Instituto Cultural Minerva
Institute of Brazilian Issues
The George Washington University
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The Architecture of the

International Financial System

By Maria Izabel Gribel de Castro Minervino

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I. INTRODUCTION

- **Why this subject?**

The world has about 5 billion people and a great part of them face today the effects of some international financial crisis. Nations half a world apart face the same crisis at the same time.

The frequency, virulence, and global spread of the financial crises in emerging market countries in the last five years, coupled with the Congressional debate in the United States over the increase in IMF quotas, has led to the most serious rethinking of the structure of the international financial system (IFS) since the breakdown of the Bretton Woods system in 1971.

These crises began, most recently, with the Mexican crisis in 1994, and the subsequent tequila contagion in Latin America, that reached for a day or two the East Asia. Then they took place in East Asia in 1997 and 1998, with contagion spreading crisis within the region. Russia faced its crash in 1998, affected by Asian contagion, with the Russian contagion spreading to Latin America in addition to Eastern Europe and the rest of the former Soviet Union.

The last 12 months were especially precarious, considering the recent turmoil in Brazil, the depth and spread of Asia's crisis, Russia's chaotic default on its debt and the resulting investor stampede away from risky markets, and also the collapse of the hedge fund Long-Term Capital Management. Capital markets proved volatile and susceptible to contagion, and emerging economies suffered the painful consequences.

Since mid-1997, the rapid spread of the financial crisis from East and South-East Asia to other developing and transition economies and even to the industrialized world led to important statements and decisions by the authorities of developed countries. There was a general concern about the substantial downward revisions of forecasts of world economic growth.

The integration of international capital markets has contributed to higher investment, faster growth, and rising living standards in many countries, but also pose difficult challenges to safeguard the world economy from financial crises of high intensity and frequency.

Nowadays the markets deal with a vast pool of resources for investment, economic growth, and social advancement but also with an increased risk.

The Mexican crisis started a debate through the International Financial Institutions (IFIs) about their new roles. The crises of the later-90s made this debate stronger and wider.

It is global voice that it is necessary to strengthen the architecture of the international financial system to lessen the frequency and severity of future disturbances.

- **The new face of the crises (global financial market)**

Based on the World Bank studies, 80 or even 100 countries suffered economic crises in the last 25 years, considering different criteria to define crisis, and more than 50 percent of them were financial or banking crises in developing countries. However, the more the authorities and economists work, they realize that the better policies to prevent crises won’t be able to inhibit future problems, considering specially the characteristics of the last ones.

The crises in the emerging markets since the mid-1990s all started with abrupt shifts in investor sentiment that reversed the large inflows of private capital enjoyed by most of the countries for several years.

In the global financial market, the good policies on the emerging markets help them to recover, but are not enough to protect them from the excessive reaction of the capital market, creating waves of optimism and pessimism – recognizes Mr. Stanley Fischer (IMF First Deputy Managing Director).

The risk became permanent that capital flows will dry up or reverse as market confidence falters. The international reverberations of the Asian crisis – characterized by plunging exchange rates and equity prices – were probably the most far-reaching of the postwar period.

The liberalization of financial flows among the industrialized and some developing countries, floating exchange rates, financial innovations and new communications techniques have increased not only financial transactions, but also volatility in recent decades.

The financial crises are contagious and under panic conditions markets do not adequately discriminate between countries with strong and weak economic fundamental. The crises tend to spread even to countries with sound economic structures and macroeconomic management.

At last, the recent crisis has demonstrated a fundamental problem in the global economy: the enormous discrepancy that exists between an increasingly sophisticated and dynamic international financial world, with rapid globalization of financial portfolios, and the lack of a proper institutional framework to regulate it.

- **The importance of the International Financial Institutions (IFIs)**

The International Monetary Fund (IMF), the World Bank, and the General Agreement on Tariffs and Trade (GATT) are the Bretton Woods institutions and even considering that the GATT is not a financial institution, we shall unclear it here together. These three institutions were successful and very important to the world in the postwar, fostering trade and financial liberalization, but also have created conditions to the opened individual economies, which made it more difficult for governments to reconcile their international obligations with their domestic policy objectives.

The Bretton Woods plans for the institutions then created evolved organically in response to changing circumstances. They have been especially important to the economic prosperity of the first 25 years after World War II, by promoting economic growth in the industrial countries and its spread to much of the developing world. After that, they’ve had to take some new tasks and had to face new challenges under some adaptations, but their performances became weaker and less effective.

- **Points that will be developed at this paper**

Since I do not intend to work on the world economic history as a goal, I’ll give an overview focused on the Bretton Woods financial institutions and go directly to the issues closely related to the New Architecture of the IFS and the emerging markets.

I. More than 50 years after Bretton Woods

- **Managing the World Economy under Bretton Woods' System – an overview (the past)**

Not all-postwar institutions were optimally structured at the start. Not all the problems that they would confront were anticipated by the framers of the Bretton Woods agreement. Nevertheless, the world achieved a remarkable record of economic growth in the fifty years after the war.

In the first 25 years, advanced industrial countries grew nearly twice as rapidly as in any comparable period before or since. In the next 25 years, a number of newly industrializing countries joined the "convergence club".

The institutions of Bretton Woods - IMF, World Bank and GATT- shaped and conditioned the behavior of governments, acting specially as the conservators of the rules, conventions, and understandings that structured international economic relations, although they were not able to enforce them solely by themselves.

The importance of the rules by that moment was centered in the needing of coordination to the movement toward current account convertibility and liberalization of the international trade, which allowed the industrial countries to rely collectively on export-led growth. The framework served to prevent individual governments from reneging on their initial commitments and also encouraged them to enter collectively into new commitments.

The key factors to the success, strength and flexibility of the Bretton Woods institutions, in the 25 years after the war, considered by Barry Eichengreen and Peter B. Kenen were:

1. The capacity and willingness of the United States to make side payments and apply sanctions, considering they had become the dominant economic power.

2. The small number of countries involved in designing the institutions and the economic and political homogeneity of those countries.

3. The closed nature of domestic economies, which were not, by that time, in a high exposure to international trade and factor flows. The controls that were implemented allowed the countries to pursue domestic goals without seriously violating international rules and the institutions to promote the liberalization of trade and payments.

4. The success with which the governments managed change domestically in most countries laying on the establishment of welfare states and social-market economies locked in cooperative behavior.

The IMF had an important role as the embodiment of the rules and understandings that shaped the conduct of international monetary policies and constituted the Bretton Woods regime.

Besides the World Bank had been created to finance development as well as reconstruction, its domain was limited. Nevertheless it run into its role, intermediating the capital from the capital markets of industrial countries to the governments of developing countries, with focus on the financing of individual projects. It did undergo adaptation, acquiring two affiliates – the International Finance Corporation (IFC) to engage in investment banking functions and thus promote private investment and the International Development Association (IDA) to provide concessional financing to low-income countries.

In the 25 years that followed, the Bretton Woods institutions faced new challenges and did not have the same performance they presented before. The main reasons for that could be summarized in three points:

1. After the spread of the economic growth through the world, specially to the developing countries, the system reduced the capacity of the United States to make side payments in order to gain support for existing institutions and for their further adaptation. The end of the Cold War reinforced this process by diminishing the interest of the United States on doing the side payments.

2. The success of the IMF, the World Bank, and the GATT attracted more countries to join these institutions and it brought requirements of a New International Economic Order. The scenario turned to more complicate negotiations and sharper cleavages between developed and developing countries, between exporters of manufactures and of primary products, and also between international borrowers and lenders.

