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The Silent Revolution

THE NEED IS FOR STRONGER POLICIES AND NOT FOR ANY complacent gradualism in adjustment efforts . . . Several countries are choosing to go this way—a painful decision in many cases—because it offers them a prospect of achieving sustainable growth. This “silent revolution” in attitudes in many developing countries . . . is now showing itself in the number of countries that have requested Fund help in formulating their growth-oriented adjustment programs.

Michel Camdessus
Managing Director, IMF
September 26, 1989¹

This book is a narrative history of the coming of age of the International Monetary Fund as a participant in the international financial system. The men who designed the framework of the system at Bretton Woods, New Hampshire, in 1944 envisaged the Fund as an independent, objective, and essentially automatic force, subject to broad political constraints and the limits of predetermined financial resources. For more than two decades afterward, the Fund’s active role was episodic and, from a global perspective, minor. The institution’s value derived primarily from its passive embodiment of the understandings and commitments that came to be known as the Bretton Woods system. Subsequently, however, the compass for action began to expand.

As recounted in earlier histories of the IMF, world economic and financial imbalances multiplied in the 1960s and 1970s.² The Bretton Woods system of fixed but adjustable exchange rates came under strain and collapsed, and a more flexible system was negotiated. Because the new system imposed few constraints on national economic policies, the Fund was drawn into a more active “surveillance” role in overseeing its implementation. Moreover, as the landscape of the world economy became more precarious, the Fund was drawn into a more active lending

¹IMF, *Summary Proceedings*, 1989, p. 15.

²The earlier histories (all published by the IMF) are Horsefield (1969), which covers the years through 1965; de Vries (1976), covering 1966–71; and de Vries (1985), covering 1972–78. Other major histories of the period that discuss the role of the Fund in the world economy include notably Solomon (1982) and James (1996).

role that required a deeper and more sustained involvement in the formulation of macroeconomic policies in countries facing economic crises. During the 11 years covered in this work, 1979 through 1989, a confluence of upheavals propelled the institution into a more central and pervasive role than ever before.

The primary purpose of this study is not to judge the Fund's success in carrying out this expanded role, but rather to explain how and why and in what circumstances the Fund acted and evolved during a period of great change. The limitations to the Fund's role and abilities are readily apparent, even to a casual observer of international affairs, while its strengths are more subtle and controversial. The "creditor countries" that provide the bulk of the financing for the Fund and that issue the main reserve currencies are obviously going to retain and exercise substantial control over their claims and over their own economic affairs. In less obvious ways, they may find it in their interest to submit to independent surveillance by the Fund. Countries that borrow from the Fund are obviously in a much weaker position and must sacrifice some policy autonomy in exchange for international financial assistance channeled through the Fund. The Fund thus has become, to some extent, an agent of an asymmetric and unequal distribution of economic power. Less obviously, the Fund's financial and policy (or "programming") assistance has in many cases helped restore borrowers' autonomy, reduce global inequities, and counteract the dominance of industrial power. An effort to provide a balanced explanation of these relationships is bound to focus more on the subtleties than on the surface gloss.

This opening chapter begins by examining the question of whether events in the 1980s really constituted a revolution, and it then introduces the men who led the institution through this period. The rest of the chapter gives an overview of the major developments in the world economy, the international monetary system, and the IMF from the end of the 1970s to the beginning of the 1990s. It is intended to serve as a primer to the major events, each of which is covered only briefly. The reader will find more detailed explanations and references in the chapters that follow.

Revolution or Evolution?

During the 11 years from 1979 through 1989, the world economy evolved in seemingly small but ultimately dramatic and profound ways. From a starting point at which the state was viewed as holding a primary responsibility for controlling economic development, the "third world" gradually diminished and even rejected that role in favor of privatization and reliance on market incentives. From a starting point at which central planning and international barter isolated much of the "second" or Communist world from the global market, internal reforms in China joined with the gradual enfeeblement of the Soviet empire to break down the barricades from central Europe to eastern Asia. From a starting point at which the largest industrial countries held sharply divergent macroeconomic philosophies and maintained that each country should pursue its own independent course, the "first world" took at least tentative steps toward more cooperative and mutually

consistent policies. The philosophical and economic barriers between North and South and between East and West remained in place at the end of the 1980s, but the means for destroying them were nearer and more evident than ever before in history. This “silent revolution,” as Michel Camdessus named it in a more specific context,³ brought an unprecedented importance to the IMF as every region in the world struggled to keep its footing in an increasingly dynamic and global economy.

Was there a revolution in international political economy in the 1980s? History does not accept such drama readily, and the term cannot be asserted without justification. No single event gave definition to a silent revolution: no storming of the Bastille, no Declaration of Independence, no satyagraha campaign, no Long March. The Fund as an institution underwent surprisingly little structural change as it responded to the challenges of this decade. But in some dimensions, the world economy changed diametrically from the beginning of the decade to the end, and that drift ultimately wore a revolutionary cloak.

The term “silent revolution” in this book refers to a shift in the prevailing paradigm for international economic and political relations, away from tendencies toward autarky, insularity, mercantilism, and governmental planning and control over economic activity; and toward a common set of beliefs and policies based on open international trade and finance, competitive pricing and production decisions, and cooperation between countries. To a great extent, the silent revolution of the 1980s resulted from a shift in economic philosophy toward a new classical synthesis in which government has an indirect role in, but not a direct responsibility for, ensuring national economic prosperity; in which private economic activity is promoted through good governance and the development of physical and social infrastructure.⁴ That shift was not born in the 1980s; in some aspects and in

³The phrase has, of course, been used in other contexts as well. Perhaps the most direct antecedent, though one with unrelated and troubling connotations, was its application to the economic reforms introduced under General Pinochet in Chile in the 1980s; see Lavín (1987). It also has been applied to Camdessus’s style of leadership at the Fund; see Sparks (1988).

⁴One should not confuse the gradual shift toward economic liberalization—the focus of the silent revolution discussed here—with the political democratization that also flourished with great drama throughout much of the developing world in the 1980s. Both logically and empirically, the two developments were distinct and independent events. To take four of many possible examples, the policies initiated in India by Finance Minister Manmohan Singh in 1993 illustrate economic reform in a democracy; economic policy in Chile under Presidents Allende and Pinochet illustrate, respectively, deterioration in a democracy and reform in a dictatorship; and the Philippines under Ferdinand Marcos illustrates economic deterioration under dictatorship. For the logical argument, see McGuire and Olson (1996), where it is shown that the “invisible hand” governing market activity works similarly under autocracies and democracies, as long as the ruler or the majority has a sufficiently long time horizon. Also see Rodrik (1996), which suggests that democratic governments may not have a sufficiently long time horizon; and Williamson and Haggard (1994), which examines the broader difficulties of explaining the political preconditions for successful economic reform. Historically, as emphasized by Myrdal (1968) and analyzed by Krueger (1993), economic development has proceeded at least as rapidly under economically enlightened dictators (Krueger’s phrase is “benevolent social guardians”) as under populist democracies. Studies of developing countries in the modern period have generally found little or no correlation between political freedom and economic progress; for a summary and references, see World Bank (1991), pp. 50 and 132–34.

some countries, such trends had long been apparent. Nor did it occur as a complete or final revolution in more than a handful of countries. From a global perspective, the silent revolution could also be described as a Quiet Evolution. To write such an epitaph, however, would greatly understate the significance of the decade for the world economy—and for the IMF.

The upheavals of the 1980s forced the Fund to reconsider its role and its ability to guide and shape the international monetary system. Throughout the decade, the staff, management, and Executive Board of the Fund debated and struggled with policy issues that went to the heart of the nature of the institution and that continued to resonate throughout the 1990s.

- In response to expanding international private credit markets, should the Fund become less of an official financial intermediary and more of a financial and policy adviser?
- Could the Fund rely on markets to provide international finance when and where it was needed, or should it devise new ways to influence private capital flows?
- Should the Fund borrow from markets to supplement its traditional lending resources?
- In response to a shift in demand for official financing from industrial to developing countries, should the Fund get more involved in structural reforms and long-term lending, or should it reduce its own lending and defer more to the multilateral development banks?
- In a system of floating exchange rates, should the Fund attempt to influence the major countries to stabilize their rates and coordinate their economic policies, or should it concentrate its energies on smaller countries where its influence was more likely to be felt?
- Was it feasible to rebuild the international financial system around the SDR as the “principal reserve asset,” as mandated by the Fund’s Articles of Agreement?
- Was there a significant role for unconditional financing for developing countries, or would the Fund have to get even more deeply involved in formulating economic policies in borrowing countries?

Leadership at the IMF

An even broader theme that came to the fore in the 1980s was the potential conflict between the Fund’s primary role as a monetary institution and the overseer of the international monetary system and its emerging role as a guiding force in economic development. The fifth Managing Director, H. Johannes Witteveen (from the Netherlands; in office 1973–78), guided the Fund into development-oriented activities such as lending for longer maturities and on concessional terms, but he also forcefully argued that the Fund’s essence was its monetary character. Reconciling that apparent paradox became increasingly difficult in the 1980s—and even more so in the 1990s—as the Fund became more deeply entrenched in

the task of helping developing countries formulate beneficial and sustainable economic policies.

To a striking degree, the story of the Fund's responses to these themes and to the silent revolution in policymaking is a story of the influence of Witteveen's successors, the two men who led the institution through the 1980s: Jacques de Larosière, who became the Managing Director some six months before the start of this narrative; and Michel Camdessus, who succeeded him in January 1987. Both French; both graduates of the *École Nationale d'Administration* (ENA, the prestigious academy whose graduates are familiarly known in France as "enarques" and constitute an elite corps of corporate and government leaders); both former directors of the French Treasury; one a former and one a future governor of the French central bank, the *Banque de France*; both holders of the same paradoxical vision of the IMF as a sound financial institution dedicated to improving the welfare of developing countries. De Larosière and Camdessus were nonetheless dramatically different in style and even in substance.

Jacques de Larosière de Champfeu was born in Paris in November 1929, was raised and educated there, and spent his entire pre-IMF career at the French treasury and finance ministry. In 1974 he was named *Chef du Cabinet* (chief of staff) to the minister of finance, Valéry Giscard d'Estaing. When Giscard became president of France later that year, de Larosière became Director of the Treasury, the post he held until moving to Washington to head the IMF in June 1978.

De Larosière, whom *The Times* of London characteristically called "the IMF's Gallic mastermind," tackled the job of Managing Director as a technical as much as a political challenge. He understood well that each of the Fund's 134 member countries (the number when he arrived in June 1978) brought its own unique issues, problems, and pressures to the table, but he took as a guiding principle that the institution should deal with all countries in as even-handed and uniform manner as possible. In conducting surveillance over macroeconomic policies, both in the public arena and in private meetings, he criticized the fiscal excesses of the United States in the same carefully structured tones that he applied to those of Argentina or Tanzania. In evaluating requests for loans, he consistently stressed that each country's economic program had to be fully financed: in the Fund's parlance, the task was to fill the "financing gap" and restore viability to the country's external accounts. The Fund was and is a political body, but the consistency and technical clarity of de Larosière's approach to problems usually prevented him from being blown far off course by strong political winds.

De Larosière's stress on technical clarity and his disciplined style led to his being widely misunderstood as a technocrat. In his first few years as Managing Director, he built on Witteveen's initiatives to greatly expand Fund lending to low-income countries and to find ways to subsidize that lending. He vigorously advocated the creation of a special lending window at the Fund to help developing countries finance food imports, and he encouraged the staff to work on issues related to the alleviation of poverty and the provision of basic human needs. Over

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Jacques de Larosière, Managing Director June 1978–January 1987

the next few years, he expanded the Fund's interaction with the United Nations, including UNICEF and the UN Development Programme. In his last two years in office, he supported the reinstatement of lending on highly concessional terms to the poorest countries. For a time, he was accused of being too soft in his lending decisions, but he gradually developed a sterner reputation and that side of him became largely forgotten.

A defining personal characteristic was de Larosière's habit of reading each of the hundreds of draft documents that crossed his desk each year with painstaking care. A 30-page staff report on a loan request or a surveillance review would come back to the author after a few days with several notes penciled in the margins in the Managing Director's tidy (and tiny) handwriting, often questioning the consistency of statements or numbers in different sections of the paper or asking why footnotes did not seem to match the text or the tables. In meetings with finance ministers and central bank governors, he often knew at least as much about the details of their economic policies as they did. During day-long meetings of the Executive Board, he would work his way through fistfuls of pencils, meticulously writing and rewriting his summing up of the meeting until every nuance was right. He astonished all who heard him with the precision of his nearly unaccented English, and he occasionally embarrassed Executive Directors from Anglophone countries by gently interrupting to ask if they had not really meant something slightly different from the phrase they had just chosen.⁵

De Larosière viewed the Executive Board as a forum for nearly unlimited debate. During his tenure of 8½ years, the Board often met long into the night until every Director had said his piece (even though statements often were simply read from texts that had been prepared in advance). Although this practice made for a lot of weariness and was not a model of efficiency, it did create an atmosphere in which every view could be fully and fairly presented and no Director felt slighted because of difficulties of language or expression.

As Managing Director, de Larosière had little tolerance for disloyalty, and he expected both hard work and high standards from his staff. He sparked fear and respect, but he also strongly defended the staff both in the Executive Board and in outside forums. When he left the Fund in the midst of his second term, his lavish praise of the staff—for their “dedication, professional competence, integrity, and capacity for hard work and personal sacrifice in the interests of the institution”—was fairly interpreted as heartfelt, and he received a rousing farewell from the several hundred staff who gathered in the tree-lined atrium of the Fund's headquarters in Washington to see him off.

After leaving the Fund, de Larosière returned to Paris and spent 6½ years as governor of the Banque de France. Then, in 1993 at the age of 63, he moved to London and took on the challenge of rescuing the European Bank for Reconstruction and Development (EBRD) from the financial excesses of its first president,

⁵English is the official language of the IMF, and meetings of the Executive Board normally are conducted in English without simultaneous interpretation.

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Meeting of the Executive Board, 1982

Jacques Attali. By that time he had been honored with the highest decorations from the governments of France and of a half dozen other leading industrial and developing countries. He retired in 1998.

Michel Camdessus was born in 1933 in the town of Bayonne, the historic gateway to the Pyrenees and the Basque country in the far southwest of France. He studied and earned degrees at the University of Paris, the Institute of Political Studies, and finally the ENA. As a junior officer in the French army during the war of Algerian independence, he developed a strong aptitude for survival by defusing land mines. Later, as Director of the French Treasury during the early years of the Mitterrand presidency, he helped design the shift to a stable anti-inflationary policy stance in 1983. He served as chairman of the Paris Club of official creditors when the group negotiated the first delicate compromises with major debtors in Latin America and elsewhere to reschedule debts after the crisis of 1982 while restoring discipline in economic policies. He chaired the Monetary Committee of the European Economic Community when the European Monetary System was stabilizing its exchange rates more firmly on the deutsche mark, and he pushed hard for an expanding international role for the ECU (European currency unit). He then took the reins at the Banque de France in 1984 and oversaw the key stages in the liberalization of both monetary policy (replacement of quantitative credit controls with open market operations as the primary policy tool) and bank regulation (strengthening of capital requirements and reducing government intervention in bank lending).

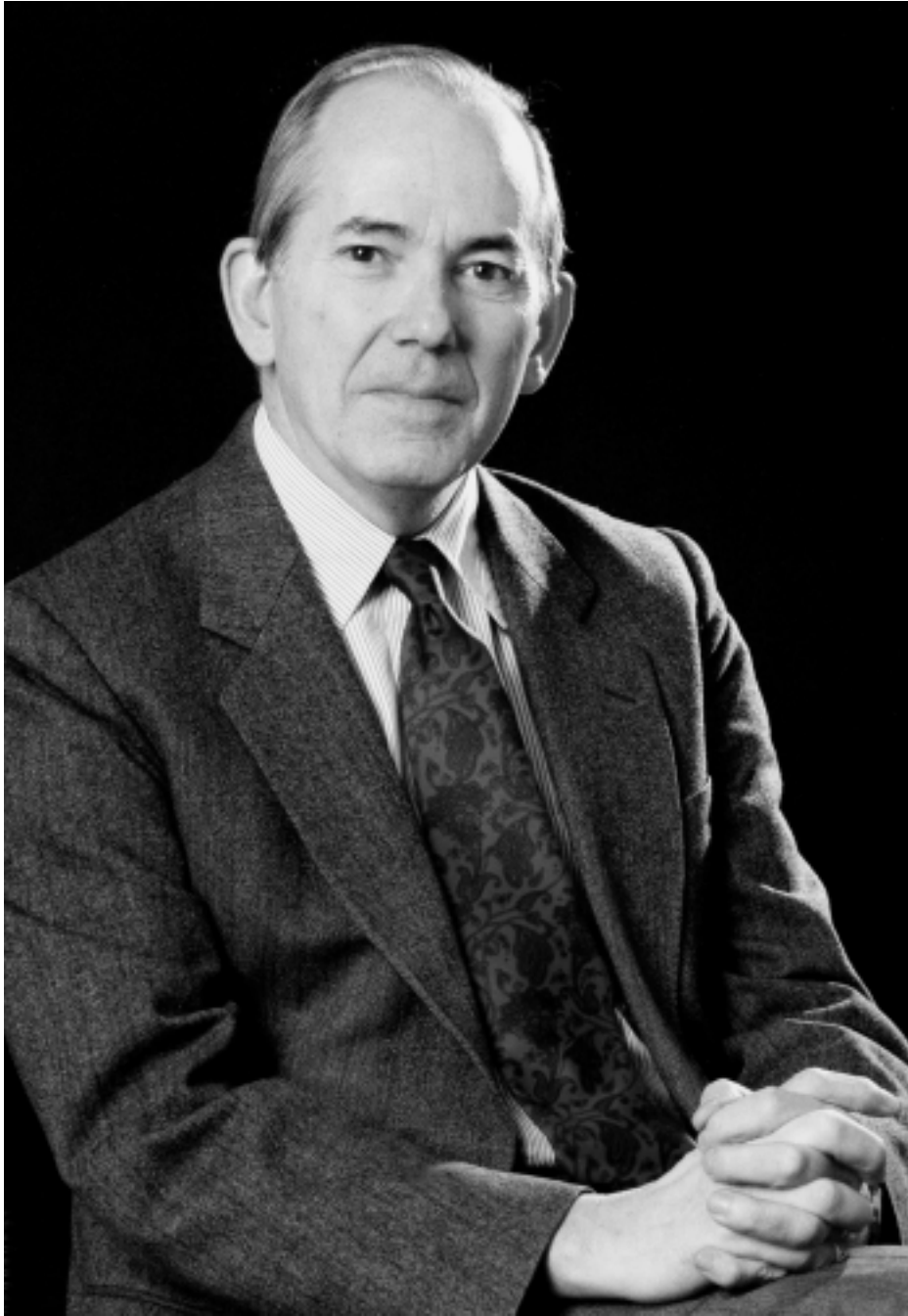
If de Larosière was the IMF's "Gallic mastermind," Camdessus was its "Gallic charmer," and it was that charm that enabled him to apply a firmness of will that often surprised and confounded those who equated good nature with invertebracy. When he arrived at the IMF in 1987, he spoke English with what journalists liked to describe as an "Inspector Clouseau" accent and was more at home in Spanish, which he spoke as flawlessly as his native French. (A decade later, a more common description of his English was "lilting.")

