchical level as the department director) to oversee that function. At the same time, the Fund renamed CBD the Monetary and Exchange Affairs Department (MAE).[7] The new department also landed responsibility for reviewing the treatment of institutional aspects of monetary and exchange policy in Fund surveillance and lending arrangements, comparable to the authority already vested in the Fiscal Affairs Department for its areas of responsibility.

Shortly afterward, the Exchange and Trade Relations Department (ETR) was renamed the Policy Development and Review Department (PDR).[8] This change acknowledged that the department had taken on broad responsibility for developing Fund policies and reviewing the consistency of the Fund's work with its policies. Every briefing paper and staff report was to be reviewed by PDR before being issued, to ensure that all policies were being applied uniformly across the membership. If existing policies were no longer adequate or appropriate, PDR was to propose and formulate revisions. The Director of PDR became one of the key advisors to the Managing Director, participating in virtually all high-level policy discussions. PDR was destined to become both the conscience of the institution and—in a term born of frustration by those who felt constrained by it—the Fund's "thought police."

After the Fund began working intensively on standardizing and disseminating national statistics in the late 1950s, it expanded the Research Department into the Department of Research and Statistics in 1961. Seven years later, the statistics function was carved out into a separate Bureau of Statistics. Over the years, the Fund's statistical work took on increasing importance. This trend resulted partly from the emergence of the publication *International Financial Statistics* (IFS) as a leading source of cross-country statistical data, especially after its wide dissemination via electronic means in the 1980s; and partly from developing and transition countries' growing demand for technical assistance in the construction and collection of economic data.

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[6]The Central Banking Service was established in 1964 and was upgraded to a department in 1980.

[7]In 2003, MAE was further expanded and renamed the Monetary and Financial Systems Department (MFD). In 2006, MFD was merged into the newly created Monetary and Capital Markets Department (MCM).

[8]In 2008, PDR was renamed the Strategy, Policy, and Review Department.

When John B. McLenaghan became Director of the Bureau of Statistics in 1989, he began lobbying to have the bureau upgraded to a department. That suggestion met with some skepticism and resistance from department directors, but the effort succeeded after two years. In May 1991, the Fund established the Statistics Department: the first new department since the creation of CBD in 1980. The elevation of data quality and transparency to a central role in surveillance, and the associated inauguration of data dissemination standards in 1996 (see Chapter 4), further enhanced the role of the Statistics Department as the decade progressed.

The IMF Institute (INS), established in 1964 to conduct the Fund's training program for government officials, took on an expanded set of responsibilities in the 1990s.[9] When the Joint Vienna Institute was established in 1992 (see Chapter 5), INS oversaw the Fund's inputs to it. By the mid-1990s, INS staff were training nearly 3,000 officials annually, through courses at headquarters, in member countries, and at the Joint Vienna Institute. That role expanded further throughout the decade when additional regional training centers were established in Africa, Asia, and the Middle East.

In addition, in 1997 INS established an internal economics training program for IMF staff. Soon after Stanley Fischer became First Deputy Managing Director in 1994, he responded to pleas from the staff for more-extensive training opportunities. He realized that he was working with staff who started off well trained in economics when they came to the IMF but who had too little time or opportunity to stay abreast of developments once they were at work. In 1996 he asked Mohsin Khan, Deputy Director of the Research Department, to move to INS as its director and to develop a program of lectures and courses about current issues in economic theory and policy. That program was in full operation about a year later, and it further expanded the size and functions of INS.

Support Services

In May 1999, the Administration Department (ADM) was split into two new departments, to separate personnel matters from other administrative functions. The new Human Resources Department assumed responsibility for all personnel functions, including hiring policies, career advancement, and the administration of benefit programs. To head the new department, Margaret R. Kelly transferred from the Asia and Pacific Department, where she had been a Senior Advisor. (This practice of appointing career economist staff to noneconomic administrative posts was standard procedure in the Fund at that time. Not until 2009 was a human resources professional hired to run the department.) All other administrative responsibilities—ranging from information technology (formerly under the Bureau

[9]For the origins of INS, see Horsefield (1969), pp. 554–55. Before 1964, the training program was run by the Administration Department.

of Computing Services, which disappeared in the restructuring) to building and maintenance operations—shifted to the other new department, Technology and General Services. Brian C. Stuart, a career economist who was then the Director of ADM was named to head Technology and General Services.

The Office of Internal Audit was upgraded twice in the 1990s. In 1991, it was renamed the Office of Internal Audit and Review, with responsibility for assessing the efficiency and effectiveness of the IMF's organizational structure. For that purpose, Camdessus brought William A. Beveridge—a former Deputy Director of ETR with nearly 30 years' experience in the Fund—out of retirement to direct the new unit for two years. In 1996, Camdessus expanded the review function further, renamed the unit the Office of Internal Audit and Inspection, and appointed Eduard Brau (Deputy Director of EU2 at the time) as director for five years.

Toward Independent Evaluation

Camdessus's interest in expanding the role of the Office of Independent Audit was a second-best strategy when he could not persuade the Executive Board to establish an independent office to evaluate the work of the IMF. In 1992, Camdessus convened a task force led by P.R. Narvekar, who had just moved from Director of ASD to serve as Special Advisor to the Managing Director, to assess the desirability of establishing an evaluation office. Both the task force and the Managing Director made strong pleas for moving ahead with the idea. Self-evaluation by the staff or by Executive Directors could not be independent enough to be credible, and the absence of credibility was damaging both to the Fund's effectiveness and to its reputation.[10] When Executive Directors discussed the proposal in general terms in January 1993, they expressed broad support but questioned whether such an office could be both independent and effective without undermining the role of management and the Executive Board. Camdessus promised to devise a more specific proposal to meet those concerns, but in the end the idea was set aside without further formal discussion.[11]

Once the Office of Internal Audit was expanded in 1996 to deal more fully with institutional issues, Camdessus proceeded with the evaluation proposal as a way to assess the Fund's policies in a more public and independent way. The pressure to do so was now more acute because the finance ministers of the Group of Seven (G7) countries had called for establishment of an independent evaluation office in the Fund in their report to the Halifax summit meeting in June 1995.[12] This time,

[10]See "Statement by the Managing Director on the Establishment of an Evaluation Office in the Fund," BUFF/92/141 (December 8, 1992); and "Establishment of an Evaluation Office in the Fund: Report by a Task Force," EBAP/92/166 (December 17, 1992).

[11]Minutes of EBM/93/10 (January 22, 1993).

[12]"We . . . encourage the IMF to establish its own independent evaluation unit"; "Halifax Summit—Review of International Financial Institutions—Background Document," EBD/95/86 (June 20, 1995), p. 12.

though, rather than trying to establish a permanent office, Camdessus and the Executive Board set up an "evaluation group" of Executive Directors.[13] This group, chaired initially by Ian D. Clark (Canada), commissioned three panels of outside experts to prepare evaluation reports of principal Fund activities. The first report, prepared by a panel led by Kwesi Botchwey (former minister of finance for Ghana), covered the effectiveness of the Fund's concessional lending window, the Enhanced Structural Adjustment Facility (ESAF). The second, chaired by John Crow (former governor of the Bank of Canada), covered surveillance. The third, chaired by Frederic S. Mishkin (professor of economics at the Columbia University Business School, and a former executive vice president and director of research at the Federal Reserve Bank of New York), evaluated the relevance and effectiveness of research by IMF staff.[14]

When these reports were published, the pressure on the Fund to establish a more comprehensive, independent, and permanent system of evaluation began to grow. Nongovernmental organizations that acted as watchdogs over the Fund stressed the importance of this proposal. The G7 summit meetings in both 1998 and 1999 called for a more systematic approach, and the Interim Committee joined in the appeal shortly afterward.[15] Finally, in April 2000, the Executive Board agreed to establish the Independent Evaluation Office, and it came into being in June 2001.

Headquarters

The increasing size of the staff throughout the 1990s required the IMF to look for new office space. Even before the expansion of membership following the collapse of the Soviet Union, the Fund had begun planning for a new wing on its headquarters building, originally built in the early 1970s. That project, known as Phase III, took more than a decade to complete, mainly because of local opposition to the destruction of a church building that had occupied the

[13]This proposal was developed through a series of Executive Board meetings in February, May, and June, 1996. For a summary, see minutes of EBM/96/55 (June 7, 1996); "Evaluation Function—Formation of Group of Executive Directors," EBD/96/102 (July 26, 1996); and "Evaluation Group—Terms of Reference," EBD/96/102, Suppl. 1 (September 9, 1996).

[14]"External Evaluation of the ESAF—Report by a Group of Independent Experts," June 1998; accessed at http://www.imf.org/external/pubs/ft/extev/index.HTM; "External Evaluation of IMF Surveillance—Report by a Group of Independent Experts," September 14, 1999; accessed at http://www.imf.org/external/pubs/ft/extev/surv/index.HTM; and "External Evaluation of the Fund's Economic Research Activities," EBAP/99/85 (July 15, 1999). For an assessment of the evaluation reports during this period, see "Review of Experience with Evaluation in the Fund" (March 14, 2000), accessed at http://www.imf.org/external/np/eval/2000/031400.HTM#fund_experience.

[15]For a summary, see "Review of Experience with Evaluation in the Fund" (March 14, 2000).

site since 1932.[16] The church itself responded positively to an intentionally generous offer from the IMF. That offer included buying the building and land at market price, constructing a new building about half a mile to the west, and making a sizeable grant to the church's ongoing program to feed homeless and indigent people. Objections, which were supported by the neighborhood's representative on the City Council of the District of Columbia, came primarily from the Foggy Bottom Citizen's Association, which represented residents in the vicinity of the church's new location. The church would be relocating its Miriam's Kitchen feeding program to its new location, and nearby residents expressed fears that an inordinate number of "street people" might be drawn to it. The city zoning commission resolved that issue in favor of the church (and thus for the IMF) in February 1992. Additional complications arose when the city demanded design changes to make the expanded IMF building less bulky and more open to the streetscape; to add garden features including fountains along the sidewalk fronting the building; and to incorporate a visitors' center with educational displays, a bookstore, and an auditorium for presentations open to the public.[17]

Phase III finally was completed in 1999, 11 years after the Executive Board initiated the plan. With that, the headquarters building occupied all of one city block, and many—but not all—of the departments and offices that had been exiled to leased space in nearby commercial office buildings could move back in.[18]

Long before the completion of Phase III, it was apparent that the ongoing staff expansion was going to outgrow the enlarged space. In 1993, in response to the staffing demands associated with the Fund's growing membership, the Executive Board asked the staff to research a variety of options for purchasing or leasing additional office space. One option given serious consideration was to move the entire headquarters operation out of Washington to a suburban area where a large building or campus could be located much less expensively. That option was rejected as impractical because it would separate management and staff physically from embassies, the World Bank, and other agencies with which the Fund had daily interactions. That left the acquisition of a neighboring property as the only practical option.[19]

[16]Phase I, completed in 1972, occupied the southern half of the block, bordering G Street NW. Phase II, completed in 1983, opened a new wing to the northwest, stretching up 20th Street to H Street. The Western Presbyterian Church was located in the northeast quadrant of the block, at the corner of 19th and H Streets.

[17]For the earlier history of the IMF's physical plant, see Boughton (2001), pp. 1019–21, and references therein.

[18]To mark the completion of the third and final phase of construction, the Fund placed a time capsule behind a commemorative stone near the front entrance on 19th Street.

[19]For an overview, see "Phase IV—Further Evaluation of Alternatives," EBAP/95/55 (June 28, 1995).

IMF headquarters before and after construction of Phase III. The top picture shows the Western Presbyterian Church in the space later occupied by the completed building. The structure to the right of the church in that photograph is the Pepco building, which was later replaced by HQ2. (IMF photos)

In 1996, the Executive Board agreed to purchase the office building located across H Street from the Fund for $98 million. That building was owned by George Washington University but was occupied by the local electric power company,

Pepco. Although the Pepco building was a bit rundown and far below the quality of the IMF headquarters, the Fund intended to renovate it and move in within a few years. After the acquisition, however, more detailed engineering studies revealed that it would be more cost-effective and suitable in the long run to tear it down and construct a new building on the site. The Executive Board approved that plan in 1999. The opening of the $150 million Headquarters Two (dubbed "HQ2") in 2005 enabled all IMF staff to move back into Fund-owned office space for the first time in more than two decades.

Governors' Meetings

The finance ministers and central bank governors who serve as the Governors of the IMF met in two forms throughout the 1990s—annually as the full Board of Governors and semiannually in the more compact body then known as the Interim Committee (formally, the Interim Committee of the Board of Governors on the International Monetary System). As had been the practice since the inaugural Governors' meeting in Savannah, Georgia (United States), in March 1946, the Annual Meetings were joint meetings of the Governors of the Fund and of the World Bank. The Interim Committee included only Governors of the Fund. In addition, the Development Committee (formally, the Joint Ministerial Committee of the Boards of Governors of the Bank and the Fund on the Transfer of Real Resources to Developing Countries) met alongside the Interim Committee (normally, the day after). Although a joint body, the Development Committee dealt primarily with issues of most interest to the World Bank. It did not have the same level of operational significance to the Fund as did the Interim Committee.

Annual Meetings

All of the annual Governors' meetings in the 1990s were held in late September or early October. Following tradition, two out of every three meetings were held in Washington, at the large convention hotel on Connecticut Avenue NW known for most of the decade as the Sheraton Washington. In 1998, the Marriott chain bought the hotel and renamed it the Marriott Wardman Park. Every third year, the meetings were held outside the United States—at the Queen Sirikit National Convention Center in Bangkok, Thailand, in October 1991; the Campo de las Naciones in Madrid, Spain, in October 1994; and at the Hong Kong Convention and Exhibition Centre in Hong Kong SAR, China, in September 1997.

