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From Suez to Tequila: The IMF as Crisis Manager

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Abstract

The IMF was established in 1944 in part to "give confidence" to member countries by providing short-term credits. Although the intention was that the availability of the Fund's resources should prevent countries from experiencing financial crises, in practice the institution often has found itself helping its members cope with crises after they occur. This paper examines how the role of the IMF as crisis manager has evolved over time, from its earliest loans to the exchange crisis that hit Mexico in December 1994. It argues that the defining moment for this role was the international debt crisis of 1982.

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Summary

The IMF was established in part to "give confidence to members by making [its] resources . . . available to them under adequate safeguards." Although the intention was that the availability of the Fund's resources should prevent countries from experiencing financial crises, in practice the institution often has found itself helping its members cope with crises after they occur. This paper examines how the role of the IMF as crisis manager has evolved, from its earliest loans to the exchange crisis that hit Mexico in December 1994. The defining moment for this role was the international debt crisis of 1982. Previously, the Fund had helped countries through numerous crises, but its role in those cases was essentially similar to its noncrisis lending activities. The Suez crisis of 1956, the gold market crisis of 1967, and the oil and exchange market crises of the 1970s provide illustrations.

When the 1982 crisis erupted, the Fund's response quickly broadened into a more systemic function. The experience of the "lost decade" of the 1980s then provided lessons that conditioned the Fund's response at the end of 1994. The latter broke ground in two important respects. First, the speed of response was unprecedented, reflecting the perception that the risk of rapid contagion was greater than in 1982. Second, the size of the credit was far greater than the Fund had even considered before, reflecting the heightened vulnerability of an emerging capital market to potential outflows.

The rationale for the Fund's role has four elements. First, financial markets may overreact to and aggravate bad news. Second, conditionality benefits the country by strengthening credibility. Third, conditionality reduces moral hazard. Fourth, reliance on a market solution requires a potentially costly international "bankruptcy" procedure; organized crisis management provides a viable alternative.

From Suez to Tequila: The IMF as Crisis Manager

Introduction

The collapse of the Mexican Peso at the end of 1994 has been characterized as "the first financial crisis of the twenty-first century."[1] The International Monetary Fund played a central role in resolving the matter, as it had in numerous cases before. The suggestion that financial crises from now on are different from earlier episodes and that they require a different institutional response calls for some historical perspective. This paper examines the evolution of the Fund's role in dealing with financial crises since its conception in 1944 in order to shed light on the similarities and contrasts between past events and the latest affair. Although it does not attempt to judge how the Fund's role should evolve to deal with the coming century, its aim is to provide part of the background for such an evaluation.

What constitutes a financial crisis? In February and April 1995, the IMF made two of the largest financial commitments in its history:[2] a $17.8 billion credit to Mexico (apparently the largest loan *ever* made by *anyone*) and $6.8 billion to Russia. The circumstances and motivation were very different.

The Russian credit was driven in a classic manner by a "balance of payments need" (in the language of the Fund's Articles of Agreement) that resulted from a legacy of misguided macroeconomic and structural policies. To restore economic growth while respecting the balance of payments constraint, the Russian government had to substantially reform its whole economic policy regime. Because that effort would take time to carry out and more time to succeed, a large amount of external financing was required for the interim. The credit from the IMF, disbursement of which was conditional on Russia's continued adherence to its policy

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[1]This characterization has been employed both by U.S. Treasury officials and by the Fund's Managing Director, Michel Camdessus.

[2]Comparing transactions both within the Fund's accounts and between the Fund and other lenders is not straightforward. The previous record for the Fund was a $5.8 billion commitment to India, made in November 1981; in SDR terms, the India commitment was larger than the one to Russia in 1995. In March 1996, the Fund extended a new credit commitment to Russia, totaling $10.1 billion. (Amounts given here in U.S. dollars are converted from the official SDR amounts at the exchange rates prevailing at the time of approval.) Actual disbursements may have been smaller than the initial commitment; Mexico drew out around $13 billion of the amount available. Finally, it should be noted that technically, IMF credits are not loans; the country borrows by exchanging domestic currency for foreign exchange or SDRs, and then repays by reversing the exchange. The economic effects of the transaction are indistinguishable from those of a conventional loan.

program, was both a significant component of the financing and a catalytic signal to other creditors that a credible and supportable policy reform was under way.[3] If the stand-by arrangement with Russia was different from the myriad of similar credits made to other countries, it was a matter of degree: of size,[4] of political importance, and of the enormity of the economic transition that the government was trying to undertake.

The Mexico credit, although also based on the country's balance of payments need, was a different matter in important respects. Macroeconomic policies and performance were weakening in 1994 but still were considerably improved over the dismal record of the 1970s and early 1980s. In many respects, the Mexican economy seemed to be as structurally sound as it ever had been. As the year progressed, however, a series of shocks ranging from the uprising in Chiapas to the murder of the leading presidential candidate, Luis Donaldo Colosio, acted like a tropical storm on a beach, washing away the smooth surface and exposing policy weaknesses and inconsistencies. Weaknesses identified in the subsequent literature included reliance on relatively low domestic interest rates to try to protect the highly vulnerable banking system, insistence on maintaining an exchange rate band that had become inconsistent with the rate of monetary expansion, and dependence on short-term capital instruments (particularly the now-infamous tesobonos) to finance the external deficit.[5]

By December, market participants were convinced that the exchange rate was seriously overvalued, rumors of an impending devaluation were rampant, and the central bank was dangerously low on reserves. A seemingly small shift in the balance of news—reports of military advances by the Zapatista rebel forces in Chiapas on December 19—triggered a sell-off in Mexican stocks and bonds and forced the government to devalue the peso. When the devaluation failed to stem the outflow (and for structural reasons even aggravated it),[6] the government gave up after just two days and allowed the peso to float. Before the crisis finally ended in March, the peso would lose more than half of its initial value against the U.S. dollar.

