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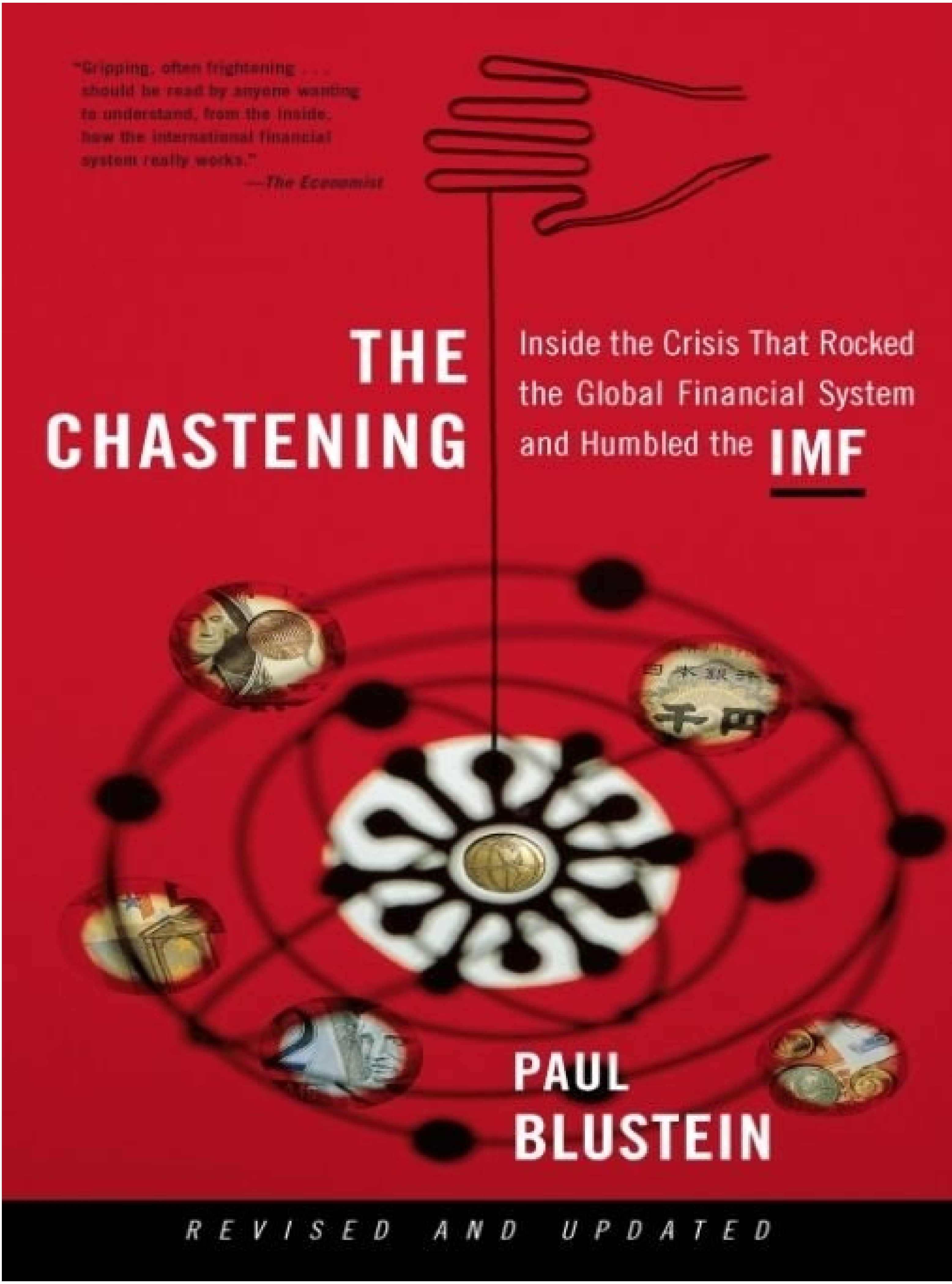
—*The Economist*

THE CHASTENING

Inside the Crisis That Rocked the Global Financial System and Humbled the IMF

PAUL BLUSTEIN

REVISED AND UPDATED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PAUL BLUSTEIN

PublicAffairs *New York*

To Yoshie, Nina, Nathan, and Dan
And in case I never get a chance to write another book,
To my mother, too
And to the memory of my father

AUTHOR'S NOTE AND ACKNOWLEDGMENTS

In all my years as an economics Journalist, I have never covered a story as dramatic as the glob financial crisis of the late 1990s. And I have never covered an institution more sorely in need o thorough Journalistic dissection than the International Monetary Fund. As I was writing for *Th Washington Post* about the crisis and the IMF's often vain efforts to quell it, I realized I had th makings of a good yarn about economic phenomena of great significance. In spring 1999, once th crisis had abated, I began arranging the time and resources to research and write this book, whic entailed a leave from the *Post* lasting from mid-September 1999 to mid-January 2001.

My research consisted mainly of interviews with approximately 180 people, many of whom we interviewed a number of times in person, on the phone, and by e-mail. They included more than fif current and former IMF officials, staffers, and board members. Other important interviewees include top officials at the U.S. Treasury, the Federal Reserve Board, the Federal Reserve Bank of New York the White House National Economic Council, the National Security Council, and the Sta Department; senior economic policymakers and staffers in the Group of Seven maJor industri nations, the World Bank, and the five maJor crisis-countries that had IMF programs (Thailan Indonesia, South Korea, Russia, and Brazil); and bankers, hedge-fund managers, and bond traders well as academic economists. The maJority of the interviews took place in Washington, D.C., but also traveled to Bangkok, Jakarta, Seoul, Tokyo, Moscow, London, Paris, Frankfurt, and New York The only maJor crisis country I did not visit was Brazil, because I was able to interview most of th key players in the Brazilian government during their visits to the United States.

I am grateful to everyone who took time to speak with me, particularly those whom I contacted f repeated follow-up interviews. Several people underwent at least ten bouts of questioning at vario times, and I greatly appreciate the good humor with which they endured my endless queries.

The vast majority of my interviews were conducted on a deepbackground basis, which meant could use the information but could not quote interviewees or cite them as sources unless grante permission to do so. Much of the information conveyed was obviously of a sensitive nature, especial at the time the interviews were conducted and during the period the book was being written; th Clinton administration was still in office then, and many of the key players were still in their Jobs. (quite a few cases, this remains true in early 2003.) So although I have tried as much as possible attribute quotes by name, I must ask readers' indulgence and understanding that obtaining permissio for attribution often proved impossible; I can only offer assurances that unattributed material in th book has been carefully researched and checked. In cases of conversations or meetings where number of people were present, I tried as much as possible to confirm the information with multip participants. In numerous important instances, sources checked their notes or produce contemporaneous documents that helped illuminate the events in question.