Camdessus imposed discipline on a willing Executive Board, limiting the length of oral statements and urging Directors to avoid oral statements altogether by circulating written statements in advance. During a period of increasing demands on the Fund to consider funding requests and to review its policies and procedures, the Board was thus able to stabilize and eventually to reduce the time it spent in meetings.

To an even greater extent than his predecessor, Camdessus quickly came to be on first-name terms not only with most of the world's finance ministers, but also with many heads of state. When de Larosière went on a fishing holiday in Canada with colleagues after the Annual Meetings of IMF and World Bank governors in Toronto in 1982, it was widely viewed as a rare display of relaxation. When Russian Prime Minister Viktor Chernomyrdin persuaded Camdessus to hunt boar with him during a break in the negotiations for a stand-by arrangement in 1994, it was only the form of relaxation that occasioned surprise.

In contrast to de Larosière's background in the center-right Gaullist tradition of French politics, Camdessus—though politically neutral—was promoted by

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Michel Camdessus, Managing Director January 1987–February 2000

François Mitterrand, the head of France's Socialist Party. His social concerns also were reflected in his deep and open commitment to religion as a guiding principle for his life. As a Roman Catholic as much as Managing Director, he often met with religious leaders, including Pope John Paul II, and vigorously advocated a role for the Fund in ameliorating global poverty and promoting "high-quality growth" in developing countries.

In view of the self-confident manner in which Camdessus pushed to strengthen the Fund's role in the world economy with little apparent concern for the opposition of officials in major countries, the world's financial press wrote him off in 1990 as unlikely to win a second term as Managing Director. He was written off again five years later as unlikely to win a third. That disparaging view, however, failed to take account of Camdessus's ability to know when to defer on points that were most important for creditor countries and when to insist on points that were critical for the institution. In January 1997, he became the first Managing Director to enter his eleventh year in the job. By the time Camdessus stepped down in February 2000, the membership had grown to 184 countries, and the assets under the Fund's control exceeded \$400 billion, more than double the level when he first took office.

The differences in working styles and personal philosophies were reflected inevitably in the priorities and in the strengths and weaknesses that each Managing Director brought to the job. Nonetheless, on the most fundamental level, both men stressed the same view of the Fund as an institution that could help strengthen the world economy only by maintaining both its own financial strength and the rigor of its standards for economic policies. Consequently, the evolution of Fund surveillance, lending practices, and the strategy for resolving the international debt crisis of the 1980s all unfolded in more of a continuum than one might have expected. Such notable successes as the establishment of a major new endowment to finance low-interest loans to the world's poorest countries and the negotiation of global standards for macro and structural economic policies are directly attributable to initiatives by Camdessus, but they built directly on the achievements of his predecessor, de Larosière.

At the Precipice of the 1980s

The World Economy

The 1970s will long be remembered as a decade of poor economic performance and poor economics. Poor performance is the easier of the two to document: high inflation around the world, sagging productivity growth, rising unemployment, and wide domestic and international imbalances. That combination of ills even brought a new word, "stagflation," into the language. A charge of poor economic analysis and policymaking is inherently more controversial, but in this case many examples may be cited: attempts to live with and accommodate inflation, attempts to fine-tune aggregate demand to sustain economic growth, attempts to use nomi-

nal policy tools to achieve real goals, and faith in the power of general principles such as Keynesian or monetarist macroeconomics and purchasing power parity (PPP) in exchange rates.⁶

Four issues dominated the debates on international economic policy in the late 1970s: restoring economic growth to the rates that had prevailed before 1973, reducing price inflation, managing exchange rates for the major currencies in the context of a pronounced “overhang” of U.S. dollars in official portfolios, and financing the current account deficits of oil-importing developing countries.

Growth

For the industrial countries as a group, real output growth averaged 4¾ percent a year from 1960 through 1973 and then slowed to 2¾ percent a year for 1973–79. Was this slowdown cyclical, in which case it could be countered through expansionary fiscal or monetary policies; was it an inevitable slowdown from high post-war growth rates; or was it a structural shift in response to the first “oil shock”—the sharp rise in oil prices in 1973–74? The possible need for a sustained policy response to a long-term problem was recognized officially as early as November 1975, when the Ministerial Council of the Organization for Economic Cooperation and Development (OECD) initiated a study by an international group of experts—chaired by a former chairman of the U.S. President’s Council of Economic Advisers, Paul McCracken—to recommend a strategy for achieving both full employment and price stability over the medium term.

The McCracken Report (1977) concluded that pre-1973 growth rates were both desirable and achievable and that countries should adopt cautiously expansionary policies until private sector growth began to accelerate on its own. The following year, the leaders of the major industrial countries agreed at their annual summit meeting in Bonn, Germany, that countries with relatively low inflation and strong external positions—notably Germany and Japan—should adopt more expansionary fiscal policies in the common interest of world growth. That strategy, which became known as the “locomotive” approach and which was supported by the Fund, served to spur inflation more than real growth and gave policy coordination a bad reputation that took years to overcome. The fundamental problem, however, was not any intrinsic weakness of the cooperative approach but rather that Germany’s growth rate (then about 2½ percent) was already about as strong as the economy could support. Only later, when the structural break in potential output growth was more fully understood, would policy coordination bear less bitter fruit.

Inflation

Inflation in the 1970s was at its highest levels since just after World War II. When inflation finally peaked in 1980, consumer prices around the world rose by

⁶Macroeconomic thought in the 1970s was dominated by a synthesis of Keynesianism and monetarism in which either fiscal or monetary policy could be assigned to stabilize aggregate demand; see Leijonhuvud (1968) and Friedman (1970). For a prominent example of the relatively benign view of inflation in the 1970s, see Tobin (1972, 1987).

nearly 18 percent over the year before: 12½ percent in industrial countries and almost 29 percent in developing countries. A decade earlier, that problem would have been analyzed as a simple case of “too much money chasing too few goods”; in Milton Friedman’s catchphrase, inflation was said to be “always and everywhere a monetary phenomenon.”⁷ After 1973, however, inflation seemed different, partly because it clearly had been aggravated by major structural shifts—the oil shock and the rapid depreciation of the U.S. dollar—and partly because it persisted through a decade of sluggish demand. This structural stagflation fostered many attempts to develop a more comprehensive model of inflation, but not with much success at producing a new consensus.⁸ Direct controls on wage or price increases, or “incomes policies,” seemed to work only weakly and only in countries with a high degree of social consensus. If the only effective weapon against inflation was a restrictive policy on aggregate demand, then prices could not be restrained without further sacrifices on an already sluggish real growth.

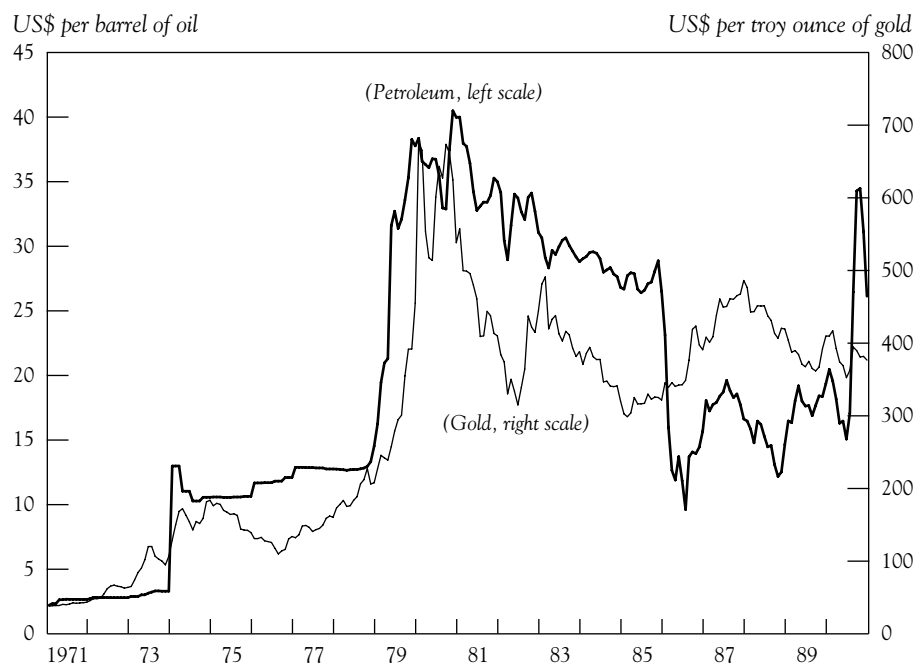
The final inflationary impulse of the 1970s was the second oil shock. In December 1978, a ministerial meeting of the Organization of Petroleum Exporting Countries (OPEC) agreed to raise export prices by 5 percent from an initial base of less than \$13 a barrel, and the group projected a further rise of close to 10 percent during the coming year. An already tight oil market then tightened dramatically the next month when a general strike in Iran forced the pro-western Shah to flee the country. Despite efforts by the largest producer, Saudi Arabia, to maintain stable prices, OPEC ministers agreed in March 1979 to approve selective price increases for other member countries, a move that signaled the beginning of the end for the organization’s remarkably successful six-year run of controlling world prices. Experts soon were predicting oil price increases of 30–100 percent from the 1978 levels.

Oil markets tightened further in April 1979 following the meltdown of the Three Mile Island nuclear reactor in the United States, sanctions by the Organization of Arab Petroleum Exporting Countries against Egypt in response to Egypt’s rapprochement with Israel through the Camp David Accords, and reports of a precipitous decline in oil exports by the Soviet Union. OPEC ministers met again, in Geneva, in late June, and set a new benchmark price of about \$20. Although that decision was generally viewed as decisive, OPEC was doing little more than recognizing and validating market realities. After the U.S. government banned oil imports from Iran in response to the takeover of the U.S. embassy and the holding of American hostages in Tehran in November 1979, after the Soviet Union further strained its own dwindling resources and disrupted conditions in the Middle East by invading Afghanistan in December, and after Iraq invaded Iran the following September, no official action could have prevented world oil prices from rising further. By the end of 1980, when prices finally began to subside, the average price of a barrel of oil in world trade had doubled again, to \$40 (Figure 1.1).

⁷Friedman’s 1963 Bombay lecture, which stresses the “always and everywhere” argument, is reprinted in Friedman (1968), pp. 21–39.

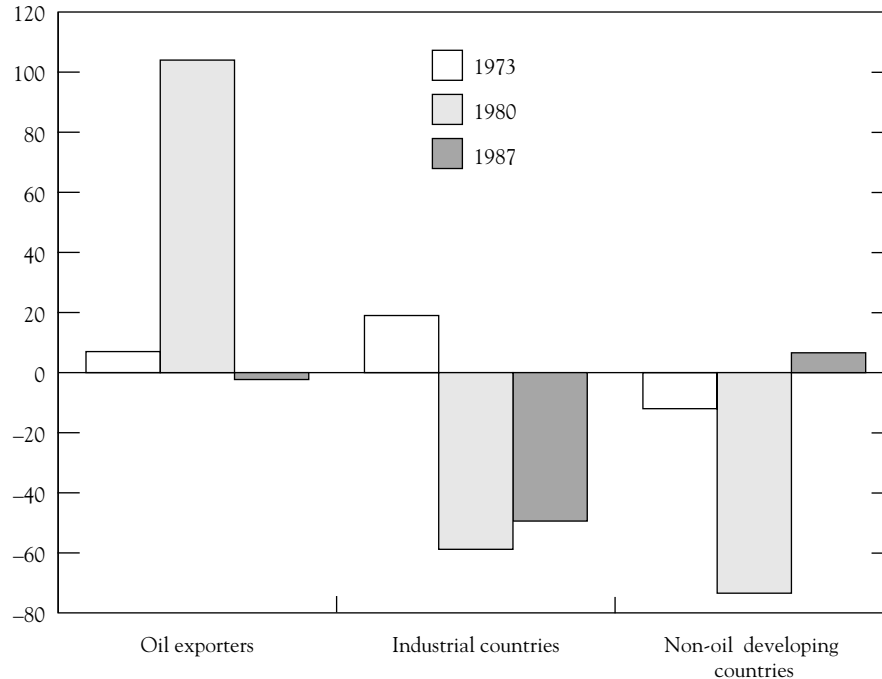
⁸See, for example, the papers in Monti (1976) and Hall (1982); and Bruno and Sachs (1985).

Figure 1.1. Petroleum and Gold Prices, 1971–90



Exchange Rates

Almost everyone favored a *laissez-faire* policy on key-currency exchange rates in the late 1970s, despite the evident imbalances and instability of the period. After some twenty-five years of pegging rates to the U.S. dollar and five with more flexibility, most economists and policymakers were convinced that floating between the dollar and other major currencies was the only viable approach for the future. The oil shock and the general economic slowdown had affected countries differently, and it was difficult to envisage how any system of fixed rates could have been managed so as to reflect those differences. From the end of 1972 to the end of 1978, the U.S. dollar depreciated by 36 percent against the Japanese yen and by 43 percent against the deutsche mark. Policy adjustments to prevent changes of that magnitude would have lain somewhere between wrenching and impossible. Even more fundamentally, economic theory was understood to suggest that floating exchange rates would adjust quickly toward equilibrium PPP levels and would follow the “fundamentals” as encapsulated in monetary models. That is, PPP theory and the monetary approach of which it was a part meant not only that stable equilibrium exchange rates existed, but also that market forces would keep actual exchange rates close to equilibrium in the absence of government intervention. Few policymakers ever completely lost their fear of relinquishing control to the private markets, but belief in the viability of floating exchange rates gradually took hold during the first several years of experience after 1973 (see Isard, 1978).

Figure 1.2. Current Account Balances, 1973, 1980, and 1987*Billions of dollars****External Imbalances***

The final thread in policy analyses of the time was the need to “recycle petrodollars.” In addition to sapping growth and driving inflation, the rise in oil prices brought a major shift in external current account balances. From 1973 to 1980, the aggregate current account surplus of oil-exporting countries rose from \$7 billion to \$112 billion, the industrial countries as a group shifted from a \$19 billion surplus to a deficit of \$44 billion, and the non-oil developing countries saw their deficit explode from \$12 billion to \$80 billion (Figure 1.2).⁹ Especially hard-hit were the many developing countries that had little or no access to international capital markets. Either they had to find some means of financing their deficits or they would have to cut back severely on imports and sharply curtail development plans and other essential spending. Multilateral official agencies including the IMF established special “oil facilities” to recycle surpluses to oil-importing countries, but the appropriate policy conditionality was lacking. The main intermediaries were the commercial banks that directly or indirectly were receiving large inflows of funds from the newly wealthy oil exporters. Faced with sluggish loan demand at

⁹Balances do not add to zero, owing to measurement errors and the exclusion of countries that were not members of the Fund in the 1970s (notably the USSR and the People’s Republic of China).

home, many banks turned eagerly to the market for sovereign loans to developing countries as the means to invest their burgeoning liquid assets. From 1977 to 1980, net international bank lending ballooned from \$68 billion to \$160 billion, of which \$49 billion went to non-oil developing countries. Only much too late did the realization set in that many of the recipients of those loans would be unable to service them, at least until they implemented difficult and time-consuming policy reforms.

The Fund

The period covered in this book begins at an arbitrary date—January 1979—that picks up the story of the IMF where Margaret Garritsen de Vries left off at the end of the last Fund History.¹⁰ Since the seminal event for the evolution of the Fund in the 1980s—the Mexican debt crisis of 1982—was still some 43 months away, the early years may seem at first glance to form little more than a prologue. And in a real sense they were a prologue, because the shocks and policy shifts of 1979–81 set the stage for the financial reverberations of 1982. Prophetically, the very first gathering of the Fund’s Executive Directors on returning from the holidays at the beginning of 1979 was for a meeting on Mexico. On January 3, the Executive Board approved the authorities’ economic program for the coming year, which was to be supported by an extended lending arrangement that was entering its third and final year. It was an upbeat and congratulatory meeting, in which the Managing Director praised Mexico for its “excellent creditworthiness” and for keeping the fiscal deficit within manageable limits. Ariel Buira, the Alternate Executive Director for Mexico, predicted a flourishing future in which Mexico’s economic growth would be fueled by revenues from petroleum exports and would no longer be constrained by the need to finance the balance of payments.¹¹ Only much later would the ironies of this routine meeting become apparent.