The main responsibility of the full Board of Governors was to vote on resolutions proposed by the Executive Board. Voting occurred either at the Annual Meetings or by mail between meetings. The Articles of Agreement require that certain

proposals be adopted by the Board of Governors with a high qualified majority. In the 1990s, resolutions of that type adopted by vote of the Governors included the two general quota increases (in 1992 and 1999), the Third Amendment to the Articles (1992), and the Fourth Amendment (1997). Adoption of each of those resolutions required the approval of Governors holding at least 85 percent of the total voting power. Approval of the amendments to the Articles required a "double majority": 60 percent of the member countries, holding at least 85 percent of the voting power. (As discussed in Chapter 15, pp. 771–73, approval of the Fourth Amendment by members was not completed until 2009.) Other proposals had to be enacted by the Governors, but with a simple majority. Of those, the most important in this decade were the resolutions to accept 32 new members into the Fund.

The chairmanship of the Board of Governors, a largely but not entirely honorific and ceremonial post, rotated among regions, with a new chairman each year.[20] The chairmen for the 1990s are listed in Table 17.1.

The formal meetings of the Boards of Governors in the 1990s occupied three days (Tuesday through Thursday) following the meetings of the various caucuses such as the G7 and the Group of 24 (G24) developing countries (usually held on Saturday), the Interim Committee (Sunday), and the Development Committee (Monday). The principal meeting was a plenary session on Tuesday morning that began with addresses by the Managing Director, the President of the World Bank, the Chairmen of the Board of Governors and the Interim and Development Committees, and a senior official—usually the head of government or state—of the host country. When the meetings were held in Washington, the president of the United States—first George H.W. Bush and then Bill Clinton in this decade—often addressed the plenary session. (Every U.S. President from Harry S. Truman in 1949 to Clinton in 1999 addressed the meetings regularly.)[21] The remaining two and a half days comprised speeches by the other Governors speaking on behalf of their own countries or, in some cases, a regional grouping.[22]

The real work of the meetings occurred outside the meeting hall. The Managing Director and his deputies held a nearly continuous series of bilateral meetings with Governors to discuss national economic issues. Official guests from international banks, civil society organizations, and media outlets lobbied or entertained the

[20]For an example of the substantive role that the chair occasionally played, see Boughton (2001), pp. 1022–27.

[21]Truman sent a message of welcome to the 1946 and 1948 meetings and delivered his first address in person in 1949. Clement Attlee, prime minister of the United Kingdom, sent a written message to the 1947 meetings, which were held in London. In the 1990s, Bush addressed the meetings in 1990, and Clinton in 1995, 1998, and 1999. Vice President Al Gore addressed the 1996 meetings. The meetings held in cities other than Washington were addressed by the prime ministers of Thailand and China (1991 and 1997, respectively) and by the king of Spain (1994).

[22]The official record of the meetings was published each year by the IMF under the title (or a variant of it) *Summary Proceedings of the . . . Annual Meeting of the Board of Governors*. Copies of the proceedings are held in the Joint Library of the Fund and the World Bank.

delegates. Receptions and social events rounded out the week for the participants, who numbered as many as 15,000.

The 1994 Annual Meetings commemorated the fiftieth anniversary of the Bretton Woods conference that led to the creation of the IMF and the World Bank. To mark the occasion, a major conference was held in Madrid just before the start of the meetings, with several delegates from the 1944 event in attendance. The anniversary conference took stock of the changes in the world economy over a half century and examined ways in which the Bretton Woods institutions should evolve in the future.[23] The following year, the meetings agenda was expanded to include a full program of seminars on topics of policy relevance. The seminar program then became a regular fixture of the meetings.

Table 17.1. Chairmen of the Annual Meetings and the Interim Committee, 1990–99

		Interim Committee Chairmen	
	Annual Meetings Chairmen	Spring	Fall
1990	George Saitoti (Kenya)	Michael Wilson (Canada)	Wilson
1991	Pablo Rodolfo Better (Ecuador)	Wilson	Carlos Solchaga (Spain)
1992	Mohamed Berrada (Morocco)	Solchaga	Solchaga
1993	Iván Szabo (Hungary)	Solchaga	Philippe Maystadt (Belgium)
1994	Saifur Rahman (Bangladesh)	Maystadt	Maystadt
1995	Paul Dossou (Benin)	Maystadt	Maystadt
1996	Eduardo Aninat (Chile)	Maystadt	Maystadt
1997	Mohamed Khalfan bin Khirbash (United Arab Emirates)	Maystadt	Maystadt
1998	Wolfgang Ruttenstorfer (Austria)	Maystadt	Carlo Azeglio Ciampi (Italy)
1999	Mahesh Acharya (Nepal)	Ciampi	Gordon Brown (United Kingdom)

Source: IMF.

The 1999 meetings were the last of these rather grand affairs in Washington. When the venue moved to Prague, Czech Republic, for the 2000 meetings, the antiglobalization protests that had been gathering steam for several years reached a level that was making circulation between hotels and meetings extremely challenging. Security requirements were forcing reconsideration of the scale of the Annual Meetings. Then came the terrorist attacks of September 11, 2001, which shut down much of official Washington less than three weeks before the scheduled start of the scaled-down Bank and Fund meetings. The 2001 meetings were canceled. When they resumed in Washington in 2002, they were arranged on a much-compressed schedule with extraordinary security measures to protect delegates. In that and future years, President George W. Bush declined the opportunity to

[23]The proceedings were published as Boughton and Lateef (1995).

address the world's assembled finance ministers and central bank governors, the first U.S. president to do so throughout his term in office.

The Interim Committee and the International Monetary and Financial Committee

The Interim Committee met twice each year throughout the 1990s—once immediately before the Annual Meeting of the Board of Governors and once in late April or early May. All of the spring meetings were held in Washington.[24]

The chairmanship of the Interim Committee was a more substantive assignment than the chairmanship of the Board of Governors. The ministerial-level committee was the principal advisory body for the IMF and effectively established the institution's work program. By controlling the agenda, the chairman influenced substantially the direction of the agency's work. Following a tradition established at the Interim Committee's creation in 1974, the chair was always held by a finance minister from an industrial country.[25] In the 1990s, five people held the chairmanship (see Table 17.1): Michael Wilson (Canada) for three meetings in 1990–91; Carlos Solchaga (Spain) for four meetings in 1991–93; Philippe Maystadt (Belgium) for ten meetings in 1993–98; Carlo Ciampi (Italy) for two meetings in 1998–99; and Gordon Brown (United Kingdom) for the final meeting of the decade in September 1999.

Another tradition allowed the Chairman to continue as long as the person remained in office as finance minister. On most occasions when a Chairman stepped down, a successor was selected by acclamation after a round of consultations among European and other industrial countries. An exception arose in September 1993 after Solchaga resigned. Ewen Waterman (Australia) nominated his country's treasurer, John Dawkins, to succeed Solchaga. Soon afterward, with European backing, Jacques de Groote (Executive Director, Belgium) nominated his finance minister, Maystadt, for the post. To avoid a public battle, each candidate agreed to accept the results of a secret ballot among Executive Directors, with the winner to be approved unanimously in a formal poll of the Executive Board.[26] Maystadt won the secret ballot, held on September 14. He then presided over the Interim Committee for most of the remainder of the decade.

[24]Through 1982, the Interim Committee often met at other venues, independently of the Annual Meetings: in Paris (June 1975); Kingston, Jamaica (January 1976); Mexico City (April 1978); Hamburg (April 1980); Libreville, Gabon (May 1981); and Helsinki (May 1982). All subsequent meetings were held either in Washington or in conjunction with the Annual Meetings in other locations.

[25]For the earlier history of the Interim Committee, see Boughton (2001), pp. 1027–31. In 2008, Youssef Boutros-Ghali, finance minister of Egypt, became the first official from a developing country to lead the International Monetary and Financial Committee, the body that succeeded the Interim Committee.

[26]See minutes of EBM/93/125 (September 8, 1993), p. 3.

Why the "Interim" Committee? It was established in 1974 to succeed the Committee of Twenty (C-20), which functioned from 1972 to 1974 as the ministerial body charged with trying to reform the international monetary system after the collapse of the Bretton Woods system of fixed exchange rates. Like the Executive Board, the structural genius of the C-20 and its successors was the constituency system, which gave all member countries input into the deliberations without the need for an impossibly large (say, 180-member) committee. Ministers participating in the C-20 envisaged that the forthcoming Second Amendment to the Articles would establish a Council as the top-level decision-making body for IMF policies. Until that step took place, the Interim Committee would meet and would advise the Fund on how to fulfill its mandate.

Agreement on how and whether to constitute the Council proved elusive. Executive Directors from smaller countries and from developing countries of all sizes found that the Interim Committee suited their purposes just fine. Simply an advisory body, it did not detract much from the powers and influence of the Executive Board. Lacking a formal voting procedure and thus requiring a general consensus to make recommendations in its communiqués, it gave developing countries a greater opportunity for influence than did the Fund's own weighted-voting structures. In the final drafting sessions for the Second Amendment, delegates agreed to delay a decision on the Interim Committee's fate by specifying that the Council would come into being only when it had been approved by the Board of Governors with an 85 percent voting majority. In 1979, the year after the amendment took effect, the United States proposed establishing the Council, but it could not secure enough support to clear the high hurdle. The proposal went dormant for most of the next two decades.[27]

In the late 1990s, Camdessus and the French government took up the cause for creating the Council. The opening salvo came from the French finance minister (and future Managing Director of the Fund), Dominique Strauss-Kahn. At the April 1998 meeting of the Interim Committee, Strauss-Kahn suggested that "to enhance the legitimacy of the Fund, the Interim Committee should take a more active role in guiding the institution. Toward that end, the Interim Committee should be transformed more closely in line with the Fund's Articles of Agreement by giving it decision-making capability."[28] Three weeks later, Camdessus endorsed the idea in a speech in London just before the start of the Group of Eight (G8) summit meeting in Birmingham.[29] In October, the Interim Committee responded

[27]For the early history of consideration of the Council, see de Vries (1985), pp. 971–72; and Boughton (2001), pp. 1027–28.

[28]"Fiftieth Meeting of the Interim Committee—Formal Plenary Meeting—Record of Discussion," ICMS/MTG/50/98/1 (April 16, 1998), p. 8.

[29]"Toward a New Financial Architecture for a Globalized World," address at the Royal Institute for International Affairs, London, MD/SP/98/11 (May 8, 1998), p. 9.

by asking the Executive Board to consider "the possibility for strengthening and/or transforming" the committee.[30]

The subtext for this revival was a response to the establishment of the Group of 22 (G22; see Chapter 3) as a self-appointed steering committee for the international financial system. Although that group (which would soon contract slightly to become the G20) comprised most of the leading industrial and emerging-market economies, it had no institutional standing, it lacked a constituency structure to pull in the views and interests of smaller countries, and it excluded low-income countries. If such a group were to become the primary forum for discussions of international financial policy, it could seriously weaken the role of the Interim Committee and effectively subject the IMF to its control. Moreover, if ministers used the G22 to ask the Fund to take on difficult and politically sensitive tasks, they could perhaps distance themselves from the outcome too easily. Replacing the Interim Committee with the Council could help ward off those effects.

The Executive Board took up the matter in March 1999. Jean-Claude Milleron (France) opened the debate with a plea for action to give "full legitimacy to a universally representative and operational body." He tried to ward off complaints from developing countries by noting that Council members, unlike Executive Directors, would be able to split their votes to reflect the diversity of views within their constituencies. Because several constituencies included both advanced and developing economies but were usually represented by the former, this practice would increase the potential voting power of developing countries from about 30 percent on the Executive Board to 40 percent of the Council. "All in all," he concluded, "if we really want to strengthen the Interim Committee, we have to transform it."[31]

Few Executive Directors were ready to buy this proposal. In fact, the long-standing opposition by many developing countries was now reinforced by Directors from larger countries that did not want to see either the role of the Executive Board or the embryonic role of the G22 diminished in any way. A. Shakour Shaalan (Egypt) responded to Milleron by proclaiming, "I find myself bewildered as to what the problem is that we are trying to solve by creating a Council." Thomas A. Bernes (Canada) questioned whether the Fund or the Interim Committee really had a problem of legitimacy or insufficient capacity for making decisions. Even Karin Lissakers (United States), who spoke for the country that had once championed creating the Council, was unconvinced. In her view, the Council "would weaken the [Executive] Board as an effective executive body."[32]

[30]Interim Committee communiqué (October 4, 1998), paragraph 3; in *Annual Report 1999*, p. 183.

[31]Minutes of EBM/99/24 (March 10, 1999), pp. 3–6. The voting rules for the Council were set out in Schedule D of the Articles of Agreement.

[32]Minutes of EBM/99/24 (March 10, 1999), pp. 7 (Shaalan), 10–14 (Bernes), and 43–44 (Lissakers).

The one innovation approved in time for the 1999 spring meeting of the committee was to hold a meeting at the ministerial deputy level to help prepare the agenda. That had long been the practice for all of the ad hoc groups of finance ministers, including the G7 and now the new G22. If the Interim Committee was to retain a central role, the deputies would have to convene in this context as well. Discussions continued through the summer but were largely preempted by the G7 finance ministers. In June 1999, that group submitted a statement to the Cologne Economic Summit of the G8 that dictated a watered-down version of the reform proposal:

> 14. A number of proposals have been discussed for institutional reform, including the proposal for transformation of the Interim Committee into a Council. At this time, recognizing our special responsibility as major shareholders in the Bretton Woods institutions, we have agreed to support the following important steps towards institutional reform.
>
> a. The Interim Committee would be given a permanent standing as the "International Financial and Monetary Committee." The Committee's mandate should be consistent with the principle, which we reaffirm, that the IMF must play a prominent role in facilitating cooperation among all countries, especially in the area of macroeconomic and monetary issues that are at the center of the IMF's mandate, as stated in Article 1 of its Articles of Agreement.
>
> - Deputy-level meetings of the new Committee would be held twice a year shortly before the Ministerial meetings, building on the successful meeting of the Interim Committee Deputies this April.
> - The President of the World Bank would play a privileged role in the new Committee. The Chairman of the Financial Stability Forum would be given observer status.
> - Joint sessions of the International Financial and Monetary Committee and the Development Committee would be held when appropriate on issues where there is a clear overlap of responsibilities.[33]

Although the report also promised to keep other ideas, including the Council, under review, the reference in this paragraph to the permanence of the transformed committee buried any realistic possibility for the foreseeable future. In September, the Executive Board and then the Board of Governors approved the transformation of the Interim Committee into the International Monetary and Finance Committee. Gordon Brown (chancellor of the exchequer of the United Kingdom), who had been elected Chairman of the Interim Committee during the summer, presided over the fifty-third and final meeting of the Interim Committee

[33]"Report of the G7 Finance Ministers to the Köln Economic Summit," Cologne, Germany, June 18–20, 1999; accessed at http://www.g8.utoronto.ca/finance/fm061999.htm.

on September 26, 1999. He then continued as Chairman of the IMFC until he became prime minister of the United Kingdom in June 2007.