3. The liberalization of the trade and financing among the countries began to enforce most economies to choose between adherence to international rules and independent pursuit of domestic economic and social policies. This conflict has weakened support for the existing institutions and has given new concerns to the further reforms and adaptations.

The institutions went through some reviews periodically in order to maintain their roles and importance.

- **A market-led global financial system – new issues**

In the 1980's, the market-led international monetary system emerged in its entirety and it's commonsense that the emergence of global financial markets has fundamentally altered the reality that the IMF was intended to manage. The institution remains promoting exchange rate stability and adjustment, but no longer has the power to pursue such goals on a global scale.

The revolution in communications and information technology, domestic and offshore financial markets were opened and integrated into a single global market, including all the industrial countries as well as a growing number of developing countries.

The narrowing of the wide institutional gap between the global nature of the market-led international monetary system and the domestic charter of central banks turned to be a major problem.

The mobility of capital worldwide and the impact of international finance on the conduct of monetary policies by the 70's were to prove Bretton Woods inadequate for a world economy that its rules and institutions had helped to integrate before.

The key task that a "new Bretton Woods" would have to run into would be the reforming of the international monetary and financial relations. There would have to be observed the new demands, once a more complete set of policy functions became necessary to ensure monetary and financial stability in global financial markets that were replacing an environment of highly regulated and segmented domestic financial markets.

Considering the three main points to manage the financial issues, which are:

- monetary and exchange rate policies;
- payment systems oversight and operations; and
- banking supervision,

the Bretton Woods system and specially the IMF were managing, somehow, only the first element and domestic systems were covering them all.

By the emergence of the market-led international monetary system raised significant public interest issues in each of these three areas. Indeed, in each of them there has been some response from monetary authorities or market participants at the international level. These responses have been weak in the field of monetary and exchange rate policies, and surprisingly strong and innovative in the fields of international payments and banking supervision.

The decision to create the World Trade Organization (WTO), the signing of the General Agreement on Trade in Services (GATS), the growth of regional trade rules/agreements, and the establishment of the Committee of Banking Supervisors in Basel were effective to limit the negative externalities up to the 1990's.

- **Foreign Direct Investment (FDI): Strengthening the Policy Regime**

The FDI is nothing new or something that had happened in the aftermath of Bretton Woods. Nevertheless, it should be focused in the purpose of this paper, the improvement in this issue from the 1983 on. The decade since the recession of the early 1980's has seen a remarkable surge in cross-border investment.

The most different economics points of view recognize the importance of international direct investment as a wealth-creating and welfare-enhancing flow, especially up to the early 1990's.

There is a convergence of international opinion on the desirability of FDI, which may have created a window of opportunity for a change in regime in order to encourage investment.

Studies show that the positive attributes of the FDI, as the transference of technology or the improving on the number of jobs around the world, do not imply that it has to be facilitated through protective rules or actions.

However, since the process for settling disputes is a complex and indirect one for a company with a complaint in this universe, further efforts both to negotiate more liberal rules – sector by sector – and to improve the enforcement of those rules became clearly needed.

A lesson of the 1980's is that private companies are more likely to invest and expand into new markets when the number of regulations and institutions governing them is reduced, not increased. Institutional interventions, especially at the international level, should be limited to areas of clear market failure.

The areas of market failure for FDI have been greatly reduced over the half-century since the Bretton Woods Conference and private financial markets have developed hedging instruments and diversification techniques that allowed investors to manage exchange rate risks.

Its important to say that, the WTO provided a skeleton, on which some sectoral codes were built, regarding the trade issues over the enterprises concerns, and the IMF worked for reductions on the exchange rate risks for the investors. Nevertheless, the 1990's did not see the completion of the process of strengthening the policy regime. The tightly woven world economy, of the 1990's, is built largely and increasingly on private-sector agents: banks, businesses, and investors. The greatest scope for wealth creation post-1994 lies in expanding international trade and investment, not in exchange rate reform or public-sector lending. This implies a redistribution of scarce international public resources towards the WTO and a revision of the IMF role.

I. The crises at the end of the 1990's & their impact

"What many expected to be no more than a slight blip has instead become the largest threat to the stability of the world's market economy since the Great Depression."
-Joseph E. Stiglitz, Senior Vice President & Chief Economist (World Bank)

- **Lessons from the crises and the way forward (IMF perspective)**

By the Asian crisis on, the IMF started to focus its efforts toward the understanding of the global financial crises framework and how to sort out the IFS in order to strengthen it and to lessen the frequency and severity of future disturbances.

The Fund concluded that the crises of the 90's, beginning with the Mexican in 1994/5, had an unsound macroeconomic policy framework and the large current account deficits as the structural problems.

They've first highlighted six points that they have considered major areas where initiatives should be strengthened:

- 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;

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

- The integration of international financial markets in order to maximize the benefits from and minimize the risks of international capital movements;

- Surveillance over regional markets;

- Good governance and fight against corruption based on the "Code of Good Practices on Fiscal Transparency - Declaration on Principles"; and

- National and international bankruptcy laws to help resolve sovereign and private debt problems.

To help in the financial support of these efforts the IMF implemented a program of the Fund’s quota increase and the New Arrangements to Borrow (NAB), which have improved the international community's ability to assist countries in the resolution of financial crises.

The IMF argues that all of the above steps support the **long-term objective** of the Fund's response to the Asian financial crisis.

- **Prospects for Developing Countries after the East Asian Crisis**

The outlooks for the last two years certainly did not anticipate the problems the developing countries would face, considering how deep and strong the crises happened in some of these economies. The analysis had presented the favorable external environment and the possibility of better performance of developing countries, once their growth was more than 5 percent a year in 1991-97, up from only 3 percent in 1981-90.

Even in a relatively favorable base-case projection, world growth in 1999 is now expected to register only 1.9 percent and developing country growth only 2.7 percent, with three of the largest developing countries in recession.

The external environment for developing countries is much more difficult than a year ago

Table 1-1 Global conditions affecting growth in developing countries, 1981–2007

(average annual percentage change, except for LIBOR)

				Forecasts					
				Global Economic Prospects 1998/99			Global Economic Prospects 1997		
Indicator	1981–90	1991–97	1997	1998	1999–2000	2000–07	1998	1999–2000	2001–06
Real GDP in G-7 countries	2.8	1.9	2.6	1.7	1.8	2.4	2.5	2.6	2.6
Inflation in G-7 countries[a]	4.6	2.6	1.8	1.5	2.1	2.5	2.3	2.5	2.7
World trade[b]	4.6	6.8	9.5	5.3	5.0	6.2	6.7	6.5	6.3
Nominal LIBOR (six months, US$)	10.0	5.1	5.8	5.5	5.5	5.9	6.0	6.3	6.3
Real six-month LIBOR[c]	5.0	2.1	3.3	3.5	2.6	3.1	2.8	3.0	3.2
Price indexes (US$)									
G-5 export unit value of manufactures[d]	3.3	1.1	–5.1	–3.8	1.9	2.5	4.6	3.0	2.5
Petroleum price[e]	–7.7	–3.6	–1.1	–25.7	7.7	0.1	–4.4	–10.9	–0.8
Nonfuel commodity price[e]	–5.4	0.2	5.0	–14.6	–0.4	0.3	–8.0	–4.2	–0.6

