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Global Oversight: Strengthening and Broadening IMF Surveillance

The modern concept of IMF surveillance dates from the 1978 amendment of the IMF Articles of Agreement, which introduced an entirely new Article IV.[1] Before that amendment, member countries that maintained restrictions on current account transactions were required to consult regularly with the Fund about their plans to reduce and eventually abandon those restrictions. Those discussions were known as Article XIV consultations, under the terms of the article that specified members' and the Fund's obligations regarding the maintenance and removal of exchange restrictions. Some of the countries that had already removed their restrictions and had agreed not to impose new ones volunteered to hold regular consultations with the Fund under the terms of Article VIII, focused primarily on the consistency of the country's macroeconomic and exchange rate policies. The Second Amendment established a new system of Article IV consultations, obligatory for all members, and it expanded the concept of surveillance to cover exchange rate policies, broadly defined.[2]

For a dozen years after 1978, as chronicled in the previous History (Boughton, 2001), the Fund experimented with ways to make the vague concept of surveillance effective and fully operational. Surveillance continued to evolve in the 1990s, but not always successfully. On the positive side, the international community made progress toward agreeing on what constitutes good economic policies, which sharpened and focused the Fund's policy advice. At the same time, surveillance activities broadened from the initial focus on macroeconomic stabilization to devote much more attention to structural policy issues such as the efficiency of labor and product markets. By mid-decade, it was nonetheless becoming painfully clear that surveillance was not effectively identifying the preconditions for economic and financial crises. That realization led to an intense but frustrating effort to strengthen the crisis-prevention function. The first two sections of this chapter examine these issues.

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[1]The text of Article IV and the principal Executive Board decision on how this work should be conducted are reproduced at http://www.imf.org/external/pubs/ft/history/2011/index.htm.

[2]Technically, Article XIV consultations remained obligatory for all members that had not yet accepted the obligations of Article VIII. In most cases, those consultations were folded into the new Article IV discussions. For a more detailed history through 1989, see Boughton (2001), Chapter 2, especially pp. 67–74.

The inadequacy of surveillance over the economic policies of the largest industrial countries was the subject of much discussion and debate in the public arena in the 1990s. This was an irreducible problem, in part because of the limited menu of available sanctions. Countries with no need to borrow from the Fund and willing to risk the disapproval of the international community could freely ignore the Fund's counsel, and often did. In some cases, discussed in this chapter's third section, poor effectiveness arose from a lack of force, clarity, or prescience in the Fund's advice.

In addition to Article IV consultations, which the IMF generally called bilateral surveillance, the staff prepared periodic studies of regional and global economic and financial developments. The general appellation for these activities was multilateral surveillance, a term that was first applied to the World Economic Outlook (WEO) and later generalized.[3] Multilateral surveillance was mandated by the new Article IV, Section 3(a), which required the Fund to "oversee the international monetary system in order to ensure its effective operation." The staff was already conducting the WEO exercise annually, and the amendment of the Articles merely raised its profile. Over time, the WEO and a companion activity to monitor international capital markets grew into the two flagship publications of the Fund.[4]

The Practice of Surveillance in the 1990s

Historically, the primary concern regarding surveillance has been to increase its effectiveness as an influence on policymakers. Article IV, as amended in 1978, sets out the obligations of each member "to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates." That requirement has been interpreted in ways that have made it difficult to judge that a member country is not in compliance. Consequently, the ability of the Fund to use Article IV consultations as a means to identify shortfalls in members' policies and to agree with the member on a solution has been severely circumscribed.

[3]The first use of the term in the Fund was in March 1978. During an Executive Board meeting on how to conduct surveillance once the Second Amendment came into effect in April, R.J. Whitelaw (Australia) noted that the Fund should be "looking at the economies of several countries and their interactions together, as was indeed done in the world economic outlook exercise. . . . No particular weight should be placed either on bilateral or on multilateral surveillance, because both had a role to play"; minutes of EBM/78/36 (March 20, 1978), p. 8.

[4]The history of the development of the WEO is covered in Boughton (2001), Chapter 5. Also see Hacche (2009).

Consultation Procedures

Throughout the 1990s, the Fund conducted periodic—generally biennial—reviews of the principles and implementation of surveillance with the aim of overcoming these limitations. It also instituted procedural changes aimed at improving the continuity and coverage of surveillance. These changes included holding periodic informal Executive Board meetings on World Economic and Market Developments (WEMD). At each of these meetings, which were held from four to seven times a year starting in February 1993, the staff reported on developments in a selection of countries thought to have systemic spillover effects on other countries, to be vulnerable to economic shocks, or to be otherwise affected by issues of concern to the Fund.

WEMD meetings were held in restricted session, without formal minutes being prepared, so that Directors could have an unfettered interchange. Initially, the WEMD sessions focused mainly on systemic developments arising in the G7 countries. Later, especially after the 1994–95 Mexican peso crisis, coverage expanded and refocused on developments in emerging markets. In addition to staff reports on individual countries, these sessions usually included a report on systemic developments by Michael Mussa (Economic Counsellor and Director of the Research Department). Mussa had an extraordinary ability to convey complex economic analysis in a way that was understandable, respectful to his audience, and often humorous; on one occasion, he even broke into song. These informal meetings thus had an aura that elevated them further in their importance in the Fund.

Also in 1993, management revived the Surveillance Committee, a group of senior Fund officials that had met semiregularly from 1978 to 1986. The original committee, usually chaired by the Managing Director, was disbanded when its deliberations became too routine. The new committee, usually chaired by the Managing Director or one of his deputies, was much more active, meeting as often as once a week to identify vital cases and to guide the Fund's priorities in focusing surveillance activities.[5] It met throughout the remainder of the decade and beyond.

One procedure that fell into disuse in the 1990s was the practice of holding "supplemental consultations" with members in cases in which the Managing Director judged that a change in exchange rate policies might be in order. Under a 1979 decision by the Executive Board, the Managing Director was empowered to initiate informal discussions with a member, report informally to Executive Directors on the findings, and then call a supplemental consultation if warranted by the circumstances. That procedure was invoked twice in the 1980s: in 1982, in response to a currency devaluation by Sweden that some of its neighbors thought to be excessive; and in 1987, in response to

[5]"Biennial Review of the Implementation of Surveillance over Members' Exchange Rate Policies and of the 1977 Surveillance Decision," SM/95/22 (January 26, 1995), p. 18. The work of the previous Surveillance Committee is described in Boughton (2001), p. 103.

an undervaluation of the Korean won that had become a thorn in relations between the Republic of Korea and the United States (Boughton, 2001, pp. 104–06, 108–19, and 128–30).

At the conclusion of the 1993 biennial review of surveillance, the Fund modified the procedures for calling a supplemental consultation with the goal of removing the stigma attached to the process and thus expanding its usefulness. Previously, to call for a supplemental consultation, the Managing Director would have to find that "a modification in a member's exchange arrangements or exchange rate policies or the behavior of the exchange rate of its currency may be important or may have important effects on other members."[6] Although that language was not intended to convey an inherently negative message about the country's policies, it came to be interpreted that way. Hence, the staff was reluctant to use the procedure, and countries were loathe to be subjected to it.

The new language approved in 1993 indicated that the Managing Director could initiate the process "whenever he considered that important economic and financial developments were likely to affect a member's exchange rate policies or the behavior of the exchange rate of the member's currency." This new wording encompassed external developments, including natural disasters, that could require a country to adjust its economic and exchange rate policies.[7] Despite these good intentions, the perception of a stigma persisted, and the procedure remained unused.

The Mexican peso crisis induced the Fund to try to direct its surveillance more effectively to foreseeing and preventing financial crises. As soon as the dust began to settle after the Executive Board approved a massive stand-by arrangement for Mexico in February 1995, Managing Director Michel Camdessus called L. Alan Whittome out of retirement to prepare a report on how to accomplish such a shift. Whittome, a former director of both the European Department (EUR) and the Exchange and Trade Relations Department (ETR), went to work immediately and completed the report in six weeks.

In a highly controversial decision, Camdessus insisted that the Whittome report should be discussed by the Executive Board in the strictest confidence. To ensure that the report would not get bogged down and watered down in the Fund's painstaking internal review processes, Camdessus had given Whittome unrestricted access to all relevant documents and personnel at the Fund and dispensed altogether with internal reviews. No one from the Managing Director on down had an opportunity to comment on it before it was circulated to Executive Directors. That made it potentially explosive, but Camdessus wanted the Board to have an unfettered assessment of the issues.

[6]Decision No. 6026-(79/13), adopted January 22, 1979; reproduced in Boughton (2001), p. 130.

[7]"Summing Up by the Chairman, Biennial Review of the Fund's Surveillance Policy," SUR/93/15 (February 3, 1993), p. 3. Also see "Biennial Review of the Fund's Surveillance Policy," SM/92/234 (December 30, 1992), pp. 17–18.

Each Executive Director was given one copy of the report, with each copy uniquely numbered on every page to discourage leaks. The Board discussion was in restricted session, with very limited attendance. When a member of the U.S. Congress asked the U.S. Treasury for a copy of the report, Camdessus and Stanley Fischer (First Deputy Managing Director) tried to block the transfer. This extraordinary effort at secrecy for a document intended to provide guidance on the Fund's future consultations with member countries would turn out to be one of the last such decisions before the Fund's gradual but ultimately dramatic shift toward openness.

Whittome made five key recommendations for strengthening the Fund's ability to detect the preconditions for financial crises, based on specific weaknesses he found in the Fund's handling of consultations with Mexico.[8]

- First, surveillance should be continuous whenever the staff has concerns about the risks of major problems developing. The annual consultation cycle is not sufficient in such cases unless staff resources are dedicated to following developments affecting the country throughout the year and unless staff keep management well informed. Throughout 1994, the staff assigned to follow the Mexican economy had additional responsibilities that may have kept them from thoroughly analyzing problems as they emerged.
- Second, the Fund should encourage members to provide, and preferably to publish, key economic data in a comprehensive and timely manner, and plainly and publicly. Mexico's policy of publishing its foreign exchange reserve position just three times a year, although not unique among emerging-market countries, had limited the ability of Fund staff and market analysts to judge the effects of shifts in financial and political conditions.
- Third, the culture of the Fund should adjust to give less "benefit of the doubt" to member countries when the staff finds indications of weaknesses in economic conditions or policies. As long as the Mexican economy appeared to be performing well, the confident tone of the authorities had had a mesmerizing effect on the Fund.
- Fourth, the staff should develop more intensive contacts with capital markets and other outside groups, and the area departments should take information from these groups more seriously. Although some private analysts had been as upbeat as the Fund in the second half of 1994, others had sounded warnings persistently without the Fund taking much notice.
- Fifth, consultation reports should be written more clearly, with sharper analysis and with conclusions stated more boldly and incisively. A careful reader might have been able to find muted cautions hidden within the staff's reports on Mexico, but few would have found any reason for alarm.

[8]"Mexico—Report on Fund Surveillance, 1993–94," EBS/95/48 (March 23, 1995).

The Executive Board responded favorably to the Whittome report and took its recommendations seriously.[9] Even so, little action was taken to strengthen the practice of surveillance. The prevailing view seemed to be that the weaknesses identified by Whittome were peculiar to Mexico. As discussed in Chapter 10, the annual consultations with Mexico happened to have been concluded long before the crisis hit, the authorities happened to have personal star power and good personal relations with Fund management, and the crisis had been initiated by specific political events that were unlikely to be repeated. Not until a new and more generalized wave of shocks in 1997 again highlighted the shortcomings would management and the Board realize how systemic these issues really were.

Coverage of Issues

The practice of surveillance faced an inevitable and constant tension between (a) comprehensive and consistent coverage of key issues and (b) selectivity in coverage aimed at focusing on the most important issues in a particular country at a particular time. Throughout the 1980s, those decisions were left primarily to the mission chief in each case, with a general expectation of selectivity. Exchange rate policy was always the central focus, but the way it was treated and its relation to other macroeconomic policies were hard to get right.

The most specific overall guidance to the staff on conducting Article IV consultation discussions was contained in a 1977 Executive Board decision setting out the "principles and procedures" for conducting bilateral surveillance under the new Article IV, which was about to take effect. Paragraph 3 of the 1977 decision decreed that the staff should assess each country's exchange rate policies by examining them in relation to the country's balance of payments, its "general economic situation and economic policy strategy," and "the conditions that are necessary for financial stability, the promotion of sustained sound economic growth, and reasonable levels of employment."[10] In other words, Article IV consultations were to be comprehensive examinations of each country's overall macroeconomic policy and conditions. The standards against which success could be judged were left vague.

The first guidance note to staff on how to conduct Article IV consultations was prepared in ETR and issued in 1980.[11] The note was approved by the Managing Director but was not discussed or reviewed by the Executive Board. On the substance of consultation reports, that note simply reproduced the wording of the 1977 decision.

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[9]See minutes of EBM/95/33 (April 4, 1995).

[10]The 1977 decision, along with the new Article IV, may be accessed at http://www.imf.org/external/pubs/ft/history/2011/index.htm.

[11]Memorandum from C. David Finch (Director of ETR) to Heads of Department, "Guidance Note on Article IV Consultation Reports," June 9, 1980. IMF archives, Historian's files. ETR was the forerunner of the Policy Development and Review Department (PDR).

For the 1991 biennial review of surveillance, the staff prepared—for the first time—a formal operational guidance note for consideration by the Executive Directors. In its final version, the 1991 guidance note stressed that exchange rate policies—whether to peg, manage, or float the exchange rate, and how to go about it—should be examined "within the framework of macroeconomic *and related structural* policies" (emphasis added) and with an eye to whether these policies were "conducive to the achievement of reasonable price stability, sustainable external positions, and orderly economic growth." The note also encouraged the staff to use its own judgment in choosing topics and to aim for "selectivity rather than uniformity of coverage of subjects."[12]

This guidance was still vague, but it clarified the framework a bit. A more substantive breakthrough came in 1995, when the Executive Board approved a new and more specific guidance note. That note called for staff reports to include a "candid assessment of . . . exchange rate policies based on an evaluation of balance of payments developments, including the size and sustainability of capital flows." As appropriate, reports also were to cover "financial market developments . . . cross-country comparisons . . . [and] deficiencies in data quality and/or lack of timely reporting."[13] As discussed in more detail in the next section of this chapter, these prescriptions and the increased specificity responded in large part to the continuing weaknesses in surveillance that had been unmasked at the end of 1994 by the financial crisis in Mexico. The final revision in this decade came in 1997, when the Board approved a new guidance note that was substantively similar to that of 1995 but with more detail on the kinds of structural policies that staff reports might cover.

To make a "candid assessment" of a country's exchange rate policies, the staff had to have an effective methodology for assessing whether the exchange rate was at an appropriate level, or at least within an appropriate range. In the late 1980s and early 1990s, the staff generally was skeptical of the ability of monetary authorities to aim at exchange rate levels that could be maintained consistently without generating competitive or inflationary pressures. Many on the staff were also skeptical about their own ability to determine whether a particular rate was in or out of an appropriate range except in the most egregious cases of misalignment.[14] Nonetheless, the Fund had to try.

Toward the end of 1994, the Research Department (RES) initiated a project to make its exchange rate assessments more systematic and consistent, starting with the

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[12]The guidance note was attached to the Summing Up for the 1990 review and was approved with some amendments at EBM/91/15 (see minutes, pp. 13–15). Much of the note dealt with procedural matters, but paragraphs 3 and 7 specified priorities for the coverage of issues in Article IV and other surveillance reports. This note may be accessed at http://www.imf.org/external/pubs/ft/history/2011/index.htm. Also see "Conclusions of the Biennial Review of the Implementation of Surveillance over Exchange Rate Policies and of the 1977 Surveillance Decision," SM/91/27 (February 1, 1991), pp. 5–6.

[13]This note is excerpted at http://www.imf.org/external/pubs/ft/history/2011/index.htm.

[14]The evolution of Fund advice on exchange rate policy in the 1980s is covered in Boughton (2001), pp. 84–88.

major industrial countries. Together with the Policy Development and Review Department (PDR), RES began developing a model-based methodology for assessing the exchange rates that would equilibrate macroeconomic (internal and external) balances of these countries. Once this work was under way in the spring of 1995, management established an interdepartmental group, the Coordinating Group on Exchange Rate Issues (CGER), that brought together staff from PDR and RES (as cochairs) with those from the relevant area departments to oversee these assessments.

As a basic methodology, the CGER chose to continue the emphasis on macroeconomic balances the Fund had relied upon since the late 1970s, as opposed to purchasing power parity or its variants. That is, the assumption was that each country had a sustainable external payments balance (not necessarily zero—it could be positive or negative, according to relative time preferences for aggregate consumption and other assumptions) and a sustainable internal balance. An internationally linked macro model would then generate the corresponding exchange rates, subject to further assumptions about the mix of other policies.[15]

Over time, this methodology played an increasingly important role in the Fund's work. Initially, it provided a consistency check against the estimates made by country-specific methods used by the economists working on the major industrial countries. By the late 1990s, it was being applied to smaller industrial countries as well, and the staff was working on models for emerging-market countries. In this period, the CGER did not result in the Fund declaring any country to be out of compliance with Article IV or to have a fundamentally misaligned exchange rate, but it enabled staff assessments to be more specific. In the early years of the following decade, when the methodology was being applied more broadly, the staff used the CGER methodology to support its conclusion that the U.S. dollar was "substantially out of line [i.e., overvalued] with medium-run fundamentals."[16]

Coverage of Countries

Another ingredient of surveillance was to ensure continuity and comprehensive coverage. From the outset, the Fund set a goal of holding annual consultations with every member country. That goal proved to be impractical, but it continued to serve as a beacon toward which the institution could and should strive. Holding less frequent discussions would risk missing important changes in circumstances and possibly failing to foresee a looming crisis. That risk had manifested itself in 1982 with the eruption of the Mexican debt crisis in mid-August. The Executive

[15]For an exposition of the CGER methodology, see Isard and Faruqee (1998).

[16]"Methodology for Current Account and Exchange Rate Assessments," SM/01/152 (May 24, 2001), p. 31. In the published version of that paper (Isard, Kincaid, and Fetherston, 2001), the United States was identified only as "Country A," and the "illustrative" assessment was that its exchange rate was "substantially stronger than its medium-run equilibrium level" (p. 17).

Board had finished the Article IV consultation a few weeks earlier, but that had been the first full review of the Mexican economy in more than two years.[17] Both management and the Board concluded that the long gap had left the Fund unable to provide adequate warnings and advice, and they committed themselves to improving the coverage and continuity of bilateral surveillance. Within a few years, however, the increased pressure on staff and Board time took its toll, and the balance swung back toward greater selectivity.

At the outset of the 1990s, the Fund was using two methods to achieve the right balance. First, for countries judged to be both well-enough managed that they would not need much assistance from the IMF and small enough that any problems would not spill over onto other countries, the Fund aimed to hold consultations every 18 or 24 months, rather than annually. Second, for countries of somewhat greater international importance but where economic problems were minor, the Fund could apply a "bicyclic" procedure. Putting a member country "on the bicycle" meant that the staff would hold discussions with the authorities and prepare a report once each year, but the Executive Board would discuss the report and reach conclusions only every other year. In the off-years, the written report would be less detailed, with the objective of reducing both staff and Executive Directors' time.[18]

Many of the country officials from bicyclic countries or those with long consultation intervals, the Executive Directors representing these countries, and the staff assigned to work on them resented being relegated to this inferior status. As of 1990, 34 countries were on the bicycle, 9 were on 24-month cycles, and 2 were to be examined every 18 months.[19] That reduced the number of annual Board meetings slightly, but at the cost of some loss of continuity in coverage and intermittent grousing about the classification of countries.

During the 1990 review of surveillance, the Executive Board agreed to modify the bicyclic procedure somewhat. Instead of circulating the off-year reports for information, the staff would circulate them to Executive Directors for approval on a lapse-of-time basis, with the understanding that any Director could ask for a meeting.[20] That decision did little to assuage hurt feelings, and it minimized the already small gains in

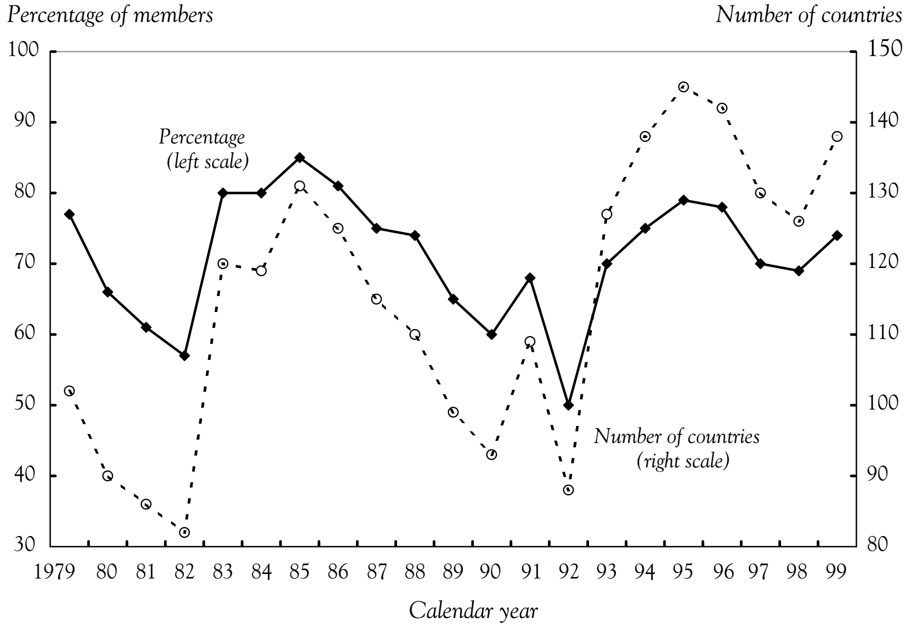
[17]The gap in Mexican surveillance in the late 1970s and early 1980s is discussed in Boughton (2001), pp. 282–88.

[18]The bicyclic procedure was established for this purpose in 1987; see Boughton (2001), pp. 95–97.

[19]"Biennial Review of the Implementation of the Fund's Surveillance over Members' Exchange Rate Policies and of the 1977 Surveillance Decision—Statistical Appendix," SM/90/103, Suppl. 1 (May 29, 1990), p. 4.

[20]Paragraph 1 of the February 1991 guidance note to staff, accessible at http://www.imf.org/external/pubs/ft/history/2011/index.htm. During the two years that this modified procedure was in effect, three interim consultations were concluded with a Board meeting at the request of an Executive Director: the Solomon Islands in 1991 and Myanmar and Greece in 1992. "Biennial Review of the Fund's Surveillance Policy—Background Paper," SM/92/234, Suppl. 1 (January 19, 1993), p. 8n.

Figure 4.1. Coverage of Article IV Consultations, 1979–99



Source: Staff reports for biennial reviews of surveillance.

efficiency that the original bicycle had engendered. Two years later, the Board agreed to scrap the bicycle altogether and place all those countries on annual cycles.[21]

From an all-time peak of 85 percent coverage in 1985, the rate steadily declined to a trough of 50 percent in 1992 (Figure 4.1). That figure resulted in part from a Board decision to postpone the 1992 consultations for countries that were not borrowing and had no imminent prospect of borrowing from the Fund and were not large enough to have systemic importance either globally or regionally.[22] Even before that decision, though, the coverage rate had been about two-thirds or less for three years, down substantially from the peak. After 1992, as the Fund added more staff to accommodate the demands of the rising membership, the number of consultations soared from a low of 88 to a new high of 145. Coverage from 1993 through 1999 averaged close to 75 percent of the membership.

