Fourteen Suggested Questions to be Investigated in the IMF's Handling of Capital Account Crises, with Specific Examples in Korea, Indonesia, and Brazil

A Report to the Independent Evaluation Office (IEO) of the International Monetary Fund

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On some issues, the Independent Evaluation Office's methodology for investigating the IMF's handling of the capital account crises of 1997-99 could include reviewing the empirical literature that has developed. But on many important issues, econometrics will not help. Thus I foresee that the investigation will include interviewing participants and observers. It will be like the police detective who goes around interviewing witnesses who have already had to tell what they know to ten law enforcement agents before. Some ground is already very well-trod, such as the endless debate over exchange rate regimes. I would urge concentrating on the interesting questions, where some resolution of facts may be possible. Collecting votes regarding the propositions "The IMF is guilty" or "The IMF did the best it could" is not in itself interesting, especially not without some additional conclusions about the alternatives.

There are three levels of sophistication in public evaluations of the IMF (or, for that matter, of other government agencies). The least sophisticated, but unfortunately very common, is simply to give an overall rating – usually quite a negative one, based on the severity of the crises -- without specifying the nature of the mistakes that were made or the direction in which the critic believes the institution should move. Frequently criticisms from one direction get mixed up with criticisms from the opposite direction. This is not honest intellectually, nor is it a very useful as a guide to reform.

I wouldn't recommend that the goal of the IEO should be to assign an overall grade to Fund performance. The second level, somewhat more sophisticated, is to specify the nature of the mistake. E.g., "the Fund encouraged the country to devalue too early," or discouraged it from devaluing early enough. At least one knows with this second level whether the criticism is coming from one direction or the other. Critics should be forced at a minimal to get this specific. Still, this sort of criticism frequently ignores the real tradeoffs, economic as well as political, that are required. Typically only one side of the argument is stated.[1]

The third level of evaluation is the most interesting, but also the most rarely heard. This is to go into the details of a specific decision that was made at a specific time:

[1] My rendition of the contradictory criticisms is Frankel (2000).

(1) to consider the actual alternatives that were possible (rather than unattainable ideals, such as “first, eliminate all corruption”), (2) to list up all pros and cons without pretending that one side of the argument or the other doesn’t exist, (3) to try to work out what would have happened under the alternatives, (4) to reach an overall evaluation of the question whether it would have on net been wiser – based on information available at the time -- to move in one direction or the other relative to the path that was actually chosen, and (5) to draw any possible lessons for the future.

Methodology: Critics have often been free to present their views without having to respond to the opposing views of other critics. I would suggest, after reviewing the written record, interviewing participants and observers on some key questions, in such a way as to test people’s claims and criticisms against each other. Interviews should include heavy use of follow-up questions by email.

There follow 14 questions that the IMF IEO could look at.

1. ***The role of the IMF in encouraging the opening of financial markets*** It has been widely alleged that the IMF and the US Treasury (Reagan, Bush I, and Clinton) pressured developing countries in Asia and elsewhere to liberalize their financial markets prematurely, in the interest of US banks but to the detriment of the countries.[2] A prominent instance was, the proposal floated at the Annual Meeting in Hong Kong in September 1997 to put capital account convertibility into the Articles of Agreement.. Did the pro-financial opening position have the effect of encouraging excessive short-term inflows of portfolio capital into emerging markets, which is widely agreed to have been dangerous?

In the case of Korea, in particular, did it play a role in encouraging short-term interbank borrowing? Does the Korean government, alone, bear responsibility for liberalizing with respect to short-term flows while keeping FDI restricted?[3]

2. ***Moral Hazard.*** Did previous IMF bailouts play a role in encouraging capital inflows in East Asia and Brazil prior to mid-1997? Specifically, some critics have charged that the Mexican rescue in January 1995 led investors to believe they had nothing to fear in emerging markets.[4] A contrary argument is that the backlash against the

[2] Among many such critiques are Bhagwati (1998), Furman and Stiglitz (1998), Kuttner (1998), and Tobin (1998).

[3] Yung Chul Park’s comments in McHale (2000a) question whether this was really a mistake. But I think he is in the minority here. There is statistical evidence that short-term inflows raise the probability of crisis and FDI inflows reduce it.