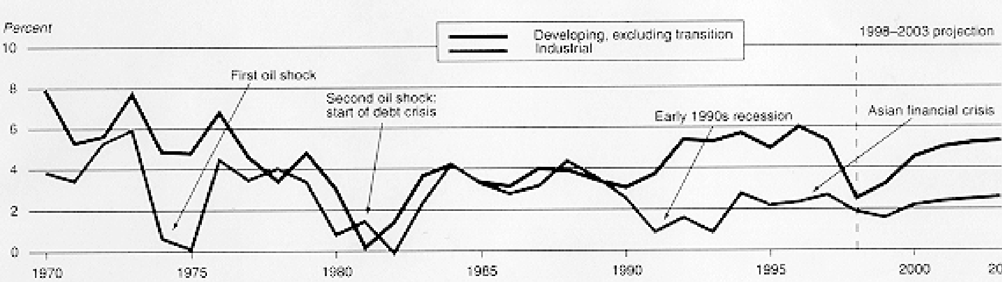
a. Consumer price index in local currency, aggregated using 1988–90 GDP weights.
b. Average of merchandise export and import volumes.
c. Deflated by U.S. consumer price index.
d. Data for G-5 countries (France, Germany, Japan, the United Kingdom, and the United States) weighted by exports of manufactures to developing countries.
e. Based on World Bank indexes and deflated by the export price of manufactures.
Source: World Bank data and baseline projections, November 1998.

Picture copied from "Global Economics Prospects and the Developing Countries" – a publication of the World Bank

The main elements of the global prospects pointed by the WB are as follows:

- **Near-term outlook, 1998-2000**

  The world economy shall remain weak. Global output growth is expected to be cut nearly in half, from 3.2 percent in 1997 to 1.8 percent in 1998, and to revive only modestly to 1.9 percent in 1999. Europe might keep a fairly strong growth, the US is expected to slow significantly, but with some room for additional cuts in interest rates to make a soft rather than a hard landing. East Asian countries and Japan are expected to shift from sharp recession in 1998 to stagnation in 1999. The developing countries' growth is expected to be around 2 percent in 1998, after a 4.8 percent in 1997, and commencing only a modest recovery in 1999. Thirty-six of 100 developing countries are expected to have had their per capita income fall in 1998.



Developing countries will be hurt most in the slowdown
Figure 1-1 Growth of industrial and developing country GDP, 1970–2003

Note: GDP measured in constant 1987 prices and exchange rates.
Source: World Bank data and projections.

Picture copied from "Global Economics Prospects and the Developing Countries" – a publication of the World Bank

- **Longer term outlook, 2001-07**

  The main challenge is still the behavior of the short-term capital flows, associated with the fragility of financial systems in many developing countries.

  It is expected the growth of 3 percent in the world economy and about 5 percent for the developing countries.

  The WB states that the potential for all countries to gain from freer trade and from expanded flows of foreign direct investment remains as compelling and valid as ever and that the developing countries will continue, as in the first part of the 1990's, to see the payoffs of almost two decades of economic reform and structural adjustment.

- **A low-case scenario**

  The risks to the base-case projection considered above are unusually large. A deeper and longer recession in Japan, a protracted shutdown of private capital flows to developing countries in 1999 and 2000, and substantial equity market correction in the US and Europe would shift the expectations to zero of growth in 1999. The developing countries would certainly suffer more severely the results. The lack of access to private capital flows, declines in export's revenue growth and in primary commodities prices reduce aggregate developing country growth by 2 percentage points to 0.7 percent in 1999.

- **Crisis in East Asia much deeper than anticipated**

  The Asian crisis was compared to the oil shocks of the 1970's in terms of the withdrawal of demand from the rest of the world. A large part of the slowdown in aggregate growth in developing countries in 1998 is due to the unprecedented depth and severity of the recession in the five crisis countries in East Asia – Indonesia, the Republic of Korea, Malaysia, the Philippines, and Thailand.

  Even after some encouraging signs of a recovering in the Asian economies, during the second half of 1998, the revenue in dollar terms was not enough to unable the firms to service foreign debt.

  The failure of important financial institutions toward the end of 1997 provoked a collapse in consumer confidence, and the economy spun into recession. Since then, further declines in consumer and investment spending and confidence, declining output, rising unemployment, falling asset prices, rising bad debts, and tightening bank credit (despite near-zero policy interest rates) have created a vicious circle that is expected to have generated a 2.5 percent decline in GDP in1998.

- **Longer run impacts of the East Asian Crisis**

  Considering the situation of no crisis as reference, the GDP in the crisis economies in 2000 is expected to be US$ 170 billion lower than it would be. The analysis shows that the crisis countries will see a moderate reorientation of activity away from capital-intensive industries, and the overall effect is going to be to lower wages.

It's important to say that even for the noncrisis regions as a whole, if the developing countries crises become longer and deeper, the long-run terms of trade effects are negative, as the crisis economies become poorer consumers of their exports and weaker suppliers of their imports.

And if worse comes to worst?

Table 1-13 Global conditions in the baseline and low-case scenarios

(average annual percentage change, except for LIBOR)

Indicator	Low-case scenario 1999	Low-case scenario 2000	Low-case scenario 2001	Baseline scenario 1999	Baseline scenario 2000	Baseline scenario 2001
World GDP	0.0	1.7	2.9	1.9	2.7	3.0
GDP in G-7 countries	–0.3	1.0	2.4	1.4	2.1	2.4
United States	–0.2	1.4	2.3	1.6	2.1	2.3
Japan	–4.0	–2.0	2.2	–0.2	1.4	2.3
Major EU economies	1.9	2.2	2.5	2.1	2.6	2.4
Imports in G-7 countries *(volume)*	2.0	4.5	5.6	6.3	5.2	5.6
World merchandise exports	3.5	5.3	6.3	5.5	6.5	6.3
Nominal LIBOR *(six months; US$)*	4.5	3.1	3.2	5.0	6.0	6.0
Price indexes *(US$)*						
Petroleum[a]	–16.0	7.3	5.0	8.1	7.3	0.2
Nonfuel commodities[a]	–10.7	–4.8	3.3	–1.7	0.9	0.5

a. Based on World Bank indexes and deflated by the G-5 unit value of manufactures.
Source: World Bank projections, November 1998.

Picture copied from "Global Economics Prospects and the Developing Countries" – a publication of the World Bank

- **The impact of crises on the poor may be irreversible**

As we have seen in the above prospects, notwithstanding the economic crises is known to hurt poor and rich, the poor are much less able to respond to a non-diversifiable risk like a recession. The domestic capital markets could help, but they are imperfect, specially in poorer economies, and credit or insurance is not available to the poor, so there is little they can do to smooth out consumption and welfare.

