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THE ROLE OF THE IMF IN RECENT CAPITAL ACCOUNT CRISES

ISSUES PAPER FOR AN EVALUATION BY THE INDEPENDENT EVALUATION OFFICE (IEO)

I. INTRODUCTION

Beginning with Mexico in 1994, a number of emerging market economies have been affected by currency crises, against the background of increasing financial market integration in recent years. While the crises have differed in their origins, with some primarily driven by public debt dynamics and others by private sector actions, they share a similar feature when compared with the more conventional type of current account crises: the prominent role of short-term private capital flows in creating vulnerabilities and triggering the crisis. Moreover, the reversal of financing for the current account deficit has been much larger and more rapid, and contagion has usually been more pronounced. We use the term “capital account crises” to describe these recent crises in order to indicate the dominance of the capital account in the balance of payments reversal.

In several of these cases, the IMF was called in to help resolve the crisis. In some of these, the IMF was criticized for its failure to mitigate the adverse consequences of the associated rapid and substantial capital flow reversals. The severity of output loss in some of the affected countries and the impact the crises had on the global economy have generated interest in how the IMF handled the past crises and how it should handle a future one.

This evaluation will focus on three country cases, Indonesia (1997/98), Korea (1997/98), and Brazil (1998/99), which represent somewhat different country typologies. For each case, the evaluation will investigate (1) the content and effectiveness of IMF surveillance during the period leading up to the crisis and (2) the design and effectiveness of the IMF-supported program in the resolution of the crisis. While most of the specific issues to be evaluated are economic, some political and social aspects of the IMF-supported programs will also be considered (see below for details).

The selection of Indonesia, Korea, and Brazil has been made by balancing considerations of diversity in origin, geography, timing, initial conditions, and outcome, in order to maximize the learning potential. In these country cases, moreover, contagion from outside seems to have played a more prominent role, compared with the other important cases of Thailand and Russia. This allows us to concentrate more fully on the interaction between policy actions and market expectations, often considered to be the hallmark of

recent capital account crises.¹ We believe that the cross-country differences—set against the similarities inherent in the nature of the experience as a capital account crisis—will provide significant comparative perspectives to generate useful lessons.

Much has already been written on the subject both within the IMF and by outside observers. The evaluation will review this literature and, in light of this review, present an assessment of areas where there is a consensus as well as areas where a consensus is yet to emerge. The purpose of the evaluation is to extract lessons for the Fund, with a view to better facilitating the prevention and management of future crises. It will also evaluate whether recent reforms undertaken by the IMF following these crises have made it more effective in handling future crises.

While this note aims to set out the issues raised, it is not meant to indicate that the evaluation will provide definitive answers to all the questions posed. In part, this reflects not only the lack of consensus in the academic literature but also the fundamental difficulties inherent in any such exercise where the consideration of counterfactuals is required. In highly complex circumstances it is often not possible to derive, in a rigorous manner, what would have been the impact of an alternative policy choice. Even so, we believe it is still possible to draw meaningful lessons in light of the current state of theoretical and empirical knowledge.

The rest of this note is organized as follows. Section 2 proposes four overriding themes that will govern the evaluation. Section 3 presents brief country backgrounds and sets of specific issues to be addressed for Indonesia, Korea, and Brazil. Finally, Section 4 sets forth the scope and methodology of this evaluation.

II. KEY THEMES

The terms of reference for the Independent Evaluation Office (IEO) indicate that its purpose is to “enhance the learning culture within the Fund” and to “promote greater understanding of the work of the Fund throughout the membership.” In view of this mandate, the objectives of this study are defined to be: (1) to draw lessons for the staff, management and Executive Board of the IMF in its future operational work and (2) to identify the processes by which important decisions were made, with a view to increasing transparency. The primary concern of the evaluation is with the decisions of the IMF itself, not necessarily with the policies of the country authorities or with an academic understanding

¹ In the academic literature, a distinction is often made between first-generation crises (in which fundamentals play the leading role) and second-generation crises (in which market expectations play the leading role). Here, without taking a formal position on the academic debate over the nature of a particular currency crisis, we are simply noting the fact that the cases of Indonesia, Korea and Brazil seem to share a stronger element of the second-generation crisis.

of the nature of currency crisis for its own sake. Recognizing that the IMF-supported programs were adapted over time as circumstances changed, the evaluation will duly consider how the IMF responded to unanticipated shocks and difficulties the country authorities faced in implementing the agreed measures.

