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BEGINNINGS OF IMF STAND-BYs

Transcript of an Oral History Recording

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Thorson: This is the first of what I hope will be a productive series of oral history recordings on how conditional stand-by arrangements between the IMF and member countries got started. Several former staff members have been concerned that no one has initiated such a process until some two decades after the foundations were laid for such a significant instrumentality. It seems desirable that we at least assemble recollections of the individuals who were the most involved. In that respect, it is fitting that the four of you who had such prominent parts in the process could be here for this initial session.

Polak: Before we go into this, presumably, we're supposed to be adding to the Fund history. I didn't take the trouble to reread the official Fund history, but there must be quite a lot about this in it.

Thorson: There are useful paragraphs on the technicalities and the performance criteria that were used progressively in early cases. But the descriptions of key cases are quite brief and appear to be drawn mainly from the discussions in the Executive Board. So the reality of the staff's invention and development of the instrument is not covered.

Finch: The Fund History tends to concentrate on how the Executive Board operated... and I think what Phil's looking for is more of the staff thought that went into the developments and the way in which the staff created the practices the Board later endorsed. Of course, it was an evolution in which the Board played an important part but not as the initiator. There were a lot of aspects which weren't that closely recorded.

Thorson: I understand that the first missions which began what we now call stand-bys went to help a few Latin American countries in the mid-1950s. Should we start out with why the technique happened to develop there and then?

Gold: The history goes back much further than that.

Finch: Before we started recording you were raising the question of when and where did it begin. Was it Paraguay, was it Bolivia? In fact, there were incremental steps. For me, the first dated back to the Mexican mission set up by Walter for February 1955 after their devaluation. Jacques was designated to be head of it but was unable to go, so Dick Goode was the head instead. Jacques did, however, supervise the writing of the report.

Robichek: There was an earlier analytical study which was the first formulation of the monetary approach to the balance of payments. David is absolutely right that it was a step-by-step evolutionary development, and I don't think we should inject conditionality at this point, because conditionality to me means the suspension of drawing rights if certain concrete tests were not met, and conditionality arrived relatively late in this evolutionary process. We needed, for example, a legal framework, which was the stand-by arrangement before the sanction imbedded in the conditional use of Fund resources could be developed. But the conceptual roots of financial programming went back even further in the past.

<u>Gold:</u> Let me try to give some account of the stages in the development of the legal basis. I use the word 'stages' advisedly because I did not refresh my recollection by looking at any records, but this development must really be regarded as incremental, as Walter says. It really starts with the Executive Board's decision of, I think, February 13, 1952, in which the idea of a stand-by arrangement appears, and that, of course, appeared in the so-called Rooth Plan because of the non-use of the Fund's resources prior to that time. So you could push it back even further than 1952. February 1952 is the first stage in the development of the idea, and that decision, by the way, I think is still the most remarkable decision in the Fund because it initiated so much of what is still current practice. The next stage of some importance, it seems to me, is the invention of the performance criterion which really became the central feature of the stand-by arrangement, and there's a whole development connected with that. Now, one of the things I wanted to look up, and I didn't, was the occasion on which the performance criterion was first used, and it is an important element or stage in this history because there was an enormous fuss about it at that time. It was the result of a discussion between Al Costanzo and myself in one of his Latin American cases. It must have been the mid-1950s somewhere. Probably, it could be.

Finch: Bolivia.

Gold: Alright.

Finch: In 1958, we had to suspend a stand-by by Board action and everyone felt alternatives should be sought.

Gold" Right, and I think that we then took up this idea with Cochran and he, of course, grabbed it, but after that I think there was a good deal of fuss. Nevertheless, it got established. Anyway, that's the second stage in the affair and, of course, what I'm not going in this account is to go into particular cases. Colleagues here will talk about that. It seems to be that the third next important stage is the development of the idea that the stand-by arrangement is not a contract with countries. This was very useful and was, in fact, clarified in order to enable the U.K. to make use of the Fund's resources because it didn't want to be in the position of violating a contract or treaty if the performance criteria were not observed. And the last of the important stages, it seems to me, is the Second Amendment which, for the first time, I repeat, the first time, recognized the stand-by arrangement as a feature of the Fund's practice. It's an extraordinary thing, but it isn't until 1978 that the stand-by was recognized formally as a part of the Fund's means of conducting its financial activities. Up to that point, it was all, as it were, informal or of subsidiary importance in the Fund's corpus juris. Well, I'll stop here, except to say that the Fund's history is, in a sense, augmented by two things. I'm sorry to have to refer to my own publications but as nobody else will, I will. One is my book on stand-by arrangements which has a lot on the origins of the idea and the development of it up to 1970. The book was published in 1970. Then, there's a Fund pamphlet on the legal character of the stand-by arrangements and two other pamphlets. They are related to the third stage, the clarification of what is a stand-by arrangement. They were published around 1980. There's a lot of detailed material in all of these publications.

<u>Polak:</u> I think there's only one whole strand mission in Joe's story that goes back before the '52 decision, and that relates to the difficulty of getting transactions going in the first place. There the great uncertainty, the great hesitation, of countries to come to transactions with the Fund was not the Fund's conditionality, because the Fund didn't have any. The Fund only had a yes/no conditionality, and countries, especially the industrial countries, were complaining that they didn't know where they stood with the Fund.

<u>Gold:</u> Right.

<u>Polak:</u> There's a speech by Governor Holtrop at, I guess the '49 Annual Meetings where he makes that complaint. That was the general complaint of the industrial countries--you never knew whether you could draw on the Fund, and if you asked, and the Fund said no, it was very embarrassing. And the origin of at least the Belgian stand-by (in mid-1952), which preceded all the Latin American countries, was to overcome that difficulty and to get a discussion going between a country and the Fund which made clear that the country would be able to draw if it needed to. Of course, the original idea of stand-bys involved assurance for a full drawing, not a drawing in tranches.

<u>Finch:</u> There was a legal foundation as Joe has outlined. There was also an economic foundation which goes farther back; Walter was referring to it earlier as the development of the monetary approach to the balance of payments. The third foundation was the application of these elements in negotiations and operations which, in a sense, is a different but interrelated strand. As for the economic foundation, the Fund started early, through its work on fundamental disequilibrium, to develop an expertise on balance of payments problems--where they came from and how they could be defined--whether the essential problem was one of exchange rates or one of demand. I think some of the early work of Sidney Alexander in Research was useful in identifying the issues, although I don't think there was any immediate application. Later, when we started to get out in the field and were asked by people like the authorities in Mexico how to protect a new par value, the Fund staff started to focus on development of the theory. It involved ensuring that the monetary expansion would in practice be sufficiently limited to be consistent with maintaining a fixed exchange rate. From there, it evolved into actual use in IMF relations in the countries, in the Paraguay's, Bolivia's, and other early programs. I think we should recognize these quite different strands. Joe's legal strand is well recorded and he has published good source material. Some of the development of the economic concepts is fairly well recorded. But the practical application by the staff, how they approached the country authorities, how they persuaded them to follow a particular approach in practice, that is the area which I think is less well recorded.

<u>Thorson:</u> In which years did that practical application, the answering of the questions from the countries, begin?

<u>Finch:</u> That was in the '50s. I personally was brought in when Walter was organizing the 1955 mission to Mexico which Jacques was to lead.

<u>Polak:</u> The mission to Mexico was, yes, in February '55, but David makes a very good point about the economic foundation. The enunciation of the economic concepts started with the fundamental speeches by Gutt, written by Eddie Bernstein. They set forth three quarters of what there is in the Alexander paper (Staff Papers, 1952)). Those points were quite well known. The legal story is quite well written down. There is the third aspect, as David said, the negotiating history, which is not all that well known.

<u>Gold</u>: I'd want to add a footnote to what Jacques was saying with which of course, I completely agree. But I think it is still useful to get some idea of the context in which the idea of the stand-by arrangement was put forward, and that occurred really in the very first years of the Fund's experience. A whole bath of decisions were taken n 1948 about the use of the Fund's resources, but the spirit of those decisions was negative. The major reason was the position of the United States that those were not the times in which it was appropriate to use the Fund's resources. So you had all that negotiation that was being recorded and, of course, it was supplemented by the Fund's EPU decision that, in fact, the European members couldn't use the Fund's resources because of the Marshall Plan. At the same time, there was great controversy about the repurchase period, and again the United States was in the lead saying that it should be a relatively short period. So you had a clarification of the reasons why the Fund could refuse

or challenge the use of the Fund's resources together with the decision on the short-term period of the use of the Fund's resources, and the result was that in 1951--I think that's right--there was absolutely no use of the Fund's resources. No one came to the Fund at all and this produced a kind of crisis atmosphere that led to the decision of 1952.

Finch: Yes, but of course, the Belgian arrangement was purely a stand-by, involving no expected use of IMF resources. It was seminal in the sense of creating the structure that could be converted to a system through which resources could be sued. But in itself, it did not change the pattern of non-use.