Surveillance

The dominant focus of the Fund’s energies in 1979 was on surveillance over the exchange rate policies of member countries. After the United States formally terminated the convertibility of the U.S. dollar into gold in August 1971 and brought the Bretton Woods par value system to an end, the Fund’s governors set out to devise a system of stable exchange rates without that gravitational center. The Group of Ten (G-10) industrial countries, which had become the predominant international policymaking group in the 1960s, initially took the lead by agreeing on a new set of fixed exchange rates against the dollar at a celebrated meeting at the Smithsonian Institution in Washington (December 1971). That agreement lasted little more than a year and collapsed with a bang in March 1973 when selling pres-

¹⁰The main theme of de Vries (1985) was the negotiation of the Second Amendment to the Articles of Agreement, which took effect in 1978.

¹¹Minutes of EBM/79/1 (January 3, 1979), pp. 7 and 19 (Buira) and 20 (Managing Director).

sure on the dollar forced European countries to close foreign exchange markets for several days and then reopen with floating rates. Once it was apparent that the initial devaluation of the dollar had been insufficient and that policies among the G-10 were too divergent to sustain fixed rates, a more globally representative committee was formed to design a system that would be more flexible while—it was hoped—restoring stability.

The ministerial-level Committee of Twenty (C-20), on which nearly all Fund members were represented directly or indirectly, met periodically in 1972–74 and produced a report recommending that the par value system of exchange rates be restored. The new system, however, was to have “more symmetrical” adjustment of parities, and express allowance was to be made for the adoption of floating rates “in particular situations, subject to Fund authorization, surveillance, and review” (de Vries, 1985, Vol. 3, pp. 169–70). A successor was then formed to the C-20, with the same membership of 20 finance ministers from around the world. This Interim Committee failed to agree on a plan to restore the par value system but did agree (at a January 1976 meeting in Kingston, Jamaica) on a comprehensive set of amendments to the Fund’s Articles of Agreement. The Second Amendment, which took effect in April 1978, eliminated the monetary role of gold, accepted that member countries could adopt whatever exchange arrangements they chose (except pegging to gold, and subject to Fund approval for certain restrictions), and authorized the Fund to exercise “firm surveillance” over the exchange rate policies of member countries.¹²

As discussed in more detail in Chapter 2 of this History, the mechanics for surveillance were already in place long before 1978, in the form of the annual consultations that the Fund held with most of its member countries. Article IV of the Articles of Agreement, which was completely rewritten for the Second Amendment, strengthened the mandate for those consultations by specifying principles both for the conduct of exchange rate policies and for the oversight role of the Fund. The task for the institution was to give content to those principles and to the meaning of the deliberately vague phrase, “firm surveillance.”

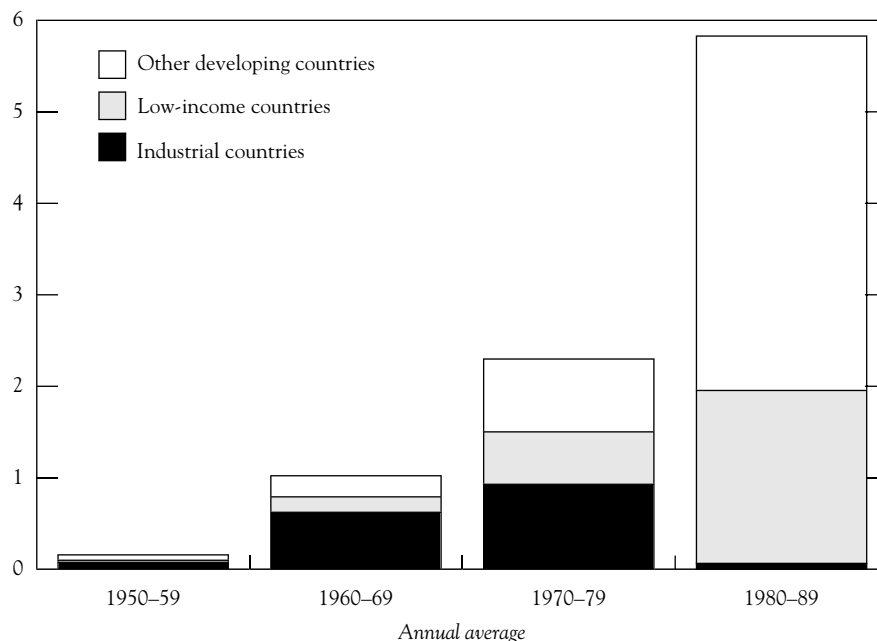
Lending

A second field of focus was the expansion of lending to developing countries. Although it was not evident at the time, the demand for Fund resources by industrial countries was drawing to a close. Private capital markets were playing an ever-increasing role in financing international payments, especially for the most developed economies. Moreover, the end of the Bretton Woods system was providing scope for exchange rates to absorb much of the shock when economic events affected countries or regions differently. Those developments had limitations. Two

¹²For the full set of amendments, with explanatory commentary, see de Vries (1985), Vol. 3, pp. 317–76. The original Articles of Agreement as drafted at Bretton Woods (in 1944) are in Horsefield (1969), Vol. 3, pp. 185–214. The Articles after the First Amendment (1969) are in de Vries (1976), Vol. 2, pp. 97–157. The Articles after the Second Amendment are in de Vries (1985), Vol. 3, pp. 379–446.

Figure 1.3. IMF Lending, 1950–89

Billions of SDRs

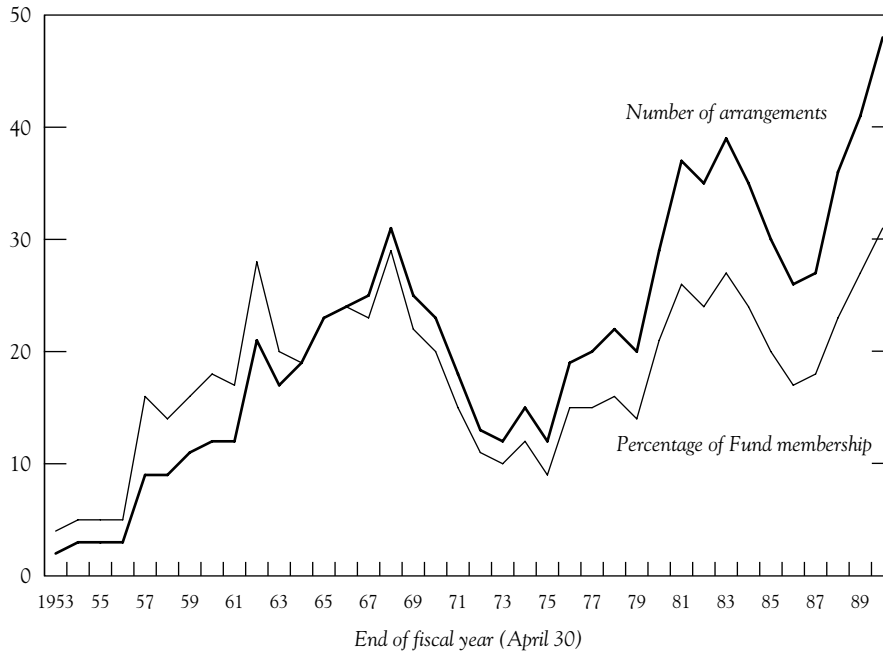


major countries—the United Kingdom and Italy—borrowed heavily from the Fund in the mid-1970s, contingency plans were made for a lending arrangement with the United States when the dollar came under speculative pressure in 1978, and smaller industrial countries continued to borrow from the Fund until 1982.¹³ It was by no means obvious in the late 1970s that industrial countries no longer needed the Fund’s financial resources.

What was obvious was that the *world* needed the Fund’s resources as much as ever. Virtually simultaneously with the decline in demand from countries with ready access to private capital markets, demand from less developed countries rose sharply (Figure 1.3 and Figure 1.4). A combination of adversities—a slowdown in growth in the industrial countries that were the principal markets for the world’s exports, worsening terms of trade for exporters of primary commodities, and the failure of many developing countries to adjust promptly to disturbances—heightened the financing needs of countries in Asia, Africa, the Mediterranean region, and Latin America. Many developing countries that borrowed heavily from commercial lenders in the 1970s came to the Fund after 1982 when commercial financing suddenly dried up in the wake of the international debt crisis. More broadly, the poorer countries that lacked access to private capital markets increasingly turned to the Fund as well as to other multilateral agencies for help in the

¹³In addition, several industrial countries drew on their reserve tranche balances in the 1980s. The last such drawing occurred in 1987.

Figure 1.4. IMF Financing Arrangements in Effect, 1953–90



1970s and even more so in the 1980s. Consequently, the portion of Fund resources being drawn by low-income countries rose in the 1970s and by even more in the 1980s.

The combination of abandoning the monetary role of gold and increasing lending to low-income countries led the Fund to begin selling or distributing a third of its massive stock of gold in 1976. Those gold sales, half of which financed the establishment of a Trust Fund to make highly concessional low-interest loans to impoverished countries, were being completed in 1979 and 1980 just as a speculative fever was driving the market price of gold to ridiculous heights (more than \$800 an ounce for a few days in January 1980, compared with average prices of less than \$200 in 1978 and less than \$400 in 1982; see Figure 1.1). Overall, the sale of gold generated profits of \$4.6 billion, an unexpectedly large sum that eventually provided the resources not only for the Trust Fund but for its 1986 successor, the Structural Adjustment Facility (SAF).

A further consequence of the shift in demand for the Fund's resources was an increased complexity in the procedures and financing for Fund lending. That development was reflected at the end of the 1970s in a moderate expansion of the special "facilities" or lending windows available to member countries. The Compensatory Financing Facility (CFF) was liberalized to allow for larger credits in a wider range of circumstances, the Extended Fund Facility (EFF) was liberalized to allow for longer maturities, and the Supplementary Financing Facility (SFF) came into effect in February 1979 to provide additional money for stand-by and EFF

arrangements. Acronymic propagation, however, was far from over as the Fund prepared for the 1980s.¹⁴

The SDR

The IMF's most important acronym, and its most inscrutable, is the SDR. Created in 1969 through the First Amendment of the Articles, the Fund's Special Drawing Rights were often described at the time as "paper gold." Neither paper nor gold, the SDR is (among other functions) both the Fund's own unit of account and an unconditional line of credit to participating countries.¹⁵ Originally defined as the gold equivalent to one U.S. dollar and intended to supplement dollars in official international reserves, the value of the SDR was redefined in 1974 as a basket of 16 internationally traded currencies and in 1981 as a basket of the 5 that were in the widest usage for international payments.¹⁶ The Second Amendment asserted that the SDR was to become "the principal reserve asset in the international monetary system" (Article VIII), and it obliged member countries to collaborate with the Fund to fulfill that objective (Article XXIII). Although neither the goal nor the obligation was ever taken as seriously as that language seems to suggest, the SDR did take on a substantial role in the life of the Fund.

The importance of the SDR as a reserve asset was on the rise at the end of the 1970s. The initial allocations of SDRs in 1970–72 had put SDR 9.3 billion at the disposal of 112 participating countries, an amount that constituted 8½ percent of the world's nongold international reserves. Political disputes over the role of the SDR in a world of floating exchange rates precluded new allocations during the next several years, and the share of SDRs in reserves dropped below 4 percent. But allocations resumed in 1979, and by the time they concluded in January 1981, the stock of outstanding SDRs amounted to SDR 21.4 billion (worth approximately \$27 billion), or 6½ percent of world reserves.

The usefulness of the SDR was also growing beyond the Fund's own accounts, as the unpredictability of the value of the U.S. dollar forced international holders to look for more stable alternatives. Several public and private organizations adopted the SDR as their own unit of account, as many as 15 countries pegged the values of their own currencies to the SDR, and markets were beginning to develop for loans, bonds, and bank deposits denominated in SDRs. The Fund encouraged that interest and nourished it through several moves to strengthen the liquidity and transparency of the asset. In 1979, management revived an earlier proposal for a "substitution account" to replace dollars with SDRs in official reserves, and for a

¹⁴The IMF's *Annual Report* for 1999 included a list of 21 abbreviations and acronyms for the institution's operations, 16 of them new since 1979.

¹⁵With remarkable devotion to acronymizing, the Fund adopted a formal decision in 1983—establishing Rule B-6 of the Fund's Rules and Regulations—that the term "SDR" (or "SDRs," as appropriate) was equivalent to "special drawing right(s)" and was to become standard usage in all Fund documentation. Decision No. 7481-(83/112), adopted July 26, 1983.

¹⁶In 1999, the number of currencies in the basket was reduced to four when the French franc and the deutsche mark were replaced by the newly created euro. The other three currencies are the U.S. dollar, the Japanese yen, and the pound sterling.

time the Interim Committee appeared likely to approve it. It was, however briefly, a golden age for the SDR.

Evolution and Revolution in the 1980s

The World Economy

The 1980s brought more economic success than the 1970s, especially through the stabilization of prices. Although global output growth continued the declining trend that began in the 1970s, a gradual improvement in policymaking laid the groundwork for the noninflationary growth that many countries would enjoy in the 1990s. Major parts of the world economy, however, suffered some of the most severe economic stresses of the century.¹⁷

End of Inflation

The greatest economic success of the 1980s was the taming of inflation in industrial countries. The second oil shock may have aggravated the problem, but it also finally galvanized policymakers in oil-importing countries into taking effective action against inflation. The centerpiece and the symbol of the new regime was the announcement in October 1979 of a new system for controlling monetary policy in the United States. Henceforth, the Federal Reserve System, instead of using short-term interest rates as a policy lever (which opened it to political pressure to prevent rates from rising), would focus more directly on the quantitative control of monetary growth through the supply of bank reserves and would use that power to break the expectation of continuing inflation. Although the growth rate of the basic money stock in the United States fell only slightly—from 8¼ percent in 1978 to 6½ percent in 1981—the shift in strategy had a dramatic effect on interest rates. Short-term rates doubled over those three years, and both long- and short-term rates increased sharply in nominal and real terms (Figure 1.5). The Federal Reserve's resolve effectively broke the psychology by which anticipations had been driving up prices. With a brief lag, consumer price inflation fell precipitately: from 13¼ percent in 1979 to less than 4 percent in 1982. Similar declines followed shortly thereafter in the other major industrial countries, and by 1983 inflation was essentially finished as a major *international* policy problem (Figure 1.6).¹⁸

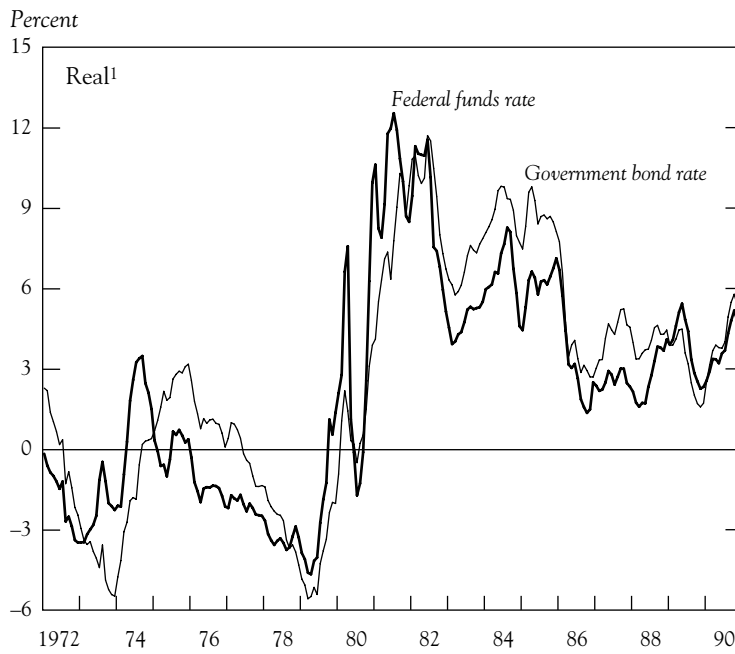
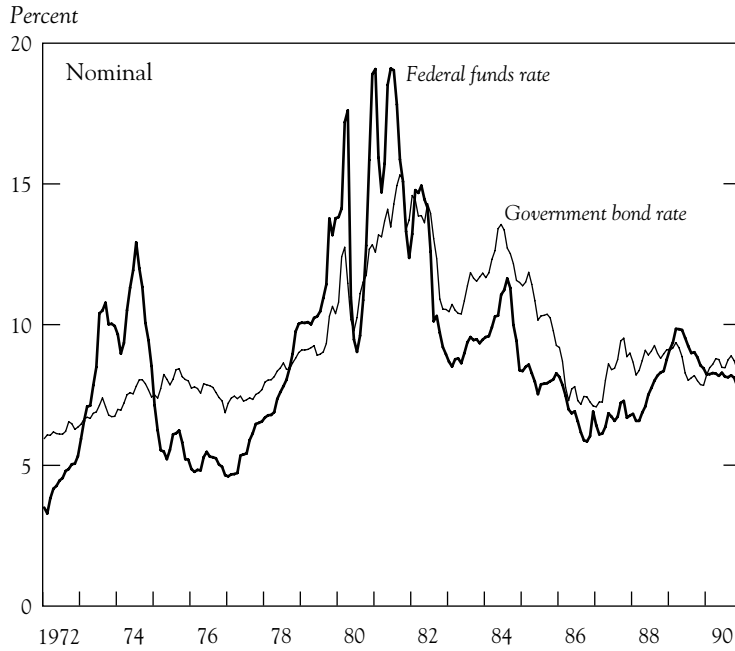
The end of inflation was not an unmixed blessing, for two reasons. It did not bring stability in all markets, and it led to a sharp, though temporary, drop in output and employment.