A list of interviewees appears in the notes section. It includes those who spoke on the record, plu those who were interviewed on deep background and later granted permission to be named as sourc for the book. It thus excludes a substantial number of people who chose to remain entirely anonymou In many cases, the source of unattributed information may be fairly obvious, but in a number instances, appearances will be deceiving. This is particularly true in episodes where I identify on policymaker or another as having correctly analyzed a problem or situation before others did.

obviously had to be wary of policymakers eager to revise history about themselves, but in quite a fe cases, people would inform me of the positions taken during the crisis by certain of their colleagu who, in retrospect, had "gotten it right," or at least more right than others—Mike Mussa, the IMF chief economist, is one example; another is Joshua Felman, a senior staffer on the Fund's mission Indonesia in late 1997. When further investigation showed these tips to be accurate and noteworthy, wrote about them, and although it may look as if certain policymakers or staffers were tooting the own horns, the facts are otherwise.

Some people refused to grant interviews. I don't want to be too specific about who did and w didn't, but I feel obliged to mention that Michel Camdessus, the managing director of the IMF durin the crisis, was among those who declined my request even after he had retired from the Fund. Wi that exception, I generally found IMF officials to be extraordinarily accommodating and helpful. M hat is off to Thomas Dawson and the rest of the IMF's able External Relations Department for havin given free rein to Fund staffers to accept my interview requests and meet me privately to the exte they felt comfortable doing so. A few years ago, the Fund would not have been nearly so open to th sort of inquiry. My thanks also go to the Treasury's public affairs office, and particularly Michel Smith, who was assistant secretary for public affairs, for having arranged meetings with t department's busy policymakers.

Aside from those who provided information, a large cast of characters and institutions supported m in the process of transforming this book from a gleam in my eye to a finished volume.

My first call went to Peter Osnos, the publisher of PublicAffairs, whom I knew to be an enthusiast and nurturing supporter of many book projects by friends and colleagues in Journalism. Peter's war reaction and sound counsel confirmed that I had made a wise choice. A book concerning the IMF a financial crises, he told me, wouldn't command a large advance from him or any other publisher, but could obtain supplementary financing from foundations. This proved to be sagacious advice, a although Peter urged me to shop my book around to other publishers if I wanted to, I have nev regretted sticking with him and PublicAffairs. (On a personal note, I was gratified to be writing for publisher who had inherited the name and legacy of Public Affairs Press, which was founded by t late Morris Schnapper, a dear friend of my family.)

My next move was to seek permission from my editors at *The Washington Post* for a leave from m reporting duties. Jill Dutt, the assistant managing editor for business news, not only consented to m request but also went to bat for me with Leonard Downie and Steve Coll, the *Post*'s executive edit and managing editor respectively; Len not only approved but granted me a partially paid sabbatical well under the terms of a provision in the *Post*'s union contract. I am deeply grateful to Jill, Len, a Steve in particular, and to the *Post* in general, for this opportunity and generous support. I o profound thanks also to several of my *Post* colleagues who made sure that my beat, internation economics, was covered during my absence. John Burgess performed so ably in the Job that he w soon promoted to an editing Job on the foreign desk; he was followed by Steve Pearlstein, who reporting preferences lay elsewhere but who covered the beat in the only way he knows how—wi tenaciousness and a passion for making sense of difficult subJect matter. All this was made possib because of the skill and cheer with which Nell Henderson, the *Post*'s economics editor and m immediate supervisor, Juggled story assignments and elicited the best from her charges. To top all th off, Jill and Nell acceded to my request in autumn 2000 for an additional four months of leave beyo the year that I was originally granted. To Jill, Nell, and Steve, I am in everlasting debt.

The Institute for International Economics offered me an office to work from, as well as a fancy tit —Visiting Fellow. But I got much more than that from Fred Bergsten, IIE's director, and h

colleagues. I had wanted to do my research at a place where I could pick brains, and IIE has the be ~~pickings around, certainly in my field of interest. The institute's fellows held a luncheon session~~ earl in my leave to discuss my outline, and later they convened for two other sessions to discuss drafts my manuscript. (Names of sources were excised from the drafts that were distributed in advance those sessions.) The comments I received, both in verbal form during the sessions and in written for afterward, helped me enormously both in conceptualizing the book and in avoiding the sort of doltis errors we Journalists are all too prone to make. I am particularly obliged to John Williamson ar Morris Goldstein for their extensive and wise counsel; others to whom special thanks are owe include Catherine Mann, Gary Hufbauer, Marcus Noland, Adam Posen, Randall Henning, Choi Inbor Marcus Miller, Kim In Joon, Cho Hyun Koo—and, of course, Fred Bergsten and his deputy, Tod Stewart. By the time my leave was over, I had come to appreciate that IIE's fellows and staff are no only tops at what they do but a very pleasant bunch of people as well.

Financial support came first as the result of a call to the Pew Charitable Trusts, whose Venture Fur director, Donald Kimelman, kindly put me in touch with John Schidlovsky, director of the Pe Fellowships in International Journalism. In an inspired act of entrepreneurship for which I a immensely thankful, John arranged for me to become the first "Journalist in Residence" at th program, which is based at the Paul H. Nitze School of Advanced International Studies of The John Hopkins University. In exchange for a stipend, John and his deputy, Louise Lief, asked that I condu two seminars about the IMF for the Pew fellows—a task that proved more pleasurable tha burdensome. As the "guinea pig" for this position, I was gratified to learn in early 2001 that Pew ha decided to institutionalize it.

I still needed funding to cover my expenses—especially for travel—and I had the good fortune obtain a generous grant from the Smith Richardson Foundation. I would like to express my gratitu to Smith Richardson and especially to Marin Strmecki, vice president and director of programs, ar Allan Song, one of the foundation's program officers, for their help and encouragement.

When I realized that I would need more than a year to finish the book, financial salvation cam from the United States-Japan Foundation, which provided me with another grant that enabled me take four extra months of leave at the end of 2000. My deep thanks go to James Schoff, a progra officer for the foundation, for helping me convey to the foundation's management that my proJec although not specifically focused on U.S.-Japan relations, would shed light on issues that had cause sharp divisions between Washington and Tokyo. I also thank George Packard, the foundation president, for perceiving the potential value of my book to informing the policy dialogue across th Pacific.

I would be remiss in omitting several colleagues and friends who assisted me both at home ar abroad with advice and contacts. They include David Hoffman, the *Post*'s former Moscow burea chief (and now the paper's foreign editor), whose book *The Oligarchs* was published in February 200 by PublicAffairs; John M. Berry, the *Post*'s famous Fed-watcher; Paulo Sotero, Washingto correspondent for *O Estado de São Paulo*; Thanong Khanthong of *The Nation* newspaper in Bangko Atika Shubert, a *Post* stringer in Jakarta; Cho Joohee, a *Post* stringer in Seoul; Manley Johnson ar David Smick of Johnson Smick International; and Richard Medley and Nicholas Checa of Medle Global Advisors in New York.

