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THE IMF AS CRISIS MANAGER: AN ASSESSMENT OF THE STRATEGY IN ASIA AND OF ITS CRITICISMS

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I. Introduction

The Asian crisis of 1997 and 1998 gave the IMF a new opportunity to play the leading part in an international effort to stave off a financial crisis of potentially systemic proportions. The first time the Fund had acted in the same capacity and in comparable scale had been during the Mexican crisis of 1994/95.[1] The Fund's performance in the Mexican crisis has largely been praised as a success story.[2] Most analysts stress the V-shaped recovery of Mexico and the early repayment of the debts created in the rescue initiative as evidence of the adequacy of the Fund's proposed adjustment policies.

The praise for the Fund's intervention in Mexico is in stark contrast with the generalized criticism received by the IMF for its handling of the Asian crisis. Criticisms poured from the right and from the left. Calls for reforming the Fund, severely curtailing its powers came both from left-wing critics pointing to the increase in unemployment and poverty caused by the recession deepened (if not actually created) by Fund-sponsored restrictive policies, and from right-wing economists and politicians that pointed to the moral hazard generated by the implicit guarantee the Fund was seen to give to international investors that their financial investments were safe even in the event of a financial or currency collapse in those countries. Criticisms were so strong that the Fund itself, notoriously oblivious to them under normal conditions, seemed to feel shaken. Unusually humble, soul-searching papers, examining the Fund's handling of the Asian crisis, were produced by staff economists and a

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[1] The attribution of a leadership role to the Fund during the Mexican crisis may give more importance to form than to substance, since the rescue package seemed to have been put together directly by the US Treasury rather than by the Fund itself.

general change of rhetoric (if not of actual content) in its approach to crisis was widely advertised, stressing the Fund's newly-discovered social concerns.

These feelings of insecurity seemed to have largely disappeared as a result of the resumption of strong growth in some of the crisis countries, and particularly in Korea, that the Fund takes as proof of the wisdom of its policies.[3] The stress on poverty reduction remained, more forcefully in the speeches of former Managing Director Michel Camdessus, as an element of the adjustment programs sponsored by the Fund, but that was all that was left from the initial moments of weakness.

The Fund was generally blamed for treating the Asian crisis as if it was a standard balance-of-payments crisis caused by excess aggregate domestic demand, thus ignoring the specificities of the affected countries' economies. The most common criticism "from the left", due mainly to Jeffrey Sachs, was that the Fund did not realize that this was a liquidity crisis, similar to bank runs. In this interpretation, fiscal austerity and rising interest rates could only deepen the crisis. More radical critics, like Stiglitz, Rodrik and, among post Keynesians, Kregel, detect deeper flaws in the Fund's approach, even if sharing, to some degree, the above diagnosis. The view seems also to have been shared by Krugman, although the latter author's positions seem to change too quickly to allow any definite classification.

From the "right", as already mentioned, the most vocal academic critics are Allan Meltzer and Anna Schwartz. The latter radically opposes the diagnosis offered by the "left", stating that the affected countries were actually insolvent and that this was due to their inefficient and corrupt domestic policies. The Fund is criticized because it supported corrupt governments and financial institutions at the expense of US "tax-payers' money". It is noticeable that both sets of criticisms, from the "right" *and* from the "left", tend to focus

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[2] But see, for instance, more pessimistic assessments by Anna Schwartz and by Euromoney magazine, referred to below.

[3] An example, among many, is the opening statement of E. Hermandez-Catá, IMF's Associate Director, African Department, in a debate sponsored by *The New Republic* on April 13, 2000: "And I begin by saying that, of course, mistakes were made. (…) I maintain, however, that basically our strategy in confronting these crisis (sic) was not wrong; it was the right one. And I think the fact that Mexico, Brazil, the Asian countries, and even Russia are now experiencing positive and often rapid growth is a clear indication of that." (www.thenewrepublic.com/imfdebate/cata.html).

mostly on the Fund's *short-term adjustment policies*, giving relatively little attention to the *structural adjustment policies* it sponsors.

In this paper, we intend to reconstruct this debate to understand the arguments raised by all three "sides". Fundamentally, we are interested in the lessons each group believes should be extracted from this episode for future interventions by the Fund. In particular, we want to make the point that too little attention has been given to the long-term, structural reforms and policies recommended by the Fund. In section II we begin by sketching the broad features of the Asian crisis to serve as background to the policy discussion that follows. The picture offered is very sketchy, since the empirical literature on practically every aspect of this crisis is exceedingly abundant. Section III is then dedicated to a presentation of the Fund's strategy to overcome the immediate crisis and to support recovery. Section IV will present the criticisms from the "left" and from the "right" as well as the Fund's rebuttal. Section V tries to identify the main problems raised in this debate as well as the most important omissions. Section VI concludes the paper.

II. The Crisis in Asia: A Broad Outline of the Facts

As already observed, the literature on this topic is exceedingly abundant and only the most essential points will be made in this section to serve as background for the discussion in the following sections. The "facts" can be gathered from many sources, but it may be particularly adequate to this paper to appeal to IMF's own publications.

In order to confine this discussion to the "facts", we will concentrate on the crisis itself, rather than on its "roots", which are, of course, a matter of interpretation. Accordingly, the facts to be reported are those of 1997, the year the crisis came into the open.

In its annual report *International Capital Markets*, for 1998, the Fund presents box 2.12 containing the "chronology of major events in the Asian crisis and its spillover". It starts from the introduction of capital controls in Thailand, in May 1997, in response to the pressure exerted on the baht in the exchange markets, that was not abated "after a week of selling pressure and massive intervention in the forward markets". In the following month, Thai authorities intervened in 16 financial institutions ordering them to merger or to consolidate. A few days later, in July 2, Bank of Thailand gave up defending its currency and announced a managed float regime. The baht devalued 15% on-shore and 20% off-shore. The collapse of the bath spilled over to the Philippines and to Malaysia in less than two weeks. By the end of July, Thailand requested the IMF's help. In August 20, an agreement was signed between Thailand and the Fund. Meanwhile, the crisis was spreading. In August 14, Indonesia abandoned the rupiah band. Two weeks later, Malaysia introduced controls in the form of a ban on short selling of stocks. In October 20 the Taiwan dollar was attacked and immediately afterwards the Hong Kong dollar was also attacked. To fight the attack, Hong Kong monetary authority raised the interest rates and stock prices fell. This fall is transmitted to the New York Stock Exchange and to emerging stock markets in Argentina, Brazil and Mexico. By October 31, Indonesia and the IMF reached an agreement. Pressures moved now to Korea, where weaknesses had been detected in the corporate and financial sectors, with the bankruptcy of an important chaebol. Again, the attack on the Korean currency led to the abandonment of the defense of the won in November 17. Four days later, Korea requested IMF's assistance, signing an agreement with the Fund in December 3. Of the five countries most affected by the financial crisis, only Malaysia chose to adopt capital controls instead of signing an agreement with the IMF.

The situation kept deteriorating even after the agreements were signed. Thus, in December 23, 20 days after the agreement with the IMF was announced, the won was still falling precipitously and Korea's rating was being downgraded. In December 30th, foreign banks and the Korean government began to negotiate a rollover of Korea's short-term debts, and an agreement is reached by January 16, 1998.[4]

Among the relevant "facts", one should also notice that fiscal indiscipline was not characteristic of these countries, as Stiglitz and Furman (1998, pp. 33 ss) have stressed. Inflation was generally low. Exchange regimes varied from pegged exchange rates (to the US dollar) to formally or informally fixed exchange rates. In terms of balance of payments,

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[4] Private banks were practically forced to renegotiate their short term credits against Korea by the US Treasury Department. The exceedingly negotiations led by Korean authorities were reported in *Euromoney*, March 1998.

a common characteristic (except for Malaysia) was the strong appeal to short term capital inflows and, thus, the accumulation of short term foreign debt.