The Executive Board

The influence of the Executive Board over IMF policies, advice to country authorities, and lending decisions is subtle but crucially important. On most occasions in the 1990s, as in earlier times, once the Managing Director submitted a lending proposal to the Board, the Executive Directors routinely approved it. In controversial cases, however, the tone of the discussion would guide management and staff in handling similar situations in the future. More generally, through informal sessions with the Managing Director as well as through formal meetings, Executive Directors would convey both their personal views and those of their authorities on the future evolution of Fund policies.[34]

When an open rebellion broke out at a Board meeting, as it did on rare occasion, it was either because of poor communication between management and Directors or because the Managing Director felt strongly enough about an issue to force it to a vote. Earlier chapters describe a few such instances. In 1994, the Board refused to approve a request from Camdessus to extend the life of the Systemic Transformation Facility (STF) beyond its sunset date (Chapter 5). In 1995, a group of European Directors tried unsuccessfully to squelch a large increase in the stand-by arrangement for Mexico (Chapter 10). In 1997, a minority bloc of Executive Directors, led by the United States, forced a delay in approval for a loan under the extended arrangement for Croatia (Chapter 6). On most other occasions, the battles took place behind the scenes.

A striking example of the Executive Board asserting its role took place toward the end of the decade. Throughout the 1990s, management had increasingly used "side letters" as a way to get borrowing countries to agree to implement politically sensitive policy measures without having to write them down in a Letter of Intent (LOI). The finance minister or other senior official would submit a private letter to the Managing Director specifying the actions to be taken. To ensure confidentiality, the Managing Director would promise not to disclose the contents of the letter to the Executive Board without the author's permission.

In 1998, Camdessus agreed that the staff could inform Directors of the existence and general nature of side letters, but without disclosing the text or the specific commitments. That failed to satisfy those who resented being kept out of the information loop, and Directors kept raising the issue through the first half of 1999. The Fund's moves to be more transparent by publishing LOIs with the concurrence

[34]The role and evolution of the Executive Board in the 1980s is discussed in Boughton (2001), pp. 1031–43.

of the borrowing country aggravated that resentment. If the LOI was going to be published, the country had a strong incentive to shift sensitive commitments to side letters. That obfuscation would prevent Executive Directors, as well as the general public, from seeing what the authorities were really promising to do. Camdessus, with the support of a number of Executive Directors, argued that side letters were an important part of the tool kit and that disclosure to the Board would destroy their usefulness. Most of the Directors from major creditor countries, however, insisted on having access to this information. Finally, in August 1999, those Directors forced a decision giving effect to their wishes.[35]

Size and Composition

On a more technical level, the size of the Board became an issue. At the outset of the 1990s, the Executive Board had 22 members: 5 appointed by the countries with the largest quotas; 1 appointed by Saudi Arabia, as one of the two largest creditors of the Fund; 1 elected by China, which had a large enough quota to elect a Director without joining forces with other members; and 15 elected by groups of countries in voluntarily formed constituencies. The size of the Board was fixed at 20 by the Second Amendment of the Articles of Agreement (1978), with the proviso that the Board of Governors could increase or decrease it temporarily. Any change would take effect for the period of one biennial election, subject to approval by an 85 percent majority vote in the Board of Governors.[36] The 1990 election left the existing configuration unchanged.

As the 1992 election approached, it was obvious that the size of the Board would have to expand. The Fund had gained 24 new or prospective members since the previous election, including two—Russia and Switzerland—large enough to lobby for their own seats. As described in Chapters 7 (on Russia) and 15 (on Switzerland), both countries managed to ratchet up their initial quotas above the staff's recommended levels to enhance their roles and prestige in the institution. Those quotas put each country in a strong position to have a seat at the table. The only way to avoid severe disruption to the composition of the Board, including potentially squeezing more than 40 sub-Saharan African countries into a single seat, was to raise the number of seats from 22 to 24.[37]

[35]See "Side Letters and Use of Fund Resources ," SM/99/66 (March 10, 1999); "Side Letters and Use of Fund Resources—Further Follow Up," SM/99/163 (July 7, 1999); minutes of EBM/99/95 (August 30, 1999), pp. 70–90; and Decision No. 12067-(99/108), adopted September 22, 1999.

[36]The composition of the Executive Board is spelled out in Article XII, Section 3. The original size of the Board, in 1946, was 12, with 5 appointed and 7 elected Directors. It was raised incrementally to 20 from 1947 to 1964 with the addition of 8 more elected Directors; see de Vries (1985), pp. 764–77.

[37]In the following decade, many observers questioned whether this expansion had been efficient and called for a return to the 20 seats specified in the Articles.

The Executive Board and senior management of the IMF in 1999. (IMF photo)

Also in 1992, Saudi Arabia's right to appoint a Director was about to lapse. Saudi Arabia had held that right since 1978 because the Fund's borrowing from it had made the country one of its two largest creditors.[38] That entitlement lapsed with the Fund's repayment of those loans. Consequently, the number of seats up for election would rise from 16 to 19: four more than the "permanent" level specified in the Articles of Agreement.

The Executive Board approved the increase in September, and the Board of Governors gave its approval through a vote conducted during the Annual Meetings later that month. Russia, meanwhile, signaled its intention to elect an Executive Director on its own, without forming a constituency. Konstantin G. Kagalovsky was already in Washington representing the interests of the Russian government, and the authorities nominated him for the new post. Switzerland, which had a somewhat smaller quota, set out to form a constituency by inviting Poland to join it along with five countries of the former Soviet Union from the Caucasus region and central Asia that were also just attaining membership in the IMF (Azerbaijan, the Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan).[39] From the time it rejoined the Fund in 1986, Poland had been part of the constituency headed by Italy. Although Poland had the second largest quota in that group, the Italian Executive Director followed the tradition of appointing a Greek national as his Alternate Executive Director. Once Poland moved to the Swiss group, it had the opportunity to have the Alternate slot. Daniel Kaeser, having conducted much of the negotiations for Switzerland, was elected the first Executive Director for the group. When he took office at the beginning of November, he appointed Krzysztof Link (Poland) as his Alternate.

Other European-led groups courted new member countries as a way to increase their voting power and to reach out to potential new trading partners. Both Switzerland and the Netherlands asked Ukraine—the second largest economy to emerge from the former Soviet Union, after Russia—to join their constituencies. When Switzerland offered Poland the right to name the Alternate Executive Director in that group, the Netherlands made a similar offer to Ukraine, which sealed the deal between the two. As shown in Appendix II to this chapter, the Belgian, Italian, and Nordic constituencies also expanded to take on neighboring new members during this period.

Middle Eastern representation on the Executive Board (broadly construed to include Pakistan) was shuffled in 1992, mainly on account of concerns about

[38]Article XII extends the right of appointment to the countries with the five largest quotas and to the two largest creditors. Except for Canada in 1958, Italy in 1968, and Saudi Arabia from 1978 to 1992, the two largest creditors were always among the countries with the five largest quotas.

[39]This effort, which Daniel Kaeser (2004, p. 139) puckishly called "a la recherche de l'Helvétistan" (which could be translated as "in search of Switzerstan"), followed a failed effort to form a constituency with existing member countries. To that end, Swiss officials held unfruitful discussions with several member countries, including Hungary, Romania, South Africa, and Turkey.

Libya's alleged involvement in international terrorism. Libya's Mohamed Finaish had served as Executive Director since 1978, heading up a 15-country group that included such regional powerhouses as Egypt, Iraq, and Pakistan. The imposition of UN sanctions on Libya in 1992 provided Egypt an opportunity to regain the seat it had held for 30 years before ceding it first to Syria (in 1976) and then to Libya.[40] Pakistan elected to move to the constituency led by the Islamic Republic of Iran, and Egypt was able to win over the rest of the group and elect A. Shakour Shaalan as Executive Director. In this group, the Alternate slot rotated among the smaller countries, with officials from Bahrain, Lebanon, and the United Arab Emirates serving under Shaalan during the rest of the 1990s.

Several countries were excluded from voting in the biennial elections of Executive Directors for parts of this decade. Two countries with substantial arrears to the Fund—the Democratic Republic of the Congo (then known as Zaïre) and Sudan—had their voting rights suspended under the terms of the Third Amendment (see Chapter 16) before the 1994 elections. Sudan was unable to participate in Executive Board elections until the Fund restored its voting rights in 1999. The Democratic Republic of the Congo was excluded until it cleared its arrears in 2002. Other countries did not participate because they lacked an internationally recognized government or were under international sanctions. These included Afghanistan (1998 and 2000), Cambodia (1976 through 1992), Somalia (1992 through at least 2010), and South Africa (1974 through 1994). None of these exclusions had any material effect on the outcome of the elections.

Key Personnel

Membership on the Executive Board turned over at a high rate throughout the 1990s, with an average length of service for an Executive Director of about three years (Appendix II). The only appointed Director who served for more than half of the decade was Karin Lissakers (United States). She was appointed by President Bill Clinton during his first year in office (1993) and served until shortly after the end of his term, in 2001. Among other industrial countries, the only ones that regularly expected their Directors to make a career out of service at the IMF were Belgium and Austria. Jacques de Groote retired as the Executive Director for Belgium in March 1994 after spending 21 years in that post. Willy Kiekens succeeded him, and still held the office 17 years later.[41] In 1987, de Groote appointed Johann Prader (Austria) to serve as his Alternate Executive Director. More than 24 years later, Prader was still in that position.

[40]From 1978 to 1986, Egypt was subject to sanctions from other Arab countries as punishment for signing the bilateral Camp David accords with Israel. As a result, Egypt did not participate in elections of Executive Directors during that period. In 1988, Egypt rejoined the constituency led by Libya.

[41]De Groote succeeded André van Campenhout, who served for 19 years (1954–73).

Alexandre Kafka (left) being decorated as Commander of the Order of Merit of Duarte, Sánchez, and Mella in 1999, shortly after his retirement as Executive Director. The award was conveyed by the president of the Dominican Republic and presented by Héctor Valdez Albizu (governor of the central bank). (IMF photo)

The most remarkable career among Executive Directors was that of Alexandre Kafka (Brazil). He won election to this post a record 16 times, through many major shifts in the balance of political power in Brazil and in the other countries in his constituency. For the last 22 years (1976–98) of his 32 years as Executive Director, Kafka served as Dean of the Executive Board. Throughout his career, he earned a reputation for caring passionately about and working effectively for the countries that elected him, for developing countries more generally, and for the IMF as an institution. In the 1960s, he helped turn the Compensatory Financing Facility into an important vehicle for helping Brazil and other primary-commodity exporters. In the 1970s, he worked to build a consensus for establishing the Oil Facilities, the Extended Fund Facility, and the Trust Fund. He served as the major architect of a staff compensation system that went a long way toward taking pay decisions out of the political arena. As Vice-Chairman of the Deputies of the C-20 in the early 1970s, he helped forge a consensus for financial cooperation with floating exchange rates. In the 1990s, he played a similar role to help bring about the permanent ESAF and the Heavily Indebted Poor Countries Initiative.

Alexandre Kafka was born in Prague, Czechoslovakia, in 1917, into the same family that had already produced the author Franz Kafka. After his education in Geneva and Oxford, he moved to São Paulo, where he was professor of economics from 1941 to 1949. He then moved to Washington and joined the staff of the IMF

as Assistant Chief of the Latin American Division in the Research Department. He often said afterward that getting a job at the IMF was one of his proudest achievements, though in truth it was a poor time to be there, with little action to stimulate the mind. He made lifelong friendships, but he left after just two years to return to Brazil to resume his academic career. By this time, he had become one of the leading figures in Brazilian economics and had developed a worldwide reputation.

In 1956, Kafka moved north again to work at the United Nations in New York. For the next decade he held overlapping appointments at the UN, as a professor at the University of Virginia, and in various posts in Brazil. In July 1966, he returned to the IMF for good, initially as Alternate to the Executive Director for Brazil, Maurício Chagas Bicalho. In November, he was elected by Brazil, Colombia, the Dominican Republic, Haiti, Panama, and Peru to succeed Bicalho as Executive Director. Although he continued to hold adjunct or visiting academic positions at the University of Virginia, Boston University, and George Washington University through the 1970s and 1980s, the Executive Board was his main vocation. He retired at the end of October 1998, and lived quietly until he passed away in November 2007.

On Kafka's retirement, the deanship passed to Abbas Mirakhor (Islamic Republic of Iran), whose eight years on the Board already made him the longest-serving Executive Director. A leading scholar on the economics of Islamic banking, he had spent the six years before his election to the Board as an IMF staff member, first in Research and then in the Middle Eastern Department. Altogether, Mirakhor spent more than 17 years as Executive Director, retiring in 2008.

Shakour Shaalan (Egypt) spent 31 years on the staff before moving to the Executive Board in 1992. Once in this new seat, he showed the same level of dedication and perseverance. In November 2007, with 15 years of service on the Board (and 46 in the Fund), Shaalan became the fifth Dean in the Fund's history.[42]

Management

The senior management of the IMF comprises the Managing Director, who serves both as the head of the staff and as the Chairman of the Executive Board, and one or more deputies. Collectively, this group is universally known in the Fund simply as "management."

