Chapter 6

Conclusions and Recommendations

In this final chapter, we first present our conclusions on major issues discussed in this report. We then draw from our findings *six recommendations*, designed to enhance the ongoing efforts to improve the effectiveness of IMF surveillance and program design in a capital account crisis.

Conclusions

Precrisis surveillance

The effectiveness of IMF surveillance varied in the three countries. Surveillance identified the central problems in Brazil reasonably accurately, but it was less effective in Indonesia and Korea. It identified specific weaknesses in these countries, but underestimated their seriousness and thereby failed to provide sufficient warning. This difference in effectiveness partly reflected the fact that Brazil suffered from macroeconomic imbalances, a traditional focus of IMF surveillance, whereas in Indonesia and Korea the problems lay in the weaknesses in the financial and corporate sectors. Surveillance identified these weaknesses, but it did not produce an accurate assessment of the extent of vulnerabilities they posed. Surveillance reports were insufficiently candid about potential vulnerabilities, especially those related to governance issues. In part, these problems reflected weaknesses in data availability that subsequent initiatives have made a major effort to correct, but they also reflected internal incentives that discouraged candor. More generally, there was an insufficient appreciation of the fact that weak balance sheets can pose substantial macroeconomic risks, even when most macroeconomic indicators suggest no obvious major problems.

The impact of surveillance was generally limited, because of (1) a reluctance to state difficult or embarrassing facts and views, for fear that this would alarm markets or generate conflict with national authorities, especially when hard evidence on some of these issues was lacking; (2) lack of receptiveness of country authorities to the policy advice of the IMF, when there were political constraints or honest differences of view; (3) limited IMF leverage in a nonprogram setting, particularly in an environment of buoyant capital flows to emerging markets; and (4) failure to influence the public policy debate or promote better risk assessment by private creditors by not making the IMF's views better known to the public.

Macroeconomic framework and projections

The three country cases illustrate the enormous difficulties in designing macroeconomic policy in capital account crises, which stem from (1) the possibility of multiple equilibria which implies the potential for large exchange rate changes; and (2) the negative impact of balance sheet effects on aggregate demand. These difficulties are intrinsic to the nature of a capital account crisis, and the IMF's conventional approach was not well-suited to dealing with them.

In all three country cases, at least part of the program design problems resulted from growth projections that turned out to be incorrect. In both Indonesia and Korea, the initial projections were overly optimistic. In contrast, the initial projections for Brazil were too pessimistic. In Brazil, overpessimism resulted in insufficiently ambitious fiscal targets. The main cause of these problems was the absence of an analytical framework in which all key factors that likely affect aggregate demand during a crisis are considered, notably the impact of balance sheet effects and confidence factors on private investment. These negative forces were very strong in Indonesia and Korea and led to a sharp decline in private investment, which had a severe contractionary impact. These effects were not present in Brazil because private sector balance sheets were well hedged and hence less vulnerable to a change in the exchange rate.

Even if macroeconomic projections for program design are improved in this way, the problem of uncertainty will remain. The nature of this uncertainty is particularly difficult to handle when there are possibilities of multiple equilibria leading to bimodal distributions of outcomes. This in turn implies that the mere fact that an IMF-supported program failed does not necessarily mean that the decision to provide financial support was unreasonable ex ante. However, in each of the three cases studied, it does appear that there were important elements of the initial strategy that lowered the probability of success—either because the program was perceived by the markets as underfinanced (e.g., the first Korea program), or not fully owned by the authorities (e.g., Indonesia), or having an unsustainable policy package (e.g., the exchange rate regime in the first Brazil program).

Fiscal policy

Fiscal policy was tightened in response to the crisis in all cases, but to different degrees and with different effects. The initial tightening of fiscal policy in Indonesia and Korea was moderate and was proposed on the assumption that growth would remain positive. It was justified on the grounds that some tightening was necessary to lessen the burden on the private sector in external adjustment and to pay for the interest cost of bank restructuring. This reasoning proved to be mistaken, as the IMF has itself acknowledged, given the severe collapses that followed in aggregate demand and output. The low initial stock of government debt also made it unnecessary for the interest cost of bank restructuring to be translated immediately into an improvement in the fiscal position.

