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Case by Case: A Retrospective on the Debt Strategy

As the preceding chapters have shown, the IMF played a major role in managing the strategy for overcoming the debt crisis that engulfed Latin America in the 1980s, and in fostering a remarkable transformation in economies throughout the region. Although the value of the Fund's role was widely acknowledged, a number of criticisms became part of the conventional wisdom about the debt crisis. Some of these criticisms reflect a perception that the Fund tended to act on behalf of the interests of creditors and industrial countries more than those of the indebted developing countries; others, that the Fund was acting outside the traditional framework established at Bretton Woods; and some, that the technical analysis was limited or weak.[1] This chapter reviews the main criticisms.

Was the Debt Crisis One of Solvency and Not Liquidity?

When the crisis hit in 1982, the IMF and creditor governments sought to contain it through a "case-by-case" strategy aimed at providing enough additional financing to cover the time required for the indebted countries to implement adjustment programs and generate enough growth to restore normal financial relations. The additional financing, however, was mostly in the form of debt obligations: obligations which, as Cline (1983) was early to note, would be appropriate only if the debtor faced a liquidity rather than a solvency crisis. As Eichengreen and Kenen (1994) later summarized the implications, "In imprecise but helpful terms, an insolvent debtor must pursue a debt-reducing strategy, but an illiquid debtor should pursue a debt-raising strategy so as to make its interest payments and defend its creditworthiness."

The primary difficulty with this argument, as Eichengreen and Kenen acknowledged, is the ambiguity of the distinction between a liquidity shortage and insol-

[1]Left aside here is criticism concerning specific elements of program design in individual countries, or concerning any failure to foresee or forestall the initial onset of the crisis. Those issues are clearly important, and they are examined in earlier chapters. The emphasis in this overview chapter, which is based in part on Boughton (1994), is on systemic issues relating to the role that the IMF played in crisis management during this period.

vency.[2] If a country has enough real resources to generate the foreign exchange to service its debts but faces a temporary inability to convert resources into foreign exchange, then it faces a liquidity crisis; without sufficient real resources, it faces a solvency crisis. In that strict sense, none of the heavily indebted Latin American countries ever faced a solvency crisis in the 1980s.[3] Mexico—to take the most readily quantifiable example—had petroleum and natural gas reserves totaling some 72 billion barrels, valued at more than $2,000 billion in 1982, compared with outstanding external public sector debts totaling just over $60 billion. Merchandise exports (mostly by the public sector) totaled $21 billion, compared with scheduled debt-service payments (amortization plus interest) on external public sector debts of $16 billion.[4] Brazil's situation was more precarious: export receipts in 1982 amounted to $18 billion, compared with scheduled debt-service payments of more than $15 billion, and by end-year net international reserves were negative. Even in that case, however, the problem was not a shortage of real resources. It was rather that the degree of required adjustment in domestic expenditure or tax policy for the authorities to mobilize those resources was simply not feasible within the available time horizon.

Even if this criticism has been inaccurately formulated, its underlying premise is still valid. A more accurate—and more relevant—phrasing would be to charge that insufficient attention was paid to the political feasibility of the required

[2]A number of analysts avoided this pothole by jumping into even deeper ones. For example, Edwards (1989) contrasted what he regarded as the view of the Fund staff in 1983, that the crisis was "a temporary liquidity problem," with his own conclusion that it "has become a development problem" (p. 38). Meller (1994) contrasted a "temporary lack of liquidity" with "a critical problem of stock imbalance" (p. 4). A 1987 Fund staff paper distinguished between "liquidity problem countries" and "debt overhang cases"; "World Economic Outlook—Recent Economic Developments and Short-Term Prospects," SM/87/54 (February 25, 1987), p. 92. While such taxonomies are helpful for some purposes, they are not clear analytical distinctions. A liquidity shortage, far from being inconsistent with deeper and more fundamental problems, is often an indicator that such problems may be developing.

[3]A less strict approach to distinguishing between liquidity and solvency is to examine whether the country has actually mobilized the resources to service its debts, either through a general adjustment program to generate a sufficiently large trade surplus or through fiscal contraction sufficient to generate the required revenues directly. By a measure focusing on the trade surplus, Cohen (1985) concludes that most Latin American countries undertook sufficient adjustment to remain solvent in the first year or two of the debt crisis; the exception was Argentina, but only because capital flight had wiped out the benefit of the trade surplus. In a later and more detailed analysis, Cohen concluded that Brazil, Mexico, and Venezuela undertook sufficient adjustment in the early 1980s to be considered solvent by this criterion, while most other countries in his sample did not. See Cohen (1991), Chapter 6. More arbitrarily, one could attempt to assess whether the required adjustment would be feasible or practicable to undertake. For example, in March 1984, Alvaro Donoso—the Executive Director for Chile at the Fund—argued that "almost all" of the heavily indebted developing countries were solvent, in that they could stabilize or reduce their external debt in relation to GDP by generating moderate trade surpluses and thereby accepting moderate losses in domestic investment and output growth; minutes of EBM/84/49 (March 30, 1984), p. 14.