¹⁷For an overview of the 1980s and the 1990s that emphasizes the evolution of the international financial system, see Solomon (1999a).

¹⁸As is clear from Figure 1.6, *world* inflation did not subside in the 1980s, owing to increases in developing countries. The aggregate data for that group are dominated by a few large countries with chronically high inflation in that period: notably, Argentina, Brazil, Nicaragua, Peru, Uganda, and Zaïre.

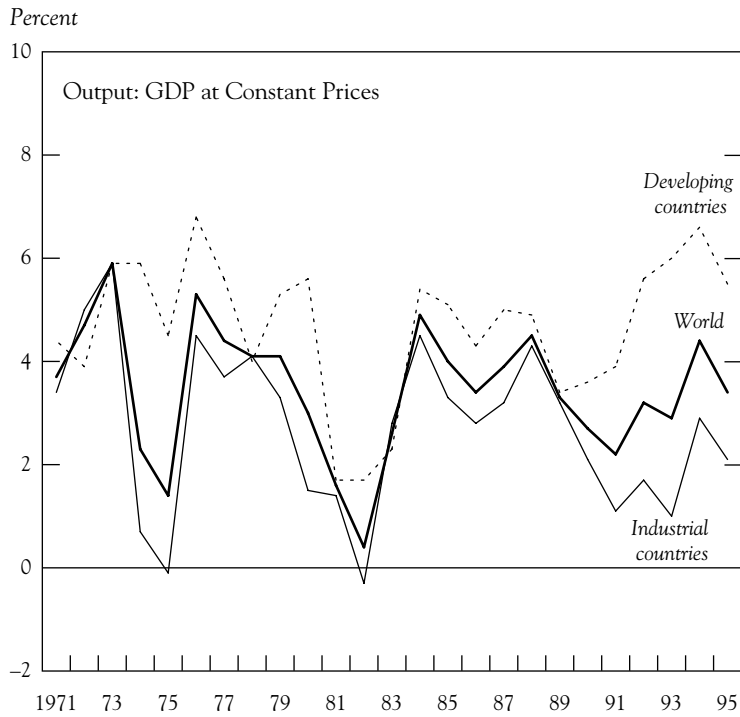
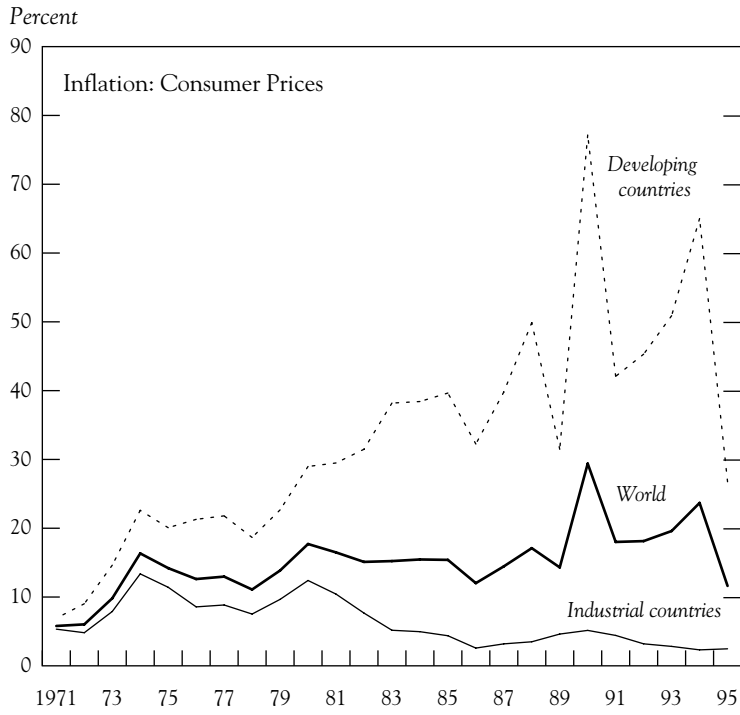
1 THE SILENT REVOLUTION

Figure 1.5. U.S. Interest Rates, 1972–90



¹Real rate equals nominal rate minus CPI inflation over next 12 months.

Figure 1.6. World Output Growth and Inflation, 1971–95



In the mid-1980s, markets collapsed for many primary commodities, causing what could reasonably be called the most severe decline in commodity prices in recorded history and severely aggravating economic declines in developing countries.¹⁹ For low-income countries and multilateral development institutions, the worldwide depression in commodity markets was the single most devastating economic event of the decade.

From a global perspective, the single most important decline was in the price of oil (Figure 1.1). While this reversal of fortunes was welcomed in many parts of the world and contributed importantly to sustaining economic growth and stable price levels throughout the 1980s, it also disrupted the development plans and investment programs of exporting countries from Saudi Arabia to Indonesia to Mexico and Venezuela.

As a further illustration of the effects of weak market conditions, consider the case of coffee. World coffee prices were relatively stable in the first half of the 1980s, as the quota system administered by the International Coffee Organization (ICO) functioned fairly smoothly. Prices then surged briefly in 1985–86 following a drought in Brazil (the world's largest producer), and the ICO temporarily suspended its quotas. After the Brazilian crop recovered, the ICO had difficulty restoring the previous calm, and competition among suppliers pushed prices well below early-1980s levels for nearly a decade. When the quota system collapsed in July 1989, prices plummeted to less than half the 1980–85 average and to less than one-third the peak levels of 1986. Not until 1994 would a semblance of normalcy be restored.

From 1987 to 1993, developing countries that depended on coffee for their livelihood and in some cases for their economic survival faced some of the most difficult policy choices in their history. Those most affected included, in addition to Brazil, several other Latin American countries (most notably Colombia), much of East and Central Africa (notably Burundi, Kenya, Madagascar, Rwanda, Tanzania, and Uganda), and a scattering of Asian countries (notably Indonesia). From the Fund's perspective, the challenge posed by this long-term collapse was to find some means of promoting major structural reforms in these countries and of encouraging large-scale financial support from other creditors. Without reform and support, the traditional medicine of macroeconomic adjustment would ultimately fail and would lead only to further impoverishment.

The process of wringing out inflationary pressures also brought on a deep global recession in the early 1980s. Every region of the world except Asia experienced

¹⁹Evaluation of the timing and extent of the decline is sensitive to the choice of index, currency denomination, and comparator. The IMF's price index for nonfuel primary commodities declined by 27 percent from 1984 to 1987 when measured in SDRs and by 27 percent from 1980 to 1986 when measured in U.S. dollars. Relative to prices of manufactured goods, the index declined by 32 percent from 1984 to 1987. See IMF Commodities Division (1990), p. 26. Relative declines of similar magnitude occurred in the early 1930s, after both of the World Wars, and in the second half of the 1970s; all of those declines, however, were reactions to preceding major booms in commodity prices. Based on the long-run index (1870–1988) developed in Boughton (1991), the relative price of commodities reached its lowest all-time level in 1987.

marked declines in the growth of output, and the majority of the world's countries recorded one or more years of negative growth. Neither the causes nor the symptoms of the cyclical downturn were unusual, except that the primacy of inflation reduction as a policy goal made the adjustment more wrenching than in previous postwar episodes. What marked this experience most clearly was a series of commitments in some of the larger countries not to respond to the downturn with countercyclical policies. For the first time since the 1930s, the prevailing official response to recession was to eschew responsibility for economic growth and employment in order to focus on the goal of stabilizing prices. That response began in Japan, under Prime Minister Masayoshi Ohira in 1978–80, and continued (with varying degrees of commitment) after a series of political shifts in the United Kingdom (the election of Margaret Thatcher in 1979), the United States (Ronald Reagan in 1980), and Germany (Helmut Kohl in 1982). Even in France, where President François Mitterrand and Prime Minister Pierre Mauroy attempted from 1981 to 1983 to engineer a unilateral economic expansion, countercyclical policy was soon abandoned.²⁰

New Classical Revolution

The shift in macroeconomic policymaking that ended global inflation was prompted by several interrelated developments in the mainstream of economic thought. Those developments together constituted a “new classical” revolution in economics. The essence of this revolution was the proposition that macroeconomic performance replicates the behavior of an immortal “representative agent” with perfect foresight of all relevant data and constrained only by budgets and technology. (For an exposition and critique, see Hahn and Solow, 1995.) From that article of faith flow four properties of macroeconomic policy that came to be widely accepted both by professional economists and policymakers in the 1980s.

First, “nominal instruments” (policy actions that directly alter the nominal values of macroeconomic variables such as interest rates or monetary aggregates) do not have predictable or stable effects on “real targets” such as unemployment or the growth rate of output. Attempting to target a below-equilibrium unemployment or real interest rate will drive up inflation with no permanent effect on the targeted variable. Second, for policymakers to try to target real variables dilutes and distorts economic incentives in labor markets. If employers and workers believe that wage increases will be validated by monetary expansion sufficient to prevent a rise in unemployment, then the equilibrium rate of wage increase will rise. Third, steady policies—implemented if necessary through fixed rules rather than through discretionary decisions by policymakers—over a period of several years (the “medium term”) will provide a more stable environment for private sector activity than will policies that must be reversed over short periods. Fourth, those steady policies should aim primarily to provide a “nominal anchor” for expectations and market behavior.

²⁰Solomon (1999b) gives a good overview of these shifts in political philosophy.

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William Dale, Deputy Managing Director March 1974–June 1984

In the early 1980s, these propositions became associated with a variety of fadish theories, each of which was motivated by a distrust of discretionary macroeconomic policy and employed extreme assumptions to argue that monetary or fiscal policy or both would have negligible or pernicious effects on real target variables even in the short run.²¹ The most prominent such fad was the “new supply side” (or, to its detractors, “voodoo”) economics, and its most notorious excess, the “Laffer curve.” According to that school of thought, a combination of liberalization of markets and reduction of the size of governments would enable private sector activity to expand rapidly to fill the vacuum left by contractionary demand-management policies. As a related proposition, some supply-side economists postulated that changes in tax rates might affect the fiscal deficit, but shifts between tax and deficit financing would have no effect on the real economy; that postulate was known as “Ricardian equivalence.”²²

A second fad was a simplified form of monetarism based on a belief that inflation was linked solely to the rate of monetary growth rather than to the relationship between the overall stance of macroeconomic policy and a possibly shifting potential rate of real growth in output. A third was a revived interest in the gold standard as a means of eliminating discretionary monetary policy.²³ By the end of the decade, however, the influence of these extremes had largely faded away.

The new classical revolution brought a second success in policymaking in the 1980s, in addition to the reduction in inflation: the introduction of structural policy changes in both industrial and developing countries that emphasized the promotion of private sector activity and the opening of markets. Owing largely to reductions in trade barriers and to reforms encouraging and helping enterprises to compete in world markets, international trade grew at nearly twice the rate of output growth throughout the second half of the decade (7 percent a year, versus 3¾ percent). At the final gathering of the Fund’s governors in the 1980s—in Washington in September 1989—the importance of open trade and the success of liberalizing structural reforms were extolled not only in the welcoming address by

²¹Smithin (1990) analyzes the fads in economic policymaking in the 1980s. The central failure in such models was the extension of theoretical long-run neutrality to the empirical horizons over which relevant policy effects occurred.

²²For the extreme case for policymaking according to the new supply-side school, see Wanniski (1983). Canto, Joines, and Laffer (1983) provide a detailed theoretical background for the supply-side view of how fiscal policy affects economic activity. For a balanced critique, see Feldstein (1986). The appellation “new” is from Feldstein, and “voodoo economics” was coined by George Bush when he was running against Ronald Reagan for the Republican nomination for U.S. president in 1980. The “Laffer curve” is based on the proposition that total tax revenue is a hyperbolic function of the tax rate; above the revenue-maximizing point, a reduction in the tax rate will raise revenues. Most empirical analyses suggested that in most countries, tax rates in the 1980s were well below that point and that cutting tax rates would reduce revenues. For a review, see Mirowski (1982). Ricardian equivalence also requires acceptance of a strong set of assumptions or hypotheses, notably that households base saving decisions on an infinite horizon rather than on individual life expectancies. For a critical review of that proposition, see Tobin (1980).

²³For the fringe effort to reestablish a form of gold standard in the 1980s, see Lehrman and Paul (1982), Mundell (1983), and Kojima (1990); Cooper (1982) provides a systematic rebuttal.

U.S. President George Bush but also in the speeches of finance ministers from such diverse developing countries as Angola, Nicaragua, Poland, and Vietnam.

These structural reforms—which Camdessus called a silent revolution and which responded to what John Williamson (1990) termed the “Washington Consensus”—did not come without controversy. State ownership, control, and guidance had always played major roles in development strategies, and it was not obvious that those roles could be reduced without exposing developing economies to instability, impoverishment of the less successful sectors, and domination by more established economies and multinational corporations.²⁴ At the 1989 Annual Meetings, dissenting voices on the global strategy were heard from (among others) the Governors for Afghanistan, Peru, and Romania. The Washington Consensus nonetheless had become the prevailing paradigm for the late 1980s and early 1990s.

The Rising Sun

A third major development, and one of the defining characteristics of the global economy of the 1980s, was the emergence of Pacific Asia as an economic power. Japan, the second largest economy in the world since 1968 and by far the largest in Asia, began liberalizing and opening the economy around 1980, including allowing foreign residents to buy Japanese securities more easily.²⁵ By 1985, when the United States embarked on a policy of multilateral policy cooperation, it turned first to Japan to work out bilateral agreements before bringing its more traditional European financial partners into the discussions. In 1989, when the Prime Minister of Australia, Robert Hawke, proposed establishing Asia-Pacific Economic Cooperation (APEC) as a forum for countries along the western rim of the Pacific Ocean, the U.S. government asked to be included so as not to be left out of the creation of one of the world’s largest trading zones.

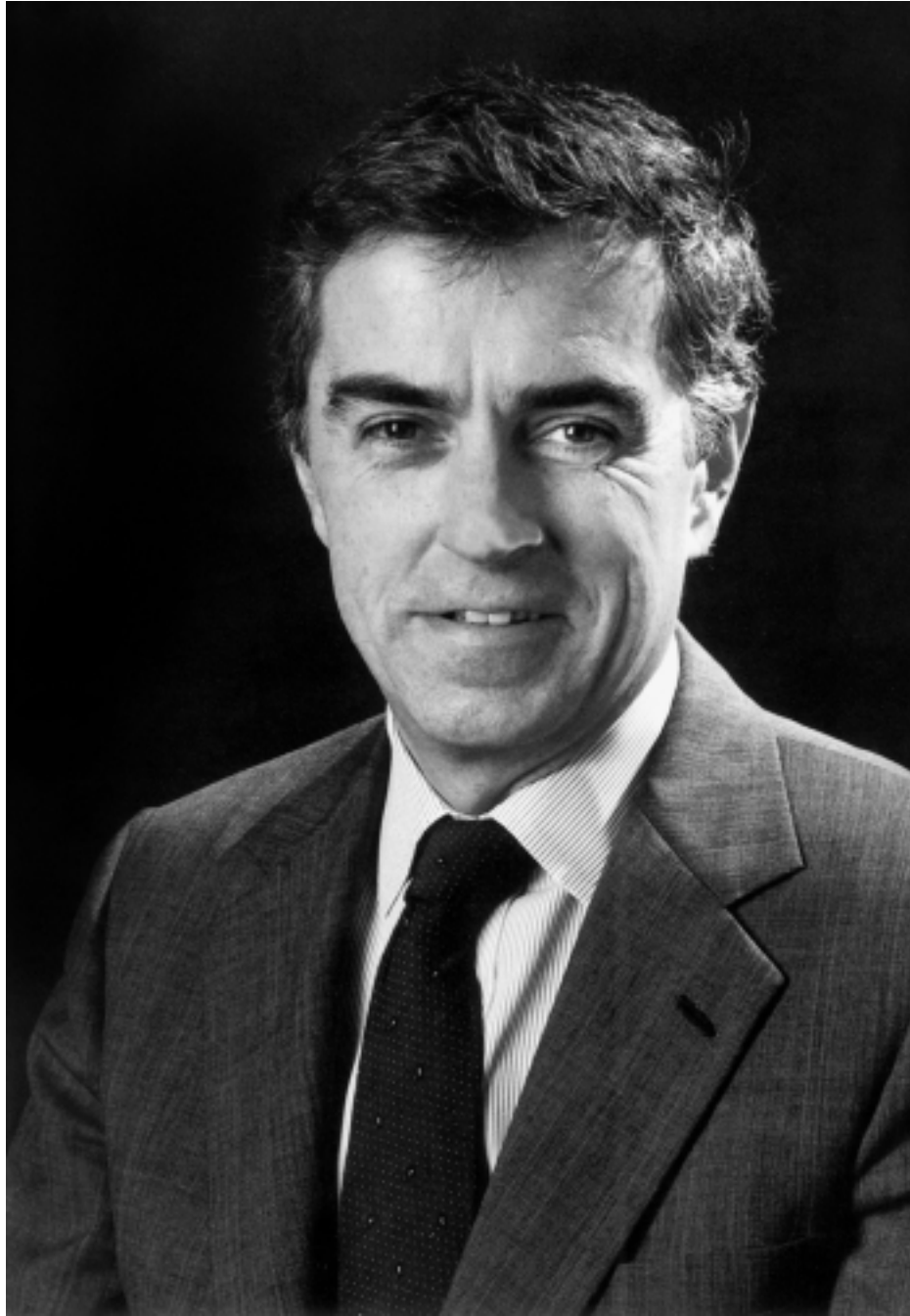
Japan participated in several large loans to the Fund, beginning with the oil facilities in the mid-1970s. In 1986, Japan’s status as a major creditor was solidified when the government lent SDR 3 billion (\$3.6 billion) to the Fund to help finance the “enlarged access” policy.²⁶ The Ninth General Review of Quotas, which began in 1987, would bring a rise in Japan’s quota and voting power in the Fund to a tie with Germany in the number two spot (from number five, where it had been since 1971).