[21]Decision No. 10362-(93/67); minutes of EBM/93/67 (May 10, 1993), p. 25.

[22]Minutes of EBM/91/157 (November 22, 1991), p. 3. That decision was motivated by the need to shift large numbers of staff to work on the Soviet Union and its component states. For the list of countries affected by this decision, see "Temporary Changes in Article IV Consultation Cycles," EBD/91/311 (November 22, 1991).

Nonmember Territories

In a few cases, the Fund held regular consultation discussions with nonmember territories following voluntary agreements with members. The prototype for this activity was an agreement with the Netherlands, beginning in 1970, to conduct Article VIII consultations with the Netherlands Antilles.[23] The Antilles (then comprising Aruba, Curaçao, and four other Caribbean islands) was an integral political part of the Kingdom of the Netherlands but had a distinct and autonomous economy based largely on tourism and petroleum. It also had its own currency, which was pegged to the U.S. dollar, not to the Netherlands guilder. A local political crisis in 1969 did considerable damage to the economy and to the balance of payments. That induced the Dutch government to ask the Fund to consult with the authorities in the Antilles and offer policy advice.[24] From then on, the Fund conducted regular consultations with the Antilles, first under Article VIII and later (after the Second Amendment took effect) under Article IV.

In 1990, the Fund entered into a similar agreement with the United Kingdom for consultations with Hong Kong. The government of the United Kingdom controlled the territory through a 99-year lease from China, scheduled to expire in 1997.[25] In April 1990, the British and Chinese authorities ratified an agreement for the return of Hong Kong to China when the lease ran out. Although Hong Kong was a major hub for international finance, its status as a British territory meant that its relations with the IMF had been limited. Beginning in 1979, the Fund included some data in the WEO. From 1987, it provided technical assistance, mainly on balance of payments accounting. Two years later, the British and Chinese teams negotiating terms for the handover agreed that Hong Kong would "continue to participate in the activities of the IMF" after the change in sovereignty. That decision enabled the IMF to begin collecting data more systematically and to initiate annual consultations and other contacts.[26]

The first Article IV consultation discussions with Hong Kong took place in October 1990, led by Bruce J. Smith (Assistant Director, Asian Department). The staff report praised the authorities' impressive record of economic success, while offering some low-key advice to strengthen balance of payments statistics, watch out for spending excesses, and consider implementing a value-added tax.[27] The staff recommended

[23]Formally and legally, these consultations were a component of the consultations with the Netherlands. In practice, they were conducted separately.

[24]"Kingdom of the Netherlands—Netherlands Antilles—Staff Report for the Article VIII Consultation," SM/70/230 (November 3, 1970).

[25]After the handover, the territory became known as Hong Kong Special Administrative Region of China, or Hong Kong SAR.

[26]See the "Fund Relations" Appendix in "United Kingdom—Hong Kong—Staff Report for the 1996 Article IV Consultation Discussions," SM/97/33 (February 6, 1997).

[27]"United Kingdom—Hong Kong—Staff Report for the 1990 Article IV Consultation Discussions," SM/90/233 (December 19, 1990).

placing Hong Kong on the bicycle, but the authorities asked for—and got—annual consultations.[28]

Regional Surveillance

Another approach the staff suggested in 1990 was to make increased use of regional surveillance. For groups of countries with close trade and other economic and financial ties, and especially for those with common currency arrangements, discussing them as a group would bring two benefits. The main advantage would be to generate more meaningful analysis of policy options. In some situations, regional surveillance would also yield economies of scale for the use of time by both the staff and Executive Directors. Groupings that seemed particularly apt included the European Communities, the CFA franc zone in Africa, and the Eastern Caribbean Currency Union.[29] The Executive Board cautiously endorsed that approach, though with the proviso that it should be primarily an analytical exercise and not a substitute for bilateral surveillance with individual member countries.

As detailed in Chapter14, the Fund began this sort of regional analysis with a study of the exchange arrangements of the CFA franc zone. That study eventually contributed to the regional understanding essential for successfully managing the devaluation of the CFA franc in January 1994. Soon afterward, when war broke out in the Middle East in response to the invasion of Kuwait by Iraq, the Fund undertook a study of the likely economic effects on the region. That study helped inform an interagency effort to provide advice and financial assistance to the most severely affected countries.[30]

Subsequent instances of regional surveillance in the 1990s, with the exception of the European issues discussed below, were mostly singular discussions of regional groupings or discrete events with important regional effects. Examples included coverage of regional policy issues in the West African Economic and Monetary Union in 1998; the establishment of the Central African Economic and Monetary Community in 1999; developments in the Eastern Caribbean Currency Union in 1998–99; postmortem analysis of the Asian financial crises of 1997–98; and studies of the economic and

[28]For a detailed review of these consultations up to the 1997 handover, see Dodsworth and Mihaljek (1997). The Fund's subsequent policy advice to Hong Kong is discussed in Chapter 12 of this History.

[29]"Biennial Review of the Implementation of the Fund's Surveillance over Members' Exchange Rate Policies and of the 1977 Surveillance Decision," SM/90/103 (May 29, 1990), pp. 13–14.

[30]For an overview, see "International and Regional Implications of the Crisis in the Middle East and its Aftermath," ICMS/Doc/91/5 (April 26, 1991).

policy implications of regional trade agreements.[31] The opening of the Regional Office for Asia and the Pacific in Tokyo in 1997 also symbolized the Fund's recognition of the need for a wider focus in that region. And in September 1998, the Fund hosted a special meeting of Latin American finance ministers and central bank governors to develop a regional approach to containing the effects of the financial crises that had already spread from East Asia to the Russian Federation (see Chapter12).

One of the most important and continuing examples of regional surveillance was with regard to the monetary integration of western Europe. The *ad referendum* signing of the Maastricht Treaty in December 1991 set in motion an integration process aimed at establishing full Economic and Monetary Union (EMU) by 1999. The staff of EUR monitored developments over the next year and then prepared a study of the regional and global implications that was intended to be discussed by Executive Directors around the end of August 1992. The paper noted that the transition from national formulation and implementation of monetary policy to joint implementation by participating European countries would take several years but ultimately would have profound effects on Europe, its trading partners, and the Fund. It proposed that the Fund begin to conduct a regional "Article IV type" surveillance consultation with the new regional monetary authorities (primarily the European Monetary Institute, or EMI, which the Maastricht Treaty would establish as a transitional body to the permanent European Central Bank, or ECB).[32]

Unfortunately, the Executive Board's discussion of the EMU paper was postponed in August 1992.[33] When the exchange rate mechanism (ERM) of the European Monetary System (EMS) came under speculative pressure in September and the British and Italian currencies were forced out, the hole in Fund surveillance was glaringly obvious. Coincidentally, European finance officials were in Washington for the IMF/World Bank Annual Meetings, and some of their negotiations took place either at Fund headquarters or at the convention hotels. The Fund itself, however, was kept on the sidelines, not only by the long-standing reluctance of European officials to seek the Fund's advice, but by the lack of a clearly articulated institutional position on EMU. Only

[31]See, for example, "Regional Trading Arrangements," SM/94/193 (July 22, 1994); "Interim Assessment of the World Economic Outlook—Regional and Global Implications of the Financial Crisis in Southeast and East Asia," EBS/97/231 (December 9, 1997); "West African Economic and Monetary Union—Recent Developments and Regional Policy Issues," SM/98/83 (April 13, 1998); "Central African Economic and Monetary Community—Recent Developments and Main Regional Policy Issues," SM/99/316 (December 30, 1999); and van Beek and others (2000) on the Eastern Caribbean Currency Union.

[32]"Economic and Monetary Union in Europe—Policy Issues and Implications for Fund Surveillance," SM/92/129 (June 26, 1992).

[33]Press reports, based on leaks from one or more Executive Directors, suggested that the delay was linked to the impending referendum on the Maastricht Treaty in France. Camdessus called that link "nonsensical" but did not offer an alternative explanation; minutes of EBM/92/105 (August 26, 1992), p. 21.

after the crisis had passed, in December 1992, did the Executive Board finally hold its postponed seminar.

That seminar led to general agreements that the Fund should hold regular discussions of EMU during the transition, that the Fund broadly supported the process despite some misgivings about the wisdom of defending exchange rates between countries with different trend rates of inflation, and that formal consultations under Article IV had to be restricted to sovereign member countries.[34] Over the next year, as turmoil continued in the ERM, the WEO and the periodic WEMD sessions became the main vehicles for these discussions. Twice in 1994 and once in 1996, the Board held more formal discussions of the broader implications of European monetary integration. The staff papers for these meetings stressed the potential benefits of EMU but also highlighted the political and technical hurdles that remained to be cleared before the process could be brought to a successful conclusion.[35]

When Executive Directors met to discuss the subject in March 1996, those hurdles were daunting. Almost none of the candidate countries for EMU met the criteria spelled out in the Maastricht Treaty, and the region was in a recession that appeared to be caused or aggravated by attempts to get fiscal deficits and debt levels down to qualifying levels. A few Directors from outside the European Union (EU) found the prospects worrying, and some were skeptical of whether EMU was really feasible on the envisaged schedule. Shakour Shaalan (Egypt) kicked off the debate by pleading for a delay in the process and expressing doubts about whether a single currency was even in Europe's best interests. Daniel Kaeser (Switzerland) joined that argument by noting that "adjusting the timetable . . . [would put the] future European monetary policy, from its inception, on a more solid and thus more robust basis." Even Directors from EU member countries expressed concerns about the convergence criteria pushing up unemployment rates across the continent. The prevailing view, though, was that no matter how difficult the process turned out to be, its successful conclusion was critically important for Europe and for the rest of the world.[36]

In March 1997, as the adoption of the Stability and Growth Pact was approaching, the Fund hosted a conference at which a number of outside experts debated the benefits and costs of Europe proceeding with EMU as planned. Despite considerable

[34]Minutes of SEM/MTG/92/4 and SEM/MTG/92/5 (December 14, 1992). For that seminar, the staff produced a postcrisis update to the June 26 paper cited in footnote 32; SM/92/129, Suppl. 2 (December 1, 1992). A first supplement (June 29) provided background information on the Maastricht Treaty and related developments.

[35]See "Monetary Policy Issues Following the Widening of the ERM Bands," SM/94/14 (January 27, 1994); "European Union: Common Policies and Recent Institutional Developments," SM/94/120 (May 12, 1994); and "Progress toward EMU—Developments and Selected Issues," SM/96/41 (February 14, 1996). These papers were discussed by the Executive Board at SEM/94/1 (March 7, 1994), SEM/94/5 (June 6, 1994), and SEM/96/3 (March 6, 1996), respectively.

[36]Minutes of SEM/MTG/96/3 (March 6, 1996), pp. 3 (Shaalan), 35 (Kaeser), and 51–54 (concluding remarks by Camdessus).

doubts on the part of many speakers, the general atmosphere was supportive.[37] In April, the Interim Committee "welcomed the progress made toward establishing conditions for EMU, the creation of which is one of the most important international monetary developments in the post–Bretton Woods period." The communiqué called on the Fund to "undertake a broad program to assess the implications of EMU for the international monetary system and for the Fund."[38]

From that point on, analysis of all aspects of EMU was an integral part of Fund surveillance. The staff was meeting regularly with counterparts in the EMI. When the ECB replaced the EMI in January 1999, the Fund granted it observer status in the Fund, with the right for its representative to attend relevant meetings of the Executive Board.[39] More broadly, the Fund agreed in 1998 that once the EU adopted a common currency (the euro) in January 1999, consultations on monetary and exchange rate policies should take place at the regional level, while Article IV consultations with euro area countries "should focus on fiscal, financial, and structural policies."[40] Thus, for the first time, the Fund adopted a specific policy establishing regional surveillance as an ongoing function.

Standards for Good Policies

To be effective, surveillance has to be based on an agreed-on model, or at least a set of agreed-on principles for what constitutes good and sustainable economic policies. In the Fund's first quarter-century, the question was simply whether a country's policies would enable it to maintain its fixed exchange rate without having to take damaging countermeasures. In the 1970s, that question modulated to include the option of allowing the exchange rate to change without becoming destabilizing. By the 1980s, confidence in the stabilizing influence of exchange rate flexibility had waned. Several efforts were made—both within the IMF and by small groups of the major industrial countries with key internationalized currencies—to agree on a "global strategy" for monitoring focused on the quality of good policies. Target zones for exchange rates, monitoring zones, reference ranges, and sets of objective or quantitative indicators all had their day in the sun. None led

[37]The proceedings were published as Masson, Krueger, and Turtelboom (1997). Also see "Summary of the Conference on EMU and the International Monetary System," SM/97/91 (April 10, 1997).

[38]Interim Committee communiqué (April 28, 1997), paragraph 6.

[39]This decision limited ECB attendance to Executive Board meetings on euro area issues, the WEO and international capital markets reports, WEMD sessions, and others "recognized by the ECB and the IMF to be of mutual interest for the performance of their mandates." This rule required some time to be properly interpreted because ECB representatives tended to take a broader view of mutual interest than did the Fund. The initial ECB representative at the Fund was Robert Raymond, the former director general of the EMI.

[40]Minutes of EBM/98/101 (September 21, 1998); the quotation is from concluding remarks by the Acting Chairman (Deputy Managing Director Shigemitsu Sugisaki) on p. 53.

to a firm footing for the assessment of the sustainability, wisdom, or consistency of countries' policies.[41]

All these efforts were based on the notion of assessing consistency between a country's exchange rate and its "fundamentals." The difficulty lay both in measuring fundamentals and in modeling the relationship between them and the exchange rate. In some contexts, the fundamentals were defined as the country's monetary and fiscal policies and other variables affecting aggregate demand and supply. Assessment of consistency then amounted to evaluating whether speculative pressures were causing the exchange rate to deviate from the level that those conditions would otherwise have generated. On a deeper level, the question was whether the country's economic policies were appropriate and sustainable. If a country had a fixed or managed exchange rate, the dual question was whether that regime was consistent with other economic policies and whether those other (fundamental) policies were appropriate. As the staff summarized the problem in 1992, the goal was to find "the level of a country's exchange rate consistent with the achievement of both internal and external macroeconomic balance over the medium term."[42] That was no small challenge.

Global Standards

Establishing good medium-term goals and policies was more a political than an economic task. The staff's technical job was to assess the economic consequences of the political decisions. Consequently, after the 1992 review of surveillance, Camdessus and the Chairman of the Interim Committee (Philippe Maystadt) decided to seek the Interim Committee's support in defining standards for good policies. That led to a three-year progression of increasingly detailed declarations by the Committee that culminated in what Camdessus later liked to call the "eleven commandments."

The initial effort was the Interim Committee's "Declaration on Cooperation for Sustained Global Expansion," adopted at the April 1993 meeting in Washington.[43] This declaration called on all countries and the major multilateral institutions "to join forces in a *global cooperative effort* to bolster confidence and strengthen prospects for a durable, noninflationary world expansion." (Emphasis is in the original text.) Specifically, the declaration stressed the importance of a multilateral effort to promote free trade, including a successful conclusion to the Uruguay Round of trade negotiations; continued reform of the transition economies; improved and better-coordinated economic policies in industrial countries, including fiscal consolidation over the medium term and structural reforms to improve the functioning of markets; and an updating of IMF lending facilities,

[41]Those various efforts are chronicled in Boughton (2001), pp. 97–101 and 186–224. The "global strategy" framework was first proposed by the U.S. Treasury Secretary in 1979; Boughton (2001), p. 100.

[42]"Biennial Review of the Fund's Surveillance Policy," SM/92/234 (December 30, 1992), p. 21.

[43]The communiqué and the declaration were published in *Annual Report 1993*, pp. 159–61.

including for concessional lending to low-income countries. The declaration reaffirmed the IMF's role as "the central international monetary institution."

This statement of principles was expressed in very general terms. Limited as it was, at that time the 1993 declaration was the most concrete international commitment to promoting market-oriented structural policies, and the most ambitious attempt to define good macroeconomic policies. It thus gave a global blessing to what had become known as the "Washington Consensus."[44]

The next step was the adoption of the Madrid Declaration at the October 1994 meeting of the Interim Committee in Madrid, Spain. That document asserted that a "strategy based on steadfast implementation of strong programs of macroeconomic adjustment and structural reform" had succeeded in "many developing economies" and should be adopted more widely. To enhance the prospects for success, it called on industrial countries to improve the "global environment" by strengthening their own macroeconomic policies, opening their markets to developing-country exports, reducing the debts of low-income countries, and increasing development assistance.[45] The Madrid Declaration offered more specific guidance than did its predecessor. That guidance focused mainly on the specific issues the world economy faced at the time, such as the continued need for a gradual reduction in fiscal deficits and for ratification of the trade agreements in the Uruguay Round, but it laid the groundwork for a more comprehensive agreement to follow.

This progressive effort culminated two years later in the adoption by the Interim Committee of the document, "Partnership for Sustainable Global Growth."[46] By this time, the principles of the Washington Consensus had become so broadly accepted that they had (temporarily, as it happened) ceased to be controversial, at least among the world's finance officials. Camdessus therefore decided that the time was ripe to redefine the purposes of the Fund beyond those set out in Article I of the Articles of Agreement. He was convinced that the IMF had to promote *sustainable* economic development, through its surveillance as much as through its conditional lending. Clarification and extension of the Madrid Declaration would make a good start.

The 1996 declaration, the final text of which was hammered out by the Executive Board in two drafting sessions just before the meeting of the Interim Committee, reiterated the validity of the earlier principles and restated them as a set of action-oriented goals.[47] It added that a goal of the global strategy was to promote the "full participation

[44]For the origin and controversies of the phrase "Washington Consensus," see Prologue, pp. lxi–lxii.

[45]*Annual Report 1995*, pp. 207–08.

[46]This document may be accessed at http://www.imf.org/external/pubs/ft/history/2011/index.htm.

[47]For the drafting process, see "Draft Interim Committee Declaration—A New Partnership for Sustainable Global Growth," EBD/96/125 (September 24, 1996); "Revised Draft Interim Committee Declaration—A Partnership for Sustainable Global Growth," EBD/96/125, Revision 1 (September 25, 1996); and minutes of IS/96/7 (September 25, 1996) and IS/96/8 (September 26, 1996).

of all economies, including the low income countries, in the global economy. . . . Because the sustainability of economic growth depends on development of human resources," the strategy had to include policies to strengthen the resources for and effectiveness of social spending and programs to protect the poor and alleviate poverty. The committee concluded the statement of 11 goals by encouraging "the Fund to continue to cooperate with other international organizations *in all relevant areas*." (Emphasis added.) To underscore the operational implications, the Interim Committee communiqué added a quotation from the Managing Director, stating that the declaration was "the distillation of Fund surveillance by the world's most representative body of finance policymakers."

The issuance of these "eleven commandments" turned out to be the apogee of Camdessus's ambitious effort to base Fund surveillance on this broad strategy. Indeed, it is difficult to discern any direct effect at all from any of these declarations on the treatment of macroeconomic or social policies in Article IV consultations with countries large or small. To a great extent, this failure reflected deep skepticism by many on the staff about whether the Fund was the right agency to promote structural reforms or that such an effort could succeed outside the framework of conditional lending. The difficulty was reinforced in the aftermath of the 1997–98 Asian financial crisis, when public, official, and academic skepticism about global trade and finance began to supplant the optimistic views of the mid-1990s. Another decade would pass before the Fund would successfully rebase its surveillance on specific but universal policy goals, and even then the scope of the reform would be greatly diminished.[48]

Codes of Good Practices

What did bear fruit in the second half of the decade was the use of IMF surveillance to examine whether countries were meeting internationally established standards on institutional development, including data dissemination, financial sector soundness, and the conduct of fiscal policies. The Fund's oversight of these specific issues is discussed later in this section. The general approach on codes of good practices evolved in response to the 1997–98 financial crisis in East Asia. While that crisis was still unfolding at the end of the summer of 1997, the Interim Committee asked the Fund to take several measures aimed at helping to prevent a recurrence. In that regard, the committee "stressed the importance of openness and accountability of economic policymaking" and asked the Fund to consider "developing a code of good practices."[49]

[48]In June 2007, the Fund replaced the 1977 decision on the principles and procedures of bilateral surveillance. The new decision specified that "the Fund will examine whether domestic policies are directed toward fostering a high rate of potential growth only in those cases where such high potential growth significantly influences prospects for domestic, and thereby external, stability"; Public Information Notice No. 07/69 (June 12, 2007); accessed at http://www.imf.org/external/np/sec/pn/2007/pn0769.htm#decision.

[49]Interim Committee communiqué (September 21, 1997), paragraph 7; *Annual Report 1998*, p. 159.

As an initial response to that request, the staff prepared a draft code of good practices on "fiscal transparency" in time for the Interim Committee's next meeting. The final version of the code reflected many modifications made by Executive Directors, who went through the draft line by line before agreeing to send it to the Interim Committee in April 1998. Agreement by consensus was nearly derailed by objections from Russia, which insisted—both in the Executive Board and in the Interim Committee—that the document should be downgraded from a prescriptive "code" to a set of suggested "principles." Eventually, Maystadt settled the issue by retaining the original title but adding "declaration on principles" as a modifier.[50] With that one change, the code was adopted and published as an attachment to the Interim Committee communiqué.[51]

Throughout 1998 and into 1999, work in this area proceeded in two directions. For one, the staff continued to develop standards for other policies for which it had a primary mandate, including on transparency in monetary and financial policies and on data dissemination.[52] In addition, the idea began to take hold that the Fund should have a central role in monitoring countries' adherence to such standards, including those that other agencies were responsible for developing.[53] In October 1998, a working party commissioned by the Group of 22 (G22, the forerunner of the G20) called on the Fund to use its Article IV consultations to prepare "transparency" reports on "the degree to which [countries meet] internationally recognized disclosure standards."[54] Shortly afterward, the G7 finance ministers endorsed that suggestion and added that the Fund, in cooperation with other agencies, should "monitor . . . the implementation of these codes and standards," publish its transparency reports, and advise member countries on how to improve compliance (Group of 22, 1998).[55]

[50]See "Draft Code of Conduct on Fiscal Transparency," SM/98/66 (March 6, 1998), which was discussed by Executive Directors at SEM/98/3 (April 1, 1998); Revision 1 of that document (April 7, 1998), discussed at EBM/98/42 (April 8, 1998); and "Draft Code of Good Practices on Fiscal Transparency," SM/98/66, Revision 2 (April 10, 1998), which was submitted to the Interim Committee as ICMS/DOC/50/98/5 (April 10, 1998). The text of the code adopted by the committee was the same as the text submitted on April 10. The code and the detailed manual that followed it were revised and updated several times beginning in 2001.

[51]This attachment was titled "Code of Good Practices on Fiscal Transparency—Declaration on Principles" and may be accessed at http://www.imf.org/external/pubs/ft/history/2011/index.htm.