[4] E.g., : The Mexican bailout helped fuel the East Asian crisis that erupted two years later” -- Milton Friedman, “Markets to the Rescue,” *Wall Street Journal*, Oct. 13, 1998; reprinted p. 126- , reprinted in McQuillan and Montgomery, 1999. “There is ample evidence that the Mexican bailout prompted the flood of lending to Asia that is now causing trouble there” – Lindsay (1998, p.27). Another critic, who mentions Brazil and

Mexican rescue in the U.S. Congress -- which included severe new restrictions on Treasury use of the Exchange Stabilization Fund and refusal to vote the US share of the IMF capital increase -- led reasonable observers to believe that it would not happen again.[5]

Those who wish to shut down IMF lending programs generally argue on moral hazard grounds.[6] The important question is not whether moral hazard exists, but how large it is in practice.[7] An alternative methodology to evaluate the moral hazard hypothesis would be to read what investment banks were telling their clients during 1995-97, to see whether IMF bailouts and the Mexican package in particular were explicitly mentioned as an incentive to invest in Asia.

3. ***Ex ante conditionality.*** Would making conditionality of IMF loans solely ex ante, rather than ex post, help? [8]

The German government believed that the US and IMF were not paying enough emphasis to the very important issue of moral hazard, and that on these grounds the US proposal for a pre-approved CCL was a bad idea.[9] Meanwhile, the Meltzer Commission believed that the US and IMF were not placing enough emphasis on the very important issue of moral hazard, and for this reason the proposal for a pre-approved CCL was a good idea (Meltzer, et al, 2000). Have these two viewpoints been forced to confront each other? Would the Germans have been happy if the CCL were the *only* Fund facility, which seems to be the Meltzer position? Why have no countries taken up the CCL; is it because they know the other facilities are available?

Russia, is Robert Barro, "The IMF Doesn't Put Out Fires, It Starts Them" *Business Week*, Dec. 7, 1998; reprinted in ib..

[5] Willett (1999).

[6] Most prominently, Schultz, Simon, and Wriston, "Who Needs the IMF," Wall Street Journal, Feb. 3, 1998, reprinted in McQuillan and Montgomery, 1999, p.197-200. Another example is Chari and Kehoe (1998).

[7] Evidence relevant to the moral hazard hypothesis, e.g., particularly by looking at interest rate spreads, include Cline and Barnes (1997), Lane and Phillips (2000), and Eichengreen and Mody (1998, 2000) and Zhang (1999).

[8] Meltzer Commission (2000). Roland Vaubel, " The Political Economy of the IMF: A Public Choice Analysis: in Perpetuating Poverty: The World Bank, the IMF, and the Developing World, edited by Doug Bandow and Ian Vasquez, 1994; especially the part excerpted as "Conditionality in Practice," pp. 84-88 in McQuillan and Montgomery.

[9] In October 1998 -- Blustein (2001, p. 333-336).

4. ***Procrastination.*** It is common for countries to seek to delay policy adjustment, often until reserves have been run down so far that there is little alternative to an even more painful adjustment. Here "policy adjustment" can be taken to mean going to the Fund and abandoning an existing exchange rate target (and cutting spending). For purposes of this question, other drastic remedies for dealing with a crisis such as dollarization, capital controls[10], or default would be as good; the point at the moment is not to debate among such alternatives. But since the three countries to be studied include no Ecuadors, or Malaysias, let us focus on devaluation.

The question is: would the country have been better off, ultimately, if it had "bitten the bullet" sooner? Does the tradeoff between expenditure-reduction and expenditure-switching disappear if the country waits until reserves run low, so that there is no alternative to recession?[11] If "yes," then was the IMF pushing in the right direction, in favor of earlier adjustment? (Another interesting question, in cases like Korea and Brazil, would be a political question: did a scheduled national election play a key role in postponing adjustment, or did a democratic change of government help provide a needed political mandate for change?)

Would early band-widening and/or crawl-acceleration have been sufficient in some cases? Or was full floating required? Indonesia initially did widen the band in response to the Thai crisis, as internationally approved; yet it ultimately suffered the worst crisis. Did the Indonesian widening help to stem the reserve loss during that brief period, even a little bit?[12] Were the negative influences (contagion, structural problems, doubts over political secession) so bad that the exchange rate regime was not relevant? Or should Indonesia have gone all the way to floating even sooner? Have we learned from these crises that there is no such thing as a controlled devaluation?