The rise of Asian economic strength was not confined to Japan. Korea transformed itself from a perennial debtor with an underdeveloped economy into a sur-

²⁴Raúl Prebisch was perhaps the most eloquent exponent of this view. For a retrospective introduction to his argument, see Prebisch (1984).

²⁵Virtually destroyed during World War II, the Japanese economy was well on the way to recovery by the time Japan joined the IMF in 1952. In 1964, the government made the yen a convertible currency, accepted the liberalization requirements of the Fund’s Article VIII, and joined the OECD. Four years later, gross domestic product (GDP) in Japan surpassed that of West Germany, making the value of Japanese output higher than that of any other country except the United States.

²⁶As an original member of the G-10, Japan had participated in the General Arrangements to Borrow (GAB) since 1962.



Richard Erb, Deputy Managing Director June 1984–August 1994

plus country with high growth rates and rapid modernization. Both Taiwan Province of China (whose authorities represented China in the Fund until 1980, under the name of the Republic of China) and the People's Republic of China (which assumed the seat at that time) recorded remarkable growth throughout the decade. Indonesia, Malaysia, the Philippines, Singapore, and Thailand all had far healthier economies at the end of the 1980s than at the beginning, both in absolute terms and relative to the rest of the developing world. Over the decade, developing countries in Asia averaged growth in output in excess of 7 percent a year, compared with less than 4 percent for all developing countries. Growth averaged 8 percent in Korea and more than 9 percent in China. The rigidities and economic weaknesses that would contribute to the crisis to this region in 1997 were well out of sight.

Financial Imbalances and Crises

These achievements—low inflation in industrial countries, structural reforms in many countries around the world, and strong economic growth in Asia—suggest that it was not the worst of times, but it was also far from the best. The decade also witnessed a worsening of economic imbalances, of which three were particularly troubling.

First, fiscal deficits widened throughout the world, reflecting the operation of automatic stabilizers, an infatuation in some countries with the extreme forms of supply-side economics mentioned above, and the practical need to maintain economic activity in the face of monetary restriction and adverse economic shocks. The combination of fiscal expansion and the reversal of earlier monetary excesses resulted in a sharp rise in real long-term interest rates—from about 1 percent in the late 1970s to an estimated 6 percent in 1983—and a global weakness in saving and investment rates. In industrial countries, net national saving rates fell by half from 1973 to 1983. That drop contributed to the reduced flow of capital into developing countries in the early 1980s, which was compounded by declining rates of domestic saving there as well (Aghevli and others, 1990).

Industrial countries began to correct their fiscal excesses in the second half of the 1980s, thereby laying the groundwork for more sustained and virtually non-inflationary growth in the 1990s. The correction, however, also brought a marked slowdown in growth that became a widespread recession by the end of the decade, in many developing as well as industrial countries.²⁷

Second, an international debt crisis erupted in 1982 as one developing country after another was forced to retrench from the excessive borrowing levels of the late 1970s. A combination of damaging external shocks—high world interest rates, adverse shifts in the terms of trade, and weak demand in industrial countries—and unsustainable economic policies at home destroyed the ability of many developing

²⁷For an analysis of the effects of industrial country growth on developing countries, see Goldstein and Khan (1982). Real GNP growth in industrial countries fell from a peak of 4.5 percent in 1988 to 1.3 percent in 1991. Growth in real per capita GDP in developing countries fell from a peak of 2.2 percent in 1988 to -0.6 percent in 1990.

countries to service their external debts. Debtors then had to choose between defaulting on their debts or attempting to adjust policies by enough to reduce their external deficits to a financeable level. Most countries chose the latter approach, and efforts to form a united front (a “debtors’ cartel”) to force creditors to accept a reduction in the present value of debt-service payments never advanced beyond general expressions of desire. The debt crisis affected developing countries around the world: those that had borrowed mainly from commercial banks and those that relied primarily on support from official creditors. A few heavily indebted countries, notably in Asia, escaped the crisis through rapid adjustment that emphasized orienting production toward exports, but many more found that degree of adjustment to be beyond their reach.

The effects of the debt crisis were contained in the early 1980s through a “case-by-case” strategy in which external financial support was provided to countries willing to adjust their economic policies. That strategy succeeded in preventing a series of defaults on sovereign debts, but it did not lead to an early resumption of normal relations between debtors and creditors. A driving assumption in the development of the strategy, much debated in the subsequent literature, was that such defaults could have led to multiple bankruptcies of major commercial banks and possibly to a collapse of the international banking system. The debt strategy also succeeded in greatly reducing the payments deficits of many developing countries, but it did so more by forcing a reduction in imports than by fostering growth in exports.

By 1985, a consensus was forming among officials in creditor countries that new approaches were needed for a more favorable and more sustainable solution to the crisis. The focus of the debt strategy during the next few years was to encourage indebted countries to undertake growth-oriented structural reforms, financed largely by longer-term loans from the World Bank and regional development banks, and to encourage commercial banks to resume net lending to countries undertaking such reforms. That effort failed to generate either long-term growth or even much long-term financing, and by 1988 almost all of the countries hit by a debt crisis several years earlier were still struggling to escape from it. For much of the developing world, the 1980s were to be a “lost decade” for economic growth.

The denouement of the debt strategy arrived when the realization took hold that a high-growth equilibrium could be attained only through debt reduction. The debt-relief approach had two prongs: one aimed at the low-income countries that owed most of their external debt to creditor governments, and the other aimed at the middle-income countries that were heavily indebted to commercial banks.

The major industrial countries agreed in 1988 to reduce the present value of external debts of certain low-income countries through the Paris Club. The “Toronto terms” for official debt relief, named for the location of the summit meeting at which the agreement was reached, were gradually improved over the next several years to become the “London” terms in 1991 and the “Naples” terms in 1994. Each succeeding agreement provided incrementally greater concession-

ality for relief on bilateral official debts, but the problem was seemingly impervious. Finally, the limited effect of even the Naples terms on the sustainability of the aggregate debt service of the most severely indebted and poorest countries induced creditors in 1996 to support a joint proposal by the IMF and the World Bank for multilateral (not just bilateral) debt reduction. (See Boote and Thugge, 1998.) As that program—the “Heavily Indebted Poor Countries,” or HIPC, initiative—began to operate in the late 1990s, and notwithstanding its limitations, the first real signs emerged that the debt crisis of low-income countries might ultimately be solvable.

The second prong was the “Brady Plan,” introduced by the U.S. authorities in 1989. The Brady Plan offered a menu of options to heavily indebted middle-income countries to replace existing bank loans with bonds on more favorable terms and to help them buy back part of their outstanding debts at the prevailing market discounts. As with the relief plans for low-income countries, debtors had to qualify to participate by agreeing to implement more sustainable macroeconomic policies and structural reforms. In the next six years (to mid-1995), debt reduction schemes reduced the present value of the debts of 21 developing countries to commercial banks by more than \$75 billion, at an official cost of \$25 billion (Dunaway and others, 1995, pp. 6–7). Aided greatly by a serendipitous and massive decline in world interest rates, the Brady Plan thus provided substantial relief to qualifying countries and brought an end to the debt crisis as an international threat.

The third troubling development of the decade was a persistence of structural rigidities that contributed to economic stagnation and high rates of unemployment in Europe and to the decline in economic fortunes in some developing countries.

Differences in job creation statistics between the United States and western Europe were startling in the 1980s: more than 18 percent growth in total employment in the United States, against less than 4 percent in Europe. Although the political rhetoric of the time attributed much of the U.S. employment growth to the supply-side policies of the Reagan administration, that performance was part of a longer-term trend, fueled and lubricated by labor mobility, strong capital markets, and a generally light-handed approach to the regulation of markets. Those factors were less evident in Europe, where social cohesion, stability, and equality were the more prevalent political ideals (with, of course, marked variations between countries and over time). During the 1980s, in most western European countries the lowest-income groups received about twice as large a portion of total income as in the United States (see Atkinson, 1996). Even if that egalitarian outcome came at the expense of job creation, it was a price that many Europeans seemed prepared to pay as long as the overall standard of living was on the rise. In the difficult economic environment of the 1980s, however, it left European countries without the means to adjust to declines in traditional employment sectors. By the late 1980s, the absence of new employment opportunities and the persistence of unemployment at double-digit levels (dubbed “Eurosclerosis”) forced a reexamination of the trade-offs between distributive and aggregative economic goals. Structural reforms aimed at liberalizing and strengthening mar-

ket forces became an increasingly central topic in annual consultations with the Fund.

In many developing countries, the shift toward privatization and liberalization that began in the late 1980s was less a natural response to shifting economic philosophy than a forced response to desperate economic circumstances. Heavy government involvement in—and direction of—the economy had led to poor choices on capital investment, disastrously high concentrations of income, degradation of the natural environment, and financial ruin. Pervasive corruption became evident in several cases such as the Philippines under Ferdinand Marcos, Haiti under Jean-Claude Duvalier, and Zaïre under Mobutu Sese Seko; and it was also a problem in many other countries where it was still masked. As new governments came into power, they naturally sought new means of improving economic performance, and many of them joined the silent revolution.

A major financial consequence of these various difficulties was that a large number of developing countries were unable—and a few were simply unwilling—to continue to service their external debts. From 1980 to 1983, that problem was concentrated primarily in syndicated loans from commercial banks, which were the most expensive, the shortest in maturity, and the most amenable to renegotiation. By 1984, prolonged and wide-scale overdue payments had spread to official creditors, including the Fund. That problem turned out to be far less tractable than initially thought. Its solution would require the belated development of a coordinated effort on the part of the indebted countries, the Fund, and donor countries that would stretch through the 1990s. From the beginning, structural reform in economic policymaking would play a critical role.

International Monetary System

The system of floating exchange rates established in the vacuum of 1973 was put to a severe test from 1978 to 1985. Major currencies fluctuated massively and with seeming disregard for underlying economic conditions.

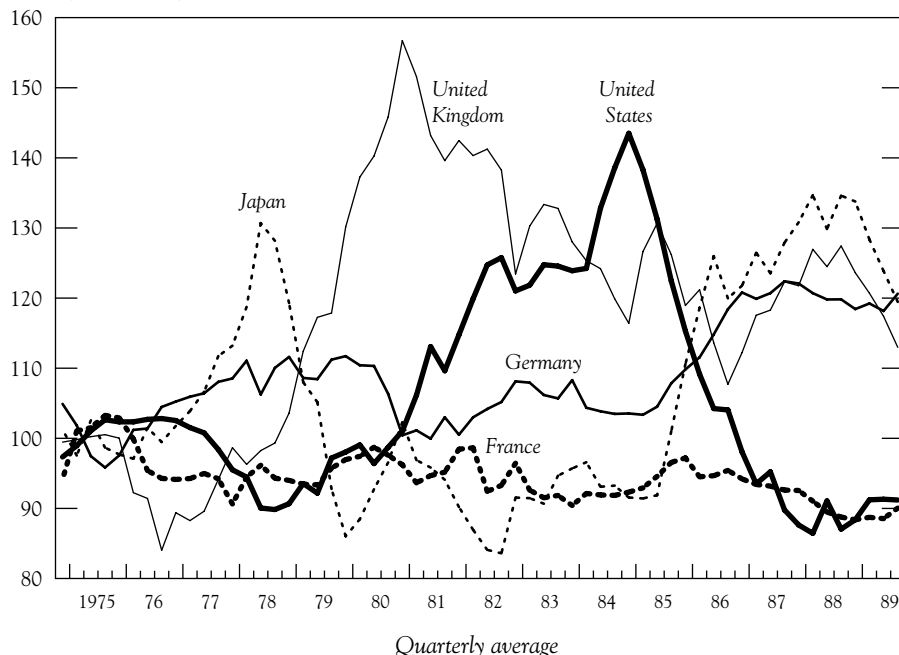
Unstable Exchange Rates

Faced with a collapse in confidence in the dollar, the U.S. authorities were forced into action in the fall of 1978. On November 1, President Jimmy Carter announced that the United States was mobilizing more than \$20 billion to defend the currency's value in foreign exchange markets. Together with an earlier moderate tightening of fiscal policy, an expected tightening of monetary policy, and tighter enforcement of national standards on wage and price increases, the announcement of large-scale intervention finally ended the long downward slide and initiated a hesitant recovery. Over the next year and a half, the dollar appreciated by more than 40 percent against the yen, 12 percent against the deutsche mark, and just over 10 percent in effective terms. The gains, however, were short-lived, and by the fall of 1980, the effective exchange rate was not much above its level before the rescue.

The reasons for the dollar's backsliding in 1980 were much debated. U.S. monetary policy had been tightened, but its effects were obscured by the intermittent

Figure 1.7. Real Effective Exchange Rates, 1975–89

Index (1975=100)



application of credit controls.²⁸ Short-term interest rates fell by more than 7 percentage points in four months while controls were in effect, and confidence weakened. In the last quarter of the year, however, both interest rates and the exchange rate again reversed course. Then in March 1981, the newly elected administration of President Ronald Reagan announced that it would no longer intervene in exchange markets except *in extremis*: in effect, that it was returning to the *laissez-faire* policies of the period before the crisis of November 1978. Interest differentials and market sentiment were already favoring the dollar, and the realization that no official action would be taken only added to the upward pressure. The dollar appreciated without a major interruption for more than 4½ years. From September 1980 to March 1985, the dollar appreciated by 20 percent against the yen, 85 percent against the deutsche mark, and 54 percent in effective terms (Figure 1.7).²⁹

²⁸For detailed descriptions of the confusing course of U.S. monetary policy in 1980, see Greider (1987), Chapter 6; and Mussa (1994) and the associated discussion.

²⁹Throughout the floating-rate period, major changes in the effective exchange rate of the U.S. dollar, as measured by the IMF, were approximately equal in nominal and real terms. This empirical regularity, which is unique among the major currencies, implies that increases in unit labor costs, measured in a common currency, were similar in the United States and collectively in its major trading partners. The reasons for the strength and persistence of that relationship are unclear. For the methodology used at the IMF to compute nominal and real effective exchange rates, see Zanetto and Desruelle (1997). Also see Chapter 2, footnote 82, p. 107.

Other major currencies did not respond passively and identically to the wide swings in the value of the dollar. The pound sterling strengthened against the dollar throughout 1979 and 1980 in response to a combination of a tightening of monetary policy under Prime Minister Margaret Thatcher and the exploitation of Britain's North Sea oil fields as an important new source of export revenues (see Buiters and Miller, 1981). In a little over four years starting in 1977, the pound appreciated by one-third in nominal effective terms and by an astonishing (and unprecedented for a reserve currency) 87 percent in real effective terms (see Figure 1.7). The yen also appreciated in nominal effective terms during the period of the dollar's major appreciation, but because Japan's inflation was low, the real effective rate was stable.³⁰ The deutsche mark and the French franc were roughly stable in real effective terms, as a result of the relative stability of intra-European exchange rates.

Fluctuations among the major currencies created an incentive for investors and governments to diversify their foreign exchange portfolios, but the effects were less than dramatic. Since World War II, the U.S. dollar had been the dominant reserve currency, and that position was eroded only gradually as a result of inflation, instability of currency values, the strengthening of other national economies, and the economic integration of Europe. During the 1980s, the dollar's reported share in foreign exchange reserves dropped from about 70 percent to 60 percent. Most international bank loans (between 65 and 80 percent) were denominated in dollars, with only a slight downward trend. Only in external bond issues did the dollar's share decline sharply, from about two-thirds to one-third. The deutsche mark was the second most important reserve currency, and a few others were held in small amounts: principally ECUs and Japanese yen.³¹

Prevailing models of the determination of exchange rates were unable to account for the major swings in rates among the key reserve currencies in the early 1980s.³² Nonetheless, it was generally accepted that the primary reason for the wide swings in exchange rates was that some major countries (notably the United

³⁰The strength of the yen relative to the deutsche mark and other European currencies in the first half of the 1980s is attributable to the same causes as the strength of the dollar: the combination of a tight monetary policy and a less tight fiscal stance. As a result, interest rates fell by much less in Japan than elsewhere, and the currency appreciated against most major currencies other than the dollar.

³¹Data on the currency composition of official reserves are of poor quality because of marked differences in reporting practices. For a summary table showing the dollar figures reported here, see de Boissieu (1996), p. 132. Detailed tables may be found in the *IMF Annual Report*.