[52]In September 1999, the Interim Committee endorsed a "code of good practices on transparency in monetary and financial policies," to complement the code on fiscal transparency; see http://www.imf.org/external/np/mae/mft/code/index.htm.

[53]For example, the Basel Committee on Banking Supervision and the International Organization of Securities Commissions had primary responsibility for setting regulatory standards for banks and securities markets, respectively.

[54]The working group was cochaired by Mervyn King (deputy governor of the Bank of England) and Andrew Sheng (deputy chief executive of the Hong Kong Monetary Authority). Jack Boorman (Director, PDR) represented the IMF as an observer.

[55]"Declaration of G7 Finance Ministers and Central Bank Governors" (October 30, 1998); accessed at http://www.g7.utoronto.ca/finance/fm103098.htm.

In March 1999, the Fund began preparing "transparency reports," not as a surveillance activity but as technical assistance to its member countries. It then broadened and renamed them "reports on the observance of standards and codes" (ROSCs). At the outset, there were four ROSC modules: banking supervision, data dissemination, fiscal transparency, and transparency in monetary and financial policy. Although supportive of the staff's proposals for this initiative, many Executive Directors insisted that participation had to be purely voluntary.[56] The first country to volunteer for an assessment by the IMF was the United Kingdom, for which the Fund prepared reports on all four categories in March 1999. That was followed by reports on Argentina and Australia in April, and on Hong Kong SAR and Uganda in August. The Fund then produced five ROSCs on Tunisia in September, adding a new category for regulation of the securities market. In addition, fiscal transparency ROSCs were issued on Ukraine in September and on Greece in December.[57]

Issues in Surveillance

The IMF tried to make surveillance more effective by intensifying its focus on the issues that were most important for financial stability and sustainable macroeconomic balance. In the 1990s, these issues included removal of exchange restrictions, management of capital flows, and reform of structural policies with macroeconomic effects.

Removal of Exchange Restrictions

One of the fundamental purposes of the IMF is to promote currency convertibility for current account transactions. In the original Articles of Agreement, Article XIV afforded member countries the option of maintaining exchange restrictions on current transactions for a transitional period. In the Second Amendment of the Articles (1978), the reluctance of many members to commit to convertibility was acknowledged by a subtle revision in language, from "transitional period" to "transitional arrangements." The Fund adopted a passive attitude toward this shift, and by the end of the 1980s—almost a half century after the founding of the IMF—only a minority of member countries (43 percent) had irrevocably committed themselves to accepting the convertibility obligations of Article VIII.[58]

During the 1993 review of surveillance, Camdessus persuaded the Executive Board that the Fund was not doing enough to encourage its members to terminate exchange

[56]See, for example, the discussion at EBM/99/34 (March 29, 1999).

[57]The Fund published these reports on its website, at http://www.imf.org/external/np/rosc/rosc.asp.

[58]For the history through 1989, see Boughton (2001), pp. 120–23.

restrictions and commit themselves to avoiding them in the future. The Fund then adopted a strategy to induce members to accept the obligations of Article VIII.[59] From that point on, every consultation mission to a noncomplying country was required to raise the issue with the authorities, to discuss the need for any remaining exchange restrictions, and to recommend a schedule for removing restrictions (if any remained) and moving to Article VIII status.[60]

The results of shifting from passive to active voice were dramatic. In the four years 1993–96, the number of Article VIII countries jumped from 74 to 138, or 76 percent of the membership (Figure 4.2). One major reason for this success was that about 40 countries had already removed all or most restrictions subject to Fund jurisdiction. Some may have been reluctant to commit to refrain from reimposing restrictions in the future, but the main reason for delay was probably simple inertia. As noted above, those four years were the heyday of acceptance of openness in international transactions. Making a public commitment to openness was, in most countries, not controversial. After 1996, acceptances of the Article VIII obligations continued to increase, but at a slower pace. By the end of 1999, the total stood at 149 countries (82 percent of the membership). Most of the holdouts were countries in Africa, the Middle East, and Central Asia.

From a global perspective, the most important result of this push by the IMF was not the number of countries accepting the obligations of Article VIII. Rather, it was that the list included some of the largest developing and transition countries, including the four major emerging markets that would later become known as the BRICs: India in August 1994 (one month after Pakistan), Russia in June 1996, China in December 1996, and Brazil in November 1999.[61] Brazil thus was the last major country to move to Article VIII status in the IMF. By 1996, the staff was pressing the Brazilian authorities to make the shift. In principle, they were willing to do so, but they still had a number of restrictions in place that would take some time to remove. Even in November 1999, when the government finally accepted the obligations of Article VIII, two restrictions were still in effect, but they were scheduled to be removed early in the new year.[62]

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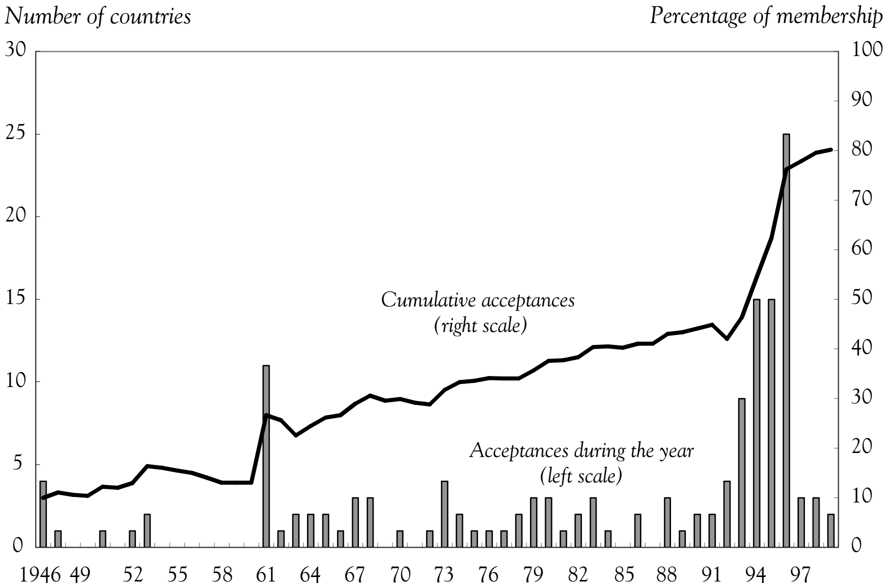
[59]For the background to this decision, see "Biennial Review of the Fund's Surveillance Policy," SM/92/234 (December 30, 1992), pp. 33 and 46–48. The decision was embodied in the Chairman's Summing Up at EBM/93/15 (January 29, 1993), p. 18.

[60]This strategy was set out in a guidance note attached to a memorandum from Boorman (Director, ETR Department) and Justin B. Zulu (Director, Monetary and Exchange Affairs Department) to Heads of Department, "Strategy for Encouraging Members to Accept the Obligations of Article VIII—Guidance Note," April 13, 1993. Also see memorandum from the Managing Director to Heads of [Area] Departments, "Encouraging Members to Accept Obligations of Article VIII," April 11, 1994. Both are in IMF archives, Historian's files.

[61]The grouping of these four leading emerging-market countries under the acronym BRICs originated in O'Neill (2001).

[62]"Brazil—Acceptance of Obligations of Article VIII, Sections 2, 3, and 4," EBD/99/140 (December 22, 1999).

Figure 4.2. Acceptance of Article VIII Status, 1946–99



Source: *Annual Reports*.

A complication in the pursuit of liberalization of international exchange arises when countries impose restrictions for what they consider to be national security reasons unrelated to trade. The IMF decided early in its history (in 1952) that it could not entirely duck the question of whether such restrictions were legitimate. It set up a procedure under which a member country could notify the Fund that it was imposing a restriction for national security, and the Executive Board would have 30 days in which it could object to that characterization. Unless the Fund objected, the restriction would then be considered to be approved.[63] Several such cases arose in the 1990s, most of which involved sanctions imposed or endorsed by the United Nations, including

- the freezing of Kuwaiti assets while the country was occupied by Iraq in 1990–91;
- sanctions imposed on the Federal Republic of Yugoslavia (Serbia and Montenegro) in 1992 in response to the war in Bosnia and Herzegovina;
- sanctions on Libya in 1993 in an escalation of pressure after the bombing of commercial airplanes in the late 1980s; and

[63]For the history of this issue before 1990, see Horsefield (1969), Vol. 2, pp. 259–60; and Boughton (2001), p. 120n116.

- sanctions on Haiti in 1994 in a UN-led effort to unseat the military dictatorship that had overthrown President Jean-Bertrand Aristide three years earlier.

In addition, in December 1997, the United States informed the Fund that it had imposed exchange restrictions on Sudan as part of a package of sanctions responding to the Sudanese government's alleged sanctioning of international terrorism, destabilizing neighboring governments, and human rights abuses. In none of these cases did the Executive Board take action to object to the representation that the restrictions were imposed for reasons related to national security.

Oversight of Capital Flows

The IMF's views on capital flows evolved during the 1990s in response to the rapid expansion of global flows and to research on the effects of such flows. Fund surveillance paid increasing attention to monitoring capital flows and to advising countries on how to manage their capital accounts. However, the extent of the Fund's mandate to oversee liberalization of capital accounts was less clear than its mandate over current account transactions. In mid-decade, momentum built up briefly for an amendment to the Articles of Agreement to clarify the Fund's role and responsibilities.

Pursuit of Orderly Liberalization

Liberalization of currency exchange for current account transactions was a widely shared goal and scarcely controversial. The same could not be said for liberalization of the capital account. When John Williamson coined the phrase "Washington Consensus" in 1990 to describe the generally accepted prescriptions for good economic policies, he pointedly omitted capital account liberalization from the list. Moreover, the Articles of Agreement did not include a mandate for the IMF to promote open capital flows. On the contrary, Article VI prohibited the Fund from lending to finance large or sustained capital outflows, and it empowered the Fund to require member countries to impose capital controls as a condition for borrowing if necessary to prevent a large or sustained outflow.

For the first quarter-century of IMF operations, private sector capital flows played a small, relatively benign, and mostly passive role in facilitating international trade and economic growth. In the 1970s, that situation began to change. The advent of generalized floating of exchange rates, combined with large-scale international wealth transfers associated with increases in oil prices, spurred rapid growth in capital flows. In a popular phrase of the day, that growth served to "recycle petrodollars." Oil-exporting countries invested earnings with large international banks that then onlent the funds to oil-importing countries, including many developing countries. Beneficially, those flows limited or delayed the negative consequences of oil price increases on economies dependent on oil imports. That benefit came at a cost, because the inflows were often on highly liquid terms and were denominated in key currencies, not the local currency of the borrower. When short-term interest rates rose internationally in the early 1980s, bank creditors tried to withdraw liquid capital from developing countries. The resulting debt crisis nearly bankrupted sovereign borrowers and private creditors alike.

As detailed in Chapter 9, private capital began flowing back into developing countries in the early 1990s. Much as it had two decades earlier, but with more force and much greater breadth, this inflow fueled economic growth. Rather than coming only from international commercial banks in the form of loans, financial capital in the 1990s came from many different sources and in many different forms. Middle-income developing countries transformed themselves into "emerging markets" where companies could issue bonds and sell equities internationally. Adapting to these new market conditions and meeting the standards for attracting international capital became imperatives for any developing country aspiring to share in global prosperity.

The financial collapse of Mexico in December 1994 unmasked the fragility of this boom period, reminiscent of Mexico's 1982 debt crisis that brought an end to the first great wave of postwar international capital flows. Most emerging markets nonetheless continued to attract capital for the next two or three years, until the Asian and Russian financial crises forced a major and broadly based pullback.

These shifting fortunes posed a challenge for IMF surveillance.[64] If a country was failing to establish economic conditions conducive to capital inflows, it would be underperforming with regard to potential growth. If it established conditions that attracted capital at an excessive rate, it could subject itself to destabilizing inflationary pressures and risk facing a sudden cessation of inflows. Either way, the IMF had a responsibility to assess the risks and offer appropriate policy advice.

The official guidance to the staff in the early 1990s did not specifically address these issues, but the Fund was aware of the dangers of uncontrolled inflows. A 1992 staff research paper, published as Calvo, Leiderman, and Reinhart (1993), was a seminal study of the potential for "sudden stops" in capital flows and their devastating effects on emerging markets. Another (Mathieson and Rojas-Suárez, 1993) examined several countries that had experienced destabilizing real exchange rate appreciations after opening their capital accounts. The Executive Board reviewed the issue in July 1993 and concluded that finding ways to stabilize and absorb capital inflows effectively should be a priority for Fund surveillance.[65] In 1994, at the request of the Asia-Pacific Economic Cooperation (APEC) finance ministers, the staff prepared a set of papers (Khan and Reinhart, 1995) on ways APEC member countries could better manage inflows of financial capital. The initial paper for the 1995 biennial review of surveillance, largely written before the eruption of the Mexican peso crisis, noted that the

[64]Independent Evaluation Office (2005) provides a thorough analysis of the IMF's approach to capital account liberalization throughout its history.

[65]Minutes of SEM/MTG/93/3-4 (July 21, 1993). The staff paper for that meeting was published as Schadler and others (1993).

Fund had to have "clearer recognition of the extreme vulnerability of the recipients . . . to a sudden cessation or reversal of the inflows."[66]

In the aftermath of the Mexican crisis, the Fund saw clearly that it had to pay close attention to the dangers of unsustainable capital inflows. Mexico had attracted sizeable inflows throughout 1994 by selling a hybrid form of government securities called *tesobonos*, which were payable in pesos but in amounts that were effectively denominated in U.S. dollars (see Chapter 10). As the outstanding stock of these notes accumulated, the potential cost of a currency devaluation rose correspondingly. The situation was unsustainable, and it crashed at the end of the year.

When the Executive Board met in mid-February 1995 to conduct the biennial review of surveillance, Huw Evans (United Kingdom) proposed modifying the 1977 decision to include a concern about private capital flows.[67] The decision already contained a reference to "policies that provide abnormal encouragement or discouragement to capital flows" as one of the factors that could signal the need for a special consultation or other discussions with a member country. The new issue was whether, despite the pursuit of reasonable policies, a country might face circumstances in which private capital flows could become volatile or unsustainable.

After further discussion, the staff proposed, and the Board approved, revising the opening of the third paragraph of the 1977 decision to read (with the new wording in bold here), "The Fund's appraisal of a member's exchange rate policies shall be based on an evaluation of the developments in the member's balance of payments, **including the size and sustainability of capital flows**, against the background of its reserve position and its external indebtedness." In addition, Evans insisted, and the Board agreed, that the list of possible signals be extended to include "unsustainable flows of private capital."[68] With those amendments, the Fund put itself on record in favor of limiting the size and volatility of capital flows to sustainable levels.

Limiting the size of capital flows did not imply that the Fund was in favor of capital controls. Rather, the Fund was in favor of a world in which (a) emerging-market countries would pursue stable macroeconomic and financial sector policies that did not abnormally encourage capital inflows and (b) advanced economies would pursue stable policies that did not give rise to abnormal incentives for capital to flow out to the emerging markets. Direct controls on capital flows were generally discouraged, although most Fund officials recognized that controls could be helpful in some circumstances if they were well designed and applied only temporarily. The long-run goal of

[66]"Biennial Review of the Implementation of Surveillance over Members' Exchange Rate Policies and of the 1977 Surveillance Decision," SM/95/22 (January 26, 1995), p. 32.

[67]Minutes of EBM/95/17 (February 17, 1995), p. 28.

[68]"Biennial Review of the Implementation of Surveillance over Members' Exchange Rate Policies and of the 1977 Surveillance Decision—Additional Material," SM/95/22, Suppl. 2 (April 3, 1995), pp. 5–6; and minutes of EBM/95/37 (April 10, 1995), especially pp. 17–18, 29, and 35–36. Also see the full revised text of the 1977 decision, which may be accessed at http://www.imf.org/external/pubs/ft/history/2011/index.htm.

many, especially in the mid-1990s, was a system in which capital would flow freely enough to spur development and growth but would not be so unruly as to destabilize national economies in the process. Unfortunately, the Fund found it difficult to convey this nuanced position with clear policy advice to its member countries.

Pleading for the Fifth Amendment

Pursuit of a stable and orderly liberalization of capital was hampered by both the complexity of the message and the lack of a clear mandate. In 1994, the Interim Committee's Madrid Declaration expressed support for the free flow of capital, and that impelled the Fund to begin thinking seriously about the adequacy of its efforts in that direction. If each country was free to set its own course, and if the IMF acknowledged that capital inflows could have both negative and positive effects, then what advice could it sensibly give? If openness to international capital was a desirable long-term goal, how could the IMF ensure that each country was progressing adequately toward it?[69]

In July 1995, the Executive Board had a preliminary discussion of the possibility of amending the Articles of Agreement to give the IMF a clear mandate to promote capital account liberalization. The staff paper was circumspect, and the strongest push for the idea came from Karin Lissakers (United States). "We would see merit," she noted, "in an amendment to the Articles of Agreement to bring capital convertibility explicitly within the jurisdiction of the Fund and to introduce obligations regarding the staged liberalization of capital account transactions." When a number of other Directors expressed reservations, Manuel Guitián (Director, Monetary and Exchange Affairs Department) responded by pleading for action. There was, he argued "general agreement about the economic advantages of such a liberalization," but "current practice did not provide the Fund with any basis for influencing effectively what a country's plans might be for capital account liberalization."[70]

The staff overall was more skeptical than Guitián, and so were most Executive Directors—especially those from emerging markets and other developing countries. The conclusions of the Board in July 1995 were that capital flows should be liberalized gradually, at a pace reflecting each country's circumstances, and that the Fund had adequate scope under the Articles to monitor and encourage that process. The matter lay dormant for the next year, while the staff conducted more detailed research on the implications of large-scale capital inflows to developing countries. Camdessus kept the

[69]For detailed academic analyses of the effort to give the IMF jurisdiction over capital flows, see Abdelal (2007), Chapter 6; and Chwieroth (2010), Chapter 8.

[70]Minutes of EBM/95/73 (July 28, 1995), pp. 24 (Lissakers), 62 (Guitián), and 68–70 (Summing Up by the Acting Chairman, Stanley Fischer). The staff paper for the Board meeting was subsequently published, with minor revisions, as Chapter II of Quirk and Evans (1995). The identification of "we" in Lissakers' remark is unclear. On the basis of interviews with senior U.S. officials, Abdelal (2007), pp. 138–39, concludes that she was arguing for an amendment primarily on the basis of her personal views, not those of the U.S. authorities.

issue alive by asking the staff to prepare papers for the Executive Board on economic and legal issues related to "capital account convertibility and the role of the Fund."[71] The Interim Committee communiqué of September 1996 encouraged the Fund to continue working on it.

Serious consideration of amending the Articles began in February 1997. A staff paper set out the rationale and scope for such an amendment, and the Executive Board held an informal discussion of it. The Board reaffirmed the view that an "orderly and sustainable process" leading over time to "an open and liberal system of capital movements" was desirable and should be promoted by the Fund. Directors were prepared to recommend an amendment that would make capital convertibility part of the Fund's mandate, but not everyone liked the idea of a prescriptive amendment giving the Fund jurisdiction over countries' capital account policies.[72]

Several Directors from developing countries were worried about the Fund pressing them to open their financial systems before they were ready, and some from industrial countries were worried about the Fund stretching into fields in which it lacked a clear rationale for its decisions. Thomas A. Bernes (Canada) suggested that other organizations, such as the Organization for Economic Cooperation and Development or the World Trade Organization, might be better placed for "rule making and negotiating." Willy Kiekens (Belgium) expressed support for the idea that "the Fund should advise countries on issues connected with liberalizing capital movements." He noted that his authorities were "not convinced that the Fund should have jurisdiction to decide whether controls are still needed during the transition period."[73] It appeared that any amendment would have to be narrowly written to have any chance of being accepted and ratified by countries holding the requisite 85 percent of the voting power.

The Interim Committee endorsed this ongoing effort in its April 1997 communiqué and asked the Fund to come up with "key elements" for a proposed amendment by its next meeting. In September, the ministerial committee would be meeting in Hong Kong SAR, making for a special occasion and therefore an ideal time to modernize the

[71]"Statement by the Managing Director on the Work Program of the Executive Board," BUFF/96/61 (May 16, 1996), p. 2. In addition to the papers submitted for discussion by the Executive Board, the staff prepared 10 working papers in 1996 analyzing various aspects of capital flows into developing and transition countries. In December 1995, the Research Department and the IMF Institute held a week-long seminar for senior officials from member countries on "Implications of International Capital Flows for Macroeconomic and Financial Policies." An overview of the conference and a selection of papers from it were published in the *International Journal of Economics and Finance*; see Khan and Mathieson (1996) and the associated papers.

[72]Minutes of SEM/MTG/97/2 (February 26, 1997); the quoted phrases are from p. 70. The staff paper discussed at that meeting was "Capital Account Convertibility and the Role of the Fund—Review of Experience and Consideration of a Possible Amendment of the Articles," SM/97/32 (February 5, 1997). The term "convertibility" in this context means that a country's currency is freely convertible into other currencies, including for transactions that are not within the current account under accepted international accounting standards.

[73]Minutes of SEM/MTG/97/2 (February 26, 1997), pp. 16 (Bernes) and 32 (Kiekens).

Fund's mandate. Throughout the summer, the staff, management, and Executive Directors worked to refine the technical aspects of the proposal. How, and under what circumstances, might the Fund approve capital controls? Should the Fund impose a time limit? What if a country committed itself to an open regime and then subsequently introduced a new restriction? Should all types of capital flows be treated alike, or should direct investment be treated differently? Should the Fund's jurisdiction be limited to currency convertibility, or should it extend to the underlying transactions? These questions would have to be resolved before a sensible amendment could be drafted, and the Fund devoted a fair amount of time to the task.[74]

A major outcome of these discussions was recognition that an overly narrow amendment would not have the desired effect. Making liberalization of capital flows a purpose of the Fund without simultaneously imposing obligations on all member countries and giving the Fund jurisdiction over those obligations would simply enable the Fund to justify imposing related conditions on its lending arrangements. To be effective, the amendment would have to be comprehensive and applicable to all members.[75]

At the Hong Kong SAR meetings, enthusiasm for the open-capital amendment was at an all-time high but was not unalloyed. At a seminar preceding the formal meetings of Fund and World Bank Governors, Stanley Fischer laid out a carefully reasoned case for the amendment, arguing that it would enable the Fund to guide liberalization in an orderly way, taking account of each country's circumstances and allowing for as long a transition as was appropriate.[76] The Interim Committee gave its blessing and trumpeted that it was "time to add a new chapter to the Bretton Woods agreement." It added a note of prudence, however, that the "Committee sees the Fund's proposed new mandate as bold in its vision, but cautious in implementation."[77]

In the months after the meetings in Hong Kong SAR, crises spread from Thailand to Indonesia and Korea and threatened to engulf the whole East Asian region. Although the fundamental causes derived from weaknesses in the financial sectors of the primarily affected countries, the shock and the crisis consisted of a sudden withdrawal of private capital. Belatedly, Fund staff realized that the "carry trade" in Japanese yen—in which speculators borrowed yen at extremely low interest rates and invested the proceeds in emerging markets with much higher yields—had greatly magnified the

[74]See "Capital Account Convertibility—Transitional Arrangements, Approval Policies and Financing under an Amendment," SM/97/173 (July 1, 1997); "Capital Movements under an Amendment of the Articles—The Treatment of Inward Direct Investment," SM/97/168 (June 27, 1997) and Suppl. 1 (July 11, 1997); and minutes of EBM/97/72 (July 15, 1997) and EBM/97/74 (July 18, 1997).

