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**THE ASIA CRISIS**  
**The Differences Between**  
**Brazil and the Asian Countries**

By **PAULO FONTOURA VALLE**  
Minerva Participant

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## **I - INTRODUCTION**

The "Asian Crisis" that started in the middle of 1997 as a regional economic and financial crisis in East Asia has now developed into global financial turmoil.

Japan is currently in a serious recession: failure to pursue banking and structural reforms may lead to a further fall of the yen. That could eventually trigger a devaluation of the Chinese currency, followed by renewed pressures on the Hong Kong dollar peg leading to another round of the devaluation in the entire Asian region.

The economic recession in East Asia is severe and now spreading from the crisis countries (Korea, Indonesia, Thailand and Malaysia) to Hong Kong, Singapore and Taiwan with economies slowing down throughout the East Asian region.

Russia, which already devalued its currency - ruble and announced a debt moratorium, is in a serious economic crisis and this can lead to contagion to Eastern Europe with currency and financial markets being affected. Stock markets are already down in Eastern Europe.

The crisis in Asian countries and Russia have already led to contagion to Latin America: Brazil's currency is under pressure and stock markets throughout the region are down significantly.

While Latin American economies are structurally stronger than Russia, investors are increasingly averse to risk. A devaluation in Brazil could lead to contagion and a currency devaluation in Argentina, Chile, Colombia and Mexico.

Current emerging market spreads over Treasuries, are close to their highs during the 1995 Mexican peso crisis. The appetite for risk of international investors has fallen.

But Why did it happen? Are the problems the same in all countries affected? Or is it the newest and biggest contagion that occurred in the world? This essay will seek answers to these relevant questions. But, first let us turn attention to the chronology of events.

## **II - CHRONOLOGY OF THE ASIA CRISIS**

### January, 1997

- *Korea*: Hanbo Steel, a large Korean chaebol, collapses under \$6bn in debts. This was the first bankruptcy of a leading Korean conglomerate in a decade.

### February, 1997

- *Thailand*: Somprasong is the first Thai Company to miss payments on foreign debt.

### March, 1997

- *Thailand*: The Thai government says it will buy \$3.9bn in bad property debt from financial institutions but reneges on this promise. IMF Managing Director Michel Camdessus says: "I don't see any reason for this crisis to develop further".

- *Malaysia*: The Malaysian central bank restricts loans to property and stocks to head off a crisis.

- *Korea*: Sammi Steel, a Korean conglomerate, fails provoking fears of a looming corporate debt crisis.

### May, 1997

- *Thailand*: Thailand's baht currency is hit by a massive attack by speculators who decided Thailand's slowing economy and political instability meant it was time to sell. Thailand and Singapore jointly intervene to defend the baht. Moves to save Finance One, Thailand's largest finance company, fail.

- *Philippines*: Its currency is affected. The central bank raises the overnight rate to 13 percent and sells dollar foreign exchange reserves.

### June, 1997

- *Thailand*: Amnuay Viravan, who argued staunchly against devaluing the baht, resigns as Thailand's finance minister. The Primer Minister Chavalit Yongchaiyudh says: "We will never devalue the baht".

The Thai central bank suspends operations of 16 finance companies which have high levels of bad debt and orders them to submit merger or consolidation plans. Thai Prime Minister Chavalit Yonchaiyudh assures the

nation once again, in a televised address, there will be no devaluation of the baht.

- *Philippines*: The resignation of the Thailand's finance minister has immediate financial impact in the Philippines, where the overnight rate rises to 15 percent.

#### July, 1997 (beginning of the crisis)

- *Thailand*: It is forced to abandon its fixed exchange rate for the baht against the US dollar. The baht plunges more than 20% immediately and continues to slide. At the end of the month, Thailand finally asks for help from the International Monetary Fund. **This triggered the East Asian crisis.**

- *Philippines*: The Philippine central bank raises the overnight lending rate to 24 percent from 15 percent. The Philippines peso falls nearly 10% against the dollar. The IMF offers the Philippines almost \$1.1 billion in financial support under fast-track regulations drawn up after the 1995 Mexican crisis.

- *Malaysia*: Malaysia's central bank - Bank Negara has to intervene aggressively to defend the ringgit. The Malaysian central bank abandons the defense of the ringgit.

- *Indonesia*: In Indonesia, the rupiah is starting to be affected. In a surprise move, Jakarta changed its rupiah trading band to 12 from 8 percent.

- *Korea*: South Korea's Kia Group, the country's eighth largest "chaebol" conglomerate, is put under the control of a government-organized alliance of banks. Kia is the fourth of South Korea's top 30 chaebols to collapse, or nearly collapse, in 1997.

