8

The Crisis Erupts

The global debt crisis of 1982–83 was the product of massive shocks to the world economy and serious misjudgments in the conduct of economic policy. A series of external shocks from mid-1979 to mid-1982, resulting essentially from policy inconsistencies and conflicts in industrial countries, made a large number of developing countries exceptionally vulnerable around the same time. The cumulative effect of long-standing policy errors in the affected countries then turned that vulnerability into a widespread financial crisis: first in Eastern Europe, then in Latin America, and finally in the rest of the developing world.[1]

The external shocks are all well known and can be briefly summarized. The first was the 1979–80 "oil shock," which more than doubled the real price of oil for the oil-importing developing countries.[2] For those countries as a group, the net cost of imported oil rose from 15 percent of exports in 1978 to nearly 23 percent two years later. Much of that increased cost could be covered in the short term only through increased recourse to external borrowing from commercial creditors. The second disturbance, close on the heels of the first, was the "Volcker shock." As the newly appointed Federal Reserve Chairman, Paul A. Volcker, set out to reverse the inflationary excesses of the preceding years, U.S. short-term interest rates (on which a large portion of external debt contracts were based) rose from 9½ percent in August 1979 to more than 16 percent in May 1981. Not until July 1982 did rates on U.S. treasury bills again drop below 12 percent.[3] The consequent sharp rise in real interest rates paid by oil-importing developing countries raised the cost of servicing ex-

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[1]The debt crisis in sub-Saharan Africa was fundamentally different from that in most other areas because the affected countries were poorer, faced more deep-seated structural problems, and were much more dependent on official rather than commercial credits. See Chapter 14.

[2]The "real price" for a given country is the price of imported oil deflated by the index of the country's export prices. Except as noted, the calculations reported in this paragraph are based on Boughton (1984).

[3]The swing in interest rates, which is shown in Chapter 1, Figure 1.5, was much more severe in real terms, owing to the intervening drop in inflation. U.S. consumer prices rose by more than 13 percent in 1979, making the ex post real short-term interest rate negative. By 1982, inflation had dropped below 4 percent, while treasury bill yields remained above 10½ percent. If interest rates are deflated by the export prices received by oil-importing developing countries, the swing would be still larger. On that basis, Goldsbrough and Zaidi (1986) estimated that for capital-importing developing countries, the real interest rate averaged –5.3 percent for 1978–80 and +17.8 percent for 1981–82.

ternal debts by an estimated 7–8 percent of export earnings between 1979 and 1982. Third, the widespread recession in industrial countries in 1981–82 severely weakened the markets for developing country exports and thereby reduced debtors' ability to generate enough foreign exchange to service their debts.[4] Finally, the effective appreciation of the U.S. dollar by 25 percent from 1980 to 1982 added further to debt-service burdens, since developing countries' liquid liabilities were larger and more concentrated in dollars than were their liquid financial assets.

These external shocks were aggravated by a variety of policy errors in developing countries. Oil-exporting countries, notably Mexico, overestimated the sustainability of high oil prices around the beginning of the decade and found themselves in trouble when prices retreated in 1981–82. Social pressures in many countries led to wage increases that the government could not afford and could accommodate only by losing control of the supply of money. Efforts to use a fixed exchange rate as an anchor to stabilize prices often led to serious losses of international competitiveness as inflation proved to be ineradicable. Attempts to promote economic development by protecting and subsidizing uneconomic enterprises had ruinous effects. As these and other mistakes accumulated, time and again the first crisis to surface was an inability to service external debts.

Prelude: Crisis in Eastern Europe

The first area where the simmering debt crisis bubbled to the surface was the Soviet bloc in Eastern Europe. Several countries in that region embarked on large-scale industrialization drives in the 1970s, only to find that their economies were unable to compete with the more established and far more dynamic western powers. They borrowed heavily from commercial banks in western Europe and elsewhere, and they counted on the Soviet Union to be both a source of fuel and raw materials and a primary market for their output. But by the time the revenues from the projects failed to materialize at the beginning of the 1980s, the Soviet economy was also on the ropes, pummeled by falling oil prices and the war in Afghanistan as well as by its own internal economic ossification. Across the region, countries turned to the West for help.

Poland

The first signs of trouble came from Poland, which was not a member of the IMF but was already engaged in preliminary and quiet membership talks with the staff (Chapter 19). At the end of 1980, Poland had over $25 billion in external debts in convertible currencies, the bulk of which was owed to western governments and to some 500 foreign commercial banks. Adding to the dangers of a possible default

[4]GNP growth in industrial countries averaged 3 percent a year for 1973–80 and 0.5 percent for 1981–82. The volume of industrial country imports from developing countries rose at an average annual rate of 0.2 percent for the earlier period and fell at a rate of 8.6 percent for 1981–82. See Goldsbrough and Zaidi (1986), Tables 47 and 49.

of that magnitude were uncertainties about the size and distribution of the debts. A significant but unknown portion of Poland's bank debt was either explicitly or implicitly guaranteed by western governments, and no one could be sure of how the burden of a default would be shared between the public and private sectors or among countries.[5]

In the first months of 1981, the government of Poland found that it lacked the foreign exchange to service all of its debts, and in early March it approached both official and bank creditors to request reschedulings. Official creditors responded promptly through the Paris Club and agreed in April to defer some $2.2 billion in principal payments due in 1981. The banks—forced to innovate to deal with a problem country that was not a member of the IMF—responded by establishing a "multinational task force" of 20 lead banks, which was a less formal prototype of what would later be known as advisory or steering committees.[6] Default would have been a serious blow to some western banks, particularly those in the Federal Republic of Germany (which had the highest aggregate exposure) and Austria (where some of the larger banks also were heavily exposed).

Negotiations took more than a year to complete, during which Poland experienced a political upheaval that climaxed in December 1981 with a declaration of martial law that forestalled an imminent takeover by the Soviet army and suppressed the budding push for democracy spearheaded by Lech Walęsa's Solidarity movement. This political setback made IMF membership an impossible goal for the moment, but it only moderately delayed negotiations with private creditors. In April 1982, a rescheduling agreement was signed with the banks. Thus the first threat of an international debt crisis was transcended without the involvement of formal multilateral institutions.

For the other two centrally planned economies that fell into a serious payments predicament in 1981—Romania and Hungary—the Fund played an active role. (Yugoslavia also encountered difficulties in this period, but its real crisis came somewhat later and is covered in Chapter 13.)

Romania

Throughout the 1970s, Romania's President, Nicolae Ceaușescu, used the IMF as an element of a strategy to distance his regime from the foreign policy goals of

[5]For a review of Poland's debt crisis from a bank creditor's perspective, see Eichler (1986). Eichler estimated that less than a third of Poland's debts at that time were owed to private banks; contemporaneous estimates, including those by the Fund staff, had suggested a much higher bank portion. Part of the uncertainty arose from German government guarantees on credits that were nominally extended by German banks. Contemporaneous press reports indicated that between 40 and 50 percent of $6 billion in outstanding credits from German banks to Poland in 1981 carried government guarantees. For the four German banks with the largest exposure, total claims were estimated at $1.4 billion, of which $442 million (31 percent) was thought to be guaranteed. See Tagliabue (1982) and Spindler (1984). Staff estimates are summarized in "Payments Difficulties Involving Debt to Commercial Banks," SM/83/47 (March 9, 1983), pp. 106–8.

[6]For a contemporaneous commentary on the difficulties posed for the banks by Poland's nonmembership in the Fund, see Brainard (1981).

the Soviet Union. In 1972, after five years of quiet diplomacy and technical talks, Romania became the first country since 1955 to be a member of both the Soviet-bloc Council for Mutual Economic Assistance (CMEA) and the IMF (see Chapter 19). The following year, when Ceauşescu traveled to Washington for a state visit with U.S. President Richard M. Nixon, he made a point of also meeting with the Managing Director of the Fund, H. Johannes Witteveen. Over a four-year period starting in 1975, while Romania was engaged in a large-scale industrialization drive, the Fund entered into two stand-by arrangements with the country and made additional resources available through the Compensatory Financing Facility (CFF) to cover flood- and earthquake-related export shortfalls. By the end of 1980, Romania's indebtedness to the Fund amounted to SDR 257 million (70 percent of quota, or approximately $330 million).

The Romanian economy was in a fragile state by that time. The investment that had supported industrialization by bringing in foreign capital goods had also weakened the external current account during a period when the rising cost of oil imports and a series of natural disasters had left no room for excesses. The authorities therefore turned again to the Fund for assistance early in 1981, and a three-year stand-by arrangement was negotiated by May. The Executive Board was skeptical of the request, because the authorities would need both major policy changes and full cooperation from creditors to meet the performance criteria. At the very least, it was felt that the authorities should have requested an arrangement under the Extended Fund Facility (EFF), which would have allowed them to stretch out repayments over a much longer period. In addition, the U.K. chair (represented by John F. Williams, Temporary Alternate) argued that Romania was unlikely to be able to roll over its large stock of short-term debts and questioned the staff's judgment that the $9½ billion in outstanding convertible-currency debt was "manageable." Nonetheless, the arrangement—for SDR 1.1 billion (300 percent of quota, or $1.3 billion)—was unanimously approved.[7]

The Fund's confidence in the Ceauşescu government was misplaced, and matters deteriorated rapidly in the second half of 1981. Part of Romania's trouble was homegrown, notably in the form of abuses of international payments mechanisms and interbank credit lines by Romanian banks. To those troubles was now added the self-fulfilling fear of contagion from the crisis in Poland. Foreign banks were quietly but increasingly withdrawing deposits from Romania and canceling inter-

[7]See "Romania—Request for Stand-By Arrangement," EBS/81/111 (June 1, 1981), and minutes of EBM/81/91 (June 15, 1981), p. 13. Outside analysts were also skeptical. The week after the Fund approved the stand-by arrangement, Wharton EFA (a major U.S. commercial forecasting firm) concluded that "Romania is an excellent candidate to be the next 'Poland' in Eastern Europe. . . . the recent IMF decisions need to be explained." Those analyses, which turned out to be fairly close to the mark, were discounted internally at the time because they were based on a much more limited database than that available to the staff and because the staff believed that the full extent of the authorities' stated intentions to reform economic policies was not known outside of official circles. See "Romania," memorandum from L. Alan Whittome (Director of the European Department) to the Managing Director (July 15, 1981), and attachments; in IMF/CF (C/Romania/1760 "Stand-by Arrangements 1973–1981").

bank credit lines. Refusals to roll over maturing loans led to arrears rather than repayments. By the end of 1981, Romania had accumulated more than $1 billion in arrears to foreign banks, had totally lost access to new credits, and was therefore out of compliance with the terms of the stand-by arrangement with the Fund. Although the staff met on various occasions with major bank creditors in the fall of 1981 to explain the nature and extent of the measures the authorities were taking to strengthen their finances, they gradually came to accept the banks' doubts about Romania's commitment to reform. The Fund refused to waive the terms of the stand-by, and it allowed no drawings during the first year of the program other than the one made at the time of initial approval.[8]

Romania began negotiating with a consortium of nine lead banks from six western countries in January 1982, with the Fund staff participating as observers.[9] By April, as those talks continued, arrears to banks were approaching $3 billion, including arrears on interest as well as principal payments. Even so, the Fund staff expected the government to reach a rescheduling agreement with the lead banks in time to resume the stand-by arrangement in June, a hope that was soon dashed. In June, the staff backed off and proposed instead that the arrangement be resumed with only a token (SDR 10 million) drawing and that more substantive drawings be deferred until the arrears were settled in some fashion.[10]

The "token drawing" proposal was unprecedented, and it drew quite a bit of fire in the Executive Board meeting on June 21. The Board was, on the whole, impressed by Romania's perseverance in implementing its adjustment program, and a number of Directors (though holding a minority of the votes) proposed that a full scheduled drawing (SDR 76 million rather than 10 million) be allowed. The Managing Director, Jacques de Larosière, insisted on sticking with the staff proposal as a matter of "prudence," though he did note that this unique decision should not become general policy.[11]

Part of the explanation for the Executive Board's optimism on Romania was that official creditors had signaled a willingness to reschedule debts as soon as the Fund arrangement was resumed; a July meeting of the Paris Club had been scheduled for

[8]Under the original terms of the arrangement, Romania was to be entitled to purchase SDR 140 million immediately and SDR 76 million in November 1981, February 1982, and May 1982. Only the first drawing was made. The abuses by Romanian banks (allegedly including kiting of checks), as understood by western banks, were reported to Fund management in September. See "Romania—Foreign Debt Position" (September 15, 1981), memorandum to Brian Rose (Deputy Director of the European Department) from the mission chief, Geoffrey Tyler, with cover memo from Rose to the Managing Director; in IMF/CF (C/Romania/1760 "Stand-by Arrangements 1973–1981").

[9]Altogether, Romania had outstanding debts to some 300 western banks at this time, plus loans from a few banks in Moscow and the Middle East. The latter two groups did not participate in the negotiations, waiting instead to reach a settlement on comparable terms.