What brought Mexico to seek the assistance of the Fund was a formerly latent balance of payments problem that swiftly became manifest in response to a financial crisis, which shall

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[3]See Fischer (1997) for a brief overview of the design and role of Fund lending.

[4]The credit to Russia, which merely equaled its quota in the Fund, was large only because the economy is large. In contrast, the commitment to Mexico was nearly seven times the size of its quota, also a record for the Fund by a wide margin.

[5]For an inside view on Mexico's progress, see Aspe (1993) and Aspe's keynote address in Boughton and Lateef (1995), pp. 126-138. For a slightly earlier outside perspective, see Loser and Kalter (1992). On the slippages in 1994, see Folkerts-Landau and Ito, 1995, p. 54. Domestic interest rates were raised during 1994, and then much more sharply after the crisis.

[6]For an analysis of how the devaluation forced Mexican banks to intensify their sales of pesos for dollars, see Garber (1996).

be defined here as a sudden and catastrophic loss of net international assets that makes continuation of the existing policy regime impossible. In a pure financial crisis, the existing regime would again be viable if the *status quo ante* could somehow be restored. In any real-world case (including this one), the existing regime almost certainly has flaws that would have to be fixed eventually, but what makes a financial crisis is that those flaws would not have posed an *imminent* threat to macroeconomic viability without a major shift in the willingness of investors and creditors to hold the country's assets and liabilities. Mexico already had a sizeable current account deficit in 1994, but it had little difficulty financing it until the crisis hit. Correlatively, the political disruptions did not cause the economic problems, but they did affect the government's financing options. The extent to which financial markets initially underreacted and then overreacted to bad economic and political news in this case is a matter of interpretation, but the financial reaction certainly had a major negative impact on an already difficult situation for economic policy.[7]

A financial crisis calls for a similar response from the Fund as any other balance of payments problem except that the response must be quicker and possibly much larger than in a more traditional case. A country facing a typical balance of payments problem might expect four to six months' work, and possibly a year or more if the problem is severe and the solution complex, between its initial request for a credit arrangement and final approval by the Fund. Upon approval, a typical stand-by arrangement might provide up to the equivalent of the borrower's quota in disbursements per year (depending on the Fund's current credit limits and the country's circumstances), which usually will cover only a moderate fraction of the initial external financing gap. The stand-by arrangement with Russia fell into the upper end of that category.[8] Negotiations began in October 1994, and the 12-month arrangement that was approved six months later was equivalent to Russia's quota. At that pace and rate, the Fund would have been able to offer Mexico just $2.6 billion, several months after the crisis erupted. Instead, the Executive Board approved an arrangement that committed approximately 4½ times as much money at an annual rate (i.e., nearly seven times as much in total, spread out over 18 months), less than four *weeks* after the initial request.

To provide the large sums that might be required to smother a financial crisis, the Fund can invoke the "exceptional circumstances" clause in its policy on access to Fund

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[7]For an analysis of the interplay between Mexico's economic and financial problems, see Calvo (1996). A contrasting view is given in a survey article in *The Economist* (December 9, 1995), which argues that "for anyone with a sense of history, there was little new in the Mexican débâcle" (p. 3) and that the crisis was an inevitable consequence of unsustainable economic policies. The view taken here is essentially consistent with that of Dornbusch et al. (1995, p. 255), that "events change the economic outlook, and markets react . . . and hence change the situation with which policymakers must work. This is a far cry from saying that markets will cause a collapse when there is no problem."

[8]Access under stand-by arrangements in that period averaged around 40 percent of quota per year; 100 percent was the upper limit.

credits.[9] Until the end of January 1995, the Fund intended to lend Mexico approximately $7.8 billion, which already would have required invoking the exceptional circumstances clause and would have been the Fund's all-time largest financial commitment. After the U.S. Congress balked at accepting the Clinton Administration's request for $40 billion in loan guarantees for Mexico, late in the evening of January 30, the Fund raised its own ante by $10 billion the next morning.[10] That unprecedented decision reflected a judgment that otherwise the crisis would have intensified quickly to the point that Mexico might not have been able to sustain the convertibility of the peso. Moreover, without decisive intervention, a "tequila" or hangover (or, to choose the more traditional metaphor, contagion) effect could have threatened other emerging markets around the world. The Fund's concern about "systemic risk" was stated succinctly by the Managing Director, Michel Camdessus, the day after the Fund approved the "unprecedented package" of financing for Mexico:

> "We . . . had the responsibility not only to provide financial support for Mexico's program and thereby to give confidence to Mexico, but also to respond to the systemic implications of the Mexican crisis and to give confidence to the international financial system. . . . [The] crisis of confidence in Mexico could have raised doubts about the situation in other countries as well—doubts not warranted by fundamentals."[11]

Without question, circumstances were exceptional, and it appeared unlikely that the crisis could have been resolved without providing much more than the usual amount of financing. Although the Fund was able to finance that operation with its own resources, it later took action to ensure that sufficient resources will be available for responding to future financial crises. In particular, the Fund arranged for a $47 billion line of credit (the "New Arrangements to Borrow") from 25 official creditors, to be drawn upon if needed to deal with threats to the stability of the international monetary system.

The other dimension of the distinction—the need for rapid response—raises more fundamental issues. Since 1952 the Fund has maintained, in effect, that it cannot ensure that it is "making its resources temporarily available to members" (to quote again from the Articles

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[9]When the Executive Board approved the Supplementary Financing Facility in 1977, it included a provision that credits larger than the specified limits could be granted "in special circumstances" by drawing on resources borrowed by the Fund. Later Board decisions on access limits replaced that terminology with references to "exceptional" circumstances.

[10]In addition, the United States agreed to provide $20 billion in credits from its Exchange Stabilization Fund, and in mid-February the Bank for International Settlements announced that it was raising its own loan offering from $5 billion to $10 billion. Although the latter was just window dressing (see the *Financial Times* of February 16, 1995, p. 4), the whole package of assistance provided a safety net for Mexico that was commensurate with the original plan.

