FIGHTING FINANCIAL FIRES

AN IMF INSIDER ACCOUNT

ONNO DE BEAUFORT WIJNHOLDS

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Abbreviations

ABS	Asset Backed Securities
AIG	American International Group
BCBS	Basel Committee of Bank Supervisors
BIS	Bank for International Settlements
BOE	Bank of England
BOJ	Bank of Japan
BOT	Bank of Thailand
CAC	Collective Action Clause
CCL	Contingent Credit Line (IMF)
CDS	Credit Default Swap
CEE	Central and Eastern Europe
EC	European Commission
ECB	European Central Bank
EFSF	European Financial Stability Facility
EMU	Economic and Monetary Union (Europe)
ESCB	European System of Central Banks
ESF	Exchange Stabilization Fund (United States)
ESM	European Stability Mechanism
EU	European Union
FCL	Flexible Credit Line (IMF)
FDIC	Federal Deposit Insurance Corporation (United States)
FED	Federal Reserve System
FSA	Financial Services Authority (United Kingdom)
FSAP	Financial Stability Assessment Program (IMF)
FSB	Financial Stability Board
FSF	Financial Stability Forum
G7	Group of Seven
G20	Group of Twenty
GDP	Gross Domestic Product
GSE	Government Sponsored Entity (United States)
IMF	International Monetary Fund
IMFC	International Monetary and Financial Committee
LTCM	Long Term Capital Management
NGO	Nongovernmental Organization
NIE	Newly Industrialized Economy
OECD	Organization for Economic Cooperation and Development
OPEC	Organization of Oil Exporting Countries

PSI	Private Sector Involvement
SA	Substitution Account
SDR	Special Drawing Right
SDRM	Sovereign Debt Rescheduling Mechanism
SGP	Stability and Growth Pact (European Union)
STF	Systemic Transformation Facility (IMF)
WB	World Bank

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Preface

Michel Camdessus, the generally affable Managing Director of the International Monetary Fund, was furious. As an observer of his verbal explosion remarked later, "the adrenaline was coming out of his ears." Camdessus had summoned six of the IMF's Executive Board members to his private conference room to scold them for having refused to support a record large credit granted by the Fund to crisis-stricken Mexico the night before. I was among those invited, since I had been instructed by the Dutch authorities to join the directors from Germany, the United Kingdom, Italy, Belgium and the Nordic countries to be recorded as abstaining from supporting the provision of a credit of $18 billion to the Government of Mexico. While the twenty-four-member IMF Board's deliberations are confidential and individual members' positions are not revealed, the world media on February 3, 1995 widely reported that the jumbo credit for Mexico, strongly advocated by the United States and approved the previous night by a majority of the executive directors, had failed to receive the support of six of the Board's European chairs. The *New York Times* caption read "Western Allies Rebuff Clinton in Mexico Vote."[1] Because of the economic and political significance of the Fund's large-scale financial support of Mexico, it was hardly surprising that a leak occurred. But for the Frenchman Camdessus it was a galling experience that the European criticism leveled at him had become common knowledge.

Thus began my involvement with the dramatic series of crises which rocked the international financial system between 1995 and 2002 and then from 2007 onward. My tenure as a member of the Fund's Executive Board, and subsequently as the European Central Bank's observer at the IMF, happened to coincide almost exactly with these events. It was a fascinating and sometimes nerve-racking experience to have to deal with situations that constituted uncharted waters to both the management and the board of the IMF. There is little doubt that during this period the international financial system endured its most challenging and, from 2007, its most dangerous test since the end of the Second World War. The IMF, largely unknown to the general public before 1995, suddenly became a household name in many parts of the world. Despite its intention to douse the fires raging in the financial markets, many resented the Fund's role and especially its policy conditionality, thereby often greatly complicating its task. While its staffers would joke that IMF stood for "It's Mostly Fiscal" – a reference to the Fund's usual prescription of fiscal austerity – its critics would talk about the "International Misery Fund," or "I'M Fired" on the placard carried by one unfortunate Korean worker pictured in the media.

