

III

The IMF and Emerging Markets

9

Five Fat Years: Recovery from the Debt Crisis, 1990–94

BEHOLD, THERE COME SEVEN YEARS OF GREAT PLENTY THROUGHOUT ALL THE LAND OF Egypt. And there shall arise after them seven years of famine; and all the plenty shall be forgotten.

Genesis 41:29–30

The debt crisis of the 1980s engulfed whole regions of the developing world: Latin America most broadly and painfully, but also Eastern Europe and Africa. In all, it directly affected at least 20 countries, with more than 30 distinct crisis episodes.¹ This trouble lasted the whole of the decade, and the withdrawal of bank loans forced the most heavily indebted countries to cut spending and revert to borrowing from the IMF and other official creditors. Latin America experienced a “lost decade,” and incomes at the end of the period were lower than at the beginning. The debt crisis finally ended in 1989, when a drop in world interest rates, official acceptance of the need for negotiated debt reductions, and the cumulative effect of several years of economic reforms made the burden of developing-country debt more tolerable.

The Brady Plan of 1989, named after U.S. Treasury Secretary Nicholas F. Brady, formed the keystone of the debt-reduction strategy that ended the crisis. Brady’s deputy, David C. Mulford, developed the plan in 1988 and the first months of 1989 with the involvement of his Japanese counterpart, Makoto Utsumi, and of IMF staff and the Fund’s Managing Director, Michel Camdessus. The plan called for commercial bank creditors to waive the usual negative pledge clauses in their sovereign loan contracts so that the dominant creditors could renegotiate their claims without getting tied up by small banks or vulture funds vying for advantaged settlements.² Creditor-country governments would adapt the

¹For an overview, see Boughton (2001), Chapter 6. This description relates only to commercial-debt crises in emerging-market countries, not to the burden of debt to official creditors by low-income countries, which was a separate problem and a crisis of a different nature.

²Negative pledge clauses require borrowers to treat all creditors equally in any settlement and thus prohibit repaying one loan in full while going into arrears on others. A “vulture fund” purchases distressed debt in a secondary market and then takes (or threatens to take) legal action to force the debtor into a settlement.

application of their bank regulations to promote a flexible menu of options for banks to renegotiate their loans to sovereign borrowers, and multilateral creditors would provide additional credits to heavily indebted countries to help finance those settlements.

The IMF's role in the Brady Plan was to negotiate stand-by arrangements (usually extended arrangements) that provided for the Fund to set aside part of its own loans to help the borrower restructure its commercial debt with reduced debt stock and reduced debt service, and to augment the size of the arrangement for the same purpose once the borrower had reached a settlement with its commercial bank creditors.³ The U.S. Treasury further supported this process by issuing special zero-coupon bonds that the heavily indebted developing countries could purchase and use as collateral for new securities ("Brady bonds") that they might issue to replace their bank loans.⁴

With the Brady Plan in place and world economic conditions coincidentally improving, the heavily indebted emerging-market countries benefited in two ways. First, they had a clear path in front of them for getting out from under the debt overhang that had stifled investment and growth throughout the 1980s. This prospect led to a wave of new IMF lending arrangements as a precondition for these countries to take full advantage of the Brady Plan. Second, once bank creditors and global investors realized that the prospects for growth had returned, private capital began flowing back to developing countries in huge and unprecedented volumes.

Latin America in particular attracted capital like a magnet. Mexico took in an average of more than \$23 billion a year in net private flows, 1990–94, after suffering net outflows in most of the preceding eight years. Argentina, Brazil, and Chile also showed sizeable net inflows for the first time in a long while. Outside Latin America, private capital was flowing into a diverse group of countries such as Côte d'Ivoire, Hungary, the Philippines, and Romania. With the notable exception of countries making the difficult transition from central planning to market economics, most of the middle-income countries that started the 1990s with heavy external debts succeeded in using these inflows to fuel sustained increases in output growth, at least for the first half of the decade.

This chapter recounts the effects of these developments on the IMF and on the affected member countries. For both, but especially for many of the countries that had suffered through the 1980s, the short-term effect was a five-year period of mostly favorable conditions. The improvements, however, did not materialize all at once or uniformly across countries.

Resolution of the Debt Crisis

Implementation of debt reduction under the Brady Plan—the most important single factor in resolving the debt crisis of the 1980s—had to be tailored to the circumstances of each indebted country. In 1990, Mexico became the first to reach

³The development of the IMF role in the Brady Plan is described in Boughton (2001), pp. 491–98.

⁴For an overview of the issuance of Brady bonds, see Izvorski (1998).

a debt-reduction agreement with its commercial bank creditors and exchange its discounted bank loans for Brady bonds. As shown in Table 9.1, Costa Rica, Morocco, the Philippines, and Venezuela followed suit before the end of 1990, but for other countries these negotiations took years to complete.

All but two of the most affected countries borrowed from the IMF under at least one conditional arrangement in the 1990s as part of their recovery efforts. Exceptionally, neither Colombia nor Nigeria borrowed from the IMF in the 1980s or the 1990s, although both were classified as heavily indebted. In 1985, at Colombia's request, the Fund gave its "seal of approval" to the country's economic policies, but Colombia did not request a stand-by arrangement. In 1999, the Fund approved an Extended Fund Facility (EFF) arrangement, on which Colombia chose not to draw. Nigeria entered into three stand-by arrangements with the IMF during this period (in 1987, 1989, and 1991), all of which the authorities treated as precautionary.

Relaxation of the Fund's policy on "lending into arrears" enabled its wave of early-1990s lending to countries with heavy debt burdens to foreign commercial banks. Before 1989, the policy had been to require countries in arrears on sovereign debts to clear those arrears before the Fund would lend to them. Beginning in 1987, the Fund began making exceptions to that rule if a country's commercial bank creditors were being recalcitrant in negotiations. Otherwise, the creditors could have continued to use the Fund's policy as leverage to exact sovereign debtors' agreement to harsh terms.

In May 1989, the Executive Board agreed to relax its policy on lending into arrears more generally and formally. From that point on, it was agreed that in deciding whether to approve a stand-by arrangement, "an accumulation of arrears to banks may have to be tolerated where negotiations continue and the country's financing situation does not allow them to be avoided. Directors emphasized that appropriate safeguards would need to be incorporated into the monitoring procedures of the Fund arrangement. The Fund's policy of non-toleration of arrears to official creditors remains unchanged."⁵

The "Big Three" of Latin America

All three of the major Latin American debt-crisis countries—Argentina, Brazil, and Mexico—underwent remarkable economic transformations in the 1990s that enabled them to recover strongly and put the 1980s behind them. All three eventually stumbled and experienced new financial shocks, but only after experiencing several years of good growth sustained by sound policies.

⁵Minutes of EBM/89/61 (May 23, 1989), p. 30. For the background to this change, see Boughton (2001), pp. 481–83 and 492–98. In 1998, the Fund extended the toleration policy to cover debts to bondholders and other nonbank creditors. The following year, it relaxed the policy further by extending it to cases in which no negotiations with creditors were taking place but the country was making a good faith effort to do so. For a review, see "Fund Policy on Lending into Arrears to Private Creditors—Further Consideration of the Good Faith Criterion" (July 30, 2002); accessed at <http://www.imf.org/external/pubs/ft/privcred/073002.htm>.

Table 9.1. IMF Assistance to Selected Heavily Indebted Countries, 1980s and 1990s

	1981–89				1990–99				
	IMF Assistance ^a (number of arrangements)				IMF Assistance ^a (approval dates)				
	Initial Crisis	SBA	EFF	SAF/ ESAF	Debt- Reduction Agreement	Brady Bonds	SBA	EFF	ESAF
Baker 15 countries^b									
Latin America									
Argentina	1982	4			1993	1993	1991, 1996	1992, 1998	
Bolivia ^c		1		2					1992, 1994, 1998
Brazil	1982	1	1		1994	1994	1992, 1998		
Chile	1983	2	1						
Colombia	1985							1999	
Ecuador	1983	5			1995	1995	1991, 1994		
Mexico	1982	1			1989	1990	1995, 1999		
Peru	1984	1	1		1997	1997		1993, 1996, 1993	
Uruguay	1983	2			1991	1991	1990, 1992, 1996, 1997, 1999		
Venezuela	1984		1		1989	1990	1996		
Other regions									
Côte d'Ivoire ^c	1984	5	1		1997	1998	1991		1994, 1998
Morocco	1982	5	1		1990	1990	1990, 1992		
Nigeria	1982	2			1991	1992	1991		
Philippines	1983	3	1		1989	1990	1991, 1998	1994	
Yugoslavia	1981, 1985	4					1990		
Croatia					1996	1996	1994	1997	
Slovenia					1996	1996			

Table 9.1. (continued)

	1981–89			1990–99					
	IMF Assistance ^a (number of arrangements)			IMF Assistance ^a (approval dates)					
	Initial Crisis	SBA ^s	EFF ^s	SAF/ ESAF	Debt- Reduction Agreement	Brady Bonds	SBA	EFF	ESAF
Other debt-crisis countries									
Costa Rica	1981	4	1		1989	1990	1991, 1993, 1995		
Hungary	1982	3					1990, 1993, 1996	1991	
Jamaica	1984	4	1				1990, 1991	1992	
Jordan	1988	1			1993	1993	1992	1994, 1996, 1999	
Poland ^d							1990, 1993, 1994	1991	
Romania	1982	1			1981	1994	1994	1991, 1992, 1994, 1997, 1999	
Other heavily indebted middle-income countries									
Bulgaria ^e					1994	1994	1991, 1992, 1994, 1996, 1997	1998	
Dominican Republic ^f		1	1		1994	1994	1991, 1993		
Panama		3			1996	1996	1992, 1995	1997	

Source: International Financial Statistics and author's calculations.

Note: EFF = Extended Fund Facility; ESAF = Enhanced Structural Adjustment Facility; SAF = Structural Adjustment Facility; SBA = Stand-by arrangement. Except for two "Baker 15" countries (Bolivia and Côte d'Ivoire), this table excludes low-income countries, which are discussed in Chapter 13.

^aFor financial assistance other than through SBA, EFF, ESAF, and SAF, see notes on individual countries.

^bThe Baker 15 was a list of countries proposed by U.S. Treasury Secretary James Baker in 1985 as the most heavily indebted to foreign commercial banks and eligible for special consideration under the Baker Plan.

^cBolivia and Côte d'Ivoire also received debt relief through the Heavily Indebted Poor Countries Initiative in 1998.

^dPoland became a member of the IMF in 1986.

^eBulgaria became a member of the IMF in 1990.

^fThe Dominican Republic also received emergency assistance for natural disaster relief in 1998.

Argentina

The most dramatic economic turnaround among emerging markets in the early 1990s, in both policies and performance, occurred in Argentina. The country started the decade with extremely poor economic conditions, a failed series of IMF lending arrangements, and protracted arrears to Paris Club official creditors and to commercial bank creditors.⁶ With consumer prices more than doubling every month, all efforts at fiscal prudence being undermined by resistance from provincial governments, and the central government close to bankruptcy, Carlos Menem, inaugurated as president in July 1989, set out to get the economy under control.

The successes enjoyed by Argentina in the 1990s, described below, were followed by a total collapse in 2001–02. Ultimately, the tension between lax fiscal policies and a strong currency brought on a financial crisis that forced the government to default on much of its debt, after which the currency lost three-fourths of its value in foreign exchange, and the government fell. Analysts later generally treated the collapse as the inevitable consequence of the policies of the 1990s, abetted by the misguided support of the IMF, and wrote about it as the chronicle of a death foretold.⁷ That is not the approach taken in this History. Here, the goal is neither to cast blame nor to excuse or paper over mistakes. The goal is to recount the interaction between Argentina and the IMF as it transpired at the time, without reinterpreting it in the glaring light of the tragedy that followed.

Practically everyone agreed at the beginning of the 1990s that Argentina's policies of the previous decade could not continue. The ideological divide between Argentine and IMF officials, and between those who rejected and those who embraced openness to international trade and finance, had become much narrower. Seeking financial stability as a path toward sustainable growth had become a common cause. The question was how best to find that path. When the government took its first decisive steps, some analysts—in Argentina, at the IMF, and in financial markets—were skeptical that the experiment would succeed. Others had more confidence. The outcome, whether the break with the past would finally succeed or fail, was not inevitable.

The probability of long-run success fluctuated greatly over the next several years. In view of the record of failure in the 1980s, that probability looked fairly low at the outset. As Chapter 10 shows, prospects improved greatly in the mid-1990s after the government took strong measures to weather the contagion effects of the financial crisis in Mexico. Subsequently, as discussed in Chapter 12, new shocks combined with flagging efforts weakened the outlook again. Both the authorities and the IMF made some good decisions along the way, and some bad. In the end, the skeptics had their

⁶Relations between the IMF and Argentina in the 1980s are covered in Boughton (2001), pp. 327–36 (on the initial crisis in 1982), pp. 385–401 (on the effort to contain the crisis in 1983–85), pp. 461–75 (on the subsequent efforts of 1986–87), and pp. 520–26 (on the last program of the 1980s, approved in 1989).

⁷See, for example, Mussa (2002); Independent Evaluation Office (2004); and Blustein (2005).

day. But the shocks and shifting fortunes could not be foreseen at the dawn of the decade, which is where this story begins.