[11]Transcript of press conference of Michel Camdessus (February 2, 1995), pp. 3-4.

of Agreement)[12] unless it makes its lending conditional on the adoption of adequate macroeconomic policies. If a financial crisis requires that resources be provided in less time than it normally takes to negotiate those conditions, how can the Fund obtain adequate safeguards for its resources? Just as importantly, the Fund has a surveillance responsibility to help countries avoid getting into crises.

Following the Mexican crisis (though not entirely as a result of it), several measures were taken to strengthen Fund surveillance, with the dual aim of uncovering problems (whether in macroeconomic policies, debt management, or oversight of the financial system) before crises erupt and of increasing the efficiency with which stabilization programs can be negotiated.[13] Measures taken so far have included the initiation of more frequent contacts and discussions when needed for continuity, the establishment of standards for the dissemination of economic data, an increased flow of information from the Fund to the general public, an intensification of the discussion of potential problem cases within the Fund and between the Fund and its members, and the adoption of what became known as the "eleven commandments" on economic policy.[14] The remainder of this paper examines issues related to the resolution, rather than the avoidance, of financial crises.

Bretton Woods, 1944

If the Mexican crisis of 1994-95 really was the "first financial crisis of the twenty-first century," it was because it was ignited in part by the actions of a large number of individual investors and creditors (resident and nonresident) operating in a global capital market.[15] By 1994, the long-simmering debate over the *wisdom* of capital controls had been completely overtaken by the realization that under many circumstances in the modern world such controls were no longer *viable*. No country can share in the benefits of international trade unless it allows capital to move freely enough to finance that trade, and modern financial markets are sophisticated and open enough that capital transactions can no longer be compartmentalized

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[12]"Temporarily" was added to this phrase from Article I in 1969, but the sense was implicit and understood from the beginning.

[13]For a summary of the Fund's analysis of the implications of the Mexico crisis for the conduct of surveillance, see the section on "Strengthening Fund Surveillance" in the IMF *Annual Report* for 1995, pp. 42-50. Measures taken subsequently are described in the 1996 *Annual Report*, pp. 42-43. For an outside official perspective, see Draghi et al. (1997).

[14]"Partnership for Sustainable Global Growth," Interim Committee Declaration (September 29, 1996). Reprinted in *IMF Survey*, Vol. 25 (October 14, 1996), p. 327.

[15]For a detailed review of international pressures on Mexican financial markets in 1994-95, see Chapter 2 of Folkerts-Landau and Ito (1995).

as trade-related or speculative. At most, "emerging market" countries might hope to stem the inflationary and other adverse impacts of capital inflows through selective controls.[16]

The development of a vibrant global capital market has thus nullified one of the guiding principles behind the Fund's Articles of Agreement as drafted at Bretton Woods in 1944. That charter created an institution designed to prevent a resurgence of the type of autarky to which so many countries resorted after World War I and which was thought to have contributed to the depths of the depression of the 1930s by stifling international trade. International *finance* was another matter. The British vision of the IMF, as drafted by John Maynard Keynes, called for a system that would "make unnecessary those methods of restriction and discrimination which countries have adopted . . . as measures of self-protection from disruptive outside forces." But Keynes also proposed that the Fund should be able to *require* a country to introduce "the control of outward capital transactions if not already in force," as a condition for borrowing.[17] In other words, Keynes saw controls on current transactions as bad, and capital controls as possibly beneficial.

The American plan, drafted by Harry Dexter White and his deputy, Edward M. Bernstein, took a similar view and elaborated the nuances and conflicts more elaborately. A 1944 U.S. Treasury document noted that capital outflows were not necessarily undesirable, but that they should be reasonably related to the need to finance trade on the current account; that is, the current account should drive the capital account, not the other way around. The U.S. team clearly feared that autonomous or speculative capital outflows were a real possibility, and that such outflows would lead not to a current account surplus but to unsustainable reserve losses that countries would seek to staunch by borrowing from the Fund. The report concluded: "It is only when the capital exports are net, large, sustained, and motivated chiefly by the desire for speculative profit that the Fund is likely to require a restriction of capital exports as a condition for continued use of the Fund's resources."[18]

Article VI of the Articles of Agreement reflects those views. To control the use of Fund credits and ensure that scarce resources will be available for the basic purpose of financing current account deficits, Article VI prohibits the Fund from financing "large or

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[16]Bhattacharya et al. (1997) and Folkerts-Landau and Ito (1995) provide thorough analyses of the role of capital controls in emerging markets in the 1990s. Concerns about the dangers of exposing developing countries to volatile capital flows were cited by participants in the April 1997 meeting of the Interim Committee as one reason for recommending caution in the pace of liberalization; for a summary, see *IMF Survey*, vol. 26 (May 12, 1997), pp. 129-144.

[17]The quotations are from the April 1943 version of the Keynes Plan ("Proposals for an International Clearing Union"), as reprinted in Horsefield (1969), Vol. 3, pp. 21 and 23.

[18]U.S. Treasury, "Questions and Answers on the International Monetary Fund," June 10, 1944. Reprinted in Horsefield (1969), Vol. 3, pp. 136-182. The quotations are from pp. 177-78.

sustained" capital outflows, and it encourages countries facing such outflows to impose controls to regulate them. (The Articles often are described as neutral on this issue, as "not discouraging" controls; the truth is that the founding fathers were downright bullish on capital controls.) As drafted at Bretton Woods, Section 1(a) of Article VI read: "A member may not make net use of the Fund's resources to meet a large or sustained outflow of capital, and the Fund may request a member to exercise controls to prevent such use of the resources of the Fund. If, after receiving such a request, a member fails to exercise appropriate controls, the Fund may declare the member ineligible to use the resources of the Fund." Although no country was ever declared ineligible on these grounds, Article VI was not substantively amended while the global capital market underwent its remarkable sea change, and it continued to govern the Fund's decisions on whether to extend credit to countries.[19]

Suez, 1956

During the first decade of the IMF's life as a financial institution, what little lending the Fund did was aimed at helping countries establish currency convertibility for *current account* transactions at fixed exchange rate parities. Then in 1956, for the first time the Fund was called upon to help its members cope with a major international crisis: the closing of the Suez Canal. The Suez Crisis, of course, was not primarily financial. After the Egyptian government nationalized the canal in July, the British, French, and Israeli governments engaged in military actions against Egypt that began in October and lasted nearly two months but succeeded only in temporarily closing the canal altogether. In the midst of this turmoil and uncertainty, all four of the combatants turned to the Fund.

