II

The IMF and the Transition from Central Planning

6

The Death of Central Planning and the Birth of Markets

Before the period covered by this History, the IMF was often described as a "capitalist club." Few socialist or centrally planned countries were members, and the absence of the Soviet bloc and (until 1980) the People's Republic of China was a glaring feature of the membership. It was not designed to be that way. As described in Chapter 2, the U.S. government under President Franklin D. Roosevelt tried hard in 1944 to pave the way for the Soviet Union to become an original member of the IMF. That effort almost succeeded, but when relations between the United States and the Soviet Union hardened into the Cold War, financial cooperation through the IMF was a collateral casualty.

In fact, the IMF never really was a capitalist club. Its membership during the Cold War always included nonaligned countries with socialist or semisocialist economies, such as Egypt, India, and Yugoslavia. It also included at least a few Soviet allies. Relations with socialist countries, however, often became strained. Poland withdrew in 1950 under pressure from the Soviet Union, and Czechoslovakia was expelled in 1954 for failing to provide required data. Cuba withdrew from membership in 1964, five years after Fidel Castro took power and began restructuring the economy along socialist lines. All three countries had been original members from 1945. Romania joined the IMF in 1972, but relations deteriorated badly in the 1980s until the overthrow of Nicolae Ceauşescu in November 1989.[1]

In some respects, matters improved in the 1980s. Deng Xiaoping's liberalization initiative in 1979 opened the way for the People's Republic of China to assume control of China's membership at the IMF. The weakening finances of the Soviet Union, combined with the international debt crisis, made it both possible and necessary for Hungary to join in 1981 and for Poland to rejoin in 1986. Nonetheless, the economic and political wall between most of the Soviet bloc and the membership of the IMF

[1]These developments, and those mentioned in the next paragraph, are covered in more detail in Boughton (2001). On the withdrawal of Poland and Czechoslovakia, see pp. 964–65 and references therein; on Cuba, p. 758; and on Romania, pp. 321–24 and 965n5. Chapter 19 covers relations with China, Hungary, and Poland through the 1980s. Cuba is discussed further in Chapter 2 of the present work, as is North Korea (officially, the Democratic People's Republic of Korea), another nonmember with a socialist economic system.

remained insurmountable until the transformational events of 1989–91 that led to the dissolution of the Soviet Union.

This chapter introduces the strategy the IMF developed for its relationships with countries undertaking a transition to market-oriented economic policies, and it reviews how the Fund applied that strategy in the countries that had been allied with but not part of the Soviet Union. Relations with the former Soviet Union itself are taken up in the next two chapters.[2]

The Challenge and the Strategy of Transition

The Soviet system of production and trade was based on central planning, and it relied heavily on regional specialization. That policy, combined with the semi-isolation of the Soviet Union throughout the Cold War, led to a very high volume of trade among the Soviet republics and between the Soviet Union and the rest of the bloc, and thus to a high degree of economic interdependence. When Mikhail Gorbachev assumed leadership of the union in 1985, he tried to reform this system to make it more consistent with the requirements for participating in global trade. That effort implied retaining the basic structure of central planning and regional specialization while gradually opening the system to market pricing, private ownership, and international competition. This gradualist strategy failed, the reform effort was abandoned in 1990, and the system collapsed without a viable alternative in sight.

For all the weaknesses of the old regime, the short-term consequences for the entire region under Soviet control and influence were even worse when it vanished. Eventually, the exposure to competitive market forces would induce each new state to evolve toward its own comparative advantage, but that adjustment process was going to take at least a few years—in some cases, many years—to complete. At the outset, just preserving as much as possible of the existing levels of production and trade posed a major challenge. Though necessary, that initial stabilization effort may have further delayed real reforms in a number of countries.

From 1949 to 1990, international trade within the Soviet bloc—the 15 republics and 10 or so closely allied countries—was conducted bilaterally, without any provision for multilateral settlement of payments, under the auspices and direction of the Council on Mutual Economic Assistance (CMEA, also known as COMECON).[3]

[2]Relations with two other transition countries, Cambodia and Vietnam, which were long-standing member countries with low incomes and communist governments, are discussed in chapters 12 and 16.

[3]CMEA membership in 1990 comprised the Soviet Union, Bulgaria, Cuba, Czechoslovakia, the German Democratic Republic (East Germany), Hungary, Mongolia, Poland, Romania, Vietnam, and Yugoslavia (as an associate member). For a historical overview, see Shrenk (1991).

The council and its settlement system were abandoned in 1990, with the intention that trade would then occur at market prices and be settled in U.S. dollars or other convertible currencies. However, few of these countries possessed hard currencies in sufficient quantities, so this decision also made matters worse in the short run.

The Soviet bloc used two currency systems, neither of which was consistent with market equilibrium. Trade within the Soviet Union either was conducted through barter or was settled in Soviet rubles, which were not convertible into other currencies. Trade between the Soviet Union and other bloc members was handled similarly, except that the unit of account was the "transferable ruble," an artifact created solely for translating inconvertible national currencies such as Polish zlotys or Hungarian florins into rubles. Like its domestic counterpart, the transferable ruble was otherwise inconvertible.

The prices at which these exchanges took place were neither market-clearing nor intended as rationing devices, but were set administratively to serve social or political objectives. Most famously, prices of basic necessities were set at low levels even when the goods were scarce, a practice that increasingly resulted in empty shelves. The drive toward market-based structures required huge increases in such prices, which in turn made the prevention of hyperinflation or a collapse in output a massive challenge and a top priority for economic policy. Attempting to alleviate the cost to consumers by stretching out the adjustment of relative prices would only magnify the problem by piling up the output losses and allowing vested interests to become even more entrenched.

Helping new member countries manage this transition gave rise to the biggest challenge the IMF had ever faced. The complexity of the required strategy overshadowed anything the staff had ever had to contemplate. In the Fund's first few years, immediately after the Second World War, western Europe, Japan, and the Soviet Union all had to make similar transitions to rebuild their economies and restore international relations, but in those cases the IMF was either marginalized or not involved.[4] In the 1990s, the international community expected the IMF to play a material role as advisor, coordinator, and financier. Most of the countries concerned were new members, so the IMF staff initially had little expertise either on these economies or on the policy transformations they were beginning to undertake. The Fund could help readily in the effort to stabilize economies and move toward a market-clearing equilibrium. However, the Fund had much less experience to draw on for the more complex tasks of establishing sound institutions and good governance.

The knowledge that the potential cost of failure was limitless added to the challenge. A failed transition could lead to hyperinflation and a collapse in output, both horrible economic outcomes; but the political and social costs of failure would be far worse.

[4]The three largest economies—Germany, Japan, and the Soviet Union—were not IMF members. (Germany and Japan joined in 1952. The Soviet Union never did.) Other European countries relied more on the World Bank, the U.S. Marshall Plan, and intra-European arrangements than on the IMF.

The Russian Federation and several other countries of the former Soviet Union held large stocks of nuclear weapons. Demobilizing those weapons and ensuring that they would not be misused, stolen, or sold to rogue states was going to be expensive. An economic collapse would make the task more difficult and the outcome more uncertain. In addition, in many states throughout the Soviet bloc, large segments of the population had fared relatively well under communism, benefiting from the notional security of a strong and centralized welfare state. The combination of nationalism and nostalgia fostered by the collapse of the Soviet Union and its economic system made a backlash against democratic and market reform all too likely. The only way to maintain forward momentum was to stabilize the new market economies as quickly as possible, generate economic growth, and ensure that the gains from reform were widely shared. Everyone trying to help these countries, at the IMF and elsewhere, understood that the potential cost of failure was nothing less than a return to the Cold War and an increased risk of a nuclear confrontation.

The IMF took on the task of helping countries liberalize their economies and position themselves to become integrated into the world economy.[5] It had three tools: policy advice, technical assistance, and lending. Lending, particularly the policy conditions that the Fund attached to its loans, got most of the publicity. Often neglected in discussion but also important, however, was technical assistance. Because of the peculiarities of the socialist economic structures, most of the transition countries had no real central banks or treasury systems, no internationally comparable economic and financial statistics, and no experience with the requirements for market or macroeconomic equilibrium. Overall, nearly a quarter of the volume of the IMF's lending in the 1990s, and 22 percent of the staff time devoted to technical assistance, went to transition countries.

Help flooded into the region from many quarters, including from the European Bank for Reconstruction and Development, which was established in 1991 specifically to provide financing and technical assistance for the development of private sectors in transition countries. The Paris-based and long-established association of industrial countries, the Organization for Economic Cooperation and Development, expanded its activities to include providing technical assistance to transition countries on a wide range of issues for which it had cross-country expertise. The Bank for International Settlements in Basel, Switzerland, and the Commission of the European Communities also provided much-needed expertise; industrial-country governments and central banks placed advisors directly in their counterpart agencies in transition countries; and nongovernmental organizations such as the Soros Foundations helped countries establish democratic institutions. In 1992, the IMF, four other multilateral organizations, and Austria established the Joint Vienna Institute as a center to train officials from

[5]For the staff's strategy at the outset, see "The Role of the Fund in Assisting Eastern European Countries," SM/91/46 (February 28, 1991).

transition countries in economics and the functioning of the international economic system (see "Technical Assistance, Training, and Resident Missions" in Chapter 5).

The Bretton Woods institutions—the IMF and the World Bank—had a central role in the provision of technical assistance, allocating massive amounts of staff time both in the field and in Washington, conducting seminars and courses for country officials. For the 11 years through 2000, the Fund devoted 345 staff years to providing technical assistance to 29 transition countries (Table 6.1). Russia and Ukraine, the two largest economies in this group, received the most assistance, followed by smaller countries with enormous needs: Albania, Georgia, Mongolia, and Bulgaria.

