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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. Among all three of the principal players in the drama—the indebted countries, their commercial creditors, and the official creditors and multilateral institutions—there was an increasing realization that not even a full resolution of the initial financial crisis and successful implementation of traditional adjustment programs would produce a resumption of growth in the most heavily indebted countries. Furthermore, in some important respects, the initial financial crisis was already over and had been overtaken by longer-run problems.

The commercial banks at mid-decade were putting the systemic financial crisis behind them in several ways. First, the combination of concerted lending packages and adjustment programs had bought enough time for many banks (especially those outside the United States, in countries with relatively favorable tax and regulatory treatment) to set aside adequate liquid reserves as a provision against potential losses. By 1986, banks in continental European countries had provisions averaging more than 20 percent of the value of loans to developing countries experiencing debt-servicing difficulties. By the following year, even U.S. banks began to provision heavily.[1]

Second—notwithstanding the concerted lending arrangements, related reschedulings, and other commitments undertaken in conjunction with Fund-supported adjustment programs—bank creditors had begun to reduce their overall lending exposure to the heavily indebted developing countries. Net bank lending to those countries dropped sharply in 1985 and turned negative in 1986. By then the withdrawal was becoming widespread across developing countries.[2]

[1]See Watson and others (December 1986), pp. 66–67; and Watson and others (1988), pp. 63–64.

[2]IMF staff estimates made around the end of 1986 showed that for 1985, net lending was negative to 9 out of 28 covered countries; for the first nine months of 1986, negative figures were reported for 19 countries. In the aggregate, credits to the 28 countries rose by $9.7 billion in 1985 and fell by $6.8 billion over the next nine months. For the 15 countries classified as heavily indebted, negative net lending totaled $0.9 billion in 1985 and $4.4 billion in the first nine months of 1986. See "Implementation of the Debt Strategy—Current Issues," EBS/87/38 (February 20, 1987), p. 6. Later estimates showed essentially zero net lending to the 15 heavily indebted countries for the two years combined (slightly positive in 1985 and slightly negative in 1986); see Watson and others (1988).

Third, the banks had begun to develop a secondary market in sovereign debt instruments. It was still a small and fledgling market, with volatile prices reflecting a trading volume estimated at no more than $5 billion a year (Allen and others, 1990, pp. 37–38); but the existence of the market was beginning to provide the smaller banks with a means of escaping the vortex.

Fourth, banks in Europe and Japan had begun to benefit from currency movements. After three years of seemingly inexorable appreciation, the U.S. dollar had begun in March 1985 to depreciate against the Japanese yen and European currencies. Throughout 1985 and 1986, this depreciation reduced the local currency value of dollar-denominated loans on the balance sheets of banks outside the United States. Although such loans normally were matched by dollar-denominated liabilities, the portion of the portfolio deemed to be at risk thereby declined. For example, during 1986 total cross-border claims of Japanese banks increased by 58 percent in U.S. dollar terms, but only by 25 percent when measured in yen.[3]

These generally favorable developments had not as yet led to a significant resumption of voluntary (or "spontaneous," the preferred phrase of the day) lending to indebted developing countries, with the exception of a few countries that had successfully completed Fund-supported adjustment programs and had negotiated multiyear rescheduling agreements (MYRAs), such as Côte d'Ivoire, Ecuador, and Uruguay. Nonetheless, the indebted countries also had begun to wrest themselves from the initial financial crisis. Two points stand out.

First, three years of negotiations with creditors had led to a smoothing of amortization schedules and a lengthening of repayment periods. Especially for the countries that had successfully negotiated MYRAs, the prospects of a new crisis being brought on by the need to roll over large amounts of obligations all at once had been greatly reduced. Mexico, for example, had faced amortization payments averaging $9.6 billion a year for the period 1986–89; the MYRA reduced that figure to $1.1 billion.[4] Nonetheless, too many countries—including Mexico—still faced dangerously high ratios of debt-service obligations to export revenues.

Second, a number of the indebted countries had restored a measure of stability and confidence by implementing Fund-supported adjustment programs, but success was neither broad enough nor deep enough. Even in countries where financial stability was being restored, much or even most of the gain had been achieved through import compression rather than through growth in exports. Without export growth, output and employment were still depressed and stagnant. Social unrest, especially in the less successful countries, was rising, and efforts to organize debtors into a cartel to resist servicing debt on the originally contracted terms were continuing. From the vantage of the Fund and other official creditors in 1985, the most pressing task was to help countries reorient policies in a way that would produce the economic growth without which the initial gains could not be sustained.

[3]These figures include loans to industrial as well as developing countries. The dollar-denominated data are found in Watson and others (1988), p. 71.

[4]"Mexico—Recent Economic Developments," SM/85/148 (May 23, 1985), p. 62.

As the debt strategy pursued by the Fund and others shifted more heavily toward meeting longer-run development needs, a catalyst came in the form of the Baker Plan, introduced in October 1985. The Fund also began to examine more systematically the role that it could play once it was no longer financially supporting particular adjustment programs. This led to a formalization of the enhanced surveillance procedures that had first been applied with Mexico in 1984. More fundamentally, the focus of the Fund's policy advice began to shift toward the structural reforms that were now judged to be an essential underpinning for the restoration of sustainable growth.

The Baker Plan

Development of the Plan

When the Interim Committee convened in Seoul, Korea, on October 6, 1985, the U.S. Secretary of the Treasury, James A. Baker III, briefly sketched out a vision for reorienting the debt strategy. The problem, as he outlined it that Sunday morning, was threefold: the principal indebted countries were flagging in their adjustment efforts, official support by creditor countries and multilateral institutions was fragmented, and net lending by commercial banks was dropping. Consequently, the indebted countries were unable to reach their growth potential. To reverse these trends, he suggested a threefold response:

> First, principal debtor countries should adopt comprehensive macroeconomic and structural policies, which must be supported by the international financial community, to promote growth and balance of payments adjustment and to reduce inflation. Second, a continued central role for the IMF is called for, in conjunction with increased and more effective structural adjustment lending by the multilateral development banks in support of the adoption by principal debtors of market-oriented policies for growth. Third, private banks should increase their lending in support of comprehensive economic adjustment programs.

Baker had a more detailed set of proposals to offer, but he told his colleagues around the table that he would wait until his address to the plenary session of the Annual Meetings, two days later, to unveil the full plan.[5]

Baker's ministerial colleagues broadly agreed on the extent of the problem: the debt strategy had reached a critical stage. Chronic fatigue was setting in, and without new leadership, the crisis was only going to get worse. With hindsight, it is clear that the lending fatigue being displayed by bank creditors had at least two underlying causes. First, more and more of the smaller banks were becoming reluctant to participate in concerted lending syndicates. The tactic of treating all bank creditors equally, though it was thought to be a necessary element in the overall strat-

[5]Minutes of Interim Committee Meeting Number 25 (October 6, 1985), pp. 10–11. Notwithstanding Baker's intention to defer, the G-5 ministerial meeting had discussed the proposal at some length the day before.

egy, was seriously delaying the completion of financing arrangements. Alternatives to concerted lending would have to be sought, although few policymakers in the major creditor countries were yet ready to think in that direction. Second, even the larger banks were increasingly taking the view that they were being asked to shoulder too much of the burden relative to official creditors. That problem, which was the focus of official thinking in late 1985, could be tackled through a coordinated form of burden sharing among creditors.

In addition to the effects of lending fatigue, the debt strategy was being overwhelmed by adjustment fatigue in a number of indebted countries. With growth slowing in the industrial countries and stagnating in developing countries, and with the prices of many export commodities falling sharply, political leaders in the indebted countries were finding it more and more difficult to justify the need for trade surpluses and for paying large portions of export revenues in interest to foreign creditors.[6] Officials in creditor countries saw that they had to find a way to revitalize the strategy, not only because depression in developing countries would weaken growth globally, but also because it would lead inexorably toward a rebellion against the full servicing of external debts and could push the international financial system back into the abyss of 1982.[7]

Within the IMF, there was a growing realization that program design ideally ought to be broadened to include structural measures aimed at strengthening the basis for economic growth; but that realization was tempered by concerns that such measures lay outside the Fund's mandate and expertise and that the empirical linkages between structural reform and growth were not well established. Both inside and outside the Fund, the World Bank and the regional development banks were seen as being more suitably placed to provide the capital and the technical advice for promoting investment and growth.

For several months between the spring and fall meetings of the Interim Committee, U.S. officials in the Treasury and the Federal Reserve System worked to develop a comprehensive plan to deal with the identified problems. Treasury officials, particularly the Assistant Secretary for International Affairs, David C. Mulford, tried to develop an ambitious plan aimed at resolving the crisis, but they were unable to formulate a proposal that would win general agreement. By late summer, after consulting on several occasions with the Managing Director of the IMF, Jacques de Larosière, both the Treasury and the Federal Reserve settled on a more modest and practical approach that would emphasize the need for greater cohesiveness among the various groups of creditors and that would call for more involvement by

[6]Several of the heavily indebted countries were facing scheduled interest payments equal to more than one-third of the revenues from exports of goods and services. Argentina faced the highest burden, at more than 50 percent.

[7]One participant in developing the Baker Plan at the U.S. Treasury wrote later (Broad, 1987) that it was "primarily rhetoric . . . pasted together quickly in breakfast meetings" between Baker and Volcker and that it "was simply an attempt to steal the thunder from" Peru's unilateral decision (discussed below in Chapter 16) to limit external debt service to no more than 10 percent of its foreign exchange earnings. Also see Lissakers (1991), p. 229.

and coordination with the multilateral development banks.[8] No one expected the idea to be a panacea, but they did hope that it would reinvigorate the debt strategy and would convince the developing countries that official creditors were concerned about their problems.

This was the background when Baker walked to the lectern in the ballroom of the Hilton Hotel in Seoul on October 8, 1985, to deliver his first address at a plenary meeting of the governors of the Fund and the World Bank. In that speech, Baker called for a "Program for Sustained Growth," built on the three principles that he had outlined for the Interim Committee two days earlier. On the first point, he stressed the importance of building and liberalizing market institutions, strengthening the private sector, and promoting domestic saving and investment. Second, he called on the World Bank and the Inter-American Development Bank (IDB) to "increase their disbursements to principal debtors by roughly 50 percent from their current annual level of nearly $6 billion." Later, treasury officials explained that this figure related to a group of the 15 most heavily indebted developing countries, a group that henceforth would be widely referred to as the "Baker 15."[9] Third, Baker called on commercial banks to resume net lending to these heavily indebted countries: "Our assessment of the commitment required by the banks . . . would be net new lending in the range of $20 billion for the next three years."

The $20 billion "indicative target" for net bank lending had been suggested to Mulford by de Larosière during a casual meeting at the Managing Director's home in northwest Washington in the summer of 1985. Though Mulford initially viewed the number as surprisingly large, he became persuaded that it was realistic and decided to stick with it. If the goal could be achieved, it would raise the banks' lending exposure in the 15 countries by less than 3 percent, and it was roughly com-

[8]In Washington, Federal Reserve officials were particularly cognizant of the need to strengthen the role of the World Bank. Many of the elements of what would become the Baker plan were sketched out by the Federal Reserve Chairman, Paul A. Volcker, in a May 13, 1985, speech to the Bankers' Association for Foreign Trade, in Boca Raton, Florida. That speech noted that the debt strategy was moving into "'stage two'—the continuing, hard-slogging effort to maintain over years internal discipline, reasonable external balance, and adequate financing, while also finding ways to restore and maintain necessary growth." Volcker observed that the IMF would soon be seeing net repayments from the indebted countries, and he called for a strengthened role for the World Bank and a renewed commitment from commercial banks. On July 30, Volcker testified before a subcommittee of the U.S. House of Representatives that "all the heavily indebted countries in Latin America and elsewhere need to move from a situation of endemic financial crisis to another stage in development, looking toward what is necessary to sustain growth. As they do, the particular skills and resources of the World Bank become increasingly relevant. Heavy reliance on the shorter-term tools of the IMF should then be phased down and out." (U.S. House of Representatives, 1985, p. 21.) C. Fred Bergsten, Director of the Institute for International Economics, expressed similar views to the same subcommittee two weeks earlier (July 18, pp. 39–40).

[9]Only 10 of the 15 were Latin American members of the IDB (Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Uruguay, and Venezuela). The other five were Côte d'Ivoire, Morocco, Nigeria, the Philippines, and Yugoslavia. The deliberate decision not to include the list of countries in Baker's speech reflected in part the concern of the Fund that the debt strategy be comprehensive rather than exclusive. In practice (especially at the World Bank), the strategy generally encompassed two additional countries: Costa Rica and Jamaica.

mensurate with the commitment that was being suggested for the multilateral development banks ($27 billion in gross disbursements over the three-year period 1986–88).[10]

These proposals were pretty mild in relation to the magnitude of the problem, but Baker's speech generated substantial interest in Seoul and in the world financial press. Part of the interest came because most observers interpreted the speech as a call for official coordination of lending by commercial banks, which would have been a major departure from previous practice. And, in part, there was a widespread belief that the speech was a slap at the IMF, that Baker wanted the World Bank to guide the strategy from now on, rather than the Fund.[11] That Baker had taken pains to defuse that impression ("emphasizing growth does not mean de-emphasizing the IMF") only added to the smell of blood in the hall. As one reporter put the question to de Larosière at the Managing Director's closing press conference in Seoul, "Who is actually going to be running the show from now on?"[12] De Larosière, however, viewed the Baker initiative as an opportunity for the Fund to get the strategy moving forward again.

Reactions

De Larosière stopped in Paris for some days on his way back from Seoul and used the occasion to discuss the Baker Plan with a number of prominent bankers.[13] Flying home to Washington on October 20, he drafted a background note for circulation to selected senior staff, describing the bankers' reactions and some possible responses by the Fund.[14]

Bankers generally agreed, according to de Larosière's assessment, that the cessation of net lending by banks to the heavily indebted countries was a problem that should be reversed but that could not be corrected by individual banks acting alone. Bankers were comfortable with the case-by-case strategy under which lending was encouraged principally for countries that had successfully negotiated ad-

[10]The $20 billion and $27 billion figures were not strictly commensurate. The former related to net lending (i.e., increase in exposure), while the latter referred to gross disbursements. Given the structure of multilateral development bank lending at the time, the Fund staff estimated that $27 billion in gross disbursements in 1986–88 would have implied about $17–18 billion in net lending.

[11]See, for example, the articles published in the *Financial Times* under the headlines, "The Watchdog Loses Some Teeth" (October 3, 1985) and "IMF Falls from Grace" (October 6).

[12]Transcript of the press conference (October 11, 1985), p. 3; in IMF/RD External Relations Department file "Annual Meetings—Press Matters 1985, Seoul, Korea" (Accession 88/16, Box 3, Section 490).

[13]See his report to Executive Directors, minutes of EBM/85/154 (October 21, 1985), p. 3.

[14]"Thoughts on how commercial banks can be involved in solving the financing problems of indebted countries," note drafted by de Larosière (October 21, 1985); in IMF/RD Research Department file "Baker Initiative, October 1985–September 1988" (Accession 89/129, Box 3, Section 276). This practice was rare and indicates the importance that de Larosière attached to the occasion. Normally, when a paper was required for a meeting, it was prepared by the staff, not the Managing Director.

justment programs with the Fund, and they supported the idea of the multilateral development banks being brought more fully into the picture. What they did not like was what many of them saw as a reluctance by the major creditor countries to provide bilateral financial support for the adjusting countries, or even to fully support the capital requirements of the World Bank or the IDB. In the view of many bankers, an essential condition for the success of the Baker Plan was for official export credits to be made more readily available and for the major shareholders to commit the resources that were needed if the development banks were to play their envisaged role.

The Managing Director saw the possibilities for a consensus in these reactions, but he also feared that splits within the banking community could make it difficult to develop a new direction for the debt strategy. Non-U.S. bankers were highly suspicious of any attempt to replace the concerted-lending syndicates by some arrangement that would exempt smaller banks from participating. The small banks were concentrated in the United States, and any such move was likely to redistribute risks toward Europe and Japan. Furthermore, well-provisioned banks, notably in Germany and Switzerland, were reluctant to make sizable new financial commitments, while the more weakly provisioned banks were reluctant to agree to less profitable terms in any new agreement. If the banks were to be persuaded to support the Baker Plan, there would have to be enough official commitment to overcome these obstacles.

The October 22 staff meeting to discuss de Larosière's note did not generate a new direction for the Fund's role in the debt strategy; nor was there much discussion of the possibility of reorienting program design toward structural reforms aimed at promoting growth.[15] Indeed, there was general agreement that the case-by-case strategy of trying to negotiate strong adjustment programs and commit enough Fund money to catalyze substantial financing from other official and private creditors should continue without major changes. The focus of the meeting was on how to ensure that commercial banks would provide the necessary financing to make the Baker initiative work. In addition to the need for support from creditor governments, a solution had to be found for the "small bank" problem. Although it was much too early to formulate an institutional view on the question, this meeting produced the first real consideration of supplementing the concerted-lending approach with a variety (in effect, a menu) of options that the multitude of smaller bank creditors might be more willing to accept: establishment of country-specific and officially supported trust funds, debt-equity swaps, exit bonds, and interest capitalization were all considered to be live options.

Further discussions over the next two weeks led the Managing Director to propose two specific changes in the strategy being applied by the Fund.[16] First, staff

[15]Memorandum for files prepared by Robert M.G. Brown (Personal Assistant to the Managing Director), October 30, 1985; in IMF/RD Research Department file "Baker Initiative, October 1985–September 1988" (Accession 89/129, Box 3, Section 276).

[16]Memorandum to heads of departments, November 7, 1985; in IMF/RD Research Department file "Baker Initiative, October 1985–September 1988" (Accession 89/129, Box 3, Section 276).

missions dealing with the heavily indebted countries were instructed to develop longer-term scenarios—through 1988 if possible—projecting policy intentions and likely financing flows and forecasting the expected performance of the economy. To clarify the financial flows, staff were asked to collaborate closely with their counterparts in the multilateral development banks. Second, the Fund's Research Department was asked to develop procedures to regularly monitor overall financial flows to developing countries, including the progress being made toward meeting Baker's indicative targets for additional lending by commercial and multilateral development banks. These were not dramatic changes, but they would help keep the Fund's work from being marginalized by the new emphasis on longer-run developments affecting the overall group of heavily indebted countries.

Up to this point, the Baker initiative had no official multilateral standing. It had not been formally discussed, much less approved, by the Interim Committee or by other groups of governors at the Annual Meetings.[17] To get the Fund on board, the Managing Director asked the staff to prepare a short paper summarizing the main features of the Baker initiative;[18] that paper could then be discussed by the Executive Board at its already scheduled annual review of international financial markets.

At that meeting, on November 13, 1985, which the Managing Director characterized as "historically important," the Executive Board gave its "very broad support" to the Baker initiative.[19] The U.S. Executive Director, Charles H. Dallara, opened the discussion by stressing that while the Baker initiative aimed at strengthening the role of the multilateral development banks in promoting structural reform, the Fund would continue to play a central role in providing both resources and policy advice and in catalyzing other financing. The U.S. authorities had concluded that a principal reason that banks were reluctant to lend to developing countries was that they doubted that some countries' adjustment efforts were adequate; a more comprehensive adjustment and reform strategy was needed to allay those concerns.[20]

After a long day of deliberation, the Managing Director's summing up of the Board meeting stressed six points regarding the Fund's detailed response to the Baker initiative.[21]

- First, the Fund should directly support growth-oriented adjustment. Fund-supported programs should include supply-oriented measures aimed at foster-

[17]Official support for the Baker Plan accumulated gradually in the weeks following the Seoul meeting. In mid-November, for example, Volcker explained the plan to his fellow central bank governors at their monthly meeting at the BIS in Basel, Switzerland. After the meeting, Karl Otto Pöhl, the president of the Deutsche Bundesbank, signaled his support and that of his colleagues. See "Des banques centrales approuvent le plan Baker" ["Central banks approve the Baker plan"], *Le Figaro* (November 13, 1985), p. 18.

[18]"International Capital Markets—Developments and Prospects, 1985—U.S. Treasury Initiative on Debt," SM/85/267, Sup. 1 (November 1, 1985).

[19]Minutes of EBM/85/166 (November 13, 1985), pp. 36 and 33.

[20]Minutes of EBM/85/165 (November 13, 1985), pp. 4–7.