For each country case, these objectives of the evaluation would suggest the following four governing themes (where the content of each theme is illustrated by a few concrete topics):

Theme 1: Role of surveillance in crisis prevention. (i) What the IMF could have done differently prior to the crisis to help prevent it or to minimize its adverse impact; (ii) how lessons learned from previous crises were incorporated into the surveillance; and (iii) whether the vulnerabilities could have been better identified, had the recent IMF surveillance initiatives been in place.

Theme 2: Program design. (i) Assumptions underlying the design of key policy measures; (ii) the trade-offs considered by the IMF; (iii) the reasonableness of the assumptions, given the constraints of time and available information; (iv) how much consideration was given to social and political factors; and (v) if the outcome was different from what had been envisaged in the program, what went wrong.

Theme 3: Decision making within the IMF. (i) The alternative approaches considered by the IMF or proposed by outsiders; (ii) the roles of various stakeholders (e.g., staff, management, Executive Directors and major shareholders) and how the differing views of various parties were resolved in the decision making process; and (iii) how and how effectively feedback from the authorities and the early implementation experience was incorporated in program revision.

Theme 4: Program impact or outcome. (i) The program's ability to restore market confidence; (ii) quantitative assessment of output loss or social cost; and (iii) effectiveness in facilitating return to the pre-crisis growth path.

As these themes are integrated, our evaluation of specific issues will necessarily be guided by more than one of them at a time. We have already noted the inherent difficulty of providing definitive answers in some areas of the evaluation. This is particularly true of questions that might be posed under Theme 1 and Theme 4, where any answers must consider appropriate counterfactuals and where considerable academic disagreement still exists on the nature of the crisis and the impact of policy response.

III. SPECIFIC ISSUES TO BE ADDRESSED

A. Country Backgrounds

Prior to the crisis, all three countries experienced sizable inflows of capital, current account deficits, and a real exchange rate appreciation.² When conditions changed for one reason or another, a massive reversal of capital flows placed intense downward pressure on the exchange rate, precipitating a rapid decline in foreign exchange reserves. IMF-supported programs were agreed with Indonesia in November 1997 for the amount of about \$10 billion, with Korea in December 1997 for the amount of about \$21 billion, and with Brazil in December 1998 for the amount of about \$18 billion, all supplemented by additional financing announced by multilateral development banks and bilateral sources.

The market's reactions to these programs, however, were less than positive. In Indonesia and Korea, the currencies continued to fall, necessitating a strengthening of the programs. In Brazil, the crawling peg had to be abandoned in the face of market pressure, and a revised program with tighter fiscal targets was agreed.

While the cases share common features, there are notable differences as well. In Indonesia and Korea, the onset of crisis in 1997 occurred against the background of seemingly sound macroeconomic fundamentals, including good export growth performance, relative price stability, and broad fiscal balance. However, vulnerabilities were present, particularly in financial sector weakness, leveraged corporate balance sheets, weak public and corporate sector governance, and rising short-term unhedged external indebtedness. In Brazil, on the other hand, macroeconomic performance was more modest against the background of an exchange rate-based stabilization program (the Real Plan), with a chronic deficit in the fiscal balance and rising public sector debt. Brazil had also struggled with the typical dilemmas involved in choosing an exit strategy from exchange rate-based disinflation. Banking sector problems, however, were not an issue motivating the crisis.

In all three countries, the IMF-supported programs consisted of two principal components: conventional contractionary macroeconomic policies (consisting of tighter monetary and fiscal policies, at least initially) designed to reduce exchange rate pressure, and structural reform measures to bolster the credibility of macroeconomic stabilization and address the structural weaknesses contributing to the crisis. In Indonesia, structural measures were extensive, covering not only the financial sector but also the overall operation of the economy. In the case of Korea, structural measures were heavily concentrated in the financial area, including the adoption of international standards in accounting, disclosure requirements, corporate governance and financial supervision. In Brazil, a more limited set of

² Despite the real appreciation, Indonesia and Korea registered narrowing current account deficits in the lead up to the crisis.

structural measures were included in the program, mainly covering public finances and the financial sector.

As to economic performance following the program, output fell sharply in Indonesia and Korea, while it rose marginally in Brazil. Subsequently, the revised programs in Korea and Brazil supported a return to macroeconomic stability and growth.³ Recovery in Indonesia, however, has been more difficult.

For each country case, the evaluation will explore the four governing themes, identified in Section 2, by examining the specific issues that have often been raised by IMF staff and outside observers. Although many of these issues are common to more than one country (particularly Indonesia and Korea), with some modifications, they are listed separately under each country heading for presentation purposes. Many of the issues are interconnected. The list is necessarily exhaustive at this initial stage; the number of relevant issues will be narrowed down as the work progresses and the final report is prepared.

