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Asian Flu: Financial Crisis in the Pacific

Gonville and Caius College (known fondly to students and faculty alike as “Keys”) was founded in 1348 as part of the University of Cambridge. It sits in the very heart of that even more ancient English city, where John Milton studied; Erasmus and Isaac Newton wrote their major treatises; and John Maynard Keynes grew up, studied, and taught. Naturally, then, an international group of economists who gathered there toward the end of the twentieth century reflected more on the past than on current events.

The occasion was a conference on “The Origins and Management of Financial Crises,” and the recent past had plenty to offer: the debt crises that engulfed Latin America throughout the 1980s; the speculative attacks on the French franc and the pound sterling in 1992 and 1993; and the collapse of the Mexican peso in 1994–95. The present, too, pressed in on the ivied walls of the lecture hall. It was early July 1997, and Thailand had just been forced to sharply devalue its currency, the baht. To most of the experts in the hall, the events happening in Thailand seemed to be a curious and interesting episode in a small country on the other side of the earth. Thailand was not the United Kingdom, and it was not even Mexico. The collapse of the baht was a national problem, perhaps even a national disaster, but not a cause for international panic.

However, these events worried Stanley Fischer. The First Deputy Managing Director of the IMF had played a key role in managing the Mexican peso crisis, and he recognized the warning signs of another collapse that could spread to neighboring countries and perhaps farther. As it happened, he had come to Cambridge to discuss a paper on “Contagious Currency Crises” (Eichengreen, Rose, and Wyplosz, 1997), in which the authors argued that trade links, not similarities in macroeconomic conditions, caused crises to spread to other countries. In his remarks, and to anyone who would listen over lunch or coffee, Fischer conveyed that the danger was broader and more serious than that. The repercussions of the events of the moment could reverberate long and widely, simply because Thailand was only one of many vulnerable countries. It was not a Thai crisis, he argued; it was a Southeast Asian crisis. Before long, even that description would prove to be far too narrow.¹

¹For a summary of the conference, see *IMF Survey*, Vol. 26, No. 16 (August 18, 1997), pp. 260–62. Fischer described his reactions to the conference at *EBM/97/72* (July 15, 1997), p. 3. The description here is based primarily on this author’s own recollections.

Onset of the Crisis: Thailand in July

ANY ORDINARY PERSON IN EARLY 1997 COULD HAVE EASILY SEEN THAT IT WAS IMPOSSIBLE to protect the currency peg system.

Nukul Commission²
1998

Before the Crisis: Two Years to Boil

Thailand—strategically located in the heart of Southeast Asia—joined the IMF in May 1949 as one important step in regaining international acceptance after a break engendered by the Second World War. Bolstered by large-scale aid from the United States, its economy grew rapidly in the 1950s and 1960s, and Thailand had no need for financial assistance from the IMF. Political instability in the 1970s and 1980s temporarily slowed this economic progress, and Thailand had recourse to IMF lending on several occasions.³ In the 1990s, however, Thailand’s economy strengthened further, and the country became one of the leading “Asian tigers” and a creditor of the Fund. When Bangkok hosted the IMF/World Bank Annual Meetings in September 1991, the contrasts between the traditional and the modern cultures were stark, but Thailand seemed to be finding a sustainable path to development.

For the next few years, discussions between the Fund and the Thai government were low-key, mostly congratulatory annual affairs. In the 1992 “interim” Article IV consultation, the staff highlighted the need for more investment in public sector infrastructure, including transportation, telecommunications, and water supply. In 1993, the Executive Board offered further encouragement for such investments and congratulated the authorities for their “outward-oriented growth strategy and commitment to a liberal external trade environment.” In 1994, the Board noted with satisfaction the progress being made in developing infrastructure and again expressed admiration for the “remarkable performance” of the economy, but expressed some concern about overheating economic demand.⁴

²Nukul Commission (1998), p. 121.

³Thailand’s first use of Fund financing came in 1972, when it drew on the Buffer Stock Financing Facility to finance its participation in the Fourth International Tin Agreement. The IMF provided a Compensatory Financing Facility drawing for export shortfalls in 1976 and four stand-by arrangements from 1978 through 1985. All of those loans were repaid by May 1990. The staff provided a generally upbeat analysis of Thailand’s economic performance in the 1980s in Robinson, Byeon, and Teja (1991).

⁴At that time, interim consultations—in which the staff would issue a report based upon discussions with the authorities and the Executive Board would take note of the report without discussing it—were used biennially for countries without major problems or systemic implications (Chapter 4, pp. 117–18). See “Thailand—Staff Report for the 1992 Interim Article IV Consultation” (SM/92/90, April 29, 1992); and the Summings Up by the chair of EBM/93/74 (May 21, 1993) and EBM/94/60 (July 8, 1994).

The intensity of the Fund's concern strengthened in 1995, in the wake of the financial crisis in Mexico. Though half a world distant from Bangkok, the collapse of the peso immediately forced global investors to reexamine their love affairs with emerging-market assets. If maintaining a stable exchange rate was risky while foreign capital was steadily and eagerly flowing in, it was likely to become disastrous once the inflow became unsteady and unreliable. Predicting disaster is always precarious, and it is not a tactic that the inherently cautious Fund willingly undertook. In this case, however, the Fund conveyed increasingly strong and ultimately desperate messages to the Thai authorities for more than two years leading up to the crisis of July 1997.⁵ The Fund's warnings failed to avert the crisis, partly because the authorities rejected some of the analysis and partly because the messages were not always clearly focused nor well delivered.

The Fund's effort to convince the authorities to alter their policies began in earnest with a visit by P.R. Narvekar (Deputy Managing Director) in June 1995. He questioned the consistency of the exchange regime (pegging the value of the baht to a basket of currencies with a heavy weight on the U.S. dollar) with the inflationary stance of monetary and fiscal policies, aggravated by the capital inflows being encouraged in part by the fixed exchange rate. This argument failed to impress the Thais with the need to change the policy stance. They viewed the exchange rate peg as an important anchor for business expectations and as a politically sensitive issue, and they thought they could contain inflationary pressures gradually by encouraging domestic saving. Narvekar returned to Bangkok in December to plead again for moderation and flexibility, but he again met polite resistance.⁶

In those meetings and in the Article IV consultations through 1996,⁷ the perceived macroeconomic dangers received most of the IMF's focus, almost to the exclusion of the more important structural financial problems that would later bring economic growth to a crashing halt. Two such problems were then simmering. One was a growing volume of nonperforming loans at major banks and finance companies, resulting from the often close ties between those institutions and the companies to which they were lending. The other was a booming market in commercial property that was evolving into a speculative bubble. As an internal review noted early in 1997, the staff had

⁵For overviews of the crisis and its resolution, see Blustein (2001) and Nukul Commission (1998). The latter is the official report prepared for the government of Thailand by a commission chaired by Nukul Prachuabmoh, a former governor of the Bank of Thailand.

⁶See Narvekar's reports to the Executive Board at EBM/95/61 (June 23, 1995), p. 4, and EBM/95/122 (December 21, 1995), p. 5.

⁷After the interim consultation of 1992, the Fund held full Article IV consultations with Thailand every year.

“identified these risks” but “not . . . with a clear sense of urgency or concern that might now seem appropriate.”⁸

The staff mission to conduct the 1996 Article IV discussions took place in late March, at which time the staff had little information on these financial imbalances. Six weeks later, in mid-May, the evidence became much clearer when the finance ministry had to take over one of the country’s largest banks, the Bangkok Bank of Commerce, to save it from bankruptcy. Even so, when the Executive Board met in mid-July to discuss the staff report, macroeconomic overheating and the vulnerability of the pegged exchange rate were the only real concerns, and even those were overshadowed by Thailand’s impressive and continuing record of economic growth. As Karin Lissakers (United States) noted during the meeting, Thailand was still “a rather extraordinary success story.”⁹ Nonetheless, the Fund’s Managing Director, Michel Camdessus, followed up by writing to the finance minister, Bodi Chunnananda, conveying the Fund’s macroeconomic advice in strong terms. He wrote about “a broad consensus among Directors that the time was now ripe to permit greater exchange rate flexibility.” More specifically, he recommended changing the composition of the currency basket (to reduce the high weight given to the U.S. dollar), substantially widening the band within which the rate was permitted to fluctuate, and tightening fiscal policy.¹⁰

Private financial markets reacted more negatively to the increasingly bad news about Thailand’s financial problems. In September 1996, Moody’s Investors Service, a leading credit rating agency, downgraded its rating on Thailand’s short-term external debt. That action generated a sizeable outflow of private capital, both from foreign investors and from companies and banks based in Thailand (Nukul Commission, 1998, p. 43). No longer would it be possible for Thailand to finance its current account deficit with foreign direct investment inflows at the fixed exchange rate. Nonetheless, in an apparent continuation of the “East Asian miracle,” economic growth slowed only slightly in 1996 from the rapid pace of the early 1990s.¹¹

Although the staff still had limited information on the worsening condition of the financial system, it realized that the authorities would have to act quickly to avoid an exchange rate crisis. Toward the end of 1996, the Fund also began focusing more on the underlying structural issues.

⁸“Biennial Review of the Implementation of Surveillance over Members’ Exchange Rate Policies and of the 1977 Surveillance Decision,” SM/97/53 (February 19, 1997), p. 71, “Box 2: Banking Issues in Thailand.”

⁹Minutes of EBM/96/68 (July 17, 1996), p. 33.

¹⁰Letter from Michel Camdessus to Bodi Chunnananda (July 25, 1996); IMF archives, Box 22096, Accession 1999-0275-0008, OMD-AD (Fischer), “Thailand 1996.”

¹¹In real terms, Thailand’s GDP grew by 5.9 percent in 1996, compared with an annual average of 8.8 percent in 1993–95. For the 1992 Article IV consultation, the Fund staff had projected total growth for the next four years of 34 percent. Actual growth totaled 36 percent.

In December 1996, Camdessus made a hastily arranged stop in Bangkok at the end of a trip to Australia, Papua New Guinea, and Singapore. He agreed with the new finance minister, Amnuay Viravan, and the governor of the Bank of Thailand, Rerngchai Marakanond, that this was probably not the best moment to change the exchange regime. As long as they were facing a large outflow of capital, widening the exchange rate band would just transfer the pressure from the central bank's exchange reserves to the exchange rate and force them into a depreciation spiral. Instead, he argued, they should immediately attack the fundamental problems by taking "early action to create a more sustainable debt structure and to strengthen the banking system."¹²

The key to understanding the Fund's advice at the end of 1996 and the beginning of 1997 is to note its subtlety of timing. A letter from Camdessus to Amnuay in late January made the clearest statement. The Managing Director began by noting that "the situation remains very unsettled, and . . . market confidence remains weak." He recommended tightening both monetary and fiscal policies and moving "rapidly and convincingly" to reform the financial sector. Then came the crucial passage: "In present circumstances, provided that policies succeed in calming markets in coming days, I would not recommend an *immediate* change in exchange rate policy. Thereafter, however, I would urge you to move quickly and decisively to reform the present system, taking into account the need for greater flexibility" (emphasis added).¹³ The authorities in Bangkok seem to have understood this to mean most clearly that the Fund was agreeing with them that they should not change the exchange rate.

A few days later, the property market bubble began to deflate when a major developer, Somprasong Land PLC, defaulted on its external debts. As foreign and domestic investors grew more wary, currency speculators began to attack the baht. The window of opportunity for the authorities to deal with the underlying problems and avoid a currency crisis was now at the shattering point, but still no policy changes were evident. On February 7, two days after the Somprasong default, the Fund abandoned its two-stage advice and strongly urged the authorities to devalue at once. This time the letter came from Fischer, hand delivered to Amnuay and Rerngchai in Bangkok by Bijan Aghevli (Deputy Director, Asia and Pacific Department, or APD). Avoiding a devaluation, Fischer warned, "will require not only maintaining high real interest rates for the foreseeable future (with serious effects on the banking system) but also entails the risk of a rapid rundown in reserves." Fischer also offered financial support from the

¹²Camdessus's report to the Executive Board at EBM/96/111 (December 13, 1996), pp. 3–4. Additional information is from interviews with participants.

¹³Letter from Camdessus to Amnuay (January 31, 1997); IMF archives, Box 22190, Accession 2000-01117-0011, DMD-AI (Fischer), "Thailand 1997 I."

Fund if the authorities were ready to act. Both the policy advice and the offer of support were firmly rejected.¹⁴

As the financial picture continued to worsen—Moody’s issued another warning in mid-February—the IMF persisted in pressing the authorities to undertake financial reforms including a devaluation, but Camdessus also tried to reassure the markets with soothing public statements so as not to aggravate the speculative pressure on the baht. At the beginning of March, he met with Amnuay in the beach resort of Phuket, in the margins of a meeting of the finance ministers of the Association of South-East Asian Nations (ASEAN). Although he received no firm assurances in response to his plea for “quick action,” he told reporters afterward that the Thais “are doing exactly what you must do to avoid a recurrence of a Mexico-like crisis. . . . I don’t see any reason for this crisis to develop further.” Even privately to the Executive Board, he reported that “there is certainly no reason for panic in Thailand.”¹⁵

With the clarity of hindsight, a crisis was already close to inevitable, and even a large devaluation or a free float of the baht could not have prevented it. The fundamental imbalance arose from the business practices of the main financiers of property speculation, known in Thailand as finance companies, and of the Bangkok International Banking Facilities (BIBFs). Unlike commercial banks, these finance companies were not primarily deposit-taking institutions. Instead, they borrowed in domestic and international capital markets and then on-lent the funds to domestic companies. Their debts were partly short-term obligations, and the BIBFs and some of the larger finance companies borrowed significant amounts denominated in U.S. dollars or other foreign currencies. Their claims, for the most part, were longer-term obligations denominated in baht. Almost any sizeable deviation from a benign growth path, regardless of whether it was an increase in interest rates aimed at cooling down the economy, a puncturing of the property bubble, or a depreciation of the currency, would render a number of financial institutions insolvent. This combination of currency and maturity mismatches had been building up through years of insufficient regulation and oversight,

¹⁴Letter from Fischer to Amnuay (and copied to Rengchai), dated February 7, 1997, and delivered on February 11; IMF archives, DMD-AI, Accession 2000-0117-0011, B22190, “Thailand 1997 I”; and memorandum from Aghevli to the Managing Director, “Thailand—Delivery of Mr. Fischer’s Memo” (February 13, 1997); IMF archives, DMD-AI, Accession 2000-0117-0011, B22269, “Thailand – 1997.” Also see Nukul Commission (1998), pp. 46–47.

¹⁵*Financial Times* (March 11, 1997), p. 4; and minutes of EBM/97/23 (March 12, 1997), p. 65. Also see Nukul Commission (1998), pp. 63–65.

and the only solution for it at this point would have been a vastly expensive takeover by the government.¹⁶

Just two days after Camdessus's meetings in Phuket, the government had to rescue the leading finance company, Finance One, by merging it with a commercial bank. That takeover further exposed the weaknesses in the financial system, but the Fund staff was more concerned with convincing the central bank to correct what the Fund regarded as a seriously overvalued exchange rate. As it happened, a staff team was preparing to go to Bangkok in mid-March to conduct the first full-scale investigation of the economic situation since 12 months earlier.¹⁷ Internally, the staff was divided in its views on what the Thai authorities should do about the exchange rate. Should they devalue the rate by a large percentage and then let it float, or should they just widen the band and reduce the weight of the U.S. dollar in the basket? The Thais had already told Fund officials that they had no intention of devaluing, but the alternative strategy might not suffice and might even make the speculative pressure worse.

Fischer resolved this debate by asking the mission chief—David J. Robinson (Division Chief, APD)—to recommend devaluation, but only through a secret letter to the finance minister so that the advice would not become public and add to the speculative pressure. The usual “final statement” that Robinson presented to Amnuay and other senior officials on March 28 warned strongly of the dangers of not changing policy, and it recommended widening the band and revising the weights in the basket. Separately, however, Robinson sent a private letter to Amnuay urging him to take the even stronger action of devaluing immediately by 10 to 15 percent.¹⁸

The authorities still believed that the country's continued economic success required a stable exchange rate. They rejected both the mild and the strong versions

¹⁶For a review of the buildup of mismatched portfolios, see “Thailand—Recent Economic Developments,” SM/97/141 (June 3, 1997). The similarities and differences between this situation and earlier crises that undermined the Savings and Loan sector in the United States in the mid-1980s and Nordic banking systems in the early 1990s are instructive. Each of these crises was initiated by the willingness of asset holders to invest in institutions offering above-market yields, without due regard for the inherent risk, apparently on the assumption that the institutions would be bailed out in the event of failure. Insufficient and poorly understood regulations played a major role in each case. The primary differences were that the bad investments in Thailand were far larger in relation to the size of the economy and were doubly vulnerable because they involved exchange risk as well as credit risk. For a systematic analysis of the similarities in financial crises over several centuries, see Reinhart and Rogoff (2009).

¹⁷Because Thailand had borrowed only intermittently from the Fund, and had not borrowed at all for several years, the Fund had never opened a resident mission in Bangkok.

¹⁸See memorandums from Fischer to Hubert Neiss (Director, APD), “Thailand—Article IV Briefing Paper” (March 11, 1997); from Bijan Aghevli to the Acting Managing Director (Fischer), “Thailand—Briefing Paper for the 1997 Article IV Consultation” (March 6, 1997); from Fischer to Neiss, “Thailand—Article IV Briefing Paper” (March 11, 1997); and from Aghevli to Fischer (April 2, 1997); all in IMF archives, DMD-AI, Accession 2000-0117-0011, B22269, “Thailand-1997.”

of the Fund's advice and refused to modify the exchange rate band or the basket.¹⁹ Instead, the central bank continued to deplete its foreign exchange reserves in a last-ditch effort to ride out the large and growing speculative attacks. Increasingly, it did so by engaging in forward swaps of foreign currencies for baht rather than through outright purchases of baht, which left the reported stock of reserves intact. Because the Bank of Thailand (like many other central banks) did not publish those forward transactions—or even divulge them to the IMF—this practice effectively disguised the extent of the real loss.

Without knowledge of the sharp and ongoing drop in net reserves, Fund officials soon concluded that the crisis had passed. When Amnuay and Rerngchai went to Washington in April for the spring meeting of the Interim Committee, they met with Fischer, who did not press them anew to devalue. Publicly, Camdessus was upbeat, though more cautious than he had been a month earlier. Responding to a question at his press conference before the meetings, the Managing Director reassured reporters:

We are also closely monitoring what the Thai authorities are doing. They have already taken a few significant steps. They continue working on strengthening their financial sector and on reducing demand pressure in order to bring their current account deficit into a more acceptable range. We are pressing them to take additional steps, and they are considering doing that. We are hopeful that they will continue acting this way.²⁰

Financial markets were not impressed, either by developments in Bangkok or by reassurances from outsiders. Speculation against the baht intensified further in early May, and the central bank staved off devaluation only with massive forward intervention (selling more than \$6 billion in one day) that brought net reserves close to zero. The monetary authorities of Hong Kong and Singapore intervened in support of the baht in mid-May. In addition, the Bank of Thailand—convinced that foreign hedge funds were causing the problem—issued a control on capital outflows, prohibiting Thai banks from lending to foreign financial institutions except to finance trade (Nukul Commission, 1998, pp. 77–82). Following the May 9 attack, Camdessus wrote increasingly pointed letters to the authorities—including to Prime Minister Chavalit Yongchaiyudh—calling for devaluation. On May 22, Fischer made a long detour to Bangkok, from a trip to Japan, to deliver the message personally.²¹ Even though Fischer reminded

¹⁹It is not clearly established that Amnuay even saw the letter recommending devaluation. The Nukul Commission report made no mention of it, and in an interview for this book in 2006, Amnuay had no recollection or record of it.

²⁰Transcript of the press conference (April 24, 1997); accessed at <http://www.imf.org/external/np/tr/1997/tr970424.htm>.

²¹Chavalit refused to see Fischer in person, citing concerns about negative publicity if he were seen receiving an emissary from the IMF. Fischer hand delivered Camdessus's letter to Amnuay, who passed it on to Chavalit. Fischer also spoke directly with the prime minister by telephone. Years later, Fischer would recall the memory of "being driven through Bangkok in a van with darkened windows on [this] secret visit"; see the transcript of Fischer's farewell speech on his departure from the Fund (August 29, 2001); accessed at <http://www.imf.org/external/np/speeches/2001/082901a.htm>.

the authorities that Mexico had faced disaster two years earlier after failing to devalue soon enough, and even though he offered large-scale lending from the IMF if the Thai authorities did act, none of his or Camdessus's urging had any discernible effect on economic policies. Chavalit had stated publicly that he would never devalue the baht, and that—for the moment—was the end of the matter.

Fischer also tried and failed to obtain data on the size of the outstanding forward swaps. By May, the Fund staff strongly suspected that the Bank of Thailand must have made sizeable forward commitments—it was obvious that they had to be intervening heavily in the market while gross reserves did not seem to be declining. Fischer was the logical choice to try to obtain the data because he was well known and respected at the Bank of Thailand. (The deputy governor, Chaiyawat Wibulswadi, had earned a Ph.D. in economics in 1974 at MIT, where Fischer later chaired the department.) Bank of Thailand officials, however, treated even gross reserves as secret and reluctantly told Fischer the total only on the condition that he not reveal it to anyone else. Even in Bangkok, no one outside a small group in the central bank seems to have realized how appalling the situation was.

The Fund's Executive Board met in restricted session on June 13 to conclude the Article IV consultation. The meeting gave Directors an opportunity to urge Thailand to adopt a more flexible exchange rate regime, strengthen its economic and financial sector policies, and provide more comprehensive and timely data. In yet one more effort to avoid fanning the flames, no Public Information Notice was issued on this occasion, and even the Summing Up of the meeting was classified as strictly confidential. Within a few days, however, wire services were reporting that the Fund was unhappy with Thailand's pegged exchange rate.²²

On June 19, Amnuay resigned from the government, frustrated by his inability to navigate a reasonable course between a prime minister adamantly and publicly committed to maintaining a fixed exchange rate and a central bank governor who would not even keep the government informed about the extraordinary risks the bank continued to take to maintain that rate. His successor, Thanong Bidaya, quickly realized he was in a crisis and had to force a decision at once. Ruling out a default on external debt, he gave Rerngchai, the central bank governor, a few days to choose between devaluation and a floating rate. On Friday, June 27, the ministry of finance and the central bank jointly announced they were shutting down or taking over 16 of the largest finance companies. On Sunday, Chavalit, Thanong, and Rerngchai met and agreed to devalue.

²²On June 17, the Knight Ridder news agency circulated a story quoting anonymous sources within the IMF as saying that the Fund had recommended a more flexible exchange rate policy. The story also quoted Camdessus as telling reporters that he was encouraging the authorities to move in that direction and to strengthen their fiscal position and the financial system; see memorandum from Neiss to the Acting Managing Director, "Thailand" (June 18, 1997); IMF archives, Box 22190, Accession 2000-01117-0011, DMD-AI (Fischer), "Thailand 1997 I."

On Thursday, July 2, the Bank of Thailand announced it was allowing the baht to float. The baht closed the day down by nearly 17 percent against the U.S. dollar in offshore trading, and the Asian financial crisis had begun in earnest.

