Evaluation Report

# IMF and Recent Capital Account Crises
## Indonesia, Korea, Brazil

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## IMF and Recent Capital Account Crises: Indonesia, Korea, Brazil

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The Independent Evaluation Office (IEO) was established by the International Monetary Fund's Executive Board in July 2001. The office operates independently of IMF management and at arm's length from the IMF's Executive Board. Its mission is to provide objective and independent evaluation of issues related to the IMF's mandate and thereby support the Executive Board in its governance and oversight responsibilities, to contribute to enhancing the learning culture of the IMF, and to promote understanding of the IMF's work.

## EXECUTIVE SUMMARY

This report evaluates the role of the IMF in three recent capital account crises, in Indonesia (1997-98), Korea (1997-98), and Brazil (1998-99). These crises have been the subject of extensive external commentary and have also been studied in detail by IMF staff. A number of important lessons have already been learned and corresponding corrective steps taken in the form of revised IMF policies and procedures. Nevertheless, it is appropriate for the Independent Evaluation Office (IEO) to conduct an independent assessment of the role of the IMF in these crises, taking advantage of its unique access to internal IMF documents while also taking note of earlier work where relevant. The evaluation seeks to draw lessons for the IMF, supplementing those that have already surfaced, and also to contribute to transparency by evaluating the internal processes by which important decisions were made.

The findings of this evaluation report are subject to three important limitations. First, any evaluation inevitably benefits from hindsight and while this can be an advantage in drawing lessons for the future, much of what we know now may not have been known at the time to those who had to make the relevant decisions, often under extreme pressure. These considerations must be borne in mind in determining accountability. Second, any evaluation implies a comparison with a counterfactual, i.e., what might have happened with alternative policies. This is very difficult to establish rigorously. Third, the behavior of an economy is always subject to uncertainty and the uncertainties are much greater in crisis situations. In the face of uncertainty, a program cannot be judged to represent a mistaken choice ex ante just because it failed ex post. The relevant criterion is whether the ex ante probability of success was high enough.

The report consists of two parts. The main report presents our assessment of the role of the IMF in the three crises and the lessons to be drawn from the experience, with some specific recommendations going beyond the steps already taken. The annexes contain the three country studies that form the basis for our judgments in the main report.

### A. Overall Assessment of the Role of the IMF

The three country cases studied share several features common to capital account crises; in each case the crisis was triggered by massive reversal of capital flows, short-term flows played a prominent role, and contagion was an important factor. However, there were also notable differences. The nature of the crisis differed in the three cases, with Indonesia and Korea exemplifying “twin crises” in which the external crisis coincided with a banking crisis. There were also differences in the policy mix advocated, the political environment in which the crisis was managed, and the effectiveness of implementation. All three programs failed in their initially stated objectives, but the subsequent experience under the revised programs was very different. Our overall assessment of the role of the IMF in each of the three crises is as follows:

**Indonesia**

IMF surveillance did identify the vulnerabilities in the banking sector that would later become crucial to the evolution of the crisis, but it underestimated the severity and the potential macroeconomic risks posed by them. In designing its crisis management strategy during October 1997, the IMF misjudged the extent of ownership at the highest political level and underestimated the resistance to reform likely to be posed by vested interests. This underestimation of political constraints was perhaps a reflection of the earlier failure of surveillance in recognizing the changing nature of corruption and cronyism.

The single greatest cause of the failure of November 1997 program was the lack of a comprehensive bank restructuring strategy, which led to a rapid expansion of liquidity to support weak banks. The resulting loss of monetary control in turn contributed to a weaker exchange rate and greater distress in the corporate sector. The crisis became intensely political, following the illness of the President in early December, making crisis management even more difficult. At this stage, the IMF negotiated a revised program in January 1998, which focused heavily on structural conditionality to signal a clean break with the past. The focus on structural conditionality was based on the assumption that this was necessary to restore confidence. It failed to do so, partly because of visible lack of political commitment to the policies promised and partly because of the failure to address the critical banking and corporate debt problems.

The Indonesian crisis was clearly the most severe of the three under review, with GDP declining by 13 percent in 1998 and a large increase in poverty. This devastating outcome cannot be attributed solely to shortcomings on the part of the IMF. The lack of firm implementation of the November program, and especially the reversal of some of the critical steps at a very early stage, eroded market confidence and the situation soon got out of control as political uncertainty increased and riots occurred against the ethnic Chinese community. These exceptional circumstances explain much of the severity of the crisis experienced by Indonesia. However, our evaluation suggests that the IMF's response to the failure was also inadequate in many respects.

