Silent Revolution

The International Monetary Fund 1979–1989

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Summary

This book is a narrative history of the coming of age of the International Monetary Fund as a participant in the international financial system. After the collapse of the par-value exchange rate system in 1973, as the landscape of the world economy became more precarious, the Fund was drawn into a more active lending role that required a deeper and more sustained involvement in the formulation of macroeconomic policies in countries facing economic crises. During the eleven years covered in this book, 1979 through 1989, a confluence of upheavals—an international debt crisis, a deepening of structural problems in low-income countries, and massive swings in exchange rates and external financial positions of major industrial countries—propelled the institution into a more central and pervasive role than ever before.

During the 1980s, the Fund struggled with policy issues that went to the heart of the nature of the institution and that continued to resonate throughout the 1990s:

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

Chapter One. The Silent Revolution

Chapter 1 gives an overview on the major developments in the world economy, the international monetary system, and the IMF from the end of the 1970s to the beginning of the 1990s. It includes a tabular chronology of world events and IMF activities, and profiles of the two Managing Directors who led the institution in those years: Jacques de Larosière and Michel Camdessus. The chapter concludes with five lessons that emerge from a study of the 1980s:

- ✓ First, successful surveillance and conditionality require partnership. The Fund must understand the political and cultural constraints that are pressing down on a country's economy, and the country must understand the economic realities that limit the compass for political action.
- ✓ Second, effective surveillance over exchange rate policies does not require a "system" of the Bretton Woods type, but it does require general agreement on the goals of those policies and on the role of the exchange rate in economic policy. Fund surveillance was hampered in the 1980s by a lack of such agreement.
- ✓ Third, private capital markets alone cannot generally achieve a satisfactory and stable response to an international financial crisis. Because holders of sovereign debts and other cross-border claims are multifarious, are spread across many countries and regulatory systems, and have diverse interests in the outcome, a multilateral arbiter can play a positive and even an essential role in arranging market-friendly solutions.
- ✓ Fourth, the Fund, as a specialized monetary institution, cannot solve the world's economic problems alone. Efforts by the Fund, the World Bank, and other agencies to collaborate were only partially successful in the 1980s. That effort did, however, help prepare the institutions for the much greater level of coordination that would be needed in the 1990s.
- ✓ Fifth, the effectiveness of the Fund's financial assistance depends on the recipient countries committing to implement both macro and structural economic reforms. Throughout the 1980s, the Fund circumscribed its own scope for action by limiting explicit conditionality to macroeconomic policies and avoiding interference with policies that could be construed as politically rather than economically motivated. The initial successes of countries that liberalized policies on their own—the silent revolution—drew the Fund out of that reluctance in ways that would enable it to play a more active role in promoting structural reform.

Part I. Revolutions in the International Monetary System

The first section of the book deals with IMF surveillance over countries' exchange rate policies and over the international monetary system. Although the Fund has always had a mandate to hold regular consultations with member countries on their exchange rate policies and had gradually extended that practice to cover all members, the amendments to the Articles of Agreement that came into effect in 1978 transformed those consultations into a more formal surveillance process. During the period covered by this History, surveillance became a primary link between the IMF and its full membership.

Chapter Two. On the Map: Making Surveillance Work

Chapter 2 explains how the modern concept of Fund surveillance came into being in the 1970s and evolved experimentally in the 1980s. It explains why countries were initially reluctant to subject themselves to international standards of economic conduct and recounts the various efforts that the Fund made to overcome that limitation: efforts that were not very successful during that period but that would bear fruit in the 1990s.

One important element of the Fund's early efforts to put its surveillance "on the map" was the use of special consultations with countries whose exchange rate policies were seen as possibly out of line and causing problems for others. That effort was largely frustrated by political difficulties, and only two such consultations were held: with **Sweden** in 1982 and **Korea** in 1987. Those two cases are reviewed here, illustrating the sensitivities involved and the challenges faced by the Fund.

Chapter Three. Seeking Symmetry: Article IV and the Largest Industrial Countries

Chapter 3 describes how the Fund conducted surveillance over the economic policies of the five largest industrial countries: the United States, Japan, Germany, France, and the United Kingdom. Although the Fund was holding similar consultations with nearly all member countries, there was an obvious lack of symmetry in effectiveness. This chapter suggests that the very limited effectiveness of surveillance over the largest economies was due primarily to differences between countries in the demand for the Fund's advice, and not to differences in the effort devoted to the task by the Fund. In some instances, effectiveness was also limited by the staff's deference to the authorities and by its reluctance to question the existing course of economic policy. Overall, however, this review of bilateral surveillance showcases the Fund's continuous but evolving efforts to warn governments of "the errors of their ways."