After the Crisis: Enter the IMF

The decision to allow the baht to float did not involve the IMF, and the authorities informed the Fund only after the fact. Nonetheless, Fischer responded quickly and positively by issuing a press release “welcoming” the policy changes and promising “technical assistance . . . for the effective implementation of these measures.”²³

Conspicuously absent from the Fund’s initial response was any promise of financial assistance, simply because Thailand had not asked for it. All hoped that the effective devaluation—which was essentially what the Fund had been advising for the past four months—would stop the capital outflow and restore stability without any need for official money from outside the country. For several days, that strategy appeared to be working: the baht stabilized and even appreciated, and prices rose in the Bangkok stock market. By mid-July, however, the financial markets were shifting to a more negative view.

The Fund sent a staff mission to Bangkok immediately after the fall of the baht, led by Aghevli, who was already nearby in Manila. Staff from the Monetary and Exchange Affairs Department also flew in to advise on monetary management and financial sector reform. The Reserve Bank of Australia sent an expert to advise on managing a floating exchange rate, and the Japanese ministry of finance sent a top official to discuss options for bilateral financial assistance. In mid-July, Thanong flew to Tokyo to follow up on those discussions while other Thai officials went to Beijing to see if China could offer a loan. No country, however, was prepared to lend to Thailand in the middle of a crisis without an IMF-supported policy program in place, as quickly became apparent.

The prospects for IMF support did not look promising. Not only was the government loathe to make such a request, but the Bank of Thailand was still refusing to provide comprehensive data on its foreign exchange reserves. Two weeks after the crisis began, the latest reserve data the Fund staff had seen were for mid-May, and the staff still had no data at all on the forward transactions that had effectively wiped out net reserves. Fischer felt frustrated both by the delay—which was frightening the financial markets more every day and leaving the Thai authorities with no options—and by the low level of cooperation. He sensed, however, that a call for help had to be coming soon, and on the last weekend in July he took the highly unusual action of sending

²³NB/97/12 (July 2, 1997).

Hubert Neiss (Director, APD), Anoop Singh (Deputy Director, APD), and several other staff to Thailand in anticipation of such a request.²⁴

By the time Neiss and the other staff landed at Bangkok International Airport on July 28, the government had decided to ask for a stand-by arrangement, and both the finance minister and the central bank governor had resigned. The Fund was prepared to consider the request on an expedited basis, using the accelerated procedures of the Emergency Financing Mechanism (EFM) it had adopted in September 1995. The two sides began negotiating terms as soon as new finance officials were in place. Once started, negotiations took only two weeks despite the difficult issues that had to be resolved. In addition to the usual disputes over the level of austerity needed to stabilize the country's finances, the major points of contention concerned the still-secret reserve data and the restructuring of the finance companies.

On financial restructuring, the central bank initially argued that by closing 16 companies at the beginning of July, they had solved the problem. The Fund staff concluded that as many as 50 more finance companies, accounting for some 10 percent of the total assets of Thailand's financial system, had balance sheets so shaky that the firms should be shuttered. In the authorities' view, that would be so disruptive as to lead to a political upheaval. Within a few days, however, they agreed to close 42 finance companies (in addition to the 16 closed earlier) and to offer a comprehensive guarantee to commercial bank depositors and creditors.²⁵

The agreement on the guarantee came only after a bitter and emotional dispute among the Fund staff, between those who saw it as necessary to prevent the shutdowns from leading to a massive run on commercial banks and those who saw it as an inappropriate bailout of risky and speculative investments.²⁶ The issue was resolved internally only because the U.S. Treasury expressed a strong view in favor of a guarantee. As it happened, both Timothy F. Geithner from the U.S. Treasury and Edwin M. Truman from the U.S. Federal Reserve Board were traveling in the region and went to Bangkok soon after the Fund mission arrived.²⁷ In meetings with Neiss and other Fund officials,

²⁴Singh was designated to be the mission chief. Neiss had plans to take home leave to Austria, but he rearranged his schedule to stop in Thailand on the way. On arrival in Bangkok, he discovered the dimensions of the situation, abandoned his leave plans, and effectively took charge of the negotiations.

²⁵The Fund's public announcement welcoming the agreement was couched in fairly general terms, referring favorably to the "comprehensive restructuring of troubled financial institutions . . . [as] essential . . . to set the stage for effective recovery"; see "Camdessus Welcomes Thailand's Policy Package," NB/97/16 (August 5, 1997); accessed at <https://www.imf.org/external/np/sec/nb/1997/nb9716.htm>.

²⁶For an example of the case against the deposit guarantee, see memorandum from Joaquin Ferrán (Deputy Director, Policy Development and Review Department) to Neiss, "Thailand—LOI" (August 4, 1997); IMF archives, Historian's files.

²⁷In August 1997, Geithner was senior deputy assistant secretary for international affairs at the U.S. Treasury, and Truman was director of the division of international finance at the Board of Governors of the U.S. Federal Reserve System.

they argued that the first priority was to prevent a financial collapse. That view eventually outweighed the concerns held by Fund officials at headquarters about the deposit guarantees.

The Hole in Reserves

Early in the negotiations, the central bank finally provided data to the Fund mission revealing the extent of the forward swaps against the foreign exchange reserves. That information raised two additional and closely related issues that would have to be resolved before the Fund could agree to finance the program: Should the “hole in reserves,” as it came to be called, be made public? And how much money would have to be advanced to Thailand to convince investors that the risk was covered?

The Fund staff and management were virtually unanimous in fearing that it would be dangerous for the authorities to announce that all of their reserves were committed to cover forward swaps. The only serious question was whether it would be even more dangerous not to announce it and leave the matter to rumor. Because the authorities were dead set against a public announcement, the Fund would not have forced the issue on its own. But U.S. officials had other ideas, and they did not hesitate to assert them. In discussions with Fischer, Lawrence H. Summers (deputy secretary of the U.S. Treasury) argued that the financial markets already had a fair idea of the proportions of the reserve situation and that revealing the numbers was more likely to calm them than to frighten them further. His insistence on this point implied that U.S. support for the stand-by arrangement would depend on the numbers’ being publicized. Fischer reluctantly went along, and Thailand’s willingness to publish the size of the forward position was made a condition for the Fund’s support.²⁸

A financing package then needed to be assembled. The IMF was prepared to approve a stand-by arrangement for close to \$4 billion (SDR 2.9 billion, or roughly five times Thailand’s quota in the Fund), to be disbursed over 34 months. No one believed that this amount alone would suffice. Even before Neiss finished negotiations in Bangkok, efforts were under way to secure additional financing.

A major difficulty arose immediately. The Clinton administration in the United States—despite its strong interest in a satisfactory resolution of the crisis—was not prepared to expend the considerable political capital necessary to try to persuade the U.S. Congress to approve a financial package for Thailand. It could not provide significant emergency financing without that approval because the Congress had imposed restrictions on the use of the Treasury’s own funds in response to what it considered to be an inappropriate “bailout” of Mexico in 1995. The “D’Amato restrictions,” as they were commonly known, would soon expire, but not soon enough to help Thailand.

As discussed in Chapter 10, when the U.S. Congress refused to approve President Clinton’s request for emergency loans to Mexico in January 1995, the president approved the use of the Treasury’s Exchange Stabilization Fund (ESF) instead. A few

²⁸EBS/97/148 (August 14, 1997), p. 9.

weeks later, New York Senator Alfonse D'Amato responded by introducing legislation limiting the use of the ESF for such purposes. The legislation, as enacted in August 1995, prohibited the use of more than \$1 billion in ESF monies for lending to a foreign country for more than 60 days without congressional approval, unless the president certified "in writing to the Congress that a financial crisis in that foreign country poses a threat to vital United States economic interests or to the stability of the international financial system."²⁹ That limitation expired at the end of September 1997. The decision not to submit such a certification regarding the crisis in Thailand or to press Congress for approval took into account that the president's party (the Democratic Party) did not control either the House or the Senate and that the administration did not want to endanger passage of pending legislation approving an IMF quota increase and establishing the New Arrangements to Borrow. Nonetheless, President Clinton later acknowledged that he "regretted not making at least a modest contribution to the Thai package. . . . [Treasury Secretary Robert E.] Rubin and I didn't make too many policy errors. I believe this was one of them" (Clinton, 2004, pp. 806–07).

Other countries responded more positively, with encouragement from the U.S. government. On August 11, the IMF and the Japanese finance ministry jointly hosted a meeting of the "Friends of Thailand" at the Imperial Hotel in Tokyo.³⁰ Delegates from East Asia, Australia, North America, the Asian Development Bank (AsDB), the World Bank, and the IMF attended the one-day meeting. Japan initiated a wave of bilateral contributions by promising to match the IMF by lending \$4 billion to Thailand through Japan's export-import bank. Six central banks in the region—the Reserve Bank of Australia, the Hong Kong Monetary Authority, Bank Indonesia, the Bank of Korea, Bank Negara Malaysia, and the Monetary Authority of Singapore—pledged financial support totaling \$5 billion, and China, the AsDB, and the World Bank promised assistance estimated to total about \$3 billion.³¹ Although the nature and firmness of these pledges varied, it was a successful day by any standard. That evening, the head of the IMF delegation, Deputy Managing Director Shigemitsu Sugisaki, announced that the total package—including the Fund's own \$4 billion contribution—would amount to at least \$16 billion.³²

²⁹Sec. 632, Treasury, Postal Service, and General Government Appropriations Act, 1996, Pub. L. No. 104-52, 109 Stat. 468 (1996).

³⁰The meeting was convened by the IMF on an emergency basis just four days beforehand; see "IMF Calls Tokyo Meeting to Discuss Thai Financing Package," NB/97/17 (August 7, 1997); accessed at <https://www.imf.org/external/np/sec/nb/1997/nb9717.htm>.

³¹For a first-hand account of this meeting and of the pledges that were offered, see Sakakibara (2000). For an official list of pledges, see EBS/97/148 (August 14, 1997), p. 42.

³²The bilateral financing from regional central banks, including from the People's Bank of China, was finalized at a meeting in Bangkok on August 20. For details, see memorandum from Thomas Leddy (Deputy Director, Policy Development and Review Department) to the Managing Director, "Thailand—August 20 Meeting in Bangkok on the Bilateral Element of the Financing Package" (August 22, 1997); IMF archives, Box 22190, Accession 2000-01117-0011, DMD-AI (Fischer), "Thailand 1997 III."

How much of this “headline” figure would be needed, and how much would really be available if it were needed, could not be known in August 1997.³³ The crucial assumption that convinced the Fund the amount was sufficient was that the Fund-supported policy package (tightening monetary policy, aiming for a surplus in the government budget, and continuing to restructure the financial system) would quickly restore confidence among both domestic and foreign investors so that a large portion of the country’s short-term external debt and of the central bank’s forward obligations would be rolled over voluntarily.³⁴ When asked by reporters whether he thought \$16 billion would suffice, Sugisaki replied that he thought it would, *if* the government fully implemented the program.

The next day, the Thai authorities met with a group of Japanese banks and secured promises that the banks would maintain their credit lines. Because the Japanese banks were Thailand’s largest external creditors, this agreement went a long way toward ensuring that official support would not just finance an outflow of private capital as creditors raced for the exits.³⁵

The following week, on August 20, the Executive Board approved the stand-by arrangement without dissent.

Limited Options

Before turning to the issue of the effectiveness of the program, it is appropriate to consider what options were available for getting through the crisis. In short, in the face of massive balance sheet weaknesses throughout the financial sector, the authorities—and the Fund—had no good choices and had to do as well as possible with limited tools.

The keys to resolving the crisis in Thailand were to restore confidence among domestic and international investors sufficiently to enable the country to finance its external deficit, to stabilize and strengthen macroeconomic policies to get the economy on a sustainable course, and to restructure the financial system to eliminate the weaknesses that caused the crisis in the first place. A start could be made right away in all three domains, but the only tools that would bring much immediate relief were monetary and exchange rate policies.

To eliminate the incentive for capital flight by domestic institutions, monetary policy would have to be adjusted to set the interest rate at a competitive level; the

³³The commitments from Japan and the regional central banks were firm and were to be disbursed in tandem with the IMF, but the other commitments were either conditional or were pending final agreements.

³⁴In addition, Bank of Thailand officials argued that they could exercise substantial leverage over the holders of the forward swaps to induce them to roll them over. The banks that held the swaps would have to obtain an equivalent amount of baht if they wanted to close them out, and the Bank of Thailand could in principle refuse to supply it in sufficient quantities.

³⁵See EBS/97/148 (August 14, 1997). Additional information is from contemporaneous press reports and from interviews for this book.

central bank would have to maintain adequate foreign exchange reserves to reassure the markets it could meet its obligations and smooth financial disturbances; and the exchange rate would have to be maintained at a level that would minimize the risk of a further depreciation. The qualitative requirements for attracting *foreign* investment were more difficult to determine, because that lending was done in foreign currency at a markup over London or New York interest rates. Domestic interest rates and the exchange rate affected expected returns on those investments only indirectly, through their effects on the country's economic performance.

Tightening fiscal policy and restructuring the banks and finance companies (closing insolvent institutions and taking over or merging others that were in trouble) would also play an essential role but would take longer to implement and to be effective. In the meantime, relying heavily on depreciation of the currency would run the risks of worsening the panic and igniting an inflationary spiral. Relying too heavily on monetary tightening would run the risk of bankrupting companies with large outstanding debts and causing a severe and possibly prolonged economic downturn.³⁶

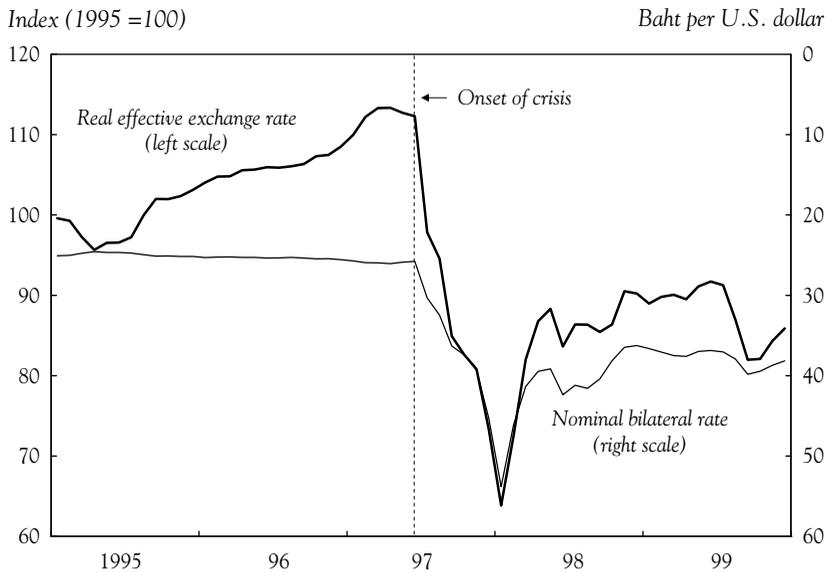
The IMF's preferred strategy for responding to the financial crisis in Thailand was to begin by insisting on a restoration of financial stability through a combination of fiscal and monetary tightening that would support the initial exchange rate depreciation without destabilizing the economy. Extraordinary luck as well as skill would be needed for the staff to guess the optimal combination of policy adjustments correctly on the first try. It would be extraordinary if the authorities were to implement the agreed program exactly as planned. It would be extraordinary if domestic and foreign investors were to respond as positively as was hoped. More likely, management of this crisis would become a continuing cycle of reaction and refinement until a genuine economic recovery was confidently under way.

Difficulties Emerge

The first difficulty to emerge was that financial markets remained skeptical about the benefits of investing in Thailand, and the baht continued to decline in value after the IMF support was announced (Figure 11.1). Part of the problem was that the announcement of the net reserve position on August 21 was badly received. As many in Thailand and in the Fund had feared, the data made it obvious that the official financial package—though it had grown to a little more than \$17 billion—was smaller than the size of the Bank of Thailand's forward commitments against its reserves (\$23.4 billion).

The amount of the package had been negotiated when both the Fund staff and the authorities believed that the size of the net reserve position would not be made public. Once the latter figure was announced, the package was no longer adequate. Even if the

³⁶This trade-off between raising interest rates and depreciating the currency became the subject of heated public debate with regard to the IMF's management of the Asian financial crises. For a summary and analysis, see Boughton (2006).

Figure 11.1. Thailand: Exchange Rates, 1995–99

Sources: Information Notice System and International Financial Statistics.

whole package eventually was made available, it looked as if the central bank might have difficulty meeting all of its existing commitments. Even though it was highly doubtful that an attempt to disguise the situation could have succeeded, and even though larger official financing was neither feasible nor desirable, clearly the decision to proceed in this way was not succeeding either.

Second, the political situation in Thailand became highly uncertain. Prime Minister Chavalit was being blamed for the onset and continuation of the crisis, and speculation was rising that he would soon be forced to resign. Even though the authorities were carrying out their commitments under the program adequately, and both Camdessus and Rubin issued public statements of support in September,³⁷ investors' lack of confidence was deepening both the financial and the political crises. The Chavalit government found itself in a downward spiral that made effective governance impossible. Thanong resigned as finance minister on October 24,

³⁷These public statements were positive but muted. In the course of a press conference in Hong Kong SAR on September 18, Camdessus stated that the Thai authorities were "complying pretty well with all the macroeconomic elements of the program," but were having more difficulty restructuring the financial sector. Four days later, also in Hong Kong SAR, Rubin met with Thanong and Chaiyawat (Chaiyawat having become central bank governor in the end-July shake-up). Afterward, he told reporters he believed that the Thais were prepared to implement the necessary reforms (Wagner, 1997). The transcript of Camdessus's press conference is at <http://www.imf.org/external/np/tr/1997/tr970918.htm>.

and two weeks later Chavalit offered his own resignation and dissolved the government. By this time the value of the baht vis-à-vis the U.S. dollar was down by some 16 percent since the announcement of the Fund's financial support and by 36 percent since July 1.

The formation of a new government led by Chuan Leekpai in mid-November had a brief calming effect on financial markets once Chuan signaled his intention to maintain the tight macroeconomic policies required by the stand-by arrangement with the IMF. Paradoxically, that led to the third difficulty with the program: The fiscal requirement—shifting the fiscal balance from a deficit of about 1.5 percent of GDP in the 1997 fiscal year to a surplus of 1 percent in 1998 at a time when incomes were also being depressed by the declining value of the currency and the withdrawal of external capital—was so rigorous that it might throw the economy into a severe recession. To a population that still faced major development needs even as it had become accustomed to steady economic growth rates of 6 percent or more each year, this prospect was grim indeed. To avoid the political fate that had befallen Chavalit, Chuan realized he would have to convince the IMF to let him ease up a bit.

Meanwhile, a fourth difficulty was brewing, in the form of financial crises in nearby countries. The crisis that hit Thailand in July, having made manifest the extent of the weaknesses in its financial sector, had made investors nervous about the possibility that conditions might be similarly poor in other countries in the region. As discussed below, by mid-November, contagion from Thailand had spread south to Indonesia and north to the Republic of Korea, both of which had internal financial weaknesses that made them especially vulnerable. Pressure on the Indonesian rupiah and the Korean won then fed back onto the baht, which continued to fall against the U.S. dollar throughout the first month of the Chuan government's tenure. Even worse, trade credit was drying up, and the need for cash to finance imports was further depressing economic activity.

To get a better sense of these developments, the IMF opened a resident mission in Bangkok, directed by Reza Moghadam (Senior Economist, APD).³⁸ In addition, Camdessus made two more visits to Bangkok, where he met with the new prime minister and other senior officials. By the time the Executive Board next met (on December 8, 1997, again in restricted session) to review the stand-by arrangement, it was evident that the program targets should be eased to prevent the economy from completely collapsing, but the staff was worried that a premature relaxation of fiscal policy could further damage confidence and would make it more difficult to finance what had become a very expensive restructuring of the banking system. Fischer concluded that some easing of fiscal policy might be appropriate once the economy had stabilized.

³⁸For a firsthand account of the opening of this office in the middle of the crisis, see Moghadam (2007).

Turning the Corner

The critical corner was turned in mid-January 1998. On January 5, Chuan announced publicly that he would ask the IMF to release the government from its commitment to aim for a budgetary surplus for the year. For a few days more, the baht continued to depreciate, and on January 12 it closed at its all-time low, 55.5 to the dollar. The baht had depreciated by 42 percent since the Fund approved the program in August and by 56 percent since the crisis erupted at the beginning of July. But then the Fund began to signal its agreement that the program was too tight and could safely be relaxed. On January 16, Camdessus held a press conference in Kuala Lumpur, Malaysia, during which he explained that the fiscal requirement in Thailand was being reassessed and the program was being adapted to “changing circumstances” in preparation for the next review. By this time, the exchange rate had finally begun to appreciate. Five months of tight policy may have seemed excessive, but it had succeeded in creating the conditions for a sustainable recovery.

In early February, Neiss and Singh went back to Bangkok with a staff team to hammer out an agreement on how the program should be relaxed and by how much. The most significant modification that emerged from these meetings was a relaxation of the fiscal target from a surplus of 1 percent of GDP in 1998 to a deficit of 2 percent. As soon as that agreement was reached, Neiss went on Thai television to announce it, stressing that the Fund and the authorities both felt the looser target was warranted. “I think that in asking for more flexibility, the Thai government has pushed on an open door,” he explained.³⁹ With investor confidence still fragile, it was important not to leave the impression that the program was being weakened under pressure.

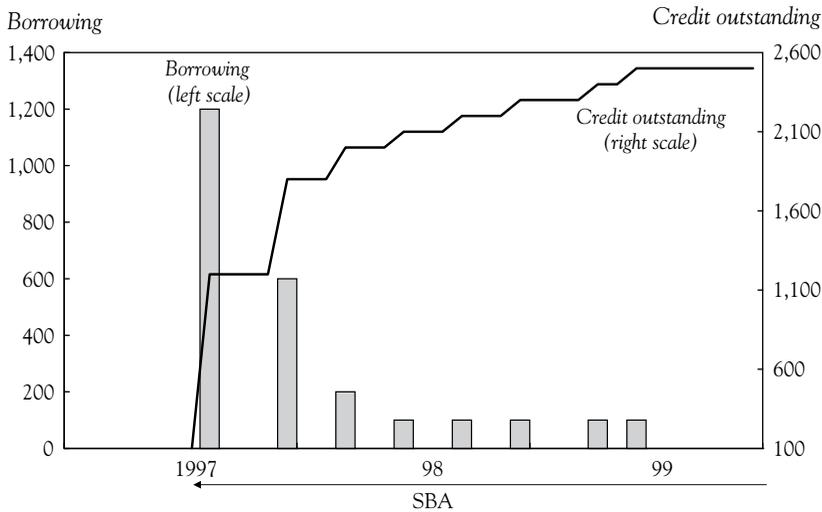
The Thai cabinet ratified the new Letter of Intent on February 24, clearing the way for the IMF Executive Board to approve the proposed changes to the program. At the conclusion of the Board meeting on March 4, Camdessus further reinforced the positive message by announcing that the fiscal requirement had been eased “in recognition of the adverse effect of the recession on revenues and the need to raise spending on the social safety net.”⁴⁰ It would take a few more months before the economy would show solid signs of recovery, but the crisis could now be said to have been resolved.

