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Jorge M. Guira

Table of Contents

I. Introduction

II. The Core International Financial Architectural Parameters
   A. Definition of Crisis
   B. The Brazilian Crisis Elements
   C. The IMF's Broad Strategy and Targeted Objectives
   D. The IMF Confidence Building Tactics and Their Constraints

III. History and Development of the Brazilian Crisis
   A. Precedents of the Crisis: The Brazilian Economy Has a Stop and Go Pattern
   B. Liberalization Moves Forward
   C. The Crunch Commences: 1997
   D. Response to Growing Crisis
      1. Denial
      2. Central Bank Action
      3. Presidential Action
      4. Congressional Voting
      5. Coordination with the IMF
   E. Prevention of Deepening Crisis: Evaluation of Crisis Management Options and Lasting Reform Prospects
      1. Crisis Management
      2. Central Bank and Government Options
      3. Lasting Reform Prospects
   F. How Legal Technical Assistance Could Help Specifically and More Broadly to Reduce the Prospects for the Situation to Become Catastrophic
      1. Legal Options
      2. Economic Options
      3. Integrated Legal and Economic Options

IV. The Crisis Unfolds and the International Community Responds
   A. The Political-Business Cycle in Brazil
   B. The International Dimension: The Capital Flows Climate and the Problem of Speculation
   C. The International Institutional Response and the Brazilian Stabilization Program
D. The 1999 Stabilization Program Takes Effect

V. The International Financial Architecture and the Brazilian Reform Program: Do the Five Pillars of the New Architecture Really Matter?

A. The Elements of the New International Financial Architecture in the Brazil Reform Plan
   1. Transparency
   2. International Standardization
   3. Financial Sector Strengthening
   4. Private Sector Involvement
   5. Contingent Credit Lines

B. Assessing the Intelligence Gathering and Response Capabilities of the New International Financial Architecture in Dealing with the Brazilian Crisis

C. Concluding Thoughts

I. Introduction

By the fall of 1998, financial crises requiring the intervention of the International Monetary Fund had taken place across Asia and in Russia. The Fall Agenda of the Joint meetings of the International Monetary Fund–World Bank were no longer focused on individual country matters or on merely incremental ways to improve the financial system. Rather, the clear, new focus, as reflected in policy pronouncements from the IMF itself as well as leading figures such as U.S. Treasury Secretary Robert Rubin and Chancellor of the Exchequer Gordon Brown, was on sweeping international financial law and institutional reform.

The threat of out of control financial crises was the stimulus for the policymaker focus on building what was emerging as the new international financial architecture. Such an edifice would ensure that domestic financial collapse did not have a “domino effect” on other nations and that crises could be prevented or contained. Since the meetings, over thirty-five proposals for strengthening the international financial architecture have arisen. The core elements of transparency, internationally accepted standards,

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financial sector building, private sector involvement, and contingent credit lines are the new common ingredients required for reform. At the same time that the above reform agenda was taking shape, Brazil was engulfed in its own full-scale financial crisis. Facing pressure on its dollar reserves to uphold the value of the Brazilian real, the Brazilian government, soon after the meetings, began the difficult process of devaluing the currency by over 35 to 40 percent versus the dollar. This resulted in the need for the Brazilian Central Bank, the federal government, and the IMF and other international financial institutions to work closely together to come up with a solution to restore certain fundamentals, and to reinvigorate confidence in the Brazilian economy and financial system.

The resulting Brazilian crisis was important not just for the Brazilians who had to face the ramifications of the financial instability on their native soil, but also for the MERCOSUR trading partners such as Argentina, Uruguay, and Paraguay. The United States, of course, was also substantially affected due to its considerable investment and trade position with Brazil. Because of Brazil's position as the eighth largest economy in the world, the economic security of much of Latin America, and North America, was seriously, and potentially gravely, affected.

This article will examine the Brazilian crisis from the point of view of an international financial law policymaker. Specifically, the objective is to examine how the Brazilian crisis developed, how it was handled, and how the current focus of the IMF and other international financial institutions to further the international financial architecture reform process may be effective in helping contain the Brazilian crisis and preventing further distressing episodes.

Part II of this article sets out the broad parameters of the IMF architectural program. Part III examines the precursors to the Brazilian real devaluation and focuses on what was happening internationally as the incipient currency crisis of 1997 emerged into a full-fledged devaluation debacle. This section also provides a history of the events as well as suggests what measures might have been taken that could have helped stem the impending crisis. Part IV broadly reviews the nature of the Brazilian problem for 1998 on


7. Id. An official devaluation took place on January 15, 1999 with a decision to let the Real float, including the failure of a massive $41 billion U.S. led capital infusion.

8. MERCOSUR has a provision that provides for macro-economic coordination as one of its core legal objectives although there are few if any institutional resources that have yet been allocated to this aspiration and intention. See generally Jorge M. Guira, MERCOSUR as an Instrument for Development, 3 NAFTA L. & Bus. REV. AM. 53 (Summer 1997); Institute of International Finance Regional Overview of Latin America—Mar. 15, 1999 (excellent discussion of trade implications of Brazilian crisis).
and the domestic and international response. Part V assesses the legal and institutional methods used by the IMF to address the issues and poses the question whether the reforms in progress provide a sufficient intelligence gathering and response mechanism to minimize the potential disruptions of financial crises.

II. The Core International Financial Architectural Parameters

Whether the issue is economic or military security, the policymaker must first face the question of defining the problem and devising appropriate strategies and tactics. This section reviews these issues, in turn.

A. Definition of Crisis

For a problem to be perceived as substantial enough to be a crisis, there is no commonly accepted benchmark or measurement (e.g., what the actual percentage of obligations outstanding is that cannot be repaid). For purposes of this article, a crisis is defined as the private sector's or sovereign's inability or impending inability to pay its foreign or domestic obligations.

The roots of such crisis events, of course, often vary. Certain objective criteria, however, exist. These include declining terms of trade (decline of oil prices in Venezuela and Texas in the mid-1980s) and decline in valuation of capital markets (the U.S. great depression in 1929). Other events, such as bank failures (Argentina 1982, Chile 1985, Venezuela 1994) and currency drops (Mexican peso devaluation 1994) are further examples of different major causes of crisis.9

B. The Brazilian Crisis Elements

The Brazil crisis is primarily based on the devaluation of the currency. It is not a bank insolvency or liquidity crisis. Moreover, the period from 1997 before devaluation when concerns existed about the ability of Brazil to maintain its currency value, and therefore continue to attract foreign investment and pay off its debts, certainly qualify as either a crisis or pre crisis "crucible" period.

The specific roots of the Brazilian crisis are widely debated. Some take the view that there were specific structural imbalances based upon too high a public debt relative to the ability of the country to repay.10 Other commentators, such as Paul Krugman, suggest that Brazil's fiscal policies were not really the problem.11 Rather, it was many factors,

including the lack of confidence in Brazilians to exercise self-control, stemming from a post-1960 history of "stop and go" policies that had cheapened the currency repeatedly.

In addition to these specific negative reputation costs, an international climate of doubt spilling over from Asia and Russia existed. A general belief that speculators could punish for being out of line with market benchmarks was also a crucial factor. Specifically, the Russian default on syndicated loans triggered a global climate of fear and psychological unrest that, following sharp falls in crucial Latin American commodity prices, could not be sated.