Gold: That's right.

Polak: There was non-use for the reasons Joe gave and a consequent effort to get out of this very difficult situation in '51-52, which led to the '52 decision. But one of the reasons for non-use, in addition to the American negative position, was that the Fund hadn't learned yet to negotiate with countries.

Gold: That's right.

Polak: The Fund had a yes/no attitude. To overcome that particular handicap, the stand-by was designed.

Gold: There was also the problem of who was to do the negotiating. It appeared that the Executive Directors wanted to negotiate.

Robichek: I very much agree with the tripartite aspects of this evolution that David has mentioned; namely, the legal aspect, the conceptual aspect, and the negotiation aspect. With regard to the conceptual aspect, it involved no less than the development of a new macroeconomic theory. I very much agree that this development goes back to Eddie Bernstein. I had been taught the wrong economics at Harvard because of the oversimplifications of the "closed economy" approach which had dominated economic thinking there. What took shape in the Fund by contrast, was the beginning of the "one world" economics. You had to go back to the early economic thinkers for guidance on such an approach, but the rethinking it involved was imperative because in a "closed economy" approach the Fund had no role to play. Without the new conceptual underpinnings the practitioners would have had little, if any, guidance for prescribing viable stabilization and adjustment programs, and yet this conceptual underpinning emerged out of a self-contained and essentially research effort rather than as a response to immediate practical problems. By contrast, the legal advance which was fundamental to the creation of the stand-by arrangement was a deliberate response to policy needs.

But it should also be said that it was the development of the staff's negotiating function related to stand-bys that shaped the Fund's conditionality. Joe noted that the Executive Board was torn over the question of who was to do the negotiating, and it was torn because conditionality, particularly in its more refined form in stand-bys, pretty much takes the Board out of the exercise. If you wrote a tight stand-by program and performance clauses under it, it entailed automatic interruption of drawing rights if this program were not adhered to. The Board had little to say once it had approved the arrangement. The Board had been much more exclusively in charge of the pre-stand-by years and that was when countries were not sure what criteria the Board might apply if they sought to use the

Fund's resources. One problem was, I believe, that the founding fathers had oversimplified the possible causes for a balance of payments disequilibrium. They took the position that such a disequilibrium is either fundamental, in which case devaluation is the solution, or it is temporary, in which case a country can choose between coming to the Fund or imposing exchange restrictions temporarily. What the founding fathers failed to provide for was the case of a self-inflicted balance of payments problem, which is by far the most typical one. It was only with the help of the stand-by technique that it became possible for the Fund to accommodate a balance of payments deficit that could be corrected by appropriate macroeconomic policies and thus be turned into a temporary deficit, but which if uncorrected would in all likelihood degenerate into a fundamental disequilibrium.

Polak: I have a comment on the last point. It seems to me that Walter really has put the general drawing policy under the stand-by envelope. I think the Fund had to come to terms with the questions of what is fundamental disequilibrium and that you can draw only if it is temporary, and that it is only temporary if you make it temporary. All these points are right, but they applied to drawings as much as to stand-bys. Why did the Fund move to the technique of stand-by? That's the difference, and it was to make sure that by doling out the money over time it could ensure that the appropriate policies would be followed.

Finch: Perhaps I could just supplement the economics. I think Jacques is right that the stand-by became an instrument, but the first thing, which in a sense links what Walter and Joe were saying, was to try to get political acceptance from the U.S. authorities that a role for IMF resources could be developed. It involved creating constructive precedents which when codified gave the staff delegated responsibility from the Board under which the staff could talk to a country knowing that the Board would support the arrangements. The stand-by became a key element in making that delegation acceptable. Underlying this evolution was the building up, as Walter was saying, of the Executive Board's acceptance of the staff approach that not just changing the exchange rate but getting the necessary changes in the country's policies were crucial. Once the staff established that they could help get such changes and thus assure the Board that more than a pause in the process of need for further resources could be delivered, the way opened for a large IMF role.

Gold: Let me react to a number of things that have been said. First of all, the powers of the Fund to challenge requests for use of the Fund's resources were stated as early as 1948. There's a batch of decisions in that year that set forth all the powers of the Fund under its various express provisions to say no, but what was missing at that time was the clarification of the circumstances in which the Fund would say yes. That's the missing element, and that didn't get evaded or avoided until the idea of the stand-by came about.

Polak: Joe, that's not right. That is in the '52 decision.

Gold: That's the next point I want to make. The breakthrough came in the '52 decision although even in that decision there is no statement of what the Fund's approach on a country's economic policies will be. It simply says that if you can agree on economic policies, then...

Polak: There's more.

Gold: Well, there's a lot more in that decision, but just let me finish the point. The reason why the stand-by was seen to be a useful instrument for enabling members to use the Fund's resources was the fact that there was an express power that the Fund could provide more than an annual 25 percent. The Articles limited the use of the Fund's resources to 25 percent a year, and this was viewed as a weakness by those countries led by the United Kingdom that held that the use of the Fund's resources was automatic. If you wanted more than 25 percent you had to get a waiver. So the Fund said, we can give you more than 25 percent under a program with a stand-by arrangement because there is the power to give a waiver of the 25 percent limit. It was that element, really, that induced countries to request stand-by arrangements rather than come in for the moderate drawing that they could make without a waiver. Let me just add at this stage one other fact, and that is that one shouldn't overlook the role of particular personalities in this whole affair. History is not just events, it's men and events, and one of the important men in this whole affair is Merle Cochran. Cochran had a kind of feeling for Latin America, and it is no accident that the use of the stand-by arrangement was developed in relation to Latin America.

Polak: Is that so?

Gold: Of, yes, definitely. He had an absolutely patriarchal and patrimonial feeling for Latin America, and he looked on it as his province. So he encouraged it and, of course, with people like Al Costanzo and Walter and David here he had people who could put that willingness to work. I think also one mustn't overlook the fact that this was a period in which the powers of the Managing Director were not very clear. I am talking again about the pre-1952 position. There was, first of all, the wish of Camille Gutt to be more like the President of the World Bank, and that was, I think, in the end frustrated, although he got something out of it because of the stand-by arrangement and the clarification of who does the negotiating. In this period too, there is the controversy between Camille Gutt and Andrew Overby. Andy Overby was not keen to see a European exercise considerable powers as the Managing Director of the Fund, acting as if he were an American President of the World Bank. There was even a kind of protocol between Gutt and Overby on the relative powers of the Managing Director and the Deputy Managing Director. There is more than the controversy between the management and the Board in this history. One comes back to the role of the United States.

Finch: If I could react quickly, we have been able to focus on the Latin American side, Walter and myself having been actively involved. But Cochran, I think, has been characterized rather too narrowly. He certainly had a keen interest in Latin America, and helped practices to evolve there with particular rapidity. But he was keenly interested in Europe, and supported important operations under the stand-by techniques rather different from those used in Latin America. These involved heavy association with U.S. aid--access to U.S. assistance becoming dependent on prior IMF action.

Gold: When was that David?

Finch: Well, Yugoslavia and Turkey were given support in roughly the same period as Latin America. Cochran had a different interest in those countries. It isn't quite right to say it was just Latin America. It was Cochran, as a very pragmatic individual, who decided that the Fund had power to negotiate policy actions and that this could be tied into donors' actions. He took the lead to organize its support and use it wherever an opportunity arose. John Gunter in the Middle East also had support from Cochran. Cochran had his network of people he could trust to promote constructive reform effectively. He didn't create the stand-by technique but he supported its development in Latin America because it became a useful instrument in his experience to maintain reform efforts. But Ernest Sturc showing an ability to operate without binding quantitative obligations in Europe was likewise supported by him.

Polak: Two points. I'm not sure, Joe, you're right in saying that the stand-by was related to exceeding 25 percent. Conditionality was related to going over 25 percent.

Gold: Oh, yes.

Polak: But in the '50s there were drawings that were conditional drawings, that is, policy understandings, but the stand-by gave the Fund the policing power, the checking-up power.

Gold: Not originally. That really developed with the performance criterion. One of the ways in which the compromise was reached between those who wanted automatic use and those who wanted no automatic use was the objective character of the performance criterion. The Fund was going to policy be means of performance criteria, but to accommodate the Fund practices to the views of those people who wanted automatic use, the theory was developed that the performance criterion must be objective in the sense that both the Fund and the member would know when a performance criterion was being transgressed. In this way, you agave assurance to a member that it could use the Fund's resources.

