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# The IMF Role in Financial Crises

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## Introduction

The growing integration of the world's economies is leading to a significantly increase in the volume of the financial markets. The increasing flow of private capital has contributed significantly to economic growth in developing countries, which can rationally allocate these resources to finance domestic investments. Although financial markets are very important to stimulate economic development, they have also contributed to a new type of crisis known as financial crisis.

Many recent financial crises in developing countries, are the reflections of the inability to minimize the risks of a change in market's sentiment. Poor macroeconomic policies leave a country vulnerable to financial crisis. The architecture of the international financial system is been questioned because of its excessive volatility, strong contagion effects and an increased scope for moral hazard in international financial markets. In this context, the IMF can play a very important role in a way to prevent the emerge of new crises and when its not possible, in a way to mitigate the crisis effects giving the necessary support to reestablish market's normality.

In the first part of this paper, we briefly explain the context that led to the creation of the International Monetary Fund and its original role. The evolution of the international monetary system (breakdown of the Bretton Woods system), as well as the Fund's evolution are also discussed.

In the second part, we try to focus on the causes of financial crises. We first try to give an account of the factors that led to the emerge of financial crises in this decade, especially the Mexican, Asian, Russian and Brazilian crises. We draw a pre-crisis scenario of each of these crises. Then we pass through the crisis development itself, ending in the IMF response for each individual case. Thus, we analyze the differences and similarities of these events, noticing their common development process and differentiating their specific causes that are often related to countries internal conditions.

The main objective of this paper is approached in the third part. There we rise the question about the new architecture of the international financial system and the IMF's role in its context. We superficially approach some of the current proposals for changing the international financial system. Thus, based on the lessons of the recent crises, we discuss the main role of the International Monetary Fund (crisis prevention and crisis management) in our actual reality and how it should be managed.

We conclude that financial markets are not responsible for crisis emerge, but its strong volatility and contagion can surely aggravate the crisis effects turning the situation economically unsustainable for the affected developing countries. In this context, the International Monetary Fund is needed to preserve the stability of the international monetary system. The Fund has the responsibility to act in a more effective way in order to prevent crises eruption and to mitigate the crises effects, helping the recovery of the developing economies in a sustainable path.

# The IMF Origins

### The International Monetary System before Bretton Woods

An International Monetary System is essential to incentive economic transactions, giving countries the condition to participate effectively in the exchange of goods and services, stimulating their development as trade leads to a rational use of resources and higher consumption possibilities. To be effective, an international monetary system requires an efficient balance of payments adjustment mechanism so that deficits and surpluses can be eliminated in a short time.

Before World War I, the prevailing international monetary system was the international gold standard. Gold constituted the international reserve asset and its value was fixed by the declared par value that countries specified. This condition to relate currencies with an internationally acceptable reserve asset (gold) helped contribute to relatively free trade and payments.

With the advent of World War I, this standard broke down and in 1920 countries permitted a great deal of exchange rate flexibility. In the middle of that decade, Britain attempted to restore the gold standard, adopting the old prewar par value of the pound. That par value greatly overvalued the pound and caused payments difficulties for Britain. With the tremendous decline in the economic activity in the 1930s, payments difficulties emerge for many countries. Governments desperate to find foreign buyers for domestic products, made them appear cheaper by selling their national money below its real value, to undercut the trade of other nations selling the same products. This practice known as competitive devaluation merely evoked retaliations through similar devaluation by trading rivals. Because of uncertainty about the value of money, nations hoarded gold and money that could be converted into gold, further contracting the amount and frequency of monetary transactions among nations. These various actions led to great reductions in the volume and value of international trade. The measures also most likely worsened the Great Depression, and the low level of economic activity continued throughout most the 1930s. Economic activity spurted upward with the advent of World War II, but involvement in the war prevented comprehensive consideration and adoption of a new system of international payments.

### The Bretton Woods System

The Bretton Woods system was in large measure the product of ambitious Anglo-American planning during the Second World War. John Maynard Keynes in Britain and Harry Dexter White in the United States were the architects behind the attempt to design a new and liberal international economic order in response to the wide fluctuations, competitive depreciation, shrinkage in trade and instability of the worlds economy in the 1930s. The results of their deliberations were incorporated in the draft Articles of Agreement of the International Monetary Fund (IMF), which were, in due course, submitted to the historic conference convened at Bretton Woods, New Hampshire, in July 1944. The IMF articles that were adopted at that conference did not merely create the legal framework for a new international institution, but also shaped the international monetary system for the next quarter of the century.

The main objective of the IMF was to seek stability in exchange rates. They developed a system of pegged but adjustable exchange rates according to what was called the par (equal) value system. The United States defined the value of its dollar in terms of gold, so that one once of gold was equal to exactly US$ 35. The U. S. Government stood behind this definition and would exchange gold for dollars at that rate on demand. Other countries then defined their currency in terms of dollars. Thus, parity values were established by agreement, but variations of 1 percent were permitted.

Another goal of the IMF was the reconciliation of country adjustments to payments imbalances with the national autonomy in macroeconomics policy. Countries experiencing balance of payments difficulties were expected to approach the fund. If difficulties were deemed temporary, a loan would be provided to finance the payments imbalance until it reversed itself. Thus there would be no need for alteration of the deficit nation's macro policies in the direction of sacrificing internal goals. This would avoid the results of an increase in interest rates to attract foreign capital, which could lead to an economy contraction causing a rise in unemployment and a fall in real income. On the other hand, with difficulties were thought to be fundamental, an exchange rate change would be approved. Further borrowing was subjected to increasingly stringent over-sight or conditions as its magnitude increases. These conditions are designed to ensure that the borrowing country is taking action to reduce its balance of payments deficit.

**The break down of the Bretton Woods System**

The Bretton Woods system has performed well from its implementation until the mid-1960s when some important problems emerged. The system was thought to be facing a liquidity problem. World trade was growing rapidly so was the size of payments imbalances. Gold was envisioned to be the primary international reserves asset, but its the supply was growing at a rate of only 1 to 1.5 percent per year while trade in the 1960s was rowing at a rate close to 7 percent per year. As reserves were not growing apace with payments imbalances, countries would have to use trade and payments restrictions to reduce their deficits and these policies could reduce the gains from trade and the rate of world economic growth.

Related to these liquidity problems was the confidence problem. The dollar was the linchpin of the system because the gold guarantee that the United States stood ready to buy and sell gold at $35 per once. However, the dollars held by non-U.S. central banks began to exceed by a substantial margin the size of the U.S. official gold stock. If all central banks attempted to convert their dollars into gold, The United States did not have enough gold to meet all demands.