In November 1989, in a tribute to the power of hope to overcome bitter experience, the IMF approved a stand-by arrangement for Argentina: the thirteenth arrangement in Argentina's 33 years of membership. Financial markets remained highly skeptical of the government's ability to stabilize its own financial position, and capital flight and price inflation persisted. Unless the IMF was willing to take a substantial risk by resuming lending, Argentina had little hope of renegotiating its debts and thus little hope of escaping the crisis without another default. As soon as the Executive Board approved the arrangement, Argentina borrowed \$234 million of the total 17-month commitment of \$1.4 billion (SDR 1,104 million).

To build on this show of confidence, Menem's government tried to slow inflation by forcibly mopping up liquidity. In January 1990, they introduced the "Plan Bonex," which froze time deposits in Argentine banks and replaced those deposits with less-liquid bonds denominated in U.S. dollars. The effect was the opposite of what was intended: capital flight intensified, the exchange rate depreciated sharply, and the fiscal overruns that had already undermined the Fund-supported program increased further. The Fund sent a staff mission to Buenos Aires to try to rescue the program, and it had some success as the government itself was trying desperately to find some way to restore equilibrium. On March 5, Menem announced a generalization of the country's value-added tax. The additional tax revenue went some distance toward balancing the budget—but not enough to finance the external deficit or to stop the accumulation of arrears to foreign creditors. The Fund took the unusual step of canceling (not just postponing) the second drawing on the stand-by arrangement and reducing the size of the arrangement to \$1.2 billion.⁸

For the rest of 1990 and the first two months of 1991, Menem continued to make progress in fits and starts. The government resumed partial payments on its foreign debts, privatized some major enterprises including the telephone company and the national airline, and prohibited the indexation of austral-denominated contracts, including wage agreements. The IMF provided extensive technical assistance throughout this period on the restructuring of tax policy and tax administration, reorganizing the central bank to make it independent of the government, and strengthening the accounting and statistical systems of the central bank.⁹ Argentina made two more drawings on the stand-by arrangement, in June and December 1990, but the Fund canceled another drawing in November and again reduced the total amount of the arrangement.¹⁰

⁸See minutes of EBM/90/82 (May 25, 1990).

⁹For an overview of this technical assistance, see "Argentina—Request for Stand-By Arrangements," EBS/91/107 (July 26, 1991), Suppl. 1, p. 39.

¹⁰When the stand-by arrangement expired on March 31, 1991, Argentina had drawn SDR 506 million, out of an initial approved amount of SDR 1,104 million. The Fund had canceled two drawings totaling SDR 368 million, and SDR 230 million remained undrawn.

To give more impetus to the reform effort, Menem made two major personnel changes at the end of January 1991. First, he moved Domingo Felipe Cavallo from the post of minister of foreign affairs to that of minister of the economy. Cavallo had a Ph.D. in economics from Harvard University and had been governor of the central bank in the early 1980s. He now wanted to build on that experience to try a bold new approach to macroeconomic policy. Second, Menem named Roque Benjamin Fernandez—an economics Ph.D. from the University of Chicago and a highly respected university professor in Buenos Aires—to lead the central bank. The combination of Cavallo’s boldness and Fernandez’s conservative Chicago credentials pointed to a new era in which the legacy of hyperinflation might finally be conquered in Argentina.

The decisive break with the past came on March 27, 1991, when the Argentine Congress approved adoption of the Convertibility Law. Similar to a currency board arrangement, this law required the central bank to hold liquid foreign exchange at least equal to the monetary base. Designed to force domestic inflation to fall immediately to international levels, the convertibility scheme was effectively equivalent to a currency board arrangement pegging the Argentine austral to the U.S. dollar at a rate of 10,000 to 1.¹¹ This plan, designed primarily by Cavallo, distressed the Fund staff and management, who feared that it would lock in an overvalued currency, force the government to tighten fiscal policy by much more than was politically feasible, and seriously weaken the real economy.

The primary challenge for the convertibility plan was to get fiscal policy under control. The government had a large stock of debt to foreign creditors, much of which was in arrears, and it needed to generate a steady stream of net revenues to service that debt. Until this point, it had been able to supplement its small primary surplus with seigniorage revenues, at the expense of generating extremely high inflation. An abrupt end to inflation would wipe out that cushion. To avoid default, the government now would have to raise tax revenues or cut spending to generate a large primary surplus, and it would have to sustain that effort for a few years. The Fund staff was highly skeptical. The day after Cavallo announced the plan, the head of the Western Hemisphere Department (WHD), Sterie T. Beza, explained the scheme to Camdessus and noted with incredulity, “Surprisingly, the initial reaction to the Minister’s statement in financial markets in Buenos Aires has been positive!”¹²

This scheme worked as intended. The plan, which took effect on April 1, 1991, quickly restored investor confidence; liquid capital flowed back into the banking system; and the central bank was able to buy large amounts of foreign exchange to rebuild

¹¹The spread of currency board arrangements in the 1990s is discussed in Chapter 1. For the text of Argentina’s Convertibility Law, see Cavallo (2001), Appendix II.

¹²Memorandum from Beza to the Managing Director, “Argentina—Back-to-Office Report,” March 21, 1991; IMF archives, Argentina 1991 Country Files, OMD-AD, Box 7626, Accession 1995-0180-0001. The staff skepticism about the plan is spelled out in more detail in a separate memorandum from the mission chief, Armando Linde (Assistant Director, WHD), attached to Beza’s.

its reserves. The following January, the government replaced the austral with a new Argentine peso worth 10,000 australs, equivalent in value to the U.S. dollar. Much of the Argentine economy was already largely dollarized, so this conversion had the psychological effect of restoring widespread confidence in the stability of the currency and in the government's ability to manage the economy.

Despite its initial skepticism, the Fund responded positively to the convertibility plan once it was in operation. In July, the Executive Board approved a new stand-by arrangement, for \$1 billion (SDR 780 million, or 70 percent of Argentina's quota). Of that total, \$193 million was available for Argentina to draw immediately, and another \$64 million was set aside in accordance with the Brady Plan for Argentina to use to finance a debt-reduction agreement with private creditors once an agreement could be reached. The country's poor record of policy implementation during the past decade made a number of Directors nervous about the size of the arrangement, but no one refrained from approving it.¹³ To everyone's relief, the government implemented the program as planned and met most of the conditions specified in the arrangement.¹⁴

By March 1992, the Menem government had established an adequate track record and was having enough economic success that the Fund was ready to offer more-substantial and longer-term loans. That month, the Board approved a three-year extended arrangement for \$2.9 billion (SDR 2,149.5 million) to replace the stand-by arrangement, which would have expired in a few months. The money set aside for the Brady Plan had not yet been used because Argentina was still negotiating with its creditor banks. The Fund agreed to carry the set-aside provision forward into the new loan agreement, and it added a promise to augment the arrangement as a further incentive for the two parties to settle.

From that point on, the settlement of Argentina's arrears and the reduction of its external debt burden proceeded smoothly. The authorities reached an agreement in principle with their bank creditors in April 1992, signing a final deal on December 6. The agreement enabled Argentina to reschedule its interest arrears and reduce the net present value of its debt by replacing loans with Brady bonds. Bank creditors could choose whether to exchange their loans for discount bonds (bonds with a market interest rate but a reduced face value) or par bonds (full-value bonds with a reduced interest rate). The two options were priced to have the same market value, and the whole operation was calculated to be equivalent to a buyback of existing debt at 38 percent

¹³Minutes of EBM/91/102-03 (July 29, 1991).

¹⁴The December 1991 drawing was allowed despite Argentina's failure to adhere to the end-September limits on the fiscal deficit specified in the stand-by arrangement. The staff determined that fiscal policy was broadly consistent with the requirements of the program and that the recorded excesses were not an impediment to meeting future targets; see "Argentina—Review and Modification of Stand-By Arrangement," EBS/91/209 (December 10, 1991). The end-December targets were all met. Altogether, the three drawings on the 1991–92 stand-by arrangement totaled \$600 million (SDR 438.8 million), and another \$200 million was set aside to help finance a future debt-reduction agreement with commercial creditors.

of face value, approximately equal to the prevailing secondary market price at the time of the preliminary agreement. The cost for Argentina to make an initial payment of past-due interest and to provide guarantees on future payments of principal and interest was estimated at \$3.7 billion, of which approximately \$1 billion was to be covered by drawing on the IMF. The World Bank, the Inter-American Development Bank (IDB), the Japanese Export-Import Bank, and Argentina's own resources were to cover the rest.¹⁵

On December 30, 1992, less than a month after the signing of the Brady deal with the banks, the IMF Executive Board approved an augmentation of the extended arrangement. The main concern at the IMF at this time was the same one that had made the staff skeptical at the outset of the convertibility plan: although inflation in Argentina had been dramatically reduced, it was still well above the U.S. rate. With the peso firmly pegged to the U.S. dollar, international competitiveness was being steadily eroded. The current account deficit was becoming wider, threatening the long-term viability of the exchange regime. That concern, however, was offset by the impressive way that the government was reforming the Argentine economy to make it more vigorous and efficient. Thomas C. Dawson II (United States) concluded his observations enthusiastically: "We believe that the sweeping market-oriented economic reforms that are being implemented are exactly the sort of policies we had in mind when the international financial community endorsed Secretary Brady's proposals for debt and debt-service reduction."¹⁶

The Board's approval enabled Argentina to draw \$1.2 billion (SDR 862.9 million) right away, on the understanding that the authorities would use most of the money to help finance the debt restructuring.¹⁷ The other official creditors quickly followed suit. With this financing secured, the government floated the Brady bonds in March 1993, effectively bringing its debt crisis to a successful conclusion.

The Argentine economy continued to improve dramatically throughout this period, fueled by large capital inflows and a resurgence of domestic activity spurred by privatization, deregulation, and other market-oriented reforms. Gradually, inflation virtually disappeared, falling from nearly 5,000 percent in 1989 to less than 4 percent in 1994. GDP growth averaged more than 7 percent a year, 1991–94. The current account remained in deficit, partly owing to the high valuation of the exchange rate but also as a reflection of the rapid return of private capital. The fiscal accounts were balanced, and the country's external debt fell substantially in relation to output. After the nightmare of the 1980s, these achievements were invigorating and transformational.

¹⁵"Argentina—Extended Arrangement—Review and Second Year Program," EBS/92/210 (December 15, 1992), pp. 7–8 and Table 4.

¹⁶Minutes of EBM/92/157 (December 30, 1992), p. 27.

¹⁷The scheduled drawing for December 1992 was SDR 146.2 million, excluding the scheduled set-aside. The augmentation amounted to SDR 333.9 million, and the sum of previous and planned set-asides was SDR 382.7 million. All of these amounts were made immediately available.

Although the central government under Menem was firmly committed to fiscal probity, it found its ability to control overall government spending limited by popular opinion in much of the country and by the powers granted to provincial governments under the Argentine constitution. As long as the economy was rebounding strongly and investor confidence remained high, the external deficit could easily be financed and opposition to fiscal tightening could be held in check. As a result, the authorities were able to satisfy the Fund's conditionality and continue to draw regularly on the EFF arrangement throughout 1993 and most of 1994.¹⁸ By then, however, domestic pressures on fiscal policy were beginning to build, and investors' worries about the viability of the policy regime were growing. As shown in the next chapter, the Argentine economy and the Fund-supported policy program were again in fragile condition when the Mexican crisis hit at the end of 1994.

Brazil

Much like Argentina, Brazil opened the 1990s in a morass of economic and financial difficulties but with new leadership committed to stabilizing the economy.

The IMF had approved a stand-by arrangement for Brazil in August 1988 in the middle of newly minted optimism about the country's prospects for economic stability. The program unfortunately foundered when the central government failed to control the general government deficit or prevent an upward spiral of inflation. The stand-by arrangement went largely unused, and Camdessus concluded the Fund's last discussion of Brazil in the 1980s by warning the authorities that "the time for gradualism had clearly run out."¹⁹

In December 1989, the Brazilian people, also disillusioned with the country's legacy of failed economic policies, elected a new president, Fernando Affonso Collor de Mello, who promised to make a fresh start. When Collor took office the following March, he immediately announced a new economic program with an ambitious menu of liberalizing structural reforms and a floating exchange rate but also with such heterodox elements as a temporary freeze on price increases.

This New Brazil Plan (or "Collor Plan," as it was often called) was not a great success. Policy implementation continued to be hampered by political disputes and undermined by the crushing weight of the country's deeply entrenched inflationary pressures. Interest payments on external government debt were in arrears to both commercial and official bilateral creditors, and the secondary market price of Brazil's sovereign debt was hovering around 25 percent of face value. The authorities had no desire for the

¹⁸Argentina made all the EFF drawings on schedule through September 1994, at which time it had drawn all but SDR 278.1 million of the augmented total amount of SDR 2,483.2 million. The last two drawings were not allowed.

¹⁹Minutes of EBM/89/137/R-1 (October 27, 1989), p. 56. The history of the IMF's relations with Brazil in the 1980s is covered in Boughton (2001), pp. 336–45 (on the initial crisis in 1982), pp. 372–84 (on the effort to contain the crisis in 1983–85), pp. 453–61 (on the subsequent efforts of 1986–87), and pp. 526–31 (on the final stand-by arrangement in 1988–89).

Fund staff to visit Brazil while these disputes and problems were raging, out of fear that the presence of an international agency would simply inflame the opposition. Nonetheless, they needed international support to regularize relations with creditors and put the economy on a sustainable growth path. After a few months' hesitation, they invited the IMF to send a staff mission to negotiate terms for a stand-by arrangement.