**Korea**

In Korea, IMF surveillance failed adequately to identify the risks posed by the uneven pace of capital account liberalization and the extent of banking sector weaknesses, owing to the adoption of a conventional approach that focused on macroeconomic variables. There were gaps in the data needed to make a full assessment, though available data on short-term debt and financial market indicators were not fully used. While concerns over Korea's weak banking sector had prompted international banks to review their lending to some Korean institutions even before the onset of the Asian crisis in July 1997, the IMF was optimistic until virtually the last minute.

The first Korea program was clearly underfinanced, but this was due primarily to the unwillingness of major shareholder governments either to take concerted action to involve

the private sector or to provide the necessary financing upfront to resolve what, of all the three cases, was most clearly a liquidity crisis. When this strategy failed, the major shareholder governments moved quickly to initiate concerted action to involve the private sector—an approach that eventually worked well. It could be argued that the first strategy needed to be tried and proven to have failed before the rollover agreement of December 24 could be secured. The IMF played a useful role as crisis coordinator in drawing attention to the problem and later facilitating information exchange among major governments and helping to set up a monitoring system to ensure compliance.

The Korean adjustment process involved a severe downturn, with GDP declining by 6.7 percent in 1998, compared with a forecast of positive growth. However, unlike Indonesia, this was followed by a robust recovery in 1999. The greater than expected downturn reflected the impact of negative balance-sheet effects, which were clearly underestimated. In retrospect, the fiscal tightening in the program was unnecessary, as the IMF staff has itself concluded.

**Brazil**

In Brazil, IMF surveillance was successful in identifying the key vulnerabilities that were at the core of the crisis, in part owing to the fact that they were largely macroeconomic in nature. However, it progressively downplayed the scale of overvaluation, and had little impact in persuading the Brazilian authorities to take sufficient corrective action even in areas where the diagnosis was correct. When Brazil faced intense speculative pressure on its foreign exchange reserves from mid-1998, the IMF reluctantly supported the authorities' preference for maintaining the existing exchange rate regime. However, intense pressure on the real developed in December 1998, and the program soon failed with the collapse of the peg in January 1999.

A major justification for defending the exchange rate was that an exit from the peg at that time would have unsettled international financial markets already nervous after the Russian default and the LTCM crisis. With the benefit of hindsight, it can be argued that this concern was overplayed. An earlier exit from the peg, widely perceived to be unsustainable, probably would not have had major systemic effects if it had been made under an IMFsupported program. The hedge provided to the private sector by the government, through the use of foreign exchange reserves and exchange rate-indexed bonds, ensured that the sharp depreciation that followed the floating of the real in January 1999 had little adverse effect on the Brazilian economy. However, this was at the cost of a substantial increase in the stock of public debt, which stored up problems for the future.

The revised 1999 program fared fairly well in the short run. Contrary to program expectations of negative growth in 1999, Brazil actually experienced positive growth of 0.8 percent. This was largely because of the healthier state of the banking system, combined with the provision of the hedge, which mitigated balance-sheet effects on the private sector. The IMF played a useful role in facilitating Brazil's transition to an inflation-targeting

monetary regime as well as a more disciplined fiscal policy regime, but in retrospect, fiscal vulnerabilities were not fully eradicated.

## B. Pre-crisis Surveillance

IMF surveillance was more successful in identifying macroeconomic vulnerabilities than in recognizing and analyzing in depth the risks arising from financial sector and corporate balance-sheet weaknesses and the governance-related problems that contributed to those weaknesses. Insufficient candor and transparency limited the impact of surveillance on policy, even in areas where the diagnosis was broadly accurate.

In Indonesia, the IMF did identify banking sector weaknesses as a problem, but surveillance reports underestimated the potential adverse macroeconomic consequences of these weaknesses. Surveillance also paid insufficient attention to the changing nature of corruption and the macroeconomic risks it posed, and surveillance reports were less candid on these issues.

In Korea, the IMF failed adequately to recognize the vulnerabilities created by the uneven sequence of capital account liberalization and the risk that a change in investor sentiment could cause a severe drain on foreign exchange reserves. While the crisis also came as a surprise to many other observers, the IMF was slow to catch the rising concerns of international banks over Korea's banking sector problems, which had begun to surface several months before the onset of the full-blown crisis. In retrospect, surveillance proved too sanguine about these growing risks.

