THE ROLE OF THE IMF IN RECENT CAPITAL ACCOUNT CRISES:

ISSUES FOR DISCUSSION

Introduction

- The evaluation covers Indonesia (1997/98), Korea (1997/98), and Brazil (1998/99)
- Focus on (1) surveillance, (2) crisis management strategy, and (3) internal governance issues

I. INDONESIA

Phases of IMF Involvement:

- Before the crisis
- After the crisis
    1. September 1997 to December 4 1997
    2. December 4, 1997 to February 1998
    3. March 1998 to February 2000

Before the crisis— Surveillance

- No obvious macro weaknesses (Chart 1)
- Main risk is political related to succession
- Weaknesses in banking system, including governance
- Concern over capital inflows and overheating
- Corruption mildly mentioned, tacked onto need for transparency and level playing field

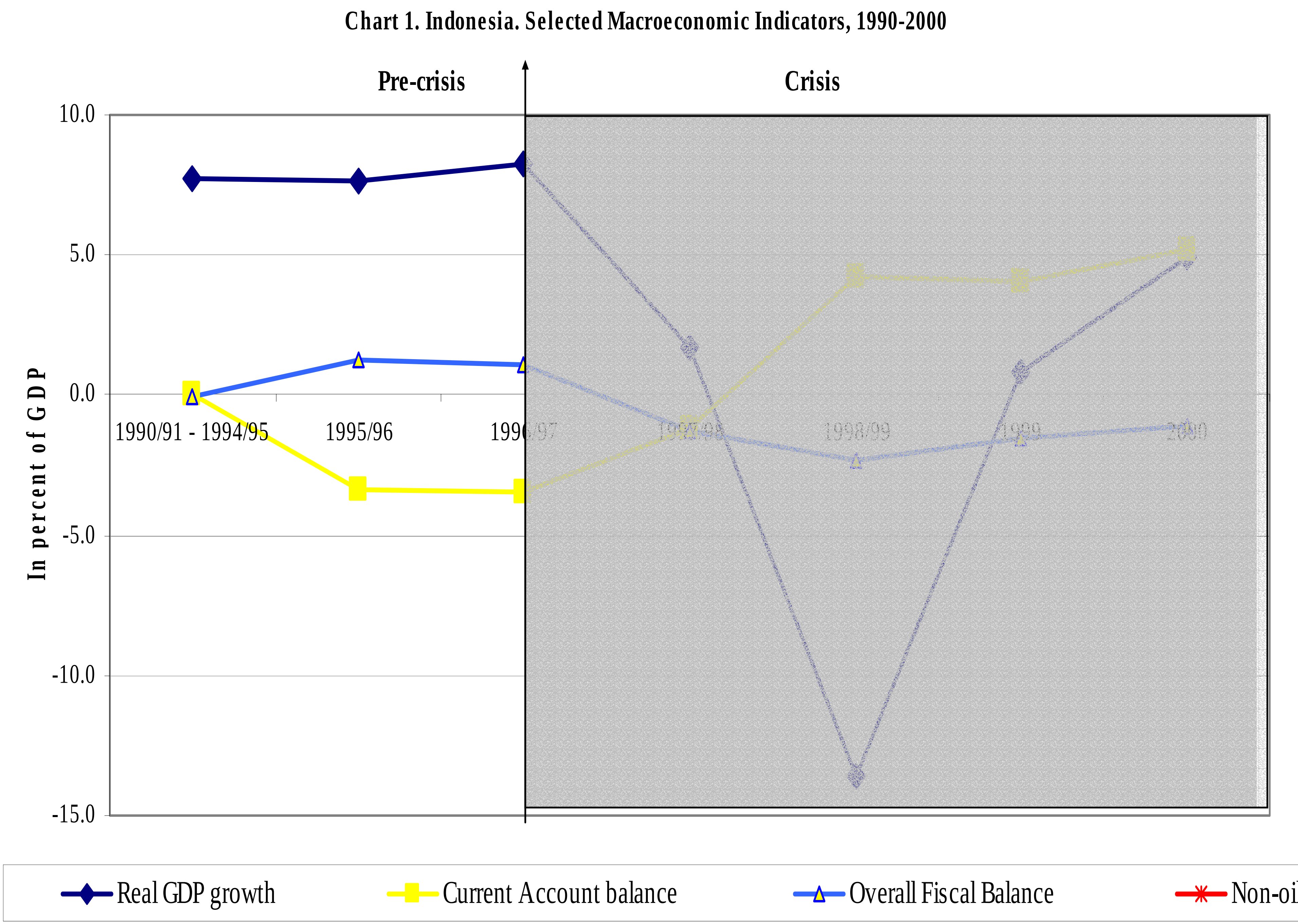


Chart 1. Indonesia. Selected Macroeconomic Indicators, 1990-2000
Pre-crisis
Crisis
10.0
5.0
0.0
-5.0
-10.0
-15.0
In percent of GDP
1990/91 - 1994/95
1995/96
1996/97
1997/98
1998/99
1999
2000
Real GDP growth
Current Account balance
Overall Fiscal Balance
Non-oi

Surveillance — Recommendations

- Tighter fiscal policy (to moderate inflows);
- Lower monetary growth;
- Greater exchange rate flexibility; and
- Accelerated structural reforms to improve efficiency in resource allocation

Issues understated in surveillance

- Capital inflows and build up of foreign debt
- Fragile banking system due to corruption:
  1. Directed credit (state banks)
  2. Connected lending (private banks)
  3. Supervisory system too weak to capture problems
  4. Unwillingness to let banks fail
- Reversal of deregulation due to rent seeking

Quality of Surveillance — Assessment

- Could have highlighted risks and made plans in case they materialized (including possible program design if Indonesia sought IMF assistance)

- Governance problems in banking were understated because:

  1. **growth was rapid**

  2. **the “subsidy” was small**

  Was this a reasonable assumption at the time?

- Dialogue focused too much on the reformist economic team.

Economic Context

- Distortions in the system were increasing as deregulation rolled back and family and cronies gain ascendancy
- Ponzi game in banking system becomes more costly over time
- Losses on corporate/banking balance sheet become large with currency depreciation and high interest rates)

Key Outstanding Questions

- How central was corruption to the overall picture?
- How important was contagion?