In the remainder of this section, three sets of country issues are stated, followed by a set of more general issues designed to draw comparative lessons from the evaluation.

B. An Outline of Country Evaluations

Indonesia

- **Pre-crisis build-up of vulnerabilities.** What was known, and what was done, in the context of IMF surveillance about the build-up of vulnerabilities in such areas as capital inflows and current account deficits, and the policy responses to capital inflows? How did the IMF assess the risk of contagion to and from Indonesia during the early stages of the East Asian crisis?
- **Pre-crisis structural weaknesses.** What was known, and what was done, in the context of IMF surveillance about financial sector and other structural weaknesses, including inadequate bank supervision, poor risk management practices, inadequate corporate governance, high leverage, lack of adequate legal institutions, and restrictive business practices? What were other agencies saying about these issues? How was this information incorporated into the surveillance?

³ All three revised programs achieved a better outcome than their respective predecessors. However, the Brazilian case was quite different with regard to the circumstances in which that occurred. The first Brazilian program, unlike the Asian counterparts or any of the revised programs, was intended to be preventive in nature. The Brazilian program was revised not in response to inadequacies of the first program in dealing with a largely unchanged set of objectives and conditions, but instead because a shift in Brazilian exchange rate policy required different instruments to achieve the objectives of the program.

- **Adequacy of financing in crisis management.** How were the size of access to IMF resources and the phasing of this access determined? How were the quantity and quality of additional official financing established? Was the catalytic role of the IMF-supported program and associated official financing in mobilizing a turnaround in capital outflows overestimated and, if so, why? How and how effectively did the IMF interact with market participants? What concrete steps were taken to maintain private capital flows to Indonesia beyond simply restoring confidence?
- **Macroeconomic policy measures.** What assumptions formed the basis for the recommendation of contractionary fiscal and monetary policies? How reasonable were they and how did the assumptions change in response to changing circumstances? What was assumed about the severity of the balance sheet problems and what were the policy prescriptions considered in response? What was the IMF's response when it became evident that the program was not working? What alternative policy responses were considered? How important were the differences between the program and its actual implementation, and might these differences have been foreseen?
- **Exchange rate measures and capital controls.** What was the view of the IMF on the feasibility of capital controls coupled with temporary pegging as a means of stemming capital flight? Was this option considered and, if so, why was it rejected? What was the IMF view of the adverse impact of exchange rate depreciation on other Asian countries?
- **Structural conditionality.** What was the decision making process behind the inclusion of the structural measures in the program? How did the IMF coordinate with the World Bank in developing structural conditionality? To what extent were they necessary or useful in crisis resolution? Did the IMF pay sufficient attention to the political constraints faced by the authorities, and the social impact of the measures proposed? What explains the lack of positive market response to the reform package?
- **Financial restructuring in a crisis.** What led to the decision to close the 16 insolvent banks in November 1997 and what were the associated problems regarding both the design and the implementation of the closure? How were the potential fiscal costs factored in? What were the alternative policies that were considered and what led to their rejection?
- **The role of major shareholders and country ownership.** What was the role of major shareholders in the design of the IMF-supported program? How were the initial proposals of the staff or IMF management modified in response to the views of major shareholders? Did the country "own" the program, particularly regarding the content of structural conditionality? What was the operational content of country ownership when, as in the case of Indonesia, different interest

groups within the government had different views of what constituted appropriate economic policies.

- **Post-program economic performance.** Why did Indonesia turn out to be the worst performer in terms of output loss and exchange rate depreciation among the crisis-hit countries? What alternatives were proposed or considered by the IMF that could have better dealt with the problems that arose?
- **Political factors.** What was the role of political factors in determining the outcome of the program? How did the IMF consider such factors and respond to them?