#### August, 1997

- *Thailand*: Announces publicly its austerity plan and complete reformulation of finance sector as part of IMF suggested policies for a rescue package. Central bank suspends 48 finance firms. The IMF approves a \$17 billion rescue package for Thailand.

- *Indonesia*: The Indonesian rupiah begins to come under severe pressure. It hits a historic low of 2,682 to the dollar before ending at 2,655. The central bank actively intervenes in its defense. Indonesia abolishes its system of managing the exchange rate through the use of a band it to float. The rupiah plunges to 2,755 to the dollar. Bank Indonesia tries mopping up liquidity with high interest rates.

- *Korea*: announces emergency measures, including soft loans to banks, to try to prevent bad debts overwhelming the banking system. Regional stock markets plunge again.

- *Hong Kong*: is affected for the first time and its stock market falls 17% in five days.

#### October, 1997

- *Indonesia*: The Indonesian rupiah hits a low of 3,845. Indonesia asks for help from IMF and an \$23 billion rescue package is assembled to help Indonesia stabilize its financial system.

- *Hong Kong*: The stock market crashes 40% during the month. But Hong Kong's Monetary Authority is able to counter heavy selling of the Hong Kong dollar and maintain its exchange rate with the US dollar.

- *Other countries and Brazil*:

**Oct. 27, Monday** - The loss ripples through global markets. On Wall Street, the Dow Jones industrial average posts its single-biggest point loss ever, falling 554.26 points or 7.18 percent to 7,161.15. The Nasdaq plunges 115.43 points and the S&P 500 index tumbles 64.65 points. The decline is so steep it prompts stock exchange officials to suspend trading.

Stock markets throughout Latin America suffered record losses as Asia's markets crisis rippled to other vulnerable emerging markets and investors frantically sold their holdings. Stock prices in Brazil, Argentina and Mexico saw their biggest single-day loss.

**Oct. 30, Thursday** - Speculators scenting a fresh kill outside Asia's wounded financial markets took aim at Latin American stocks and currencies on Thursday, causing heavy losses in Brazil and Argentina. Fears about the value of Brazil's Real currency and a liquidity crunch in its banking system quickly spread to neighboring Argentina and also infected Mexico's volatile markets, sending prices to their lowest levels in months.

**Oct. 31, Friday** - Concerns over the fate of world financial markets dominate U.S. stocks in a week that saw both record losses and record gains posted in record volumes of trading. After several wide gyrations, stocks closed on a positive note Friday, but ended the week well below where they were a week ago. The Dow Jones industrial average gained 60.41 points to close at 7,442.08, some 273.33 points down from last Friday's closing level of 7,715.41.

Brazilian shares rose Friday after the nation's central bank nearly doubled interest rates to fight off currency speculators. In early trading, the Sao Paulo exchange's benchmark Bovespa index gained 57 to 8912. Brazil's Central Bank raised its basic interest rate late Thursday to 3.05 percent monthly from 1.58 percent. The government was pushed into the move as speculators began an attack on the country's currency, the real, sensing that it would suffer the same fate as Asian currencies driven ever downward. A presidential spokesman said that the Central Bank already had spent \$5 billion in defending the currency.

November, 1997

**Nov. 3, Monday** - Asian stock markets rallied on Monday as a financial aid package for Indonesia helped restore calmness to the region, enabling investors there to refocus on their domestic markets and help European markets get off to a good start. On Monday, Hong Kong saw some of the most dramatic gains, with the Hang Seng index rising 2.62 percent at the opening before zooming ahead amid fresh interest in China related shares. The Dow Jones Industrial Average soared 3.12 percent.

**Nov. 4, Tuesday** - Asian stock markets got an early boost on Tuesday from Wall Street's powerful rally, but a big retreat in Hong Kong spilled over to other markets in the region, erasing many of the early gains. The recent gains in Asia reflected optimism that some calm may be returning to the region after Indonesia agreed on a financial aid package with the International Monetary Fund (IMF). But many traders remained wary about whether the gains could be sustained.

**Nov 6, Thursday** - Brazilian shares dropped 3.74 percent to 9,615 points in early trade as investors dumped equities in continuing uncertainty in the local financial markets after two weeks of global turmoil, traders said. After the shakeup in worldwide markets the last few weeks, business leaders' biggest concern was that a collapse of the Brazilian currency would devastate the economy and drag all of Latin America into a prolonged recession like that which followed the 1994 Mexican peso debacle. Brazil's central bank nearly doubled interest rates in October in an attempt to fight off currency speculators. Shares on the nation's stock exchange initially rose after the hike, but now seem to be running scared.