The IMF's expertise was particularly relevant for developing a strategy for establishing currency convertibility. At the beginning of the decade, almost all currencies in the transition countries circulated only in the countries in which they were issued. Residents could not convert their home currencies into others, and nonresidents were legally required to convert foreign currencies at the official (and artificial) rate to visit or do business in each of these countries. As each country embarked on the transition process, the long-run goals obviously included a convertible currency. Each country had to find a way to get there without destabilizing trade and payments along the way.

In Europe, the notion took hold in 1990 that the defunct CMEA should be replaced by a new system for multilateral clearing of payments within the same region. Until the transition countries could raise their standards of production of goods to a level that could compete with the established western market economies, they would be at a severe disadvantage. That they started with little or no hard currency reserves of their own added greatly to the problem. The European Payments Union had served the transitional purpose fairly well for western Europe in the 1950s, and it seemed reasonable that the eastern bloc could benefit from something similar for the 1990s.

At the IMF, the Research and European Departments both took the "eastern payments union" idea seriously but ultimately concluded it was unlikely to help. The practical problem was that the only way such a clearing mechanism could work would be by relying heavily on support from the Soviet Union. It thus would delay, not promote, the transition to economic integration with the west. Without a payments union, the major industrial countries—or the IMF—could provide the financial assistance to advance the transition. Whether they would actually do so was not obvious. Yet, the payments union idea faded from view even before the Soviet Union collapsed in 1991.[6]

[6]The European Department's opposition to the payments union proposal was shaped primarily by Princeton University Professor Peter B. Kenen, who spent several months in 1990 as a consultant to the department. See Kenen (1991), which includes a review of proposals for an eastern European payments union. The Research Department view initially was more neutral. A staff paper discussed by the Executive Board in June 1990 concluded that "if a modern EPU [European Payments Union] were deemed to be desirable, its benefits would be greatly increased if its membership could be made as broad as possible in order to encourage the development of true multilateral trade"; minutes of Executive Board Seminar 90/1 (June 6, 1990), p. 5. Also see the discussion of the dismantling of the ruble area, in Chapter 8.

Table 6.1. Technical Assistance to Transition Countries, 1990–2000

Country	Staff Years	
Russian Federation		38.7
Baltic countries		22.8
Estonia	5.8	
Latvia	5.8	
Lithuania	11.2	
Other Central and Eastern European countries		
Former Soviet Union		61.0
Belarus	13.3	
Moldova	13.6	
Ukraine	34.2	
Pre-1990 IMF members		23.9
Hungary	3.4	
Poland	13.7	
Romania	6.7	
Yugoslavia and successors		32.1
Bosnia and Herzegovina	11.5	
Croatia	7.5	
Federal Republic of Yugoslavia (Serbia and Montenegro)	3.3	
FYR Macedonia	9.4	
Slovenia	0.4	
Other European countries		47.9
Albania	23.4	
Bulgaria	17.3	
Czechoslovakia	1.7	
Czech Republic	3.1	
Slovak Republic	2.4	
Caucasus region		45.0
Armenia	11.9	
Azerbaijan	12.3	
Georgia	20.8	
Central Asia		73.8
Kazakhstan	14.8	
Kyrgyz Republic	14.6	
Mongolia	17.6	
Tajikistan	10.3	
Turkmenistan	10.1	
Uzbekistan	6.4	
Total staff-years		345.3
Percentage of total IMF technical assistance		22.2

Source: Staff calculations.
Note: Columns may not total because of rounding.

Without an effective payments system, without good channels for exporting goods to the west, without large-scale external support, and in the wake of large price increases and a sharp drop in demand for military and other capital equipment, a short- to medium-term collapse in output, trade, incomes, and employment was unavoidable.

The challenge was to get through that collapse as quickly as possible and to minimize the impact on the poorest and most vulnerable segments of society.

At the outset of the transition, IMF Managing Director Michel Camdessus laid out the immediate tasks for the region in a pair of speeches in May 1990. In Budapest, he acknowledged that it was "humanly impossible to change everything in a short period of time." Nonetheless, the full scope of the transition should be announced right away, and each reform should be introduced as rapidly as possible. Otherwise, inefficiencies would persist, "adjustment fatigue" would set in, and the long-term costs would be all the greater. Two days after that speech, at Georgetown University in Washington, Camdessus again made the case for a comprehensive and aggressive approach to reform. The first priority for the state in a new market economy, he argued, should be "to establish an institutional framework (legal system, regulatory agencies, etc.) so that the market system can operate smoothly and unleash the growth potential that lies in private initiative." Second, the state should develop a "popular consensus" for using macroeconomic policies to stabilize the economy. Third, the state should provide "social safety nets" including "unemployment insurance, . . . job training schemes, and assistance to help the poor and vulnerable who are the least able to cope" with a rapidly changing economic environment.[7]

Each of these three elements proved difficult, both for the transition countries and for the IMF. The fundamental problem was the interaction between economic stability and institutional development and reform. To limit the downward spiral, the economy had to be stabilized quickly, but stability could not be sustained without strong institutions and infrastructure. Developing those institutions took longer and was made more difficult by economic instability. In many (but not all) transition countries, weak public institutions—undeveloped legal and regulatory systems, inadequate bankruptcy procedures, hastily contrived privatization schemes, and other ills—prevented stabilization and delayed the recovery. In addition, the social safety nets often failed because they were expensive and were inadequately supported either by national governments or by external donors.

In attempting to help countries make the transition to a market economy, the IMF had no choice but to accept the current state of institutional development as a starting point. The Fund often found itself signing off on programs that would succeed only if the authorities developed strong institutions rapidly once the financial support was already approved and was being disbursed. As the overviews in the next two sections illustrate, in most cases the authorities were not unwilling to take the necessary actions to strengthen macroeconomic policies and institutions. Although the quality of leadership varied

[7]Remarks at a conference on "Economic Reform in Central and Eastern Europe: A Challenge for All of Europe," organized by the Parliamentary Assembly of the Council of Europe, Budapest, MD/SP/90/9 (May 16, 1990); and remarks at a joint IMF–Georgetown University seminar on "Eastern Europe in the Nineties," Washington, MD/SP/90/10 (May 18, 1990).

widely across countries, the central problem in many cases was to sustain popular support for reforms in the face of extraordinarily difficult external and internal conditions.[8]

The Transition in Existing Member States

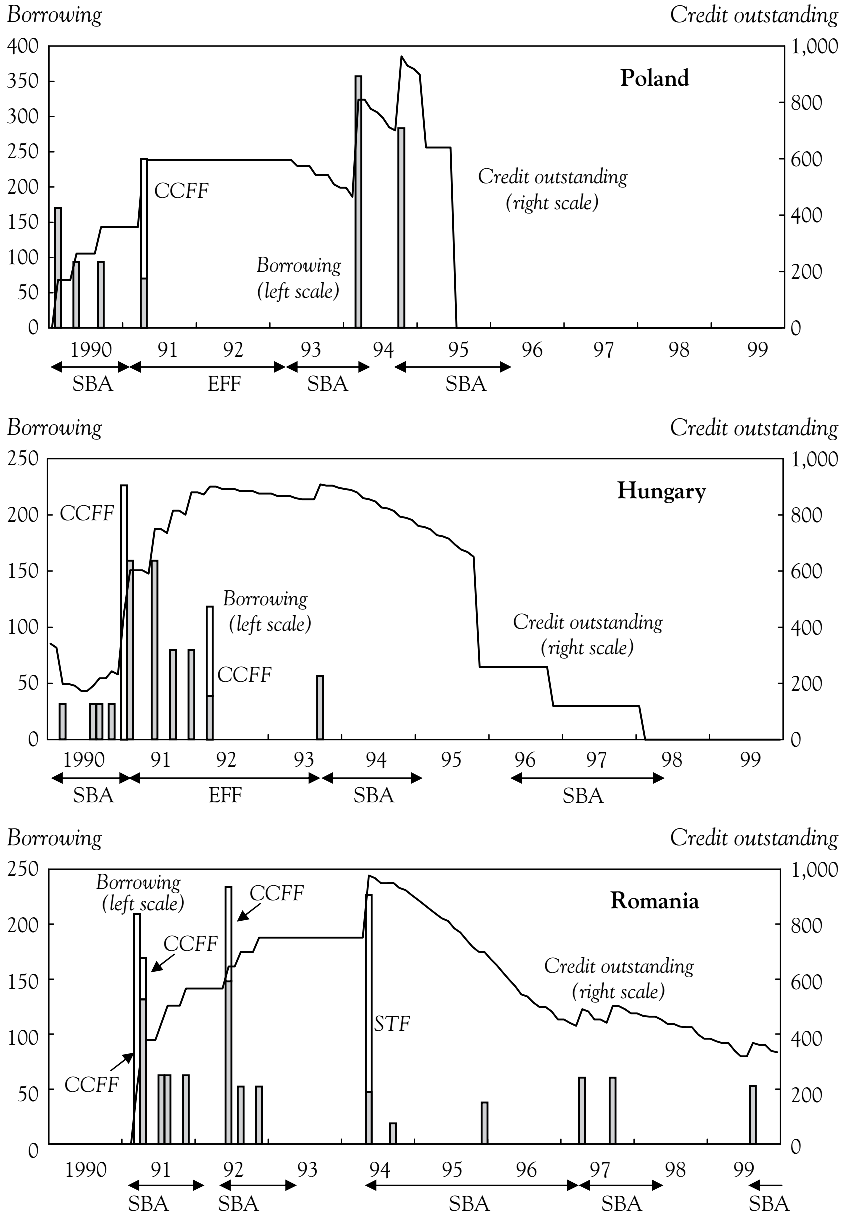
None of the three Soviet-bloc countries with IMF membership at the beginning of the 1990s had been borrowing significant amounts in the preceding five years. Poland's desire to borrow after it rejoined in 1986 had been rebuffed owing to strong opposition from the U.S. authorities. In Romania, President Nicolae Ceauşescu made the disastrous decision in 1984 to stop all external borrowing and to try to repay foreign creditors as rapidly as possible. The Romanian authorities canceled an IMF stand-by arrangement in January 1984 and completed the repayment of all outstanding obligations five years later. Hungary borrowed heavily through two stand-by arrangements from 1982 through 1985. Drawings under a third arrangement in 1988–89 were large enough only to offset repayments on the earlier loans and effectively reschedule those debts by a year. As soon as new, democratically elected governments took office in these three countries, financial assistance from the IMF quickly resumed (Figure 6.1).