³²The most widely accepted model at the time was the Dornbusch-Frankel "overshooting" model, which postulated an equilibrium based on PPP and an adjustment process based on a "rational" expectation that the actual rate would regress toward that level. A tightening of monetary policy in one country would initially raise the real interest rate relative to those in other countries, which in turn would bring a temporary appreciation of the real exchange rate. The extent of appreciation would be such as to create an expectation of a rate of depreciation equal to the interest differential, so that the expected rate of return on financial assets would be the same in all currencies. Early empirical tests of that model seemed favorable, but later tests showed that it had very weak explanatory power and implausible parameter estimates. See Meese and Rogoff (1983) and Boughton (1984, 1987, 1988).

States and the United Kingdom) were adopting restrictive monetary policies while maintaining expansionary fiscal policies, whereas others (notably Germany) had rather the opposite stance. The contrast produced relatively high real interest rates in the former group, which led to a continuing flow (not a sudden and massive shift, as predicted by the simple models of the 1970s) of funds into dollar- and pound-denominated assets. To explain this phenomenon, economists had to develop models that allowed for “preferred habitats” by different classes of investors and that incorporated the structure (not just the overall stance) of macroeconomic policies. Assessing the magnitude and timing of these effects was a tall order, and it was not clear how much of the observed changes in exchange rates were due to hard-to-measure but rational shifts in preferences and expectations, rather than to herd instincts and bandwagon effects. Only if the big swings were rationally based could it be said that the floating rate system was contributing to the health of the world economy.

Models that allowed for less complete substitution between financial markets in different currencies (and different countries) fared a little better than earlier perfect-substitution models, but the improvements were not enough to produce a new consensus on how exchange rates were determined. The 1980s therefore became a decade of agnosticism on exchange rates, as the notion that exchange rates followed a random walk and were subject to rational or irrational “bubbles” became prevalent.³³ When the U.S. dollar continued to appreciate at the end of 1984 and beginning of 1985 even after interest rate differentials and policy stances suggested that it should go the other way, the very idea of an exchange rate equilibrium grounded in relative economic conditions seemed to be in doubt.

External Imbalances

Globally, external current account imbalances diminished during the 1980s. Declining oil prices and rising imports erased the aggregate surplus of oil-exporting countries, while contractionary policies adopted in response to the debt crisis wiped out the aggregate deficit of non-oil developing countries (see Figure 1.2). Despite these trends, external imbalances became pronounced in the large industrial countries, for the same reasons that their exchange rates gyrated so greatly.

³³This terminology was developed and became part of the economist’s toolkit in the 1980s. A rational bubble occurs in the context of a model in which expectations are formed consistently with the model’s predictions (“rational expectations”). If the current value of a variable such as the exchange rate depends on rational expectations of its future level, it can take on values that differ persistently from those that would otherwise be determined by the “fundamental” determinants in the model. By back-formation, a bubble that occurs because of herding behavior or other factors unrelated either to fundamentals or to rational expectations may be characterized as an irrational bubble. The seminal article on testing for rational bubbles, by Robert P. Flood and Peter M. Garber, was published in the *Journal of Political Economy* in 1980 and was collected with related papers in Flood and Garber (1994). Tests for the existence of rational bubbles in exchange rates were hampered by the empirical weakness of models of the fundamental determinants; see Meese (1986).

From 1981, when most of the largest countries had small current account positions, imbalances accumulated rapidly until 1987. In that year, the United States had a deficit of \$166 billion (3½ percent of GDP), while Japan and Germany had surpluses of \$87 billion (3½ percent) and \$46 billion (4¼ percent), respectively. Opinions differed, however, on whether this phenomenon was a problem.

To some theorists and policymakers, a current account imbalance was a benign reflection of different time preferences between countries: nations that saved more than they invested had external surpluses, and conversely. The view that current account deficits were bad only if they reflected government rather than private sector deficits became popular for a time. After the British Chancellor of the Exchequer, Nigel Lawson, espoused that linkage in his speech at the 1988 Annual Meetings of IMF and World Bank governors in Berlin, it became known as the “Lawson Doctrine.”³⁴

Others argued that current account imbalances had the potential to reduce economic welfare regardless of their origins (Frenkel, Goldstein, and Masson, 1991, Chapter III). If households became more myopic and reduced their saving rates, then government action to raise its own saving (usually by reducing the fiscal deficit) would be an appropriate policy response. If a country developed a current account surplus because of a decline in the rate of domestic capital investment, then a fiscal stimulus (either as a tax cut to reduce the cost of investing or as investment spending by the government) might be called for.

The predominant view among policymakers in the 1980s was that current account imbalances were an important source of concern. Apprehensions in developing countries were heightened by the difficulty of financing large deficits after the onset of the international debt crisis in 1982. Misgivings in industrial countries were heightened by political pressures from industries that were having difficulty competing in world markets. If the alternative to external balance was an intensification of protection against import competition through tariff and other trade barriers, the choice was clear: large imbalances must be avoided. That political concern sometimes turned the spotlight on bilateral trade imbalances rather than the overall surplus or deficit. The most notable example was the trade surplus that Japan recorded vis-à-vis the United States. Measured in U.S. dollars, the bilateral surplus rose steadily from 1980 to 1987, when it amounted to \$57 billion. Although the portion of the total U.S. trade deficit accounted for by the deficit against Japan fell slightly during that interval (from 41 percent to 36 percent), and although the rise in both the overall gap and the bilateral deficit were due primarily to expansionary fiscal policies in the United States, political discussions were

³⁴See IMF, *Summary Proceedings*, 1988, pp. 78–85, and Lawson (1992), pp. 854–59. The Fund staff conducted a number of research studies during the 1980s on the questions of whether private sector deficits tended to be self-correcting and whether undesirable deficits were confined to those of the public sector; see Bayoumi (1990) and references therein, and Frenkel, Goldstein, and Masson (1991). W. Max Corden (1986, 1987), then a Senior Advisor in the Research Department, questioned the use of current account balances as a target for international economic policy, and he later embraced the Lawson Doctrine (Corden, 1994, Chapter 6).

driven by the highly visible bilateral imbalance and were leading to increasingly insistent calls for protection against Japanese imports.³⁵

Policy Coordination

These problems created pressure for greater stability, which led first to a spate of studies on the possibility of restoring a degree of fixity to exchange rates and then to a major effort to promote cooperation in formulating macroeconomic policies in the large industrial countries. Although few argued seriously for restoration of a system of fixed exchange rates (aside from a fringe movement to reestablish some form of gold standard), and most economists and policymakers accepted that official attempts to hold rates within a limited range were likely to fail, a minority view developed in support of what came to be known as “target zones.” In official circles, the leading exponents were in the French government, continuing a long tradition of French advocacy for official control and stability in exchange markets. By 1985, industrial countries as a group had rejected target zones as a policy option, but outside economists—notably at the Institute for International Economics (IIE) in Washington—continued to refine the analysis of how target zones might work. Staff studies at the IMF, particularly after Jacob A. Frenkel became Economic Counselor and Director of Research in 1986, were mostly skeptical of target zones as a practical option for the key currencies.³⁶

Reaching with more muted ambition, the major industrial countries (originally the five largest but later expanded to the Group of Seven) forged a series of modest and only partially successful agreements in the second half of the decade aimed both at stabilizing exchange rates and reducing current account imbalances. This policy cooperation exercise began with coordinated intervention in exchange markets in February 1985 aimed at reversing the appreciation of the U.S. dollar. It was solidified in September 1985 with the “Plaza” agreement to push for further dollar depreciation and in December 1986 by the “Baker-Miyazawa” agreement that enabled the Bank of Japan to cut interest rates without fear of a destabilizing reaction in exchange markets. It culminated in the “Louvre” accord of February 1987, when the major countries agreed to stabilize exchange rates “around current levels” with the explicit objective of avoiding the reemergence of large external imbalances. By 1989, however, the objectives of stabilizing exchange rates and reducing imbalances were less easily reconciled, and cooperation in policymaking became less well focused.

In a more permanent move toward stability and cooperation, the European Monetary System (EMS) was founded in March 1979. The EMS was preceded by the European Payments Union (1950–58), which reestablished currency convertibility and multilateral trading relationships among European countries after the

³⁵From 1980 to 1987, U.S. trade with Japan grew more rapidly than with other countries, and imports grew much more rapidly than exports. Merchandise exports to Japan rose by 33 percent, compared with 9 percent to all other countries. Imports from Japan, however, rose by 171 percent, while imports from all other countries rose by 49 percent.

³⁶For a comprehensive statement of the IIE case for target zones, see Miller and Williamson (1987). For an overview of the more skeptical view that prevailed at the Fund in that period, see Frenkel and Goldstein (1996).

devastation of World War II; the European Monetary Agreement (1958–72), which effected convertibility and established a fund for financing temporary imbalances; and the European Monetary Cooperation Fund (from 1973), which administered short-term credit facilities in support of common margins around central values for intra-European exchange rates. The agreement on margins—known initially as the “snake in the tunnel” when it was established in 1972 and then just as the “snake” when the “tunnel” of dollar-based margins broke apart in March 1973—succeeded only intermittently at stabilizing intra-European exchange rates.³⁷ Since European countries had a wide range of experience on price stability and economic growth, they also had a wide range of interest rates in both nominal and real terms. The EMS therefore faced an uphill battle to establish credibility for its similar but more comprehensive exchange rate mechanism (ERM).

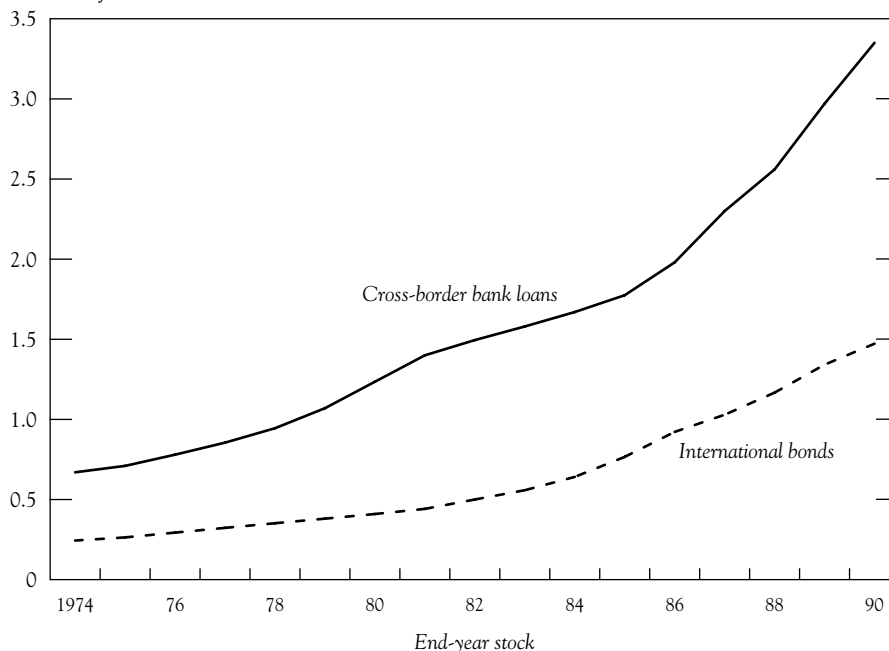
In its first several years, the EMS underwent a series of exchange rate realignments that made it function very much like a “crawling peg.” The deutsche mark was both the largest and the strongest currency in the arrangement. The other currencies were occasionally devalued against the mark, which became the de facto anchor for the system. In 1987, however, the EMS was firmed up by the “Basel-Nyborg” agreement into a more stable system in which policy convergence was given greater prominence and realignments were to be avoided.

Open Capital Markets

These various efforts to reestablish a measure of stability were made against the backdrop of rapidly expanding international capital markets. Cross-border bank loans outstanding nearly tripled during the 1980s, from \$1.1 trillion to \$3.0 trillion. The stock of international bond issues grew even more rapidly, from \$380 billion to \$1.3 trillion. Both of those rates of increase were up sharply from the preceding several years (Figure 1.8).

By the 1980s, policymakers had come to accept and even to embrace the growth in internationally open capital markets. When this growth began in earnest, with the advent of the eurodollar market in the 1960s, much of the discussion of its implications concerned how to regulate and control it. The existence of unregulated offshore markets for bank deposits and loans in competition with regulated onshore markets threatened to weaken national monetary control and raised fears of unfettered inflation. By the late 1970s, empirical and theoretical research had demonstrated conclusively that the inflationary consequences of euromarket growth were negligible, because monetary authorities in the main industrial countries retained the ability to control domestic money creation (see, for example, Mayer, 1982). Moreover, internationally active banks had played an invaluable

³⁷This picturesque terminology derived from the appearance of a graph plotting the values over time of European currencies against the dollar. The tight margins of fluctuations allowed within the group produced a sinuous joint movement within the wider band (the tunnel) allowed under the Fund’s par value system. For a history of the snake in the context of world political and economic events in the 1970s, see Solomon (1982). For a history of monetary integration in Europe, see Ungerer (1997).

Figure 1.8. International Financing, 1974–90*Trillions of U.S. dollars*Source: Bank for International Settlements, *Annual Reports*.

role in financing the deficits of oil-importing countries after 1973. Consequently, in the late 1970s and throughout the 1980s, capital controls were loosened and dismantled throughout western Europe, North America, and Japan. Developing countries—many of them hesitantly and reluctantly—followed suit, and the pattern spread gradually as the decade progressed (Quirk, Evans, and others, 1995).

Growth and liberalization of capital markets contributed to the integration and interdependence of the world economy in the 1980s. The clearest benefit of that development was the strengthening of international trade as an engine of growth, as described above. The potential cost, which became abundantly clear in the second half of the 1990s, was that a financial crisis in one country was now more likely to affect other markets—and to affect them more quickly. One manifestation of that danger was the speed with which the international debt crisis spread around the world in 1981–83. A second came in the global stock market crash of October 1987. Moderate declines in equity prices in New York on October 16 and 17 were followed immediately by a similar softening in markets throughout Europe and Asia, and the record one-day decline of 22 percent in New York on October 20 then triggered a global sell-off in equities.³⁸ In the most vulnerable markets, the collapse of

³⁸For a statistical analysis of international transmissions during the crash, see Bennett and Kelleher (1988).

equity values was prolonged and had serious consequences for economic activity. In Mexico, for example, the stock market lost 75 percent of its value in a sustained decline over six weeks. Some markets in the Asia-Pacific region, including Australia, Hong Kong, Singapore, and Malaysia, also suffered quite large percentage losses. As an international phenomenon, the stock market crash of 1987 was a brief storm, but if it was easily weathered, part of the credit must go to regulations introduced in the wake of the crash (see Allen and others, 1989, Chapter 5).

The Fund

As the Fund began to face the external challenges of the 1980s, it was also confronting some serious internal weaknesses. The surge in lending to developing countries at the end of the 1970s had come at the expense of maintaining the quality of adjustment programs and of the Fund's financial portfolio. The failure of the effort to establish a substitution account had weakened the potential for the SDR to play a central role in the international monetary system and deprived de Larosière of the centerpiece of a strategy for strengthening the institution. The waning of demand for the Fund's resources by industrial countries, together with the very limited consensus on whether and how to stabilize exchange rates, left the Fund struggling to define a clear role for its core function, surveillance. If the Fund was to remain the world's premier monetary institution, it would have to nurse its roots back to health or redefine its role. As the decade progressed, it did enough of both to dominate the global economic stage more than ever before.

The activities of the Fund, described in detail in the chapters that follow, had three primary dimensions in the 1980s: surveillance over the international monetary system and the "exchange rate policies" of member countries, development and management of the strategy for resolving the international debt crisis, and restoring and strengthening the quality of Fund lending and conditionality.

Surveillance

Surveillance was hampered from the outset by a lack of clearly defined objectives or standards. Before the Fund could assess the appropriateness of a country's exchange rate policies, it had to judge the correct level of the real exchange rate, and it had to have at least an implicit model linking that level to macroeconomic policies and to the behavior of the nominal exchange rate. Much of the evolution of the practice of surveillance by Fund staff in the 1980s was concerned with refining those assessments, both in the Article IV consultations and through periodic reports on the World Economic Outlook. More substantive improvements were to await the 1990s, when the international community became more willing to adopt a broad code of conduct for macroeconomic and structural policies.

At the same time, the Fund tried to develop effective procedures to make its surveillance both even-handed and "firm," but those two goals were hard to recon-

cile. Wielding a club was not always compatible with being part of a club. If surveillance was to be applied even-handedly to all member countries—to those with floating rates as firmly as to those with fixed rates, to countries with strong external balances as firmly as to those that were heavily in debt, and to large countries as firmly as to small ones—then it risked becoming pro forma and routine. Time and again, blame for the failure of the Fund to foresee and forestall economic crises was leveled at the genteel and diplomatic coziness of surveillance routines.

The Fund tried to mitigate this difficulty by developing procedures for identifying potential problem cases and holding special, ad hoc, reviews in addition to the regular annual consultations. The Executive Board, however, was reluctant to establish procedures that would cast a shadow over a member's economic policies, especially when the member was not seeking to borrow from the Fund. Two special consultations were held during the 1980s (with Sweden in 1982 and Korea in 1987), but that procedure was not flexible enough to be of general value, and it fell into disuse. An effort beginning in 1984 to give an “enhanced” operational value to surveillance by allowing countries in specified circumstances to release consultation reports to commercial creditors was marginally more successful but also was not widely applied.

Another factor that weakened the effectiveness of the consultation process was that gaps in the timing of some consultations made it difficult to maintain current knowledge about conditions in countries with emerging financial problems. In the early 1980s, that problem was most critical in Mexico: the Executive Board did not hold a review of the Mexican economy from March 1980 until July 1982, just a few weeks before the debt crisis hit. The frequency of consultations was subsequently increased, but improving effective continuity remained a goal until well into the 1990s.