[10]Compare "Romania—Staff Report for the 1982 Article IV Consultation and Review of Stand-By Arrangement," EBS/82/73 (April 29, 1982) with "Additional Information," EBS/82/73, Sup. 1 (June 14, 1982). Additional information is from the staff statement at EBM/82/85 (June 21, 1982), pp. 3–4.

[11]Minutes of EBM/82/85–86 (June 21, 1982). Beginning in 1983, the Fund developed a policy of approving arrangements "in principle" to deal with situations such as this. See Chapter 9.

that purpose.[12] That part of the package was successfully concluded in late July, but negotiations with bank creditors continued for several more months. Romania and the banks finally signed a rescheduling agreement in December 1982, ending this phase of the crisis and permitting a resumption of the stand-by arrangement.

Following the resolution of this crisis, the Romanian economy deteriorated further, and Ceaușescu's policies eventually lurched into a totally new direction. Around 1986, after difficulties arose in repaying the Fund and other creditors, the government began appropriating an increasingly disproportionate share of domestic output, even of basic foodstuffs, to export for foreign exchange. In a disastrous overreaction to the strains of 1981, part of those revenues were then used to repay foreign debts early and as rapidly as possible. As hardships and domestic unrest grew, Romania ceased providing basic data to the Fund in 1987 and repeatedly postponed the scheduled Article IV consultation. The economy, the political instability, and the international isolation of Romania continued to worsen until the overthrow of Ceaușescu in November 1989.

Hungary

Hungary developed a stronger and more open economy than its neighbors in the 1970s, and it became known as the crown jewel of the CMEA. That success, however, did not shield the country as the debt crisis spread across Eastern Europe. On the contrary, Hungary's economic growth had been nurtured by foreign borrowing, and those debts became unbearably costly to service as the 1970s faded into the 1980s.

Hungary's crisis began in the first quarter of 1982, while the government's application for membership in the IMF was still in process (see Chapter 19). The previous year had been hard, as export receipts fell in response to the deterioration in the world economy even as world interest rates were still rising. For two years, banks had been shortening the maturities at which they were willing to lend to heavily indebted countries, and Hungary—like so many other countries in similar circumstances—had failed to curb its appetite as the bill of fare had become ever richer. With over $10 billion in external debt, much of it short-term, Hungary faced a tightening squeeze between falling resources and rising debt-service costs. When the debts of first Poland and then Romania began to hemorrhage, the stain naturally ran toward Budapest. Bank creditors all tried to pull out at once, and by March 1982, Hungary was virtually devoid of foreign exchange.

Up to this point, the story had a familiar resonance. Where Hungary departed from the earlier cases was in the authorities' efforts to staunch the capital outflows by turning first to the Bank for International Settlements (BIS) in Basel, Switzerland. Hungary had participated actively in the BIS for decades, and since the 1950s

[12]The Board meeting on Romania was originally scheduled for June 14, 1982, but it was postponed by a week while the management of the Fund obtained assurances from Paris Club creditors that the outcome was likely to be positive. On June 11, the Managing Director indicated to the Board that such assurance was a necessary condition for reactivating the Fund arrangement. Minutes of EBM/82/81 (June 11, 1982), p. 3.

had normally been represented there by Janos Fekete, who in 1982 was the First Deputy President of the National Bank of Hungary. Fekete went to see Fritz Leutwiler, the newly elected president of the BIS, with a request for an innovative approach. Hungary did not have the foreign exchange or gold to put up as collateral for a conventional loan from the BIS, but perhaps an alternative could be found.[13] Would the BIS be willing to arrange for a bridge loan *from its member central banks* to help Hungary meet its payments obligations until it could join the IMF and get a stand-by arrangement?

Poland had sought a similar arrangement from the BIS the year before, but that request had not been enthusiastically received and had been dropped when Poland's reform momentum was brutally halted in December. Hungary's situation, however, was far more favorable. Leutwiler picked up the telephone and called de Larosière in Washington. When the Managing Director assured him that he fully expected Hungary to qualify for IMF credits within a few months, Leutwiler decided to support Fekete's request, and he set out to get the support of his fellow BIS governors and other major central banks. Within a few weeks, he was able to complete the deal, and the BIS made two syndicated loans to Hungary in March and May 1982, for $100 million and $110 million, respectively. Though small in relation to the demands on Hungary's meager reserves (and less than the $500 million for which Fekete had asked), the announcement of the loans had a calming effect on the financial markets.

The BIS bridge loans enabled Hungary to avoid defaulting on its bank loans while the authorities completed the IMF membership process (in May) and began negotiations for a stand-by arrangement. A further $300 million in short-term credits was provided by the BIS in September, and with that amount in hand Hungary was able to clear its outstanding arrears in time for the Executive Board to approve the use of the Fund's resources in December.[14] The Hungarian crisis was thereby put to rest, in part through coordinated international action that set a precedent that would turn out to be crucial for success when the debt crisis soon spread to Latin America.

In Concert: Crisis in Latin America

Mexico

As told in Chapter 7, the core of the debt crisis was in Mexico. Eastern Europe had been threatened, and that crisis had in turn endangered the solvency of major

[13]In earlier years, Hungary could have counted on the Soviet Union to lend it the gold for collateral, but part of the squeeze that Hungary now faced was a withdrawal of that type of support.

[14]The BIS loans are described in the BIS *Annual Report* for 1982–83, pp. 164–65; additional information used here is from background interviews. On December 8, 1982, the Executive Board of the IMF approved a 13-month stand-by arrangement for SDR 475 million (127 percent of quota, or $520 million), plus a drawing of SDR 72 million ($80 million) under the CFF to compensate for a shortfall in export earnings. Note that the three BIS loans were short-term credits; the amounts cannot be added together to derive total bridge financing to the Fund arrangement, because the first two loans expired between September and December.

Talk to the IMF, by Dan Wasserman

European banks; but it neither openly erupted nor posed an immediate direct threat to the functioning of the international financial system. When Mexico announced in August 1982 that it could neither roll over nor repay principal on its bank loans, it alerted the world that the crisis was spreading and growing and that the system itself was now at risk. The major U.S. and Japanese banks were threatened for the first time, and the European banks faced large new risks on top of those that still lingered from their eastern borders. The resources that the creditor countries had so far brought to bear could not begin to cope.

The Mexican crisis placed the IMF squarely at the center of the emerging debt strategy. From August 1982 through the rest of the decade, Mexico would be the crucible where the strategy would be developed and tested.[15] As the problems became manifest in other countries throughout the developing world, that strategy would be applied and modified in case after case. The remainder of this chapter examines three major cases in Latin America: Argentina, Brazil, and Chile.[16] The three stories have much in common—unsustainable external borrowing and a shortage of discipline in domestic economic policy—but also some important differences. Because of Brazil's economic strength and Chile's tradition of good policies, the Fund tried to avoid resorting to concerted lending to close their financing gaps. The failure of that effort showed just how deep and protracted the debt crisis was likely to become.

Argentina

The Managing Director had much on his mind at the Annual Meetings in Toronto. Managing the effects of the Mexican crisis was by itself a full-time job, but the rest of the world economy could not be ignored. On Tuesday morning, September 7, de Larosière would be called upon to attend the plenary sessions of the meetings of the Boards of Governors starting at 10:00, and at about 11:00 would deliver a major address. Before that, however, he had a series of meetings with the governors of several countries, including one with Dr. Jorge Wehbe, the minister of economy from Argentina, at 8:40 a.m. In a chain of threatened economies across Latin America, the Argentine link was about to break.

The story of Argentina's debt crisis had opened just before Christmas in 1978, some 2½ years after the military had wrested power from Isabel Perón. Adolfo Diz, the very able president of the central bank, had implemented financial reforms, negotiated a stand-by arrangement with the Fund, and generated enough credibility with foreign commercial banks that the country never had to draw on that line of credit.[17] This

[15]See Gold (1988) for a general history of the importance of Mexico to the development of IMF policies.

[16]For a more general overview on Fund-supported programs in the heavily indebted countries in this period, see Chapter 9.

[17]The stand-by arrangement was approved on September 16, 1977, for SDR 159.5 million (36 percent of quota). At the time, the Fund's holdings of Argentine pesos amounted to just over 200 percent of quota, reflecting earlier drawings on stand-by arrangements, the Oil Facility, and the CFF. The 1977 arrangement expired one year later, by which time the Fund's holdings of pesos were down to 75 percent of quota.

victory, however, was incomplete. In 1978, Argentina had a surplus in its external current account and in its overall balance of payments, but the domestic economy was in a shambles: output was falling while consumer price inflation raced along at about 175 percent a year. On December 20, the minister of economy, José Martínez de Hoz, announced a new set of policies designed to gradually weaken the inflationary psychology of the country and stimulate investment and output.

The basic elements of the Martínez de Hoz plan were to control and preannounce the rates of currency depreciation, wage increases, and growth of the domestic monetary base; gradually reduce import tariffs over five years; and strengthen the central government's finances by restraining spending and suspending central bank lending to the government.[18] The element that got the most attention and that gave the plan its popular name was the crawling peg for the exchange rate, for which the government issued printed tables—*tablitas*—in advance.[19] Inflation did fall under the *tablita*—to 160 percent in 1979 and 100 percent in 1980—but it remained well above the fixed rate of depreciation. Gradually but inevitably, Argentine exporters suffered a disastrous loss of international competitiveness. By 1980, the balance of payments was back in deficit, output (after a brief spurt of growth in 1979) was again stagnant, capital investment was plummeting, and the country was becoming dangerously dependent on continual borrowing from foreign banks.

In October 1980, the military junta named General Roberto Eduardo Viola to replace President Jorge Rafael Videla the following March. During this interregnum, exchange rate policy was administered erratically, speculation of a major devaluation became widespread, and maintaining the *tablita* became impossible. A 10 percent devaluation on February 2, 1981, did little to calm the markets and may even have accelerated the collapse of the exchange regime. When Viola took office at the end of March, his new economy minister, Lorenzo Sigaut, immediately announced a further devaluation of 23 percent but otherwise attempted to preserve the preannounced crawling peg. When speculation continued against the peso, Viola's team resorted more and more to exchange and other controls and failed utterly to manage the government's finances or to extinguish the inflation that the deficit was fueling. By late summer, when an IMF team (led by Christian Brachet, Chief of the River Plate Division in the Western Hemisphere Department) arrived in Buenos Aires to conduct the Article IV consultation, the economy was seriously destabilized.

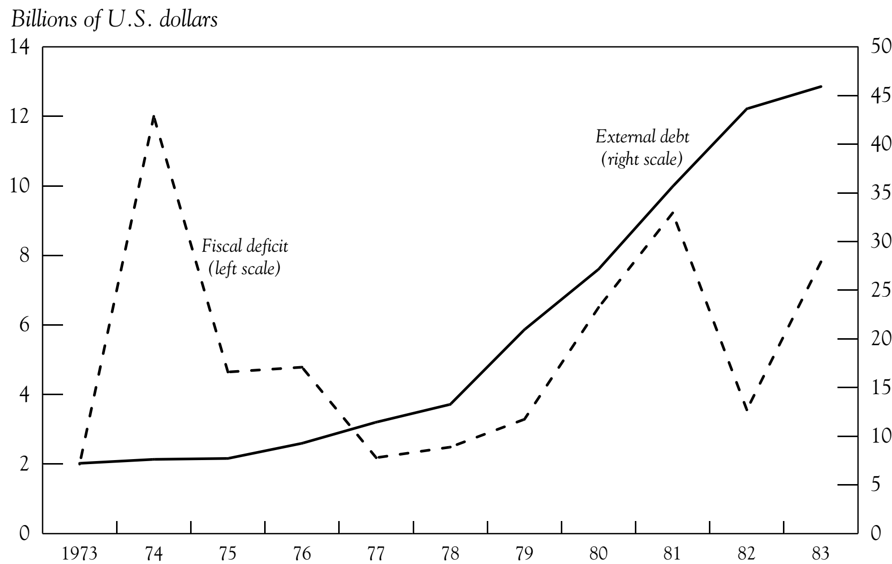
Brachet's report warned of the dangers to the economy if measures were not taken to reduce the fiscal deficit and control monetary growth.[20] A few days after the mission's return to Washington, the Managing Director reinforced this message

[18]For a general analysis of economic policy under Martinez de Hoz, see Calvo (1986).

[19]Chile had adopted a similar crawling-peg policy from 1976 to 1979, and it later came into common use in several Latin American countries that were attempting to get inflation under control. The term *tablita,* however, originated in Argentina as a description of the "little tables" that listed the evolution of controlled prices.