Another perceived concern was the adjustment problem. This problem refers to the fact that in the actual operations of the Bretton Woods system, individual countries had prolonged their payments imbalances. Countries directed monetary policies toward internal targets rather than external ones. Thus the contraction in the money supply expected of a deficit country did not occur, nor did the expansion of a surplus country. This was especially true in respect to the United States deficit because of its concern about slow economic growth and high unemployment. In a similar vein, Germany's concern about inflation prevented it from adjusting to a surplus by expanding its money supply.

In 1967, the British Pound was officially devalued as a consequence of declining U.K. foreign exchange reserves in large part due to the speculative short-term capital flows. The devaluation was significant because the pound and the dollar were key currencies, that is, the two national currencies most prominently held by central banks as official international reserves.

The private demand for gold increased putting upward pressure on its price. This pressure could only be relieved through sales of gold by central banks. As this pressure increased, all major central banks decided in 1968 that they would no longer engage transaction with private individuals and firms. Transaction in gold between central banks would be made at the official gold price of $35 per once, but private individuals would buy and sell among themselves at whatever price cleared the private market. This new structure for gold was called the "two-tier gold market".

On August 15,1971, because of its continuing deficit, escalating inflation, and lagging economic growth, the United States announced that it would no longer buy and sell gold with foreign central banks, thereby altering the nature of the existing monetary system. Without the gold guarantee, there was no anchor to the value of the dollar. This action amounted to an abandonment of the Bretton Woods system.

After that, there was considerable turbulence in the international monetary system. Trying to work out a new set of exchange rate arrangements that would neutralize the speculation and uncertainty of the moment, the chief monetary officials of the leading industrial nations convened in Washington at the Smithsonian Institute in December 1971. This meeting led to the Smithsonian Agreement, which established a new set of par values, but further speculation against the dollar led to other changes. Britain began floating the pound in June 1972. In February 1973, the U.S. dollar was again devalued against gold and than other currencies began floating.

On January 1976, with the Jamaica Accords, the IMF made a series of changes that were incorporated into IMF's Articles of Agreements altering officially the international monetary system. The most important of these changes were:

1. Each member country was free to adopt its own preferred exchange rate arrangements

2. The role of gold was downgraded in the international monetary system. By these measure the IMF itself sold one-third of its gold holdings.

3. The role of the SDR (unlike gold and other international reserve assets, the Special Drawing Rights-SDR is a paper asset created by the IMF to provide additional world liquidity to the international monetary system) was to be enhanced. It was anticipated that SDRs would become very important in the reserve assets portfolios of central banks, although this objective has not been achieved.

4. The IMF was to maintain surveillance of exchange rates behavior. In general terms the IMF would examine all aspects of the members economy willing to avoid exchange rates manipulation, to prevent effective balance of payments adjustments and promote an orderly economic and financial conditions and a monetary system that does not tend to produce erratic disruptions.

In practice these measures essentially mean that the IMF advises its members, through regular consultations, on their exchange rate actions so that the international monetary system does not become subject to considerable uncertainty and instability.

As we can observe, the IMF has been playing an important role in determining the rules for the international monetary system, and by taking actions (some of them financial) towards its sustainability. Never than less, its role is constantly been adapted as the system develops and the yesterday's needs does not fit in today's reality.

# Financial crises

Since the 1980s, the number and costs of financial crises have risen, partly because relatively small economies are more exposed to the risk of international capital reversals. The growing integration of the world's economies led to a significantly increase in the volume of the financial markets particularly after 1990. According to the World Bank reports, the private capital flows to developing countries rose from about US$ 42 billion in 1990 to roughly US$ 250 billion in 1996. The easier availability of a relative cheap international capital may encourage excessive private risk taking, which can turn into a major when favorable financial sentiments erodes.

In this context, we will try to scrutinize the major financial crises in this decade, specifically the Mexican, Asian, Russian and Brazilian crises. We will try to focus on the root of their problems and what was done to solve them. We will pass through the IMF's response in each case, and its role in this singular challenger.

# The Mexican Crisis - 1994

**The scenario before the crisis**

By late 1993, there were some factors that were signaling as an early disequilibrium in the Mexican economy: the overvaluation of the peso and the current account deficit.

The real exchange rate had appreciated relative to the long-term average, perhaps by 20 to 25 percent. However, Mexican inflation had declined sufficiently by early 1994 that the extend of overvaluation had stabilized: the gap was no longer widening. Moreover, the U.S. dollar itself was depreciating in real terms against the European currencies and the Japanese Yen.

The current account deficit, which was balanced in the late 1980s, had started deteriorating in 1990, reaching 6.8 percent of GDP in 1993 and 7.9 percent in 1994 (see table 1). The widening of the current account deficit was the result of overall investment as well as a decline in the national savings. The external deficit did not reflect irresponsible fiscal behavior. Government consumption remained almost constant since 1990, while public investment increased marginally. The current account reflected an excess of private investment over private savings; the bulk of external borrowing in those last few years was done by the private sector. It was clear that the presence of such a large current account gap would necessitate a sharp policy turnaround if, for some reason, foreign investors decided to stop financing it.

Another important aspect is that the levels of the Mexican public debt were low by the world standards, particularly with compared to OECD countries. The public debt was reduced from 67 percent of GDP in 1989 to 33.7 percent of GDP in 1993. Of this, 21.7 percent of GDP was foreign debt and 12 percent was domestic debt (see table 2).

**The crisis development**

On January 1st 1994, the Zapatistas "army" staged an uprising in the southern state of Chiapas, and as a result of increased political uncertainty, in late February the exchange rate moved to the upper limit of the band. Interest rates did not increase substantially and international reserves did not fall; in fact from January to mid February there was an inflow direct foreign investment.

On March 23rd, the presidential candidate of the ruling party – Luis Donaldo Colosio was assassinated. This time the financial community reacted in panic. Investors, foreign and domestic, reduced their demand for Mexican securities. Under the impression that this was a shock of a temporary nature, the authorities strongly intervened to shore up the peso.

In order to attract foreign investor to put in new funds into Mexico, the government needed to increase domestic interest rates. Concerned about the risk of increasing the likelihood of bankruptcy of the banking system, that could cause additional capital flight, the government opted to maintain the exchange rate rule, and to prevent further increases in interests rates by expanding domestic credit and by converting short-term peso denominated government liabilities falling due into dollar denominated bonds (Tesobonos).

To expand domestic credit, the Mexican central bank began to buy securities from the Mexican private sector at about the same pace, and at the interest rates below those demands by foreign investors. The private sector used the pesos generated by the credit expansion to continue to fund the current account deficit. Since the central bank was pegging the exchange rate, it would sell the dollars needed to cover the deficit to the importers. As a result, the short-term dollar-denominated debt increased and reserves therefore fell in the amount of the current account deficit.

