

CASE STUDY

Middle-Income Countries Managing Financial Crises

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IEG Evaluation of the World Bank's Support to Middle-Income Countries

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This report was prepared by Thomas Reichmann (IEG consultant) based on research conducted in Summer 2006.

EXECUTIVE SUMMARY

The two decades to about 2002 witnessed several financial crises in middle income countries (MICs). These abrupt and disruptive events –involving acute problems in the exchange rate, the banking system, or the external debt—carried considerable costs in terms of economic recession and a worsening of poverty conditions. More recently, a number of countries have taken advantage of benign world economic conditions to build up defenses against the recurrence of crises –mainly stronger reserves and fiscal positions—but these defenses have yet to be tested in the downside of the cycle, let alone in a situation where the existing global imbalances do not resolve themselves harmoniously. The possibility of further crises can not be ruled out.

In the existing architecture of the international financial system, the international financial institutions –including the Bank—are expected to join in providing assistance, especially financial, to countries affected by crises. This is particularly the case when the crisis country is of systemic relevance and contagion to other MICs is feared. In fact, the Bank has been called to provide financial assistance in the great majority of recent crises. This report attempts to assess this assistance on the basis of the experience in the crises of Thailand (1997), the Russian Federation (1998) and Brazil (1999).

In all three cases, the Bank was insufficiently familiar with the macroeconomic situation prior to the crisis. This was most marked in the case of Thailand, where the Bank’s minimal involvement in the country before the crisis had been mostly focused on infrastructure projects. In Brazil and Russia there had been a shift towards adjustment lending and sectoral work a few years earlier, but which by the time of the crisis had not yet yielded adequate knowledge about ongoing macroeconomic developments.

Crisis cannot be predicted accurately, but it is possible to identify vulnerabilities that may lead to crises. Prominent among these are a country’s dependence on international capital markets for its financing (and the associated risk of a reversal of these capital flows) and weaknesses in the financial system, usually the result of identifiable failings in prudential regulation or banking supervision. **Vulnerabilities of this type were present in all three cases studied, but they were not highlighted in Board documents issued prior to the crisis.** Inadequate knowledge was only part of the explanation for this omission, but there was also the apparent lack of a system whereby candid assessments can be conveyed in a confidential manner.

Inadequate knowledge about the macroeconomic situation prevented a meaningful participation by the Bank in the early discussions coordinated by the IMF on measures to stave off or respond to the crisis. This resulted in a few instances where the Bank acquiesced to measures that were subsequently judged to run counter the objectives of the assistance the Bank was providing. The Bank gained in influence only in later stages, when countries moved on to the specifics of restarting the economy and correcting the structural deficiencies that had contributed to the crisis.

The insufficient attention to ongoing developments had as a corollary that the Bank was not prepared with contingent plans for the event of a crisis. Once the crises broke, the

Bank was quick in providing the financial assistance agreed with other partners in the rescue effort. However—other than in the case of Russia, where an adjustment loan was already in preparation—the lack of prior analytical work that would have identified structural weaknesses and needed reforms implied that the initial assistance had to be directed to the support of initiatives already adopted by the governments or local agencies, and in whose design the Bank may have had little influence. This blurred to some extent the difference between adjustment lending and plain balance of payments support and caused also difficulties in the justification of the relevance and scope of some of these loans, which subsequently affected adversely the rating of these loans' outcome.

Indeed, the evaluation of the 13 loans granted in relation to these three crisis cases indicated that only 9 (69 percent) of them had a satisfactory outcome. This is significantly below Bank-wide averages. The four loans deemed unsatisfactory included that for Russia—where reforms were insufficiently implemented—and three adjustment loans for the reform of Thailand's financial system—where the Bank's role in the closing of distressed intermediaries was deemed unsatisfactory. In general, overly ambitious objectives given to these loans in order to justify their large size, and an overestimation of the governments' implementation capability or commitment to reform were the most prominent causes for the shortfall in performance.

Deficiencies in crisis preparedness were particularly evident in the area of poverty.

Crises pose a major threat to the more vulnerable segments of society, both because of the recession and rising unemployment that accompany them, and the curtailment of governmental social programs entailed by the fiscal adjustment required in their aftermath. In none of the three cases in this study did the Bank have contingency plans that would have allowed the rapid deployment of measures to strengthen the social safety net. In the case of Russia, where the impact on poverty was the largest, the Bank had proven unable before the crisis to interest the Government in setting up formal safety net mechanisms. Local assistance arrangements, but mainly the rapid rebound of economic activity after the crisis prevented a social crisis of major proportions. In Brazil and Thailand the Bank effectively supported existing programs that served as safety net. However, as the Bank had not been involved in the design of these programs, it was not perceived as being active in the area of poverty. A client survey, which otherwise indicated favorable views on the Bank's effectiveness during crises, revealed high levels of dissatisfaction with the Bank's role in protecting the poor.

The Bank took advantage of the window of opportunity created by the crises to promote structural reforms, but the record in regard to these efforts is mixed. Reforms made a lasting contribution mainly in those areas where they coincided fully with the interest of the governments. Ownership proved to be crucial once the urgency of the crisis waned. Thus, the assistance provided in the area of social protection left little in terms of lasting reform, given the circumstances described in the preceding paragraph. On the other hand, the other crisis loans, which focused on the public and financial sectors, by and large helped secure improvements that contributed to the permanence of the fiscal adjustment and to the strengthening of the financial sector in the three economies (even when considering that these loans included the four loans that received less than satisfactory ratings).

The flurry of activity during the crisis period did not translate into a long-term lending engagement. Once the crisis was over, the countries' demand for Bank loans declined abruptly (with the possible exception of Brazil). However, subsequent evaluations found that the Bank's influence in all cases had increased from what it was before the crisis. The heightened profile the Bank acquired through its assistance during the crisis increased the Bank's relevance to these countries as a source of knowledge.

There is also evidence that the policy and institutional environment in the crisis countries strengthened at a faster rate than in the average of all countries where Country Policy and Institutional Assessments (CPIAs) are made. In the three cases studied, the CPIA index showed gains in the years after the crisis that were significantly larger than those made contemporaneously by the rest of the countries. The need to address weaknesses that had led to the crisis appears to account for this stronger performance. Bank assistance played a part in this process, although precise attribution is not possible.

The division of responsibilities and coordination with other IFIs, particularly the IMF, showed problems in some instances, particularly in the case of Thailand. Eventually these discrepancies were resolved, but not before a period of conflicting views and confusion had complicated the assistance effort. In general, and reflecting the broad mandates of the institutions, the IMF took the lead in coordinating the assistance in the early stages of the crises and in discussing with the governments the measures to restore order to markets, stem the run on the currency and/or the banks, and reestablish confidence. The Bank came into its own in latter stages, when countries moved to the specifics of restarting the economy and addressing structural weaknesses.

There is no univocal overall assessment of the Bank's assistance to crisis MICs. The countries eventually did emerge from the crisis, and did so with important structural changes that increased their resilience to further shocks. It is not possible, however, to disentangle the extent to which the recovery was due to the assistance from the IFIs or to country-specific factors. The Bank did contribute to the liquidity assistance required at times of crisis and, beyond that, it clearly was instrumental in advancing relevant reforms, but it remains open to question whether the advances made were commensurate with the large, mostly unconditional, resources that were involved in crisis support.

This evaluation suggests a few areas where improvements could be made to enhance the effectiveness of the Bank's assistance in crisis cases:

- While it is not possible to devote resources to maintain general macroeconomic surveillance in every MIC in which the Bank is involved, regular monitoring should be established for a selected small group of MICs, including those systemically relevant countries that are exposed to capital markets or where significant vulnerabilities have been detected through the FSAP. This task should be pursued in a regular and structured manner, regardless of the strength of a particular economic situation or the degree of the Bank's involvement in the country. This should be complemented by the establishment of a formal mechanism of discussion with the respective counterparts at the IMF, periodically to exchange views on the situation and prospects of the vulnerable countries.

IEG Evaluation of Bank Support to MICs

- The response of the Bank to crises would be enhanced if advance work were to be done on the preparation of those policies and reforms that may become feasible once the crisis has happened. The preparation of this “reserve portfolio” could speed up the design of adjustment loans in the aftermath of a crisis.
- Particular attention in this regard should be given to social protection, given the sharply adverse effect of crises on poverty conditions. Advance work should be done in countries at risk to prepare contingent social protection measures (a safety net) to be deployed at the time of need.
- Crises are not frequent enough to justify setting up a dedicated unit to deal with them. Moreover, the resolution of crises may require quite diverse types of expertise, depending on the circumstances. However, such expertise exists in the Bank and it should be possible to identify staff that could help in the event of a crisis and make the institutional arrangements that would allow their quick deployment when needed.
- Communication channels in the Bank should be reexamined with a view to allowing the candid exchange of information with Management and the Board, with due regard to effects on country authorities or the markets.
- Crises are chaotic events, and in their immediate aftermath there are bound to be disagreements and problems of coordination among the IFIs involved in the assistance effort. These problems should be minimized. A more continuous dialogue between the institutions in the run up to the crisis could help reduce misunderstandings. Once the crisis has erupted, efforts should be made at the outset to coordinate activities and define areas of responsibility.

1. INTRODUCTION

CONTEXT

1. There is no established view on what constitutes a financial crisis. Different authors, analyzing different cases, focus on different factors among those that characterize the abrupt negative disruption of an economy that is labeled a crisis. In general, the events that are referred as financial crises are grouped under three broad headings: a *currency crisis* –marked by a sharp loss of foreign exchange reserves that forces the abandonment of a currency peg; a *banking crisis* –when significant parts of the banking system are either illiquid or insolvent; and a *debt crisis* – an inability to service the debt on time.¹ These crises seldom come in isolation, with one type of disturbance likely to trigger one or both of the other, e.g., a currency crisis may result in a banking crisis –if there is a large currency mismatch in the bank’s balance sheet—or vice versa, a run on the banks may spill over into a run on the currency, and in turn both could trigger a debt crisis if they affect the debtors’ ability to pay or they reduce the inflow of the funds needed to roll over maturing obligations.

2. This study has selected three countries for case study that well illustrate the range of possibilities: Brazil, which had a currency crisis in early 1999 that did not spill over into banking or debt crises; Thailand, where the 1997 currency crisis triggered a banking crisis, but the Government managed to continue honoring its debt; and Russia (August 1998), where all three crises were present. There can hardly be a question that, regardless of the definition of crisis one may wish to adopt, each of these countries experienced out-of-the ordinary turbulence that required a reaction from the Bank beyond that made in normal circumstances.

3. The lack of consensus as to the definition of crisis was also acknowledged in the 2005 OED evaluation of the Bank’s role in countries experiencing a crisis in their financial system.² In that evaluation, the focus on financial sector reform prompted a definition in terms of “countries that experienced both a banking crisis and a macroeconomic crisis, either simultaneously or in quick succession.” With this definition the study identified 15 crisis countries over the 1993-2003 period, although it excluded one of the cases underlying the present paper, Brazil. (Box 1).

CRISES—CAUSES AND CONSEQUENCES

4. Crises also vary with regard to their causes or their consequences. In a stylized view of emerging market economies –the group of middle income countries (MICs) that enjoy significant access to international capital markets—the trigger of a crisis is usually the sudden stop of the inflow of capital (or the threat of it), which causes pressure on the exchange rate, distress in the local financial and corporate sectors, and roll over problems for the external debt.³ Often this occurs in a context of a fixed, or heavily managed, exchange rate policy, whose breakdown precipitates abrupt changes in balance sheets and

¹ See Ishihara (2005) for a discussion of conceptual and operational definitions of crises.

² OED (2005) and its background paper, Long (2003)..

³ Calvo (1998).

disruptions of expectations. The more removed, or underlying, cause, still in this stylized view, is in most cases a weak and unsustainable position of the public finances.