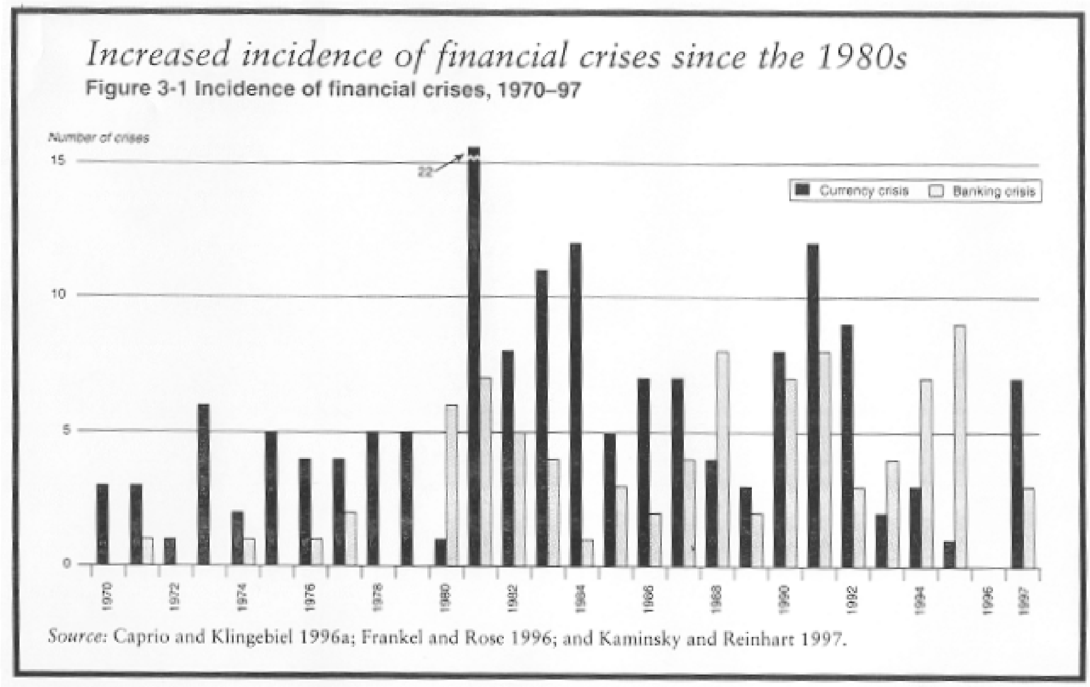
The effects of crises and recessions over non-developed or developing countries may become, in different levels of strength, irreversible damage to the poor: malnutrition or death from starvation (in extreme case) and lower schooling levels.

- **Incidence of financial crises, 1970-1997**

Since the beginning of the 1980s the financial crises have become more frequent in developing countries. They have taken three main forms: currency crises, banking crises, or both.

The growth in the frequency of crises has been associated with surges in international capital inflows to developing countries and the growing integration of these economies with world financial markets.

Picture copied from "Global Economics Prospects and the Developing Countries" – a publication of the World Bank



Increased incidence of financial crises since the 1980s

Figure 3-1 Incidence of financial crises, 1970–97

Source: Caprio and Klingebiel 1996a; Frankel and Rose 1996; and Kaminsky and Reinhart 1997.

- **Russia**

In 1998, the fall in world oil prices, in part due to the recession in East Asia, reduced Russian export earnings and government revenues, and domestic political disagreements were preventing progress in reducing the fiscal deficit, financed in part through short-term foreign currency borrowings. The Russian’s currency, the ruble, collapsed in August under these pressures.

Russia declared unilateral debt moratorium and private capital flew to safety in industrial country bond markets, running from the developing and transition economies. The downward pressure on the emerging markets currencies and assets prices increased severely.

Since the Mexican crisis and even after the East-Asian crisis, debt moratoriums had been systematically avoided, with the assembling of large international rescue packages. These packages caused spreads on emerging market debt to fall sharply after the Mexican episode, and in many cases they remained moderate even after the onset of the East Asian crisis. But with the Russian crisis, it was not enough effective and spreads shot up once again.

- **Brazil**

"As a result of monetary policy errors, Brazil faces a steep and unnecessary recession. At one level, the story is straightforward: Brazil defended an overvalued currency until it finally snapped", stated Jeffrey Sachs, an American economist of the Harvard University.

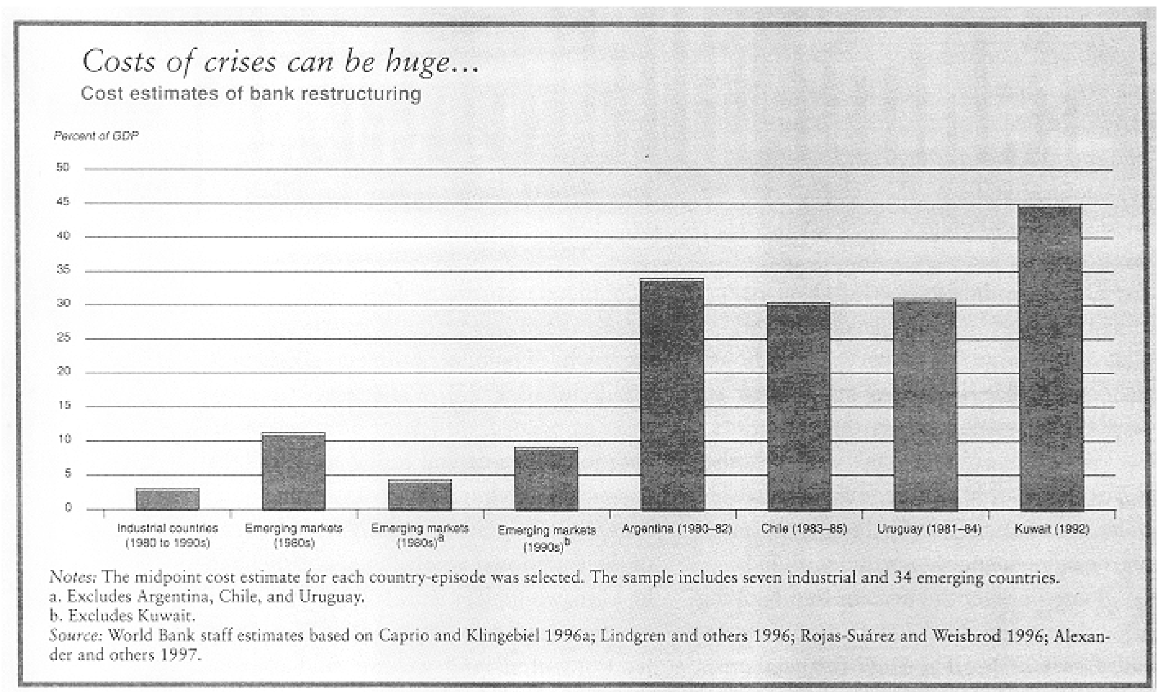
Besides the debates over the adequacy of the monetary policy and the macroeconomics adjustments Brazil was carrying on, there is almost a consensus that the collapse of the Brazilian currency, the Real, in the last January, was closely related to the volatility of the private capital flows on the emerging markets.

In this way, the Executive Board of the IMF has been developing, since the Asian crisis, the possibility of introducing a contingency or precautionary facility, to supplement the reserves of countries threatened by a crisis but not yet in one. The recent loan to Brazil already included several of the features contemplated for the contingency facility.

- **Costs of financial crises**

Studies of the World Bank and of IMF found that there is an average decline in output growth after crises. Emerging countries lose output after crisis in a much higher level than the developed economies.