The stand-by arrangement remained in effect until June 2000, but after June 1999 Thailand no longer requested to draw on it (Figure 11.2). By that time, it had drawn \$3.4 billion under the arrangement (SDR 2.5 billion, out of an approved total of SDR 2.9 billion). It had also borrowed \$14.3 billion from the creditors participating in the \$17.2 billion package of supplementary financing, as the pledges made in Tokyo turned out to be firmer than many observers had initially feared. The Thai economy was

³⁹Quoted by Agence France-Press (February 12, 1998) from an interview on Independent Television.

⁴⁰“IMF Executive Board Completes Second Review of Thailand’s Economic Program,” NB/98/5 (March 4, 1998); accessed at <https://www.imf.org/external/np/sec/nb/1998/nb9805.htm>. The Board meeting was held in restricted session, and no minutes of the discussion are available.

Figure 11.2. Thailand: Use of Fund Credit, 1997–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics.
 Note: SBA = Stand-by arrangement.

growing again (by 4.5 percent in 1999 and 4.75 percent in 2000), and the authorities were able to repay all of these credits in full and on or ahead of time.

The Crisis Spreads to Indonesia

UNDOUBTEDLY, IN THE END, OUR FATE LIES IN OUR HANDS.

President Suharto⁴¹
 March 1, 1998

The first country to be affected by contagion from the crisis in Thailand was Indonesia: one of the most populous countries and for more than two decades one of the most successful economies in the region.

Indonesia joined the IMF in 1954 and borrowed occasionally from 1956 through 1972.⁴² After the first major increase in oil prices in 1973, this oil-exporting country

⁴¹Speech to the People’s Consultative Assembly, as quoted on www.cnn.com.

⁴²In January 1965, President Sukarno pulled Indonesia out of the United Nations to protest the seating of Malaysia on the Security Council. In August of that year, the country withdrew from the IMF as well. Indonesia rejoined the IMF in February 1967 after the transfer of power to Suharto. For the next three years, Indonesia drew on a series of stand-by arrangements; see de Vries (1976), Vol. 1, pp. 359–60.

no longer had any need to borrow from the Fund. In 1975, the government managed to overcome the disastrous collapse of Pertamina, the country's monopoly oil and gas company, without financial assistance from the IMF. Indonesia soon became a Fund creditor except for two brief periods in the 1980s when world oil prices slumped. Even then, Indonesia drew only on the Buffer Stock Financing Facility to finance its commitments under the international rubber and tin agreements and on the Compensatory Financing Facility for shortfalls in oil revenues and other exports. Throughout this middle period, Indonesia had no need for either a stand-by arrangement or debt re-scheduling from other creditors.⁴³

From the beginning of the Suharto era in the late 1960s, Indonesia maintained good and close relations with the IMF. Policy advice and technical assistance from the IMF, other multilateral agencies, and private sector supporters such as the Harvard Institute for International Development played an instrumental role in Indonesia's initial development of professional expertise and management capability.⁴⁴ Even long after Indonesia stopped borrowing, the Fund maintained a Resident Representative office in the central bank and enjoyed ready access to senior officials and advisors to the president. Many of those officials had earned graduate degrees at U.S. universities (the "Berkeley mafia" was a popular sobriquet for the group, although Boston University was an even more common training ground) and broadly shared the liberal economic and political perspective of the typical Fund economist. In sum, Indonesia was long regarded as a strong performer and a willing adherent to the economic principles advocated by the Fund.

The IMF's role as a valued advisor to the Suharto regime endured well into the 1980s. Gradually, however, the importance of that role diminished as the apparent likelihood of Indonesia ever borrowing again from the Fund steadily fell. Coincidentally, by the early 1990s, when Suharto had been president for some 25 years, the concentration of power and wealth in the hands of his family and associates began to weigh heavily on his ability—and that of his still reform-minded advisors—to sustain the country's economic progress. A small set of individuals close to the president now owned or controlled many of the key sectors in the economy, from major industries to agricultural marketing to banking. The death of Suharto's wife in April 1996 seems to have further weakened his ability to hold the reins, particularly against the greed and power of his now-adult children. The Indonesian economy continued to grow at a good pace, but the underpinnings of that growth were gradually becoming less secure.

⁴³For background on these developments, see Boughton (2001), pp. 273, 737, and 743.

⁴⁴In 1971, the Fund's Central Banking Service established a training institute in Jakarta for both central bank staff and private bankers. For an overview of technical assistance in that period, see de Vries (1976), Vol. 1, pp. 581–85.

Before the Crisis: Unheeded Advice

In January 1994, the Fund again began providing regular technical assistance to Indonesia, mostly on issues related to coping with banks that had large amounts of nonperforming loans (particularly to companies with powerful political connections) or with other financial difficulties. Over the next four years, including in the aftermath of the country's financial crisis, the Fund sent 15 technical assistance missions to Jakarta: 10 on banking problems, 4 on strengthening national statistics, and 1 on improving tax administration and broadening the tax base.

By 1995, the Fund also began expressing increasingly urgent concerns about overheating in the Indonesian economy, through the annual Article IV consultations and management visits to Jakarta. When Stanley Fischer made his first visit to Indonesia in May 1996, he publicly called on the government to grant independence to the central bank. Privately, he gave Suharto an *aide-mémoire* urging him to tighten fiscal policy so as to reduce the current account deficit and the inflation rate; to eliminate off-budget spending and other nontransparent fiscal actions; and to authorize the central bank, Bank Indonesia, "to take all necessary actions" to clean up the problem banks. On his return to Washington, Fischer reported back to Camdessus that he was quite worried about the level of corruption in the government and the lack of transparency in government accounting, which he feared was covering up a "multitude of sins." To the Executive Board, however, Fischer was more sanguine, concluding that Indonesia's problems were "not of serious concern, in the sense of a looming crisis."⁴⁵

In November 1996, Camdessus met with Suharto in Jakarta, where the Managing Director was to give the keynote address at a regional conference. In addition to repeating the broad warnings about overheating and weak banks, Camdessus urged the president to begin dismantling the agricultural monopolies that were strangling economic progress in the country and to cut the country's large military expenditures as one especially effective way to reduce overheating.⁴⁶ Suharto responded with general agreement and vague assurances, as he had with Fischer earlier in the year, but took no effective actions to implement the recommendations.

The Fund continued to press for reform in this low-key manner throughout the first half of 1997, through staff visits; the annual Article IV consultation mission at the end of March; and direct meetings between Camdessus and the minister of finance, Mar'ie

⁴⁵See memorandum from Fischer to the Managing Director, "Visit to Indonesia, May 20–25" (May 29, 1996); IMF archives, OMD (Fischer), Accession 1999-0275-0003, "Indonesia – 1996." Also see minutes of EBM/96/51 (May 29, 1996), p. 3; and *Jakarta Post*, "IMF Executive Calls for Independent Central Bank" (May 23, 1996). In July, the Executive Board endorsed management's recommendations for tighter policies and a strengthening of public control over the banking system; see minutes of EBM/96/72 (July 26, 1996), pp. 56–57.

⁴⁶Memorandum for files by Kadhim A. Al-Eyd, "Indonesia—Managing Director's Meeting with President Soeharto" (November 14, 1996); IMF archives, OMD (Fischer), Accession 1999-0275-0003, "Indonesia – 1996."

Muhammad, in Phuket, Thailand, and with the central bank governor, Soedradjad Djiwandono, in Washington. Although these officials and others did not dispute the need for reform, the Fund's advice was not taken seriously. After a quarter-century of economic progress without an IMF-supported program, most Indonesian officials no longer regarded the agency as the important force it once had been.

The Crisis Hits

The forced devaluation of the Thai baht at the beginning of July 1997 did not immediately disturb the sense of economic tranquility in Indonesia. Initially, most observers and the Fund thought the Indonesian economy had largely escaped being thrown off course by the crisis in Thailand. As it happened, the Executive Board met to conclude the 1997 Article IV consultation with Indonesia just one week after the devaluation of the baht. For the moment, the rupiah—which was being managed within a crawling band against the U.S. dollar—was fairly stable, and Directors generally expressed relief that the crisis did not seem to have spread across the South China Sea.⁴⁷ Nonetheless, Bank Indonesia took the prudent step on July 11 of widening the exchange rate band: a step that on previous occasions had resulted in a welcome appreciation of the rupiah.⁴⁸

As the summer progressed, pressure gradually developed on the rupiah, partly because of regional contagion and partly because Indonesian companies were facing a liquidity squeeze from the large amount of external debt falling due. Suharto personally decided in mid-August that the central bank should stop intervening to support the exchange rate. In a move welcomed but not initiated by the IMF, Bank Indonesia floated the rupiah on August 14 and tightened monetary policy so as to restrict the growth of bank liquidity and thus reduce the pressure on the exchange rate (Soedradjad, 2005, p. 44).⁴⁹ Unfortunately, both actions *increased* pressure on the balance sheets of the major banks, pressure that few of them could readily withstand. Of the 238 banks in the country, perhaps 1 in 10 was insolvent even before the Thai crisis, but these banks were able to keep operating thanks to continuing infusions of cash from Bank

⁴⁷Minutes of EBM/97/69 (July 9, 1997). The following day, World Bank staff gave a similarly reassuring report to the Bank's Executive Board; see Blustein (2001), p. 96, and Mallaby (2004), p. 184. A few days later, bilateral donors meeting as the Consultative Group on Indonesia met in Tokyo and expressed relief and congratulations to the government for responding well to the crisis.

⁴⁸The widening of the band from ± 4 percent around the central rate to ± 6 percent was the eighth such shift in five years and represented the culmination of a strategy to manage the crawl more flexibly. For an account of the widening, and background on the exchange rate policy, see Soedradjad (2005), pp. 37–42.

⁴⁹In response to the float, Aghevli informed Camdessus that the policy was “appropriate and in line with our advice.” See his memorandum to the Managing Director, “Indonesia: Exchange Rate Float” (August 14, 1997); IMF archives, OMD (Mr. Fischer's files), Accession 1999-0275-0003, “Indonesia (1) – 1997.”

Indonesia. The floating of the rupiah in August and the accompanying withdrawal of liquidity support from the central bank rendered this practice unviable, owing to the widespread acceptance of open currency positions, maturity mismatches, and other high-risk balance sheet positions. Within weeks, the whole banking system was either insolvent or nearly so.⁵⁰

In retrospect, by mid-August Indonesia had already passed the point at which the government could avoid a crisis. Trying to maintain a strong exchange rate and simultaneously provide enough liquidity to keep the banks afloat would surely and steadily have worsened speculative pressures and depleted the country's reserves. Applying capital controls almost certainly would have been ineffective and would have led to an even greater speculative panic. But allowing the exchange rate to float and tightening liquidity—the course that Suharto and his advisors chose and that the Fund eventually supported—was bound to undermine the viability of the country's already fragile financial system. A year of ignoring the warning signs in the economy and from the IMF had left the authorities with no good options.

Indonesia's crisis, more than any other the IMF helped manage in the 1990s, was deeply rooted in domestic systemic failures that had long lain dormant but that, in the end, had to be corrected before the crisis could be resolved. Furthermore, steadily escalating competition between two very different groups of advisors to the president compounded the difficulty of fixing these underlying problems.

One group close to Suharto was the "Berkeley mafia" mentioned above: the generally reform-minded economic team, including those with formal official duties such as the minister of finance and the central bank governor, but also a group of informal advisors led by the legendary intellectual Widjojo Nitisastro. The second competing group comprised family and associates of Suharto, who owned or controlled many of the banks, major industries and utilities, and agricultural monopolies in Indonesia and thus benefited from enormous economic rents. This group, often called the "cronies," opposed all serious efforts at reform.

Generating support for reform required working through the economic team, but outsiders found it difficult to determine how best to evaluate and—if possible—to bolster the influence of that group relative to the cronies. To some extent, the IMF and its external allies had direct access to Suharto, but the impact of that access was ephemeral in the absence of more consistent and dominant influence on the part of the economic team. Hence, the key to success or failure turned out to be the waxing and waning of the relative clout of the two competing groups of domestic advisors.

Before the crisis, the two groups enjoyed an uneasy standoff in which each had enough influence with Suharto to further its own agenda. The economic team had a

⁵⁰The extent and depth of the problems in the banking sector before the crisis are difficult to assess because various indicators point in different directions. For a relatively upbeat assessment, see Hill (1999), pp. 61–67. Grenville (2006, p. 107) describes the mid-August withdrawal of bank liquidity as a "key mistake" in the handling of the crisis.

measure of independence in maintaining macroeconomic growth and stability, and the resulting high growth in the economy year after year produced an expanding economic pie. In these circumstances, the cronies could cut ever-larger slices for themselves without destroying the prosperity of others. In fact, Indonesia gradually managed to reduce extreme poverty to very low levels and to promote the interests of a growing middle class. Dissatisfaction with and rebellion against the great privileges of the few were never far from the surface, but political instability was broadly containable as long as the economy was progressing reasonably well.

The onset of the financial crisis initially emboldened and strengthened the hand of the reformers, but it then led to a “war of attrition” between the two groups.⁵¹ The Fund soon found itself drawn into the maw of this vortex.

In the wake of the mid-August decision to float the rupiah, both the Indonesian reformers and the IMF team thought the only hope for avoiding a full-blown financial crisis was for Suharto to agree to implement a comprehensive set of reforms centered on macroeconomic stability and banking reform. In response to a request from Mar’ie, Fischer decided to stop in Jakarta in mid-September. There, Mar’ie and Widjojo alerted him that slow progress on banking reform was still a major obstacle. Fischer then met with Suharto, praising him for acting expeditiously to ward off speculative pressures but also warning him again of the dangers of not dealing with the many problem banks. This time, Suharto seemed to get the message, promising Fischer that some banks would soon be closed or merged.⁵² At this time, neither Fischer nor the economic officials in Jakarta thought macroeconomic conditions in the country were a problem or that Indonesia might need financial support from the IMF.

As soon as Fischer returned to Washington at the end of September, he wrote to Suharto and other officials, offering to send a staff mission to Jakarta to negotiate a precautionary stand-by arrangement. The Fund would make a specified sum of money available to the authorities as a stand-by line of credit, on the understanding that the money would not be drawn unless circumstances worsened unexpectedly. In return, the authorities would commit themselves to implementing a reform program, which in this case was expected to be limited primarily to tightening fiscal policy and restructuring the financial sector.⁵³

⁵¹The phrase is from a model developed by Alesina and Drazen (1991) that explains delays in essential economic reforms when interest groups compete for control.

⁵²Memorandum from Fischer to the Managing Director, “Visit to Indonesia, September 16–17” (September 23, 1997); IMF archives, OMD (Mr. Fischer’s files), Accession 1999-0275-0003, “Indonesia (1) – 1997.”

⁵³For the letters to Soedradjad and Mar’ie (dated October 1, 1997), see IMF archives, OMD (Fischer), Accession 1999-0275-0003, “Indonesia (1) – 1997.” On the expected content of the program to be negotiated, see memorandum from Neiss to Fischer, “Indonesia” (October 3, 1997), in the same file. For a September 30 draft of the letter to Suharto, see attachments to a note from Margaret Kelly to Fischer, “Indonesia—Draft Letters” (October 1, 1997); IMF archives, APD/AI, Neiss collection, Box 19, file 4.

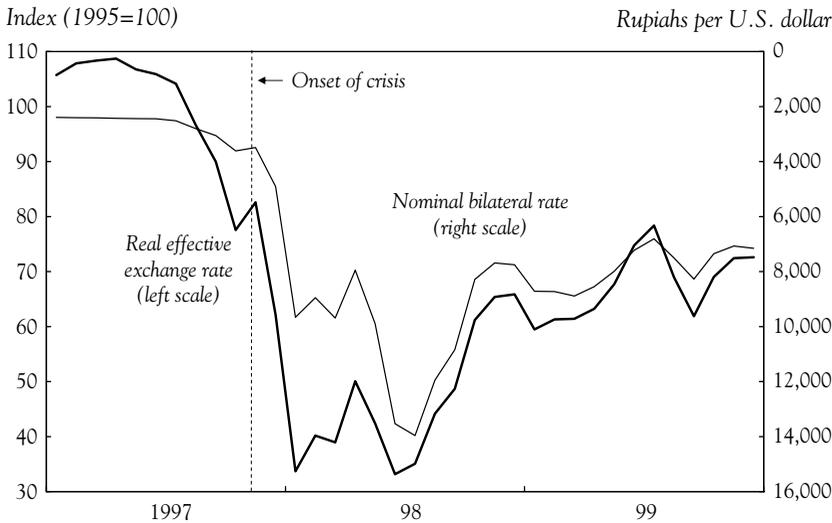
During the next week, as the Fund prepared to send a small staff team to Jakarta for these discussions, speculative pressure against the rupiah began to worsen, for reasons that everyone involved found hard to understand or to relate to Indonesia's economic circumstances. Although Bank Indonesia had resumed intervening to try to stabilize the rate, by October 8 the rupiah had lost more than a third of its value against the U.S. dollar since the initiation of floating less than two months earlier—including some 10 percent in the previous two days (Figure 11.3). Fund officials still believed the drop was excessive and that it was mainly fallout from the ongoing crisis in Thailand.⁵⁴ Nonetheless, they quickly escalated the urgency of the mission. Whatever the cause, Indonesia now needed not just advice and moral support, but a lot of money as well.

Officials in Jakarta were just as convinced as the Fund staff that they faced an increasingly dire situation. They still had \$27 billion in foreign exchange reserves, but unless they could convince investors that it was safe to hold rupiah assets, either they would have to spend all of that and more in a short period or they would have to let the value of the currency plummet even further. That same day (October 8), Suharto announced to the public that he was seeking financial support from the IMF, and also from the World Bank and the AsDB. The announcement by itself came as a positive shock to the financial markets, and for several days the situation calmed down as the IMF staff team rushed to Jakarta and began meeting practically around the clock to get an agreement on paper before the next shock wave could hit.

The Fund negotiating team for this first mission had an unusual structure, owing to the range of issues involved and the shortage of detailed knowledge of Indonesia among the available senior staff. The senior official in APD with regular oversight of the department's work on Indonesia was Margaret Kelly (Senior Advisor). Given the magnitude of the problem at hand, two even more senior officials in the department would also have to be closely involved: Bijan Aghevli (Deputy Director), who was already in charge of the program with Thailand, and the director of the department, Hubert Neiss. For obscure bureaucratic reasons, Aghevli and Kelly were designated as joint chiefs of the mission, but everyone involved understood that Aghevli was really in charge. When Neiss arrived for a few days in the middle of the negotiations, he supplanted both of the nominal chiefs.

Normally, the personalities of Fund officials at this level can be largely ignored for purposes of understanding interaction between the institution and the national authorities or the reasons for success or failure of Fund-supported programs. No individual is a mere cog in a wheel, but the intellectual discipline that the IMF imposes on its staff usually dominates ego and persona. That rule did not hold in the Indonesia crisis, owing to the intense public interest in the proceedings. Bijan Aghevli was an Iranian national who had left the Middle East in the early 1960s to study in the United States. After earning a Ph.D. in economics at Brown University, he joined the IMF staff in 1972 and rose rapidly through the ranks, mostly in the Asian Department. As a

⁵⁴Minutes of EBM/97/100 (October 8, 1997), pp. 4–6.

Figure 11.3. Indonesia: Exchange Rates, 1997–99

Sources: Information Notice System and International Financial Statistics.

negotiator, he came across as supremely self-confident and tough-minded, a trait that struck many Indonesians as akin to arrogance. Aghevli was nonetheless highly respected on both sides of the table. His style did not delay agreement on the program, though it does seem to have added to the tension in the early stages.

In appearance, Neiss was even more of a bulldog than Aghevli. Contemporary news accounts and subsequent literature often commented prominently on his trademark hairstyle, a kind of 1950s-era crisp flattop.⁵⁵ An Austrian national with a doctorate in economics from the Hochschule für Welthandel in Vienna, Neiss joined the IMF staff in 1967, spent two years in Jakarta (1974–76) as the Fund's Resident Representative, and was named Director of the Central Asian Department (a forerunner of APD) in 1991. By 1997, he had accumulated a wealth of experience as a negotiator in Asia, including on the initial stand-by arrangement with China in 1981, relations with the Philippines during the last years of Ferdinand Marcos's regime and the transition to democracy, the 1991 arrangement with India, and the Thai crisis in the summer of 1997. Almost from the moment he returned to Jakarta in the autumn, he became the public face of the IMF. Many Indonesians saw Neiss, in contrast to their view of Aghevli, as a listener. He met often with groups other than the negotiating team, including the press, parliamentarians, and students; and he clearly and patiently explained the issues as he saw them. He liked to go jogging in the parks of Jakarta and to

⁵⁵“With his distinctive shock of close-cropped vertical hair . . . he became the face of a faceless IMF” (*International Herald Tribune*); “distinctive spiky blonde [sic] hair” (*Dow Jones International News*); “. . . an economic disciplinarian for troubled countries, and with his flattop haircut and sober demeanor, he looked every bit the part” (Blustein, 2001, p. 1).

stop by the local markets to get a clear picture of economic conditions. He was widely recognized wherever he went, and he eventually came to be seen by many almost as a local hero: a positive and refreshing antidote to the increasingly corrupt and declining forces surrounding the Suharto regime.⁵⁶

Many other Fund officials also played prominent roles, including several staff from the Monetary and Exchange Affairs Department (MAE) as well as both Fischer and Camdessus. The MAE staff often worked concurrently with the main APD mission in Jakarta but functioned independently, primarily to advise on the restructuring of the financial system. Fischer was involved mostly in Washington, guiding and reviewing the staff work and speaking frequently by telephone with government and central bank officials in Jakarta. Jack Boorman (Director of PDR and a key advisor to management) had served as the Fund's Resident Representative in Jakarta in the mid-1970s, had visited the country regularly ever since, and knew many of the country's senior officials well. He was involved in nearly every management meeting throughout the crisis. Camdessus's participation was more episodic but no less crucial, especially his three meetings with Suharto (in November 1996, November 1997, and January 1998). As discussed below, the last of those meetings turned out to be a notable negative turning point for the program, the government, and the lasting impression of the IMF in Indonesia.

The initial negotiating mission worked in Jakarta from October 13 to the end of the month. Reaching agreement was not easy, in large part because Fischer and others at the IMF had become convinced that broader structural reform was not only possible but had become an essential part of the solution to the crisis. Even on the core element of reform—closing or merging the insolvent banks—the two sides were some distance apart on how extensive the required solution had to be. How many banks should be closed, and how much compensation should be given to “bail out” the owners (who included Suharto's children)? Less central proposals, such as that the government scrap plans to produce and market automobiles (generally known as the “national car project”) and that the major agricultural monopolies be broken up, provoked even more contention and were set aside temporarily. Of more immediate concern, the Fund was insisting that Bank Indonesia sharply raise short-term interest rates, a move that Soedradjad and others feared would destroy the country's fragile banking system.

The IMF did not initiate the bulk of the structural reform agenda. Much of the drive for deep reform and many of the specific ideas about what had to be reformed came from the Indonesian reformers with whom the IMF team was in regular contact, both in Jakarta and in Washington. Once the Fund's senior management became convinced that the Indonesians themselves wanted strong action, the role of the Fund staff was to press for the reforms as part of the conditionality for the stand-by arrangement.

⁵⁶This positive impression did not extend to all Asian countries where Neiss led program negotiations. In some cases he was seen as the recognizable face of a much disliked foreign agency.