In Korea, there was scope for a "debt for debt" swap in which the government could draw on its spare borrowing capacity to offer its obligations in exchange for those of the troubled financial sector. In Indonesia, the weak banking sector presented large contingent liabilities to the government, which in turn faced severe financing constraints. There was thus less scope for substantially expansionary fiscal policy. However, the initial fiscal tightening was not the primary cause of the contraction in either country. The contraction was largely due to balance sheet effects that had not been taken into account in making macroeconomic projections. In any event, the targeted tightening was quickly reversed as it became clear that aggregate demand and output expectations were way off the mark.

In Brazil, the fiscal adjustment was much more substantial than in Indonesia or Korea, and this was appropriate because public debt sustainability was indeed the major factor driving the evolution of the crisis. However, it turned out to be insufficient in achieving the objective of stabilizing and then reducing the debt-to-GDP ratio, leaving Brazil vulnerable to further shocks that materialized soon after the period covered by our evaluation.

Monetary policy

Monetary policy under the IMF-supported programs shared similar objectives, but ultimately differed in implementation and impact in each country. In Indonesia, the program envisaged a continuation of already tight monetary policy, but this intention was completely reversed in actual implementation. The open-ended provision of liquidity support to troubled banks led to a substantial loosening of monetary policy, resulting in increasingly negative real interest rates. In Korea, monetary policy was tightened as intended, but this proved ineffective until after a rollover agreement was put in place. It can be argued with hindsight that the tight monetary policy in Korea was continued for too long in face of the unexpectedly sharp output contraction. However, the period in which rates may have been higher than necessary was relatively short and the delay in monetary loosening was not the major factor causing the recession. In Brazil, there was an initial failure to tighten monetary policy to protect the peg as envisaged in the program, but policy was tightened again after the currency was floated and proved effective in stabilizing the situation. The relatively sound condition of corporate and financial sector balance sheets in Brazil meant that there was only a limited impact on investment and aggregate demand. However, a disproportionate share of the interest rate burden was borne by the public sector, which had seen a large increase in the share of the public debt linked to short-term interest rates.

It is difficult to draw simple conclusions about the efficacy of an interest rate defense of the exchange rate in a capital account crisis from these country experiences. This is not surprising since the broader theoretical and empirical literature has also not provided a definitive answer on the question. As is now well recognized, the health of the banking sector is a critical factor, and the effectiveness of interest rates in stabilizing exchange rates is reduced when a twin crisis is involved. This was the case in both Indonesia and Korea.

Official financing and private sector involvement

Our evaluation suggests that availability of official financing can potentially lead to better outcomes in capital account crises, provided that underlying trends and policies are sustainable. The chance of success is always uncertain, but the IMF should not limit itself only to backing "sure things"—indeed, IMF financing would not be needed if the probability of success of adjustment programs were near 100 percent, since markets would respond very rapidly to such situations.

The scale of financing needed in a capital account crisis is often very large, making it difficult for the IMF to meet the entire financing requirements on its own. In such cases, it is possible to supplement IMF resources with financing from other IFIs or bilateral sources. However, it is important to ensure that the predictability of such financing meet the scrutiny of the markets. Including in the financing package resources that are not perceived to be available on an assured basis can actually reduce the credibility of the program. This has implications for the conditions under which bilateral or other multilateral financing can be relied upon.

The role of the IMF in promoting PSI was fairly limited in all three cases, largely reflecting the prevailing rules of the game that did not give the IMF any special mandate to be proactive in this area. In Korea, the rollover agreement was a decisive factor, but this was essentially initiated by the major shareholders, with the IMF playing an important role by setting up systems to monitor changes in exposure on a daily basis, thereby facilitating information exchange among governments. The IMF performed a similar role in Brazil. However, exhortations for "voluntary" PSI (as in the case of the first Brazil program) had limited impact when the program lacked credibility.