Highlights of this effort included:

- ✓ a long-running campaign to convince the government of the **United States** to abandon its neglect of the fiscal deficit as a policy concern;
- ✓ occasional encouragement to the authorities in **Japan** to use fiscal and monetary policies to stimulate the economy;
- ✓ increasingly focused advice to the government of **Germany** to adopt more flexible structural policies, especially for labor markets;
- ✓ belated but positive support for the shift toward more disciplined policies in **France**; and
- ✓ muted pressure throughout most of the 1980s for better exchange rate stability in the **United Kingdom**, including occasional calls for membership in the exchange rate mechanism of the European Monetary System.

Chapter Four. Policy Cooperation: The Fund and the Group of Seven

One purpose of Fund surveillance is to promote cooperative economic policies that will benefit all countries and to discourage countries from pursuing their own interests at the expense of others. Chapter 4 examines how the major industrial countries struggled to develop their own cooperative policies in the 1980s and how the Fund supported that effort. This story focuses on the annual economic summits of the G-7 and on the more frequent meetings of finance ministers and central bank governors. The Fund's involvement in those meetings began in earnest in the run-up to the 1982 summit in Versailles, and it intensified after the ministerial meeting at the Plaza Hotel in New York in 1985. By the time of the Louvre meeting in 1987, the Fund's role seemed assured, but the whole policy coordination movement petered out by the end of the decade.

Chapter Five. Keeping Score: The World Economic Outlook

The Fund began producing regular forecasts of world economic developments—known as the World Economic Outlook, or WEO—in 1969. During the 1980s, the IMF developed the WEO into the polestar of its analytical work and of its communication with the public at large. It became the principal means for the Fund to conduct oversight over the international financial system and an important vehicle for providing information to governments struggling to cope with complex global economic relationships. Through it, the Fund aimed to strengthen bilateral surveillance by making policy recommendations more consistent and more reflective of the international context. Chapter 5 covers three quite different but related strands of the history of the WEO:

- ✓ how the exercise itself evolved, and in particular, how and why longer-term policy analysis became even more important than the short-term forecasts;
- ✓ the economics of the WEO: what views the Fund expressed in its analyses of the world economy, and what theories led to those views; and
- ✓ the development of empirical models at the Fund and of their application to the WEO.

The chapter concludes with a brief review of assessments of the WEO forecasting record.

Part II. Revolutions in Managing International Debt

The second broad topic of the book is the international debt crisis of 1982-89: how it happened and how the IMF and other agencies and creditors responded to it. These chapters focus on countries whose external debts were to commercial as well as official creditors. (The even more serious debt problems of low-income countries that lacked access to commercial credits are examined later on.) After an initial period when the debt crisis erupted in Eastern Europe, this became almost entirely a story about Latin America.

Chapter Six. Crisis and Strategy

Chapter 6 introduces the Fund's handling of the international debt crisis by describing the causes of the crisis and the way it built up steam for three years before exploding in **Mexico** in August 1982. It then sets out the main themes of this part of the book: the need for a multilateral agency to help reconcile the competing interests of creditors and debtors, the need for an evolving strategy as circumstances changed, and ultimately the need for direct debt reduction once all attempts to "grow out of the debt" had failed.

Chapter Seven. The Mexican Crisis: No Mountain Too High?

Chapter 7 examines the central event of the initial part of the debt crisis: **Mexico** in 1982. It begins by recounting the web of earlier policy mistakes and adverse shocks that prevented Mexico from avoiding a crisis, and the limited ability of the Fund to monitor, predict, or forestall the calamity as it unfolded. It then examines how the initial rescue package was assembled in August, analyzes the difficult and lengthy negotiations on the adjustment program that were successfully concluded in November, and reviews the initiatives that ensured that the banks would help finance the program. The Fund's approval of an extended arrangement for Mexico in December 1982 and the banks' approval of a complex package of rescheduling and new lending three months later marked the end of an extraordinary effort to avert a systemic collapse.

Chapter Eight. The Crisis Erupts

Chapters 8 through 11 examine the four broad stages in which the debt strategy evolved. Starting in 1982, the Fund organized "concerted lending" arrangements for several countries while they implemented adjustment programs grounded primarily in traditional macroeconomic policy corrections. Concerted lending worked for only a few years, but it constituted the Fund's first systematic attempt at what is now called "private sector involvement." The first two years of that strategy are reviewed in Chapter 8. This chapter also kicks off a close examination of the Fund's interactions with **Argentina** and **Brazil** in the 1980s, a story that continues through the next three chapters. A study of the 1983 crisis in **Chile** rounds out the chapter.