[4]Figures are contemporaneous IMF staff estimates derived from government data. Estimates for private sector debts are less reliable. Adding them in would raise both debt and debt service by about one-third.

adjustment or to the real economic costs of the increased indebtedness engendered by the additional financing that characterized the first few years of the debt crisis (see, for example, Dornbusch, 1993, pp. 53–55). To continue with the example of Mexico, imports in dollar terms fell by two-thirds from 1981 to 1983 and remained depressed through 1987, and real wages declined by a similar magnitude; meanwhile, the stock of external debt *rose* by more than a third. The magnitude of these changes and the effects that they had on Mexico's economic stability were far greater than anyone foresaw in 1982.

To some extent, lack of foresight on how much adjustment was required resulted from optimism in assessing the growth prospects of Latin American countries after the debt crisis. Throughout the region, the adjustment programs developed in 1982 and 1983 were predicated on forecasts of a rapid resumption of economic growth that would gradually bring down-debt service *ratios* to sustainable levels. In Mexico, the late-1982 staff projection for real GDP showed zero growth in 1983, 3 percent growth in 1984, and 6 percent in 1985. For Brazil, the program initially assumed a 3½ percent decline in real GDP in 1983, to be followed by growth of 2 percent in 1984 and 4 percent in 1985. Not surprisingly, output growth proved to be difficult to forecast in the prevailing crisis conditions. Perhaps more surprisingly, however, the forecasts *on average* were only modestly optimistic. At one extreme, in Mexico, three-year growth totaled 2 percent, compared with the initial projection of 9 percent. But in Brazil, growth totaled 10 percent through 1985, compared with a forecast 2 percent. For the whole region, the one-year-ahead forecasts published in the IMF's *World Economic Outlook* added up to just over 6 percent growth, and the outturn was closer to 4 percent.[5] Excluding Brazil, of course, the gap would have been wider.

The explanation for the slowness of growth to resume in some but not all heavily indebted countries after 1982 is complex and cannot be encapsulated in the liquidity-solvency dichotomy. First, a drop in real wages was essential to restore financial balance, but wage cuts also depressed aggregate demand. Hence, a few countries that resisted adjustment were able to maintain short-run growth better than those that took early action—but that growth was unsustainable without the needed adjustment.[6] Second, both the Fund staff and officials in indebted coun-

[5]The three-year forecasts described above were made only for countries requesting the use of IMF resources through the Extended Fund Facility. For other countries, forecasts were normally made only for 12 to 18 months ahead (or for the period of a requested stand-by arrangement). For Argentina, for example, in December 1982 the staff projected 4 percent growth for 1983. The outturn for that year was 3¾ percent, and growth faltered only after the end of the program period. For Chile's two-year stand-by arrangement, the staff projected 4 and 5 percent growth for 1983 and 1984, respectively. The outturn was ¾ of 1 percent for 1983, followed by almost 6½ percent growth the following year.

[6]Brazilian output essentially stopped growing after 1986, while growth resumed in Mexico. For 1983–86, the average annual growth rates for the two countries were 4½ percent and –½ of 1 percent, respectively. For 1987–92, growth averaged ¼ percent a year in Brazil and 3 percent in Mexico. (Subsequently, Mexico developed a new crisis, and Brazil implemented new reforms.) Also see Chapter 10, especially Figure 10.1.

tries were slow to recognize the breadth of structural reform that was necessary if macroeconomic stabilization was to be implemented without stunting growth. Not until the mid-1980s did market liberalization and reform become a full partner with stabilization. Third, and largely for these reasons, political resistance to effective adjustment was strong and prevented some countries from fully implementing the programs to which they had agreed. These factors were in principle foreseeable. If they were not fully incorporated in the projections, bias would result.[7]

In addition, however, important unforeseeable factors were at work. For one, protectionism, especially through nontariff barriers, reduced the markets for developing country exports and affected different markets in quite different ways.[8] Even more important, export market conditions varied across commodities: oil prices (important for Mexico) drifted downward throughout the first half of the 1980s and collapsed in 1985–86; coffee prices (important for Brazil) were reasonably strong in the early 1980s, skyrocketed in 1986 in response to a disastrous harvest, and then collapsed; copper prices (important for Chile) weakened at the beginning of the decade and rose sharply toward the end. On balance, commodity price declines weakened growth in Latin America during the critical adjustment period in the early 1980s. Correcting for that effect would explain part—but only part—of the bias.[9]

Did the IMF Serve the Interests of Banks and Not Its Member Countries?

Sachs (1989, p. 84) stated this argument clearly: "The basic strategy of the IMF and the creditor governments since 1982 . . . has been to ensure that the commercial banks receive their interest payments on time."[10] Dooley (1995, p. 10) concluded "that for a long time the strategy that was intended to force the banks to continue to lend while the debtor countries embarked on reform programs worked in the narrow interests of the banks." Lissakers (1991, pp. 201 and 206) characterized the IMF of the early 1980s as an "enforcer" for creditors that "let the banks exact harsh terms from already desperate borrowers on the grounds that this was the only way to keep smaller banks in the game."