[21]Minutes of EBM/85/166 (November 13, 1985), pp. 31–34.

ing domestic savings, restoring confidence in (i.e., credibility of) fiscal and monetary policies, and promoting investment. Thus, in contrast to the staff's reluctance to sail in uncharted waters, the Executive Board felt that this shift in direction was of primary importance.

- Second, the Fund should strengthen its collaboration with the World Bank and regional development banks, the institutions that would now have a crucial role to play in making the debt strategy work. There was, however, an undercurrent of doubt that this aspect of the strategy would bear fruit. As the Managing Director put it, "the willingness of industrial countries to increase the capital of these institutions . . . will be a test of the cooperation required under Secretary Baker's proposal."
- Third, the Fund should move—albeit cautiously—toward strengthening its role in encouraging commercial banks to provide new lending to the heavily indebted countries. During the Board's discussion, Directors had been sensitive to the need to preserve the commercial and market-oriented nature of bank lending. Attempting to force banks to lend, or providing incentives through government or other official guarantees, was seen as inappropriate. But Directors also had stressed that increased lending to countries making appropriate adjustment efforts was in the banks' own collective interest and should be encouraged and catalyzed wherever it was suitable to do so.
- Fourth, Directors were uneasy about endorsing, even implicitly, Baker's indicative list of 15 countries. Countries not on the list would also need concerted lending arrangements, and not all of the countries on the list would merit such financing.[22] More generally, it was important for the Fund to be evenhanded in its relations with member countries. The Baker 15 existed only as a list; it would become an analytical subgroup for the World Economic Outlook and other purposes, but it would have little practical significance for the work of the Fund.
- Fifth, the Board generally viewed Baker's $20 billion indicative target for new bank lending as a minimum requirement for financing the external deficits of the 15 countries. Directors (especially Guillermo Ortiz, Alternate—Mexico) had pointed out that this increase (less than 3 percent over initial exposure) would be negative in real terms and would still result in substantial net transfers from the indebted countries to bank creditors.[23] Nonetheless, to achieve this target would be a real accomplishment, since banks currently were doing no more than maintaining the existing level of exposure. With regard to how to encourage banks to cooperate, there had been some tentative discussion of the need for a broader menu approach as a means of preventing the basic concerted-lending approach from collapsing.

[22]The Managing Director's summing up noted that the list had been compiled "without regard to the degree to which any of these countries have progressed toward the regularization of their relations with commercial banks." Minutes of EBM/85/166 (November 13, 1985), p. 34.

[23]That is, net lending would be less than the scheduled interest payments due on the outstanding debt.

- Sixth, there was a recognition that the Baker initiative could not work without substantial support from the major creditor countries (in addition to financing for the multilateral development banks). In particular, creditor governments would have to implement supporting policies, including flexibility in regulating financial institutions, providing adequate export cover (a potentially major source of financing that had not been mentioned at all in the Baker initiative),[24] reducing protectionism, and (especially for the United States) reducing fiscal deficits.

The November 13 meeting gave an official IMF stamp of approval to the Baker Plan,[25] and on December 2 the Managing Director and the President of the World Bank, A.W. Clausen, issued a joint press release expressing their "strong support" for the initiative.[26] This unusual joint statement served to some extent to counteract the widespread speculation in the press (see above) that the Baker Plan would result in a shift in power and influence from the west side of Washington's 19th Street (the Fund's headquarters) to the east side (the World Bank).

Implementation

Operationally, the main advantage to the Fund from the Baker Plan was that it provided a systematic channel for catalyzing resources from other creditors at a time when the Fund's own net financial contribution would inevitably be declining.[27] The Managing Director's number one priority therefore was to do whatever he could to make sure that the financing from other creditors came as close as possible to the indicative targets. By December 1985, commercial bankers were generally expressing quite positive views of the plan, but that enthusiasm would not necessarily be converted into cash for developing countries. On the contrary, the primary basis for the banks' enthusiasm seemed to be that they expected (or hoped) that it would lead to more money being provided by official creditors. For example, representatives of 58 creditor banks met in Washington on October 28 to consider the implications of the Baker initiative, with IMF and World Bank staff participating along with Mulford. At the end, the banks issued a press release stat-

[24]Export cover refers to guarantees provided by official agencies in creditor countries, covering private (usually bank) loans to importers of goods from the guaranteeing country. The $20 billion indicative target for bank lending was understood to refer only to unguaranteed loans.

[25]The Interim Committee endorsed the plan at its April 1986 meeting. "The Committee welcomed the progress that is being achieved in strengthening the current debt strategy along the lines proposed by the United States at the last Annual Meetings. . . . The Committee reaffirmed the central role of the Fund . . ." (Communiqué, April 10, 1986, Paragraph 3).

[26]IMF Press Release No. 85/37 (December 2, 1985); in *IMF Survey*, Vol. 14 (December 9, 1985), p. 369.

[27]The anticipated decline in IMF net lending reflected both the scheduled repayments from the large arrangements of the preceding years and the desirability of avoiding prolonged use of Fund resources by individual member countries. As the *Annual Report 1986* summarized the situation (p. 43), the Fund's "financial support is not likely to be on the same scale as in the early stages of the debt crisis; thus a somewhat greater emphasis has been given to the catalytic role of Fund support."

ing that they "welcomed the idea of a coordinated approach involving, together with a renewed effort in the debtor countries and support from the industrialized countries' governments, an extended role for the international financial institutions."[28] Then on November 8, at a meeting in New York, members of the Committee of Advisory Banks told the Deputy Managing Director, Richard D. Erb, that they were asking for a guarantee from the World Bank on new lending that they were being asked to make to the Baker 15 countries. Erb warned them not to expect such a guarantee. In mid-December, groups of banks in the United States, the United Kingdom, Japan, Canada, and continental European countries issued a coordinated series of statements that generally expressed positive but qualified support.[29] On December 15, de Larosière and Clausen again issued a joint statement, to "welcome these positive and encouraging expressions of support for the debt initiative from the banking community."[30]

Clearly the bankers were confused during the first few months after Baker's speech. They believed that they were being asked to participate in a forced lending scheme that would be officially organized on noncommercial terms. They accepted that such a scheme could be preferable to the increasingly burdensome task of organizing massive concerted lending syndicates, but they insisted that the idea made sense only if their risks were to be covered in some fashion by official guarantees. Their coordinated but tentative expressions of support were predicated on the view that a detailed official plan was being developed to flesh out the Baker initiative.

The banks were not alone in believing that the Baker Plan was more sweeping in scope than it actually was. Unless the $20 billion that banks were being asked to lend to the Baker 15 was to be aggregated and coordinated in some fashion, then it was difficult to view the request as having any more substance than some form of moral suasion. At the November 13 Executive Board meeting, Jacques J. Polak (Netherlands) concluded that "the essence of Secretary Baker's plan was that the commercial banks would not set the conditions that would apply to their new credits under the plan." He envisaged that the Fund, in collaboration with the World Bank, would exercise responsibility for determining which countries qualified for

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[28]Quoted in the *IMF Survey*, Vol. 14, No. 21 (November 11, 1985), p. 349, under the headline, "Banks Express Support for Debt Plan of U.S." The press release was issued by the Institute of International Finance (IIF), which organized the meeting of its member banks. The *Survey* article also quotes the IIF Managing Director, André de Lattre, as saying after the meeting that "no public commitment was being made at this time."

[29]Typical of these pronouncements was one issued on December 12 through the Bank of England on behalf of major British banks and clearing houses, stating that the signatories "confirm their willingness to play their part on a case-by-case basis, provided that all other parties, governmental, institutional, and banking, do the same." The message was released to the press and simultaneously sent to de Larosière and Clausen. For examples of the press coverage, see *The Guardian* (December 13, 1985), p. 23, on the Bank of England announcement; and *The Journal of Commerce* (same date), p. 5, on similar announcements by Japanese banks. Also see related cables in the Managing Director's file, "Baker Plan"; IMF/RD "Debt Initiative—The Baker Plan, December 1985" (Accession 88/285, Box 5, Section 250).

[30]IMF Press Release No. 85/41 (December 15, 1985); in *IMF Survey*, Vol. 15 (January 6, 1986), p. 3.

additional support.[31] In fact, neither the banks nor the U.S. authorities saw matters in that light.[32] The truth was that the plan was fabricated from much thinner cloth than most observers believed.

For four years now, from the first days of itching concerns over the possibility that a debt crisis might emerge (see the opening pages of Chapter 6), de Larosière had found it useful to meet informally with small groups of key bankers to discuss possible innovations in the debt strategy. In early December, he decided to hold such a meeting as soon as he returned from the Christmas holidays. It would be a small gathering, on January 6, 1986, at which he and Clausen could explain how they saw the implications of the Baker initiative and could get a clearer sense of the views and concerns of the key bankers.[33]

De Larosière opened the meeting by outlining the key issues as he saw them.[34] The Baker initiative was unquestionably the right approach to deal with the "disquieting factors" that were undermining the effectiveness of the debt strategy: the indebted countries had to resume economic growth, the World Bank was well placed to help them do so, and the commercial banks had to continue to help finance these countries' Fund-supported adjustment programs during this period of global slowdown and falling commodity prices. For their part, the bankers were mainly worried that the creditor governments would leave them stranded: What commitments were governments prepared to make, to correspond to the extra burden that the banks were being asked to carry? De Larosière was not in a position to answer that question. On a more positive note, there was common ground for all to agree that a greater focus on structural reforms in developing countries was essential; banks would be more willing to lend if the obstacles to private investment could be breached. Nonetheless, there was little reason to conclude from this gathering, however convivial it might have been, that a revival of bank lending to the heavily indebted countries was on the horizon.

The most salient operational question for the IMF raised by the Baker initiative was whether the design of Fund-supported adjustment programs could be broad-

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[31]Minutes of EBM/85/165 (November 13, 1985), p. 9.

[32]In the days surrounding Baker's speech in Seoul, U.S. officials apparently did envisage a more concrete plan emerging, though they had not yet worked out any of its details. As soon as Baker returned to Washington from the Annual Meetings, he told the press that Volcker had suggested—and the U.S. administration was considering—that the major creditor banks form an "international superbank" to arrange loans to developing countries. The superbank would have replaced the existing informal bank syndicates and Advisory Committees, but the idea met with general skepticism and was quickly abandoned. See Jane Seaberry, "International 'Superbank' Proposed," *Washington Post*, October 11, 1985, pp. D1–D2.

[33]The dozen or so participants in this private meeting included the chief executive officers of several of the world's largest banks: Yusuke Kashiwagi (Bank of Tokyo), Franz Lutolf (Swiss Bank Corporation), Sir Jeremy Morse (Lloyds Bank), Lewis T. Preston (Morgan Guaranty Trust Co.), John Reed (Citibank), and Jacques Thierry (Banque Bruxelles-Lambert).

[34]This account is based in part on a January 8 file memorandum on the meeting, in IMF/RD Managing Director file "Debt Initiative—The Baker Plan, December 1985" (Accession 88/274, Box 8, Section 269); and in part on the report that the Managing Director made to the Executive Board on that same day (minutes of EBM/86/4, January 8, 1986, pp. 3–8).

ened to more directly promote economic growth. That question was taken up by the Executive Board in the first quarter of 1986, as part of the regular review of the guidelines for conditionality on financial arrangements. As described in Chapter 13, Directors were reluctant to push very hard in that direction. They approved of the fact that the staff was encouraging borrowing countries to adopt structural reforms aimed at liberalizing markets, increasing efficiency, and strengthening incentives to invest; but they were less comfortable with the idea of mandating the staff to more generally require countries to adopt such policies as a condition for drawing on Fund resources. They were concerned that many programs were failing because of an overemphasis on demand restraint over structural adjustment, but they generally accepted that the World Bank had both a clearer mandate and greater expertise on structural issues. Increased collaboration with the Bank, rather than an expansion of the Fund's role, was seen as the principal requirement for promoting growth in program countries.[35]

For the Fund, then, the Baker initiative amounted to a plan to closely monitor developments for a specific group of 15 heavily indebted countries, to pay greater attention to the requirements for restoring sustainable growth in those countries, and to collaborate more intensively with the World Bank, especially in dealing with that group of countries. Success would be judged, at least by outside observers, by whether the suggested financing flows were forthcoming and by whether the recipients of all of this attention actually saw a strengthening of real economic growth.

Effects

How well did the Baker Plan work? Did the commercial and multilateral development banks provide the level of financing that was envisaged, and did the targeted countries see a significant improvement in economic performance? These questions are more difficult to answer than they appear at first, owing to methodological and data problems, but the monitoring exercise carried out by the Fund staff over the three years that the plan was in place provides some strong clues.

The Research Department issued its first monitoring report to the Managing Director on February 14, 1986, three months after the Executive Board had given its approval to the plan. The staff then submitted reports every quarter through September 1988, aimed at shedding light on the questions posed above. The most straightforward question is whether the multilateral development banks provided their indicated share of financing: to a remarkable degree, they did. The initial monitoring report projected gross disbursements to the Baker 15 of about $24 billion for 1986–88, compared with the indicative target of $27 billion, which implied net lending of just over $15 billion. The projections also implied increases of about $2 billion a year over the previous level of lending in 1984–85, in both gross and net terms, compared with Baker's call for an extra $3 billion. The staff's final

[35]The Executive Board held another detailed review of the debt strategy on March 24–25, 1986. With respect to the implications of the Baker initiative, that discussion essentially confirmed the conclusions of the January meeting. Minutes of EBM/86/51–54 (March 24–25, 1986).

monitoring report, in September 1988, estimated that actual net lending for the three years totaled about $16½ billion, very close to the initial projection and the original U.S. proposal.[36] The fear that the multilateral development banks would not get enough support to do their job was largely unfounded.

The answer to the second question, whether the commercial banks increased their own lending commensurately, is much more controversial. From the very beginning, the staff's monitoring reports revealed that actual net lending by banks had been negative since the onset of the Baker Plan, and they projected no more than small increases through 1988 (in fact, over much of the period, the staff predicted no increase at all). The reports noted that the banks appeared to be skeptical about the level of official support that would be forthcoming and were reluctant to be left holding the bag. The last report indicated essentially zero net lending for 1986 through 1988, and the final outcome was estimated to have been significantly negative.[37] In contrast, one prominent outside study concluded that the banks' net lending to the Baker 15 totaled $13 billion for the three years through 1988: less than asked, but still considerable. The banks had indeed made substantial new commitments to a number of the heavily indebted countries, but they had reduced their exposure through other channels. Whether they had contributed to the financing of these countries' external payments deficits depended on how one valued those offsetting transactions.[38] In any event, by 1988 there was no question that the banks' willingness to provide new financing was essentially finished.

Perhaps most surprisingly, the Fund staff did reasonably well at forecasting total real growth for the Baker 15 countries as a group. The February 1986 report projected real GDP growth of 2½ percent for 1986–88 for the whole group, and

[36]By that time, the staff had stopped monitoring gross disbursements. After September 1988, the detailed monitoring of the Baker initiative stopped, because the 15 countries were no longer viewed as a centrally important grouping and because the focus of thinking was shifting toward more comprehensive solutions to the debt crisis. (Baker resigned as Secretary of the U.S. Treasury in August 1988 to become chairman of Vice President George Bush's campaign for the presidency.)

[37]The September 1988 internal monitoring report estimated net bank lending to the Baker 15 countries to have been –$1.3 billion for 1986 and +$1.6 billion for 1987, and it projected –$2.0 billion for 1988. (Preliminary data were then available only for the first quarter of 1988.) A year later, the *World Economic Outlook* for October 1989 (Table A42) estimated the outcome to have been –1.6, +2.3, and –15.3 for the three years, respectively. For a discussion of the statistical problems in estimating these flows, see the *World Economic Outlook* for April 1989, pp. 26–27.

[38]The $13 billion figure, which was cited (without specific attribution) by Rhodes (1992) in a defense of the banks' contribution, was from Cline (1989). Cline later (1995, p. 209) updated his estimate to +$18 billion. The primary difference between estimates made by the Fund staff and those made by some outside analysts, the U.S. treasury staff, and by the banks is that the latter looked at actual flows (and in some cases focused on gross lending in the form of new-money agreements), while the Fund staff looked at changes in stocks. Measuring by changes in stocks implicitly adjusted for flows that were offset by such diverse and otherwise incommensurate operations as swaps, write-downs, and buybacks. There is, however, no single, generally accepted, measure of the banks' contribution. See Watson and others (February 1986), pp. 73–76, for the staff position; and Cline (1995), pp. 208–15, for an alternative view. The U.S. treasury staff's view was expressed in a letter from Mulford to de Larosière dated August 4, 1988 (in IMF/CF, S 1190 "Debt Renegotiation and Multilateral Aid, June 1988–November 1988"); that letter cited an estimate of $17 billion in net lending by banks since October 1985.

throughout the period the aggregate forecast ranged from that level to about 3 percent. The outcome was 2½ percent.[39] This degree of accuracy is surprising, not only because of the inherent difficulty in such an exercise, but also because the staff was frequently criticized at the time for being excessively optimistic about the growth prospects of the heavily indebted developing countries. At a 1988 Executive Board meeting on the World Economic Outlook, for example, Guillermo Ortiz (Mexico) argued that the staff projections were "overly optimistic, . . . encouraged the view that the problem will somehow sort itself out, and presented a perspective that is at odds with reality and also with economic analysis done elsewhere."[40]

A growth rate of 2½ percent was an improvement over the early 1980s (output declined from 1981 through 1983 and grew by just 2 percent in 1984), but it was well below the heady days of the 1970s when growth averaged nearly 6 percent a year (Figure 10.1). Furthermore, the highest growth years were 1985 (pre-Baker) and 1986, after which rates on average dropped off again. Whatever the Baker Plan might have achieved in laying the groundwork for growth, it did not by itself bring robust growth back to the heavily indebted countries.

Enhanced Surveillance

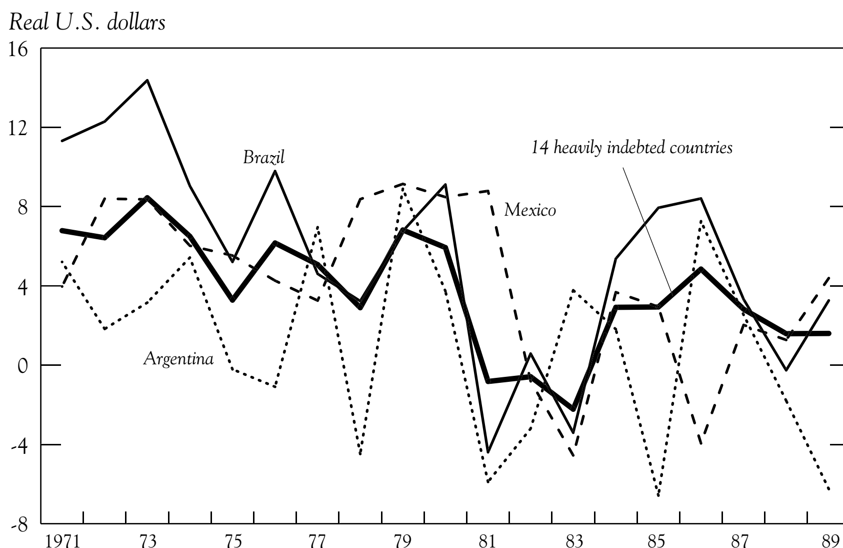
Another manifestation of the effort to use the Fund as a catalyst for external financing by other creditors was the development of "enhanced surveillance" procedures in 1985. As the reader will recall from Chapter 9, when commercial banks first assented to reschedule sovereign loans via MYRAs, they insisted that the Fund undertake to monitor developments more intensively than under the standard Article IV consultation cycle. If the country did not have a financial arrangement with the Fund, this procedure would provide a means for the authorities to provide the banks with the Fund staff's assessment of policies and economic conditions in the country on a frequent (semiannual) basis. In the second half of 1984, the existence of this option made it possible for the banks to approve MYRAs for Mexico and Ecuador and to approve in principle a MYRA for Venezuela.