When it came time to edit the manuscript, Paul Golob managed to engineer massive and sensib organizational revisions without inflicting damage on my ego. The book is immeasurably bett thanks to Paul's many interventions. Ida May B. Norton, who copyedited the book, also improved th manuscript in numerous ways. I owe an appreciative nod also to others at PublicAffairs, includin

Managing Editor Robert Kimzey, his assistant Melanie Peirson Johnstone, and Assistant Editor Davi
Patterson, for ably handling many production and administrative tasks.

I would have loved to send copies of the manuscript—or even individual chapters—to my sourc to obtain their comments and suggestions. But the press of time made that impossible, especially sin I returned to the *Post* in January 2001, before the book was finished. The one exception was Sta Fischer, the IMF's first deputy managing director, who asked me in August 2000 to send him what had written to help him prepare for a series of lectures he was giving. With considerable trepidation sent Stan a draft of the material that would later become Chapters 1 through 8 (again, with sourc names excised). As I had hoped, I was eventually repaid with extraordinarily thoughtful feedbac much of which I incorporated into the manuscript—although in the case of the Indonesian crisis, I' afraid Stan and I continue to see the story rather differently. I hasten to add the usual caveats that h bears no responsibility for errors or omissions that remain in the text (nor do the scholars at IIE wh read the manuscript) ; blame for all goofs and shortcomings rests entirely with me.

My children Nina and Nathan enJoyed teasing me about writing a book on such an arcane subjec yet they helped sustain me by conceding that it would be cool to have a published author as a dad thank them for accepting the demands the book put on my time, for ignoring the files piled in th living room, and for enduring such unspeakable inconveniences as being forced to log off of th Internet so that I could send urgent e-mails and conduct research. I also thank my son Dan, who entry into the world six weeks prematurely in May 2001 added a dash of, um, excitement to the fina frantic couple of months of quote-clearing, fact-checking, and footnote-writing. His good health—an that of his sister and brother—helped me keep my perspective about what is truly important in m life.

Finally, I could never have survived this undertaking without the love and support of my wi Yoshie, who despite her own heavy work responsibilities made many sacrifices for the sake of m comfort at home during long, mentally draining days of writing. Yoshie heroically kept our newbor son from waking me on nights when I had to get a decent rest so that I could plow through the fin versions of the manuscript the next morning. Most important, she let me know she is with me all th way.

> A note on Asian names: In keeping with common usage and local custom, Southeast Asia names will appear in this book with the first (given) name used in second reference; Chine and Korean names, in which the family name customarily appears first, will likewise appe with the first name on second reference; and Japanese names are rendered in the Western styl with given name first and family name second, with the family name used on second referenc

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THE COMMITTEE TO SAVE THE WORLD

Hubert Neiss spent most of his career as an economic disciplinarian for troubled countries, and wi his flattop haircut and sober demeanor, he looked every bit the part. A native of Austria, Neiss was veteran of three decades at the International Monetary Fund, which he had Joined in 1967 aft finishing his Ph.D. in economics at the Hochschule für Welthandel in Vienna. He was short bu remarkably barrel-chested, the result of an enthusiasm for fitness that evoked both admiration an amusement among colleagues and friends. He often limited himself to eating, say, a banana at midda so he could spend lunchtime at a gym lifting weights.

Among Neiss's strengths was an ability to remain serene and businesslike amid turbule circumstances. His steeliness had helped him rise through the IMF's ranks, culminating in h appointment in early 1997 at age sixty-one to one of the institution's highest staff positions, directo of the Asia and Pacific Department. But nothing in Neiss's career prepared him for the series of even that began the morning of Wednesday, November 26, 1997, when he landed in Seoul, the capital o South Korea, following a sixteen-and-a-half-hour plane trip from Washington.

After a brief stop at his hotel, Neiss and a couple of other IMF staffers were driven past glass an granite skyscrapers and the openair Nam Dae Mun market, where digital watches and handhe computer games are on sale alongside dried squid, boars' heads, and vats of *kimchi*. The car passe through the iron gate of the Renaissancestyle headquarters of the Bank of Korea, the nation's centr bank, and Neiss was ushered into its international department for a briefing on Korea's latest financi data. He expected the news to be grim; he didn't know the meeting would thrust him into a frenzy activity aimed at staving off global economic disaster.

Neiss had come to Seoul to launch a process at which he was well practiced—negotiating an IM "program." In simple quid pro quo terms, the Fund would make a loan to the South Korea government in exchange for Seoul's agreement to undertake a specific list of steps to put the nation economy on a sound footing. Normally, IMF programs take two or three months to negotiate. But th Korean situation was shaping up as unusually urgent.

Korea's financial markets were undergoing a bout of turmoil similar to the crisis that ha devastated another of Asia's dynamos, Thailand, about five months earlier, during summer 1997. I late October, the Hong Kong stock market had crashed, followed by a 554-point drop in the Dow Jone industrial average on October 27, and once-thriving Indonesia had turned to the IMF for help shoring up the value of its currency. Now many big international investors and lenders were bettin that Korea would be the next domino to fall; the Korean currency, the won, had fallen 17 perce against the dollar in the past four weeks. The "Electronic Herd" (a term popularized by Journali Thomas Friedman), whose ranks included mutual funds, pension funds, commercial banks, insuran companies, and other professional money managers, was spooked by revelations about Korea financial problems, such as the increasing amount of unrecoverable loans held by Korean banks.

Korean government officials had taken the humiliating step of seeking IMF assistance only aft considerable anguish and debate. They were enormously proud of having guided their nation from th ~~ruins of war in the 1950s to the status of an export powerhouse that boasted the eleventh-largest~~ gro domestic product in the world. But the country's financial position was becoming increasing precarious. The Herd's actions were depleting the Bank of Korea's reserves of hard currency—th U.S. dollar and the handful of other maJor currencies that are essential for nearly all transactio across international borders. Foreign banks were calling in short-term loans to Korean banks, a foreign investors were dumping the Korean won for dollars as they unloaded their holdings of Korea stocks and bonds. If this drain continued, the central bank's reserves would run so low that the ban would be unable to provide dollars to people who needed them. The ultimate nightmare was defau meaning that the government, the nation's banks, and virtually all the maJor corporate names in Kore Inc., such as Hyundai, Daewoo, and Samsung, would not be able to obtain enough dollars to ma payments due to foreign creditors and suppliers.

Neiss's mission was to negotiate a plan that would calm the markets and banish the nightmare. Th IMF, as well as top U.S. government officials who exercised major influence over the Fund, feare that a default by Korea could cause the country to suffer a prolonged, crippling cutoff of loans a investments from abroad; further, as the creditworthiness of neighboring countries came into questio they might follow Korea into default, sending the entire Asian region into a decade of stagnation a depression like the one that afflicted Latin America during most of the 1980s. Conceivably, the nerv of investors and lenders the world over would be so shattered that the financial conflagration wou leap across the Pacific, lay waste to the U.S. economy, and engender global recession.