Chapter Nine. Containing the Crisis, 1983-85

In the Latin American countries that were hit hardest by the 1982 crisis, escaping from the debt burden, restoring normal relations with creditors, and resuming economic growth turned out to be more difficult than was at first anticipated. Chapter 9 reports on how the Fund worked with **Argentina, Brazil, and Mexico** to maintain progress on economic reforms while those countries, the Fund, and other official creditors worked with the commercial banks to preserve financial viability. More broadly, it assesses how the initial strategy began to break down by 1984, leading to a search for longer-term solutions.

Chapter Ten. Growth, the Elusive Goal: 1985-87

By 1985, the debt crisis was as major a problem as it had been in 1982, but it had changed greatly in character. The commercial banks were putting the systemic financial crisis behind them, and a number of countries were making progress toward financial stability. Success, however, was neither broad enough nor deep enough. Even in countries where stability was being restored, much or even most of the gain had been achieved through import compression rather than through growth in exports, and output and employment were still depressed and stagnant. Social unrest was rising, and efforts to organize debtors into a cartel were continuing. From the vantage point of the Fund and other official creditors in 1985, the most pressing task was to help countries re-orient policies in a way that would produce the economic growth without which the initial gains could not be sustained. Chapter 10 describes how that task was pursued, including notably under the aegis of the Baker Plan, and it continues the story of the struggles in **Argentina, Brazil, and Mexico**. The focus of the Fund's policy advice now began to shift toward the structural reforms that were now judged to be an essential underpinning for the restoration of sustainable growth. These efforts, did not succeed before the end of the decade.

Chapter Eleven: Debt Denouement, 1987-89

If countries could not grow rapidly enough to service large amounts of external debt comfortably, then it was natural to turn to debt reduction as a way out of the crisis. Chapter 11 reviews the debates that took place in 1987 and 1988, both inside and outside the IMF, on whether debt reduction would help or hurt the most heavily indebted countries, and it recounts how the Fund began to experiment with supporting a menu of approaches in selected cases (mainly **Bolivia** and **Mexico**). It then tells how the Brady Plan of 1989 came into being, reviews the first programs where the Fund supported agreements under that plan (**Costa Rica**, **the Philippines**, **Mexico**, and **Venezuela**), and contrasts those successes with **Argentina** and **Brazil**, which were not yet ready.

Chapter Twelve. Case by Case: A Retrospective on the Debt Strategy

The final chapter on the debt crisis reviews several criticisms that were made of the Fund's role in managing the strategy. It concludes that although much of the criticism was either misplaced or exaggerated, two interrelated lessons emerge clearly. First, at the outset of the crisis the Fund was overly optimistic in several cases about the prospects for highly indebted countries that lacked good market access being able to implement sustained adjustment programs and resume economic growth. Second, the Fund only gradually came to give prominence to structural reforms in its policy advice to these countries. The early emphasis on tightening fiscal and monetary policies left countries that had rigid economic systems without a means to get back quickly to positive growth.

Part III. Revolutions in Structural Adjustment

By the late 1970s, the IMF was lending more and more to countries with deep-seated structural economic problems that could not be remedied within the usual time span of a Fund-supported program or through macroeconomic policies alone. The third part of the book examines how the Fund responded to this new challenge.

Chapter Thirteen. Lending for Adjustment and Growth

Chapter 13 looks how the Fund set policy conditions on its lending in the 1980s. It recounts the battles over how strict conditionality should be, and how extensive, and it shows how the Fund got into trouble in the early 1980s by approving a number of weak programs. It also examines several specific issues in more detail: how exchange rate, fiscal, debt, and structural policy issues were treated in Fund-supported programs, illustrated with examples from specific country cases, and whether conditionality can be redesigned to promote economic growth more effectively. Countries covered in this chapter include:

- ✓ **Sierra Leone**: was conditionality strong enough?
- ✓ **Yugoslavia**: could the exchange rate be allowed to depreciate without letting inflation get out of control?
- ✓ **Côte d'Ivoire**: could they restore balance without devaluing?
- ✓ **South Africa**: could the IMF deny credits because of apartheid?
- ✓ **Kenya**: was macroeconomic stabilization sufficient without structural reform?
- ✓ **Tanzania**: was structural reform possible?
- ✓ **the Philippines**: why could they not get on their own feet after more than two decades of nearly continuous borrowing from the Fund?

Chapter Fourteen. The IMF and the Poor: Soft Loans, Hard Adjustment

The general resources of the IMF are lent to member countries at interest rates that are based on world market rates. Beginning in 1975, the Fund developed a sequence of special funds, financed by loans and grants, to offer loans to low-income countries on concessional terms. Chapter 14 explains how two of these funds—the SAF and the ESAF—were established, and how they functioned in the late 1980s. The effectiveness of these structural adjustment facilities is illustrated with four case studies: loans to **Pakistan**, **Bangladesh**, **Ghana**, and **Uganda**. The chapter concludes with a retrospective on how the Fund's focus on poverty alleviation evolved during this period, driven by internal debates, political pressures, and—in several cases—riots.