Guidance by the IMF is set in two types of documents, the first of which, the "letters of intent", has been made public by the Fund in its website, and the other, the actual agreements, with detailed quantitative targets to be achieved, is not. Typically, a letter of intent contains an analysis of the roots of the situation that led the country to request the IMF's assistance, followed by a roll call of policies and measures the client country is willing to adopt as "collateral" against the financial help from the Fund.[5] The "roots" of the crisis are traditionally found to be some kind of spurious intervention by governments in the economy, that the country promises to stop. In the case of Korea, for example, it is stated that "in the process of development, the limitations of Korea's system of detailed government intervention at the micro level have become increasingly apparent. In particular, the legacy of intervention has left an inefficient financial sector which has led to a highly leveraged corporate sector that lacks effective market discipline."[6] One should keep in mind that although, in theory, letters of intent are written by governments requesting help and are *addressed to* the IMF, they are in fact carefully negotiated with the Fund, with the latter notoriously dictating the main points to the client government.

The Korean agreement with the Fund stipulated that, in the short term, "[t]o demonstrate to markets the government's resolve to confront the present crisis, monetary policy is being tightened immediately to restore and sustain calm in the markets and contain the inflationary impact of the recent won depreciation. In line with this policy, the large liquidity injection in recent weeks is being reversed and *money market rates have been raised sharply and will be maintained at a high level as needed to stabilize markets*."[7] But not only monetary policy should be very restrictive, fiscal policy should contribute to show markets the same resolve, remaining "tight" in 1998.

[5] The process of negotiation of the terms contained in a Letter of Intent is described in Mussa and Savastano (1999).
[6] Cf. IMF, Press Release 97/55, of December 4, 1997.
[7] Idem, my emphases.

The Fund also demanded that *structural* reforms should be implemented. These reforms should change corporate practices and the behavior of financial institutions, besides making labor markets more "flexible", and further pursuing trade and capital account liberalization.[8] Broadly similar policies and structural reforms were imposed on Thailand and Indonesia. When the Korean agreement was announced, the Fund expected that economic growth would decelerate in 1998 to 2.5%. As we see in table 1, GDP actually *fell* 5.8% in Korea and, from table 2, 10.4% in Thailand, not to mention Indonesia where GDP fell even more sharply.

Table 1 - Republic of Korea: Selected Indicators

	1995	1996	1997	1998	1999
	(percent changes unless otherwise noted)				
Real GDP	8,9	6,8	5	-5,8	9
Private consumption	9,6	7,1	3,5	-9,6	10
Gross fixed investment	11,9	7,3	-2,2	-21,1	3,7
Exports	24,6	11,2	21,4	13,3	18,1
Imports	22,4	14,2	3,2	-22	31
CPI	4,5	4,9	4,4	7,5	0,9
Unemployment rate	2	2	2,6	6,8	6,6
Consolidated central govervnt. Balance (percent of GDP)	0,3	0	-1,7	-4,2	-4,6

Source: IMF, Public Information Notice 99/115, December 29, 1999

Table 2 - Thailand: Selected Indicators

	1996	1997	1998 (estimate)	1999 (projected)
Real GDP growth	5,9	-1,8	-10,4	4
Consumption	7,5	-1,2	-12	5,5
Investment	7,4	-20,3	-38,1	3
Overall public sector balance	1,7	-2,7	-5,8	-6,6
Exports growth	-1,9	3,8	-6,8	5,1
Imports growth	0,6	-13,4	-33,8	14,2

Source: IMF, Public Information Notice 00/5, February 10, 2000

[8] Idem. The list of reforms demanded by the Fund from Korea ran for about 20 pages. A particularly important "reform" consisted in the opening of domestic financial systems to foreign institutions. Letters of intent are regularly updated and new demands are added. More than a year after the agreement, the list of demands contained in Korea's Letters of Intent signed in 1999 still ran 20 pages (www.imf.org/external/np/loi/1999/031099.htm#memo). Generally, these reforms follow the so-called Washington Consensus, a reform program for developing countries, emphasizing the liberalization of markets, privatization, commercial and financial opening, etc. For a very critical examination of the Consensus, see Stiglitz (1998).

III. The IMF's Adjustment Strategy

A frequent criticism of the IMF's behavior in the Asian crisis is that it did not recognize the specificities of Asian economies, offering them the same diagnosis that it always applied: balance of payments problems are always rooted in excess domestic demands caused by governments running persistent fiscal deficits.[9] This criticism is, at least in part, unfair. The Fund *did* recognize the structural specificities of Asian economies.[10] Nevertheless, the short-term adjustment policies the Fund recommended were, somewhat surprisingly, *identical* to those proposed to conventional cases of excess demand imbalances. The rationale for recommending high interest rates and tight fiscal policies, in this case, was to restore the "confidence of the markets".[11]

In fact, the Fund had been changing its approach to the nature of balance of payments crises and its remedies for some time before the Asian crisis.[12] After the collapse of the Bretton Woods system of fixed exchange rates, industrial countries no longer demanded the Fund's assistance to deal with external problems. Developing countries, instead, became the typical clients of the Fund. For these countries, the Fund developed the view that dealing with balance of payments problems required not only better macromanagement but also *structural* change. With the Asian crisis, these structural changes became explicit conditionalities.[13]

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[9] See, e.g., Stiglitz and Furman (1998).

[10] See, for instance for the case of Korea, the "background" for the adjustment program negotiated with the Fund in December 1997 in the IMF Press Release 97/55, of December 4, 1997, in the Fund's website. In IMF (1997), one could also find an analysis of the rising Asian crisis that emphasized its "new" elements.

[11] "All things considered, the notion that in the context of the Asian crisis easings of monetary policy would have induced exchange-rate appreciation is nonsense." (Mussa and Savastano, 1999, p. 107). For a general defence of the Fund's policies based on this motive, see, e.g., Kochhar, Lougani and Stone (1998). Radelet and Sachs (1999), in fact, accuse the Fund of adopting the wrong policies, not the wrong diagnosis of the crisis.

[12] The changes in the IMF's approach to crises and of the strategies proposed to deal with them were discussed in Carvalho (2000a).

[13] Conditionalities of a nature and extent comparable to those imposed on the Asian countries did not have to be imposed on México. As explained by M. Camdessus, "the exceptional assistance provided to Mexico was warranted equally by the strength of the program adopted and *Mexico's track record of macroeconomic and structural adjustment*." (Camdessus, 1995a). Additional demands were made to the Mexican government, to pursue "further the strategy of privatization and liberalization of activities previously reserved for the public sector"(idem). Also in the case of Brazil, structural conditionalities were mostly unnecessary since the local government had already implemented most of them of its own will.

Under these circumstances, strategies to deal with an external crises were bound to become much more complex and intrusive than before. The Asian crisis, much more than the Mexican crisis before it, allowed the Fund to develop the new approach into a formal set of targets.

Two features define the new environment demanding new anti-crisis strategies. On the one hand, we find "the globalization of financial markets", in which "not only did the magnitude of [capital] inflows increase … but their composition changed fundamentally. In particular, private market sources more than accounted for the surge in capital inflows" but also "while in earlier periods private sector lending had mainly been in the form of bank lending the new surge in capital flows consisted primarily of portfolio investment, with increased direct investment also playing a role." (Camdessus, 1995b). The second defining feature, as already mentioned, is that the Fund's client economies are now developing and underdeveloped economies.