**Nov 7, Friday** - Heavy losses in Asia and the U.S. extended to Latin American markets on Friday, where investors in Brazil and Mexico ran scared from the global turmoil. Brazilian shares closed down 6.38 percent. The mood was further darkened by renewed concerns that Brazil's real may be the next emerging market currency to come under speculative attack as a result of its looming budget and current account deficits. The Mexican bourse took its cue from the shaky Brazil market and also posted sharp losses. The story was continued in Argentina and Venezuela, where stocks swooned in sympathy with an international market sell-off.

**Nov 10, Monday** - Brazil on Monday unveiled an \$18 billion budget belt-tightening plan designed to reassure investors it was prepared to swallow whatever bitter medicine was necessary to defend the economy against attack. The measures, which include a 10 percent hike in income tax, a 15 percent cut in 1998 federal spending and almost 33,000 job losses in the public sector, are Brazil's latest attempt to shore up its defenses against global financial turmoil. Brazil is seen as vulnerable to devaluation pressures because of its wide current account deficit, its bleeding public sector accounts and its overvalued real currency.

Market reaction to the plan was positive but cautious. At the Sao Paulo stock exchange blue chips retreated from earlier highs to end up 1.96 percent. Bankers described the government plan as aggressive but warned the measures would slow economic growth in 1998, and might even lead to recession. Higher taxes are unlikely to boost Cardoso's popularity as he heads towards October 1998 with re-election in mind. But, having staked his political future on the continuing success of the "Plano Real" economic stabilization plan which brought hyperinflation down to just 10 percent last year, Cardoso has vowed to defend the real currency at all cost.

#### December, 1997

In Brazil, progress in government reforms and currency stability bolstered confidence. A new crisis would occur after Russia's moratorium, in August 1998.

Now, having described the events, let us turn our attention to an analyze of the causes of the crisis.

### III - WHAT HAPPENED TO ASIA?

**III.1 - Main Reasons for the Crisis** Asia has been the world's economic miracle for the last 30 years. First South Korea, Hong Kong, Taiwan and Singapore, then Malaysia, Thailand, Indonesia and the Philippines have achieved remarkable rates of growth, building high-quality manufacturing industries in everything from clothes to computers.

Why are these economic tigers now struggling with collapsing currencies and plunging stock markets? Thailand, Indonesia and South Korea, the world's 11th largest economy, have had to ask the IMF for emergency loans. Even Japan, the world's second largest economy after the United States, looks vulnerable.

The Asian financial crisis took most observers by surprise, by its virulence, if not by its timing. A variety of explanations have been offered for the crisis after the fact.

The "fundamentalist" view of the crisis, most commonly associated with Paul Krugman, holds that the origin of the crisis lie in the structural weakness in domestic financial institutions in Asian countries - *"I believe that crony capitalism in general, and moral hazard in banking in particular, created a bubble economy that had to burst sooner or later. Yet it is hard to deny that there is a strong element of self-fulfilling panic in the Asian crisis"*.

An alternative view defends that the crisis was just a problem of the "panic", most often associated with Sachs and Stiglitz - *"There is no fundamental reason for Asia's financial calamity except financial panic itself"*.

The starting point of the fundamentalist argument is that crises that emerged in Asia originated in the financial system. The Asian financial crisis was a product of large capital inflows into deeply flawed financial sectors and exchange rate misalignment.

The exchange rates of most developing Asian currencies were pegged to the US dollar. During the 1990s, the *Thai bath* was fixed in a narrow range of 25.5 to 25.6 to the US dollar. The *Malaysian ringgit* was allowed a bit more flexibility, staying within a 10 percent band of 2.5 to 2.7 ringgit to the US dollar. The *Philippine peso* moved within a 15 percent band of 24 to 28 to the US dollar until 1995 when was fixed at 26.2. *Indonesia* maintained a crawling peg, and the currency was allowed to depreciate in nominal terms from 1,900 *rupiah* to the US dollar in 1990 to 2,400 *rupiah* at the beginning of 1997. The *South Korea won* followed a controlled float, but was held within a narrow range of 770 to 800 won to the US dollar from early 1993 to mid-1996, when it was allowed to depreciate by about 10 percent.

Companies in countries like South Korea, Indonesia and Thailand, borrowed vast sums of money as their economies boomed. Even worse, they borrowed much of it in US dollars because interest rates were much lower than on their own currencies. As the exchange rates of local currencies were pegged

against the dollar, so they had no fears about having to earn money in local currency to pay back loans in dollars. This was fine while the economy was booming.