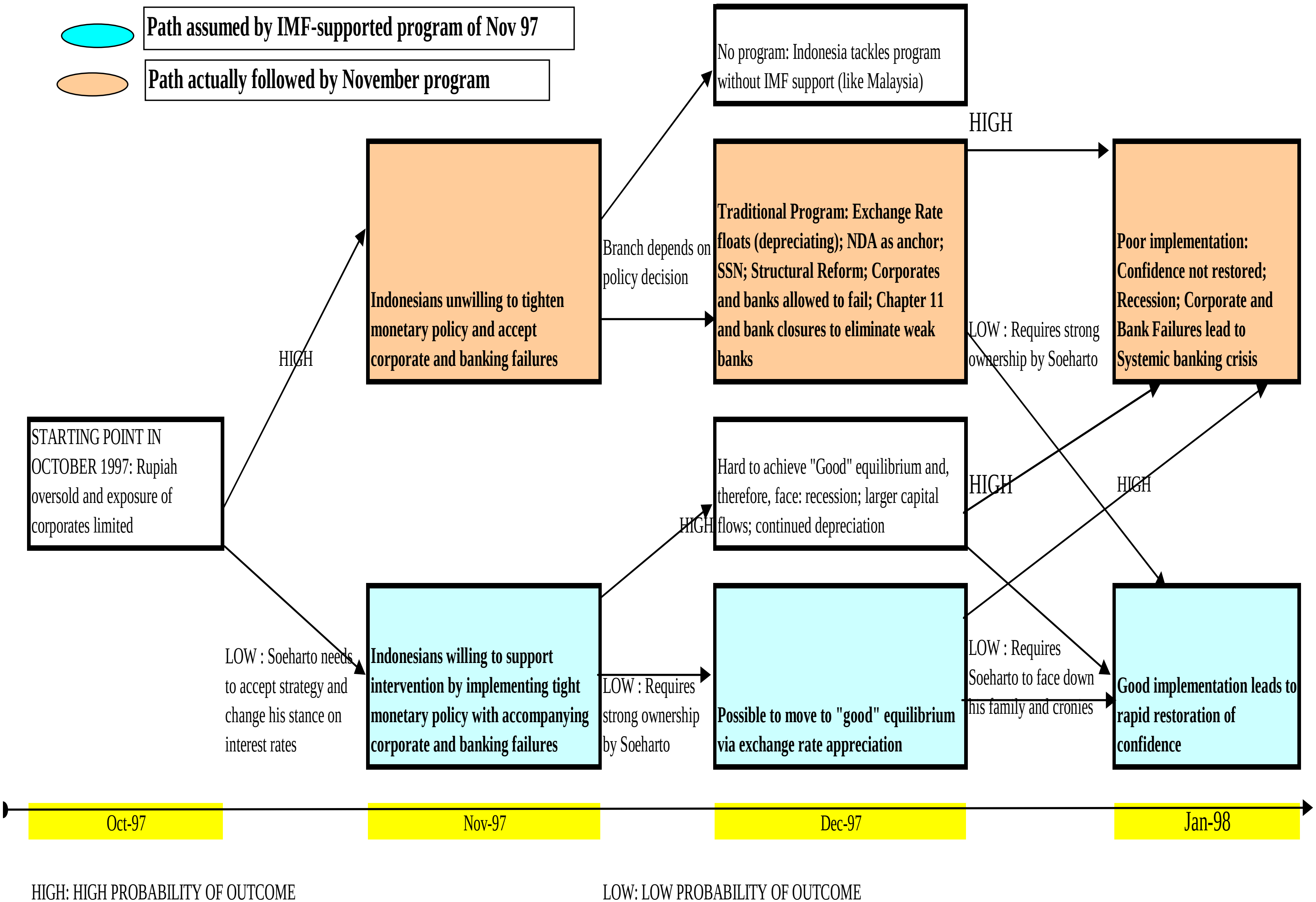
Political Context

- Impossible to reassure cronies and their foreign financiers while also deregulating
- Cronies and family faced large and increasing losses
- Succession fears and perception that Habibie and Ginandjar are anti-Chinese
- Soeharto vacillates between supporting reform and pressure from family

What were the Options for the IMF?

- Treat as liquidity crisis and provide, without emphasizing reform, massive amounts of money to bail out cronies and their foreign financiers
- Accept reform necessary for medium term but impossible to restore confidence in short term i.e., prepare for sharp recession (stronger countercyclical fiscal policy emphasizing SSN)
- Not support a program for Indonesia?
- Any other options???

Figure 1. Indonesia: Decision making under uncertainty in the face of the 1997 crisis, October 97 to January 98



Could Indonesia avoid deep and/or long recession?

Rapid move to “good” equilibrium requires:

1. Soeharto changes stance on interest rates and accepts corporate and banking failures
2. Supports interest rate defense of the exchange rate
3. Deal to share losses of Indonesian corporates between shareholders, taxpayers, foreign financiers
4. Deregulation to ensure future investment based on market signals instead of connections to palace

- Even with all the above, could recession be avoided once succession concerns emerged on December 4, 1997?

Could more have been done to rollover debt?

- Could Brazil and/or Korea type PSI be attempted in the absence of a credible IMF program?
- Could interbank trade credit lines be kept open?
- What was required to support such measures (e.g., chapter 11, opening investment to foreigners to facilitate takeovers/sale of assets, transparent rules?)

Initial failure in November 1997 reflected:

1. Conflicting signals from the authorities concerning their commitment
2. Hesitation in monetary tightening
3. Problems in closure of the 16 banks and ineffective communication of the logic and objectives of the program

These failures reflect mistakes arising from the way the Fund interacted with the Indonesian authorities and processed information.

Misjudgments..

- Severity of crisis
- Missed systemic nature of banking problems
- Wrong assessment of Indonesian readiness to support intervention with high interest rates and/or bank closures
- Design problem with unsterilized intervention and base money targeting

...compounded by internal governance problems

- Organizational weakness/culture
- Poor use of institutional knowledge
  1. two mission heads in October
  2. delay in posting banking expert to Jakarta
  3. alternating missions instead of reinforcing ground presence
- Rushed clearance process
- Split between MAE and APD missions
- Excessive involvement of Board

Points on which critics have focused:

- Was fiscal policy tight (Table 1)?
- Was monetary policy tight (Charts 2-4)?
- Was it just a liquidity crisis?
- Too much structural conditionality

Table 1. Indonesia: Overall Fiscal Balance (%GDP; including bank restructuring cost, but excluding privatization receipts)

	96/97	97/98	98/99
Nov 1997 Program		+0.75	+0.5
Jan (Mar)1998 Revision		-1.0~2.0	-1.0 (-4.7)
Actual outcome	+1.1	-1.3	-2.4

Chart 2. Indonesia, Real 1 month SBI, 1 month Deposit Rate and Lending Rates for Working Capital and Investment, 1997-1999

(2 months forward)