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[42]Of the original Executive Directors who took office in 1946, the longest serving was Ahmed Zaki Saad (Egypt), who retired in 1970. The first Executive Director to be designated Dean was André van Campenhout (Belgium), who was Executive Director from 1954 to 1973 and became Dean after Saad's retirement. The second, preceding Kafka, was Pieter Lieftinck (Netherlands). For personal reasons, Mirakhor stepped aside as Dean three months before he retired as Executive Director.

The Managing Director

The face of the IMF, and its most important single position, is the Managing Director. The tone, the direction, and the agenda of the institution are guided by a combination of "the MD," as he is universally known in Fund circles; his deputies; the G7 and related external groups; the Interim Committee, especially its Chairman; and the staff who carry out the work program. Yet, it is in the office of the MD that all of these influences are distilled, refined, and turned into specific policies and actions.

During the first 55 years of its existence, the IMF had seven Managing Directors, all from Europe. The first (1946–51) was Camille Gutt, who had been Belgium's finance minister during the years of exile amid the Second World War and had led the Belgian delegation at Bretton Woods. Then came two Swedes: Ivar Rooth (1951–56) and Per Jacobsson (1956–63). Rooth, a former governor of the central bank of Sweden, was head of an economic research institute in Stockholm when he was appointed as Managing Director. Jacobsson was head of the monetary and economic department at the Bank for International Settlements (BIS), a post he had held since shortly after the founding of the BIS in 1930. Widely regarded as the strongest of the early Managing Directors, Jacobsson took office in the middle of the Fund's first major international lending operation, triggered by the Suez crisis. In May 1963, while on a visit to London, he died suddenly of a heart attack.

From 1963 to 2000, all but one of the Fund's Managing Directors were French. Pierre-Paul Schweitzer (1963–73) was deputy governor of the French central bank, the Banque de France. The U.S. authorities during President John F. Kennedy's administration proposed him for the job. A decade later, having become the first Managing Director to serve two full five-year terms, he sought a third. His quest failed on account of bitter opposition by the administration of U.S. President Richard M. Nixon, whose officials were upset that Schweitzer had called publicly for a devaluation of the U.S. dollar. H. Johannes Witteveen (1973–78), a former finance minister and deputy prime minister of the Netherlands, succeeded Schweitzer. Witteveen's decision not to seek a second term in 1978 opened the way for France to nominate another candidate. Jacques de Larosière, director of the French Treasury at the time of his election, served from 1978 to 1987. When he resigned for personal reasons in the middle of his second term, the French authorities stepped up again, this time to nominate the governor of the Banque de France, Michel Camdessus.

This tradition of electing only Europeans to the post of Managing Director did not derive from any formal or informal agreement.[43] The informal agreement in 1946 was that the U.S. authorities would control the appointment of the President of the World Bank, because the Bank would be borrowing in the New York bond

[43]For a detailed history of the selection process, see Kahler (2001), pp. 20–42.

Michel Camdessus, Managing Director (1987–2000). (IMF photo)

market and having an American at the helm was thought to be necessary for establishing credibility and maintaining the confidence of investors. The Managing Director of the IMF, therefore, would be someone not from the United States. Europe dominated the non-U.S. financial world at that time, so it had the largest and most logical pool of candidates from which to draw. Nonetheless, the appointment of Jacobsson in 1956 came only after a Canadian candidate withdrew from consideration.[44] Over time, European finance officials developed an effective strategy of agreeing among themselves and then persuading the United States to support their candidate. With that level of support, no one else could possibly compete. On occasion—notably in the discussions that led ultimately to the election of Witteveen in 1973—an internecine battle among European countries preceded the final choice but was resolved in time to present a unified front to the rest of the Executive Board.

[44]John Fforde, in his history of the Bank of England, wrote that "the international monetary fraternity of treasuries and central banks" initially offered the post to Graham Towers, who had recently retired as governor of the Bank of Canada. When Towers declined, several other candidates were approached until finally a U.S. Treasury official (W. Randolph Burgess, under secretary for monetary affairs) suggested Jacobsson (Fforde, 1992, p. 573n).

Europe failed to coalesce around a single candidate for the first time in 1986. The usually cohesive bloc was deeply divided, with three viable candidates: Camdessus, Onno Ruding (Netherlands; finance minister, and Chairman of the Interim Committee), and Jeremy Morse (United Kingdom; former Chairman of the C-20 deputies). Even after Morse withdrew, the split between Camdessus and Ruding remained. Eventually, Camdessus was chosen by a secret poll of the Executive Board in which support from developing countries proved to be decisive. At the time, the U.S. authorities quietly favored Camdessus, though mostly because of their distrust of Ruding as a reliable ally for U.S. interests. When Camdessus came up for reelection in 1991, the U.S. view of Camdessus was decidedly less favorable. By then, however, support from Europe and elsewhere was sufficiently strong to overcome U.S. opposition. In 1996, Camdessus easily won reelection for an unprecedented third term.

Michel Camdessus was born in Bayonne, France, on May 1, 1933. He served in the French army during the Algerian war of independence, where his duties included defusing land mines. At age 24, he married Brigitte d'Arcy and formed a lifelong partnership that would produce six children and many grandchildren. After graduating from the prestigious École Nationale d'Administration in Paris (and thereby becoming an *énarque*, the colloquial distinction of the French elite), he embarked on a career of public service. Much of his early career was spent in the French Treasury, where he eventually became its director and served as chair of both the Paris Club of official creditors and the monetary committee of the European Economic Community. For the two years before his election as Managing Director of the Fund, he was governor of the Banque de France. On retiring from the IMF in February 2000 at age 66, Camdessus became president of the Centre d'Études Prospectives et d'Information Internationales (CEPII), a Paris-based economics research center.

Deputy Managing Directors

The post of Deputy Managing Director, or DMD, was established in 1949, when Andrew N. Overby—who had been the U.S. Executive Director—was named to the position. As the Fund's first Historian noted, this appointment "had the unfortunate result of strengthening a suspicion in the minds of many members—perhaps particularly European members—that the Fund's policy was being dictated by the United States" (Horsefield, 1969, p. 232). Over the years, as a succession of U.S. officials was similarly rewarded, that suspicion grew in intensity and spread to the Fund's external critics.[45] Recognizing that the suspicion was not without foundation, Camdessus set out in 1994 to counteract it by appointing deputies from outside the traditional sources.

[45]The succession to 1994 was Overby (1949–52), H. Merle Cochran (1953–62), Frank A. Southard, Jr. (1962–74), William B. Dale (1974–84), and Richard D. Erb (1984–94). All except Cochran were U.S. Executive Director before being appointed Deputy Managing Director. Cochran was the U.S. ambassador to Indonesia at the time of his appointment.

The Deputy in the early 1990s was Richard D. Erb, who was appointed U.S. Executive Director in 1981 and Deputy Managing Director in 1984.[46] As Erb's second five-year term in office neared its end in the spring of 1994, Camdessus informed the U.S. Treasury that he would be happy to have the appointment renewed for another five years. Treasury officials wanted to nominate someone more closely aligned with their own thinking about economic policy, but they suggested a candidate whom Camdessus found unacceptable. At that point Camdessus began discussing the possibility of having three deputies, a solution that would spread the growing workload more reasonably, inject a regional balance into the inner circle of the Fund's management, and dilute the influence of any one deputy.

Treasury officials could not prevent the Managing Director from appointing three deputies, but they found a way to retain the privilege of having a U.S. national in the number two slot. One of the three, they insisted, would be designated the First Deputy Managing Director (a title oddly reminiscent of Russia's "first deputy" ministerial posts). This FDMD would have prerogatives above the others and would serve first as Acting Managing Director whenever the Managing Director was away from headquarters. Camdessus reluctantly accepted that distinction, but he insisted that the Treasury give him a choice of candidates for the job. They did so, and from that list he chose Stanley Fischer.[47] The Executive Board discussed the proposal in a series of restricted sessions in late May and early June and approved it on June 6.[48] It was the first significant change in the Fund's senior management structure since creation of the DMD post 45 years earlier.

Fischer's appointment was greeted with delight and relief by most staff members. Well known, much liked, and highly respected, he was coming to the Fund from a lofty position in the economics profession—Killian Professor and chairman of the economics department at the Massachusetts Institute of Technology (MIT). Almost everyone had read his undergraduate and graduate textbooks on economics. Moreover, he had already spent two and a half years on 19th Street, as Vice President and Chief Economist at the World Bank. A naturalized U.S. citizen, Fischer had a strongly international background, having been born and raised in Africa, in the territories that had become Zambia and Zimbabwe; and having studied or taught in England and Israel as well as the United States. Many of his graduate students at MIT had gone on to hold senior policymaking positions in their home countries.

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[46]For a profile, see Boughton (2001), p. 1044.

[47]This account is based primarily on interviews with participants in these deliberations. Recollections differed on some details, but the essence of the sequence of events was not in dispute.

[48]The first formal discussion of this matter by the Executive Board was in restricted session at EBM/94/45 (May 23, 1994), by which time the proposal was far enough along to include the names of the three candidates. The next day, Erb publicly announced his intention to resign, and the Managing Director circulated curriculum vitae for his three proposed successors; see "Deputy Managing Directors," EBAP/94/41 (May 24, 1994); and "Erb Announces Intention to Leave IMF," NB/94/12 (May 24, 1994). The relationship between the FDMD and the other two deputies was clarified in "Deputy Managing Directors," EBAP/94/43, Revision 1 (June 3, 1994). The Executive Board approved the proposal, again in restricted session, at EBM/94/51 (June 6, 1994).

As FDMD, Fischer's influence on the Fund greatly exceeded what might be expected from the "number two" in the organization. Although Michael Mussa—Economic Counsellor and Director of Research, and a formidable intellect in the profession—was nominally the Fund's chief economist, everyone knew that Fischer had an even greater claim to that title. Within a few months of his arrival, the Mexican peso crisis struck. As detailed in Chapter 10, Fischer already knew many of the key Mexican officials from when they had studied at MIT. The crisis erupted over the Christmas holidays, when Camdessus was vacationing in France. Camdessus entrusted much of the initial handling of the crisis to Fischer, the Acting Managing Director at the time.

The success of the Mexican operation made Fischer the natural choice to handle much of the Fund's work on East Asia when that region suffered a financial meltdown in 1997 (see Chapter 11). Moreover, while at MIT, Fischer had been part of a team that helped Russian advisors draft an early proposal for transforming the Soviet economy. Throughout his first four years at the Fund, Fischer immersed himself in the support and rescue efforts for Russia. Later, he played a central role in negotiating rescues for Brazil and Turkey, where again he was already on a first-name basis with the leading officials.

Fischer's role extended beyond crisis management. He was the main force behind the Fund's cultural shift from secrecy to transparency, described in Chapter 4. He initiated an internal training program for Fund staff that resulted in economists getting an average of three days' training per year in the latest developments in economic theory and policy. He mentored, inspired, and attracted bright young economists to the Fund. He pushed for and initiated a program to increase the diversity—especially gender diversity—in the Fund's professional and management ranks. He also continued to make groundbreaking contributions to the theory and practice of economic policy, including the promotion of inflation targeting, the concept of an international lender of last resort, and the theory that became known as the bipolar approach to exchange rate management (see Chapter 1).

Fischer's role at the IMF was not without controversy. Inside the building, he was such a dominant and even revered individual—both brilliant and gentlemanly—that criticism was seldom heard and was always blunted. Outside, by the time his term ended in 2001, some critics were more open. Had the Fund become too ready to bail out every country that found itself in hot water? Was it right to help countries such as Russia, Brazil, and Argentina defend fixed exchange rates that financial markets viewed as unsustainable? More generally, did the bipolar approach really make sense? Was Fischer too close to U.S. officials, notably Lawrence Summers, to be independent and objective? These and other questions were hotly debated for years after Fischer left Washington.[49] In the end, the

[49]The nastiest and least credible attack on Fischer came from Joseph Stiglitz, who suggested that Fischer's post-IMF appointment at Citigroup was a reward for "having faithfully executed what he was told to do" while working at the Fund (Stiglitz, 2002, p. 208). For a rebuttal, see Kenneth Rogoff, "An Open Letter to Joseph Stiglitz," at http://www.imf.org/external/np/vc/2002/070202.HTM.

The original troika of Deputy Managing Directors: Stanley Fischer (First Deputy, center), flanked by Alassane Ouattara (left) and Prabhakar R. Narvekar (right). (IMF photo)

criticisms, regardless of their merits, detracted little from the magnitude of his achievements.

One of the most unusual episodes in Fischer's tenure at the Fund was the way it ended. When Camdessus resigned in February 2000, the Executive Board was bogged down in its effort to elect a replacement. While that effort continued, Fischer became Acting Managing Director. For a time, the German authorities were pressing for acceptance of Caio Koch-Weser (deputy minister of finance in Germany and a former senior official at the World Bank) as Managing Director. A group of developing countries opposed to Koch-Weser or to the perpetuation of Europe's privilege to select the winner nominated Fischer—the first time a non-European candidate had been formally nominated. At that point, the Japanese authorities nominated Eisuke Sakakibara (a former deputy finance minister). With the Board deadlocked, Germany withdrew Koch-Weser's name and substituted that of Horst Köhler (president of the European Bank for Reconstruction and Development). Köhler's election in May put Fischer in the awkward position of serving as deputy to the person to whom he had lost. The two nonetheless worked

together for nearly two years. Fischer remained FDMD until August 2001 and then served as Special Advisor to the Managing Director through January 2002.

After Fischer left the Fund, he moved to New York where he was appointed Vice Chairman of Citigroup and President of Citigroup International. Three years later, he accepted the post of Governor of the Bank of Israel.

The other two deputies who were appointed in 1994 came from developing countries. Both had extensive prior experience at the IMF.