Thomas Reichmann, who had worked on Brazil through much of the 1980s and was now an Assistant Director of WHD, spent all of August 1990 in Brasilia with a staff team and brought home at the end of the month an agreement on an acceptable policy program for the next year and a half. Brazil's central bank governor, Ibrahim Eris, went to Washington the next week to put the final touches on a draft Letter of Intent. On September 7, Camdessus informed the Executive Board that everything was set, and that Brazil's request for an arrangement would be submitted to them by the middle of the month.²⁰

It was not to be. The Brazilian authorities needed to take the next crucial step toward recovery: reaching agreement with commercial bank creditors on a debt- and debt-service-reduction deal consistent with the Brady Plan. That required both sides to agree on terms that reflected the market evaluation of Brazil's huge stock of outstanding debts. The Brazilian team would be led by an experienced diplomat, Ambassador Jorio Dauster, and the banks' advisory committee would be led by William R. Rhodes, Vice Chairman of Citibank and the world's most experienced debt negotiator. Despite these credentials, the discussions started badly and then stumbled downhill.

At a meeting in New York on October 10, with Reichmann on hand to help explain the policy program, Dauster tabled a proposal that the banks flatly rejected on the grounds that it was far below market value. The Fund also considered it unacceptable, especially because it seemed inconsistent with what Dauster and Eris had promised to Camdessus in early September. Several follow-up meetings were held, including one in which Rhodes and his boss at Citibank, John S. Reed, went to Washington to try to persuade Camdessus to lean harder on the Brazilians. Those efforts failed, and at the end of November, Rhodes abandoned the effort.²¹

With no prospect for a bank deal, the program the IMF had intended to support could not be financed. Camdessus had no choice but to drop his plan to take Brazil's

²⁰See memorandums from Beza to the Managing Director, "Mission to Brazil," September 4, 1990; and "Brazil—Meeting with the President of the Central Bank," September 6, 1990; both in IMF archives, OMD-AD, Accession 1994-0289-0001, Box B6908. For the Managing Director's report to the Executive Board, see minutes of EBM/90/137 (September 7, 1990), p. 3.

²¹See memorandums from Beza to the Managing Director, "Report of Staff on First Round of Negotiations between Brazil and the Commercial Banks," October 12, 1990; "Brazil—Meeting with the President of the Central Bank," October 23, 1990; "Meeting with Mr. Reed and Mr. Rhodes," October 24, 1990; and "Brazil—Negotiations with Banks," November 7, 1990. On the adjournment of the meetings, see cable from the banks' advisory committee, December 7, 1990. All these documents are in IMF archives, OMD-AD, Accession 1994-0289-0001, Box B6908.

request to the Board for approval.²² At the end of 1990, Collor's first attempt at reviving the Brazilian economy had come to nothing.

Collor and his economic team made a second attempt in January 1991, announcing a new program that the press called "Collor II." Like its predecessor, it relied heavily on controls to stifle price and wage inflation, combined on this occasion with substantial increases in gasoline prices and other public sector tariffs on basic consumer goods and services. The new plan worked adequately for a few months, while Dauster resumed negotiating with the banks' advisory committee. Those negotiations led to a settlement of a portion of Brazil's interest arrears to foreign banks in early April, at which point the authorities renewed their request for a stand-by arrangement with the IMF. Camdessus responded by sending Reichmann back to Brasilia to assess the new program, but in the middle of those meetings Collor's economic team abruptly resigned. Reichmann and his team returned to Washington to wait for the new finance minister, Marcílio Marques Moreira, to get settled.

Although the resignations had been triggered primarily by personal rather than policy issues, the appointment of Moreira—who had worked at the IMF 30 years earlier—turned out to be pivotal in Brazil's efforts to resolve its debt crisis. For the first time in Brazil's modern history, the government decided to try to stabilize the economy by using conventional ("orthodox") macroeconomic policies rather than by relying on controls and other heterodox measures. Just as important, the new finance team decided to emphasize negotiation over confrontation in its international discussions. From then on, negotiations with creditors—now led by Pedro Sampaio Malan, who had spent the preceding five years in Washington as Brazil's Executive Director at the World Bank and then the IDB—proceeded apace.

When the IMF Executive Board finally concluded the Article IV consultation in October 1991 (the first Board meeting on Brazil in two years), discussions aiming at a Fund-supported program were nearly complete. The authorities needed only to flesh out the draft Letter of Intent and to get the Brazilian Congress to enact several fiscal measures considered critical for macroeconomic stability. The real obstacle to the IMF's agreement, however, was the government's weak international credibility, the legacy of a decade of disappointment.

Personally skeptical and facing the possibility of a rebellion by Executive Directors, Camdessus flew to Brasilia in late November 1991 to assess the strength of Collor's commitment to the program and of his ability to get it adopted by congress. The trip nearly turned into farce when Camdessus arrived in the capital only to find that the president had just left for a summit meeting of Latin American heads of state in Cartagena, Colombia. Government officials in Brasilia quickly realized the importance of rearranging the meeting, and they saved the day by putting an official plane at the

²²The requirement for approval, under the Brady Plan and the IMF's general policy on financing assurances, was that discussions with creditors be "firmly launched with a good prospect of a satisfactory conclusion"; see "Brazil—Financing Assurances," EBS/90/163, Suppl. 1 (September 21, 1990).

Managing Director's disposal and flying him directly to Cartagena. There, he met with Collor, who made a convincing case for proceeding. In a press conference after the meeting, and again in remarks at the IDB in Washington a few days later, Camdessus praised Collor and expressed confidence that the program would succeed.

The Executive Board approved the stand-by arrangement on January 29, 1992, but only after several Directors from creditor countries expressed deep misgivings about the strength of Brazil's economic program and about the Managing Director's public discussions of it ahead of the Board meeting. Feeling that they had been presented with a *fait accompli*, all Directors approved the request, but they strongly put management on notice that subsequent drawings and any future request for a larger or extended arrangement would be subjected to a higher standard.²³

Directors' worries and misgivings were well placed, despite Collor's best efforts to implement the program as promised and the best efforts of the international community to provide support. The Paris Club of official creditors agreed in February 1992 to reschedule Brazil's debts and to accept a plan to settle outstanding interest arrears. In July, the authorities also reached an agreement in principle with the banks' advisory committee on a comprehensive reduction in debt and debt service. By then, however, Collor was bogged down in a political scandal that would soon lead to his impeachment and removal from office. With the government unable to formulate a credible fiscal policy for 1993, the IMF had no basis for continuing to lend. As with the 1988 stand-by arrangement, Brazil made only the initial drawing and then fell out of compliance.²⁴

In May 1993, Collor's successor as president, Itamar Franco, picked Fernando Henrique Cardoso to be his fourth finance minister in the space of six months. Cardoso immediately set out to strengthen Brazil's economic and financial policies, but it took him some time to convince skeptical investors of his ability to make a real break with the failed policies of the previous decade. IMF officials were equally skeptical. When the authorities requested a new stand-by arrangement in July, Beza told them that the request "would be very difficult to support in view of experience." He suggested that they would need to show more of a track record on fiscal policy and inflation control.²⁵

Cardoso responded to the Fund's rebuff by pushing ahead on his own. The terms of the July 1992 agreement with Brazil's bank creditors posed the chief obstacle, by

²³Minutes of EBM/92/9 and EBM/92/10 (January 29, 1992). Although the Board meeting was conducted in restricted session, a detailed and accurate account of it was leaked immediately afterward to a Washington-based reporter from a Brazilian newspaper; see Sotero (1992). For the Sotero article, an English translation, and related internal correspondence, see attachments to a February 13, 1992, note to the Acting Managing Director from Leo Van Houtven (Secretary of the Fund); IMF archives, OMD-AD, Accession 1996-0187-0001, Box B9105. The source of the leak was never uncovered.

²⁴The arrangement was for \$2.1 billion (SDR 1.5 billion). On approval, Brazil drew the equivalent of \$180 million, and the Fund set aside \$60 million to help finance a future Brady deal between Brazil and its bank creditors. The rest of the commitment was unused when the arrangement expired in August 1993.

²⁵Memorandum from Beza to the Managing Director, "Meeting with Brazilian Officials," July 27, 1993; IMF archives, OMD-AD, Accession 1997-0067-0001, Box B9955.

requiring the government to collateralize its rescheduled debts with zero-coupon bonds to be issued by the U.S. Treasury in accordance with the Brady Plan. The Treasury would not issue the bonds in the absence of an IMF-supported economic program, and the normal practice in other Brady Plan countries had been to use part of the money borrowed from the Fund to finance the purchase of those bonds. To circumvent this roadblock, the central bank—led by Malan, appointed as governor in September 1993—began quietly (through a leading U.S.-based investment bank) purchasing existing U.S. Treasury zero-coupon bonds in the secondary market using its own dollar reserves.

The agreement with the banks' advisory committee was to become effective once negotiations on specific terms were concluded successfully with at least 95 percent of Brazil's several hundred commercial bank creditors. The agreement offered creditors a complex array of options for restructuring a total of \$46.6 billion of debts, and it gave them a year to complete the deal. The deadline was repeatedly extended, and the critical mass of approvals was finally reached. The comprehensive agreement—restructuring all eligible debt with a new value of about 38 percent of the original level—was signed at a ceremony in Toronto, Ontario (Canada), on November 29, 1993. The primary remaining obstacles were for the authorities to acquire the necessary collateral and for the IMF to approve a stand-by arrangement to ensure implementation of the supporting policies.

In March 1994, bank creditors agreed to waive the requirement for a Fund-supported program, in effect agreeing to place more trust in President Franco, Finance Minister Cardoso, and Central Bank Governor Malan than the IMF was yet willing to do. This extraordinary reversal negated the IMF's conventional role of providing financial support backed up by policy conditionality when private creditors were not yet ready to lend or invest. From the banks' perspective, even if the IMF was right and the fiscal policy stance turned out to be inconsistent with inflation control, Brazil was strong enough financially to service its external debts once a debt-reduction deal was in place (see Malan, 2004, pp. 165–66).

On April 15, 1994, Brazil deposited \$2.8 billion in zero-coupon U.S. Treasury bonds in an escrow account at the Bank for International Settlements (BIS) in Basel, Switzerland. Brazil's Brady deal was complete, and its relations with its bank creditors were back on normal footing.²⁶

Restructuring and reducing external debt was an important step in Brazil's recovery from the debt crisis, but the bigger and more crucial challenge was to restructure economic policies to prevent another debt crisis. On this front, too, the IMF's own reluctance to resume lending in the absence of a solid and sustained move toward a sustainable fiscal balance relegated it to the sidelines. In the last quarter of 1993, Cardoso and Malan began to develop a new and truly ambitious plan to wring the

²⁶For a detailed description of the agreement, see "Brazil—Recent Economic Developments," SM/94/182 (July 14, 1994), pp. 18–23.

inertial force of high inflation out of the economy. They discussed this proposal with a Fund mission, led by José Fajgenbaum (Assistant Director, WHD), in November and announced the outlines of the plan at the end of that month.

The basis for the Cardoso plan was recognition that extremely high inertial inflation had created such a large fiscal deficit that the hole could not realistically be filled simply by the conventional means of cutting expenditures or raising taxes. The first step had to be to change market expectations and contract-writing practices so that inflation could be reduced quickly without wrecking the economy. For that purpose, the government would begin by introducing a new indexation mechanism linked to the U.S. dollar, which it hoped would be taken up by the private sector as superior to the backward-looking indexing to inflation that was then the almost universal practice. Once the new indexation scheme was established, the original plan called for the government to replace the cruzeiro with a new currency pegged to the dollar, perhaps by introducing a currency board. The new exchange regime would be reinforced by new procedures for setting public sector wages, tax rates, and other key variables.²⁷

The staff reacted cautiously to this scheme, just as it had to the convertibility plan in Argentina two years earlier—and for essentially the same reason. Unless the government could tighten fiscal and monetary policies substantially and quickly, and maintain that stance for as long as it took to break fully the momentum of inflation, the plan would almost certainly fail. Specifically, the staff calculated that the public sector would have to achieve a primary budget surplus (the fiscal balance excluding interest payments on government debt) on the order of 1 percent of GDP in 1994 to avoid a financial meltdown. No surplus was then being contemplated, and achieving one seemed unlikely. Cardoso and his economic advisors were, however, determined to push ahead with or without IMF support.

The Fund tried to help, though without committing any money and without formally endorsing the policy program. The staff agreed to monitor the economic program for 1994 and to continue the frequent missions that had become the norm for Latin America's largest economy. Twice in February 1994 Fajgenbaum and his team returned to Brasilia to conduct Article IV consultation discussions, with the ancillary intent of helping the authorities hammer out the details of the new policies. In the middle of the second mission, on February 28, the authorities announced what came to be known as the Plano Real, named after the new index: the Unidade Real de Valor. The indexation mechanism would be introduced immediately, and once it was fully operational in the middle of the year, a new currency—the Brazilian *real*, a name selected to invoke both a royal heritage and a solid real value—would be issued to replace the cruzeiro. No currency board would be established because the indexation scheme itself was expected to serve as an anchor for expectations and for monetary policy.

²⁷For an inside account of the origins of the scheme, see Cardoso (2006), pp. 179–88.

When the *real* was introduced on July 1, 1994, it was allowed to float against the U.S. dollar, subject to a commitment by the government to prevent the currency from depreciating below parity with the dollar. For the rest of the year, the new currency appreciated against the dollar, and the central bank continued rebuilding its stock of foreign exchange reserves.