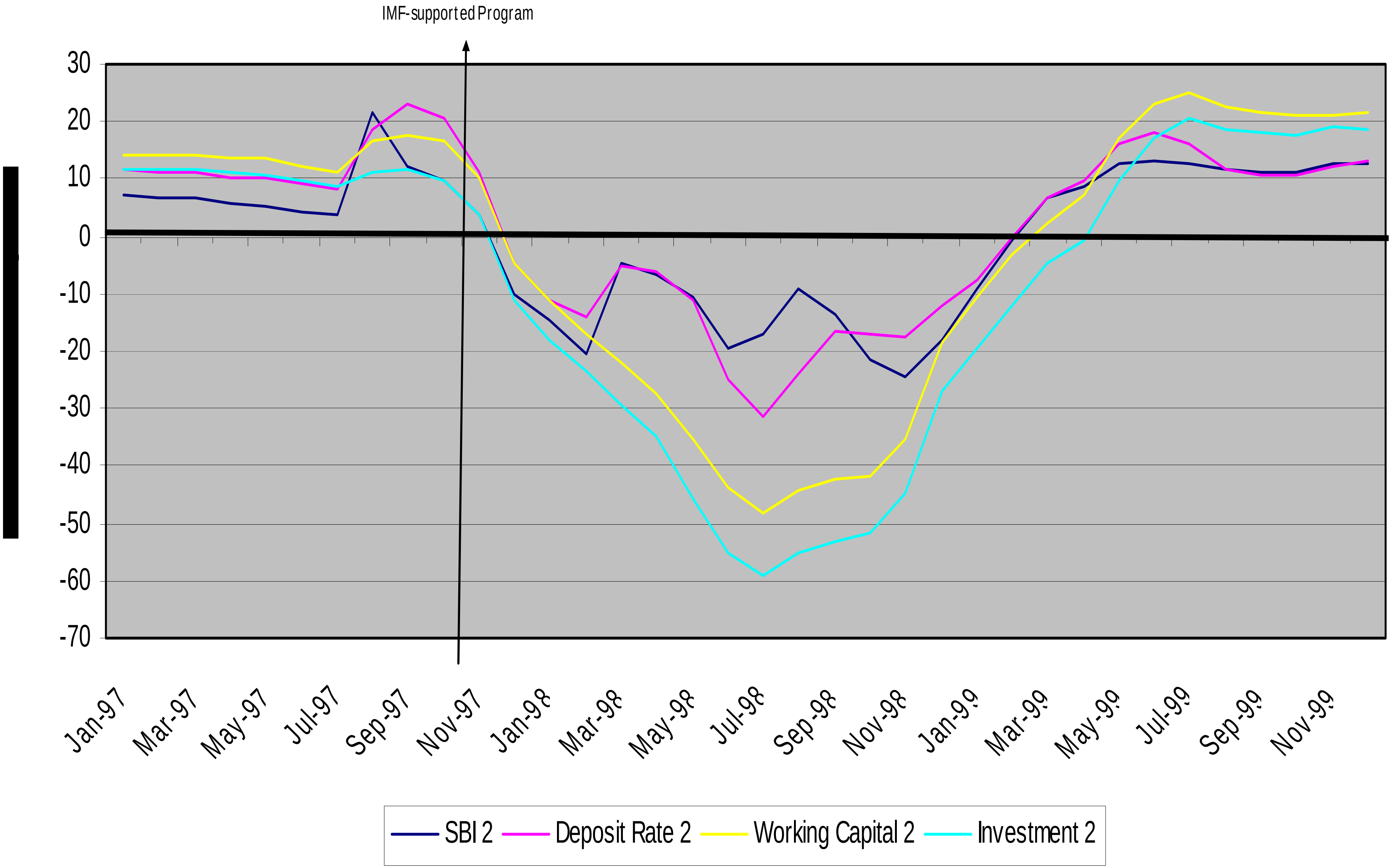


Chart 3. Indonesia: Nominal interest rates, 1997-1999

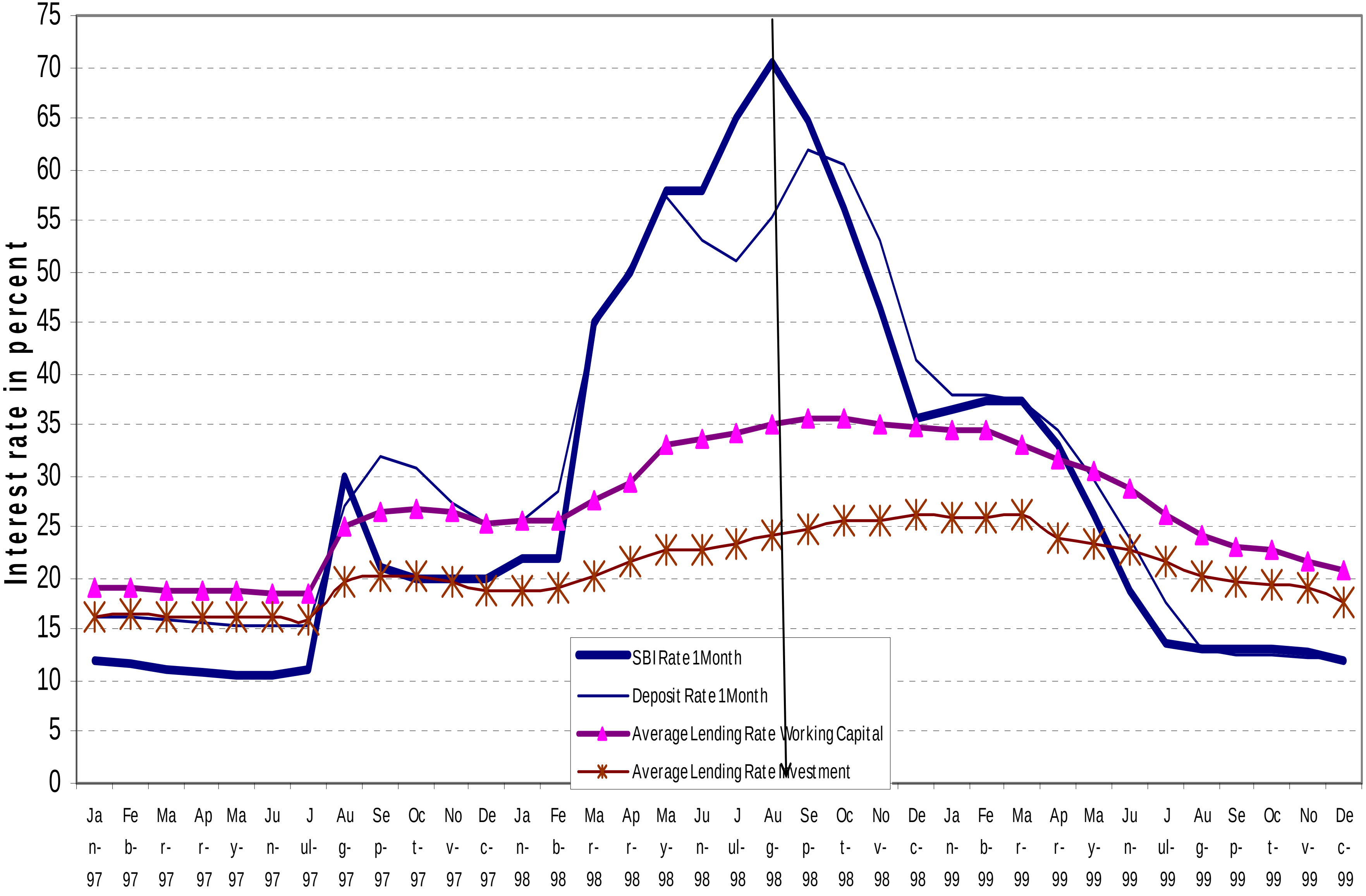
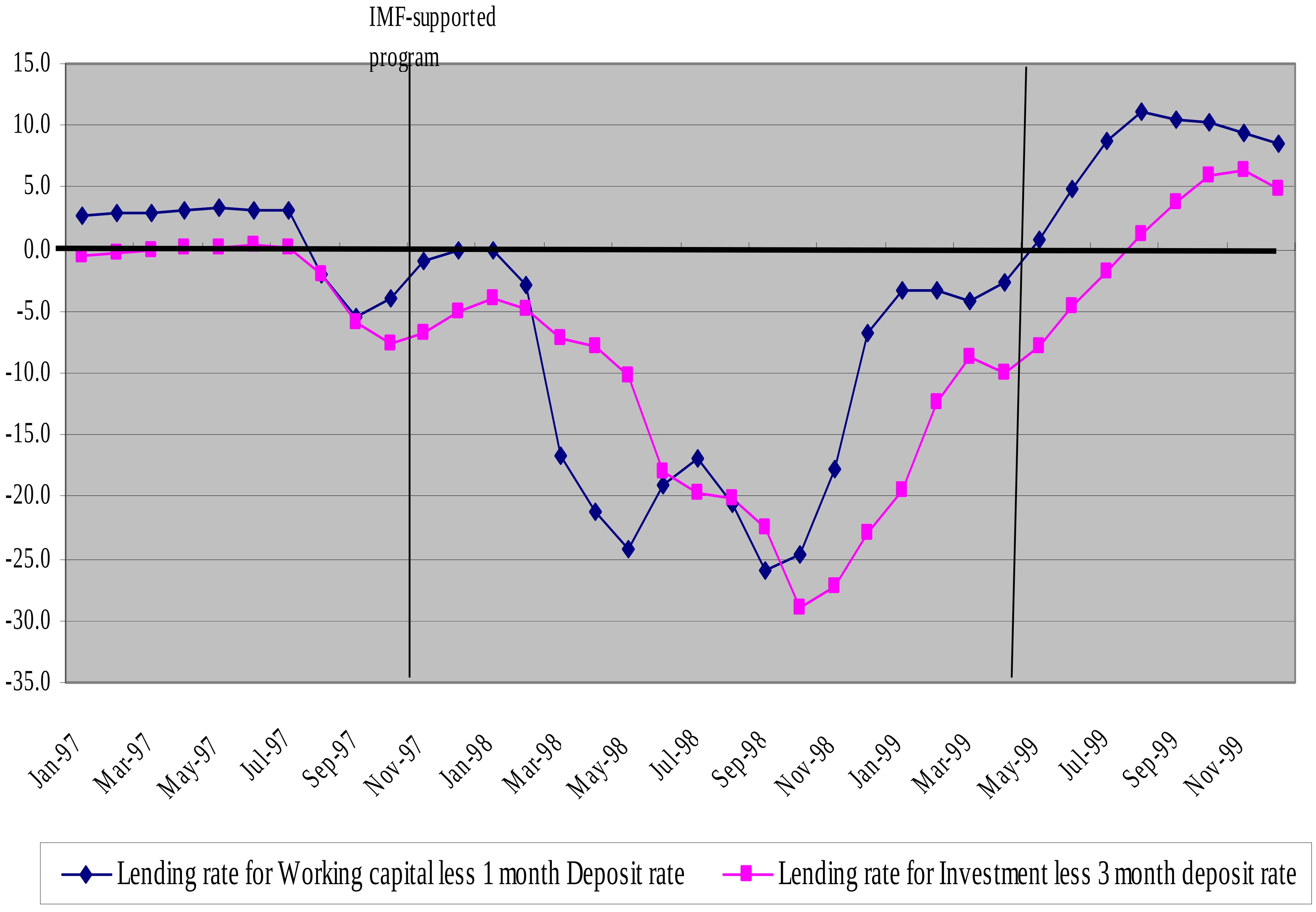