[20]"Argentina—Staff Report for the 1981 Article IV Consultation," SM/81/233 (December 2, 1981), pp. 16–18

Figure 8.1. Argentina: Fiscal Deficit and External Debt, 1973–83



Sources: IMF, *IFS*; and World Bank, *World Development Indicators*.

in a meeting with Sigaut at the 1981 Annual Meetings. Sigaut expressed confidence that a rebound in economic activity would soon strengthen tax revenues enough to resolve the fiscal imbalance, but de Larosière cautioned him that this supply-side effect was no more likely to succeed in Argentina than it was in the United States.[21] Three months later, with no further progress toward stabilization being evident, an ailing Viola was overthrown in a coup, and a new economic team—led by Dr. Roberto T. Alemann—was brought in to restore order.

Alemann confronted an escalating external debt, which had already tripled in three years (Figure 8.1). He moved quickly to restore competitiveness by floating the exchange rate and to reduce the fiscal deficit by freezing public sector wages and cutting support to unprofitable public sector enterprises: both of which would help to ameliorate the rampaging borrowing from international banks. Brachet and his team returned to Buenos Aires in January 1982 to complete the Article IV consultations that the Executive Board was scheduled to discuss in mid-March. Although the team was worried that the military government was deeply divided in its support for Alemann's policies, they were impressed by the minister's own resolve, and the consultations were concluded without difficulty.[22]

[21]The exchange was noted in the departmental file memorandum of September 28, 1981, on the bilateral meeting; in IMF/RD Western Hemisphere Department file "Argentina Correspondence—I, January 1979–October 1982" (Accession 88/151, Box 1, Section 531).

[22]See "Argentina—Staff Report for the 1981 Article IV Consultation," SM/81/233 (December 2, 1981) and Sup. 1 (February 25, 1982), and minutes of EBM/82/29–30 (March 12 and 15, 1982).

Alemann was largely isolated from the junta's strategic planning, and he spent the last few days of March 1982 participating in the annual meetings of the Inter-American Development Bank (IDB) in Cartagena, Colombia. It appears he was completely surprised to learn on April 2 that Argentina had launched a military effort to occupy the islands in the southern Atlantic that the British called the Falklands but the Argentines knew as the Malvinas. Within days, the United Kingdom and Argentina had frozen each other's financial assets, and the European Community had banned all imports from Argentina; and by the end of April, the United States had banned arms sales to Argentina and had ceased providing trade support through the Export-Import Bank and the Commodity Credit Corporation. Servicing the external debt became all but impossible in these circumstances, as the banks only reluctantly agreed to roll over existing credits. The debt crisis had come to Latin America.

Throughout the war, Alemann did as much as could be expected to conduct business as usual. At the Interim Committee meeting in Helsinki on May 12, he assured both de Larosière (in a private meeting) and the Committee that he was determined to persevere with the adjustment policies that he had initiated before the invasion.[23] Nonetheless, by the time peace was restored in June, Argentina had accumulated more than $2 billion in external arrears and had no prospect of resuming normal financial relations with its bank creditors in the near future.

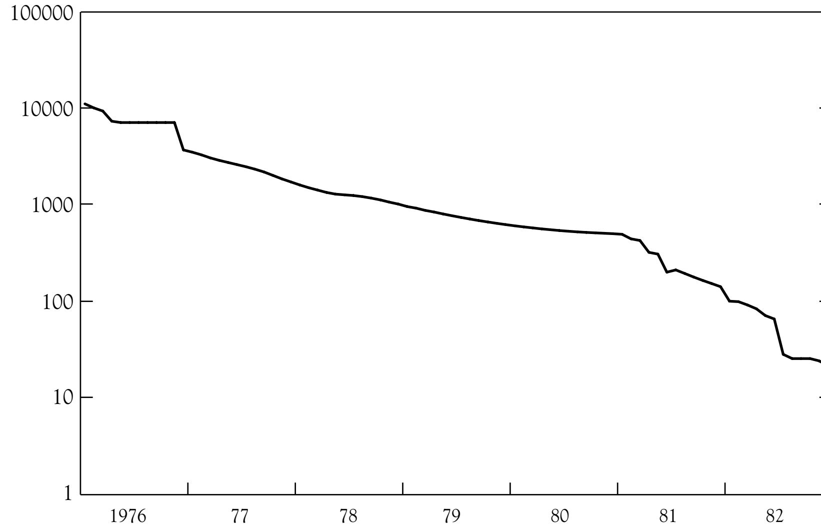
In July 1982, the army took effective control of Argentina, named General Reynaldo Benito Antonio Bignone to serve as president, and announced a commitment to hold elections for a civilian government by March 1984. Bignone brought in a new economic team headed by Economy Minister José María Dagnino Pastore, but little was done to restore order to economic policy. On July 6, just four days after Pastore's appointment, the peso was devalued (Figure 8.2) and the exchange market was split into commercial and financial segments. This effort to protect commercial transactions largely failed, however, as a parallel market arose with huge discounts (about 60,000 pesos per U.S. dollar, compared with 20,000 in the commercial market and under 40,000 in the financial market), and price and wage inflation accelerated. Brachet's team returned to Buenos Aires a week later and concluded that economic conditions were deteriorating and that these policies were doing little to improve them.[24]

[23]The Interim Committee meeting in Helsinki provided a prototypical demonstration of the separation of economics from politics that—though inevitably imperfect—gives life to the IMF's efforts to serve a varied and often fractious membership. Alemann and Sir Geoffrey Howe, the United Kingdom's Chancellor of the Exchequer, were both members of the 22-person Committee, and a confrontation between them would not have been surprising. Alemann spoke first at the afternoon session, avoided all references to the war, and gave what seemed to Howe to be even a Thatcherite commentary on the need for financial discipline and economic reform. Howe responded in kind with a speech that pointedly ignored the hostilities altogether. Afterward, the two ministers met and exchanged pleasantries, and the occasion passed without incident. ICMS/Meeting 18 (5/13/82), second session (3:00 p.m.), pp. 1 and 4–6. For Howe's published account, see Howe (1994), p. 268.

[24]Stiles (1987) erroneously reported (p. 62) that this mission was asked to discuss the possibility of a stand-by arrangement but drew negative conclusions. In fact, the authorities did not raise the question of a financial arrangement until several weeks later, as discussed below.

Figure 8.2. Argentina: Exchange Rate, 1976–82

U.S. dollars per million pesos; log scale



Note: Scale is in terms of the currency in effect from 1977 to 1983.

From an economic perspective, Argentina's fundamental problem was an inability to reduce the fiscal deficit. From the political perspective of the authorities, however, restoring fiscal discipline was a secondary issue. In the absence of access to foreign bank loans, only a draconian adjustment program could have resolved the domestic and external imbalances. With the military split, no government could have generated the political support for such measures. The authorities therefore focused much of their efforts on stanching the bleeding of bank credits. That effort, which would have been difficult in any case because of the lack of economic stability, was complicated further by Argentina's prohibition against making payments to British banks.[25]

The syndication agreements under which the banks had lent to Argentina gave any bank that was not paid its share the right to force a default against the entire loan. Facing this very real possibility and fearing the systemic consequences, senior officials of the Bank of England worked quietly with their counterparts in Argentina throughout the months following the war to keep everyone in the game. (The regular meetings of the BIS in Basel provided a convenient forum for such contacts.) A solution was finally negotiated at the Annual Meetings in Toronto, with assistance from Richard T. McNamar (Deputy Secretary of the U.S. Treasury). For their part, the Argentine authorities arranged to bypass the agent for the

[25]On May 18, in the midst of the war, Law 22591 was enacted, prohibiting business payments to residents (including banks) of the United Kingdom.

bank syndicate and instead pay—through their own agent—the individual banks other than the British. The receiving banks would then pay the British banks, as they were required to do under the sharing clauses of the syndication agreements. For several months, until normal financial relations were restored between Argentina and the United Kingdom, this string-and-bandages procedure held together, and a default was avoided.

When banks suddenly stopped lending to Mexico in August, Pastore realized that he would not have the luxury of time to deal with the deeper economic problems. After less than two months in office, he—along with the central bank president, Domingo Cavallo—abruptly resigned on August 24. The new team, headed by Wehbe, immediately decided to approach the IMF for financial assistance. First in Washington and then at the Annual Meetings in Toronto, Wehbe met with the Fund staff—including principally Walter Robichek, the Director of the Western Hemisphere Department—to discuss the feasibility of an arrangement. Robichek was receptive to the idea, but he expressed concern about whether there was enough political support in Argentina for implementing an effective adjustment program, especially in view of the elections that would be held around the end of 1983: Was it realistic to expect firm action during the run-up to the elections, and could the elected government be counted upon to continue with the required reforms? These concerns led Robichek to recommend against an extended arrangement (which would have required a three-year policy commitment) in favor of a 15-month stand-by arrangement.

These, then, were the circumstances that Wehbe faced as he met with de Larosière at the Toronto Sheraton early that Tuesday morning in September. The question of discrimination against British banks was crucial from the Fund's perspective, because Executive Board approval of an arrangement would have been impossible without a prior resolution of this problem. Wehbe was able to assure the Managing Director that they were working through indirect channels to ensure equitable treatment (as described above). The more substantive issue was whether Wehbe would be able to generate enough support among the military leaders to implement the program. For the moment, what mattered was that he was prepared to try. De Larosière agreed to send a mission in September to conduct the annual Article IV consultations and to begin negotiations on a program that could be supported by a stand-by arrangement for SDR 1.5 billion.

By the end of September, the Argentines were negotiating on several fronts. They were negotiating with the IMF team (led by Brachet, with Robichek taking over the negotiations after mid-October) on the terms of the proposed program; with the politicians who were likely to form a new government after the elections, for their implicit support for the program; with the leading bank creditors for a $1.1 billion bridge loan; and with the BIS for a $750 million bridge loan.[26] The BIS de-

[26]None of the large heavily indebted countries in Latin America requested a rescheduling of official bilateral obligations, through the Paris Club or other creditor group, in 1982. The first to do so was Mexico, in June 1983. Argentina had relatively few such debts at the time and did not seek a Paris Club deal until 1985.

murred for the time being (apparently owing to a disagreement over collateral), but agreement in principle was reached with both the Fund and the banks before the end of October.[27] At that point, the authorities felt ready to relax the controls on the foreign exchange market. The commercial rate was devalued by 13½ percent and partially unified with the financial rate, and it would then be depreciated regularly in line with domestic inflation to maintain competitiveness.

On the surface, Argentina was firmly on the path to recovery. Underneath, the footing was much less secure. The authorities had made a general commitment to control the main macroeconomic aggregates, but they had not yet fully specified the policy changes that would achieve those results. Not only were some of the spending cuts and revenue measures to reduce the fiscal deficit not yet defined, but also the readiness of the authorities to raise interest rates by enough to make domestic assets competitive and stop capital flight remained in doubt. This latter uncertainty reflected a difference in view that was (and is) common in negotiations between the IMF and developing countries: starting from a position where interest rates are sharply negative in real terms, how far and how fast *must* rates be raised to reverse the outflow of financial capital, and how much *can* rates be raised without undercutting real investment demand? For the time being, this debate was left to simmer.[28]

Furthermore, the program that the staff had negotiated assumed only that the commercial banks would continue to roll over existing medium- and long-term loans. By implication, all interest due on those loans would be paid when due. Except for the temporary effect of the bridge loan, the banks' exposure would not rise, and the additional financing would come entirely from the Fund and other official creditors. To restore more balance into these financing arrangements and to provide for a margin in the event that the still-unspecified policy measures turned out to be weaker than envisaged, the Managing Director insisted that the program be modified to include a $1.5 billion (roughly 7 percent) increase in bank exposure.

Julio Gonzáles del Solar, the president of the central bank, came to Washington in the second week of November 1982, and he and his staff worked intensely for several days to hammer out the details of the Letter of Intent with both the IMF staff and the Managing Director. Then on November 16, de Larosière flew to New York to meet with the bank creditors: the same dramatic meeting that confronted the Mexican crisis, as described above in Chapter 7. As with the Mexican EFF arrangement, the Managing Director made clear to the banks that he could not propose approval of the stand-by arrangement to the Executive Board until he received written assurances from the banks that they would grant an additional term loan (the so-called new-money loan, which in effect would refinance a substantial portion of the interest due on existing credits).

[27]The Fund discussions are described in the staff report, "Argentina—Staff Report for the 1982 IV Consultation and Request for Stand-By Arrangement," EBS/83/8 (January 10, 1983).

[28]This issue resurfaced often in the financial crises of the 1990s, especially in Korea at the end of 1997, and became a focal point for many critics of the Fund's crisis management.

Following the November 16 meeting, the main creditor banks organized themselves into an Advisory Committee—headed, as was the Mexico committee, by Citibank's William Rhodes—to negotiate the terms of the requested bridge and term loans. In addition to the financial terms, the banks were also concerned about the macroeconomic program negotiated by the Fund. During the next few weeks, Fund staff met on several occasions with the Committee or their representatives to explain the program, but they did not participate in the negotiations between the Committee and the authorities. By December 10, agreement was reached with the Committee, and on December 31, the Argentine authorities and the banks signed the contracts for both loans.