Poland

Poland got off to the fastest start, with the seminal "big bang" economic reform program of January 1990. As recounted in more detail in Chapter 9, the IMF supported that program financially from February 1990 through October 1994, using three stand-by arrangements and one extended arrangement. After 1994, Poland had excellent access to private capital markets, enabling it to repay its IMF loans ahead of schedule. Over that same five-year period, the Fund provided 12 staff-years of technical assistance to the Polish authorities. The bulk of that assistance came from the Monetary and Exchange Affairs Department (MAE), which sent 14 missions to help officials at the National Bank of Poland (NBP) modernize virtually all aspects of its operations and the conduct of monetary policy. In addition, MAE coordinated numerous visits to the NBP by experts from other central banks, and for a year it provided a full-time resident advisor to the NBP president. The Fiscal Affairs Department and the Statistics Department sent a total of 10 staff missions

[8]A full examination of the reasons for different records of success across the region would be beyond the scope of this History. The initial quality of institutions, experience with the rule of law, the ability and willingness of political leaders and economic officials to design and carry out reforms, the extent to which the country's collective memory was favorable to openness and liberal economic systems—all these (and probably other) factors had a role. For a thorough analysis, see Havrylyshyn (2006).

Figure 6.1. Poland, Hungary, and Romania: Use of Fund Credit, 1990–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics.
Note: CCFF = Compensatory and Contingency Financing Facility; EFF = Extended Fund Facility; SBA = Stand-by arrangement; STF = Systemic Transformation Facility.

to government agencies during that period. At the height of this effort, in 1990–91, Poland was the third largest recipient of technical assistance from the IMF.

Hungary

The IMF provided primarily financial and catalytic support for the transition in Hungary since the country requested relatively little technical assistance. Throughout the first half of the 1990s, the Fund tried to press the authorities to take a more aggressive approach to both stabilization and reform. In response to weak conditions in Hungary's traditional export markets (the Soviet bloc and Yugoslavia) and in western Europe, the fiscal and external current accounts shifted sharply into deficit. A succession of governments in Hungary tried to cope by tightening policies and promoting development of a more vibrant private sector, but the Fund regarded the implementation of those measures as no better than halfhearted.

The first stand-by arrangement, approved in March 1990, began well enough and was soon replaced by a larger three-year extended arrangement. By the middle of 1992, however, slippages in policy implementation generated an excess fiscal deficit, which induced the Fund to suspend disbursements for the remainder of the arrangement. A smaller 15-month stand-by arrangement was approved in 1993, but the Fund allowed only the initial drawing. That turned out to be Hungary's last drawing on the Fund. Although Hungary's large outstanding external debt made it highly vulnerable to contagion from the Mexican crisis at the end of 1994, the authorities took strong and successful action to defend their financial position, including through a devaluation of the forint. They gradually regained good access to international capital markets and were able to treat their final stand-by arrangement (1996–98) as precautionary. That final arrangement was aimed primarily at reassuring private creditors that the country's policies were sound. When that arrangement expired in February 1998, Hungary finished repaying all of its outstanding obligations to the Fund.

Romania

Romania began the 1990s in disastrous economic condition but with a fresh political start. Relations with the international community, including the IMF, had deteriorated in the second half of the 1980s, as the government of Nicolae Ceauşescu tried desperately to repay all of its external debt, even if that meant deprivation and perhaps starvation at home. In the late 1980s, the authorities stopped providing so much as basic economic data to the Fund and refused to accept an Article IV consultation. By the end of the decade, Romania had nominally solved its debt problem and had repaid all of its earlier borrowings from the IMF, but its economy was devastated. Inspired by revolutions spreading throughout

eastern Europe, a popular but violent uprising overthrew Ceauşescu in December 1989.[9]

Once a new government was elected and in office, Camdessus visited Bucharest in October 1990 to reestablish communications. The IMF then began an intensive program of technical assistance and lending that lasted through the 1990s. The lending occurred mainly through a series of five stand-by arrangements, supplemented by three drawings on the Compensatory and Contingency Financing Facility and one on the Systemic Transformation Facility (STF). The bulk of the lending and technical assistance took place early in the decade. Romania's indebtedness to the Fund peaked in May 1994, at a little under $1.4 billion (SDR 977 million, or 130 percent of quota). After that, a succession of democratically elected governments continued to make economic progress, though slowly and unevenly. Romania borrowed from the Fund repeatedly through 2003 and finished repaying those loans in 2008, a year after it became a member of the European Union.[10]

The Transition in New Members

In 1990–91, three central European countries—Czechoslovakia, Bulgaria, and Albania—and one central Asian country—Mongolia—joined the IMF as part of a transition from Soviet-style to market economics. In the following year, the breakup of both Czechoslovakia and Yugoslavia further expanded the membership and broadened the IMF's work on transition economies.

Czechoslovakia and Its Successors

REFORM MUST START WITH A HEAVY DOSE OF RESTRICTIVE MACROECONOMIC POLICY. . . . the country that deliberately—without IMF pressure—and most vigorously implemented this unpopular step was undoubtedly Czechoslovakia.

Václav Klaus[11]
Prime Minister of the Czech Republic
1993

As recounted in Chapter 2, a newly democratic Czechoslovakia rejoined the IMF in September 1990 after the "velvet revolution" brought Václav Havel to power as president. As important as Havel was to the political transformation of Czechoslovakia, the leading economic reformer in the government was the minister of finance, Václav Klaus. A great admirer of the British economic reforms introduced by Margaret

[9]Relations with Romania through 1989 are covered in Boughton (2001), pp. 321–24.

[10]The other two countries in this group—Hungary and Poland—acceded to EU membership in 2004.

[11]Klaus, 1993, p. 3.

Thatcher a decade earlier, Klaus set out to stabilize and reform the Czech economy as quickly and thoroughly as possible. He began preparing a "big bang" price liberalization for January 1991, to be followed by a comprehensive privatization program. The IMF did not have to press for reform. It only had to advise on procedures for effective reform, provide some short-term financing for the early stages of the transition, and assure potential creditors and investors that the reform program was on track.

In the weeks following Czechoslovakia's admission to membership, a staff mission led by Bijan Aghevli (Senior Advisor, Research Department) visited Prague twice to conduct the initial Article IV consultation discussions and negotiate a program to be supported by a stand-by arrangement. Those talks readily succeeded, and the Executive Board approved the arrangement on January 7, 1991, just as the liberalization process was getting under way. Havel's government carried out that program and borrowed all of the $880 million (SDR 619.5 million, or 105 percent of quota) available under the 15-month arrangement. They entered into a second stand-by arrangement in April 1992 and easily met all the policy conditions. This time, though, the authorities decided not to draw on the arrangement after the initial disbursement because the balance of payments was strengthening and private capital was flowing into the country.

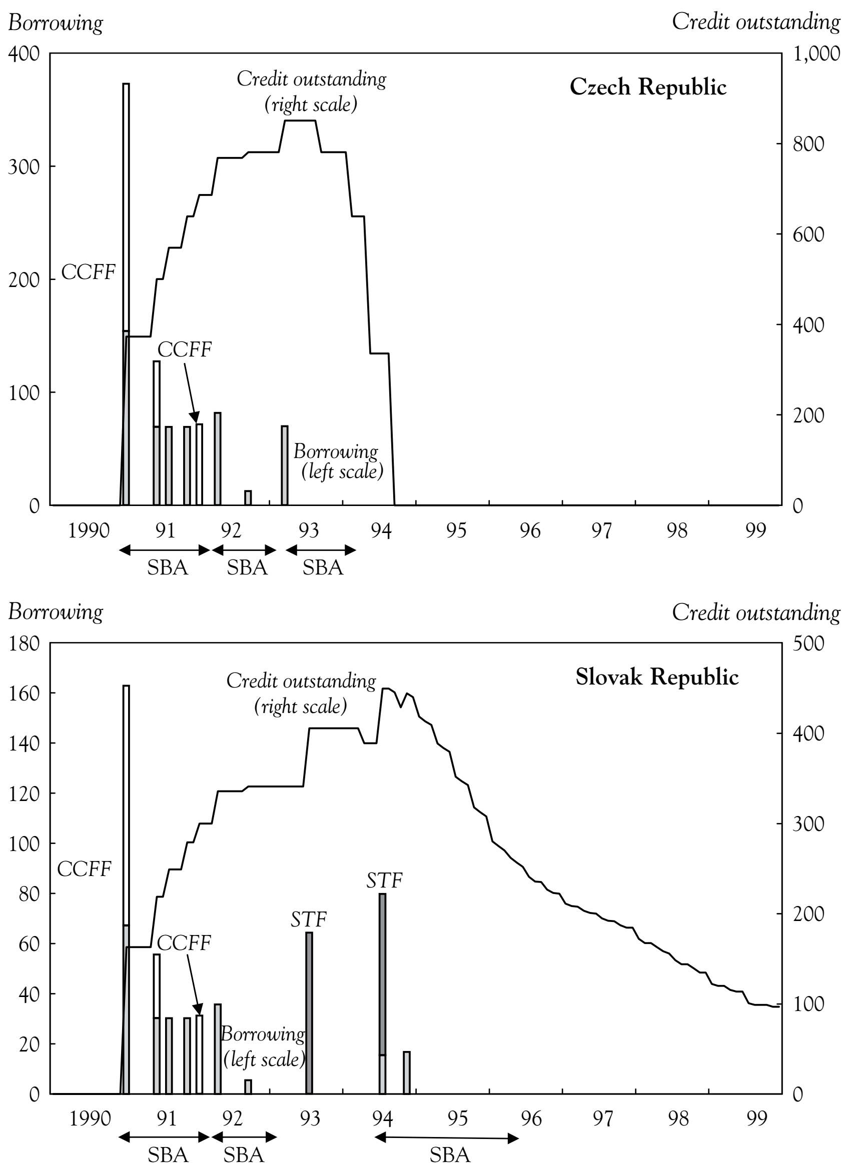
While this second stand-by arrangement was in its early stages, the Czech and Slovak federation was gripped by political separatism. After a few months of negotiations, Czechoslovakia was succeeded by two separate successor states.