5. With regard to consequences, there is no doubt that crises carry high short run costs. They result in major disruption of economic activity –likely a period of negative growth—in corporate distress and in increased unemployment, with significant adverse impact on poverty and social indicators. In the three countries under review there was a noticeable effect of the crisis on growth –Brazil virtually stagnated in 1998-99, Russia’s GDP contracted by more than 5 percent in 1998, while Thailand’s GDP fell by a cumulative 12 percent in 1997-98. (Figure 1). Unemployment in each of the three countries rose by about 2 percentage points during the crisis years. Falling output and rising unemployment had devastating effects on poverty, particularly in Russia given her still fragile social situation at the time of the crisis. About 25 million people were thrown into poverty in Russia (World Bank 2005), while in each Brazil and Thailand about 3 million people dropped below the poverty line in the immediate aftermath of the crisis.⁴

Box 1: Crisis lending in OED Review of Bank Assistance for Financial Sector Reform.

Chapter 7 of the OED’s evaluation of Bank Assistance for Financial Sector reform (OED 2005) casts a wider net in covering similar ground than the present study. It analyzes 37 operations involving crisis loans with financial sector components in 14 countries over the period 1993-2003. As such, it includes two of the cases analyzed here (Russia and Thailand), but it excludes Brazil, which did not have a banking crisis. The main findings and recommendations of this study are as follows:

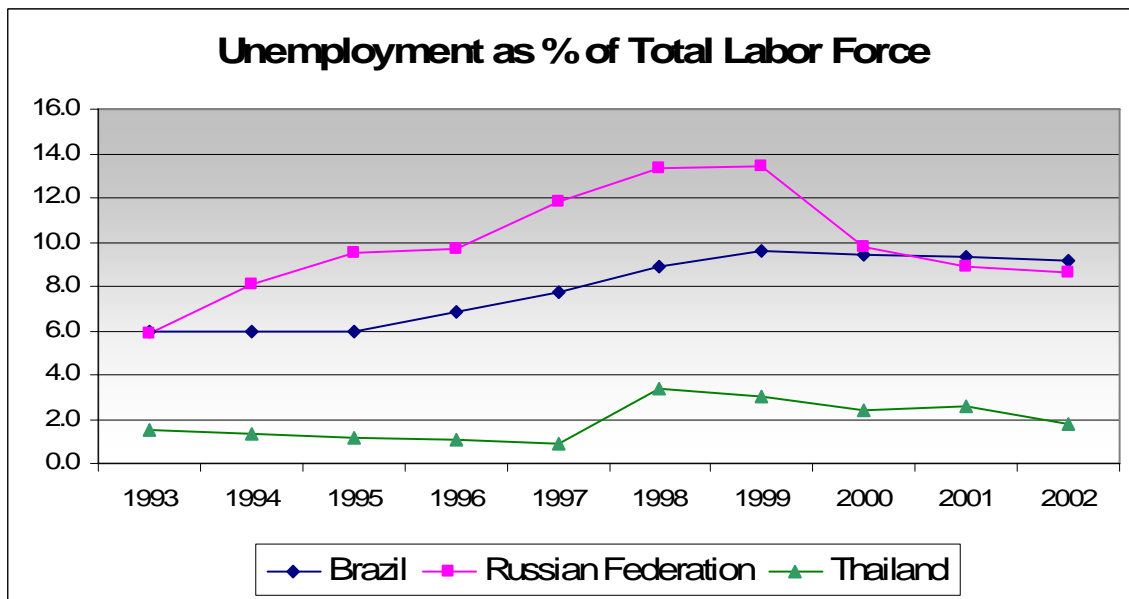
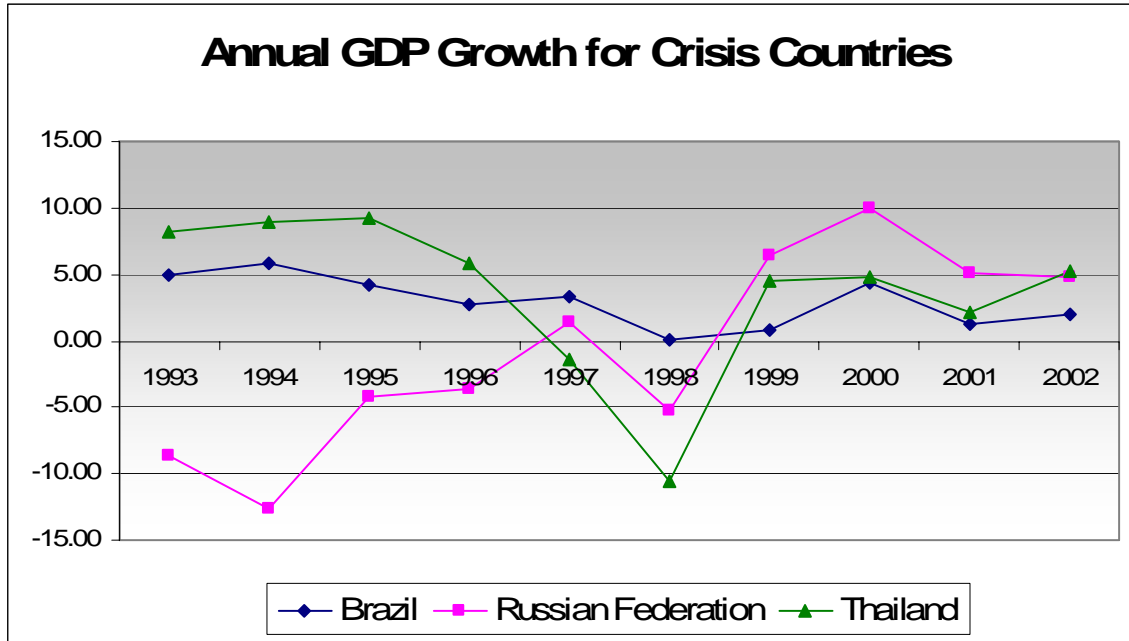
- Although the Bank cannot predict crises, it can do a more systematic job of assessing vulnerability to crises. More candor is needed when discussing risks in documents.
- Pressure on the Bank to lend in crisis situations is likely to continue. The Bank should be clear that in first instance the objective of such lending is to provide liquidity and restore market confidence. The objectives of emergency loans should be realistically scaled to what the governments can do under the circumstances, regardless of the size of the loans.
- Coordination with IMF and other IFIs needs improvement. The division of responsibilities among the institutions should be specified at the outset of a crisis. The Bank should appoint a top manager to be responsible for coordinating the Bank’s response to crises.

6. However, whether crises inflict lasting damage, i.e., affect a country’s long term growth potential, can not be unambiguously determined. A crisis may not necessarily represent a drop off the long-term path, but rather a move towards it if it comes at the end of a period of unsustainably high growth and just signals a return to rates more in agreement with the country’s fundamentals. Moreover, crises can usher in structural reforms that allow a country to move to a higher path of long term growth. In many

⁴ In relative terms the fraction of the total population in poverty increased from 24.1 percent to 41.5 percent in Russia, from 11.4 percent to 16 percent in Thailand, and from 32.7 percent to 34 percent in Brazil.

cases, crises have brought home the need to address their root causes, leading to the removal of structural weaknesses that had also been hindering growth.⁵

Figure 1. Growth and Employment in Crisis Countries



7. Financial crises may occur in any country, but the crises that have attracted most attention in recent years are those experienced by emerging market MICs, given both their relative size and their systemic relevance in view of contagion. After the series of crises that spread during 1997-2001—of which our three case studies are part—many

⁵ IMF (2005) analyzes the evidence on the effects of currency crises on output.

emerging market economies have taken advantage of benign world economic conditions to build up defenses—mostly larger reserves and stronger fiscal/debt positions—to prevent the recurrence of crises. These enhanced defenses, however, have yet to be tested in the downswing of the cycle, let alone in a situation where the present global imbalances fail to be resolved in a harmonious way. Financial crises are likely to recur, not the least because “...volatility and contagion cannot be banished, for asset prices inevitably move sharply, and there are significant correlations among the price of assets, particularly in related industries.” (Fischer, 1999). Moreover, even though in many countries, but by no means in all, the threat of crises developing through the capital account has somewhat receded, the globalization forces that have fueled the recent expansion have also increased these countries’ vulnerability to crises developing through the current account, i.e., it has exposed them to a sudden drop in the demand for their products due to recession in major industrial countries or a rise in protectionism.

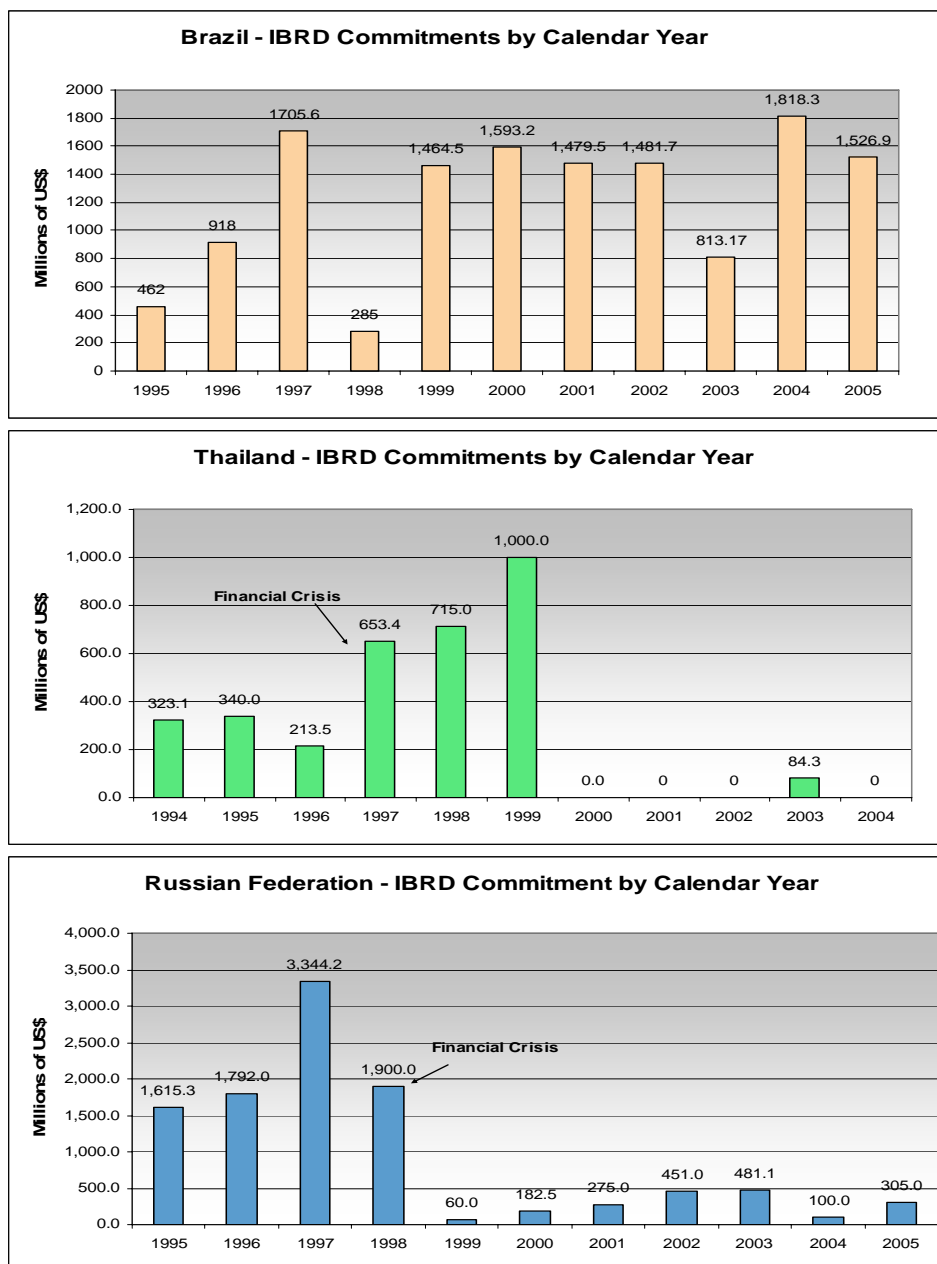
CRISIS AND THE BANK

8. For the Bank, the ability of MICs to access capital markets gives rise to two sets of issues. On the one hand, as was seen in all three case studies, the availability of commercially-determined unconditional financing leads countries to lower their recourse to the Bank, which sees its lending possibilities and consequently its involvement in the country reduced. On the other hand, MICs’ reliance on private financing makes them vulnerable to sudden reversals in financing flows—often for reasons not necessarily related to the country’s situation or policies—and cause them suddenly to request the help of the international community, and eventually of the Bank. It appears that, even when countries have moved their borrowing to the private sector, the Bank is considered to remain among the sources of financing that can be activated in case of difficulties. By the same logic, once countries emerge from a crisis and are able to get back to the market, they tend again to reduce their involvement with the Bank.