The idea of enhanced surveillance was cautiously endorsed in the course of 1985 both by the Group of Ten (G-10) industrial countries and by the Group of Twenty-Four (G-24) developing countries. Creditors, however, were somewhat more enthusiastic than debtors. The report on the international monetary system that was issued by the deputies of the ministers of finance of the G-10 countries in June 1985 stated that "the Deputies encourage the IMF to continue to develop [enhanced surveillance] procedures on a case-by-case basis . . ." (para. 47). In re-

[39]*WEO*, October 1989, Table A5. The initial staff forecast was that growth would start slowly and then build up (the projected growth rates for 1986–88 were 1.8, 2.3, and 3.4 percent, respectively); the outcome was that growth was robust in 1986 and then tapered off (4.0, 2.6, and 1.1 percent). The data shown in Figure 10.1 are aggregated from later World Bank tables and exclude Yugoslavia, but the discrepancies are minor and do not affect the conclusions.

[40]Minutes of EBM/88/141 (September 7, 1988), p. 7.

Figure 10.1. Output Growth in Heavily Indebted Countries, 1971–89



Source: World Bank, *World Development Indicators*.

sponse, the G-24 deputies argued that the case for enhanced surveillance rested on "creditor unwillingness to restore normal access to external financing despite significant adjustment efforts" by the indebted countries. Their report (para. 89) recognized that in these circumstances enhanced surveillance might be necessary for countries seeking a MYRA, and it endorsed its temporary and exceptional use as a means of securing "the early normalization of market relations between the member country and the international financial system."[41]

While these outside assessments were being made, the Fund staff produced its own evaluation of enhanced surveillance, calling for its use in exceptional circumstances and proposing a set of criteria for judging whether it was appropriate in a particular case. The Executive Board met to consider the proposals shortly after Directors returned from their annual mid-August recess.[42] Both the staff and the Board were concerned that the Fund could be drawn into becoming a credit-rating agency on sovereign debts for the banks. They also were concerned that if enhanced surveillance provided a viable alternative to stand-by arrangements as a means of restoring normal access to commercial credits, the Fund's influence and "condi-

[41]"The Functioning of the International Monetary System: A Report to the Ministers and Governors by the Group of Deputies," June 1985; and "The Functioning and Improvement of the International Monetary System: Report of the Deputies of the Group of 24," August 21, 1985; both reprinted in Crockett and Goldstein (1987).

[42]"The Role of the Fund in Assisting Members with Commercial Banks and Official Creditors," EBS/85/173 (7/23/85), pp. 15–18; and minutes of EBM/85/130 (August 30, 1985) and EBM/85/131–132 (September 4, 1985).

tionality" could be weakened. As Guenter Grosche (Executive Director for Germany) noted, the "Fund's ability to influence policies of members under enhanced surveillance was extremely limited."[43] Directors generally supported the idea of enhanced surveillance, but only as a temporary and strictly limited expedient.

On September 4, 1985, the Executive Board agreed on basic principles for conducting enhanced surveillance. First, the procedure would have to be requested by the member country. Members had no obligation to accept enhanced surveillance, and it was seen as important to recognize that the procedure was being introduced as a service to those members that wanted to undertake it.[44] Second, the member would have to have already achieved a good record of adjustment and must have developed "a fully articulated and quantified policy program." In other words, the Board had to be confident that the member was willing and able to carry out an adjustment program without the conditionality of a stand-by arrangement. Third, enhanced surveillance should be limited to cases where creditors have approved a MYRA and where the procedure therefore would promote improved market relations with creditors.[45]

"Enhanced surveillance" was an unfortunate choice of terminology, because it created resistance in some countries where the procedure was considered. It seemed to imply even more severe outside policing of the government's policies and a further weakening of economic sovereignty. Translation of the phrase into other languages occasionally worsened this connotation. Officials in Yugoslavia preferred the term "enhanced monitoring," and those in Brazil preferred the even more equivocal "enhanced contacts" (or, a decade later, "enhanced collaboration"). The Fund agreed to use these euphemisms when requested, and the choice of phrasing had no substantive effect on the arrangements.[46]

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[43]The staff paper also stated this point succinctly: "Clearly, the Fund's leverage under enhanced surveillance is substantially less than in the implementation of Fund policies for the conditional use of Fund resources." See "The Role of the Fund in Assisting Members with Commercial Banks and Official Creditors," EBS/85/173 (July 23, 1985), p. 23; and minutes of EBM/85/130 (August 30, 1985), p. 36. The concern about "conditionality" was also noted in the Managing Director's summing up, at EBM/85/132 (September 4, 1985), p. 5.

[44]The legal basis for conducting enhanced surveillance as an extension of the standard Article IV consultation process was Article V, section 2(b), of the Fund's Articles of Agreement: "If requested, the Fund may decide to perform financial and technical services . . . that are consistent with the purposes of the Fund. . . . Services under this subsection shall not impose any obligation on a member without its consent." The legal position was stated by the Director of the Legal Department at EBM/85/131 (September 4, 1985), p. 6.

[45]See the Chairman's summing up of EBM/85/132 (September 4, 1985), in *Selected Decisions, Twenty-First Issue*, pp. 50–53. The summing up listed four criteria; the description here collapses the retrospective second and the prospective third into one. In February 1986, the Board clarified the terms on which members were permitted to release staff reports to creditors. Release was to be on the understanding that the reports were for no other purpose and were to be held confidentially. Decision No. 8222-(86/45), March 12, 1986; *op cit.*, pp. 49–50.

[46]See "Yugoslavia—Enhanced Surveillance—Note Prepared by the Staff for the Background Information of Executive Directors," EBS/85/171 (July 19, 1985), p. 5. "Enhanced contacts" was the brainchild of the Executive Director for Brazil, Alexandre Kafka, who coined it in 1986 to break an impasse in negotiations between de Larosière and the finance minister, Dilson Funaro.

Venezuela

In view of these doubts and strictures, it is not surprising that there were few applications of enhanced surveillance and that each of these posed its own problems. The seminal case of Venezuela (see Chapter 9) finally got fully under way after the banks signed the MYRA in February 1986, closing 17 months of negotiations. Five months later, creditors were given a staff report that detailed the staff's doubts about the adequacy of the authorities' policy stance following the sharp drop in the price of oil (Venezuela's principal export): fiscal and monetary policies were too lax, the exchange rate was overvalued and was sustained by a distortionary system of multiple rates, and structural reforms were badly needed.[47]

In discussing the staff report in late July 1986, Executive Directors endorsed the staff's views.[48] It was clear that if the banks had required Venezuela to have a Fund stand-by arrangement in place as a condition for the MYRA, a greater adjustment effort would have been required. The banks were nonetheless satisfied to accept the situation as long as the authorities stayed current in paying the interest that was due under the terms of the MYRA, and they were even prepared to renegotiate the MYRA in response to a further sharp drop in oil prices in the first half of 1986. And there the situation remained throughout the next two years, until the lack of adjustment finally induced a newly elected government (headed by President Carlos Andrés Pérez) to request an extended arrangement in February 1989 (Chapter 11).[49]

Yugoslavia

The second case of enhanced surveillance was also problematic. In August 1985, commercial bank creditors approved in principle a MYRA for Yugoslavia, under which enhanced surveillance was to become effective when the existing stand-by arrangement (the fifth consecutive such arrangement since 1979) expired in May of the following year. This time, the banks protected themselves to some extent by setting aside a portion of the debts to be covered later, conditional on a finding by creditors that Yugoslavia would be able to service the debts. The Fund reports that were expected to be provided under the enhanced surveillance procedure would be a major input for that decision.[50]

Although the Fund had earlier indicated a willingness to consider enhanced surveillance for Yugoslavia, the Managing Director was becoming increasingly reluctant to accept the proposal; the state of macroeconomic and structural policies

[47]"Venezuela—Staff Report for the 1986 Article IV Consultation," SM/86/152 (June 25, 1986); the staff appraisal is on pp. 24–26.

[48]Minutes of EBM/86/122 (July 25, 1986).

[49]For a chronology of enhanced surveillance with Venezuela, 1984–88, see "Review of Enhanced Surveillance," EBS/88/247 (December 2, 1988), p. 30.

[50]See "Yugoslavia—Enhanced Surveillance—Note Prepared by the Staff for the Background Information of Executive Directors," EBS/85/171 (July 19, 1985), to which the commercial banks' draft MYRA is attached.

was too far from what the Fund considered reasonable. At the end of May, he informed the visiting prime minister, Mrs. Milka Planinć, that a further strengthening of policies was needed before Yugoslavia would be ready for enhanced surveillance.[51] As discussions continued through the second half of the year, however, the authorities met the performance criteria under the stand-by arrangement. As the expiration of the arrangement drew nearer, the obstacles to moving ahead became less imposing. Finally, on February 12, 1986, Yugoslavia submitted a formal request to the Fund for enhanced surveillance (to be called "enhanced monitoring"), which the Executive Board approved a month later.[52]

Before the enhanced surveillance procedure was implemented for Yugoslavia, a complication arose when official creditors participating in the Paris Club asked to be included as well. When the Paris Club met in mid-April to consider Yugoslavia's request for a MYRA, it faced an exceptional situation. Official creditors normally required the indebted country to have an upper-tranche (i.e., high-conditionality) Fund arrangement in place before it would consider a rescheduling, but Yugoslavia's existing stand-by arrangement was in trouble and was about to expire.[53] Furthermore, despite the difficulties in stabilizing the economy, Yugoslavia's current account balance had shifted into surplus and the authorities were aiming to enter a period of solid debt reduction. New borrowings from the Fund were therefore ruled out. Creditor governments wanted to approve Yugoslavia's request for a multiyear rescheduling, and the Fund's intention to conduct enhanced surveillance provided a convenient basis for breaking precedent.

The implication of this development was that the Fund would have to be a bit more flexible in conducting enhanced surveillance for Yugoslavia, in order to meet the needs of official as well as commercial creditors. In particular, official creditors would—in the normal course of affairs—receive not only the staff report, but also the record of the discussion of the report by the Executive Board. Since this was the first case of enhanced surveillance in support of an agreement with official creditors, some Directors were concerned that the release of the Board's views to those creditors would necessarily trigger on/off decisions regarding the MYRA. That is, if Executive Directors agreed that the authorities had not met the goals of their program, official creditors might well use that information to not go ahead with the next installment of their rescheduling. The Fund in that case could find itself taking responsibility for decisions and actions over which it had little influence and no control, as it had in the special arrangement with Colombia a year earlier (Chapter 9).

[51]Memorandum for files (June 13, 1985) by Brian E. Rose (Deputy Director, European Department); in IMF/RD Managing Director file "1985—Yugoslavia I" (Accession 87/136, Box 3, Section 168). Also see memorandum of May 30, 1985, by L. Alan Whittome (Counsellor and Director, European Department); same file.

[52]The request was in a letter reproduced in "Yugoslavia—Staff Report for the 1985 Article IV Consultation and Review Under the Stand-By Arrangement," EBS/86/38 (February 19, 1986), pp. 36–37. The Executive Board considered the request at EBM/86/44–45 (March 12, 1986) and approved it via Decision No. 8221-(86/45), adopted March 12, 1986.

[53]The first four drawings had been made on time, but two waivers would be required from the Executive Board for the authorities to make the last scheduled drawing in mid-May.

The distinction that the staff emphasized in allaying these concerns was that under enhanced surveillance the member country did not undertake to meet specific quantitative performance criteria. The staff report would discuss the extent to which various goals had been reached, but it would emphasize whether the thrust of the program was being carried out, not whether each target had been met. Both within the Executive Board and among official creditors, opinions might well differ on the significance of departures from desired performance. Furthermore, once initiated, enhanced surveillance could continue regardless of whether the program was carried out as intended; there was no requirement for waivers in case of missed targets as there was for stand-by arrangements. There would thus be no automatic triggers implied either in the staff report or in the Board discussion. On the basis of that understanding, on May 12, 1986, the Board approved the extension of enhanced surveillance with Yugoslavia to cover official creditors acting through the Paris Club.[54]

The Fund's experience in implementing enhanced surveillance with Yugoslavia was not entirely happy. By the time the first consultation report was discussed, in August 1986, policies were already going off track. Economic policy in Yugoslavia was at a crossroads in the mid-1980s: the momentum was toward liberalization, but the inertia of the old "workers' self-management" system remained strong. At the Executive Board meeting on August 8, a number of Directors noted that they had approved the use of enhanced surveillance rather than insisting on a new stand-by arrangement in the belief that the authorities were committed to pushing ahead toward a market economy. Now, just a few months later, that commitment was in doubt.[55]

The Fund's confidence in the thrust of policies in Yugoslavia continued to deteriorate over the next year. In March 1987, the Executive Board (in consonance with the views of the staff) expressed even stronger reservations than before. Not only was the liberalization of the economy proceeding at a very slow pace; monetary and fiscal policies were lax, and inflation was accelerating. Directors were beginning to have second thoughts about continuing with enhanced surveillance ("a sense of some discouragement about the experience to date," as Dallara phrased it, was not uncommon), and some urged the Yugoslav authorities to apply once again for a stand-by arrangement.[56]

Following the Board meeting, the Yugoslav authorities quickly reformulated policies to strengthen the adjustment effort before the Paris Club met at the end of March. On March 30, the Federal Secretary for Finance (i.e., the finance minister), Svetozar Rikanović, presented the new measures to the Paris Club: notably, interest rates were being raised to levels that exceeded the inflation rate, and leg-

[54]Specifically, the Board authorized the Managing Director to release the summing up of the Board discussions, along with the staff reports, to the Chairman of the Paris Club. Whereas the reports released to commercial creditors would be purged of confidential information such as recaps of earlier consultation discussions, the Paris Club would receive the unexpurgated version. Minutes of EBM/86/80 (May 12, 1986), pp. 23–24.

[55]Minutes of EBM/86/134 (August 8, 1986).

[56]Minutes of EBM/87/44–45 (March 13, 1987). Dallara's remark is on p. 20 of EBM/87/44.

islation was being implemented to limit the growth in wages.[57] Official creditors demurred, responding that they would reconsider the request for a MYRA only after the Fund reevaluated Yugoslavia's policies on the basis of the minister's presentation.

When the Executive Board met again just three weeks later to resume the enhanced surveillance discussion on Yugoslavia, Directors were less than impressed. Most of what was announced on March 30 had already been known when the Board had met earlier, and what was new was still less than what Directors had already said was needed. The Board concluded that a further strengthening of policies would be needed before the authorities could expect to see a sufficient improvement in economic conditions.[58]

Other creditors were somewhat more upbeat. In May, the banks proceeded with the second tranche of their MYRA, and the next month the Paris Club followed suit. But the Executive Board remained adamant. The next time Directors met to consider the situation, on August 31, 1987, most of them were agreed that Yugoslavia could not get policies under control until they undertook a new conditional arrangement with the Fund. As the Managing Director summed up the discussion:

> Yugoslavia's record of adjustment under enhanced surveillance had been disappointing and this had adversely affected both Yugoslavia's credibility abroad and the needed flow of foreign financing. . . . Directors concluded that a firm stabilization program accompanied by supply-promoting measures was essential to get inflation under control and to pursue satisfactory rates of growth and that such a program should be elaborated and implemented in a close and formal relationship with the Fund.[59]

In short, enhanced surveillance had failed in this case: it had succeeded in catalyzing external financing on a multiyear basis, but at the cost of a serious delay in stabilizing the economy.

Before the end of 1987, the Fund's view prevailed with other creditors as well. By November, both the banks and the Paris Club informed the Yugoslav authorities that they would have to negotiate an upper-tranche arrangement with the Fund as a precondition for any further rescheduling. The authorities requested a stand-by arrangement in December, a program was successfully negotiated over the next four months, and in June 1988 the Executive Board approved a one-year arrangement for SDR 306 million (50 percent of quota, or just over $400 million).[60]

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[57]For the first quarter of 1987, inflation had been running at an annualized rate of about 130 percent. On April 1, interest rates on term deposits of six months or more were raised from around 60 percent to more than 80 percent. On the basis of a partial price freeze that had been put in place on March 20, these interest rates were projected to be positive in real terms. "Yugoslavia—Consolidation of External Debt Vis-à-Vis Official Creditors," EBS/87/79 (April 13, 1987), pp. 6–15.

[58]Summing up of the discussion; minutes of EBM/87/62 (April 20, 1987), pp. 53–54.

[59]Summing up of the discussion; minutes of EBM/87/126, pp. 29–30.

[60]Minutes of EBM/88/88 (June 1, 1988).

Uruguay

The third and final application of enhanced surveillance in the 1980s was at least initially more successful. Uruguay was in the middle of an 18-month stand-by arrangement with the Fund when the banks approved a MYRA in July 1986. The bank agreement provided that reschedulings in 1987–89 were to be contingent on Uruguay either having a new stand-by arrangement with the Fund or being under enhanced surveillance. Uruguay successfully completed the Fund-supported program in March 1987, and the Executive Board approved the authorities' request for enhanced surveillance in July.[61] The Fund then conducted enhanced surveillance with Uruguay for the next two years. Through 1988, both the staff and Executive Directors gave a generally good report card to the authorities for the implementation of stable economic policies. By 1989, however, the authorities were losing the momentum of their adjustment effort, and fiscal policy was becoming increasingly lax. Enhanced surveillance was successfully completed, but the following year, the newly elected authorities requested a new stand-by arrangement.

Assessment

Judging only from the record of implementation in the 1980s, enhanced surveillance would have to be rated a failure: three cases were approved in the first five years of operation, and in at least the first two cases the process probably delayed and certainly did not prevent the need for more stringent and Fund-supported adjustment measures. There were, however, several other cases in which the option of having the Fund conduct enhanced surveillance in the future gave confidence to private or official creditors that were contemplating requests for multiyear reschedulings. In addition to the cases of Mexico and Ecuador that were discussed in Chapter 9, commercial bank creditors approved MYRAs with enhanced surveillance provisions for both the Dominican Republic and Côte d'Ivoire in 1986, and in several more countries in later years. With this broader perspective in mind, though no one would consider enhanced surveillance to have been an unqualified success, a case could be built for its continued use in dealing with the exceptional strains facing some of the world's most heavily indebted countries.[62]

[61]Minutes of EBM/87/110 (July 27, 1987).

[62]The Executive Board conducted three general reviews of enhanced surveillance in this period. In March 1987, the Board approved continuation of the procedure but suggested that some means should be found of terminating it in case of noncooperation by the authorities. In March 1988, no further changes were recommended. In February 1989, it had become clear that the Fund had no effective means of extricating itself from undertaking enhanced surveillance once the procedure had been initiated. The Board determined that the use of the procedure should be further restricted by applying the criterion of "a strong record of adjustment" more strictly. See the minutes of EBM/87/48–50 (March 17–18, 1987); EBM/88/53–55 (March 30–31, 1988); and EBM/89/12–13 (February 8, 1989).

Stand-By Arrangement with Mexico

Mexico was in crisis at the beginning of 1986. Fiscal policy had to be reined in substantially to cut public sector borrowing from the extraordinarily high level (about 10 percent of GDP) of 1985, and the adjustment would have to be made at a time when the economy was scarcely in shape to absorb another shock. As recounted in Chapter 9, the Fund lent just under SDR 300 million (approximately $330 million) in January 1986 under the natural disaster relief program to help Mexico rebuild after the earthquakes of the previous year. A few months later, the IBRD lent Mexico $400 million for the same purpose. Long-run growth prospects were brightening in response to the substantial measures being implemented to liberalize foreign trade; Mexico was now close to completing its accession to the GATT.[63] These and other efforts were, however, small in relation to the magnitude of the initial economic imbalances in Mexico, and they were completely swamped by the ongoing collapse in the world price of petroleum, Mexico's primary export.

Relations between Mexico and the IMF in 1986–87 revolved around two main problems. First, there was a major dispute over fiscal policy: how much adjustment was needed to contain inflationary pressures and reduce the external deficit, how much could the budget be reined in without unduly restraining economic growth, and how should the adjustment be measured and assessed? After several months of negotiations, a compromise was reached under which Mexico agreed to strengthen its adjustment effort, while the Fund agreed to include a contingency plan in case of an unanticipated decline in output and to use an inflation-adjusted measure of the fiscal balance as one measure of success. Second, commercial bank creditors—especially the smaller banks—were reluctant to help finance the Mexican program on the large scale that the Fund judged to be necessary. Overcoming that reluctance seriously delayed and complicated implementation of the program and nearly caused it to fail altogether.