Chart 4. Indonesia: Difference between Lending and Deposit Rates, 1997-1999



Structural Conditionality

Actually, there were two phases—

1. October: 3 year horizon, little specificity
2. January: Break with the past to address political crisis—as a signal

Main failures — Misdiagnosis

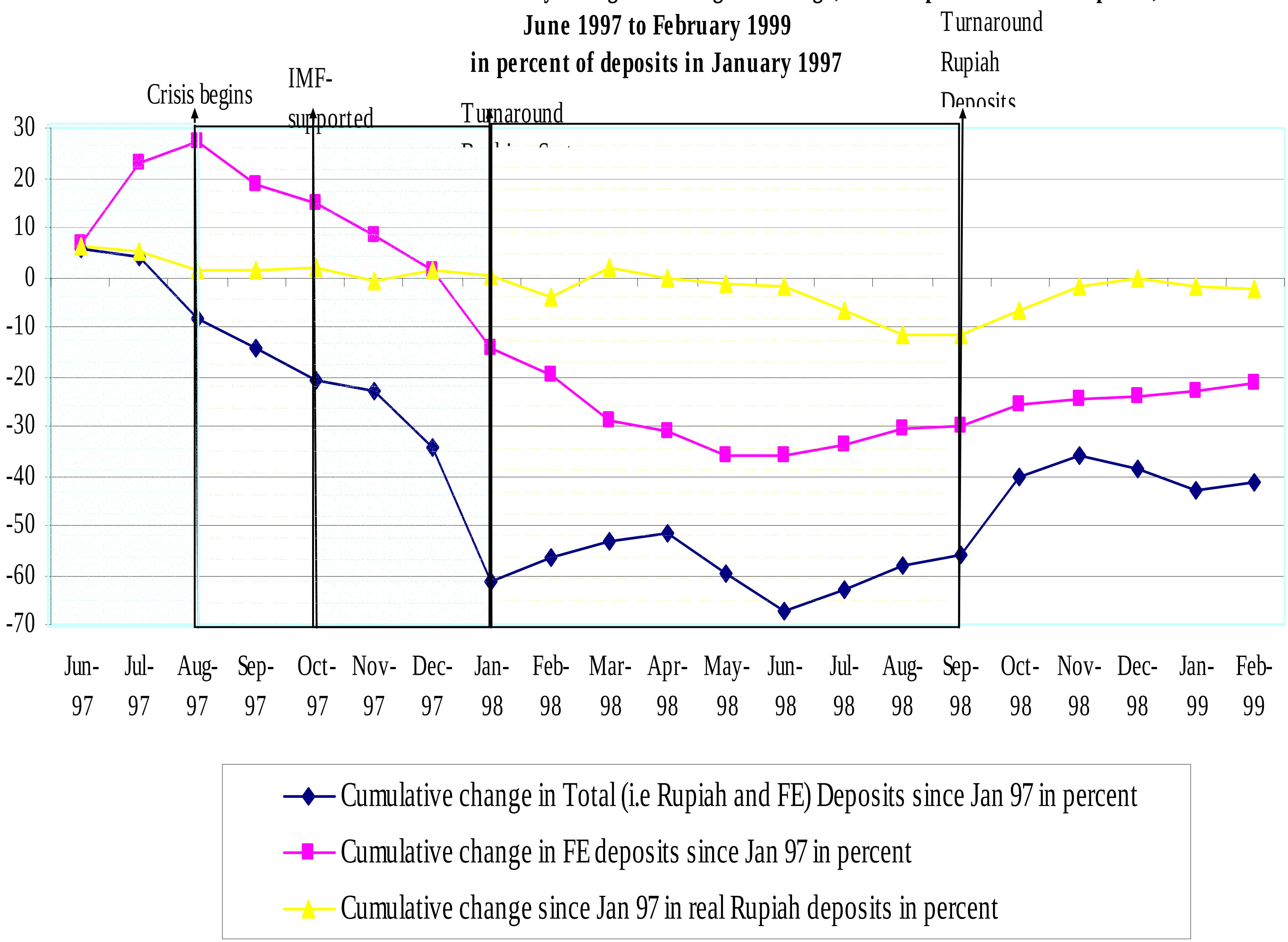
- Convinced contagion and oversold by markets and impressed by orthodox response
- Banking problems focused on bad apples
- Easy move to “good” equilibrium led by intervention
- Economic team can sell reforms as in past
- Ignore fear of Governor over high interest rates and his statement that “would rather not intervene if it means higher interest rates”

Closure of 16 Banks—Facts

- Shifting nature of crisis (Chart 5)
- MAE found 50 problem banks (34 insolvent of which 26 private; 3 under conservatorship and 13 to be watched)
- No strategy announced except for closure of 16 of the 26; 10 “nursed” by BI
- Partial guarantee of Rp 20 million for moral hazard (IMF) and cost (Indonesians) covers 93 percent of accounts and 20 percent of deposits

Chart 5. Indonesia: Cumulative monthly change in Foreign Exchange, Real Rupiah and Total Deposits, June 1997 to February 1999

in percent of deposits in January 1997



Closure of 16 Banks—Errors

- Impact of the exchange rate and interest rates on the health of the banking system
- Potential for things to go wrong
- Failure to communicate a strategy

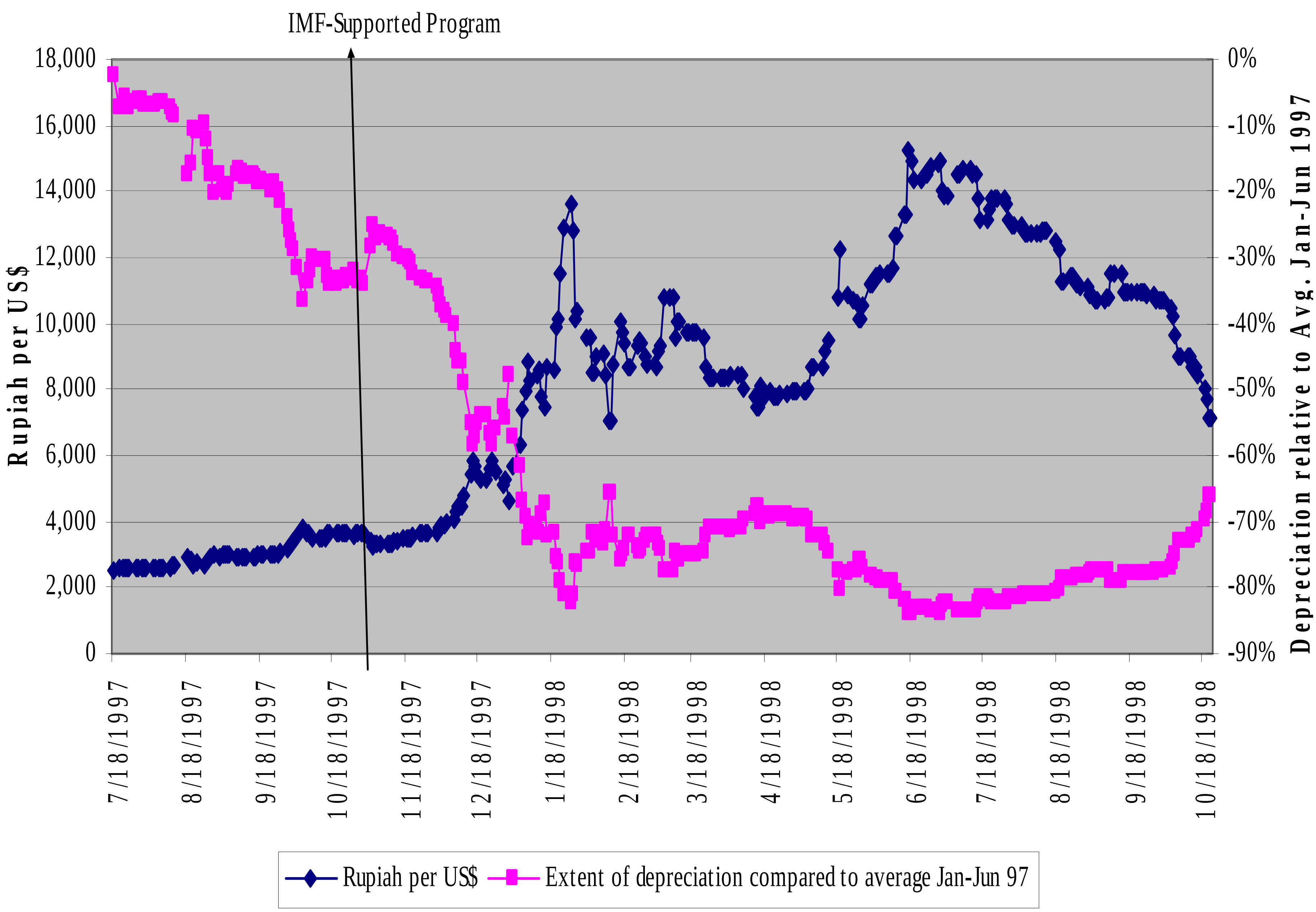
Central Bank Liquidity Support

- Sporadic runs on banks became more systemic by December 1997
- Given presidential order not to close any more banks, liquidity support was unlimited, amounting to Rp. 145 trillion by April 1998
- 75 percent went to four banks; 93 percent to fourteen banks

Liquidity Support (continued)

- When provision became routine, moral hazard became real
- Corrupt individuals connected with certain banks created shortfalls at clearing, making the banks eligible for support
- According to the State Auditor’s office, about Rp. 85 trillion had nothing to do with legitimate deposit withdrawals. Much was used to fund capital outflows, accelerating exchange rate depreciation (Chart 6)

Chart 6. Indonesia: Exchange rate and percent depreciation relative to average for Jan-Jun 1997