The Letter of Intent and Memorandum of Understanding, which formalized the request for the stand-by arrangement and the government's policy commitments, were submitted to the Managing Director on January 7, 1983, along with a more detailed memorandum on specific policy measures that had been taken or were being contemplated.[29] The proposed program was fairly standard and incorporated limits on the balance of payments deficit, the borrowing requirement of the nonfinancial public sector, and the growth of the net domestic assets of the central bank. The formulation of these limits, however, was unusually detailed and complex, owing to the need to account for inflation and to translate Argentina's domestic accounting structure into an internationally acceptable format.[30] Nonetheless, by the January 7 signing, the substance of the issue had been largely resolved.

The Executive Board met on January 24, 1983, to consider Argentina's request for the SDR 1.5 billion stand-by arrangement and a CFF drawing of SDR 520.1 million to cover a temporary loss of export receipts. Directors raised a number of issues regarding the proposed program. Jacques de Groote (Belgium), for example, expressed frankly what several of his colleagues phrased more delicately, that the planned adjustment effort "could impose such a heavy burden on the government as to exclude the possibility of complete observance." He also was bothered by the slow pace at which Argentina was eliminating the discriminatory practices against British residents, and he suggested that all restrictions be eliminated before the first scheduled performance review (May 1983), rather than by end-year, as proposed. Finally, de Groote questioned whether the temporary shortfall in export receipts that constituted the basis for the requested CFF drawing was really the result of circumstances beyond the control of the member (as required by the CFF decision) rather than "the events of 1982" (the war) over which they did have some control.[31]

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[29]"Argentina—Stand-By Arrangement," EBS/83/8, Sup.1 (January 25, 1983), Attachment and Annexes I and II.

[30]This issue, for which no single approach is unambiguously preferred, is similar to the debate over the use of the "operational deficit" as a program criterion in Brazil (Chapter 9). The Argentine accounts treated the estimated inflation component of interest payments (i.e., the effects of interest rates being higher than they would have been in the absence of inflation) as amortization rather than financing. The actual deficit therefore was much higher than the recorded deficit, the gap between the two became progressively larger over time, and the calculation of the actual deficit had to be spelled out in detail.

[31]Minutes of EBM/83/17 (January 24, 1983), pp. 9–10.

The question of the authorities' resolve to implement the program could not very well be settled in January; the staff team reiterated its conviction that a serious adjustment effort would be undertaken, and the Board fully accepted that judgment. The question of the elimination of discriminatory practices was likewise deferred, on the basis of the assurance of Mario Teijeiro (Alternate—Argentina) that the "authorities will make their best efforts to ensure that all exchange arrangements that are in effect beyond the May review, including any restrictions that may temporarily remain, will be completely nondiscriminatory in both character and operation."[32]

Approval of the request for a drawing under the CFF required that the shortfall in export receipts be "largely" outside the control of the member, but that requirement was interpreted to treat political disturbances as if they were unavoidable (see Chapter 15). In judging the Argentine request, the staff position had been that macroeconomic policies had shifted in the right direction under Alemann after December 1981 but had been blown off course by "the hostilities in the South Atlantic." Therefore, as long as the war could be considered for this purpose as being outside the authorities' control, the request should be approved. Directors generally accepted this interpretation, and both the stand-by arrangement and the CFF drawing were approved without dissent.

For the next few months, the program was implemented with reasonable success. The BIS, led by the United States, granted a short-term stand-by credit in late January to serve as a bridge to the scheduled May drawing under the Fund arrangement, but the Argentine authorities—who wished to preserve control over their collateral—were able to avoid drawing on it. The Fund staff became nervous in March when Wehbe announced an intensification of price controls, fearing that this policy would deal with the symptoms rather than the root causes of inflation. Eduardo Wiesner (Director of the Western Hemisphere Department) then undertook a special mission in April to review the situation but concluded that fundamental progress was also being made. The scheduled May review mission, under Brachet, found that the program was on track, except for the assumption by the public sector of a substantial portion of private sector debts to foreign banks.[33] That practice required a modification of the performance criteria under the stand-by arrangement, which the Executive Board granted on a lapse-of-time basis in late May.[34]

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[32]Minutes of EBM/83/17 (January 24, 1983), p. 7.

[33]During parts of 1981 and 1982, the Central Bank of Argentina granted exchange rate guarantees on $9.2 billion in bank loans to the private sector. By the time these loans began to mature in late 1982, the peso had depreciated heavily and the central bank lacked the foreign exchange to cover the guarantees. Consequently, the government offered to exchange the private sector loans for its own dollar-denominated securities on terms to be negotiated with the foreign creditors. The associated restrictions on the purchase of foreign exchange to repay the private sector debts were subject to approval by the Fund as a condition for the continuation of the stand-by arrangement.

[34]Minutes of EBM/83/76 (May 27, 1983), pp. 30–31. See also "Argentina—Modification of Performance Criteria Under Stand-By Arrangement and Approval of Certain Exchange Measures," EBS/83/97 (May 18, 1983).

At the end of May 1983, Argentina made its scheduled drawing under the stand-by arrangement, for just under SDR 300 million. Two days later, the government introduced a new "peso argentino" worth 10,000 of the badly devalued old pesos. Reform and optimism were in the "good air" of Buenos Aires, and the chill winter wind could not yet be felt.

Brazil

The debt crisis came a little later to Brazil than to either Argentina or Mexico, but its effects would ultimately be no less severe. Brazil had borrowed substantial amounts from foreign commercial banks through much of the 1960s and 1970s to finance economic development and had generated one of the highest sustained growth rates in the world. Notwithstanding the adverse consequences of the two oil shocks of the 1970s (by 1981, oil accounted for more than half of all of Brazil's imports), the growth in output and exports came reasonably close to keeping up with the growth in external debt through most of that difficult decade. By 1980, foreign bankers had begun showing some reluctance to raise their exposure in Brazil, and official foreign exchange reserves had fallen by some $3 billion. That year, and again in 1981, the Fund staff raised questions during the annual Article IV consultation regarding the adequacy of the fiscal retrenchment in the face of a deteriorating global environment and steadily rising external debt (Figure 8.3).[35] Most ominously, inflation was becoming ingrained, averaging more than 90 percent a year for 1980–81, more than double the rate of the preceding two years. In view of Brazil's pervasive wage indexation, stabilizing prices would become progressively more difficult over time. Nonetheless, the economy was strong overall, and there was no reason to think the situation was unmanageable.

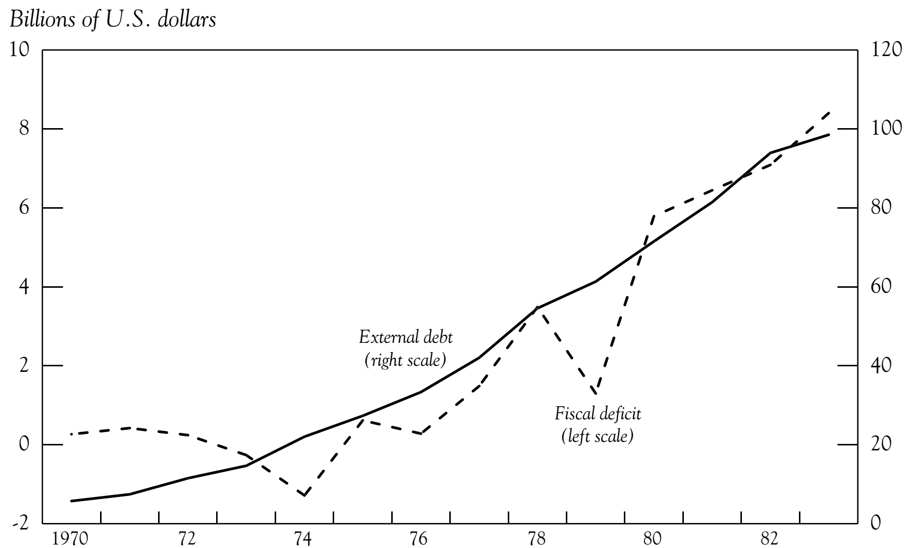
Through the first seven months of 1982, Brazil was able to borrow from the banks as much as was needed to maintain reserves (albeit at somewhat higher spreads), even though the level of output had stagnated while inflation continued to mount. Twice in that period, a small staff team led by Horst Struckmeyer (Chief of the Atlantic Division, Western Hemisphere Department) visited Brazil to hold a mini-consultation on what increasingly appeared to be a shaky financial situation. The conclusions were upbeat in February, reflecting the effects of the adjustment measures implemented in 1980–81; but in early July, as the second mission was preparing to leave for Brazil, a weakening of the adjustment effort in the face of persistent stagflation led the Deputy Managing Director, William B. Dale, to comment on the briefing paper that the outlook was "beginning to look ominous again."[36]

The Mexican crisis in August 1982 brought a sudden end to business as usual in Brazil—through the remainder of the decade and into the 1990s. Almost immedi-

[35]The relevant staff reports are "Brazil—Staff Report for the 1980 Article IV Consultation," SM/80/141 (June 17, 1980), based on consultation discussions in Brazil in March–April 1980; and "Brazil—Staff Report for the 1981 Article IV Consultation," SM/81/205 (October 28, 1981), based on discussions in August–September 1981.

[36]Note on the cover memorandum to the briefing paper (July 12, 1982), in IMF/CF (C/Brazil/810 "Mission—Struckmeyer and Staff, July 1982").

Figure 8.3. Brazil: Fiscal Deficit and External Debt, 1970–83



Sources: IMF, *IFS*; and World Bank, *World Development Indicators*.

ately, additional bank loans, without which the public sector debt could not be serviced, became impossible to get. Foreign exchange reserves totaled less than $6 billion and less than the debt-service payments that would come due by the end of the year. It must be said that the link with the crisis in Mexico does not imply that Mexico's problems caused those in Brazil. The fundamental causes were the Brazilian economy's dependence on a global economy that was no longer strong enough to generate the growth rate to which the country had become accustomed, and a serious domestic imbalance manifested in a persistently high inflation rate. The effect initially was "only" a financial crisis, but the authorities then allowed themselves to be lulled into believing that they could ride it out without implementing major policy adjustments.

For three months after the crisis erupted, policy in Brazil was frozen in place by the approach of the first nationwide congressional elections since the military had taken over in 1964. The bank creditors, however, had no patience for this political timetable. Some, including Lloyds Bank—the largest creditor outside the United States—were telling the authorities that they were prepared to consider additional credit, but only after a Fund-supported program was in place. Others, including Citibank—the largest creditor—were threatening to pull out altogether. To try to ward off a ruinous fight by banks to withdraw ahead of the competition, Anthony Solomon—president of the Federal Reserve Bank of New York—convened a small private meeting at his apartment on Park Avenue in Manhattan. The most heavily involved U.S. bankers were there, including Lewis Preston from Morgan Guaranty (along with his top Brazil hand, Tony Gebauer) and Walter Wriston from Citibank

(with Rhodes). Paul Volcker was there, Beryl Sprinkel represented the U.S. Treasury, and de Larosière represented the IMF. Wriston made it clear at the outset that he saw Brazil as a poor credit risk and that his intention was to gradually withdraw credits until Citibank was completely out. The Federal Reserve officials argued, however, that the situation was too delicate for precipitous action: if Citibank started reducing its credit lines, everyone else would follow suit, no one would get his money out, and the stability of the banking system would be threatened. Wriston was not convinced that the problem was too big for the banks to handle by themselves, but he eventually agreed to participate in an advisory group to try to stabilize financial flows to Brazil. For the moment at least, the systemic crisis was averted.

Elections were held in Brazil on November 15, 1982, after which the economic team—which retained power—moved quickly to formulate an adjustment program that could command the necessary support from the Fund and from their commercial bank creditors. Carlos Langoni, the president of the central bank, went immediately to New York to secure a bridge loan from the committee banks[37] and then to Washington to request financial assistance from the IMF. In his initial meeting with the Managing Director and the Fund staff, everyone agreed on the main obstacle to adjustment: Brazil had a pervasive system of wage indexation that could be modified only with the concurrence of the congress, and the likelihood of any significant reduction in the inflation rate or improvement in international cost competitiveness was extremely remote before the spring of 1983 at the earliest.[38] In the meantime, the government would have to get its fiscal deficit under control by some means other than cutting wages or devaluing the exchange rate.[39]

A mission headed by Struckmeyer was sent to Brazil at the end of November to conduct the Article IV consultation for 1982, negotiate the terms of an EFF arrangement, and collect data related to Brazil's request to make drawings under the CFF and buffer stock facility. In contrast to the protracted negotiations with Mexico and Argentina—both of which faced more difficult economic straits than those of Brazil—all of the basic elements of the program were agreed upon in the course of this one mission: reductions in subsidies and increases in taxes designed to reduce the public sector borrowing requirement from nearly 14 percent of GDP in 1982 to less than 8 percent in 1983; reduced growth in net domestic assets of the monetary authorities; increases in domestic interest rates; reductions in the indexation of wages; and a continuation of the frequent "mini-devaluations" of the cruzeiro so as to more than offset domestic inflation and thereby strengthen international competitiveness.[40]

[37]That effort is described in Lampert (1986), p. 161.