Finch: In 1958, the issue was brought to a focus by Bolivia. In December of 1956, a fundamental reform program was undertaken. It worked reasonably well but, of course like Bolivia today, the country had great difficulty maintaining discipline. The miners in mid-1958 forced a wage increase, and the Fund was faced with a program which had been breached. The staff had to ask the Board to suspend the stand-by in order to withhold the money until the problem had been overcome. Some in the Board objected to the judgmental nature of our recommendation despite their acceptance of it. The Australian, Callaghan, was one of them. It was the first mission I led, so as an Australian I was particularly sensitive to being attacked by the Australian Director. (LAUGHTER)

Gold: I had such an experience with an Australian Director. (LAUGHTER)

Finch: But anyhow, out of the discomfort for the Board in being exposed to responsibility for an action that a country could feel was arbitrary came an intensive effort to make the suspension automatic, so that a precise description would exist of the circumstances in which the country could not draw. In fact, it did not prove possible to avoid all judgments so review clauses were continued which, to a degree, kept the Board responsible.

Gold: Not nearly like the practice now which is every three months or six months.

Finch: But it was an attempt to try to get automaticity. As it developed, I would stress, it didn't involve distrust of the financial authorities by the Fund. They actually benefitted by being able to tell their political bosses that these agreements were serious. The quantitative promises on fiscal and monetary performance weren't in stand-by agreements just to let the country get its hands on the money: they were attempts to keep the Fund involved, to help see that the basic problem was solved.

Gold" Arrangements, not agreements. Arrangement. It's important.

Finch: It's important, I agree. It's not a contract as you put it. But the idea was the performance clauses enabled the Treasuries to maintain power to ensure implementation over time that was lacking where you just had pre-conditions and no check-ups.

Gold: And they were sure to get the money if the program was maintained.

Finch: There were sure to get the money. It culminated, of course, in the U.K. drawing in '67. The U.K. took the money and ran, and the problem came back until the Fund managed to get performance clauses accepted in 1968.

Robichek: It just occurred to me, David, that the format of arrangements probably really complicated the negotiating processes because the signatures on letters of intent put the monkey on the backs of the governments by technically asking the Fund to accept certain sensitive undertakings that would need to be carried out. I believe that in many cases governments would have bene more amenable to overt dictation by the Fund. But instead the Fund made its demands in the process of negotiations and the governments had to accept the political responsibility for applying them as their own policies.

Polak: Before moving on, I just wanted to clarify one earlier point, namely that the Fund put this role approach in economic terms in the 1952 decision. The 1952 decision was based on the memorandum from the Managing Director to the Board, which I happened to write. It put in economic terms the same things that Walter said, namely, that problems are temporary if there are policies that make them temporary, and I think you'll find that exactly in the decision.

Gold: Well, of course, that '52 decision did a lot more. It did, for example, create the concept of the gold tranche which again wa a concession to the concept of automatic uses. I did want to say something again on the performance criterion which really is at the very heart of this whole affair, although I believe now, myself, in present practice that the concept is being whittled away by a lot of subjectivity that has got into the so-called stand-by arrangements of the present day. The performance criterion was itself the outcome of some very controversial aspects of the use of the Fund's resources under stand-by arrangement. One of the sharpest controversies was the fact that the Fund, I think under the influence of Executive Directors, put into the early stand-by arrangement something called a prior notice clause.

This is, looking back, a kind of absurdity. The main development was the idea of performance criteria, very explicit applications of Jacques' policy on the use of the Fund's resources that gave a good indication of when you were transgressing the criteria and lost the use of the Fund resources. But, at the same time, the Fund was putting into the stand-by arrangements a clause which said we can suspend the use of the Fund's resources under the stand-by arrangements simply by giving you notice. Nothing was said about the circumstances or why the Fund could give notice. It was just at the will of the Fund. This really was a reversal back to the subjective.

Polak: Was that clause ever used?

Finch: Yes, with Bolivia, and that led to the objections I mentioned.

Gold: That's right, and that wasn't really until, I think, your Australian case where finally the prior notice clause wa abandoned. It was declared inadmissible because it destroyed the concept of the assurance of the use of Fund's resources. This was an important element in the stand-by arrangement.

Thorson: You said Australia? Or was it the Bolivian case, where one of the objectors was the Australian Director, Callaghan?

Gold" Well, I don't know. I'd have to look at my book.

Finch: We had better not be quoted as giving an exact history here.

Gold" There was a very elaborate Board discussion, but I thought, perhaps, it was Australia because I know that Callaghan was fighting the prior notice idea.

Finch: All the smaller countries wanted as much definition as possible because they were afraid of discretion being used against them.

<u>Thorson:</u> I wonder if we could start on a sort of step-by-step analysis, starting off with the Mexican case which you've mentioned, to indicate the sequence of developments in the conditional approach in a more orderly fashion than we have.

<u>Finch:</u> Well, from my point of view, Mexico was the start, but you are going to find that these things have got different individual histories for others. We went to Mexico in early 1955 to do a survey they asked for because they'd just devalued and they didn't want to have to repeat it. Dick Goode was the head of the mission in the field and Walter was the originator of the plan. Jacques Polak was to head it but had health problems. During the six-week mission we went into the Central Bank, with Walter having done the advance ground work so well that we got absolutely full access to all their material, even to being able literally to go through their files. In writing the report it became evident that the simple way to describe the problem to the Mexican authorities was that if they wanted to keep the exchange rate they had to limit the domestic credit expansion. We found from the files that some credit advances had been quite automatic after previous devaluations. The rationale had been to compensate some of the state agencies for the costs of the devaluation, giving them power to spend to offset the devaluation and as a result removing some of the value of the devaluation. So we set out in our report that if they were going to hold the exchange rate they had to keep the expansion of credit within fairly tight limits. That was the beginning, for me anyhow, of thinking through how to get these policies set up so that when you reached an agreement with the country to commit Fund resources you would have a

continuing test of how serious the authorities were and how effective they were in making the policies consistent with keeping the balance of payments under control.

Thorson: Was there any magic new economics in this or was it already well known?

Finch: No, no.

Robichek: Yes, there was a magic.

Polak: Yes, I think so. Yeah.

Robichek: David says no because he had a lot to do with providing the key to the whole thing. But in a sense the breakthrough did not occur in a vacuum. The Mexican mission became a landmark in Fund history because it wa the sequence of perhaps the very first step in the evolution of Article VIII countries. A short time after the Fund initiated Article VIII consultations in 1952 I was assigned the Mexico country desk. In this capacity I wrote a memorandum arguing that Article VIII countries were, if anything, more vulnerable to balance of payments reversals than Article XIV countries. After the United States and Canada, Mexico was the most important among them. My memo was endorsed by management and an arrangement was made with Rodrigo Gomez who was the effective head of the Banco de Mexico that permitted me to visit Mexico informally twice a year, once under the guise of giving lectures at CEMLA and once without any cover. My resulting exposure to Mexico allowed me to witness the 1954 peso devaluation, and the insight I gained led to the suggestion that the Fund send a special mission there.

Rodrigo Gomez, the de facto head of the Bank of Mexico, one of Mexico's representatives at the Bretton Woods Conference and an absentee Executive Director of the Fund, cautiously encouraged a role in Mexican affairs for Fund management and staff. Being an Article VIII country from the start, Mexico was not subject to mandatory consultations with the Fund as the majority of the Fund members were, beginning in 1952. Instead, Rodrigo Gomez was instrumental in paving the way for me, newly assigned the Mexican country desk, very informally and very discreetly to visit Mexico twice a year in order to bring Fund management up-to-date on the developments in that country. From one of my early visits I returned very pessimistic about the fiscal situation, and in a memorandum to my department head I foreshadowed the possibility of a peso devaluation. Such a devaluation occurred shortly and came as a surprise in Mexico and abroad. The information that I had been allowed to gather in Mexico enabled me to prepare speedily the documentation to accompany Mexico's devaluation proposal and contingent request for use of Fund resources.

On my next visit to Mexico, Rodrigo Gomez was speculating if and how Fund staff might be able to help him avoid another peso devaluation. When I suggested a special technical mission, he said he was interested but only after the passage of several months. Fund management was very supportive. The mission was fielded in early 1955. We had been in Mexico about three weeks when we all were gathered one day at lunch. I complained that we had made no progress toward giving Rodrigo Gomez what I believed he expected from the mission. After a moment's silence David somewhat diffidently offered a simple formula. The formula that he came up with was that money supply can be allowed to expand at a rate no faster than real GNP grows. This formula, in my opinion, instantaneously justified the organization of the mission, although I had reason to believe that it did not tell Rodrigo Gomez anything new. But it did give him confirmation from a disinterested technical source, and even if I began to have certain reservations about the precise formulation, I firmly believe it started the Fund off on pioneering in financial programming, and thus was of far greater consequence to the Fund than to Mexico.

Finch: Let me feature a couple of things. The report was most unusual in the light of history in the sense it was secret, never given to the Board, because the Mexicans did not want it to be available to others. Second, its value to Don Rodrigo in Mexico was above all to enhance the power of the Bank of Mexico. This came from its stress on monetary control, but he also valued its featuring first, a purchasing power parity in relation to the U.S. which Tim Sweeney developed, and second, the level of reserves needed for an Article VIII country to be secure which Jacques produced.