So when he arrived at the Bank of Korea that cool November day, Neiss thought he understood ho dire the circumstances were—until he started examining the figures furnished by the central bank international staff. To his horror, Neiss realized that Korea was far closer to default than anyone in th IMF had understood. The readily available reserves of dollars were so paltry that the country w almost certain to run out within days—perhaps as soon as a week.

Only a couple of weeks before, in conversations with IMF officials, the Koreans had put the reserves at $24 billion, which was low for an economy Korea's size but did not pose an emergenc Now Bank of Korea staffers were citing figures suggesting that "usable" reserves were about $ billion and declining at a rate of roughly $1 billion a day. This was mainly because foreign bank which had previously made short-term dollar loans to Korean banks and routinely extended the month after month, were suddenly demanding repayment as the loans came due. The situation w even worse because the bulk of the central bank's reserves couldn't be used in a crisis like this. Th funds had been deposited in the overseas branches of Korean commercial banks, which had been usi the money to pay obligations; withdrawing the funds would make it impossible for the ban themselves to avoid default, and that in turn would bring down the nation's entire financial system.

Seated at a small conference table across from Bank of Korea officials, IMF staffers hea increasingly bad news as they pressed for details about the country's international indebtedness. couple of months earlier, an IMF mission conducting a routine annual review of the economy ha been told that the short-term debts owed by Korean firms to foreigners totaled around $70 billio Now it seemed clear that the previous mission had failed to ask sufficiently probing questions: Th debts of Korean firms' overseas operations hadn't been included in the previous estimate; with tho debts included, the figure was closer to $120 billion. Worse, Bank of Korea officials acknowledg that much of the debt would fall due in the next few weeks—so the need for dollars was particula acute.

The more the IMF team queried the Koreans, the more desperate the situation looked. Nei recalled that two things went through his mind: One, what to do? And two, how to inform IM ~~management quickly? Despite his relatively senior position, Neiss had no authority to cut a deal~~ wi Seoul on his own.

Back in Washington, the long Thanksgiving weekend was Just starting, and the IMF, which pride itself on its rapid-response capacity in financial emergencies, was almost comically unprepared f the impending bankruptcy of a maJor economy. The managing director, Michel Camdessus, was in h native France. Stanley Fischer, the first deputy managing director, was attending a seminar in Egyp Jack Boorman, the director of the Fund's Policy Development and Review Department and the ma generally viewed as the Fund's third most powerful official, was at his vacation home in Rehobo Beach, Delaware, where twenty-four guests were about to arrive for turkey dinner.

Neiss handwrote a fax to IMF headquarters explaining the depth of the problem he faced and listi a couple of options for dealing with it. First, a wealthy country such as Japan could extend a shor term emergency loan to Korea (though he knew the Koreans had already tried unsuccessfully to g such a loan). Second, Korean banks could obtain emergency permission to pay their forei obligations with bonds instead of cash (though that would constitute a virtual default as far as mar foreign creditors were concerned).

Another option would be to throw together an IMF rescue program before Korea ran out of reserv —an undertaking that Neiss described as "barely feasible" and "not credible." After all, one purpo of the rescue was to stem the market panic by showing banks and investors that plenty of dolla would be available for those who needed them, and this would require marshaling a loan package f the Korean government of unprecedented size, larger even than the $50 billion Mexico had received 1995. Another purpose was to draw up plans for a thorough overhaul of Korea's economic policies show the markets that the country was eliminating its most glaring weaknesses. A few days did n seem sufficient for devising a full economic program of this magnitude.

Yet this was the option Neiss was ordered to pursue, following a series of meetings and conferenc calls involving top officials of the U.S. Treasury, Federal Reserve, State Department, and Nation Security Council and their counterparts in other governments belonging to the Group of Seven maJ industrial countries (the G-7). Proceeding with that option was an incredible ordeal, both mentally ar physically, for almost everyone involved.

Starting on Friday, November 28, Neiss began conducting nearly around-the-clock negotiations the Seoul Hilton with officials of Korea's Ministry of Finance and Economy concerning the bailout conditions—that is, the painful economic changes and reforms that Seoul would have to pledge exchange for an international loan. For three full days and nights, Neiss got no sleep; Wanda Tseng, Chinese-born economist who was cochief of the IMF mission, went even longer without so much as catnap—four days and nights. For nutritional sustenance, IMF team members resorted mainly snacking on chicken wings and other hors d'oeuvres served on the hotel's executive floor. Taking th time to dine in a restaurant, or even to eat a proper meal ordered from room service, seemed out of t question given the mountain of work required to cobble together an IMF program that stood a chan of calming the markets before Korea's reserves ran completely dry.

Other distractions and inconveniences abounded—not to mention the fact that the Korea negotiators were strenuously resisting many of the reforms sought by the IMF. Most of the talks we held in the Kuk Hwa banquet rooms, located in the hotel's lower level a mere thirty paces from t entrance to Pharaoh's, a hotel disco with ancient Egyptian decor, which continued to operate ar emanate a thumping beat. The main entrance to the negotiating room was quickly surrounded hordes of Korean reporters and TV crews. Determined to avoid potentially market-rattling encounte with the media, IMF staffers had to take a circuitous route to a back entrance that involved going u and down flights of fire stairs and through the Hilton’s vast kitchen. When they weren’t talkin directly with the Koreans, they were contacting their superiors and colleagues, by phone, fax, and mail, to discuss the complex details of the negotiations. They also had to contend with David Lipto the U.S. Treasury undersecretary for international affairs, who had flown to Seoul and checked in the Hilton to convey the views of the U.S. government, a visible manifestation of the influence t United States wields over IMF policy.

Alas, all these heroic exertions were to produce an embarrassing flop.

On Wednesday, December 3, an agreement between the two sides was triumphantly announced b Michel Camdessus, who had flown to Seoul on the final day of talks to use his stature as managin director to close the deal. Under the accord, the Korean government would receive loans totaling $5 billion, more than any country had ever before received, including a record $21 billion from the IM backed with additional loans and pledges of credit from the World Bank, the United States, Japan, an other countries. The program involved a staggeringly wide array of promises by Seoul: The budg would be cut; interest rates would be raised; ailing financial institutions would be closed for the fir time in modern Korean history; government-directed bank loans for the nation’s powerf conglomerates would be eliminated; foreign investors would be allowed greater freedom to buy stoc and bonds; and the economy would be liberalized in a host of other ways.

Camdessus pledged that the plan would be submitted within forty-eight hours to an emergen meeting of the IMF Executive Board, which represents the member countries. Following boa approval, the IMF would immediately disburse $5.6 billion, and another disbursement would follo two weeks later—all of which, in accord with IMF custom, would be deposited in the nation’s centr bank. The “far-reaching” reforms that Korea had promised would enable the nation’s economy t recover, Camdessus predicted, adding, “I am confident this program will also contribute to the neede return of stability and growth in the region.”

