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Approach Used to Establish and Monitor Conditions for Financial Assistance

UNITED STATES GENERAL ACCOUNTING OFFICE

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Congressional Committees:

To facilitate congressional oversight of U.S. policy concerning the International Monetary Fund (IMF), the Omnibus Appropriations Act for 1999 required us to report on the conditions the IMF establishes with its borrower countries.[1] IMF member countries may request financial assistance from the IMF when they face or anticipate balance-of-payments problems, that is, when they have difficulty obtaining the financial resources needed to meet their payments to nonresidents. IMF staff and the borrower country agree upon the financial assistance and policy changes that the country intends to undertake as conditions for that assistance. Upon approval from the IMF's Executive Board,[2] the country gains initial access to the financial assistance.[3]

The objectives of this report are to (1) describe how the IMF establishes financial arrangements with borrower countries and the types of conditions set under these arrangements and assess how this process was used for six borrower countries; and (2) describe how the IMF monitors countries' performance and assess how this process was used for the same six borrower countries, detailing the conditions met and not met, the reasons why conditions were not met, and the actions the IMF took in response. We reviewed the most recent IMF financial arrangements for the following six borrower countries: Argentina, Brazil, Indonesia, Republic of Korea (hereafter referred to as Korea), the Russian Federation (Russia),

[1] The Omnibus Appropriations Act for Fiscal Year 1999 (P.L. 105-277, Oct. 21, 1998) appropriated about $18 billion for the IMF and required us to report on a seven-point mandate for reviews of the IMF. We are addressing this mandate in three reports— this report on the terms and conditions of IMF financial assistance; one addressing the IMF's financial condition, to be issued by September 30, 1999; and the third addressing borrower countries' trade policies, to be issued in June 1999 (GAO/NSIAD/GGD-99-174, June 22, 1999).

[2] The Executive Board is the IMF's primary decision-making body. The Board comprises 24 Executive Directors who are appointed or elected by member countries or by groups of member countries.

[3] With the exception of some financing for low-income countries, the IMF does not loan funds to a country, per se. Rather, the country "purchases" the currency it needs from the IMF with an equivalent amount of its own currency and then later "repurchases" its own currency according to the terms applicable to the IMF financing policy. For the purposes of this report, we will use the terms "disbursement" and "loan" to refer to "purchases," and "repayments" to refer to "repurchases." We use the term "arrangement" to describe the broad concept of IMF's financial assistance to countries and the associated conditions that are intended to address the underlying causes of the countries' need for financial assistance. We use the term "program" to describe the conditions, which are the policy changes or reforms, as outlined in the documents countries prepare in the context of their IMF financial assistance.

and Uganda. We selected these countries because they are geographically diverse and represent a mix of borrowers that were having actual or potential balance-of-payments difficulties. Several of these countries were in the midst of a financial crisis at the time they requested assistance. Unless otherwise noted, data in this report are current as of April 30, 1999.

Results In Brief

The IMF's process for establishing and monitoring financial arrangements with member countries gives it wide latitude in assessing a country's initial request for assistance, establishing terms and conditions for that assistance, and determining the country's continued access to IMF resources. Under its Articles of Agreement, as amended, the IMF limits financial assistance to those countries with a balance-of-payments need. In practice, the IMF has broadly interpreted this provision to encompass a wide array of financial difficulties. Continued disbursement of assistance to a country is based on the IMF's consideration of data on and judgment of the country's progress in meeting the agreed-upon conditions. The IMF has continued making disbursements to countries that have not met all key conditions when it decided that the country had made sufficient progress. However, when the IMF determined that a country's progress in meeting key conditions was insufficient, disbursements have been delayed and have not been resumed unless or until, in the IMF's judgment, satisfactory progress has been achieved.

Over time, the IMF has developed a broad framework for establishing a financial assistance arrangement that is to be applied on a case-by-case basis considering each country's circumstances. This process, based on the IMF's analysis of country data and projections of future economic performance, gives the IMF considerable latitude in establishing the balance-of-payments need, the amount and timing of resource disbursements, and the conditions for disbursements. Under its Articles of Agreement, as amended, the IMF provides financial assistance only to those countries with a balance-of-payments need. These Articles do not precisely define "need," and, according to IMF documents, the IMF's Executive Board has been reluctant to establish guidelines that would add greater specificity to the Articles' general criteria. The broad interpretation of need has enabled it to consider countries' circumstances and changes in the international monetary and financial system, such as the increasing amounts and variability of capital flows between countries. The specific conditions that the IMF and the country authorities establish are intended to address the immediate and underlying problems that contributed to the country's balance-of-payments difficulty, while ensuring repayment to the IMF. These conditions can include a variety of changes in a country's fiscal, monetary, or structural policies; changes in structural policies may include revisions to financial market regulation or tax policies. Political constraints and economic uncertainty can make these sensitive, difficult negotiations. After a country fulfills any early IMF requirements, known as "prior actions," and the IMF Executive Board then approves the financial arrangement, the program is to take effect and the country is eligible to receive its first disbursement of funds.

According to information we reviewed for the six countries in our study, the IMF generally followed this process to establish the financial assistance package and the conditions for the assistance. The underlying causes and magnitude of the balance-of-payments difficulty varied among the countries but generally stemmed from concerns about their continued access to external financing. In some cases, the concerns were embedded within a larger set of reasons for IMF assistance, including continued support for the countries' economic reform programs. Thus, the specific financing arrangement and conditions also differed, as exemplified by the programs for Korea and Argentina.

- Korea's program provided substantial funding at the earliest stage of the program to counter an ongoing balance-of-payments crisis in late 1997 resulting from substantial losses in Korea's foreign currency reserves and the depreciation of the won, Korea's currency. The main goals for the program's monetary policy were to limit the depreciation of the won and contain inflation. Structural reforms were centered in the corporate, financial, and international sectors as well as in the labor market.

- In contrast, Argentina's 1998 program was designed as a precaution against a potential balance-of-payments problem that could result from external economic shocks; its program was concerned principally with maintaining fiscal discipline and enacting labor market and tax reforms that were intended to maintain investor confidence and strengthen the economy's competitiveness.

The IMF's process for monitoring a country's progress toward overall program goals and compliance with program conditions is designed to respond to an individual country's progress and situation. According to IMF staff, many IMF disbursements are conditioned only on the determination by IMF staff that the country has met prenegotiated quantitative criteria; other disbursements are subject to reviews by the IMF Executive Board. The process for conducting IMF Board reviews, which involves the borrower country and the IMF, is designed to incorporate data on a country's economic performance as well as the judgment of the IMF Executive Board and staff. IMF staff reviews a member's economic performance and implementation of policy changes that were negotiated as conditions of the financial assistance; then the staff formally reports to the IMF Executive Board at regularly scheduled intervals for each assistance program. In situations where conditions have not been met, the staff formally or informally advises the IMF Executive Board. The staff may recommend that the Executive Board grant a waiver for the nonobservance of the unmet conditions. If there is no waiver, additional financial assistance is not to be made available to the country. At that time, the program is effectively suspended until there is an agreement between IMF staff and the country that is approved by the IMF Executive Board. This agreement may mandate policy changes before any further assistance is granted and change the conditions for future assistance.

According to the information we reviewed, the monitoring of the IMF's conditionality program in the six countries in our study was generally consistent with this approach. IMF missions to each country reviewed the country's economy and documented the country's progress in satisfying conditions. In some cases, the IMF determined the countries had made sufficient progress in meeting program conditions so that additional funds could be made available. In other cases, however, the IMF determined that country progress in meeting the conditions had not been sufficient, and its response varied depending on the specifics of the condition and the judgment of the IMF staff and Executive Board on the country's overall progress. Some examples of this flexibility are the following:

- The IMF Executive Board granted Argentina, Uganda, and Russia waivers for nonobservance of specific conditions at various points during their programs. These waivers were based on the IMF's judgment that there was sufficient overall progress in implementing the program and that deviations from meeting required conditions were minor. Access to funding was not delayed in these cases.
- The IMF Executive Board delayed disbursements to Brazil, Indonesia, and Russia at various points during their current programs. In most of these cases, waivers were granted for nonobservance of particular conditions, and/or the country agreed to additional conditions as part of the IMF's decision to resume disbursements. For Brazil and Indonesia, the most recent delays lasted until the IMF determined that the country had made sufficient overall progress in meeting the program requirements; however, in Russia's case, the program was terminated at Russia's request in March 1999. In April 1999, IMF staff and Russian authorities announced they had reached agreement on an economic program that IMF management hoped

to be able to recommend to the IMF Executive Board in support of a new arrangement. As of June 16, 1999, the IMF Board had not approved the new arrangement.

The IMF and borrower countries may also negotiate changes in conditions to respond to unanticipated developments. For example, the IMF and Korea revised Korea's program several times during its first 2 months. The IMF acknowledged that the initial program was "overly optimistic" as economic conditions worsened; Korea continued to have access to financial assistance during these renegotiations.

Background

The International Monetary Fund, established in 1945, is a cooperative, intergovernmental, monetary and financial institution. As of April 1999, it had 182 members. The IMF's first purpose is the promotion of international monetary cooperation. Its Articles of Agreement (as amended), or charter, also provide that it may make its resources available to members experiencing balance-of-payments problems; this is to be done under "adequate safeguards." Making resources available to counter balance-of-payments problems is intended to shorten the duration and lessen the degree of these problems and avoid "measures destructive of national or international prosperity."

Member countries govern the IMF through the Executive Board—the IMF's primary decision-making body.[4] The IMF Executive Board comprises 24 Executive Directors who are appointed or elected by one or more IMF member countries. The U.S. Executive Director, for instance, represents the United States at the IMF. When a country joins the IMF and later when IMF members agree to increase the IMF's capital, the country pays a quota or a capital subscription to the organization. The quota serves several purposes: (1) the funds paid to the IMF contribute to the pool of funds that the IMF uses to lend to members facing financial problems and (2) the amount of quota paid determines the voting power of the member.[5] The IMF calculates the quota by assessing each member country's economic size and characteristics—economically larger countries pay relatively larger quota amounts. The United States pays the largest quota and thus

[4] The IMF's Board of Governors is the top policy-making body of the IMF and generally meets once a year. The members are usually ministers of finance, heads of central banks, or officials of comparable rank. The Executive Board is responsible for conducting the business of the IMF and exercises the powers delegated to it by the Board of Governors.

[5] The quota has also, traditionally, been the basis for determining how much the contributing member can borrow from the IMF under stand-by and extended arrangements–the more a country contributes, the more that it can borrow, other things being equal. For example, the guideline on access limits for stand-by or extended arrangements is 100 percent of each country's quota annually or 300 percent cumulatively, but these limits may be exceeded in "exceptional circumstances."

has the largest single share of voting rights. The IMF also has access to lines of credit provided by member countries under the General Arrangements to Borrow and, more recently, under the New Arrangements to Borrow.[6]

As part of the IMF's mission to promote economic and financial cooperation among its members, the IMF may provide financial assistance to countries facing actual or potential balance-of-payments difficulties that request such assistance. Balance-of-payments difficulties may have short-term, as well as longer-term aspects. The IMF's approach to alleviating a country's balance-of-payments difficulties is intended to address both aspects, as needed. As such, the IMF's approach has two main components—financing and conditionality—that are intended to address both the immediate crisis as well as the underlying factors that contributed to the difficulties. Although financing is designed to help alleviate the short-term balance-of-payments crisis by providing a country with needed reserves, it may also support the longer-term reform efforts by providing needed funding. Similarly, although conditionality, usually in the form of performance criteria and policy benchmarks, is intended to primarily address the underlying causes of the balance-of-payments difficulties over the medium term, it can also assist in alleviating the immediate balance-of-payments problems by, for example, reducing the country's aggregate demand, including imports.

The access to and disbursement of IMF financial assistance is conditioned upon the adoption and pursuit of economic and structural policy measures the IMF and recipient countries negotiate.[7] This IMF "conditionality" aims to alleviate the underlying economic difficulty that led to the country's balance-of-payments problem and ensure repayment to the IMF. As the reasons for and magnitude of countries' balance-of-payments problems have expanded (due, in part, to the growing importance of external financing and changes in the international monetary system since the

[6] The General Arrangements to Borrow are long-standing arrangements under which 11 industrial countries stand ready to lend to the IMF to finance purchases that aim at forestalling or coping with a situation that could impair the international monetary system. Under the New Arrangements to Borrow, which became effective in November 1998, 25 member countries or their financial institutions stand ready to lend to the IMF under circumstances similar to those covered by the General Arrangements to Borrow.

[7] As described in footnote 3, IMF financing is not generally in the form of a loan but is rather a purchase or repurchase of currency. As such, the IMF does not consider the establishment of a conditionality program to be a "negotiation." Rather, the member explains the economic reform program in the documents it prepares in the context of its request for financial assistance and the IMF Executive Board decides whether to support the program. The decision takes the form of the "arrangement," which notes certain aspects of the member's program that will be conditions for continued IMF financing under the arrangement.

1970s), conditionality has also expanded. According to IMF staff, conditionality has moved beyond the traditional focus of reducing aggregate demand, which was appropriate for relieving temporary balance-of-payments difficulties, typically in industrial economies. Structural policies—such as reducing the role of government in the economy and opening the economy to outside competition—that take longer to implement and are aimed at increasing the capacity for economic growth became an important part of conditionality. More recently, the financial crises in Mexico (1994-95) and in Asia and Russia (1997-99) have resulted in an increased focus on strengthening countries' financial sectors and the gradual opening of the economy to international capital flows.

The main instruments used by the IMF to provide financial assistance are

- Stand-by Arrangements (SBA), that provide short-term assistance for problems of a temporary nature;
- extended arrangements, under the Extended Fund Facility (EFF), that provide longer-term balance-of-payments assistance for problems arising from structural maladjustments; typically, when established, a program lists the general objectives for the first year; objectives for subsequent years are spelled out in program reviews;
- a Supplemental Reserve Facility (SRF), provided under an SBA or extended arrangement, that provides assistance for exceptional balance-of-payments problems owing to a large and short-term financing need resulting from a sudden and disruptive loss of market confidence reflected in pressure on the capital account and reserves; it is likely to be used when the magnitude of capital outflows may threaten the international monetary system; and
- an Enhanced Structural Adjustment Facility (ESAF), which is the principal means for providing financial support (highly concessional, or low-interest, loans) to low-income countries facing protracted balance-of-payments problems.[8]

The first three arrangements are funded through the IMF's general resources account (GRA). The ESAF is funded through separate

[8] These IMF financing instruments were used for the countries in our study. The IMF has other instruments, including the recently approved contingent credit line, that we do not discuss in this report.

resources.[9] A country may also draw on its "reserve tranche," that is, call on funds that initially represented about one-quarter of its quota.[10] Except for the highly concessional ESAF loans, the country pays market-based interest rates on money it receives.[11] The SRF is a new facility that charges a higher amount for its use than other IMF instruments. According to the IMF, for a member country to use this facility, there should be a reasonable expectation that the implementation of strong adjustment policies and adequate financing will result in the early correction of its difficulties.

IMF financial assistance may be a part of a larger package of financial assistance committed to countries in crisis. Brazil, for example, received commitments for a package that included about $18 billion to be provided by the IMF and approximately $4.5 billion each from the World Bank and the Inter-American Development Bank–primarily to provide improved social safety nets and banking reform. Additional bilateral sources agreed to provide $14.5 billion in financing, primarily to guarantee credits extended to Brazil from the Bank for International Settlements. The resulting package for Brazil amounted to more than $41 billion in commitments.

An IMF program can also serve as a catalyst for debt relief from other creditors. For example, to qualify for debt relief from the Paris Club of creditor governments,[12] countries must reach agreement with the IMF on a reform program. The Paris Club conditions its debt relief on countries'

[9] Under the IMF's Articles of Agreement, as amended, financing under the GRA is not in the form of loans, as noted in footnote 3. Financing from the ESAF is in the form of loans and is governed by the ESAF Trust Instrument adopted under Article V, Section 2(b). The ESAF Trust's primary source of financing is lending from contributor countries.

[10] A member's reserve tranche position is equal to the difference between a member's quota and the IMF's holdings of its currency. This amount was initially equal to one-quarter of its quota subscription. The position changes as the IMF uses its holdings of the member's currency in its financing activities. A reserve tranche position is part of a member's external reserves, upon which the member can draw any time without being required to take specific policy actions.

[11] The interest rate charged by the IMF is not necessarily what the borrowing country would have to pay on the open market. Rather, it is determined by reference to a combined market interest rate, which is a weighted average of yields or rates of short-term instruments in the capital markets of the members whose currencies comprise the special drawing right (SDR). The special drawing right is a reserve asset created by the IMF and a unit of account that the IMF uses to denominate all its transactions. Its value comprises a weighted average of the values of the euro (representing the currencies of France and Germany), Japanese yen, pound sterling, and U.S. dollar. The rate of charge is set in relation to the IMF's cost of financing and includes an amount to cover the IMF's administrative expenses, the financial consequences of charges that members have not yet paid, and an addition to the IMF's precautionary balances.

[12] The Paris Club is an informal group of creditor countries that meets, on an as-needed basis, to negotiate debt relief efforts on official debt.

implementation of economic and structural reforms under IMF-supported financing programs. Part of the motivation for Russia's IMF arrangement in 1996 was to facilitate its debt rescheduling from the Paris Club.

The IMF's Process for Establishing Programs Incorporates Country-specific Data and Analysis as Well as IMF Judgment

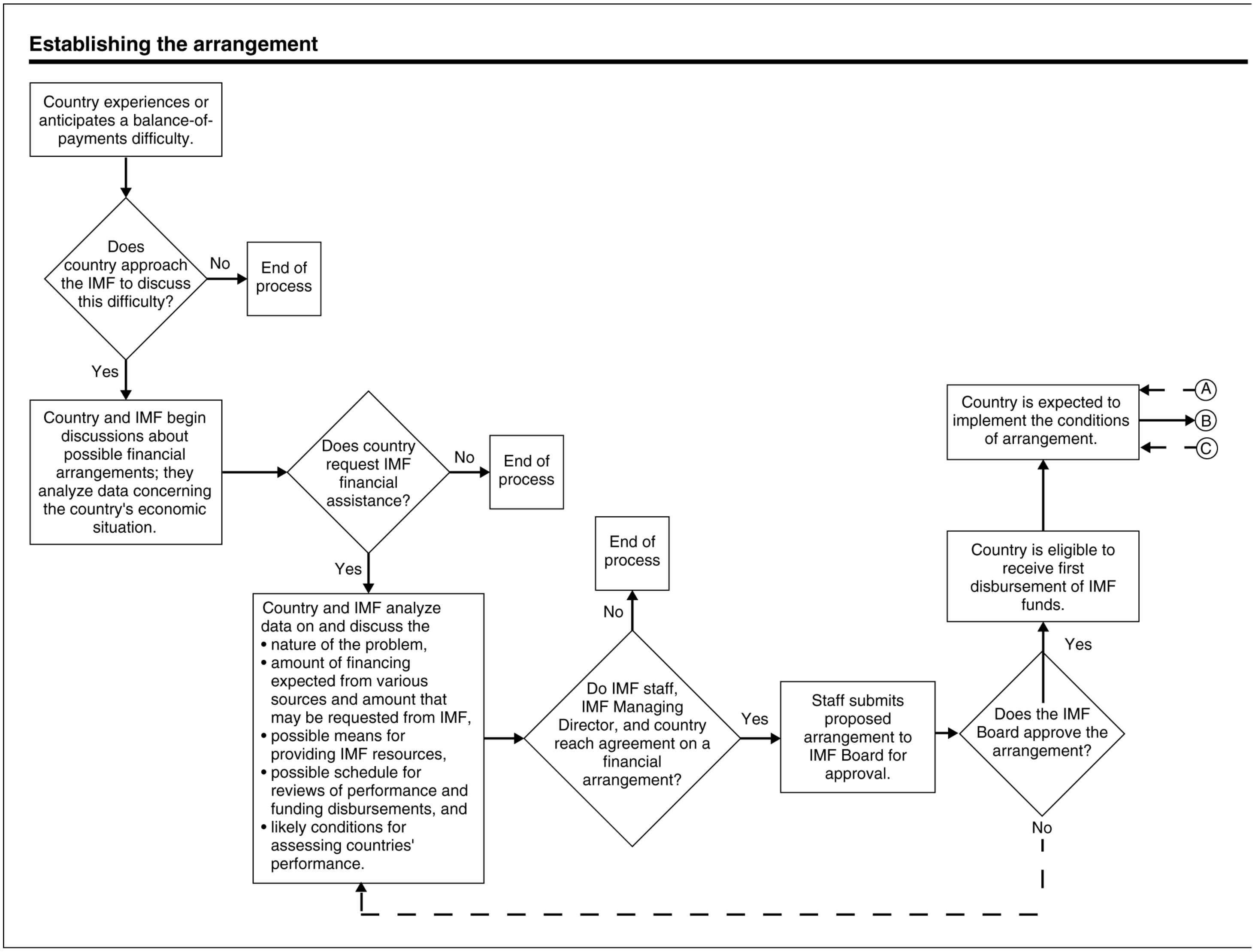
The IMF's general framework for establishing a financial assistance arrangement is intended to be applied on a case-by-case basis that considers each country's individual circumstances. This process gives the IMF considerable latitude in establishing the balance-of-payments need, the amount and timing of resource disbursements, and the conditions for disbursements. Under its Articles of Agreement, as amended, the IMF limits financial assistance to those countries with a balance-of-payments need. However, the Articles do not precisely define "need," and, according to IMF documents, the IMF's Executive Board has been reluctant to establish guidelines that would add greater specificity to the charter's general criteria. The specific conditions that the IMF and the country authorities negotiate are intended to address the underlying problems that contributed to the country's balance-of-payments difficulty, while ensuring repayment to the IMF. These conditions include a variety of changes in a country's fiscal, monetary, or structural policies. After the country completes any "prior actions"[13] and the IMF Executive Board approves the financial arrangement, the program is to take effect and the country is eligible to receive its first disbursement of funds. We found that the IMF generally followed this process for the six countries we reviewed.

The IMF's Process for Establishing Financial Arrangements With Member Countries

The formal process the IMF generally uses to establish countries' financial arrangements is outlined in figure 1. IMF staff, the IMF Executive Board members, and country authorities may also consult informally at any stage throughout this process.

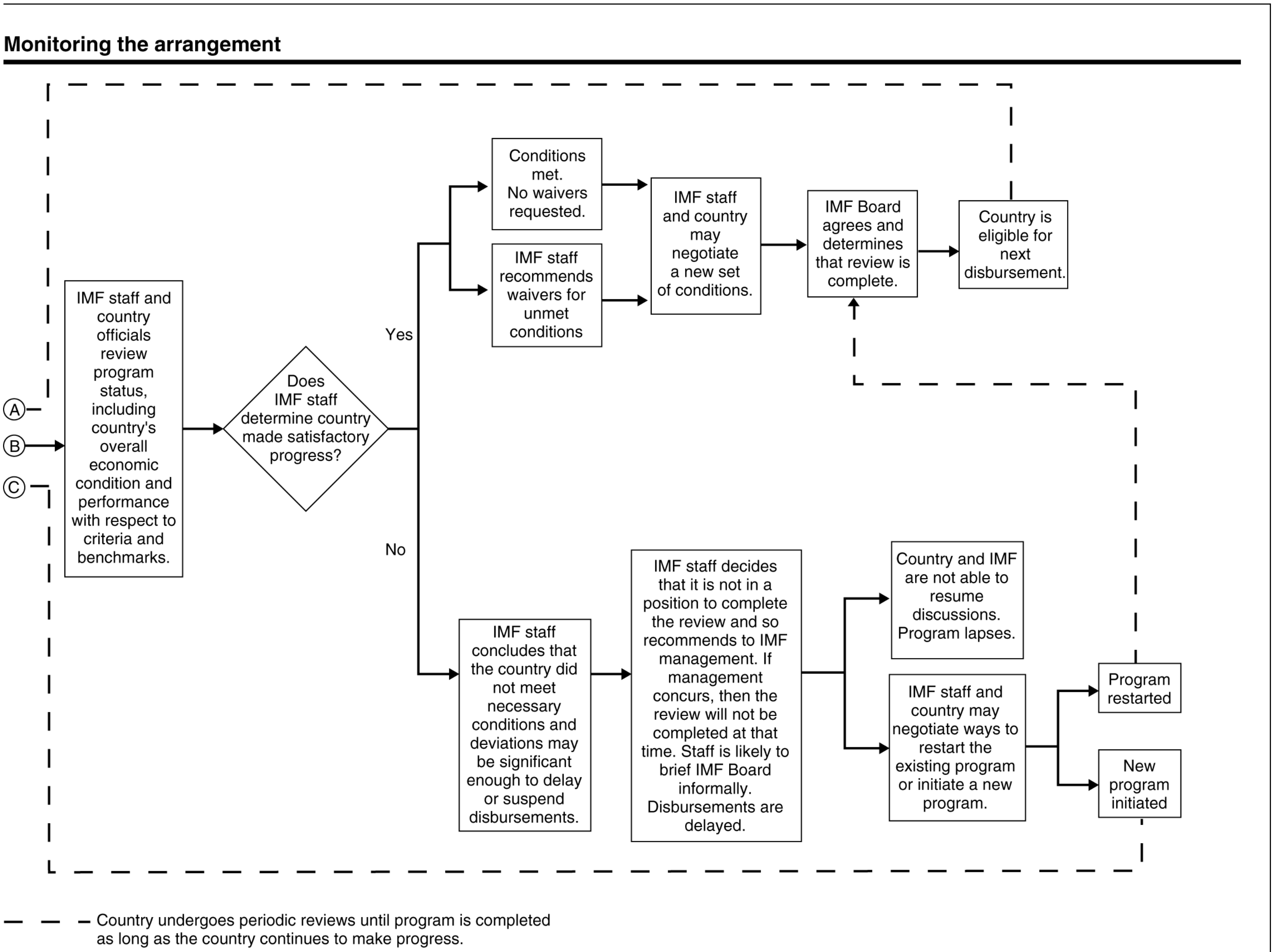
[13] Prior actions—policy measures that the IMF views as key to the effectiveness of a country's program—may have to be implemented before the IMF Board approves an IMF arrangement or disbursement. Such actions are particularly important if severe imbalances exist or in cases where the record of policy implementation has been weak.

Figure 1: The Formal Process Generally Used to Establish and Monitor an IMF Financial Arrangement



Note: This figure summarizes the process the IMF generally uses to establish financial arrangements with member countries. In the case of monitoring, this flowchart focuses on disbursements that require review by the IMF Executive Board. Countries may receive IMF funding disbursements without IMF Executive Board action, if they meet quarterly performance criteria in between scheduled IMF Executive Board reviews.

Source: GAO analysis of IMF documents.



Establishment of an IMF financial arrangement begins with discussions between IMF staff and country officials and continues through the IMF

Executive Board's approval of the arrangement. If a member country determines that it is experiencing or could experience a balance-of-payments problem, it can initiate discussions with IMF staff that may lead it to request IMF financial assistance. These discussions can occur at any time, including during the country's annual consultation with the IMF or through informal consultations requested by the member. At these consultations, IMF staff and country authorities discuss economic data and policies as well as the

- nature of the country's balance-of-payments difficulty,
- amount of financing expected to be provided by various sources and the amount that may be requested from the IMF,
- instruments under which the IMF resources could be provided,
- potential schedule for reviewing countries' performance and disbursing funds, and
- likely conditions for assessing countries' performance under the program.

IMF staff noted that key tasks during country missions to conduct the negotiations are (1) the collection of extensive data describing the country's economic conditions and (2) an analysis of those data to recommend the amount and timing of the IMF financial assistance and conditionality. The IMF's review of a country's economy is an iterative process that is often based on country-provided data, projections of key macroeconomic variables, and judgment by the IMF staff and country officials.

The design of an IMF program is complicated, and negotiations between IMF staff and country authorities can be difficult for several reasons. First, the countries are facing an adverse or uncertain economic situation. Second, the negotiators may disagree on the type, pace, or feasibility of the reforms needed to help overcome the difficulty. In some cases, needed reforms reflect long-standing problems and are difficult to undertake due to political constraints. For example, reforms may entail changes to labor practices opposed by unions or removal of tax preferences benefiting certain sectors. Third, conditionality and financing are based, in part, on projections of key variables such as estimated growth rates and access to external financing. Fourth, in some cases, the country may lack reliable data for analyzing the current situation or making projections.

IMF staff and country authorities may or may not reach agreement on a package of financing and conditionality. If they do not reach agreement, then the member may seek other means for addressing its difficulty. If they reach agreement, the arrangement is presented to the IMF Executive Board for approval. IMF staff generally brings to the IMF Board only arrangements it believes the IMF Board will accept. After the country satisfies any required "prior actions" and the IMF Executive Board approves the arrangement, the arrangement will take effect and the country can get funds from the IMF.

The IMF Has a Broad Framework for Assessing Countries' Balance of Payments

Under the IMF's Articles of Agreement, as amended, the IMF considers any of the following three elements to be a basis for providing financial assistance[14] from the GRA:

- the country's balance of payments,
- the country's reserve position, and
- developments in its reserves.

However, the Articles do not precisely define the elements or provide criteria for assessing need. While the IMF Executive Board has not established guidelines that would add greater specificity to the Articles' general criteria, over time the IMF has developed a broad framework that serves as a basis for analyzing a country's economy and forming judgments regarding the existence and magnitude of balance-of-payments deficits and the adequacy of international reserves.

The first element—the country's balance of payments—represents the economy's external financing requirement and equals the sum of a member's current and capital account balances. The current account primarily includes exports and imports in goods and services; transfers; and income payments, such as interest payments. The capital account provides summary data on the changes in the net foreign assets of domestic residents arising from transactions such as external borrowing or repayments, foreign direct investment, portfolio investment (equity and

[14] For a country to access funds through the GRA, its balance-of-payments need can be ongoing at the time IMF financial assistance is sought, or a precautionary program can be negotiated prior to the actual emergence of a balance-of-payments need. A country does not have to demonstrate a balance-of-payments need at the time it requests an IMF arrangement, but it is expected to demonstrate need before receiving a financial disbursement.

bonds), and short-term capital movements.[15] The second element—the country's reserve position—refers to the amount of resources (hard currency, reserve position in the IMF, special drawing rights, and monetary gold) that can be used to pay for imports and make payments on external debt. IMF documents indicate that the third element—developments in the reserve position—has a very narrow application. This element is intended to ensure that members of the IMF whose currency is a reserve currency (such as the United States) would be able to use IMF resources when requested, despite the absence of a need as outlined in the first two elements.[16]

The IMF's framework has enabled it to consider countries' individual circumstances and changes in the international monetary system. These include increased capital flows between countries and changes in the composition and source of those flows as well as the shift in the primary recipients of IMF financial assistance from industrialized countries to developing countries.[17] Given such considerations, decisions about a country's need for IMF resources have become more difficult. According to IMF documents, determining need based solely on the overall balance-of-payments position is relatively clear-cut because the balance is either in surplus or deficit. Assessing need based on whether a country's foreign reserves are sufficient requires a greater degree of judgment because no precise criteria define the appropriate level of reserves. In determining the sufficiency of a country's reserves, the IMF can adjust the definition of "sufficient" reserves to account for such country-specific factors as the volume and variability of exports and imports, the size and variability of capital flows, the amount of short-term liabilities, and the nature of the country's exchange rate regime.[18] Significant declines in the foreign reserve

[15] In the IMF's monthly publication *International Financial Statistics*, changes in a country's reserves are not included in the capital account.

[16] This element is designed to cover situations in which a country may not have a balance-of-payments deficit or a weak reserve position but may still have a need because of a development in its reserves. For example, the IMF Board was concerned that the first two concepts would preclude members of the European Economic Community (the predecessor to the European Union) from requesting IMF assistance in discharging obligations among each other. By virtue of their currency being a reserve asset, the use of their currency in foreign transactions would not result in a balance-of-payments deficit or weak reserve position by such countries, although difficulties in the external environment may still require some support.

[17] As late as 1977, developed countries accounted for about 50 percent of credit outstanding from the GRA. Since 1988, developed countries have had no outstanding credit from the GRA.

[18] In principle, a country with a fixed exchange rate could be expected to need a higher level of reserves to assist in defending the rate than a country that allowed its currency to float. However, in practice, such distinctions are difficult to make. Most IMF members have adopted some type of floating exchange rate regime, with the degree to which the currency is allowed to float depending on domestic

position may be of concern if they indicate that a country may have difficulty financing its imports or repaying its external debt in the future.

IMF documents indicate that the Executive Board has been reluctant to establish guidelines that would add greater specificity to the general criteria for balance-of-payments need set forth in the Articles of Agreement, as amended. Members of the IMF Board have been concerned that "codification" of the concept of need would create unnecessary inflexibility. For this reason, they urged that the concept of need should continue to be applied on a case-by-case basis. As a result, application of this concept involves considerable data analysis as well as judgment.

The IMF uses somewhat different criteria for low-income countries requesting resources under the ESAF. In contrast to the criteria for demonstrating a need for GRA resources, when assessing whether a member that meets income and other criteria for ESAF eligibility has a protracted balance-of-payments problem, emphasis is to be placed on the components of its balance of payments rather than solely on its overall balance-of-payments position. According to IMF staff, the underlying balance-of-payments problems of many low-income countries did not necessarily result in conditions similar to those reflecting the GRA criteria; that is, an actual balance-of-payments deficit or low reserves. For this reason, emphasis would have to be placed on those indicators that would normally evidence "poor external performance." Such indicators include a deterioration in the terms of trade and diminished access to capital markets. Moreover, protracted balance-of-payments problems would often be reflected by exchange rate restrictions, payments arrears, or prolonged use of IMF resources.[19] As with the GRA criteria, the IMF Executive Board agreed to continue to use flexibility in applying the ESAF criteria. Some Board members have expressed the opinion that a low-income country, by definition, has a protracted balance-of-payments problem.

Once a balance-of-payments need is established under the GRA or ESAF, the country may be eligible to receive IMF financing. IMF staff and country authorities will estimate the total amount of financing the country requires as well as the amounts that may be provided by the IMF and other sources. The IMF's share is based on several factors, including the member's

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and external developments. For example, owing to a rundown in its reserves, a country may allow its currency to float more freely until adjustment policies take effect and reserves are rebuilt.

[19] In addition, for an ESAF arrangement to be approved, a country generally must have a protracted balance-of-payments problem. However, the country is not required to have a present need when it actually requests a disbursement.

resource needs, IMF quota, outstanding IMF resources, and previous performance in using IMF financing; the strength of its adjustment program; and its capacity to repay the IMF. While the IMF has discretion in deciding the total amount of resources it will provide to a country, disbursements are to be limited to the amount needed by the country. If the IMF later discovers that a country drew IMF funds without a need for those funds (that is, the information on which the financing need was determined was later found to be incorrect), it can undertake remedial action.

The IMF Executive Board encourages countries to request its assistance early and to undertake corrective actions early in order to minimize the potential costs and disruption of correcting the underlying causes of a balance-of-payments problem. However, a number of factors—including the belief that the problem is temporary or can be solved without official assistance, or the concern that political and social problems may arise from needed structural changes—can cause some countries to hesitate in asking for IMF assistance. For example, Korea did not draw on IMF resources until its reserves had fallen substantially.

IMF Conditionality Focuses on Fiscal, Monetary, and Structural Reforms

Once the IMF staff has determined the balance-of-payments needs of a member and its eligibility to draw resources, the IMF must be satisfied that the member can meet its repayment obligations to the IMF and that the policy measures agreed to are sufficient to overcome the member's balance-of-payments problem. The IMF does this, in part, through conditionality. Fundamental weaknesses in the underlying economy, such as a large budget deficit and/or high inflation, or in the structure of the financial or corporate sectors, may contribute to the balance-of-payments problem of a country. Conditionality may vary with each country's individual program as it seeks to address these weaknesses. As such, according to the IMF, there is no "rigid and inflexible" set of operational rules in the establishment of a country's conditionality program. The process is one of negotiation between the country authorities and the IMF to reach agreement on a number of issues, ranging from economic assumptions to the speed and magnitude of structural reforms.

The IMF arrangement often occurs within the context of the country's larger reform efforts. As a result, not all of a country's policies or reform efforts may be included as conditions of the IMF arrangement. For example, some structural reforms and trade liberalization measures may be mentioned in the arrangement reached between the IMF and the country authorities, but only the actions the IMF judges to be particularly important for achieving program objectives will become performance criteria and benchmarks within the arrangement. IMF officials noted that achieving performance criteria is not the ultimate goal of conditionality; rather, the performance criteria are selected as clearly observable and measurable indicators that a country is making progress toward the overall program goals, such as strengthening the balance of payments and reducing inflation. The IMF uses two types of performance criteria that generally must be met for members to qualify for disbursements. The first are quantitative performance criteria, or macroeconomic indicators, such as monetary and budgetary targets. The second are structural performance criteria, or quantifiable/observable actions that demonstrate progress toward the borrower country's structural reform goals. Benchmarks are points of reference against which progress may be monitored but disbursements are generally not dependent on meeting them. Benchmarks are not necessarily quantitative and frequently relate to structural variables and policies, such as tax reform and privatizing state-owned enterprises.

IMF conditionality tends to focus on three areas: fiscal, monetary, and structural. These three areas are designed to support a general framework that aims to strengthen the balance-of-payments position, achieve market-based growth, and decrease the role of the government in a country's economy. Borrower country IMF arrangements generally consist of a combination of efforts in these three areas, which depend on the country's particular circumstances.

According to the IMF, poor fiscal management in a member's economy generally has been a major factor underlying such problems as high inflation, large current account deficits, and sluggish growth. Large and persistent budget deficits may tend to overheat the economy, contributing to high inflation (especially when financed by the printing of money), excess imports, and low domestic savings. IMF staff and the member country negotiate ways to address this fiscal deficit, including instituting reductions in government spending and increases in tax revenues. Numerical targets for the fiscal level consistent with these reforms are often part of a country's quantitative performance criteria.

Similarly, IMF staff and the member country will negotiate monetary policy changes as part of the conditionality package. The underlying goals of these conditions are typically strengthening the balance-of-payments position, safeguarding or rebuilding international reserves, restoring market confidence, reducing sizeable exchange rate changes, restraining growth in domestic credit, and/or reducing inflation. For example, limits may be imposed on the increase in short-term debt owed or guaranteed by the government; this may be done in an effort to restrict the ability of a government to use short-term external financing to meet reserve targets or finance fiscal deficits. Another performance criterion that is frequently used is a limit on the net domestic assets of the central bank. By limiting the resources made available by the central bank to the economy, the growth of the money supply is slowed and inflation is lessened. Frequently, the country and the IMF reach agreement on the minimum level of foreign reserves that the country may hold; such a requirement reduces the country's ability to manage its exchange rate through interventions in the foreign currency market. The performance criterion on international reserves is a key indicator of progress toward external viability.

According to IMF staff, the presence of pervasive structural problems in a member's economy and the need to ensure the sustainability of a country's reform effort require that structural policy changes be included within the overall conditionality negotiated. These structural problems encompass a broad array of issues, including inefficient state enterprises, trade restrictions, and lack of transparency in the financial and corporate sectors. Reforms in these areas are included as part of a country's structural benchmarks, which the country is strongly encouraged to satisfy, although the benchmarks do not have the same significance as the performance criteria. However, in certain instances, structural changes may be established in a precise quantitative manner and made part of a country's structural performance criteria.

Once the financial arrangement has been negotiated, it is presented to the IMF Executive Board for approval. The IMF Board generally accepts the recommendations of the staff, largely because the staff brings to the IMF Board only proposals that the staff believes the Board will accept. The decision to approve an arrangement depends on a judgment by the IMF staff, management, and Executive Board that the program is sufficient to overcome the country's balance-of-payments difficulty and the country will be able to repay the IMF. After the country completes any prior actions and the IMF Executive Board then approves the arrangement, the arrangement will take effect and the country becomes eligible for its first disbursement of IMF funds. The country is then expected to implement the policy measures agreed to under the arrangement.

(See app. I for more information on the IMF's process for establishing financial arrangements.)

The IMF Generally Followed its Process in Establishing the Six Arrangements

According to the IMF documents we reviewed, the IMF generally followed the process described previously in establishing the financial assistance arrangements with each of the six countries that we reviewed. In each case, the balance-of-payments problem was described and the conditionality program was intended to address the underlying problems of the individual countries as defined by IMF staff and country authorities. Our analysis showed that, to varying degrees, the balance-of-payments problems of the six countries we studied stemmed from concerns regarding the access of the countries' public and private sectors to external financing. In addition, the reform programs of each country generally addressed the areas of concern identified by country and IMF officials as contributing to the balance-of-payments problems. Moreover, the type of financial arrangement each country received, the time period of the arrangement, and the total amount of financing the IMF agreed to provide were based on the IMF's analysis of the needs and circumstances of the individual countries. In determining the potential amount of IMF assistance, the IMF also considered the country's outstanding IMF resources in relation to its quota. Table 1 outlines the current IMF financial arrangements for the six borrower countries.

Table 1: Current Financial Arrangements Agreed to by the IMF and Six Borrower Countries

Country	Type of arrangement	Date of arrangement	Expiration of arrangement	Total amount agreed ($ in millions)[a]	Total amount disbursed (as of April 30, 1999) ($ in millions)
Argentina	EFF	Feb. 4, 1998	Feb. 3, 2001	$ 2,822	0
Brazil	SBA/SRF	Dec. 2, 1998	Dec. 1, 2001	17,668	$ 9,570
Indonesia[b]	SBA/EFF	Nov. 5, 1997	Nov. 5, 2000	12,267	9,215
Korea	SBA/SRF	Dec. 4, 1997	Dec. 3, 2000	21,026	19,305
Russia[c]	EFF/SRF	Mar. 26, 1996	Mar. 25, 1999	17,915	10,486
Uganda	ESAF	Nov. 10, 1997	Nov. 9, 2000	136	76

[a] The amounts were initially calculated in SDRs. Because the value of the SDR relative to the U.S. dollar changes daily, the dollar value of amounts converted from SDRs also changes daily. For this table, we used the 1998 average SDR conversion rate of $1.3565.

[b] The information presented includes the 3-year SBA agreed to in November 1997 and the EFF agreed to in August 1998. The SBA was terminated and replaced with the EFF.

[c] Russia terminated this arrangement with the IMF in March 1999. In April 1999, IMF staff and Russian authorities announced they had reached agreement on an economic program that IMF management hoped to be able to recommend to the IMF Executive Board in support of a new arrangement. As of June 16, 1999, the IMF Board had not approved the new arrangement. The total amounts listed include funding under the Compensatory and Contingency Financing Facility (about $2.8 billion) and increased EFF funding (through the SRF) agreed to by Russia and the IMF in July 1998.

Source: IMF documents.

(These arrangements are described in greater detail for each country in apps. II to VII.)

According to our analysis, the balance-of-payments problems of the six countries we studied were due to concerns about the countries' continued ability to obtain external financing. In the cases of Korea, Indonesia, and Brazil, concerns over severely diminished reserves and continued access to external financing were clearly identified as important factors in the initial set of documents that recommended the establishment of an IMF financial arrangement in these countries. In the cases of Argentina, Russia, and Uganda, concerns over continued access to external financing were not as clearly defined but were embedded within a larger set of reasons for IMF assistance, including continued support for the countries' economic reform programs. Nonetheless, the information provided by IMF staff and country authorities was sufficient to determine that a potential balance-of-payments problem existed in each of these three countries.

Our analysis also indicated that the individual IMF programs were geared toward the specific IMF assessment of the needs of the six countries, as shown in table 2.