Robichek: It was a big report with a lot of data in it.

Finch: Of course there was a lot of material but it was organized into sections which made these points of value to Don Rodrigo. This helped create an alliance between the staff and the monetary authorities to generate acceptance of monetary controls, which would help to run the country efficiently.

Robichek: It was remarkable how far we had come. I recall a senior Fund officer--I don't remember now who it was--saying in 1948 or 1949 that the staff is not in the balance of payments forecasting business.

Finch: Whoever that was. Eddie Bernstein himself was very much opposed to conditionality in Fund lending, though he was mainly thinking about the big countries. He did feel it was plan wrong for the staff to try to set demand policy conditions for sovereign countries.

Robichek: But Bernstein's mission to India had some of the ingredients that were picked up by the Mexican mission. When was the Indian mission fielded?

Finch: I think it was the year before. But it was an attempt to give a country general advice as an expert public witness. That report was also not a report to the Board but it was published as a service to the country. In that case, unusually for the Fund, the country was encouraged to be a bit more expansionary in demand policy.

Robichek: The 1955 Mexican report was strictly in the nature of a service to the country; it was not given to the Board. But what began to be established was that the Fund should engage in regular consultations with Article VIII countries.

Finch: Yes and no.

Robichek: I meant only the Article VIII countries in Latin America. They accepted the arrangement one after another.

Finch: In that sense, the authorities could see that this might be useful to them internally, so I think a belief got started that Fund staff were allies and friends in helping them to get constructive policy developments. That was one of the particular strengths in working with Don Rodrigo, that he was respected throughout Latin America, an if he found the staff useful, other people were encouraged to accept it.

Gold: Of course, in a sense, the relationship was much more like six years before--the '48 biennials--and there is a paper which on the masthead gives all the names of people who worked in research at that time and were interpreting the '48 devaluation and warning about Mexico.

Finch: Everyone who was associated with the paper had to be named because there was quite a suspicion of the staff in the Board. They wanted to make sure there were no nationalistic policies creeping in.

Gold: It was not discussed in the Board, it was not a Board paper.

Finch: I see, but this paper had to show on the masthead even with whom the paper was discussed.

Polak: Yes.

Finch: Tim Sweeney was telling me that the next thing that happened, he thought was Bolivia, but I'm not sure. I have the impression Al Costanzo thought it was Paraguay.

Robichek: The first actual stand-by in Latin America was with Peru. It was a very unique arrangement, negotiated by George Luthringer and Julio Gonzalez del Solar; all that it involved was providing for an exchange rate change under certain conditions.

Polak: That came soon after the Belgian, before Mexico.

Finch: Mexico was quite different. It wasn't related to use of resources of conditionality, if was purely advisory.

<u>Polak:</u> Belgium was '52 or '53. '52, I think. I think the Belgian, so-called stand-by arrangement was not under the decision... Peru was first, I think. But that was a very strange one.

<u>Finch:</u> Paraguay was the first, of what we would call conditional use of resources. But that came after Peru. Belgium was June '52... it is after the decision of February 13, 1952 but I think we clarified that it was not under the decision because it had certain unusual features. but, let me check--the first Bolivian stand-by was November 1956. I have the dates here. What other candidates do you have there? Paraguay was July '57. Peru was February '54.

<u>Polak:</u> That's what I thought. Between '52 and '56. And it was a very strange one.

<u>Finch:</u> But Paraguay must have gotten drawings in '56, I think. There was a program, some money made available to Stroessner.

<u>Thorson:</u> Tim Sweeney was telling me, Joe, that Al Costanzo was new in the Fund and Cochran had insisted that there ought to be some sort of instrument that would be legally binding and you had come up with the idea of letters of intent.

<u>Polak:</u> That's right. Letters of intent coupled with the idea of performance criteria, and you would end pulling elements out of it.

<u>Thorson:</u> Was that a new gimmick?

<u>Polak:</u> Yes, it is an attachment to the stand-by.

<u>Finch:</u> The Bolivian stand-by in late 1956 marked the first stage in the evolution. Costanzo came to the Fund in early '56 with experience from Greece as a member of the Monetary Board with the right of veto over

allowing any additional loans and credits there. He adapted the concept to Bolivia where there was a stabilization council at the ministerial level and chaired by the President, by having a Fund staff member put on that council. With this he felt that he had something like he had in Greece, in a sense it was going to be a technique in which the Fund would be present and could have a say on anything that the Central Bank was doing which would perhaps undermine the balance of payments of the country. What I think we gave to the Board as documentation was an actual stabilization council decision. It wasn't strictly a letter of intent as I remember it, but rather it was what the stabilization council had agreed to, and we presented that to the Board along with the paper analyzing it. It evolved into a letter later as the communication to the Fund which had as its main element the policy commitments signed by those responsible.

The U.S. Government also had an appointed representative, Mr. Eder, who was given powers like Al in Greece to help reconstruct Bolivia. He was having an awful time getting anywhere and the Fund staff was brought to give him support. In practice, it was the Fund staff member who developed the strength needed, but it was based on the growing U.S. support for Fund advice as its preferred vehicle. Jack Woodley was the first Fund resident rep and he was followed by Zassenhaus. Jack went down there in December after a mission; he was on the negotiating mission and then immediately he packed up and went down. He didn't want to stay there long--about six months--and Zassenhaus went for two years. Jack Clark followed him. The Bolivian authorities were pleased with the cooperation throughout. They officially proposed that Jack Clark be accorded the honor of being a hero of the revolution or some such title. The Fund staff couldn't accept such an honor in a formal sense but there was just no question that the staff were considered to be part of their team. Siles was the President in the first period of support, and at the end of his term went to Uruguay as Ambassador for Bolivia. When the Uruguayan press criticized the Fund, he went to them and said, "I know the Fund. The Fund is a friend." Very helpful, because he was regarded as a near communist, not a natural supporter of the Fund. In fact, the Bolivian revolutionaries found they needed economic order and the Fund staff became part of their team to produce order.

An earlier example involved Al Costanzo. At a ministerial meeting, they worried about having a good slogan to use to get popular support for the new economic program. Al said, what about "consolidate the revolution", and that was it. In a week, banners were everywhere with that slogan and it caught on with the public. They were looking for some one to give order.

Polak: The first use of performance criteria was in 1957, and I do recall they were really suggested at the request of Al Costanzo. I remember clearly we got together. He wanted some sort of measures to make the economic program effective, and up to that point we really did not have any in concrete terms. So I suggested to him that we could indeed really insist on terms for the use of Fund resources and that a decision could be written in which the terms were stated; the Fund had the power to really manage its resources and it could declare the circumstances in which it would allow its resources to be used. So the idea of performance criteria as a term came out of that. Now, all this was fitted into the idea that the stand-by arrangement was not a formal agreement, so the member set forth in its proposed letter of intent its policies including the quantified objective policies, and then in the Fund's decision the Fund said that such and such a paragraph, or such and such element in the paragraph was to be a term on which the Fund's resources could be used. This was a noble idea and, like I said, caused a good deal of controversy and consternation in some minds because of the novelty of the thing and, in a way, the open use of the Fund's power to declare the terms on which it would allow its resources to be used. Let me just add in connection with that, oddly enough it was not until 1961, I now find, that the prior notice clause was not official and was abandoned.

Robichek: You know, like a good lawyer you put everything in positive terms. It wasn't quite the way you described it; the stand-by stipulated the conditions under which the Fund's resources could not be used, not under which they could be.

Polak: That's true.

Robichek: It had the important consequence among the Fund staff that was when the lawyers picked up a lot of economics and some of us picked up a bit of the law. Because, given the performance criteria, the lawyers came to us and said it is up to you to stipulate binding conditions in such a way that it will be as self-evident to the country authorities as to the Fund staff whether or not the country is eligible to draw under the arrangement. Refraining from drawing as a substitute for ineligibility required that the red light had to go up at the same time in the country's central bank and in the Fund. This required a much more precise formulation of critical conditions than before the introduction of performance criteria. It also required the availability to the staff of more and more up-to-date information pertaining to performance under the performance clauses. I believe the requisite flow of better and more timely information led to a quantum improvement in country coverage and analysis by the staff. Coverage became more systematic and hence analysis gained in depth. It forced the negotiators to be more logical in conceptualizing a program, and this is why I believe that it was at that point that negotiations came into their own, that is, when the negotiating process became really important.