In August Dr. Ernesto Zedillo was elected president, and after an active debate within the government, no major policy changes were introduced. The decision to maintain the policy course unaltered was the result of a combination of factors. First, reserves had stopped falling in June and had remained roughly constant at $ 16 billion until October. This constancy was mostly illusory, but it surely loomed large in Mexican policymaking circles. Second, interest rate differentials between U.S. and Mexican assets were shrinking and direct foreign investment continued unabated.

In November some investors opted to reduce their exposure in Mexico, largely as a result of uncertainties linked to the inauguration of a new administration in December. By the end of the month reserves stood at $12.5 billion, with short-term public debt in excess of $27 billion, around 70 percent of it in dollar-denominated Tesobonos. The situation had surpassed a simple current account or misaligned currency problem, and had all the characteristics of a major financial crisis. Reserves at the central bank had become clearly insufficient for short-term domestic public debt.

The decline in reserves that started in November continued into December. The lack of current information on Mexico's reserves position played an important role in elaborate, magnifying the crisis. On December 20th the authorities opted for a change in policy. The exchange rate band was widened, to allow for 15 percent devaluation without any supporting program. In disbelief, investors fled, rendering the change in policy ineffective; in one day the central bank lost $4 billion. The stage was set for panic at the end of the year. The Mexican Government was at risk of default not because it was insolvent, nor it was unwilling to pay, but because it was illiquid. It lacked the reserves to cover its short-term debts as they fell due, and it could only cover the debts if it received new loans. The fear of default substantially raised the probability of the default and the authorities realized that they had no alternative but to flow the peso.

**The IMF response**

The IMF responded with the announcement of financial support program to forestall default and to bolster confidence in the Mexican economy. The financial package included the participation of the U. S. government (Exchange Stabilization Fund – ESF of the treasury was used in large scale) and the Bank of International Settlements, that jointly made available close to $ 40 billion in credit lines to avoid Mexico's liquidity problem. The program was accompanied by commitments of the Mexican Government to a set of policy lines.

By the third quarter of 1995 the specter of a major default had disappeared, as virtually all Tesobonos had been paid off. Although 1995 was a terrible year, there were some considerable improvements in 1996 and the year ended with a rate of growth of 4.5% of GDP. As foreign investors' confidence was restored in the Mexican economy, private capital flowed at increasing rates into the country, allowing the authorities to maintain stability of the peso while relaxing monetary policy and, thus reducing domestic interest rates.

Without the assurance of the substantial support from the IMF and the U.S. government, the Mexican government might well have been forced to reschedule unilaterally its external and internal debt, most notably the Tesobonos. Such an outcome would almost surely have led to a deeper and longer recession in Mexico, stronger and more persistent contagion effects for other emerging markets, and impairment of Mexico's medium-term economic growth prospect.

# The Asian Crisis - 1997

**The scenario before the crisis**

The macroeconomics fundamentals in the so-called Asean-5 countries – Korea, Malaysia, Indonesia, Thailand, and the Philippines, affected by the crises, were very positive in the years that predecessed the crises. Their fiscal position was rather far from a conventional pre-crisis period. In the early 1990s, there were some moderate fiscal deficits in a few countries (Korea, Malaysia, especially the Philippines) but they were eliminated, by 1996. In Thailand significant budget surpluses were recorded every year from 1990 through 1996. In fact they were so prudent that they were often lauded for their tightening fiscal police in response to capital inflows and incipient overheating. The public debt as a share of GDP was low (see table 3), both compared to other emerging countries and to OECD countries. The monetary growth was kept reasonably tight, resulting in low inflation.

The Asian growth rates were considerably positive throughout the 1990s. The Asean –5 countries saved a lot, but invested even more. Correspondingly, their current accounts were generally in deficit (see table 4).

Continued current account deficit may become unsustainable once accumulated foreign debt becomes large. However total foreign levels were moderate for all Asian countries in exception for Indonesia. Its debt was not substantially greater if compared to other countries such as Chile and Peru that were running by the time higher current account deficits, and both came out unscathed.

Economic activity slowed in 1996, and production over capacities built up during investment boom. In Korea and Thailand, the deceleration in production was more pronounced and led to increases in unemployment rates, while in Indonesia the economy continued to operate at close to its productive capacity. The slowdown in output growth reflected a market deceleration of export growth against the background of weakening demand in partner countries and modest real effective appreciation, which in Indonesia and Thailand led to a fall in export markets shares. In addition to this, the prices of key export commodities were declining significantly; as a result export revenue fell in Korea and Thailand, and grew only modestly in Indonesia. Current account imbalances remained large (Thailand) or widened considerably (Korea), as high domestic investment continued to outstrip national savings.

**The crisis development**

Political pressures to maintain high rates of growth had led to a long tradition of public guarantees to private projects, some of which were effectively taken under government control, directly subsidized, or supported by policies of directed credit to favored firms and/or industries. Markets operated under the impression that the return on investment was somewhat insured against adverse shocks. Such pressures and beliefs represented the underpinnings of a sustained process of capital accumulation.

The weakness in financial systems, stemming from inadequate financial sector supervision and regulation, tradition of government guarantees and heavy interference in credit allocation, led to inflated asset prices and misallocation of financial resources. Another critical fragility was associated with the maintenance of relatively fixed exchange rates that led banks and corporations to borrow large amounts of international capital, much of it short-term, denominated in foreign currency, and unhedged.

Declining asset prices provided one of the earliest signs of trouble in the region. In 1996 stock prices fell by more than 20 percent in Korea and by almost one third in Thailand. It continued in Thailand in early 1997 and was temporarily interrupted in the first half of the year. The declines in stock and property prices and the slowdown of economic activity reinforced each other, aggravated the stock imbalances, and led to a process of bankruptcies and bank failures. This weakened the already fragile situation and led to increasing difficulties in external borrowing. Policy uncertainty stemming from the lack of commitment to structural reforms by domestic authorities worsened the overall climate. From the summer of 1997 onward, rapid reversals of financial capital inflows led to the collapse of regional currencies amidst domestic and international investors' panic.

Fragile and illiquid banks prevented central banks from raising interest rates sufficiently to defend their exchange rate pegs; but this could last only until international reserves were exhausted, at which point the pegs had to be abandoned and exchange rates plummeted.

On July 2, 1997, Thailand was forced to float the bhat as a result of the financial turbulence and speculative attacks in the foreign exchange market. As a result the role region was affected and seemed vulnerable to erosion of competitiveness. The financial fragility made it easy for the crisis to spread throughout the region. As the contagion reached Korea, the possibility of default was raised and financial panic took over.

**The IMF response**

In response to the crisis, the IMF arranged programs of economic stabilization and reforms intending to restore confidence in the region. The fund approved a financial support of US$ 35 billion of its own resources to programs in Indonesia, Korea and Thailand, and mobilized US$ 77 billion of additional financing from multilateral and bilateral sources.

