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OVER THEIR HEADS
THE IMF AND THE PRELUDE TO THE EURO-ZONE CRISIS

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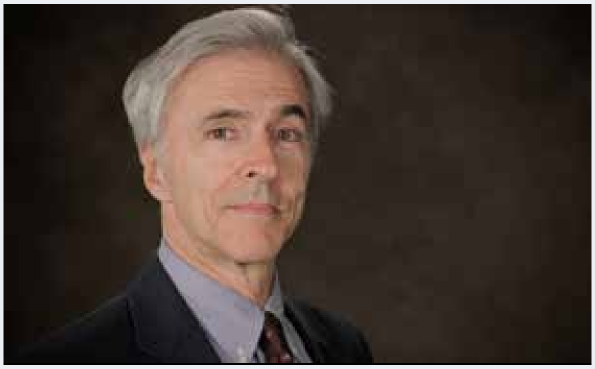

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A native of Washington, DC, Paul attended the University of Wisconsin (B.A., history), before heading to Oxford University on a Rhodes Scholarship, graduating with an M.A. in philosophy, politics and economics in 1975. Paul began his career as a business and economics journalist shortly thereafter, returning to the United States to work as a writer at *Forbes* magazine. He then moved to *The Wall Street Journal*, where he became the newspaper's chief economics correspondent, covering the US Federal Reserve, budget and tax policy. In 1987, Paul moved to *The Washington Post* and began to focus his writing on the global economy, serving five years in the paper's Tokyo bureau and eventually becoming the paper's international economics correspondent in 1995.

Paul is the author of *The Chastening: Inside the Crisis That Rocked the Global Financial System and Humbled the IMF*; *And the Money Kept Rolling In (and Out): Wall Street, the IMF, and the Bankrupting of Argentina*; *Misadventures of the Most Favored Nations: Clashing Egos, Inflated Ambitions, and the Great Shambles of the World Trade System*; and *Off Balance: The Travails of Institutions That Govern the Global Financial System*, published by CIGI in October 2013.

EXECUTIVE SUMMARY

The years prior to the global financial crisis were a peculiar period for the International Monetary Fund (IMF). The IMF was struggling to define its role and justify its existence even as trouble was brewing in countries it would later help to rescue. To understand the Fund's current strengths and weaknesses, a look back at this era is highly illuminating.

This paper chronicles three major developments that span the years 2005 to 2009. First, the IMF's very purpose and relevance came under question during a seemingly crisis-free era, and it was forced to downsize. Second, the IMF failed to perceive or raise sufficient alarm about forces that would eventually trigger crises in countries where its aid would be required — first in Eastern Europe, later in the euro zone. Third, the Fund was relegated for the first time to the status of "junior partner" when a crisis erupted in Latvia, with the European Commission playing the senior partner role.

These developments merit extensive exploration for the insight they provide on controversies that have flared over the IMF's role in the euro-zone crisis, the greatest the Fund has ever faced. The IMF has come under intense criticism for having succumbed at key junctures to pressure from powerful European policy makers, the result being an erosion of the Fund's most precious asset — its credibility as an independent, neutral arbiter and fixer of economic problems. The critics often blame the IMF's governance problem, namely European dominance over the Fund's board and management. But that is only part of the backdrop to the IMF's travails in the euro zone; a more informative picture emerges from a full account of pre-crisis events.

The IMF remains haunted by these events. They put the Fund in a weak position at the time the euro-zone crisis erupted in 2010, making it difficult for the Fund to avoid the situation now deplored by critics. The implications for future crises are disturbing, and in the absence of corrective action, the Fund's ability to fulfill its historic role of fostering global stability will be diminished.

INTRODUCTION

In the early spring of 2006, an economist at the IMF, Bas Bakker, gave a presentation to colleagues, which was a rare example of foresight in policy-making circles prior to the global financial crisis. Bakker, who is from the Netherlands, argued that Eastern Europe was a hotbed of financial vulnerability, with many countries becoming dangerously dependent on inflows of capital from abroad that could reverse abruptly with devastating consequences. Titled "Asia 1996 and Eastern Europe 2006 — Déjà vu all over again?" the presentation was kept strictly within the confines of the IMF, since its message might have sparked market perturbations. It was based on data showing that many countries in the former Communist bloc bore alarming similarities to the economies of East and Southeast Asia in the mid-1990s prior to their financial crises.

It is now clear that Bakker was right; crises battered a number of Eastern European countries in 2008 and 2009. If anything, he was understating the case, because more advanced European economies that use the euro also underwent severe turmoil starting in 2010, necessitating major international bailouts. But at the time his analysis was produced, it drew a sharply negative retort from members of the IMF's European Department, which had chief responsibility for overseeing the economies of the countries involved. European Department economists contended that Bakker was exaggerating the peril in Eastern Europe, and although a couple of countries might be at risk, he was misconstruing the situation in the region. As for the possibility of crises in the euro zone, the Fund missed the boat completely.[1]

This is the story of that period — a peculiar one in the IMF's history, when it was struggling to define its role in a seemingly crisis-free world, even as trouble was brewing in countries it would later help to rescue. In the course of researching a book on the IMF, I have been struck by the profound ramifications of developments at the Fund during this era. A look back at this period is highly illuminating for anyone seeking to understand the Fund's strengths and weaknesses in the wake of the series of calamities that swept the globe following the bankruptcy of Lehman Brothers in September 2008. Those calamities have underscored the importance of a healthy IMF capable of fulfilling missions that its founders envisioned seven decades ago — fostering international economic cooperation, maintaining financial stability and assisting countries undergoing temporary hardship.

Three major developments at the IMF during the years 2005 to 2009 are chronicled in this paper. First, the IMF's very purpose and relevance came under question amid a global boom in financial markets that raised doubt about whether the world needed such a large institution dedicated to crisis prevention and crisis management. The Fund was compelled to downsize in 2008, mainly because of pressure from its major shareholder nations. A second element, related to the first, is the IMF's surveillance shortcomings — that is, its failure to perceive or raise the alarm about the forces that would eventually trigger the crises in Europe. Had the Fund been more perspicacious about these forces, it might have been able to rebut the claims about its irrelevance and, conceivably, it could even have resisted the demands for downsizing. Indeed, when the global crisis erupted in late 2008, world leaders began to realize that they needed a bigger IMF, rather than a smaller one. But then the third key development materialized — a crisis in Latvia, where the Fund was, for the first time, relegated to the status of "junior partner," contributing a minority share of the rescue money while Europe put up the lion's share, and got a commensurate amount of influence over certain terms and conditions.

These developments merit extensive exploration and accentuation because they provide historical perspective on controversies that have flared over the IMF's actions during the euro-zone crisis. This crisis was the greatest the Fund has ever faced, taxing its resources and testing its mettle in ways that were inconceivable a few years earlier. The sums the Fund lent to three euro-zone countries — Greece, Ireland and Portugal — were of unprecedented magnitudes, far exceeding the rescues launched previously for emerging economies such as Mexico, Indonesia and South Korea. Also unprecedented was the scale of risk, and complexity of forces, that the Fund was confronting as it laboured to keep a financial conflagration from engulfing a regional economy comprising nearly one-fifth of global output as measured by gross domestic product (GDP).

The IMF is widely credited with analyzing the euro-zone crisis reasonably well after the crisis erupted, certainly compared with European officialdom. But the Fund has also come under intense criticism, because at key junctures it succumbed to pressure from powerful European policy makers, who maintained heavy influence over the Fund's levers of control. In the "Troika," the tripartite grouping of crisis lenders that also included the European Commission and European Central Bank (ECB), the Fund accepted a junior partner role. Then, despite grave misgivings among many of its top officials, the Fund joined in emergency loan packages that piled debt atop of existing debts, extracted crushingly high interest charges and imposed inordinately harsh conditions on the countries that were borrowing the money. The most salient case is that of Greece, where in retrospect the country was saddled with an excessively high debt and should have received relief from its indebtedness much earlier than it eventually did.