Czech Republic

In anticipation of the dissolution of the federation, Czechoslovakia canceled its stand-by arrangement as of the end of 1992. The Czech authorities' intended to have no further need to borrow from the Fund, but events overtook this hope. As an interim measure, the two republics had agreed to continue using the Czechoslovakian koruna in a currency union until they could issue their own currencies in the second half of 1993. Investors proved to be leery of that plan, and both of the new states suffered large-scale capital flight throughout the first several weeks of the year. The Czech government asked the Fund for help, and the Executive Board approved a stand-by arrangement in mid-March. After the initial drawing, the capital market calmed down, and the crisis passed. The next year, the Czech Republic repaid its debts early, completing the process in September 1994 (Figure 6.2).

In 1996–97, conditions in the Czech economy deteriorated. Enticed by strong demand for investment and a five-year record of exchange stability, foreign capital was flowing into the Czech Republic in volumes sufficient to sustain a high rate of domestic investment and a growing external current account deficit. In the 1996 Article IV consultation, the staff agreed with the authorities that continuation of tight monetary

Figure 6.2. Czech and Slovak Republics: Use of Fund Credit, 1990–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics.
Note: CCFF = Compensatory and Contingency Financing Facility; SBA = Stand-by arrangement; STF = Systemic Transformation Facility. When the two countries separated, the IMF allocated 69.61 percent of Czechoslovakia's outstanding obligations to the Czech Republic and 30.39 percent to the Slovak Republic. The data for 1990–92 have been allocated using this formula.

policy and a strong exchange rate were needed to keep inflation under control. Control of inflation, in turn, was necessary so that the Czech Republic could converge to European Union (EU) levels and thus qualify for Economic and Monetary Union.[12] This policy, however, constrained the authorities' ability to manage the external deficit. In the early months of 1997, just a modicum of bad economic news reversed the inflow of financial capital and put strong pressure on the exchange rate. A currency crisis ensued, and in May events forced the authorities to let the exchange rate float.

The volatility of capital flows to and from the Czech Republic and the vulnerability of its economy to a sudden cessation of inflows in 1997 were a direct consequence of the liberalization of the capital account in October 1995. That liberalization was a requirement of the Organization for Economic Cooperation and Development for accession to membership, which was completed two months later. For its part, the IMF staff took a cautious position, concluding in 1996 that "progress toward full liberalization of the capital account will be facilitated by policies that effectively address the economic imbalances." In other words, liberalization was a worthy goal, but it should not get ahead of the economy's ability to absorb flows stably. A year later, after the crisis had abated, the staff noted the economy's continued vulnerability to capital account instability and urged the authorities to proceed more aggressively to get wage increases under control and to broaden structural reforms.[13]

Slovak Republic

The Slovak Republic's transitional adjustment needs were more acute than those of its larger partner. Throughout the communist era, the Slovak economy had been forced into specialized industrial production aimed at serving the CMEA trading region. The collapse of the CMEA and Czechoslovakia's rapid shift toward trade with the west in 1990–92 had left a largely unfinished agenda here. Personal incomes were 25 percent below those in the Czech Republic, unemployment was more than three times as high, and much of the public infrastructure remained to be built.[14]

One of the IMF's first tasks was to provide technical assistance in establishing the National Bank of Slovakia as a central bank and developing a viable strategy for

[12]"Czech Republic—Staff Report for the 1996 Article IV Consultation," SM/96/285 (November 12, 1996).

[13]"Czech Republic—Staff Report for the 1996 Article IV Consultation," SM/96/285 (November 12, 1996), p. 23, for the quotation; and "Czech Republic—Staff Report for the 1997 Article IV Consultation," SM/98/29 (January 29, 1998), p. 11, for the subsequent assessment. These staff reports, and similar cautionary statements from Executive Directors, belie the later conclusion by Václav Klaus that the crisis resulted from "idolization of the IMF" by the central bank and a slavish acceptance of its policy recommendations (Klaus, 2005, p. 81). Klaus resigned as prime minister in November 1997 and was replaced briefly by Josef Tošovský, who was head of the central bank during the crisis.

[14]For the staff's contemporaneous analysis, see "Czech Republic—Staff Report for the 1993 Article IV Consultation and Review Under Stand-By Arrangement," EBS/93/107 (July 6, 1993); and "Slovak Republic—Staff Report for the 1993 Article IV Consultation and Use of Fund Resources—Request for a Purchase Under the Systemic Transformation Facility (STF)," EBS/93/117 (July 15, 1993).

monetary policy. The staff also assisted with the initial stages of setting up tax and public expenditure systems. Because it would take some time before the authorities could present a fully fledged stabilization or reform program, the Fund agreed to provide interim financing through the STF. Over the course of 17 months in 1993–94, the Slovak Republic borrowed $230 million (SDR 160.85 million, or 62.5 percent of quota). That sum, added to the debt that the new member inherited from the former Czechoslovakia at the end of 1992, brought the country's obligations to a peak of $645 million (SDR 449 million). From that point on, the Slovak Republic had no further need to borrow, and it repaid all this debt by October 2000.

The Successors to Yugoslavia

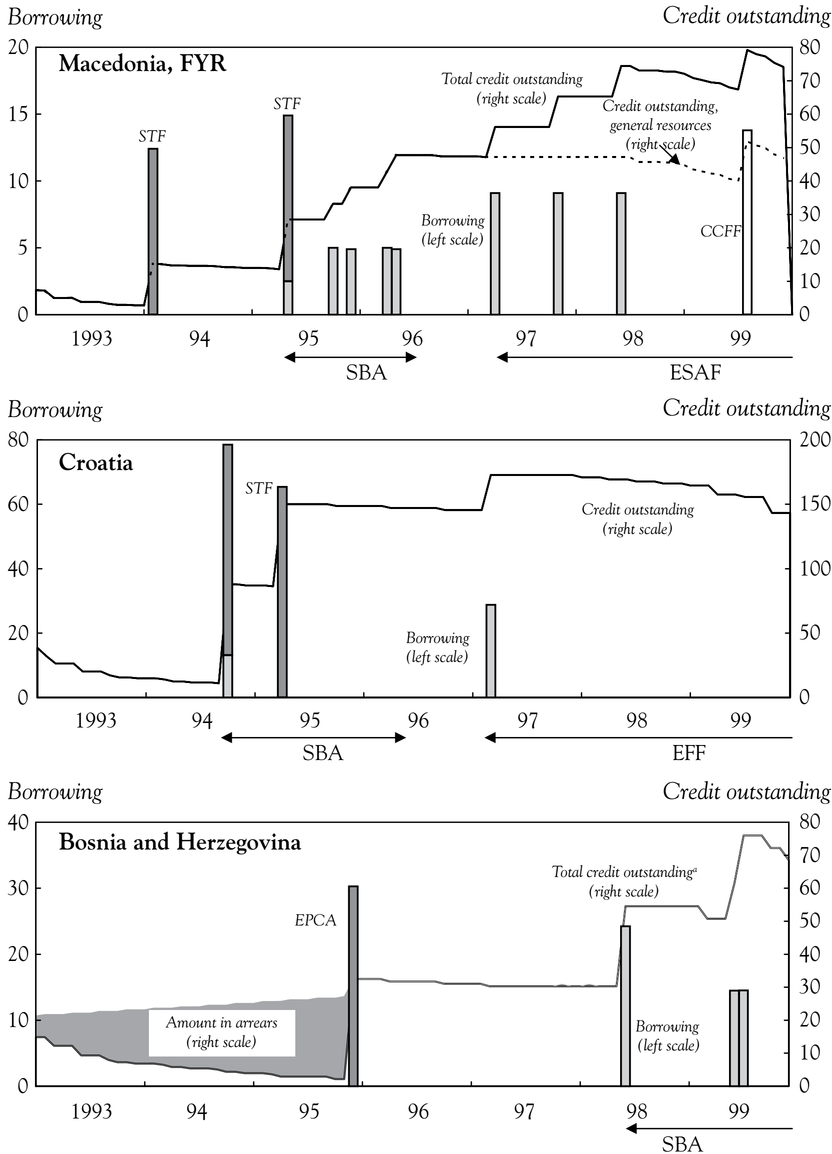
The breakup of the Socialist Federal Republic of Yugoslavia in 1992 created far more complications than did Czechoslovakia's breakup. Its unique economic system, based on a form of "market socialism" with heavy reliance on administrative controls, also encompassed a vibrant private sector of small and medium enterprises without Soviet-style central planning. For more than a decade, this system's effectiveness had been in a downward spiral, owing as much to political disarray as to intrinsic policy weaknesses. The combination of economic mismanagement and a severe breakdown of social cohesion and coordination among the republics had led to extremely high inflation, a sharp drop in industrial output, and high and rising unemployment.

The federation's disintegration resulted in five (and eventually more) disparate new countries. Each one had to find its own reform path, starting from a ruined economy and unstable social and political relations, both internal and external. Some warred with each other, while some faced bitter and violent internal conflicts. As recounted in Chapter 2, two of the new countries were subject to United Nations (UN) and other international sanctions that crippled their ability to meet the obligations of membership in the IMF and other international organizations. Once each successor state met those requirements, the Fund responded with financial and other assistance (Figure 6.3).