Negotiating on a Treadmill: October 1985–June 1986

The IMF planned to send a staff team to Mexico City in October 1985 to begin negotiations on a possible stand-by arrangement. The Mexican authorities, however, preferred to come to Washington instead. Consequently, a number of Mexican officials, led by the minister of finance, Jesús Silva Herzog, made several visits to Washington between December 1985 and March 1986, meeting not only with the Fund staff but also with the Managing Director, U.S. officials, the management and staff of the World Bank and the IDB, and commercial bank creditors. The key issue during these meetings was fiscal policy. The government had proposed, and congress had approved, a budget for 1986 calling for a public sector borrowing requirement of about 4 percent of GDP. That target was down from the outturn of nearly 10 percent in 1985 and was sufficiently ambitious, but the Fund staff

[63]Mexico formally joined the GATT on August 26, 1986.

pointed out that the target for 1985 had also been about 5 percent. In the circumstances, the staff believed that credibility could be achieved only by taking substantial action early in the year. The authorities countered that the adjustment had to be gradual to avoid throwing the economy into an even more serious tailspin.

By mid-March, Mexico faced a mini-crisis in its external financing, in that a payment of $950 million in principal was due to foreign commercial bank creditors on March 21, and little progress had been made toward establishing the terms on which the banks would be prepared to roll it over. The banks' position was that they could not agree to an overall financing plan until the Fund approved and Mexico signed a Letter of Intent for a stand-by arrangement. After Mexico agreed to open full negotiations with the Fund, however, the banks agreed to the six-month rollover. Soon afterward, Joaquín Pujol (Assistant Director, Western Hemisphere Department) led two missions to Mexico City to negotiate terms for a stand-by arrangement.[64]

The outlook for the economy and for success in these talks was grim. From December 1985 to April 1986, while the government tried to implement tax and spending measures aimed at nearly halving the fiscal deficit, the decline in the export price of Mexico's oil reduced fiscal revenues by some 4 percent of GDP. Meanwhile, higher-than-anticipated inflation and depreciation raised the government's projected interest outlays for the year by 4½ percent of GDP. The government responded by making further cuts in the budget, but they were being beaten back on the treadmill. The deficit was going up, not down.

Pujol recommended that the authorities find a way to cut the deficit by another 5–6 percentage points of GDP. Otherwise, they would be unable to cover it without heavy recourse to inflationary finance. The authorities responded that the effects of inflation and depreciation on interest costs should be accommodated and thus excluded from the calculated financing requirement. Accordingly, they proposed to limit additional measures to 2½ percent of GDP, or just under half what the Fund was asking. In effect, the Mexican position was the same as that of Brazil since 1983: that the appropriate measure of fiscal policy was not the actual deficit, including inflationary effects on interest payments, but rather the operational budget, excluding those effects.

Pujol's missions having ended in an impasse, a team of Mexican officials went to Washington on May 21–23, 1986, to talk directly with the Managing Director. De Larosière did not budge, believing that Mexico had to undertake a major fiscal retrenchment if the government was to escape its dependence on external borrowing. The authorities indicated that they were prepared to open discussions with bank and other creditors with or without the Fund, but what little ability they might have had to do so was rapidly disappearing. Through April, Mexico had

[64]The decision to limit the request to a stand-by arrangement rather than a longer-term extended arrangement was dictated in part by the electoral cycle; a new government would take office in 1988. In addition, there was a general view at the time that the EFF was to be reserved for detailed structural programs; Mexico having just completed such a program in 1985, an ordinary stand-by arrangement was considered more appropriate.

maintained a measure of credibility in foreign exchange markets by keeping the exchange rate competitive and by pursuing a tight domestic credit policy. By May, however, worries about the fiscal deficit were inducing an acceleration of capital flight. On June 3, the central bank announced that it had lost $500 million in reserves during May, bringing the total loss for the first half of the year to more than $1.5 billion and leaving net reserves at a precarious level.[65] Mexico had to negotiate a solution quickly—or default.

Discussions between Mexico and the Fund continued nonstop through the first half of June, with de Larosière and Silva Herzog both actively involved and Volcker and Mulford serving as U.S. intermediaries. The sequence of events was complex, but it is worth examining in some detail in light of what followed.

By June 6, de Larosière agreed in principle with Silva Herzog that Mexico could use the operational deficit as one fiscal target, so long as the overall deficit was also targeted; the two sides, however, remained far apart on the issue of how large the fiscal adjustment should be. On June 9, Volcker traveled to Mexico City to meet with President Miguel de la Madrid, under an elaborate cloak of secrecy aimed at preventing reporters from spotting the extremely visible Chairman and generating speculation about the meaning of his visit at this delicate time.[66] Over breakfast that morning, he impressed upon the president the importance of reaching an agreement both with the Fund and the commercial banks, and he received what he interpreted as a positive and encouraging response. The next day, Silva Herzog phoned de Larosière to say he was encouraged by Volcker's visit, and he suggested that negotiations be quickly resumed.

Silva Herzog immediately sent a team of officials to Washington, but negotiations remained deadlocked over the ceiling on the fiscal deficit. When Silva Herzog telephoned de Larosière again on the evening of June 12, the Managing Director insisted that Mexico make a commitment to cut the deficit by 2½ percent in 1986 and another 2½ percent in 1987. Although that would leave the deficit larger than originally envisioned, it would require much larger program cuts to achieve, reflecting the adverse shocks that had already occurred. Silva Herzog replied that such measures would be impossible to undertake, and he offered to come to Washington himself the next day for face-to-face talks.

[65]Mexico's gross foreign exchange reserves totaled $7.3 billion at the end of 1984, $4.7 billion at the end of 1985, and less than $3.2 billion at end-June, 1986. For those three dates, net international reserves (including payments agreements but subtracting net liabilities to the IMF and to official creditors for swaps) amounted to $6.5 billion, $3.1 billion, and $1.2 billion, respectively. "Mexico—Staff Report for the 1986 Article IV Consultation and Request for Stand-By Arrangement," EBS/86/161, Sup. 1 (August 15, 1986), p. 11.

[66]At a height of 6 feet, 7 inches, Volcker proved difficult to hide, though he made part of the trip in a Mexican government plane and was housed at a private home instead of a hotel. His presence was soon discovered by the Mexican press (see *Uno Más Uno*, June 10, 1986, p. 3). In Washington, President Reagan inadvertently broke the secrecy by mentioning the trip *en passant* during a press conference on June 11. Years later, Volcker discussed the trip in Volcker and Gyohten (1992), p. 214–15. Additional information here is from background interviews and file memorandums.

De Larosière also was encouraged by the way events were unfolding. He and Silva Herzog knew and respected each other well, having struggled together for four years to put Mexico on a sustainable path. On the morning of the 13th, he reported to the Executive Board that the staff was in close contact with the authorities and that—although the political situation was "fluid"—discussions were "moving in a constructive way."[67] His optimism was premature. Silva Herzog had to postpone his trip to the Fund, which he now planned to make on June 17. In the meantime, de Larosière met on the 16th with U.S. Treasury Secretary James Baker, who applied pressure by reminding him that if the Fund did not show enough flexibility to reach an agreement with Mexico, the alternative would be a confrontation with creditors that could have repercussions on other countries in the region.

The stage was thus set for a likely agreement, but then the curtain fell. Silva Herzog, either because he was seen as too closely identified with Washington or because he was being outmaneuvered by others in the cabinet who saw him as an obstacle to their political ambitions, apparently had become isolated from the inner circle in the government.[68] On June 17, instead of coming to Washington to meet with de Larosière, Silva Herzog resigned. The president immediately named Gustavo Petricioli to replace him, and before the day was out de Larosière telephoned the new minister to "renew our acquaintance" and to suggest an early resumption of negotiations.

Approval "In Principle": July–September 1986

Petricioli headed north on June 27 for his first meeting as minister with the Managing Director. His message was straightforward: too much fiscal contraction would stifle economic growth, and without growth Mexico would be unable to meet its obligations to foreign creditors. He did not want an agreement to which he could not adhere. De Larosière responded that the current fiscal stance would aggravate inflation; the only way to resume and sustain growth was to undertake substantial structural reforms. An agreement was as distant as ever, but the two men agreed to meet again in two weeks, on July 11.

On July 7–8, the Managing Director attended the monthly meeting of the BIS governors in Basel, Switzerland, to make the case for a bridge loan to Mexico from the major central banks. He felt that the authorities were still very close to reaching an agreement with the Fund, and it would be essential for Mexico to have enough money up front to staunch the outflow of reserves in the interval before the Executive Board could meet to approve the loan. The Basel discussion, however, was preliminary, and no action was taken on the request.

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[67]Minutes of EBM/86/96 (June 13, 1986), p. 3.

[68]In the 1980s, responsibility for the budget in Mexico was split between the secretary of finance and the secretary of budget and planning. Basically, the former (Silva Herzog) controlled revenues while the latter (the future president and eventual fugitive, Carlos Salinas) controlled spending.

Petricioli's message to the Managing Director at their second meeting, at the end of the afternoon of July 11, was distinctly pessimistic. Mexico was losing reserves so rapidly that it could not afford to continue negotiating. He understood that the Fund had to adhere to its conditions, but he had no more concessions to give. It would be better for him to go home with no agreement, even knowing that such a failure would force Mexico to default on its interest payments and impose exchange controls, than to go home with an agreement that would wreck economic growth and that would be seen as an external imposition of policies on the government. In fact, he had already made his airplane reservation for the next morning, and he showed his ticket to de Larosière as a demonstration of his resolve. Although Petricioli may have been bluffing, de Larosière was determined that these talks should not fail: they were critically important both for Mexico and for the Fund. He responded to the minister that the two sides were not that far apart, and he persuaded him to stay in Washington and to meet with him again the next morning (Saturday) to consider how they might break the impasse quickly.

The day before this meeting, Petricioli's technical advisors had tabled a new proposal to the Fund staff, to the effect that the government would agree to implement additional fiscal cuts if the price of oil were to fall below a benchmark level. Friday night, after consulting with a few of his senior staff, de Larosière decided to use that idea as the foundation for an innovative program. His meeting with Petricioli had convinced him that the government's fundamental concern was that additional fiscal action would reduce growth. The Fund staff, in contrast, based its recommendations on projections indicating that growth could be sustained better with some additional fiscal restraint. By 10:00 Saturday morning, when Petricioli and his team[69] returned to the Managing Director's office on the twelfth floor of the IMF, de Larosière had devised a plan to reconcile the two positions.

De Larosière's proposal was to introduce a growth contingency into the program. As he presented it on Saturday morning, the idea was that the authorities would agree up front to make an extra fiscal effort. If GDP growth were to fall below a benchmark level, then they could implement an additional public investment program, financed by additional loans from the Fund. If the Mexican growth forecast was correct, they would get the program they wanted. If the Fund forecast was correct, Mexico would implement the more austere budget suggested by the Fund staff. Petricioli agreed that this proposal could serve as the basis for continuing the negotiations.

Meetings between the staff and the Mexican technical team, and between the Managing Director and the finance minister, continued throughout Saturday and Sunday.[70] De Larosière—after consulting with Barber Conable, the president of

[69]Petricioli's strong group of advisors on this trip included the three men who would succeed him as finance minister over the coming decade: Pedro Aspe Armella (1988–94), Jaime Serra Puche (1994), and Guillermo Ortíz Martínez (1994–97).

[70]This account of the negotiations is based in part on the author's interviews with participants and on notes taken by the staff during the meetings, in IMF/RD Managing Director file "Mexico—Vol. IV" (Accession 88/274, Box 9, Section 269).

the World Bank—modified his proposal so as to shift the commitment to finance the contingent investment program from the Fund to the International Bank for Reconstruction and Development (IBRD) and the commercial banks. Meanwhile, the Mexican team insisted that in addition to the growth contingency, they needed to allow for the possibility of a further decline in the price of their oil exports. The Fund accepted that idea, with the modification that the mechanism be symmetric: the Fund would provide additional resources if the export price fell below $9 a barrel, and its commitment would be commensurately reduced if the price rose above $14. For its part, Mexico agreed to strengthen its measures to reduce the fiscal deficit, primarily by raising public sector prices enough to raise revenues by about 1 percent of GDP.

By Sunday evening, agreement had been reached on the substance of a program that Petricioli felt comfortable taking to President de la Madrid for approval and that de Larosière felt comfortable taking to the Executive Board for its approval. The economic program was to be supported by an 18-month stand-by arrangement for SDR 1.4 billion (120 percent of quota, or approximately $1.7 billion), including SDR 1 billion from borrowed resources made available under the enlarged access policy (see Chapter 17). If the oil-price contingency was fully utilized, another SDR 800 million would be made available. In less than a week, the president approved the program, and on July 22, Petricioli returned to Washington to sign the Letter of Intent. The main remaining difficulty was a rather large financing gap that would have to be filled by other official and commercial creditors.

The official financing would be large and complex, involving both short-term bridge financing from the United States and from G-10 central banks via the BIS, but it would not be out of line with previous practice since 1982. To make sure there would be no slippages, de Larosière took personal responsibility for lining up support. He met with Mulford and other U.S. officials on Thursday, July 17; a few days later, Secretary Baker publicly supported the program, and the treasury began quietly arranging for additional short-term financing including assistance from the Export-Import bank and similar agencies in other major creditor countries. The following week, de Larosière cabled the BIS governors, all of whom responded favorably to the request for a bridge loan; the BIS formally approved the loan in late August. On July 22, Conable announced the World Bank's intention to support the program with new loans. The Bank announcement, for a series of loans totaling some $1.4 billion, was especially important for the program, not only because it would provide medium-term support for investment and structural reforms, but because it constituted the second leg of the Baker strategy for three-legged support.[71]

To complete the official package, Mexico requested a rescheduling of outstanding obligations through the Paris Club. What complicated this process was the web

[71]Conable issued a press release on July 22, announcing that the Bank's Executive Directors would soon be considering three loans totaling $698 million, that additional loans totaling $700 million would be considered within a few months, and that the International Finance Corporation (IFC, a member of the World Bank Group) would also be lending to Mexico. The Board approved the initial request on July 29.

of interrelationships between various pieces of the official financing. The Paris Club required Fund approval for Mexico's program and maintenance of export cover by bilateral creditors. Those bilateral credits in turn depended on the Paris Club. The BIS bridge loan and the Fund stand-by arrangement depended on each other, and the BIS deal also depended on participation by private as well as central banks and the U.S. Treasury. Throughout August and early September, the Managing Director acted as an intermediary, keeping various creditors informed on the status of others' deliberations and intentions and making sure the package held together.

The third leg of the strategy—a rise in exposure by commercial creditors—was even more of a problem, both because many bankers were skeptical about Mexico's promises and because the amount of the financing that the Managing Director was about to request would have to be so large that there was a real risk that it would be rejected. On July 23, de Larosière and Petricioli flew together to New York for a pair of meetings with bank creditors: a general meeting and dinner at the Pierre Hotel that evening with some 80 bankers (attended as well by Conable) and a smaller session with the Advisory Committee the next day at the offices of Citibank's legal advisors. De Larosière explained to the bankers the complex financial package, including the oil and growth contingency mechanisms. While the latter would be financed largely by the World Bank, the oil-price contingency would have to be funded partly by the IMF and partly by the banks; de Larosière suggested that the banks make a contingent commitment of $1.6 billion, compared with the Fund's SDR 800 million commitment.[72] Apart from this contingency, he asked the banks to arrange a "new money" loan for $6 billion covering the rest of 1986 and 1987.

The Advisory Committee for the commercial banks sent its economic subcommittee to Mexico City in early August (following a briefing at the Fund) to review the economy and assess Mexico's financing needs. The authorities, meanwhile, were devising a complex financing proposal of their own, which included partial capitalization of interest payments, several options relating to different maturities, and indexing interest payments to oil prices. Detailed negotiations between the Committee and the authorities (led, as always, by Mexico's chief debt negotiator, Angel Gurría) did not begin until September, by which time there was no possibility of reaching an agreement—much less assembling a "critical mass" of commitments—before the scheduled meeting of the Executive Board on September 8.

On Thursday, September 4, William Rhodes, Citibank's vice chairman and head of the Advisory Committee, informed the Managing Director that the banks'

[72]This 2:1 ratio, as the Managing Director characterized it, became an accepted part of the ensuing negotiations, but the term initially was misleading because the two shares were denominated in different currencies (SDRs from the Fund and U.S. dollars from the banks). At prevailing exchange rates, the Fund's contingent exposure was approximately $940 million, and the effective ratio of commitments was therefore 1.7:1. The total contingent liability to Mexico under this mechanism, which would have come into play if the oil export price had fallen persistently below $9 a barrel, was intended to be $2.5 billion. In the final agreement, as explained below, these amounts were reduced, but the notional 2:1 ratio was essentially retained.

negotiations were going to take quite a bit longer. That evening, de Larosière telephoned several of the Fund's Executive Directors to seek their support for holding the Board meeting as scheduled but with the intention of taking the "exceptional" step of approving the stand-by arrangement "in principle," subject to provision of financing by the banks and Paris Club creditors.[73] He made a more formal report to the Board Friday morning, and without objection the meeting was left on the schedule for Monday.

The Board meeting on September 8 was tense. Several Executive Directors, including Jacques Polak (Netherlands), expressed serious reservations about Mexico's ability to service the additional debts that it was proposing to take on. In their view, the staff's medium-term scenarios were unduly optimistic. Directors also expressed doubts about the wisdom of including a target for the operational fiscal deficit, on the grounds that it could weaken the authorities' incentive to control inflation. For the most part, however, these objections were swept away by the fear that refusal to approve the arrangement would undermine the adjustment program, that without the program the Mexican economy would collapse, and that failure in Mexico would have global and systemic repercussions that the world could not afford. Polak, for example, noted "the crucial role of Mexico in the development of the international debt situation," and Michael Foot (Alternate, United Kingdom) stressed the "importance of its orderly adjustment to the international monetary system."[74]

Some Directors also questioned the appropriateness of the two contingency mechanisms in the program.[75] As a matter of principle, Polak would have preferred that the oil-price contingency be handled through the Compensatory Financing Facility (CFF) rather than as part of a stand-by arrangement. Those Directors representing developing countries, however, found the handling of the growth and oil-price contingencies to be a welcome sign of flexibility, and Charles Dallara (United States) and Hirotake Fujino (Japan) also supported the innovation. De Larosière defended the growth contingency by noting simply that it was designed to bridge the difference in view between the authorities and the staff on the effects of fiscal contraction: the authorities believed it would slow growth, while the staff believed "strongly" that it would promote the growth of the private sector. Introducing the contingency mechanism had persuaded the authorities to accept "what they had believed to be an excessively demanding fiscal component" of the program.[76] In any

[73]The practice of approving programs in principle, pending completion of agreements with other creditors, began with the 1983 stand-by arrangement with Sudan (see Chapter 16). For a general discussion of the practice between that case and that of Mexico in 1986, see Chapter 9; on the interaction between stand-by arrangements and purchases under the CFF when arrangements are approved in principle, see Chapter 15.

[74]See minutes of EBM/86/148–49 (September 8, 1986). The remarks by Polak and Foot are at meeting 86/148, pp. 23 and 24.

[75]The proper treatment of contingencies was under general discussion at the time, in the context of reviews of the design of Fund-supported programs. See Chapter 15.

[76]Minutes of EBM/86/149 (September 8, 1986), p. 34; also see the statement by Pujol on the growth contingency, p. 39.

case, concern over the growth contingency was no doubt muted by the fact that the Fund's involvement in it was largely technical rather than financial.[77]

One Director, Yusuf A. Nimatallah (Saudi Arabia), complained that the Managing Director had acted unilaterally during the negotiations and had not adequately consulted with the Board. In response, de Larosière expressed his concerns and asked the Board collectively whether there was a lack of confidence in his handling of the negotiations. Alexandre Kafka (Brazil), the Dean of the Board, spoke for his colleagues in expressing their "full confidence" in him, and the moment passed.[78]

In the end, only one Director—C.R. Rye (Australia)—abstained from approving the arrangement in principle. In Rye's view, Mexico's economic problems had arisen from fundamental policy errors that predated the earthquakes and other exogenous disturbances; real interest rates were negative, the real effective exchange rate had been allowed to appreciate, and growth in domestic credit was excessive. He doubted, therefore, that the proposed program was sufficient to correct the imbalances in the economy. Other Directors, including Dallara and Jacques de Groote (Belgium), shared the view that Mexico had failed to implement its previous program but were less pessimistic about the future.