Among the most unsparing critics of the Fund's performance have been some of its former staff members, who fear it has been sapped of its most precious asset — its credibility as an independent, neutral arbiter and fixer of economic problems besetting countries, regions and the world as a whole. According to one former staffer, Ousmene Mandeng (2013), the Fund "has been dragged along in an unprecedented set-up as a junior partner within Europe, used as a cover for the continent's policy

1 Information about Bakker's presentation, and certain other matters reported in this paper, comes from a number of documents not available in the public record, from which excerpts will be quoted. Henceforth, such documents will be cited without footnotes. Information about the debate that took place within the IMF about Bakker's presentation comes chiefly from interviews with participants, as does other information in this paper about internal IMF deliberations and positions that various Fund officials took. These interviews were conducted on a "deep background" basis, with interviewees assured of confidentiality unless they gave permission to be quoted. Thus, some information derived from these interviews will also be presented without footnotes.

makers and its independence lost." Susan Schadler (2012a), former deputy director of the European Department (now a CIGI senior fellow), accused the institution of "bowing to the exigencies of European politics." Echoing similar sentiments, Mohamed El-Erian (2014), also a former staffer, lamented that "European leaders showed little hesitation in bullying the IMF into flouting its own lending rules."

These critics often blame the IMF's governance problem — namely, European dominance over the Fund's board and management. As El-Erian (2011) put it, "Many countries interpret the IMF's actions in Europe as confirmation that they are members of an institution that speaks about uniformity of treatment but makes large exceptions for its historic masters." This factor is obviously crucial, and deserves heavy emphasis in any critique of the role that the IMF played. Relative to its economic size, Europe enjoys overrepresentation on the IMF's board and a disproportionate share of the voting power. Even more pernicious is the hoary "gentlemen's agreement" between Europe and the United States regarding the top jobs at the IMF and World Bank — a deal that has ensured the Fund's managing directorship remains under European control.

The governance issue, however, is only part of the historical backdrop to the IMF's travails in the euro zone. A more informative picture emerges from a fuller account of pre-crisis events at the Fund, which helps explain what the IMF did (and did not do) during the euro-zone crisis, and also provides insight into the Fund's efficacy, frailties and inner workings. The era of deceptive tranquility in global markets proved important in the context of the euro-zone crisis because the Fund was especially eager to play a part in Europe. It was recovering from a long period of inactivity on the crisis-fighting front, and it had to overcome strenuous opposition from European officials who felt that their region ought to handle its own problems without international assistance. This helps to account for the IMF's acceptance of junior partner status in the Troika, which, in turn, obliged it to yield to the clout of policy makers in Berlin, Frankfurt, Brussels and Paris, according to people who were involved in the decision making at the time.[2] The Latvian episode was also crucial because the junior partnership arrangement for the Fund in that case established a precedent for the euro-zone crisis.

The three elements cited above are the focus of the narrative that follows about the pre-crisis period. This account is based on extensive interviews and, in the case of the Latvian rescue, confidential IMF documents that have never been publicly disclosed. It is a tale rich in paradox, starting with the Fund's efforts to prepare for a world without much crisis lending, at the same time as some of its economists were downplaying classic danger signals in one part of the emerging world.

HIGH DUDGEON IN THE EGGHEAD HAVEN

Economists on the 2,400-strong IMF staff fall into two broad categories, which some of them call "grunts" and "eggheads." Grunts have expertise in programs — that is, mobilizing loans for troubled member countries. These staffers pride themselves on their skill at performing under pressure as currencies crash and markets swoon, jetting off on missions to stricken capitals to negotiate the terms of rescue aid. Eggheads prefer surveillance — that is, appraising the economic and financial policies of individual nations, regions and even entire global systems. These men and women get their greatest professional satisfaction from producing reports that shed new light on key economic issues, with the aim of helping to move policy in a favourable direction.

The Fund's European Department was a haven for eggheads during the years prior to the global financial crisis. The countries it oversaw had gone for a long time — several decades, in the case of the advanced economies of Western Europe — without any IMF programs, and most were prospering or at least growing at respectable rates. In the absence of program work, the department's economists, seeing surveillance as the surest path to career advancement, generated a voluminous and well-regarded body of analytical work, with titles such as "Reforming Employment Protection Legislation in France," a working paper published in April 2006, and "Coping with Spain's Aging: Retirement Rules and Incentives," which was published in May 2007. But an important aspect of surveillance — arguably the most crucial — is detecting vulnerabilities that may lead to financial crises, and on that score, the European Department did not cover itself in glory during this period.

A key watchword in the department was "convergence," a concept that has long held almost mystical importance for specialists in Europe's grand march toward economic and monetary union. The term refers to the process by which the integration of European economies, especially those that adopt the euro, will cause the nations of the continent to become more alike as they enhance their policies, economic performances and living standards in similar, and presumably favourable, directions. For most members of the European Department staff, it was an article of faith that convergence was producing the desired effects in the region, including in the poorer nations of Eastern Europe and the Baltic area that had joined the European Union in 2004.

So, leading members of the European Department were in high dudgeon when Bakker sharply challenged the

2 The events leading to the IMF's junior partner status in the Troika are explored at length in a companion paper to this one. See Blustein (2015).

convergence story. Bakker was, at the time, a member of the Strategy, Policy, and Review Department (SPR),[3] whose mission is ensuring that the Fund's rescue programs, monitoring and advice are applied consistently and in accord with the institution's standards. The dispute was a typical example of a clash between one of the Fund's area departments, which are responsible for major regions (for example, Europe, Africa, the Asia-Pacific), and its "functional departments," including Bakker's, which have global responsibilities. This tension is both natural and healthy; the area departments regard themselves as possessing specialized knowledge about the economic forces and political realities in the countries they oversee, while the functional departments regard themselves as repositories of expertise about how economic policies work best around the world.

Bakker, who joined the IMF in 1993 after receiving a Ph.D. in economics from the University of Groningen, a leading Dutch university, worked in a unit that conducted "vulnerability exercises" on emerging economies. His central point was that Eastern European countries such as Bulgaria, Latvia, Hungary and Estonia were running large deficits in their current accounts, the broadest measure of the balance of trade, just as Thailand, South Korea, Malaysia and other Asian countries were doing in 1996. Current account deficits were well over 10 percent of GDP in a few of the Eastern European countries, even bigger than the one a decade earlier in Thailand, where the Asian crisis started. Each year, in other words, these countries were importing more goods and services from abroad than they were exporting, with the gap being a significant fraction of their economies' overall sizes. And, to pay for that extra amount of foreign goods and services, they were using funds coming from abroad in the form of loans and investments.

Although it was no secret that current account deficits of such dimensions existed in Eastern Europe, Bakker cited other striking parallels with pre-crisis Asia: a story had taken hold that the robust growth in Eastern European economies must be attributable to strong fundamentals. "Remember the East Asian miracle," one of Bakker's PowerPoint slides advised his IMF colleagues. Fuelling the Eastern European booms was the rapid expansion of bank lending and other credit, particularly lending by banks from wealthier countries that were providing loans denominated in foreign currencies. (In Asia, those loans had been largely in US dollars and Japanese yen; in Eastern Europe, they were typically in euros and Swiss francs.) The problem with borrowing so much in foreign currency was that if Eastern European currencies fell substantially, the burden of repaying the loans would swell, bankrupting many debtors. Bakker acknowledged that Eastern Europe deserved credit for some important strengths that differentiated it from Asia, including the generally high quality of public institutions, especially bank supervisory agencies, and he also noted that Eastern Europe did not suffer from "crony capitalism" of the sort that had plagued Asian financial systems. Yet the possibility of "sudden stops" in capital inflows, with potentially severe ramifications, looked too high for comfort. Why, then, he asked, was there so little worry about Eastern Europe other than the modest concern expressed in some quarters about Hungary? Might not the complacency about Eastern Europe among policy makers and private analysts prove just as misplaced as it had in Asia's case?

Imbalances of the sort that Bakker was highlighting are one of the chief elements for the IMF's raison d'être. Time and again in recent decades, emerging markets and developing countries have encountered trouble by running excessive current account deficits, which essentially implies that they are living beyond their means. Like individuals who max out their credit cards and can no longer obtain the funds needed to maintain their lifestyles, these countries sometimes find themselves cut off from sources of hard currency (US dollars, Japanese yen, euros, British pounds) — which is necessary to conduct international transactions, including the importation of goods essential to running a modern economy and maintaining a decent living standard. When this happens, the Fund, which maintains a large pool of hard currency, can provide a loan to help tide the country over, with the loan forthcoming on the condition that the government makes the policy changes necessary for restoring reasonable balance between its income and outgo.