Table 2: Basis for and Key Initial Conditions in Current IMF Financial Arrangements With Six Countries

Country	Reasons IMF assistance requested	Balance-of-payments problem	Underlying causes of the problem
Argentina	- Precautionary program to support reforms and maintain market confidence	- Widening current account deficit and its potential financing	- Strong import demand coupled with recent weaknesses in the export sector - Uncertain investor confidence given international environment
Brazil	- Loss of foreign investor confidence - Protect the exchange rate regime	- Declines in current account - Foreign reserves declined sharply	- Large and growing government budget deficits - Substantial short-term private sector debt in need of refinancing
Indonesia	- Sudden currency depreciation - Loss of financial market confidence	- Substantial fall in the capital account resulting in a sharp decline in reserves	- Weaknesses in financial sector - Structural impediments in economy, such as import monopolies - Substantial short-term private sector debt in need of refinancing
Korea	- Usable foreign reserves declined sharply - Sharp currency depreciation - Substantial short-term private sector debt - External financial conditions deteriorated	- Capital flight - Sharp drop in reserves	- Weaknesses in corporate and financial sectors - Market confidence turned overwhelmingly negative - Foreign exchange reserves declined as central bank provided support to prevent domestic banks from defaulting on foreign debt
Russia	- Federal budget deficit - Inflation - Need to transition to a market-based economy and to build required institutions and legal framework - Need for comprehensive debt restructuring	- Current account is expected to weaken over next several years - Need to achieve medium-term balance-of-payments viability - Stabilize ruble exchange rate	- Inability to collect tax revenues - Excessive government spending - Culture of nonpayment of taxes - Weak banking system - Lack of an institutional and legal framework to support market economy - Bunching of debt obligations anticipated - Inadequate level of reserves - Net capital outflows
Uganda	- Maintain macroeconomic stability - Support structural and institutional reforms - Support economic liberalization	- Projected current account deficits - Uncertain financing from official creditors	- Fragile external position - Vulnerability to external shocks - Uncertainty over revenue measures - Substantial expenditure pressures - Deterioration in terms of trade

Country	Overall key goals	Fiscal performance criteria	Monetary performance criteria	Key structural reforms
Argentina	- Maintain investor confidence - Complete structural reforms - Promote sustained growth in production and employment - Reduce the vulnerability of the economy	- Limit government deficit, debt, and expenditures	- Decrease net domestic assets of central bank	Benchmarks: - Tax reform - Labor market reforms - Privatization - Government administration
Brazil	- Quickly arrest the rapid growth of public sector debt - Maintain existing exchange rate regime - Safeguard international reserves	- Limit public sector debt	- Limit net domestic assets of central bank	Benchmarks: - Pension and tax reforms - Improvements in the budgetary process - Administrative reform - Reduction in the number of state-owned banks
Indonesia	- Restore market confidence - Reverse decline in external financing - Correct underlying weaknesses in the financial sector and remove structural impediments in the economy	- Limit short-term government borrowing and new publicly guaranteed debt - Limit on overall Central Bank balance	- Limit net domestic assets of central bank and stock of base money - Set minimum level of net international reserves	Performance criteria: - Financial sector restructuring - Trade liberalization and domestic deregulation - Privatization Benchmarks: - Corporate, financial, regulatory, and government reforms
Korea	- Restore investor confidence - Build international reserves - Set the stage for resuming and sustaining growth - Contain inflation	None	- Limit net domestic assets of central bank - Set minimum level of net international reserves - Set minimum charge on foreign exchange given to Korean commercial banks or their overseas branches	Benchmarks: - Financial sector restructuring - Corporate governance reform - Capital account liberalization - Increased transparency
Russia	- Achieve financial stabilization while transitioning to a market-based economy - Lay basis for sustained growth	- Limit government budget deficit - Increase government cash revenues	- Limit net domestic assets of monetary authority - Set minimum level of net international reserves of monetary authority - Limit credit to the government	Benchmarks: - Tax administration - Banking system - Privatization - Natural monopolies - Social safety net - Budget system and process
Uganda	- Promote broad-based economic growth - Liberalize and diversify economy - Promote good governance - Promote structural reforms	- Limit claims of the banking system on the government - Limit short-term government debt and nonconcessional government debt - Set minimum spending on social areas	- Limit net domestic assets of banking system and short-term debt of the central bank - Set minimum level of net international reserves	Prior action: - Remove 3 import bans Performance criterion: - Increase taxpayer audits Benchmarks: - Privatization of public sector enterprises - Bank inspections - Government restructuring - Taxpayer audits

Source: GAO analysis of IMF and borrower country documents outlining initial arrangements.

The purpose of the programs was to address the immediate or potential balance-of-payments problem of each country as well as the underlying factors that IMF staff and country officials identified as contributing to that problem. The fiscal, monetary, and structural objectives of all six countries' arrangements had the goal of helping to improve the medium-term economic growth and/or bolster investor confidence in order to continue to finance or reduce the balance-of-payments deficit or to build reserves. However, within the context of these general goals, the magnitudes and definitions of the performance criteria and the specifics of structural reforms differed across the countries.

The financing of each package addressed the balance-of-payments problem of each country. In the cases of the three countries with significant losses in their reserves (Brazil, Indonesia, and Korea), the amount of the IMF financing was substantial and frontloaded, meaning that the countries were to receive much of the funding early, with the intent of providing a signal to market participants that the commitment to these countries was strong. In the three remaining countries, IMF financing was designed to be more evenly distributed throughout the duration of the program. The financing for Russia and Uganda was to be provided in relatively equal installments over the life of the program to assist in addressing the reforms agreed to under the program. Argentina's financing was viewed as a precautionary line of credit, available only if necessary.

Korea and Argentina exemplify the differences that can exist between countries' financial arrangements with the IMF. The IMF's approach to the financial crisis in Korea was intended to address the country's immediate need for financing as well as the underlying causes identified by IMF staff and country authorities as contributing to the balance-of-payments difficulties. The IMF arrangement in Korea was heavily frontloaded, with the country receiving much of the agreed-to financing at the beginning of the arrangement, in order to address the country's immediate need to replenish depleted reserves. The country faced balance-of-payments problems primarily due to significant capital outflows. Korean banks had a large amount of foreign debt, composed substantially of short-term external loans that needed frequent refinancing. As market confidence fell, the willingness of external creditors to roll over (that is, refinance) the debt declined rapidly. The attempt by the government to support the former exchange rate rapidly depleted the foreign reserves by providing creditors with the hard currency that they ultimately withdrew as short-term debt matured. As reserves reached precariously low levels, Korea abandoned its attempt to support the exchange rate, moved to a flexible rate, and sought IMF support.

The conditions outlined in the IMF arrangement were intended to address immediate concerns as well as the underlying causes of the balance-of-payments difficulties as determined by IMF staff and Korean authorities. The immediate causes were a loss of market confidence, depleted foreign reserves, and a rapidly depreciating currency. The arrangement's immediate goal was to restore calm in the markets and contain the inflationary impact of the currency's depreciation by providing substantial financing and requiring a tightening of monetary policy. In terms of longer-term changes, IMF staff and Korean authorities identified weaknesses in the corporate and financial sectors as underlying causes for the difficulties. Specifically, increases in corporate bankruptcies (caused by large debt burdens and excess capacity) and nonperforming (unpaid) loans exacerbated weaknesses in the banking system. Weaknesses in the banking systems included a focus on maximizing revenues (not profits) and limited experience in managing risk, combined with lax prudential supervision. As a result, under Korea's IMF arrangement, compared to other countries' arrangements, greater emphasis was placed on structural reforms—particularly corporate and financial restructuring.

Unlike Korea's IMF arrangement, Argentina's arrangement addresses a potential, rather than existing, balance-of-payments problem. Although Argentina enjoyed good access to capital markets and employed a strategy to lengthen the maturity of its debt and borrow when interest rates were low, it faced an uncertain future due to deteriorating conditions in the international financial environment and the effect this likely would have on its future access to capital markets. To address this potential problem, Argentina and the IMF reached agreement on a precautionary program, with Argentina agreeing to access IMF resources only if external conditions made it necessary.[20]

The government and the IMF identified fiscal discipline and structural reforms (particularly in tax systems and labor markets) as two of the most crucial elements of Argentina's program. In Argentina, the goal of maintaining fiscal discipline is to reduce the federal government deficit, stimulate domestic saving, and strengthen confidence in the continued viability of the convertibility regime, under which Argentine pesos are exchanged at a 1-to-1 rate with U.S. dollars. Reducing the amount of the government's deficit lowers the amount of funds the government needs to

[20] As of May 31, 1999, Argentina had not drawn funds under the current arrangement.

borrow from domestic and external creditors, therefore freeing up resources for other uses and decreasing the government's dependence on external borrowing. Argentina's government is limited in its ability to print money (pesos) to finance its deficit because under its currency board arrangement, the government has agreed to exchange each Argentine peso circulating in the economy with a U.S. dollar if requested.[21] Consistent with this, the quantitative performance criteria agreed to under the IMF arrangement emphasize fiscal issues and are intended to limit the federal government's budget deficit and government debt levels. Monetary issues are not emphasized as strongly due to the government's limited power to affect the money supply and interest rates. Structural reforms aimed at, for example, decreasing the costs of labor and lowering taxes on production are aimed at making the economy more competitive, with the goal of reducing the trade deficit and thus the current account deficit.

The IMF's Process for Monitoring Conditionality Is Intended to Respond to Individual Borrower Country Progress in Implementing Its Program

The IMF's process for monitoring conditionality is intended to respond to individual country progress in meeting required conditions. After the IMF Executive Board approves the arrangement, the country is expected to implement the conditions. The programs are subject to periodic reviews, at which time decisions are made on future fund disbursements. In cases where the IMF determines the country has made sufficient progress in meeting the program's conditions, the next disbursement will be made available. The IMF Executive Board may grant waivers for nonobservance of conditions and approve access to funds for countries that do not meet all required conditions if, according to the IMF, it concludes that the deviation was minor and the country had made sufficient progress in implementing the program. However, if the IMF staff concludes that a country has not made sufficient progress in implementing policies and meeting conditions it considered essential, it may recommend that disbursements be delayed or funds withheld. In these cases, the IMF Board is generally not asked to make a negative decision; rather, the review is not completed and it is not formally brought before the Board for a decision at that time. IMF staff and Executive Directors told us that these cases are

[21] A currency board has governed Argentina's monetary policy since 1991. Under the currency board arrangement, the central bank maintains a sufficient level of U.S. currency in international reserves to guarantee the convertibility of all outstanding Argentine pesos at the official exchange rate (1 peso equals 1 dollar), known as the "convertibility regime." While this arrangement provides comfort to foreign investors that their investments are protected from fluctuations in the exchange rate, the currency board significantly reduces the discretion of central bank authorities to influence Argentina's money supply. Argentina's money supply rises and falls with the level of international reserves. For example, the domestic money supply will contract if investors choose to convert their pesos into U.S. dollars following a loss of confidence. Also, a balance-of-payments deficit that reduced reserves would contract the money supply, raise interest rates, and reduce aggregate demand, including that for imports. This self-correcting adjustment process can increase unemployment in response to such factors as reduced investor confidence in world markets.

discussed with the Executive Board informally and in “country matter” sessions.

The IMF’s process for monitoring the conditions included in support programs allows for program modifications, depending on a country’s individual circumstances. Modifications are usually summarized in updated program documents. The programs in each of the countries we reviewed were modified, in some cases frequently, for a variety of reasons. In some instances, modifications were made because of the effect unforeseen internal or external factors had had on the country’s ability to meet the conditions in the program. In other instances, the IMF determined the initial conditions were not feasible or realistic.

The IMF’s Monitoring of a Borrower Country’s Program Is a Process That Involves IMF Staff, Country Officials, and the IMF Executive Board

As illustrated in figure 1, once the IMF Executive Board has approved a program, the country is expected to implement its conditions. IMF staff monitors the program continually, and the program is subject to periodic reviews by the IMF Executive Board in order to evaluate if the country’s progress in meeting the conditions under the program justifies the continuation of disbursements. In some cases, disbursements depend only on a determination by the IMF staff that the country has met prenegotiated criteria. As such, according to IMF staff, for most programs, review by the IMF Executive Board is not required prior to each quarterly disbursement. For these programs, semiannual reviews by the IMF Executive Board are the more typical approach. In these cases, IMF staff reviews whether the country has met its performance criteria quarterly and, if they have been met, a disbursement can follow without a full IMF Board review. Larger programs, such as several we studied, tend to have tighter monitoring, and reviews can be held quarterly, bimonthly, or monthly. Future disbursements are contingent on the outcome of these reviews. In order for a country to be eligible for the next disbursement, the review has to be considered “complete.” IMF staff missions to the country review the country’s progress in meeting the program’s performance criteria and other structural reforms with country officials. Progress is outlined in documents provided to the Executive Board by both country authorities and IMF staff. IMF staff appraises a country’s progress and makes a recommendation to the Executive Board. According to IMF staff, this process involves a considerable amount of judgment and allows for a number of options depending on the country’s performance and the effect of both internal and external events on that performance.

If the IMF Executive Board determines that a country has made sufficient progress in meeting the program’s conditions, the next disbursement, as specified in the arrangement, will be available for release. However, according to IMF staff, it is fairly common for one or more of the program's conditions to be missed, including performance criteria. When this happens, IMF staff and country officials discuss the causes behind the missed criteria and changes that may be needed in the program. According to an IMF official, if the staff concludes that the deviation is minor and self-correcting or the underlying objectives of the program can be met despite the deviation, they may recommend to the IMF Executive Board that it grant the country's request for a waiver and be eligible for the next disbursement. However, if the staff concludes that the reform program is not on track and that the criteria were missed because the country was not sufficiently pursuing an agreed-upon policy, the staff will not recommend approval of a waiver at that time and will instead delay or suspend the completion of the country's review. Negotiations between the two parties can continue if and until the two sides reach agreement on how to restart the existing program or initiate an entirely new program, or the borrower country requests that the program be terminated. When the staff is assured that the country is once again committed to reform (sometimes by undertaking "prior actions"), it can recommend to the Executive Board that waivers be granted for the previously unmet conditions, and the review be completed. Upon IMF Executive Board approval, the country is eligible to receive the next disbursement. The documents we reviewed demonstrated that this process was generally followed for the six countries in our study, as summarized in table 3.

Table 3: IMF Monitoring of Current Financial Arrangements With Six Countries, as of April 30, 1999

IMF Executive Board reviews completed under current arrangement	Reviews completed with no waivers requested	Waivers granted without delays in completing review or disbursing funds	Delays in completing reviews and disbursing funds	Observations
Argentina				
Since the arrangement was approved in Feb. 1998, three reviews were completed in Sept. 1998, March 1999, and May 1999.	Two	One - In March 1999, the IMF Board approved a waiver because Argentina's federal government deficit exceeded the quantitative performance criterion. IMF staff concluded that the amount by which the criterion was exceeded was minor and that the nonobservance was due to circumstances outside the government's control.	None	In the course of its three reviews, the IMF Board has determined that Argentina has met all performance criteria except the one noted under "waivers." The IMF noted that Argentina performed in a satisfactory manner in a relatively turbulent international economic environment.
Brazil				
Since the arrangement was approved in Dec. 1998, one set of reviews was completed in March 1999.	None	None	One - The first and second review, scheduled for completion in February 1999, was delayed until March 1999.[a] The IMF Board granted a waiver for the government's nonobservance of the ceiling on net domestic assets of the central bank.	The review was delayed until the IMF and Brazil agreed to changes in the program to reflect the impact of the new currency regime. The IMF said Brazil has made substantial progress in implementing its structural and fiscal program.
Indonesia				
Since the initial arrangement was approved in Nov. 1997, six reviews have been completed.	Two	None	The IMF delayed completion of four reviews for several reasons, including lack of progress in meeting monetary criteria, privatizing state enterprises, and merging troubled banks. The IMF released funds after it determined that Indonesia had made sufficient progress in implementing the IMF conditions.	There were nine revisions to the initial program, reflecting the continuing evolution of the program. The IMF has been concerned about the government's stability and its commitment to implement reforms.

IMF Executive Board reviews completed under current arrangement	Reviews completed with no waivers requested	Waivers granted without delays in completing review or disbursing funds	Delays in completing reviews and disbursing funds	Observations
Korea				
Since the initial arrangement was approved in Dec. 1997, seven reviews have been completed.	Five	Two - In December 1998 and April 1999, the IMF Board approved waivers allowing more time for the government to complete required structural performance criteria. These actions have since been completed, according to IMF officials.	None	Korea's program changed substantially to reflect the deeper-than-expected recession. Korea has made substantial progress in implementing financial sector policy changes and has begun repaying its IMF borrowings.
Russia				
Since the initial arrangement was approved in March 1996, 12 reviews were completed through June 1998.	Five	Two reviews were completed after the IMF Board granted waivers for Russia's nonobservance of performance criteria. In these instances, the government missed the performance criteria on the government deficit or revenue targets.	The IMF delayed disbursements and/or program approval five times. The delays occurred because Russia had gotten too far off program regarding the government deficit and revenue targets. Also, there were delays because Russia had to implement prior actions and/or there were cabinet changes.	The substantive reasons for Russia's failure to meet key goals, according to IMF officials, have been a lack of political will to collect taxes and a pervasive culture of nonpayment of taxes. In March 1999, the program was terminated at Russia's request; the IMF and Russia are currently negotiating terms for a new program.
Uganda				
Since the arrangement was approved in Nov. 1997, two reviews were completed in April 1998 and Nov. 1998.	One	One - In April 1998, the IMF Board approved a waiver for the quantitative performance criterion that limits government obligations to the banking sector, judging that non-observance was due to a reversible technical factor rather than a failure of policy.	Following a February 1999 IMF staff mission that found the government missed five of nine performance criteria, disbursements have been delayed pending the findings of the staff mission that returns in June 1999. Government officials expect to meet the criteria then.	IMF and U.S. Treasury officials have described Uganda as generally exhibiting a strong commitment to economic reform. Recent developments indicate a greater emphasis by the IMF on increasing priority social-sector spending, improving privatization efforts, and new concern over increases in military spending.

Note: More detailed discussions of these programs and IMF monitoring of compliance with terms and conditions are contained in the country-specific appendixes to this report.

[a]According to IMF staff, Brazil's first and second reviews were completed simultaneously because Brazil received funds under two different IMF policies, an SBA and an SRF, and drew from these sources simultaneously. If they had been drawn sequentially, the reviews would have been completed separately.

Source: GAO analysis of IMF documents.

The IMF Executive Board May Approve Access to Funds if Overall Progress Is Sufficient

As previously discussed, during the review process, if the IMF determines that a country has met all of the performance criteria, the country is eligible to receive its next IMF disbursement. If IMF staff believes that the country has satisfactorily implemented the requirements for the period under review but that all criteria were not met, it can recommend that the IMF Executive Board grant the borrower country's request for a waiver of nonobservance of those unmet criteria. Generally, in these cases, the deviations are determined to be minor, of a technical nature, or temporary. The granting of such waivers generally happens fairly quickly, and access to the next disbursement is not delayed. In addition to reviewing a country's progress on performance criteria, its progress toward meeting indicative targets and structural benchmarks is also considered in the review process and the decision to approve the next disbursement.

For example, Argentina requested a waiver for the IMF Board review in March 1999 because its federal government deficit slightly exceeded its target. This situation was primarily due to adverse external factors. In this instance, the federal government deficit, estimated at $3.85 billion in 1998 (1.1 percent of gross domestic product [GDP]), exceeded its ceiling by about $350 million, or around 0.1 percent of GDP. According to the Argentine government, its efforts to contain expenditures could not compensate fully for the revenue shortfall. The shortfall mainly reflected the slowdown of economic activity in the second half of 1998 and its adverse effect on taxes, particularly the value-added tax. IMF staff viewed the deviation as minor and as not detracting from overall fiscal performance. Hence, they recommended the waiver be granted; in March 1999, the IMF Executive Board approved the waiver.

In another example, Uganda requested a waiver for nonobservance of one quantitative performance criterion during its April 1998 IMF Board review. In this instance, the quantitative performance criterion was a limit on the net claims on the government by the banking system. During the review period that ended in December 1997, the Ugandan government experienced a temporary shortfall in its checking accounts with the banking system, thereby causing it to miss the performance criterion. According to IMF documents, the shortfall was due to government payments being made sooner than expected. IMF staff recommended the waiver be granted because they viewed this nonobservance as minor and of a technical nature rather than a policy violation; the IMF Executive Board approved the waiver in April 1998. The shortfall was corrected within a short period of time.

The IMF May Delay or Withhold Funds if Sufficient Progress Is Not Made

During the review process, instances in which the country did not meet key quantitative or structural performance criteria may be considered significant enough to delay or suspend disbursements. According to IMF staff, a country's record in implementing performance targets and benchmarks influences this determination. Under these circumstances, IMF staff recommends to IMF management that the review not be completed. If IMF management concurs, the staff will likely informally brief the IMF Board, but the IMF Board will not be asked to make a formal decision on the program's continuation at that time. Depending on the situation, IMF staff may continue to work with country officials to negotiate new terms of the program so that it can be restarted or so a new program can be initiated. If country officials and IMF staff are unable to agree on terms, it is possible that the program will lapse.

Indonesia's program is an example of a situation in which disbursements were delayed several times. The Indonesian IMF program began with Executive Board approval in November 1997, with completion of the first review scheduled for mid-March. The IMF, however, delayed Indonesia's disbursements from mid-March to early May 1998 due to the IMF staff's determination that Indonesia had not made sufficient progress in carrying out its program. The first review was completed in May 1998, with Indonesia meeting none of the quantitative performance criteria and one of the required structural performance criteria. IMF staff recommended and the Executive Board granted Indonesia's request for waivers of nonobservance of these criteria based on actions taken by the government, and disbursements resumed. At this time, the IMF moved from quarterly to monthly reviews of Indonesia's program. Disbursements were also delayed in the process of completing several subsequent reviews.

Brazil's program is a more recent example of a delay in disbursements. The program began in November 1998, with the first disbursement occurring in early December. In January 1999, the government of Brazil was forced to devalue and then float its currency. Up until that time, Brazil's currency was pegged to the U.S. dollar, and maintenance of the exchange rate was an objective of Brazil's IMF program. Because Brazil received funds under two different IMF policies and drew from these sources simultaneously, the first and second reviews were scheduled to occur simultaneously. Completion of this set of reviews and the second disbursement were initially scheduled to occur no later than the end of February 1999. The change in the currency regime required substantial revision to the program, thus delaying until late March completion of the review. Brazil's program was modified to reflect new economic and exchange rate circumstances. Brazil missed one of its quantitative performance criteria (a ceiling on net domestic assets in the central bank). The Executive Board granted Brazil a waiver for the nonobservance of this performance criterion, agreed to the program modifications, and approved completion of the first and second review on March 30, 1999, thus opening the way for Brazil to receive the next disbursement of funds.

Russia's program is an example of one in which the IMF delayed disbursements and program approval, reduced the amount of the disbursement, and ultimately suspended the program. The IMF delayed four disbursements: one in June and two in September and October 1996, and then another in November 1997. Russia received no funds between February and May 1997, pending approval of the 1997 program, which was delayed until May 1997, based on Russia's successful completion of prior actions. The delayed approval of the 1998 program, due to cabinet changes and difficulty in meeting the revenue package, meant that Russia received no funds between January and June 1998. The program was finally approved in June 1998, based on implementation of prior actions. In July 1998, the IMF approved additional funds to Russia but reduced the amount of the initial disbursement from $5.6 billion to $4.8 billion due to delays in getting two measures passed in the Duma (the lower house of the Russian parliament). The IMF was scheduled to release the next disbursement in September 1998, but Russia had deviated so far from the program that the IMF made no further disbursements. Ultimately, according to the IMF, it delayed disbursements because of Russia's poor tax collections, reflecting a lack of government resolve to collect these revenues. However, throughout Russia's program, the IMF staff expressed the view that Russia's key senior authorities were committed to the program and should be supported; therefore, the IMF Executive Board continued to approve disbursements. In March 1999, Russia requested that the program be terminated. In April 1999, IMF staff and Russian authorities announced they had reached agreement on an economic program that management hoped to be able to recommend to the IMF Executive Board in support of a new arrangement. As of June 16, 1999, the IMF Board had not approved the new arrangement.

Conditions May Be Modified for a Variety of Reasons

Modifications to a borrower country's program are usually based on an agreement between the IMF and country officials summarized in updated program documents. In these cases, such agreements outline modified performance criteria, indicative targets, and benchmarks.

IMF and country officials may modify conditions contained in borrower country programs for a variety of reasons, depending on individual country circumstances. Two reasons for modifications of programs are (1) the effect of unanticipated internal and external factors on the country's ability to fulfill the required conditions and (2) the determination that the initial conditions were not realistic or feasible. In many instances, there is overlap between these two reasons. Unanticipated internal factors generally reflect events over which the government had less control than it had hoped. Examples include the inability of the government to enact required legislation, or other political turmoil. Unforeseen external factors are generally changes in the global economic environment that affect the ability of a borrower country to fulfill the macroeconomic conditions of its program. Examples include such things as a decline in investor confidence and/or capital flows, a decrease in demand for or price of primary exports, default by a major debtor, a recession or other economic problems in another country to which one's economy is closely tied, and natural disasters like droughts and floods. Unrealistic or unfeasible conditions can result when a country's problem is misdiagnosed or when the impact of certain conditions is different from what was expected.

Developments in the early stages of Indonesia's current program are an example of an instance in which unanticipated internal events made it difficult for Indonesia to fulfill the conditions it had agreed to. These events included (1) circumvention of government decrees to dismantle cartels and open up markets, (2) the government's consideration of a currency board (which was not part of the program), (3) social unrest, and (4) the resignation of the president. Indonesia experienced a significant loss of investor confidence that resulted in a run on the banks, the reduction of foreign credit lines, and a continuing depreciation of the currency. The IMF and Indonesia revised the economic program a number of times before the situation stabilized.

Brazil is another example in which unanticipated internal events resulted in program revisions. The maintenance of the exchange rate regime was an objective of the country's IMF program. Brazil turned to the IMF for assistance in September 1998, when its currency came under pressure as a result of the Russian crisis, and it experienced a significant loss of reserves. This reserve loss decelerated after the negotiations began, but, according to Brazilian officials, Brazil's currency came under additional pressure for a variety of reasons after its IMF program had started. These reasons included three internal setbacks that were out of the government's control, including the defeat in Brazil's congress of two tax measures deemed crucial to the fiscal adjustment program and the reluctance of a number of Brazilian state governors to fulfill their financial obligations to the government. To try to stem the additional loss of reserves, the Brazilian government found it necessary to devalue and then float the currency. The IMF program was then revised to reflect the new economic situation and currency regime.

In Korea, a significant external factor that limited its macroeconomic performance, in the view of the IMF, was the continued Japanese recession. According to an IMF assessment, the weakening of the Japanese yen affected Korea's export competitiveness by making Korea's exports more expensive in comparison with Japanese exports. In addition, it was a contributing factor in worsening and lengthening Korea's own recession.

Reassessment of initial conditions can take place because these conditions are later determined to be unfeasible or unrealistic due to economic factors that were not well known at the time. For example, Treasury and IMF officials told us the IMF projections for Korea were overly optimistic at the beginning of the program. These estimates were based on Korea's past strong growth and did not accurately project the "rolling financial crisis" throughout Asia. Also, the true state of Korea's financial sector was not clear when Korea's initial program was designed. Part of Korea's agreement with the IMF was to improve transparency (openness) in its financial reporting, but as greater information became available, investor confidence dropped when the market learned more about the level of usable international reserves, corporate debt, and banks' nonperforming loans.

Apart from waivers and reviews, quantitative performance criteria and indicative targets can be changed by means of "adjusters" that are included in some country programs. Adjusters are prenegotiated to account for specific actions and assumptions about economic and financial movements. We found that there were basically two types of adjusters in the agreements we reviewed: adjusters due to unexpected external events that temporarily affect a key variable and adjusters due to in-country policy changes that affect a key variable or the measurement of that variable.

The first type of adjuster automatically changes the level of a quantitative performance criterion when there are unexpected changes—generally outside of the country's control—to one or more key variables. The rationale is that occasionally countries may fail to reach a particular quantitative performance criterion due to fluctuations in economic conditions outside their control and that temporary changes in key variables should not derail an IMF agreement. Also, some adjusters are designed to take into account the effect of positive as well as negative external developments on the quantitative performance criteria. For example, Uganda's program had a quantitative performance criterion that set a minimum level for net international reserves. This minimum level was based on an assumed level of inflows of funds from bilateral and multilateral lending agencies. An adjuster was added to the quantitative performance criterion in order to adjust the required minimum level upward (or downward) in the event that creditors provided more (or less) debt relief than was expected.

The second type of adjuster automatically changes the level of a quantitative performance criterion when policymakers choose to make changes in their monetary or fiscal policy instruments in a manner that would either directly or indirectly affect the target variables. For example, an IMF official noted that a common performance criterion in programs is a maximum permissible level of net domestic assets of the central bank, usually included as part of a strategy to target the growth of the money supply. However, other policy decisions can affect the level of the money supply. For instance, decreases in the required reserve ratio (the proportion of the total value of deposits that a commercial bank must keep either in its vault or in an account at the central bank) may increase commercial bank liquidity and the money supply. Thus, frequently the quantitative performance criteria include an adjuster that automatically decreases the performance criterion for the net domestic assets of the central bank when the required reserve ratio is reduced to offset potential increases in the money supply. This adjuster is intended to prevent policy changes from compromising the achievement of overall program objectives, such as price stability or low inflation.

Objectives, Scope, and Methodology

Our objectives were to (1) describe how the IMF establishes financial arrangements with borrower countries and the types of conditions set under these programs and assess how this process was used for six borrower countries; and (2) describe how the IMF monitors countries' performance and assess how this process was used for six borrower countries, detailing the conditions met and not met, the reasons why conditions were not met, and the actions the IMF took in response. To meet our objectives, we obtained access to IMF officials and documents (public and nonpublic) through the Department of the Treasury and through the staff of the U.S. member of the IMF Board of Executive Directors. These documents describe the IMF's background, policies, and practices. We reviewed borrower country documents outlining IMF arrangements and conditionality, including letters of intent,[22] and

[22] Letters of intent are prepared by the member country. They describe the policies that a country intends to implement in the context of its request for financial support from the IMF.

documents presented to the IMF Executive Board, such as staff reports on arrangements. We also reviewed several IMF assessments of its operations, including reviews of ESAF and the IMF's response to the Asian financial crisis.

We discussed the IMF's process for establishing and monitoring the conditions of its financial arrangements with officials of the IMF, U.S. government agencies, and borrower governments. To obtain additional information from in-country officials, in February 1999, we requested access to Department of State cables related to the most current IMF arrangement and economic and financial conditions in each of the six countries. According to State, it identified and reviewed over 550 cables that were determined to be responsive to our request. Due to the volume of the cables and the limited time in which to review them, State was unable to provide timely access for us to analyze the content of many of these cables and meet the legislatively required reporting date. We also obtained information from nongovernmental and academic organizations. We did not evaluate the appropriateness or effectiveness of the IMF's terms and conditions.

We reviewed the most recent IMF financial arrangements for the following six borrower countries: Argentina, Brazil, Indonesia, Republic of Korea (Korea), the Russian Federation (Russia), and Uganda. We selected these countries because they are geographically diverse, represent a mix of borrowers that were having actual or potential balance-of-payments difficulties at the time they requested IMF financial assistance, and have varying histories with the IMF. Several of these countries were in the midst of a financial crisis at the time they requested assistance. Three countries—Argentina, Russia, and Uganda—had successive IMF financial arrangements, whereas two other countries—Indonesia and Korea—had not had IMF financial arrangements for about 10 years before their most current arrangements.

The information contained in this report is based on the implementation of countries' programs from their inception through April 1999, unless otherwise noted.

We conducted our review in Washington, D.C., between November 1998 and April 1999 in accordance with generally accepted government auditing standards.

We recognize that the IMF's actions have been subject to debate and criticism. An evaluation of these criticisms is clearly outside the scope of this report. We identify some of these criticisms in appendix VIII.

Agency Comments and Our Evaluation

We requested comments on a draft of this report from the Under Secretary (International) of the Department of the Treasury and the Managing Director of the International Monetary Fund. The Treasury provided written comments on a draft of this report, which are reprinted in appendix IX. These comments characterized the report as balanced and informative. The Treasury did note its concern that our discussion of flexibility in monitoring and implementing IMF programs could be misunderstood. The Treasury commented that while the IMF's process does incorporate flexibility and latitude, "there is a fundamental link between program implementation and program support." We agree that IMF's process is designed to allow adjustment to a country's program in appropriate cases, taking into account changing circumstances. We provide many examples of such adjustments in our description of the arrangements for six borrower countries. Also, in response to the Treasury's concern, we added clarifying language to the Results in Brief to note that the resumption of IMF disbursements following a delay depends on IMF judgment that there has been satisfactory progress in meeting key conditions. For a full discussion of the process, see appendix I of this report.

Both the IMF and the Treasury provided technical and clarifying comments, which we incorporated where appropriate. We also asked responsible Department of State officials to review the accuracy of the in-country information in the draft. They provided technical and clarifying comments, which we have incorporated where appropriate.

We are sending copies of this report to Senator Connie Mack, Chairman, Representative Jim Saxton, Vice Chairman, and Senator Charles Robb and Representative Fortney Pete Stark, Ranking Minority Members, Joint Economic Committee; Senator William Roth, Chairman, and Senator Daniel Moynihan, Ranking Minority Member, Senate Committee on Finance; Senator Phil Gramm, Chairman, and Senator Paul Sarbanes, Ranking Minority Member, Senate Committee on Banking, Housing, and Urban Affairs; and Representative Benjamin Gilman, Chairman, and Representative Sam Gejdensen, Ranking Minority Member, House Committee on International Relations. We are also sending copies of this report to the Honorable Robert Rubin, the Secretary of the Treasury; the Honorable Madeleine Albright, the Secretary of State; the Honorable Jacob Lew, Director, Office of Management and Budget; and the Honorable

Michel Camdessus, Managing Director, IMF. Copies will be made available to others upon request.

This report was prepared under the direction of Susan S. Westin, Associate Director, Financial Institutions and Markets Issues, and Harold J. Johnson, Jr., Associate Director, International Relations and Trade Issues. Please contact either Ms. Westin at (202) 512-8678 or Mr. Johnson at (202) 512-4128 if you or your staff have any questions about this report. Other major contributors are acknowledged in appendix X.

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Contents

Abbreviations

BCB	Brazil Central Bank
CBR	Central Bank of Russia
CCFF	Compensatory and Contingency Financing Facility
EFF	Extended Fund Facility
ESAF	Enhanced Structural Adjustment Facility
ESF	Exchange Stabilization Fund
GDP	gross domestic product
GRA	General Resources Account
HIPC	Heavily Indebted Poor Countries
IBRA	Indonesian Bank Restructuring Agency
IMF	International Monetary Fund
INDRA	Indonesian Debt Restructuring Agency
SBA	Stand-by Arrangement
SDR	Special Drawing Rights
SRF	Supplemental Reserve Facility
STF	Systemic Transformation Facility
VAT	Value Added Tax

The IMF's Process for Establishing and Monitoring Countries' Financial Arrangements

The process that the International Monetary Fund (IMF) generally uses to establish and monitor financial assistance arrangements is intended to be flexible and applied on a case-by-case basis to address the specific balance-of-payments problems of member countries. The IMF staff and the member country begin the process by assessing the country's overall economy, balance-of-payments position, ability to finance any balance-of-payment deficit, and potential need for IMF financial assistance. If the country decides to seek IMF financing, the IMF staff and the country negotiate an arrangement that describes the amount of financing, the type of financing instrument, and the schedule for review. The IMF staff and the country also negotiate conditions—the policy measures that the country intends to fulfill in order to continue to access IMF funds. After the arrangement is negotiated, the IMF Executive Board discusses and approves it.

IMF staff conduct periodic reviews to monitor the country's progress in meeting the IMF program conditions. The frequency of the reviews depends on the type of financial arrangement that the country is under and the nature of its problem. The IMF uses both data and judgment in assessing the extent of the country's progress in meeting program conditions. If it determines that the country is on track in implementing its program conditions, additional allotments of funds can be made available. In cases where the IMF determines deviations from the program are significant, it can delay or withhold funding unless and until, in its judgment, the country has made further progress.

Country Officials Consult With the IMF

When a member country faces an actual or potential balance-of-payments problem, it may consult with the IMF to analyze information on the economy and discuss various methods of managing the problem. These discussions may lead the country to request IMF financial assistance in order to alleviate the imbalance. If the IMF and the country do not reach final agreement on a financial assistance arrangement, the country may seek other means to address the difficulty. Discussions can occur at any time, including during the country's annual "Article IV" consultation with the IMF or during informal consultations as requested by the member.[1]

[1] The Article IV consultation is an annual review of members' macroeconomic circumstances conducted as part of the IMF's "surveillance" responsibilities as spelled out in its Articles of Agreement, which is its charter. The Articles also call on each member to provide the IMF with the information needed for such surveillance.

Country Officials and the IMF Analyze the Country's Situation

To aid in the IMF's assessment of a country's overall economic situation and to determine the magnitude of potential financial assistance required by the country, IMF staff evaluates the balance-of-payments problem and determines the financial support measures that would assist in correcting the imbalance. The IMF staff's review of the state of a member's economy is an iterative process and is based on country-provided data, assumptions about key macroeconomic variables, and judgment by the IMF staff and country officials. To do this, the IMF staff examines the following four related sectoral statistical systems over the medium term of 3 to 5 years with the assumption that the government will follow its stated policies: (1) national income and product accounts for gross domestic product (GDP), (2) government financial accounts for the fiscal sector, (3) consolidated banking system accounts for the monetary sector, and (4) external accounts for the balance-of-payments position.

In order to analyze these four sectors, an IMF team (IMF mission) travels to the country to review the situation within the country. The team begins the analysis by reviewing the data previously collected from country officials for the most recent Article IV consultation as well as other requested information provided by the country. The information includes data on the country's balance of payments; fiscal variables, such as government expenditures and receipts; and monetary variables, such as monetary reserves and bank deposits, stock of currency, and interest rates. In addition, it includes country authorities' projections for areas such as real GDP growth and inflation; real sector indicators, such as employment levels, manufacturing, production, agriculture, and service sectors; budget plans for government expenditures; and subsidies for public enterprises.

As part of the process of analyzing a country's economy and determining the balance-of-payments position, the IMF staff verifies the country-provided information, searching for both consistency and contradictions in the information. According to an IMF official, data inconsistencies may be discovered in a variety of ways. For example, if IMF staff believed that the country-provided trade data were inaccurate, it would cross-check that country's trade data with similar data of a neighboring county with whom it trades in order to verify whether the information was accurate. In other cases, if the data suggested that the manufacturing level in a country had increased and at the same time indicated that electricity usage had decreased, the staff would be alerted to the inconsistency and would seek to verify the data. In such instances, the IMF team would work with government employees in ministries or agencies to calculate and verify the information. According to an IMF official, this type of analysis is, by necessity, undertaken on a case-by-case basis, and it would be difficult to develop a universal set of standards for verifying such information. For this work, the IMF relies on its mission chiefs, who have acquired knowledge and experience in each country to assist in verifying the data.

According to an IMF official, determining the balance-of-payments position is central to both the analysis of the economy and the determination about whether the country would be eligible for IMF financial support. The concept of a balance-of-payments need is broadly defined in the IMF's Articles of Agreement and includes (1) the country's overall balance of payments, (2) the country's foreign reserve position, and (3) developments in its reserve position. IMF documents state that these three elements are regarded as separate, and a member's representation of a balance-of-payments need can be based on any one of them. The first element—the country's overall balance of payments—represents the economy's external financing requirement and equals the sum of a member's current and capital account balances. The current account primarily includes exports and imports of goods and services. The capital account provides summary data on the changes in net foreign assets of domestic residents arising from such transactions as external borrowing or repayments (borrowing from or repaying foreign sources), foreign direct investment, portfolio investments (both equity shares and bonds), and short-term capital movements.

The second element—the country's reserve position—refers to the amount of resources (convertible currency, special drawing rights,[2] and gold) a country has to support its imports and external debt payments. The reserves are under the control of the monetary authority. The third element—developments in the reserve position--has a very narrow application and is intended to ensure that members of the IMF whose currency is a reserve currency (such as the United States) would be able to use IMF resources when requested, despite the absence of a need as outlined in the first two elements.[3]

[2] The special drawing right is a reserve asset created by the IMF and a unit of account that the IMF uses to denominate all its transactions.

[3] It is designed to cover situations in which a country may not have a balance-of-payments deficit or a weak reserve position but still has a need because of a development in its reserves. For example, the Executive Board was concerned that the first two concepts would preclude members of the European Economic Community, (the predecessor to the European Union) from requesting IMF assistance in discharging obligations among each other. By virtue of their currency being a reserve asset, the use of their currency in foreign transactions would not result in a balance-of-payments deficit or weak reserve position by such countries, although difficulties in the external environment may still require some support.

According to an IMF official, determining an actual balance-of-payments need is easier than projecting a potential balance-of-payments need. This is because the process of assessing an economy is subject to many assumptions and uncertainties, including factors within and outside of the country's control. For example, in the case of Russia, the IMF documents establishing the 1996 extended arrangement do not explicitly describe the underlying balance-of-payments need. However, the IMF documents do present a clear case for the role that IMF funding was to play in catalyzing debt rescheduling and encouraging the inflow of private capital to avoid a potential balance-of-payments problem. In 1996, Russia had a basic weakness in its external accounts due in part to short-term capital outflows and an inadequate level of reserves. Furthermore, many debt service obligations were expected to occur between 1996 and 2000, adding more stress to Russia's external accounts. An IMF financial arrangement in 1996 was seen as critical for Russia to avoid a potential balance-of-payments problem. The IMF arrangement helped Russia obtain debt rescheduling to reduce the future burden on the federal budget and improve Russia's access to private capital markets.

Analyzing the nature, source, and severity of any existing or potential balance-of-payments problem involves assessing data about the balance-of-payments deficit and the country's ability to finance it. To determine the nature of the imbalance, the IMF determines whether the problem is short term or longer term. For example, a short-term problem could be a cyclical or seasonal imbalance caused by the falling price of a primary export. A longer-term imbalance might be caused by underlying or structural weaknesses in the economy, such as an unsustainable government budget deficit. The IMF staff also determines to what extent the reasons for the imbalance are within the government's control, along with the dimensions and urgency of the problem, including the availability of financing.

After the balance-of-payments gap analysis is complete and if the country decides to seek IMF financial assistance, the country officials and IMF staff begin to discuss IMF financing as well as the conditions for the country program.[4] However, according to the IMF, in order to adapt programs to individual country circumstances, it has no inflexible set of operational rules for establishing a country's program. Nonetheless, Deputy Managing Director of the IMF, said that staff enter into negotiations with detailed instructions, agreed upon within the IMF staff

[4]According to the IMF, it provides financial resources to members under certain conditions designed to encourage what it views as appropriate economic adjustment and ensure that the member's use of IMF credit is temporary and that it will have the capacity to repay the IMF on time.

offices and then by IMF management. This IMF official stated that negotiations are often long and sometimes contentious, involving several rounds of discussions. The disagreements tend to be over difficult issues, for example, whether the budget needs to be tightened, the inflation rate should be reduced less rapidly, or the agreed-upon balance-of-payments deficit can be larger.

To address the balance-of-payments problem, typically the IMF uses economic models to project the potential impact of a variety of adjustment measures to develop several scenarios of possible program elements. Based on these scenarios, the IMF staff and the country negotiate what they view as the appropriate mix of fiscal and monetary adjustment, structural reforms, and financing required to achieve their overall goals; these goals can include an increase in economic growth or in investor confidence.[5]

For example, for the external sector, two independent projections of imports need to be made and reconciled. The first is based on the demand for imports, derived from information including the projected level of output and relative prices, and the second is based on the capacity to import, derived from the target change in international reserves and projections of other components of the balance of payments. For example, if the demand for imports is greater than the country's capacity to import, the basic options for adjustment may include the following: (1) seek additional foreign exchange, (2) lower the initial target for net international reserves, (3) reduce the initial projection for output to lower the demand for imports, or (4) some combination of the above. Similar iterative analyses are also carried out for the fiscal and monetary sectors.