Next, the Brazilian consolidation of all public debt, rather than accounting for it, into state, municipal, and federal units, was also held significant as overstating the true state of default risk for many investors. This is important because investors were otherwise constrained in evaluating creditworthiness by these negative combined parameters. It is argued that the confluence of these perceived weaknesses, rather than any actual major problem, led directly to the self-fulfilling prophecy of devaluation.

Although there is little doubt that there could have been certain structural and fiscal improvements to the Brazilian economic plan, this is shortsighted in minimizing the preeminent position of confidence in retaining market support for the currency. To the extent that this more broadly defines the Brazilian crisis, the key issues to resolve are how the international financial architecture proposals can contribute to crisis prevention and management through addressing the above fundamentals and the underlying confidence factor.

C. THE IMF'S BROAD STRATEGY AND TARGETED OBJECTIVES

The IMF strategy of prevention has primarily focused on maintenance of confidence through surveillance and monitoring and on encouraging the adoption of certain international agreements and policy prescriptions in banking and securities law. Those policy positions articulate certain fundamental benchmarks that provide guidance as to how individual country finance should be undertaken. They are complemented by the work of rating agencies that price a country's debt based upon supposedly objective criteria or risk.

Acceptance of certain ratios determines the level of creditworthiness. Conditional funding was also available under certain conditions when a crisis broke out. The broad objective of most global efforts prior to the Asian financial crisis that

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13. See Krugman, supra note 11.
14. See Roubini, supra, note 1, at Rating Agencies: Why Did They Fail to Predict the Asian Crisis?
15. The proper extent of how much funding should actually be permitted based upon a country's reserves with the IMF is, of course, at the core of the debate, rather than the decision to bail out Brazil or any of the above countries. This reflects an orthodox perspective on the need.
took place from 1996 on was therefore remarkably similar to the ex ante proposals advanced in their approach. The major difference, in addition to the heightened sense of urgency precipitated by the threat of systemic collapse, was the choice of a new set of tactics to ensure that the above objectives could be successfully implemented. Reviewing the specific tactical elements is therefore important to assess the "new parameters" or specifications for risk management in the new international financial architecture. The next section therefore articulates the core concepts and their limitations as confidence building measures in building the five pillars of the new international financial architecture.

D. THE IMF CONFIDENCE BUILDING TACTICS AND THEIR CONSTRAINTS

The first objective of transparency is not new. Indeed, transparency has been a hallmark of law reform proposals deemed essential to capital markets liberalization and the attraction of foreign investment. This is because U.S. institutions are often more reluctant to become financially involved in foreign countries that do not adopt certain standards, such as generally accepted accounting principles. The IMF's specific emphasis, therefore, was to encourage further cooperation with the Special Data Dissemination Service, and to publicly release internal IMF reports of country finance assessments to increase opportunities for understanding and standardization.

The problem, of course, is that transparency does not and cannot capture problems that exist due to private sector mismanagement. Moreover, it may, ironically enough, unduly punish certain countries for wrongs that they have not committed. In the case of Asia, broadly speaking, the problem was not the public sector borrowings being unsustainable, but the closed nature of private institutions such as banks. In this sense, the only solution is tighter internal regulation of banking and investment houses, including less opaque reporting. The three major credit rating agencies and the IMF, however, largely failed to focus on this concern in Asia, and better information by public authorities, by itself, would not have prevented the Asian crisis from deepening.

Moreover, as to Brazil, Paul Krugman and others have stressed that the lack of sophistication and the psychology of self-fulfilling prophecies among investors were more responsible for the devaluation crisis than the fundamentals. Specifically, the anomaly in Brazilian law whereby state accounts reflect a fiscal deficit that is accumulated with federal debt created the basis for an institutional investor misperception of the state of the health of the Brazilian economy. Standard measurements used by many private investors to judge Brazil, rather than the absence of any meaningful public benchmarks, to provide such assistance. See IMF, Brazil—Technical Memorandum of Understanding, July 2, 1999, available at http://www.imf.org/external/np/LOI/1999/070200a.htm.


17. See Norton, supra note 6, at 311-14; Basle Committee review of international accounting standards (No. 70, Apr. 2000).

18. See Roubini, supra note 1, Sources of Official Data and Reports, IMFs Dissemination Standards Bulletin Board (DSBB); see also IMF, supra note 16.
was instead a core problem of perception. Still, there is no question that reducing capacity and raising disclosure standards, even if this introduces additional costs and transfers the playing field for creative use of financial information, is highly desirable.

The second strategy is the development of internationally accepted standards.\textsuperscript{19} What this means precisely is codes of general ethical conduct as well as specific regulatory and supervisory banking and securities practices. Additional work in accountancy (International Accounting Standards Board), corporate governance (OECD), securities (IOSCO), banking (Basle), and in social policy areas (the respective development banks and the World Bank) comprise the institutional support for these new developments.\textsuperscript{20} There is little question that, despite the sensitivity of this area in domestic political environments who do not like such "soft law" imposed on them, such institutional development serves a highly positive social purpose.\textsuperscript{21} In addition, it may also have unanticipated consequences, such as allowing leaders of many countries to do the politically unpopular, because the IMF and other standard setting bodies with market influence require it.

The third strategy is complemented by the financial sector-strengthening program of the IMF.\textsuperscript{22} This consists of continuous country assessment and Basle cooperation. Continuous country assessment did not prevent the last set of crisis from Asia. The rapidity of electronic international financial movements, opportunities for regulatory arbitrage in cross-border transactions, off-balance sheet instrumentation that derivatives provide to embed risk in transactions to unwary investors, and the lack of an international lender of last resort present substantial challenges that assessment alone cannot fix. Basle, to its substantial credit, has been working on many such issues in an inclusive manner with emerging economies rather than maintaining an aloof posture.\textsuperscript{23} Such cooperation is vital to the implementation of rapid response monitoring systems for capital flows.

The fourth strategy is greater private sector involvement to mitigate the moral hazard problem, such as where banks or other financial institutions are too big to fail so they must be rescued.\textsuperscript{24} There is no doubt that the proliferation of bond finance rather

\textsuperscript{19} See IMF, supra note 18, note 5.
\textsuperscript{21} See Joseph Gold, The Rule of Law in the International Monetary Fund, Pamphlet Series No. 32 (IMF 1980) for the seminal discussion of this topic.
\textsuperscript{23} See generally Roubini, supra note 1, Do We Need an International Lender of Last Resort and Hedge Funds and Derivatives and Systemic Risk; see also Rosa, Lastra, The International Last Lender of Resort, BRITISH JOURNAL OF INTERNATIONAL AND COMPARATIVE LAW QUARTERLY (Oct. 1999); The Three Reports of the G-22 Group on International Financial Architecture Reform (Oct. 1998).
\textsuperscript{24} See Roubini, supra note 1, Moral Hazards; see also Olsen, Banks in Distress: Misdirection in Public Policy and Law (Kluwer, forthcoming 2000).
than syndicated loans as the mainstay of developing country finance make decision-making regarding debt substantially more unwieldy than in the days when syndicated loan creditors could all be gathered in one room to take collective action. Accordingly, appropriate reforms to adjust to this new reality are most urgently needed.