First in the queue was Egypt, which had never borrowed from the IMF since joining as an original member in December 1945. Egypt drew its gold tranche ($15 million) in September 1956, while it was keeping the canal open in the face of the sudden departure of all of the European boat pilots. In February 1957, while trying to get the canal cleared and ready to reopen, Egypt borrowed another $15 million (its first credit tranche). By going no higher and not requesting a stand-by arrangement to borrow from the upper credit tranches, the government avoided explicit conditions on its economic policies and obtained immediate access to the money.[20]

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[19]In 1956, the Executive Board reaffirmed the right of members to impose capital controls, for whatever reason, without needing approval from the Fund (see Horsefield, 1969, Vol. 3, p. 246). In the 1969 amendment of the Articles, Article VI was amended to exclude "gold tranche purchases" from any declaration of ineligibility. In the 1978 amendment, that exclusion was modified to refer to reserve tranche purchases. In April 1997, the Interim Committee endorsed the idea of amending the Articles to give the Fund a mandate to promote the free flow of capital.

[20]The gold tranche was, in effect, the amount that member countries paid into the Fund in gold or U.S. dollars, normally equal to 25 percent of their quota. A "gold tranche purchase" was a

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Next came France, which obtained a one-year stand-by arrangement for its gold and first credit tranches, totaling $262.5 million (the largest commitment undertaken by the Fund up to that time). The credit was requested informally in late September, while France was arming Israel in preparation for an invasion of the Sinai, and it was approved by the Executive Board on October 17.[21] Initially, the government intended to treat the arrangement as a true stand-by and draw on it only as necessary. From February through June 1957, however, the full amount was drawn.

The British government announced on December 3 that it was withdrawing its troops from Egypt and giving up its attempt to force Egypt to return control of the canal to the internationally owned Suez Canal Company. A week later, it drew out its gold tranche and its first credit tranche from the Fund ($561.5 million), and the Executive Board approved a one-year stand-by arrangement under which Britain could borrow another $738.5 million. Exceptionally, in deference to the United Kingdom's role in the institution and in the world economy and to the government's intention not to draw on the arrangement, no explicit policy conditions were attached to the upper-tranche stand-by.[22]

Five months later, Israel, completing the circle not long after its pullback from the Gaza Strip, drew out its gold and first credit tranches ($3.8 million). By then, the IMF was on the world's financial map for the first time in its brief history. In nearly ten years of operations before the Suez crisis, the Fund had lent an average of $135 million a year to its member countries. In the two years immediately preceding the crisis, only five countries had borrowed from the Fund, for a total of $90 million. Of those, only one (Mexico) had a stand-by arrangement, and only one (the Philippines) drew in the upper tranches. The Fund was lolling in a backwater. Then in 1956-57, beginning with the Egyptian credit, total drawings jumped

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[20](...continued)
drawing of foreign exchange from the Fund that did not raise the Fund's holdings of the member's currency above its quota. Under the rules then in effect, a withdrawal of the gold tranche was treated as a credit that had to be repaid. When the First Amendment became effective in 1969, members could automatically and permanently draw out the gold tranche if they chose. (The Second Amendment, enacted in 1978, renamed it the "reserve tranche.") A drawing on the first credit tranche was always treated as a credit but was not usually subject to explicit policy conditions. The remaining three credit tranches could be borrowed, usually under a stand-by arrangement, subject to acceptance by the Fund of a proposal by the government to adopt specified policies capable of restoring external financial viability.

[21]France's economic difficulties predated the Suez crisis and were related also to the war in Algeria. For a fuller discussion of this and other economic aspects of the Suez crisis, see Kunz (1991).

[22]The stand-by was renewed twice and remained in effect until December 1959, but no drawings were ever made on it.

to nearly $1.7 billion. Of that, $989 million (59 percent of the total) was to the four principals in the Suez affair.[23]

At its core, Suez was a political crisis. On the periphery, it was an economic hardship that placed pressure on the balance of payments of each participant. For the United Kingdom, it also had some of the financial characteristics defined at the outset of this paper, though without the immediacy that came later to be the hallmark of a financial crisis. Sterling came under heavy speculative pressure in the form of short-term capital outflows unrelated to the current account. In the absence of that speculation, British reserves would have been stable and adequate; even with the commercial effects of the closing of the canal, the United Kingdom had a current account surplus for both 1956 and 1957. For the other countries, however, the external imbalances arose mainly from the current, not the capital, account.

In responding to the requests for financial assistance that arose out of the Suez crisis, the IMF merely applied its existing procedures, with some flexibility. The fact that the stand-by arrangement for the United Kingdom was aimed at protecting the country's reserves against speculative capital flows rather than a current-account deficit did not prevent the Fund from approving it, nor even provoke much debate.[24] The efficacy of the process helped to demonstrate the value of the Fund as a lending institution and thus contributed to a sharp and sustained increase in the level of its activities. It was the first case in which the Fund was drawn into a crisis, but it would greatly overstate the institution's role to call it a crisis manager.

Collapse of the Gold Pool, 1968

The capital account as an independent force became a more general issue in the early 1960s, after most industrial countries had reestablished convertibility for current account transactions. When countries with the most advanced financial systems began dismantling capital controls, the Fund treated it as a welcome development and thus began to distance the

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[23]Curiously, Horsefield (1969) made only a few passing references to the Suez in discussing the jump in Fund lending from 1956 on. See James (1995, pp. 102-105 and 137) for a fuller discussion. As James observed, total Fund lending was higher in relation to world trade during the years right after Suez than at any other time before or since.