The IMF staff and the country negotiate an arrangement that describes (1) the amount of financing expected to be provided by various sources and the amount that may be requested from the IMF; (2) the instruments under which the IMF resources could be provided, for example, Stand-by Arrangement (SBA) or Extended Fund Facility (EFF); and (3) the potential schedule for reviewing a country's performance and disbursing funds. The IMF has many instruments through which it provides financing to member

[5] IMF financing is not generally in the form of a loan but rather is a purchase or repurchase of currency. As such the IMF does not consider the establishment of a conditionality program to be a "negotiation." Rather, the member explains the economic reform program in the documents it prepares in the context of its request for financial assistance and the IMF Board decides whether to support the program. The decision takes the form of an "arrangement," which notes certain aspects of the member's program that will be conditions for continued IMF financing under the arrangement.

countries. Table I.1 illustrates IMF instruments used by the six IMF member countries discussed in this report.

Table I.1.: Frequently Used IMF Financing Instruments

Instruments	Purpose	Duration/ Disbursements/ Repayments	Reviews
Regular arrangements			
Stand-by Arrangements Used by Indonesia, Korea, and Brazil	Short-term, balance-of-payments assistance for deficits of a temporary or cyclical nature	1-3 years/ quarterly/ within 3-1/4 - 5 years of each drawing	Periodic reviews provided that appropriate monitoring of macroeconomic developments would be ensured, normally through quarterly performance criteria. Staff prepare an analysis and assessment of the performance under programs
Extended arrangements, under EFF Used by Argentina, Indonesia, and Russia - Established in 1974, likely to be beneficial for developing countries in particular	Longer-term, balance-of-payments assistance for (1) deficits arising from structural maladjustments in production and trade and widespread cost and price distortions and (2) an economy characterized by slow growth and an inherently weak balance-of-payments position that prevents pursuit of an active development policy. Can provide larger total amounts of assistance.	3-4 years/ quarterly or semiannually/ 4-1/2 - 10 years of each drawing	Periodic reviews, typically quarterly performance criteria. Country provides annual reports on progress made, and policies and measures to be followed, including any modifications.
Special facilities			
Supplemental Reserve Facility (SRF) Used by Brazil, Korea, and Russia - Opened in 12/97, provided under SBA or extended arrangement	Exceptional balance-of-payments problems owing to a large, short-term financing need resulting from a sudden and disruptive loss of market confidence reflected in pressure on the capital account and reserves. Likely to be used where the magnitude of outflows may threaten the international monetary system.	1 year/ 2 or more drawings/ within 1- 1-1/2 years from date of disbursement but may be extended another year, including surcharges	Reviews done in conjunction with SBA or extended arrangement.
Compensatory and Contingency Financing Facility (CCFF) Used by Russia -Opened in 1988 to combine the Compensatory Financing Facility with contingency financing	Helps members deal with temporary current account shocks that are largely beyond their control. A "compensatory" element is available in case of shortfalls in export earnings or excesses in cereal import costs. A "contingency" element helps members with existing arrangements keep their programs on track when faced with adverse current account shocks.	Significant limits on amounts; defined methodology for determining whether CCFF is needed and, if so, type and amount. Disbursements linked to phasing of existing arrangement. For the compensatory element, disbursements normally in one installment. For the contingency element, disbursements linked to phasing of existing arrangements. Repayment is in 3-1/4 to 5 years.	Board review at the time of request and, in the case of the contingency element, on the occasions stipulated in the underlying arrangement.

Instruments	Purpose	Duration/ Disbursements/ Repayments	Reviews
Concessional facility			
Enhanced Structural Adjustment Facility (ESAF) Used by Uganda	Principal means for providing financial support (highly concessional loans) to low-income members facing protracted balance-of-payments problems.	3 years/ semiannually/ repaid in 10 equal semi-annual installments, beginning 5-1/2 years and ending 10 years after date of each disbursement.	Quarterly monitoring of financial and structural benchmarks. Semiannual performance criteria are set for key quantitative and structural targets.

Source: GAO analysis of IMF documents.

In addition, the country and the IMF staff negotiate the likely conditions to be used to assess a country's performance under the arrangement. These conditions are generally intended to advance the country's larger objectives–such as a reduced balance-of–payments problem, higher economic growth, and lower inflation—as well as the reform efforts undertaken to achieve those objectives.

"Performance criteria" (quantitative and structural) and "prior actions" are conditions that a country is required to meet and that the IMF uses to monitor the country's performance and determine whether it is eligible for disbursements of resources. "Benchmarks" and "indicative targets" are other measures the IMF uses to monitor a country's progress; however, disbursements are not generally dependent on meeting them. "Quantitative performance criteria" are clearly defined numeric targets (macroeconomic indicators), such as a specified ceiling on the government's budget deficit or on the net domestic assets of the central bank. According to IMF staff, "structural performance criteria" must be accurately and unambiguously defined so that no subjective judgment is involved in determining whether they have been met. For example, a structural performance criterion could be that a country has to solicit bids to privatize three state-owned enterprises by a prespecified date.

A prior action is a particular policy measure that is considered to be essential to the effectiveness of an adjustment program. Prior actions may be negotiated by IMF staff and country officials as part of the country's initial arrangement or during subsequent program reviews; they generally have to be implemented before an IMF arrangement or a disbursement of funds is approved. An example of a prior action is the issuance of a regulation or other forms of legal reform.

Other measures used to assess a country's progress include benchmarks and indicative targets. They may relate to macroeconomic variables or to specific policy commitments, such as changes in key structural areas of the economy. Benchmarks can be difficult to define and are best explained as a set of specific target measures to be accomplished by a certain date, used by the IMF to assess progress toward an overall goal. In general, benchmarks could include targeted structural changes for tax policy and administration reform, financial sector reform, or exchange system reform. For example, to achieve the overall goal of strengthening a country's banking system, the IMF and the country may agree to a structural benchmark, such as enacting legal reforms for bankruptcy or developing a bank recapitalization plan. Indicative targets are quantitative targets set on many of the standard goals of macroeconomic policy and could include targets set on the balance of payments, the rate of inflation, or the public deficit.

The IMF Executive Board Discusses and Approves Program

After the arrangement is negotiated, it has to be accepted by the IMF Managing Director before it is brought before the IMF Executive Board. According to an IMF official, the Executive Board generally accepts the recommendations of the staff, largely because the staff brings to the Executive Board proposals that the Board will accept. Generally, the Executive Board is briefed formally or informally during the negotiation process, and board decisions are made on a consensual basis. Since negotiations with a country continue throughout the life of a program, the Executive Board will often use a meeting to send signals about what it will and will not accept in the future.

IMF Staff and Country Officials Review Program Status

After the IMF arrangement is approved by the Executive Board, the country is then expected to implement the agreed-upon conditions in the IMF program. To determine whether the program is on track and the country is eligible to receive the next disbursement of funds, the IMF staff conducts periodic reviews of the programs. The review schedule is built into the arrangement between the country and the IMF. For the reviews, a team of IMF staff and country officials assesses the program status, including the country's overall economic conditions and performance with respect to criteria, prior actions, and benchmarks.

According to the IMF, reviews are typically held on a semiannual basis, although disbursements can be made if countries achieve the quarterly performance criteria and prior actions. Some countries, however, including those suffering a financial crisis or receiving funds from the Supplemental Reserve Facility (SRF), tend to have tighter monitoring because funding tends to be heavily front-loaded and disbursed within a year. In these cases, the program reviews can be held monthly or bimonthly. SRF funding is for countries with exceptional balance-of-payments problems owing to a large, short-term financing need resulting from a sudden and disruptive loss of market confidence.

The IMF staff monitors the program continuously and the program is subject to periodic reviews by the IMF Executive Board in order to evaluate if the country's progress in meeting the conditions under the program justifies the continuation of disbursements. In some cases, IMF disbursements are conditioned only on the determination by IMF staff that the country has met prenegotiated quantitative criteria. According to the IMF, for most programs, review by the IMF Executive Board is not required prior to each quarterly disbursement. For these programs, semiannual reviews by the IMF Executive Board are the more typical approach. In these cases, IMF staff review whether the country has met its performance criteria quarterly and, if so, a disbursement can follow without a full IMF Board review.

Larger programs tend to have tighter monitoring and all disbursements are subject to reviews by the IMF Executive Board. In these cases, through its monitoring, the IMF staff believes that the country has satisfactorily implemented the program or the staff believes that the country has not satisfactorily implemented the program. In the first case, the review is "completed" and the borrower country is eligible to receive an additional disbursement. In the latter case, review completion is delayed and the country is not eligible to receive a disbursement at that time.

Satisfactory progress can be judged in one of two ways. If the IMF staff believes that the country has met all of the performance criteria and considers the review "complete," the staff presents the results of the review to the Executive Board. In addition, the IMF and the country may negotiate a new or revised set of criteria and benchmarks. Upon the Executive Board's approval, the country is eligible to receive the next disbursement of IMF funds.

In other instances, the IMF staff could conclude that the country did not meet all performance criteria but that most deviations were minor and did not affect the country's overall performance. The staff would then generally recommend to the Executive Board that a waiver be granted and the review would be completed on time. A country's inability to meet a performance criterion could be due to

- cyclical or seasonal problems that are self-correcting;
- the difficulty in making economic projections, that is, if key factors, such as the money supply were underestimated;

- unanticipated events, for example, a tumultuous political environment; or
- an incorrect assessment of the cause or solution to the problem.

After the IMF Executive Board grants the waiver, the country is eligible to receive IMF funds.

The IMF staff considers that a country has not made satisfactory progress when key conditions are not met and deviations are significant. In these cases, "completion" of the review and disbursements are generally delayed and are not resumed unless and until, in the IMF's judgment, satisfactory progress has been achieved. During the delay period, country officials and IMF staff negotiate the steps necessary to complete the review and make funds available. According to IMF staff, if the country did not meet the performance criteria because it is unwilling or unable to do so, the IMF will negotiate with the authorities to determine the nature of the problem and possible corrective measures. In these instances, the IMF may request that the country demonstrate its commitment to the program by undertaking a specific prior action before it recommends the Executive Board grant waivers for nonobservance of the unmet criteria and "complete" the review.

In other cases where the country has not met key performance criteria, the IMF staff may determine that deviations are so significant that it is not possible to negotiate steps to get the program back "on track." When this happens, the IMF staff generally concludes that it is not in a position to complete the review and notifies IMF management. If management concurs with the recommendation, staff briefs the Executive Board on the situation. The review will not be completed at that time and disbursements would be delayed. In these cases, the IMF staff and the country may negotiate ways to restart the existing program or initiate a new program. In some cases, for example, in Russia, some deviations from the program may be significant enough that the IMF delays or withholds further disbursements for a considerable length of time, and the program lapses.

Apart from waivers and reviews, quantitative performance criteria and indicative targets can be changed by means of "adjusters" that are included in some country programs. Adjusters are prenegotiated to account for specific actions and assumptions about economic and financial movements. There are two types of adjusters: (1) adjusters related to unexpected external events and (2) adjusters due to in-country policy changes. The first type of adjuster automatically changes the level of a quantitative performance criterion when there are unexpected changes—generally outside of the country's control—to one or more key variables.

For example, in Uganda's program, an adjuster was added to the quantitative performance criterion that set a minimum level for net international reserves in the event that creditors provided more (or less) debt relief than was expected. The second type of adjuster automatically changes the level of a quantitative performance criteria when policy makers choose to make changes in their monetary or fiscal policy instruments in a manner that would either directly or indirectly affect the target variables. It is intended to prevent policy changes from compromising the achievement of overall program objectives, such as price stability or low inflation.

The IMF's Financial Arrangement with Argentina

Summary

The current 3-year IMF Extended Fund Facility (EFF) arrangement agreed to in February 1998 is intended to be precautionary, meaning that Argentina will draw IMF resources only if external conditions make it necessary. At the time it negotiated the arrangement, Argentina was not experiencing an actual balance-of-payments problem. The IMF expressed concern about the sizable current account deficits expected over the next few years—although these deficits reflect to a large extent the growth of productive investment—and the economy's vulnerability to changes in external market conditions. The IMF arrangement of about $2.8 billion is intended to support the government's medium-term economic reform program for 1998-2000. Given Argentina's dependence on external capital, the arrangement is also focused on maintaining investor confidence in the country's economy.[1] Because of the recent adverse external developments stemming, in part, from Brazil's financial crisis, the IMF and the Argentine government agreed to adjust the performance criteria in May 1999. As of May 31, 1999, Argentina had not drawn resources under the arrangement.[2]

According to the Argentine government, the policy measures outlined in the IMF arrangement represent the government's priorities. Argentina's program with the IMF contains quantitative performance criteria under which the government agreed to limit the federal government budget deficit, central bank assets, and government debt. The goals of the fiscal deficit criteria are to reduce the federal government deficit, stimulate domestic saving, and strengthen confidence in the continued viability of the currency regime. The monetary program is intended to strengthen confidence in the banking system by maintaining a sound financial system and providing for an adequate cushion of liquidity. The structural benchmarks include reforms in the labor market, tax system, public sector budgeting and operations, health system, and judicial system as well as further progress in privatizing the remaining institutions. The government and the IMF identified fiscal equilibrium and structural reform (particularly in tax systems and labor markets) as two of the most crucial elements in the program.

[1] For additional information on investor confidence, see International Financial Crises: Efforts to Anticipate, Avoid, and Resolve Sovereign Crises (GAO/GGD/NSIAD-97-168, July 7, 1997).

[2] In late 1998, in response to turbulence in international capital markets, Argentina received World Bank and Inter-American Development Bank loans totaling approximately $2 billion, with another $2.5 billion due in early 1999. The loans were intended to be precautionary and part of the effort to mitigate the social and economic impact of unsettled international financial markets and to advance the country's reform agenda. The World Bank loans are to be used for reforms in banking, capital markets, access to credit, regulatory institutions, and intergovernmental fiscal relations; to help meet critical foreign exchange needs of the government; and as a line of defense for banking liquidity.

The IMF Executive Board reviewed the current program three times (based on IMF staff documents that provided data on and assessments of a country's performance), completing the first and third reviews with no waivers requested from the Argentine government, granting a minor technical waiver during the second review, and concluding that Argentina had made progress in achieving structural reform. Under the first review in September 1998, Argentina met all of its performance criteria and made progress in completing several structural reforms, with the exception of not fully passing labor market legislation. In the second review, Argentina met all but one of its performance criteria. Argentina requested a waiver because the target for lowering the federal government deficit was not reached. IMF staff viewed the deviation as minor, primarily due to adverse external factors, and as not detracting from overall fiscal performance; the IMF Executive Board granted the waiver. The Argentine government noted that, significantly, the structural deficit for 1998 was smaller than that of 1997. The government's efforts to contain expenditures did not fully compensate for the fall in revenue. In response, the fiscal deficit criterion for the next review was raised. During the second review, the IMF determined that Argentina made progress in carrying out several structural reforms. The government implemented most of the tax reforms but was only able to pass some of the intended labor market reforms. Under the third review, the IMF Executive Board determined that Argentina met the performance criteria as of March 1999 and agreed to adjust some of the performance criteria for the next review in light of deteriorating external conditions. The key events concerning Argentina's current EFF are outlined in table II.1.

Table II.1: Chronology of Key Events Concerning Argentina's Current IMF Arrangement

Year	Month	Event
1997	December	Argentina requested EFF and proposed performance criteria and structural benchmarks.
1998	February	IMF Executive Board approved 3-year EFF totaling about $2.8 billion.
	September	IMF Executive Board completed first review of EFF, as scheduled. The IMF Board determined that Argentina met all performance criteria and made progress in structural reforms.
	October	Argentina accessed capital markets, among the first emerging market countries to do so after the Russian financial crisis in August.
	November	The World Bank approved $3 billion in loans to Argentina intended to mitigate the impact of unsettled international financial markets and advance reforms.
	December	The Inter-American Development Bank approved a $2.5 billion loan to Argentina designed to counteract global financial shocks resulting from the crises in Asia and Russia.
1999	January	Argentina issued a policy memorandum and letter of intent: - saying it met all but one of the IMF performance criteria (fiscal deficit level) as of December 1998. The government made efforts to limit government expenditures but could not fully compensate for revenue shortfalls. - describing the policies the government intended to implement in 1999 under the EFF. The policies remained broadly the same. Brazil, Argentina's largest trading partner, floated its currency, thus making exports to Brazil more expensive because the currency depreciated.
	March	IMF Executive Board completed second review of Argentina's program, as scheduled. The IMF Board determined that Argentina met all 1998 performance criteria except one and granted a waiver for nonobservance of the fiscal deficit criterion. IMF staff noted that the deviation was minor and did not detract from the country's overall fiscal performance. IMF Executive Board agreed to performance criteria and structural benchmarks proposed by Argentina in January. The level of the fiscal deficit criterion for the next review was raised because the government missed the amount for the previous quarter due to deteriorating external conditions.
	May	Argentina requested an early review and modification of its 1999 performance criteria to address adverse external conditions. IMF Executive Board completed third review. The IMF Board found that Argentina had met all of its performance criteria as of March 1999 and agreed to adjust the performance criteria for the next review in light of external, cyclical changes.

Sources: Documents from the IMF, World Bank, Inter-American Development Bank, and Argentine government.

Macroeconomic Context When Current IMF Arrangement Negotiated

Argentina has undergone radical changes since 1991 when it enacted the Convertibility Law, which established the currency board arrangement. Under this system, the central bank maintains a sufficient level of U.S. currency to guarantee the convertibility of all outstanding Argentine pesos at the official exchange rate (1 peso equals 1 U.S. dollar).[3] The currency regime is seen as greatly helping to reduce Argentina's inflation from over 1,000 percent in 1990 to less than 1 percent in 1998, instill fiscal and monetary discipline, build investor confidence, and contribute to economic growth. The government also undertook major structural reforms between 1992-94, including substantial privatization, deregulation, trade liberalization, and pension reform. The Argentine government described the time from 1991-98 as periods of sustained growth interrupted by external shocks, including the Mexican financial crisis in 1995 and the Asian, Russian, and Brazilian crises in 1998. Argentina has had successive IMF programs since 1983. The previous arrangement was an IMF Stand-by Arrangement of over $900 million from April 1996 to January 1998.

According to IMF staff and the Argentine government, Argentina registered a strong macroeconomic performance in 1997. The economy grew very rapidly, the unemployment rate fell, and inflation was virtually zero. The fiscal position improved as programmed, and there were no major difficulties in financing a widening of the current account deficit. The prudent borrowing strategy (preborrowing at lower interest rates, stretching out maturities) followed by the public sector, and the strengthening of the banking system achieved in recent years, allowed Argentina to weather the turbulence that affected international capital markets in 1997 without major immediate consequences for the economy. Nonetheless, Argentina and the IMF decided an IMF financial assistance

[3]The currency board has governed Argentina's monetary policy since 1991. The currency board limits the government's ability to affect the money supply and exchange rates. While this arrangement provides comfort to foreign investors that their investments are protected from fluctuations in the exchange rate, the currency board significantly reduces the discretion of central bank authorities to influence the operation of Argentina's money supply. Argentina's money supply rises and falls with changes in the demand for the peso, with, for example the domestic money supply contracting if investors insist on converting their pesos into dollars. This arrangement ensures that Argentina will not have a balance-of-payments problem, since an "unsustainable" current account deficit will self-correct as investors refuse to finance it, the money supply contracts, interest rates rise, and aggregate demand declines, thus reducing imports and the current account deficit. However, this adjustment process could be very painful and occur due to factors unrelated to the Argentine economy, such as (1) a decline in export revenue, and thus a widening current account deficit, due to the economic contraction in a major trading partner such as Brazil; or alternatively, (2) generally reduced willingness of creditors to invest in developing economies stemming from the financial crises in Asia, Russia, and Brazil. Argentina has the ability to partially mitigate this effect by relaxing its exchange rate guarantee (holding up to one-third of its dollar reserves in government-issued, dollar-backed securities); however, such an approach could undermine the investor confidence generated by the currency board.

program was necessary because of risks to the economy posed by events in international financial markets.

Current Arrangement Intended to Be Precautionary

Argentina and the IMF Executive Board reached agreement on the current 3-year EFF arrangement in February 1998. This arrangement is intended to be precautionary, meaning that Argentina will draw IMF resources only if external conditions make it necessary. The government noted that the agreement is of great significance because the IMF's review of Argentina's accounts provides information to investors on the country's economic progress. The arrangement of about $2.8 billion is intended to support the government's medium-term economic reform program for 1998-2000 and to help maintain investor confidence. When Argentina negotiated this arrangement, the country did not have an actual balance-of-payments problem. The country's current account deficit had been increasing primarily due to its widening trade imbalance, with rising imports outpacing exports, but was funded with external capital. Foreign direct investment covered over 50 percent of the deficit in 1997 and was estimated to cover about 40 percent of the deficit in 1999. The IMF expressed concern about the sizable current account deficits expected over the next few years—although these deficits reflect to a large extent the growth of productive investment—and the economy's vulnerability to changes in external market conditions. The policies implemented to meet these targets were intended to promote sustained growth in production and employment, increase public saving, and reduce the vulnerability of the economy to disturbances on international financial markets. As of May 31, 1999, Argentina had not drawn resources under the current EFF arrangement.

IMF Program Focused on Fiscal Conditions and Structural Reforms

The current EFF arrangement includes quantitative conditions and structural benchmarks for the period 1998-2000. Consistent with the IMF's approach, the government and the IMF negotiated the performance criteria and structural benchmarks for the first year of the EFF; criteria and benchmarks for subsequent years have been negotiated on an annual basis. As agreed to for 1998, Argentina's program with the IMF contained quantitative performance criteria that limited the federal government budget deficit, central bank assets, and government debt. The structural benchmarks for Argentina included reforms in the labor market, tax system, public sector budgeting and operations, health system, and judicial system as well as the completion of the privatization program. The government and the IMF identified fiscal equilibrium and structural reform (particularly in tax and labor) as two of the most crucial elements of the program.

The Argentine government is on record as strongly supporting the conditions under the IMF program because they reflect the government's own priorities. According to the Argentine government, disagreements between the IMF staff and Argentina officials have been minor. One area of disagreement has been the significance of the current account deficit. While IMF staff is concerned about Argentina's increasing current account deficit, some government economic officials are less so. They contend that the current account deficit should not be overemphasized since it is due, in part, to investment-led growth and since external investors have been willing to finance it, thus signaling their confidence in Argentina's economy.

Quantitative Performance Criteria Focused on Fiscal Levels

As shown in table II.2, three of the four quantitative performance criteria focused on Argentina's fiscal policy. The fourth—limits on central bank assets—targeted Argentina's monetary policy.

Table II.2: Argentina's Quantitative Performance Criteria and Indicative Targets, 1998-2000, (Dollars in Millions, U.S.), as Agreed to in February 1998

	Dec. 1997 – Mar. 1998	Dec. 1997- June 1998	Dec. 1997- Sept. 1998	Dec. 1997- Dec. 1998	Dec. 1998- Dec. 1999[a]	Dec. 1999- Dec. 2000[a]
Quantitative performance criteria						
Cumulative federal government deficit	$ -1,400	$ -1,800	$ -2,750	$ -3,500	$ -2,650	$ -1,000
Cumulative change in net domestic assets of the central bank	-470	-530	-800	-800[b]	—	—
Net cumulative disbursements of public sector debt[c]	2,900	5,200	6,800	5,700[d]	—	—
Net cumulative increase in short-term debt	2,000	2,000	2,000	2,000	—	—
Indicative targets						
Expenditure target[e]	10,200	19,450	29,550	38,800	—	—
Combined deficit of the federal government and provinces	—	-2,175	—	-4,250	-3,250	-1,200

[a]The criteria for 1999-2000 were proposed by the government but were not subject to IMF approval since, under an EFF, only the targets for the first year of the program are set.

[b]The criterion could be adjusted by $200 million (to -$600 million) to reflect a temporary increase in the amount of government securities purchased from commercial banks. According to IMF staff, the "adjuster" accounts for central bank purchases of government securities from commercial banks in order to meet commercial banks' temporary liquidity needs during December. The central bank will sell the securities back to the commercial banks in January.

[c]The criterion limits the total increase in public-sector debt (external and internal).

[d]The criterion could be adjusted by up to $2 billion in overborrowing by the public sector and deposited in the central bank. According to IMF staff, the "adjuster" accounts for preborrowing by the public sector to meet 1999 financing needs. The IMF does not want to penalize the government for the preborrowing strategy, under which the government borrows funds at lower interest rates and longer maturities when possible, that has helped Argentina weather uncertainty in capital markets.

[e]The expenditure target sets the maximum level of government spending, excluding interest.

Sources: IMF and Argentine government documents.

The goals of the fiscal deficit criteria were to reduce the overall federal government deficit while increasing spending in social areas, stimulate domestic saving, and strengthen confidence in the continued viability of the currency convertibility regime. The $3.5 billion deficit represents about 1 percent of GDP, which was estimated at about $340 billion for 1998. The monetary program was intended to strengthen confidence in the currency board and the banking system by maintaining a sound financial system and providing for an adequate cushion of liquidity that could compensate for the limited role of the central bank as a lender of last resort.

Structural Benchmarks Covered Many Areas

Under the current EFF, the Argentine government agreed to meet the following structural benchmarks by the end of 1998:

Tax reform

- Submit to the Argentine congress a tax reform program before mid-1998 for approval before the end of 1998. Tax reforms were intended to improve the efficiency and equity of the tax system and promote the competitiveness of the economy. The reforms were aimed at contributing to a reduction in labor costs by cutting employers' payroll contributions, diminishing distortions in corporate and individual taxes, broadening the income tax base, applying the value-added tax to products not currently taxed, introducing a single tax to replace the value-added and income taxes due from small businesses, strengthening tax auditing procedures, and modifying customs codes in line with MERCOSUR (the Southern Common Market, or customs union) and World Trade Organization norms. The changes were generally focused on decreasing taxes on production and increasing taxes on consumption.
- Implement the first stages of a program to strengthen tax administration by revising penalties and interest on past due tax obligations to help normalize relations between taxpayers and tax authorities, privatizing collection of past due taxes, and introducing pre-shipment inspection of imports for the short term.

Labor market reform

- Implement labor reforms before mid-1998–a precondition for the conclusion of the first review. Increased flexibility in the labor market was intended to decrease unemployment, strengthen economic competitiveness, and ultimately ensure the viability of the currency convertibility regime. The reforms were to significantly reduce the costs of dismissing employees, eliminate statutes that impede the renegotiation of labor contracts (expired labor contracts remain legally binding if there is no agreement to renegotiate them between employers and unions) and inhibit entry into certain professions, eliminate certain temporary labor contracts, decentralize labor negotiations, and promote increased competition among union-run health care organizations.

Public sector administration

- Reform budgeting operations. The government was to submit a multiple-year budget for income, expenditure, and results covering a 3-year period, with the goal of providing transparency, efficiency, and control for budgetary administration.
- Take measures to promote efficiency in public spending, especially in education, public health services, and the social security and social assistance systems, and improve the quality of public sector administration. The measures were to include governance rules for public employees outlining obligations and increasing penalties for corruption.

Social sector reform

- Conclude reforms to the public social security system to help increase the efficiency of expenditures.
- Continue reforms to the health insurance system for retirees and health care organizations (public and private), as agreed with the World Bank, in order to strengthen health care, contain the demand for high-cost hospital care, and promote efficiency in health services.

Judicial

- Take steps to speed up rulings in court cases involving taxes and financial guarantees and collateral.

Privatization

- Grant leases for airports, telecommunications frequencies, and power stations.
- Draft proposals to privatize Banco de la Nación, the country's largest bank.

Financial/corporate governance

- Revise legislation to help financial institutions more quickly execute guarantees and collateral, and to develop a legal and supervisory framework for financial derivatives.
- Approve new antitrust laws.

First Review: Argentina Met All Performance Criteria; Mixed Progress on Structural Reforms

The IMF Executive Board completed the first review of Argentina's program in September 1998, as scheduled. It found that all applicable quantitative performance criteria were met in March and June 1998 and that substantial progress had been made in the implementation of structural reforms, with the notable exception of labor market reforms. Argentina's congress passed some of the intended labor market reforms; it passed legislation lowering dismissal costs but did not pass legislation intended to make the collective bargaining process more flexible. The IMF Board urged the Argentine authorities to take further steps in regard to labor market reform, noting that the reform recently approved by Argentina's congress fell short of what would be necessary to enhance labor market flexibility and reduce labor costs adequately. The IMF Board also expressed concern over the possible adverse impact of the Russian debt crisis on Argentina's access to external financing and urged the authorities to maintain firm macroeconomic policy to help promote a rapid improvement in market confidence.

Second Review: Argentina Met Most Performance Criteria; Mixed Progress on Structural Reforms

According to IMF and Argentine documents for the second review, completed as scheduled in March 1999, Argentina met all but one of its quantitative performance criteria[4] (for which a waiver was granted) and made progress on structural reforms. The waiver was requested because the federal government deficit, estimated at $3.85 billion in 1998 (1.1 percent of GDP), exceeded its ceiling by about $350 million, or around 0.1 percent of GDP.[5] However, IMF staff viewed the deviation as minor, primarily due to adverse external factors, and as not detracting from overall fiscal performance. The government noted that, significantly, the structural deficit for 1998 was smaller than that of 1997. The IMF Executive Board granted the waiver. According to the Argentine government, its efforts to contain expenditures could not compensate fully for the revenue shortfall. The shortfall mainly reflected the slowdown of

[4] At the time of the second review, the IMF adjusted two other performance criteria—addressing central bank assets and public sector debt—in line with previously agreed-to levels due to factors beyond the government's control.

[5] The government also noted that the indicative target on aggregate provincial deficit is estimated to have exceeded the ceiling by 0.2 percent of GDP, reflecting the combined effects of the tax revenue shortfall and higher than programmed expenditures by some provinces.

economic activity in the second half of 1998 and its adverse effect on taxes, particularly the value-added tax. The government noted that debt limits were met in the context of tighter conditions in international capital markets. A larger than anticipated share of the deficit was financed using public sector deposits and receipts from asset sales.

Argentina made progress in several areas of structural reform, according to IMF and country documents. The government implemented most of the tax reforms but was only able to pass some of the intended labor reforms. The government implemented tax reforms that, among other things, expanded the bases of the income and value-added taxes and improved tax administration by enhancing tax audit procedures and hastening the resolution of court cases involving tax enforcement. Regarding labor reforms, Argentina's congress approved a law to reduce dismissal costs and eliminate most forms of temporary labor contracts with decreased social security contributions. Reforms regarding collective bargaining were not passed. While IMF staff stressed the importance of making Argentina's labor market more flexible—particularly given the uncertainty about continued access to foreign financing and trade levels—they told us that they do not expect the government to complete the remaining labor reforms before the fall 1999 elections. As such, according to IMF staff, the emphasis on labor reforms is likely to be eased. Argentina continued making reforms to budgeting operations, public sector administration, and the public hospital system. Restructuring of the health-care system continued, as agreed with the World Bank. The government completed leasing arrangements for airports and continued working on leasing arrangements for telecommunications frequencies, which were delayed by judicial challenges, and power stations. It concluded reforms to the public social security system.

New Criteria and Benchmarks

In January 1999, the government outlined its proposed objectives, criteria, and benchmarks for the second year of the arrangement. The government intends to continue to focus its economic policies on promoting sustainable growth in output and employment, addressing priority social needs, and maintaining low inflation and a viable external position. The government noted that in light of the presidential election scheduled for October 1999 and the uncertainty of the adverse international environment, it recognized the critical importance of maintaining disciplined and restrained macroeconomic policies, further improving public finances, strengthening the financial system, enhancing competitiveness, and deepening structural reforms. In March 1999, Argentina and the IMF reached agreement on the quantitative performance criteria and structural benchmarks for monitoring the country's progress during 1999, as shown in table II.3.

Table II.3: Argentina's Quantitative Performance Criteria and Indicative Target for 1999, (Dollars in Millions, U.S.), as of March 1999

	Jan. 1999 – Mar. 1999	Dec. 1997- Sept. 1998	Dec. 1998- Dec. 1999	Dec. 1999- Dec. 2000
Quantitative performance criteria				
Cumulative federal government deficit	$ -1,300	$ -1,675	$ -2,300	$ -2,950
Cumulative ceiling on noninterest expenditures of the federal government	9,500	18,800	28,700	38,050
Cumulative change in net domestic assets of the central bank[a]	-200	-325	-590	-690
Net cumulative disbursements of public sector debt[b]	2,500	5,200	5,200	4,000
Net cumulative increase in short-term debt	1,000	1,000	1,000	1,000
Indicative target				
Combined deficit of federal government and provinces	—	-2,475	—	-4,400

[a]The criterion will be adjusted upwards by the equivalent to any purchase from the IMF. The measurement of net domestic assets throughout the year will be adjusted to reflect any difference between the end-1998 stock of swaps and projected levels. The measurement for December 1999 will also be adjusted downward for up to $300 million to account for temporary liquidity needs reflected in an equivalent increase in swaps.

[b]The measurement of disbursements will be adjusted to reflect any difference between actual privatization receipts and projected levels.

Sources: IMF and Argentine government documents.

The estimated cumulative federal government deficit between January 1999 and December 1999 was increased from $2.65 billion to $2.95 billion (0.8 percent of GDP) to reflect the criterion missed in the previous quarter. The ceiling on the noninterest expenditures of the federal government was changed from an indicative target to a quantitative performance criterion because, according to IMF staff, there was concern about the sufficiency of tax revenues.

Many of the new structural benchmarks continue ongoing reforms. By the third review (August 1999) the Argentine government is to

- present a proposal to reform the system of tax-revenue sharing with the provinces. In light of the fiscal deficit, IMF staff stressed the importance of achieving this reform. The reform of the tax-sharing arrangement between the government and the provinces is intended to strengthen the provinces' own revenue-raising capacity and design a more equitable, transparent, and flexible system of intergovernmental transfers.
- lease telecommunication frequencies.
- implement new monitoring systems for the external debt and the finances of provincial administrations.

- implement the enabling regulations for the labor statute for small- and medium-size firms.
- submit to the Argentine congress a proposal to transform the Banco de la Nación into a state-owned corporation. This benchmark represents a change from the government's original intention to privatize the bank. When it appeared that congress would not approve the privatization of the bank, the authorities decided to propose the transformation of the bank into a state-owned corporation that could include private capital and management, be listed in the stock exchange, and thus be subject to increased public disclosure requirements.
- submit to the Argentine congress a proposal to further reform social security.
- complete the sale of the first package of shares of the National Mortgage Bank.

Also, by August 1999, the Argentine congress is to approve

- the proposed changes to the central bank charter and the financial entities law, which are intended to improve banking supervision and risk assessment of financial institutions; and
- the fiscal responsibility law, which sets limits on government indebtedness, constrains the growth of public expenditure, and establishes a fiscal stabilization fund to smooth out the impact of cyclical fluctuations or external shocks on tax revenue. The government intends to improve the efficiency of social spending in education and social protection programs.

By the fourth review (Feb. 2000), the Argentine government is to

- implement the tax administration program aimed at, among other things, shifting to a new electronic tax filing and collection system; strengthening auditing procedures; and amending the customs code, after congressional approval, to incorporate MERCOSUR (the Southern Common Market, or customs union) norms and new World Trade Organization valuation rules; and
- eliminate the 3 percent import surcharge to the common external tariff.

Also by this time Argentina's congress is to approve the social security reform and new law for Banco de la Nación.

The key factors affecting Argentina's short-term macroeconomic outlook were the need for improvements in trade and the continued availability of private-sector capital. Argentina recorded a satisfactory macroeconomic performance in 1998, in a relatively difficult international macroeconomic environment. However, the economy slowed considerably in the second half of 1998, in response to the tightening of external financing conditions in the wake of Russia's and Brazil's financial crises and the slowdown in export earnings. For 1998, GDP growth was estimated at about 4.2 percent, down from 7 ¼ percent in the first half of the year. Since mid-January 1999, the external macroeconomic environment (trade and investment) has deteriorated because of adverse events in Brazil. The program agreed to in March 1999 (including quantitative performance criteria for 1999) was negotiated in December 1998, consistent with the external environment at that time. Argentina and IMF officials noted that the country had weathered the turbulence in external markets well; however, given the uncertain environment, the government and the IMF agreed to reexamine the program and modify it, if needed.

Third Review Accelerated; Performance Criteria Modified

The third review was conducted 3 months ahead of schedule in order to reevaluate the assumptions underlying the 1999 program and modify the performance criterion in light of the deterioration in the external environment since the program was negotiated. Despite the decline in Argentina's economic activity and current account balance, preliminary information indicated that the country made progress on the structural reforms and met the quantitative performance criteria for end-March 1999. However, GDP in 1999 is expected to decline by 1.5 percent (from the previously projected gain of 2.5 percent), which is expected to significantly reduce federal government revenues from the previous estimate by about $2.5 billion.

Argentine government officials and IMF staff noted that while the government was able to compensate for the revenue shortfall in the first quarter of 1999, fully compensating for the total estimated shortfall through additional spending cuts would seriously impair the quality of public services and aggravate the economic downturn. The government therefore requested an increase in the 1999 federal deficit performance criterion from $2.95 billion (0.8 percent of GDP) to $5.1 billion (1.5 percent of GDP), an increase of $2.15 billion, or about 70 percent, from the amount agreed to in March 1999. The increase reflects about 85 percent of the expected shortfall of $2.5 billion, with the government expected to absorb the remainder. Attaining the new level will require cuts in government expenditure, including spending for social programs.

The deficit level was increased to help ensure that additional government borrowing to finance the deficit does not crowd out private-sector borrowing or raise uncertainty about the government's commitment to fiscal discipline. To help achieve the new target, the ceiling on the noninterest expenditures of the federal government is to be lowered by $450 million. The debt ceiling was raised in line with the increase in the deficit in order to accommodate additional borrowing. The modified performance criteria are shown in table II.4.

Table II.4: Argentina's Proposed Quantitative Performance Criteria and Indicative Target for 1999, (Dollars in Millions, U.S.), as of May 1999

	Jan. 1999 – Mar. 1999	Jan. 1999 – June 1999	Jan. 1999 – Sept. 1999	Jan. 1999 – Dec. 1999
Quantitative performance criteria				
Cumulative federal government deficit	$ -1,300	$ -2,850	$ -4,200	$ -5,100
Cumulative ceiling on noninterest expenditures of the federal government[a]	9,500	18,750	28,450	37,600
Cumulative change in net domestic assets of the central bank[b]	-200	-325	-590	-690
Net cumulative disbursements of public sector debt[c]	2,500	6,800	7,350	6,150
Net cumulative increase in short-term debt	1,000	1,000	1,000	1,000
Indicative target				
Combined deficit of federal government and provinces	—	-3,750	—	-6,800

[a]The amount will be adjusted upward in excess of the projections of tax refunds. This "adjuster" is intended to limit delays in granting refunds, which could create additional revenue and thus create room for increasing expenditures. The maximum cumulative adjustment will be $50 million, $250 million, and $450 million in the second, third, and fourth quarters, respectively.

[b]The amount will be adjusted upwards by the equivalent to any purchase from the IMF. The measurement of net domestic assets throughout the year will be adjusted to reflect any difference between the end-1998 stock of swaps and the projected level of $275 million. The measurement for December 1999 will also be adjusted downward for up to $300 million to account for temporary liquidity needs reflected in an equivalent increase in swaps.

[c]The measurement of disbursements will be adjusted to reflect any difference between actual privatization receipts and projected levels. The amount of debt for December 1999 will be adjusted downward for any borrowing up to $2.5 billion related to financing requirements for the year 2000 deposited at the central bank.

Source: Argentine government document.

The Argentine government recognized the importance of reinvigorating the structural reforms to improve economic efficiency and strengthen market confidence. Many of the new structural benchmarks continue or accelerate ongoing reforms. By the third review (May 1999) the Argentine government is to

- present a proposal to reform the system of tax-revenue sharing with the provinces.
- implement new monitoring systems for the level and composition of the financing to the provincial administrations.

- submit to the Argentine congress a proposal to transform the Banco de la Nación into a state-owned corporation.

By the fourth review (November 1999) the Argentine government is to

- submit to the Argentine congress a proposal to reform social security.
- implement a new monitoring system for conditions of access by commercial banks to external credit lines.
- submit to the Argentine congress a proposal to reform the tax code.
- lease telecommunication frequencies.

Also by November 1999, the Argentine congress is to approve the fiscal convertibility law and the changes to the central bank charter and the financial entities law.

The IMF's Financial Arrangement with Brazil

Summary

The turbulence in international financial markets hit Brazil especially hard in the fall of 1998. Brazil's capital account came under serious pressure in the wake of the Russian crisis and Brazil's foreign currency reserves declined substantially. To shore up confidence in its economy, Brazil negotiated a 3-year program with the IMF, which was announced in November 1998.[1] It consists of a 3-year Stand-by Arrangement (SBA), supplemented in the first year by the Supplemental Reserve Facility (SRF), for a total amount equivalent to about $18 billion.[2] The IMF Executive Board approved Brazil's program on December 2, 1998, and Brazil received its first disbursement of $4.6 billion.

The second disbursement was scheduled for February 1999 after the IMF completed the first and second reviews of Brazil's progress in implementing the program.[3] Because of continued problems in Brazil's economy and a new exchange rate regime after the first disbursement, Brazil's IMF program needed to be revamped before a second disbursement would be made available. At the time of the combined SBA and SRF reviews, Brazil did not meet one of four quantitative performance criteria (meeting a ceiling on net domestic assets of the central bank). The IMF Executive Board granted a waiver for not meeting this criterion and approved the revised program on March 30, 1999, thereby opening the way for the next disbursement. Brazil received $4.9 billion from the IMF on April 6, 1999.

The cornerstones of Brazil's IMF program, as announced in November 1998, were strong improvement in Brazil's public finances, the acceleration of the congressional approval of structural reforms, and maintenance of its exchange rate regime that was pegged to the U.S. dollar. The program combined a large up-front fiscal adjustment of over 3 percent of gross domestic product (GDP) with reforms of social security, public

[1] Brazil's IMF program is part of a package of international financial support totaling about $41 billion.

[2] The stand-by credit is equivalent to 600 percent of Brazil's IMF quota. To help finance Brazil's financial drawings from the IMF during the first year, the IMF also approved the first activation of the New Arrangements to Borrow. The New Arrangements to B orrow came into effect in November 1998. According to the IMF, it is designed to supplement resources available to the IMF to cope with an impairment of the international monetary system or deal with an exceptional situation that poses a threat to the international system. Of the total credit, 70 percent is to be made available under the SRF and the remainder through the IMF's regular lending facilities.

[3] According to the IMF, the completion of the first and second reviews simultaneously was required due to the fact that Brazil had received funds under two different policies, a credit tranche and the SRF. The second disbursement could have been drawn as a floating (second) tranche in December 1998, if needed, after the first review had it been requested by the Brazilian government. Had that happened, the first and second reviews would not have taken place simultaneously. However, Brazil did not request a drawing of this floating tranche, and so the first and second reviews were carried out together.

administration, public expenditure management, tax policy, and revenue sharing. Although the Brazilian government was successful in passing many of the promised fiscal measures or instituting interim offsetting measures, delays in passing some of the fiscal measures, combined with reports that a state governor was unwilling to service his state's debt to the federal government, further eroded market confidence and resulted in additional loss of reserves. Brazil was forced to devalue its currency on January 13, 1999, and then float its currency, the real, on January 15, 1999. IMF mission staff began meeting with Brazilian officials in late January to design a modified program, which was then announced in early March.

Brazil's revised program requires strengthened fiscal adjustment and replaces the exchange rate as the nominal anchor of the monetary system with a monetary policy targeted at securing low inflation. Fiscal policy aims to reduce the net public debt to GDP ratio to 2 percentage points below the original target of 46.5 percent by the end of 2001. The original program's comprehensive structural reform agenda, in such areas as social security, civil service reform, tax policy, budgetary procedures, and fiscal transparency, has been enhanced. The government also intends to accelerate and broaden its privatization program.

Table III.1 outlines a brief chronology of key events in Brazil's current IMF arrangement.