Financing the Program: September–November 1986

The Executive Board approved the arrangement on the condition that the bank and Paris Club financing be in place by September 29.[79] That left just three weeks to complete the negotiations and obtain a critical mass of commitments. Few people other than the Managing Director seemed to believe it could be done, but de Larosière was determined to try. On September 11, he met with Ortiz and the minister of planning, Carlos Salinas. His message to them was that the Fund was refusing to give in to pressure from the banks to reduce the financing request below $6 billion, but Mexico would have to be flexible and realistic in discussing terms with the banks. He specifically asked that Mexico drop its insistence on capitalizing interest and linking interest payments to the price of oil, both of

[77]Under the final terms of the arrangement, the Fund assumed responsibility for certifying whether industrial production had fallen by more than a 1 percent annual rate in any period. If so, and if the growth facility—formally known as the "supplementary capital expenditure contingency mechanism"—were then activated by a request from the authorities, the performance criteria for the arrangement would be modified to allow the public sector borrowing requirement to rise by up to $500 million. The IBRD agreed that under these circumstances, it would seek to identify investment projects that would promote real growth. Such projects then would be cofinanced by the IBRD and the commercial bank creditors. "Mexico—Stand-By Arrangement," EBS/86/161, Sup. 6 (November 20, 1986), pp. 20–21.

[78]Minutes of EBM/86/148 (September 8, 1986), pp. 13–14.

[79]"The stand-by arrangement . . . shall become effective on the date on which the Fund finds that satisfactory arrangements have been made with respect to the financing of the estimated balance of payments deficits for the period of the stand-by arrangement, but provided that such finding shall be made not later than September 29, 1986." Executive Board Decision No. 8385-(86/149), adopted September 8, 1986.

which the banks were extremely reluctant to accept.[80] An interim deadline of September 19 had been set for concluding an agreement with the Advisory Committee, but that deadline could be met only if rapid progress was made on such issues.

The Paris Club agreed on September 15 to reschedule official credits, but the September 19 deadline for a committee agreement came and went without seeing much progress on that front. Negotiations between Mexico and its bank creditors were still deadlocked on the handling of the contingency mechanisms and other terms. At the end of the month, however, the expiration of the provisional Board approval of the stand-by arrangement provided an incentive for both sides to reach an accommodation. The Annual Meetings were being held in Washington, and on September 30 the chairmen of the Advisory Committee banks met with the Mexican negotiators at the Sheraton Hotel to try to unblock the agreement.[81] Volcker, Conable, and de Larosière also attended at least part of the meeting, which lasted for several hours. The World Bank helped the process along by offering to guarantee up to 50 percent of the banks' disbursements under the growth contingency, applied to the longer maturities.[82] Eventually, all that was preventing an accord was a disagreement over the interest rate to be charged. The Mexican government was refusing to pay more than ¾ of a percent over LIBOR, while some of the major banks were holding out for ⅞. At one point, it appeared that a compromise would be reached whereby part of the loan would be at one rate and the rest at the other, but the bankers could not agree among themselves as to how to split it. Finally, Volcker—clearly frustrated—found the winning formula by suggesting that they make the whole loan at 13⁄16 over LIBOR: a solution that had escaped everyone simply because such a fraction had never been used before and seemed silly on its face.[83] (Oddly, in future bank deals, the use of sixteenths in computing spreads became a fairly common practice.)

After Rhodes informed de Larosière that the banks and the Mexican authorities had reached agreement in principle on the $6 billion package, the Managing Director called an Executive Board meeting for that evening (held, exceptionally, at 6:15 p.m., at the Sheraton). The decision taken on September 8 to approve the program contingent on bank financing had lapsed the day before. The banks now also had an agreement in principle, but the Fund had to give the Advisory Committee time to negotiate detailed terms and then to secure commitments from hundreds of creditor banks. In the meantime, Mexico would have some additional

[80]In fact, it was primarily the U.S. banks that were opposing the capitalization of interest. In many countries, bank creditors preferred that option to concerted lending.

[81]A separate meeting was held across town, at the National Geographic Building, at which a Mexican team headed by Ernesto Zedillo (an advisor to Petricioli and later president of Mexico) successfully negotiated terms for rescheduling private sector debts under the FICORCA scheme (on which, see Chapter 9, p. 360).

[82]"Mexico—Request for Stand-By Arrangement," EBS/86/161, Sup. 5 (October 29, 1986), pp. 11–12.

[83]For an account of this meeting, see Volcker and Gyohten (1992), p. 215. Additional information is from background interviews with participants and from IMF files.

financing available in the form of the bridge loan from the BIS.[84] De Larosière informed the Board that Rhodes believed the banks could obtain a critical mass of commitments by the end of October;[85] if they failed, then it would be difficult for the banks to disburse any money from the new loan before the end of December. He was not asking Directors to renew their provisional approval at this time, but he expected to be in a position to ask for final approval by October 31.[86]

The banks also had to agree on the details of their participation in the two contingency clauses, a process that took another precious ten days to complete and that further complicated and delayed final approval of the stand-by arrangement. The banks insisted that their participation be linked to that of the IBRD as well as the Fund. After some resistance, Mexico agreed. The banks also obtained agreement from the Fund that its participation in the oil-price contingency would be front-loaded, so that the 2:1 participation ratio would be reached only if the facility were fully utilized.[87] Erb reported to the Executive Board on October 10 that discussions on these and other points were continuing and were likely to require some modification to the program.[88] Agreement on terms was finally reached among the Mexican authorities, the Advisory Committee, and the management of the Fund and the Bank on October 16. That evening, the Managing Director cabled the Committee banks that he would need written assurances of their financing commitments (i.e., a critical mass of acceptances) by October 31 in order for the stand-by arrangement to proceed.

The second half of October was a virtually nonstop "road show" in which the Advisory Committee, the staff and management of the Fund and the IBRD, the central banks of creditor countries, and the Mexican authorities all tried to sell the loan package—which now had a potential total value of $7.7 billion—to reluctant bankers around the world.[89] Matters were not helped when the Mexican govern-

[84]The bridge loan totaled $1.6 billion: $400 million from the BIS, guaranteed by 11 central banks; $700 million from the U.S. Treasury and the central banks of Argentina, Brazil, Colombia, and Uruguay; and $500 million from a syndicate of 54 commercial banks. See BIS, *Annual Report*, 1986/87, p. 184.

[85]The magnitude of the critical mass was understood in this particular case to be "approximately 90 percent." Cable from de Larosière to the office of Shearman and Sterling, the principal attorneys for the Advisory Committee (November 21, 1986); in IMF/RD Managing Director file "Debt—1985" (Accession 88/179, Box 3, Section 517). The 90 percent level had been used in the original concerted lending package for Mexico in December 1982 (Chapter 7), but subsequently 95 percent had become more customary.

[86]Minutes of EBM/86/163 (September 30, 1986).

[87]Under the final terms of the agreement, the Fund agreed to cover the first $200 million shortfall in export receipts in the event of a decline in oil prices below the benchmark level. Beyond that, the participation ratio would be 3:1 up to a maximum of $1.2 billion from the banks and $600 million from the Fund. (In a further departure from standard practice, the Fund's commitment under this clause was made in dollars, not SDRs. The ratio thus had an outer limit of 2:1.) "Mexico—Stand-By Arrangement," EBS/86/161, Sup. 6 (November 20, 1986). See also footnote 72, p. 443.

[88]Minutes of EBM/86/168 (October 10, 1986).

[89]The basic concerted "new money" loan had been reduced to $5 billion, but it was supplemented by $1 billion in cofinancing with the IBRD, another $500 million in cofinancing with the IBRD of the growth contingency facility, and $1.2 billion in contingent financing linked to oil prices. On the terms of the agreement, see "Mexico—Request for Stand-By Arrangement," EBS/86/161, Sup. 5 (October 29, 1986).

ment announced that it was switching from semiannual to quarterly adjustments in the minimum wage and would thereby be granting workers an unscheduled increase immediately. With inflation already running over 100 percent a year, this seemingly technical policy change ran the risk of throwing the program off track before it was even approved. Skepticism about Mexico's economic prospects was rampant, and when the Executive Board met on October 31, less than 40 percent of the necessary commitments from banks had been obtained. Directors had no choice but to extend the deadline a second time, to November 19.[90]

November finally brought success. While Pujol led a mission to Mexico City to review progress under the still-pending program, the multipronged effort to win bank support continued. By November 19, when the Board next met to consider the requested arrangement, the critical 90 percent level of commitments was in hand. The stand-by arrangement was approved without dissent, enabling Mexico to borrow the first two SDR 225 million ($270 million) installments (the first of which had been originally anticipated for September).[91]

Keeping the Program on Track: December 1986–June 1987

Mexico's economic program began well despite the earlier hiccup with the minimum wage, but the government failed to maintain that initial success. In mid-December, Pujol informed the Board that Mexico was in compliance with the various program criteria "by ample margins."[92] However, when he returned to Mexico City in February 1987 to try to negotiate the program for that year, he realized that the fiscal effort was already being relaxed, and he had to postpone the negotiations. He went again in March and found an ever-worsening fiscal position. The question now was not whether Mexico was in compliance with the program; multiple criteria had not been met at the end of 1986. The question was whether it was reasonable to expect the authorities to comply, given that the criteria had been formulated on the assumption that bank financing would be available at an early date. As it happened, the last few percentage points of the bank package were taking a painfully long time to obtain, not least because of the fears generated by Brazil's declaring a moratorium on interest payments to banks in February 1987 (see below). Mexico was unable to draw on the bank loan until April 30, 1987, long after the bridge loan arranged by the BIS had expired.[93]

The March mission led to an agreement, and Petricioli sent a Letter of Intent for the 1987 program to the Managing Director (now Michel Camdessus) on April 7. In addition to setting quantitative targets for the original performance criteria

[90]Minutes of EBM/86/175 (October 31, 1985). November 19 was the date that the government was scheduled to present its budget for 1987 to the congress.

[91]Minutes of EBM/86/185 (November 19, 1986).

[92]Minutes of EBM/86/201 (December 17, 1986).

[93]The initial drawing amounted to $3.5 billion out of the $6 billion total. The $1.6 billion bridge loan (see footnote 84, p. 447) was repaid in February. "Mexico—Review Under Stand-By Arrangement and Program for 1987," EBS/87/103, Sup. 1 (May 12, 1987), p. 11.

for each quarter in 1987, the amended agreement added two new elements designed to monitor inflation more directly. First, a floor on the primary fiscal surplus (i.e., the overall balance minus interest payments on the public debt and thus the most directly controllable component) was added as a third measure of fiscal stringency, along with the overall deficit and the operational balance. Second, the authorities agreed that if inflation were to rise above the rate on which their program was based (an annual rate of 85 percent), they would negotiate new understandings on fiscal policy aimed at relieving inflationary pressures.[94]

The staff report reviewing the program, issued on May 12, implicitly acknowledged the effect of the delay in obtaining bank financing. It detailed the fiscal overruns that had occurred, but it recommended that the fiscal performance criteria for 1987 be relaxed relative to the government's own budget of December 1986, and that the Fund allow Mexico to draw SDR 400 million ($510 million) under the stand-by arrangement in June without regard to whether the end-March performance criteria were met. Three weeks later, just one day before the Board meeting, the staff was able to certify that—despite the fiscal problems—all of the newly established performance criteria had been met and that no waiver would be required at this time.[95]

When the Executive Board met in restricted session on June 3 to review Mexico's performance in implementing the economic program, the financing role of the banks was a key issue to be examined. Two weeks earlier, the strategy of depending on the banks for additional financing had been dealt an unexpected blow when Citibank announced on May 19 that it was adding $3 billion to its reserves as a provision against possible losses on its loans to developing countries. Citibank's action was by no means the first, but it was the largest and most dramatic provisioning by a U.S. bank. Competitors such as the Bank of America that had much weaker capitalization would be forced to respond in kind, and that would weaken their ability to participate in concerted efforts to maintain the level of financing for Mexico and other major debtors. Coming on the heels of the destructive delays in approving the Mexican bank package, this development made it highly likely that future financing arrangements of this genre would be even more difficult to secure.

At the Board meeting (in restricted session), following an opening statement by Ortiz, de Groote laid the blame for Mexico's weak implementation of the program squarely on the banks, who, in his view, had "shot themselves in the foot."[96] The banks' sluggish response had deprived the private sector of essential financing for investment and had thereby stifled economic growth. Consequently, the

[94]"Mexico—Review Under the Stand-By Arrangement and Program for 1987—Letter of Intent," EBS/87/103 (May 12, 1987).

[95]Under the terms of the stand-by arrangement, Mexico normally would have drawn SDR 200 million in February and another SDR 200 million in May. The various delays resulted in the two drawings both being made in June. "Mexico—Review Under Stand-By Arrangement and Program for 1987," EBS/87/103, Sup. 1 (May 12, 1987) and Sup. 2 (June 2). On fiscal conditionality, see Sup. 1, pp. 13 and 38.

[96]Minutes of EBM/87/81/R-1 (June 3, 1987), p. 7.

growth contingency clause had kicked in, and the banks now had to provide additional financing.[97] Ortiz argued that the fiscal austerity required by the Fund had also been a significant contributor to the decline in output. Although Mexico did not need additional bank financing for balance of payments purposes, it did need to finance major investment projects in order to restart economic growth. Consequently, he concluded, Mexico intended to activate the growth contingency mechanism.[98] Overall, the Board viewed Mexico's performance as satisfactory under difficult circumstances. The program targets for 1987 were approved, and Mexico was able to draw SDR 600 million over the next two months, bringing its total indebtedness to the Fund to nearly SDR 3.8 billion ($4.9 billion), or 324 percent of quota.

Crash and Recovery: July 1987–March 1988

The second half of 1987 brought a new crisis that required yet more innovative efforts to stabilize the Mexican economy.

For a year now, the Mexican stock market had been booming, in response to trade liberalization, reprivatization of banks, a program to "swap" external debts for domestic equity, and the general effects of the agreements reached with the Fund and other foreign creditors. In mid-August, Mexico and its bank creditors agreed to convert $9 billion of private sector debt to commercial banks into a loan to the public sector. That agreement covered debts that had previously been restructured under the FICORCA scheme. The difficulty was that the banks still preferred to get as much of their money back as they could right away rather than take on yet more exposure to the government. Substantial discounts were offered to borrowers as an incentive for them to prepay their loans before the restructuring was to go into effect in February 1998. Between $3.5 and $4 billion in face value was prepaid in this way at a cost of $2.7 billion. The Fund staff generally supported this process, as it was a relatively economical means of reducing external debt. By October, however, private sector borrowers were selling large volumes of assets to raise the cash to pay off their FICORCA debts, putting severe downward pressure on asset prices. When equity markets came under attack in major markets around the world on "Black Monday," October 19, the Mexican market went into an uncontrolled stall and crashed. In six weeks through mid-November, shares listed on the Mexi-

[97]This judgment was premature. Mexico ran into difficulties meeting some of the conditions for the bank loan, and the banks' commitment was reduced by the activation of the oil-price contingency when the export price rose above the projected range of $9–14 a barrel. In total, the banks disbursed $4.4 billion under the new-money loan in 1987, $600 million less than originally planned. The growth contingency mechanism was not activated until 1988. The shortfall in output, which normally would have activated the growth contingency process, is documented in "Mexico—Review Under Stand-By Arrangement and Program for 1987," EBS/87/103, Sup. 2 (June 2, 1987), p. 1. The effect of the two contingencies on bank financing in 1987 is described in "Mexico—Staff Report for the 1987 Article IV Consultation and Second Review Under Stand-By Arrangement," EBS/88/23 (February 4, 1988), p. 14n.

[98]Minutes of EBM/87/81/R-1 (June 3, 1987), pp. 31–32.

can stock market lost 75 percent of their market value—far in excess of the global declines.[99]

The bursting of the stock market bubble, coming at a time of growing concerns over inflation (now approaching 150 percent a year) and doubts about the sustainability of the economic program as the presidential election approached, precipitated a resumption of large-scale capital outflows from Mexico. As the crisis developed, a Fund mission—led by Claudio Loser, Assistant Director of the Western Hemisphere Department—went to Mexico City to review progress under the stand-by arrangement and to conduct the annual Article IV consultations.[100]

On November 18, while the mission was in progress, the peso came under strong enough pressure that the Bank of Mexico was forced to withdraw from supporting it in the "free" market.[101] Within a few days, the free-market exchange rate lost a third of its value against the U.S. dollar. Barring a dramatic shift in policies, the program and the stand-by arrangement would inevitably fall apart.

The dramatic shift came in mid-December with the announcement of a heterodox regime, the *Pacto de Solidaridad Económica* (known simply as the *Pacto*). The *Pacto*, developed independently of the discussions that had just been held with the Fund staff, had four key goals: immediately restore and then maintain international competitiveness, strengthen the fiscal balance over the coming year, further liberalize trade policy, and establish a permanent basis for maintaining a social consensus on wage policy. To achieve the first goal, the controlled exchange rate was devalued straightaway by 18 percent in a successful bid to wipe out the spread that had emerged between the controlled and free rates.

Second, the *Pacto* aimed to raise the primary fiscal surplus by 3 percent of GDP in 1988, through a combination of expenditure cuts and higher prices for energy products, utilities, etc. Third, trade liberalization would be promoted by a sharp reduction in tariffs and the virtual elimination of nontariff trade barriers such as requiring import permits. Fourth, wage policy would be controlled at the national level through periodic agreements to be made between the government and representatives of employers and labor unions on the basis of projected inflation (not on actual past inflation, as before). The Fund staff endorsed all elements of this package. The shift to forward-looking wage indexation was seen as a valuable contributor to the fight against inflation. The pegging of the exchange rate was ac-

[99]In the major industrial countries, major declines in equity prices were mostly confined to the few days around October 19 and ranged from 11 to 22 percent. See Allen and others (1989), pp. 62–65.

[100]Under the amended terms of the stand-by arrangement, Mexico could not make the next drawing (SDR 200 million, originally scheduled to be made in December 1987) until this review was completed and until understandings were reached on policies to bring inflation back to an annual rate of 85 percent or less. See paragraph 10 of the Technical Memorandum of Understanding, as amended on April 7, 1987; "Mexico—Review Under the Stand-By Arrangement and Program for 1987—Letter of Intent," EBS/87/103 (May 12, 1987), Attachment II, p. 7.

[101]Mexico had maintained a dual exchange market since August 5, 1985: a "controlled" market for most trade-related transactions and a "free" market for transactions not eligible for the controlled market. The controlled rate was determined by a managed float, and the authorities also intervened in the free market to keep the two rates close together. "Mexico—Modifications of Exchange and Trade System," EBS/85/188 (August 9, 1985).

cepted on the understanding that the authorities would switch to a real-rate rule (adjusting the nominal rate in line with inflation) within a few months.[102]

If the *Pacto* could be made to work, it was clearly both bold enough and comprehensive enough to put the economy back on a sustainable path.[103] Loser took his staff team back to Mexico City in January 1988 to review the situation. Although fiscal policy, as measured by the primary or operational fiscal balance, had been implemented in keeping with the program, the effect of inflation on interest rates had forced the overall public sector borrowing requirement above the programmed ceiling. Hence a waiver would be required before Mexico could be permitted to make the final drawings under the stand-by arrangement.[104] The mission concluded that the *Pacto* framework provided the potential for overcoming the problem and that the measures now being taken to implement it appeared to warrant granting the waiver.

At the end of February 1988, the government granted a small increase in the minimum wage and then implemented a freeze on prices and on the exchange rate. These measures ran the risk of reversing the progress on competitiveness, because the price freeze was certain to be less effective than the fixing of the exchange rate. It was nonetheless judged by the authorities (and accepted as such by the Fund staff and management) to be essential for getting inflation under control. Without it, targeting the real exchange rate raised the risk that the momentum of inflation would be unchecked.[105]

At the same time, Petricioli finally initiated a request to the Managing Director to activate the commercial banks' Growth Contingency Financing Facility. With policies in place to control inflation, the time was ripe to implement the intention expressed the previous June to stimulate growth through externally financed investment projects.

On March 10, 1988, the Executive Board endorsed the staff's appraisal that the Mexican economic program deserved the Fund's continuing support. On the basis of a waiver of the end-1987 requirements, it approved the final two tranches of the

[102]Memorandum from Sterie T. Beza (Director of the Western Hemisphere Department) to the Managing Director (December 18, 1987); in IMF/RD Managing Director file "Mexico, December 1987–December 1988" (Accession 89/131, Box 3, Section 282).