9. This general observation is by and large borne out by the three case studies, although it is partly obscured by particular circumstances in each country. In Brazil, the general tendency of Bank commitments to decline as a proportion of the country’s total borrowing was only briefly interrupted in 1999-2000 by the commitment of structural loans associated with the crisis. Russia clearly dispensed with Bank loans after the crisis was over by 1999, but the picture in the years before is blurred by the sharp rise in structural lending that took place in 1995-97 to support the government’s stabilization and reform program.⁶ Thailand is the one that most clearly conforms to the expected pattern: commitments were small before the crisis and virtually collapsed after it. All in all for the three countries, cumulative lending in the three years after the years of crisis was 56 percent below that in the three years prior to the crisis, and 63 percent below the assistance granted during the crisis. (Figure 2).

⁶ The Bank had started operating in Russia only after 1991 and the Bank’s work up to 1995 centered on much needed technical assistance and a number of hastily designed projects that remained largely undisbursed. After 1995 there was a shift towards adjustment operations, but with this late start, by the time of the crisis, the Bank’s knowledge base and policy dialogue with the authorities were still not fully developed.

Figure 2. Loan Commitments to Crisis Countries



VULNERABILITY TO CRISES

10. Crises can not be predicted accurately. There are many structural or policy weaknesses that may result in a crisis, but these weaknesses are neither a necessary nor sufficient condition for a crisis to materialize. Two countries may exhibit the same constellation of weaknesses, yet a crisis may hit one but not the other, or the events that lead to the crisis may move at quite different speeds in either country. This calls for vigilance and continuous study of the conditions and developments in countries susceptible to crises. Even if a crisis can not be predicted with exactitude, the conditions that may lead to one should be identified and watched. “Surveillance should....be evaluated not in terms of its ability to predict a crisis, but rather in terms of effectiveness

in identifying the vulnerabilities that could lead to a crisis.”(IMF, 2003, page 25). Prominent among these vulnerabilities is a country’s involvement with capital markets. While not ignoring that financial crises may occur for purely local reasons, the sensitivity of capital flows to factors outside the control of the recipient country, constitutes a factor of vulnerability that should not be ignored, no matter how well managed and stable the economy may appear.

11. Weak financial systems, usually the result of identifiable failings in prudential regulation or bank supervision, are another major source of vulnerability. The work on financial sector assessment (FSAP) undertaken jointly by the Bank and the IMF can help in identifying these failings and thus help limit this vulnerability (Box 2), but there still will be local factors or specific shocks that in the end will be key in triggering the crisis. OED (2005) points out that “All of the countries that had financial crises.....had systemically weak financial systems, but not all countries with weak financial systems have had crises...” and concludes that “....it would be unrealistic to expect the Bank, or any other institution, no matter how well-informed, to predict timing of crises. It is reasonable, however, to expect the Bank to assess the vulnerability of its clients to crisis and therefore to be prepared to respond quickly once a crisis hits.”

Box 2. The FSAP and vulnerability to crises.

The Financial Sector Assessment Program (FSAP) was established in 1999 as a joint undertaking of the Bank and the IMF to provide diagnoses of the financial sectors of key countries that would, *inter alia*, facilitate the early detection of financial sector vulnerabilities. One of its objectives is: “...the identification and resolution of financial sector vulnerabilities and their macroeconomic stability implications, which would then lead to a reduction in the likelihood of crisis and improved global financial stability...” (IEG 2006b, page 1). Thus far, FSAPs have been conducted with a sizable number of MICs; but, as participation is voluntary, not with all that are systemically important. The FSAP has received largely positive evaluations from both the IEG at the Bank and the IEO at the Fund. The IEG nevertheless points out “...the program is still too new to have measurable effects on ultimate outcomes (such as reduction of vulnerabilities and improved financial sector development).” (page 25); while the IEO is concerned about the necessarily sporadic nature of the exercise and its lack of integration with the surveillance process: “...financial stability assessments have not yet been fully “mainstreamed” as a regular part of IMF surveillance....” and “...incentives for participation (are not) sufficient to ensure continuing coverage of the bulk of countries where strong financial sector surveillance is most needed.” (IMF 2006, paragraph 56).

12. The studies underlying this report indicate that all three countries were clearly vulnerable in regard to both their exposure to international capital flows and the fragility of their banking system. The countries were heavy borrowers in private markets and although their fiscal position gave some assurance about the long-term sustainability of their debt position, it did not ensure them against roll-over risk. At the same time, they exhibited serious deficiencies in their banking system, related mainly to currency mismatch and the quality of the bank’s portfolio. These difficulties and vulnerabilities were not highlighted in Board documents issued before the respective crises. To the extent that staff was aware of them, it appears that fear of alarming the markets or the desire not to antagonize country authorities called for toning down or ignoring the vulnerabilities.

2. THE CALL ON THE BANK

13. The resolution of financial crises in MICs frequently involves the assistance of the international community, including that of the Bank. OED (2005) found that in 14 out of the 15 countries identified as experiencing a crisis, the Bank's response included a financial input. This was also the case in the three countries underlying the present study, which requested sizable Bank support either to stave off the crisis or to alleviate its immediate consequences. In these three cases, the IMF took the lead either in coordinating a donors' meeting after the crisis in Thailand or in putting together financial packages to support the exchange rates of Brazil and Russia. Given the size of these countries and their systemic relevance, the assistance effort was joined, indeed actively promoted, by the main industrial countries, which not only participated with their own funds, but ensured the sharing of the burden across the pertinent international financial institutions.

14. The expectation that the Bank would participate in the resolution of financial crises overrode misgivings Bank staff or management may have harbored in some of these cases. Indeed, participant's comments report of doubts about joining the early efforts in Thailand or about the wisdom of trying to defend the exchange rate in Russia.⁷ But the reality was, and still is, that in the existing architecture of the international financial system the international financial institutions—including the Bank, the IMF, and the regional development banks—are expected to provide financial assistance to countries in crisis, particularly if the country is of systemic relevance and there is a risk of contagion. Long (2003) points out: "...until the international community decides on a different approach to "national bankruptcy and the international financial architecture" pressure will remain on the Bank to participate in emergency loans." (Long 2003, page 12).⁸

15. Crisis lending can have a significant impact on Bank activities. Given the size of the assistance required and the fact that, because of contagion, crises may affect several countries at the same time, crisis assistance can during certain periods amount to a substantial part of total Bank commitments. For instance, OED (2005) reports that adjustment loans made to 14 countries experiencing banking crises in the period 1995-2003 amounted to US\$21.4 billion, or 16 percent of total Bank commitments. Crisis support to just the three countries underlying the present paper amounted to US\$6 ½ billion, or almost 10 percent of total commitments in 1997-2001 (Table 1).

⁷ In the case of Brazil, both the Bank and the IMF shared concerns about the sustainability of the exchange rate regime, but the strong stance of the government in this regard, supported by major shareholders in the Bank and the Fund, led the institutions to go along with the, ultimately futile, attempt to defend the parity.

⁸ There are also questions about the overall appropriateness of the Bank's role as a provider of liquidity assistance. In a previous report, OED stated: "The Bank may want to deliberate further on its role as a development institution versus its role as a provider of emergency liquidity...." (Korea, OED Evaluation Summary, "Economic Reconstruction Loan," August 1999 as cited in Long (2003) page 12).

Table 1: Crisis Loans

Country	Loan Name	Loan Type	Commit. Amount ⁹	Date of Approval ¹⁰	Outcome Rating ¹¹	Bank Perf. rating
Brazil	Social Security Loan	S/SECAL	757.6	Jan. 1999 (0)	Satisfactory	Satisfactory
	Social Protection	S/SECAL	252.5	Jan. 1999 (0)	Highly Satisfactory	Highly Satisfactory
	Fiscal and Admin. Reform	S/SECAL	505.1	Mar. 2000 (14)	Satisfactory	Satisfactory
	Social Security II Loan	S/SECAL	505.1	Mar. 2000 (14)	Satisfactory	Satisfactory
	Programmatic Fiscal Reform Loan	SAL	757.6	Jan. 2001 (24)	Satisfactory	Satisfactory
Russian Fed.	Structural Adjustment Loan III	SAL	1500.0	Aug. 1998 (0)	Unsatisfactory	Satisfactory
Thailand	Financial Sector Implementation Assist.	TA	15.0	Sep. 1997 (2)	Satisfactory	Satisfactory
	Finance Companies Restructuring ¹²	SAL	350.0	Dec. 1997 (5)	Moderately Unsatisfactory	Unsatisfactory
	Economic Management Assistance Project	TA	15.0	Mar. 1998 (8)	Satisfactory	Satisfactory
	Social Investment Project	SAL	300.0	Jul. 1998 (12)	Moderately Satisfactory	Satisfactory
	Economic and Financial Adjustment Loan	EFAL	400.0	Jul. 1998 (12)	Moderately Unsatisfactory	Satisfactory
	Economic and Financial Adjustment Loan II	EFAL	600.0	Mar. 1999 (20)	Moderately Unsatisfactory	Satisfactory
	Public Sector Reform Loan	PSAL	400.0	Oct. 1999 (27)	Satisfactory	Satisfactory

⁹ In millions of US dollars.

¹⁰ In brackets, the number of months after the onset of the crisis.

¹¹ ICR ratings, unless otherwise noted

¹² Ratings from PPAR for this loan as well as EFAL I & II. The ICR review had given satisfactory ratings.

3. PREPAREDNESS OF THE BANK

16. Considering that emerging market MICs are prone to crisis and that, once a crisis is present, it is likely that the Bank will be called upon to provide financial and technical assistance, the question arises as to the degree to which the Bank had been prepared for the eventuality of such a crisis. In the three cases underlying this study, the Bank had in the years before the crisis devoted little attention to following up on overall macro-economic developments, let alone to preparing contingency plans for an eventual crisis. Lending and knowledge activities were for the most part focused on infrastructure, agriculture, and education to the detriment of economic and sector work. The CAE for Thailand (OED 2000) mentions that “the part of (the Bank’s) Thailand budget devoted to economic work was cut to the bones” in the 1994-97 period. This, and the fact that the Bank was a truly marginal source of financing for Thailand, accounting for 2 percent of the country’s total borrowing, resulted in the virtual total disregard of current macro-developments in the economy. The situation was somewhat better in Brazil and Russia, where in the years immediately preceding the crisis there had been a shift to structural lending (in 1995 in Brazil and 1996 in Russia), but this had not yet developed far enough to establish the required knowledge base. In most cases Bank staff was aware in a general way of impending difficulties, but there was no precise view on the extent of key vulnerabilities. As Long (2003) notes in the context of banking crises: “...while aware of the financial systems’ weaknesses in a qualitative sense, the Bank was less informed of their quantitative importance.” (Long, 2003, page 6).

17. In the existing division of responsibilities among the international financial institutions, surveillance, crisis prevention, and emergency liquidity assistance belong primarily to the IMF. Thus, closer contact with the Fund could have helped alert the Bank to impending changes in the Bank’s work on key MICs. But even in this context, exchange of information with the IMF was irregular and exercised to varying degrees across regions. (Not that this would have been of much help in the 1997 crisis in Southeast Asia, which caught everyone, including the IMF, by surprise.) Given the impact of crisis assistance on Bank activities and, more fundamentally, that often crises are symptomatic of more deep seated structural failings, whose correction clearly falls under the remit of the development banks, the possibility of crisis needs to enter in the planning of the Bank’s work on MICs.