The existence of lower interest rate internationally, together with the existence of long-standing exchange rate pegs, encouraged financial institutions to borrow foreign exchange abroad, convert it into domestic currency, and lend it domestically, assuming the exchange risk. These reckless practices were facilitated by weak and careless supervision.

But from the middle of 1995, the US dollar started to rise against the yen and major European currencies, so Asia's exports became more expensive and less competitive on world markets, in what were major exports markets. Moreover, the Asian countries' inflation rates, despite being low, were higher than those of most developed countries.

These two effects generated modest real effective exchange rate appreciation. In 1996 export growth began to slow significantly and the composition of capital inflows began to change. While much of the inflow in the 1980s had taken the form of foreign direct investment, the composition of the capital inflow began shifting toward more liquid portfolio investment in 1990s.

The savings-investment became more concentrated in the non-traded sector. Much of it was concentrated in assets of relatively fixed supply such as land and real state. These investments were mediated by local banks and non-bank financial institutions, in the widely held belief that governments would not allow these institutions to fail.

### **III.2 - Speculative Attack**

From May of 1997, international banks and money traders came to realize that Asian currencies would have to abandon the dollar peg and be devalued in order to revive exports. Asian governments resisted, knowing that a devaluation would cripple firms which had borrowed huge sums in dollars and would now have to earn much more in local currency to pay back the loans.

Focusing first on Thailand, the money traders sold massive amounts of Thai baht often selling it forward, that is concluding a sale today but promising to deliver the currency at a date one month or more in the future. They were betting that when the date came, they would be able to buy the baht they needed for much less than they had already sold them for, making an instant profit.

Once capital flows are reversed, the process feeds on itself: asset prices begin to fall, creating nonperforming loans and eroding the value of collateral. Foreign lending dries up, and the stock markets fall and net capital flow turns negative.

The rush for foreign investor to exit put pressure on the exchange rate peg. The conventional remedy is to raise interest rates, but given the fragile state of the domestic financial system, monetary authorities were forced to choose between maintaining the peg or solvency of the domestic financial system.



Asian governments tried to resist devaluing their currencies. When the traders sold the local currency and bought dollars, the Asian central banks bought the local currency and sold dollars. But even central banks had run out of dollars.

Inevitably, the peg was abandoned, and the currency collapsed. First Thailand, then Malaysia, and Indonesia gave up the fight and allowed their currencies to devalue. Stock markets plunged because it was clear many companies would have problems repaying dollar loans. For firms with a significantly high foreign currency debt, the exchange rate depreciation meant insolvency and bankruptcies cascaded through the financial system.

Hong Kong had enough reserves of dollars to fight off the traders, and even there the stock market crashed because it was clear that the cost of keeping the Hong Kong dollar pegged to the US dollar would be high. Hong Kong exports would become uncompetitive and interest rates would have to be kept high to make the Hong Kong dollar attractive, so businesses would slump.

As the crisis spread, weaknesses in the Asian economies which had seemed unimportant during the boom suddenly looked serious. Much of the vast amounts of borrowed money had been spent on speculative property developments, prestige projects and unneeded factories.

The problem was bad in Thailand, where a succession of weak governments had allowed money to flood into building unwanted skyscrapers rather than investing in roads, telecommunications and education.

But it was worst in South Korea, where the entire economic system was based on the government encouraging banks to make cheap loans to big conglomerates for continual expansion, regardless of world demand. Reality had to bite, and four of South Korea's chaebol conglomerates collapsed or nearly collapsed in 1997.

As I've demonstrated in this section, the financial sector was a major contributor to the crisis. The next chapter will describe in further detail the current problems confronting Asian governments.

## **IV - CURRENT PROBLEMS IN ASIA**

### **IV.1 - Moral Hazard and Financial System**

The Asian financial crisis was a product of large capital inflows into a deeply flawed financial. A combination of inadequate financial sector supervision, poor assessment and management of financial risk, and the maintenance of relatively fixed exchange rates led banks to borrow large amounts of international capital, much of it short-term, denominated in foreign currency, and unhedged.

East Asian governments didn't guard them against the possibility of currency devaluation. So bankers assumed they would forever be able to make an easy baht or rupiah by borrowing in dollars to buy local currency assets. Now, however, borrowers are repaying loans in plummeting local currencies, making the banks dig into their own pockets to meet their dollar liabilities.

According to the Bank for International Settlements - BIS, at the end of 1996 foreign currency debt with a maturity of less than two years was equal to about 120% of foreign-exchange reserves in Thailand and nearly 200% of reserves in both Indonesia and Korea.