The effects over the GDP are considerable and a highlight of them is in the two figures below:



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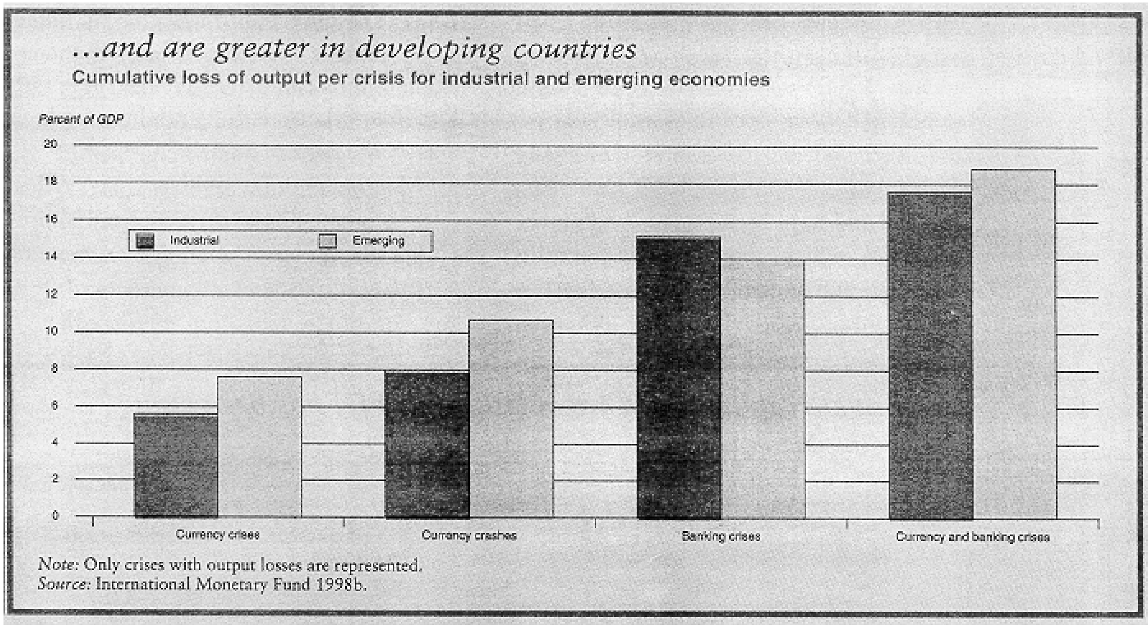

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I. Exchange Rate Flexibility and the Increased Size of Capital Flows

The exchange rate regimes are central to the debate about global architecture. The choices the emerging countries have to do between fixed and floating currencies are critical to the way the international financial system will see the behavior of capital flows.

The importance of this decision comes along with the difficulty of it. The emerging countries have to balance a great deal of elements to make their choice.

Some policymakers state that any exchange rate regime is good if under sound economic fundamentals (fiscal and monetary policy). Nevertheless, as recent events have shown, a country's choice of exchange rate regime affects its vulnerability to crises.

Even the IMF's attitude towards exchange rates seems to be full of uncertainty. In 1997, the Fund urged Asian countries to devalue or float their currencies. In 1998, it lent billions to Russia and Brazil to try to help them maintain their exchange rates.

The major external crises of the last two years – in Thailand, Korea, Indonesia, Russia, and Brazil – have affected countries with more or less pegged exchange rates. At the same time, other countries with fixed rates, specially Argentina and Hong Kong, have succeeded in holding the line, and some with flexible rates, among them Mexico, South Africa and Turkey, have been severely affected by the global economic crisis.

The emerging countries have also another dilemma regarding to the exchange rate regime, it is the way they manage their monetary policy. Monetary authorities frequently intervene to increase foreign reserves when capital inflows begin to surge, in order to preserve stability of the exchange rate (when the domestic currency is implicitly or explicitly anchored to an exchange rate peg) and to reduce market uncertainty.

- **IMF perspective**

The Fund argues that there is a tradeoff between the greater short-run volatility of the real exchange rate in a flexible rate regime versus the greater probability of a clearly defined external financial crisis when the exchange rate is pegged.

It's acceptable that a country decides to fix its exchange rate, but if it happens, the country may choose to fix so definitively, the Fund says, through a currency board, rather than a less credible normal peg, assuming of course that the necessary preconditions are in place.

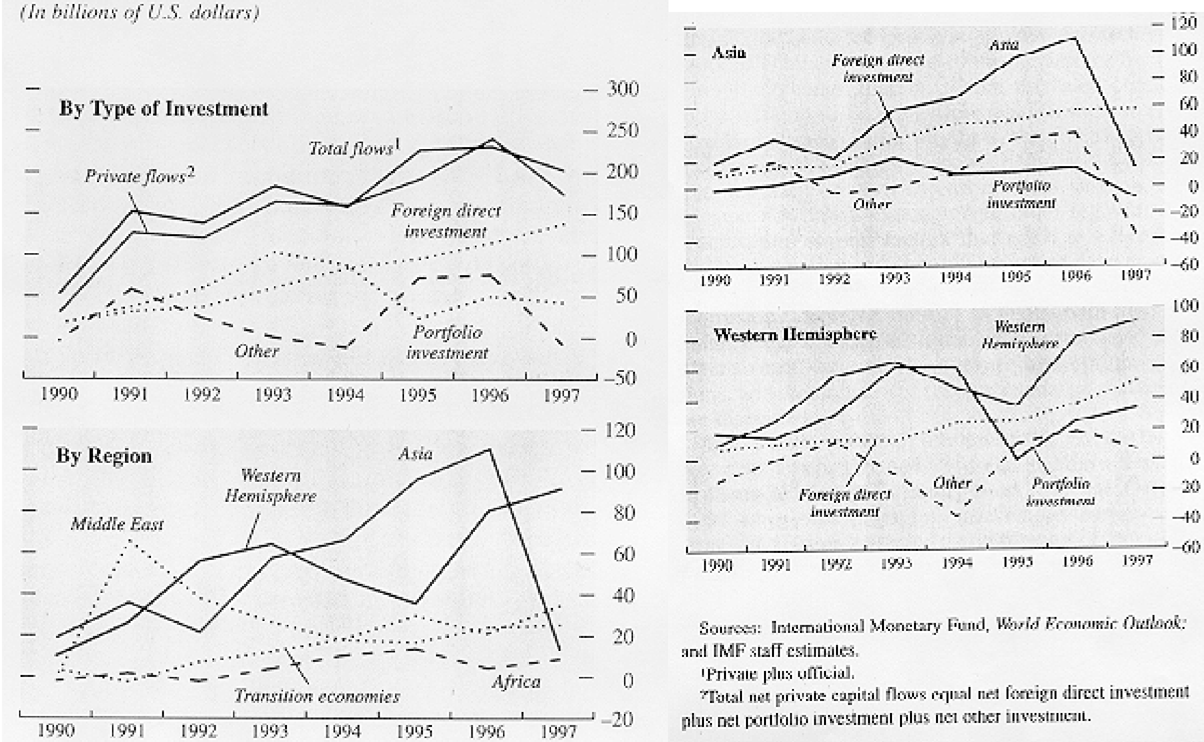
Considering that in the coming years it's not expected that many emerging economies peg their currencies that hard, the Fund keeps its speech that the floating system can work better in our days.

By the other side, the Fund recognizes that, even under the belief that a shift towards floating rates is likely to reduce the frequency of sharply defined foreign exchange crises, some countries will continue to peg their rates in some levels. Since sharp shifts in international investor sentiment regarding even a country with a floating rate can setoff a panic and contagion, there will be a need for an international lender of last resort.

- **Private and official capital flows to developing countries**

To illustrate the importance of the capital flow, specially the private capital, in the last years over the emerging countries economies, the IMF presents the figures below, showing the behavior of the flows:

Figure 2.1. Net Private Capital Flows to Emerging Markets
(In billions of U.S. dollars)



Sources: International Monetary Fund, *World Economic Outlook*; and IMF staff estimates.
[1]Private plus official.
[2]Total net private capital flows equal net foreign direct investment plus net portfolio investment plus net other investment.

It's remarkable that the FDI has been so large toward the emerging markets and it's also predominantly from private sources.