[24]Discussing the request, several Executive Directors regretted that it was not driven by the current account, but they also noted that unless the capital account was stabilized, the British authorities might be forced to impose exchange restrictions that would suppress trade. With that forward-looking perspective, the arrangement was consistent with the Fund's Articles. Only the Executive Director speaking for Egypt abstained from approving the request. See minutes of Executive Board Meeting 56/59 (December 10, 1956); IMF Central Files, C/United Kingdom/1760, "Stand-by Arrangements 1952-1960."

institution further from the view that had prevailed at Bretton Woods.[25] The honeymoon was short. By the mid-1960s, autonomous capital flows were becoming a significant irritant to the major industrial countries. As early as July 1963, the United States imposed an "interest equalization tax" to discourage short-term capital outflows, at a time when its current account balance was in surplus. The United Kingdom also tightened its capital controls around that time. By the late 1960s, many other industrial countries were doing so as well, and the incipient capital account revolution was in full retreat.[26]

The second major international economic crisis of the postwar era was a direct product of those disruptive capital flows: the collapse of the Gold Pool in 1968. Through a system established in 1961, the central banks of eight major industrial countries acted together to stabilize the market price of gold in London at $35 an ounce.[27] Inflationary fears and rising commercial demand put pressure on that price that mounted throughout 1966 and 1967, but the Gold Pool maintained stability in the face of massive capital outflows by drawing heavily on official exchange reserves. When reserve losses became too large to sustain, the London gold market shut down temporarily in March 1968 and reopened only after the official Gold Pool was disbanded. From that point on, the major central banks exchanged gold for reserves only among themselves (if at all), and the price of gold was left to find its own value in the private markets.

The only Gold Pool member that turned to the IMF for help during the crisis was the United Kingdom. Most members had comfortable reserve cushions; U.S. reserves, which had declined sharply through the late 1950s and early 1960s, actually stabilized in 1967-68. France protected its reserves by withdrawing from the Pool in June 1967. British resources, however, were not strong enough to withstand the onslaught, and the government was forced to devalue sterling and seek a $1.4 billion credit from the IMF in November 1967. Less than two years later, France also devalued and obtained a supporting stand-by arrangement from the Fund.

Neither the British nor the later French stand-by resulted from the international gold crisis. Both derived from more general balance of payments problems. British reserves had

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[25]In a February 1961 discussion on whether it was appropriate for the Fund to finance "capital transfers," the Managing Director, Per Jacobsson, stated that "some of these movements are a normal feature of international business under conditions of widespread convertibility *and freedom of transfers*, which are most certainly welcomed by the Fund" (emphasis added). The Executive Board decided at that time that neither the Articles nor previous Board decisions precluded the Fund from financing capital transfers, as long as the transfers were not "large or sustained." See Horsefield and Lovasy (1969), pp. 415-416.

[26]Solomon (1982), Chapter 3, provides a good overview of these developments.

[27]The original participating countries were Belgium, France, Germany, Italy, the Netherlands, Switzerland, the United Kingdom, and the United States.

been weakened by years of mismatched policies—fiscal and monetary expansions that were inconsistent with a fixed parity for sterling—and by the burdens of preserving the sterling monetary area. The French franc was vulnerable because of the strength of the deutsche mark, because of the disruptions to both trade and finance from the domestic unrest of 1968, and finally because of the collapse of the government of General de Gaulle.[28] The international financial crisis that threw $35 gold into the dustbin of history neither aggravated nor hastened the external economic imbalances in Europe.

What is most striking about the late 1960s, viewed from the perspective of the late 1990s, is that the role of the IMF was confined to the realm of economic policy and was linked only indirectly to events in financial markets. At no point was the IMF involved in the effort to stabilize the gold market, but it did play a crucial role in convincing the British and French governments that they could no longer escape devaluation, in evaluating the size of the required parity changes, in helping to design the accompanying adjustments to macroeconomic policies, and in providing large credits until the new policy regimes could take hold.

Collapse of Bretton Woods, 1971-73

The independence between economic and financial problems unraveled further in the 1970s, partly because of a dramatic growth in international private capital markets and partly because of questionable policy making. As a first approximation, current account deficits were no more than a short-term nuisance for the large industrial countries during the Bretton Woods era. As late as 1970, all of the Group of Seven (G-7) countries reported very small current account surpluses (less than $3 billion). What they had on occasion in the 1960s were capital account outflows that applied pressure to official reserves. Although at the time those outflows were blamed on speculation in "hot money," sober reflection showed that they were caused primarily by overly expansionary macroeconomic policies. Their causes were economic, and their effects were both economic and financial.

External economic balance was shattered in the 1970s. Current account imbalances became larger and more cyclical, and shifts in macroeconomic policies to limit those imbalances became more pronounced (see Bayoumi, 1990). Current deficits, which were fed further by the 1973-74 oil shock, were financed to a greater extent than before by short-term capital flows through the nascent Eurocurrency markets. The exchange market crisis of 1973, the one that ushered in the modern era of floating exchange rates, was fundamentally different from the gold market crisis of 1968: it resulted directly from trade and current account deficits, and it quickly made those deficits unfinanceable at the existing exchange rates. American tourists abroad were shocked to find that the U.S. dollar was not welcome in shops, in restaurants, or in banks. The response, of course, also was fundamentally different: instead of deficit countries devaluing, adjusting, and borrowing from the IMF, the major creditor countries simply stopped intervening to support the dollar's value.

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[28]See James (1995), pp. 183-91, for the background to the British devaluation and stand-by; and pp. 193-97, on France. Also see Solomon (1982), Chapters 5 and 9, respectively.

What did not change was that the IMF still was not directly involved in managing or resolving the crisis. The Fund provided technical assistance and advice to the Group of Ten (G-10) during the months of work leading up to the group's Smithsonian meeting, when a new set of fixed exchange rates was established. The Fund provided the institutional framework for the Committee of Twenty and its successor, the Interim Committee, to try to reform the international monetary system in 1972-76. The Fund held annual consultations with all of the major countries and provided systemic analysis through its World Economic Outlook exercise. But the decision to allow currencies to float against the U.S. dollar temporarily insulated the economies of the G-10 countries from the immediate consequences of the financial crisis and obviated a direct financing role for the Fund.