As the financial sector problems were a major cause of the crisis, the centerpiece of the Asian programs was the reform of the financial systems. The programs have arranged for the closure of unviable financial institutions, the re-capitalization of the weak ones, the improvement of foreign participation in domestic financial system. Structural reforms to remove features of the economy that had become impediments to growth (monopolies, nontransparent corporate practice) were undertaken. A tightening of monetary policy to stem exchange rate depreciation was adopted as well as the maintenance of a sound fiscal policy; the programs have also tried to reduce the government's interference in the financial system by breaking the close links between business and governments, improving the efficiency of markets.

The magnitude of the recession in the affected Asian countries has exceeded all initial expectations. The weakening of the Japanese economy has had a particular negative impact on demand in the region and on international market sentiment. Despite the significant setbacks that have occurred, there are also some sighs of progress. The exchange rates have strengthened from their lows; Interests rates have declined in Korea and Thailand. The current account positions have change from deficits to surpluses. Equity prices rose significantly so did their foreign reserves.

# The Russian Crisis - 1998

**The scenario before the crisis**

After the breakdown of the Soviet Union in 1991, a considerable part of the new independent countries in the region have resorted to external borrowing from multilateral, official bilateral, and the private creditors to meet their financial needs. The public sector undertook the overwhelming proportion of this borrowing, primarily to finance current spending. The median external debt /export ratio had reached 36 percent by the end of 1993. It continued to rise to 59 percent at the end of 1996, and reached an estimated 70 percent at the end of 1997 (see table 5).

This external debt buildup and concentration in the public sector was attributed to different reasons. During the early years of transition the government revenues reduced considerably generating a large government budget deficits. This was combined with substantial pressures to maintain spending levels associated with the social safety net. Initially, governments financed this spending with central banks credit, however it seemed to pressure inflation rates so the financing source was changed to external capital. Domestically, monetary stringency and uncertainty caused residents to hold savings in foreign currency rather than in banks or in domestic securities and tended to keep domestic interests rates high, while foreign loans conditions were more favorable as the interests rates were lower and the maturity was longer. In addition, the international financial community were willing to participate more intensively in the region as a perception that these countries had lower external indebtedness than most developing economies and were therefore worthwhile risk, especially as substantial margins could be picked up relative to traditional sovereign borrowers.

The advantage of the external borrowing opportunity would allow the region to adopt policies towards macroeconomics stabilization that would led to growth prospects in the transition period to a market economy, however the structural reforms were postponed in most cases.

The rising stocks of external debt increased the vulnerability to changes in the market sentiment and by the end of 1997, access to external finance tightened as market reassessed emerging markets as a consequence of the Asian crisis.

**The crisis development**

Since October 1997, Russia's financial markets faced considerable volatility. Capital outflows led to steep increases in interest rates, worsening fiscal consolidation and the nascent economy recovery. The federal tax receipts amounted to 9.7 percent of GDP, and the government, unable to collect enough revenues was often in arrears on wage and pension payments.

In 1998, the tax collection improved and for the first time, in the second quarter of the year, federal revenues covered non-interests spending. Inflation was also declining but falling oil and commodity prices reduced export revenue generating a deficit in the balance of payments. Interests rates rose and the government had to roll over US$ 1billion a week in Russian treasury bills (GKOs) or short-term rouble denominated debt.

In July, the IMF assembled a package of US$ 22 billion, on condition that the Russians undertake major tax reforms with the objective of accelerating a return to financial stability and intensifying structural reforms. The program comprised a major fiscal adjustment in 1999, with a supporting fiscal measures being put in place in the early stage and a voluntary debt restructuring scheme for GKO holders to switch to longer-term dollar obligations.

The Communist-dominated Lower House of parliament (The DUMA) rejected two tax measures (though it passed most of the legislation submitted to it) and with doubts about the ability of the government to deliver on structural reforms, the GKOs holders did not renegotiate their maturing holdings.

In this situation, as the external reserves were continuing to shrink, and the banking system was experiencing difficulties, the government and the Bank of Russia deemed it necessary to take a set of measures towards the normalization of financial and budget policy. On August 17, 1998, they opted to devalue the ruble according to a new currency band fixed at the level from 6 to 9.5 rubles for the US dollar. They also imposed unilaterally a GKOs restructuring and a temporary moratorium was imposed on private debt payments.

**The IMF response**

Since the Russia government failed to implement the structural reform program developed in agreement with the IMF, and consequently imposed a unilaterally restructure in its domestic debt, the IMF stepped aside and suspended its disbursements predicted in the broken agreement. However, it manifested its intention to collaborate financially as soon as the Russia government returned to the task of reforming its economy in a more sustainable matter.

On March 27, the IMF Managing director Michel Camdessus visited Moscow and met the Russian Prime Minister. As a result the parties agreed on a primary budget surplus of 2 percent of GDP to be realized in 1999 and most of the measures needed to achieve it. It was also agreed that the IMF would send a mission to work with the Government and the central bank of Russia on an economic policy program. This program will then be submitted to the executive board of the fund for approval and will provide the basis for an extension of the IMF financial support to Russia.

# The Brazilian Crisis

**The scenario before the crisis**

The introduction of the Real Plan on March 1, 1994 brought Brazil a precious interlude of economic stability. Combined with more open trade, a strong and stable currency forced Brazilian business to cut costs and invest in technology. As a result the inflation annual rate fell from 2500 percent in 1993 to under 3 percent by September 1998 (figure 1 shows the inflation development from Oct/95 to Mar/97); real GDP grew at an average annual rate of 4.1 percent in 1994 through 1997 (see figure 2). Real GDP per capita increased at an annual rate of 2.7 percent.

Macroeconomic and financial stability was accompanied by substantial structural reforms, including the continued liberalization of trade and capital flows, and a fundamental strengthening of the banking system. The government also introduced a vast privatization program that helped to attract record levels of foreign investments that have risen from US$ 2 billion in 1994 to US$ 23 billion in 1998.

Despite the successes in macroeconomic stabilization, the government's efforts to contain federal spending, and promote fiscal discipline at state level have remained a source of concern. Before the launching of the Real, ex-ante fiscal disequilibrium was largely transformed into ex-post equilibrium by rising inflation in a context of indexed revenues and only partially indexed expenditures. With the advent of price stability, this adjustment mechanism, which masked to some extent the serious structural problems affecting the public sector, could no longer function.

The weakness in public finances has been manifested in a significant deterioration of the primary balance of the consolidated public sector. In addition, the combination with high interest rates has contributed to the maintenance of substantial overall deficits of the public sector, and to a steady climb in the ratio of the public debt to GDP. The increasing expenditure of the public sector has necessitated a growing resort to external savings to finance the rise in domestic investment. This led to an increase in the current account deficit of the balance of payments from under 0.5 percent of GDP in 1994 to over 4 percent of GDP in 1997.