The Fund staff remained skeptical about the sustainability of the Plano Real. Until the government could take the steps necessary to achieve a primary fiscal surplus, the staff view was that Brazil would be at risk of a ruinous resumption of inflation. The Fund admired the “considerable skill” with which the authorities phased in the new currency and their “initial success” in reducing inflation, but it also “cautioned . . . that a lasting reduction . . . had not yet been secured.”²⁸ Management and the Board were willing to consider new lending, but only after Brazil showed more lasting success in carrying out the program.

The economy performed better than expected, owing primarily to a resurgence of confidence by domestic and foreign investors. Except for a few months after the Mexican crisis (see Chapter 10), private capital flowed into Brazil. Price inflation fell sharply and persistently, from a monthly rate of 47 percent in June 1994 to just over 1 percent eight months later. Even with the tightening of macroeconomic policies that accompanied the Plano Real, real GDP grew strongly, by 5.7 percent for 1994 as a whole. The rebound in economic activity produced a primary fiscal surplus that exceeded what the Fund had insisted upon (and that even the authorities had thought was not practical). Despite the trauma induced by the Mexican crisis at the end of the year—stock prices on the São Paulo exchange fell by 40 percent in three months—the contagion effect from the peso crisis was soon contained, and Brazil had no further need for IMF financing until a new financial crisis hit in the fall of 1998 (see Chapter 12).

Mexico

The transformation of the Mexican economy seemed less dramatic than those of Argentina and Brazil because it took place more gradually and in several stages. Although faced with a severe debt crisis, Mexico avoided defaulting throughout the 1980s. It liberalized its trade regime and joined the General Agreement on Tariffs and Trade (the forerunner of the World Trade Organization) in 1986. In 1989, it became the first country to complete a Brady deal with its commercial bank creditors, a deal supported by the IMF with an exceptionally large extended arrangement using the

²⁸See the staff appraisal in “Brazil—Staff Report for the 1994 Article IV Consultation,” EBS/94/204 (October 21, 1994), pp. 18–21; and “The Chairman’s Summing Up at the Conclusion of the 1994 Article IV Consultation with Brazil, Executive Board Meeting 94/100 – November 16, 1994,” SUR/94/132 (November 29, 1994). Stanley Fischer, who joined the IMF as First Deputy Managing Director that fall, took a more sanguine view of Brazil’s prospects and subsequently played a key role in shifting the Fund’s stance.

EFF.²⁹ For the next four years, the government continued to pursue sound macro-economic policies and to loosen regulations and promote private sector economic activity. Foreign capital flowed back into the country after a virtual absence of more than seven years. As the capstone of this transformation, Mexico entered into a major free trade agreement with the United States and Canada—the North American Free Trade Agreement (NAFTA)—at the beginning of 1994. A few months later, it was granted membership in the Paris-based Organization for Economic Cooperation and Development (OECD)—the “club” of advanced industrial countries.

Although this transformation may have been relatively gradual, its effects on the Mexican economy were revolutionary. Inflation fell from almost 30 percent in 1990 to 7 percent in 1994, while output growth resumed and averaged 3 percent a year. For three years, Mexico continued to draw on the EFF arrangement without major difficulty. In May 1992, the IMF extended the arrangement for a fourth year as a signal of its continuing support, but Mexico announced that it no longer intended to draw on it. By the time the arrangement expired a year later, Mexico was repaying its earlier drawings and appeared to have graduated decisively from dependence on official creditors. “Nevertheless,” averred Thomas Dawson (United States), “we still have some nagging fear that, with everything looking so right, something might yet be wrong.”³⁰

Other Major Brady Agreements

Argentina, Brazil, and Mexico in the early 1990s provide outstanding examples of how troubled and debt-ridden economies can be turned around through a combination of strong domestic economic policies and international support. The economies of other countries in the so-called Baker 15 (see Table 9.1, note b) changed less radically in these years, but several benefited from the Brady Plan, and almost all enjoyed better performance in the early 1990s than they had in the preceding years. Two of these countries, the Philippines and Venezuela, completed Brady deals early in the decade. Two others—Ecuador and Peru—completed the process later in the decade.

The Philippines

Economic recovery in the Philippines responded to the country’s major political changes. The election of Corazon C. Aquino as president in 1986 marked the beginning of democratization and a new era of cooperation with the international community. The IMF had provided financial assistance to the government of Aquino’s autocratic predecessor, Ferdinand Marcos, for a long time, but the country

²⁹The history of the IMF’s relations with Mexico in the 1980s is covered in Boughton (2001), pp. 281–318 (on the initial crisis in 1982), pp. 359–72 (on the effort to contain the crisis in 1983–85), pp. 437–53 (on the subsequent efforts of 1986–87), and pp. 510–15 (on the EFF arrangement and Brady agreement in 1989).

³⁰Minutes of EBM/92/64 (May 20, 1992), p. 16. The realization of that fear is discussed in Chapter 10.

in the first half of the 1980s had been troubled by inconsistent economic policies, financial corruption, and increasingly widespread political opposition to Marcos's rule. The Aquino government successfully restored a measure of economic stability to the Philippines, and the IMF supported that effort with a stand-by arrangement (1986–88) and an extended arrangement approved in May 1989.³¹

Performance under the EFF arrangement started off well, and in January 1990 the government used part of the proceeds to buy back a small part of its external debt at a 50 percent discount, under the terms of the Brady Plan. Completing the debt-reduction plan, however, proved to be more difficult.

A series of shocks hit the economy in 1990, including a drought, an earthquake, a major typhoon, and the sharp run-up in oil prices after Iraq's invasion of Kuwait. The government responded by easing macroeconomic policies, but that move put them out of compliance with the EFF arrangement, and the Fund suspended disbursements throughout 1990. In February 1991, the Fund canceled that arrangement and replaced it with a smaller and shorter-term stand-by arrangement, supplemented by a sizeable drawing under the terms of the Compensatory and Contingency Financing Facility (CCFF), as a way of restarting the adjustment program and catalyzing an agreement with bank creditors. The latter process took more than another year to complete, but the Philippines finally reduced its debt service to a sustainable level through a comprehensive Brady deal in July 1992.³²

Before the debt-reduction agreement, the burden on the economy had reached such a point that the IMF found it necessary (in April 1992) to declare the Philippines eligible for loans on concessional terms through the Enhanced Structural Adjustment Facility (ESAF). Following the debt-reduction agreement, the Philippines made a remarkable, though still gradual, recovery. President Aquino declined to run for reelection, and in June 1992 this young democracy recorded a smooth electoral transition to a new president, Fidel V. Ramos. Meanwhile, the Fund extended the stand-by arrangement twice, to March 1993, and the government met the conditions and drew on it regularly. A new extended arrangement was approved in 1994, but by then the Philippines was enjoying good access to private capital on favorable market terms. After the initial drawing, the authorities decided to treat the arrangement as precautionary and to borrow no more against it. In December 1995, the Fund removed the Philippines from the list of countries eligible to borrow from the ESAF, a privilege that the country had chosen not to use.

³¹The history of the IMF's relations with the Philippines through 1989 is covered in Boughton (2001), pp. 508–10 (on the 1989 EFF arrangement) and 619–29 (on the prolonged use of Fund resources from 1962 to 1989).

³²For the background to the 1991 arrangement, see "Philippines—Staff Report for the 1990 Article IV Consultation and Request for Stand-By Arrangement and Purchase Under the Compensatory and Contingency Financing Facility," EBS/91/17 (February 6, 1991). The 1992 Brady agreement is described in "Malawi—Request for a Fourth Annual Arrangement Under the Enhanced Structural Adjustment Facility," EBS/92/153 (September 16, 1992), pp. 44–45.

Venezuela

Another country in the Baker 15—Venezuela—got off to a fast start toward recovery from the debt crisis, but it was unable to sustain the momentum. In June 1989, in a strong signal of support for the macroeconomic policies being implemented by the newly elected president, Carlos Andres Pérez, the IMF approved an EFF arrangement for Venezuela with a potential total of \$5.3 billion, or just over three times the member's quota.³³ Bank creditors still balked at agreeing to reduce Venezuela's debt because they believed that this oil-exporting country had the resources to service its debts in full. After a few months, however, they relented, and the two parties reached a Brady-type settlement in June 1990.

Venezuela drew regularly on its extended arrangement through 1991, but then ran into difficulties. Despite high oil prices in the months surrounding the Gulf War, it was politically difficult for Pérez to get the Venezuelan Congress to put fiscal policy on a solid footing, either by cutting expenditure or by enacting a value-added tax. As oil prices began to fall again, the government found itself in a fiscal dilemma, and the end-1991 performance criteria were breached. The authorities and the Fund never could reach agreement on a plan to restore fiscal balance. Two attempted military coups during 1992 did not help matters, and the arrangement expired in March 1993 with almost \$2.6 billion (SDR 1.85 billion) unused.

The Pérez government collapsed in 1993 in a financial corruption scandal that led to a banking crisis in 1994. Pérez's eventual successor, Rafael Caldera, was unable to restore stability, and the economy stagnated for several years until oil prices again spiraled upward in the late 1990s. Venezuela's last IMF borrowing of the decade occurred in 1996, when the government made a promising start on a fiscal retrenchment program, and the Fund responded by approving a one-year stand-by arrangement. Implementation of that program also fell short of expectations. The government made only the initial drawing, and its request for a follow-up EFF arrangement had to be abandoned.

Ecuador

Ecuador, like Venezuela, benefited from high world prices for its oil exports in the early 1990s. The government also tried to take more lasting measures to limit its fiscal deficit. In anticipation of a Brady agreement with bank creditors, the IMF approved a stand-by arrangement in December 1991 with a provision for setting aside part of each drawing to finance future debt reduction. Unfortunately, the country's fiscal effort soon faltered, no drawings were made after the initial one, and Ecuador's negotiations with bank creditors made little progress. By 1994,

³³The amount approved at that time was the equivalent of \$4.6 billion (SDR 3.7 billion). The decision also provided for a possible augmentation by 40 percent of quota once agreement was reached with bank creditors. The Fund eventually augmented it by a much smaller amount (11 percent of quota) in December 1990; see Boughton (2001), pp. 515–19.

a new government was having more economic success, and the Fund made a second effort to help rid Ecuador of its commercial debt overhang.

Once the government had achieved some early successes in reducing inflation, removing inefficient subsidies, and stabilizing its fiscal accounts, the Fund approved a 22-month stand-by arrangement in May 1994. Ecuador did not immediately draw on it, but the Fund's approval enabled both the Paris Club and commercial bank creditors to reschedule Ecuador's debts. In November, the Fund reinforced its support by releasing the set-asides and augmenting the size of the arrangement to help finance the conversion of bank debt into Brady bonds and other debt- and debt-service-reduction operations. Ecuador then made a single drawing of about \$146 million (SDR 98.9 million). As 1994 drew to a close, Ecuador appeared to be progressing steadily on a path of sustainable economic growth.

This period ended suddenly in January 1995, when a long-simmering border dispute with Peru erupted into open warfare. The cost of the conflict and its disruptions to normal activity halted the economic program. The Fund provided nonfinancial assistance by having the staff monitor the government's economic program for 1995–96, but stability remained out of reach.³⁴

Peru

Next door to Ecuador, Peru was among the last countries to issue Brady bonds. At the beginning of the decade, Peru had protracted arrears to the Fund and other creditors, and it had been ineligible to borrow from the Fund since 1986. The outlook brightened considerably in June 1990, when Alberto Fujimori won the election to succeed Alan García as president. García had initiated Peru's payments arrears by decreeing that the government would use no more than 10 percent of its export receipts to service its external debts. Fujimori pledged to take a more cooperative approach and to adjust economic policies in an effort to strengthen the country's finances and restart economic growth.

The IMF responded quickly to Fujimori's initiative. As discussed in Chapter 16, it accepted Peru into the first group of countries that were eligible to undertake a Rights Accumulation Program to settle arrears by establishing track records of good economic policies. Peru successfully completed the program in March 1993, leading the Fund to approve an EFF arrangement for \$1.4 billion (SDR 1,018 million, or 218 percent of quota). That arrangement provided for 25 percent of each scheduled drawing to be set aside to finance an anticipated debt-reduction agreement with commercial creditors.

After making the March 1993 drawing from the Fund, Peru recorded a remarkable turnaround in economic performance. Thanks in part to a major privatization effort and liberalization of international trade, private capital began flowing into Peru in steadily increasing amounts. Growth accelerated, the exchange rate appreciated, and inflation fell to internationally comparable levels. Not even the 1995 military conflict with

³⁴Subsequent developments are discussed in Chapter 12.

Ecuador could throw this improvement substantially off track. The government met all the conditions in the EFF arrangement, but it chose not to borrow any of the money after the initial drawing, instead treating the arrangement as precautionary and as a continuing signal of international support. Ironically, this strong performance made reaching a debt-reduction settlement with commercial creditors more difficult, and those negotiations continued throughout the three years the arrangement was in effect.

The final stage in Peru's resolution of its debt overhang came in 1996–97. Peru reached an agreement in principle with its commercial creditors in June 1996, and the Fund approved another three-year EFF arrangement the following month. On that basis, and with an additional commitment from the Fund and Peru to maintain enhanced surveillance for three years after the arrangement expired, the Paris Club granted Peru a multiyear rescheduling agreement. Peru successfully carried out the economic program and completed the debt-reduction operations in February 1997. Peru drew on the arrangement primarily to help finance the issuance of Brady bonds and the repurchase of some of its bank debt.