IMF surveillance effectively diagnosed the major vulnerabilities in Brazil, largely because Brazil's vulnerabilities manifested themselves primarily as macroeconomic phenomena, such as the rising stock of public debt and real exchange rate appreciation, which were part of the IMF's traditional toolkit.

In all three countries, the IMF's role as confidential advisor was not very effective in persuading countries to modify their policies even when key vulnerabilities were identified. The IMF was not provided with much sensitive information required for effective surveillance. While it is difficult to generalize from three cases, or to test the counterfactual concretely, the IMF probably could have been more effective in influencing policy if it had made its analyses public so as to contribute to a wider policy debate.

## C. Program Design and Implementation

### Macroeconomic framework and projections

In all three cases, macroeconomic outcomes turned out to be very different from program projections. In Indonesia and Korea, the initial projections were overly optimistic, leading to a design of macroeconomic policies that turned out to be too tight given the outcome in aggregate demand and output. In contrast, the initial projections for Brazil in 1999 were too

pessimistic, which contributed to fiscal adjustment that turned out to be insufficient, in light of that country's adverse public debt dynamics.

Part of this problem arises because macroeconomic projections in an IMF-supported program are necessarily the outcome of negotiation. However, there were also analytical weaknesses since forecasts were not derived from an analytical framework in which the key determinants of output, and their likely behavior during the crisis, could be dealt with adequately. In particular, there was insufficient appreciation of (i) the large currency depreciation which might occur in view of the possibility of multiple equilibria, and (ii) the severe balance-sheet effects that might result. It is inherently difficult to forecast macroeconomic outcomes reliably, especially in crisis situations, but these problems could have been reduced if there was a more explicit focus on the key factors affecting aggregate demand, particularly private investment.

In light of the considerable uncertainties, a more explicit discussion in program documents of the major risks to the macroeconomic framework, with a clear indication of how policies would respond if the risks materialized, would have been helpful. In practice, subsequent program reviews on Indonesia and Korea did show flexibility, but an upfront recognition of risks would have sent a more transparent signal on the expected stance of policies.

**Fiscal policy**

All three programs involved fiscal tightening. The extent of tightening was mild in Indonesia and Korea, while it was fairly strong in Brazil. In view of output developments, the initial tightening of fiscal policy in Indonesia and Korea was not warranted, and it was in fact relaxed quickly when the extent of output collapse became evident. In any event, in both countries, the initial fiscal tightening was not the cause of the output collapse. This was the result of balance-sheet effects, which were not factored into program design. In Brazil, fiscal tightening was much sharper. This was appropriate because fiscal sustainability was a major issue driving the evolution of the crisis. However, it turned out not be sufficient to achieve the objective of stabilizing, and then reducing, the debt-to-GDP ratio.

**Monetary policy**

The stance of monetary policy in all three countries was initially set tight, with an explicit recognition of the tradeoff between higher interest rates and a weaker exchange rate. However, the experience of the three countries varies and does not provide a definitive answer to the ongoing debate on the effectiveness of high interest rates in stabilizing the exchange rate.

In Indonesia, the maintenance of tight monetary policy envisaged in the program was simply not implemented, as the monetary base expanded rapidly and real interest rates became increasingly negative during the early months of the program. The assertion by some critics that the tight monetary policy advocated by the IMF was a cause of the output collapse is not warranted for the simple reason that it was not implemented for most of the crisis period.

Exchange rate stability returned in March 1998, when the rupiah had sufficiently depreciated and interest rates were raised and monetary control regained.

In contrast, Korea implemented the tight monetary policy envisioned in the initial program by raising domestic interest rates and the penalty rate charged to banks for central bank foreign currency advances. These moves were appropriate to defend the currency, but they were not by themselves sufficient to stabilize the exchange rate, because much of the capital outflow was in fact driven by credit considerations rather than yield. It can be argued that real interest rates were kept higher than might have been necessary in early 1998, when the exchange market had stabilized. However, the still uncertain situation understandably called for some caution. Given the contractionary impact of bank restructuring on credit flows, the few months of higher than necessary interest rates could not have been the dominant cause of the recession.

In Brazil, the excessive easing of interest rates—over the IMF's objections—may have contributed to the timing, if not the eventuality, of the collapse of the crawling peg. A decisive tightening of monetary policy in March 1999 coincided with the restoration of stability in the foreign exchange market. However, one must be careful about the causality, given the fact that an informal agreement by major international banks to maintain credit lines to Brazil was reached around the same time. High interest rates did not have a major negative impact on the private sector, because of the sound state of the banking system and the low leverage of the corporate sector, compared with the situations in Asia. Subsequently, the IMF supported Brazil's transition to an inflation-targeting regime, which allowed for price stability and a rapid reduction in interest rates.