The basis for this criticism is that the net effect of indebted countries reaching agreements with the Fund and the banks in the 1980s was to transfer resources from debtors to creditors. That is, the combination of the temporary reduction in debt-service payments under rescheduling agreements and the provision of "new

[7]IMF forecasts assume that programs that have been agreed upon will be implemented. The question is whether the projections made in the course of negotiating the program were realistic.

[8]See World Bank (1987), pp. 133–53.

[9]For an assessment of the effects of commodity price changes on output growth, see World Bank (1994), Chapter 2.

[10]Also see Sachs (1986) for elaboration.

money" through IMF-supported concerted lending was generally less than the originally scheduled debt service. Hence indebted countries still had to make net payments to banks and thus in a direct financial sense were worse off than if they had just defaulted.[11]

The underlying premise is that in the absence of concerted lending, the indebted countries would have had to default, after which the discounted value of the banks' assets would have been substantially lower. Moreover, because the exposure of a number of the major money-center banks to heavily indebted countries exceeded their capital, a series of defaults—but not a series of negotiated reschedulings—could have led to a collapse of the international banking system. Clearly the IMF played a key role in preventing that catastrophe. The right question, however, is not whether the Fund helped the banks. The question is whether it did so at the expense of, rather than to the mutual benefit of, the indebted countries.

The case for mutuality of interests rests directly on two arguments: that default would result in a loss of access to international capital markets, and that the value to indebted countries of maintaining access exceeds the real economic and political cost of the adjustment that is required if the country is to be able to service its debts. Both the requirements for and the value of capital market access have been extensively debated, without a clear resolution.[12] The Fund position, however, was based on the logically prior proposition that the required adjustment would be beneficial for its own sake, regardless of its ability to crowd in private foreign capital.

To understand the IMF position on this issue requires a perspective broader than that of a game-theoretic model of financial relations. From a macroeconomic perspective, maintaining debt service is one element of a strategy to prevent a slide into autarky. The heavily indebted countries in the early 1980s could not service their debts in the short term without obtaining external support, and they could not service them in the longer run without undertaking fundamental policy reforms. Even if these countries could have defaulted without rupturing future relations with creditors, the prevailing view in the Fund was that they would have been worse off in that case than if they had undertaken the required policy adjustment and stayed current on interest payments to creditors. The case for this proposition rests essentially on the value of the adjustment program, rather than on the expected penalties from default.

Alternatively, taking a financial perspective, it is instructive to focus on the size of the country's financing gap and the means of filling it in. Given external and domestic economic conditions, the magnitude of the adjustment in policies determines the size of the external deficit to be financed. Ex post, that deficit must be

[11]Some critics of the Fund have drawn the opposite conclusion, namely, that concerted lending worked against the banks' interests. Roland Vaubel, for example, has argued that Fund lending generally benefits bank creditors by improving debtors' creditworthiness. Through concerted lending, however, "the IMF extracts from the banks part of the gain that its lending confers to them" (Vaubel, 1991, pp. 217–18).

[12]Calvo (1989) develops a "theory of penalties" to explain the ambiguities. For a sympathetic view of default from a former World Bank vice president, see Knox (1990).

equal to the sum of multilateral, bilateral official, and private credits. The standard procedure for the IMF in dealing with most heavily indebted countries from late 1982 through early 1989 was to negotiate as much adjustment as was feasible, factor in as much official financing as was available, and insist that the lending exposure of the existing bank creditors increase by enough to fill in the remaining gap. This procedure was effective as long as the residual was substantially less than the scheduled interest payments due to banks during the period in question, and as long as the banks' initial exposure was large in relation to their capital base. Only if both conditions were met, as they were during the first three or four years after the crisis began in 1982, did the banks have a collective interest in playing the game and in not trying to use their leverage to exact highly favorable terms from desperate borrowers. Given the short-term constraints imposed by the feasibility of adjustment, the availability of official financing, and market conditions, the alternative strategy in those years would have been to fill the gap through the accumulation of arrears. As discussed in Chapter 11, the IMF rejected that strategy until late in the decade on the grounds that it would have endangered the international financial system and rendered the persistence of effective adjustment impossible.

Although economic theory does not suggest that default is necessarily an inferior option to negotiated settlements, the record on policy reform in Latin America suggests that it usually is. Countries that adopt unilateral policies on debt service seem likely to experience economic deterioration quickly, and countries that delay macroeconomic adjustment seem likely to become worse off after a spurt of short-term benefits. The first category would include Peru under Alan García and Brazil under José Sarney. The second category would include (for much of the 1980s) Argentina as well as Brazil. In contrast, successful postcrisis adjusters such as Chile, Mexico, and Bolivia at least laid the basis for more balanced growth over the longer run. The eventual realization of that growth will provide the surest test of the case-by-case strategy.