The Rest of the Baker 15

In the first half of the 1990s, most of the other countries in the Baker 15 enjoyed achievements comparable to those discussed above. **Yugoslavia**, which had an IMF stand-by arrangement in 1990, posed the most problems upon its descent into civil war. The federation dissolved in 1992 and was replaced by five successor states, each of which accepted responsibility for a share of the outstanding debts. As hostilities continued, those successors had varying degrees of economic success and varying access to IMF support for the rest of the decade (see Chapters 2 and 5).

At the other extreme, **Chile** recovered on its own. After Augusto Pinochet stepped down as president in 1989 and allowed free elections to resume, private capital began flowing into Chile in such quantities that the government felt it prudent to impose selective controls on inflows. These “speed limits” (differential reserve requirements on short-term inflows) generally worked well and became a model for applying capital controls effectively, so long as they are limited in scope and duration and applied in an economy with a sound financial system.³⁵ Chile had no need for official financial support in the 1990s.

The two low-income countries in this group—Bolivia and Côte d'Ivoire—reached debt-reduction agreements with commercial creditors in which they bought back their debts at a deep discount using funds provided by the World Bank. In August 1989, the Bank established a Debt Reduction Facility for the lowest-income (“IDA-only”)

³⁵For an analysis of how Chile's controls worked, see Cowan and de Gregorio (2007). For a review of the IMF's reaction to the controls, which began positively, turned negative after the first few years, and then again became more favorable, see Independent Evaluation Office (2005), p. 28. Chile abolished its controls in September 1998.

countries, funded by IBRD net income and by cofinancing from donor countries.³⁶ **Bolivia** bought back \$170 million of commercial debt in 1991–93 for 16 percent of its face value. **Côte d’Ivoire** drew on the facility to buy back \$724.5 million at 24 percent of its face value through 1998. The IMF’s role in these two cases was to provide financing, mostly through its own concessional facility, the ESAF,³⁷ to support the countries’ macroeconomic stabilization and structural reform programs; and to provide debt relief through the Heavily Indebted Poor Countries Initiative (see Chapter 13). IMF support also was a precondition for the participation of most donors in debt relief.

As noted above, **Colombia** and **Nigeria** took advantage of the IMF’s seal of approval but did not request any loans during this period. Nigeria obtained a Brady agreement in 1991 while implementing a program supported by a precautionary stand-by arrangement from the IMF. **Morocco** issued Brady bonds as part of a 1990 rescheduling agreement with bank creditors. The IMF supported that process with two stand-by arrangements, in 1990 and 1992. **Uruguay** began issuing Brady bonds in 1991, financed mostly with its own money and loans from the World Bank and the IDB, but also in small part by set-asides from a Fund stand-by arrangement. Uruguay also made a strong effort to liberalize its economy, with good results on both growth and price stability. A successor stand-by arrangement in 1992 was mainly for precautionary and signaling purposes.

Other Debt-Reduction Agreements

Those classified as the Baker 15 in 1985 were not the only developing countries to begin the 1990s with an unsustainable overhang of debt to foreign commercial creditors. A brief review of the others illustrates just how widespread and diverse the circumstances were, and the extent to which the IMF had to adapt its responses to those circumstances.

³⁶Within the World Bank Group, the International Bank for Reconstruction and Development (IBRD) lends to middle-income developing countries on market terms, and the International Development Association (IDA) lends to low-income countries on concessional terms. Near the margin, some member countries (known as “blend” countries) are eligible for a mix of loans from both agencies. Those that receive loans only from the IDA are referred to as IDA-only countries. For an explanation of how the Bank’s facility operated, see the World Bank website, at <http://go.worldbank.org/2CRHS4N500>.

³⁷In the 1980s, the Fund lent regularly to Côte d’Ivoire on market terms, through an extended arrangement, five ordinary stand-by arrangements, and drawings on the Compensatory Financing Facility (CFF) and the Buffer Stock Financing Facility (BSFF). After one more stand-by arrangement in 1991–92, the Fund shifted to concessional financing for Côte d’Ivoire and approved two ESAF arrangements (1994–97 and 1998–2001). The latter arrangement included an augmentation of access by \$70 million (SDR 51 million) to help cover the upfront costs of restructuring commercial debt; see “Côte d’Ivoire—Staff Report for the 1998 Article IV Consultation and Request for Arrangements under the Enhanced Structural Adjustment Facility,” EBS/98/36 (March 4, 1998), pp. 7 and 20. As noted in Chapter 13, that augmentation was the only instance in which ESAF resources were approved for use in a commercial debt–reduction operation.

The Dominican Republic

The Dominican Republic began the decade with a record of deteriorating macroeconomic performance and policies. After three years with a growing fiscal deficit financed by inflationary domestic policies and heavy borrowing abroad, in mid-1989 the government could no longer service its outstanding debts. Already in arrears to commercial and official creditors, in August 1989 the country also fell into arrears on its obligations to the IMF.³⁸

In the summer of 1990, the authorities embarked on a serious effort to get their fiscal accounts on a more sustainable footing, then entered into extended discussions with the Fund staff aimed at settling arrears and obtaining new financial and other assistance. They settled their arrears to the Fund in April 1991 (see Chapter 16), and in August the Fund approved a stand-by arrangement and a CCFE drawing. In view of the country's large outstanding debts, the stand-by arrangement was small (\$52 million, equivalent to 35 percent of quota).³⁹ Its primary purpose was to send a signal of confidence that would catalyze both a debt rescheduling by official Paris Club creditors and a debt-reduction agreement with commercial creditors.

The signaling strategy worked. The Paris Club agreed to reschedule the Dominican Republic's debts in November 1991, and negotiations with an advisory committee of commercial bank creditors began shortly afterward but proceeded slowly. Economic conditions continued to improve through most of 1992, and the authorities chose not to draw on the stand-by arrangement until December.⁴⁰ Ironically, that choice seems to have made negotiations with bank creditors more difficult, because it led the banks to believe the country had the capacity to repay its existing debts. The Fund staff, however, judged that the country's external balance was still fragile and that the country still deserved a Brady deal. Agreement in principle with the banks was finally reached in April 1993, and the authorities resumed making partial interest payments to banks in May.

The Fund provided further assistance in the second half of 1993 in the form of a new stand-by arrangement and another drawing under the CCFE. Although the country's economic performance deteriorated somewhat in 1994, the economy had recovered enough that the authorities could sign a final debt-reduction agreement with its bank creditors in February. Over the next several months, the authorities bought back part of the debt at a deep discount and issued Brady bonds to cover much of the rest. They

³⁸For an overview of that period, see "Dominican Republic—Staff Report for the 1989 Article IV Consultation," SM/89/265 (December 13, 1989).

³⁹The CCFE drawing was for \$60 million (40 percent of quota) and was intended to compensate for a drop in revenues from ferronickel and other exports and the increased cost of oil imports in the wake of the Gulf War.

⁴⁰Following completion of the second review of the program by the Executive Board in November 1992, the authorities drew all but a small portion of the stand-by arrangement in December. They drew the remaining balance in February 1993, and the arrangement expired in March.

also reached a series of agreements with official creditors. By the end of 1994, the Dominican Republic had fully resolved its debt crisis, and it had no further need to borrow from the IMF until a devastating hurricane hit the island in 1998 (see Chapter 5).

Bulgaria

Bulgaria's debt crisis was the least of its problems. One of the Soviet Union's closest allies, Bulgaria was not a member of the IMF and was heavily dependent on its trading and financial links within the Soviet bloc. As the Soviet economy crumbled in the second half of the 1980s, Bulgaria's foreign trade declined along with it. The government tried to adapt by gradually replacing the centralized command structure with a somewhat more liberal system (for example, by legalizing some forms of private ownership). Similarly to the Soviet system under Gorbachev, this partial relaxation left the economy in limbo, neither controlled sufficiently to function in the old way nor sufficiently free to function through market activity. The government forestalled collapse for a time by borrowing increasingly (and at increasingly shorter maturities) from commercial banks in western Europe and Japan, but by the end of the 1980s the burden of that debt was becoming unmanageable. Meanwhile, a popular uprising in November 1989 forced out Bulgaria's long-standing communist leader and Soviet loyalist, Todor Khristov Zhivkov. In March 1990, when Bulgaria stopped servicing its debt to foreign banks, the default was but one manifestation of general economic and political disintegration.

With Zhivkov out of the way, the Bulgarian Communist Party moved quickly in 1990 to reform itself and to begin to reorient the country away from the Soviet sphere. In February, the government applied for membership in the IMF. In May, it signed an agreement on economic cooperation with the European Communities. It held elections in June, which it won narrowly under its new banner of the Bulgarian Socialist Party. Two months later, a new coalition government was formed in which the Socialists shared power with the opposition Union of Democratic Forces. In the meantime, the economic downturn continued, not only because of doubts about the government's ability to manage the economy but also because of external shocks: the disintegration of the Soviet-led trading bloc (the Council on Mutual Economic Assistance, or CMEA) and the invasion of Kuwait and the impending outbreak of the Gulf War. The Fund staff later estimated that these shocks, by squeezing export markets and worsening the terms of trade, worsened Bulgaria's balance of payments by \$3.5 billion, equivalent to 17 percent of GDP.⁴¹ Notwithstanding these setbacks, the coalition government was unified in its desire to reform the economy and ultimately to integrate it with western Europe.

The IMF responded positively to the request for membership. Bulgaria formally joined during the IMF/World Bank Annual Meetings in Washington in September

⁴¹"Bulgaria—Staff Report for the 1992 Article IV Consultation and Request for Stand-By Arrangement," EBS/92/55 (March 20, 1992), p. 2.

1990 (see Chapter 2). Bulgaria's commercial bank creditors also responded positively, by forming an advisory committee chaired by the principal creditor, Deutsche Bank. The committee accepted a temporary standstill on outstanding loans and agreed to consider a debt-reduction deal under the terms of the Brady Plan.⁴² Thus, by the fourth quarter of 1990, Bulgaria had at least made a start at normalizing its economic and financial relationships with the international community.

Before the government could implement its reform agenda, it needed to develop administrative capacity throughout all departments. During the first two years of Bulgaria's membership, the Fund sent about 20 technical assistance missions to Bulgaria, covering a wide range of issues including fiscal and central bank operations, bank supervision, foreign exchange management, national accounts, price statistics, and the legal system.⁴³ In addition, the IMF Institute held three training seminars in Sofia for Bulgarian officials, and the Fund opened a resident office in the city. These technical and training services continued throughout the decade.

As the Fund prepared to begin lending to Bulgaria, the staff saw clearly that the country's financial needs were so severe that it was likely to be dependent on official credits, including from the Fund, for a prolonged period (see Chapter 5). In this case, the Fund would have to do both what it had always done best—acting quickly to manage a crisis situation—and what it was usually reluctant to be drawn into—lending steadily to a country for many years. Eventually, however, normalization with commercial creditors and resumption of economic growth enabled the Fund to withdraw to the sidelines.

IMF lending to Bulgaria began in February 1991, with a loan of \$87 million (SDR 60.6 million) to help cover the increased cost of importing oil resulting from the Gulf War. This CCF drawing was followed quickly by a stand-by arrangement for \$385 million (SDR 279 million) and a promise to increase the arrangement by up to \$107 million if the price of oil continued to rise substantially. Bulgaria successfully carried out its policy commitments and borrowed almost all of the money over the next year. These sums, however, were minor relative to the country's financing needs, and a sizeable gap remained.⁴⁴

Upon completion of the first stand-by arrangement, the Fund quickly agreed to provide another. This second arrangement, approved in April 1992, was predicated on the assumption that the Bulgarian authorities would continue to negotiate with their commercial creditors but would not reach a final agreement during the 12-month life of the Fund's commitment. The Fund would lend up to \$212 million (SDR 155 million) over the coming year, without the set-aside or augmentation provisions that

⁴²"Bulgaria—Calculation of Quota," EB/CM/Bulgaria/90/1 (August 6, 1990), pp. 11 and 69.

⁴³See "Bulgaria—Staff Report for the 1992 Article IV Consultation and Request for Stand-By Arrangement," EBS/92/55 (March 20, 1992), Appendix I.

⁴⁴The oil-price contingency was offered under the terms of the External Contingency Mechanism that the Fund enacted in 1988 by converting the CFF into the CCF (see Chapter 5).

would normally have been included when a Brady deal was pending. It was understood, however, that the only way that Bulgaria would be able to repay these and earlier loans from the Fund would be by reaching an agreement on debt reduction with its other creditors.⁴⁵

The coalition government ran into increasing difficulty maintaining broad support for its reform program, and in October 1992 it lost a parliamentary confidence vote and had to resign. Its successors were less committed to the reform process and for the next four years achieved little economic progress. When Bulgaria failed to meet the monetary targets in the Fund-supported program, the final drawing under the stand-by arrangement was not allowed.⁴⁶ Despite these setbacks, the Paris Club of official creditors rescheduled Bulgaria's outstanding debts in December, and negotiations continued with the committee of commercial creditors.