**Official financing and private sector involvement**

The size and format of the official financing package were inadequate in Korea and contributed to the failure of the first program. The ambiguity over the availability of US$20 billion in bilateral assistance pledged as a "second line of defense" in Korea created uncertainty in the market about the ability of the program to meet the country's immediate liquidity needs.

In the other two countries, the programs failed for other reasons. The failure of the initial Indonesian program was due, not to inadequate financing, but to other factors, including nonimplementation of the key elements of the program by the authorities and the subsequent explosion of liquidity because of the failure to resolve the banking crisis. Once the program had failed, the crisis became intensely political, leading to a large amount of capital flight by domestic residents, and the sharp depreciation of the rupiah began to create solvency concerns. No reasonable amount of official financing could have restored confidence at that time. In the case of Brazil, the initial program failed because the key policy, namely, that of supporting the crawling peg, was not credible with the markets.

In Korea and Brazil, the IMF's role as crisis coordinator in organizing private sector involvement (PSI) was limited by the unwillingness of major shareholder governments to use

nonmarket instruments to influence the behavior of private sector institutions and concerns that such action might precipitate an exodus of capital from emerging markets. However, when a decision was made by the major shareholders to involve the private sector, the IMF played a useful role in facilitating information exchange among major governments and helping to set up systems of monitoring compliance.

An earlier attempt to involve the private sector in Korea would have been warranted, but given the initial unwillingness of the IMF's major shareholder governments to take concerted action, there was probably little the IMF could do. The agreement by major international banks to roll over interbank debt on December 24, 1997 was a turning point in the crisis. The success of this approach owed much to the fact that most of the short-term external debt was interbank credit. The Brazil experience in the second program suggests that a program with a high degree of credibility is necessary for the "voluntary" approach to PSI to work. In Indonesia, the IMF provided technical assistance for corporate debt restructuring, but its role was limited.

**Bank closure and restructuring**

The experiences of Indonesia and Korea suggest that a successful bank closure and restructuring program must include a comprehensive and well-communicated strategy in which transparent rules are consistently applied. The Korean program by and large achieved its objectives, largely because a comprehensive strategy was developed at the outset. The Indonesian banking sector program, by contrast, initially suffered from the lack of a comprehensive strategy and the failure to communicate the logic and outline of the policy to the public. As a result, the closure of 16 banks in November 1997, with subsequent reversals exacerbated, rather than dampened, the crisis. Bank closures in Indonesia in April 1998, however, were more successful because they were done as part of a comprehensive strategy that was well communicated to the public and was based on the consistent application of uniform and transparent criteria.

The issue of whether a blanket guarantee, instead of the partial guarantee actually offered, should have been introduced in Indonesia in November deserves careful consideration. Our evaluation suggests that the banking crisis was not yet systemic in November, so that the partial guarantee was appropriate. In the end, the blanket guarantee introduced in January was subject to abuse and consequently raised the fiscal cost of bank restructuring. The problem in bank restructuring was more with the initial lack of a comprehensive and well-communicated strategy, and not the nature of the guarantee.

**Structural conditionality**

All three programs involved structural conditionality, but the experience with conditionality was very different. The Indonesian and Korean programs were characterized by extensive structural conditionality (especially the January 1998 Indonesian program) covering several areas that were not macro-critical. The scope of structural conditionality in the Brazilian program was limited to structural fiscal reform and prudential regulation. Part of this

difference reflected the absence in Brazil of many of the distortions that had been present in Asia.

Measures to rehabilitate and reform the financial sector were necessary in both Indonesia and Korea and were appropriately included in the programs. In Indonesia, it was also important to tackle corporate restructuring by reforming the legal system, but this element was missing in the first two programs. As for the various nonfinancial structural reform measures included in the Indonesian and Korean programs, many of these may have been beneficial in improving long-run economic efficiency, but they were not necessary.

In Indonesia, many governance-related measures were included in the January program at the urging of some of the IMF's major shareholders in the belief that confidence could only be restored by signaling a clean break with the past. However, the evaluation suggests that the proliferation of nonfinancial structural conditionality led to a loss of focus on critical reforms in the banking sector which was more important for restoring stability. Proliferation of structural conditionality may also have led to lack of ownership at the highest political level and nonimplementation, both of which damaged confidence.