Bank closure and restructuring

The three country cases reaffirm the importance of having a sound banking system in order both to minimize vulnerability to crisis and to mitigate the adverse impact of a crisis when it does occur. In Indonesia and Korea, a weak banking system significantly contributed to the onset as well as the severity of the crises. The experiences of both countries suggest that successful bank restructuring requires a comprehensive and well-communicated strategy, in which uniform and transparent criteria are consistently applied to bank closure and other intervention decisions. The Indonesian experience in particular shows that, where the legal system and bank supervision are weak or corrupt, early steps to preserve and correctly value assets are essential. The experience of the two countries is less clear on the exact modality of public sector involvement in the restructuring process (i.e., consolidated versus nonconsolidated restructuring supervision).

The nature of the deposit guarantee to be introduced during a crisis requires careful consideration. A blanket guarantee may be *sufficient* to stop runs prompted by a perceived weakness of the banking sector, but it involves large contingent liabilities for the government, and can have serious regressive implications for burden sharing. In a poorly regulated banking system where governance problems are serious, a blanket guarantee can also lead to abuse if it is extended to banks that are left under the control of existing managements. In introducing a blanket guarantee, benefits must be weighed carefully against potential costs, and country-specific factors must be fully taken into consideration.

Structural conditionality

Our review of the three country cases reaffirms the need for structural conditionality to focus on critical areas and the importance of country ownership of the resulting policy measures. This conclusion supports the recent initiatives by IMF management to streamline conditionality and enhance ownership by applying conditionality more sparingly to "structural measures that are relevant but not critical, particularly when they are not clearly within the IMF's core areas of responsibility and expertise."[1]

Reform in macro-critical areas is usually essential to restore market confidence, as in the case of financial sector reform in Indonesia and Korea, as well as fiscal policy reform in Brazil. The crisis should not be used as an opportunity to seek a long agenda of reforms with detailed timetables just because leverage is high, even though such reforms may be beneficial to long-run economic efficiency. If reform in areas that are not generally regarded as macro-critical is required (in the sense that they are not directly linked to domestic and external sustainability)—when for example widespread distortions are well known and the authorities are committed to reform—the principles of parsimony and focus should apply. This implies a broad approach of identifying such areas of reform, but providing maximum flexibility to the authorities on implementation details as a means of enhancing ownership.

Communications strategy

Restoring confidence involves more than just program design and must include an effective communications strategy to enhance country ownership and credibility. Effective communications with the public are necessary to build broad support during a capital account crisis, when time is of the essence and wider consultation to build ownership is therefore not feasible. Communication is also needed with the markets, in order to understand what they are looking for in a program and to explain the logic of the program. In this effort of building credibility, transparency can be a useful tool. In a capital account crisis, the IMF does not necessarily have more information than the private sector. Without disclosure of critical information for the investors, for example concerning the financing assumptions, or how policies might be adjusted to

[1] "Managing Director's Report to the International Monetary and Financial Committee—Streamlining Conditionality and Enhancing Ownership," IMFC/Doc/4/01/6, November 6, 2001.

evolving developments, it is difficult to expect the markets to perceive the program to be credible.

Internal governance

The IMF's mode of surveillance, as well as its crisis response, particularly in Asia, revealed some internal process weaknesses. These are of general relevance but emerged particularly strikingly in these cases. First, there were insufficient incentives for the staff to be forthright in discussing risks and governance issues in a candid manner. Second, the organizational structure prevented the expeditious deployment of human resources or a sufficient integration of the work and views of technical departments with those of area departments. Third, as a reflection of the broader problem with excessive turnover of country teams within the IMF, very few staff members with previous country experience worked on the crisis-related programs in each of the three countries.

In a crisis of confidence, when it was desirable for all to speak with one voice, the failure to resolve differences of view among IFIs was damaging. This seems to have reflected a lack of clear procedures for resolving disputes (in the case of the Asian Development Bank) or because such procedures were not followed (in the case of the World Bank).

Recommendations

Since the three crises reviewed in this report, a great deal of learning has already taken place within the IMF. New guidelines have been issued, or are being discussed, to incorporate that learning into policies and operational procedures, particularly in the areas of surveillance, conditionality, access policy, bank restructuring strategy, IMF–World Bank collaboration, and external communications strategy. These initiatives will help to improve the effectiveness of IMF surveillance and program design. Nevertheless, our evaluation suggests some specific areas where these initiatives could be enhanced. These are set out below as *six recommendations*, covering precrisis surveillance, program design, and the role of the IMF as crisis coordinator.