Bulgaria managed for a year without IMF financial assistance, but lending resumed in April 1994. At that time, the Fund approved a small stand-by arrangement (Bulgaria's third), for \$98 million (SDR 69.7 million, or just 15 percent of quota), plus an immediately available \$163 million (SDR 116.2 million) through the Systemic Transformation Facility. By this time, Bulgaria had reached agreement in principle with its commercial bank creditors, and was progressing rapidly toward final resolution of the debt crisis that had begun four years earlier. To help finance the resolution, the Fund also promised to consider augmenting the stand-by arrangement once a final agreement was reached.⁴⁷

On July 28, 1994, Bulgaria completed its debt-reduction deal, spending \$716 million of its own reserves to buy the necessary Brady bonds for collateral, buy back some of the outstanding loans at a discount, and pay other costs (Houben, 1995). It could make those payments largely because earlier loans from the Fund, the World Bank, and other official lenders had enabled the central bank gradually to build up a reserve cushion, but now it needed to rebuild its reserves fairly quickly. On September 12 the Fund doubled the size of the stand-by arrangement and made the additional amount (\$102 million) available immediately. With additional support from the World Bank, the Japanese Export-Import Bank, and the Group of 24 (G24), Bulgaria replenished its reserves and fully financed its balance of payments for the rest of the year.⁴⁸

Although Bulgaria resolved its debt crisis by 1994, the country's economic potential remained unrealized, primarily because of weak political will to make the transition

⁴⁵See "Bulgaria—Staff Report for the 1992 Article IV Consultation and Request for Stand-By Arrangement," EBS/92/55 (March 20, 1992), pp. 17–19.

⁴⁶The arrangement provided for SDR 155 million to be drawn in five equal installments of SDR 31 million. The first four were made on schedule, but the fifth was not.

⁴⁷See "Bulgaria—Request for Stand-By Arrangement and Purchase Under Systemic Transformation Facility," EBS/94/52 (March 14, 1994), and minutes of EBM/94/33 (April 11, 1994).

⁴⁸These developments are detailed in "Bulgaria—Augmentation of Stand-By Arrangement, Waiver of Performance Criteria, Financing Assurances Review, and Consultation Under Article XIV," EBS/94/160 (August 16, 1994).

from central planning to reliance on market forces. When the Socialist Party regained power in January 1995, the conditions were already ripe for a new financial crisis (see Chapter 6).

Poland

Poland's circumstances at the beginning of the decade superficially resembled those in Bulgaria. A communist dictatorship had been forced out of power, and a new democracy was being established. Four decades of central planning were being scrapped to make room for a market economy. A decade of poor economic performance and partial isolation had left the government with an unsustainable overhang of external debt that would take at least four years to clear. There the similarities ended.

The government that won Poland's first modern free elections in June 1989 moved with extraordinary boldness and speed to allow prices to rise to market-clearing levels, remove impediments to private enterprise, and stabilize macroeconomic policies. After lengthy discussions with the IMF staff and other external advisors, the architect of this "big bang" strategy—Leszek Balcerowicz, the newly installed finance minister and deputy prime minister—decided to peg the exchange rate to the U.S. dollar. The peg would provide a nominal anchor for policies and expectations, and the rate Balcerowicz selected was amply depreciated to ensure that Polish exports would be competitive in world markets for at least the first year.⁴⁹ Unfazed by widespread skepticism about the viability of this plan, Balcerowicz had the key elements in place by the end of the year.⁵⁰ The transition would be far from easy or smooth, but over the next several years Poland was to record a growth rate and a record of financial stability that easily outstripped those of its neighboring transition economies.

The IMF began lending to Poland in February 1990, with the approval of a stand-by arrangement for \$723 million (SDR 545 million, or 80 percent of quota). A central goal of the program was to prevent the necessary sharp increase in consumer prices from spiraling into sustained inflation. Price inflation was running at a frightening pace of nearly 80 percent a month, but the government was trying to restrict both credit expansion and government outlays to stop the process as quickly as possible. A group of bilateral donors had assembled a \$1 billion currency stabilization fund for Poland, and the Fund's stand-by arrangement was intended to help rebuild the central bank's foreign exchange reserves and instill confidence in the government's shock program.

This strategy soon ran into trouble when output and employment fell much more than anticipated. In the second half of 1990, the government reacted by easing policies

⁴⁹In May 1991, the zloty was devalued by 14 percent and pegged to a basket of currencies instead of just to the dollar.

⁵⁰For the background to Poland's membership in the Fund (which was restored in 1986 after a hiatus of 36 years) and the initiation of the transition in 1989–90, see Boughton (2001), pp. 986–92. For inside accounts of the negotiation and functioning of the initial program, see Lane, Ossowski, and Russo (2009) and, in the same volume, the comment on that article by Balcerowicz.

and granting some large wage increases, but those moves brought little relief. Doubts began to settle in, both domestically and abroad. Poland made the first three drawings under the 1990 stand-by arrangement, but it then went out of compliance and did not make the last two.⁵¹

By November the government was ready to make a renewed stabilization effort, and it entered into a new round of negotiations with the Fund. Peter Hole (Assistant Director, European Department), who had helped negotiate the first arrangement, took charge of these negotiations, assisted by Mark Allen, who had moved to Warsaw as Senior Resident Representative, and a team of five Fund economists. Their first discussions, however, could only be preliminary, because the mission team arrived at a critical moment in Poland's political history. Lech Wałęsa, the former electrician at the Gdansk shipyards who spearheaded the labor movement in the 1980s and made *Solidarność* into a household name around the world, became the country's first democratically elected president in December 1990. Balcerowicz remained as finance minister, but the new government would have to reassess just how far and how fast to push the liberalization of the economy.

The authorities understood that exiting successfully from the dismal trade-off it faced between financial stability and economic growth required the country to shed a substantial part of the debt to foreign creditors it had inherited from the failed regime of the 1980s. More than 70 percent of that debt (\$33 billion) was owed to Paris Club creditors. Commercial banks held 25 percent (\$10 billion), and the rest (\$2 billion) was owed to Russia and other former members of the CMEA. Poland needed to begin by negotiating a new program with the IMF. That would unlock the Paris Club, which in turn would open the door to agreements with commercial and other creditors.

The first critical stage was completed in late February 1991, after nearly five weeks of negotiations in Warsaw between the two teams led by Balcerowicz and Hole. The government now had a viable program for the next three years, which the Fund was ready to support with a sizeable extended arrangement.

The Paris Club met in mid-March, with Jean-Claude Trichet (director of the French Treasury) in the chair. This meeting was to be decisively important, both for Poland and for the Paris Club. For the first time, official creditors agreed (provisionally) to reduce the stock of a debtor's outstanding principle. The agreement did not come easily. Poland was asking for a 75 percent reduction in the present value of its debt. In preliminary discussions, most official creditors expressed willingness to accept some reduction, but none was prepared to cut that deeply. Most of them wanted to cap the reduction at less than 50 percent, but the IMF—eager to ensure that Poland would be able to finance its adjustment program—was quietly lobbying for an agreement

⁵¹“Republic of Poland—Staff Report for the 1991 Article IV Consultation, Request for an Extended Arrangement and External Contingency Mechanism, and Purchase Under the Oil Element of the Compensatory and Contingency Financing Facility,” EBS/91/60 (April 4, 1991), p. 9.

close to Poland's request. Trichet proposed 50 percent as a reasonable compromise, and that target was eventually accepted.⁵²

The Paris Club offer became part of a comprehensive debt-restructuring plan unprecedented in its scope and generosity. As soon as the Fund formally approved the EFF arrangement, official creditors would take actions to reduce the net present value of Poland's debt by 30 percent. If Poland successfully carried out its commitments under the three-year Fund-supported program, official creditors would reduce those debts by another 20 percent of their initial value, for a total reduction of 50 percent.⁵³

The IMF approved the EFF arrangement on April 18, 1991. The financing package offered by the Fund totaled about \$2.6 billion over three years, of which \$325 million would be available at once. The rest would be contingent on performance and on external developments and would be phased in over the next three years.⁵⁴ The Paris Club met again on April 21 and finalized the terms of its debt-reduction agreement.

When the IMF approved the EFF arrangement, the staff expected Poland would soon reach a debt-reduction agreement with its commercial creditors and private capital would gradually start flowing into Poland to restore longer-term viability to the balance of payments. Those assumptions were an important piece of the expected financing of the balance of payments, but they turned out to be overly optimistic.

A large part of the problem in the negotiations with commercial creditors was a sharp difference in view on how much debt reduction was consistent with market conditions. Before the Paris Club made its exceptional offer, Poland's commercial debt was trading in the secondary market at prices close to 20 percent of face value. As soon as Trichet announced the breakthrough in March 1991, the market price rose to 30 percent. As far as the banks were concerned, that higher level was now the minimum price at which a settlement could be reached. The Fund, however, supported the government in arguing that the benefit of the Paris Club offer should go to Poland, not to

⁵²See handwritten and untitled memorandum dated March 12, 1991, from Thomas Leddy (Deputy Director, ETR) to Richard D. Erb (Deputy Managing Director), and memorandum from Hole to the Managing Director, "Poland—Paris Club" (March 15, 1991); IMF archives, Poland 1991 Country Files, OMD-AD, Box 7630, Accession 1995-0180-0005.

⁵³"Republic of Poland—Report on External Debt Negotiation," SM/91/103 (May 17, 1991).

⁵⁴The main element in the package was the EFF arrangement, for \$1.7 billion (SDR 1,224 million, or 180 percent of quota). One-fourth of each scheduled disbursement was to be set aside and released later if needed to help finance a Brady-type debt- and debt-service-reduction agreement. In addition, the Fund committed up to \$600 million as a contingency provision under the CCFF, to be made available to Poland if oil or natural gas prices were to rise by more than anticipated and were to put pressure on the balance of payments. The third component, also under the terms of the CCFF, was intended to compensate for the temporary increase in the cost of fuel imports associated with the Gulf War. That component provided an immediate disbursement of \$221 million (SDR 162.6 million) and a possible \$119 million more (SDR 87.6 million) once more complete data were in and assuming the conditions for it were met. For a detailed description, see "Republic of Poland—Staff Report for the 1991 Article IV Consultation, Request for an Extended Arrangement and External Contingency Mechanism, and Purchase Under the Oil Element of the Compensatory and Contingency Financing Facility," EBS/91/60 (April 4, 1991).

the foreign bank creditors. That position implied that Poland should be able to buy back or restructure its commercial debt at a cost approximating 20 cents to the dollar. The banks balked, and the ensuing dispute took three years to resolve.

The Polish economy survived during those three years through a combination of reasonably stable and well-implemented macroeconomic policies, surprisingly strong performance by state-owned industries now operating under hard budget constraints and market discipline, and continuing support from the Fund and other official creditors. Once investors recognized the country's pent-up potential, private capital also began to flow into the economy.

Poland satisfied the policy conditions in the EFF arrangement, but the authorities chose not to make any further drawings. As the financing gap shrank, the Fund canceled the arrangement in March 1993 and replaced it with a smaller one-year stand-by arrangement on which the authorities initially chose not to draw. Finally, in March 1994, just as a debt-reduction agreement with commercial creditors was finally being reached, Poland borrowed \$500 million (SDR 357 million), or two-thirds of the total available under the arrangement.⁵⁵

By 1994, the Polish economy was shifting into high gear, with real GDP growing by 4.5 percent a year. Inflation was still a worry, as was the persistence of large income inequalities that had arisen when the old socialist support system was withdrawn. Tellingly, in discussions with the IMF, the authorities worried about these sticking points more than the staff did. The Fund perceived that the government clearly had the capacity and the will to overcome the difficulties, though it would take time.⁵⁶ In August, the Executive Board approved one last loan to Poland, a two-year stand-by arrangement for slightly less than \$800 million (SDR 545 million, or 55 percent of quota). Two months later, the Brady debt-reduction agreement with commercial bank creditors was finally activated, enabling Poland to restructure \$14.4 billion of debt at an upfront cost of \$1.9 billion. The market-equivalent value of the restructured debt was estimated to be 27 cents on the dollar, comfortably near the range of secondary market prices around the time of the 1991 Paris Club offer and well below the secondary market price in effect when the agreement in principle was signed in March 1994 (39 cents).⁵⁷

On October 26, 1994, just one day before the signing ceremony for the Brady deal, the Executive Board approved a disbursement of \$423 million (SDR 283 million) to help finance that deal. Poland's indebtedness thus reached an all-time peak of just 90 percent of quota, and after that Poland had no further need for IMF borrowing.⁵⁸

⁵⁵The Fund's approval of the March 1994 disbursement also enabled completion of the second stage of the Paris Club debt-reduction agreement.

⁵⁶"Republic of Poland—Staff Report for the 1994 Article IV Consultation and Review Under the Stand-By Arrangement and Review on Financing of the Program," EBS/94/48, (March 11, 1994).

⁵⁷"Republic of Poland—Request for Financial Support for a Debt and Debt Service Reduction Operation," EBS/94/195 (October 12, 1994).

⁵⁸For more on Poland's recovery in the early 1990s, including a figure showing its indebtedness to the IMF, see Chapter 6.

Poland's economic transformation continued at a remarkable pace. The country accepted the currency-convertibility obligations of Article VIII in June 1995, repaid all of its IMF debts a month later, and joined the OECD in November 1996. Within a few years, Poland would be a creditor country in the IMF and would be well on its way to joining the European Union in 2004.

Costa Rica

Costa Rica got an early start at recovering from its decade-long debt crisis by becoming the first country to benefit from the Brady Plan, in May 1989. That fast takeoff, however, masked underlying weaknesses preventing the country from taking full advantage of its debt reduction.