**Communications strategy**

A program for restoring confidence must include a strategy to communicate the logic of the program to the public and the markets, in order to enhance country ownership and credibility. None of the three programs initially contained such a strategy.

Effective public communications are essential to build broad support for the program. Likewise, effective dialogue with the markets would improve program design through understanding the expectations of market participants, and also help build credibility for the program. For this purpose, it is important for the IMF to explain clearly the logic and strategy of the program, including spelling out the major risks, with a broad indication of how policies would respond to them.

## D. Internal IMF Governance and the Mode of Operations

The evaluation identified a number of weaknesses in the IMF's internal governance and mode of operations. In the area of **human resource management practice**, the effectiveness of surveillance was reduced by the lack of sufficient internal incentives to make judgments that were frank and potentially unpopular (with country authorities), resulting in a tendency for sharper elements of a diagnosis to be diluted in final Executive Board papers. In crisis management, the quality of the IMF's response was compromised by a delay in the reallocation of staff resources to the Asia and Pacific Department (APD) whose staff was overstretched by multiple regional crises; the insufficient integration of staff from MAE and the area department; insufficient utilization of available internal knowledge; and the failure to mobilize staff members with up-to-date country knowledge.

**The role of the Executive Board and the IMF's major shareholders** was particularly prominent during the crises, when major decisions needed to be made quickly, calling for close collaboration with staff and management. While the close involvement of the Board and the major shareholders was proper and necessary, close contacts at multiple layers unnecessarily subjected staff to micromanagement and political pressure, contributing to a blurring of technical and political judgments. For example, the visible presence of major country officials close to the IMF negotiating teams sometimes created a misperception of the motives behind IMF involvement, thus weakening the sense of country ownership.

In all three programs, the IMF collaborated, both in financing and technical work, with **other international financial institutions** (IFIs). When there was a clear separation of responsibilities, as in Brazil, no major problems occurred. In Asia, however, where the IMF and the other IFIs all worked in the financial sector, tensions developed over the role they should play in an IMF-supported program. While a good working relationship eventually developed, it depended too much on personalities, and not on a well-defined procedure. Moreover, existing procedures to resolve differences of view between the IMF and the World Bank on key policy matters were not effective in avoiding public criticism by the Chief Economist of the World Bank; indeed, as far as the evaluation team can tell, these procedures were not utilized.

## E. Recommendations

Since these crises, the IMF has taken numerous initiatives to strengthen surveillance and program design. Many of the weaknesses in surveillance and program design identified by the evaluation have already been addressed by the IMF in its revised policies and procedures. Nevertheless, additional steps will be necessary to further enhance the effectiveness of the IMF in surveillance and crisis management. We make six broad recommendations, which are set out in the final chapter of the report along with their rationale. Rather than summarize them again here, we suggest that Chapter VI be read in conjunction with this Executive Summary.

## RECOMMENDATIONS

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

**Pre-crisis surveillance**

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

- Staff reports for Article IV consultations could itemize the major potential shocks that the economy could face in the near future, explore the likely real and financial consequences of each of these shocks—including balance-sheet effects—and discuss the authorities' plans for dealing with them should these shocks arise.[1] Such discussion should cover the effectiveness of any existing social safety nets both as automatic fiscal stabilizers and as a means of mitigating the impact of a crisis on the most vulnerable sections of society.

- Staff should try to develop a greater understanding of the political constraints that may affect policy making and of market perspectives on policy. Article IV consultation missions to systemically important countries should therefore seek a wider dialogue with individuals beyond senior economic officials, including especially those in the domestic and international financial communities. This is already done in "best practice" cases, but it would be desirable to formalize the process. In this context, it would be useful to include separate sections in staff reports where market views and political economy analyses are provided. Expertise available

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[1] Allen et al. (2002) sets out much of the framework that would be necessary for such an analysis.

in ICM could be tapped on the former. Resident Representatives should also be incorporated into the preparation of staff reports in a more systematic way.

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

- The recently revised surveillance guidelines call for Article IV consultation reports to contain a more systematic assessment of what happened as a result of the IMF's previous policy advice (along with an opportunity for the authorities to comment on the advice). To make such assessments more operationally relevant, **management could develop modalities for escalated signaling when key identified vulnerabilities are not addressed over several rounds of surveillance.** While it is beyond the scope of this evaluation to spell out a detailed proposal on how this would be achieved, the aim should be to provide the Executive Board with a vehicle for signaling when failures to address identified vulnerabilities have become an increasing source of concern. In this context, escalated signaling would help strike a right balance between the role of the IMF as confidential advisor and its role as a vehicle for transmitting peer reviews on members' policies and for providing quality information to markets. Escalated signaling would give member countries enough time to address underlying vulnerabilities, while also progressing toward greater candor as a means of increasing the effectiveness and impact of surveillance. It would also help to create an environment in which there is a clearer perception of the major vulnerabilities that would need to be suitably addressed as part of program design, should a crisis occur and IMF support be requested.