Precrisis surveillance

Recommendation 1. To increase the effectiveness of surveillance, *Article IV consultations should take a "stress-testing" approach to the analysis of a country's exposure to a potential capital account crisis*. The current guidelines, revised in September 2002, already suggest that surveillance should include "comprehensive assessments of crisis vulnerabilities," covering "economic fundamentals that may have an impact on market sentiment," "risks arising from global market developments," and "factors affecting a country's ability to deal with a sudden shift in capital flows." We recommend extending and systematizing this approach.

- Staff reports for Article IV consultations could itemize the major potential shocks that the economy could face in the near future, explore the likely real and financial consequences of each of these shocks—including balance sheet effects—and discuss the authorities' plans for dealing with them should these shocks arise.[2] Such discussion should cover the effectiveness of any existing social safety nets both as automatic fiscal stabilizers and as a means of mitigating the impact of a crisis on the most vulnerable sections of society.
- Staff should try to develop a greater understanding of the political constraints that may affect policymaking and of market perspectives on policy. Article IV consultation missions to systemically important countries should therefore seek a wider dialogue with individuals beyond senior economic officials, including especially those in the domestic and international financial communities. This is already done in "best practice" cases, but it would be desirable to formalize the process. In this context, it would be useful to include separate sections in staff reports where market views and political economy analyses are provided. Expertise available in ICM could be tapped on the former. Resident Representatives should also be incorporated into the preparation of staff reports in a more systematic way.

Recommendation 2. Management and the Executive Board should take additional steps to increase the impact of surveillance, including through making staff assessments more candid and more accessible to the public, and providing appropriate institutional incentives to staff.

- The recently revised surveillance guidelines call for Article IV consultation reports to contain a more systematic assessment of what happened as a result of the IMF's previous policy advice (along with an opportunity for the authorities to comment on the advice). To make such assessments more operationally relevant, *management could develop modalities for escalated signaling when key identified vulnerabilities are*

[2]Allen and others (2002) set out much of the framework that would be necessary for such an analysis.

not addressed over several rounds of surveillance. While it is beyond the scope of this evaluation to spell out a detailed proposal on how this would be achieved, the aim should be to provide the Executive Board with a vehicle for signaling when failures to address identified vulnerabilities have become an increasing source of concern. In this context, escalated signaling would help strike a right balance between the role of the IMF as confidential advisor and its role as a vehicle for transmitting peer reviews on members' policies and for providing quality information to markets. Escalated signaling would give member countries enough time to address underlying vulnerabilities, while also progressing toward greater candor as a means of increasing the effectiveness and impact of surveillance. It would also help to create an environment in which there is a clearer perception of the major vulnerabilities that would need to be suitably addressed as part of program design, should a crisis occur and IMF support be requested.

- *Management and the Board should explore the possibility of seeking "second opinions" from outside the IMF as part of the surveillance process when the authorities disagree with the staff's assessment on issues that are judged to be of systemic importance.*[3] This would improve the degree of objectivity with which contentious issues are handled in the surveillance process and may enhance the impact of surveillance. It would also serve as a building block for the idea of escalated signaling.

- While we recognize that there are risks in generalizing from a small number of cases, the experience of the three countries supports the case for *a presumption that staff reports for Article IV consultations should be published.*[4] Publicizing such information will help to generate a more informed debate on the need for structural reforms oriented toward crisis prevention. The public would also be better informed about the underlying rationale of the reforms that the IMF might subsequently deem necessary in the event of a program. Concerns have been expressed that publication of staff reports may compromise candor in terms of both what the authorities are willing to share with the IMF and what staff is willing to disclose in public. But the country experiences discussed in this report suggest that, without publication, there is also a risk that the IMF can have the worst of both worlds—with limited impact as a "confidential advisor" and limited scope for making its views known in the broader policy debate.

- Encouraging publication of country-level analytical work by staff will contribute to the quality of IMF advice and public policy debate. Existing guidelines are ambiguous about whether *publication, with the appropriate disclaimers, of country-related Working Papers by staff* requires clearance by the relevant Executive Director. It is desirable to create a presumption that publication is encouraged.