One school of thought is that the IMF is guilty of pushing countries to devalue when they shouldn't. This allegation has been made in each crisis, including Brazil's.[13] In reality, it was apparently the rest of the G-7 that wanted to force Brazil to devalue[14]; the

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[10] E.g., Rodrik and Kaplan (2002) argue that Malaysia did well in 1998 by choosing a capital controls as an alternative to an IMF program.

[11] Frankel (2001).

[12] Soedradjad Djiwandono noted, in McHale (2000c), that band-widening had worked for Indonesia in the past. Felman defended the initial IMF program.

[13] E.g., "The IMF Crisis," *Wall Street Journal* editorial, April 15, 1998 supported Brazil's Malan determination to stick to exchange rate target; it alleged that Camdessus and the US Treasury unrealistically assume it is possible to have a controlled devaluation. {reprinted in McQuillan and Montgomery, 1999.}

[14] Especially Mervyn King, Klaus Regling and Jurgen Stark, at an October 5 discussion of a new IMF program for Brazil -- Blustein (2001, p. 340,360).

United States and the IMF went along with the Brazilian government's determination to hold the peg. In January 1999, the IMF effectively implemented the new "corners" or "bipolarity" principle for the first time, pressuring Brazil to abandon altogether intermediate exchange rate regimes in favor of free floating (given Brazil's lack of interest in the opposite corner, the firm fix).

Why did Brazil do so much better after its devaluation than Mexico, Thailand, Korea and Indonesia after theirs? Wasn't one of the key lessons of East Asia that the worst thing to do was to postpone devaluation/floating until reserves had been run low, if the currency peg was ultimately going to have to be abandoned anyway? Was the key factor that by early 1999 speculators had unwound their positions and world monetary conditions had been substantially eased?[15] Does a lower level of dollar-denominated debt explain why the Brazilian devaluation did not turn out to be contractionary as it was for Korea and Indonesia?

5. ***Data transparency.*** Everyone agrees that transparency is good. Hence, e.g., the Data Dissemination Initiative. But was inadequate aggregate data really a crucial causal component of these crises?

Announced Korean reserves subsequently turned out to have included some that were unavailable for use because deposited with Korean banks (much as Thailand's announced reserves had not taken into account large forward and swap exposure). Short-term debt subsequently turned out to have been understated because the figures did not include obligations of Korean entities that were nonresident/based overseas. This is usually reported as another example (like Mexico's silence on its reserve loss in the autumn of 1994) where the crisis was exacerbated by the local government's lack of transparency and the Fund's failure to ask the right questions. What should the Fund have done differently in this regard (e.g., at the time of the clandestine Camdessus visit to Kang on November 16)? Could the IMF have been reasonably expected to ask the questions about "reserves" deposited at Korean banks, or is it entirely the Koreans' fault for incorrectly counting these as reserves? Could the IMF have been reasonably expected to ask questions about the short-term liabilities of Korean off-shore affiliates? Would the Korean government have known the answer?

It is interesting that, each time, there turns out to have been some *new* crucial component of the reserve/liability data that the international community forgot to ask about, even as it is careful to avoid the omissions of previous crises. Is this hindsight? What numbers would the IMF ask for today?

And what would/should the IMF have done if it had obtained the "true" Korean numbers on November (or earlier)? It got them ten days later (November 26, the day before Thanksgiving); was anything really different then? Is all the fuss about "Why didn't you tell this before" really just a way of trying to shift the burden of guilt? Should

[15] On US leadership toward easier global monetary conditions in the Fall of 1998, see Frankel and Roubini (2003), or Woodward (2000).

the IMF announce such figures as soon as it gets them? The Fund did not officially release the Korean numbers even when they got them. But when a Fund staff report with the Korean numbers was leaked to the *Chosun Ilbo* December 3, the market reaction helped doom the program.[16]

6. ***US influence.*** Champions of other industrialized countries and of the developing countries alike have charged that the IMF is excessively subject to dictates of the United States, especially of the US Treasury.[17]

   "…[C]ertain national governments -- and the United States in particular -- exercise a disproportionate influence over the decisions taken by the Fund. In this view, the Fund too often pursues policies that serve the interests of Wall Street and the US State Department rather than the world as a whole…[T]he IMF is too responsive to the agendas of national governments (the governments of its principal shareholders in particular)…The US government's prominence in international financial markets and large voting share in the Board enable it to exercise a disproportionate influence over decision-making in the Fund" (De Gregorio, Eichengreen, Ito and Wyplosz, 1999, pp.1-4).