Table III.1: Chronology of Key Events in Brazil's Current IMF Arrangement

Date	Event
Aug. 1998	Brazil's capital account comes under pressure in wake of Russian crisis; significant reserve outflows
Sept. 1998	Brazil began talks with the IMF and announced that it would prepare a 3-year fiscal program aimed at stabilizing the net debt to GDP ratio.
Nov. 13, 1998	Brazil and the IMF announce agreement on Brazil's 3-year arrangement and an $18 billion IMF commitment (as part of a larger $41.5 billion international financial support package)
Dec. 2, 1998	IMF Executive Board approves Brazil's arrangement, opening the way for Brazil's first disbursement of $4.6 billion
Jan. 13, 1999	Brazil's central bank widens *real* trading band, thereby allowing an 8 percent devaluation ($3 billion currency outflow)
Jan. 15, 1999	Brazil's central bank allows *real* to float free of the trading band in foreign exchange markets (results in an additional 12 percent devaluation)

Date	Event
Feb. 1999	Completion of the first and second reviews of the IMF program scheduled
March 8, 1999	Announcement of agreement between the IMF and Brazil on a revised IMF program
March 30, 1999	IMF Executive Board approves the revised IMF program, opening the way for Brazil's second disbursement
April 6, 1999	Brazil receives second disbursement of $4.9 billion

Source: GAO analysis of IMF and other documents.

Brazil's November 1998 IMF Program

In August 1998, Brazil's capital account came under serious pressure in the wake of the Russian crisis. The Brazilian authorities responded with a sharp increase in interest rates; significant fiscal measures, including substantial spending cuts; and strengthening of institutional mechanisms to monitor developments in public finances and take further timely corrective actions, if needed. The IMF Managing Director said he was encouraged by the determination of Brazil's president to give high priority to further fiscal reforms. Brazil also began a dialogue with the IMF to ensure that adequate financial support could be arranged quickly, if needed. The government of Brazil saw the nature of the IMF program as preventive—to assist the country in facing a period of deep uncertainty in international financial markets and to enable the government to continue gradual depreciation of the exchange rate without having to move to a floating currency system.

IMF Program Announced

A 3-year IMF program was announced in November and approved by the IMF Executive Board on December 2, 1998. The IMF program represented one portion of a larger support package totaling about $41.5 billion made up of commitments from the World Bank; the Inter-American Development Bank; and bilateral financing from 20 countries, in most cases to guarantee credits extended to Brazil by the Bank for International Settlements.

When the program was announced in November, the IMF stated, in its press release, that the program first and foremost addresses the chief source of Brazil's external vulnerability—namely its chronic public sector deficit (5-7 percent of GDP). The reduced savings of the public sector necessitated a growing resort to external savings to finance the rise in domestic investment, leading to an increase in the current account deficit of the balance of payments from under 0.5 percent of GDP in 1994 to over 4 percent of GDP in 1997.

The IMF Arrangement and the Objectives of the Conditionality Program

The IMF program is supported by a 3-year SBA, augmented in the first year by the SRF, for a total amount equivalent to about $18 billion. Around 70 percent of the funds were to be under the SRF. Brazil received its first disbursement of $4.6 billion in early December. The second disbursement was scheduled for February 1999 after completion of the first and second reviews; however, due to the events in January, it was delayed until after the revamped program was agreed upon by the IMF Executive Board on March 30, 1999.

The November 1998 IMF program had four program objectives:

- a frontloaded fiscal adjustment effort (with most of the fiscal adjustment expected to occur in the first half of 1999) aimed at arresting quickly the rapid growth of public sector debt;
- maintenance of the exchange rate regime that existed at the time;
- a tightly controlled monetary policy, aimed at supporting the exchange rate regime that existed at the time, while safeguarding net international reserves; and
- wide-ranging structural reforms.

IMF Program Comprised Fiscal, Structural, and Monetary Reforms

The economic program was centered on fiscal adjustment and structural reform. The macroeconomic scenario underlying the fiscal program assumed that confidence would be rebuilt gradually as measures were implemented and began to improve Brazil's fiscal accounts and as access to foreign financing improved.

Elements of the Fiscal and Monetary Adjustment Program

The initial program had fiscal, external sector, and monetary targets. These were a mixture of quantitative performance criteria and indicative targets.[4] The fiscal targets were

- a performance criterion for the "public sector borrowing requirement," which set ceilings on the "cumulative borrowing requirement" of the consolidated public sector through June 30, 1999;[5]

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[4] Quantitative performance criteria are macroeconomic indicators that the IMF requires a borrower country meet in order to qualify for the next disbursement. Indicative targets are also macroeconomic indicators, which the IMF uses to monitor a country's performance, but disbursements are not contingent on their being met.

[5] The cumulative borrowing requirement of the public sector is defined as the sum of the cumulative borrowing requirements of the federal government, state and municipal governments, and the public enterprises; the federal government includes the central government, the social security system, and the Brazil Central Bank (BCB). The respective borrowing requirements are measured in Brazilian Reais (R$), as the sum of total net financing from all sources, including, among others, changes in cash balances of the public sector.

- an indicative target that set a minimum on the primary surplus of the primary balance of the federal government; and
- an indicative target that set a minimum floor on the recognition of nonregistered public sector debt net of privatization proceeds.

The fiscal quantitative performance criteria were intended to stabilize the ratio of the net public debt to GDP by the year 2000 and then reduce it gradually thereafter. Under these assumptions, the public sector borrowing requirement would decline to about 4.7 percent in 1999, to about 3 percent in the year 2000, and to 2 percent in 2001. The bulk of this adjustment was planned at the federal level; however, the states and municipalities were expected to shift their consolidated primary balance from an estimated deficit equivalent to 0.4 percent of GDP in 1998 to a surplus of 0.4 percent of GDP in 1999, rising to 0.5 percent in the years 2000 and 2001. The main elements behind the assumption of the state and local governments' primary balance improvement were the implementation of the administrative reform laws and the firm enforcement of their debt restructuring agreements with the federal government. The fiscal adjustment program had both revenue-raising and expenditure-reducing measures designed to yield overall budget savings of 3.4 percent of GDP in 1999.

Revenue measures to achieve the indicative target on the primary balance of the federal government included

- increases in the financial transactions tax rate from 0.2 percent to 0.3 percent with a temporary surcharge of 0.08 percent for 1999;
- an increase in the rate of the tax on corporate turnovers from 2 to 3 percent, one-third of which is to be creditable against the corporate income tax;
- an increase of 9 percentage points in the contribution to the public sector pension plan by civil servants earning more than R$1,200/month;
- the extension of this contribution to public sector pensioners (at the rate of 11 percent for those with pensions of R$1,200/month or less and of 20 percent for the others); and
- a number of other measures aimed mainly at widening the bases of existing taxes and contributions, and eliminating distortions.

Expenditure measures included substantial cuts in discretionary current and capital spending and savings expected from implementation of already approved constitutional reforms of the civil service and social security.

The external sector targets were

- a performance criterion on external debt of the nonfinancial public sector, which set a ceiling on the stock of this debt;[6]
- a performance criterion that set a ceiling on new publicly guaranteed external debt;[7]
- an indicative ceiling on total short-term external debt disbursed and outstanding; and
- a floor on net international reserves in Brazil's Central Bank (BCB).[8]

The monetary target was a performance criterion that set a ceiling on net domestic assets in the BCB.[9]

The goal of monetary policy was continued low inflation. The BCB intended to continue to apply a flexible interest rate policy as appropriate while safeguarding foreign exchange reserves, and to rely on indirect policy instruments to guide short-term interest rates. The government, with the support of the IMF, intended to maintain the pegged exchange rate regime with a gradual widening of the exchange rate band and to keep the increase in public sector external debt within prudent limits, around US$10 billion in 1999.

The Program Contained Varied Structural Reforms

While Brazil's program does not contain structural performance criteria, it did include a variety of structural benchmarks and measures to address long-standing weaknesses in the budget process; the tax system and tax administration; public administration; social security; and the efficiency of public expenditure, especially in the social area. Table III.2 outlines the

[6] The nonfinancial public sector includes the central, state, and municipal governments, the public enterprises, and the social security system. Excluded from measured debt stocks are any liabilities incurred in the context of the proposed financing package, either vis-à-vis the IMF or bilateral lenders.

[7] The limit applies to all private external debt guaranteed by the public sector. The public sector includes the nonfinancial public sector (as defined above), the BCB, and the financial public sector.

[8] The net international reserves in the BCB are measured in terms of the balance of payments concept of the net international reserves and include gross official reserves minus gross official liabilities.

[9] This performance criterion is to be calculated on the basis of the following definitions: net domestic assets in the BCB are defined as the difference between the monetary base and the net international reserves in the BCB valued in Brazilian Reais (R$). The monetary base consists of currency issued and total reserves on demand deposits of financial institutions. Total reserves on demand deposits include both required reserves and free reserves. The net international reserves are equal to the balance of payments concept of net international reserves in the BCB. This performance criterion indicates the maximum level of net domestic assets in the BCB. There are adjusters applied to the net domestic asset ceilings (for an increase in the rate of the contribution on funds transfers; for changes in the required reserve ratio on demand deposits; for changes in the reservable base of demand deposits; and for an unforeseen loss of net international reserves).

various structural reforms contained in Brazil's November 1998 IMF program.

Table III.2: Structural Reforms Contained in Brazil's November 1998 IMF Program

Type of Reform	Description
Budget process reform	Reforms aimed at strengthening budget discipline at all levels of government–Fiscal Responsibility Act to be submitted to the Brazilian Congress by December 1998.
Social security reform	A set of new legislative initiatives to be presented to the Brazilian Congress in the first quarter of 1999 based on the principle of actuarial balance.
Tax reform	Legislation to be presented to the Brazilian Congress before the end of 1998 to address weaknesses in Brazil's current indirect tax system, which is viewed as inefficient and unduly complex.
Administrative reform	Passage of enabling legislation already submitted to the Brazilian Congress to ensure administrative reform already passed begins to produce effects in 1999.
Labor market reform	The government sent to the Brazilian Congress a proposal for constitutional reform that reduces restrictions on unions and creates incentives for public collective bargaining.
Privatization	Programs focused in public utilities (electrical sector; and some water, gas, and sewage public utilities) and state banks.
Social expenditure programs	The government intends to give priority to primary education and basic health care in the allocation of social expenditures, to promote the more efficient use and financing of health and education, and to better target social expenditures to the poor.
Banking reforms	Reduction in the share of total deposits of the Brazilian financial system held by state banks to about 7 percent by end-1999. All remaining state banks are to be subject to the same regulatory and supervisory scrutiny as private banks. Legislative and supervisory framework–considerable strides have been made in implementing the 25 basic principles of the Basle Committee, and the government believes that Brazil can be fully compliant by the year 2000. Addition of a stand-by facility to the deposit insurance fund to improve its finances. Measures to speed up the resolution of failed banks and to increase asset recovery rates.
Brazilian economic statistics improvements	Subscribe to the Special Data Dissemination Standards as soon as technically feasible.

Source: IMF documents.

Trade-related Elements of the Program

The government committed to continue the policy of trade liberalization by doing the following:[10]

- promoting the integration of the Brazilian economy with those of its MERCOSUL (the Southern Common Market, or customs union) and other regional trading partners;
- increasing trade with countries outside the region; and
- not imposing trade restrictions or restrictions including for balance of payments reasons

The government also said it would continue to promote the competitiveness of Brazil's exports through steps aimed at leveling the playing field for Brazilian exporters, thus facilitating access to financing and to export credit insurance.

Prior Actions Contained in the November Program

The following prior actions were included in the November 1998 IMF agreement:

- By end-November 1998, increase the rate of the financial transactions tax to 0.38 percent for 1999 is to be under consideration by the Brazilian Congress.
- For completion of the first review (which was scheduled by month-end February 1999, but could have been advanced to December 15, 1998), enact revenue and expenditure measures sufficient to give confidence that the fiscal program targets for 1999 are likely to be met, and enact the constitutional amendment for social security reform, for both the private sector social security system and the federal public sector social security system.

Brazil's Progress in Implementing the Program's Components

The government of Brazil was initially successful in implementing many of the elements of the fiscal package that were the core of its program. Prior to the approval of the Stand-by Arrangement by the IMF Executive Board on December 2, 1998, it had successfully guided through the Brazilian Congress, the constitutional amendment on social security reform and an increase in the tax on corporate turnover. However, the proposed measure to increase the social security contribution on active civil servants and extend it to retired ones, was not approved in early December, and the government's efforts to pass the financial transactions tax were delayed. These were requirements under the November IMF program. In response to delays in getting an increase in the financial transactions tax, the

[10] See International Monetary Fund: Trade Policies of IMF Borrowers (GAO/GGD/NSIAD-99-174, June 22, 1999) for a further description of Brazil's trade-related conditions.

government increased taxes on corporate profits and financial operations by executive decree.

In early January 1999, a few Brazilian state governors demanded better payment terms on their debt payments to the federal government, and one declared a moratorium on these payments (24 of Brazil's 27 state governors have agreements with the federal government whereby, in exchange for fiscal adjustment, the federal government has assumed their debt, rescheduled it over the long term, and agreed to charge preferential interest rates). This action precipitated the most recent crisis and put pressure once again on Brazil's exchange rate, with major outflows of international reserves.

In early January 1999, the president of the central bank resigned. On January 13, his successor then widened the real's trading band. This action effectively devalued the currency by 8 percent. Massive currency outflows followed, and 2 days later Brazil gave up defending its currency and let the real float. This action, in turn, resulted in an immediate devaluation of another 12 percent.

Progress continued on implementation of the fiscal program in January. After the real was allowed to float and new negotiations began with the IMF, Brazil's Congress passed a law increasing the pension contribution of civil servants, which had been rejected previously. Brazil also approved a bill to increase the financial transactions tax, which had been delayed before. Both of these measures were requirements of the November IMF program. The BCB raised interest rates even further to try to encourage investors to keep their money in Brazil.

Completion of the First Review Was Delayed Slightly

Under Brazil's arrangement with the IMF, completion of the first and second review was scheduled to take place no later than the end of February 1999; however, due to the change in the exchange rate regime that was pegged to the U.S. dollar and the currency devaluation, Brazil and the IMF delayed the review completion until March. As a result, Brazil did not receive an additional disbursement as scheduled in February.

In addition to negotiating revisions to the economic program with the IMF, Brazilian officials also negotiated voluntary support commitments with their creditor banks. According to the IMF's Managing Director, this effort was integral to the success of the program and was seen as a key factor in the IMF Executive Board's consideration of the program in late March. Brazilian officials reached the necessary agreement in mid-March. In the voluntary agreement, banks agreed to keep trade and interbank credit lines at end of February levels until the end of August.

Revised Program Announced in March

On March 8, 1999, the IMF's Managing Director announced his intention to recommend to the IMF's Executive Board the approval of the revised economic program for 1999-2001 proposed by the Brazilian government. The amount of support to be provided by the IMF portion and the total package, including that provided by multilateral banks and bilateral financing, remained the same. The key elements of the revised program are strengthened fiscal adjustment and, in light of the floating exchange rate, the adoption of a new nominal anchor for monetary policy. The additional fiscal improvement and a firm monetary policy are expected to limit the impact of the currency depreciation on prices in the first half of 1999 and to facilitate a decline in the annualized monthly inflation rate to single digits by the end of the year. Brazil's balance of payments is expected to improve as capital inflows recover and Brazil capitalizes on its improved competitiveness.

The IMF's Executive Board approved the revised program on March 30, 1999, thereby opening the way for Brazil's next disbursement. Brazil requested and was granted a waiver of nonobservance of one performance criterion—the ceiling on net domestic assets in the BCB. According to IMF officials, the nonobservance of the performance criterion was the result of a premature easing of monetary policy.

Fiscal and Monetary Elements of the Revised Program

Like the initial program, the revised program contains fiscal, external sector, and monetary targets, some of which are the same as previous criteria or indicative targets and others of which are different. According to the IMF, the changes were the result of two factors: (1) understandings that were formulated in an informal way under the original program were made into performance criteria, and (2) the reformulation of the program required different performance criteria on technical grounds.

The two fiscal targets are different from the initial program. They consist of:

- a performance criterion that set a floor on the cumulative primary balance of the consolidated public sector[11] and

[11] The public sector is defined to comprise the central government, state and municipal governments, and the public sector enterprises (including federal, state, and municipal enterprises). The central government includes the federal government, the social security system, and the BCB. The cumulative primary balance of the public sector is defined as the sum of the cumulative primary balances of the entities that make up the public sector.

- an indicative target that set a ceiling on the total net debt outstanding of the consolidated public sector.[12]

The government intends to steadily reduce the ratio of public debt to GDP to below 50 percent by end-1999, and to below the value initially projected in the November 1998 program for the end of 2001 (46.5 percent). The government expects to accomplish this through higher than originally targeted primary surpluses of the consolidated public sector in the next 3 years. The government intends to increase the targeted primary surplus to at least 3.1 percent of GDP in 1999, 3.25 percent of GDP in the year 2000, and 3.35 percent of GDP in 2001. According to the IMF, the need for higher primary surpluses comes from the higher interest bill that resulted from the currency being devalued. Hence, to achieve the same debt-GDP ratio, primary surpluses needed to be higher.

As in the initial program, the additional fiscal adjustment is to be achieved through a range of revenue-raising measures and expenditure cuts. This effort will be concentrated at the federal level, but the state and local governments are expected to contribute through the implementation of their debt restructuring agreements with the federal government and by complying with the requirements of the administrative reform laws.

The first two external sector targets were the same as in the initial program, while four more performance criteria were added:

- a performance criterion that set a ceiling on the total external debt of the nonfinancial public sector,
- a performance criterion that set a ceiling on new publicly guaranteed external debt,
- a performance criterion that set a ceiling on total short-term external debt of the nonfinancial public sector,[13]
- a performance criterion that set a limit on net sales of foreign exchange by the BCB,[14]

[12] The total net debt outstanding of the consolidated public sector equals the public sector's gross debt net of its financial assets.

[13] This criterion applies to all external debt (disbursed and outstanding) of the nonfinancial public sector with original maturities of strictly less than 1 year. According to the IMF, this performance criterion replaced an indicative target under the original program that covered all public debt. This more narrow definition allowed it to be a performance criterion.

[14] According to the IMF, this performance criterion is similar in purpose to the net international reserves floor of the original program.

- a performance criterion on the BCB's exposure in foreign exchange futures markets,[15] and
- a performance criterion on the BCB's exposure in foreign exchange forward markets.[16]

The monetary target is the same—a performance criterion that sets a ceiling on net domestic assets in the BCB;[17] however, in the view of Brazil's government, monetary policy became a more important component in the revised program. The overriding objective of monetary policy is securing low inflation. The BCB intends to put in place as quickly as feasible a formal inflation-targeting framework. This is expected to take some time and in the meantime, it intends to rely on a quantity-based framework under which it will target its net domestic assets.

Structural Benchmarks and Reforms in the Revised Program

According to IMF documents, the Brazilian government has reaffirmed its commitment to the wide-ranging program of structural reforms included in the November program in such areas as social security, taxation, fiscal transparency, and the financial sector. In most of these areas the government believes it has already made significant progress. Accelerating and broadening the scope of the privatization program is also a goal of the revised program. In addition, the government remains committed to the policy of trade liberalization (summarized in the November 1998 program) adopted by Brazil's President. Table III.3 shows the structural benchmarks contained in the revised program.

[15] This performance criterion says the BCB will refrain from entering into any new operations in the foreign exchange markets.

[16] This performance criterion says that the BCB will refrain from entering into any foreign exchange futures contracts. According to the IMF, Brazil never had any exposure in foreign exchange forward markets. This performance criterion was added to clarify this issue.

[17] A number of adjusters apply to this performance criterion. The first is an adjuster for net international reserves being below the baseline, up to a certain amount According to the IMF, this is to allow for a limited amount of sterilized intervention in the event of unforeseen capital outflows. Sterilized intervention in foreign exchange markets does not affect a nation's money supply; rather, it offsets any monetary expansion or contraction from the intervention through domestic monetary policy tools. The two other adjusters are for changes in the required reserve ratio on demand deposits, and for changes in the reservable base of demand deposits.

Table III.3: Structural Benchmarks in Brazil's March 1999 Revised IMF Program

Completion date	Structural benchmark
By end-May 1999	Submission to the Brazilian Congress of a law on the complementary private pension system. Submission to the Brazilian Congress of an ordinary law on the pension system for private sector workers. Presentation to the Brazilian Congress of the Fiscal Responsibility Law.
By end-August 1999	Issuance of new regulation on the foreign exchange exposure of banks, in conformity with international standards in this area. Acceptance of the obligations under Article VIII, sections 2, 3, and 4 of the IMF's Articles of Agreement, with a definite timetable for removing any remaining restrictions (if any). Proposal of an action plan for statistical improvements that will permit Brazil's subscription to the Special Data Dissemination Standards.[a] Submission to the Brazilian Congress of the multi-year plan that incorporates improvements in the budgetary process along the lines described in the November 1998 program. Implementation of the remaining administrative improvements in the social security system, as described in the November 1998 program.
By end-November 1999	Submission to the Brazilian Congress of an ordinary law on the pension system for public sector workers. Privatization of a number of state-owned banks. Implementation of a regulation for the institution of a capital charge related to market risks, based on the Basle Committee (in line with technical assistance from the World Bank). Implementation of a forward-looking loan classification system that takes into account the capacity of borrowers to repay (and in accordance with technical assistance from the World Bank).

[a]The Special Data Dissemination Standards have been developed by the IMF to guide members in the provision of macroeconomic and financial data to the public.

Source: IMF documents.

The IMF's Financial Arrangement with Indonesia

Summary

Indonesia[1] negotiated a $10.1 billion[2] (special drawing rights (SDR) 7,338 million),[3] 36-month Stand-by Arrangement (SBA) with the IMF in the fall of 1997.[4] At the time, Indonesia faced the loss of confidence of financial markets demonstrated by a sharp currency depreciation, a fall in equity prices, a decline in foreign currency reserves, and a substantial fall in its capital account. Although Indonesia had had real GDP growth averaging 7 percent annually since 1970, investors concerned about the 1997 currency devaluation in Thailand also became concerned about structural conditions in Indonesia. These concerns included long-standing weaknesses in the financial system; restrictive domestic trade regulations; import monopolies; and substantial, short-term, foreign-currency-denominated, private sector debt in need of refinancing, along with concerns about political transition, drought, and the resulting need to import food. The deep-seated nature of the balance of payments and structural problems facing the economy had become increasingly apparent to IMF officials, who believed a thorough restructuring of the banking and corporate sectors was needed for the economy to recover from the crisis.

The IMF’s initial package of conditions in November 1997 called for various monetary, fiscal, structural, and other reforms. Monetary policy was to be tight to stabilize the exchange rate and foreign currency reserves. Once this was achieved, interest rates could be eased. Fiscal policy started off with a budget surplus, but became increasingly deficit oriented as the economic situation worsened. More so than in previous IMF programs with other countries, structural reforms took a central role. The initial IMF program and subsequent modifications attempted to restructure insolvent financial institutions, promote competition in the domestic economy, strengthen social safety nets, and address deficiencies in governance in financial, corporate, and government sectors. At one

[1] Indonesia had a population of 202 million in 1997, had a nominal gross domestic product (GDP) of about $211 billion in 1997, and had a per capita income of about $1,047 in 1997, according to IMF.

[2] This amount was augmented twice in July 1998 and March 1999 for a total amount available to Indonesia of $12.2 billion as of April 13, 1999.

[3] U.S. dollar amounts are computed from SDR amounts based upon annual averages for the SDR/dollar exchange rate. For example, in 1997 one SDR was equivalent to $1.3760. For 1998 the rate was $1.3655 and $1.3807 for the first part of 1999.

[4] The announced amount of assistance for Indonesia was $23 billion of which $10 billion was from IMF, $4.5 billion from the World Bank, $3.5 billion from the Asian Development Bank, and $5 billion in central bank use of reserves. In addition, some countries—the United States, Australia, Brunei Darussalam, China, the Hong Kong Special Administrative Region, Japan, Malaysia, and Singapore--indicated that if necessary they would make available supplemental financing. Bilateral commitments amounted to over $18 billion. The tentative supplemental commitment from the United States was for $3 billion from the exchange stabilization fund (ESF).

point, structural policy commitments in Indonesia's program with the IMF comprised 117 distinct items.[5]

Between November 1, 1997, and April 30, 1999, the IMF's financial arrangements with Indonesia went through nine letters of intent[6] and six reviews and evolved from an SBA to an Extended Fund Facility (EFF), which allows Indonesia more time to repay the IMF. IMF officials told us that in most cases new letters of intent reflect further development and elaboration of the reform program rather than substantial revisions of the program. Economic, social, and political developments following Indonesia's initial letter of necessitated program revisions—these adjusted conditions were documented in new Indonesian letters of intent. Although parts of the structural program have evolved over time, the structure of the financial sector program was revised twice.

Continued access to IMF funds was contingent on meeting quantitative performance criteria dealing with levels of currency reserves, the stock of short-term debt contracted by the government of Indonesia or guaranteed by Indonesia's public sector, and other criteria. Accessibility of funds was also contingent on an evolving set of structural performance criteria dealing with the financial sector, domestic economic regulation and monopolies, and food prices. These performance criteria changed as economic and social conditions evolved, specific criteria were met or not met, and new criteria were added.

In four of the six program reviews, the IMF Executive Board granted waivers for nonobservance of performance criteria. In each of these four cases, waivers on structural measures were requested and received. In one case a waiver was granted for nonobservance of financial targets.

At least twice, scheduled disbursements were rephased to reduce the amounts of funds available and spread the disbursements out over a longer period of time. The completion of four of the IMF reviews was delayed, and access to funds was temporarily withheld until Indonesia made additional progress in implementing conditions. IMF officials told us that only two reviews were significantly delayed—the first and second reviews under the SBA. Reviews completed under the EFF, although concluded

[5] Structural policy commitments, terms used in the Indonesian letters of intent, are policy actions that the government of Indonesia agrees to take within a certain timeframe. Structural performance criteria and benchmarks are a subset of the larger group of structural policy commitments.

[6] Letters of intent are prepared by the member country. They describe the policies that a country intends to implement in the context of its request for financial support from the IMF.

shortly after their scheduled completion, were broadly on schedule. These short delays in completion of reviews under the EFF, reflect provision of extra time to implement key actions or scheduling constraints given the frequency of reviews. As of March 25, 1999, a total of $9.38 billion (SDR 6.793 billion) had been disbursed from the $12.2 billion of potentially available IMF funds. Disbursements were made at 8 points in time—2 on approval of the SBA and EFF and 6 disbursements were subject to reviews. (See table IV.1 for a chronology of events related to IMF conditionality in Indonesia.)

Table IV.1: Chronology of Selected Events in Indonesia's Current IMF Arrangement

Year	Month	Day	Events
1997	July	2	Thailand ceases to maintain the exchange rate peg for the baht
	August	14	Bank Indonesia allows its currency, the rupiah, to float
	October	8	Indonesia seeks IMF aid to alleviate its financial difficulties
		31	Indonesia requests IMF assistance and announces the first letter of intent under the SBA
	November	1	Indonesia closes 16 insolvent banks and places marginal banks under conservatorship or intensified supervision
		5	IMF Executive Board approves a 3-year SBA equivalent to $10.1 billion (SDR 7.338 billion). Supplemental financing commitments included $18 billion as a second line of defense if the IMF money was not sufficient. Indonesia receives a $3.0 billion (SDR 2.201 billion) disbursement
	December	30	Two-thirds of the banks, representing over one-half of the banking system assets, experience runs on their deposits
		31	Government announces plans to restructure the state-banking sector through mergers and privatization

Year	Month	Day	Events
1998	January	12	Senior IMF officials visit Indonesia to consult with the President on an acceleration of reforms
		15	Indonesia announces the second letter of intent under the SBA
		26	Indonesia announces a comprehensive program to rehabilitate the banking sector and put into place a framework for creditors and debtors to deal, on a voluntary and case-by-case basis, with the external debt problems of corporations
	March	1	Sixth Cabinet is dissolved
		6	President reelected
		15	Scheduled completion of first review under the SBA
		10	Indonesia announces third letter of intent under the SBA
	April	4	The IMF Executive Board approves completion of the first review under the SBA. Indonesia receives a $995.7 million (SDR 734 million) disbursement
	May	21	President resigns after several days of rioting, with fatalities reportedly numbering close to 1,000
	June	4	Agreement reached with private creditors in Frankfurt, Germany, covering restructuring of interbank debt, a trade facility, and a framework for restructuring corporate debt
		15	Scheduled completion of second review of the SBA
		24	Indonesia announces fourth letter of intent under the SBA

Year	Month	Day	Events
1998	July	15	The IMF Executive Board completes the second review of the SBA, disbursing $995.7 million (SDR 734 million), and approves an increase in IMF financing under the SBA by $1.37 billion (SDR 1 billion). IMF announces that additional multilateral and bilateral financing for the program will be made available, in part through an informal arrangement among bilateral creditors that involved debt rescheduling or the provision of new money—for total additional financing of more than $6 billion, including the increase in IMF funding
		29	Indonesia requests SBA be replaced by an EFF. Letter of Intent outlines first program under the EFF
	August	21	The government of Indonesia announces a major bank restructuring package that covers banks with almost half banking system assets
		25	IMF Executive Board approves a request to replace the SBA with an EFF. This program would last 26 months in the amount of $6.336 billion (SDR 4.67 billion) and would be 312 percent of quota. Indonesia receives a $995.7 million (SDR 734 million) disbursement
	September	9	Announcement of Jakarta Initiative—a framework designed to promote voluntary restructuring of corporate debt
		11	Indonesia announces second letter of intent under the EFF
		23	Agreement reached on the rescheduling or refinancing of Indonesia’s bilateral external debt to official creditors
		25	Scheduled and actual completion of first review of EFF. Indonesia receives a $928.26 million (SDR 684.3 million) disbursement
	October	19	Indonesia announces the third letter of intent under the EFF
		24	IMF staff submits and IMF Executive Board approves completion of second review under the EFF. Indonesia receives $928.26 million (SDR 684.3 million)
		25	Scheduled completion of second review of the EFF
		30	IMF Executive Board approves completion of second review of the EFF.
	November	6	Indonesian receives a $928.26 million (SDR 684.3 million) disbursement
		13	Indonesia issues fourth letter of intent and memorandum of economic and financial policies
	December	15	Scheduled and actual completion of third review of the EFF. Indonesia receives a $879 million (SDR 648 million) disbursement
1999	February	15	Scheduled completion of fourth review under the EFF
	March	16	Indonesia announces its fifth letter of intent under the EFF.
	March	25	Completion of the fourth review under the EFF and approval of a request for augmentation of $985.8 million (SDR 714 million). This was the first bimonthly review. Indonesia receives $465.3 million (SDR 337 million).
	June	7	Scheduled completion of the fifth review under the EFF $465.3 million (SDR 337 million) available at disbursement.

Source: GAO analysis of IMF documents.

Condition of Indonesia Prior to Its Financial Crisis—Years of Growth and Low Inflation

Until its recent financial crisis—starting in mid-1997—Indonesia had 30 years of real economic growth, averaging 7 percent annually, with annual inflation held continuously below 10 percent in the previous 2 decades. Over the past 2 decades, the incidence of poverty was greatly reduced, assisted by improvements in primary education, effective health care, and family planning. Poverty rates declined from 70 million people in 1970 to 22.5 million in 1996. Universal primary school education was achieved in the 1980s.

Indonesia's economic performance over the past several decades ranked among the best in the developing world. GDP per capita income was rising toward the level of middle-income countries. The economic structure had become diversified, as dependency on the oil sector had declined. An export-oriented manufacturing sector had emerged led by a dynamic private sector and fueled by high domestic savings and large inflows of foreign direct investment. Prior to the regional market turbulence in 1997, Indonesia's macroeconomic situation appeared by many measures reasonably sound: the budget was in balance, inflation had been contained to single-digit levels, current account deficits were low, and international currency reserves were at a comfortable level. This strong economic performance helped attract large capital inflows.

These achievements masked persistent underlying structural weaknesses in the economy, however, that made Indonesia vulnerable to adverse developments. Extensive domestic trade regulations and import monopolies impeded economic efficiency and competitiveness. Indonesia had many commodities with restrictive marketing arrangements and many state enterprises. A government agency—the State Logistics Agency—had a monopoly over the importation of essential food items, a domestic market monopoly, and the ability to restrict prices on these food items. A lack of transparency in decisions affecting the business environment and data deficiencies increased uncertainty and adversely affected investor confidence.

Indonesia had a banking system that had expanded too rapidly and was not prepared to withstand the financial turmoil that affected Southeast Asia in the latter half of 1997. Too many weak banks had larger than normal levels of nonperforming loans, foreign exchange risk, concentrated bank ownership, large exposures to risks in the property sector, and connected lending—lending to related companies. Furthermore, Indonesia had a large, unhedged, private, short-term foreign currency debt prompted by large differentials between domestic and foreign interest rates. Indonesian corporations were heavily exposed to such debt and thus were vulnerable to the adverse effects of a currency depreciation. Growth in short-term foreign liabilities outpaced growth in available international currency reserves. Also, a severe drought in 1997, the year leading up to the crisis, created a need for large food imports.

Following the widening of the intervention band[7] on July 11, 1997, the rupiah was allowed to float on August 14. By October 1997, the rupiah had depreciated significantly as the regional financial crisis deepened. The sudden rise in the rupiah value of the foreign-currency-denominated loans and increased interest rates that ensued placed the banking and corporate sectors under enormous stress. At the time, Indonesia faced the loss of confidence of financial markets demonstrated by a sharp currency depreciation, a decline in foreign currency reserves, and a substantial fall in its capital account.

Initial SBA—Monetary, Fiscal, and Structural Conditions

On October 31, 1997, Indonesian authorities requested and on November 1, 1997, the IMF granted a 3-year SBA equivalent to $10.1 billion (SDR 7,338 million).[8] The typical SBA is designed to provide short-term, balance-of-payments assistance for deficits of a temporary or cyclical nature. The IMF granted Indonesia the right to draw the funds provided Indonesia met the conditions of the program. Drawings were scheduled in 13 disbursements but were to be substantially front-loaded with $3.0 billion (SDR 2,201 million) disbursement on November 5, 1997, and an equivalent amount to be released on March 15, 1998. Interest charges were levied on a quarterly basis—at a rate slightly above the SDR interest rate. Repayments of principal under this arrangement were to be in eight quarterly installments beginning 39 months after disbursement and ending 60 months after disbursement. The principal justification for such large access was that the availability of sizable external financing would catalyze a speedy return to confidence and the resumption of normal capital market financing. Subsequent releases of $785.4 million (SDR 579 million) were to be available on June 15, September 15, and December 15, 1998. Amounts of $206.8 million (SDR 149.8 million) were to be released at eight times during 1999 and the year 2000, according to the IMF.

[7] Bank Indonesia set a central rate for the Indonesian currency, the rupiah, based on a basket of foreign currencies and intervened in the foreign exchange market to buy or sell rupiah at an intervention band around the central rate. The intervention band was gradually depreciated to offset the inflation differential between Indonesia and its main trading partner countries. The intervention band was widened three times in 1996.

[8] As of April 30, 1999, Indonesia has an IMF quota of $2.9 billion (SDR 2,079.3 million). IMF holdings of rupiah are $12 billion (SDR 8,726.7 million) or 419.7 percent of quota. The reserve position in the IMF is $200.9 million (SDR 145.5 million).

Tentative Financing From the U.S. Exchange Stabilization Fund

On October 31, 1997, the Treasury Secretary indicated that the United States was prepared to provide contingent additional financial support that could be made available for a temporary period, if necessary, to supplement the resources made available by the IMF. This support was to be conditioned on the implementation of an appropriate set of macroeconomic and structural policies supported by the IMF, the World Bank, and the Asian Development Bank. The Treasury Secretary said that the United States was prepared to provide up to $3 billion in assistance from the ESF.[9] No negotiations on a possible ESF arrangement were ever concluded. No legal agreement was reached concerning such financing. In the event an agreement had been reached, provision of funds could occur only upon a determination by the U.S. Treasury that conditions for a drawing had been met. No money from ESF was ever disbursed to Indonesia, according to the U.S. Treasury.

IMF Objective and Program Design

According to the IMF and documents we reviewed, the overarching objective of the IMF financial arrangement was to restore market confidence and reverse the decline in external financing. The rupiah depreciation and loss of confidence in Indonesia following the Thai crisis was far more severe than IMF staff expected. The assistance package was formulated in the context of an urgent need to deal with the sharp depreciation of the currency and avert a prolonged deterioration in the economic situation. The crisis exposed and intensified underlying weaknesses in the financial sector and structural impediments in the economy. There was concern about the large private sector external debt and whether a significant portion of this maturing debt would be renewed in the short term. Thus, the package was designed to stabilize exchange market conditions, ensure an orderly adjustment of the external current account in response to lower capital inflows, and lay the groundwork for a resumption of sustained, rapid growth. The program sought to reduce the current account deficit to 2 percent of GDP and maintain gross official reserves at about 5 months of imports. The IMF's initial package of conditions in November 1997 called for various monetary, fiscal, structural, and other changes.

Monetary and Exchange Rate Policy Included High Interest Rates

Monetary policy was designed to strengthen the rupiah-dollar exchange rate and limit increases in inflation. High interest rates were intended to make rupiah-denominated investments more attractive to domestic and foreign investors, leading to a greater demand for the rupiah and an increase in its value. In the period immediately following the

[9] The U.S. Treasury can use ESF to provide loans, credits, guarantees, and reciprocal currency arrangements.

announcement of the program, Indonesian authorities were to tighten liquidity. If the rupiah appreciated, then interest rates could be eased. Authorities were allowed to intervene in the foreign exchange market to resist downward pressure on the exchange rate. However, it was not seen as appropriate to deplete reserves in an effort to resist pressure on the rupiah, however, so there were limits on foreign exchange intervention.

Fiscal Policy Aimed For a Budget Surplus

The aim of fiscal policy was to preserve a budget surplus, despite a slowing of the economy, by reducing low-priority expenditures and implementing new revenue measures. The program targeted a budget surplus of about 1 percent of GDP in 1997/1998 and 1 percent in 1998/1999 to facilitate external adjustment and provide resources to pay for financial restructuring. The fiscal measures involved cutting what were seen as low-priority expenditures, including postponing or rescheduling major state enterprise infrastructure projects; reducing government subsidies; eliminating value added tax exemptions; and adjusting administered prices, including the prices of electricity and petroleum products.

Financial Sector Restructuring Involved Closing and Merging Banks

A key component of the Indonesian authorities' reform and stabilization program was financial sector restructuring that would address the financial system weaknesses that underlay the crisis. The first step in restructuring was to separate nonviable institutions from the rest of the banking system. Insolvent banks were to be closed and placed under receivership. Special teams of banking experts were to take over these institutions, liquidate assets, and repay liabilities. State banks were to be merged. A timetable was to be developed for dealing with the remaining weaknesses in the financial sector.

The second step in restructuring was to establish proper procedures and policies to deal with weak but viable institutions. Banks were to develop rehabilitation plans—outlining sources of new funding and changes in ownership and management—and the plans were to be evaluated by Bank Indonesia, Indonesia's central bank. Banks without plans to restore solvency and bring them into conformity to prudential regulation were to be closed and placed under receivership.

The third step in restructuring was to resolve specific problems of state and regional development banks. The goal was to make sure that the banks were safe and sound and reduce the risks to the government's budget of ensuring their capital adequacy. Some state banks were to be merged, while others were to be privatized. A rehabilitation plan for regional development banks was to be developed so that they could adopt commercial banking practices—institutions that could not be strengthened in 1 year were to be closed.

The final step in restructuring was to improve the institutional, legal, and regulatory framework for banking operations. Laws governing the central bank, bank operations, bank liquidation, and bankruptcy were to be revised according to best international practices. Loans by Bank Indonesia to illiquid but solvent banks were to be fully collateralized. Bank Indonesia was to strengthen prudential regulations and supervision to reduce connected lending.

Other Structural Reform Included Dismantling Monopolies

Another part of the package concerned removing structural impediments to economic activity and further deregulation of the domestic economy. Reform measures included liberalizing of foreign trade and investment, dismantling monopolies and price controls, allowing greater private sector participation in the provision of infrastructure, and expanding the government's privatization program.[10] Numerous barriers still stood in the way of both imports and exports, significant sectors were not open to foreign investment, and extensive regulation restrained domestic competition. Tariffs on items already subject to tariffs were to be further reduced. Nontariff barriers such as quantitative import restrictions were to be diminished as well. Also, the scope of the tariff program was to be broadened by incorporating a number of major items previously excluded. Export taxes were to be lowered. Domestic competition was to be enhanced through deregulation and privatization. In addition five agricultural commodities controlled by the National Logistic Agency and subject to price controls, production controls, and distribution monopolies were to be deregulated.

Progress Was to Be Measured by Quantitative and Structural Performance Criteria

Indonesia's implementation of the initial program was to be measured by both quantitative and structural performance criteria. Quantitative performance criteria were

- a ceiling on the growth of the outstanding stock of base money,[11]
- a cumulative floor on the overall central government balance,[12]
- a floor on net international reserves,[13]

[10] For a more detailed description of trade conditions, see International Monetary Fund: Trade Policies of IMF Borrowers (GAO/NSIAD/GGD-99-174, June 22, 1999).

[11] This is the currency in circulation, bank deposits at Bank Indonesia, private sector demand deposits at Bank Indonesia, aggregate debt balances at Bank Indonesia, and the aggregate reserve deficiency.

[12] This is the negative of the sum of (1) net foreign borrowing, (2) change in net credit from the banking system, and (3) net financing from all other sources to the government.

- a ceiling on the contracting or guaranteeing by the public sector of new nonconcessional external debt with an original maturity of more than 1 year, and
- a ceiling on the stock of short-term external debt contracted or guaranteed by the public sector.

Targets on base money and international reserves were to provide measures of the effectiveness of monetary policy. Targets on the central government balance, a limit on public sector contracting or guaranteeing of new debt with a maturity of more than 1 year, and a limit on the stock of short-term debt were to provide a measure of the effectiveness of fiscal policy.

Structural performance criteria were

- the closure of banks placed under intensified supervision or conservatorship that did not submit rehabilitation plans or whose plans were not approved by Bank Indonesia by end-December 1997,
- the establishment of quantitative performance criteria for state-owned banks by end-December 1997,
- the issuance of implementation regulations on procurement and contracting procedures by end-December 1997,
- an increase in prices of petroleum products to eliminate subsidies by end-March 1998, and
- a rise in electricity prices of 30 percent by end-March 1998.

Other structural measures were benchmarks by which program progress was measured but upon which the availability of IMF funding was not contingent. Benchmarks included financial, corporate, regulatory, and government reforms. The first IMF review of the IMF's arrangement with Indonesia was to be March 15, 1998. Three billion dollars (SDR 2,201.5 million) were to be available from the IMF at that time. IMF staff recommended to the Executive Board that the IMF should support Indonesia's policy program because, in part, Indonesia had a record of taking prompt corrective actions in the face of adverse external developments and had a sound capacity to repay the IMF.

[13] This is the sum of (1) the dollar value of gross foreign assets in foreign currencies minus gross liabilities in foreign currencies, (2) the net forward position of Bank Indonesia, and (3) reserves against foreign currency deposits.

Program Revisions and Board Reviews of the SBA—Progress and Problems

A series of letters of intent issued by the government of Indonesia and program reviews by the IMF of the SBA followed. The SBA had 4 distinct letters of intent that documented program changes that took account of changing economic and social factors in Indonesia. The IMF reviewed the SBA twice during the November 1997-August 1998 time period. Fund disbursements were delayed twice over the course of the SBA—Indonesia's access to funds associated with the completion of the first and second reviews was withheld. At the end of the first review funding was rephased so that amounts available for disbursement were reduced and reviews were changed from quarterly to monthly. The initial Stand-by program was not successful in restoring confidence in the economy. By August 25, 1998, the SBA had been replaced by an EFF.

According to IMF documents, the first IMF Stand-by program with Indonesia met with some initial success, as confidence appeared to be boosted by the tightening of liquidity and exchange market intervention. But financial market sentiment soon began to sour. This deterioration of market sentiment reflected the government's failure to follow through quickly on the policy measures. The closing of 16 banks while other weak banks continued operation also contributed to a loss of confidence. Indonesia's promise to carry out a tight monetary policy was derailed by a strong liquidity expansion to deal with runs on banks. There was also political uncertainty triggered by concerns about the health of the President. Foreign creditors refused to roll over maturing credit lines, and pressure on the exchange rate intensified. By early January 1998, the rupiah had undergone a cumulative depreciation of some 75 percent from pre-crisis levels. This created severe tension in both the corporate sector and banking sectors.