[75]"Report to the Interim Committee on the Liberalization of Capital Movements under an Amendment of the Articles," SM/97/230, Rev. 2 (September 10, 1997), pp. 2–3.

[76]Fischer's paper was published in Fischer and others (1998), pp. 1–10.

[77]The full text of this statement, "Liberalization of Capital Movements under an Amendment of the Articles," is reproduced at http://www.imf.org/external/pubs/ft/history/2011/index.htm.

consequences of domestic policy shortcomings in emerging-market countries.[78] In a January 1998 speech on the Asian crises, Fischer noted that

> developments in the advanced economies and global financial markets contributed significantly to the buildup of the imbalances that eventually led to the crises. . . . Large private capital flows to emerging markets, including the so-called "carry trade," were driven, to an important degree, by these phenomena and by an imprudent search for high yields by international investors without due regard to potential risks.[79]

The fear of exposure to the vagaries of international capital markets had begun to outweigh the desire to reap the uncertain benefits.

From that point on, the debate over the amendment was muddled. Camdessus and Fischer tried to project the message that their goal was to guide liberalization gradually, country by country. In their view, each country should first strengthen its economic, legal, regulatory, and other institutional policies. The longer-run goal of full convertibility would help speed up and guide that process, and the IMF was the agency best situated to monitor and lead it. They were not aiming to induce countries to open their financial systems to capital inflows before the preconditions were in place. After the financial crisis in Asia, that message got lost. Critics focused on the dubiety of both the goal and the means. Were capital controls necessarily bad? Was the IMF the right agency to promote their elimination? As discussed in Chapters 11 and 12, the Fund was mistakenly accused of having forced Asian countries to open their capital accounts prematurely, thus aggravating the crisis. That perception added to the difficulty of having a reasonable discussion of the Fund's role and mandate.[80]

The bureaucracy of the IMF continued to work on preparing an amendment, and Camdessus continued to press for a successful conclusion to what he called a "major historic opportunity." The staff organized a two-day seminar in March 1998 at which a number of senior government officials spoke alongside leading academic economists. Although most speakers and participants in the discussions agreed capital liberalization should be made a purpose of the Fund, they were much less enthusiastic about giving

[78]The first staff paper to discuss the effects of the carry trade was "Hedge Funds and Financial Market Dynamics," EBS/98/9 (January 16, 1998), which was subsequently published as Eichengreen and Mathieson (1998). As that paper noted (p. 17), the prevalence of carry trade began with capital inflows to Malaysia in 1991–92.

[79]"The Asian Crisis: A View from the IMF," address by Stanley Fischer at the Midwinter Conference of the Bankers' Association for Foreign Trade, Washington, DC (January 22, 1998); accessed at http://www.imf.org/external/np/speeches/1998/012298.htm.

[80]Even among those who clearly understood the issue, the range of arguments brought to bear on both sides of this debate was remarkable. In the volume of papers collected in Fischer and others (1998), Rudiger Dornbusch asserted that "capital mobility ought to be unrestricted" (p. 20), a conclusion that Dani Rodrik called "genuinely odd" (p. 56). Stanley Fischer concluded that the "proposed amendment . . . will serve . . . the international community well" (p. 10), while Jacques J. Polak concluded that it would be neither necessary nor effective (p. 50). For a detailed assessment of criticisms of the Fund's role in capital account liberalization, see Independent Evaluation Office (2005).

the Fund jurisdiction over it in any way comparable to the Fund's existing jurisdiction over current account restrictions.[81] Even inside the Fund, much of the steam behind the amendment effort had dissipated.

The Executive Board met on April 2, 1998, to consider a proposal from Camdessus to amend the Fund's purposes as set out in Article I and to agree in principle on "the general rule [with specific exceptions] that members are prohibited from imposing restrictions on international capital movements without Fund approval." No formal vote was taken, but enough Directors spoke out against the jurisdictional rule that it had to be shelved.[82]

For the April 1998 meeting of the Interim Committee, Camdessus therefore submitted a proposal for a possible fifth amendment that would merely revise Article I to add the "orderly" liberalization of capital flows as an additional purpose of the Fund. Specifically, the purposes of the Fund set out in Article I would read as follows, with the new language in bold here:[83]

> The purposes of the International Monetary Fund are:
>
> (i) To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems.
>
> (ii) To facilitate the expansion and balanced growth of international trade **in goods and services and an efficient international allocation of capital**, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.
>
> (iii) To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.
>
> (iv) To assist in the establishment of a multilateral system of payments in respect of current **and capital** transactions between members, **in the orderly liberalization of international capital movements**, and in the elimination of foreign exchange restrictions which hamper the growth of world trade **and investment.**
>
> (v) To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with

[81]See "Summary of the Seminar on Capital Account Liberalization," SM/98/75 (March 25, 1998). Camdessus's "historic opportunity" remark was made at EBM/98/38 (April 2, 1998), p. 6.

[82]Minutes of EBM/98/38 (April 2, 1998).

[83]See attachment to "Liberalization of Capital Movements under an Amendment to the Articles," ICMS/DOC/50/98/7 (April 10, 1998). The reference to a "fifth" amendment presumed that the Fourth Amendment, allowing for a selective allocation of SDRs, would soon be ratified; see Chapter 15.

opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.

(vi) In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.

The Interim Committee put the best possible lipstick on the proposal by endorsing this language for Article I while noting that amendments to the more operational articles would also be required as part of the package. The matter was thus back in the hands of the Executive Board, which remained reluctant to push forward. During the rest of 1998 and 1999, the Board held several meetings to discuss various aspects of capital controls and liberalization, but its only further formal discussion of a possible fifth amendment was in an inconclusive seminar in July 1999.[84] Even the uncontroversial extension of purposes quoted above was never submitted to the Board of Governors for consideration.

Monitoring the Markets

Aside from developing policies on capital flows, the IMF had to determine the best way to monitor what was going on. When international banking flows exploded in the early 1970s, the Fund began tracking the implications by holding special discussions with the monetary authorities of countries with major financial centers. In 1974, the Executive Board reviewed developments in what were then called euro-currency markets and concluded that the staff should continue to build up a knowledge base about these markets. For the next five years, market developments were reported to the Board through the WEO. Then in 1979, staff in ETR began preparing a separate annual report, initially under the name "International Capital Markets: Recent Developments and Near-Term Prospects." Whereas the 1974 report was based on meetings only with country officials, the preparatory missions in

[84]The principal meetings during the year after the failure of April 1998 were EBM/98/85 (August 3, 1998), EBM/99/31 (March 24, 1999), and EBM/99/32 (March 25, 1999). The staff papers discussed at those meetings were published as Eichengreen and Mussa (1998) and Ariyoshi and others (2000). The Legal Department then prepared a list of options for an amendment in "The Role of the Fund in the Liberalization of Capital Movements—Options for Consideration," SM/99/147 (June 23, 1999), which Executive Directors discussed in seminar format at SEM/MTG/98/4–5 on July 9 and 12, 1999. A follow-up Legal Department paper, "The Role of the Fund in the Liberalization of Capital Movements—Further Considerations on a Two-Tiered Approach," SM/99/220 (September 3, 1999), was circulated but never discussed in a Board meeting. The final meeting of the decade on this topic (EBM/99/101 [September 10, 1999]) was limited to a review of country experiences with liberalization.

1979 met with private sector bankers as well.[85] These capital markets missions and reports became an annual exercise for the Fund. The following year, the Fund began publishing the reports, the first one being Williams (1980).[86]

The debt crisis of the 1980s brought Fund staff into much more regular contact with commercial and investment bankers, foreign exchange traders, and other market participants. The acceleration and diversification of capital flows in the 1990s pulled the staff in even more deeply. For the 1999 report, staff missions traveled to 17 countries, including all of the major international financial centers as well as such emerging markets as Argentina, China, Hungary, Malaysia, and Turkey. As this work intensified, the missions and the reports were elevated to a more central role in Fund surveillance.

The growing importance of the capital markets report led to a subtle change in its subtitle in 1992, to "Developments, Prospects, *and Key Policy Issues*." (Emphasis added.) At the same time because the report was becoming more analytical in scope, primary responsibility for its preparation was shifted from ETR to RES (which was also responsible for preparation of the WEO). Throughout the 1990s, the capital markets report took its place alongside the WEO as one of the two flagship publications of the IMF.

The clearest example of the influence of the capital markets report came in 1995, when the report included a detailed and (by IMF standards) unusually blunt retrospective analysis of the Mexican peso crisis. A debate had been raging in Mexico about the role of foreign investors and speculators in precipitating the crisis. Taking sides, to the consternation of the authorities, the Fund report concluded that "the pressure on Mexico's foreign exchange reserves . . . came not from the flight of foreign investors or from speculative position-taking by these investors, but from Mexican residents."

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[85]The need for direct and regular contacts with financial markets was perceived much earlier. In 1957, for example, Irving S. Friedman (Director, Exchange Restrictions Department) became concerned that the Fund did not have enough information to assess the appropriateness of exchange restrictions Argentina was introducing. Reflecting on the problem, he wrote to a colleague, "If, as it seems likely, we are to become increasingly involved in passing judgments or giving advice on current restrictive practices and in judging a country's need for financial assistance, it would seem desirable to get to know much more of what is happening in the market and what people on the private side feel about developments"; untitled memorandum (January 26, 1957); IMF archives, CF/Country files, Argentina. The matter appears not to have been pursued further, however. The subsequent consultation report made no mention of meetings with market participants; see "1956 Consultations—Argentina," SM/57/68 (August 7, 1957), p. 1.

[86]The 1979 report was circulated internally as SM/79/185 (July 10, 1979). That paper and the first four published reports, issued in the Occasional Paper series, were prepared by ETR staff teams led by Richard C. Williams. In 1984, C. Maxwell Watson took over. Beginning in December 1986, the reports were issued in the World Economic and Financial Surveys series. In 2002, the capital markets report was reconstituted as the *Global Financial Stability Report* and was prepared by the newly formed International Capital Markets Department.

The ensuing controversy eventually became an important element in the evolving understanding of how to avoid such a crisis in the future.[87]

The capital markets report was also a major channel through which the staff analyzed other crises in the 1990s, including the ERM crisis of 1992–93 and the Asian crises of 1997–98. As discussed in Chapter 11, the capital markets mission to Korea in April 1997 raised an alarm about how deep and widespread the weaknesses in the Korean financial system were, well before the crisis erupted in November. Unfortunately, that message was not absorbed by either the area department or senior management until much later. One of the critical lessons from the Asian crisis was the need for much better integration of capital markets and macroeconomic analysis, especially for vulnerable emerging markets.

New Focus on Structural Policies

The Fund's new emphasis on helping countries achieve "high-quality growth" rather than financial stability alone meant that surveillance had to cover a much wider range of policies.[88] Exchange rate and macroeconomic policies were the keys to controlling demand to ensure that external payments balances were financeable and sustainable at reasonably high employment. To exceed that goal and try to ensure that the economy was on a path of strong growth sustainable over a longer period, that offered real benefits across the spectrum of the citizenry, and that avoided degradation of the natural environment and its resources, structural policies would need attention as well. The challenge for the IMF in the 1990s was to find ways to extend its field of vision without extending its reach into areas in which it had no mandate and little expertise.

Financial Sector Soundness

Certain structural policies linked naturally to the Fund's traditional focus on macroeconomics and finance. The most important of those was the soundness of a country's banking system. Until the mid-1990s, the institutional structure of national finance was not systematically reviewed by the IMF unless a country requested technical assistance on the subject.[89] If a country had manifest problems or if it was undertaking major institutional changes, the staff would take note of it

[87]The quotation is from Folkerts-Landau and Ito (1995), p. 7. For an example of the reaction in Mexico, see Salinas (2002), pp. 1121–22. Within the Fund, the Executive Director for Mexico (Luis E. Berrizbeitia of Venezuela) took note of what the Mexican authorities regarded as "factual inaccuracies" in the report; minutes of EBM/95/51 (May 24, 1995), pp. 61–62.

[88]For the background to high-quality growth as an objective of the IMF, see Chapter 1, pp. 14–15.

[89]Perhaps the earliest example of a technical assistance request for a comprehensive look at the financial sector was from Mauritius in 1975; see "Mauritius—Technical Assistance," EBD/75/258 (November 19, 1975). A team of three economists from the Central Banking Service spent a few weeks in the country and prepared a report for the authorities. The report was not circulated further and had no discernible effect on the consultations with Mauritius, which were conducted independently by the African Department.

in its Article IV consultation reports, but the Fund did not generally attempt to uncover institutional weaknesses in anticipation of a crisis. The limitations of this approach are best illustrated by the Swedish banking crisis.

Sweden. Throughout the 1980s, Sweden carried out major structural reforms aimed at making the financial sector more competitive, both domestically and internationally. As nonbank finance companies flourished in response to these reforms, banking regulations were removed or reduced to enable banks to compete. In the second half of the decade, a number of Swedish banks merged with one another, and large international banks established offices in Sweden. These changes generated substantial capital outflows, as residents took advantage of new opportunities to invest in foreign currencies and in foreign financial institutions, but both the authorities and the Fund staff viewed this as a benign side effect of the transition to a more open and vibrant system. Assessing the situation in mid-1990, the staff "welcomed" the liberalization of the financial sector, through which the "highly regulated financial sector had been transformed into a market system."[90]

In fact, the "market system" had a fatal flaw, similar to the one that gave rise to the crisis in U.S. Savings and Loan institutions in the late 1980s and that later would fuel other financial crises such as those in Thailand in 1997 and worldwide in 2008.[91] Although interest rate and some prudential regulations had been softened, allowing financial institutions to offer high rates to attract deposits they could onlend to finance risky investments, depositors and investors generally viewed those institutions as implicitly protected by the regulatory authorities. This underpricing of risk led to excessive borrowing and hence to a bubble in asset prices, notably in commercial real estate. When the deterioration in asset quality became evident, sizeable government assistance was required to prevent a wave of insolvencies from undermining the payments system.

The imbalances in the Swedish financial sector were already evident by 1990, but IMF surveillance at that time was focused on macroeconomic data. Bank assets were growing rapidly and aggregate profits were holding up well, but the underpricing of risk meant that profit margins were being squeezed. As the staff would later acknowledge, banks were already becoming increasingly vulnerable to risks and increasingly dependent on ever more costly sources of funds.[92] Real estate prices had peaked in 1989, but the declines were not yet large enough to precipitate a crisis, and the staff saw no reason to raise an alarm.

In December 1990, the Swedish parliament authorized the government to apply for membership in the European Communities, which would soon be reconstituted as the

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[90]"Sweden—Staff Report for the 1990 Article IV Consultation," SM/90/146 (July 27, 1990), pp. 12 and 17.

[91]For an overview of the U.S. Savings and Loan crisis, see Fries (1992). On Thailand, see Chapter 11 in this History.

[92]See "Sweden—Recent Economic Developments," SM/93/169 (August 3, 1993), Appendix I.

EU. The following May, as one step toward membership, Sweden changed its exchange rate policy from a trade-weighted basket peg to a peg against the European Communities' unit of account, the European currency unit (ECU). Although that shift had the effect of hardening the currency at a time when the real economy was beginning to soften, the staff noted that it immediately produced an inflow of portfolio capital and thus led to a decline in interest rates. It was expected to bring a drop in inflation as well, and the staff accordingly fully endorsed it. The 1991 staff report also continued to praise the way the authorities were overseeing the financial sector. "Sweden has had considerable success in carrying out structural reforms," the mission wrote in August 1991. "The tax reform and the deregulation of financial markets have made important contributions."[93]

When the next staff mission went to Stockholm in May 1992, it was to conduct only a bicyclic "interim" consultation, which would be concluded without a meeting of the Executive Board. That decision implied that the Fund viewed Sweden's circumstances as benign, not posing a serious macroeconomic threat either to itself or to its neighbors. The staff mission was led by the third chief in as many years, reflecting the demands being placed on the staff by work on the large number of new European member countries.

In the course of the 1992 discussions, the authorities informed the staff they were having problems with the banking sector, notably in the form of large losses at two major banks attributable to "the steep falls in commercial property prices." Those losses were sufficiently large to require substantial government support. Most banks, however, still satisfied international capital adequacy standards, and neither the authorities nor the staff expressed much anxiety. The overall appraisal in the mission's report did not mention the issue at all.[94]

The Fund's concern about the banking situation—not only in Sweden but in the whole Nordic region—began to grow during the summer of 1992. In August, Camdessus stopped in both Finland and Sweden for some quiet discussions about steps that might be needed if more banks got into trouble. Although it was highly unlikely that either country would ask for loans from the IMF, he stressed to the authorities that the Fund was ready to help if needed.

The Fund's apprehension about financial stability in Sweden heightened considerably when the ERM crisis stuck on Black Wednesday, September 16, 1992. Although Sweden did not participate in the EMS, it pegged the krona to the ECU and thus was just as vulnerable to a speculative attack. The central bank, the Riksbank, mounted a classic and vigorous interest rate defense, briefly raising interest rates as high as

[93]Sweden—Staff Report for the 1991 Article IV Consultation," SM/91/158 (August 9, 1991), p. 15.

[94]"Sweden—Staff Report for the 1992 Interim Article IV Consultation," SM/92/124 (June 23, 1992). The quotation is from p. 8.

500 percent. When that defense failed to stem the attack, the authorities were forced to abandon the peg in November and allow the currency to float.

During this period, the Fund twice responded to invitations from the Riksbank to send staff—led by Desmond N. Lachman (Assistant Director, European I Department)—to Stockholm to advise the authorities. The first visit, in mid-September, coincided with the ERM crisis and focused on how to insulate Sweden from the attack. The Riksbank was determined to defend the exchange rate peg, but Lachman argued that the first priority should be to reduce Sweden's burgeoning fiscal deficit. Even with a "bold fiscal package," he warned that the exchange rate would still be overvalued and a float was close to inevitable. His second visit came right after the Riksbank was indeed forced to float the krona on November 19. Again the staff's main concern was the lack of political will to get the government's fiscal accounts in order.

The 1993 consultation finally provided an opportunity for the staff to respond comprehensively to the ongoing emergency, which it called Sweden's "worst economic crisis since the 1930s . . . characterized by . . . a marked decline in output and employment, a ballooning fiscal deficit, and a banking system under severe strain."[95] Moreover, the staff now acknowledged that the crisis had been brewing for several years:

> During the second half of the 1980s, in a climate of financial market deregulation, Sweden's banking sector overextended credit in an effort to gain market share, thereby contributing to an asset price boom. The subsequent slowing in the economy and puncturing of the asset price bubble resulted in substantial credit losses in the banking sector. Between 1990 and 1992, Swedish bank groups had to make provisions for bad debts totaling . . . almost 12 percent of total bank lending, while the State had to intervene directly in support of a number of important banks. In order to maintain public confidence in the banking system, the Government was obliged to provide direct budget assistance to individual banks totaling . . . almost 2 percent of GDP, in late 1991 and 1992.[96]

By then, the authorities were already well on their way to resolving the problems in the banking sector. After 1993, no further government support of the troubled banks was required, and real GDP was growing again.[97] For the rest of the decade, consultations with Sweden continued to focus primarily on deficit reduction and related fiscal policy issues. More generally, however, the main lesson for the IMF from this episode was the need to examine the health of the banking system as an integral part of bilateral surveillance. In the Swedish case, the Fund was able to assess the extent and the implications of the sectoral weakness once the problem had come to a head, but not before. Only by broadening the annual discussions so as to examine the financial sector routinely could this shortcoming be alleviated.

95"Sweden—Staff Report for the 1993 Article IV Consultation," SM/93/150 (July 13, 1993), p. 1.

96"Sweden—Staff Report for the 1993 Article IV Consultation," SM/93/150 (July 13, 1993), pp. 4 and 6. For a detailed discussion of the banking crisis as seen by the staff at that time, see "Sweden—Recent Economic Developments," SM/93/169 (August 3, 1993), pp. 43–59.

97For a postmortem on the banking crisis, see Ingves and Lind (1996).

Toward a systematic analysis. The Swedish banking crisis stimulated the staff to begin thinking in general terms about the potential for similar problems in other advanced economies, but it did not immediately alter the conduct of surveillance. The Fund's treatment of financial sector issues in its surveillance activities began to evolve only in 1995, in the wake of the financial crisis in Mexico. As pressures on the peso built up during 1994, one of the reasons the Mexican authorities were reluctant to raise interest rates was a fear that major banks would suffer large losses. At the time, IMF staff had no way to evaluate this threat. As the realization set in that this gap was a substantial hindrance to the effectiveness of surveillance, the Fund set out to strengthen its procedures.

In April 1995, the Interim Committee "noted the risks attached to overreliance on easily reversible capital inflows, and invited the Fund to pay more attention to members' financing policies, and the soundness of their financial sectors, in its surveillance activities."[98] The staff intensified its work in this field, mainly in the Monetary and Exchange Affairs Department (MAE), where Carl-Johan Lindgren (Chief of the Banking Supervision and Regulation Division) led a team effort. The findings in the staff report were alarming, beginning with the opening sentence: "Since 1980, over 130 countries, comprising almost three fourths of the [IMF's] member countries, have experienced significant banking sector problems" (Lindgren, Garcia, and Saal, 1996, p. 3).[99] In response, the Board decided in March 1996 that Fund surveillance should be reoriented to focus more directly on bank soundness and especially on the interactions between the banking sector and the macroeconomy.[100]

The emphasis on examining banking sectors increased further in 1997, after the staff produced two follow-up studies. In February, the Board agreed that the Fund was "uniquely placed," because of its surveillance and technical assistance roles, to alert member countries to weaknesses in their banking systems and to encourage countries to adhere to internationally accepted standards. In March, the Board asked the staff to develop a more detailed analytical framework for assessing the strength of countries' banking and financial sectors. In July, management approved a revised guidance note for the conduct of surveillance activities, which—for the first time—specifically asked that all staff reports "should include assessments of financial market developments and

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[98]Interim Committee communiqué (April 26, 1995), paragraph 4; *Annual Report 1995*, p. 210. Similar language was included in the next communiqué, dated October 8, 1995.

[99]The wording of this sentence was slightly different, with a lower estimate of the number of affected countries, from the original draft discussed by the Executive Board.

[100]Minutes of EBM/96/21 (March 11, 1996).

prospects as well as problems and policy issues in the banking and financial sector where they are of macroeconomic significance."[101]

Two external developments further spurred the Fund's work on financial sector soundness. One was the issuance of a set of "core principles" by the Basel Committee on Banking Supervision. The committee—a standing body of central bank officials convened by the Group of Ten (G10) and headquartered at the Bank for International Settlements (BIS) in Basel, Switzerland—issued its recommendations in draft form in April 1997 and in final form in September, after receiving comments from the Fund and other agencies.[102] That document provided guidelines for the staff to follow in assessing the soundness of national banking systems.