[38]The meeting was described in memorandums prepared by participants, in IMF/RD Managing Director file "Brazil 1983" (Accession 89/46, Box 2, Section 224).

[39]In the context of Brazil's persistent inflation, the cruzeiro was depreciated on a regular basis, in small steps known as "mini-devaluations." What was at issue was the prospect of a "maxi-devaluation," which at that time was judged by both the Fund and the Brazilian authorities to be unfeasible owing to the expectation that any resulting cost reductions would be offset by mandated wage increases.

[40]"Brazil—Staff Report for the 1982 Article IV Consultation, Request for Extended Arrangement, and Use of Fund Resources—First Credit Tranche," EBS/83/33 (2/11/83), Appendix IV.

While the authorities in Brasilia were negotiating with the IMF staff, officials from the central bank were negotiating with the commercial bank committee to arrange a short-term loan for $2.4 billion and a medium-term "new money" loan. By early December, most of the major bank creditors from North America, the United Kingdom, and France were on board, but a number of banks in other regions—notably Germany, Japan, and the Middle East—were reluctant to join in. The New York bankers who were assembling the package were eager for the IMF to make an appeal to their recalcitrant competitors, similar to the appeal that de Larosière had made in November on behalf of Argentina and Mexico (as described in Chapter 7 and earlier in this chapter). For the moment, however, the Managing Director was hesitant to do so, partly because the outcome of the negotiations in Brazil was still uncertain and partly because he did not wish to resort to concerted lending if a package could be completed on a voluntary basis.[41]

In addition to financing from the IMF and the commercial banks, Brazil was seeking help from bilateral official creditors. Secretly, in October and November, the U.S. Treasury had already advanced nearly $1¼ billion in short-term credits to Brazil from the Exchange Stabilization Fund. In mid-December they provided another $250 million.[42] The United States also took the lead in pushing for a $1.2 billion bridge loan through the BIS.[43] Nonetheless, until Brazil could conclude its negotiations with the Fund, the crisis atmosphere continued to worsen. When the finance ministers and central bank governors of the five largest industrial countries met on December 8 in Kronberg, Germany (see Chapter 4, p. 196), they found themselves forced to spend much of their time trying to contain the crisis in Brazil. Then on December 13, as the IMF mission in Brasilia was wrapping up its work, de Larosière cabled Günther Schleiminger, the Managing Director of the BIS, indicating that he would soon be recommending approval of Fund financial support for the Brazilian adjustment program and requesting that the BIS approve a short-term loan as a bridge to those credits. After intense negotiations at Basel among the participating central banks, the BIS loan was approved and disbursed before the end of the year.[44]

By December 20, 1982, Brazil had won tentative approval for a Fund-supported program and had obtained substantial support from other official creditors. What remained was the bank package. On that date, de Larosière, accompanied by Alexandre Kafka, the Executive Director who had represented Brazil on the Board since 1966, met with the Brazilian authorities over lunch in New York. The Brazilian team was led by Antonio Delfim Netto, the planning minister and the effective head of the economic team; Ernane Galvêas, the finance minister; and Lan-

[41]The dangers of relying on concerted lending are discussed in Chapter 7, pp. 313–14, and Chapter 9, pp. 406–8.

[42]The loans were kept secret until December 1, at which time they were announced with the fanfare of U.S. President Ronald W. Reagan's state visit to Brasilia.

[43] The BIS loan was augmented in January 1983 to $1.45 billion, with the participation of additional central banks. That was the figure reported in the BIS *Annual Report*.

[44]See de Larosière's cable dated December 13, 1982 in IMF/CF (C/Brazil/1710 "Exchange Transactions, 1967–1983"). The BIS loan is described in "Payments Difficulties Involving Debt to Commercial Banks," SM/83/47, p. 60.

goni. At 2:30 that afternoon, they all went to the Plaza Hotel to meet with 100 or more bankers from the 50 or so largest creditor banks. This would be the key meeting: the official credits were important, but they paled in comparison with the money that Brazil had to get from or reschedule with the commercial banks.

The Managing Director's role at the Plaza that afternoon was simply to explain the Brazilian program to the assembled bankers and to indicate that he was satisfied that the program was viable and was likely to be approved by the Executive Board within a matter of weeks. The requested bank financing was indispensable to the program, but de Larosière still did not insist, as he had the month before for Argentina and Mexico, that the banks make a firm written commitment as a precondition for his taking the arrangement to the Executive Board for approval. He would give it more time, to see if it could go through without being forced. If not, he still had the doomsday ultimatum in reserve.

For 1983, Brazil faced a total financing gap of $12.7 billion, of which the IMF would cover $2.5 billion (approximately $1.6 billion from the first year of the EFF arrangement, and most of the rest from the CFF for temporary export shortfalls). Another $2 billion would come from governments, suppliers, and other multilateral institutions; $1.5 billion from anticipated foreign direct investment; and $1 billion from miscellaneous sources. That left $5.7 billion, or nearly half the total, to come from the commercial banks. Part of that subtotal was already committed through the short-term loans arranged a few weeks earlier, but the big-ticket remainder was the request that Delfim and his colleagues now put to the banks for a "new money" syndicated loan of $4.4 billion: much bigger than the Argentine loan, and nearly as large as Mexico's.

The banks reacted to the request in a rather chaotic way. From a systemic perspective, Brazil was "too big to fail," and all of Brazil's major creditors now sensed that there was no exit from their existing commitments in the immediate future. Nonetheless, surely every banker in the room would have preferred to cut and run; not only were they seeing their credit lines to weak Latin American economies rising dangerously as a result of the two earlier cases, but also the three-month delay in carrying out policy changes in Brazil had made many of them skeptical of the authorities' ability to deliver an effective adjustment program. Furthermore, the proposed financial package was extraordinarily complex. The $4.4 billion, which became known as Project 1, was only the beginning: equally important was the need to reschedule and maintain the level of all outstanding credits. Project 2 was to reschedule the principal on a large number of medium- to long-term loans, Project 3 involved rolling over trade credits and other short-term obligations, and Project 4—which turned out to be the most difficult of all—required persuading hundreds of banks to maintain overnight interbank credit lines. It would take nearly a month (to January 17) before the banks could organize an Advisory Committee for the four projects, and several months more before they would have the reins firmly in hand.

On January 6, Galvêas and Langoni signed a Letter of Intent, formally requesting IMF support for the adjustment program that had been negotiated with Struckmeyer's team the month before. To the Brazilian authorities, the key commitment was to raise the trade surplus from less than $1 billion in 1982 to $6 billion in 1983,

a goal that they intended to achieve through a combination of spending cuts (mainly reductions in subsidies) and revenue measures (notably an acceleration of the schedule for collecting income taxes, and indexing payments to inflation). To the Fund staff and to de Larosière, of equal importance was a commitment to reduce the inflation rate from 100 percent at the end of 1982 to 70 percent in 1983 and to 40 percent in 1984.[45] Without stable prices, they reasoned, the trade surplus could not be sustained. Delfim and his team did not at all disagree with the conclusion that inflation ought to be reduced, but they saw that goal as secondary to stopping the hemorrhaging of their foreign exchange reserves, and they doubted that it was possible to solve both problems in 1983.

That year, Brazil already was experiencing what would later come to be called "inertial" inflation, driven less by excess demand pressures than by structural pressures marked by inconsistent demands on the distribution of income.[46] The choice, as the authorities saw it, was either to passively accommodate the existing inflation rate through monetary expansion or to aggravate the economic downturn through severe increases in interest rates. Since they did not believe that a squeeze on aggregate demand would succeed in reducing inflation in these circumstances, the choice seemed clear. To the IMF staff, the trade-off could be improved to the extent that wage indexation could be reduced. Real wages had to be cut in order to strengthen international competitiveness and to reduce inflation, and real wages could not be reduced until indexation was curtailed. The authorities were reluctant to act very decisively on indexation, partly because they sensed that the distributional battle would simply erupt on another front[47] and partly because they knew that congress would resist.

By late January, these divergent views on the structure of the inflation problem were leading the authorities to distance themselves from the program that they had just signed and that had not yet even been considered by the Executive Board. In telephone discussions with the staff, they proposed a weakening of the agreed changes in wage policy and a corresponding relaxation of the ceiling on domestic credit expansion. Informed that these proposals would permit real wages to rise further, de Larosière issued a warning via Kafka. But when Delfim and Galvêas insisted that they could not achieve the broader policy goals without accommodating these wage pressures, the Managing Director decided to retreat on the wage issue for the time being.

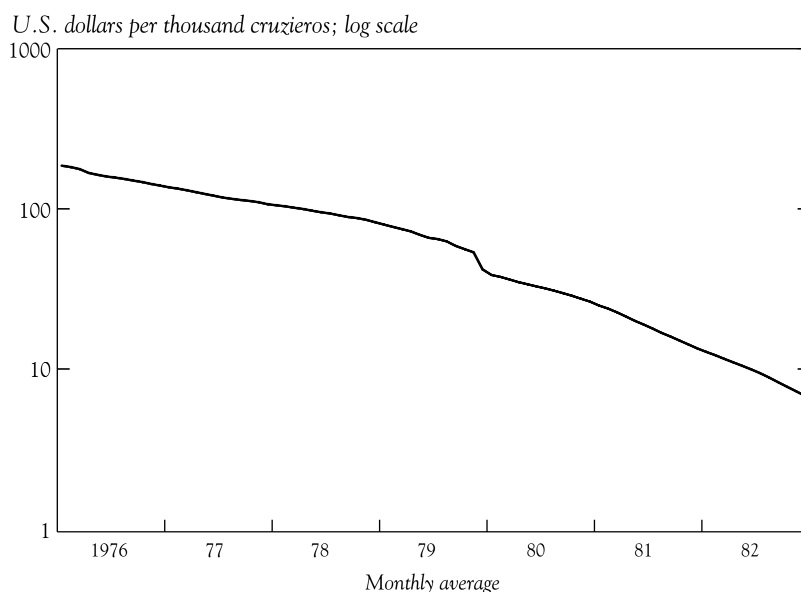
A few weeks later, on February 21, 1983, the Brazilians made a bold bid to strengthen their external finances but in the process threw the program totally off

[45]"Brazil—Staff Report for the 1982 Article IV Consultation, Request for Extended Arrangement, and Use of Fund Resources—First Credit Tranche," EBS/83/33 (2/11/83), pp. 8 (inflation) and 23 (trade surplus).

[46]The theory of inertial inflation is an offshoot of "structuralist" or "supply-driven" theories. For a treatment of the Brazilian case and the development of structuralist theories in Latin America, see Bresser Pereira and Nakano (1987). For an alternative view that stresses the role of fiscal excesses and downplays the importance of indexation, see Cardoso (1991).

[47]Bresser Pereira and Nakano (1991) later would articulate this concern, noting for example that indexation of bonds helped prevent or at least delay dollarization in Brazil, by offering a measure of protection to those who kept their assets in local currency (p. 43).

Figure 8.4. Brazil: Exchange Rate, 1976–82



course. Delfim and Galvêas had both concluded that the program was insufficient in that the exchange rate was too highly valued to promote a strengthening of the trade balance. Accordingly, without any warning to the IMF, they devalued the cruzeiro by 23 percent (Figure 8.4). Far more commonly, of course, it would have been the Fund pushing a reluctant government to take the politically risky but economically necessary course of devaluing to correct an overvalued exchange rate. In this case, however, the Fund's view was that depreciation should be limited to the initial rate of crawl to avoid an upsurge in inflationary pressures, and that the overvaluation should therefore be reduced by a more direct control over wage increases. Nonetheless, the Fund decided after the fact to support the decision, primarily because the authorities expressed a determination not to modify the wage indexation formulas. If inflation was higher than previously projected, the fixed formulas would not permit nominal wages to rise commensurately; hence real wages would decline and thus would act as an automatic stabilizer.[48] A revised Letter of Intent was quite hurriedly drafted and approved, and the program went forward to the Executive Board as planned.

[48]The predevaluation program envisaged that the average real wage rate would rise by 2 to 5 percent in 1983, but the real wage *bill* was expected to be reduced through a combination of staffing cuts and tighter control over promotions and productivity-related increases. The revised program envisaged that the real wage rate would decline by 2½ percent. See "Brazil—Staff Report for the 1982 Article IV Consultation, Request for Extended Arrangement, and Use of Fund Resources—First Credit Tranche," EBS/83/33 (February 11, 1983), pp. 11–13; statement by the Managing Director at EBM/83/40 (February 28, 1983), p. 18; and memorandum from the Secretary to Executive Directors, "Brazil—Extended Fund Facility" (February 25, 1983), in IMF/CF (C/Brazil/1791 "Extended Fund Facility, 1982–March 1983").