Debt Strategy

The international debt crisis that erupted in 1982 catapulted the Fund into a vortex, and the ensuing efforts to contain the crisis greatly increased the Fund's role in the international monetary system. Arguably, the debt crisis was a greater catalyst for change—and certainly was a greater catalyst for growth—in the Fund than was the shift to floating exchange rates a decade earlier. That the 1980s marked the Fund's “coming of age,” as asserted at the outset of this chapter, was due in large measure to the role that the institution played in developing and carrying out the debt strategy after 1982.

Before 1982, the IMF did not have a central role as a manager of international financial crises. The Fund lent sizable sums to the four countries involved in the 1956 Suez crisis—the first major wave of lending by the institution—and it extended credits to countries affected by subsequent shocks such as the collapse of the Gold Pool in 1968, the turmoil in G-10 currencies in the early 1970s, and the oil shocks of the 1970s. The character of that lending, however, differed only marginally from the multitude of credits extended to member countries in quieter times (Boughton, 2000). When Mexico moved to the brink of default in August 1982, the Fund was quickly drawn into the crisis in new ways. Other

official lenders, including government agencies and the Federal Reserve in the United States and the Bank for International Settlements (BIS) in Switzerland, moved quickly to provide short-term financing to forestall default, but it became apparent that a lasting solution required centralized coordination of creditors.

The Fund stepped into that breach by insisting that it would provide financial support for debtors' adjustment programs only after receiving assurances from other creditors, especially commercial banks, that they would increase their own lending exposure to the indebted countries. This "concerted lending" tactic, which brought the Fund into a close ad hoc working relationship both with commercial banks and with U.S. government officials, became the cornerstone of the debt strategy for the next several years. Although the tactic ceased to work in the latter part of the decade, the presence of the Fund remained as the centerpiece of the strategy. The debt strategy evolved gradually through the 1985 Baker Plan (growing out of debt), experimentation by the Fund and other creditors with a menu of debt-relieving operations in 1987–88, and the decisive 1989 Brady Plan for debt reduction. That evolution broadened participation in ways that gave the World Bank, regional development banks, and bilateral official creditors a greater role but did not diminish that of the Fund.

Quality of Fund Lending

In addition to the development of the practice of surveillance and of techniques for resolving the debt crisis, the shift in composition in demand for Fund resources in the late 1970s and early 1980s posed challenges for the Fund that took all of the decade and more to resolve.

The traditional view of the Fund was similar to that of a bank for countries: a provider of short-term, self-liquidating loans to tide central banks over temporary disturbances to the balance of international payments. The Fund began to move away from that "monetary character" in 1976 by establishing the EFF, which provided Fund resources on longer maturities to countries with more deeply seated economic problems.³⁹ The average maturity of the Fund's regular stand-by arrangements lengthened as well, and more countries became prolonged users of Fund resources. By the early 1980s the Fund began to reexamine its lending policies in light of the continually worsening economic plight in many of its borrowing countries.

Several proposed financing arrangements provoked concerns among the Fund's Executive Directors in the late 1970s and early 1980s. Part III of this History recounts the debates over whether conditionality was sufficiently strong in proposed multiyear arrangements for Sierra Leone in 1979, Grenada in 1981, and India in 1981. The extended arrangement for India, which was the largest financial com-

³⁹The Trust Fund, which was also established in 1976 and which also made longer-term loans, was funded and maintained independently from the Fund's general resources. The terminology stressing the Fund's "monetary character" originated with the Dutch central bank; see Duisenberg and Szász (1991).

mitment made by the Fund up to that time, was questioned by some senior staff as well as by Executive Directors, who wondered whether India really had a need to call on the Fund for balance of payments financing and whether the Fund's conditions for lending the money were sufficiently strong. Was conditionality meaningful and effective if it merely required a country to do what it planned to do anyway? These controversies had little effect on the flow of financing to the countries in question, but they were emblematic of a deepening sense of doubt—both inside and outside the Fund—about the overall quality of the Fund's portfolio of financial claims.

The customary conditions placed on Fund lending, which stressed the need for sound and sustainable macroeconomic policies, were certainly not misplaced. The need for macroeconomic adjustment was in fact as great as ever. Macroeconomic adjustment alone, however, was insufficient to cure the structural maladies that prevailed in many of the Fund's newer borrowers. Throughout the 1980s, the Fund experimented with ways to supplement its calls for monetary restraint and fiscal integrity with demands for structural reform, and ways to integrate those reforms more fully into the design of Fund-supported adjustment programs. Although that process took hold only partially and only rather late in the decade, it did eventually succeed in encouraging and helping many countries to liberalize their economic policies.

Before the silent revolution in policymaking took root, some countries—as noted above—became so heavily indebted to the Fund and other external creditors that they either would not or could not continue to service all of their debts on time. Quite apart from the defaults and threats of default that characterized the international debt crisis, several countries fell seriously behind in meeting their obligations to the Fund. In 1984, for the first time in its history, the Fund found itself facing a crisis of arrears. By the end of the decade, more than 10 percent of the Fund's claims would be on countries with protracted arrears to the institution. Developing a strategy for reducing and eventually eliminating those arrears absorbed an increasing portion of the energies of management and staff.

Institutional Change

The single greatest problem faced by the Fund in the 1980s was to garner the financial resources to meet the demand for its services. Three times—in 1980, 1983, and 1990—member countries were asked to approve increases in quotas, which are the basic source of permanent financing for the Fund. In addition, the Fund undertook on several occasions to borrow from surplus countries (though pointedly *not* from private credit markets) to supplement its resources temporarily. The pivotal development here came in 1981, when Saudi Arabia agreed to lend the Fund SDR 8 billion (\$9 billion) for six years. When quotas were not raised in line with demand for Fund credits, the Fund used this borrowed money to stretch its resources by agreeing to approve credit arrangements that were larger in relation to quotas than had previously seemed prudent. In combination with the arrears problem, these developments pushed the Fund's balance sheet and income flows into a precarious position, especially in the second half of the decade. The quota increase

that was approved in 1990 (and which took effect in 1992), along with development of a more effective arrears strategy and the resolution of the debt crisis, restored some order to the picture. The experience, however, also restored and strengthened the Fund's caution and its resolve to maintain its monetary character and its ability to preserve its resources for the continued use of countries in need.

As originally conceived, the Fund had a single focus to its lending: financing the overall balance of payments. Since 1963, however, it has sought to provide credits to member countries for specialized purposes related to the causes of payments problems or to the problems of certain groups of countries (particularly developing countries). The 1963 CFF was followed by the Buffer Stock Financing Facility of 1969, the "oil facilities" of 1974 and 1975, and the EFF and the Trust Fund of 1976. In addition, the Fund occasionally lent quick-disbursing funds for emergency disaster relief. Although the oil facilities and the Trust Fund were phased out in the early 1980s, the Fund still had a variety of specialized lending windows in effect (Table 1.1).

The inability of many low-income countries to service debts on market terms in the 1980s led to efforts to renew and expand the Fund's low-interest (concessional) lending. That activity had begun with the 1976 Trust Fund but had gone dormant once the Trust Fund became fully committed in 1981. Concessional lending to low-income countries resumed in 1986 with the establishment of the SAF and was expanded through the establishment of the Enhanced SAF (ESAF) the following year. The ESAF eventually became one of the Fund's great success stories, as the institution channeled billions of dollars at low cost and for long maturities to many of the world's poorest countries and served as a catalyst for much larger sums from other official creditors. Nonetheless, and even though ESAF money was completely separate from the Fund's general resources, the Fund came under quite a bit of criticism: for departing from its monetary character, for imposing strict adjustment conditionality on countries in need of increased economic growth, and especially for intruding into the traditional realm of the World Bank, which had a much clearer mandate to make longer-term loans on concessional terms.

In addition to coping with rising demand for financing against a background of limited resources, the Fund faced some subtle but profound changes in its membership. With the People's Republic of China represented in the Fund beginning in 1980, Hungary joining in 1982, and Poland rejoining in 1986, the Fund had a greater concentration of centrally planned and socialist economies to look after than at any other time in its history. The short-term consequences of the inclusion of Hungary and Poland were largely confined to those countries, neighboring countries in Europe, and the staff who were working with them. The consequences of the inclusion of mainland China were greater, owing to the size and global economic importance of the country and the fact that it had a seat on the Executive Board. The Fund worked closely with the Chinese authorities throughout the 1980s, as both sought to promote the opening up of the Chinese economy and its integration into the world economic system.

Table 1.1. Fund Financial Facilities, 1979–89

Reserve tranche	Available to each member country, subject only to a representation of a balance of payments need. Reserve tranche drawings are not subject to interest charges and need not be repaid.
First credit tranche	Drawings are subject to Fund approval and are conditional on the member cooperating with the Fund to resolve its balance of payments problems.
Emergency disaster relief	Similar to first credit tranche drawings but available in additional amounts. Designed to help countries cope with natural disasters.
Upper credit tranche stand-by arrangements	Drawings are phased over a specified period, subject to quantitative performance criteria and periodic reviews by the Fund.
Extended Fund Facility (EFF)	Similar to ordinary stand-by arrangements except that amounts are generally larger and are made available for longer periods; used for countries with longer-term structural problems.
Compensatory Financing Facility (CFF)	Designed to compensate countries for the economic effects of a temporary shortfall in export earnings or (beginning in 1981) a temporary increase in the cost of importing cereals. Subject to conditionality similar to that for a drawing under the first credit tranche, and to a finding that the problem arose for reasons beyond the authorities' control. Funds could be drawn immediately upon approval.
Compensatory and Contingency Financing Facility (CCFF)	Replaced the CFF in 1988; purpose and terms similar but with the addition of a mechanism to help countries maintain adjustment programs in the face of unanticipated adverse shocks.
Buffer Stock Financing Facility	Helped finance countries' contributions to certain international agreements to maintain buffer stocks of primary commodities.
Trust Fund	A concessional facility financed by profits from the sale of a portion of the Fund's stock of gold. The Trust Fund offered longer-term low-interest loans to low-income countries from 1976 to 1981.
Structural Adjustment Facility (SAF)	A concessional facility established in 1986 as a successor to the Trust Fund, financed primarily from repayments of Trust Fund loans.
Enhanced Structural Adjustment Facility (ESAF)	The successor to the SAF; financed partly from reflows from SAF loans but primarily from loans and grants to the ESAF Trust.

At the Brink of the 1990s

The World Economy

At the close of the decade, a strong record of several years of steady economic growth in industrial countries seemed to be coming to an end. In 1989, the

only industrial country with negative growth was New Zealand, which was just beginning a radical new approach to monetary policy in an effort to rid the country of persistent inflationary pressures.⁴⁰ But Canada joined the list in 1990, followed by the United States, the United Kingdom, and four others in 1991. Part of the decline was a classical business cycle, as the long upswing from 1983 to 1989 produced an accumulation of sectoral imbalances. That ongoing process was aggravated in 1990 by the economic uncertainties that followed the invasion of Kuwait by Iraq. In contrast to the last widespread recession, however, this time the major countries had room to adjust monetary and fiscal policies, thanks to the absence of any serious threat from inflation. World interest rates fell quickly, and the recession of 1990–91 passed without a global decline in output.

Growth in developing countries was also beginning to slow at the end of the 1980s, in every region except Asia. African economies were still weighted down by weak markets for their commodity exports, and in many cases by ineffective economic policies and other domestic ills. Some of the larger Latin American countries, notably Argentina, Brazil, and Peru, were still stumbling under the hyperinflationary weight of the failed policies of the 1980s. Even before the crisis in Kuwait in 1990, growth in the Middle East was already slowing because of the continuing weakness in international oil prices. On the positive side, more and more countries were laying the preconditions for sustained growth by joining the silent revolution toward more stable and market-oriented economic policies. That movement was already pervasive in east Asia and was beginning to prevail in Latin America, including in the countries just mentioned. Even in sub-Saharan Africa, which had the highest preponderance of state-dominated policies in the late 1980s, the list of countries with reasonably successful policies was clearly lengthening.⁴¹

Overshadowing these developments was the most significant political shift in the postwar era: the beginning of the end for the Soviet empire and for communism as an international force. While the Soviet government in Moscow was preoccupied with its own economic troubles and with a growing number of

⁴⁰The essence of the New Zealand policy innovation of 1989, which followed a gradual move toward economic liberalism and inflation reduction starting in 1984, was a contractual commitment by the governor of the Reserve Bank (Donald T. Brash) to keep the inflation rate within a narrow range (then 0–2 percent) and to free monetary policy from output and employment goals. Despite an initial three years of slight declines in output, the New Zealand approach became a model for central bank independence and contributed to strong growth beginning in 1993. For an official overview, see Spencer and others (1992); for an insider's analysis, see Archer (1997); and for a critical outside view, see Kelsey (1997).

⁴¹The road to economic success in Africa was still bumpier than elsewhere, and only a few of that continent's 50 countries achieved lasting progress. The May 1990 *World Economic Outlook* cited Ghana, Madagascar, and Uganda as countries where "a significant recovery in economic activity is now underway following fundamental macroeconomic and structural policy reforms," and it also praised Côte d'Ivoire, Nigeria, and Zambia for policy improvements (pp. 12 and 49). Policies in Ghana, Madagascar, and Nigeria were again cited favorably in May 1991, but in that year the other countries mentioned in this context were Kenya, Togo, and Tunisia (p. 14).

ethnic and regional conflicts in several Republics, the dictatorships that controlled its European satellites began to crumble in 1989. In that year and the next, Czechoslovakia, Romania, Poland, Hungary, and Bulgaria held multiparty elections for new governments and brought such already legendary figures as Václav Havel and Lech Wałęsa to power.⁴² Massive demonstrations in East Germany (the German Democratic Republic) and an unstoppable emigration of its citizens through a newly open Hungary forced the downfall of the government of Erich Honecker in October 1989, brought down the Berlin Wall in November, and made possible the reunification of Germany less than a year later. The political consequences of these emancipations occurred swiftly. The economic consequences would take longer, as these and other socialist states gradually rejoined the world economic system in the 1990s, but they ultimately would be no less profound.

While eastern Europe was clawing free politically, western Europe was rumbling along toward economic unification. Under the terms of the Single European Act of 1987, the European Union was taking steps to establish the free movement of goods, capital, and labor by the end of 1992. Overcoming initial skepticism about the 1992 timetable, European leaders reached a further agreement in 1989 to end all capital controls within a year. Under the terms of the Basel-Nyborg Agreement of 1987, the European Monetary System was solidifying its commitment to maintaining stable exchange rates and strengthening policy coordination. This process would be severely tested in 1992–93 by speculative attacks against several currencies, but that crisis would turn out to be only a temporary setback to the drive for complete monetary unification.

The Fund

More than ever before, the Fund was at the heart of the international monetary system at the end of the 1980s. Its membership was nearly universal, except for the crumbling sphere of Soviet influence. Its surveillance over member countries' exchange rate and macroeconomic policies, though not yet as effective as it might have been, was universally accepted as an essential element in the system. Demand for its loans and other credits was high and rising: 22 countries were implementing adjustment programs supported by Fund stand-by or extended arrangements, and 29 low-income countries had programs supported by the SAF or the ESAF. Altogether, nearly half of all members (73 out of 152) had outstanding financial obligations to the Fund. To meet the demand without new borrowing by the Fund, a consensus was forming that quotas should be increased substantially and soon. When the debt crisis had erupted in 1982, the Fund's role in defining and organizing the strategy had emerged out of a void. As that crisis ended in 1989, there could be little doubt that the Fund would play a central role in managing the next one.

⁴²Havel, a well-known dissident playwright and political prisoner, was elected president of Czechoslovakia in 1989. Wałęsa, a leader of the Solidarity movement since 1980, was elected president of Poland in 1990.

How well did the struggles of the 1980s prepare the Fund for the next decade? Future historians will have the luxury and the burden of viewing the period through what Barbara Tuchman called a “distant mirror,” and they will thereby gain a perspective that is not available to the post-Bretton Woods generation. At the turn of this century, five implications of the 1980s seem to emerge clearly.

First, successful surveillance and conditionality require partnership. The Fund must understand the political and cultural constraints that are pressing down on a country’s economy, and the country must understand the economic realities (macro and distributive) that limit the compass for political action. The mantra for local endorsement or “ownership” of adjustment programs captures only half of this requirement. Unless each side comprehends and even empathizes with the other, the process will fail: the Fund’s policy advice will be ignored, and its conditions for lending will not be implemented. The more deeply ingrained the problem, especially when arrears to the Fund are accumulating, the more essential is the need for alliance.

Second, effective surveillance over exchange rate policies does not require a “system” of the Bretton Woods type, but it does require general agreement on the goals of those policies and on the role of the exchange rate in economic policy. Fund surveillance was hampered in the 1980s by a lack of such agreement. With a wide diversity of regimes being tried, ranging from exchange rates still pegged to the value of the U.S. dollar to those floating independently with little or no official intervention, policy advice could only be experimental and would often appear inconsistent. What was needed was a clearly articulated judgment on the circumstances when a country should peg to gain stability and when it should float to maintain international competitiveness. More generally, in dealing with economic systems that ranged from central planning to free and open markets and from pervasive state intervention to an absence of adequate regulation, Fund surveillance aimed to accommodate whatever system prevailed in each country. With neither an internationally accepted policy strategy nor an effective code of good practices on national economic structures, the Fund had to rely on its ability to persuade each country to make marginal improvements within a dizzying variety of regimes. The limitations and frustrations of that experience stimulated professional debate on economic policies in the 1990s and gradually strengthened the resolve of the international community to develop and accept a code of national economic conduct.