To be sure, a large current account deficit does not lead inexorably to crisis. Countries that use foreign capital inflows to invest wisely in their long-term strength may continue to do so indefinitely, much like businesses that go heavily into debt to develop promising new products or technologies. And economists in the European Department took strong exception to Bakker's conclusion that the current account deficits in Eastern Europe were symptomatic of financial fragility.

Leading the European Department's attack on Bakker was Ashoka Mody, an Indian with a Ph.D. from Boston University. The comparison between Eastern Europe and the Asian crisis countries irked Mody for several reasons: first, he believed Bakker was overgeneralizing from one or two countries — Hungary in particular — where policies were questionable, as if all of Eastern Europe should be tarred with the same brush. Transparency and governance in Eastern Europe was far superior to Asia, and investors who were pouring money into Eastern European markets were sensible to discern the region's virtues, in Mody's view. Moreover, he contended, Bakker's analysis was typical of a mindset among many at the Fund, in which staffers were

3 The department was known at the time as Policy Development and Review, but its name was changed in 2008, and to avoid confusion the current name and acronym will be used throughout this paper.

all too ready to assume that economic booms were the same as bubbles. According to Mody, global markets had come a long way since the 1990s, with investors showing much greater sophistication and discrimination in their assessments of emerging market economies.

Mody fired off a memo in March 2006 urging an end to discussions likening Eastern Europe to pre-crisis Asia, and he co-authored a working paper, published in March 2007, titled "International Finance and Income Convergence: Europe is Different" (Abiad, Leigh and Mody 2007). According to this paper, the poorer countries of Eastern Europe were not overheating; they were converging, slowly but surely developing more like their wealthy neighbours to the west, and this was significantly attributable to the capital that was flowing from west to east. "In Europe," Mody's paper said, "a larger current account deficit raises growth and this is all the more so the lower a country's per capita income. In other words, a larger current account deficit contributes to the speeding up the convergence process." This was the view that essentially prevailed; a number of public statements and documents published by the IMF during this period also depicted Eastern Europe's breakneck growth in relatively benign terms.[4]

Looking back on this debate, those who supported Bakker's alarmist analysis ruefully admit that they did not make a convincing enough case, mainly because they could not show what would likely trigger an Eastern European crisis. That, in turn, was because they did not foresee the much bigger global crisis that, in the fall of 2008, would sow panic in financial markets and spook investors into pulling money out of any country that looked vulnerable. One result was that when crises did erupt in Eastern Europe — much more broadly than the European Department had anticipated (although perhaps not as broadly as implied by Bakker's presentation), the IMF would be less prepared to mount rescues than it should have been.

Perhaps the most remarkable fact about this episode is that Eastern Europe was the only region where anyone in the IMF was ringing alarm bells, even in private.

NOT EVEN A CAT TO RESCUE

Severe ennui was afflicting the IMF's grunts in the middle years of the twenty-first century's first decade. Not since 2002 had a major crisis materialized that demanded the IMF's attention, and most typical recipients of Fund loans showed no signs of needing such help in the foreseeable future. Countries throughout Latin America, emerging Asia and the Middle East were flush with cash — that is, hard currency of the sort the Fund doles out in emergencies. In these regions (in contrast to Eastern Europe), most countries were running large current account *surpluses*, thanks in part to the high prices of commodities that they exported. And the dollars, euros and yen they were earning on those exports were filling the coffers of their central banks, much to the delight of national leaders who could relax in the knowledge that these reserves of foreign exchange were helping to insure against ever having to seek IMF help. One of the Fund's department heads, Mohsin Khan, acknowledged in a story I wrote for *The Washington Post* (Blustein 2006) that although the dearth of financial turmoil was obviously desirable, tedium was taking a toll on staff morale. "Firefighters don't like to sit in the firehouse," Khan said. "If you're in this organization and you've been caught up in the excitement of rushing around to countries helping them fight crises — well, if there are no crises, you're sitting around wondering what to do."

A vexing problem thus confronted Rodrigo de Rato, the IMF managing director — how to justify the Fund's existence. A Spaniard who had served as his country's finance minister before gaining appointment to the managing directorship in mid-2004, de Rato was besieged by criticism that the Fund needed to find new ways of making itself relevant in a world where so few countries appeared to need its money. New loans in the financial year ended April 30, 2005, were just US$2.5 billion, the lowest since the late 1970s. Moreover, countries that had borrowed large amounts in previous years — Brazil, Argentina and Indonesia — decided to pay back their loans ahead of schedule. If the Fund did not find a productive new role for itself now that crisis lending was becoming passé, it would "slip into obscurity," Bank of England Governor Mervyn King warned in a widely cited speech (King 2006).

A flurry of media articles and op-eds highlighted questions about the IMF's usefulness. "Not Even a Cat to Rescue," was the mocking headline on an April 2006 article in *The Economist*. Conferences were held, learned articles written, eminent persons groups convened and reports published regarding how the Fund might reorient its priorities to provide value.[5] One popular suggestion was for the Fund to devote more resources and energy to surveillance, and to bluntly "name and shame" countries that were guilty of reckless policies. Skeptics scoffed that the Fund's advice had generally had a significant impact only when backed up with loans.

In addition to the IMF's existential crisis, de Rato was under pressure to solve another problem related to the tranquility in markets — the IMF's own financial difficulties. The Fund had long used interest income on its loans to pay staff salaries and finance its other expenses, which totalled about US$1 billion. But now that it was

4 See, for example, IMF (2007a, 69–71.).

5 One of the most influential sources of input was the report by a committee chaired by Andrew Crockett, president of JPMorgan Chase International and former general manager of the Bank for International Settlements. See IMF (2007b).

barely making any new loans, and old loans were being paid off in advance, projections showed that, based on then-current trends, the operating budget would fall into the red to the tune of US$300 million in 2009. "Turkey was the only big loan outstanding, and [interest on] it was the greatest source of revenue for covering expenses, including salaries," recalled Garry Schinasi, who was then a member of the IMF's finance department. "As part of our annual budget projection exercises, we considered scenarios in which lending by the Fund could rise back to even half of peak lending. But it was very difficult to identify a group of countries that would need funding over the relevant forecast horizon."

On top of all these worries concerning the Fund's future were the mounting complaints about its poor governance. After much deliberation and consultation, de Rato generated proposals to sell some of the IMF's gold holdings, adjust countries' voting shares and strengthen the Fund's focus on surveillance, with the most ambitious ideas including efforts to tackle major current account imbalances and "fundamentally misaligned" currencies (de Rato 2006).

In retrospect, justification abounded for the IMF's existence in 2007, not only because of the imbalances building in Eastern Europe, but because of worries about the euro. Some people, in fact, were expressing concerns about the euro at that time — but they were not at the Fund.

IMF ON THE EURO ZONE: "OUTLOOK IS THE BEST IN YEARS"

"As the euro rides high, an unhealthy sense of complacency pervades European capitals about the currency's long-run viability...[c]racks in the euro's very foundations are widening....European policy makers' pride in their currency today might be yet another example of pride before a fall" (Lachman 2007).

Those assertions appeared in an op-ed published in the *Financial Times* on February 28, 2007. The author was Desmond Lachman, a South Africa-born scholar at the American Enterprise Institute who had worked at the IMF in the 1980s and 1990s. Lachman was hardly the first to discern weaknesses in the system underpinning the euro. During the 1990s, when European officials were moving forward in earnest toward their goal of monetary union, US and UK economists were particularly vocal in questioning whether a common currency for such a disparate group of countries made sense. But Lachman saw highly worrisome trends underlying the confidence that financial markets were showing member states in the years after the euro's creation, as if the countries' creditworthiness were almost identical. Even for a country such as Greece, where in the early 1990s borrowers had had to pay roughly three times as much in interest as German borrowers did, funds could be raised in 2007 at wafer-thin "spreads" — 4.29 percent for Greek government 10-year bonds versus 4.02 percent for the German equivalent (Irwin 2013, chapter 13). As Lachman (2007) pointed out in his op-ed:

> [D]evelopments in the individual countries comprising the eurozone have hardly evolved in the direction that the euro's founders had envisaged. Nor have they evolved in the direction necessary for the currency's survival.
>
> At the time of the euro's launch, it was hoped that adoption of a single currency would force all member countries to become more disciplined in their public finances and more competitive in their labour and product markets. By depriving countries of the easy way out of restoring lost competitiveness through exchange rate devaluation, it was hoped that countries would be forced to reform their labour markets and to undertake sweeping market reform with a keen eye on their relative competitive position.
>
> Looking at the continued wayward wage and price performance of Greece, Italy, Portugal and Spain since 1999, one might be forgiven for thinking that little has changed in these countries in spite of their having joined the euro. In the short space of seven years, these countries have managed to lose between 30 and 45 per cent of international competitiveness to Germany.