But his optimism proved misplaced. The Electronic Herd showed little sign of being impressed b the Fund’s rescue efforts, and within days, Korea was in even worse financial straits than befor During the week of December 8, trading in the Korean won was suspended every day because it ha fallen against the dollar by the 10 percent limit set by the government—on some days, this occurre within three minutes after the start of trading. Foreign banks in New York, Tokyo, London, Frankfur and other financial capitals continued to cancel credit lines and demand immediate repayment o loans they had once routinely extended and reextended to Korean banks. The chaos in Korea se markets tumbling anew in the United States, Europe, and Asia.

Shell-shocked members of the IMF mission in Seoul began an exercise they called the “dra watch.” This involved sending a staffer or two to the Bank of Korea at around 9 P.M. until well afte midnight, when markets were open in the United States and Europe, to monitor how the central ban was being forced to relinquish precious reserves to meet the demands of foreign banks for repayme on their loans. The long faces of the drain-watchers at breakfast the next day often betrayed the ba news that another $1 billion or so had been withdrawn from the country overnight in this manner.

By the week of Christmas, almost all of the $9 billion the IMF had disbursed had gone to pay o foreign banks that were calling in their loans to Korean borrowers. The Korean won was nearly 4 percent below its level at the time the IMF rescue was unveiled. And Seoul once again stood at th brink of default.

The failure of the IMF's rescue of Korea in early December 1997 was one of the scariest moments the series of crises that rocked the world economy in the late 1990s. But it was far from the only su moment. Time and again, panics in financial markets proved impervious to the ministrations of t people responsible for global economic policymaking. IMF bailouts fell flat in one crisis-strick country after another, with the announcements of enormous international loan packages followed crashes in currencies and severe economic setbacks that the rescues were supposed to avert.

In August 1997 in Thailand, for example, the nation's currency, the baht, which had already fall substantially in value, plunged further almost immediately after the approval of an IMF-led resc totaling $17 billion. In Indonesia, a $33 billion package of loans marshaled by the IMF at the end October 1997 generated only a brief rally in the Indonesian rupiah, which soon thereafter resumed decline in currency markets. A "strengthened program" unveiled in January 1998 fizzled even mo spectacularly, with the value of the rupiah shrinking to a sliver of its former level.

Likewise, Russia received a $22 billion IMF-led package in July 1998, followed about a month la by the announcement that Moscow was devaluing the ruble and effectively defaulting on its Treasu bills—a development that sent U.S. financial markets into a terrifying tailspin. In January 1999, t same script was followed in Brazil, where nine weeks after agreeing to a $41 billion IMF progra officials found themselves forced to abandon the fixed-rate policy for the Brazilian real, whi promptly sank 40 percent against the dollar.

This book offers a retrospective of key events in the crisis and how they were handled by the glob economy's "High Command," which includes not only the IMF but also powerful officials at the U. Treasury, the U.S. Federal Reserve, and other economic agencies among the G-7, who oversee IM operations and steer international economic policy. (To some extent, the IMF's sister institution, t World Bank, is part of the High Command as well, though the bank took a distinctly subordinate ro during the crisis.) I use the term "High Command" advisedly, and with a pinch of irony, for the ta recounted in this book suggests that this group's ability to safeguard the global economy from cris is neither high nor commanding.

The events of 1997-1999 cast disquieting doubt on the IMF's capacity to maintain financi stability at a time when titanic sums of money are traversing borders, continents, and oceans. The IM is an institution designed to help countries correct problems in their economic fundamentals, and th was a manageable task when the flows of private capital moving around the world were much small than they are now. But the late 1990s brought crises of confidence in markets whose size, speed, a propensity for large-scale disruptions have vastly outstripped the Fund's resources and ability to ke up. The IMF's efforts to contain the crises were analogous to a team of well-trained orthope surgeons trying to cure a ward of patients experiencing emotional breakdowns, and the Fund h emerged from the experience with its credibility damaged. Thorough scrutiny of these developme lays bare how distressingly volatile the global economy has become in the new era of massi international capital flows. Unless steps are taken to make the system safer, future crises could much more disastrous.

The IMF was itself at the vanguard of the movement that liberalized the flow of capital around t world in the 1990s, taking globalization to new heights. International trade in many goods—sho chemicals, microchips—was already substantially free. So was investment in overseas factories multinational manufacturers. A new goal for the globalizers at the IMF—and their backers in maj governments including the United States and Great Britain—was the elimination of national barri to foreign funds, which was expected to help create a more efficient world economy, raising livin ~~standards in rich and poor countries alike. A further Justification was that developing countries~~ woul reap enormous benefits by establishing modern stock and bond markets to finance their industri instead of relying heavily on traditional (and often corrupt) banking systems. The advocates globalized capital were by no means unconcerned about the dangers of international crises, and the hedged their recommendations by urging countries to develop proper legal institutions and impro supervision of their banks before allowing the Electronic Herd to invest large amounts of money their markets. But money poured into fast-growing emerging markets nonetheless, much of it "hot meaning it could be sold or withdrawn quickly, often at the stroke of a computer key, by portfol managers or commercial bankers or currency traders sitting in offices thousands of miles away.

The precipitous drop in the Mexican peso in late 1994 and early 1995 provided a Jarring example the potential for volatility that lurked within the system. But the Mexican crisis caused litt contagion, and it ended triumphantly for the Clinton administration and the IMF in January 199 when a recovering Mexico repaid—in advance—the $12 billion it had borrowed from the U. Treasury. If anything, the Mexican case gave the High Command an overblown sense of its power manage such situations. Only after the much more widespread gyrations and perturbations of the la 1990s did the system's lack of governability begin to hit home.

The popular perception of the High Command was illustrated by an article published in *Time* early 1999, titled "The Committee to Save the World." The magazine's cover displayed a photo Robert Rubin, the secretary of the treasury, his deputy (and eventual successor) Lawrence Summer and Alan Greenspan, chairman of the Federal Reserve Board, posing amid the marbled splendor of th Treasury with arms folded and faces cheerfully composed. As the photo and accompanying artic suggested, these three men, working hand in glove with the IMF, were exercising extraordinar influence over the strategy for containing the crisis.

The soothing notion that the world was being "saved" by brilliant policymakers was understandabl for the crisis did have a more or less happy ending. In a couple of countries in particular, the IM posted notable successes as well as failures. Following the Fund's abortive attempt to bail out Kore in early December 1997, a second rescue a few weeks later used a different approach to resto confidence in that country's financial system, averting what might have been a far wider crisis. second IMF program for Brazil in March 1999 also worked, and even the earlier bailout, while failin in its avowed goal of preventing a Brazilian devaluation, at least staved off a collapse in the country currency until global markets had recovered from other devastating shocks.