- To encourage greater candor in the assessment of country risks and vulnerabilities, *management and the Executive Board should agree on a systematic plan of action to provide staff with appropriate institutional incentives, possibly including measures to give greater independence to teams conducting surveillance*. The recently modified guidelines call for greater candor in surveillance reports, but such guidelines are unlikely to yield fundamental change unless they are compatible with internal incentives.

- *The biennial reviews of surveillance should, inter alia, focus on assessing the impact of surveillance on key systemic issues in member countries*. As part of this assessment process, the existing Surveillance Guidelines should be made public, so that the criteria against which the IMF expects to judge its own performance are clear to all.

Program design

Recommendation 3. A comprehensive review of the IMF's approach to program design in capital account crises should be undertaken. The IMF's own internal reviews have already generated many important lessons for program design and this evaluation has highlighted a number of others. The proposed review or redesign should be oriented around two key elements: (i) the objective of a crisis management program is first and foremost to restore confidence; and (ii) the interaction of balance sheet weaknesses and key macroeconomic variables is critical to how the economy will respond. This broad approach suggests the following specific initiatives:

- *It is necessary to pay much greater attention to balance sheet interactions and their consequences for aggregate demand*, especially in capital account crises where possibilities of

[3]The Executive Board has already indicated its acceptance in principle of such an approach in the discussions following the evaluation of the prolonged use of IMF resources.

[4]The Crow Report also recommended routine publication of all staff reports for Article IV consultations.

multiple equilibria exist. With the associated prospect of a large change in the exchange rate, an obvious message from the case studies is that designing programs around a single real GDP growth projection, which is inevitably the result of negotiation, can lead to significant problems in macroeconomic program design. It is not easy to ensure that all relevant determinants of growth are adequately taken into account, but a more systematic framework should be elaborated to ensure that program design should take account of how the status of balance sheets would influence aggregate demand, as well as the role of interest rates and exchange rates in particular cases.

- *Program design should allow for a sufficiently flexible response, in case unfavorable outcomes materialize*. Although reviews and waivers can be said to serve this purpose in a conventional crisis, large potential changes in key variables in a capital account crisis may render the original program irrelevant very quickly, and the appearance of persevering with a failed program can be damaging to market confidence. This suggests that the major risks to the program should be identified explicitly, along with a broad indication of how policies will respond. In the area of fiscal policy, for example, if public sector debt sustainability is not a constraint, program design could allow for countercyclical fiscal policy—either by adjusting quantitative fiscal targets automatically to allow explicitly for the operation of automatic fiscal stabilizers or by targeting the level of discretionary expenditures rather than the fiscal deficits per se. More generally, program documents should spell out explicitly how macroeconomic policies will respond in the event of sharper-than-programmed economic downturns, and this should be clearly communicated to the public.

- *The conventional framework of conditionality based on financial programming (including quantitative monetary targets) should be reviewed to see if, and how, it should be adapted to the circumstances of capital account crises*. Quantitative performance criteria (PCs) are often not useful as a guide to policy in a capital account crisis when the behavior of key economic variables can be highly uncertain and volatile and large deviations can develop, which may be difficult to correct later. It may be preferable to agree, in addition to performance criteria, to a mechanism of triggering consultations on monetary and fiscal policy, with some understanding on how the mix of policy needs to change in light of evolving circumstances. Just such an approach was taken in Korea in December 1997 in the setting of interest rates and in Indonesia in March 1998 when specific interest rate actions were specified. The approach to program conditionality in countries with formal inflation targeting frameworks for monetary policy is also evolving in this direction.

- *A crisis should not be used as an opportunity to force long-outstanding reforms, however desirable they may be, in areas that are not critical to the resolution of the crisis*. When political judgment necessitates addressing significant distortions that are known to exist, and the government is committed to reform, it should be sufficient to lay out a road map for these reforms as an indicative direction outside IMF conditionality, and this fact should be communicated to the public. Parsimony and focus should be the principles to guide the design of structural conditionality in a program whose objective is to restore confidence quickly. In this respect, we endorse the current initiatives of the IMF to streamline conditionality, while stressing that, in a capital account crisis, the critical test of a particular measure involves whether or not it helps to restore confidence.