The fifth strategy of contingent credit lines is based on alleviating temporary balance of payments problems for countries with strong policies. This, of course, builds on the special drawing rights facilities based upon the IMF Article I confidence building to prevent "mal-adjustments in the balance of payments... destructive of national or international prosperity" but is a new "preemptive" measure. There is no dispute that strong legal, economic, and political risk management to avoid escalation of dangerous situations that threaten the public good of international confidence is a potentially helpful measure. The problem, of course, is determining standards and sophisticated country judgment as to when it is prudent to provide help and when the IMF may merely be enabling destructive behavior that is market self-correcting.

III. History and Development of the Brazilian Crisis

A. Precursors of the Crisis: The Brazilian Economy Has a Stop and Go Pattern

The June 1994 Real plan stabilized the economy through the introduction of a new currency loosely tied to the dollar. The plan broadly consisted of combining tight monetary policy (M1 money circulation was 2.5 in 1994 compared to 3.8 in 1996) and loose fiscal policy and incentives to attract portfolio foreign investment, such as privatization.

The plan succeeded in reducing inflation from a 640% annual rate to less than 18 percent within one year. This allowed for business and consumers to plan their budgets. The effect of increased certainty was greater spending on goods and services: a consumption and related credit boom, particularly in the purchase of foreign goods among the top 10 percent of the population who control over 50 percent of disposable spending.

The economy was now in a clear "go" stage. Indeed, too much of a "go" stage. The banking authorities became concerned about over-heating of the economy and cut back on credit in 1995. The overall inflation rate was 23.2 percent in 1995 and 16 percent in 1996.


26. See IMF, supra note 16.

27. See IMF-Brazil Letter of Intent, supra note 6.

28. Id.

B. Liberalization Moves Forward

The Finance Minister who introduced the Real Plan, former California Berkeley Sociology Professor Fernando Henrique Cardoso, became President of the Republic. He implemented the liberalization through privatization of key sectors such as mining and oil, with telecommunications and ports to follow. The idea was that increased selling-off of state owned enterprises would increase the competitiveness of such industries and stimulate massive foreign investment flows. This has happened, with over $18 billion in new capital flowing in and substantially more on its way expected prior to the end of 1998.

Brazil is the key player in MERCOSUR, the regional customs union. It is therefore wed to a common external tariff (CET) of 14 percent, although many exemptions exist, and the automobile and sugar sector is exempted. A large and growing percentage of trade is developing regionally rather than globally as the relevant local economies benefit from harmonization of legal and customs policies that reduce costs and promote other synergies.

The above tariff rate was expected to diminish over time, but a 1997 policy reversal meant that tariff rates rose to 17 percent average. MERCOSUR member states, during 1997, continued to boom, although later economic shocks did take place.

No major regional financial services liberalization measures have been undertaken, either unilaterally or through MERCOSUR, although there are working groups in MERCOSUR (Financial System Commission of Sub-Group four) to advance this end. Some positive steps in linking the stock exchanges in each country through broad ranging cooperative agreements and setting regional supervisory standards have been made.

Brazil is involved in the GATS negotiations, as are the other MERCOSUR states.

The over $400 billion banking sector in Brazil is administered through the National Monetary Council (NMC), the Central Bank, Banco de Brasil (the federal government bank), the Securities Commission (the CVM), the National Development Bank (BNDES), and public and private financial institutions. The NMC is the key group and is comprised of the Minister of Finance, the Planning and Budget minister, and the Central Bank president. The Central Bank follows the rules of the NMC. The bank is responsible for regulation and supervision of the banking system.

30. See Thomas O'Keefe, Latin American Trade Agreements (1997); see also IMF-Brazil, supra note 27, at 2. See http://www.intr.net/mercosur for all relevant agreements including the initial Treaty of Asuncion.

31. See Yearbook, supra note 1; Guira and Tavarone, MERCOSUR: Consolidation Among Turmoil, p. 43.

32. See Brazil Inflation Up, Output Down (Assoc. Press, Feb. 12, 1999); Diderich, Brazil Debt Dispute Overshadows Trade Summit, REUTERS (Feb. 12, 1999); Documents also available of trade summit meetings held in the Mercosur website, supra note 30.


34. See Reform and Renewal: Current Regulatory Developments in Latin American Capital Markets, (Anne Stetson & Antonio E. Stolper, eds., 1996); see also Mercosur website supra note 30 for an on-line listing of documents. The Mercosur Administrative Secretariat in Montevideo, Uruguay is the repository for all documents.
Many banks were taken over after the Real plan was put into effect due to poor management. The most spectacular failure was the demise of Banco Nacional, which was riddled with fraud; most of its functions were transferred to another private bank, Unibanco, with the interim administration and approval of the Central bank.

The privatization of the state banking sector thereafter began to take place, with the Rio de Janeiro state bank sale, as well as one of the larger Minas Gerais banks. The state of Sao Paulo bank was scheduled to be sold and was sold before the end of 1998. This is an important trend because the state banks have sometimes been perceived as fonts of corruption for unscrupulous state politicians to reward political friends (Indeed, this policy of "patronage banking" has long historical antecedents going back to the nineteenth century).

Due to the above consolidation, many jobs were lost in the commercial banking sector, in particular. Because of low current valuations and an opening up to foreigners, these banks were viewed as a ripe target for mergers and acquisitions activity. The extent to which these purely foreign banks (as opposed to foreign participation in domestic banks) have been made welcome is evidenced by the increase of over 100 percent in the 1994–96 period in foreign assets.

C. THE CRUNCH COMMENCES: 1997

The Real plan saw the monetization of the currency to the dollar from other money substitutes; the end of indexation of currency; the slow increase of credit, other than overnight funds borrowing; the beginning of the privatization process; and the incipient flow of foreign funds.

But these positives did not and could not hide the surging current account deficit. By 1997, the government's deficit was taking up over 30 percent of GDP, not to mention the large overall public sector debt of 32 percent, soaking up domestic savings, effectively driving up interest rates, crowding out other investment. The relatively high, albeit more relaxed, degree of regulation which exists in the Brazilian capital markets, as compared to liberalizing regimes like Argentina and Chile, also contributed to distortions in capital flows.

In sum, the Brazilians were forced to find the right tools to maintain the value of their currency. Monetary policy restraint, exercised through tight money growth, credit constraints, and relatively high interest rates were the tools available to help prop up the Real.

Fiscal policy problems relating to state government pensions and the size of the civil service in certain key states left the growing impression that Brazilian state creditors might not be able to pay their foreign exchange obligations, thus putting pressure on the federal government to devalue the currency. Bringing in record quantities of direct

35. See IMF-Brazil Letters of Intent, supra note 27, at 1. Apparently more than forty banks were closed, according to Brazilian Central Bank sources, but the exact number could not be confirmed.
38. See IMF-Brazil Letter of Intent, supra note 6, 27, at 2–3.
foreign investment helped to alleviate this negative perception but did not cover up the fundamental long-term perception of the problem. Indeed, only one year after launch, the IADB's review of IMF statistics showed the Real was now at .92:1, down significantly from a par value of 1:1 to the dollar at launch.39

Under these conditions, the downside risk was that the Real was not only increasingly perceived as overvalued; absent strong government policy to address the fiscal issues, it seemed to have no other way to go but down. Indeed, in the summer of 1997, noted MIT economist Rudiger Dornbusch said that Brazil's Real currency was in real trouble, owing to the disequilibrium in the above numbers.40 The major positives were that foreign investment was coming in strong, the current account deficit was easily financed for six months based on existing international reserves (in contrast to Mexico's 1994 liquidity problems), and the U.S. dollar upon which the Real was monetized was relatively steady.