The bankers' second error was to lend recklessly on property. Convinced that demand for offices, hotels and luxury homes would continue to soar, they threw money at grandiose construction projects. But overcapacity has caused rents and prices to fall sharply in many Asian cities. That, in turn, has squeezed some of the biggest banks, which now typically have between 15% and 40% of their loans committed to properties, as we can see below:

	<b>Property Exposure</b>	<b>Nonperforming Loans in 1997</b>	<b>Nonperforming Loans in 1998</b>	<b>Capital ratio</b>
<b>Thailand</b>	30%-40%	15%	25%	6%-10%
<b>Malaysia</b>	30%-40%	7.5%	15%	8%-14%
<b>Indonesia</b>	25%-30%	11%	20%	8%-10%
<b>Korea</b>	15%-25%	16%	22.5%	6%-10%

Source: JP Morgan - Asia Financial Markets, January 1998

But perhaps the most important error was caused by a mixture of hubris and inexperience. Convinced that rapid economic growth would forever rescue them from bad lending judgments, bankers failed to examine the financial risks they were undertaking.

Regulators have failed to check bankers' bad habits. In retrospect, these countries have provided an object lesson in how not to deal with a banking system in distress. For a long time, the government and regulators turned a blind eye to growing evidence that lending to a property bubble had contributed to a dangerous level of bad debts.

In 1996, one of the country's 15 commercial banks, Bangkok Bank of Commerce, went bust. The government rescued it. The bank had lent large sums to corrupt politicians, provoking accusations of a stitch-up between the institution and its supervisors.

Thailand's central bank has also blessed the banking sector with lenient disclosure rules. Until recently, these allowed banks to regard a secured loan as "performing" even if no interest had been paid for a year. As the property glut grew worse, the value of assets held as security by lenders became a matter of guesswork.

The government had to suspend 58 finance companies, or specialist lenders. But it has not suspended any of the country's commercial banks. The central bank said to be spending 100 billion baht (\$2.6 billion) a month to keep the financial system going.

Lax supervision has hampered Indonesia, too. Thanks to deregulation in the past few years, the number of commercial banks exploded. But the country's

central bank failed to step up its monitoring of the risks involved.

The cost of bailing out distressed banks has been upwards of \$250 billion in emerging markets since 1980, but the problem has by no means been limited to the developing countries. Over the past decade, America, Britain, Japan and a number of other rich countries have all fallen victim, to a greater or lesser extent, to economic instability generated and then amplified by the banks.

## **IV.2 - The Latin America Experience**

The best example of how to fight against the east Asian banks crisis may well be those who witnessed Latin America's banking crisis of 1994-95.

The 1994-95 crisis had many features similar to those at work in Asia today: economies leveraged to the hilt with short-term, foreign debt; meddlesome politicians; currency devaluation; flighty foreign portfolio investors; imprudent and inexperienced banks; and, to cap it all, regional contagion.

As Mexico's bad loans ballooned to a quarter of all loans outstanding, the illness spread to Argentina, where panicky bank customers withdrew 40% of their deposits in early 1995.

The cost of clearing up that mess was huge. In Mexico alone, the final bill for repairing the financial system is likely to top \$30 billion. This would have been impossible to meet without an enormous rescue package from America and the IMF. Still, Latin American governments deserve credit for introducing a series of measures that have put their banks on a sounder footing and helped to shorten the road to economic recovery. The main features of the measures adopted are:

a) Open banking to foreigners: Since the crisis, foreign banks have gone into the region, lured by bank privatization and a relaxation of ownership rules. The newcomers have brought capital and high standards of credit assessment and service, which the remaining local banks have to emulate in order to remain competitive. Over a fifth of Mexico's banking system is now in foreign hands. By contrast, Asia's banking markets are still highly protected.

a. Encourage consolidation: Latin governments moved quickly, admittedly under international pressure, to close the worst banks. But they had to strike a balance, as too many closures risked undermining confidence rather than restoring it. The solution was to raise banks' capital requirements and, above all, to force them, thus leaving cash-strapped institutions no alternative, but to merge with rivals or die.

Since 1995, over a quarter of Argentina's 200 banks have been swallowed by competitors, strengthening the system's resistance to shocks. Some Asian governments have tentatively encouraged mergers, but have then usually given in to opposition from the bank owners, who guard their independence jealously.

c) Tighten supervision and regulation: In Chile, the central bank visits banks regularly and classifies them according to how responsibly it thinks they are grading their loans; it then publishes its findings. Banks are made to classify their loans according not just to borrowers' past behavior but also to their future prospects. Sometimes they are required to build reserves against loans that are not yet in default but look like becoming shaky. Some governments have completely overhauled the regulators' duties.