[103]For an analysis of the *Pacto* as the culmination of the evolution of economic policy in Mexico in the 1980s, see Rojas-Suárez (1992).

[104]One other program criterion had also been violated for reasons that were essentially beyond the control of the authorities: growth of net domestic assets of the monetary authorities was too high, having been inflated by the cash-flow requirements of firms prepaying FICORCA debts and by the need to compensate for continuing shortfalls in the availability of external financing to the public sector. See "Mexico—Staff Report for the 1987 Article IV Consultation and Second Review Under Stand-By Arrangement—Request for Waiver and Supplementary Information," EBS/88/23, Sup. 1 (March 7, 1988), p. 3.

[105]The weaknesses of targeting real exchange rates are discussed in Chapter 13, pp. 573. The staff view on this case is given in "Mexico—Staff Report for the 1987 Article IV Consultation and Second Review Under Stand-By Arrangement—Request for Waiver and Supplementary Information," EBS/88/23, Sup. 1 (March 7, 1988). Also see memorandum from Beza to the Managing Director (February 29, 1988); in IMF/RD Managing Director file "Mexico, December 1987–December 1988" (Accession 89/131, Box 3, Section 282).

stand-by arrangement.[106] Once again, although previous hopes had been dashed by events, the spring of 1988 was bringing a renewal of optimism for Mexico.

Brazil: From the Cruzado Plan to Default

The mid-1980s were a fallow period in financial relations between the Fund and Brazil, but the Fund continued to push for reform policies and to try to improve Brazil's relations with other creditors. The third year of the 1983–85 extended arrangement had not been activated, as a year of negotiations had failed to produce an agreement on an economic program. The arrangement expired in February 1986 with SDR 1.5 billion (just under $2 billion) of the original SDR 4.2 billion commitment unused. For the next year, the Brazilian government sought to avoid requesting new loans from the Fund while it tried to negotiate separate deals with other creditors. That effort partially succeeded, but it collapsed in February 1987 when Brazil unilaterally stopped paying interest on its bank debts.

Development of the Cruzado Plan: November 1985–February 1986

In the months following the 1985 Annual Meetings in Seoul, the minister of finance, Dilson Funaro, visited Washington twice to discuss Brazil's plans and needs with the Managing Director. In Seoul, de Larosière had stressed to Funaro the need for a major shift in policies as a precondition for restoring normal relations with creditors. On Sunday, November 24, Funaro and de Larosière lunched together at the Brazilian Embassy on Massachusetts Avenue, in a meeting that stretched through the whole afternoon.[107] Funaro's message was that by mid-week he would be announcing a new orientation to economic policy in Brazil; he did not want either financial assistance or enhanced surveillance from the Fund, but he did want the Managing Director to issue a statement of support to Brazil's commercial bank creditors. De Larosière was wary, because the policy shift was not comprehensive: it was narrowly focused on limiting the inflationary pressures arising from indexation and would do little to stabilize the public finances. Fiscal policy was still to be aimed primarily at maintaining strong economic growth (on the order of 7 percent for 1986) rather than raising the domestic saving rate. Without stronger policies and more direct support from the IMF, Brazil would have little hope of avoiding a new payments crisis.

Bank creditors also reacted with skepticism when the policy package was unveiled in Brasilia on November 27. The Advisory Committee met with Brazil's debt negotiators in New York on December 12 and 13, but the talks broke down

[106]Following the meeting, Mexico borrowed SDR 350 million ($480 million). The stand-by arrangement was thus fully utilized, and Mexico's obligations to the Fund totaled just under SDR 4 billion (335 percent of quota), the highest level reached up to this time.

[107]Memorandum for files by the Managing Director (November 25, 1985); in IMF/RD Managing Director file "Brazil, 1985—Vol. II" (Accession 88/179, Box 7, Section 517). The trip was intended to be kept secret, but the news that Funaro was traveling to Washington to meet with U.S. and IMF officials was carried on wire services beginning November 22.

without any sign of progress. Follow-up discussions were scheduled for mid-January, which prompted Funaro to make his second trip to Washington, on January 9, to seek a statement of support from the Managing Director. The situation was now a little cloudier, because the authorities were formulating an ambitious stabilization program for 1986, but they were not yet ready to specify the policy actions to achieve the program's goals. After hearing the staff's view that there were serious doubts about the government's ability to implement the program, de Larosière informed Funaro that he could give only a guarded endorsement to the banks. Funaro made the best he could of the matter by telling the press afterward merely that the Managing Director had agreed to issue a supporting statement.[108] De Larosière then conveyed the following statement to Rhodes (quoted in its entirety), in which the caveats are as plain as a bureaucracy can stand to make them:[109]

1. In early January 1986, I met with Mr. Funaro, Minister of Finance of Brazil, and Mr. [Fernão Carlos Botelho] Bracher, President of the central bank of Brazil.
2. The Minister of Finance outlined the economic policies of the Government of Brazil for 1986. The staff had earlier received the pertinent documentation.
3. Achievement of the objectives as set by the Brazilian authorities would strengthen the economic performance of the country, and would help to maintain the favorable external results of recent years.
4. However, fulfillment of these objectives would require implementation of strong measures in order to deal with the risks in the present economic situation.

On January 16, 1986, the Advisory Committee of commercial banks agreed to roll over existing credits to Brazil—totaling $16 billion in principal—until March 1987. That decision, on which the banks really had no choice under the circumstances, set the stage for the announcement of the new policy package at the end of February. The Cruzado Plan, as it became known, included several "heterodox" elements and minimized the more conventional—and essential—stabilization policies.[110] Brazil got a new currency, the cruzado, worth 1,000 of the old cruzeiros. Prices were temporarily frozen, but nominal wages were raised by an average of 15 percent. Wages then were to be fixed for a year unless prices rose by 20 percent in the meantime, in which case they would be automatically indexed. The exchange rate was fixed at the prevailing level; i.e., the crawling peg was suspended as part of the general effort to deindex the economy. Fiscal policy was essentially unchanged.

[108]The Brazilian press interpreted Funaro's statement as a prediction that the Fund would give the banks a "green light" for renegotiating Brazilian debt. See *O Globo* (Rio de Janeiro), January 12, 1986, p. 1.

[109]The message was initially conveyed (on January 13) only by telephone, in an effort to maintain strict confidentiality. The next day, however, the Dow-Jones news service carried a story on the report, which it characterized as a "qualified approval" by the Managing Director. Four weeks later, the text of the message was sent to the Advisory Committee by cable. Cable of February 7, 1986; in IMF/RD Western Hemisphere Department file "Brazil, January 1986–December 1986" (Accession 89/2, Box 1, Section 91).

[110]The Cruzado Plan is summarized in "Brazil—Financial Measures," EBD/86/57 (March 3, 1986). Edwards (1995, pp. 33–40) discusses its development and compares its heterodoxy to those of other plans introduced in Latin America in the late 1980s.

Stabilizing Without the Fund, March 1986–January 1987

For several months, the Cruzado Plan worked largely as intended. To succeed, inflation had to be brought down very quickly from the pre-Cruzado rate of about 250 percent a year and then had to be kept very near to international levels; otherwise, wage indexation would kick in, the exchange rate would soon become unsustainable, and the value of the cruzado would plummet. For March and April 1986, the price level was more or less unchanged, owing largely to the strict freeze on price increases. Over the same two months, the monetary base expanded by 36 percent; some portion of that was attributable to a remonetization of the economy following the currency reform, and it was easy for the authorities to overestimate the extent and sustainability of that phenomenon. In July, the government implemented some selected tax increases and cuts in government subsidies (dubbed the "Cruzadinho" plan by the press) in an effort to mop up some of the excess liquidity and strengthen the credibility of the program (see Faria, 1993, p. 187). Pressures from monetary growth began to build up, but it would now take a bit longer before the system would collapse.

Brazil's next goal was to normalize relations with official creditors, to whom they had been accumulating arrears for more than a year. In 1985, Brazil had been rebuffed by the Paris Club on the grounds that any rescheduling would first require Brazil to have a program agreed with the Fund. In March 1986, the authorities renewed their request for a rescheduling of official credits through the Paris Club, but they were told that they first needed at least to make progress toward a Fund-supported program and that they needed to take action to clear their arrears, neither of which Brazil was prepared to do. Faced with this impasse, Brazil shifted to a more conciliatory stance in May, promising to make payments aimed at limiting the rate of increase in arrears to official creditors as long as they could do so without reducing their own international reserves. This was not enough, however, and the standoff continued.

Once again Brazil found itself in need of an endorsement of its policies by the Fund, and once again Funaro decided to try to walk a narrow plank between asking for a financial arrangement and going it alone. Around the end of August, Thomas M. Reichmann (Chief of the Atlantic Division, Western Hemisphere Department) led a mission to conduct the annual Article IV consultations, which had been postponed several times during the spring and early summer. Although Reichmann concluded that both monetary and fiscal policies had to be tightened if the Cruzado Plan was to hold together, he also recognized that so far the plan was still working reasonably well. Publicly, President José Sarney was taking an anti-Fund, go-it-alone stance.[111] Behind the proscenium, however, he was more conciliatory. Notably, a few days after the mission was completed, the president—in Washington on a state visit and to address a joint session of the U.S. Congress—

[111]On September 4, he told a visiting reporter that the "IMF formulas for Brazil simply did not work. They led us into the most dramatic recession in our history. But we have addressed our problems with seriousness." *New York Times* (September 7, 1986), p. A10.

took the time to meet with the Managing Director. De Larosière conveyed the same message to the president that Reichmann had just delivered to his advisors: additional policy measures were needed. Sarney's response, which went well beyond previous promises, was that he was prepared to take the necessary measures even if it meant accepting an interruption in the strong economic growth that Brazil had experienced for a number of years.

By the time of the 1986 Annual Meetings of the Board of Governors, in early October, de Larosière was taking a more optimistic view of Brazil's prospects. At his scheduled press conference at the conclusion of the meetings, he described to reporters his "sympathy and admiration" for the "very courageous actions taken in Brazil." Then when the Paris Club next met, in the third week of October, delegates appeared to be looking for ways to help, even though they recognized that Brazil was still a long way from qualifying for an arrangement with the Fund. The tide was still out, but it was turning.

The question now was how to formulate the steps that would eventually normalize relations with creditors. On October 27, de Larosière met with Mulford and other officials at the U.S. Treasury. He suggested that both the authorities and the various creditors might be ready to accept a form of enhanced surveillance as a step in that direction. That is, the Fund staff would conduct more frequent consultations (perhaps semiannually), and he, as Managing Director, would issue reports to creditors assessing the progress of stabilization and reforms. This procedure—contrasted with the standard enhanced surveillance, under which the authorities would release the staff reports on semiannual consultations to creditors—would lend additional weight to the assessment but would stop short of giving creditors an official seal of approval from the Fund. Both de Larosière and Mulford were concerned about setting a precedent that would induce other heavily indebted countries to seek similar treatment, but they agreed nonetheless that the idea was worth trying for Brazil. Funaro still resisted accepting that much monitoring, but he relented after the Managing Director agreed to call the procedure "enhanced contacts."[112]

The next step was for Brazil to strengthen its policies. Following the congressional and gubernatorial elections of mid-November, the government announced a package of policy changes on November 21. These heterodox measures included reductions in government subsidies, controls on wages, the introduction of new financial instruments to promote saving, and the reintroduction of a daily adjustment in the exchange rate (suspended since the introduction of the Cruzado Plan in February) aimed at dampening speculation of a large devaluation. The Fund staff viewed these adjustments as making "an important contribution in correcting . . . imbalances" in the economy.[113]

The Executive Board met on December 10, 1986, to conclude the Article IV consultations, the first such review since August 1985.[114] Much of the discussion

[112]See footnote 46, p. 431.

[113]"Brazil—Staff Report for the 1986 Article IV Consultation," EBS/86/253, Sup. 1 (December 4, 1986), p. 9.

[114]The delay was necessitated by the timing of the elections in Brazil.

focused on the Cruzado Plan and its subsequent refinements, which Directors generally viewed quite positively. (Speaking for the United States, Dallara viewed it as having brought "historic, positive change" to Brazil.)[115] The groundwork was now in place for a positive report to creditors. That same day, de Larosière wrote to Jean-Claude Trichet, the chairman of the Paris Club, summarizing developments in Brazil and the Fund's reactions, and concluding: "I share the view that these developments, together with the Brazilian authorities' intention to enhance their contacts with the Fund, provide the basis and impetus for an early normalization of relations between Brazil and its creditors. A Paris Club agreement would be an essential step in that process."[116]

The battleground now shifted to Paris, where official creditors met on December 18. Brazil requested a rescheduling of its debts on terms that were far weaker than those that had ever been granted by the Paris Club up to this time. Not only would creditors have to pin their hopes on the effectiveness of "enhanced contacts" with the Fund rather than a financial arrangement with all of the standard conditions attached; Brazil also was asking that it not be required even to make current interest payments (as opposed to catching up on payments that were already in arrears) until July 1987. Even so, on the basis of the Managing Director's request, creditors agreed to consider the request at their next meeting.[117]

The rescheduling request was approved on January 21, 1987, at the conclusion of a Paris Club meeting of record length. Reichmann and K. Burke Dillon (Chief of the External Finance Division, Exchange and Trade Relations Department) led the delegation from the Fund.[118] The agreement broke precedent in three ways.[119] First, it was the first time in this decade that a rescheduling had been agreed upon in the absence of either an upper-tranche financial arrangement with the Fund or even a formal agreement for enhanced surveillance. Second, completion of the arrangement was linked in part to the successful completion of negotiations with commercial bank creditors. Though creditors agreed that this linkage was needed in this case, they were reluctant in general to expand the number of linkages in such agreements. Third, a substantial part of the debts to be rescheduled were set aside until July, and that portion of the deal was made conditional on the IMF Executive Board drawing positive conclusions from the upcoming Article IV consultation or agreeing on a financial arrangement. These terms obviously represented a very delicate balance between the desire to main-

[115]Minutes of EBM/86/193 (December 10, 1986), p. 25.

[116]Letter of December 10, 1986; in IMF/CF (S 1191 "Brazil—Debt Renegotiation and Multilateral Aid").

[117]Executive Directors were formally notified of the request on January 9, 1987; "Brazil—Request for Renegotiation of External Debt Owed to the Paris Club" (EBD/87/2).

[118]For a summary of the agreement, see Dillon and others (1988). For a detailed report, see "Brazil—Report on External Debt Renegotiation," EBS/87/32 (February 13, 1987).

[119]January 30, 1987, memorandum by Dillon and Peter M. Keller (Deputy Chief of the External Finance Division, Exchange and Trade Relations Department); in departmental file, "External Debt: Paris Club 1987"; in IMF/RD Exchange and Trade Relations Department file "Paris Club, 1987" (Room 4384, Section 6, Shelf 1, Bin 4).

tain forward momentum and an inescapable skepticism about the prospects for success.[120]

Moratorium: February–December 1987

On February 20, 1987, President Sarney shocked the world—and the Fund—by declaring a "moratorium" on the payment of interest on medium- and long-term loans from foreign banks. As explained in a cable sent the same day by Funaro to creditor banks, Brazil viewed the moratorium as justified because circumstances had made the outward transfer of resources incompatible with economic growth. As of that day, the Brazilian government would deposit all principal and interest due to foreign commercial banks in an escrow account at the central bank. Payments would continue to be made on short-term loans and trade credits.

Sarney's and Funaro's decision[121] to default was prompted by the continuing depletion of Brazil's foreign exchange reserves. Brazil, however, did still have the means to meet its interest payments for the next several months, assuming that policies could be strengthened at the same time. Gross reserves had fallen from approximately $9¼ billion at the end of 1985 to $5¼ billion at end-1986 and to about $4 billion by the time of the moratorium. At that level, reserves were just about equal to Brazil's projected financing requirements for the year. More fundamentally, the moratorium reflected the disarray in policymaking at the time. Fiscal policy had been far too lax throughout most of 1986, as essential actions were delayed until after the November elections. By the time the November package was introduced, the distorting effects of price controls had become severe, and inflationary pressures were becoming uncontainable. Restoration of exchange rate flexibility had given the coup de grace to price stability. Under the terms of the Cruzado Plan, wage indexation would resume once inflation was rekindled; inflation thus would be impossible to stop without further reforms. For the first quarter of 1987, inflation was already running at an annual rate of about 400 percent.

The moratorium and the accompanying collapse of stability in Brazil posed problems not only for Funaro and the bank creditors, but also for Camdessus, who had just taken over from de Larosière as Managing Director. The only way to keep the crisis with the banks from further contaminating relations with official creditors was to be sure that Brazil could meet the conditions for the second tranche of the Paris Club deal in July. An IMF mission would have to go to Brazil by April or early May, and—more important—new policies would have to be implemented before then. Funaro submitted a new financing plan to congress at the beginning of

[120]At one point in the meeting, negotiations reportedly almost collapsed when the Brazilian delegation relayed a message from Funaro calling the creditors' proposals "an insult and equal to a declaration of war" and threatening to suspend all payments at once if the terms were not relaxed. Memorandum by Reichmann (January 23, 1987); in IMF/RD Western Hemisphere file "Brazil, 1987" (Accession 89/14, Box 1, Section 550).

[121]The moratorium was not universally supported by senior economic officials in Brazil. Notably, João Sayad, the minister of planning since March 1985, and Fernão Bracher, president of the central bank since August 1985, both resigned in protest.

April, and shortly thereafter he went to Washington to meet with Camdessus, but the Managing Director made it clear that much stronger and more specific actions would be needed to resolve the crisis.

Sarney finally realized that he would need to make a clean break with the past, and at the end of April he replaced Funaro as finance minister with Luiz Carlos Bresser Pereira, a professor of economics at the Getúlio Vargas Foundation and an official in the state government in São Paulo. Bresser Pereira, moving quickly to attempt to restore order, called his staff together and told them he wanted to implement a conventional macroeconomic stabilization program: a Fund-type adjustment program, though for the moment without involving the Fund. To make it work quickly enough, he would once again temporarily freeze prices and wages, but this time he would make sure that the supporting macroeconomic policies were put in place at the same time. By stabilizing the economy first, he reasoned, he could then get on favorable terms with the banks and other creditors, and only then would he go to the Fund for financial assistance.

An IMF Article IV mission had already been scheduled to take place in the middle of May, and that provided Bresser Pereira with an opportunity to sound out the staff on the Fund's views. This initial meeting with Reichmann, however, was awkward because Bresser Pereira did not feel that he could yet inform the staff that he intended to implement a shock program. Reichmann—like Bresser Pereira—saw an economy that was in free fall, and the gradual adjustment that Bresser Pereira outlined for him did not look adequate. After a week of talks, they agreed to break off for a few weeks and to resume once the new policies had been announced. Meanwhile, Bresser Pereira's sketchy plans were also failing to impress the banks. The day Reichmann left Brazil for Washington, Citibank made its dramatic announcement that it was setting aside some $3 billion to cover possible losses on loans to developing countries (see above, p. 449).

The Bresser Plan, introduced on June 12, 1987, called for a 90-day freeze on wage or price increases, backed up by a tightening of monetary policy, a small fiscal correction (mainly adjustments in public sector prices), and a devaluation of the exchange rate.[122] It was only a start, but the plan appeared to have an internal consistency that had been missing from the Cruzado Plan. When Reichmann and his team returned to Brazil later that month to finish work on the Article IV consultations, they were able to draw reasonably positive conclusions.

The next step, in Bresser Pereira's mind, was to convince the bank creditors that Brazil both needed and deserved more relief from its debt burden. He was prepared to let the Paris Club agreement lapse and to put off seeking an arrangement with the Fund. Official creditors eventually would come around, and he regarded the Fund and the World Bank as little more than "delegates" or "arms" of the U.S. government (Bresser Pereira, 1999, pp. 15–16). In mid-July, Bresser Pereira made his first trip to Washington as finance minister. He met with both Camdessus and Conable, but his real focus was on getting debt relief from commercial banks.

[122]For details and background, see Bresser Pereira (1999).