For the next five months or so since Dornbusch's summer pronouncement, nothing much happened, at least in Brazil. Outside, of course, Thailand went into financial crisis, Indonesia and Malaysia were in clear trouble, and hints that Korea and Japan might need reserves to prop up the value of their currencies drew the increasing attention and concern of international banking authorities.

Whether the causes were attributable to closed financial systems, a speculative bubble in the property market, corruption, lax accounting, and bank supervisory systems, one point was clear: an IMF bail-out of these economies, with a substantial element of legal reform conditions, seemed to be on its way and needed.

Concurrently, stock markets around the world, most importantly the U.S. market, had reacted to the October 1997 drop in the Hong Kong Hang Seng Index, with a short, sharp, but ultimately modest, correction of less than 10 percent. The reason is that the market did not perceive that massive collapse was in order in the U.S. markets.

Confidence and calm were preserved as major U.S. financial leaders pronounced the correction taking place as business as usual; earlier pronouncements that over-allocation of assets in the stock market could result in a speculative bubble seemed to have inoculated the market from any psychological panic or distress.41

Without question, the U.S. and Brazilian markets are highly linked. Unfortunately for the Brazilian market, the leading exchange, the Sao Paulo Bolsa, or the BOVESPA, dropped dramatically in response to every shift. In fact, the market dropped over 82 percent from the beginning of the year.42

This event, on top of increasing pressure on the currency markets, made it clear that serious asset allocation out of Brazil would result in hedge fund portfolios if corrective

40. See Roubini, supra note 1, Brazil and Latin America, Brazil's Incomplete Stabilization and Reform by Rudi Dornbusch (1997); see also Dornbusch, Brazil and the IMF (Nov. 12, 1998). Dornbusch's comments were widely publicized in various media, such as Business Week, and other influential mainstream and popular publications.
42. See generally http://www.bovespa.com.br for documents relating to price history of assets in various monthly bulletins and other official publications.
action were not taken to restore confidence in the Brazilian Real. The impending crisis was not arising from short-term liquidity problems or insolvency but from the perception that its currency value could not be sustained.

From the vantage point of 1997, the key elements precipitating crisis were fiscal or perceived fiscal overspending, the lack of political will to address the problem, and the perception of Real over valuation. The Brazilian and U.S. stock market fall in October 1997, indirect contagion due to the psychological effect of the Asian crisis, and the growing perception that unfavorable speculative pressure was building were other key negatives.

The fundamental issues to be addressed were ensuring broad government reform on key fiscal issues and providing the political will to educate citizenry on the need to absorb short-term pain to ensure long-term gain. Reinstilling confidence in the domestic stock market and monitoring negative spillovers from the U.S. stock market correction was also important. Defending the currency at an appropriate level after the Asian contagion dampened confidence in emerging markets was becoming a major problem without an easy solution.

D. Response to Growing Crisis

1. Denial

Shortly after the Sao Paulo stock exchange suffered drastic falls, there was public sentiment of confidence expressed in the overall need to take action to reform the economy drastically. This sentiment soon changed as the painful reality of stabilization medicine, such as cutting public spending drastically, and raising interest rates higher, came into sharper focus.

2. Central Bank Action

The first public signal that Brazil recognized it was in a potential crisis was the Central Bank's decision to increase its interest rate from about 22 to 43 percent. It was now clear that something in the market persuaded the Brazilian authorities that strong and decisive corrective action was urgently needed.

3. Presidential Action

Throughout 1997 and beyond, President Cardoso rallied the country with a call to fiscal prudence, declaring that he would attempt to push through a civil service reform plan (and some other fiscal measures such as pension reform) to address the need to correct imbalances and restore international confidence in Brazil. Within a matter of days, the proposal was prepared and delivered to Congress, over the opposition of major Sao Paulo unions and the leader of his own party who said that the party would not be decreed to on such a painful issue.

43. IMF-Brazil Letter of Intent, supra note 6, at 2-3; Waters, supra note 6.
4. Congressional Voting

Three hundred fifty votes in the lower chamber were needed for the proposed $9 billion reduction package to be approved. Brazilian politics does not flow along party lines since it has a strong personalist, local patronage component, such that the vote was expected to be close. Indeed, mustering the votes for this package or the less ambitious $3 billion package was also perceived as not so easy.

5. Coordination with the IMF

Through the end of 1997, the situation was one of consultation only. This approach, whether it was real or merely on the surface, seemed sensible, as further crisis avoidance rather than active involvement was the right dose of public diplomacy required to maintain still-existing confidence levels. Given that the effective real (as opposed to nominal) exchange rate was perceived to be anywhere from 10 to 30 percent less than its peg, further close consultation was clearly needed.44

E. Prevention of Deepening Crisis: Evaluation of Crisis Management Options and Lasting Reform Prospects

1. Crisis Management

The sense of crisis appeared to have been seized upon as an opportunity to make needed correction before an even more unreal Real is perceived as the unit of exchange. For example, the Brazilian Central Bank November 1997 Bulletin reflects that the banking system appears sound, with no damaging capital surges that can be discerned either into or out of the country.

2. Central Bank and Government Options

Obviously, guessing at what the Brazilian authorities with or without the assistance of the IMF would do next was scenario specific. There were numerous scenarios that hedge fund managers could draw up in trying to decide whether, and in what proportion, to allocate their assets. Assuming the reform of Brazilian fiscal policy takes place, a gradual devaluation could still be in order or it might be possible to “buy time” using one of the instruments described below.

Assuming the fiscal/civil service reform plan either fully or partially did not go into effect, the increased pressure was likely to result in either further tightening of monetary policy (if possible) and further liberalization.

It also seems that the Brazilians agreement to raise the MERCOSUR CET to 17 percent would raise some additional revenues, to the extent the bulk of these goods are price inelastic and not subject to any other substitutions. Indeed, the widening trade deficit of over $5 billion represents a cause of concern that only increased competitiveness, not protectionism, will cure.

44. Id.
3. Lasting Reform Prospects

From the vantage point of 1997 crisis management, whether the current crisis yields to a process of reform depends heavily on the results of the congressional reaction to the proposed plan, the public mood, and the degree of recession, including the outcome of the Presidential and other electoral contests. Brazil's president is in a unique position to voluntarily ask citizens to accept pain before rather than after the election to maintain greater price stability over the long run.

Such a political position may work, because the alternative of a return to rampant hyperinflation seems worse and is a prospect not so far away in memory. There also do not appear to be any creditable alternatives that can carry the presidential banner. This is because Pedro Maluf is perceived by many to be a captive of the much more radical Socialists, and Cardoso is, by contrast, respected as a reasonably honest politician, who has not been dogged by any of the vote-buying scandals which have afflicted other prominent politicians this year.45

To the extent banking law reform and related economic measures are contemplated, the next section discusses the specific approaches that could be used to prevent further crisis.

F. How Legal Technical Assistance Could Help Specifically and More Broadly to Reduce the Prospects for the Situation to Become Catastrophic

At the beginning of 1998, the following legal and economic advice represents some of the more salient co-coordinated policy options available to contain crisis.