Meanwhile, the commercial bank creditors were busy assembling the financing for the four projects that the Brazilian authorities had requested at the Plaza Hotel just before Christmas. The new-money package (Project 1) was fully funded with relatively little difficulty, as were the rescheduling and trade-credit rollover commitments (Projects 2 and 3); Project 3 was actually oversubscribed by more than $1 billion by the end of February. Unfortunately, much of that effort was in vain because of the failure of Project 4. Many of the same banks who were making these other commitments were compensating by reducing their short-term credit lines. Of the $9.2 billion outstanding in overnight and other very short-term credits in June 1982, less than $6 billion remained at the beginning of February 1983.[49] The creditor banks argued that they had to retain flexibility and control over these lines, which were never intended to be a permanent source of funds, but that attitude created enormous problems all through the late months of 1982 and the first half of 1983. Problems for the Brazilian government, which had on-lent much of the money at longer maturities; problems for the adjustment program agreed with the Fund, which relied on a total financing figure from the banks; and problems for the banking system, because the Brazilian banks that were losing credit were often unable to cover their overnight commitments. Night after night, the solvency of the interbank clearing system (CHIPS) was in danger, but the committee bankers always managed, by working the phones ("dialing for dollars," in the mordant phrase of the day), to raise the money to cover each day's losses.

As the date of the Executive Board meeting (February 28) approached, the banks' portion of the financing for the program was still in doubt, and the Fund's management applied increasing pressure on reluctant banks to make the needed commitments. On February 8, Dale met with representatives of 50 creditor banks[50] in New York to stress the importance of their support. Two days later, on the evening following the Interim Committee meeting in Washington, de Larosière met in his office at the IMF with the Brazilian authorities and the governors from creditor (G-10) countries. He indicated that he was satisfied with the program and the authorities' commitment to implement it; but he was deeply concerned about the lack of firm financing commitments, and he needed their help. Finally, on February 25, four days after the devaluation and three days before the Board meeting, the Managing Director for the first time made an explicit threat to the banks, similar to his earlier action on Argentina and Mexico, that he would not recommend approval of the EFF arrangement for Brazil without a firm assurance that all four bank projects would be fully financed. The Fund's effort to distinguish the strategy for Brazil from the treatment of Mexico and Argentina had finally collapsed.

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[49]Statement by the Deputy Managing Director at EBM/83/40 (2/28/83), p. 18.

[50]An unusual aspect of the banks' management of Brazilian debt was that there were two committees functioning in 1983: the standard Advisory Committee, comprising 13 banks, and a coordinating committee of some 50 banks. This structure was necessitated by the sheer size and complexity of the banks' exposure in Brazil.

By Monday, when the Executive Board gathered to consider Brazil's request for nearly SDR 5 billion ($5.4 billion) in financing over three years,[51] the Managing Director was able to assert his confidence that the program was viable and would be fully financed. Questions raised by Executive Directors tended to be technical rather than sweeping, and no one objected to the approval of the arrangement. Dale, who had spent many hours in contact with the banks to complete the package, explained to the Board that because of the slippages in Project 4, there was a financing gap estimated at $1–1.5 billion. The banks, however, had indicated informally that if this amount could not be raised in the interbank market, they would consider augmenting the amount of the new-money project. This was not a very firm commitment, but it reflected the reality that the banks could not offer a guarantee on the availability of short-term credit lines if those lines were to function properly as a highly liquid asset.

Unfortunately, the Fund's confidence in the banks was misplaced. Money market lines were still being withdrawn, and by the week after the Board meeting, the central bank of Brazil was frantically and unsuccessfully trying to get additional bridging loans from the U.S. Treasury and the BIS to make up for the shortfalls in Project 4. In mid-April, a major new effort was launched to stop the bleeding of the money markets, starting with a meeting in London of bankers, the Brazilian authorities, and observers from the Bank of England and the Federal Reserve. The goal now was not just to hold the line on Project 4, but to raise an additional $1.5 billion in money-market credits (from the $7.5 billion then still outstanding). That effort culminated on May 9, when the Advisory Committee banks met in New York and agreed on a slightly higher total, $9.4 billion, which finally concluded Project 4.

Although the banks seemed to have come through at last, the Brazilian authorities had not. By May 1983, just three months into the program, both domestic credit growth and the fiscal deficit were well above the targeted ceilings, and it was clear that inflation would not be reined in without additional policy actions. The drawing that Brazil could otherwise have made at the end of May (SDR 374 million) would now be denied by the Fund.

What had gone wrong? Without question, the authorities had undertaken a serious and substantial adjustment effort, after the disastrous delay in the fall of 1982. The trade surplus in the first half of 1983 was above target, and—aside from the effect of inflation on the government's domestic interest payments—the fiscal accounts had also strengthened.[52] To some extent, the program targets may have been misconceived in the first place, owing to the very poor quality of the data and to the quite different conceptions of the problems and the underlying economic

[51]The EFF arrangement was for SDR 4,239.375 million over three years (1983–85). In addition, Brazil requested to draw its first credit tranche (SDR 249.375 million) and to make a purchase under the CFF for SDR 466.25 million, for total scheduled drawings of SDR 4,955 million. At the time, the SDR was worth approximately $1.09.

[52]The effect of inflation on the fiscal deficit in Brazil and the adjustments that were eventually made to the fiscal performance criteria are discussed in Chapter 9.

model held by the Fund staff and the authorities. To some extent, the implementation of the program was weakened by the authorities' conviction that inflation could not (indeed, should not) be sharply reduced in the short term. And to some extent, the management of the Fund overestimated the ability of the committee banks to deliver. Even with the strongest adjustment effort, the program very likely would have gone off track owing to delays in obtaining the promised financial support from the banks. Mistakes had come from all sides, and now a fresh start would be needed in the second half of the year.

Chile

The debt crisis that hit Chile in 1983 differed in important respects from those that hit Mexico, Brazil, and Argentina. Viewed from the perspective of the end of the 1990s, this case is especially illuminating because it introduced some facets that became more generally evident in the Asian crisis of 1997–98. First, it occurred despite what appeared to be sustainable fiscal and monetary policies. Second, macroeconomic strains were compounded by a weak banking system and overly cozy relationships between banks and nonfinancial corporations. To restore international confidence, the government had to find an affordable way to prevent the collapse of the domestic financial system. Third, the crisis became very difficult to contain because of a heavy reliance on borrowing in foreign currencies. Fourth, the onset of financial strains was preceded by a period of large capital inflows that the authorities attempted to manage through selective controls.

Ten years of free-market reforms and economic success did not spare Chile from the debt crisis, but it did speed its recovery. For the last five months of 1982, Chile negotiated almost nonstop with the IMF to arrange an adjustment program and financial assistance that could get the country out of a slump that was threatening to destroy much of its banking system. The debt burden, however, was too heavy to shuck off in that little time, and the system finally collapsed in January 1983. How did Chile, without the dirigiste regimes that had ossified the economies of Mexico, Argentina, and Brazil, and without even suffering the contagion effects that had prevented many developing countries from rolling over maturing bank loans, end up in the same dinghy on the same sea?

The reform of the Chilean economy into a model of the marketplace had begun nearly a decade earlier with the most illiberal of political events: the violent overthrow of the democratically elected government of Dr. Salvador Allende in a coup led by General Augusto Pinochet on September 11, 1973. In one demonstration of the orthogonality of political freedom and economic progress, Allende's government had severely weakened the economy. Increased government spending could not be financed, protection from imports had created production bottlenecks, overvaluation of the currency had depleted foreign exchange reserves, and the economy had been sucked into a stagflationary eddy. Then, in a second, no happier, demonstration, the dictatorship that supplanted Allende used its powers

to open the economy and to give market economics as free a rein as Latin America had ever seen.[53]

Well before Pinochet came to power, liberal free-market economics was taking root in Chile. The "Chicago boys" who took over the economy in the mid-1970s were not imported. They were Chileans who had learned their trade from notable Chicago-school economists, partly at the University of Chicago and partly at the Catholic University in Santiago. Across a broad part of the political spectrum, a consensus was developing that Chile could develop best by opening up the economy both internally and externally.[54]

After a brief transitional period in 1973–74 when reforms were handled by the military (under Pinochet's first minister of finance, Lorenzo Gotuzzo), the economic program was turned over to the civilian Chicago boys, beginning with Jorge Cauas, who continued and accelerated the reforms.[55] Cauas, and his successor, Sergio de Castro, implemented fiscal as well as structural reforms that kept the deficit low while generating real output growth that averaged nearly 7½ percent from 1975 to 1979. On the negative side, inflation—owing to the inertial effects from wage adjustments—remained high despite a sharp rise in unemployment, and skyrocketing imports widened the trade and current account deficits.[56]

During the initial reform phase, the IMF provided financial assistance through three different channels (Figure 8.5). A one-year stand-by arrangement was approved in January 1974, and the full SDR 79 million (50 percent of Chile's quota, or about $95 million) was drawn that year, along with a CFF purchase to cover temporary export shortfalls and a drawing on the oil facility to help with the effects of the first oil shock (approximately 25 percent of quota on each facility). A second stand-by arrangement in 1975 was largely unused, but Chile did make three further drawings on the oil facility in 1975–76 and one on the CFF in June 1976, for total net purchases over those 2½ years equivalent to SDR 382 million (242 percent of quota, or a little less than $450 million). From that point on, however, Chile had ready access to private capital markets and had no further need of official credits.[57] Virtually all of Chile's obligations to the Fund were repaid by the end of 1982.

[53]It must be emphasized that the point is not that political repression is either a necessary or a sufficient condition for economic reform in developing countries. The point is rather that political and economic liberalism are independent phenomena, both logically and empirically (see Chapter 1, footnote 4, p. 3).

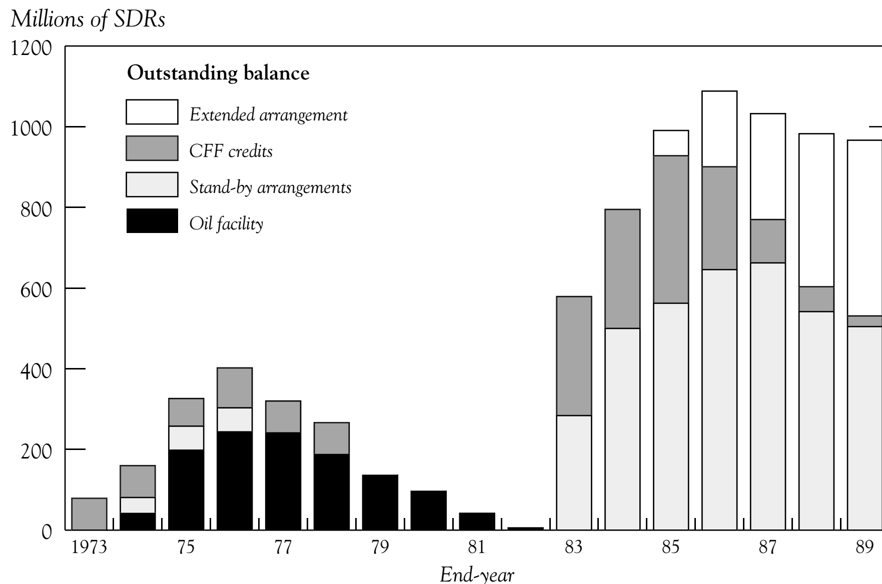
[54]For histories and analyses of the role of the Chicago school of economic thought in Chilean politics and policy, see Barber (1995), Silva (1991), and Valdés (1995).

[55]Cauas studied at Columbia University in New York, not Chicago, but he was widely considered to be part of the same intellectual tradition.

[56]Economic developments in Chile during the 1970s are summarized in Hoelscher (1981). Corbo and Solimano (1991) provide a longer-term overview, as do Edwards and Edwards (1991).

[57]In addition, by 1977, political support for the Pinochet regime had begun to wither in the major industrial countries. The shift was especially pronounced in the United States, where the administration of President Jimmy Carter was elevating human rights to a central criterion in foreign policy and where the assassination of Allende's former minister of defense, Orlando Letelier, on the streets of Washington, D.C., in September 1976 had galvanized the opposition to Pinochet. Without U.S. support, approval of multilateral credits would have been difficult at best.