The 12-month stand-by arrangement the Executive Board approved in 1989 covered too short a time to provide the confidence bank creditors needed before they would agree to reduce Costa Rica's outstanding debts. The Fund was not willing to commit its own resources for a longer period because Costa Rica's highly respected president—Oscar Arias Sanchez, the winner of the Nobel Peace Prize in 1987—would be stepping down in 1990, and his successor was not yet known. This political uncertainty led to a vicious circle. As negotiations with bank creditors dragged on, the authorities were unable to meet their program targets. That meant they were unable to draw on the stand-by arrangement, which made the debt settlement more difficult, further worsening the fiscal outlook. Fortunately, the U.S. government and other official creditors recognized the problem and stepped in with bilateral financing for a special Voluntary Contribution Account established and administered by the IMF.⁵⁹ Bank creditors then quickly agreed to a debt-reduction deal in May 1990 that included buybacks and negotiable bonds, though not collateralized Brady bonds.⁶⁰

Following that agreement, Costa Rica continued to seek and obtain the support of the IMF throughout most of the 1990s, though without borrowing large amounts of money. This effort had only mixed success through the decade. In April 1991, the Fund approved a one-year financing package totaling \$119 million (SDR 88.3 million, or 105 percent of quota). Of that, \$74 million was disbursed immediately. The rest was contingent on conditions and on the strength of economic policies. A few months later, the government ran into difficulty servicing its debts to other external creditors, and most of the conditional and contingent financing went unused.⁶¹

⁵⁹Decision No. 9420-(90/65), April 25, 1990. Also see PR/90/19 (May 2, 1990).

⁶⁰For the background to Costa Rica's debt crisis and the 1989–90 settlement, see Boughton (2001), pp. 499–508.

⁶¹The initial disbursement in April 1991 included a \$45 million drawing under the CCF to compensate for the high price of oil imports and a \$29 million drawing on the stand-by arrangement. That left a \$16 million balance on the stand-by arrangement to be disbursed later if the conditions were met, and a possible \$28 million disbursement to be released under the contingency window of the CCF in the event of adverse external developments. The contingency element was not activated, and the only further drawing on the stand-by arrangement was \$5.5 million in April 1992.

By 1993, Costa Rica's financing needs eased somewhat but were still too high for comfort. The authorities requested another stand-by arrangement, but this time they indicated they just wanted the Fund's seal of approval; they intended to treat the arrangement as precautionary and not draw on it if they could avoid doing so. The Fund approved a 10-month arrangement, but again the program went off track after a few months, and the midyear review was not completed.

The country's final stand-by arrangement of the decade, approved in November 1995, provided for six drawings over 15 months, totaling \$78 million (SDR 52 million, 62 percent of quota). Again, the authorities treated the arrangement as precautionary, and again they were unable to meet the program conditions for more than a few months. Even so, they continued to repay their earlier borrowings, and in March 1997 they made the last scheduled payment. That November, the Fund agreed to a staff-monitored program that stayed in effect until a newly elected government could take office in May 1998. By that time, the Costa Rican economy was on a more sustainable path, and the government was able to exit fully from dependence on IMF support.

Other Heavily Indebted Countries

The only other middle-income country to reach a debt-reduction agreement with commercial creditors was **Panama**. The circumstances were a little unusual, in that Panama started the decade in arrears to the IMF and had been declared ineligible to borrow. That situation had arisen out of a dispute with the United States that blocked Panama from getting access to its foreign exchange reserves and thus from repaying its outstanding IMF loans.⁶² Following settlement of that dispute in 1990, Panama successfully carried out a Fund-monitored program that helped to restore economic growth and financial stability. That program enabled the government to obtain financial support from the United States and other creditor countries that it could use to settle its arrears to the IMF in 1991 (see Chapter 16). Panama then had two stand-by arrangements with the Fund, in 1992–94 and 1995–97, and turned its attention to regularizing relations with other creditors. The second stand-by arrangement included set-aside and augmentation provisions in anticipation of a Brady agreement with commercial bank creditors. Those provisions were activated when an agreement was concluded in 1996. Panama had one last borrowing arrangement, a three-year EFF arrangement approved in December 1997.⁶³

As the experiences of Bolivia and Côte d'Ivoire (both low-income members of the Baker 15) illustrate, the burden of excessive indebtedness to international commercial

⁶²For the history of that dispute, which culminated in a U.S. invasion and the arrest of Panama's military ruler, see Boughton (2001), pp. 799–802.

⁶³Disbursements under the EFF arrangement stopped in 1998, owing to fiscal overruns. After presidential elections in 1999 and the transfer of the Panama Canal from U.S. to local ownership at the end of 1999, a new government entered into a stand-by arrangement with the Fund, but it treated the arrangement as precautionary and did not draw on it. Panama repaid all the principal on its outstanding obligations to the Fund by 2008.

banks was not limited to middle-income countries. By the end of the 1990s, the World Bank's Debt Reduction Facility for IDA-Only Countries had financed or was preparing to finance reductions in commercial debt for more than 20 low-income countries (see footnote 36). As discussed in Chapter 13, the IMF provided related financial assistance on concessional terms to all those countries.

Finally, two other middle-income countries experienced debt crises in the 1980s: Hungary and Jamaica.⁶⁴ Neither was included in the Baker 15, and neither one had a debt-reduction agreement in the 1990s. They did, however, benefit from stand-by arrangements in the early 1990s to help them grow out of and resolve their debt difficulties. In both countries, the problem stemmed from the debt crises that were spreading around the developing world in the early 1980s.

Hungary joined the IMF in 1982, after its bank debt had already become unsustainable. Extensive borrowing from the Fund throughout the rest of the 1980s did little good, largely because the government failed to meet the program conditions and justified its loan requests with inaccurate data (Boughton, 2001, pp. 980–86). Only after the country's first democratic elections brought in a new government was Hungary able to normalize relations with creditors and resolve its debt problems. Hungary borrowed steadily through 1993 but repaid all those loans by 1998.

Jamaica was a prolonged user of IMF financing, with six stand-by and three extended arrangements from 1973 through the end of the 1980s, plus drawings on the CFF and the Oil Facilities. Jamaica's debt to the IMF peaked in June 1985, following the successful completion of a stand-by arrangement. At that time, Jamaica was struggling to stay current on its interest payments to commercial creditors and was staying afloat only by rescheduling the repayment of principal and occasionally of interest. Subsequent financing from the IMF was designed to catalyze rescheduling agreements with commercial and official creditors and to provide for a gradual unwinding of Jamaica's outstanding debts to the Fund. In 1986 and 1987, Jamaica fell behind in its payments to the Fund, but not so badly as to trigger a declaration of ineligibility to keep borrowing. The government's difficulties in managing its external debt continued throughout the rest of the decade and into the 1990s.

By 1990, Jamaica's economy and its finances had strengthened, putting it on the verge of regularizing its relations with external creditors. In June of that year, soon after the IMF approved a 14-month stand-by arrangement, commercial bank creditors extended new terms for a multiyear rescheduling agreement that had originated in 1987. That turned out to be the last debt relief Jamaica would need from its commercial creditors. The Fund continued to roll over its own financing, with another stand-by arrangement in 1991–92 and an EFF arrangement in December 1992 that eventually stretched to March 1996. With additional relief from the Paris Club, new lending on

⁶⁴A third country in this group, Romania, had resolved its debt crisis before 1990 but was mired in an even worse economic and political crisis. That case is covered in Chapter 6.

favorable terms from various official creditors, and a gradual resumption of foreign direct investment and other private capital inflows, Jamaica graduated from IMF borrowing.⁶⁵

Crisis and Transformation in India

Resolution of the major debt crises was just the tip of the globalization iceberg, as many other countries turned toward more open and market-oriented policy regimes to promote stable economic growth.

India provides one of the most remarkable examples of the “silent revolution” in economic policy in the developing world. The starting point was not auspicious. Not only a longtime adherent of dirigiste policies and state-driven development, India was a major intellectual and cultural inspiration for countries following similar strategies. Moreover, 40-some years of independence from Britain had not diminished the massive and pervasive bureaucracy that India had inherited. Both Indira Gandhi and her son Rajiv—the country’s two dominant political leaders of the 1980s—had tended toward reforming and liberalizing the economy, but only in tentative half-steps that improved economic performance compared with previous decades but did not fundamentally alter ways of doing business or of interacting with the rest of the world.⁶⁶ That approach was about to change.

The IMF supported the initial reforms of the 1980s through a three-year EFF arrangement (1981–84) for \$5.8 billion (SDR 5 billion), the largest loan commitment ever made by the Fund through the 1980s (see Boughton, 2001, pp. 709–16). Partly because of an easing of trade restrictions (an element of the program under the IMF arrangement), but more because of a major infrastructure investment program and the serendipitous development of a major oil field, the economy recovered and grew. Two years into the program, the government announced that it no longer needed the Fund’s money, and it canceled the final year of the arrangement.

This gradual liberalization continued for a few more years, but when Rajiv Gandhi’s government got bogged down in scandals in 1987, the effort lost much of its momentum. Economic growth continued, but the basic inefficiency of the economic system was again showing through the cracks in the surface. By 1989, the government could finance its burgeoning fiscal deficit only through increasing reliance on short-term borrowing from foreign banks.

⁶⁵The last disbursement to Jamaica in this period was in December 1995. Jamaica repaid all of its borrowings by March 2007 and then resumed borrowing in 2010.

⁶⁶Indira Gandhi, who had served as prime minister from 1966 to 1977, was elected to that post again in 1980 and served until she was assassinated in 1984. Rajiv Gandhi succeeded her and served until his party was defeated in the election of 1989. For an overview of the economic reforms of the 1980s, see Joshi and Little (1994).

The Indian economy might have trundled along in this manner for some time, but a political crisis intervened. Although Rajiv Gandhi had lost much of his popular support, the Congress Party that he chaired was widely expected to retain its long-standing hold on the reins of government in the parliamentary elections of November 1989. However, Rajiv's former finance and defense minister, V.P. Singh, managed to form a non-Congress coalition government that was united only in its opposition to the old ruling party. Governing effectively turned out to be impossible, and confidence in the economy was badly damaged both at home and abroad. The coalition collapsed less than a year later, and its successor was just as ineffective.

The next push down this slope came from the threat of war in the Middle East after Iraq invaded Kuwait in August 1990. The price of India's oil imports rose sharply; the flow of remittances from Indian workers in the region slowed; and the government had to expend substantial sums repatriating many of those workers. As if that were not enough, one of India's major trading partners, the Soviet Union, began falling to pieces. Suddenly, a mudslide had become an avalanche, diminishing India's foreign exchange reserves more and more rapidly.

As a first stop-gap measure to stabilize the economy, the authorities began withdrawing India's reserve-tranche balance at the IMF in July 1990. That action covered the repayments falling due to the IMF from the 1981 extended arrangement and thus helped stabilize the country's foreign exchange reserves for a few months.⁶⁷ The authorities knew, however, that they soon would need much more. Within weeks after the invasion of Kuwait, V.P. Singh authorized his officials to ask the Fund for a loan, the first such request in a decade.

The politics of borrowing from the IMF is always complex, but in India it was especially so. On the one hand, Indian politicians had long viewed IMF conditionality with some disdain. As soon as it became known that the government was applying for a stand-by arrangement, its leaders would be attacked in parliament and in the press for subjugating the country's interests to foreign domination. On the other hand, most of the country's economic and financial officials had good relations with the IMF, and an unusually high degree of trust had developed on both sides over the years.

India was an original member of the Fund, and its delegation had played an important part in the negotiations to create the institution at the 1944 Bretton Woods conference. Although not yet independent from Great Britain, India was awarded the fifth largest quota among the 40 original members and thus was entitled to appoint its own Executive Director.⁶⁸ Although it lost that privilege in 1972 after Japan was

⁶⁷In most cases, before a country borrows from the IMF, it withdraws its reserve-tranche credit balance. It is not required to do so, however, and India had elected to maintain a reserve position while drawing on the CFF and the EFF in the 1980s.

⁶⁸The members with the five largest quotas are entitled to appoint an Executive Director, while those with smaller quotas generally participate in a biennial election. India's quota in the Bretton Woods list was the sixth largest, but the Soviet Union (third on the list) declined to join. For the history of India's role in the design of the Fund, see Simha (1996), Chapter 2.

awarded a larger quota, India then formed a small regional constituency and was able to elect a Director and maintain a continuous presence on the Executive Board. Because of this history and India's position of leadership in various groups of developing countries, its Executive Director often took an active role in broader policy debates in the Fund. Thus, in 1990, despite the fragile condition of India's fiscal and external finances, both the Indian government and IMF management perceived their relationship to be founded on a long record of mutual respect.

To balance these two considerations, V.P. Singh's government decided initially to limit its request to whatever it could borrow from the Fund without making specific forward-looking policy commitments. A stand-by arrangement for the first credit tranche (25 percent of quota) and a CCF drawing to compensate for the effects of the Iraq-Kuwait war on the cost of oil imports would provide about \$1.8 billion, all of which would be available immediately without further conditions.⁶⁹ India's projected financing gap exceeded that, and as soon as the new government took office following V.P. Singh's defeat in November, the authorities informed the Fund that they planned to ask for larger loans in the near future. The priority at the moment was just to make a fast start. The Executive Board met on January 18, 1991, and readily approved the arrangement.⁷⁰

The day before the Board meeting, the Gulf War began, as U.S.-led coalition forces attacked Iraqi positions from the air. Over the next few weeks, the Indian government struggled to maintain a neutral stance amid strong domestic opposition to the refueling of U.S. military airplanes at Indian bases. Prime Minister Chandra Shekhar found it increasingly difficult to govern in these circumstances, and he was unable to present a budget to parliament. That effectively put discussions with the IMF on hold. With no prospect in sight for resolution of the political stalemate, Shekhar resigned on March 6 but agreed to lead a caretaker government for a few months until elections could be held.