It is clear that the US indeed has influence over the IMF that is in some sense "disproportionate" -- that is greater than not only its share of the world's population, but also greater than its share of gross output even IMF quota. But, rather than verifying that self-evident fact, there are two big interesting questions that bear evaluation. First, in a long-term structural sense, is it in general beneficial for the largest country to exercise some hegemonic leadership (as per Kindleberger), because it provides a global public good? Or such hegemony destructive because it is anti-democratic? Second, in a shorter-term historical sense, did the US exercise its power in a way that was, on average, beneficial or detrimental, in the late 1990s? One could conclude that the Clinton Treasury mostly exercised its influence in a skillful and beneficial way, and yet conclude that future US personnel are unlikely to be as competent, so that the long-term argument for US hegemony is weaker than the short-term argument.

What specific effects would it have had on IMF policies if the US had had less (or more) influence than it actually had? Ever since the Mexico package, the Europeans had been skeptical of big rescues favored by US Treasury, e.g., a Brazilian bailout. The switch to structural conditionality in the Indonesia program of Oct. 1997 was under US pressure, and opposed by Japan. US pressured IMF (Neiss mission in November) to be

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[16] The Treasury had induced the Fund to force the Thais to reveal its "true" reserve numbers, at the time that that country's IMF program was approved in late August. This is perceived to have precipitated a further loss of confidence and the failure of the program. Fund staff "admitted this mistake" in "IMF-Supported Programs in Indonesia, Korea and Thailand: A Preliminary Assessment," staff report, Lane et al, 1999.

[17] E.g., Sachs (1998) and De Gregorio, Eichengreen, Ito and Wyplosz (1999).

tougher in Korean negotiations, particularly on financial liberalization and tight money, as personified by David Lipton's presence in the hotel, and Rubin phone call to Camdessus shortly after the latter's arrival in Seoul December 3. By the time of the Brazil package of Fall 1998, all the other G-7 partners had come to regard the US as being lenient toward countries in its own backyard (Latin America).[18]

Another line of inquiry is to what extent the United States, via the Fund, used the leverage of a crisis program to extract trade concessions for its own industries. Allegations have made, for example, that Korea was asked to open its auto industry.[19]

7. ***Was the IMF overly sanguine?*** To ask "did the IMF fully foresee the crises" is not entirely useful. Predicting crises is very hard, just as every US recession is under-predicted. Nevertheless, it is important to ask if the IMF has systematically and avoidably erred on the side of over-optimism. Or, to consider the opposing criticism, is the IMF guilty of exacerbating, or even causing, some of these crises by "crying 'Fire!' in a crowded theater," as Jeff Sachs claims?

It seems clear that the Korea staff report one month before November 1997 crisis was too optimistic, and that the Fund was caught by surprise. What is the lesson from this experience? Why was the Fund so much better able to foresee problems in Thailand (where it should get credit for having issued stern private warnings to the government) than in Korea?

The Fund's initial reaction in mid-1997 that Indonesia seemed to be in good shape had some clear justification: macro policies had historically been good, and widening of the band seemed the right thing to do, while structural problems, though recognized, seemed unlikely to cause a crisis. Why did Indonesia turn out the worst of all?

What progress has been made with early warning indicators? Does senior management have illusions about how accurate these can be?

8. ***Excessive interest rates?*** The Fund is widely faulted for having prescribed macroeconomic austerity in East Asia, mistaking the disease for the overexpansion syndrome that was so familiar from Latin America and elsewhere.

When the Indonesia crisis hit, Camdessus, PDR, and the ED from US, and other European EDs wanted Indonesian interest rates to go (even) higher than they did. Inside the Fund, APD had more sympathy for the liquidity needs. As it developed Sudradjad bowed from pressure in Indonesia to expand the money supply. Who was right?

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[18] Blustein (2001), especially pages 346-348.

[19] Lipton denies that the US ever raised the auto issue in the discussions of the Korea package (e.g., in McHale, 2000a). My recollection is that the Letter of Intent has a provision regarding imports of *Japanes*e autos.

Is there merit to the claim particularly associated with Joe Stiglitz, that the Fund did not sufficiently recognize that higher interest rates bring higher perceived probability of default, so that the willingness of international investors to hold assets in Indonesia would go up rather than down?[20]

(i) Ignoring politics for the moment, if Indonesian interest rates had been raised even higher, would the net effect on the capital account have been better or worse (aside from the effect on the real economy)? Would lower interest rates have helped attract foreign capital, due to lower default risk? Is the argument supposed to be that a combination of lower interest rates and a more depreciated currency would have satisfied the external financing constraint (with a much better path for the real economy than what actually occurred)? Or was the macro basically irrelevant, given the problems of the banking system?