Lachman then shone a spotlight on "a further symptom that something is amiss in the working of the single currency system" (ibid.) — namely, divergent trade imbalances among member countries. Whereas Germany had run a current account surplus of 6.1 percent of GDP the previous year, and the Netherlands' surplus was even bigger, at 8.2 percent of GDP, current account deficits were running between 8 and 11 percent of GDP in Greece, Spain and Portugal. "It would be a grave mistake for European policymakers to assume that...supportive conditions will persist indefinitely," Lachman concluded (ibid.).

The imbalances problem is now widely identified as one of the major factors that drove the crisis. The surplus countries of northern Europe were helping to finance a binge of consumption and housing purchases in deficit countries such as Spain and Ireland, as well as a binge of government spending in Greece. Capital was pouring from the thrifty, ultra-competitive north into the peripheral countries of the euro zone; among the most enthusiastic funders were Germany's Landesbanken, public-sector regional institutions with close connections to local politicians. This flood of money made it much easier for governments, businesses and individuals in the periphery to borrow — and, in many cases, to borrow excessively, as the world would eventually learn, to its sorrow.

So, how did the IMF perceive the situation around the time of Lachman's op-ed? Rather differently, as indicated by the conclusion of the so-called Article IV report for the euro area that year. Article IV reports are produced by missions that visit capitals for a couple of weeks — usually once annually — to conduct economic checkups, and the first sentence of the 2007 euro-zone report summarized conditions there as follows: "[T]he outlook is the best in years. The economy is poised for a sustained upswing, partly because of cyclical considerations, but also because of policies" (IMF 2007c).

The Fund was especially blasé — before the crisis, at least — about imbalances within the euro zone. The surpluses pretty much cancelled out the deficits, putting the zone overall in rough balance, so there was little point in raising the issue, as far as the Fund was concerned. Michael Deppler, the director of the European Department, was one of the staunchest and most influential advocates of this view, which European policy makers widely shared.

A US citizen who spoke fluent French, Deppler was popular in European officialdom, not only for his manner — he manifested none of the cockiness that Europeans associated with Americans — but for his depth of knowledge about the euro zone and belief in its virtues. When challenged by other Fund economists about the imbalances issue, Deppler often noted that nobody pays attention to the large trade surpluses run by some US states and the large trade deficits run by others, because US states are part of a nation with a single currency. Likewise, he contended, the creation of the euro zone, with its own central bank, had essentially eliminated the risk that member countries might suffer "sudden stops" in which they would lose access to the currency needed for their economies to function. Greece or Portugal could no more undergo that type of crisis than, say, Oregon, in other words.

This nonchalance about intra-European imbalances was especially striking because the IMF was striving mightily at the time to take a leading role in encouraging other major countries, notably the United States and China, to shrink current account deficits and surpluses. IMF reports on global trends, such as its flagship *World Economic Outlook*, repeatedly sought to raise the alarm about this issue, the mantra being that a "disorderly adjustment" (which essentially meant a large-scale flight from the US dollar) "could impose heavy costs on the global economy" (IMF 2006, Executive Summary). But Europe, being in overall balance, was spared any pressure in this regard.[6]

It would be unfair to suggest that the IMF saw no problems in the euro zone, or that it believed a crisis there would somehow violate the laws of physics. Although its reports on the countries that underwent crises look rosy in hindsight, they pointed out vulnerabilities and urged sensible reforms. But there is no gainsaying how blind the IMF was to the forces building within Europe that would eventually menace the entire globe. In a review that the Fund commissioned in 2011 of its surveillance of the euro zone, the authors, who worked at Bruegel, the Brussels-based think tank, found the Fund guilty of a fundamental error: its surveillance, they wrote, "failed to take account of the implications of being in a monetary union" (Pisani-Ferry, Sapir and Wolff 2011). As this report also stated: "The Fund was the institution best placed to recognize that credit booms, large current account deficits and large external indebtedness are eventually associated with significant turbulence. It had a clear comparative advantage with respect to the institutions responsible for EU surveillance. However the Fund fell victim to the mind-set that 'Europe is different'" (ibid., 16).

And, in another report, the Bruegel authors elaborated on this point: "[Balance of payment] crises are the bread-and-butter of IMF assistance. However, even the Fund was unprepared for the possibility of BOP crises in the euro area. In their surveillance work during the period 1999-2009, IMF staff never raised the possibility of major sovereign or balance-of-payment crises in the euro area despite their intimate knowledge of crises elsewhere and potential parallels with the euro area that should have drawn their attention, in particular consumption booms... and large current account deficits, which are typical in countries before a BOP crisis" (Pisani-Ferry, Sapir and Wolff 2013, 9).

An unflattering assessment, and it is well deserved.

6 In one high-profile initiative, dubbed the Multilateral Consultations, the Fund convened discussions in 2006-2007 among representatives of five big economies, the hope being that they would reach an agreement or at least accelerate efforts to reduce overspending and excessive borrowing in deficit countries while inducing surplus countries to rely less on exports for economic growth. The five economies naturally included the country with the most gaping deficit — the United States — and the biggest surplus generators, namely China, Japan and Saudi Arabia. The euro zone was the fifth economy represented, because of its size. But the IMF's concern regarding Europe had nothing to do with the surpluses in the north and deficits in the south. Confidential records of the discussions that took place, and the IMF's own internal memos preparing the initiative, include no mention of those internal imbalances. Rather, the Fund exhorted Europe to boost overall productivity and growth, thereby helping at least a little in absorbing goods produced elsewhere and sustaining global economic expansion.

THE ULTIMATE SYMBOL OF CLUELESSNESS

In the fall of 2007, the IMF was pulsing with a frisson of excitement as a new managing director, Dominique Strauss-Kahn, arrived to replace de Rato, who had resigned citing family reasons. Strauss-Kahn was far more charismatic than de Rato had been, and he wowed his subordinates with his dynamism and engagement, typically arriving at meetings with small pages of bullet points, which he discussed with an impressive command of detail.

But he came under orders from the biggest shareholders, in the form of the Group of Seven (G7) major industrial nations, to downsize the institution, given the doubts that had arisen about the need for a sizable crisis lender, as well as the Fund's own inability to generate sufficient income to cover its expenses. Those orders included a significant reduction in personnel, the first in the Fund's history. Previous efforts to trim the Fund's operating budget had made little headway, because of resistance among the board and staff to cuts in expensive perks such as home leaves. Now, demands were coming from the US Treasury and members of the US Congress in particular, for shrinkage of an international bureaucracy that appeared to be doing a lot less than before while continuing to receive handsome compensation. (Entry-level Ph.D.'s at the IMF were earning salaries between US$79,600 and $119,400, tax free.) And the US authorities had leverage, because in order to obtain the income necessary for financing its budget, the Fund was planning to sell some of its gold reserves, for which shareholder approval (including that of Congress) was required.

In early December 2007, Strauss-Kahn announced plans to cut staff by as much as 15 percent — 300 to 400 positions. With his customary aplomb, he managed to explain the necessity of this move in ways that appealed to the staff's logic as economists: it would not be credible for the Fund, an institution that often preached budgetary frugality, to shore up its revenue through gold sales without taking commensurate action on the expenditure side, he argued. The lavish pay and bonuses that Wall Street firms were offering ex-IMF economists, to be sure, helped dampen the distress with which the news was received. Still, it was a demoralizing period. "It was the low point of my career. My worst experience in the Fund was managing that process in my department," recalled Teresa Ter-Minassian, who was director of the Fiscal Affairs Department.