The first of these features imply the emergence of new sources of potential instability that client economies have to learn to cope with. Two difficulties focus the Fund's attention: first, "capital inflows can complicate domestic economic management"; secondly, and more dramatically, "countries that successfully attract large capital inflows must also bear in mind that their continued access to international capital is far from automatic, and the conditions attached to that access are not guaranteed. *The decisive factor here is market perceptions*: whether the country's policies are deemed basically sound and its economic future, promising. The corollary is that *shifts in the market's perception* of these underlying fundamentals can be quite swift, brutal, and destabilizing."(Camdessus, 1995b, my emphases)[14] Interestingly enough, these risks do not lead the Fund to favor controls on capital movements. The "right" choice is for governments to behave in such a way as to "lull the disquietude" of financial investors, to borrow Keynes's phrase. In fact, to preserve the "sentiment of the market" will be the paramount criterion to set the policies that client

[14] One should note that it is not so much the actual policies that matter but the *perception* of markets that counts. Like with Caesar's wife, it is not enough to be honest, one must *look* honest. One should also notice that *markets* is an euphemism for *financial investors* that helps to disguise the fact that "markets" are not disinterested referees of what is "sound" or "promising" for the economies involved. Investors, naturally, will not have favorable perceptions of policies that may go against their interests, be they "sound" or not.

economies will have to follow in order to access the Fund's financial help. *In the view of the IMF, financial investors and speculators are supposed to perform the very positive role of imposing discipline on otherwise profligate governments.*

Although the fleeting nature of capital movements is explicitly acknowledged by the Fund, financial investors are mostly treated, in its analyses of crisis episodes, as innocent bystanders. The crisis in Asia, accordingly, was to be explained by structural weaknesses inherent to the way these economies were organized, notwithstanding the fact that these same modes of organization had been responsible for bringing them from poverty to prosperity in an amazingly short period of time. IMF directors seemed to never tire of pointing out these weaknesses. A few examples of statements by Fund's authorities should suffice to illustrate the point:

"[the crisis] reflected deep-seated weaknesses in corporate governance; ineffective bank supervision; nontransparent relationships among government, banks and corporations; and macroeconomic imbalances evidenced by rising current account deficits and short-term external debt." (Sugisaki, 1999)

"… three other[15] factors helped trigger the crisis: the weakness of their public and private banking and financial structures; an unsustainable accumulation of short-term financing … which made countries particularly vulnerable to a sudden shift in market sentiment; and, last but not least, deep-seated problems of governance, corruption, and what US commentators call 'crony capitalism'." (Camdessus, 1998a)

"The problems facing Asia's banking systems are the legacy of years of bad lending practices and inadequate supervision and regulation that led to rapid lending growth and excessive risk taking. Very high leverage ratios heightened financial fragility." (Fischer, 1998)

Given that the crisis was to be explained by internal imbalances and maladjustments rather than a consequence of global financial fragility, its solution could only be attained through changes in the domestic economies of the crisis countries themselves. To solve the crisis means, in these circumstances, stabilizing exchange rates, rebuilding reserves, and restoring capital inflows. Governments should win back the confidence of financial investors.

[15] Other than changes in the exchange rate between the yen and the dollar to which the currencies of some Asian countries were pegged.

According to the IMF, to regain confidence a strategy had to be followed consisting of three elements:

"to tighten macroeconomic policies in the initial stage in order to stabilize exchange rates, and stop capital flight, and inflation; to mobilize large-scale external assistance from multilateral and bilateral sources, in order to help break the vicious cycle of capital outflows, currency depreciation, and deterioration in the financial sector; and to tackle the key structural problems (mainly in the financial sector), to address the root cause of the crisis." (Sugisaki, 1999)

The first measures to be adopted, thus, were to raise interest rates to bring back foreign capital and to promote fiscal austerity to show the resolve to attack the sources of vulnerability.[16] This, together with the supply of external funds coming with the rescue package, should calm down investors and, hopefully, persuade them to keep their resources in the country (or bring them back if they were already taken out). Apparently (and somewhat curiously) the IMF seemed to believe that these measures would be just *slightly* restrictive. The Fund seemed to expect that the downward pressure on aggregate demand could be compensated by the expansive effect of attracting capital inflows and improving the mood of entrepreneurs. In fact, discussing the aftermath of the Mexican crisis of 1994, M. Camdessus made this rather amazing statement:

"Economic growth is projected to resume next year. *To achieve these goals, the [IMF] program [for Mexico] is centered on a further tightening of the fiscal position and a strong monetary policy*." (Camdessus, 1995a)

The Fund seemed to expect the following sequence to take place: rising interest rates would attract capital inflows on the crisis countries, stopping the devaluation of the currency, eliminating panic, easing domestic liquidity, increasing the price of domestic financial assets, at some point stimulating investments. These virtuous effects should dominate the depressive influence on consumer demand. The Fund authorities and analysts seemed

[16] In fact, as we saw, Asian countries did not exhibit, as a rule, relevant fiscal déficits. The emphasis on fiscal austerity in the initial IMF adjustment programs was explained by the need to finance the restructuring of the financial sector (see, for instance, Camdessus 1998). Later, the rhetoric was changed, and fiscal surpluses should be used to finance the creation of social safety nets. In the end, fiscal *deficits* became acceptable to accommodate recoveries and to finance safety nets.

sincerely shocked when it became clear the extent of the damage that these policies had actually caused in terms of falling output and rising unemployment.[17]

One can debate, and this was a point raised by the Fund's critics, whether these measures were actually responsible for the improvement in the balance of payments position recorded still in 1998. In any case, for the Fund just to restore currency stability, in the case of developing and underdeveloped countries was not enough. It was also necessary, as proposed by Sugisaki, "to tackle the key structural problems". According to Michel Camdessus, in the IMF programs,

> "we can discern three tiers of recovery: the first tier is to **restore stability**. As usual, immediate action is needed for countries faced with sudden acute pressure on their balance of payments; the second tier is to **improve soundness**. Lost confidence, especially in domestic financial and corporate systems, has to be restored through fundamental institutional changes; the third tier is to **boost efficiency**. *The approach of 'managed development' underlying economic policy, characterized by mechanisms that interfered with market allocation of resources has become increasingly out of tune with the rigorous demands of our globalized economy.*" (Camdessus, 1998b, italics added)

Long-term "structural reforms" for the Asian countries consisted, in the Fund's view, of mainly three initiatives. The financial sector had to be "cleaned up". Financial reform meant basically to close down unviable financial institutions, particularly those burdened with excess debts from corporations, and the permission for foreign institutions to operate in the domestic market. The Fund argued that foreign banks would bring with them not only their superior expertise but also their more advanced techniques to deal with risks. This reform should be implemented immediately and it was a point of particular importance for the IMF.

The second area of "reform" should be corporate governance. Firms, especially large firms, had to change their capital structure, reducing the burden of debt and appealing more intensively to equity markets. The connections between firms within industrial groups should be broken, markets should be liberalized and competition intensified.

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[17] See Lane et al. (1999), quoted below.

Finally, the relationship between governments, financial institutions and industrial groups should be redefined. Economies had to be reconstructed along lines similar to those prevalent in Anglo-Saxon economies. The relationship between government, banks and firms should be kept at arm's length. Banks should be free to decide their credit policies, and activist industrial policies were seen, as we saw above, as being "out of tune with the rigorous demands of our globalized economy". That the point was to make the Asian economies more like the US economy was made plain by Deputy Managing Director Stanley Fischer:

"In this new environment, Asian economies should seek to spur growth by promoting productivity growth. This means more open and freer financial, goods, and labor markets as well as liberal trade and exchange systems – in other words, a move away from the highly centrally directed systems of the past, toward a new more market-oriented model." (Fischer, 1999).

The "mission" the Fund began to explicitly pursue after the Asian crisis was, thus, not only to help sustaining balance of payments equilibrium and exchange rate stability, as in the past. This was now just the short-term goal, to stop panic. The larger strategy is, however, much more ambitious: *to redesign the economic systems of client economies in the image of the US economy.*[18]

All these points found their way into letters of intent and agreements signed by the crisis countries and the Fund. To the surprise of the IMF's directors and staff, in contrast to what happened during the Mexican crisis, criticism of the Fund mounted right from the beginning in the light of the disastrous results that followed.