- **Management and the Board should explore the possibility of seeking "second opinions" from outside the IMF as part of the surveillance process when the authorities disagree with the staff's assessment on issues that are judged to be of systemic importance.**[2] This would improve the degree of objectivity with which contentious issues are handled in the surveillance process and may enhance the impact of surveillance. It would also serve as a building block for the idea of escalated signaling.

- While we recognize that there are risks in generalizing from a small number of cases, the experience of the three countries supports the case for **a presumption that staff reports for Article IV consultations should be published.**[3] Publicizing such

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

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

information will help to generate a more informed debate on the need for structural reforms oriented toward crisis prevention. The public would also be better informed about the underlying rationale of the reforms that the IMF might subsequently deem necessary in the event of a program. Concerns have been expressed that publication of staff reports may compromise candor in terms of both what the authorities are willing to share with the IMF and what staff is willing to disclose in public. But the country experiences discussed in this report suggest that, without publication, there is also a risk that the IMF can have the worst of both worlds—with limited impact as a "confidential advisor" and limited scope for making its views known in the broader policy debate.

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

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

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

**Program design**

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

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

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

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

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

- **A crisis should not be used as an opportunity to force long-outstanding reforms, however desirable they may be, in areas that are not critical to the resolution of the crisis.** When political judgment necessitates addressing significant distortions that are known to exist, and the government is committed to reform, it should be sufficient to lay out a road map for these reforms as an indicative direction outside IMF

conditionality, and this fact should be communicated to the public. Parsimony and focus should be the principles to guide the design of structural conditionality in a program whose objective is to restore confidence quickly. In this respect, we endorse the current initiatives of the IMF to streamline conditionality, while stressing that, in a capital account crisis, the critical test of a particular measure involves whether or not it helps to restore confidence.

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

**The IMF as crisis coordinator**

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

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

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

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

- Management should provide candid assessments of the probability of success and a frank feedback to the Executive Board and shareholders if some elements of the strategy are significantly lowering the probability of success.

- While involvement of shareholders is necessary and appropriate, particularly in large access cases, management should ensure that the technical judgment of staff be protected from excessive political interference.

- While decisions on the nature of private sector involvement will have to be made on a case by case basis, the IMF should play a central role in identifying circumstances where more concerted efforts (as was eventually undertaken in Korea) can be useful in overcoming "collective action" constraints. This should be based on a meaningful dialogue with the private sector, building on the new mechanisms for such a dialogue that have been established in recent years.

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

- **New institutional arrangements** within the IMF should be established to ensure that the IMF is in a position to deliver a rapid response, in terms of policy advice, to member countries facing crises and to assist in program design in such cases. A variety of organizational approaches could be used to achieve this objective, and we do not propose to suggest a specific structure. However, the aim should be to ensure that dedicated resources are maintained to respond to crisis management situations and to learn from past experience. This is precisely the approach proposed by management in the reorganization of MAE. The same principles should be adopted on an IMF-wide basis to deal with crisis cases involving large access.

- The length of staff assignments to country desks should be monitored to ensure that sufficiently recent country expertise is maintained within the staff. This information should be reported periodically to the Board.

- The terms of reference of Resident Representatives should be modified to encourage them to play a more central role in surveillance and program design (see also Recommendation 1, above). This already happens in some, but not all, cases.

- Internal guidelines and human-resource procedures should be modified to protect mission chiefs and others who raise uncomfortable issues through any authorized channel and thereby attract complaints from the authorities. For example, the internal Annual Performance Review (APR) exercise could be enhanced to give greater weight to the ability and willingness to make independent, candid judgments.[4] Ex

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

post assessments of surveillance (see Recommendation 1, above) could be used as a basis for evaluating senior staff performance in this regard.

- A medium-term IMF-wide program should be established to develop a critical mass of staff members with significant country expertise in each of the emerging market economies that have been identified as systemically important, including mechanisms to allow staff to make visits to these economies for professional development and systematic efforts to assign relatively junior members as Resident Representatives. An information system to track this expertise should be established.[5]

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