The downsizing can be seen as the ultimate symbol of cluelessness among the world's top economic policy makers about impending developments in financial markets; it was akin to a fire department laying off its hook-and-ladder crew for lack of recent blazes even as smoke was wafting around the firehouse. By that time, early signs of the global crisis were manifest, in the near-collapse of two hedge funds that had invested heavily in securities backed by US mortgages, similar woes at the mid-sized German lender IKB Deutsche Industriebank AG, the shocking run by depositors to withdraw money from the British bank Northern Rock, and a seize-up in markets in August 2007 that required emergency injections of vast amounts of cash by the ECB and the US Federal Reserve.

Strauss-Kahn was plenty uneasy about the ramifications of those market developments on economies around the globe, and he demonstrated readiness to scrap the IMF's traditional ways of thinking about such issues. During a public colloquy with economist Larry Summers at the World Economic Forum in Davos, Switzerland in January 2008, Strauss-Kahn asserted that major countries should pursue more expansionary fiscal policies to help stimulate demand. Surprised by this stark departure from the Fund's past emphasis on budgetary stringency, Summers said, "This is the first time in 25 years that the IMF managing director has called for an increase in fiscal deficits, and I regard this as a recognition of the gravity of the situation that we face" (Giles and Tett 2008).[7]

But spurred on by G7 board members, Strauss-Kahn forged ahead energetically with the downsizing. "I remember he asked me, 'Why do we need a Stand-By Operations Division, when we have so few stand-by's?'" said Mark Allen, who was then the director of the department overseeing that division. (A stand-by arrangement is a typical form of IMF loan to a financially distressed country.)

The idea was to avoid forced departures if possible, by offering generous inducements (up to two years' pay) for people to quit voluntarily, although Strauss-Kahn made it clear that cuts would be mandatory if too few people left on their own. The problem with this approach was that the ones taking the offer might be the most talented, while the lesser lights would stay — and that, in many cases, was what happened. "In our department, we were drawing up lists of the 20 or so people who, you might say, would not affect our effectiveness if they left," said one former senior manager who requested anonymity. "A few months later, when the whole thing had been done and dusted, the

7 Kudos from other quarters followed for Strauss-Kahn's audacity, though a more nuanced message, exhorting stimulative policies only for countries that clearly had the room for it, would have looked more sensible in retrospect. Spain ended up taking the advice to heart and adopting the biggest budgetary stimulus, relative to GDP, of any euro-zone country — only to regret the move a couple of years later when serious problems in the Spanish banking system led markets to question the government's fiscal soundness. (I am indebted to Professor Barry Eichengreen for this observation.)

In any event, Summers may have been overstating the unprecedented nature of Strauss-Kahn's comments. Michel Camdessus, a previous managing director, sometimes supported expansionary policies in countries that the Fund considered to have room to engage in such policies.

people who were drawing up the list were gone, and the people who were on the list were mostly still there."

In the end, the exercise exceeded expectations. Nearly 600 members of the staff — about 20 percent of the workforce — accepted the buyout offer, which was more than intended, and the Fund told more than 100 staffers who wanted to take the package that they would have to stay. By some accounts, this process rid the IMF of a fair amount of deadwood — staffers, especially senior managers, who had worked at the institution too long and were slow to adapt to new ways of functioning.

But, in the words of the Fund's own Independent Evaluation Office (2014, 43), "the IMF lost some of its most experienced staff" — especially those well-practiced in designing and running programs — "just when it was needed." Indeed, within months the Fund would reverse course and launch a recruitment drive resulting in the hiring of more than 100 economists by the end of April 2009. These warm bodies would be required, much sooner than anybody at the Fund realized in mid-2008, during the hell that was about to break loose in global financial markets.

THE FIRE BELL CLANGS AT LAST

A momentous call from Budapest came for James Morsink, the IMF's mission chief for Hungary, shortly after his return to his desk from lunch on October 9, 2008. Less than a month had passed since the Lehman Brothers bankruptcy, and financial markets the world over were undergoing staggeringly large gyrations that week, with some of the biggest banks and securities firms in New York and London on the brink of going under as credit virtually ceased flowing. Although attention was riveted on developments in major financial centres, Hungary was also a Lehman-shock victim; indeed, a Hungarian government bond auction that day had failed for lack of buyers. It therefore came as little surprise to Morsink to hear from Andras Simor, Hungary's central bank governor, that his country was requesting assistance from the Fund. But the call for help was the first of its kind that the Fund had received in years — and the alacrity with which the institution responded reflected its determination to play a substantial part in the worldwide effort to forestall a systemic financial breakdown.

Morsink immediately put the governor in touch with John Lipsky, the first deputy managing director, whose duties included management oversight for Hungary. Approval was promptly forthcoming that day, a Thursday, for "emergency procedures," enabling a mission to depart as soon as the executive board was notified and a briefing paper could be drafted. In non-emergency cases, missions commonly take a month or even more to go through this process, so that all relevant departments get a chance to reflect and comment on how programs should be designed; the go-ahead for this mission came on Friday evening. Morsink managed to attend his son's soccer game on Saturday before rushing to the airport to join colleagues flying to Budapest.

At last, the world's firefighters were no longer condemned to sit around their firehouse. Within days of the Hungarian mission's departure, negotiations were underway on more programs — for Ukraine, Iceland and Pakistan; others would follow in late 2008 and early 2009 for Latvia, Serbia, Belarus and Romania. Not that anyone at the IMF took pleasure in the privations that were being visited upon ordinary people in crisis-torn countries, but the new sense of institutional purpose was obviously welcome, especially since it sparked widespread commentary that the world needed a bigger IMF rather than a smaller one.

Unfortunately, the IMF was not fully prepared for springing into action. The timing was especially inopportune for the European Department, whose purview included nearly all of the countries outside of the United States that were hardest hit in the weeks and months following Lehman's implosion. The department suffered from a serious dearth of grunts with experience negotiating programs; as noted previously, its staff was generally inclined toward surveillance work. (Morsink, who had worked on the Thai crisis, was an exception.) The downsizing exacerbated the staffing problem, and to make matters worse, both the department director, Michael Deppler, and his deputy, Susan Schadler, had left the Fund (Deppler in May 2008, Schadler the previous year), with neither having been replaced. An acting director, who was on the verge of leaving, was handling the department's administrative functions.

On the other hand, the Eastern European crisis afforded valuable experience for both IMF and European officials. It was a dress rehearsal for the euro-zone crisis; it obliged the Fund and European authorities in Brussels to learn how to work together — something they would have to do later under much higher-pressure circumstances.

The need for such experience became painfully clear right at the outset. Word of the IMF's Hungary mission aroused a tempest in Brussels, where the European Commission was jealously guarding its role as the executive body of the European Union and, thus, had no intention of allowing the IMF to run the whole show in Hungary. An indignant Joaquin Almunia, the commissioner for economic and monetary affairs, called the leadership in Budapest to point out that before going to the Fund, Hungary was supposed to seek help first from Brussels, which had a loan facility called Medium-Term Financial Assistance for EU member states undergoing balance-of-payments difficulties. (It was available only for EU countries that did not use the euro, such as Hungary, which has its own currency, the forint.) The Hungarians had been unaware of this facility — a forgivable oversight because it had been used only twice before, the most recent time being 1993. Given the commission's deficiency of expertise in mobilizing rescues, Almunia's tantrum evoked much eye rolling at the IMF. Strauss-Kahn mollified the commissioner so that the IMF mission could proceed, but the point was established: the Europeans would have to be at the table, even if they would not be exerting detailed control over the terms, when one of their own was in trouble. And more of their own were clearly in trouble.

Up to just a few weeks earlier, Wall Street's tribulations had generated only modest effects abroad. But as the shockwaves from Lehman reverberated around the globe, they buffeted Eastern Europe with particular intensity for several reasons. The region's exports fell precipitously in the final quarter of 2008 and first quarter of 2009 as demand for goods and services shrank worldwide. Other regions' exports suffered as well, but in Eastern Europe, the Western European banks that had previously been shifting large amounts of capital to their Eastern European subsidiaries abruptly ceased doing so because of their own needs to husband capital and cash at home —the upshot being a massive contraction of lending in the region. The failed bond auction in Hungary reflected a similar phenomenon; the Hungarian government had been selling a large chunk of its bonds to foreigners, who no longer had either the ready cash or the inclination to fund the country's large budget deficit.