Alassane Dramane Ouattara, a national of Côte d'Ivoire, was a familiar presence at the IMF, having first worked there as an economist while completing his Ph.D. at the University of Pennsylvania from 1968 to 1973. He left the staff in 1973 to begin a career at the Central Bank of West African States (BCEAO), first in Paris and later at the bank's headquarters in Dakar, Senegal. In 1984, Ouattara returned to Washington to become Director of the Fund's African Department (AFR), a post he held until he was named governor of the BCEAO in 1988.

In 1990, Ouattara accepted an invitation from the president of Côte d'Ivoire, Felix Houphouët-Boigny, to chair a special committee charged with revamping the country's economic policies. In November, Houphouët elevated Ouattara to be the country's first prime minister. Following Houphouët's death three years later, Ouattara began his third assignment at the IMF, this time as one of the first three Deputy Managing Directors appointed in 1994. He served until July 1999, when he assumed the leadership of the political party Rassemblement des Républicains (RDR) with the intention of competing in the 2000 presidential elections in Côte d'Ivoire. After a military coup in December 1999, the RDR and Ouattara were banned from the elections. Political repression and instability settled in, and Ouattara spent the next decade in exile, trying to broker a peaceful transition to democracy. In November 2010, he was elected president of Côte d'Ivoire.

Prabhakar R. Narvekar served in staff and management positions in the Fund from 1953 to 1997, longer than anyone else in the institution's history.[50] A native of India, Narvekar joined the staff as a Research Assistant in the Asian

[50]A few other longevity records should be noted here. On the basis of informal research, it appears that Irène de Heurtemont, who joined the staff in the secretarial pool in the early 1950s and retired as Administrative Services Officer in the Paris office in 1995, was (as of 2010) the longest-serving member of the regular staff, with more than 43 years of service. For a tribute, see Aldo Guetta and Christine Ursenbach, "Au Revoir to the Fund's Dean of Staff," *IMF Staff News* (December 1995), p. 21. Brian Rose, a British national who joined the staff in 1947 and retired in 1988, was a close second. Jacques J. Polak, whose connection to the IMF began as a member of the Netherlands delegation at the 1944 Bretton Woods conference, served on the staff for 32 years (1947–79) and accumulated another 16 years of service to the Fund as Advisor to the Managing Director, Executive Director (Netherlands, 1981–86), and president of the Per Jacobsson Foundation. On his ninetieth birthday, in 2004, the Fund renamed its annual research conference in his honor. He continued to spend part of each work week in his office in the Fund until 2007. The last surviving delegate to Bretton Woods, Jacques Polak died in March 2010. For a more complete account of his career, see the Introduction to Boughton (2004) and Boughton (2011).

Deputy Managing Directors Shigemitsu Sugisaki (1997–2004; left) and Eduardo Aninat (1999–2003). (IMF photos)

Department. He was promoted repeatedly within the department until he became its director in 1986. He stepped down in 1991 when the department was split in two, spent the next three years as Special Advisor to the Managing Director, and was named Deputy Managing Director in 1994. He served in that position for three years, after which he retired again, though not for long. His exceptional diplomatic skills and experience in Asia were recognized anew in 1998, when Camdessus called on him during the East Asian crisis to serve as his special liaison to Indonesia's President Suharto, as described in Chapter 11.

When Narvekar stepped down as DMD in 1997, Japan's role in the IMF was in the ascendancy. Japan was a major creditor to the Fund, not just as the country with the second largest quota but also as a donor to various trust funds and other IMF operations. It was thus not surprising that a Japanese official would be considered for the top tier of staff positions. In anticipation of this possibility, Shigemitsu Sugisaki had left his post as head of the Executive Bureau of the Securities and Exchange Surveillance Commission in Tokyo in 1994 to spend three years as Special Advisor to the Managing Director. He was named DMD in February 1997, a post he held for the next seven years.

Ouattara's resignation in 1999 opened a final opportunity for Camdessus to name a new deputy. This time, he turned to Latin America and selected Eduardo Aninat. No stranger to the Fund, Aninat had spent the preceding five years as finance minister for Chile. He was chairman of the Board of Governors for the 1996

IMF/World Bank Annual Meetings and served for three years on the Development Committee. He served as DMD from December 1999 to June 2003.

The Staff

During the 1990s, the size of the staff of the IMF increased by nearly a third, from 1,748 to 2,297, in response to the growing membership and its growing demands. At the end of the decade, almost half of the staff were economists; 30 percent were administrative assistants or other support staff; and the rest were professionals in other fields such as accounting, information technology, or law. An additional 444 employees were hired under short-term contracts to serve as consultants or experts on specific topics. The staff came from more than 130 countries in all regions of the world. As of 1997, 42 percent came from developing countries, but those staff were somewhat concentrated in the lower grades; just 30 percent of management-level staff were from developing countries. One-fourth of the staff came from the host country, the United States. The geographic diversity of the staff increased slightly during the decade, particularly after the Fund instituted a diversity program in 1995.[51]

Leadership Changes

In 1990, the IMF had been in business for 44 years, longer than the normal staff career. The staff who built the agency from an uncertain fledgling to a powerful international financial institution had all retired. The men—they came from many countries and many cultures, but like their predecessors they were all men—who now led the IMF had mostly arrived in the 1960s or even the 1970s. Over the course of a decade, most of them too would retire and would make way for an even more diverse leadership corps.

As can be seen in Appendix I, only two department heads served in one position throughout the decade of the 1990s. Vito Tanzi, an Italian who joined the staff in 1974 as an Assistant Division Chief in the Fiscal Affairs Department, became that department's director in 1981 and remained in that post until he retired at the end of 2000. François P. Gianviti, from France, joined the Fund in 1985 as Director of the Legal Department and remained in that post until he retired in 2004.

Each passing decade witnessed the departure of remarkable leaders who had made notable contributions to the institution. The first of those to exit in the 1990s was Leslie Alan Whittome, who retired in 1990 after a 27-year Fund career.

[51]See *Annual Report of the Executive Board 2000*, pp. 95–97; and "Diversity Annual Report 1997," FO/DIS/98/41 (May 20, 1998). These figures do not include the staff of Executive Directors' offices, who are hired by and work for the Executive Director.

Fondly known to many of his acronym-sensitized colleagues as "The LAW," Whittome arrived at the IMF in 1964 at age 38, when he gave up his post as deputy chief cashier of the Bank of England to become Director of the European Department (EUR). In 1980, he received the additional title of Counsellor, an honor then held by only two other senior officers of the Fund.[52] As head of EUR, Whittome led all of the department's most important negotiating missions, including those that led to stand-by arrangements for the United Kingdom in 1967, 1969, and 1977, and for Italy in 1974 and 1977. In 1987, he was named Director of ETR. Following his retirement, Camdessus asked him to return for a year as Special Counsellor in 1990–91, to direct the preparation of the Joint Study of the Soviet Union, described in Chapter 2. In 1995, Camdessus called on him again to prepare what became the Whittome report on avoiding a repeat of the Mexican peso crisis, described in Chapters 4 and 10. A British citizen, Sir Alan was knighted by Queen Elizabeth II in 1991. He died in 2001.

The next major departure from the staff was P.R. Narvekar. As discussed above in the section on management appointments, he stepped down as Director of the Asian Department in 1991 after spending 38 years there.

Then in 1992, A. Shakour Shaalan retired as head of the Middle Eastern Department (MED), a post he had held for 15 years. Shaalan joined the staff of the Research Department in 1961, moved to MED two years later, and spent the rest of his 31 years on the staff in that department. As noted earlier in this chapter, he then was elected Executive Director for Egypt and 12 other countries.

Three other department directors with long service at the Fund retired in the early 1990s.

Azizali Mohammed, a Pakistani national, spent 30 years on the staff (1960–90), the last 10 as the first Director of the External Relations Department (EXR). He retired at the end of 1990 to become the Alternate Executive Director to Mohamed Finaish, a post he held for two years.[53] Mohammed was replaced at EXR by another person with a long career in the Fund, Shailendra Anjaria. A national of India, Anjaria arrived at the Fund as a summer intern in 1967 and joined the full-time staff the following year. He spent most of his career in ETR, moved to AFR in 1988, and was promoted to Director of EXR in 1991. Anjaria served in that post until 1999, when Camdessus appointed him Secretary of the Fund. He retired in 2009.

Sterie T. (Ted) Beza retired in 1994 after a 33-year career in the Western Hemisphere Department. Beza, a U.S. national, was replaced as director by Claudio

[52]The title "Counsellor" was awarded occasionally to department heads to designate an elevated status. (The double-l is a rare Anglicism, in contrast to the usual North American spelling and usage in the Fund.) Those holding this title in the 1990s were Ted Beza, Jacob Frenkel, Michael Mussa, Mamoudou Touré, Leo Van Houtven, and Alan Whittome. Camdessus did not name any Counsellors after Mussa in 1991.

[53]Mohammed was also profiled in de Vries (1985), pp. 1028–29.

Loser, who was previously Beza's deputy.[54] Loser, from Argentina, held that post until he retired in 1999.

Mamoudou Touré first joined the staff as Director of AFR in 1967. He held that post until 1976, when he returned to his native Senegal to become special advisor to the president of the republic. He eventually became minister of finance in Senegal (1983–88) and then returned to his former post at the Fund. After six more years directing AFR, Touré retired in 1994.[55]

In broad terms, the work of AFR was divided linguistically, with two branches covering the francophone and mostly anglophone countries. When Touré retired, he was succeeded by Evangelos Calamitsis, a Greek national who had served as Deputy Director of AFR with responsibility for francophone countries since 1987. Calamitsis had been on the Fund staff since 1965. He retired in 1998 and was succeeded by Goodall E. Gondwe, who had been the deputy with responsibility for anglophone countries. Gondwe retired in 2002 and returned to his native Malawi, where he became minister of finance.

When Touré returned to Senegal in 1976, the Fund hired Justin B. Zulu to run AFR. Zulu, a former governor of the Bank of Zambia, had served as Alternate Executive Director for the anglophone African countries for the two years before his appointment. In 1984, he moved to the Central Banking Department (CBD), which he directed until 1995, when he moved to New York to direct the Fund's UN liaison office. He retired in 1999.

In 1992, as described above, CBD was expanded and renamed Monetary and Exchange Affairs (MAE), with Manuel Guitián as Associate Director. A native of Spain with a Ph.D. from the University of Chicago, Guitián worked in ETR for 17 years (1970–87) before being named Deputy Director of EUR (1987–91). He became Director of MAE when Zulu left the department in 1995. Four years later, gravely ill, he took early retirement and returned to Spain, where he died a few months later at age 61.

Massimo Russo, an Italian national, first joined the staff of the IMF in 1964 as an economist in AFR. He resigned in 1972 to spend two years at the Organization for Economic Cooperation and Development in Paris. He then returned to the Fund, rose to become Deputy Director of ADM, and left for a second time to become director general of the Commission of the European Communities. He returned to the Fund for good in 1987 and succeeded Whittome as Director of EUR. He held that job for a decade (taking over EU1 when the department was bifurcated) and then succeeded Sugisaki as Special Advisor to the Managing Director. Russo retired in 1998.

The Secretary of the Fund has a central role in the institution, as a bridge between management and the Executive Board. At meetings of the Executive Board, the

[54]Beza was profiled in de Vries (1985), p. 1028; and in Boughton (2001), p. 1047.

[55]Also see de Vries (1976), p. 644; and Boughton (2001), p. 1049.

Secretary sits next to the Managing Director, manages the running of the meeting and the preparation of the Summing Up or other outcome, and tallies the vote (if one is taken) or assesses the "sense of the meeting" (no formal vote is taken in the great majority of cases). This job can be a routine bureaucratic function, but in the right hands it can have a powerful effect by preventing stresses from blocking consensus. From 1977 to 1996, Leo Van Houtven was Secretary, and for the last nine of those years he also held the title of Counsellor. A citizen of Belgium, Van Houtven joined the staff in 1958. Before becoming Secretary, he worked in EUR and directed the Paris office. Reinhard Munzberg, a German national who had been Deputy General Counsel in the Legal Department, succeeded Van Houtven as Secretary.

Two economists from the University of Chicago headed the Research Department in the 1990s: Jacob A. Frenkel (1986–91) and Michael Mussa (1991–2001). Frenkel was the David Rockefeller Professor of International Economics at Chicago when de Larosière invited him to replace William C. Hood as Economic Counsellor and Director of Research. When he left after five years to become governor of the Bank of Israel, Camdessus brought in Michael Mussa, who was on the faculty at the University of Chicago Graduate School of Business. Not only an academic, Mussa had served on the U.S. Council of Economic Advisers during President Ronald Reagan's second administration. In contrast to Frenkel's emphasis on theoretical economic research,[56] Mussa made the World Economic Outlook (WEO) exercise the highest priority of the department and refocused research toward economic modeling relevant to the WEO and to practical analysis of exchange rate policies. On leaving the Fund, he joined the Peterson Institute for International Economics as a senior fellow.

One department director played a much more important role throughout the 1990s than is revealed in the central chapters of this History. As head of ETR and its successor department PDR from 1990 to 2001, John T. (Jack) Boorman directed work on all of the major policy changes instituted by the Fund. Although every policy document issued by the department reflected his close involvement, he worked mostly behind the bureaucratic curtain and put his division chiefs out front. In management deliberations, he was nearly always present as a key advisor. (As an example, see the photograph in Chapter 10, p. 478). A U.S. national, Boorman joined the staff of the IMF in 1975 after several years of university teaching and four years with the Federal Deposit Insurance Corporation. In 1976–78, he was the Fund's Resident Representative in Indonesia, an experience that greatly informed his participation in the workout of the Indonesian crisis in 1997–98. He joined ETR in 1985 and spent the rest of his career there until his retirement in 2001.

[56]For an overview of the research agenda under Frenkel, see "Major Themes in the Work of the Research Department, 1987–91," SM/91/238 (December 11, 1991).

