

**FOR
AGENDA**

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Correction 1

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To: Members of the Executive Board

From: The Secretary

Subject: **Evaluation of the Role of the Fund in Recent Capital Account Crises—
Report by the Independent Evaluation Office—Volume I**

The attached correction to SM/03/171, Volume 1 (5/9/03) has been provided by the staff:

Page 79, para. 180, line 2: for “seven recommendations” read “six recommendations”

Questions may be referred to Mr. Takagi (ext. 35676), Mr. Mansoor (ext. 38527), and Mr. Cohen (ext. 39805) in IEO.

Att: (1)

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Department Heads

differences of view on strategy did not follow a simple IMF-World Bank divide.¹ It is difficult for the evaluation team to draw any general conclusion except to say that the established collaborative procedures clearly broke down at one of their major tests, with significant adverse consequences.

VI. CONCLUSIONS AND RECOMMENDATIONS

180. In this final chapter, we first present our conclusions on major issues discussed in this report. We then draw from our findings **six recommendations**, designed to enhance the ongoing efforts to improve the effectiveness of IMF surveillance and program design in a capital account crisis.

A. Conclusions

Pre-crisis surveillance

181. The effectiveness of IMF surveillance varied in the three countries. Surveillance identified the central problems in Brazil reasonably accurately, but it was less effective in Indonesia and Korea. It identified specific weaknesses in these countries, but underestimated their seriousness and thereby failed to provide sufficient warning. This difference in effectiveness partly reflected the fact that Brazil suffered from macroeconomic imbalances, a traditional focus of IMF surveillance, whereas in Indonesia and Korea the problems lay in the weaknesses in the financial and corporate sectors. Surveillance identified these weaknesses, but it did not produce an accurate assessment of the extent of vulnerabilities they posed. Surveillance reports were insufficiently candid about potential vulnerabilities, especially those related to governance issues. In part, these problems reflected weaknesses in data availability that subsequent initiatives have made a major effort to correct, but they also reflected internal incentives that discouraged candor. More generally, there was an insufficient appreciation of the fact that weak balance sheets can pose substantial macroeconomic risks, even when most macroeconomic indicators suggest no obvious major problems.

182. The impact of surveillance was generally limited, because of (i) a reluctance to state difficult or embarrassing facts and views, for fear that this would alarm markets or generate conflict with national authorities, especially when hard evidence on some of these issues was lacking; (ii) lack of receptiveness of country authorities to the policy advice of the IMF, when there were political constraints or honest differences of view; (iii) limited IMF leverage in a non-program setting, particularly in an environment of buoyant capital flows to emerging

¹ In this context, the World Bank's Operations Evaluation Department provides its own analysis of the Bank's crisis response in Indonesia, showing that there were differences between the assessment of the Office of the Chief Economist and that of the Bank's regional staff (World Bank, 1999b).

markets; and (iv) failure to influence the public policy debate or promote better risk assessment by private creditors by not making the IMF's views better known to the public.

Macroeconomic framework and projections

183. The three country cases illustrate the enormous difficulties in designing macroeconomic policy in capital account crises, which stem from (i) the possibility of multiple equilibria which implies the potential for large exchange rate changes; and (ii) the negative impact of balance-sheet effects on aggregate demand. These difficulties are intrinsic to the nature of a capital account crisis, and the IMF's conventional approach was not well-suited to dealing with them.

184. In all three country cases, at least part of the program design problems resulted from growth projections that turned out to be incorrect. In both Indonesia and Korea, the initial projections were overly optimistic. In contrast, the initial projections for Brazil were too pessimistic. In Brazil, overpessimism resulted in insufficiently ambitious fiscal targets. The main cause of these problems was the absence of an analytical framework in which all key factors that likely affect aggregate demand during a crisis are considered, notably the impact of balance-sheet effects and confidence factors on private investment. These negative forces were very strong in Indonesia and Korea and led to a sharp decline in private investment, which had a severe contractionary impact. These effects were not present in Brazil because private sector balance sheets were well hedged and hence less vulnerable to a change in the exchange rate.

185. Even if macroeconomic projections for program design are improved in this way, the problem of uncertainty will remain. The nature of this uncertainty is particularly difficult to handle when there are possibilities of multiple equilibria leading to bimodal distributions of outcomes. This in turn implies that the mere fact that an IMF-supported program failed does not necessarily mean that the decision to provide financial support was unreasonable *ex ante*. However, in each of the three cases studied, it does appear that there were important elements of the initial strategy that lowered the probability of success—either because the program was perceived by the markets as underfinanced (for example, the first Korea program), or not fully owned by the authorities (for example, Indonesia), or having an unsustainable policy package (for example, the exchange rate regime in the first Brazil program).

Fiscal policy

186. Fiscal policy was tightened in response to the crisis in all cases, but to different degrees and with different effects. The initial tightening of fiscal policy in Indonesia and Korea was moderate and was proposed on the assumption that growth would remain positive. It was justified on the grounds that some tightening was necessary to lessen the burden on the private sector in external adjustment and to pay for the interest cost of bank restructuring. This reasoning proved to be mistaken, as the IMF has itself acknowledged, given the severe collapses that followed in aggregate demand and output. The low initial stock of government