As the crisis spread, the inexperience of some of the IMF missions became apparent in their difficulties drafting technical memoranda and other documents such as the "letters of intent" that top economic policy makers must sign for their governments to receive Fund loans. To compensate, a group of crisis veterans from other departments was formed; they helped the teams in European capitals formulate positions and explained how to draft the necessary documents — in some cases, by speaking late at night over the phone or in video conferences.

This did not prevent the IMF from deploying a distinct approach in these rescues, which differed in important respects from the stereotypically stringent programs of past years. Noting Strauss-Kahn's background in the French Socialist Party, pundits and media reports depicted him as launching a "charm offensive," requiring less fiscal and monetary belt-tightening than the Fund had demanded in Asia. Also noteworthy was the more relaxed approach to the number of conditions demanded of borrowing countries. The Serbian program did not require Belgrade to privatize its state-owned industries, for instance, and the Hungarian program did not include an overhaul of the country's generous pension system, somewhat to the surprise of Fund watchers. To be sure, the IMF was hardly adopting a no-strings policy to its lending; Iceland had to endure a steep rise in interest rates and Ukraine had to pass new banking legislation (Davis 2009; Beattie 2008). But even long-time critics of the Fund credited it with learning from past mistakes. "The IMF seems to be modestly improving its flexibility and conditionality, compared to its dreadful practices in previous decades," said a report published by the Bretton Woods Project, an organization that had frequently accused the Fund of disregarding the needs of the poor (Bretton Woods Project 2009).

Although the terms obviously differed according to national circumstances, they generally followed a pattern: the Fund mobilized rapid responses, and provided sizable, fast-disbursing loans — "shock and awe," Lipsky liked to call it, to the discomfort of some on the staff — aimed at impressing the markets that the countries had ample cash on hand to meet all claims coming from abroad. (Some of the Asian programs, the Thai one in particular, had drawn criticism for providing inadequate amounts of funds. The first four programs in Europe were as much as three to five times larger, in relation to the respective countries' GDP, than the Asian ones.) Before long, the IMF's pool of hard currency was starting to look uncomfortably small relative to the potential for further troubles in large emerging economies. At the landmark summit of the Group of 20 advanced economies in London in April 2009, the biggest single measure announced was the endorsement of a tripling in IMF resources, with major countries pledging specific amounts that the Fund could tap in a hurry if necessary.

In EU countries, where IMF missions had to work alongside staffers from the European Commission, the Fund was clearly calling the shots in two cases — Hungary and Romania. The IMF's superiority in program design was beyond dispute, and its loans going to those countries were bigger than the loans coming from Brussels.

However, in a third Eastern European country — Latvia — the IMF's view would clash with that of European policy makers, and the Fund would give way. It would put up a minority share of the money, and its influence over the terms would diminish accordingly. Worse yet for the Fund, the outcome would give potent ammunition to critics of IMF judgment. Despite involving a tiny nation of just 2.2 million people, the Latvian case would haunt the Fund during the still-unseen crisis in the euro zone.

A "REVERSE HUNGARY"

The IMF mission that travelled in mid-November 2008 to the Latvian capital of Riga encountered numerous logistical problems. The hotel where they first checked in, although conveniently close to both the finance ministry and central bank, had poor Internet connectivity, and team members sometimes had to crouch in the hallways near routers to send and receive emails. They also felt compelled to evacuate to Warsaw at one point, because of fears that their lives might be at risk from vengeful financial executives who were suffering major losses due to government actions. At mission meetings in the bar of another hotel where they later stayed, they had to cope with the distraction of a couple of prostitutes who regularly sat at a nearby table, soliciting drunken tourists.

Apart from those inconveniences, however, the biggest difficulty the mission faced was in pitched battles over Latvia's policy concerning its currency, the lat, which was tightly pegged to the euro at an exchange rate of about 0.7 lats per euro. (The lat could rise or fall as much as one percent, but not more, from the pegged rate.) Most IMF economists dealing with Latvia believed the currency was grossly overvalued and should decline substantially. But Latvian policy makers, backed by European officials in Brussels and elsewhere, rejected the idea of abandoning the peg, insisting that it would deprive the economy of an essential stabilizing force. So sensitive was the issue that members of the Fund mission used code words, thus making sure that if they were overheard in public places — a restaurant, for example — outsiders would not be able to decipher the conversation. "Obama" referred to a change in currency policy, since the newly elected US president had campaigned on a promise of change. "McCain" was the code word for Ilmars Rimsevics, the governor of the Bank of Latvia, the country's central bank, because of his ironclad opposition to "Obama." And "Palin" referred to Parex Bank, one of Latvia's biggest banks, not only because of the identity in the first letters of their names, but because the troubled bank was a liability to Latvia just as the Republican vice presidential nominee had appeared to be for the Republican ticket.

Of all the boom-bust stories in Eastern Europe, Latvia's was at the extreme end of the spectrum. Its economy had been one of the world's fastest growing since the dawn of the twenty-first century, with GDP nearly doubling from 2000 to 2007. Rocket fuel for the expansion came largely from foreign banks, especially Swedish ones, which enthusiastically provided credit to Latvian businesses and homeowners based on the giant strides this former Soviet satellite was making toward qualification for membership in the euro zone. Predictably, a real estate bubble materialized; the price of an average apartment in Riga more than quadrupled, in square metre terms, from early 2004 to early 2007. Just as predictably, Latvia's current account fell deeply into the red as the economy sucked in goods and capital from abroad. By 2007, the current account deficit was running at an eye-popping 25 percent of GDP.[8]

The laws of financial gravity began to work in 2007 as Swedish banks curtailed their lending spree, leading to a credit crunch and downward plunge in home prices. The crisis trigger came a few weeks after Lehman's bankruptcy, when a "walk" by depositors at Parex turned into a run that posed a severe threat to confidence in the country's entire financial system. As with a number of other Latvian banks, a substantial portion of Parex's deposits came from abroad, and the bank appeared unlikely to be able to muster the cash to make some large repayments on obligations that were coming due in 2009. Chances also appeared dim, given the way money was flowing out of the country, that the Bank of Latvia would have enough hard currency to keep the banking system afloat, especially since it also had to maintain ample reserves to support the lat exchange rate.

That was why the Latvians turned to the IMF (after making their first request to the European Commission, as they were supposed to do), and it also helps explain why the Fund wanted a change in currency policy as a condition of providing a loan. A country with a large current account deficit needs foreign creditors and investors to pour money in to keep the economy moving, but foreigners were doing the opposite in Latvia. The country would, therefore, have to shrink that deficit in a hurry — and using the exchange rate offered the most obvious way of doing so. The IMF's research department estimated that the lat was overvalued by 23 percent to 37 percent, depending on the methodology used, meaning that a decline in the exchange rate of that order of magnitude would be required to reduce imports and increase exports sufficiently to bring the current account to something approaching a reasonable balance.

An email sent on November 17 by Christoph Rosenberg, the IMF mission chief, conveyed the depth of Latvian antipathy toward the idea of altering the peg: "The governor [Rimsevics, of the central bank] is emphatic that any change...is completely out of the question....When I asked him if he still wanted to proceed with his request for Fund assistance under this premise, he accused me of 'issuing an ultimatum'....[The governor said a devaluation] would 'completely destroy the economy.' In fact, he said that suggesting such a thing was unprofessional and immoral (I will spare you his more graphic language used in this context.)"