Did the IMF Recognize the Need for Debt Relief?

When the Brady Plan was introduced in March 1989, the IMF reacted quickly to support it and to play a key role in implementing it. For several years preceding that development, however, a variety of debt-relief proposals were floated by advocates including Bill Bradley, Henry Kaufman, Peter Kenen, James Robinson, and Felix Rohatyn; and the emergence of official support was reflected during 1988 in proposals such as the Mitterrand and Miyazawa plans. During that period, the IMF kept a low profile on the issue, and a general perception arose that the institution was opposed, or at best indifferent. As I.G. Patel later put it, "the Fund . . . was certainly too late in actively advocating debt relief—as indeed was the [World] Bank" (Patel, 1994, p. 12).

The official public stance of the Fund reflected its role as an intergovernmental institution: it could not get too far ahead of political leaders in the main creditor countries without generating a backlash. Nonetheless, as detailed in Chapter 11,

Camdessus and other senior Fund officials began urging creditor countries to develop debt reduction plans in 1987, and by early 1988 they were actively—but quietly—promoting specific proposals. A more aggressive public posture might have accelerated the process, or it might have been counterproductive. As an inherently conservative and multinational institution, the Fund judged the risk to be not worth taking. In any event, the case for generalized debt relief could not have gained credence until enough time had elapsed to allow both creditors and debtors to pass from crisis to quagmire: that is, until 1987 at the earliest. Citibank's decision in May 1987 to add $3 billion to its reserves as a provision against possible losses on sovereign loans was a major stepping stone, because it demonstrated that at least the stronger banks had reached the point where they could afford to absorb the losses that debt reduction would bring.

Related questions are whether the staff was a leader or a follower in the intellectual field, and whether the Fund was prepared to accept debt relief once the countries and the banks agreed on a deal. Staff members, of course, were not always of one mind on this issue. Concerns about encouraging unilateral debt repudiation or discouraging a return to voluntary bank lending, accompanied by doubts about the reliability of both coercive and market-based approaches, kept the bandwagon in the garage. Nonetheless, the staff position increasingly favored recognition of the need for debt relief once the initial systemic crisis began to fade, and several staff members—notably in the Research Department—contributed to the literature on how debt relief could be accomplished within a market framework. Michael P. Dooley was an early proponent. His string of studies on the issue began in 1985 with a paper arguing that the existence of a stock of bank debt selling at deeply discounted prices implied that a bank making a new loan to that borrower would face an immediate capital loss. Only by eliminating the debt overhang could the borrower expect to regain normal access to such credits.[13] At the beginning of 1987, the staff used a *World Economic Outlook* paper to take a clear stand in favor of debt relief for the most heavily indebted countries, identified collectively as "the debt overhang cases":

> For these countries, the lack of an appropriate international mechanism for writing down the book value of the debt to a level more reflective of its market value may be resulting in market failures: investment opportunities that would otherwise have been seized are being neglected because of the effect on the expected post-tax rates of return of the need to meet the outstanding debt-service claims of the public sector's existing creditors.[14]

[13]The paper was circulated informally in 1985 and then as an IMF Working Paper, Dooley (1986). A revised version was published much later as Dooley (1989). The publication lags no doubt reflected the controversy of the conclusions. For overviews of the staff contributions, see the collection of papers in Frenkel, Dooley, and Wickham (1989); and Dooley and others (1990).

[14]The quoted passage is from "World Economic Outlook—Recent Economic Developments and Short-Term Prospects," SM/87/54 (February 25, 1987), p. 92. Following an objection from Charles H. Dallara, the Executive Director for the United States, the references to "debt overhang cases" and "an appropriate international mechanism" were omitted from the published version of the paper (IMF, 1987, p. 84); see minutes of EBM/87/46 (March 16, 1987), p. 47.

Operationally, the Fund implicitly moved toward an acceptance of debt relief in the 1986 stand-by arrangement with Bolivia, in that the program was approved without a prior agreement between the country and its commercial creditors and on the assumption that interest obligations would be met only in small part. The buybacks that gave Bolivia its initial debt relief in 1987 were implemented while that program was active and were administered by the IMF through a contribution account. In October 1987, the Fund approved a stand-by arrangement with Costa Rica under which the accumulation of arrears to bank creditors was accepted as a form of financing the payments gap. Shortly thereafter, the December 1987 deal between Mexico and the Morgan Guaranty Bank, in which a portion of Mexico's bank debt was voluntarily replaced by collateralized bonds with a lower face value, was also undertaken with the implicit support of the Fund, with which Mexico had an active stand-by arrangement at the time. Hence, while the Fund displayed no less than its usual caution and played a largely contemporaneous rather than leading role, both its words and its actions in the 2½ years before the Brady Plan broadly supported the development of debt reduction plans.[15]

Was the Debt Strategy Consistent with the IMF's Mandate?