Only a small number of the many books and articles written about financial crises in recent years have been authored by individuals who were actually dealing with them. There are hardly any contributions from former IMF management or staff, and none that I am aware of from former executive directors.[2] Of those insiders who have told their part of the story, practically all have been former high American officials. This is not all that surprising, since the United States played a pivotal role, together with the IMF, in guiding the resolution of the various crises. However, although less visible, European monetary authorities and their representatives at the IMF, enjoying a considerably larger share of voting power and financial contributions in the IMF than the United States, were very much part of the process as well.

This book is meant to fill the gap left by the paucity of insider contributions, from both former IMF and European officials, on the highly challenging financial crisis management during the last fifteen plus years. The aim here is not to provide a Europe-centric view of what happened, but rather to give a more comprehensive treatment of the part played by the various players, including the embattled officials from the debtor countries during the emerging country crises, and the role taken on by the European Central Bank (ECB) and other protagonists in dealing with the global financial crisis that erupted in 2007. The description and analysis of the events that occurred during those years are first of all based on my personal recollections, supported by the notes I kept as events unfolded, as well as reports by my office of informal meetings in which I participated during my eight-year tenure on the IMF Board. Minutes of Fund Board meetings only provide information on the formal phase of the crisis resolution process. Surprises are generally absent from formal board meetings, as management tends to prepare the ground before presenting controversial credit requests before the Executive Board. The interviews I conducted with individuals who were at the forefront of the crisis management process have been a second important source for this book. I have also read widely on what others have had to say about emerging market and advanced country financial crises.

The book is organized as follows. In order to provide a historical background for the treatment of the various modern financial crises, the Prologue describes earlier major crises of the postwar era. These include the collapse of the US dollar of 1971–73, and the first oil crisis that followed on its heels, as well as the Latin American debt woes of the 1980s.[3] The less dramatic developments preceding the emerging country crisis of between 1995 and 2002 are covered, as well as the seeds that were sown for the calamitous events that followed. Subsequently the various systemic crises that erupted are described and analyzed, beginning with the Mexican crisis of 1994–95, followed by the Asian financial crisis (Chapters 2 and 3) and those that arose in Russia in 1998 (Chapter 4) and Brazil in 1999 and 2002 (Chapter 5), the debacle in Argentina in 2001–02 (Chapter 6), and the crisis in Turkey from 1999 to 2002 (Chapter 7). The main features of these crises and the lessons learned from them, and those not learned or ignored, are analyzed in Chapter 8. The worldwide financial firestorm that broke out in August 2007 is dealt with in Chapters 9 and 10. Chapter 9 briefly describes the near-meltdown of the financial system in advanced countries and the remedies being put in place. Chapter 10 focuses on the contagion that it spawned, especially in Europe. Finally, Chapter 11 is devoted to reforms that are needed to save the international financial and monetary system from collapsing at some time in the future.

Three main threads run through the book. The first is the leading role – in part politically inspired – played by the United States, together with the IMF, in dealing with international financial crises, generally with the support of other economically advanced countries. The second is the crucial role played by the IMF in managing balance of payments crises, often successfully but sometimes with unsatisfactory results. The third thread has to do with the nature of international financial crises. Such crises have differed in several ways, but demonstrate a number of common characteristics, including excessive risk-taking, herd behavior, a lack of transparency, supervisory shortcomings, and macroeconomic policy mistakes. Lessons have been learned, but often forgotten or ignored, so that the global financial system has remained fragile, requiring additional measures to save it from collapse in the future.

Contents

Prologue

Financial crises, like the poor, will always be with us. Kindleberger, author of the classic *Manias, Panics and Crashes,* described financial crises as "a hardy perennial."[1] The modern capitalist system, despite all its positive results, produces financial crises at a steady rate. Some of these are relatively harmless and limited to a single country or small region, while others are much more insidious and can cause great harm. Crises that pose a threat to the global financial system are labeled *systemic*. Since the end of the Second World War there have been a number of such inflammable crises, the most recent and most dangerous of which started in the summer of 2007. The modern history of financial crises is riddled with lessons learned, not learned, ignored, or forgotten. While the focus of this book is on systemic crises since 1995, it is instructive to recall in a succinct manner the experience with crises of a few decades earlier.