II. Korea

Phases of IMF involvement

(1) Surveillance before the crisis

(2) Original program, Nov-Dec 1997

(3) Revised program, Dec 1997-Mar 1998

Surveillance—Long-term vulnerabilities

- Capital account policies in the 1990s

(1) Limited opening of stock market

(2) Short-term bank borrowing liberalized from 1995

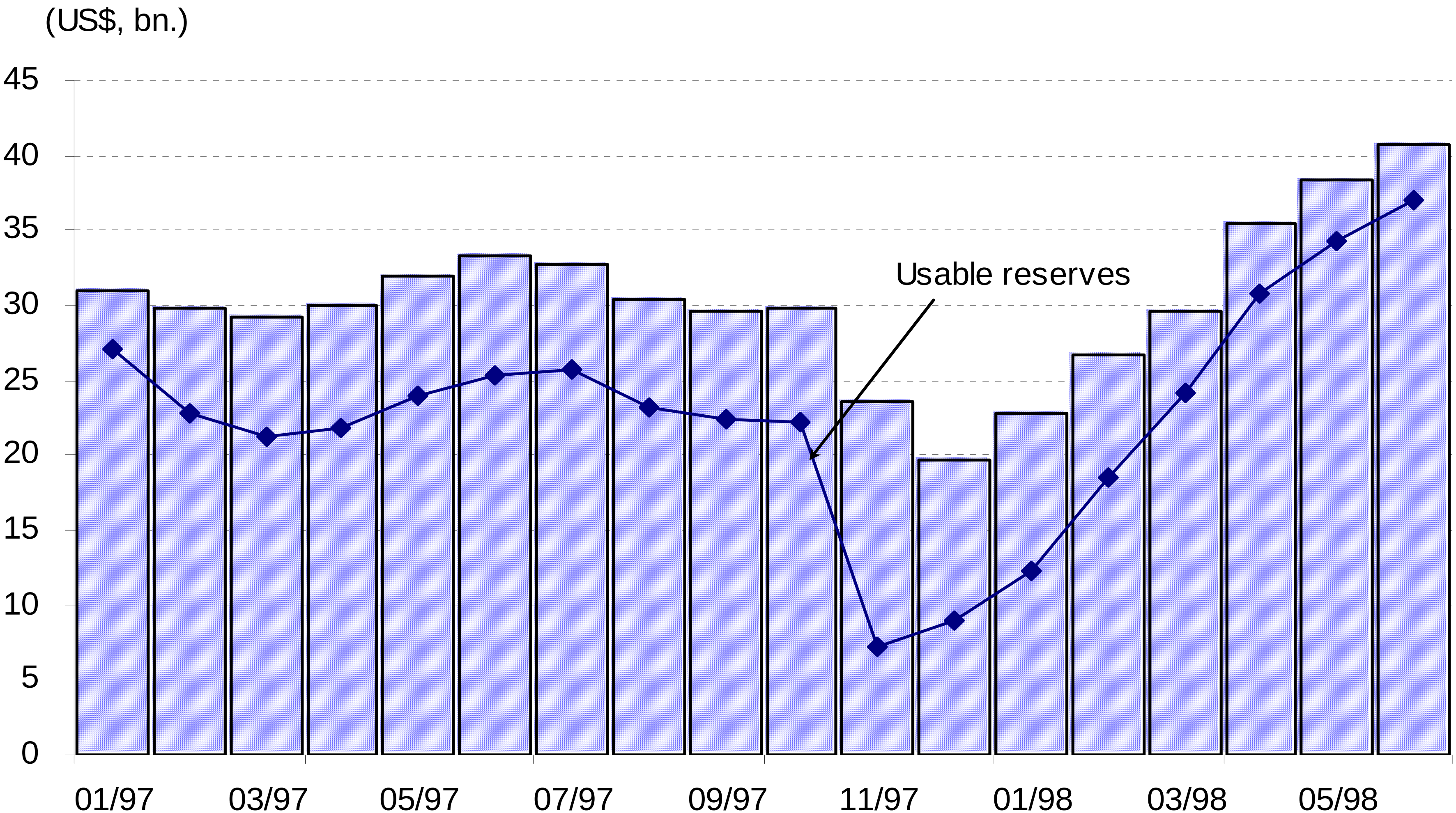
(3) Long-term external debt restricted

- Corporate governance
- Government intervention

Surveillance—Short-term risks

- Weakness in the Korean financial and corporate sectors before the crisis
- Leverage and maturity mismatches
- Connections between these weaknesses and reserve position
- Lack of information (e.g., usable reserves, see Chart 7)
- Communication within the Fund

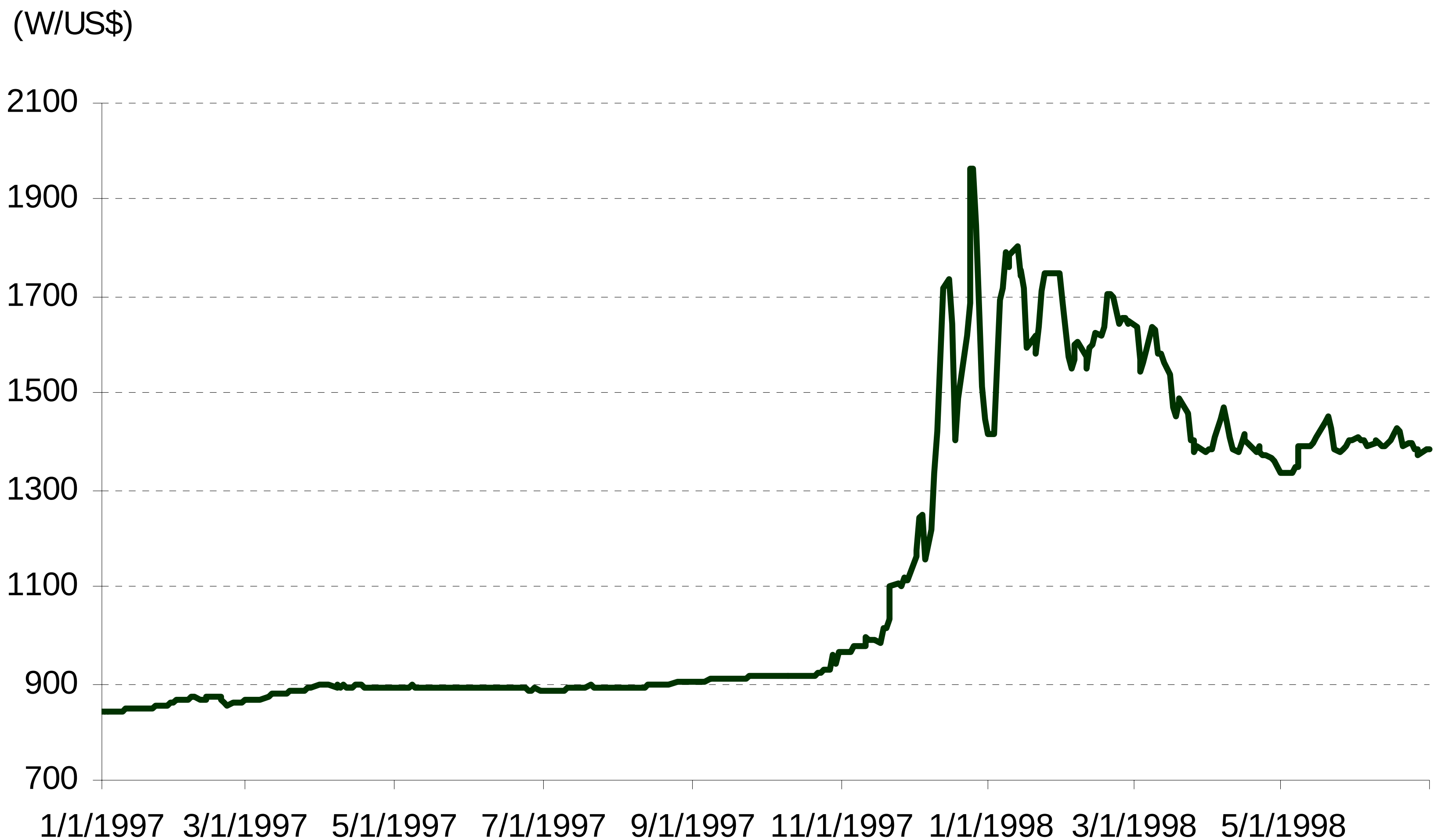
Chart 7: Foreign exchange reserves in Korea



Background to the crisis

- Strong growth and macroeconomic stability
- Exchange rate policy with moderate flexibility (Chart 8)
- Fall in semiconductor prices in 1996
- Corporate bankruptcies
- Implicit government guarantee (?) for banks' foreign currency debt in August 1997
- Banks face increasing difficulty to roll over interbank loans