18. It is not possible to devote resources to maintain general macroeconomic surveillance in every MIC in which the Bank is involved, nor does it behoove the Bank to do so. But Management may wish to retain an adequate brief in a selected small group of MICs –starting with those of more systemic relevance that have access to capital markets or where FSAP has detected significant vulnerabilities. This task should be pursued in a regular and structured manner, regardless of the strength of a particular economic situation or of the degree of the Bank’s involvement in the country. The Economic Monitor Series, now prepared by some country offices, is a step in this direction. This should be strengthened and complemented by the establishment of a formal mechanism of discussion with the respective counterparts at the IMF, periodically to exchange views

on the situation and prospects of the more vulnerable countries.¹³ The different perspective the Bank would bring to such discussions would contribute to the Fund's surveillance. In turn, better knowledge and understanding of the macroeconomic developments would not only enhance the Bank's preparedness in these cases but, if a crisis strikes, would strengthen the Bank's ability to participate in the discussions on how to deal with the crisis.

19. The response of the Bank to a crisis would be further enhanced if advance work were to be done on the preparation of policies and reforms that, even though they may be blocked in the period of low Bank influence before the crisis, may become feasible once the crisis has happened. This advance work, a kind of "reserve portfolio", would greatly speed up the preparation of adjustment loans in the aftermath of the crisis. These potential lines of activity, together with a candid assessment of risks, should be part of the CAS prepared for these countries –thereby also facilitating, or even voiding, the revision of the CAS that was required in most crisis cases.

20. On a different dimension of preparedness, there are personnel issues that on occasion have become a factor of delay. For instance, in the case of Thailand, considerable time passed before a team that could effectively deal with the crisis was assembled. There is no easy solution to this problem. Crises are not frequent enough to justify setting up a dedicated unit to deal with them.¹⁴ Besides, the type of expertise required can vary from case to case, e.g., depending on how the crisis evolves, there may be a need for experts on areas as diverse as bank resolution, corporate workouts, or debt restructuring, among others. However, such expertise exists in the Bank and it should be possible to identify in advance staff that could help in the event of a crisis and make the institutional arrangements that would allow their quick deployment when needed.

4. SPEED OF RESPONSE

21. Once a multilateral package of support is agreed, the Bank needs to move fast and with sizable amounts of quick-disbursing assistance. The Bank does not have a crisis liquidity assistance facility as such, and the task of providing balance of payments or budget support under crisis conditions has usually fallen on structural adjustment loans (SALs) –or special SALs that have shorter maturities and carry higher interest rates. SALs also become the instrument of choice as the Bank takes advantage of the opportunity provided by the crisis to move into reform areas from which it had previously been excluded by its reduced presence in the country, the authorities' lack of interest, or political obstacles to reform. However, a full fledged reform program to be supported by a SAL requires a preparation time that in most cases is not compatible with the urgency of a crisis. "... The first adjustment loan approved immediately after the crisis was often

¹³ Practice in this regard varied from region to region, but for instance it appears that the greater readiness of LAC to deal with crises in the region was in part due to its closer contact with the IMF's Western Hemisphere Department.

¹⁴ Such a central unit, the Special Financial Operations unit was created in 1998 to respond to the crisis in Asia. However, this unit, cutting across regions, could not fit in the organizational structure of the Bank and was disbanded in 2001.

made under emergency and difficult conditions, where speed was essential and the need for comprehensive understanding of the issues or government's capacity to address them, secondary." (OED 2005, page 39).

22. In the early stages of crises the Bank is often forced into an *ad hoc* response that "...may not benefit from prior diagnostic work on the sector or from a close dialogue with government on reforms." (OED 2005, page 36). In the case of Russia it was possible to rush out and augment a SAL that was already in preparation (and was based on the experience with two previous SALs), but the initial response in Brazil and Thailand needed to be limited to the support of activities and programs the respective governments had already in place. It is not easy to determine the extent to which the Bank had a hand in the original design of these programs. In the three countries, the Bank appeared to be quick off the gate with its initial assistance. In both Brazil and Russia, Board approval of the first crisis loans was virtually contemporaneous with the beginning of the crisis; although it needs to be borne in mind that these loans had been part of the package the international community had put together months earlier in the vain effort to prevent the crisis. In Thailand, the Bank approved a small TA loan within two months and the first substantive loan within 5 months of the onset of the crisis, which was not unduly slow considering the surprise element in the Thai crisis and the Bank's unfamiliarity with the situation.

23. If one considers all 13 crisis loans approved for the three countries, the average time elapsed between the initial concept document (PCD) and the date of Board approval was 4.2 months (2 months for the very first loans).¹⁵ Again, however, not much should be read into this finding as, on the one hand, it is not possible to pinpoint how much discussion and preparation could have occurred before the PCD was issued and, in those cases where the Bank supported existing government activities and programs, how much and for how long the Bank had been involved in their formulation. All in all, the review did not come across complaints over undue delays in the delivery of Bank assistance.

5. THE FOCUS ON POVERTY

24. Deficiencies in crisis preparedness were particularly evident in the area of poverty. Crises pose a major threat to the more vulnerable segments of society, both because of the recession and rising unemployment that usually accompany a crisis, and because of the curtailment of governmental social programs entailed by the fiscal adjustment that often is required in the aftermath of a crisis. In none of the three cases in this study did the Bank have contingency plans that would have allowed the rapid launching of programs to strengthen the social safety net. In the case of Russia, where the impact on poverty was the most dramatic, the Bank's work on social protection in the years before the crisis had been mainly focused on pension reform and the labor market consequences of the restructuring of state enterprises, but the Bank had proven unable to

¹⁵ This compares favorably with another category of lending where speed is of the essence: that of lending for disaster relief, where the average time elapsed between the event and Board approval amounted to 6.7 months (IEG 2006c, page 36).

interest the Government in setting up formal protection mechanisms that could serve as safety net. Staff involved in the country at the time report that despite the Bank's inaction in this regard, once the crisis hit its worst consequences on poverty were somewhat mitigated by local assistance arrangements—including the residual role of state enterprises in social protection—and the access of large segments of the population to basic food production. In the event moreover, and notwithstanding the sharply adverse initial impact, the consequences of the crisis on poverty proved to be short-lived. The rapid rebound of the economy, helped by the devaluation and rising oil prices, quickly reversed the deterioration in poverty indicators and by 2002 the fraction of the population in poverty had receded to 19.6 percent, below the pre-crisis level.

25. The Bank showed a better record in the other two cases. In Thailand, the government had taken the lead in alleviating the effects of the crisis on the poor and, albeit with a year's delay, the Bank responded to the authorities' concerns and approved a Social Investment loan that effectively supported the poverty alleviation programs that had been set up by the government itself or by local private organizations. In Brazil, it was the Bank the one that emphasized social protection and to this end moved rapidly in the aftermath of the crisis with a budget support loan that specifically protected 22 relevant programs from the budget cuts the government was making. Both these initiatives proved to be quite successful and were rated as satisfactory; however, it should be noted that they were aimed at buttressing existing programs, which had mostly been prepared with little or no involvement of the Bank.

26. Given the centrality of poverty alleviation in the Bank's work and the significantly adverse consequences that crises have in this regard, efforts should be made to strengthen the Bank's ability to protect vulnerable sectors in the event of a crisis. Again, advance work could be done in countries at risk to define and prepare contingent social protection measures to be deployed at the time of need (e.g., support for unemployed heads of households, food programs, school subsidies, etc.). Initiatives of this kind were eventually prepared in Brazil, where two social protection investment operations—to support the eradication of child labor and temporary work-fare programs for the poor—were prepared in early 1999 for rapid deployment in the event that the economic downturn were to prove more serious than forecast. The fast recovery from the crisis caused these programs not to be activated.

6. ACHIEVEMENT OF OBJECTIVES AND CONTRIBUTION OF THE BANK

27. Of the 13 loans given to these countries during the financial crises, 9 were considered satisfactory¹⁶ (69 percent). This percentage is considerably lower than the Bank average of 79 percent for all loans given during this period (or 76 percent for all adjustment loans¹⁷), but similar to that obtained by the 27 cases of completed crisis loans

¹⁶ Moderately satisfactory or higher

¹⁷ Excluding the loans to the three crisis countries.

reported in OED (2005).¹⁸ The four loans deemed unsatisfactory included that for Russia –which was rated unsatisfactory in view of the incomplete implementation of agreed reforms, that also led to its early cancellation— and the three adjustment loans for the reform of Thailand’s financial system –which were given a moderately unsatisfactory rating because of the Bank’s “misguided and unsatisfactory” role in the closure of finance companies.¹⁹ Commenting on the latter’s unsatisfactory ratings; OED (2005) indicates that these may be the consequence of overly ambitious objectives that were in turn the result of an over-estimation of the government’s commitment to reform and of “a need to assure the Bank’s Board that the measures being undertaken are sufficiently deep and broad to justify such a large loan”. (OED 2005, page 44). While this comment seems particularly pertinent to the first of the loans –the Finance Companies Restructuring Loan, rushed out just a few months after the crisis—it is far less of an explanation for the poor rating of the other two adjustment loans. By July 1998 and May 1999, respectively, the Bank should have had a better grasp on the government’s ability to deliver, and could have been more realistic regarding the scope of the objectives and the risks involved.

28. A client survey identified a significant level of satisfaction with the Bank’s assistance to countries dealing with financial crises. Over 70 percent of respondents expressed a favorable opinion (from moderately effective to highly effective) about the Bank’s assistance, both technical and financial. This result stands in sharp contrast with the clients’ perception of the Bank’s effectiveness in protecting the poor from the effects of the crisis. Only 37 percent of respondents thought the Bank effective in this regard (Table 2). The poor opinion about the effectiveness of the Bank’s efforts in the social protection area, efforts which the Bank itself rated as satisfactory, may be due to the poor visibility, or lack of identification with the Bank that these operations had. As mentioned above, the social protection loans in Brazil and Thailand were emergency operations aimed at supporting or preventing the curtailment of existing programs, which had originally been put in place without the Bank’s participation. As these programs were eventually not curtailed, this constituted a satisfactory outcome for the Bank. However, in the inability to establish the counterfactual of the extent to which these programs would have been cut in the absence of the Bank’s loans, it became difficult in the end to associate the Bank with social protection or to differentiate these loans from straight liquidity assistance (budget support) during a crisis.

Table 2. Client rating of the Bank’s assistance during crises

	Moderately effective	Effective	Highly effective	Total
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¹⁸ It should be noted that in both evaluations one is dealing with a small sample (13 or 27 observations). When each observation is worth some 8 percent (or respectively 4 percent) of the total, it suffices to change the rating of one loan, drastically to change the overall picture.

¹⁹ The Bank’s performance (as different from the loan’s outcome) in the case of the Russia loan was deemed satisfactory, mainly given the positive influence that the Bank’s dialogue with the authorities on this loan had on the design of the overall reform process. The financial sector loans for Thailand were fraught with controversy: initially an OED desk review had rated these loans as satisfactory, but this was subsequently modified in OED (2005).

IEG Evaluation of Bank Support to MICs

Technical assistance	38.3%	26.3%	5.6%	70.2%
Financial assistance	37.4%	25.5%	10.8%	73.7%
Protecting the poor	28.6%	6.1%	1.8%	36.5%

29. The Bank took advantage of the window of opportunity provided by the financial crises to push for structural reforms. Crises, by highlighting the structural weaknesses that caused them, focus the attention of governments on the need to address these weaknesses and open a window of opportunity to overcome political opposition to reforms. In some cases (e.g., Russia, Thailand) the crises also permitted the ascendancy of reformist groups within the government, which were keen to welcome the Bank's support for their reform agenda. Nevertheless, not too much should be made of this opportunity window. As in most areas of IFI assistance, strong ownership is the single most important factor in securing a satisfactory outcome, and the experience of the three case studies indicates that once the crisis passed, enthusiasm for those reforms that were not close to the heart of the authorities quickly waned.