Gold: Walter has proved that he learned the law because he has made a very important point of legal character I should have mentioned earlier. It is the question of eligibility and ineligibility. One of the important reasons for developing the stand-by arrangement was that the express power in the Articles to make it clear in advance that a country couldn't use the Fund resources was simply ineligibility; but that has so much the aura of a sanction that the Fund was reluctant to resort to it. Not until recent times have we come to see declarations of ineligibility becoming kind of common practice in the Fund, but in those days, it gave shock waves of horror to all people within the Fund as well as member countries if the Fund had to declare a country ineligible to use the Fund resources. So the technique of the performance criteria in the stand-by arrangement was the substitute that was developed by practice, not in the Articles, to avoid declarations of ineligibility. It simply said that unless you observe the terms, or if you did transgress the terms, you cannot accept the Fund resources.

Robichek: I think it was important that the terms were effectively monitors.

Finch: I too think it's important that they were monitored, and that moves us towards another area that should be covered. When you were trying to get observance of policies, you had to be able to say at the time of the drawing that the policies were being observed. That meant that timeliness was of the essence. You could not be delaying a drawing for three months to wait for the data; you had to be able to decide straight away. A lot of the effort on the missions was to make sure that you had the data sent weekly by cable so that you knew quickly what was happening. This made monetary data the only possibility for monitoring current policy. There were two aspects of this that perhaps need to be stressed. On the one hand, it did make the Fund staff look "monetarist", but in fact I don't believe that particular economic theory had anything to do with it. Workability, the practicability of the reporting, was key. But second, it was a decision-influencing device. It linked to Al's experiences in Greece. Through a stabilization council in Bolivia you were able to ensure that government decisions which influenced its balance of payments were known also to affect relations with the Fund. So you were trying to ensure that politicians, when they decided to spend more had to face up then to the issue that Fund support could be endangered.

This linking of the Fund negotiation to the negotiation of the sovereign country decisions involved in the budget was a key development.

It enabled the Fund negotiation in countries that were in payments crisis to become a key to the set of fiscal decisions. This culminated in '82 with the Minister of Finance of Mexico sitting down here in Washington with de Larosiere and going through an entire budget exercise. Recovery from payments crisis required decisions, and the Fund technique of having performance clauses became a guiding technique to help governments get the needed decisions made. A Finance Minister could present a coherent economic program to his Cabinet. Overall, it was very much a pragmatic operational thing and not a theoretical abstract approach.

Robichek: I want to elaborate on this because it completely changed all our operations. First of all, in the consultations with countries in a stand-by relationship they were required to report weekly or every ten days by cable. We developed special techniques for reporting and cross-checking the reported numbers, using a letter-numbered code. By way of a footnote, several Executive Directors representing these countries were pressuring us to share the cabled information with them, but we had to resist these pressures because the information was sent to us on a strictly confidential basis. Regular receipt of the information enabled us to save time in information gathering when we visited the countries for Article XIV or Article VIII consultations, leaving more time for policy discussions. Another positive result was that when officials and technicians in member countries realized how the information which they were providing helped us to follow changes in their economic situations, they adopted our techniques themselves and used the figures cabled to us in the same tabular forms. This had in a number of instances the further beneficial result that the economists working on the numbers in central banks tended to identify with the Fund staff at time became our valuable allies.

I would like to cite one illustration of the usefulness of the numbers cabled to the Fund staff. A cable received one day in the late '50s or early '60s from Peru, then in a stand-by relationship, indicated such a shocking sudden deterioration in the country's fiscal situation that I took the next flight to Lima. When I arrived I surprised the management of the Central Bank with my findings. When they were confirmed, remedial action was undertaken. I mention this to show that the regular provision of up-to-date information of a statistical nature brought about an enormous improvement in the staff's coverage of member countries, and with it a quantum change in the Fund's relationship with them, within the framework of financial negotiations, consultations, and even strictly advisory functions. As the saying goes, it became an entirely new ball game. Let me add one point to this discussion of the need for current, up-to-date information. One of the compromises, as it were, that was made to get agreement on the idea of the stand-by arrangement was that a member would be able to go on using the resource involved in the stand-by arrangement unless it had already received a notice by the Fund, a statement by the Fund, that it had transgressed a performance criterion. So in order to protect the Fund's resources an to be able to give this advance notice before the request came in, you had to have the current information. Once the member made a request if you had to had not given notice of the failure to observe the performance criteria, you could not stop the drawing.

Finch: Everyone here understands that you timed the receipt of the information to the drawing dates so that you had the most recent data at the time the country was poised to become eligible for the next drawing.

Thorson: Were the drawings six monthly, or quarterly?

Finch: Quarterly. It varied, but usually quarterly. It's true that we only needed the right data to permit them to draw, but we were not intending this to be the sole purpose. The value of the Fund-negotiated programs was dependant on the country authorities watching what was happening too. In that sense, there could be a breakdown when the data showed the criteria were being breached as in Walter's example in Peru. They should have been watching like he was. They did, of course, react when you got there but the objective was that you could expect the country to feel responsible for keeping the figures within the ceilings.

Robichek: There were three documents for a stand-by. There was the letter of intent, there was the stand-by arrangement itself, and there was a memorandum of understanding. The memorandum of understanding covered, for instance, reporting requirements, how the things to be reported are defined, and these definitions themselves at times became important elements in the negotiating process.

Polak: It developed into quite a document, all kinds of technical aspects of the program...

Robichek: Right, because we were not supposed to include all the details in the letter of intent. This letter was supposed to be kept simple, and that is why we needed a memorandum of understanding for elaboration, and thus it happened that this memorandum had occasionally more meat in it that the letter of intent.

<u>Polak:</u> There wasn't always phasing, and then of course a huge amount of money was made available at one time, and then our friend Kafka really campaigned for equal treatment of members, and there was a decision that there would be phasing in all stand-by arrangements and not simply for those countries that didn't have reserve currencies.

<u>Finch:</u> The Fund staff, in effect learned early that economic problems don't go away. If you don't take continuing action, the problem persists, so if you give a country money and they go on spending to excess, you need a second chance to raise policy questions. It was like that with the U.K., he payments problems persisted and you were able to say, well, the existing assurances don't work. Therefore, we got stronger and stronger in the attempts to build up the policy commitments toward the performance clauses that had been used in the Western Hemisphere.

<u>Polak:</u> The mixture of diplomacy, economics, and law, I don't know how it is better illustrated than in a stand-by arrangement. But it all came together as a result of experience with stand-bys. Before we lose sight of it, the fiscal side was mostly patrolled by the government. One of the essences of the Fund relying on these things was for the Fund to obtain consistent data on the fiscal, the monetary, and the balance of payments. I am now observing an interesting development at the World Bank; they are now developing a principle of consistent data on the monetary, the fiscal, and the BOP aspects. This is now an issue on which the Bank organizes conferences.

<u>Thorson:</u> In the Bolivian case, when were the performance criteria introduced? In the first stand-by in 1956?

<u>Finch:</u> No, performance clauses developed out of events in 1958. In September '58, there was a 30 percent wage increase. In '56 there was no performance clause. There were straight-forward stabilization council resolutions written largely by the staff which were presented in a supporting document to the Fund paper. This comprehensive program abolished exchange restrictions, set a new depreciated fluctuating exchange rate, with new fixed wages for the miners, and new tax and price arrangements. It was an important stand-by for conditionality, but it was phasing, not performance clauses which was the big innovation at that point. Due to phasing we had money to disburse later with even more important U.S. money attached to it. In September '58 there was a major breach in demand control as a large mining wage increase began to require financing from the Central Bank beyond the program. As thee wa no automatic clause like the present performance clause to stop use of Fund resources, we had to use the prior notice clause to stop the next drawing due. This required formal Board action against the country, which the Board didn't like. This reaction is recorded in the official Fund History as leading to the development of automatic performance clauses. I think we probably reopened the Bolivian stand-by without an actual performance clause, but the Board instructions were clear for future arrangements.

<u>Thorson:</u> According to the table I'm looking t, in a string of three stand-by arrangements for Bolivia n very short order there is one in

November 1956 for 75 percent of quota, another in December '57 for 35 percent of quota, and a third in May '59 for 50 percent of quota.

Finch: We were running out of money and that time. Fifty percent was, I believe US$1.5 million, but the impact was made much bigger by parallel U.S. support. With the U.S. supporting the stabilization program Fund action basically controlled the availability of U.S. money. OF course, with the U.S. appointing a member on the Bolivian stabilization council, information on what was happening was fully available to the U.S. Government.

Polak: This touches on a very important point; it shows that the stand-by arrangements and what could be done under them had enormous influence on monies from other sources. And this influence has increased over time and now, as an example, under U.S. legislation the provision of backing by the U.S. depends to a large extent on what the Fund says on a stand-by arrangement.

Finch: Yes, donors are now supportive of a Fund connection but they were originally touchy about the connection with the Fund. Like the Paris Club also in the early days, there was a sensitivity that the Fund might be too pro-country.

Polak: They have various categories of reactions and so they can really do less. I see that the second Bolivia drawing came in December '57 which was just after Paraguay.