Third, private capital markets alone cannot generally achieve a satisfactory and stable response to an international financial crisis. Holders of sovereign debts and other cross-border claims are multifarious, are spread across many countries and regulatory systems, and have diverse interests in the outcome. That lesson was manifest in the 1980s when commercial banks holding large amounts of low-quality sovereign debt attempted to cease rolling over their loans and were able to coordinate agreements with debtors only after the Fund and other official creditors took charge of the process. In such conditions, which may involve severe overreactions to bad economic news, a multilateral arbiter can play a positive and even an essential role in arranging market-friendly solutions. Those solutions, however,

require that creditors can be organized for concerted lending or orderly debt reduction. Optimism on that score was reasonably high at the end of the 1980s but deteriorated as capital markets grew more complex in the 1990s.

Fourth, the Fund, as a specialized monetary institution, cannot solve the world's economic problems alone. The reliance of many low-income countries on short- and medium-term financing from the Fund in the early 1980s and the attempt by many middle-income developing countries to rely on macroeconomic policy reforms in the mid-1980s exposed weaknesses in the coordination of multilateral assistance. Efforts by the Fund, the World Bank, and other agencies to collaborate more fully in the second half of the decade were only partially successful. That effort did, however, help prepare the institutions for the much greater level of coordination that would be needed in the 1990s, when countries in transition from central planning would have to make comprehensive structural and macroeconomic reforms in a very short period of time.

Fifth, the effectiveness of the Fund's financial assistance depends on the recipient countries committing to implement both macro and structural economic reforms. Throughout the 1980s, the Fund circumscribed its own scope for action by limiting explicit conditionality to macroeconomic policies and avoiding interference with policies that could be construed as politically rather than economically motivated. The initial successes of countries that liberalized policies on their own—the silent revolution—drew the Fund out of that reluctance in ways that would enable it to play a more active role in promoting structural reform in the 1990s.

Whether this last lesson—that macro and structural reforms go hand in hand—fully applies in general or was merely a circumstance of the 1980s cannot yet be judged. All of the countries with substantial debt problems in the 1980s had readily identifiable macro and structural imbalances that required major corrections. In the following decade, many countries were forced to reconsider the scope and speed of economic liberalization and focus instead on more mundane structural issues such as the regulation and soundness of financial systems. Moreover, nothing in the experience of the 1980s prepared countries or institutions for a financial crisis when macro policies were reasonable *ex ante*. The scale and breadth of the flow of capital into developing countries with fledgling financial markets after 1990 raised the possibility of a new type of financial crisis—and a first glimpse into the 21st century—in which the solutions of the 1980s could be no more than a platform from which to jump into the void.

The international flow of capital in the 1990s was a product of the confluence of three great events of the late 1980s: the successful conclusion of the debt strategy for middle-income developing countries, the silent revolution in policymaking, and an acceleration in the globalization of capital markets. As positive as those developments must be in the long run, it should not have been surprising that they had destabilizing effects in the short run. The oil and dollar shocks of the 1970s flowed inexorably from the policies and problems of the 1960s, exploded into new crises that required fresh solutions, and ultimately forced policymakers to adopt more open policies. The debt shock of the 1980s was merely the next wave in this course of economic history.

Appendix: Chronology, 1979–89

Date	World Events	Activities of the Fund
1979		
January	<p>World petroleum prices begin sharp rise following the overthrow of the Shah of Iran by forces loyal to the Ayatollah Khomeini.</p> <p>Vietnamese forces overthrow the regime of Pol Pot in Cambodia (then known as Democratic Kampuchea) and rename the country the People's Republic of Kampuchea.</p> <p>The United States extends full diplomatic recognition to the People's Republic of China.</p>	Third Basic Period of SDR allocations begins with the first allocation of SDRs since 1972 supplementary surveillance procedure introduced.
February		Supplementary Financing Facility (SFF) becomes effective, as the Fund borrows SDR 7.8 billion from 14 official creditors to supplement resources from quotas.
March	<p>Margaret Thatcher elected Prime Minister of the United Kingdom, replacing James Callaghan; pound sterling begins major period of appreciation in response to monetary restriction and rising oil production.</p> <p>European Monetary System (EMS) is formed; the ECU is created as a common currency unit in the European Community (EC).</p>	<p>Major review of conditionality results in greater flexibility and concern for circumstances of individual countries.</p> <p>Interim Committee asks Executive Board to consider establishing a substitution account for converting foreign exchange reserves into SDRs.</p>
April	Tokyo Round of multilateral trade negotiations concluded.	
June	<p>Second oil shock initiated at OPEC ministerial meeting.</p> <p>Idi Amin Dada overthrown as Head of State in Uganda.</p>	
August		Liberalization of the Compensatory Financing Facility (CFF) to provide for larger loans to countries facing temporary declines in merchandise exports.

1 THE SILENT REVOLUTION

Appendix (continued)

Date	World Events	Activities of the Fund
September	<p>First of 11 realignments of EMS parities in which one or more currencies will be devalued relative to the deutsche mark.</p> <p>Sixth Summit of Non-Aligned Nations, in Havana, calls for "global negotiations" to give the UN General Assembly control over the IMF.</p> <p>Jean-Bédél Bokassa overthrown as Head of State in the Central African Republic.</p>	
October	<p>U.S. Federal Reserve adopts new operating procedures designed to get tighter control over monetary growth.</p> <p>President of Korea, General Park Chung-Hee, assassinated.</p>	<p>Interim Committee, meeting in Belgrade, urges industrial countries to pursue vigorous anti-inflationary policies; asks Executive Board to develop specific proposals for a substitution account.</p>
November		<p>Financing to Jamaica under the Extended Fund Facility (EFF) and the CFF brings Fund's holdings of Jamaican dollars to 462 percent of quota, a record for any country up to this time.</p>
December	<p>Soviet Union invades Afghanistan.</p>	<p>Liberalization of the EFF to allow countries to repay loans in ten years instead of eight.</p>
1980		
January	<p>Price of gold peaks at more than \$850 an ounce.</p>	
March	<p>Robert G. Mugabe elected Prime Minister of Rhodesia, which is renamed Zimbabwe.</p>	
April		<p>People's Republic of China assumes China's seat.</p> <p>Kuwait accepts participation in the SDR Department; from this date, all Fund members are participants.</p> <p>Meeting in Hamburg, the Interim Committee decides not to establish a substitution account.</p>

Appendix (continued)

Date	World Events	Activities of the Fund
May	Yugoslav President Josip Broz Tito dies.	Final sale of Fund gold under program that began in 1976; 24 million ounces had been sold for a total of \$4.6 billion, leaving the Fund holding 103 million ounces. First publication of the <i>World Economic Outlook</i> .
June	Issuance of the “Arusha Initiative” by a conference in Tanzania, calling for major reforms in the Fund.	
September	Beginning of war between Iran and Iraq, which will continue for the rest of the decade.	Zimbabwe, newly independent, becomes the 141st member of the Fund.
November		Quotas under Seventh Review become effective, raising total quotas by just over 50 percent.
December		Subsidy account established for the SFF to reduce charges to low-income countries.
1981		
January	Ronald Reagan assumes office as President of the United States, replacing Jimmy Carter; proposes major tax cuts. Greece joins the European Communities.	Final SDR allocation under Third Basic Period; SDR converted to five-currency basket.
March		Enlarged Access policy introduced; permits longer adjustment programs and increased access to Fund resources, and formalizes relationship between use of ordinary resources and use of borrowed funds.
April		Trust Fund lending program completed; assets transferred to the SFF subsidy account. Reconstitution requirement on SDR holdings abrogated.

Appendix (continued)

Date	World Events	Activities of the Fund
May	François Mitterrand elected President of France, replacing Valéry Giscard d'Estaing.	Saudi Arabia's quota is approximately doubled, and the Fund establishes SDR 8 billion borrowing arrangement with the Saudi Arabian Monetary Agency (SAMA) to finance the Enlarged Access policy. Cereals-imports facility established within the CFF. SDR interest rate set equal to combined market interest rate, ending the practice of setting it below market rates.
August		Borrowing arrangement agreed with BIS and central banks of industrial countries.
October	North-South summit meeting in Cancún, Mexico.	
November		Hungary and Poland apply for membership. EFF arrangement approved for India; at SDR 5 billion, the largest loan commitment in Fund history until 1995.
December	Declaration of martial law in Poland. Formation of Preferential Trade Area for Eastern and Southern African States (forerunner of Common Market for Eastern and Southern Africa).	Membership discussions with Poland suspended. First SFF subsidy payments are made, to 21 low-income countries.
1982		
April	Three-month war begins between the United Kingdom and Argentina.	
May		Hungary joins IMF, begins negotiations for a stand-by arrangement.
June		Summit conference of the leaders of the Group of Seven (G-7) industrial countries at Versailles establishes a multilateral surveillance process with informal participation by the IMF Managing Director.

Appendix (continued)

Date	World Events	Activities of the Fund
July	<p>Penn Square Bank fails in the United States, raising fears of similar problems in other major U.S. banks.</p> <p>U.S. Federal Reserve shifts away from the restrictive policies that had contributed to record-high levels of real interest rates.</p>	
August	<p>Mexico unable to meet principal payments on bank debt; emergency rescue package assembled.</p> <p>Liquidation of Banco Ambrosiano in Italy, owing to massive losses by its Luxembourg and offshore subsidiaries, raises concerns about stability of eurocurrency markets.</p>	
September		<p>Annual Meetings in Toronto; initial surveillance meeting between the Managing Director and the G-5 finance ministers.</p>
October	<p>Helmut Kohl elected Chancellor of Germany, replacing Helmut Schmidt.</p> <p>Sweden devalues by 16 percent against a basket of currencies, triggering concerns in neighboring countries.</p>	
December	<p>Miguel de la Madrid inaugurated as President of Mexico.</p>	<p>EFF arrangement approved for Mexico, for SDR 3.4 billion; conditional on \$5 billion new money package from banks.</p> <p>Supplementary surveillance procedure applied to the Swedish devaluation.</p>
1983		
January		<p>General Arrangements to Borrow (GAB) expanded.</p> <p>Stand-by and CFF loan approved for Argentina, for SDR 2 billion.</p>
February		<p>EFF arrangement approved for Brazil, for SDR 4.2 billion.</p> <p>Interim Committee approves quota increases, completing the Eighth General Review.</p>

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Appendix (*continued*)

Date	World Events	Activities of the Fund
March	French government shifts policy from expansion to stabilization.	Information Notice System introduced for large changes in real effective exchange rates.
June	G-7 summit at Williamsburg commissions a G-10 report on the international monetary system.	Jacques de Larosière begins a second five-year term as Managing Director.
July		Fund holdings of Jamaican dollars reach a record 653 percent of quota.
August		Oil Facility terminated.
September		Conditionality requirements are tightened for CFF loans.
October	United States invades Grenada after the government is overthrown in a coup.	
November		Quotas under Eighth General Review become effective.
December	Raúl Alfonsín elected President of Argentina, ending seven years of military rule.	
1984		
April		Switzerland joins the GAB.
June	Bolivia suspends payments on external bank debt. Latin American leaders meet in Cartagena, Colombia, and set a strategy for resolving debt crisis without defaulting.	Richard D. Erb becomes the Fund's fifth Deputy Managing Director, succeeding William B. Dale.
July		Enhanced surveillance applied for first time, through decision to release staff report on Mexico to commercial bank creditors in order to promote agreement on multiyear rescheduling of debt.
September	Brian Mulroney elected Prime Minister of Canada. ECU currency basket revised, and Greek drachma added to it.	

Appendix (continued)

Date	World Events	Activities of the Fund
1985		
January	Brazil holds its first democratic election for President since 1964.	Vietnam becomes first country to be declared ineligible to use Fund resources owing to arrears.
February	Effective U.S. dollar exchange rate peaks, culminating a five-year appreciation.	
March	Mikhail S. Gorbachev becomes Head of State of the Soviet Union. José Sarney assumes office as President of Brazil.	
April	Paris Club completes first MYRA, for Ecuador.	Fund records first annual budget deficit since 1977, owing to rise in arrears.
July	Alan García assumes office as President of Peru and announces debt-service limits that will result in arrears to the Fund and other creditors.	
September	Saudi Arabia abandons role as swing producer in OPEC, starts major oil price decline in motion. G-5 meeting at Plaza Hotel.	
October	Baker-Miyazawa accord on interest rate policy.	Annual Meetings in Seoul; Baker Plan introduced; G-10 and G-24 reports submitted to Interim Committee.
December	Gramm-Rudman-Hollings deficit reduction act passed by U.S. Congress.	
1986		
January	Spain and Portugal join the EC. Yoweri Museveni becomes President of Uganda.	
February	Corazon Aquino elected President of the Philippines, ending more than two decades of rule by Ferdinand Marcos. Jean-Claude Duvalier overthrown as President of Haiti. Single European Act signed; sets December 31, 1992 as deadline for economic integration of Europe.	

1 THE SILENT REVOLUTION

Appendix (continued)

Date	World Events	Activities of the Fund
March		Structural Adjustment Facility (SAF) established.
April	Major reactor accident at Chernobyl nuclear power plant in Ukraine.	
May	G-7 summit in Tokyo marks commitment to policy cooperation; President Mitterrand proposes debt concessions for poorest countries.	
June		Poland becomes 151st member.
September	Uruguay Round of trade negotiations launched at Punta del Este. U.S. federal government finishes fiscal year with record budget deficit of \$238 billion.	Formal procedures adopted for conduct of enhanced surveillance.
1987		
January	Paris Club of official creditors agrees to consider rescheduling requests for countries with SAF loans, rather than requiring a stand-by arrangement. Last EMS realignment of the decade.	Michel Camdessus becomes the Fund's seventh Managing Director, following the resignation of Jacques de Larosière.
February	Louvre Accord issued by six of the G-7 countries.	
May	Citibank sets aside \$3 billion as a provision against potential losses on loans to developing countries.	
June	G-7 summit in Venice formalizes Fund role in assisting the policy coordination process.	
July	Single European Act takes effect, leading to economic integration in the EC by the end of 1992.	Access limits raised for SAF loans. Work begins on Ninth General Review of quotas.
August	Argentina signs the first restructuring agreement with commercial banks that incorporates the expanded menu approach.	
September	Basel-Nyborg Agreement strengthens the EMS and leads to greater currency stability in Europe.	
October	Global stock market crash.	

Appendix (continued)

Date	World Events	Activities of the Fund
November	Latin American leaders meet in Acapulco, Mexico; issue declaration on cooperative debt strategy.	
December		Enhanced Structural Adjustment Facility (ESAF) established.
1988		
January	United States and Canada sign Free Trade Agreement, to take effect in January 1989.	
June	G-7 summit in Toronto endorses debt-concession proposals ("Toronto terms"). EC agrees to lift all capital controls by July 1990.	
July	G-10 governors endorse Cooke Committee recommendations on capital standards for banks.	
August		CFF replaced by an expanded facility, the Compensatory and Contingency Financing Facility (CCFF).
September		Last repayment to the Buffer Stock Financing Facility, by Côte d'Ivoire.
October	Punta del Este declaration on debt strategy by seven heads of state in Latin America. Paris Club, implementing the Toronto Terms, introduces expanded menu of policies for debt relief to poorest countries. In the restoration of democracy in Chile, General Augusto Pinochet loses a plebiscite and is required to relinquish the presidency by 1990.	Interim Committee, meeting in Berlin, endorses debt reduction as part of menu approach; also endorses the "intensified collaborative approach" for dealing with arrears.
December	Benazir Bhutto becomes Prime Minister of Pakistan. Carlos Salinas inaugurated as President of Mexico.	

1 THE SILENT REVOLUTION

Appendix (continued)

Date	World Events	Activities of the Fund
1989		
February	<p>General Alfredo Stroessner overthrown as President of Paraguay.</p> <p>Soviet Union completes its withdrawal of troops from Afghanistan.</p>	
March		<p>U.S. Treasury Secretary Nicholas Brady proposes debt reduction scheme; Camdessus notes negative effects from large debt stocks in address to IBD annual meeting.</p> <p>Administered account established for Japanese contributions in support of the collaborative approach to settling arrears.</p>
April	<p>Polish government concludes "Round Table" talks, legalizes Solidarity, and agrees to hold free elections.</p>	
May		<p>Executive Board adopts guidelines on supporting debt reduction schemes. First Brady Plan programs completed, with Costa Rica, the Philippines, and Mexico; 25 percent (30 percent for Mexico) of purchases to be set aside for debt reduction.</p>
June	<p>EC summit meeting in Madrid receives report of the Delors Committee, recommending steps leading to full monetary union for member countries.</p> <p>Spain joins the Exchange Rate Mechanism of the EMS.</p> <p>Solidarity wins elections in Poland, leading to a non-Communist government headed by Tadeusz Mazowiecki.</p> <p>Crackdown against prodemocracy demonstrations in Tiananmen Square, Beijing.</p>	

Appendix (concluded)

Date	World Events	Activities of the Fund
September	ECU currency basket revised, and Spanish peseta and Portuguese escudo added to it. Vietnam withdraws from Cambodia.	Angola becomes the 152nd member of the Fund; all countries in Africa are now members of the Fund except Namibia, which will join in 1990.
November	Berlin Wall dismantled, effectively ending the Cold War. Inaugural ministerial meeting of the 12-nation Asia-Pacific Economic Cooperation (APEC).	
December	Overthrow of Nicolae Ceaușescu as Head of State in Romania. Election of Václav Havel as President of Czechoslovakia, concluding the “Velvet Revolution.” U.S. troops invade Panama.	

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