Partly because of the contemporaneous economic crisis that resulted from the 1973-74 rise in oil prices, and partly because of major differences in the way countries adjusted macroeconomic policies in the aftermath of the two shocks, both Great Britain and Italy developed balance of payments deficits that required substantial financial help from the IMF in 1976-77. The United Kingdom temporarily retained its status as the largest borrower from the Fund, and it became clear that floating exchange rates were not a substitute for sound policies. Nonetheless, the British and Italian credits arose from what now can be called old-fashioned twentieth-century crises: economic, but not yet truly financial in the sense used in this paper.

Although the role of the IMF in dealing with crises was not yet evolving, the seeds for a transformation were germinating in the wake of the first oil shock. As soon as the oil-exporting countries began to accumulate current account surpluses, both the IMF and the OECD, as well as officials in the major oil-importing countries, undertook to examine how those surpluses could best be "recycled." For the first time in history, the world faced a *global* problem of payments imbalances, one which could not be solved within the group of advanced economies or even between that group and the newly wealthy oil exporters. It was unrealistic to expect the oil exporters to directly finance the increased deficits of the 100 or so oil-importing developing countries. The solution that emerged was a classic case of financial intermediation: the oil exporters invested the bulk of their surpluses in the financial systems of the industrial countries, and the banks onlent a substantial portion of those funds to the oil-importing developing countries. As a result, total international bank lending tripled in size from 1973 to 1978 (BIS *Annual Report*, various dates).[29]

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[29]Officials in the major creditor countries and international institutions such as the Fund are often blamed for encouraging the banks to take on the task of recycling oil surpluses in the 1970s. Because those loans carried no effective conditionality, and because market interest rates through much of the period were negative in real terms, developing countries found it all too easy to over borrow and were left with no means of coping when world economic conditions worsened. That criticism is true enough, but the banks did not recycle funds out of a sense of public spirit. Regardless of any public proclamations or exhortations coming from officialdom, the major international banks logically would have made substantial loans to the developing world, because that was where the highest (apparently risk-adjusted) rates of return were to be found. The real question is why the risks were inadequately assessed.

The initial phase of recycling, from 1973 to 1978, caused few immediate problems, in large part because of a cyclical boom in primary commodity prices that raised the value of many developing countries' exports pari passu with their increased external debt service. Although the aggregate current account deficit of the oil-importing developing countries widened slightly in relation to total exports (from 13 percent to 15 percent), the ratio of external debt to exports fell (112 percent to 102 percent). Nonetheless, owing to a combination of rising interest rates and shortening maturities, the debt *service* ratio rose from 14¼ percent to 16¾ percent (see Boughton, 1984).

In 1979-80, the combination of the "Volcker shock" (which ended the calamitous inflation of the 1970s but also sharply raised world interest rates and depressed the markets for developing-country exports) and the second oil shock (which further worsened the terms of trade for oil-importing countries), drastically altered the playing field, and the latent imbalances in the global distribution of wealth finally became manifest. By 1981, the aggregate current account deficit of oil-importing developing countries had reached 25 percent of exports, and the debt service ratio had risen to nearly 19 percent. Capital was still flowing freely into developing countries, but at steadily increasing prices and at a steadily rising burden to the borrowers.

The International Debt Crisis, 1982

The major turning point both for the international financial system and for the crisis-management role of the IMF came in 1982. The fact that the world did not witness an *international* financial crisis in 1995 is attributable in no small measure to the lessons learned then.

The debt crisis of the 1980s—the "lost decade" for economic growth in much of the developing world—erupted when the major international banks ceased lending and attempted to stop rolling over existing credits to a large number of economically troubled developing countries. It built up steam slowly as it rolled across Eastern Europe in 1981 and the first half of 1982, but it globalized rapidly after it landed in Latin America that summer.[30] It was not the first international debt crisis, nor will it be the last, but it was a major turning point in the history of the world economy because it marked the coming of age of the international financial system.

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[30]Because of the rapid international spreading of the 1982 crisis, countries other than Mexico appeared to be the victims of a contagious disease. At the time, it was fashionable to claim that the countries that were affected soon after Mexico—notably Argentina and Brazil—would have been able to continue to borrow and conduct business as usual, but for the Mexican crisis. It was not then called a tequila effect, but that is what was meant. The Fund staff and management never accepted that argument, and in retrospect it is clear that it had little merit. All of the affected countries have since undergone wrenching and often remarkable policy reformations, in a unanimous rejection of the policy regimes that were so staunchly defended in the early 1980s. Contagion accelerated the process, but it did not cause the crisis.

Many people saw that problems were coming in 1982, but virtually no one foresaw a crisis. All of the developing countries that were hit by the debt crisis in the early 1980s were following inconsistent and unsustainable policies, characterized by heavy external borrowing to support domestic consumption spending. Many also had serious deficiencies in public administration and regulation. The Fund staff recognized those deficiencies, as did most outside analysts. By mid-1982, banks were charging higher spreads to those countries, and they were experiencing greater difficulties in assembling lending syndicates. But syndicated bank lending to Mexico, for example, continued until end-July, just two weeks before the crisis hit.

The debt crisis of 1982 was a true (though not a pure) financial crisis, in that it occurred because the banks suddenly stopped lending. The timing and even the fact of such an event is inherently impossible to forecast, because it is not an inevitable consequence of bad economic policies. Many observers at the time, including those in the Fund, believed that Mexico could hang on until December, when a new government under President Miguel de la Madrid would take office. Taking on new debt to pay interest on old debt is a Ponzi scheme only in the absence of a viable exit strategy from the process, and the July elections seemed to provide that rationale. Ex ante, depending on lenders' assessment of risks, degree of risk aversion, and financial strength, waiting for December might or might not have been optimal. In mid-August, however, new money dried up, and Mexico faced a crisis that could be resolved only through international coordination.