One task for which a new country would normally seek advice from the IMF had already been completed. As monetary disarray in Yugoslavia spiraled toward hyperinflation in 1991 and 1992, each seceding republic had to establish its own currency. In contrast to the former Soviet Union, where the various countries had a bit of time to phase out rubles while preparing the groundwork for national currencies (see Chapter 8), waiting until IMF membership was in place was not an option in Yugoslavia. The Federal Republic of Yugoslavia (Serbia and Montenegro) continued to use the dinar, but by the end of 1992 all the other republics had begun issuing their own currencies, each of which—like the Yugoslav dinar—was pegged to, or at least closely managed against, the deutsche mark (Table 6.2).

As each new country completed the membership process, the IMF provided substantial technical assistance—a total of 32 staff-years by the end of the decade (see Table 6.1). It also entered into discussions for lending. The northernmost and most economically advanced country, Slovenia, took strong action early to establish an

Figure 6.3. Successors to Yugoslavia: Use of Fund Credit, 1993–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics.
Note: CCFF = Compensatory and Contingency Financing Facility; EFF = Extended Fund Facility; ESAF = Enhanced Structural Adjustment Facility; EPCA = Emergency postconflict assistance; SBA = Stand-by arrangement; STF = Systemic Transformation Facility. "Credit outstanding, general resources" excludes ESAF loans.
[a] Total credit outstanding for Bosnia and Herzegovina includes overdue obligations (principal, interest, and charges).

Table 6.2. Introduction of New Currencies in the Former Yugoslavia

Country	Currency	Effective Date	Initial Exchange Regime
Federal Republic of Yugoslavia (Serbia and Montenegro)	Yugoslav dinar	(already in use)	pegged to deutsche mark (DM)
Slovenia	Slovenian tolar	October 1991	managed against DM
Croatia	Croatian dinar Croatian kuna	December 1991 May 1994	managed against DM
Macedonia, FYR	Macedonian denar	April 1992	pegged to DM
Bosnia and Herzegovina	Bosnia and Herzegovina dinar[a] Convertible marka	July 1992 August 1997	pegged to DM

Source: Staff reports.

[a]Operations and transactions with the IMF were conducted in DM, which also circulated alongside dinars as a domestic medium of exchange.

effective market economy and did not need financial assistance from the IMF. Slovenia repaid its inherited obligations gradually through 1997. The Federal Republic did not begin borrowing until December 2000, after it finally completed the membership process. The other three new members all took advantage of the opportunity to borrow, each in its own way.

The Former Yugoslav Republic of Macedonia

The first successor to borrow from the IMF was the former Yugoslav Republic of Macedonia (FYR Macedonia). With by far the smallest economy of the group, FYR Macedonia accepted its share of the outstanding liabilities incurred by Yugoslavia before the breakup, and it was accepted as a member in the IMF in April 1993 after a brief dispute about the name of the country (discussed in Chapter 2). As noted above, the country already had a national currency, having abandoned the Yugoslav dinar and begun issuing a local "denar" in April 1992.

The first staff mission—arriving in Skopje in May 1993, led by Poul Thomsen (Deputy Division Chief, European I Department)—had difficulty evaluating the depth of the economy's depression, owing to a lack of reliable statistics. Clearly, however, trade and other economic activity had been hit hard by developments in neighboring countries. Trade with the rest of the former Yugoslavia was suppressed by the UN sanctions against the Federal Republic, and trade with other transition countries was depleted by the collapse of the CMEA and the depressed condition of most of the region. The staff estimated that industrial production barely exceeded half the level of three years earlier. On the positive side, FYR Macedonia had inherited a decentralized

economic system with a number of well-functioning enterprises and an open system of international trade and finance.[15]

The challenge in FYR Macedonia was to create the preconditions for a normal economy rapidly so that the authorities could obtain new flows of foreign aid and put it to good use before the economy degenerated much further. That would require quickly stabilizing monetary and fiscal conditions, reforming the state's role in the economy, and clearing arrears to both public and private creditors. The IMF began providing technical assistance on statistical and fiscal reforms within a few months after the Board accepted the request for membership. In February 1994, the Fund made its first loan to FYR Macedonia, the equivalent of $17 million (SDR 12.4 million, or 25 percent of quota), through the STF. Meanwhile, the government of the Netherlands organized a donors' group to help FYR Macedonia pay off its overdue debts to a variety of creditors and thereby qualify for new loans.

Completing even the initial stages of the transition process was bound to take several years for a country as economically depressed as FYR Macedonia, but the authorities responded well to the challenge and continued to benefit from support from the IMF and other international agencies. The Fund lent regularly to the country throughout the rest of the 1990s and well into the next decade. It made FYR Macedonia eligible for loans from the Enhanced Structural Adjustment Facility (ESAF) in 1994, but recognized that the authorities would need some time before the country could meet the high standards for that concessional facility. After the successful completion of a stand-by arrangement in 1995–96, macroeconomic policies were remarkably strong, in fact, strong enough to meet the Maastricht criteria for Economic and Monetary Union within the EU. When visiting Skopje in 1997, Camdessus pronounced this achievement "miraculous" under the circumstances, but the horrendous war raging just beyond the border tempered the Managing Director's optimism. The best that he could find to say about the country's economic prospects was that "it was heartening to note . . . that the worst outcome was not necessarily the most probable."[16]

The "worst outcome" soon receded from view, though the transition would be prolonged. FYR Macedonia borrowed through the ESAF in 1997 and 1998 and through the Poverty Reduction and Growth Facility (the successor to the ESAF) in 2000. By that time, the economy was improving sufficiently that further borrow-

[15]See "Former Yugoslav Republic of Macedonia—Staff Report for the 1993 Article IV Consultation," SM/93/171 (August 4, 1993).

[16]Report to the Executive Board after a visit to the former Yugoslav Republic of Macedonia; minutes of EBM/97/49 (May 14, 1997), p. 3.

ing could be done on normal market terms.[17] Lending continued until 2005, and in 2007 the authorities repaid all the outstanding loans three years ahead of schedule.

Croatia

The IMF began providing technical assistance to Croatia in November 1992, before completion of the membership process. The Fund approved a stand-by arrangement in October 1994 and quickly disbursed two loans through the STF, bringing Croatia's total indebtedness in April 1995 to about $237 million (SDR 150.1 million, or 57 percent of quota). Despite the difficulties Croatia faced, the Fund was reasonably impressed with the adjustment and reform effort under that stand-by arrangement and with the government's prospects for sound and sustainable economic growth. By the beginning of 1997, it was prepared to approve a much larger three-year arrangement through the Extended Fund Facility (EFF), which, if fully used, would more than triple Croatia's outstanding borrowings. The Executive Board approved the arrangement in March, and the authorities made the initial drawing.

In the months that followed, Croatia met nearly all the conditions under the EFF arrangement. The staff expected that the release of the second disbursement, scheduled for July 1997, would be routine. Accordingly, the staff circulated its assessment for approval by the Executive Board on a lapse-of-time basis, with no need for a formal Board discussion. Unexpectedly, the U.S. authorities objected and called for a meeting. Barry Newman (Alternate, United States) pointed out that Croatia was not in compliance with the international agreement for ending the conflict next door in Bosnia and Herzegovina. In particular, Croatia was alleged to be declining to extradite war criminals, restricting transportation between Bosnia and Herzegovina and Serbia, and limiting the movements of refugees. In the U.S. view, "the lack of compliance with the Dayton Accords was jeopardizing regional stability and had important consequences for [Croatia's] reform efforts [that] go to the heart of its capacity to repay the Fund."[18]

Most Executive Directors viewed Newman's "capacity to repay" argument as a transparent cover for the political objective of compelling Croatia to cooperate more fully with the Dayton peace process (on which, see Chapter 2, pp. 73–74). Directors were not comfortable with the prospect of the IMF making lending decisions on the basis of political concerns. Marc-Antoine Autheman (France) spoke for many in

[17]FYR Macedonia also borrowed a small amount (SDR 13.8 million, 20 percent of quota) through the CCFF in August 1999, to compensate for the effects on exports of the war in neighboring Kosovo. In June 2003, the IMF removed FYR Macedonia, along with Bosnia and Herzegovina, from the list of countries eligible to borrow on concessional terms. By then, both countries' per capita GDP was well above the standard cutoff level.

[18]Minutes of EBM/97/69 (July 9, 1997), p. 5. For the staff assessment, see "Republic of Croatia—First Review under the Extended Arrangement," EBS/97/115 (June 25, 1997).

saying that "it is essential for the Fund to abide by its mandate and to continue to refrain from making decisions on the basis of explicitly political purposes, however legitimate they may be. . . . I think it would be improper for the Board to substitute its judgment [for] the judgment [that] should be made by the United Nations Security Council." The Director representing Croatia, J. Onno de Beaufort Wijnholds (Netherlands), reacted furiously to the U.S. effort. Supported by Willy Kiekens (Belgium), staff representatives, and others, Wijnholds stressed that Croatia had ample foreign exchange reserves to guarantee its ability to repay the Fund even if its economic performance were to fall well short of projections. Treating countries this way could "signal the beginning of a breakdown of the Fund as an institution," he concluded. When Kiekens pressed the staff for examples of cases in which the Fund had failed to complete a program review after the country had satisfied the conditions specified in the arrangement, the staff was unable to cite any such instance.[19]

Set against this concern for the Fund's independence from political pressures was a concern that the international community was united in wanting the Dayton peace process to succeed, and a recognition that the government of Croatia was not doing its part. Initially, five other Directors, representing Germany, Italy, Japan, Saudi Arabia, and the United Kingdom, supported Newman's request for an indefinite postponement. Those six Directors held just over 37 percent of the voting power. Two Directors abstained, and the others all favored either an immediate approval of the disbursement or only a brief delay. The stated purpose of having a short delay was to give Directors time to consult further with their authorities, to try to generate consensus on the Board, and to give the UN and other institutions time to pressure Croatia independently on the political issues. Stanley Fischer (First Deputy Managing Director), who was chairing the meeting, concluded that the "short delay" option reflected the majority view. He promised to bring the matter back to the Board for further consideration within three weeks (that is, by the end of July).[20]

On July 25, the Board took up the issue for a second time, only to find that positions had barely shifted. As before, the Managing Director firmly argued that the review should be completed immediately in Croatia's favor. The majority, however, concluded that the request should be further postponed until after the IMF/World Bank Annual Meetings and taken up again no later than October 10. Wijnholds tried to force a vote on an earlier decision, but he ultimately withdrew the threat. Finally, on October 9, the Board quietly completed the review on lapse of time without further discussion.[21]

[19]Minutes of EBM/97/69 (July 9, 1997), pp. 6, 12, and 17 (Wijnholds); p. 9 (Autheman); and pp. 12–13 (discussion of precedents).