The global crisis was widely pronounced to be over in spring 1999, and that assessment by and larg held up. Not only did world growth proceed apace in 1999 and 2000, but most of the hardest-h countries bounced back. Korea was growing feverishly; the Brazilian economy was bounding along a healthy clip; Thailand was on the mend; and Russia was posting positive growth, an achieveme that eluded it for most of the 1990s. Even Indonesia, whose economy had been the most severe damaged, was growing, though its recovery was extremely fragile. Arguably, the crisis strengthene the long-term economic prospects of some of these countries; Korea, in particular, benefited fro loosening the ties among its banks, conglomerates, and public officials.

Thus, despite all the hardships wreaked on people in places like Jakarta and St. Petersburg and R de Janeiro, the crisis might be viewed as a setback of little consequence for a world enjoying a spell robust growth. Who cares that a handful of countries suffered a comeuppance for the crony capitalism corruption, overborrowing, and other sins of which they were guilty—and since they didn't drag th rest of the world economy down with them, doesn't that reflect the resilience of the global financi system, the effectiveness of its safety nets, and the cleverness of its High Command?

~~On the contrary, such a blithe interpretation of the crisis ignores its implications, both~~ for th stability of individual countries' economies and for that of the global economy as a whole. Th affected nations, for all their flawed economic fundamentals, had been the darlings of financi markets not long before their crises struck, and once the Electronic Herd turned negative, th punishment it inflicted was grossly out of proportion to the countries' "crimes." Disregarding the fate is tantamount to shrugging off the crash of a new type of advanced aircraft on the grounds that th only passengers killed were a careless few who left their seatbelts unfastened—and concluding th since everyone else miraculously survived, worry about future flights is unwarranted.

The news accounts at the time of the crisis, as disturbing as they were, do not adequately conve how frightening, disorderly, and confounding it all was, most notably for the people in charge quelling it. An extensive look inside the crisis-fighting effort illuminates the degree to which th policymaking wizards of Washington and other capitals found themselves overwhelmed and chasten by the forces unleashed in today's world of globalized finance.

The pace at which economies were felled by "contagion"—the spread of market turmoil from o country to another—caught top policymakers flat-footed. So rapid was the onset of Korea's crisis November 1997 that it came less than a month after the IMF staff had drafted a confidential repo assessing the Korean economy as essentially safe from the turbulence besetting Southeast Asi Equally unsettling was the swiftness with which the markets often delivered their negative verdicts the IMF's handiwork. Fund officials had Just sat down to lunch in Jakarta on January 15, 1998, celebrate the signing that morning of Indonesia's "strengthened" program when they heard th shocking news, from cellphone calls, that the rupiah was falling instead of surging as they ha anticipated.

Most chilling of all was how perilously close the U.S. economy came to Joining the glob meltdown in September and October 1998, when U.S. financial markets, especially the bond mark ceased functioning normally as a provider of capital to business, and the near-collapse of a gia hedge fund threatened to paralyze the nation's financial system. Thanks to the benign outlook f inflation, the Federal Reserve felt free to cut interest rates sharply at that time—but had it not done s the convulsions on Wall Street might well have engendered a worldwide slump.

Rubin, Summers, and Greenspan are brainy, all right—indeed, they rank among the smartest a most capable economic policymakers in recent memory—but the aura they attained as econom saviors conveys the false impression that the international economy was in the hands of mastermin coolly dispensing remedies carefully calibrated to tame the savage beast of global financial marke The reality, as I describe in chapters to come, is that as markets were sinking and defaults loomi the guardians of global financial stability were often scrambling, floundering, improvising, a striking messy compromises.

The mad dash to rescue Korea in November 1997 was Just one illustration of how the IMF and th rest of the High Command were knocked for loop after loop during the crisis. The second rescue Korea, though successful, came harrowingly close to falling apart as the U.S. Treasury and the Fe deeply uncertain about the viability of the plan, waited until the last minute to sign on. In Brazil, t Treasury and IMF officials backed a bailout, over the strenuous obJections of European policymake aimed at propping up the Brazilian real—only to find when the real crashed that the European skepticism about the bailout's prospects was Justified.

As the crisis progressed, fierce disputes erupted within the G-7 and between the World Bank a other players. The United States, which dominated G-7 decisions, was at loggerheads with Japan ov the issue of the IMF's right to force crisis-stricken Asian countries to revamp their economic system U.S. ~~officials also clashed repeatedly with their German counterparts, who criticized large IMF~~ loa packages as bailouts for the rich that would foster reckless investor behavior in the future. By the tin the Brazilian crisis rolled around in late 1998, British and Canadian officials were also taking sha issue with the U.S. approach, urging that instead of resorting to large IMF loans, the internation community should use its leverage to impose temporary halts on the withdrawal of money fro countries in crisis by private lenders and investors.

These and other episodes afford a dramatic backdrop for understanding and scrutinizing the IMF, a institution that, even to wellinformed laypeople, is a source of great perplexity—sinister to som awe-inspiring to others. Demystifying the IMF has never been more important, not least because of i sudden notoriety as the target of antiglobalization protesters.

Fund officials may complain about how poorly the public understands their institution, but the IM cultivates its mystique, seeking to appear all-knowing, scientific, and detached. To outsiders, it ofte comes across as a high priesthood with pretensions of divine powers and insight. Its publ pronouncements and documents are loaded with economic Jargon that seems almost deliberate designed to obfuscate or intimidate. Sometimes this practice descends into farce. Several years ag for example, an IMF report described Vietnam's invasion of Cambodia as "a misallocation o resources due to involvement in a regional conflict."

The IMF has a tremendous stake in maintaining an image of omniscience as it dispenses loans an prescribes remedies for ailing economies, because it wants to convince everyone—especially financi markets and officials of the governments seeking its assistance—that it knows what it's doing. Whe a nation with an IMF program fails to regain stability, the Fund almost invariably blames th country's government for failing to meet the conditions and targets that were agreed to, or for failin to show convincing commitment to achieving them. IMF officials typically shake their heads resignation over the difficulty the country's politicians are having in, say, slashing popular subsidi or maintaining painfully high interest rates. From their lofty positions, they enlist support fro professional analysts and the press for their view that the fault surely does not belong with the prescriptions. "It's the only program that serious people can imagine putting together," a senior IM official told me, with a touch of asperity, in mid-December 1997 as Korean markets were meltin down after Seoul had Just received the biggest IMF loan in history.

Peering behind the IMF's facade provides a less confidenceinspiring picture, even for those wh broadly share the Fund's views about how to handle countries in economic difficulty. I have m current and former IMF staffers who, speaking candidly under a promise of anonymity, recall wi anguish having been thrown into the midst of crises with bewildering origins and no obvio solutions. "Everyone was working on the assumption that all you need is an IMF program, but this w proved wrong over and over," lamented one such Fund economist. "We reached agreement with thes countries Just to see the currency go over and over again."