As negotiations continued with the Fund on terms for a larger stand-by arrangement, Rajiv Gandhi and the Congress Party he chaired appeared headed for a return to power. That possibility tragically and brutally vanished on May 21 when Gandhi was assassinated while campaigning. Confidence crumbled, and suddenly the country's financial outlook was even worse. As an emergency measure, the government quickly sold 20 tons of gold with a six-month repurchase option, in effect borrowing

⁶⁹The first-tranche stand-by arrangement was worth \$785 million, and the CCF drawing \$1,020 million (SDR 552 million and SDR 717 million, respectively). IMF policies limit the phasing of stand-by drawings and the application of performance criteria to arrangements that extend into the upper credit tranches. First-tranche drawings require only a finding that the member country is cooperating with the Fund and has a balance of payments need for the drawing. Cooperation usually requires implementation of a number of policy actions prior to Board approval of the arrangement and the formulation of a set of macroeconomic policies that will enable the member to resolve its payments problem and repay the loan.

⁷⁰See minutes of EBM/91/7 (January 18, 1991). For the government's economic program and the staff's appraisal of it, see "India – Use of Fund Resources – Request for Stand-By Arrangement and for a Purchase Under the Compensatory and Contingency Financing Facility," EBS/91/4 (January 7, 1991).

\$200 million from a consortium of foreign banks at the London interbank offered rate (LIBOR). For a country that for centuries has viewed gold as an almost mythical store and symbol of value, the sight of so much gold being physically shipped to Zurich for safekeeping came as a shameful shock, but under the circumstances it had to be accepted as necessary. The government also obtained a commitment from Japan for up to \$300 million in loans on concessional terms.

The election was postponed for a few weeks, and on June 21 the Congress Party regained power and named P.V. Narasimha Rao to the premiership. India now had an effective government, but a year of turmoil had brought it to the brink of default. With about \$4 billion in external debt falling due in the near term, India had less than \$2 billion in official foreign exchange reserves. A lot of loose talk about the country being “bankrupt” occurred, but the government and the Reserve Bank of India (RBI) still owned another 380 metric tons of gold, at least part of which could be sold or pledged if need be. At the very least, Rao was facing the most severe liquidity crisis in India since 1966. Even the IMF was losing confidence and was close to a decision to ship its own gold out of the country to safer shores.

In what would turn out to be a decisive moment for the future of the Indian economy, Rao immediately named Manmohan Singh to be his minister of finance. Singh was already well known in financial circles in India, having been governor of the RBI (1982–85) and head (deputy chairman) of the Planning Commission (1985–87). More recently, he had directed the Geneva-based intergovernmental agency, the South Commission (1987–90), and had served as advisor to the prime minister on economic affairs during the few months of Chandra Shekhar’s coalition government (1990–91). Armed with a doctorate in economics from Nuffield College, Oxford, he had built a reputation as a soft-spoken intellectual who could work within the political system without being tainted by its demands. His real achievements, however, were still ahead of him: five years as finance minister (1991–96) and eventual election as prime minister in 2004.

Manmohan Singh initiated several policy changes in his first few weeks in office, aimed at closing the financing gap as quickly as possible. First, he devalued the rupee relative to the U.S. dollar by nearly 19 percent in two steps in early July.⁷¹ Second, he arranged to borrow \$400 million from the Bank of England and the Bank of Japan, using gold from the official reserves of the RBI as collateral. As before, owing to the dire state of India’s finances, the gold had to be shipped out of the country—this time to the Bank of England—to be acceptable collateral. Third, he asked for and received a public statement of support from Camdessus on behalf of the IMF and then borrowed another \$800 million (SDR 635 million) through the CCFE.⁷² Fourth, he asked the

⁷¹For an analysis of the pressures on the exchange rate at this time, see Cerra and Saxena (2002).

⁷²Camdessus’s statement of support was issued to the press on July 4, 1991, the day after the devaluation of the rupee was completed. In it, he noted that the Fund was “in close contact with the Indian Government” and stood “ready to support India’s adjustment policy”; see “Camdessus Says IMF in Close Contact with Indian Government,” NB/91/9 (July 4, 1991).

Fund to provide larger loans: first with an upper-tranche stand-by arrangement and later—when he had had time to devise a more comprehensive reform program—with an extended arrangement.

Throughout this time, the Fund staff kept in almost continuous contact with the Indian authorities. The working relationship was a little unusual, in that the authorities knew full well what they needed to do to qualify for the Fund's seal of approval and financial support. The decision to devalue, for example, was not made at the insistence of the Fund, but on the understanding that the Fund would approve it and that both sides believed it was necessary and was in India's interest. As had been true for the 1981 negotiations, these discussions were amicable and collegial.⁷³

The main negotiations took place in Bombay and Delhi in August 1991, with the Fund mission led by Hubert Neiss (Deputy Director, Asian Department). Manmohan Singh signed a Letter of Intent on August 27, and after some delay, the Executive Board met on October 31 to consider India's request for a 20-month arrangement totaling \$2.3 billion (SDR 1,656 million, equivalent to 75 percent of India's quota). As the date of the meeting approached, the only significant uncertainty was whether the United States would raise any objections. As noted above, India's reluctance to allow military jets to refuel during the Gulf War earlier in the year had not endeared the country to the United States. Separately, the U.S. Treasury was keen to press India to move rapidly to open and liberalize its economy. However, the U.S. Executive Director, Thomas Dawson, praised the "sea change in India's economic orientation." Although the U.S. view was that India needed "a far more radical reform" of the economic role of the government, Dawson concluded that India had already "earned the support of the international community." The stand-by arrangement was thus approved without dissent.⁷⁴

By October, the Indian government was embarked on a major drive, not just to stabilize the economy and resolve the liquidity crisis, but more important, to liberalize the economy as much and as quickly as possible. As Singh put it in a supplement to his August 27 letter to Camdessus, the goal was to "impart a new element of dynamism . . . in the economy." To that end, the government intended "to increase the efficiency and international competitiveness of industrial production, to utilize foreign investment and technology to a much greater degree than in the past, to improve the performance and rationalize the scope of the public sector, and to reform and modernize the

⁷³The chief contrast between the two episodes was not in the relations between the Asian Department staff and the authorities, but rather in the internal discussions within the Fund. On the earlier occasion, the idea of supporting a "homegrown" program was less easily accepted, and doubts were expressed—by some senior staff and by the U.S. authorities—as to whether India really had a balance of payments need for the loan.

⁷⁴See minutes of EBM/91/145 (October 31, 1991). Dawson's statement is on pp. 15–18.

financial sector.”⁷⁵ It was a bold agenda, and it would be strongly resisted by entrenched interests within India.

Over time, it became clear that the government would carry out these reforms in a heterodox way and on its own terms. For example, in March 1992, the authorities temporarily introduced a dual exchange rate scheme as a way to finance subsidies to imports of essential goods (notably petroleum products and fertilizer) while shifting to a market-determined rate for most transactions. As a multiple currency practice, the dual rate violated the terms of the stand-by arrangement. The staff, however, chose not to object to it, and the Fund readily granted a waiver so that India could continue to draw on the arrangement.⁷⁶ The underlying premise throughout this time was that no one seriously doubted the government’s commitment to the ultimate objective of liberalizing the economy, especially foreign trade and payments.

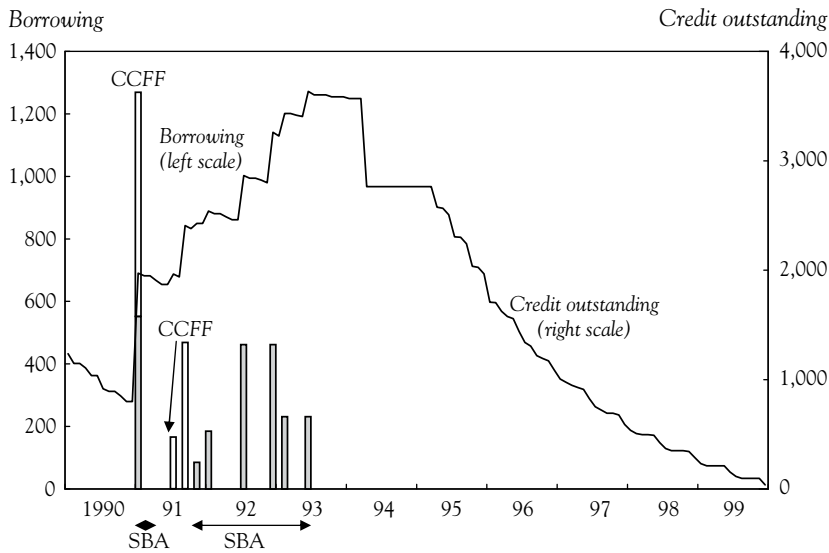
Despite the complexity of the structural reform program and the centrality of those reforms to the program’s success, the stand-by arrangement with the Fund was deliberately kept simple and uncluttered. The availability of disbursements after the initial drawing would depend on a standard set of performance criteria: ceilings on overall borrowing by the central (“Union”) government, on the net domestic assets of the RBI, and on net credit to the Union government from the RBI; a floor on net international reserves; and boilerplate prohibitions on introducing exchange restrictions, multiple currency practices, bilateral payments agreements, or import restrictions for balance of payments purposes. The program also included a list of 16 “structural benchmarks” that the Fund would review after a few months, but only two of those were considered critical.⁷⁷ The Fund was prepared to give the government free rein in carrying out its reform agenda. If the effort faltered, the subsequent negotiations on an extended arrangement would provide an opportunity to take a more proactive stance.

⁷⁵“India – Request for Stand-By Arrangement – Letter of Intent and Memorandum on Economic Policies,” EBS/91/143 (August 27, 1991), p. 3.

⁷⁶Before the initiation of the reform program, the government banned the importation of most consumer goods. Beginning in August 1991, that practice was phased out in favor of a system in which exporters received “EXIM scrip” as a portion of their export receipts, which could be used to purchase imported goods or could be traded in an open market; see “India – Recent Economic Developments,” SM/91/207 (October 18, 1991), Appendix IV. The dual exchange rate, which was in effect only until March 1993, replaced the scrip scheme as the next stage of the transition to an open market system. For the staff’s assessment, see “India – Review under Stand-By Arrangement,” EBS/92/96 (June 3, 1992).

⁷⁷The distinction between a “performance criterion” (PC) and a “benchmark” is subtle. Both are conditions for the Fund’s approval of each disbursement under a stand-by arrangement. If a PC is not met, the Executive Board has to make a formal decision to grant a waiver or the disbursement must be disallowed. If the borrower fails to meet a benchmark, the Board can choose to complete the review anyway, and no formal waiver is required. The more substantive distinction is that the Fund generally expects only that the authorities will make a serious effort to meet the benchmarks and will carry out the spirit of its commitments. If an arrangement includes a large number of benchmarks, the expectation is that many, though probably not all, will be met, whereas the expectation is always that all PCs will be met.

Figure 9.1. India: 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.

India emerged from its fiscal crisis with amazing alacrity. The Fund's first review of the stand-by arrangement was delayed while the government prepared its budget for the 1992/93 fiscal year, but all performance criteria were met, and all of the stand-by arrangement was eventually disbursed. By the time the arrangement expired in mid-1993, India's economy was thriving and private capital was flowing in so steadily that the country had no further need to borrow from the IMF. The government began repaying the Fund early in 1994 (Figure 9.1), and it quietly dropped the idea of asking for an extended arrangement.

Even in the initial year after the crisis, India's real GDP did not decline, and for the next three years growth averaged more than 5 percent a year. Net international reserves, virtually zero in mid-1991, surpassed \$17.5 billion four years later. Even more impressive, the reform program led to spectacular economic growth rates throughout the rest of the decade without threatening financial stability.⁷⁸

⁷⁸This view of the importance of the 1991 reform agenda for subsequent economic performance is widely but not universally accepted. For detailed explanations of the pro-reform argument, see Joshi (1998) and Srinivasan and Tendulkar (2003). An alternative view, that growth in the 1990s was primarily a continuation of a pattern that began with the less comprehensive reforms of the 1980s, has been advanced by DeLong (2003) and by Rodrik and Subramanian (2005). The central issue dividing these camps is the extent to which the 1991 crisis resulted from the failings of the reforms of the 1980s; see Panagariya (2005).

The 1991–93 stand-by arrangement with India proved to be an outstanding success story, both for the Indian government and for the IMF. Faced with a dangerous fiscal and political crisis, Rao’s government seized the opportunity to begin a reform program that irreversibly altered the very nature of the Indian economy. Although by all accounts the reform agenda was still far from being completed, it continued throughout the decade, and it enabled the Indian economy to weather the turbulence in the world financial system in the late 1990s. In 2003 India became a creditor of the Fund. Through the end of that decade, it did not have to borrow.

The IMF played two roles in assisting the process in India. First, it provided substantial financial support at a critical juncture, enabling the authorities to take default off the list of options for dealing with the crisis. Second, it gave its full and very public support to the government’s reform program and forbore from piling on additional conditions to its lending commitment. The Fund could show such restraint because it understood that the government, though newly elected and untested in its ability to deliver on its promises, was deeply committed to the reform process. These circumstances may have been unique, but the lessons for the Fund and for other countries in crisis—the importance of domestic ownership and of mutual confidence, trust, and restraint—are universal.

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