Within days of the start of the October mission, it became apparent that support for structural change was held only narrowly within the government and that no agreement would be reached unless Suharto himself could be persuaded to endorse it. That induced Neiss to join the fray for the first time, and he flew to Jakarta for a direct meeting with Suharto on October 21. Neiss reported back that the meeting with the president had been friendly, but that it might be necessary for Camdessus to get involved as well. The Managing Director did not do so directly at this time, but a telephone call to Mar'ie from Lawrence Summers (then under secretary of the U.S. Treasury) that seemed to imply a promise of substantial backup financial support from the United States helped to generate new forward momentum.⁵⁷

As October drew to a close, the structural agenda to be implemented right away was narrowed to the banking sector. On October 29, Aghevli agreed to the authorities' counterproposal to close just 16 banks immediately, including two that were prominently linked to members of Suharto's family. The 10 others identified as insolvent would remain open for the time being but would receive only limited short-term liquidity support from the central bank. Fischer agreed, and the next day Mar'ie and Soedradjad signed a Letter of Intent spelling out the program—including the bank closings, a tightening of fiscal policy, a phased-in liberalization of foreign trade and payments, and the maintenance for the time being of high interest rates—to be implemented with support from the IMF.⁵⁸

Camdessus quickly issued a public statement of praise and support that spelled out both the “impressive,” “strong,” and “ambitious” policy measures to be taken and the “substantial” financial assistance being offered in exchange by the international community. The headline figure for the total financial package was “a first line of financing of the order of US\$23 billion,”⁵⁹ but the makeup and availability of its components were remarkably varied and in fact amounted to rather less than the headline suggested:

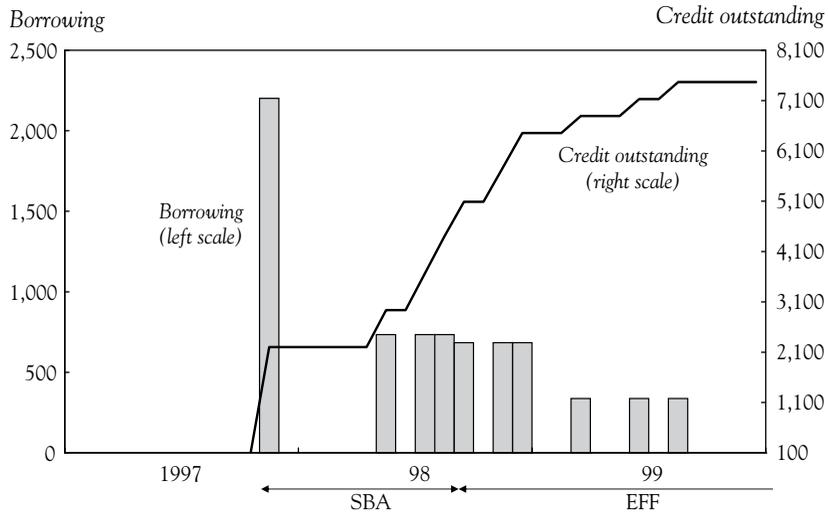
- The IMF was providing a three-year stand-by arrangement in the amount of \$10 billion (SDR 7.3 billion, or 490 percent of Indonesia's quota), of which \$3 billion would be available as soon as the Executive Board approved the arrangement a few days later (Figure 11.4). Some \$4 billion more could be disbursed during 1998 if the program was implemented as planned, and the rest would become available in 1999–2000.
- The World Bank and the AsDB had indicated their intention to provide \$4.5 and \$3.5 billion, respectively, in loans and related assistance. The terms for this assistance were still being discussed.

⁵⁷See notes by Fischer on a telephone call with Mar'ie (October 27, 1997); IMF archives, Accession No. 2000-0117-0005, B22263, DMD-AI (Fischer), “Indonesia (II).”

⁵⁸“Indonesia—Request for Stand-By Arrangement,” EBS/97/195, Suppl. 1 (November 1, 1997).

⁵⁹“Camdessus Commends Indonesian Actions,” NB/97/22 (October 31, 1997); accessed at <http://www.imf.org/external/np/sec/nb/1997/nb9722.htm>.

Figure 11.4. Indonesia: Use of Fund Credit, 1997–99
 (In millions of SDRs, monthly data)



Source: International Financial Statistics.
 Note: EFF = Extended Fund Facility; SBA = Stand-by arrangement.

- The sources for the remaining \$5 billion were unspecified, except for “the use of part of Indonesia’s own substantial external assets.” That phrase meant that the terms of the stand-by arrangement with the IMF allowed Indonesia to draw down its foreign exchange reserves by approximately that amount if necessary.⁶⁰

Through 1998, then, the total specified “first line” of external assistance was about \$15 billion, subject to further negotiation and implementation. In addition, several countries and monetary authorities—Australia, China, Hong Kong SAR, Japan, Malaysia, Singapore, and the United States—agreed in principle to provide a *second* line of defense “in the event of unanticipated adverse external circumstances.” Although none of that second line was ever provided in the form of medium- or longer-term financing, the agreement for it was followed quickly by coordinated large-scale intervention by Bank Indonesia, the Bank of Japan, and the Monetary Authority of Singapore to support the rupiah in the early days of the program.

⁶⁰Soedradjad (2005) pp. 85–88, explains that the basis for this unusual specification was that Bank Indonesia used a more conservative accounting method than the IMF for computing its reserve holdings. By converting to the standard international accounting, Bank Indonesia could spend up to \$5 billion from its own holdings without reducing its reported reserves. As head of the central bank, Soedradjad preferred to adhere to the conservative accounting principle, and he found the Fund’s advice on this point to be “strange, to say the least” (pp. 85–86).

Even before the Executive Board met on November 5 to ratify the stand-by arrangement, the weaknesses of the program began to emerge. The fundamental problem was that the bank restructuring plan was not going to restore confidence in the banking system. Deposits in the 16 banks being closed were mostly uninsured, and the plan offered a guarantee for repayment only up to 20 million rupiah (then worth about \$5,000). Everyone with deposits in the domestic banks remaining open had to reassess the risk of losing those deposits. Moreover, it was obvious that a significant number of the still-open banks were not very far from meeting the same fate. The classic conditions for a run on the banking system were building rapidly.

Why did the program not incorporate a comprehensive guarantee on bank deposits, along the lines of the agreement in Thailand just two months earlier? As noted above (p. 507), the highly controversial idea had been agreed to for Thailand only after a lengthy internal debate that had never been fully settled. This time, the case for using scarce government money to bail out people who had deposited large sums in banks with political connections and unsound balance sheets seemed even less persuasive, and those who saw it as giving rise to moral hazard were able to carry the day. The case for a guarantee was also weakened by the government's willingness to close the worst banks right away, in the hope that bold action to take the bad apples out of the basket would prevent the others from catching the rot. Because the closed banks accounted for only about 3 percent of total deposits, the Fund mission concluded that a systemic run was unlikely. Regardless of the merits these arguments may have had at the time, the negative effects of the decision on confidence soon became apparent.

The decision not to offer a more general guarantee attracted extensive analysis and substantial criticism in the aftermath of the crisis. In an internal confidential report, the Fund staff acknowledged at the beginning of January 1998 that the determination to close 16 banks without a guarantee on deposits in other banks had led to a "flight to safety," not only into state banks where many believed an implicit guarantee from the government would protect them, but also out of the banking system altogether. As a consequence, the government was already considering additional guarantees (above the 20 million rupiah limit) as a way to "improve confidence in the banking system." That internal report was leaked to the press almost immediately, and a front-page story on it in the *New York Times* generated further consternation both in Jakarta and abroad.⁶¹ Subsequently, Radelet and Sachs (1998, pp. 62–63) called the decision "egregious" because it left large depositors "unprotected." Grenville (2004, p. 82) argued that the limited guarantee "was no help in limiting runs on banks that remained open."

The IMF's Independent Evaluation Office took a more nuanced position, noting that "the concept of a partial guarantee was entirely reasonable in a corrupt banking system" and concluding that "the most damaging aspect . . . was not the nature of the guarantee itself, but the lack [of] a well-communicated, comprehensive strategy to deal

⁶¹"Indonesia—Stand-By Arrangement—Review under the Emergency Financing Procedures," EBS/98/2 (January 7, 1998), pp. 12–15; and Sanger (1998).

with problem banks” (Independent Evaluation Office, 2003, p. 85). Soedradjad (2005, pp. 117–25) provided a detailed defense of the handling of guarantees, and McLeod (2004) argued that it was appropriate to force bank depositors, not taxpayers, to bear the brunt of the cost of systemic failures. In any event, the requirements for restoring investor confidence in the middle of a financial crisis lie well outside the bounds of economics and may be impossible to judge correctly in advance (see Boughton, 2006).

Indonesia’s implementation of the program was spotty and confused, especially on monetary policy. Interest rates rose sharply in early November, at least partly as a result of foreign exchange intervention and the withdrawal of liquidity through the bank closings rather than a deliberate move to tighten policy. On November 12, Camdessus stopped in Jakarta as part of a regional trip and met privately with Suharto. For Camdessus, the key outcome of the meeting was an assurance by the president that he remained willing to undertake difficult structural reforms even if they adversely affected members of his own family. For Suharto, the main outcome seems to have been a perception that the IMF would not object if interest rates were allowed to drop to reverse the recent increases. Almost immediately after this meeting, Suharto met with his cabinet and instructed Soedradjad to lower interest rates by five percentage points across the board.⁶² A week later, however, under renewed pressure from the Fund, Bank Indonesia again raised rates fairly sharply.⁶³

In the middle of this confusion, which had completely undone the initial strengthening of the rupiah that followed announcement of IMF support, Suharto tried to calm financial markets by announcing that no more banks would be closed. He then left the country to attend the annual summit meeting of the Asia-Pacific Economic Cooperation forum in Vancouver, Canada, where U.S. President Bill Clinton urged him to implement the IMF-supported program fully. Separately, Summers met with Widjojo in Vancouver and expressed concern about the easing of monetary conditions. Shortly after they returned to Jakarta, however, the technical issues were overshadowed by rumors that Suharto had suffered a heart attack or a stroke. Certainly the president was taken seriously ill, and he did not appear in public for the next two weeks, during which time the rupiah lost about a third of its value against the U.S. dollar. Suharto had been a strong and dominant political force for more than two decades, enabling him to preserve a kind of truce between the indigenous Javanese populace and the ethnic Chinese community that figured prominently in business affairs in Jakarta.

⁶²Memorandum from Aghevli to the Managing Director, “Indonesia—Progress in Program Implementation” (November 25, 1997); IMF archives, Accession No. 2000-0117-0005, DMD-AI (Fischer), B22263, “Indonesia (III).” Also see Soedradjad (2001), p. 9.

⁶³The staff was divided on the critical issue of what advice to give Indonesia on interest rate policy. In discussions with the authorities, Aghevli was a consistent and forceful advocate of reversing the mid-November rate cut, but only because he was pressured in that direction by Fund management and the U.S. authorities. On this point, the account in Blustein (2001) p. 114, is corroborated by senior staff who were involved in these deliberations.

If Suharto was gravely ill, many feared this calm could be shattered and they began transferring liquid assets out of the country.⁶⁴

By this time (mid-December), the Indonesian policy apparatus was immobilized and in complete disarray. The massive capital flight driving down the rupiah was just the most obvious bellwether for a situation that was rapidly escalating from a financial crisis into one with broad economic and political consequences. The benign assumptions about the rupiah's value and economic activity that had underpinned the program in October no longer applied, and the likelihood that the policies in the lending program would be implemented were minimal. To resolve the crisis would require a fresh start in the new year.

Rush to Resume: January 1998

To restart the program and revive investors' confidence in the government's ability to manage the economy, Camdessus agreed to send a staff mission back to Jakarta in early January and to go there himself to meet directly with Suharto. Karin Lissakers (United States) then asked for a formal discussion by the Executive Board so that staff and management would have the unambiguous and full backing of the Board behind them as they tried to persuade Suharto to strengthen and carry out the reform program. A Board discussion was hastily arranged for January 8 in restricted session. Camdessus informed Directors that he would insist—as a condition for continuing support from the IMF and other official creditors—on an unusually strong and comprehensive set of actions led personally by the president. The Board agreed to this approach, and that evening the Fund issued a press release announcing that a mission would soon be on its way.⁶⁵

Aghevli and his team arrived in Jakarta on January 11, formally to conduct the first review of the stand-by arrangement. His task—convincing a proud but declining president to act forcefully in the long-run interests of his country and against strong resistance from his own family and close associates—was daunting, but he was not alone in attempting it. Fischer joined Aghevli for the first few days, and Camdessus was scheduled to arrive on the fourteenth. In the days surrounding the arrival of the Fund mission, Suharto also received urgent telephone calls from Clinton, German Chancellor Helmut Kohl, Japanese Prime Minister Ryutaro Hashimoto, and other world leaders, urging him to reach an early agreement with the IMF on the reform agenda (Blustein,

⁶⁴For a statistical analysis of the effect of rumors about Suharto's health on financial markets in Indonesia, see Fisman (2001).

⁶⁵"IMF Team to Visit Indonesia to Assess Developments," NB/98/1 (January 8, 1998); accessed at <https://www.imf.org/external/np/sec/nb/1998/nb9801.htm>.

2001, pp. 207–09; and Rubin and Weisberg, 2003, p. 245).⁶⁶ Paul Volcker, the former chairman of the U.S. Federal Reserve System, flew to Jakarta and met with Suharto on the same day that Aghevli and Fischer arrived. Those efforts were followed in close order by visits from Summers (who delivered a personal message from Clinton to Suharto); from the principal finance deputies from most of the other Group of Seven (G7) countries; from Horst Köhler (formerly Germany's finance deputy, then the president of the German Savings Bank Association) as a special envoy from Kohl; and from the prime minister of Singapore, Goh Chok Tong.

The extraordinary outcome of all of this external pressure was that Suharto decided he could no longer trust his economic team to negotiate with the IMF, and he effectively took personal charge of the process. If agreement was to be reached, it would be the president who would decide. Instead of the outcome being the usual Letter of Intent (LOI) signed by the minister of finance and the central bank governor (Mar'ie and Soedradjad), Suharto would take full responsibility and sign it himself.

On Monday morning, January 12, the Fund mission was informed that Suharto wanted to see a draft LOI by midday on Tuesday. That generated some hope but also not a little panic given that no such draft yet existed. The staff stayed up all night working in their hotel rooms and managed to produce a 25-page document spelling out the full proposed reform agenda in detail.⁶⁷ It called for a balanced government budget at an assumed exchange rate of 5,000 rupiah to the dollar (the rate was then about 7,200, but everyone involved believed it was undervalued owing to market overreactions). More fundamentally, it called for several major monopolies, including the marketing boards for cloves and vanilla, to be dismantled by February 1. That requirement constituted an atypical level of micromanagement by the IMF, but Indonesian technocrats were pushing for it, and Fischer and others in the Fund believed it was necessary if the authorities were to demonstrate a commitment to strengthening economic governance. The structural reform program, much of which was formulated by the World Bank staff in Jakarta, also included a long list of detailed policy changes such as increases in fuel and electricity prices, increases in sales and excise taxes, a broadening of the base for value-added taxes, cancellations of the development of the national

⁶⁶After the United States, Japan was the most intensively interested and involved country. The Japanese government disagreed with much of the structure of the Fund-supported program, including the initial decision to close commercial banks and the later decision to dismantle monopolies, but it still supported the Fund's role in resolving the crisis.

⁶⁷The LOI itself—the document to be signed by the president—was just a short four-paragraph letter addressed to the Managing Director. The detailed program was described in a 51-paragraph attachment to the LOI, the Memorandum of Economic and Financial Policies (MEFP). For simplicity, and following standard usage, the letter and the memorandum together are referred to here as the LOI.

car project and several major infrastructure projects, strengthening of the social safety net to protect the poor, and an intensification of environmental regulations.⁶⁸

Fischer sent the draft LOI to Suharto at 2:00 p.m. on Tuesday, and he then met the president at his home for 90 minutes that evening to go through the draft page by page. Suharto agreed to the full agenda, but Fischer left with the impression that the president did not fully grasp the extent of what the Fund was asking. In any case, the next step was to refine the LOI and have it in final form to hand to Camdessus when the Managing Director arrived in Jakarta Thursday morning. Separately, Fischer now proposed that the Fund reverse course on the issue of guaranteeing bank deposits.⁶⁹ As part of a comprehensive restructuring of the banking system, Indonesia should offer a full guarantee on deposits, which now appeared to be the only way to stop the ongoing run on the banks that were still open. Formulating the guarantee would take some time, so it was not part of the formal conditionality associated with the January review, but the process was now in motion.

Camdessus arrived on schedule on Thursday, January 14. That evening he and Suharto met privately for more than two hours and reviewed the final LOI item by item in all its detail. Suharto not only agreed to the program—he informed Camdessus that his family had also reviewed it and did not object. Camdessus already knew the economic team was strongly behind the reform plans. There now seemed to be no serious impediment to full national ownership of the program.

The next morning, Suharto and Camdessus met again at 7:30 to go over the LOI one more time before the public signing ceremony. The president reaffirmed his support, and at 10:00 a.m. the two appeared together before the television cameras at the presidential palace. Suharto took his seat alone at the table, while Camdessus moved over to one side where he had no choice but to stand awkwardly and watch Suharto sign the document setting out the government's program. For the moment, it seemed like a diplomatic triumph and a decisive step toward resolving the Indonesian crisis.

Almost immediately, the whole effort unraveled. Throughout the week leading up to the signing ceremony, newspapers in Indonesia and around the world had been replete with stories about the discontent of world political leaders with Suharto's reluctance to follow the IMF's policy advice. Now that Suharto had seemingly reversed course, the general reaction was that he had done so under duress rather than willingly, and his insistence on signing the LOI personally and publicly had only reinforced that impression. In the press reports on the ceremony, the dominant image was of Camdessus standing with his arms folded while Suharto bent closely over his desk to sign a

⁶⁸See memorandum sent by fax from Aghevli (in Jakarta) to Fischer (in Washington), "Indonesia: Letter of Intent and MEFP" (January 15, 1998); and e-mail from Josh Felman (also in Jakarta) to Fischer, "Indonesia" (January 15, 1998); both in IMF archives, Accession No. 2001-0284, Box 6, OMD/DMD (Fischer). For the signed LOI (in Bahasa Indonesia, with an English translation), see IMF archives, APD/AI, Neiss collection, Accession 2005-0681-03.

⁶⁹Memorandum from Fischer to Aghevli, "Indonesia—Options for Restoring Banking Sector Stability" (January 16, 1998); IMF archives, OMD (Fischer), Accession 2001-0284, Box 6, "Indonesia (1) – 1998."

document that had essentially been dictated by the IMF. For months and even years afterward, these photographs were reprinted or described with Camdessus characterized variously as “smug,” “grinning,” “imperious,” “triumphalist,” a “schoolmaster,” and even an “angry father,” watching over a “humble” and even “desperate” Suharto. Indonesia’s centuries under colonial rule had ended more than half a century earlier, but memories ran deep, and a news photograph is a powerful image.

Perhaps in response to being perceived almost as a lackey of the IMF, perhaps in response to pressure from within his inner circle, perhaps because the rupiah continued to depreciate after the signing ceremony, or perhaps because he never intended to carry out the program—for reasons known only to himself—Suharto almost immediately undercut the implementation of the promises in the LOI. Privately, he informed his cabinet and other aides that it was not necessary to implement the program fully, and he likened his apparent approval of it to the guerrilla warfare he had practiced against the Dutch many years earlier. When Clinton and other world leaders called to press him to carry out the program, he told them bluntly that the IMF’s advice was not working and that he wanted to find an alternative plan. Publicly, he let it be known that he intended to select Bucharuddin Jusuf Habibie to be his vice president following elections in March. Because Habibie was widely regarded as opposed to economic reform, this tactic further undermined confidence and engendered an even further decline in the exchange value of the rupiah.⁷⁰

Meanwhile, the IMF financial experts in Jakarta, led by Charles Enoch (Division Chief, MAE), were hard at work devising a plan to restructure the banking system and implement the comprehensive guarantee on bank deposits. An essential element in that plan was the establishment of the Indonesian Bank Restructuring Agency (IBRA), which was to take control of the troubled banks and sell them to new investors with the means to revive them. Other Fund staff were devising a plan for restructuring corporate foreign debt, which involved first getting corporations and their external creditors to agree on debt relief, and then having the government subsidize the repayments. Despite these efforts, with the exchange rate approaching 13,000 rupiahs per dollar in late January—an 80 percent depreciation from the precrisis level—the prospects for escaping the crisis were growing dimmer by the day.

In desperation, Suharto decided to try the economic equivalent of alternative medicine. In late January, he allowed one of his daughters to invite Professor Steve H. Hanke of Johns Hopkins University (Baltimore, Maryland, United States) to Jakarta to discuss Hanke’s proposal for establishing a currency board as a way to stabilize the rupiah.⁷¹ Hanke met with Suharto in early February and then presented his proposal

⁷⁰On these developments, see Kenward (2002), pp. 67–68; and Soedradjad (2005), p. 163.

⁷¹A currency board is “a monetary regime based on an explicit legislative commitment to exchange domestic currency [for foreign currency] at a fixed exchange rate, combined with restrictions on the issuing authority—the currency board—to ensure the fulfillment of its legal obligation” (Baliño and Enoch, 1997, pp. 1–2). For an overview of the history of currency boards and the IMF’s views on them, see Chapter 1, pp. 26–27.



President Suharto (right) greets Camdessus at his home in Jakarta, January 14, 1998. (Reuters photo)

to government and central bank officials. Although few if any of those officials were impressed by the plan,⁷² Suharto's inner circle of family and close associates continued to press for it. Initially, the IMF staff declined to take the currency board proposal seriously, but once they realized it might be taken up by the Suharto family they took a closer look and concluded it would quickly lead to disaster.

The program signed by Suharto on January 15 assumed that a restoration of investor confidence would stabilize the rupiah fairly quickly. Although the rate at which it might stabilize was not spelled out, the staff projections were predicated on a restoration of the rate to what was then considered to be a more normal level. The rupiah had traded at a rate of about 5,000 to the dollar for a while in late December, but the

⁷²Soedradjad (2001) dismissed the proposal as having come from a "shady professor." In interviews for this book, no Indonesian official acknowledged having taken the idea seriously at the time. For an internal account of the debate, see Soedradjad (2005), pp. 187–96. Within the IMF, the only senior official to argue in favor of a currency board for Indonesia was Michael Deppler (Director, European I Department), who had been impressed by the success of a similar policy in Bulgaria earlier in the year (see Chapter 6). Kenward (2002) pp. 75–78, discusses the issue from the perspective of a staff member in the World Bank's Jakarta office at the time. Also see Radelet (2000), pp. 57–58. For Hanke's own account, see Culp, Hanke, and Miller (1999).



Camdessus (left) observes Suharto signing the Letter of Intent, January 15, 1998. (Reuters photo)

assumption that it might return to that range had become increasingly unrealistic as the traumas of January unfolded.