The central banker was not alone. From the prime minister on down, Latvian officials contended that the currency peg was a linchpin of the economy's progress. It enjoyed enormous popular support, not least because the public understood that it would help Latvia gain euro membership sooner rather than later — and euro membership would mean moving permanently away from the despised orbit of Moscow. Moreover, Latvian policy makers feared that a decline in the lat exchange rate would lead to widespread bankruptcies, as it would inflate the debt burdens of businesses that had borrowed in hard currencies from abroad. Officials at the European Commission and ECB vigorously concurred, and cited other reasons for why any rescue program should be based on keeping the peg. The

8 For an excellent overview of developments in Latvia (including the figure on the quadrupling of apartment prices in Riga), see Blanchard, Griffiths and Gruss (2013). Also extremely insightful is Aslund and Dombrovskis (2011).

most important was the danger of contagion: modifying Latvia's exchange rate system would lead to heavy assaults on the similar currency arrangements of neighbouring countries, Estonia and Lithuania, and since Swedish banks were exposed throughout the Baltic region, a much broader crisis would likely result that might spread to the rest of Europe.

Rosenberg proposed to his superiors that the IMF should go along with the Latvians on the exchange rate issue, in part because the Fund places importance on the principle of "ownership" by the authorities in countries that undergo programs. But this would be an exercise in futility, according to hard-liners in Washington centred in SPR, which, as previously noted, is the department responsible for upholding the Fund's rigorous standards. Tessa van der Willigen, a top economist in this department, authored a memo spelling out the argument against allowing Latvia to keep the peg: "Fund support would at best buy time and at worst fail to stabilize the immediate pressures," she wrote, adding that the pro-peg camp seemed to have little understanding of how much pain their approach would entail. In the absence of a more flexible currency, turning around the current account would require "a prolonged period of low and negative growth to put downward pressure on employment and wages," combined with "draconian incomes policies" (i.e., government-mandated freezes or reductions in wages and salaries) and other politically difficult steps. Although a devaluation certainly had drawbacks, there were ways of mitigating them, van der Willigen continued, and since a shift in the currency regime was bound to happen one way or another, doing so in a planned fashion was preferable to risking a disorderly, uncontrolled crash in the lat. Strauss-Kahn largely agreed with this perspective, according to an email from another staffer, who quoted the managing director as saying at a meeting: "I don't believe for one second it will be possible to maintain the peg."

Irritated with what they considered the IMF's high-handedness, European officials vowed to proceed with the Fund playing, at most, a minor part. On December 2, Marco Buti, the director-general for economic and financial affairs at the European Commission, told Lipsky in a phone call that the Europeans were contemplating a "reverse Hungary," according to an email from Lipsky to his colleagues. In other words, instead of the IMF ponying up the bulk of the loans and dictating the key terms, with the European Commission as junior partner (as had happened in Hungary), Brussels would take the senior partner role.

This idea affronted principles on which the IMF is supposed to operate, as Reza Moghadam, one of the Fund's most powerful staffers, observed in an email to Lipsky and other senior Fund officials. Having just been appointed to head SPR, Moghadam was zealously seeking to guard against any erosion of Fund standards. His words merit quotation at length, because they are highly relevant to criticisms of the way the Fund would handle itself later in the euro-zone crisis:

> We need to explain to the Europeans that we cannot delegate responsibility for use of Fund resources [Moghadam wrote]. This applies whether we put in one cent or the entire financing of the program. The Fund needs to be able to have...underlying policies that enable us to support the program...EU can always put in place its own program and financing without the Fund if that is what they and the Latvians want but our support, and by implication that of the international community, requires a normal Fund program which can of course be done jointly with the Europeans.

Notwithstanding these high-minded sentiments, the IMF backed down, at least on the issue of the peg. A few days after Moghadam's email was written, the Fund agreed to join the European Commission and the governments of several Nordic countries in a program that would allow Latvia to keep its currency system. How did this happen? In a nutshell, the Europeans insisted, and they were in a position to get their way, given their voting power on the IMF board. To be sure, the Fund also insisted that in exchange for its support, Latvia would have to agree to extremely tough conditions, aimed at achieving what economists call an "internal devaluation," in which the exchange rate stays stable, but the economy gains competitiveness and the trade balance improves through other means, essentially a lowering of wage costs and living standards. The Latvian authorities had to slash the number of public employees by 15 percent, cut public wages by a similar percentage, raise the value added tax by three percentage points and boost other taxes on goods such as fuel and alcohol. For the Fund, the Latvians' pledges to fulfill these conditions provided substantive comfort that the program hung together in economic terms. But the political difficulty of implementing such measures was precisely why Strauss-Kahn didn't "believe for one second it will be possible to maintain the peg."

The IMF also accepted the proposal that it should play a junior partner role, providing less than one-quarter of a €7.5 billion (US$10 billion) loan to Latvia. Indeed, emails show that top Fund officials fought hard with European policy makers to keep the Fund's share as low as possible, reflecting the wariness among the Fund staff about the unlikelihood of the program's success. Approval by the IMF board came on December 23.

An important precedent was thus set: the Fund might take a subordinate position in a program in Europe, and European policy makers could prevail over the best technocratic judgment of the Fund's management and staff, if Europe was putting up the majority of the funding.

Seen from a certain perspective, this outcome was right and proper. The IMF, after all, does not consist solely of the managing director and the staff; it belongs to its shareholders, and a large segment of the shareholders held adamant views about the type of program they wanted their institution to support. Moreover, nobody could claim with certainty that the program would fail. Judgments about economic policies are always a matter of probabilities and risks, so even if the chances of the Latvian peg surviving appeared slim to just about everyone working in the IMF headquarters building, they had to admit that they might be wrong.

And they *were* wrong, at least on that very crucial issue. Long after the European-IMF program was agreed, Latvia continued to defy loud predictions by prominent economists (with whom many at the IMF privately agreed) that its peg was doomed. The resolve of the Latvian body politic to continue down the path of full marriage with Europe, and lasting divorce from Moscow, proved stronger than any economic force that technocrats with spreadsheets could imagine. To attain this national goal, Latvia underwent one of the most wrenching economic contractions in history, a fall in GDP of 25 percent from its peak in the fourth quarter of 2007 to its trough in the third quarter of 2009. The jobless rate, once as low as six percent, soared to 21 percent. But in the process, Latvia achieved its internal devaluation; amazingly, the country was running a current account surplus in 2009. This was due mainly to the fact that demand for imports had dried up, but the economy soon began to enjoy an increase in exports, thanks in part to a major reduction in unit labour costs (the expense of paying workers to produce a given amount of output), which stemmed from both lower wages and higher productivity (Blanchard, Griffiths and Gruss).

Champions of austerity would later brandish the example of Latvia as "Exhibit A" for their belief that crisis-stricken countries in the euro zone could likewise manage internal devaluations, if only they could discipline themselves to do so. The rebuttals by those opposed to austerity — that Latvia is a small, heavily trade-oriented economy different from those of the Mediterranean, and that the Latvian people might have suffered a lot less without the peg — would not impress the disciplinarians much. In this regard, too, the Latvian case had important precedental impact.

CONCLUSIONS AND POLICY IMPLICATIONS

A lot of water has passed over the dam at the IMF since the events chronicled above: the outbreak of the euro-zone crisis, which quickly overshadowed the one in Eastern Europe; the scandalous downfall of Strauss-Kahn as managing director; and the emergence on the world stage of Christine Lagarde, who has helped repair the Fund's tattered image and infuse it with glamour and grace. Indeed, from the vantage point of the present day, the period when the IMF was an obscurity-bound institution forced to undergo a downsizing can be seen as a historical anomaly. Concerns about whether the Fund has a raison d'être are a distant memory; Lagarde's pronouncements routinely receive international (if not fawning) attention and the Fund's war chest is hundreds of billions of dollars bigger than before.

Yet, developments during that pre-crisis period continue to haunt the IMF today, chiefly because of the impact they had on the Fund during the euro-zone crisis. For reasons spelled out in the preceding narrative, the Fund was in a weak position at the time the euro-zone crisis materialized in 2010. It was still recuperating from its existential crisis, a problem it had brought on itself to some extent by failing to recognize how much Eastern Europe — and later the euro zone itself — would need emergency aid. Developments in Latvia rendered the IMF even more feeble vis-à-vis Europe. Not only did the Fund accept junior partner status for the first time in the case of that country's rescue, Latvia's success at maintaining its currency peg handed an important victory to European policy makers. IMF economists might well argue (and some do) that Latvia would have suffered a less catastrophic shrinkage in its economy by following the Fund's advice to devalue, but, in public relations terms at least, the Fund ended up with egg on its face as events showed how wrong it had been to doubt the peg's long-run viability.