(ii) Now answer those questions with political constraints taken into account. If the IMF had applied even more pressure for higher interest rates, how would the Indonesian government have reacted? If the IMF had elected for an easier monetary policy what could have been achieved?

Again, in the Korean mission of November 1997 the IMF insisted on raising interest rates (then at 12 ½ %) higher than the Koreans thought reasonable. (The IMF was acting under pressure from the US Treasury; Wanda Tseng, for example, argued internally that interest rates were being raised enough.) This was especially the case when Camdessus arrived December 3, and insisted on 25 percent > 15-20 % range that was then under negotiation.[21] At an NBER meeting, Koreans responded to IMF claims that "the IMF program was their program," by saying they had been forced to raise interest rates against their better judgement.

When Fraga raised interest rates, upon becoming the new head of the Brazilian central bank in March 1999, it attracted capital and stabilized the currency, allowing interest rates to come back down subsequently. Why did the policy that had failed in Korea, Thailand, and elsewhere (monetary and fiscal austerity with exchange rate flexibility, after a prolonged period of postponing adjustment) work in the Brazilian case?

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[20] Furman and Stiglitz (1998), Radelet and Sachs (1998), Feldstein (1998). There are a few attempts to test the Stiglitz-Sachs hypothesis (that higher interest rates raise perceived default risk enough to reduce rather than increase the attractiveness of domestic assets, at least under crisis conditions). Dekle, Hsiao, and Wang (1999) find that raising the interest rate had the usual effect of appreciating East Asian currencies. The rest of the literature is mixed: Goldfajn and Baig (1998), Kaminsky and Schmukler, Ghosh and Philips (1998), Goldfajn and Gupta (1998), Furman and Stiglitz and Kraay (1998).

[21] Blustein (2001). Atkinson, Lipton and Roubini defend the insistence on a high interest rate for the Korean program, in their comments in McHale (2000a).

9. ***Excessive fiscal austerity?*** The IMF's Asian programs initially called for sharp budget improvements, notwithstanding that most of the crisis victims had had strong fiscal positions, and this exacerbated their subsequent recessions.[22] This is one of a handful of failings that is generally perceived as having been confessed by ("even") the IMF, with the defense that the mistake was soon corrected; e.g., in a PDR report in 1999. How much of the overly optimistic budget targets are attributable to overly optimistic growth projections, as opposed to deliberate fiscal contraction? How much of that is in turn attributable to a country's own reluctance to accept lower growth projections? (Numerical answers would be good.)

At the time of Stan Fischer's Nov. 20, 1997, visit to Seoul, new Finance Minister Lim insisted that Korean growth had to be > 5%, though Fischer thought more like zero was more realistic. [23]

10. ***Structural conditionality***, especially corruption.[24] The IMF has been widely criticized for expanding its claimed purview beyond the traditional territory of macroeconomics, into details of countries' economic structures.

Previously, though the World Bank had repeatedly raised the KKR issue with Indonesian government, the IMF had not, considering it outside the mandate. This switched in the course of the October 1997 Aghevli mission, where IMF for the first time added a lot of structural conditionality. (Local reformers had already been in agreement, but President Suharto was the problem.) This was under strong US pressure on the IMF to do so, and strong Japanese opposition. Banking issues, especially, were not addressed by the IMF until the crisis. Should the IMF have sought to address these structural problems earlier? If so, would that have required expanding its staff, hiring people with expertise in banking and corporate governance?

Or was the IMF wrong to bring in these new issues in October 1997 and January 1998; i.e., is it guilty of Mission Creep?[25] Would Suharto have been more likely to abide

[22] Critiques of IMF austerity include, among many others: Jeff Sachs, "Power Unto Itself," *Financial Times*, December 11, 1997; reprinted as "The IMF Crisis," pp. 115- in McQuillan and Montgomery, 1999; Jeff Sachs "The Wrong Medicine for Asia," *New York Times*, Nov. 3, 1997; Radelet and Sachs (1998); Furman and Stiglitz (1998); Tobin (1998); Robert Kuttner, "Bailout Blunder," *Washington Pos*t, Jan. 5, 1998.
Attempts to discern the macro impact of Fund programs include: Faini, de Melo, Senhadji-Semlali and Stanton (1991), Killick (1995), Hutchison (2003), among others.