The continuing depreciation of the rupiah posed a real dilemma for the proposed currency board. To be effective, the board would have to back up the monetary base (currency and bank reserves) with an equivalent amount of foreign exchange reserves. The ratio of domestic money to reserves depends on the exchange rate. Bank Indonesia's foreign exchange reserves were barely adequate to cover base money at an exchange rate near 5,000, and that would have left nothing to cope with the projected deficit in the balance of payments or the large amount of external debt that was falling due in 1998.⁷³ If establishment of a currency board quickly restored credibility and confidence, then tying up the whole stock of reserves in this manner might not be a problem, but the prospects for that degree of success looked dim in the chaos that gripped Indonesia in February 1998. The observation that wealthy and powerful members of Suharto's own family had been among those most eager to move their money

⁷³On February 9, according to a report in the next day's *Wall Street Journal*, Suharto announced his intention to peg the exchange rate at 5,500 per U.S. dollar. Also see Blustein (2001) p. 222, based on the same report. The staff then calculated that a currency board would require more than \$40 billion in reserves to sustain that exchange rate, given the other expected demands on reserves. At that time, Bank Indonesia held \$14.5 billion in reserves; see unsigned note in IMF archives; Accession 2001-0284, Box 6, OMD-DMD (Fischer), "Indonesia 1998 (1),"

out of the country and were also the strongest proponents of the currency board did little to instill confidence that the proposal made any sense.

Camdessus was distressed at the possibility that Suharto might proceed unilaterally to establish a currency board and completely undermine any possibility of restoring stability or reviving the Fund-supported program. On February 11, he gambled that he could dissuade the president from that course by sending him a personal letter implying that a resumption of IMF support depended on his abandoning the currency board proposal. "I believe strongly," he wrote, "that such a move is inappropriate in Indonesia's current circumstances." The same day, Aghevli circulated a note to the authorities setting out the IMF staff's objections in more detail, and two days later P.R. Narvekar, a former Deputy Managing Director of the IMF who had just arrived in Jakarta to serve as a liaison between Camdessus and the president, met with Suharto to try to work out an acceptable forward course.⁷⁴ To help resolve the impasse, in public the Fund maintained a generally neutral stance on the currency board issue.⁷⁵

Clinton also called Suharto again to urge him to implement the program he had signed in January, but Suharto reportedly told him that the IMF-supported program had failed and that if the U.S. government did not like the currency board plan, it should propose an alternative. Shortly afterward, Gordon Brown, the British chancellor of the exchequer, issued a statement on behalf of the finance ministers of the European Union, saying that the currency board proposal was "premature."⁷⁶ In early March, Clinton sent former U.S. Vice President Walter F. Mondale to Jakarta to tell Suharto once again that the currency board proposal was a bad idea in Indonesia's current circumstances.

Indeed, with the collapse of the rupiah rendering both the IMF-supported program and the currency board proposal unworkable, the complete disintegration of the Indonesian economy appeared to be inescapable. Under more normal circumstances, the January 15 LOI would have been submitted to the Fund's Executive Board as the basis for releasing another \$3 billion under the stand-by arrangement in the middle of March. Instead, it was held back and ultimately was never circulated. The fanfare and high hopes of January were but a faded memory.

⁷⁴For the letter and the staff note, see IMF archives, Accession 2001-0284, Box 6, OMD-DMD (Fischer), "Indonesia 1998 (1)."

⁷⁵At a news conference on another matter in Washington on March 10, reporters asked Fischer repeatedly about the consequences if Indonesia should adopt a currency board regime. After trying to duck the question a few times, Fischer replied, "We haven't changed our view that if pre-conditions were met, a currency board could work in Indonesia"; transcript, UNDOC/98/54 (March 12, 1998), p. 6.

⁷⁶In response to a request from Suharto, Narvekar spent several weeks in Jakarta, with the title Special Advisor to the President of Indonesia and Senior Consultant to the Managing Director of the IMF. On Clinton's telephone call and Brown's press release, see Blustein and Richburg (1998), p. D1.

The End of the Indonesian Crisis: April to June 1998

As a first step toward reviving the program, Fischer and Neiss privately urged the U.S. government to take the lead in providing stronger political and financial backing to Indonesia. In their view, that would restore credibility to Suharto and enable him to regain the domestic support he would need to carry out the program.⁷⁷ Unfortunately, Suharto was still flailing around in search of a quick fix. He soon abandoned the currency board idea, but he decided on his own to fully compensate all creditors of the 16 banks that had been closed in November; he abruptly replaced the governor of Bank Indonesia; and he toyed with imposing a multiple currency scheme that would have placed Indonesia in violation of the IMF Articles of Agreement.

In these circumstances, the United States was not about to offer money to Indonesia, nor to support lending by the IMF. U.S. Treasury officials were becoming convinced that Suharto would not reform economic policy and that a recovery now depended on his removing himself from office. That alarmed the Australian government, which had much closer links to Indonesia than the United States did and which already believed the IMF program would “tear apart the social fabric” of Indonesia by insisting on far-reaching economic reforms.⁷⁸ Over the next few weeks, the Australian foreign minister, treasurer, and governor of the central bank all went to Washington to try to persuade their U.S. counterparts that Suharto still deserved their support and that of the IMF, to no avail. They also tried to persuade Camdessus that the IMF was insisting on excessive austerity and excessive structural reform as conditions for reviving the program, also to no avail.⁷⁹

On March 10, the People’s Consultative Assembly of Indonesia reelected Suharto to a seventh five-year term as president. Suharto then appointed a new cabinet that excluded most of the reformers and replaced them with several of his own associates who were generally regarded as presidential cronies. He nonetheless renewed his commitment to working with the IMF, apparently deciding to give the conventional approach one more try. To that end, he elevated the highly respected planning minister, Ginandjar Kartasasmita, to the top economics position in the cabinet, the state coordinating minister for finance, industry, and development.

⁷⁷Memorandums from Fischer to the Managing Director, “Developments in your absence—mainly Indonesia,” (February 11, 1998); and from Neiss to the Managing Director, “Indonesia” (February 16, 1998); both in IMF archives, Accession 2001-0284, Box 28263, OMD-DMD (Fischer), “Indonesia 1998 (1).”

⁷⁸Remarks to news reporters by the Australian foreign minister, Alexander Downer; quoted in Taylor (1998).

⁷⁹Blustein (2001) pp. 227–30, discusses the shift away from Suharto within the U.S. government. Information on the Australian effort is from interviews for this book and contemporaneous news reports. For an overview of the Australian objections to the IMF program for Indonesia, see Grenville (2004).

Though Fischer acknowledged privately that he was hoping for a miracle, he sent Neiss and three separate mission teams (from APD, MAE, and the Legal Department) back to Jakarta to resume negotiations on March 16. At the same time, three senior G7 finance officials—David Lipton (United States), Eisuke Sakakibara (Japan), and Klaus Regling (Germany)—arrived simultaneously to oversee the process.⁸⁰ Working as a team (the local press dubbed them the “three musketeers”), they quickly convinced the government to raise interest rates, in part by promising that the World Bank would help protect small enterprises from the worst effects.

Neiss’s mission succeeded in negotiating a new program, and Ginandjar signed a new LOI on April 10.⁸¹ The revised program reflected the serious deterioration in economic conditions since mid-January and called accordingly for a larger fiscal deficit to be financed by larger official financing from the AsDB, the World Bank, and creditor countries. In return, the IMF insisted on completion of 20 steps before it would release any more financing, covering a range of actions from standard macroeconomics to detailed structural policies (e.g., “provide historical data on the accounts of the Reforestation Fund”). The Fund also decided to switch from the usual quarterly monitoring and disbursing schedule to monthly reviews, as it was already doing with Russia (Chapter 7, p. 307). Prior actions were duly completed, and the Executive Board meeting was set for May 4.

The policy program, on which billions of dollars of external financing from the IMF and other official creditors would depend, was daunting. The program included the standard quantitative performance criteria that set maximum values for the net domestic assets of Bank Indonesia and the fiscal deficit of the central government, a floor on net international reserves, indicative ceilings on the growth of base money and the amount of liquidity support that Bank Indonesia could offer to banks, and ceilings on the contracting or guaranteeing of new external debt with a subceiling on the stock of short-term debt. In addition, the LOI included the 20 prior actions mentioned above and a seven-page table listing 114 “structural policy commitments” to be carried out during the life of the program. Completion of these commitments would constitute nothing less than a revolution and would transform the Indonesian economy from one based on monopolies, personal relationships, and rent-seeking to one of open markets and transparent policy making.

One measure that the Fund had intended to be a prior action was a sharp increase in fuel and electricity prices, a step essential for getting the budget deficit under control. Ginandjar agreed that the increases were necessary, but he pleaded successfully

⁸⁰In the same vein, two days before the arrival of the IMF mission, Japanese Prime Minister Hashimoto went to Jakarta for a two-and-a-half-hour meeting with Suharto, during which he urged Suharto to adhere to the Fund-supported program; see “Press Conference by the Press Secretary March 17 1998,” accessed on the website of the Japanese ministry of finance, <http://www.mofa.go.jp/announce/press/1998/3/317.html#C>.

⁸¹“Indonesia—First Review under the Stand-by Arrangement—Letter of Intent,” EBS/98/73 (April 10, 1998).

with Neiss that they should wait until schools and universities were in recess and the inevitable protests would be dissipated. Consequently, the price increases were reformulated as an end-June performance criterion on which the next disbursement would depend.⁸²

Inexplicably, Suharto personally decided to announce the unpopular price increases early, the day before the Executive Board was to meet to complete the program review.⁸³ Either he underestimated the outcry that would follow, or he assumed that by linking the announcement to the timing of the Board meeting he could redirect the public's anger from himself to the IMF. Either way, it was a disastrous misjudgment. Throughout the next week, protests by students and their supporters in Jakarta were directed squarely at Suharto and the corruption that surrounded him. The riots increased in size and intensity until police opened fire on May 12 and killed several protesters. Most of Suharto's key ministers resigned. As the riots and the recriminations continued, the IMF staff were forced to evacuate their offices at Bank Indonesia and leave the country in a specially chartered plane for Singapore. By May 20, Suharto had mobilized 150,000 troops to quell the demonstrations, but the unrest persisted. That evening, Madeleine Albright, the U.S. secretary of state, publicly called on Suharto to "preserve his legacy" by undertaking an "historic act of statesmanship" and resigning. The next day he did so, turning over the presidency to Habibie.

As this drama was beginning to unfold, the Executive Board met as scheduled on May 4 and approved the immediate disbursement of nearly \$1 billion (SDR 773.8 million) to Indonesia. Although no one abstained or voted against the request, Directors were severely divided between those from developing countries who thought the Fund was injecting itself much too deeply into micromanaging Indonesia's structural policies and those from the main creditor countries who were highly skeptical of the government's willingness or ability to reform and carry out the program. Lissakers was particularly outspoken. She called on the staff to ensure that by the next monthly review, they would see "progress on establishing a review committee" for the bank restructuring agency; and "unambiguous evidence" that the monopolies on marketing cloves, palm oil, and other commodities were being dismantled and that these markets were being opened to foreign investors. She also decried "Indonesia's . . . lack of respect . . . for human rights," which "weakens support for the program and reduces the likelihood of success. . . . Attempts to bottle up the growing aspirations of the Indonesian people for political reform could well produce an explosion that would demolish the economic program."⁸⁴

⁸²"Indonesia—First Review under the Stand-by Arrangement—Letter of Intent," EBS/98/73 (April 10, 1998), p. 20.

⁸³On the calendar, Suharto's announcement in Jakarta and the Board meeting in Washington both took place on May 4. On Washington time, the announcement came a day earlier.

⁸⁴Minutes of EBM/98/51 (May 4, 1998), pp. 19–21.

The IMF made no secret of the fact that it was supporting Suharto with great reluctance. In a press briefing right after the Board meeting, Fischer was asked how the IMF might respond if there were a “brutal crackdown on demonstrations.” Fischer declined to speculate, but he noted that “there are cases where governments [IMF members] will decide, as they have in this one, that they would rather try to work with the government concerned to change the way it behaves.” Some two and a half years later, on the day that Camdessus announced that he was resigning as Managing Director, he admitted to an interviewer that the IMF had “created the conditions that obliged President Suharto to leave his job,” although “that was not our intention.”⁸⁵

Suharto’s resignation did not end the political uncertainty or the economic chaos that had paralyzed policymaking for half a year, but neither did it derail the Fund-supported program. The staff continued to work closely with Ginandjar and the economic team, who continued in office under Habibie, to restructure the external debt of the corporate sector; revitalize the banking system; secure additional external official financing and a rescheduling of debt to Paris Club creditors; and provide technical assistance on tax reform, monetary and balance of payments statistics, and other issues.

In mid-June, the rupiah finally hit bottom, at an exchange rate of 16,650 to the dollar—an almost unimaginable 85 percent depreciation since a year earlier. From that point on, matters gradually improved on most fronts. The IMF disbursed another \$1 billion in July and raised the total commitment under the stand-by arrangement by about \$1.3 billion (SDR 1 billion, to a total of SDR 8.3 billion). In August, it disbursed another \$1 billion and replaced the stand-by with an extended arrangement for the remaining balance so that Indonesia could repay the loans over a longer period.

The financial crisis was at an end. Indonesia continued to experience both political and economic setbacks, but by the end of 1998 the rupiah had recovered to about 8,000 to the dollar, and in 1999 output began to recover despite a major banking scandal and a violent conflict over independence in East Timor. The situation in East Timor led to a temporary suspension of IMF support under pressure from the United States and other concerned countries.⁸⁶ The conflict was eventually resolved, and by

⁸⁵For Fischer’s remarks, see *IMF Survey*, Vol. 27, No. 9 (May 11, 1998), p. 143; accessed at <http://www.imf.org/external/pubs/ft/survey/pdf/051198.pdf>. For Camdessus’s remark, see Sanger (1999), p. A1.

⁸⁶On September 10, 1999, the British Broadcasting Corporation quoted Neiss as saying that discussions with the Indonesian authorities were on hold pending a resolution of the crisis in East Timor. “The events in East Timor are first of all a large human tragedy, and the international community including the IMF cannot be indifferent to that An IMF program can only be successful if there is the necessary internal as well as external support to the efforts”; see “IMF Suspends Talks with Indonesia”; accessed at http://news.bbc.co.uk/1/hi/business/the_economy/1442969.stm. Clinton (2004) p. 869, refers obliquely to the U.S. pressure, noting that “At first the Indonesians were opposed to” an Australian plan to lead an international peacekeeping force in East Timor, “but soon they would be forced to relent.” Specifically, Clinton privately told Ginandjar that a resolution of the East Timor crisis was a precondition for a resumption of talks with the IMF.

the time the program ended in October 2000, Indonesia had borrowed just more than \$10 billion from the Fund (SDR 7.5 billion, or 90 percent of the augmented and extended arrangement and 359 percent of Indonesia's quota; see Figure 11.4). It began repaying the loans the following year, and the IMF approved a new EFF arrangement that enabled the country to smoothen and stretch out the amortization schedule. The economy continued to improve, and by 2006 Bank Indonesia had accumulated reserves sufficient to repay the remaining balance ahead of schedule.

The Debt Also Rises: The Republic of Korea

THE FUND HAS BEEN CALLED FOR A RESCUE BECAUSE WE HAVE FAILED TO DO OUR JOB TO take care of our own economy.

Kim Dae-Jung⁸⁷
President of the Republic of Korea
December 18, 1997

GOOD MEDICINE TASTES BITTER.

old Korean saying⁸⁸

Even more than Indonesia, Korea seemed—and should have been—a highly unlikely candidate for a financial crisis. Since 1980, when the government initiated a major economic adjustment program with help from the IMF, the annual growth of output per capita had averaged 7 percent, and any macroeconomic or structural imbalances had appeared to be moderate and under control. Korea hosted the IMF/World Bank Annual Meetings in 1985 and the Olympic Games in 1988. The government eliminated current account exchange restrictions in the late 1980s and increasingly allowed the exchange value of the won to be determined by market forces.⁸⁹ In the wake of this liberalization, economic performance strengthened even further, while inflation averaged just 5 percent a year. The central government budget was balanced or in surplus, the current account deficit was small and easily financed, and the exchange rate was stable.⁹⁰

Recognizing these achievements, in 1995 the World Bank “graduated” Korea from the status of a borrower. In the same year, Korea became an original member of the

⁸⁷Speech to the nation following his election as president on December 18, 1997; quoted in minutes of EBM/97/125 (December 19, 1997).

⁸⁸Quoted by Okyu Kwon (Alternate, Korea) at the Executive Board meeting of December 4, 1997.

⁸⁹For developments through the 1980s, see Boughton (2001), pp. 113–19.

⁹⁰For an overview of the Korean economy throughout the 1990s, including the crisis and recovery periods, see Chopra and others (2002) and Chung and Eichengreen (2004). For detailed accounts of the crisis by journalists who covered it, see Kirk (2000) and Blustein (2001).

World Trade Organization,⁹¹ and the government applied for membership in the Organization for Economic Cooperation and Development (OECD), which was granted a year later along with membership in the Bank for International Settlements. No longer just a developing country, Korea was reclassified by the IMF as an “advanced economy.”⁹² By 1997, Korea was the quintessential “Asian tiger” and the principal inspiration for the phenomenon the World Bank staff and others had called the “East Asian miracle.”

In this environment, the annual Article IV discussions with Korea were relaxed and positive in tone. The 1990 and 1991 missions found that macroeconomic policies were a bit lax and warned of the risk that the economy could be overheating. The authorities did not disagree, and by the time of the 1991 consultations, they were already tightening fiscal and monetary policy both. Subsequent missions continued to urge further fiscal restraint and advised the authorities to let the exchange rate appreciate more rapidly to help contain inflationary pressures. Nonetheless, even when the external current account began to shift back into deficit in 1996, neither the Fund nor the government was particularly concerned about macroeconomic stability.

Structural policies were more of an issue. Throughout the early 1990s, the IMF regularly urged the government to adopt a more market-oriented stance by reducing the government’s role in the economy and opening up the financial and external sectors. Although Korea was moving in that direction in small steps, the Fund was concerned that the approach was slow and piecemeal and thus much less effective than it should be. The authorities implicitly rejected this advice, partly because they felt the economy was doing better under its regime than it would under a more liberal approach, and partly because many other observers—including the World Bank—were praising their approach as a “miracle” that contrasted favorably both with pure market approaches and with traditional socialist regimes.⁹³

⁹¹Korea acceded to membership in the General Agreement on Tariffs and Trade in March 1967 and became a member of the WTO upon the organization’s establishment in January 1995.

⁹²In the spring of 1997, the IMF changed its classification of countries by replacing the “industrial country” group (23 countries) with an expanded group called “advanced economies.” Korea—formerly treated as a “newly industrializing” developing country—was placed in this new group along with Israel, Hong Kong (later Hong Kong SAR), Singapore, and Taiwan Province of China. This reclassification recognized these economies’ “relatively high income levels . . . , well-developed financial markets and high degrees of financial intermediation, and diversified economic structures with rapidly growing service sectors” (IMF, 1997, p. 118).

⁹³For the World Bank view, see World Bank (1993) and Stiglitz (1996). At the IMF, Stanley Fischer, among others, broadly endorsed this view (Fischer, 1996). Among independent analysts, Kim and Lau (1994), Krugman (1994), and Young (1995) explicitly or implicitly rejected the Bank’s (and others’) argument that well-directed government intervention was behind the high rate of growth in Asian countries. They argued instead that Asian growth rates fundamentally reflected those countries’ work ethics, rising education levels, and high national saving rates. Precrisis debate within Korea tended to be more nuanced than the external debate, with most analysts seeing a mix of benefits and costs to the high level of government intervention in financial markets. See, for example, the papers by Won-Am Park and Sang-Woo Nam in Ito and Krueger (1996).

Two crucial structural issues during this benign period concerned liberalizing capital flows and the financial sector. Although much had been done in recent years, the staff concluded in 1996 that “Korea’s financial sector and capital account transactions remain subject to many regulations and government interventions, and further liberalization continues to be a key challenge for structural policies.”⁹⁴ In light of the nature of the subsequent crisis, the staff’s lack of focus in 1996 on prudential issues such as the level of nonperforming bank loans or currency and maturity mismatches—which the authorities were reporting to be under control—is striking. The emphasis rather was on the heavy regulation of interest rates, which was seen as producing an inflexible rate structure and inappropriately low rates.

On the capital account, the staff raised the point that the government had eased regulations on outflows of capital (allowing Korean residents and firms to buy foreign securities) by “far more” than on inflows (limiting the ability of nonresidents to buy Korean assets). Consequently, when the terms of trade moved against Korea in the mid-1990s in response to a large drop in semiconductor prices, the won was seen to be depreciating by more and for a longer period than the Fund staff thought healthy. The Fund accordingly advised Korea to accelerate the liberalization of capital inflows. None of these problems, however, received serious attention in Seoul or in Washington.⁹⁵

Before the Crisis: Secrets in Seoul

Korea’s economic performance deteriorated badly in the early months of 1997. A seminal event came on January 23, when Hanbo Steel Industry, Korea’s second largest producer of steel, declared bankruptcy. When investigations uncovered evidence of bribery and political pressures in connection with large bank loans that were intended to keep the company operating, confidence in the government’s economic management began to erode. A small staff team, led by Charles Adams (Division Chief, APD), arrived a few days after the Hanbo bankruptcy and initiated discussions on restructuring the financial sector. At this stage, however, few observers foresaw a systemic crisis in the banking system.⁹⁶

The staff began to take the problems in the banking sector more seriously in the course of an April mission from the Research Department, led by David Folkerts-Landau (Assistant Director of the department), as part of the standard preparation of the Fund’s annual report on developments in world capital markets. At this time, while

⁹⁴“Korea—Staff Report for the 1996 Article IV Consultation,” SM/96/262 (October 22, 1996), p. 18.

⁹⁵The main push to encourage Korea to liberalize capital flows came from the OECD, which required the country to comply with its Code of Liberalization of Capital Movements as a condition of membership; see OECD (2002) and Abdelal (2007), pp. 117–21.

⁹⁶See memorandum from Neiss to the Managing Director, “Korea—Staff Visit January 29–31, 1997” (February 3, 1997); IMF archives, DMD-AI (Fischer), Accession 2000-0117-0007, “Korea I.”

the government was reporting that banks' nonperforming loans comprised only about 1 percent of total loans, market participants believed that the real figure was about 20 percent and that the government was implicitly guaranteeing the bad loans as a way of bailing out weak companies off-budget.⁹⁷ Meeting with hedge fund managers in New York in February, Folkerts-Landau and his staff had learned that market participants were convinced that the won and the Korean equities market were overvalued, and that New York-based investors were worried about the solvency of potential counterparties in Korea.⁹⁸ The mission was instructed not to press the authorities on the sensitive issue of nonperforming bank loans, but Folkerts-Landau nonetheless concluded that the banking system was "experiencing a serious deterioration in its balance sheet." Although the problems were still manageable, the situation required a substantial and quick improvement in oversight and regulation that did not seem likely.⁹⁹

Overall, the staff continued to express confidence in Korea's economic management and prospects. When newspapers began reporting in May that foreign bankers were getting worried that Korea's growing external debt might lead to a crisis similar to that in Mexico two and a half years earlier, Anoop Singh informed the Managing Director that "we continue to believe that such fears are exaggerated."¹⁰⁰ Even after the crisis in Thailand put additional pressure on the won, Hubert Neiss argued that while the staff was concerned about "domestic events" such as the fallout from the Hanbo Steel bankruptcy, it was not worried about external pressures.¹⁰¹ A month later, he elaborated that "we . . . assign a low probability of a major Thai-type external crisis."¹⁰²

These reassuring assessments reflected the positive information being provided to the staff by the authorities. Much of the most critical data, including up-to-date intervention figures and external borrowing by overseas branches of Korean banks, were not

⁹⁷For an insider account of how these links worked, see Kang (2003).