The evolution of official and private capital flows to the emerging markets shows a considerable increase in the private sector, with the wealth of the industrialized countries looking for profits and growth in a globalized world.

The private capital, considering the non-FDI flows and the portfolio investment, is much more volatile and answers the crises very quickly, running from the risky markets as soon as the signs of potential crisis arise.

The policymakers' challenge is to find better mechanisms to facilitate more stable and longer term capital inflows to developing countries.

Macroeconomic policies designed to avoid large external and internal imbalances are a first line of defense in the prevention of financial crises. They are essential in order to reduce financial risks that comes along with an economic boom, where weak regulation and government guarantees of financial liabilities lead financial institutions to engage in excessively risky lending.

It is frequently the monetary authorities intervening to increase foreign reserves when capital inflows begin to surge, in order to preserve stability of the exchange rate (when the domestic currency is implicitly or explicitly anchored to an exchange rate peg) and to reduce market uncertainty. However, it is a costly measure to sterilize the capital inflow effects, as inflation for example, and has been largely used by the emerging economies.

The risks associated with capital account liberalization hinge on the volatility of capital flows and the risks of reversal during bad times, when access to additional financing is especially important. For FDI flows, the risks are small because these flows respond more to longer-term considerations than to short-term international interest rates, and because they interact less with domestic financial markets.

- **Capital liberalization/controls**

Open capital markets potentially bring enormous benefits to the developing countries, supplementing domestic savings, encouraging the efficient use of scarce capital, and bringing collateral improvements in know-how. However, it is important to take good care in the way the liberalization is made, concerning specially on the lack of sound financial systems the country has, the country's ability to adjust to shocks and absorb risk, and on the volatility of flows.

Many economists and even the IMF are stating that there may be circumstances when temporary capital controls could be called for. Most of them advocate "throwing sand in the wheels" of international markets to inhibit volatile, short-term capital flow. But, it is very controversial, because it is hard to define how and when to implement it once this kind of measure may bring long-term damage to investor confidence, the distorting effects in resource allocation, and the loss of discipline and incentives that capital flows can bring.

The experiences of the past lead to the conclusion that capital controls have helped the economies in different aspects for a short-term, but most of the time, scared off foreign investor.

I. The Need for Reforms and Perceptions

The financial crisis that began in Asia and has now spread to other continents lends urgency to efforts to strengthen the architecture of the international financial system.

- **Current IMF purposes (Article I of the Fund's Articles of Agreement)**

The role of IMF is mainly reported as financing and creating conditions to the stability of exchange rates in the IFS. Its role considers financing in interaction with adjustment and surveillance.

The purposes are:

- To promote international monetary cooperation through a permanent institution which provides machinery for consultation and collaboration on international monetary problems

- To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the production resources of all members as primary objectives of economic policy

- To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation

- To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper growth of world trade

- To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustment in their balance of payments without resorting to measures destructive of national or international prosperity

- In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members

The Fund shall be guided in all its policies and decisions by the purposes set forth in this Article.

- **The discussion over the New Architecture of the IFS and the provision of adequate international liquidity in times of crisis**

The discussion over the New Architecture of the International Financial System is sharply centered in the role of the IMF and especially in its behavior in times of crisis or in the processes of crisis (before, during and after the crises).

It is common voice that, while thinking about the architecture of the international monetary system is important, shall not be forgotten that, in the midst of and due to the financial crisis, there is an ongoing human crisis as well. Millions of lives being affected.

The question therefore arises whether the IMF's role focused as a supplier of balance of payments financing can continue to be justified. Its actions over the market imperfections are under analysis. A number of approaches that have been taken in the past, and some new ones, are being considered for use in future crises.

There is a great deal of perceptions over the IMF role and performance. Some of them point toward structural reforms in the Institution, other ask for the end of the Fund as a solution, and there are also those that think that the reviewing of its purposes in some points would be enough.

As reported by the magazine "The Economist" in a survey: " Everybody who is anybody has opined on the matter. President Clinton wants to ' adapt the international financial architecture to the 21st century ' ; Tony Blair, Britain's Prime Minister, wants 'a new Bretton Woods for the new millennium' ; Alan Greenspan, head of America's central bank and a man not given to hyperbole, has called this once-boring subject 'a cage-rattler'. He, too, wants to change the 'patchwork of arrangements' governing global finance."

Milton Friedman, a well known economist, argues that the IMF is not necessary at all and should be extinguished because it is not only worthless to the world economy, but it brings more problems to it.

After the Mexican crisis, the G-10 deputies suggested that bond contracts should be modified to permit a country to reschedule payments in the event of a crisis. A crisis could be defined either by a set of objective indicators (including possibly an approach by the country to the IMF for assistance) or by a formal declaration by the IMF. This approach could be extended to other contracts as well. Some developing countries object that changes in bond contracts would make borrowing more expensive for them, but that would in this case reflect a more appropriate pricing of risks.

There is a suggestion of Jeffrey Sachs, closely related to the one last mentioned above, that the system needs the ability in effect to declare a country bankrupt, and to provide an orderly framework for a debt workout. For instance the IMF, representing through its Executive Board the governments of all 182 members, could be given the power -- no doubt with a special majority -- to declare a stay on payments by a member in difficulty. This would provide time for the country to work out a restructuring of its debts with its creditors. Problems with the interference of the governments over the private sector debts restructuring and the moral hazard, specially discouraging the investors to deal with the developing countries have been pointed against this alternative.

Paul Volcker, former president of the New York Federal Reserve Bank, argues that the crisis of the financial capitalism is related to a lack of surveillance and a lack of capacity of the multilateral institutions to interfere. It would be necessary to review the foreign exchange policies and the role of the IFIs. He considers that the "currency board" adopted by Argentina would be a good measure for the economies of the emerging markets, once their relatively small economies would be more protected against the attack of the trillionaire market of speculative capital flows.

Sebastian Edwards, an economist of UCLA, ratifies that the IMF structure does not allow it to operate effectively in the global financial market, where the private capital is preponderant and the trust of the investors and the transparency of information are essential. He lists two generic solutions in the world scene debate and goes against them. Even the control over the capital flows (rewarding in the globalization process) and a full redraw of the IMF are considered not feasible by him. He argues that it is necessary a new sort of new multilateral institutions, small and efficient, which would be able to provide information and act quickly avoiding crises. Three specialized institutes would replace the IMF:

1. Global Agency of Information – would provide information in current basis and without any filter about the financial healthy of the countries (it would use techniques of risk management in order to evaluate the weaknesses of the different economies)

2. Global Contingent Financial Line of Credit – would provide contingents lines of credit in considerable amounts, to those countries that, even solvents, are facing temporary liquidity problems (short terms lines of credit and rates relatively high)

3. Global Agency for Restructuring – would help countries in crises to restructure their debts and would afford them with resources under certain conditions. One of its most important goals would be to allow a sorted debt restructuring.

Edwards suggests that the personal of the agencies would come from the IMF and the private sector, and the resources from the IMF, WB, and the G7. He insists that all countries shall be allowed to participate on the benefits of the globalization, but avoiding its obstacles.