The second development was the wave of financial crises that hit Thailand, Indonesia, and Korea in the second half of 1997. That shock laid bare the extent of weaknesses in financial sectors throughout the world's emerging markets and the depth of the interconnectivity between those weaknesses and macroeconomic vulnerability. It also revealed weaknesses in surveillance. The affected countries were not providing enough information for the Fund to assess the strength of their banking sectors, and the staff did not have sufficient specific expertise to uncover problems independently or to challenge the authorities' representations. The need for better and more consistent surveillance of financial systems was to be one of the crucial lessons from the Asian crises.[103]

By 1998, almost every staff report on Article IV consultations with emerging-market countries included an assessment of the country's framework for financial sector oversight. The great majority of those reports included recommendations for reform. In May 1999, the Fund and the World Bank jointly launched an additional program on a pilot basis, known as the Financial Sector Assessment Program (FSAP). On the Fund side, this program involved sending a special FSAP mission to each participating country ahead of the regular Article IV mission to prepare a Financial Sector Stability Assessment. Those assessments, prepared by a separate team of specialists rather than as a side activity by the area department's country team, provided in-depth analyses of financial soundness and oversight for review by the Fund as an integral part of its bilateral surveillance. Four FSAP missions were sent out in 1999, to Lebanon (in May), Colombia (July), Canada (October), and South Africa (October). The first reports

[101]The papers discussed in February were subsequently published in slightly revised form; see Alexander and others (1997). The staff papers discussed in March were "Toward a Framework for Sound Banking," EBS/97/38 (March 10, 1997) and three supplements; see minutes of EBM/97/12 (February 10, 1997) and EBM/97/30 (March 28, 1997). The relevant paragraphs of the 1997 staff guidance note may be accessed at http://www.imf.org/external/pubs/ft/history/2011/index.htm. The full note was circulated as "Staff Operational Guidance Note Following the 1997 Biennial Surveillance Review," SM/97/178 (July 3, 1997).

[102]The 1997 document, which was subsequently revised, may be accessed at http://www.bis.org/bcbs/history.htm.

[103]"Review of Members' Policies in the Context of Surveillance—Lessons for Surveillance from the Asian Crisis," EBS/98/44 (March 9, 1998), pp. 14–16.

were completed in 2000, and the FSAP program was made permanent later that year.[104]

Unproductive Spending

In 1988, Helmut Schmidt (chancellor of Germany, 1974–82) convened a UN-sponsored commission of distinguished officials from around the world to prepare a report on what could be done to increase aid flows to developing countries. The resulting 1989 report made several recommendations, one of the more intriguing being that donor countries should direct their scarce aid resources to countries spending less than 2 percent of GDP on the military. At the time, developing countries were spending an average of 4.7 percent of GDP on military outlays—more than four times what they were receiving in official development assistance. By cutting back on the "excess" and getting more aid as a reward, countries could make large gains in education, health, infrastructure, and other development essentials (see Schmidt, 1989).[105]

Camdessus took up this proposal as a cause for the IMF. In February 1990, a few months after the Schmidt Commission report was published, Camdessus used a speech in the Philippines to warn his audience that "countries that take their social responsibilities seriously . . . are more likely to attract international help than countries that waste money on unproductive prestige projects or excessive military display."[106] Meanwhile, the crumbling of the Soviet empire and the consequent end of the Cold War were raising the prospect that the major countries could and should sharply reduce their own military spending. The combination of the moral imperative for development and the economic benefit of the presumed "peace dividend" was pushing "unproductive spending" to the forefront of international debates.

In the first half of 1991, the Development Committee, the World Bank's *World Development Report*, and the G7 summit meeting all appealed to countries to cut back on military spending.[107] The summit leaders specifically welcomed the efforts being made by Camdessus and by Barber Conable, President of the World Bank, to call attention to "excessive military spending, in the context of reducing unproductive public expenditure."[108]

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[104]For more on the origins of the program, see Chapter 3, pp. 85–86. Also see "Financial Sector Assessment Program (FSAP) – A Review: Lessons from the Pilot and Issues Going Forward," (November 27, 2000); accessed at http://www.imf.org/external/np/fsap/2001/review.htm#I.

[105]The data estimates cited here are from "Military Expenditures and the Role of the Fund," EBS/91/155 (September 10, 1991), p. 5.

[106]"Some Global Economic Issues for the 1990s; remarks before the One-Asia Assembly, Manila, February 19, 1990," MD/SP/90/2, p. 4.

[107]The Development Committee (formally, the Joint Ministerial Committee of the Boards of Governors of the Bank and Fund on the Transfer of Real Resources to Developing Countries) was established in 1974 in parallel with the Interim Committee, to advise the World Bank and the IMF on development issues.

[108]"Declaration on Conventional Arms Transfers and NBC [Nuclear, Biological and Chemical] Non-Proliferation" (July 16, 1991); accessed July 1, 2009, at http://www.g7.utoronto.ca/summit/1991london/arms.html.

In preparation for the 1991 IMF/World Bank Annual Meetings in Bangkok, the Fund responded to these various appeals by reviewing its own ability to assess members' military budgets in the context of its bilateral surveillance under Article IV. Not surprisingly, the Fund's Executive Directors were not of one mind on this controversial issue. Many countries closely guarded any information on military spending, and they were not likely to give it out to satisfy the IMF. If they expected the Fund to use the data to try to induce them to cut down, they would be even less willing to divulge it. Several African countries were fighting off armed insurrections, a particularly brutal example being the one waged by Liberia-based rebels against the government of Sierra Leone. In such circumstances, at what level could military spending be said to be excessive? Lacking a clear mandate, the Fund's options seemed limited, and its case seemed weak.

After two days of discussion, the Executive Board agreed on a minimalist policy under which the staff could request data on military spending in the course of Article IV consultation discussions but could not require the authorities to provide it. The staff was expected to respect national sensitivities and sovereignty concerns. The Board explicitly eschewed using such data to establish conditions on loans from the Fund.[109] The policy thus amounted to little more than an expression of concern that "information on [military] expenditures may be necessary to permit a full and internally consistent assessment of the member's economic position and policies."[110]

The Interim Committee, meeting in Bangkok, also took a cautious view, noting only that in the global effort to promote national saving, "an important contribution could be made by reassessing spending on defense and subsidies."[111] Camdessus was undeterred, and for the next few years he conducted a personal campaign to persuade countries to curtail military spending. He began by stopping in India and Pakistan on his way back to Washington from Bangkok. In both countries, he pressed the authorities to take advantage of more peaceful global conditions by redirecting spending from military outlays to education and health. In both countries, he made the same point in public speeches: "What a fine example it will be to the rest of the developing world, if these two great nations can each transfer substantial human and financial resources to activities that will more directly contribute to growth and to the

[109]The IMF already had a policy, adopted in September 1946, that its loans could not be used by borrowers to purchase armaments; minutes of Executive Board Meetings 70 and 71 (September 25 and 26, 1946); and Horsefield (1969), Vol. II, p. 385, and Vol. III, p. 245. That policy, however, was difficult to apply because of the fungibility of financing. For example, when India decided to purchase $3 billion in military aircraft in 1981 while it was seeking a $5.9 billion extended arrangement from the IMF, the timing raised eyebrows but did not prevent or delay approval; see Boughton (2001), p. 714.

[110]"Military Expenditures and the Role of the Fund," ICMS/DOC/91/13 (October 4, 1991). Also see the staff paper with the same title, EBS/91/155 (September 10, 1991).

[111]Interim Committee communiqué (October 14, 1991), paragraph 2; *Annual Report 1992*, p. 126.

reduction of poverty. What a prospect that could create for a better life for everyone in the subcontinent!"[112]

Staff in the Fund's Fiscal Affairs Department (FAD) were assigned to monitor the adequacy of statistics and data reporting and to undertake research on the macroeconomic effects of military spending, and the subject was raised in about 9 percent of Article IV consultation reports (none in industrial countries).[113] The Fund's involvement remained on a low flame—just bright enough to throw some light onto the most troubling cases—and it was not elevated further in the course of the 1990s. Other types of "unproductive" spending, such as the subsidies to which the 1991 Interim Committee communiqué alluded (see the preceding paragraph), were never systematically treated in a Fund policy statement but were made the subject of staff analysis in some consultations.[114]

National Governance and "Reform of the State"

As with excessive military spending, staff and management at the IMF were always concerned about corruption and weak governance in member countries but had difficulty figuring out what if anything to do about it. Until the 1990s, they were reluctant to express those concerns openly or to take any action in response. There were exceptions, usually limited to specific advice or requirements in the context of IMF lending. For example, if tax policies were routinely abused, or government spending practices were poorly documented, or banks were induced to lend to official or politically connected borrowers, the Fund might try to find ways to persuade or induce countries to limit such practices. The Fund also offered technical assistance to many countries to help strengthen fiscal and financial sector practices by making them more open and transparent.

These occasional efforts did not amount to a real policy. From the late 1970s through the 1980s, for example, the IMF lent frequently to Zaïre despite knowing that much of the proceeds were being siphoned off by President Mobutu Sese Seko and his cronies for their

[112]"Address to the India International Center, New Delhi, India, October 24, 1991," MD/SP/91/17, p. 6; and "Address to a Seminar on Structural Adjustment and Macroeconomic Policy Issues, Lahore, Pakistan, October 27, 1991," MD/SP/91/18, p. 6. Also see Camdessus's report to the Executive Board, minutes of EBM/91/145 (October 31, 1991), pp. 3–4.

[113]"Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision," SM/00/40 (February 18, 2000), p. 43. The staff also produced several working papers on military spending and its effects; see Davoodi and others (2001).

[114]In 1994, FAD prepared an analysis of various categories of public expenditure in a preliminary attempt to identify those that were relatively unproductive, including "white elephant" projects; see "Economic Implications of Unproductive Public Expenditures," EBS/94/69 (March 31, 1994). Also see Chu and others (1995); and Gupta and others (2000).

personal benefit (see Boughton, 2001, pp. 804–10). Protecting the Fund from political pressure and stopping such practices was becoming a necessity and a priority.[115]

In the 1990s, the Fund broadened its involvement in fighting corruption and in improving fiscal and financial governance and applied its concerns more consistently. It also extended this reach more regularly into its surveillance activities as well as its lending practices. To do so, it had to pull back a bit from its long-standing reluctance to inject political considerations overtly into its lending decisions and policy advice.

The drive to reduce military spending that rose to the fore in 1991 was motivated in part by a conviction that such excesses were often a symptom of official corruption. For the most part, those who spoke out on the issue stuck publicly to the theme of promoting development and increasing economic efficiency. Nearly everyone understood, however, that corruption was the heart of the problem. At the 1991 Annual Meetings in Bangkok, the point was made most clearly by Wim Kok, deputy prime minister of the Netherlands, who told the assembly that successful development policies require a "substantial investment in human resource and physical infrastructure. . . . The effectiveness of such policies depends on international economic cooperation and support, but mainly on good governance, and could often be enhanced by a cutback of disproportionate military expenditures" (IMF, 1991, p. 35).[116] Still, the time had not yet come when the IMF, or even the World Bank, had enough official support from the international community to take on corruption openly as a policy issue.[117]

In contrast to the Fund's reluctance and timidity in the 1980s, in the 1990s the institution gradually showed a willingness to address at least the most egregious cases of official corruption. As recounted in Chapter 14, the staff, the Executive Board, and Camdessus strongly criticized the Kenyan government in 1993 for the country's pervasive culture of bribery, nontransparent relations between the government and economic enterprises, and other forms of corruption. Those criticisms were made in private and did not—at that time—block approval of the financial support Kenya was asking for, but they at least served notice of unease. In the transition economies, especially those that emerged from the former Soviet Union, the Fund routinely included loan conditions aimed at reducing corruption and promoting good governance. Effective enforcement of those conditions, however, proved difficult.[118]

[115]At the 1991 IMF/World Bank Annual Meetings in Bangkok, for example, Frank Potter (Executive Director for Canada in the World Bank) was quoted as saying, "Our countries are sick of giving money to Mr. Mobutu and seeing it go into some Swiss bank account" (Stackhouse, 1991, p. B4).

[116]Kok was speaking at the plenary session on behalf of the member states of the EU.

[117]Barber Conable, President of the World Bank from 1986 to 1991, tried to take it up. For example, he wrote in 1989 that "Private sector initiatives and markets mechanisms are important, but they must go hand-in-hand with good governance—a public service that is efficient, a judicial system that is reliable, and an administration that is accountable to the public" (Conable, 1989, p. xii). But he stopped short of asserting a role for the Bank in promoting good governance.

[118]For a review, see Wolf and Gürgen (2002).

In January 1994, Camdessus decided to take his broader concerns public. Addressing a meeting of world church leaders at the Inter-American Development Bank headquarters in Washington, he asserted that "high quality growth . . . the ultimate objective of our work at the IMF . . . requires good governance. By this I mean publicly accountable and participatory government that serves the whole of society rather than sectional interests, and legal and regulatory frameworks that are transparent, fair, and limited to what is strictly necessary, so that the scope for arbitrary administrative decisions and corruption is minimized."[119] In a 1995 speech to the UN Economic and Social Council, he made a direct link to economic development: "to fight corruption . . . is a difficult task, requiring courage and perseverance. But progress must continue: it will profoundly strengthen the development process."[120]

Talking about corruption was a vital first step, but the greater challenge was to broaden support in the Executive Board sufficiently to turn that campaign into action. An opportunity arose in March 1996, when the Board was scheduled to hold an overnight retreat in the Virginia suburbs of Washington. One of the issues that Camdessus put on the table for discussion was "whether and how the Fund, in its relations with members, should address governance issues that have significant macroeconomic implications that are important to the Fund's surveillance and financial assistance."[121] As background material, Camdessus circulated a working paper by Vito Tanzi (Director, FAD) on "Corruption, Government Activities, and Markets," which set out a theory of the way corruption affected economic performance and how it might be controlled.[122]

When Camdessus made the case over dinner that Fund-supported programs were failing frequently because of corruption, Executive Directors were mostly skeptical that this was an issue that the Fund could or should tackle. As the discussion continued in the morning, however, views began to shift. Obviously, corruption could and did undermine the effectiveness of the Fund's financial support. More generally, if the Fund were to ignore corruption it knew was weakening a country's macroeconomic performance, the credibility and effectiveness of its surveillance would be damaged. At the end of the day, Directors agreed to try to develop a broad and evenhanded policy for examining corruption and other governance issues in the context of surveillance, lending, and technical assistance.[123]

The IMF was not alone in ramping up its efforts to combat corruption. In the mid-1990s, a wide variety of international organizations—the EU, the Financial Action Task

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[119]"The Economic View of Growth: Evaluation of the Impact of Economic Reforms in Latin America," MD/SP/94/1 (January 13, 1994), pp. 2–3 (delivered in Spanish; official translation).

[120]"Address at the High-Level Segment of the UN Economic and Social Council, Geneva, July 6, 1995," MD/SP/95/11, p. 5 (delivered in French; official translation).

[121]"Executive Directors Retreat, March 4–5, 1996; Issues for Discussion," FO/DIS/96/8 (February 23, 1996), p. 2.

[122]A revised version was published as Tanzi (1995). The version circulated for the retreat was IMF Working Paper 94/99 (September 1, 1994).

[123]"Summary Record of Retreat Discussion on March 4–5, 1996," FO/DIS/96/22 (April 26, 1996).

Force, the Organization of American States, the Organization for Economic Cooperation and Development, the UN Development Program, the World Bank and other multilateral development banks, and the World Trade Organization—were taking actions within their own mandates to promote good governance. Several of those bodies as well as civil society organizations were actively pushing the Fund to join in the battle. In most cases, the IMF had observer status or otherwise participated in relevant discussions.

The legal basis for an IMF role was not spelled out clearly, but with a little ingenuity it could be inferred from Article IV, Section 1, of the Articles of Agreement. That section required each member country

> to endeavor to direct its economic and financial policies toward the objectives of fostering orderly economic growth with reasonable price stability, and to seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions.

On that basis, the Fund determined it had an obligation to evaluate, through its surveillance activities, whether poor governance was impinging seriously on a country's economic performance and, if so, whether its policies were in compliance with Article IV.[124]

While the debate was continuing over a possible role in addressing governance through surveillance, the Fund moved ahead in dealing with governance problems in borrowing countries. Notably, when Kenya asked for an ESAF arrangement in the fall of 1995, the Fund insisted that the authorities take specific measures to control corruption before it would approve the request. On the basis of initial signs of progress, the Executive Board gave its approval in April 1996 and allowed a first disbursement. When the government failed to follow up, and evidence of pervasive corruption persisted, the Fund cut off further lending for the next four years.[125]

The clarity of the Fund's mandate to evaluate governance was given a further boost with the adoption of the "eleven commandments" by the Interim Committee in September 1996.[126] The tenth item on the committee's list of objectives was "promoting good governance in all its aspects . . . as essential elements of a framework within which economies can prosper." The declaration concluded by encouraging "the Fund to continue to cooperate with other international organizations in all relevant areas."[127]

[124]"The Role of the Fund in Governance Issues," EBS/96/197 (December 20, 1996), p. 7.

[125]These developments are covered in more detail in Chapter 14.

[126]Accessible at http://www.imf.org/external/pubs/ft/history/2011/index.htm.

[127]The declaration was drafted by Fund staff and then revised after two days of discussion by Executive Directors. The original text on governance was more pointed, calling on countries "to renovate the state, including by ensuring the rule of law, strengthening the judiciary, protecting the security of persons and property, improving the efficiency and accountability of the public sector, and fighting corruption and money laundering"; see "Draft Interim Committee Declaration—A New Partnership for Sustainable Global Growth," EBD/96/125 (September 24, 1996), and Supplements 1 and 2 (September 25 and 27); and minutes of IS/MTG/96/7 (September 25, 1996) and IS/MTG/96/8 (September 26, 1996).

Within days after that document was issued, Camdessus used his speech to the Governors assembled at the IMF/World Bank Annual Meetings to call for a "reform of the state," meaning that "governments must demonstrate that they have no tolerance for corruption in any form." At the same meeting, World Bank President James D. Wolfensohn made an even more explicit statement on the subject, decrying the "cancer of corruption" and promising that "the Bank Group will not tolerate corruption in the programs we support."[128] Camdessus was not yet able to make a similar promise, because the Fund still lacked a clear policy on corruption. The time had now come.

The Interim Committee declaration provided the impetus for Camdessus to ask the staff to prepare a guidance note for the Fund's role in governance issues. When the Executive Board had its first look at a draft in January 1997, the key point that emerged from the discussion was that the Fund should limit its involvement to the "economic aspects of governance" and strictly avoid getting embroiled in political issues. Everyone seemed to agree, though, that the demarcation between the two was extremely fuzzy and ill-defined.[129] The staff was sent back to refine its proposals, and it finally submitted a guidance note that the Board agreed was appropriate and within the Fund's mandate.[130] The guidance note set out a specific, though not necessarily exclusive, list of economic governance issues the staff might reasonably address, as well as any instance of corruption judged to have "significant macroeconomic implications, even if those effects are not precisely measurable" (paragraph 10). In the normal course of Article IV consultations, the staff was expected to raise such issues with the authorities and report on the discussions to the Executive Board.

During the next three years, staff reports for Article IV consultations addressed governance issues in nearly a quarter of all cases, up from 18 percent in the preceding two years. More important, the nature of the references tended to be more pointed.[131] Many of those reports, though not all, were for countries borrowing from the Fund or asking to borrow. A notable exception was the 1999 report on Nigeria, to which the Fund had not lent any money since 1992. President Olusegun Obasanjo had just taken office in the country's first democratic elections, and he wanted to get the Fund's seal of approval and restore the country's credibility in international markets. The staff

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[128]A mythology later took hold that Wolfensohn's "cancer of corruption" speech was the seminal event in the governance agenda of the Bretton Woods institutions; see, for example, Mallaby (2004, p. 176), and "Ten Things You Did Not Know About the World Bank and Anti-Corruption," at http://go.worldbank.org/MR1Y8R0ZA0. In fact, as shown here, both the Bank and the Fund had already been strengthening their agendas for several years.

[129]Minutes of EBM/97/3 (January 15, 1997).

[130]Accessible at http://www.imf.org/external/pubs/ft/history/2011/index.htm.

[131]"Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision," SM/00/40 (February 18, 2000), p. 43. The record for 1994–96 is summarized in a memorandum from Il Houng Lee (Economist, Development Issues Division of PDR) to Benedicte V. Christensen (Chief, Development Issues Division), "Governance in Article IV consultation discussions" (August 2, 1996); IMF archives, Accession 2008-0251-12, PDR-DS, "Good Governance – August–October 1996."

report noted that in economic terms, Nigeria was no better off in 1999 than it had been in 1970, mainly because of long-standing and pervasive corruption, "financial malfeasance," and other forms of weak governance. The staff mission, led by Hiroyuki Hino (Senior Advisor, African Department), told the new authorities that the Fund could not approve their policies until they took concrete steps to deal with these problems. Obasanjo was already committed to doing so, and the report served to reinforce the message that the international community was behind the effort.[132]

All of the Article IV staff reports covering governance problems in the late 1990s were for developing or transition countries. Despite the repeated calls for evenhandedness, mission chiefs remained reluctant to call attention to such issues in the more advanced economies. A clear example occurred in 1997, when the Fund conducted its annual consultation with Austria. The staff mission, led by Hans M. Flickenschild (Advisor, European I Department, or EU1), held extensive discussions with the authorities in Vienna and with trade union representatives and other nongovernmental organizations on the pressing need for Austria to adopt structural reforms that would make it more competitive in an increasingly globalized marketplace. The approaching date of the introduction of the euro added to this imperative. At the time, the Austrian government still had a heavy hand in the economy, and a wide range of rigidities was hampering overall economic performance. One important factor was the role of political patronage in the appointment of senior managers in enterprises and banks. The staff was aware of and concerned about the problem, but no mention was made of it in the staff report.[133]

When the Executive Board met to conclude the consultation with Austria, Flickenschild explained the staff's concerns and noted that the issue had been omitted from the report owing to its "sensitive nature." That drew rebukes from Martin A. Brooke (Advisor, United Kingdom) and Eva Srejber (Sweden), who reminded staff of the need for evenhanded treatment of all countries. Wolf-Dieter Donecker (Alternate, Germany) defended the staff for its caution and even questioned whether "exerting political influence on major companies and banks" was really "bad governance" or was "simply a custom in many countries." Rejoining for the staff, David Burton (Senior Advisor, PDR) acknowledged that even treatment was important and that the matter "should probably have been touched upon in writing in the staff report." Even so, the Summing Up of the Board discussion made no mention of it.[134]

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[132]"Nigeria—Staff Report for the 1999 Article IV Consultation," SM/99/276 (November 17, 1999). As recounted in Chapter 14, Camdessus also went to Nigeria in 1999 to convey the anti-corruption message directly to Obasanjo. Nigeria was seeking a precautionary stand-by arrangement, on which it did not intend to draw (and did not).

[133]"Austria—Staff Report for the 1997 Article IV Consultations," SM/97/126 (May 23, 1997).

[134]Minutes of EBM/97/59 (June 13, 1997), pp. 51–52 (Flickenschild, identified in the minutes as "the staff representative from" EU1), 62 (Brooke, Donecker, Srejber, and Burton), and 65–67 (Summing Up).