Finch: That drawing followed the same pattern as the first one. The program was working but it was not long after that the miners who had unrivaled political strength got their 30 percent. The President was very reluctant to halt sales of the foreign exchange at the old rate. The issue was forced when the Fund Board suspended the stand-by.

Polak: This happened in '58?

Finch: September, October '58.

Polak: What you say makes a point which needs to be made clear, that performance criteria were not limited to certain financial clauses; they also could include criteria related to import restriction, to exchange practices, really quite a range. I think there were stand-by arrangements for which Walter used to have a very impressive list...

Robichek: Some segments of the staff wanted fewer performance clauses and others, notably ETR, wanted more.

Polak: Well, in '79 the Board, in its March decision, settled the issue by saying as few as possible... (LAUGHTER) But current practice in stand-by arrangements in many respects is different from even the relatively recent past with which we are most familiar.

Finch: What we found over time as more sophisticated cases arose was you needed first a fiscal clause in order to focus the purely fiscal decisions, then an overall credit clause because for most countries the division between what is fiscal and what is credit is pretty shaky. There were practically always clauses on the exchange system arising partly from Fund jurisdiction. If there was a particularly heavy use of restrictions, or any multiple rates, you had to have some provision ensuring progress in dismantling them. Then you started to find issues like foreign borrowing. If you were limiting credit from the banking system, you couldn't encourage borrowing abroad. So you quickly got into that area. You had 11 sorts of elaborations in the fiscal area which you found were necessary to keep the central limitations intact. You had implementing questions when a decision reached by Cabinet had an implementing timetable which you wanted to be maintained, so you started to put in some specific clauses related to specific implementing actions.

Polak: It went beyond macroeconomic policies. Again in '79 you had to justify that practice by saying well, they were essential to the observance of the performance criteria on macroeconomic policies.

Robichek: For instance, is a bank holiday an exchange restriction or not? But leaving aside such fine points, you could live with the widely accepted classification. But import restrictions are more difficult to define. Besides, when a Department of Commerce or its equivalent bans a specific import for a very short time, the Fund staff might not learn of this temporary ban. Hence, the hair-trigger clause would not have been enforceable in such a case. One is forced to the conclusion, therefore, that actual developments under several performance criteria of a stand-by or extended arrangement were not equally observable and, therefore, not equally enforceable, and some of them were, in fact, more symbolic than binding.

Finch: Let me explain. Everybody here understands that a performance clause always could be waived by the Fund. So although you had to be precise in the definition, if you found that the deviation was truly not important you always had the power and, in fact, always exercised it to waive the clause. The idea was that if a departure could be justified and shown to be consistent with the recovery, no problem was raised to any drawing. That was the whole intend of this approach.

<u>Gold:</u> This was the concept that developed later that the waiver would not be granted if the departure from the performance criterion meant that the program might be off course and consultation therefore was needed.

<u>Finch:</u> The point I am making is the separate one that if you did find an acceptable departure you could always waive the condition. It was a flexible procedure. It was meant simply to give the Fund Board control. There is one other issue which I think perhaps is important. It was particularly critical that you had good statistics and reliable accounting. It's one of the things when you think of the Soviet Union becoming a member. A centrally directed system typically doesn't seem to provide good statistics. It seems too often to be window-dressed. We've had trouble with Romania for that reason. I stress this because it is an absolutely essential element of the whole philosophy that you are relying on the monetary authorities to be on your side. You are their ally in trying to see that their country is run right. As soon as they start to shift and to regard the Fund as an alien force, they can come up with all sorts of gimmicks to rig the figures. Then it is virtually impossible for the Fund staff to know quickly what is really happening. Because we haven't got an army out there, we are relying essentially on the authorities basically cooperating.

<u>Robichek:</u> But we did have some ways of knowing, and they were based on cross-checking certain macro accounts. We referred to them as the bridging accounts as they were parts of more than one accounting set. Our reporting requirements relied heavily on the inter-relations of these accounts.

<u>Finch:</u> We tried to make them self-enforcing but basically all figures can be rigged.

<u>Robichek:</u> They could always cheat by saying that a domestic asset was a foreign asset and there was no way of checking this; it seems that a few central banks eventually learned to cheat this way.

<u>Finch:</u> The debts were not being recorded.

<u>Gold:</u> Well, there was a general decision on this matter of accuracy that lets you use the word "accuracy" of statistics provided to the Fund. The decision does distinguish between manipulated statistics and those inconsistencies that are really unintended.

<u>Polak:</u> That's the decision of '83/'84 or thereabouts.

<u>Gold:</u> Of '84.

<u>Polak:</u> It was a very late decision.

<u>Gold:</u> But there were problems with statistics on monetary reserves unrelated to stand-by arrangements in the early years of the Fund.

<u>Polak:</u> Ah, yes.

<u>Gold:</u> On the calculation of monetary reserves on which repurchase obligations were based, there were suspicions in a number of cases that the numbers were cooked.

<u>Finch:</u> But the history of the stand-by, when you reflect on it generally, is that when you had the local financial people thoroughly on your side, they cared about the honesty of the reporting. They believed with the Fund staff that the real information on developments was essential for running the country. This belief goes back to Mexico and Don Rodrigo.

He wanted to have control and the Fund staff worked from the principle throughout.

Robichek: Don Rodrigo didn't believe his own Research Department. That was one of the reasons.

Polak: Don Rodrigo--and I think that this has to go into the history--was the greatest ally of the Fund, and, as far as I'm concerned, he was in part responsible for the monetary theory of the balance of payments because he lived by it.

Gold: He was an important figure in Bretton Woods too.

Robichek: I was once in 1956 or 1957 invited to an internal discussion at the Bank of Mexico. Don Rodrigo asked me to talk about my general views on the appropriate thrust of monetary policy. I offered my opinion that in a country like Mexico the Central Bank cannot control the money supply. It can only control the division into domestic and foreign assets. And Don Rodrigo congratulated me on having discovered a truth he had known all those years. (LAUGHTER)

Polak: This ought to be complemented by a story about the U.K. consultations in '65 or '66 which ended up as a session with the Chancellor. I've told the story in the Board, to the chagrin of the U.K. Director. The Chancellor very proudly told us that he had been very successful in keeping the growth of the money supply to 10 percent. I said, yes Chancellor. You did that by always filling up by new credit creation all the money that leaked out.

Thorson: In respect of having friends in the countries, Jack Clark was relating to me that when the mission to Paraguay around 1957 came back with the proposed conditions for a stand-by, the Executive Director representing Paraguay raised objections to the conditionality in the formal Board meeting. Whereupon the Governor of the Central Bank, Gustavo Storm was his name, who had been invited to attend the meeting, protested. He said "but I want these conditions." (LAUGHTER).

Finch: Funny, but true. It was very clearly a local alliance which the Board Director might not have been part of. The same happened openly with Bolivia once. Julio Gonzalez del Solar was Director for Bolivia along with several other countries, but the Bolivians wouldn't make use of him. He was in La Paz on one occasion when we were negotiating, and they kept him outside the whole time. It was very much local support that the staff needed and the local authorities weren't particularly wanting to have anybody outside getting involved in int.

But let me also add on the U.K., when we wanted to get some performance clauses which were not strictly classified into that first agreement in '68. I had an agreement with Dick Goode who was heading the mission that we should propose ceilings on fiscal and domestic credit expansion ceilings. Dick was worrying that being the U.K. it would probably be difficult to get the two, and he was ready to settle for the overall credit limit as the key on. He proposed the two and someone on the U.K. side raised the question whether they needed both and couldn't they drop the fiscal. Before I could intervene, Guy Huntrods who was present as Alternate Executive Director for the U.K. said: "We asked earlier in the Fund Board that the inclusion of fiscal commitments be standard Fund policy, and we're not going to be able to walk away from them in our own case." The situation was solved then and there. (LAUGHTER) It was never raised again. They had a fiscal ceiling and were happy with it.

Thorson: Was that the first case where stand-by was applied to a major country?

Finch: It was the first such case where we had clear quantitative clauses. Strictly, the agreement on that occasion was that drawings were to be subject to successive quarterly reviews by the Board. We had the phasing which Joe referred to before and we told the Board we had quarterly benchmarks on the fiscal and the overall credit sides, and the staff would support each drawing if those benchmarks were met. It was the first time we had quantitative credit monetary figures which were agreed with the authorities and claimed by them as their figures. This was the first for a major country with effective quantitative clauses.

Polak: The U.K. stand-by of '65 was the first one that had a credit commitment. But it had no performance criteria.

Finch: What they had, I've left out, was a figure. But no, it wasn't a domestic credit expansion (DCE). They hadn't developed a strict concept. What they had was a commitment that I think was put in terms of what the next year would show or something of that sort. The mission did get them to focus on the point that credit was the cause of a balance of payments problem and they acknowledged it. But without the phasing of the drawings, it wasn't a condition, whereas later they accepted the procedure for phased drawings, and a British official who wanted it helped to make the fiscal performance an essential part.