The prevalence of the masculine pronoun in much of this chapter reveals the traditional gender bias of the institution. For many years, that bias was consistent with the economics profession in general and international finance in particular. By the 1990s, the Fund clearly was lagging the broader trends toward balance and diversity. As noted in the preceding section, Stanley Fischer showed concern about this gap and instituted a diversity program for the Fund. A Special Advisor on Diversity—Leena Lahti-Kotilainen, from Finland—took office within ADM. The Fund revised its hiring practices to try to hire and promote more women, including in the most senior staff positions, but for the first few years the effort bore little fruit: the proportion of female economists in supervisory positions (less than 7 percent at the level of division chief or above) remained roughly constant from 1993 (before the effort began) to 1997. The program did, however, lay the groundwork for future progress—the percentage of women hired for professional positions rose steadily from 23 percent in the early 1990s to 33 percent in 1999.[57]

On the plus side, the Fund appointed its first three female department directors during this period. In 1995, K. Burke Dillon, a U.S. national with 22 years of Fund experience, broke the glass ceiling when she assumed leadership of ADM. Carol S. Carson, a U.S. national who was director of the Bureau of Economic Analysis in the U.S. Commerce Department before joining the Fund staff in 1995, replaced the retiring John B. McLenaghan as Director of the Statistics Department in 1996. Margaret R. Kelly, from Australia, became the third in this select group when she took control of the Human Resources Department in 1999. (Within the economics departments, the first chief would be Teresa Ter-Minassian, Director of the Fiscal Affairs Department from 2000 to 2008.)[58]

Work Pressures and Staff Safety

Rising work pressures throughout the 1990s caused concern that the Fund was becoming a less desirable place to work, especially because of the stresses on family and personal life when staff were compelled to spend large parts of the year traveling. When management, under pressure from major creditor countries, downgraded the standard staff travel allowance from first class to business class in 1994, many on the staff viewed it as an affront that would make long-distance travel

[57]See "Steps to Achieve Greater Diversity and Address Discrimination Among the Fund's Staff," UNDOC/95/127 (June 1, 1995); "Appointment of Special Advisor on Staff Diversity," UNDOC/95/247 (October 13, 1995); "Diversity Annual Report 1997," FO/DIS/98/41 (May 20, 1998); and "Staff Recruitment and Retention Experience in 1999," EBAP/00/40 (April 11, 2000).

[58]Margaret Garritsen de Vries, before finding her true vocation as Historian of the IMF, was the Fund's first female Division Chief, in the Asian Department (1957). On the Executive Board, Lore Fuenfgelt (Germany) was the first female Alternate Executive Director (1968–74). Hélène Ploix (France) was the first female Executive Director (1986–89). Of the 79 Executive Directors appointed or elected in the 1990s, 5 (6.3 percent) were women.

(often undertaken on short notice) more arduous. As pressures increased, the Staff Association became increasingly active in presenting staff concerns to management and to the Executive Board. In 1995, in response to a flow of grievances about work practices and policy decisions affecting individuals on the staff, the Fund established an Administrative Tribunal to adjudicate disputes. For the first time, the Fund had an independent body that could overrule its administrative decisions. In the late 1990s, the Fund took more general steps to relieve work pressures, including by introducing more-flexible work schedules; and to improve the balance between work and personal life, for example, by establishing a child care center at the headquarters building. Overall, staff morale held up reasonably well because the rewards of working on important financial challenges generally offset the encroaching negative aspects of life in a large bureaucracy.

The frequency of international and domestic armed conflicts around the world in the 1990s raised serious concerns about staff safety. As a general rule, the Fund's policy was that staff missions would not travel to countries where their safety could not be assured. For example, no consultations were held in Afghanistan in 1988 or 1989 owing to the war against Soviet occupation. The 1990 Article IV consultation discussions with Afghanistan were held in New Delhi, India. The staff returned to Kabul in March 1991, but the security situation deteriorated anew when the Mujahideen and then the Taliban took control. No further consultations were held until U.S.-led coalition forces overthrew the Taliban in late 2001.

The effectiveness of this cautious policy broke down when conflicts suddenly erupted or when simmering problems that had seemed containable boiled over. Staff encountered these problems much more frequently in the 1990s than they had earlier. Prominent examples included the following:

- When Iraq invaded Kuwait in August 1990, an IMF consultant was in Kuwait City providing technical assistance. He went into hiding from the invading army and eventually managed to establish telephone contact with the Fund. Camdessus and Kofi Annan (Secretary-General of the United Nations) negotiated secretly with Iraqi officials until an agreement was reached for the International Red Cross to find the official and escort him to safety.
- In February 1993, a staff member was flying to Asmara, Eritrea, to participate in a premembership mission. On the leg from Frankfurt to Cairo, a gunman from Ethiopia hijacked the Lufthansa plane and demanded to be flown to New York, threatening to kill passengers. The Fund staff member was sitting in the seat closest to the cabin door and thus was in the gravest danger. Eventually, the plane reached New York safely, and the hijacker surrendered.
- Staff assigned to postconflict countries in the mid-1990s, including Bosnia and Herzegovina, Georgia, and Tajikistan, often reported hearing the sound of gunfire while they were working.
- In January 1996, a terrorist's bomb exploded in Colombo, Sri Lanka, shattering the windows of the Fund's office in the central bank building, killing

80 people and wounding 1,400. A staff assistant in the IMF office was badly injured by flying glass.
- In 1997, a Fund staff member was evacuated from Albania after receiving a death threat while investigating reports of financial malfeasance at the central bank.
- In May 1997, rebel army officers in Sierra Leone staged a coup d'état. One night, the Fund's Resident Representative was awakened by a marauding gang of armed soldiers who eventually broke through the security barrier around the residence and into his home, looting it and shooting indiscriminately, evidently intent on killing him and his family. After being robbed repeatedly at gunpoint throughout the day and night, he, his wife, and their children escaped on foot to safety in the U.S. embassy down the street.
- When antigovernment violence erupted in Indonesia in the spring of 1998, the Fund's Resident Representative and his staff, along with personnel from the World Bank, had to be evacuated from Jakarta in a chartered airplane (see Chapter 11, p. 537).
- Michel Camdessus—the last Managing Director to travel regularly without a bodyguard or other special security measures—had food, drink, and even paint thrown in his face on several occasions in the late 1990s.

A different type of staff security issue arose in December 1995, when the Chinese government arrested a staff member—a Chinese national—while he was in the country on official Fund business. The authorities had requested his participation in the discussions for the annual Article IV consultations. During the mission, he was arrested on a charge related to an alleged criminal matter that predated his appointment at the IMF. Although the charges had no relation to the man's employment at the Fund, and the IMF took no position as to his innocence or guilt, the circumstances of his arrest were deeply troubling to the staff at large. The government averred that it had not intended to arrest the staff member, but its subsequent inquiry had left it no choice. To the Fund staff, however, it looked as if their colleague had been led into a trap.

For close to two years, Camdessus, Hubert Neiss, and other senior Fund officials held secret negotiations with the Chinese authorities to try to ensure that their colleague was being treated fairly and humanely, and ultimately to gain his release from prison. In addition to discussing the matter with national officials at every opportunity, Camdessus refused to send the Fund's Resident Representative to Beijing or to take other measures to strengthen relations throughout the lengthy stalemate. In the fall of 1997, shortly after the IMF/World Bank Annual Meetings in Hong Kong SAR, the staff member was allowed to leave China and rejoin his family in Washington.

The possibility that one could be arrested while traveling on official business for the IMF and not have diplomatic immunity came as a shock to many on the staff. To clarify rights and responsibilities and look for ways to avoid a repetition of this

Figure 17.1. Real Fund Salaries, 1970–99

Sources: IMF annual salary reviews and author's calculations.

affair, in March 1996 Camdessus appointed a Working Group on Safety of Staff on Fund Missions. The group, led by staff from the Legal Department, completed its work that November, but the report was not issued until the following May.

For those hoping for a strengthening of protections, the working group's report was disappointing. It clarified that the staff was granted only "functional" immunity, which related only to prosecution for official acts and therefore was much weaker than "diplomatic" immunity. To enhance protection in any significant way would require at least a broad agreement among member countries and possibly an amendment to the Articles of Agreement. On the bright side, the report advised that "the Fund, as employer, should recognize that it has a duty to protect its employees from risks while on mission or assignment, regardless of whether or not immunity applies."[59] In the case of the Chinese staff member, management clearly had done all that it could to fulfill that duty, but it was painfully obvious that its powers were limited.

Staff salaries stagnated in real terms from 1980 to 1988 under political pressure, mainly from the U.S. authorities. After a multiyear study of the compensation system, salaries were adjusted upward in 1989 to a level calculated by an independent consultant to be commensurate with pay in similar "comparator" positions.

[59]"Report of the Working Group on Safety of Staff on Fund Missions," FO/DIS/97/40 (November 8, 1996; issued May 22, 1997), p. ii.

As work pressure ratcheted up in the early 1990s, the pay scale was adjusted upward accordingly (Figure 17.1). On average from 1989 to 1999, the net salary of an economist in the Fund rose in real terms (deflated by the U.S. consumer price index) by about 1 percent a year.[60]

One of the least expected results of the intensification of work in the early 1990s was the formation of a successful blues band. In the course of an otherwise grueling mission to Moscow in March 1993, several staff members realized they shared a passion for playing American popular music. They linked up with a few others, and the Fundamentals band was born. By 1995, the band, composed almost entirely of IMF staff, was "ready for prime time," and it began booking engagements at parties and other venues around Washington. That December, they headlined at the Fund's holiday party. Their talented, thunderous, and hard-driving blues rhythms soon became the highlight of the annual party. The personnel changed a bit over the years, but the Fundamentals stayed together and became a fixture on the party scene at least through the following decade.[61]

A Retrospective on the Camdessus Era

Michel Camdessus served as Managing Director of the IMF for a longer period—13 years—than anyone else. His stewardship of the institution was the dominant influence on the work program and the effectiveness of the Fund's efforts throughout the period of this History.

The central characteristic of the Camdessus era was the expansion of the role of the IMF in the world economy. For better or worse, Camdessus took the view that the Fund had to respond to the major international economic challenges of the time, even if that response carried the Fund far afield from its traditional practices and from what many others viewed as its narrow mandate as a financial institution. Conditionality on financial assistance became broader, more extensive, and more detailed. Surveillance consultations were similarly expanded to cover issues other than macroeconomic conditions and policies.

Beyond any dispute, the IMF was a significant force in the 1990s. It played crucially important roles in the global opening of trade and finance; in the structural transformation of centrally planned economies; in the reduction of poverty and the relief of debt burdens in low-income countries; and above all, in the

[60]The political debates of the 1980s are recounted in Boughton (2001), pp. 1050–56. The average annual real increase from 1970 to 1999 was 0.8 percent. Fund salaries are computed on a net-of-income-tax basis. Staff who are not U.S. residents for tax purposes are paid a net salary and do not pay income taxes on it. U.S. residents are paid an additional tax allowance and pay income taxes on the gross amount.

[61]On the origins of The Fundamentals, see Lynn Aylward, "Focus on the Fundamentals," *IMF Staff News* (December 1995), pp. 35–36.

resolution of international financial crises. It devised a set of standards and codes for policies and for data dissemination and worked with countries to get them implemented. It gave increased attention to poverty reduction and the requirements for what Camdessus called "high-quality growth" in developing countries. The staff became deeply engaged in the specification and sequencing of structural reforms in transition economies. By the mid-1990s, the Fund was ready to refuse financial support to countries plagued with financial corruption. When the East Asian financial crises erupted, the Fund did not shy away from confronting the links between domestic political problems in the affected countries and their financial collapse. When the financial crisis in Mexico threatened to affect other emerging markets, the Fund took preemptive action to stop the contagion. It thus undertook preventive lending in addition to its traditional lending in reaction to shocks. In the late 1990s, management explored the possibility of enabling the Fund to be a true lender of last resort for countries facing major financial crises.[62]

Michel Camdessus's legacy included the establishment of a permanent Trust Fund for lending to low-income countries on generous terms; the engagement of the IMF in programs to reduce the massive debts of both low-income and middle-income developing countries; the Fund's leadership in the transformation of centrally planned economies into open markets and integration with the world economy; an unprecedented record of involvement in the management of international financial crises in Latin America, Europe, and Asia; and an intensification of engagement with countries across Africa aimed at strengthening macroeconomic policies.

To those who knew Camdessus, who understood his ecumenical religious commitment, and who followed his work at the IMF, his dedication to public service, to financial probity, and to improving the lot of the world's poor was unquestioned. Nonetheless, by the time he stepped down in February 2000, he had become "the most criticized man in the world" according to one prominent interviewer (Naím, 2000, p. 35).[63] Youthful protesters threw things at him in public meetings. More serious critics on the right viewed him as too eager to bail out governments and speculators that had implemented weak policies and made bad decisions. They wondered why the IMF—the guardian of macroeconomic and financial stability—lent to poor countries more in need of development aid over extended periods. Critics on the left viewed Camdessus as too avid in pushing for open, globalized trade and finance, supposedly to the detriment of disadvantaged countries. The Fund's management of the East Asian crises of 1997–98 brought these criticisms onto Camdessus's head all at once.

[62]See, for example, Stanley Fischer's 1999 paper, "On the Need for an International Lender of Last Resort," in Fischer (2004), pp. 7–32.

[63]Naím was editor-in-chief of *Foreign Policy* magazine and a former minister of trade and industry in Venezuela.

On a more general level, the many successes that the Fund achieved, as summarized above, tended to get swallowed up by the chorus of naysayers.[64] Was the expansion of the Fund's role a case of "mission creep," as some critics alleged,[65] or was it the only way for the Fund to help countries solve their problems? Did Camdessus try to turn the IMF into a development institution, or was he just applying the mandate set out in Article I in a modern and more effective way? The preceding chapters have attempted to put these questions into perspective. Arguably, most of the technical mistakes the Fund made in the 1990s resulted from the need to deal with extraordinarily challenging initial conditions in a very short time and under tremendous political pressure. Some weaknesses resulted from applying the lessons of mainstream economics too readily.