Small wonder, therefore, that the IMF found it difficult to avoid the situation now deplored by critics such as Mandeng, Schadler and El-Erian — that is, being accorded second-fiddle status in the Troika, and submitting to pressure from powerful European policy makers regarding the way the euro-zone crisis was handled. Understandable though this outcome may have been, however, that does not make it either right or desirable, and the implications for the future are disturbing.

For all its flaws, the IMF provides what academics call global public goods, from which all nations broadly benefit and which no single nation can deliver alone. The Fund is chief guardian of global financial stability, and given such weighty responsibilities, it has consistently strived to maintain an image as a technocratic institution, free of gross political interference. Although it has often fallen short, there are sound reasons for hewing as close as possible to the ideal. The Fund stands the best chance of success when, in both appearance and reality, it represents the interests of the world community writ large, rather than any single power or region. In the case of financial emergencies, for example, one of the Fund's primary goals is to help a country that has lost the confidence of investors regain access to financial markets. If the Fund's judgment is severely tarnished, especially by the perception of manipulation by forces from on high, its effectiveness at restoring market confidence will be eroded. Cynicism among market players about the Fund's susceptibility to political meddling makes its job much harder.

Now the danger is that when the next crisis erupts — perhaps in Asia or Latin America — powerful countries in those regions may want to use the IMF to endorse their view of how matters should be handled, possibly for narrow reasons of national interest (protecting their big banks from taking severe losses, for example). They may insist that their influence over Fund policy be comparable to that exercised by Europeans in the euro zone, and that the Fund play a junior partner role again. Regional financial institutions and ad hoc arrangements among countries are on the rise, one motive being to create alternatives to the IMF or at least influential adjuncts to it. The most recent of these is the US$100 billion Contingency Reserve Arrangement (CRA) among the BRICS countries (Brazil, Russia, India, China and South Africa), a pool of currencies intended "to forestall short-term balance of payments pressures, provide mutual support and further strengthen financial stability" (People's Bank of China 2014). The CRA, the establishment of which was agreed in June 2014, is modelled on the Chiang Mai Initiative launched some years ago among Asian countries. Although these entitles will never supplant the IMF, it is not hard to imagine that in a crisis they could be used to help tilt the terms of rescue packages in directions that suit major countries' governments, against the Fund's best judgment.

One way of viewing the events recounted in this paper is that there is little reason for concern if the IMF ends up in junior partner roles again when future crises arise. Since the Fund was so far off the mark in its pre-crisis surveillance of Europe, as well as its assessment regarding the viability of Latvia's currency, why should the Fund's judgments be taken as gospel? And, since the Fund agreed to the precedent of junior partnership set in the Latvian crisis, why shouldn't that arrangement be replicated many times over?

Such an approach would further erode the IMF's value as a global public goods provider, which would be to the long-term detriment of all. Much more appropriate lessons can be drawn from pre-crisis events. Yes, the Fund's analyses — both in surveillance and crisis management — are sometimes erroneous, a problem that stems inevitably from the bewildering complexity of modern financial markets. But the Fund should not compound those errors by shrinking from its legitimate responsibilities, or, worse yet, ceding them to other agencies or governments in ways that cast doubt upon its institutional integrity.

The Fund needs to reclaim its historic role as the ultimate arbiter of how to manage crises in which its money is at stake — and to do so, it must base its case not on its infallibility (which it clearly does not have), but on its independence, objectivity and global perspective. In other words, although the Fund cannot credibly claim to have superior insight regarding each and every crisis that comes along, it should be in a position to assert that its analysis must take priority by dint of its status as a multilateral institution empowered by the international community to exercise neutral, objective judgment about the best possible resolution. The Fund can, and in certain cases should, join with other institutions in rescues, tapping them for money to supplement its own — it has done so in many past instances. And it should obviously listen closely to those institutions' opinions, along with the views of other outsiders. But there should be no doubt about which institution is calling the shots on the terms and conditions for the assistance involved.

As things now stand, unfortunately, the IMF cannot command sufficient respect for its independence or neutrality to be able to stake out such a position. It has acquired too much baggage, especially during the euro-zone crisis, which calls its independence into question. Considerable effort will be required, both at the Fund and among its shareholders, to shed that baggage.

The first and most essential step is governance reform. The IMF's member countries agreed to a redistribution of voting shares in 2010 along with an accord to double permanent contributions. However, this agreement goes only part of the way toward reducing the surfeit of European power on the executive board relative to Europe's share of world GDP — and even then the deal has yet to be implemented. It has been stymied by a stalemate in the US Congress, where Republican lawmakers have balked at approving the necessary legislation, in part because of antipathy toward the Fund. A strong IMF is in American interests, as many commentators have correctly noted, and the White House and Congress should act accordingly.

Just as important in this regard, if not more so, would be an end to the European monopoly over the IMF managing directorship — which will in turn require an end to the US monopoly over the World Bank presidency. Despite repeated promises by US and European officials to eliminate this problem, political pressures to maintain the current system are strong on both sides of the Atlantic.

Second, the IMF should go further toward making sure that its judgments are as technocratic as possible — and considered to be so. One good way to do this would be to borrow a leaf from the World Trade Organization (WTO) by using independent tribunals to weigh in on contentious issues. The WTO's system, for good reason, is widely recognized as one of the few successful innovations in international governance. When countries accuse each other of violating the rules of international trade, panels of outside experts weigh the evidence and render judgments, which command impressive respect and compliance because of their perceived fairness and objectivity. As I have suggested elsewhere, tribunals of this kind could be used by the IMF to render verdicts on complaints that countries are guilty of fomenting "external instability" or maintaining "fundamentally misaligned" exchange rates (Blustein 2013, chapter 9). Emerging market countries are understandably skeptical that such issues will receive a fair hearing if the judge and jury consists of the IMF staff, management and board; they would probably be more willing to abide by rules if the allegations were to be judged by neutral parties according to objective criteria. The Fund ought to look for ways of incorporating this kind of mechanism into all manner of important decisions. Schadler (2012b) raises an interesting example of how this might work in cases such as that of Greece, when she posits the following question:

> Does the IMF have sufficient independence from political influences to make efficient and timely decisions on the balance between financing, adjustment and restructuring? Should a separate, independent body, charged with assessing the nature of crises — specifically whether a crisis stems from illiquidity or an inability/unwillingness to repay — be set up? Would such a body, serving its judgment in advance of decisions on financing and adjustment made by the IMF itself, help to offset political interference?

Third, the IMF board should formally adopt a "never again" position regarding the Fund's assumption of junior partner status in rescues. This would understandably draw objections from non-European countries that it is akin to closing the barn door long after the cow's escape, because it would come after the Fund had already been run roughshod over during the euro-zone crisis. The Fund cannot undo the past in Europe, but it can rectify at least some of the institutional damage that was inflicted. The board could state that if IMF assistance is required for any euro-zone member in the future — hardly an implausible scenario — members of the board representing the euro-zone's countries would be expected to refrain from voting. Jim Flaherty, Canada's late finance minister, offered this proposal (CBC News 2012). It should be resurrected and approved.

A final observation is in order about the story told in this paper. The IMF's mistakes, as bad as they sometimes are, do not stem from stupidity or venality on the part of the people who work there, who include some of the smartest and most public-spirited policy makers I have ever met. To be sure, considerations about career advancement, and the desire to please higher-ups, sometimes colour their judgment, as does "groupthink." But their policy errors are usually traceable to systemic forces, both financial and political, that are beyond the control or comprehension of civil servants working for an international institution in a world of sovereign nations and massive flows of capital traversing borders, continents and oceans. This is what makes the Fund's failures so worrisome; if replacing its economists with more competent ones was all that was required to assure its success, the task of foreseeing, preventing and mitigating financial crises would be a lot less daunting.

The IMF has a tough job. Sometimes it fails at it. Whether the measures proposed above would improve its performance could obviously be debated, but the hope is that the historical information in this paper helps inform the public debate about how to enhance the IMF's muscularity, so that it wields power and authority commensurate with the strength and vagaries of global markets. The need for such an institution has never been more manifest.

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