The breakdown of Bretton Woods

The so-called Bretton Woods system of fixed but adjustable exchange rates (also known as the par value system) lasted for about twenty-five years after the Second World War. The dollar was the pivot of the system, with other currencies pegged to it. This reflected the dominant economic position of the United States and the general desire to avoid repeating the chaotic monetary breakdown of the 1930s. The arrangement worked well until increasing imbalances in industrial countries' external positions appeared in the 1960s. The United States' balance of payments had swung into deficit, while European countries and Japan were accumulating sizable surpluses. These imbalances foreshadowed future problems in the international monetary system. Toward the end of the 1960s surplus countries became increasingly unwilling to accumulate more dollars, as they viewed the US's ability to run large balance of payments deficits indefinitely as contributing to inflation in their countries. Many of them, with France leading the way, converted their "excess" dollars into gold. By the early

1970s the par value system, of which the IMF was the guardian, broke down, and the Fund found itself dealing with a serious currency crisis. Pierre-Paul Schweitzer, an affable but assertive former French central banker, was the first IMF Managing Director to face a problem of global proportions. Advocating a devaluation of the dollar on television cost him his job in 1973, when the Fund's largest shareholder did not support a third five-year term for the Frenchman.

By 1971 the United States had come to the conclusion that a fixed relationship between the dollar and gold, and thereby between the dollar and other currencies, was no longer in the interest of the US. This sentiment was expressed most clearly by the then Secretary of the Treasury, John Connally, in stating, to the alarm of the US's main trading partners, that "the dollar is our currency and your problem." President Richard Nixon announced in August 1971 that foreign central banks could no longer convert their dollars into US gold, with the result that exchange rates were no longer fixed and currencies floated against the dollar. But, since most policymakers were reluctant to give up the adjustable peg system, attempts were made to shore up the system through a new configuration of fixed exchange rates. The new set of exchange rates, which became known as the *Smithsonian Agreement* as the final talks took place in the Smithsonian Institution Castle in Washington, was announced with considerable fanfare in 1973. The euphoria was short-lived, however, as markets soon demonstrated their lack of faith in the new parity grid through a renewed wave of dollar sales. This spelled the definitive end of the Bretton Woods system and called into question the role of the IMF. It also undermined the success of the special drawing rights (SDRs) in the IMF that were introduced at the end of the 1960s to supplement what was perceived as a shortage of international reserves.

While the Fund had been the centerpiece of the international monetary system under the Bretton Woods system, its role after 1971 as overseer of the system was seriously eroded. In a world of floating exchange rates between industrial countries, it was unclear what the IMF could do to remain involved with countries' exchange rate policies, assuming that they had such a policy. Moreover, while the Fund was charged with monitoring the adequacy of international reserves, the need for reserves would in theory be zero in a system of fully floating rates. (In practice, countries tended to manage the float, and at times intervened heavily in the market.) But the IMF management, together with the support of several important member countries, worked hard to ensure that the Fund remained relevant as the overseer of the international monetary system. At first it formulated guidelines for floating exchange rates, and subsequently incorporated in its Articles of Agreement a set of rules on how member countries should behave in a floating rate regime. This was followed in 1977 by a decision on surveillance over countries' exchange rate policies. But, as such decisions constitute "soft law," the

Fund's role was considerably diminished. What remained was the Fund's ability to wield considerable influence over countries that needed to borrow from it. If, for instance, the IMF felt it necessary for a borrowing country to devalue its currency, this usually happened. But for countries that did not need the IMF's resources, especially the large ones, the situation was quite different. Despite exhortations over the years to give the Fund's surveillance more teeth, the application of the 1977 decision was not very effective. Thirty years later, the decision was reviewed, its scope broadened, and its language sharpened, as described in Chapter 11.