- *Program design should include an agreed strategy to communicate the logic of the program and any subsequent program-related information to the public and the markets*. Such a strategy should be characterized by a high degree of transparency, including the immediate publication of LOIs and early disclosure of any unfavorable information.

The IMF as crisis coordinator

Recommendation 4. Since restoration of confidence is the central goal, *the IMF should ensure that the financing package, including all components, should be sufficient to generate confidence and also of credible quality*.

- *Financing packages prepared by the IMF should not rely on parallel official financing, unless the terms of access are clear and transparently linked to the IMF-supported strategy*. Attempts to inflate the total amount of financing by including commitments made under uncertain terms would risk undermining the credibility of the rescue effort. This implies that if the IMF is to play an effective role as crisis coordinator, either it must have adequate financial resources of its own or the availability of additional official financing should be made subject to a single, predictable framework of conditionality.

- *When parallel financing is sought from other IFIs, the terms of reference for their engagement should be specified at the very outset*, including mechanisms to resolve differences of view and the manner in which their inputs are reflected in program design. This is particularly important in the case of collaboration with regional development banks, for which no established procedures exist.

Recommendation 5. The IMF should be proactive in its role as crisis coordinator. Such a proactive role would include the following elements:

- Management should provide candid assessments of the probability of success and a frank feedback to the Executive Board and shareholders if some elements of the strategy are significantly lowering the probability of success.
- While involvement of shareholders is necessary and appropriate, particularly in large access cases, management should ensure that the technical judgment of staff be protected from excessive political interference.
- While decisions on the nature of private sector involvement will have to be made on a case by case basis, the IMF should play a central role in identifying circumstances where more concerted efforts (as was eventually undertaken in Korea) can be useful in overcoming "collective action" constraints. This should be based on a meaningful dialogue with the private sector, building on the new mechanisms for such a dialogue that have been established in recent years.

Recommendation 6. Human resource management procedures should be adapted further to promote the development and effective utilization of country expertise within the staff, including political economy skills, and to ensure that "centers of expertise" on crisis management issues allow for a rapid application of relevant expertise to emerging crises. Some important steps are already being taken in this area (including encouraging greater training in political economy), but a broader effort, based on long-term strategic planning, is needed. It is also desirable to formalize the procedure for encouraging candor in country work.

- *New institutional arrangements* within the IMF should be established to ensure that the IMF is in a position to deliver a rapid response, in terms of policy advice, to member countries facing crises and to assist in program design in such cases. A variety of organizational approaches could be used to achieve this objective, and we do not propose to suggest a specific structure. However, the aim should be to ensure that dedicated resources are maintained to respond to crisis management situations and to learn from past experience. This is precisely the approach proposed by management in the reorganization of MAE. The same principles should be adopted on an IMF-wide basis to deal with crisis cases involving large access.
- The length of staff assignments to country desks should be monitored to ensure that sufficiently recent country expertise is maintained within the staff. This information should be reported periodically to the Board.
- The terms of reference of Resident Representatives should be modified to encourage them to play a more central role in surveillance and program design (see also Recommendation 1, above). This already happens in some, but not all, cases.
- Internal guidelines and human-resource procedures should be modified to protect mission chiefs and others who raise uncomfortable issues through any authorized channel and thereby attract complaints from the authorities. For example, the internal Annual Performance Review exercise could be enhanced to give greater weight to the ability and willingness to make independent, candid judgments.[5] Ex post assessments of surveillance (see Recommendation 1, above) could be used as a basis for evaluating senior staff performance in this regard.
- A medium-term IMF-wide program should be established to develop a critical mass of staff members with significant country expertise in each of the emerging market economies that have been identified as systemically important, including mechanisms to allow staff to make visits to these economies for professional development and systematic efforts to assign relatively junior members as Resident Representatives. An information system to track this expertise should be established.[6]

[5]The Annual Performance Review form for IMF managers already contains sections calling for the assessment of competencies that are relevant to this issue (e.g., sound judgment/analytical skills, and strategic vision) but does not address it directly.

[6]For example, at present there is no central system that would allow management to ascertain easily which staff members have worked on particular countries in the past.