Second Stand-by Letter of Intent—Implementation Commitment and Detailed Banking and Corporate Conditions

On January 15, 1998, the Indonesian authorities released a new letter of intent which included major revisions to their economic program and addressed new conditions. The new measures were designed to reverse the decline of the rupiah before it triggered a surge in inflation and a wave of corporate bankruptcies. Key changes from the previous program included a commitment to implement a tight monetary program, and to accelerate deregulation and trade reform. In late January, the program was strengthened with the introduction of a comprehensive bank restructuring program—to be implemented by a new agency called the Indonesian Bank Restructuring Agency (IBRA) and the announcement of a voluntary scheme to restructure private corporate debt.

Market reaction to the January 15 letter of intent was swift and negative. Shortly after the announcement of the new letter of intent, the rupiah was depreciating rapidly and had lost a cumulative 85 percent of its value compared to 7 months earlier. Owing to difficulties in implementing required policy changes following the announcement of the second letter of intent under the SBA, continuing uncertainty about the government's commitment to elements of the program, and other developments, the rupiah failed to stabilize, inflation picked up sharply, and economic conditions deteriorated. Base money grew rapidly, fueled by Bank Indonesia's liquidity support for financial institutions. Moreover, program implementation was sidetracked by a February announcement that the government was considering the introduction of a currency board as a means of stabilizing the rupiah. There was widespread international concern that Indonesia's financial and credibility crisis would make such a measure extremely risky. IMF officials viewed a currency board as inappropriate for Indonesia at this time because they were concerned about the rupiah's credibility and sustainability—especially at an exchange rate far above the prevailing market rate—in light of ongoing capital outflows.[14] Decisive policy action was also inhibited by preparations for the change in government after a March presidential election. The economic downturn deepened, while inflation accelerated sharply. Against this background, as well as the need to await the appointment of a new cabinet in the wake of the reelection of the President, the first IMF quarterly review was delayed.

First Review of SBA—Access to IMF Funds Temporarily Withheld

The first quarterly review was scheduled to be completed on March 15, 1998, and was to be tied to targets for December 1997 according to the IMF. However, the review was not completed—and hence additional funds were not available to Indonesia—until May 4, 1998. During February and March 1998, only limited progress was made in implementing the revised program. There had been a precipitous depreciation of the exchange rate and a large-scale outflow of capital. The banking sector and the private corporate sector were basically insolvent. Consumer prices increased 39 percent in the first quarter of 1998. In addition, Indonesia's overall external payments position deteriorated sharply, especially the capital account, because of a decline in new inflows, the reluctance of foreign creditors to roll over bank and corporate external debt, and the repatriation of portfolio investment. IMF officials were concerned that, without a strong adjustment effort, Indonesia would encounter an even more severe crisis and a deepening recession.

[14] See Lane, Ghosh, Hamann, Phillips, Schulze-Ghattas, and Tsikata. "IMF Supported Programs in Indonesia, Korea and Thailand: A Preliminary Assessment." Washington, D.C.: IMF, Jan. 1999.

Bank Indonesia had lost control over monetary policy in the first quarter of 1998. Monetary policy was dominated by the crisis in the banking system, with liquidity support provided to the banks reflecting the drawdown in foreign currency deposits, the reduction of credit lines by foreign banks, a shift into foreign currency from rupiah deposits, losses on forward contracts, and higher nonperforming loans. Moreover, Bank Indonesia had been hurt by the complete turnover of staff in the most senior positions. To deal with the crisis, foreign experts were appointed to a monetary panel to help strengthen implementation of monetary policy. The budget, too, was adversely affected by the deterioration in the economic environment, experiencing substantial revenue losses and increased outlays. Furthermore, government decrees designed to dismantle cartels and open up markets were delayed and circumvented in several sectors, which raised concern about the government's commitment to the IMF program.

None of the five quantitative performance criteria required for completion of the first review were met, and only one of four structural performance criteria was implemented. Quantitative performance criteria were not observed on base money and public sector short-term debt outstanding at end-December 1997 and end-March 1998. Quantitative performance criteria were also not observed on the government balance and net international reserves at end-March 1998.

One structural performance criterion was completed on schedule—that Indonesia issue implementation regulations on procurement. Two structural performance criteria were superseded by the creation of IBRA—the closure of banks under intensified supervision and the establishment of performance criteria for state-owned banks. Two performance criteria were pending and were expected to be implemented by end-June 1998—increases in petroleum prices and increases in electricity prices.

The Indonesian government requested waivers for the nonobservance of the performance criteria. IMF staff supported granting these waivers in view of actions undertaken prior to the proposed completion of the review and the proposed actions of Indonesian authorities included in the revised program. Originally $3 billion (SDR 2,201.5 million) was to be available for Indonesia, but this amount was restructured so that equal amounts of $1 billion (SDR 733.8 million) were to be available each month over the next 3 months. On May 4, 1998, the IMF Executive Board granted the waivers and Indonesia received a $995.4 million (SDR 733.8 million) disbursement. At that point the IMF moved from scheduling quarterly to monthly reviews of the arrangement.

Third Stand-by Letter of Intent—117 Structural Policy Commitments

On April 10, 1998, the IMF and the government of Indonesia issued a third letter of intent to address the far-reaching changes that had occurred in political, social, and external circumstances. The new program complemented and modified the program outlined in the previous letter of intent. According to IMF documents, the economic situation had deteriorated since the beginning of 1998: prices had increased, the government's budget was under severe pressure as a result of the decline in economic activity, subsidies were needed to protect low-income groups from the rise in prices of staples and essentials due to the depreciation of the rupiah, restructuring the banking system was costly, and international oil prices had declined. In addition, the financial position of the domestic banking system had dramatically deteriorated and Bank Indonesia had granted very large-scale liquidity support. Furthermore, foreign banks had cut trade and other credit lines to Indonesian banks.

The revised program built on the program specified in the previous letter of intent but placed more emphasis on debt strategy, banking system restructuring, privatization, and bankruptcy procedures. The revised program comprised 117 structural policy commitments covering fiscal issues, monetary and banking issues, bank restructuring, foreign trade, investment and deregulation, a social safety net, the environment, and other issues.

The program required sharply raising interest rates to secure a sustained appreciation of the rupiah and strict control over the net domestic assets of Bank Indonesia. Liquidity support to banks was to be brought firmly under control. The program included an accelerated strategy for restructuring the banking system—including the takeover of seven banks that accounted for most of the liquidity support and raising the capital levels of healthier banks. The cost of bank restructuring was estimated to be 15 percent of GDP. The revised program also sought reform of bankruptcy procedures. It required a revised budgetary framework, with higher subsidies for some food and other items to soften the impact of the currency depreciation on the poor, as well as funds to cover the costs of bank restructuring. The revised program outlined a framework for restructuring private corporate debt with limited government support.

This letter of intent shifted one quantitative performance criterion—the monetary policy target—from base money to net domestic assets because the net domestic assets of Bank Indonesia had been the source of monetary instability. The change was made because of the necessity of bringing under control the rapid expansion of central bank credit to banks with liquidity problems, according to Indonesian government documentation. Other quantitative performance criteria remained, with targets changed. New structural performance criteria were to

- merge Bank Bumi Daya and Bank BAPINDO and transfer problem loans to the asset management unit of IBRA by end-June 1998;
- initiate sales of additional shares in listed state enterprises including, at a minimum, the domestic and international telecommunications corporations by end-September 1998; and
- reduce export taxes on logs and sawn timber to 20 percent by end-December 1998.

New or strengthened structural policy commitments[15] since January 15, 1998, included

- raising profit transfers to the budget from state enterprises including Pertamina—the state oil company,
- publishing key monetary data on a weekly basis,
- appointing high-level foreign advisors to Bank Indonesia to assist in the conduct of monetary policy,
- setting minimum capital requirements for banks of rupiah 250 billion after loan loss provisions,
- providing external guarantees to all depositors and creditors of all locally incorporated banks,
- establishing IBRA,
- transferring 54 weak banks to IBRA,
- transferring claims resulting from past liquidity support from Bank Indonesia to IBRA,
- announcing 7 enterprises to be privatized,
- submitting to Parliament draft law on competition policy, and
- establishing a monitoring system for structural reforms.

Second Review of the SBA—Access to IMF Funds Temporarily Withheld

The second review of the SBA was scheduled to be completed on June 15, 1998, but the review and the subsequent disbursement of $995.4 (SDR 733.8 million) was delayed by about a month. The social unrest that boiled over in mid-May and culminated in the resignation of the president. There were runs on Indonesia's largest private bank, and unemployment and inflation started to rise dramatically. The country was seen as facing an extremely severe and rapidly deepening systemic economic crisis. As a result, the review was completed on July 15, 1998. Indonesia did not have access to additional IMF funds during the delay period.

[15] Availability of IMF funds was contingent on satisfaction of quantitative and structural performance criteria but not on structural policy commitments.

According to IMF documents, the April 1998 program had gotten off to a good start. Monetary performance was kept within program targets specified in the April letter of intent, even though liquidity support to banks was higher than expected. Banks requiring most of Bank Indonesia's liquidity support were put under the control of IBRA. New bankruptcy procedures were enacted, and restrictions on foreign investment in wholesale trade were lifted.

However, IMF documentation shows that the social disturbances and political change in May 1998 derailed the April program despite generally good policy implementation. Arson, rioting, and looting in Indonesia undermined business confidence and damaged the distribution system. Business confidence was shaken, capital flight resumed, and the rupiah depreciated sharply pushing many corporations and banks further into insolvency. GDP fell by 8.5 percent in the first quarter of 1998 and by 7 to 8 percent in the second quarter of 1998. The banking system was paralyzed—unable or unwilling to lend to corporations—and the corporate sector was deeply insolvent. According to MF documents, at this time, the Indonesian economy faced the risk of falling into an even deeper systemic crisis, with normal financial market mechanisms breaking down completely, banks unwilling to lend to insolvent corporations, and access to international markets denied.

Despite this situation, Indonesian officials reported that Indonesia had met three of the four IMF quantitative performance criteria. For example, they judged the structural performance criterion to increase petroleum prices and eliminate subsidies to have been met because petroleum prices had been raised on average by 38 percent, although the increase in kerosene prices was subsequently rescinded to assist poor households. Data on two quantitative performance criteria were not available—the end-June performance criteria on the contracting or guaranteeing of new external debt and the stock of public sector short-term debt outstanding.

Indonesia met the end-June 1998, structural performance criteria to raise fuel and electricity prices according to an agreed schedule. One of the structural performance criteria was not met—the end-June 1998, merging of two banks and the transfer of problem assets to the asset management unit of IBRA were delayed. The Indonesian government requested a waiver for its nonobservance. The IMF staff supported this request because the preparatory work took longer than anticipated, and the merger was expected to take place by end-July 1998. The IMF staff also supported Indonesia's request to waive the applicability of the other quantitative and structural performance criteria that were not met. On July 15, 1998, the

IMF Executive Board granted the waivers and Indonesia received a $995.4 million (SDR 733.8 million) disbursement. At this time, the government of Indonesia requested and the IMF's Board approved a $1.4 billion (SDR 1 billion) augmentation of the SBA.

Fourth Stand-by Letter of Intent—Strengthening the Social Safety Net

On June 24, 1998, the government of Indonesia issued a fourth letter of intent to address the prevailing economic conditions. Although the overall objectives and policy content of the revised program remained the same as in previous letters of intent, the new program was to be substantially revised to reflect the deterioration in the economic situation, and the emphasis placed on some IMF conditions changed to some extent. The economy faced a serious crisis as a result of the social and political upheavals in May. Tight monetary policy was thought necessary to prevent hyperinflation. The new monetary program envisaged no increase in base money or net domestic assets. The budget was the area where major changes were made to the IMF program, including requirements for a substantially increased subsidy bill for basic foodstuffs, petroleum products, and electricity; greater expenditures for health and education; and expansion of employment-creating projects. Deficit spending was expected to amount to more than 8 percent of GDP—with the recognition that this deficit was not sustainable and would need to be reduced as the economy recovered. The bank-restructuring strategy—focused on putting in place as quickly as possible a core functioning banking system—envisioned an increased role for foreign advisors. A revised strategy was added to assist the resolution of the problems of the corporate sector through the establishment of the Indonesian Debt Restructuring Agency (INDRA), which was designed to provide exchange rate protection for restructured debts.

A strengthened social safety net to cushion the escalating effects of the crisis on the poor was now required. As a result of the reduction in real incomes, the number of households below the poverty line was growing rapidly. The food distribution system was to be repaired to ensure adequate supplies of food and other essential items to all parts of the country. Nevertheless, it was thought that the revised program was likely to encounter great risk from unsettled political conditions and growing social strains.

Quantitative performance criteria were the same as in the prior letters of intent, but targets were changed. New structural performance criteria were as follows:

- Initiate sales of additional shares in listed state enterprises including, at a minimum, the domestic and international telecommunications corporation by end-September 1998.
- Submit to parliament a draft law to institutionalize Bank Indonesia's autonomy by end-September 1998.
- Reduce export taxes on logs and sawn timber to 20 percent by end-December 1998.
- Complete audits of the State Oil Company, the State Logistics Agency, the State Electric Company, and the Reforestation Fund by end-December 1998.

New or strengthened structural policy commitments included the following:

- Issue presidential decree to provide appropriate legal powers to IBRA, including its asset management unit.
- Reduce the minimum capital requirements for existing banks.
- Take action to freeze, merge, recapitalize, or liquidate the six banks for which audits have already been completed.
- Conduct portfolio, systems, and financial reviews of all other banks by internationally recognized audit firms.
- Introduce community-based work programs to sustain purchasing power of poor in both rural and urban areas.
- Increase subsidy for food and essential items.
- Introduce microcredit scheme to assist small businesses.

Request for an EFF—Indonesia to Get More Time to Repay the IMF

On July 29, 1998, Indonesia requested that the SBA be canceled and the existing policy program be supported instead by an EFF.[16] Several IMF Board members had previously suggested that such an arrangement might be more appropriate than a SBA due to the deep-seated nature of Indonesia's structural and balance-of-payments problems. The EFF was established to provide assistance to meet balance-of-payments deficits over longer periods of time. By this time, Indonesia had received $4.96 billion (SDR 3.66 billion) in disbursements under the SBA. The EFF was to cover the remaining period of the SBA—26 months—and access under the new arrangement was to be the same as the amount remaining to be drawn

[16] The third review of the SBA was incorporated into the analysis of the request for an EFF. Quantitative performance criteria—for contracting or guaranteeing new external debt and limits on the stock of public sector short-term debt outstanding—were met. One structural performance criterion was completed on schedule—raising fuel and electricity prices according to a schedule. One structural performance criterion was delayed, and the IMF Board granted a waiver for its nonobservance on July 15, 1998—merge Bank Bumi Daya and PABINDO and transfer problem loans to the asset management unit of IBRA. IMF officials told us that if the August 1998 disbursement had not been made on approval of the EFF, no waivers would have been needed for the completion of the third review of the SBA.

under the SBA—$6.33 billion (SDR 4.67 billion). An EFF allows a country more time to repay the IMF, according to an IMF official. Repayment of principal under an EFF was to be made in 12 semiannual installments beginning 4-½ years after disbursement and ending 10 years after the date of each disbursement whereas repayments under an SBA are scheduled 3-¼ to 5 years after each disbursement.[17]

The deep-seated nature of the structural and balance-of-payments problems facing the economy had become increasingly apparent. A thorough restructuring of the banking and corporate sectors was needed for the economy to recover from the crisis, even if this restructuring would take some time to complete. IMF staff supported the Indonesian government's request that the SBA be replaced by an EFF. On August 25, 1998, the IMF Board approved the request for an EFF, and Indonesia received a $995.4 million (SDR 733.8 million) disbursement.

Program Revisions and Board Reviews of the EFF—Progress and Problems

A series of five letters of intent and four reviews followed the switch to an EFF. The five letters were an elaboration of the elements of the reform program, according to the IMF. Monetary policy requirements continued to be tight and focused on getting the exchange rate into an acceptable range. Fiscal policy requirements pinpointed deficit spending. Structural policies focused on reforming the financial sector, eliminating anticompetitive structures in the Indonesian economy, and providing social safety measures. Disbursements were on time twice and delayed twice when IMF officials judged that Indonesian officials were not satisfactorily implementing the set conditions.

First EFF Letter of Intent—New Social Safety Net and Banking Measures

On July 29, 1998, at the time the government of Indonesia requested an EFF, Indonesia issued a new letter of intent to address the prevailing conditions. Program modifications were introduced in budgetary management, corporate debt restructuring, and bank restructuring. There was progress in implementing the Frankfurt agreement[18] with foreign commercial banks and the introduction of auctions for central bank instruments. Progress was also being made on elaborating the details of the plan for bank restructuring. IBRA and its asset management unit were fully operational, and foreign investment banks and a leading foreign

[17] See Financial Organization and Operations of the IMF (Washington, D.C.: Treasurer's Department, IMF, Sept. 1998).

[18] The Frankfurt agreement was reached on June 4, 1998. It (1) restructured interbank debt falling due before end-March 1999, (2) made available a trade facility under which participating banks would use their best efforts to maintain their aggregate trade credit to Indonesian banks to help restore normal flows of trade financing, and (3) established a framework for voluntary restructuring of corporate debt.

commercial bank were assisting the bank restructuring process. These developments had a beneficial impact on market confidence.

At the time of the request for the EFF, the economic situation remained precarious. Output had declined 10 percent and was likely to decline as much as 15 percent for 1998/1999, according to the IMF. Inflation was projected to be 80 percent for 1998. Food security was a continuing concern—food prices had risen dramatically since the beginning of May 1998. Severe problems in the banking system and corporate sector were still not adequately addressed. Actions to resolve six private banks that were taken over were needed. Actions were also needed on the recapitalization of sounder banks and the restructuring of state banks. Progress on corporate debt workouts was very slow, and IMF staff judged that the Indonesian government needed to be involved in facilitating such workouts. The outlook for the program was vulnerable to changes in the political and social climate. The June program had slippages in monetary policy—concerns about further bank closures led to renewed withdrawals of deposits from troubled banks, and the move by Bank Indonesia to reabsorb liquidity led to a rise in interest rates. Strenuous efforts were necessary to bring base money in line with program targets.

New measures were added to repair and strengthen the distribution system, to mitigate the humanitarian effects of the crisis by expanding social safety net programs and improving the targeting of subsidies, to remove obstacles to corporate sector restructuring through the adoption of regulatory and administrative reforms, and to restructure insolvent banks. The distribution and subsidy systems were improved to ensure that essential goods were available at affordable prices. In addition, a new program was created to provide rice at highly subsidized prices to the poorest families. Components of this strategy were the following:

- The State Logistics Agency was to release large quantities of rice of all qualities into the market.
- The rice was to be released into the market at less than the market price.
- The State Logistics Agency was to increase direct deliveries of medium-quality rice to retailers and cooperatives.
- To put further downward pressure on prices, the value-added tax on rice was to be suspended.
- The program for delivering rice at prices well below market prices to poor families was to be expanded as quickly as possible, with the help of provincial governors.
- The State Logistics Agency was to actively seek new imports for rice to ensure that stocks remained adequate.

- Private traders were to be freely allowed to import rice.

Quantitative performance criteria were the same as those in effect in the final letter of intent of the SBA except for changes in targets. Structural performance criteria were to:

- initiate sales of additional shares in listed state enterprises including, at a minimum, the domestic and international telecommunications corporations by end-September 1998;
- submit to parliament a draft law to institutionalize Bank Indonesia’s autonomy by end-September 1998;
- reduce export taxes on logs and sawn timber to 20 percent by end-December 1998; and
- complete audits of the State Oil Company, the State Logistics Agency, the State Electric Company, and the Reforestation Fund by end-December 1998.

New or strengthened structural policy commitments included

- an IMF review of public expenditure management,
- the transfer of assets of the seven frozen banks to the asset management unit,
- the transfer of the responsibility for six state banks from the Ministry of State Enterprises to the Ministry of Finance,
- the launch of the Indonesian Debt Restructuring Agency,
- the institution of tax neutrality for mergers,
- the submission to the Indonesian parliament of a new arbitration law consistent with international standards,
- the completion of a review of accounting and auditing standards to make them consistent with international standards, and
- the establishment of a voluntary framework to facilitate corporate restructuring.

First Review of the EFF—Good Policy Implementation

On September 17, 1998, IMF staff presented its first review of the EFF to the IMF’s Executive Board. Completion of the review was to be based on indicative fiscal and monetary targets, as well as external targets for end-July and end-August 1998. IMF staff recommended that the review be completed and that Indonesia continue to have access to IMF assistance. The policy discussions with the government of Indonesia were conducted in close collaboration with the World Bank and the Asian Development Bank.

According to IMF documents, Program implementation was generally good and the program was broadly on track. Market sentiment had improved as a result of good implementation and increased financing for the program. Steps were being taken in key areas where problems had occurred, especially in regard to food security, or where progress needed to be accelerated, such as corporate restructuring. A cautious easing of monetary policy was seen as possible once inflation had been brought down from its high levels. The challenge for policy at that time was to proceed with structural reforms—chiefly banking system and corporate restructuring. Improving the food situation was crucial for ensuring social stability.

Real GDP was estimated to have declined by 12 percent in the first half of 1998, while cumulative inflation for the first 8 months of the year was 69 percent. Although the political situation had stabilized to some degree by September, it remained fragile, as indicated by street protests. The privatization program was behind schedule, and a shortfall from the target for privatization revenues was believed to be likely. The budget was running far within program targets in part because of delays in increasing spending on social programs. Because the government had adopted a strategy for addressing the urgent problems created by the recent rapid increase in rice prices, IMF staff believed it helped limit risks to the program from social unrest.

On the other hand, bank restructuring had been subject to delays. The transfer of assets to the asset management unit was being delayed pending passage of amendments to the banking law. In addition, little progress had been made in corporate restructuring. To address some of these issues, a package of measures to address bank restructuring was announced on August 21, 1998. The package included the recapitalization of core banks, the closure of six large private banks, the merger of four state banks, and other items. An important development with respect to corporate restructuring was the announcement of the Jakarta Initiative—a voluntary framework to guide and streamline out-of-court restructuring of corporate debt. This initiative was announced in early September 1998 and used approaches that were proven successful in other countries. The approach covered all foreign and domestic debt and applied equally to all creditors. To promote financing to distressed companies, the principles encouraged creditors to subordinate their existing claims to lenders that were willing to provide interim financing.

Several benchmarks were implemented during the course of this review. The end-June 1998 measure to allow transferability of forest concessions and to de-link their ownership from processing of new concessions was done by end-August. The end-July measure to issue a presidential decree to provide appropriate legal powers to IBRA, including its asset management unit, was done on schedule. The end-August measure to submit to parliament a draft amendment to the banking law, incorporating procedures for the privatization of state banks, and the removal of the limits on private ownership of banks was done on August 24, 1998. On September 25, 1998, the IMF Board completed the review and Indonesia received a $928.3 million (SDR 684.3 million) disbursement.

Second EFF Letter of Intent—New Strategy for Rice and Banks

On September 11, 1998, at about the time of the first IMF review of the EFF, the government of Indonesia announced a revised program to address the new conditions. The letter of intent established indicative targets for monetary and fiscal variables and for international reserves. The letter of intent indicated that the program intended to continue to implement a firm monetary policy. As inflation declined, the government of Indonesia expected interest rates to decline, easing pressure on the corporate and banking sectors. Development expenditures, particularly those for the social safety net, which were running below the programmed levels, were to be stepped up. Rice was to be provided at highly subsidized levels to poor families. For the first time in 30 years, the government was to allow private traders to import rice. This letter of intent included commitments related to an August 21, 1998, announcement by the government of Indonesia of a major bank-restructuring package that covered banks with almost half the assets of the banking system.

The end-September targets for net domestic assets, overall central government balance and net international reserves, and net international reserves were quantitative performance criteria. The letter of intent contained an updated matrix of structural policy commitments with the following new or strengthened commitments:

- Eliminate subsidies on imports of sugar, wheat, wheat flower, corn, soybeans, soybean meal, and fishmeal.
- Strengthen public expenditure management.
- Prepare a final plan for restructuring three banks.
- Complete the legal requirements for the merger of four state banks.
- Prepare a plan for the operational merger and restructuring of four state banks.

Second Review of the EFF—Waivers Requested and Granted

On October 23, 1998, IMF staff submitted a second IMF staff review of Indonesia's program. IMF staff reported that further progress had been made with stabilization since the last review and that policy implementation under the IMF program continued to be generally good. The priority for policy at this juncture was to foster recovery in output, consolidate gains in stabilization, and strengthen programs to protect the poor. IMF staff recommended that waivers for nonobservance be granted for two missed structural performance criteria provided that there was a satisfactory arrangement for the repayment of liquidity support by private banks.

The situation remained fragile and the economy extremely weak. Unemployment and poverty were on the rise. Although the political situation had stabilized, the outlook remained uncertain and, in the IMF staff's view, further turbulence in coming months was not ruled out. There had been slippages in some areas, notably privatization. Privatization of several mining companies and the domestic telecommunications concern had been postponed until market conditions improved. The inability of most corporations to pay high rates on loans had resulted in a negative spread between commercial bank deposit and lending rates, contributing to continuing decapitalization of the banking system. At this time there was no satisfactory agreement on the repayment of liquidity support by private banks.

By the third week in October 1998, the rupiah had strengthened beyond expectations, inflation had moderated, and prices for many staple food items had declined. Key elements of bank restructuring were moving ahead. Indonesia then announced a government-assisted recapitalization program for viable banks. The merger of four state banks had been initiated, and plans had been announced for resolving the debt situation of six major private banks. Progress was being made in establishing the appropriate legal and regulatory framework for the Jakarta Initiative.

Completion of the second review under the EFF was to be based on indicative and performance targets for end-August and end-September 1998. The government of Indonesia had complied with performance criteria for end-September 1998 on net domestic assets and net international reserves. However, Indonesia requested a waiver for the following end-September performance criteria due to the lack of available data on

- the central government balance,
- the contracting or guaranteeing of new external debt, and
- the short-term external debt outstanding.

One benchmark for the end of September 1998 was done on schedule while the completion of another benchmark was delayed. The benchmark to complete action plans for all 164 state enterprises was done on schedule. The benchmark to complete divestiture of two state enterprises that were unlisted was delayed because of weak market conditions.

The government also requested waivers for structural performance criteria that were not met. These criteria dealt with share sales of domestic and international telecommunications companies and submission to parliament of a draft law to institutionalize Bank Indonesia's autonomy. Although share sales of one company had been completed, other shares had not been sold due to weak market conditions. The draft law was nearing completion, and submission to parliament was expected by mid-November. On October 30, 1998, the IMF Board granted the requested waivers. On November 6, 1998, Indonesia received a $928.3 million (SDR 684.3 million) disbursement.

Third EFF Letter of Intent—Additional Banking Reform and Corporate Debt Restructuring Commitments

On October 19, 1998, the government of Indonesia announced a new letter of intent incorporating adjustments to prevailing conditions. This was the third letter of intent to be announced under the EFF. This revision contained several measures to further strengthen the IMF program, especially in the areas of banking and corporate debt restructuring. The letter of intent called for lowering interest rates as long as the rupiah remained strong and inflation was falling. Development spending was to be accelerated. Monitoring of development spending was to be strengthened to protect against leakage and corruption. The preparation of the master plan for privatization was completed—all but a few selected enterprises were to be privatized within the next decade. The program included requirements to streamline the food distribution procedures and make adequate food supplies available to the most vulnerable groups.

On September 28, 1998, the government announced the formal merger of four state banks into the newly established Bank Mandiri. The next day, Bank Indonesia announced key elements of a bank recapitalization program for potentially viable private banks—including higher capital adequacy ratios, injections of new capital, lower levels of nonperforming loans in accordance with new prudential requirements, and preparation of business plans demonstrating achievement of medium-term viability and compliance with prudential regulations. Indonesia's parliament approved amendments to the banking law on October 16, 1998, which facilitated the restructuring process by strengthening the legal powers of IBRA and its asset management unit.

The Jakarta Initiative on corporate debt restructuring was expected to be fully operational by end-October. The decrees necessary to give effect to the Initiative were signed and a chairman appointed. At this time about a dozen companies, with a combined debt exposure in excess of $3 billion, were entering the process. On October 23, 1998, a draft government regulation was to be signed to provide for tax neutrality for mergers and removal of other tax disincentives for restructuring.

Quantitative performance criteria were as specified in the first EFF, with targets changed. New and strengthened structural policy commitments were to

- complete a review by Bank Indonesia of business plans of relatively strong private banks,
- recapitalize banks whose business plans are accepted by Indonesia,
- transfer to IBRA banks that are determined to be insolvent and ineligible for the recapitalization plan,
- resolve 26 banks currently subject to IBRA control for which audits were expected to be completed by mid-November,
- establish centralized control of lending decisions and treasury management in the four state banks that were being merged into Bank Mandiri,
- reach final settlement with former owners of two private banks for repayment of Bank Indonesia liquidity support,
- encourage the initiation of negotiations between debtors and creditors under the Jakarta Initiative, and
- expand the subsidized rice scheme to 17 million poor families.

Fourth EFF Letter of Intent—Implementing Corporate and Financial Restructuring

On November 13, 1998, the government of Indonesia issued a letter of intent and supplementary memorandum of economic and financial policies that detailed revised conditions under the EFF. The new letter of intent undertook a number of additional steps to implement the key areas of corporate and financial restructuring. The letter of intent reaffirmed the government's commitment to keep base money under control so as to stabilize prices and accommodate further appreciation of the rupiah. Progress continued to be made on lengthening the maturity structure of monetary instruments. Development expenditure was targeted to rise. The revised program sought collaboration at all levels in stepping up internal government oversight mechanisms to help identify leakages and ensure accountability. The letter of intent had a commitment to sell majority interests in the Jakarta container port and minority interests in the Jakarta airport operations, the largest palm oil plantation in Indonesia, and the international telecommunications enterprise. The letter of intent contained a commitment to taking steps to release detailed financial information about the state logistics agency, the state oil company, and the state electric company. Banking sector reforms included requirements for recapitalization of private sector banks, resolution of debt in certain frozen banks, and other actions.

There was to be a renewed effort to implement the Jakarta Initiative. A foreign exchange monitoring system was to be developed to allow Bank Indonesia to oversee foreign currency flows on a more timely basis. As of April 30, 1999, the system had been approved by the government of Indonesia but had not begun operations.

The letter of intent only had one structural performance criterion—reduce export taxes on logs and sawn timber to 20 percent by end-December 1998. New and strengthened structural policy commitments included the following:

- Raise aviation fuel prices to international levels.
- Complete terms and conditions of bank recapitalization bond.
- Reach agreement with former owners of six banks for repayment of Bank Indonesia liquidity support and connected lending.
- Issue three new prudential regulations on connected lending, the capital adequacy ratio, and the semi-annual publication of financial statements.
- Establish a mechanism for the appointment of ad hoc judges to the Commercial Court.
- Expand the subsidized rice scheme and increase monthly allocations to 20 kilograms per family.
- Eliminate exchange rate subsidies for rice imports by the National Logistics Agency and replace them with explicit budgetary subsidies.

Third Review Under the EFF—Completion of Review Delayed

On December 15, 1998, IMF staff presented their third review under the EFF to the IMF Board. In its view, macroeconomic policies were on track, financial sector reform was proceeding, progress was being made on corporate restructuring, and slippages and delays in some areas were being addressed. The rupiah had strengthened, allowing money market rates to begin falling. Inflation had abruptly slowed. Fiscal policy had been less stimulative than envisaged but development spending was accelerating. Moreover, the rice program was being broadened beyond the initial target of 7.5 million families. The privatization agenda was narrowed to 4 or 5 enterprises from the original list of 12 enterprises. Financial sector and corporate restructuring was moving forward on several fronts with the aim of restoring the soundness of the banking system. On November 7, 1998, final agreement was reached with the previous owners of four banks to repay the equivalent of 9 percent of GDP in obligations stemming from loans obtained by their enterprises from these four banks. An increasing number of companies were seeking assistance in initiating negotiations with creditors.

The review noted slippages in some areas of the program, including privatization and some risk that political unrest could again derail the program. Government authorities remained reluctant to finance the restructuring costs because of the political implications. There had only been limited progress in corporate debt restructuring—further steps were needed in expediting regulatory approvals for restructuring, establishing a public registry to facilitate interim financing, and streamlining the Commercial Court.

According to IMF documents, Indonesia met the indicative targets on net domestic assets and net international reserves. Data were not available for the indicative target for the central government balance, but the IMF believed that the target had been met. IMF staff recommended completion of the third review and supported the introduction of three bimonthly reviews during the first half of 1999 before moving to quarterly reviews. On December 15, 1998, the IMF Board approved completion of the review. Indonesia received a $928.3 million (SDR 684.3 million) disbursement.

Fourth Review Under the EFF—Indonesia Requested Additional Funds

On March 25, 1999, the IMF completed its fourth review of the EFF and the request for augmentation of funds. The review was scheduled to have been completed on February 15, 1999. This was the first bi-monthly review. Although progress was reported in implementing the IMF program, delays had occurred in implementing key banking and corporate restructuring measures. Nevertheless, the IMF staff was satisfied that policies and developments were continuing to evolve as well as could be expected under difficult and unsettled domestic conditions. Progress toward achieving macroeconomic stability had been helped by a firmer and more consistent monetary policy. The external current account kept its solid surplus of almost 5 percent of GDP in 1998-1999, offsetting a weaker capital account. A trade surplus of $17 billion accounted for the bulk of the improvement in the current account. In mid-March 1999, net international reserves of $15 billion remained above the program targets. Opposition political parties supported the IMF program.

Indonesia continued to pose exceptional risks for the IMF, particularly until the political transition was further advanced, according to IMF staff. The economy had not yet bottomed out. Export volumes had declined sharply, and domestic banks were reluctant and unable to extend credit to exporters. Although the judiciary had not implemented the bankruptcy law in a manner consistent with international practice, Indonesian authorities were believed to be cooperating fully in carrying out a corrective strategy. This corrective strategy included proposed legislation aimed at improving governance of the judiciary and expectations that state banks and IBRA were aggressively to pursue their largest borrowers. Corporate debt restructuring under the Jakarta Initiative had yet to spread rapidly—only 15 companies, involving about $2 billion in foreign currency debt, had concluded debt restructurings with creditors.

Several benchmarks were completed on schedule. For example, the measure to finalize a decision on the resolution of all banks that fail the criteria for eligibility to the recapitalization program was implemented in that all these banks were closed or intervened on March 13, 1999. The IMF granted a waiver for nonobservance of the structural performance criterion—to reduce the export tax on logs and sawn timber to 20 percent at end-December 1998. The measure was adopted in February 1999. The result of the review was that on March 25, 1999, Indonesia received a $465.3 million (SDR 337 million) disbursement, and the total amount available to Indonesia was increased $985.8 million (SDR 714 million).

Fifth EFF Letter of Intent—Strengthening the Program for the Banking System and Corporate Restructuring

The government of Indonesia issued a fifth letter of intent under the EFF on March 16, 1999. This letter of intent included a number of new steps to strengthen the program—especially the banking system and corporate restructuring. Banking reforms requirements included state bank resolution; private bank recapitalization; resolution of debt in banks under IBRA control; and improvement of the legal, regulatory, and supervisory framework.

Steps to strengthen the corporate restructuring framework included the following:

- A regulation became effective that removed company law limitations on debt-to-equity conversions.
- The Ministry of Finance passed a decree providing more favorable tax treatment of cancellation of indebtedness income in restructurings.
- Legislation was to be submitted for the registration of security interests that would give certainty concerning the priority rights of lenders.

Actions related to the rice situation included

- elimination of the state trading agency's exchange rate subsidy for imports of rice,

- a public procurement floor price policy that was aimed at keeping domestic rice prices broadly in line with world prices, and
- the unhindered import of rice by the private sector.

To supplement the People's Economy Initiative for development of small- and medium-sized enterprises and cooperatives, Indonesia was to

- review commercial lending practices to and the financing needs of small- and medium-sized enterprises and cooperatives,
- transform the BRI state bank into a specialized bank with a mandate to lend only on commercial terms, and
- simplify directed credit schemes to cooperatives and small- and medium-sized enterprises and ensure that lending rates are positive in real terms and adjust them periodically to reflect market conditions.

The letter of intent set end-March and end-May quantitative performance criteria and indicative targets for the rest of 1999 and the year 2000 as well as structural performance criteria and benchmarks through September 1999. There were no new structural performance criteria in this letter of intent. Policy actions were to continue to be guided by the matrix from the November 1998 letter of intent.

The IMF's Financial Arrangement With South Korea

Summary

South Korea, officially named the Republic of Korea,[1] experienced an external financing crisis in late 1997, which stemmed from underlying weaknesses in its corporate and financial sectors. These sectors relied heavily on short-term external borrowing. This reliance stemmed in part from a government policy that allowed flexibility in short-term capital flows, while retaining controls on long-term capital flows. A common belief that the government would prevent major firms in certain sectors from failing may also have contributed to the heavy reliance on debt financing. In November 1997, when Korea requested the IMF's assistance, Korea had almost depleted its foreign reserves and its currency was depreciating rapidly. In an effort to stabilize Korea's economy and stimulate economic growth, the IMF negotiated a large financing package for Korea, combining adjustments in macroeconomic policies with accelerated and strengthened structural reforms. Korea's IMF program was intended to restore market confidence, limit private capital outflows, and restore economic growth.

The macroeconomic and structural reforms were considered complex and aggressive. The macroeconomic program initially focused on stabilizing Korea's currency exchange rate and increasing Korea's foreign currency reserves by raising interest rates and limiting government spending. Financial sector restructuring was a key focus of the structural reforms. As the program progressed, the program's reforms in the banking and corporate sectors became more specific and detailed. As Korea's domestic economy began to contract, the IMF encouraged Korea to lower interest rates and increase government spending, bringing Korea's formerly balanced budget into a deficit position. For example, when Korea's IMF program began, Korea's fiscal target was to have a surplus of 0.2 percent of gross domestic product (GDP). The IMF adjusted its growth projections in the first quarterly review to reflect declining economic conditions in Korea. In Korea's March 10, 1999, letter of intent signed with the IMF, Korea's fiscal target was lowered to a deficit of 5 percent of GDP that was budgeted for in 1999.

After announcing Korea's program on December 4, 1997, the IMF monitored Korea's progress beginning in December 1997 with its first biweekly review. In January 1998, the IMF conducted a second biweekly review, followed by four quarterly reviews beginning in February 1998. The IMF conducted its fifth quarterly review in March 1999. All reviews were completed and disbursements made. The IMF accelerated its disbursements to Korea at the end of 1997, and the majority of the IMF's

[1] We will refer to the Republic of Korea as "Korea" in this appendix.

funding ($19.3 billion out of $21 billion) was disbursed by April 30, 1999. Korea met all its performance criteria until its fourth quarterly review. IMF staff recommended a waiver for meeting a condition of the agreement at the fourth quarterly review due to delays in obtaining bids for the sale of two Korean banks. Korea has subsequently obtained bids for these sales. In addition, the IMF staff requested waivers at the fifth quarterly review for (1) completing an audit of the Korea Asset Management Corporation to reflect any losses identified in the external audit in the Corporation's audited financial statement and (2) the delivery of recommendations to the Ministry of Finance and Economy as to any remedial action based on a financial supervisory review of the Korea Development Bank. These two actions have since been completed.

Although Korea's IMF program began slowly due in part to its presidential election, Korea has made substantial progress in advancing its financial sector reforms and has begun repaying its IMF borrowings. As of April 30, 1999, Korea has repaid about $6.1 billion of its IMF borrowings. Some officials we spoke with noted that Korea still faced difficult reforms in its corporate sector and emphasized that it would take time for Korea to complete the reforms it has begun.

History of the Crisis

Prior to Korea's 1997 financial crisis, Korea had experienced about 30 years of economic growth and was considered to have had broadly favorable macroeconomic performance. Korea had recorded real GDP growth of about 6 percent in the first 3 quarters of 1997, and inflation was around 4 percent. Korea's external financing crisis stemmed from fundamental weaknesses in its corporate and financial sectors. Korea had experienced a mild recession in 1993. In response, Korea's elected officials promised growth and encouraged Korea's conglomerates (called "chaebols") to invest heavily in new factories. In turn, Korean firms made substantial investments, leaving Korea with excess production capacity and large debt burdens for Korean firms. This overcapacity led to falling prices for its main exports—computer memory chips, cars, ships, steel, and petrochemicals—and weakened profitability.

The large amount of short-term borrowing compounded these other problems. Most of the corporate debt was either short-term borrowing from domestic financial institutions or from the issuance of promissory notes. At the end of December 1997, the 30 largest conglomerates owed approximately 111.3 trillion won[2] (the Korean currency) in loans and

[2] Using the conversion rate of 1,900 won (approximate exchange rate at the end of December 1997) to the dollar this amount is about $58.6 billion.

payments to Korean banks, according to Korea's Office of Bank Supervision. The conglomerates' current liabilities (less than 1 year) accounted for 60 percent of total liabilities and roughly half of nominal GDP in 1996. These factors resulted in an increase in bankruptcies beginning in 1997, including a large Korean steel company and car manufacturer.

These bankruptcies weakened the financial system, since bank loans were not being paid off, and non-performing loans rose sharply, causing strains in the banking system. Korean government estimates of nonperforming loans at the end of 1997 were 34.9 trillion won.[3] Weaknesses in the banking system were thought to be based on a lack of commercial orientation (that is, a focus on increasing market share over improving profitability) and limited experience in managing risk, combined with lax prudential supervision. These factors, as well as the large-scale, external short-term borrowing of the Korean banks, made Korea vulnerable to the contagion effects of financial problems in Southeast Asia.

The weak state of the banking sector led to successive downgrades by international credit rating agencies and a sharp tightening in the availability of external financing. External creditors began to reduce their debt exposure to Korean banks in the latter part of 1997, causing a sharp decline in usable reserves. A large amount of these reserves were being used to finance the repayment of the short-term debt of Korean commercial banks' offshore branches. Historically, Korean authorities had a policy of not letting private banks go into default. Consequently, the Bank of Korea was providing foreign exchange support to commercial banks as foreign creditors reduced their exposure on short-term lines of credit. The total amount of foreign currency reserves the Bank of Korea, the central bank of Korea, held at the end of December 1997 was $20.4 billion, the usable portion of which was $8.9 billion.[4] As of December 31, 1997, the total amount of Korea's private and governmental external liabilities was $154.4 billion, calculated under IMF standards. The Korean government estimated that at the end of December 1997, approximately $27.3 billion was due by the end of the first quarter in 1998. The ability of

[3] Using the conversion rate of 1,900 won to the dollar (approximate conversion rate at the end of 1997), the amount would be $18.4 billion.

[4] Under the IMF program, Korea tightened its definition of "usable reserves" and has reported its reserves under this stricter definition. Previously, Korea had included its deposits with overseas branches of Korean financial institutions when reporting its foreign exchange reserves, thus overstating its usable reserves. Usable foreign currency reserves equal the total foreign currency reserves less amounts on deposit with overseas branches of Korean financial institutions and swap positions between the Bank of Korea and other central banks.

Korea to repay its short-term foreign debts was dependent on the willingness of foreign lenders to extend the terms of existing loans and/or to offer new financing.

Korea had made earlier attempts to reform the financial sector and had taken steps to liberalize its capital account. Korea permitted short-term foreign borrowing but had not allowed domestic banks access to longer-term foreign borrowing, which added to Korea's financing problems. Korea was faced with depleted foreign reserves and a rapidly depreciating currency when it asked for IMF assistance in late November 1997. It had been 10 years since Korea had had an IMF program, and Korea did not have any outstanding IMF credit. Korea had made its last repayment of prior borrowings to the IMF in 1988. Table V.1 presents a history of Korea's recent financial problems.