[20]Minutes of EBM/97/69 (July 9, 1997), pp. 3–18.

[21]See minutes of EBM/97/77 (July 25, 1997), pp. 3–16; and minutes of EBM/97/102 (October 15, 1997), pp. 125–26.

This incident severely strained relations between Croatia and the IMF and weakened the authorities' commitment to carry out the Fund-supported policy program. The authorities declined to borrow any of the money that the Fund had made available, and over the next year policies deviated substantially from the agreement reached early in 1997. In most respects, the economy continued to perform well, but financial stability suffered in 1998, and a recession set in during 1999. The EFF arrangement formally remained in place until it expired in March 2000, but the program lapsed, and no further performance criteria were ever set.

Bosnia and Herzegovina

Circumstances in Bosnia and Herzegovina were especially dire, owing to one of the worst internal and regional conflicts in post–Second World War European history. The Fund's relations with the country began in tandem with the November 1995 conclusion of the Dayton peace accords, which aimed to end the conflict in Bosnia and Herzegovina that had given rise to the gruesome phrase "ethnic cleansing." Three major ethnic groups—Bosniaks, Croats, and Serbs—coexisted uneasily both in the new country and in neighboring regions. Security in and around the capital city, Sarajevo, was poor, and the economy was in shambles. IMF staff found that per capita GDP had fallen by 75 percent, from $2,400 in 1990 to $600 in 1995.[22]

Before the IMF could lend to Bosnia and Herzegovina, the country first had to start settling the arrears on debt it inherited from the breakup of Yugoslavia in 1992. Total arrears to external creditors were estimated to be about $2 billion, including some $37 million in overdue obligations to the IMF. The small IMF slice was solved easily through carefully coordinated transactions on or near December 20, 1995. First, the U.S. government made a short-term loan to enable Bosnia and Herzegovina to pay the reserve-asset portion of its quota subscription so that it could complete the process of becoming a member of the IMF. The Netherlands provided a similar bridging loan, which the authorities used to settle their arrears to the Fund. Then the Executive Board approved an Emergency Post-Conflict Assistance (EPCA) loan of $45 million (SDR 30.3 million, or 25 percent of quota), part of which the authorities could use to repay the Netherlands. On balance, this sequence provided Bosnia and Herzegovina with about $8 million in foreign exchange reserves. Finally, the authorities drew out their reserve tranche balance and used those proceeds to repay the United States.

With these initial agreements in place, the Bosnian authorities set about clearing other external arrears, including through a similar arrangement with the World Bank

[22]For the background, see "Republic of Bosnia and Herzegovina—Use of Fund Resources—Emergency Post-Conflict Assistance," EBS/95/215 (December 8, 1995), pp. 1–5. The per capita GDP figures quoted here were revised upward in the first half of 1996 from those reported in EBS/95/215. These data are from "ESAF Eligibility—Bosnia and Herzegovina," EBS/96/121 (July 29, 1996), p. 2.

and a rescheduling by the Paris Club.[23] Meanwhile, the Fund provided technical assistance on a wide range of topics and set up a Resident Representative office in Sarajevo. Both the Bank and the Fund declared Bosnia and Herzegovina to be eligible for borrowing on concessional terms, with the intention that the economy would grow out of that low-income status within a couple of years.

The Fund's EPCA loan did not require the authorities to agree to a detailed economic policy program. It required only a statement of principles aimed at leading to a fully articulated program as soon as possible. As a critical first step, the authorities agreed to establish a strict monetary policy, similar to a currency board, to ensure that they could preserve parity between the dinar and the deutsche mark. The most serious obstacle to further progress was political in origin but had undeniable economic consequences. The Dayton accords had recognized that the country was divided into two major political entities: the Federation of Bosnia and Herzegovina and the Republika Srpska. The Fund took the view that it could not undertake further lending until both divisions had functioning policies in place and were willing to cooperate with each other. "Without closer cooperation," the staff argued, "no government in Bosnia and Herzegovina will have the capacity to implement a program to address the country's balance of payments problems—even in the Federation, let alone for the whole country."[24] Overcoming deep-seated ethnic rivalries and hostilities was going to take time.

By 1998, Bosnia and Herzegovina had made adequate progress toward stabilizing the economy, controlling the budget, and establishing viable market institutions, allowing the Fund to offer new loans. Real political cohesion was still some way off, but the country had a new central bank with an IMF-appointed governor. The central bank was operating an effective currency board arrangement with a new currency (the convertible marka) that was circulating as legal tender throughout the whole territory. Other currencies were still circulating in parallel, and structural reform was still embryonic. Consequently, the Fund could not offer an ESAF arrangement, and the authorities had to settle for a smaller, shorter-term, and more expensive stand-by arrangement. Everyone hoped that this arrangement could be replaced in 1999 by a three-year ESAF arrangement. Instead, as progress continued at a slow pace, the Fund repeatedly ex-

[23]World Bank procedures for clearing arrears were simpler than those of the IMF and permitted direct consolidation of outstanding obligations, including amounts that were in arrears, into new loans. The Bank completed that process in June 1996. It also provided new financial assistance throughout 1996, starting even as the membership accession process was still under way. For a summary, see Appendix II of "Bosnia and Herzegovina—Staff Report for the 1996 Article IV Consultation," SM/96/203 (August 5, 1996).

[24]"Bosnia and Herzegovina—Staff Report for the 1996 Article IV Consultation," SM/96/203 (August 5, 1996), p. 7.

tended the stand-by arrangement until the last tranche was finally drawn in May 2001.[25]

Other New Members

Three other formerly socialist countries joined the IMF and received policy advice and financial assistance to support their transitions to a market economy: Albania, Bulgaria, and Mongolia.

Albania

Adjacent to Yugoslavia on the western edge of the Balkan Peninsula, Albania stood out as the world's most isolated and autarkic country throughout the Cold War era. Its communist dictator from 1944 to 1985, Enver Hoxha, rejected both the Soviet and the Chinese economic systems as insufficiently faithful to Marxism and Leninism. By the 1980s, Albania's political and social isolation from the rest of the world was practically complete, and its economic ties were limited to a relatively small amount of trade with European neighbors and China.[26] Disillusionment on China's part, Hoxha's death, and the collapse of the CMEA and the Soviet system put this regime in an untenable position. Estimates of per capita income were not reliable, but incomes obviously fell far short of those of any other European country, at no more than a few hundred dollars a year.[27] In the second half of the 1980s, Albania embarked on its own form of *glasnost* and *perestroika*, a journey that culminated in full democratization in 1992.

In January 1991, Albania applied to join the IMF. Discussions began on the size of the quota and other matters, and Albania became a member on October 15. By that time, popular pressure for democratization was becoming overwhelming. The communist-led coalition resigned in December, to be replaced by a democratically elected government in March 1992. These developments paved the way for the Fund to conduct its first full review of the economy and of economic policies. This initial Article IV consultation revealed more clearly the extent of Albania's devastation and poverty, but it also convinced the IMF that the new government was already implementing a

[25]Bosnia and Herzegovina never drew on the ESAF (or on its successor, the Poverty Reduction and Growth Facility) before the Fund removed the country from the list of eligible borrowers in 2003. The Fund approved a second stand-by arrangement in 2002, which was fully drawn. In 2008, the authorities completed the repayment of all their outstanding borrowings.

[26]For the IMF's initial analysis of developments up to 1991, see "Albania—Calculation of Quota," EB/CM/Albania/91/1 (September 13, 1991).

[27]In 1991, the staff estimated 1990 GDP per capita to have been $623 at the prevailing commercial exchange rate; "Albania—Calculation of Quota," EB/CM/Albania/91/1 (September 13, 1991), p. ix. A year later, it estimated the 1991 figure to be closer to $300; see "Albania—Staff Report for the 1992 Article IV Consultation and Request for Stand-By Arrangement," EBS/92/121 (August 3, 1992), p. 6a.

serious and well-designed stabilization and reform program. In August 1992, instead of starting slowly with a small STF loan as it had for several other transition economies, the Fund approved a regular stand-by arrangement for 80 percent of Albania's quota (SDR 20 million, equivalent to $29 million).

Because of the high risks of lending to a country at such an early stage of the transition, the Fund required the authorities to complete several of the key policy conditions before approval of the 1992 stand-by arrangement. The authorities did so, and they also successfully met all the performance criteria once the arrangement was in place. Within a year, the Fund escalated its commitment by approving a three-year ESAF arrangement for 120 percent of quota (SDR 42.4 million, or $59 million).[28] That, too, succeeded, as the government stabilized its finances and aggressively promoted private sector development. Economic growth averaged about 9 percent a year, and the authorities drew the first four semiannual tranches of the ESAF arrangement (Figure 6.4).