1. Legal Options

The first step available to policymakers is to review opportunities to use various short-term facilities with the IMF in a confidential manner. Setting targets for key numbers can determine whether the currency appears to be sliding, in addition to the floating peg itself. For example, the ratio of M1 as a percentage of international cash reserves discloses much about the seriousness of the domestic authorities to their commitment to price stability.

A second step is to discuss possibilities for macroeconomic coordination with the United States and other major creditors. This should be done on an informal basis, tracking the APEC approach wherein the IMF is the lead player. Nevertheless, securing United States support for such assistance may not be so easy, given the Republicans rebuff of Clinton's pledge to provide the IMF with additional capital suggests that legislative efforts to provide exchange stabilization if the situation worsens substantially seems currently unlikely.

The third step is to discuss possibilities for macroeconomic co-ordination with MERCOSUR. One of the key intentions of the 1990 Treaty of Asuncion is macroeconomic coordination. It seems reasonably clear that since the Argentine peso is likewise pegged to the dollar and that its economy turns in large part on the degree to which it

can export products to Brazil, a regional partnership agreement, even if primarily sym-

bolic, sends a signal of solidarity, which is helpful. There is, however, no MERCOSUR
Development Bank or other institution with reserve capacity to be of assistance. Chile,
although an associate member, could also be of help. The coordination of member states
with the Bank of International Settlements (BIS) is possible, as took place after the
Mexican crisis.46

The fourth step is ensuring that the central bank uses its authority wisely to ensure
appropriate measures are taken. These include:

(i) Authorization for a central pool of information about borrowers to monitor
risk with release of this information to Brazilian banking supervisory authorities
outside regulatory and supervisory bodies for purposes of monitoring liq-

uidity risk. The particular target here is monitoring the potential for capital
flight through surveillance and disclosure requirements. Existing memorandum
of understandings (mou) with the U.S. SEC, Commodities Future and Trading
Commission (CFTC), Argentina, and Paraguay already exist.

(ii) Training of staff who can understand consolidated accounting methods used in
foreign branches and overseas offices; tighter enforcement of domestic account-
ning standard to ensure greater transparency. The purpose here is to ensure that

the possibility of excessive loss of funds through various transfer mechanisms
is provided for through innovative recharacterization of transactions. This is
important because valuation of banking assets is critical to any underlying issue
relating to liquidity.

(iii) Strict tax enforcement. A specific concern here is enforcement of the 7 percent
entry tax on entry of short-term capital flows, with longer-term borrowings
having tax reduced on a sliding scale. This tool is a means to deter flight and
provide for a higher quality of funds to come in, in the first instance.

(iv) Interest rate setting at high levels relative to external Brady bonds. The economic
reasoning for this is to encourage arbitrageurs to come in and buy domestic
Brazilian bonds, which rose dramatically in 1997, in line with the interest rate
rise, rather than going out on the external Brady market. The importance of
this sound policy is to keep the current account strong with strong currency
reserves.

(v) Upholding the Basle requirements of at-risk capital (implemented in 1994). This
is needed in order to maintain capital requirements that help ensure public
confidence in the banking system.

2. Economic Options

A first step is further maintenance of sophisticated information technology systems
to track liquidity flows.

A second tool is for the Central Bank to buy dollars, such that currency speculators
have limited incentives to fight the Central Bank’s pricing of the Real. Indeed, to the
extent the international market is thin in Reals, this makes sense as part of a portfolio
strategy; you can’t sell short what you can’t get. Specifically, this sends a signal to nervous

international bankers that short-term foreign debt exposure can be covered and that
the government is taking places to support the Real. This may not help Brazil with any
market interpretation that the currency value is truly unsustainable due to high budget
deficits, market psychology, or short-term debt and exporter’s inability to finance goods
due to the high value of the currency. However, more reserves, if corrective action is
taken, is better than nothing.

The answer to whether the latter component of this strategy is feasible depends upon
an empirical evaluation of the situation. If the market is a difficult one to become a
major player in, gradually selling Reals makes more sense, so that if a devaluation arises,
it is much smaller than it would otherwise be because of the strength of the economic
fundamentals.

In addition, another alternative for the government or central bank may be to fash-
ion an OTC transaction(s) where as an undisclosed principal, they intervene with some
novel products to protect their currency. There are a variety of bond-based products, in
addition to currency-based products, which are highly correlated, and in which the Bank
possesses superior information as to its own policy. Depending upon the degree of thin-
ness in the market, this is another way for the Brazilians to possibly protect themselves,
and even to flourish.

3. Integrated Legal and Economic Options

The above suggestions are not addressed to problems of concentration of wealth
(certain leading families dominate the private banking sector, for example). Neverthe-
less, the degree of independence of the central bank and key government agencies is of
paramount importance.

Reducing the long-term possibility of corruption through true financial liberalization
with foreign parties and increased international oversight is a long-term concern that
also deserves some attention as the Brazilian banking sector modernizes further. This is
particularly true in the state banking sector in the federal regime and the commercial
sector overall, in the largest capitalized banks.

Likewise, the current situation is not one where the large Brazilian banking sector
is confronting the specter of a high number of non-performing loans. Careful action,
backed up by the government's response now and potential international assistance,
can help anticipate the need for increased dollar liquidity, so that banks have prepared
themselves for a worsening economic situation with greater dollar reserves.

IV. The Crisis Unfolds and the International
Community Responds

A. THE POLITICAL-BUSINESS CYCLE IN BRAZIL

The year 1998 was a presidential election year in Brazil. What this meant, of course,
was that the party in power had a strong incentive to maintain itself with economic
policies that were designed to keep the currency strong, the economy growing at a fast
rate, and to minimize inflation.

The international financial community had a slightly different agenda. While it also
had a strong desire to see that Brazil remained prosperous, its more focused concern
was to protect its direct and portfolio investments there.
The 1998 campaign was a show of contrasts. Cardoso promised that he would continue to push for reforms that would reduce the bureaucracy and supported pension "right sizing" in the larger Brazilian states. He promised above all to keep the currency strong and to serve as the voice of reason to the outside world of Brazil's seriousness in maintaining fiscal and monetary policies that promoted price stability. Even to his doubters, Cardoso positioned himself as not only the savior of Brazil through the formulation and implementation of the Real plan, but also as the lesser of two evils compared to his socialist rival. With crisis looming but credibility at home and abroad higher than his counterpart, Cardoso played the economic cards in a sufficiently skillful way to garner an easy re-election victory.

But the party was not to last long. The above-articulated problems of short-term debt levels building up had not been resolved and the central bank's interest rate tightening policies had not sufficiently reduced demand for borrowings. The fact of the primary surplus, when viewed against international fiscal standards, should have been impressive, but was ignored in light of state inaction to address under-funded pension and other liabilities to international and domestic creditors.

In sum, Brazil had an overall debt of 8 percent of its gross domestic product that, depending upon your point of view, either was too high or was perceived to be too high. Lack of confidence to pay back the debt had been growing as short-term interest rates climbed, but these were the only sources to repay debt. Paradoxically, short-term interest rates would not be so punitive, if there was confidence in the ability to repay the debt.

The logic of investment in Brazil had now created a vicious circle. Cardoso's policy of increasing foreign investment, privatization, and a real pegged to the dollar were intended to create a virtuous circle of stable, investment-led growth. This effort, however, could not sustain confidence in the wake of unforeseen Asian and Russian crises that had seen currencies pummeled by speculators. Interest rate rises to prop the perception that the central bank had sufficient dollar reserves and that President Cardoso had the political will to sustain the real to its pegged value could not hold, if confidence in the real fell on the international markets.