Mexico could not solve its problem unilaterally, except possibly through a major devaluation or a default. The government ruled out both of those options as being far too risky. Mexico's major trading partner, the United States, was not prepared to bail out the Mexican government and was willing to provide new financing only at a high cost and only after Mexico entered into negotiations for a Fund-supported program. The IMF—the only institution with both the mandate and the resources to react quickly—stepped into the breach. On Friday, August 13, 1982, the key Mexican finance officials arrived in Washington to meet with their U.S. counterparts and with senior officials in the Fund. The meetings held throughout that weekend led immediately to an emergency financing package from the United States, and they set in motion a process that would lead to a bridge loan from the BIS a few weeks later, an agreement with commercial banks in November, and an extended arrangement from the Fund in December.

The IMF played two essential roles in that process.[31] First, the agreement between the Managing Director (Jacques de Larosière) and the Mexican finance minister (Jesús Silva Herzog) to negotiate an adjustment program to be supported by a large-scale Fund arrangement restored the possibility of an exit strategy and enabled official creditors to justify new loans. A Fund staff mission left for Mexico City as soon as the weekend was over and completed a tentative

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[31]This brief synopsis of the Fund's role in the 1982 crisis and in the development of the debt strategy throughout the rest of the 1980s necessarily omits much detail and nuance; my forthcoming history of the IMF for the years 1979-89 covers these developments in full.

agreement in just two weeks. That agreement was soon scuttled by the outgoing President, José López-Portillo, but it was gradually patched back together over the next two months and was ready to be implemented by the time the new government took office on December 1.

Second, de Larosière devised a novel solution to the problem posed by the large number of international bank creditors with strikingly diverse interests. The Fund's normal operating procedure in providing financing for a country's balance of payments deficit was to estimate the total amount of financing required, determine the appropriate amount to come from the Fund on the basis of the institution's rules and practices, and approve the arrangement if the balance appeared likely to be forthcoming from other creditors. In the 1982 crisis, that procedure failed, because private creditors were unwilling to fill the gap. The key insight was that although each creditor bank had an interest in reducing its exposure, the banks had a collective interest in maintaining Mexico's ability to service its debts, even if that meant increasing their exposure. If a collective solution could be imposed, the banks would be better off.

The Managing Director went before the banks, at a meeting in New York in mid-November, and informed them that he would recommend to the IMF's Executive Board that the Fund lend Mexico around $3.8 billion over three years, only if he received written assurances from the banks within six weeks that they would increase their own exposure to Mexico by $5 billion.[32] That gambit, which initiated the practice of what came to be known as "concerted lending" (or, misleadingly, as "new money" packages), succeeded in filling the financing gap and became the hallmark of the "case by case" debt strategy for the next four years. Because concerted lending required an outside and international agent with considerable financial involvement in the outcome, the Fund in effect became the manager of the crisis.[33]

The Debt Strategy after 1982

The rationale for the IMF taking on the role of crisis manager in 1982 had four elements: (a) that several of the most heavily indebted developing countries would have had to default if they had not obtained additional loans on a large scale; (b) that default posed a serious threat both to the economic health of the borrowers and to the international financial system; (c) that taking on new debts was a sound economic strategy if done on appropriate terms and in conjunction with reforms in macroeconomic policies; and (d) that neither the financing nor the reforms could be obtained without multilateral intervention. The first element—the inevitability

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[32]By that time, the Fund and the banks were engaged in similar negotiations with Argentina. The New York meeting dealt with both countries.

[33]The requirement that the external agent have a considerable financial involvement was necessary to make the threat credible. The banks understood that approval by the Fund of a large extended arrangement would not make sense if the money provided to Mexico would have to be used to repay the banks.

of default—was simply a matter of arithmetic, at least in the short run.[34] The second element—the cost of default—was more controversial, but what must be remembered is that the 1982 debt crisis was fundamentally different from all others in that the debts were almost entirely in the form of large syndicated bank loans, rather than bonds (as in the 1930s and earlier) or bonds and equities (as in the 1990s) held by large numbers of individual investors. Syndication, in combination with low capitalization by many of the leading banks, contributed to a fragile and interdependent system that could much more easily be brought down through a rippling or cascading of defaults.

The third element—the wisdom of taking on new debt—was based on an implicit calculation that countries could service their debts, given enough time to strengthen their economies and their fiscal systems. Only later was the need for deeper structural reforms fully appreciated. The final element—the need for an outside agent—was based partly on the lack of cohesion among creditors and partly on the direct and obvious observation that agreements could not be achieved by any other means.

Both the debt strategy and the role of the IMF evolved between the onset of the crisis and its resolution in 1989. Concerted lending, as practiced in the 1980s, had several weaknesses. First, adjustment programs were not supported by the structural reforms that were needed to put the countries on a sustainable growth path. It was not until the mid-1980s that the Fund and the indebted countries together moved to a more broadly based strategy of structural reform. Second, the "new money" provided under concerted lending arrangements was invariably less than the countries' interest obligations; the banks' exposure rose, but each country was still required to make net cash payments to the banks. This eventually opened the Fund to criticism that it was little more than a collection agency for the banks (Lissakers, 1991). Third, concerted lending effectively precluded normal capital inflows as long as it was in effect. Throughout the 1980s, no bank had any incentive to lend to a highly indebted country other than through a concerted arrangement. Fourth, concerted lending was inherently a temporary patch, not a lasting solution. After the second or third agreement with a country, and particularly after the banks had had enough time to restore some strength to their own capital, the difficulty of rounding up hundreds of participants escalated geometrically. Thus by around 1987, the strategy that had worked well at the beginning was rapidly losing its viability.