[23] I found the same when, as a member of the US Council of Economic Advisers, I met with counterparts from Korea and other Asian countries at the APEC Summit in Vancouver in November 1997 to produce forecasts for growth in the region.

[24] Goldstein (2002) reviews structural conditionality.

[25] Among the many observers criticizing the IMF for mission-creeping into structural issues is Feldstein (1999).

by his promises in the January program if the structural reforms demanded had not been so extensive? If the view that big structural reform is necessary to restore market confidence was right, why were the markets completely unimpressed with Suharto's agreement to the sweeping IMF demands on January 15, 1998? (Is it really that nobody expected Suharto to abide by his promises? Or was the problem the presidential succession? Or was it Indonesian corporate debts, and if so could they have been addressed by a freeze on debt servicing or rescheduling? "In hindsight, the program did not move quickly enough to address the problems of corporate debt" says the 1999 staff report[26]. Who exactly was taking money out of the country in January?)

If the IMF indeed was guilty of taking structural conditionality too far, was some smaller expansion of mission appropriate instead (into banking, for example, but not into BULOG, the clove monopoly and national car), but it went too far? The last possibility is that the IMF did it about right, expanding its claimed purview somewhat in the course of the crisis. If so, is that expansion of mission part of a general trend, corresponding to increased international integration, or was there something unique about Indonesia?

Was the January program responsible for the social unrest and overthrow of Suharto in May? If so, was that consequence to some extent intentional and predictable? If so, was that desirable on economic grounds? If so, was that aspect a legitimate part of the calculations?

Similar issues arose with respect to Korea.[27]

11. ***Banking system.*** One question, as noted above, is whether, assuming IMF was right in emphasizing the Indonesian banking system beginning in October 1997, it should have paid more attention to this earlier. But by far the most important question that outside observers will want to see addressed is whether the IMF made mistakes when closing the 16 banks in Indonesia. The visibility of this question derives in part from the widely publicized claim that "even" the IMF admits it blew it here. This stems in large part from a staff document that included the conclusion that the policy regarding the bank closures "now appears to have been ill-advised,"[28] and from the leaking of this conclusion by someone in Jakarta (probably a visiting consultant).

The IEO should try to ascertain:

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[26] "IMF-Supported Programs in Indonesia, Korea and Thailand: A Preliminary Assessment," Lane et al, 1999.

[27] In McHale (2000a), Yung Chul Park is among those accusing the IMF and US Treasury of forcing structural reforms on Korea, while Koo agrees with IMF and Treasury representatives that the reform program was home-grown.

[28] "IMF-Supported Programs in Indonesia, Korea and Thailand: A Preliminary Assessment," staff report, Lane et al, 1999. See also comments by Felman, Radelet and Cole, Subianto and E. Stern, in McHale (2000c).

(1) did the economically optimal policy involve a harsher line than was taken (to address moral hazard) or a less harsh (to try to maintain confidence and avoid the bank runs)?
(2) more specifically:
  (i) should it have involved closing more banks than those 16, or fewer?
  (ii) should it have guaranteed all depositors (as the IMF program recently had in Thailand, with apparent success[29], and as was belatedly done in Indonesia in the January program), guaranteed more depositors than it did (e.g., up to a certain, higher, maximum), as many depositors as it did (published reports say the IMF prescribed guaranteeing deposits up to 20 million rupiah in the October program, but do not say whether that guarantee, at least, in the event operated effectively), or should it have guaranteed no depositors?
  (iii) More emphasis on Bambang Suharto's bank specifically, or less?
  (iv) Anything else (e.g. regarding the criteria for which banks were closed and which left open)?
(3) How do the answers to questions 1 and 2 change, when one takes into account the political constraints: Suharto's resistance, and the fact that the level of aggressiveness actually adopted by the IMF resulted, at least ex post, in Suharto's overthrow (which could be viewed under the circumstances as either good, bad, or outside the purview of IMF contemplation)? If a more comprehensive plan was impractical under the time pressures of the October negotiations over a program, could it have been done in November?
(4) The IEO might also seek to ascertain if the public has received an incorrect impression of the nature of the mistakes that were made with regard to shutting down the 16 banks. If the report's quoted conclusion and its leakage turn out to have been instrumental in identifying and exposing a clear and key mistake by the IMF, then this fourth question might be disposed of.
(5) If the same thing happened today, is the IMF better-equipped to handle banking issues?
(6) How could cooperation with the World Bank in this area have been better at the time? (How about now?)