30. The social protection loans in Brazil and Thailand (there was no poverty related crisis lending in Russia), relevant and opportune as they were, left little in terms of lasting reforms. These loans did not lead to significant institutional changes nor did they establish permanent programs to act as safety net in the event of future economic downturns. Once the crises were over, in both Brazil and Thailand the Bank reverted to its prior focus on core social protection areas such as education, health, and rural poverty.

31. Otherwise, the Bank's support for structural reform focused on the public sector and on the financial sector, and in these areas, the loans seem to have made a more permanent and sustainable contribution. Of the 13 crisis support loans approved for the three cases, 7 focused on the public sector, mainly on civil service reform, expenditure management and social security reform. As reforms in the public sector were the object of efforts by all IFIs and responded also to initiatives of the governments themselves, it is difficult to isolate the particular contribution of the Bank. Overall, however, these reforms (including the Bank's contribution) seem to have been by and large successful, securing improvements that contributed to the permanence of the fiscal adjustment in the three economies.²⁰

32. This study dealt with four loans aimed at the financial sector, all in Thailand –in addition, considerable TA was provided to Russia in the post-crisis for banking reform and there were two financial sector loans to Brazil (that formally were even part of the original package of crisis assistance). Assessment of the financial loans in Thailand has been influenced by the views held in regard to the fiscal stance adopted in the early stages of the crisis and to the policy on suspension and closure of failed finance companies. In both these areas, the IMF had recommended drastically stringent policies that in the view of many critics unnecessarily hindered the subsequent recovery. The Bank loans endorsed

²⁰ The exception may have been the two social security loans for Brazil, where pension reform met with considerable opposition from affected parties.

the Fund's policies and were thus tainted by this criticism. The issues involved remain controversial and, notwithstanding that, from a longer term perspective, Thailand emerged from the crisis with a by and large leaner and stronger financial system the PPAR (IEG, 2006a) for the three financial sector loans rated their outcome as moderately unsatisfactory.²¹

33. Finally, from a slightly different angle, there is some evidence that the policy and institutional environment of the countries affected by crises strengthened at a faster rate than that of other countries. Table 3 shows the results of the Bank's Country Policy and Institutional Assessments (CPIA) for the three countries under study in the three-year periods before and after the crisis and in the most recent available period (2003-05). In all three cases, the index shows an improvement in the three years after the crisis with respect to the situation at the time of the crisis and, from a longer perspective, that the situation in the most recent period is clearly stronger than in the period before the crisis. The average gain from the earliest to the latest period for these countries, 0.63 points, significantly exceeds the gain of 0.4 points made by all countries for which this assessment is made. This stronger than average performance likely reflects the crisis countries' response to the crisis and the effort to address its root causes. This is particularly noticeable among the components of the CPIA, where the cluster related to economic management (inflation, fiscal policy, etc.) shows the greatest improvement. Bank assistance –and that of other IFIs— played a part in this process, but again, precise attribution is not possible.

Table 3. CPIA ratings

	Brazil	Russia	Thailand	All countries
3 years before crisis	3.4	3.0	4.0	3.2
Crisis year	3.9	2.3	3.8	...
3 years after crisis	4.1	3.3	3.9	3.4
2003 - 2005	4.2	3.8	4.3	3.6

7. RELATIONS WITH THE IMF

34. Coordination between the Bank and other IFIs, especially the IMF, showed some instances of (quite visible) discrepancies, but which were by and large satisfactorily resolved. In Russia, the Bank had misgivings prior to the crisis about the sustainability of the exchange rate regime, but went along eventually with the strategy of supporting the ruble, given the Government's, the IMF's, and other stakeholders' strong sentiments about keeping in place the stabilization program launched in 1995. Bank staff working in Russia at the time indicated that in any case they had felt that further support for the program was justified on its own merits, particularly if thereby a crisis could be

²¹ The Financial Sector Implementation Assistance (TA) loan was still under implementation at the time the PPAR was prepared.

prevented. Coordination problems figured more prominently in the case of Thailand where an initial agreement to divide responsibilities on the reform of the financial sector between the Bank, the IMF and the ADB soon broke down given the overlap of the issues involved. There was a harmful period of conflicting views and confusion, before the issues could adequately be sorted out. Perhaps coordination worked best in Brazil. This may have been due, as staff pointed out, to the closer contact established over time between the region and the corresponding area department at the IMF and to the fact that the Government insisted on assuming the coordination of external assistance (OED 2004, page 13).

35. There are areas, such as the fiscal and financial areas, where there is considerable overlap between the Bank and the IMF, and where lack of coordination, particularly during the rush of the early stages of a crisis, can lead to disagreements or duplication of work between the two institutions. There have been efforts, particularly since 1999, better to delineate the areas of responsibility of each institution with, in principle, the IMF taking care of the shorter end of the events surrounding a crisis, including the coordination of the rescue effort and the immediate actions needed to stem the crisis, while the Bank is to focus on the medium-term reforms that are required. This general difference in emphasis was broadly reflected in the three case studies. In the early stages of the crises, either while efforts were being made to stave it off or in their immediate aftermath, the IMF assumed the coordination of the assistance effort and took the lead in the discussion with the authorities on the measures to restore order to the markets, stem the run on the currency and/or the banks, and reestablish confidence. At this stage, both in Russia as well as in Thailand, but much less so in Brazil, the Bank had, in the words of a staff member, “to struggle to get a seat at the table.” This reflected in part the inherent difference in the roles of both institutions, but also the Bank’s reduced involvement in structural issues in these countries in the years before the crisis and a lack of adequate knowledge about ongoing macroeconomic developments. The Bank gained in influence in the latter stages, as the countries moved on to the specifics of restarting the economy and correcting the structural deficiencies that had led to the crisis.

36. Notwithstanding the recent efforts, the exact boundary between the roles of the Bank and the Fund is likely always to remain unclear. Some degree of friction is perhaps inevitable, particularly in crisis situations, but disagreements among IFIs can adversely affect confidence and the discussions with the authorities, and need therefore to be minimized. A more continuous dialogue between the institutions, involving an effective exchange of information on country developments and on each institution’s interpretation of them, even if it were not to result in a common policy approach, could go a long way to eliminate misunderstandings in the run up to a crisis. Once a crisis has erupted, efforts should be made to coordinate as best as possible the activities of each institution and, in areas of joint responsibility –such as the resolution of a banking crisis—to agree at the outset on strategy and modalities of operation.

8. AFTER THE CRISIS

37. Crises have also affected the nature of the Bank’s work either by rendering existing projects obsolete, opening new areas of reform, or changing the mix of project/

structural lending and knowledge activities. In all three cases under review, the crises were followed by a restructuring of the existing loan portfolio. However, the reasons for the restructurings varied from case to case. In Brazil, the fiscal restraint required to put the economy on a sustainable basis imposed the need to curtail expenditures, including on investment, and led the Bank to defer major infrastructure projects until the country's domestic funding availability was greater, and to contemplate some early closing and restructuring of loans. In Russia, where the Bank was saddled with a portfolio of slow disbursing, ill performing loans—which had been rushed out without adequate preparation in the early days of the Bank's involvement with the country—the crisis served as an excuse for a major clean up of this portfolio.²² The restructuring of the portfolio in the case of Thailand obeyed to a slightly different rationale, namely that most of the projects in the portfolio had been designed for a fast growing economy, with a rising demand for infrastructure and social services, and did not fit anymore in the recession that followed the crisis.

38. Contrary to the expectations of a long-term engagement spurred by the flurry of activity during the crisis period, the countries' appetite for Bank loans declined once the crisis was over and they regained access to capital markets. This notwithstanding, subsequent evaluations in all three cases found that the Bank's influence had increased from what it was before the crisis. In Brazil: "...This evaluation concluded that the Bank can still play a relevant role in a middle income country such as Brazil. The Bank is most relevant as a source of knowledge and technical assistance. It is less relevant as a source of finance but not irrelevant, particularly for poorer regions and in a scenario of volatile capital markets." (OED 2004, page 36). In Russia: "...In the three and a half years since the 1998 crisis...the relevance and design of Bank assistance have improved significantly ...Most importantly, the dialogue between the Bank and senior Russian policy makers on structural reform, which intensified since late 1998, played a major role in helping the current government formulate its program of market-oriented reforms, good governance, and social responsibility. These are solid achievements." (OED 2002, page 28). Whereas in Thailand: "...As Thailand has emerged from the crisis, the Bank's mode of engagement has evolved....No new Bank projects have been delivered since...October 1999... At the same time, the Bank's role has evolved to place greater emphasis on supporting Thailand with analytical and advisory services...This shift toward analytical services and policy dialogue represents a major shift in the Bank's role since before the crisis." (CAS for Thailand, January 2003, Report No. 25077-TH, page 14).

39. In the opinion of participating staff, this increased relevance of the Bank's knowledge activities was in part due to the heightened profile the Bank acquired through its assistance during the crisis and also to the new reform areas opened as a result of it. While lending activity declined in the post crisis, the Bank's relevance as a source of knowledge and TA increased. After the crisis, Russia received substantial TA for the restructuring of its financial system; in Brazil the process was accompanied by a move since 2001 to programmatic lending; whereas Thailand entered in 2000 into a Country Development Partnership with the Bank.

²² Besides, the Government's increased ownership of the reform program after 1999 allowed for the cancellation of projects without appearing as if the Bank was abandoning the country.

9. CONCLUSION

40. It is not possible to arrive to a univocal overall assessment of the Bank's assistance to crisis MICs. Eventually all these countries emerged from the crisis, and did so with important structural changes that increased their resilience to further shocks. However, the extent to which the recovery from the crises was due to the assistance from the IFIs, or it reflected specific country factors or the countries' economic cycle, can not easily be disentangled. Similarly, the counterfactual of what would have happened without the Bank's assistance can not be measured. It is clear nonetheless that, beyond the financial resources it provided, the Bank was instrumental in advancing relevant reforms. By and large, after the crises the countries could show significant improvements in public sector management and stronger banking systems. It remains open to question whether these advances were commensurate with the large, mostly unconditional, resources that were involved in crisis support, and it may well be that in retrospect these were cases of too much lending for too little reform. Also, in two of the three cases the Bank made a positive difference in respect to moderating the crises' adverse consequences for the poor, but this was done mostly through supporting existing programs and initiatives of the government, masking thereby the Bank's lack of preparedness for this eventuality.