Indeed, only two weeks after his October re-election, President Cardoso ordered his finance minister to start the process leading to the devaluation of the Real. The virtuous circle had turned vicious and a new cycle—facing the harsh reality of devaluation—was about to begin.

B. The International Dimension: The Capital Flows Climate and the Problem of Speculation

At the time of the Brazilian devaluation, confidence in the international financial system had been shaken. The IMF had embarked on an exhaustive program of conditional lending through 1997-98, and serious concerns were expressed that its special drawing rights and other liquidity facilities could not cope with a crisis of this scale. Criticism of the IMF failure to spot the problem early was widely criticized.

But of course, the IMF was in a trap. If indeed it did indicate that it lacked confidence in an economic program, such as that of Brazil, it could itself cause a crisis atmosphere. In addition, it could not, short of advocating currency controls for country implementation, propose policies that constrained investors and corporate financial officers to—quite correctly—"vote with their currency hedging policies" when they lose confidence in the domestic governments' ability to uphold price stability. Indeed, financial
discipline via the market workings of the currency market actually encouraged prudent government policies.

But to some extent, some of the problems extant were due to the overly positive perceptions of investors regarding the fortunes of emerging market financial products. For example, let’s say a currency speculator decides that he wants to take a position on emerging markets currency, the Brazilian Real, the Chicago Board of Trade, the Chicago Merc, Liffe, or any of a series of other exchanges. The trader knows that the option has been priced to anticipate expectations of certain events over time that reflect a pricing trend in the currency commodity. Indeed, if the price movement is perceived to be too one-sided (e.g. everybody thinks the real will drop) then no trades will be executed, because no market exists.

The same dynamic exists in the over the counter (OTC) market. This time, however, trillions of dollars of securities deals, far dwarfing the size of Wall Street and the City stock exchanges transactions, takes place between parties on an individual contractually tailored basis. Products are developed to sell to investors, based on black box proprietary formulas, seeking to capture market under-valuations, growth curves or tax advantages, and sometimes all three.

Emerging markets have benefited from these products because they have been used as methods to repackage sales of bonds and other financial items as linked to “bets” on market behavior, such as the degree to which a bond rises or falls during a given period. Sometimes, such products can be engineered as tax advantaged because they arise in an offshore jurisdiction in the Caribbean or Mauritius, and are executed by a charitable party, thus guaranteeing better tax treatment if not outright exclusion from one level of taxation.

Each of the above types of transactions can present the hypothetical investor with a higher yield curve with no greater degree of risk. This argument of an “emerging markets free lunch” has in fact been used as a staple for investing in equities in emerging markets. The comparable argument for bond yields is more difficult to make, as the risk reward ratio curve relationship is more linear and straightforward.

All of these above products, unforeseen in the days of designing the Bretton Woods international financial system, are not closely regulated. These products are responsible for a tremendous percentage of short-term capital flows in emerging and developed markets alike. For well-managed firms, they present rich trading opportunities. Major investment firms may make as much as 40 percent of recent profits from proprietary trading activities, and no doubt much of this profit is embedded deep within the contract fine print of the over-the-counter trade.47 And as long as both parties make money, who cares?

When a bet goes against the value of an emerging markets currency, like the Brazilian Real, such bets can cost a Central bank precious reserves. A Bank must therefore find some kind of money that can help stabilize the market, usually dollars or other high quality paper. It will then enact policies to show that it is not about to go out and print money; this robs the currency of more value, as it inflates its way out of the squeeze.

This type of scenario is not what took place in Brazil, but it was the case in Malaysia and Indonesia. It ended up costing the IMF lots of money as it helps stabilize the economy and directly costs taxpayers in all the major developed countries substantial sums of money, since they are the major underwriters of the Fund. In addition, the major developed countries can sometimes be called upon to underwrite exchange stabilization pacts, as was the case with the U.S. loans to Mexico, after the 1994 peso crisis.

The game of chance that the speculators are engaging in above is encouraged by the market and has long been a staple of financial history in some form or another (Rothschild supposedly made his initial fortune by capitalizing on the fall of the French currency and the rise of the British that would follow Napolean's defeat at Waterloo. John Maynard Keynes, a Cambridge and Harvard economist, and prominent U.S. economic advisor Martin Feldstein, are reputed to have made large fortunes on successful currency bets).

What has changed is that currency or related bets on bonds, equities, interest rates, or proxy financial instruments can bring down an economy quickly. It is the speed of the financial transactions, along with their leveraged size, that kills. It is difficult to be responsive when you don’t really see the calamity coming.

C. The International Institutional Response and the Brazilian Stabilization Program

The IMF and Brazil jointly announced a support package on November 17, 1998. Brazil requested $18.1 billion for three years with $4.5 billion in special drawing rights reserve funds. This was to be phased in various increments and was conditional upon the meeting of certain fiscal targets. The World Bank and the Inter-American Development Bank likewise stated their intention to commit over $4.5 billion towards social support programs, priority public investments and public administration, and small business credits.

The justification for support was that the Real had come under significant pressure due to the Asian crisis. The 43.5 percent interest rate set for overnight lending and the government’s revenue raising measures, amounting to 2.5 percent of gross domestic product, were deemed ineffective in stemming the crisis. The effect of such policies causing the pain of higher unemployment rising from 6 percent to 7.5 percent through

50. IMF Brazil-Letter of Intent, supra, note 6.
51. Id.
52. Id.
1998, and higher consumer prices had lowered incomes, without dampening consumer demand sufficiently. The mid-July figure of $70 billion in reserves had dwindled to just under $46 billion after the October 1998 elections and the IMF-World Bank meetings announcing the initiatives to formulate a new international financial architecture. The announcement of devaluation was a foregone conclusion before the elections as sustaining the value of the Real at its previous levels could not be maintained.

In sum, hindsight suggests that of the policy prescriptions stated above as crisis management tools, none could have prevented the crisis, with the possible, albeit dubious prospect of massive OTC speculation by Brazil on its own behalf in the currency markets. Whether because of Real weakness or the perception that the reforms of pension trimming and such were not sufficiently satisfying, the conclusion is the same, that increased international and domestic coordination could not have prevented, although they could have contained, the devaluation crisis.

The policy reforms of cutting state pensions and various other measures that had begun in 1997 to ward off crisis had largely been enacted but had not been fully successful in restoring the loss of market confidence.

The Brazilian government's new 1999 program was comprised of front loaded fiscal adjustments, including planned reduction primarily at the Federal level. Specifically, primary surplus targets were to rise from 1.8 to 3.0 percent of gross domestic product. The overall federal deficit was to fall from 5.6 percent of gross domestic product in 1998 to 3.6 percent in 1999. Taxes were to increase, including that on corporate transactions. Moreover, the states were expected to do their share in reducing the deficit by agreeing to certain targets set by the government. The Senate was to limit borrowing, such as new bond issues, and provide further limitation of deficit financing of the public sector.

In addition to the above, a wide ranging set of fiscal and administrative support policies were proposed or enacted. These included a new planned Fiscal Responsibility Act that would set debt benchmarks, a Social Security constitutional amendment that would cap state pension contributions, as well as limits on the size of the state bureaucracy, tax reduction, and further privatization.