Turning to the case of Korea, was the Ministry of Finance and Economy wrong to announce in August 1997 that foreign obligations of its banks would be guaranteed by the government? What should IMF advice be on this issue?

12. ***Scale of Fund resources.*** Would more have worked better, if available? On the one hand, the scale of private flows in international capital markets is far higher than in

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[29] Though not without the same sorts of criticisms that came in Indonesia: "But the Fund also contributed to the stampede [of withdrawals from Thai banks] by insisting that dozens of financial institutions quickly close their doors." – Sachs (1997, p. 20). Also J. Sachs "The Wrong Medicine for Asia," *New York Times*, Nov. 3, 1997. And as quoted in Richard Lacayo, "To the Rescue," *Time*, Dec. 8, 1997, p.39.

the past; on the other hand, the rescue packages were already far in excess of usual entitlements in terms of quotas. Were expectations of a big bailout ratcheted up by reports in the press? Among the G-7, Japan (Sakakibara) thought big rescue packages were needed, a la "Powell Doctrine," while Germany (Tietmeyer) was more worried about moral hazard.

13. ***PSI*** One plausible view is that the most important reform the IMF could make is to systematize the involvement of the private sector in crisis rescue packages, so as to "bail in" investors rather than "bailing them out." Some even propose turning the IMF into an international bankruptcy court.[30]

Why did Korea 2 work (the Christmas 1997 rescue) when Korea 1 failed (the Thanksgiving rescue)? Did Private Sector Involvement make the difference? Could a coordinated rollover/standstill have been tried earlier?[31] In the first attempt at a Korea program (early December 1997), the IMF team, faced with the unwelcome news that the US would not allow them to count the bilateral "second line of defense" money as financing that was expected to be used, they simply wrote down that 20% of bank loans would be rolled over. No effort was made to involve the private sector as a prior condition for going ahead. Reportedly, Rubin and Greenspan were opposed to even trying, in part out of fear that it would cause bankers to pull out of other countries, especially Russia and Brazil, causing crises there. (Truman and the Germans were more in favor. Most importantly, the bankers themselves complained later that they were not collectively asked earlier.) Some IMF people, like Mussa, predicted the program would thus fail. Camdessus and Fischer, too, favored an attempt at bailing in the private sector. Could the IMF management have asserted itself more strongly in favor of "bailing in" banks, against Treasury reluctance, as de Larosiere perhaps did in the 1982 crisis? Is the absence of PSI this why the initial program failed? Would the reaction by Korean presidential candidate Kim Dae Jung, that he would renegotiate the program if elected, have produced a failure even if the financing numbers had been better? Would an attempt at PSI have been futile if it had been tried anytime before Christmas week – when (1) the crisis had become more obviously desperate and (2) Kim Dae Jung had an election mandate, Kim Kihwan came up with the "IMF plus" plan, and DJ agreed to support it? Would such an attempt, even if successful in Korea, have precipitated a crisis in Brazil or elsewhere? Or were Rubin and Greenspan at fault for not being willing to try PSI earlier?

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[30] For a survey of the issues and specifics in Private Sector Involvement, see Roubini (2001), Frankel and Roubini (2003) or Cline (2003).

[31] This question was one of those discussed at the NBER conference on the Korea crisis. See comments by Lipton, Lane, Pflug, Roubini, Shafer, Atkinson, Feldstein and Krugman in the McHale (2000a) writeup. Many observers have noticed that the increased role for securities in 1990s capital flows, as opposed to bank loans which dominated in the 1980s, makes concerted lending in a crisis more difficult. But banks still dominated in Korea.