IV. Criticisms of the Strategy and the Fund's Rebuttal

A barrage of criticism coming from very different corners hit the IMF almost immediately after its intervention began. Some of this criticism was concerned with the damages the

[18] The incredibly patronizing position assumed by the Fund with respect to developing countries, according to which it would be up to the Fund to define how these countries' economies should be structured, was strikingly reflected in remarks made by Fischer, from which the preceding quotation was extracted. In this same speech, Fischer actually *thanked* the politicians and bureaucrats of the client economies for implementing the Fund's programs! Managing Director Camdessus, on the other hand, addressed the President of Korea and other authorities in December 1999 stating about the Korean recovery: "This looks

Fund's conditionalities could cause to the crisis countries and their population. We will call these concerns criticisms from the "left", taking some liberty with the meaning of the word. On the other hand, the Fund was also criticized for unduly "giving a break", to use a colloquial expression, to undeserving countries and financial institutions. These criticisms, that we will call criticisms from the "right", accused the Fund of subsidizing countries that were suffering crises for reasons of their own creation and of bailing out financial institutions that invested on them. Perhaps because of the intensity of criticism, perhaps because of the disastrous initial results of its intervention, the Fund took at first a defensive position, softening some of its demands on the crisis countries and introducing in its rhetoric a specific concern with the social impact of its adjustment programs. Later, however, although the social rhetoric was maintained, the IMF seemed to feel sufficiently comfortable with the evolution of the situation to resume its previous views as to the need for the affected countries to move forward with liberalizing reforms.

i. Criticisms from the "Left"

This first group of critics of the IMF actually included authors of very different origins. To treat them as a *group* is only proposed in this paper as an argumentative device. These authors had in common the view that the adjustment programs negotiated with the Fund by the crisis countries unnecessarily worsened the latter's situation, intensifying panic, causing steep rises in bankruptcies and in unemployment, and compromising the improvement in living conditions that these countries had painfully achieved over the preceding years. The wider area of agreement between authors included in this "group" was that the *short term policies* imposed by the Fund were misguided and inefficient. We could count here analysts such as Jeffrey Sachs, Joseph Stiglitz, Dani Rodrik and Jan Kregel, to cite a few. In one time or another, Paul Krugman could also be counted in this group, despite the difficulties of pinning down his ever-changing ideas on this issue. Fewer economists in this group would also add another dimension to their criticisms, related to the appropriateness of the longer term policies imposed by the Fund. Doubts were expressed and objections

very much like the V-shaped curve of growth *I promised you* two years ago, if you were to persevere with your program." (Camdessus, 1999, emphases added) raised either with respect to the nature of structural reforms demanded by the IMF or to their timing.

The central point made by the "left" in its criticism of the short term adjustment policies implemented under the Fund's guidance was that the Asian crisis was a *liquidity crisis*.[19] The IMF was used to deal with external payments imbalances generally attributable to domestic excess aggregate demand rooted in government fiscal indiscipline. Under these conditions, monetary tightening and fiscal austerity were seen as efficient policies sufficient to bring the economy back to equilibrium. In the case of the Asian crisis countries, the fiscal accounts were either balanced or slightly in deficit.

These countries were plagued by a different problem. It was not located in the current account, to begin with, but mostly in the capital account. The crisis countries had absorbed foreign capital in large scale, mostly as portfolio private investments or financial placements but also as syndicated loans.[20] The external liabilities created by these inflows were short-term, either because of fears by foreign financial investors to commit themselves for longer periods or because of advantages offered by the host countries themselves. These inflows were used either to buy liquid assets, such as stocks, bonds or land, or to finance productive investment. Those funds directed at second-hand asset markets most probably fed price bubbles. The share of the inflows used to finance investments, however, was transformed in long-lived, illiquid assets. In either case, a sudden attempt to reverse capital flows would impose heavy losses on foreign creditors and investors. Authors like Sachs insisted on observing that these countries were not insolvent: funds were not squandered in useless enterprises or dispersed through capital flight.[21] A serious maturity and currency mismatch, however, marked the external operations of these economies: the purchase of iliquid assets was being financed with short-term liabilities.

[19] This point was insistently made by Jeffrey Sachs. See Radelet and Sachs (1998) and (1999), Stiglitz and Furman (1998), Chang and Velasco (1998). An early version of the argument is presented in Sachs, Tornell and Velasco (1996).
[20] J. Stiglitz has repeatedly argued that financial liberalization, leading to the accumulation of short term debts, was actually forced on the Asian countries by the IMF and the industrial countries, notably the US. See, for instance, his now famous article in The New Republic, "What I learned at the world economic crisis", www.thenewrepublic.com/041700/stiglitz041700.html.
[21] See, for instance, Radelet and Sachs (1998) on the importance of distinguishing between insolvency and iliquidity.

To show how a liquidity crisis can arise, these authors appealed to a classical model of bank runs.[22] In this model, a bank is defined by its sight liabilities, like demand deposits, issued to buy much less liquid earning assets. In the short term, its liabilities cannot be liquidated in full because assets would be worth less than their full value if they had to be sold before its maturity. If all creditors of a bank decided to wait until the asset matured, everybody would have their money back and the bank would proceed without problems. However, if any subgroup of creditors decided to claim their money before that date, the last ones to do it would end up with nothing, because the receipts from selling the assets would not add up to the value of total liabilities. The question, of course, is why would anybody try to anticipate the liquidation of one's claims against the bank?

The answer is that, without some kind of coordinating mechanism, the simple fear that others could do it could be enough to stimulate someone to take the initiative, since the first ones in line would probably get much more of their money than the last. Any rumor, any event that could lead somebody to run to the bank should be enough to make others do the same, preferably even before the run actually began. If this happens, a solvent viable bank can go bankrupt because of a liquidity crisis.

Most "left-wing" critics of the IMF think that the description just given offers a proper analogy for the run against the crisis countries currencies in Asia. Rumors of capital controls, of domestic bank problems, of political instability, anything in fact, could trigger such a run against these currencies, because investors knew that the first ones to flee would minimize possible capital and exchange rate losses.

In addition, once a country suffers a "run" on its foreign currency reserves, other countries in similar predicament become the object of "contagion", that is, they become subject to "preventive runs" by their own foreign creditors and investors.

How liquidity should be measured in these cases? According to Radelet and Sachs (1998), the most significant indicator is the ratio between reserves and short-term foreign liabilities. This ratio measures a country's ability to honor their obligations *in foreign currency*. Any ratio below unity indicates that if any creditor triggers a run, the last ones in the creditors' line will suffer losses. The liquidity ratio proposed by Sachs and Radelet would predict financial crises in four of the five Asian countries affected, according to Stiglitz and Furman (1998). Malaysia would be the odd country out.

When a domestic bank run begins, the right policy to deal with it is the activation of lender-of-last-resort facilities. What should a multilateral institution like the IMF do in a similar situation? Certainly not push domestic governments to raise interest rates, something which reduces the value of domestic assets and increases the share of non-performing assets. A liquidity crisis is solved by supplying additional liquidity while preserving the essential soundness of the countries assets and, thus, its capacity to pay back its liabilities when investments mature. In other words, the correct policy would be the Fund itself to act as a surrogate lender-of-last-resort, with its own funds and those it could obtain from other countries, to show creditors that there was no reason for a run.