In conclusion, three counterpoints to the criticisms stand out.

First, Camdessus's belief that national economies could not be allowed to collapse was scarcely radical, and it was shared by virtually all officials of major countries. Even if poorly chosen domestic economic policies were entirely to blame, the consequences of failure could be too severe, both for the country and for its trading and financial partners. Instead of "bailing out" the government, the goal was to use the Fund's financial leverage to get better policies in place and to buy time for the economy to stabilize. The Fund acknowledged the moral hazard associated with repeated crisis lending, but it had to balance that concern against the more immediate costs of a spreading regional or even global crisis.

Second, without structural conditionality, both political economy theory and the historical record showed clearly that domestic political pressures would often lead to myopic policy decisions contradictory to long-term stability. At its best, conditionality served as a commitment mechanism through which national authorities could carry out policies they knew to be in the country's long-term interests but that could not be adopted without external pressure and assistance. By the end of the decade, the risks of this strategy were becoming more evident, especially the risk of undercutting the emergence of genuine domestic support for reforms and weakening national ownership of the process. The Fund, therefore, would spend much of the following decade trying to cut back on the depth and breadth of its role in policy formation in borrowing countries. Finding the right balance, however, remained a major challenge.

Third, the purpose of the Fund's concessional lending through the ESAF (and its successor, the Poverty Reduction and Growth Facility) was not to provide long-term development assistance to low-income countries. The purpose was to induce and assist those countries to strengthen economic policies. Without official financing sustained over several years, the poor initial conditions in most low-income

[64]In 2009, a group of current and former IMF officials set out to rebalance the record by publishing a collection of "success stories," including several from the 1990s; see Brau and McDonald (2009).

[65]See, for example, "Mission Creep in Russia," Woods (2006), Chapter 5.

countries would prevent development from taking hold. Without improvements in institutions and economic policies, financing might well be wasted. The goal of ESAF lending was to complement and catalyze development aid in a way that would lead to a coherent global policy. In retrospect, many ESAF borrowers did strengthen their policies, and the group as a whole established an excellent record of implementing ESAF-supported programs and of repaying the loans on time. The facility thus worked much as the Extended Fund Facility (EFF) did for middle-income borrowers, though with a different source of funding and more favorable financial terms.

On a personal level, Camdessus was determined to ensure that the Fund remained relevant in a rapidly changing world and to place the work of the Fund within a broader context. He felt strongly that the Fund could not be effective if it acted purely as a technical agency without regard to the ethical, moral, and political effects of its actions. As he wrote in 1999, "Even if the IMF's mandate obliges us to concentrate on the economic and financial aspects of the crisis, this effort only makes sense if it is oriented to the improvement of living standards and primarily the alleviation of the plight of the poor" (Camdessus, 1999, p. vii). That conviction often put him at odds with the finance ministers and central bank governors who were the political masters of the Fund and with the staff who were charged with conducting the Fund's technical work. He persevered in the face of that opposition and prevailed more often than most observers expected. Whether the resulting tactics succeeded sufficiently to justify the enlargement of the Fund's role will become clearer as history unfolds.

Appendix I: Organization of the IMF in the 1990s

Board of Governors
(Interim Committee; succeeded by International Monetary and Financial Committee in 1999)
(Development Committee – joint with the World Bank)

Executive Board

Managing Director
(and Chairman of Executive Board)
Michel Camdessus, 1987–2000

First Deputy Managing Director
Stanley Fischer, 1994–2001

Deputy Managing Directors
Richard D. Erb, 1984–1994
Prabhakar R. Narvekar, 1994–1997
Alassane D. Ouattara, 1994–1999
Shigemitsu Sugisaki, 1997–2004
Eduardo Aninat, 1999–2003

Area Departments

African
Mamoudou Touré, 1988–94
Evangelos A. Calamitsis, 1994–98
Goodall E. Gondwe, 1998–2002

Asian (to 1991)[b]
P.R. Narvekar, 1986–91

Central Asia (from 1991 to 1997)
Hubert Neiss, 1991–97

Southeast Asia and Pacific (from 1991 to 1997)
Kunio Saito, 1991–97

Asia and Pacific (from 1997)[c]
Hubert Neiss, 1997–2000

Functional Departments and Offices

Central Banking Department (became Monetary and Exchange Affairs Department in 1992)
Justin B. Zulu, 1984–95
Manuel Guitián, 1995–98
Stefan Ingves, 1999–2005

Fiscal Affairs Department
Vito Tanzi, 1981–2000

IMF Institute
Gérard M. Teyssier, 1972–90
Patrick B. de Fontenay, 1991–96
Mohsin S. Khan, 1996–2003

Legal Department
François P. Gianviti, 1985–2004

Information and Liaison

External Relations Department
Azizali F. Mohammed, 1980–90
Shailendra J. Anjaria, 1991–99
Thomas C. Dawson II, 1999–2006

Office in Europe (Paris)
Andrew J. Beith, 1986–92
Joaquin Ferran, 1993–96
Christian Brachet, 1996–2000

Office in Geneva
Helen B. Junz, 1989–94
Alan A. Tait, 1995–98
Grant Taplin, 1998–2002[e]

Support Services

Administration Department (to 1999)[a]
Graeme F. Rea, 1985–95
K. Burke Dillon, 1995–99
Brian C. Stuart, 1999

Human Resources Department (from 1999)
Margaret R. Kelly, 1999–2004

Technology and General Services Department (from 1999)
Brian C. Stuart, 1999–2005

Secretary's Department
Leo Van Houtven, 1977–96
Reinhard Munzberg, 1997–99
Shailendra J. Anjaria, 1999–2009

Bureau of Computing Services (to 1999)[f]
Warren N. Minami, 1982–99

Appendix (continued)

Area Departments	Functional Departments and Offices	Information and Liaison	Support Services
European (to 1992)[d] *Massimo Russo, 1987–92*	Exchange and Trade Relations Department (became Policy Development and Review Department in 1992) *L. Alan Whittome, 1987–90* *Jack Boorman, 1990–2001*	Office at the United Nations (New York) *Rattan Bhatia, 1987–95* *Justin B. Zulu, 1995–99* *Reinhard Munzberg, 1999–2007*[g]	Bureau of Language Services (to 1999)[h] *Alan Wright, 1986–92* *Patrick Delannoy, 1993–99*
European I (from 1992) *Massimo Russo, 1992–97* *Michael Deppler, 1997–2003*	Research Department *Jacob A. Frenkel, 1987–91* *Michael Mussa, 1991–2001*		Office of Internal Audit (became Office of Internal Audit and Review in 1991, and then became Office of Internal Audit and Inspection in 1996) *Robert Noë, 1985–90* *William A. Beveridge, 1991–93* *Marcello Caiola, 1993–95* *Eduard Brau, 1996–99*
European II (from 1992) *John Odling-Smee, 1992–2003*	Bureau of Statistics (became Statistics Department in 1991) *John B. McLenaghan, 1989–96* *Carol S. Carson, 1996–2004*		Office of Budget and Planning (from 1992) *Lindsey A. Wolfe, 1992–98* *Ernst-Albrecht Conrad, 1998–2001*
Middle Eastern *A. Shakour Shaalan, 1977–92* *Paul Chabrier, 1992–2001*	Treasurer's Department *F. Gerhard Laske, 1987–92* *David Williams, 1992–99* *Eduard Brau, 1999–2004*		Regional Office for Asia and the Pacific (from 1997) *Kunio Saito, 1997–2002*
Western Hemisphere *Sterie T. Beza, 1987–95* *Claudio Loser, 1995–2002*			

Source: IMF.

Note:

[a]Split in 1999 into Human Resources Department and Technology and General Services Department.

[b]Split in 1991 into Central Asia Department and Southeast Asia and Pacific Department.

[c]In 1997 Central Asia Department and Southeast Asia and Pacific Department merged into Asia and Pacific Department.

[d]Split in 1992 into European I Department and European II Department.

[e]Taplin was designated Acting Director of the office in October 1998, and he held that designation until his retirement in 2002. His official title beginning in August 1999 was Special Representative to the WTO and Assistant Director of the Office in Geneva.

[f]In 1999, the Bureau of Computing Services was absorbed by the Technology and General Services Department.

[g]In this post, Munzberg initially also had oversight of the Geneva office in his personal capacity.

[h]In 1999, the Bureau of Language Services was absorbed by the Technology and General Services Department.

Appendix II: Executive Directors and Their Alternates, 1990–99

Part I. Appointed Directors[a]

Country	Executive Director (*Alternate*)[b]	Dates of Service[c]
United States	Thomas C. Dawson II	9/21/89–9/7/93
	Charles S. Warner	7/15/88–7/14/90
	Quincy M. Krosby	8/5/91–2/8/93
	Karin Lissakers	12/1/93–4/15/01
	Barry S. Newman	3/28/94–9/30/99
Japan	Koji Yamazaki	12/22/86–8/25/91
	Shinichi Yoshikuni	12/12/87–12/24/90
	Naoki Tabata	12/25/90–12/30/93
	Hiroo Fukui	8/26/91–7/31/94
	Toshihiko Fukuyama	12/31/93–5/19/96
	Hachiro Mesaki	8/1/94–3/15/97
	Hideaki Ono	5/20/96–12/9/98
	Yukio Yoshimura	3/16/97–7/4/01
	Masahiko Takeda	12/10/98–12/31/99
Germany	Guenter Grosche	9/1/84–12/9/90
	Bernd Goos	9/1/84–12/9/90
	Bernd Goos	12/10/90–11/23/92
	Bernd Esdar	2/1/91–7/31/93
	Stefan Schoenberg	11/24/92–7/14/96
	Erika Wagenhoefer	8/1/93–6/30/95
	Bernd Esdar	7/15/95–7/14/96
	Bernd Esdar	7/15/96–5/20/01
	Wolf-Dieter Donecker	7/15/96–5/20/01
France	Jean-Pierre Landau	10/30/89–9/10/93
	Jean-François Cirelli	9/21/89–9/25/91
	Isabelle Martel	9/26/91–8/22/93
	Marc-Antoine Autheman	9/11/93–11/30/97
	Michel Sirat	8/23/93–8/28/95
	Ambroise Fayolle	8/29/95–8/29/97
	Jean-Claude Milleron	2/7/98–7/31/01
	Ramon Fernandez	8/30/97–6/18/99
	Gilles Bauche	6/19/99–1/31/02
United Kingdom	Frank Cassell	1/25/88–7/22/90
	Charles Enoch	10/31/87–7/13/90
	David Peretz	7/23/90–2/18/94
	Paul Wright	7/14/90–8/28/92
	John Dorrington	8/29/92–10/16/94
	Huw Evans	2/19/94–3/14/97
	Gus O'Donnell	3/15/97–7/31/98
	Jon Shields	10/17/94–10/31/98
	Stephen Pickford	8/1/98–12/16/01
	Stephen Collins	11/1/98–1/15/02
Saudi Arabia[d]	Yusuf A. Nimatallah	5/1/81–6/30/90
	Muhammad Al-Jasser	10/11/89–6/30/90
	Muhammad Al-Jasser	7/1/90–10//31/95
	Abdulrahman Al-Tuwaijri	2/11/91–11/15/95

Appendix II (continued)

Part II. Elected Directors[a]

Constituency[e]	Executive Director (*Alternate*)[b]	Dates of Service[c]
Armenia (from 1993)	G.A. Posthumus (Netherlands)	11/1/86–10/31/94
Bosnia and Herzegovina (from 1997)	*G.P.J. Hogeweg (Netherlands)*	7/24/87–7/28/91
Bulgaria (from 1991)	*Zarko Trbojevic (Yugoslavia)*	8/1/91–11/30/92
Croatia (from 1995)	*Oleh Havrylyshyn (Canada)*	1/1/93–5/31/96
Cyprus	J. de Beaufort Wijnholds (Netherlands)	11/1/94–1/14/03
Georgia (from 1993)	*Yuriy G. Yakusha (Ukraine)*	6/1/96–
Israel		
Macedonia, former Yugoslav Rep. of (from 1995)		
Moldova (from 1993)		
Netherlands		
Romania		
Ukraine (from 1993)		
Yugoslavia (to 1992)		
Austria	Jacques de Groote (Belgium)	11/1/73–3/31/94
Belarus (from 1993)	*Johann Prader (Austria)*	7/1/87–
Belgium	Willy Kiekens (Belgium)	4/1/94–
Czechoslovakia (to 1992)		
Czech Republic (from 1993)		
Hungary		
Kazakhstan (from 1993)		
Luxembourg		
Slovak Republic (from 1993)		
Slovenia (from 1995)		
Turkey		
Costa Rica	Leonor Filardo (Venezuela)	11/1/88–10/31/90
El Salvador	*Miguel A. Fernández Ordóñez (Spain)*	11/1/88–10/15/90
Guatemala		
Honduras	Angel Torres (Spain)	11/1/90–10/31/92
Mexico	*Roberto Marino (Mexico)*	11/1/90–10/31/92
Nicaragua	Roberto Marino (Mexico)	11/1/92–10/31/94
Spain	*Gerver Torres (Venezuela)*	11/1/92–10/31/94
Venezuela	Luis E. Berrizbeitia (Venezuela)	11/1/94–10/31/96
	Vicente J. Fernandez (Spain)	11/1/94–10/31/96
	Juan José Toribio (Spain)	11/1/96–10/31/98
	Javier Guzmán-Calafell (Mexico)	11/1/96–10/31/98
	Javier Guzmán-Calafell (Mexico)	11/1/98–7/11/99
	Hermán Oyarzábal (Venezuela)	11/1/98–10/31/00
	Augustín Carstens (Mexico)	7/12/99–10/31/00
Albania (from 1993)	Renato Filosa (Italy)	1/17/89–1/14/93
Greece	*Nikos Kyriazidis (Greece)*	5/1/86–1/17/92
Italy	*Ioannis Papadakis (Greece)*	2/10/92–3/11/94
Malta	Giulio Lanciotti (Italy)	1/15/93–10/31/95
Poland (to 1992)	*Nikolaos Coumbis (Greece)*	3/21/94–2/5/98
Portugal	Enzo R. Grilli (Italy)	11/1/95–10/31/98
San Marino (from 1993)	*John Spraos (Greece)*	2/6/98–3/5/00
	Riccardo Faini (Italy)	11/1/98–6/13/01