On the monetary side, the objective of price stability was to be furthered with the above fiscal policies as well as the use of indirect monetary instruments. These include lengthening the public debt maturity and other measures to reduce the cost of capital, especially since short-term dollar debt is oftentimes the most expensive burden that a country can face.
As to banking policy, the previous policy of privatizing state banks and further liberalization in 1998, continuing the pre-1997 program, was listed as a positive confidence instilling achievement. Implementation of the Basle capital adequacy standards at higher levels than required by law (Basle recommends 8 percent for tier one capital, the rule was 11 percent in Brazil for 1999, and the top domestic banks had 15 percent to back up their savings) was another positive development. Moreover, a capital charge against counter party operations of derivative operations had been required since 1997, and other credit risk tightening had been undertaken.

The Basle twenty-five principles of banking supervision were adopted and the goal was year 2000 compliance. The World Bank was involved with bringing more sophisticated technical banking supervision practices and a series of initiatives; resulting in better risk management and transparency were the result.

Further, the exchange rate band was to be widened with gradual devaluation of the Real. Trade liberalization with MERCOSUR with respect to tariff barriers was to be continued (it was in fact curtailed), and other broader liberalization measures, consonant with the WTO, were pledged. Finally, Brazil's statistical base was to be adjusted in line with international standards so that the degree of public sector debt was not over-reported.

D. THE 1999 STABILIZATION PROGRAM TAKES EFFECT

By February 1999, there was reason to fear that Brazil was on the verge of collapse. Inflation was rising, and industrial output was falling. Concerns that Brazilian banks might not have sufficient reserves had begun to be addressed, and soon thereafter contingent credit lines from private sources in the United States were arranged.

By June 1999, a climate of skepticism regarding government policymaking began to take hold as it emerged that certain large capital outflows had taken place right before the devaluation.

63. Id.
64. Id. Counterparty risk is a subject of increasing concern among the Basle Committee as well. See Roubini, supra note 1, Prudential Supervision and Basle Committee on Banking Supervision for an extensive collection of reports on the above issues.
65. IMF Brazil Letter of Intent, supra note 6.
66. Id.
68. IMF-Brazil letter of Intent, supra note 6.
69. See N. Yamaguchi, Brazil's Former Foe, Inflation Creeps Back, (REUTERS, Feb. 12, 1999). The best article I've seen on understanding the core issues that give rise to a potential banking crisis, as opposed to a more generalized financial crisis, is Daniel C. Hardy, Are Banking Crises Predictable? Finance and Development (IMF, Dec. 1998), available at http://www.imf.org. Here the authors argue for greater credit lines and other contingency measures. This is especially important as may be required to repay short-term dollar denominated debt.
70. The IMF-Brazil Memorandum of Economic Policies, March 8, 1999, summarizes the changes in programs prior to this date to minimize capital out flows. For background information on the problem in a broader canvas, see Ricardo Ffrench-Davis and Stephany Griffeth-Jones, Coping with Capital Surges (Reiner, 1995). In the Brazil situation, specific concerns were expressed in the Brazilian Senate and in the newspapers (Gazeta Mercantil) that the Central
But if the public news about the handling of the crisis was not completely positive and the possibility of a liquidity crisis was being seriously prepared for, the confidence building process in Brazil was remarkably about to take a turn for the better.

The IMF, which had approved the use of $44.5 in conditional stand by funding in February, had to be pleased with the economic performance of the country and its decision to provide standby assistance. This is because gross domestic product seemed to be on the decline to only 1 percent rather than 4 to 5 percent by July 1999.\(^{71}\) Inflation that had been targeted at 11 percent was only 7.4 percent, and was expected to go to less than 5 percent by end of 2000.\(^{72}\) Fiscal performance in reducing the deficit was better than expected, and the measure to take prompt corrective action to reduce the state, federal, and municipal deficits were going significantly better than anticipated.\(^{73}\)

Still, the Fiscal Responsibility Act had not been passed by mid-year, although this was expected to resolve itself by the end of the year. Streamlining of the pension system had helped contain expenses as had other administrative reforms enacted in 1998 and initiated seriously in 1997. (By December 1999, the Brazilian Supreme Court ruled that the above civil service reform was unconstitutional, although this did not seem to substantially negatively affect the economy).

Monetary policy had shifted to a flexible exchange rate system as of January 1999, and the effect had been viewed as positive from the IMF's perspective in diminishing inflationary expectations.\(^{74}\) Specifically, the government instituted a formal inflation-targeting framework in March, and monetary aggregates were kept within a narrow range.\(^{75}\)

The banking system had weathered the crisis well with adequate hedging of their Real positions vis-à-vis the dollar in advance of the crisis. Moreover, non-performing loans had risen only slightly from 7 percent to 8.9 percent owing to the recession, and the capital adequacy system instituted and recommended by Basle and adopted by Brazil had meant that a strong overall capital base was in place.\(^{76}\)

The pace of foreign direct investment was high, flowing in at a remarkable $18 billion pace, notwithstanding the financial turmoil.\(^{77}\) Remarkably, a balance of payments surplus was projected for the end of 1999, and the trade balance was expected to improve with the United States, even as reports for the first two quarters seemed less than promising.\(^{78}\) In short, the coordinated IMF and Brazilian government program (with some private sector and other international financial institutions assistance) was yielding positive results that were fueling confidence in Brazil's ability to manage its way out of the devaluation into a smoother stabilized future.

Bank may have tipped off certain large banks and allowed them to protect certain depositors and investors.

\(^{71}\) IMF-Brazil Memorandum of Economic Policies, July 8, 1999.

\(^{72}\) Id.

\(^{73}\) Id.

\(^{74}\) Id.

\(^{75}\) Id.

\(^{76}\) IMF-Brazil Memorandum of Economic Policies, July 8, 1999.

\(^{77}\) Id.

\(^{78}\) Id.
V. The International Financial Architecture and the Brazilian Reform Program: Do the Five Pillars of the New Architecture Really Matter?

From the vantage point of early 2000, the success of the IMF-Brazil program seems even more remarkable. Positive economic growth is expected this year, in this, the second year of stabilization and no banking or liquidity crisis has taken shape. The November IMF review shows that the decline of 1 percent of gross domestic product and only 1 percent of inflation was substantially better than had even been predicted six months earlier. Some setbacks had taken place, notably the unconstitutionality of social security reforms, but the government had responded to this and other setbacks, uniformly, with prompt corrective action. In sum, it seems that the capability of the Brazilian policymakers to enact reform policies since the first Cardoso administration, and the ability to plan for and foresee that a devaluation crisis might hit the Real throughout 1997–98, were valuable in preventing a deeper crisis and ensuring quicker recovery.

The stabilization plan implemented represented the opportunity of crisis to engage in deeper reform than politically might otherwise have been allowed, and it was seen positively by the market. The Brazilian government was able to issue Euro-Bonds by November 1999. Inter-bank credit lines were being rolled over at a 97 percent rate, and were being supplemented by various private sources. Progress was being achieved, it seems, amidst the pain of recession.

A. The Elements of the New International Financial Architecture in the Brazil Reform Plan

The core elements of the new international financial architecture are comprised of many details but are essentially comprised of transparency, international standardization, financial sector strengthening, private sector involvement, and contingent credit lines support. This section reviews to what extent these concepts were part of the strategy and tactics involved in the Brazil crisis, the first post "new international financial architectural" crisis.