Chapter Fifteen. Extended and Specialized Lending

The IMF also uses special facilities to lend for specific purposes. Chapter 15 reviews how the Extended Fund Facility (EFF), compensatory and contingency lending through the CFF and CCFF, financing of buffer stocks of primary commodities, and emergency disaster relief progressed during this period. The 1981 EFF arrangement for **India**, the largest financial commitment made by the Fund until the mid-1990s, and a small but politically charged arrangement for **Grenada** in 1983, illustrate the challenges of longer-term lending.

Chapter Sixteen. Digging a Hole, Filling It In: Payments Arrears to the Fund

If the IMF is to have the resources to keep lending, borrowing countries must repay their loans on time. Until the early 1980s, that was never a serious problem. By 1984, however, one country after another began going into prolonged arrears to the Fund: **Vietnam**, **Guyana**, **Liberia**, **Sudan**, **Peru**, **Zambia**, **Sierra Leone**, **Somalia**, **Panama**, **Honduras**, and finally **Zaïre**. Chapter 16 explains how each case happened, what misjudgments and mistakes were made, and how the Fund eventually devised a strategy for coping with the problem. Most of these cases resulted from a combination of bad economic policies and extreme and sudden economic declines, but several also involved delicate political issues. The chapter argues that there was no single cause of the arrears problem. Political pressures on the Fund to lend in marginal situations, unpredictable adverse economic shocks, and domestic political resistance to undertaking necessary economic reforms all played a part.

Part IV. Evolution of the Institution

The book concludes with a closer look at the IMF as an institution: how its lending was financed; how the SDR fared as an asset; how Fund membership grew; and how the Fund worked as a bureaucracy and was managed.

Chapter Seventeen. Fund Financing: Demand and Supply

The primary source of financing for the IMF is members' quotas, which in principle are reviewed and—if necessary—raised once every five years. As Chapter 17 describes, raising quotas is usually a highly contentious and drawn-out operation. The **United States** and a few other major creditor countries have often delayed the periodic reviews. In the 1980s, two reviews took place, both were delayed, and both finally succeeded when global economic difficulties gave the United States an incentive to support a quota increase. In the meantime, for much of the 1980s the Fund resorted to borrowing from governments and central banks to supplement its owned resources. One such loan, from **Saudi Arabia** in 1983, was the largest single loan in history up to that time. Chapter 17 also examines how the Fund adjusted its access policies (how much it was prepared to lend relative to quota), and how a larger portion of the cost of the Fund was shifted from creditor to debtor countries.

Chapter Eighteen. Evolution of the SDR: Paper Gold or Paper Tiger?

In 1979, prospects for the future of the SDR as an international unit of account and means of financing reserve accumulation seemed bright. Virtually all member countries had agreed to make the SDR the principal reserve asset in the international monetary system. A third round of allocations to member countries was under way, and it even seemed possible that a "substitution account" would be established to encourage countries to hold SDRs instead of U.S. dollars as reserves. Chapter 18, however, is primarily a story of decline and neglect, which greatly diminished both the role of the SDR and the prospects for its revival.

Chapter Nineteen. Toward Universal Membership

Global membership for the IMF was not always a widely shared ideal, but it became so by the end of the 1980s. Chapter 19 tells three separate stories that together help explain how the Fund was ready to take on a large number of new member countries after the collapse of the Soviet Union in 1991. The **People's Republic of China**, **Hungary**, and **Poland**—all with socialist and planned economies at the time—joined the Fund in the 1980s. Although China was not a new member, the 1980 shift in representation from Taiwan Province of China to the PRC had major implications both for the Fund and for China. Hungary became a member in 1982, just in time to get the Fund's help in dealing with its debt crisis. Poland was all set to join about the same time, but the declaration of martial law in the midst of Soviet intervention caused a rift with the United States that put Poland's membership on hold until 1986.

Chapter Twenty. Managing the Fund in a Changing World

The concluding chapter turns inward for a closer look at the IMF as an institution. It begins by explaining how the Fund interacted with other international entities in the

1980s (principally the World Bank, but also the UN, the GATT, the Paris Club, the BIS, and the European Community). It explains the role of the Board of Governors, illustrated by the story of how the Governors disposed of a move to invite the Palestine Liberation Organization to the Annual Meetings in 1979. It recounts the roles played by the Interim Committee, the Executive Board, and the management and staff, including profiles of the key players.