The view is often expressed that the IMF's role of overseeing the international monetary system and helping countries overcome short-term balance of payments problems is incompatible with—or at least orthogonal to—assisting and advising developing countries on longer-term structural problems. This general criticism was stated by the Bretton Woods Commission (1994, p. 6), which concluded that "in developing [countries] the IMF should focus on short-term macroeconomic stabilization." With specific respect to the debt crisis, Edwards (1989, p. 8) characterized the criticism as being that "the Fund has ceased to operate as a financial institution" and "is acting more and more as a development aid–granting agency." This line of criticism continued to gain adherents throughout the following decade, as the Fund became increasingly engaged in the pursuit of structural reforms.

What specifically did the IMF do in response to the debt crisis, and how did those activities relate to the Articles of Agreement and the Fund's previous work? In general, the Fund assisted countries in designing macroeconomic adjustment programs and supported those programs financially through stand-by and extended arrangements. The only relevant question in that regard is whether these loans were consistent with the Fund's mandate to provide temporary financing for balance of payments purposes. The creation of the Extended Fund Facility (EFF) in 1974 provided a mechanism for making the IMF's general resources available for longer periods than under ordinary stand-by arrangements. The EFF, which was de-

[15]A related question is whether the exceptional treatment of Bolivia and Costa Rica should have been generalized *before* the adoption of a formal plan for debt relief. That issue is covered in the above discussion of the "handmaiden" criticism.

signed to cover situations where a country's payments imbalance resulted from deep-seated structural problems, was activated for several Latin American countries in the 1980s, including Peru in 1982, Mexico and Brazil in 1983, Chile in 1985, and Mexico and Venezuela in 1989.

How temporary was this financing? A number of these countries became prolonged users of Fund resources as they dug out from the initial crisis, but only Peru fell into protracted arrears with the IMF.[16] Most Latin American borrowers gradually but punctually repaid their debts. Mexico's indebtedness peaked in 1990 at SDR 4.8 billion ($6.5 billion) and fell to SDR 2.6 billion ($3.8 billion) in January 1995, before Mexico undertook a new stand-by arrangement the following month. Argentina reduced its obligations from SDR 4 billion in 1988 to 1.6 billion in early 1992 (from $5.4 billion to $2.2 billion) before undertaking new drawings under the EFF. And Brazil reduced its indebtedness from a peak of SDR 4.3 billion ($4.4 billion) in 1984 to less than 100 million by end-1995. Maturity profiles were elongated in the 1980s, but they did not vitiate the requirement of temporariness.

The IMF did, however, introduce some important innovations in the course of managing the debt crisis.[17] First, it assumed a much more active role than heretofore in arranging the total financing packages for adjustment programs. As discussed in Chapter 11, the standard practice for the staff before the crisis was to estimate the financing that would be provided by other private and official creditors under normal conditions and with good policies in place. The Fund would then negotiate a program that would make such financing possible, and it would provide financing (within the established access limits) to close any remaining gap. For Mexico and Argentina in 1982, the initial working assumption had to be that the commercial bank creditors would make every effort to reduce their exposure as rapidly as possible, in which case (1) the access limits would be inadequate to finance the program and (2) IMF financing would do little more than to enable the country to service its dwindling bank debts.

The solution was to require concerted lending by the banks so as to stabilize their aggregate financing. That solution worked because it was in the collective interest of the banks but not in the individual interests of those who might otherwise become free riders. If the procedure had been generalized, it would have represented a major extension of the IMF's activities. In practice, however, it was used only in cases where the program could not otherwise have been financed. By the late 1980s, the debt strategy evolved away from concerted lending into a more general "menu" approach in which the role of the IMF was generally the traditional one of approving an adjustment program that could serve as the basis for the use of Fund resources and a catalyst for outside financing.

[16]Protracted arrears are obligations that are overdue by six months or more; Argentina occasionally had shorter-term (less than 60 days) overdue payments in the late 1980s. The Fund did, of course, face a significant problem with protracted arrears starting in the mid-1980s (see Chapter 16). The point is that the arrears problem did not result either from the debt strategy or from prolonged use of Fund resources.

[17]For a longer historical perspective on these innovations, see Boughton (2000).

The second major innovation was the development of procedures for monitoring adjustment programs that were *not* supported by IMF financing. Under the heading of "enhanced surveillance," the IMF in 1984 began authorizing the release to private creditors of staff reports that evaluated programs that were financed by creditors other than the Fund (Chapters 9 and 10). In most cases, the programs were undertaken in conjunction with multiyear rescheduling agreements (MYRAs) that extended beyond the conclusion of IMF financing. As with concerted lending, it quickly became apparent that the practice had merits but that it would be a mistake to generalize it. In particular, care had to be taken to ensure that private creditors did not come to think of the IMF only as a credit-rating agency, and that the institution's credibility would not be undermined by delinking policy advice from financial commitment. The practice therefore was limited primarily to cases in which the Fund had provided financing and maintained close contact with the authorities through the subsequent completion of the adjustment process. In addition, it was usually applied by making information and analysis available to private creditors without implying an official seal of approval. After 1989, there were few new cases of enhanced surveillance.