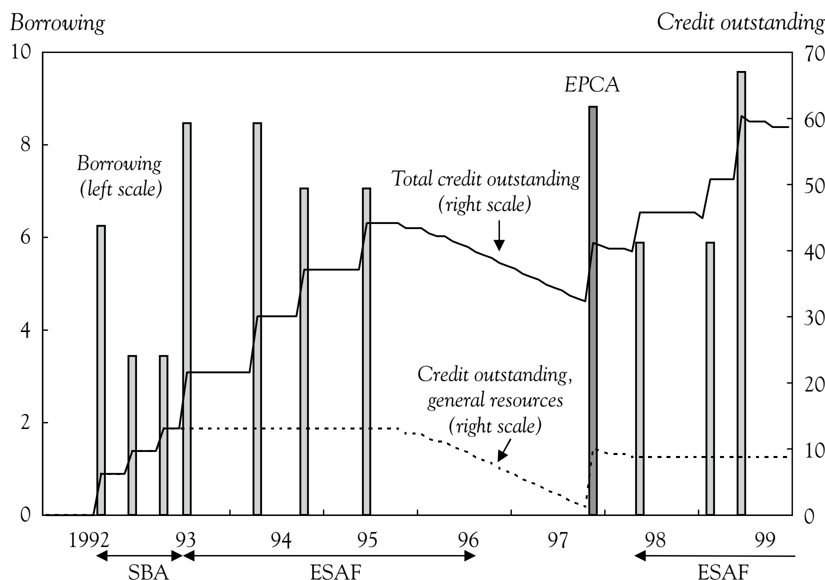
Albania's economic transformation soon got ahead of the development of sound institutions, with calamitous results. By 1996, a large number of informal investment companies running Ponzi schemes and other financial pyramids overwhelmed the banking system. As those schemes spiraled out of control, their nominal value approximated six months of GDP. When they inevitably collapsed, near the end of 1996, the ensuing panic threatened to bring down much of the economy. Inflation soared, output and government revenues fell sharply, and the value of the currency collapsed. The government was unable to contain the panic, which worsened throughout the first half of 1997. By March, the country was in a state of anarchy. Only when a UN peacekeeping force restored order and national elections led to a new government could a new beginning be made.[29]

As the size of the pyramid schemes grew in the second half of 1996, the IMF, the World Bank, and other external advisors warned the authorities of the dangers, to no avail. In November, Camdessus wrote to President Sali Berisha (whom he knew from a visit to Albania in 1992) to warn him that "there is an urgent need to tackle the rapid and uncontrolled expansion of the informal deposit market." A staff mission, led by Ranjit Teja (Deputy Division Chief, European I Department, or EU1) was in Tirana at the time, and rumors quickly spread that the IMF was trying to shut down what most people in the country still thought were legitimate businesses. Teja held a press conference during which he warned the public about the true nature of the schemes and explained that the government, not the IMF, was responsible for dealing with them:

[28]Albania's quota had been raised from SDR 25 million to SDR 35.3 million in November 1992, as the result of a general quota review.

[29]The rise and fall of the pyramid schemes is summarized in "Albania—Use of Fund Resources—Emergency Post-Conflict Assistance," EBS/97/188 (October 16, 1997). See especially Box 1, p. 6. For a detailed analysis, see Jarvis (2000). Jarvis suggests that "the IMF and the World Bank should have seen the problem in Albania coming earlier, and warned the authorities more sternly"; and that the government ultimately handled the crisis well enough (including by refusing to bail out the perpetrators of the schemes) to limit the macroeconomic effects.

Figure 6.4. Albania: Use of Fund Credit, 1992–99
(In millions of SDRs, monthly data)



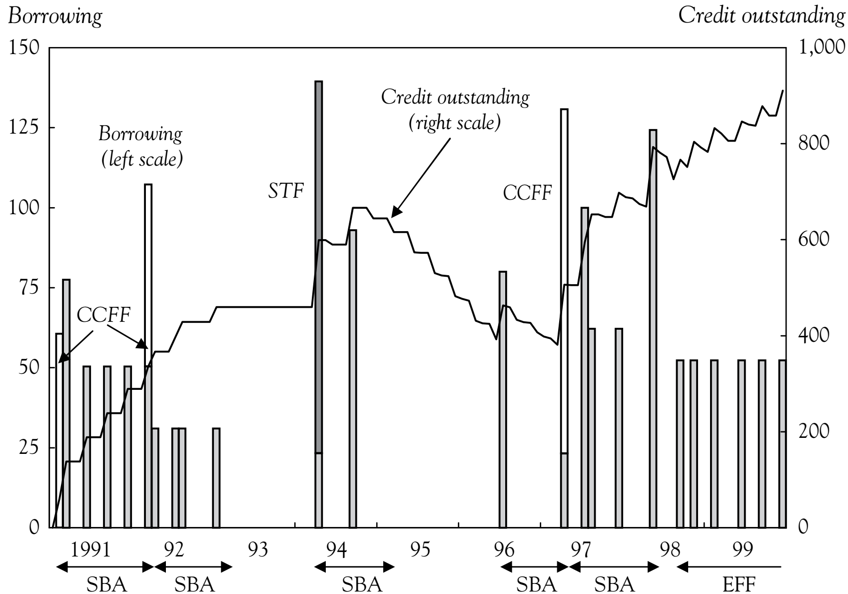
Source: International Financial Statistics.
Note: EPCA = Emergency postconflict assistance; ESAF = Enhanced Structural Adjustment Facility; SBA = Stand-by arrangement. "Credit outstanding, general resources" excludes ESAF loans.

"fraud in the informal market was indeed a concern, but . . . it was up to the authorities to investigate and take action in the public interest."[30]

Those discussions failed to lead to an agreement, either on controlling the pyramid schemes or on a resumption of IMF lending to Albania. Specifically, the staff rejected the government's policies as a basis for approving the third annual disbursement from the ESAF. The Fund thus was largely sidelined during the collapse in 1997. After order returned, the new government asked the Fund to renew its assistance. The Fund responded quickly by lending $12 million (SDR 8.8 million, or 25 percent of quota) as an EPCA loan in November 1997 and resuming ESAF lending six months later.

[30]For Camdessus's letter, see attachment to memorandum from Massimo Russo (Director, EU1) to the Managing Director, "Albania: Draft Response to Letter from President Berisha," November 15, 1996. For the mission's findings and actions, see memorandum from Teja to the Acting Managing Director, "Albania—Back to Office Report following ESAF and Article IV Consultation Discussions," (December 4, 1996). The staff became aware of the pyramid schemes and first warned the authorities to take action in August 1996. See memorandum from Teja to the Managing Director, "Albania—Back-to-Office Report," August 16, 1996. These documents are in IMF Archives, OMD-AD, Accession 1999-0270-0001, "Albania 1996."

Figure 6.5. Bulgaria: Use of Fund Credit, 1991–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics.
Note: CCFF = Compensatory and Contingency Financing Facility; EFF = Extended Fund Facility; SBA = Stand-by arrangement; STF = Systemic Transformation Facility.

Albania successfully implemented the ESAF-supported program, put the reform effort back on track, and borrowed the full available amount.[31]

Bulgaria

When Bulgaria joined the IMF in 1990, it was undertaking a complete political and economic transformation while simultaneously trying to cope with a large overhang of debt to external commercial creditors. As noted in the preceding chapter, the staff warned the Executive Board that Bulgaria was likely to be a prolonged user of Fund resources for years to come. Sadly, that prediction proved to be correct (Figure 6.5). The government managed to restructure its debt by 1994, with substantial financial and other assistance from the IMF. That story is told in Chapter 9, along with other debt-restructuring cases. The transformation of economic policy proceeded more slowly, and this gradual approach eventually led to a serious financial crisis.

[31]For an analysis of the postcrisis reforms, see Treichel (2002).

When national elections were held in December 1994, Bulgaria was out of compliance with the terms of its third stand-by arrangement with the IMF, owing mainly to lax monetary control and weak regulation of the banking system. The Bulgarian Socialist Party (the former Communist Party) won those elections and set out to take an even slower and less-committed approach to economic reform. The financial imbalances worsened throughout 1995, degenerating into a crisis in 1996. A high and rising fiscal deficit, the collapse of some prominent pyramid schemes, and rumors of bank solvency problems led to a series of bank runs. Ironically, the panic worsened after the government announced a limited deposit insurance plan, because most depositors had previously assumed the existence of an implicit government guarantee on *all* deposits. Capital inevitably took flight. In the first five months of 1996, the central bank's foreign exchange reserves and the exchange value of the currency (the lev) both fell by half.[32]

At that point, the Bulgarian government decided to try to make a clean break with the past, stabilize the economy once and for all, accelerate market reforms, and put the country on a clear path toward eventual membership in the EU. Along with the first steps in that direction, the authorities applied for a fourth stand-by arrangement.

A notable element in the reform program that the Fund was being asked to support was a restructuring of the domestic banking system. The plan included closing or taking over the weakest banks and recapitalizing others. The staff mission, led by Anne Kenny McGuirk (Division Chief, EU1), supported the plan but cautioned that "virtually all" of the Bulgarian banks were insolvent. Restoring confidence in the banking system and in the government's ability to manage the economy was going to require both a "bold and carefully structured . . . strategy" and a great deal of imagination and luck.[33] An overlapping mission from MAE, led by Charles A. Enoch (Division Chief), arrived in Sofia to provide technical assistance.

The Fund put approval of the stand-by arrangement on a fast track to quell rumors and assure the Bulgarian public that the international community supported the government's program. Fears became so acute that at the last minute, management rescheduled the Board meeting from the afternoon to the morning so that news of the approval of the stand-by arrangement could reach Sofia before financial markets closed for the day. On the Executive Board, a few Directors were every bit as skeptical as the Bulgarian public, particularly because the economic news from Sofia continued to worsen in the days leading up to the Board meeting. The previous government's track record had been poor, and the odds of sustained implementation in the future seemed

[32]These developments are reviewed in "Bulgaria—Request for Stand-By Arrangement," EBS/96/116 (July 5, 1996), pp. 2–5.