Figure 8.5. IMF Credit to Chile, 1973–89

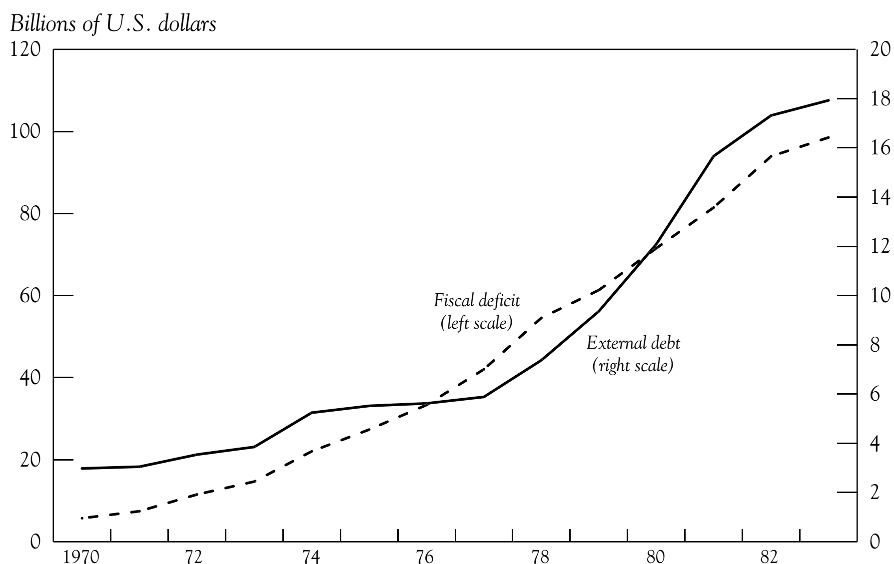


In 1978, Chile began to amass a large external debt to foreign commercial banks (Figure 8.6). Reflecting the privatization of state enterprises and a speculative boom fueled by the liberalization of domestic markets, most of this debt was owed by the private sector. In 1979–80, this borrowing was a natural byproduct of (and contributor to) economic growth, but in the next two years it was aggravated by a drop in world copper prices (Chile's principal export) and a severe recession in the domestic economy. From end-1978 to end-1981, the external debt of the private sector more than doubled, from $5.9 billion to $12.6 billion.

While these imbalances were still embryonic, the IMF monitored the situation primarily through routine annual surveillance consultations. As one such mission was preparing to go to Santiago around the middle of 1979, de Castro announced on June 29 that the crawling-peg exchange rate policy was being scrapped in favor of a firm peg against the U.S. dollar (Figure 8.7). The intent was to establish a nominal anchor for expectations and thus to put an end to the inertial force of inflation. Because the authorities had already made significant progress toward reducing inflation from the very high levels of a few years earlier (from 600 percent in 1973 to 30 percent in 1978), and because the shift was supported by a tightening of fiscal policy, both the staff and the Executive Board generally applauded the decision to tackle the problem head-on.[58] The strategy failed. Wage increases, by

[58]The staff report on the consultations described the decision to peg the exchange rate as a "bold step" aimed at bringing inflation into line with U.S. experience, "an expectation that does not seem unreasonable. . . ." See "Chile—Staff Report for the 1979 Article IV Consultation," SM/79/243 (September 18, 1979), p. 16. Specifically (as indicated in the mission's back-to-office

Figure 8.6. Chile: Fiscal Deficit and External Debt, 1970–83



Sources: IMF, *IFS*; and World Bank, *World Development Indicators*.

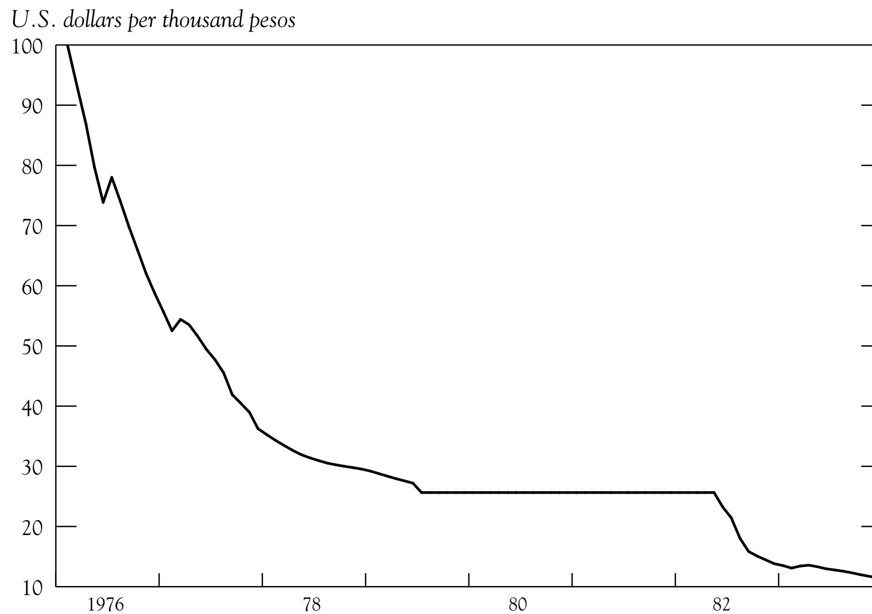
law, were required to equal or exceed past inflation, so both actual and expected inflation came down only very slowly. The effect therefore was a steady rise of domestic costs relative to those abroad, and a gradual and ultimately severe loss of international competitiveness.[59] For the next three years, the need to restore the viability of exchange rate policy would be one of the central issues facing Chile and the IMF.

As costs rose, the current account deficit widened further, but the authorities treated it with what they thought was benign neglect. Their view was a precursor of what would later come to be known as the "Lawson doctrine," that a current account deficit was not a problem for macroeconomic policy as long as it resulted

report to management), the expectation was that by late 1979, inflation in Chile would fall from a rate of about 30 percent a year to about half that rate. See memorandum from Beza to the Managing Director (August 28, 1979), in IMF/RD Managing Director file "Western Hemisphere" (Accession 87/27, Box 15, Section 535). At the time, U.S. inflation was not much below 15 percent. At the Executive Board meeting concluding the consultations on November 16, 1979, the Managing Director summed up the discussion as follows: "Directors drew attention to the marked reduction in the rate of inflation from the high level reached during the mid-seventies. . . . [F]iscal and monetary management appeared to be consistent with the achievement of the deceleration of inflation that was being sought, and it was noted that the new exchange rate policy seemed to be appropriately geared to this objective." Minutes of EBM/79/176 (November 16, 1979), p. 23.

[59]The inflation gap was further exacerbated by the success of the U.S. authorities in reducing that country's inflation rate, beginning in the fourth quarter of 1979.

Figure 8.7. Chile: Exchange Rate, 1976–83



from the actions of the private sector.[60] The Fund staff did not dispute the logic of this view, but they were less convinced than the authorities that government borrowing was under control. The Director of the Western Hemisphere Department, Walter Robichek, warned Chile of impending debt difficulties in a speech in Santiago in January 1980. What mattered, he argued, was not the current account deficit—which was still manageable at that time—but the level of public sector borrowing from private international creditors, in relation to various indicators. By that measure, he placed Chile in a group of potential problem countries in the region.[61]

An additional problem with applying the Lawson doctrine to Chile was that a growing portion of the financing of the deficit was not conducted at "arm's length," owing to the close ownership and management linkages between banks and enter-

[60]In a meeting with the Managing Director during the 1981 Annual Meetings, as recorded by the Fund staff, "the Chilean representatives replied that they were not [concerned about the current account deficit], because this deficit reflected exclusively the saving/investment gap of the private sector. This gap was by definition self-adjusting. . . ." See minutes of the meeting, in staff file, "Chile, August 1980 to March 1982, L.M. Koenig" in IMF/RD Western Hemisphere Department files (Accession 84/96, Box 5, Section 76). Nigel Lawson—Chancellor of the Exchequer in the United Kingdom, 1983–89—enunciated the doctrine in a speech at the Annual Meetings in 1988; see Chapter 1, p. 37.

[61]Speech by E. Walter Robichek, in IMF/RD Managing Director file, "'Some Reflections About External Public Debt Management,' Central Bank of Chile Seminar, January 21–22, 1980" (Accession 84/151, Box 3, Section 374). The other countries identified in the speech as possible problems were Bolivia, Brazil, Ecuador, Mexico, Panama, Peru, and Venezuela.

prises. In December 1979, the Fund responded to a request by the central bank for a technical assistance mission to review the functioning of the Chilean financial system. While praising the rapid transformation of the system into a dynamic private sector, the mission (headed by Vicente Galbis, Senior Economist in the Central Banking Service) also warned about the dangers of inadequate regulation over the interlocking directorates that had taken over both the banks and many nonfinancial enterprises. It would be necessary, the mission concluded, to correct the "emerging pattern of abuses" in order to limit the risk of bank failures and to protect depositors.[62] Other than these warnings, the sanguine view was generally endorsed by the Fund, and no other serious concerns were expressed about the deteriorating outlook until well into 1982.[63]

Toward the end of 1981, a severe recession set in, responding to weakness in copper prices, a reversal of the domestic investment boom under the pressure of high world interest rates and the overvalued exchange rate, and very high domestic real interest rates aimed at stemming the acceleration of capital flight. By the end of that year, growth had halted, the unemployment rate had risen to 13½ percent, and the current account deficit for the year had approached 15 percent of GDP. Notwithstanding the slowdown in both growth and inflation, interest rates had continued to rise and reached annual rates of 63 percent for loans. Commercial banks were badly overextended with loans that were increasingly difficult for the borrowers to service, and the central bank was being increasingly forced to provide emergency credits to prevent banks from failing.

In April 1982, Koenig and her staff team arrived in Santiago just as the economic strategy of the government was beginning to unravel. The first week of discussions was fairly routine, but on April 22 Pinochet announced a cabinet shuffle aimed in part at resuscitating the economy and restoring confidence in the peso. The Chicago boys would remain in charge, but with their most prominent member—Finance Minister de Castro—replaced by a close associate, Sergio de

[62]The lack of adequate regulation is discussed on p. 5 of the report, which was submitted to the authorities in draft form in May 1980 and in final form in October. The quoted phrase is from the debriefing memo to the Managing Director (December 28, 1979). Both documents are in the files of the Monetary and Exchange Affairs Department, IMF/RD Monetary and Exchange Affairs Department file "Chile: Financial Sector Survey" (Accession 83/62, Section FC59/FR).

[63]There was no full Article IV consultation in 1981, but a staff team headed by Linda M. Koenig (Assistant Director, Western Hemisphere Department) visited Santiago in March to review developments since the August 1980 mission and drew generally positive conclusions. In addition to reviewing exchange rate policy with the authorities, the staff visited several private companies that produced goods for export or in competition with imports. The managers of those firms reported that the hard-currency policy had resulted in some loss of profits, but they all viewed the policy positively and regarded it as both viable and necessary for inflation control. Memorandum of March 24, 1981, from Koenig to the Managing Director; in IMF/RD Western Hemisphere Department file, "Chile—January–December 1981" (Accession 84/70, Box 1, Section 74). Also see Hoelscher (1981), for a statement of the Fund's optimism at that time. Harberger (1985) explains the positive effects of the fixed exchange rate in this period as resulting from the stabilization of prices and the consequent rise in production. Edwards (1985) focuses more on the capital inflows that followed the exchange rate peg, and he documents the deterioration that set in around mid-1981.

la Cuadra. The intention of the new team was to keep the exchange rate fixed at 39 pesos per U.S. dollar, as it had been for nearly three years, and the IMF staff again responded favorably (though only after a difficult internal debate).[64] The new authorities recognized, however, that they had to quell the mounting speculation of an impending devaluation and to take action to protect the economy against the high and still-rising cost of international bank loans and the ongoing rapid loss of foreign exchange reserves. Toward the end of the mission, therefore, they approached Koenig to express interest in a CFF drawing related to the depressed level of world copper prices, and possibly a stand-by arrangement as well.

Less than a month later, the mission team returned to Chile to complete the Article IV discussions and to negotiate a program in support of the requested stand-by arrangement. The authorities proposed, and the staff agreed, to base the program on the assumption that the exchange rate would remain fixed at its current level. Pinochet had committed himself publicly to maintain the fixed exchange rate, and the cabinet was eager to make the promise good if at all possible. The cost imbalance that was causing the external disequilibrium would thus have to be eliminated through a cut in nominal wages.

On June 4, 1982, the mission concluded its work in Santiago, and by the following Thursday, June 10, the agreed Letter of Intent for the program was on the Managing Director's desk for his approval. Meanwhile, however, the cabinet in Chile was finding itself unable to agree on the proposed wage cut, without which—as they clearly understood—the exchange rate could not be maintained. By the weekend, they gave up: the wage cut was politically unfeasible, and devaluation was inevitable.

On Sunday evening, June 13, Minister of Economy Luis Francisco Danus announced that the peso would be immediately devalued to 46 pesos a dollar, and that it would then be depreciated at a fixed pace vis-à-vis a basket of the currencies of the G-5 countries. The next day, the government declared an end to the formal indexation of wages and announced a new round of privatization of state enterprises. At the same time, de la Cuadra telephoned the IMF to offer to come to Washington to renegotiate the stand-by arrangement on the basis of the new package of policies.