1. Transparency

As to the objective of transparency, a review of the IMF proposals in this regard suggests that this was an issue of limited public concern for the IMF. Specifically, the IMF did not ask that any public sector accounts be opened up further to public scrutiny. Moreover, it did not request further clarification of bank or other financial sector reporting requirements vis-à-vis Brazil's letter of intent and memorandum of economic policies.

80. Id.
81. Id.; see http://www.imf.org/external/country/BRA/index.htm for the most complete information as to the IMF's relationship with Brazil, including commentary on lessons learned by the Brazilian Central Bank Chief Antonio Fraga, as well as IMF Managing Director Stanley Fischer.
It did, however, demand that public sector spending be reduced, a problem caused by the patronage practice of rewarding supporters with jobs—and then pensions for which they really did not have to work. In this sense, the IMF was able to bypass the simple request for greater transparency and attack the greater evil of corruption as a means of raising economic performance.

Likewise, the IMF did not have to set out transparency per se as an overriding policy objective as to bank supervision. This is because Brazil was extensively involved in such a program with the IMF and was therefore required as a condition of participation in various aid programs to maintain certain prudential standards, such as loss ratios for nonperforming loans and capital adequacy generally. In other words, Brazil had plans in place and was operationally executing a clean up of its banking operations. The sale of many state banks to the private sector had required, as a pre-condition of sale, greater transparency than might previously have been required for the sales to be closed. In short, transparency as a process was well underway in banking as a by-product of liberalization, and of cooperation with the World Bank and other institutions in implementing tough, new regulatory and supervisory safeguards.

2. **International Standardization**

The impact of international standardization likewise pre-dates the Brazilian reforms. Specifically, Brazil had adopted the Basle capital adequacy standards, the Basle off-balance sheet reporting requirements to minimize value at risk for derivatives. It was in the process of adopting the Basle twenty-five Principles for Effective Banking Supervision, as indicated in the IMF-Brazil memoranda.82

Perhaps more significantly, the damage that Brazil had suffered by having its consolidated public debt considered together rather than just the Federal debt as a percentage of gross domestic product was remedied. This meant that bond agencies assessing creditworthiness would not have to add a restricted rating that could raise interest rates or other risk premium, beyond that required by international standards. Brazil’s return to the international bond markets in the second half of 1999 was no doubt helped by the widespread recognition of and adjustment for this statistical reporting anomaly.

3. **Financial Sector Strengthening**

As the above has shown, a strong component of the IMF program was geared toward enhancing the quality of services through improved supervision and reform. This was already underway, and although the IMF reports do not so indicate, there is little doubt that prompt corrective action measures and improved monitoring have resulted from

the crisis. The fact that the banking sector has not suffered in any substantial way and remains robust, indicates that this area was in any event well-prepared for devaluation, and not at the heart of the problem in the same way that fiscal and administrative reform was.

4. Private Sector Involvement

The obvious idea behind this was to eliminate or mitigate the problem of moral hazard so that if a banking or another important economic institution failed, it was not immune from the consequences. This is due to the Asian system of close partnerships between private and public sector, an issue that is less important in the Brazilian context. Still, this is not to say that there are not some concerns about favoritism and the passing of inside information to selected depositors by the Central bank prior to the devaluation, resulting in the preservation of capital through capital flight.

5. Contingent Credit Lines

There is little question that the IMF’s provision of standby credit, and the private sector commitment of contingent credit lines, eased the way for Brazil to come out of the depths of its crisis. The concept of public contingent credit lines is primarily focused on preventive measures. In the case of Brazil, it was private sector involvement for major U.S. financial institutions that helped contain the crisis from turning into a possible collapse during the crucial January 1999 to July 1999 period. Paying off short-term debt with private debt rollovers was required with Brazil and major commercial banks agreeing to help. Contingent credit lines have not thus far been used in the exclusively public arena and are based on legally and economically complex set of parameters that may make their potential use as a useful policy tactic moot.

83. See Roubini, supra note 1, homepage—Private Sector Involvement in Crisis Prevention and Resolutions: Market Views and Recent Exposure, ch. 5.
84. In a recent Foreign Affairs spring 2000 article, the Council on Foreign Relations (CFR) Special Task Force on Strengthening the International Financial Architecture observed that setting firm standards as to the proper ratio of credit available relative to reserves in the IMF was an important issue. It also focused on the unwieldy nature of the contingent credit line process. The CFR task force recommended that more specific criteria be worked out for the percentage of lending facilities for a country relative to reserves and noted that Brazil had required substantially greater facility than prior practice and guidelines might suggest. For contingent credit lines, the same emphasis on setting standards was discussed, and it was indicted that the use of public credit seemed unlikely, absent processes that permitted quick response to crisis. For the full Special Task force report, see Carla Hills and Peter Peterson, Safeguarding Prosperity in a Global Financial System: The Future International Financial Architecture (Sept. 1999). For a sweeping view of the above issues from the IMF perspective, see Michael Camdessus, Economic Prospects for the Americas Under a New Financial Architecture; June 2, 1999 conference remarks, available at http://www.imf.org/external/np/speeches/1999/060299.htm. The most recent summary of the IMF’s efforts is the Acting Managing Director to the International Monetary and Financial Committee on Progress in Reforming the IMF and Strengthening the Architecture of the International Financial System, Apr. 12, 2000.
B. Assessing the Intelligence Gathering and Response Capabilities of the New International Financial Architecture in Dealing with the Brazilian Crisis

The above snapshot does not, of course, capture the full range of proposals or all the dimensions captured by the new international financial architecture in leading to meaningful reform in Brazil. More importantly, we must measure the degree to which the Brazilian reform program has benefited from the conceptual focus on the above areas and the operational execution of proposals consistent with this in preventing and containing crisis. In short, do these core elements provide a foundation for improved intelligence gathering and response to crisis?

The answer, of course, is mixed. The new financial architecture proposals are useful in heading off a crisis, but they do not address the problem of structural imbalances, such as investors perceived in Brazil's fiscal accounts. Moreover, they cannot control the outflow of capital that may arise in response to impending devaluation, further weakening a currency's downward spiral.

On the other hand, the improvement in information systems through implementation of better transparency, international standardization, and financial sector-strengthening provide an improved early warning system to what was the case prior to the Asian crisis asset bubbles and private sector over-borrowing became apparent. They may therefore not have been as specifically useful to heading off crisis in Brazil as they might be in other parts of the world. But, that only means that this was a different type of crisis than that which struck Asia, not that the tools do not have some current and future utility.

As to responding to crisis, there is no question that the financial sector-strengthening program already underway was most helpful in containing the extent of the crisis. Likewise, contingent credit lines are, when moral hazard is properly accounted for and diminished, a potentially useful tool to be applied in responding to crisis.

C. Concluding Thoughts

In light of the above, it is therefore suggested that the international financial architecture proposals had a modestly positive effect on the ability of Brazil's decision makers to adopt legal and institutional reform measures that matter. Crisis prevention and management capabilities are significantly enhanced by the broad agenda proposed by the new international financial architecture proponents. Indeed, to do nothing means that countries like Brazil may lack the political cover, not to mention the risk management tools, to prepare for market speculators and others that may seek to pounce on weakness. Further continuation of this agenda provides a basis for the strengthening of international financial law and institutions.