Chart 8: Won/Dollar Exchange Rate



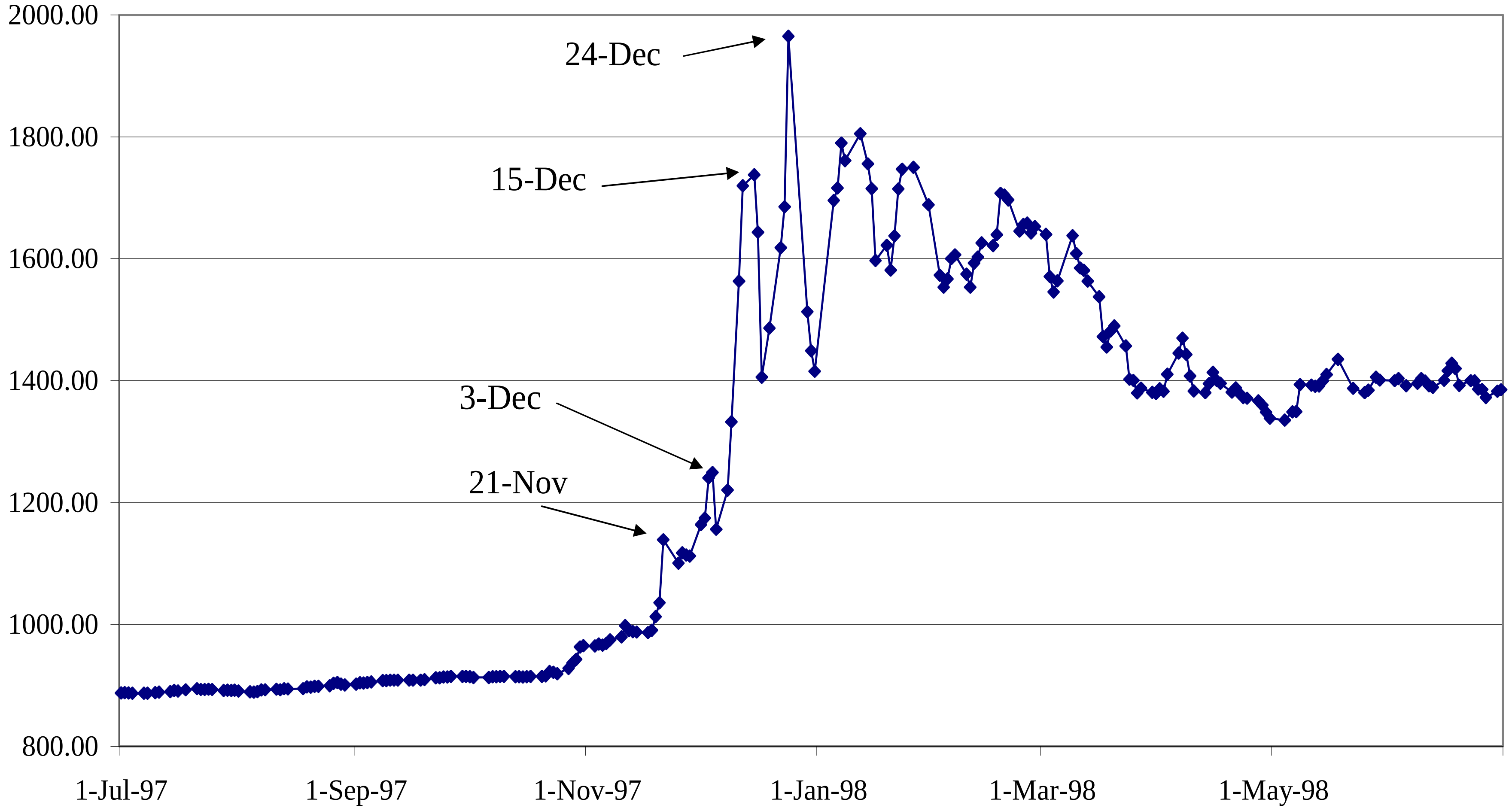
The onset of the crisis

- End-October 1997: Speculative attacks on Hong Kong and Taiwan.
- Bailout of Kia in October
- Capital outflows and a run on the currency by mid-November 1997
- Election year politics
- Parliament defeats a financial-sector reform bill on November 18, leading to the resignation of the Finance Minister.
- Negotiations with the Fund begin

The first package flops

- Low usable reserves (Chart 7)
- A support package on December 3:
  - $21 billion from the Fund
  - $10 billion from other multilateral institutions
  - Some $20 billion in a “second line of defense”
- The package does not restore confidence in Korea
  - The usable reserve figures are leaked to the press.
  - The leading presidential candidates seem to backtrack from earlier statements of support.
- The won goes into free fall (Chart 9) and reserves disappear (Chart 7)

Chart 9: KRW/USD, 7/97-6/98



The crisis resolved

- Kim Dae-Jung elected, gives support for reform measures
- On Christmas eve, creditor banks agree to roll over Korean exposure and to negotiate debt restructuring
- A few days later, Korea agrees to a strengthened package
  - Detailed structural conditions and accelerated disbursement of IMF and World Bank money
- January 1998: The creditors' agreement holds and the currency recovers. An extension of maturities is agreed to
- February 1998: A new sovereign debt issue is successfully floated
- The government implements reform and bank restructuring
- Growth recovers in the second half of 1998, with moderate inflation.

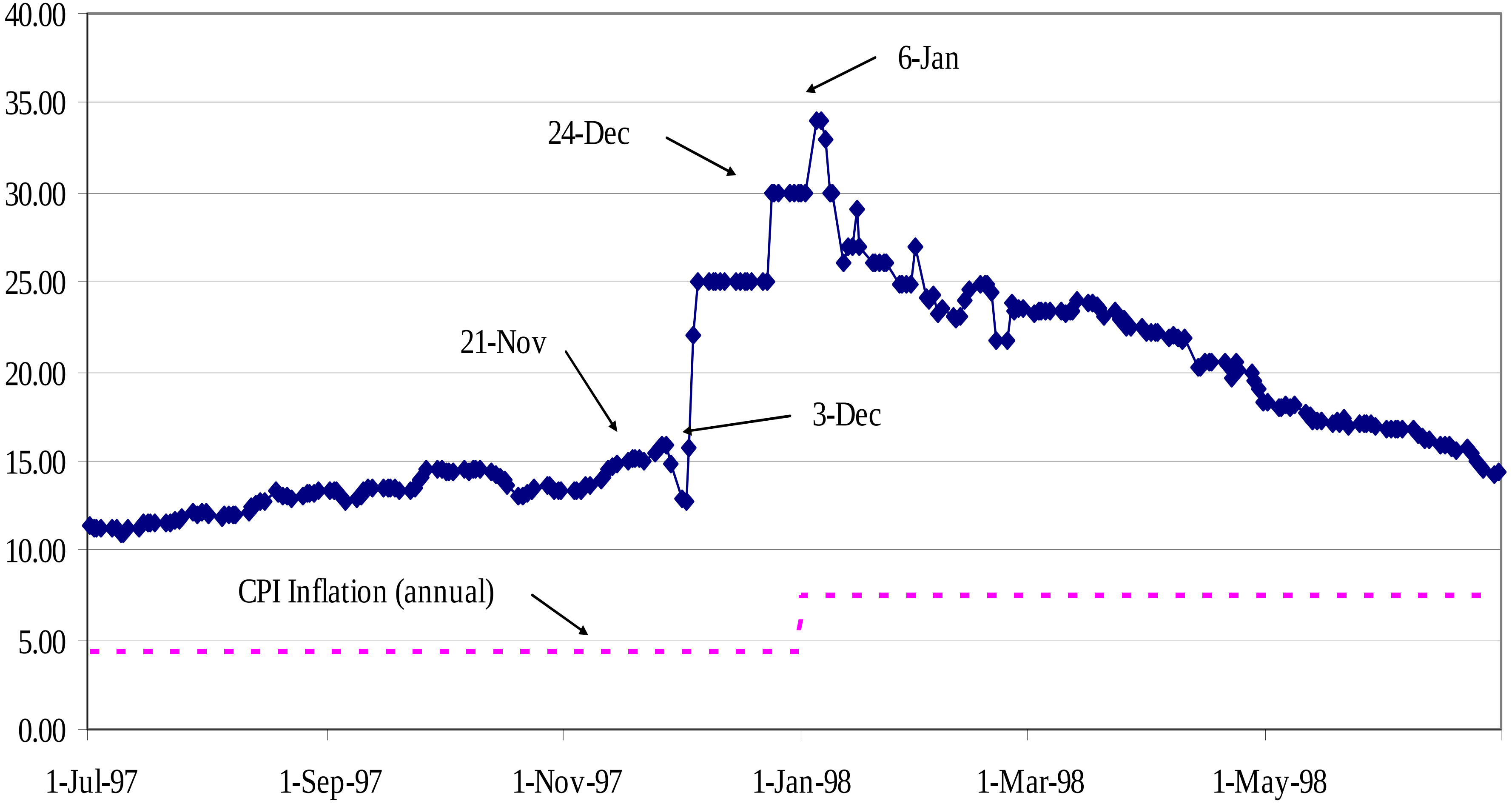
Some key issues

- Pre-crisis surveillance:
  - Why the risk of partial liberalization underestimated?
  - Why the Fund caught by surprise?
- Crisis response:
  - Why the initial financing package came up short?
  - Were monetary and fiscal policies too tight?
  - Were the structural reforms appropriate?
- Decision-making:
  - Was the Fund’s response flexible?
  - Did Korea “own” the program?

Crisis response—Monetary policy (Chart 10)

- Did interest-rate defense fail or succeed?
- Did high interest-rate policy make matters worse?
- Were real rates too high in the immediate aftermath of the crisis?

Chart 10: Overnight Call Money Rate



Crisis response—Fiscal policy

- Did the Fund pressure Korea to engage in tight fiscal policy?
- How did fiscal policy adjust to lower than expected growth in 1998?