Protection of the Environment

No issue illustrates the delicate balance between focus and breadth better than preservation of the natural environment. Could the IMF assess the sustainability of a country's macroeconomic policies without examining the effect of economic growth on the environment? Before the 1990s, few would have taken that question seriously. The World Bank, the UN, and civil society were much better equipped than the Fund and had much clearer responsibilities in this domain. By this decade, however, preserving the environment was becoming such a critical and universally shared goal that all able-bodied institutions were being conscripted into the cause. The IMF was no exception, but views differed strongly on how it should respond.

The prime advocate for IMF involvement in this area was the U.S. government. In 1989 and 1990, the U.S. Congress passed two laws calling on the U.S. Executive Director to encourage the IMF to consider the effects of its policies on environmental sustainability and to reduce or eliminate any negative impacts. The Fund responded by preparing a study discussed by the Executive Board in December 1990. The staff study noted that Fund-supported programs were macroeconomic rather than structural and therefore had no direct or generalized impact on the environment. It acknowledged, though, that the indirect effects could be significant and harmful. If a country had to take action to control aggregate demand or reduce imports to fix an unsustainable payments deficit, exporters might take actions such as increasing logging of old-growth forests to make up for the short-term losses. Positive responses also were possible, such as an increase in taxes on polluting activities or cuts in subsidies on chemical fertilizers. The challenge was to understand these various possibilities and possibly to guide the responses in a positive direction.[135]

Camdessus had no doubt that the environment was an appropriate concern for IMF surveillance. The U.S. authorities were asking the Fund to monitor the effect of economic policies on the environment, and he proposed establishing a small unit of two or three staff within FAD for this purpose. The existing staff was already stretched thin, and he pointed out that the Fund could not take on this task without the budget authority to hire additional specialists.[136] The Executive Board, however, was unconvinced.

Executive Directors raised two objections, one general and one more specific. The general issue was that the IMF lacked a mandate to deal with environmental issues. The Fund's General Counsel, François Gianviti, disposed of that objection in a Board seminar in March 1991. Article I of the Articles of Agreement, in his explanation, implied that "while the Fund was not concerned with the environment as such, it was

[135]"The Fund and Environmental Issues," SM/90/219 (November 16, 1990).

[136]"Statement by the Managing Director on the Fund and Environmental Issues," BUFF/90/230 (December 18, 1990).

concerned with the economic and financial consequences of environmental degradation."[137]

The second issue was more subtle. If the Fund were to hire environmental specialists, how would it use their findings? Would it deal evenhandedly with industrial and developing countries, or would it become part of a broad campaign to force environmental standards on developing countries that needed to borrow from the Fund? After two Board meetings on the subject, only six Directors, holding less than 40 percent of the voting power, were willing to support Camdessus's proposal. Of those, only one was from a developing country—Tanya Sirivedhin (Alternate, Thailand). She conditioned her support on the understanding "that Fund environmental scrutiny could be applied under Article IV consultations with any member—with or without a Fund-monitored program—if the circumstances seemed to warrant it."[138]

As soon as nongovernmental environmental organizations learned of this internal debate, they began lobbying for Fund involvement. One major group, Friends of the Earth, wrote letters to Executive Directors in early February urging a positive response, but that served only to strengthen the opposition.[139] Shortly afterward, Camdessus toned down his proposal in four ways. First, the Fund would not undertake any original research on links between macroeconomics and the environment. Instead, it would "monitor relevant research [by others] and channel information to staff members in area departments." Second, he dropped the plan to designate the specialists as a separate unit within FAD and promised that they would instead "be fully integrated within the work of that department." Third, he proposed that there be no "environmental conditionality" and that the new approach "be applied to all members in an evenhanded way." Fourth, he agreed that "the decision to devote Fund resources to environmental issues will be given minimal publicity."[140]

With these modifications, a majority of the Executive Board reluctantly agreed to go along. Several chairs that had earlier opposed any move in this direction, including Japan and Saudi Arabia, now were willing to accept it. Others, including Australia and China, remained opposed.[141] Enthusiasm, however, was notable in its absence. The combination of Camdessus's infectious promotion and U.S. pressure for action had simply worn down the opponents. The Board made no formal decision, and management issued no public announcement.

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[137]Minutes of SEM/MTG/91/3 (March 1, 1991), p. 13.

[138]Minutes of EBM/91/13 (February 1, 1991), p. 21. The other chairs expressing support for the proposal were the Directors appointed by France and the United States, and the constituencies headed by Belgium, Canada, and Italy.

[139]Minutes of EBM/91/16 (February 8, 1991), p. 11.

[140]"Remarks by the Managing Director on the Fund and Environmental Issues," BUFF/91/37 (February 22, 1991). The "evenhanded" phrasing is in Camdessus's concluding remarks at SEM/MTG/91/3 (March 1, 1991), p. 24.

[141]Minutes of SEM/MTG/91/3 (March 1, 1991).

Once this policy was accepted, the staff began including brief summaries of environmental issues in Article IV consultation reports. To ensure that no one could accuse them of not being evenhanded, one of the early examples was the 1991 consultation with the United States.

In discussions held in Washington in May and June 1991, just two months after the Board agreed to the proposal, the staff suggested to the U.S. authorities that they should consider an increase in gasoline and other energy taxes as an environmentally helpful way to reduce the fiscal deficit. In 1992, the staff raised this issue again and noted that energy taxes aimed at reducing carbon dioxide emissions by 6–10 percent by 2000 would yield up to 1 percent of GDP in additional revenues. The environment then became a routine part of the annual discussions for a few years. In 1993, the new Clinton administration stressed its view that environmental concerns "should play an important role in economic policy considerations," subject to a cost-benefit analysis.[142] After that, coverage of the topic gradually died down. For the next five years, references to environmental policy in the U.S. reports were limited to brief explanations of administration plans with respect to balancing environmental concerns against its pursuit of bilateral and regional free trade agreements. The 1999 report included no reference at all to the environment.

Consultations with developing countries often reported favorably on governments' efforts to preserve the environment. The 1991 report on Malaysia, for example, noted that

> Malaysia's environmental policies are focused on the preservation of virgin forestry resources . . . . Malaysia has begun reducing log exports and encouraging higher value-added downstream processing through the application of quotas and fiscal incentives in the wood industry. The authorities also argued, however, that environmental issues should generally be placed in a more balanced historical and regional perspective, including the role and responsibilities of industrial countries in this respect.[143]

Similarly, in 1995 the staff praised the Dominican Republic for taking actions to deal with long-standing environmental problems:

> Regarding environmental issues, the authorities . . . explained that key . . . issues are deforestation, degradation of the urban environment, and the impact of certain unplanned population settlements in the tourist areas that seem to be negatively affecting the coastal ecosystems. A National Environmental Action Plan has been elaborated with the assistance of UNDP to address these problems as well as to improve the management and preservation of river basins. A commission headed by the Vice President of the Republic was recently created to coordinate and supervise this plan.[144]

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[142]Staff reports of the U.S. Article IV consultations, SM/91/159 (August 13, 1991), p. 21; SM/92/149 (August 3, 1992), p. 10; and SM/93/172 (August 4, 1993), p. 15.

[143]"Malaysia—Staff Report for the 1991 Article IV Consultation," SM/91/130 (June 27, 1991), p. 18.

[144]"Dominican Republic—Staff Report for the 1995 Article IV Consultation," SM/95/118 (May 24, 1995), p. 12.

Despite the intended prohibition on environmental conditionality, the Fund did follow up on negative assessments in a few cases in the second half of the decade. As was true generally, the Fund's influence in this field was bound to be more effective when a country was seeking to borrow than when it was merely consulting on the quality of its policies.

IMF advice to Cambodia in the mid-1990s illustrates the Fund's delicate balancing act between demonstrating concern for the environment and steering clear of overt environmental loan conditions. As part of the 1992 UN-brokered peace agreement in Cambodia, the transitional authorities agreed to ban log exports, partly for environmental reasons (deforestation was causing massive flooding) and partly to restrict the flow of money to military and paramilitary forces including the Khmer Rouge. When the Fund resumed normal relations with Cambodia soon afterward, the staff included this export ban among its policy concerns. It soon transpired that illegal log exports were continuing to occur and that some state-owned enterprises were simply exporting sawn timber instead of logs. The staff called attention to the problem in its 1993 report on the Article IV consultation discussions.[145]

In February 1994, the authorities submitted a Letter of Intent and an accompanying Memorandum of Economic and Financial Policies as the basis for the first tranche of a three-year ESAF arrangement. The staff team on Cambodia, led by Owen J. Evans (Advisor, Central Asia Department), was determined to make this arrangement the Fund's first "green program," and the team asked the authorities to set out their environmental policies, including on logging, as part of the documentation. Paragraphs 42 and 43 of the memorandum read as follows:

> 42. Environmental concerns are receiving increased attention from the Cambodian Government. In late 1993, the Secretariat of State for the Environment was established as a permanent government agency, with authority to supervise and develop a National Protected Areas System covering 3.3 million hectares designated for national parks, wildlife sanctuaries, protected areas, and multiple use management areas. During 1994 the Government intends to formulate a National Environmental Action Plan in consultation with the World Bank and other donors.
>
> 43. The forestry sector faces particular environmental challenges. Although Cambodia has a relatively large forest area by regional standards, logging for export timber and fuelwood is a concern for the Government. Thus far logging has been controlled largely through export restrictions, but in 1994 the Government will investigate ways to achieve its environmental goals more directly.[146]

The ESAF arrangement took note of the memorandum, but it did not include fulfillment of the plans set out in those two paragraphs in the list of specific conditions

[145]"Cambodia—Staff Report for the 1993 Article IV Consultations," SM/93/74 (April 12, 1993), p. 8.

[146]"Cambodia—Request for Three-Year Arrangement under the Enhanced Structural Adjustment Facility—Letter of Intent," EBS/94/44 (March 9, 1994), p. 13.

that could derail the scheduled disbursements under the arrangement.[147] In December 1995, Deputy Managing Director P.R. Narvekar visited Cambodia and noted that the illegal export of logs was depriving the government of "much-needed revenue," but he did not focus on the environmental consequences.[148]

This low-key approach changed in 1995, when the staff noted that forests were "Cambodia's largest and most valuable natural resource. . . . The pace of deforestation has become a prime environmental concern. Uncontrolled logging, mostly for export, has reduced forest cover from around 74 percent of land area in the early 1970s to an estimated 30–35 percent today."[149] In response, the Fund cooperated with other multilateral agencies to persuade the authorities to take stronger action. The policy memorandum for the second year of the ESAF arrangement included a more specific promise from the government:

> An area of especially great concern to the Government is to avoid an environmentally unsustainable rate of cutting of trees. To this end, the Government will begin to prepare a forest management code in 1995. . . . The Government has agreed to formulate, in consultation with the World Bank, [the International Tropical Timber Organization], and other contributors, a program and a timetable for a National Environmental Action Plan.[150]

Early in 1996, the government entered into new agreements to export logs, prompting the Fund to question the authorities' commitment to implement the agreed-on forestry policies. Specific actions were then required to be taken before the Fund would make the next disbursement under the ESAF arrangement. When the authorities failed to take those prior actions on time, the Fund interrupted and eventually canceled the arrangement. In doing so, it emphasized the fiscal rather than the environmental consequences of the failure.[151] Throughout this three-year period, the Fund prodded the authorities—first gently and then more forcefully—to limit the environmental damage from the stressed condition of the economy, all the while trying to avoid basing its advice explicitly or exclusively on this controversial issue.

The Fund adopted similar approaches in other countries where environmental concerns were paramount. Deforestation was an important issue in numerous developing and transition countries all over the world. Altogether, IMF staff reports discussed

[147]"Cambodia—Enhanced Structural Adjustment Arrangement," EBS/94/76, Suppl. 1 (May 12, 1994).

[148]Minutes of EBM/95/122 (December 21, 1995), p. 6.

[149]"Cambodia—Staff Report for the 1995 Article IV Consultations and Request for the Second Annual Arrangement under the Enhanced Structural Adjustment Facility," EBS/95/145 (August 29, 1995), p. 6.

[150]"Cambodia—Staff Report for the 1995 Article IV Consultations and Request for the Second Annual Arrangement under the Enhanced Structural Adjustment Facility," EBS/95/145 (August 29, 1995), pp. 50–51.

[151]"Forestry could yield annual budgetary revenue equivalent to 3.5 percent of 1995 GDP on a sustainable basis"; "Cambodia—Staff Report for the 1996 Article IV Consultation," SM/97/12 (January 17, 1997), p. 5n.

deforestation in 71 countries at some time in the 1990s. The Fund also raised concerns about a wide variety of other environmental issues such as unsustainable fishing yields (e.g., in Mauritania and Senegal), depletion of water resources owing to underpricing of water usage or insufficient penalties for polluting activities (e.g., in Ethiopia), and environmental degradation from inappropriate industrialization (e.g., from aluminum production in Tajikistan). In most cases, the Fund's concerns in these areas reflected those of other agencies—principally the World Bank, but also the UN and its specialized agencies—with which the Fund staff consulted in its preparatory work on each country.[152]

Transparency of the IMF

As discussed more generally in Chapter 3, a major cultural reversal occurred at the IMF in the 1990s, from confidentiality to transparency. When the Fund conducted the 1990 biennial review of surveillance, the prevailing view held, as in the past, that publishing the results of consultations with member countries would undermine the Fund's role as a confidential advisor to its members. To be effective, the staff had to feel free to express views candidly. They also had to have confidence that country officials would provide information willingly and completely. Publication of their findings could compromise those processes. If country authorities knew that what they told the staff would soon be in the public domain, they would be reluctant to share sensitive information. If the staff knew that what they wrote was intended for publication, they would feel less free to criticize a country's policies. These were serious concerns. All that the staff was willing to propose was that the Fund publish selected research studies on "some large countries with systemic influence," and to continue to use the WEO exercise, the Fund's *Annual Report*, and speeches by management as the main avenues for disseminating the Fund's analysis.[153]

The policy of not publishing conclusions or staff reports on consultations remained in place through the first half of the decade, even while the Fund began expanding its publication policies in other ways. In July 1994, the Fund adopted a policy to begin publishing most of the background papers prepared for consultations—then usually called "Recent Economic Developments"—subject to the approval of the country concerned. Even that limited step, which Camdessus called a "modest first stage in the process of gradually improving the Fund's information policy," proved to be controversial. Several Directors from developing countries feared it would lead to pressure on them to divulge more information than they might otherwise. Some also

[152]The Fund's interagency liaisons are summarized in "The Fund and the Environment," SM/93/251 (December 2, 1993).

[153]"Biennial Review of the Implementation of Surveillance over Members' Exchange Rate Policies and of the 1977 Surveillance Decision," SM/90/103 (May 29, 1990), pp. 15–17. The concurrence of the Executive Board with this view was summed up in Supplement 3 to that paper (August 23, 1990).

predicted—correctly—that it would lead eventually to a policy of publishing full staff reports. A "distinct majority," however, led most strongly by Karin Lissakers (United States), favored the proposal, which was adopted.[154]

The Fund also began quietly encouraging some countries to release the "final statements" of staff missions—that is, the staff's preliminary assessment of the country's economic conditions and policies—to local media outlets. In a few cases, mission chiefs began holding press conferences at the end of the mission to explain the staff's findings. The full staff report, however, was still treated as a confidential document.[155]

As these developments became known, the Fund came under increased public pressure to release its staff reports as a way to make the Fund more accountable. Internally, the staff and management were increasingly questioning whether the tradition of secrecy was really most effective. In addition, the rising trend for central banks to open up their own decisions and processes to public scrutiny was making the case for continuing confidentiality less compelling.

The next step came in 1997. Since 1978, it had been the policy of the IMF to conclude each Article IV consultation with a "Summing Up" by the Managing Director (as Chairman of the Executive Board) or by a Deputy Managing Director (as Acting Chairman).[156] That document summarized the views of the Executive Board, whereas the staff report obviously represented the views of the staff.[157] The Summing Up was routinely sent to the senior monetary authorities of the country concerned, normally under cover of a letter from management stressing the key messages. It often contained politically sensitive and market-sensitive information and thus was treated with great confidentiality. Starting in 1989, however, the Fund began publishing summary reports on selected Article IV consultations in the *Annual Report*, initially just for the G7 countries and then for a gradually expanded sample of others. Although not labeled as such, those summaries were adapted from the Summings Up. The question now was whether to begin publishing the full documents for individual countries soon after issuance.

In the course of the 1997 review of surveillance, the staff came up with a proposal to publish "press information notices" (PINs) shortly after the conclusion of each Article IV consultation. Each PIN would have two sections. One would provide a couple of pages of background on economic developments in the country concerned. The

[154]Minutes of EBM/94/61 (July 11, 1994), pp. 3–26. The two quotations are from p. 25.

[155]For a summary of these developments, see "Biennial Review of the Implementation of Surveillance over Members' Exchange Rate Policies and of the 1977 Surveillance Decision," SM/97/53 (February 19, 1997), pp. 32–33.

[156]The origin of this practice is described in Boughton (2001), pp. 89–90 and 127–28.

[157]In practice, the distinction was not quite that clear. Before each Board meeting, the staff prepared a draft of the Summing Up. That first draft usually was based on the assumption that Executive Directors would agree with the staff's views, unless the staff anticipated a specific controversy. Management and staff would revise the draft during the meeting to reflect the discussion as it progressed. At the conclusion of the discussion or shortly afterward, the Chair would read out the revised draft. Directors then would have an opportunity to ask for revisions.

second would "correspond closely to the Chairman's summing up of the Board discussion." Publication would be voluntary and would require the explicit consent of the country. To prevent the PIN from being bowdlerized, Camdessus proposed that editing of the Summing Up section "be kept to a minimum, removing only highly market-sensitive information, probably limited mainly to Fund views on exchange rate and interest rate matters in selected circumstances."[158]

The Board approved the issuance of PINs in April 1997.[159] Although participation was voluntary, publication (on the website http://www.imf.org) quickly became the norm. By the end of 1999, more than 80 percent of all Article IV consultations were resulting in publication of a PIN, which by then had been rechristened as a public (rather than press) information notice. Most of those were virtually identical to the Summing Up, but about 18 percent had some sensitive information removed.[160]

Finally, in 1999, the Fund was ready to begin publishing staff reports. Because a sizeable minority of the Executive Board was still skeptical about the wisdom of it, the Board agreed only to establish a "closed-end" pilot project. That is, any member country could volunteer to participate, but the project would run for only 18 months. If fewer than 20 countries volunteered, the project would not proceed at all. Success would be evaluated after the first year or so. Unless the Board agreed then to make the policy permanent, the experiment would end.[161] It worked better than expected. Staff reports for 46 countries were published in the first year, and another 20 countries expressed a desire to participate. The public—including financial market participants, academic analysts, media outlets, and nongovernmental advocacy groups—also responded enthusiastically. The staff found very little evidence of any loss of candor in consultation discussions.[162] Most of the opposition withered away, and in January 2001 the Fund adopted a permanent policy to continue publishing staff reports on a voluntary basis.

Data Quality

The IMF had a long-standing concern, dating from the 1940s, with the quality and international standardization of macroeconomic and financial data. In the 1980s and early 1990s, statisticians in the Fund focused in particular on improving the

[158]"Biennial Review of the Implementation of Surveillance over Members' Exchange Rate Policies and of the 1977 Surveillance Decision—Additional Material," SM/97/92 (April 10, 1997), p. 4.

[159]Decision No. 11493-(97/45); minutes of EBM/97/45 (April 24, 1997).

[160]"Review of the Pilot Project for Voluntary Release of Article IV Reports and Other Issues in Fund Transparency—Background Paper," SM/00/190, Suppl. 1 (August 11, 2000), pp. 29–30.

[161]See "Transparency and Fund Policies—Further Steps," SM/99/45 (February 19, 1999); minutes of EBM/99/22 (March 5, 1999); "Transparency and Fund Policies—Further Considerations," SM/99/79 (March 26, 1999); and minutes of EBM/99/38 (April 5, 1999).

[162]See "Review of the Pilot Project for Voluntary Release of Article IV Reports and Other Issues in Fund Transparency—Background Paper," SM/00/190, Suppl. 1 (August 11, 2000).

reporting of balance of payments data, including by reducing the statistical discrepancies preventing the global balance of payments from adding to zero. The "Godeaux Report," prepared by an international working party headed by Baron Jean Godeaux and published as IMF (1992), provided guidance for subsequent work in the Fund and in other international agencies, especially the 1993 publication of the fifth edition of the Fund's *Balance of Payments Manual*. The next major challenge was to improve the reporting of these and other essential data for purposes of Fund surveillance.

The Mexican peso crisis of 1994–95 highlighted a shortcoming in surveillance that had to be corrected. Almost from the moment the crisis erupted, Fund officials realized their ability to assess precrisis conditions in Mexico and to try to forestall the crisis had been hampered by the inadequacy of available data. A few weeks after the Executive Board approved the massive stand-by arrangement for Mexico, it conducted the biennial review of surveillance. Introducing the review at the Board meeting, Camdessus suggested that the number one priority for the future was to get more "timely and comprehensive data" from countries.[163] That generated an intensive work program over the next year that culminated in a commitment by the Fund to ensure and coordinate the dissemination of adequate data, not only to the Fund but to the public as well.

The effectiveness of Fund surveillance was being hampered by three data-related shortcomings. First, many countries had inadequate data on key variables, such as fiscal obligations and external debt. Second, countries might not be providing timely and comprehensive data to the Fund. That problem was most acute with respect to foreign exchange reserves and intervention in foreign exchange markets. Third, even when data were made available, the staff might not be making full use of them, in particular by sharing sensitive data with staff working on countries that might be affected by adverse developments elsewhere. The first problem could be alleviated by stepping up technical assistance to official agencies that were collecting and producing statistical data. The third problem could be alleviated by improving internal processes.[164] Alleviating the second problem—inadequate dissemination of data—would require an expansion of Fund surveillance into new areas.

Through the spring and summer of 1995, the Board met several times to review the Fund's policies and practices vis-à-vis national statistics and to devise a more effective approach. With regard to the provision of data to the Fund, the Board readily agreed to establish a "list of 11 core data categories as the minimum set to be provided to

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[163]Minutes of EBM/95/17 (February 17, 1995), p. 6.

[164]These three issues were summarized by Jack Boorman (Director, PDR) at EBM/95/18 (February 22, 1995), pp. 17–18.

the Fund on a regular and timely basis for continuous surveillance."[165] Management then directed the staff to integrate efforts to collect these data into Article IV consultations.

The more challenging task was to define the Fund's role—if any—in encouraging countries to provide adequate data to the public. Inadequate and untimely data were judged to have been a major shortcoming in Mexico in 1994. If, for example, depositors and investors had known about the decline in reserves as it happened or with minimal lag, the central bank and the government would have been forced to take remedial actions much more quickly, and the crisis might have been averted.