The essential criticism made by this group, therefore, was that the Fund's policies worsened the situation because they worsened the perspectives that these countries would be able to pay back their debts in the future. The appropriate policy mix would be some intervention to guarantee the proper availability of international liquidity to the affected countries and to promote some kind of renegotiation and rollover of debts between them and their creditors. According to Sachs and Radelet, the evidence in favor of his argument is that the Korean currency did not stop sliding with the signature of the agreement with the IMF. The won stabilized only after banks and the Korean government got together to negotiate the rollover of the latter's short term debt.[23]

As to the longer term aspects of the adjustment strategy of the IMF, there was less agreement among the authors of this group. For some, this was not even an important subject (or at least it did not deserve more than a passing mention). Researchers like Stiglitz and Rodrik raised more fundamental questions about the vision of capitalism sponsored by the Fund. A particularly important subject related to the trend toward global financial

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[22] See Sachs, Tornell and Velasco (1996).
[23] Radelet and Sachs (1998).

integration. Both Stiglitz and Rodrik were much more cautious about the wisdom of pursuing financial integration as conceived by the Fund, removing barriers to any kind of capital flow and liberalizing capital transactions through the establishment of the convertibility of capital accounts.[24] Stiglitz stresses that there is no support in economic theory and research to the idea that actual capital markets work as efficiently as the Fund seems to assume.[25] In his view, asymmetry of information problems are important enough to justify a much less optimistic view of capital markets' capacity to self-regulation than seems to be believed in institutions like the IMF. Rodrik, on the other hand, relies on empirical research to show that there is no evidence that countries that removed their controls over capital flows perform better than those that did not.[26] Be it as it may, the issue of whether there is an ideal form of market economy is still too uncertain.[27] But even if one accepts the Fund's long term view, said Stiglitz, it is still debatable whether the moment to begin implementing these reforms is in the middle of a short-term liquidity crisis. In his view, while a panic situation is developing is not the best moment to close banks, for instance, as it was done, under the IMF's prodding in Indonesia.

Kregel introduces some important subtleties in the general argument of this group. In his view, to characterize the Asian crisis as a capital account crisis may be misleading since capital accounts, as much as current accounts, measure *flows* of capital, when the crisis was motivated by *stock* mismatchings. Kregel approaches the Asian crisis from a Minskyian point of view.[28] The balance sheets of firms in those countries were marked by two kinds of mismatchings: on the one hand, they financed the production or purchase of long term assets with short term liabilities, including those issued in favor of foreign investors; on the other, their assets were denominated in local currencies, but a portion of their liabilities were denominated in foreign currency. These firms were very vulnerable both to movements in exchange rates and in interest rates. The crisis and the Fund's intervention

[24] Membership in the Fund only entails, according to the Articles of Agreement, the convertibility of current account transactions.
[25] See Stiglitz and Furman (1998), for a detailed discussion of the risks and difficulties of capital liberalization, particularly in emerging countries.
[26] See, for instance, Rodrik (1998). (IMF's Stanley Fischer, at least, seems to be aware of the lack of empirical evidence in favor of liberalization of capital movements. For Fischer, it is a question of hope: evidence will be eventually available. See Fischer (1999), fn. 20.
[27] See, e.g., any of the numerous works of R. Wade on Asian economies.
[28] See particularly Kregel (1998a) and (1998b).

actually caused both. The correct short term package of policies would provide liquidity to these countries to prevent capital flight without raising the interest rate. In a longer term perspective, Kregel also does not favor liberalizing capital movements, but, instead, proposes the adoption of controls that penalizes short term capital inflows.

ii. Criticisms from the "Right"

The main criticism raised against the Fund by conservative economists was that it rewarded financial speculators, by bailing them out, and that it wasted US taxpayer's money financing insolvent countries and their corrupt governments. Two striking features of this approach, of which Anna Schwartz and Allan Meltzer seem to be the leading figures, are precisely that, in contrast to the "left" view, the judgment that the Asian countries were actually *insolvent*, rather than just illiquid, and the tendency to approach the issue from a narrow US point of view rather than as problem of the world economy. Thus, the Fund is criticized not exactly because of wasting resources, but mostly because in part those resources are "US taxpayer's money".

According to Schwartz, the crisis countries were actually insolvent because after the sharp devaluation of their currencies, their assets, denominated in local currency, were worth less than their dollar-denominated liabilities.[29] Of course, the argument seems to beg the main question: after a liquidity crisis runs its course unchecked, bankruptcy actually *does* take place. But this is not a proof that the problem was not, ex ante, one of liquidity. Any bank would be bankrupt if its balance sheet had to be reckoned at liquidation prices instead of the expected value of its assets!

Be it as it may, the argument proceeds to propose that insolvency, on its turn, was not caused by global financial instability in any relevant way, but by financial malpractice, corruption and inefficiency. Contagion itself should be seen as a false question because the affected countries were not "innocent bystanders". Indonesia and Korea were hit after the crisis in Thailand because they shared the same weaknesses, namely, corruption and inefficiency. In Schwartz's view, having caused their own problems, they should bear the cost of correcting their ways. Schwartz's criticism, thus, contrary to what is proposed by the 'left", is not directed just to the short term policies supported by the Fund, but also to the financing of long-term reforms. In her view, the delinquent countries should pay for their own sins, not the "American taxpayer". In her words:

"The countries in Asia that are experiencing financial problems will either adopt measures to reform their banking systems, to eliminate political domination of credit allocation, and to earn restoration of their creditworthiness in international capital markets, or they will not. To do so requires political resolve, not the IMF. Not to do so means those countries will fail to grow out of their problems. *The world financial system will not be undermined if the IMF does not bail out those countries. Low-income countries have gotten into trouble financially many times in the past two centuries. Investors who lost money in ventures in those countries were hurt, and the countries involved had setbacks. The world did not collapse.*" (Schwartz, 1998, my emphases)

Schwartz does raise an important point though: it is not to the IMF to dictate how countries should organize and run their economies. The author agrees with the Fund that balance of payments problems of underdeveloped or developing countries have structural roots. Her view, however, seems to be that the Fund should refrain to deal with them, not to enlarge the scope of its intervention.

Allan Meltzer's emphasis is on the danger of moral hazard resulting from the Fund's rescue programs.[30] His point is that the IMF's rescue packages represent some kind of guarantee to financial investors that they will be bailed out in the event of a crisis. In his words:

"First in Mexico, and now in Thailand, it has lent money at low interest rates to shore up insolvent financial institutions and protect foreign banks and investors by limiting their losses. … International banks and financial institutions can now act safe in the knowledge that the IMF will provide a safety net to protect them from some, or even most, of their losses." (Meltzer, 1997)

Meltzer's criticism are not , thus, concerned with the relationship between the Fund and the client economies, but with the indirect relation between the IMF and the financial institutions that put their money into those countries. By bailing them out, the Funds signals

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[29] "The borrowers and creditors in the Asian country crises are not faced with liquidity problems. The problem is insolvency. At most, the IMF can provide a bridge loan. It cannot deal with the underlying insolvency problem." (Schwartz, 1998).

[30] The same argument is repeated by Eichenbaum (1999), for whom only critics like Calomiris, who raised this point, are "persuasive".

that it is not important to worry about the credit quality of the country borrowing money or receiving an investment, because if things go wrong the IMF will provide the necessary funds to allow them to cur their losses and leave. Of course, this criticism could be raised against any form of ultimate liquidity provider or lender-of-last-resort.

iii. The "Meltzer Report" and the US Treasury Reform Proposals for the IMF

A particularly notorious piece of criticism of the IMF's policies became known as the Meltzer Report[31]. Produced by a committee named by the US House of Representatives, under the chairmanship of Allan Meltzer, the report contained tough words on the performance of the IMF (and the World Bank). Although the committee was bi-partisan, some of its participants declined to sign the report. At least one of them saw it as vehicle for Republican Party ideas rather than a really bi-partisan effort.[32] Despite being co-signed by Jeffrey Sachs, a committee member, the report is widely believed to mostly represent Professor Meltzer's views. It should be considered, thus, as another piece of criticism from the "right" in the terms adopted in this paper.

The report reserves some strong words for the intrusiveness of IMF's conditionalities, that serve to weaken democratic processes in client economies. It shares Schwartz' view that US style market-liberalization reforms are indeed necessary but that developing countries should realize it by themselves, not by dictat from the Fund. Accordingly, the report proposes an apparently drastic curtailment of the Fund's power to impose structural reforms, by actually taking the Fund out of the long term loans business. The Fund should confine its activities to supporting balance-of-payment adjustment programs in the more traditional sense.