Finally, the practices of the IMF were extended in 1989 to provide for the application of IMF resources to support reduction of bank debt under the Brady Plan. Fund resources were lent to member countries but were earmarked for the repurchase of bank loans at prices approximating those prevailing in secondary markets. To ensure that benefits accrued to the borrower and not just to creditors, buybacks under this program initially were restricted to cases where banks were increasing their exposure; and, in selected cases, programs were approved and drawings were permitted before the borrowing country had reached agreement with commercial creditors to settle arrears. As the plan evolved, banks took advantage of an increasingly sophisticated menu of options for participating.

The temporary effect of these three innovations was to make bankers into something between bedfellows and hostages of the IMF: for several years starting in 1982, bankers working on Latin American loans had to maintain close and frequent contacts with IMF staff and management. By 1989, however, when the first Brady deals were being negotiated, the traditional arm's-length relations had been restored. At least for the 1980s, the Fund largely avoided the risks of moral hazard and bureaucratic overreach that could have ensued if crisis management had ossified into standard operating procedure.

Was There Enough Coordination with the World Bank?

The IMF and the World Bank have been criticized for dancing to different drums and for stepping on each other's toes. Feinberg and Bacha (1988) expressed the allegation of coordination failure as follows: "The Fund's financial reaction to the Latin American debt crisis was both swift and deep—but it was not lasting. [Meanwhile,] . . . Initially perceiving the debt crisis to be a temporary phenomenon, the World Bank sat back and watched the IMF take the lead" (pp. 377 and 383).

During the first phase of the crisis, the Bank played a relatively limited role while it concentrated instead on longer-run development problems, especially of lower middle-income countries.[18] The Bank made substantial adjustment loans to Brazil, but it lent less to Mexico and little to Argentina. In 1983–84, the IMF took the lead and extended net credit totaling approximately $9 billion to the 11 most heavily indebted Latin American countries, compared with a net flow of just over $3 billion from the World Bank. By 1985, the picture began to change: Brazil's and Mexico's Fund-supported adjustment programs faltered, and the Bank began to step up its lending throughout the region. Overall, net flows from the Bank were slightly larger in 1985 than those from the Fund (more than $1¾ billion, compared with $1½ billion).

One purpose of the Baker strategy, introduced in October 1985 at the Annual Fund-Bank Meetings in Seoul, Korea, was to promote investment and growth in the indebted countries by strengthening the role of the Bank group (Chapter 10). Secretary Baker called for the International Bank for Reconstruction and Development (IBRD) and the Inter-American Development Bank to increase their lending to the "principal debtor countries" and for other agencies in the World Bank group (International Finance Corporation and Multilateral Investment Guarantee Agency) to work toward attracting equity capital flows to those countries. This initiative significantly strengthened the Bank's role in the debt strategy: not only did its own lending rise sharply, but the example of IBRD disbursements to some extent supplemented IMF credits as a trigger for commercial bank rescheduling agreements. Over the next three years (1986–88), Bank lending to the 11 major Latin American borrowers totaled nearly $6½ billion, at a time when net credit from the IMF was just about $500 million, as the normal flow of repayments to the Fund nearly matched new lending.[19]

Neither before nor after the Baker plan was lack of coordination between the two Bretton Woods institutions a *systemic* problem. In the early 1980s, the Fund took the lead, and in the second half of the decade the Bank played a larger role. Total net flows from the two institutions were reasonably stable throughout. Rather than reflecting a coordination problem, this passing of the baton reflected the long-standing differences in mandate and priorities of the Fund and the Bank. Lack of coordination did sometimes reduce the effectiveness of each institution in dealing with individual countries. Moreover, both institutions did occasionally tread heavily and clumsily on each other's toes, most notably in 1988 when they differed in their assessment of the viability of Argentina's proposed fiscal reforms.

[18]Underwood (1989) provided a detailed analysis of the World Bank's response to the debt crisis. On the Bank's "graduation" policy for countries that have reached a sufficiently advanced stage of development, see its *Annual Report* for 1982, p. 35. On the more general background for the Bank's limited response to the debt crisis in 1983–84, see Miller (1986), pp. 181–91.

[19]The figures cited in the text are aggregated from flow data for the 11 countries: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, Mexico, Peru, Uruguay, and Venezuela. Broader groupings confirm that the major increase in Bank lending came in the period 1985–87. For example, the stock of IBRD loans outstanding to the severely indebted middle-income countries rose from $10.6 billion at the end of 1984 to $27.3 billion three years later. Over the same period, IBRD loans outstanding to Latin American and Caribbean countries rose from $12 billion to more than $30 billion. Source: IBRD, World Debt Tables.