George Soros, one of the biggest international investors, argues that the IFS is in the risk of a crash. He shows that the IFIs, especially the IMF and the WB, were drawn to a world without a capital flow in the scale it became to be. In the recent crises the IMF was presented as part of it, instead of a solution to it. He notices that the IMF shall be concerned about the Moral Hazard of being giving unequal treatment to the parts, granting the investors, who operates under the mind that IMF’s helps if anything goes wrong. Soros believes that the global financial markets are essentially not stable and need a stronger rules framework. He proposes that the IMF comes to be a International Central Bank, not like The Federal Reserve Bank or the European Central Bank, but under the four following parameters:

1. Acting as a lender of last resort for a special group of countries, which should have: right macroeconomic policies implemented, healthy banking system, transparency to the markets, floating exchanging rates, adequate measures to control the excess of the capital flows, adequate laws to failures and bankruptcies, respect to the human rights, and obedience to the laws.

2. Promoting in these countries the support on the capital flow adequacy when the markets fail.

3. To the other countries that do not become able to reach the requirements or do not agree with them, they would keep their current conditions with the Fund, but this one would impose conditions to the country and to the investor in times of crises.

4. Regulating the environment in which the international capital flows occur.

Soros is not very far off the main direction in which the studies are being driving to in the IMF. As it has already been reported in some papers, the IMF is closely considering the liquidity matter.

Stanley Fischer, IMF First Deputy Managing Director, is presenting the solution as being better to transform the IMF into a lender of last resort, in order to guarantee the countries solving their problems of liquidity, than any other alternative. He states that the Fund should act with the clear idea of the difference between insolvency – where a country is unable to pay its debt definitely - and iliquidity - where there is a temporary difficulty on the cash flow to pay the debt.

He shows that there is a critical point, because the line between solvency and liquidity is not determinate in a crisis -- it depends on how well the crisis is managed. The task of distinguishing insolvent from illiquid becomes more difficult, and an official lender of last resort is likely to be needed to help restore normalcy.

His concerns over the international capital flows are not only in its extremely volatility but also in the effects of contagious. This applies particularly to the emerging market countries, where the crises of the last five years have been concentrated.

In a specific way of considering the matter, Mr. Fischer does not suggest that the IMF would become an International Central Bank. The Fund would not interfere in the global interest rates or in the liquidity cycles of the international markets, but would help the countries running into crises as a reaction to the erratic movement of the global capitals.

It's interesting to observe here that a new perspective emerges at the IMF traditional ideology. The Fund had always believed that the crises were a function of the internal unbalanced situation of the country, and now the crises turn to be seen or accepted also as an effect of the biases of the global financial system itself.

Focusing on the Stanley Fischer work, the following paragraphs will reach the main points on the needs for reforming the international system, improving the IMF functioning as the International Lender of Last Resort.

Some thought is being given to the possibility that countries could prequalify for assistance when threatened by a crisis but even not yet in one, and their reserves may need a supplement. A contingency or precautionary facility would be given by the Fund in this case, following the Supplemental Reserve Facility (SRF) principles, introduced at the end of 1997, in which the IMF can make short-term loans in large amounts at penalty rates to countries already in crisis.

The adoption of international standards of transparency, with the increasing of relevant information, together with improved procedures to bail in the private sector are very important to allow effectiveness to the other measures. The SRF and the contingent facility now under consideration, together with the changes to the international system now under discussion, would go a long way towards making the international capital markets operate as well as the better domestic capital markets if those cares have been taken.

Mr. Fischer remarks that Calomiris (1998) and Calomiris and Metzler (1998) have made an important suggestion in this regard. They recommend that the IMF should act only as lender of last resort, under Bagehot rules - Bagehot (1873) most famous lesson is that "in a crisis, the lender of last resort should lend freely, at a penalty rate, on good collateral". Only countries that meet a stiff set of requirements, most importantly on the banking system, would require the loans under collateral but without policy conditionality.

The IMF considers that this would also have good incentive effects on the country, because if it had to have internationally acceptable assets available to serve as collateral, it would presumably be discouraged from running down its reserves too far before calling on the Fund for assistance. In other hand, basing the decision to lend on the availability of acceptable collateral, the lender of last resort reduces the moral hazard that the potential borrower would take excessive risks in its portfolio by holding assets that would not be accepted as collateral.

The Bagehot lessons are incorporated in the SRF, once policy conditionality can be interpreted as a further element of the penalty, as seen from the viewpoint of the borrower country's policymakers. Besides that, there is also the possibility of "lending freely" in the context that the international lender of last resort should stand ready to lend early and in sufficient amounts to other countries that might be affected by contagion from the crisis (the Fund's capacity to do that has been enhanced by the agreement on the quota increase).

Considering that some countries won’t be able to qualify, it will be necessary to find alternatives to them, either varying the rate of charges or enforcing tougher policy conditionality, which would make sense given the structural weaknesses implied by the country’s failure to meet the standards.

The knowledge that the development of the standards, and of the international mechanisms to monitor them, will take time (they believe 5 years) drives the IMF to a temporary track. The countries could qualify for the new facility based on their making of good faith efforts to come closer to meeting the standards, specially on the banking standards, while the transition process could be designed.

Stanley Fischer concludes that: "We should not underestimate the complexity of the task and the resources that would be required to improve standards in this way, but any cost-benefit analysis for the world economy of a successful effort to reduce the frequency and scale of crises would justify making the attempt".

Still under the IMF concerns over the question, Hubert Neiss, Director of the Asia and Pacific Department of the IMF, remarks four key elements to the rebuilding of IMF:

1. Greater private and public sector transparency and new standards of corporate governance. He thinks that the IMF is ready to play its part by increasing the amount of information it makes public and by monitoring the implementation of the standards

2. Increased scrutiny of economic policy by national governments and multilateral organizations

3. A commitment to financial sector reform to bring markets and banking systems up to international standards and to enable countries to adjust to the complex demands of the global market

4. Plans to involve the private sector in preventing future crises and keep it involved – on a voluntary and co-operative basis – in the solutions the next time problems erupt.

This approach shows clearly the idea that the IMF shall review some of its purposes considering the new environment of violent and temporarily reversals in cash inflows at some countries. Out of the IMF the other players of the market would also work harder to improve stability to the system.

- **Surveillance**

One of the most discussed points in the new architecture's debate is the needing of improvement in surveillance.

The IFIs are being asked to improve surveillance, specially the IMF. The Fund's function of surveillance were redefined by the second amendment of the Articles of Agreement in 1977, and in practice, the main focus of IMF's surveillance has been on members' economic policies which, in turn, influence the international monetary system and the behavior of exchange rates.

The last years changes in the world economy, such as the rapid growth of private capital markets, increased regional and monetary integration, and the implementation of current account convertibility and market-oriented reform in many countries, have heightened the importance of effective and timely surveillance and increased responsibilities for the IMF.

A broader range of institutional measures is being required and the scope of surveillance at the IMF tends to expand to reach it. More than the concerns with macroeconomic imbalances, inflation, key trade, and exchange, the challenge is now to help in structural and institutional reforms necessary for the countries to establish and maintain private sector confidence and lay the groundwork for sustained growth.

The improvements in surveillance are linked to the strengthening of the efficiency of the financial sector, improving of data collection and disclosure, making of government budgets more transparent, and promoting legal reforms and good governance.

- **Moral Hazard**

Any choice for the definition of the IMF's role has to contemplate the risks of moral hazard. Three types of it are possible to occur: the first type relates to expectations by developing country governments of a bailout, which can reduce incentives to implement better policies; a second one can arise because international creditors expect to be protected if a crisis occurs; and, a third type can arise because banks and private corporations undertaking risky activities expect to be bailed out under workouts of foreign debts, leading to the domestic socialization of these debts.