⁹⁸Notes on the February mission to New York are in the archived files of Folkerts-Landau's Deputy Division Chief, Garry Schinasi; IMF archives, FIN-AI, Accession 2006-0059-01.

⁹⁹See memorandum from Folkerts-Landau to the Managing Director, "Capital Markets Surveillance Mission to Asia" (April 30, 1997); IMF archives, DMD-AI (Fischer), Accession 2000-0117-0007, "Korea I." The quotation is from p. 12.

¹⁰⁰Memorandum to the Acting Managing Director (Fischer), "Korea—*Financial Times* Article on Debt Surge" (May 8, 1997), covering a reprint of John Burton and Peter Montagnon, "Debt Surge Raises Fears over Korea," *Financial Times* (May 7, 1997); IMF archives, DMD-AI (Fischer), Accession 2000-0117-0007, "Korea I."

¹⁰¹Memorandum from Neiss to the Acting Managing Director (Fischer), "Korean Developments" (July 16, 1997); IMF archives, DMD-AI (Fischer), Accession 2000-0117-0007, "Korea I."

¹⁰²Memorandum from Neiss to the Managing Director, "Korea" (August 22, 1997); IMF archives, DMD-AI (Fischer), Accession 2000-0117-0007, "Korea I."

yet available to the Fund or other analysts.¹⁰³ All that the staff could do at this time was to infer from market behavior and from the government's reactions to events what might be happening below the surface.¹⁰⁴ One such inference came in late August, when the government announced it would guarantee up to \$20 billion of the external debts of Korean banks. The staff found this "troubling," because it suggested that the continuing wave of corporate bankruptcies was weakening the banking system more than the official data indicated.¹⁰⁵ Only much later, in December 1997, did it become clear that the announced guarantee was just window dressing, given that it had no legal standing without parliamentary approval (which was never granted) and the central bank was running out of foreign exchange reserves to cover the guarantee.

In October, Adams returned to Seoul with a staff mission to conduct the first full-scale consultation discussions since August 1996.¹⁰⁶ By this time, the problems in the banking system were reasonably well understood,¹⁰⁷ but Adams and most others on the staff still regarded them as manageable. Moreover, the most serious weakness, the one that would trigger the crisis within a few weeks, remained a closely guarded secret even in Seoul. A large portion of the central bank's foreign exchange reserves consisted of deposits in overseas branches of Korean banks, and those banks had committed the money to cover their own external debts. The IMF had never encountered such a situation before, and the staff did not even know what questions to ask to uncover it.

¹⁰³Short-term borrowing in foreign currencies by overseas branches did not show up in the official balance of payments data, because the borrower was considered nonresident. The discrepancy between residency-based and ownership-based external debt did appear in data collected and reported by the BIS, but the IMF staff did not pursue the issue before the financial crisis. The OECD took an equally benign view of Korea's prospects. The June 1997 *OECD Economic Outlook* projected that "real GDP growth may decelerate further to around 5½ percent in 1997 [from 7 percent in 1996], with some pick-up in growth likely in 1998" (p. 95). A positive shift in the external trade balance was expected to contribute to this turnaround. Like the Fund staff, the OECD staff considered the main risk to be "the possibility of further business failures," which "would further weaken the banks" (OECD, 1997, p. 96).

¹⁰⁴Anne O. Krueger, who was professor of economics at Stanford University in 1997, later recalled that Korean "economic policy makers" had conveyed a sense of "deep gloom" at a conference in August of that year "about the chaebol [large business conglomerates], the state of the financial system, and the potential for reforms of economic policy" (Krueger and Yoo, 2002, p. 169n21).

¹⁰⁵Memorandum from Bijan Aghevli to the Managing Director, "Korea—Bank Support Package" (August 28, 1997); IMF archives, Historian's files.

¹⁰⁶Although Adams led both the 1996 and the 1997 missions, during the intervening months he was assigned to work on China and particularly on the transfer of sovereignty over Hong Kong from the United Kingdom to China. He returned to work on Korea only in August 1997 and had to bring himself up to date quickly.

¹⁰⁷At the IMF/World Bank Annual Meetings in Hong Kong SAR in September, the Korean finance minister had acknowledged publicly that the corporate insolvencies of 1997 were "symptomatic of the Korean economy's structural imbalances" and had induced the government to restructure the financial system and to undertake a "complete overhaul of Korea's central banking and financial supervisory systems"; (statement by the Hon. Kyong Shik Kang at the Joint Annual Discussion, 1997 Annual Meetings, September 23–25, 1997, Press Release No. 42).

The mission's report to management did not foresee a crisis; instead, it focused on the longer-term and still-simmering financial sector problems:

A string of bankruptcies among Korea's major conglomerates . . . has led to a sharp increase in nonperforming loans and spilled over into higher spreads and increased difficulty borrowing abroad. Korea has been relatively unaffected by contagion from Southeast Asia but confidence is extremely weak and the stock market has been depressed. . . . Attracting private capital—from domestic or foreign sources—is not likely to be easy until comprehensive reforms are introduced to improve the safety and soundness of the financial system and raise expected profitability. . . . The staff's judgment is that the authorities are relatively well equipped to deal with moderate additional external pressures on account of the continued relatively strong macroeconomic situation.¹⁰⁸

Publicly, Adams was even more upbeat, telling reporters at a press conference marking the close of the mission that although the economy was in a cyclical downturn, “the long-term outlook for the Korean economy is very bright” (Veale, 1997). That statement was certainly true, but it unfortunately proved the worth of John Maynard Keynes's famous dictum that economists must focus as much on the short term as on the long, “for in the long run we are all dead.”

Onset of the Crisis: Disappearing Reserves

Korea's financial problems worsened in the second half of October, right after the conclusion of Adams's mission. The floating of the Taiwan dollar on October 17 and a sharp sell-off in the Hong Kong stock market on October 23 aggravated the decline in confidence in the already weakening Korean markets. Continuing collapses of large corporations (so far that year, 6 of the 30 largest conglomerates, or *chaebol*, had declared bankruptcy), and the consequent pressures on the banking system and on the potential bailout costs to the government, led the rating agency Standard & Poor's to downgrade its assessment of Korea's sovereign debt on October 24. At the same time, the agency warned that the outlook was poor and that further downgrades were possible in coming months.¹⁰⁹ By the end of October, the main index of Korean equities was down nearly 40 percent from its early August level, and the won was falling against the U.S. dollar. Although the staff still believed that the authorities had the foreign exchange reserves and the policy

¹⁰⁸Memorandum from Charles Adams to the Managing Director, “Korea—Back-to-Office Report for the 1997 Article IV Consultation Discussions” (October 21, 1997); IMF archives, DMD-AI (Fischer), Accession 2000-0117-0007, “Korea I.” The staff report for this mission was overtaken by events and never completed.

¹⁰⁹The one-level downgrade affected both short- and long-term debt, and domestic-currency as well as foreign-currency debt. The lowest rating, as before, applied to short-term debt denominated in foreign currencies (lowered from A+ to A). See “Standard & Poor's Cuts Korea and Entities' Foreign Currency Ratings to A+; Outlook Negative,” PR Newswire (October 24, 1997); accessed at <http://www.thefreelibrary.com/Standard+%26+Poor's+Cuts+Korea+and+Entities+Foreign+Currency+Ratings+to...-a019913205>.

flexibility to handle these pressures, Neiss and Adams warned management that the “risk of a foreign exchange crisis . . . is increasing significantly and the authorities could be overwhelmed if the current pressures continue.”¹¹⁰

In fact, the crisis was already at hand. Korean financial institutions owed an estimated \$30 billion on very short-term external borrowings in foreign currencies, which they were using to fund longer-term won-denominated loans to domestic corporations. External lenders were showing increasing reluctance to roll over those claims on maturity.¹¹¹ Although practically no one outside the central bank knew it at the time, the country’s official reserves were woefully inadequate to cover those claims, as were the domestic banks’ own reserves.

Even the little that was known was enough to alert Stanley Fischer to the potential for a developing crisis. He began to lay the groundwork for IMF assistance in the first week of November. Through several telephone calls with Korean officials, he tried to persuade them to accept a staff mission from the Monetary and Exchange Affairs Department (MAE) to conduct a more in-depth analysis of the banking system in anticipation of a possible “Indonesian style program.” Those officials, however, were not yet ready. With a lame duck president in office and a presidential election campaign in progress, the government was effectively paralyzed and unable to make difficult decisions. Moreover, much like the initial Mexican reaction in December 1994, Korean officials believed that their new status as a member of the OECD made borrowing from the IMF both inappropriate and unnecessary. Fischer told them bluntly that this attitude was “stupid” and could “cost them dearly.”¹¹² He then asked the staff to prepare a draft briefing paper for a negotiating mission in case the Koreans changed their minds.

Korea’s finance officials knew they were in trouble and needed help. They just wanted to avoid getting it from the IMF if possible. The U.S. government was not prepared to step in, as it had tried to do for Mexico, partly because of the political trauma the earlier effort had engendered and partly because the case for bailing out a country whose industries were aggressively and successfully competing against

¹¹⁰Memorandum from Neiss to the Managing Director (drafted by Adams), “Korea: Severe External Pressures” (October 31, 1997); IMF archives, DMD-AI (Fischer), Accession 2000-0117-0007, “Korea I.”

¹¹¹For an analysis of Korea’s external debt problem, see Yanagita (2000).

¹¹²Memorandum from Fischer to the Managing Director, “Brazil, Korea, Russia” (November 8, 1997), and Fischer’s handwritten notes on a telephone conversation of the previous day; IMF archives, DMD-AI (Fischer), Accession 2000-0117-0007, “Korea I.” More than a year earlier, Fischer had publicly rejected this “OECD syndrome” in Korea, telling a conference at the Brookings Institution in Washington that the IMF “will help again, if needed” (Fischer, 1996, p. 347).

U.S. firms would be even harder to sell domestically.¹¹³ That left Japan as the most viable alternative.

Korea had helped its wealthier neighbor finance the rescue of Thailand in August, so the prospects for assistance from Japan seemed good. That avenue, however, was also blocked. The Japanese authorities had already refused an appeal to dissuade Japanese banks from withdrawing funds from Korea, and they had informed the Korean central bank governor, Kyung Shik Lee, that they would not establish a bilateral swap line without an IMF-supported program in effect. In a last-ditch effort, the Korean finance minister, Kyong Shik Kang, sent an assistant minister to Tokyo on November 11 to ask for official bilateral financing. When that effort failed, the IMF became the lender of last resort.¹¹⁴

Kyong Shik Kang knew that if he approached the IMF openly, financial markets would panic, instigating a crisis. In the course of a telephone call with Fischer, he learned that Camdessus was already in East Asia for a series of one- to two-day stops in Kuala Lumpur, Jakarta, Singapore, Bangkok, and Manila. As it happened, ambassador-at-large Kihwan Kim was in Bangkok to give a speech, so Kang asked him to find Camdessus and persuade him to come to Seoul for an emergency, top-secret meeting with the senior finance officials. After some searching, Kim finally caught up with Camdessus on Friday evening, just as the Managing Director was in the middle of an official dinner at the Bank of Thailand. To Kim's surprise, after he quickly explained the situation to Camdessus in a corridor outside the dining room, Camdessus immediately agreed to extend his trip. He had to go to Manila on Saturday, but he would then divert to Seoul instead of returning directly to Washington.

Camdessus, accompanied by Hubert Neiss, arrived at Gimpo Airport near Seoul on Sunday evening, November 16. From there, they were driven in an unmarked car to the Intercontinental Hotel, where they were registered under assumed names and could meet in secrecy with Finance Minister Kang and Governor Lee. Camdessus's intention at this meeting was to try to convince the Koreans that they would need an IMF-supported program. By this time, however, Kang and Lee had already persuaded President Young Sam Kim that they would have to ask for IMF support.¹¹⁵ The only relevant questions concerned what policies they would have to agree to change and how much money the IMF was prepared to lend.

¹¹³The legislative restrictions that had prevented the U.S. government from helping Thailand in July (see above, pp. 508–09) expired in September. As regards Korea, the political constraint on U.S. action in November was less formal but no less important. In addition, at this time most U.S. finance officials believed that Korea—as an OECD member country—could handle its own economic troubles and that bailing them out could create a serious moral hazard.

¹¹⁴On Kang's final attempt to get support from Japan, see Blustein (2001), p. 128; additional information is from interviews for this book.

¹¹⁵The crucial meeting with the president took place at the Blue House on the morning of November 14; see Kang (1999), pp. 332–34.

Camdessus first wanted to know how much Korea really had in usable foreign exchange reserves. What he learned was alarming, but it was still not the full story. Kang and Lee told him they had about \$25 billion in reserves and some \$6 billion in forward commitments against that balance.¹¹⁶ They estimated that perhaps \$10 billion to \$15 billion in short-term external debt would not be rolled over, implying they might have to use more than half of their uncommitted reserves to help the banks meet their commitments for the next couple of months. On that basis, Camdessus concluded that Korea could run out of reserves by the end of December. He still did not know that much of the nominal stock of reserves consisted of deposits in overseas branches of commercial banks that had committed the money to repay their own debts. Although the Bank of Korea was not legally obligated to use its reserves to cover those commercial debts, refusing to do so would bankrupt much of the country's financial system. Even without taking that implicit obligation into account, the Korean authorities were suggesting they needed \$30 billion in official financing, which the IMF would be hard-pressed to provide on its own.¹¹⁷

The First Program: December 4, 1997

The ball was now rolling inexorably toward a negotiated program. By the time Camdessus returned from Seoul, the staff had prepared a briefing paper that envisaged a two-year stand-by arrangement for an unspecified but large amount: large enough to require exceptional access in relation to Korea's unusually small quota. In view of Korea's regional importance, the staff anticipated that additional official lending would be forthcoming from the United States, China, Japan, and other countries. The briefing paper noted the contagion effects from adverse developments elsewhere in Asia, but it also stressed the importance of "weaknesses . . . in Korea's corporate and financial sectors and the inability of the authorities to address the situation."¹¹⁸

Despite the acknowledged good record of macroeconomic policymaking in Korea, the staff proposed tightening policies, noting that the program would "build upon the authorities' current macroeconomic policy framework (updated to take into account the implications of the recent deterioration in the external situation)." The proposed

¹¹⁶These figures are what Camdessus reported to the Executive Board on his return to Washington. Kang (1999, p. 338) reported that Lee told Camdessus that gross reserves were only \$17 billion.

¹¹⁷See the report by Camdessus and Neiss (who accompanied Camdessus to the meetings in Seoul) to the Executive Board at EBM/97/112 (November 21, 1997), pp. 5–10. Also see memorandum from Neiss to the Managing Director, "Korea—Briefing Paper for Negotiation of a Stand-By Arrangement" (November 21, 1997); IMF archives, DMD-AI (Fischer), Accession 2000-0117-0007, "Korea I."

¹¹⁸Memorandum from Wanda Tseng (Deputy Director, APD) to Michael Mussa and other concerned department heads, "Korea Briefing Paper" (November 18, 1997); IMF archives, DMD-AI (Mr. Fischer's files), Accession 2000-0117-0007, "Korea I."

measures included tightening fiscal policy by 1.5 percent of GDP to offset the expected cost of financial restructuring and to promote investor confidence, and tightening monetary policy to prevent “a significant further weakening of the currency.”¹¹⁹

While Camdessus was returning from Seoul, Fischer was on his way to Manila for an ad hoc international meeting of finance officials to set up what would become known as the Manila Framework (Chapter 12). From there Fischer planned to go on to Seoul in response to an invitation from the finance ministry. On the day of the meeting—November 19—the Korean delegation withdrew the invitation. President Young Sam Kim had just dismissed Kyong Shik Kang from his posts as finance minister and deputy prime minister, and the government now seemed to be pulling back from the brink of asking the IMF for help. Fischer, however, was determined, and he informed the delegation that he intended to go to Seoul anyway, even if it meant that he would have to sit alone in a hotel room.¹²⁰

By the time Fischer got to Seoul on November 20, the president had installed a new finance minister, Chang-Yuel Lim, a former Alternate Executive Director at the IMF (1986–89). Lim had already announced a financial restructuring and had widened the band within which the exchange rate was allowed to fluctuate. It was a promising beginning, and he and Fischer had a productive meeting over dinner that evening. Although Fischer’s trip—like Camdessus’s a few days earlier—was supposed to be a secret, the press discovered he was in town, and he was followed by paparazzi for the rest of his visit except when he “barricaded” himself in his hotel room (Fischer, 2001).

The next morning, while Fischer delayed his scheduled departure for Washington, Lim went to see the president to get his final approval for seeking financial assistance from the IMF. Young Sam Kim gave his approval, conditional on getting a public statement of support from each of the three main candidates for the presidential elections to be held on December 18. That support was in everyone’s interest: the outgoing president did not want to take all the blame for accepting a painful adjustment process, and the IMF had to be sure that the incoming leader would continue to implement the program. Fischer agreed, although he was worried about whether the government was really prepared to take the tough steps required to restore confidence. “This is going to be a very difficult negotiation,” he reported back to Camdessus.¹²¹

From this point on, the process picked up momentum. Within hours, the government announced to the Korean people that it was seeking an arrangement with the

¹¹⁹Memorandum from Wanda Tseng (Deputy Director, APD) to Michael Mussa and other concerned department heads, “Korea Briefing Paper” (November 18, 1997); IMF archives, DMD-AI (Mr. Fischer’s files), Accession 2000-0117-0007, “Korea I.”

¹²⁰Memorandum from Fischer to the Managing Director, “Visits to Qatar, Manila, and Seoul, November 16–21” (November 21, 1997); IMF archives, DMD-AI (Fischer), Accession 2000-0117-0007, “Korea I.”

¹²¹Memorandum from Fischer to the Managing Director, “Visits to Qatar, Manila, and Seoul, November 16–21” (November 21, 1997); IMF archives, DMD-AI (Fischer), Accession 2000-0117-0007, “Korea I.”



Fischer and Chang-Yuel Lim photographed during Fischer's "secret" trip to Seoul.
(Associated Press file photo)

IMF. Camdessus spoke to the president, the prime minister, and the finance minister by telephone to express his support and explain the way in which the Fund would proceed. He also made plans to go to Korea himself as soon as possible. The previously planned MAE mission arrived in Seoul that evening, headed by Tomas Baliño

(Assistant Director, MAE), and the negotiating mission from APD was preparing to leave Washington in a day or two.

When the Executive Board met the next day, November 21, to hear Camdessus's report on Korea, the two issues that would dominate the debate—not only in the coming weeks but for years afterward—were already in the air.

First, was it desirable and necessary for Korea to raise interest rates? Doing so, as Okyu Kwon (Alternate, Korea) pointed out, would further weaken the profitability of many businesses and lead to even more bankruptcies. Failing to do so, as Lissakers (United States) and Gus O'Donnell (United Kingdom) argued, would perpetuate the capital flight already under way and would either dissipate the country's official reserves or lead to a collapse in the exchange rate, or both. A middle ground would have to be located.

Second, was it feasible and desirable to induce the external creditors of Korean banks to take losses or increase their exposure, or should the program aim to restore confidence quickly, thus convincing foreign banks to stay in the game voluntarily? Bernd Esdar (Germany) argued that creditors should be compelled to make their "fair share" of loans to Korea, to which Lissakers responded that for creditors to reduce exposure in the current circumstances was a sensible and prudent business decision with which the Fund should not try to interfere.¹²²

Both problems were acute, and the two were linked. Short-term interest rates were hovering around 15 percent, which was adequately high in relation to the inflation rate but very low in relation to the expected depreciation in the exchange rate. The incentive for capital flight was therefore quite high. Understandably, creditors were equally reluctant to roll over their maturing loans. That evening, Camdessus telephoned Lim to try (unsuccessfully) to persuade him to raise interest rates immediately, in a preemptive strike aimed at avoiding a much larger increase later.

The Fund was, from the outset, less concerned about fiscal than about monetary policy. The staff mission team recognized that restructuring the banking system and keeping both the banks and their business customers operating was going to drain the public treasury. They therefore believed that some offsetting measures would be needed to cover the cost. They also were no doubt influenced by the Fund's experience in Mexico and in other crisis situations in which a combined tightening of fiscal and monetary policies had been a central component of restoring credibility and stability. Still, they also realized that the government had some room to maneuver as a result of several years of fiscal prudence before the crisis. The tightening proposed in the draft briefing paper—1.5 percent of GDP—was fairly modest, but when Fischer reviewed the paper on November 24, he approved it only after lowering the recommendation to a mere 0.5 percent.¹²³

¹²²See minutes of EBM/97/112 (November 21, 1997), pp. 5–10. Additional information is from interviews with participants.

¹²³Memorandum from Neiss to the Managing Director, "Korea—Briefing Paper for Negotiation of a Stand-By Arrangement" (November 21, 1997), with handwritten notations by Fischer (November 24, 1997); IMF archives, DMD-AI (Fischer), Accession 2000-0117-0007, "Korea I."

On November 26, the negotiating mission arrived in Seoul and immediately went to work.¹²⁴ That evening, Neiss, the mission chief, faxed a handwritten note back to Fund headquarters with a frightening message. On arrival, the staff had finally discovered the full extent of the weakness in Korea's foreign exchange position. No more than \$9 billion of Korea's \$24 billion in official reserves was usable, and \$15 billion in external debt would fall due before the end of December. Given that no more than 30 percent of that debt was being rolled over, the Bank of Korea was likely to run out of reserves completely before the tentatively scheduled meeting of the Executive Board to approve a stand-by arrangement (December 18). Neiss urgently advised the Managing Director to try to arrange for supplementary financing or a standstill on redemption of private credits.¹²⁵

The Fund's decisions and actions on Korea would not be made in a vacuum. The major creditor countries not only had to approve the stand-by arrangement at the Executive Board, but it appeared that they also would have to provide supplementary credits if the overall financing was to be sufficient. Time was short, and a long holiday weekend was approaching in the United States. (Thanksgiving Day was on Thursday, November 27.) In a hastily arranged meeting at Camdessus's request, the G7 finance deputies assembled in the Air France Concorde lounge at John F. Kennedy Airport in New York City on November 26 to decide how to proceed. Camdessus, who was starting his second trip around the world in as many months, met them there along with his Economic Counsellor, Michael Mussa. Camdessus reported that his initial discussions in Seoul had been extremely difficult, and that it was by no means clear that the Korean authorities realized the precarious state of their financial situation. The Fund would insist on tough conditions, which Korea might or might not accept. If negotiations broke down, Korea inevitably would default on its external debts.

Although the G7 deputies and their ministers were considerably worried about the prospects for a default, they were prepared to leave the financial solution in the hands of the IMF for the time being. They rejected the idea of providing a bridging loan if negotiations dragged on; they rejected the idea of offering a "second line of defense" to supplement an IMF loan; and they rejected the idea of taking coordinated action to persuade private creditors to maintain credit lines. One or more deputies were in favor of each proposal, but others were strongly opposed.¹²⁶

Later that day, Acting Managing Director Alassane Ouattara held an emergency meeting with a few senior staff to decide how to proceed in the absence of a backup

¹²⁴For an inside account of the work of the staff missions, see Neiss, Tseng, and Gordon (2009).

¹²⁵Handwritten memorandum from Neiss to the Managing Director, "Korea—Foreign Exchange Situation" (November 26, 1997); IMF archives, DMD-AI (Fischer), Accession 2000-0117-0007, box B22265, "Korea I."