What became clear as the staff—in the Statistics Department and in PDR—worked on this issue was that data provision to the public was especially important for emerging-market countries seeking capital inflows from international financial markets. If those countries could be certified as meeting certain international standards for data provision, their access to financial markets would be more secure. In the fall of 1995, the staff visited nearly two dozen countries to seek their views on the appropriate standards and on their willingness to subscribe to them, and they corresponded with more than 40 other countries for the same purpose. That exercise revealed widespread enthusiasm for the project, and the Fund decided to proceed with it.[166]

The guidelines for disseminating data by market-access countries—initially called the "More Demanding Standard" and then the "Special Data Dissemination Standard" (SDDS)—were complex and detailed, but the essence may be briefly summarized. The Fund would set the standard in consultation with countries interested in subscribing to it. The standard would specify the types of data to be issued and the maximum acceptable lags for their issuance. Each participating country would agree to announce a calendar for the release of relevant data and to publish the data within the established intervals. The Fund would set up an electronic bulletin board on its website, with explanations of how the statistics are produced and disseminated by each country ("metadata") and hyperlinks to the national authorities' websites where the actual data would be posted.

The Executive Board approved establishment of the SDDS in April 1996, the system went live on the web that September, and the first hyperlinks to national data were opened in April 1997. At the outset, 33 countries participated. The list grew

[165] "Provision of Information to the Fund for Surveillance—Further Considerations and Draft Report to the Interim Committee," SM/95/229 (September 7, 1995), p. 12. The list was approved at EBM/95/32 (April 5, 1995), on the basis of proposals set out in "Strengthening Fund Surveillance—Provision of Statistical Data by Members," SM/95/59 (March 24, 1995).

[166] "Development of Standards for Dissemination of Economic and Financial Statistics to the Public by Member Countries," SM/95/321 (December 29, 1995).

gradually, and by the end of 1999 the SDDS bulletin board included 47 members.[167] Following the Asian financial crisis, the Fund and a committee of the G10 central banks jointly developed an additional template for the SDDS that provided for more information on reserve assets and on actual and potential drains on those assets.[168]

Meanwhile, the Fund was also developing a less demanding set of guidelines designed to apply to all countries, which it called the General Data Dissemination System (GDDS). The GDDS was to be a framework through which the IMF could help countries set up better statistical systems. In contrast to the SDDS, joining the general system did not require a country to meet specified standards. All that a member had to do was commit to cooperating with the Fund to improve the production and dissemination of statistical data. The Executive Board approved the GDDS in December 1997, and it gradually became a central component of the Fund's efforts to strengthen the quality and availability of national statistics.[169]

Surveillance over Major Economies

Formally, the IMF treats all countries alike when conducting Article IV consultations. The practical reality, however, is that the way countries respond to surveillance varies across groups. Developing countries with substantial financing shortfalls are more obliged to take the Fund's advice. Even if they are not active borrowers from the Fund, they are likely to depend on the Fund's "seal of approval" to get financing from other creditors and from donors. By the 1990s, most smaller advanced economies were immune from that kind of pressure, but they still were more likely to benefit from external policy advice and commendation than were their larger neighbors.

A good example of the benefits of surveillance for a small advanced economy was Belgium. In the late 1980s, Belgium was following a policy within the EMS of maintaining stability between the Belgian franc and the ECU basket. For various reasons, it was having trouble achieving the high level of credibility for this policy that was necessary if it hoped to keep interest rates close to those in Germany, the standard bearer for

[167]In its original form, the SDDS allowed countries to subscribe even if they did not fully meet all of the prescribed conditions, as long as they had adopted a "transition plan" to meet the standards by a specified date. At the end of 1999, 36 of the 47 subscribing countries were still completing their transition plans (Carson and Austin, 2008, p. 11).

[168]The Data Template on International Reserves and Foreign Currency Liquidity, which was approved at EBM/99/30 (March 23, 1999), represented a compromise between those countries favoring maximum information and those that sought to preserve more privacy. For details, see "Second Review of the Special Data Dissemination Standard," SM/99/65 (March 10, 1999), and the discussion at EBM/99/30 (March 23, 1999).

[169]For an overview of the way the dissemination standards worked over the next several years, see the papers in Alexander, Cady, and Gonzales-Garcia (2008); and see Dawson and Enoch (2009), pp. 156–64.

the region. In the 1989 consultation discussions, the IMF staff mission, led by Michael Deppler (Director, EUR), recommended shifting to an even stronger policy of tracking the deutsche mark rather than the ECU and publicly announcing that it was doing so.[170] The authorities took that advice, acted on it, and soon saw a substantial reduction in the interest rate differential. At the Executive Board meeting concluding the 1990 consultation, Belgium's long-serving Executive Director, Jacques de Groote, paid tribute to the role of the IMF in this outcome:

> Last year's Board discussion of the Article IV consultation report and the staff's convincing arguments on the desirability of the strong currency option for Belgium prepared the ground for the impending exchange rate decision. Belgium's reliance on the Fund's advice throughout the adjustment process begun in 1982 thus continues at every step.[171]

The response of the largest industrial countries tended to be more reserved. In most cases, senior officials—finance ministers and central bank governors—would meet the mission chief and listen politely to the Fund's policy advice. Heeding that advice was no better than a rare occurrence, and examples of the authorities of a major country acknowledging doing so were even rarer. For the Fund, the implicit objectives of Article IV consultations with the largest countries were to assess economic policies and conditions, offer the best advice it could, explain that advice both to the country's authorities and to the world at large, and provide a forum in which the international community could convey its collective views on these issues. Even if the advice was ignored at the time, meeting these objectives could serve a useful purpose over the longer run.

The following summaries cover consultations in the 1990s with the five largest economic powers: the United States, Japan, Germany, the United Kingdom, and France. The coverage of issues is selective rather than comprehensive, focusing on the key issues that arose in the discussions.

The United States

The biggest challenge in IMF surveillance has always been giving advice to the monetary authorities of the United States. Part of the challenge is that the U.S. economy is constantly and extremely well analyzed, in exquisite detail, by armies of official and private sector economists. How to add value is far from obvious. The other part is that the sheer dominance of the world's only superpower does not encourage its leaders to listen to outside advice. And yet, if the IMF were not to make every possible effort to try, it would justly be accused of bowing to that dominance, of yielding to its largest contributor, of an unforgivable asymmetry. Despite the frustration, Article IV consultations with the United States have to be a key feature of the surveillance landscape.

[170] "Belgium—Staff Report for the 1989 Article IV Consultation," SM/89/68 (April 14, 1989), pp. 9–10 and 12.

[171] Minutes of EBM/90/94 (June 15, 1990), p. 3.

Even when the U.S. authorities were not actively seeking the Fund's advice, both sides took the consultations seriously and engaged in discussions at the highest level. In each of the consultations in the 1990s, Camdessus personally concluded the discussions by meeting with the chairman of the Federal Reserve System, Alan Greenspan, and with the secretary of the Treasury. In most of those meetings, the Deputy (or First Deputy) Managing Director also participated, as did the U.S. Executive Director. The technical and policy discussions with Treasury, the Federal Reserve, and other officials were usually led by the Director or a Deputy Director of the Western Hemisphere Department (WHD) and lasted for several weeks. Even the second in command on these missions, an assignment that often rotated frequently for other countries, was held by just three assistant directors of WHD in the 1990s.[172]

In the preceding decade, the Fund's primary concern in its consultations with the United States had been the low level of national saving. Driven by the high fiscal deficits of that decade, the net national saving rate in the United States was one of the lowest among all industrial countries.[173] That issue gradually (and, it would turn out, temporarily) diminished in importance in the 1990s. The Omnibus Budget Reconciliation Act of November 1990, which raised several types of taxes and placed "pay as you go" limits on congressional spending decisions, initiated a decade-long improvement process that culminated in a series of annual fiscal surpluses beginning in 1997. It also ushered in a period in which discussions between the IMF and the U.S. authorities became much less confrontational.

The major issues in the U.S. consultations in the 1990s included maintaining economic growth without an acceleration of inflation; raising the level of national saving, notably by continuing to reduce the federal fiscal deficit; and strengthening the country's commitment to free trade. At the end of the decade, the possibility of a bubble in equity prices, especially in technology stocks, became a concern.

In 1990, the U.S. economy was slowing down and was falling into the first recession since 1981. By a quirk of timing, however, the recession was not a major issue in the Article IV discussions. It was not foreseen at the time of the 1990 discussions, and by the time of the next discussions, it was all but over. In June 1990, the U.S. representatives in the consultation discussions "saw few reasons to expect a recession." They nonetheless feared that aggressive action to reduce the fiscal deficit could trigger a downturn, but the staff urged them to ignore that risk and tackle the underlying

[172]Yusuke Horiguchi was in charge of work on the United States from 1987 to 1991. Jorge Márquez-Ruarte took over for the 1992–95 consultations, and Steven V. Dunaway held the post through 2001. Readers of this volume will encounter Horiguchi and Márquez-Ruarte again in Chapter 7; they were the mission chiefs on Russia in 1994–97 and 1997–99, respectively. Márquez-Ruarte also turns up later in this chapter because he was in charge of work on Japan before moving to WHD in the fall of 1991.

[173]Article IV consultations with the United States in the 1980s are covered in Boughton (2001), pp. 138–54. For an assessment of the saving rate, see Aghevli and others (1990).

problem. The staff appraisal concluded that "neither the U.S. authorities nor the staff forecast a recession."[174]

The recession started in August 1990 and lasted until March 1991, during which time real GDP in the United States contracted by about 2.25 percent.[175] By mid-1992, the unemployment rate had risen to 7.75 percent from just more than 5 percent. In the 1991 discussions, it was apparent that the recession was either already over or nearly over. With a resumption of growth in sight, the staff urged the authorities to focus on implementing the 1990 budget agreement as a way to strengthen national saving over the medium term. In 1992, the concern was that recovery from the recession was slow. On that occasion, the staff endorsed the monetary easing that the Federal Reserve had already initiated. In subsequent years, growth in the U.S. economy was strong enough not to be a real issue in the discussions.

In the early part of the decade, the staff and the U.S. authorities were both advocating strengthening the country's commitment to free trade, but some differences in nuance arose. In a nutshell, the U.S. authorities were disillusioned with the pace of global negotiations through the General Agreement on Tariffs and Trade (GATT), and they wanted to take bilateral initiatives to speed up the process. Their strategy was to develop a network of free trade agreements with individual countries or regions and gradually expand it into a generalized system. The Fund advocated the global approach, and the staff worried that regional agreements might turn out to be trade-diverting rather than trade-expanding. In the U.S. consultations, that general concern was reinforced by occasional protectionist acts by Congress or the administration.

The important developments spurring a dialogue on free trade were the Enterprise for the Americas Initiative (EAI), announced by President George H.W. Bush in 1990, and the initiation a year later of negotiations with Canada and Mexico on the North American Free Trade Agreement (NAFTA). NAFTA was intended to be the prototype for free trade agreements throughout the Americas under the broad framework established by the EAI. The IMF was skeptical. In the staff view, these "regional initiatives could signal a lessening of the commitment to multilateralism." Accordingly, the staff "wondered whether the proposed NAFTA and the various proposed agreements under the EAI were fully compatible with the Administration's objectives for freer multilateral trade."[176]

[174]"United States—Staff Report for the 1990 Article IV Consultation," SM/90/155 (August 30, 1990), pp. 7, 11, and 24.

[175]The dates of U.S. recessions are determined by the National Bureau of Economic Research, which makes and announces its determinations only after enough data are available. The onset and conclusion of the 1990–91 recession were announced in April 1991 and December 1992, respectively; see http://www.nber.org/cycles/cyclesmain.html.

[176]"United States—Staff Report for the 1991 Article IV Consultation," SM/91/159 (August 13, 1991), p. 16. Most Executive Directors broadly agreed with these concerns; see minutes of EBM/91/126 (September 18, 1991), pp. 20–21.

The Fund repeated its concerns about trade-diverting agreements in 1992 and 1993, but it quietly abandoned the battle after NAFTA took effect in 1994 with clear trade-expanding effects. For the rest of the decade, the focus of discussions on trade in the U.S. Article IV consultations was on the authorities' continuing to resort to measures such as antidumping legislation and countervailing duties, which U.S. officials viewed as legitimate tools to pry open foreign markets but which the Fund viewed as protectionist.

Toward the end of the 1990s, a sharp rise in equity prices—more than 30 percent annual rates of return for three straight years—gave rise to a new controversy. Was it a legitimate and sustainable reflection of a "new economy" resulting from a rash of advances in information technology, or was it a bubble born of a craze over the phenomenal early success of new technology-related companies? If it was a bubble, might its eventual bursting bring a marked slowdown in the economy? The U.S. authorities' position was that it might or might not be a bubble, but in either case there was no reasonable policy option for dealing with it. Therefore, they were content to let the stock market develop without any corrective action on their part. The staff warned in 1998 that it did look like a bubble, but the mission agreed that the risk of trying to prick it might not be worthwhile. Even with no action, the staff report concluded, a "correction . . . might slow the economy momentarily, . . . [but] would not be expected to have a prolonged or pronounced effect on demand."[177]

When the rise in equity prices continued for another year, the Fund became more alarmed. In the 1999 report, the staff warned that the clearly overvalued market was the principal risk to a continuation of economic growth and that monetary policy should gradually be tightened to force an orderly correction before the bubble burst on its own. As the value (on paper) of household wealth had risen, households had taken on increasing debt burdens and had driven the national saving rate to a record low level. These imbalances were no longer sustainable. Again, however, the argument fell on deaf ears. The authorities concluded "that one could not assert with a high degree of confidence that the market was overvalued. Even if such a judgement could be made, macroeconomic policy tools could not be finely calibrated to gently deflate a bubble."[178]

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[177]"United States—Staff Report for the 1998 Article IV Consultation," SM/98/179 (July 13, 1998), p. 11.

[178]"United States—Staff Report for the 1999 Article IV Consultation," SM/99/159 (July 6, 1999), p. 19. U.S. equity prices peaked in March 2000, after which the main index of technology stocks declined by more than 50 percent in a little more than a year. Prices of more established firms (as measured by the Standard & Poor's index of 500 stocks) fell by about one-sixth. The ensuing recession began in March 2001.

Japan

At the beginning of the decade, Japan—the second largest economy in the world—was in an extraordinary economic boom, fueled by an easy monetary policy that encouraged substantial lending for real estate ventures and ultimately led to a property price bubble. The seeds for the bubble had been sowed in the Plaza accord among the Group of Five countries in September 1985, under which the yen was to be allowed to appreciate against the U.S. dollar, and the Baker-Miyazawa agreement of 1986, in which Japan agreed to cut short-term interest rates (see Boughton, 2001, pp. 206–18). Fearing that yen appreciation would bring a downturn in the economy, the Japanese authorities began easing monetary policy more aggressively. While consumer price inflation remained low overall, the rise in asset prices—notably corporate equities and commercial real estate—began to accelerate dramatically. Equity prices began falling once the Bank of Japan shifted back to a policy of raising interest rates in 1989, and real estate values followed shortly. By 1992, stagnation had set in, and Japan was mired in what would become known—in an eerie echo of Latin America's woes in the 1980s—as its "lost decade."

The central issue in the IMF's response to these developments was how to use monetary and fiscal policies to stabilize the Japanese economy.[179] Both at the time and afterward, many Japanese officials concluded the Fund was taking an overly Keynesian position—trying to fine-tune aggregate demand through countercyclical policy adjustments. There was a measure of truth to that complaint, but the dispute was mainly within the Executive Board, not between the authorities and the staff.

For the first half of the decade, consultations with Japan took place against a backdrop of bickering between Japan and the United States over the appropriate course of fiscal policy.[180] The U.S. view, under the administrations of both George H.W. Bush and Bill Clinton, was that Japan needed a more expansionary fiscal policy. Japan's sluggish aggregate demand was stifling economic growth and driving up the external surplus. By stimulating demand and causing the real exchange rate to appreciate, fiscal expansion could bring down the surplus and correspondingly reduce the U.S. current account deficit. The Japanese view was that fiscal policy should be directed at longer-term issues, especially the anticipated fiscal costs associated with the aging of its population. The Fund staff team tended to side with the Japanese, and that stance led to increasingly outspoken reactions from the United States.

[179]The appropriateness of exchange rate movements was another recurring theme, as was structural reform in the financial sector. Those and related themes are discussed in Callen and Ostry (2003).

[180]This policy dispute dated from the early 1980s; see Boughton (2001, pp. 154–64) on the effect it had on consultations with Japan in the 1980s; and Golub (1994) on the causes of the bilateral imbalance.

In the 1990 consultation discussions, the staff mission—led by P.R. Narvekar (Director, Asian Department) and seconded by Jorge Márquez-Ruarte (Division Chief)—concluded that demand-management policy in Japan was appropriately aimed primarily at containing inflationary pressures. "It is imperative that Japan's excellent record of macroeconomic stability be preserved. This will be the foundation of both continued sustainable output growth and stability in domestic financial and foreign exchange markets."[181] At the Board meeting, Thomas C. Dawson II (United States) questioned both the conclusion and the premise that latent inflation was a major risk. Most Directors agreed with the staff that the best way to deal with the external surplus was to reduce disincentives to import, but several agreed with Dawson that fiscal stimulus should also play a role.[182]

The 1991 staff report wryly took note of that disagreement among Executive Directors. ("The judgment that inflation was a serious risk was, of course, not shared universally in the Executive Board.") Narvekar and Márquez-Ruarte nonetheless stuck to their earlier assessment and called again for steady application of restraint in both monetary and fiscal policies. Again the U.S. chair, supported by a few others, disagreed and called for a more expansionary policy stance.[183]

Matters continued in that vein in 1992; neither the Japanese authorities nor the staff realized the economy was beginning to stagnate more permanently under the weight of declining asset prices. In the view of the staff team (now led by Bijan Aghevli, Deputy Director, Central Asian Department, and seconded by Ulrich Baumgartner, Assistant Director), "additional stimulus should be undertaken only if there were unmistakable signs of greater economic weakness than [is] expected now." At the Board meeting, Jacques de Groote (Belgium) took the lead in calling for a shift toward expansion. He was followed closely by Dawson, who mocked the staff position as an "Amen Chorus of Kasumigaseki," referring to the vernacular name of the Japanese government bureaucracy. The majority view in the Board, however, still favored a steady application of fiscal restraint.[184]

By 1993, the Japanese stagnation was well under way. The authorities had initiated a mild fiscal stimulus and were convinced that a recovery had begun as a result. The staff accepted that scenario and agreed that the moderately expansionary policy was appropriate. Views on the Executive Board were mixed. The prevailing view was

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[181] "Japan—Staff Report for the 1990 Article IV Consultation," SM/90/112 (June 8, 1990), p. 26.

[182] Minutes of EBM/90/107 and EBM/90/108 (July 9, 1990). Dawson's intervention is on pp. 10–15 of the first (morning) meeting, and the Summing Up of Directors' views is on pp. 10–12 of the afternoon session.

[183] "Japan—Staff Report for the 1991 Article IV Consultation," SM/91/126 (June 19, 1991), p. 17; and minutes of EBM/91/93 (July 17, 1991), p. 12.

[184] "Japan—Staff Report for the 1992 Article IV Consultation," SM/92/122 (June 17, 1992), p. 18; minutes of EBM/92/88 (July 15, 1992), pp. 10 (de Groote) and 12 (Dawson); and minutes of EBM/92/89 (July 15, 1992), pp. 26–29 (Summing Up).

supportive, but Dawson took an even more negative and contemptuous view of the matter than he had in the preceding years. He had "fundamental differences of view" with the staff analysis, which he found to be "far too optimistic" and to reflect a "misdirected preoccupation with fiscal consolidation." "More fundamentally," he continued, the U.S. "authorities have instructed me to convey their basic dissatisfaction with the orientation of these consultations with Japan. Nowhere is there the focus on international economic cooperation that ought to be at the heart of Fund surveillance of major industrial countries."[185]

Dawson's prediction that economic growth was not about to resume proved to be correct. A year later, the staff again accepted the Japanese authorities' view that growth was on the verge of recommencing. Although they expected the rebound to be anemic, they also accepted the authorities' conclusion that any further stimulus should come through monetary easing, not fiscal. Again, the U.S. Executive Director (Karin Lissakers, who had succeeded Dawson) took exception. She argued that Japanese national saving was too high and was being propped up by inappropriately tight fiscal policy.[186]

The only year in this decade when the Fund questioned the fundamental stance of macroeconomic policy in Japan was 1995. By then the evidence that the economy was in long-term stagnation was becoming overwhelming, and confidence had been further shaken by a devastating earthquake near Kobe in January and by a domestic terrorist attack using poison gas on the Tokyo subway system in March. Nonetheless, the authorities were reluctant to make more than a modest shift toward stimulus. The staff strongly urged them to implement further stimulus through both fiscal and monetary actions.[187] Most Executive Directors agreed. On this occasion, Lissakers expressed the agreement of the U.S. authorities with the "broad contours of the staff assessment" and suggested only that "the message [of further stimulus] should carry a much greater sense of urgency."[188] To convey that urgency, Stanley Fischer soon traveled to Tokyo, where he met with both the finance minister and the central bank governor to explain why the Fund believed further action was necessary.[189]

For the rest of the decade, the Fund's macroeconomic advice to Japan responded more to cyclical fluctuations than to the longer run. Unfortunately, as the Fund predicted in 1995, the recovery from the postbubble stagnation proceeded at a weak and

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[185]Minutes of EBM/93/100 (July 16, 1993), p. 13. Also see "Japan—Staff Report for the 1993 Article IV Consultation," SM/93/132 (June 22, 1993).

[186]The economic logic of this argument was that excess domestic investment had been generated by the "bubble economy" of the late 1980s. Investment subsequently had fallen to a more realistic level, but saving had not followed suit. Lissakers developed this line of reasoning at EBM/94/69 (July 27, 1994); see minutes, pp. 17–20. The staff argument that Japanese saving was at or near an equilibrium level was based on an analysis using neoclassical growth theory; see Section II ("Does Japan Save Too Much?") of "Japan—Recent Economic Developments—Supplementary Material," SM/94/185, Suppl. 1 (July 22, 1994).

[187]"Japan—Staff Report for the 1995 Article IV Consultation," SM/95/160 (June 30, 1995).

[188]Minutes of EBM/95/69 (July 21, 1995), p. 16.

[189]See Fischer's report to the Executive Board at EBM/95/78 (August 23, 1995), p. 4.

unsteady pace. The Fund had trouble foreseeing the ups and downs of this feeble cycle, and its advice suffered accordingly. In 1996, the recovery seemed to be accelerating nicely, and the Fund advised Japan that the "exceptional fiscal stimulus" introduced early in the year "should be phased out in 1997 if the recovery continued as envisaged." It offered similar advice in August 1997, even though it later came to light that the economy was already back in recession and that the downturn was both aggravating and being aggravated by the burgeoning regional financial crisis.[190] At the conclusion of the 1998 consultation, the Fund acknowledged that "the performance of the Japanese economy had been much weaker than anticipated" a year earlier. In these circumstances, it was "vital for the authorities to ensure that fiscal support for the economy remains in place until the recovery takes hold." At the end of the decade, the Fund implicitly returned to its earlier stance of just supporting the main thrust of the authorities' program. Although neither the government nor the Fund had much confidence left in their ability to forecast the direction of the economy, "Directors endorsed the government's evolving strategy" in 1999 and "suggested that the present supportive fiscal stance should be sustained until a recovery in private demand takes hold."[191]

European Union

The most visible financial crisis in the first part of the decade was the one that hit the countries participating in the Exchange Rate Mechanism (ERM) of the EMS in 1992–93. Since German unification in 1990, speculative pressures had gradually built up against the fixed exchange rates within the ERM. The rejection of the Maastricht Treaty on EMU in a Danish referendum in June 1992 and an exchange crisis in the Nordic region in September brought these speculative pressures to a head. The Italian lira and the British pound sterling came under especially heavy attack, and both countries responded by pulling out of the ERM on "Black Wednesday," September 16. When generalized speculation resumed in 1993, European finance officials dramatically widened the intervention bands in the system in August, from ±2.25 percent to ±15 percent. The crisis then passed, and the long trek toward full monetary union across Europe resumed.[192]

[190]For an analysis of the financial interconnections between Japan and Asian emerging markets in the 1990s, see Sheng (2009), Chapter 2.