**The crisis development**

Financial markets had first attacked the Real in March 1995, as a consequence of the Mexican crises that led to the devaluation of the peso. The government responded by announcing a package of increased revenue and expenditure cuts equivalent to about 2.5 percent of GDP. The central banks also doubled its basic lending rate to 43.5 percent, and adopted a pegged exchange rate, under which the Real devalued by 7.5 percent a year against the dollar. This succeeded in rebuilding confidence and allowing a gradual return of interest rates to pre- crises level.

It seemed painless, as long as foreign capital poured in. However it was clear that the situation was unsustainable and the economy was vulnerable to other shocks, while the government did not act definite to resolve its fiscal unbalance. Although, by the end of 1997, the combination of an overvalued currency, and a soft fiscal policy had resulted in a large and growing public sector deficit and a large current account deficit.

In August 1998, the current account came again under serious pressure reflecting the wake of the crisis in Russia. The government initial response was to tighten fiscal policy by enacting cuts in federal budgetary expenditures equivalent to 1.8 percent of fourth quarter of GDP. This fiscal tightening was completed by successive increases in the central interest rates, which reached 42.5 percent in late October. These measures did not succeed in stopping the capital outflow and by the end of October the central banks reserves, that were in US$ 70.2 billion at the end of July, fell to around US$ 42.6 billion.

It became clear that a speeding-up of the pace of change in policy and reforms was more needed than ever. President Cardoso delivered a speech 11 days prior to the election saying that a major fiscal adjustment and reform effort would represent a cornerstone of a second mandate for his government.

**The IMF response**

After the reelection of President Cardoso, the government negotiated a stand–by arrangement package with the IMF. The Fund mobilized resources from the World Bank, the Inter-American Development bank, the Bank of International Settlements, other industrial countries and its own to support the Brazilian government program that totaled the amount of US$ 41.5 billion dollars. The loan was tied to an emergency program of tax increasing and spending cuts worth 28 billion Reais, by that time equivalent to US$ 23 billion or 3 percent of GDP.

The government was initially successful in implementing the elements of the fiscal package. However, as the executive branch of the government was prioritizing other issues, such as the formation of a new cabinet for President Cardoso and problems involving the resignation of the Minister Luis Carlos Mendoca de Barros, the approval of the measures agreed with the IMF were compromised. As a result, the congress rejected the proposal to increase the social security contributions and to extend it to retired ones and the proposal to raise the temporary tax on financial transaction (CPMF) ran into delay. In addition to all these problems, Itamar Franco, a former president and newly elected governor of Minas Gerais, announced a moratorium on the state's debt, raising a wave of numerous governors declaring their inability to meet their debt payments, putting the central government's fiscal efforts into terminal doubt.

On January 13, 1999, as reserves dropped precipitously, the central bank widened the exchange rate fluctuation band, and stepped up interventions in the spot and future markets. However, the market quickly demonstrated that this level was unsustainable. Thus, on January 15, the real was allowed to float.

Even though the Congress approved the remaining measures of the fiscal program, in particular the increase in social security contribution and the temporary tax on financial transaction (CPMF), these setbacks did not prevent progress. On January 29, the pressure on the exchange rate pushed the Brazilian currency to a low of R$2.15/US$ compare to with R$1.21/US$ prior to the change in regime 16 days before. The market was considering the possibility of a moratorium on domestic debt.

To compensate for the adverse impact of the depreciation of the exchange rate and considering the new floating regime, the IMF and the Brazilian government renegotiated some conditionalities of the financial support program. Basically there were some changes in the monetary policy that will have to play a key role in pursuit of low inflation by containing the growth of the monetary and credits aggregates. Interests rates will be adjusted to prevent the emergence of the inflationary pressures. The government was committed to improve the originally primary surpluses in the range of 3 – 3.5 percent of the GDP in 1999. Other measures should been take to strength the central bank 's operational independence.

Finally, on March 8th, after five weeks of discussion, the IMF announced a new agreement, which replaced the aborted accord of last November. This agreement allowed Brazil to draw a second US$ 9 billion of the amount of US$ 41.5 billion package. It also authorizes the central bank to spend up to US$ 8 billion of reserves in the coming weeks to help meet demand for dollars from private banks and firms that must pay foreign debts.

Brazil has some positive points in its favor. Unlike Russia, or Mexico, a big amount of the government domestic debt is held by local investors, mainly banks, and investment and pension funds. The financial private sector is healthy. The three private big banks are known to be solid and well administrated. Although the share of the non-performing loans in the bank's portfolio has risen from 6 percent in June to 9.2 percent in November, provisions remained above 120 percent through November. The depreciation of the real has provided an advantage to Brazil's competitiveness and the trade balance is now expected to show a more pronounced improvement. The inflation should be limited by a weak demand.

Although the situation is still unfolding, there are some prevailing positive results. There are records of capital inflows, the balance of payments is improving results, the federal government is running primary surpluses and also announced some other cuts in expenditures. The exchange rate was stabilized earlier than expected the inflation rates were lower than forecasted. Those leave some room for a decrease in interest rates that is now occurring.

**Differences and similarities of the crises**

We saw that financial crises in developing countries have a lot of similarities. First, countries become dependent on the foreign capital to finance their imbalances. Foreign financing dependence increases as these internal imbalances are aggravated, turning the country's economy vulnerable to changes in market's sentiment. More dependence means more probability that this change may occur. Normally this is followed by an exogenous element (commonly a political one) that leads to a precipitated reaction in the market, reversing the financial flow. At this point, even if the country's economic condition seems to be prosper if compared to other countries, the lack of short-term financing turns the economy illiquid and though unsustainable.

After the crisis eruption, we also find some similar elements. Usually governments devalue their currencies, stock prices fall, domestic interest rates rise, but despite all this, financial panic ensued. The IMF than comes to the scene and develops a reform program with financial support, tied to changes in internal policies to eliminate the country's imbalances (except in Russia's case, where a unilateral moratorium was imposed). As this policies changes are implemented and countries imbalances are lessened, market's confidence is gradually restored and capital begins to flow into the country.

The international financial markets are playing a very important role in developing countries, contributing to their growth and welfare. However, as the frequencies of these crises have increased, many questions are been raised toward the need of changes in the financial architecture. Before raising these questions, we should first to look at their causes and not only observe their effects. But what are their causes?

In the case of Mexico, we observe that the current account deficit was very high in the years prior the crisis, as a result of an appreciated exchange rate and also excessive external borrowing done by the private sector. This characterizes the first pre-requisite of the crisis, which is the dependence of foreign capital related to internal problems. The exogenous element that act as a precipitator of the crisis, was filled by the assassination of the presidential candidate – Colosio, The political uncertainty reversed the financial flow. The government response was not appropriated for the situation. First it was thought to be a temporary shock, maybe because of the positive future prospects created by the enactment of NAFTA. Second the banking system internals conditions were not very healthy, and a restrictive policy without an internal restructure could disrupt the entire system. The combination of these factors with the lack of current information on Mexico's reserves erupted the crisis.