Table V.1: Chronology of Selected Events Concerning Korea's Financial Problems, 1997-May 1999

Year	Month	Day	Action
1997	January		Hanbo Steel, a large Korean conglomerate, collapses under $6 billion in debts, first bankruptcy of a Korean conglomerate in a decade.
	April		President's Committee on Financial Sector Reform recommends short-term reform measures.
	July	2	Thailand devalues its currency, the baht.
			Kia, Korea's third largest carmaker, requests emergency loans.
	August	25	Korean government announces plan for providing special financing for certain commercial and merchant banks. Announced government guarantee for overseas foreign currency borrowings by Korean commercial banks.
	October		IMF mission goes to Seoul for an Article IV consultation.[a]
			Credit rating agencies begin to downgrade the ratings of Korea and Korean companies to below investment grade.
		22	Kia Motors Corp. announces bankruptcy.
	November	6	Bank of Korea intervenes to attempt to halt the decreasing value of the won. IMF announces it is ready to provide assistance if needed.
		19	Bank of Korea loosens band on currency, won begins to drop sharply.[b]
		21	Korean government requests IMF assistance.
		24	Korea bank asset workout program announced. Korea Asset Management Corporation reorganized to acquire and dispose of nonperforming loans.
	December	4	$21 billion IMF package announced, which was part of a larger financing package totaling about $58 billion.
		16	Korea eliminated its daily currency exchange rate band.

[a] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies.

[b] As discussed later, in 1997 Korea had operated with a currency exchange rate system that permitted exchange rates to float freely within a daily range of plus or minus 2.25 percent. On November 19, 1997, the Korean government announced that the range of daily exchange rate fluctuations would be expanded from plus or minus 2.25 percent to plus or minus 10 percent. The daily exchange rate band was eliminated as of December 16, 1997 and, as a result, the exchange rate for the won now floats according to market forces.

Year	Month	Day	Action
		17	IMF staff conduct first biweekly review of Korea's program.
		18	South Korea elected opposition party Kim Dae-jung to serve a 5-year presidential term.
		22	Moody's rating service announces that it lowered Korea's foreign currency ratings.
		23	Won drops to its low of 1,963 won to the dollar. Standard & Poor's announces that it lowered Korea's long-term foreign currency credit ratings.
		24	IMF funding accelerated, debt restructuring talks begin. IMF and 12 country lenders agree to advance Korea $10 billion to prevent default. Korea issues second letter of intent with accelerated and strengthened reforms.
		29	Korea's National Assembly passes 13 financial reform bills designed to facilitate financial sector restructuring, accelerate capital market liberalization, and improve prudential regulation.
1998	January	8	IMF conducts second biweekly review of Korea's program.
		28	$22 billion in Korean foreign debt restructured.
	February	6	Tripartite accord (among labor, management, and the government) reached on Korea's restructuring program and sharing the burden of reform.
		17	IMF conducts first quarterly review of Korea's program.
		25	President Kim and the new administration take office.
	April		Korea issues global bond offering of $4 billion to add to its official reserves.
		1	Financial Supervisory Commission formed.
	May	29	IMF conducts second quarterly review of Korea's program and completes its Article IV consultation.
	July	23	Korea signs memorandum of understanding with the World Bank for implementing corporate sector reforms.
	August	28	IMF conducts third quarterly review of Korea's program. Review completed and disbursement made.
	December		IMF conducts fourth quarterly review of Korea's program. Korea requests waiver for obtaining bids for the sale of Korea First Bank and Seoul Bank. IMF Board approves waiver, review is completed, and disbursement made.
		31	Korea First Bank signs Memorandum of Understanding with Newbridge Capital for sale of Korea First Bank.
1999	February	22	Seoul Bank signs memorandum of understanding with HSBC for sale of Seoul Bank.
	April	7	IMF conducts fifth quarterly review of Korea's program. IMF recommends waivers for completion of an audit of Korea Asset Management Corporation and delivery of recommendations based on a financial supervisory review of Korea Development Bank. The financial supervisory review was conducted within the timetable under the review, and the remaining actions were subsequently completed. IMF completes review and disbursement was made.

Source: GAO analysis of IMF, Korean, Treasury, Securities and Exchange Commission, and State Department documents.

IMF Agreement Announced

On December 4, 1997, the IMF approved a 3-year stand-by arrangement[5] with Korea for an amount equivalent to special drawing right[6] (SDR) of 15.5 billion (amounting to about $21 billion). This program was formulated under emergency procedures[7] and later drew on the IMF's newly

[5] A Stand-by Arrangement is a decision of the IMF by which an IMF member is assured that it will be able to make purchases (drawings) from the General Resources Account (GRA) up to a specified amount and during a specified period of time, usually 1 to 2 years, provided that the member observes the terms set out in the supporting arrangement.

[6] Special drawing right is defined by the IMF as the international reserve asset created by the IMF in 1969 as a supplement to existing reserve assets.

[7] According to IMF documents, under an emergency financing mechanism, the IMF has developed "a set of exceptional procedures to facilitate rapid Executive Board approval of IMF financial support for a member while ensuring the conditionality necessary to warrant such support. These emergency measures are used only in circumstances representing, or threatening to give rise to, a crisis in a member's external accounts that requires an immediate IMF response."

established Supplemental Reserve Facility.[8] The World Bank and the Asian Development Bank committed $14 billion to the Korean government. In addition, interested countries pledged $22 billion as a second line of defense[9] for a total package of $58.4 billion. At the time of the announcement, the IMF staff team continued to work with Korean officials to develop more fully the policy measures for the program. The full program was to be reviewed by the IMF's Executive Board in January 1998. It was planned that the review would expand the scope of the performance criteria and set performance measures and benchmarks for 1998. Customary clauses were also included as conditions for Korea's IMF program.[10] Each subsequent review adjusted and expanded the performance criteria for the next reviews, that is, they were set as "rolling" performance criteria. The IMF's monitoring of Korea's program started with two biweekly reviews in 1997 and quarterly reviews for 1998 and the first quarter of 1999. After the fifth quarterly review in March 1999, the IMF plans to conduct reviews every 6 months, and Article IV consultation discussions are planned for June or July 1999.

IMF Program Comprised Macroeconomic Policies and Structural Reforms

The IMF program for Korea included a combination of macroeconomic policies—changes to monetary and fiscal policies—and structural reforms. The IMF-directed response was to tighten monetary policy, including raising interest rates to stabilize the currency[11] and reduce government spending, along with an ambitious reform program for financial sector and corporate restructuring. Macroeconomic policies were an essential part of Korea's program. The large official financing package was assembled to help break the cycle of capital outflows, exchange rate depreciation, and financial sector weakness. However, compared with other countries' IMF programs, the structural reforms in Korea, as well as Indonesia and

[8] The Supplemental Reserve Facility is a facility (window) established in December 1997. Its aim is to provide financial assistance to IMF members experiencing exceptional balance-of-payments difficulties due to short-term financing needs resulting from a sudden and disruptive loss of market confidence reflected in pressure on the capital account and the members' reserves.

[9] The United States offered Korea a line of credit using the Exchange Stabilization Fund in December 1997, as a bilateral agreement. According to Treasury officials, this line of credit was not used by Korea. According to IMF officials, Korea did not use the second line of defense offered by other countries.

[10] For Korea, the customary clauses on overdue financial obligations to the IMF, on no accumulation of external payment arrears, on exchange restrictions, on multiple currency practices, on bilateral payments agreements inconsistent with Article VIII, and on import restrictions for balance-of-payments purposes apply as performance criteria.

[11] Since Korea's currency, the won, was losing its value in the foreign exchange markets (Korea's exchange rate), raising interest rates was seen as a way to encourage current and new investors to hold their won-denominated investments or to invest in won-denominated undertakings that would help to stabilize or raise the country's overall reserves.

Thailand, were central to dealing with the underlying causes of the financial crisis, restoring market confidence, and setting the stage for resuming and sustaining growth in Korea.

According to Korea's December 3, 1997, IMF letter of intent, Korea's IMF program was "built around (1) a strong macroeconomic framework designed to continue the orderly adjustment in the external current account and contain inflationary pressures, involving a tighter monetary stance and substantial fiscal adjustment; (2) a comprehensive strategy to restructure and recapitalize the financial sector, and make it more transparent, market-oriented, better supervised and free from political interference in business decisions; (3) measures to improve corporate governance; (4) accelerated liberalization of capital account transactions; (5) further liberalization of trade; and (6) improvement in the transparency and timely reporting of economic data."

The broad policy goals of restoring investor confidence and building international reserves have remained throughout the program, although the emphasis has changed and adjustments have been made in specific targets as Korea's reforms progressed.

Quantitative Performance Criteria Outlined in Initial Agreement

Korea's macroeconomic program included monetary and fiscal policy measures. The initial letter of intent did not fully specify Korea's reform program but did provide a framework of reforms that Korea intended to pursue. IMF staff continued to work with Korean officials to develop more detailed policy measures to be taken. To monitor Korea's progress under the program, the initial agreement detailed the following quarterly quantitative performance criteria:

- a ceiling on net domestic assets of the Bank of Korea,[12]
- a floor on net international reserves of the Bank of Korea,[13] and

[12] In this agreement, the IMF provided precise definitions of the quantitative variables monitored under the program. The IMF set indicative targets for reserve money and broad money (M3) and provided definitions to be used. In addition, it was agreed that the ceiling on net domestic assets and the indicative limit on reserve money would be increased (or decreased) for any increase (or decrease) in required reserve ratios.

[13] The net floor on net international reserves of the Bank of Korea was defined as the sum of (1) the U.S. dollar value of gross foreign assets in foreign currencies minus gross liabilities in foreign currencies and (2) reserves against foreign currency deposits. The floor of the net international reserves was to be adjusted (1) downward by the U.S. dollar equivalent (converted at the program exchange rate) of the increase in foreign liabilities of the Bank of Korea associated with the emergency financing package, (2) upward by the amount of financing under the emergency financing package in excess of the program baseline (and downward by any shortfall), (3) upward by the amount by which deposits of the Bank of Korea at overseas branches and subsidiaries of domestic financial institutions are below the baseline specified in the program, and (4) upward for any increase in the net forward position over the end-November position of US $6.2 billion.

- the interest rate charged by the Bank of Korea on foreign exchange injections to Korean commercial banks or their overseas branches was not to be below 400 basis points above LIBOR.

These quantitative macroeconomic performance criteria, in addition to other indicative targets, structural performance criteria, and structural measures, were used to monitor Korea's progress. The IMF and Korea also agreed to indicative targets to monitor Korea's economic progress, including

- a floor on the consolidated central government balance,[14]
- reserve money,[15]and
- broad money (M3).[16]

The principal macroeconomic objectives of Korea's IMF program, as detailed in the initial December 3, 1997, letter of intent, include

- building the conditions for an early return of confidence so as to limit the deceleration of real GDP to about 3 percent in 1998,[17] followed by a potential recovery in 1999;
- containing inflation at or below 5 percent; and
- building international reserves to more than 2 months of imports by end-1998.

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[14] The "consolidated central government balance" is defined as the consolidated balance of the central government (comprising the general accounts and the special budgetary funds) and the public enterprises special accounts. The balance is the difference between the total revenues and the sum of total expenditures and net lending. Expenditures include all interest costs associated with the restructuring of the financial sector borne by the public sector (including monetary authorities and public banks).

[15] "Reserve" money is defined as the bank notes and coins issued plus reserve deposits of domestic money banks.

[16] Korea's IMF agreement defines "M3" as "M2" plus deposits of other financial institutions, debentures issued, commercial bills sold, "deposits of credit unions," mutual credits of the National Federation of Fisheries, "Community Credit Cooperatives," Mutual Savings and Finance Cooperatives situated in local and reserve life insurance companies, certificates of deposit, repurchase agreements, and cover bills. "M2" is defined as currency in circulation plus deposit money (demand deposits at monetary institutions, time and savings deposits, and residents' foreign currency deposits at monetary institutions).

[17] In Korea's initial program, the IMF had not yet projected Korea's declining GDP for 1998. The IMF's projections were revised in the first quarter of 1998.

Monetary Policy

The main objective of the monetary policy was to contain inflation to 5 percent in 1998 and limit depreciation of the won.[18] To demonstrate to markets the government's resolve to confront the crisis, monetary policy was tightened immediately—interest rates were raised—to restore and sustain calm in the markets and contain the inflationary impact of the won depreciation.[19] The government of Korea reversed its policy of providing liquidity to Korean banks and allowed money market rates to rise to a level sufficient to stabilize markets.[20] The day-to-day conduct of monetary policy was guided by movements in the exchange rate and short-term interest rates, which were used as indicators of how tight monetary conditions were. A flexible exchange rate policy was maintained, with monetary and exchange rate policy being implemented in close coordination with IMF staff.[21]

Fiscal Policy

Fiscal policy in Korea had traditionally been formulated prudently, according to the IMF. In recent years, the Korean government's budget was in broad balance, with government savings of around 8 percent of GDP and a low level of public debt. Unlike economic problems in Latin America (large public debts), the Korean crisis was centered in the private sector. For 1998, Korea was to maintain a tight fiscal policy—by cutting government spending and raising certain taxes—to limit upward pressure on interest rates and to provide for the still uncertain costs of restructuring the financial sector.

[18] Foreign investors will often hold foreign currencies, in this case the won, to earn profits and interest. For the profits to be valued, foreign investors must exchange their earnings in won into their own currency. If the value of the won falls in value, foreigners' earnings on the won-denominated asset will also fall. To encourage foreign investors to invest in Korean won-denominated assets, Korea must pay a higher interest rate to attract investors.

[19] As the won depreciates, exports may increase as Korean goods become cheaper when paying for them in other currencies. If exports expand too quickly, excess demand could lead to inflation. Prices of imports increase with won depreciation.

[20] The quantitative performance criteria limiting Korea's net domestic assets and the understandings on the call rate were used to guide monetary policy.

[21] Historically, the Bank of Korea set daily exchange rates—the Bank of Korea concentration base rate—for the won based on a trade-weighted, multicurrency basket system. Starting in 1989, the Korean government followed a plan intended to progress gradually to a free-floating exchange rate. By 1997, the government was operating with an exchange rate system that permitted exchange rates to float freely within a daily range of plus or minus 2.25 percent. In response to the substantial downward pressures on the won caused by Korea's economic difficulties in late 1997, on November 19, 1997, the Korean government announced that the range of daily exchange rate fluctuations would be expanded from plus or minus 2.25 percent to plus or minus 10 percent. The daily currency exchange rate band was eliminated as of December 16, 1997, and, as a result, the exchange rate for the won now floats according to market forces.

The quantitative performance criteria were adjusted at subsequent reviews to reflect changes in economic assumptions, discussed more fully below. The first quarterly review of the full program was completed in February 1998, which expanded the scope of performance criteria and set performance criteria and benchmarks for 1998. Two biweekly reviews were conducted in the interim period after announcement of the Korea program and before the first quarterly review in February 1998.

Structural Performance Criteria

The IMF used numerous structural performance criteria to monitor Korea's progress in making structural reforms. Korea's structural reforms focused on financial sector reforms, capital account liberalization, strengthening corporate governance and corporate structure, labor market reforms, trade liberalization, and information provisions and program monitoring. After the first IMF quarterly review, measures to increase spending for Korea's social safety net, including unemployment insurance, were added to the program. The third quarterly review added a World Bank component on corporate sector reforms.

For monitoring Korea's reforms, the IMF set benchmarks in the initial letter of intent for the first and second biweekly reviews. As Korea implemented its reforms, the structural performance criteria used to monitor progress changed to reflect the reforms undertaken (see table V.2 and discussion that follows). The IMF set Korea's benchmark for the first biweekly review "to comply with the understandings between the Korean government and the Fund staff regarding the implementation of interest rate policy." For the second biweekly review, to be completed on January 8, 1998, Korea was "to call a special session of its National Assembly, shortly following its presidential elections in December 1997 to pass reform bills on financial sector reforms, capital account liberalization, and trade liberalization." Korea was also "to publicize its foreign reserve data." Also, "the Bank of Korea was not to increase its deposits with nonresident branches and affiliates of domestic financial institutions after December 1997."

At the first quarterly review, and at each quarterly review throughout 1998, the IMF and Korea agreed to additional specific structural performance criteria to monitor Korea's reform efforts. For example, at the third quarterly review, Korea was to obtain bids for the sale of Korea First Bank and Seoul Bank by November 15, 1998. Korea was monitored against this performance criterion at its fourth quarterly review in December 1998. Table V.2 details Korea's reported progress and changes in its structural performance criteria from the initial IMF program in December 1997 through the fifth IMF quarterly review in March 1999.

Table V.2: Structural Performance Criteria for Korea's IMF Program

Date of review	Structural benchmarks and performance criteria to be met	Disposition
First biweekly review, 12/17/1997	Structural benchmark set: Compliance with understandings between the Korean authorities and the IMF regarding the implementation of interest rate policy.	Call rate rose to about 30 percent on Dec. 24, 1997. Increase in interest rate cap from 25 percent to 40 percent was approved by cabinet on Dec. 16 and became effective Dec. 22, 1997.
Second biweekly review, 1/8/1998	Structural benchmarks set:	
	Call a special session of the National Assembly after elections to pass reform bills that (1) revise Bank of Korea Act to provide central bank independence; (2) consolidate bank supervision; and (3) require corporate financial statements to be prepared on a consolidated basis and certified by external auditors.	Passed the three financial reform bills by the National Assembly on Dec. 29, 1997. The Financial Supervision Board will be under the Prime Minister's office.
	Submit legislation to harmonize the Korean regime on equity purchases with the Organization for Economic Cooperation and Development's practices.	Raised ceiling on aggregate foreign ownership of listed Korean shares from 26 to 50 percent and the individual ceiling from 7 to 50 percent on Dec. 11, 1997. Raised the aggregate ceiling on foreign investment in Korean equities to 55 percent on Dec. 30, 1997. Under Korea's foreign direct investment law, Korea already allowed foreign investors to buy equity in the stock market (as well as over the counter) for the purpose of friendly mergers and acquisitions, without limits.
	Submit legislation concerning hostile takeovers to harmonize Korean legislation on abuse of dominant positions in line with industrial countries' standards.	Legislation submitted to allow greater foreign ownership of banks. It was announced that foreign participation in merchant banks would be allowed without limit.
	Publication of foreign reserve data.	Publishing data on Korea's foreign reserves began Dec. 17, 1997. Data on usable reserves of the BOK is published twice monthly (for 15th and the last day of each month) within 5 business days. Data on net forward position of the Bank of Korea is being published monthly. All of these data were placed on the Bank of Korea's web site, starting May 15, 1998.
	The Bank of Korea's deposits with nonresident branches and affiliates of domestic institutions will not be increased after end-Dec. 1997.	Began Dec. 24, 1997. The Bank of Korea was to limit its funding of financial institutions to short-term liquidity support, which the BOK offered to commercial banks through its liquidity support program.
First quarterly review, Feb. 1998	Eliminate interest rate ceiling. Korea was to submit legislation to National Assembly to remove interest rate ceiling as soon as necessary procedures are completed, but not later than Feb. 28, 1998.	Increase in interest rate cap from 25 percent to 40 percent was approved by cabinet on Dec. 16, 1997, and became effective on Dec. 22, 1997.
	Assume government control of Korea First Bank and Seoul Bank and request the management of these banks to write down the equity of existing shareholders.	These banks came under intensive supervision beginning Dec. 24, 1997. The equity capital was written down, and the government recapitalized these banks and took effective control of the banks by Jan. 31, 1998.
Second quarterly review, May 1998	By March 31, 1998	
	Complete second round evaluation of the remaining 20 merchant banks and suspend operations of those banks that fail to pass the evaluation.	Completed Feb. 26, 1998.
	Allow foreign banks and brokerage houses to establish subsidiaries.	Came into effect on Mar. 31, 1998

Date of review	Structural benchmarks and performance criteria to be met	Disposition
	By June 30, 1998	
	Complete an assessment of the recapitalization plans of commercial banks.	Completed June 29, 1998
	Introduce legislation to allow a full writedown of existing shareholder equity, eliminating the current minimum bank capital floor for this purpose.	Legislation was enacted to allow the writedown of existing shareholders' equity in insolvent financial institutions.
	Establish a unit for bank restructuring under the Financial Supervisory Board with adequate powers and resources to coordinate and monitor bank restructuring and provision of public funds.	Unit established on Apr. 1, 1998.
Third quarterly review, Aug. 1998	In addition to the end-June performance criteria, IMF added the following for end Sept. 1998:	
	Submit legislation to allow for the creation of mutual funds (by Aug. 31, 1998)	Legislation submitted to the National Assembly on Aug. 8, 1998; related legislation put into effect in Sept. 1998.
	Require listed companies to publish half-yearly financial statements prepared and reviewed by external auditors in accordance with international standards (by Aug.31, 1998)	Completed.
	For end-Dec. 1998:	
	Obtain bids for Korea First Bank and Seoul Bank (by Nov. 15, 1998)	At the fourth quarterly review, the IMF staff recommended a waiver to extend the date for obtaining bids for Korea First Bank and Seoul Bank from Nov. 15, 1998, to end-Jan. 1999. Korea First Bank: memorandum of understanding signed with Newbridge Capital, Dec. 31, 1998; Seoul Bank: memorandum of understanding signed with HSBC on Feb. 22, 1999.
	Introduce consolidated foreign currency exposure limits for banks, including their offshore branches (by Nov. 15, 1988).	Completed July 1998.
Fourth quarterly review, Dec. 1998	In addition to end-Dec. 1998 performance criteria, additional criteria were set for end-March 1999:	
	To complete an audit of Korea Asset Management Corporation to international standards by a firm with international experience in auditing this type of agency and to reflect any losses identified in the Korea Asset Management Corporation's financial statement	IMF staff recommended a waiver for this action at the fifth quarterly review but it has since been completed. External audit report completed March 12, 1999. Losses identified in external audit report were reflected in the Korea Asset Management Corporation's financial statement as of April 30, 1999.
	The Financial Supervisory Commission to complete supervisory examination of the Korea Development Bank and make recommendations to Ministry of Finance and Economy, as needed, as to any remedial actions required.	IMF staff recommended a waiver for this action at the fifth quarterly review but it has since been completed. Financial Supervisory Commission completed its examination of the Korea Development Bank March 20, 1999. Recommendations coming from the examination were submitted to the Ministry on April 26, 1999.

Date of review	Structural benchmarks and performance criteria to be met	Disposition
Fifth quarterly review, March 1999	Period of April 1-August 31, 1999 (1) Issue regulation by April 1, 1999, requiring insurance companies that fail to meet the mandatory solvency margin thresholds (specified in the Memorandum of Economic Policies for the fifth review of the stand-by arrangement) to submit recapitalization plans by July 31, 1999. (2) By June 1, 1999, begin publishing data on revenue, expenditure, and financing of the consolidated central government on a monthly basis with no more than a 4-week lag. (3) By June 30, 1999, issue new loan classification guidelines that fully reflect capacity to repay. These guidelines would also cover the treatment of restructured loans and the valuation of equity and convertible debt acquired as part of corporate restructuring. (4) For merchant banks, implement prudential rules for foreign exchange liquidity and exposures based on a maturity ladder approach by July 1, 1999. (5) Issue instructions, effective July 1, 1999, that at least 20 percent of the new guarantees issued by Korea Credit Guarantee Fund and Korea Technology Guarantee Fund will cover only 80-90 percent of the value of guaranteed obligations depending on the credit rating of the firm.	Ongoing. (1) Regulation was issued on March 26, 1999.

Sources: GAO analysis of Korea's letters of intent, and IMF and Korean documents, in addition to discussions with Korean and IMF officials.

Financial Sector Restructuring

The centerpiece of Korea's structural reform package was financial sector restructuring. Korea's goals were to have a sound, transparent (improved Korea's financial reporting, according to international accounting standards), and more efficient financial system. Korea had already begun efforts to reform its financial sector prior to seeking IMF assistance but had not been successful in passing reform legislation. Korea's initial IMF letter of intent detailed the government's plans for addressing the financial restructuring of the banks. The Korean government, in consultation with the IMF, prepared a comprehensive action program to strengthen supervision and regulation in accordance with international best practices. The IMF agreement built upon the framework for financial sector reforms that the Korean government had published in November 1997.

In its original letter of intent, Korea specified the need for a credible and clearly defined method for closing troubled banking institutions. The strategy required that troubled institutions present viable rehabilitation plans and close those insolvent financial institutions that failed to carry out their rehabilitation plans within specified periods. Korea also planned to set a timetable for all banks to meet or exceed Basle capital standards.[22]

[22] Bank regulators from industrialized countries adopted common risk-based standards for bank capital for internationally active banks in 1988 under the auspices of the Bank for International Settlements. Known as the Basle Accord, the standards were fully implemented in 1992 by member countries. The

The disposal of nonperforming loans was to be accelerated. All forms of assistance to banks, including financing from the Korean Asset Management Corporation and the deposit insurance funds, would be provided only as part of viable rehabilitation plans. All support to financial institutions, other than Bank of Korea liquidity credits, were to be recorded transparently in the fiscal accounts. In addition, blanket guarantees were to be phased out and replaced by a limited deposit insurance scheme.

In its first IMF agreement, Korea stated its intentions to restructure and recapitalize troubled financial institutions. Timeframes and rules for doing this were detailed in later agreements that accelerated and strengthened Korea's plans for addressing these problems. For example, the Koreans were successful in passing financial reform legislation and established a high-level team to negotiate with foreign creditors by the end of December 1997. The Korean government (1) appointed a high-level task force to develop and implement a strategy to address the financial crisis, (2) assumed control of Korea First Bank and Seoul Bank and hired outside experts to develop a privatization plan, and (3) hired experts to conduct due diligence with respect to the balance sheets of merchant banks and to assess the rehabilitation plans.

Other Structural Measures

Other measures included in Korea's initial IMF agreement were reforms in

- trade liberalization,
- capital account liberalization,
- corporate governance and corporate structure,
- labor market reforms, and
- information provisions and program monitoring.

The reforms for trade liberalization were part of changes already underway in line with Korea's World Trade Organization commitments and were accelerated during Korea's IMF program.[23] The changes in Korea's

standards are formula-based and apply risk-weights to reflect different gradations of risk. Since 1992, the rules have been amended. One of the most notable change is the establishment of risk-based capital requirements to cover market risk in bank securities and derivatives trading portfolios.

[23] For more specifics on Korea's efforts to liberalize its trade policies, see International Monetary Fund: Trade Policies of IMF Borrowers (GAO/NSIAD/GGD-99-174, June 22, 1999).

capital account were aimed at increasing competition and efficiency in the financial system. The schedule for allowing foreign entry into the domestic financial sector was to be accelerated. The United States supported these reforms and sought to move them forward quickly. Treasury officials told us that these were conditions they considered necessary to address underlying structural problems. More details were added in later agreements about the other structural reforms. For example, details about support for Korea's social safety net were added after the first quarterly review in February 1998.

The IMF Made Adjustments in Performance Criteria After Each Review

As part of monitoring Korea's progress in meeting IMF conditions, the IMF conducted quarterly reviews. After these quarterly reviews, monetary and fiscal targets were revised for the conditions outlined in the original IMF agreement. From the initial review to Korea's present program, the IMF added details and conditions to structural reforms that address underlying problems in the financial and corporate sector. According to IMF, Treasury, and State Department officials, changes in conditions for Korea's program reflected the progress made under the IMF's program.

Korea's initial program was intended to restore market confidence and limit private capital outflows through the large financing package, which was heavily front loaded, together with sound economic policies. However, according to program documents and our discussions with IMF officials, the program was not initially successful in restoring investor confidence, and private capital outflows far exceeded program projections. According to IMF officials, the changes made to Korea's macroeconomic targets reflected worsening conditions in the external environment (for example, the weakening of the Japanese yen, affecting Korea's export competitiveness) and were adjusted to match actual economic data. Nevertheless, the IMF was criticized for the fact that the policies taken in Korea to stabilize the economy caused monetary conditions to become too tight. IMF and Treasury officials told us the IMF projections were overly optimistic at the beginning of the program, based on Korea's past positive growth, and emphasized that the IMF did not accurately project the "rolling financial crisis" throughout Asia.

Within First 2 Weeks, the IMF Modified Korea's Program to Accelerate Funding Disbursements

According to IMF officials and program documents, Korea's response to the program was slow at first because of its national presidential election on December 18, 1997. The positive impact of the announcement of the IMF program on exchange and stock markets was small and short-lived. In the 2 weeks from the announcement until the first biweekly review, the won dropped to its low of 1963 won per dollar on December 23, 1997. Before the crisis, the value of the won was 915 to the dollar on September

30, 1997. Investor confidence was further undermined by doubts about Korea's commitment to the IMF program, as the leading candidates for the presidential election hesitated to endorse it publicly. Moreover, new information became available about the state of Korea's financial institutions, the level of its usable reserves, and short-term obligations falling due, raising concerns among investors about Korea's widening financing gap.[24] Part of Korea's agreement was to improve transparency in its financial reporting because the levels of usable international reserves, corporate debt, or banks' nonperforming loans had not been readily apparent from published data.

A temporary agreement was reached with the private, foreign bank creditors on December 24, 1997, to continue lending to Korean borrowers (to roll over short-term loans), and discussions on voluntary rescheduling of short-term debt were initiated. At the same time, Korea issued another letter of intent requesting the IMF to accelerate its funding, which the IMF agreed to do. Specifically, on December 24, 1997, Korea asked the IMF to modify the disbursement date under the stand-by agreement to December 30 from the original date of January 8, 1998, to permit an advancement of its IMF drawings. In negotiating the advancement of funds, Korea agreed to strengthen its structural reform agenda to accelerate financial sector restructuring and facilitate capital inflows into the domestic economy and bond market. Interest rates were raised significantly to about 30 percent at end-December 1997 from rates of about 12 percent in September 1997. Conditions for the Bank of Korea to provide foreign currency liquidity support to banks were tightened. One condition (quantitative performance criterion) of the IMF agreement was to raise the interest rate on Bank of Korea foreign exchange loans to commercial banks.[25] These actions were considered a signal of a clear commitment by the incoming administration to support reforms under the IMF program.

According to IMF documents, signs that Korea's economy was stabilizing emerged by the time of the second biweekly review on January 8, 1998. Korea met the end-December 1997 quantitative performance criteria for the net domestic assets and net international reserves. The other conditions for the review were met, and efforts to liberalize Korea's capital account were accelerated substantially. For example, Korea lifted the

[24] According to Treasury officials and IMF documents, a leak of IMF documents to the press released specific information on two Korean banks and the low levels of usable international reserves that had not been readily apparent from public sources. IMF documents showed the actual adjusted net international reserves as a negative $3 billion at the end of December 1997.

[25] The rate was gradually increased from 400 basis points above LIBOR on December 2 to 1,000 basis points by December 23, 1997, and would be raised further, if necessary.

restriction on foreign borrowing of over 3-year maturity on December 16, 1997.

To address Korea's vulnerability to its short-term debt and improve its rollover rates,[26] on January 28, 1998, Korea reached an agreement-in-principle with private bank creditors. IMF and Treasury documents note that this agreement was a voluntary rescheduling of Korean banks' short-term debt into loans with longer-term maturities. The agreement covered interbank deposits and short-term loans maturing during 1998, equivalent to about $22 billion.

First Quarterly Review Showed Korea's Market Situation Improving

The IMF completed its first full quarterly review of Korea's program in February 1998. According to IMF documents, Korea's exchange market situation was improving, but there were growing signs of a decline in economic activity. According to IMF, Treasury, and Korean officials, the agreement with bank creditors had helped to improve Korea's financing conditions. Korea's usable reserves had increased, and the won had appreciated by nearly 20 percent from the low in late December 1997.

In terms of fiscal policy, the IMF said it had proved difficult to adjust government spending rapidly. With the large currency depreciation occurring and domestic demand contracting, the IMF made adjustments in Korea's program. The revised program was based on lower (but still marginally positive) growth projections. The fiscal target for 1998 was lowered from a surplus of 0.2 percent of GDP in the original program (including bank restructuring costs) to a deficit of 0.8 percent of GDP. The IMF and Korea agreed that Korea would maintain a tight monetary policy as long as the exchange market situation continued to be fragile.

While Korea had already taken a number of steps to implement the program's comprehensive structural reform agenda, the revised program specified additional commitments in financial sector restructuring and capital account and trade liberalization. For example, Korea was to establish a unit for bank restructuring under the Financial Supervisory Board with adequate powers and resources to coordinate and monitor bank restructuring and the provision of public funds. Korea established this unit in April 1998.

[26] The effective rollover rate is defined as the proportion of short-term loans by foreign lenders to domestic financial institutions that are either rolled over or are matched by the opening of new lines of credit. This term is considered the rate that investments are converted or "rolled over" into another investment. The term is often used by banks when they allow a borrower to delay making a principal payment on a loan. Also, a country that has difficulty in making its debt payments may be granted a rollover by its creditors. With governments themselves, rollovers in the form of refundings or refinancings are routine.

After the new government took office in late February 1998, business, labor, and the government reached a tripartite accord. Based on this accord, the reform agenda was broadened to include measures to strengthen the social safety net, increase labor market flexibility, promote corporate restructuring, and enhance corporate governance.

At Second Quarterly Review, the IMF Reported that Korea's Reforms Were on Track

According to IMF documents and announcements, Korea's program remained on track, and market confidence in the new government's commitment strengthened. Growth projections were marked down further during the second quarterly review, which was completed May 29, 1998. Korea had successfully launched a global sovereign bond issue, significant capital inflows into the domestic stock and bond market had been registered, and usable reserves now exceeded $30 billion. According to IMF documents, Korea's sharp decline in economic activity, however, was weighing heavily on corporations, necessitating an acceleration of structural reforms in the financial and corporate sectors. Korea had lowered interest rates, but monetary policy continued to focus on maintaining exchange market stability. In view of the weaker outlook for growth, the fiscal target was eased further to permit automatic stabilizers (that is, adjustments in tax and government spending) to take effect.

In Korea's July 1998 letter of intent, Korea reported that it had made substantial progress in overcoming its external crisis. However, market sentiment weakened somewhat in June in view of growing concerns about the domestic recession and the impact of economic conditions in the region. Nevertheless, the won remained broadly stable and appreciated vis-à-vis the U.S. dollar in July, permitting Korea to further lower interest rates to pre-crisis levels. The Korean government prepared a supplementary budget to support economic activity and strengthen the social safety net. Output was now projected to decline by 4 percent in 1998, inflation had decelerated and was expected to average 9 percent during the year, and the current account surplus was expected to reach nearly $35 billion (over 10 percent of GDP).

The IMF's Third Quarterly Review Focused on Strengthening Structural Reforms

The IMF's third quarterly review, completed on August 28, 1998, focused on a further easing Korea's macroeconomic policies to mitigate the severity of the recession and on strengthening Korea's structural reform agenda. For example, Korea broadened its corporate restructuring efforts significantly, supported by the World Bank. In a July 23, 1998, memorandum of understanding between the government of Korea and the World Bank, Korea agreed to develop a framework and capacity to do voluntary corporate workouts and to provide policy support for corporate restructuring, in addition to taking other actions to reform the corporate sector. By the end of October 1998, Korea had drawn $27.2 billion of the total financing package for Korea, including $18.2 billion from the IMF and $9 billion from the World Bank and the Asian Development Bank.

Output was projected to contract by 5 percent in 1998, inflation had decelerated further and was expected to average 8.5 percent during the year, and the current account surplus was still expected to reach nearly $35 billion. Exchange market conditions permitting, interest rates were to be lowered again. According to Korean officials, they reluctantly agreed with the IMF to raise Korea's fiscal deficit target to 4 percent of GDP. Korea introduced a supplementary budget to increase government spending, including additional spending for social programs for those most affected by Korea's recession.

IMF Staff Recommended a Waiver in Fourth Quarterly Review

The IMF completed its fourth review of Korea in December 1998. The IMF staff recommended, and the Executive Board granted, a waiver for the structural performance criterion to obtain bids for the sale of two Korean banks. According to IMF staff, Korea's implementation of policies had been good, and all their quantitative criteria had been observed. It was apparent that Korea would not obtain bids for selling two Korean banks by the November 15, 1998, deadline, although the bidding process had begun. Since the World Bank was assisting Korea with this process, according to IMF staff, completing this action was a matter of timing, and it was necessary to allow a sufficient period for Korea to complete these negotiations. This action has since been completed.

Fifth Quarterly Review Completed

The IMF Executive Board met on April 7, 1999, for Korea's fifth quarterly review. According to IMF documents, the Korean authorities met all their quantitative performance criteria for end-December 1998 and fulfilled its policy commitments under the program. However, the IMF staff recommended waivers for (1) completing an audit of Korea's Asset Management Corporation to reflect any losses identified during the audit in its financial statement and (2) delivery of recommendations based on a financial supervisory review of the Korea Development Bank. According to IMF and Treasury officials, Korea has since completed these actions. Korea completed its audit of Korea's Asset Management Corporation on March 12, 1999, and the losses identified during the audit were reflected in its financial statement as of April 30, 1999. Also, Korea's Financial Supervisory Commission finished its supervisory examinations of the Korea Development Bank on March 20, 1999, (within the timetable of the review) and made recommendations to the Ministry of Finance and Economy on April 26, 1999.

Status of Program—Reform Efforts Remain Strong

IMF, Korean, U.S. Treasury, and State Department officials we spoke with were consistent in their views that Korea's reform efforts remain strong, but difficult reforms still need to be made in Korea's corporate sector. As noted earlier, Korea's program began slowly due in part to a presidential election. But to date, Korea has made substantial progress in its financial sector reforms. The U.S. Department of the Treasury reported to Congress[27] that Korea had complied with its IMF program. The Treasury reported that Korea's external financing crisis has been alleviated—the Bank of Korea's usable foreign exchange reserves recently surpassed $50 billion, reflecting a current account surplus in 1998 of nearly 12 percent of GDP and strong net inflows of portfolio capital. According to the Treasury's report, Korea's short-term external liabilities declined by nearly half, from $63.2 billion at the end of 1997 to an estimated $32.5 billion at the end of 1998. The Treasury also reported that Korea's continued adherence to the restructuring program set forth by the IMF and World Bank will be crucial to Korea's sustained recovery. Korea has already begun to repay its IMF borrowings for a total of about $6.1 billion, as of April 30, 1999.

According to Korean government documents, Korea's domestic economy remains weak, although stable. While Korea's economy still is vulnerable to external shocks, the government is projecting growth for 1999. IMF officials have changed its growth projections for 1999 from a negative 1 percent to a positive 2 percent GDP growth rate. As of April 1999, other private sector projections for Korea were also more optimistic. Some officials we spoke with noted that Korea still faced difficult reforms in its corporate sector and emphasized that it would take time for Korea to complete the reforms they have begun.

[27] This report was the Treasury's first semi-annual report, dated March 15, 1999, to the U.S. Senate Committees on Banking, Housing, and Urban Affairs and on Foreign Relations, in addition to the U.S. House of Representatives' Committees on Banking and Financial Services and on International Relations. This report provided details on financial stabilization programs in Brazil, Indonesia, and Korea.

The IMF's Financial Arrangement with Russia

Summary

When the Soviet Union disintegrated in 1991, Russia suffered a massive output collapse, with real GDP estimated to have fallen by 35 percent during 1991-94. Since the dissolution of the Soviet Union, Russia has borrowed from multilateral, official bilateral, and private creditors to meet its financing needs. Beginning in 1992, the IMF became the main vehicle for assisting Russia and promoting economic reform. The IMF faced the challenging task of helping Russia achieve financial stabilization while making rapid progress in transforming the economy to a market-based system. This was difficult from the start, as the reformers never had full control over economic policy.[1] Nevertheless, Russia was then, and remains, a focal point of U.S. national interests. Russia's political and economic stability are critical for the rest of the former Soviet Union, Eastern and Central Europe, and bordering areas. Further, Russia is a nuclear superpower and has large supplies of some of the world's key resources, including oil, natural gas, and strategic metals. According to the IMF, the world's stake in Russian reform has been too critical not to make the effort to help the economy.

Russia negotiated the now-terminated $10 billion, 3-year Extended Fund Facility arrangement[2] with the IMF in March 1996. Disbursements under the EFF were to be largest in the 1st year (65 percent of the quota in the first year and 55 percent in the second and third years); they were to be made monthly until early 1997 and quarterly thereafter. Performance under the program, to be monitored through its quantitative targets, was also to occur on a monthly basis, switching to a quarterly basis beginning in 1997. (It was the only IMF program to be monitored monthly at the time.)[3] Monthly "indicative targets" were established to serve as early warning signals of slippages in the program and to trigger the implementation of revenue measures in the event of deviations from the program revenue path. The 1996 program also contained a number (20) of structural benchmarks aimed at accelerating transition to a market-based system. These structural measures were formulated through intensive collaboration with the World Bank staff beginning June 1995, and Bank

[1] The current President, Boris Yeltsin, and the Duma, the lower house of Russia's parliament dominated by the Russian Communist Party, have frequently been in conflict. According to an IMF official, President Yeltsin, the Duma, regional governments, and portions of the federal executive all failed to support measures that were unpopular, especially with powerful interest groups.

[2] The Extended Fund Facility (EFF) is designed to support medium-term programs that generally run for 3 years. The EFF aims to overcome balance-of-payments difficulties stemming from macroeconomic and structural problems. Repayments are made in 4½ to 10 years.

[3] The IMF Executive Director representing Russia attributed the positive developments Russia achieved under adverse political circumstances during 1996 to the IMF's stepped-up monitoring of Russia's economy.

staff participated in every mission that dealt with structural policy contents of the program.

During the IMF program, Russia achieved some notable successes including sharply reduced inflation, a freely traded and convertible ruble, the abolition of central planning, a reduction in trade barriers, and the continued spread of privatization initiatives throughout Russia. Then, as now, the critical problems facing Russia were fiscal and monetary imbalances, combined with very slow progress toward a functioning market-based economy. While external developments, including the Asian crisis and associated weakness of energy prices, contributed to Russia's financial difficulties, the root cause of the unsustainable and intractable fiscal situation was Russia's inability to collect taxes. Building on the earlier programs, the 1996 extended arrangement continued to press for further reductions in the fiscal deficit and inflation, and for implementation of the key structural reforms that underpin a market economy. Increased revenue collection and improved government expenditures were the centerpiece of the program, given Russia's significant weaknesses in these areas, which persisted during the entire program.

Between March 1996 and July 1998, there were 12 reviews of the program, most of which included program modifications. Russia missed quantitative performance criteria targets in more than half of these reviews, and the IMF delayed disbursements and/or program approval numerous times. There are several explanations as to why Russia missed its targets: elections and political uncertainty, high interest rates and large interest payments, spending pressure and rise in arrears, investor uncertainty, and capital outflow. However, the substantive reasons for Russia's failure to achieve key goals, according to the IMF, were a fundamental lack of political will to collect revenues and the pervasive culture of nonpayment. The staff always noted the uncertainties and risks the IMF assumed in providing support to Russia. However, based on the IMF's assessment that Russia's efforts warranted continued IMF support, the IMF granted waivers for Russia's nonobservance of quarterly performance criteria, citing Russia's exemplary cooperation with the IMF and the determination of key senior officials to abide by the program.

Amidst the financial crisis of summer 1998, Russia requested and received additional IMF funds on the condition that Russia undertake major tax and other structural reforms. However, this was not enough to halt the crisis. Russia's persistently weak fiscal position and delays in structural reform, in combination with the adverse impact of the declining price of oil on

Russia's external balance and heavy reliance on short-term foreign capital inflows led to a full-scale banking and currency crisis by mid-August. Subsequently, Russia deviated so significantly from the program that the IMF halted further disbursements. In March 1999, the program was officially terminated upon Russia's request. Currently the IMF and Russia are negotiating a new arrangement.[4] Key events are indicated in the timeline in table VI.1.