Often, IMF officials felt outgunned—and small wonder. While the Fund can marshal hug resources for the countries it aids and can demand far-reaching reforms from their governments, it h been dwarfed by the growth of global markets.

The Federal Reserve, one of the most potent crisis-fighting institutions around, provides a illuminating comparison. As the U.S. central bank, the Fed plays the role of America's "lender of la resort," standing ready during financial crises to use its power to create unlimited amounts of mone The classic scenario of Fed intervention involves a run on a bank caused by rumors that prom depositors to withdraw their funds, which in turn causes runs on other banks that do a lot of busine with the first bank. The Fed's duty is to lend as much cash as the banks need to cover their depositor ~~demands—and keep lending until the panic eases, because otherwise the whole system might crash.~~

The IMF plays a similar role on the international stage. As with Korea in 1997, countries sometim run dangerously low on hard currency, so the IMF stands ready as a lender of last resort. But the IM can't simply create more hard currency—be it dollars, Japanese yen, British pounds, euros, or an other such monetary units—the way a central bank like the Fed can. The IMF has a war chest of the currencies contributed by member countries, and the size of its loans is limited as a result. In absolu size, the war chest is gigantic, and it has grown—from $27 billion in 1980, to $60 billion in 1990, $88 billion at the beginning of 1997, Just before the advent of the crisis in Asia. (The figure in 200 was $135 billion.) But during that same period, purchases and sales of bonds, stocks, and oth securities across international borders by firms and individuals resident in the United States soare from $249 billion in 1980 to $5 *trillion* in 1990 and $17.5 trillion in 1997. (When similar figures a added for residents of other advanced countries such as Germany, Japan, and France, the sums a more than twice as big.) For emerging markets alone, the amount of private capital flowing into the from abroad rose from $188 billion in 1984-1990 to $1.043 trillion in 1991-1997.

Beyond the problem of the IMF's limited resources, though, is its sometimes inept deployment them. It is no secret that the Fund made serious mistakes in its efforts to rescue countries from crise Some of these involved the Fund's well-known penchant for overprescribing austerity, an examp being the excessive fiscal stringency it demanded of Thailand. Others reflected the Fund's lack expertise in banking issues, an example being its decision to close sixteen banks in Indonesia witho providing a proper safety net for the remainder of the country's banking system.

This weakness does not mean, as some suggest, that the IMF is a hopelessly misguided or malig institution that systematically imposes harmful economic blueprints on countries in distres Universities and think tanks are full of people who believe that if only the Fund would follow the approach, crises like the ones in the late 1990s would never occur or would be much less sever Whether these advocates are right is impossible to say with certainty, and the arguments continue be the subject of much dispute. Some critics wage their attacks from diametrically opposi perspectives. Supplyside economists, for example, excoriate the IMF for being too quick encouraging countries to devalue their currencies. By contrast, Jeffrey Sachs of Harvard Universi and his followers assert that the Fund errs grievously by forcing countries to stick too long wi currencies that are overvalued. This book is not an economic treatise, however, and thus does n champion any particular ideology or school of thought about how the IMF should change its econom paradigm.

For anyone evaluating the IMF's performance, the question "compared with what?" must b constantly borne in mind. The fact that the Fund blundered does not mean that it failed to do a lot good, or that it failed to keep outcomes from being even worse than they turned out to be. F example, the Korean economy, and quite possibly the global economy as a whole, might be far weak today had Seoul not been prevented from defaulting in late 1997.

Even so, the crisis of the late 1990s exposed how woefully illequipped the IMF is to combat the ne strain of investor panics plaguing recently liberalized markets. The Fund proved unable to prevent th countries victimized by crises, especially in Asia, from suffering much worse than they deserved. I ineffectiveness at minimizing the punishment meted out by the Electronic Herd does not bode well f the future. Nor does its ineffectiveness at foreseeing and squelching contagion.

Subsequent events have reinforced these conclusions. A sizable IMF bailout for Turkey in late 200 failed at keeping the Turkish lira from collapsing in value two months later. More tragic was the cas of Argentina, whose economic performance had won acclaim from Washington and Wall Street durin the ~~late 1990s. Despite a $40 billion IMF-led package in December 2000 and another $8~~ billio program in August 2001, Buenos Aires was forced in early 2002 to default on its debts and abandon i pegged currency system; the result was an economic contraction that threw millions into poverty an obliterated the wealth of the country's middle class. Not long thereafter, financial paroxysms bes Brazil anew; in early 2003 it was unclear whether a $30 billion IMF program approved the previo summer would keep Brazil from following Argentina's course.

The global financial system showed its susceptibility to upheavals of intense destructive power the late 1990s. We could leave the system more or less as it is and hope that when future crises strik the Ph.D.s at the IMF, together with "the Committee to Save the World," rise to the occasion. But th account of how they struggled the last time around should chasten us all out of any sense complacency.

2

OPENING THE SPIGOT

Every year the IMF extends positions to about 100 economists, many of them recent recipients doctorates from the world's most prestigious graduate schools—Harvard, Stanford, MIT, Chicag Oxford, Cambridge, the London School of Economics. The organization they are Joining emplo 2,600 people, including lawyers, computer technicians, and other support personnel, but the heart its staff is the economists, who number more than 1,000.

Their new workplace stands on 19th Street in downtown Washington, three blocks west of th White House. It is a beige limestone building thirteen stories high with a curved driveway that is oft the parking spot for one or two limousines bearing visiting dignitaries. In the lobby, which has a sunl atrium and polished marble floor, a cosmopolitan atmosphere pervades, thanks to the patter Spanish, French, Arabic, and other languages spoken by staffers (all of whom are required to be flue in English) casually flicking their ID badges to pass through the electronic security apparatu Although smartly tailored business clothing predominates, the occasional turban, head scarf, dashiki adds a touch of color. Staffers hail from more than 120 nations; about a quarter are American

The new recruits have been lured partly by the pay. In 2002, entry-level Ph.D.s at the IMF earn salaries between $69,000 and $103,500 a year—tax free. Another draw is their status as eli international civil servants, who fly business class (often, first class) and stay in deluxe hotels wh on mission. But a maJor attraction for these newly minted Ph.D.s is the knowledge that, with months, they are likely to find themselves overseas sitting across the table from a finance minister central bank governor, helping to design a country's economic policies.

Upon reporting for duty, the recruits head for the IMF Institute, located in an office building couple of blocks north of the headquarters, where they undergo a two-week training program. addition to lectures on technical economic issues, the students take a course called "Financi Programming," which teaches them how the IMF helps countries in trouble. The institute's directo Mohsin Khan, spent a couple of hours one wintry afternoon walking me through the course in manner comprehensible to non-Ph.D.s. The result was an illuminating introduction to the IMF modus operandi, and Khan, a cheerfully outspoken Pakistani, also treated me to some cand observations about deficiencies in the Fund's traditional approach.