Gold: Which of the nine stand-by arrangements had as the letter of intent a speech by the Chancellor that was substituted for a letter of intent? The U.K. didn't want to have a letter of intent. Do you remember?

Polak: In '65 the DCE commitment was a condition for the number of tranches they would get. Discussions essentially broke down on that point and the mission returned home.

Gold: The Chancellor was MacMillan, as I recall it, with whom this compromise was reached, that his speech just be attached instead of a letter of intent.

Finch: The first real conditionality for the U.K. was really Jacques' accomplishment, although Dick Goode headed the missions. It was Jacques, I believe, who earlier won the position the U.K. would have to devalue before further money would be given. I remember you, Jacques, as being the key figure in that particular thing. We got it agreed that they couldn't draw before there was a further devaluation, and that was maintained until the November drawing. Having won that issue we were not in a strong enough position to insist that the November 1967 stand-by have a DCE or fiscal commitment.

Polak: Wasn't it then?

Finch: No. DCE was later. You actually understate your role again a little in the sense that DCE came after the Cairncross seminar in 1968, where you led the Fund team. DCE was not actually developed as a figure until after that seminar; in subsequent negotiations, the change was major. The '67 stand-by had a general description of intent on fiscal and credit policy but we knew the British were always able to say after any departures, well, of course, we intended to do that but conditions forced us to do something a bit different. We didn't have the sort of follow through commitment which came with the quantified program negotiated subsequently.

Robichek: That was the first time that prior conditions were indirectly mentioned. It's strange that we've been talking all this time and prior conditions have come up so late in the discussion.

Finch: Prior conditions were always important but the U.K. was a major country with the second largest vote. It was difficult. I think Jacques was the one who created that strength. I first was involved in the mission in May of 1967 and my understanding is that the precondition of devaluation was set well before that.

Polak: Yes.

Finch: Maintaining tough conditions for the big country, once won, settled the issue for all members.

Polak: Yes.

Gold: May I say a word on the expression "performance criterion"? It's of interest. It is said that all problems are problems of words, and this is certainly one good example. In this discussion, friends here have been talking about conditions for use of the Fund's resources. Well, this was an unholy word to use because the Articles themselves set out the conditions for the use of the Fund's resources. There was nothing in the Articles about stand-by arrangements, or performance criteria, so we evolved the expression "performance criterion" so as to avoid using the word "condition" because the enemies of stand-by arrangements would have said ah-ha, you're adding a condition which is not in the Articles. But then we said, it is implied in the Articles that you must have policies and all we're doing is to make your policies effective. So the subsequent history is that it was not until the First Amendment in 1969 that the Articles said the Fund must have policies and must impose policies for the use of the Fund's resources, and then, in 1978, there is express mention of stand-by arrangements, terms, assurance, and so on.

Polak: These things have become "conditions" which were gathered together under the heading "conditionality". (LAUGHTER)

Gold: Yes, I know. That must have been an economic term. (MORE LAUGHTER) but I was always wrestling with Walter. Walter would come with one of his cases saying now the conditions on which we are going to use the Fund's resources..., and I would say, Walter, not "conditions". (LAUGHTER)

Finch: And not "agreement".

Gold: And not "agreement". Examples of verbiage were very important steps in the development of the stand-by arrangements. Not disparaging the economic policies which were, of course, equally essential.

Polak: Verbiage rhymes with garbage? (LAUGHTER)

Gold: Garbage. (MORE LAUGHTER)

Polak: One area that we ought to touch on now perhaps is the stand-by that was not intended to be used. I'm not particularly familiar with them, but isn't it true that they were a type apart?

Gold: Yes, although the justification for it was that the original concept of the stand-by arrangement was that you didn't have an immediate need.

Polak: No, it's not the legal distinction. Legally, those are the most natural stand-bys.

Gold: That's right.

Polak: But in economic terms, Walter, you must have negotiated some of those; with Peru, wasn't it?

Robichek: That they were not supposed to be used? Well, you're quite right. I negotiated a lot of stand-bys where the country had to buy its way into a successive stand-by arrangement in that it had to repurchase the drawings from the previous arrangement in order to qualify for the new one. What the authorities were really interested in obviously, was maintaining the program more than the drawing rights. But it seems to me that this configuration sort of evaporated over time. One reason for the change was that the Fund became more generous in opening up access to its resources so that countries that were already indebted didn't necessarily have to repurchase in order to maintain stand-by programs.

Finch: Perhaps there's one issue that could be clarified. Walter was referring to occasions in which, because of the limit on the scale of use of Fund resources, the country had to repurchase in order to get a new stand-by and, obviously, although they got somewhat longer terms they didn't get immediate cash out of that sort of arrangement. So such arrangements were made for other reasons, such as for financial support from somewhere else. A quite different category of stand-bys without net resource use were the so-called symbolic stand-bys where the country had no need and no intention of drawing. There was a certain resistance to these in some parts of the Fund, I think from the lawyers and the Board.

Gold: Yes, I know.

Finch: The financial authorities found them useful for leverage in their policy making. The Brazilians after 1965 felt this way.

Gold: I always liked that arrangements. I thought I couldn't convince you about it. (LAUGHTER)

Finch: Those misinterpretations... But there was some resistance at some stage that they weren't intended under the provisions of the Fund.

Gold: I think those reservations came from the Board. I thought it was immensely useful.

Finch: Certainly, and there was a whole string of them, Korea and Brazil were two that used them quite systematically to try to help maintain their policy-making and probably, I think, to improve their credit standings.

Robichek: Wasn't there originally a distinction between an extension of a stand-by and the negotiation of a new one?

Gold: Yes.

Robichek: Wasn't the distinction initially along the line that if there was money left over from an expiring stand-by it could be extended, and if no money was left over, a new arrangement had to be concluded?

Gold: Well, that may have been really in the background--that there was still money. But the real reason for those extensions was that there was no time to negotiate a new stand-by arrangement. That sort of thing disappeared after a while because people didn't like the idea of carrying over the old terms into a new stand-by arrangement.

I do want to say something about the amounts of stand-by arrangements and why it was that you had to repurchase, because this is not just a narrow technical point; it's a broader technical matter. For many years, the Fund's policy for some reason was that a country couldn't increase the Fund's holdings of its currency beyond 175 percent. Jacobsson was very keen on this and he tried to argue with me that this was written in to the Articles somehow because a country paid its subscription of 75 percent in its own currency and then it could draw another 100 percent, so the Fund's holdings of the currency went up to 175 percent. I said this is not correct. The Articles themselves say the country could draw up to 200 percent. Nevertheless, that was the policy. For many years countries couldn't increase the holdings beyond 175 percent, which meant that if one wanted to have a stand-by arrangement for a substantial promotion of the quota, it had to draw down the Fund's holdings to a certain level that would enable it to make an adequate increase. In those days, because of this policy, the stand-by arrangements were expressed not in terms of an absolute amount. You wouldn't say 75 percent or $75 million, you would say the county could draw to the point where it increased the Fund's holdings to 175 percent.

Robichek: But Mr. Rooth would never allow any country to come even close to 175 percent of quota.

Gold: Yes, but he did, of course, in the end. Wasn't it the U.K. case?

Polak: No. That was under Jacobsson. The Suez drawings in 1957, they were under Jacobsson.

Finch: But the principles were set a little earlier. I think with Jacobsson there was a transition, but in a sense, Rooth had contributed.

Gold: Oh. I mean Jacobsson. That was the case in which the taboo of going beyond 175 percent was broken.

Robichek: Double waiver.

Gold: Yes.

Thorson: To get back to the sequence. Why was it that Paraguay happened to be the first case where an effective stand-by with conditions was established and a letter of intent, and so on, was set up?

Finch: Well, I'm not sure that we've established which was the country. We'd have to look at the record. There was a program with Paraguay in '56 where they first moved their rate to a more realistic level. It looks as if, from the record, there wasn't a stand-by. It must have been a drawing, I think, on that occasion. The 1956 Bolivian support arrangement was a stand-by, and it was the first in this, and Paraguay came with a stand-by in July of '57 according to what the table in Joe's book says.

Gold: This is a correct tabulation, I'm sure.

Finch: But as we started out saying, these went through stages. The question of whether support was through an immediate drawing or a stand-by was set after the issue of supporting developing country reform programs became significant. After Paraguay, Bolivia was, I think, pushed toward a stand-by because U.S. assistance money had been associated with a reform program and wanted to be phased out. I'm not certain that the legal form was crucial. The question was more what fitted the particular circumstances, and certainly we were rapidly evolving the technique of working closely with the countries. So we felt in Latin America, and also I think in Eastern Europe, with Sturc, that the willingness of other donors, other people, to put up money parallel gave importance to our relatively small amounts of Fund money. That relationship to other sources of support made the Fund's money the key element in getting much more finance for programs of change.