- **The Private Sector**

Michel Camdessus, Managing Director of the International Monetary Fund, emphasizes that the crises in the emerging markets since the mid-1990s all started with abrupt shifts in investor sentiment that reversed the large inflows of private capital enjoyed by most of the countries for several years.

In that context, it's easy to see that the private sector has a core role in the new architecture of the IFS. The challenge is to create conditions for the private sector to benefit more from the opportunities of the globalized markets, while being a more efficient and responsible intermediary for channeling financial resources to their best use.

These conditions shall be built through achievable objectives and the IMF is working on three straightforward principles to base the reforms:

- The universal promotion of free market mechanisms strengthened by a set of standards and principles of good conduct;
- A mature partnership between banking and financial institutions and their sovereign and corporate clients; and
- A cooperative approach of crisis management in the mutual interest of all market participants.

I. The Architects

The President of France, J.Chirac, asked the IMF, the WB and the IDB to better organize the global economy, since they are at the forefront of this effort and have the legitimacy of representing the whole community of nations.

This is why France is in favor of increasing the resources necessary for this mission. Nevertheless, the President argues that there must be something to counterbalance the expansion of those institutions' roles and of the reliance which governments place upon them: the general policy orientation of the institutions must be defined by the political authorities of their shareholders.

It was not only Mr. Chirac that raised this question. There is a consensus among all those involved in the debate on the importance of a strong cooperative effort to find a way to achieve and maintain sustainable high-quality growth and stability in global capitalism.

However, the mission is not easy and the efforts and the ideas are not well guided yet. We can see some points of convergence among the blueprints but there is not an agreement yet regarding to the different interests of the parties involved.

Following, there are the main architects:

G7 - A club of seven industrialized countries (US, Canada, Britain, Germany, France, Italy and Japan) that meets regularly to discuss international issues. It first coined the expression "international architecture", in 1995, and last year claimed "an emerging consensus for modifications to the [international] architecture";

G22 - An informal group of representatives of 22 emerged and emerging economies, set up by Bill Clinton in April 1998. It prepared three working papers on the subjects under discussion – transparency and accountability, strengthening financial systems and dealing with international financial crises. These working papers have become the unofficial agenda for reform;

G10 - A group of central-bank governors and finance ministers from 11 industrial countries. Closely related to the Basle Committee of Banking Supervision, it is focused on the international standards of capital adequacy and surveillance over the banking systems of the countries;

IMF - The central international financial institution, under fire from all sides for its apparent mishandling of the recent crises. Nevertheless, it is determined to keep control over architecture issues and is working hard, looking for a new way to assure the stability of the IFS. The IMF is using the ideas of the G22 to develop the improvements inside the institution and among the parties of the global market.

WB - The World Bank is an institution concentrated on long-term development and programs to the poorer countries. Even this institution is not considering its role to deal with financial crises, it is conscious that it has a role at the crises prevention, once the reforms it finances in these countries strengthen then against the threats of the global capital flows.

There are other institutions, as IDB or the institutes of the WB Group (IFC, MIGA, IDA…) that along with the main architects of the IFS listed above have the challenges of understanding the new financial market behavior, the prospects, the threats, and the effects in the short and the long terms of dealing with the alternatives in a common direction.

As said by the WB's President, Mr. James D. Wolfensohn, development will be a result of a partnership lead by the governments of the countries, affected by the civil society, to whom the national and the international private sector shall join, as well as the bilateral and multilateral donors. In this context, he claims the IFIs to think beyond the international financial architecture but also about the foundation of development, because the poorer can not wait and later the whole world may become conscious that the human crisis affects them all.

Finally, the architects shall have in mind the points that the IFIs, including the IMF, must be adapted and strengthened. There are three main aspects of this adaptation: first, their internal reform toward more efficiency; second, clearer mandates from the international community for their respective roles in a reformed system; and third, the coordination of their activities not only with each other but also with the objectives of overall international reform.

II. The Developing Countries

Volatility in international interest rates and economic growth in industrial countries affect the allocation of assets to emerging markets and create risks of booms and reversals in capital flows.

The crises in the emerging markets related to capital flows, however, are not entirely clear. The developing countries have a demand for resources to finance their development and there has occurred a process in the last decade, where financial and external liberalizations took place. These liberalizations led to a capital inflow in those countries, followed by an improvement in economic fundamentals and credit ratings, and then, in turn, more inflows. It has been verified that some times there is an under-evaluation of the risks and some moral hazard linked to the investors behavior; that leads to the high volatility of those markets, sudden shifts in market sentiment associated with euphoria, panics, herd behavior, and contagion, ending in those crises we faced in the last three years.

To the extend that surges are fueled by moral hazard or imperfect information, policymakers in emerging markets need to take steps to reduce expectations of bailouts and to improve transparency in government decision making and the operation of the banking and corporate sectors.

They also might be concerned about imposing temporary measures to restrain certain types of inflows, argues the IMF. The Fund believes that given that there are limits to the pace at which financial sectors can be strengthened, policymakers need to undertake an orderly opening of their financial systems, and may need to consider imposing kind of temporary capital controls.

Since the emerging markets need the international capital to finance their developments and considering that these markets are extremely relevant to the international investors, and also believing that the international financial system requires some improvements to assure gains either to the emerging markets as to the industrialized countries, the debate of the new architecture of the IFS might hear the developing countries.

III. From Architecture to Action

This conclusion rests on the view that international capital mobility is potentially beneficial for the world economy, including for the emerging market and developing countries. But this potential can only be realized if the frequency and scale of capital account crises can be reduced.

There is no shortage of suggestions for reshaping the IFS. Among the main ones are plans to strengthen national banking and financial systems; mechanisms to reduce contagion; capital controls; the need to minimize moral hazard; new exchange-rate regimes; and reform the IMF itself.

The more involved all the architects and countries must be with the necessary reforms toward a new global financial architecture it is not clear yet that a structured answer may arise in the near future.

The participants of the global market as well as the IFIs will have to, and they are already in the track, make improvements and innovations in their countries policies, sectors behaviors and institutions frameworks in order to reduce the weaknesses.

The emerging markets shall provide the improvement of economic policies, of corporate governance, and in the ability to deal with reversals of capital flows, and also strengthen banking and financial systems. Their challenge, by the way, is to achieve the global capital market, which is vital for them, with appropriate regulation and supervision, while maintaining national sovereignty.

In the industrialized countries where the capital flows originate, measures shall be effective to improve the regulation of and information about the activities of international investors. No less important, the rich countries shall lead with the example, improving their standards of financial disclosure, including collective-action clauses in their foreign-bond contracts, beginning to change the norms of international financial markets.

The IFIs, specially the IMF and the WB, shall center efforts in the near term to involve the private sector in the reforms, improving transparency and surveillance through the IFS as much as they can (among the emerging countries and among the investors) and requiring the partnership of the sector to find cures for both the excess volatility that affects individual countries and the contagion that is one of the mechanisms through which excess volatility is propagated.

However, to make the future financial crises and global panics less frequent and damaging for investors and regulators and less painful for emerging economies, the IMF has a main challenge. Working with the SRF and the contingent facility, managing the source of funds to become a lender of last resort and improving the global "consensus" over the better exchange rate regime, the Fund may redefine its role and create a more stabile environment to development of the global financial market.

The new architecture of the IFS shall be seen, by the moment, as a redrawing of some important parts and concepts of the system, but it is still far from being a building of a new and effective framework, which redesigns globalized financial market and remove the tension among national sovereignty, capital-market regulation and global financial integration.

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