¹²⁶This account is based on interviews with participants. Also see Rubin and Weisberg (2003), pp. 229–30.

plan from the G7.¹²⁷ The staff concurred on the one hand that avoiding a default, which “would run a substantial risk of precipitating a serious financial crisis in the region and elsewhere,” was critically important. On the other hand, persuading the Koreans to raise interest rates “up-front” was also critically important. Otherwise, the crisis was likely to continue. Somehow, the staff would have to reach an agreement with the authorities on this issue before Camdessus arrived in Seoul to wrap up negotiations in early December.¹²⁸ If they succeeded, then the Board meeting could be advanced from mid- to early December, tentatively as early as December 4. Because the central bank was losing reserves much more quickly than the staff had thought before the mission arrived, if Korea did not get at least a few billion dollars from the Fund by early December, it would have to begin defaulting on its external debt.

The level of interest rates was only one of several points making these negotiations extremely difficult. More generally, the U.S. government was pushing hard for a broad agenda of structural reforms in Korea, including liberalization of capital inflows and deep reform of the financial system.¹²⁹ This push came partly out of conviction that reforms were needed and partly in reaction to lobbying by U.S. industries competing with those in Korea. On Thanksgiving Day, President Clinton telephoned President Young Sam Kim “to strongly urge reforms,” and the treasury secretary, Robert Rubin, decided to send an aide, David A. Lipton, to Seoul immediately “to get an independent assessment of the situation as well as to reinforce the importance of strong reform measures.” Lipton—who had once worked for Neiss at the IMF—promptly checked into the Seoul Hilton, where Neiss and the rest of the Fund team were staying. He spent several days meeting both with the Korean authorities (separately from the Fund mission’s meetings) and with Neiss (Blustein, 2001, pp. 6 and 143–44; and Rubin and Weisberg, 2003, pp. 233–34).¹³⁰ In effect, Neiss had to negotiate with both the Korean and the U.S. authorities to arrive at a program that the one would implement and the other would support.

After some 72 hours of all-day meetings and all-night preparations, Neiss sent a first draft of a Letter of Intent (LOI) back to headquarters on Saturday, November 29. Based on what he thought Korea was willing to accept, the draft called for a small rise in interest rates and a fairly modest beginning to a reform agenda. Several department heads read it that day, and they all rejected it as too vague and too weak. Mussa was especially strident. The draft program, he wrote, “appears to be a massive and

¹²⁷At this time, Camdessus was in Europe, en route to Korea, and Fischer was in the Middle East.

¹²⁸Memorandum for files by Aghevli, “Korea—Options for Dealing with the Crisis” (November 26, 1997); IMF archives, DMD-AI (Fischer), Accession 2000-0117-0007, “Korea I.”

¹²⁹Most restrictions on capital outflows had already been liberalized, either as part of the general opening of the economy in the 1980s and early 1990s or as a requirement for Korea’s accession to OECD membership in 1996; see OECD (2002), especially pp. 97–105.

¹³⁰In addition, Rubin occasionally telephoned Camdessus to convey U.S. views, and both Summers and Lipton would call Fischer.

unjustified bailout without adequate conditionality, which will set a terrible precedent for the future.”¹³¹

On Sunday afternoon, a broader group of senior staff met with Deputy Managing Director Shigemitsu Sugisaki and reached the same conclusion. The draft LOI was too weak and would fail to restore investor confidence. For the program to succeed, they felt it would have to include a “strong explicit commitment on how far the authorities would be willing to raise interest rates” and a set of prior actions to be completed even before the Managing Director would agree to support the program.¹³² That evening, Fischer—who had just returned to Washington during the day—informed Executive Directors that negotiations were at this critical stage. All of the Directors from major creditor countries apparently agreed that their support would depend on the strength of the program.¹³³ For better or worse, the Fund was preparing to stiffen its collective backbone.

In addition to the program conditions, the Fund had to figure out how to make the numbers tally. With very little of the existing private sector credits being rolled over and the central bank losing reserves at the rate of \$700 million a day, official creditors would have to commit much more money than the IMF could possibly provide. This gap had two dimensions: the amount of money needed to restore investor confidence, and the amount needed to keep the central bank from running out of reserves.

The first problem—restoring confidence—was psychological. Having seen the effect on markets of the \$40 billion package assembled for Mexico in 1995, Fischer concluded that Korea would need a similar commitment and probably a bit more. He envisaged a \$50 billion package, even if a fair bit of it consisted of vague and conditional commitments. Fortunately, by Tuesday, December 2, creditor countries had realized they would have to provide supplementary bilateral financing after all, at least on a contingent basis. Assuming commitments to this second line of defense would total about \$20 billion and the World Bank and the AsDB could be persuaded to lend Korea another \$10 billion, then a credible package totaling \$50 billion would be within reach if the IMF was prepared to approve a record-setting \$20 billion stand-by arrangement.

The second problem—keeping the Bank of Korea from running out of cash—was both more immediate and, in principle, more firmly grounded. Now that the staff had a reasonably accurate count of Korea’s usable reserves and of the stock and duration of short-term external debt, the essential question was what portion of the debt would be renewed. As the impossibly tight deadline for completing negotiations approached,

¹³¹See attachments to a memorandum from Aghevli to Jack Boorman, Manuel Guitián, and Mussa, “Korea: Program Documents” (November 30, 1997); IMF archives, DMD-AI (Fischer), Accession 2000-0117-0007, “Korea I.”

¹³²Memorandum from Fischer to the Managing Director, “Korea” (November 30, 1997); IMF archives, DMD-AI (Fischer), Accession 2000-0117-0007, “Korea I.”

¹³³Memorandum from Fischer to the Managing Director, “Board meeting, etc.” (November 30, 1997); IMF archives, DMD-AI (Fischer), Accession 2000-0117-0007, “Korea I.”

the mission team had no choice but to assume that private creditors would roll over whatever was necessary to stabilize the reserve balance. At a time when a 30 percent renewal rate would have been a very favorable outcome, the staff assumed heroically that the forthcoming announcement of an agreement with the Fund would quickly restore confidence and lead to a 90 percent renewal rate. The mission team knew this assumption was unrealistic. In essence, the Fund was internalizing the backup official financing (the second line of defense) as if it were private credit.

Camdessus arrived in Seoul early Wednesday morning, December 3 (Tuesday afternoon in Washington, where discussions were also continuing among the staff), after an overnight flight from Bangkok. Despite the early hour, his plane was met by a large contingent of journalists taking photographs and shouting questions to him. Ignoring them, he was taken by official car to the presidential residence, the Blue House, where he met with President Young Sam Kim. Through a day of discussion, the two leaders ironed out the few remaining differences on terms for the proposed stand-by arrangement. By this time, Korea had already implemented the required prior actions, including an initial increase in interest rates, measures to raise tax revenues, and commitments to shut down several insolvent banks and to allow foreign financial institutions to acquire Korean banks.¹³⁴

All that remained was for Young Sam Kim to secure the support of each of the candidates who might succeed him after the December 18 presidential election. With time running out, he sent emissaries by helicopter to obtain the letters of support the Fund was requiring. Within hours, all three leading contenders had submitted letters addressed to Kim stating that if elected, they would implement the economic program. Ominously, one of the three—the eventual winner, Kim Dae-Jung—carefully hedged his support:

If I am elected president, I will fulfill, in principle, the content of the agreement with the IMF. . . . However, in concretely carrying out the terms of the agreement, we should, through continuous discussions and negotiations concerning the details, reduce to a minimum the suffering of the people resulting from mass nonpayment and mass unemployment accompanying the sudden economic recession.¹³⁵

Normally, the staff would have several weeks after a mission to prepare a detailed staff report, which would be circulated to Executive Directors along with the LOI and other relevant documents at least three weeks before the Board meeting at which the

¹³⁴The publicly announced actions were described in a letter from Finance Minister Chang-Yuel Lim to Camdessus (December 4, 1997); IMF archives, DMD-AI (Fischer), Accession 2000-0117-0007, “Korea I.”

¹³⁵Memorandum from The Secretary to Members of the Executive Board, “Republic of Korea—Letters,” FO/DIS/97/104 (December 10, 1997), conveying copies of the letters in the original Korean language and in English translation. The Speaker of the National Assembly, Su-han Kim, also submitted a letter promising the president that he would “actively cooperate to ensure that prompt legislative measures are enacted.” The other two candidates promised simply to “execute the content of the agreement as it was mutually agreed upon.”

proposed arrangement would be considered. Directors would use the three-week interval to circulate the papers to their national capitals for consideration and comments. In this case, Korea's financial crisis was imminent and no delay was possible. The Fund therefore invoked its Emergency Financing Mechanism, an accelerated procedure adopted in 1995 in the wake of the Mexican crisis (see Chapter 10). After Camdessus's meeting with Young Sam Kim, the mission team stayed up all night drafting the staff report. Neiss faxed it to headquarters, and it was circulated to Executive Directors the same day (the production being aided by the 14-hour time difference between Washington and Seoul). Camdessus flew from Seoul to Tokyo, where he was to deliver a long-scheduled speech and where he could take advantage of videoconferencing facilities to brief Executive Directors without having to wait until he could return to Washington. This was the first time the IMF Executive Board ever met via video-conference. The regular Board meeting was then scheduled for the next day, December 4, to be chaired by Fischer.

The Board meeting was held in restricted session, and the associated documents—the LOI and the staff report—were classified “strictly confidential.” The authorities, under pressure from Executive Directors from creditor countries, soon agreed to publish the LOI. Publishing the staff report was a more delicate matter because it contained critical statements about economic policies that could further damage confidence. That issue was set aside for a few days, but when the newspaper *Chosun Ilbo* obtained a copy (apparently from a source in the government) and published it, the ministry of finance had no choice but to release it officially.

Despite nearly universal skepticism about whether the program would succeed, the Board approved Korea's request for a three-year stand-by arrangement totaling \$21 billion (SDR 15.5 billion). This was not only the largest arrangement the Fund had ever approved; it also was the largest by far in relation to the member's quota (1,938 percent).¹³⁶ Of that, Korea was able to draw about \$5.6 billion (SDR 4.1 billion) without delay. To cobble together that much money to transfer to Korea, the Board immediately followed its consideration of the stand-by arrangement with a brief discussion of the operational budget. As soon as the Board formally agreed to increase the amounts of several currencies

¹³⁶The previous records were held by the stand-by arrangement for Mexico in 1995, both in absolute amount (SDR 12.07 billion) and in percentage of quota (688 percent). The large ratio for Korea was justified by the country's extremely low quota and was made possible by invocation of the long-standing “exceptional circumstances clause.” On the background for the low quota, see Boughton (2007). On the exceptional circumstances clause, see Boughton (2001), pp. 878–79. The absolute and relative sizes of the Korea arrangement were surpassed in May 2010, when the Fund approved a stand-by arrangement for Greece totaling SDR 26,432.9 million (€30 billion, or \$33.8 billion), more than 32 times Greece's quota.

the Fund could use, the Treasurer, David Williams, signaled his staff to begin the transfers.¹³⁷ For the moment, Korea's central bank was saved from bankruptcy.

As noted above, the broader objective of convincing private creditors to roll over their loans voluntarily required assembling a large package of official commitments. Although the World Bank had just graduated Korea from its list of eligible borrowers, and even though the Bank's President, James Wolfensohn, complained privately to the Fund about not being consulted while the program was being negotiated, the Bank now announced it was prepared to lend Korea up to \$10 billion, pending negotiation of specific terms. The AsDB indicated its willingness to lend up to \$4 billion, and a group of 12 industrial countries announced a \$20 billion contingent package, or second line of defense. Altogether, including the Fund arrangement, by the end of the day on December 4 Camdessus was able to announce that the international community was prepared to place up to \$55 billion at Korea's disposal.¹³⁸

The First Review: December 18, 1997

Despite all the bold talk of a \$55 billion package, the Bank of Korea had at its disposal when it opened for business on December 5 just the initial disbursement from the IMF (\$5.6 billion) and its own dwindling reserves. These resources would suffice only if the rollover rate on private credits rose from 30 percent to a rate close to the assumed 90 percent, and everyone involved knew that was a long shot. Further lowering the likelihood, four factors combined to undermine investors' confidence that the authorities and the IMF had the situation under control.

The first problem was that the delay in publishing the staff report created fertile ground for leaks and for rumors about the depth of the crisis and the level of austerity being forced upon the government. Then, when the finance ministry finally released the document on December 9, news reports typically focused on the IMF staff's assessment that the government's attempts to avert the crisis had been piecemeal and insufficient and that usable reserves were far below what had been announced earlier

¹³⁷See "Enlargement of the Operational Budget for November 1997 – February 1998," EBS/97/221 (December 3, 1997), and minutes of EBM/97/116 (December 4, 1997). Korea drew the \$5.6 billion in seven currencies, with the U.S. dollar and the Japanese yen each accounting for about 36 percent of the total. The rest was transferred in deutsche marks, Italian lire, Swiss francs, pounds sterling, and Canadian dollars. Four years later, when Fischer was about to retire from the IMF, he vividly recalled the memory of Williams "standing at the door of the Board room, waiting for the vote, to give the signal to send the money"; see <http://www.imf.org/external/np/speeches/2001/082901a.htm>.

¹³⁸See "IMF Approves SDR 15.5 Billion Stand-by Credit for Korea," PR/97/55 (December 4, 1997); accessed at <http://www.imf.org/external/np/sec/pr/1997/pr9755.htm>. On Wolfensohn's displeasure, see memorandum from Fischer to the Managing Director, "Korean Loan" (December 2, 1997); IMF archives, DMD-AI (Fischer), Accession 2000-0117-0007, "Korea I." The World Bank disbursed the first tranche of its \$10 billion Economic Reconstruction Loan on December 23, 1997.

(see, for example, Bulman, 1997). The knowledge that publication had come grudgingly and only after the document had been leaked to the press no doubt added to the generally poor reaction.

Second, in a televised debate among presidential candidates on Sunday, December 7, two of the leading candidates—Kim Dae-Jung and In-Je Rhee—pledged to try to revise the terms of the Fund arrangement if they were elected. In Kim's case, the pledge merely reiterated the contents of his letter to Young Sam Kim four days earlier, but the broadcast likely heightened investors' fears that the government was not really committed to carrying out the program. In an effort to rectify this problem, Kim Dae-Jung wrote to Camdessus on December 11 expressing his support for the program, though he still insisted it had "shortcomings" that should be fixed. After Camdessus replied by asking him to make that support public, he did so on December 13 by stating unequivocally, "I will fully support the agreement made between the government and the IMF."¹³⁹

Third, the countries that had committed to provide \$20 billion in a second line of defense expressed reluctance to make any of that money available. For the first two weeks into the program, their prevailing view was that they had agreed only to consider providing bilateral support in the event of unexpected adverse shocks. Until that circumstance arose, they were not prepared to make a more specific commitment.¹⁴⁰ First the staff and then the Managing Director pleaded with the potential creditors to firm up their pledges and put the money on the table, but that effort did not bear fruit until December 18. In the meantime, the sense that official creditors were holding back made private creditors even less willing to roll over their own investments.

Fourth, the authorities were disinclined to raise interest rates by as much as was needed to stabilize the exchange rate. Doing so would risk bankrupting many of Korea's highly leveraged corporations and affect the impending presidential election. The LOI did not specify a target for short-term interest rates, other than to state that these rates would be "allowed to rise sufficiently" and would be "maintained at that level or higher as needed to stabilize [financial] markets."¹⁴¹ Unbeknownst to the IMF staff during negotiations, the authorities had a legal obligation (under the Interest Rate Limitation Law) to establish a ceiling of 25 percent on short-term interest rates. The Bank of Korea continued to apply that ceiling after the program was put in place. To monitor developments and to try to reach firmer understandings on policy commitments, several members of the staff mission stayed in Seoul after the preliminary agreement had

¹³⁹For the exchange of letters, see memorandum from The Secretary to Members of the Executive Board, "Republic of Korea—Letters," FO/DIS/97/105 (December 12, 1997).

¹⁴⁰See memorandum for files by Boorman, "Meeting with Executive Directors" (December 9, 1997); IMF archives, Accession 2000-0117-0006, DMD-AI (Fischer), "Korea II."

¹⁴¹"Republic of Korea—Request for Stand-By Arrangement," EBS/97/222 (December 3, 1997), p. 39. The LOI did specify that the interest rate charged by the Bank of Korea on "foreign exchange injections to Korean commercial banks or their overseas branches" would be set at least 4 percentage points above the London interbank offer rate (LIBOR).

been reached on December 3. Neiss returned to Washington, but Wanda Tseng (Deputy Director, APD) took over as mission chief. She was advising the authorities to raise the ceiling to 40 percent, on the grounds that the constraint on rate increases, in combination with a 10 percent band on daily exchange rate movements, had “paralyzed” the exchange market.¹⁴²

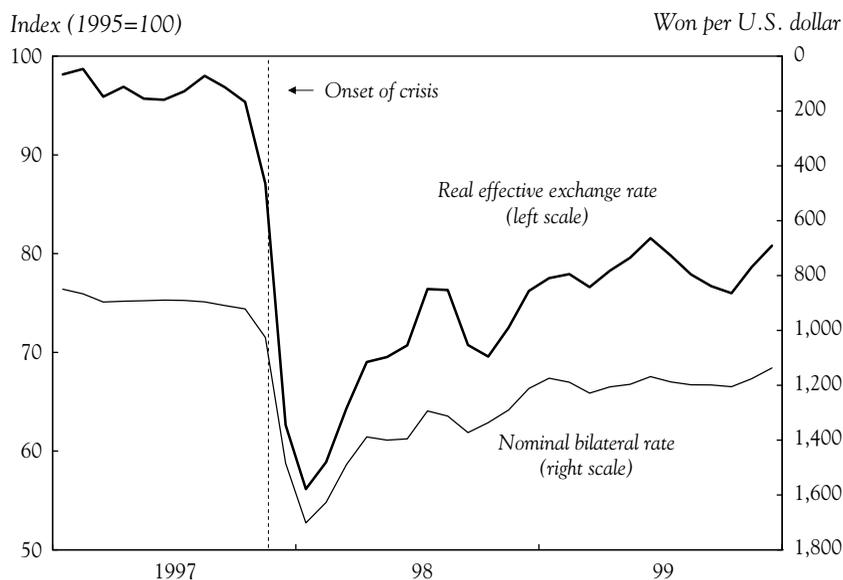
Tseng was also concerned, however, that if interest rates actually rose by that much, the consequences for the economy could be horrendous. Even at 25 percent, the pace at which companies and banks were being driven out of business was rising sharply. Although the high rates seemed necessary at that moment so that Korean banks could continue to service their short-term debts, a continuation ran the risk of bringing on “an enormous, and perhaps unsustainable, cost to the economy.”¹⁴³ The most realistic escape from this dilemma was via an organized standstill on debt redemptions, but creditor governments were not yet ready to try that approach.

Much of the criticism of the IMF’s handling of the Korean crisis that welled up in December and festered for years afterward started from the premise that the Fund was imposing excessive austerity on a country that already had established a record of sound macroeconomic policies. That premise was flawed, for three reasons. First, even if policies are sound before a crisis, the withdrawal of a major source of financing (foreign bank loans) may require a substantial policy adjustment. Second, the program was not designed to tighten fiscal policy or even to offset fully the effects of the anticipated recession on the budget. The required fiscal adjustment was intended only to offset the budgetary costs of managing the crisis. Without that adjustment, the rise in interest rates would have had to be even higher to enable the government to cover its borrowing requirement without resorting to massive inflationary financing. Third, to a large extent the monetary tightening was made necessary by the desire—shared by all—to avoid a default and by the decision—less widely shared—not to try to engineer a collective standstill on debt redemptions. The appropriate criticism is not that the program was too tight, at least not *ex ante*. If there was a major flaw in the design of the program, it was that a serious consideration of a standstill came only quite late in the process.

The IMF reacted particularly strongly to suggestions from Harvard Professor of Economics Jeffrey Sachs and World Bank Chief Economist Joseph Stiglitz that the program should have allowed interest rates to stay low even if it meant a collapse of the exchange rate. Fischer wrote an article for the *Financial Times* (“IMF—The Right Stuff”) responding to that criticism, and Shailendra Anjaria (Director, External Relations Department) published a letter in the same newspaper asserting that Sachs’s attack was “facile and distorted . . . on the basis of analysis that he must know to be

¹⁴²Memorandum from Tseng to Neiss, “Korea—Foreign Exchange Market” (December 11, 1997); IMF archives, Accession 2000-0117-0006, DMD-AI (Fischer), “Korea II.”

¹⁴³Memorandum from Tseng to the Managing Director, “Korea: Program Issues and Strategy” (December 14, 1997); IMF archives, Accession 2000-0117-0006, DMD-AI (Fischer), “Korea II.”

Figure 11.5. The Republic of Korea: Exchange Rates, 1997–99

Sources: Information Notice System and International Financial Statistics.

half-true or untrue.” As would soon become clear, instead of an easier monetary policy Korea urgently needed a restructuring of its external debt to slow or halt the redemptions that were bankrupting the central bank.¹⁴⁴

The Executive Board met to review the program on December 18, right after the presidential election won by Kim Dae-Jung.¹⁴⁵ Confidence in the Korean economy had not recovered; in fact, it was continuing to worsen. In the two weeks since the stand-by arrangement had been activated, the stock market in Seoul had fallen by 20 percent, and the won had fallen by 45 percent against the U.S. dollar (Figure 11.5). The authorities had agreed to raise the interest rate ceiling to 40 percent, but for the moment they were continuing to inject enough liquidity into the banking system to keep actual short-term rates at about 25 percent. Banks were afraid to lend, and their customers were frantically withdrawing their deposits. At this time, two weeks into the Fund-supported program, the central bank was still privately calculating that it was likely to completely deplete its reserves by the end of the month (Kim, 2006, p. 10). In the Fund’s view, reserves were already fully depleted or committed.

¹⁴⁴See Sachs (1997) p. 21, and the articles by Fischer and Anjaria in the *Financial Times* (December 17, 1997), p. 16. The *Financial Times* articles were circulated in the IMF as Prep/97/17 (December 18, 1997). The argument for a debt restructuring to lengthen maturities was presented cogently in Yanagita (2000). For a fuller discussion of the general criticisms and of the rationale for tightening policy to restore external balance, see Boughton (2006).

¹⁴⁵The news that Kim Dae-Jung had won the presidency arrived during the Board meeting but had no discernible effect on the discussion.

The public's fears did not result primarily from doubts about the program or the government's willingness to implement it. Aside from the hesitation about raising interest rates, everyone in power now seemed committed, and they were implementing the program more or less on schedule. The central problem was that it would take months or even years to complete the financial reforms at its heart. In the meantime, both foreign creditors and domestic depositors were reluctant to accept the risk of lending to or investing in Korean banks. Not even a \$55 billion package of official financing could sufficiently diminish that risk.

By this time, the staff was assuming only a 30 percent rollover rate on existing short-term debt, but even that rate looked increasingly optimistic. The election of a new government should have removed a source of substantial uncertainty, but investors were jittery about earlier statements by the president-elect suggesting he might undercut the reform program. In these conditions, the Fund could do little to turn the situation around except to continue its own financing and try to reassure markets that the government was carrying out the program. Accordingly, the Executive Board approved the completion of the first biweekly review of the stand-by arrangement and released an additional \$3.5 billion (SDR 2.6 billion), for a cumulative disbursement of \$9 billion (SDR 6.7 billion) so far in December. This second tranche, as anticipated from the outset, was made at a higher interest rate and a shorter maturity than the first, under the terms of the new Supplemental Reserve Facility (SRF) that the Board had approved only the day before (see Chapter 5).