Very similar to Mexico's case was the Asian crisis. Like Mexico they were very dependent on external borrowing because of their continuing current account deficits. Also their financial system was profoundly compromised and we can say, in a higher level than the Mexican's. The government's interference in the sector guaranteeing private projects led to inadequate supervision and also a misallocation of the financial resources leaving the system vulnerable to a market shock. The internal scenario was set up for a crisis.

The exogenous element than appeared. Export commodities prices declined, widening the current account imbalances. Stock prices began to fall and economic activity reduced, aggravating the stock imbalances. Bankruptcies, payments moratoria and asset prices collapse proliferated. The financial panic started, causing foreign creditors to call in loans magnifying the domestic illiquid problem. The crisis was set.

The Russian's case also fits in our observation that crisis are related to countries internal vulnerabilities, although its singular condition is different from the others. Since the break up of the Soviet Union, Russian is trying to pass from a government- oriented economy to a market- oriented one. The government role in this transition process is a very complex one, in the extension that it has to promote structural reforms in order to create an environment to encourage private economic activity and investment. At the same time it must give support to a huge social safety net, while taxes revenues generated by the private sector in this transition period are insufficient. The government has than relied on external borrowing to finance its needs. The increasing stock of external debt raised the economy vulnerability, fulfilling the first potential crisis pre-requisite, which is the dependence on foreign external financing associated with internal weak economic fundamentals.

The exogenous element can be attributed by the following factors. First the contagion effect promoted by the Asian crisis tightened the external finance. Second the fall of oil and commodities prices reduced export revenue generating a deficit in the balance of payments. These two associated with the inability of the government to deliver on structure reforms occasioned the crisis.

Unlike Mexico and the Asian countries that had a positive fiscal position before their crises, the Brazilian internal disruption is basically related to its budget deficit. This can be attributed in certain terms to the transition from an inflationary economic situation, where the government's revenues were indexed while part of its expenditures were not, masking the desequillibrium already existent. This could no longer be hidden with the advent of price stability, emerging though in a growing budget deficit. As the government expenditures were increasing and in order to finance the demand on domestic investment, external savings were needed leading to an increase in the current account deficit. Despite the positive performance of the domestic private financial sector, unlike the Mexican's and the Asian's, this was enough to fulfilling the first condition for a crisis eruption.

The exogenous element in this case can be related to two factors. First was the Russia crisis. Foreign investors sold some of their Brazilian assets in order to compensate their losses generated by the Russian moratorium. The fear that the Russian's moratorium would spread to emerging countries also contributed to the capital outflow. The second factor can be associated to the government's inability to approve its fiscal reform on time and to the political instability created by the announcement of a moratorium on Minas Gerais state's debt, complicating the central governments efforts to deal with the fiscal deficit problem. The combination of these elements emerged in the crisis.

We noticed that although financial crises in emerging markets have many common elements such as capital outflow, falling currencies, and loss of confidence, their specific causes often differ. Commonly, their causes are related to countries internal conditions, usually weak economic fundamentals, leading to a dependence on external borrowing. After the crisis emerges, the market's reaction normally surpasses a rational one, leaving the country's crisis only two options. One is to declare a unilateral moratorium that could lead to a deep and long recession, and the other one is to rely on the IMF support tied to its conditionalities.

# The role of the IMF on financial crises

The advent of financial crises has generated controversial points of views about the necessity of a new architecture in the international financial system and especially about the role of the IMF in dealing with this new reality. There have been many suggestions, but whatever solutions may be formulated, it has to consider the danger of contagion. An effort to involve private sector in solving problems of one country can lead to capital outflows from another, thus spreading the crisis even as it may be contained in the originating country. This possibility has to be taken in account.

George Soros defends that financial markets are inherently unstable, thus impose market's discipline means impose instability. He has called for an international credit insurance corporation, which would establish borrowing ceilings for individual countries, charging a modest fee to lenders and guaranteeing the loans. Restrictions to capital flows are endorsed by Jagdish Bhagwati, Paul Krugman and others. The Chilean plan, under which 30 percent of money entering the country must be held by the central bank for one year with no interest, has also been defended. Another suggestion, most prominently associated with Jeffrey Sachs, is the possibility of a formal imposition of a stay on payments by countries in crisis. At one extreme are those who ask for the elimination of the Fund, based on the argument that it has induced crises by creating moral hazard.

It is for sure that the original rationales (exchange rate stability) that emerge in the creation of the IMF are no longer relevant. Now, the major industrial countries meet when there are key exchange rate or macroeconomic coordination issues among them. The general rationale for the IMF's role is now grounded in the existence of market imperfection (excessive volatility, contagion, and panic) and in the inadequate provision of public goods.

Considering that no consensus has yet been reached about the new architecture and also what we have learned from the latest crises, we visualize two main responsibilities to the Fund. First, acting in crises prevention through strengthening surveillance and improving the arrangements for monitoring flows of international capital and second dealing with the crises by providing financing for countries needing international assistance and willing to take appropriate measures to restore market's confidence.

**Crises prevention**

The recent financial crises, have underscored the importance of more comprehensive and timely information on international reserves, to help promote informed decision-making in the public and private sector and thereby improve the functioning of the global financial markets. It is an essential task to IMF surveillance to recognize emerging balance of payments difficulties and to provide timely and relevant policy advice on how to deal with this difficulties and thereby limiting the danger of major economic and financial disruptions.

The IMF's performance in identifying emerging tensions at an early stage, particularly the Mexican's and the Asian's crises had been mixed. It was clear that some affected countries vulnerability had been underestimated, including by the markets. If timely policy measures had been taken to deal with the appreciation of the Mexican peso and the low national saving rate, Mexico might had escaped of its economic difficulties. The same idea can be related to the Asian crisis, focusing more specifically to the financial sector where prudential regulation and supervision combined with structure reform would have avoided the crisis.

Based on the lessons of the recent crises the IMF has taken steps to enhance transparency and openness, including the establishment of standards to guide countries in publishing a regular and timely flow of comprehensive economic financial data. The special data dissemination standard – SDDS are intended to establish new standards for the provision of information to the public. This information consists on the amount and the composition of reserves assets, other foreign exchange assets held by central bank and the government, short-term foreign liabilities, and related activities that can lean to demands on reserves.

The Fund has also been working to help disseminate the set of "best practices" in the banking supervision area, as developed by the Basle Committee on Banking Supervision, so that standards and practices which worked well in some countries can be adapted and applied in others. It also had adopted a code of good practices on fiscal transparency in order to enhance the accountability and credibility of members' fiscal policies.