Korea

- **Pre-crisis build-up of vulnerabilities.** What was known, and what was done, in the context of IMF surveillance about the build-up of vulnerabilities in such areas as capital inflows and current account deficits, the policy responses to capital inflows, the composition of capital inflows, and foreign exchange reserves? What was the advice of the IMF when the Korean authorities simultaneously encouraged short-term interbank borrowing while restricting FDI flows?
- **Pre-crisis structural weaknesses.** What was known, and what was done, in the context of IMF surveillance about financial sector and other structural weaknesses, including inadequate bank supervision, directed lending, inadequate corporate governance, and high leverage? What were other agencies saying about these issues? How was this information incorporated into the surveillance?
- **Responses to 1997 developments.** What was the IMF staff's assessment of risk when the six chaebols went bankrupt in early 1997? What was their initial assessment of the risk of regional contagion in the early stages of the East Asian crisis? How did the IMF respond in August 1997, when the Minister of Finance and Economy guaranteed the foreign obligations of Korean banks? Why did the Article IV mission fail to correctly assess the severity of the problems in October 1997? Why and how did the situation change so suddenly?
- **Timeliness.** How could the IMF have assured early financing of the program to maintain market confidence at the outset? How promptly did the IMF staff respond to the changing circumstances both during the negotiations and in the early part of the program?
- **Adequacy of official financing in crisis management.** How adequate were the size of access and the pacing of phasing, given the underlying assumptions for the balance of payments? How adequate were the quantity and quality of other official financing? Was the so-called second line of defense credible and what

was the IMF staff's assessment at the time? To what extent was there a tradeoff between speed and size?

- **Interaction with the private sector.** What were the nature and quality of interactions with market participants throughout the negotiations? What was the role of the rollover agreement with major international banks in the success of the revised program? How did the absence of such an agreement in the original program contribute to the failure to restore market confidence? Was the success due to a more forceful involvement of private sector banks or to the strengthened elements of the program itself? Did the IMF consider the possibility of “bailing in” banks at an earlier stage and could this have been accomplished?
- **Macroeconomic policy measures.** What assumptions formed the basis for the agreed fiscal and monetary policies? How reasonable were they and how did the assumptions change in response to the changing circumstances? How much of the overly optimistic budget targets was attributable to overly optimistic growth projections? How much of that is attributable to the authorities' reservation about accepting lower growth projections?
- **Exchange rate action.** What was the view of the IMF on the feasibility and effectiveness of capital controls coupled with temporary pegging? Was this option considered and, if so, why was this rejected? What was the view of the IMF on the tradeoffs and impact on investor confidence in allowing the currency to depreciate further in support of lower interest rates? What was the impact of the exchange rate/interest rate mix on credit flows, corporate bankruptcies and output loss? How was the vulnerability of the corporate sector to exchange rate depreciation and interest rate hikes factored into the policy prescriptions?
- **Structural conditionality.** What was the decision making process behind the inclusion of the structural measures in the program? To what extent were they necessary or useful in crisis resolution? Were they politically realistic and feasible? What explains the lack of positive market response and to what extent did this reflect the climate of Presidential election politics?
- **The role of major shareholders and country ownership.** What was the role of major shareholders in the design of the IMF-supported program? How were the initial proposals of the staff or IMF management modified in response to the views of major shareholders? How does one assess the ownership of the program, particularly regarding the content of structural conditionality?

Brazil

- **Sustainability of pre-crisis policy mix.** What was the IMF's view of Brazil's policy mix of tight monetary policy and loose fiscal policy during the exit from high inflation? How did the IMF view the sustainability of fiscal policy? What

was the nature of the dialogue with the Brazilian authorities on this issue? How did the lack of IMF support for the launching of the Real Plan affect the quality of that dialogue?

- **Pre-crisis exchange rate policy and the build-up of vulnerabilities.** What was the view of the IMF on the real value of the currency and on modifying the crawling peg strategy to address the tradeoff between the need to maintain an appreciated exchange rate (designed to anchor the price level) and the need for exchange rate adjustment? What was the assessment of Brazil's choice, namely, accelerating the depreciation of the crawl to eliminate the overvaluation of the exchange rate? What was the quantitative assessment of any overvaluation and its implications for the sustainability of the external current account deficit?
- **Capital controls and other financial sector regulations.** What role, if any, did the capital controls and other financial sector regulations play in either preventing or mitigating the capital account crisis? What was the IMF's view on this? How did the absence of widespread dollar-denominated balance sheets in Brazil contribute to a smaller adverse impact of the crisis and what account did the IMF take of this feature of the Brazilian economy?
- **Response to Asian and Russian crises.** What precautions were taken at the time of the Asian and Russian crises? How did the IMF assess the risk of contagion? What was the view of the IMF on terminating the peg at that time and how was this option discussed with the authorities?
- **Support for the crawling peg.** What was the rationale for the IMF to support the crawling peg, as opposed to a devaluation or downward float, in the original program? What factor played the decisive role (e.g., undue consideration of the impending Presidential election, the fear of systemic impact in the wake of the Russian and LTCM crises, or the fear of a resurgence of inflation)? How sustainable was the peg?
- **Floating the real.** How did the IMF handle the decision of the Brazilian authorities to abandon the peg and to float the real in January 1999? What factors determined the abandonment of the peg? What was the quality of the dialogue at this critical time? How timely and how flexibly did the IMF respond to the changing circumstances?
- **High interest rate policy.** Did the high interest rate policy work better in Brazil? What difference did the relatively sound banking system make? What was the link between the debt management policy advice offered by the IMF and the interest rate policy?
- **Country ownership and flexibility.** What explains the relative paucity (in terms of substance, if not number) of extensive structural measures in the program,