To reinforce the positive signal from the completion of the review, Camdessus issued a clear statement of support:

The Korean authorities are moving swiftly to implement the economic program approved by the IMF on December 4, 1997. The interest rate ceiling is being raised, the won is now freely floating, and important actions have been taken on the fiscal front. Action plans for restructuring the financial sector, constituting the cornerstone of the program, are also proceeding, and the IMF looks forward to continued close cooperation with the authorities in this critical area.¹⁴⁶

Privately, however, the staff remained worried that if the rollover rate continued to fall, the Bank of Korea could still run out of usable foreign exchange reserves by the end of December, even after the addition of \$9 billion from the IMF. The Fund had no plan to deal with that possibility.

¹⁴⁶“IMF Executive Board Completes 1st Review of Korean Program: Activates Supplemental Reserve Facility,” NB/97/30 (December 18, 1997); accessed at <http://www.imf.org/external/np/sec/nb/1997/nb9730.htm>.

The Revised Program: December 30, 1997

CHRISTMAS DAY 1997 . . . WAS THE WORST EXPERIENCE I HAVE EVER HAD IN POLITICS . . .
I will never forget . . . what I have called . . . “white knuckle time.”

Peter Costello¹⁴⁷
Treasurer of Australia
December 20, 2005

If Korea’s bank creditors were unwilling to continue lending, if the international community of finance officials was unable or unwilling to force or persuade them to keep lending, and if the money that the international community was willing to commit to Korea was still not enough to cover all of the repayments falling due, then Korea’s only remaining option was to default. By the time the Fund-supported program had been in effect for just a few days, the IMF had to confront that prospect as a real possibility. On December 9, Thomas Leddy (Deputy Director, Policy Development and Review Department, or PDR) warned the Managing Director “that, in the worst case scenario, Korea would have to declare a debt moratorium, impose exchange controls limiting the private sector’s ability to service short-term loans, and seek to restructure the debt.”¹⁴⁸

This alarm induced Camdessus and Fischer to use one of their periodic informal lunches with Executive Directors, on December 11, to quietly raise the question of whether they should begin trying to push Korea’s creditors somehow to maintain their loan exposures. Some Directors, including those from Japan, Germany, and a few other European countries, spoke in favor of the idea, but they were a small minority.¹⁴⁹

Not only in the IMF but in world capitals, enthusiasm for a negotiated debt moratorium (a standstill on repayments) was muted, for various reasons. Some people were opposed because they thought that markets should find their own way without official guidance or intervention; some because they still thought (or hoped) that the announcement of official support would quickly restore confidence (as it had in Mexico); and some because they did not believe that a standstill would work. In contrast to the 1980s, when debt crises primarily involved syndicated bank loans to sovereign governments, capital flows in the 1990s were much more diverse. Flows into Korea, more than for other Asian countries, took the form of bank loans, but the number of creditors was large, their geographic range was wide, and their loans were mostly to Korean banks, not to the government. Quite apart from ideology, organizing a standstill would be a complex operation involving creditor institutions in many countries. More and more, however, it was becoming clear that such an operation would have to be tried.

¹⁴⁷Interview with Stephen Mayne of ABC Radio (Australia) (December 20, 2005); accessed at <http://www.treasurer.gov.au/tst/content/transcripts/2005/172.asp>.

¹⁴⁸Memorandum by Leddy to the Managing Director, “Korea—Contingency Planning” (December 9, 1997); IMF archives, Accession 2000-0117-0006, DMD-AI (Fischer), “Korea II.”

¹⁴⁹Information provided by participants.

The next day, December 12, Boorman circulated a note to the Managing Director setting out options for restructuring the external debt of Korean banks involuntarily. At this stage, these options were considered just a contingency plan.¹⁵⁰ Four days later, he circulated a more detailed proposal, which he characterized as “Plan B.” One of the challenges for Korea if it was forced to default was that the external debt was owed by private financial institutions, not by the sovereign government. If the country had to declare a standstill unilaterally, the IMF staff was recommending that the authorities should impose exchange controls preventing banks from repaying principal on their debts, and they should declare a bank holiday while the controls took effect. For their part, the banks should continue paying interest so as not to go formally into default.¹⁵¹

Plan B was received coldly. The U.S. authorities—in particular, both Rubin and Alan Greenspan (chairman of the U.S. Federal Reserve System)—were opposed on the grounds that a standstill could make banks less willing to lend to other emerging-market countries (Rubin and Weisberg, 2003, pp. 236–38). That opposition made the internal Fund debate moot, and most of the key personnel already agreed with the Americans. Manuel Guitián (Director, MAE) and his top aides were opposed to Plan B on the grounds that a unilateral standstill could “trigger a massive capital flight” unless it was backed up by extremely comprehensive and effective capital controls. Neiss was also concerned, fearing that Korea could lose access to international capital markets for an extended period and suffer a serious and prolonged recession as a result.¹⁵² Fischer was determined to get a voluntary and cooperative agreement if at all possible.

These concerns were based partly on experience and partly on a strong preference for market-based policies. As the rollover rate continued to decline, however, the need for a fresh approach would become more compelling. The moment was rapidly approaching when the only choice would be between a negotiated standstill and a unilateral one (i.e., a default).

Once the presidential election and the December 18 Board meeting were over, the major creditors knew they had to act. The critical decisions in this regard had to come from the U.S. authorities because they were both the dominant official creditor and the one that had been most opposed to the idea of a standstill. On December 19,

¹⁵⁰Memorandum from Boorman to the Managing Director, “Korea—Restructuring Short-Term Debt” (December 12, 1997); IMF archives, Accession 2000-0117-0006, DMD-AI (Fischer), “Korea II.” Also see Blustein (2001), p. 185, where the authorship of the memorandum was (correctly) attributed to Matthew Fisher (Division Chief, PDR).

¹⁵¹Memorandum from Boorman to the Managing Director, “Korea: Plan B” (December 16, 1997); IMF archives, Accession 2000-0117-0006, DMD-AI (Fischer), “Korea II.”

¹⁵²See memorandums from Guitián to Boorman (December 16, 1997), from Boorman to Guitián (December 18, 1997), and from Patrick T. Downes (Assistant Director, MAE) to Boorman (December 22, 1997), all titled “Korea: Plan B”; and Neiss and David J. Goldsbrough (Senior Advisor, APD) to the Managing Director, “Korea—Cash Flow and Financing Strategy” (December 16, 1997); IMF archives, Accession 2000-0117-0006, DMD-AI (Fischer), “Korea II.”

Kihwan Kim met with Summers at the U.S. Treasury in Washington and offered to strengthen Korea's reform agenda well beyond the requirements of the IMF—an idea that Kim called an “IMF-plus” program—if the United States would help persuade creditor banks to roll over their loans to Korea. The additional reforms could include increased flexibility in labor markets, so that firms could fire unproductive workers more easily, and increased access to some Korean markets for foreign firms. Summers made no promises, but the next day the Treasury sent David Lipton to Seoul to meet with Kim Dae-Jung and confirm that the president-elect was committed to carrying out and even going beyond the IMF-supported program. They met on December 22, and Kim Dae-Jung assured Lipton he understood the need for structural reform and would do whatever it took to resolve the crisis and put the country onto a strong and sustainable path of economic growth. Rubin then initiated a broad effort among finance officials and central bankers from the major creditor countries to try to persuade (not force) their banks to roll over their loans to Korean borrowers (Blustein, 2001, pp. 193–96; Rubin and Weisberg, 2003, pp. 238–41; and interviews for this book). By this time, that effort was very likely to succeed because Korea's large bank creditors had already assured the staff they would welcome an organized solution.

Meanwhile, Neiss returned to Seoul to renegotiate the macroeconomic program. It was now almost inevitable that Korea would run out of reserves within a week unless it got even more new injections from official creditors. Korea still had \$5 billion in usable reserves, and it was due to receive \$4 billion in loans from the World Bank and the AsDB in the next few days. But the rollover rate was now only 15 percent and still falling, which implied that more than \$7 billion out of a total of about \$9 billion in outstanding principal would have to be repaid before the end of December. In addition, \$2 billion in overnight deposits was unlikely to be renewed, and that would completely exhaust the resources of the central bank. As a first step toward regaining credibility and reinstilling confidence, the authorities signed a new LOI on December 23, after just three days of discussions with Neiss and his team. The new LOI offered more explicit commitments than the first one, including a promise to raise short-term interest rates to 30 percent.¹⁵³

That evening, Fischer joined a conference telephone call among the G7 finance deputies that turned out to be pivotal in Korea's recovery from the crisis. It was already the predawn hours of Christmas Eve in Europe, where four of the deputies were sitting, and late morning in Japan. As important as the holiday was to most of them, this year it would have to wait. They all knew how desperate Korea's financial situation was and how serious the consequences could be if Korean banks began to default on billions of dollars in foreign debts. The deputies now all agreed that a standstill would have to be tried, and they devised a plan along the following lines: First, the finance ministries of each country—not the central banks, which would have to preserve some

¹⁵³The draft LOI and a table showing the reserve situation was sent by fax from Neiss to Fischer on December 23; IMF archives, Accession 2000-0117-0006, DMD-AI (Fischer), “Korea III.”

distance from the operation because of their role as bank regulators—would try to persuade their banks to maintain their loan exposures in Korea.¹⁵⁴ Second, the IMF would work with the Bank of Korea to collect and disseminate data on the success of that operation. Third, the central banks would coordinate the debt rollovers internationally and make sure that aggregate exposure was being maintained.¹⁵⁵

The next morning, to prepare the ground for the standstill by putting their own money on the line, official creditors announced newly concrete commitments. The G7 finance ministers and central bank governors issued a statement welcoming the strengthening of the program in the new LOI and promising to begin disbursing funds from the second line of defense. Later in the day, the group of 13 countries participating in the second line issued a public statement promising specifically to lend Korea \$8 billion (out of total potential commitments of \$20 billion) “by early January.”¹⁵⁶

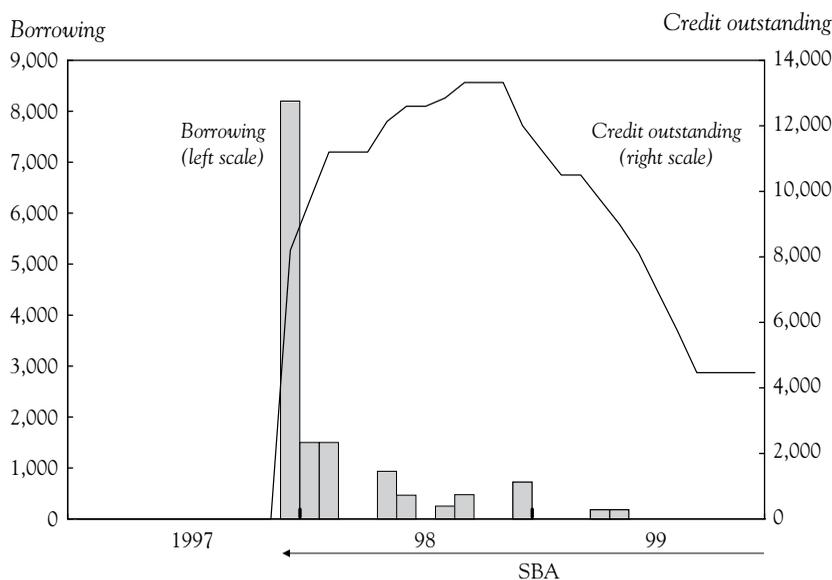
Now it was indeed “white knuckle time.” Would enough commercial banks go along with the plan? Could they even be reached during the long holiday weekend that had already begun? When Jean Lemierre, the French finance deputy, telephoned one banker at home, he was told that he would have to call back after the holiday, because the banker was busy shucking oysters for his Christmas dinner. Lemierre refused to take that for an answer, and he eventually persuaded the banker to help. One by one, over the next few days, most of the major banks in North America, Europe, Japan, and Australia were gradually brought into the fold. Although cooperation was less than complete—Russian banks, for example, were reportedly reluctant to participate in the standstill—Korea’s external debt was successfully stabilized within a few weeks.

The IMF’s role in the standstill was to help the Bank of Korea monitor the amount of debt being rolled over, broken down by individual creditor. This operation required getting each Korean bank, including overseas branches, to report their detailed outstanding obligations every day. Once these data were tabulated, the Fund conveyed the information to creditor-country central banks through confidential reports and a daily conference call. Each central bank got figures for banks in its own country and aggregate data for other countries. If the banks in one country were failing to roll over their

¹⁵⁴As regulators, central bankers had to ensure that commercial banks did not make imprudent investments, but they also had a responsibility to help prevent the instability and even panic that could have resulted from a default on banks’ existing claims. In this instance, the most common way that this conflict was resolved was by allowing treasury officials to hold meetings with bankers in the offices of the central bank, thus hinting that the operation had the regulators’ support, but without the direct participation of the central bankers themselves.

¹⁵⁵See handwritten notes made by Fischer during the telephone call on December 23, 1997; IMF archives, Accession 2000-0117-0006, DMD-AI (Fischer), “Korea III.” Additional information is from interviews with participants.

¹⁵⁶See “G7 Statement on the Korean Situation” (December 24, 1997), released by Finance Minister Paul Martin of Canada; accessed at http://www.g7.utoronto.ca/finance/fin_dec2497.htm. Since the initial agreement on the second line of defense, the number of participating countries had risen from 12 to 13 with the addition of New Zealand. The statement by the 13 participants was circulated in the IMF as EBD/97/140 (December 24, 1997).

Figure 11.6. The Republic of Korea: Use of Fund Credit, 1997–99*(In millions of SDRs, monthly data)*

Source: International Financial Statistics.

Note: SBA = Stand-by arrangement.

loans, that country's officials would apply additional persuasion. It was an immensely complex process involving Fund staff in Seoul and in Washington, a massive command center set up and run by the Bank of Korea in Seoul, and central and private bankers in at least two dozen countries around the world. It had never been tried before, and it had to be handled delicately to avoid crossing the line between persuasion and compulsion. With evident satisfaction and relief, one deputy happily recalled—in an interview for this book—that success was achieved “more or less voluntarily” by the major bank creditors.

To complete the renewal of the program, the Executive Board met on December 30 and agreed to accelerate the disbursement of funds under the stand-by arrangement. The Korean authorities had agreed to strengthen their own efforts, in particular by greatly increasing the penalty rates the Bank of Korea was charging Korean banks for liquidity support. In return, the Fund brought forward a \$2 billion drawing that had been scheduled for January 8 and disbursed it on December 30 instead, bringing total disbursements for the month to a staggering \$11 billion (SDR 8.2 billion, see Figure 11.6, more than 10 times Korea's quota).¹⁵⁷

By eight p.m. on New Year's Eve, only a few lights were still on at IMF headquarters in Washington, for staff in Fischer's office and that of the U.S Executive Director.

¹⁵⁷See “Republic of Korea—Request for Modification of Schedule of Purchases—Letter of Intent,” EBS/97/246 (December 24, 1997) and Suppl. 1 (December 28, 1997).

The staff mission was finally home after more than five weeks in Seoul (though it had already been replaced by another team). The most dramatic year in IMF history was finished, and no one yet knew that another such year was about to begin. They did know, however, that the Korean crisis was still not resolved. Most of the staff finally had a weekend off, but only a weekend.

The Korean Financial Crisis Resolved: January 1998

The two remaining tasks, in broad terms, were to devise a more permanent plan for restoring and stabilizing Korea's financial strength and to reverse the horrendous collapse in the Korean economy. Only the first task could be tackled quickly.

Once the coordinated persuasion by country officials began in the last week of December, the precipitous decline in loan exposure by bank creditors slowed and then reversed. By late January 1998, the rollover rate had risen from a low of 10 percent just before Christmas to nearly 80 percent. That bought enough time for a group of the largest banks to organize a longer-term debt restructuring deal. Led by William R. Rhodes, the manager of many a concerted lending operation in the 1980s, a bank advisory committee met with a group of Korean representatives at Citibank headquarters in New York on January 8 and heard a telephone briefing by Fischer on the economic situation.¹⁵⁸ That meeting initiated a process that resulted in a January 28 agreement to restructure \$24 billion in short-term bank debts into longer-term loans secured by the Korean government.

The most remarkable component of Korea's crisis recovery was the spontaneous outpouring of support from families throughout the country. The centerpiece of that support was the voluntary sale—not organized by any government agency—of massive amounts of privately held gold jewelry and similar personal treasures. Individuals, mostly women, sold their gold to corporations in exchange for won, and the companies then sold the gold for foreign exchange that they could use to repay debts to foreign creditors. This activity generated more than \$2 billion that otherwise would have further drained the scarce foreign exchange reserves of the central bank. The psychological benefit to a people whose self-confidence had been badly damaged by the crisis was incalculable.

With these developments, the financial aspects of the crisis were largely resolved by the end of January. The Korean banking system was still fragile, and the Fund's financial markets experts—alongside experts from the World Bank and the AsDB—would spend several more months in Seoul advising the authorities on a restructuring

¹⁵⁸While Fischer took charge of the Fund's role in the rescheduling operation, David Burton (Senior Advisor, PDR) represented the IMF staff at the January 8 meeting; see Burton's memorandum for files (January 9, 1998); IMF/RD, Accession 2001-0284, OMD-DMD (Fischer), Box 8, "Korea - 1998 (1)." At this time, Rhodes was vice chairman of Citibank. On his role in the 1980s, see Boughton (2001), Chapters 7-10.

plan. The plan that emerged involved fully protecting bank depositors through a comprehensive deposit insurance scheme, closing the weakest institutions, recapitalizing others by buying distressed assets, and strengthening supervision so as to enhance competition and market discipline. To further promote competition and inject fresh capital, foreign financial institutions were allowed to purchase domestic banks.¹⁵⁹ The international monitoring of debt rollovers also would continue for a few more months, but the rollover rate continued to rise, and more and more Korean banks were able to repay the expensive liquidity support they had obtained from the Bank of Korea during the crisis. By the middle of 1998, the central bank had rebuilt its reserves to a comfortable level (equivalent to four months of imports), and the exchange rate was steadily appreciating. Confidence in Korea had returned.

The real economic picture in Korea was not so benign. As a result of more than 30,000 bankruptcies of firms in the past year, Korea was in an economic depression, with sagging output, rising unemployment, continuing corporate bankruptcies, and severe hardships for a large part of the population. From the outset, the IMF staff had seriously underestimated the magnitude of the negative shock to the economy that would result from the combination of the massive bankruptcies throughout 1997, the loss of external financing in the last two months of the year, and the tightening of macroeconomic policies starting in December. Once the extent of the downturn became clear, and the financial crisis faded into the background, the focus had to shift to restoring economic growth.

To a large extent, the underestimation of the downturn may have been an unavoidable consequence of the implicit constraint against devising a reform program that was expected to leave the economy in a recession. Certainly the staff in the field understood that the poor circumstances in Korea could engender a serious risk of a decline in output from 1997 to 1998. That prospect, however, was unthinkable for the Korean government or the Korean people, who had just enjoyed a heady decade of rapid growth and expected their success to continue. The staff report for the original program in early December 1997 therefore envisaged real GDP growth for 1998 of 2.5 percent, a figure that was as low as was politically acceptable in Korea.¹⁶⁰

By the time the Fund held the first quarterly review of the stand-by arrangement in February 1998, the staff's growth projection for 1998 had been reduced to 1 percent, with the caveat that the yearly growth rate could even be negative. At the second quarterly review, in May, the staff acknowledged that output was likely to decline by 2 percent for the year, and the report added that "a larger contraction is possible." Output continued to weaken, and the outcome for 1998 was a massive contraction of 6.7 percent. But the economy then recovered even more sharply and surprisingly, with

¹⁵⁹For an overview, see EBS/98/20, Suppl. 1, pp. 8–11.

¹⁶⁰Throughout the crisis, the Korean authorities conveyed strong concerns to the staff and urged that the IMF not publish projections that were much less optimistic than the official forecasts.

real growth in 1999 reaching 10.7 percent.¹⁶¹ For the two years together, growth thus averaged 3.3 percent, which most independent observers in late 1997 probably would have thought to be a reasonably satisfactory result, given the severity of the initial conditions.

As Korea's financial outlook improved, the government increasingly was able to resume control over economic policy instead of being constrained by the policy conditions of the IMF stand-by arrangement. This control would be especially strong once Kim Dae-Jung took office at the end of February, but it was evident even earlier. Notably, by the end of 1997 the authorities became firmly convinced that they could not afford to propose a fiscal deficit without triggering a backlash in the form of renewed pressure on the exchange rate. They therefore decided on their own to raise taxes to preserve fiscal balance. In February, the government reached a "tripartite accord" with business and labor groups on a social compact and safety net to protect the poor and preserve employment. By stating publicly that the unpopular elements of these reforms were needed to meet the conditions imposed by the IMF, Kim Dae-Jung was able to defuse much of the domestic political opposition.

An unfortunate side effect of this strategy was that the IMF took an inordinate portion of the blame for the suffering that resulted from "the IMF crisis." In Seoul, a cheap meal became an "IMF lunch," and people joked that IMF stood for "I'm fired." These phrases stayed in the popular imagination for years. In truth, the president's personal commitment was the critical ingredient in getting economic policies and labor and other markets to change fundamentally, from heavy regulation and dependence on the government to a much more market-friendly environment.¹⁶²

By the spring of 1998, as confidence began to improve, the government began easing fiscal policies and further improving the social safety net. The Fund did not initiate that shift either, though it fully supported it once it was under way. In what may have been an excess of caution, both the government and the IMF staff were reluctant to see an aggressive easing of monetary policy until it was abundantly clear that confidence was fully restored. Consequently, although interest rates began retreating from peak levels in February 1998, they did not return to precrisis levels until late in the year.

Throughout the three years that the stand-by arrangement was in effect, Korea consistently met and often exceeded the program targets set by the Fund. Korea continued to draw on the stand-by arrangement through May 1999, after which it had no further need for official financing. Altogether, the country borrowed \$19.6 billion out of the \$21 billion arrangement, all of which it repaid by 2001. That same year, Korea

¹⁶¹See EBS/97/222 (December 3, 1997), Table 3; EBS/98/20, Suppl. 1 (February 13, 1998), p. 4 and Table 1; EBS/98/86 (May 19, 1998), p. 18 and Table 2; and EBS/00/137, Suppl. 1 (August 21, 2000), Table 2.

¹⁶²With respect to labor market issues, the Fund staff generally avoided getting involved; see Neiss, Tseng, and Gordon (2009), p. 26.

again became a creditor country, with a currency strong enough for the IMF to use in its lending to other countries.¹⁶³

Of all the emerging-market countries hit by financial crisis in the 1990s, Korea made the fastest and most sustained recovery. The downturn in 1997–98 was severe and painful, but at least it was short-lived, owing primarily to the extraordinarily strong and unified response eventually made by the government and the Korean people.

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¹⁶³The stand-by arrangement expired in December 2000. Although Korea still had outstanding debts to the Fund, its strong reserve position and its stated intention to repay all of its borrowings ahead of schedule in the coming months induced the IMF to add the Korean won to the list of currencies usable for lending.

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