[191]For the 1996 assessment, see the Summing Up at EBM/96/71 (July 24, 1996), pp. 52–54. The assessments for 1997–99 were published as Public Information Notices at http://www.imf.org/external/news/default.aspx?pn.

[192]For an overview and analysis of the ERM crisis, see Buiter, Corsetti, and Pesenti (1998) and references therein. They attribute the crisis primarily to the failure of the participating countries to find a cooperative response to the new financial realities posed by monetary unification in Germany, a response that could have combined a cut in German interest rates with a realignment of parities.

Because the major western European countries did not view the IMF as a necessary or valued source of financial advice, the Fund's participation in managing the ERM crisis was never an option. The interesting historical question is whether the Fund, through its annual Article IV consultations or other means, provided adequate warnings or analysis, especially while conditions worsened from 1990 to 1993.

Germany

The largest and wealthiest country in the European Communities came under tremendous financial pressure at the beginning of the 1990s. As the physical barriers symbolized and anchored by the Berlin Wall crumbled, hundreds of thousands of people emigrated from the long-isolated and depressed German Democratic Republic (East Germany) into its much freer and richer western sibling, the Federal Republic of Germany. In May 1990, the two countries signed a treaty of economic and monetary union to make the deutsche mark (DM) the common currency of both. East German ostmarks would be exchanged for DM at parity up to a specified level per person and at a 1:2 rate for the rest. In October, the two countries merged, and East Germany ceased to exist as a separate state.

The economic and financial burden of German unification was large enough to induce the authorities to consider asking for financial assistance for East Germany from the IMF. During a March 1990 Executive Board discussion of the need for an increase in the Fund's financial resources, the German Executive Director, Guenter Grosche, noted that "his authorities had foreseen a need to draw on Fund resources to facilitate adjustment in the German Democratic Republic." Now that unification was proceeding, "while he expected that Germany would not need to enter into a Fund program in the foreseeable future, that possibility could not be totally ruled out."[193] Although Germany did not end up asking for help, it was incumbent on the Fund to respond more generally to these dramatically changed circumstances.[194]

The crucial consultation discussions with Germany, led by Manuel Guitián (Deputy Director, EUR), took place in Bonn and Frankfurt in the first part of June 1990, after the German authorities had finalized plans for unification and for the currency conversion. The German authorities were in the middle of preparations for implementing the currency conversion, and they were committed to engineering a full economic, social, and political unification as soon as possible. The staff noted that the conversion of claims, salaries, debts, and so forth into DM was going to be expensive and potentially inflationary, but they did not question the choice of conversion rates. Instead, the staff report counseled more aggressive fiscal tightening, particularly

[193]Minutes of EB/CQUOTA/MTG/90/13 (March 20, 1990), p. 11.

[194]For the Fund's initial analysis of German unification, see the papers collected in Lipschitz and McDonald (1990).

through tax increases and containment of subsidies.[195] If the entire burden of inflation control were to fall on monetary policy, interest rates could rise sharply, putting a strain on Germany's neighbors. Without price and interest rate stability in Germany, the viability of the ERM would be gravely threatened, with potentially serious adverse consequences for all of Europe. Two weeks after the conclusion of the staff mission, Camdessus went to Germany to reinforce this message in meetings with the finance minister and the president of the Bundesbank.[196]

The authorities viewed the Fund's advocacy for fiscal tightening as excessively strict. Without large subsidies, the rise in unemployment in the eastern states was likely to be devastating and was expected to perpetuate the massive labor migration to the west. Both sides agreed, however, that while a realignment of exchange rates within the ERM (effectively revaluing the DM) would help the stabilization process, that advantage was outweighed by the risk of weakening the European commitment to maintain firm parities and advance toward EMU.

The staff continued to make the case for policy adjustments in 1991 when Patrick de Fontenay (Deputy Director, EUR) led the first staff mission since unification.[197] The fiscal deficit had ballooned, making the Bundesbank's task of maintaining price stability much more difficult. As the staff report noted, "much of Europe has come to depend on the firm anchor of German monetary policy." Without greater fiscal discipline, monetary discipline would be continually threatened.[198]

The 1992 consultation discussions took place both before and after the September ERM crisis. At the time of the first mission, led by Jacques Artus (de Fontenay's successor as Deputy Director, EU1)[199] in early September, the previous missions' fears were being realized. The high interest rates that had resulted from the continuing fiscal deficit were strengthening the DM in exchange markets, and the effort to keep up with it was weakening economic activity in other countries participating in the ERM.[200]

[195]"In the view of the staff the effective conversion rate was sufficiently depreciated to absorb excess (and potentially inflationary) monetary balances in the GDR." The report noted that Bundesbank officials had argued for a 1:2 conversion rate for all ostmarks, and that the effective rate (a weighted average of 1:1 and 1:2 for different types of balances) was expected to be about 1:1.8; "Federal Republic of Germany—Staff Report for the 1990 Article IV Consultation," SM/90/153 (August 1, 1990). The sentence quoted here is in footnote 1, p. 12.

[196]Report to the Executive Board; minutes of EBM/90/106 (July 2, 1990), pp. 3–4.

[197]While the head of mission changed fairly frequently during this period (Guitián—who had led several earlier missions to Germany—had moved to another department), the second in command provided a bit more continuity. The analytical work on Germany was directed by Leslie Lipschitz (Assistant Director, EUR), who participated in missions to Germany from 1985 to 1991. For a review of pre-1990 consultations with Germany, see Boughton (2001), pp. 165–77.

[198]"Germany—Staff Report for the 1991 Article IV Consultation," SM/91/164 (August 14, 1991), p. 24.

[199]The European Department was split in 1992, with all countries outside the former Soviet Union assigned to European I (EU1).

[200]"Germany—Staff Report for the 1992 Article IV Consultation," SM/92/194 (October 30, 1992), p. 21.

Speculative pressures against the ERM parities were building up rapidly. Shortly after that mission concluded, the crisis erupted. When the dust settled, the staff returned for follow-up discussions, mainly to assess how the financial landscape had changed. The basic message on macroeconomic policy—tighten fiscal policy to relieve the pressure on monetary policy—remained the same.

The staff and the German authorities shifted roles a bit in 1993. The economy was now in recession because the earlier appreciation of the DM had taken its toll on international competitiveness. Bundesbank officials were nonetheless still focused primarily on price stability, while the staff suggested that the time had come for some easing to restore the momentum of aggregate demand. The mission—again led by Artus—was still calling for a tightening of fiscal policy, but it was more open than before to a preemptive easing on the monetary side without waiting for fiscal action.[201] By the time of the next mission, in May 1994, the ERM crisis had passed. The widening of the intervention bands had restored calm in exchange markets, and the German economy was recovering from recession.

Had the Fund given the right advice? From a macroeconomic perspective, it had. With a different mix of monetary and fiscal policies, the German authorities could have maintained the pace of aggregate demand without relying so heavily on high interest rates to preserve price stability. That approach would have relieved pressure on exchange rates and might have averted the ERM crises of 1992 and 1993. From a structural perspective, the authorities' objections to that course also made sense. The costs of unification had to be met in part by borrowing, and that required larger fiscal deficits than would otherwise have been optimal. A less aggressive response to the severe imbalance in initial conditions in the eastern and western Länder would have seriously delayed and could have derailed the successful integration of the two Germanies. The rejection of an early realignment may have been questionable, but the rationale for it was strong at the time. All the good options were hemmed in by real constraints.

The United Kingdom

On October 5, 1990, the government of the United Kingdom announced that the pound sterling was joining the ERM, though with wider bands (± 6 percent around central parities) than most other members were using (± 2.25 percent). This decision ended a multiyear period in which the British authorities had experimented—without much success—with various strategies for stabilizing the exchange rate. The "medium term financial strategy" introduced at the beginning of the 1980s, which aimed to stabilize prices by controlling the growth rate of the money stock, had led to very wide fluctuations in the exchange rate. For a year in 1987–88, the strategy had been to "shadow" the DM to prepare the way for eventual ERM

[201]"Germany—Staff Report for the 1993 Article IV Consultation," SM/93/136 (June 30, 1993), pp. 20–21.

participation. When that strategy led to unstable domestic conditions, the exchange rate was again allowed to float to a market-determined level. By 1990, a coalition of strong supporters of financial integration with Europe and others who were frustrated with the lack of a good alternative finally won the day.[202] The triumph was short-lived.

The Fund supported the authorities' intention to join the ERM. In fact, for several years, the staff had been quietly encouraging the authorities to prepare for such a step. The only questions were when and at what exchange rate. When the 1989 consultations were concluded in March 1990, every Director who addressed the subject urged an early entry, but a few—including Bernd Goos (Germany)—cautioned that Britain should first bring down its high rate of price inflation.[203] When the Board next discussed the United Kingdom, after the entry was a *fait accompli*, a few Directors were still nervous about the consequences. With British inflation roughly double that on the continent, did it really make sense to hitch the exchange rates together? However, the prevailing view by far was support for the staff's conclusion that ERM participation would enhance the credibility of the authorities' determination to reduce inflation, and that it was indeed the only hope for success.[204] In February 1992, the Executive Board again agreed with the staff that adherence to the ERM was the right strategy and that the pound should be brought into the narrow band as soon as the inflation differential could be substantially eliminated.

Even with the flexibility afforded by the wide band, the pound was vulnerable to a speculative attack against the ERM parity. That vulnerability increased with every month that prices rose more rapidly in Britain than on the continent. Because of the sheer size of the British financial system and of the foreign exchange reserves held by the Bank of England, neither the authorities nor the staff of the IMF seems to have regarded an attack as a serious threat in 1991 or 1992. By August 1992, however, the pound was trading near the floor of its trading band, while the whole ERM was coming under pressure owing to a rise in German interest rates and growing doubts about the extent of public support for EMU. Speculation turned into an attack and then into a rout in mid-September, when Italy was forced out of the ERM on September 14. After the Bank of England tried desperately to defend the pound by raising short-term interest rates sharply, it gave up on Black Wednesday, September 16. The investor and hedge fund manager George Soros soon became known as "the man who broke the Bank of England" when he revealed that he had led the attack by betting $10 billion against the pound and that he had made nearly $1 billion in profits when the Bank was forced to abandon the fight (Kaletsky, 1992, p. 1).

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[202]For these and related developments, see Boughton (2001), pp. 180–83.

[203]Minutes of EBM/90/31 (March 5, 1990). Goos's remarks are on pp. 29–31.

[204]Minutes of EBM/91/17 and EBM/91/18 (February 11, 1991); the Summing Up begins on p. 38 of the latter meeting. Also see "United Kingdom—Staff Report for the 1990 Article IV Consultation," SM/91/14 (January 17, 1991); p. 20 presents the staff appraisal of the ERM decision.

Following withdrawal from the ERM, the British authorities knew they needed new rules to replace the discipline of the European system. They therefore adopted an inflation-targeting regime. They remained committed in principle to an eventual resumption of ERM membership, but only after a convergence of cyclical economic conditions vis-à-vis Germany. The staff mission that arrived in London in early December, led by Artus, endorsed the inflation-targeting regime but cautioned that fiscal policy would have to be tightened substantially for it to succeed.[205]

For the next few years, a crucial question was how to gain greater credibility for British macroeconomic policies so that robust and noninflationary growth could take hold. Inflation targeting was working reasonably well but seemed fragile. Beginning in 1994, the staff urged the authorities to enable the Bank of England to implement monetary policy independently of the Treasury, as one way to establish a more credible anti-inflationary policy regime.[206] The authorities resisted that advice until after the May 1997 parliamentary elections, which ended 18 years of rule by the Conservative Party and elevated the Labor Party's Tony Blair to the premiership. Blair's chancellor of the Exchequer, Gordon Brown, was a strong advocate of central bank independence, and he granted it to the Bank of England within a few days after taking office.

Another of Brown's first acts as chancellor was to announce a set of five tests that would have to be met before it would make sense for Britain to adhere to EMU and adopt the euro as the national currency. Because none of the tests was met at the time and the prospects were somewhat remote, this tactic enabled the government to maintain a formal commitment to EMU while postponing it indefinitely. This policy, too, was endorsed by the Fund, and the rest of the decade's consultations proceeded without major controversy.[207]

France

Meanwhile, France—the other major power in the EMS, along with Germany—was firmly committed to a policy of maintaining parity with the DM, even if that meant pushing interest rates higher than might seem desirable for domestic policy purposes.[208] Throughout the early 1990s, Article IV missions endorsed that policy

[205]"United Kingdom—Staff Report for the 1992 Article IV Consultation," SM/93/14 (January 21, 1993), pp. 18–20.

[206]"United Kingdom—Staff Report for the 1994 Article IV Consultation," SM/94/248 (September 23, 1994), p. 15.

[207]The staff appraisal in 1997 was muted on this issue, noting only that "the recent opening of a thorough national debate on where the United Kingdom's economic interests lie" with respect to EMU participation "was overdue"; "United Kingdom—Staff Report for the 1997 Article IV Consultation," SM/97/251 (October 6, 1997), p. 24. The Executive Board was a little more direct, concluding that it "welcomed the government's declaration of support in principle for participation in monetary union, subject to its meeting certain economic tests, particularly regarding cyclical convergence"; minutes of EBM/97/106 (October 27, 1997), p. 60.

[208]This "franc fort" or hard currency policy originated in 1986. That shift and the Fund's relations with France in the 1980s are covered in Boughton (2001), pp. 177–80.

and marveled at the sight of France achieving inflation rates below those of Germany. Consequently, no major policy issues arose in the discussions. Instead, the crucial meetings came after the ERM crisis, which France survived without a devaluation but with a legacy of macroeconomic imbalances that were difficult to ignore.

The Maastricht Treaty specified several "convergence criteria" for countries intending to enter into EMU in 1999, including that they must make steady progress toward a sustainable fiscal deficit of no more than 3 percent of GDP by 1997. France's deficit was close to 6 percent in 1993, only partly because the economy was in recession. The following year, the Fund began to question whether the authorities' plans to converge quickly enough to the target were based on credible assumptions. With high unemployment (judged by the Fund to result from structural rigidities in labor markets, not from inadequate demand) and the prospect of presidential elections less than a year away, the government had not yet announced the specific spending cuts that would be needed to stay on course. The staff pronounced the required cuts to be "severe," and it projected that the deficit would remain well above the convergence path. With characteristic diplomacy, however, the staff report concluded that it "welcomes the strong assurances" by the authorities that France would meet the targets.[209]

The fiscal debate intensified in 1995, when a staff mission led by Artus arrived a few weeks after the election of Jacques Chirac as president. Chirac's succession to the post held for 14 years by François Mitterrand completed a shift to the right that had begun with the parliamentary elections of 1993. The election also removed the political necessity of promoting short-term over longer-term goals for economic policy. With the fiscal deficit still clinging stubbornly to 6 percent, reducing it was becoming imperative if France hoped to meet the Maastricht target and avoid a possibly debilitating panic in foreign exchange markets. Accordingly, Artus and his team set out a detailed "adjustment scenario" for fiscal policy and urged that it be incorporated into the government's forthcoming budget.[210]

On this occasion, the staff's analysis appears to have made a difference. At the outset of the Executive Board meeting concluding the 1995 consultations, Marc-Antoine Autheman (France) averred that the points made by the staff, "which echoed the opinion of the Bank of France, were convincing." The government had planned to present a budget that was projected to bring the deficit down just to 3 percent of GDP by 1997, but now it would be more aggressive in cutting spending and more ambitious in its deficit reduction. He acknowledged that the "credibility of our fiscal policy has

[209]"France—Staff Report for the 1994 Article IV Consultation," SM/94/210 (August 9, 1994), p. 17.

[210]"France—Staff Report for the 1995 Article IV Consultation," SM/95/251 (September 21, 1995). The general policy recommendation is on p. 31, and the detailed scenario is set out on pp. 36–38.

suffered from the lack of strict implementation of past commitments." This time would be different, "because my authorities do not consider nonconvergence an option."[211]

That lack of credibility was evident in the staff's response to the budget announcement and in the responses of other Directors to Autheman's assurances. After reviewing the budget for 1996, the staff concluded, "Much more is needed and time is running short."[212] At the Board meeting, Directors piled on. J. Onno de Beaufort Wijnholds (Netherlands) suggested that meeting the government's deficit target by 1997 would "require a 'tour de force'." Stefan Schoenberg (Germany) suggested that the French social security system was in need of "radical reform." Huw Evans (United Kingdom) eruditely reminded his colleagues that the "immediate cause of the French revolution was the fiscal crisis of 1788," which he thought was not too different from that of 1995. Karin Lissakers (United States) picked up that theme by quoting the always quotable American baseball legend Yogi Berra—reading about France's fiscal problems was "déjà vu all over again." At the end of the day, Fischer summed up the Board's sense of urgency by noting that "France's task was now truly historic . . . [as] the future of European monetary integration lies largely with France. For the authorities and for the French people, fiscal convergence is a challenge that must be met."[213]

It was met. Proving the skeptics wrong, Chirac and Prime Minister Alain Juppé tackled the social security problem and took other measures to strengthen the fiscal accounts. The staff mission for the 1996 consultations—again led by Artus—found that the deficit was likely to be held to 4 percent and then keep falling. That defused much of the worry about the convergence target for 1997, and from that point on the debates were more muted. In the end, the deficit for 1997 was 3 percent, although the target was met only by a one-time transfer of privatization receipts. That year, the EU adopted a new set of more flexible and dynamic targets for EMU convergence, in the Stability and Growth Pact. France continued to meet those targets through the end of the decade.

Lessons Learned

Throughout the 1990s, the IMF repeatedly tried to hone its surveillance work to make it more effective and efficient. Some of these efforts may have been misguided, such as the various attempts to broaden bilateral surveillance consultations to cover nonfinancial issues like military spending and the natural environment. However beneficial a successful move in that direction might have been, the lack

[211]Minutes of EBM/95/100 (October 25, 1995), pp. 3–7.

[212]"France—Staff Report for the 1995 Article IV Consultation," SM/95/251, Suppl. 1 (October 18, 1995), p. 10.

[213]Minutes of EBM/95/100 (October 25, 1995), pp. 17 (Wijnholds), 21 (Schoenberg), 25 (Evans), 38 (Lissakers), and 62 (Summing Up).

of mandate, expertise, or real commitment made success elusive. Other efforts may have been quixotic, such as the various attempts to strengthen the Fund's ability to anticipate financial crises. The onset of a financial crisis is, in most cases, not foreseeable, because it depends crucially on a psychological tipping point as markets assess and act on the likelihood of their own collective responses. Still other efforts failed because of poor timing or execution. Notably, the attempt to amend the Articles of Agreement to assign the Fund a mandate to oversee a process of orderly liberalization of capital accounts collapsed because the Fund was perceived to be overreaching and trying to force countries to liberalize prematurely. The endeavors with the best chances of success were the efforts to focus surveillance on the issues critical to reducing countries' vulnerability to crisis. Those efforts did not always succeed, but they perceptibly improved the practice of surveillance by the end of the decade. The Fund also had some clear successes in ensuring that its surveillance was applied evenhandedly and in an increasingly transparent framework.

The primary vehicle for reassessing the practice of surveillance was the biennial review process. In the 1990s, those reviews led to a number of revisions and extensions to the guidance that management and the Executive Board gave to the staff. The more important of those revisions, detailed at various places in this chapter, included an increased focus on financial market developments, the provision of data to the Fund and to the public, and the orderly liberalization of capital markets. On three other occasions, the Fund looked "outside the box" to see if it could make more-fundamental changes.

The first occasion was in 1995, when Camdessus commissioned Alan Whittome to prepare a report on the failures of surveillance in the run-up to the Mexican peso crisis. As discussed in the "Consultation Procedures" section earlier in this chapter, the Whittome report recommended that the Fund endeavor to make its surveillance of vulnerable countries more nearly continuous, to obtain better and more current data, to be more critical of soothing reassurances from national authorities, to listen more to financial markets, and to report its findings more boldly and with greater clarity. Although the staff tried to improve performance in all of these areas, the most evident subsequent improvement was in the Fund's interactions with and understanding of financial markets.

The second occasion was a postmortem internal review of the effectiveness of Fund surveillance in the period before the Asian financial crises in 1997–98. That review, conducted in the first quarter of 1998, reinforced the messages of the Whittome report, especially the importance of continual monitoring of macroeconomic and financial market conditions and of the timely availability of relevant data. It also concluded that the Fund needed to pay greater attention to the spillover effects from policy errors and other problems in regionally important countries, and it needed to do more to disseminate information about emerging problems, because "policy transparency" was crucial for gaining or restoring credibility in financial markets. Finally, the review suggested that the Fund should encourage the further development of other peer review mechanisms such as regional policy forums.[214]

Also in 1998, the Executive Board commissioned an outside panel, led by John Crow, a former governor of the Bank of Canada, to evaluate the conduct and effectiveness of Fund surveillance. The Crow report (Crow, Arriazu, and Thygesen, 1999) was the first comprehensive external review of Fund surveillance. It offered a large number of recommendations, ranging from procedural issues (e.g., establish a surveillance committee of Executive Directors, publish all Article IV staff reports) to broad issues of substance. One key recommendation was to focus surveillance much more sharply on "the core issues of exchange rate policy and directly associated macroeconomic policies, in particular the international implications of such policies" than had been done in the 1990s. The report criticized the staff for trying to optimize all aspects of countries' economic policies and thereby losing sight of what mattered most. It argued for paying more attention to systemically important countries and less to small countries whose domestic problems had little effect on their neighbors.[215]

Many of the specific recommendations of the Crow report clashed with the culture and traditions of the IMF. Both the staff and the Executive Board issued detailed rebuttals (published as part of the report), mainly pertaining to the procedural rather than the substantive proposals. On the main substantive issues, though, the three major reviews all conveyed the same message: stay focused, get and analyze as much relevant information as possible, and convey a clear message both to the authorities and to the public. That advice was gradually incorporated more fully into the practice of surveillance in the years that followed.

[214]"Review of Members' Policies in the Context of Surveillance—Lessons for Surveillance from the Asian Crisis," EBS/98/44 (March 9, 1998); and minutes of EBM/98/34 (March 26, 1998. The lessons from the review were published in *Annual Report 1998*, pp. 34–38. This review dealt only with the role of surveillance. The separate question of how well the Fund responded to the crisis through its lending, policy advice, and technical assistance was taken up in other reviews, as discussed in Chapter 12.

[215]Crow, Arriazu, and Thygesen (1999), especially Chapter 6. The quotation is from p. 63.

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