This sudden policy shift generated some additional intense debate within the IMF staff. With hindsight, the new regime was clearly more realistic than the old, but it was not clear that the exchange rate was now on a sustainable path. Despite some misgivings, the Washington meetings of the Chilean authorities (led by de la Cuadra and Miguel Kast, the president of the central bank) with the staff and with the Managing Director generated agreement on a new Letter of Intent by the beginning of July. A staff report was issued to Executive Directors on July 26, and a Board meeting was scheduled for August 23. This schedule, however, would

[64]See p. 5 of memorandum from Koenig to the Managing Director (May 5, 1982); in IMF/RD Western Hemisphere Department file "Chile, January 1982–December 1982" (Accession 85/19, Box 1, Section 393).

soon be run over by the continuing turbulence in financial markets and by the inability of the authorities to formulate a sustainable policy strategy.

The crawling peg of the Chilean peso collapsed on August 5, 1982, just 52 days after its initiation and just 8 days before Mexico's revelation that it could no longer service its foreign debts. Faced with plummeting foreign exchange reserves, unemployment rising to 20 percent, and a run on domestic bank deposits, the authorities were forced to allow the exchange rate to float. At the Fund, it was obvious that the Board meeting could not go forward on August 23 as planned, and a new mission—headed by Jan van Houten (Chief of the Pacific Division of the Western Hemisphere Department)—was sent immediately to Santiago to assess the situation.

The continuation of currency depreciation, which coincided with a crumbling of demand for domestic output, put unbearable pressure on the already weak Chilean banking system. Domestic firms had undertaken loan commitments denominated in U.S. dollars when the exchange rate was pegged at 39 pesos to the dollar. By August, they were paying well over 50 pesos per dollar to service those debts, and by September the cost would rise above 60. Many firms were unable to service their debts to domestic banks, which in turn could service their debts to foreign banks only by borrowing still more dollars. The government provided some help by agreeing in August to establish a preferential exchange rate to subsidize the servicing of existing obligations, but the authorities—and the IMF staff—were concerned that further subsidies would seriously weaken fiscal stability and could create expectations of a massive bailout. In the wake of the Mexican crisis, how much longer would the banks be willing to lend to Chile, knowing that the dollars were needed just to service the already outstanding loans?

The August mission resulted in agreement that the economic program to support the requested stand-by arrangement would have to be renegotiated for a second time, and the authorities requested that a mission be scheduled for that purpose after the Annual Meetings in Toronto. But Chile's turbulence was only just beginning. On August 27, Pinochet once again replaced his cabinet; de la Cuadra's five-month tenure as finance minister was ended, and he was replaced a few days later by Rolf Lüders (also Chicago-trained). Lüders immediately headed for Toronto, where he met with de Larosière during the Annual Meetings, explained his intentions for stabilizing and reviving the economy, and won agreement for a late-September negotiating mission.

Van Houten and his team arrived in Santiago on September 27, 1982, to resume negotiations, where they found the authorities to be struggling to regain control over the exchange rate following a depreciation of some 30 percent since the rate had been allowed to float the month before.[65] On September 29, Lüders intro-

[65]For a detailed account of exchange rate developments during this period, see Meller (1992), pp. 41–45. Meller infers from data on changes in foreign exchange reserves that the float was less clean than was claimed by the authorities, especially in September. He cites rather larger percentage values for the depreciation of the peso, because he calculates the changes in local currency terms rather than in terms of dollars.

duced yet another deeply flawed policy regime, this time in the form of a real-exchange-rate rule. That is, the exchange rate would henceforth be controlled to depreciate daily according to the difference between the domestic CPI inflation rate and an assumed rate for foreign inflation, so as to keep the real exchange rate roughly constant.[66] The preferential exchange rate was to be continued for a few months, but—with the urging of the IMF staff, who observed that this constituted a multiple currency practice subject to Fund jurisdiction—the authorities agreed to terminate it by the end of the year.

When the mission finished its work on October 11, the authorities and the staff had agreed on a revised Letter of Intent. The Managing Director approved the program the following week, and a meeting of the Executive Board was scheduled for December 17. This schedule, like its predecessors, would again turn out to be overly ambitious. This time the fatal flaw was the government's decision to continue subsidizing the servicing of foreign debts, although a decision to terminate the subsidy might well have made debt servicing impossibly expensive for many companies and thus precipitated an even worse crisis.

Remarkably, notwithstanding the refusal of international banks to roll over credits to Mexico, Argentina, or Brazil, Chile was able (albeit not without difficulty) to persuade most banks to maintain lines of credit throughout the second half of 1982. Maintaining these lines, however, was not enough to enable firms to stay current without a subsidy.[67] Meanwhile, the only way the government could balance its books while subsidizing the preferential exchange rate was to expand domestic credit through the central bank. By the end of November, it was clear that the programmed ceiling on domestic credit expansion could not be met, and the staff informed the Managing Director that the program would be off track even before it was approved. De Larosière had no choice but to postpone the Board meeting to January 10, 1983, to give the authorities in Santiago time to get monetary growth back under control.[68]

During December 1982, the authorities made some progress in calming the markets and limiting their reserve losses. In mid-December, Carlos Cáceres, the president of the central bank, went to Washington to explain to de Larosière and the staff the measures they were taking to reduce credit expansion, and to get agreement on the degree of progress that would be needed for the Managing Director to recommend approval of the program to the Executive Board. On the basis of these assurances, the Executive Board met on Monday, January 10, 1983, and

[66]For a general discussion of the Fund's advocacy and critique of such rules, see Chapter 13, p. 573.

[67]Despite the prevailing free-market philosophy, the government supported the private sector in numerous ways, including serving as agent in debt negotiations with foreign creditors. See Ffrench-Davis (1991) for a discussion.

[68]The three-week delay would avoid the necessity of permitting the first drawing under the stand-by arrangement to take place in December, when the credit ceiling would not be met. If the program were approved in January, the end-year excess would not constitute a violation of the agreement, and—as long as the path of credit growth was on target by January—the authorities would have three months (until end-March) to regain control of the level.

approved a 24-month stand-by arrangement in the amount of SDR 500 million (154 percent of Chile's quota; $550 million) and a CFF drawing for SDR 295 million (91 percent of quota, or $325 million). The CFF drawing plus SDR 122 million under the stand-by arrangement would be available immediately, and the rest would be phased in the usual manner, subject to Chile's observance of the program criteria.[69]

Three days after the Board meeting, the debt crisis came to Chile. The authorities had been keeping the banking system barely afloat, hoping that the IMF's approval of the program would quickly restore confidence enough to stem capital flight and attract additional bank loans from abroad. With an earlier start on policy reform, the strategy might have worked, but the cumulative effect of eight months of ineffective backfilling could not be made up overnight. On January 13, Cáceres informed van Houten by telephone that they were declaring a bank holiday on the 14th, liquidating three major banks, and intervening in the operations of five others. The program was dead, and economic and financial recovery would require a major overhaul in government policies.[70]

One priority for the authorities after January 13 was to open a dialogue with the commercial bank creditors. Neither the private nor the public sector had the resources to service, much less to repay, the bank loans that were coming due. The government nonetheless undertook to guarantee the liabilities of the problem banks and to remain current on all public sector interest payments. Initially, the authorities announced that the government-owned Banco del Estado would assume the debts of the five banks in which they had intervened (up to a specified limit), but not those of the other three that they had closed. That policy contributed to a panic among foreign creditors, and in late January the guarantee was extended to the liabilities of the closed banks as well.

The foreign bank creditors recognized the difficulty, but they also realized that they had badly overestimated Chile's capacity to implement sound economic policies. Most of their loans were to the private sector, and they had been implicitly assuming that the authorities either would keep economic performance strong enough to enable the private banks to meet the payments or would bail out the problem debtors (as they had to some extent, through the preferential exchange rate). Analysis of "country risk" had not been a priority for the international banks. It was now, but the realization had come too late for a smooth recovery. The banks had no choice but to reschedule, and at the end of January they agreed to roll over the principal on their loans for 90 days while negotiating a more permanent settlement.

The other priority, which also foreshadowed crisis management of the following decade, was to obtain the assistance of the IMF and the World Bank in stanching the outflow of capital. Since most of the debts to foreign bank creditors were owed by private firms, many of which were in serious financial difficulties, the govern-

[69]Minutes of EBM/83/8 (January 10, 1983).

[70]For a detailed analysis of the crisis, see Larrain (1989). For an overview of the role of banks in the crisis, see Rojas-Suárez and Weisbrod (1995), Chapter III (and see references therein for further details).

ment gave some thought in January to guaranteeing all such debts. The Fund strongly discouraged them from that approach, and they quickly abandoned it. Instead, the Fund offered to help determine which firms were able to pay and which were not, so as to ensure that defaults could be contained and not generalized; and to renegotiate the program so as to ensure that the adjustment effort was sufficient to restore viability to the economy.

Van Houten took another staff mission to Santiago in late January and confirmed that the whole program would have to be renegotiated in light of the banking crisis. Meeting the end-March criteria for the next drawing under the stand-by arrangement was completely unrealistic (the ceiling on domestic credit expansion was already exceeded), and there was no real possibility of getting back on track without a much greater effort to strengthen the government's fiscal position. On January 27, Lüders and Cáceres met in Washington with de Larosière, who conveyed that message to them, along with his desire to help them reshape economic policy. From there, the officials went to New York for an initial meeting with the newly formed Advisory Committee of the commercial banks (chaired by Manufacturers' Hanover Trust).

Progress at this stage was agonizingly slow, because Chile was caught in a sequencing dilemma: without new money from the banks, the external financing gap could not be closed, and therefore there could be no Fund-supported adjustment program; but without a program, the banks were unwilling to commit themselves to an agreement. The Fund could have tried to impose a concerted-lending solution similar to those already in place for Mexico and Argentina, but—as with Brazil at the same time—both the Managing Director and the authorities preferred to try first for a market-based solution. In this instance, the strategy met with greater success.

Pinochet once again lost patience with his economic team, and on February 14 he replaced Lüders with Cáceres as finance minister. By the end of February, Cáceres had met with the IMF staff in Santiago and with the banks' Advisory Committee in New York. In March, van Houten led a new negotiating mission to Chile, though with a new mandate. Rather than attempting to resuscitate the stand-by arrangement immediately, the Fund staff were to negotiate a "shadow program" that would enable the government to convince the banks that their policies deserved financial support.

The mission completed its work on March 20, and on the 22nd Cáceres announced an emergency economic program. The key measures included an accelerated depreciation rate for the currency (while retaining the basic elements of the real-exchange-rate rule),[71] a rescheduling of the bank debts of private enterprises, a tightening of foreign exchange controls, and several fiscal measures including a

[71]Previously, the daily rate of depreciation had been based on the inflation rate of the CPI for the previous month, less 1 percent a month. That adjustment, which was intended to approximate the rate of foreign (i.e., U.S.) inflation, was eliminated as of March 23. U.S. inflation had averaged 11.7 percent a year for 1979–81 but had dropped to 6.2 percent in 1982 and would fall further to 3.2 percent in 1983. The policy shift (raising the depreciation rate by 1 percent a month) thus was from overcorrecting to undercorrecting for U.S. inflation.

temporary surcharge on import tariffs. The goal of this package was to revive economic growth and the financial system and to get the economy in line with the original targets of the adjustment program by end-September: an ambitious goal, but no more than was needed to restore confidence. From March to September, reserves would be lower and net domestic assets would be higher than programmed, reflecting the lower level of available financing.

Shortly after the emergency program was announced, the authorities reached agreement in principle with the banks' Advisory Committee on a package for the remainder of 1983. That package was to include $1.3 billion in "new money" as well as a rescheduling of principal payments on medium- and long-term official debts. Private sector debts to foreign banks, however, were omitted from the agreement: they could be renegotiated individually, but no official guarantee was to be given. The banks also asked the Fund to grant a waiver so that the stand-by arrangement could be reactivated before end-September if Chile established a track record by sticking with the shadow program through June. The Fund staff expressed reservations about weakening the requirements for its loans, and the Managing Director agreed only to propose a waiver *after* the banks had completed their own agreement and had made their initial disbursement. In addition, over the next month, de Larosière, with the assistance of U.S. officials, quietly arranged for a bridge loan through the BIS to prevent Chile's reserve levels from falling to an uncomfortably low level during this initial adjustment phase. He and the staff also met frequently with the principal bankers on the Advisory Committee to help explain the details of the shadow program and the necessity for the level of financing that was being asked. Some of the banks were balking at signing an agreement without a guarantee on corporate sector debts, but the Managing Director insisted to the banks that the authorities were right in refusing to bail out weak borrowers.

In July 1983, van Houten went once more to Santiago to review developments and found that Chile had met the fiscal and monetary targets set under the shadow program. Two days after he returned to Washington with this favorable report (the substance of which the Managing Director conveyed to the bank creditors), the banks agreed to sign the proposed loan agreement. Finally, on July 27, the Executive Board met to approve the waivers and to release both the delayed April drawing and the originally scheduled August drawing;[72] on July 28, the bank creditors formally signed their agreement. In just over six months, Chile had climbed from the depths of one of its greatest financial crises to the verge of financial stability. The next two years would show how precarious the footing was on that ledge, but Chile's initial debt crisis had been resolved.

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