Table VI.1: Chronology of Key Events in Russia's IMF Arrangements (SDRs in Millions)

Date	Event
Mar. 26, 1996	IMF Executive Board approves $10billion, 3-year EFF arrangement to Russia
Mar. 29, 1996	Russia receives 1st tranche (233.63 SDRs)
Apr. 29, 1996	1st Monthly Review Modify deficit limit (strong spending pressure and revenue shortfall coming). Concern over presidential elections for the 1st half of 1996.
May 3, 1996	Russia receives 2nd tranche (233.63 SDRs)
Jun. 5, 1996	1st Quarterly Review (2nd Monthly Review) Modification of deficit target.
Jun. 1996	Presidential election
Jun. 10, 1996	Russia receives 3rd tranche (233.63 SDRs)
Jun. 24, 1996	3rd Monthly Review Missed May floor targets for international reserves for external reasons.
Jun. 28,1996	Russia receives 4th tranche (233.63 SDRs)
Jul. 31,1996	4th Monthly Review completion delayed - program too far off track. Missed end-June targets: net domestic assets, monetary authority credit, reserves. Barely complied with deficit target. Lack of revenue collection effort. Broad performance modifications. Waiver for nonobservance of end-June targets. Postpone completion of 2nd Quarterly Review. Delay in June disbursement. Concerns over weak health of president in 2nd half of 1996.
Aug. 24,1996	4th Monthly Review complete based on July targets
Aug. 26,1996	Russia receives 5th tranche (233.63 SDRs)
Sep. 13,1996	2nd Quarterly Review (5th monthly review) Focus on structural policies and found disappointing slippages. Missed additional end-June performance criteria: monetary authority credit to government, deficit of enlarged government. Waiver requested for nonobservance of additional end-June criteria.
Sep. 18,1996	Russia received 6th tranche (233.63 SDRs)

[4] The IMF's Managing Director announced on April 28, 1999, that IMF staff and Russia had agreed on an economic program involving Fund finance of approximately $4.6 billion over 18 months. As of June 16, 1999, the IMF Board had not approved the arrangement.

Date	Event
Oct. 9,1996	6th monthly review Met all end-August targets. Continuing pressure against ruble.
Oct. 8,1996	Russia receives 7th tranche (233.63 SDRs)
Dec. 13,1996	3rd Quarterly Review (7th monthly review) – completion delayed. Missed 3 end-Sept. targets (deficits, reserves). Missed 1 end-Oct. target. Waiver for nonobservance of end-September performance criteria. Modification of performance criteria. Delay in Sept. and Oct. disbursements.
Dec. 13,1996	Russia receives 8th disbursement (233.63 SDRs)
Feb. 7, 1997	4th Quarterly Review (8th monthly review). Complied with end-Dec. targets.
Feb. 12, 1997	Russia receives 9th tranche (467.25 SDRs to make up for 1996 delays). No disbursements until 1997 program approved; dependent on implementation of prior actions; also purchase schedule revised.
May 16, 1997	Article IV Staff Report (9th monthly review) and approval of 1997 program.
May 16, 1997	Russia receives 10th disbursement (500 SDRs)
Jun. 1997	Preliminary data show first signs of growth in years
Sep. 3, 1997	5th Quarterly Review (10th monthly review) Missed end-June cash revenue floor. Signs of recovery becoming apparent. Waiver for nonobservance of revenue target.
Sep. 3, 1997	Russia receives 11th disbursement (500 SDRs)
Oct. 1997	Financial crisis in world financial markets affects Russia's financial markets. Substantial foreign exchange outflows. Decline in world oil prices.
Jan. 8, 1998	6th Quarterly Review (11th monthly review) Completion delayed due to non-observance of Jan.-Sept. 1997 performance criteria on federal government revenue. Program continues to face serious risks. Persistent fiscal fragility relating to revenue collection and expenditure control, and continued financial turmoil. 1997 progress: revitalization of privatization on transparent basis, continued progress in closing and restructuring smaller banks, and further rationalization of natural monopolies. Missed end-Sept. targets: cash revenue and international reserves. End-Sept. performance criteria not operationally relevant. Deviations from program path widened making achievement of end-Dec. performance criteria impossible. Modification requested for end-Dec. performance criteria (cash revenue, monetary aggregates, net international reserves)though Dec. performance criteria not available yet (being revised during the 6th review). Waiver of applicability of end-Dec. performance criteria. Delay in Nov. disbursement.
Jan.13, 1998	Russia receives 12th disbursement (500 SDRs)

Date	Event
Mar. 23, 1998	Prime Minister Chernomyrdin dismissed. Weakening of oil prices.
Apr. 24, 1998	Duma approves Sergei Kiriyenko as Prime Minister
Mid-May 1998	Severe financial crisis in Russia coinciding with renewed financial instability in South East Asia; reversal in market confidence; labor unrest in Russia – miners' strike. No disbursements until 1998 program approved. Delay in approval of 1998 program. Contingent on implementation prior actions. Fiscal targets revised with staff visits in April and May; also purchase schedule revised. Oil prices still weak. Staff supports request for extension of EFF for a 4th year.
Jun. 12, 1998	7th Quarterly Review (12th review) and approval of 1998 program. Missed end-March targets (federal cash revenue, deficit). Waiver requested for noncompliance with end-Dec. (1997) targets. Delay in disbursement of quarterly tranche until June due to cabinet changes and difficulty in meeting revenue package; fiscal targets revised. Russia requested extension of EFF arrangement for a 4th year
Jun. 30, 1998	Russia receives 13th disbursement (500 SDRs)
Jun. 23-Jul. 16, 1998	IMF mission in Moscow to negotiate augmented package
Jul. 17, 1998	Russia requests augmentation of extended arrangement and requests purchase under CCFF.
Jul. 20, 1998	IMF Board approves $11.2billion additional financial support to Russia. End-June data not available to assess compliance with June targets, so requirement was waived.
Jul. 20, 1998	Russia receives disbursement, but amount reduced from $5.6 to $4.8 billion because of delays in passing two key tax measures (personal income tax and pension fund). No further payments made.
Aug. 17, 1998	Russia government imposes unilateral restructuring of its ruble-denominated sovereign debt and announces a 90 day moratorium on private external debt payments. Subsequently ruble depreciates by more than 60 percent.
Sep. 11, 1998	German government acknowledges that Russia missed virtually all of a DM800 million interest payment due on August 20 on Soviet era sovereign debt.
Sep. 11, 1998	Dissolution of the Kiriyenko government; Duma approval of Yevgeny Primakov as Prime Minister.
Sep. 1998	Remaining $10.3 billion IMF commitment from the July 1998 package is no longer available. Negotiations begun on new economic program.
Mar. 31, 1999	Program officially terminated at Russia's request.
Apr. 28, 1999	IMF Managing Director announces that Russia and the IMF agreed in principle on an approximately $4.6 million Stand-by Arrangement; not yet approved by IMF Executive Board.
May 12, 1999	President Yeltsin dismisses Prime Minister Yevgeny Primakov (4th prime minister dismissed in 14 months).

Source: IMF and Russian government documents.

Early Programs and the Context of the 1996 IMF Russia Programs

The early IMF programs in Russia faced unsettled conditions, systemic problems, and large macroeconomic imbalances. During 1992-94, the initial period of market reform, Russia received financial assistance from the IMF in the form of a first credit tranche Stand-By Arrangement (SBA) and two purchases under the Systemic Transformation Facility (STF).[5] From the outset, the Russian economic programs focused on reducing macroeconomic imbalances and moving toward a market-based economy. The IMF, along with the World Bank and other bilateral and multilateral agencies, also began providing a broad range of technical assistance that would develop the supporting macroeconomic management capability. These early programs were implemented under unsettled political and constitutional conditions that severely complicated the already daunting task of stabilizing the economy while transforming its basic features. While significantly reducing the fiscal deficit and curtailing credit expansion aided a decline in consumer price inflation from 2,500 percent at end-1992 to around 200 percent at end-1994, none of the programs was successfully carried through: stabilization remained elusive, reforms fell short of the goals, and inflation remained excessive.

Inflation Was a Primary Focus of 1995 Stand-by Arrangement

The 1995 SBA was negotiated over several months against the backdrop of policy failures and worsening economic performance. For example, in January 1995—midway through program negotiations—the monthly inflation rate accelerated to 18 percent and there was a further $1 billion reserve loss. The SBA was approved in April 1995, despite a large measure of uncertainty regarding the Russian government's ability and determination to implement the program. The program itself was characterized by what the IMF considered to be a large reliance on expenditure restraint. The SBA program focused on Russia's achieving a substantial and sustained reduction in inflation, seen as essential for economic recovery. This was to be effected by imposing an even tighter monetary policy and a reduction of the deficit from 5 percent of GDP in 1996 to 2 percent of GDP in 1998. Although inflation in Russia declined significantly in 1995 – the consumer price index was 134 percent at the end of 1995 – it nonetheless remained significantly above the level targeted in the SBA program.

The 1996 Extended Fund Facility Program

The focus of the 1996 arrangement was on reducing fiscal and monetary imbalances while transitioning to a market-based economy. The primary

[5] The STF was a temporary facility in effect between 1993 and 1995 to assist transition economies. It's purpose was to provide financing to member countries facing balance-of-payments difficulties arising from severe disruptions of their international trade and payments arrangements owing to a shift away from significant reliance on state trading at nonmarket prices toward multilateral, market-based trade.

problems were the fiscal deficit, weak tax collection, and excessive government spending.

The recently terminated $10-billion, 3-year EFF arrangement, approved by the IMF in March 1996, was negotiated on the heels of the 1995, 12-month, SBA arrangement, under increasingly adverse political circumstances. The program's broad objectives were to achieve financial stabilization while transitioning to a market-based economy and to lay the basis for sustained growth. This was to be accomplished by reducing the budget deficit from around 5 percent in 1995 to 4 percent in 1996 and 2 percent in 1998, lowering the inflation rate from around a 7-percent monthly average in 1995 to 1.9 percent per month in 1996, and implementing key structural reforms. In addition to improving tax administration and limiting government expenditures, the fiscal strategy was to reduce the deficit by improving revenue collections – raising the revenue-to-GDP-ratio from around 10 percent in 1995 to 11 percent in 1996 and to 15 percent by 1999. The monetary strategy was to continue to lower inflation and strengthen the banking system by resolving the problem of weak and insolvent banks.

At the time the IMF and Russia were negotiating the 1996 arrangement, the critical problems facing Russia were – and continue to be – fiscal and monetary imbalances, combined with very slow progress toward a functioning, market-based economy. At the heart of the fiscal deficit problem lay weakness in tax revenue collection and government spending in excess of what was affordable. To address the revenue problem, the program focused on improved tax administration, collecting outstanding tax arrears – especially from the energy sector – and eradicating the culture of nonpayment. The Russian government also agreed to resist strong spending pressures and to make cuts in noninterest spending to achieve the deficit reduction target. A restrained credit stance was intended to lower inflation further toward a single-digit annual rate and to serve as the first line of defense against depreciation pressures on the ruble. The 3-year EFF program also continued to press for implementation of the structural reforms key to a market-based economic system, including improving the structure of government spending and treasury functions, strengthening the banking system, reaccelerating the privatization process, and completing the process of trade policy liberalization.

Need to Strengthen Balance of Payments

IMF funding in 1996 was also seen as critical for Russia to establish medium-term balance-of-payments viability. At the time of the 1996 extended arrangement, the IMF described Russia's trade balance as "robust": the trade balance had been in surplus since 1993. However, the current account was expected to weaken over the next few years as investment recovered, private savings declined, and imports rose. Also, Russia was experiencing a basic weakness in its external accounts, due in part to net short-term capital outflows and an inadequate level of reserves. Further, a bunching of debt service obligations was expected to occur between 1996 and 2000. IMF funding was viewed as critical in catalyzing both Paris and London Club debt rescheduling and encouraging the inflow of capital to the private sector. This would reduce the future burden on the federal budget and strengthen Russia's balance of payments.

Progress Measured by Quantitative Performance Criteria and Structural Policy Benchmarks

Key to evaluating Russia's progress in the program, and to the decision to release the next quarter's loan tranche, were the quarterly performance criteria. These quantitative quarterly performance criteria included the following fiscal, monetary and international reserve targets:

- federal and enlarged (including regional and extrabudgetary funds) government deficit,
- federal government cash revenue floor,
- limit on the stock of net domestic assets of the monetary authority (that is, currency in circulation and bank deposits at the Central Bank of Russia, [CBR]),
- limit on the monetary authority's claims on the federal and enlarged government, and
- floors on both gross and net international reserves.

The 1996 plan was based on an ambitious structural reform program aimed at improving the functioning of markets. The following are some of the 20 structural benchmarks proposed under the 1996 program:

By March 31, 1996, Russia was to complete an evaluation of the financial condition of the 10 largest banks.

By June 30, 1996, Russia was to

- establish procedures for gas prices to reflect variation in transmission costs to launch audit of 5 major fully or majority-owned state owned enterprises and
- submit legislation for move to an accruals-based system for the profit and value added tax.

By September 30, 1996, Russia was to

- ensure that all remaining import duties rates above 30 percent are replaced with excise taxes,
- submit specific legislation to improve the fiscal relations between the federal and subnational governments, and
- conclude an evaluation of the financial situation of the 200 largest banks.

By December 31, 1996, Russia was to

- complete an annual audit of the Pension and Employment Funds according to international standards,
- prepare a list and launch an audit of an additional 5 major enterprises in which the state has full of majority ownership, and
- initiate an implementation procedure to deal with problem banks.

Russia also had to undertake certain prior macroeconomic actions (for example, introduce additional revenue measures) and structural policy actions (for example, revoke import restrictions on alcoholic beverages) before the IMF Executive Board would approve the 1996 EFF program. Both structural performance benchmarks and prior actions for IMF Board reviews of the program were altered frequently throughout the program to reflect changing conditions.

IMF Board Reviews

Overall, the IMF determined that Russia's efforts during 1996 fell short of the targets. There were seven program reviews during the program's first year. These seven reviews included four instances of program modification, three occurrences of waivers for nonobservance of performance criteria, and three delays in disbursements. While Russia had success in moderating inflation – the monthly average inflation rate for 1996 was 1.7 percent – there was less success in achieving fiscal goals. For 1996, the federal deficit registered 6.3 percent of GDP instead of the planned 4 percent, and federal revenues fell from 10.5 percent of GDP in 1995 to only 9.5 in 1996, in contrast to the targeted increase of nearly 1 percent in 1996. Moreover, exchange rate stability was bought at the expense of a significant loss of reserves. Additionally, progress in pursuing structural reforms was disappointing, according to the IMF. In the first half of 1996, uncertainties related to the election outcome influenced fiscal performance and revealed the fragility of the 1996 fiscal framework; in the second half of 1996, concerns about the health of the Russian president contributed to heightened uncertainty. More fundamentally, however, fiscal slippages were attributable to a lack of sufficient political commitment to insist on the payment of tax liabilities, especially by large taxpayers, as well as the weak capacity of tax administration and the deficiencies in the tax system. Nonetheless, while they delayed the completion of a number of reviews for failure to meet program conditions, the IMF staff continued to recommend approval of the program, despite uncertainties about the government's capacity to implement it, because, as the staff said, the new government demonstrated strong leadership, which could lead to a successful program if backed at the highest level.

Program Adjustment and Disbursement Delays Marked the First Four Months of Program Reviews

Russian presidential election concerns dominated the first half of 1996. During this period, the IMF reviewed the program four times (three monthly reviews and one quarterly review), modifying the deficit limits in the first two reviews and making broad performance modifications in the fourth month review. Inflation continued to decline as the monetary authority adhered to a tight credit stance, and the central bank was able to maintain a stable exchange rate corridor despite the political uncertainty and pressure toward ruble depreciation. There were other positive developments: Russia had (1) achieved some structural reforms in banking and tax-related fiscal measures;[6] and, (2) satisfied the quantitative targets in the first two reviews, aided by modification of the deficit limits to accommodate the clearance of accumulated wage arrears and the jump in treasury bill rates. However, the fiscal situation remained quite vulnerable, owing to both internal and external factors. The continuing weakness in revenue collection reflected the lack of will to enforce existing law, deficiencies in the tax system, rising tax arrears, and strong spending pressures with the approaching June presidential elections. The higher treasury bill rates, which raised the interest payments to higher levels than assumed under the program, was in large part due to the highly charged political environment. On this basis, Russia and the IMF agreed to an upward adjustment in the deficit ceiling, while securing the government's commitment to focus on collecting tax arrears. Two other areas that were also a source of ongoing concern were the sustained depreciation pressures on the ruble, which put the international reserve targets at risk, and the sluggish progress on structural reforms. The staff also attributed the pressure against the ruble, and the consequent loss in reserves, to the market sensitivity generated by this historic, election-dominated situation.

[6] At the second monthly review, on May 29, 1996, Russia had fulfilled 3 of the 20 structural benchmarks and 19 of the 38 structural measures.

Officials Committed To Program, But Systemic Weakness in Tax Revenue Collection Continue

Throughout this period, the IMF staff commented on the determination of key senior officials to abide by the program, noting their commitment and determined efforts. However, the completion of the fourth review and the disbursement of the July tranche was postponed until late-August because the program had gotten too far off track. Russia had missed its monetary targets and had barely complied with the deficit target. The main concern was the progressive weakening of the federal government's cash tax revenues, reflecting an environment in which paying taxes appeared to be more a matter of choice than an obligation. The upcoming heavy interest payment schedule and accumulation of wage and pension arrears made the deficit target virtually out of reach. Hence there was a broad reassessment of policy requirements for the remainder of the year to bring the program back on track. The completion of the fourth review was made conditional upon Russia's meeting end-July targets as modified and significantly increasing tax revenues. Russia also received a waiver for nonobservance of end-June targets. In the end, the IMF staff's support for the program reflected their assessment that immense pressures had led to Russia's missing the targets, that the Russian authorities were taking actions to bring the program back on track, and that the Russians' efforts "deserve the benefit of doubt and warrant continued Fund support."

Missed Targets, Waivers, Program Modifications, and Delays in Disbursement Characterized the Remainder of the 1996 Program

Three reviews were completed from August through December 1996 (following the completion of the fourth review). The first review focused on progress in structural policies and found the results disappointing, though structural reform efforts had been recently stepped up. Fourty-four modifications were proposed for the structural program, and the Russian authorities agreed to a revised set of 10 new structural benchmarks for the remainder of the year. During this period, the IMF continued to encourage the government to open the treasury bill market to nonresidents so that Russia could have better access to private capital markets. The CBR officials agreed in principle but expressed concerns regarding the volatility of foreign capital inflows that could easily be converted into dollars rather than rolled over into new debt. Meanwhile, by September, the dominant concern was continuing pressure on the ruble and international reserves, despite the favorable inflation trend and the cautious macroeconomic policy. The IMF staff believed that noneconomic, temporary, and reversible factors such as concerns about President Yeltsin's health, the postponement of the completion of the fourth review, changes in the rules governing nonresident access to the Treasury bill market, and concern about the health of the banking system contributed to the exchange market pressure. While continuing to note the major risks and difficulties in the Russian situation, the IMF maintained a cautious optimism that the authorities would address these problems and continue to achieve program objectives.

At Third Quarter Review, Program Off Track, and Review and Disbursement Delayed–Weakness in Revenue Collection at Source

However, by the third quarterly review, originally scheduled for completion in October 1996, Russia had gotten too far off the program, and the review was delayed until December. Consequently, both October and November disbursements to Russia were delayed. Russia had missed the September international reserve and deficit targets – the deficit of the federal government amounted to 6.7 percent of GDP. There was a marked deterioration in revenue performance because of a tax code change that gave priority to wage payment over meeting tax payments: revenues had declined to 9 percent of GDP at November 1996. The nonobservance of the deficit target was due, in part, to the need to make large interest payments on treasury bills that had been issued at high interest rates in the second quarter. But more fundamentally, the deficit continued to originate from a weakness in revenue collection due to a lack of government resolve to enforce tax laws. As a result of weaker-than-anticipated revenue and higher-than-anticipated interest payments, the IMF and Russia agreed to modifications to the fiscal and monetary performance criteria for end-December 1996. These modifications were to serve as the first step of the 1997 program. Also, understandings were reached on a comprehensive action plan that sought to improve revenue collection by creating a tax-paying culture in Russia rather than just proposing tax measures.

Progress in Structural Reform Lagging, Fiscal Situation Difficult–Waiver Granted Based on Good Faith Efforts

The IMF staff noted that, in hindsight, the structural work plan might have been too ambitious for Russia to manage, given its limited institutional capacity. Even though program revisions had just been introduced in August/September to reflect the slower pace of implementation of structural reforms in the first half of 1996, progress in the structural policy agenda was still lagging at this time. With the important exception of banking reform – where actions were in line with the program – structural reforms fell short of the objectives in all areas in 1996. Only two of the seven structural benchmarks that were the subject of this review had been met, and immediate action was required before the staff could recommend completion of the third quarter review. At the end of 1996, the situation in Russia remained fragile, and the fiscal situation was difficult. However, the staff determined that the authorities continued to demonstrate their firm intention to maintain a restrained credit stance to forestall inflation and to reduce pressure on international reserves. The staff also acknowledged the authorities' good faith efforts and exemplary cooperation with the IMF. In the end, the IMF granted Russia a waiver for its nonobservance of end-September performance criteria.

Approval of 1997 Program Delayed Pending Completion of Prior Actions

The completion of the May 1997 Article IV staff report also gave the Executive Board's approval of the 1997 EFF program. The report followed the April negotiations and the setting of program targets. The approval came after Russia implemented a series of prior actions, including submission of the tax code and a new 1997 spending plan to the Duma, a crackdown on large tax debtors, and announcement of transparent privatization procedures. The 1997 program included a revised schedule of disbursements for the 1997 program year (Russia had received no program disbursements since the one following the completed eighth month review in mid-February 1997). As envisaged under the program, performance was to be monitored quarterly on the basis of quarterly performance criteria. However, because of the significant risks that Russia still faced, the IMF continued to closely monitor developments throughout the period of the extended arrangement.

A major focus of the fiscal program in 1997 was the reversal of the declining trend in federal cash revenues in relation to GDP and the elimination of the use of noncash revenue sources. Cash revenues were targeted to increase, on average, to 8.3 percent of GDP in 1997, compared with 7 percent of GDP in 1996. To improve revenue collection, the Russian authorities agreed to major tax reform and the full implementation of the comprehensive November 1996 action plan. The annual limit on the federal deficit in 1997 was set at 5.5 percent of GDP, higher than the original EFF target of 3 percent of GDP for 1997, but lower than the 6.3 percent deficit at yearend 1996. A further reduction in inflation to a monthly rate of 1 percent in 1997 was one of the program's main economic goals. In addition to implementing the November 1996 action plan in full, the structural program for 1997 was designed to accelerate the process of building the institutional and legal framework to support a market economy. Table VI.2 shows Russia's performance in some critical areas.

Table VI.2: Russian Federation: Federal Budget Aggregates and Inflation, 1993-1997 (in Percent of GDP)

	1993	1994	1995	1996	1997 IMF Program
Revenue	13.7	11.8	10.6	9.5	9.4
of which:					
Cash	13.7	11.4	9.1	7.0	8.3
Expenditures	20.2	23.2	15.4	15.8	15.0
Noninterest	18.2	21.2	12.5	11.3	10.8
Interest	2.0	2.0	2.9	4.5	4.2
Fiscal deficit	-6.5	-11.4	-4.8	-6.3	-5.5
Inflation (annual percent change)	874.5	307.4	197.4	47.6	14.2 (actual 1997, 14.6)

Source: Various IMF documents.

Positive Developments in First Half of 1997

Preliminary data at this time were showing that the economy had begun to turn around since the third quarter of 1996. Output appeared to have stabilized in 1997 after years of decline; inflation continued to decelerate – the monthly percent change for the last quarter of 1996 had declined to 1.7 percent; and the exchange rate was stable. Structural reforms had gained momentum in the areas of natural monopolies and public utilities, and the government had eased restrictions on access to capital markets by nonresidents. While the authorities had used a sizable reserve cushion to defend the ruble during 1996, there was a reversal of exchange market pressure in the first half of 1997 attended by large capital inflows. The easier monetary conditions due to the capital inflows and the clearing up of arrears brought with them the associated risk of renewed inflation, and the IMF monetary program was revised for the second half of 1997. Compared to the severe difficulties experienced in 1996, the developments during the first half of 1997 were encouraging. The IMF staff noted, however, that there were still considerable uncertainties in Russia, and that the IMF assumed a potentially large exposure to risk[7] in providing support to the country. Given Russia's substantial reliance on energy exports, there was also a risk of external shocks, for example, due to a decline in the price of oil or gas. Amid uncertainties about the government's capacity to implement the program, the IMF approved the 1997 program based on the strong leadership demonstrated by the new government as well as the completion of the prior actions.

[7] The risk that Russia would not be able to repay the loan.

Fall 1997: Ripple Effects From the Asian Financial Crisis Spill Over to Russia's Financial Markets, Compounding Russia's Fiscal Problems

In mid-1997, the economic crisis that started in Thailand quickly spread to other Asian countries and to Russia, aborting the nascent economic recovery that had just begun in Russia after 8 years of deep output decline. From October 1997 on, Russia continued to experienced recurrent financial crises. The government and the CBR attempted to protect the main economic policy achievements of the recent years—low inflation, a fixed ruble, and the living standards of the people – through foreign exchange market interventions and interest rate hikes, both seen as needed to defend the ruble.

Waivers, Modifications, and Program Delays Ensue

The spillover from the Asian financial turbulence in the fall of 1997 spread to Russia's financial markets and further undermined investor confidence, already adversely impacted by Russia's ongoing fiscal problems. Federal cash revenue collections were not improving, and the government was able to achieve the deficit target only by holding down cash expenditures, thus creating new expenditure arrears. Substantial foreign exchange outflows accompanied the financial turbulence. The CBR's response was to sell foreign exchange and, later, to raise interest rates. Consequently, Russia was unable to meet its international reserve target. Originally intended to be an assessment of end-September performance, the IMF's sixth quarterly review and the corresponding quarterly disbursement were delayed until January 1998. The delay was due to the serious underlying weakness and slow progress in addressing the fiscal problems, as indicated by the nonobservance of the government revenue performance criterion from January to September 1997. The review also indicated that the September performance criteria, which Russia did not meet, were no longer operationally relevant. The December criteria were being modified, as they were no longer attainable either, and thus could not be applied against Russia's performance yet. Thus, the review requested a waiver of the applicability of December performance criteria.[8] During this period, structural reforms proceeded generally as envisaged under the 1997 program, particularly in the areas of natural monopolies (gas) and privatization, and there was continued progress in closing and restructuring smaller banks. Overall, however, the IMF staff recognized that the program continued to face serious risks.

[8] A "waiver of applicability" generally is used when a review slips. If the IMF staff believes it cannot certify the country's compliance with the performance criteria during the relevant time period but is confident that the program is on track, this waiver will be recommended. However, the staff is likely to try to verify the country's compliance with the waived performance criteria at a later time, generally the next review.

New Fiscal Action Plan Addresses Budget Difficulties and Tax Collection

In late 1997, the IMF and Russia created a credible fiscal action plan and developed monetary policy actions and targets to reestablish monetary policy restraint, which had deviated considerably from the program. On the fiscal side, the discussions emphasized the difficulties in controlling budget expenditures, as well as ineffective efforts to collect taxes from large debtors, as the source of fiscal problems. For example, the inability of the government to pay its own bills, combined with extensive use of monetary offsets and noncash mechanisms to settle budgetary arrears against tax debtors' arrears, undermined incentives for paying taxes in cash. The Russian government agreed to take steps (prior actions) based on the newly developed strategy to bring the fiscal program back on track, including the abolition of all types of noncash tax arrangements on January 1, 1998. The monetary policy discussions were concerned with the CBR's response to sizable foreign exchange outflows and how to ensure that these outflows would not become a source of inflationary pressure. Informal and flexible understandings[9] were reached on a revised monetary program for end-December 1997 that permitted some room for expansion of base money but also emphasized keeping inflation on a downward trend and protecting international reserves. To complete the review, the government had to undertake fiscal measures, agree upon targets for the 1998 federal budget, revise monetary performance criteria for end-December 1997, and complete actions on the structural side.

Lack of Political Will Behind Lax Revenue Collection

The IMF staff conceded that little had been accomplished on the fiscal side by end-December 1997, particularly in the collection of tax revenues, owing to a lack of "forceful and focused implementation," along with slow progress in improving tax administration, and that the credibility of the Russian authorities was at stake. However, they recommended the completion of the sixth review based on the newly adopted fiscal action plan that brought a new approach to tackling the fiscal problem and the expectation that the authorities would make a concerted effort to follow through this time.

[9] For example, the mission staff stressed that when faced with sizable foreign exchange outflows, the CBR should allow domestic money market conditions to tighten (that is, let interest rates rise), or at least refrain from intervening to prop up the price of treasury bills. The CBR concurred.

Cabinet Changes Delayed 1998 Program Approval and Disbursement of First Tranche–Low Oil Prices Led to Further Program Modifications

During February 1998, amid the ongoing pressures on Russia's financial markets, an IMF mission team visited Moscow to hold discussions for the seventh quarterly review and to complete the talks begun earlier on the 1998 program. The subsequent dismissal of Prime Minister Victor Chernomyrdin in March and the Duma's approval of Yevgeny Kiriyenko in April, together with weak oil prices, delayed the review and implementation of the program, as well as the disbursement of the $700 million credit tranche. Follow-up staff visits took place in April and May to revise the fiscal targets and policies for 1998.

1998 Program Approved Amid May Financial Crisis

In mid-May, following the formulation of the 1998 program, a severe financial crisis hit Russia, coinciding with renewed financial instability in Asia (Indonesia) and labor unrest in Russia. The CBR's interventions in the foreign exchange market led to a large decline in reserves, and sharp increases in interest rate and financial volatility underscored Russia's vulnerability to changes in market sentiment. The IMF staff again recognized that the program might have to be revisited unless confidence returned. The completion of the review and approval of the 1998 program occurred in June 1998, following Russia's completion or satisfactory progress in 27 fiscal, financial, and structural measures (many were from the November 1997 Fiscal Action Plan) and observance of the March targets. Some measures included (1) collecting taxes from large tax debtors, (2) taking steps to improve tax collection, (3) establishing better monitoring and control over expenditure commitment, and (4) identifying additional expenditure cuts. Although Russia missed the deficit and cash revenue targets for end-March, no waiver was requested,[10] though a waiver was granted for nonobservance of one December 1997 performance criterion. The staff also supported Russia's request for the extension of the EFF arrangement for a fourth year in light of the delayed purchases during 1996-97 and the need to catch up with the original program objectives.

The 1998 Program Emphasized Expenditure Cuts and Pursuit of Tax Debtors With Large Arrears

The Russian government favored achieving the deficit target through spending cuts, as officials did not think that they could collect the required amount of cash tax revenues or that the Duma would agree to the required tax measures. However, the IMF staff's opinion was that expenditure cuts often translated into new expenditure arrears, hence they emphasized strengthening collections from large, delinquent tax debtors. In the end, the program relied on both approaches. For example, the Emergency Tax Commission met in May and made a decision to collect arrears from a

[10] The IMF Board discussed the seventh quarterly review on June 25, 1998. The relevant performance criteria were those that were established for end-December 1997. There were no performance criteria for end-March 1998 (only indicative targets) and, as a result, the end-December 1997 performance criteria remained in effect at the time of the IMF Board review.

number of large tax debtors, and the Expenditure Reduction plan was adopted by presidential decree that month as well[11]. Eliminating mutual offsets, which undermined the incentives to pay taxes in cash, was also critical to resolving the fiscal problem. No new offset operations had been approved since January 1, 1998, and federal government abstention from any offset operations was to be a performance criterion under the 1998 program.[12]

Structural Reforms Were Front-Loaded; Transparency and Accountability Were Emphasized

The 1998 structural reform program was front loaded with a wide range of measures taken as prior actions ahead of the IMF Executive Board’s consideration. Structural reforms that would have important macroeconomic impact over the medium term were designated benchmarks for each quarter. Some areas of focus for the structural reform agenda included making improvements in corporate governance through ensuring a more transparent accounting by public utility and transport monopolies, engaging in an open and competitive privatization process, liberalizing the trade regime, and strengthening the prudential and supervisory framework of the banking sector. Some of the fiscal prior actions Russia had to undertake for the completion of the seventy quarterly review were based on elements from the November 1997 Fiscal Action Plan, for example, collecting taxes from large tax debtors, establishing better monitoring and control over expenditure commitments, and identifying additional expenditure cuts needed to observe the program targets. Progress in structural reforms continued to be based on an overall assessment, but with a particular emphasis on the structural benchmarks.

1998 Program Had Substantial Risks

While the IMF’s projections for 1998 and beyond indicated a strengthening of Russia’s balance of payments over the medium term that would permit Russia to service its obligation to the IMF, the IMF staff was cognizant of substantial risks to the program, such as:

- a variability in capital flows and foreign exchange outflows, magnified by Russia’s dependence on nonresident’s participation in the treasury bill market (as illustrated by May 1998 events);
- a vulnerability to external shocks, given Russia’s reliance on energy exports;
- a sluggish pace in transitioning to a market economy; and

[11] One item, for example, in the Expenditure Reduction Plan included reducing the number of spending units from 139 to 99.

[12] According to the U.S. Treasury, the Russian government did another round of offsets in February 1999.

- the upcoming elections that could undermine the government's will and ability to implement tough measures.

Nevertheless the IMF staff indicated that the program was deserving of continued IMF support because of the government's strong commitment to the program and the important steps it took to stabilize and reform the economy during the first 2 years of the EFF. Further, the staff noted, the Russian authorities were taking additional prior actions before the IMF Board meeting, were implementing many of the fiscal measures, and were committed to an ambitious structural reform agenda.

Economy Vulnerable to Variable Capital Flows and Foreign Exchange Outflows

The Russian government had financed its high, and ultimately unsustainable, budget deficits by selling ruble-denominated, short-term debt to both foreign and domestic investors. By May 1998, nonresident investors were holding about one-third ($20 billion) of domestic treasury securities. The government borrowed in capital markets and issued treasury bills and bonds at high yields to attract capital. This added a heavy debt service burden to the Russian budget. Further, the short-term maturity of the debt meant that Russia constantly had to roll over the debt. This made the economy highly vulnerable to changing investor sentiments in the capital market. As long as foreign and domestic investors were willing to renew short-term debt, this practice could continue, but Asia's financial problems intensified the instability in global financial markets. The combination of high yields, deteriorating investor sentiment, and the short-term maturity of the treasury bills raised investor concerns that the Russian government would not be able to meet around $1.5 billion in debt service that fell due each week in the remainder of 1998. By June 1998, domestic borrowing to finance the federal budget came to a virtual halt.

June 1998: Russia Requests Additional Funds to Avert Financial Crisis

The Russian government had been in a race between its need to collect more taxes and to pay the rising interest bill on its growing debt – the government had to roll over more than $1 billion per week of treasury bills. This became impossible, as export revenues declined with falling oil and commodity prices and interest rates sharply increased when capital fled the country. The persistent weaknesses in tax collection and government spending in excess of what was affordable exacerbated the situation. Russia was forced to request international assistance

- to replenish international reserves,
- to overcome liquidity problems arising from foreign investors redeeming their short-term ruble-denominated debt, and

- to provide the government with reserves of dollars and other foreign currencies to keep the ruble at its current value in foreign exchange markets.

The government needed more dollars to attempt to prevent the ruble from losing too much of its value against the dollar. A depreciated ruble could create serious problems for the Russian banks and industries that had to buy dollars with rubles to repay their loans from foreign banks. It could also reignite the ruinous inflation that had plagued Russia in the early 1990s by raising the price of imports.

IMF Approves Request – Exceptional Risk Noted

Recognizing that it was a calculated risk,[13] and to try to help Russia avoid devaluation, the IMF made a decision to provide $11.2 billion in extra funding on an augmented EFF arrangement on July 20, 1998. The financing consisted of an increase in the EFF arrangement of about $8.3 billion, and about $2.9 billion under the Compensatory and Contingency Financing Facility (CCFF)[14] to compensate for a shortfall in export earnings, mainly due to lower oil prices. Of the augmented amount to be provided under the extended arrangement, about $5.3b was to be made available under the Supplemental Reserve Facility[15] (SRF), and the remainder was new EFF funding. The augmentation of the extended arrangement came from borrowing the equivalent of about $8.3 billion under the IMF's rarely used General Agreement on Borrowing.

As June 1998 data were not available to assess Russia's performance under the 1998 program, this requirement was waived in the proposed decision, and the IMF approved the first disbursement under the CCFF. The remainder of the disbursements were to be in three additional installments phased through February 1999. Because of Russia's delays in implementing the personal income tax and pension measures, the amount being made available immediately was reduced from $5.6 billion to $4.8 billion. The difference was to be made available in September, assuming the measures were satisfactorily implemented.

[13] The risk to the IMF was that in this deteriorating situation the attempt to avert devaluation and its adverse impacts would fail and Russia would not be able to deliver on its policy commitments.

[14] The CCFF provides financial assistance to IMF members experiencing temporary export shortfalls. Repayments are made over 3¼ to 5 years. A decline in world oil prices had reduced Russia's foreign exchange earnings.

[15] The Supplemental Reserve Facility provides financial assistance for exceptional balance-of-payments difficulties due to a large, short-term financing need resulting from a sudden and disruptive loss of market confidence. Repayments are to be made within 1 to 1½ years.

New Package Could Not Halt Crisis

The new package included fiscal measures to aimed at reducing the fiscal deficit. These included:

- tax reforms, measures to increase tax revenues, and spending cuts;
- new structural reforms to address the arrears problem and promote private sector development; and
- steps to reduce the vulnerability of the government debt position (for instance, a voluntary restructuring of short-term treasury bills).

The July 20, 1998 announcement of the IMF's additional policy package had a positive, but very short-lived, effect on Russia's financial markets. Ultimately, the Duma's lack of support for the program in the areas of personal income tax and pension fund financing and the veto by the president of several measures led the IMF to reduce the initial amount of the disbursement from $5.6 billion to $4.8 billion.[16] The program also faced opposition in the key energy sector, and the collection of overdue tax payments from a number of oil companies proved difficult. Finally, the government-owned Sberbank's decision to not roll over its sizable treasury bill holdings falling due in the last 2 weeks in July culminated in cancelled bond auctions because of prohibitively high borrowing rates. With pressure growing against the ruble and spreading to the banking sector, the CBR was forced to intervene on a large scale. However, these actions were not enough to avert a serious crisis. Russia was facing a full-scale banking and currency crisis by mid-August.

Russia's persistently large fiscal imbalances, heavy reliance on short-term foreign borrowing financed at high interest rates, the impact of the declining price of oil on Russia's external balance, and delays in structural reform led to Russia's replacing Asia in August 1998 as the center of the financial crisis afflicting emerging markets, thus potentially erasing many of the gains of prior years.

Russia Defaults on Debt and IMF Suspends Program

In August 1998, the Russian government abandoned its defense of a stable ruble exchange rate – one of the major accomplishments of the previous years – essentially devaluing the ruble, forced a restructuring of government domestic debt, and placed a 90-day moratorium on commercial external debt payments. The financial crisis intensified following the dissolution of the Kiriyenko government and the approval of

[16]The IMF program required the passing into law, ahead of IMF approval on July 20, a series of measures needed for the achievement of revenue and expenditure targets.

Yvegeny Primakov as Prime Minister on September 11, 1998.[17] On that day as well, the German government acknowledged that Russia missed virtually all of a DM800 million interest payment due on August 20 on sovereign debt dating from the Soviet era. Russia's decision to unilaterally restructure its ruble-denominated sovereign debt and impose a moratorium on private external debt payments had significant repercussion in the financial markets, effectively destroyed Russia's external creditworthiness, and cut Russia off from international capital markets. Currently, Russia's debt service exceeds Russia's ability to pay. The IMF's second tranche was scheduled to be delivered on September 15, 1998, but the IMF has made no further payments following the initial $4.8 billion disbursement because of the Russian government's failure to meet its loan conditions.

According to the IMF, the immediate cause of the Russian economic crisis was the growing loss of financial market confidence in the country's fiscal and international payments situation, leading to a loss of reserves and an inability to roll over treasury bills as they matured. However, fundamental problems having to do with Russian economic policy and economic structure lay behind Russia's vulnerability.

Russia's Problems Are Deeper Than the Deficit

According to the IMF and the Congressional Research Service, deeper problems involving the incomplete restructuring of Russia's economy caused Russia's vulnerability. Russia's fiscal problem originated in Russia's failure to reform its huge and inefficient tax system, resulting in inadequate tax collection. Further, the culture of nonpayment and the widespread use of barter have made it difficult to resolve the fiscal imbalances. According to one estimate by Russia scholars, more than 50 percent of payments are conducted by barter and 40 percent of the tax revenues are paid in a nonmonetary form. Public spending has not been adequately controlled, and the government has not been able to cover its expenditures with revenues. Other structural problems include the lack of clarity in the administrative relationship between the federal government in Moscow and the regional and local governments. This situation produces confusion and conflict over control of assets and tax authority. The vagueness of relationships is further complicated by problems in dealing with the oligarchs, a group of individuals who have amassed a great deal of wealth and who control the major banks and enterprises. There has also been slow progress in making key structural reforms such

[17] On August 23, 1998, President Yeltsin dismissed then-Prime Minister Sergei Kiriyenko and his government. According to the Congressional Research Service, Primakov chose for his government individuals largely considered to be less inclined to pursue economic reforms than had the previous government.

as introducing accountability and transparency at all levels of government operations, establishing a federal treasury system, and restructuring enterprises and the legal framework, which adversely affects the economy's performance more broadly.

The IMF's Financial Arrangement with Uganda

Summary

Uganda has had continuous IMF arrangements since 1987. In November 1997, the IMF approved a new 3-year arrangement of about $138 million under its Enhanced Structural Adjustment Facility (ESAF). The IMF arrangement was requested by the Ugandan government to support its 1997-2000 economic program. The arrangement was approved by the IMF Executive Board on the basis of the government's balance-of-payments needs.[1] IMF and U.S. Treasury officials described the Ugandan government as a good performer that had consistently met IMF terms and conditions and attributed this performance to the Ugandan president's commitment to economic reform. U.S. Treasury officials said the IMF program is in line with U.S. objectives for the country. However, an IMF official said that Uganda did not meet some of the conditionality for completion of the February/March 1999 midterm review, and began undertaking prompt remedial measures to enable the review to be completed after a lag of a few months. The IMF consequently, delayed the second disbursement of the arrangement until the review is completed.

The IMF established the ESAF in 1987 to address macroeconomic policy and structural reform measures in low-income countries facing protracted balance-of-payments problems. ESAF loans have lower interest rates and longer terms than regular IMF arrangements. ESAF loans carry a concessional interest rate of 0.5 percent a year and are to be repaid in 10 equal semiannual installments, beginning 5 ½ years and ending 10 years after the date of each disbursement. ESAF loans are disbursed semiannually, beginning with approval of the arrangement by the IMF Executive Board and subsequently upon the ESAF borrower's adherence to performance criteria and following a midterm review by IMF staff. In contrast, regular IMF arrangements have quarterly reviews and disbursements. ESAF borrowers must develop a 3-year policy framework paper, which is updated annually, setting forth the macroeconomic and structural adjustment policy objectives and measures to be undertaken, along with the external financing needs. The purpose of the process is to catalyze and coordinate financial and technical assistance from assistance donors.

The Ugandan government outlined its principal objective for its economic program, to be supported by an ESAF arrangement, as sustaining high and broad-based economic growth in which the poorest segment of the

[1] Structural reforms are a key element of ESAF arrangements. The IMF rationale for supporting structural reforms is that they are critical elements in achieving balance-of-payments viability and lay the basis for sustainable economic growth by eliminating institutional rigidities, such as market segmentation and vested interests' resistance to change, which channel resources away from efficient use.

population can participate. To accomplish this objective, the government intended to (1) maintain macroeconomic stability; (2) continue liberalization of the economy to promote diversified, export-oriented growth; (3) undertake structural and institutional reforms that will further reduce impediments to economic growth; and (4) promote good governance.

According to the IMF, key elements for the government's achievement of its objectives are completion of ongoing structural reforms in the financial sector, public service, tax policy and administration, external trade, privatization, and public enterprise restructuring. IMF staff reported that the government must also improve its technical capacity and statistical data bases, especially those relating to balance of payments, monetary statistics, and social indicators.