Camdessus and others told him that the idea was premature. The banks could not grant significant debt relief until the various national authorities were ready to support it, which at this point they were not. Camdessus urged him instead to work toward a stand-by arrangement, but Bresser Pereira was not interested.[123] A few days later, Bresser Pereira went to New York to meet with the chairmen of the major creditor banks, whom he asked for a major new-money loan at zero interest. The banks, not surprisingly, were not interested in that offer. Instead, they also urged the minister to concentrate on first reaching an agreement on policies with the Fund.[124]

The Executive Board met on September 9 to conclude the 1987 Article IV consultations. Everyone now agreed that policies were on the right track; the authorities were "praised . . . for having moved promptly since late April 1987" (i.e., since Bresser Pereira had become minister) to deal with the "very difficult economic situation." The difficulty was that some means had yet to be found to normalize relations with the banks, or the external deficit could not be properly financed. "Several" Directors concluded that a stand-by arrangement should be pursued, as in their view such an arrangement was a precondition for a bank agreement, but "a few" others thought that "shadow programs or enhanced contacts might be considered an alternative."[125] Following the meeting, Camdessus sent his summing up to Trichet for information. The summing up could not confirm that orderly arrangements were in place to finance Brazil's 1987 balance of payments deficit, so it did not meet the requirements of the January 1987 agreement of the Paris Club. Arrears to official as well as private creditors would therefore continue, and the Brazilian authorities would have to negotiate with the banks on their own.

To settle his affairs with bank creditors, Bresser Pereira would have to come up with a convincing adjustment program and demonstrate flexibility in negotiations. Accordingly, he asked the Fund to send a mission to discuss the possibility of a program to be supported by Fund resources. Camdessus was not convinced that Brazil was ready for a financial arrangement. The operational fiscal deficit was projected to be about 5 percent of GDP for 1987, the staff estimated that it would have to be brought down to about 2 percent in 1988 for it to be adequately financed, and there was no indication at this time that policies could be changed sharply enough to achieve that result. The staff's instructions for the mission (in the second half of November) were therefore merely to assess the situation and establish a dialogue.[126]

Negotiations also proceeded with the banks throughout October, and in November Bresser Pereira signed an "interim agreement" with a subset of the creditor banks, aimed at gradually settling Brazil's still-accumulating arrears. Brazil owed foreign banks some $1.5 billion in interest for the fourth quarter of 1987. Under the agreement, Brazil would pay one-third of that amount from its reserves, and the

[123]For more on the development of Bresser Pereira's views on debt relief, see Chapter 11.

[124]The meeting with bankers was reported in the *New York Times* (July 27, 1987), pp. D1 and D2.

[125]"The Chairman's Summing Up at the Conclusion of the 1987 Article IV Consultation with Brazil, Executive Board Meeting 87/133—September 9, 1987," SUR/87/98, 9/17/87.

[126]Memorandum from Reichmann to management (November 9, 1987), with handwritten response; in IMF/RD Managing Director file "Brazil, 1987–1988" (Accession 89/118, Box 1, Section 511).

participating banks would lend Brazil the remainder, so that current interest payments could be made in full. The agreement also set a target date of mid-January, 1988, for settling with the Advisory Committee on terms for a full medium-term financing plan that would then become effective by June 1988. The coverage of that plan would include the $3 billion in interest that was still in arrears from the first three quarters of 1987.

Relations both with the Fund and with the banks thus were beginning to improve, but to maintain this new momentum, policies—especially control over the public finances—would have to be strengthened. That task was the Achilles' heel of the strategy. To reduce the operational deficit by 2–3 percentage points of GDP for 1988, Bresser Pereira proposed implementing a package of substantial spending cuts and tax increases, but the proposal was strongly resisted by others in the cabinet and by much of the business community in Brazil. President Sarney, whose political power and influence were still weak, rejected much of the package, leaving only token fiscal adjustments. Bresser Pereira, knowing that the rejection meant that Brazil could not hope to gain an accord with either the IMF or its bank creditors in 1988, resigned from office in mid-December.[127] For Brazil, another major opportunity to regain economic stability had been lost.

Argentina: After the Austral Plan

Argentina was in trouble at the beginning of 1986. The stabilization program known as the Austral Plan was failing: well designed on paper, it was simply too ambitious in its goals for the Alfonsin government to sustain it for more than a few months. The new currency introduced in June 1985, the austral, was pegged to the U.S. dollar, an arrangement that could be sustained only if inflation in Argentina was quickly reduced to the level of U.S. inflation. In the event, inflation was substantially reduced from the extremely high pre-Austral levels, but by nowhere near enough. By late in the year, Argentine prices were still rising by 2–3 percent a *month*, while those in the United States were rising by about 3 percent a *year*. Before the November elections, the government lacked the political power either to stabilize wages or to take needed fiscal actions (notably privatization of job-creating but money-losing state enterprises); after winning the elections, the government lacked the political will. Consequently, as noted in Chapter 9, the Fund staff's review of the program in December 1985 ended in failure, and Argentina was not able to make the stand-by drawing that had been scheduled for that month.

The parallels between the macroeconomic difficulties facing Argentina and those just described for Brazil were numerous. Perhaps the most fundamental similarity, from which all the others sprung, was that both countries were struggling

[127]Some accounts of this episode interpret it differently. For example, Pang (1989), p. 138, concludes that Bresser Pereira was fired by Sarney for his failure to successfully negotiate a settlement with the Fund and the banks. That interpretation, however, conflicts with the factual record of the state of those negotiations at the time.

new democracies in which the baton of economic control had very recently been passed from the military (March 1985 in Brazil, December 1983 in Argentina). Political support for economic stability and reform was weak, and reform advocates faced substantial populist pressures both from the electorate and within the government. Both fledgling governments had already failed to implement the economic programs that had been drawn up by their predecessors in the wake of the initial debt crisis, and consequently their financing from the Fund had been withdrawn. Brazil's EFF arrangement was dormant throughout 1985 and expired in early 1986 with about one-third of the original commitment unused. Argentina's stand-by arrangement failed around the middle of 1983 and expired with less than half of the money drawn.

Argentina, like Brazil, faced seemingly uncontrollable inflationary pressures in the mid-1980s, and in neither case was the government able to stabilize the economy. In Brazil, consumer prices in 1985 were more than three times their 1984 level, and in February 1986 alone rose by 12½ percent (an annual rate of more than 300 percent); in Argentina, 1985 prices averaged nearly eight times the level of the year before and by midyear were rising at an annual rate of more than 2,300 percent. In both countries, inflation was perpetuated by a pervasive indexation of wages and other prices, but fiscal imbalances were at the heart of the problem. As discussed above and in Chapter 9, Brazil had a persistently high public sector borrowing requirement (PSBR) (27½ percent of GDP for 1985); even taking out the effect of inflation, the operational balance was persistently in deficit (4¼ percent of GDP in 1985). The elected Argentine government inherited a public sector deficit of 18 percent of GDP for 1983; they reduced it sharply, to 13 percent in 1984 and 5½ percent in 1985, but that level was still too high to be comfortably financed. And of course in both countries, the fiscal problem was severely exacerbated by an overhang of external debt: Brazil owed $105 billion (46 percent of GDP) to foreign creditors at the end of 1985, while Argentina owed $48 billion (75 percent of GDP).

The gist of the policy response was also similar, but with a major difference. Argentina's Austral Plan, like Brazil's Cruzado Plan that came a few months later, was a heterodox package whose essence was to stop inflation suddenly through deindexation and the introduction of a new currency. The crucial difference was that, in contrast to Brazil's attempt to implement the Cruzado Plan and its subsequent refinements without financial assistance (or conditionality) from the Fund, Argentina maintained a more active dialogue with the Fund throughout the period.

Promises and Waivers: January–June 1986

In January and February 1986, Argentine officials went to Washington to negotiate a resumption of the stand-by arrangement with the Fund. These talks led to an agreement by the government to implement fiscal reforms aimed at reducing the budget deficit from 5½ percent in 1985 to less than 3 percent in 1986. On February 20, a Letter of Intent setting out policy commitments for the first half of 1986 was signed by the minister of economy, Juan Vital Sourrouille, and the president

"Good afternoon. In which office of this ministry does Mr. Jacques de Larosière work?"
by Landrú

of the central bank, J.J. Alfredo Concepción.[128] They also agreed to state their intention to seek a new stand-by arrangement following the expiration of the current one. On that basis, the Managing Director agreed to recommend to the Executive Board that the stand-by arrangement be extended through May 1986, with drawings in March and May.[129]

The Executive Board met on March 10 to consider the Argentine request. There was a general feeling that policies were on the right track, that the program for 1986 was adequate, and that the time to push for stronger adjustment would come when the staff negotiated the anticipated stand-by arrangement for 1987. Without dissent, the Board approved the proposed modifications in the existing arrangement.[130]

A month later, in mid-April, Joaquín Ferrán, Senior Advisor in the Western Hemisphere Department, took a staff team to Buenos Aires to determine whether Argentina had met the criteria for the May drawing and to begin negotiations for a new stand-by arrangement. The news was bad. At least three program criteria had not been met at the end of the first quarter: the net domestic assets of the central bank, the public sector deficit, and the level of arrears to foreign creditors were all above the agreed ceilings. The budget deficit was at a rate of about 5 percent of GDP, and the monthly inflation rate had more than doubled, to about 4½ percent.[131] The mission spent more than a month evaluating the problems and trying to persuade the authorities to take immediate measures to get the program back on target. For their part, the authorities were doubly concerned: if they could not reach an agreement, they not only would lose the SDR 236.5 million loan from the Fund ($270 million), but also could lose a $600 million installment that was due to be made at the end of June under the concerted bank loan signed the previous August. Nonetheless, Sourrouille was unwilling to bend to the Fund's demands, and when Ferrán returned to Washington in mid-May he recommended against granting a waiver in the absence of strong prior actions by the government.

The Executive Board agreed in late May to extend the stand-by arrangement by another month while the staff conducted further negotiations in Washington and Buenos Aires.[132] (The technical discussions took place in Washington, while

[128]"Argentina—Staff Report for the 1985 Article IV Consultation and Review of Stand-By Arrangement," EBS/86/39, February 21, 1986.

[129]The arrangement approved in January 1985 had called for six drawings of SDR 236.5 million, for a total of SDR 1,419 million, with the last drawing scheduled for March 1986 (approximately $240 million and $1.44 billion, respectively, at average 1985 exchange rates). The second drawing, scheduled for March 1985, was not allowed until August, after the Austral Plan was in place. The third drawing then took place in September, which still left the program three months behind schedule. When no drawing was allowed in December, the program was six months behind. The intention now was to approve a drawing for March 1986, reschedule one of the two missed drawings for May, and cancel the other by reducing the total size of the arrangement to SDR 1,182.5 million (approximately $1.36 billion at March 1986 exchange rates).

[130]Minutes of EBM/86/43 (March 10, 1986).

[131]For a detailed description of the difficulties in meeting program criteria, see "Argentina—Request for Waiver Under Stand-By Arrangement," EBS/86/131 (June 18, 1986).

[132]"Argentina—Stand-By Arrangement—Extension of Period," EBS/86/39, Sup. 1 (May 29, 1986); and Executive Board Decision No. 8297-(86/91), adopted May 29, 1986.

Sterie T. Beza, Associate Director of the Western Hemisphere Department, met with senior officials in Buenos Aires.) The Managing Director also joined the effort, telephoning Sourrouille to let him know that he fully concurred with the staff that further measures had to be taken before he could recommend a waiver to the Board. Sourrouille then sent one of his principal deputies, José Luis Machinea, to Washington to talk directly with de Larosière. None of this activity had much immediate effect on Argentine policies, but the authorities did at least agree to reduce their arrears to official creditors and to seek a rescheduling of official debts through the Paris Club, and they set out their general intention to tighten policies in the second half of 1986.[133] Despite the staff's obvious skepticism about the authorities' ability to carry out their intentions, they recommended a waiver principally out of concern that otherwise the banks would refuse to reschedule Argentina's debts.[134] De Larosière finally agreed on June 14 to recommend approval of the final drawing under the stand-by arrangement, and he scheduled a meeting of the Executive Board for the following week.

The Board met on June 23 in the midst of intense interest from the press, both in Argentina and in Washington. Without the approval of the Fund, journalists understood that Argentina could scarcely avoid defaulting on its loans from foreign banks.[135] The impact of Citibank's large-scale and quite recent provisioning against its loans to developing countries (see p. 449, above) was still very much on everyone's mind, and Argentina was thus seen as a key test case for the debt strategy and for the continued solvency of major international banks. Although several Executive Directors expressed concerns, reservations, and even, in one case, "trepidation" (Marcel Massé—Canada), no one was prepared to oppose this one final drawing on the existing arrangement.[136] The waiver was unanimously approved, and Argentina then drew down the SDR 236.5 million. Argentina's obligations to the Fund now stood just under SDR 2.5 billion (224 percent of quota and approximately $2.9 billion), their highest level to date.

A New Stand-By Arrangement "In Principle": September 1986–February 1987

Discussions between Argentina and the Fund resumed in September. By this time, fiscal and monetary policies were slipping further out of control, even in re-

[133]"Argentina—Request for Waiver Under Stand-By Arrangement," EBS/86/131 (June 18, 1986), Attachment II.

[134]The staff report concluded in hedged tones that "implementation of these policies . . . would make an important contribution toward bringing the adjustment program back on track. . . . In these circumstances, it is proposed that the nonobservance of performance criteria . . . be waived, in order to permit the final purchase. . . . This purchase also would be of significance to the financial relations between Argentina and the commercial banks on which the continuing normalization of Argentina's external situation depends." "Argentina—Request for Waiver Under Stand-By Arrangement," EBS/86/131 (June 18, 1986), p. 13.

[135]See, for example, *Clarín* (Buenos Aires), June 24, 1986, p. 14.

[136]Minutes of EBM/86/101–102 (June 23, 1986). The quotation is from meeting 86/102, p. 4.

lation to the scaled-down effort applied in June. Preliminary talks in Washington and Buenos Aires revealed deep differences in view as to what was needed. The staff team, now headed by Brian C. Stuart (Deputy Chief of the River Plate Division in the Western Hemisphere Department), concluded that Argentina could not reduce either its stubbornly high inflation rate or its unsustainably high current account deficit without a renewed tightening of policies. The Argentine officials believed that their adjustment effort was sufficient and that greater flexibility was called for, from the Fund and from other creditors. In particular, they wanted any arrangement with the Fund to include contingency clauses similar to those granted to Mexico (see above, pp. 441–42) and to provide as much access to Fund resources, in relation to quota, as had been allowed for Mexico. The Fund considered the Mexican arrangement to have been exceptional, and it was not ready to formulate a general policy on the use of contingency mechanisms in stand-by arrangements. Starting in late October, Stuart spent a full month in Buenos Aires trying to reconcile these views, without success.

Negotiations continued in Washington through much of December and early January. A first breakthrough occurred on Christmas Eve, when Machinea called Erb from Buenos Aires to say that Argentina was prepared to accept the Fund's request for a lower target for the current account deficit and to offer to come immediately to Washington to draft a Letter of Intent.[137] A second and final breakthrough came on Saturday morning, January 10, when the negotiating team in Washington agreed to reduce their inflation target. Finally, on January 12, 1987, Sourrouille and Machinea (who was now president of the central bank, having replaced Concepción) signed a Letter of Intent setting out policies for 1987 and requesting a 15-month stand-by arrangement for SDR 1,113 million (100 percent of quota, equivalent to some $1.4 billion).[138]

Agreement on macroeconomic policies was to be only the beginning of a lengthy process to bring the Fund arrangement to fruition. Although de Larosière informed the Executive Board on January 13 (at his penultimate meeting with the Board before the chairmanship passed to Camdessus) that the staff and the authorities had agreed on a program, he was not yet ready to set a date for the Board to consider the proposed arrangement.[139] Argentina had not even begun negotiations with commercial bank creditors on a financing agreement for 1987, and the recent experiences of other developing countries (notably Mexico, Nigeria, and the Philippines) indicated that those negotiations were likely to be even more prolonged and difficult than in the past. The staff estimated that, even with maximum access to Fund credits, Argentina would face a financing gap of more than $3 billion for 1987, of which close to $2 billion would have to be filled by a concerted-lending deal with

[137]It is important to note that by this time, negotiations were focused on targets for economic conditions (e.g., inflation or the external deficit) rather than policies that were more directly under the authorities' control (notably the fiscal deficit, which was the real culprit). As Machinea (1990, p. 58) later observed, the authorities "felt helpless to reduce the fiscal deficit" because of the depressed state of the economy and the strength of the political opposition.

[138]"Argentina—Request for Stand-By Arrangement," EBS/87/5 (January 13, 1987).

[139]Minutes of EBM/87/7 (January 13, 1987).

bank creditors.[140] Even if negotiations began immediately, disbursements from the banks were unlikely to start before September.[141] Argentina also needed to reach an accord with official creditors through the Paris Club, and that process was being delayed by Argentina's reluctance to finalize bilateral agreements that were still outstanding under the Paris Club rescheduling of January 1985.

In the first part of February 1987, Camdessus consulted on several occasions with Executive Directors on how the Fund might proceed. Meanwhile, Argentina took the necessary actions to unlock discussions with the Paris Club, and negotiations between the authorities and the banks' Advisory Committee began on February 12 (in New York, at a meeting in which Erb made a presentation both on the program and on Argentina's financing needs). Those developments, of course, would lead nowhere without a positive signal from the Fund. Accordingly, Camdessus decided to seek approval of the program "in principle," as had been done a few months earlier for Mexico (see above, pp. 443–45).

The Executive Board met on February 18 to consider Argentina's request for a stand-by arrangement, along with a separate request for a drawing under the CFF to compensate for a temporary shortfall in export receipts. The management proposal was to approve both requests in principle, to become effective after a critical mass of bank financing had been committed (provided that Argentina was in compliance with the program at that time). Most Directors were cautiously optimistic about the adjustment program, notwithstanding their concern about Argentina's record of slippages in implementing earlier programs. As was often the case in this period, the strongest expression of concern came from Rye (see pp. 445, 465), in whose view this was a particularly "high-risk" program for the Fund to support.[142] Nonetheless, no Director abstained from approving the arrangement in principle.

A more widespread concern surfaced over the handling of two aspects of the approval process. First, several Directors objected to the proposal to delay final approval of the CFF financing until the critical mass was secured. François Gianviti, Director of the Legal Department, reminded Directors that the 1983 guidelines for the CFF (see Chapter 15) required the member to be cooperating with the Fund

[140]Although the expected balance of payments deficit for 1987 was only \$1.7 billion, Argentina also needed \$2.4 billion to service existing debts to official creditors and to replenish its reserves, plus \$0.5 billion to clear outstanding arrears. The gross financing requirement was therefore about \$4.6 billion. A Fund arrangement could cover \$1.4 billion, a Paris Club deal would reduce financing needs by another \$1.1 billion, and about \$0.2 billion could come in the form of bilateral official export credits. Those calculations left a residual of some \$1.9 billion to be covered by commercial bank creditors.

[141]In addition to the general problem that banks were becoming increasingly reluctant to participate in concerted lending packages, delays were expected to arise because of the length of the "tail" in the distribution of outstanding exposure to Argentina by bank creditors. Participation by the 150 largest creditors would secure a critical mass of commitments covering 95 percent of the required amount, but it would take another 120 banks to get to 99 percent and that many again to cover the final 1 percent. Memorandum from Maxwell Watson to the Managing Director (February 18, 1987); in IMF/RD Managing Director file "Argentina, January to March 1987" (Accession 88/274, Box 2, Section 269).

[142]Minutes of EBM/87/29 (February 18, 1987), p. 3.

for a drawing of this nature, and that the relevant test of cooperation in this case was that a financing arrangement be in place. Seven of the 22 Directors nonetheless preferred to grant the CFF drawing immediately and opposed the decision to approve it only in principle.[143] Second, a number of Directors were uncomfortable with the unprecedented request to make the in-principle approval of indefinite duration; normal practice would have been to require financing to be in place within 30 days. In view of the limited progress that had been made so far in Argentina's negotiations with banks' creditors, setting a 30-day limit in this case would have been tantamount to denying approval altogether and could effectively have undone the positive signal that the Board was attempting to send. Camdessus agreed, however, to bring the matter back quickly to the Board so that a reasonable date could then be set.