APPENDIX 1: CASE STUDIES

A. BRAZIL—CASE STUDY

1. For Brazil, a successful stabilization plan implemented by the Government in 1994 put an end to a period of economic stagnation and hyperinflation that had extended for more than a decade. Inflation dropped to low single digits, from an annual rate in excess of 2500 percent in 1993, at the same time that economic activity strengthened, with real GDP growing at an annual rate of more than 4 percent in 1994-97. This robust growth performance allowed the attainment of low rates of unemployment and a significant improvement in living standards, which, together with the strong positive impact the elimination of inflation had on income distribution, resulted in a major reduction in poverty.
2. The success in stabilizing the economy paved the way for notable progress on structural reforms, including the liberalization of trade and capital flows, a major privatization program, and a strengthening of the banking system. The adjustment of the public finances that accompanied the stabilization effort fell short, however, of what was required adequately to support it, and the stabilization achievements were gradually undermined by an appreciation of the real exchange rate, a widening current account deficit, and a dangerous increase in the public and external debt. The deterioration in the international environment that followed the Asia crisis in the latter part of 1997 put pressure on the *real*. This was handled by a decisive tightening of economic policies –and the resulting dampening of the growth performance. A year later, however, this policy stance proved insufficient to contain the pressures arising from the Russia crisis in August 1998 and, after a fruitless attempt at a further tightening of policies, the *real* was allowed to float in January 1999.
3. Before the exchange rate crisis, Brazil's recourse to Bank assistance had been declining. The unsettled conditions up to 1994 had resulted in a significant drop in Bank commitments and disbursements, reflecting also the deterioration of the portfolio of existing loans in a situation of sharp macroeconomic imbalances and political upheaval. The more stable conditions after 1994 and the new government's willingness to engage in the elaboration of the assistance strategy allowed for a recovery of lending in nominal terms, albeit without changing the declining trend of the Bank's share in total financing flows to Brazil. The nature of the Bank's involvement in Brazil also changed over time. The 1993 assistance strategy made alleviation of poverty the central objective of Bank assistance to Brazil, with the increased emphasis on social sectors coming at the expense mainly of agriculture and energy projects. In the late 1990s, while maintaining the centrality of poverty alleviation, the thrust of the assistance shifted again, as the crisis brought out the need for adjustment lending, and the Bank availed itself of the opportunity to support broad-based structural reforms.
4. The crisis did not come as a surprise to the international community. By mid-1998 the initial satisfaction with the authorities' response to the Asia crisis was giving way to growing concerns over the Government's inability fully to deliver the promised fiscal adjustment. There was an internal debate at the Bank on whether to maintain Brazil in the

CAS's base case, given the weaker than expected fiscal outturn in early 1998 (offset in the end by the stronger performance on structural policies) and the country team was instructed to heighten its vigilance over fiscal matters.²³ There was also unease over the size of the external current account deficit, the vulnerability of its financing to shifts in market confidence, and particularly over the sustainability of the crawling peg exchange rate regime.

5. As pressures on the external position grew stronger after the Russia crisis, a major operation was mounted, at the request of the authorities, to support the exchange rate regime and allow time for the required fiscal adjustment and structural reforms to be implemented. A large financing package, with a headline amount of US\$42 billion, was assembled and announced in November 1998. Given the multilateral nature of this package—in which even major shareholders participated through a loan arranged through the BIS—there was no question that the development banks had to participate too, and the Bank and the IDB each committed US\$4.5 billion to the package. The decision to support the crawling peg, notwithstanding the misgivings of staff at both the Bank and the IMF was necessitated by the authorities' strong opposition to contemplate changing the exchange rate arrangement, mainly for fear of reigniting inflationary expectations. However, this central element of the program was soon to fall by the wayside, as less than two months after the support package was announced strong market pressure forced the exchange rate crisis that resulted in the flotation of the *real*. It should be noted that the risk of this happening was not mentioned in the paper presenting the support program to the Executive Board.²⁴

6. The Bank's participation in the international financing package prompted the need to revise the 1997 assistance strategy, which had not foreseen any substantial amount of adjustment lending. Poverty alleviation continued to be the overarching objective of the revised strategy but, given Brazil's recent history, it was recognized that growth and poverty reduction depended crucially on the maintenance of macroeconomic stability. There was a fear that the crisis could return the country to the economic stagnation and rising poverty of the inflationary period. In addition, the Government was indicating a willingness to pursue the substantive reforms that would justify a shift to adjustment lending and, in any case, further project disbursements were impeded by the limitations on counterpart funds and on borrowing by sub national governments arising from the fiscal effort. Thus, the revised strategy, subsequently formalized in the 2000 CAS, gave prominence to fiscal discipline and the strengthening of fiscal management, including social security reform. Also, the strategy was to address the better targeting of social programs, and the correction of distortions in financial intermediation that were hampering growth.

7. The required fiscal restraint imposed the need to reduce expenditures, including those on investment, and led the Bank to limit the number and amount of investment

²³ CAS – Progress Report, R98-116, May 12, 1998.

²⁴ Framework Paper: Special Program of Support for Brazil, SecM98-943, November 25, 1998. The only reference to these issues in the paper reads: "...the authorities...have reiterated their commitment to the present exchange rate regime and have stressed that they see no need for concerted lending or other "burden sharing" exercises with respect to private creditors."

loans proposed for 1999, to defer major infrastructure projects until Brazil's domestic funding availability was greater, and to contemplate some early closings and restructuring of loans. At the same time, the crisis opened new areas for Bank activity, with the revised strategy including a number of possible loans that were deemed part of the response to the crisis. As time progressed, however, it became increasingly difficult to ascertain the extent to which these loans could directly be associated with crisis support, particularly since the recovery from the crisis was relatively fast and some loans were approved substantially after the crisis had passed. The package of loans, worth some US\$2.8 billion, that most clearly traces its roots to the crisis included two loans supporting fiscal/fiscal management reform, two loans supporting social security reform, and one social protection loan.²⁵ Most of these loans were accompanied by technical assistance loans supporting their implementation.

8. The need to provide a quick and substantive response in crisis conditions, determined that the Bank's initial assistance had to be both large and fast-disbursing and be structured around already existing initiatives. The first two adjustment loan operations approved as the Bank's contribution to the Brazil Rescue Package, amounting together to slightly more than US\$1 billion, essentially validated reforms that by and large had already been implemented. In both cases, the Social Security (SS) S/Secal and the Social Protection (SP) S/Secal, discussions on the reforms had been going on long before the Russia crisis ratcheted up pressure on Brazil's financial position, and their main legislative implementation had taken place (in November 1998) before the loans were presented to the Bank's Board in January 1999. The ICRs for these loans²⁶ indicate that this course of action gave rise to confusion in regard to the nature of adjustment lending, as opposed to plain emergency liquidity assistance. Indeed, a substantial amount of money was disbursed up front and with little or no forward looking commitments from the Government. Nevertheless, the ICRs point out that the loans "...in addition to preempting a payments crisis, accomplished substantial reforms in both policy areas." Moreover, the choice of allocating reform goals over several single tranche operations, i.e., planning on a sequence of two or more loans for each area of reform, "...allowed the Bank to reward reforms already taken in the months previous to the crisis, as well as provide incentives for deeper, subsequent measures."

9. As indicated above, the greatest contribution to poverty alleviation had been provided by the successful stabilization program of 1994, which cut the poverty rate by some 30 percent over the following two years. However, the looming financial crisis in 1998 was seen as a serious threat to this progress, as large segments of the population lay vulnerable to the economic downturn and contraction of government social services that would likely accompany a crisis. The Government saw the preservation of the hard-won stability as its primary task, and was intent on aggressively addressing the country's fiscal deficit. There was a need, therefore, to reduce the impact of the crisis and the fiscal adjustment on the poor, and to protect the key social programs that comprised Brazil's

²⁵ The revised CAS included also a second social protection loan that was later not considered, and two loans for the financial sector that were eventually approved in May 2001 and June 2002 respectively,

²⁶ Reports 19966-BR and 19967-BR, December 1999.

social safety net. The SP S/Secal, for \$US252 million, approved in January 1999, was to support this effort.

10. The SP S/Secal was designed specifically to minimize budget cuts to the social assistance, health, education, and labor sectors during the fiscal adjustment, and to provide budgetary protection for twenty two targeted programs for the poor. Accordingly, the revised federal budget proposal, submitted to Congress in November 1998, maintained resource allocations to these programs for fiscal year 1999 at 1998 levels, despite deep cuts in other sectors. Knowledge and operational work in the social protection area continued after the approval of SP S/Secal, particularly on two social protection investment operations –to support the eradication of child labor and temporary work-fare programs for the poor—that were readied for rapid deployment in the event that the 1999 economic downturn were to prove more serious than forecast.

11. The other loan that was part of the Bank’s immediate response was the Social Security S/Secal, for US\$757 million, also approved in January 1999. The imbalance in the social security accounts had been seen as one of the main factors in the deterioration of the country’s fiscal position, and the Government focused on the strengthening of the social security finances as a principal element of its adjustment strategy. In addition, social security reform was to be a signal to the international community of Brazil’s ability to tackle fundamental structural problems. The reform was to be implemented in two stages. The first stage, which was the one supported by the SS S/Secal, involved the approval of a Constitutional Amendment to introduce the principle of actuarial and fiscal balance for all (public, private, and sub-national government) pension systems, and to reduce inequalities between these systems. The Amendment had already been passed in November 1998. The second stage of the reform, involving implementation of the Amendment and certain institutional changes to the system was subsequently supported by a second loan, SS S/Secal II for US\$505 million, approved in November 2000. The reforms succeeded in partly reducing the system’s actuarially projected expenditures and deficits, but fell considerably short of their initial objectives, as strong opposition by affected interests managed to thwart key elements of the original project.

12. The final two loans in the crisis response package were in support of the Government’s fiscal adjustment program, which was at the heart of the strategy to overcome the crisis, regain the market’s confidence, and establish a sustainable basis for growth and poverty reduction. The first of these loans, the Fiscal and Administrative Reform loan (FARL) for US\$505 million approved in March 2000, aimed at improving fiscal performance through supporting the implementation of a number of laws that had already been approved by Congress and that dealt with administrative reform, the debt of and borrowing by sub national governments, and the reduction of personnel costs throughout the public sector. The by and large successful implementation of these initiatives, helped along by the FARL, made an important contribution to the operational efficiency of the public sector and helped raise the sector’s primary surplus, from virtually nil in 1998, to the levels between 3 percent to 5 percent of GDP at which it has been maintained since. The second loan, approved in January 2001, took the shape of a programmatic loan. This loan was built around the Fiscal Responsibility Law the Brazilian Congress had approved in May 2000 and included policy actions to improve

fiscal performance, and expenditure and debt management. The Brazil CAE (2004) notes that, even though the Bank was not the main actor in the fiscal scene—with the determination of the Government taking pride of place, and also notable contributions from the IMF and the IDB—the solid fiscal performance the country has delivered since the crisis, and the relevance of reforms such as that in social security or the Fiscal Responsibility Law, point to a satisfactory contribution from the Bank.²⁷

13. The Government's determined and disciplined response to the crisis, helped by timely assistance from the international financial institutions, succeeded in preventing the crisis from realizing its full negative potential. To universal relief, a financial sector meltdown and a debt default were avoided, while the adverse consequences of the devaluation proved less than initially feared. Although the show of force intended with the November package could not prevent the collapse of the exchange rate regime, it did succeed in providing the financial cushion that helped stave off a banking or a debt crisis. The economy's reaction to the crisis was also better than expected. After an early spike, inflation was brought back under control. Economic activity recovered quickly, with real GDP registering slight positive growth in 1999 before moving to a rate of 4.5 percent in 2000. Helped by the devaluation, the external current account deficit narrowed to a level that could be fully covered by foreign direct investment already by 2000. The short duration and contained extent of the crisis, together with the effective measures to protect social programs, greatly tempered the negative impact on poverty, and indicators soon resumed their improving trend in line with the renewal of growth. Progress was briefly disrupted in 2001 as a result of a conjunction of adverse developments, including an energy crisis, the international slowdown, the unsettled situation in Argentina, and uncertainties about the upcoming presidential election in Brazil. Nevertheless, the country weathered these difficulties without relapsing into a new crisis, attesting to the strength of the reforms put in place after 1998.

14. The Bank's relevance as a financing source for Brazil resumed its downward trend after the crisis had passed. The Brazil CAE (2004) reports, nevertheless, that the authorities still regarded Bank resources as an important element in their financing strategy, particularly as a buffer in times of increased market volatility. Moreover, the Bank's participation in the shaping of the reforms put in place during the period of the crisis had increased the Bank's relevance as a source of knowledge and technical assistance. During the crisis, the Bank had sharply expanded its Economic and Sector Work, acknowledging the contribution that this work could make to reforms and the quality of sectoral policies. This process culminated in the move to programmatic policy-based lending in 2001. The programmatic loans that have since been extended have proven a flexible instrument that allows the continued policy dialogue with the Government.

²⁷ At variance with this assessment, the IMF's Independent Evaluation Office (IMF, 2003) provides a more somber assessment: "The structural content of (the program) was modest. Policy measures were almost entirely drawn from the authorities' existing policy agenda....Implementation of structural reforms was mixed....only about one-half of the program's structural benchmarks were met, often because of difficulty in securing congressional approval."