Although the report is very critical of recent IMF's performance, it can be construed as a means of actually strengthening the pressures on developing and emerging economies to adopt market-friendly reforms. In fact, currently only countries appealing to the Fund's help have to accept its conditionalities. In the system proposed by the Meltzer Report,

[31] The report was officially produced by the International Financial Institution Advisory Commission, IFIAC (2000).
[32] See committee member Jerome Levinson's opening remarks at the debate on the IMF organized by The New Republic in April 13, 2000 (www.thenewrepublic.com/imfdebate/levinson.html).

potential beneficiaries of the IMF's funds would have to "pre-qualify" by showing a *track record* of liberalizing reforms. The committee suggests that, among the requirements, "eligible" countries had to open their domestic financial systems to foreign institutions, similarly to what the IMF already demanded from the Asian crisis countries. In other words, every country would be "stimulated" to adopt liberalizing reforms since no one knows who is going to need the Fund's help in the future.[33]

With less strong words and less radical proposals, the US Treasury has also formalized a reform program for the Fund that seems to share some of the Meltzer Report criticisms.[34] According with this proposal, the IMF should restrain its activities to short-term financing of balance of payments problems and to become more integrated with private capital markets. The proposals made by the Treasury range from measures to increase transparency not only to member governments but also to private markets to attempts to coordinate private solutions to financial crises. Opening domestic financial markets to foreign banks as well as increasing the role of private capital markets are common elements in the Meltzer Report and the Treasury proposal.

Both documents also share the idea that the extension of the powers of intervention of the IMF to cover long-term structural reform programs has not worked as expected. Accordingly, for both of them the Fund should be "downsized" back to its older and narrower mission. Both proposals are also openly concerned with reducing the burden of the US in the cost of financing the Fund's activities, but each offers a different solution. The Meltzer Report states that by reducing the range of intervention of the IMF will reduce its need for resources. The Treasury proposes a recalculation of member countries quotas that would increase the contribution (and the share in votes) of other countries, relieving the pressure on the US.

iv. The IMF's Responses to its Critics

The unusually strong and widespread criticism seemed to have taken its toll from the Fund. Its reaction to the attack went through two different stages. At first, while the crisis was

[33] As the Prince of Denmark put it: "Readiness is all".

dramatically deepening, the Fund seemed really shaken and willing to reexamine its experience in Asia. Afterwards, however, to the extent that the affected economies began to recover, particularly the Korean economy, the Fund seemed to reassure itself of the wisdom of its policies and was quick to claim the credit for the recoveries. The Fund reaffirmed its programmatic views, and attributed the strength of the recovery to the policies it recommended, even though the record on structural reforms was very weak both in Korea and in Thailand.

A very interesting manifestation of the first stage is the long paper prepared by Lane et al (1999), that was made available in the IMF's website followed, very uncharacteristically, by a summary of the comments made by the Fund's Executive Board on the text. In this paper, the analysts explicitly admit an error of diagnosis on which the IMF relied to formulate its adjustment program. The paper, in fact, acknowledges that the Asian crisis was largely a liquidity crisis, due to the faster accumulation of short term liabilities than of reserves. According to the authors:

"Understanding of the nature of the crisis was less clear when the programs were being formulated than it is now with the benefit of hindsight, but some broad aspects of the situation were apparent from the start. In contrast to many other Fund program situations, the currency crises in East Asia did not reflect substantial fiscal imbalances. Rather, *the proximate cause was a liquidity crisis*, which called for a large financing package together with other steps intended to restore confidence and catalyze private capital flows alongside the financial support provided by the Fund and the official community more generally." (Lane et al., 1999, p. 31, my emphases)

The paper also recognizes that these economies with liquidity problems are especially vulnerable to shifts in "market sentiment".[35] The paper also concedes that the Fund's was surprised by the crisis that followed the adoption of its programs.[36] It goes as far as acknowledging that projections prepared by the Fund may be wrong most of the time, since

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[34] The reform proposals were actually put out in a speech by Treasury Secretary Lawrence Summers in the London School of Business. US Treasury News, LS-294, December 14, 1999, in the Treasury website.

[35] "Growth in short-term foreign liabilities also outpaced growth in available international reserves and created the potential for liquidity problems." (Lane et al, 1999, p. 21).

[36] "Economic events during the crisis have been dramatic and have defied expectations." (Idem, p. 6)

"as in all Fund-supported programs, macroeconomic projections were predicated on the success of the programs, including the restoration of confidence." (Lane et al, 1999, p. 45)[37]

It is interesting to notice that, for the authors, the acknowledgment that one was dealing with liquidity crises did not mean that the tight monetary policies imposed by the Fund, with rising interest rates, was inadequate. The authors seem still to maintain that rising interest rates were necessary to restore the confidence of foreign investors. Even the plain fact, recognized by Lane et al., that the policy did not work the way they expected and that capital outflows proceeded as strongly after the signature of the agreement between the Fund and Korea, for example, as before, did not seem enough to require reassessment of its wisdom. The authors concede that fiscal policies were stronger than necessary, causing the downturn to be sharper than expected, but exonerate the monetary policy from a similar responsibility.[38] In fact, Lane et al argue that there is no evidence that restrictive monetary policies have worsened the situation.

In any case, even if downplayed by the authors, the acknowledgment that capital outflows in Korea were stopped by the agreement between banks and government to rollover short term debts, and not by the Fund's program is important in itself.[39] The authors also basically defend the nature and timing of implementation of structural reform measures, particularly with respect to financial institutions, arguing that doing otherwise would jeopardize recovery because the financial sector would continue to deteriorate (idem, p. 111). Finally, it is also important to point out that the criticism that the Fund was oblivious to the social costs of implementing its policies was finally pinching a nerve. Although this subject is touched only in the paper's last pages, rather as an afterthought, the authors seemed to have felt important to mention that:

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[37] In fact, the authors acknowledge that the Fund may *have* to present improbable success forecasts even if it did not really believe them because of the effect unfavorable forecasts would have on market expectations.

[38] This assessment is also present in IMF (1999), cap. 2.

[39] In fact, IMF (2000, p. 7) describes the failure of the IMF program to stem capital flight that forced the renegotiation of debts with banks in words that suggest that it was all part of the same strategy, creating even an acronym to refer to it: "But as confidence was not restored quickly, concerted **private sector involvement** (PSI) became necessary in all three countries to stem capital outflows". (emphasis in the original)

"Concerns about the effects of the crisis on the most vulnerable segments of society played a significant role in the programs from the outset, given the rudimentary formal social safety nets in the three countries." (idem, p. 115)

The paper by Lane et al was made public in January 1999, when there were no definite signs of economic recovery in the three client economies, Korea, Indonesia and Thailand. It largely reflected the insecurity of the Fund as to the efficiency of its programs given the catastrophic impact they had on those countries. This feeling all but disappeared during the year, however, to the extent that evidence accumulated that Korea was staging a strong recovery, Thailand's situation was improving and that Indonesia's continuing problems could be attributed to its political instability rather than to the Fund's policies. Accordingly, the speeches made by the main authorities in the Fund, as Director Camdessus and Deputy Director Fischer changed radically their tone. The recoveries were evidence of the correction of the short term policies suggested by the IMF. Strong capital inflows had allowed a reduction of interest rates, a strengthening of the local currencies, and the recovery of stock exchange activities.