The main incentive for a country to adopt these standards is the expectation that the economy would operate more efficiently and the hope that international investors would treat the economy more favorably. It is for sure that, their financial system should work better, and the likelihood and intensity of the crises would be reduced.

**Crisis manager**

The financial support provided by the IMF to emerging countries in recent crises has raised many questions about the "moral hazard". On the affected country side, moral hazard would arise if expectation of subsidized financial support induced governments to pursue otherwise unsound policies on the basis of the potential support would make such policies advantageous. It is clear that the economic pain of the recent crises is very substantial and no government probably would have rationally decided to risk the economic difficulties because of the expectation of financial support. Also the support program is usually tied to the implementation of structural reforms and restricting monetary measures, which increases considerably the political coast.

Another concern about the moral hazard is related to investor's side. Market agents may take on riskier behavior, in the expectation that if they fail, an IMF- arranged bailout would be provided. Russia's unilateral debt moratorium and the willingness of the fund to extend a rescue package without progress toward policy reforms, sent a message to lenders that they could not always count on international bailout.

We noticed that the financial support given by the IMF was not enough, by itself, to interfere in the recovery of the crisis economy. We could observe this specifically in the case of the Brazilian crisis, where a stand-by arrangement was settled, but the government's inability to pass the agreed reforms led to a crisis eruption. The most important element in this case is not the financial support that can give some extra time to the economy, but the measures that are tied to the agreement willing to eliminate the disruptive causes. The fulfilling of these measures have shown to be more important than the financial support, in order to restore the capital inflows and consequently giving support to the economy develops by itself.

# Conclusion

The potential advantage of global financial trade is unquestionable. Developing countries with little capital can borrow to finance investment, thereby promoting economic growth without sharp increases in saving rates. This financing contributes to the welfare of countries and their partners in trade and in capital markets transactions. However, if unsound policies are taken, (for example excessive government borrowing, inadequate bank regulation) developing countries may become more vulnerable to disturbances that can affect their balance of payments, including shifts in the world capital market condition and in investor sentiment.

The market's response in those cases can be very traumatic. It usually overpasses the rationale prospects causing large changes in asset prices and in the economic activity. The capital outflow magnifies the panic leading the economy potentially illiquid and though unsustainable.

In order to take advantage from the international financial markets, developing countries and other emerging market economies need to undertake the hard work of discipline macroeconomic policies, involving sound public finance, a stability oriented monetary policy, and a responsible and transparent supervision in the domestic banking and financial system.

The IMF has a very important role in this scenario. First it is in a unique position to exercise surveillance over its members and to identify policy problems with potential regional or global impact. This surveillance can provide early diagnosis and motivates timely adjustment that can diminish the likelihood and the severity of maladjustment in the balance of payments of its members.

Second, the presence of a Fund support program is very important not only for the financial source that it provides giving the country government some precious time to adjust. But more important are the signals for private creditors, which can restore the market's confidence, if correct policies are undertaken. Access to the fund in times of balance-of payments crises has encouraged many countries to undertake more far-reaching adjustments, than they would otherwise had.

The institution dreamed by Keynes has dramatically changed its original role as the international economy developed, but at the end it seems that Keynes objective have been reached as the Fund acts as a mediator in response to the painful market discipline.

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**Table 1**

**Saving and Investment**

(As percentage of GDP)

| | Savings | | Investment | | (S-l) | | Current Account |
|---|---|---|---|---|---|---|---|
| | Public* | Private** | Public | Private | Public | Private** | |
| **1988** | 1.4 | 17.6 | 5.0 | 15.4 | -3.6 | 2.2 | -1.4 |
| **1989** | 3.1 | 15.6 | 4.8 | 16.5 | -1.7 | -0.9 | -2.6 |
| **1990** | 6.7 | 12.5 | 4.9 | 17.0 | 1.8 | -4.5 | -2.7 |
| **1991** | 7.5 | 10.3 | 4.6 | 17.8 | 2.9 | -7.5 | -4.6 |
| **1992** | 7.1 | 9.5 | 4.2 | 19.1 | 2.9 | -9.6 | -6.7 |
| **1993** | 6.3 | 8.9 | 4.2 | 17.8 | 2.1 | -8.9 | -6.8 |
| **1994** | 5.0 | 10.7 | 4.5 | 19.1 | 0.5 | -8.4 | -7.9 |

Source: Banco de Mexico.

Notes: * Defined as the Operational Deficit plus Public Investment.

** Defined as Current Account Deficit less (S-l) public.

*** Defined as (S-1) Private plus Private Investment.

**Table 2**

**Gross Public Debt**

(as a percentage of GDP)

| | 1988 | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 |
|---|---|---|---|---|---|---|---|
| **MEXICO** | 74.7 | 66.6 | 57.5 | 46.8 | 36.3 | 33.7 | 50.7 |
| **External Debt** | 46.8 | 39.5 | 33.4 | 26.4 | 23.2 | 21.7 | 36.4 |
| **Internal Debt** | 27.9 | 27.1 | 24.1 | 18.4 | 13.1 | 12.0 | 14.3 |
| **OECD Countries** | 58 | 57.5 | 58.3 | 59.9 | 64.1 | 68.1 | 70.6 |

Sources: Informe Sobre la Situacion Economica, las Finanzas Publicas y la Divida Publica. SHCP.1995 and OECD. Economic Outlook. December 1994.

**Table 3**

**Public Sector Debt**

(as a percentage of GDP)

| | Indonesia | Korea | Malaysia | Philippines | Thailand |
|---|---|---|---|---|---|
| **1990** | 45.7 | 8.3 | 81.3 | 51.3 | 18.4 |
| **1991** | 40.3 | 11.5 | 76.4 | 49.7 | 13.3 |
| **1992** | 42.7 | 11.5 | 66.1 | 52.8 | 10.9 |
| **1993** | 37.5 | 10.9 | 59.3 | 67.1 | 8.4 |
| **1994** | 36.6 | 10.0 | 50.1 | 56.4 | 5.8 |
| **1995** | 30.9 | 9.0 | 42.8 | NA | 4.7 |
| **1996** | 24.1 | 8.6 | NA | NA | 3.7 |

Source: World Bank

**Table 4**

**Current Account Surplus**

(as a percentage of GDP)

| | Indonesia | Korea | Malaysia | Philippines | Thailand |
|---|---|---|---|---|---|
| **1990** | -2.8 | -0.9 | -1.9 | -6.1 | -8.5 |
| **1991** | -3.7 | -3.0 | -8.5 | -2.3 | -7.7 |
| **1992** | -2.2 | -1.5 | -3.4 | -1.9 | -5.9 |
| **1993** | -1.2 | 0.1 | -4.2 | -5.5 | -5.3 |
| **1994** | -1.4 | -1.2 | -5.7 | -4.8 | -8.1 |
| **1995** | -3.2 | -2.0 | -7.7 | -2.6 | -7.6 |
| **1996** | -3.3 | -4.8 | -6.5 | -3.5 | -7.5 |