15. The international support during the crisis centered on the Bank, the IMF, and the IDB. The initial package of support, put together in the latter part of 1998, was led and coordinated by the IMF, but subsequently the coordination of external assistance was taken over by the Government, and the assignment of responsibilities among the three institutions was determined by their respective interactions with the Government. There seems not to have been major coordination difficulties or differences of view in regard to strategy between the Bank and the two partner institutions.

B. RUSSIA

16. After the collapse of the Soviet Union in 1991, the authorities of the newly created Russian Federation focused their efforts on the transition to an open market economy. This involved the dismantling of the state's controls over the means of production and of its intervention in the process of price formation, the paring down of the major macroeconomic imbalances inherited from the Soviet Union, and the development of the institutional and legislative frameworks required by a market economy. In these early years, progress, albeit patchy, was made in the freeing of the price mechanism and the disposition of state assets, but major objectives of the reform program remained unfulfilled, particularly in respect to regulatory and institutional reform and enterprise restructuring (including in the financial sector). Macroeconomic stability was also not attained: although an outright loss of control was avoided, inflation continued high and fiscal discipline remained an elusive objective.

17. The pernicious instability and the threat of runaway inflation—inflation had already exceeded 200 percent in 1994—led the government the following year to adopt a comprehensive stabilization program based on a fixed exchange rate for the ruble and tight monetary and fiscal policies. This program was supported by an Extended Fund Facility from the IMF. Implementation of the program, however, was uneven and its results slow in coming. Only by 1997 did real GDP attain positive growth and inflation decline to single digit levels. Given the fixed exchange rate, the elevated inflation prevailing in the intervening period resulted in a sizable appreciation of the ruble in real terms, with further adverse effects on real GDP growth. The crucial policy slippage was the government's inability to rein in the fiscal deficit, which caused a rapid growth in the public debt and laid the basis for the crisis that was to come in August 1998.

18. The 1995 program provided the context for a major change in the Bank's involvement with Russia. Up to that time, the Bank had sought to emphasize technical assistance and analytical work, but had also expanded lending from virtually nil to almost \$5 billion, of which only about one fourth was budget support. The stabilization program and the arrival of a small group of reformists into positions of influence presented the Bank with an opportunity to advance the reform agenda on a broad front, and over the two-year period beginning in March 1996 the Bank increased its commitments to Russia by \$5.3 billion, much of it (\$3.5 billion) in the form of quick-disbursing adjustment operations. This period also saw increased activity from IFC and MIGA. The expansion in lending responded to the desire to provide the group of reformists with leverage vis-à-vis the line ministries, but it also reflected pressure from the international community to buttress the IMF-supported program and the perception at the Bank that only through significant involvement in structural adjustment would the Bank gain recognition from the government as a full fledged partner in the discussion of the reform agenda.²⁸

19. In the government at large, however, there was little ownership of the program beyond the thin group of reformists, and implementation remained weak, particularly in

²⁸ While acknowledging these points, the CAE for the Russian Federation (September 2002) questions the appropriateness of the Bank's lending expansion in 1996-97 arguing that the paucity of the results in terms of reforms did not justify the volume and low conditionality of the assistance provided.

the fiscal area. In late 1997, as the effects of the financial crisis in Asia began to be felt, the government asked for further significant and quick-disbursing assistance. In circumstances where the first fruits of the stabilization program (in terms of growth and inflation) were beginning to show, and with international capital markets still positive on Russia, the Bank complied with the government's request, increasing the size of ongoing structural operations, with substantial frontloading of disbursements. Although there was some incipient concern about the overvaluation of the exchange rate, it was felt that further support for the program was justified on its own merits: there was a good chance of getting the lagging (fiscal) parts of the program to work, and it was better to prevent the crisis that otherwise could ensue. This would also increase the relevance of the Bank in Russian eyes.

20. By the spring of 1998 the risk of a crisis had become increasingly evident. Fiscal adjustment was held back by internal political wrangling, the terms of trade declined abruptly following the drop in the price of oil, and international capital markets were increasingly reticent in the wake of the Asia crisis. The Bank, nonetheless, felt compelled to participate in the major financial package that was being assembled in order to restore confidence and allow time for the program to work out. The authorities exerted strong pressure, underscored by major Bank shareholders, for the Bank to share in the financing burden. The IMF, in turn, still saw a possibility that the looming crisis would entice the government to take the required fiscal action to restore the thrust of the program. The Bank indicated that it would contribute \$6 billion to the \$23 billion pledged for the package and, to this end it accelerated work on a large structural adjustment loan (SAL III) that was in preparation. However, in contrast to the previous adjustment operations, this time the loan was substantially back loaded and subject to detailed conditionality. The loan was to be seen more as an indication of the Bank's long term commitment to Russia than an immediate provision of financing at times of crisis. A first disbursement of only \$300 million was made in early August 1998.

21. The crisis hit less than a fortnight after the disbursement of the SAL tranche. On August 17 the government announced the devaluation of the ruble, the restructuring of official ruble debt obligations (effectively a default), and a moratorium on private external debt. Thus, the attempt by the international community—including the Bank—to stave off the crisis ended in failure and became subject to the criticism that it had served just to bail out private investors. The critical argument goes that by the spring of 1998 the fundamentals were irretrievably out of line and that the attempt to pile senior debt on top of the already precarious amount of existing debt detracted more than added to the confidence of investors.²⁹ Defenders of the rescue operation claim that both points, although seen as clear with hindsight, were not at all that evident ex-ante. Firm commitments to fiscal and structural measures had been obtained from the government and the attitude of investors had not been univocally negative in the run up to the crisis. There had been a reasonable probability of sparing Russia the faith that had befallen the East-Asian crisis economies. As far as the Bank was concerned, this argument was reinforced by the sense that, as put by a then staff member of ECA: “the Bank could not walk away while the IMF and the Russian reformists stayed the course.”

²⁹ See for instance Kharas, Pinto, and Ulatov. 2001

22. Notwithstanding the shockwaves the crisis sent around the world's financial markets and the sharply negative effects it had on the domestic financial system, the worst fears about its consequences did not materialize. There was considerable political instability—the year after the crisis witnessed the dismissal of three prime ministers—but there was no backsliding in the reform process and a relatively tight fiscal policy was followed. Inflation had an initial spike but declined rapidly thereafter, the exchange rate stabilized soon after its initial sharp depreciation, and economic activity started to recover helped by the devaluation and improving terms of trade.

23. Social protection programs had been part of the Bank's assistance strategy from the beginning of its involvement in Russia. However, the Bank's activities in this area were hampered by the lack of indicators and coherent information on the social situation, the difficulties of dealing with the bureaucracy and the federal structures of the country and, in general, the reduced interest of the government on these issues. Prior to 1998 several loans, particularly the adjustment loans of 1996-7 had important social components, focused on the modernization of the social security system and the labor laws, on dealing with the social consequences of the restructuring of the coal mining industry, and on enhancing institutional capability in the social area.³⁰ Nevertheless, at the time of the crisis there were great concerns about the consequences the crisis could have on the still precarious social situation. Nothing could be done, however, to allay these concerns. The suddenness of the crisis, the continuing lack of adequate information, and the inability to attract the government's attention to these issues impeded the deployment of any kind of social safety net to alleviate the effects of the crisis on the poor.

24. In the event, the consequences of the crisis on poverty were less than feared. The initial impact of the crisis was dramatic, some 25 million people were thrown into poverty, with the incidence rate rising from 24.1 percent in 1997 to 41.5 percent in 1999 (World Bank, 2005). However the rapid decline of inflation after its initial spike prevented lasting adverse effects on income distribution, and the early onset of the recovery avoided major increases in unemployment and allowed for a recovery of the headcount rate, which by 2002 was already below its 1997 level. Moreover, some unexpected relief in the social area came from the rump state-owned enterprises that, inefficient as they were, still continued to provide basic services and to maintain employment, particularly in the regions, and from the basic-food self sufficiency of large segments of the population. Pensioners and others on fixed income were in the end the most affected by the crisis. Substantive progress on social protection issues only began to be made in the context of the reforms permitted by the economic recovery that followed the crisis. The Bank was active with advice and technical assistance, particularly on pension and labor market reform and on setting up a household budget survey and a system of poverty indicators.

25. The period after the 1998 crisis saw not so much as a change in the Bank's strategy in regard to Russia than a change in the way the Bank was perceived in Russia.

³⁰ Perhaps the most relevant of these in terms of poverty alleviation were the Coal SECALs approved in 1996 and 1997, for a total of \$1.3 billion. See their PPAR (OED, 2003).

This was the consequence of several factors, including that the Bank was not directly associated with the collapse of the exchange rate based stabilization strategy, that the Bank had been prompt in offering ample collaboration after the crisis at a time when the IMF and the government were embroiled in a governance dispute and capital markets were still reeling from the default, and that the improved economic prospects provided a more amenable environment for the Bank's initiatives.

26. Beyond the fiscal disarray and unsustainable debt dynamics, the crisis had made evident the structural weaknesses remaining in the Russian economy, particularly in terms of institutional reform and enterprise restructuring. After some hesitation, the government reaffirmed its commitment to reform and worked with the Bank to restructure SAL III and re launch the reform process. A second tranche of \$100 million under the loan was disbursed in July 1999. A year later, in view of the improving economy and reduced financing needs, the government requested the cancellation of the undisbursed commitments under this loan. Nevertheless, SAL III had made a significant contribution to the shaping of the government's own reform agenda, which came to incorporate virtually all of the elements of the loan.

27. The crisis had provoked the virtual collapse of the banking system. The default on government securities and the devaluation had had a major negative impact on the bank's balance sheet, causing most of the private banks to fail. The Bank and the IMF intensified their technical assistance in the financial area with a view to advance the restructuring of the financial system, the reform of its legal and supervisory arrangements, and the resolution of failed banks. These efforts were only partially successful and a number of these objectives remained unmet.

28. The Bank's improved dialogue with the authorities in the post-crisis period reflected also the government's increased ownership of the reform agenda. Having survived the crisis and faced with improved economic prospects, the more self confident authorities showed increased willingness to tackle major reforms and receptivity to difficult advice. Significant progress could be made in civil service reform, public expenditure management and decentralization. This was accompanied, however, by a progressive reduction of the Bank's financial involvement in Russia. With declining financing needs, commitments became smaller and the Bank moved increasingly to a role of provider of advice and knowledge.

C. THAILAND

29. Thailand's economic performance was exceptionally strong in the three decades prior to 1995. During that period, growth averaged 7.5 percent a year, per capita income more than trebled and there was a marked decline in poverty, with the share of the population below the poverty line dropping by two thirds. During that time, however, the Bank was only marginally involved with Thailand, as the country was increasingly relying on private capital markets for its financing needs. By the 1990s, the Bank accounted for less than 2 percent of gross loan inflows into the country, with most of the Bank loans going to infrastructure. The Bank's reduced profile in Thailand, its inattention to structural reforms, and its limited impact on policy would have consequences once the economic situation abruptly turned for the worse in 1996-97, catching the Bank—and the rest of the international community for that matter—by surprise and unprepared to deal with the ensuing crisis.

30. Thailand's rapid industrialization and the progress it made in poverty reduction masked important fault lines that were developing underneath the spectacular growth performance. These related mainly to a progressive loss of competitiveness—as wage increases exceeded productivity gains—and to fundamental weaknesses in the financial system, where the capital account liberalization of the early 1990's had not been accompanied by adequate regulation and supervision. This had resulted in poorly capitalized institutions with a prevalence of related lending and opaque accounting practices, which in turn had led to a growing misallocation of savings and deterioration in the quality of the bank's balance sheet. The fragility of the financial institution's portfolio was aggravated by a significant currency and maturity mismatch.