In a recently published re-assessment of its policies in Asia, the Fund adopts an openly self-congratulatory tone:

"The financial crisis in Asia beginning in mid-1997 are now behind us and the economies are recovering strongly. This rebound did not happen spontaneously, but came about as a result of steadfast policy implementation by the affected countries and large-scale financial support from the international community, especially under IMF-supported programs for Indonesia, Korea, and Thailand. … While, with the benefit of hindsight, the IMF's policy advice to these countries during the emergency was not flawless, corrections and adjustments to circumstances were made promptly, and the strategies adopted proved successful in restoring financial market confidence and stability and in achieving a resumption of economic growth, in most cases by late 1998." (IMF, 2000, p. 2)

In fact, even the initial failure to stop capital flight is, at least partly, attributed to *domestic* policy mistakes by the affected governments:

"The IMF-supported programs were initially less successful that hoped in restoring confidence in all three countries, with capital outflows and currency depreciations continuing after the programs were introduced. This was related to a variety of factors, including:

. initial hesitations and policy reversals in program implementation, such as premature rollbacks of monetary tightening, together with political and electoral uncertainties that cast doubt on prospective policies; …" (IMF, 2000, p. 4)[40]

That unemployment in Korea was three times as high as before the crisis, even with GDP growing at the rate of 9%, investments stagnated and the balance of trade was in surplus because of the collapse of imports rather than the increase of exports went by hardly mentioned by the Fund. In fact, only private consumption actually recovered from the crisis. On the other hand, government deficits, which were about 1.7% of GDP before the crisis was now more than 4% of GDP, being actually responsible for fueling the recovery. None of this clouds the self-satisfaction of the IMF. As Director Camdessus has triumphantly put it:

"With each passing month, we see ever more encouraging indicators of the speed and vitality of Korea's recovery, clear evidence – Mr President [Kim Dae-Jung, of Korea] – that the policies you adopted in response to the crisis were the right ones and that they are working." (Camdessus, 1999).

Just in case anyone forgets it, Mr. Camdessus reminds the audience that:

"This crisis, and the measures that *together we have designed* and you have implemented …" (idem)

If the Korean recovery, in particular, was well-received by the Fund and served to soften the criticisms it received, some discomfort remains with the fact that the proposed structural reforms are either not being implemented or are implemented very slowly. The Fund has repeatedly warned against "complacency" that could cause the crisis to flare up again later:

"Despite recent achievements, there are continuing concerns as to whether the economic recovery will lead to sustained growth, or whether vulnerabilities may reemerge. While the track record may be better than some critics predicted, structural reforms have not proceeded as rapidly as desired. It is essential to ensure the completion of the large unfinished agenda of structural reforms. This is a major and difficult task, for which

[40] As Mussa and Savastano (1999) comment: "In fact, in Thailand and Korea, where the IMF advice on monetary policy was followed after some initial hesitation, exchange rates were stabilized and subsequently recovered to more reasonable levels, and nominal interest rates were then progressively reduced to below pre-crisis levels." (p. 107)

political support may not always be forthcoming. It is important to prevent reform fatigue and complacency setting in because of the recent strong performance." (IMF, 2000, p. 8) [41]

From all this debate, in which the IMF was targeted by critics from many sides, what was left as a new permanent feature of the Fund's discourse about crises, at least until now, is the new-found concern with the social impact of the adjustment programs. In fact, a more general preoccupation with poverty in general found its way into the Fund's programs of the last two years. How the Fund proposes to deal with this problem, however, cannot be treated within the limits of this paper.[42]

V. An Assessment of the Debate

Some issues stand out in this debate. Firstly, there is the question of the adequate short-term policies to deal with liquidity crises. As we saw, the Fund's staff, if not necessarily its highest authorities, accepted the diagnosis offered by Sachs, Stiglitz and others that the Asian crisis was actually a liquidity crisis. The Fund differs from them in assigning *ultimate* causes to this crisis, but apparently agrees as to the *proximate* ones.[43] Be it as it may, if it is recognized that one is dealing with a liquidity crisis, it is difficult to understand how it could be expected that tightening monetary and fiscal policies could have had any other effect than worsening the situation. Higher interest rates and lower aggregate demand (because of fiscal contraction) could only quicken the pace of the crisis by causing domestic borrowers, especially firms, to go bankrupt. To accelerate bankruptcies is a strange way of restoring confidence, unless there are ulterior motives for suggesting such policies, such as allowing foreign investors to buy domestic assets at fire sale prices.[44]

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[41] Also: "The gains you have made have created a golden opportunity for further action to sustain and consolidate the recovery. For you know well that since the task of reform is far from complete, the current favorable macroeconomic environment makes this a fitting moment for a gearshift in the reform process to ensure that the recovery is sustained." Camdessus (1999).

[42] The Fund's social concerns and programs are discussed in Carvalho (2000b).

[43] Accordingly to Lane et al (1999), the ultimate causes of vulnerability were the structural financial weaknesses found in those economies. Stiglitz and Furman (1998), on the other hand, insists that these economies were sound and could continue progressing if it weren't for global financial turbulences. The vulnerability to shifts in capital flows should be assigned to the pressures coming from institutions such as IMF itself on these countries to liberalize their foreign capital transactions.

[44] That the IMF had been transformed into an instrument of defense of US interests has been brought to attention even by publications like *Institutional Investor* (September 1999) and *The Economis*t (September 18, 1999). US Treasury Secretary Larry Summers defended the support to the Fund using, among others, the following argument: "If there was no IMF in these circumstances: there would be no multilateral vehicle for conditioned reform, reform which has achieved more trade liberalization in Asia in the past few months than

It is well known that liquidity crises are best dealt with through lending-of-last-resort devices. It is by supplying liquidity at moments of heightened uncertainty that one "lulls the disquietude" of the markets, allowing the indebted units to proceed with their projects until they mature and are able to generate the cashflows that will validate the debts. Of course, there are many difficulties of transforming the IMF into an effective international lender-of-last-resort, but the awareness of these difficulties does not make the restrictive policies proposed by the Fund the second best alternative.[45]

One deleterious effect that is usually disregarded in the examination of the short-term policies imposed by the Fund is that the repeated appeal to rising interest rates (or the perspective thereof) strengthens bearish sentiments in the financial markets and contribute to make interest rates permanently higher than they could be otherwise. Since sudden shifts of capital flows remain always a possibility when capital movements are free, the possibility of having governments to raise interest rates to stop actual or potential capital flight will probably lead wealth holders to expect higher rates of interest in the future, withholding money for speculative reasons in the present or, perhaps, shortening the maturity of their financial investments to minimize the risk of capital losses.[46]

As to the structural reforms advanced by the Fund, the debate, as we showed, is less lively. Either because critics of the Fund's short-term policies agree with its long-term views, or because they don't believe the Fund will actually be able to impose them once the immediate danger of collapse has been removed, not much has been attention is given to the fact that the Fund seems to have added to its list of "missions" that of transforming every economy into a free market economy as some idealize the US economy to be.[47]

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many years of trade negotiations in the region." (Summers, 1998) Of course, to promote trade liberalization is *not* the mission of the IMF as defined in its Articles of Agreement.

[45] On the issue of transforming the IMF into an international lender of last resort, one should see Fischer (1999). A very perceptive criticism of Fischer's views, and the outline of an alternative, is given by Davidson (forthcoming).

[46] One could take as an example the case of Brazil, where overnight interest rates controlled by the Central Bank were raised to above 40% p.a. four times since the Mexican crisis in 1995. Even if one does expect 40% to be the "normal" rate of interest, in the sense used by Keynes in *The General Theory*, one cannot ignore either that these rates are well within the range of possibilities.

[47] That the Fund itself seems to be unsure of their ability to effectively force the client countries to reform their economies is shown by the insistence with which its directors warn against the danger of "complacency"

In fact, the Fund is trying to sell a model of society that it would be difficult to find anywhere, even in the United States.[48] The showcases the Fund has to offer, particularly Chile and, even more, Mexico, are far from making a compelling case for full economic liberalization. Chile still maintains capital controls, besides being an economy heavenly dependent on foreign trade, with exports concentrated in a very small number of goods. Mexico seems to be even less an example. What is presented as a success story is a very unsatisfactory model in which, as observed by *Euromoney* magazine, citing Mexican economist Juan Enriquez (September 1998), the minimum wage is 28% of its real value in 1976, per capita income is similar to what it was in the 1960s, and external debt is higher than ever. One has also to remember that banking fragility is higher than ever, despite a rescue package involving a large amount of public resources, and that the productive sector has its destiny completely dependent on the performance of the US economy. According to Schwartz (1998), the early repayment of Mexico's debts with the IMF and other countries after the crisis of 1994/5, that is also presented as evidence of the success of IMF programs, is, to a large extent, a political hoax. Recalling that the US share in the rescue package was funded with resources of the Exchange Stabilization Fund, Schwartz points out that:

"It was politically advantageous to have Mexico repay that loan in advance of the scheduled date. Mexico did so by borrowing longer term in Europe at higher interest rates than it paid on ESF loans. Largely as a result, Mexico's current total public and total foreign debt exceeds its 1994 debt." (Schwartz, 1998)

One can reasonably doubt that, even if the Fund holds the power to influence the direction of private capital flows in a liberalized global economy, it would hardly be conceivable that it could actually force unwilling countries do adopt structural reforms as radical as the IMF envisages.[49] The Fund's clout certainly decreases during more stable times in which private investors are unable to resist the Syreen song of the expectation of high returns offered by emerging economies even if the latter do not have the IMF's blessing. It suffices to realize

by local authorities in pursuing the reforms. There is no other reason for the constant reminding of Korean authorities of the need to move forward with reforms.