> We start the course [Khan told me] with a very simple analogy. Consider the case of a individual. He's faced with a negative net worth—that is, his liabilities, his debts, are great than his assets—and his income is less than his expenditures. He's spending more than he making.
>
> How can he do this? Because he's got credit—he can borrow. But now he's maxed out on h credit cards. No one will give him credit anymore.
>
> The bank says to him, "OK, we will bail you out. We will advance you some money. Bu now, everything you do has to be controlled by a financial planner. We can't allow you to kee spending the way you have, because you'll Just run out of credit again. The financial planner

going to do two things: He's going to help you increase your income and help you control yo
spending. So that, in fact, you can only spend, beyond your income, to the extent we supp
you with credit. We'll give you a loan of $10,000. The most you can overspend is that $10,00
And the financial planner is going to set targets for spending and help you earn more incom
so you can pay the money back.

"Furthermore, you are going to be watched very carefully. You're not going to get th $10,000 all at once. It's going to be spread out over a year. If you're living up to you commitments, you'll get the money. If not, we'll have to talk again."

After being given this analogy, the students at the IMF Institute examine the case of a typic country that lives beyond its means and ends up coming hat in hand to the Fund. For simplicity's sak I'll call this country Shangri-la, and its currency the rupee; in fact, these names are used in one of th Institute's textbooks.

Like most countries that seek the Fund's help, Shangri-la is running a large current account defic —a term that is roughly equivalent to a trade deficit, though it's a little broader. Shangri-la's impor substantially exceed its exports, and the money the people of Shangri-la earn by providing services foreigners—tourism, for example—still doesn't fill the gap.

Another way of looking at the situation is that Shangri-la is spending more than it is earning- measured in hard currency. These currencies, which include the U.S. dollar, the Japanese yen, th euro, the British pound, and a handful of others, are the only currencies commonly accepted international transactions. Without a supply of hard currency, a country can barely function in th global economy. Unfair as it may seem, the people and companies who sell oil, wheat, comput chips, pharmaceuticals, and other products across national borders will almost always insist on bein paid in dollars or yen or pounds or euros (the dollar being by far the most prevalent). The Ukrainia hryvnia, Vietnamese dong, and Haitian gourde may be essential for conducting business when bo buyer and seller are located within Ukraine, Vietnam, and Haiti respectively, but such currencies a usually refused as payment for goods and services outside their borders. This is not Just because rich countries tend to be more stable than poorer ones; it is also because hard currencies are easy and chea to trade, invest, and hedge against changes in their value. The world needs a stable medium exchange for commerce among nations, and hard currency is it.

So in a country like Shangri-la that is spending more than it is earning, exporters are earnin dollars, yen, and other hard currencies by selling their products to foreigners, and the tourist trade bringing in some more. But Shangri-la's importers are spending all this and more on the goods the buy from abroad, and their demand for hard currency is draining the central bank's reserves.

Just like the individual in Khan's analogy, Shangri-la can borrow on credit when it is spending mo hard currency than it is earning. For example, its companies may obtain loans of dollars or yen fro international banks to buy foreign machinery. Sometimes running a tab makes good economic sense- especially if, say, the foreign machinery purchased on credit can be put to good use producing hig quality products for export. In the nineteenth century, the United States, Canada, and Austral pursued a similar economic tack, running large trade deficits and borrowing heavily from abroad finance the development of railroads and other infrastructure.

But if Shangri-la runs too large of a tab, it may suddenly find itself in the same situation as th individual who has maxed out on his credit cards. Maybe there's an unexpected shock—a sudde surge in the price of imported oil, for example, or a dip in the price of a key export, such as coffee computer chips. Whatever the reason, Shangri-la has developed what economists call a "balanc ofpayments problem." Sources of hard currency from abroad dry up, because foreign lenders conclu that ~~for the foreseeable future, Shangri-la has little prospect of generating enough proceeds~~ from i exports to pay all its obligations to foreigners.

At this point, Shangri-la's finance minister and central bank governor are likely to be fou stepping out of a limousine in that curved driveway in front of IMF headquarters. The Fund is the on place an overextended country like Shangri-la can obtain the hard currency it needs to obtain vit imports and keep its economy functioning. In fact, this is the Fund's main purpose—to serve as a so of giant credit union, in which the members (the 183 nations belonging to the Fund) deposit ha currency into a kitty and borrow from it when they are strapped. Moreover, as Khan put it, "the Fu in a sense becomes the financial planner for this country, because it has to design a program th involves reductions in spending, and policies to increase income and production, so that the country living within the constraints of what's available."

Now comes the creative part of the institute's course—where the students learn, in theory at leas how to design a rescue plan for a country that has landed in hot water. In graduate school, most hav already studied the basic principles of economic policy. They have learned how to determine t proper levels for a government budget deficit and interest rates to help keep inflation a unemployment as low as possible. They have learned, too, that devaluing a country's currency h pros and cons. If, for example, Shangri-la devalues the rupee, its exports will presumably sell bette because they'll become cheaper relative to other countries' goods on world markets. At the same tim devaluing the rupee increases the cost of imports to Shangri-la's consumers, thereby lowering t country's living standards.

"What is completely new to the students is how you put all this together in designing a constructing an IMF program," Khan said. So, like medical students performing surgery on a cadave the IMF class considers a real case involving a real country that ran into a balance-of-paymen problem in the not-too-distant past. The students are divided into teams of about ten each and told produce a solution. The students' textbooks provide them with reams of data on the country government budget, money supply, business investment, foreign indebtedness, and the like. They hav learned, Khan said, to start with a fundamental question: "Suppose the country continues on its mer way, spending and producing as it has in the past. How much money [i.e., hard currency] would need? So we proJect exports, imports, and so on, and then see what the gap is. If the country continu on its merry way, this is what it will need."

The students are provided with a figure showing how large a package of loans the country c expect to obtain, given its size and importance, from the IMF and other official sources, such as t World Bank. The loans help fill the gap between hard-currency "income" and hard-currency "outgo but the country still needs to squeeze down its imports and increase its exports so that it can get itse on a sustainable path and earn enough hard currency to pay back the loans.

Thus the students must decide on a line of attack: Should the government slash its budget deficit raising taxes and curbing government outlays? Should it raise interest rates and curtail the growth the money supply? Almost certainly, their answer to both questions will be yes—the only re question is how much—because painful as those measures might be in terms of increasi unemployment, this is a country that needs to reduce its import bill, which entails a decline in overa spending. Should the currency be devalued? Again, the answer is likely to be yes. A lower value f the currency would also cause consumers to cut back on imports as foreign goods become mo expensive, and by making exports more competitive, it would enable the country to sell more of i output overseas—the result being increased supplies of hard currency.