31. Up to 1996, macroeconomic policy was ostensibly on the right track: inflation was low, the exchange rate was stable, the public sector was in surplus, and high rates of domestic savings were supplemented by sizable inflows of foreign capital. However, the bursting of a real estate bubble in 1996 amidst a slowdown in export demand—resulting from the appreciation of the US dollar, to which the baht was pegged—led to a turnaround in market sentiment and a reversal of foreign capital flows. The authorities failed to take timely action—in spite of several attacks on the currency—and on July 2, 1997 they were forced to abandon the fixed exchange rate. Panic ensued in the financial sector, fueled by a depositor run on financing companies and on smaller banks, there was a drop in domestic consumption and investment, and the economy headed for a deep recession. (Nabi, 2001, includes a chronology of the events leading to the crisis.)

32. In the immediate aftermath of the crisis, the government saw the need to adopt very tight monetary and fiscal policies to prevent the situation from running out of control. These policies were enshrined in an IMF supported program. The collapse of the financial system was avoided (barely) by suspending operations in most finance companies and providing close to 4 percent of GDP in liquidity assistance to failing banks. The resulting monetary expansion was fully sterilized by a sharp contraction in credit to the private sector, which resulted in a major liquidity crunch in spite of the attempt to have the public sector share in the burden of adjustment by maintaining a

budget surplus.³¹ Tight policies were also required to keep inflationary expectations in check and to stabilize the exchange rate. The baht lost more than half its value after being floated, but recovered in part after the credit contraction and ensuing recession, to stabilize at about one third below its pre-crisis level. Caught between the liquidity crunch and spiraling debt servicing costs—particularly on foreign currency denominated debt—the corporate sector was in distress, with many firms defaulting on their loans. This in turn contributed to the bank’s unwillingness to lend, and aggravated the credit crunch.

33. Because of its limited prior involvement, the Bank was ill prepared to deal with the crisis once it happened. The Bank’s insufficient knowledge and policy influence was compounded by the fact that the staff dealing with Thailand had been changed shortly before the crisis and, more fundamentally—as pointed out in the PPAR on the financial sector loans—by the Bank’s lack of ready available personnel with experience in dealing with crises. Much time and opportunities to exert useful influence were lost before an appropriate team was deployed. At the onset of the crisis there was strong pressure from major shareholders for the Bank to join in the rescue operation that was being spearheaded by the IMF. There was a donor’s meeting in Tokyo in August at which the Bank pledged US\$1.5 billion towards an overall package of US\$14.2 billion. The Bank was quick to act on this pledge and, notwithstanding the staff’s unfamiliarity with the situation, could approve a TA loan that same August and prepare a SAL in the financial sector for approval in December 1997.

34. The government’s national policy following the crisis focused on the short-term goal of maintaining monetary and fiscal stability and reviving growth, and on the medium-term goal of making this growth sustained and more balanced by addressing issues of competitiveness, governance, and social and environmental concerns. The Bank’s contribution to this program was subsumed in a package of 7 loans—5 fast disbursing policy-based loans and 2 technical assistance loans—worth slightly more than US\$2 billion.³² These loans helped Thailand, in the short-term, to rebuild its reserves and carry out its stabilization program and, in the medium-term, to finance its reform and social programs.

35. The Bank took advantage of the window of opportunity provided by the crisis to move away from infrastructure projects and involve itself in the structural reform areas from which it had been excluded during the boom years. In particular, the financial and corporate sectors were identified as the areas most clearly in need of reform, given their role in the genesis of the crisis and the precarious position they were left as a result of it, and four of the seven loans in the Bank’s package were directed to this area. Of the

³¹ This initial tightening of the policy stance came to be criticized after the crisis had passed, on account of the depth and duration of the recession that ensued. The PPAR for three of the adjustment loans given for the financial sector (IEG 2006a) castigates the Bank for having endorsed these policies at the time these loans were approved. This criticism, of course, benefits from hindsight, while the counterfactual of having the private sector bear the full brunt of the balance of payments adjustment, and of the consequences of runaway devaluation and inflationary expectations, can not be determined. See Lane, et.al. (1999).

³² The 1998 CAS originally contemplated lending for FY98-00 in an amount of US\$3.4 billion for 12 projects, but Thailand’s demand for loans petered out after 1999. In addition to the seven loans approved in the aftermath of the crisis, the Bank approved in 1998 a Partial Credit Guarantee for the Electricity Authority to help it obtain the financing needed to maintain its investment and reform program.

remaining loans, two were aimed at strengthening the public sector's resource management and the final one to help maintain the social safety net and address poverty alleviation issues.

36. A side effect of the crisis was to render out of date most of the existing portfolio of pre-crisis projects. These projects, which had been designed for a fast growing economy with a rising demand for infrastructure and health or educational services, now sat ill in the midst of a depression with large unutilized capacity. Disbursements out of this portfolio declined sharply after the crisis, notwithstanding the heightened need for financing. The portfolio was eventually restructured in 1999 and most of the pre-crisis loans were cancelled.

37. The rapid growth prior to the crisis had lifted wide segments of the population out of poverty –with the incidence of poverty dropping from almost 33 percent (18 million people) in 1988 to 11.4 percent (less than 7 million) in 1996.³³ With the crisis, however, this progress was abruptly reversed and by the turn of the century poverty incidence had climbed back to about 16 percent (10 million people). From there a gradual recovery ensued, but the incidence of poverty did not return to pre-crisis levels until 2004. Having relied on growth to reduce poverty, the government had not devoted much attention to formal social protection mechanisms, and the bulk of the burden of dealing with the poverty and unemployment consequences of the crisis had to be carried by the informal safety net provided by community and family ties. This notwithstanding, the government did what it could with the instruments at its disposal, mounting a wide-based response that utilized the budgets of different ministries and regional entities to support programs in health, education, social insurance, and employment creation, among others.

38. The Bank was slow in joining this process. A loan in the amount of US\$300 million for a Social Investment Project (SIP) was approved only in July 1998, a full year after the onset of the crisis. The SIP was designed along two channels. The first responded to the short-term objective of alleviating the immediate effects of the crisis by giving financial support to the government's programs launched to provide jobs and basic social services to the unemployed and the poor. This involved dealing with seven different executing agencies that, after a decade of minimal Bank involvement in Thailand, were unfamiliar with Bank processes. Nevertheless, the reliance on already existing programs greatly diminished uncertainty and speeded up the effectiveness of the assistance. The second channel used the crisis as an opportunity to further more medium-term objectives aimed at supporting bottom-up service delivery through financing locally generated projects. This also answered to the government's new priorities of balancing economic and social growth, as it was felt that in the past growth had come too much at the expense of human development. This channel's activities are deemed to have had a significant institutional impact in promoting decentralization and strengthening the capacity of local governments and communities to participate in development.

³³ The poverty line is drawn at people living with less than US\$1.60 a day (in 1993 purchasing power parity)

39. As indicated above, the bulk of the Bank's post-crisis assistance was directed to the reform of the financial sector. The financial meltdown of 1997 had made evident to the Thai political and social classes the need to address the many failings in the financial sector, and thus the offer of the international financial institutions to help in this area was welcomed. The task of financial sector reform was further complicated by the need simultaneously to engage in the restructuring of the debts of corporations, on which the health of many financial institutions depended.

40. The Bank's program for Thailand's financial sector consisted of four loans, the TA loan for US\$15 million approved in August 1977 and three SALs, the first of which, the Finance Companies Restructuring Loan (FCRL) for US\$350 million, was approved in December 1977 and was followed by two Economic and Financial Adjustment Loans (EFAL I for \$US400 million and EFAL II for \$600 million) that were approved in 1998 and 1999, respectively. Beyond providing balance of payments support and helping the ongoing fiscal and macroeconomic adjustment, the loans aimed at supporting the rehabilitation of the financial sector, strengthening its supervisory and regulatory framework, dealing with corporate accountability and governance, and developing the bond market.

41. The rehabilitation of the financial sector was the main and most difficult of these tasks. Substantial progress was made and, eventually, out of the closure, merger, and recapitalization of weak institutions a leaner and stronger system emerged. The rehabilitation process nonetheless had also significant shortcomings that may have unnecessarily prolonged the crisis, deepened the economic recession, and contributed to a negative public perception of the overall reform effort. At the time of the crisis, the government had suspended, and subsequently closed, 56 of 91 financial companies (FC) representing some 14 percent of the assets of the financial system, and had intervened in six banks, which in turn accounted for 24 percent of the loans in the system. The closure of the FCs was fraught with controversy as it disrupted the payments system and pushed loans that otherwise were being serviced into the non-performing category. The IMF, had insisted on this measure, disregarding misgivings from Bank staff, but then got embroiled in a dispute with the government regarding the disposal of FC assets, dispute that considerably delayed matters.³⁴ The FCRL and the two EFALs were designed to help with the resolution of the closed FCs and the disposal of their assets, to deal with the guarantees given to depositors and creditors to stop the run on the system, and to assist with the restructuring and recapitalization of the intervened banks. In the event, the depth of the crisis, political interference of affected sectors, and delays in the adoption of crucial measures detracted from the performance of the Bank's loans. The PPAR for these loans, prepared by the IEG in January 2006, rates only the disposal of FC assets as moderately satisfactory, while performance in regard to the closure of FCs, the guarantees, and the intervened banks is deemed unsatisfactory.

³⁴ The IMF had proposed that this task should be entrusted to international consultants, proposal that was not accepted by the government. By the time (a year later) that a local entity was created to handle these assets, most of them had deteriorated beyond recovery.

42. The financial sector loans earned a better evaluation in respect to their other objectives. Beyond the eventual rehabilitation of the financial sector, the loans made an important contribution to the modernization of the legal, supervisory and prudential regulations of the system. Also, substantive advances were made in regard to corporate governance and transparency –even though progress in corporate restructuring was slow and incomplete, as it was hampered by political resistance to reforms in bankruptcy and foreclosure procedures. Finally, major improvements were also made in the infrastructure and organization of the government bond market.

43. The agreement on a support package for Thailand included an attempt to delimit the responsibilities of the IFIs involved in the reform of Thailand’s financial sector, with the IMF assuming responsibility for the banks, the Bank for the finance companies (FCs) and for improving the regulatory and supervisory framework, whereas the Asian Development Bank was to take care of capital market development. This division of labor, however, broke down as the actual issues were closely intertwined and institutions dealing with one set of problems inevitably got drawn into dealing with issues pertaining to some other agency’s turf. Coordination between the Bank, the IMF and the ADB was often lacking. This resulted in “conflicting views, confusion of the long-term effects of short-term actions, and a failure to recognize the interaction between micro-policies and macro-conditions.” Nevertheless, after the initial differences of view between the Bank and the Fund were sorted out, work on the financial sector was done by and large in a harmonious way.

44. In the fiscal area, the Bank’s assistance package included a TA loan, the Economic Management Assistance Loan (EMAL) for US\$15 million approved in 1998, and the Public Sector Reform Loan (PSRL) an adjustment loan for US\$400 million approved in 1999. The PSRL was aimed at enhancing the management of human and financial resources in the public sector, improving service delivery, and strengthening accountability and transparency. The ICR for this loan deems its outcome as satisfactory: besides providing US\$400 million in balance of payments support, the loan helped create acceptance of the need for public sector reform and is said to have “achieved its major objective of *launching* a comprehensive reform process.”

45. By the time the PSRL was approved, Thailand was well on its way to recover from the crisis and about to reenter the international capital markets for its financing needs. These needs, however, were much reduced given the resumption of growth, the adjustment of the public finances, and the government’s preoccupation with managing the public debt. No major Bank operation was approved between the approval of the PSRL in October 1999 and December 2003. In these circumstances, the nature of the Bank’s involvement with Thailand evolved to place greater emphasis on analytical and advisory services. In 2000 the Bank and Thailand entered into a Country Development Partnership (CDP), which has helped maintain the Bank’s presence in the country and to enhance preparedness in the event a new crisis were to develop.

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APPENDIX III: LIST OF INTERVIEWS

Michael Carter
Alexey Kvasov (Executive Director)
Johannes Linn
Jorge Marquez (IMF)
Gerd Schwartz (IMF)
Julian Schweitzer
Marcelo Selowsky
Jayasankar Shivakumar
Teresa Ter-Minassian (IMF)