Crisis response—Financial sector restructuring

- Did the Fund impose radical financial sector reforms on Korea or did Korea own the program (e.g., Presidential Commission report)?
- Did financial restructuring contribute to slow down in 1998?
- Was the focus on measurable benchmarks appropriate

Crisis response—Non-financial structural reforms

- The reforms included:
  - international accounting standards
  - Appointment of outside directors
  - Liberalization of the labor market
  - Trade liberalization
- Were the reforms in corporate governance, labor market policies and trade policies relevant to crisis resolution?
- Did some measures undermine domestic political support

Ownership

- How much did the program reflect Korea's own initiatives?
- Did the Fund consider country-specific conditions? E.g., institutional features of financial markets

III. Brazil

Phases of IMF involvement:

- The Real Plan, 1993-94
- Surveillance, 1994-98
- Support for the peg, Sep-Dec 1998
- Program revision, Jan-Mar 1999
- Continued engagement, 1999-2002

Key Issues

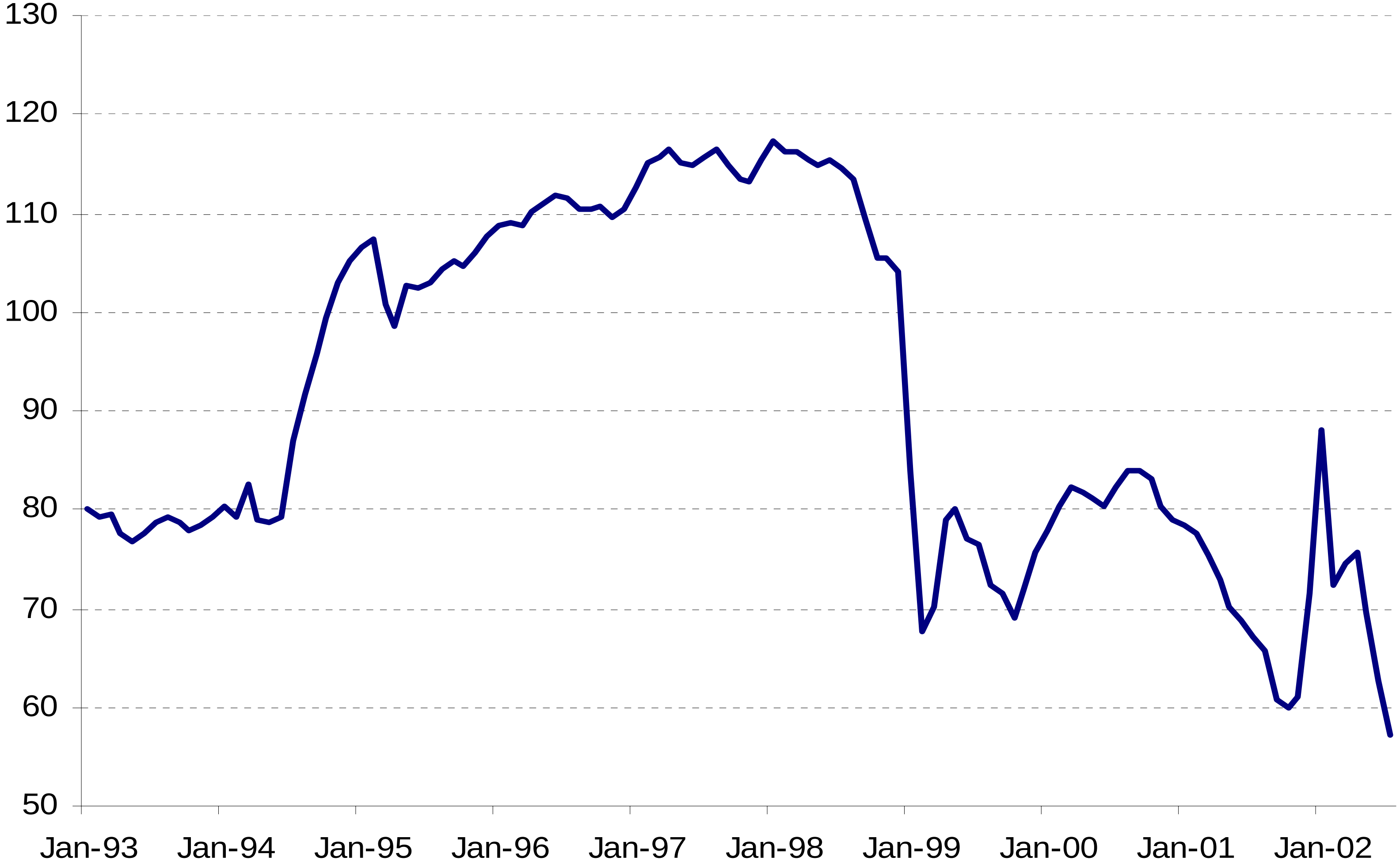
- Dialogue and relationship with the authorities
- Surveillance on the policy mix and debt sustainability
- Decision to support the crawling peg
- Remaining vulnerabilities despite implementing programs

The Real Plan (1994)

- Based on deindexation mechanism to eliminate inertial inflation
- Very effective at eliminating high inflation
- Did IMF failure to support the plan damage relationship?
- Insufficient fiscal adjustment
- The policy mix of tight monetary policy and loose fiscal policy—legacy of high interest rates and appreciated exchange rate (Chart 11)

Chart 11: Real Effective Exchange Rate

(CPI based, 1990=100)



Loss of inflation tax (and asymmetric indexation) led to.....

- Serious fiscal deterioration in federal and state governments
- Banking sector problems

The policy mix led to..

- Large capital inflows
- Large accumulation of FX reserves
- Persistent current account deficits
- Rapid rise in debt/GDP ratio

Surveillance

- Diagnosis – unsustainability of the policy mix
- Need for fiscal adjustment emphasized
- Was appropriate attention paid to external sector and capital flows?
- Exit strategy advice - accelerate the crawl
- Was degree of overvaluation appropriately judged?
- Concern over FX-linked debt
- Why was IMF influence on policy debate limited:
    - Central Bank relationship?
    - Lack of Transparency ?
- Were official documents candid?

Lack of Transparency on Vulnerability Data

- Team sent October 1998 to clarify
- Not disclosed as in Korea
- IMF not aware early of scale of futures market intervention – reached $40 billion
- $5.8 billion of reserves deposited with overseas branches of Brazilian banks
- $5.1 billion of reserves were holdings of Brazilian Bradies
- Limited coverage of official short-term debt

Policy options became limited by...

- Asian crisis
- Election year politics
- Russian and LTCM crises

.....Capital outflows (Table 2) and loss of reserves (Chart 12), leading to the decision to approach the IMF

Table 2: Short-term Capital Outflow from Brazil, Aug-Dec 1998 ($billion)

• Unwinding of trade “leads and lags”*	-10.0
• Fixed Income Funds*	-6.5
• Res.63 (agriculture)*	-4.4
• Floating rate mkt (incl CC5*)	-16.6
• Portfolio (mainly equity)	-3.7

* not included in official definition of ST debt

Chart 12: Foreign Exchange Reserves in Brazil [1]

(US $bn)

1) Net of IMF and BIS-coordinated credit.

Key Elements of 1998 Program

- Maintain crawling peg
- Significant fiscal adjustment
- Supportive Monetary Policy
- Structural Reforms:

  - Public Finance: Tax, admin, social security, Fiscal Responsibility Law

  - Privatization

  - Financial system

  - Labor market

Did IMF sufficiently examine Ownership of 1998 Program?

- Strong ownership of core program – particularly crawling peg - by direct counterparts

BUT

- Was Central Bank fully committed to supportive monetary policy?
- Did priorities for President change?
  - peg essential pre-election
  - shift to greater flexibility and development emphasis planned for second term?
- Was Congress committed – lost vote on pension contributions?

Market Reaction to 1998 program

- International investors less convinced
- Skepticism about sustainability
- Nevertheless, futures position reduced at first; reserve loss slowed
- Possibility could last for a while—permit soft landing
- Rapid loss of confidence as fiscal strengthening and government commitment to peg doubted

Exit from Peg

- Lopes replaces Franco
- Consultation with IMF only at very last minute
- Fund tried to dissuade but President already committed
- “Endogenous Diagonal Band” proves disaster
- After mid-January Washington meeting: decision to float, with move to inflation targeting
- Lopes replaced by Fraga end-January

Private Sector Involvement

- Authorities very reluctant to have any PSI
- Very light touch in 1998 — credibility in doubt
- Monitoring system established
- More serious official suasion in revised program
- Peer pressure - private sector co-ordinators
- Understanding on rollover rate in context of reviews – limited coverage
- Was it necessary or were credible policies/economic team more important?
- Did voluntary nature encourage repeat in 2002?

The Revised Program

- Very strong ownership by authorities
- Further fiscal tightening
- Limited structural conditionality
- Transition to inflation targeting
- Strengthened commitments from banks
- Considerable success

BUT

- Debt Sustainability proved Achilles' heel
- Limited structural progress

Outstanding Questions..

- Why was output loss so small?
- Why was price pass-through so small?

Projections Too Pessimistic!