In the end, Brazil turned out to be on the receiving end of contagion less from Korea than from Russia eight months later. In August, 1998, just before the Russian government announced its decision to devalue and default on GKOs and other debts, Camdessus sought (via Odling-Smee) to apply intense last-minute pressure on Kiryenko to involve its creditors in a restructuring, i.e., to act less unilaterally. The Russians went ahead unilaterally, though fearing the IMF would condemn them. (In the event, Camdessus public reaction was fairly sympathetic.) Creditors would have been caught by surprise by the Russian default in any case, because they were expecting another IMF/G-7 bailout (the moral hazard play). But they felt especially betrayed because of the unilateral nature of the default, while restructuring discussions had been underway. This sense of betrayal played a role when Deutsche Bank's David Folkerts told investors in a famous August 26, 1998, conference call that the rules had changed, and they should pull their money out of other countries with high government debt. That conference call exemplified the contagion that then hit Brazil, and many others. A potentially revealing question: would investors have been less likely to pull out of Brazil after August 26 if the IMF had applied even stronger pressure for PSI in the Russian case (but still without new IMF, which pretty clearly would have been a mistake), because they would have perceived less of a change in the rules? Or would investors have pulled out of Brazil even faster, fearing that to hold emerging-market bonds was now to risk being pressured to roll them over? Do the Brazilian officials feel that, if the international financial community had done things differently in Korea and Russia, they would not have felt as much pressure from investors in Fall 1998?

In March 1999, the IMF and US implemented a version of PSI in Brazil – creditor banks agreed to maintain credit lines before the IMF Executive Board was asked to approve the next loan tranche – that was less coercive than that applied in Korea. Was this appropriate? Not sufficiently coercive and interventionist, or too much so?

14. ***Long-term dependency?*** Has the IMF strayed too far from its assignment of short-term lending, as programs are extended and loans are rolled over? The charge of long-term dependency is more relevant to, e.g.,, many African countries. Nevertheless, it is worth asking whether the large crisis programs of 1997-1998 operated in the short-term manner desired and the loans repaid. [32]

[32] Meltzer Commission (2000). "The International Monetary Fund: Outdated, Ineffective and Unnecessary," by Bryan Johnson and Brett Schafer, Heritage Foundation – especially the part excerpted as "Why the IMF is Ineffective," pp.55-57 in McQuillan and Montgomery, 1999 .

Summary of key questions

1. *Financial opening.* Does IMF support for financial liberalization bear some 99responsibility for excessive short-term banking flows, e.g., to Korea in 1997?

2. *Moral hazard.* Did previous bailouts, particularly Mexico 1995, create moral hazard that showed up as a motivation for capital flows to Asia, particularly in 1996-97?

3. *Ex ante conditionality.* Why have no countries taken up the CCL? Is it because they know other facilities are available?

4. *Procrastination.* It has been argued that the IMF abetted Brazil's procrastination on devaluing throughout the second half of 1998. But the aftermath of January 1999 proved far more benign for Brazil than was the case in the delayed devaluations of Mexico, Thailand and Korea. Why?

5. *Transparency:* If the IMF had asked Korea harder questions about its reserve and debt numbers in November 1997, would anything have been different?

6. *US influence*: Where it is decided that the IMF made mistakes, did US influence play a role (and vice versa)? E.g., was the US responsible for the structural conditionality in the Indonesia program of Oct. 1997, for insisting on high interest rates and financial liberalization in Korea in December 1997, and for leniency toward countries in its own backyard, such as Brazil in the Fall of 1998; and, if so, were these policies mistaken?

7. *Sanguinity:* Why was the Fund so much better able to foresee problems in Thailand in 1997 than in Korea?

8. *Monetary austerity:* What would have happened if interest rates had not been raised so sharply in the Indonesian and Korean programs? Would the external financing constraint have been met, with less of recession?

9. *Fiscal austerity:* What would have happened if initial budget surplus goals had not been so ambitious in these programs? And to what extent were those goals a result of insistence by national governments on optimistic growth forecasts?

10. *Structural conditionality :* What would have happened if the IMF had not emphasized structural conditionality in the Indonesian program? Was the January 1998 program responsible for the social unrest and overthrow of Suharto in May?

11. *Bank closures:* In Indonesia, should the IMF have taken a harsher line than was taken in closing banks (to address moral hazard) or a less harsh (to try to maintain

confidence and avoid the bank runs)? Could it have done more regarding deposit insurance?

12. *Scale of resources:* Would bigger have been better? Smaller?

13. *Private Sector Involvement*: Why did Korea 2 work (the Christmas 1997 rescue) when Korea 1 failed (the Thanksgiving rescue)? Did PSI make the difference? Did requiring the international banks to roll over their loans in Korea make things harder for Brazil?

14. *Long-term dependency:* In the case of the late-1990s crisis programs, have the programs satisfactorily ended and the loans repaid?

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