The follow-up meeting was set for February 26. On the 25th, Sourrouille surprised everyone by announcing a temporary wage-price freeze and a set of related fiscal actions. The fiscal adjustment, however, was relatively weak, so that these measures actually worsened the inconsistency between macroeconomic and incomes policies. The new package would soon lead to a worsening of price pressures, but that problem was not immediately evident.[144] At the beginning of the Board meeting, Ernesto V. Feldman (Alternate—Argentina) briefed his fellow Directors on the development, suggesting that it was not a shift in the policy regime, but rather an effort to bring expectations in line with the government's intentions. Inflation had been accelerating since the beginning of the year, not because of a loosening of policies but because people did not believe that the program would succeed in stabilizing prices. The staff, who had had no advance notice, were unable to draw a judgment on whether this new package was consistent with the existing program, but Directors were generally prepared to wait and see.

Most of the discussion on February 26 focused on the application of the "in-principle" procedure to the CFF. The Managing Director's proposal was to make the CFF drawing available to Argentina by July 15, regardless of the status of the financing package for the stand-by arrangement, "provided that Argentina continues to cooperate with the Fund." This amendment would provide an additional incentive for the authorities to adhere to the program over the next several months, even if difficulties in the negotiations with banks made it unlikely that the stand-by arrangement were to be activated. The problem was how to define whether the member country would be cooperating with the Fund if the stand-by arrangement were not activated by that date. The Managing Director suggested that he could inform creditors that the test of cooperation would be satisfied if (1) the criteria of the stand-by arrangement were met, regardless of whether the

[143]Minutes of EBM/87/28–29 (February 18, 1987); Gianviti's explanation is on pp. 25–26 of meeting 87/29. The seven objecting Directors, holding a total of 24.5 percent of the voting power on the Board, were Alhaimus (Alternate—Iraq), de Groote (Belgium), Feldman (Alternate—Argentina), Nimatallah (Saudi Arabia), Ortiz (Mexico), Salekhou (Iran), and Sengupta (India).

[144]See Machinea (1990), pp. 61–62, which concludes: "It is quite clear now that this freeze was a mistake."

arrangement was effective; (2) the economy was performing as expected, even if a waiver would have been required; or (3) the member was "actively negotiating with the Fund . . . on a revised or new stand-by arrangement." A few Directors objected to this last suggestion, on the grounds that it was too open-ended, but most Directors either liked the proposal or preferred to wait until the forthcoming CFF review to discuss it. The level of enthusiasm for the process was minimal, but the proposal was accepted so that attention could be focused squarely on the task of finding the money to finance the Argentine deficit for the year ahead.[145]

Financing the Program: March–August 1987

Normally, as soon as the Fund approved a stand-by arrangement with a member country, the member could expect to receive favorable consideration for a rescheduling of official bilateral credits through the Paris Club. In this case, that process was still being delayed, not only because the Fund was not yet providing any financing to Argentina, but because the process of clearing arrears under the previous Paris Club agreement was still ongoing. To get some official financing in place, Camdessus asked the main creditor countries to provide a $500 million bridge loan through the BIS. The United States took the lead in assembling the participation of 11 other industrial countries (and contributed just under half of the total). That deal was completed in early March, but not without difficulty. It was exceptional in that the loan was secured by the resources that the Fund had just committed in principle to Argentina.[146]

Argentine officials, led by the chief debt negotiator, Mario Brodersohn, met almost nonstop with representatives of the banks' Advisory Committee over a two-month period starting in mid-February 1987. Stuart also met with the bankers on several occasions, providing independent information on policies and economic conditions in Argentina. Negotiations nearly broke down entirely around the end of March, but by mid-April the deal was ready to be signed. The banks agreed to reschedule some $30 billion in loans and to assemble the new-money loan for $1.95 billion that had been requested by the Fund. Part of the difficulty was that the deal being negotiated was unusually complex and contained a number of innovative features designed to ameliorate Argentina's debt burden (discussed below, in Chapter 11). Another difficulty was that whenever one indebted country succeeded in negotiating terms that were more favorable than those granted previ-

[145]Minutes of EBM/87/33 (February 26, 1987), p. 9; and Executive Board Decision No. 8535-(87/33).

[146]Specifically, the government instructed the Fund to pay any sums that Argentina would be eligible to draw under the stand-by arrangement or the CFF into an escrow account at the Federal Reserve Bank of New York until the bridge loan had been fully repaid. Such instructions had been issued on a number of occasions starting in the late 1970s, but until this instance, the practice had been applied only to bridge loans from commercial banks, not official creditors. The terms of the escrow agreement are specified in a March 5, 1987, cable from the central bank to the Federal Reserve Bank of New York; in IMF/RD Managing Director file "Argentina, January to March 1987" (Accession 88/274, Box 2, Section 269).

ously to other countries, those terms would become the expected norms by indebted countries around the world. The fact that Mexico had persuaded its bank creditors in September 1986 to price its new-money loan at 13⁄16 of a percent over LIBOR, rather than at 7⁄8 (see above, p. 446), emboldened Argentina to press for similar terms; the banks felt it necessary to resist, if only to avoid having to fight similar battles elsewhere. The compromise solution priced the new-money loan at a spread of 7⁄8 and the rescheduling at 13⁄16.[147]

The Advisory Committee estimated in mid-April that they could produce a critical mass (95 percent) by the end of May. With help from Eduardo Wiesner (Director of the Western Hemisphere Department) and Desmond Lachman (Chief of the River Plate Division), Committee bankers and Argentine officials went on a global "road show" through much of May, trying to secure the participation of hundreds of small to medium-sized banks throughout Europe, North America, the Middle East, and Asia. Lachman also participated in the May meeting of the Paris Club, at which official creditors agreed to reschedule Argentina's outstanding obligations on favorable terms. Set against these positive developments, however, were early signs that Argentina was once again failing to stick with its economic program. Lachman went directly from the road show and the Paris Club meeting to Buenos Aires, where a staff team had just spent ten days reviewing the latest economic statistics. Monetary policy had slipped, and inflation was running well above program targets. Fiscal policy also was off target and would have to be tightened if the targets were to be met. The source of the problem was obvious and familiar: parliamentary elections were to be held in September, and until then the authorities' room for maneuver was limited.

Because of these difficulties, progress came slowly; but it did come. On June 19, Rhodes (who was chairing the Argentine Advisory Committee, along with those for Mexico and Brazil) informed Erb that 92 percent of the concerted lending package was now committed, and he expected to complete the deal sometime in July.[148] Discussions continued between the staff and the authorities, and a new Letter of Intent—spelling out a number of actions aimed at raising fiscal revenues and implementing structural reforms—was signed in Washington on July 8.[149] On paper, at least, all of the required conditions for the stand-by arrangement were in place: official financing, bank financing, and a viable economic program. When the Executive Board considered (in restricted session) the proposal to implement the arrangement (Argentina's twelfth) on July 23, Directors expressed widespread disappointment with the many policy slippages that had occurred since they had approved the program in principle back in February, but they felt that they once

[147]For a detailed description of the deal, see "Argentina—Recent Economic Developments," SM/87/162 (July 15, 1987), pp. 102–5.

[148]By July 9, commitments covered 99 percent of the total. The agreement was finalized at a ceremony in New York on August 20, which Camdessus attended on behalf of the Fund.

[149]Lachman's mission concluded its work in Buenos Aires on June 3. Subsequently, Sourrouille and Machinea went to Washington to hold talks with the Managing Director and conclude the negotiations. Those talks ended in success in early July. "Argentina—Letter on Economic Policy," EBS/87/155 (July 8, 1987).

again had to give the authorities the benefit of the doubt. The SDR 1.1 billion ($1.4 billion) arrangement was unanimously approved.[150]

Collapse of the Program, August 1987–March 1988

As the time of the parliamentary elections approached, Alfonsín found himself heavily criticized for caving in to the demands of foreign creditors. The Peronist (Justicialista) Party, with a platform of unilaterally halting the servicing of external debt, gained enough seats in the September 6 election that Alfonsín's Radical Civic Union lost its majority in parliament. When Sourrouille and Machinea arrived in Washington a few weeks later for the Annual Meetings, Argentina seemed more likely than ever before to join with other major Latin American indebted countries in resisting pressure from the banks to pay large amounts in interest or from the IMF to adjust policies further.

In spite of these difficulties, the authorities showed a willingness to try to keep their economic program on track and to keep the stand-by arrangement with the Fund alive. The task would not be easy. It was only two months since the arrangement had been activated in July, but the program's quantitative targets were already being breached, in some cases by wide margins. Both the staff and the Managing Director stressed to the authorities at the Annual Meetings that Argentina would not be eligible to make the next drawing under the arrangement (scheduled to be made on October 20) without some tightening of the policy stance.[151] Several officials stayed on in Washington after the Meetings to negotiate a set of program commitments for 1988, and on October 14, the government announced a new package of revenue measures and policy reforms that the staff judged to be adequate to restore viability to the program. Two days later, the U.S. Treasury issued a press release announcing plans for a new $500 million multilateral bridge loan, in anticipation of an early resumption of Fund lending under the stand-by arrangement.[152] After the remaining details were worked out, on November 12 Camdessus approved the program for submission to the Executive Board.

Executive Directors were being asked, for the sixth time in 4½ years, to approve a drawing for Argentina under a stand-by arrangement after the original criteria had not been fulfilled.[153] In each case, Directors had shown a sensitivity both to the political difficulties that prevented the government from undertaking more effective adjustment and to the dangers of forcing Argentina into a default on its external debt. (The elected government at this time was enduring frequent army rebellions and coup attempts.) Each case, however, brought into sharper focus the

[150]Minutes of EBM/87/107/R-2 (July 23, 1987).

[151]See "Argentina—Amendment of Stand-By Arrangement," EBS/87/234 (November 16, 1987).

[152]As had been done in February, this loan was to be secured by a pledge against future drawings on the Fund arrangement.

[153]Under the stand-by arrangements approved in January 1983, January 1985, and July 1987, Argentina made a total of 10 drawings. Three were made upon the initial approval of the arrangement; the other seven (of which this was the sixth) required either a waiver or a new Letter of Intent that modified the original commitments.

contrast between promise and performance. In this instance, the uncertainty was compounded by the absence of a firm assurance on financing. Rather than requiring a fixed increase in lending exposure from bank creditors (with a critical mass of commitments) prior to the Board's approval—a commitment that was simply unachievable at the time—the Fund was merely noting that future drawings would require a review by the Board. If the banks failed to sign an agreement with Argentina, then the program would be underfinanced, and the Fund would have to decide at that time whether to suspend the arrangement or grant yet another waiver. On December 2, 1987, Directors finally began to rebel a bit.

Most Directors, especially those from creditor countries, agreed that the government's program was inadequate and was unlikely to be fully implemented,[154] and that the balance of payments deficit for 1988 could not be financed; but they also feared that to disallow the request would bring severe financial consequences to Argentina, to other indebted countries, and to the international financial system. Perhaps Guenter Grosche (Germany) best represented the view of the Board in concluding that he was supporting the request "with considerable reservations, and only because Argentina is an exceptional case." Once again, Rye was among the strongest critics, complaining that the program had "been patched beyond recognition," contained "unacceptable risks," and would set "an extremely dangerous precedent." Along with two other Directors (T.P. Lankester of the United Kingdom, and G.A. Posthumus of the Netherlands), Rye abstained from approving the request.

Two Directors—Jorgen Ovi (Denmark) and Posthumus—attempted to steer the Board onto a middle course by suggesting that extra conditions be placed on future drawings under the arrangement (i.e., from February 1988 on), but the staff objected that such conditions would decrease the already precarious likelihood that the commercial banks would be willing to approve their part of the required financing.[155] Other Directors expressed concerns that the Fund's hands were being tied by the practice of closely linking Fund approval to the bank packages, but no one had any practical alternative to offer. At the end of the day, the request was approved.[156]

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[154]The October 14 package of fiscal actions was still awaiting approval by the parliament, in which Alfonsín's party no longer controlled a majority.

[155]Under the terms of the existing agreements with bank creditors, Argentina's failure to draw the full scheduled amount of Fund resources would make the previously rescheduled payments immediately due. Ovi's proposal was to make the second drawing under the arrangement conditional on adoption of the authorities' proposed fiscal package; Posthumus's variation was to propose that a portion of the initial drawing be withheld until a track record of fiscal adjustment had been established.

[156]The Executive Board decision waived the conditions on the drawing originally scheduled for October 1987, approved conditions governing the four remaining drawings scheduled to be made through August 1988, and permitted a drawing under the CFF to compensate for a temporary shortfall of export receipts. The next drawing was scheduled for December 20 and was conditional on compliance with the newly established quantitative performance criteria for October 31. The three 1988 drawings were made conditional on the successful completion of an additional review by the Board. Minutes of EBM/87/163/R-1 (December 2, 1987) and EBM/87/164/R-1 (same date). References to individual Directors in this and the preceding paragraphs are from meeting 87/163, pp. 14 (Grosche), 15–18 (Rye), 20 (Ovi), and 39 (Posthumus). The modifications to the stand-by arrangement are described in Decision No. 8739-(87/164), adopted December 2, 1987.

Directors' fears were not in vain, and slippage was not long in coming. The review mission that had been scheduled to go to Buenos Aires immediately after the Board meeting was delayed by difficulties in getting the October budget revisions through parliament. The package was finally approved in early January, but only after it had been watered down to satisfy opposition demands. By the time Lachman's team arrived, the government was projecting a fiscal deficit for 1988 equivalent to at least 4¼ percent of GDP, compared with the 2 percent ceiling under the program signed two months earlier.[157] While the mission continued with its work, Sourrouille and Machinea went to Washington to ask the Managing Director to consider letting them raise the ceiling, but Camdessus held his ground, insisting that Argentina could not finance a deficit of that magnitude. In late January, when Beza went to Buenos Aires to deliver the same message, not only did the authorities reject the suggestion that they tighten policies; they also skipped a payment due to the Fund on January 26, thus going into arrears to the Fund for the first time. The mission ended in an impasse.

In an attempt to resolve these differences, Camdessus and Alfonsín met tête-à-tête in secrecy in Madrid, Spain, at the beginning of February.[158] Camdessus promised the president that he would help him make the case for debt relief, on condition that Argentina adopted a tough adjustment program that the Fund could support. On that basis, Alfonsín indicated that he could accept a lower target for the fiscal deficit.[159] The details would still have to be worked out, but the two leaders appeared to have found a winning formula.

Sourrouille and Machinea went again to Washington in mid-February 1988 to negotiate the terms for restoring the financial program. Argentina had cleared its arrears to the Fund, and the U.S. government was putting together plans to provide an additional $500 million in short-term financing for Argentina as a bridge to anticipated drawings from the Fund.[160] The authorities were prepared to make a commitment to the Fund to reduce the deficit to 2 percent of GDP for 1988 and to balance the budget in 1989, but they preferred not to put those targets in a formal Letter of Intent that inevitably would be subjected to public scrutiny at home.

[157]The rapid deterioration of economic conditions in Argentina at that time gave rise to an unusual circumstance: although the performance criteria governing the December 20 drawing under the stand-by arrangement applied to data as of end-October and had been set retroactively by the Executive Board on December 2 (on the basis of a Letter of Intent that had been finalized and signed on November 12), those criteria were not met, and the drawing was delayed. The decision to set the criteria retroactively was questioned at EBM/87/163/R-1 (December 2, 1987), pp. 45–46, by Angelo G.A. Faria (Temporary Alternate—Kenya). The basis for this unusual practice was explained by the staff in the afternoon session of the meeting (EBM/87/164/R-1, pp. 1–3).

[158]Camdessus had met with Alfonsín on earlier occasions, while he was chairman of the Paris Club. Those meetings were usually in Buenos Aires and were always held in secrecy, to avoid complicating ongoing negotiations with creditors. On this occasion, Alfonsín was in Spain on a state visit, and Camdessus made a side trip from a stopover in Paris.

[159]Polak (1994), p. 33, describes this as "a meeting in which Alfonsín had received the impression that Argentina might obtain substantial debt relief." Polak's account is based on a private conversation with Alfonsín in 1992.

[160]This amount was made available in the form of a swap facility with the U.S. Treasury.

Camdessus responded positively to these signals, and after a week of further negotiations, agreement was reached on a revised Letter of Intent with a 1988 deficit target of 2.7 percent of GDP.[161]

Obviously, Executive Directors could not be expected to be much happier with the new proposal than they were in December. If one focused on what had actually been achieved, as opposed to what was being promised, Argentina was no closer either to balancing the budget or to reaching an agreement with its commercial creditors. The staff now estimated that the external financing gap could be closed only if the banks agreed to increase their exposure by about $1.75 billion in 1988, on top of the $700 million to which they were already committed under the existing agreement. A deal of that magnitude, given the state of economic conditions and policies in Argentina, would take several months at best to complete. Nonetheless, both the adjustment program and the financial arrangement were important enough for Argentina that the Managing Director was prepared to argue that pushing ahead was the best course "for Argentina, the Fund, and the cooperative debt strategy."[162]

Meeting on March 18, Directors made a rare show of resistance and insisted that the terms of the stand-by arrangement be strengthened before they would approve it. This resistance was all the more remarkable, in that Feldman announced early in the meeting—without alluding specifically to the Camdessus-Alfonsín agreement—that "additional measures [were] being developed to limit the deficit [for 1988] to 2.0 percent of GDP to set the basis for achieving equilibrium [i.e., a zero deficit] next year." In view of the frequent and substantial slippages in implementing programs throughout the 1980s, it was not easy to establish credibility for a promise of that dramatic an improvement.

Ovi initially requested that the proposed decision be modified to require that appropriate financing be in place before any more drawings be allowed. Ovi's proposal was supported by Rye, who indicated that he would abstain unless the amendment was accepted; by Charles Enoch (Alternate—United Kingdom), who indicated that he would prefer even stronger assurances; and by Posthumus. At that point, however, Feldman intervened to state that his authorities could not accept such an amendment, and Camdessus noted that—with only two months to go before the next drawing would be due—it was unlikely that any bank financing would be ready in time. Camdessus therefore proposed that the amendment be amended to require only that "satisfactory progress" be made by May on financing and on eliminating arrears to commercial and bilateral official creditors. Objecting on behalf of the United States, Dallara argued that the Fund's normal practice was to require financing assurances only at the time of initial approval, not at a midterm review; to which the Managing Director replied that the Argentine situation was "without precedent owing to the magnitude of the possible gap that could emerge over the next few months." Several other Directors made strong

[161]"Argentina—Letter on Economic Policy," EBS/88/41 (February 24, 1988).
[162] Minutes of EBM/88/40/R-2 (March 18, 1988), p. 1.

statements of reservation, but the Ovi-Camdessus amendment was accepted and the revised program was approved without objection.[163]

The program, unfortunately, was dead on arrival. At the end of March, Argentina began missing interest payments on its foreign bank loans, effectively halting what little progress had been made in negotiating a settlement. Shortly afterward, new slippages in implementing fiscal policy became apparent. Under the circumstances, Camdessus no longer felt that he could take the case for debt relief to creditors. In view of the strong opposition by the U.S. authorities to any form of officially sanctioned debt relief (as discussed in the next chapter), it seems highly unlikely that the Managing Director could have delivered on his promise even if Argentina had stayed the course on fiscal policy. Be that as it may, by June (when the next Fund mission went to Buenos Aires and by which time the scheduled May drawing had not been made), it was clear that the deficit for 1988 could not be kept below 5 percent of GDP. Further discussions (even to complete the annual Article IV consultations) were put on hold, and the Argentine stand-by arrangement lapsed into history.

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[163]Rye was particularly forceful: "I challenge the staff to recall one previous arrangement where so much effort has been expended, and so much has been conceded, to keep a foundering program afloat." The Board's approval allowed one drawing (for SDR 165.5 million, equivalent to approximately $225 million and 15 percent of Argentina's quota, originally scheduled for December 1987) to take place immediately under the stand-by arrangement, reduced the total size of the arrangement by that same amount by canceling the drawing originally scheduled for February 1988, and allowed a drawing of SDR 233.15 million ($320 million and 21 percent of quota) under the CFF. At this stage two future stand-by drawings (also for SDR 165.5 million) remained scheduled, for May and August 1988. Minutes of EBM/88/40/R-2 (March 18, 1988) and EBM/88/41/R-1 (same date). References to individual speakers are from meeting 88/40, pp. 2 (Feldman), 24 (Rye), 47 (Camdessus), and 47–48 (Dallara). Approval was in Decision Nos. 8820- and 8821-(88/41), adopted March 18, 1988.

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