The first oil shock

Almost immediately after having absorbed the turmoil following the breakdown of the Bretton Woods system, the international financial community was faced with a serious new challenge. Oil prices shot up at the end of 1973 as the oil exporting countries, organized in the Organization of Oil Exporting Countries (OPEC) cartel, cut back their production at a time when demand was rising in a booming world economy. The result was an unprecedented change in the balance of payments positions of most countries, with the oil exporters running large surpluses and oil importing countries suddenly facing much higher energy costs and, in quite a few cases, needing balance of payments support. The impact of the oil shock on the populations of these countries was akin to that of a hefty tax increase, leading to a combination of lower economic growth with a surge in inflation, posing a serious threat to the health of the world economy. Here, clearly, was a new global role for the IMF, in acting as an intermediary between oil exporters, which were running up large surpluses, and those oil importers that could not borrow on international financial markets. Stepping up to the plate, the Fund soon played a major role in facilitating what came to be known as the *recycling* of oil revenues.

After Schweitzer's departure, H. Johannes Witteveen, a bookish Dutchman, was elected as the IMF's Managing Director in 1973. Having been a minister of finance in the Netherlands and a professor of economics, Witteveen came with ample technical qualifications for the job. Moreover, it turned out that he was an adherent of Sufism, a mystic tradition within the Islamic faith which has as one of its tenets that many religions ultimately have the same basis. This also made him an attractive candidate for many developing countries. There probably were some doubts about Witteveen's firmness in dealing with demanding situations, but it quickly emerged that he was quite capable of stepping into the breach, dealing with the oil crisis with a combination of decisiveness and quiet diplomacy. Soon after taking office, the new Managing Director was traveling the world in search of contributions for the IMF's newly established *oil facility*.

The money borrowed from oil exporters was to be used to provide credits to those oil importing countries especially hard hit by high energy costs, a process known as recycling. The conditionality was light, since these countries' lack of foreign exchange was caused by circumstances beyond their control. Witteveen succeeded in borrowing $8 billion, a substantial sum in those days, from energy exporter countries. The facility was terminated in 1976 after having significantly eased the economic pain of oil importers.

Besides its direct role as financial intermediary, the Fund also served as a catalyst for recycling of oil money by the private sector, a role that enhanced its reputation. But the IMF's timely recycling initiative also came at a cost, as the oil exporting countries were accorded very large increases in their quota (capital) share in the Fund. This was considered necessary at the time to ensure sufficient future resources for the IMF's lending activities. While this was fine, a higher quota share also implied a larger share of the voting power. And, as the oil exporters' importance in the world economy as measured by factors such as gross domestic product and trade openness (the main elements on which quota share are normally based) did not increase in the following decades, the voting structure of the Fund became skewed. Moreover, and more importantly, official recycling helped foster a process of overzealous international lending by international banks. Internationally operating banks increasingly provided loans to cover balance of payments and budget deficits of a host of countries, going beyond their needs resulting from the oil shock. Thus began a process of *overrecycling* which eventually led to pervasive debt problems in developing countries.

The Latin American debt crisis

During the second half of the 1970s a large number of emerging countries became caught up in a borrowing frenzy. This was especially true of Latin America. With lending possibilities limited in industrial countries due to a period of near-stagnation, international banks engaged in a competitive race to provide lucrative loans to developing countries. Many sovereign borrowers built up unsustainable levels of external debt as they sought financing for chronic balance of payments deficits. As many of these international loans financed consumption rather than investment, they contributed very little to strengthening the economic structure of the borrowing countries. A recurring pattern in financial markets and the activities of banks is the tendency to lend excessively under competitive pressure; market share is of great significance to individual banks. Loan officers are incentivized to bring in loans and have little incentive to be concerned with risk. Risk managers tend to see their position weakened when a lending boom is underway. The result is often that lenders suffer from a herd mentality, leading to excesses and eventually to a restructuring of borrowers' debt and losses for the banks. The lending euphoria of the late 1970s and early 1980s was also influenced by the notion that sovereign debtors posed little credit risk, as countries could not go bankrupt, as famously averred by Walter Wriston, who headed Citibank at the time. But, since many of the loans extended to Latin American and some Eastern European countries were provided on the basis of adjustable interest rates, the surge in interest rates in the early 1980s (the Federal Reserve had pushed up rates in order to suppress accelerating inflation) caused the borrowers to face much stiffer debt service obligations. While the banks had shifted the risk of higher interest rates to the borrowing countries, they had unwittingly promoted another risk, that of default. This process of transferring one risk while incurring another risk is a recurring theme in the history of financial crises.