Similarly, Argentina has developed a new approach to supervision which shares the burden of overseeing banks between the state and the market. The central bank monitors banks' auditors, as well as the banks themselves. Banks are made to issue bonds linked to the value of their deposits the idea being that the price of the bonds indicates how strong the market considers the banks. In addition, Argentina's central bank has imposed capital adequacy rules that are tougher than international norms in order to compensate for unforeseen volatility. That could be very useful in Asia.

d) Improve accounting and disclosure: Latin regulators have learned that crisis hits harder when banks have been able to hide their problems behind misleading numbers. Mexico has made its banks adopt accounting standards based on America's. Argentina has also brought in tougher rules, including one that requires banks to set aside higher reserves for loans with high interest rates (ie, those that are deemed riskier). Contrast this with, say, South Korea, where banks do not even have to disclose, let alone make provisions against, all of their suspect loans.

e) Cut links between bankers and politics: In Latin America this has been achieved by putting banks in the hands of professionals, and enforcing anti-corruption laws more rigorously.

These reforms have also been adopted in Brazil, where regulation and supervision has been tightened and all banks are forced to comply with the Basle Committee until 1999. The regional banks have been privatized with incentives and a credit line from the Central Government.

How we can see, the 1994-95 crisis in Latin America highlighted the importance of reform in financial institutions. Despite Brazilian government have adopted measures to enable stricter regulation of the banking system, structural economic problems persist.

## **V - CURRENT SITUATION IN BRAZIL**

### **V.1 - Main Events that Occurred**

The government has accelerated the dismantling of the corporate state built up since 1940s, by selling companies in the telecommunications and utilities sectors. Last year it raised US\$ 17.8 billion through privatization, compared with US\$ 14.8 billion between 1991 and 1996. In July, Brazil successfully sold Telebras, its giant telecommunications company, raising US\$ 19.3 billion in Latin America's biggest ever privatization.

Foreign investment has flooded into the country in other sectors as well. This year international companies are expected to invest US\$ 22.5 billion in

Brazil, in spite of the Asia crisis and Russia's moratorium.

The banking system has been strengthened. Following a string of takeovers in 1997 and 1998, well capitalized foreign banks, such as HSBC, ABN, Santander and BBV, have effective control of 19% of the bank system, compared with 10% at the end of 1996. Many smaller and weaker banks have disappeared and regulation and supervision has been tightened. Between 1995 and 1997 31 banks were liquidated and 74 changed ownership.

There are two concerns about the Brazilian economy: current account and fiscal deficits. Since 1995, Brazilian imports have increased much more quickly than exports. Trade surpluses registered during the period between 1990 and 1994 have become trade deficits. The current account deficit is nearly 4% of the GDP.

Until the recent turmoil, Brazil could count on a combination of direct investment and debt on the capital markets to finance this gap.

However, the reduction of funds available for emerging markets imposes the need for a lower dependence on external savings. The interest paid by Brazil and other emerging market borrowers has increased and the markets will be effectively closed for many borrowers.

The deterioration of the international scenario affected market confidence in the government's capability of sustaining its currency, leading to a process of international reserve losses in Brazil.

The foreign reserves plunged from US\$ 70 billion to less than US\$ 45 billion in few weeks, and it forced the government to raise interest rate twice, from 19.25% to 49.75%.

## **V.2 - Measures Adopted by Brazilian Government**

After the facts related above it is clear that the fiscal adjustment assumed a major role, compromising the former policy of a gradual fiscal adjustment.

Thus, the President Fernando Henrique Cardoso announced a new Fiscal Stabilization Program. This program is divided in two parts: First the program proposes to create legal mechanisms to enforce greater fiscal discipline at the three tiers of government. The main instruments are: Fiscal Responsibility Law, Social Security General Law, Tax Reform, Modernization of Labor Legislation and Federal Expenditures Restructuring.

The second part is related to the fiscal measures proposed to assure the primary surplus necessary to stabilize the debt/GDP ratio over the next few years. The target for the consolidated public sector primary surplus presented in the Fiscal Program is 2.6% of the GDP in 1999, 2.8% in 2000, and 3.0% in 2001. Given the macroeconomics assumptions considered, this primary surplus is consistent with a consolidated public sector debt stabilization at the level of 44% of the GDP.

The distribution of the fiscal effort among the Central Government (which includes Central Bank), the states and local governments, and the public enterprises is demonstrated below:

## FISCAL STABILIZATION PROGRAM

### Primary Surplus Required

GDP%

	<b>1999</b>	<b>2000</b>	<b>2001</b>
- Central Government	1.8	2.0	2.3
- State and Local Governments	0.4	0.5	0.5
- Public Enterprises	0.4	0.3	0.2
<b>TOTAL</b>	<b>2.6</b>	<b>2.8</b>	<b>3.0</b>

Source: Ministry of Finance - Brazil

To achieve this result, the Central Government strategy is divided into four lines of action: structural reforms, expenditure cuts, reduction of the social security deficit, and tax increases.