compared with Indonesia and Korea? How did strong country ownership contribute to the flexibility with which the IMF addressed the problems that arose? How did the lessons learned from the East Asian experience, if any, influence the design of the program?

- **Interactions with the private sector.** In terms of restoring market confidence, how important was the fact that the PSI of early 1999 (in which an agreement was reached with major international banks to maintain the level of country exposure for six months) was as voluntary as it was?
- **Post-program performance.** Why did output not decline, despite the imposition of a tight primary stance of fiscal policy and the fact that such a sharp depreciation of the currency has had elsewhere a strongly contractionary balance sheet effect? Was it because Brazilian financial institutions and firms were structurally less leveraged and exposed to currency risk, or because they had access to a hedge from the government? If the hedge provided by the government played a role, was it important mostly as an expansionary fiscal transfer or as a fix to individual balance sheets? What role did country ownership play in the success of the revised program?

C. Some Cross-Country Issues

- **Surveillance.** What role did technical assistance play in surveillance? How can technical assistance be better incorporated into Area Departments' surveillance work in identifying and mitigating member countries' vulnerabilities to crisis?
- **Uniform prescription.** Does the evidence support the view that the IMF-supported programs were too uniform across countries to take account of the country-specific circumstances?
- **Post-program performance.** What lessons can be learned for program design and surveillance, from the divergent outcomes in post-crisis macroeconomic performance across the three countries?
- **Role of structural conditionality.** What role, if any, should structural reform play in crisis management? Does the evidence support the view that the IMF-supported programs were too rigid with respect to trade, financial and corporate sector reforms? How can the IMF collaborate more effectively with the World Bank and other agencies in the area of structural issues in a time of crisis?
- **Roles of country ownership and major shareholders and the resolution of internal disagreements.** What should be the roles of country ownership and major shareholders in the decision making process? What criterion should we use to assess country ownership and how can we make it operational? Were there

instances where significant differences of opinion existed within the IMF or with major shareholders? If so, how were the differences resolved?

- **Social and political considerations.** Does the evidence support the view that the IMF-supported programs did not pay adequate attention to their potential social costs and political aspects? Would alternative courses of action have yielded a better political or social outcome, and what were the tradeoffs involved?

IV. THE SCOPE AND METHODOLOGY OF THE STUDY

Given the overriding objectives of this study—to draw lessons for the IMF and to increase the transparency of its operations to the public—we will emphasize the process of decision making in the IMF and identifying the context within which the key decisions were made. For this purpose, the best way of addressing most issues seems to be to rely on written documents and interviews. This part of the evaluation involves uncovering factual information, so as to dispel uncertainty about how and why certain key decisions were made. Here the topic is decision making under uncertainty. The focus is on the sequence by which new information became available and how decisions were made against what was known and available in terms of information and viable options.

The relevant documents will include published reports, unpublished Board papers, internal briefing papers and staff memoranda and reports of more restricted nature, including technical assistance reports. Interviews will be conducted with those who were involved significantly in the decision making process, including current and former IMF staff, management and Executive Directors, as well as the Indonesian, Korean, Brazilian, and other member country authorities. Private sector individuals, including members of civil society, will also be interviewed to assess the actions of market participants during the crises and to obtain a range of perspectives on the issues.

In those situations where outcomes must be evaluated, written documents and interviews will not suffice. In such cases, we will draw on the existing academic literature, supplemented by basic conceptual tools of economics and data analysis. Given the IEO's comparative advantage, no attempt will be made to conduct major econometric initiatives of our own.⁴ We will draw on the existing empirical evidence to form an informed judgment about the likely economic relationships among key variables and to evaluate the impact of a particular policy measure and the overall effectiveness of the IMF-supported programs.

⁴ By its very nature, empirical work in economics involves hypothesis testing, which yields a probabilistic statement about some economic relationship. The IEO's mandate does not seem to support its engagement in adding another probabilistic statement to the already existing academic literature.

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