[33]"Bulgaria—Request for Stand-by Arrangement," EBS/96/116 (July 5, 1996), p. 6.

almost as poor. With full knowledge of the risks, the Board approved the arrangement unanimously on July 19, 1996.[34]

The Fund-supported program quickly failed, mainly because the public at large had no confidence in the banking system, nor in the government's ability to manage the economy. On macroeconomic policy, the authorities were doing all that they could—the primary fiscal surplus exceeded 10 percent of GDP. But every effort to strengthen the banking system was being undercut by continuing runs on deposits and continuing flight into deutsche marks and dollars. A drastic departure from this orthodox strategy was needed.

McGuirk and her staff team returned to Sofia in November 1996 to negotiate a new program. On this occasion, Michael Deppler (Deputy Director, EU1) joined them to raise the profile and the political influence of the mission. That escalation came at a critically important juncture because the staff was about to press the authorities to take a radical step that they would be loathe to take on their own. After meeting with President Zhelyu Zhelev and other senior officials, Deppler held a press conference to announce that the IMF was asking the government to establish a currency board arrangement as the basis for monetary policy. By placing a strict legislative limit on the issuance of currency, the government would tie its own hands and thus increase its credibility—at least, that was the hope. If it failed, the government would have no backup resources to stabilize the economy.

The imminent prospect of a total financial meltdown in Bulgaria compelled the timing of the Fund's proposal, but it was politically awkward. Zhelev was a lame-duck president, having been defeated in an election in late October. The national assembly would thus have to debate and enact highly controversial legislation in a politically charged environment. Although the major political parties publicly supported the currency board proposal, the government's support was understood to be shallow, and it was not shared by the leadership at the central bank. As the debate over this and other reforms proceeded, Prime Minister Zhan Videnov found his own political support waning, and he abruptly resigned on December 21. Realizing that it was now working in a political vacuum, the IMF staff had no choice but to return to Washington and wait for a new government to emerge.

On February 12, 1997, the Bulgarian National Assembly named a caretaker government led by a former opposition party, the Union of Democratic Forces (UDF). A week later, McGuirk's team returned to Sofia to resume negotiations. Once the technical

[34]See minutes of EBM/96/69 (July 19, 1996), pp. 3–31. Vicente J. Fernández (Alternate, Spain) objected to the front-loading of scheduled disbursements in the arrangement, but he did not abstain from approving it. Alassane Ouattara (Deputy Managing Director), who was chairing the meeting, took note of the "considerable reservations" that some Directors had expressed.

details were set, Deppler also returned, and an agreement was quickly finalized.[35] In the meantime, the economic collapse had become much worse. Faced with hyperinflation (prices were rising at a monthly rate of 240 percent) and Depression-era output declines, Bulgarians were ready to embrace reform and the proposal for a new Fund-supported program.

The severity of the economic downturn improved the feasibility of the proposed currency board, economically as well as politically. With the lev greatly depreciated against major currencies, the authorities could peg it to the deutsche mark with full backing for the outstanding currency issue. The staff and the authorities worked out the details over the next few months, during which time the UDF won control in parliamentary elections. Advocates of reform now had a clear mandate, and the new government established the currency board in July.

Finally, the reform effort took hold.[36] The IMF approved a fifth stand-by arrangement in April 1997 and followed that with an extended arrangement in September 1998. The authorities carried out these programs as expected, and economic performance steadily improved. The staff's initial prediction had proved correct: Bulgaria had become a prolonged user of Fund resources, with borrowing arrangements in place almost continuously from 1991 through 2004. By then, however, the market economy was well established. In April 2007, the authorities repaid all outstanding credits ahead of schedule. One month later, they acceded to membership in the EU. The currency board arrangement, established in 1997 as a last-ditch measure to stabilize an economy in crisis, remained in place as an anchor while Bulgaria moved toward formal entry into the euro area.

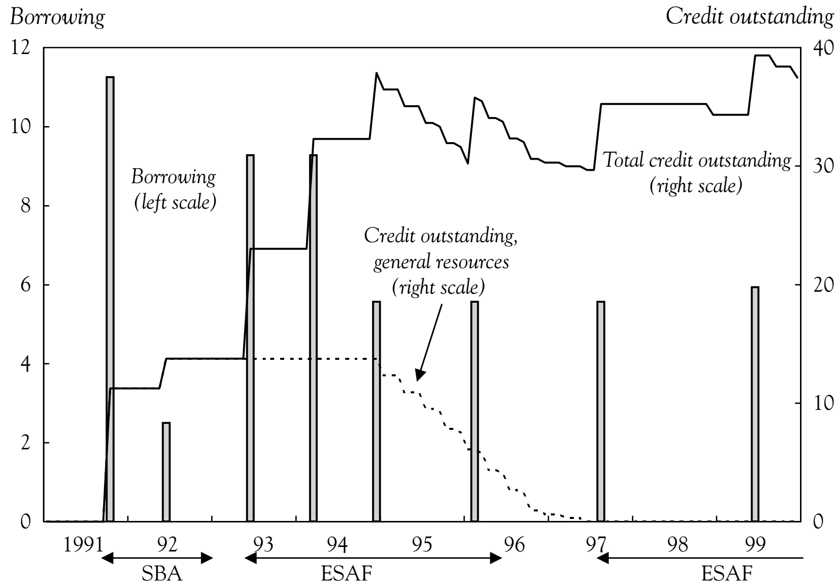
Mongolia

The Mongolian People's Republic was founded as an independent state in 1924, ending an era of Chinese rule or dominance. Political and economic ties with Mongolia's northern neighbor, the Soviet Union, were gradually strengthened over those with China, on its southern border. Throughout the Cold War period, Mongolia maintained an economic system based on central planning, similar to the Soviet model. A succession of rulers gradually managed to reduce Mongolia's international isolation. After 15 years of rejection, the UN admitted Mongolia as

[35]See "Bulgaria—Use of Fund Resources—Request for Stand-By Arrangement and Request for Purchase Under the Compensatory and Contingency Financing Facility," EBS/97/53, Suppl. 1 (April 3, 1997). For the staff's detailed proposal for the currency board arrangement, see the (unnumbered) technical assistance reports, "Bulgaria—Preparations for a Currency Board Arrangement," Volumes I and II (February 1, 1997).

[36]For an overall assessment, see "Bulgaria: Ex Post Assessment of Longer-Term Program Engagement" (May 19, 2004); accessed at http://www.imf.org/external/pubs/ft/scr/2004/cr04176.pdf.

Figure 6.6. Mongolia: Use of Fund Credit, 1991–99
(In millions of SDRs, monthly data)



Source: International Financial Statistics.
Note: ESAF = Enhanced Structural Adjustment Facility; SBA = Stand-by arrangement. "Credit outstanding, general resources" excludes ESAF loans.

a member in 1961. Only in June 1990, however, did the government apply to join the IMF.[37]

A new constitution in May 1990 provided for multiparty elections. The ruling Communists (reconstituted as the Mongolian People's Revolutionary Party) won the elections but brought representatives of other parties into the government and initiated an economic reform program. Stabilizing the economy proved difficult because the collapse of the CMEA and upheaval in the Soviet Union severely disrupted external trade. Output, already so low as to classify Mongolia as a low-income developing country, was being further depressed by external conditions. To help the country cope, the IMF began providing technical assistance in November 1990, advising primarily on tax reforms. The IMF broadened and intensified that assistance in 1991, after Mongolia became a member of the Fund on February 14. The Fund also acted quickly to offer financial assistance, as the Executive Board approved a stand-by arrangement for $30 million (SDR 22.5 million, or 90 percent of quota) in October 1991.

[37]For a more detailed history, see Milne and others (1991), and references therein. That monograph was based on the initial staff report to the Executive Board, "Mongolia—Calculation of Quota," EB/CM/90/1 (November 29, 1990).

A change of government in 1992 derailed economic policy for a time, and Mongolia received only the first two scheduled disbursements under the stand-by arrangement. By mid-1993, however, the authorities were getting policies back under control, and they prepared a Policy Framework Paper—the essential requirement for gaining access to ESAF loans. More generally, the government was demonstrating a remarkable capacity for economic reform at a time when its institutional development was still in its infancy. Prices were being set freely in the market, private enterprise was flourishing, the floating exchange rate was unified and reasonably stable with little intervention, and inflation was low and falling. The Fund responded in June 1993 by approving a three-year ESAF arrangement for $58 million (SDR 40.8 million), thereby shifting Mongolia's borrowing into that longer-term and less-expensive facility (Figure 6.6).

The difficulty of establishing strong public and financial institutions continued to plague Mongolia. Throughout the three-year period of the ESAF arrangement, the banking system was subject to periodic runs by depositors, and weaknesses in the interbank market occasionally resulted in unstable exchange rate movements. The slowing pace of reform led the IMF to delay disbursements under the arrangement, which expired in June 1996 with a quarter of the total unused.

Elections in 1996 and 1997 brought new coalitions to power, but the focus on market-oriented reforms remained in place and gradually intensified. Fund staff regularly reviewed the government's economic program and broadly endorsed it. In July 1997, the Fund resumed lending, with a three-year ESAF arrangement for $46 million (SDR 33.4 million).

Overall, the issue for the Fund in assisting Mongolia throughout most of the 1990s was not whether the government was sufficiently committed to its program. The Fund did not have to push the Mongolian authorities. The issues were whether implementation was forceful enough to maintain momentum, and whether the right balance was being struck between stabilization of macroeconomic conditions and reform aimed at stimulating medium- and longer-term growth. The Fund's confidence in the government's course of action increased further in the late 1990s, as the only serious setback came in the wake of the regional crisis across East Asia and Russia in 1997–98. That crisis interrupted the ESAF-supported program for a time, but by 1999 it was back on track.

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