The benefits associated with Structural Measures are basically related to the approval of the Social Security Reform. The cuts in the expenditures are concentrated on current consumption and investment, preserving as much as possible the social area. The reduction of the social security deficit is going to be achieved by increasing the contributions from the civil servants, and imposing a similar contribution for retirees, who are currently exempted from this contribution. Tax increases are concentrated on the CPMF (Contributions on Financial Transactions) and COFINS, which is a social levy on enterprises revenue.

The contribution of each measures is illustrated below:

### COMPOSITION OF THE CENTRAL GOVERNMENT

Fiscal Effort for 1999-2001

Description	1999		2000		2001	
	R\$ bn	GDP %	R\$ bn	GDP %	R\$ bn	GDP %
1. Primary Result (Forecast)	(11.6)	(1.28)	(13.9)	(1.45)	(16.1)	(1.58)
2. Primary Surplus Required	16.4	1.80	19.1	2.00	23.3	2.30
<b>3. Fiscal Effort (2-1)</b>	<b>28.0</b>	<b>3.08</b>	<b>33.0</b>	<b>3.45</b>	<b>39.4</b>	<b>3.88</b>
a) Structural Measures	3.5	0.39	9.2	0.96	12.5	1.24
b) Expenditure Reduction	8.6	0.95	8.8	0.92	9.0	0.89
c) Social Security (Revenue)	2.5	0.28	4.3	0.45	4.4	0.44
d) Tax Increases	13.2	1.46	11.4	1.19	11.9	1.18

Source: Ministry of Finance - Brazil

This Program clearly expresses the importance of the fiscal adjustment to the Brazilian Government. The change of the fiscal regime, and the

generation of primary surpluses needed to keep the debt/GDP ratio stable over time, cannot be delayed.

## **VI - PROPOSED POLICY SOLUTIONS**

### **VI.1 - Measures Adopted by International Monetary Fund**

After the crisis erupted in Thailand with a series of speculative attacks on the baht, contagion spread rapidly to other economies in the region that either seemed vulnerable to an erosion of competitiveness after the devaluation of the baht or were perceived by investors to have similar financial or macroeconomic problems. As the contagion spread to Korea the possibility of a default by Korea raised a potential threat to the international monetary system.

Since its inception, the IMF is charged with safeguarding the stability of the international monetary system. Thus, a central role for the IMF in resolving the Asian financial crisis was clear, and has been reaffirmed by the international community in various multilateral forums. The IMF's priority was also clear: to help restore confidence to the economies affected by the crisis.

In pursuit of its immediate goal of restoring confidence in the region, the IMF responded quickly by:

- a. helping the three countries most affected by the crisis - Indonesia, Korea, and Thailand - arrange programs of economic stabilization and reform that could restore confidence and be supported by the IMF;
- b. approving in 1997 about US\$ 35 billion of IMF financial support for reform programs in Indonesia, Korea, and Thailand, and spearheading the mobilization of some US\$ 77 billion of additional financing from multilateral and bilateral sources in support of these reform programs. In July 1998, the assistance committed for Indonesia was augmented by an additional US\$ 1.3 billion from the IMF and an estimated US\$ 5 billion from multilateral and bilateral sources;
- c. intensifying its consultations with other members both within and outside the region that were affected by the crisis and needed to take policy steps to ward off the contagion effects, although not necessarily requiring IMF financial support. The IMF's immediate effort to reestablish confidence in the affected countries entailed:
  - a. a temporary tightening of monetary policy to stem exchange rate depreciation;
  - b. concerted action to correct the weaknesses in the financial system, which contributed significantly to the crisis;
  - c. structural reforms to remove features of the economy that had become impediments to growth (such as monopolies, trade barriers, and non-transparent corporate practices) and to

- improve the efficiency of financial mediation and the future soundness of financial systems;
- d. efforts to assist in reopening or maintaining lines of external financing; and
  - e. the maintenance of a sound fiscal policy, including provisions for the rising budgetary costs of financial sector restructuring, while protecting social spending. As it became apparent that the economic impacts of the crisis were deeper than expected earlier, fiscal targets have been progressively relaxed to accommodate the cyclical downturn in revenues without lowering public expenditure.