- Did projections reflect Asian/Mexican experience as much as analysis of Brazil ?
- Private sector at least as pessimistic
- Limited impact on financial sector: already restructured; well-hedged; limited lending
- Inflation contained: indexation and “inflation mentality” did not return
- IMF overestimated exchange rate impact on current account

Monetary Program

- Original program:NDA target-partial sterilization (not implemented)
- Currency board considered but not pushed hard
- NDA targeting difficult given small money base and seasonal/other fluctuations
- Transitional combination continued NDA targets
- Pioneered inflation targeting conditionality in IMF-supported programs
- Provided mechanism for continued consultation
- Successful in containing inflation-credibility crucial
- Central Bank independence not formally established

Debt sustainability

- Central to fiscal programs—targeted 44% by 2001, but now 62% or more despite meeting fiscal PCs (Chart 13)
- Partly skeletons, but privatization offset: exchange rate linked debt central (Chart 14)
- Was sensitivity analysis adequate?
- Were verbal understandings to change sufficient incentive to improve debt composition?
- Overemphasis on primary surplus?
- Alternatives: Higher primary/ Restructuring/ Different PCs

Chart 13: Net Public Debt in Brazil (% of GDP)

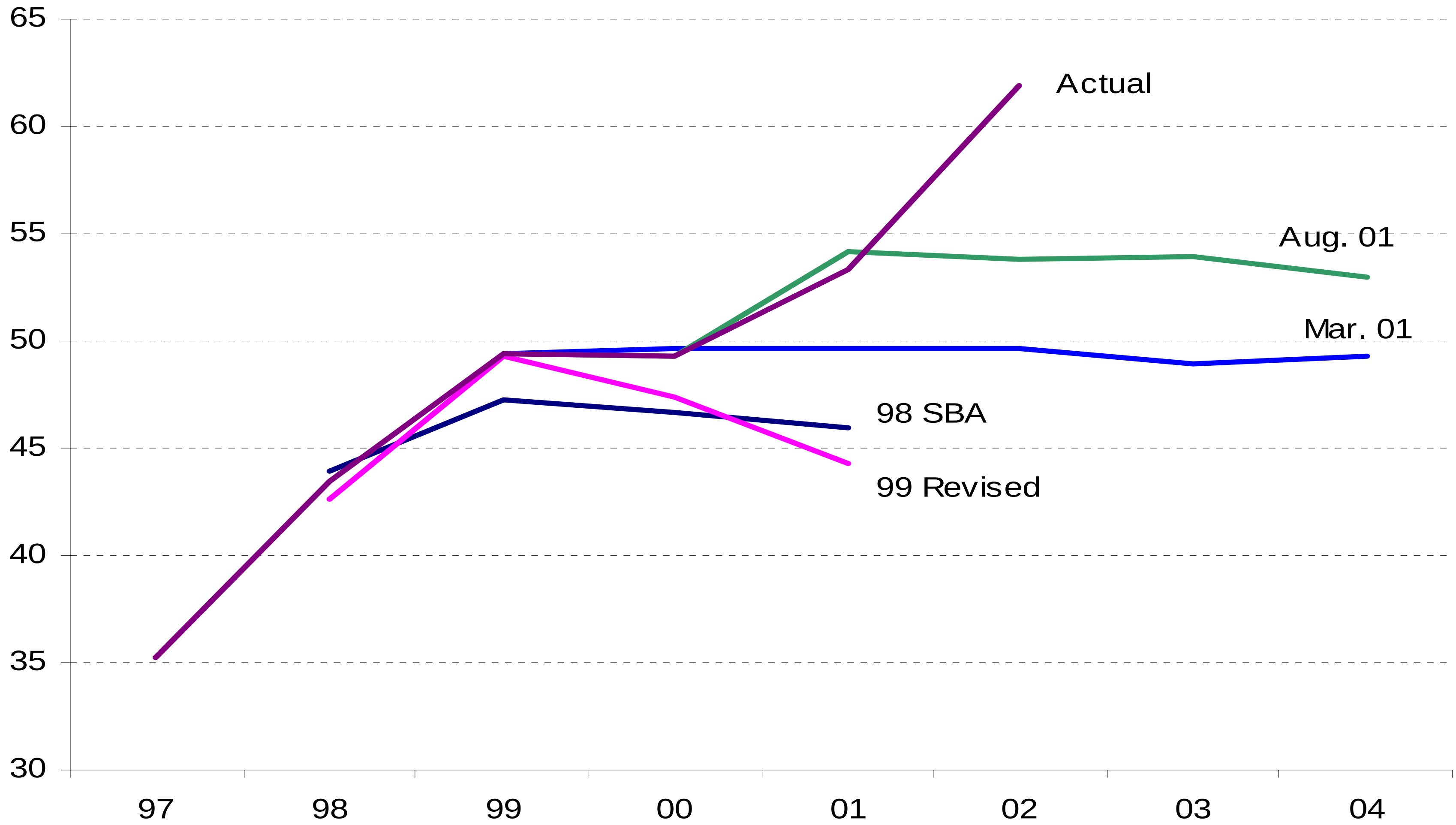
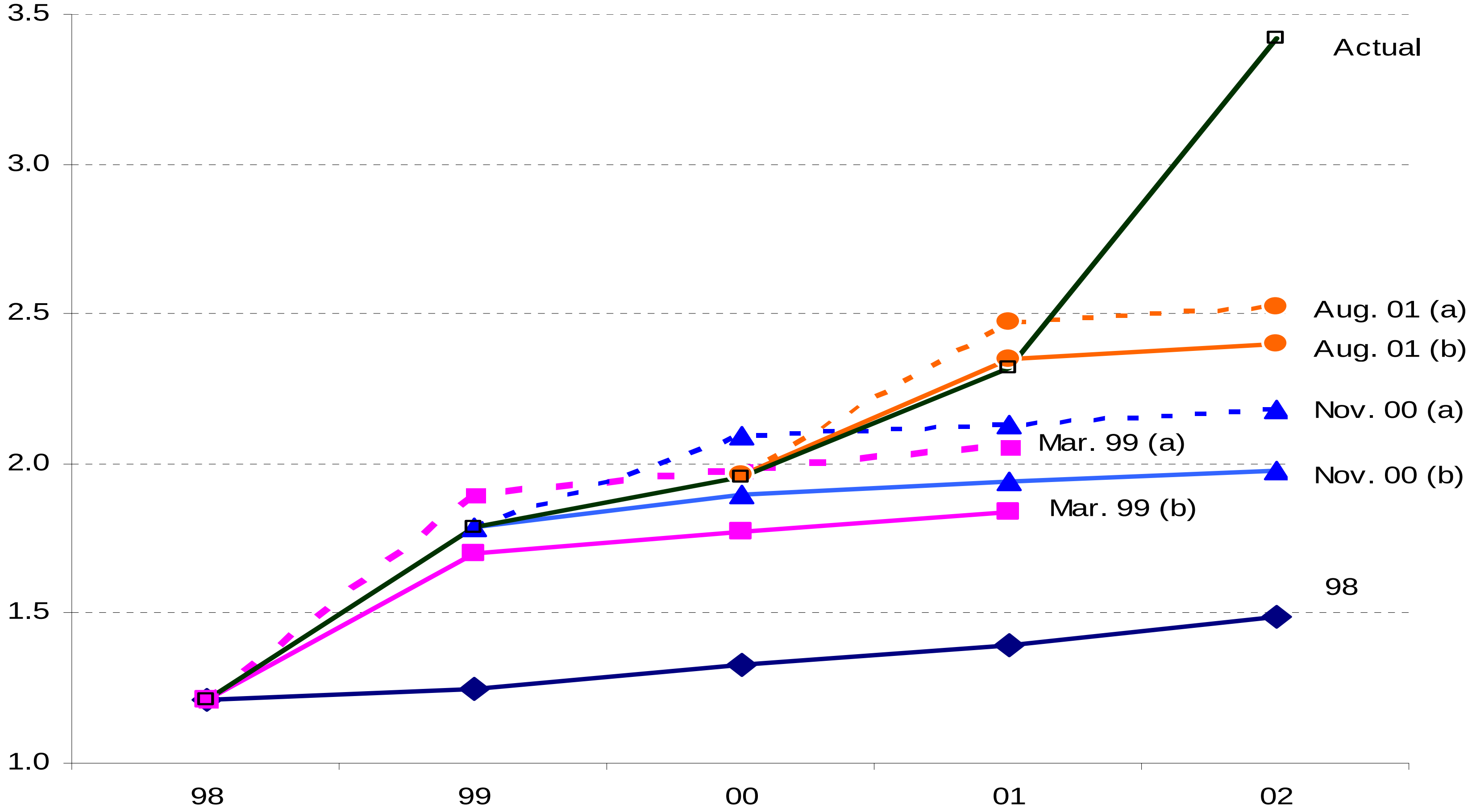


Chart 14: Debt Sustainability Analysis Exchange Rate Projections in Brazil (R$/$, end-year)



(Note) (b) is a base scenario and (a) is an alternative scenario

IV. Some Cross-country Issues

- Surveillance and dialogue
- Private sector involvement (PSI)
- What accounts for differences in output performance across three countries?
- Country ownership
- The role of major shareholders