While the IMF was still negotiating the terms for a stand-by arrangement to replace the one that was about to expire and was holding out for more substantial cuts in the budget deficit, the Bank weakened the Fund's bargaining position by announcing (at the Annual Meetings in Berlin) the approval of four loans (three sectoral loans plus one for trade policy) totaling $1¼ billion (Chapters 11 and 20). That embarrassing *contretemps* forced the institutions to develop somewhat more detailed understandings of their respective responsibilities. Though those understandings were still vague and did not remove the potential for overlap and conflict, the Argentine incident remained an aberration.

Was the Adjustment Strategy Appropriate for Latin America?

In an influential paper, John Williamson (1990) characterized the IMF's approach to adjustment programs as part of a "Washington consensus" founded on "prudent macroeconomic policies, outward orientation, and free-market capitalism." While supporting that general orientation, Williamson also noted that it implicitly dismisses "the ideas spawned by the development literature" (pp. 18–20). With respect to Latin America, he concluded that it "is not at all clear that the policy reforms currently sought by Washington adequately address all of the critical current problems" (p. 18). As examples, he cited the need for price controls as a component of inflation-reducing strategies, the need to allow for skepticism by entrepreneurs when projecting the ability of adjustment programs to generate new investment, and the need to allow for the likely persistence of capital flight following implementation of a stabilization program.[20]

No one would argue seriously against the view that the IMF has insisted that financial responsibility and stability require market-oriented policies, low fiscal deficits, and limits on the growth of domestic credit financed by the monetary authorities. The issue is whether these prescriptions were applied rigidly in cases where they were not strictly appropriate. In practice, the specific elements of adjustment programs vary greatly according to the circumstances facing each country, but the real issue is whether a different approach altogether might have been required in some cases. In Latin America, possible exceptions include the following, in addition to the specific examples cited by Williamson:

- Countries where the state plays a large role in promoting development, for example through the operation of state enterprises or by directing capital flows toward favored sectors, may not be susceptible to market-oriented stabilization policies;
- Countries where inflation arises primarily from structural or inertial forces may suffer especially high real costs from conventional stabilization programs;[21] and

[20]Also see Killick and others (1984).

[21]Bresser Pereira (1992, p. 10) noted that "inertial inflation theory had been fully developed in Latin America in the early 1980s, though it was virtually ignored by Washington and the IMF."

- Countries where confidence in the domestic currency or in domestic financial institutions is low may be destabilized by a dismantling of capital controls.

Without attempting to resolve such issues in this short summary, it seems clear that there are grounds for a debate here. Throughout Latin America, the adjustment programs supported by the IMF in the wake of the debt crisis were predicated on a model in which the development role of the state, inertial inflation, and the autonomous role of financial weakness played little part. Rather, the basis for IMF policy advice was that price stability is essential for growth and can be promoted effectively only through appropriate macroeconomic policies; that structural reforms should aim at reducing market distortions and giving full play to market incentives; and that capital controls are ineffective at best and are usually counterproductive. Furthermore, the last two elements of that approach received relatively little attention until about the middle of the 1980s, before which the Fund's policy advice focused rather more heavily on stabilization than on development-oriented structural reforms. The fact that—in some cases, especially in the early 1980s—negotiators on each side of the table were arguing on the basis of such different models was doubtless an important contributor to the failure of negotiations to produce programs that governments could "own" and could implement firmly in the face of domestic political opposition.

Following the intensive and extensive dialogues that took place between the IMF and the authorities of indebted countries in the 1980s, these debates were partially resolved. On the side of the Latin American countries, the silent revolution gradually weakened the belief in state-dominated economic development and in the need for capital controls.[22] Edwards (1995, Chapter 3) has argued that what emerged by the early 1990s was not an acceptance of a "Washington consensus" but rather the development of a "new Latin American consensus." For its part, the IMF showed an increasing degree of flexibility as the decade progressed. For example, program conditions (beginning with Brazil in 1984) acknowledged the role of inertial inflation through acceptance of the operational deficit as one measure of fiscal policy. In a few cases where the threat of external shocks made the success of a program especially risky (most notably in the EFF arrangement negotiated with Mexico in 1986), the Fund incorporated innovative contingency clauses in the program terms. More generally, the Fund endorsed and even helped design a wide range of heterodox programs, such as Argentina's 1985 Austral Plan. Nonetheless, much room remained for further dialogue and for research on the linkages between the literature on macroeconomic stabilization and on structural reform and development (see Corbo and others, 1987; and Khan and Montiel, 1989).

[22]For a general discussion of the evolution of thought on the developmental role of the state, see Krueger (1993).

Should the IMF Have Been Willing to Write Down Its Claims?

The Brady Plan provided for a coordinated approach to debt reduction in which commercial banks, bilateral official creditors, and international financial institutions (IFIs) would all play a role. The new role for the IMF was to allow borrowers to apply a portion of their drawings from the Fund to reduce their outstanding bank claims on the basis of market, rather than face, values. Subsequently, however, criticism arose because the debt owed to the IMF and other IFIs was spared from any rescheduling, much less writing down in value. Helleiner (1996) summarized the views of many in developing countries: "The possibilities and modalities for writing-down some IMF/Bank debt need to be discussed directly and openly rather than remaining unacceptable topics for discussion" (p. 7).