Forceful, far-reaching structural reforms are at the heart of all the programs, marking an evolution in emphasis from many of the programs that the IMF has supported in the past, where the underlying country problem was an imbalance reflecting inappropriate macroeconomics policies.

Because financial sector problems were a major cause of the crisis, the centerpiece of the Asian programs has been the comprehensive reform of financial systems. While tailored to the needs of individual countries, in all cases the programs have arranged for:

- a. the closure of unfeasible financial institutions, with the associated write down of shareholders' capital;
- b. the re-capitalization of the undercapitalized institutions;
- c. close supervision of weak institutions; and
- d. increased potential for foreign participation in domestic financial systems.

To address the governance issues that also contributed to the crisis, the reform of the financial systems is being buttressed by measures designed to improve the efficiency of markets, break the close links between business and governments, and ensure that the integration of the national economy with international financial markets is properly executed. Transparency is being increased, both as regards economic data (on external reserves and liabilities in particular) and in the fiscal and corporate sectors, as well as in the banking sector.

The reform efforts have been invaluablely aided by the World Bank, with its focus on the structural and sectional issues that underpin the macroeconomy, and the Asian Development Bank (ADB), with its regional specialization.

## **VI.2 - Lessons from the Crisis**

While the Asian financial crisis is still unfolding, the IMF has already begun to draw lessons from the crisis on how to strengthen the architecture of the international financial system to lessen the frequency and severity of future disturbances. The Asian crisis has once again highlighted the importance of a sound macroeconomic policy framework, and the dangers of



unsustainably large current account deficits. Beyond this, the IMF has identified six major areas where initiatives already under way should be strengthened:

1. More effective surveillance over countries' economic policies and practices, facilitated by fuller disclosure of all relevant economic and financial data. The IMF has established, and will further improve, data standards to guide members in releasing reliable and timely data to the public. The Fund is presently engaging in a consultative process with all interested parties concerning the reporting of data on monetary authorities' foreign reserves, amid the growing recognition after the developments in Asian financial markets of the importance of gross reserve and related data;

2. Financial sector reform, including better and more prudential regulation and supervision. Working with the Basle Committee on Banking Supervision and the World Bank, the Fund has helped develop and disseminate a set of "best practices" in the banking area;

3. Ensuring that the integration of international financial markets is orderly and properly sequenced (supported by, among other things, a sound financial sector and appropriate macroeconomic and exchange rate policies) in order to maximize the benefits from and minimize the risks of international capital movements;

4. Promoting regional surveillance;

5. A worldwide effort to promote good governance and fight against corruption, including the adoption by the Interim Committee of the Board of Governors of the IMF on April 16, 1998 of the "Code of Good Practices on Fiscal Transparency - Declaration on Principles" to serve as a guide for members, and to enhance the accountability and credibility of fiscal policy as a key feature of good governance; and

6. More effective structures for orderly debt workouts, including better bankruptcy laws at the national level and better ways at the international level of associating private sector creditors and investors with official efforts to help resolve sovereign and private debt problems.

These efforts need to be supported by adequate financial resources for the IMF, supplemented in case of need by other bilateral and multilateral resources, that can be deployed in support of strong adjustment programs.

All of the above steps support the long-term objective of the IMF's response to the Asian financial crisis, which is to enable the affected Asian economies to emerge more strongly to resume development and to help strengthen the international monetary system to meet the challenges of the next century.

## **VII - FINAL REMARKS**

It is very important to make a distinction among the situations of countries such as Korea, Thailand and Indonesia, that received expressive values in external financial assistance, and Brazil that is negotiating a loan from IMF.

The situation of Brazil and of Latin America is totally different. Brazil has more than 40 billion dollars in reserves. Those Asian countries when received that type of assistance had almost zero in reserves. Brazil is at an advanced stage of the financial system reformulation and now is accelerating the fiscal adjustment.

Therefore, in Brazil case is not a rescue operation, it is a preventive operation, it is an international coordination effort in which the IMF plays an important role as an element of this coordination effort.

The industrialized countries, which have already demonstrated in successive declarations, in statements by the United States' secretary Rubin and president Clinton, that they understand the importance of crisis-prevention operations, which is totally different from rescue operations.

It is an international coordination effort to prevent crises. Incidentally, this is a historic opportunity that Brazil and others Latin American countries, the multilateral institutions and the governments of the G7 countries to act in a coordinated and concerted manner to prevent a crisis that might occur were this preventive action not initiated.

Following Asia crisis and Russia's unilateral moratorium, the evaluation of the risk of emerging countries, in general, reached a level that is considered totally inadequate and that is not justified when based on the fundamentals of Brazil's economies and on efforts that its has made, and will continue to make to preserve the gains obtained over the last years.

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