[48] According to Mussa and Savastano (1999), "Growing emphasis on structural issues in IMF-supported programs also reflects the (not so linear) evolution of the profession's views about the prerequisites for a well-functioning market economy." (pp. 102/3)

[49] Of course, things are different when national governments decide to adopt these reforms of their own will, as it happened with many Latin American countries, notably Argentina, Brazil and México.

that capital controls, condemned by the Fund, did not make Malaysia a pariah. Even Russia has been receiving foreign capital, although investors understandably avoid financial institutions.

The Fund itself, pragmatically, seem to focus its efforts, for now at least, in one aspect of its long-term goals, the further liberalization of capital movements. IMF authorities have repeatedly congratulated themselves for the limited number of countries that reacted to the recent crises and their contagion by imposing controls.[50] For the IMF, capital movements liberalization does not pose significant risks to countries in which governments accept market discipline to allay the market sentiment. Risks, for the Fund, are created domestically, not systemically. Free global capital markets should bring the same benefits global goods and services markets are supposed to bring, even if this cannot be proved for the moment.[51] Capital would flow to the places where it could be most productive, leaving countries where it is overabundant to those where it is rare. Sound macropolicies, good financial regulation and supervision, and structural reforms should all add up to a very safe and stable environment.

This view ignores many problems.[52] Most importantly, it disregards the possibility of inherent sources of instability in the operation of the economy in general and in the operation of capital markets in particular. New Keynesians such as Stiglitz and Rodrik and Post Keynesians such as Davidson, Kregel and the late Hyman Minsky have showed that when analyzing asset markets one ignores problems of information asymmetry (for the New Keynesians) or uncertainty (for the Post Keynesians) at one's own peril. Belief in the efficient market hypothesis or in the rational expectations hypothesis requires ignoring crucial elements of the capitalist reality. Keynes offers an alternative theory of expectations formation, particularly valid for the asset markets, known as the "beauty contest" hypothesis, that have been shown to be much more fertile than the hypotheses mentioned above. According to this hypothesis, assets markets, especially those for which second hand

[50] As Director Camdessus hás put it: "… it is quite remarkable to see how limited in the impact of these so-called 'alternatives' or experiences". (Camdessus, 1998b)
[51] See Fischer (1999). A (rare) skeptical view of the benefits of trade liberalization is Rodriguez and Rodrik (1999).
[52] A more detailed discussion on the Fund's push for liberalization of capital accounts is found in Carvalho (2000).

markets exist, are driven mostly by expectations of other agents' expectations about market performance. These expectations are necessarily conventional and volatile, making up for very unstable market prices for the assets concerned.

If an emerging country accepts global financial integration, its exchange rates become determined mostly by asset price movements, rather than goods price movements. In other words, exchange rates will be determined by relative asset price changes rather than by relative goods prices changes. But if Keynes's expectations hypothesis is correct, exchange rates will become more volatile because relative asset prices are much more volatile than relative goods prices. If capital flows are motivated by actual and expected changes in relative asset prices, one should then expect more volatile behavior of capital flows. This, in fact, should be observable both in developed and in developing countries. However, while capital flows may represent a relatively small share of financial investments in large developed economies, this is not so for emerging countries. For the latter, capital flows are disproportionately large and can cause balance-of-payments as well as currency crises. The risk of suffering repeated bouts of crises (as, for instance, has happened recently both with Brazil and Argentina) may be too high to be accepted, especially if one has in mind that there is no evidence of benefit resulting from the liberalization of all kinds of capital movements.

Finally, in an integrated global financial system, emerging countries would lose their freedom to implement any policy that could be judged favorably by their own people but that could be seen as a threat by foreign investors. Again, the latter would vote with their feet in the face of any policy that could be construed as unfriendly. Since capital flows are usually very large when compared to domestic flows of saving and investment in emerging countries, capital outflows would be more than a vote, they would actually be a veto on those policies.

VI. Conclusion

The IMF adjustment programs implemented at least in part in the Asian countries that requested assistance during the 1997 crisis have been subjected to intense criticism both from the "right" and from the "left". For the right, the IMF supported corrupt regimes and bailed out speculators with American taxpayers' money. The Fund should be concerned with developed countries, because balance of payments problems in these countries arise only as a result of macroeconomic imbalances that can be easily solved. Developing countries, in contrast, suffer from structural problems that cannot be solved by the IMF. These countries should be left alone even because these authors believe that they do not really pose any systemic risk for the global financial system.

The "left" examined both the short and the long term policies imposed by the Fund on the Asian countries, with special emphasis on the short term. The Fund failed to realize that the correct policies to solve a liquidity crisis are the activation of lender-of-last-resort facilities and of inducing renegotiation of short-term debts between debtors and creditors. Raising interest rates and tightening fiscal policies had a double damaging impact: it raised the burden of debt at the same time in which it reduced aggregate demand and, therefore, curtailed firms' cashflows. It should not be surprising that the signature of agreements with the IMF did not stop or avoid the sharp downturn in those economies. Devaluations only stopped after short term debts were rolled over.

There is less agreement as to the inadequacy of the Fund's long-term policies and structural reforms. For some, the reforms are not bad in themselves, but they should have been left for future implementation, when the Asian economies had recovered. Others disputed the reforms themselves, or at least some of them. Special attention was given to the pursuit of further capital flows liberalization, targeted by the Fund since its 1997 Hong Kong meeting.

The IMF reacted defensively to these criticisms at first, but recovered the confidence in its own views once countries like Korea began to show evidence of recovery. Even if recognizing that the Asian countries went through a liquidity crisis, the Fund still seems to believe that rising interest rates and fiscal tightening are the right policies to cope with capital flight. On the other hand, the Fund also insists that structural reforms are an essential element of a sustained recovery because markets would not punish those who accept its discipline.

The central point of the Fund's doctrine is the assumption that capital markets are efficient and stable, so integration should bring only benefits for those countries that give up for good “populist” policies. Accordingly, the main objection to this doctrine is that not only capital markets, but in fact *entrepreneurial economies* are plagued by uncertainties and information problems, as Keynes suggested, making them very unlikely to fit in the (very strong) assumptions that describe an economy with efficient market properties. Besides, for emerging economies, freeing capital flows is even more dangerous than it is for developed economies because a *size effect*: capital flows, into and out of emerging economies, are too large in comparison with the size of these economies. Capital flight episodes can be very destructive for the host economies.

In sum, if crises as those who affected the Asian crises are liquidity crises, the right way to deal with them is by empowering an effective lender of last of resort to supply them with liquidity when necessary. It is very doubtful if the IMF could be this lender of last resort. On the other hand, it is not for a crisis manager to decide how economies should structure themselves. Under these conditions, emerging countries facing the possibility of an external crisis, or trying to prevent it, should consider alternative instruments, such as capital controls, to insulate them from the intrinsic volatility of modern global capital markets and to preserve their freedom to choose the domestic policies that their own people should judge adequate.

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