The IMF resisted suggestions that it write down or reschedule member countries' obligations, primarily on the grounds that to do so would be inconsistent with the institution's mandate to make its resources available on a temporary and conditional basis. Instead, countries with debt-servicing difficulties were encouraged to implement Fund-supported adjustment programs that could serve as the basis for rescheduling or debt relief agreements with private and official bilateral creditors. New credits from the Fund to already indebted countries served de facto to reschedule those countries' repayment obligations. The Fund's argument was that this process, which underpinned the debt strategy from the beginning, would be seriously compromised by any effort to weaken member countries' commitments to it.[23] (For a more general discussion of the Fund's policies on rescheduling, see Chapter 16.)

More fundamentally, this issue is largely irrelevant from a financial perspective. The post-Brady debt strategy recognized that countries could not extricate themselves from a depressed-growth path unless their debt overhang was eliminated and debt-service obligations were reduced to a sustainable level in relation to anticipated export receipts. Although there are nominally three tranches to external debt (obligations to private creditors, bilateral official creditors, and IFIs), practically speaking there are only two: private and official. Since official creditors already had numerous mechanisms for taking joint action in this field, including the Paris Club and the G-7 summit process, there is only a limited free-rider problem that would have required intervention by the IFIs.[24] Whether creditor governments choose to take the full "hit" on bilateral credits or allocate

[23]For a statement of Fund policy on rescheduling, see "Overdue Payments to the Fund—Experience and Procedures," EBS/84/46 (March 9, 1984), pp. 9–11.

[24]Not all creditor countries participate in the Paris Club, but in general no country is able to obtain better repayment terms than those agreed to in Paris. There is, however, a free-rider problem of a sort, in that some countries might be multilateral but not bilateral creditors to a heavily indebted country. As long as the IFIs do not write down their own claims, those countries would not share in the cost of debt reduction.

some portion of it to IFI credits has little financial or even political relevance to the debtor.[25]

What is relevant are the total size of the write-down on official credits and the IMF's role in supporting debt reduction. For the six years from the Bolivian buybacks of 1987 through mid-1993, 11 Latin American countries with IMF-supported adjustment programs were granted rescheduling agreements through the Paris Club. Those agreements covered more than $35 billion in debts. With only a few exceptions (notably for Bolivia and Nicaragua), official bilateral debt cancellations were not applied to this region.[26] Private sector debt relief, supported both by official bilateral creditors and by the IMF and other IFIs, was much larger: over the same period, eight Latin American countries used a variety of operations to reduce their debt and debt-service obligations by $42 billion (on an initial stock of $104 billion), at a cost of just over $14 billion.[27] Given the political and economic constraints on public-sector debt reduction operations for middle-income countries, there is no basis for thinking that a more direct participation by the IMF would have been either necessary or sufficient for providing greater relief.

Conclusions

Even if much of the criticism of the IMF's role in Latin America was either misplaced or exaggerated, it contains some essential lessons for successful crisis management in the future. Assessing what the IMF did wrong in managing the debt crisis of the 1980s, two points stand out. First, the initial forecasts of the likelihood of a resumption of sustained output growth—and thereby for meaningful reductions in debt-service ratios—were, with important exceptions, optimistic. The bias in these cases resulted only in part from unforeseeable external shocks posterior to the crisis. In part, it resulted because the growth forecasts did not allow for the political resistance that often prevented the government from implementing the adjustment programs that were needed before growth could be restored. Second, the importance of combining macroeconomic adjustment with structural reforms aimed at promoting sustainable development gained operational significance only gradually as the decade progressed. Both of these problems reflected the difficulty of developing a comprehensive approach to adjustment and growth: of synthesizing the macroeconomic and development aspects of political economy. That the-

[25]This conclusion obviously does not apply to those low-income countries whose external debt is concentrated in obligations to the IFIs, but that issue is not relevant to the present review. A more general caveat (with the opposite effect) is that the indebted countries as a group would actually be worse off if the IFIs rather than bilateral creditors wrote down their debts, because the consequent reduction in net IFI earnings would be borne in part by higher charges on borrowings (see Chapter 17).

[26]IMF lending to both Bolivia and Nicaragua was shifted from the General Resources Account to the concessional trust funds administered by the Fund (the SAF, for Bolivia in 1986; and the Enhanced Structural Adjustment Facility (ESAF), for Bolivia in 1988 and Nicaragua in 1994).

[27]See IMF (1993) and Kuhn and Gajdeczka (1994).

oretical and empirical shortcoming poses a challenge not only for the analysis of the Latin American debt crisis, but also for reforms aimed at strengthening the IMF's response to crises throughout the developing world.

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