Source: IMF

**Table 5**

**Ratios of External Debt to Exports (%)**

| | 1993 | 1994 | 1995 | 1996 |
|---|---|---|---|---|
| **Advanced Reformers** | | | | |

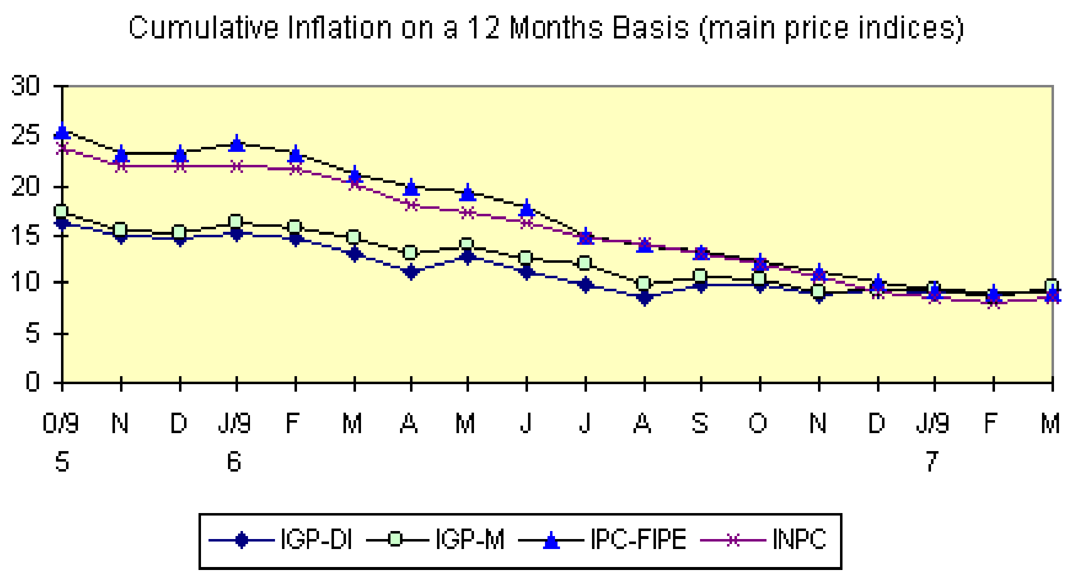
| | | | | |
|---|---|---|---|---|
| Estonja | 12.3 | 9.2 | 8.8 | 9.4 |
| Latvia | 15.3 | 23.5 | 19.6 | 18.5 |
| Lithuania | 18.9 | 26.9 | 29.3 | 34.7 |
| **Intermediate Reformers** | | | | |
| Armenia | 76.3 | 77.9 | 121.6 | 168.0 |
| Georgia | 4.4 | 204.4 | 258.8 | 255.5 |
| Kazakhstan | 38.7 | 73.2 | 59.8 | 55.8 |
| Kyrgyz Republic | 86.6 | 105.1 | 135.0 | 128.0 |
| Moldova | 56.7 | 82.3 | 90.8 | 102.5 |
| Russia | 181.6 | 152.6 | 122.6 | 126.4 |
| **Late Reformers** | | | | |
| Azerbaijan | 6.0 | 51.9 | 69.8 | 67.1 |
| Ukraine | 32.9 | 59.2 | 59.6 | 58.6 |
| Uzbekistan | 36.1 | 37.7 | 44.1 | 56.7 |
| **Others** | | | | |
| Belarus | 36.1 | 47.4 | 32.7 | 16.3 |
| Tajikistan | 111.6 | 136.1 | 124.4 | 186.0 |
| Turkmenistan | 6.2 | 12.7 | 26.4 | 39.5 |
| **Other Developing Countries** | | | | |
| Brazil | 308.1 | 286.8 | 245.9 | 194.9 |
| Czech Republic | 54.2 | 64.6 | 61.0 | 60.3 |
| Hungary | 267.2 | 319.8 | 206.1 | 201.4 |
| Poland | 276.1 | 183.8 | 122.7 | 111.5 |

'Exports of goods and services, except for Belarus, Latvia, Lithuania, the Kyrgyz Republic, Tajikistan, and Turkmenistan, which are exports of goods only.

'External debt includes public and private sector borrowing from multilateral and bilateral lenders as well as private sources (mainly commercial banks),except for Estonia and Russia, which is only public and publicly guaranteed debt. Debt also includes rescheduled debt service and arrears accumulation.

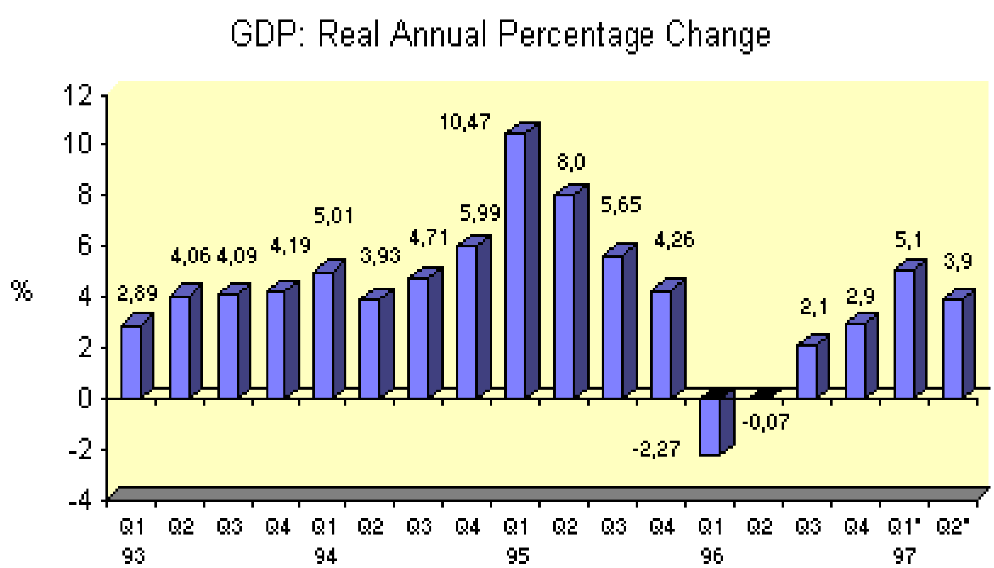
Data: IMF staff estimates

Figure 1




Source : Brazilian Central Bank

Figure 2




* Forecast by IPEA

Source : IBGE