IMF quantitative performance criteria and benchmarks include ceilings on the net domestic assets of the banking system, net claims on the government by the banking system, gross issuance of promissory notes by the government, and external borrowing and debt, as well as increases in the central bank's international reserves, minimum revenues, and minimum expenditures on priority (including social) areas in the government's 1998/99 economic program. Structural performance criteria focus on government arrearages and bank examinations. Structural performance benchmarks specify reforms in trade, fiscal, and privatization issues; and in the civil service and financial sectors. There were also prior actions relating to trade liberalization and privatization for completion prior to the February/March 1999 midterm review.

In performing their first review in December 1997, IMF staff found that the government had met the quantitative and structural performance criteria except for the ceiling on net claims by the banking system. An IMF official said the IMF Executive Board issued a waiver after deciding the non-observance of the criterion was due to a reversible technical factor that had not seriously jeopardized government performance. According to this official, the government has generally met IMF benchmarks, although observance of some elements was delayed by a short period due to technical reasons. However, the government's nonobservance in meeting benchmarks in the area of privatization of state-owned enterprises was characterized by IMF staff as "significantly set[ting] back the privatization program."

An external evaluation of ESAF done for the IMF in March 1998 concluded that Uganda had been successful both in terms of achieving stabilization and growth and stated that key decisions were taken by the government on its own initiative.[2] IMF officials indicated that Uganda was one of the few countries where there had been no major program interruptions over a number of years. They attributed this to the government's commitment to reform. Also, government officials were aware of IMF procedures and generally were careful to avoid nonobservance of program conditionality. In some instances, however, program performance criteria or benchmarks were not observed mainly due to unintended technical factors, or the government was unable to deliver on implementation. For example, the pace of privatization fell short of what was envisioned for in the first half of 1998/99 and was a major reason for the IMF delaying the completion of the February/March 1999 midterm review. The midterm review mission also found that some of the quantitative performance criteria were not met, although by modest amounts. The government was expected to get back into program targets within a short period of time, according to an IMF official. An IMF staff mission was in Uganda in May 1999 to reassess the situation regarding completion of the midterm review.

[2] Report by a Group of Independent Experts, External Evaluation of the ESAF (Washington D.C.: IMF, 1998).

Table VII.1 shows the timeline for Uganda's current 3-year ESAF arrangement.

Table VII.1.: Timeline of Key Activities for Uganda's Current Arrangement

Year	Month	Activity
1997	October	— Uganda requested a new 3-year ESAF arrangement
	November	— Ongoing ESAF arrangement completed — IMF approved a new 3-year ESAF arrangement — IMF made the first disbursement under the first annual arrangement
1998	February	— Article IV consultations and midterm review by IMF staff mission assessed Ugandan observance of performance criteria — Uganda did not meet all criteria for December 1997
	March	— Uganda requested waiver from IMF for nonobservance of criterion
	April	— IMF Executive Board granted waiver — IMF made second disbursement under the first annual arrangement
	October	— Uganda requested approval for second annual arrangement
	November	— IMF staff review completed — IMF approved second annual arrangement — IMF made first disbursement under the second annual arrangement
1999	February	— IMF Article IV and midterm review by IMF staff mission assessed Ugandan observance of performance criteria — Uganda did not meet all December 1998 criteria — Completion of IMF review delayed to provide time for the government to take corrective actions —Second disbursement under the second annual arrangement delayed until completion of the review
	May	— IMF staff mission in Uganda to reassess progress on program implementation prior to completion of the midterm review and subsequent release of the second disbursement

Source: IMF data.

History of the IMF Arrangements With Uganda

Years of war and civil strife in the 1970s-1980s destroyed Uganda's infrastructure, public services, and agricultural production and impoverished the population. Per capita GDP in 1986 was 60 percent below its level of 1970, annual inflation had risen to 240 percent, and external debt service was more than 50 percent of exports. Exports other than coffee had all but ceased by 1987. The country had annual declines in terms of trade each year from 1986 to 1992. However, the country has been undergoing successful macroeconomic adjustment and structural reform with IMF and other donor support since 1987. Economic growth has averaged over 5 percent per annum since 1987, but a European Union representative in Uganda told us in April 1998 that much of the country's growth has been "recovery growth" and that the country was only reaching levels in 1998 that it was at in 1972. He also said that, after 25 years of war and chaos, with the society surviving largely at the subsistence level, the country was vulnerable to corruption.

Uganda has had 10 IMF arrangements since 1987. The current 3-year ESAF arrangement approved by the IMF Executive Board in November 1997 totals about $138 million and is to support the Ugandan government's 1997/98-1999/2000 economic plan. The first semiannual installment of $27.6 million of the first annual arrangement was made in November 1997. In April 1998, Uganda was the first country to complete an international initiative aimed at reducing the debt burden of some heavily indebted poor countries.[3] The IMF has had a resident representative in Uganda since July 1982. U.S. Treasury officials said that, over the past few years, problems have become apparent in (1) government privatization of state-owned enterprises, (2) corruption within government, and (3) government military spending. IMF and U.S. Treasury officials said that, unlike many governments, the Ugandan government is committed to addressing the corruption problem. There appears to be increased emphasis by the IMF and other donors on reducing corruption within the government and holding down military expenditures to ensure that funds are available for needed social spending. The IMF resident representative also told us in April 1998 that the rule of law needs to be strengthened since laws, regulations, and procedures are weak throughout the system.

According to the external (independent) experts' 1998 evaluation of ESAF, the government's reform program benefited from intensive public education and consensus-building initiatives. The external evaluation also

[3] In 1996, the World Bank and the IMF proposed the Debt Initiative for the Heavily Indebted Poor Countries (HIPC Initiative) in response to creditors' concern that some poor countries face debt burdens too large relative to their ability to pay, even after receiving debt relief through the then-existing mechanisms. The Initiative's stated goal is to reduce countries' debts to levels that are sustainable, meaning that in the future they can make debt payments on time and without reschedulings. As a condition to receiving HIPC assistance, countries must undertake economic and social reforms. As a result of its adjustment record, Uganda was the first country to be granted a Paris Club stock-of-debt operation on Naples terms in February 1995 – the equivalent of restructuring 32 percent of its outstanding debt with Paris Club creditors. Uganda was the first country to reach its completion point under the Initiative in April 1998, resulting in receipt of $69 million in HIPC debt relief. Uganda's total external debt was US$3.7 billion as of June 1998. In nominal terms, total debt relief over time under the Initiative is estimated to amount to US$650 million. The Ugandan government said it intends to spend the funds garnered from debt relief in the health and education sectors. For more information on the HIPC initiative see the GAO report Developing Countries: Status of the Heavily Indebted Poor Countries Debt Relief Initiative (GAO/NSIAD-98-229, Sept. 30, 1998).

noted that the Ugandan president defended government policies in the face of public opposition and protests, rather than opting for political expediency as is done by "most presidents." IMF officials said the Ugandan parliament supports the ESAF program, although there are some questions among legislators about the speed at which it is implemented. While the Ministry of Finance is responsible for specific monitoring of program performance criteria and benchmarks, the parliament's Economy Committee monitors the program in a general way. IMF missions to Uganda meet with the president, the Ministry of Finance, and the Central Bank, and in recent years have also met with noneconomic ministries, parliamentary committees, nongovernmental organizations, and private-sector organizations.

The IMF is providing technical assistance to the government to

- implement changes in customs management and administration,
- establish a large-taxpayer unit for the 100 largest taxpayers,
- improve budget management through improved expenditure control and financial accounting,
- promote secondary markets in treasury bills, and
- improve the statistical base through enhanced collection and reporting of national accounts, revenue, expenditures, balance-of-payments and debt statistics, and implementation of prior technical assistance missions' recommendations.

Uganda's Performance Under the 1994/95-1996/97 Annual Arrangement

The IMF reported that, during the annual arrangement in 1994/95-1996/97, annual real GDP growth averaged 8 percent and inflation was 5 percent. The fiscal deficit, excluding grants, was reduced from 11.2 percent of GDP in 1993/94 to 6.5 percent in 1996/97. The external current account deficit, excluding grants, declined to 6.1 percent in 1996/97, and improved balance of payments increased international reserves to 4.6 months of imports of goods and nonfactor services. Government elimination of marketing boards, price controls, export taxes, and foreign exchange restrictions contributed to expansion and diversification of the export base. Uganda's debt service ratio as measured by the annual payments on debt outstanding as a ratio of export earnings fell from 53.7 percent in 1993/94 to 18 percent in 1996/97 following Paris Club debt reschedulings.

The external experts' 1998 evaluation reported that the 1994-97 ESAF arrangement did not need a stabilization component and consequently focused on a development agenda of structural reforms. The scope of IMF-government policy dialogue focused on issues not traditionally within the

IMF's area of expertise. As part of Uganda's structural adjustment, the following reforms were undertaken.

- The civil service was reduced in size by 25 percent, noncash benefits were monetized and salaries increased, and army demobilization was completed.
- Within tax policy reforms, the tax identification number system was expanded, a value-added tax (VAT) introduced, most discriminatory tax exemptions were eliminated, and a new income tax bill was submitted to parliament.
- The Bank of Uganda was restructured and its recapitalization begun, two commercial banks were restructured, the Uganda Commercial Bank was recapitalized and steps to privatize it begun, and enforcement of adequate capital requirements in the banking sector was undertaken.
- Fifty-five public enterprises were privatized, actions were initiated to privatize telecommunications, and a communications act and amendments to remove the Uganda Electricity Board's monopoly and regulatory powers were submitted to parliament.
- Import tariffs and import duty exemptions were reduced, export taxes were eliminated, and an external debt-management and borrowing strategy that eliminates nonconcessional borrowing was implemented.

IMF disbursements for the 3 -year arrangement were $24.5 million in September 1994 and $26.3 million in April 1995; $29.8 million in December 1995 and $29 million in May 1996; and $33.7 million in December 1996 and $32.5 million in May 1997.

Uganda's New 3-Year Arrangement and the First Annual Arrangement

On October 22, 1997, the government requested a new 3-year ESAF arrangement of about $138 million to support its economic plan for 1997/98-1999/2000. Uganda's fragile external position left it vulnerable to external shocks; and it faced deteriorating terms of trade, uncertainty over the effectiveness of revenue measures, and substantial expenditure pressures. The IMF approved the arrangement on November 10, 1997. IMF officials said that other donors wanted Uganda to have an IMF program as an anchor for their assistance. They also said that some IMF executive directors felt that Uganda needed assistance on structural issues such as financial sector reform, privatization, trade liberalization, and social spending. IMF and U.S officials emphasized the Ugandan government's commitment to reform. The IMF made its first disbursement to Uganda under the new arrangement in November 1997 for $27.6 million.

Quantitative Performance Criteria and Benchmarks

The quantitative performance criteria for Uganda focus chiefly on bolstering Uganda's liquidity and creditworthiness by improving its ability to reduce inflation, by garnering resources readily usable for the purpose of financing deficits in the balance of payments, and by stabilizing the foreign exchange value of the currency (Ugandan shilling).

The quantitative performance criteria for the first annual arrangement covered the following:

- Ceilings were set on net domestic assets of the banking system as a monetary policy measure intended to control the rate of inflation by limiting the amount of money in circulation. Increases in the net domestic assets of the banking system are, in effect, increases in outstanding loans to the nonbanking sector that raise the amount of money in circulation and represent a potential source of inflation.

- Limits were set on the net claims of the banking system on the government, as a mechanism to restrict the growth rate of government borrowing. Net claims of the banking system on the government are loans to the government by the banking system. Bank loans to the government may either increase the amount of money in circulation and possibly raise the rate of inflation in the country or raise the interest rate by fostering competition with the private sector for loans. Moreover, by discouraging banks from lending to the government, limiting net claims may also serve as a fiscal restraint on the government.

- A prohibition was set on the issuance of promissory notes by the government to curb the rate of growth of government spending financed through issuance of negotiable instruments, such as bonds. This fiscal restraint prohibits government borrowing from the public to finance government expenditures.

- Arrears on outstanding external debt was forbidden. This prohibition enforces the Ugandan government's agreement with the IMF and the

World Bank to maintain an on-time payment history to remain eligible for past and future debt reduction benefits under the HIPC.

- The Bank of Uganda was prohibited from incurring debt with a maturity of less than 1 year. Short-term external debt of the Bank is loans from external sources contracted by the Bank when it is unable to provide sufficient foreign exchange to pay for expenses that are incurred for routine international transactions. This prohibition, therefore, ensures that the Bank maintains sufficient foreign exchange on hand to pay for each year's imports of good and services. Consequently, short-term credit extended to Uganda to facilitate trade with international trading partners cannot be converted to long-term international debt.

- Limits were established on new public- or publicly-guaranteed nonconcessional debt. This was intended to reduce total external debt by restricting government borrowing from international sources, unless the debt contains a grant element of at least 35 percent.

- A minimum net international reserve level for the Bank of Uganda was set. Setting a minimum reserve level enhances the availability of foreign exchange for the purposes of stabilizing the value of the currency and maintaining adequate foreign exchange to pay for several months of imports of goods and services.

Table VII.2 shows the specific criteria and timetable, or benchmarks, for the first annual arrangement.

Table VII.2: Quantitative Performance Criteria and Benchmarks for the First Annual Arrangement

Quantitative criteria	Performance criteria for December 1997	Benchmark for March 1998	Benchmark for June 1998	Remarks
Ceiling on the increase in net domestic assets of the banking system[a]	U sh 24.8	U sh 36.2	U sh 29.8[b]	Adjustments to be made for import support in excess of cumulative projections.
Ceiling on the increase in net claims on the government by the banking system[a]	U sh -35.0	U sh -40.5	U sh -55.9	Adjustments to be made for debt service paid by the central government in excess of cumulative projections.
Ceiling on issuance of promissory notes by the government[a]	0	0	0	Excludes notes issued to regularize domestic payment arrears not to exceed 24.1 billion.
Ceiling on the stock of external payment arrears[c]	0	0	0	This criterion must be continuously observed.
Ceiling on new nonconcessional external borrowing over one year contracted or guaranteed by the government[c]	$10.0	$10.0	$10.0	Excludes debts contracted in the context of reschedulings.
Ceiling on outstanding short-term external debt of the Bank of Uganda[c]	0	0	0	External debt with maturity of less than 1 year excluding normal import related credit.
Minimum increase in net international reserves of the Bank of Uganda[c]	$35.9	$64.2	$71.7	Concurrent adjustments to be made in case of adjustments in ceiling of net domestic assets and net claims on government.

[a]Cumulative change in billions of Ugandan shillings from end of June 1998.

[b]This benchmark was originally set at 36.9 million Ugandan shillings.

[c]Cumulative change in millions of U.S. dollars from end of June 1997.

Source: IMF.

Structural Performance Criterion and Benchmarks

The structural performance criterion for the first annual arrangement was to complete government auditing of at least 200 VAT payers, 50 of which would be from the top 400 VAT-registered taxpayers, and the rest of which would be based on revenue-risk criteria. Achievement of the criterion was to be completed by December 31, 1997. Three prior actions for the removal of import bans by March 31, 1998, were also established. Table VI.3 shows the structural performance benchmarks for the first annual arrangement.

Table VII.3: Structural Performance Benchmarks for the First Annual Arrangement

Category	Performance benchmark
Privatization	•Relinquish government control of 80 public enterprises by December 31, 1997. •Relinquish government control of 89 public enterprises by March 31, 1998. •Relinquish government control of 95 public enterprises by June 30, 1998. •Divest 23 enterprises including 7 with asset values of 5 billion Ugandan shillings or more by June 30, 1998; divestiture of at least 3 of these 7 large enterprises by December 31, 1997. •Offer Uganda Telecommunications Ltd. for sale following its separation from the Uganda Posts and Telecommunications Corp. by December 31, 1997.
Government restructuring	•Set the size of the number-limited civil service on the payroll, excluding primary school teachers, at 57,100 by December 31, 1997, and 55,600 by June 30, 1998. •Gain Cabinet approval of agreed structures and establishments for 9 central ministries/departments by January 31, 1998. •Reduce Uganda Electricity Board employment from 3,060 as of June 1997 to 2,800 by December 31, 1997, and 2,300 by June 30, 1998. •Ensure minimum nonwage budgetary expenditures for the Priority Program Areas of health and education at $24.6 million by December 31, 1997, and $45.5 million by June 30, 1998.
Taxation	•Audit 600 taxpayers based on revenue/risk criteria by June 30, 1998.
Banking	•Conduct annual on-site inspections of at least 40 percent of banks by June 30, 1998.

Source: IMF.

Uganda's Observance of Criteria and Benchmarks

In its March 24, 1998, Article IV consultation and midterm review, the IMF staff reported that the government had met its quantitative and structural performance criteria for December 31, 1997, with the exception of the government's net position vis-à-vis the banking system. This criterion was missed, according IMF staff, because of the more rapid liquidation of domestic nonbank liabilities than expected (government checks cleared the banking system sooner than expected). The IMF Executive Board granted a waiver because nonobservance was deemed to be technical in nature, as opposed to a policy violation. Performance was reported as satisfactory with respect to the structural benchmarks. However, some of the benchmarks were categorized by IMF staff as "observed with delay," meaning that the benchmarks were met but not within the timeline envisioned. In addition, the removal of three import bans, a prior action with a completion date of March 31, 1998, was met according to the IMF. In the October 28, 1998, IMF staff paper to the IMF Executive Board on Uganda's request for a second annual arrangement, the staff stated that the government had met the removal of bans on three imports on time. The IMF disbursed $27 million in April 1998.

Uganda's Second Annual ESAF Arrangement

On October 28, 1998, the Ugandan government requested the second annual ESAF arrangement. The IMF staff had reported in its October 28, 1998, ESAF policy framework paper that heavy rains in 1997/98 had adversely affected Ugandan food and coffee production, transportation, and exports; real GDP growth was 5.5 percent and inflation 5.8 percent. The current account deficit excluding grants as a share of GDP was 8.3 percent. Capital and official transfers financed the current account deficit and generated a balance-of-payments surplus so that gross international reserves rose to 4.9 months of imports of goods and services. The IMF Executive Board approved the arrangement on November 11, 1998. The first disbursement of $23.1 million was made November 25, 1998.

Quantitative Performance Criteria and Benchmarks

The quantitative performance terms and conditions for Uganda‘s second annual arrangement added two criteria to those of the first annual arrangement:

- a minimum amount of total revenue was to be collected in order to reduce fiscal deficits, and
- a minimum amount of nonwage expenditures to be made in the priority program areas of education and health so that the social sector would not be overlooked relative to other priorities, particularly military expenditures.

Table VII.4 shows the quantitative performance criteria and benchmarks for the second annual arrangement.

Table VII.4: Quantitative Performance Criteria and Benchmarks for the Second Annual Arrangement

Quantitative criteria	Performance criteria for December 1998	Benchmark for March 1999	Benchmark for June 1999	Remarks
Ceiling on the increase in net domestic assets of the banking system[a]	U sh 50.1	U sh 36.9	U sh 29.3	Adjustments to be made for import support in excess of cumulative projections.
Ceiling on the increase in net claims on the government by the banking system[a]	U sh -9.1	U sh -41.9	U sh -73.8	Adjustments to be made for debt service paid by the central government in excess of cumulative projections.
Minimum revenue collected by the Uganda Revenue Authority[a]	U sh 440.0	U sh 671.0	U sh 924.0	
Minimum nonwage expenditures on priority program areas[a]	U sh 75.6	U sh 124.6	U sh 179.1	Minimum expenditure would be increased by no less than 50 percent of the first 8.6 billion of import support in excess of cumulative projections.
Ceiling on issuance of promissory notes by the government[a]	0	0	0	Excludes notes issued to regularize domestic payment arrears not to exceed U sh 24.1 billion.
Ceiling on the stock of external payment arrears[b]	0	0	0	This criterion has to be continuously observed.
Ceiling on new non concessional external borrowing over 1 year contracted or guaranteed by the government	$10.0	$10.0	$10.0	Excludes debts contracted in the context of rescheduling agreements.
Ceiling on outstanding short term external debt of the Bank of Uganda	0	0	0	External debt with maturity of less than 1 year excluding normal import related credit.
Minimum increase in net international reserves of the Bank of Uganda	$18.9	$50.2	$94.8	Concurrent adjustments to be made in case of adjustments in ceilings of net domestic assets and net claims on government.

[a]Cumulative change in billions of Ugandan shillings from end of June 1997.

[b]Cumulative change in millions of U.S. dollars from end of June 1997.

Source: IMF.

Structural Performance Criteria and Benchmarks

The following structural performance criteria for the second annual arrangement (1998/99) were to be completed by December 31, 1998:

- verification by the Verification Subcommittee of the Ugandan government line ministries' report on arrears outstanding at the end-June 1998 and submission of its findings to the Arrears Monitoring and Reporting Unit, and
- completion of follow-up site examinations of the banks for which the Bank of Uganda sent a timetable of corrective actions.

Prior actions that were to be completed by March 31, 1999, for the midterm review were

- the removal of the import ban on cigarettes, and
- approval of divestiture plans in 1998/99 by the Divestiture and Reform Implementation Committee and commencement of investment search (defined as issuance of information memorandum, advertisement of sale, or placement of shares on stock exchange) for 10 enterprises by March 15, 1999, of which 5 were to be high-priority enterprises.

Table VII.5 shows structural performance benchmarks for the second annual arrangement.

Table VII.5: Structural Performance Benchmarks for the Second Annual Arrangement

Category	Performance benchmark
Privatization	•Approval of divestiture plans in 1998/99 by the Divestiture and Reform Implementation Committee and commencement of investment search (define as issuance of information memorandum, advertisement of sale, or placement of shares on stock exchange) for 16 enterprises by June 30, 1999. •Decision by the Cabinet on options for increasing private sector involvement in the operations of the Uganda Railways Corporation by December 31, 1998.
Government restructuring	•Finalization by the Arrears Monitoring and Reporting Unit of a plan to clear verified outstanding arrears within 3 years by end-February 1999. •Reduction in the size of the number-limited civil service on the payroll, excluding primary school teachers to 53,190 by December 31, 1998, and 512,640 by June 30, 1999, with a margin of error of up to 99 for new pending cases. •Limitation of the waiting period between the date of reporting to work and that of being put on the payroll to no more than 4 weeks to be a continuous benchmark beginning October 1, 1998.
Taxation	•Completion by the Large-Taxpayer Unit of 10 comprehensive on-site audits by December 31, 1998. •Completion by the Large-Taxpayer Unit of an additional 40 comprehensive on-site audits by June 30, 1999. •Completion of on-site audits of all retail and nonretail gasoline outlets by the Uganda Revenue Authority by June 30, 1999.
Banking	•Completion of on-site examination of four commercial banks that have been identified as showing less-than-full compliance with bank regulations or being in need of stronger management practices, and issuance of relevant examination reports by September 30, 1998.

Source: IMF.

In the IMF staff paper to the Executive Board on Uganda's request for the second annual arrangement, the staff stated that the government had met its macroeconomic objectives for 1997/98 and that real growth was reviving and inflation was low. The staff also said the end-June 1998 quantitative and structural benchmarks were largely met, with the exceptions of net claims on the government by the domestic banking system (which was exceeded by a very small margin) and the number of public enterprises privatized (which set back significantly the privatization program).

The 1998 external experts' evaluation of ESAF noted that the IMF's traditional role is crisis management and that this has generally been the context for the extension of ESAF arrangements. The evaluation stated that Uganda had fully achieved stabilization and the major macroeconomic reforms had been implemented, and consequently, the IMF has reached the point where it had to decide whether to (1) maintain its exclusive focus on crisis-management and so withdraw from Uganda, or (2) extend its mandate and remain in Uganda. It noted that the case for withdrawal from Uganda is that the IMF's work is done. The case for continued involvement was that (1) investors and donors still regard Uganda as high risk and want the reassurance that an IMF presence brings, (2) the Ugandan government still needs IMF expertise, and (3) ESAF resources are most productive in an already reformed policy environment such as Uganda's. The evaluation favored continued IMF involvement in Uganda. U.S. Treasury officials felt that continued IMF involvement in Uganda is warranted because the reform program is still in a fragile state due to (1) serious weaknesses in human and institutional capacity that the IMF is uniquely suited to help remedy, and the recently-identified problems with corruption that are in part related to these capacity deficiencies, and (2) the threats to fiscal and economic stability posed the military security problems in the region.

Uganda's Nonobservance of Criteria Results in the IMF Delaying of Disbursement

IMF staff conducted their midterm review of Uganda's performance under the arrangement in February/March 1999 in conjunction with their annual Article IV consultations. Staff found that the government had missed the December 1998 quantitative performance criteria on (1) net domestic assets, (2) net credit to the government by the banking sector, (3) issuance of promissory notes for current expenditures, (4) minimum non-wage expenditures in the social sectors of health and education, and (5) minimum net reserves. The structural performance criterion on the verification of arrears was also missed. The midterm review was consequently not completed and the IMF delayed the second disbursement under the arrangement.

An IMF official said the non-observance was marginal and the country's macroeconomic picture had not changed, with inflation remaining low and the real growth rate possibly exceeding the government's target of 7 percent. The official said that Ugandan revenues were very good due to (1) improved controls of corruption in customs, (2) improved tax administration, and (3) income tax reforms, such as a broadened tax net and elimination of tax exemptions, which were paying off. However, the official said the government had used the unexpected revenues to increase military spending from 1.9 percent of GDP to 2.5 percent. Although the increased military spending does not violate IMF criteria, the official expressed concern that government officials not continually expect revenues to exceed expectations in order to pay for increasing military expenditures. The official said that IMF staff's major concern was that Uganda's privatization effort was completely off track due to political factors and corruption. The official said there is a loss in government credibility and therefore buyers are reluctant to bid for enterprises in the privatization program. The parliament had suspended the program while it conducts an investigation. The IMF staff set prior actions relating to the privatization program and the financial sector, which the government must meet prior to the staff's completion of the midterm review, which resumed in May 1999 and is expected to be completed in June 1999. Despite these problems, the IMF official said the Ugandan government has been quick to react to IMF findings, is making efforts to meet IMF conditions, has fired corrupt officials, has promised to hold down military spending, and should still be classified as a good performer.

Criticisms of the IMF

The financial support that the IMF has provided to member countries, along with the conditions attached to that support, has long been a topic of debate. This issue recently received considerable prominence when the U.S. Congress considered an increased U.S. quota contribution to the IMF in 1998. While a full discussion of these issues is outside the scope of this report, several themes, including "moral hazard," the appropriateness of IMF conditionality, and the effect of IMF programs on the poor, have been consistently raised and illustrate the complexity of this debate.

The issue of moral hazard has two components: (1) the willingness and ability of an international financial institution, such as the IMF, to "rescue" a country from problems that may be of its own doing; and (2) the concern that the financing provided by these institutions is shielding private sector participants from the risks inherent in their investments. In the first instance, critics argue that the incentives for a country to avoid financial difficulties are diminished by its reliance on IMF assistance to lessen the impact of its policy mistakes. In response to this criticism, the IMF stresses that crises inevitably bring painful consequences, and that, in exchange for receiving its financial assistance, countries have to agree to adopt a stringent conditionality program that is designed to address each country's underlying problems. The adjustments required in implementing such a program can be very costly and painful, and thus should provide sufficient disincentive to countries from pursuing questionable policies. Furthermore, countries are obligated to repay the IMF for the financial assistance provided.

Under the second moral hazard issue, critics of the IMF contend that in providing financial support to countries, the IMF also "bails out" large international banks and other private lenders. When a member country receives financial assistance from the IMF, the funds can be used to pay off existing creditors including those in the private sector. This activity has raised concerns about the efficiency of the international financial system by shielding private sector participants from the risks inherent in their investments. If some creditors are not fully assuming investment risk, and are lending under the assumption that the IMF and other official support will be forthcoming if necessary, distortions could be introduced into the international financial system. The IMF and the Group of Seven (G-7),[1] in recent public announcements, have acknowledged the existence of this threat to the international financial system and are exploring strategies for reducing it. However, it has been argued that the danger of moral hazard

[1] The G-7 consists of seven major industrialized countries (Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States) that consult on general, economic, and financial matters.

should be balanced against the danger of the further spread of financial difficulties, or "contagion." During a crisis, lenders and investors may try to limit their exposure to all developing countries, not just those in crisis. This can result in countries with sound economic policies experiencing a financial crisis, driven largely by external events out of their control. By providing assistance to nations facing such a crisis, the IMF may also slow or stop the exit of private-sector lending to other developing countries and thus help minimize this potential threat to the international financial system.

The appropriateness of IMF conditionality has also been subject to a considerable amount of debate. First, some critics believe that the IMF has overstepped its original mission by including conditions related to economic and social development strategies ("mission-creep"). Second, some critics have stressed that the imposition of an IMF conditionality program, under crisis conditions, that lacks a political consensus is unlikely to be successful and could in fact generate instability within the country. Third, during the Asian financial crises, several critics questioned the IMF's underlying economic assumptions for these countries, believing the initial IMF programs in Korea, Thailand, and Indonesia represented the IMF's standard approach to crises (macroeconomic austerity) that was inappropriate for these countries' situations. According to those critics, the IMF's "cookie-cutter approach" was doing those countries more harm than good. In response, the IMF has said that the flexibility of its approach to countries has allowed it to adapt to changing situations. In particular, its increasing emphasis on structural issues has reflected a growing understanding that balance-of-payments problems cannot be resolved if an economy suffers from deep-seated structural weaknesses. Moreover, the IMF has emphasized that its arrangements for individual countries constantly evolve, depending on developments, and that conditions are modified as necessary. The Thai, Indonesian, and Korean programs, for instance, were modified to take account of these countries' unexpectedly severe recessions. The IMF has also striven in recent years to coordinate its efforts with other international financial institutions, including the World Bank.

The IMF has also been criticized because of the belief that its programs impose undue hardships on the poor. These critics point out that IMF programs often require that governments cut expenditures and reduce budget deficits in order to meet the IMF's macroeconomic goals. They argue that such cuts often result in reductions in spending on health, education, and other social programs vital to the poor. The IMF has acknowledged that, in certain cases in the past, programs for the poor have been excessively reduced. To lessen this potential, the IMF says that it now pays considerable attention to social issues and to social safety nets, to the point of sometimes now requiring that countries maintain minimum spending levels for social programs, despite the need for a general reduction in government spending.

Comments from the Department of the Treasury

DEPARTMENT OF THE TREASURY
WASHINGTON

UNDER SECRETARY

June 10, 1999

Susan S. Westin
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Dear Ms. Westin:

Thank you for your letter of May 26, 1999, and the opportunity to review the draft report entitled "International Monetary Fund: Approach for Establishing and Monitoring Conditions of Financial Assistance." Our view is that the draft report provides, overall, an informative and balanced treatment of the subject and should contribute to a better understanding of the issues that it addresses.

In addition to the technical comments that Treasury staff has already transmitted to your staff, I would like to point out one concern with the substance of the report. The discussion of flexibility in monitoring and implementing IMF programs–a feature of IMF programs and practice which is both appropriate and necessary–is somewhat overemphasized and, in certain cases, could be misunderstood. For example, on page 5 the draft report states that, "[t]he IMF's process for monitoring a country's compliance with program conditions is designed to adapt to an individual country's progress and situation." This suggests that the IMF's process for monitoring compliance depends on the country or its evolving situation. I think it would be more accurate to indicate that the IMF's process for monitoring compliance with program conditions is designed *to allow the IMF to adjust a country's program in appropriate cases, both with respect to conditions and support, taking into account changing circumstances.*

Now on p. 3.

In describing the critical linkage between IMF disbursements and fulfillment of program conditions, the draft report states the following on page 3: "Continued disbursement of assistance to a country is based on the IMF's consideration of data on and judgment of the country's progress in meeting the agreed-upon conditions. The IMF has continued making disbursements to countries that have not met all key conditions if it decides that the country has made sufficient progress. However, when the IMF determines that a country's progress in meeting key conditions was insufficient, disbursements have been delayed." This last sentence suggests that it is only a matter of time before disbursements are resumed. It would be more accurate to indicate that when the IMF determines that a country's progress in meeting key

Now on p. 2.

conditions was insufficient, disbursements have been *halted, and are not resumed unless or until satisfactory progress is achieved.*

I think it is important for the reader to be left with an understanding that, while the process for developing and implementing IMF terms and conditions is characterized by a degree of flexibility and latitude, there is a fundamental link between program implementation and IMF support.

We look forward to seeing the final version of your report.

Sincerely,

Timothy F. Geithner
Under Secretary (International)

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Glossary

This glossary is provided for reader convenience, not to provide authoritative or complete definitions for IMF funding arrangements, programs, and facilities.

Arrangement

A decision by the IMF that gives a member the assurance that the institution stands ready to provide foreign exchange or special drawing rights (SDRs) in accordance with the terms of the decision during a specified period of time. An IMF arrangement—which is not a legal contract—is approved by the IMF Executive Board in support of an economic program under which the member undertakes a set of policy actions to reduce economic imbalances and achieve sustainable growth. Resources used under an arrangement carry with them the obligation to repay the IMF in accordance with the applicable schedule, and to pay charges on outstanding purchases (drawings). (See "purchases and repurchases.")

Article IV Consultation

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of directors, and this summary is transmitted to the country's authorities.

Articles of Agreement

An international treaty that sets out the purposes, principles, and financial structure of the IMF. The Articles, which entered into force in December 1945, were drafted by representatives of 45 nations at a conference held in Bretton Woods, New Hampshire. The Articles have since been amended three times, in 1969, 1978, and 1992, as the IMF responded to changes in theworld economic and financial structure.

Balance-of-Payments Accounts

A country's balance-of-payments accounts summarize its dealings with the outside world. Balance-of-payments accounts are usually divided into two main parts, the current account and the capital account. A country is said to have a surplus in its balance-of-payments if there is an increase in its net official assets (official reserves minus its liabilities to foreign official institutions). It is said to have a deficit (or external deficit) if there is a decrease in its net official assets.

Basis Points

The smallest unit in quoting yields on bonds, mortgages, and notes, equal to one one-hundredth of one percentage point.

Basle Capital Standards

Bank regulators from industrialized countries adopted standards for credit risk exposure for internationally active banks in 1988 under the auspices of the Bank for International Settlements. Known as the Basle Accord, the standards were fully implemented in 1992 by member countries. The standards are formula-based and apply risk-weights to reflect different gradations of risk to each asset category. Since 1992, the standards have been amended. The most notable amendment is the establishment of risk-based capital requirements to cover market risk in bank securities and derivatives trading portfolios.

Basle Core Principles

A set of standards for effective bank supervision, issued by the Basle Committee on Banking Supervision in September 1997. The core principles were developed in close collaboration with supervisors from around the world, the IMF, and World Bank. The standards are comprised of 25 core principles that form a sound framework on which to build supervisory structures that meet the needs and conditions prevalent in individual countries.

Benchmarks

In the context of IMF programs, a point of reference against which progress may be monitored. Benchmarks are not necessarily quantitative and frequently relate to structural variables and policies. In Enhanced Structural Adjustment Facility Arrangements, some benchmarks are designated as semiannual performance criteria and are required to be observed in order to qualify for phased (semiannual) borrowings. In addition, quantitative benchmarks are set for the quarters for which there are no performance criteria, and structural benchmarks are set for any date agreed upon under the arrangement.

Capital Account

The capital account of the balance-of-payments shows all flows that directly affect the national balance sheet. It includes (1) direct investment by foreign firms in domestic affiliates and by domestic firms in their foreign affiliates; (2) portfolio investment, which include net purchases by foreigners of domestic securities and net purchases by domestic residents of foreign securities; (3) net lending to domestic residents and net lending by domestic residents to foreigners; and (4) changes in cash balances, which include changes in cash balances held by banks and other foreign-exchange dealers, resulting from current and capital transactions.

Compensatory and Contingency Financing Facility

A special IMF financing facility (window) that was established in 1988 to combine the long-standing Compensatory Financing Facility (retaining its essential features) with elements of contingency financing. The compensatory element provides resources to members to cover shortfalls in export earnings and services receipts, as well as excesses in cereal import costs, that are temporary and arise from events beyond the members' control. The contingency element may help members with IMF arrangements to maintain their economic programs when faced with a broad range of unforeseen adverse external shocks.

Conditionality

As defined by the IMF, economic policies that members intend to follow as a condition for the use of IMF resources. These are often expressed as performance criteria (for example, monetary and budgetary targets) or benchmarks, and are intended to ensure that the use of IMF credit is temporary and consistent with the adjustment program designed to correct a member's external payments imbalance.

Current Account

This is the broadest measure of a country's international trade in goods and services. Its primary component is the balance of trade, which is the difference between merchandise exports and imports. The current account shows all the flows that directly affect the national-income accounts. It includes exports and imports of merchandise and services, inflows and outflows of investment income, and grants, remittances, and other transfers.

Emergency Financing Mechanism

A set of exceptional procedures established by the IMF to facilitate rapid Executive Board approval of IMF financial support for a member while ensuring the conditionality necessary to warrant such support. These emergency measures are to be used only in circumstances representing, or threatening to give rise to, a crisis in a member's external accounts that requires an immediate IMF response.

Enhanced Structural Adjustment Facility

An IMF facility established in December 1987 to provide assistance on concessional terms to low-income member countries facing protracted balance of payments problems. The ESAF's operations are financed through borrowing by a trust administered by the IMF as a trustee.

Exchange Rate Policy

A government's policies concerning at what price (or whether) it will seek to stabilize or otherwise influence the rate of exchange between domestic currency and other currencies.

Exchange Stabilization Fund

Currency reserve fund of the U.S. government employed to stabilize the dollar and foreign exchange markets. ESF is managed by the Treasury. The Federal Reserve Bank of New York acts as fiscal agent for the Treasury. ESF holds special drawing rights allocated to the United States by the IMF.

Extended Arrangement

A decision of the IMF under the Extended Fund Facility that gives a member the assurance of being able to purchase (draw) resources from the General Resources Account, in accordance with the terms of the decision, during a specified period, usually three to four years, and up to a particular amount.

Extended Fund Facility

A financing facility (window) under which the IMF supports economic programs that generally run for three years and are aimed at overcoming balance-of-payments difficulties resulting from macroeconomic and structural problems. Typically, an economic program states the general objectives for the 3-year period and the specific policies for the first year. Policies for subsequent years are spelled out in program reviews.

External Deficit

See “Balance of Payments Accounts.”

Fiscal Policy

Taxation and government spending policies designed to achieve government goals, such as achieving full employment, price stability, or growth in the economy.

Foreign Direct Investment

Foreign direct investment occurs when citizens of one nation purchase nonfinancial assets in some other nation. Distinguished from portfolio investment (below), foreign direct investment generally involves ownership of assets used in production (e.g., factories).

Foreign Portfolio Investment

The purchase by one country’s private citizens or their agents of marketable noncontrolling positions in equity and debt securities issued by another country’s private citizens, corporations, banks, and governments. Commonly, these marketable noncontrolling positions can be easily reversed.

Foreign Exchange

Foreign exchange is the money issued by a foreign country.

Foreign Exchange Market

The foreign exchange market is an interbank or over-the-counter market in foreign exchange that is a network of commercial banks, central banks, brokers, and customers.

Foreign Exchange Reserves

The stock of liquid assets denominated in foreign currencies held by the monetary authorities (finance ministry or central bank). Reserves enable the monetary authorities to intervene in foreign exchange markets to affect the exchange value of their domestic currency in the market. Reserves are typically part of the balance sheet of the central bank. Reserves are invested in low-risk and liquid assets—often in foreign government securities.

Front-loading

In an IMF arrangement, placing a more that proportional part of the disbursement of the financial resources available to a member near the beginning of the arrangement.

General Arrangements to Borrow

Long-standing arrangements under which 11 industrial countries stand ready to lend to the IMF to finance purchases (drawings) that aim at forestalling or coping with a situation that could impair the international monetary system. Since the establishment in 1962, these arrangements have been renewed every four to five years and been invoked 10 times, according to IMF documents. Additional funds are also available to the IMF under an "associated agreement" with Saudi Arabia.

General Resources

Assets, whether ordinary (owned) or borrowed, maintained within the IMF's General Resources Account.

London Interbank Offer Rates (LIBOR)

Key interest rates at which the major banks in the London interbank market are willing to lend funds to each other at various maturities and for different currencies. LIBOR has become the most important floating rate pricing benchmark for loans and debt instruments in the global financial markets. These rates are published daily by the Bank of England and are based on a sampling from a group of reference banks that are active in the Eurocurrency market, but agreements that use LIBOR do not necessarily rely on quotes published by the Bank of England.

Macroeconomic Policy

Macroeconomic policy is governmental and central bank policy concerning a nation's economy as a whole including, among other things, price levels, unemployment, inflation, and industrial production. The macroeconomic analysis of open economies is concerned with the effects of international and domestic transactions on output, employment, and the price level and the effects of these in turn on the balance of payments and exchange rate. It is also concerned with the implications of openness and of exchange-rate arrangements for the functioning of monetary and fiscal policies.

Monetary Policy

Monetary policy is the central bank's use of control of the quantity of money and interest rates to influence the level of economic activity. The quantity of money can affect price levels and, for a given real income, the level of nominal income within a given system. The central bank often concentrates its policy actions, such as the interest rates it charges banks to borrow, to achieve a money stock target. In theory, the demand for money changes with changes in income and interest rates, in addition to other factors.

New Arrangements to Borrow	Arrangements under which 25 member countries or their financial institutions would be ready to lend to the IMF under circumstances similar to those covered by the General Arrangements to Borrow (see General Arrangements to Borrow). The New Arrangements to Borrow are not to replace the General Arrangements to Borrow, and the total amount of resources potentially available under the New Arrangements to Borrow and the General Arrangement to Borrow is about $46 billion. The New Arrangements to Borrow can be activated when participants representing 85 percent of the credit lines' resources determine that there is a threat to the international financial system. The New Arrangements to Borrow became effective on November 17, 1998 and were activated in December 1998 in connection with the financing of an arrangement for Brazil.
Performance Criteria	Measurable and observable indicators, such as monetary and budgetary targets, or structural (policy) adjustments, that must be met, typically on a quarterly basis, for a member to qualify for purchases under a country's arrangement with the IMF. These indicators measure a country's implementation of conditions agreed to under the country's IMF program. Performance criteria are generally categorized as quantitative or structural depending on the conditions being measured. (See also "benchmarks.")
Phasing	The practice of making the IMF's resources available to its members in installments over the period of an arrangement.
Purchases and Repurchases	When the IMF makes its general resources available to a member, it does so by allowing the member to purchase SDRs or other members' currencies in exchange for its own (domestic) currency. The IMF's general resources are, by nature, revolving; purchases (or drawings) have to be reversed by repurchases (or repayments) in installments within the period specified for a particular policy or facility.
Quantitative Performance Criteria	See "performance criteria" and "benchmarks."
Quota	The capital subscription, expressed in SDRs, that each member must pay to the IMF on joining, up to 25 percent is payable in SDRs or other acceptable reserve assets and the remainder in the member's own currency. Quotas, which reflect members' relative size in the world economy, are normally reviewed every five years.

Sovereign Debt	The debt instruments issued or guaranteed by the central government of a country. Debt instruments are typically bonds evidencing amounts owed and payable on specified dates or on demand.
Special Drawing Right	International reserve asset created by the IMF in 1969 as a supplement to existing reserve assets. Its value as a reserve asset is derived, essentially, from the commitments of participants to hold and accept SDRs and to honor various obligations connected with its proper functioning as a reserve asset. The IMF defines its value in terms of a basket of major international currencies that fluctuates with market conditions.
Stand-by Arrangement	A decision of the IMF by which a member is assured that it will be able to make purchases (drawings) from the General Resources Account up to a specified amount and during a specified period of time, usually one to two years, provided that the member observes the terms set out in the supporting arrangement.
Structural Performance Criteria	See "performance criteria" and benchmarks."
Supplemental Reserve Facility	A facility (window) established in December 1997 to provide financial assistance to members experiencing exceptional balance of payments difficulties due to short-term financing needs resulting from a sudden and disruptive loss of market confidence reflected in pressure on the capital account and the members' reserves.

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