Although the IMF continued to play a central role in managing the debt strategy throughout the 1980s, the major refinements in the strategy were initiated by others. In 1984, de Larosière gave form and substance to a proposal from a few commercial bankers and from U.S. Federal Reserve officials for "multi-year rescheduling agreements" (MYRAs) aimed at

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[34]This statement does not imply that the indebted countries in Latin America were insolvent. Mexico had tradable assets (oil reserves) that were enormous in relation to the government's external debt, but it had only a very limited political ability to mobilize those assets for servicing external debts or to generate sufficient additional fiscal revenues. As I have argued elsewhere, the distinction between illiquidity and insolvency is a red herring in this context (Boughton, 1994).

freeing indebted countries from having to constantly renegotiate terms on their outstanding obligations. Beginning with an agreement with Mexico, commercial banks (and, later, official creditors) entered into MYRAs with several developing countries that showed prospects of graduating from dependence on financial support from the Fund. Those agreements were made possible by a decision by the Fund to undertake "enhanced surveillance" to monitor the progress of "shadow programs" implemented without direct Fund support.

The Fund's longer-term financial involvement in the debt strategy was limited by the revolving character of IMF resources. Although many countries required several years of back-to-back annual or longer adjustment programs, the Fund's exposure usually peaked after the first few years. At the point when countries were trying to move beyond adjustment to restore economic growth, the Fund was seldom able to do much more than maintain its exposure. To compensate for that gap in the strategy, and to revive the commercial banks' flagging willingness to participate in concerted lending, the U.S. Treasury introduced the Baker Plan in October 1985. The Fund responded to the initiative with a major effort to develop "growth-oriented" adjustment programs, primarily by encouraging borrowers to undertake market-oriented structural reforms alongside macroeconomic stabilization. Perhaps not surprisingly, neither that effort nor a parallel endeavor in the World Bank succeeded in restoring growth in the heavily indebted countries within the limited time frame of the Baker Plan (1986-88). Structural reforms take time to succeed, commercial bank creditors provided little of the hoped-for increase in loans, and the covered countries had to overcome the nearly insurmountable burden of their "debt overhang."

Several proposals were advanced by officials of creditor countries in 1987 and 1988 for providing direct debt relief,[35] most notably the Miyazawa Plan that was first floated at the G-7 summit in Toronto in the summer of 1988. During that time, the IMF experimented with a "menu" of departures from the concerted lending approach but avoided taking a direct institutional stand in favor of debt relief. Finally, the announcement of the Brady Plan in March 1989 provided the political support for multilateral action to reduce debt overhang. The key elements were to link debt relief to IMF and World Bank medium-term conditional lending arrangements, and to create a menu of debt-relief options that was broad enough to be attractive to banks from North America, Western Europe, Japan, and the Middle East. For its part, the IMF modified its procedures to permit lending more generally to countries that had unresolved arrears to commercial creditors and to dedicate some Fund resources to finance debt relief operations.

Over the next six years, more than $75 billion of the present value of debt was written off, at a cost of some $25 billion, mostly through Brady deals that were supported in part by the Fund and other multilateral financial institutions. With serendipitous support from a coincidental massive decline in world interest rates, the Brady Plan finally made debt service manageable, restored voluntary lending by commercial banks, and brought the debt crisis to an end.

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[35]The phrase "debt relief" should be understood to comprehend any measure that reduces the discounted present value of a debtor's obligations, whether by writing off principal, reducing the effective interest rate, or otherwise modifying payment terms.

The 1990s and Beyond

When the Mexican financial crisis erupted at the end of 1994, most of the elements of the role that the IMF was to play were already in place. Mexico quickly turned to the Fund when it was unable to resolve its difficulties either internally or with the bilateral assistance of the United States. The Fund applied its existing "exceptional circumstances" clause so as to provide an unusually large credit. A program of macroeconomic adjustment was negotiated between the government and the staff as part of the arrangement: more quickly than average, but no more quickly than in 1982.[36] Both the stand-by and the adjustment program that it supported were based on the view that Mexico faced a "balance of payments need" that justified Fund support. Ground was broken, however, in at least two respects that reflect the "twenty-first century" nature of the crisis. First, the speed of response was unprecedented for a credit in the upper credit tranches, reflecting the perception that the risk of rapid contagion—the tequila effect—was much greater than in 1982.[37] Second, the size of the credit was far greater—in both absolute and relative terms—than the Fund had even considered in the past, reflecting the heightened vulnerability of an emerging capital market to potential outflows.

That the IMF has become, on occasion, a manager of financial crises calls for an analysis of why such a role is appropriate. What is the rationale for an organized rather than a pure market response to a financial crisis? A full answer would require another paper, but the historical review given above suggests at least a framework for it.[38]

First, financial crises result from a specific market failure: financial markets at least occasionally—and sometimes spectacularly—initially misjudge and eventually aggravate bad news. In the twentieth century, when economic activity was affected gradually by financial disruptions, allowing financial markets time to correct their own course was often feasible. In the twenty-first century, that luxury will no longer be affordable. Second, safeguarding the real economy requires conditionality. The bad news to which financial markets overreact results either from policy errors or from exogenous shocks that require policy adjustments. To shift policies requires credibility, and credibility often cannot quickly be restored unilaterally. Accepting external conditionality benefits the country by strengthening credibility. Third, conditionality also reduces moral hazard to the indebted country: financial assistance, instead of bailing out a government, forces it to accept the short-term costs of shifting to a more sustainable course. Fourth, as Miller and Zhang (1996) argue, reliance on a market solution requires a

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[36]In 1982, preliminary discussions on the terms of a possible stand-by had already begun before the crisis hit. In that regard, the rapidity of the 1995 negotiations is more remarkable.

[37]The 1956 upper-tranche stand-by arrangement for the United Kingdom was approved within a few days of receipt of the request, but—as noted above—that case was expedited by the understanding that the authorities intended not to draw on the arrangement.

[38]For a thorough review of the issues from the vantage of official (G-10) creditors, see Rey et al. (1996).

"bankruptcy" procedure to avoid prisoners' dilemmas and creditors' races for the exits. Crisis management provides a viable alternative to a potentially much more costly international bankruptcy procedure. If the institution succeeds in resolving crises (or, *a fortiori*, in avoiding them through effective surveillance), it clearly provides a public good.

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