Appendix II (continued)

Constituency[e]	Executive Director (*Alternate*)[b]	Dates of Service[c]
Antigua and Barbuda	C. Scott Clark (Canada)	9/29/89–11/1/92
Bahamas, The	*Gabriel C. Noonan (Ireland)*	10/27/89–10/31/92
Barbados	Douglas E. Smee (Canada)	11/2/92–10/31/94
Belize	*Garrett F. Murphy (Ireland)*	11/2/92–10/31/95
Canada	Ian D. Clark (Canada)	11/1/94–10/31/96
Dominica	*Charles X. O'Loghlin (Ireland)*	11/1/95–11/1/98
Grenada	Thomas A. Bernes (Canada)	11/1/96–10/7/01
Ireland	*Peter Charleton (Ireland)*	11/2/98–11/18/01
Jamaica		
St. Kitts and Nevis		
St. Lucia		
St. Vincent and the Grenadines		
Denmark	Markus Fogelholm (Finland)	7/1/89–10/31/91
Estonia (from 1993)	*Mágnus Pétursson (Iceland)*	7/1/89–1/12/90
Finland	*Indridi H. Thorláksson (Iceland)*	1/13/90–3/31/91
Iceland	*Ingimundur Fridriksson (Iceland)*	4/1/91–10/31/91
Latvia (from 1993)	Ingimundur Fridriksson (Iceland)	11/1/91–10/15/93
Lithuania (from 1993)	*Jon A. Solheim (Norway)*	11/1/91–12/31/93
Norway	Jarle Bergo (Norway)	10/16/93–12/31/95
Sweden	*Eva Srejber (Sweden)*	1/1/94–12/31/95
	Eva Srejber (Sweden)	1/1/96–12/31/97
	Benny Andersen (Denmark)	1/1/96–12/31/97
	Kai Aaen Hansen (Denmark)	1/1/98–12/31/99
	Olli-Pekka Lehmussaari (Finland)	4/1/98–12/31/99
Australia	E.A. Evans (Australia)	4/29/89–4/28/93
Kiribati	*Seung-Woo Kwon (Korea)*	6/1/89–10/31/90
Korea, Republic of	*Grant H. Spencer (New Zealand)*	11/1/90–2/2/92
Marshall Islands (from 1993)	*R. Lindsay Knight (New Zealand)*	2/3/92–10/31/92
	Ewen L. Waterman (Australia)	4/29/93–5/9/97
Micronesia, Federated States of (from 1995)	*Amando M. Tetangco, Jr. (Philippines)*	11/1/92–11/1/94
Mongolia (from 1993)	*Jung-Ho Kang (Korea)*	11/2/94–4/30/97
New Zealand	Gregory F. Taylor (Australia)	5/10/97–10/31/00
Palau (from 1999)	*Okyu Kwon (Korea)*	5/1/97–9/1/99
Papua New Guinea	*Jong Nam Oh (Korea)*	9/2/99–1/31/01
Philippines		
Samoa		
Seychelles		
Solomon Islands		
Vanuatu		
Saudi Arabia[d]	Muhammad Al-Jasser	7/1/90–10//31/95
	Abdulrahman Al-Tuwaijri	2/11/91–11/15/95
	Abdulrahman Al-Tuwaijri	11/16/95–10/31/99
	Sulaiman M. Al-Turki	2/20/96–10/31/99
	Sulaiman M. Al-Turki	11/1/99–2/22/07
	Ahmed Saleh Alosaimi	11/1/99–9/12/02

Appendix II (continued)

Constituency[e]	Executive Director (*Alternate*)[b]	Dates of Service[c]
Brunei Darussalam (from 1997)	J.E. Ismael (Indonesia)	7/1/83–10/31/96
Cambodia (from 1995)	*Tanya Sirivedhin (Thailand)*	11/1/89–10/31/92
Fiji	*Kleo-Thong Hetrakul (Thailand)*	11/1/92–10/31/94
Indonesia	*Latifah Merican Cheong (Malaysia)*	11/1/94–10/31/96
Lao People's Democratic Republic	ZAMANI Abdul Ghani (Malaysia)	11/1/96–11/30/98
Malaysia	*Subarjo Joyosumarto (Indonesia)*	11/1/96–4/19/98
Myanmar	*Cyrillus Harinowo (Indonesia)*	4/20/98–10/31/00
Nepal	Kleo-Thong Hetrakul (Thailand)	12/1/98–11/30/00
Singapore		
Thailand		
Tonga		
Vietnam		
Angola (from 1991)	El Tayeb El Kogali (Sudan)	11/1/88–10/31/90
Botswana	*L.B. Monyake (Lesotho)*	11/1/88–10/31/90
Burundi	L.B. Monyake (Lesotho)	11/1/90–10/31/92
Eritrea (from 1995)	*L.J. Mwananshiku (Zambia)*	11/1/90–10/31/92
Ethiopia	L.J. Mwananshiku (Zambia)	11/1/92–10/31/94
Gambia, The	*Barnabas S. Dlamini (Swaziland)*	11/1/92–10/31/94
Kenya	Barnabas S. Dlamini (Swaziland)	11/1/94–9/3/96
Lesotho	*Dinah Z. Guti (Zimbabwe)*	11/1/94–10/31/96
Liberia	Dinah Z. Guti (Zimbabwe)	11/1/96–10/31/98
Malawi	*José Pedro de Morais Jr. (Angola)*	11/1/96–10/31/98
Mozambique	José Pedro de Morais Jr. (Angola)	11/1/98–10/31/00
Namibia (from 1991)	*Cyrus D.R. Rustomjee (South Africa)*	11/1/98–10/31/02
Nigeria		
Sierra Leone		
South Africa (from 1996)		
Sudan (to 1993)		
Swaziland		
Tanzania		
Uganda		
Zambia		
Zimbabwe		
Russian Federation	Konstantin G. Kagalovsky (Russia)	11/1/92–10/31/94
	Aleksei V. Mozhin (Russia)	11/1/92–10/31/96
	Dmitri V. Tulin (Russia)	11/1/94–10/4/96
	Aleksei V. Mozhin (Russia)	11/1/96–
	Andrei Vernikov (Russia)	11/1/96–7/5/98
	Andrei Lushin (Russia)	7/6/98–
Bahrain	Mohamed Finaish (Libya)	1/1/78–10/31/92
Egypt	*Abdul Moneim Othman (Iraq)*	6/22/87–12/31/90
Iraq	*Azizali F. Mohammed (Pakistan)*	1/2/91–10/31/92
Jordan	A. Shakour Shaalan (Egypt)	11/1/92–
Kuwait	*Yacoob Yousef Mohammed (Bahrain)*	11/1/92–11/1/97
Lebanon		
Libya	*Mohamad Hassan Elhage (Lebanon)*	14/24/98–1/19/99
Maldives		

Appendix II (continued)

Constituency[e]	Executive Director (*Alternate*)[b]	Dates of Service[c]
Oman	*Abdelrazaq Faris Al-Faris*	1/20/99–8/31/01
Pakistan (to 1992)	*(United Arab Emirates)*	
Qatar		
Somalia (to 1992)		
Syrian Arab Republic		
United Arab Emirates		
Yemen, Republic of[f]		
Azerbaijan	Daniel Kaeser (Switzerland)	11/1/92–10/31/97
Kyrgyz Republic	*Krzysztof Link (Poland)*	12/1/92–8/31/95
Poland	*Danuta Gotz-Kozierkiewicz*	9/1/95–10/10/97
Switzerland	*(Poland)*	
Tajikistan	Roberto F. Cippà (Switzerland)	11/1/97–10/31/02
Turkmenistan	*Wieslaw Szczuka (Poland)*	10/11/97–5/9/04
Uzbekistan		
Brazil	Alexandre Kafka (Brazil)	1/1/66–10/31/98
Colombia	*Luis M. Piantini (Dominican*	4/1/89–3/31/91
Dominican Republic	*Republic)*	
Ecuador	*Juan Carlos Jaramillo (Colombia)*	4/1/91–3/18/94
Guyana	*Alberto Calderón (Colombia)*	3/31/94–2/11/97
Haiti	*Hamid O'Brien (Trinidad and*	5/1/97–4/2/99
Panama	*Tobago)*	
Suriname	Murilo Portugal (Brazil)	11/1/98–5/14/05
Trinidad and Tobago	*Olver Luis Bernal (Colombia)*	4/3/99–9/30/99
	Roberto Junguito (Colombia)	10/1/99–7/31/02
Bangladesh	Bimal Jalan (India)	11/1/88–1/2/90
Bhutan	*L. Eustace N. Fernando*	1/1/87–1/2/95
India	*(Sri Lanka)*	
Sri Lanka	G.K. Arora (India)	1/3/90–3/15/93
	K.P. Geethakrishnan (India)	3/16/93–7/31/96
	W. Hettiarachchi (Sri Lanka)	1/3/95–12/31/95
	H.B. Disanayaka (Sri Lanka)	1/1/96–3/31/98
	M.R. Sivaraman (India)	8/1/96–7/31/99
	A.G. Karunasena (Sri Lanka)	4/1/98–10/31/00
	Vijay L. Kelkar (India)	8/1/99–7/31/02
Afghanistan, Islamic State of	Mohammad Reza Ghasimi	11/1/88–10/31/90
(to 1998)	(Islamic Rep. of Iran)	
Algeria	*Omar Kabbaj (Morocco)*	11/1/80–1/16/94
Ghana	Abbas Mirakhor (Islamic Rep. of	11/1/90–1/31/08
Iran, Islamic Republic of	Iran)	
Morocco	*Mohammed Daïri (Morocco)*	3/1/94–
Pakistan (from 1993)		
Tunisia		
China	DAI Qianding (China)	11/1/86–9/4/91
	ZHANG Zhixiang (China)	9/5/91–12/31/91
	CHE Peiqin (China)	9/5/91–10/3/93
	WEI Benhua (China)	3/11/93–12/31/95
	ZHANG Ming (China)	3/11/93–2/29/96
	ZHANG Zhixiang (China)	3/1/96–2/28/99
	HAN Mingzhi (China)	1/2/96–6/30/98
	WEI Benhua (China)	3/1/99–10/31/03
	ZHANG Fengming (China)	7/1/98–1/31/00

Appendix II (continued)

Constituency[e]	Executive Director (*Alternate*)[b]	Dates of Service[c]
Argentina	Ernesto V. Feldman (Argentina)	11/1/88–10/31/90
Bolivia	*Ricardo J. Lombardo (Uruguay)*	11/1/88–9/29/90
Chile	Alejandro Végh (Uruguay)	11/1/90–10/31/92
Paraguay	*A. Guillermo Zoccali (Argentina)*	11/1/90–10/31/92
Peru	A. Guillermo Zoccali (Argentina)	11/1/92–10/31/94
Uruguay	*Manuel Estela (Peru)*	11/1/92–5/3/93
	Alberto F. Jiménez de Lucio (Peru)	5/4/93–10/31/94
	Carlos Saito (Peru)	11/1/94–10/31/96
	A. Guillermo Zoccali (Argentina)	11/1/94–10/31/96
	A. Guillermo Zoccali (Argentina)	11/1/96–10/31/98
	Jorge Leiva (Chile)	11/1/96–2/28/97
	Nicolás Eyzaguirre (Chile)	3/1/97–10/31/98
	Nicolás Eyzaguirre (Chile)	11/1/98–3/3/00
	A. Guillermo Zoccali (Argentina)	11/1/98–10/31/00
Benin	MAWAKANI Samba (Zaïre)	11/1/86–10/31/90
Burkina Faso	*Corentino V. Santos (Cape Verde)*	11/15/86–10/31/90
Cameroon		
Cape Verde	Corentino V. Santos (Cape Verde)	11/1/90–10/31/94
Central African Republic	*Yves-Marie T. Koissy (Côte d'Ivoire)*	11/1/90–10/31/94
Chad		
Comoros	Yves-Marie T. Koissy (Côte d'Ivoire)	11/1/94–10/31/96
Congo, Republic of		
Côte d'Ivoire	*Alexandre Barro Chambrier (Gabon)*	11/1/94–10/31/98
Djibouti		
Equatorial Guinea	Koffi Yao (Côte d'Ivoire)	11/1/96–10/31/98
Gabon	Alexandre Barro Chambrier (Gabon)	11/1/98–10/31/02
Guinea		
Guinea-Bissau	*Damian Ondo Mañe (Equatorial Guinea)*	11/1/98–10/31/02
Madagascar		
Mali		
Mauritania		
Mauritius		
Niger		
Rwanda		
São Tomé and Príncipe		
Senegal		
Togo		

Source: *Annual Reports*.

Note: For Executive Directors and Alternates from countries where family name precedes given name, the family name is in all upper case letters.

[a]Within each part, Directors are listed in descending order of voting power.

[b]Alternate Executive Directors are listed under the Director who initially appointed them. Where dates overlap, the Alternative Executive Director was reappointed by the next Director.

[c] Dates are given as month/day/year. The absence of an ending date in this column means that the individual was still in office in 2011.

[d] Saudi Arabia appointed Directors until 1992 and elected Directors from 1993.

[e] "From" dates indicate the year in which the country first participated in the election of the Executive Director for the listed constituency. "To" dates indicate the year the country left the constituency. For changes in country names during this period, see the Appendix to Chapter 2.

[f] The Republic of Yemen was formed in 1990 by the merger of the Yemen Arab Republic and the People's Democratic Republic of Yemen, both of which were in this constituency.

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Index

Note: Page numbers followed by f, n, or t refer to figures, footnotes, or tables, respectively.

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