Thorson: Did the donors' representatives take part in the negotiations and help to set up the arrangements?

Finch: Basically, in any case that I was involved with the negotiations entailed very little direct U.S. role. Financial support was coordinated through the State Department here in Washington.

Thorson: That was Don Palmer's job?

Finch: Don Palmer was not there in the early stage. Harry Turkell was the key State Department figure.

Gold: I don't remember him at all.

Finch: "No tickie, no washie", I remember, was his trademark. It was Cochran basically who did the coordinating with him here on the Fund side.

Robichek: Don got into the picture directly only during the Alliance for Progress days later.

Gold: Certainly, the first stand-by with performance criteria was in 1957 with Bolivia.

Gold: Paraguay had no performance criteria. This was clearly stated in the Board. I checked this.

Thorson: Then Bolivia was the seminal case.

Finch: Yes, but as to which was the seminal one, it was just a chance which one happened to come after the Board had asked for something. It was changed in response to the Board.

Robichek: When it came to coordination with the U.S., Frank Southard played a major role too as Executive Director for the United States. He had to be educated, but then he was very helpful in conveying Fund staff views to the authorities.

Finch: I remember his role as key when the suspension of Bolivia took place in 1958. The plane home after the mission was delayed four times. It was delayed in La Paz, then went out again in Peru and we spent overnight there. We got to Miami and had a delay even there. The Foreign Minister of Bolivia was accompanying us. Finally in Washington he was met by a State Department representative after we had been something like 36 hours on the way. It was early in the morning, and they were there at 8 o'clock to pick him up. Coming directly to the Fund, I went straight to Southard's office to make sure that the U.S. was briefed on what the situation was. It had to be closely coordinated because it was their money that was decisive.

Thorson: Was there any consistent and continued resistance on the idea of conditional stand-bys in the Executive Board once they got started?

Gold: Not really.

Finch: Because the drawing country was always an ally. The country wanted it, and therefore, the Board wouldn't, basically, turn the arrangement down.

<u>Gold:</u> There were some Directors, a few Directors, who took a negative attitude to the mention of stand-by arrangements in the Second Amendment. They feared that this would make the Fund tougher in its policies on the use of the Fund's resources, but they couldn't stand up against the fact that this was the way the Fund had been behaving for many years, and one of the ways in which the Second Amendment was described and defended was that it was a modernization of the Fund. You could hardly have modernization without recognizing the fact that this is the way that the Fund worked.

<u>Thorson:</u> I have one other question. Did you ever use economic models of the economies in those days?

<u>Polak:</u> Sure, monetary models were being used.

<u>Finch:</u> Well, basically, you didn't.

<u>Polak:</u> They were so simple that they didn't appear as models to the authorities. (LAUGHTER)

<u>Finch:</u> But, basically, you were reaching agreement with the country authorities on figures which were manageable. There were no strict econometric attempts to derive coefficients from past statistics, for example. You were very straight forward in that you had to keep the credit expansion very limited. Even in subsequent cases in Italy or the U.K. there was very little real attempt to model in a formal sense.

<u>Robichek</u>: Perhaps you won't agree with this, but the only variable that lent itself to econometric modeling in a macroeconomic monetary model wa the income velocity of money, and these models didn't give decent results either in industrialized countries or in LDCs. Every time we used the figures in

the few cases that we tried, they didn't work. So in practice we always fell back on simple rules of thumb.

Finch: The problem is that when you use something as a control it starts to shift its role. (LAUGHTER)

Robichek: I used to argue that it didn't really matter much. If you pursued sound monetary policies, you were likely to get better results than you expected. And if you pursued bad policies, the results were likely to be worse than expected.

Finch: On Italy, we had been worried a bit abut the feedback of good policies on income velocity.

Robichek: Of course, the income velocity of money is critically affected by whether savings are kept at home or escape abroad, and this is one reason why you should do better than expected and vice versa. But we were quite frequently criticized for not relying more on modeling.

Finch: But Walter, in most cases, the authorities you were dealing with didn't have confidence in models. If anything, they were probably a but more cautious than we were on what they could support and have a success. They were worried about too big an expansion, and they were quite happy to accept fairly conservative figures on money growth. Italy was the one that I remember with this bias. Their income velocity varied with the public's perception of policies. It was systematic that when you put up interest rates for a while the growth in income velocity was reduced. Italy's got a very extraordinary rate of growth of money and credit relative to GNP, especially in previous periods of tightening. But the Bank of Italy was totally an ally to ignore this as they worried just as much as we did that the drop in velocity came after policies were demonstrably sufficiently restrictive.

Gold: Well, Italy didn't have a stand-by arrangement.

Finch: Yes it did. In '79 actually. Negotiations started in '76, but we didn't finish them until'77.

Gold: What about the Fund's transactions with Japan? Were they under stand-bys?

Finch: No. I remember once there were feelers for a stand-by, but they got nowhere.

Gold: They did use the Fund's resources.

Finch: Yes, but like the U.S. has used it.

Robichek: The proof of the pudding is in the eating. I am firmly of the opinion that our predictions, our forecasts were unmatched by any other institution involved. Although we were rarely wrong in our macro forecasts, we did put in a bit of a professional bias to exaggerate the scale of problems and lean perhaps toward pessimism. This was probably tactical in part. But you're not going to convince many people that our record of predicting was outstanding, mainly because there were so many instances of deviations from negotiated programs. In such cases, the Fund's forecasts and prescriptions were typically blamed. We would warn that in the absence of corrective policies a crisis would occur, and it almost always did. I will cite just one example. It was during de Larosiere's first Annual Meeting in 1978 and we were into the second year of Mexico's first three-year extended arrangement. de Larosiere had just congratulated the Mexican delegation for the country's excellent performance due to a great extent to the first oil price surge. On the way out of the MD's office I turned to the Finance Minister and warned him of a crisis down the road if the budget deficit was not slashed. The Minister just laughed off my warnings, but the crisis came less than four years later.

Thorson: Before we break up. I want to thank the Visitor's Center very much for taking care of us this morning. Then I wonder if we could spend a few minutes talking about where we go from here. Al Costanzo and Jack Clark are enthusiastic about the project, and want to come down in June. Maybe Frank Southard will be here then and he might want to sit in. And we ought to get Jack Woodley to come. He had a conflict this morning. Whom else do you think ought to come?

Polak: Who's going to write this up, or do you just leave it on the tapes?

Robichek: Can it be written up? It's so complex.

Gold: Yes, there are so many incidents and stages. It's really a monograph and not just a short piece at all. I think a historic account is really the sensible way to go about it, but it's a big task.

Finch: It's a big task. You need probably someone, a ghost writer, in a sense, to put the various pieces together.

Polak: I'm sure Margaret de Vries could do it.

Gold: But one thing that has emerged from this session is not merely the complexity of the history but the complexity of the contributions from many fields.

Polak: Yes.

<u>Finch:</u> We didn't get into the debt area in which the Fund came to dominate the early Paris Club and the development of a role with the steering committees of the banks.

<u>Gold:</u> I think it is a project that someone could give a year to writing a monograph on. Maybe External Affairs could put this thing on its agenda. One of its bright people.

<u>Thorson:</u> Should it be written by somebody inside or would it be a Ph.D. thesis for somebody else, or what?

<u>Gold:</u> I think inside. Really, I have, well, no great confidence in outsiders who haven't had some experience on the inside. A feel for the institution.

<u>Finch:</u> Yes, but an outsider has a potentially wider audience. I know. I've written my own piece that Jacques has seen.

<u>Thorson:</u> I mentioned to Azizali Mohammed that we were having a session today, just as a matter of interest. Do you think that there's somebody in his shop that could pick it up?

<u>Gold"</u> Well, that was my suggestion. Why not let him listen to the tape and see whether there is enough in it to excite his interest?

<u>Thorson:</u> Do you think we could get a stipend from the Fund to pay somebody, an alumnus let's say?

<u>Finch:</u> I don't think so. I think probably one of the issues would be the image of self-serving propaganda if an insider wrote it.

<u>Gold:</u> One of the problems may be the fact that to be useful this account should be candid.

<u>Robichek:</u> Surprisingly, I've learned quite a bit, and it's been thoroughly enjoyable, and I certainly don't mind spending more time on it. Well, the lawyers were not fair. I tell you why they were not fair. What Joe calls monetary criteria, including the one for foreign debt that David mentioned, I think you call, say, all of them are monetary, but I like to call them quantified or quantifiable criteria. The lawyers were very strict that everything had to be just absolutely precisely defined and really totally enforced. It happened a couple of times that countries that I was involved in, that one of the ceilings was exceeded by 1/10 of a unit, which meant 100,000 probably in their currency or U.S. dollars and they couldn't draw....

<u>Thorson:</u> Well, thank you all very much. I think this was a good start to getting recorded the real story of how stand-bys got started.