The global financial community was shocked when the Mexican government announced in August 1982 that it was experiencing difficulty in servicing its external debt. As happened on a few occasions later on, the IMF was slow in recognizing the extent of the problems building up in Mexico and other Latin American countries, concentrating more on the question of whether financial flows to developing countries were sufficient than on the dangers of overborrowing. But, once the seriousness of the situation became clear, the reaction of the Fund was swift. First, a financial lifebuoy provided by central banks was organized through the Bank for International Settlements (BIS), followed by a credit from the IMF with strong policy conditionality. Other Latin American countries, including the region's largest economy, Brazil, soon also experienced payments problems and asked for IMF support. As international banks hurried to reexamine their exposures to developing countries, they froze their credit lines to Latin American economies and Eastern European countries. During the years of overrecycling, banks had relaxed their internal standards of risk assessment, but, as the bad news on sovereign debt spread, in a typically herd-like fashion they abruptly cut off financing to emerging and centrally planned economies, without much differentiation. This process of *contagion* was frequently to cause problems in the future.

The IMF once again found itself in the spotlight, having to deal with a new crisis with potentially serious ramifications for the international financial system. While the Fund stood ready to support those countries that were facing a liquidity crisis, which if prolonged too long could develop into a solvency problem, it did not wish simply to bail out the creditors. After all, foreign banks had been engaging in imprudent lending and would have to suffer the consequences. But the banks were cutting credit lines, something that was individually in their self-interest, but collectively severely complicated the situation. What ensued was a classic collective action problem in which intervention from the public sector was urgently needed to untangle the mess. The IMF rose to the challenge.

The solution was to pressure the banks into pledging that they would maintain their exposure to sovereign borrowers. Only when a *critical mass* of commitments from banks had been obtained was the Fund willing to release the first portion ("tranche" in IMF parlance) of the credits it had negotiated with Mexico, Brazil, and others. The main architect of this approach was Jacques de Larosière, the energetic and shrewd former head of the French Treasury, who had taken over from Witteveen as the IMF's Managing Director in 1978. The dapper Frenchman employed an effective tactic for dealing with the world's most important commercial banks. He invited those with the largest credit exposures to send their representatives to a meeting with the IMF management. Ushering the bankers into a room, he exerted maximum pressure on them to provide assurances that they would contribute to solving the payments problems of Mexico and other distressed borrowers. Such action was usually supported by the central banks and banking supervisors in the home countries of the creditors. De Larosière succeeded again and again in attaining the sought-after *critical mass*, usually around 85 per cent of outstanding bank loans. By keeping the banks involved in the process, a collapse of the economies of the largest Latin American countries was avoided. The strong-arm tactics employed by the IMF proved to be successful, thereby greatly enhancing the reputation of the IMF as a crisis manager and effective coordinator of collective action.

While the critical mass approach proved its worth, the problems in most Latin American countries were so deep-seated that it took many years for their economies to recover. The international banks initially did their part, after strong "encouragement," by generally maintaining their exposure, and later renegotiated the outstanding debts. But the damage done by *dirigiste* and populist economic policies in Latin America in the 1970s and early 1980s was simply so extensive that it could not be repaired swiftly. Thus, the region experienced what came to be known as the *lost decade* in the wake of the Mexican crisis. It took further official intervention, initiated by the United States, to fully resolve the Latin American debt problem. The first initiative was taken in October 1985 and dubbed the *Baker Plan* after James Baker III, then US Secretary of the Treasury. It consisted of a three-pronged approach: an exhortation to debtor countries to follow sound macroeconomic and structural policies, a central role for the IMF in managing the adjustment process, and a reversal by the commercial banks of the drop in their net lending to Latin American countries.

The renewed debt strategy proved not to go far enough, and led to a new initiative for a comprehensive and sufficiently far-reaching solution. This time it was Baker's successor, Nicolas Brady, who put forward a plan that enjoyed widespread support in the international community. Agreement on Brady's proposal was speeded up by serious riots that broke out in Venezuela as a response to the government's attempts to implement IMF policy conditions,